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Are domain names recession-proof? Probably not, next question?

I didnâ€™t see the Fortune article Are domain names recession proof until the weekend, and being the author of the now infamous Domain aftermarket overdue for an asset repricing last year I feel somewhat obligated to comment on it.

There can be no doubt now that the recession is here. I went on record nearly a year ago that it was coming, so I nearly gagged when I saw Jim Cramer say something along the lines of â€œI told you all this was comingâ€• over the Christmas holidays. So now itâ€™s ok to say â€œrecessionâ€• in polite company although the politicians and the pundits still try to soften it up by making sure they modify it with words like â€œmaybeâ€•, â€œslightâ€•, â€œmildâ€• and â€œpossibleâ€•. Make no mistake, itâ€™s underway and I think weâ€™re far closer to the beginning of it than the end.

So, how will domain names fare in a recession? The Fortune article was upbeat:

â€œGlobal markets are in a state of panic. Credit markets are all but closed. And recession fears are everywhere. But at the conference I attended in Hollywood this week, called DomainFest, youâ€™d have little clue that the financial world was melting down.

The domain world - the people that buy and sell names and make money from pay-per-click ads on their websites - is booming. Downturn? Bring it onâ€¦.â€•

While the rest of the article is little more than a laymanâ€™s intro to the domainer business model, the question is timely. Now that the recession is here and, to paraphrase the old detergent commercial â€œweâ€™re soaking in itâ€•, are domain names as an asset class a â€œsafe havenâ€•? Will they in general terms produce â€œabove averageâ€• returns compared with other places to put oneâ€™s money such as stocks, bonds, commodities or inflation protected t-bills?

The difficulty of treating domains as an asset class per se

One of the troubles with examining domains names as an asset class is the short amount of time theyâ€™ve been around: compared to mainstream assets and financial instruments, domain names and the DNS have been around a few microseconds. Thus, we donâ€™t have a lot of historical data to make inferences from. In the history of the commercial internet (say since 1994 or so), thereâ€™s been one recession/bear market (2000-2002) and itâ€™s almost a stretch to call it a meaningful one.

One domain broker I know related that â€œaftermarket values tankedâ€• after the Nasdaq bubble burst. I know that prior to the crash, one of my clients paid $90,000 USD for a domain and he didnâ€™t even bother renewing its DNS last year. Itâ€™s sitting right now on our â€œDNS expiredâ€• pages so I even have insight into itâ€™s traffic and PPC value. It gets a steady 20 to 40 â€œtype-insâ€• per day, but at current PPC revenues the domain will break even in 4,500 years.

So on one hand, we donâ€™t have much of a past track record to give us insight into how domains as an asset will perform through various stages of economic cycles, the other problem is to the future: will there even be domain names in 5, 10, 50 or 100 years? We can, with some confidence, assert that in 100 years time people will still eat, wear clothes and sleep indoors, putting some kind of a demand based floor under things like real estate, textiles and commodities.

Domains on the other hand, work because of â€œDNSâ€•, and even though my personal livelihood depends on â€œlong live DNSâ€•, I am not fool enough to think that in 10 or 20 years some completely different method will be employed that enables computers and network services to uniquely identify and locate each other across disparate networks. I called this future protocol â€œquantum foamâ€• once as a placeholder. Letâ€™s for our purposes just label it â€œQNLâ€• for â€œQuantum Network Locatorâ€• and wonder if some kid in a garage is going to invent it at some point. Even if that event is 50 years out, paying 100X on a domain may not work out so well.

What is recession-proof?

Warren Buffet loves recessions because they enable him to pick up undervalued assets on the cheap. Heâ€™s parlayed $100,000 into a personal fortune worth over $30 Billion doing just that. What attracts Buffet to investments are what he calls â€œdurable competitive advantagesâ€•, or what his mentor Benjamin Graham termed â€œmoatsâ€•. In tech land we often equate this with â€œbarriers to entryâ€• but they are not exactly the same thing. The phrase I personally identify with it is â€œthe ability to defendâ€•. How defensible are domain names?

