

Elephant Talk Communications, Inc.

OTCBB: ETAK Industry: Telecommunications

Maintaining Rating & Target

Buy, \$ 8.00

May 17, 2011

MARKET DATA

Share Price:	2.20
Market Cap:	217.40 M
52wk Range:	1.49—3.60
Ave. Volume:	175,000
Basic S/O:	98.82 M
Diluted S/O:	161.93 M
Float:	46.18 M
Institutional %:	N/A
Insider %:	12%

FINANCIAL DATA (mrq)

Cash:	4.36 M
ST Debt:	0.87 M
LT Debt:	0.48 M
Book Value:	34.65 M
EBITDA (ttm):	(8.70) M
CFFO (ttm):	N/A

Auditor: BDO USA, LLP

USD	2010A	2011e	2012e	2013e
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Revenue (in Millions)

March	9.94	8.51A	17.08	46.72
June	9.67	8.61	22.10	79.55
Sept	9.04	10.90	26.12	128.65
Dec	8.51	14.10	34.93	168.45
REV	37.17	42.11	100.22	423.36
P/S	6.78	5.43	2.27	0.56

Diluted EPS

March	(0.06)	(0.05)A	(0.02)	0.05
June	(0.10)	(0.05)	0.00	0.11
Sept	(0.07)	(0.04)	0.01	0.20
Dec	(0.06)	(0.03)	0.03	0.26
EPS	(0.28)	(0.18)	0.04	0.63
P/E	N/A	N/A	N/A	3.59

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Cash Coming In To Resolve Going Concern Issue, A Prelude To An Exchange Uplisting

Key Updates

Revenue for the first quarter declined 14.4%, to \$8.5 million, or 13.3% adjusted for currency changes. The decrease was due to a \$1.9 million decline in the Company's landline business, which was partially offset by a 67% increase, to \$1.6 million, in the higher margin Mobile and Security Solutions business. The growth in this segment was due to initial fees from migrations in Spain and the mobile platform contract in the Middle East. The Company has signed an agreement Cleartech to become its Mobile Virtual Network enabler in Brazil and provide infrastructure services. We believe that the higher margin revenue from Mobile and Security solutions could generate \$6 million in revenue for the fourth quarter, split between the MVNO and ValidSoft segments.

The cost of service decreased 19%, to \$7.6 million, or 94% of revenue. The percentage should decline throughout this year as the percentage contribution of revenue from higher margin services increases. Cash SG&A increased \$1.5 million, or 82%, with roughly 64.5% of the increase due to the inclusion of ValidSoft in the results and 17% due to increased staffing. Non-cash compensation was \$1.1 million. The net loss for the quarter was \$4.7 million, or \$0.07 per share, versus \$12.3 million, or \$0.25 per share in the year ago period.

The Company plans to improve the liquidity of its common stock by listing on one of the exchanges by the end of second quarter, which will require it to resolve the going concern issue. About \$8 to \$10 million in cash has come in from the exercise of the warrants thus far and if necessary, ETAK's largest investor, QAT, will exercise enough warrants to cover the remainder. The burn rate today is about \$800,000.

Valuation

We are maintaining our Buy rating and \$8.00 target price on Elephant Talk Communications, Inc. Our target price is based upon a P/E multiple of 25 times our 2013 earnings estimate of \$0.63 per diluted share discounted two years at a rate of 40% to reflect the uncertainty and timing of ValidSoft's contribution to earnings and the timing of the mobile solutions ramp up. We believe there could be significant upside to our 2013 estimates if ValidSoft becomes successful in the United States market.

Business Summary

Elephant Talk is an international provider of business software and services to the telecom and financial services industries. The Company's telecom services include landline network outsourcing and mobile virtual network enabling (MVNE) in Europe and Asia. It also offers a suite of fraud prevention and security solutions through its ValidSoft subsidiary, which has begun working with Visa Europe.

COMPANY OVERVIEW

Q1 Results

Revenue for the first quarter declined 14.4%, to \$8.5 million, or 13.3% adjusted for currency changes. The decrease was due to a \$1.9 million decline in the Company's landline business, which was partially offset by a 67% increase, to \$1.6 million, in the higher margin Mobile and Security Solutions business. The growth in this segment was due to initial fees from migrations in Spain and the mobile platform contract in the Middle East. The Company has signed an agreement Cleartech to become its Mobile Virtual Network enabler in Brazil and provide infrastructure services. The Company also has targeted other mobile markets in Mexico, Columbia and Turkey. ValidSoft is working with a European governmental agency to improve the unemployment system through recipient verification, with a live trial to commence in Q2:11. ValidSoft has attracted interest from other jurisdictions throughout Europe and is in advanced discussions with a financial institution in Mexico concerning Internet banking. The Company is also in commercial discussions with a major international financial institution concerning a ValidSoft solution for credit card provision. We believe that the higher margin revenue from Mobile and Security solutions could generate \$6 million in revenue for the fourth quarter, split between the MVNO and ValidSoft segments.

