EQUITY RESEARCH

Telecom, Media, Tech

INITIATION REPORT

Fusion Connect, Inc. (NASDAQ/FSNN)

BUY $3.88 Price Target: $7.00

Fusion Connect is a New York-based communications services provider exclusively serving small to mid-size business and government customers.

July 10, 2018

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Initiate at Buy as Fusion's Size Puts in the Sweet Spot

- We initiate coverage of Fusion Connect shares with a Buy rating and a $7 price target.
- Fusion is a New York City based telecom company providing a full range of voice and data services ranging from connectivity, to data hosting to security to advanced software offerings.
- It targets small to mid-sized business and government customers with over 160,000 customers.
- The company has grown mainly via acquisition with ten acquisitions over the last six years. The two most recent – Birch and Megapath – more than doubled the size of the company.
- Acquisitions have been done at an average of 4.1x EBITDA, pro forma for synergies, versus 7.3x pro forma 2017 EBITDA, so transactions have been highly accretive.
- We forecast $565 mm in revenue over the next four quarters, versus $575 mm guidance, and $576 mm next year.
- EBITDA should come in just over $100 mm this year and $139 mm next year when full synergies are in effect by year end. Our 2019 estimate represents a 24% EBITDA margin with the company achieving its 25% target by 4Q.
- We believe that Fusion is in a sweet spot in its industry since its size gives it higher margins than the thousands of subscale competitors (some of whom it has acquired) and smaller than large national carriers like Verizon and CenturyLink which are too large to provide effective customer support for small and mid-sized businesses.
- We value FSNN shares at 8.5X our 2019 EBITDA estimate while comps trade between 12x to 24x, to account for merger integration risk.
- In our view, the key risk to our thesis is execution. Fusion provides an essential service to its customers, and the industry is moving towards its technology architecture. While a recession would hurt its customer base, many would likely use economic weakness as a reason to move toward more cost-effective solutions of the type offered by Fusion.

Fusion Connect, Inc.
420 Lexington Avenue, Suite 1718
New York, NY 10170
(212) 201-2400

Rating	BUY	
Target Price	$7.00	
Ticker Symbol	FSNN	
Market	NASDAQ	
Stock Price	$3.88	
52 wk High	$6.63	
52 wk Low	$1.67	
Shares Outstanding:	78.3	M
Public Market Float:	20.6	M
Avg. Daily Volume	307,398	
Market Capitalization:	$304	M
Institutional Holdings:	12.0%	
Dividend Yield:	0.0%	

Earnings Per Share	**Pro forma for Birch and Megapath**			
FYE - December	**2017**	**2018E**	**2019E**	**2020E**
1Q - March		($0.21) A	($0.08)	($0.06)
2Q - June		($0.17)	($0.07)	($0.05)
3Q - September		($0.19)	($0.06)	($0.04)
4Q - December		($0.11)	($0.07)	($0.05)
Year	**($3.46)**	**($0.67)**	**($0.28)**	**($0.21)**
Revenue ($mm)	**567.3**	**531.1**	**576.1**	**604.9**
EV/Rev	1.8X	1.9X	1.8X	1.7X
EBITDA ($mm)	**140.0**	**101.5**	**139.0**	**157.3**
EV/EBITDA	7.4X	10.2X	7.4X	6.6X

Senior Executives	
Matthew Rosen	Chief Executive Officer
Don Hutchins	President
Kevin Dotts	Chief Financial Officer
Jon Kaufman	Chief Strategy Officer
Dan Foster	Chief Revenue Officer
Russell Markman	Chief Operating Officer

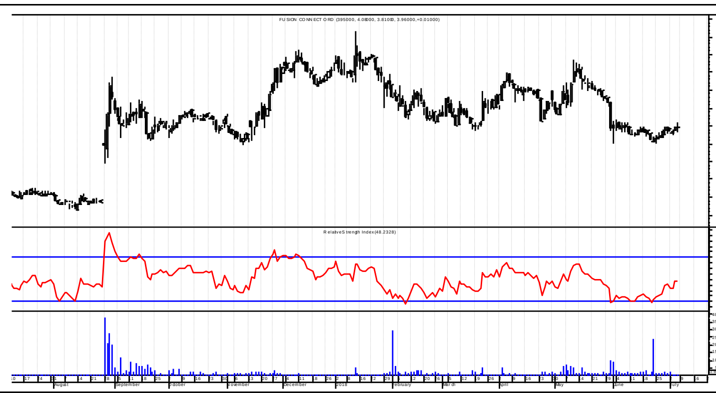
Common Ownership Profile

Shareholder	**Shares ('000)**	**% of Total**
Cooper Creek Partners Management LLC	1,074,009	1.4%
Park West Asset Management LLC	1,031,123	1.3%
Gilder, Gagnon, Howe & Co. LLC	920,148	1.2%
The Vanguard Group, Inc.	892,326	1.1%
Driehaus Capital Management LLC	621,869	0.8%
Directors and Officers	57,627,922	73.6%

Capitalization

Market Value Basis ('000)	**07/06/2018**	**%**
Long-Term Debt	$736,500	71.1%
Market Value of Equity	303,660	29.3%
Preferred	15,000	
Less: cash	-20,000	-1.9%
Enterprise Value	$1,035,160	100.0%

Book Value Basis ('000)	**03/31/2018**	**%**
Long-Term Debt	$736,500	119.5%
Other Liabilities	2,349	0.4%
Book Value of Equity	-122,286	-19.8%
Total Capital	$616,563	100.0%



Source: Company reports, Metastock and Dawson James estimates.

Fusion's Size Puts it in a Sweet Spot

We initiate coverage of Fusion Connect with a Buy rating and a $7 target price. The company provides a full suite of communications solutions to small and mid-sized business customers across the U.S. Unlike many larger companies, Fusion is an "asset light" carrier leasing much of its network taking advantage of a saturated fiber market. In its industry, there are thousands of small subscale and marginally profitable providers offering similar services, although none offer the breadth of services that Fusion offers. At the other end of the spectrum, there are a handful of mega-carriers such as AT&T, Verizon and Comcast, which have become too large to provide adequate service. For the service industry customers in segments such as healthcare, finance and legal that Fusion serves, their telecom connection is their lifeblood so they need the personal service a Fusion provides. So, the company is in what we consider to be a sweet spot sizewise.

It is also in a sweet spot from an investment perspective with a market cap of just over $300 mm, below the cutoff of most investors and analysts, but within range of the $500 mm cap level that, in our experience, usually leads to more attention.

We have known this company since analyzing its 2005 IPO and have met with its CEO numerous times since 2012 and are very comfortable with management, its product offerings and target market. The company likely has some integration and digestion to do over the rest of this year before we see organic growth. But it has perfected its acquisition model, and as we detail in this report, has pieced together a collection of assets which on the surface may not make a lot of sense together, but upon the further inspection we provide in this report, the strategy becomes clearer and compelling. Fusion's mix of organic and inorganic growth is a time tested model in telecom and once the acquiror consolidates up to significant enough size, it typically becomes the acquired, as we saw last year with Level 3 Communications.

