Zacks Small-Cap Research

May 19, 2016

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Elephant Talk Communications Corp. (ETAK-NYSE)

ETAK: ValidSoft Still Not Sold; Rightsizing Continues

Using 2017 estimates, we believe the stock could be worth $0.46 using a blend of industry averages of EV to EBITDA and EV to Sales.

Current Price (05/18/16)	$0.19
Valuation	**$0.46**

OUTLOOK

Elephant Talk Communications Corp., a provider of virtualized mobile platforms (ET Software DNA 2.0) for MNOs and MVNO operators worldwide is recovering from the loss of its 2nd largest customer. Its new Executive Chairman, a telecom turnaround specialist, is in the process of restructuring of the business to reach cash breakeven in the next two quarters and reposition the company. We expect the sale of the ValidSoft division could fund operations and pay off debt if completed in the next few months but the company may also need additional funds to execute its plans.

SUMMARY DATA

52-Week High	**$0.63**
52-Week Low	**$0.17**
One-Year Return (%)	**-52.3**
Beta	**0.17**
Average Daily Volume (sh)	**109,687**
Shares Outstanding (mil)	**164**
Market Capitalization ($mil)	**$31**
Short Interest Ratio (days)	**N/A**
Institutional Ownership (%)	**3**
Insider Ownership (%)	**16**
Annual Cash Dividend	**$0.00**
Dividend Yield (%)	**0.00**
5-Yr. Historical Growth Rates	
Sales (%)	**-3.5**
Earnings Per Share (%)	**N/M**
Dividend (%)	**N/A**
P/E using TTM EPS	**N/M**
P/E using 2015 Estimate	**N/M**
P/E using 2016 Estimate	**N/M**
Zacks Rank	**N/A**

Risk Level	**Above Average**
Type of Stock	**Small-Growth**
Industry	**Comm Network Sol**

ZACKS ESTIMATES

Revenue
(in millions of $)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2014	5.4 A	5.1 A	4.4 A	5.4 A	20.4 A
2015	5.0 A	19.2 A	3.5 A	3.3 A	31.0 A
2016	3.3 A	3.5 E	4.2 E	4.4 E	15.4 E
2017					20.0 E

Earnings per Share
(Non-GAAP EPS is operating earnings before non-recurring items)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2014	-$0.04 A	-$0.04 A	-$0.04 A	-$0.01 A	-$0.15 A
2015	-$0.04 A	$0.07 A	-$0.02 A	-$0.02 A	-$0.01 A
2016	-$0.02 A	-$0.01 E	-$0.01 E	-$0.00 E	-$0.04 E
2017					$0.00 E

Zacks Projected EPS Growth Rate - Next 5 Years 20%

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WHAT'S NEW

Q1 Continued the Restructuring, Constrained by Cash

Q1 came and went without the sale of ValidSoft. Although the formerly announced deal is not dead, the acquirer has not been able to secure the financing to proceed. As a result the company is extremely cash constrained and has not been able to implement its plans on its former timetable. Its number one priority is to raise cash, preferably in a non-dilutive manner, (even above and beyond selling ValidSoft). Its second priority is to reduce the cash burn and its third priority is to grow the business through sales and marketing while completing a complete shift to the cloud. It seems the next news we could see from the company is a financing arrangement. It still has another $1.3 million to sell in its currently marketed private placement.

Elephant Talk reported Q1 revenues of $3.3 million versus $5.0 last year, down 35% and flat sequentially. This was slightly below our estimates. Gross margins were slightly higher at 65.6% versus 62.7% as cost cutting efforts reduced expenses in cost of goods sold.

G&A was higher than we expected even taking out the $638,000 in severance and write-offs in the quarter at $2.9 million versus $3.0 last year. We had thought costs would come down faster. Both G&A and Product development were up in the quarter sequentially. Certainly management has been focused on the sale of ValidSoft and raising cash to function until ValidSoft is sold. In the quarter it raised another $2.2 million in a private placement for a total of $3.5 million. Despite this the working capital deficit increased another $900,000 to a negative $11.7 million.

