T11 Capital Management

NAME: EVOLVING SYSTEMS	SYMBOL: EVOL
MARKET CAP: $76 MILLION	FLOAT: 5.5 MILLION SHARES

THE BACKDROP

As opposed to the standard "dive in with both feet" type of analysis on individual companies that I have been publishing for the past 18 months, this report will begin by taking a brief look at the environment surrounding technology investing as we enter Q3 2013.

Investment analysis is never black and white. There are a multitude of grey, blue and green areas that investors need to remain cognizant of. The formula driven investment methodology of simply analyzing company fundamentals and forecasts without concern for the multitude of variables that exist outside of traditional analysis will compromise performance over the long-term.

With that said, the 2013 U.S. stock market has certainly been accommodating to investors. With this accommodating environment has come a certain comfort level among participants that places the chances of any abnormally adverse occurrences at a much lower level than 12, 18 or 24 months ago.

At the same time, the macro environment is shifting dramatically as the Fed seems to be preparing the markets for a shift away from a massively accommodating monetary policy to something a bit more even keeled over the long-term.

This has caused all types of asset classes ranging from fixed income to precious metals to foreign exchange to witness an upheaval in volatility that inevitability trickles down to the equity markets.

In the face of a shifting landscape, it becomes prudent to scale back on aggressive, high-beta names and look for more conservative opportunities that offer minimal volatility and risk paired with a substantially attractive fundamental picture that will eventually lead to the creation of value in the stock price.

EVOLVING SYSTEMS BUSINESS

At its core, EVOL is a telecom software services company. Their business caters to telecom service providers, with a special focus on overseas operators. The company counts Virgin Mobile, Tmobile and Vodafone as some of their 50 clients spread throughout the globe.

The business itself is split into three segments:

1. Dynamic Sim Allocation: Allowing telecom service providers to give their customers a full range of personalization options at the moment of activation and throughout the use of the phone.
2. Intelligent M2M Controller: Management of machine to machine controls and devices.
3. Tertio: Allowing telecom service providers to manage service assembly, verification, activation and integration for their customers.

This type of complete offering for telecom companies allows EVOL to be an essential piece of the puzzle for a full integration of services. The business they are in, especially since transitioning to a software based, recurring revenue model sometime ago, provides consistent growth in top and bottom line numbers. Also, as you will learn, the stability of the industry given the foundational aspect of EVOL's operations allows for extremely efficient growth in what is one of the most shareholder friendly companies you can find in the small-cap space.

<u>GIVING LOVE TO SHAREHOLDERS</u>

As far as companies with market caps under $500 million go, you can expect a fairly standard method of operations when it comes to returning value to shareholders. The general attitude is that growth will be managed and with that shareholder appreciation will ensue. The appreciation shareholders receive is management's responsibility. Any other perks such as quarterly dividends, special dividends, buybacks etc. are thought of as the stomping ground of more established, large companies.

EVOL has been returning cash to shareholders in a relatively steady fashion since 2010. In fact, since May 2010, EVOL has returned $4.30/share in quarterly and one-time special dividends. In 2012, the company returned $3.85 in special dividends to shareholders.

It doesn't stop there, however. In 2011, EVOL announced a share buyback program to repurchase $5 million worth of stock throughout the year.

This type of love shown to shareholders tells you a few things about the company:

1. They are comfortable enough with the strength of balance sheet to pay out the substantial amount of cash they generate to shareholders
2. They are comfortable enough with the prospect for generating future cash to not have to stack up cash on the balance sheet in case of Armageddon breaking out in their sector
3. Management is aligned with shareholder interests. This is especially true since insiders hold 32% of the outstanding shares.

<u>RELIABILITY IN EARNINGS</u>

The telecom sector has a reputation for erratic, volatile earnings that keep share prices within the sector either depressed or sideways for what can seem like an eternity. EVOL seems to be an exception to the volatility as their business is predicated on a reliable revenue stream that supports not just the current market valuation but the appreciation that should come in the months and years ahead.

- RELIABILITY: The company has seen 20 consecutive quarters of positive net income

- COST STRUCTURE CONTROLLED WELL: For Q1-2013 reported record gross margins at 72%, operating margins of 27% and Adjusted-EBITDA margins of 30%

- BOTTOMLINE GROWTH: For Q1-2013 reported $.10/share EPS cont. operations versus $.07/share for Q1-2012

- CASH GENERATION: At 3/31/13 reported $11.5M in cash up 30% from 12/31/12. Generated $2.8 million cash from operations in Q1 from $1.5 million a year ago

- REVENUE GROWTH: Revenue for Q1-2013 increased 13% yoy

The point here is that unlike other telecom companies that have seen an erratic history of operating data, EVOL seems to be intent on bucking that trend.

This has become especially true recently with their focus on creating a recurring revenue stream through cloud and software based initiatives as pointed out by the Chairman Thad Dupper in the most recent conference call:

"Let me conclude by saying that I'm very pleased with the results we announced today. And we are equally excited about the progress we're making in transforming our business model to more of a recurring revenue model. This is driven by our work on DSA in the cloud, as well as the progress we are making at our DSA accounts and the impact that increasing volumes will have on recurring FUI revenue and profits going forward."

<u>REAL HOUSEWIFE OF NEW JERSEY</u>

Whenever I take a position in a company, I like to know who I am holding hands with. In other words, I want to know the major institutional holders of a company that have the ability to influence management regarding future financial decisions. Especially in small companies, this type of awareness makes a difference, since it is a lot easier to exert influence over the management of a $100 million company as opposed to a $10 billion company.