Our valuation equates to just 11x our 2018 EBITDA estimate and 8.5x our 2019 estimate which more fully reflects full expected synergies from two recent sizable M&A transactions. Fusion is somewhat difficult to comp given its lack of similar size comparables and its range of capabilities. So, we have used a larger comp set in valuation. These comps trade at an average valuation of 17.2x trailing EBITDA, per Factset, so our valuation represents a significant discount to account for the risks we see here.

The key risks, in our view are integration and execution. Fusion is now the combination of three sizable companies merged together on May 7 and June 18. Management must merge networks, systems, personnel and most importantly cultures. One pitfall we have seen in telecom mergers, for example, are billing system integrations which fail and when bills don't go out, payments don't come in cutting off cash flow. But Fusion is not new to acquisitions having completed eight prior transactions from late 2012 through January of this year.

The other risk is execution. In this report we detail several key operating metrics of pre-merger standalone Fusion which demonstrate solid execution. We believe this is indicative of results post-merger since the same management team is largely intact. However, Fusion is now a much larger company and Birch did not have as robust a history of performance as Fusion did. So, a key question is can the Fusion management team run the new larger company as well as it did the smaller standalone company? We think yes, but it is a key risk. In addition to management's track record, we note that the company is enjoying a strong economy and is selling the type of cloud services which are seeing strong demand as customers convert from legacy technologies of the last century, to modern cloud-based services. In the event of a recession, some of its customers would likely fail, but there would also be a move to the type of more cost effective solutions it offers. So, Fusion has the wind at its back.

From International Long Distance to Business Communications

Fusion was founded in 1997 by the current CEO's father, Marvin Rosen, as a domestic long-distance provider. Rosen is very well connected in both finance and business and served as finance director for the Democrat party under President Clinton. Among other board members were John Sununu, former New Hampshire governor and Chief of Staff to President George H.W. Bush and basketball great Julius Irving, better known as Dr. J.

Fusion went through a restructuring and management change in 2000 bringing on board current CEO Matt Rosen. We are always highly skeptical of nepotism in public companies, but Matt came with an incredible resume of his own. We have had the opportunity to have a number of long meetings with him over the last several years to better understand the company's strategy as it has grown. In our opinion, he is the real deal.

Matt Rosen started out as a healthcare investment banker at Merrill Lynch but soon moved into industry. He first served as Director of Operations for a startup owned by Oxford Health Plans later becoming Director of Operations for the entire $4 billion company from 1996 to 1998. From there, he moved into the telecom industry becoming a regional president for Expanet, which grew to become a $1.3 billion telecom company. In the Spring of 2000, his father brought him into Fusion as President of U.S. operations. In 2006, he took over as CEO. Since then the stock has depreciated from just under $200 (split adjusted) while quarterly revenue increased by 1,356%.

For much of Matt Rosen's tenure, revenue fluctuated but trended sideways. In 2012, revenue of $44.3 mm was actually 6% below where it was in 2006 when he took over. However, he dramatically turned EBITDA around from a loss of over $11 mm in 2006, to $15 mm positive last year. It's important to recall what was going on with the national economy during this period, with the U.S. entering the worst recession since the depression, and not fully returning to pre-recession growth levels until recently.

With the business solidly profitable, he next focused on growth, employing a time-tested mix of organic and acquisition-driven growth. For Fusion, acquisitions have both broadened the product mix and increased the customer base. Perhaps more importantly, several of the key executives came via acquisitions with Chief Strategy Officer Jon Kaufman joining in the 2012 acquisition of Network Billing Systems, which he founded in 1984. More recently, Dan Foster, the company's new Chief Revenue Officer, joined from the acquisition of Megapath in June 2018.

Fusion Has Transformed Over Its 20 Year History

September	1997	Fusion founded as domestic long distance carrier by Marvin Rosen
March	2000	Company restructuring and new management
March	2000	Current CEO Matt Rosen joins as head of US operations
September	2001	Domestic local access business sold
February	2005	IPO at $6.45 per share or $483.75 adjusted for splits
March	2006	Matt Rosen appointed CEO
November	2012	Acquires Network Billing Systems for $19.6 mm
January	2014	Acquires Broadvox for $32.1 mm
May	2014	1:50 reverse stock split
November	2014	Acquires PingTone for $10 mm
September	2015	Acquires RootAxcess for $1.2 mm
December	2015	Acquires Fidelity Voice and Data for $30 mm
April	2016	Aquires Technology for Business for $1 mm
November	2016	Acquires Apptix for $28 mm
January	2018	Acquires IQMax for $1.0 mm
May	2018	1:1.5 reverse stock split
May	2018	Acquires Birch Telecom for $281 mm
June	2018	Acquires Megapath for $71.5 mm

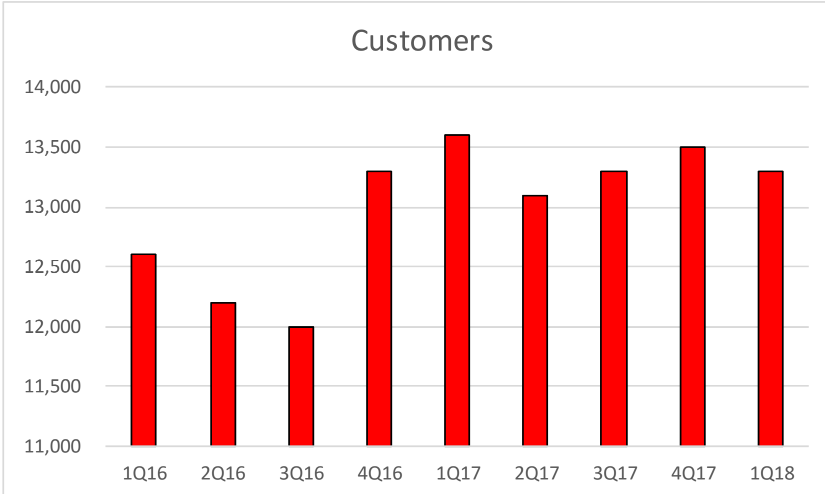
Source: Company reports and Dawson James estimates

Recent History Shows Solid Fundamental Performance

While under accounting standards, Fusion's history is now that of Birch, not Fusion, from an analytical standpoint we think it is more relevant to examine Fusion' operating history. In addition to financials, Fusion has historically provided a number of operating metrics, which we believe are helpful to better understand management's past performance as well as its ability to execute in the future.

Looking at results over the last two years, business services revenue increased from $21 mm to $29 mm, although as we discuss in the next section, much of this was acquisition driven. The company's customer base increased from 12,600 to 13,300 over the two-year period from 1Q 2016 to 1Q 2018, an increase of 5.6%. Some of this was due to acquisitions but we believe that it likely also represented some organic growth as well.

