Valuation Focus

By: Richard Reynolds
Senior Financial Analyst
San Francisco Office

Internet Services Valuation Studies – Part 1: Data Storage and Colocation Companies

The need for stable, reliable data storage infrastructure has become crucial at a time when business and consumer technology are accelerating towards real-time, global communication. The professionals at Cogent Valuation ("Cogent") are experts in valuing data storage and colocation companies, which are characterized by the following: high capital investments for the purposes of building new storage facilities and purchasing networking equipment; providing real-time management to maintain server stability and security; and, managing a network between users to provide access to the data that is vital to business operations. Cogent will publish a series of three short articles regarding the internet services industry. This first article will focus on the principles of fundamental financial analysis in the context of a privately held company operating in the data storage industry. We will outline the process of using fundamental financial analysis in order to determine the value of a data storage company through the use of company-specific financial metrics, market multiples, and implied multiples from recent corporate acquisitions.

Observations on Data Storage

Data and colocation companies require significant capital investment in order to build facilities that are reliable, secure, and large enough to allocate the fixed charges and overhead of the building among many individual servers to achieve cost efficiency goals. The facility also must be designed to support on-site backup electricity generators as well as systems for cooling and reducing emissions. Furthermore, the infrastructure of the facility must be capable of housing many servers, while providing sufficient space between servers to reduce heat and encourage airflow in order to maintain the room temperature at appropriate levels. The large capital outlays exhibited by the data and colocation business require valuation techniques that recognize the implications of a capital-intensive business.

For example, price-to-earnings (P/E) and certain enterprise value (EV) multiples may not be appropriate because management has the ability to apply different acceptable accounting reporting methods, which may minimize the comparability of earnings between data and colocation companies. Cogent recognizes that exceptional care must be demonstrated in the selection of the appropriate valuation techniques that can account for the significant capital investment to finance data storage companies.

Cogent Method and Analyses

With the advent of cloud computing (widely known as "the cloud"), data storage and management is in high demand. For example, the demand from internet publishing and broadcasting is expected to increase between 14-20% per year between 2013 and 2018 . While revenues for the data storage industry are expected to increase from $83.8 billion to $97.3 billion between 2013 and 2018, the number of data center firms is expected to decrease by approximately 23% during the same period.

While there are many start-ups within the industry, consolidation is active because the strategic imperatives within the industry to increase market share, geographic distribution, and economies of scale cannot be met by small providers. Cogent's income and market based methodologies are applied respective of the stage of development and size of the firm.

A valuation analysis that is specific to this industry requires the recognition and relationships between sources of financing, capital expenditures, expected long-term cash flows, variable and fixed costs, and customer turnover. These metrics provide a basis for discerning and adjusting cash flows for purposes of developing an income approach as well as identifying a set of comparable firms used to calculate the appropriate weighted average cost of capital ("WACC").

WACC

Weighted average cost of capital is a discounting tool used in calculating the present value of the entire capital structure of a firm. It takes into consideration the cost of after-tax equity and debt financing of a firm and is appropriate in project selection in capital budgeting .

Valuations performed for venture capital backed companies in the data storage and colocation industry require exhaustive research related to demand, M&A activity, IPOs, secondary offerings, business news, and SEC filings of comparable firms. Early-stage companies are characterized by investment in new facilities that require private capital or debt financing. Mature firms may seek the purchase of existing facilities or diversifying into new geographic segments. Therefore, it is an analytical imperative that the set of comparable firms selected demonstrates similarities in the stage of development, size (measured both in terms of physical size and financial metrics), geographic distribution, and capital structure. The same principles apply in the selection of similar

ABOUT COGENT

Cogent Valuation, with offices in Los Angeles, Orange County, and San Francisco, is a nationally recognized firm that has provided independent valuation and financial advisory opinions in thousands of situations since 1991. Cogent utilizes proprietary research, intensive due diligence, and the experience and insights of its seasoned valuation professionals to produce thoroughly supported, well documented opinions that adhere to the best practices for enterprise and securities valuations and financial opinions.

