Yellow Pages green with Web envy

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BMO Nesbitt Burns analyst Tim Casey had a bit of fun with Marc Tellier on Tuesday. As the **Yellow Pages** boss waited to make his speech to an investor conference, the analyst took a poll.

"Pick up your handsets," Mr. Casey instructed, "and address the following question: What is your primary source of information for local businesses in your household?" Each member of the audience had a small voting machine and three choices: the Yellow Pages directory, a search engine like Google or Yahoo, or another on-line directory.

Fifteen seconds later, the results were in. The winners: Google and Yahoo.

Not quite fair, Mr. Tellier responded. A bunch of BlackBerry-addicted stiffs from Bay Street aren't exactly representative of the Canadian public. With other crowds, the Yellow Pages business is growing. Like who? Sushi eaters, apparently. " 'Sushi' is a fast-growing heading [for advertising]," Mr. Tellier said. " 'Tattoo parlours' is one of our fastest-growing headings. Walk by any university campus today and you'll see who's getting tattoos."

You can see Mr. Tellier's problem. He runs a great business and has a gold-plated stock valuation to match (that's true even after a 10-per-cent drop in the unit price this year). Yellow Pages enjoys operating profit margins of about 40 per cent with little competition. But most investors don't give a damn whether John's Sushi Emporium just bought a half-page ad. What worries them is, how much longer until the Internet starts to eat Yellow Pages' business?

Mr. Tellier is nothing if not a good salesman -- how could he be otherwise, when he's tapping the equity markets so frequently? So, naturally, he's got answers. Google's great for a lot of things, he'll point out, but it's not as handy as Yellow Pages' own sites if you want to find, say, a plumber in Toronto. Yellow Pages has also been buying specialty Web names, like http://www.doctors.ca, in the hope of turning them into new revenue sources. Other initiatives are in the works.

But for all of that, Yellow Pages still gets more than 90 per cent of revenue from putting ads on dead trees. This summer, Veritas Investment Research sent a summer intern to the library to count pages in the yellow books in five major cities. Their finding: The number of advertising pages fell 8 per cent in 2006. Conclusion: "Unmitigated decline," Veritas analyst Neeraj Monga wrote.

The report stirred up a hornet's nest of controversy on Bay Street, where the coverage of Yellow Pages normally ranges from positive to sycophantic. But even some of the bulls are starting to concede the end is in sight for the company's growth phase. Blackmont Capital's Barbara Gray figures the company will run out of growth by 2010 (nonetheless, she rates the stock a "buy").

If she's right, what does that say for the stock's value? Most analysts think the company will produce between $1.25 and $1.30 in distributable cash a unit in 2007. If we assume Mr. Tellier can squeeze out 5-per-cent growth until the end of the decade, after which the business levels off, and then calculate the present value of that cash flow, Yellow Pages could be modestly undervalued. (In that scenario, the units are probably worth between $16 and $17. Yesterday, they closed at $14.68.)

But that involves a pretty big assumption-- that the business will *never* decline, but merely stagnate. If you assume even a modest drop in cash flow, starting in 2011, the numbers begin to change quickly, and Yellow Pages starts to look overpriced (Mr. Monga reckons they'd be fairly valued at $13). And that, it seems, is a view that's starting to take hold among investors, if not with Mr. Tellier. "How many other media companies will come here today that have growing franchises?" he boasted at the BMO conference. True, but for how much longer?