The company has reduced the workforce from 265 in November 2015, to 199 in Q4 and 195 at the end of Q1 2016. Last quarter it said it expects headcount to be 160 by the end of Q2 2016. Management is using sales per employee as its metric to judge progress as well as its ability to be cash flow positive. At the end of Q1 revenue per employee was $67,000 with a goal of $90,000 by the end of Q2, and the ultimate goal of $200,000.

2016 Forecast

We have reduced 2016 revenues to be $15.4 million versus the unusual 2015 revenues of $31 million caused by the purchase of Iusacell by AT&T. Starting at a base line of $3.5 million and assuming a 2016 sale of ValidSoft we hope for sequential improvement in quarterly revenues throughout the year. Even if sales were to score big wins this year, revenues will be slow to build as the company needs a number of months to onboard new customers and even then is paid monthly thereafter. Given that management believes it can reach EBITDA breakeven in Q2, we are looking for a loss per share of $0.04 in 2016.

INVESTMENT THESIS

- Elephant Talk provides software-defined network (SDN) platforms (ET Software DNA 2.0) that enable mobile phone service providers to increase the value of their network legacy, outsource back office operations, and reduce their total cost of operations.

- The SDN market is enjoying rapid growth as operators transition away from cumbersome and expensive hardware and appliance based systems. According to SDxCentral, this market is expected to grow from $15 billion today to $105 billion by 2020 for a CAGR of 44%.

• The company owns ValidSoft, a provider of voice biometric technology. It has initiated a process to explore strategic alternatives for this division up to and including an outright sale. The company had an offer to buy the company for $12.5 million, but that deal has not occurred according to plan and may never. The company is continuing to pursue its sale.

• There is risk as the company continues to right size itself after the loss of Iusacell while adding new customers. It is currently significantly free cash flow negative but hope to reach breakeven in the next two quarters, restructure its debt, and raise more capital.

• We believe there is **considerable risk in the stock** until the company finds financing to sustain operations as it ramps current and potential new customers. This may be achieved by the sale of ValidSoft, issuing new stock or debt, or any combination thereof. While we believe in the long-term prospects of the company, short-term there are many questions. At a fully diluted market cap of $40 million and revenue run rate of $13 million and negative EBITDA we believe the company is fully valued due to short-term risks. There is risk in not knowing how much capital will cost or if dilution may occur. There is risk ValidSoft may not be sold in a timely fashion or for a favorable price. There is risk company may (and should) reverse split the stock an action that usually causes a stock to go down (unless it is done in conjunction with an uplisting.) There is risk investors may not be expecting revenues will be down dramatically year over year for the next few quarters or that fully diluted share count has grown dramatically. When these risks are mitigated we will adjust our valuation.

CURRENT CUSTOMERS

Vodafone Spain is the company's largest customer. In addition to Vodafone's own low-priced service *Lowi*, Elephant Talk provides the platform for six different MVNO operators on the Vodafone España network. These six operators are: Lebara Mobile ES, BT Movil, Eroski Movil, NEO SKY (bought by MasMovil), HITS Mobile, and Orbitel. Elephant Talk renewed its five-year contract with Vodafone España in 2013. The grand majority of the rest of revenues come from **Zain Saudi Arabia** and **Netherlands ETAK** who operates as an MVNE for T-Mobile, and some from Valid Soft.

ValidSoft

ValidSoft is a software and services provider of User Authentication, Voice Biometric, and Device Trust technology and solutions to financial services governments and enterprise customers. Elephant Talk recently announced that it was exploring strategic options for ValidSoft up to and including its sale. The company was bought in 2010 for approximately $15 million in stock. Most of the $3 million in goodwill that the company has on its balance sheet is from ValidSoft. The company does not break out revenues for this entity. The division is located in London.

