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Elephant Talk (NasdaqOTCBB/ETAK)

BUY Triple-digit growth in Mobile and Security revenue, Adepra deal about to bear fruit

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Elephant Talk provides wireless telecommunications services

Investment Highlights

1) Mobile and Security revenue delivers triple digit growth – Earlier this week Elephant Talk announced results for its fiscal third quarter ended September 30, 2011. The Company reported sales of \$7.8 million for Q3/11, down 14% from sales of \$9 million in Q3/10. The decline in sales was driven by a \$2.1 million reduction in legacy landline revenue, partially offset by an \$850,000 gain in mobile and security revenue from Q3/10 to Q3/11. Mobile and security sales grew an impressive 152% year-over-year (128% on a constant currency basis.) Further, gross margins improved from 4.4% in Q3/10 to 10.3% in Q3/11 driven by growth in higher margin mobile and security sales. Overall, Elephant Talk reported a loss per share of (\$0.09) in Q3/11, an improvement from a loss per share of (\$0.32) in Q3/10 as warrant liabilities ceased to weigh on earnings. Additionally, the Company reported that its cash on hand increased from \$4.7 million at the end of Q2/11 to \$10.8 million at the end of Q3/11, largely driven by warrant exercises. Based upon the results of Q3/11, we are slightly adjusting our estimates for FY2011E. We are decreasing our forecasted revenue to \$32 million from \$35 million and increasing our estimated loss per share to (\$0.24) from (\$0.21).

2) Adepra deal about to bear fruit – On September 21, 2011 ValidSoft first announced its partnership with Adepra to combine ValidSoft’s fraud detection capabilities with Adepra’s fraud management and customer communications solutions. Management now expects the Company to receive “its first significant contract award within the coming weeks” with a top-five global banking institution as a result of its Adepra alliance. Once announced and fully functioning, we believe a well-publicized win for ValidSoft with a major bank can act as an important proof of concept and catalyst to help the ValidSoft sales team/channel drive additional contract awards.

Current Price \$2.50

Price Target \$4.75

Estimates	F2009A	F2010A	F2011E
Revenue(\$000s)	\$43,651	\$37,168	\$32,096
1Q March	9,429	9,944	8,508 A
2Q June	11,311	9,674	7,791 A
3Q September	11,455	9,040	7,797 A
4Q December	11,455	8,510	8,000 E
Prev. Rev. Estimate (\$000s)			\$35,000

EPS	(\$0.32)	(\$1.33)	(\$0.24)
1Q March	(0.05)	(0.23)	(0.02) A
2Q June	(0.04)	(0.28)	(0.06) A
3Q September	(0.09)	(0.32)	(0.09) A
4Q December	(0.13)	(0.44)	(0.07) E
Previous EPS Estimate			(\$0.21)
P/E (x)	N/A	N/A	N/A

EBITDA/Share	(\$0.11)	(\$0.11)	(\$0.13)
EV/EBITDA (x)	N/A	N/A	N/A

Stock Data	
52-Week Range	\$1.53-\$4.77
Shares Outstanding (mil.)	107.8
Market Capitalization (mil.)	\$269.6
Enterprise Value (mil.)	\$260.6
Debt to Capital (9/11)	4.3%
Book Value/Share (9/11)	\$0.38
Price/Book	6.5 X
Average Trading Volume (10-day)	300,000
Insider Ownership	10.0%
Institutional Ownership	5.0%
Short interest	N/A
Dividend / Yield	\$0.00/0.0%



Price target and ratings changes over the past 3 years:
Initiated - November 26, 2010 – Buy - Target \$4.75

3) Stage set for “significant increase” in Mobile Services revenue in 2012 – During its earnings call, management laid out several operational efforts and achievements that are expected to increase the number of subscribers under management significantly in 2012 and thereby also drive robust revenue growth in Mobile Services next year. More specifically, through its efforts with partner Vodaphone, Elephant Talk anticipates a large scale migration of subscribers in Spain to occur in the next few weeks with another tranche slated for next spring, bringing the total number of managed subs in Spain to approximately 1 million. Also this year, Elephant Talk anticipates its first contract win in the US market and plans to work with several US virtual operators in 2012. Negotiations are currently ongoing for further international expansion with Brazil, Chile, Colombia, the UK, Italy and Germany as target countries. Lastly, ValidSoft’s current pilot phase with Visa Europe will conclude in Q4/2011 enabling the Company to move forward with its efforts to monetize the relationship in 2012.

