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FARMSTEAD TELEPHONE GROUP INC. (AMEX: FTG)

Rating: Speculative Buy Maintained

Price Target: $12.25

Financial Summary	
52-Week Range	$0.26/$2.60
Recent Price (07/01/05)	$1.90
Market Cap	$6.4 Mn
Current Shares Outstanding	3.4 Mn
Float	2.89 Mn
Daily trading volume (3mo)	16.0K
Insider Holdings	7.88%
Institutional Holdings	0.20%
LTM Revenues	$12.9 Mn
LTM EPS, diluted	($0.54)
Fiscal Year-End	31-Dec
Current Book Value (per share)	$0.3

US$ '000	2004A	2005E	2006E	2007E
Revenue	12,344	17,961	41,737	116,978
EBITDA	(1,279)	(967)	1,625	24,102
Operating Income	(1,402)	(1,211)	815	20,942
Net Income	(1,424)	(1,382)	449	13,303
Total Assets	4,050	8,628	14,445	27,562
Total Debt	226	2,500	5,000	2,000
Shareholders Equity	1,879	2,465	3,636	17,303
Debt/Equity	0.12	1.01	1.38	0.12
ROE	-75.8%	-56.1%	12.4%	76.9%
ROA	-35.2%	-16.0%	3.1%	48.3%
EPS, diluted	($0.43)	($0.36)	$0.09	$2.44
PE	N/M	N/M	21.0	0.8

S*ource: Yahoo! Finance, SEC filings, Analyst Estimates*

We reiterate our Speculative Buy Rating on FTG following the recent announcement of quarterly financial results and the approaching "moment of truth" for FTG – the launch of its One IP Voice initiative in September. The stock gained close to 73% since the date of initiation of coverage on the company less than two months ago and we believe that there continues to be significant upside potential, over and above what other companies in the industry can offer. FTG's current market capitalization of just $6.4 million is tiny when compared to the forecasted $100+ million annual revenues starting with FY07. Even if the share count double or triples in the meantime (worse case scenario), company's shares are likely to reach in excess of $10-15.

Our current price target calculation shows an upside potential of 545% over the next eighteen months. It is higher than in our initiation report but still contains a significant execution discount that is very likely to go away in the next two-three quarters, as the company rolls out its VoIP initiative and we can see some solid results and have a better vision on the likelihood of success. So far FTG has shown solid financial performance in terms of stabilizing and turning around its traditional business. The management announced that the month of June was the first profitable month since May 2003 and we believe that there is a chance of a profitable Q3FY05, though we have conservatively modeled a loss for the quarter, trying to cover for the costs of VoIP initiative roll-out. FTG is gaining momentum in terms of revenues and its expansion and stabilization of the traditional business are likely to have positive spill-over effects for the VoIP initiative. For instance, by the end of June 2005, the Company's direct sales and sales support group was 85% larger than June 2004. This same salesforce is likely to contribute both to higher traditional products sales, as well as to better visibility and higher customer acceptance rate of the SMB VoIP project. In any case, the launch of the VoIP initiative is nearing and we believe that by the end of Q3FY05 we are likely to have a first briefing from management about the initial response from customers. Early success will lead to a rapid price increase.

