

Note: **IMPORTANT**
DISCLOSURES ON BACK PAGE

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Key Statistics

SECTOR:	Comm Services
PRICE:	\$12.75
52 WK:	\$12.61-17.25
MKT CAP:	\$2.0bn
EV:	\$1.7bn
TARGET:	\$24 (24-month)
RATING:	Buy
YEAR END:	December

Quarterly Results

2005/6	Sales	Profit
Jun-A	\$59.4	(\$63.62)
Sep-A	\$73.8	(\$65.99)
Dec-A	\$95.2	(\$71.71)
Mar-A	\$118.8	(\$85.16)

Note: All figures in millions

Annual Estimates

Year	Sales	Profit
'04-A	\$79.71	(\$69.92)
'05-A	\$269.20	(\$261.33)
'06-E	\$628.24	(\$276.77)

Note: All figures in millions

Company Description

Rapidly growing broadband telephone company serving 1.6mn subs via VoIP. US subs represent 95% of total but with operations in Canada and UK.

Report Summary: Coverage initiation. We rate the stock a BUY with a 24-month price target of \$24. Vonage is a proven survivor with a serious play for leadership status in 21st century global comms landscape. Many risks and barriers exist, but the goal is visible.

Key Issues Considered in Determining our Rating:

- **Expansion before profits:** Vonage looks like an alcohol fueled dragster as it rushes to build its customer base. This expensive proposition has the marketing spend running 70-130% of revenues. The strategy allows Vonage to benefit from first mover status, but the fuel and drag strip will end at some point.
- **Vonage 10x scale independent peers:** There exist no credible independents with any hope of challenging Vonage. Sun Rocket has deep pocket venture funders, but it can claim less than 10% of Vonage's numbers. Price competition from another independent was an early threat that now seems unlikely.
- **RBOC's and MSO's hate competing on price:** The incumbent cable/telco's will work very hard to make VG's life uncomfortable, but the list of offenses will not include price competition. It's not in the DNA of a monopolist to compete on price.
- **at&t, Verizon, and the fight against the "33% landscape":** Market share exceeding 33% represents an anomaly in capitalism. The RBOC's focus their energies on consolidation and creating barriers to entry, because they know they can't maintain 90% share of voice revenues in a competitive market. The arrival of customer choice in the form of a company like Vonage or the ability of people to communicate via email or IM leaks away revenues.
- **Vonage mettle tested with FCC E911 misadventure:** The E911 controversy offered a significant test of Vonage's long term prospects. The excitement surrounding E911 arises entirely as an artificial creation of the incumbents with the FCC playing the role of a rubber stamp. Vonage should expect a constant stream of such controversies with legal intercept (CALEA), Telecom Relay Service, and Universal Service already in the pipeline.

Valuation Summary: VG trades at price-sales multiple of 2x projected 2007 revenues. With each quarter of success, we believe the multiple will rise toward our 3x valuation multiple on 2008 forecast, which is when we believe VG attains profitability. Based on our 2008 EPS forecast, our \$24 target price implies a 35x multiple, which we also view as fair and probable if our fundamental outlook is achieved. Note: investors need patience for the stock to reclaim the \$17 IPO price.

SWOT Analysis

Strengths

- **Jeffrey Citron:** Vonage's rocket start to #1 in the category 10x the scale of other independents owes almost entirely to Jeffrey Citron. He seems uniquely suited in overcoming the obstacles raised by incumbent telco's and finding lots of cash to fund an aggressive marketing strategy.
- **Tier 1 venture funding and banking:** The success of Vonage's IPO owes to the first rate relationships the founder and principles of the supporting venture firms with the Wall Street banks that remain gatekeepers to the public markets. Vonage spread the wealth naming Citigroup, Deutsche Bank, and UBS as underwriters.
- **No fear strategy:** The telecom business remains poisoned by the control telco incumbents wield over the regulatory process. There exist lots of challenges in raising money to launch a business that challenges a dominant monopoly not to mention actually making the business work. Vonage's aggressive style allowed the company to survive long enough to make the poisonous environment at net positive reducing the number of independent competitors.
- **Brand awareness and customer base:** The first mover status of Vonage won the company abundant media coverage on top of paid advertising toward a customer base of 1.6mn by early 2006. This puts the company in the position of enjoying increasing returns as the customers become more educated about Internet calling options.
- **Distribution and marketing prowess:** Vonage demonstrated significant skill in building out a broad distribution channel that includes all the usual consumer electronics suspects in Best Buy, Radio Shack, et al. While many will question the magnitude of the marketing spend, Vonage can at least point to significant success in generating brand awareness.

