Zacks Small-Cap Research

September 26, 2013

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FAB Universal Corp. (NYSE MKT: FU)

FU: FAB Signs Two Major Deals- Outperform

Current Recommendation	**Outperform**
Prior Recommendation	N/A
Date of Last Change	05/13/2013
Current Price (09/25/13)	$9.70
Target Price	**10.00**

OUTLOOK

FAB Universal Corporation is a distributor of global digital media worldwide. The company serves its customers through three segments including: Retail, Wholesale and Digital Media. We feel that no other stock provides the investor the unique blend of several high growth businesses that range from podcasting to Kiosk. FAB is the only company in China that uses Kiosk as a digital content distribution platform. Podcast growth has been very strong and could contribute $1 million to the bottom-line in 2013. Finally the firm should see margin expansion in the coming quarters as the fastest growing segments also have the highest margin contribution.

SUMMARY DATA

52-Week High	**$9.70**
52-Week Low	**$2.43**
One-Year Return (%)	**98.36**
Beta	**0.64**
Average Daily Volume (sh)	**1,359,842**
Shares Outstanding (mil)	**21**
Market Capitalization ($mil)	**$202**
Short Interest Ratio (days)	**1.74**
Institutional Ownership (%)	**3**
Insider Ownership (%)	**5**
Annual Cash Dividend	**$0.00**
Dividend Yield (%)	**0.00**
5-Yr. Historical Growth Rates	
Sales (%)	**43.9**
Earnings Per Share (%)	**N/A**
Dividend (%)	**N/A**
P/E using 2013 Estimate	**10.2**
P/E using 2014 Estimate	**7.6**
Zacks Rank	**1**

Risk Level	**Moderate**
Type of Stock	**Small-Value**
Industry	**Media/Entertainment**

ZACKS ESTIMATES

Revenue
(in millions of $)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2012	2 A	2 A	2 A	24 A	27 A
2013	22 A	26 A	26 E	28 E	102 E
2014					135 E
2015					167 E

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

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2012	-$0.12 A	-$0.04 A	-$0.50 A	$0.11 A	-$0.34 A
2013	$0.15 A	$0.28 A	$0.25 E	$0.28 E	$0.95 E
2014					$1.27 E
2015					$2.02 E

Estimates use basic shares, valuation discussion uses diluted shares

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WHATS NEW

FAB Signs Two Deals

On September 24, 2013 FAB entered into an agreement with Future TV Co. Ltd. to distribute its copyright-protected media content through pay TV terminals used in the home by Future TV's subscribers.

Under the terms of the agreement, FAB will provide copyright protected content including high-definition video, music lessons, children's programs, and other educational and related programming. Future TV will integrate the content provided by FAB Universal with its operational platform and manage subscriber payments.

On September 17, 2013, FAB Universal, the distributor of digital entertainment, reported it secured music distribution rights from the top 3 mobile phone service providers in China.

The agreements to distribute its copyright-protected digital music content through China Unicom, China Mobile and China Telecom expands FAB's distribution platform and increases the quantity and variety of its content.

Additionally, by allowing FAB to add a mobile phone channel to its distribution platform, the agreements further leverage the company's exclusive and acquired copy-right protected digital music content and also reaches new customers for its catalog of FAB-branded digital media and entertainment content.

Digital Powers Growth at FAB Universal

On August 14, 2013, FAB Universal, reported its second quarter and six month financial results for the period ended June 30, 2013.

Revenues for the second quarter rocketed to $25.857 million, an increase of $24.987 million over revenues of $870,164 for the three months ended June 30, 2012. Sequentially, revenues improved by $3.221 million from revenues of $22.636 million for the three months ended March 31, 2013.

The jump in year over year revenues was well above management's guidance of between $23.4 million and $23.9 million and was led by continued gains from FAB's fast-growing, high-margin digital segment, which includes its Intelligent Media Kiosk business.

FAB kiosks, located in high-traffic areas of office buildings, shopping malls, retail stores and airports, are self-service terminals that provide a range of entertainment and consumer applications. The company continued to expand its network of Intelligent Kiosks during the second quarter, adding over 2,000 for a current total of nearly 16,000 Kiosks and 5C brand licensees in 40 cities throughout China.

Similarly, there is ample room to expand its network of Intelligent Kiosk by adding new locations in the cities in which FAB already operates and establishing a presence in the other 120 cities in China with a population of over 1 million people.

As a result, management intends to continue to aggressively build out its network during the second half of the year.

Revenue for the wholesale business unit was $14.0 million for the second quarter of 2013 compared to none in the year ago period and $13.8 million for the first quarter of 2013. Revenue for the digital business unit was $9.6 million for the second quarter of 2013 compared to $0.9 million for the second quarter of 2012 and $6.9 million for the first quarter of 2013. Revenue for the retail business unit was $2.3 million for the second quarter of 2013 compared to none in the comparable period of 2012 and $2.0 million for the first quarter of 2013.

Gross profit jumped year over year by $10.987 million to $11.494 million for the second quarter resulting in gross margin of 44.5 percent up sequentially from 37 percent for the first quarter fiscal 2013. The improvement in gross margin was driven by the increased mix of digital revenue and tighter control of cost of revenue from both the wholesale and podcasting businesses.

Net Income for the second quarter jumped to $5.729 million. This third consecutive quarter of solid profits was up sequentially from $3.003 million for the three months ended March 31, 2013 and year over year from a net loss of ($330,139) for the second quarter of 2012.

Based on a weighted average number of basic and diluted common shares of 20.761 million, basic and diluted net income per share resulted in net income of $0.28 per share for the second quarter fiscal 2013. This compares to a basic and diluted net loss per share of $0.04 on a weighted average number of basic and diluted shares of 8.658 million during the three months ended June 30, 2012 and to net income per share of $0.15 on 20.628 million basic and diluted common shares for the first quarter 2013.

It should be noted that variances in FAB's reported results is almost entirely due to the acquisition of Digital Entertainment International Ltd. (DEI) in September 2012.