RISKS

- Steven Van der Velden, who was Chairman, CEO, and President, and is the majority shareholder of the company, resigned as of November 16, 2015. He was replaced as Chairman by (Hal) Turner, who in turn brought on Gary Brandt as Chief Restructuring Officer. They are implementing a complete revamp of the company.

- The majority of the revenues are from one customer Vodafone Spain; 86.1% of revenues in Q1 were from two customers both based in Europe.

- There is currency risk as most of the company's operations are in Euros.

- The company was given a going concern opinion by its auditors because of it negative cash flow since it lost its contract with Iusacell. The company needs to raise considerably more cash to maintain operations and pay off current debt.

VALUATION

While there are many MVNEs worldwide, many are private. Those that are public are all small expect for Amdocs (DOX) a $7.3 billion company. On average they trade at 1.7 times enterprise value to sales. They also trade at an average of 17.7x enterprise value to EBITDA. Looking to our 2017 estimated revenues and EBITDA for ETAK, and using fully diluted market caps and an industry average multiples we get a stock price of $0.17 per share. The company believes in future quarters it can get back to its past EBITDA of $2.3 million per quarter. If it can, then at that point the stock would be worth $0.76 on an enterprise value to sales basis. Taking an average of the two, we get a price of $0.46 by 2017.

However more importantly, as the company moves completely to a cloud-based SaaS provider, its should present much higher margins and thus will be compared to an entirely different list of SaaS vendors which trade at an average multiple more than twice this group.

