

PAC.NW TRAVEL ONLINE

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CASE DESCRIPTION

Michael Powers licensed a series of domain names that he thought would allow him to create a profitable set of online tourism marketing sites. The case asks students to evaluate the feasibility of the business, given Michael's projections. Given what they find, students are then asked to assess how reasonable are two of his current arrangements with stakeholders. The case allows students to practice fundamental valuation techniques on a cutting-edge business model. It is targeted toward MBA and advanced undergraduate corporate finance courses.

JEL: G10, G11

KEYWORDS: SEO, SEM, Internet Marketing, Private Firm Valuation

CASE DESCRIPTION

After fees?!” Michael Powers could not believe what he had just heard. ViewIT—the company he was hiring to do the actual *work* on his supposedly “passive-income” internet venture—was now demanding that it receive half of whatever was left after Michael paid their costs. As if half of revenues *before* costs was not bad enough! This 11th-hour demand could send 60% of Michael’s revenues straight to ViewIT. How was he supposed to make any money? If he could not figure out a way to counter this demand from ViewIT, maybe he could renegotiate the perpetual 10% of revenues he had promised his dad (his “venture capitalist”). He would have to think of something fast, or give up on the ticket to his future—his internet start-up, Pac.NW Travel Online.

MICHAEL POWERS

Michael Powers was a risk-taker, but not a fool. He was a black-diamond freestyle skier (“chutes, cliffs, and trees”), competitive downhill mountain biker, and avid longboarder. Whatever the game was, he wanted to win—assuming he liked the odds.

Michael graduated in 2006 from a small, liberal-arts college in Washington state, where he was a standout in his honors business program. In his junior year, he decided to give up varsity soccer for an internship, where he was fortunate enough to meet an experienced real-estate entrepreneur. Michael realized he loved real estate, and immediately started lobbying his father to help him buy a house close to campus (a house he still kept as a rental).

After graduating (and after a year as a ski instructor—fun, but not professionally challenging), he applied for a job as marketing coordinator for which he was not remotely qualified. Surprisingly, he got it; perhaps not surprisingly, he succeeded brilliantly.

The job was to market a town and manage its rental business. The town, Newoston, Washington, was the brainchild of fellow college alum and new-urbanist visionary Kelvin C. Rolf. Kelvin was a developer whose dream had always been to found a new town along the Washington coast. He started Newoston in 2002 on an unplatted pile of sand. The town would eventually be a walkable blend of retail and residential areas, with 1,000 homes all carefully designed to ensure a consistent New England-style look. Homeowners could rent their homes to vacationers, and one of Newoston Land Company’s jobs was to manage those rentals. That is where Michael came in.

Michael started as Newoston's marketing coordinator in early 2007, working under the director. Within a year, he was the only person in the entire marketing department. As the credit crisis of 2008 ground the real estate market to a halt, he quickly spearheaded the company's push online; in three years, he reduced online ad spending tenfold, while increasing the e-commerce "capture" by 35% every year. In 2010 he was promoted to director of sales and marketing. He continued developing online platforms—implementing systems to manage rental reservations, home-sale prospects, and web-generated lead data—increasing Newoston's revenues by 58%/year. His efforts paid off in accolades: one of Newoston's multimillion-dollar homes was named the "ultimate beach house" by *Coastal Living* magazine, and Newoston itself beat out 400 other competitors to become "residential project of the year." Kelvin recognized Michael's contributions, and in 2011 promoted him again, this time to Vice President of Business Development.

All was not all wine and roses for Michael and Newoston, however. He was in the very highest echelons of the company, but he was also probably as high up as he could go. Kelvin ran the company. The CFO, who had been with Kelvin since the beginning, was not going anywhere. There really were no other jobs above Michael's. Added to his lack of mobility were the tensions of the job he did have. Michael oversaw the sales team, but the majority of that team came from Kelvin's immediate family. Some of them were great salespeople; others were impervious to Michael's suggestions for improvement, and Kelvin was apparently unwilling to encourage them. Kelvin also seemed less than enthusiastic about Michael's career development goals. Kelvin had acted betrayed when Michael enrolled in law school to learn more about real estate law. (For Kelvin, it was bad enough that Michael—the Director of Sales and Marketing!—had decided to sell his Newoston house, which, unlike the campus-area rental, was not generating sufficient income.) Michael managed to convince him that Newoston would benefit from having legal expertise in-house, but the rift in their relationship persisted.

Michael excelled in law school, even starting a real estate club there. However, full-time school and full-time work (work that required a six-hour round-trip commute from Seattle to Newoston every weekend) took its toll. Faced with the prospect of adding a required law-clerking position his first summer, Michael reluctantly took a leave from school.

However, there was still his day job, which was not getting any better. Michael began to think more often about being his own boss. He had already taken steps to start his own online travel business—securing what he thought were nearly bullet-proof internet domain names. He wanted to use them to leverage his expertise in internet marketing, creating a business that could almost run itself: Pac.NW Travel Online.

PAC.NW TRAVEL ONLINE

Michael formed Pac.NW in the summer of 2011 after obtaining rights to 90 destination and real estate domain names. These domain names contained valuable keywords that would perform well in Google's search algorithm. He wanted to develop the sites to provide tourism information—lists of hotels and restaurants, publicity for local events—for towns along the west coast. He believed his business plan would capitalize on the growing demand for "hyper-local" content, publishing user reviews and local vendor content for highly targeted locations (like Coos Bay, Oregon, a town of 16,000 people).

Michael believed that the time was right for hyper-local tourism sites. The bad economy had forced many states to cut back or eliminate their own tourism spending. Tourists increasingly were looking to the web for trip planning, but local businesses did not have the type of search engine optimization (SEO) expertise that would allow them to promote themselves effectively. Pac.NW could step into the void left by the state tourism boards and provide small businesses with a user-friendly advertising platform—all facilitated, of course, by Michael's expertise in internet marketing.

Michael identified numerous possible revenue streams from Pac.NW. These are summarized in Table 1 and discussed briefly below.

Table 1: Summary of Revenue Sources for Pac.NW

REVENUE SOURCE	CATEGORIES	TYPES OF FEES
Business Listings	hotel/motel B&B RV & camping food & drink activities shopping services	monthly listing fee based on term of ad: Semiannual Annual
Vacation Rentals		monthly listing fee based on term of ad: semiannual annual plus per-unit fee
Events	premier basic	monthly fee
Display Advertisements	small-market mid-market major-market	monthly listing fee based on term of ad: Monthly Quarterly Semiannual annual and on ad intensities: awareness leader exposure

The “revenue sources” listed above are the four primary sales generators for Pac.NW: business listings, vacation rentals, events, and display advertisements. The types of fees associated with each revenue source are listed in the third column.

REVENUE

Business Listings

Pac.NW would allow local businesses to list in a directory, with categories like “hotel/motel” and “food & drink.” Michael estimated monthly listing fees ranging from \$7.20 to \$19.76, based on fees charged by another site. (See Table 2.) For example, a 1-year listing for a hotel in Lincoln City, Oregon (a very popular tourist destination, featuring a large casino) was \$37.60/month; a similar listing in Tillamook, Oregon (home of a cheese factory) was only \$12.00/month. Six-month listings were slightly more expensive, so, to be conservative, Michael used the 1-year rates in his projections.

Although Michael had seven business listing categories, incorporating them all into his expected revenue projections gave him “growth that seemed way too fast.” He decided to “fix” this result by using an average listing rate. Thus, Michael’s adjusted estimates account for business listing revenue as if he had only one type of listing—priced at an average rate—instead of the actual seven. He expected to start in month 4 with 3 listings at tiers I and III, and 2 at tier II. (Tiers are discussed below).

Vacation Rentals

Pac.NW also would list properties available for rent. Rental listings required property managers to pay two types of fees: one for the business listing itself, and another for each unit listed (the per-unit fee). Each fee could be based on a 1-year or 6-month contract. As with the business listings, the 1-year contract was less expensive; again, Michael used the annual term for his projections. His month-4 estimate was for 1 business listing with 5 per-unit fees at all tiers.

Table 2: Monthly Fees for Business Listings

	<u>Average</u>	<u>Maximum</u>	<u>Minimum</u>	<u>Mode</u>	<u>Median</u>
<u>Hotel/Motel</u>					
Semiannual	\$24.71	\$47.00	\$15.00	\$16.00	\$20.00
Annual	\$19.76	\$37.60	\$12.00	\$12.80	\$16.00
<u>B&B</u>					
Semiannual	\$10.47	\$12.00	\$9.00	\$10.00	\$10.00
Annual	\$8.38	\$9.60	\$7.20	\$8.00	\$8.00
<u>RV & Camping</u>					
Semiannual	\$9.47	\$16.00	\$9.00	\$9.00	\$9.00
Annual	\$7.58	\$12.80	\$7.20	\$7.20	\$7.20
<u>Food & Drink</u>					
Semiannual	\$9.00	\$9.00	\$9.00	\$9.00	\$9.00
Annual	\$7.20	\$7.20	\$7.20	\$7.20	\$7.20
<u>Activities</u>					
Semiannual	\$12.00	\$12.00	\$10.00	\$10.00	\$10.00
Annual	\$8.00	\$9.60	\$8.00	\$8.00	\$8.00
<u>Shopping</u>					
Semiannual	\$9.00	\$9.00	\$9.00	\$9.00	\$9.00
Annual	\$7.20	\$7.20	\$7.20	\$7.20	\$7.20
<u>Services</u>					
Semiannual	\$9.00	\$9.00	\$9.00	\$9.00	\$9.00
Annual	\$7.20	\$7.20	\$7.20	\$7.20	\$7.20
<u>All 7 Listing Types</u>					
Semiannual	\$11.73				
Annual	\$9.38				

The monthly fees for various listings used in the Pac.NW projections are averages of destination-specific charges for 17 specific northwest destinations. For example, the \$19.76/month used to price the hotel/motel listings is the arithmetic average of the actual charges for hotel/motel listings for the various destinations (assuming an annual contract), which range from \$12.00/month for Tillamook, OR, to \$37.60/month for Lincoln City, OR. The underlying fees were estimated by ViewIT. Michael used the annual-term average of all seven listing types, \$9.38, to estimate his business-listing revenues.

