

MagicJack: My Next Netflix

Whitney Tilson, February 9, 2014

What do Amazon, Costco, Netflix and Southwest Airlines have in common? They offer their customers big savings and great service. Are Americans smart enough to figure this out? Of course! These have been some of the most successful companies of all time, vastly outperforming their peers and delivering phenomenal returns to shareholders over long periods of time. Imagine investing in one of these stocks when they were small companies...

In fact, I did just that with Netflix 16 months ago when I pitched it at my Value Investing Congress when it was at \$54.44 (click [here](#) to see the slides I presented that day) and have made almost *eight times* my money since then.

Not surprisingly, I'm always looking for my next Netflix: another stock with multi-bagger upside potential. Such stocks tend to have the following 10 characteristics:

- 1) A tainted company with a beaten-down, heavily shorted stock;
- 2) Great management;
- 3) Fixable problems;
- 4) An enormous, global market;
- 5) Big, lumbering competitors that are resistant to change;
- 6) A paradigm-shifting technology or way of doing business;
- 7) A position of market leadership in the new arena;
- 8) Attractive economic characteristics: high margins, low capital intensity, robust cash flows, a strong balance sheet, and customer acquisition cost far lower than the lifetime value of each incremental new customer; and
- 9) A moat around the business to ensure that the company's market leadership and attractive economic characteristics endure;
- 10) An extraordinary value proposition to customers, combined with great service, resulting in intensely loyal customers who are "evangelists" for the company.

Netflix had every one of these characteristics 16 months ago and, I believe, magicJack has – or will soon have – all of them as well:

- 1) **A tainted company with a beaten-down, heavily shorted stock.** MagicJack's stock, at \$13.75, is barely half its peak reached in September 2012, trades at a mere 5.6x trailing EPS and 3.3x EV to EBITDA, and 29% of the company's shares (and 43% of the float) are sold short.
- 2) **Great management.** I've met three times with the new management team (which has only been in place for a few months without interference from the founder and former CEO), and I'm extremely impressed with them and their track records.
- 3) **Fixable problems.** MagicJack's problems – spotty customer service, unsophisticated marketing, unprofessional web site, and the tendency to manipulate the stock – were all attributable to the former CEO, and are rapidly being fixed.
- 4) **An enormous, global market.** In the U.S. alone, there are 70 million households with either plain old telephone service or a bundled "triple play" of TV, internet and phone service from their cable company. While the number of people "cutting the cord" and getting rid of their home

phone line is growing, magicJack's 3.3 million subscribers are only a drop in the bucket, so even if the total market shrinks over time, there's still enormous room for magicJack to grow in the U.S. In addition, there's another huge market that magicJack hasn't even begun to address: the individuals and businesses overseas who want the ability to inexpensively make and receive U.S. phone calls. My parents live in Kenya and are thrilled to now have a home phone line that operates as if they lived in the U.S.

- 5) **Big, lumbering competitors that are resistant to change.** Verizon, AT&T, the cable companies...you get the idea...
- 6) **A paradigm-shifting technology or way of doing business.** MagicJack uses the internet (voice over IP or VOIP) to carry its calls rather than traditional phone lines, which cuts costs dramatically. I've been using the product, both as a second phone line in my home as well as during a vacation in Costa Rica, and I think it's fantastic. It's easy to set up and use, the sound quality is excellent, and I'm saving a ton of money.
- 7) **A position of market leadership in the new arena.** There's some ambiguity here because it depends on how one defines the "new arena". MagicJack has 3.3 million active subscribers and 5.6 million registered users of its smartphone app, so it's bigger than Vonage, which has 2.4 million subscribers. But if one defines the new arena as all internet calling, Skype is exponentially larger – but as I describe below, it's comparing apples and oranges, as Skype typically doesn't replace a home phone line.
- 8) **Attractive economic characteristics: high margins, low capital intensity, robust cash flows, a strong balance sheet, and customer acquisition cost far lower than the lifetime value of each incremental new customer.** In the first three quarters of 2013, magicJack's gross and net margins were a mouth-watering 66% and 24%, respectively, cap ex was a mere \$84,000, and free cash flow exceeded net income by a healthy margin. In addition, the balance sheet shows no debt and more than \$60 million in cash, equal to nearly 25% of the company's current market cap.