Weaknesses

- **Jeffrey Citron:** Citron stepped down as CEO leading up to the public offering to avoid his controversial past becoming an obstacle to shareholder perceptions. The S1 includes extensive disclosures about problems that lead to a \$22mn settlement with the SEC in a dispute about his role in bringing electronic trading to Wall Street.
- **Customer service:** Vonage remains in the hunt for a workable customer service model. The complexity of customer installs given the diversity of home networks and relative performance of broadband connections produces plenty of problems. Vonage does not even count in churn numbers customers that last less than 30 days. The startup problems likely mean 5% of customers never get successfully installed.
- **Dependence on broadband providers:** The ability of a customer to obtain multiple services via a single broadband connection represents an essential feature of the new comms landscape. However, these broadband connections come from the companies disrupted by Vonage's business model. Expect trouble.

Opportunities

- **First new age telco:** Participating in telephone business in the 20th century required owning a network. MCI and Sprint had to roll out networks independent of AT&T in order to get started. The Internet removes this barrier to entry by enabling any service to run on a single network. This makes marketing and customer acquisition prowess the new barrier to entry.
- **Friends and family offers:** Vonage needs to reduce the hooks rival telco's have into its cost of goods. This means reducing the number of call terminated into the PSTN. Vonage can expand the percent of calls that stay on-net by pushing friends and family like offers. Customers should have plenty of incentives to make sure everyone they call is also a Vonage customer.
- **Embed Vonage solution in consumer electronics devices:** Consumer electronics will be a driving force in the Internet enabled communication landscape. Vonage needs to make sure as many devices as possible include a native Vonage capability. The arrival of a Hi-Fi telephone offering CD voice quality is long over due. A Hi-Fi phone would could only work between Vonage customers an therefore helps reduce PSTN termination costs.
- **Vonage as global brand ala Coke:** Vonage has an opportunity to win status as a global brand like Coke or Starbucks as everyone needs communications and the Internet reaches everywhere. The various MSO's pushing VoIP offers will remain stuck selling in-region. The largest cableco Comcast will likely hit saturation around 8-9mn subscribers. There already exist 160mn broadband users around the world, so a 10% market share gets Vonage up to 16mn.

Threats

- **Telco's remain major suppliers:** PSTN related costs make up 30% of Vonage's cost of goods. The number has remained steady as a percent of revenue for two years. Vonage needs to get this number below 15% as soon as possible or ideally to zero. A company that wants you dead as a supplier does not represent a good idea.
- **Grief from FCC unlikely to diminish:** The regulatory sphere represents the #1 tool of incumbents to defend their turf, so Vonage should expect a steady stream of attempts to derail their prospects as with the E911 story in 2005. The pipeline includes legal intercept, USF, and distribution of telephone numbers.
- **Growing pains:** Steady annual growth of 300% for several years will test the mettle of any manager. The rapid growth makes it very difficult to achieve efficient operations as one is in a constant state of building capacity. Everyone looks very new and very inexperienced. Vonage needs to make its way toward a sustainable life growing 30% per year.
- **Pricing competition:** The price competition that remains the greatest threat to Vonage has not arrived. The lack of competition owes to the fact the Bells and MSO's hate price competition at the same time the poisonous atmosphere created by these incumbents keeps independents on the sidelines.

Analysis of 1Q06 Financial Results

Financial Summary

Vonage, a privately held IP communication services firm, amended its S-1 filing for an IPO, which proposes a valuation approaching \$3bn when options and the green shoe are factored in. Vonage plans to sell 31.25mn shares at \$16-18/share and will trade on the NYSE with a "VG" ticker. T1R has previously commented that the company was seeking takeout offers above \$2bn (along the lines of eBay's \$2.5bn purchase of Skype), but obviously none were found/received. That said, Vonage's 1Q06 results show a bit of leverage achieved, but still a greater operating loss as it has grown to a current 1.6mn subscriber lines (95% in the U.S.) from spending over 80% of its \$. In the past five quarters (2005 + 1Q06), Vonage spent \$332mn on marketing, which is more than 80% of the \$388mn in revenue from 1/1/05-3/31/06. T1R still sees many challenges to the business model and are left wondering when the company will pursue the sale of services above and beyond basic, traditional, ones offered by its competition. The world is changing rapidly around Vonage and with their commercials (wh-ooo-wh-oo-oooo) starting to annoy some, the time for put-up-or-shut-up will need to happen in 2006...especially since the IPO proceeds (at current spending levels of cash outflow) will not last much beyond fall 2007 unless the leverage becomes more substantial.