Conclusion

Elephant Talk has leveraged an existing legacy telephone business into what we view as an enviable market position in two new areas of expected growth: mobile telecomm back office services and transaction authentication and verification services. In its mobile telecomm unit, Elephant Talk continues to add partners and capacity in its core European market, and recently signed its initial joint venture in Brazil to open up a second large market outside of Europe. The Company’s ValidSoft division is now starting to commercialize its fraud-protection technology, and this year could see the completion of two large pilot programs in distinct yet potentially large markets. With several growth initiatives on tap, an improved balance sheet, and increased share price, trading volumes and capitalization potentially leading to a larger National Exchange listing in the US, we feel that Elephant Talk will soon begin to attract greater interest from investors and thus we are maintaining our BUY rating on ETAK and 12-18 month price target of \$4.75 per share, or 11.6X estimated revenues of \$44 million for next year.

Comparable Company Analysis/Stock Valuation

We have compiled a five-member group of comparable stocks to Elephant Talk, including several firms providing software services for mobile telecommunications companies, notably Amdocs (Nasdaq/DOX/Not Rated), newly-public Motricity (Nasdaq/MOTR/Not Rated), PROS Holding (NYSE/PRO/Not Rated), and Virtusa (Nasdaq/VRTU/Not Rated), as well as VeriSign (Nasdaq/VRSN/Not Rated) the leading provider of identity and authentication services similar to the services provided by Elephant Talk’s subsidiary ValidSoft. Using the Company’s projected revenues for FY2012 of \$44 million, we find that Elephant Talk’s price/revenue multiple is above the mean of 2.7X for the five member comparable group; however by using the average multiple of the two fastest growing and most well-known stocks in our group, VeriSign and PROS, we find that Elephant Talk is valued more closely to this average ratio of 5.1X. Thus, we believe that as Elephant Talk grows and its story and prospects become more familiar to technology investors, ETAK shares can appreciate to an average price/revenue multiple over 11X, allowing for share price appreciation to approximately \$4.75, due to higher growth expected for Elephant Talk next year (38% as compared with 23% for the group on average). Thus, we are recommending that investors Buy shares of ETAK with a 12-18 month price target of \$4.75, representing a price/revenue multiple of approximately 11.6X estimated revenues of \$44 million for the Company for next fiscal year.

Catalysts/Investor Timeline

- 1) Further agreements signed with Visa Europe member banks – 2011-12
- 2) Initial implementation with Adeptra client banks by ValidSoft – 2011
- 3) Pilot program completed for first two Visa Europe client banks – 2011
- 4) Pilot program completed for European unemployment governmental agency – 2011
- 5) Initial MVNO joint venture platform established with MECO Group – 2011
- 6) Growth in mobile user migrations in Spain, the Netherlands and Belgium – 2011-12
- 7) Additional MVNOs signed as part of existing platform agreements – 2011-12
- 8) Mobile service agreements for new European countries – 2011-12
- 9) Mobile service agreements for South America and other new continents – 2011-12

Risk Factors

In addition to normal economic and market risk factors that impact most small capitalization equities and the common risks shared by Elephant Talk with other companies in the industry, we believe the primary risks to our price target include the following:

- **Lack of historic profitability** — Elephant Talk has not achieved operating profitability since its initial organization several years ago, and the Company is furthermore not projected to reach profitability for several more years by our estimate. Although Elephant Talk has recently raised additional operating funds from the public equity markets, there can be no assurance that the Company will not need to raise additional equity capital in the future before it can turn profitable and begin to operate on a positive cash flow basis.
- **Share price issues** – Currently ETAK shares trade on the US Over-the-Counter bulletin board, making the trading of these shares very problematic for many investors and thus reducing the overall market for these shares. However, the recent increase in trading volumes has made amassing and holding investment positions in ETAK shares less difficult, and with the recent improvement in the Company's balance sheet and increase in share price the Company may soon be able to complete a move of its shares to a larger, more established US-based stock exchange, for example Nasdaq or the American Stock Exchange.
- **Reliance on partners** – At present, Elephant Talk derives much of its revenues and future growth prospects from customers of a relatively few large telecommunications providers such as T-Mobile (a subsidiary of Deutsche Telekom, (NYSE/DT/Not Rated)), Vodafone (NASDAQ/VOD/Not Rated) and privately-held MECO Group. There can be no assurance that these large partners will continue to add new customers or migrate older customers into new platforms, including MVNO subsidiaries.
- **Reliance on acquisitions for growth** – Historically, Elephant Talk has relied on acquisitions to fuel growth, for example with ValidSoft acquired in 2010. Recently, due in part to an improvement in the Company's balance sheet, Elephant Talk's management has once again been able to focus on potential acquisitions, as evidenced by recent comments at its annual meeting as well as SEC filings. However, there can be no assurance that potential acquisitions can be found by Company management, and even if they are found there can be no assurance that potential acquisitions can be completed by the Company at a reasonable price.
- **Material weakness in financial controls** – The Company's most recent quarterly filing (10-Q for September 30, 2011) contains the following financial controls disclaimer, "Our management has identified a material weakness in our disclosure controls and procedures due to a lack of personnel and technological resources. This material weakness restricts our ability to ensure that information required to be disclosed in our reports filed or submitted under the Exchange Act is accumulated and communicated to management and that information is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms." As such, it is possible that material information that could negatively impact ETAK shares is not communicated to investors in a timely manner.

