

UK Smaller Telecoms

A different take on telecoms

November 2006

Within the broad UK telecoms sector, the smaller independent communications services resellers are well placed to grow revenues and profits by driving consolidation within the huge and fragmented SME market. Entities such as Alternative Networks and AT Communications are structured to serve this market and are ready for the rollout of new converged technologies. Demand for traditional voice and data services from UK SMEs remains huge and this sector offers an interesting consolidation play.



Consolidation drives economies of scale and margins

We have featured companies with broad consolidation strategies to aggregate revenues and introduce efficiencies to improve margins. Some include diverse service and technology portfolios to meet existing, or anticipated customer needs.

Opportunities for niche players

SME demand for converged services is growing gradually so far but the significant technical challenges involved will drive supplier consolidation. Customers should progressively seek single providers who are able to meet their evolving needs.

Telecoms sector: Resellers can handle turbulence

Sector dynamics are characterised by chronic oversupply, bids and break-ups, 'free' broadband rollout, technical challenges and profit warnings. This underlines how difficult it is for infrastructure owners to build profitable businesses.

Valuation: Focus on the 'virtual' model

Smaller caps are valued at discounts, yet the large infrastructure owners are most exposed to commoditisation of wholesale services. A 'virtual' reseller of services can build a business based upon increasingly durable customer relationships and visible revenues and, we believe, the benefits are beginning to emerge.

Analysts

| | |
|---|---------------|
| Roger Leboff | 020 7190 1755 |
| rleboff@edisoninvestmentresearch.co.uk | |
| Marshall Whiting | 020 7190 1755 |
| mwhiting@edisoninvestmentresearch.co.uk | |

Companies

Alternative Networks*
AT Communications*
AdEPT Telecom
Calyx
Redstone

Table of contents

| | |
|---|-----------|
| Investment Summary & Valuation | 3 |
| 1. Smaller Telcos | 5 |
| 1.1 Unrealised value: small business telecoms providers | |
| 1.2 Small Telco Strategies | |
| 1.3 Sensitivities | |
| 1.4 Meeting the needs of the UK SME market | |
| 2. Industry Themes | 11 |
| 2.1 The advantages of virtual structure | |
| 2.2 Convergence or crunch of IT & telecoms? | |
| 2.3 Industry Consolidation | |
| 2.4 Next Generation networks | |
| 2.5 The impact of Voice Over Internet Protocol (VIOP) | |
| 3. Company focus | 20 |
| Valuation: undervalued consolidation plays | |
| Profiled Companies | |
| • Alternative Networks | |
| • AT Communications | |
| • AdEPT Telecom | |
| • Calyx | |
| • Redstone | |

Investment summary

Major telco: Ever decreasing circles

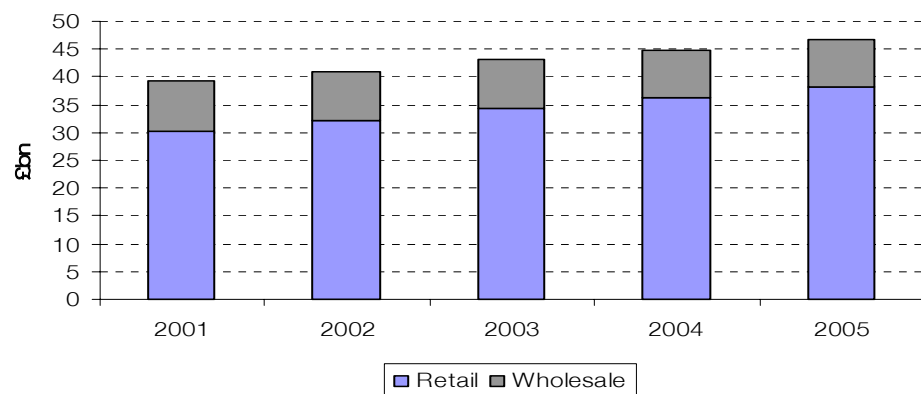
The core speech business, both fixed and mobile, has become increasingly commoditised and the sector characterised by profit warnings and expensive consolidation strategies. Consolidation is a key component of the strategy of both the large and small sector companies, but in the case of the former group, often seems to create more opaque business models.

Smaller telco: conversely clarity and themes are emerging

The underlying industry environment remains tight and highly competitive and new, emerging technologies such as internet telephony are unlikely to ease matters. However, the UK telecoms market still generates enormous revenues; over £45bn in 2005. Within the industry there are interesting subcategories of companies with potentially profitable opportunities to grow revenues organically and via acquisition, combine services such as voice, data and security and leverage margins by pursuing fairly traditional business models.

This is not a new strategy, and neither is, per se, a technology play although the provision of new services should create stickier customer relationships. The UK telecoms market is huge and fragmented and in common with many other industries, smaller players seek to acquire market share, drive out overheads, and by bringing a broader range of complementary products under a single brand improve the terms of access – for example to wholesale services such as call minutes, broadband and mobile telephone calls.

Exhibit 1: UK telecoms industry revenue (£bn)



Source: Ofcom

The UK telecom market is a good illustration of such an opportunity and we would focus upon the smaller end of the quoted providers. As the sector leaders have increased their focus on large customers (Cable & Wireless recently revealed that it seeks accounts worth £0.5m p.a. and over) a number of interesting themes play to the strengths of the smaller providers. These smaller providers have recently proactively built up their shares of the UK market via acquisition.

SME focus appears particularly valid

A strategy that focuses on the SME space is not particularly new, and this market has proven a challenge to break into in the past. However telephony (voice and data) is a mission critical component of all businesses, so a trusted provider to this market has considerable potential. This business model is driven by a number of interesting emerging themes.

- **Consolidation** to gain critical mass/economies of scale
- The importance of **single supplier strategies** to appeal to SME customers seeking expert guidance and cost savings.
- **Convergence of technologies** and services e.g. fixed and mobile telephony and broadband packages – driving customer buying decisions.
- The **competitive advantages** of the smaller alternative companies includes their ability to access more advanced IT platforms and CRM/billing systems, which are more flexible than the legacy systems of the national operators
- Aggressive and defensive strategies driven by the threats and opportunities posed by **disruptive technologies**, especially VoIP i.e. internet telephony
- The emergence of next generation networks, such as **BT's 21st Century Network** that can be leveraged to the advantage of a 'virtual' communications services provider
- **The migration of fixed telephony to mobile** is leading to growing opportunities. Provision of bundled fixed/mobile products is clearly seen in the offering of a single bill to customers. The new products can utilise the VoIP backbone, and enable offices to seamlessly use wireless access as well as fixed services. Flexible, smaller service providers are able to react to these demands quicker than the incumbent operators.

Key investment picks and valuation

We have extracted and assessed the strategies of five quoted companies seeking to build their share of the UK SME communications market.

These companies, Alternative Networks, AT Communications, Adept Telecom, Calyx Group and Redstone are each following an approach that seeks to grow organically and via acquisition.

We regard such moves as particularly well timed in the current cycle and capable of delivering attractive returns over the medium term.

1. Smaller telcos

We think the most interesting investment potential lies in the smaller telecom companies that specifically service the growing needs of the SME market. This section looks at the market opportunities and the strategies these companies are adopting. We conclude that this market segment, whilst already substantial, is likely to undergo structural changes in the short term that will result in an increasing demand for higher value services and trusted relationships with suppliers that the companies featured are well-placed to provide.

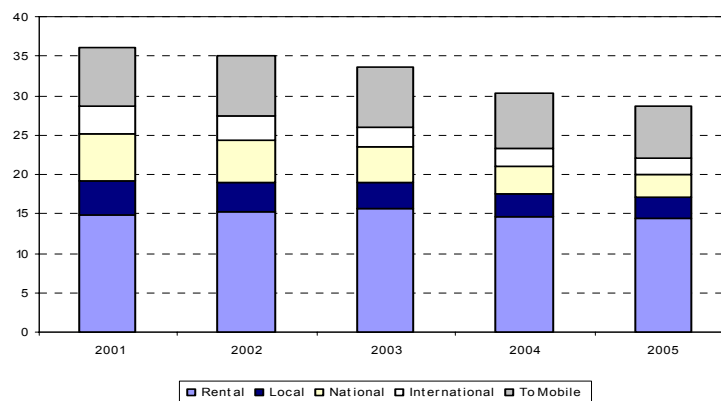
1.1 Unrealised value: Small business telecom providers

We have provided an overview of the strategies of a number of smaller providers of communications and networking services. These are not necessarily quoted in the telecoms sector, but all have portfolios of communications services aimed at the UK SMEs. This highly fragmented market is competitive, but below the scale likely to appeal to the major carriers.

What are the opportunities for small cap resellers?

Enormous competition over the last decade, predominantly driven by oversupply, has helped condition customers to expect steady reductions in the cost of standard telecoms services and left little scope to compete on price alone. Indeed, it is conceivable that prices are at a point where the inconvenience involved in switching is not likely to deliver the value to justify the move.

Exhibit 2: Average voice call volumes per business fixed line (£ per month)



Source: Ofcom

An additional characteristic that this second tier has in common is that they own very little of the infrastructure that was traditionally a core component of a telecoms provider. This has increasingly become a burden that requires enormous capital expenditure each time an important new technology is implemented, but has often failed to generate the appropriate returns. The smaller telcos put a greater emphasis on creating defined services that meet client requirements.

Additionally, our discussions suggest that the target SME customer is generally taking only early steps, thus far, towards implementing new technologies such as internet telephony and may be more interested in interim services that ease them along that path.

