

December 6, 2005

## **FARMSTEAD TELEPHONE GROUP INC. (AMEX: FTG)**

### **Rating: Not Rated**

#### **Share statistics**

<u>12/5/2005</u>	
Symbol	FTG
Last Trade (12/5/05)	\$1.54
Low/High 52 weeks	\$0.51 - 4.55
Average Volume (3m)	1,787,954
Market Capitalization	\$5.8 Mn
Shares Outstanding	3.75 Mn

*Source: Yahoo! Finance, analyst estimates*

#### **Analyst Summary**

**We have changed our rating on FTG to “not rated”. The company reported strong revenue and gross margins for Q3FY05 and also announced completion of several milestones in development of its infrastructure and the deployment of One IP Voice product offerings. While we believe a successful launch of One IP Voice in Q1FY06 could fuel revenue growth and help the company break even, we are concerned about the following developments which can negatively affect FTG’s stock price and liquidity in the short to medium run:**

#### **Risk of being delisted from AMEX**

On November 14’05, FTG received a notice from AMEX about non-compliance with listing standards due to the failure to maintain stockholders’ equity of at least \$4 million. In order to regain compliance, FTG has taken several steps:

- requested AMEX for a ninety days extension from November 7’05;
- began the process of soliciting its shareholders’ approval for one or a series of private and public offerings. This capital should allow FTG to satisfy AMEX’s listing requirements and at the same time to fund the ongoing build-out of its new IP telephony business.
- on October 31’05, FTG entered into an agreement with a New York-based investment banking firm. This investment banking firm has agreed to act as the lead placement agent for an immediate private offering of securities and to be the managing underwriter for a possible secondary public offering of common stock planned for sometime in FY06. The aggregate proceeds expected by FTG stand between \$6 million and \$26 million.

Delisting is probable because AMEX already granted FTG an eighteen-month period to regain compliance with the standard, and such compliance period ended on November 7, 2005.

#### **High dependence on external financing**

FTG has limited cash resources and therefore has to rely on external funding in order to finance its business expansion plans and regain compliance with AMEX’s listing standards. Despite the private and public offerings expected in the short run, it is difficult to assess their timing and outcome since the terms of the proposed offering are on a best effort basis and not a firm commitment.

## **STATUS OF ONE IP VOICE PROJECT**

### **FTG's One IP Voice project is running right on schedule according to management**

After launching its carrier-based platform in late September'05, FTG has deployed the One IP Voice service nationwide in Tier 1 cities. According to Jean-Marc Stiegemeier, Farmstead's Chairman and CEO, FTG intends to complete its Tier 1 support platform to aid its One IP Voice offering over the next few weeks.

One IP Voice was previously expected to offer carrier-based hosted IP telephony services along with network services by the end of 2005. However, recently FTG announced One IP Voice is expected to become operational in Q1FY06. This should slightly affect the timing of revenue, while the potential will still remain enormous.

## **RECENT FINANCIAL PERFORMANCE**

### **Income statement**

#### **Strong revenue growth in both operating segments**

FTG reported strong revenue growth in both of its operating segments for Q3FY05 versus Q3FY04. As a result, consolidated revenue jumped by 44% year-over-year. The growth was fueled mainly by the increase in end-user equipment sales partially offset by a decline in equipment sales to resellers.

#### **Improving gross margins**

The revenue growth was associated by an improvement in gross profit margin of almost 2 percentage points for Q3FY05 versus Q3FY04. FTG explained this growth by significantly higher commission revenues earned from the sale of Avaya maintenance contracts, which generate a 100% profit margin.

In the meantime, the gross margin for FTG's largest segment – Equipment Sales – declined slightly and management expects gross margins for this segment to be further pressured due to continuing price competition.

#### **Increasing operating expenses for infrastructure development and deployment of One IP Voice product offerings**

Although revenue and gross margin increased year-over-year, FTG reported higher operating loss and net loss for Q3FY05 compared with Q3FY04. This was mainly due to almost double SG&A expenses related to infrastructure development and deployment of One IP Voice product offerings. The expenses consisted primarily of employee compensation, consulting, marketing, training and office expenses. FTG's management expects its SG&A expenses to increase due to further development and deployment of the One IP Voice product offerings.

#### **Q3FY05 top and bottom lines below our estimates**

FTG reported lower revenues and earnings for Q3FY05 than we expected. However we believe the deviation is nonrecurring and negligible if compared to the top and bottom lines we expect for the next 2-3 years.

