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What to Consider When Carving Out the Value of a Firm's Website

By Stuart Weiss, CPA/ABV

Recently, I was asked to value a retail company doing business solely over the Internet. The company's finances were weak, but the owner insisted that the website itself had intangible value that I was ignoring. He may have been right, but I passed on the engagement.

Do websites have intrinsic value separate from the businesses they front? After all, go online and you'll see page after page of sites purporting to value or act as a marketplace for Web addresses. You can also go to www.flippa.com and bid on websites in an auction.

I recently spoke with Mike Pellegrino, MBA (Pellegrino & Associates LLC), author of *BVR's Guide to Intellectual Property Valuation*, Second Edition, and we discussed this very intriguing topic.

Stuart Weiss: How does one know whether a website actually has a separate value from the business?

Mike Pellegrino: A business is nothing but a mutual fund of discrete assets. A business value is the sum of its parts. A website value is separate from the business and can enhance the value of a business. A website always has a separate value. But it's based on the incremental economic improvement related to the rest of the business. And it could also be negative because it is a cost and you get no economic benefit from it.

SW: It seems that more and more businesses today have abandoned sales forces and are doing all of their business over the Web. Does this replace the intangible "sales force in place" asset?

MP: Yes, in some businesses, that is absolutely the case. What's the value of the website there? It's going to show up in terms of reduced marketing costs. One way you can value a site like this is through an income-based approach. Another way is to look at the cost of reproducing the asset or one of equivalent utility. That's not only the hard dollars but the opportunity costs and the capital charges associated with it.

SW: How do you know that the site is causing an increase in income rather than the business itself?

MP: It depends on the business. If you have both a brick-and-mortar operation and a website operation, then you have a basis of comparison between the two. If it's a Web-only business, then the value of the website could represent the entire value of the business. But if it also had other intangibles—maybe a production supply agreement or rights to a raw material that is not available on the open market—then those become additional assets to the business.

SW: Let's assume that the website has value. What are some ways of determining that value?

MP: It all comes down to cash flow. There's no black magic here. I don't wave a wand and then say, "Here it is, abracadabra." It's just a measure

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of the cash flows attributable to that website, the incremental improvement of cash flow over a base case. Now, if there is no base case, then you might ascribe the entirety of the sales and marketing component to the website, absent any other marketing or distribution channels.

SW: What about clicks or Google ranking?

MP: Unless it turns into dollars, who cares? This is the trouble that we got into with the dot-coms. I never got into that trouble because I thought the methods were theoretically invalid. You get into things like the value of the website is the number of eyeballs or the number clicks. Heck no. I can't go to the grocery store and buy roast beef based on the number of clicks on my site. There's a lot of junk science in this area, and it doesn't have any credibility.

SW: Let's say somebody is in a startup phase and they've been able to develop these Web metrics, but they don't have the cash flow yet. Are you saying that you can't put a value on a website that doesn't have cash flow because it gets you back to the dot-com era?

MP: What I'm saying is that you're going to have an expectation of future cash flows and that has to have some economic substance associated with it. It has nothing to do with how many eyes are looking at it. YouTube is a perfect example. Google paid $1.65 billion for YouTube in 2006, but I would argue that the Google shareholders have nothing to show for it. Google's search algorithm is so profitable that it pays for some bad decisions. Two years ago, I looked at 10 Justin Bieber videos and determined that Google loses money hosting those videos. Google doesn't disclose YouTube financials in its annual report. They say it's not material, even though YouTube is the third most visited site on the Internet; they're scrounging every way they can to make money on that site. I don't really care if they have a billion views a month because it doesn't turn into cash flow at the end of the day.

SW: You're talking about this using an income approach, but is there an asset approach that might take those metrics into account?

MP: No, it's a losing asset. Think of it in terms of real estate. What's the value of a building that, on paper, is worth a million dollars but has $68 million in environmental liabilities? Who's going to buy it? That's the carrying value of YouTube. Not those numbers, of course, but the principle.

SW: Can you give me a recent engagement where this issue came up and you had an owner who said to you, "What do you mean, there's no value to this website?" Have you had these kinds of arguments recently?

