FALL 2014

A 'Rose.com' Is a 'Rose.com': What's the Value of a Domain?

Many people are interested in what a glass of whisky costs, but what would you pay for "whisky.com"? The answer is $3.1 million, the price paid earlier this year by the firm that owns "whisky.de," the German version. "Whisky.com" had been more or less "parked" for over a dozen years before it sold.

How do you value domains?

Source of value. There are two parts to every domain: a top-level domain (TLD) and a second-level domain (SLD). The TLD appears after the dot and is either generic (such as ".com," ".net," and ".edu") or country specific (such as ".de," ".uk," and ".eu"). It could also be a new custom TLD, which belongs to a single organization (e.g., an automobile manufacturer could be ".car"). The second part of the domain name, the SLD, appears before the dot, such as ValueManagementInc.com.

Domains have value because:

- They help users evaluate the reliability of search results;
- Like real estate, they establish "proximity" with users;
- Branded domains are part of a company's image; and
- Generic names can drive consumers to a brand and strengthen its market power (e.g., "toothpaste.com" is owned by Proctor & Gamble, "motorcycles.com" is owned by Honda).

Valuation approaches. So how do you value these? The cost approach is not applicable here, so we look to the market and income approaches.

Under the market approach, the guideline public company method is rarely applicable. The guideline transactions method can be strong,

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Issues & Updates

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VMI Highlights

Value Management Inc. sponsored the Philadelphia Estate Planning Council luncheon on September 16th at the Union League of Philadelphia. The topic was "ATRA and Estate Planning for the Moderately Wealthy - A Consideration of Transfer and Income Taxes." The speaker was Beth D. Tractenberg.

Value Management Inc. was a sponsor at the 19th Annual Multi-State ESOP Association Conference held at the Hilton Scranton Hotel & Conference Center. Ed Wilusz, ASA, CFA, Managing Director, presented on September 17th. The topic was "Driving Value by Steering the Company." Greg Kniesel, ASA, also presented on the 17th. His topic was "In-Depth Reviewing the Valuation Report."

Andrew Wilusz, ASA, presented the topic "The 5Cs of Ethics" to the Burlington County Bar on September 17th. David Peer, ASA, presented the topic "Basic Business Valuation Issues" to the Burlington County Bar on September 22nd.

Ed Wilusz will be the guest speaker at the Lancaster Estate Planning Council on October 16th.. His topic is "Valuation Discounts - Can They Be Sustained at a Tax Audit?"

Greg Kniesel will participate on a panel at the 2014 ESOP Association Las Vegas Conference and Trade Show. The topic is "Bring Your ESOP Issues - Interactive Session with In-House Trustees and ESOP Professionals."

Congratulations to Kaitlin Wilusz, CFA, on her recent engagement to Christopher Long! Chris popped the question in Corfu, Greece. Best of luck!

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although it is trickier to find comparables than analysts are accustomed to in business valuation. Comparables might be determined by:

- Site traffic;
- Number of letters (shorter is more valuable; last year, 92% of the biggest domain name sales were for names fewer than 10 characters);
- Number of words—one versus two versus three (drinkwhisky.com is worth a lot less than whisky.com);
- Size of market (niche versus large consumer market);
- The TLD (".com" is worth more than ".net," over 83% of top sales last year were ".com" addresses); and
- Age of the URL and the site (older is typically more valuable).

You can get domain name sales data from *DN Journal* (dnjournal.com), NameBio (namebio.com), or Sedo (sedo.com).

As for the income approach, it can be based on projected cash flows, the relief from royalty method (what would it cost me to license this domain?), or discounted cash flow methods. These methods also require the identification of comparables.

Using the relief from royalty method is very similar to work done for purchase price or trademark valuations. By forecasting revenues and royalty payments, you can calculate the value of the domain by applying a discount rate to the avoided licensing costs. With this method, you can start with royalty rates from, for example, ktMINE, RoyaltySource, or RoyaltyStat. However, these can be tough because it's rare to find only domain name licenses.

