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How to value internet companies. By Stuart Whitwell

Placing a realistic value on an internet company is difficult. Ideally, the valuation should be no different from that of a bricks and mortar company; predicting future cash flows through an understanding of the business and market dynamics. However, internet companies are still a relatively new phenomenon and there is often little robust historical data to support the valuations. Internet companies are also, by nature, unpredictable. They can enjoy huge success for a short while and quickly plummet into obscurity. Internet users can also afford to be fickle since the latest, best technology is only a click away.

Example valuations

There have been a number of high profile, high value acquisitions in recent years. Only recently, Yahoo! rejected a $45bn bid from Microsoft claiming it undervalued the company. Although the total consideration is significant, the offer is actually reasonably conservative, based on a multiple of six times Yahoo!'s $7bn annual revenue. It would take Microsoft 11 years to get its investment back from Yahoo!'s profits but with the synergies this would inevitably be much sooner. Yahoo!'s refusal is therefore not that surprising, especially considering the more outlandish multiples that other deals have been based on.

Skype, for example, was acquired by eBay in 2005 for $2.6bn. In the same year, Skype generated only $7m in revenues from its 53m subscribers in 225 countries – a multiple of 371 times annual turnover. The valuation was clearly not based on current performance but in anticipation of heroic annual growth. Despite revenue forecast to exceed $200m two years after acquisition, eBay's investment appears not to have paid off as it was subject to an impairment charge of $1.4bn in 2007. Ebay admitted an overpayment.

In 2005, MySpace was bought by News Corp for $580m. This valuation used a more sensible multiple of 12 times turnover. In 2008, MySpace is forecast to generate approximately $1.2bn, over double what it was bought for three years previously. News Corp succeeded in both securing access to the business without overpaying and also in generating revenues from the site, both of which are a rarity for internet acquisitions.

The multiple's internet companies command are broad, highlighting the difficulty of realistic valuations. ITV paid £145m for Friends Reunited's in 2005, a multiple of eight times its annual turnover, with £7m allocated to tangible assets, £38m to intangibles, and £100m to goodwill. Google bought YouTube for $1.2bn in 2006 which valued the business at 113 times revenue and 428 times profits, with 92% allocated to goodwill. Microsoft's acquisition of 1.6% of Facebook values the business at $15bn, or 100 times turnover.

How it should be done

These examples illustrate the problems for anyone attempting to value internet companies. The range is huge, from a multiple of six to nearly 400 times turnover. The safest way to value internet companies is using the traditional methods applied to traditional companies. However, it is prudent to adopt a more thorough analysis of key issues such as consumer and market trends, achievable growth, barriers to entry and competitive threats, as well as a realistic view of how to convert non-paying visitors into revenue through either advertising, subscription fees or commercial transactions.

Development on the internet is rapid and consumers are quick to change allegiance as internet-based brands lack the longevity that helps install loyalty. There will always be potential for huge successes for those few who are lucky enough to tap into an online goldmine. History has shown how rapidly an internet company's value can rise and fall. It is a gamble but to reduce the risk, stick to the basic business fundamentals of cash flow generation and good management without getting over-excited by the novelty.