

Equity Research

**TECHNOLOGY:  
SOFTWARE &  
SERVICES**

Employer Services

October 19, 2004

**Research Note**

Ticker: JCOM  
Price: \$31.15  
52-week: (\$19-\$47)

Stock Rating:  
**Outperform**

Company Profile:  
**Aggressive Growth**

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# j2 Global Communications, Inc.

## Strong Quarter and Outlook; Inexpensive Stock

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### FINANCIAL SUMMARY

Fiscal Year Ends:	December	Dividend/Yield:	\$0.00/0.0%
Long-term EPS Growth Rate:	35%	Market Value (mil.):	\$724

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FISCAL YEAR	2003A	2004E	2005E
<b>ESTIMATES</b>			
Earnings Per Share	\$1.05	\$1.20	\$1.58
<b>VALUATION</b>			
Price/Earnings Ratio	29.7x	26.0x	19.7x

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- Solid quarter showing historically high profitability and guidance reflecting continued high growth expectations
- Significant portion of revenue remains recurring with no real customer concentration
- Net paying customer additions highest in history; conversion of prior free customers remains large opportunity and “consistent with historical trends.”
- We highlight some investor concerns we believe will prove transitory
- Strong outlook buffeted by international expansion opportunity that we believe could more than double the addressable market. No change to fiscal 2005 EPS estimate of \$1.58 (up 31%)
- Stock looks inexpensive given consistency, strong profitability model, and outlook for rapid earnings growth from several avenues; reiterate Outperform rating.

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### **Solid Quarter Showing Historically High Profitability and Guidance Reflecting Continued High Growth Expectations**

J2 reported solid third-quarter results, with revenue of \$27.8 million at the high end of its expectations and EPS of \$0.32 exceeding its guidance by \$0.01 and our estimate by \$0.02. EPS grew about 13% due to the full tax provision in fiscal 2004, but on a normalized basis, pretax earnings grew 65%. Gross and operating margins remained impressive at 84.3% and 43%, respectively, and free cash flow of \$11.9 million remained strong, representing 43% of revenue and 146% of reported net income. Annualized return on equity was about 24% with very little debt in the capital structure (less than 5% of total capital) and cash balances reached more than \$3.50 per share. Relative to our model, a stronger top line and in-line gross margins were partially offset by higher operating expenses in each expense category as it continues to invest to build and broaden the business, and incurred regulatory expenses (Sarbanes-Oxley). The company offered bullish fourth quarter and full year 2005 guidance that we would characterize as in line with bottom-line expectations, with a stronger expected top line offset by additional spending to broaden its business in international markets and other areas.

### **Significant Portion of Revenue Remains Recurring With No Real Customer Concentration**

Revenue grew 47% over the prior year and exceeded our estimate by nearly 8%, as the number of paying users offset a seasonally lower revenue per user (ARPU) of \$16.95 (down from \$17.22 in the second quarter but up from \$15.36 in the previous year, benefiting from the price increase). Similar to other quarters, subscriber revenue—representing more than 97% of the total—comprised about 69% fixed recurring monthly charges and 29% variable usage charges; we further note that we believe about 60% of the user base is individuals, suggesting no significant customer concentration.

### **Net Paying Customer Additions Highest in History; Conversion of Prior Free Customers Remains Large Opportunity**

Paying customers increased by nearly 46,000 to slightly more than 515,000, its biggest quarter ever and about 3,600 above our estimate. Net paying additions had been running about 34,000 over the past two quarters but were expected to benefit this quarter as the company attempted to convert a large number of free users added in the first two quarters of the year; it did and was above our estimates despite a small uptick in customer churn of 20 basis points, to 2.6%.

It is difficult to quantify the conversion ratio—we have looked at it numerous ways but there is significant noise in the calculations as the company has, at times, “cleaned up” its free base of users, we do not have gross additions for the free and paid user base (which is the proper way to evaluate it), and the calculation assumes that all paying customers are converted from free status, which isn’t the case. The company reiterated again that its most productive channel is its Web sites, where users visit and sign up for the service. While we have a difficult time proving it with the numbers available, management indicates that the conversion ratios of customers received from the new marketing channels are consistent with its historical experience in more mature marketing channels.

### **We Highlight Some Investor Concerns We Believe Will Prove Transitory**

We may see some investors focus attention on slower free net customer growth this quarter, a slight tick up in customer churn, and higher operating expenses—but we believe they were all explainable. Net free customers increased sequentially about 233,000 after increases of about 1 million and 700,000 in the prior two quarters. Management indicated that it was more aggressive in “cleaning up” its free base—something it has done in the fourth quarter in recent periods, suggesting the likelihood that only minor adjustments will be needed in the near term. The apparent slowing free customer growth was called out on the call but management indicated that on a gross basis—which is what matters—it was very similar to the very strong second quarter, accounting for the relatively flat sales and marketing spend in the quarter. Churn did tick up 20 basis points on a reported basis, but management indicated it was more like 10 basis points with some rounding between the quarters. It was still down significantly from historical levels and 20 basis points over last year, and management noted that without the canceling of a relationship in Latin America, it would likely have been flat; we are not yet concerned. Operating expenses were higher than expected, particularly in the general and administrative area, growing 30% over last year but still at a pace less than revenue growth. Management noted that it incurred higher Sarbanes-Oxley regulatory expenses, some professional fees related to tax and accounting, added some more people in network operations, and incurred

general and administrative expense related to its Call Sciences/OneBox acquisition. It is expected to be flat in the fourth quarter and may fall.

**Strong Outlook Buffeted By International Expansion Opportunity That We Believe Could More Than Double The Addressable Market**

The outlook was strong, in our view. Fourth-quarter revenue was pegged at \$29.5 million with \$0.34 in EPS. In fiscal 2005, revenue was pegged to grow about 40% and net earnings 30%-35%, with the slower earnings growth relative to revenue attributed to its investments in future growth opportunities including international market expansion.

We believe that this was one of the more exciting items to emerge from the call. Management indicated that it has already localized Spanish, German, and French versions of its product offering to complement its recently introduced Dutch version. We estimate the international addressable markets are at least twice as large as the underpenetrated domestic market. The product sounds ready and the company will be securing marketing relationships over the coming quarters; we believe the international markets offer the company additional significant growth opportunities that we believe will allow it to sustain its already high levels of growth for several years. We have not updated our model but do not expect to change our \$0.34 fourth-quarter EPS estimate and fiscal 2005 EPS estimate of \$1.58, up more than 31%.

**Stock Looks Inexpensive Given Consistency, Strong Profitability Model, and Outlook for Rapid Earnings Growth From Several Avenues**

We believe the stock is very attractive at a price-to-earnings multiple of about 19 times our fiscal 2005 estimate, a significant discount to our expected EPS growth rate in excess of 30%. The company has exhibited consistent execution of a highly profitable business model with very strong cash flows (positive float on credit card payments). More than 70% of its revenue is recurring, with effectively no significant customer concentration. Reported EPS growth should accelerate into fiscal 2005 as the tax situation normalizes. We believe the stock has significant upside potential and recommend purchase.

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Additional information is available upon request.



**Current Rating Distribution (as of 09/30/04)**

Coverage Universe	Percent	Inv. Banking Relationships*	Percent
Outperform (Buy)	61	Outperform (Buy)	4
Market Perform (Hold)	33	Market Perform (Hold)	3
Underperform (Sell)	6	Underperform (Sell)	1

\*Percentage of companies in each rating category that are investment banking clients, defined as companies for which William Blair has received compensation for investment banking services within the past 12 months.

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