Table 3 gives Michael's five-year estimates for these first three revenue streams.

Table 3: Estimates for Growth in Business Listings, Vacation Rentals, and Events for First Five Years

		<u>Months</u>				
		5-12	13-24	25-36	37-48	49-60
TIER I	business listings (7 types)	15%	10%	5%	5%	2.5%
	vacation rentals (both fees)	15%	10%	5%	5%	2.5%
	events (both basic & premier)	15%	10%	5%	2.5%	1.25%
TIER II	business listings (7 types)	15%	10%	5%	5%	2.5%
	vacation rentals:					
	annual fee	15%	10%	5% through t=26, then flat at 10 units		
	per-unit fee	15%	10%	5% for t=25, then flat at 50 units		
	events (both basic & premier)	15%	10%	5%	2.5%	1.25%
TIER III	business listings (7 types)	15%	10%	5% through t=30, then flat at 40 units		
	vacation rentals:					
	annual fee	15%	10% through t=17, then flat at 5 units			
	per-unit fee	15%	10% through t=14, then flat at 20 units			
	events (both basic & premier)	15%	10%	5%	2.5%	1.25%

This table presents Michael's estimates for business listings, vacation rentals, and events. The entries give either the number of units (e.g., 10 vacation-rental annual fees per month for tier II after t=27) or percent growth (e.g., 15% per month for months 5 through 12 for tier-I business listings).

Display Advertisements

Display advertisements would allow businesses to post special ads on the sites—like billboards along the highway—giving much more information than a simple business listing. Pac.NW would offer three display ad products, based on the intensity of the ad: “awareness,” “leader,” and “maximum exposure.” “Awareness” was the least expensive, but offered the least space; “maximum exposure” was, as its name

suggested, the top-of-the-line option. The products' cost depended on the size of the advertiser's market segment (small, medium, or "major"). Larger markets demanded higher fees.

The company Michael was considering to manage his sites, ViewIT, had recommended prices for each ad product, based on rates charged by their current customers in Spokane, Washington. Michael found the pricing structure reasonable, compared to what he was used to. For example, the "pencil ads" he placed on the *Seattle Times*' website cost \$6,000 per week. (Pencil ads were as wide as the webpage—450 pixels—and 10 pixels tall, or about the size of a pencil.) Print ads were also as expensive as always: \$100,000/month for a full page in *Sunset* magazine, or \$50,000/month in *Coastal Living*.

The pricing structure was the same for all three of Pac.NW's tiers, or website groupings. (See Table 4.) Prices were based on an ad term of one month. If an advertiser chose a longer term, he got a discount: quarterly ads cost 95% of the monthly rate, semiannual ads 90%, and annual ads only 80%. Michael had chosen to use the annual rate for all of his projections. His estimates for the number of ads he can sell at each tier are shown in Table 5.

Table 4: Prices for Display Ads

SMALL MARKET	Awareness	Leader	Exposure
Monthly	\$195	\$495	\$995
Quarterly	\$185	\$470	\$945
6 months	\$175	\$445	\$895
Annual	\$155	\$395	\$795
MID MARKET	Awareness	Leader	Exposure
Monthly	\$295	\$695	\$1,295
Quarterly	\$280	\$660	\$1,230
6 months	\$265	\$625	\$1,165
Annual	\$235	\$555	\$1,035
MAJOR MARKET	Awareness	Leader	Exposure
Monthly	\$395	\$895	\$1,795
Quarterly	\$375	\$850	\$1,705
6 months	\$355	\$805	\$1,615
Annual	\$315	\$715	\$1,435

This table gives ViewIT's suggested prices for the various market/intensity combinations for display ads. As the term of the ad got longer, the monthly fee fell. Exposure ads were the most expensive intensity option; for market segments, major-market ads were the most expensive.

There were two other ways the company could make money besides those listed In Table 1: affiliate marketing and real estate commissions. Pac.NW would earn affiliate revenues if a visitor to one of its sites clicked through to an affiliate's site (for example, to the travel booking site Kayak); each click-through meant 20¢ for Pac.NW. Google helped here, too. Its content network automatically tracked available space on webpages and placed its own ad inventory there; the rates it paid on click-throughs depended on the popularity of the original search term. (Michael considered these payments his "last ditch" way to make money.) For the real estate listings, Pac.NW would earn 25% of the commission on any house sold to a buyer who was referred through its sites. Pac.NW would forward contact forms completed on its sites by interested buyers to local brokers. When a broker closed the sale, Pac.NW would get its commission. Michael thought there was a lot of potential in these commissions and in the affiliate revenues, but—to be conservative—he left them out of his initial revenue estimates.

EXPENSES

Pac.NW had a fairly simple cost structure. (See Table 6.) There were start-up costs, ongoing maintenance costs, and monthly payments to Michael's "venture capitalist" and his license holder. The licensing fees would go to Larry Carter, who actually owned the domain names. Michael had promised him a monthly payment, plus a percentage of the firm's revenues, for 20 years. His VC—also known as

his father, Joseph—would get 10% of monthly revenues in return for paying the start-up costs. Those costs, plus the monthly variable maintenance costs, were specified in Michael’s contract with ViewIT (a company that sold content management systems and services to site owners)—the contract he needed to renegotiate.

Table 5: Estimates for Display Ad Sales

		Month						
		4	5	6	7	8	9	10+
TIER I								
small:	awareness				3 for all			
	leader	2	3	4	5	6	6	6
	exposure				1 for all			
mid:	awareness	1	3	5	5	5	5	5
	leader	2	4	6	8	10	11	11
	exposure	1	2	2	2	2	2	2
major:	awareness	2	4	6	8	8	8	8
	leader	2	5	7	10	12	15	17
	exposure	1	3	4	4	4	4	4
TIER II								
small:	awareness				3 for all			
	leader	2	3	4	5	6	6	6
	exposure				1 for all			
mid:	awareness	1	3	5	5	5	5	5
	leader	2	4	6	8	8	8	8
	exposure	1	2	2	2	2	2	2
major:	awareness	2	4	6	8	8	8	8
	leader	2	5	7	10	10	10	10
	exposure	1	3	4	4	4	4	4
TIER III								
small:	awareness	2	4	6	8	8	8	8
	leader	2	5	7	10	12	15	17
	exposure	1	3	4	4	4	4	4

This table gives Michael’s estimates for the number of display ads for the three tiers for all 60 months.

Licenseholder Fees

Larry Carter owned Michael’s domain names, but was willing to license them for a fee. Larry had a mini-empire of domain names—having purchased as many tourism-related URLs as he could in the mid-90s—but had let all but one, *Washington waterfronts*, languish. He launched that one in 1998, and it rewarded him with 15 years of solid real estate leads. However, by 2010, Larry admitted to himself that he lacked the passion to build a comprehensive marketing platform using his other names. He was familiar with Newston Land Company, though, so he knew Michael. Michael was the man to build his URL empire.

Larry agreed to license the sites to Michael in return for monthly payments plus a share of the sites’ revenues. There were three sets of sites. “Tier I” sites were the potentially most valuable domains: *Visit Oregon*, *Washington Waterfronts*, and *California Waterfront*. Michael thought that these three domain names alone would be enough to make Pac.NW profitable. “Tier III” sites were “small-market” sites (e.g., *Visit San Juan Island*). In between were Michael’s “broad-scope sites”—*Visit King County*, *Visit Pierce County*, and *Visit Bellevue*. (King and Pierce counties are the homes to Seattle and Tacoma, Washington, respectively; Bellevue is a large, wealthy city across Lake Washington from Seattle, near the home office of Microsoft.) For tier I, Larry wanted \$5,000 per month (or 50% of revenues, whichever was lower), plus annual payments of 2% of the prior year’s revenue. (These annual payments were due in

months 15, 25, 37, 49, and 60, at 2% of revenue from months 4-12, 13-24, 25-36, 37-48, and 49-60, respectively.) For both tiers II and III, he asked for a monthly fee of 18% of revenue, with no minimum, maximum, or additional annual fee.

