SABER | SABER CAPITAL MANAGEMENT, LLC

John Huber, Managing Member
(919) 610-6809
john@sabercapitalmgt.com
www.sabercapitalmgt.com

Verisign: The Toll Road of the Internet

September 2nd, 2016

Verisign's Business

Verisign operates the domain name registry for the .com and .net "top-level domains" (TLDs). This means the company acts as a directory for the internet, pointing people to the correct website when they type in any site ending in .com or .net. The company also operates two key root servers and ensures the root-zone for the Domain Name System (DNS) is functioning properly (which basically means the company is in charge of making sure the Internet is working properly). These are obviously essential services that are crucial to the functioning of the internet.

Verisign's position could be considered a "toll road" of the internet. The company makes money mainly by collecting $7.85 per year for each .com domain name that is registered, and there are around 127 million .com domain names.

The company also gets paid a similar fee for each of its roughly 16 million .net domain names. Verisign is the exclusive registry for domain names ending in .com and .net (among a few others), an extremely attractive and enviable competitive position that could be likened to a monopoly within the .com and .net TLD's. The margin on this recurring revenue is extraordinarily high, and there is very minimal need for cash in this business. The high margin recurring revenue and the low capital requirements lead to stable and predictable free cash flow, which the company uses almost exclusively to buy back stock.

In the last ten years, fully-diluted shares outstanding have shrunk from around 250 million to 130 million. In recent years, the company has narrowed its focus on exclusively managing the registration process for domain names, which has significantly simplified its business. Operating margins have expanded to 60%, and while domain name registration is a mature business, any incremental revenue growth through volume and/or price increases drops almost straight to the bottom line. The company doesn't pay a dividend, there doesn't seem to be any risk of ill-advised acquisitions or poor capital allocation decisions. The company simply collects its toll and consistently eats away at its own shares.

It's a very predictable business with significant free cash flow that should grow slowly but steadily over time, with per-share earning power growth magnified through the consistent buybacks. It's not a growth compounding machine, but a steady cash cow. I think the stock is currently undervalued, given its near monopoly-like competitive position, the high-margin recurring revenue, the capital light nature of the business, and the capital allocation policies that management have implemented.

Two issues that have caused a roughly 20% decline in Verisign's stock price in recent months:

1. The planned transition of Internet oversight from the US government to an international multi-stakeholder community
2. The uncertainty regarding Verisign's contract extension to the .com Registry Agreement (the contract that allows Verisign to collect fees for registering .com domain names)

Transition of US Government Oversight

A main reason for the recent 15-20% decline in Verisign's stock price has to do with the events involving the planned transfer of oversight of the internet from the US Government to the international community. The Obama administration is pushing forward with this planned transfer, which is set to take place on 10/1/16.

Basically, the US government has provided oversight to ICANN (Internet Corporation for Assigned Names and Numbers) since the early days of the internet. ICANN is a non-profit organization that helps oversee technical functions of the internet, ensuring its stability and proper functioning. It also works with companies like Verisign, which operate top-level domain names (or TLD's). TLD's are the suffixes in a domain name like .net or .com.

This oversight transfer has become somewhat controversial and political, as some feel the internet is working fine under US oversight, while others want a more "open" internet with oversight provided by a multi-stakeholder body represented by other countries and various parties around the world.

However, this transfer process actually started almost immediately after ICANN was founded in 1998, and while it has taken much longer to complete, it has been a work-in-progress for nearly two decades spanning three different presidential administrations. But the fast approaching October 1st deadline has brought new attention to this matter, which has created uncertainty for Verisign's contract with ICANN.

This contract currently runs through 11/30/18, but ICANN and Verisign are working on an early extension agreement as part of this overall transfer process that would extend Verisign's contract another six years to 2024. I believe it is highly likely that the contract will get extended, as Verisign provides a hugely important critical function, namely providing stability and ensuring proper functioning of the internet.