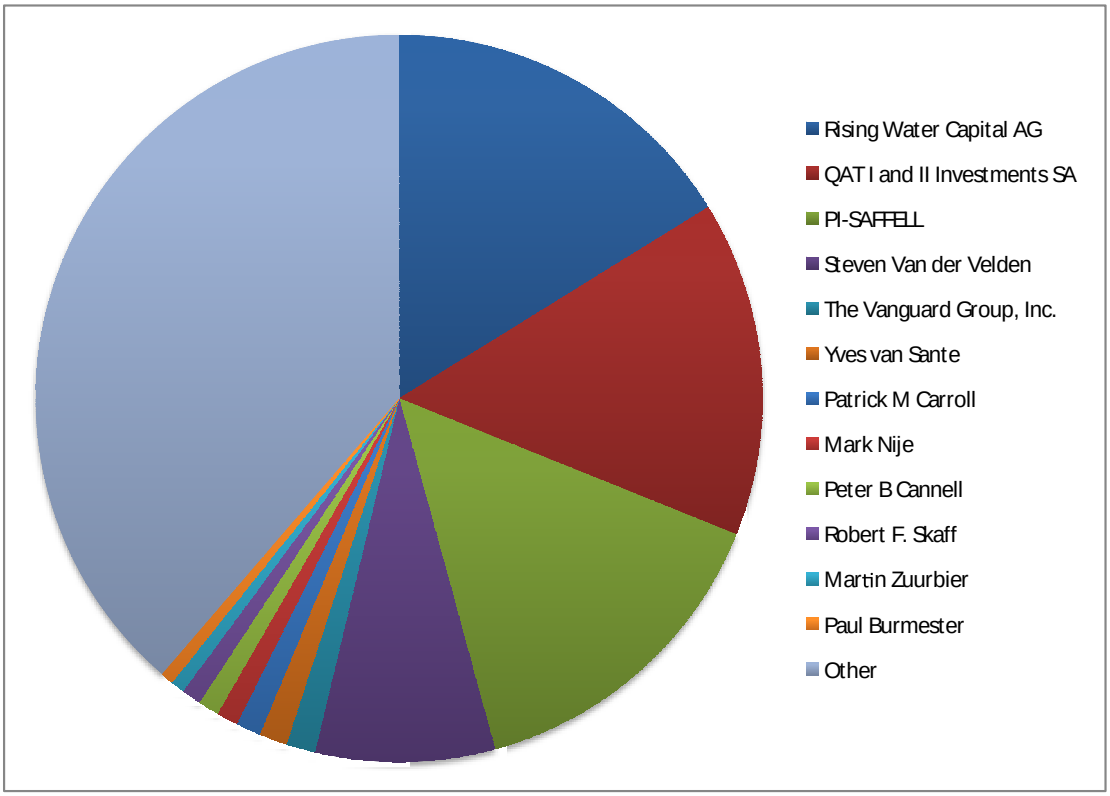
MVNEs

Company	Ticker	Revenue 2016E	Revenue LTM	EBIDTA Margin	EV/TTM EBIDTA	Diluted Enterprise Value / Sales 2016E	Diluted Enterprise Value / Sales LTM	Included in Average?	Enterprise Value
Amdocs	DOX	$3,762	$3,680	19%	10.5x	2.0x	2.0x	y	7,330
Redknee Solutions	RKN.TO	$184	$196	6%	33.3x	1.2x	1.1x	y	209
CSG Systems	CSGS	$750	$753	21%	9.3x	2.0x	1.9x	y	1,430
MER Telemanagement Sol	MTSL	NA	$15	-5%	-3.2x	NA	0.4x	n	5
Ericsson	ERIC	$28,990	$30,290	15%	4.6x	0.7x	0.7x	n	20,250
Average				**15%**	17.7x	**1.7x**	**1.7x**		**$2,990**

	Revenue 2017E	Revenue 2016E	EBIDTA Margin		Enterprise Value / Sales 2017E	Enterprise Value / Sales 2016E	Valuation Range Low	Valuation Range High
Updated 5-13-2016	**$20**	**$15**	**16%**		**1.7x**	**1.7x**	**$25**	**$35**
YoY growth								
Conclusion of Enterprise Value			**$30,152,393**	**$162,840,000**				
Market Value**			**$36,702,537**	**$169,390,144**				
Shares Outstanding			214,662,287	214,662,287				
Price per Share			**$0.17**	**$0.76**		**$0.46**		

OWNERSHIP

There are 164.1 million shares outstanding as of May 1, 2016. Steven van der Velden, former Chairman and CEO, owns approximately 31.5% of QAT, which owns 51.3% of the outstanding capital stock of Rising Water Capital. These three combined own 39% of the total outstanding.