- **Valuation unsurprising; Nor is lack of a sale or the post-IPO ownership/control levels:** Everyone knows by now (from the "wh-oooo-wh-oo-oooo" commercials or otherwise) that Vonage was richly funded with a focus on revenue/subscriber growth as opposed to profits. Investors who placed \$450.5mn with Vonage from inception through 3/31/06 will own 70.3mn shares or 45% of Vonage post-IPO (including: 3i, Bain, IVP, Meritech, and NEA) while now-Chairman and Chief Strategist Jeffrey Citron will own 48.4mn shares or 31% of Vonage. These percentages are calculated by the 155.7mn total share count, which notably excludes the possible 4.69mn share greenshoe and the 16.9mn shares from unexercised options (which have an average exercise price of \$7.89/share). Since it is probably fair to assume that the green shoe will be exercised and that at least 10mn of the options will be in the money, the right share count to use when valuing Vonage is better off at 170mn. At the two ends of the \$16-18/share proposed IPO pricing level, Vonage would have a \$2.72bn to \$3.06bn market cap.
- **Some challenges to consider:** Vonage faces challenges that traditional local phone companies have not (in the same magnitude), including: 1) achievement of 100% E-911 support on a deadline; 2) the need to provide customer support to a rapidly changing home networking environment; and 3) the continued need

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for reliance on competitors to enable quick provisioning of service to new customers.

- **1Q06 found some leverage, but its not enough to call the growth/profit debate off:** Vonage grew revenues by 189% Y/Y in 1Q06, which is higher than expense growth in everything except direct costs of telephony services, which rose 210% Y/Y. Since COGS for telephony services is well below the level of money spent on SG&A and even further below the level spent on marketing, we can say that the company is achieving some leverage on its business model by the data presented for its 1Q06 results.
- **More stats:** Revenue in 1Q06 was \$111.66mn, which is up 189% from \$38.58mn in 1Q05. Direct COGS for telephony service rose 210% Y/Y to \$37.58mn (31.6% of sales) while other direct COGS rose a lesser 51.7% Y/Y to \$17.58mn (14.8% of sales). SG&A rose 157% to \$52.88mn (44.5% of sales) while the largest expense item - marketing - rose 59% Y/Y to \$88.29mn (69.2% of sales). In total, operating expenses rose 98.7% Y/Y to \$201.29mn, which is 169% of its sales in 1Q06 and explains why the company grew its operating loss from \$60.59mn in 1Q05 to an operating loss of \$82.4mn. Of note, headcount rose to 1,416 ending 1Q06, which is up 36% Y/Y and is up a net 61 sequentially.
- **Where's the value-add service strategy?:** Why doesn't Vonage consider bundling into a device like MovieBeam (to join with the trend for movies-on-demand) or one of the gaming console makers (to join with the trend for interaction, multi-player gaming communication such as Microsoft's XBox 360 holds the promise for). There is still no plan of attack or partnerships rumored to make sense of what the company will eventually pursue.

Investment Considerations

Investment Thesis	<p>Vonage (www.vonage.com), the once and perhaps future king of VoIP telephone replacement offers completed its stock offering at \$17. In the lead up to the IPO, Vonage replaced Jeffrey Citron (who will become Chief Strategist still Board Chairman) with Michael Snyder (presently President Tyco's ADT unit) as CEO. Vonage added 400k subs in last four months to bringing the base of subs up to 1.6mn. The underwriters Citigroup, Deutsche Bank, and UBS did their job, and the company raised \$650mn as a private company. Jeffrey Citron and his VC funders likely had hoped for as much as a \$4bn valuation given the \$4bn buyout of Skype and the fact an IPO price of \$15 per share times the original S1 267mn share count float tallies up nicely to \$4bn. The S1 settled speculation on a long list of numbers associated with Vonage's operations at least through September 30, 2005. The company generated \$174mn in revenues in the first 9mo's of 2005 or 3.5 times the same period in 2004. The filing points to a \$260 per net ad marketing expense during 2005, monthly churn of 2.11%, and ARPU of \$26.63. The churn number suggests an average customer life of 48mo's and multiplying by ARPU suggest \$1250 per sub life time value. Subtracting the average direct cost of telephony services of \$8.31 per month leaves Vonage with about \$850 gross margin or \$600 per sub after marketing costs. This explains the willingness of Vonage to spend more than 100% of revenues in marketing. The pace that produced a \$190mn net loss for the first nine months of 2005 does not seem sustainable beyond 2006. Vonage would appear to be immediately profitable with the expected 2.5mn subscribers by the end of 2006 to the extent marketing expenses fall to something more typical say less than 30% of revenues.</p>
"Bull" Case	<p>Vonage has found a way to tap the trillion dollar voice communication market without building its own network. The company can leverage a brand intensive model in selling communications everywhere the Internet reaches – planet earth. The first mover and #1 status allows Vonage to ride the wave of end user awareness. The incumbents remain loathe to compete on price. The cable companies remained locked into delivering services in region. The cost of customer acquisition puts Vonage out of reach of other independents.</p>
"Bear" Case	<p>The cost of customer acquisition will sink Vonage before the company reaches critical mass. The public markets have very little tolerance for a money losing company. Vonage will continue to face a defensive onslaught from the incumbents via public relations that attempts to cast doubt on Vonage and moves in Washington DC that raise the regulatory costs of staying in business. The net neutrality debate represents one example where incumbents seek the ability to add application specific tolls to Internet access. Any success will stop Vonage cold.</p>

