

Vonage Holdings Corp. (NYSE: VG) Memo

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Vonage: Sounds Good...not



Important Company Financial Data			
Price (4/25/11):	\$5.11	Revenues ('08/'09/'10):	\$900/889/885
Market Cap:	\$1,130	Net Income ('08/'09/'10):	\$(65)/(43)/(84)
52 week range:	\$1.45-5.20	Cash/Debt:	\$79/193

**data in millions except share price info*

Thesis / Key Points

- Vonage is a doomed company because it offers a VoIP service that is more expensive than low-end providers like Skype and Google Voice and is not a viable option for serious small or home business owners. Its poor customer service and unreliable phone service turns off all of its customers and prevents others from joining. Other VoIP providers like 8x8 and JaJah, as well as major telecomm providers like AT&T, Comcast, or Cox Communications all provide more extensive and high quality solutions that appeal to people on the premium on end.
- People are expecting too much growth from the company and will be disappointed by its future growth in the coming months and years. The stock has run up 130% YTD on positive net subscribers change after bleeding customers for several quarters, and a bright outlook after 2010 earnings has investors believing Vonage is heading for the stars. However, increasing marketing costs per new subscriber and price competition from below will start to eat away at the financial health of the company. More VoIP solutions that provide better services will come to the forefront and make it increasing difficult for Vonage to continue to grow.
- The VoIP industry has low barriers to entry and high price competitions will put severe stress on the company and make the competition to get new users fierce. The success of Google Voice (which has had almost no advertising) and the increasing domination of Skype in the international calling market spells trouble for Vonage. Companies are able to enter the market fairly easily and match Vonage on its pricing. To further the company's problems, landlines are a dying breed and people will continue the trend of using video calls (like Skype) for international calls or use smartphone applications (like Google Voice and Skype), eating away at Vonage's core product.

Misperception

- **Bulls believe that Vonage will benefit from the trend of increasing VoIP user and its user base growth will continue and outpace that of rivals.**
 - Unfortunately for the bulls, there are many reasons why Vonage will lag its competition and become irrelevant in the VoIP industry. New(er) players like Skype, ooVoo, and Google Voice offer far cheaper solutions with less hassle. These players, along with others, have been able to enter the market with force because of the advent video/web calling and smartphone applications. In addition to using your laptop to video chat (which is totally free) or place calls, users of Skype, ooVoo, and Google Voice can also use their smartphones to place calls with these providers. This requires no hardware installation on the users' part and only a simply software download. Vonage requires its subscribers to install their own router and pay a monthly plan regardless of how many minutes they use. For the three competitors named above, one only pays for the minutes they use if they want or a far cheaper monthly plan compared to Vonage's plans.
 - Vonage is unable to keep up the pace of growth seen by competitors. Despite only being founded 2 years ago, Google Voice already has 1.4 million users (compare this to Vonage being founded in 2001 with 2.4 million subscribers). Furthermore, the service offers users a free phone number, free calls and texts to US numbers, and competitive rates per minute to Vonage with no monthly subscription fee. Skype has 663 million users as of 2010. Not all of these are using Skype's VoIP services, but Skype is able to cheaply market to this vast user network and promote their services. Including video calls, the company has become the world's largest international voice carrier with over 13% of international call market share. Calls from Skype's VoIP services have been increasing at a very health clip. Looking at long-term trends, with more developing countries gaining access to broadband Internet, video calling services that are free will continue to gain popularity and will challenge VoIP services.
 - Other firms like 8x8 and JaJah cater exclusively to home offices and small to medium businesses. They provide more comprehensive solutions for businesses that include cloud computing, video conferencing, and types of online meeting capabilities. These companies also have a better track record with their customer service and service reliability.
 - Customer service and reliability will drive current customers away and keep new customers from joining. Vonage does not have a good reputation with many of its users because of its lengthy call waiting times for poor and uninformative customer service. Vonage also requires users to install their own routers in order for the phone service to properly work. This is

Vonage Holdings Corp. (NYSE: VG) Memo

their bundled services. Few customers have developed a love for Vonage and any compassion that is there is mainly generated from the costs savings the company has given them over traditional phone plans.

