

FARMHOUSE EQUITY RESEARCH, LLC

RESEARCH REPORT

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iMERGENT, INC. (IIG – \$14.25)

Initiating at Buy on Prospects for Small Business e-Commerce

EPS (\$)						REVENUES (\$000)			
Fiscal Year:									
June	2004A*	2005E	Prev.	2006E	Prev.		2004A	2005E	Prev.
Q1	\$0.11	\$0.14A		\$0.16		Q1	18,840	23,709A	
Q2	\$0.08	\$0.14		0.16		Q2	19,827	23,250	
Q3	\$0.12	\$0.17		0.22		Q3	19,565	25,600	
Q4	\$0.20	\$0.21		0.26		Q4	24,967	28,000	
Year	\$0.50	\$0.66		\$0.81		Year	83,199	100,559	
P/E	28.5x	21.6x		17.6x		Mkt Cap/Revs	2.1x	1.7x	

52-Week Range:	\$14.20-6.95	Proj. 3-Year Revenue Growth:	25%
Market Cap. (\$Millions):	\$175.3	Dividend/Yield:	None
Est. Shares Out. (000):	12,300	Total Cash, mils. (9/04):	\$5.6
Estimated Float (000):	10,600	Cash/Share (9/04)	\$0.46
Est. Insider Holdings:	20%	Debt/Equity (9/04)	1%
Est. Institutional Holdings:	10%	Trailing Twelve Month Revs:	\$88.1m
10-Day Average Volume:	210,000	12-Month Price Target:	\$21
Next EPS Report:	January, 2005	Rating	Buy

* Reported EPS for FY04 differ from our numbers. The Company only started paying income tax in 1Q05, and we have restated historical results to more accurately portray the performance. For example, reported EPS in 1Q04 was \$0.20 vs. our taxed EPS equivalent of \$0.11

We are initiating coverage of iMergent (IIG-Amex) with a Buy Rating for several reasons:

1. It has established a solid position selling software that enables very small businesses to market their products on the Web.
 2. It has a unique product integration with eBay that may enable IIG to “ride eBay’s coattails.”
 3. It has revenue growth prospects of 20% to 30% for the next several years with EPS growth prospects exceeding that range
 4. This is somewhat of an “undiscovered” company, and its resulting valuation is a good opportunity for investors to make a low risk investment in the intersection between the growth of small businesses and the growth of e-commerce (as well as the growth of eBay).
- **iMergent is based in Orem, UT, and has a unique business model with competitive advantages.** They have spent the past ten years building a unified platform that includes their own proprietary technology along with integration with Intuit, UPS, eBay and others. Their strategy is to become the one-stop shop for small businesses on the Web, and they have already shown the ability to execute. IIG has grown 53% over the trailing 12 months and is on pace to record about \$100 million in revenues for FY05 (YE:June). The Company is quite profitable, and could record 2005 EPS of \$0.66. It trades at a PE of 22x and PEG of 0.96x, an integral reason we are excited about this stock.

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The Market Opportunity

It is estimated that there are 24 million small businesses domestically. Even if only 15 million are addressable (the rest are service industries and/or other non-users of e-commerce software), this market is less than 20% penetrated. Additionally, one million new very small businesses are being started every year. To put this into more perspective, IIG will only gain 20,000 of these as clients this year, or less than 1%. Furthermore, this is only domestic – the international market at least doubles this opportunity. These customers are becoming more sophisticated and need full platforms to help them run their businesses – that is IIG's opportunity.

The Marketing Strategy

One reason that we are optimistic about iMergent is that it has perfected its channel marketing strategy to a science, and it truly understands how to attract the small business owner to its software. IIG defines the small business as 1-5 employees and/or less than \$1 million in revenue. The formula is simple:

The formula:

1. It sends out 1.5 million pieces of direct mail a month to potential customers, or 18 million a year.
2. Of these, 150,000 per year come to a free two-hour preview session, in which they learn the overview of the products and are then asked to come to a full day session.
3. About 40,000 then come to the full day session, which costs \$30. They ran about 540 of these in 2004.
4. 15,000 of these 40,000 decide to become customers. The average deal size is about \$4,300 for a customer who buys at the session. About 20% pay cash and 80% pay on installment contracts at 18% per annum. More on this in the financial section. Management believes that in the current year it will sign up over 20,000 new clients, growth of at least 33%.