Nonetheless, we believe that emerging trends will drive the adoption of new services and ultimately push customers towards single suppliers of converged IT/telephony services able to understand their needs and provide the solutions required by corporate customers. We are most convinced by a strategy designed to position a particular supplier accordingly.

1.2 Small telco strategies

During the last few years, companies such as AT Communications, Alternative Networks, Redstone and Adept Telecom have adopted business models that put increasing focus on leveraging a small number of core strengths and consolidating customer bases through acquisition. In general these companies joined AIM in the last two years in order to fund their short term expansion plans.

Additionally, IT services company Calyx Group has sought to leverage its skills in the networking area and added telephony skills via acquisition.

Exhibit 3: Recent deal flow

| Acquirer | Target | Date | Sum paid (max) | Historic Revenues | Revenue Multiple | Historic PTP | PTP Multiple |
|----------------------|----------------------|----------|----------------|-------------------|------------------|--------------|--------------|
| Adept | Transglobal Telecoms | Feb 2006 | N/A | N/A | N/A | N/A | N/A |
| Adept | Admiral | Mar 2006 | 1.6 | 2.0 | 0.8 | 0.2 | 8.4 |
| Adept | Fizz Telecom Ltd | Jun 2006 | 3.2 | N/A | N/A | N/A | N/A |
| ATC | Sterry Group | Nov 2005 | 6.3 | 11.3 | 0.6 | N/A | N/A |
| ATC | T-Liaison Ltd | Dec 2005 | 2.7 | N/A | N/A | (0.3) | (7.9) |
| ATC | Britannia Telecom | May 2006 | 3.8 | 5.5 | 0.7 | 0.4 | 8.9 |
| ATC | Rocom Group Ltd | Aug 2006 | 17.6 | 43.1 | 0.4 | N/A | N/A |
| Alternative Networks | ICB | Oct 2005 | 11.0 | 14.8 | 0.7 | 0.5 | 22.0 |
| Calyx | Matrix Companies | May 2006 | 40.5 | 35.1 | 1.2 | N/A | N/A |
| Redstone | Tolerant Group | Jul 2006 | 3.8 | 5.5 | 0.7 | N/A | N/A |
| Redstone | Symphony | Jun 2006 | 21.9 | 19.4 | 1.1 | N/A | N/A |

Source: RNS

These companies have successfully capitalised upon:

- customer facing, value-added services;
- built up portfolios of these by accessing existing and emerging technologies provided by third party vendors of minutes and hardware;
- combined these with efficient 'back office' systems and a strong understanding of the practicalities of integrating acquisitions.

They have leveraged these core strengths to underpin their competitive advantages; namely to grow revenues and margins from their existing customer bases and supplement these via acquisitions. The consolidation of customer bases and technical skill-sets should also put them in a position to sell new services to existing clients.

The acquisitions have been engineered to deliver a number of potential benefits:

- Economies of scale e.g. lower wholesale costs via improved terms.
- Build customer bases more rapidly at a lower cost of acquisition than direct marketing.
- Improve margins by applying an efficient processing platform to an enlarged client base.
- Add skill sets and technologies expected to be needed as clients progressively increase demand for complex, converged telecoms services.

1.3 Sensitivities: Issues for resellers

The prospects for the 'virtual' telecoms companies or resellers look particularly interesting. They have the ability to deliver broad services to a substantial corporate market below the typical client target range for a major carrier. The market has grown over the last decade in line with the choice of service providers, technologies and networks.

This segment has however been targeted by smaller technology suppliers in the past with mixed results. The SME market is not necessarily an early adopter of new technologies and can be risk averse in nature, particularly regarding a decision to buy extended ranges of services from single suppliers. However as voice communications remains a vital component of any modern small business its relationship with a trusted supplier represents an increasingly important barrier to entry.

The UK SME Market

Estimates put the UK SME market at between two and four million companies, responsible for possibly up to 90 per cent of GDP. The precise number depends upon the definition, but an SME is generally between five and 1000 employees and it thus represents a complex customer set with its own particular needs; typically a function of its vertical sector, rather than size.

The scale would appear to be sufficient to appeal to a major carrier, against which a small service provider would struggle to compete. However the UK SME market for telecoms is highly fragmented and comprises a mass of relatively small deals. Aggregating thousands of small deals can certainly represent significant revenues and a well spread portfolio, but managing many small deals can be challenging and make any sales effort very inefficient. The larger providers are therefore structured to provide wholesale services to the smaller resellers that target SMEs.

An increasing awareness of what services are available should focus SME demand on:

- Customised, rather than 'off-the-shelf' telecoms services
- Service partners that understand the specific business and local issues i.e. not entirely focused on the needs of their largest customers, with packaged solutions for all others.
- Managed services, capable of adapting to the challenges of a rapidly changing business environment and evolving in-line with technological innovations such as VoIP.
- Converged services if they save money and increase profits

There are advantages for this target market if it could cut the number of suppliers, but it needs also to find reliable IT and telecoms partners that can both deliver the nuts and bolts and understand the impact of emerging technologies on their business strategies. A virtual provider should seek to leverage niche skills, industry and regional knowledge, relationships and brands to provide the kind of customer focused, bespoke services likely to be in increasing demand.

A substantial opportunity

SMEs collectively spend an enormous amount on the products and services that the virtual resellers are well-placed to provide and support. Most SMEs, particularly towards the smaller end lack dedicated IT and telecoms staff. They therefore seek expert advice, particularly when dealing with something as complex as telecom services. Nonetheless, any SME that is entrepreneurial by nature will also recognise the need to keep up-to-date with IT.

Thus far suppliers have gained competitive advantages by bundling together a range of services or by specialising in industry or geographic verticals. The vendor/reseller can make a meaningful margin by combining components and ideally create an offering that it can resell to other SMEs. This actually provides a competitive advantage versus the individual vendors that they represent; indeed can make them more valuable to those partners.

A large organisation such as a multinational may instinctively stick with a big-name IT supplier. This is a risk-averse strategy and the bigger providers spend enormous sums on advertising and marketing that a reseller may find it hard to compete with. However smaller customers also prefer a recognisable brand and a strong vendor trading history. On the whole, SME-focused resellers and dealers need to look at how to differentiate their services ahead of demand. Most are already well aware that it can be difficult to drive new ideas, products and technologies into their customer base before these have gained general market acceptance, resulting in a high average cost of sale.

Hosted services to the forefront

The big IT vendors invest huge amounts in new and enhanced technologies. These are not likely to appeal to SMEs, which generally seek safe, cost-effective offerings that meet their immediate problems and opportunities. That includes business models such as subscription-based software and leasing agreements, because these help them to manage their cash flow; or third-party hosted software via which they can outsource IT management and more effectively plan their IT budget.

Many smaller providers already offer hosted services that deliver carrier equivalent quality to small-time users including call diversion, voice mail, short codes, pick up from another extension and many other functions.

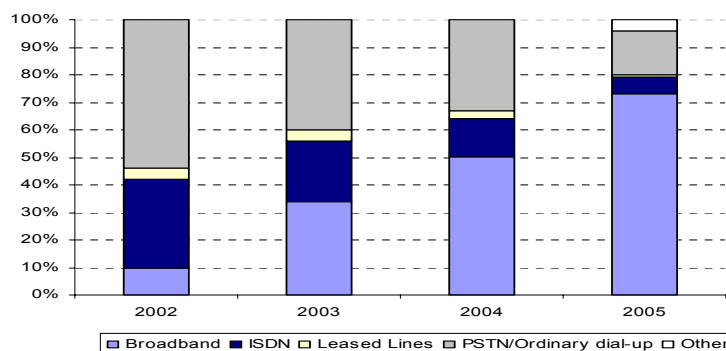
While the larger carriers would struggle to support the SME sector cost effectively, the resellers can offer fully managed services where customers are charged a per-user, per-month fee for all of their voice and data requirements. Consequently, a number of resellers (AT Communications relationship with BT is an example) have become the exclusive partner of choice for carriers looking to sell specific services into this huge market.

1.3 Focus on services not technologies

VoIP or Hype?

The roll out of broadband has the potential to replace reliance on traditional telephone systems, and this has implications for ongoing costs and upfront payments. Although VoIP functionality is built into most new digital phone systems, it is interesting that the take up of IP telephony by UK businesses has been modest thus far. Recent surveys reveal that small businesses are often confused by VoIP. Most have not deployed it and don't really understand why they should do so.

Exhibit 4: SME internet access by main connection method



Source: Ofcom

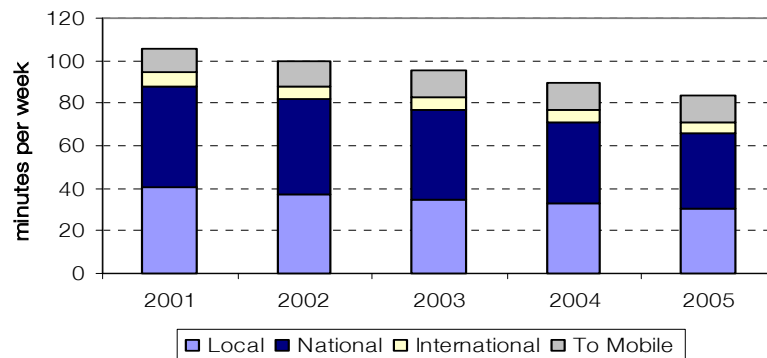
Amongst the reasons for the slow adoption of IP telephony include the lack of a Local Area Network (LAN) capable of supporting voice and data, and the fact that IP handsets are considerably more expensive than standard ones. This represents a good example of SME attitudes to technology for its own sake i.e. that IP telephony will be of interest in terms of cost savings and usability where there is bandwidth to spare and intermittent traffic. These conditions are unlikely to be present in a cost-sensitive small business.