Other questions:

- What is the correct discount rate? Look to the WACC as a starting point, and make sure you have a good reason to veer from it.
- What is the expected life of a domain name? Generic words tend to last longer than brand-related terms.

Looking at discounted cash flow can be particularly helpful for unused websites that have been "parked." Those sites—generally lacking in content—might generate some ad revenue based on traffic and page views. Many acquired domains do, in fact, have revenue streams already associated with them. So valuation is not always just a matter of assessing the name.

A good source for understanding the value allocated to IP in transactions is the Houlihan Lokey PPA study, done every year. Recent studies show that trademark IP is generally less than 2.5% of total value—and, of course, domain names are often a small slice of this amount. So, often, the value is small (average value is $5,000 to $6,000).

IRS Kicks Off 'Limited' 409A Audit Project

Tax code Section 409A audits of selected taxpayers are underway. While the initial scope of the audits is limited, this is likely just the first step toward a more expansive project.

Section 409A regulates the tax treatment of nonqualified deferred compensation plans. The IRS audit project will focus on three issues: (1) initial deferral elections; (2) subsequent deferral elections; and (3) payouts under Section 409A, including the six-month delay for specified employees.

The IRS will select no more than 50 employers for the audits, which will be limited to the top 10 highly compensated individuals, according to **Thomas D. Scholz**, IRS senior technician reviewer, Office of Division Counsel/Associate Chief Counsel, Tax Exempt and Government Entities. Scholz spoke unofficially May 9 at a session of the American Bar Association Section of Taxation meeting, reports *Bloomberg BNA*.

More audits likely: Of course, most companies will avoid the 409A audits—for now. "If past history holds true, this program is just a first step in a process that will allow the IRS to hone its audit techniques and areas of inquiry with respect to 409A issues before the program is expanded to more employers," according to executive pay experts *Towers Watson*. It advises plan sponsors to periodically conduct self-audits to make sure their plans are in compliance.

Best Practices for Fund Valuations as SEC Cracks Down

The Securities and Exchange Commission is in the midst of conducting "presence exams" of investment advisers to private funds that recently registered with the SEC. This is part of a two-year initiative—started in October 2012—designed to examine five areas the SEC sees as "high risk." Valuation is one of those high-risk areas (along with marketing, portfolio management, conflicts of interest, and safety of client assets).

Last year, in a speech before a Private Equity International conference, Bruce Karpati, then-chief of the SEC Enforcement Division's Asset Management Unit, stressed the importance the agency puts on valuation matters when it comes to private equity funds. He characterized the industry as one that lacks transparency over the valuation of illiquid portfolio company assets. Karpati also pointed out the connection between valuation and marketing, saying: "Valuations, while always important, take on greater significance during the period of fund marketing." He cited past cases where managers would increase portfolio company valuations during the marketing of a new fund to exaggerate performance. This, he says, underscores the need to ensure the integrity of interim fund valuations.

Enforcement settlements. The SEC has emphasized the importance that it places on fund valuation through several enforcement action settlements (see below). It's significant to note that in one settlement the fund was required to hire an independent consultant to recommend new policies and procedures for the valuation of assets and to test their effectiveness after being put into place. Some believe that you'll see a lot more of this.

The upshot of these cases is that the SEC intends to take a much more aggressive approach toward valuation decisions. It will scrutinize both the determination of the valuations and the processes surrounding such determinations. The agency will also challenge the specific valuation determinations and the extent to which those determinations allegedly deviated from the "true" value of assets.

The SEC has conducted approximately 250 audits and is within reach of its goal of visiting 25% of the firms during the course of this initiative. The SEC has issued deficiency letters in about half of the exams it has conducted.

Best practices. Two areas of focus for best practices are: (1) policies and procedures; and (2) the valuation process itself.