Their conversion rate at the sessions is about 35% ($15,000/40,000=35\%$). The company held about 540 workshops in the last year, and believes it can sign up 21,000 customers this year. As the Company gets more experience and broadens its platform even more, management believes this conversion rate will increase, offering very low-cost, high margin incremental benefits to the bottom line.

Each session is an educational experience, not a “cheesy” hard sell. With the preview and then the full-day, IIG gets about 12-15 hours of face time with each potential customer. IIG takes an educational approach, because keeping and training customers is much more inexpensive than continually having to replenish the customer base. At each session, there are 10 IIG employees, including 2 speakers, 7 salespeople, and 1 financial/credit manager. The Company currently has 5 sales teams traveling and conducting these sessions, with the fifth having launched in November, a sixth being hired currently, and a seventh planned for 2H05.

The Platform and Products

Another reason we are optimistic is that we have not found a company quite like this one in terms of competitive advantage and years of development. The CTO of the Company has been working on this platform for about 10 years, and it is easy to use and very function rich for the small business owner. Many customers of IIG are entrepreneurs who originally started on Yahoo Shops or Amazon, but found that these providers really do not provide a solid transactional platform. Management estimates

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that almost 90% of new customers come from AMZN or YHOO – *a sign that they are not signing up novices, but entrepreneurs who are actively seeking to increase Web-based sales.* The platform is a feature-rich platform that enables vendors to sell products on the Web, with inventory management, auctions, and other financial information available, including analytics and other management tools. There is no preference in terms of customers – their customers sell boots, medical devices, books, etc using this platform.

IIG's opportunity is in adding more recurring revenues and back-office services to these customers, which it is already showing that it can do. As additional services to its customers and to provide a more compelling value-add to potential customers, it has developed relationships with several valuable partners, such as UPS, eBay, Intuit, and several banks for credit card processing. For example, the eBay product enables these vendors to sell with only several mouse clicks on the eBay web site. Selling material amounts of inventory is devilishly difficult on eBay, so a service like this is another reason to get excited about IIG.

For example, it also offers:

1. Basic web site hosting service for \$24.95/month
2. Full day eBay training sessions for \$399. Almost 80% of clients are paying for this service, suggesting both how much of a revenue impact it will have, and how much of a tangential play on eBay that this story can be (not just for the fee but for the EBAY on-ramp that IIG could become).
3. Coaching and mentoring support, for \$100/day. About 40% of customers are paying for this.
4. Credit card processing, for a slice of the transaction fees.

Its strategy is to increase the number of services that each customer buys and to continue adding marketing partnerships which bring in new customers and add new services.

Other Revenue Growth/Operating Profit Drivers

- Some of the Company's best leads have been from lists of attendees at previous sessions who did not buy. It has a list of 500,000 names and 200,000 of these have even attended the full day sessions. This will reduce the cost of acquiring subscribers if it can beneficially target this gold mine.
- **International – in some ways, international provides an even vaster target.** IIG just reported on its first British test run, conducting 13 sessions. It raised \$3.4 million, almost 30% more than average domestic seminar series. This has higher potential because they have been relatively untouched by the e-commerce wave and are much earlier in the adoption phase. They are working in many of the international English-speaking companies currently.
- **Increasing its close rate and Average Deal Size.** As we stated, it is closing just over 35% of attendees at the full-day sessions. Management believes it can get this up to over 40% and increase the \$4,300 ASP by these add-on services such as eBay and other new relationships it is developing. They have already improved the close rate from about 20% two years ago, so we believe it has further room to grow.
- **Rapidly investing in the business.** This opportunity is so large that IIG's revenue growth is simply dependent on adding sales teams. With team number seven planned for 2H05, it is adding a team every six months or so. It takes about four months to fully train and launch a sales team.

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- **Customer retention is also a focus.** By adding features and functionality, it assists in making the customer's e-commerce ventures more successful and hence, makes IIG more successful. Many of these add-on services help here, and they offer boot camps, DVD support packages, and other ancillary services which provide training.

Financials and Balance Sheet

The Company is on track to achieve \$100 million in sales this year, up from \$83 million last year. Its target is to grow revenues between 20% and 30% every year, with EPS growth exceeding revenue growth. We project FY05 revenues of \$100.6 million and EPS of \$0.66. These represent growth rates of 20% and 24%. Their business model is highly efficient – management had pretax margins of about 12% in Q1, and management believes that they can increase this to above 15%. Most of the expenses incurred are:

- **the training of new sales teams**, which reduces margins in the short-run but increases them almost as soon as they launch (this is included in the Cost of Sales),
- **Traveling, lodging and other expenses** related to the workshops and seminars.
- **Materials on a new sale**, which amount to \$30 - \$50 per package. At 20,000 new customers a year, this is about \$60,000 per year.

