

Fusion Connect, Inc. (Nasdaq/FSNN)

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Barry M. Sine

Senior Research Analyst

646-422-1333

bsine@dawsonjames.com

BUY

Fusion is a national telecom and data services provider offering a full suite, of data, security, voice and cloud services.

Fusion Reports Better than Expected 2Q

- With two major acquisitions in the quarter, Fusion reported better than expected results in a complex reporting period.
- It acquired Birch on May 4, although Birch is strangely treated as the acquiror under GAAP, and Megapath on June 15.
- We have modelled the company on a pro forma basis expecting \$130.0 mm in revenue and \$24.1 mm in EBITDA.
- Reported GAAP results were for revenue of \$120.8 mm and EBITDA of \$26.6 mm.
- We estimate that pro forma revenue was \$139.5 mm, 5% above our estimate, and pro forma EBITDA was \$27.9 mm, 15.6% above our estimate.
- The company is already bringing the relatively high churn rate of Birch down, with the rate of revenue decline slowing.
- Our overall investment thesis on FSNN shares is intact and strengthened by the recent mergers which give the company greater scale in what is generally a fixed cost industry.
- We value FSNN shares at 8.5x our 2019 EBITDA estimate whereas comps trade at roughly double that.
- 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.

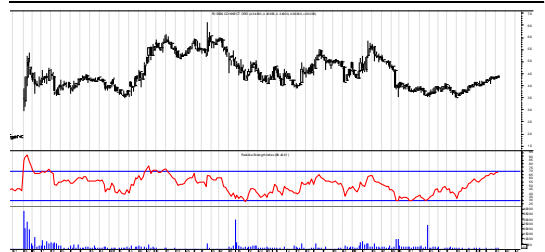
Current Price \$4.36
Price Target \$7.00

Estimates	2017A	2018E	2019E
Revenue(\$000s)	\$567,309	\$521,899	\$580,890
1Q March		131,829	142,238
2Q June		139,465	147,000
3Q September		127,267	154,153
4Q December		142,000	144,840

EPS	(\$3.46)	(\$0.63)	\$0.06
1Q March		(0.21)	0.00
2Q June		(0.59)	0.02
3Q September		(0.07)	0.02
4Q December		(0.06)	0.02
P/E (x)		0.0X	67.6X

EBITDA	\$140,000	\$106,567	\$145,982
EV/EBITDA (x)	N/A	N/A	6.4X

Stock Data		
52-Week Range	\$1.79	\$6.63
Shares Outstanding (mil.)		78.4
Market Capitalization (mil.)		\$341.8
Enterprise Value (mil.)		\$932.8
Debt to Capital		72.3%
Book Value/Share		N/A
Price/Book		N/A
Average Trading Volume (3-month) Mill		0.3
Insider Ownership		74.2%
Institutional Ownership		14.7%
Short interest		5.5%



Price target and ratings changes over the past 3 years:
 Initiation - July 10, 2018 - Buy - Price Target \$7.00
 Company Update - August 15, 2018 - Buy Price Target \$7.00

F1Q Results on Track, But the Sizzle is in the Now Unfolding Strategic Plan

Fusion reported strong second quarter results last night, well above our estimates. GAAP revenue came in at \$120.8 mm with EBITDA at \$26.6 mm. The company closed two major acquisitions in the quarter - Birch Telecom on May 4 and Megapath on June 15. The Birch deal was treated as a reverse acquisition so from the start of the quarter until May 4 results only include Birch, with Fusion added in from then on and Megapath from June 15th on. We had modelled the company on a pro forma basis, using pro formas Fusion provided in its SEC filings. On that basis, we were looking for revenue of \$130 mm and EBITDA of \$24.1 mm. We calculate pro forma revenue at \$139.5 mm for 2Q, or 7% above our estimate and pro forma EBITDA at \$27.9 mm beating our estimate by a strong 16%. For 3Q, the numbers should be more straightforward with GAAP results including all three businesses for the full quarter.

