

## SANGOMA TECHNOLOGIES CORPORATION

STC-TSX V: C\$1.34 — BUY

NICK AGOSTINO, MBA, CFA, P.ENG. 416.860.6790

[NICK.AGOSTINO@RESEARCHCAPITAL.COM](mailto:NICK.AGOSTINO@RESEARCHCAPITAL.COM)

ROB CAVALLO (ASSOCIATE) 416.860.7618

### Q3/F08 Results – Record Results Despite Tightened Credit Policy

#### Per Share Data (C\$)

|                       |        |                    |        |
|-----------------------|--------|--------------------|--------|
| Price:                | \$1.34 | Basic Sh. O/S (mm) | 28.2   |
| Target Price (1 yr.): | \$2.20 | FD Shares (mm):    | 28.9   |
| Projected Return:     | 64.2%  | Float (Shares mm): | 16.2   |
| 52 Wk. High:          | \$1.72 | Market Cap (mm):   | \$38.7 |
| 52 Wk. Low:           | \$0.86 |                    |        |

| FY June 30 | 2006A  | 2007A  | 2008E  | 2009E  |
|------------|--------|--------|--------|--------|
| EPS        | \$0.04 | \$0.08 | \$0.13 | \$0.19 |
| P/E        | 33.5x  | 16.8x  | 10.3x  | 7.1x   |
| CFPS       | \$0.06 | \$0.10 | \$0.16 | \$0.21 |
| P/CF       | 22.3x  | 13.4x  | 8.4x   | 6.4x   |

#### Quarterly EPS before special items

| Quarter | 2006A | 2007A | 2008E | 2009E |
|---------|-------|-------|-------|-------|
| Q1      | 0.01  | 0.01  | 0.03  | 0.04E |
| Q2      | 0.01  | 0.02  | 0.03  | 0.05E |
| Q3      | 0.01  | 0.02  | 0.03  | 0.05E |
| Q4      | 0.01  | 0.03  | 0.04E | 0.05E |

#### Target Valuation Parameter

10x C2009 EPS



Courtesy of BigCharts.com

#### Upcoming Events

August: Q4/F08 results.

#### Profile

Sangoma Technologies Corporation ([www.sangoma.com](http://www.sangoma.com)) designs, manufactures, and distributes data and telephony hardware and software that allow PCs to be used as telephony devices or high-performance data routers. The company primarily targets the open-source telephony OEM market. The company's solutions are used in varying applications such as PBX, call centers, data transmission systems, voice monitoring networks, and Internet services.

#### Key Risks

A slowdown in end-market demand for telephony cards, increased competition, adoption of alternative technologies, and currency are all factors that could materially affect the share price.

#### INVESTMENT OPINION

Sangoma reported Q3/F08 results yesterday. **FQ3 marked another quarter of record revenues and profitability despite the company's tightened credit policy.** Overall demand for Sangoma's product offering remains robust, particularly in international markets. As such, we maintain our **BUY** recommendation and one-year target price of \$2.20.

#### ANALYSIS

**Seventh consecutive quarter of record revenues:** FQ3 revenues of \$3.2 mm were up 44% Y/Y and 5% Q/Q, coming in just shy of our \$3.4 mm estimate (Figure 1). A relatively stable C\$/US\$ rate during the quarter had very little impact on top-line growth. Much like in past quarters, FQ3 sales were almost entirely from Wide Area Network (WAN) adapter cards. In general, Sangoma continues to see increasing demand for its data transport products; as such, we expect the company to continue posting record quarterly revenues throughout F2008 and into F2009. The company saw growth Y/Y and Q/Q in all geographies except Canada (which accounts for only 7% of sales), with the biggest Y/Y gains coming again from non-North American markets (which accounted for 53% of total sales versus 49% in FQ2), rising 84% Y/Y. We expect international sales to continue leading top-line growth, particularly as the company focuses on improving its international distribution channels. Sangoma expects Canadian sales to re-accelerate in FQ4 following a recent signing of a material contract with a Canadian customer.

