# Domain-Name Acquisition Strategy & Valuation Drivers

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## INTRODUCTION

We address two questions:
(1) Given an acquisition motive, what is the best strategy?
(2) Given the best strategy, what are the valuation drivers?

## VALUE-CREATING ACQUISITION STRATEGIES

To develop a prescriptive domain-name acquisition framework, we consider two motives: investment for development,[1] and investment for complementing a firm's domain portfolio. Acquisition strategies are divided into two mutually exclusive options: buying to sell and buying to hold.

The planning stage for a buy-to-sell strategy includes a Web site development analysis and an exit strategy. Exit is achieved through placing the domain name for sale when certain return thresholds are met. The buy-to-hold strategy, on the other hand, is based on holding the domain name until such a time that an acceptable offer is received. Thus, the decision to sell in the buy-to-hold strategy is tactical, not strategic.

The following example illustrates the difference between the strategies:

| Options | Before-tax Return (annual) | | | | | |
|---|---|---|---|---|---|---|
| | Undeveloped | Developed by Acquirer | | | | |
| | Years 1-5 | Yr 1 | Yr 2 | Yr 3 | Yr 4 | Yr 5 |
| Domain-1 | 5% | 50% | 50% | 15% | 15% | 15% |
| Domain-2 | 10% | 40% | 40% | 40% | 40% | 20% |

Assume that the entity making an acquisition decision faces the above two mutually exclusive options and that the options have been presented at prices reflecting the respective undeveloped annual returns. An investor following a buy-to-sell strategy would buy Domain-1, develop it, sell it at the end of year 2, acquire Domain-2 at the end

[1] Development includes customized parking, forums, and ecommerce.

of year 2, and sell it at the end of year 4. Given the above example, the buy-to-sell strategy yields superior returns over buying Domain-1 and holding on to it. Thus, a buy-to-sell strategy is value adding. Nevertheless, after the developed site has been sold, both domain names would generate healthy returns to the entity acquiring them. Moreover, the acquirer of a developed domain may be able to create additional value with further development.

An acquiring firm first needs to make sure that the role of the domain name considered for acquisition is consistent with the firm's corporate domain name strategy.[2] An acquisition that complements a firm's domain name strategy is, by definition, value adding. For example, acquisitions under the umbrella of brand/trademark protection can be value destroying and thus, the company should refrain from such acquisitions.[3] On the other hand, value creation potential from a buy-to-sell strategy is ambiguous. In general, firms should stay away from investments that are not within the firm's core competencies. Acquiring such domain names is no different than a company using shareholder money to make financial or real estate investments hoping to generate higher shareholder return. Moreover, a buy-to-hold acquisition is a strategic complement to the firm's domain name portfolio, while buy-to-sell is nonstrategic and involves Web site development and active selling in relatively thin markets, which are not necessarily part of the firm's core competencies. Nevertheless, the firm's ultimate decision should not conflict with its overall corporate strategy.

It should be noted that a corporate buy-to-hold strategy does not preclude the firm from selling any of its domain names. On the contrary, domain names that no longer play a contributing role or are no longer part of the corporate domain name strategy should be put up for sale.

Thus, the analysis can be summarized in the following simple 2x2 model.

**Value Creation**

| Strategies | | Buyer Motives: **Development** | Buyer Motives: **Firm** |
|---|---|---|---|
| | **Buy to sell** | + | +/- |
| | **Buy to hold** | - | + |

[2] See Alex Tajirian, "Roles of Corporate Domain Names," DomainMart.

[3] For an alternative option to acquisitions of trademark-related domains, see Alex Tajirian, "Don't Litigate, Open Them Up!," DomainMart.

## VALUE DRIVERS

For a firm, the main value driver is compatibility with its domain name strategy. For developers, on the other hand, we outline the impact of the following drivers: monetization venue, tax rate, and transaction cost.

### Monetization Venue

The three main domain-name monetization venues are parking[4], ecommerce, and leasing.[5] The venue selection depends on the buyer's risk tolerance, competencies, and financial resources. Nevertheless, the acquirer may delegate domain-name monetization management to an agent.

There are risk-return tradeoffs between parking and ecommerce.[6] Thus, an acquirer's choice depends in part on their appetite for risk. Also important is the acquirer's competencies, especially when it comes to the decision between building and managing an ecommerce site on one hand and parking on the other. Moreover, with parking, the acquirer may opt for a portfolio diversification[7] or a tactical domain allocation[8] strategy. The former requires knowledge of portfolio optimization, while the latter requires knowledge about the performance of the various monetizers. Nevertheless, access to funds makes ecommerce and boutique parking feasible.

### Tax

A domain name acquired to generate profit is regarded as inventory (you carry it for resale purposes).  Therefore, a gain on the sale of such a domain name is not a capital gain but ordinary income.[9] In contrast, a domain name acquired to run your Web site may be considered an intangible asset, not inventory, thus, profit on s sale of such a domain name is generally considered a capital gain.

On the other hand, fund managers can go around paying the ordinary income tax rate by organizing the firm either as a private equity or an investment trust. The current tax provision considers fund managers' profit as return on investment instead of income from services.  However, currently there is a US congressional debate as to whether to raise the

[4] We define parking as monetization through the placement of ads on Web sites, irrespective of who performs content customization and to what extent.

[5] For information on domain name leasing, see Alex Tajirian, "The Leasing Option Premium," DomainMart.

[6] See Alex Tajirian, "Parking or Ecommerce?," DomainMart.

[7] See Alex Tajirian, "Toward Large Domain Name Portfolios," DomainMart

[8] See Alex Tajirian, "Tactical Domain Monetization Allocation: A Statistical Approach," DomainMart.

[9] In the US, the ordinary income tax rate can be as much as 35 percent, while the capital gains rate does not exceed 15 percent.

tax rate on the investment gains of fund managers.[10] Congress is looking into whether this tax provision gives fund managers an unfair advantage.[11] As for investment trusts, such an organizational structure places legal and regulatory restriction on the firm's operations, such as its ability to acquire public companies and the amount of allowable debt financing. However, these restrictions do not constitute a significant barrier to establishing domain name investment trusts.

### Transaction Costs

Transaction costs[12] include searching for potential sellers and buyers (either through direct contact[13] or established marketplaces), negotiations, and escrow fees. As domain name markets are becoming more efficient, these costs are decreasing. Moreover, they are not big enough to offset the advantages of a buy-to-sell strategy.

## IMPLICATIONS

Ignoring the appropriate strategy and tax treatment biases domain name valuations, and thus results in lower returns to the acquirer. Moreover, the monetization venue options put some selection constraints on the type of domain names that should be acquired. For a firm, acquisitions must complement their domain name strategy. ■

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[10] The tax rate on investment gains for fund managers is known as "carried interest."

[11] It should be noted that such provisions have been recently eliminated in a number of EU countries.

[12] See Alex Tajirian, "Are Domain Name Commissions Justifiable?," DomainMart.

[13] For direct contact strategies, see Alex Tajirian, "Chat-up Lines, "Hard to Get," & Domain Name Markets," DomainMart.