Also (and very importantly), Verisign's contract with ICANN contains a presumptive renewal clause, which essentially means that unless Verisign screws up its role of operating and maintaining critical internet infrastructure, its contract will automatically get extended without getting bid out to competitors. Here is the relevant language:

> *"This Agreement shall be renewed upon the expiration of the term set forth in Section 4.1 above and each later term, unless the following has occurred : (i) following notice of breach to Registry Operator in accordance with Section 6.1 and failure to cure such breach within the time period prescribed in Section 6.1, an arbitrator or court has determined that Registry Operator has been in fundamental and material breach of Registry Operator's obligations set forth in Sections 3.1(a), (b), (d) or €; Section 5.2 or Section 7.3 and (ii) following the final decision of such arbitrator or court, Registry Operator has failed to comply within ten days with the decision of the arbitrator or court, or within such other time period as may be prescribed by the arbitrator or court."*

Verisign has a perfect record (100%) in terms of operational accuracy and stability for the TLD's it manages. It has never sent someone to Walmart.com that was looking to go to Amazon.com, and while that sounds simple, the root-zone maintainer functions (i.e. the critical infrastructure that makes the Internet work) that Verisign performs are absolutely crucial to ensuring the safety and stability of the Internet. It's unlikely that the stakeholders will be incentivized to change the status-quo, when it is so important and working so well. Verisign is likely to get their contract extension.

Verisign's Competitive Position

The attractive competitive position was cited in a recent letter from Senator Ted Cruz and couple of his fellow committee members. They refer to Verisign as a monopoly, and warn that the company could exploit its position as the only .com domain registry to raise prices on consumers:

> *"If the .com Registry Agreement is extended to 2024 and the NTIA subsequently relinquishes its oversight of the process for registering Internet domain names, it appears that the Department of Justice (DOJ) may be prevented from having meaningful input into the prices that Verisign charges for registering a domain name within the .com domain for an extended period. We therefore write to urge the DOJ to conduct a thorough competition review of the agreement before any oversight transition is undertaken and any agreement extension is approved."*

Cruz's letter to the DOJ was partly responsible for an additional decline in Verisign's stock price. On August 31st, the NTIA published a letter in response.

As the DOJ mentions in their response, Cruz's fears over Verisign's pricing power seem unwarranted. While the US government will no longer be the official watchdog of ICANN, it will have the authority to approve domain name price increases. This means that, contrary to Cruz's assertion, Verisign can't raise prices for .com domain registrations unless the DOJ approves the increase:

> *"We note that the current extension proposal contemplated by ICANN and Verisign does not change the price cap contained in the 2012 .com Registry Agreement, which will remain in effect through November 30, 2018.* ***Nor does the current extension proposal alter the price cap in Amendment 32 of the Cooperative Agreement. Moreover if NTIA were to approve an extension of the .com Registry Agreement, it would have the right in its sole discretion to extend the term of the Cooperative Agreement with the current price cap in place until 2024*** *at any time prior to November 30, 2018, the date on which the Cooperative Agreement is currently scheduled to expire. If this occurs, the $7.85 fee cap would be extended for another six years to 2024."*

The response letter basically states that the government can still cap VRSN's price of $7.85 per .com and that while Verisign can ask for a price increase (per amendment 32), the company will still need the DOJ's approval to raise the price, even after the transfer of oversight occurs.

Here are some relevant documents:

- Ted Cruz Letter to DOJ (which basically outlines the investment case for VRSN)
- DOJ Response to Ted Cruz
- Amendment 32 to Verisign's agreement with the US government ("Cooperative Agreement")
- Cooperative Agreement
- .com Registry Agreement
- Proposed Extension of .com Registry Agreement

What Does This All Mean?

In my interpretation, this letter seems to imply that the government feels things are working well (Verisign has always performed—i.e. kept the internet "on"), and my read is that the contract will likely be extended without any major changes.

The risk/reward from the government's (or ICANN's) perspective should be: Why mess with a function that is so crucial, when the company performing that function is doing so (and has always done so) perfectly? For 19 years, Verisign has maintained **100% operational accuracy and stability** for the .com and .net domain infrastructure. The upside is maybe saving $1 or $2 per domain if they took a lower bid from another company (what customer really cares about paying $7 instead of $8 for a domain?). The downside—should the new operator screw things up—means the internet stops functioning properly. It's unlikely the public would notice if domain prices fluctuated (up or down) by a few dollars. It's very likely they'll notice if the Internet stops working properly.

That doesn't seem like a risk/reward trade-off that the authorities would be excited to try.

So the DOJ is attempting to calm Cruz's "fears" about Verisign's monopoly by saying (paraphrasing of course): "**Verisign can't raise prices unless we say so**."

While it would be ideal if Verisign could raise prices (and they still might be able to eventually if they can prove that competition among other TLD's is increasing), my interpretation of the letter is that it certainly doesn't seem likely that this will result in any major changes (if any) to Verisign's current agreement with ICANN.