Regarding customer acquisition cost, magicJack has said that its CPGA (cost per gross add) is in the \$4-5 range, a phenomenally low number. I believe this includes the de minimis cost of renewing customers, however, so to be conservative I assume that the cost to attract each new customer is \$10. This is still very low relative to the lifetime value of a new customer, which I estimate is around \$80, based on the following assumptions:

- The purchase of a \$35 magicJack unit at a 60% incremental margin (excluding SG&A) = \$21
- 3-4% monthly churn (which I think new management will be able to reduce substantially), which means the average customer stays approximately 30 months
- \$2.75/month in service fees (a bit more than the base \$2.50/month fee because some customers buy international minutes, vanity numbers, etc., partially offset by some customers who pay \$100 up front for five years, or \$1.67/month)
- 70% incremental margin on service fees
- Total: 30 months x \$2.75/month x 70% margin = \$58 + \$21 in hardware = \$79 in incremental lifetime pretax profit for each new customer

In summary, I estimate that magicJack is getting an incredible 8:1 return on its investment in new customer acquisition.

- 9) **A moat around the business to ensure that the company's market leadership and attractive economic characteristics endure.** The question I get most often is: "How does magicJack make such fat margins charging such a low price? It's either unsustainable or it will attract many, larger competitors." (Boy, does this remind me of the consensus thinking about Netflix over the years, yet Netflix continues to grab the lion's share of all new streaming subscribers.) The key thing to understand about magicJack is that it's a CLEC (competitive local exchange carrier), which means that, while magicJack has to pay "termination fees" when its customers make outbound phone calls, other carriers must pay magicJack when their customers call magicJack users. This incoming call volume allows magicJack to negotiate better rates with other carriers and significantly reduce network costs. You can see this in magicJack's financial statements: in 2009, network costs were 22% of revenues, a number that has fallen steadily to less than 18% in 2013.

- 10) **An extraordinary value proposition to customers, combined with great service, resulting in intensely loyal customers who are "evangelists" for the company.** MagicJack has nailed the value proposition – at \$2.50/month, it's exponentially cheaper than what most people are currently paying for their home phone line – and the phone service itself works great, but there's no doubt that magicJack has a lot of work to do on its customer service. In spite of this, however, the company continues to attract new subscribers – 273,534 last quarter alone – with minimal advertising, which speaks to magicJack's strong brand name and word-of-mouth. Once magicJack improves its customer service and ramps up a sophisticated marketing campaign, I think subscriber growth could take off – which is precisely what drove Netflix's stock to the moon. I believe tens of millions of Americans – and anyone overseas who wants to make and receive U.S. phone calls – should have one (and, marketed properly, *will* have one!).

Risk

I want to underscore, however, that this is a risky investment and should be sized appropriately. It's a small company with a checkered history, competing with giants, and there are some regulatory risks, which I think are minimal but shouldn't be ignored. For me, this stock is a small part of a portfolio of mostly conservative, value-oriented stocks like Berkshire, AIG, Citigroup, Canadian Pacific, Hertz, and Boeing.

The high short interest also introduces risk because short sellers are the smartest investors in the market – they have to be to survive! – so, in general, it's a terrible idea to go long a heavily shorted stock. However, on rare occasions when I've developed a high degree of conviction that the shorts are wrong and bought such a stock, it's resulted in some of the biggest winners in my 15+ years of running a hedge fund. In addition to Netflix, examples include Deckers, which rose 110% in 2013, and General Growth Properties, which I shorted from \$40 to \$1 and then went long it from \$1 to \$20.

What is MagicJack?

Before I go on, allow me to describe magicJack, which is both a product (hardware) and service (software). Here's what the magicJack Plus looks like:



As you can see, it's very compact: less than 3" long, 2" wide, and weighs less than 2 ounces (very nice when you travel). There's a USB port with a plug at one end and an Ethernet jack and regular phone jack at the other end.

It works in two ways: At home, plug the magicJack into a standard electric outlet and into your router via the provided Ethernet cable, and then plug your current phone into the phone port (note that, unlike earlier versions of magicJack, no computer is needed – it's always on). Then go to the web site to register (which you only have to do once) and you're good to go. It's very easy to set up: no software needs to be installed and the entire process takes only a few minutes.

If you only have access to wifi, not a router, just plug the magicJack into your computer. Then, you can make and receive phone calls, either on your computer or by plugging a regular phone into the magicJack.