Customer Installments. An important aspect to their business model is the installment contracts that customers can use to pay. This does result in a percentage of bad debts that IIG must reserve and expense every quarter. It took a little explaining, but we became comfortable with their approach. Bad Debt Expense was 27% of revenues in Q1, so we do need take some time to look at this (even with this as a line item, they are still fairly profitable). Additionally, through 2004, 70% of all installment contracts were fully collected and this percentage has been declining.

Domestically, 60% of new customers finance their purchases, at an 18% interest rate for 24 months. The company always collects 5% at the sale, which results in a down payment of about \$125 to \$310, enough to cover the packages and costs associated with the seminar. In estimating their bad debt reserve, the Company uses many of the same factors as banks; FICA scores, how many payments have been made by the customer, aging, etc. If no payment has been made in the first 60 days, they write it off. Also, when a customer goes delinquent, they simply shut off access to the Website, so there is no incentive to take the product and run it for free. If there were heavy up-front costs in getting a new customer up and running, I would be much more worried about the bad debt expense. All they take with them is the initial \$30 to \$50 start-up package. And, at the least, the Company is getting the 5% down payment, which effectively shuts down the potential effect of any losses from the delinquent customers.

Bad debt expense has been decreasing, from 33% of sales in Q1 last year, to 27% of sales to Q1 this year. As always this number can be managed, but as long as this number is decreasing and the expenses are greater than the actual write-offs, we should remain comforted.

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Table 1: Bad Debt Expense vs. Reserve

Allowance balance June 30, 2004	\$ 8,951,329
Plus provision for doubtful accounts	6,398,401
Less accounts written off	(4,489,179)
Plus collections on accounts previously written off	614,472
Allowance balance September 30, 2004	<u>\$ 11,475,023</u>

Source: The Company's Q1 10-Q

In Table 1, it can be determined that the bad debt expense, from Line 2, of \$6.4 million (which is also the line item in the income statement) is higher than the actual write-off. This is calculated by the net of Line 3, Accounts Written Off (\$4,489,179) Minus Line 4, collections of previous amounts written off. This nets to \$3.9 million, lower than \$6.4 million expense. Again, we believe that the marketing strategy of signing up many customers (with low up-front expenses) is shrewd – sign many up and then see who “sticks”, while keeping a conservative bad debt line.

The Company previously factored many of these installment contracts to increase cash flow but had to offer a 20% to 22% discount to the counterparty. Collectability on these contracts has recently improved, and they have decided not to do as much factoring. When they were selling these, they were taking the discount but also losing the interest payments of 18%. With less factoring, NOI should increase, but it does reduce cash flow in the short term, a number that decreased in Q1 (also due to the ramping up of sales teams). Q1 CFFO was (\$1.7 million), down from \$0.1 million a year ago. In the long run, this will increase receivables and net other income, and eventually will benefit EPS and the balance sheet.

Summary and Investment Opinion

iMergent is a unique way to play the rise of e-commerce, particularly eBay, and the rise of the small business. With a vast market waiting to be penetrated and very little competition in their channels, we believe that IIG is an attractive way to play these trends. With margins that should only increase as more sales teams get launched, we believe our estimates are achievable. With the potential to do \$0.81 next year, we believe a price target based on a 25x PE of \$21 is appropriate. If they really start “riding eBay’s coattails”, and/or they grow faster than we expect, the mid-\$20’s are attainable.

Risks

Among the risks in buying shares of iMergent are:

1. **The Bad Debt Expense.** We believe that management has been fairly upfront about how this line item works, but if we underestimate the long-term effects or if management is “playing games”, then it will likely mean stock troubles. Since there is such a small amount of COGS that goes into each sale and the down payment really recoups seminar costs and the packaging costs, it does not seem to us to be a major turnoff.
2. **Competition:** From what we can tell, there is no company with the same technology and marketing strategy. While YHOO, AMZN, and INTU have some of these offerings, we repeat

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that 90% of IIG's customers have tried these and failed. However, it is possible that one of these or some other up-and-comer may try to duplicate this strategy and cut into IIG's growth.