Table 6: Pac.NW's Cost Structure

FEE TYPE	CATEGORIES	FEE STRUCTURE
Licenseholder Fees	tier I	monthly fees based on tier::
	tier II	tier I: lower of \$5,000 or 50% of revenues
	tier III	plus 2% of prior year's revenues
		tier II: 18% of revenue
		tier III: 18% of revenue
"Venture Capitalist" Fees		10% of monthly revenue
Start-up Fees	CMS	\$95,000 for CMS
	area-specific modules	plus \$20,000 per module
Management Fees	costs	ViewIT's monthly costs
	revenue share	plus 50% of remaining revenues
		(up to 60% of monthly revenues)

This table describes Pac.NW's four types of costs. Most are percentages of revenue, although there is a minimum payment for the license holder.

Monthly Payments to "Venture Capitalist"

Michael's VC was his father. Joseph had recently retired from his job as senior VP of human resources for a multibillion-dollar international manufacturing firm. He was already Michael's business partner, since he owned half of both the university-area rental house and the vacation house at Newoston. Joseph was ready to invest in Pac.NW, too, and had agreed to borrow \$155,000 from his retirement fund (paying LIBOR for the privilege) to launch the first set of sites. In return, Michael had promised him 10% of monthly revenues, indefinitely. Even at that rate, Joseph acknowledged that it might take ten years to get his money back (telling Michael, "if the world ends tomorrow, this is the amount of money I'd be willing to kiss goodbye...and don't expect an inheritance!").

Start-up Costs

The most significant initial capital expense for Pac.NW was the content management system (CMS). This system would allow Michael to control each site's content and appearance without a web designer. The CMS also integrated the sites with social media, so that Michael could take a snippet of a published article and distribute it widely with just the click of a mouse. ("Just another cheap way to drive traffic and subsequently advertising dollars!") Perhaps most importantly, the CMS would provide the statistics (click-throughs, page views, impressions) that tracked the sites' activity.

Michael would buy the CMS from ViewIT for \$95,000. ViewIT also charged \$20,000 for each customized module that provided area-specific information like local weather. Michael needed three of these modules for his first three tiers, so his total initial payment to ViewIT would be \$155,000. Michael knew that these costs were standard for the business. Nonetheless, he had been negotiating with ViewIT about the timing of this payment. He wanted to defer 30% of the cost, \$46,500, for twelve months.

Monthly Fees to ViewIT

ViewIT would manage the sites, and also would be responsible for selling all display ads, business listings, vacation rental ads, and event ads. (This is why Michael considered Pac.NW to be a “passive-income” business.) In return, ViewIT wanted 50% of the monthly revenues generated from these four sources. (ViewIT got no payments from affiliate marketing or real estate referrals.) Michael initially thought this meant that he and ViewIT would share the sites’ revenues equally, but had just learned—during their ongoing negotiations—that ViewIT wanted 50% of the revenue that was left *after* Michael paid their costs. Thus, ViewIT not only wanted payment for the costs it incurred in managing Pac.NW’s websites, but half of the remaining revenue as well; its total monthly compensation for month t would therefore be: $\text{costs}_t + .50 * (\text{revenue}_t - \text{costs}_t)$. The contract specified that compensated costs could not exceed 20% of revenues, so ViewIT could take, at most, 60% of Pac.NW’s monthly revenues. Michael was extremely uncomfortable ViewIT’s last-minute (in Michael’s opinion) demand for a 60/40 split. He had floated the idea of making payment contingent on some (unspecified) performance-based metrics, but ViewIT rebuffed him. Michael was afraid Pac.NW would not pencil-out at 60/40; he thought his dream of being his own boss was evaporating before his eyes. He had to find some way to renegotiate *something*—the start-up fees, ViewIT’s monthly payments, his dad’s take—in order to salvage this business.

THE RENEGOTIATIONS

Michael thought that the domain names he had licensed from Larry Carter were “money.” His dad had been ready, willing, and able to give him the start-up funds. Then came ViewIT’s eleventh-hour demand that they be paid 50% after costs, not just 50% off the top. Michael thought ViewIT should prove itself before he handed over 60% of his revenue; he wanted to work out a deal to defer some of the start-up costs or to reduce their percentage. They seemed unwilling to deal, though—they had plenty of work.

Michael reluctantly began to confront the fact that his only leeway might be with his father. He had promised Joseph 10% of revenues because 10% was a round number and sounded fair. But was it *too* fair? Was he giving away the store? Michael felt he needed to come up with several alternative proposals that would compensate his father equitably but still allow Pac.NW to succeed—even if ViewIT would not deal.

Michael was sick of the long commute to Newoston and the drama he had to deal with when he got there. He wanted to go back to law school. The clock on that was ticking; pretty soon, he would have to start all over. His dad needed a decision, too; he had other opportunities for his money. Michael had to make a move now. Pac.NW could be his golden ticket, but only if it did not collapse under the weight of the upfront costs and revenue-sharing arrangements. He had to figure out how to rework his financial deals, and soon—preferably before school started again in the fall.

APPENDIX: INTERNET MARKETING BASICS

The internet opens new worlds to marketers. Instead of beaming commercials out to anonymous viewers, advertisers can monitor and analyze—in real time—user interaction with messages, tracking every click and page view. Social network data can instantly tailor ads to a specific user. This is “true psychographic advertising” (Ruxin, 2008): “Nearly instantaneously, ...companies can log your visit [and] place ads tailored for your eyes specifically... The websites you visit reshape themselves before you like a carnivorous school of fish” (Madrigal, 2012). The downside: there is *so much* material. Even back in 2008, eight hours of video were uploaded to YouTube every minute (Ruxin, 2008). In this environment, money alone is not enough to guarantee exposure—advertisers have to earn “eyeballs” by offering compelling content.

Advertisers also have to exploit Google's search algorithm. Google rules search—over two-thirds of U.S. internet queries are “Googled” (Catan and Efrati, 2011). It manages this process using algorithms to determine which results will be the most useful to the searcher (“organic” results). Useful results mean money for Google. Unless searchers actually click on an ad (“click-through”), Google does not get paid.

Click-through depends on where an ad is displayed on the search results page. One way to score a premium top position is to create “landing pages” that Google's algorithm deem high-quality. (As Michael put it, “Content = search traffic = revenue.”) Although the algorithm is proprietary, marketers know that older domains are preferred. “Exact-match domains” are given special consideration in the algorithm: in a correlation study of the relationship between “on-site/on-page” features and search rankings, no other factor “even came close” to explaining relative rankings. (In fact, the preference for exact matches was so strong—perhaps because Google wants to ensure that people searching for specific businesses find them easily—that there is a backlash brewing. Many in the search community expect Google to introduce more “subtlety” to their algorithm by mid-2011; Fishkin, 2010.) Of course, exact matches are not required: having search terms in the title, header, or URL tags makes a page appear relevant to someone searching on those words. (Header tags are section headers on a webpage; title tags are displayed in the top bar of a webpage. URL tags allow search engines to identify “duplicate” content on associated webpages.) Experienced optimizers know to use critical keywords (like “Washington” and “oceanfront”) in tags. Managing content with an eye toward performing well in the organic search is called “search engine optimization” (SEO).

Marketers can also pay for exposure through “search engine marketing” (SEM). Michael put it like this: “SEM is like crack: you pay to satisfy your fiend. SEO, though, is like rehab: you don't immediately satisfy your fiend; instead, you figure out what's driving it.”

Successful SEM depends on mastering Google's keyword auctions. These auctions allow advertisers to bid to have their ads displayed at various positions on the results page. Each position has an assumed average “conversion rate” (rate of click-throughs). (See Figure 1.) For example, an ad at the top of the page gets more clicks than one on the right-hand side; it might also be distributed among the engine's syndication partners, bringing even more clicks (Efficient Frontier, 2007). Nonetheless, an advertiser might choose to bid to a lower position, hoping to get his ad in front of the user for free (this is the “billboard effect”—getting an impression without cost).

Position was just one dimension of a bid. The keywords themselves were also critical. Online marketers made daily bids on keywords they predicted would be used in searches by their potential customers. Words like “beach,” while frequent search terms, were also bid on by more advertisers. (“Beach” marketers also had to consider words like “beech,” since there was no guarantee that their potential customers were good spellers.) Longer strings of keywords—like “Washington waterfront vacation rentals”—had better click-through rates, but required magnitudes more bids than single keywords. Marketers also had to decide how many search engines to use (Google's, Microsoft's, Yahoo's...), the number of geographic regions to target, the seasons or times of day on which to focus, the amount they could afford to spend, and the return on investment they wanted. Even a relatively simple scheme of twenty keywords targeted to twenty geographic markets on two search engines translated into 800 bids a day (Efficient Frontier, 2007). Given the complexity of the system, e-marketing was not for the faint of heart. Michael Powers was a proven competitor, and he expected Pac.NW to allow him to profit from his expertise. However, the market he knew was starting to change dramatically.