Do UK SMEs really want converged services?

Surveys of UK's SME report that they are receptive to 'solutions', rather than technologies.

Wholesale services are best provided by carriers such as BT, so smaller providers must offer more and combining and repackaging services for their discrete market is one opportunity. Although propositions likely to appeal to the broader market are relatively limited at present, the convergence of services around a telecoms core should work in favour of the specialist, as the way in which their business customers use communications evolves.

Despite the fact that BT has a more coherent and convincing strategy than much of its peer group, it is still a large, formulaic organisation. None of the companies that we feature are in any position to provide a network to match BT's, especially post the launch of the 21st Century Network next year and it is developing a specific range of products and services to be marketed via BT Global Services. However it is geared up for million pound deals aimed at big multi-nationals, mobile operators etc., which suggests a target client list of 300 to 400 key UK clients.

Exhibit 5: Average voice call volumes per business fixed line (minutes per week)

Source: Ofcom

Small telcos must therefore be able to assemble the total solution and manage the network. This offer includes the bespoke provision of tailored networks or 'content driven' applications. The model that emerges from our review is the provision of smart solutions to customer problems. If this, 'added value' model doesn't sound particularly new, the complexity of what customers are likely to require may nonetheless progressively work in favour of the systems integrators.

In conclusion, we think that smaller providers can provide converged services to compete with BT only by offering tailored solutions on a company by company basis.

2. Industry themes

We see five key themes affecting investment decisions in this space:

- Virtual structure – the advantages of smaller players with no costly infrastructure
- Convergence – the potential integration of Telecom and IT service markets
- Consolidation – acquisitive strategies seems to be gathering pace
- Next Generation networks – the importance of BT's competitive position
- Voice over Internet protocol (VOP) and the scale and timing of its impact

2.1 The advantages of a 'virtual' structure

The companies featured can generally offer their customers a bundled, single supplier service that incorporates the latest technologies. This is based upon a supplier agnostic, 'best of breed' offer that accesses broad services and conveys certain advantages over infrastructure owners, which generally need considerable scale to generate an acceptable return from their capital investment. Indeed, the cost benefits previously perceived as an advantage for the typical infrastructure owner would appear to have been eroded materially.

In contrast, there is scope for a 'virtual' company to buy-in access to state-of-the-art infrastructure and assemble the new services expected to be in increasing demand from the UK SME market.

The strategy is to establish increasing strong customer relationships based on longer term contracts, supplemented by acquisitions that drive economies of scale.

No infrastructure, no baggage

Where the lack of an owned telecoms infrastructure may once have been considered to be a disadvantage, it now adds flexibility to the strategy for a smaller telecoms company. We see smaller operators able to differentiate their offers if they cleverly repackage available technologies and become a single source provider of all telecoms services required by their customers.

Exhibit 6: Communications Strategies

| | |
|-------------------------------------|---|
| Infrastructure owners | This is an older strategy, but one which we believe has uncertain longevity as legacy infrastructure struggles to compete post the roll out of next generation networks. In addition, marketing initiatives such as the so called 'free' broadband offers have had a material negative impact on the revenue streams of a number of these entities. |
| Pure i.e. virtual service providers | These have better opportunities to generate margins by providing added value services to customers, but rely on others for infrastructure. Their margins are vulnerable unless they find ways to innovate, but customer demands for new services will potentially play to their skills. |
| Network and systems integrators | The distinction between this and the second group may be vanishing, but it is an interesting subset. The traditional IT services supplier is a credible provider of many network integration challenges posed by convergence of fixed, mobile, broadband and other services. |

Some of the smaller providers have consistently followed this strategy and the increasing pervasiveness of the internet is expected to gradually drive demand for new, converged services, as well as investment in the means of access e.g. via mobile phones, upon which they seek to capitalise. This fits with a determination to build relationships with an SME customer base, minimise churn and identify ways to embed their technical skills and add value to their customers' businesses by innovation.

The prospects and competitive advantages for the smaller telcos hinge on their ability to 'package' services for specific, but potentially substantial niche industry markets; even provide them generically such that they appeal to a particular geography or region. They are conceivably in a position to benefit from the introduction of BT's new, next generation network in mid 2007. New generation fixed and mobile infrastructure, combined with the emergence of a number of potentially disruptive technologies has already created a surplus of capacity that has undermined revenue models for the infrastructure owners. Yet this could be good news for the niche players.

Indeed, the emergence of next generation networks will challenge competitor infrastructure owners (e.g. Cable and Wireless) and without further substantial investment in infrastructure upgrades, they would be increasingly exposed.

Smaller providers: Bundle services and capitalise on niches

Although enthusiastic about the potential cost saving, there appears to be some inertia over the pace of the switch to new technologies such as VoIP based telephony among smaller businesses. They understandably await proof of the quality and reliability of alternative services, despite the apparent appeal of 'free' telephony. Business customers have concerns regarding the dangers of early adoption of leading edge technology.

One of the keys for niche service providers will be to sell into those parts of the market in which BT is less interested. If new technologies, such as internet telephony are integrated in a commercial way to the customer's benefit, the smaller, 'virtual' companies should be able to encourage their clients to keep upgrading. They should then be able to leverage their competitive advantages in areas such as:

- VoIP
- Remote working
- Speech recognition
- Mobile applications
- Integration – PC/PDA/mobile

Wide growth potential

By capitalising upon their existing skills in network and systems integration, the featured companies should be in a strong position to assist with specific projects. An example of this may be to work with local authorities in the build out of local broadband (possibly wireless) infrastructures. With a number of tenders in the market currently for regional broadband networks, a 'virtual' operator may identify smart ways to repackage BT's 21st Century Network product.

Examples of the kinds of services businesses may seek are hosted or remote access to databases (SAP/Oracle) with secure authentication, such as bespoke secure solutions for field teams. This may help generate a compelling proposition, although this is territory also targeted by large IT consultancies, which build solutions and bring in the necessary IT providers. The challenge is to become part of the solution value chain.

2.2 Convergence or crunch: When telecoms hits IT

Sector outlook

As IT services companies have folded in traditional telecoms services, margins in the latter area have been driven down. The roll out of IP enabled telecoms infrastructure could potentially further undermine any distinction in favour of IT services, but it is not certain that IT services and telecoms providers are interchangeable. There are cultural distinctions that, from a customer perspective, may remain important for a while.

The telecoms industry has however been transformed over the last few years. Once it was an expert, relatively high-margin provider of hardware or software, often sourced and installed by a customer's in-house team or jointly with an external supplier. The convergence of technology has added complexity that has driven buyers to service partners that should support margins, but the distinction between telecoms and IT services (e.g. Calyx), traditionally a lower margin industry, has been blurred as the latter group has incorporated network services (LAN services) and hosting.

IT vs. Telecoms: Does it matter who provides the service?

The smaller players have shown considerable flexibility in regard to their relationship with their customers. Business models have been redesigned around customer demands in order to add durability. For example, the rollout of VoIP/internet telephony, often based upon the use of open-source software, makes the provision of value-added services increasingly important.

What were previously alternative telecoms companies have already largely redefined themselves as 'communications providers'. This recasts them as business service providers, trusted intermediaries able to identify the most appropriate vendors and build and maintain the system that best meets their immediate and future requirements. This status ironically puts them in a better position to defend revenues than the infrastructure owners, many of whom offer increasingly commoditised products. It is also an important consideration for investors.

It is increasingly rare that SMEs employ skilled in-house telecoms teams. Many have become active outsourcers, and those providers able to offer 'turnkey' solutions appear best placed. New technologies appear to enable a variety of pure IT concerns to compete in the space, but also tend to level the playing field in the direction of the smaller players with the requisite skills.

We believe that the key for investors will be to focus upon companies able to provide increasingly clever solutions to a customer base below BT's target threshold, in ways that clients value. In this sense, we believe that the companies featured in this report fit the bill.

2.3 Industry consolidation

Industry consolidation is gathering pace. This includes relatively smaller combinations such as ATC/Rocom, Redstone/Symphony, the acquisition of smaller infrastructure owners such as Fibernet by Global Crossing and substantial mergers such as NTL/Telewest/Virgin Mobile. These moves complete gaps in technology portfolios and provide access to potentially significant economies of scale via an enlarged customer base, into which they will seek to cross-sell services, create more stable customer relationships and drive down costs to grow margins.

BT represents a challenge to the smaller telcos as a highly dynamic and aggressive provider of services and systems integration. However it is really geared up to service the most substantial accounts. Consolidation strategies are designed to take advantage of aspects of the market expected to experience fastest growth over the next few years, for example such as hosted IP.

The industry expects managed VoIP services to be offered by both specialist service providers and large carriers. However these will in all probability be rolled out as affordable voice services, rather than new internet-based telecommunications technologies. The customer is likely to be receptive to an offer to provide relatively standard services of equivalent quality, at a significant cost saving. Smaller providers have increased their access to IP enabled networks for this reason.

Fixed/Mobile

The convergence of fixed and mobile services is likely to be increasingly important to businesses. The mobile companies have up until quite recently managed to substantially maintain their prices, at least relative to fixed line services, but there has been considerable price erosion.