And the status quo is a good thing for Verisign, as they are able to continue to collect recurring revenue as the "toll booth" for the internet.

New TLD's a Risk?

When the internet started, there were just a handful of TLD's (.com was (and still is) the most popular by far). But in recent years, ICANN has begun auctioning off the rights to countless other TLD's, which is being viewed by some as a risk to Verisign's dominance on a key piece of "internet real estate". In other words, if you start a pizza restaurant, you might choose JoesPizzaShack.pizza instead of JoesPizzaShack.com. If you're a CPA, you might choose JohnsCPApractice.cpa instead of JohnsCPApractice.com.

The potential of these new TLD's is a valid question to consider for Verisign, but so far the new TLD's don't seem to be slowing the steady growth/renewal of .com domain names. I would say that almost anyone who buys a domain name, especially if it involves a business, will likely buy the .com domain for their name even if they choose to advertise the alternate TLD.

In other words, Joe is going to spend $8 and buy JoesPizzaShack.com even if he wants to advertise the .pizza domain name. It's not worth $8 to accept the risk that someone else can take your name under .com. It makes sense to buy it just to remove its availability. I think the .com suffix is too ubiquitous at this point, and the cost is so small, that I think it's unlikely that new TLD's will dent its dominance in a significant way.

Also, domain names continue to climb each year, and unlike traditional real estate, internet real estate is unlimited. New TLD's can coexist with current TLD's, and the two might actually contribute in some ways to each other's growth.

Valuation

As for the valuation:

- Diluted shares including converts: 130 million
- Senior debt: $1.24 billion
- Convert debt: $1.25 billion (cash amount required for buyback under "Treasury Method")
- Cash: $1.91 billion
- Enterprise Value: $10.7 billion (at $78 share price)

Since Verisign simplified its business model to focus solely on domains (and the related functions), cash flow has been $538m, $579m, $601m and $651m. Since this isn't a cyclical business and the growth in free cash flow is mainly tied to VRSN becoming a more focused operation, I don't see the need to discount or average these past 4 years of cash flow. I estimate about $50m in ongoing maintenance capex, which gives me about $575m of free cash flow (adjusting for working cap changes). So current shareholders are paying around 17.5 times free cash flow. This doesn't look cheap by most value-investor standards, but given the competitive position, the significant free-cash flow fueled buybacks, and the toll-road nature of the business, I think the current valuation is very reasonable.

If free cash flow continues to grow at 7% annually, and the company continues using the majority of free cash flow to buy back shares, the business will be doing around $800 million of free cash flow and around 100 million shares outstanding in five years. This means intrinsic value per share is compounding at around 12% annually. A multiple of 20 times cash earnings–a reasonable price for such a great business–would equal a $160 stock price in five years, or roughly 15% annual returns from the current price.

However, this doesn't factor in any benefit to future price increases, which I think is fairly likely to occur going forward in the coming years. Not a home run investment, but a great business at a reasonable price. One of the best parts about the investment is that the lower the stock price goes, the more shares the company will be able to retire, thus increasing the percentage ownership and the earning power per share of the remaining shareholders. The predictable cash flow (and thus predictable buybacks) give the intrinsic value a very pleasant tailwind as time goes on.

Over the next year, I see 3 things happening:

1. Transition contract and amendment extension
2. Request for pricing increase on .com registrations
3. Consistent free cash flow and continued share buybacks

I think Verisign is a safe and cheap stock of a business that is extremely well-positioned. The company has a complete focus on managing its domains and the internet infrastructure, which is obviously a critical function to ensuring the stability of the internet. Capital allocation decisions are very straightforward—management isn't sidetracked with other revenue opportunities or "diversification" efforts—they simply use excess free cash flow to buy back shares.

The company will continue to see modest volume growth, modest margin expansion, very little capital requirements, extremely predictable free cash flow that steadily climbs—a combination that results in a steadily shrinking share count and steadily rising free cash flow per share.

Although unexciting, Verisign is akin to a quality piece of real estate in a land constrained location that trades at a better than average cap rate with built in rent increases. There are a few catalysts that are present in the coming months which could result in the multiple expanding. But regardless, Verisign becomes more valuable as time goes on.

John Huber is the Managing Member and Portfolio Manager of Saber Capital Management, LLC, an investment firm that manages separate accounts for clients. Saber employs a value investing strategy with a primary goal of patiently compounding capital for the long-term.

John can be reached at john@sabercapitalmgt.com.