DEI is engaged in marketing and distributing various officially licensed digital entertainment products under the "FAB" brand throughout the PRC. Its products and services are primarily distributed through its flagship stores, wholesale services, proprietary "FAB" kiosks, and online virtual stores.

The balance sheet remained strong with cash of $27.675 million and working capital of $19.138 million as of June 30, 2013. This compares to cash of $29.768 million and working capital of $19.634 million at the end of the first quarter 2013.

Additionally, the company generated approximately $10 million in operating cash flows during the quarter, equaling the first quarter's cash generation and doubling the $5 million of cash generated in the fourth quarter of 2012.

FAB has a strong foothold in the explosive growth of the entertainment industry in China, which is being propelled by the increasing spending tower of a rising middle class and the government stated plans for the industry to become a major economic growth engine over the next few years.

With its strong brand recognition and distribution base, FAB is perfectly situated to capitalize on the industry's rapid growth, by expanding its distribution network, driving more content through the network, and extending its market leadership and brand strength, all the while positioning the company to take advantage of the increasing rate of internet penetration and expanding internet infrastructure in China.

As a result, management continues to expect to generate between $98.9 million to $102.6 million of revenue and net income of $19.3 million to $20.1 million for the full year.

Does Rogers Presence on the Board Legitimize the Business Model?

FAB Universal (FU), the worldwide distributor of digital entertainment, announced that the international financier and Quantum Fund co-founder, Jim Rogers, was named to the board of directors of FAB Universal.

On June 19, 2013 Mr. Rogers filed SEC form 4 papers to disclose he had purchased an additional 10,000 shares priced at $3.50. This brings his current total holdings in the firm to 19,060 shares.

Mr. Rogers made from a special visit to FAB's Beijing offices where he inspected FAB's wholesale, retail, kiosk, talent management and live performance businesses. The partnership was a natural given that Rogers has stressed on many occasions his long-term belief in the digital media and entertainment industry in China.

Background
The famous investor, financial professor, author and "father of Austria Stock Market", has been praised by those including the legendary investor Warren Buffett. Mr. Rogers graduated with a bachelor's degree in History from Yale University in 1964. He then acquired a second BA degree in Philosophy, Politics and Economics from Balliol College, Oxford University in 1966. In 1998, Rogers founded the Rogers International Commodity Index. In February 2011, Rogers announced that he has started a new index fund that focuses on "the top companies in agriculture, mining, metals and energy sectors as well as those in the alternative energy space including solar, wind and hydro." The index is called The Rogers Global Resources Equity Index and according to Rogers, only the best and most liquid companies go into the index.

He was the Co-founder of the Quantum Fund with George Soros, which famously returned 4,200% to investors in the first 10 years. (The S&P only mustered up a 47% gain over the same period.)

Takeaway
Clearly Rogers has an impressive track record, but what is the takeaway? What does his pickup of shares and placement of the board mean to investors? The Answer is simple. **He sees trends before others do.** His investments all have that in common. He has been ahead of the game whether it is selling banks in 2006 or calling the commodities market correctly several times this decade. It legitimizes the business model just as we wrote in the following pages.

Recall the point we made in our initiation of FAB on June 4, 2013.

The firm has four things that separate it from the pack in our opinion.

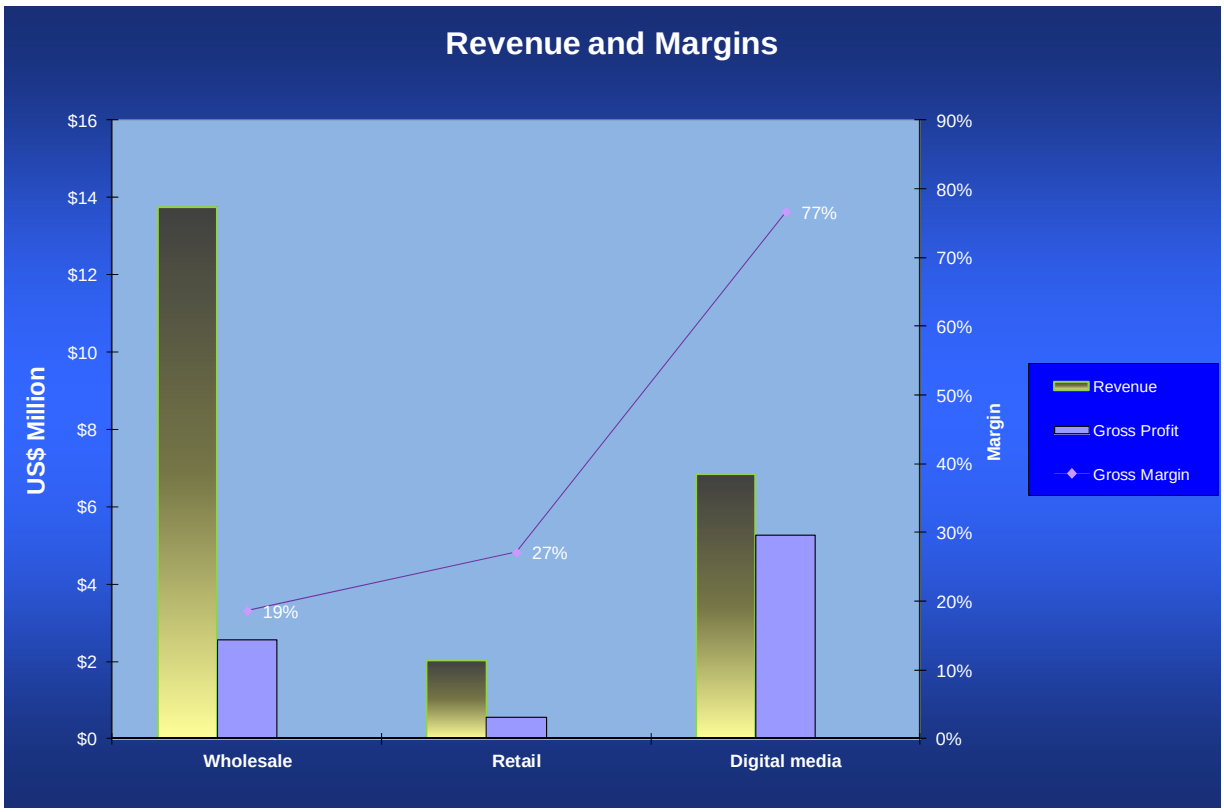
- Explosive Top-Line growth potential
- Exclusivity in Kiosk and Podcast
- Margin Growth
- Markets where they are in the sweet spot of the statistics, such as
    - Internet growth in Asia
    - Download Content Worldwide
    - Disposable income growth in China