Valuation Considerations

Valuation Summary

Vonage managed a \$2bn valuation even as a private company during the final rounds of funding. The IPO price gave the company a \$2.5bn valuation, but there will be plenty of volatility in the market cap, which has already been displayed to the downside in its first week of trading. The company traded down during the first week on significant volume, but seems to have put a floor in at the mid \$12s. In determining our valuation for the company, we decided to work from the year in which we believe Vonage will attain profitability, which is 2008. The company is currently trading at a 2x revenue multiple on our 2007 forecast. We believe the company can attain a multiple much larger than this as it demonstrates success and discipline toward profitability. Accordingly, we believe the company can earn a 3x revenue multiple on our 2008 revenue forecast, which implies a \$24 target price. Also, since our forecast is for EPS in 2008 of \$0.69/share (which does include an assumption for a 30mn share secondary offering in the share count), our \$24 target price equates to a 35x multiple of EPS against our 2008 EPS estimate. We believe this would be a fair and reasonable multiple since the growth rate for the company would likely still be at or above 30% in 2008.

With the failed pricing of the IPO at \$17, the company will need some significant news and execution to deliver the stock back above this level. However, the company certainly has patience and a long-term view, which is exactly what we believe investors NEED to have in order to deal with the likely volatility in the shares over our 24-month time horizon. We say this also because various holders and analyst firms will be using vary different valuation metrics to value the company until a few quarters of execution has been demonstrated.

T1R expects Vonage to moderate the marketing push sufficient to keep losses flat at \$240-\$260mn per year even as revenues grow dramatically. This burn rate will allow the post IPO cash position to last 2.5 years or long enough for the company to hit 5mn users and profitability by the end of 2008. But again, our model and target price assumes the company will again execute a secondary offering to the tune of roughly another 30mn shares before 2008 begins.

Recent Commentary

05/24/2006

Vonage prices mid range at \$17 does VG mean volatility or value

Vonage [VG] announced pricing mid range at \$17 at 5:44pm on May 23, 2006. T1R expects VG will get a first day lift, because the breadth of interest gets supply and demand pushing the price up. The longer term opportunity will prove interesting only to the extent Vonage charts a clear path to profitability that did not appear in the S1. T1R views Vonage as the first significant post convergence communication company. This means a company that lives and dies on marketing rather than owning network assets. Vonage needs to end up with gross margins and SG&A as a percent of revenues like Coke rather than a Verizon or AT&T. Brand intensive Coca-Cola [KO] generates net income margins of 20% via a gross margin of 65% and SG&A as percent of revenue of 40%. Vonage starts its publicly traded life with a gross margin of 53% and SG&A as percent of revenue of 118%. The SG&A number looks the worst of the two, but Vonage will have more trouble reducing COGS than SG&A. The bulk (68%) of the 47% COGS number comes from telephony costs associated with their primary competitor Bell companies. The telephony costs have remained a steady 30-31% of revenues for all the reported quarters. Vonage's marketing costs run 70-130% of revenues for the last eight reported quarters. Citron and company can justify the spend if they believe the cost of customer acquisition only gets more expensive over time and achieving scale improves prospects for survival. The alcohol fueled dragster strategy can only run so long before it hits the wall. Vonage's IPO proceeds only buy about 6-8 quarters unless the leverage improves. The loss for 1Q06 only increased 50% even as revenue increased 300%, so Vonage does appear to understand the realities. T1R expects even Comcast to hit saturation in its regions around 8mn subs, so Vonage need only target 10mn by 2010 to retain its #1 status. At the current pace, Vonage would hit 20mn by 2010, so the company can certainly pull the throttle back in 2007 and beyond.

