



FORTUNE DIVERSIFIED INDUSTRIES, INC. (AMEX: FFI)

Rating: Upgrade to Buy

Price Target: \$17

Financial Summary		US\$ '000	2004A	2005E	2006E
52-Week Range	\$2.5/\$12.5	Revenue	66,882	110,598	144,521
Recent Price (07/14/05)	\$5.95	EBITDA	3,712	4,190	7,661
Market Cap	\$62.8 Mn	Operating Income	2,548	2,455	5,285
Current Shares Outstanding	10.5 Mn	Net Income	2,402	1,423	3,561
Float	1.0 Mn	EPS, basic	\$0.24	\$0.14	\$0.32
Avg. Daily Trading Volume (3M)	10,698	P/E	25.1	43.9	18.4

Source: Yahoo! Finance, SEC Filings, Reuters, analyst estimates

Summary

We reiterate our price target of \$17 but upgrade our rating to Buy from Speculative Buy due to several recent developments:

- (1) FFI has posted progress in all of its three segments, announced a large backlog in the wireless segment, succeeded to increase sales of the distribution segment despite the loss of a distributor agreement and reported improved margins in the business solutions segment.**
- (2) Increasing liquidity of FFI shares; after the AMEX listing initiation, the daily average trading volume increased significantly.**

Highlights

- ◆ For the next 12 months, FFI plans to increase the number of employees in all of its corporate segments. At the same time, FFI aims to keep the growth in SG&A expenses within the revenue growth rate.
- ◆ Year to date, FFI extended its revolving line of credit twice; thus at June 10, 2005, FFI was able to borrow up to \$19 million compared to \$13 million at the beginning of the year. At the same time, the Company succeeded to lower the interest rate by 0.5 percentage points. Among others, we perceive these changes as anticipation and preparation for business growth.
- ◆ FFI's grows sales and margins in the Manufacturing and Distribution segment despite the loss of the distributor agreement with Thomson effective April 1, 2005. The Company succeeded to replace Thomson products with LG/Zenith products after signing an agreement with LG/Zenith on March 1, 2005. Moreover, the distribution agreement with LG Electronics positively affected segment margins.
- ◆ JH Drew, FFI's largest revenue generator, reported backlog of \$32.3 million; however, this backlog seems to be long-term as FFI expects lower year-over-year revenues. At the same time, we anticipate the Magtech and ITC subsidiaries in the same wireless segment partially to offset the decline.
- ◆ FFI's trading volume has improved significantly since the 2nd half of June, after FFI started trading on AMEX.

Recent financials

\$000's	Q3FY04	Q3FY05	%Chg, YoY	%Chg QoQ
<i>Business solutions segment</i>	4,988	8,290	66%	47%
<i>Wireless infrastructure services</i>	5,965	17,949	201%	83%
<i>Manufacturing and distribution segment</i>	6,302	5,665	-10%	21%
TOTAL NET REVENUES	17,255	31,904	85%	58%
GROSS PROFIT	4,055	6,631	64%	79%
OPERATING INCOME	783	1,345	72%	n/m
NET INCOME	639	1,078	69%	n/m
EPS	\$0.06	\$0.10	67%	n/m

Source: SEC filings

Revenues for Q3FY05 were at \$31.9 million, posting an 85% year-over-year growth and increasing by 58% compared with the prior quarter. FFI ended Q3FY05 with net income of \$1.1 million or \$0.10 EPS compared with \$639,000 or \$0.06 per share for Q3FY04.

	Q3FY04	Q3FY05	%Chg, YoY	%Chg QoQ
Gross margins				
Corporate	24%	21%	-2.7 pp	2.4 pp
<i>Business solutions segment</i>	19%	23%	4.0 pp	-0.4 pp
<i>Wireless infrastructure services</i>	22%	17%	-5.1 pp	5.4 pp
<i>Manufacturing and distribution segment</i>	29%	30%	1.3 pp	3.0 pp
Operating margin	5%	4%	-0.3 pp	9.6 pp

Source: SEC filings

Despite the lower corporate gross margin than in Q3FY04, the Company succeeded in raising the margins compared to the previous quarter. We remind that the lower than expected margin in the previous quarter motivated us to decrease the price target for FFI's shares in our previous update.

Another FFI's accomplishment was the fact that the Company managed to maintain its operating expenses at 17% of revenues in Q3FY05 compared to 19% in Q3FY04 and 24% in the prior quarter.

Wireless Infrastructure

Wireless segment contributed the most to the corporate revenues growth due to organic growth as well as due to acquisitions. JH Drew, the major contributor to FFI's revenues, is expected to post lower year-over-year sales in Q4FY05, however we consider this is a one-time occurrence because the subsidiary posted larger backlog at the end of Q3FY05. Management expects lower margins for the next quarter due to contracts with tighter margins for the upcoming quarter. The Company foresees further expansion of wireless segment's revenue and believes the higher revenues will compensate the downtrend in margins.

We appreciate the sales growth at Magtech and ITC subsidiaries acquired during 2004 compared to the pre-acquisition levels. Thus, Magtech has shown an increase of about 72% and ITC – 300% year-over-year. Currently, the sales of these two subsidiaries are not significant (\$2.3 million combined), but these small subsidiaries should offset the fluctuations in sales of JH Drew.

Business Solutions

Revenues for the Business Solutions segment posted a 66% year-over-year growth in Q3FY05. For Q4FY05, management stated they expect revenues to grow by about 15-20% due to the purchase of CSM in April, 2005 as well as due to the higher revenues of PSM. However, profits are expected to lag behind the revenue growth because of expansion investments in Human Resource divisions.

Manufacturing and Distribution

Manufacturing and Distribution segment revenues decreased 10%, mainly due to the loss of the Thomson distributor agreement in April 2005. However, on the quarter-over-quarter basis, the segment revenues grew. Additionally, the Kingston subsidiary implemented a more rigid sales and credit policy, on one hand limiting sales growth, but on the other hand enhancing margins. Management anticipates sales to post slow quarter-over-quarter growth for the next Q4FY05.

Stock Performance: FFI versus S&P500, 6 months



Source: Reuters,

http://www.reuters.wallst.com/reuters/chartapi/chart_index.asp?chart=advanced&user_id=123456789&symbol0=FDVF.OB&symbol1=.SPX&display=LINE&grid=BOTH&width=0&frequency=1hour&height=0&duration=6month&indicator0=Volume, accessed online on July 15, 2005

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