They are also now also seeking to capitalise upon some of the opportunities to become less of a commodity service and the launch of broadband services by Orange to its mobile customer base is an example of an attempt to drive its service proposition.

2.4 Next generation networks

Switch to packet-based technology

The UK is arguably a leader in the upgrade of the core telecoms infrastructure. BT's 21st Century Network, elements of which come on stream within the next 12 months is an example of a fundamental switch from current (circuit-switched) to new (packet-based) technologies likely to be rolled out across the global telecoms market over the next five years.

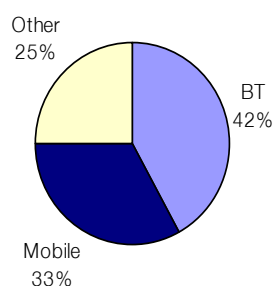
This will facilitate the delivery of new converged, fixed and mobile, voice and data, data and content and IT and telecommunications services. It will also, ironically, put enormous financial pressure on the large carriers to upgrade their infrastructure, as reliable business and pricing models unravel.

Also new services, such as VoIP (voice over internet), are also in the domain of the IT service providers. Even where the carriers do retain control, it is difficult to see how they can leverage acceptable returns from a technology that may take longer to roll out amongst their target customers (due to inertia and concerns over reliability) than the market anticipates. As a result, large telcos are identifying business models that incorporate a range of new bolt-on services involving content, interactivity and broadcasting, e.g. TV over mobile handsets that will see them stray into areas that are already crowded and intensively competitive.

BT: A forward thinking strategy

Convergence expands the capacity of networks to carry not only telephony but also broadband and video. BT is a rare example of an incumbent with a strong strategy designed to deal with the threats represented by convergence, including the consolidation of individual players in these markets i.e. NTL/Telewest/Virgin Mobile and BSkyB/Easynet.

Exhibit 7: Share of 2005 UK telecoms industry revenue (retail and wholesale)



Source: Ofcom

With traditional residential voice traffic now representing only a quarter of its revenues, BT has kicked off a £10bn investment to replace its entire network with a new "21st Century" network based upon internet technology. In a peer group characterised by profit warnings and excessive debt, BT's vision is to have in place, by 2009, the world's most advanced national network. The key for BT is that this new network has the capability of carrying content such as video, and it has already signed a number of content deals with the BBC, Paramount and Warner Music.

2.5 The impact of Voice over Internet Protocol (VoIP)

'Disruptive' technology VoIP provides opportunities

The most important of the new technologies, from the telecoms industry standpoint, is unquestionably internet telephony, known as VoIP (Voice over Internet Protocol). The emergence of a technology that routes calls, for free, over the internet could undermine existing industry pricing models. Indeed, there is a general presumption that voice telephony will in due course become a free service, bundled with other data-related products.

It is best represented by the popularity of Skype (owned by eBay since Q305) to enable the use of the internet to make free telephone calls. Although Skype is broadly regarded as most suitable for a retail consumer base, VoIP is regarded as a threat or 'disruptive' technology to the incumbent telecoms operators.

However the argument that VoIP technology will cost the carriers billions in lost revenues (and cause the type of damage inflicted on the music industry by file sharing) has subsided. It is now becoming recognised that VoIP is not as disruptive as first imagined.

What exactly is VoIP?

The telecoms world is governed by consistent standards to enable all to manufacture equipment and operate networks with one another. These standards are Protocols and Voice over Internet Protocol or VoIP is the standard adopted to send voice over the Internet, which is actually a data network. Any public or private telecoms network can use the Internet Protocol to send data. Increasingly private networks are adopting IP as their standard to transmit data.

VoIP uses packet switching rather than circuit switching. The difference is fundamental to appreciating the features of VoIP and there is more opportunity to turn the advantages and efficiencies of packet switching to profitable growth than was first considered. In particular the bundling together of data and voice to run business communications more productively is being leveraged by the operators. In fact BT is leading the way and persuading business customers to use ways to combine data and voice.

Packet switching: Voice integrated with data

The telephone network was created along the logical premise that calls were made by a physical connection between the calling phone and the receiving phone, using a phone line. Primitive systems needed a dedicated line for each connection, a circuit based upon electro-mechanical technology that persisted for over seventy years to 1995. This was gradually replaced by electronic analogue exchanges, then by computer driven digital exchanges, but the principles remained the same. Calls were made over switched telephone lines with a tangible connection. However, the efficiency of circuit switching is limited, and extra capacity means either squeezing more and more data within the limits of the cable or radio transmission systems, or building new systems. Packet switching changed this.

The development of digital switches resulted in a different form of transmission used for data sent to and from computers. The greater proportion of traffic on a telecom network is now data, not

voice. Packet switching networks, which have been around for decades, divide the computer data into small packets which have an identifying address attached to them. These are sent over the network by different routes and are then reassembled at the destination in the original sequence.

The advantage of packet switching over circuit switching is that it makes much better use of the network's capacity, by sending data over the available, least busy parts of the network, and so is unconstrained by busy times of the day or system congestion.

Up to recently packet switching was considered too low quality to use for voice traffic because the process of pulling apart and assembling the signals resulted in too low a quality, mainly because of variations in the delay of the packets. Most of these problems have now been overcome, giving a boost to the transmission of voice calls via the data network. Carriers are now integrating voice and data traffic using packet switching.

Billing: Minutes replaced by packets

A common misconception surrounding VoIP is that it is free to users across the board. The introduction of residential peer to peer (P2P) telephone and messaging services, principally by Skype in 2003 was therefore interpreted as the death knell of the incumbent operators.

It certainly alarmed the planners, who responded by designing packet-based Next Generation Networks (NGNs) making use of IP networks. True P2P systems will grow, but they lack the flexibility and resources of IP networks required by businesses, government departments and other major telecom users. Also, residential services will be augmented by very high bandwidth applications, particularly video services, and voice can easily be added very cheaply to these by the operators. What this represents is slow, but free, messaging and PC to PC communications – not a real threat to the mainstream.

Subscribers on BT's current PSTN (Public Switched Telephone Network) are billed by the minute, or its equivalent data rate. The switches and transmission systems (cable and satellite), both fixed and mobile, use the time spent on the network to work out the tariff for users and the tariffs were set by the operators. Competing networks use minutes to compare tariffs, and customers can compare prices on this basis.

The advent of packet switching has caused a change in billing systems. The tariffs are still set by the operators, but not in terms of minutes (which are irrelevant for VoIP) but in terms of packets. The billing is just as visible, only now the unit has changed to reflect the characteristics of the network. The comparison of prices can still be carried out by customers, using packet prices instead of minutes.

2.6 VoIP opportunities opening up

The change in networking from circuits to packets is throwing up opportunities for enablers of telecom solutions, especially selling to small and medium sized enterprises. The confusion surrounding VoIP is ironically assisting the development of these enablers.

- 'Virtual' carriers have a significant role to play in the new market. They offer access to major carriers in the UK and can route traffic according to business priorities. They can choose from a range of voice solutions, which deliver cost savings and call quality, ensuring that a SME's current network can grow more easily as the business evolves.
- Specialist telecom software suppliers are developing modules to run office switches, which use the internet's data network rather than the traditional circuits. The flexibility that these software packages offer will replace the existing hardware associated with office systems.

VoIP's advantages

The advantages to businesses using an IP network are convincing, and can be summarised as follows:

- The most important consideration is **cost**. Companies that send computerised information on a data network find that they can also use the same network for all their communication requirements. They have internal communication needs to run the business, and external requirements to contact customers and suppliers. By consolidating their data and voice networks onto one platform, companies can save money.
- The **technical requirements** are simplified. By having one all embracing communications platform which carries both data and voice, the management of a company's information technology is simplified. Maintenance, network management, and improvements can be organised more resourcefully than using both circuit-switched and packet-switched networks.
- The increasing use of e-mail, combined with the expansion of mobile telephony, has created the need for the **consolidation** of communication needs of personnel on the move. Information is being sent to and from staff using the internet on mobile phones.
- **Capacity requirements** on the network are increasing. The integration of communication applications is creating a demand for teleconferencing, dissemination of spreadsheets, call-back and recording requirements, which the extra bandwidth offered by IP can resolve. There is little doubt that these demands on capacity will increase as businesses discover extra ways of using their communication network. One example is text messaging which is showing signs of renewed life for business applications.
- **Customer management systems** are increasingly being based on the Internet. Obvious examples are airlines and tourism, but it is hard to find a business where the internet does not play a pivotal role in marketing, production and management strategy. Maximising customer contact, for example through outsourced call centres, are ideally suited to IP.

2.7 The future of the IP network: Broadly predictable

The telecoms industry is moving so fast that there is little certainty over the detailed shape of the future. But some broad trends are predictable:

Next Generation Networks

The public networks operated by the incumbent operators are all planning Next Generation Networks (NGN). In the UK, BT has already unveiled its 21st Century Network (21CN), which will integrate the existing separate public switched network (PSTN) and data networks into one unified converged packet switched network using IP. At the centre of the future network will be a handful of core routers and switches, replacing all the thousands of local exchanges, digital Subscriber Line Access Multiplexers (DSLAM) and Remote Concentrator Units (RCU).

