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Longing The Internet

A compounder through buybacks

Key data

Ticker	NASDAQ:VRSN
Market cap	US$7.56bn
Price	US$65.02
Cash	US$1.9bn
Debt	US$1.9bn
	As @ 31 Mar 2015
Intrinsic value	US$77.30

DCF assumptions

Year 0.5 adjusted FCF	
FY2015	US$518mn

Adjusted FCF growth	
FY2015	2.0%
FY2016	1.5%
FY2017	1.0%
FY2018	0.5%
FY2019, FY2024, FY2030, FY2036	14.0%
All other years	0.0%

WACC	
Equity @ US$7.6bn	9.00%
Debt (Unsecured) @ US$0.5bn	5.25%
Debt (Convertibles) @ US$1.25bn	3.25%
WACC	8.00%

Core Business - Verisign holds the registry monopoly of .com and .net Top Level Domains ("TLDs"). It charges US$7.85 for a .com TLD per year while paying ICANN US$0.25 per year. For the .net TLD, it charges US$6.79 per year and pays ICANN US$0.75 per year. As at June 2015, there were a total of c.118mn .com TLDs and 15mn .net TLDs. Verisign bulk resells the TLDs to registrars such as GoDaddy. In return for profits, Verisign is responsible for the maintenance of 2 of 13 global root servers that keeps the internet working.

Moat – Verisign has an ironclad agreement with ICANN for indefinite renewal of .com TLD as long as the internet infrastructure is maintained properly. It has historically attained close to/no downtime.

Quality of Financials and Business – Operating income exceeds revenue growth in in past 5 years, even during FY2013 and FY2014 when ICANN froze .com price increases since 2012 till 2018. This implies tight cost controls and fixed costs, allowing majority of revenue increment to fall directly to bottom line.

For 4 of past 5 years, Verisign has consistently generated adjusted FCF (deducted stock based compensation and new HQ capex) in excess of operating income after interest and taxes, with adjusted FCF margins of above 50%.

Verisign has trimmed large tracts of its non-core businesses over the years, with the last large piece (SSL certification sold to Symantec) sold in 2010. Using cash flows from organic sources and divestments, large buybacks/dividends were initiated. Returned cash of US$4.2bn over last 5 years vs current market cap of US$7.2bn.

ROC/ROE are infinity since Verisign runs on negative equity with the large buybacks generated with the huge cash flow and its current debt load matches its cash holdings. Return on assets (less cash) has been above 50% in the last 3 years.

Risks and Mitigating Factors

- Increased acceptance of generic TLDs (eg. .co, .info, .mobi)
  - A definite trend which will lead to slower growth
  - But very unlikely to kill .com business
- Loses.com monopoly (Suffer fate of Neustar)
  - Indefinite renewal agreement with ICANN
- Internet disruption that causes grounds for non-renewal with ICANN
  - Good track record of uptime for at least a decade
- ICANN disallows .com price increment from US$7.85 during November 2018 renewal
  - Other TLDs' have been allowed to raise prices by 7% to 10% per year for 10 years (till c.2024) and will exceed .com's US$7.85 by 2x if .com is renewed another 6 years without price increase

In good company since Berkshire is Verisign's 2nd largest shareholder, owning 11.2% stake and Lou Simpson has been a director since 2005.

Variant Perception and Catalysts – Verisign likely to successfully renew with at least a one-time 7% price increment for 6 years and that .com will grow, albeit at a slower pace. At the very least, revenue will remain stable while the biggest threat of ballooning cost base will be kept in check as they have done in the past. The largest cost relates to salaries and the number of employees decreased from 1,099 in FY2012 to 1,061 in FY2014 and most recently to 1,025 in March 2015. As November 2018 approaches, clarity of renewal increases coupled with the constant buybacks of undervalued shares will also likely act as catalysts.

Valuation – 1. DCF with assumptions that prices are raised 7% every 6 years for 20 years which results in adjusted FCF growth of 14% (since average 3 year adjusted FCF margin is 50%) in each milestone year. At terminal value 20 years later in FY2035, at R = 8% and G = 0%, PV of Verisign is at c.US$9bn, representing c.16% MOS.

2. This monopoly with growth upside generates adjusted FCF yield of c.7% vs fixed income of 3% from 30 year US bond.

Historical Financials

(US$ '000)	FY2014	FY2013	FY2012	FY2011	FY2010
Revenue	1,010,117	965,087	873,592	771,978	680,578
Growth	*5%*	*10%*	*13%*	*13%*	10%
Operating income	564,427	528,232	457,327	344,901	249,144
Growth	*7%*	*16%*	*33%*	*38%*	*42%*
Operating cash flow	600,949	579,397	537,630	335,901	215,206
Growth	*4%*	*8%*	*60%*	*56%*	-46%
Stock based compensation	-43,977	-36,649	-33,362	*-43,272*	-52,178
Adjusted capex	-39,327	-65,594	-53,023	*-58,186*	-80,527
Adjusted FCF	517,645	477,154	451,245	*234,443*	82,501
Growth	*8%*	*6%*	*92%*	*184%*	-64%
FCF Margins	51%	49%	52%	30%	12%
FCF ROadj.A (less cash)	71%	51%	89%	46%	22%