Birch had serviced smaller business customers and had experienced declining revenue with higher churn and lower ARPU. Fusion and Megapath, on the other hand, were largely similar. In 1Q, Fusion reported churn of 1.2% with ARPU of \$715. With the acquisitions, the customer based jumped from a previously reported 13,300 to 159,000 with most of the new customers coming from Birch. However, churn was higher at roughly 1.5% and ARPU is now just \$309 per month.

The challenge now is completing the integration and returning the combined company to growth, with a major opportunity in selling the Birch customer base more services, bringing down churn and increasing ARPU and margins. The new chief revenue officer, who was Birch's COO, was on the earnings call and is tasked with this feat. He expects to finish the salesforce integration early in the fourth quarter to bring back growth. We believe Fusion offers a very attractive portfolio of products and that the Birch customer base offers an attractive target.

On the operations side, the gross margin came in at 45.2% representing essentially the operation of three networks for much of the quarter. On this front, the company has already made rapid progress so we expect to see expansion in the gross margin in coming quarters. The EBITDA margin was 22% on a GAAP basis, and an estimated 20.0% on a pro forma basis as Fusion was generating a 12% EBITDA margin in 1Q and Megapath was roughly breakeven. We fully expect, and forecast, that the company will hit its 25% EBITDA target over the next year as synergies are fully realized.

For the rest of this year, the focus for investors will be on merger integration, with corresponding risks but a potentially significant margin expansion assuming synergies are realized as expected. Looking out to 2019, we see a larger Fusion, with a full portfolio of services and the benefits of economy of scale, able to return to growth. In our view, while there are a handful of larger competitors in the market, such as GTT, Cogent, CenturyLink, AT&T and Verizon, none has shown much interest in addressing the small to medium business market as Fusion has. So we view it as having an ideal opportunity, particularly with a booming economy.

Therefore, we reiterate our Buy rating and \$7 price target.