3. **Failure to adopt recurring/add-on revenues.** We are fairly confident that the demand is out there, but if the company has a low success rate of its customers, then they will not stick around. The Company has an "Educate, don't sell" training strategy, so we think the chances are good. However, if the Internet becomes saturated, it is possible that this small vendor will not do well. There was recently an interesting article in the Wall Street Journal regarding the rise of the small e-commerce vendor. WSJ cited the homogeneity of the large sites as driving the need for the unique and varied product offerings that the universe of small vendors provides.
4. **The Possibility that the Company May Seek Additional Financing.** We specifically asked management whether they would need to go to the capital markets. They were fairly adamant that they can grow organically on their own working capital and cash flow. Therefore, we rank this as a low risk, but if revenue is not as rapid as projected, they may need to access capital.

Publicly trade companies mentioned in this report:

Amazon (NASDAQ: AMZN, \$39.05, Not Rated)

Intuit (NASDAQ: INTU, \$43.40, Not Rated)

Yahoo! (NASDAQ: YHOO, \$38.02, Not Rated)

Unless otherwise noted, prices are as of the close December 10, 2004.

The Farmhouse Equity Research, LLC Rating System:

Strong Buy: We believe that shares of this stock are significantly undervalued and should be acquired immediately. Over the next 12 months, we believe that the share price will increase more than 50% on a sustained basis. As of 4/19/04, of the 17 companies we have under coverage, 6 are rated as Strong Buy.

Buy: We believe that shares of this stock are relatively undervalued and should be acquired on an opportunistic basis. Over the next 12 months, we believe that the share price will increase more than 25% on a sustained basis. As of 04/19/04, of the 17 companies we have under coverage, 6 are rated as Buy.

Market Perform: We believe that shares of this stock are fully and fairly valued. Over the next 12 months, we believe that the share price will track with the overall market. As of 04/21/04, of the 17 companies we have under coverage, 5 are rated as Market Perform.

Market Underperform: We believe that shares of this stock are relatively overvalued and should be sold on an opportunistic basis. Over the next 12 months, we believe that the share price will decrease more than 25% on a sustained basis. As of 04/21/04, of the 17 companies we have under coverage, none are rated as Market Underperform.

Sell: We believe that shares of this stock are significantly overvalued and should be sold or sold short immediately. Over the next 12 months, we believe that the share price will decrease more than 50% on a sustained basis.

For the complete version of this report, please contact your CAPIS salesperson at 800.247.6729 or 214.720.0055 or Farmhouse Equity Research, LLC at 972.562.0429.