The cost of service decreased 19%, to \$7.6 million, or 94% of revenue. Approximately \$120,000 of the decrease was due to the favorable impact of currency translation. The percentage should decline throughout this year as the percentage contribution of revenue from higher margin services increases. Cash SG&A increased \$1.5 million, or 82%, with roughly 64.5% of the increase due to the inclusion of ValidSoft in the results and 17% due to increased staffing. Non-cash compensation was \$1.1 million. The net loss for the quarter was \$4.7 million, or \$0.07 per share, versus \$12.3 million, or \$0.25 per share in the year ago period.

Uplisting

The Company plans to improve the liquidity of its common stock by listing on one of the exchanges by the end of second quarter, which will require it to resolve the going concern issue. About \$8 to \$10 million in cash has come in from the exercise of the warrants thus far and if necessary, ETAK's largest investor, QAT, will exercise enough warrants to cover the remainder. The burn rate today is about \$800,000.

Model Update

We are adjusting our 2011 revenue estimate from \$46.4 million to \$42.1 million and reducing our EPS estimate from a loss of \$0.08 per share to loss of \$0.18 per share to reflect lower revenue from the low margin landline business. Despite the reduced landline estimates, the higher gross margins going forward resulted in an increase in 2012 EPS from a loss of \$0.01 per share to a gain of \$0.04 per share, while 2013 EPS stayed at \$0.63 per share.

RISKS

History of Losses

The Company has incurred significant losses in the past and there are no assurances it will be successful in ramping up operations for its MVNE and ValidSoft operations.

Large Competitors

The Company is substantially smaller than some of its competitors and could put a significant strain on its financial resources to compete.

Telecom Regulations

Changes in the regulation of the telecommunications industry in the European community or the federal and state level could adversely affect the Company's business, revenue and cash flow.

Lengthy Sales Cycle

The process to secure and execute new contracts is lengthy and may result in volatility in revenues and earnings.

Third Party Relationships

The Company connects its customers' telephone calls and data-Internet needs through access agreements with facilities-based Mobile Network Operators and land-line carriers. Any deterioration in these relationships could have an adverse effect on the Company's telecommunications traffic business.

Rapidly Changing Industry

The telecommunications industry rapidly changing due to deregulation, privatization, consolidation, technological improvements and availability to alternative services, which could force the Company to adjust its strategy to be able to compete effectively.

VALUATION

We are maintaining our Buy rating and \$8.00 target price on Elephant Talk Communications, Inc. Our target price is based upon a P/E multiple of 25 times our 2013 earnings estimate of \$0.63 per diluted share discounted two years at a rate of 40% to reflect the uncertainty and timing of ValidSoft's contribution to earnings and the timing of the mobile solutions ramp up. We believe there could be significant upside to our 2013 estimates if ValidSoft becomes successful in the United States market.

