

Monday, July 7, 2008

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 clumsy 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 Type	Number of Domains	Average Value	Total
Gems	1000	\$10,000	\$10,000,000
Surnames	39000	\$1,000	\$39,000,000
Brandable	22000	\$1,000	\$22,000,000
Direct Nav	88000	\$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 navigation" 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, its 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

$$IV = EPV + (NAV - EPV) \times \%p$$

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%:

$$\begin{aligned} IV &= EPV + (NAV - EPV) \times \%p \\ IV &= 0.31 + (1.58 - 0.31) \times .5 \\ IV &= 0.94 \end{aligned}$$

%p = 70%:

$$\begin{aligned} IV &= EPV + (NAV - EPV) \times \%p \\ IV &= 0.31 + (1.58 - 0.31) \times .7 \\ IV &= 1.20 \end{aligned}$$

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

%p = 100%:

$$\begin{aligned} IV &= EPV + (NAV - EPV) \times \%p \\ IV &= 0.31 + (1.58 - 0.31) \times 1 \\ IV &= 1.58 \end{aligned}$$

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-portfolio's founder [Yun Ye], by selling their names one by one. I previously estimated a conservative breakup value of Marchex's 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 Marchex's in any given year (and that'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

Friday, June 6, 2008

What is wrong with this picture?

Ad from Craigslist:

Pro Day Trader (Millions_) (Toronto)

Pro Day Trader Looking for venture capital
High return possible (potential Millions) Glad to negotiate
Several years experience in equities, futures
Only serious inquires !200k to do it right
Thank You Don

I've seen ads like this many times. It begs a few obvious questions:

Why seek outside capital to daytrade? The risk premium to the investor would make the cost-of-capital quite prohibitive. If these daytraders are so good, where is their own pile of cash that they've taken out of the market? And why aren't they using that to stake themselves?

What kinds of gains are these guys promising? I've talked to daytraders advertising on Craigslist, some of whom claimed consistent, repeatable returns of 20% per month but couldn't explain to me why they weren't several orders of magnitude wealthier than Warren Buffet or George Soros who have managed 15-20% annual returns for decades (and who eschew daytrading like the plague, btw)

I have been following a couple of high-end daytraders (Wall St. Window and The Informed Trader) over the course of this last bear market after the credit markets locked up. They are both saying the same thing: this has been one of the toughest markets to trade that they have ever seen. They've both spent most of their time sitting on the sidelines, in cash watching the market for some feel of where it's going.

As professional daytraders know, "cash is a position" - often the best trade is no trade.

My suspicion when I see ads like this is that I'm reading the ad from a guy who's addicted to daytrading, gone bust and looking for somebody else to stake him so he can wipe out again.

I've come to the conclusion that the only way to become a successful daytrader is to do it fulltime. You can't run a business and daytrade on the side. So personally I don't daytrade (anymore). But I do highly recommend *The Investor's Quotient: The Psychology of Successful Investing in Commodities and Stocks* - which teaches us that the most important aspects of trading are having a coherent system one sticks to, mental discipline and other psychological factors. In other words, becoming a successful trader is not about conquering the markets, it's about mastering oneself.

In a couple weeks I'm off to the *The Search for Value* seminar at Western for a week where I hope to hone my acumen at fundamental analysis and value investing.

Posted by Mark Jeftovic in This is not investment advice at 09:33

Monday, March 17, 2008

Q: How do you get out of a mess? A: don't cause one.

I had to laugh out loud when I watched Jim Rogers interviewed on CNBC, after he lambasted Bernanke for his abject mishandling of the credit market implosion, one interviewer asked: "Tell me two things you would you do if you were Bernanke tomorrow?" - Without missing a beat he said 1: Abolish the fed and 2: Resign

His tirade against what capitalism is not, and that what passes for capitalism today is really just socialism for bankers is a must see. The thing I love about Rogers (and Buffet, and Munger and Soros et al) is you can't really argue with success. These are bar none, the most successful investors in the world and they have always said the same thing: All this fed liquidity will end badly.

Still, you say that on CNBC and some twit like Kudlow makes it sound "unAmerican". Hell, maybe it is un-American to let people take responsibility for their own actions and to let market forces do their job after a bunch of knuckleheads juice up the system on artificial stimulus for a few decades.

I'd be shorting the hell out of the markets even from here if 1) I could find a halfway decent re-entry point and 2) I thought US dollars would be worth anything on the other end. But since 1) isn't happening and 2) appears dubious at best I have to be satisfied with not having my net worth being chewed into pulp by a meat-grinder stockmarket each passing day (don't get me wrong, I'm very satisfied with that)

Amazingly, there are still talking heads talking as if the Recession is still hypothetical, avoidable or if not, how mild and soothing it will be and why this a fantastic chance to be buying stocks on the cheap. Tell me this: if "now" is always a great time to be buying stocks and the market is underpriced, how lucky are the bargain-hunting saps who bought Bear Stearns at \$30 on friday?

Let the class actions on that one commence, there will be many more to follow. As long as the Fed is acting as if an investment bank going out of business is purely unthinkable there will be much more of this to come, and if Bernanke keeps it up, this will end in a hyperinflation induced flameout of apocalyptic proportions (think James Wesley Rawles' Patriots, which describes a Mad-Max-like post-hyperinflation economic meltdown in the US)

Posted by Mark Jeftovic in This is not investment advice at 14:05

Tuesday, June 5, 2007

Time to jump off the parabola

As readers of this blog know, I typically stay away from "hot" investment sectors because I'm antisocial and dislike crowds. Over the last few days I have seen what can only be called red flashing warning lights from a few different places like The Privateer ("Warning lights flashing worldwide"), Larry Wallman's "Sunday Comments" ("We are someplace in the "mania" segment of the bull run." and George Ure's Urban Survival.

I have yet to read Marc Faber's May GloomBoomDoom but then again, he already said this last month. So imagine to my surprise when my memory jogs and I realize: I've been socking somewhere around 40% of my company RRSP contributions into emerging markets for over 5 years! Those same markets Bucker is calling "parabolic" and in the "blow-off" phase and with China taking near-weekly 8% dumps in the stock market. Oh my!

I nearly forgot about these holdings because I simply did a "set and forget" about 6 years ago, when I setup my corporate RRSP contribs go into 1) Emerging markets 2) Japan (don't laugh), 3) income producing real estate funds and 4) natural resources. I managed to average about a 20% annual return with that formula but I don't think his mix can continue that pace.

As such I've redeemed my emerging markets into cash (money markets) and lowered my contributions into Japanese equities. I've added an income fund and allotted more into money markets.

In short, as far as this particular RRSP goes, I've bailed on emerging markets, stuck it out with Japan (hey, they're due) and gone "above weight" in cash. Which bankers hate, but hey, when everything is overvalued what the hell else am I going to do with it? Buy domain names on the aftermarket?

Remember, this is not investment advice, remove cellophane before eating, etc.

Posted by Mark Jeftovic in This is not investment advice at 14:29