KEY POINTS

- FAB's retail division carries the largest selection of copyright protected audio and video products in China, including CDs, VCDs, DVDs, blu-rays, books, magazines and portable electronic devices.
- Currently, FAB is the only company in China that uses a Kiosk as a digital content distribution platform.
- The Company's objective is for the number of licensees and installed network count to double and membership card holders to jump to 1 million in three years.
- Liberated Syndication (libsyn) pioneered a system to host and monetize podcasting in 2004. By 2012 Libsyn had hosted over 13,000 shows with over 1.6 billion downloads and 28 million audience members.
- Libsyn hosts several big name podcast producers such as Adam Carolla and Marc Maron as well as small start-ups. The goal is for Libsyn to generate $1 million in profits this year.

OVERVIEW

FAB Universal Corporation is a distributor of global digital media. The Company serves its customers through three segments including: Retail Media, Wholesale Media and Digital Media. Libsyn, which is a subsidiary of Digital Media operates podcast hosting technology. On April 5, 2012 FAB signed an official share exchange agreement with Wizzard Software Corp. The acquisition closed September 26, 2012 and the new company became FAB Universal (ticker symbol NYSE MKT: FU).

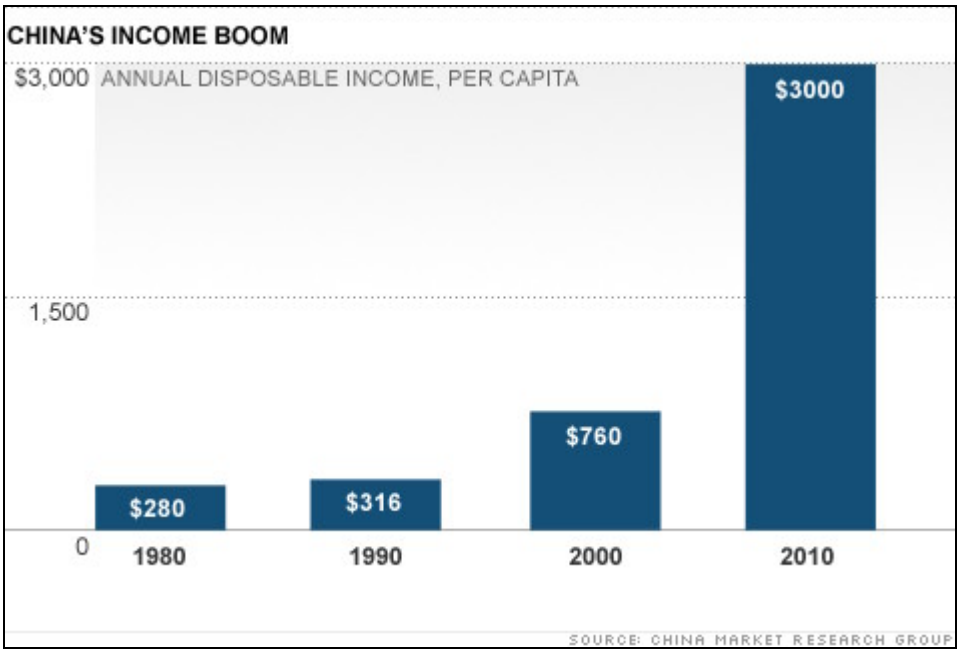


Retail Media
Retail business is conducted through its flagship stores. One is located in the Joy City shopping mall and the other is an entertainment superstore in SoShow. Each store is over 20,000 square feet in size and carries one of the largest selections of copyright protected audio and video products in China, including CDs, VCDs, DVDs, blu-rays, books, magazines and portable electronic devices. The flagship stores are recognized by many Chinese consumers as the most trusted place to buy copyright protected products. The corporate goal is to go from 2 flagship stores to 6 stores over three years and perhaps as many as 200 smaller stores.

FAB has regularly used celebrity signing events as a major driver to FAB's retail stores. This is a popular venue for Chinese music and movie stars to meet their fans. Recently stars from outside mainland China, from Hong Kong, Taiwan, Korea and Japan, wishing to enter the Chinese market have chosen FAB as their launching platform. These events not only promote sales of audio-video products but also increase FAB's brand recognition.

What makes this a high growth segment is the growth of the Chinese middle class and their disposable income. China continues to transform much of its population and economy from poverty to a middle class environment. The urban population has doubled from 302 million in 1990 to 622 million in 2009 and is projected to approach one billion by 2025. There were 40 large cities that had more than one million residents in 2000. That number tripled to 122 in 2008. The Economist Intelligence Unit (EIU) forecasts that there will be more than 200 large cities by 2025. Rapid urbanization calls for an integrated modern transportation system, and China's government has responded with intense investment in infrastructure. According to ChinaView.com, China built six new airports in 2009, bringing the total number to 166 as of last December. Naturally the internet has gone through a modernization as well.

The average disposable income of urban Chinese households rose to around $3,000 per capita in 2010, according to an analysis of official government statistics by China Market Research Group. That means a typical family of three earns around $9,000 a year.