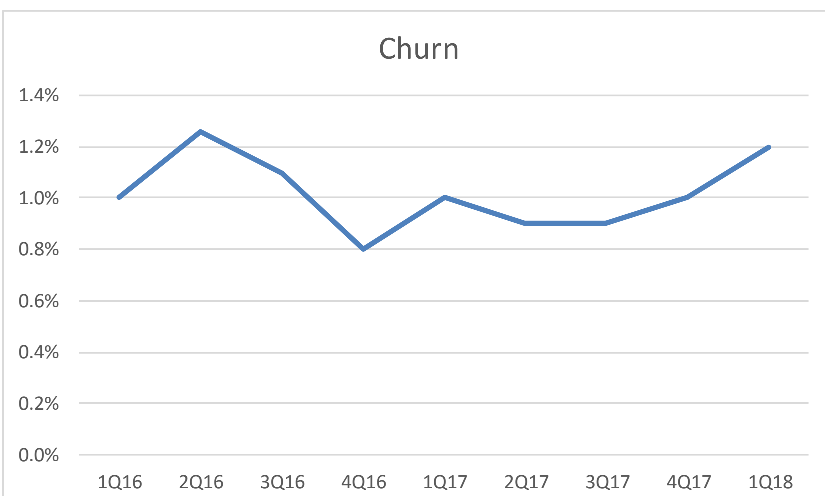
Fusion Grew Its Customer Base 6% From 1Q 2016 to 1Q 2018



Source: Company reports and Dawson James estimates

During the same period, churn fluctuated from 0.8% per month to 1.2%, which is generally below industry averages. Fusion targets a smaller average customer than many of its publicly traded telecom peers and smaller businesses have higher failure and sale rates than larger firms, both of which can result in the loss of a customer. Overall, Fusion lost about 3,500 customers to churn, so to post the net 700 customer increase that it did, acquisitions added 2,000 customers and its salesforce added 2,200, most of which just offset churn. This underscores one of the challenges of the telecom services business.

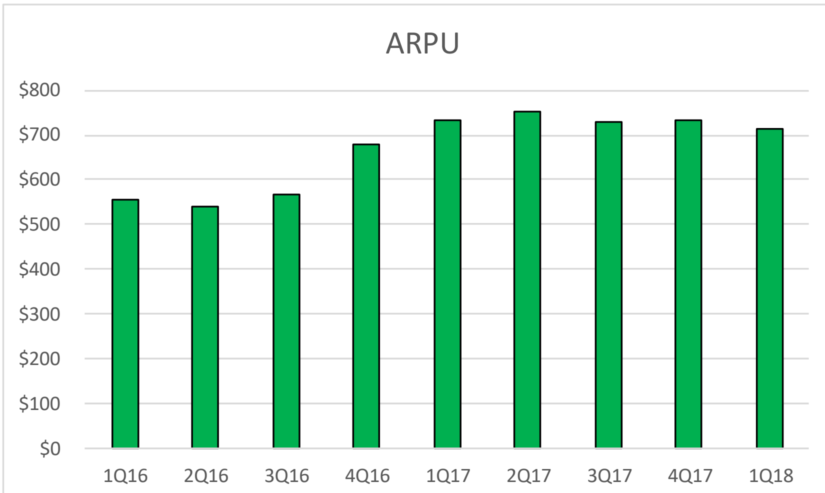
Customer Churn Has Been Relatively Low for the Telecom Industry



Source: Company reports and Dawson James estimates

The third operating metric we look at is ARPU or average revenue per user. A key plank of Fusion's strategy is to offer its customers a full suite of voice and data services. Customers brought in via acquisition are cross sold other services in Fusion's portfolio. The more services a customer has, generally the lower their propensity to churn and the more profitable they are. The other factor driving ARPU at Fusion has been a focus on moving upscale in terms of the size of their target customer. With a full product suite, a national network and a litany of blue chip reference customers, Fusion is better able to attract larger customers. From 1Q 2016, ARPU increased by 28%, from $557 per month to $715. Even at $715, this still represents relatively small customers, so we see continued opportunity to move upscale. However, we note that Birch brings a much lower ARPU of $220, so look for a sharp decline once 2Q results are reported to include Birch, before moving up again.

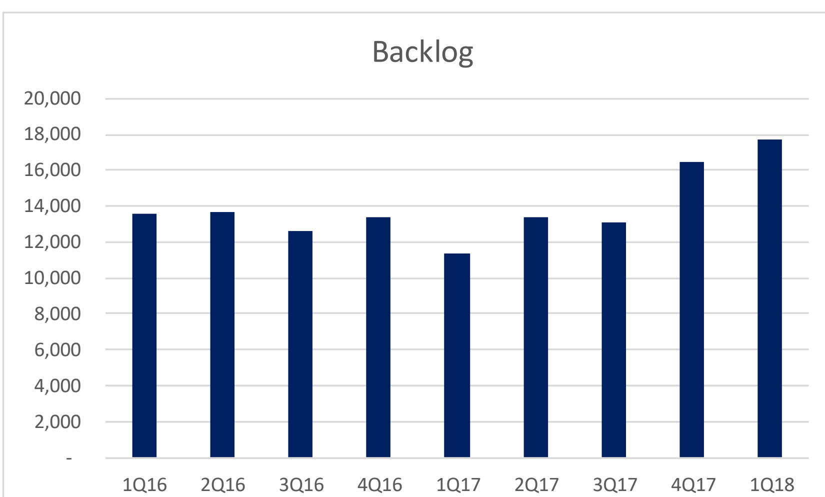
Fusion Boasts a 28% Increase in ARPU Over the Last Two Years Reflecting Larger Customers and More Cross Selling



Source: Company reports and Dawson James estimates

Lastly, the other data metric of note is backlog. At the end of March, the company had $17.7 mm in contracts in backlog, up 58% from a year earlier and 30% from 1Q 2016. This growth tells us two things. First, the company continues to have an active and successful salesforce, and second, there are enough newly signed contracts waiting for service to be activated to drive growth.

Backlog Was Up 58% YoY in 1Q 2018, Reflecting Strong Sales Performance and Future Growth



Source: Company reports and Dawson James estimates

Acquisitions Complement Organic Strategy

Since 2012, the company has embarked on a series of ever larger acquisitions which have transformed the company to a current revenue run rate of around $575 mm per year with an EBITDA target of 25% once synergies from the recent Birch and Megapath acquisitions are realized.

Since 2012, the company has spent roughly $800 mm on ten acquisitions ranging from the tiny $1 mm it spent for IQMax to the massive company changing $600 mm merger with Birch in May (as noted, Birch was the acquiror for accounting purposes). These deals have individually and collectively been accretive to valuation as FSNN shares presently trade at 5.8x pro forma trailing EBITDA whereas acquisitions were done between 2.8x and 5.0x trailing EBITDA pro forma for synergies. The deals brought in carriers from around the country with Megapath bringing 156k customers.