The problem there as I see it is that there are two pillars holding up domain values: PPC and direct navigation.

On the PPC side, there is very nearly a single-point-of-failure for the entire industry and that is Google. As Jay Westerdal pointed out, Google may very well have single-handedly killed the domain tasting industry last week, which is significant. The registrarsâ€™ constituency tried to hammer out a consensus, the registries themselves have been scratching their heads over how to best deal with perceived abuses of the AGP and along comes Google, from completely outside the inner circle and toasts the entire sector in one edict: no more monetization of domains less than 5 days old. End of story, end of the AGP carry trade.

So GOOG has the power to kill an entire slice if the domain pie, what would happen to the rest of it if they failed completely? It doesnâ€™t matter how far-fetched that sounds, the point is that there is a lot of capital pouring into the domain monetization game and the entire domain monetization game is dependent on a single external entity. What if GOOG says â€œno more parked pagesâ€• next? They wonâ€™tâ€¦but they could.

The other aspect of domain monetization is, of course, direct navigation and again, this is where the rest of the domainer world and myself agree to disagree. Once again, there is the ability for entities outside the domainerâ€™s sphere of influence to have a huge impact on type-in. What if Google (them again) releases Gbrowser (or Gfox, or G-zilla) puts the search box where the location box is, puts the location box under Shift-Ctrl-F-L and grabs 20% or 30% of the market over the next few years? What if IE (who already has 20% on IE7 and another 30% on IE6) did it tomorrow?

Future input devices (the stuff we havenâ€™t thought of yet), likely wonâ€™t interface with the computer using keywords with â€œ.comâ€• appended to it. When you think of it, typing that into your browserâ€™s location bar is a quite antiquated, not to mention uninformed method of getting around the internet. Future UI will succeed on the basis of infusing the userâ€™s known preferences with relevant search queries and agents. I donâ€™t know what itâ€™ll be or what itâ€™ll look like, but I know innovations will happen in UI and they will probably obsolete or at least end-run type-in.

So if you listen to me (donâ€™t worry, very few do), there are two gaping holes in the ability for domain names to defend or construct moats of safety around their current revenue models. The common factor in both is that too much crucial underpinnings of the PPC model are subject to control outside of the PPC/domainer industry. Unless Oversee can buy Google in the next few years.

Neither of these scenarios ever need happen to impact our assessment of domains as an investment vehicle and to ponder their value through a recession. If thereâ€™s one thing Iâ€™ve taken away from my studies of value investing itâ€™s â€œmargin of safetyâ€•. All business is in a word, risk. So we want our entry points into our investments to offset the risks. At current levels, I think if any technical analysts existed in the domain aftermarket, they would call them â€œoverboughtâ€•. Hence no â€œmargin of safetyâ€• against these risks.

What are safe havens?

During times of trouble, people flock to â€œsafe havensâ€•. These havens have certain characteristics, including being dull, boring and thus (hopefully) safe. Such times are often eventful, tumultuous and are often by definition, not boring, so whatever people flee to during a crisis, they arenâ€™t looking for more excitement. Gold is a good example. We may not really understand exactly why a polished metal out of the ground holds itâ€™s â€œvalueâ€• perpetually but we are hard pressed to find a tailor anywhere in the world who wonâ€™t sell you a suit for an ounce of it.

Everybody has to eat, everybody has to sleep, everybody needs shelter. Nobody must surf the net or send email. If you find yourself in tough economic times deflation or hyperinflation,   typified by scarcity, fear, uncertainty and financial chaos and you have an ounce of gold in one pocket and the auth code for food.com the other, I doubt youâ€™ll be able to feed your family with the latter. While we all hope times donâ€™t get that dire, that is the thought process at the root of all flights to safety among the asset classes: â€œHow useful will this be if the crap really hits the fan?â€• and â€œHow much value will this hold in all dire circumstances?â€• (deflation, hyperinflation, stagflation, etc)

Some factors that favour of domain names relative to other asset classes.