The college campus market in China represents approximately RMB300 billion of the consumer market each year. There are 30 million college students, with an annual increase of 7 million new students, making it one of the largest stable consumer groups in the world. Behind each of the students there are more Chinese households, with nearly one hundred million consumption power.

Wholesale
The wholesale business provides audio-video products such as compact discs, video compact discs and digital video discs as well as books and magazines to audio-video product retailers. FAB distributes these media products to over 80 customers. FAB's wholesale business caters to three types of customers: large retail stores, FAB license stores and small wholesale/resellers. Customers place orders by telephone, through the internet or in-person and fulfillment is handled by FAB's vehicle fleet or through direct warehouse access.

The Changing Landscape of Entertainment (partial source filmmaking.net)
Just as VHS and DVD once looked threatening to the movie industry, the internet threatens to change distribution once again. The industry is seeing P2P/IP TV as the new TV, download-to-own as the new DVD, and worldwide-synchronous online releases as the new cinema. In the past when the industry viewed new technology as a threat, that very threat ended up increasing sales.

The internet does not only represent a threat (piracy) but rather an opportunity to reach bigger audiences with more product, more quickly for far less cost. Think of the cost benefit of taking DVD's out of the supply chain. Several insiders also point to built-in marketing tools like peer-review and recommendations, and brand new methods for taking advantage of old revenue sources such as advertising.

Desire for Cinema and programs have not changed - just how we choose to access it. And we now have plenty of choices. Download services are re-populating our distribution landscape, giving rise to many exciting new opportunities. The early pioneers in content delivery are iTunes, Netflix, Amazon.com, Sony Playstation, and Microsoft Xbox.

Digital Media
Kiosks/Licensing-The company's Intelligent Media Kiosks, based on 61 proprietary intellectual property rights, are ATM style terminals where consumers can download copyright protected music, video games, ringtones, digital books and movies directly to their cell phones, memory sticks or other mobile storage devices. The Kiosks also run video ads on the high-tech LCD screens and accept payments for utility bills, and credit card bills. Currently, FAB is the only company in China that used Kiosk as a digital content distribution platform. Similarly, the company's 5C intelligent media kiosks have now expanded to 40 cities with around 8,400 licensees and an installed network count approaching 12,500 Intelligent Media Kiosks.



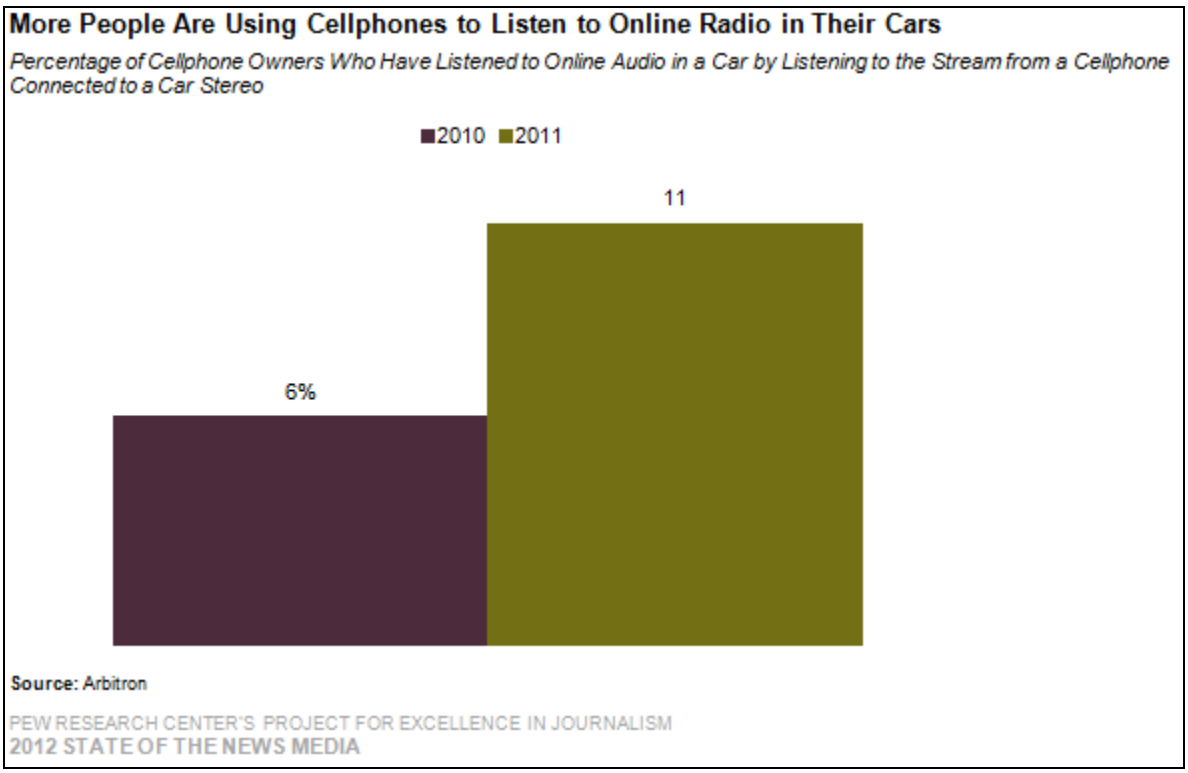
Kiosk produces revenues through membership cards, advertising fees, and agent and franchise fees. This segment enjoys the highest margins in the company at approximately 84%. The corporate goal for Kiosk is double the amount of machines from 12,500 today to 25,000 over three years. FAB has more than 350,000 membership cardholders. The company's objective is for the number of licensees and installed network count to double and membership card holders to jump to 1 million in three years.

