Demand Media (DMD) – The Times They are a Changin'

Date: July 28, 2014

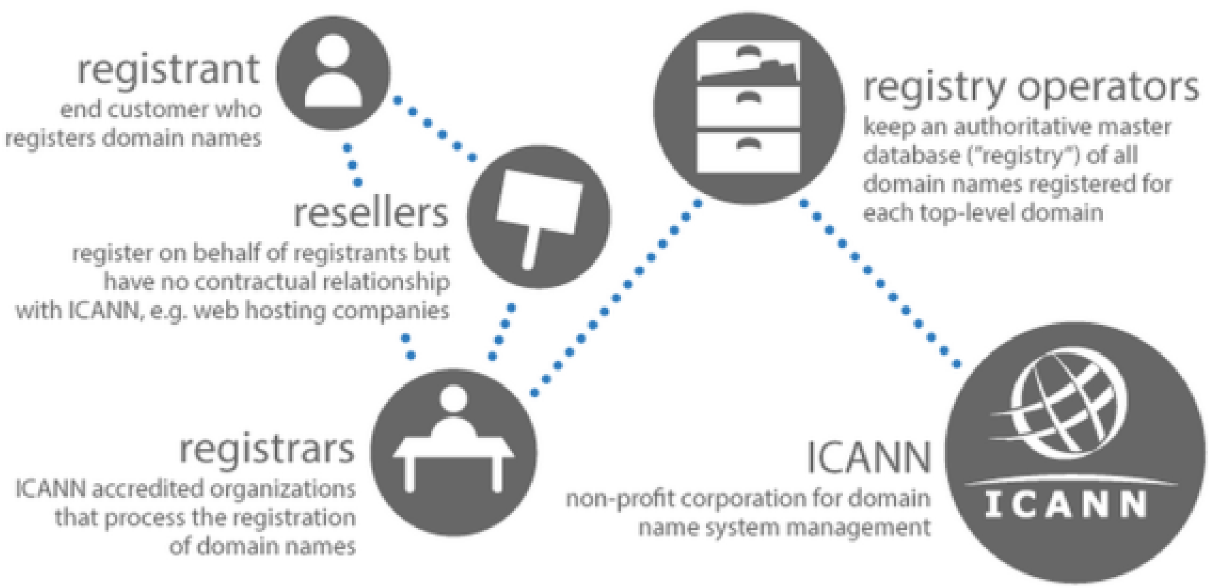
> "This is the most important and exciting change in the internet in a long, long time. Maybe since the beginning of the modern internet."
>
> *- Ben Fried, Google's Chief Information Officer (source)*

Investors should take note every time a Google exec goes on record saying they are "incredibly excited" about something because most of the time, there's a good reason for it. Which is why when I heard the above quote at Google's I/O, I decided to dig in. And what I found was a truly great business being ignored by the market with a value creation catalyst just a few trading days away.

Let's start at the bottom by walking through the modern domain registry business. There are 4 main constituents in the domain registry value chain:

- Registries - create and manage top-level domains like .com and .net (e.g., VeriSign). Technically, the registry is what makes a domain name function. It puts a domain in the right databases so the rest of the internet can find it. Every top-level domain has only 1 registry operator, making registries natural monopolies.
- Registrars - sell top-level domains from Registries; accredited by ICANN (e.g., GoDaddy, Name.com, Network Solutions, etc)
- Resellers – partner with Registrars (e.g., Web hosting companies)
- Registrants - purchase top-level domains (e.g., businesses and consumers)

Here's a view of the marketplace:



In terms of who gets what, the economic breakdown of every .com sold looks like this (average sales price is about $10 today):

- ICANN (non-profit; charges for operating costs): $0.18 (2%)
- Registry operator (VeriSign): $7.85 (78%)
- Registrars / Resellers split: $2 (20%)

As you can see, the closer you are to ICANN, the more value you capture. **The registry operator is clearly king, keeping 78% of the economics from every .com sold.**

Today, VeriSign is the registry king. VRSN runs the ICANN-mandated monopoly registry that powers the .com and .net top level domains. For every .com sold, VRSN keeps nearly $8. For every .net, VRSN gets nearly $6. It's good to be VeriSign.

But as Bob Dylan once put it, **the times they are a changin'**.