Fusion Has Spent $800 Million on Ten Acquisitions Since 2012

Date		Target	Target HQ	EV	Cash	Stock	Debt	Revenue	EBITDA	Synergies	EV/E	PF EV/E	Customers	ARPU / Month	Churn
Nov.	2012	Network Billing Sys.	Wayne, NJ	19.6	17.8	0.6	1.3	26.5	4.9	2.0	4.0x	2.8x	5,000		
Jan.	2014	Broadvox	Dallas, TX	32.1				32.7	4.1	2.4	7.8x	4.9x	5,800		
Nov.	2014	PingTone	Herndon, VA	10.0	7.5	2.5		8.1	1.2	1.0	8.7x	4.8x	250	2,900	0.5%
Sept.	2015	RootAxcess	Oak Brook, IL	1.2								3.0x		2,900	
Dec.	2015	Fidelity V&D	Beachwood, OH	30.0	28.5	1.5						5.0x		750	0.5%
Apr.	2016	Tech. for Bus.	Manhattan Beach, CA	1.0									500		
Nov.	2016	Apptix	Herndon, VA	28.0	23.0	5.0		25.0	3.2	4.8	8.8x	3.5x	1,500		
Jan.	2018	IQMax	Charlotte, VA	1.0											
May	2018	Birch	Atlanta, GA	600.0		281.1	444.0	451.0	124.0	28.2	4.8x	3.5x	156,000	220	2.0%
June	2018	Megapath	Pleasanton, CA	71.5	61.5	10.0		70.0				5.0x	8,000	750	1.0%
			Totals:	**794.4**	**138.3**	**300.7**	**445.3**				**Avg.**	**4.1x**		**1,504**	**1.0%**

Source: Company reports and Dawson James estimates

Network Billing Systems - $19.6 mm in November 2012

NBS was an early unified communications and cloud provider before those terms were widely known. The company was headquartered across the river from Fusion in Wayne, NJ so integration was relatively straightforward. The company had 5,000 customers at the time of the acquisition, versus just over 13,000 for Fusion at the end of 2017, so this transaction really moved the needle. Perhaps as importantly, Fusion's current Chief Strategy Officer, Jon Kaufman, was the founder and CEO of NBS. Fusion paid $19.6 mm at a time when NBS was generating around $26.5 mm in revenue and $4.9 mm in EBITDA. Factoring in $2 mm in annual synergies, the purchase price worked out to just 2.8x EBITDA.

Broadvox - $32.1 mm in January 2014

In January 2014, Fusion acquired the cloud services business of Broadvox. With synergies, we estimate that it paid around 5.0x EBITDA. Broadvox was based in Dallas and had around 5,800 customers at the time of acquisition and 300 channel customers. Broadvox was a technology vendor providing some of Google Voice's functionality. In 2015, Onvoy bought the remaining wholesale VoIP portion of Broadvox that Fusion did not acquire and in 2017 it merged with Inteliquent.

PingTone - $10 mm in November 2014

In November 2014, the company acquired PingTone out of Herndon, Va. for 4.8x pro forma EBITDA. This added another cloud services provider serving Washington, D.C. area customers including a number of government accounts. PingTone served larger customers with an ARPU of about six times that of the prior two acquisitions.

RootAxcess - $1.2 mm in September 2015

The acquisition of RootAxcess in September 2015 added a much smaller company similar to PingTone serving the Chicagoland area out of Oak Brook, Il. The company paid just 3.0x pro forma EBITDA in this transaction.

Fidelity Voice and Data - $30 mm in December 2015

A few months later, in December 2015 Fusion completed another sizable deal acquiring Beachwood, OH based Fidelity Voice and Data for $30 mm or 5.0x pro forma EBITDA. Fidelity brought in 2,000 small business customers with an average churn of 0.5%.

Technology for Business - $1 mm in April 2016

The small $1 mm acquisition of Technology for Business brought with it Fusion's long-sought desire to add technology to serve the call center market as it shifts to cloud-based communications technology. TFB had about 500 customers. Fusion has adapted this hardware-based technology to a cloud solution that it can offer on a per user basis including home-based workers.

Apptix - $28 mm in November 2016

In November 2016 Fusion returned to Herndon, Virginia for another large transaction acquiring Apptix for $28 mm or 3.5x pro forma EBITDA. Apptix provided IT infrastructure support services to about 1,500 customers. The goal here was for Fusion to cross sell its voice and data services to the Apptix customer base and to offer Apptix's IT support services to Fusion's customer base.

IQMax- $1 mm in January 2018

After taking a year off, Fusion made a small acquisition in January 2018 acquiring Charlotte, NC-based IQMax's operating assets for just $1.0 mm. IQMax had spent $20 mm developing a secure mobile messaging app targeted at the health care market as it meets all HIPAA standards. At the time of the acquisition, management noted the synergy of utilizing Fusion's cloud platform as the backbone for Apptix services. As Fusion already enjoyed a strong health care customer base, we can see this as a valuable product. The transaction was all stock, and Fusion also agree to pay royalties for a short period of time.

Birch Telecom - $600 mm in May 2018

More recently, Fusion has made two large acquisitions. In the first deal, it paid $761 mm to acquire the business services segment of Birch. Birch has long been a large acquiror of troubled telecom assets including cBeyond in 2014. The Birch/Fusion transaction was more of a reverse takeover although Matt Rosen and the rest of the Fusion management team continue to run the company. Birch shareholders now control 75% of shares outstanding. Importantly, the transaction did not include Birch's low margin consumer and single line business. Additionally, Fusion spun off its own low margin carrier services business as well, making it a pure play business services carrier. Birch had been in the process of exiting its own underperforming businesses for the year or two prior to the deal closing, so it showed declining revenue but improving EBITDA. Birch served a very large customer base of 156,000 customers excluding its residential and single line customers but they generated a lower ARPU of just $220 per month with a high 2.0% per month churn rate.

Megapath - $71.5 mm in June 2018

Shortly after the Birch deal finally closed a bit later than expected, Fusion was at it again acquiring small business services unit of Megapath that GTT did not buy back in 2015 when it acquired the rest of the business. Megapath added another 8,000 customers with an ARPU of $750 and churn of just 1%. These metrics are closer to legacy Fusion metrics. With both Birch and Megapath closing in short order, Fusion now must undertake a sizable integration project with a key goal of unifying back office systems onto the Fusion platform. Management noted in May that it was already ahead of schedule having realized 20% of planned Birch synergies already.