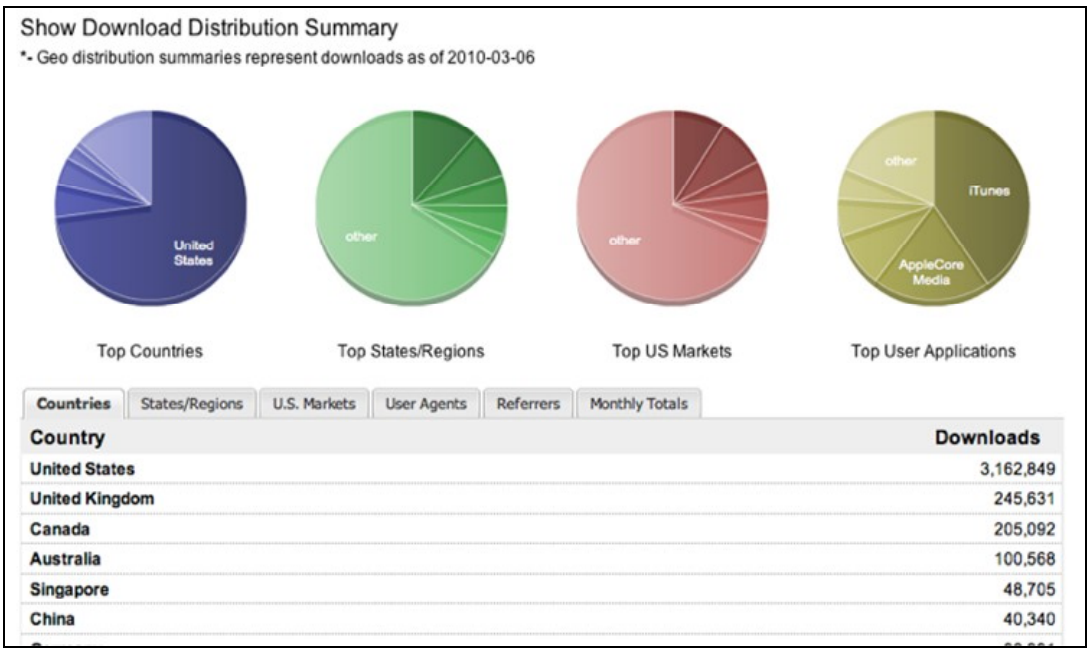
Podcasting - FAB provides a web based podcast distribution platform for podcast producers wanting to broadcast their audio or video shows to people worldwide, in most cases through RSS distribution. FAB's podcast hosting service accumulates and provides audience statistics as well as advertising sales, ad insertion and App creation and sales to help podcasters generate revenue. Throughout 2012, Libsyn had approximately 50 million total audience members and 1.6 billion download requests for podcast episodes.

Podcast has shown explosive growth. Unique monthly audiences have experienced accelerated growth from 20 million people in the first quarter of 2012 to 28 million people in the first quarter of this year. The 40% increase is a result of the addition of 8 million podcast audience members enjoying podcasts from 240 countries around the world on the Libsyn Network each and every month.

More shows are now being distributed to mobile devices than to traditional PC's. Media distribution to mobile devices such as iPhones and iPads demonstrate a fundamental shift away from the traditional method of downloads via iTunes to the PC. This fundamental catalyst represents a significant opportunity for monetization of podcasts through advertising due to the fact that these mobile downloads can now be tracked in the same manner as streaming video content from a website like YouTube. This type of tracking was not possible before this shift in audience consumption habits.

FAB Universal, the parent company of Libsyn, is looking for Libsyn to generate $1 million of profit this year, a first for the podcast division.



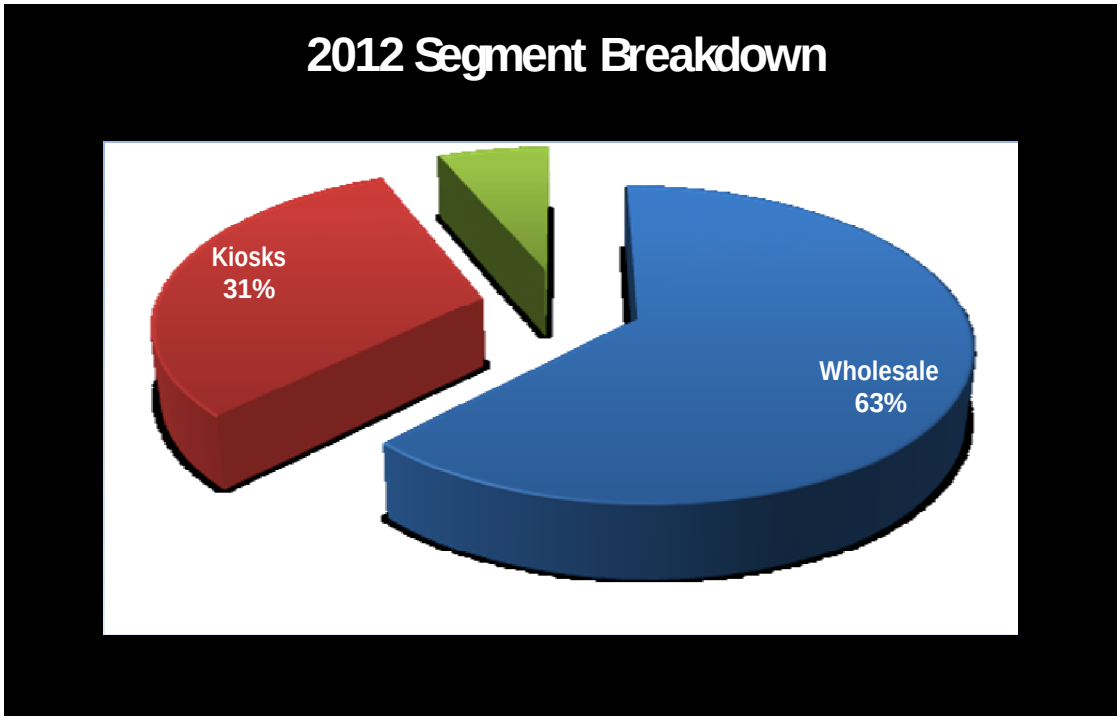


According to a recent Edison Research Study on the Podcast Consumer, awareness of Podcasting has grown 105% since 2006 from 22% in 2006 to 45% in 2012. Likewise, the percentage of consumers indicating they have listened to an audio podcast has grown 163% from 11% in 2006 to 29% in 2012.