MP: Of course. That's why I'm so quick on the responses here. I had somebody call me up. They wanted to sell a domain name and wanted a "strong" valuation. So I tell them, "Let me get this straight. You have a domain name that you paid $13 a year to maintain, and you think that's worth $12 billion?" I turned the job down. The product that was of interest in that domain name was doing a billion dollars in sales. Nobody cares, because they're getting the sales without the domain name. When a business owner says, "I've got a million dollars invested in it," I say, "I don't care. What's the economic benefit?"

SW: Some websites are just nice billboards, but you can't do any e-commerce on the site. Others allow you to buy something there. Isn't the latter, by definition, worth more?

MP: Not at all. As a matter of fact, we don't have e-commerce on our site, but it's still a remarkable engine for growth for Pellegrino & Associates. Why is that? If we look at the alternatives to websites for getting the message out, there's speaking, there's writing, there's magazine ads. All of those things have a cost measured in cost per thousand impressions. If you type in anything in Google on patent or copyright valuation, we're the number-one listing. There is no amount of money I wouldn't spend on that because marketing professionals would be salivating at our CPMs. My CPMs are about $500 to $600 per thousand impressions. What's the CPM for a typical television ad? Maybe $8. What's the CPM for a Facebook ad? Maybe 50 cents? I'm paying a thousand times that. But the return is there for me.

Valuing Web Traffic: Another Viewpoint

Just because a website has little or no cash flow doesn't mean there's no market for the site. Just ask David Gass of Las Vegas, who has been buying and selling websites for five years at www.buyingandsellingwebsites.com.

Some of these websites generate cash flow, and some don't. "A lot of people out there have websites who don't know how to generate revenue off of them," says Gass, who holds a bachelor's degree in hotel and restaurant management from the University of Nevada at Las Vegas. "They've got a ton of traffic, but they're not doing much with it. Maybe they're just making a few hundred dollars with it. Someone might be able to buy it and turn it into $10,000 or $20,000 a month because they know what they're doing."

Gass says sites that don't have cash flow are priced based on the value of the traffic coming to the site, which you can determine by going to Google Analytics, a service with a free and premium version. "They have an analytics report that you can install on your website that will tell you exactly where every visitor comes from, what they do on the site, and how engaged they are," he says. Let's say someone is getting 10,000 hits a month. Google will tell you what people are spending on a cost-per-click basis to get that traffic. "If a person is paying a dollar per unique visitor to come to their site, then there's a value attached to that traffic," he says.

"We have created a spreadsheet that we use with 220 different metrics. We don't just look at traffic. We want to know where the traffic is coming from. Is it paid? Is it organic? We try to understand who the users are and how engaged they are. Are they just coming to the site and leaving, or do they continue to come back?" With paid traffic, you pay Google or another provider to drive traffic to your website. In contrast, organic search is free. "We find that paid traffic is more valuable than organic traffic because it's more predictable."

SW: How would you value your own website and make it separate from your business?

MP: Whenever a call comes in, I track the source. We know the source of all of our products, whether it is an article I wrote, an ad that I ran, a speech I made … this is why I don't participate in certain marketing activities—there's no return to it.

SW: You said you were number one every time someone types in your name, but the result is that you get a lot of revenue from the website and that's what you care about.

MP: That's true. It has to translate into economic activity. So, in my case, I can translate my number-one Google position in patent valuation into economic activity.

SW: In your case, the website has value only if your other business is there. If you went out of business personally, the website has no value anymore. It's not a separate living thing.

MP: That's not necessarily true. Companies go out of business all the time, but those assets might still have value in terms of brand equity. Look at Kodak. The company is in bankruptcy, but some of its assets still generate over a billion dollars in sales. How can that be if they're worthless? They've got their intellectual property portfolio and the Kodak brand.

SW: If somebody, say, a family business, comes to me and says, "We're doing most of our business on the Web. We have a really great position on Google, and we get 90% of our revenues from our website. We still have a showroom, but it only accounts for 10% of sales." The answer is that it's not the website per se—it's the whole package. Your company exists, and it happens to be selling through your website. Does it have a separate value in and of itself? Is that an important question?

MP: The math should be the same. If the business is worth a dollar and the website contributes 90 cents to the economic activity and the traditional stuff generates a dime, then the business value doesn't change. It's just the apportionment of it. What would it cost to get those customers, if it would even be possible to get them, using other means?

As you can see from this discussion, the valuation of a website is not straightforward by any means. What's more, in an ever-changing technical world, it will only get more complex

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