Elephant Talk Communications, Inc.
Consolidated Statements of Operations and Comprehensive Loss
(In 000s, except per share data)

FYE December	2007	2008	2009	1Q10	2Q10	3Q10	4Q10	2010	1Q11	2Q11	3Q11	4Q11E	2011E	2012E
				March	June	Sept	Dec		March	June	Sept	Dec		
Revenues	\$47,361	\$44,359	\$43,651	\$9,944	\$9,674	\$9,040	\$8,510	\$37,168	\$8,508	\$7,791	\$7,797	\$8,000	\$32,096	\$44,000
Cost of services	45,609	43,336	41,453	9,374	9,005	8,639	8,103	35,121	7,557	7,495	6,997	7,000	29,049	32,000
Gross Profit	1,752	1,023	2,198	570	668	402	407	2,047	951	296	800	1,000	3,047	12,000
Operating Expenses:														
Selling, general & administrative expenses	5,826	7,570	7,959	1,905	2,079	2,796	2,840	9,620	3,416	3,825	4,325	4,500	16,066	18,000
Non-cash compensation	5,046	1,266	1,728	541	2,713	780	1,555	5,588	1,130	2,038	2,432	2,400	8,000	9,000
Depreciation and amortization	2,233	2,903	3,051	845	1,515	1,481	1,471	5,312	1,303	1,338	1,353	1,350	5,344	5,500
Impairment change & other one-time	0	3,731	0	0	0	0	0	0	0	0	0	0	0	0
Total operating expenses	13,105	15,470	12,738	3,291	6,308	5,057	5,866	20,521	5,849	7,200	8,111	8,250	29,411	32,500
Income (loss) from operations	(11,352)	(14,447)	(10,540)	(2,721)	(5,639)	(4,655)	(5,459)	(18,474)	(4,899)	(6,904)	(7,311)	(7,250)	(26,363)	(20,500)
Other Income														
Interest income	101	42	161	33	33	41	134	240	23	24	75	50	172	200
Interest expense	(849)	(499)	(939)	(447)	(536)	(538)	(282)	(1,803)	(67)	(72)	(35)	(35)	(209)	(200)
Other expenses	1,470	(1,602)	(5,790)	(9,725)	(11,384)	(17,757)	(35,236)	(74,102)	2,549	1,168	(2,326)	0	1,392	0
Income (loss) before tax	(10,630)	(16,506)	(17,108)	(12,860)	(17,527)	(22,909)	(40,843)	(94,138)	(2,393)	(5,783)	(9,597)	(7,235)	(25,008)	(20,500)
Provision for income taxes	1	1	1	1	1	0	(1)	1	1	0	0	0	0	0
Net income (loss)	(10,631)	(16,506)	(17,109)	(12,861)	(17,527)	(22,909)	(40,842)	(94,139)	(2,394)	(5,783)	(9,597)	(7,235)	(25,008)	(20,500)
Basic income per share	(\$1.12)	(\$0.55)	(\$0.32)	(\$0.23)	(\$0.28)	(\$0.32)	(\$0.44)	(\$1.33)	(\$0.02)	(\$0.06)	(\$0.09)	(\$0.07)	(\$0.24)	(\$0.18)
Diluted income per share	(\$1.12)	(\$0.55)	(\$0.32)	(\$0.23)	(\$0.28)	(\$0.32)	(\$0.44)	(\$1.33)	(\$0.02)	(\$0.06)	(\$0.09)	(\$0.07)	(\$0.24)	(\$0.18)
Basic shares outstanding	9,531	30,263	53,553	55,667	62,356	72,142	92,517	70,671	96,283	100,468	107,843	110,000	103,648	112,000
Diluted shares outstanding	9,531	30,263	53,553	55,667	62,356	72,142	92,517	70,671	96,283	100,468	107,843	110,000	103,648	112,000
Key ratios:														
Revenue growth		-6.3%	-1.6%	5.5%	-14.5%	-21.1%	-25.7%	-14.9%	-14.4%	-19.5%	-13.8%	-6.0%	-13.6%	37.1%
Gross margin	3.7%	2.3%	5.0%	5.7%	6.9%	4.4%	4.8%	5.5%	11.2%	3.8%	10.3%	12.5%	9.5%	27.3%
S G & A/sales	12.3%	17.1%	18.2%	19.2%	21.5%	30.9%	33.4%	25.9%	40.2%	49.1%	55.5%	56.3%	50.1%	40.9%
Depreciation, amort, non-cash comp	\$7,279	\$4,169	\$4,779	\$1,386	\$4,228	\$2,261	\$3,026	\$10,901	\$2,433	\$3,376	\$3,786	\$3,750	\$13,344	\$14,500
Operating margin	-24.0%	-32.6%	-24.1%	-27.4%	-58.3%	-51.5%	-64.1%	-49.7%	-57.6%	-88.6%	-93.8%	-90.6%	-82.1%	-46.6%
EBITDA/share	(\$0.43)	(\$0.34)	(\$0.11)	(\$0.02)	(\$0.02)	(\$0.03)	(\$0.03)	(\$0.11)	(\$0.03)	(\$0.04)	(\$0.03)	(\$0.03)	(\$0.13)	(\$0.05)