WORLD INTERNET USAGE AND POPULATION STATISTICS						
World Regions	Population (2009 Est.)	Internet Users Dec. 31, 2000	Internet Users Latest Data	Penetration (% Population)	Growth 2000-2009	Users % of Table
Africa	991,002,342	4,514,400	65,903,900	6.70%	1359.90%	3.90%
Asia	3,808,070,503	114,304,000	704,213,930	18.50%	516.10%	42.20%
Europe	803,850,858	105,096,093	402,380,474	50.10%	282.90%	24.20%
Middle East	202,687,005	3,284,800	47,964,146	23.70%	1360.20%	2.90%
North America	340,831,831	108,096,800	251,735,500	73.90%	132.90%	15.10%
Latin America/caribbean	586,662,468	18,068,919	175,834,439	30.00%	873.10%	10.50%
Oceania/Austraila	34,700,201	7,620,480	20,838,019	60.10%	173.40%	1.20%
World Total	**6,767,805,208**	**360,985,492**	**1,668,870,408**	**24.70%**	**362.30%**	**100.00%**

*source: World Internet Stats

In our opinion the internet is still growing and has a relatively low 24.7% penetration rate compared to the population. Especially if one considers Asia which has approximately 56% of the world's population yet remains only 18.5% penetrated. Another trend to consider in assessing the FAB growth rate is the explosion of handheld devices such as iPhones and iPads. There are in effect more and more devices being connected and each new connection is a new element in the chain.



Margin Expansion
From a margin standpoint the division expected to grow the fastest (Kiosk) has the highest corporate margin ranging from 75-84%. Retail is next with a margin range of 26-27% and Wholesale is the lowest margin business at 18-20%. Looking at expected growth rates margin expansion should be a part of the story.

	% Current Revenue	Growth Rate	Gross Margin Range
Wholesale	62%	Slower	18-20%
Retail	7%	Moderate	26-27%
Kiosk	31%	High	80-84%

Leadership

Hongcheng Zhang, Chairman of the Board of Directors
Mr. Zhang has 24 years experience in digital entertainment product publishing and distribution industry in China. He serves as the Vice President of China Audio & Video Association, Member of Copyright Society of China, Chairman of National Anti-Piracy Commonwealth, Chairman of the China Digital Education Industry Alliance, Executive Chairman of International Digital Culture Industry Investment Forum. He attended China - Europe International Business School and holds an EMBA degree.

Christopher J. Spencer, CEO
Christopher has served as the CEO and president of Wizzard Software since its founding in 1996. He is responsible for the overall direction of the company and was selected as one of the top 20 most influential individuals by Speech Technology Magazine. His business experience is widely varied, including the founding and CEO roles with ChinaWire, Inc. and Lotto USA, Inc. He attended West Virginia University.

John L. Busshaus, CFO
Prior to joining Wizzard, Busshaus acted as an independent business consultant, responsible for the implementation of Sarbanes Oxley, SEC reports filing and IPO. He once served as the Chief Financial Officer of Talanga International, and Controller and Vice President in Mellon Financial Institution.

Douglas Polinsky, Director
Douglas Polinsky has served as a Director of FAB since October 2007. Mr. Polinsky serves as the President of Great North Capital Corp., a Minnesota-based financial services company he founded in 1995. Great North advises corporate clients on capital formation and other transaction-related financial matters. Mr. Polinsky earned a Bachelor of Science degree in Hotel Administration at the University of Nevada at Las Vegas.

Greg Smith, Director
Greg Smith has served as a Director of FAB since October 2007. Mr. Smith is an award-winning producer and entrepreneur with over 10 years of experience in Non-Fiction Television. In 2000, Mr. Smith established The Solution Film Group, LLC and acts as the Company's President. Mr. Smith provides professional production and editorial support for various forms of non-fiction television entertainment, including the direction of media projects from development through production and post-production. His clients include Discovery Channel, Science Channel, Discovery HD Theater, Animal Planet, The Military Channel, PBS, and Discovery Networks International. Mr. Smith most recently won an Emmy in 2006 for the Discovery Channel's animated special Before the Dinosaurs. His other awards for excellence in production and editing include Emmys for the Discovery Channel's Walking with Prehistoric Beasts and Allosaurus: A Walking with Dinosaurs Special. From 1997 to 2000, Mr. Smith worked for Discovery Communications, Inc. in the capacity of Supervising Producer from January 1998 to November 2000, and Producer/Editor from October 1997 to January 1998. From 1995 to 1996, Mr. Smith worked for Discovery Channel Pictures serving as Assistant Editor from March 1996 to October 1997, and Production Assistant from September 1995 to March 1996. From 1994 to 1995, Mr. Smith worked for Crawford Communications in Atlanta, Georgia as a Manager of Satellite Services for The Learning Channel.

Denis Yevstifeyev, Director
Denis Yevstifeyev has served as a Director of FAB since October 2007. Mr. Yevstifeyev currently serves as the Director of Financial Planning & Analysis for Education Management Corporation – Online Higher Education. From 2007 to 2008, Mr. Yevstifeyev served as Sr. Financial Reporting Analyst for American Eagle Outfitters, Inc, in Pittsburgh. His duties included: preparing and analyzing various internal and external financial reports; researching new accounting pronouncements and evaluating any impact on the financial statements. He also reviewed accounting work papers and prepared the company's SEC filings for forms 8-K, 10-Q and 10-K. From 2005 to 2007, Mr. Yevstifeyev worked for Schneider Downs, Inc., where he worked on Sarbanes-Oxley compliance engagements. In 2005, Mr. Yevstifeyev graduated with a Bachelor of Science degree in Business from Washington and Jefferson College. He also graduated with honors from the Moscow Bank College of the Central Bank of Russia in Moscow with a degree in Finance in 2000. From 2002 to 2003, Mr. Yevstifeyev served as the Settlement Department Manager for SDM BANK in Moscow, where he dealt with domestic and international corresponding banks, among other responsibilities.