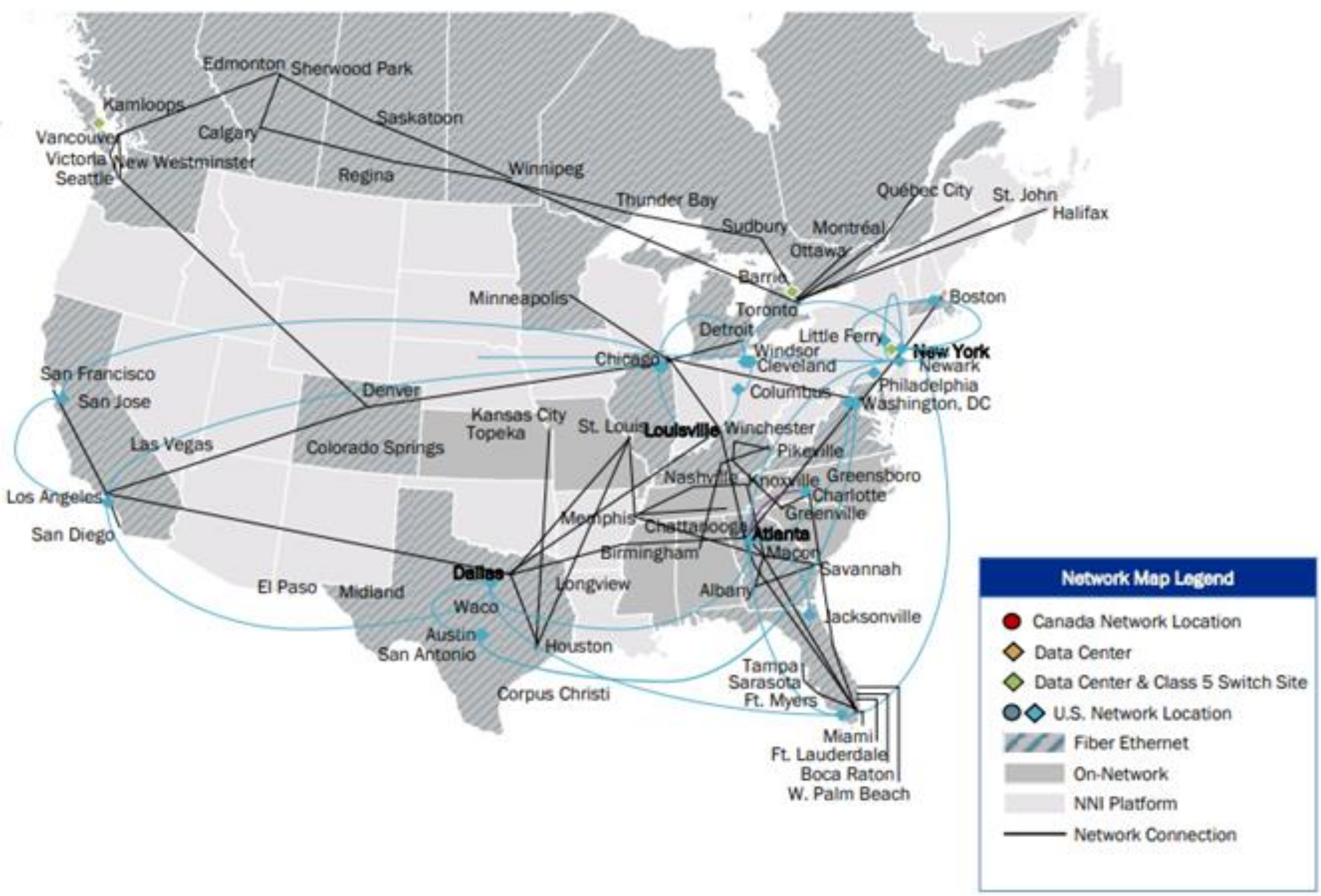
Asset Light Network Strategy Keeps CAPX Low, and Cash Flow High

Fusion is an asset-light telecom carrier meaning it owns as little of its network as possible and leases as much as possible. It does own the network assets that control network quality, so it can offer performance guarantees to its customers. Its network is monitored by two redundant network operations centers (NOCs), one in Atlanta and the other in Toronto. The company leases wavelengths from long haul fiber network owners to connect its 30 internet points of presence (POPs) where it peers with or interconnects with other carriers. It leases 31,000 miles of fiber with all of its U.S. fiber leased on a dark fiber basis from Zayo over 20 year IRU (indefeasible rights of use) contracts. Fusion then provides its own optronics equipment to light the fiber. In Canada, it inherited fiber from the Primus operations Birch had acquired in 2016. Primus had used a low cost, fast fiber installation technology also favored by Google Fiber called microtrenching. Fusion's network physically connects into roughly 800 office buildings. For access to other buildings, it uses a combination of leased fiber, copper, cable modem or 4G LTE, mainly for backup. With Megapath, it acquired colocation into about 600 ILEC central offices where it installed DSLAMs so it can utilize all of the incumbents copper connections to buildings in the serving area.

It primarily uses Cisco ASR 9000 high end routers as well as Cisco customer premises equipment. Its preferred desk phone set provider is Polycom and we can attest to the quality of the service as our firm is a Fusion customer. Overseeing all of this technology is Brian George, who joined the company in the 2012 NBS acquisition and who serves as SVP of technology and infrastructure. He manages a team of about 230 people out of a total of about 1,200 employees.

The company also has a presence in roughly 27 "data centers" but we put the term data centers in quotes because it has two very different meanings. The company has fiber connections into about 27 carrier hotels where it peers with other carriers. It also operates more traditional data center footprint in three buildings in Louisville, Cleveland, Dallas and Atlanta where it leases the building and provides the power and cooling. Much like data center pure plays such as Equinix or Internap, it provides hosting services either using its own servers or allowing clients to install their own servers into Fusion's own secure data centers. While this is not the company's core business, by having this competency, it can offer another service to business customers in its efforts to be a full-service provider.

Fusion's Network Spans the Country, Mainly by Leasing Capacity from Other Carriers



Source: Fusion Connect

In addition to the physical network, Fusion is also unique from its peers in that it owns a significant amount of its own intellectual property. There are three main products:

- **Fusion360** is the company's multi-feature voice solution. It is based on proprietary technology acquired with NBS. Fusion also offers Cisco/Broadsoft for customers or for acquisitions of other companies using this widely used solution. On its website, Fusion touts the difference of its HD voice technology. We actually noticed this voice quality when we first began using Fusion at Dawson James, before we knew who the carrier was. By contrast, for our home telephony, we utilize a small VoIP provider, and the voice quality is noticeably worse. Owning its own VoIP technology reduces Fusion's cost as it does not have to pay a licensing fee to Broadsoft, and it also allows it to customize and better manage the service for customers.

- **Contact360** is the company's cloud-based call center solution. When it acquired TFB this was an expensive ($500,000) hardware-based solution. Fusion hosts the same functionality in its data centers reducing customers' upfront cost and increasing flexibility. It can also then easily support home workers with the same software they would use at a physical call center. Fusion's solution also supports integration with all major ERP and CRM solutions.
- **MobileConnect** is the company's mobile solution. This technology was originally acquired in the IQMax acquisition for just $1 mm, while that company had spent $20 mm developing it. The software is designed to meet strict HIPAA privacy requirements for the health care industry and is a souped up text messaging platform. With this solution, medical professionals can securely and legally send data such as lab results to each and conduct secure conversations, including those subject to strict patient confidentiality laws. The company intends to leverage this technology to other professions where it already has a strong footprint, such as the legal profession. Since HIPAA standards are the most stringent of any industry, its HIPAA compliant tools should meet the privacy standards of other industries as well.

While an asset light network philosophy provides operational advantages, the key advantage is financial. As noted, Fusion targets a 25% EBITDA margin. Subtracting an estimated 10% of revenue for CAPX, the company's model should generate about 15% of revenue to first pay off bondholders, second support further acquisitions and third, reward shareholders. Although we do not see Fusion paying a dividend for the foreseeable future.