Times are changing because the internet has become too successful. Names – the key to making the internet work for us humans – have to be readable, memorable and meaningful. But as the internet has grown, finding a sensible domain name has become increasingly difficult. They are simply all sold out. As an example, there are 456,976 possible four letter .com domains. Guess how many remain unregistered today?

0.

In response to this, ICANN is unleashing a huge amount of generic top-level domains (e.g., .app, .social, etc). Currently, there are over 1,400 top-level domains approved and moving through the ICANN activation program. It is this program that Ben Fried, Google's CIO, was referring to when he said, "This is the most important and exciting change in the internet in a long, long time. Maybe since the beginning of the modern internet."

This program will expand the internet namespace beyond the realms of .com, .gov and .org. **And this expansion creates enormous opportunity for Demand Media and its subsidiary Rightside.**

You see, Demand Media owns Rightside (here). Rightside is the second largest domain registrar behind GoDaddy (source) and the world's largest wholesale registrar, with >20,000 active resellers. As of 1Q14, Rightside had more than 16MM domains under management.

Rightside's business has always been interesting, but it's been a business relegated to the bottom end of the value chain. By definition, it wasn't a high-quality business like VeriSign.

But times they are a changin'.

In the shift to generic top-level domains (gTLDs), new registries had to be created. And Rightside has capitalized on this opportunity by leapfrogging from registrar to registry operator –

the very top end of the value chain. Correction: they aren't just sitting at the top end of the value chain. **They have become the owners of the entire domain registry value chain for 29 gTLDs.**

Combining their leading domain distribution network with a registry business means Rightside won't capture 78% of the incremental revenues on gTLD sales, but something closer to 100% (note: historically, ICANN prohibited registries from owning more than 15% of a registrar; there is no such restrictions with the new gTLD program). This dramatic shift in economic positioning isn't well understood by most investors.

What's also not well understood is how dramatically the economics of the business are changing. You see, today ICANN controls the prices for .com and .net domains – there is a ceiling on what VeriSign can charge. But with the new gTLDs, ICANN no longer sets the price – Rightside does. Already, on average, new gTLDs are priced more than double the prices of .com and .net (source, p 109). Over time, I expect that fee to increase – to the direct benefit of Rightside shareholders.

Pulling these two levers at the same time (ownership of the entire value chain along with unregulated price increases) means the cash generation capability of Rightside is only limited by the popularity of their gTLDs. So let's take a look at the 29 gTLDs Rightside currently owns (source). They are:

.actor
.airforce
.army
.attorney
.consulting
.dance
.degree
.democrat
.dentist
.engineer
.futbol
.gives
.haus
.immobilien
.kaufen
.lawyer
.market
.moda
.mortgage
.navy
.ninja
.pub
.rehab
.republican

.reviews
.rocs
.social
.software
.vet

I don't have much of an opinion on the future popularity of these gTLDs. But I can point to something that I think is interesting – the manner in which Rightside went about acquiring these gTLDs. To understand how they did it, you need to understand how Demand Media (the parent) approaches their content business:

> DMD deploys algorithms to scour search terms from billions of daily search queries and internet traffic activity to find certain popular keywords and phrases. These keywords are then compared to rates that advertisers are willing to pay to be associated with that keyword. Once a phrase is deemed to be profitable, DMD generates a headline from that phrase which is then turned into an article by a legion of waiting freelancers.
>
> Source: Anon Analytics (here)

In a similar way, Rightside performed an analysis of new TLD opportunities by data mining everything from markets to user behavior to linguistic nuances (source). When they found an opportunity they deemed big enough, they plunked down $185,000 to apply for the gTLD (total initial investment is approx. $500,000 per gTLD; annual maintenance is likely around $200,000 per gTLD). It's hard to find fault in this data-based approach.

In any event, Rightside is now the registry operator for 29 gTLDs (14 of which have recently launched). But through their rights-sharing agreement with Donuts (a VC-funded gTLD acquisition vehicle, here), Rightside is an economic participant in 139 more (source), with hundreds of applications still pending (source).

What does this mean? It means that Rightside will be providing registry services (the top part of the value chain) to more than 20% of the new gTLDs that are created. This will make Rightside one of the largest end-to-end domain name companies in the world.

The times they are a changin'.

Like VeriSign, Rightside is now positioned as an internet toll booth. And it's the best type of toll both: one with high barriers to entry, low maintenance CapEx, gross margins approaching 100% and perhaps most importantly – and unlike VeriSign – unregulated pricing power. This is the type of business investors dream about owning.

