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Looking at internet company valuations

Stuart Whitwell, Intangible Business

The financial sector's propensity for putting high multiples on often shakily estimated revenues on internet companies, dragged global equity markets south at the turn of the century. Placing a realistic value on them is difficult but ideally the valuation process should be no different from other firms: future free cash flows, compound annual growth, rates of return on investment and so on.

The best analysts argue that it is by understanding the underlying business and its market dynamics that you correctly value a company. In reality experience has shown that valuations, even from large financial houses, have been optimistic. It was only a year prior to the crash of global equity markets in 2000 driven by over-priced internet and tech companies that Goldman Sachs classified them as akin to the emergence of electricity generating companies. While this may yet be proven correct, then business angels, mutual funds and private equity investors were throwing money at over-priced companies that had little or no business track record.

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. Remember Netscape the company whose browser revolutionised the internet and dominated the marketplace in the mid-90s with its flotation attracting record investment? Its parent company, AOL, has discontinued both the brand and support for it.

Example valuations

There have been a number of high profile, high value acquisitions in recent years. Only recently, Yahoo! rejected a \$45 billion 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 \$7 billion annual revenue. Currently it would take Microsoft 11 years to get its investment back from Yahoo!'s profits although with business synergies this could be much sooner. Yahoo!'s refusal is therefore not that surprising, especially considering the more outlandish multiples that other deals have been based on.

Older deals point to a habit of mis-pricing a company. Skype, for example, was acquired by eBay in 2005 for \$2.6 billion. In the same year, Skype generated only \$7 million in revenues from its 53 million 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 revenues forecast to exceed \$200 million two years after acquisition, eBay's investment appears not to have paid off as it was subject to an impairment charge of \$1.4 billion 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. This year MySpace is forecast to generate approximately \$1.2 billion, twice 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.

Internet companies command a wide range of multiples which indicate difficulties in realistic valuations. ITV paid £145 million for Friends Reunited in 2005, a multiple of eight times its annual turnover, with £7 million allocated to tangible assets, £38 million to intangibles, and £100 million to goodwill. Google bought YouTube for \$1.2 billion 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 \$15 billion, 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 them 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.

The author is joint managing director of Intangible Business, a brand valuation consultancy. www.intangiblebusiness.com