Iâ€™m saving some optimistic thoughts for the true believers and Iâ€™ll outline why â€œdomains-as-assetâ€• class have a few favorable factors going into a recession which may help them become a lagging casualty (meaning the damage will occur later, and may not be as deep).

Domains in general are not leveraged. This quite possibly can make the difference between suffering through a few lean years and going bankrupt. If there is a defining character of this financial meltdown it is illiquidity. The damage is coming from overleverage and compounded by the fact that in many sectors (mortgages, LBOs, etc) too much debt has been issued, and then packaged up and resold. The result are a flurry of crisis moments where entire books of instruments canâ€™t be marked to market and liquidity totally seizes up.

There may be a reciprocal effect in advertising mediums to the benefit of domain names. During recessions, many businesses reign in their marketing budgets. (This is often times a mistake but in many cases they donâ€™t have a choice). Institutional advertising may suffer declines and as companies pare back on, say, Superbowl ads, they sustain or even increase their online ad spending because ROI can actually be measured. Also, online spending tends to be more accessible to small businesses than institutional advertising so the more savvy small businesses may actually step up their PPC spends. But I must stress, I think all this happens against a backdrop of overall falling budgets and falling spending, lower bids. Good for the buyers (recessions always are), but bad for the sellers (which is what the domainers are).

So our examination of the question "Are domain names recession proof?" can be summarized, I would say that the lack of track record (domains havenâ€™t existed long enough to gain insight on how they will react under differing economic climates), means domains wonâ€™t qualify as a safe haven asset during a recession or an economic storm.

I would go on to say that at current overbought, overheated aftermarket pricing, there is no â€œmargin-of-safetyâ€• on buying domain names as an investment (either by PPC at inflated multiples, trying to flip into a cooling market, or just thinking generic .comâ€™s are the â€œreal estate of the futureâ€• â€“ real estate has bubbles too)

The good news is there is no pronounced leverage in the sector generally. Jay Westerdal may wish banks would â€œget itâ€• and finance domain names, but going into this recession it may be a benefit to the domainers that there isnâ€™t a lot of debt overhanging the industry. Most domains are (assumed) to be owned outright, so if PPC revenues fall, there isnâ€™t the spectre of being underwater on debt service looming.

While I donâ€™t consider domains â€œrecession proofâ€•, I will be looking for signs of a bottom on this one, and for those of us who are still solvent (hopefully you and me included), there should be some bargains to be had.

I think part of the fallout against my â€œAftermarket Overvaluedâ€• article last year was people thought I was saying â€œdomain names suckâ€•, and that wasnâ€™t my intent. Iâ€™ve always loved domain names, Iâ€™m a geek and Iâ€™m in the DNS business and I was collecting domain names before I ended up being a registrar. I just called an overbought aftermarket as I see it.

What happens during recessions? Overreactions to the downside. Iâ€™m not a permabear so stay tuned for my someday-in-the-future article â€œDomain name aftermarket screaming BUYâ€•. Hopefully it wonâ€™t be 10 years from now.

`Posted by Mark Jeftovic in Venture Crapital at 14:08`

Friday, January 18. 2008

The Economy: Time to Panic? (Not yet, but wear diapers)

As a child, my mother remembers peaking through a window into the bedroom of her grandfather, my great-grandfather, who would sit at a table frantically counting and recounting a few gold coins in a bag. He had gone off his nut, basically, and this was his obsession: emptying a few coins out of his bag and recounting them into it. I was told this tale at a fairly young age and had taken it as a cautionary tale against being miserly or otherwise obsessed with money.

It was only during a recent visit from my mom that I learned the other piece of my great-grandfather's story. He was rich, already a wealthy man before all that "Great War" unpleasantness. WWI ended and he had all of his wealth in (wait for it...) gold. What happened next is what broke the man. A business partner of his convinced him that gold was old news and about as valuable as it was ever going to get (A "barbarous relic" in today's parlance). My great-grandfather agreed he may be right and liquidated the vast majority of his gold bullion and coins into cash. This was in around 1920's Germany, better known then as "The Weimar Republic". Ask any halfway competent student of history about the Weimar Republic and they will all say the one thing it was remembered for the most: HYPERINFLATION.