VALUATION

7/1/2005 COMPANY NAME	Ticker Smbl	M. CAP ($mn)	Share Price	PE ttm	PE CY06	PE CY07	PSR ttm	PSR CY06	PSR CY07	Price to Book	Price to Cash Flow	EV/ EBITDA
Farmstead	**FTG**	**6.4**	**1.90**	**NA**	**NA**	**0.78**	**0.49**	**0.00**	**0.00**	**21.91**	**NA**	**NA**
VERIZON COMM	VZ	91,676	33.13	13.00	12.70	12.50	1.25	1.18	1.15	2.40	4.40	5.00
SBC COMMUNICATIONS	SBC	79,374	24.03	16.10	14.60	13.70	1.93	1.25	1.22	2.00	6.40	6.60
COMCAST 'A'	CMCSA	69,472	31.5	50.80	31.80	21.60	3.26	2.82	2.59	1.70	11.60	10.30
AT&T	T	15,792	19.71	8.10	15.30	35.20	0.55	0.68	0.76	2.10	2.80	2.80
ALCATEL ADR	ALA	15,626	11.97	20.00	14.40	-	0.97	0.95	0.89	2.30	8.10	7.30
BROADCOM	BRCM	14,114	42.44	36.60	26.70	-	6.03	4.65	-	5.60	29.60	22.70
MCI	MCIP	8,349	25.67	35.70	NM	NM	0.43	0.50	0.51	2.00	3.70	3.30
QWEST COMMUNICATIONS	Q	7,107	3.91	NM	NM	NM	0.51	0.52	0.52	NM	3.00	5.70
Mean				**25.76**	**19.25**	**20.75**	**1.87**	**1.57**	**1.09**	**2.59**	**8.70**	**7.96**
Median				**20.00**	**14.95**	**17.65**	**1.11**	**1.07**	**0.89**	**2.10**	**5.40**	**6.15**
CDW	CDWC	4,970	60.95	20.20	17.00	14.60	0.82	0.71	-	4.30	18.90	10.70
LEVEL 3 COMM	LVLT	1,348	1.93	NM	NM	NM	0.35	0.39	0.36	NM	6.90	9.40
SONUS NETWORKS	SONS	1,226	4.93	54.80	32.90	21.40	6.68	4.99	4.11	4.90	40.10	30.20
REALNETWORKS	RNWK	895	5.21	86.80	47.40	26.00	2.98	2.35	2.09	2.30	34.90	27.40
PREMIERE GLOBAL SVS	PGI	687	9.55	13.60	11.60	10.10	1.40	1.28	1.19	2.40	8.00	6.40
ASIA SATELLITE ADR	SAT	796	20.4	14.50	14.00	-	6.32	0.79	-	1.60	8.60	8.00
GLOBAL CROSSING	GLBC	385	17.48	NM	NM	-	0.17	0.22	-	NM	NM	NM
SUREWEST COMMUNIC	SURW	408	27.95	NM	87.30	-	1.88	1.83	-	1.70	8.40	9.60
AUDIOCODES LTD	AUDC	373	9.98	41.60	21.70	18.10	3.60	2.53	1.46	3.10	31.00	27.50
INTERVOICE	INTV	361	9.53	16.20	19.90	16.40	1.95	1.96	1.79	4.40	12.00	9.10
NET2PHONE	NTOP	133	1.71	NM	NM	8.60	1.64	1.11	0.63	1.30	NM	NM
DELTATHREE	DDDC	82	2.75	NM	91.70	-	3.26	2.32	1.62	5.20	87.70	78.10
8X8	EGHT	96	1.79	NM	-	-	6.25	2.34	0.97	5.00	NM	NM
DIGITAL GENERATION	DGIT	50	0.68	11.30	-	-	0.78	-	-	0.60	4.90	NM
US LEC	CLEC	59	1.93	NM	NM	5.80	0.16	0.14	0.13	NM	4.50	6.10
PRIMUS TELECOM GRP	PRTL	79	0.8	NM	-	-	0.06	0.06	-	NM	13.70	8.60
BOSTON COMMUNIC GRP	BCGI	32	1.84	3.30	18.40	-	0.31	0.38	-	0.20	1.00	NM
XETA TECHNOLOGIES	XETA	24	2.35	23.50	-	-	0.42	-	-	0.60	12.40	10.80
DSL.NET	BIZ	19	0.08	NM	-	-	0.30	-	-	3.10	NM	11.40
Mean				**28.58**	**36.19**	**15.13**	**2.07**	**1.46**	**1.44**	**2.71**	**19.53**	**18.09**
Median				**18.20**	**20.80**	**15.50**	**1.40**	**1.20**	**1.33**	**2.40**	**12.00**	**10.15**

Source: Baseline, Yahoo! Finance, Analyst Estimates

FTG remains a superior investment opportunity in a very attractive industry. As seen in the comparative valuation table above, FTG is only trading at 0.78x its projected FY07 earnings and practically 0.0x its projected FY07 sales. The large established competitors currently trade at approximately 20x trailing PE and 1.1x trailing PSR, though we have to mention that the range is relatively wide, with significant differences between means and medians of the respective multiples within the group.

The smaller and more dynamic competitors, many of which are relatively new, representing the new wave of alternative telecom players are valued at multiples somewhat above those of the larger competitors group. So, the P/CF and EV/ EBITDA multiples are as much as two times higher for the smaller group, while the PSR is 26% higher. We believe that once FTG is established as an emerging SMB VoIP player, it will start to enjoy the higher multiples of the smaller/ dynamic telecom players.

Price Target

We will continue to employ the same methodology as in the initiation report – namely a weighted average of DCF, EV/ EBITDA, PS and PE valuations.