In the case of EVOL, the ownership picture is a bit unique, you can say. I will get to the institutional holders owning between 5-10 percent of the outstanding shares in the next section. That is not the unique part in all this.

What makes EVOL unique is that a housewife from New Jersey owns roughly 40% of the company that she has been buying through her family trust for some years now. In fact, she recently has been on another buying spree, scooping up nearly $1 million worth of stock in 2013 alone.

This New Jersey housewife is Karen Singer. She has been active in public telecom companies over the past decade, taking major ownership positions in several companies. She is certainly not in these companies for the short-term as her modus operandi is to buy, buy, buy and hold, hold, hold for a period of many years.

The catch here is that Karen Singer is married to Gary Singer who participated in a junk bond trading scheme with the Keystone group of mutual funds while he was an executive at Cooper Companies, eventually serving a couple years in prison and paying millions in penalties. Additionally, Mr. Singer was permanently barred from acting as an officer or director of any public company, which kind of makes the Singer's investment style a little difficult to pursue unless he operates under his wife's name, of course.

There is more to this, however. Gary Singer is the brother of Steven Singer. If you look at the profile of Steven Singer you will see that he has been involved with quite a few distressed situations, especially in the telecom space:

Dr. Steven G. Singer has been the Chief Executive Officer of American Banknote Corporation, parent company of Leigh Mardon Australasia Pty Ltd., since November 2000. From 1993 to November 2000, Dr. Singer served as Executive Vice President and Chief Operating Officer of Romulus Holdings, Inc., and served as Chief Executive Officer and Chairman of Pure 1 Systems since 1994. He serves as the President of Executive Board of American BankNote S.A. For 10 years, he has been the Chairman of the Board at ABnote Limitada do Brasil and Leigh Mardon PTY. He served as Chairman at American Banknote Corporation. He served as the Chairman of the Board of American BankNote S.A. He served as Chairman of the Board of TerreStar Corporation (formerly, Motient Corp.) since June 20, 2003. He served as Chairman of the Board of NEON Communications Group, Inc. (formerly, Globix Corporation) from December 15, 2002 to October 31, 2005. Dr. Singer has been a Director of NEON Communications Group, Inc. since April 2002. He has been a Director of Anpath Group, Inc. since November 22, 2010. He has been a Member of the Board of TV Max Holdings LLC, Galaxy Cable LLC and Technicon Instruments Corp. for 10 years. He serves as Chapter 7 Trustee of American Pad & Paper Company. He served as Director of TerreStar Corporation since May 2002. For five years, he served as a Director of Anacomp, Inc. Dr. Singer holds a Bachelor of Arts degree, summa cum laude from the University of Pennsylvania and a Juris Doctor Degree from the Harvard Law School.

According to this BusinessWeek article, the Singer brothers essentially share an office and I'm assuming operate what amounts to a distressed telecom investment fund together:

The SEC has permanently barred Gary Singer from acting as an officer or director of any public company. Nevertheless, Highland's complaint says that he "shares an office with Steven Singer, has participated in many Motient board meetings and conference calls, and even acted in a managerial role on behalf of the company." Gary Singer has allegedly pressured Motient's board for compensation and owns warrants to acquire Motient shares.

The point of all this is that Karen Singer is certainly not simply a New Jersey housewife. When the Karen Singer Trust becomes involved in an investment, they are acting as an activist entity in a distressed situation. They are led by the experience and knowledge of both Gary and Steven Singer who have had quite a track record of turnarounds investing in the space.

Ibasis, LVWR and PTGI (a company that was in the portfolios briefly in 2012) are just a few of their other investments that have proven profitable over the past decade.

The Singer's have been involved in EVOL since 2007, starting their buying in the $1 range and buying it all the way up to $7 range. They haven't sold a single share.

INSTITUTIONAL INVOLVEMENT

The two major institutional holders in EVOL are Argent and Rutabaga Capital Management.

Argent describes their small-cap strategy as *a bottom-up fundamental strategy emphasizing valuation and anticipating change in active stock picking. The small cap strategy capitalizes on the intersection of solid valuation, accelerating growth, and catalysts that are not quickly recognized by the investment community. Our disciplined investment process enables us to identify pricing inefficiencies in smaller capitalization companies due to lack of effective research, a stock's trading liquidity and lower institutional ownership.*

Rutabaga is run by Robert Schlieman who has been running this small-cap fund since 1999. What little I could find about his strategy, I found in this interview from 2001:

A big believer in the regression to the mean, Schliemann searches out small companies whose margins have temporarily deteriorated for reasons he thinks he has a handle on. And while he wants to see a catalyst for improvement, he's willing to wait two or three years for the full turnaround. He prefers companies with a dominant niche and a good balance sheet — though he will buy leveraged outfits if they have ample cash flow to service and pay down debt.

Argent and Rutabaga own 9 and 7 percent of the outstanding shares in EVOL, respectively.

THE BOTTOMLINE

There are three factors that make for a good small-cap investment:

1. A mitigation of risk in the pricing of the shares brought about by unrecognized restructuring and growth in the company
2. A management team that is aligned with shareholders in pursuing growth
3. A knowledgable institutional shareholder base that is quietly seizing the opportunity

EVOL has managed to maintain steady growth over the past several years while continuously rewarding shareholders through dividend payouts and share buybacks. All the meanwhile, the institutional shareholder profile, especially with the involvement of the Singers, is an impressive lineup of knowledgeable investors who see the value both in the business the company pursues and the management that is steering the decision making process.

The risk in the shares here is minimal given the progress the company has been making in achieving consistent profitability, especially as their focus turns to a recurring, high-margin revenue generation model.