What is the best possible thing to have oodles of during a period of hyperinflation? Gold What's the worst thing you can do with gold just prior to an episode of hyperinflation? Sell it for cash.

That's what my great-grandfather did and he spent the rest of his days a crazed pauper with OCD. For some reason that story really, I mean really resonates with me on a lot of levels. If I believed in re-incarnation, I would say "I'm that guy, and this time I'm going to get it right goddammit. "

When I flipped past Larry King's show last night and the headline was "The Economy: Time to Panic?" I realized just how badly spoiled we are here in the west.Sure, the stock market is down 14%. That's 14% down from an idiotic high it had no business being near in the first place. But all told, a 14% pullback is peanuts. But in the mindset of the typical lumpenvestor, this is inexcusable and grounds for a massive government mobilization. What kills me about all this is the implicit assumption that consequences are for other people.

When this subprime unwinding really started to impact the market, the financial sector screamed bloody murder and demanded a bailout, the archetypical representation of the entire sector's ethos is captured beautifully by the now legendary Jim Cramer meltdown on CNBC. At around 52 seconds into the clip he says something interesting,

that something is along the lines

"he [Bernanke] has no idea how bad it is out there...I have been on the phone with the heads of all these firms in the past 72 hours and he has no idea how bad it is out there, my people have been in this game for 25 years, and they are losing their jobs and these firms are going out of business"

It is indeed a meltdown to behold and, as Bart Simpson would quip: "The ironing is delicious".

When GM or IBM or some other non-financial giant lays off thousands of workers, guys like Jim Cramer will quip that it's the way of the world and the stock price of those companies will actually bounce a bit. Who gives a crap, those workers are nothing more than cells in a spreadsheet. But when a bunch of bankers, who have been selling each other shit and calling it shinola for years finally get caught out and it all crumbles, the prospect of the consequences coming home to roost is unthinkable. That bankers lose their jobs and firms go underwater because billions of dollars of bullshit derivatives that they dreamed up themselves can't be marked to market is a bona fide crime against humanity.

Citigroup and Merryl Lynch coughed up a 20 billion dollar furball between them this week, then Bear Stearns (who kicked all this subprime mess off last year by having a debt auction that nobody showed up for) added the comedic punchline by upgrading the financial sector. With the exception of Goldman Sachs (who gave subprime such a wide berth they are being investigated by regulators, no good deed goes unpunished), the entire investment services sector looks like a bunch of financially illiterate retards and we're supposed to seriously heed their upgrade recos on the financial sector? These are the same guys who called people like me (contrarians who shunned growth stocks and bought gold in 2002) a bunch of idiots that "just don't get the new economy".

Now the US president has mobilized into action, back from the middle east where he begged the Saudi king for lower oil prices he's crafting a 150 billion dollar stimulus package to ward off a recession that no talking head in Washington will even admit is happening. Everything is fine, but suddenly a 50 basis point cut on the 30th probably won't satisfy the street, it needs an unheard of 75 basis point cut now and if they get it, somewhere some twit will in the same breath re-iterate America's commitment to a "strong dollar policy". We live in truly Orwellian times folks.

I started off last year predicting predictions for a "second half recovery" in 2008 and I haven't heard that magic phrase...yet. The R-word (recession) has only begun to be usable in polite company the last couple weeks and suddenly it's everywhere, but it's still being used in a benign, unalarming context. "Recession? Yeah, I guess there's a remote possibility that we could have a mild recession" but if you read between the lines, alarm bells are ringing, central bankers and politicians are scrambling and the people who see behind the scenes are crapping their pants. Who knew?

Posted by Mark Jeftovic in Venture Crapital at 13:23