ESTIMATED INCOME STATEMENT

	2010A	Q1:11A	Q2:11e	Q3:11e	Q4:11e	2011e	Q1:12e	Q2:12e	Q3:12e	Q4:12e	2012e	Q1:13e	Q2:13e	Q3:13e	Q4:13e	2013e
Mobile Network Operators	37,168	8,508	8,610	9,902	10,595	37,614	12,078	15,097	18,117	19,929	65,221	22,719	36,350	50,890	71,246	181,204
ValidSoft	-	-	-	1,000	3,500	4,500	5,000	7,000	8,000	15,000	35,000	24,000	43,200	77,760	97,200	242,160
Total Revenues	37,168	8,508	8,610	10,902	14,095	42,114	17,078	22,097	26,117	34,929	100,221	46,719	79,550	128,650	168,446	423,364
MNO	35,121	7,557	7,620	8,317	8,900	32,394	9,662	11,323	12,682	13,950	47,617	15,903	25,445	35,623	49,872	126,843
ValidSoft	-	-	-	600	2,100	2,700	2,750	3,850	4,400	8,250	19,250	13,200	23,760	42,768	53,460	133,188
Total COGS	35,121	7,557	7,620	8,917	11,000	35,094	12,412	15,173	17,082	22,200	66,867	29,103	49,205	78,391	103,332	260,031
Gross Profit	2,047	951	990	1,984	3,095	7,021	4,666	6,924	9,035	12,729	33,354	17,616	30,345	50,259	65,114	163,333
SG&A	9,620	3,416	3,530	3,652	3,806	14,404	3,928	4,309	4,832	5,763	18,832	7,709	13,126	19,297	25,267	65,399
Stock-Based Compensation	5,588	1,130	1,125	1,125	1,125	4,505	1,150	1,150	1,150	1,200	4,650	1,200	1,200	1,200	1,200	4,800
Depreciation & Amortization	5,312	1,303	1,325	1,335	1,350	5,313	1,350	1,375	1,375	1,375	5,475	1,400	1,400	1,450	1,450	5,700
Asset Impairment	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Operating Income	(18,473)	(4,898)	(4,990)	(4,128)	(3,185)	(17,201)	(1,762)	90	1,678	4,390	4,397	7,307	14,619	28,311	37,197	87,435
EBITDAS	(7,573)	(2,465)	(2,540)	(1,668)	(710)	(7,383)	738	2,615	4,203	6,965	14,522	9,907	17,219	30,961	39,847	97,935
Interest Income	240	23	25	35	35	118	65	65	75	75	280	75	75	75	75	300
Interest Expense	(1,803)	(67)	(65)	(65)	(65)	(262)	(25)	(20)	(20)	(20)	(85)	-	-	-	-	-
Amortization - Debt Discount	(21,094)	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Other Expense	-	230	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Fair Value - Warrant Liability	(48,108)	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Amort - Deferred Financing Costs	(3,239)	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Net Income Before Taxes	(92,477)	(4,712)	(5,030)	(4,158)	(3,215)	(17,115)	(1,722)	135	1,733	4,445	4,592	7,382	14,694	28,386	37,272	87,735
Income Tax Expense	(1)	(1)	(1)	(1)	(1)	(4)	(2)	(3)	(4)	(20)	(29)	-	-	-	-	-
Net Income Before Min. Int.	(92,478)	(4,713)	(5,031)	(4,159)	(3,216)	(17,119)	(1,724)	132	1,729	4,425	4,563	7,382	14,694	28,386	37,272	87,735
Minority Interest	(5)	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Net Income (GAAP)	(92,483)	(4,713)	(5,031)	(4,159)	(3,215)	(17,118)	(1,724)	132	1,729	4,445	4,583	7,382	14,694	28,386	37,272	87,735
Net Income (non-GAAP)	(20,042)	(4,713)	(5,031)	(4,159)	(3,215)	(17,118)	(1,724)	132	1,729	4,445	4,583	7,382	14,694	28,386	37,272	87,735
Foreign Currency Translation Gain	(1,656)	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Diluted EPS (non-GAAP)	(0.28)	(0.05)	(0.05)	(0.04)	(0.03)	(0.18)	(0.02)	0.00	0.01	0.03	0.04	0.05	0.11	0.20	0.26	0.63
Diluted Shares Outstanding	70,671	96,283	97,150	97,558	97,967	97,239	98,379	127,892	130,450	133,059	122,445	135,720	138,435	141,204	144,028	139,847
	2010A	Q1:11A	Q2:11e	Q3:11e	Q4:11e	2011e	Q1:12e	Q2:12e	Q3:12e	Q4:12e	2012e	Q1:13e	Q2:13e	Q3:13e	Q4:13e	2013e
Gross Margin	5.5%	11.2%	11.5%	18.2%	22.0%	16.7%	27.3%	31.3%	34.6%	36.4%	33.3%	37.7%	38.1%	39.1%	38.7%	38.6%
Operating Margin	-49.7%	-57.6%	-58.0%	-37.9%	-22.6%	-40.8%	-10.3%	0.4%	6.4%	12.6%	4.4%	15.6%	18.4%	22.0%	22.1%	20.7%
EBITDAS Margin	-20.4%	-29.0%	-29.5%	-15.3%	-5.0%	-17.5%	4.3%	11.8%	16.1%	19.9%	14.5%	21.2%	21.6%	24.1%	23.7%	23.1%
Net Margin	-53.9%	-55.4%	-58.4%	-38.1%	-22.8%	-40.6%	-10.1%	0.6%	6.6%	12.7%	4.6%	15.8%	18.5%	22.1%	22.1%	20.7%

Source: Documents filed by Elephant Talk with the SEC and Gar Wood Securities estimates

NOTE: non-GAAP EPS excludes amortization of debt discount, amortization of deferred financing costs, change in warrant liabilities, and note beneficial conversion feature.

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Rating	Count	Percent	<u>I.B. last 12 months</u>	
			Count	Percent
BUY	13	93%	1	8%
HOLD	1	7%	0	0%
SELL	0	0%	0	0%
NO RATING	0	0%	0	0%

Explanation of Ratings

- BUY: Describes stocks we expect to provide a total return (capital appreciation + yield) of 15% or more in the next 12-month period.
- HOLD: Describes stocks we expect to provide a total return (capital appreciation + yield) of plus or minus 15% or more in the next 12-month period.
- SELL: Describes stocks we expect to provide a total negative return (capital depreciation + yield) of 15% or more in the next 12-month period.
- NO RATING: Describes stocks that have their investment rating and/or target price temporarily removed for fundamental or compliance-based reasons.

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