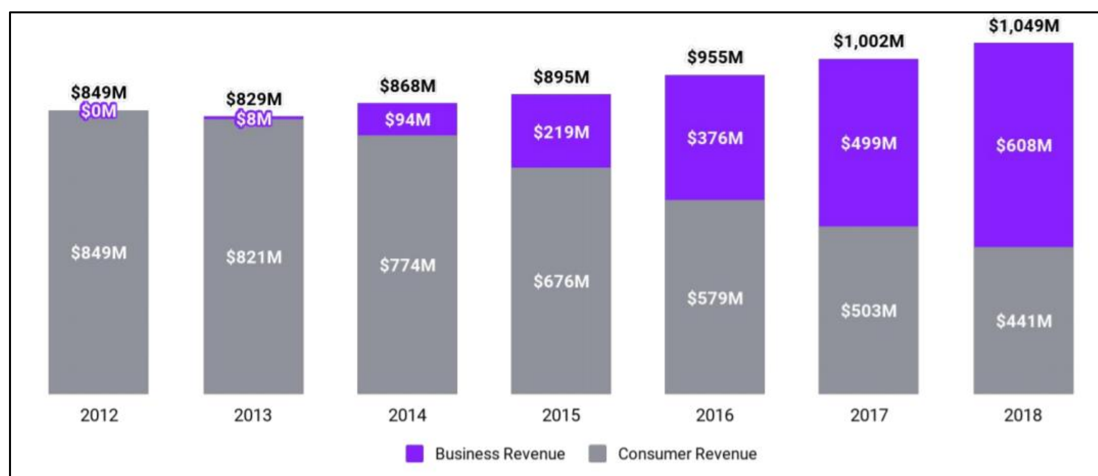
Vonage (VG): One opportunity that fits this mold of SOTP investments is Vonage (VG), whose value only becomes apparent when you consider each of its separate business lines individually. Many may already be familiar with Vonage thanks to their frequent TV commercials from 10-15 years ago (the ones with the catchy “Woo Hoo” song), advertising then-revolutionary internet phone service. What most people probably don’t know, though, is that the company has totally remade itself in recent years and successfully pivoted from residential phone calling to unified, cloud-based communications solutions for the workplace (see graphic below).



The company’s original business, which today comprises its consumer segment, allows customers to make and receive phone calls over the internet at cheaper rates than traditional landline service. This business is a melting ice cube with no prospects of turning around, but: 1.) it’s melting slowly, churning only 1.8-2% of customers a year, and 2.) it generates a lot of free cash flow because of the now very limited reinvestment needs. This is important because the company is now able to fund its more promising lines of business without having to tap the capital markets.

While Vonage’s consumer operation is the best known of its segments, it’s the company’s business division that generate most of its value today. This segment is split into two groups. The first, Applications, is made up of the company’s Unified Communications as a Service (UCaaS) and Call Center as a Service (CCaaS) solutions. These offerings were mostly formed through a series of acquisitions that the company made upon seeing the writing on the wall for the long-term prospects of home phone centric services. Today, this is the larger of the two groups and continues to grow, though at a modest rate given the maturity and competitiveness of the market.

The company’s other group within the segment, APIs, was essentially created through Vonage’s purchase of Nexmo in 2016. Nexmo added the Communications Platform as a Service (CPaaS) vertical to the company’s offering, and it has proven to be great investment, with proliferating use cases generating rapid market growth. Today, the API group is growing at 50%, and in my view, it’s already the company’s most valuable asset.

Vonage traded near multi-year highs as recently as August, but continued deceleration in the Application group’s growth, coupled with a surprise loss in Q3 that caused the company to miss its full-year OIBDA guidance, led to a nearly 50% share price decline in the last few months of the year. Though

there has been some recovery in 2020 to date, the stock is still well off its 52-week highs. Indeed, given the modest consolidated revenue growth and increased losses last year, a cursory glance shows little for anyone (or any machine) to be excited about.

However, VG is a classic sum of the parts (SOTP) investment, as each of the segments described above are in vastly different parts of their lifecycles. A quick version of the investment case is that the value of the company's API group operations is more than VG's current enterprise value, meaning we get the Applications group and Consumer segment for free. Below I'll dig into a bit more detail, but before beginning, I want to explain why I utilize an EV/sales multiple approach here. First, the company doesn't provide a breakdown of segment costs below the gross margin line, so it eliminates the guesswork of allocating expenses. Second, many of the company's business segment peers are not profitable, so an EV/sales valuation helps produce a more robust comp set that gets closer to how investors actually value these businesses today.

Let's first consider the consumer operations, which are the least valuable portion of the company. Assuming another 12.5% sales decline for 2020 and applying a 0.5x EV/S multiple leads to a value of $168 M for the division. This multiple is well below both what peer MagicJack VocalTec was acquired for in 2018 and roughly in line with the VG's historical average multiple before it branched into business services, so I'm comfortable with the estimate. Moreover, a quick DCF using Vonage's pre-2013 FCF margins yields a similar value at a 12% discount rate.

VG's Applications group competes with 8x8 (EGHT), RingCentral (RNG), Five9 (FIVN), and Jive Communications (now private). This group currently trades at an average multiple of 10.8x (including Jive's takeout valuation), but Vonage is currently growing at a slower pace than its rivals. Given that VG's growth rate for the segment is roughly a third of peers', applying a multiple that's a third of peers (3.6x) seems reasonable. This works out to $1.69 B.

So what's the crown jewel API group worth? CPaaS peers Twilio (TWLO) and Bandwidth (BAND) trade at an average EV/S of 8.7x, and VG's 47% growth rate (above the peer average) means it might be fair to apply that for our valuation. But double check the result, I ran a regression created based on the growth and margin metrics that have historically been predictive of SaaS business valuations[1], which suggested a fair multiple of 6.7x. Let's use this lower number and then apply a further 10% discount to it to remain conservative. This produces a value of $2.49 B for the segment, which is roughly equivalent to Vonage's EV at its current market capitalization and thus implies its other business lines are being ascribed zero value.

Putting the pieces together, we get a fair EV of $4.34 B. Backing out the net debt and dividing by the diluted share count, I get to a per share value of about $15; I then apply a further 20% SOTP discount to arrive at a target price of $12, which is over 40% upside at the current price. As an added bonus, there is a potential near-term catalyst – in its last earnings release, Vonage announced that it was undertaking a strategic review of its consumer operations, which would hopefully crystalize their value and collapse the sizable SOTP discount currently embedded in the stock. Accordingly, I believe the risk-reward here is

[1] I should note that it would also be possible to apply this methodology to the Applications group, but because 1.) its revenues are not purely recurring service-based ones, 2.) it has more listed peers to make comparisons with, and 3.) there are more moving parts given its M&A activity, I decided it was unnecessary for our purposes here.

very favorable, and am content to wait until other investors – or maybe even computers – catch on to the opportunity.

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