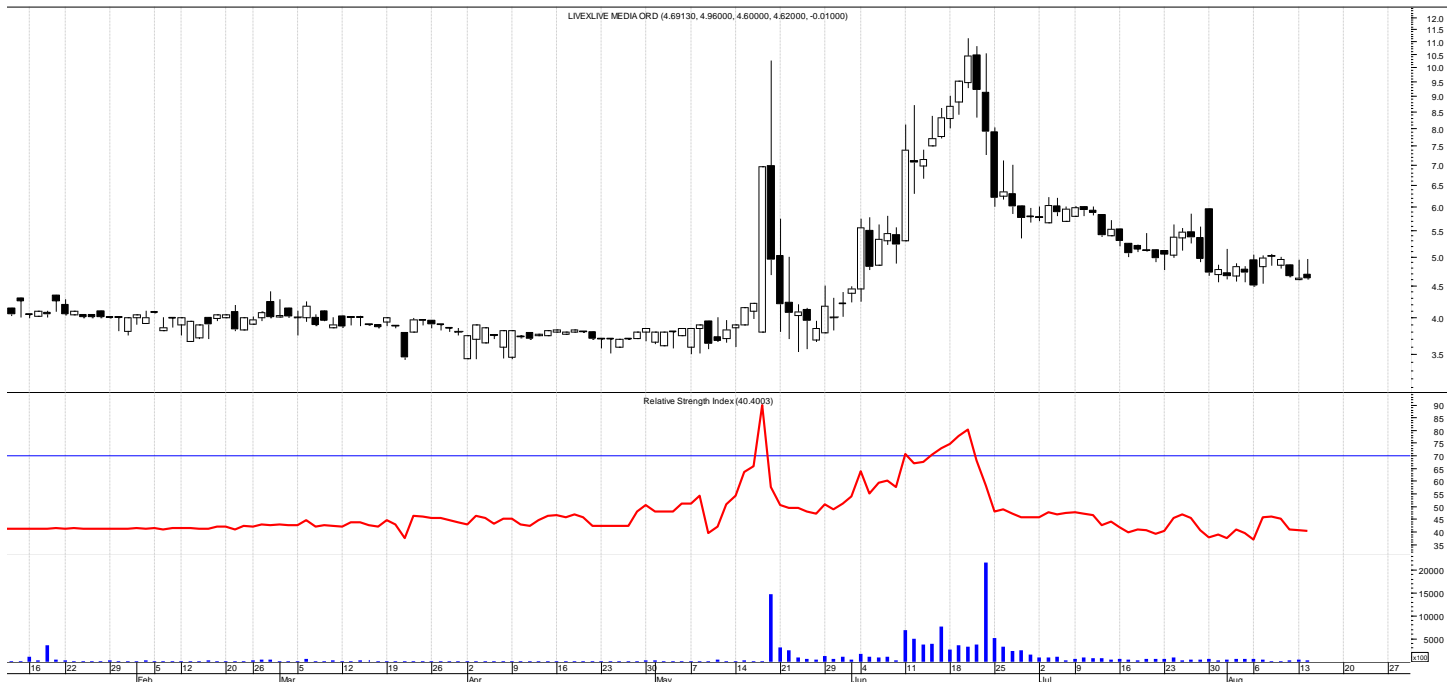
Fusion Connect Income Forecast

Dollars in thousands, except per sh:		2017					2018E					2019E					2020E				
Fiscal years ended December 31		YEAR	1QA	2QA	3Q	4Q	YEAR	1Q	2Q	3Q	4Q	YEAR	1Q	2Q	3Q	4Q	YEAR				
Revenue		567,309	131,829	120,803	127,267	142,000	521,899	142,238	147,000	146,812	144,840	580,890	149,349	154,350	154,153	152,082	609,934				
YoY growth								7.9%	21.7%	15.4%	2.0%	11.3%	5.0%	5.0%	5.0%	5.0%	5.0%				
Seq growth					105.4%	111.6%		0.2%	103.3%	99.9%	98.7%		3.1%	103.3%	99.9%	98.7%					
Cost of Revenue		296,638	69,267	66,189	71,269	80,940	287,665	75,386	77,910	77,076	75,317	305,689	77,662	80,262	79,389	78,322	315,635				
Gross Margin		270,671	62,562	54,614	55,997	61,060	234,233	66,852	69,090	69,736	69,523	275,201	71,688	74,088	74,764	73,760	294,300				
As a percent of revenue		47.7%	47.5%	45.2%	44.0%	43.0%	44.9%	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	28,033	29,271	32,660	127,666	32,715	32,340	32,299	31,865	129,218	34,350	33,957	33,914	33,458	135,679				
As a percent of revenue		23.0%	28.6%	23.2%	23.0%	23.0%	24.5%	23.0%	22.0%	22.0%	22.0%	22.2%	23.0%	22.0%	22.0%	22.0%	22.2%				
EBITDA		140,000	24,860	26,581	26,726	28,400	106,567	34,137	36,750	37,437	37,658	145,982	37,337	40,131	40,850	40,302	158,621				
YoY growth		-			0.5%	6.3%		37.3%	38.3%	40.1%	32.6%	37.0%	9.4%	9.2%	9.1%	7.0%	8.7%				
Seq growth					21.0%	20.0%		20.2%	7.7%	1.9%	0.6%		-0.9%	7.5%	1.8%	-1.3%					
EBITDA margin		24.7%	18.9%	22.0%	21.0%	20.0%	20.4%	24.0%	25.0%	25.5%	26.0%	25.1%	25.0%	26.0%	26.5%	26.5%	26.0%				
Depreciation and amortization		95,704	19,591	16,712	17,346	18,096	71,746	18,848	19,628	20,407	21,276	80,158	22,146	23,046	23,944	24,831	93,967				
Charges		53,876	3,511	14,968	-	18,479	18,479	-	-	-	-	-	-	-	-	-	-				
Adjustments		49,201	-	241	-	241	241	-	-	-	-	-	-	-	-	-	-				
Operating income		(58,781)	1,758	(5,340)	9,380	10,304	16,101	15,289	17,122	17,030	16,383	65,825	15,191	17,085	16,906	15,471	64,653				
Operating margin					7.4%			10.7%	11.6%	11.6%			10.2%	11.1%	11.0%						
Interest expense		(73,913)	(18,412)	(17,608)	(15,189)	(15,189)	(66,397)	(15,189)	(15,189)	(15,189)	(15,189)	(60,755)	(15,189)	(15,189)	(15,189)	(15,189)	(60,755)				
(Loss)/gain on derivative liabilities		(909)	194	-	-	-	194	-	-	-	-	-	-	-	-	-	-				
(Loss)/gain on extinguishment of debt		(21,771)	-	(14,414)	-	-	-	-	-	-	-	-	-	-	-	-	-				
Loss on disposal		(312)	(3)	-	-	-	(3)	-	-	-	-	-	-	-	-	-	-				
Change in value of contingent liability		1,012	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-				
