T11 Capital Management

A research report detailing **MITEL NETWORKS CORPORATION (Symbol: MITL)**

An Introduction

- Canadian company founded in 1972

- MITEL stands for **MI**ke and **TE**rrys **L**awnmowers. The company hasn't been in the lawnmower business since shortly after their founding.

- Company has been focused on Voice Over IP (VOIP) products since 2001.

- MITL originally wanted to IPO in 2006. However, due to the purchase of InterTel , they withdrew their IPO registration.

- MITL did go public in April 2010 at $14 per share. By October 2011 MITL was trading at $2.

- Current market price = $3.64 for a market cap of $195 million

A Look Into The Ghosts Of Mitel's Past

Through the benefits of hindsight it is apparent that MITL should never have attempted their IPO given the structure of the company at the time it came public. The expected range for the IPO was in the 18-20 dollar range. It never made it close to that offering price. It was priced at $14 on the day of its offering, closing the day in the $12 range, nearly 40% below the target range. A disaster by any stretch.

It is obvious why the market not only frowned on MITL as an investment worthy entity but participated in pummeling the company. At the offering price, MITL was sporting a P/E above 50. That is in an industry where the average P/E was in the 20 range at the time of its IPO. VOIP has not been considered a high growth technology segment for years now. It can even be argued that networking companies like MITL and their competitors Cisco and Alcatel-Lucent are "old technology" companies that deserve conservative multiples given their growth characteristics. It is obvious now that a premium multiple for MITL simply wasn't acceptable given the profile of its technology offerings. The problems didn't stop there, however.

MITL had three major problems as it came to market:

1. Revenues were down low double digit percentage year over year. Somehow the underwriters in tandem with company management thought the market would be willing to pay growth stock prices for a company that wasn't growing in the least bit.

2. Market share was slipping away from them at a fairly consistent pace.

3. Debt was extraordinarily high. They came to market with nearly $500 million in debt incurred mostly as a result of their merger with InterTel. Cash flow, at the time of the IPO, was only $30 million versus that extraordinary debt load. Additionally, the rating agencies downgraded MITL's debt in the months before its IPO.

This combination of obvious faults along with a market that was prone to Euro-crisis led overreactions in 2011, punished MITL for their haste in getting the IPO done at any cost. An 86% decline in the valuation of MITL was the punishment for the oversight.

The devastation in share price now needed a catalyst to reverse the trend.

<u>Restructuring Efforts</u>

2011 was a year of complete restructuring for MITL from the ground up. In order to accomplish this, the former CEO of the company was replaced by Richard McBee. A few months later, the COO of the company was relieved of his duties and that position was eliminated entirely.

Immediately McBee started an aggressive plan of restructuring:

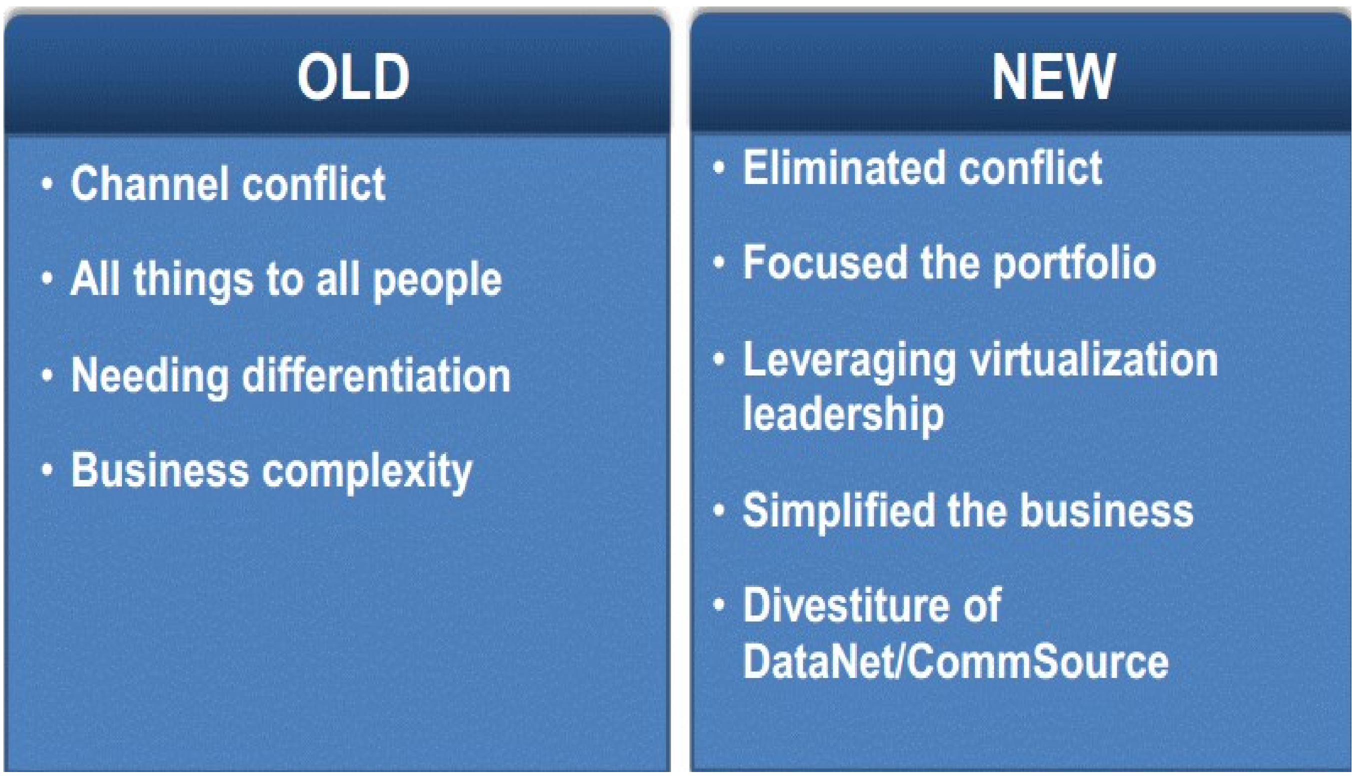
1. Reorganization of the business units into 3 key units to drive growth over the long-term.

2. A streamlining of operations eliminating 200 jobs

3. Closing of excess facilities.

4. Introduction of new services, including a cloud based service.

5. Moving the company successfully away from a hardware model into a software based model well ahead of competitors.



<u>An Attractive Valuation Emerges</u>

There are a number of reasons that MITL is being discounted as heavily as it is presently:

1. **They have a leveraged business model** that will not react favorably to the adversity they have faced over the past couple of years. Uncertainty with respect to leverage creates fear in the institutional investor community. Often times, they are late returning to the party, as I believe is the case here.

2. **It was an unsuccessful recent IPO with Canadian roots.** A simple reality of today's public markets is the fact that small-cap stocks lay forgotten irrespective of the how attractive they are in valuation, business model , prospects etc. The institutional investment community is too big and the retail investment community is focused on AAPL and GOOG.

Add to this fact that MITL is a recent IPO based in Canada and right there you have the recipe for small-cap ghost to float around the NASDAQ. Investors are just now starting take notice of MITL, as I will demonstrate with the technical look at the end of this report.

3. **Old technology label.** It is not 2000 anymore. Being a networking company is no longer cool. This removes an entire segment of investors who enjoy having an exciting component attached to any technology stock they choose to invest in.

These components of pessimism unite to form opportunity in simple ignorance.

Valuation

There is certainly a valuation proposition here as a result of the dynamic taking place:

- Selling at 4 times EV/EBITDA

- Substantial cash flow generation allowing the company to continue paying down their debt. Selling at 3 times free cash.

- Full year revenues in the $600 million range.

- Gross margins came in at a record 56% in the recent earnings report demonstrating early success at converting their model to a software based platform allowing for expanding margins.

- Adjusted EBITDA from continuing operations reported in most recent earnings report was $24.1 million or 16.6%, up from $21.4 million or 13.8% from the prior year quarter.

Business outlook reported in November for quarter ending January 31st 2013 (Q3 FY 2013). Management has a history of being very conservative with estimates. These estimates are true to form:

