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Tucows may be overlooked as a value stock (no, really)

Some time ago Tucows (AMEX:TCX, TSX:TC) issued a press release reminding the world that they hold a sizable portfolio of premium domain names, the subtext to which was ostensibly "look at us, we're undervalued". Jay Westerdal over at DomainTools commented in his blog in essence that the premium domain portfolio of Tucows was not priced into the stock and in his estimation he could see the stock doubling within 2 years. Jay's assessment was an estimate. After looking at this in detail, I personally think Tucows has an intrinsic value between 0.94 and 1.58 per share (currently trading at .60) - Note that everything that follows is based on the CDN listing price.
Before I took a week off to attend the Center for Advanced Value Investing Excellence at Western's Ivey School last month, I did a rather clumsey spreadsheet analysis of Tucows where I basically stripped out all the goodwill, all the intangibles, massively devalued some Tucows business units (such as the email division) and basically did a very crude "break-up" value of the company.

Keeping in mind I'm not a financial analyst, nor do I play one on TV, my analysis is probably prone to error and very inexact, but at the end of it, depending on various fudge factors I came up with a break-up value of roughly 0.55/share, excluding the premium domain portfolio. So margins of error and possible methodology flaws aside, what this basically means is Tucows, according to this model, is trading slightly above "book value".

After my seminar I had a lot clearer insight on methodology so I was able to do the model over again with a lot more "mathiness", but the constant between the two models was the value of the premium domain portfolio.

Taking the numbers directly from the Tucows press release I came up with the following table for valuing the portfolio (recall, I was the bombthrower who publicly stated that the domain aftermarket was overheated and overpriced in early '07, so I lowballed all my numbers):

Domain TypeNumber of DomainsAverage ValueTotal
Gems1000$10,000 $10,000,000
Surnames39000 $1,000 $39,000,000
Brandable22000$1,000$22,000,000
Direct Nav88000$270$23,760,000
Total $94,700,000

The immediate thing one notices from this, given that Tucows total market cap is around 45M, is that this portfolio is worth more than double the current market cap. We immediately have to question the assumptions above, and I have done so, speaking with numerous domainers in the industry who agree with me that my numbers are probably safely to the conservative side. In fact I had originally priced the 88,000 "direct navaigation" names at $100/per until Tucows CEO Elliot Noss revealed in their last conference call that they had sold about 3700 names from this inventory in the prior quarter at just over $1 million, which put the average at $270 each, so that's what I used.

From this, I begin to suspect that Tucows is a possible "value stock" candidate, in that it has assets which are largely off balance-sheet and not yet priced into the stock. I believe this is the most accurate way to view Tucows.

In my week away at the CAVIE seminar, under the tutelage of Dr. Athanassakos, we learned the Earning Power Multiple methodology of equities valuation. Briefly, we look at any company by figuring out its Weighted Average Cost of Capital (WACC), its Return On Invested Capital (ROIC), its Net Asset Value (NAV) from a replacement cost perspective, and its Earning Power Value (EPV) which is basically Free Cash Flow with the growth stripped out. From looking at the relationship between those four factors we can infer a picture of the company, it's Intrinsic Value and calculate what entry price would give us a reasonable Margin of Safety.

With Tucows I came up with:

WACC: 8.17%
ROIC: 8.25%
NAV: 1.58
EPV: 0.31

Since EPV is less than NAV we then do

IV = EPV + (NAV - EPV) x %p

Where %p is our probability of a catalyst event. I have used numbers here between 50% and 75% and lean toward the high end because if I'm right about the value of the domain portfolio, it's not going to sit there inert forever. With a few different %p's we get

%p = 50%:

IV = EPV + (NAV - EPV) x %p
IV = 0.31 + (1.58 - 0.31) x .5
IV = 0.94

%p = 70%:

IV = EPV + (NAV - EPV) x %p
IV = 0.31 + (1.58 - 0.31) x .7
IV = 1.20

and if you happen to have inside knowledge of a "sure thing" catalyst event (I don't) then:

%p = 100%:

IV = EPV + (NAV - EPV) x %p
IV = 0.31 + (1.58 - 0.31) x 1
IV = 1.58

All of these numbers are lower than the "value" I came up with in my original model which put the value at $1.70/share, so I tend to think the second model is more realistic.

Value Investors use their own cushion for a decent margin of safety, but 30% is often used, so we calculate our entry prices from there:

Optimal Entry Prices for various IV

IV / Entry

0.90 / 0.66
1.20 / 0.84
1.58 / 1.10

Given that Tucows has moments ago closed at 0.60 on no volume (zero shares traded today), we seem to be well within our margin of safety under all three scenarios above.

At the end of the day I honestly feel Tucows is a value stock candidate and is profoundly misunderstood by the wider market and even ostensibly professional market watchers. For example, Pat McKeough of "Stock Pickers Digest" has picked Tucows and has talked it up in his newsletter as a growth stock more than once. But if my model is anywhere close to correct, with WACC and ROIC so close to each other to be nearly equal, growing Tucows for growth's sake will not add any value. Return On Invested Capital must be meaningfully higher than WACC for growth to add anything (and if it's lower, watch out! Growth will destroy your value!)

It all comes down to the value of the premium domain portfolio. Is there really tangible value there? Again, we have to use margin's of safety in our calculations. The premium domains only partially show up on the balance sheet under

intangible assets in connection with the names they acquired from buying out ItsYourDomain. The rest of the portfolio has largely been built via the domain expiration cycle and thus they do not appear on the balance sheet at fair market value, if they appear anywhere they show up at registration value. But there is a caveat with placing a value on the the premiums, Frank Schilling said it best last year:

The disconnect I have built to is that large groups of names are actually worth less together than their individual break-up value apart (and by a considerable margin). In a perverse way, it would almost be better for a company like Marchex to unwind the foresight of that name-portfolioâ€™s founder [Yun Ye], by selling their names onesey twosey. I previously estimated a conservative breakup value of Marchexâ€™ domain names alone at north of a billion. Problem is, even the best name-sellers can only liquidate about 2% of a large portfolio like Marchexâ€™s in any given year (and thatâ€™s pushing it), so in exchange for "cash now", a name-seller has to give up the upside.

With this in mind, we can hope that Tucows turning up the aftermarket channels, such as their recent partnership with Afternic will enable them to turn this portfolio into a good stream of free cash flow.

They also recently announced a $10 million share buyback which will only help matters if they carry it through as it should reduce the float by about 10%.

I don't make stock recommendations, but I will make disclosures, and I have invested in Tucows at an average cost of 0.62/share.

`Posted by Mark Jeftovic in This is not investment advice at 09:15`