

Wednesday, February 28, 2007

Domain Aftermarket Overdue for an "Asset Repricing"

For the last couple years the domain aftermarket has been hot again, we're seeing valuations not seen since bubble1.0, which saw valuations like 7 million dollars for business.com and 4 million for drugs.com. The TechWreck was induced by the Nasdaq crash of 2000 and the fun was over for awhile.

What differentiates this bubble in the domain aftermarket from Bubble 1.0 is domain parking and monetization. While it existed in 2000, it was a weirdism on the fringe. Yun Ye was quietly building his Ultsearch empire and cleaning up.

When he sold out to Marchex, for 60+ million cash, the masses "woke up" to parking and PPC. Now we have Internet REITs, domainer conferences and, the second last sign of an overheated market dropping in to place: VC funds are tripping over themselves to invest into PPC and the monetization game. (The last sign of an overheated aftermarket are the sales letters I get from places like domainprofiteer.com offering me courses in how to get rich buying and flipping expired domain names)

Now individual domains and portfolios sell for multiples of their revenues plus a premium for the name itself in the case of generics and other "type-in" names. These multiples have gone vertical over the last twelve to eighteen months. During the nadir of the tech wreck, actual web businesses were going for about 1 year's revenues and that was the departure point for domain sales.

The interesting thing is since then, the multiples on domain names have outstripped the multiples on developed websites. To me, this is the equivalent of the "inverted yield curve" that portends economic recessions.

The logic, apparently, is that "developed websites" require actual work to keep them current and maintain the userbase. As such they often sell along typical business valuations: 1 to 2 times revenues or 3 to 5 times earnings. Often less.

PPC domains, type-in, generics, et al are going for minimum 5-7 years revenues and that was before things were heating up. Among domainer circles 12 and 15 year multiples are becoming more common, more sellers are looking for 20 years.

I've heard domainers talk in terms 40 or 60 year multiples or more. Really.

Valuations of this magnitude are financially unsound. We should all be familiar with the Rule of 72 (if you are not then you shouldn't be "investing" in anything, stop daytrading or whatever you're doing right now and go read Benjamin Graham's Intelligent Investor or something).

This handy rule of thumb instructs us to divide the rate of interest on an asset into 72 and you're left with the number of years it takes to double (or recoup) your money. With valuation multiples, do the opposite, divide the multiple into 72 to find out what your actual rate of return is:

MultipleRate of ReturnSnide comment

7 years10.2%not bad

12 years6%GMAC territory, if you sell yours before GM goes bankrupt and buy a domain at this multiple you may actually be better off for it

15 years4.8%we're getting into 10 year T-bill territory here

20 years3.6%we're below the nominal inflation rate here

60 years1.2% here we'd be better off hoarding empty aluminum cans

As one "domain flipper" on a closed domainer board gloats,

"In the domain aftermarket returns of 30-50% a year are commonplace. It's almost a certainty that \$65k [for] will turn into a \$100k within six months from my experience. This is what I term "long term" as I tend to flip within days.."

Evidence of tulipmania in the modern age.

"All my short term flips have made me 50%-200%"

"I agree [that it is] madness of people paying 10-20 years on ppc domains, but if you buy at even 8 years and sell asap to someone higher up the food chain, you don't have to agree with their madness, do you? :)"

At the time I started writing this article, John Gotts had recently paid 3 million dollars for the wiki.com domain name because he thinks "wikis are going to be hot" and from that premise, a lot of people are going to type "wiki.com" into their browser location bar.

Then "after he makes his money back on the 3 million he paid for the name, the rest will be pure profit". No, that isn't a line from a Simpson's episode, it's a real strategy, and according to Gotts there were two VCs interested in funding it. Big surprise. (Recent speculation is that the deal hasn't fully consummated and that Gotts left himself a large escape hatch if it didn't work out. The whois record doesn't seem to reflect a completed transaction.)

Type-in traffic is always nice, but anybody building a long-term business strategy or "investing" large quantities of cold hard cash on the premise that it will continue forever (or even escalate) will, I think, be disappointed. The underlying premise is that internet users will grow less sophisticated over time and that there will be no further or meaningful user interface changes from here on in, that net neutrality will prevail and ISPs, access providers, network carriers, web browsers and even root or recursive nameserver operators are going to stay out of the realm of "errant or exploratory internet traffic" and leave it all to the domainers.

Type-in traffic is the realm of grandmothers and the not-so-tech-savy. As people get more knowledgeable about the internet, their type-in usage declines. They stop "typing into" the browser's location bar and start using the browser's search tab.

I think these facts will work against any assumptions about type-in traffic, especially those who hope it will increase into the future. In Gotts' case, anybody clueful enough to know what a wiki is, knows better than to stumble their way around the internet typing what they want into the location bar. He'd have been better off buying wiki.org, which at least comes up near the top of the organic search engine results for "wiki", while his wiki.com doesn't even list on the first page.