05/23/2006

Vonage IPO likely to raise targeted \$500mn yet skeptics remain

Vonage [soon NYSE ticker VG] looks likely to raise the targeted \$500mn in an IPO via pricing Wednesday, May 24, 2006 with rumors suggesting interest exceeds allocations. The accomplishment does not satisfy the vast majority of folks commenting on the company's prospects, but the Vonage seems in good shape among the investors participating in the IPO. Even the controversial allocation of 13% of the shares to Vonage customers appears oversubscribed. The fact Vonage stands utterly alone as the only independent still relevant versus the cable VoIP plays illustrates the gauntlet faced by wannabe telecom companies. By the end of 2006, Vonage will have acquired more customers than any of the efforts arising from the Telecom Act of 1996. The 2.5mn subscribers will have Vonage at a \$700mn revenue run rate. The \$450mn raised from investors and \$250mn in debt puts Vonage in a relatively elite crowd, but other companies have raised more. Vonage's success shows up in the pace of growth and the relatively low 2.1% reported monthly churn. The incumbent telco's will continue to raise regulatory obstacles, but Vonage demonstrated its ability to cope in its response to the E911 deployment issues in 2005. The expected valuation of Vonage at \$2.6bn yields a 5x return for the \$350mn invested by NEA, Bain, 3i, and Meritech. Jeffrey Citron will retain a 31% stake even after the IPO and a 10x return on his personal investment of \$80mn. Various restrictions and worries about the impact of sales on the valuation will keep Citron and his venture partners invested for at least the next 12 mos. T1R does not share the conventional wisdom that competition threatens Vonage. The various offers of Skypes, Yahoo, Google, et al do not represent substitutable replacement for Vonage's service. The cable VoIP offers

	<p>get priced well above Vonage and targeted at a different demographic. Cable and Vonage compete for different parts of the traditional telco's customer base. The cable players will also hit saturation in their fixed regions of operation long before Vonage slows down. The telco's themselves don't put much energy in their own VoIP offers.</p>
<p>05/18/2006 <i>Cablevision with \$20/mo flat rate for 500 mins international calling</i></p>	<p>Cablevision [CVC] moved the cause of international flat rate calling forward with a \$20/mo call anywhere plan. The deal is for customers of their digital voice offer already on the \$35 unlimited domestic calling plan. The offer might seem like a response to Vonage adding EU destinations to its unlimited plans, but Cablevision's primarily tries to make Verizon uncomfortable. Cablevision leads other MSO's in getting 20% of homes passed to take their voice offer adding up to 900k customers across NY, NJ, CT. T1R expects the end game will have unlimited calling with respect to destination and minutes much like what already exists for Internet based activities like browsing the web or email. This vision conflicts significantly with the plans driving the Bells toward the reconstitution of AT&T, so the unlimited world will not arrive without opposition. Pricing innovation represents a inexpensive way to reduce customer acquisition costs, so look for the savvy players to deploy additional variations moving toward plans unlimited by destination or duration. Companies can't store communication capacity like energy, so free offers using idle capacity can prove "profitable" via lower customer acquisition costs.</p>
<p>05/15/2006 <i>Google adds Nokia to growing list of mobile partners</i></p>	<p>The WSJ reported Google [GOOG] is teaming with Nokia for the updated release of its Nokia 770 Internet Tablet. Ahhh yes, Google's mission to continue partnering and making its services accessible and readily available to the land of mobile communications continue. However, the Nokia 770 is not a cell phone, but is actually an internet browsing device that operates on WLAN. Google is partnering with Nokia to have the new 770 come pre-loaded with Google Talk on the device to enable IM communication and VoIP calls. However, users will only be able to communicate with other GTalk users and GTalk is currently unable to call landlines or cell phones. The fact this is a short-range WIFI device makes perfect sense for Google to get its products onboard given Google's muni WIFI efforts in San Fran and Mountain View. Given Google is the clear laggard in the adoption of its IM client, T1R believes the real opportunity for Google with the 770 and devices like it will be with search. T1R anticipates the formal release scheduled for Tuesday is likely to include details around a Google Search bar, or perhaps a Google button similar to its partnership with Motorola. While the 770 might not be quite as cool in terms of style as an ipod, T1R still believes the device has gusto, but is likely to remain a niche market for early adopters given it does not operate on cellular networks and mass muni WIFI is still in its early stages. All that said, it appears the deal is not exclusive and Nokia is reportedly in talks with other companies to incorporate their IM communication software onto the device. The likely candidates are YHOO (already has services on several Nokia phones), MSFT, and perhaps AOL and Skype. Given Skype's popularity across Europe, a partnership with Skype would make sense for Nokia in order to market the device to a larger user audience. However, Skype is launching its own WIFI phone with Netgear, which is expected to be available in July 2006. Vonage already offers a WIFI phone.</p>
<p>05/09/2006 <i>Vonage reserves IPO</i></p>	<p>Vonage (www.vonage.com) announced plans to set aside a portion of IPO shares for customers. While not entirely novel, this represents a relatively untested (i.e.</p>