In terms of valuation policies and procedures, a fund should:

- Establish effective valuation policies and specific and detailed procedures including a methodology for estimating the fair value of Level 3 assets.
- Make sure that the policies and procedures are robust, transparent, and flexible.
- Ensure that there is consistency in the application of the policies and procedures and document any divergence. During an audit, there's a particular focus on "one-offs".
- Create a valuation committee to define roles for the personnel responsible for implementing and maintaining the valuation policies and procedures. Make sure that the personnel at all levels in the process are all on the same page.

That last point is important because, during a presence exam, the SEC will interview the personnel responsible for implementing valuation policies and procedures. The number-one trip-up is when the different people involved are not all on the same page with respect to the valuation policies: If one person has a very different story than someone else, it's likely that the SEC will issue a deficiency notice. Therefore, everyone—at all levels—needs to be consistent when it comes to the fund's valuation policies and procedures.

As for the valuation process itself, a fund should:

- Utilize multiple valuation approaches (when appropriate) and explain the rationale for the weighting of the approaches. If an approach is not utilized, provide an explanation for why that approach was excluded.
- Document and explain the selection of key valuation assumptions (both observable and unobservable) and make all inputs into the model transparent.
- Provide a risk assessment update that considers macroeconomic industry and company-specific factors that may change the value of the investment in the near future.
- Link the current valuation to the investment thesis and provide key facts as you monitor the investment.
- Utilize independent third-party verification for the fund's most significant Level 3 assets at least annually. This will help funds mitigate valuation risk and facilitate a more efficient audit process.

The use of third-party valuators is often recommended. Some funds don't want to do it due to cost or the feeling that they just don't need it. But it is expected that there will be an increase in demand for valuation firms doing work in this area.

Key SEC Cases Involving Fund Valuation Issues

Here are the important SEC enforcement actions against private funds concerning valuation issues that triggered settlements.

KCAP Financial. This was the first action in which the SEC alleged that a public company violated the provisions of ASC 820 by failing to properly value certain assets. No penalties were paid by KCAP, but the CEO, CIO, and CFO agreed to pay penalties totaling $125,000.

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Yorkville. The SEC alleged that this hedge fund advisory firm and two of its executives deliberately overvalued the amount of assets under management to hide losses and increase fees. In one situation, it allegedly valued convertibles of a bankrupt company at $17 million after entering into a $1.3 million settlement with the bankruptcy trustee.

Alderman (Morgan Keegan). The SEC filed this action against eight board members of mutual funds run by Morgan Keegan, including its founder, over alleged valuation errors. This case scared a lot of boards, so they beefed up their efforts to review the appropriateness of the valuation methods used in their portfolios.

GLG Partners. The SEC alleged that a U.K.-based hedge fund adviser and its former U.S.-based holding company had internal control failures that caused the overvaluation of the fund's 25% private equity stake in an emerging market coal mining company. GLG settled these charges for nearly $9 million.

Healthcare M&A Spending Is Up 171% In 2Q14 over 1Q14

Spending on healthcare M&A hit a new record in the second quarter of 2014, according to *Health Care M&A News*. The combined total for M&A activity in the second quarter reached $135.2 billion, up 171% compared with the first quarter spending total ($49.9 billion). M&A spending is also up 152% versus the same period in 2013.

Tech is hot: The vast majority (91%) of combined M&A spending came from transactions on the healthcare technology side, while healthcare services contributed the remainder (9%). Dollar volume for technology exploded by 229% over the first quarter of this year. Dollar volume for services was down 3% compared to the first quarter.

ABOUT VALUE MANAGEMENT INC. VMI is a financial consulting firm specializing in valuing businesses, corporate securities and professional practices. Our firm is built on the performance of more than 6,500 valuations. Appraisals are rendered for estate tax planning, litigation support, and many other situations requiring independent appraisal. Our newsletter is published quarterly and does not constitute legal or financial consulting advice. It is offered as an information service to **VMI's** clients and friends. Those interested in specific guidance for legal and accounting matters should seek competent professional advice. Inquiries on specific valuation matters are welcomed.

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