**Taking cautious stance on receivables:** In spite of an apparent economic slowdown in the U.S. economy, demand for Sangoma's adapter cards remains robust. The company, however, has elected to be more aggressive in controlling its receivables with high credit risk distributor customers, in anticipation of tighter business conditions, particularly in the U.S. This stance resulted in some delayed shipments in the quarter and in some cases lost revenues that inhibited FQ2 sales by an estimated \$100k-\$200k. We believe that Sangoma is being cautious with this proactive stance as it currently has no customers in default, has historically witnessed very low bad debt expenses, fiscal year-to-date is witnessing a 6% Q/Q sales growth rate in the U.S. market, has A/R at a very reasonable 60 days (although the company would like to lower this rate), and its account receivables have been constant for the last three quarters at roughly \$2.1 mm. With EDC offering credit insurance of ~\$50k on average for Sangoma's customers, the company wants to ensure its high-risk customers remain below this threshold. This new policy may hinder some near-term top-line growth, which we are modeling in our new estimates, but overall we reiterate that demand in general remains very healthy as the products are enablers of remote communications, which is a desired application in the marketplace.

**Record GAAP profitability:** Sangoma reported an adjusted EPS of \$0.03, \$0.01 below our estimate, namely due to a higher-than-normal tax rate and the lower gross margin. We continue to model a 32% rate going forward. The company also had a \$230k F/X gain, which we exclude from adjusted earnings. The company continues to demonstrate sustainable profitability, having realized profits for the past 15 sequential quarters. Overall, we have tweaked our forward estimates following FQ3 results (Figure 2).

**Solid balance sheet and cash-flow generation:** With minimal capex requirements and strong profitability, the company generated roughly \$1.3 mm in cash flow from operations. Sangoma ended the quarter with \$5.2 mm in net cash (no debt), or \$0.18 per share, and \$8.3 mm in working capital.

**Compelling valuation:** Based on forward EPS estimates, the shares are trading at 7.9x, a 41% discount to the peer group average of 13.4x (excluding outliers). Considering Sangoma's demonstrated strong profitability growth, we expect the multiple gap relative to the peer group to narrow as its addressable market grows, new products are launched, and the company gains increased investor awareness. We reiterate our **BUY** recommendation and one-year target price of \$2.20 based on 10x our calendar 2009 earnings estimate of \$0.22.

**Gross margins below expectations:** FQ3 gross margins came in at 67.8%, 320bps below our 71% estimate. Margins were impacted by a higher contribution from lower-margin OEM business. We have always expected this to be the case as the company grows its OEM business. We have and continue to model 65% gross margins for Sangoma for F2009. FQ3 suggests margins are starting to move to that level. Given the natural hedges in place, F/X had no meaningful impact on margins in the quarter.

**Operating costs slightly lower:** Operating costs of \$619k were \$36k lower than our estimate, with the difference due to lower than expected S&M expenses. Sangoma also had R&D cash expenditure of \$260k in the quarter, which was up 17% Y/Y due to higher staffing levels to focus on enhancing the product portfolio to tackle the growing business opportunities. EBIT margins remained a healthy 40.0%. Despite the declining gross margins, we expect EBIT margins to remain above the 40% mark as we forecast operating expenditures to grow at a slower rate than top-line growth, delivering operating leverage for Sangoma.

### Sangoma Q3/F08 Results

| C\$                | Q3/08A | Q3/08E | %Chg.   | Q3/07A | %Chg.   | Q2/08A | %Chg.   |
|--------------------|--------|--------|---------|--------|---------|--------|---------|
| Sales (000)        | 3,214  | 3,444  | -6.7%   | 2,238  | 43.6%   | 3,071  | 4.7%    |
| Gross Margin (%)   | 67.8%  | 71.0%  | -320bps | 68.2%  | -40bps  | 72.0%  | -420bps |
| EBITDA (000)       | 1,459  | 1,690  | -13.7%  | 1,086  | 34.3%   | 1,586  | -8.0%   |
| EBITDA Margin (%)  | 45.4%  | 49.1%  | -370bps | 48.5%  | -310bps | 51.6%  | -620bps |
| EBIT (000)         | 1,287  | 1,540  | -16.4%  | 954    | 34.9%   | 1,440  | -10.6%  |
| EBIT Margin (%)    | 40.0%  | 44.7%  | -470bps | 42.6%  | -260bps | 46.9%  | -690bps |
| EPS (cont. oper.)  | 0.03   | 0.04   | -25.0%  | 0.02   | 50.0%   | 0.03   | 0.0%    |
| EPS                | 0.03   | 0.04   | -25.0%  | 0.02   | 50.0%   | 0.03   | 0.0%    |
| Net cash per share | 0.18   | 0.16   | 12.5%   | 0.07   | 157.1%  | 0.13   | 38.5%   |