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**shares for customers;
 Smart or desperate?**

risky) IPO strategy. AT&T set aside shares for employees as a part of AT&T Wireless's multibillion IPO. They and their employees lived to regret the plan as the stock languished below the IPO price for several years. Vonage's motivation looks like a mix of marketing savvy and insufficient "good hands" institutional demand for the stock (meaning there is lots of demand - hence the upsize of the number of shares offered - but questionable intentions of these to be long-term holders). The marketing savvy part paid off immediately with the news generating several hundred press mentions. The novelty factor seems likely to provide demand among customers, although nowhere does Vonage reveal the total amount of stock available to customers. The terms limit customers to purchase between 100 and 5000 shares. Stock ownership will make customers more loyal, but it will also make them more vocal. There exists little experience with the outcome of causing customers to lose money. Customers qualify to purchase shares where they are customers since December 15, 2005, US citizens with a US social security number, US residents, not a corporation, and eligible to open a limited brokerage account.

05/01/2006
**at&t and Verizon view net
 neutrality debate as fight
 for survival**

T1R spent several days last week participating on net neutrality panels organized for the Senate Commerce Committee, House Judiciary Committee, and House Commerce Committee. The issue of net neutrality has dogged the efforts of Verizon and at&t's to win national video franchise rules, but the dominant telco's do not plan to compromise on their pursuit of a world without net neutrality. The issue comes down to a fight between the PSTN which accounts for 95% of the Bellco revenue and the Internet. The incumbents already succeeded in winning leverage over provision of Internet access with 99% of US broadband access coming from an ILEC or MSO. This represents a significant reversal as they never managed much of a stake the during the dialup years. Unwinding net neutrality represents the next step in making sure the PSTN and associated revenue persists. The principle of net neutrality means pricing does not discriminate by use or user. This allows the value of Internet connectivity to grow relative to PSTN connectivity. The Bells want the ability to assert a toll on voice or video or any other service over and above the basic connectivity charge as they see fit eliminating any price advantages of Vonage et al.

03/31/2006
**Vonage IPO: maybe so,
 maybe no!**

Vonage will pass 2mn lines some time in April 2006 maintaining its pace at 10x the lines of the nearest independent and 30% ahead of #2 Time Warner. The apparent appeal with customers does not seem to translate well to investor relations as Vonage skeptics seem as ubiquitous as Vonage ads. The company filed for a \$250mn IPO on February 8, 2006. The relatively small size of the fundraising target versus the \$670mn already raised and the \$250mn annual burn rate points to some worries about valuation. T1R does not doubt Vonage would prefer a buyout as a cleaner lower cost liquidity event for Jeffrey Citron and his funders, but the obstacles to a buyout seem higher than those associated with an IPO. The deep pocket players do not want the validation of Vonage's business model that would come with paying a premium. Note that Verizon [VZ] and at&t [T] have never acquired a CLEC and bought out AT&T/MCI at deep discounts after destroying them. Very few companies likely have the vision required to pay top price for Vonage. The eBay [EBAY] Skype deal looks like a one time event. T1R expects Vonage will press ahead with the IPO and wait out critics.

Vonage does not need to rush the IPO or a buyout: Vonage controls its destiny by

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controlling its marketing spend. Management knows its costs and cash reserves. Vonage can wait out skeptics either by slowing the customer acquisition engine or asking its deep pocket funders for another round. Vonage's mega spend land grab strategy makes it the biggest VoIP player and too big to fail. NEA and Bain Capital have plenty of incentive and plenty of cash to keep feeding the monster. Jeffrey Citron could continue to float Vonage himself.