Further, all it takes is one major browser (IE, for instance) to make a shift in the out-of-box layout of the browser dashboard: say putting a search input field right where the current location input bar is and type-in revenues will begin to decline in earnest.

Whatever type-in domains are doing now, I don't think there won't be as much of it in 10 years. So paying 10 years revenue on a type-in domain or portfolio seems highly speculative to me. Paying 20 borders on insanity.

One of the reasons I take this view is because I disagree with the wider sentiment that domains have an innate underlying value like a piece of real estate.

The argument goes that if you pay, say \$100,000 for a name, then it has an underlying value of that amount, and the revenues earned by parking the name is a return on investment over and above the initial outlay.

I disagree with this. I think the domain has an underlying innate value of zero. If you pay 100K for a name, you are out 100K until the name earns it back for you, at which point you've broken even (aside from the loss of purchasing power of the currency via inflation in the intervening time).

You haven't turned a profit on the name until it earns back your initial investment plus an amount greater than inflation, at which point you're finally in the black on your "investment". If you do sell the domain for some amount afterwards, either recouping your funds or turning a profit, it's because you got lucky and you've succeeded in speculating, not investing.

Repeat after me: What makes a domain name valuable? It's what you do with it. If there's one thing the whole "Web2.0" phenomenon has proven, it's that for the most part domain names don't matter.. Pick a word, any word. Is the domain name taken? No. Great. Reg it, and get back to business, building the website and advancing the business plan.

Blog Export: Exile From the Herd, <http://www.privateworld.com/>

While nobody really knows what "web 2.0" means, the naming styles that emerged from it were a direct result of unfunded, agile start-ups working within the gaps left by domain hoarding and an overheated aftermarket.

So what will trigger "asset repricing" in the domain aftermarket? Basically aftermarket domains will be another casualty of the current liquidity bubble bursting, which will happen any day now. The talking heads on CNBC are already "upbeat" after yesterday's 400+ point selloff on the DOW. Downplaying the extreme imbalances in the financial markets. But I have maintained for years that the entire 2003-2005 runup in the equities markets is just one big-ass bear market rally and I stick by my assertion that we will see new lows on the Nasdaq a lot sooner than we will see new highs.

Yes, the DOW hit a series of new highs which technically violate a bear market rally scenario. The DOW has hit new highs due to credit expansion and excess liquidity, pure and simple, and will unwind soon if it hasn't started already.

Yes, I am one of those nutjob quacks who is convinced there is a global recession bearing toward us like a freight train. Many early indicators already show successive months of contraction. In it, housing values, equities and corporate bonds are all going to take a dump.

The domain aftermarket isn't gold bullion or a t-bill. It isn't by any stretch a safe haven. There is no reason to think for a second that aftermarket domain pricing will move inversely to the wider asset classes which are going to spend the next few years cratering.

We're in a secular bear market, they tend to last 12 to 20 years. It started in 2000. Do the math.

My advice to anybody sitting on some monster domains or portfolios is to either sell them fast or develop them into something useful that can produce an income stream that doesn't depend on blind type-in traffic or pre-existing link-pop from an expired domain's previous incarnation.

The domain parking services are going to have to get a whole lot more creative if they want to survive the TechWreck2.0. Marchex may be headed there with their much anticipated openlist initiative, other operations like communicate.com are developing their properties into verticals.

Lots of people are working on a better, smarter, parked platform. The problem in this space is that there is a fine line between dynamically generating "contextual content" and an automated scraper splog.

At the end of the day, I don't see a lot of long term upside for domains on their own, there has to be a viable website on them, there has to be something original, innovative and useful. There is real work involved.

The pink cloud days of easy PPC money from type-in traffic are numbered, get used to it.

Posted by Mark Jeftovic in Living off the net at 17:57

Jeff,
Just read your article "Domain Aftermarket, overdue for an Asset Repricing" It is good to read something about the domain market from someone who is objective and has knowledge of markets and business cycles. I am familiar with "The Rule of 72, The Intelligent Investor" and "Tulip Mania" and can totally relate to your view. I just entered the domain business world three months ago. I believe the industry is in an overall upward trend for the long term but has all the signs for volatility along the way. Lets call it industry growing pains. There is so much hype out there. I think you are right, something has to be done with the names to add value and innovation needs to continually be pursued. I would like to follow your insights and opinions on the domain industry.

Sincerely,
Bob Jack
eCom Assets, Inc.
Bob@DomainsAvailable.com
Anonymous on Jul 28 2007, 23:27

Regarding this comment: "In the domain aftermarket returns of 30-50% a year are commonplace. It's almost a certainty that \$65k [for] will turn into a \$100k within six months from my experience.

A similar comment came to me from a friend back in 1999 who had loaded up on stocks like Pets.com, CMGI, Level 3 and dozens of other "sterling companies". She actually admitted to expecting a 10% PER DAY RETURN!

"Those who cannot learn from history are doomed to repeat it."
Anonymous on Feb 13 2008, 13:53