Porter's 5 Forces and Domain Name Value

One of the methodologies used in domain name valuations is the discounted cash flow (DCF) approach. This approach requires the estimates of future cash flows. A strategic modeling approach must be adopted to analyze the demand for the domain name.

I will then take a closer look at the Porter's Five Forces as a tool to assess the various value drivers in domain name valuations. I assume some familiarity with the frameworks.

Strategy Framework

A widely used methodology to analyze the attractiveness of an industry is Porter's Five Forces framework.

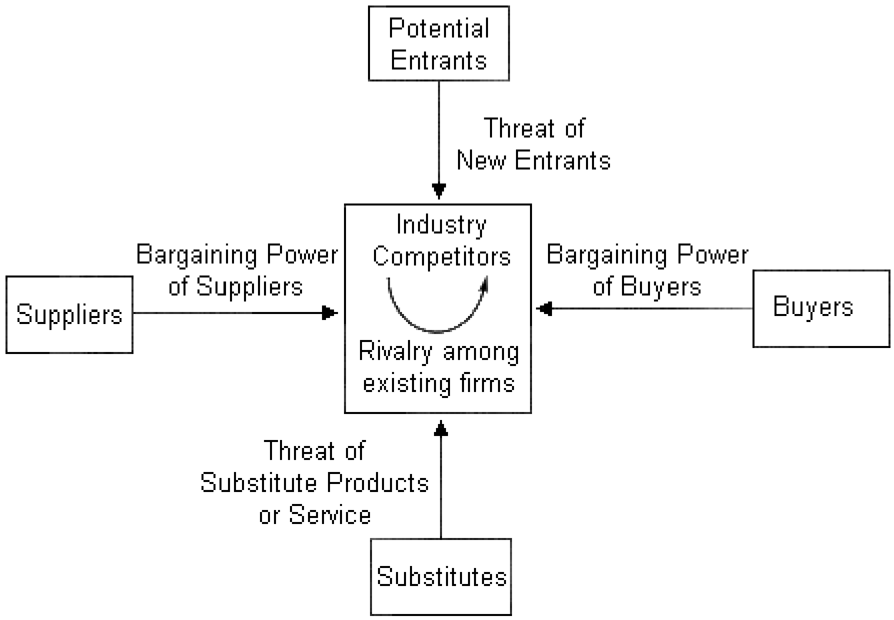
The fist step in implementing a strategy framework is to define the relevant market. The boundaries of the market are not always well marked, which makes the task more challenging, yet insightful and thought provoking as to what the relevant competitive forces are.

The attractiveness of an industry is measured in terms of excess returns, not just industry growth rates. For a domain name, the attractiveness is measured in terms of additional shareholder value the acquisition of the domain name would create. The growth rate in the additional CFs, in turn, depends on future growth rate of Internet use, sources of traffic, industry growth rate, and inflation rate.

The Five Forces

The 5-Forces framework is summarized in diagram 1, below, followed by an outline of the various components of each force.

Figure 1: Porter's Five Forces



1. **Intensity of Rivalry among Existing Firms**.
   In the standard industry analysis, competition is measured by industry concentration ratio. The factors that impact demand rivalry are:
   a. Large numbers of firms increase rivalry.
   b. Market growth rate; low growth rate increases rivalry.
   c. A low level of product differentiation increases rivalry. Brand recognition, on the other hand, reduces rivalry.
   d. Strategic rivalry is high when a company is losing market position or there is the potential of great gains.
   e. High existing barrier and asset specificity. With domain names this factor translates to the ability of a buyer to sell it if things go wrong. The less specific the domain name is to an owner's products and services, the more intense the rivalry.
   f. Low customer switching cost increases rivalry.
   g. Asymmetric information about benefits of domain names. The more the firms within an industry recognize the various roles of domain names, the more intense the rivalry.

2. **Bargaining Power of Buyer.**
   a. The lower the number of potential buyers, the more bargaining power of buyers.
   b. A buyer who owns a trademark implicit in a domain name has more bargaining power. A trademark is a barrier to entry.

- **c.** A buyer who previously aggressively litigated domains has more bargaining power than a bully, especially when the owner is aware of trademark issues.
- **d.** Availability of existing substitute products and the degree of substitutability. The more substitutes, the more bargaining power of the buyer.
- **e.** Switching cost of seller to a different domain name after sale. The lower the switching cost, the more the bargaining power of the buyer.

3. **Bargaining Power of Seller.**
   a. Ownership of a trademark associated with the domain name increases bargaining power of seller.
   b. Geographical location of owner. A seller's residence in a country that is different than that of the seller or that doesn't have IP protection laws increases the bargaining power of a seller.
   c. Asymmetric information about value and trademark laws. The more knowledgeable the seller is about sources of domain name value and trademark issues, the more the bargaining power of the seller.
   d. Amount of value creation to the buyer. The more value a domain name creates to a buyer, the more the bargaining power of the seller.
   e. The more negotiation skills and experience a seller has, the more the bargaining power.
   f. The deeper the pocket a buyer has, the more the bargaining power of the seller.

4. **Threat (and attractiveness) of Substitute Products and Services.**
   a. Online the search strategy of potential customers. When users cannot find a desired site or information through domain name type-ins, they can try one of the following:
      i. Go to a competitor's website
      ii. Abandon the search
      iii. Find the desired website using a search engine
      iv. Ask a friend

      Options (i) and (ii) increase the threat from substitutes.

   b. Threat from new domain name extensions. The degree that the introduction of, say, .eu on .fr and the introduction of .asia on .jp would complement existing extensions.

   c. Amount of value creation of the domain name compared with substitutes.

d. Availability of alternative means to reach the company. The strength of threat depends on the list of options available to the user, the volume, and the quality of customers in terms sales conversion rates. The more viable alternatives exist, the higher the threat. Alternatives are

- Online information search through:
  - Type-in domain name in browser. Whether the domain name is .com or other extension. If not .com, what are the losses associated with not finding the information (see (a) above)? If it is .com, is the .com is active?
  - A search engine. The size of the threat depends on whether the link-result is organic or a sponsored listing.
  - Shopping bots.
  - Links from other websites.
  - User Bookmarks.

- Alternatives to online searches
  - Visits to a brick and mortar store
  - Responding to other forms of online advertising
  - Responding to traditional advertising
  - Word of mouth

5. **Potential Entrants.**

   a. It is not just industry incumbents that pose a threat to firms in the industry; the possibility of new entrants also impacts competition. It should be noted that the incumbents might not be aware that the domain name is up for sale. Thus, the seller can increase the potential of immediate entrants by marketing the domain name more aggressively. Moreover, if there is reason to believe that there might be new entrants interested in the domain name, the seller can wait for a more opportune time.

   b. Capital requirements for entry will increase as new entrants need to buy a portfolio of relevant domain names for positioning, branding, price differentiation, and traffic.

Besides the above five forces, sometimes the government is added as a sixth force. For example, the U.S. government exerts influence on the domain name industry directly through legislation and indirectly through the Internet Corporation for Assigned Names and Numbers (ICANN), the Internet's governing body.

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