Financial Model

	A Mar-05 1005	A Jun-05 2005	A Sep-05 3005	A Dec-05 4005	A Mar-06 1006	E Jun-06 2006	E Sep-06 3006	E Dec-06 4006	A Dec-04 CY	A Dec-05 CY	E Dec-06 CY	E Dec-07 CY	E Dec-08 CY
DRIVERS													
Subscriber Lines: BOP	390,566	639,899	847,849	1,061,786	1,269,038	1,597,317	1,904,633	2,253,932	85,717	390,566	1,269,038	2,647,007	4,049,920
Gross Adds	280,123	262,310	282,176	275,032	421,890	399,329	457,112	518,404	364,214	1,099,641	1,796,736	1,852,905	2,024,960
Churn	30,790	54,360	68,239	67,780	93,611	92,014	107,812	125,330	59,365	221,169	418,767	449,991	647,987
Net Subscriber Adds	249,333	207,950	213,937	207,252	328,279	307,316	349,300	393,074	304,849	878,472	1,377,969	1,402,913	1,376,973
Subscriber Lines: EOP	639,899	847,849	1,061,786	1,269,038	1,597,317	1,904,633	2,253,932	2,647,007	390,566	1,269,038	2,647,007	4,049,920	5,426,893
Avg Subscriber Lines	515,233	743,874	954,818	1,165,412	1,433,178	1,750,975	2,079,282	2,450,469	238,142	829,802	1,958,022	3,348,463	4,738,406
Churn Rate (Quarterly)	4.81%	6.41%	6.43%	5.34%	5.86%	5.76%	5.66%	5.56%	15.20%	17.43%	15.82%	17.00%	16.00%
Churn Rate (Monthly)	1.60%	2.14%	2.14%	1.78%	1.95%	1.92%	1.89%	1.85%	1.3%	1.5%	1.3%	1.4%	1.3%
Reported Churn (Monthly)	1.70%	2.08%	2.26%	1.90%	2.11%								
Gross Adds as % of Base	71.7%	41.0%	33.3%	25.9%	33.2%	25.0%	24.0%	23.0%	425%	282%	142%	70%	50%
Revenue/Mo/Subscriber Line	\$24.96	\$25.78	\$24.84	\$26.00	\$25.97	\$25.87	\$25.77	\$25.67	\$318.57	\$311.12	\$304.91	\$300.00	\$303.00
Equip/Ship as % of Telephony	5.5%	3.3%	3.8%	4.7%	6.5%	5.5%	5.0%	4.5%	5.1%	4.3%	5.2%	4.2%	4.0%
COGS - Telephony Service/Sub	\$7.83	\$7.94	\$8.56	\$8.50	\$8.74	\$8.69	\$8.64	\$8.69	97.46	101.29	102.66	95.00	91.00
GrMargin - Telephony Services	68.8%	69.2%	65.5%	67.3%	66.3%	66.4%	66.5%	66.1%	69.4%	67.4%	66.3%	68.3%	70.0%
GrMargin COGS - Other Direct	-445%	-387%	-255%	-133%	-143%	-120%	-110%	-100%	-391%	-267%	-117%	-85%	-75%
Marketing per GrossSub Add	\$197.90	\$236.12	\$208.76	\$244.06	\$209.27	\$205.00	\$200.00	\$200.00	\$153.96	\$221.35	\$203.29	\$190.00	\$165.00
SG&A as % of Revenue	50.5%	55.9%	61.0%	58.7%	44.5%	40.0%	38.0%	35.0%	61.7%	57.5%	38.7%	33.0%	32.0%
Employees	1,045	1,397	1,393	1,355	1,416				648	1,355	0		
INCOME STATEMENT													
Telephony Service Revenue	38,583	57,539	71,158	90,885	111,658	135,893	160,749	188,711	75,864	258,165	597,011	1,004,539	1,435,737
Equipment/Shipping Revenue	2,127	1,896	2,713	4,295	7,225	7,474	8,037	8,492	3,843	11,031	31,229	42,191	57,429
Total Revenue	40,710	59,435	73,871	95,180	118,883	143,367	168,787	197,203	79,707	269,196	628,240	1,046,730	1,493,167
COGS - Telephony Services	12,108	17,719	24,514	29,709	37,584	45,648	53,895	63,884	23,209	84,050	201,011	318,104	431,195
COGS - Other Direct	11,588	9,241	9,622	9,990	17,580	16,443	16,879	16,984	18,878	40,441	67,886	78,053	100,502
Total COGS	23,696	26,960	34,136	39,699	55,164	62,091	70,774	80,868	42,087	124,491	268,896	396,157	531,697
Gross Profit	17,014	32,475	39,735	55,481	63,719	81,276	98,013	116,335	37,620	144,705	359,343	650,573	961,470
SG&A	20,553	33,225	45,030	55,908	52,875	57,347	64,139	69,021	49,186	154,716	243,382	345,421	477,813
Marketing	55,436	61,937	58,906	67,125	88,288	81,862	91,422	103,681	56,075	243,404	365,254	352,052	334,118
D&A	1,610	2,266	3,150	4,096	4,959	5,455	6,000	6,600	3,907	11,122	23,015	25,316	27,848
EBITDA	(58,975)	(62,687)	(64,201)	(67,552)	(77,444)	(57,933)	(57,548)	(56,367)	(67,641)	(253,415)	(249,292)	(46,900)	149,538
Operating Income	(60,585)	(64,953)	(67,351)	(71,648)	(82,403)	(63,388)	(63,549)	(62,967)	(71,548)	(264,537)	(272,307)	(72,216)	121,691
Interest Income	583	1,330	1,357	1,078	2,741	3,500	5,625	5,650	1,156	4,348	17,516	17,616	17,716
Interest Expense	0	0	(1)	(1,092)	(5,494)	(5,494)	(5,494)	(5,494)	(5)	(1,093)	(21,976)	0	0
Other Expenses	0	0	0	(442)	(4)	0	0	0	0	(442)	(4)	0	0
PreTax Income	(60,002)	(63,623)	(65,995)	(72,104)	(85,160)	(65,382)	(63,418)	(62,811)	(70,397)	(261,724)	(276,771)	(54,600)	139,407
Taxes	0	0	0	390	0	0	0	0	475	390	0	0	0
Net Income	(60,002)	(63,623)	(65,995)	(71,714)	(85,160)	(65,382)	(63,418)	(62,811)	(69,922)	(261,334)	(276,771)	(54,600)	139,407
EPS	(\$0.38)	(\$0.40)	(\$0.42)	(\$0.45)	(\$0.54)	(\$0.41)	(\$0.39)	(\$0.38)	(\$0.44)	(\$1.64)	(\$1.72)	(\$0.33)	\$0.69
Shares	159	159	159	159	159	161	162	164	159	159	161	166	201
Margin Analysis													
Gross Margins	41.8%	54.6%	53.8%	58.3%	53.6%	56.7%	58.1%	59.0%	52.8%	46.2%	42.8%	37.8%	35.6%
SG&A	50.5%	55.9%	61.0%	58.7%	44.5%	40.0%	38.0%	35.0%	61.7%	57.5%	38.7%	33.0%	32.0%
Marketing	136.2%	104.2%	79.7%	70.5%	74.3%	57.1%	54.2%	52.6%	70.4%	90.4%	58.1%	33.6%	22.4%
EBITDA Margin	-144.9%	-105.5%	-86.9%	-71.0%	-65.1%	-40.4%	-34.1%	-28.6%	-84.9%	-94.1%	-39.7%	-4.5%	10.0%
Growth Analysis													
Q/Q Revenues	39%	46%	24%	29%	25%	21%	18%	17%	-	-	-	-	-
Y/Y Revenues	255%	270%	223%	225%	192%	141%	128%	107%	-	238%	133%	67%	43%
Q/Q EBITDA	-118%	-6%	-2%	-5%	-15%	25%	1%	2%	-	-	-	-	-
Y/Y EBITDA	-496%	-309%	-316%	-150%	-31%	8%	10%	17%	-	-275%	2%	81%	419%