Figure 1: Stylized Results Page

Google		Oregon Coast Vacation Rentals	
Everything	1	<u>Oregon Vacation Rentals</u>	Ads
Images			Ads
Videos	2	<u>Lincoln City Vacations - Luxury Beachfront Vacation Rentals</u>	<u>Ribbon Vacation Rentals</u> 4
News			<u>Oregon Coast Getaway</u> 5
Shopping	3	<u>Oregon Beach Home Rentals</u>	<u>Oregon Coast Rentals</u> 6
Books			<u>OR Coast Cabin, Manzanita</u> 7
More			<u>Lincoln City Vacation</u> 8
<u>Sammamish, WA</u>		<u>Oregon Vacation Rentals Oregon Coast Vacation Rental Home</u>	<u>Oregon Coast Vacation</u> 9
Change location		<u>Beach House Rentals - Oregon & Washington</u>	etc.
<u>Any time</u>			
Past hour		<u>Oregon Coast Vacation Rentals</u>	
Past 24 hours			

This figure presents a stylized version of the screenshot from a search results page. The links in the grey box at the center of the figure (labeled #1 through #3) and those along the right-hand edge (labeled #4 through #9) are ads; the numbers indicate the position element of an online marketer's Google Adwords bid. Positions 1, 2, and 3 are in premium positions at the top of the page, where they should generate higher conversion (click-through) rates.

THE INTERNET ENVIRONMENT IN MID-2011

Michael was considering launching Pac.NW at a time when investors were spurning old tech companies for new “darlings,” and as the internet itself underwent significant transformations.

In mid-2011, investors seemed bored with older technology stocks. For the first time since 1992, the forward P/E ratio for technology stocks (about 12.1 times) was lower than the multiple for the S&P500 (12.4). Apple was at an even 12, Google at 13.8, and Microsoft and Intel were less than 10 (Cheng, *et al.*, 2011).

In contrast, the new-issue market was sizzling. The second quarter of 2011 was the highest-grossing quarter for internet IPOs since fall, 2000 (Ovide, 2011). One internet investor compared the internet IPO market of mid-2011 with the 1995-1996 period, when Netscape and Yahoo—firms with actual business models, not just “dot-com” names—went public. However, other investors deemed the market “frothy.” As the *Wall Street Journal* put it:

In its stock market debut this past quarter, LinkedIn briefly had a market value that on a similar sales multiple would value Apple at \$3 trillion. Groupon had a \$420 million operating loss last year, yet the daily-discounts website may leapfrog Google as the biggest U.S. internet-related initial public offering ever, based on money Groupon is expected to raise. Facebook is shooting for a stock-market value of more than \$100 billion, a price tag boasted by fewer than three dozen U.S. companies. (Ovide, 2011)

Groupon's IPO filing appeared to value the firm at \$20 billion, over 31 times its first-quarter 2011 revenue of \$644.7 million—this despite the “proliferation” of daily-deal clones (Chon and Woo, 2011; Raice and Woo, 2011). LinkedIn, which had three sources of revenue—job search, ad sales, and premium subscriptions, “each showing some healthy growth”—was priced at 16 times prior year's revenues and 100 times EBITDA (Jaffe, 2011). It closed its first day of trading at double those numbers, or 592 times earnings. “Even if you think it's a great business model, the feeling is that the valuation is way beyond what even the most bullish guys were hoping for” (Conway, 2011). Online radio company Pandora successfully priced its IPO at 12 times projected revenues (compared to a multiple of six times for internet giants Google and Apple). Many analysts were skeptical that such valuations reflected fundamental value.

The market for internet search—and the internet itself—was also evolving. (This section draws heavily on Holmes and Rhodes, 2011). In June 2011, the international body that coordinated domain names, ICANN (Internet Corporation for Assigned Names and Numbers), loosened the restrictive naming system that had previously governed web addresses. Originally, there had been 22 “generic top-level domain” names (the words coming after the “dot,” like “dot-net” or “dot-org”). Almost 45% of the more than 211 million global web addresses used the most popular of these top-level domain names, the suffix “dot-com.” ICANN’s new system allowed *anything* to follow the dot, creating an infinite number of new web-address possibilities. ICANN believed that this system would help protect firms’ brands by ensuring that counterfeiters could not use deceptively similar domain names; businesses owning their own “dot-firm” name (like “dot-PacNW”) could allow only licensed distributors to use that suffix. The system would also allow firms unable to get attractive “dot-com” addresses to create comparable “dot-web” sites.

Of course, there were downsides. The new system could lead to customer confusion, as domain names proliferated. Registration of the new suffixes was expensive: the application alone—the guidebook for which was 352 pages long—cost \$185,000. Some businesses had already concluded that the hassle was not worth it: “For us [Electronic Arts], the domains seem expensive and offer negligible value” (Holmes and Rhodes, 2011). The former chairman of ICANN warned that the new scheme would create work for lawyers and web marketers, but would “put large companies in a position like that of a farmer forced to carve up his land into tiny parcels and pay to retain ownership of each one...ICANN’s offer to help companies safeguard their plots—for a fee—seems like a protection racket” (Dyson, 2011). Nonetheless, businesses like Pac.NW banking on “dot-com” addresses had to be aware of the potential complications arising from the new system.

There were also some changes in search in mid-2011. Google’s search dominance had made it an antitrust target. Rivals continually complained that “Google’s anticompetitive practices include using other companies’ content without their permission, deceptive display of search results, manipulation of search results to favor Google’s products, and buying up competitive threats to dominance” (Catan and Efrati, 2011). In 2011, the complaints were about Google’s new “Places” service. Google launched Places in April 2011 to aggregate reviews of local businesses from other sites. It displayed snippets of those reviews on special pages. Instead of running Places pages through its usual algorithm, it often simply put them near the top of the search page—above results for competitors like TripAdvisor. Although Places included links to the original content, competitors nonetheless accused Google of “stealing our content to create a competitor.” Google’s response was that Places was just pointing users toward the best information, and that this “stealing” was protected by fair-use doctrine. Nonetheless, in June 2011, the pressure—combined with an antitrust investigation by the Federal Trade Commission, “the biggest showdown between regulators and Silicon Valley since the government took on Microsoft”—became too much, and Google announced it would display only reviews written by its own users (Streitfield and Wyatt, 2012; Efrati, 2011b). The rivals were gratified, although they complained that “it’s too bad it took an antitrust investigation for them to do something” (from Yelp) and “I’d love for them to come out with a statement that ‘we promise not to do it again’” (from TripAdvisor).

Google had been expanding in other areas, also. Given that 20% of its searches were related to local businesses, it bought Zagat, the restaurant review company, hoping to attract more local ads (Efrati, 2011c). Also, at almost the same time it was backing off on its Places approach, it was acquiring Admeld, a “supply-side platform” that helped large publishers sell advertising space on its webpages. Analysts believed that Admeld would help Google strengthen its ad exchange (essentially a stock market for advertising) by adding high quality ad-space inventory (Efrati, 2011a).

Adding space for display ads was an important part of Google’s growth strategy. The company hoped that its display-ad business eventually would be as important as its \$30B/year search business.

eMarketer, a digital research firm, expected the display market to grow 24.5% in 2011 (Peers, 2011), and, given growth like that, Google projected that the market would need only a few years to hit a total of \$100B. The Admeld deal itself would help spur that growth. However, others were skeptical. Rivals noted that with over 1,000 competitors in the market, even a Google/Admeld combination faced significant headwinds. Yahoo had already been buffeted: its revenue growth rate fell from 10% to 5% in the second quarter of 2011, a “drastic deceleration of display advertising revenue growth” that some attributed to inroads by Facebook and Google (Peers, 2011). Even worse, the competitors may have been scrabbling over an unprofitable market. Sir Martin Sorrell, a British advertising executive with “a better handle on the fractured, panicky state of the media business than almost anyone else,” believed that consumers were already bombarded with too many messages. There was too much internet content: “more means less.” Worse: “[a]dvertising-only models don’t work. There isn’t enough advertising to go around. Period” (Lipman, 2011). If Sorrell were right, there could be significant ramifications for Michael Powers and Pac.NW Travel Online.

QUESTIONS

1. Perform a SWOT analysis of Pac.NW.
2. Evaluate Pac.NW’s capital structure and leverage.
3. Determine the value of the Pac.NW project to Michael, using his initial understanding of ViewIT’s compensation (i.e., 50% of revenue, *not* 50% after ViewIT’s costs).
4. What are the most important drivers of Pac.NW’s business?
5. Evaluate Michael’s arrangement with his father, Joseph. Could Michael offer him a less “rich” deal and still offer Joseph a fair return?
6. Given your analysis of Pac.NW’s business model, how should Michael address ViewIT’s revised proposal that it receive 50% of revenues *after its fees*?

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PAC.NW TRAVEL ONLINE

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TEACHING NOTES

CASE DESCRIPTION

Michael Powers had licensed a series of domain names that he thought would allow him to create a profitable set of online tourism marketing sites. The case asks students to evaluate the feasibility of the business, given Michael's projections. Given what they find, students are then asked to assess how reasonable are two of his current arrangements with stakeholders. The case allows students to practice fundamental valuation techniques on a cutting-edge business model.