Our DCF model used the following assumptions:

All figures '000s USD, except per share data	
MAJOR ASSUMPTIONS	
WACC Calculation	
Stock Price	$1.90
Shares Outstanding	3,353
Shares end of CA06	5,303
Mkt Cap	6,370
Book Value of Net Debt, FY05	2,500
Book Value of Net Debt, FY06	5,000
Beta (assumed)	1.50
Risk Premium	5.0%
Risk Free Rate	4.5%
Micro-cap premium	3.0%
Cost of Equity	15.0%
Long-term Equity Weight	100%
Weighted Cost of Equity	15.0%
Cost of Debt	8.0%
Long-term Tax rate	40%
Tax Effected Cost of Debt	4.8%
WACC	15.0%
Terminal growth	3.5%

The explosive development of the VoIP business in the next three years is expected to provide the following cash flows:

USD, '000	FYE05E	FYE06E	FYE07E	FYE08E	Terminal Value
EBIT (1-T)	(1,211)	815	12,565	24,307	
Dep & Amort	244	810	3,160	6,560	
(-) Cap Ex	(453)	(6,500)	(14,250)	(18,500)	
(-) Changes in Non Cash Working Capital	319	2,329	1,387	(2,500)	
Free Cash Flow	**(1,100)**	**(2,546)**	**2,862**	**9,867**	**88,805**

Finally, the current value per share and the price target at the end of FY06 are as follows:

Discounted Cash Flow	FY05	FY06
DCF stream	4,642	6,438
DC terminal value	50,774	58,391

Total DC Enterprise Value	55,416	64,829
(Less) Interest Liabilities	2,500	5,000
Equity Value	52,916	59,829
Equity Value Per Share	**$9.98**	**$11.28**

Our DCF model produces a current fair value per share of $9.52 ($9.98 discounted for four months) – that is more than five times the current price per share. Also, our FY06 price target is close to six times the current price per share.

The alternative price target calculation using multiples are as follows:

EBITDA valuation		**P/S valuation**		**P/E valuation**	
EBITDA FY07E	24,102	Revenues FY06E	41,737	EPS FY07E	$2.44
Industry multiple	6.0	Industry multiple	1.3	Industry multiple	15.0
Premium (Discount) assumed	-40%	Premium (Discount) assumed	-40%	Premium (Discount) assumed	-40%
Forward ratio discount	-15%	Forward ratio discount	-15%	Forward ratio discount	-15%
Company traded at multiple	3.1	Company traded at multiple	0.7	Company traded at multiple	7.8
Equity value	70,448	Equity value	28,309		
Price target	**$13.28**	Price target	**$5.34**	Price target	**$19.09**

We continue to employ a 40% discount to peers reflecting the fact that the promising VoIP division does not yet exist and there is a degree of risk relating to its future. However, we believe that the size of discount covers for even the most risk-averse investor and that the price targets that result after applying the discount are very attractive. The simple mathematical average of the four calculations – DCF, EV/ EBITDA, PS and PE – is $12.25. It represents an upside potential of more than 500% and as a result we reiterate we Speculative Buy rating on the stock with an eighteen month price target of $12.25.

FINANCIAL PERFORMANCE

FTG has done extremely well during Q3FY05 exceeding our estimates both in terms of revenues and net income. The $4,483,000 in revenues for the quarter ended June 30, 2005 was the highest revenue quarter since the second quarter of 2002, and the Company recorded a profit for the month of June, which was the Company's first profitable month since May 2003.

Farmstead Telephone Group

Financial Highlights

	Quarter ended June 30,		Six months ended June 30,	
	2005	2004	2005	2004
<s>	<c>	<c>	<c>	<c>
Revenues	$4,483,000	$2,889,000	$ 6,892,000	$6,295,000
Net Loss	$ (474,000)	$ (414,000)	$(1,112,000)	$ (755,000)
Basic and Diluted Net Loss Per Share	$(0.14)	$(0.12)	$(0.33)	$(0.23)
Weighted Average Shares Outstanding	3,353,000	3,316,000	3,340,000	3,314,000

From a balance sheet perspective, we can see that the company has increased total assets to $6.2 million from $4.5 million at the end of Q1FY05 and $4.05 at the end of FY04. The main increase was in the balance of accounts receivable, financed primarily through higher accounts payable and more debt, reflecting a higher level of business activity. Total stockholders' equity continued to decrease and reached just under $1.0 million, however we expect that the company will raise additional cash by the end of the year, strengthening its long-term financing structure. Even if weren't to raise additional share capital in the near future, the expected level of future losses are unlikely to be greater than the current level of shareholder equity.