We Forecast $101 mm in EBITDA This Year on $531 mm in Revenue, Growing to $139 mm in EBITDA Next Year on $576 mm in Revenue

As noted, in another of the many illogical twists of accounting, Birch is considered the surviving entity for accounting purposes after their May merger, not Fusion. The company was kind enough to provide pro forma 2017 and 1Q 2018 financials in its May 25th 8K to give us some sense of what the combined company will look like. However, a key omission was any year-over-year comparisons, so while we can get a good sense of margins, we do not have a good sense of pro forma growth. Looking at pre-merger Fusion results also does not give us a good sense either since they were so heavily impacted by acquisitions.

For 2017, the company generated $567 mm in revenue and pro forma EBITDA of $140 mm. With expected synergies, this was estimated to be $162 mm in their February 13th 8K. They also provide 1Q 2018 pro forma data with revenue of $131.8 mm and operating income of $1.8 mm. From this, we estimate EBITDA of $24.9 mm, but we may be omitting non-recurring items not broken out in the filing. This results in an EBITDA margin of 18.9%, versus management's aspiration for 25% a year from now.

Second quarter results are due to be reported in August and analyzing them will be a bit tricky. We built our model on the pro forma numbers and our 2Q estimates are also pro forma, whereas the Birch deal did not close until May 7, and so the GAAP numbers won't include the legacy Fusion financials until that date. We believe that management will provide pro forma financial information for comparability. Megapath closed on June 18, so 2Q results will only include 12 days of their results.

Management guidance is for run rate revenue of $575 mm for the twelve months from July 1, 2018 to June 30, 2019. Our model is a bit more conservative at $565 mm, as Birch was in decline, and may decline further before Fusion management can grow it again. EBITDA guidance is for 25% margins, once all synergies are realized a year from now or 2Q 2019. Our model does not get there until 4Q 2019. Again, we note that the company did not provide an EBITDA reconciliation when it provided pro forma EBITDA in February, so it is not clear where they are currently. We estimate an 18.9% EBITDA margin, meaning they need to pick up six points from synergies or cut about $35 mm from a $440 mm expense base, which at less than 10% strikes us as reasonable since other companies in the sector have achieved this after mergers.

So again, to summarize the numerous caveats around results we note that we model 2Q pro forma, but GAAP will only include Birch results through May 7, with no Fusion results. Consensus could also be an issue as we do not know how other analysts are viewing results. Calculating EBITDA is also not clear but should be clearer once they report in August. But these issues and the confusion they create are, in our opinion, a key reason for the discount on the shares.

We Value FSNN at $7 Per Share

As is shown in the table below, FSNN comps trade between 12x and 24x trailing EBITDA. The table below is from FactSet, to keep the numbers consistent, but without updates for recent M&A, they show a trailing valuation for FSNN of 37.5x EBITDA. If we use the $140 mm pro forma EBITDA for Fusion/Birch (from their February 13th 8K) and add $14 mm for Megapath ($71.5 mm purchase price divided by 5x stated multiple) we get $154 mm in pro forma EBITDA for a current valuation of 6.6x. Note this is still well below comps.

At 10X Estimated 2018 EBITDA, FSNN Shares Would Be Worth $7

Company Name	Fiscal Period	Price	Shares Outstanding	Market Value	Enterprise Value	Sales	EBIT	EBITDA	Enterprise Value/ Sales	Enterprise Value/ EBIT	Enterprise Value/ EBITDA
Fusion Connect	03/31/2018	3.96	78.26	309.92	367.43	143.76	(4.28)	9.54	2.6x	-	38.5x
FSNN @ target using 2018E	12/31/2018	7.00	78.26	547.84	1,177.84	531.10	13.82	101.52	2.2x	85.3x	11.6x
FSNN @ target using 2019E	12/31/2019	7.00	78.26	547.84	1,177.84	576.13	43.10	139.03	2.0x	27.3x	8.5x
Citrix Systems, Inc.	12/31/2017	106.57	135.53	14,442.90	15,115.35	2,824.69	662.67	814.65	5.4x	22.8x	18.6x
Zayo Group Holdings, Inc.	06/30/2017	38.37	248.56	9,537.09	15,036.69	2,199.80	394.30	1,001.20	6.8x	38.1x	15.0x
RingCentral, Inc. Class A	12/31/2017	74.95	66.81	5,899.49	5,701.04	501.53	(27.28)	(11.06)	11.4x	-	-
LogMeIn, Inc.	12/31/2017	106.75	52.21	5,573.63	5,208.45	989.79	47.98	269.30	5.3x	108.5x	19.3x
j2 Global, Inc.	12/31/2017	89.50	49.11	4,395.35	5,068.37	1,117.84	248.01	410.05	4.5x	20.4x	12.4x
Vonage Holdings Corp.	12/31/2017	13.20	237.49	3,134.85	3,344.23	1,002.29	64.49	137.02	3.3x	51.9x	24.4x
GTT Communications, Inc.	12/31/2017	45.25	44.96	2,034.21	3,223.61	827.90	66.90	199.50	3.9x	48.2x	16.2x
Five9, Inc.	12/31/2017	35.72	57.68	2,060.47	2,027.03	200.23	(7.85)	0.46	10.1x	-	-
8x8, Inc.	03/31/2018	21.20	93.01	1,971.71	1,819.44	296.50	(32.43)	(16.71)	6.1x	-	-
Mitel Networks Corporation	12/31/2017	10.96	122.61	1,343.82	1,902.12	1,059.10	51.60	127.90	1.8x	36.9x	14.9x
Vocera Communications, Inc.	12/31/2017	32.03	29.76	953.08	872.19	162.55	(14.02)	(6.38)	5.4x	-	-
Average									**5.8x**	**46.7x**	**17.2x**

