

BLYTH FUND | SONS UPDATE

By Charles Najda

Date: 04-17-03
Proposal: Sonus Networks Update
Ticker: SONS
Current price: 3.26 (close 04-16-03)
Analyst: Charles Najda
Profile: Sonus Networks, Inc. is a provider of voice infrastructure products for the new public network. The Company's suite of voice infrastructure products includes the GSX9000 Open Services Switch, the Insignus Softswitch, and the Sonus Insight Management System. The Company's products, designed for deployment at the core of a service provider's network, reduce the cost to build and operate voice services compared to traditional alternatives. (From *Yahoo! Finance*)

The Numbers:

Shares Outstanding	204.9 mln	Market Cap	\$667.0 mln
Mean Target Price 12 months	\$2.63	EPS Growth - 5 years	20.0%
P/book	12.19	P/sales	10.30
Gross Margins	61%	Net Margins	N/A
Cash	\$111.2 mln	Debt/Equity	0.26
EPS (03)	\$-0.10	EPS (04)	\$-0.05
Dividend	N/A	Cash Per-share	\$0.54

Overview

- In my November Buy Proposal I wrote, "I believe that there is further room for the market to move upwards and at a minimum for Sonus to move upwards with the market." Without a doubt, Sonus has come back from the dead and to borrow an often used cliché is firing on all cylinders. After hitting a 52 week low of 0.18 it has surged to over 3 dollars and the momentum remains strong. The Blyth Fund has gained over 1000% on its October 2002 purchase at \$0.29 and over 210% on its December 2002 purchase at \$1.04. I believe that both of these purchase prices won't be revisited and that new customers will continue to drive the stock up.
- Management has done a great job of paring back costs while maintaining and cultivating important relationships with current and potential customers. They have also been judicious and conservative in their predictions and outlook, which is the mark of a good management team. Likewise, you don't see members of the Sonus management team doing countless interviews or trying to appear on CNBC all the time. Many of the dot com failures had management teams that were more concerned with media publicity and air time than the actual business.
- Sonus has a great product set that is beginning to gain traction even in a difficult economic climate. In fact, one could argue that the difficulties of the past few years are the primary factor forcing the telecommunications companies, cable companies, and cellular providers to revisit the cost structure of their equipment and look at lower cost next generation alternatives. Although historic barriers separate these industries today, these regulatory and technological barriers are falling, which raises the possibility of increased competition. The only way to succeed in a competitive environment is to have a great product set at the lowest possible cost. A great example of this phenomenon is Southwest Airlines in the airline industry.

Q1 Earnings Highlights

- Service revenue: \$4.9 mil.
- Gross margin: 61%, expected to be 50-55% in Q2.
- \$106 mil in cash.
- Total deferred revenues: \$31.8 mil.
- 10% customers: Qwest, Global Crossing; non-10%: Bellsouth, DT, etc; 13 customers in Q1, 21% of revenues are international.
- Near term opportunity: 271 wireless carriers across the globe, to date only 1% of all voice traffic is packet.
- Two unannounced tier 1 U.S. carriers, leader in VoIP for 10 consecutive quarters.
- Seeing a rotation of capex away from old technologies to next-gen voice over packet equipment.
- Cable: U.S. deployments in 2004; international deployment by end of 2003.
- Improved visibility, Q2: 15-20% increase in revenue over Q1, expected flat EPS.
- Break-even revenue: \$27-28 mil.; cash burn in Q2: 5-10 mil.

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- Number of trials is going up.
- Nortel (NT) is Sonus' largest competitor in U.S.