There will be more software and intelligence in the terminals

The PSTN carries most of the technology within itself, but IP is better suited to moving all the 'bells and whistles' into the subscriber end. Already there is a rapid trend towards software enhanced private exchanges, which use off the shelf hardware and install software modules to switch the calls (both data and voice). These business exchanges can be remotely maintained, connected together for a variety of reasons (call monitoring, billing and so on), but all this is done by software.

Mobility

The internet is a PC based network, but this is because the World Wide Web is designed to distribute pages of text information. The resources of the mobile phone are clearly based on voice, which will remain the primary application. Nevertheless the very fact that mobile phones are carried everywhere and can be plugged into other devices such as PCs means that the Internet network will be increasingly used to carry data as well as voice using VoIP to mobile phones. Business applications and new functions, such as real estate and auctions, will be supplemented by entertainment and information services, thus bringing down the overall costs.

3. Company focus

We highlight five companies (separately featured); Adept Telecom, Alternative Networks, AT communications, Calyx and Redstone. We discuss the factors affecting their valuation and conclude that their differentiated strategies will provide real opportunities for consolidation driven growth in the medium term.

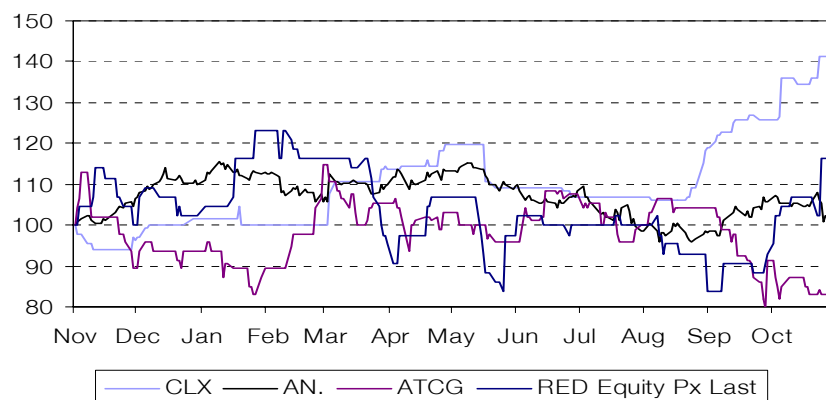
Valuation: Undervalued consolidation plays

We believe that the companies are moderately rated, generally at discounts to more substantial, larger cap providers of comparable services. The two groups involve quite different models, albeit subject to some of similar market dynamics. An assessment of the UK telecoms market that perceives the smaller providers to be in a weaker competitive position ignores their potential to leverage returns from consolidation of a fragmented sector. We do not think the shares reflect this opportunity, and there is distinct upside from current levels as the benefits of a durable and scalable business model are proven.

An undervalued sub-sector

The companies featured have pursued a determined strategy designed to scale up and build a differentiated service offering to a substantial corporate market. Although they have added economies of scale and grown their customer bases, these moves have, in broad terms, yet to be reflected in their share prices or ratings.

Exhibit 8: Relative share price performance



Source: Bloomberg

There are a number of reasons why we think these companies are undervalued:

- Firstly, the trends affecting the wider 'telecoms' sector, including profit warnings from large carriers and providers of niche services from broadband to mobile content have hit the small providers as well.
- An innate mistrust by investors in an industry that has traditionally found the lure of heavy capital expenditure irresistible, but often failed to generate the returns that justify the risks.

The companies we feature own very little infrastructure, but operate a 'virtual' vendor agnostic model that enables them to pull together independent, best-of-breed structure.

- All are at an early stage of transforming their businesses through quite substantial acquisitions. Some of these entities only recently floated, while others, like Redstone have reinvented themselves more than once and proven costly for investors.
- In most cases those acquisitions, although generally earnings enhancing, represent relatively substantial 'bets', necessarily funded through share issues or debt as they were well beyond the scope of existing resources.
- Intuitively, smaller telcos appear vulnerable relative to telecoms giants' ability to undercut them, if they generate above average margins. This is not necessarily valid, as these entities have assembled added value services, often lying outside the scope and target client base of the typical carrier and consequently are able to build stickier relationships with SME and smaller corporate customers. This has already been reflected in improved contract terms and revenue visibility, and lower churn rates. Examples of this are provided by companies such as Alternative Networks, AT Communications, Calyx and Redstone.

We expect news flow over the next 12 months to illustrate the potential to grow scale and profit margins, and build revenues based upon relationships and services provided to a broader client base.

Peer group comparisons

The table below shows that the companies we feature fall to what we regard as relatively modest ratings, that don't reflect the kind of potential to leverage returns from a huge, fragmented market.

Exhibit 9: Peer group

| | | | 2005 | | | | 2006e | | | | 2007e | | | |
|------------------|-------------|----------------|-------|-------|-----|-------|-------|-------|-----|--------|-------|------|-----|------|
| | Share price | Market Cap. £m | PTP | EPS | DPS | P/E | PTP | EPS | DPS | P/E | PTP | EPS | DPS | P/E |
| AdEPT Telecom | 127 | 27 | N/A | N/A | N/A | N/A | 1.4 | 6.4 | 0.0 | 19.8 | 3.9 | 14.1 | 0.0 | 9.0 |
| Alternative Nwks | 118 | 52 | 4.3 | 7.0 | 1.5 | 16.8 | 6.3 | 9.9 | 2.2 | 11.9 | 7.3 | 11.5 | 3.0 | 10.2 |
| ATC | 39 | 24 | (0.0) | 4.1 | 0.0 | 9.5 | 5.3 | 6.8 | 1.0 | 5.7 | 7.6 | 8.6 | 1.1 | 4.5 |
| Calyx | 92 | 62 | 2.0 | 4.7 | 0.0 | 20.9 | 9.0 | 14.3 | 0.0 | 6.4 | 15.3 | 19.8 | 0.0 | 4.6 |
| Redstone | 6.25 | 71 | (2.5) | (0.9) | 0.0 | (6.9) | (1.7) | (0.2) | 0.0 | (31.2) | 5.1 | 0.5 | 0.0 | 12.5 |

Source: Hemscott/Consensus Forecasts (prices at 31 Oct)

Newsflow: a component of a higher rating

A range of factors will justify and underpin progressively higher ratings. These would include evidence that the companies are capitalising upon economies of scale including:

- Lower client churn rates in individual services
- Longer term contracts providing improved revenue visibility
- Higher market share and margins in target niches

- Improved access to wholesale services/exclusive arrangements
- Proof that cross selling of a broader service portfolio is happening

The quoted sub-sector has been distilled into a small group, each with a relatively modest share of a substantial UK smaller corporate market. It is certainly conceivable that they will themselves become interesting targets as companies from inside or outside of the industry comprehend the potential for profitable growth through accelerated consolidation.

Appendix: Company profiles

AdEPT Telecom

127p

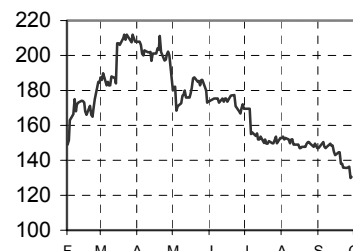
| Y/E Apr | Revenue (£m) | EBITDA (£m) | PBT (£m) | EPS (p) | P/E (x) | P/CF (x) |
|---------|-----------------|----------------|-------------|------------|------------|-------------|
| 2006A | 11.5 | 1.9 | 1.4 | 6.4 | 19.8 | N/A |
| 2007E | 21.6 | 4.0 | 3.9 | 14.1 | 9.0 | N/A |
| 2008E | 25.0 | 4.7 | 4.6 | 16.2 | 7.8 | N/A |
| 2009E | 28.3 | 5.3 | 5.2 | 18.2 | 7.0 | N/A |

Source: Company accounts / consensus forecasts

Business description

AdEPT provides voice telephone services to tens of thousands of customers, including both domestic consumers and businesses.

Share price graph



Company details:

| | |
|-----------------|--------|
| Market cap | £28m |
| Ticker | ADT |
| Listing | AIM |
| Shares in issue | 21.07m |

Managing Director:

Ian Fishwick

Financial Director:

Timothy Holland

Major shareholders:

| | |
|-----------------|-------|
| Croyde Ltd | 13.6% |
| Codium Ltd | 9.3% |
| Mach II Ltd | 8.2% |
| Roger Wilson | 6.8% |
| HSBC Nominees | 6.6% |
| Others above 3% | 40.0% |

Company address:

77 Mount Ephraim,
Tunbridge Wells,
Kent
TN4 8BS

www.adept-telecom.co.uk

- Company strengths:** AdEPT's strengths lie in its ability to identify small UK telecom resellers which have insufficient scale or management to compete or build their businesses. It then quickly integrates these businesses (i.e. within six weeks) to leverage its highly efficient suite of back office systems, the core of which is a billing system that automates many of the most repetitive processes. It has actively acquired volume and built its SME business in traditional areas such as voice and wholesale call minutes. Over the last three years it has made thirteen acquisitions, on average one per quarter, with the focus on adding business to business capacity and improving the margins of the acquired business by removing overheads and utilising its highly scalable, largely fixed cost operation.
- Products:** Business customers historically churn less frequently than residential customers. Around 70% of AdEPT's business customers now take line rental and this has the impact of both increasing revenue and reducing churn as customers are tied in on long-term contracts. Growing line rental revenues has been a key objective and line rental revenues increased dramatically to £1.3m in the last year compared with £43,000 in the prior year.
- Financials:** The group has impressive revenues per employee of circa £700,000 and seeks further acquisitions in an area of less interest to many other consolidators. It has also benefited from the continual decline in wholesale prices (buying from C&W, Verizon/MCI and Gamma). It believes that this strategy has a few more years to run, although recent additions to management suggest that it is also looking to build its sales channels, broaden services and also bolt on new technologies as customer demand for these emerges.
- Forecasts:** There remains scope for AdEPT to continue making earnings enhancing acquisitions. Current year line rental and call revenues are significantly ahead of last year. The group should see the first benefits of the full year impact of the four acquisitions made in 2005/6 along with revenues from Fizz Telecom's customer base acquired in May 2006. EBITDA has grown for 11 consecutive quarters and both revenue and profits have the potential to continue to grow substantially.