## Income Statement Analysis

(\$ th., except loss per share amounts)	Q3FY04	Q3FY05	% Chg	9moFY04	9moFY05	% Chg
<b>Total revenues</b>	<b>3338</b>	<b>4807</b>	<b>44%</b>	<b>9633</b>	<b>11699</b>	<b>21%</b>
Equipment	2967	3890	31%	8473	9578	13%
Services and other revenue	371	917	147%	1160	2121	83%
<b>Operating loss</b>	<b>-176</b>	<b>-646</b>		<b>-915</b>	<b>-1704</b>	
<b>Net loss</b>	<b>-175</b>	<b>-704</b>		<b>-930</b>	<b>-1816</b>	
<b>EPS, \$</b>	<b>-0.05</b>	<b>-0.20</b>		<b>-0.28</b>	<b>-0.53</b>	
<b>Consolidated gross margin</b>	<b>24%</b>	<b>26%</b>	<b>2% pts</b>	<b>24%</b>	<b>28%</b>	<b>5% pts</b>
GM, Equipment	27%	26%	-1% pts	27%	28%	1% pts
GM, Services and other revenue	31%	38%	7% pts	38%	47%	9% pts
<b>Operating margin</b>	<b>-5%</b>	<b>-13%</b>	<b>-8% pts</b>	<b>-9%</b>	<b>-15%</b>	<b>-5% pts</b>
<b>Net margin</b>	<b>-5%</b>	<b>-15%</b>	<b>-9% pts</b>	<b>-10%</b>	<b>-16%</b>	<b>-6% pts</b>

Source: company's SEC filings

## Balance Sheet

Since the beginning of 2005, FTG increased its total assets by 55% to \$6.3 million. The main increase took place in accounts receivable, financed primarily through higher accounts payable and more debt. The increase in PPE was in connection with the build-out of FTG's IP telephony plan.

FTG's total stockholders' equity continued to decrease as a result of the increase in accumulated deficit.

## Balance Sheet Analysis

\$thousands	December 31'04	September 30'05	% Change
Cash and cash equivalents	217	186	-14%
Accounts receivable, net	1,453	3,598	148%
Inventories, net	1,627	1,345	-17%
Property and equipment, net	268	563	110%
<b>Total Assets</b>	<b>4,050</b>	<b>6,291</b>	<b>55%</b>
Accounts payable	1,110	3,123	181%
<b>Total Liabilities</b>	<b>2,171</b>	<b>4,939</b>	<b>127%</b>
<b>Stockholders' Equity</b>	<b>1,879</b>	<b>1,352</b>	<b>-28%</b>

Source: company's SEC filings

## Cash Flow

During 9moFY05, as well as during 9moFY04, FTG failed to generate positive cash flow from its operations. Moreover, cash used in operating activities increased by 6% year-over-year during 9moFY05, due to the increase in loss from operation and the increase in accounts receivable. In its turn, the increase in FTG's accounts receivable was primarily attributable to significant growth in its systems sales, for which the cash receipt cycle is longer since there is typically an installation to be completed prior to full payment.

\$thousands	9moFY04	9moFY05	YoY %
Net cash used in operating activities	906	958	6%
Net cash used in investing activities	25	320	1,180%
Net cash provided by financing activities	490	1,247	154%
Cash and cash equivalents at end of period	386	186	-52%

Source: company's SEC filings

The increase in cash used in investing activities was caused mainly by the purchase of network equipment and licenses in connection with the build-out of an IP telephony platform for FTG's One IP Voice subsidiary.

The increase in cash from financing activities during 9moFY05 was mainly due to the following:

- 1) year-over-year increase in net borrowings under revolving credit lines to \$0.9 million in 9moFY05 compared with \$0.2 million in 9moFY04, and
- 2) \$0.5 million cash from proceeds from convertible note payable.

### EXPANDED MANAGEMENT TEAM

On November 30'05, FTG announced that its wholly owned subsidiary One IP Voice, Inc. had appointed three Regional Vice Presidents in support of its national rollout plan of One IP Voice offerings as follows:

**Walt Snider**, a 25 year industry veteran, has extensive experience in channel distribution and sales and marketing. For the past six years he has served as Sales and Marketing Vice President for a major network services reseller and was responsible for the start-up of that company's VoIP business. His prior experience includes senior management roles in sales and marketing with AT&T. Mr. Snider will be responsible for the Eastern region.

**Robert Harrison** has been appointed Regional Vice President for the Western region. Mr. Harrison's background spans over 20 years. He started with his family's Executone Communications business and was Vice President Enterprise Sales and Partnerships with Carrier Access Corporation, and President and CEO, responsible for \$40 million divisions of General Fiber Communications, Inc. In addition, he served as Vice President Marketing and Sales with Integrated Network Services, Inc. where revenue grew to \$42 million during his 10 year tenure.

**Barry Goldberg**, who will be responsible for the Central region, started his career in telecommunications over 17 years ago with TIE Communications. As Area Vice President, he directed a staff of 240 generating \$80 million in the Eastern region. For the past four years he has served as Vice President/General Manager for Frontrunner Network Systems, where he was responsible for increasing revenue and operating income over 400%.

### FTG's STOCK PERFORMANCE (1 YEAR)



**Alexandru Vozian** is a Senior Analyst with Spelman Research. He joined the company in 2003 and has been covering the Technology, Healthcare and Services sectors. Prior to joining the Company, Mr. Vozian held economist positions at two commercial banks. Mr. Vozian earned his bachelor's degree in finance from the Academy of Economic Studies of Moldova in 2000. Mr. Vozian passed Level 1 exam of the CFA program and is currently registered for the Level 2 CFA exam.

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