INCOME STATEMENT

Elephant Talk Communications, Inc.	Q1 2015 31-Mar	Q2 2015 30-Jun	Q3 2015 30-Sep	Q4 2015 31-Dec	Q1 2016 31-Mar	Q2 2016E 30-Jun	Q3 2016E 30-Sep	Q4 2016E 31-Dec	2015	2016E	2017E
Non-GAAP (cash) revenues	$8.0	$7.4	$3.4	$2.5	$3.1				21.3		
Total GAAP revenue	**5.0**	**19.2**	**3.5**	**3.3**	**3.3**	**3.5**	**4.2**	**4.4**	**31.0**	**15.4**	**20.0**
Yr-to-yr Growth	-7%	279%	-22%	-40%	-35%	-82%	20%	34%	52.4%	-50.4%	30.0%
Cost of services	1.9	1.4	1.4	1.3	1.1	1.2	1.4	1.4	5.9	5.1	4.0
Gross profit	3.1	17.8	2.1	2.0	2.1	2.3	2.8	3.0	25.1	10.2	16.0
Gross Margin	62.7%	92.5%	60.9%	61.6%	65.6%	67.0%	67.0%	68.0%	80.9%	66.6%	80.0%
Operating expenses:											
Product Development	1.0	1.5	1.0	1.0	1.290	1.0	0.9	0.8	4.5	4.0	3.0
Sales and Marketing	0.7	0.3	0.6	1.0	0.542	0.5	0.6	0.8	2.6	2.4	3.7
G&A	3.0	2.7	2.5	2.3	2.856	2.4	2.2	2.0	11.7	9.4	8.0
Depreciation and Amortization	1.7	1.7	1.8	1.4	1.098	1.1	1.0	1.0	6.6	4.2	2.0
Restructuring charge	0.0	0.0	0.0	1.3	0.638	0.0	0.0	0.0	1.3	0.0	0.0
Impairment for assets held and used	0.0	0.9	0.0	1.7	0.000	0.0	0.0	0.0	2.7	0.0	0.0
Total operating expenses	6.4	7.2	5.9	8.6	6.423	5.0	4.7	4.6	29.4	20.0	16.7
Operating income:	(3.3)	10.6	(3.8)	(6.6)	(4.3)	(2.6)	(1.9)	(1.6)	(4.3)	(9.8)	(0.7)
Operating margin	-65.1%	55.2%	-109.4%	-201.6%	-130.6%	-74.5%	-44.9%	-36.5%	-13.9%	-63.7%	-3.5%
Other income:											
Interest income	0.0	0.0	0.0	0.0	0.0	-	-	-	0.1	0.0	-
Interest expense	(0.4)	(0.6)	(0.3)	(0.285)	(0.3)	(0.3)	(0.3)	0.0	(1.5)	(0.9)	(0.2)
Int exp. For debt discount & converstion feature	(0.1)	(0.4)	(0.1)	(0.1)	(0.4)	(0.4)	-	-	(0.7)	(0.7)	-
Change in fair value of conversion feature	-	-	-	0.3	0.5	-	-	-	0.3	0.5	-
Change in fair value of warrant liabilities	0.2	0.1	-	(0.4)	-	-	-	-	-	-	-
Loss on extinquishment of debt	2.5	-	-	-	-	-	-	-	2.5	-	-
