

Vonage's First Call

By Josh Long

It is no secret that Vonage has forked out a mountain of dough to lure its more than 1.85 million subscribers. And its marketing costs continue to climb as rivals cut the price of Internet telephone service, placing added pressure on a company whose shares have tanked since its recent initial public offering.

In its first earnings report since netting \$492 million in its initial public offering, Vonage disclosed that marketing costs rose 46 percent to \$90.2 million compared to a year ago.

The aggressive initiative helped Vonage tack on 256,000 lines in the second quarter, the second-highest level of additions in its history.

But subscribers don't come cheap. Holmdel, N.J.-based Vonage, which expects its base of customers to up to 2.45 million by year's end, incurred marketing costs per gross subscriber line addition of roughly \$239. That's up from \$236 in the year-ago period.

Slashing marketing costs is imperative for Vonage, says independent analyst Jon Arnold.

"They have to get that cost way down because the economics don't work and they know that," says Arnold of J Arnold & Associates, an analyst and marketing consultancy.

AT&T and Verizon, the largest U.S. telephone companies, have cut the prices on their flagship IP-based voice offerings, calling into question whether Vonage can sustain its margins in the future on what is already a low-priced Internet phone service.

"So much of what Vonage's business models work around is maintaining a certain gross margin on every subscriber," says Arnold, who notes it's no coincidence that price cuts by rivals have been enacted around the same time Vonage has emerged as a public company.

"None of these big incumbents want to see Vonage succeed because every subscriber Vonage gets ultimately is coming at the expense of the incumbent," the analyst says. "Vonage is not creating a new market here."

Since Vonage debuted as a public company in May with a stock price of \$17, its shares have plunged to less than \$7.

per subscriber.

In the second quarter, Vonage reported average monthly revenue per line of \$27.70, an increase of \$1.07 from a year ago. Meanwhile, Vonage's operating revenue rose 141 percent to \$143.4 million. However, a larger percentage of subscribers fled: average monthly churn increased to 2.3 percent compared to 2.1 percent the prior quarter.

It is conceivable that offering more advanced calling features, such as a do-not-call capability that would only patch through specified callers, could help Vonage boost sales and subdue the customer exodus.

"They have the opportunity to be more creative and offer new services that [distinguish] themselves from others in the marketplace," says Arnold.

But as it strives to broaden its appeal,

Vonage faces obvious constraints given that it lacks the wireless, TV and Internet arsenal of the national telephone and cable operators.

Vonage, Arnold says, is aiming to break into the small business market. That's a segment of the communications sector that the mammoth phone companies have been known to neglect in the past.

However, Arnold argues the small business market could pose a challenge for Vonage because it cannot guarantee the same quality of service as the incumbent carriers since its telephone service runs over the public Internet. No sooner does the analyst make this comment than his phone line goes dead.

His telephone company? None other than Vonage. **VBN**

Vonage "Key Milestone Targets"

Fiscal year 2006 ending subscriber lines	2.3 to 2.45 million
Fiscal year 2006 total revenue	\$600 to \$615 million
Fiscal year 2006 marketing expenses	\$360 to \$380 million
Second half 2006 direct margin (% of total revenue)	62% to 65%
Second half 2006 adjusted SG&A (% of total revenue)	39% to 41%
Positive adjusted operating income	Early as 1Q08

Source: Company reports

Analysts say Vonage must expand its offerings beyond its core Internet telephone service in order to emerge out of its slump.

"If you're just doing [voice], then we know where that game goes," says IDC analyst Will Stofega. "The pricing has gone down already. You start looking the same."

"I think the place is mobility, maybe Wi-Fi, maybe WiMAX if there is ever a standard," Stofega adds.

Such observations have not fallen on deaf ears. Through a partnership with UTStarcom, Vonage allows subscribers with pocket-sized phones to chitchat wirelessly over Wi-Fi hotspots.

The offering could help Vonage keep customers and boost its average revenue