Source: Company reports and Dawson James estimates

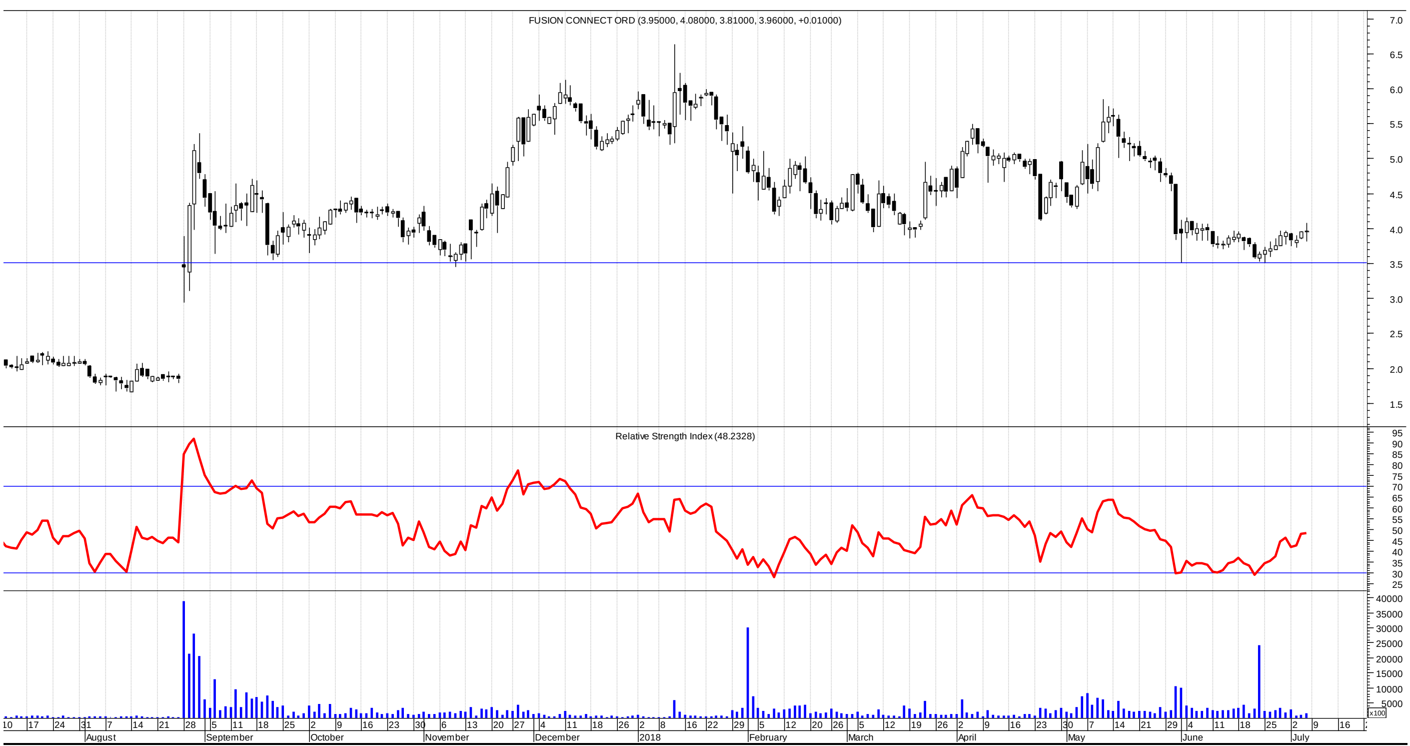
We apply a multiple of 8.5x our 2019 estimate to arrive at our valuation with the discount due to a number of factors. First, FSNN numbers are messy with so many acquisitions. In our opinion, it will take a couple of relatively clean quarters for investors to get used to the new Fusion. Second, with Birch, Fusion will likely not show much topline growth, and perhaps some near term decline. Third, margins will take time to get to the 25% aspirational level as merger synergies are realized – assuming that they are. And fourth, comps are not exactly comparable with some generating higher growth and or margins. Several have higher growth rates and or margins. Others do not have positive EBITDA, so we list no relevant EBITDA multiple.

Since gapping higher last August, FSNN shares have generally traded sideways in a $3.50 to $6.00 per share range. The stock hit at $6.63 on January 11 but has made lower highs on each succeeding rally. On the downside, support has held relatively firm at $3.50 and with the stock only 10% above this level, we see technical downside as relatively limited. Note that this trading action is adjust for a 1 for 1.5 reverse split effected on May 7 with the closing of the Birch transaction.

Longer term, the company also initiated a 1 for 50 reverse split in May 2014 to adjust for the fact that FSNN shares came public in another era. The company priced its February 2005 IPO at $6.45 but with the two splits, this works out to $483.75 per share. We don't believe that there are any remaining shareholders with a basis nearing this high (which would represent selling pressure).

Our $7 price target is only 6% above the 52-week high, so from a technical perspective, we are not looking for the stock to significantly break out of its range. In fact, we would advise investors to be a bit cautious if we did approach $6.63 as this might spark some selling pressure.

FSNN Trading in a $3.50 to $6.00 Range, With Technical Downside Around 10% to Support



Source: Company reports and Dawson James estimates

Fusion Connect Income Forecast

Dollars in thousands, except per sh	2017			2018E					2019E					2020E		
Fiscal years ended December 31	YEAR	1QA	2Q	3Q	4Q	YEAR	1Q	2Q	3Q	4Q	YEAR	1Q	2Q	3Q	4Q	YEAR
Revenue	**567,309**	**131,829**	**130,000**	**127,267**	**142,000**	**531,096**	**142,238**	**142,238**	**146,812**	**144,840**	**576,127**	**149,349**	**149,349**	**154,153**	**152,082**	**604,933**
YoY growth							7.9%	9.4%	15.4%	2.0%	8.5%	5.0%	5.0%	5.0%	5.0%	5.0%
Seq growth			98.6%	97.9%	111.6%		0.2%	100.0%	103.2%	98.7%		3.1%	100.0%	103.2%	98.7%	
Cost of Revenue	296,638	69,267	68,900	67,451	75,260	280,878	75,386	75,386	77,076	75,317	303,165	77,662	77,662	79,389	78,322	313,034
Gross Margin	270,671	62,562	61,100	59,815	66,740	250,217	66,852	66,852	69,736	69,523	272,962	71,688	71,688	74,764	73,760	291,899
As a percent of revenue	47.7%	47.5%	47.0%	47.0%	47.0%	47.1%	47.0%	47.0%	47.5%	48.0%	47.4%	48.0%	48.0%	48.5%	48.5%	48.3%
Selling General and Admin	130,671	37,702	37,000	37,000	37,000	148,702	34,137	32,715	33,767	33,313	133,932	34,350	32,857	33,914	33,458	134,579
As a percent of revenue	23.0%	28.6%	28.5%	29.1%	26.1%	28.0%	24.0%	23.0%	23.0%	23.0%	23.2%	23.0%	22.0%	22.0%	22.0%	22.2%
EBITDA	**140,000**	**24,860**	**24,100**	**22,815**	**29,740**	**101,515**	**32,715**	**34,137**	**35,969**	**36,210**	**139,031**	**37,337**	**38,831**	**40,850**	**40,302**	**157,320**
YoY growth	-						31.6%	41.6%	57.7%	21.8%	37.0%	14.1%	13.8%	13.6%	11.3%	13.2%
Seq growth			-3.1%	-5.3%	30.4%		10.0%	4.3%	5.4%	0.7%		3.1%	4.0%	5.2%	-1.3%	
EBITDA margin	24.7%	18.9%	18.5%	17.9%	20.9%	19.1%	23.0%	24.0%	24.5%	25.0%	24.1%	25.0%	26.0%	26.5%	26.5%	26.0%
Depreciation and amortization	95,704	19,591	20,845	21,533	22,220	84,189	22,909	23,598	24,312	25,108	95,927	25,906	26,704	27,528	28,340	108,479
Impairment charges	53,876	3,511				3,511					-					-
Adjustments	49,201	-				-					-					-
Operating income	**(58,781)**	**1,758**	**3,255**	**1,283**	**7,520**	**13,816**	**9,806**	**10,539**	**11,657**	**11,102**	**43,104**	**11,431**	**12,127**	**13,323**	**11,961**	**48,842**
Operating margin			2.5%	1.0%			6.9%	7.4%	7.9%			7.7%	8.1%	8.6%		
Interest expense	(73,913)	(18,412)	(16,250)	(16,250)	(16,250)	(67,162)	(16,250)	(16,250)	(16,250)	(16,250)	(65,000)	(16,250)	(16,250)	(16,250)	(16,250)	(65,000)
(Loss)/gain on derivative liabilities	(909)	194	-	-	-	194	-	-	-	-	-	-	-	-	-	-
(Loss)/gain on extinguishment of debt	(21,771)	-	-				-	-				-	-			
Loss on disposal	(312)	(3)	-	-	-	(3)	-	-	-	-	-	-	-	-	-	-
Change in value of contingent liability	1,012	-	-				-	-				-	-			
Other	1,858	(148)	-	-	-	(148)	-	-	-	-	-	-	-	-	-	-
	(94,035)	(18,369)	(16,250)	(16,250)	(16,250)	(67,119)	(16,250)	(16,250)	(16,250)	(16,250)	(65,000)	(16,250)	(16,250)	(16,250)	(16,250)	(65,000)
Pretax Income	(152,816)	(16,611)	(12,995)	(14,967)	(8,730)	(53,303)	(6,444)	(5,711)	(4,593)	(5,148)	(21,896)	(4,819)	(4,123)	(2,927)	(4,289)	(16,158)
Taxes	(2,509)	(758)	-	-	-	(758)	-	-	-	-	-	-	-	-	-	-
Net income - continuing ops	**(155,325)**	**(15,853)**	**(12,995)**	**(14,967)**	**(8,730)**	**(52,545)**	**(6,444)**	**(5,711)**	**(4,593)**	**(5,148)**	**(21,896)**	**(4,819)**	**(4,123)**	**(2,927)**	**(4,289)**	**(16,158)**
Net income margin	-27.4%	-12.0%	-10.0%	-11.8%	-6.1%	-9.9%	-4.5%	-4.0%	-3.1%	-3.6%	-3.8%	-3.2%	-2.8%	-1.9%	-2.8%	-2.7%
Minority interest		(166)	(200)	(200)	(200)	(766)	(200)	(200)	(200)	(200)	(800)	(200)	(200)	(200)	(200)	(800)
Net income to common	**(155,325)**	**(16,019)**	**(13,195)**	**(15,167)**	**(8,930)**	**(53,311)**	**(6,644)**	**(5,911)**	**(4,793)**	**(5,348)**	**(22,696)**	**(5,019)**	**(4,323)**	**(3,127)**	**(4,489)**	**(16,958)**
Diluted shares outstanding	44,907	76,583	78,283	78,308	78,333	77,877	78,358	78,383	78,408	78,433	78,396	78,458	78,483	78,508	78,533	78,496
Seq change			1,700.0	25.0	25.0		25.0	25.0	25.0	25.0		25.0	25.0	25.0	25.0	
EPS diluted	**($3.46)**	**($0.21)**	**($0.17)**	**($0.19)**	**($0.11)**	**($0.67)**	**($0.08)**	**($0.07)**	**($0.06)**	**($0.07)**	**($0.28)**	**($0.06)**	**($0.05)**	**($0.04)**	**($0.05)**	**($0.21)**