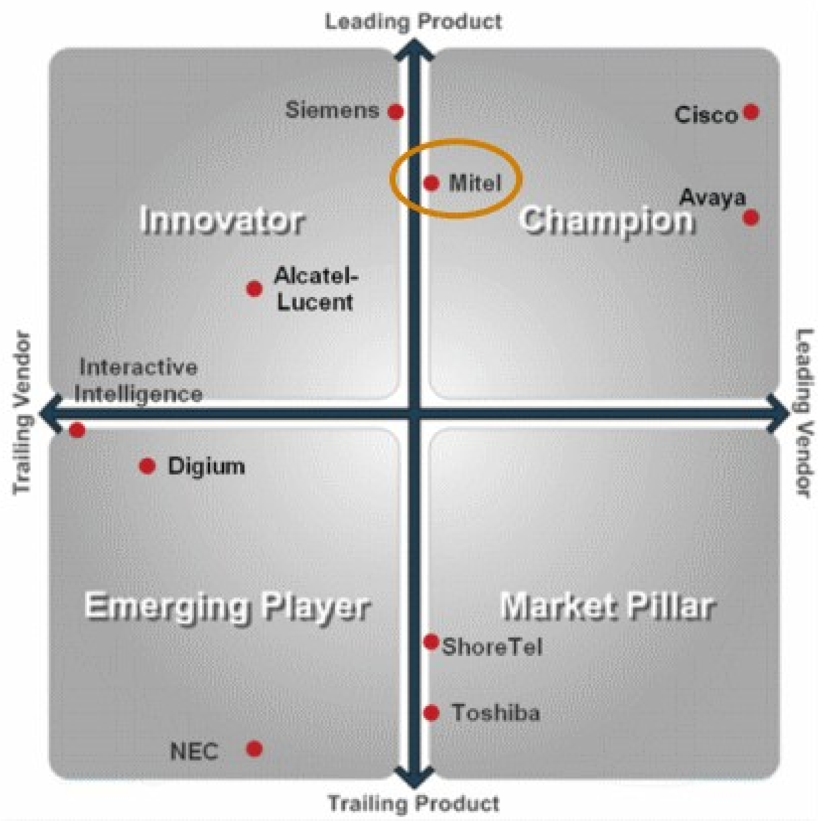
- Revenue from continuing operations is expected to be in the range of $141 to $146 million.

- Gross margin percentage from continuing operations is expected to be in the range of 55.0 to 56.0 percent.

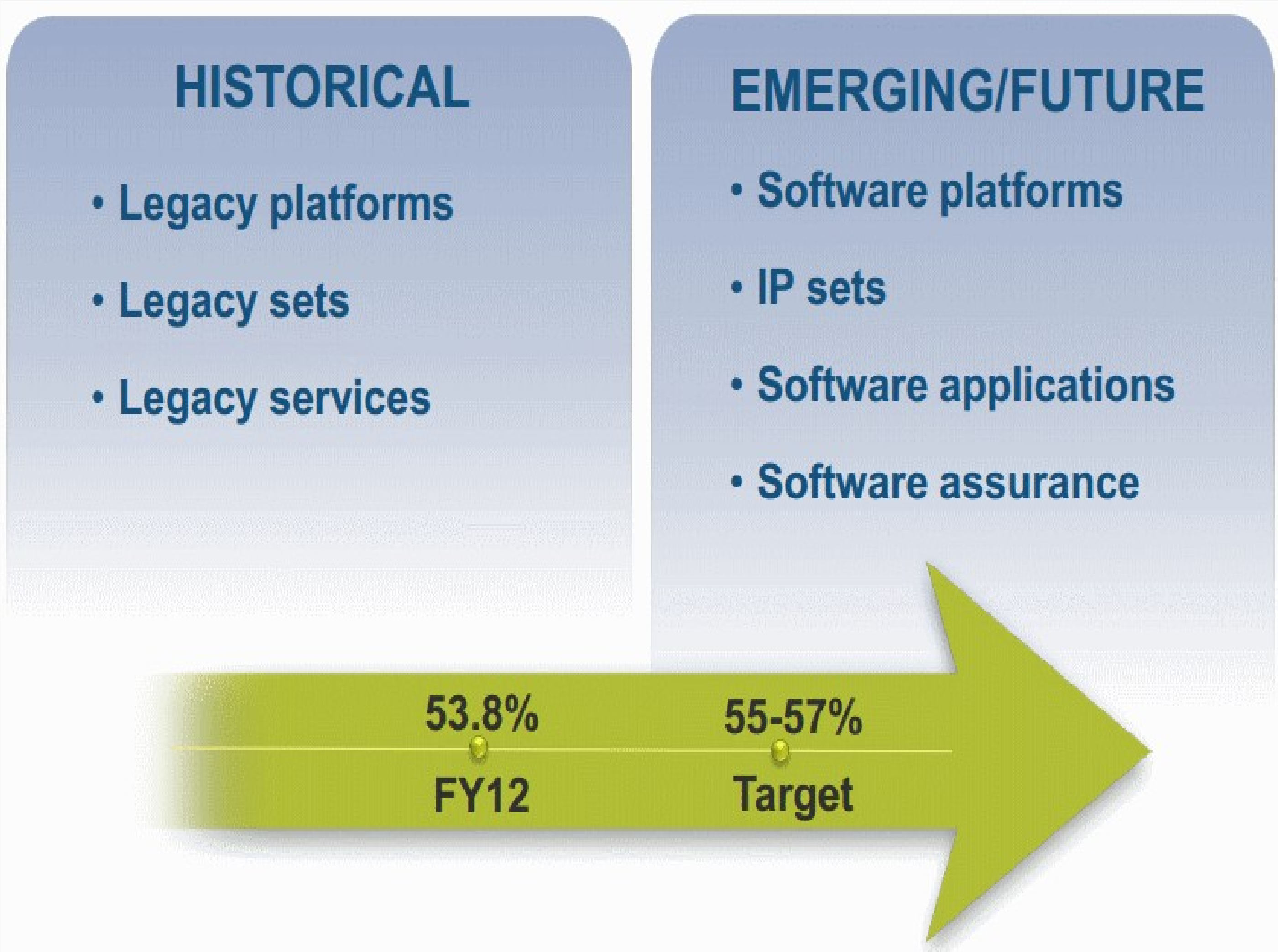
A Potential Takeover Candidate?

