3 Reasons Tucows (TSX:TC) Is Doomed

Description

Investors who added **Tucows** (TSX:TC)(NASDAQ:TCX) to their portfolio five years ago are now sitting on a six-fold return. After more than a decade of expanding its digital services business, the company is now one of the largest digital service providers in the country. However, it now seems like this growth spurt is finally coming to an end.

Tucows's market has evolved over the years, and the company is now scrambling for growth while trying to preserve its legacy core operations. In recent years, the company has outlined a plan for diversification and continued growth, but investors have started to lose patience and have been punishing the stock over the past few months.

After hitting an all-time high of $118 in April this year, the stock is down 30% to just under $82. Some experts believe the stock could fall much further, as the company continues to struggle. Here are three reasons investors should worry about Tucows's prospects.

The domain business is saturated

Everyone, including the company's management, agrees that selling domain names is far from an exciting growth opportunity. After years of acquisitions and expansion, Tucows is now the second-largest wholesale domain seller in the industry. The segment represents 72% of revenue and just over half of the company's gross profit.

While the business is lucrative and cash flow positive, growth is often less than the rate of inflation. Over the past three years, the domain service segment has expanded by under 1% annually.

The mobile business is too competitive

Tucows’s second-largest segment is its virtual mobile network called Ting Mobile. Branded as a budget mobile service provider in America’s unreasonably expensive telecom market, Ting represents just over a quarter of Tucows’s revenue and the other half of its gross annual profits.

However, there’s plenty of competition in the space, since the business model leaves a lot of room for new entrants. Any reasonably sized company can strike a wholesale deal with a major carrier and resell wireless services to a niche audience.

The natural limits of the serviceable market in North America and the intense competition in this space makes Ting mobile a risky venture. In fact, subscriber numbers have been declining since 2017, which is a clear red flag. This is probably why the company is trying to build its own moat in another segment — fibre optic cables.

The fiber optic network is too expensive

Creating a fiber optic broadband network across the United States could be a lucrative and robust venture, if it weren’t so expensive. Several tech and telecom giants have attempted this model in the past, but none have succeeded in deploying an extensive high-speed internet network across the country.

Tucows’s attempt, branded as Ting Internet, was launched in 2014 and already serves 7,700 customers across six markets, with two more going live soon. However, whether the subscriber base in these small towns is valuable enough to justify a capital investment worth hundreds of millions and spread out over nearly a decade remains to be seen.

Many other corporations and deep-pocketed investors have backed off from this model precisely because the risk/reward ratio was skewed unfavourably. Could Tucows win where so many others have failed? It’s too early to say. However, the stock is trading at 28 times earnings, which could indicate that the growth is already priced in.

Bottom line

At the moment, Tucows’s business can be divided into three segments. The domains business is stable and profitable, the mobile business is declining, and the fibre optic business is losing money but just getting started.

The company’s fate lies in the success of the risky and expensive fibre optic venture, which the market seems to have already priced in as a success. In my opinion, that leaves the stock overvalued.

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