Financials

| £'000s | 2006 | 2007e | 2008e | 2009e |
|--|------|-------|-------|-------|
| Year-ending 31st March | | | | |
| PROFIT & LOSS | | | | |
| Revenue | 11.5 | 21.6 | 25.0 | 28.3 |
| EBITDA | 1.9 | 4.0 | 4.7 | 5.3 |
| Operating Profit (before GW and except.) | N/A | N/A | N/A | N/A |
| Profit Before Tax (norm)* | 1.4 | 3.9 | 4.6 | 5.2 |
| Profit After Tax (norm)* | 0.2 | 1.3 | 1.8 | 2.3 |
| BALANCE SHEET | | | | |
| Shareholders equity | 10.3 | 10.0 | 10.1 | 10.8 |
| Net Debt | 1.4 | 0.1 | 0.9 | 2.1 |
| Gearing% | N/A | N/A | N/A | N/A |
| Interest cover x | N/A | N/A | N/A | N/A |

Source: Company accounts / Consensus forecasts

*PBT & EPS are normalised (pre-goodwill and exceptionals)

Revenue and profit mix

Exhibit 1: Revenue and gross profits for the year ending 31 March 2006

Not available

Source: Company accounts; Edison Investment Research

Company history

| Date | Event |
|--------|---|
| Feb 06 | AIM IPO |
| Feb 06 | Acquisition of Transglobal Telecommunications (£3m) |
| Mar 06 | Acquisition of Admiral Managed Networks (£1.6m) |
| Jun 06 | Acquisition of Fizz Telecom (£3.2m) |

Alternative Networks

118p

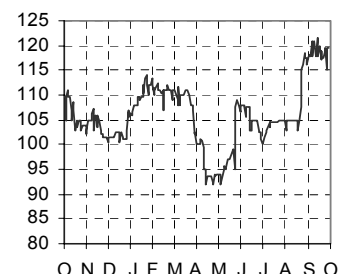
| Y/E Sep | Revenue (£m) | EBITDA (£m) | PBT (£m) | EPS (p) | P/E (x) | P/CF (x) |
|---------|-----------------|----------------|-------------|------------|------------|-------------|
| 2004A | 41.0 | 3.5 | 3.4 | 4.7 | 25.1 | 63.7 |
| 2005A | 46.4 | 4.6 | 4.3 | 7.0 | 19.3 | 14.7 |
| 2006E | 65.6 | 6.7 | 6.3 | 9.9 | 12.0 | 10.7 |
| 2007E | 72.7 | 7.8 | 7.3 | 11.5 | 10.3 | 11.4 |

Source: Company accounts / Edison Investment Research

Business description

Alternative Networks (AN) is a leading UK business-to-business communications reseller. AN offers a full range of fixed line and mobile voice and data products, including Blackberry and full mobility solutions. Within the Advanced Solutions portfolio it supplies, installs and maintains business telephone systems as well as call centre, video conferencing and integrated data applications. It supplies and maintains business telephone systems using partnerships with tier-one operators.

Share price graph



Alternative Networks is a research client of Edison Investment Research

Company details:

| | |
|-----------------|-------|
| Market cap | £54m |
| Ticker | AN. |
| Listing | AIM |
| Shares in issue | 45.2m |

Chief Executive Officer:

James Murray

Financial Director:

Edward Spurrier

Major shareholders:

| | |
|--------------------|-------|
| James David Murray | 35.2% |
| Christopher Wilson | 14.6% |
| Merrill Lynch I.M | 7.8% |
| Ed Spurrier | 6.5% |
| Canada Life | 4.6% |
| Others over 3% | 20.7% |

Company address:

Chatfield Court,
56 Chatfield Road,
London
SW11 3UL

www.alternativenetworks.com

- Company strengths:** The breadth of solutions, including mobile, are in advance of its competition. AN's strengths are its low risk strategy which underpins its impressive organic track record, and its solid prospects as the UK's leading independent business communication service provider. The integrated nature of the business has meant that customer retention rates are high.
- Products.** AN maintains flexible partnerships with a variety of tier-one telecom suppliers with AN billing the client company with a single invoice. AN addresses small and medium sized businesses (SMEs) who typically spend £10,000 to £100,000 on telecoms a year and which are often too small to warrant the national operators' attention. AN does not need to develop new products as it can introduce leading edge services as these are provided by the national operators. A key driver going forward is corporate mobile products.
- Financials:** Revenue is predictable and is derived from three divisions. Network Services is the group's outbound fixed line operations. AN resells voice traffic over national wholesale providers' networks, where bulk discounts are negotiated. Mobile Services is increasing in importance, driven by the need of businesses to use the combined power of both the internet and mobile phones to increase efficiency of communication. Advanced Solutions comprise incoming telephony, data connections and IP sales and maintenance. Contribution from this division is stable. Overall group sales and earnings have grown consistently over the past decade, and have allowed the company to declare a healthy dividend for many years, with a policy progressing to 30% cover. Underlying cash flow is positive.
- Forecasts:** Estimates for future earnings and dividend growth depend largely on the solid prospects for turnover growth, particularly for mobile telephony. Turnover is growing at about 12% a year. Overall group EBITDA margins are hovering about the 10% level and should be at least maintained. The dividend cover is likely to be maintained at over three times. The pre-close update confirmed that trading in the second half since March 2006 has continued in line with market expectations and that its success in cross selling to existing customers has resulted in a steady increase in the percentage of customers taking more than one product and a net increase in the number spending over £1000 p.m.

Financials

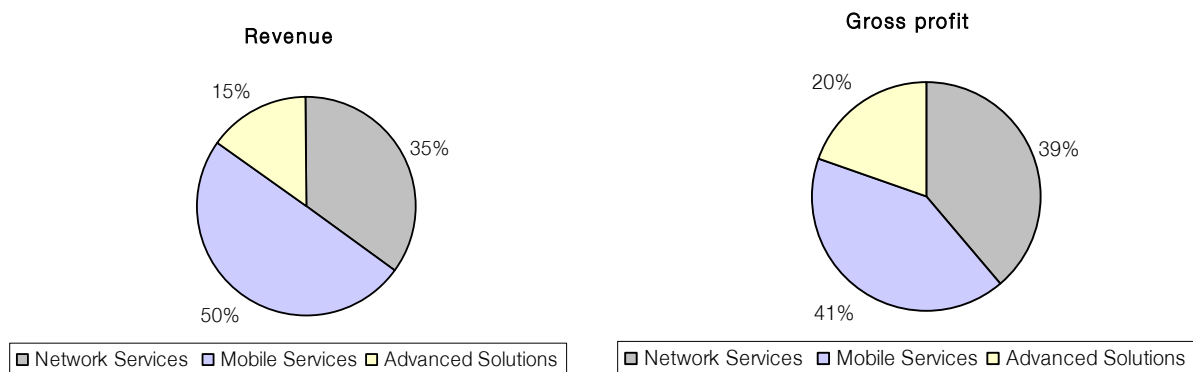
| £'000s | 2005 | 2006e | 2007e | 2008e |
|--|------|-------|-------|-------|
| Year-ending 31st September | | | | |
| PROFIT & LOSS | | | | |
| Revenue | 46.4 | 65.6 | 72.7 | 80.6 |
| EBITDA | 4.6 | 6.7 | 7.8 | 8.6 |
| Operating Profit (before GW and except.) | 4.2 | 6.2 | 7.2 | 8.0 |
| Profit Before Tax (norm)* | 4.3 | 6.3 | 7.3 | 8.1 |
| Profit After Tax (norm)* | 3.1 | 4.4 | 5.1 | 5.7 |
| BALANCE SHEET | | | | |
| Net Assets | 7.2 | 12.2 | 13.6 | 15.1 |
| Net Cash | 5.1 | 2.9 | 3.9 | 5.0 |
| Gearing% | N/A | N/A | N/A | N/A |
| Interest cover x | N/A | N/A | N/A | N/A |

Source: Company accounts / Edison Investment Research

*PBT & EPS are normalised (pre-goodwill and exceptionals)

Revenue & profit mix

Exhibit 1: Revenue and gross profit for the six months ending 31 March 2006



Source: Company accounts; Edison Investment Research

Company history

| Date | Event |
|------------|---|
| 1994 | Company founded with £9,000 by James Murray and Chris Wilson. |
| 2002 | Became a mobile service provider for O2 & Vodafone |
| 1994-2005 | Organic growth |
| 2005 (Feb) | AIM IPO rising £12.7m |
| 2005 (Oct) | ICB acquired for total of £6.2m. |

AT Communications

39p

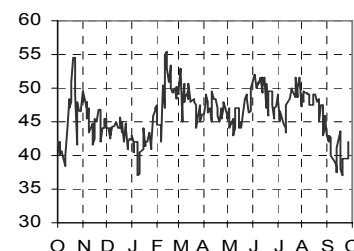
| Y/E Apr | Revenue (£m) | EBITDA (£m) | PBT (£m) | EPS (p) | P/E (x) | P/CF (x) |
|---------|-----------------|----------------|-------------|------------|------------|-------------|
| 2004A | 9.6 | 0.5 | 0.3 | N/A | N/A | N/A |
| 2005A | 15.1 | 1.6 | 1.1 | 4.1 | 9.5 | 20.1 |
| 2006A | 56.1 | 6.7 | 5.1 | 6.6 | 5.9 | 3.8 |
| 2007E | 95.0 | 9.5 | 7.5 | 8.6 | 4.5 | 2.0 |

Source: Company accounts / Edison Investment Research

Business description

ATC is a leading UK communications systems integrator. It can meet business customers' needs for voice, data, mobile and video solutions. It specialises in Internet Protocol (IP) technology, plus design consultancy and bespoke support for its SME and corporate customers in the UK.