acquisition targets from recent corporate acquistions. Utilizing the financial and market data collected, Cogent applies a combination of the following three valuation methodologies to develop indications of value of the subject company or their security interests:

1) Discounted Cash Flow Analysis
2) Comparative Analysis to Publicly Traded Companies
3) Comparative Analysis to Acquisitions of Similar Companies

UNIQUE CONSIDERATIONS

Cogent recognizes that each facility built or expanded by a data storage company must be measured based on its expected return. Therefore, when analyzing the capital expenditures of a data storage company, start with the firm's historical return on assets ("ROA"), expected return of the proposed project, and ROA metrics from comparable companies. A thorough comparison of these metrics is pertinent to the viability of management's capital use and expected cash flow generation from the capital project. For newly established companies that are in the process of building their first facility, it is necessary to compare the size of the proposed facility to similar facilities when forecasting expected cash flow generation. Measures of ROA should be based on the square footage of the facility and the number of servers in the facility. Another issue that arises in the valuation of data storage and colocation firms is the presence of customer attrition, or "churn". Attrition is present in most subscription-based businesses where customers demand reliable, affordable services. Therefore, a churn rate is a key component of a firm's ability to generate revenues.

If the churn rate is higher than the firm's competitors, it is important to consider the competitiveness of the it's pricing policy, service uptime, and customer support as causes. Cogent has uses the due diligence process as a means of addressing these factors and their relationship with cash flow generation and profitability.

CHURN RATE

The attrition or turnover of customers of a business or users of a service. In the new economy (which provides unprecedented choice, and instant and global access to products and information) churn rate determines business earnings and growth. Acquiring and maintaining customer loyalty from customers is a constant.

Certain key elements drive the value of the company. Management's ability to retain customers through quality of service and competitive pricing provides sustainable revenues that are less volatile. The core competencies exhibited by management result in cash flows that are more stable and mitigate risks associated with volatile returns. Presence of such core competencies reduces uncertainty and the company's required rate of return, thereby increasing the company's value. Another driver of value is the company's ability to utilize the facility efficiently and invest in assets that increase the marginal ROA. Investing in new hardware that has more capacity, is faster, and generates less heat improves the efficiency and profitability of the company's data storage facility. Management's ability to negotiate favorable pricing for hardware upgrades ultimately reduces costs, and expands capacity, which increases the company's value.

IN SUMMARY

While traditional valuation methodologies are appropriate for data storage and colocation companies, consideration of the expected return of capital investment projects initiated by the firm must be integral to any analysis. Capital projects that exhibit below market expected returns will result in lower cash flow generation and higher fixed costs per server. By measuring expected project return and churn rates, Cogent is able to create a nexus of information pertaining to the firm's position and competitiveness within the industry. Armed with such industry specific and subject firm information, Cogent selects appropriate capitalization multiples and rates used in the development of value indications that accurately reflect the unique features of the data storage and colocation industry and its participants.

FOOTNOTES

1. *Krabeepetcharat, Andrew. "Data Processing & Hosting Services in the US." IBISWorld.*
2. *Ibid.*
3. *Pratt, Shannon P. "Cost of Capital: Estimation and Applications." John Wiley & Sons, Inc. 2002.*
4. *BusinessDictionary.com*

COGENT VALUATION OFFICES

SAN FRANCISCO
601 CALIFORNIA ST., SUITE 800 415.392.0888 V
SAN FRANCISCO, CA 94108 415.392.7070 F

LOS ANGELES
21700 OXNARD ST., SUITE 1080 818.905.8330 V
WOODLAND HILLS, CA 91403 818.905.8340 F

ORANGE COUNTY
650 TOWN CENTER DR., SUITE 550 714.668.0272 V
COSTA MESA, CA 92626 714.668.0137 F

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