Microsoft Loss Reflects Web Display Ad World's Woes

The writedown of almost all of that deal's value, announced this week, shows how misguided those expectations were, and how brutal the once-thriving business of selling banner ads on websites has become.

The main culprit is an explosion of advertising space offered by Facebook Inc and other websites that is outpacing steady demand. But automated online exchanges, smarter search advertising and a growing skepticism about the effectiveness of jamming ads in people's faces have also conspired to slash prices and suck profits out of the business.

"The inventory or amount of ad spots grew so fast, it outgrew demand," said Dave Morgan, an industry veteran and entrepreneur. "That brought pricing down massively. So a lot of display advertising really became a ghetto for bad direct-response advertising."

Morgan founded Tacoda, an online advertising firm that AOL acquired in 2007 for $275 million. He is now in TV advertising as the CEO of SimulMedia.

"That's where the big money and margins are," he said.

Microsoft's spectacular capitulation is the latest admission of failure on display advertising. Ad industry executives say the software leader might now join Yahoo in re-thinking its approach to Internet advertising, though there's no simple solution to the fundamental challenges they face.

Marketers today have more choices than ever, as Internet penetration swells in emerging markets and popular websites like Facebook multiply the amount of available online pages.

Advertisers now question the performance of display ads more as Internet users train themselves to avoid such marketing. A study of Reddit readers by GazeHawk last year found that veterans of the social news site focus on the content they're interested in, and unconsciously filter out everything else.

"At the end of the day, they don't work," said Wine.com CEO Rich Bergsund, of display ads online. "The display ad people are in the business of selling impressions, which may not convert to customers or sales."

Ad exchanges are also undermining the business by helping marketers reach a bigger target audience more quickly and efficiently, helping them spend less.

BUBBLE, BUBBLE, TOIL AND TROUBLE

Display ad prices have roughly halved since the first dot-com boom.

ValueClick, which has a big display ad business, has lost about half its value since May 2007, when the stock hit a record. Microsoft bought aQuantive that same month - around the same time that Google acquired display ad company DoubleClick and Yahoo bought online ad network Right Media.

The average cost to reach 1,000 people with an online display ad fell to about $11.50 at the end of 2011 from $13.35 in late 2009, according to SQAD Inc, which tracks negotiated ad deals. In July 1998, Yahoo was getting about $25 per thousand, according to The Wall Street Journal.

Yahoo, still among the dominant players, has struggled for years to arrest sliding revenue growth. Today it is worth about half of its May 2007 market value.

"Display isn't going away, but it's becoming harder to make money from it," said David Hallerman of eMarketer, which tracks online advertising.

Google's $3.1 billion purchase of DoubleClick is one of the few display ad deals that has succeeded, analysts say.

It used its dominant search technology to make DoubleClick's display ads more relevant and better targeted, while Microsoft failed to use its Bing search engine to improve aQuantive ads in the same way, said Ben Schachter, an analyst at Macquarie.

Wine.com used to buy a lot of display ads, but now mainly uses Google paid-search, affiliate marketing and comparison shopping engines, Bergsund said.

In 2007, Yahoo launched an initiative similar to Google's, but Schachter said it did not deliver on its potential.

"The promise of the Internet was always getting the right ad, at the right time, to the right person," Schachter said. "It's just not there yet in display ads."

HOW NOW?

Microsoft remains committed to Internet advertising despite hemorrhaging billions each year from its online services division that encompassed aQuantive and includes search business Bing, which has barely dented Google's market share.

But it may have to reconsider its approach.

The aQuantive writedown may presage moves such as giving away display ads for free, according to Gilad de Vries, vice president of brands and agencies at Outbrain, a content recommendation startup.

"The value of ad serving has become completely commoditized and the marginal cost of serving a banner ad has gone down to zero," he said.

If Microsoft gave away what are already high-volume, low-margin display ads, it may be a "brilliant" move because it would help the company compete better against Google's DoubleClick, agreed Donnie Williams, chief digital officer of Horizon Media.

Microsoft is more interested in selling premium online ads, which run on highly trafficked areas such as the MSN home page or are shown on its Xbox 360 video game console. The company could sell a premium display ad to run on the MSN home page, and throw in free banner ad spots that appear in other less popular areas of its websites as part of the same package, he argued.

But for now, the company is not publicly articulating its attack plan.

"We're just starting to hear a little around Microsoft re-evaluating their ad model altogether," Williams said.

"Things haven't panned out the way prognosticators once thought. Five years ago, no one understood the impact Facebook was going to have on consumers and advertisers."

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July 9, 2012

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