Source: Company reports and Dawson Jamesn estimates.

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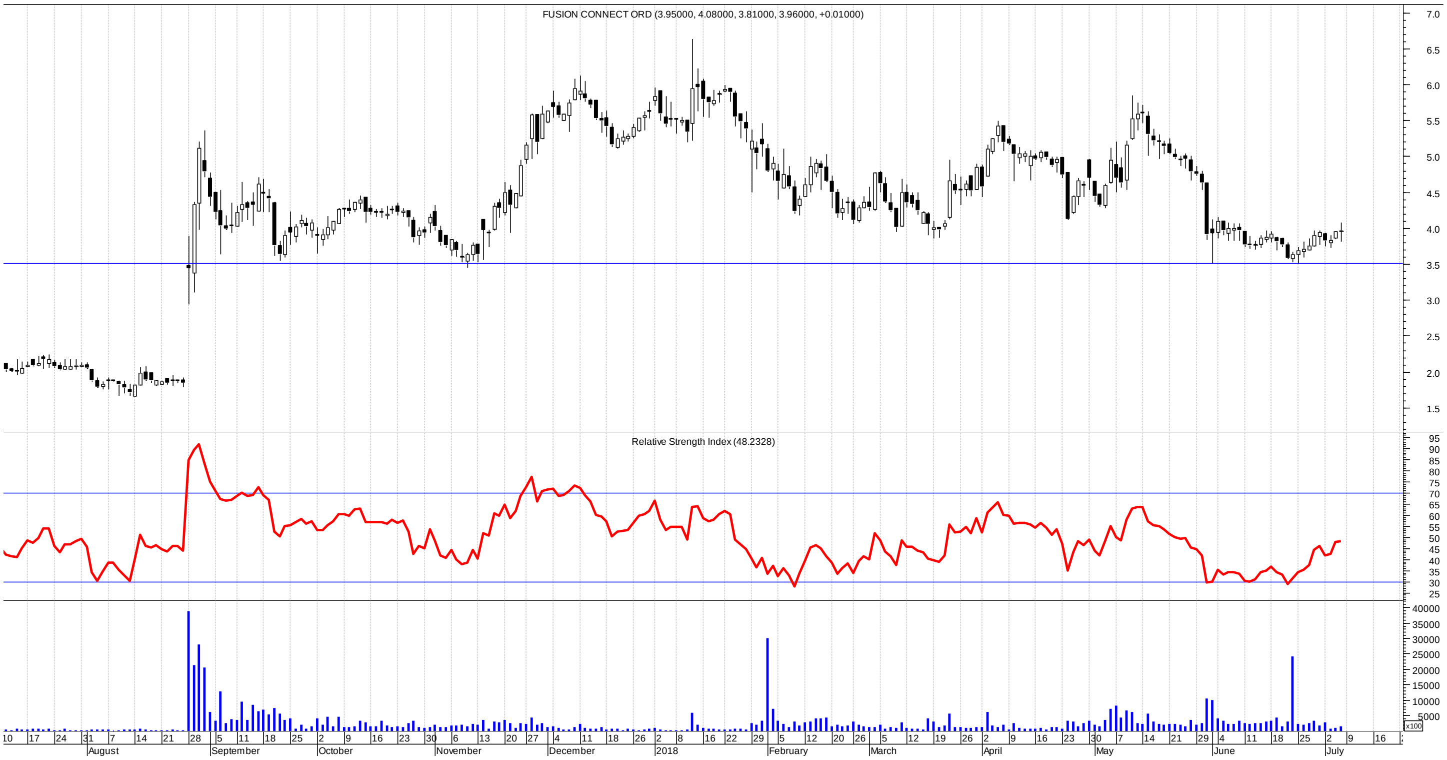
Important Disclosures:



Source: Metastock

Price target and ratings changes over the past 3 years:

Initiated – Buy – July 10, 2018 – Price Target $7.00

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The following chart reflects the range of current research report ratings for all companies followed by the analysts of the Firm. The chart also reflects the research report ratings relating to those companies for which the Firm has performed investment banking services in the last twelve months.

	Company Coverage		Investment Banking	
Ratings Distribution	# of Companies	% of Total	# of Companies	% of Totals
Market Outperform (Buy)	22	88%	7	32%
Market Perform (Neutral)	3	12%	0	0%
Market Underperform (Sell)	0	0%	0	0%
Total	25	100%	7	28%

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