GENERAL COMMENTS

The case supports the several learning objectives. First, it introduces students to a new business model. Online marketing is a rapidly expanding business replete with its own strategies, platforms, and acronyms. Consider the following recent quotes from a mainstream (print) news publication, *The Week*: "Having a great social-media strategy is part of what makes your business more robust" ("Finding Value in Tweets," 2/17/12); "A one-star increase on review site Yelp improves a restaurant's revenue by 5 to 9 percent." ("The Bottom Line," 10/21/11); "[W]hile there are many antecedent forms of advertising, never before in the history of human existence has so much data been gathered about so many people for the sole purpose of selling them ads." ("My Digital Shadow," Madrigal, 2012); "The best minds of my generation are thinking about how to make people click ads." ("My Digital Shadow," Madrigal, 2012). Students of marketing must become familiar with the jargon and strategies of online marketing. Second, the case allows students to apply cash-flow and discount-rate estimation to a small, private business. Finally, it allows them to evaluate alternative schemes for providing an adequate return to equity funders.

SOLUTIONS

Question 1: Perform a SWOT analysis of Pac.NW.

Solution 1: Table 7 outlines some salient aspects of a SWOT analysis of Pac.NW. In summary, evaluating Pac.NW on value, imitability, and organization, we find that its services would add value for tourists (strength). However, while the domain names themselves are unique, the sites are highly imitable; Michael would need to focus on creating unique content (weakness). In addition, the organization is dependent upon a third party, who provides the same services to all comers (weakness).

Question 2: Evaluate Pac.NW's capital structure and leverage.

Solution 2: Pac.NW has several claimants: Michael, the true residual stakeholder; his father, Joseph, who will be paid 10% of firm revenues; and the license holder, Larry Carter, who has several different arrangements, all of which have some percentage link to revenues. (For tier I sites, Larry gets both 50% of revenue or \$5,000/month, whichever is lower, and 2% of the prior year's revenues. For tiers II and III, he gets 18% of revenues.)

Table 7: SWOT Analysis of Pac.NW

STRENGTHS
Michael is a capable and highly competitive person. His family is supportive of his business idea.
Michael considered his domain names to be extremely strong. Google's emphasis on "exact-match domains" in searches enhanced the value of domains like <i>California waterfronts</i> . Control of these domain names was the primary advantage of Pac.NW.
The <i>Washington waterfronts</i> site has been running since 1998. This means that it has a sustainable competitive advantage over potential competitors for organic search results, given Google's algorithm's emphasis on the age of a domain name.
Michael is an expert at search engine marketing (SEM: structuring bids for good placement in search results, leading to high click-through rates) and search engine optimization (SEO: creating content that will score well on search engine's algorithms, leading to good "organic" placement). His work at Newston has proved his capabilities in this area.
Google's expansion into display advertising could stimulate the growth of that market, creating opportunities for Pac.NW's primary business line.
WEAKNESSES
Michael was dependent upon the content management system of ViewIT. He also relied on that company to sell the business listings and display ads, the heart of his revenue model.
Pac.NW's results were driven almost exclusively by display ads. However, some commentators believe that "advertising-only models don't work," given the massive proliferation of internet media sites.
Michael needs to be able to create unique, valuable content in order to draw visitors, and that content must draw an audience from web users who are already supersaturated with messages. He therefore cannot treat Pac.NW as a purely "passive" business; he must write (or find someone to write) material that not only exploits search engine algorithms, but that also draws users (and clicks).
ViewIT uses the services of inventory distribution platforms like Admeld. If Google's acquisition of Admeld makes these services less competitive, Pac.NW could face higher costs.
OPPORTUNITIES
Investors' current excitement with new internet companies might give Michael a pool of potential capital beyond the sources he had currently identified. It also could help maintain the enthusiasm of his current investors. For example, seven months after a \$200 million funding round, Twitter Inc. planned a new round of private financing that valued the firm at \$3.7 billion. Discussions surrounding the follow-up round suggested a revised valuation of up to \$7 billion, an increase some commentators tied to the "soaring" valuations for firms like Zynga, Groupon, and Facebook (Efrati and Ante, 2011).
The cutback of state and federal funds to support tourism left a void that Pac.NW could fill. Vacationers were increasingly using the internet to research and plan their trips. They needed timely and accurate information, which Pac.NW would provide.
THREATS
If Google changed its algorithm to become more "subtle," reducing its reliance on exact-match domains, Pac.NW's sites could see worse organic search placement.
The new ICANN system for generic top-level names could be a threat. There was a two-pronged threat here: first, that consumers came to trust the "dot-vacation" (or suitable alternative(s)) for their vacation-planning needs, bypassing older "dot-com" sites; and second, that a competitor used the new suffix(es) to mimic the same addresses that Pac.NW had. A rival could, for example, register a "dot-vacation" suffix, then sell "California_waterfront.vacation" or "Visit_Bellevue.vacation." This threat was mitigated by the expense involved with the new suffix registration.
There were already multiple sites that provide user-generated reviews of local businesses: the case mentioned TripAdvisor, for example, not to mention Google's "Places" service. (There are others: UrbanSpoon, Yelp, and CitySearch, for example.) Places, in particular, had already raised competitors' ire for "stealing" content from other sites' pages. Pac.NW's pages would be as tempting a target as any of the other sites'. (Google had promised no more stealing, though.)
Although tourists need quality information, they may have no loyalty to any particular site. Michael had no way of creating that loyalty, beyond developing a reputation for useful content.
Google's expansion into display ads (e.g., through its purchase of Admeld) could result in its being the dominant player in the market. This could make it more difficult for ViewIT and Pac.NW to get the best ads and/or the best prices.

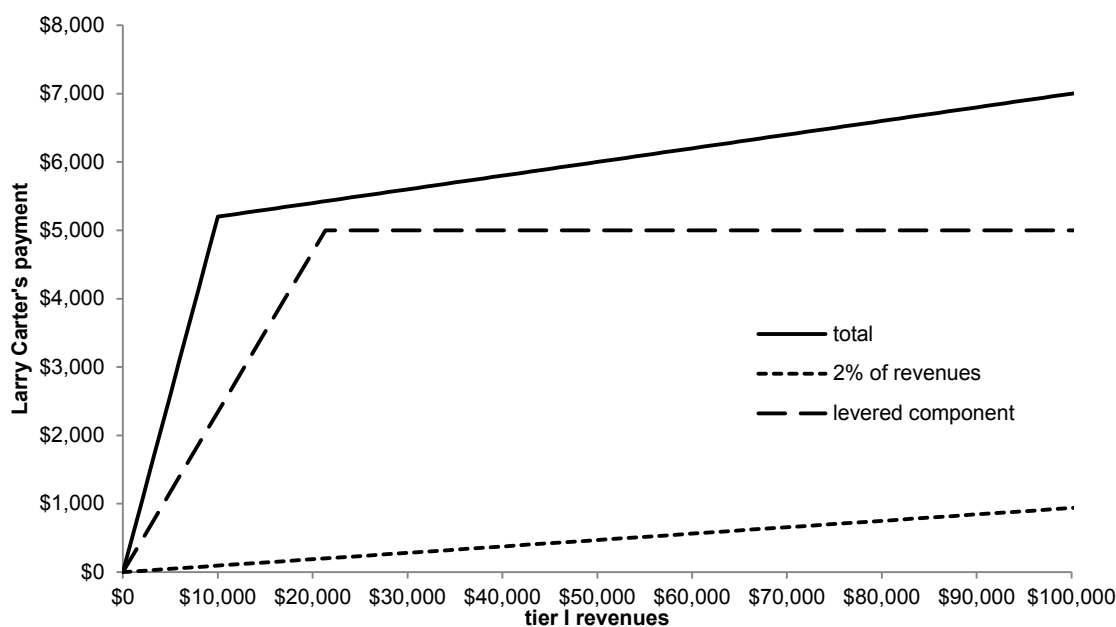
This table outlines the strengths, weaknesses, opportunities, and threats for Michael's online travel service.

We could also consider ViewIt a claimant in the same sense as the three gentlemen. Assuming that ViewIT receives 50% of revenues (the initial understanding), then its claim is effectively no different from Joseph's. However, the nature of ViewIT's payments is conceptually different, since ViewIT's payments are operating costs, not payments for the use of capital. We do note that, given the structure of ViewIT's payments, Pac.NW has no operating leverage.

What about financial leverage? Using the cash flows from question #3 below, we find that Joseph's payments are perfectly positively correlated with revenues (as they always will be). Given the timing issues, Larry's annual revenue sharing payments have only a .76 correlation with revenues, but—given the relatively small size of this part of his payments—the annual sum of his payments from all sources has a correlation of almost .98 with revenues. Similarly, Michael's payments, assuming no horizon value and ignoring the start-up costs, have a .98 correlation with revenues. Thus, there does not seem to be a lot of financial leverage, either.

There is a bit, though, driven by the arrangement with Larry Carter for tier I. We can see this below in Figure 2, which graphs Larry's tier I payments for a range of total income values. (These revenues are assumed to consist of display ad payments only. The share of revenue attributed to each tier is based on the proportions from Michael's initial estimates: 47% from tier I, 37.5% from tier II, and 15.5% from tier III.) The bottom line is the 2%-of-revenues payment (which is assumed to be paid immediately). The dashed kinked line is the tier-I conditional payment, equal to the minimum of 50% of tier-I revenue or \$5,000. The top kinked line, Larry's total tier-I payment, is the vertical sum of the two other curves.