Importance of Tier 1 Customers

- Sonus is building a formidable presence in the VoP equipment market. The firm already counts two RBOCs as its customers and currently has two unannounced tier 1 customers buying its product. These two additional customers would bring its number of tier 1 customers in the United States to 4.
- Verizon and AT&T Wireless are the rumored to be the two unannounced tier 1 customers. Both of these companies would play an important part in Sonus' strategy of growing revenues; moreover these two companies may "force" their competitors to also adopt VoP technology or risk being left behind. Verizon recently announced an initiative to run a broadband fiber network to every one of its customers within the next ten years.
- The possible adoption of Sonus technology by AT&T Wireless means the other cellular providers may soon have to follow AT&T's lead. None of the cellular providers are making money. Moreover, by using a central soft switch these carriers can lower their cost basis. Cingular may be the first to follow since BellSouth owns 50% of the firm. Then SBC since SBC owns the other 50% of Cingular. SBC will have to follow Quest's, BellSouth's, and Verizon's lead or risk becoming the weakest RBOC. Recall the new FCC regulations that came out in March? VoIP will allow the RBOCs to cut off the leaching competition (DSL providers, long distance carriers) from their central office legacy switches.

The Wireless Initiative

- Sonus' new SMART Wireless products allow the firm to expand its customer base beyond telephone and cable carriers to one of the fastest growing communications markets, the wireless cellular market. Sonus' products allow wireless providers to provide services more efficiently. In fact, as the pricing of plans remains fixed, but the number minutes being used grows, cellular carriers, such as AT&T Wireless, must figure out how to keep costs under control. In a recent Business Week interview Sonus CEO Hassan Ahmed offered a clear example of how Sonus lowers a carrier's cost basis.

"A simple example is this: My cell phone has a Boston area code. Imagine if I'm in California, and you call me from your desk. The call goes from you to Boston, and the Boston switch says Hassan is in California. Then the call goes to California. Connecting in a circuitous manner eats up a lot of resources and costs money. Our product figures out that I'm in California in the first place and routes your call there directly. That saves capital and all transmission costs."

Shifting Capital Expenditures

- Current spending on legacy switching by the Bells is at an all time low - inflation adjusted. Many industry experts attribute this drop off in spending as a strategy by the Bells to force the FCC to close off competitive access (UNE-P). Experts say the Bells have stopped spending on legacy switching equipment and will eventually claim that there are no more useful ports for access points for the competitors to use. One strategy talked about is for the Bells to abandon legacy circuit switches and build out a Voice over IP network. The Bells claim that the FCC can not dictate what technology paradigm they [Bells] must use. The triple win for the RBOCs will be cost savings of using their existing IP backbones while abandoning their circuit switched network, lower port cost for soft switching, and better service features for customers at higher cost structure bundled premiums.
- The shift in capital expenditures not only affects Sonus' customers, but also affects its competitors. Most of the other startup VoIP suppliers have gone out of business or will soon. However, the major telco equipment makers aren't the dominant players in the VoIP market. The possible paradigm shift (described above) has many worried. Lucent (LU) and Nortel (NT) whose revenues are mostly generated from the Bells capital expenditures have a major cause for concern since neither company has a carrier class VoIP offering. The 900 pound gorilla Cisco (CSCO) may be scrambling to get a foot-hold into the carrier class VoIP via acquisitions, but they currently have no product line to cover this paradigm shift.

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Closing Thoughts

- The Fund embarked on a speculative investment (SONS) with a small percentage of the portfolio back in October. While the outlook was bleak back then, there were a number of outstanding issues that if resolved would lead to a recovery in Sonus. Sonus has added a number of new customers, expanded its product line to target a new group of service providers, and is managing its cash and expenses well. The future looks bright for Sonus; the addition of two tier 1 customers will grow annual sales significantly. I expect that Sonus will turn earnings positive during the 4th quarter of 2003. I also suspect that Sonus has built valuable customer relationships and will maintain a dominant market share of the VoIP equipment market. As a result, I believe that Sonus will outperform the NASDAQ for the next 3-5 years; moreover, Sonus is the portfolio's growth stock and I believe that the Fund should hold on to Sonus for the foreseeable future.

1 Year SONS Chart:

Note the 15x (1500%) rise from its 52 week low of 0.18, which occurred over the last 6 months.



6 Month SONS Moving Average Chart:

Note how Sonus has risen above the 50, 100, and 200 day moving averages sequentially over the last few months.