Gu Jansen, Director
Gu Jansen has served as a Director of FAB since September 2012. Ms. Gu is a musician who has served as a composer at Central Song and Dance Ensemble. She has been a council member for several international organizations, including the China International Cultural Exchange Center, Association for Promoting Peaceful Reunification of China, and Beijing Municipal Association for Friendship with Foreign Countries. Ms. Gu has been recognized by several organizations for her compositions. She won an Excellent Work Award of Asian & Pacific Region, sponsored by UNESCO. She was elected vice-president of the Chinese Musicians Association in 1999. Ms. Gu graduated from the Composition Department of Northeast Music School.

Does Rogers Presence on the Board Legitimize the Business Model?

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- Margin Growth
- Markets where they are in the sweet spot of the statistics, such as
    - Internet growth in Asia
    - Download Content Worldwide

- Disposable income growth in China

INDUSTRY OUTLOOK

Media and Entertainment

The ongoing shift to online and mobile distribution of content is significant across the sector. Mobility, in particular, changes everything. The opportunities to engage the consumer — to have almost instantaneous distribution and to provide an integrated experience — are immense and market-shifting. Continuing to enhance the user experience and create new business models addressing changing consumption patterns will be significant challenges.

The proliferation of new devices and customer segments that increasingly span multiple platforms open up new ways for engaging with and understanding consumers. A recent Deloitte study showed that nearly 48 percent of U.S. consumers who own tablets report taking their tablet rather than laptop on overnight trips. With tablets, we now have a mobile platform that has high-resolution capabilities in larger form factors that can deliver a high-quality customer experience — something that didn't even exist a few years ago.

Between the multitude of platforms, increased personalization and understanding of consumer preferences, it is possible to deliver media to customers in a variety of ways, which creates opportunities for new targeting and content pricing models. These new models will have to take into account the user experience, expectations (for a given platform), and preferences, and perceptions of value. As franchises extend across platforms, media and entertainment companies have to ask themselves: What pricing structure will meet each market's expectations without devaluing the brand?

Worldwide devices spending which includes PCs, tablets, mobile phones and printers, is forecast to reach $666 billion in 2013, up 6.3 percent from 2012 (Gartner). However, this is a significant reduction in the outlook for 2013 compared with Gartner's previous forecast of $706 billion in worldwide devices and 7.9 percent growth. The long-term forecast for worldwide spending on devices has been reduced as well, with growth from 2012 through 2016 now expected to average 4.5 percent annually in current U.S. dollars (down from 6.4 percent) and 5.1 percent annually in constant dollars (down from 7.4 percent). These reductions reflect a sharp reduction in the forecast growth in spending on PCs and tablets that is only partially offset by marginal increases in forecast growth in spending on mobile phones and printers.

INDUSTRY POSITION

The firm competes with several companies that distribute online content. FAB primarily competes with distributors of content over the Internet, including content sites, Web directories, search engines and Internet service providers. These sites compete with FAB for customers and advertising dollars. The Internet market in China is relatively new and rapidly evolving. Competition is intense and expected to

increase significantly in the future, given the fact that there are no substantial barriers to entry in the market.

The firm competes on the basis of:

- Technological advancements
- Brand recognition
- Strategic relationships;
- Quality of services;
- Effectiveness of sales and marketing efforts;
- Pricing.

FAB's competitors may have certain competitive advantages such as substantially greater financial and technical resources or greater brand recognition among Internet users;

VALUATION

FAB remains well positioned to achieve solid revenue growth and operating leverage as, digital media is distributed over a variety of devices given the company's competitive advantage led by innovation.

The firm has four things that separate it from the pack in our opinion.

- Explosive Top-Line growth potential
- Exclusivity in Kiosk and Podcast
- Margin Growth
- Markets where they are in the sweet spot of the statistics, such as
    - Internet growth in Asia
    - Download Content Worldwide
    - Disposable income growth in China

We don't see another stock in the space that exposes the investor to such a rich collection of growing businesses. While the firm has the difficult task of bringing these business units together under one roof, we see it as a solid risk reward opportunity.

FAB is set to increase the share count as preferred shares will be convertible into common shares in three tranches. The shares will be issued to Digital Entertainment International (DEI) as part of an agreed upon arrangement. The issue will add shares of 14,689,444, shares of 5,488,364 and shares of 7,484,132. It will bring the share count to approximately 48.5 million shares. In valuing FAB we use diluted shares outstanding.

Valuation
To value the firm we assume FAB takes a moderate share of the market over the next five years and then grows at the rate of the economy after that. We assumed all future dilutive securities are exercised and outstanding. (Source for background info: Investment Valuation; Aswath Damodaran)

Two Stage Free Cash Flow to Equity Model

FCFE = Net Income - Net Capital Expenditure - Change in Net Working Capital + New Debt - Debt Repayment

Assumptions

- The firm is expected to grow at a higher growth rate in the first period.
- The growth rate will drop at the end of the first period to the stable growth rate.

Rationale for using the Model
As kiosks are doubled and podcast continues its explosive growth we expect the firm to grow at a rate above the growth rate of the industry. As These products and services mature and the firm faces more competition we expect the growth rate to level off.

Weakness of the Model
As you add more layers to the model it is more sensitive to the assumptions you make. The growth may look more "lumpy" than we have it in the model.

Output
We used the following inputs:

- A 5-year period with an earnings growth rate of 15% and a discount rate of 12.75%.
- A continuing period assumed to go on forever, with earnings growing at 4% and a discount rate of 10.50%.