Figure 2: License Holder's Arrangement for Tier I



Figures 2 and 3 illustrate the leverage inherent in Pac.NW's financing arrangements, using hypothetical revenues produced solely by display ads. Figure 2 illustrates the source of the leverage, which is Larry's arrangement for tier I.

The leverage for Pac.NW comes from Larry's conditional payment. The middle curve in Figure 2 is the same as that for a corporate bond: the flat piece corresponds to income levels sufficient to pay the bond as promised; the steeper piece at the left is the default region. For the corporate bond application, Brealey, Myers, and Allen (2006) describe the blue curve as "the position diagram for a default-free bond *minus* a put option on the assets with an exercise price equal to the face value of the bonds" (emphasis original).

This put is Michael's "default put," which allows him to pay less than a fixed dollar amount (\$5,000) if revenues of the firm are below a certain threshold.

In Figure 3, we can see the leverage inherent in Michael's position. Joseph's position is purely a function of revenue, so it, like revenue, is simply a straight line from the origin. The same is true for the line called "Michael if 29.5% of revs"; this illustrates a hypothetical situation in which Michael's payoffs were simply $(100\% \text{ of revenue} - 50\% \text{ of revenue to ViewIT} - 10\% \text{ of revenue to Joseph} - 10.5\% \text{ of revenue to Larry}) = 29.5\% \text{ of revenue}$. This is what Michael would face if Larry's tier-I payments were simply 2% of revenues. (Based on the relative proportions of revenues we have used for the three tiers, getting 2% for tier I and 18% for tiers II and III would give Larry a weighted average of 10.5% of revenue.) However, since Larry's actual payoff curve is kinked, so is Michael's. Once Larry's steady state is reached (that is, once tier I revenues are sufficient to make Larry's payment \$5,000 instead of 50% of revenue), Michael's actual payoff curve rises parallel with the 29.5% curve. (Before Larry reaches the steady state, of course, the reverse is true, and Michael is worse off. Michael really does not derive the benefit of leverage—the magnified payoffs at high revenues—since the "leverage" here is so minute.)

Figure 3: Michael's Residual Claim

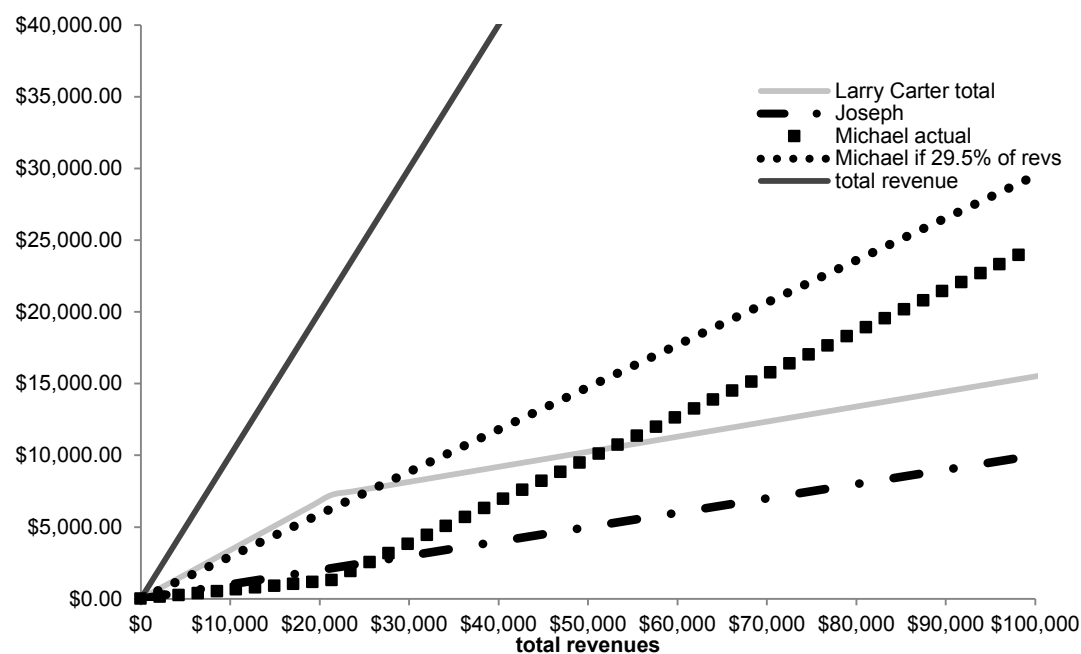


Figure 3 charts the implications of Pac.NW's leverage, and show that Michael's residual claim, shown by the kinked dotted line, rises more slowly at low levels of revenue, before Larry's "steady-state" is reached.

Thus, Larry's tier-I payment scheme introduces some leverage. However, as the correlation values given earlier attest, and as can be seen from Figure 3, there is really no leverage over the relevant range of income. Pac.NW essentially has neither operating nor financial leverage.

Question 3: Determine the value of the Pac.NW project to Michael, using his initial understanding of ViewIT's compensation (i.e., 50% of revenue, *not* 50% after ViewIT's costs).

Solution 3: To find the Pac.NW project's value to Michael, we must calculate the free cash flows to Michael attributable to the project. We will first determining these cash flows, then discount them at the cost of equity.

Detailed revenue and expense calculations are available from the author. Summary cash flows are presented in Table 8. Data for these tables comes from Tables 2 through 6 in the case.

Table 8: Value of Pac.NW to Michael

Year:	0	1	2	3	4	5
Revenue		\$519,311	\$869,766	\$886,517	\$902,609	\$917,048
Operating Costs (50% of Revenue _t to Viewit)		(\$259,656)	(\$434,883)	(\$443,258)	(\$451,304)	(\$458,524)
Operating Income		\$259,656	\$434,883	\$443,258	\$451,304	\$458,524
Total Monthly Fees to Licensor		(\$95,056)	(\$143,351)	(\$145,917)	(\$146,396)	(\$147,503)
Total Annual Fees to Licensor (2% of Revenue _{t-1})		\$0	(\$8,861)	(\$14,622)	(\$14,851)	(\$30,464)
Fees to Venture Capitalist (10% of Revenue _t)		(\$51,931)	(\$86,977)	(\$88,652)	(\$90,261)	(\$91,705)
Income after Licensor and VC		\$112,669	\$195,694	\$194,069	\$199,796	\$188,852
Capital Expenditures	(\$155,000)					
Horizon Value						\$0
Total Free Cash Flow to Michael	(\$155,000)	\$112,669	\$195,694	\$194,069	\$199,796	\$188,852
PV(Cf _t) At 13.88%	(\$155,000)	\$98,937	\$150,898	\$131,405	\$118,795	\$98,602
Total PV	\$443,636					
% Change in Revenue			67.48%	1.93%	1.82%	1.60%
% Change in Income after Licensor and VC			73.69%	-0.83%	2.95%	-5.48%
% Change in CF to Michael			73.69%	-0.83%	2.95%	-5.48%
Michael as % of Revenue		21.70%	22.50%	21.89%	22.14%	20.59%

This table provides summary cash flows and PV calculation for Michael. This table assumes a horizon value of \$0 and a discount rate of 13.88%. Various summary percentages are shown at bottom.

We use a discount rate of 13.88% to discount Michael's cash flows. This was determined using the Capital Asset Pricing Model, assuming a beta of 1.2 (based on leverage-adjusted publicly traded comparables Expedia and Priceline), a risk-free rate of 4.28% (the contemporaneous 30-year Treasury bond rate), and a market risk premium of 8%. (Details on this calculation can be found in Livingston, 2013.) As Michael specified, business listings are priced at the average cost of the seven business lines (hotel/motel, B&B, etc.). The line costs stay constant throughout; these are found in Table 2 (e.g., \$19.78 for hotel/motel listings). The number of listings for a particular month can be determined using Table 3. For example, for month 5 in tier II, there will be [(# of listings for month 4 in tier II)*(1 + growth rate from month 4 to month 5 for tier II)] = (2)*(1.15) = 2.3 listings. The average business listing cost is (\$19.76 + \$8.38 + \$7.58 + \$7.20 + \$8.38 + \$7.20 + \$7.20)/7 = \$9.38. Month 5's business listing revenue for tier II is therefore (2.3)*(\$9.38) = \$21.59. Again, note that this is calculated *as if* there were only one business listing category instead of seven; this adjustment was specified by Michael, in the name of conservatism.

Students should recognize that there are ways other than Michael's to price the business listings. For example, by choosing to use a simple average of the rates charged for various towns, he is assuming that all destinations contribute equally to Pac.NW's revenue. However, listings for larger, more popular towns (like Lincoln City, Oregon) may have more listings than smaller towns. Michael could capture the relative contributions of the different destinations by using a weighted average price instead of the arithmetic average. However, this would add yet another level of estimation and potential error. Using the arithmetic average is also consistent with Michael's desire to be conservative in his analysis.

The calculation in Table 8, and in many of the sensitivity checks below, we assume a t=60 (year 5) horizon value of \$0. This assumption obviously decreases our estimate of Pac.NW's value to Michael (assuming that he would not have to incur a cost to abandon the business). To properly value the business, however, we would need to address the question of what the firm would be worth after 5 years. There are two traditional approaches to estimating horizon values: discounted cash flow (DCF) models and multiples.