So why then is the market treating the parent (Demand Media) like a dog?

Mostly likely because DMD's content business has struggled post Google's 2011 – 2013 search algorithm changes. Instead of writing up all the issues at DMD, I'll point you to Anon

Analytics, which did a decent job covering the company in May – see here.

Personally, I have no interest in owning the content business. I want to own Rightside – one of the truly great upcoming internet infrastructure businesses. But given that it exists inside DMD, how would you access it?

In this case, the answer is the opportunity: DMD is spinning off Rightside (ticker = NAME) on August 1.

So accessing NAME can be done by buying the when-issued stock, which started trading this past Friday under NAMEV.

The only remaining question is: what do you pay for NAME?

Well, there's the existing registrar business, which I'd value at $10 per domain (that's a discount to the $12 per domain DMD paid for Name.com in Dec-12; source), there's $25MM in cash (source, p 154) and zero debt. That's $185MM.

Plus there's the registry business, which I view in two separate buckets:

1. 29 company-owned gTLDs that will generate nearly 100% incremental gross margins. This is the part of the business where Rightside will own the entire domain registration value chain.
2. A strategic alliance with Donuts where Rightside will provide back-end registry services for their gTLDs.

Here's what the unit economics look like (source, p 14):

	.COM on Rightside Registrar	.GURU on Rightside Registrar	.SOCIAL on GoDaddy	.SOCIAL on Rightside Registrar
Revenue	$9	~$30	$20	~$30
Cost to Registry	~$8	$20	$0	$0
Direct Profit (1)	$1	$10	$20	$30
Direct Margin (1)	11%	33%	>90%	>90%

(1) Direct profit defined as domain registration revenue less registration costs paid to the registry

As you can see, bucket #1 (the 29 company-owned gTLDs) is represented by the last two columns on right. Rightside gets ~100% incremental margin and the only question is who originates the sale – their in-house registrar or someone else (e.g., GoDaddy)?

Bucket #2 isn't accurately represented in the above table. For that, let's assume their "equal rights" agreement with Donuts – an agreement which remains non-public – means any revenue is split 50/50. That means Rightside will get either $15 per domain (if sold direct to consumers via their registrar) or $10 per domain (if sold through another registrar).

To value the registry business, you then have to take a guess on how many gTLD domains will be sold.

It's a difficult analysis but we do have one early data point (source, p 14):

> To date, over 300 gTLDs have been launched and more than 1.3 million domain names have been registered within the New gTLD Program. Of those domain names registered, over 50% operate on Rightside's registry platform.

Keep in mind, this program just launched in December 2013 (here) and many of the gTLDs aren't even released yet. So consumer awareness is very, very low. But even still, Rightside is operating 650,000 domains via its registry. Assuming the lowest end revenue contribution per domain ($10), Rightside is doing $6.5MM in high-margin revenue. Put a 10x multiple on that and add it to the $185MM calculated above and Rightside is worth $250MM.

But that's backwards looking. And doing a backwards looking calculation in a blue sky growth market doesn't make any sense. So let's look forward and try and frame what the gTLD business will look like in 10 years. Currently, there are 271MM internet domain names and that number is growing at over 7% per year (source). Do you think gTLDs could get to 100MM domains? I do. What about 300MM domains? In 10 years, I'd say the probability is >50% (remember, domain aren't mutually exclusive; it's much more likely that Starbucks will own starbucks.com and starbucks.coffee; this is true for most businesses, especially given the de minimis annual cost of a domain name). So let's use 100MM and assume Rightside powers 20% of those domain names via its registry business. Assuming the lowest revenue contribution per domain ($10), no future price increases, 60% operating margins (on par with VRSN) and a 10x multiple, Rightside's registry business would be worth:

20MM domains x $10 per domain x 60% margins x 10 multiple = $1.2BN

Demanding a 15% return per year (implying a double every 5 years) means an investor should be willing to pay $300MM today for this business. Add that to the $185MM from above and you're at nearly $500MM. So that's where I'm drawing my line – I'm a buyer of NAME all the way up to $500MM EV.

Considering the market currently is valuing NAME at peanuts inside of DMD, today's investors are given the rare opportunity of buying into a truly fabulous business – a metaphorical internet toll bridge – for next to $0.

These times they will change. And you might never get this chance again.