Other income	(1.2)	0.2	0.1	0.0	0.2	-	-	-	(0.9)	0.2	-
Amortization of deferred financing costs	(0.1)	(0.4)	(0.0)	(0.0)	(0.1)	-	-	-	(0.5)	(0.1)	-
Total other income	1.1	(1.0)	(0.3)	(0.5)	(0.0)	(0.3)	(0.3)	0.0	(0.7)	(1.0)	(0.2)
Income before income taxes	(2.2)	9.6	(4.1)	(7.1)	(4.3)	(2.9)	(2.2)	(1.6)	(5.0)	(10.8)	(0.9)
Provision for income tax	(0.1)	0.1	0.0	0.0	0.0	-	-	-	0.0	0.0	-
Tax rate	3%	1%	0%	0%	0%	0%	0%	0%	0.0%	0.0%	0.0%
Net income	(2.1)	9.5	(4.2)	(7.0)	(4.3)	(2.9)	(2.2)	(1.6)	(5.0)	(10.8)	(0.9)
Currency translation	(1.7)	0.5	-	(1.5)	0.3	-	-	-	(2.7)	-	-
Comprehensive loss	(3.8)	10.0	(4.2)	(8.5)	(4.0)	(2.9)	(2.2)	(1.6)	(7.7)	(10.8)	(0.9)
Stk based compensation	0.8	0.8	0.9	1.0	0.9	0.8	0.8	0.8	3.5	2.7	2.7
One-time expenses	(2.5)	(15.3)	(0.2)	3.0	0.6	-	-	-	3.9	-	-
Non-GAAP Income	(5.5)	10.3	(3.2)	(3.1)	(2.7)	(2.2)	(1.4)	(0.8)	(1.6)	(7.1)	1.8
Yr-over-Yr				-701%					-92.5%	NM	NM
Net income per share:											
Basic	**(0.01)**	**0.06**	**(0.03)**	**(0.04)**	**(0.03)**	**(0.02)**	**(0.01)**	**(0.01)**	**(0.03)**	**(0.07)**	**(0.01)**
Diluted	(0.01)	0.04	(0.02)	(0.03)	(0.02)	(0.01)	(0.01)	(0.01)	(0.02)	(0.05)	(0.00)
Non-GAAP Primary	**(0.04)**	**0.07**	**(0.02)**	**(0.02)**	**(0.02)**	**(0.01)**	**(0.01)**	**(0.00)**	**(0.01)**	**(0.04)**	**0.01**
				90%	-47%	-122%	-56%	-74%			
Shares											
Basic	154.9	156.4	160.2	161.6	162.9	164.1	168.0	170.0	158.2	166.2	170.0
	9.2%	6.8%	7.2%	6.6%	5.2%	4.9%	4.9%	5.2%	7.1%	5.1%	2.3%
Diluted	226.8	226.9	216.1	214.7	212.5	213.7	217.6	219.6	221.1	215.9	219.6
				-4.4%	-6.3%	-5.8%	0.7%	2.3%	48.2%	-2.4%	1.7%
Bookings	$4.5	$17.9	$4.1	$3.2	$3.3						
Adjusted EBITDA	2.30	2.19	(1.21)	(1.29)	(2.37)	(0.76)	(0.13)	0.14	1.99	(3.12)	4.01
Cap EX	1.51	2.60	2.61	0.98	0.77	0.50	2.00	2.00	7.71	5.27	4.50
Free cash flow	0.79	(0.41)	(3.83)	(2.27)	(3.14)	(1.26)	(2.13)	(1.86)	(5.72)	(8.38)	(0.49)

