

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

Friday, February 23, 2007

One man's minor bug is another man's tipping point

I've been on the fence about dumping once of my outsourced solutions providers and bringing the functionality they provide in-house. We've been with them a long time, I have regular lunches with some of their VPs and trade phone calls with the CEO on a semi-regular basis. They're good guys, we like each other. It's all very friendly.

But business is business. I can save a nice sum of cash each year if I ditch them and bring the functionality in-house. But I didn't pull the trigger on this during a round of cost cutting last year because the service was good and it was one less thing to worry about.

Lately tho, we've had some issues and we end up having to worry about some of the stuff anyway. Looking at the future roadmap, we want to go into a market they don't service and we'd have to come up with the toolset to service those functions in that market from somewhere else anyway.

Then last week, a bug rears it's head. A seemingly minor bug over there is causing daily doses of grief over here. We finally isolate it complete with process id's and transaction numbers from their side and open a ticket last night. "Hi, your system has recently started doing X twice every night instead of just once. This causes problems over here because we key off of process-X".

The response came in today:

"The Developers have looked at this and say that it is a very rare occurrence. We are not able to guarantee that [process-X never fires twice] as that would slow down the process significantly."

Okie then. We'll muddle through on our own with that. And while we're at it we may as well develop the entire toolkit over the next couple months and then we can send you our notice of termination.

Case closed and thanks for helping me with that decision.

Posted by Mark Jeftovic in Taking care of business at 16:17

Thursday, February 8, 2007

That comfy cozy Nanny State

A couple of recent developments have got me thinking about the nature of the socialist, nanny state, what it does to people's self-reliance and the insidiousness of entitlement programs in general.

South of the border, a minimum wage raise has been passed while up here the airwaves are full of cheery ads from the CDIC that the amount of bank deposits covered by the CDIC has been raised to \$100,000.

The Canadian implementation of deposit insurance is supposed to be funded by the premiums of its member institutions. Thus the CDIC is a Crown Corporation funded by its member banks and it pays out settlements from its own reserves, or if depleted it is allowed to borrow up to \$6 billion to cover banking collapse. So on the surface it appears as if bank failures covered by CDIC don't come out of the taxpayers pockets.

This looks nice on paper. In reality the CDIC has cash reserves on-hand of 1.4 billion to cover payouts on a failed bank. It can, in a pinch, borrow that further 6 billion which brings it up to 7+ billion. Which basically means it has the resources to cover about 1.6% of the 437 billion worth of deposits insured, most of it with borrowed money. In the event of some sort of systemic or cascading banking failure, the rest would have to come from the Federal Government, better known as, the taxpayers.

We've seen exactly this happen in the US during the S&L scandal of the late 80's. The sister body to the FDIC, the FSLIC (which covered S&L's specifically) went insolvent and the entire debacle is said to have cost the American taxpayer \$150 billion.

In a very under appreciated and obscure book called *The Monetary Elite vs. Gold's Honest Discipline* by Vincent LoCascio, the flawed logic of government underwritten deposit insurance is revealed time and again.

"[P]eople fail to consider that federal guarantees make bank failures more likely by artificially encouraging people to choose the highest interest rates available, which in turn causes bankers to seek riskier, higher-yielding loans and investments".

Because in our cozy nanny state, the bankers enjoy an exalted safety net the rest of us capitalist pigs can't, in fact, mustn't depend on:

"Failing banks do not face the same fate as other failing businesses. Other failing businesses must contract, face more restrictive credit conditions, tighten their belts, and turn adverse results around as quickly as possible to become more viable. Failing banks, however, can ignore the reality of their situation...They can use federally guaranteed deposits to try to speculate themselves out of trouble

What if businesses could operate impervious to the whims and pitfalls of the real world? Imagine if you will a scenario in which all businesses operating in Canada were automatically covered by the CBEOLIC, the Canadian Business Errors & Omissions Liability Corporation. Over time, you watch the effectiveness of the entire business sector erode away to incompetence of tragic proportions. Why try harder to mitigate risks? If anything goes wrong the government will mail you a cheque. What a country!

