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Will an IPO Still Be In Demand?

INTERNET: SEC raises flags over website operator's accounting.

By Natalie Jarvey *Staff Reporter*

When one of L.A.'s hot media startups announced in August that it was preparing for an initial public offering, analysts widely assumed it would have happened by now. But questions about **Demand Media Inc.**'s accounting have pushed its public debut back to an undetermined date.

Now, analysts are saying that if the Securities and Exchange Commission allows the Santa Monica company to go public despite its unconventional expensing method, it could be a game-changer for similar media companies.

Demand, a content-creation company that churns out thousands of articles and videos daily for its many websites, amortizes the cost of producing this online content over a five-year period. In its SEC filing Dec. 21, the company claims that it can do this because its content continues to generate revenue years after it was first published. Most online publishing companies expense the cost of creating content immediately.

If the accounting method is approved, "this will set a precedent and cause other media companies already in the public domain to change their accounting," said Lloyd Greif, chief executive of downtown L.A. investment banking firm **Greif & Co.**

Demand-ing Boss: Richard Rosenblatt, chief executive of Demand Media, at the company's Santa Monica office in 2007.

Demand, which is headed by Myspace veteran Richard Rosenblatt, contracts more than 13,000 freelancers to produce articles and videos for its websites, such as eHow.com and LiveStrong.com, or outside publishers, such as USAToday.com. The majority of the company's revenue comes from the advertising it sells around this content. Demand also runs a domain name registry, eNom, which makes up about 44 percent of its revenue.

The company announced Aug. 6 that it planned to raise up to $125 million in an initial public offering. Demand plans to be traded on the New York Stock Exchange under the ticker symbol "DMD" and use the money from the sale of its 7.5 million shares – 3 million of which will come from current stockholders – to expand internationally, develop content and products, and invest in sales and marketing initiatives.

But the SEC appears to have asked Demand to push back its public debut, which was underwritten by Goldman, Sachs & Co. and Morgan Stanley, until the company better explained how it amortizes the cost of making its content.

"It looks like they filed in the summer expecting the deal would get done well ahead of the holidays," Greif said. "But clearly the original filing was deemed to be incomplete."

Now that it has submitted its amended filing, Demand must wait for the commission to give it the green light to continue with its IPO.

Accounting questions

The company did not want to comment. But in its updated filing with the SEC, it explains that because Demand creates mostly "how-to" articles and videos, its content stays relevant for several years and can continue generating advertising revenue for up to 5.4 years. That means the company can amortize the cost of creating this content – it pays freelancers $15 to $30 per story or video – in a straight line over five years.

"These estimates are based on our current plans and projections for our content, our comparison of the economic returns generated by content of comparable quality and analysis of historical cash flows generated by that content to date," the company stated in the filing.

The updated filing also includes a warning from Demand about its accounting, stating that any shortening of the company's amortization schedule would hurt its financials.

But some analysts question whether the amortization method is just a way for Demand to artificially boost its bottom line.

"They're playing games," said Bo Peabody, a managing general partner at New York venture capital firm Village Ventures. "The fact is most of the content that gets generated, it generates the vast majority of its revenue in the first year or two. What they're hoping is that they'll use this accounting methodology to increase the value that the public gives to them."

Demand has yet to reach profitability. The company reported a net loss of $22 million in 2009, down from a net loss of $14.2 million in 2008. In recent months, Demand has shown that it is moving closer to profitability. It reported a net loss of $305,000 in the third quarter of 2010, compared with a net loss of $4.17 million in the same quarter in 2009.

In the years before Demand filed for a public offering, Rosenblatt was quoted in several interviews claiming that the company was profitable. Although the company's nonadjusted financials show a net loss each year, its adjusted operating income before depreciation and amortization shows that the company made $36.8 million in 2009.

A number of Wall Street insiders have said that Demand would be better off reporting a worse bottom line than generating controversy over accounting practices.

In a Business Insider article titled "Come On, Demand Media, Just Drop the Bogus Accounting," Henry Blodget, the website's editor and a former analyst, calls Demand's accounting "unusual and aggressive." He argues that the company will draw more speculation from its amortization method than from showing a wider net loss.

Peabody said Demand should wait to go public until it can show a few quarters of profitability without amortizing the cost of content.

"It's not that I think the business is corrupt. They just need to follow the same accounting standards that all media companies follow," he said. "It would be better for the public markets to allow them to show that they can generate three or four quarters of sustained profits before going public."

Content creation

But Lou Kerner, vice president in equity research at Wedbush Securities in New York, said Rosenblatt's past successes should make potential investors bullish on Demand's forthcoming IPO, despite the company's financials.

Before Rosenblatt co-founded Demand in 2006 with Shawn Colo, the company's head of mergers and acquisitions, he served as chief executive of Intermix Media Inc. of Beverly Hills, the former parent company of Myspace, and helped lead that company's $580 million acquisition by News Corp. Rosenblatt also sold his first startup, iMall, for $565 million to Internet portal Excite.

"Entrepreneurs can get lucky once, but they almost never get lucky twice. This is Richard's third significant success," Kerner said. "I think investors should get great comfort from that."

Since 2006, Rosenblatt has helped Demand raise more than $350 million in funding.

In 2009, the company was rumored to be the subject of a billion-dollar acquisition by Yahoo Inc., Google Inc. or AOL Inc. Now, however, Yahoo owns Demand's largest competitor, Associated Content, and AOL has incubated its own content creator, Seed.com.

If the SEC green-lights Demand's IPO, it could change how these public companies, and other publishers that produce similar long-lived how-to content for the Internet, report their financials.

"If they go public and the SEC allows them to use this accounting standard, every other media company is going to go and restate their earnings and restate them higher," Peabody said.

What the SEC will do with Demand's amended filing is unclear. But Greif said the company has explained its accounting in a way that should satisfy the SEC. Once the company goes public, it's up to potential investors to educate themselves on how Demand reports its financials.

"As long as there's full disclosure, you, the individual investor, can decide if you're comfortable with the accounting," he said. "Ultimately, it's your decision."