The simplest approach to DCF modeling is to assume the firm enters constant growth at year 5. We can then estimate horizon value as $[FCF_5 * (1+g)/(k_e - g)]$, where FCF_5 is the cash flow to Michael at year 5, and g is the sustainable growth in that free cash flow (which starts at year 5). Given the values for growth of the various series shown in Table 8, we will use 1.5% as our g . Thus, we have $\text{horizon value}_{\text{year 5}} = [\$188,852 * (1.015)/(.1388 - .015)] = \$1,548,342$. (For some private firms, assuming infinite lives is problematic. However, given the passive nature of Pac.NW, we expect no issues with ownership transition that should cause such problems. See Damodaran, 2009.)

If we wanted to be more sophisticated, we could use a multi-stage model, allowing growth to stabilize later than year 5. (See, for example, CFA, 2007, Vol. 5.) However, given the stabilization of the series in Table 8 at “reasonable” (sustainable, given the growth in the overall economy) rates, this does not appear warranted.

For the multiple approach, we should have an idea about the multiples that are traditionally used in the relevant market. This is an especially salient point for internet businesses, which have often traded at huge multiples of traditional metrics. For example, as noted in the case, Pandora’s IPO was priced at 12 times projected revenue. LinkedIn closed its first day of trading at 592 times earnings (Conway, 2011), after being priced at 16 times 2010 revenues and more than 100 times EBITDA (Jaffe, 2011). For these sorts of firms, analysts often resort to novel metrics instead (e.g., number of page views). (There is at least one unique measure used in the internet world: Groupon measures its success using a “profit-before-cost” measure, excluding its expenses for online marketing. This measure turns its loss into a profit, a “patina of profitability” that a *Wall Street Journal* analysis calls “bizarre.” See Winkler, 2011.) However, since we have no information on what sorts of specific metrics would be appropriate for Pac.NW, we will resort to using the price/sales data for comparable firms. Choosing 2.5 (just a bit higher than Expedia’s, a public comparable for Pac.NW, and much lower than the possibly “frothy” IPO values), we find a horizon value of $[\$917,048 * (1.015) * (2.5)] = \$2,327,009$. (We have assumed that revenues grow at 1.5%, as before, and have applied the multiple to year-6 sales. See Brealey, Myers, and Allen, 2011.) The problem with this method, however, is that this value applies to the entire firm, not just to Michael’s interest. It is therefore not directly comparable to the \$1,548,342 found above. We have used the latter value when using a horizon value.

Question 4: What are the most important drivers of Pac.NW’s business?

Solution 4: Pac.NW’s results are driven by display ad revenue. Display ads generate well over 90% of the expected revenue for the first 5 years. Of this, the “major” market ads are most important, accounting for half of total display ad revenue. The “leader” intensity ads dominate each market size; in aggregate, “leader” ads generate 58% of revenue. Tier I and tier II markets contribute about equally to major category revenues, except for the “leader” ads (where tier I is more important). Tier III markets contribute only to the “small” ad categories.

This revenue depends on two inputs: Michael’s estimates of the number of ads in each category, and ViewIT’s recommendations for the prices for each ad. These are the variables around which a sensitivity analysis must revolve, and these are the inputs Michael must estimate with exceptional care.

Given the extreme dependence of Pac.NW’s results on display ad revenue, it is critical to appreciate the effect that changing ad prices or ad sales will have on Michael’s results. Table 9 below shows the effect on Michael’s total PV (the quantity initially calculated in question #3, \$443,636, which assumes that horizon value is \$0) from decreasing one display ad category’s price by 10%. (If Michael’s cash flow were perfectly positively correlated with revenue, there would be no difference between the with- and without-horizon cases. As it is, the with-horizon percentage changes in PV are slightly lower than the without-horizon PVs.) The top panel gives the revised PV, and the corresponding cell in the lower panel

gives the percent change in PV. For example, changing the “leader”-intensity price in the major markets from \$715 to \$644 decreases PV by 5.21%, to \$420,531. This is the largest effect from price changes in an individual ad category—which is not surprising, given that this category is the largest single contributor to ad revenue.

Table 9: Sensitivity Analysis

New Total PV for Michael with 10% Change in Monthly AD Price			
	Awareness	Leader	Exposure
Small	\$441,519	\$432,847	\$439,114
Mid	\$440,892	\$431,128	\$438,755
Major	\$437,796	\$420,531	\$430,186
% CHANGE IN TOTAL PV			
	Awareness	Leader	Exposure
Small	-0.48%	-2.43%	-1.02%
Mid	-0.62%	-2.82%	-1.10%
Major	-1.32%	-5.21%	-3.03%

This table gives the results of a sensitivity analysis assuming 10% decreases in prices of each category of display ads. Each cell in the upper panel gives the new PV to Michael after decreasing the price of the associated ad category by 10%. The corresponding cell in the lower panel translates that new PV into a percent change from the original.

A single category’s price decrease does little to reduce Pac.NW’s PV to Michael. But what if there were multiple price decreases? Table 10 below presents the results of several such scenarios.

Table 10: Scenario Analysis

	<u>CHANGE</u>	<u>NEW PV</u>	<u>% CHANGE IN PV</u>
<i>ad prices:</i>			
	all decline by 10%	\$363,678	-18.02%
	all major + small awareness = \$0	\$197	-100%
<i>units:</i>			
	10% decline, tier I only	\$362,641	-18.26%
	10% decline, all tiers	\$304,451	-31.37%
	50% decline, all tiers	\$190,752	-57.00%
<i>price & units:</i>			
	all decline by 10%	\$242,891	-45.25%

This table gives the results of a scenario analysis. The various scenarios are described in the leftmost column; the next two columns give the present value of Pac.MW to Michael under these scenarios and the percentage change in PV from the base case from Table 8. PV is strongly affected if both price and units decline by 10%. The second row shows one “break-even” scenario.

In the first two rows of results, we show the new PV and the percent change after decreasing multiple prices at once. The next three rows switch the focus to units, decreasing them while leaving ViewIT’s estimated prices unchanged. Finally, the last row changes both inputs—both prices and units.

If all prices decrease by 10%, PV falls by 18%. This is approximately the same result we get if we decrease tier I’s units by 10%. (The units were not uniformly decreased by 10%. Instead, for each ad category, we used the smaller of either a 10% decrease in units or a decline of one unit from the initial estimate: revised units = $\min\{[\text{initial units} \times (1 - 0.10)], [\text{initial units} - 1]\}$.) Thus, in some cases we decreased units by much more than 10%.

Thus, we see again that tier I is the most important of the website groupings. Decreasing the units for all tiers decreased PV by 31%; a 50% decline across all tiers cut PV by more than half. Decreasing both prices and units by 10% cut PV by 45%.

Finally, we see in the second row that PV falls essentially to \$0 if we have no sales in all tiers for the “small awareness” category and in any major-market category. This is one of Pac.NW’s break-even scenarios.

Question 5: Evaluate Michael’s arrangement with his father, Joseph. Could Michael offer him a less “rich” deal and still offer Joseph a fair return?

Solution 5: We have already estimated Joseph’s required return to be 13.88%. Given the cash flows that we expect Joseph to receive (shown in Table 8), we can find the following:

year:	0	1	2	3	4	5
cash flows to venture capitalist	(\$155,000)	\$51,931	\$86,977	\$88,652	\$90,261	\$91,705
PV(CF _t) at 13.88%	(\$155,000)	\$45,602	\$67,067	\$60,027	\$53,667	\$47,880
total PV	\$119,242					

IRR = 39.77%

Thus, even if Joseph’s cash flows ended at year 5, he would be earning an extremely high return. (Of course, it still may be less than required if we have underestimated the systematic risk of the project.)

Thus, there does appear to be some room for renegotiation. There are several possible frameworks. For example, Michael could offer Joseph a bond-like payment stream of $(13.88\%)(\$155,000) = \$21,514/\text{year}$ for five years, plus a return of \$155,000 principal at year 5. He also could offer to structure the payments like a perpetuity, offering Joseph $(13.88\%)(\$155,000) = \$21,514/\text{year}$ forever, with no return of principal. Michael could also suggest an equivalent annual payment. Assuming inflation is 2%/year, we would find Joseph’s real required return as $(1.1388)/(1.02) - 1 = 11.65\%$. The equivalent annual payment would then be found as $\$155,000 / \{(1/1.1165) * [1 - (1/1.1165)^5]\} = \$45,019/\text{year}$. This real payment would be adjusted annually for inflation (\$45,019 for year 1, \$45,109*(1.02) for year 2, and so on; see Brealey, Myers, and Allen, 2011).

Each of these three approaches makes the present value of Joseph’s investment \$0—so that he is getting a fair economic return of 13.88%. Structuring the payments in any of these ways does not imply that Michael is substituting a debt claim for an equity claim; these payments would not be promised (or else they would not justify the 13.88% return). Instead, Joseph’s claim could be seen more as a preferred equity stake, simply in terms of priority of payment (Joseph before Michael). (Given the amount of estimation here, we should not need to worry about any decrease in required return from this reconceptualization of Joseph’s claim.)