Source: Company reports and Tier1 Research estimates

Note: All figures in \$thousands, except per share amounts.

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<p>About The Authors</p>	<p>Andrew Schroeffer founded Tier1 Research in August of 2000 to create a new business model for research. Most recently, Mr. Schroeffer was a VP and Sr. Equity Analyst with Goldman Sachs covering the Internet Infrastructure Services sector. Earlier, Andrew held the same title at U.S. Bancorp Piper Jaffray. Mr. Schroeffer is an honors graduate of St. John's University having earned a BA in Economics and Accounting. Andrew has been quoted in numerous worldwide publications such as the Wall Street Journal, New York Times and IBD and was profiled in a 2004 issue of Buyside. Mr. Schroeffer has been interviewed on such television and cable programs as CNBC, CNNfn, ABC, and the Nightly Business Report.</p> <p>Daniel Berninger joined Tier1 Research in August 2004 as Senior Analyst covering the telecom industry. Daniel has over a decade of experience that includes helping to launch three prominent VoIP startups - ITXC, Vonage, and Free World Dialup. His expertise on the intersection of telecom and the Internet has been sought by Congress, FCC, Federal Reserve, and state PSC's. Daniel led earlier VoIP deployments at Verizon, HP, and NASA for VocalTec. Mr. Berninger won the 1999 VON Pioneer Award for co-founding the VON Coalition and worked on the original assessment of VoIP at Bell Labs. He completed doctoral studies in preparation for a Ph.D. in System Engineering at the University of Pennsylvania. Daniel was the subject of a Wall Street Journal editorial addressing the prospect for antitrust enforcement and is quoted as a source for articles in BusinessWeek, Bloomberg, Forbes, LA Times, Dow Jones, and many trade press publications.</p>
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