To determnine a target price we took an average of the two stage model and a conservative Price to Earnings (P/E) ratio of 9.5x 2013 estimated EPS. With these inputs we arrive at a target price of **$10.00.**

Factoring in Dilution and applying our 2013 Net Income estimate of $19.6 million we get a P/E ratio of 25x 2013 earnings. We feel this is appropriate given the growth profile of the firm, but expansion beyond $10.00 per share in the short to medium term may not be warranted.

RISKS

- For the year ended December 31, 2012, four vendors provided 16%, 13%, 13% and 10% of the Company's purchases, respectively, one vendor accounted for 14% of the total outstanding accounts payable.

- As a component of its growth strategy, FAB intend to actively identify and acquire assets, technologies and businesses that are complementary to its existing businesses. Acquisitions could result in the use of substantial amounts of cash, potentially dilutive issuances of equity securities, significant impairment losses

- FAB's net loss available to common stockholders was $4,004,225, or $0.34 per share and $9,979,883, or $1.31 per share, for the years ended December 31, 2012 and 2011, respectively. FAB expects to incur increasing sales and marketing, as well as product development and administrative expenses.

PROJECTED INCOME STATEMENT

INCOME STATEMENT ($ Mil)	FY 2011	FY 2012	FY 2013 E	FY 2014 E	FY 2015 E
REVENUE					
Net Revenue	**3.11**	**27.46**	**101.99**	**135.00**	**167.00**
Sequential Growth					
OPERATING EXPENSES					
Cost of Revenues	1.17	16.44	58.12	80.00	97.00
% of Revenue					
Gross Profit -	**1.94**	**11.02**	**43.9**	**55.00**	**70.0**
Proforma Gross Margin	*62.4%*	*40.1%*	*43.0%*	*40.7%*	*41.9%*
SG&A	2.8	10.7	15.3	20.5	22.0
% of Revenue	*90.3%*	*38.9%*	*15.0%*	*15.2%*	*13.2%*
Depreciation and Amort	7.05	-	-	-	-
% of Revenue	*226.5%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*
Research & Development	*0.29*	*0.27*	*0.29*	3.00	*4.00*
% of Revenue	*9.2%*	*1.0%*	*0.3%*	*2.2%*	*2.4%*
Consulting Fees	*0.9*	*2.8*	*1.93*	1.0	*2.00*
% of Revenue					
Total Operating Expenses	11.05	13.77	17.51	24.50	28.00
% of Revenue	*354.7%*	*50.2%*	*17%*	*18.1%*	*17%*
Operating Income -	**(9.10)**	**(2.75)**	**26**	**30.50**	**42**
Operating Margin	*-292%*	*-10%*	*26%*	*23%*	*25%*
NON-OPERATING ITEMS					
Non operating Income/Expense	$ (0.39)	$ (0.08)	$ (0.32)	$ (0.35)	$ (0.25)
% of Revenue	*-12.43%*	*-0.29%*	*-0.31%*	*-0.26%*	*-0.15%*
Tax Provision	0.00	1.35	6.4	4.0	0.0
Effective Tax Rate	*0%*	*-49%*	*24%*	*13%*	*0%*
Net Income -	**(9.49)**	**(4.18)**	**19.6**	**26.15**	**41.8**
Net Income Margin	*-304.7%*	*-15.2%*	*19%*	*19.4%*	*25%*
Adjustments for Disc Ops	**-0.06**	**0.02**			
EARNINGS PER SHARE					
EPS - Basic	-$1.31	-$0.34	$0.95	$1.27	$2.02
EPS - Diluted	-$1.31	-$0.34	$0.95	$1.27	$2.02

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INCOME STATEMENT ($ Mil)	Mar-13 Q1 2013	Jun-13 Q2 2013	Sep-13 Q3 2013 E	Dec-13 Q4 2013 E	FY 2013 E
REVENUE					
Net Revenue	**22.64**	**25.86**	**26.00**	**27.50**	**101.99**
Sequential Growth					
OPERATING EXPENSES					
Cost of Revenues	14.26	14.36	14.50	15.00	58.12
% of Revenue					
Gross Profit -	**8.37**	**11.49**	**11.50**	**12.50**	**43.9**
Proforma Gross Margin	*37.0%*	*44.5%*	*44.2%*	*45.5%*	*43.0%*
SG&A	3.6	3.5	4.0	4.2	15.3
% of Revenue	*15.8%*	*13.6%*	*15.4%*	*15.3%*	*15.0%*
Depreciation and Amort	-	-	-	-	-
% of Revenue	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*
Research & Development	*0.07*	*0.07*	*0.07*	0.08	*0.29*
% of Revenue	*0.3%*	*0.3%*	*0.3%*	*0.3%*	*0.3%*
Consulting Fees	*0.5*	*0.4*	*0.5*	0.5	*1.93*
% of Revenue					
Total Operating Expenses	4.12	4.05	4.57	4.78	17.51
% of Revenue	*18.2%*	*15.7%*	*17.6%*	*17.4%*	*17%*
Operating Income -	**4.26**	**7.45**	**6.93**	**7.73**	**26**
Operating Margin	*19%*	*29%*	*27%*	*28%*	*26%*
NON-OPERATING ITEMS					
Non operating Income/Expense	$ (0.01)	$ (0.06)	$ (0.10)	$ (0.15)	$ (0.32)
% of Revenue	*-0.04%*	*-0.23%*	*-0.38%*	*-0.55%*	*-0.31%*
Tax Provision	1.24	1.66	1.70	1.8	6.4
Effective Tax Rate	*29%*	*22%*	*25%*	*23%*	*24%*
Net Income -	**3.00**	**5.73**	**5.13**	**5.78**	**19.6**
Net Income Margin	*13.3%*	*22.2%*	*19.7%*	*21.0%*	*19%*
Adjustments for Disc Ops	**0.00**	**0.00**			
EARNINGS PER SHARE					
EPS - Basic	$0.15	$0.28	$0.25	$0.28	$0.95
EPS - Diluted	$0.15	$0.28	$0.25	$0.28	$0.95

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HISTORICAL ZACKS RECOMMENDATIONS



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