Another key benefit is the seamless integration between the device and the smartphone app. If someone calls my magicJack number, it rings at home but also on my smartphone, so it's a universal number. (Incidentally, I think the magicJack app, by itself, could be enormously valuable someday, in light of its 5.6 million registered users.)

MagicJack's Extraordinary Value Proposition

MagicJack's biggest advantage is its ultra-low cost: its *annual* price of \$30 (\$20 for customers who pay \$100 up front for five years) is less than the *monthly* \$30-\$50 price of most households' regular phone line (even phone lines bundled with internet and TV service are typically around \$20/month). In other words, magicJack is more than *ten times cheaper* than what the average American is paying for home phone service. Do you think the average American cares about an annual price differential of \$20-\$30 vs. \$360? You bet!

It's really important to understand how cheap magicJack is and the implications of this. When something is *massively* cheaper than current alternatives and costs so little – less than a cup of coffee – it can lead to a paradigm shift and mass adoption.

I didn't fully appreciate this when I first analyzed Netflix – and paid a terrible price because I was short the stock as it more than doubled against me in 2010-11. My short thesis was based in part on Netflix's limited selection of streaming content, but what I failed to grasp was that the average user was watching more than one hour of content every day yet was paying a mere 26c/day (\$7.99/month) – a truly extraordinary value proposition that reminds me of magicJack's.

A Case Study

A friend of mine, after reading an early version of this article, wrote me with the following story, which I think is a good example of how entirely new markets can be created when the price of a product drops by 90-95%:

I have been using MagicJack products for years and I think you nailed it. But I believe you completely missed the way that MagicJack is a unique market disrupter. Let me explain.

I am a principal of a New York City public school. It costs over \$1,000 for us to install a new telephone extension line, and from the time we order the line to the time the line is installed, it takes over a month. Don't even ask how much it costs for a new outside line.

I want my teachers to be able to easily call parents. My school only has four outside lines, so in the past teachers would have to go to the main office to dial a parent. Some teachers would use their cell phones but this meant that students and parents would now have their cell phone numbers, something that not every teacher is comfortable with, particularly in this litigious age where teachers are often accused of inappropriate contact. Others would complain that calling families on their cell phones used up precious cell phone minutes.

So a few years ago, I stopped adding expensive telephone lines and started using MagicJacks instead. I didn't want my teachers to use our poor telephone infrastructure nor their reluctance to use their personal cell phones to stand in the way of parent outreach, so I installed three MagicJacks (along with used phones I purchased at flea markets) into our staff room for teachers to use anytime they wish. I also purchased five other MagicJacks for teachers to take home with them if they wish to make outreach calls at home.

The manner that I have been using MagicJacks in my school is the way it could be a disruptive technology. Schools like mine, and companies around the world, now have an inexpensive way to scale up their phone capabilities without having to install very expensive phone systems such as those sold by Cisco. (I imagine that Cisco, Samsung, or Facebook will acquire MagicJack as soon as they get wind of it.)

Icing on the cake would be if the programmers at MagicJack understand what their product truly is and figure out a way to transfer a call from one unit to another; then it truly becomes a candidate for a viable replacement of office phone systems.

Old vs. New Marketing

Speaking of proper marketing, it's hard to describe how incredibly unsophisticated and unprofessional magicJack's marketing was under its former CEO – basically cheesy late-night infomercials. The fact that the company was able to overcome this and have 3.3 million active subscribers and 5.6 million registered users of its smartphone app is a testament to magicJack's value proposition.

This is what magicJack's web site looked like until a few weeks ago:

The screenshot shows a cluttered homepage for magicJack PLUS. At the top, a banner reads "THE NEW 2014 magicJack PLUS" and "Over 11 million Sold". Below this is a yellow banner with "Computer NOT Required". The main content area is divided into several sections: "FREE PHONE SERVICE FOR LIFE", "Get FREE Voice APP Too", and "Click Here for Free Trial". A central section titled "Installs in 2 Easy Steps!" shows a woman using a phone. To the right, there are "magicJack Reviews" with a quote from The New York Times. The overall design is busy with many text elements and small images.