Another approach Michael could take is to offer Joseph a lower percentage of the firm. The table below shows the cash flows after ViewIT and Larry are paid (these numbers come from Table 8). We have also included a terminal value here (using the DCF approach, as described and calculated in question #3). These cash flows have a present value of about \$1.7M at 13.88%. Joseph’s \$155,000 contribution is about 9% of that value. Michael could therefore offer Joseph 9% of the equity of the firm. This is the type of approach that Michael decided to take. He and Joseph agreed that Joseph would get 10% of revenue until he had been paid a flat \$400,000, which would reimburse him for the amounts he had lent Michael for the campus-area house and the Newoston house. After that, Joseph would get 5% of revenue.

year:	0	1	2	3	4	5
income after licensor terminal value	\$0	\$164,600	\$282,671	\$282,720	\$290,057	\$280,557
PV(CF _t) at 13.88%	\$0	\$144,538	\$217,965	\$191,432	\$172,462	\$154,888
total PV	\$1,681,285					
VC contribution	\$155,000					
VC %	9.22%					

Question 6: Given your analysis of Pac.NW's business model, how should Michael address ViewIT's revised proposal that it receive 50% of revenues *after its fees*?

Solution 6: In Michael's worst-case scenario, ViewIT would get 60% of revenue, as derived in the case. The table below recreates Table 8, assuming that ViewIT gets 60% of revenue instead of 50%. The PV falls dramatically, from \$443,636 to \$169,394 (a decline of almost 62%). Clearly, this arrangement would make the success of Pac.NW much more vulnerable to lower display ad sales.

Table 11: Value if ViewIT Receives 60% of Revenues

year:	0	1	2	3	4	5
Revenue		\$519,311	\$869,766	\$886,517	\$902,609	\$917,048
operating costs (60% of revenue _t to ViewIT)		(\$311,587)	(\$521,860)	(\$531,910)	(\$541,565)	(\$550,229)
operating income		\$207,725	\$347,906	\$354,607	\$361,044	\$366,819
total monthly fees to licensor		(\$95,056)	(\$143,351)	(\$145,917)	(\$146,396)	(\$147,503)
total annual fees to licensor (2% of revenue _{t-1})		\$0	(\$8,861)	(\$14,622)	(\$14,851)	(\$30,464)
fees to venture capitalist (10% of revenue _t)		(\$51,931)	(\$86,977)	(\$88,652)	(\$90,261)	(\$91,705)
income after licensor and VC		\$60,738	\$108,718	\$105,417	\$109,536	\$97,147
capital expenditures	(\$155,000)					
horizon value						\$0
total free cash flow to Michael	(\$155,000)	\$60,738	\$108,718	\$105,417	\$109,536	\$97,147
PV(CF _t) at 13.88%	(\$155,000)	\$53,335	\$83,831	\$71,379	\$65,128	\$50,722
total PV	\$169,394					
% change in revenue			67.48%	1.93%	1.82%	1.60%
% change in income after licensor and VC			78.99%	-3.04%	3.91%	-11.31%
% change in CF to Michael			78.99%	-3.04%	3.91%	-11.31%
Michael as % of revenue		11.70%	12.50%	11.89%	12.14%	10.59%

This table summarizes Michael's worst-case scenario with ViewIT, in which the content management firm receives 60% of revenues.

Michael has considered several ways to mitigate the risks of ViewIT's influence on his results. As mentioned in the case, one idea was to defer payment of 30% of the start-up costs, \$46,500, for twelve months; presumably, this deferral would give Michael some leverage in case ViewIT was not performing up to expectations. (The *ability* to withhold any part of this payment was not made explicit in the case, however, and would need to be part of the revised contract with ViewIT.)

Another approach would be to proceed in stages, taking advantage of the "real option" to expand. If the first stage produced good enough results, Michael could choose to expand. If the results are not good, he could choose to abandon the project. Both of these options have value, and neither is considered in our initial analysis.

For example, assume that Michael chose to start only the tier I sites at $t=0$. The PV of this smaller project is \$180,364, as shown below in Table 12:

This is less than half of the original value, which is not surprising: tier-I sites provide about half of the expected revenue, but the start-up costs fall by only \$40,000 (26%), since only the marginal \$20,000/tier is avoided.

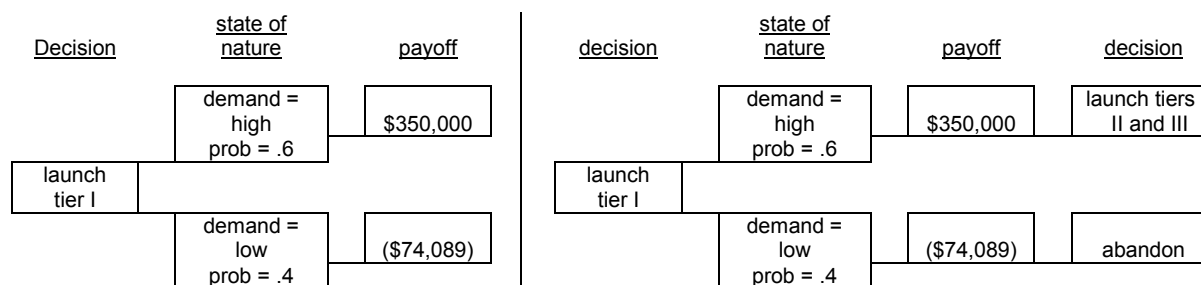
Now, consider that this PV is our expected value, given a 60% chance high demand and a 40% chance of low demand, with the associated payoffs shown in the left-hand panel below. (These probabilities and payoffs are just illustrations; there was not sufficient information in the case to make more informed estimates.) As shown in the right-hand panel, we can easily expand this simple decision tree to incorporate options, such as launching the other two tiers if initial response to tier I is positive, or abandoning the project if demand is poor. Although we do not have the information we would need to go farther with this type of analysis, students should nonetheless appreciate that Michael's decision is not all-or-none at $t=0$; they should be encouraged to consider what sorts of real options might exist in a project of this type.

Table 12: Revised Results Assuming Only Tier-I Sites Launched

year:	0	1	2	3	4	5
Revenue		\$235,691	\$406,704	\$414,039	\$422,629	\$430,918
operating costs (50% of revenue _t to ViewIT)		(\$117,846)	(\$203,352)	(\$207,020)	(\$211,314)	(\$215,459)
operating income		\$117,846	\$203,352	\$207,020	\$211,314	\$215,459
total monthly fees to licensor		(\$44,004)	(\$60,000)	(\$60,000)	(\$60,000)	(\$60,000)
total annual fees to licensor (2% of revenue _{t-1})		\$0	(\$4,714)	(\$8,134)	(\$8,281)	(\$17,071)
fees to venture capitalist (10% of revenue _t)		(\$23,569)	(\$40,670)	(\$41,404)	(\$42,263)	(\$43,092)
income after licensor and VC		\$50,273	\$97,968	\$97,482	\$100,771	\$95,296
capital expenditures	(\$115,000)					
horizon value						\$0
total free cash flow to Michael	(\$115,000)	\$50,273	\$97,968	\$97,482	\$100,771	\$95,296
PV(CF _t) at 13.88%	(\$115,000)	\$44,145	\$75,542	\$66,006	\$59,916	\$49,755
total PV	\$180,364					
% change in revenue			72.56%	1.80%	2.07%	1.96%
% change in income after licensor and VC			94.87%	-0.50%	3.37%	-5.43%
% change in CF to Michael			94.87%	-0.50%	3.37%	-5.43%
Michael as % of revenue		21.33%	24.09%	23.54%	23.84%	22.11%

This table outlines the results of Michael's choosing the option of starting only with his most valuable sites.

Figure 4: Considering Real Options



This figure presents a simple way to begin to visualize the real options inherent in Michael's project opportunity. For example, if demand for his service is high, he may choose to expand (a call option), whereas he may choose to abandon the project completely if demand is low (a put option).

Another approach to renegotiating with ViewIT is the one Michael actually took: renegotiate the percentage split. They agreed to launch all three sites, with no deferral of any start-up costs, but to split the revenue 55/45 instead of 60/40.

EPILOGUE

Michael was able successfully to negotiate revisions with both Joseph and ViewIT. As noted in the answer to question #5, Michael and Joseph agreed that Joseph would get 10% of revenue until he had been paid a flat \$400,000, which would reimburse him for the amounts he had lent Michael for the campus-area house and the Newston house. After that, Joseph would get 5% of revenue. As for

ViewIT—as just noted in the answer to question #6—they agreed to launch all three sites, with no deferral of any start-up costs, but to split the revenue 55/45 instead of 60/40.

Michael’s newly revised *Washingtonwaterfronts.com* site went live in 2011.

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This case was written in close consultation with “Michael Powers,” who was a coauthor on an early version of the case. Mr. Powers met numerous times with the case author, provided all cash-flow and other company-specific data for the case, and provided the updates about the ultimate outcome of both the “ViewIT” and “Joseph Powers” negotiations. Mr. Powers identified the comparable companies used in the IM, and identified critical aspects of the online marketing world which are highlighted in the case appendix. Data on the internet environment came from secondary sources, some of which were suggested by Mr. Powers.

BIOGRAPHY

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