Somewhere along the line the desire to collectively pool resources (taxation) to protect the unfortunate during hard times mutated into a perversion where a coddled citizenry expect "the government" to absolve them from taking responsibility for their own lives.

It permeates into all walks of life whether people care to admit it to themselves or not. Why bother saving any money? If you lose your job you get Unemployment Insurance. Why put anything away for the future? When you get old you will get payments from the Canada Pension Plan. People don't cop to this on a conscious level, it just manifests as the aggregate household savings rate slides down over the years. Seldom do people carry out simple back-of-the-napkin calculations that would help them understand that UI is no substitute for lost wages and if you actually tried to live off your projected CPP benefits then plan your retirement around living in a cardboard box and eating out of dumpsters.

Students and leftists carry this to extremes, demanding all manner of fantasy world perks like a "guaranteed living wage", not understanding that if their dreams were to come true, the nature of inflation and money supply would kick in and after a nasty and unbargained for displacement, they would be back to, or worse than where they started. All a guaranteed minimum living wage would succeed in doing is moving the effective poverty line to the new minimum wage.

A very good dissection of minimum wage laws I've seen is James Ostrowski's *How To Help Low-Wage Workers (Without Raising the Minimum Wage)* where he gives us five reasons our nanny state overseer politicians love to pass minimum wage laws:

"Why do politicians love to propose increases in the minimum wage?

1. It costs them nothing other than the ink and paper the bill is printed on.
2. The vast majority of the law's supporters simply do not understand the technical economic reasons why the law fails to help the working poor.
3. Many people do not understand what the law actually means.
4. Powerful special interests favor the minimum wage for reasons unrelated to the welfare of low-wage workers.
5. The minimum wage promises to give us something for nothing."

and proceeds to outline exactly why raising the minimum wages exacerbates unemployment. So politicians can get people to vote for them by dangling this carrot, but in the end more of the working poor will lose their job for their troubles.

To put it simply, minimum wage laws don't force employers to keep workers at the new minimum wage. If the economic output of a worker is below the new minimum wage, he won't get paid more, he'll be fired. The politician won't care, he's already been elected.

"Tragically, those priced out of the labor markets by the minimum wage are often young, unskilled, high school drop-outs, or minorities. Those who most need that first unskilled, low-wage job are most likely to be economically and legally unemployable after the wage rate is raised.

Thus, the first obvious effect of the minimum wage is to cause unemployment among the least skilled and most disadvantaged workers!"

Beyond the seemingly counter-intuitive outcome of increasing unemployment, Ostrowski identifies the following 5 after effects of increasing minimum wages:

1. causes unemployment among the least productive workers;
2. reduces wealth, causing prices to rise (same amount of money chasing fewer goods and services causes prices to rise)
3. causes premature replacement of workers with technology, which again, reduces wealth and causes prices to rise.
4. raises the cost of living for all
5. increases the ranks of criminals and black market workers such as drug dealers with all the attendant social costs.

and punctuates it with the thought experiment:

"If the minimum wage law does not cause unemployment and can raise living standards at zero cost, why keep it so low? Why not have a minimum wage of \$50 an hour? That way, we can all be upper middle class. The answer is that it would cause mass unemployment because most people aren't worth \$50 an hour. "

He concludes his analysis with what really would work to improve the lot of the low-income working poor:

1. reduce their taxes
2. reduce their cost of living
3. increase capital investment

Which also seems to work for the not-so-poor, the middle-class, the rich and for businesses. Go figure.

I've looked at both ends of the spectrum of self-sufficiency eroding Big Government initiatives that purport to provide "safety nets" and guarantees for that which can never be guaranteed.

There is only one person in the world who can guarantee that if a bank folds, I won't be wiped out. There is only one person to guarantee that I earn a living wage that can provide for my needs and those of my family.

That person is me. And that person is you.

Posted by Mark Jeftovic in Armchair Analysis at 15:29