- **Vonage is facing tough competition from broadband and telecomm companies like Cox Communications, Verizon, and Comcast, who bundle services together to provide phone service to customers for very cheap prices.**
 - Vonage appeals to customers who want to save on phone bills. However, for those people who do not mind paying a premium, Vonage has no appeal to them. Telecomm, cable, and broadband companies able to appeal to customers at the higher end because of their bundling of services. All of these companies offer some sort of packaging deal for those customers who buy television, Internet, and phone services from them. These landlines provide the best quality voice service with great reliability. A landline does not require Internet service (so if the internet goes down it is not affected) and can still operate without power service. Although landlines are dying off with increasing uses of cell phones, people still sign up for phone services particularly with these bundles because of how cheap the phone service becomes with the other services.
 - Most businesses still want to use landlines rather than VoIP phones. This comes from the reasons stated above, landlines are not reliant on the internet nor power to continue this operation. If business are going to use VoIP, they want a quality product that will not fail them. Vonage has tried to play to both penny-saving consumers and small businesses, but fails to live up to a serious business' standards. Business customers of Vonage have often complained about dropped calls, poor call quality, and terrible customer service. Business are willing to pay a little extra to get a better VoIP experience that won't adversely affect their operations.

VAR

- Many customers complain of poor customer service and poor quality calls with Vonage. → "Stay away from Vonage. They lie, lie, and lie. We had terrible service – lots of dropped calls and awful sound quality." "Vonage has let me down to such a massive disappointment and abandoned this customer." "Try competitor VoIP companies instead." "My business suffered from lack of service."
- After speaking with users of Skype's VoIP service here in Copenhagen, most are please with the results. These students have been using Skype's smartphone applications to call home while abroad. They say that the call quality has been good (and no dropped calls unless they have a poor signal) and has allowed them to save a lot of money instead of using their cell phone provider's international plan.
- Personal use and talking with Google Voice users have also led me to the conclusion of high customer satisfaction. All Google Voice users get a free phone number (something that you have to pay for with Skype and Vonage) and free calls/texts to U.S. domestic numbers. That means that here in Europe, I can call home from the Google Voice number for free. There are many students using this service in Copenhagen and none have had anything bad to say about the service. I have noticed a slightly airy or echoing sound on the calls sometimes but nothing so bad as to affect the call itself.
- None of the students I talked to used Vonage to communicate with people. The preferred methods were Skype video chatting or some other firm of video chatting, followed by Google Voice, and then Skype's VoIP service.

How It Plays Out

Vonage resumes it trend of bleeding customers from its subscriber base (or at the very least fails to keep pace with the industry). The company continues to pay more in advertising for each new subscriber while eventually being forced to cut calling cost by competitors. Vonage's efforts to establish itself with smartphone applications fail. It cannot keep up with higher quality VoIP providers catering to businesses and doesn't reach premium consumers who are being serviced by the "bundles" provided by Comcast, Cox, etc. With landlines dying out altogether and broadband internet (and thus video calling) reaching more and more corners of the globe, Vonage will eventual become irrelevant and die out.

Risks / What Signs Would Indicate We Are Wrong?

- Vonage continues to add net subscribers at a health clip and its Facebook and smartphone applications become hits with users.
- It finds a service or improves it current service that appeals more towards business users. This would require improving call quality, customer service, or getting into the cloud computing/virtual meeting business.
- Vonage gets into the video calling business online much like Skype and is able to successfully compete with other similar services. This would allow it to provide free calling from user to user online.

Signposts / Follow-Up

- Watch net subscribers trend of Vonage versus competitors and the VoIP industry as a whole
- See how much it costs for Vonage to add new subscribers and how much revenue they are getting from each line.
- Monitor to see if they start trying to alter their plans more towards casual consumers or businesses. They still face the same competitors in both sectors.