MITL is operating in a field with some incredibly large players who have made it a habit to gobble up companies like MITL when they are able to gain operating and competitive efficiency as MITL has recently. Not to mention the fact that the company is selling at an incredibly attractive price at these levels.

Here is a look at where MITL lies in the info-tech, IP telephony landscape according to Info-Tech Research Group:



Here is a look at what historically drove margin expansion at MITL versus what MITL sees as being the future drivers of margin expansion:



Courtesy of MITL

The company sees itself as more of a software based entity within the space, which gives MITL a leg up on the competition. Again, this will drive efficiency in the operations of the company AS WELL as potentially making MITL an attractive takeover candidate.

The Cushion

There isn't an investment that is made within my process that doesn't involve a substantial cushioning of risk. While MITL has a little more risk than a typical portfolio company due to their leveraged structure, there is a substantial risk cushion at work here.

The restructuring of MITL that has taken place since McBee took over has essentially transformed the company from the ground up. We are now dealing with what is essentially a software based business model that is a leading innovator within its field. A substantial amount of cash flow is being used to pay down debt, with the possibility of further measures taking place in the near future to reduce debt further, thereby increasing cash flow.

Their competitive position as an innovator within the industry, along with the aggressive restructuring efforts that have taken place make the $3 range a highly favorable area for accumulation. The risk at $3 and change now versus where the company was when it was trading at the same price roughly a year ago are night the day. Vast improvements have taken place as the restructuring process has matured and is proving a successful initiative.

Risks

- **Substantial Debt -** Although MITL has been paying down debt recently, it goes without saying that any hiccup in their ability to generate cash flow will adversely impact their ability to pay down debt.

- **Reliability On Economic Consistency -** Being that MITL is a leveraged small-cap company, they are more reliable on consistency in not just their market segment but the macro economy at large. MITL does have significant exposure to overseas markets. Any type of macro dislocation will impact the company disproportionately due to their leveraged model.

Summary

MITL is a well established presence within the business telco space. Seen as an innovator within the space, this has become even more cemented recently with their efforts at moving into a high margin, software based service model.

The disaster that was MITL's IPO in 2010 paired with an unfavorable market environment in 2011, caused MITL shares to fall to a price that has made the company a low risk proposition to this day. Given that the company is leveraged they are susceptible to economic and industry specific shocks that will create further overreactions in share price.

However, given the accommodating environment that has developed for global equities, the probability of large shocks occurring has diminished substantially. The leveraged nature of their business then becomes a positive attribute during a more predictable environment.

By every valuation metric MITL is substantially undervalued relative to its peers, in what is likely a delayed market reaction to the successful restructuring initiatives that have taken place under CEO McBee.

A $6 stock price can very simply be attained by remaining consistent in their current efforts. Between $10-$12 will take place over the next 12-24 months on any perceived acceleration of their initiatives, which I believe will be the case.