Balance Sheets

(\$000s)

	12/31/10	9/30/11
Assets:		
Cash and equivalents	\$2,246	\$10,846
Restricted Cash	190	192
Accounts receivables, net	5,601	6,715
Prepaid expenses & other current	2,338	1,436
Total current	10,374	19,189
Long Term Deposits	610	676
Property and Equipment	8,453	13,135
Intangible assets, net	16,254	14,544
Goodwill	3,231	3,317
TOTAL ASSETS	38,922	50,861
Liabilities:		
Overdraft	356	303
Accounts payable	4,704	3,686
Deferred Revenue	0	418
Accrued expenses	3,844	3,278
Loans payable	877	958
Total current	9,782	8,642
Long Term Liabilities	469	896
TOTAL LIABILITIES	10,250	9,538
Stockholders' equity	28,671	41,323
TOTAL LIAB & EQ	\$38,922	\$50,861

Quarterly Earnings Comparisons

	March	June	Sept	Dec	Total
Revenues (in \$Mill)					
2009	\$9,429	\$11,311	\$11,455	\$11,455	\$43,651
2010	9,944	9,674	9,040	8,510	37,168
2011E	8,508	7,791	7,797	8,000	32,096
Earnings per Share					
2009	(\$0.05)	(\$0.04)	(\$0.09)	(\$0.13)	(\$0.32)
2010	(0.23)	(0.28)	(0.32)	(0.44)	(1.33)
2011E	(0.02)	(0.06)	(0.09)	(0.07)	(0.24)

Operating Statistics

	2009	2010	2011E	2012E
Sales by Type (\$000s)				
Landline Services	\$37,809	\$34,342	\$26,400	\$25,000
Mobile and Security Solutions	5,842	2,827	5,696	19,000
Total Revenue (Constant Currency)	43,651	37,168	32,096	44,000
Sales by Region (\$000s)				
Netherlands	\$33,611	\$27,623	\$22,860	\$26,000
Spain	2,278	1,752	1,250	4,000
Switzerland	6,118	6,653	7,260	12,000
Middle East	1,207	623	20	0
Other countries	438	517	706	2,000
Total Revenue	43,651	37,168	32,096	44,000

Source: Dawson James Securities, Inc. estimates; Company documents

Important Disclosures:

Price Chart:



Price target and ratings changes over the past 3 years:
 Initiated – November 26, 2010 – Buy - Target \$4.75

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Ratings Distribution	Company Coverage		Investment Banking	
	# of Companies	% of Total	# of Companies	% of Totals
Buy	27	84%	8	30%
Neutral	4	13%	3	75%
Sell	1	3%	0	0%
Total	32	100%	11	34%

Information about valuation methods and risks can be found in the “STOCK VALUATION” and “RISKS” sections of this report.

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