Other		1,858	(148)	(211)	-	-	(359)	-	-	-	-	-	-	-	-	-	-				
		(94,035)	(18,369)	(32,233)	(15,189)	(15,189)	(66,565)	(15,189)	(15,189)	(15,189)	(15,189)	(60,755)	(15,189)	(15,189)	(15,189)	(15,189)	(60,755)				
Pretax Income		(152,816)	(16,611)	(37,573)	(5,809)	(4,885)	(50,464)	101	1,934	1,842	1,194	5,070	2	1,896	1,717	282	3,899				
Taxes		(2,509)	(758)	(3,872)	-	-	(4,630)	-	-	-	-	-	-	-	-	-	-				
Net income - continuing ops		(155,325)	(15,853)	(33,701)	(5,809)	(4,885)	(45,834)	101	1,934	1,842	1,194	5,070	2	1,896	1,717	282	3,899				
Net income margin		-27.4%	-12.0%	-27.9%	-4.6%	-3.4%	-8.8%	0.1%	1.3%	1.3%	0.8%	0.9%	0.0%	1.2%	1.1%	0.2%	0.6%				
Minority interest			(166)	(787)			(166)	(200)	(200)	(200)	(200)	(800)	(200)	(200)	(200)	(200)	(800)				
Preferred stock dividends																					
Net income to common		(155,325)	(16,019)	(34,488)	(5,809)	(4,885)	(46,000)	(99)	1,734	1,642	994	4,270	(198)	1,696	1,517	82	3,099				
Diluted shares outstanding		44,907	76,583	58,248	78,464	78,489	72,946	78,514	78,539	78,564	78,589	78,552	78,614	78,639	78,664	78,689	78,652				
Seq change					20,216.0	25.0		25.0	25.0	25.0	25.0		25.0	25.0	25.0	25.0					
EPS diluted		(\$3.46)	(\$0.21)	(\$0.59)	(\$0.07)	(\$0.06)	(\$0.63)	\$0.00	\$0.02	\$0.02	\$0.02	\$0.06	\$0.00	\$0.02	\$0.02	\$0.00	\$0.05				

Source: Company reports and Dawson James estimates.

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Important Disclosures:



Source: Metastock

Price target and ratings changes over the past 3 years:

Initiation - June 4, 2018 - Buy - Price Target \$7.00
 Company Update - August 15, 2018 - Buy Price Target \$7.00

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Valuation:

We value FSNN shares at 8.5X our 2019 EBITDA estimate while comps trade between 12x to 24x, to account for merger integration risk.

Risk Factors:

- 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.
- We also see a risk in integrating the two recent acquisitions particularly in integrating billing systems. If billing systems don't work, bills don't go out and customers don't send payments so cash flow dries up.
- The company also carries relatively high leverage.
- Additionally, FSNN shares are relatively illiquid and can be volatile.
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Ratings Distribution	Company Coverage		Investment Banking	
	# of Companies	% of Total	# of Companies	% of Totals
Market Outperform (Buy)	23	88%	7	30%
Market Perform (Neutral)	3	12%	0	0%
Market Underperform (Sell)	0	0%	0	0%
Total	26	100%	7	27%

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