In contrast, this is the web site today – a look that is now consistent across all marketing:

The current website has a clean, modern design. The top navigation bar includes "magicJack", "HOW IT WORKS", "FEATURES", "PLANS", "SUPPORT", social media icons, and "RE-UP" and "LOGIN" buttons. The main hero section features a woman on the left and the headline "The Choice is Clear Do the Math." on the right. A comparison table shows the cost difference between magicJack (\$3/month), Vonage (\$24.99/month), and Phone Company (\$30/month). Below this is a "GET FREE TRIAL" button. The lower section is titled "Calling All Savings Seekers." and offers a "FREE 6 Months magicJack Phone Service" with the purchase of magicJack PLUS. A list of benefits includes "No Monthly Bills", "Free Caller ID", "Free Voicemail", "Free Call Forwarding", "Free Call Waiting", and "Free 411". A "GET FREE TRIAL" button is at the bottom.

For another example, click [here](#) to see magicJack's new, polished video explaining the service and then compare it to the video that was posted on the home page of the old web site: it was very grainy and unprofessional and showed the former CEO sitting with his daughter and their two dogs, Magic and Jack, talking about the service. It was farcical.

MagicJack vs. Vonage

Perhaps the best way to understand magicJack is to compare it to two better known internet calling service, Vonage (VG) and Skype (which is owned by Microsoft). MagicJack combines the best of both – at a fraction of the cost.

For a home phone setup, magicJack and Vonage are nearly identical: plug your phone into a small device, connect it to an outlet and a router, and you're good to go. MagicJack, however, has three advantages, one huge and two minor: first, though Vonage provides its device for free (vs. magicJack at \$34.95 plus \$15 for the first six months service = \$49.95 plus S&H&tax), its monthly cost (after an initial promotional period) is *14 times as much*: \$36.07/month (including fees and taxes) for the same unlimited calling in the U.S. and Canada that magicJack offers for only \$2.50/month. (Vonage has launched a new service, Basic Talk, but it still costs 5x as much and doesn't even include unlimited free calls to Canada.)

Secondly, the Vonage box only works when plugged into a router with an Ethernet cable – it won't work plugged into a computer like the magicJack does (though both magicJack and Vonage have apps for Android and Apple phones). So imagine you're on vacation in a hotel room or condo with a regular phone in it, where there's wifi but no access to the router. If you prefer to make calls using a phone rather than through the computer (I certainly do!), you can plug the phone into the magicJack and it's just as if you were at home – you can make unlimited domestic calls, receive calls, etc., even if you're overseas.

Lastly, the Vonage box is quite a bit larger than the magicJack (plus it has a bulky power adapter), so it's not as easy to toss in your bag when you travel.

MagicJack vs. Skype

Skype is cheap – it's free to download and make calls to other Skype users – but both you and the other person have to be logged on at the same time. If you want phone service like magicJack, you have to buy a special Skype phone that costs at least \$80 and then pay \$60/year to get a phone number and another \$36/year to get unlimited calling in the U.S. and Canada – in total, more than triple what magicJack costs.

Capital Allocation

When I met with the management team last week, at the end of our conversation, I shared with them the following thoughts on capital allocation:

I only buy stocks that are trading well below what I believe intrinsic value is, so normally I push companies to buy back shares. If your stock is trading at half its intrinsic value, then each dollar spent to buy back stock creates two dollars of value – a great return on investment.

But your case is different. If your customer acquisition cost is \$10 and the lifetime value of a customer is \$80, then you're creating *eight dollars* of value for every dollar you spend on marketing – a vastly better return.

If that's true, then I don't want you to buy back any stock, but instead ramp up your marketing spend to acquire new customers. Obviously you need to carefully track it to make sure it's working, but as long as your customer acquisition cost remains a tiny fraction of the lifetime value of a customer, I want you to forego near-term profitability and invest every dollar of your cash and cash flow into seizing the growth opportunity, just like Netflix decided to do a couple of years ago (and look how that worked out!).

I was pleased when they replied: "We understand what you're saying and are thinking along the same lines." They, like I, are not in this stock for a mere double.

Conclusion

MagicJack is a fantastic product and service, which offers its customers an extraordinary value proposition, but its potential was barely tapped under the former CEO. The new management team has (correctly) delayed investing in growth until they fix customer service, finish upgrading the web site, etc. (which is why advertising spending was down 56% in the first three quarters of 2013).

But they're moving fast – and the results are already visible – so I think when magicJack reports Q4 earnings in mid-March we're likely to see the beginnings of an enormous marketing push, which will result in rapid subscriber growth for the foreseeable future.

I think the sky is the limit for the company – and the stock. This is the kind of growth story that investors could really fall in love with, so I wouldn't be surprised if magicJack has a \$2.5 billion market cap in a few years – which would make the stock a 10-bagger from here.