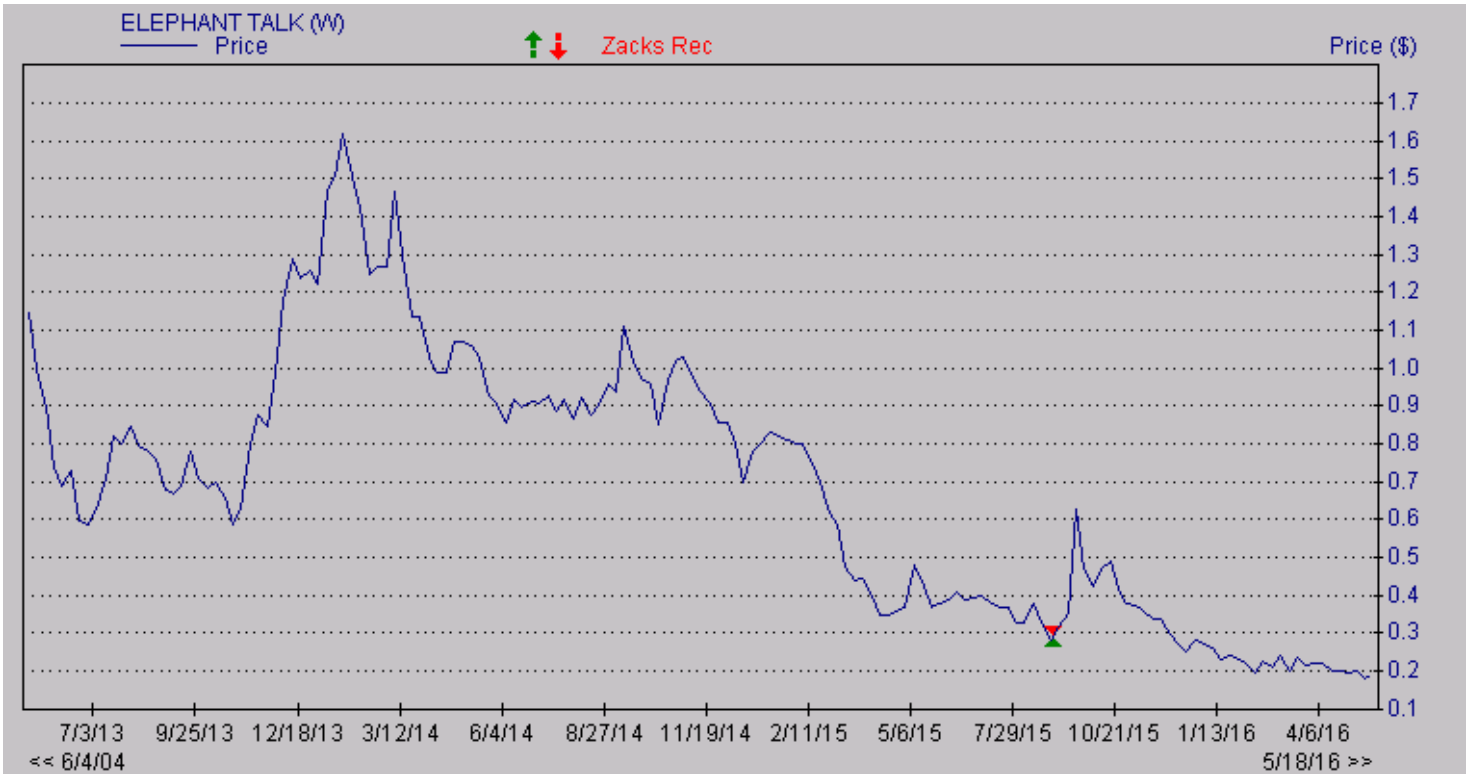
BALANCE SHEET

	March 31, 2016	Dec 31, 2015	% Change
CURRENT ASSETS			
Cash and cash equivalents	**$406,509**	**$369,250**	10%
Financing receivable	**0**	**272,425**	-100%
Restricted cash	**249,253**	**246,151**	1%
Accounts receivable	1,125,868	1,112,032	1%
Prepaid expenses and other current assets	1,877,894	2,016,236	-7%
Total current assets	3,659,524	4,016,094	-9%
NON-CURRENT ASSETS			
OTHER ASSETS	373,644	473,893	-21%
PROPERTY AND EQUIPMENT, NET	12,973,465	13,051,375	-1%
INTANGIBLE ASSETS, NET	210,685	258,630	-19%
ASSETS HELD FOR SALE	4,695,132	4,564,972	3%
GOODWILL	3,144,370	3,027,422	4%
TOTAL ASSETS	25,056,820	25,392,386	-1%
CURRENT LIABILITIES			
Accounts payable and customer deposits	3,177,360	2,639,863	20%
Obligations under capital leases (current portion)	185,600	310,403	-40%
Deferred Revenue	1,307,350	1,259,545	4%
Change in deferred revenues	**47,805**	**(711,605)**	-107%
Accrued expenses and other payables	4,374,097	5,031,712	-13%
Advanced payment on "Assets held for Sale"	700,000	0	NM
2014 10% + libor 3rd Party Loan	**5,629,681**	**5,580,277**	1%
Total current liabilities	15,374,088	14,821,800	4%
LONG TERM LIABILITIES			
Derivative Liabilities	1,972,261	945,618	109%
Non-current portion of obligation under capital leases	0	5,621	-100%
Other long term loan	0	0	
Non-current portion of deferred revenue	1,093,452	1,066,687	3%
Other long term liabilities	255,552	260,290	-2%
9% Sub Conv Promissory Note	**968,358**	**238,829**	305%
Total long term liabilities	4,289,623	2,517,045	70%
Total liabilities	19,663,711	17,338,845	13%
Commitments and Contingencies (See Notes)			
STOCKHOLDERS' EQUITY			
Common Stock	270,784,151	269,470,165	0%
Accumulated other comprehensive income (loss)	(5,448,761)	(5,789,975)	-6%
Accumulated deficit	(259,949,321)	(255,635,531)	2%
Elephant Talk Communications, Corp. stockholders' equity	5,386,069	8,044,659	-33%
NON-CONTROLLING INTEREST	7,040	8,882	-21%
Total stockholders' equity	5,393,109	8,053,541	-33%
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$25,056,820	$25,392,386	-1%
Current and Quick Ratio	0.2	0.3	-12%
Working Capital	(11,714,564)	(10,805,706)	8%
Total Debt	7,298,039	5,819,106	25%
TD/TA	29%	23%	27%