Figure 1. Q3/F08 Results  
 Source. Company reports, Research Capital

### Sangoma - Revised Estimates

| C\$               | New<br>Q4/08E | Old<br>Q4/08E | %Chg.   | New<br>2008E | Old<br>2008E | %Chg.   | New<br>2009E | Old<br>2009E | %Chg.  |
|-------------------|---------------|---------------|---------|--------------|--------------|---------|--------------|--------------|--------|
| Sales (000)       | 3,598         | 3,840         | -6.3%   | 12,704       | 13,177       | -3.6%   | 18,039       | 18,601       | -3.0%  |
| Gross Margin (%)  | 68.0%         | 71.0%         | -300bps | 69.7%        | 71.4%        | -170bps | 65.0%        | 65.0%        | 0bps   |
| EBITDA (000)      | 1,667         | 1,822         | -8.5%   | 6,057        | 6,442        | -6.0%   | 8,568        | 8,606        | -0.4%  |
| EBITDA Margin (%) | 46.3%         | 47.4%         | -110bps | 47.7%        | 48.9%        | -120bps | 47.5%        | 46.3%        | 120bps |
| EPS (cont. oper.) | 0.04          | 0.04          | 0.0%    | 0.13         | 0.14         | -7.1%   | 0.19         | 0.19         | 0.0%   |
| EPS               | 0.03          | 0.04          | -25.0%  | 0.11         | 0.12         | -8.3%   | 0.18         | 0.18         | 0.0%   |

Figure 2. Revised Estimates  
 Source. Company reports, Research Capital

### Sangoma Comps: Comparables Table

| Company              | Ticker       | Rec.       | Target Price  | ROR          | Currency   | Yr End     | Closing Price | Market Cap (MM) | EPS Growth   |              |              | P/E          |              |              |              |
|----------------------|--------------|------------|---------------|--------------|------------|------------|---------------|-----------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|
|                      |              |            |               |              |            |            |               |                 | NTM          | C2008        | C2009        | LTM          | NTM          | C2008        | C2009        |
| <b>Sangoma</b>       | <b>STC-v</b> | <b>BUY</b> | <b>\$2.20</b> | <b>64.2%</b> | <b>C\$</b> | <b>Jun</b> | <b>\$1.34</b> | <b>\$38</b>     | <b>50.0%</b> | <b>50.0%</b> | <b>40.0%</b> | <b>11.2x</b> | <b>7.9x</b>  | <b>8.9x</b>  | <b>6.4x</b>  |
| Aastra Telecom       | AAH-t        | N/A        | N/A           | N/A          | C\$        | Dec        | \$25.50       | \$409           | -1.9%        | -1.9%        | 16.8%        | 12.1x        | 12.3x        | 12.3x        | 10.5x        |
| Audiocodes           | AUDC-o       | N/A        | N/A           | N/A          | US\$       | Dec        | \$4.14        | \$165           | n/a          | n/a          | 33.9%        | n/a          | 12.0x        | 12.0x        | 9.0x         |
| Interphase           | INPH-o       | N/A        | N/A           | N/A          | US\$       | Dec        | \$3.74        | \$24            | n/a          | n/a          | n/a          | n/a          | n/a          | n/a          | n/a          |
| Polycom              | PLCM-o       | N/A        | N/A           | N/A          | US\$       | Dec        | \$24.35       | \$2,132         | 81.6%        | 81.6%        | 18.6%        | 28.7x        | 15.8x        | 15.8x        | 13.3x        |
| Ruggedcom            | RCM-t        | N/A        | N/A           | N/A          | US\$       | Dec        | \$14.15       | \$166           | n/a          | n/a          | n/a          | n/a          | n/a          | n/a          | n/a          |
| <b>Group Average</b> |              |            |               |              |            |            |               |                 | <b>39.9%</b> | <b>39.9%</b> | <b>23.1%</b> | <b>20.4x</b> | <b>13.4x</b> | <b>13.4x</b> | <b>10.9x</b> |

Figure 3. Comparables Table  
 Source. Company reports, Bloomberg, Research Capital



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1. None applicable.

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Toronto 416.860.7600

Montreal 514.399.1500

Vancouver 604.662.1800

Calgary 403.265.7400

Regina 306.566.7550