Share price graph



AT Communications is a research client of Edison Investment Research

Company details:

| | |
|-----------------|--------|
| Market cap | £25.0m |
| Ticker | ATCG |
| Listing | AIM |
| Shares in issue | 60.9m |

Chief Executive Officer:

Timothy Tupman

Finance Director:

Mark Woodbridge

Major shareholders:

| | |
|-------------------|-------|
| TA Tupman | 38.6% |
| Rathbone Inv Mgt. | 9.6% |
| Scott Kean | 8.6% |
| Merrill Lynch | 5.0% |
| Bernard Nominees | 5.0% |
| Canada Life | 4.5% |
| Others above 3% | 7.3% |

Company address:

Greenway House
Pinnacles
Harlow
Essex
CM19 5QD,

www.atc.co.uk

- Company strengths:** ATC's key strength is its ability to consolidate similar communications companies in order to build a strong independent telecoms integrator. ATC has been proactive since it joined AIM in July 2005. Four acquisitions have created an independent structure that enables it to access the components required to tailor services to the needs of individual business customers. This is a strong, scaleable model and the emphasis on IP (internet protocol) technologies will position it to meet customer demands for newly converged services. The recent acquisition of Rocom adds scale, revenue visibility, new business lines and opportunities for cross selling.
- Products:** Via strategic, independent partnerships with a range of leading manufacturers, suppliers and carriers, ATC offers best of breed "one stop shop" communications solutions. Existing partners include Mitel Networks, Avaya, Nortel, Cisco, HP, 3Com, BT, Orange and T-Mobile. At the core of the group's acquisition strategy is to seek targets that are immediately earnings enhancing, which provide operational benefits via a step-up in the range of services it can offer as a group, or increase the scale of the overall business. Its recent acquisition of Rocom represents a good fit.
- Financials:** The Rocom acquisition was largely (i.e. £13.6m) debt financed, with the expectation that the cashflow generated by the enlarged group will reduce net debt by the year end to about £17m. That does not include an unencumbered freehold property, valued at £3.6m and likely to be subject to a sale and leaseback. Economies of scale should be considerably improved. Opportunities for cross-selling are apparent.
- Forecasts:** The enlarged group contains substantial opportunities for cross-selling services, with a broader corporate client base and earnings visibility, especially via Rocom's long term maintenance activities. Strong interim results were announced in August, in terms of both underlying performance in the existing business and the integration of the first three acquisitions (Sterry, T-Liaison and Britannia Telecom) since IPO. These have already helped prove the case for consolidation by delivering economies of scale, cost savings and improved leverage within its target market.

Financials

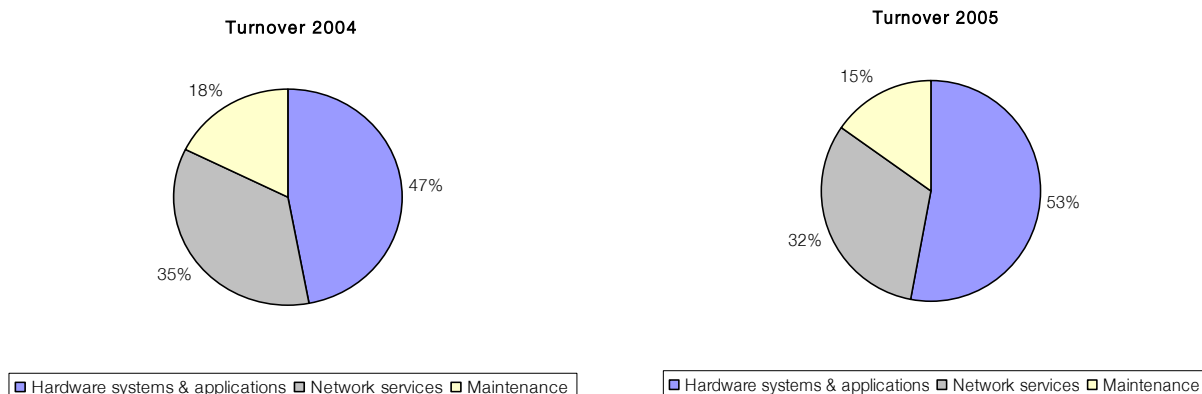
| £'000s | 2004 | 2005 | 2006e | 2007e |
|--|-------|------|-------|-------|
| Year-ending 31st December | | | | |
| PROFIT & LOSS | | | | |
| Revenue | 9.6 | 15.1 | 56.1 | 95.0 |
| EBITDA | 0.5 | 1.6 | 6.7 | 9.5 |
| Operating Profit (before GW and except.) | 0.4 | 1.4 | 5.9 | 8.5 |
| Profit Before Tax (norm)* | 0.3 | 1.1 | 5.1 | 7.5 |
| Profit After Tax (norm)* | 0.3 | 1.1 | 3.7 | 5.3 |
| BALANCE SHEET | | | | |
| Net Assets | (0.6) | 11.3 | 16.8 | 19.1 |
| Net Debt | 2.0 | 1.6 | 17.5 | 9.2 |
| Gearing% | N/A | 14 | 104 | 47 |
| Interest cover x | N/A | 4.8 | 7.8 | 8.5 |

Source: Company accounts / Edison Investment Research

*PBT & EPS are normalised (pre-goodwill and exceptionals)

Revenue breakdown

Exhibit 1: Revenue breakdown 2004-2005



Source: Company accounts

Company history

| Date | Event |
|-------------|--|
| 1999 | Company founded by CEO, Alex Tupman |
| July 2005 | AIM IPO raises £3.5m to fund VoIP growth opportunities |
| Nov 2005 | Acquisition of Sterry Group (£6.27m) |
| Dec 2005 | Acquisition of T-Liaison (£1.1m) |
| May 2006 | Acquisition of Britannia Telecom Group (£3.8m) |
| August 2006 | Acquisition of Rocom Group (£17.6m) |

Calyx Group

89p

| Y/E Apr | Revenue (€m) | EBITDA (€m) | PBT (€m) | EPS (p)* | P/E (x) | P/CF (x) |
|---------|-----------------|----------------|-------------|-------------|------------|-------------|
| 2005A | 38.4 | 4.6 | 1.7 | 4.8 | 18.4 | N/A |
| 2006A | 89.8 | 11.8 | 4.5 | 9.4 | 9.5 | N/A |
| 2007E | 134.1 | 18.2 | 10.4 | 12.4 | 7.1 | N/A |

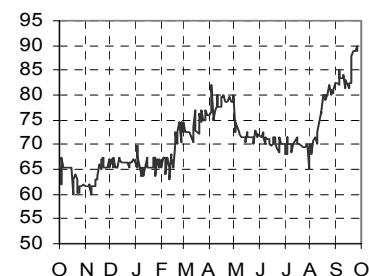
Source: Company accounts / consensus forecasts

*note converted at £1 = €1.47

Business description

Calyx is a single-source provider of networked IT solutions with operations across the UK and Ireland. Calyx is listed on both the AIM market in London and the IEX in Dublin.

Share price graph

**Company details:**

| | |
|-----------------|-----------|
| Market cap | £59m |
| Ticker | CLX |
| Listing | AIM / IEX |
| Shares in issue | 67m |

Chief Executive Officer:

Maurice Healy

Finance Director:

Peter Jenkins

Major shareholders:

| | |
|------------------|-------|
| Maurice Healy | 30.9% |
| Gartmore Inv Mgt | 5.0% |

Company address:

Unit 03, North Ring Business Park
Santry
Dublin, 9
Ireland

www.calyx.ie

- Company strengths:** The acquisition of Matrix in March provided the group with scale and broader UK geographic reach. In addition, the combination of Matrix's wide-area networking and Calyx's desktop support and managed services is a strong offering, and demonstrates the intention of more traditional IT support companies to leverage its typically strong customer relationships and networking skills into the territory occupied by the telephony providers.
- Products/ target market/ sector environment.** Since its March 2005 IPO Calyx has indicated its intention to build its UK presence and five acquisitions later, the group comprises broad telecoms and data networking skills, an attractive offering to a growing market for converged network services and an interesting proposition for small to medium size UK enterprises seeking to outsource these functions. It is also progressively becoming an interesting partner (or target) for the larger telecoms operator wishing to access a percentage of a substantial, but fragmented market
- Financials:** The group's most recent results (interims to June 06) revealed acquisition led revenue growth of 61% (27% organic) at an improved gross margin approaching 40%. Recent acquisitions were supported by a £17.5m equity issue at 70p, and a £25m long term loan.
- Forecasts.** Consensus forecasts illustrate the expected benefits of the Matrix acquisition and continued organic growth. There are, in addition, material synergies to be derived from the consolidation of the two groups, both cost savings from consolidation of back offices and premises and leverage of Calyx's Dublin network operating centre.