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Source: Bigcharts.com

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Fiscal Year End: 12/31	2003A Jun-03	1Q04A Sep-03	2Q04A Dec-03	3Q04A Mar-04	4Q04A Jun-04	2004A Jun-04	1Q05A Sep-04	2Q05E Dec-04	3Q05E Mar-05	4Q05E Jun-05	2005E Jun-05	1Q06E Sep-05	2Q06E Dec-05	3Q06E Mar-06	4Q06E Jun-06	2006E Jun-06
Total Revenues	49,938	18,840	19,827	19,565	24,967	83,199	23,709	23,250	25,600	28,000	100,559	27,470	28,000	31,400	34,000	120,870
Cost of Revenues	10,902	4,362	4,546	4,059	5,779	18,746	6,575	6,460	6,900	7,480	27,415	7,710	7,700	8,400	8,920	32,730
Gross Profit	39,036	14,478	15,281	15,506	19,187	64,452	17,133	16,790	18,700	20,520	73,143	19,760	20,300	23,000	25,080	88,140
Gross Margin	78.2%	76.8%	77.1%	79.3%	76.9%	77.5%	72.3%	72.2%	73.0%	73.3%	72.7%	71.9%	72.5%	73.2%	73.8%	72.9%
Sales & Marketing	15,440	4,441	6,704	5,581	6,410	23,136	6,541	6,350	6,900	7,460	27,251	7,500	7,750	8,500	9,050	32,800
% Total Revenue	30.9%	23.6%	33.8%	28.5%	25.7%	27.8%	27.6%	27.3%	27.0%	26.6%	27.1%	27.3%	27.7%	27.1%	26.6%	27.1%
Product Development	77	77	86	93	102	359	139	142	145	160	586	175	175	180	190	720
% Total Revenue	0.2%	0.4%	0.4%	0.5%	0.4%	0.4%	0.6%	0.6%	0.6%	0.6%	0.6%	0.6%	0.6%	0.6%	0.6%	0.6%
General & Admin	4,762	1,862	2,257	1,970	2,741	8,831	2,044	2,050	2,190	2,320	8,604	2,330	2,400	2,650	2,770	10,150
% Total Revenue	9.5%	9.9%	11.4%	10.1%	11.0%	10.6%	8.6%	8.8%	8.6%	8.3%	8.6%	8.5%	8.6%	8.4%	8.1%	8.4%
Bad Debt Expense	14,256	6,220	5,143	6,020	6,761	24,145	6,398	6,360	6,860	7,270	26,888	7,290	7,500	8,000	8,480	31,270
% Total Revenue	28.5%	33.0%	25.9%	30.8%	27.1%	29.0%	27.0%	27.4%	26.8%	26.0%	26.7%	26.5%	26.8%	25.5%	24.9%	25.9%
Total Op. Expenses	34,534	12,600	14,190	13,665	16,014	56,471	15,123	14,902	16,095	17,210	63,330	17,295	17,825	19,330	20,490	74,940
Operating Income	4,501	1,878	1,091	1,841	3,173	7,981	2,010	1,888	2,605	3,310	9,813	2,465	2,475	3,670	4,590	13,200
Operating Margin	9.0%	10.0%	5.5%	9.4%	12.7%	9.6%	8.5%	8.1%	10.2%	11.8%	9.8%	9.0%	8.8%	11.7%	13.5%	10.9%
Net Other Income	785	274	399	467	502	1,642	788	810	850	900	3,348	930	950	1,020	1,160	4,060
Pretax income	5,286	2,152	1,490	2,307	3,675	9,624	2,798	2,698	3,455	4,210	13,161	3,395	3,425	4,690	5,750	17,260
Pretax Margin	10.6%	11.4%	7.5%	11.8%	14.7%	11.6%	11.8%	11.6%	13.5%	15.0%	13.1%	12.4%	12.2%	14.9%	16.9%	14.3%
Income Taxes	319	813	563	872	1,222	3,471	1,058	1,025	1,313	1,600	4,996	1,290	1,302	1,782	2,185	6,559
Tax Rate	6.0%	37.8%	37.8%	37.8%	33.3%	36.1%	37.8%	38.0%	38.0%	38.0%	38.0%	38.0%	38.0%	38.0%	38.0%	38.0%
Net Income	4,967	1,339	927	1,435	2,453	6,153	1,740	1,673	2,142	2,610	8,166	2,105	2,124	2,908	3,565	10,701
Shares Outstanding	11,369	11,966	12,275	12,354	12,399	12,249	12,288	12,310	12,500	12,700	12,450	12,900	13,100	13,300	13,500	13,200
OPERATING EPS	0.44	0.11	0.08	0.12	0.20	0.50	0.14	0.14	0.17	0.21	0.66	0.16	0.16	0.22	0.26	0.81
Y-O-Y Change	Yr-Yr	1Q04A	2Q04A	3Q04A	4Q04A	Yr-Yr	1Q05A	2Q05E	3Q05E	4Q05E	Yr-Yr	1Q06E	2Q06E	3Q06E	4Q06E	Yr-Yr
Total Revenues	-27.8%	67.0%	87.2%	36.6%	81.7%	66.6%	25.8%	17.3%	30.8%	12.1%	20.9%	15.9%	20.4%	22.7%	21.4%	20.2%
Cost of Revenues	#DIV/0!	77.4%	97.4%	32.6%	87.7%	71.9%	50.8%	42.1%	70.0%	29.4%	46.2%	17.3%	19.2%	21.7%	19.3%	19.4%
Gross Profit	-43.6%	64.0%	84.4%	37.6%	80.0%	65.1%	18.3%	9.9%	20.6%	6.9%	13.5%	15.3%	20.9%	23.0%	22.2%	20.5%
Operating Income	-78.2%	73.6%	61.0%	0.0%	252.0%	77.3%	7.1%	73.0%	41.5%	4.3%	23.0%	22.6%	31.1%	40.9%	38.7%	34.5%
Pre-Tax Income	-74.5%	74.7%	76.5%	12.7%	215.9%	82.0%	30.0%	81.1%	49.8%	14.5%	36.8%	21.3%	26.9%	35.7%	36.6%	31.1%
Net Income	-76.6%	8.7%	76.5%	-10.1%	52.0%	23.9%	30.0%	80.5%	49.3%	6.4%	32.7%	20.9%	26.9%	35.7%	36.6%	31.1%
Earnings Per Share	-9.0%	0.2%	61.2%	-17.9%	46.4%	15.0%	26.6%	80.0%	47.5%	3.9%	30.6%	15.2%	19.3%	27.6%	28.5%	23.6%

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