Financing

Cash and liquidity remain one of the main issues for the company. As its VoIP customer base grows, FTG will need increasing amounts of cash for CAPEX, at a rate of $1.5-2 million a quarter initially. It is not an impossible amount, however it is relatively large for FTG. We can expect the company to raise additional finance through secondary public offerings in the near future. In order to finance its business expansion plans, effective March 31, 2005 the Company entered into a $3 million credit arrangement with a new lender, replacing a $1.7 million credit facility with Business Alliance Capital Corporation. This cash should suffice in the initial stage, however we believe that by the year-end the company will have to look for additional cash which will lead to dilution for current shareholders. The company stated that "working capital requirements are expected to significantly increase by year end as we continue to buildout the infrastructure of capital equipment, systems and personnel required to deploy our hosted VOIP service offerings through our newly-formed subsidiary One IP Voice, Inc." In our assumptions, the stock count increases from the current 3.35 million to 4.55 million at the end of FY05 and 5.2 million at the end of FY06.

SHARE PRICE PERFORMANCE

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Sergiu Lisnic, CFA is a Senior Analyst with Spelman Research. Prior to joining the company, he worked as an analyst for Evanston Capital Advisors for a year and a half, and subsequently served for two years as a financial analyst with a gas distribution and a FMCG company. He was primarily responsible for financial statement analysis, budgeting and reporting to shareholders. He earned the CFA title in September 2003.

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FINANCIAL PROJECTIONS

Statement of Operations USD' 000	FY03	FY04	*Q1FY05*	*Q2FY05*	*Q3FY05E*	*Q4FY05E*	FY05E	FY06E	FY07E	FY08E
Revenues										
Equipment	12,928	10,964	*1,965*	*3,723*	*4,361*	*4,932*	14,982	24,622	29,300	30,765
One Voice IP	0	0	*0*	*0*	*0*	*150*	150	12,629	82,184	200,381
Services and other revenue	1,981	1,380	*444*	*760*	*800*	*825*	2,829	4,485	5,494	6,318
Net revenues	**14,909**	**12,344**	***2,409***	***4,483***	***5,161***	***5,907***	**17,961**	**41,737**	**116,978**	**237,465**
Equipment	8,886	7,987	*1,319*	*2,695*	*3,162*	*3,453*	10,628	17,428	21,322	22,766
VOIP, carrier	0	0	*0*	*0*	*50*	*75*	125	6,512	41,572	104,745
Services and other revenue	1,310	846	*234*	*321*	*336*	*355*	1,246	2,069	2,719	3,475
Other cost of revenues	827	618	*102*	*131*	*100*	*75*	408	200	200	200
Total cost of revenues	**11,023**	**9,451**	***1,655***	***3,147***	***3,648***	***3,957***	**12,407**	**26,210**	**65,813**	**131,187**
Gross profit	**3,886**	**2,893**	***754***	***1,336***	***1,514***	***1,950***	**5,554**	**15,527**	**51,165**	**106,278**
SG&A	4,561	4,295	*1,384*	*1,765*	*1,730*	*1,886*	6,764	14,063	27,223	59,366
Depreciation	0	0	*0*	*0*	*0*	*0*	0	650	3,000	6,400
Operating profit/ (loss)	**(675)**	**(1,402)**	***(630)***	***(429)***	***(216)***	***64***	**(1,211)**	**815**	**20,942**	**40,512**
Interest expense	(28)	(28)	*(8)*	*(43)*	*(50)*	*(75)*	(176)	(365)	(122)	(115)
Other income	7	6	*3*	*1*	*0*	*0*	4	0	0	0
Loss before income taxes	(696)	(1,424)	*(635)*	*(471)*	*(266)*	*(11)*	(1,383)	449	20,820	40,397
Provision for income taxes	13	0	*4*	*(3)*	*0*	*0*	1	0	(7,517)	(16,159)
Net loss	**(683)**	**(1,424)**	***(631)***	***(474)***	***(266)***	***(11)***	**(1,382)**	**449**	**13,303**	**24,238**
EPS, basic and diluted	($0.21)	($0.43)	*($0.19)*	*($0.14)*	*($0.07)*	*($0.00)*	($0.36)	$0.09	$2.44	$4.07
Shares outstanding	3,305	3,317	*3,328*	*3,353*	*3,953*	*4,553*	3,797	4,978	5,453	5,953