Financials

| £'000s | 2005 | 2006e | 2007e |
|--|------|-------|-------|
| Year-ending 31st December | | | |
| PROFIT & LOSS | | | |
| Revenue | 38.4 | 89.8 | 134.1 |
| EBITDA | 4.6 | 11.8 | 18.2 |
| Operating Profit (before GW and except.) | N/A | N/A | N/A |
| Profit Before Tax (norm)* | 1.7 | 4.5 | 10.4 |
| Profit After Tax (norm)* | | | |
| BALANCE SHEET | | | |
| Net Assets | 41 | N/A | N/A |
| Net Debt (cash) | 38.7 | N/A | N/A |
| Gearing% | 95 | N/A | N/A |
| Interest cover x | 4 | N/A | N/A |

Source: Consensus forecasts

*PBT & EPS are normalised (pre-goodwill and exceptionals)

Revenues and gross profit mix

Exhibit 1: Revenues and gross profit mix for the year to 31 Dec 2008

Not available

Source: Company accounts; Edison Investment Research

Company history

| Date | Event |
|---------|--|
| Mar 05 | AIM IPO |
| July 05 | Acquisition of Convergent Systems Ireland (€0.6m) |
| Oct 05 | Acquisition of QCL Technologies (€1.3m) |
| Oct 05 | Acquisition of ITS Technology Services Ltd (£2.5m) – the first move into the UK ICT market |
| Mar 06 | Acquisition of Entropy (€5m) |
| Jun 06 | Acquisition of Matrix Companies (£40.5m) |
| July 06 | Appointment of new CFO |

Redstone

6.2p

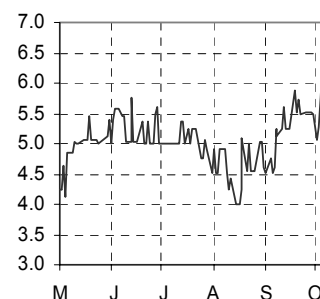
| Y/E Mar | Revenue (£m) | EBITDA (£m) | PBT (£m) | EPS (p) | P/E (x) | P/CF (x) |
|---------|--------------|-------------|----------|---------|---------|----------|
| 2005A | 49.6 | (1.9) | (2.5) | (0.9) | N/A | N/A |
| 2006A | 72.5 | 0.1 | (1.7) | (0.2) | N/A | N/A |
| 2007E | 128.2 | 7.4 | 5.1 | 0.5 | 12.4 | N/A |
| 2008E | 166.6 | 11.5 | 8.8 | 0.7 | 8.9 | N/A |

Source: Company accounts / consensus forecasts

Business description

Redstone is an independent provider of IT and communications solutions for business, concentrating on smaller enterprises

Share price graph



Company details:

| | |
|-----------------|--------|
| Market cap | £65.6m |
| Ticker | RED |
| Listing | AIM |
| Shares in issue | 1,140m |

- **Company strengths:** Redstone has reinvented itself a number of times since the end of the last decade, but new management has redefined the strategic objectives over the last year and created an entity to build value via consolidation of a fragmented UK IT/telecoms market. The intention is to establish one of the UK's leading independent IT and communications solution providers and extract value via consolidation. Two recent acquisitions have demonstrated its intention to drive this process, and there remains potential for similar moves in the future.

Chief Executive Officer:
Martin Balaam

- **Products:** The group has been restructured into five autonomous operating units. Redstone Telecom - selling value added inbound and outbound minutes; Redstone Mobile - mobile service provider and distributor; Redstone Converged Solutions - converged IP solutions provider; Redstone Managed Solutions - managed IT solutions; and Redstone Technology - business critical server solutions, storage area networks and complex server clusters.

Financial Director:
Tim Perks

Major shareholders:

| | |
|---------------------|-------|
| SVG Inv. Managers | 19.5% |
| Gartmore Inv. Ltd | 14.3% |
| Artemis Inv Man Ltd | 4.8% |
| Canada Life | 4.6% |
| Stephens Group Inc | 3.7% |

- **Financials:** In July, Redstone paid £3.75m for the Tolerant Group's network security solutions. These are high value services that Redstone intends to integrate into its Managed Solutions division, in order to add scale and cross-sell across its entire customer base. This followed the £17.3m acquisition in June of Symphony Telecom Holdings. This improved the group's ability to provide a single source of telephony to SME customers. It also added mobile products; Symphony is a distributor for all five UK mobile network operators.

Company address:

80 Great Eastern Street
London
EC2A 3RS

www.redstone.co.uk

- **Forecasts:** Redstone has reduced the cost base by approximately £7m and hopes to deliver profits and grow revenues. It has developed a stronger platform for its future growth, is largely debt free and expects to be cash generative. We regard it as much better positioned to take advantage of a developing and consolidating market place. A trading update for the six months to end September confirmed that trading is in line with expectations and that the integration of recent acquisitions is proceeding according to plan. Results are expected towards the end of November.

Company recent results and estimates

| £m | 2006 | 2007e | 2008e | 2009e |
|--|-------|-------|-------|-------|
| Year-ending 31 st Mar | | | | |
| PROFIT & LOSS | | | | |
| Revenue | 72.5 | 128.2 | 166.6 | 184.2 |
| EBITDA | 0.1 | 7.4 | 11.5 | 15.7 |
| Operating Profit (before GW and except.) | N/A | N/A | N/A | N/A |
| Profit Before Tax (norm)* | (1.7) | 5.1 | 8.8 | 12.9 |
| Profit After Tax (norm)* | N/A | N/A | N/A | N/A |
| BALANCE SHEET | | | | |
| Net Assets | 29.0 | N/A | N/A | N/A |
| Net Cash | 5.4 | N/A | N/A | N/A |
| Gearing% | N/A | N/A | N/A | N/A |
| Interest cover x | N/A | N/A | N/A | N/A |

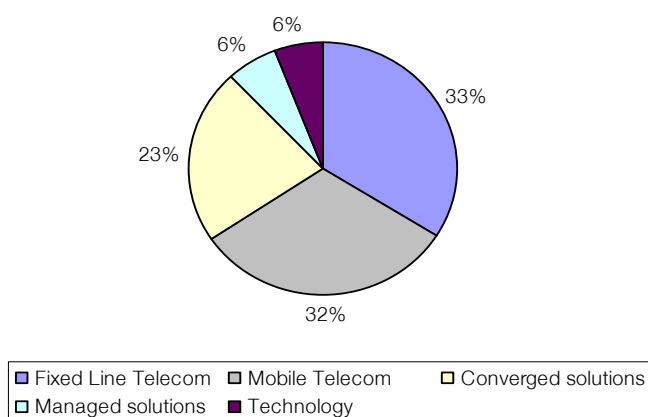
Source: Consensus forecasts

*PBT & EPS are normalised (pre-goodwill and exceptionals)

Estimated revenue breakdown year end 31 Mar 2006

Exhibit 1: Financials (estimated pro forma)

Estimated turnover 2006



Source: Company accounts; Edison Investment Research

Company history

| Date | Event |
|--------|--|
| 1995 | Company founded |
| 1999 | IPO on LSE main market |
| 2000 | Financial Restructuring |
| 2004-5 | Appointment of new executive team |
| Apr 05 | Acquisition of Xpert Group (£25.6m) |
| May 06 | Move to AIM |
| Jun 06 | Acquisition of Symphony Telecom (£17.3m) |
| Jul 06 | Acquisition of Tolerant Group (£3.75m) |

EDISON INVESTMENT RESEARCH LIMITED

Edison Investment Research produces reports on smaller quoted UK companies that we believe have been overlooked by the market. We provide smaller quoted UK companies with access to equity research coverage that is normally only available to larger companies. Our research is distributed free to professional advisors such as institutional investors and private client brokers.

DISCLAIMER

Copyright 2006 Edison Investment Research Limited. All rights reserved. This report has been commissioned by Alternative Networks and AT Communications and prepared and issued by Edison Investment Research Limited for publication in the United Kingdom. All information used in the publication of this report, has been compiled from publicly available sources that are believed to be reliable, however we do not guarantee the accuracy or completeness of this report. Opinions contained in this report represent those of the research department of Edison Investment Research Limited at the time of publication. The research in this document is intended for professional advisors in the United Kingdom for use in their role as advisors. It is not intended for private individuals or investors. This is not a solicitation or inducement to buy, sell, subscribe, or underwrite securities or units. This document is provided for information purposes only and should not be construed as an offer or solicitation for investment. This research is non-objective. Edison Investment Research Limited does not conduct investment business and as such does not hold any positions in the securities mentioned in this report. However its directors, officers, employees and contractors may have a position in any or related securities mentioned in this report. Edison Investment Research Limited or its affiliates may perform services or solicit business from any of the companies mentioned in this report. The value of securities mentioned in this report can fall as well as rise and are subject to large and sudden swings. In addition it may be difficult or not possible to buy, sell or obtain accurate information about the value of securities mentioned in this report. Past performance is not necessarily a guide to future performance.

Edison Investment Research

Bracton House, 34-36 High Holborn, London, WC1V 6AE ■ tel: +44 (0)20 7190 1760 ■ fax: +44 (0)20 7190 1759 ■ www.edisoninvestmentresearch.co.uk
Registered in England, number 4794244