Company Description

VG is a company providing voice and messaging services over broadband networks to residential, small office, and home office customers in the U.S., Canada, and the U.K. It offers various features and capabilities to its customers like visual voicemail, caller ID, and call forwarding. It has recently been expanding into software applications for computers, laptops, social media sites, and smartphones to further promote its services and compete with new competition. At the end of 2010, the company had 2.4 million subscribers.

Vonage Holdings Corp. (NYSE: VG) Memo

(Page of Exhibit/s)

Exhibit 1 – Vonage data

	2008	2009	2010
Marketing costs per gross subscriber line addition (in dollars)	\$266.14	\$304.52	\$309.54
Gross subscriber line additions	952,014	748,681	640,205
Subscriber lines	2,607,156	2,434,896	2,404,883

Exhibit 2 – Skype VoIP usage

	SkypeOut (VoIP) Minutes (in billions)
Q1 2006	0.7
Q2	0.8
Q3	1.1
Q4	1.5
Q1 2007	1.3
Q2	1.3
Q3	1.4
Q4	1.6
Q1 2008	1.7
Q2	1.9
Q3	2.2
Q4	2.6
Q1 2009	2.9
Q2	3.0
Q3	3.1
Q4	N/A

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Exhibit 3 – Vonage Stock Info

1-yr data



1-yr versus 8x8 (competitor)



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Exhibit 4 – Vonage plans & competitor plans

Vonage

Vonage World SM	Most Popular Plan	World Premium Unlimited
\$14.99/mo. for 3 months then \$25.99/mo. [†] plus taxes & fees		\$54.99/mo. plus taxes & fees
<ul style="list-style-type: none">60 countries with unlimited¹ calling to landlines included.Unlimited¹ local and long distance home phone service across U.S., Canada and Puerto RicoMore than 10 countries and territories with unlimited¹ calling to mobile phones - even India.411 Enhanced Directory Assistance included at no extra chargeUnlimited readable voicemail transcriptions sent via text and email		<ul style="list-style-type: none">80 countries with unlimited¹ calling to landlines included.Unlimited¹ local and long distance home phone service across U.S., Canada and Puerto RicoMore than 40 countries and territories with unlimited¹ calling to mobile phones - including UK, Mexico, Dominican Republic, Colombia & Brazil.411 Enhanced Directory Assistance included at no extra chargeUnlimited readable voicemail transcriptions sent via text and email
Learn More Compare Plans		Learn More Compare Plans
Order Now		Order Now

Skype

	Call landlines and mobiles worldwide from:	2.3¢/min	Call landlines in over 30 countries for our lowest rate
Unlimited calls ¹ with a Pay Monthly subscription starting from \$1.09/month			

	Unlimited Europe	\$8.99/month	Buy now
Make unlimited ³ calls to landlines in 20 European countries. See details		\$10.34 incl. VAT	
	Unlimited World	\$13.99/month	Buy now
Make unlimited ³ calls to landlines in 40 countries worldwide. See details		\$16.09 incl. VAT	
	Unlimited World Extra	\$19.99/month⁵	Buy now
Make unlimited ³ calls to 40 countries worldwide plus \$15 of Skype Credit every month ⁴ . Find out more		\$22.99 incl. VAT	

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Ideas for the Club

- One way to keep our members and followers informed on stock performances of the portfolio would be to have a list of our holdings on the website with live performance of the stock for that day. It would be a ticker or a link to the holdings of the company. Similar to the boards in the Comm School but something that actually works.
- Find investment professionals (like those from UVIMCO or other asset management companies) to come and speak to the club about how they chose the stocks they pitch and how they research them and keep updated on the company. I think this would be a great way for members to learn more about the research and pitching process as well as gain insight into the real world of investing.
- Hold some sort of pitching contest just among members. The best way to learn how to research and pitch a stock is to actually do it. By having a mini contest among members, they would have the opportunity to practice as well as give the club new ideas.