CASH FLOW

	31-Mar-15	30-Jun-15	30-Sep-15	31-Dec-15	YR 2015	31-Mar-16
CASH FLOWS FROM OPERATING ACTIVITIES:						
Net loss	(2,125,173)	9,521,918	(4,156,337)	(8,246,643)	(5,006,235)	(4,313,790)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:						
Depreciation and amortization	1,746,147	1,745,034	1,781,478	1,351,326	6,623,985	1,097,604
Provision for doubtful accounts	8,184	17,230	(25,414)	269,608	269,608	-
Stock based compensation	831,813	752,510	937,101	960,484	3,481,908	944,024
Change in fair value of warrant liability	(246,702)	(149,203)	-	95,957	(299,948)	(518,986)
Amortization of deferred financing costs	62,502	362,845	41,224	46,986	513,557	136,929
Interest expense relating to debt discount and conversion feature	63,972	403,679	125,086	89,652	682,389	351,799
Unrealized foreign currency translation gain (loss)	1,191,270	(155,252)	(82,760)	(30,364)	922,894	(221,640)
Extinguishment of Debt	(2,475,799)	-	4,951,598	(4,951,598)	(2,475,799)	-
Impairments for assets held and used	-	937,835	-	1,743,572	2,681,407	-
	(943,786)	13,436,596	3,571,976	(8,671,020)	7,393,766	(2,524,060)
Changes in operating assets and liabilities:						
Decrease (increase) in accounts receivable	(5,983,834)	10,289,300	994,422	1,266,611	6,566,499	35,624
Decrease (increase) in prepaid expenses, deposits and other assets	489,564	610,503	(112,891)	(227,901)	759,275	59,993
Increase (decrease) in accounts payable and customer deposits	626,729	1,401,175	(207,308)	807,149	2,627,745	571,047
Increase (decrease) in deferred revenue	2,981,659	(11,871,208)	17,896,808	(18,760,484)	(9,753,225)	(136,050)
Increase (decrease) in accrued expenses and other payables	296,266	(1,037,134)	(447,693)	2,574,336	1,385,775	78,570
Net cash provided by (used in) operating activities	(3,477,188)	13,773,018	25,267,290	(31,682,329)	16,373,601	(4,438,936)
CASH FLOWS FROM INVESTING ACTIVITIES:						
Purchases of property and equipment	**(1,511,179)**	**(2,602,129)**	**(2,612,460)**	(984,204)	**(7,709,972)**	**(765,955)**
Net cash used in investing activities	(1,511,179)	(2,602,129)	(2,612,460)	(984,204)	(7,709,972)	(765,955)
CASH FLOWS FROM FINANCING ACTIVITIES:						
Financing related fees	-	(67,445)	(83,223)	150,668	-	-
Financing receivable	2,000,000	-	0	(355,000)	1,645,000	355,000
Exercise of warrants and options	5,861	-	0	-	5,861	-
Equity and debt issuance costs paid			0	(532,558)	(532,558)	(360,249)
Principal payment on 2014 10% LIBOR 3rd Party Loan		(9,927,333)	4,427,333	-	(5,500,000)	(85,000)
Proceed from 9% Unsecured Sub Convertible Note	-	-	-	1,275,000	1,275,000	2,273,000
Advanced payment on "Assets held for sale"						450,000
Net cash provided by financing activities	2,005,861	(9,994,778)	4,344,110	538,110	(3,106,697)	2,182,751
		-				
EFFECT OF EXCHANGE RATES ON CASH AND CASH EQUIVALENTS	1,129,253	5,507	(834,462)	1,626	301,924	85,339
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(1,853,253)	2,524,888	26,164,478	(32,126,797)	(1,534,910)	(2,936,801)
CASH AND CASH EQUIVALENTS, BEGINNING OF THE PERIOD	1,176,650	994,693	1,232,525	858,911	1,904,160	369,250
CASH AND CASH EQUIVALENTS, END OF THE PERIOD	994,693	1,232,525	858,911	369,250	369,250	(2,567,551)
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:						
Cash paid during the period for interest	359,521	506,911	269,589	(237,322)	1,136,021	233,864
Cash paid during the period for income taxes	14,246	235	290	55	14,771	-

HISTORICAL STOCK PRICE



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