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## VG - Q4 2010 Vonage Holdings Corp. Earnings Conference Call

**Event Date/Time: Feb. 15. 2011 / 3:00PM GMT**

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## PRESENTATION

**Operator**

Good day everyone and welcome to the Vonage Holdings Corporation fourth quarter 2010 earnings conference call. Just as a reminder, today's call is being recorded. At this time for opening remarks and introductions, I would like to turn the conference over to Ms. Leslie Arena, Vice President of Investor Relations. Please go ahead, Ms. Arena.

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**Leslie Arena** - *Vonage Holdings Corp. - V.P. - Investor Relations*

Thank you. Good morning. And welcome to our fourth quarter and full-year 2010 earnings conference call. Speaking on our call this morning will be Marc Lefar, Chief Executive Officer; and Barry Rowan, CFO, and Chief Administrative Officer. Marc will discuss the Company's progress and strategic direction and Barry will discuss our financial results. Slides that accompany Barry's discussion are available on the investor relations website. At the conclusion of our prepared remarks, we will be happy to take your questions.

As referenced on slide two, I would like to remind everyone that statements made during this call that are not historical facts or information may be forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These and all forward-looking statements are based on management's current beliefs and expectations and depend on assumptions or data that may be incorrect or imprecise. Such forward-looking statements are subject to risks and uncertainties that could cause actual results to differ materially. More information about those risks and uncertainties is highlighted on the second page of the slides and contained in Vonage's SEC filings. We caution listeners not to rely unduly on forward-looking statements and we disclaim any intent or obligation to update them. During this call, we will be referring to non-GAAP financial measures. A reconciliation to comparable GAAP measures is available on the investor relations website. And now, I will turn the call over to Marc.

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**Marc Lefar** - *Vonage Holdings Corp. - CEO*

Thank you, Leslie. I would like to begin by commenting on the year and then I will discuss our strategic direction and outlook for 2011. We've made strong progress over the past three years and 2010 was no exception as we generated record EBITDA and cash flow, achieved the best churn performance in five years, and exited the year with a fresh balance sheet. Record high EBITDA of $156 million was achieved by increasing average revenue per user and by driving operational improvements across virtually every aspect of our business. We aggressively managed SG&A, reducing expenses by double digit percentages for the second year in a row. We increased telephony services revenue and built market share in international calling segments, a key strategic focus over the past year. Monthly service revenue per user grew by more than $1, driven by improvements in rate plan mix and selective pricing actions we implemented along with enhancements to our service. And we crossed a major milestone as we generated positive free cash flow for the first year in the Company's history. Our increasing mix of loyal international long distance customers, combined with a Company-wide focus on a frictionless end to end customer experience, reduced annual churn to 2.4%, the lowest level in five years. We improved our customer satisfaction ratings and believe we are now among the best in the industry and we've made material improvements in call quality and reliability.

During 2010, we continued to execute against our strategy to penetrate international calling segments. We strengthened our customer base as we increased the number of subscribers on Vonage World to approximately 40% of our base. As we reported in January, fourth quarter gross line additions increased sequentially to 167,000 and were up 8% from the first quarter of the year. We finished the fourth quarter with nearly 6,000 positive net lines. Based on this progress, we expect to achieve positive net lines for the full year in 2011. In December, we announced the completion of a comprehensive refinancing. Through the series of transactions, we replaced nearly $200 million of high cost restructuring debt, which will reduce 2011 interest expense by $23 million, or nearly half of the 2010 level. The new debt is pre-payable at par, carries far less restrictive covenants, allows greater operating and financial flexibility and provides management with a broader range of alternatives to deliver value to shareholders. This is strong progress.

Based on this solid operational and financial foundation, we're now poised to execute the next phase of our strategy. To drive profitable revenue growth. While we continue to attract domestic customers dissatisfied with the customer service and promotional gamesmanship of large service providers, we have focused our growth initiatives in three primary areas. First, we will grow share in the international long distance market for both home and mobile. Second, we will meet the emerging needs of mobile and other connective device users by delivering easy to use applications that provide significant cost savings in large existing markets. And third, we will pursue additional international expansion opportunities outside of the US.

Let me elaborate briefly on each of these opportunities. 18 months ago, we shifted our primary emphasis from the mass domestic home phone market to the international long distance market. The international long distance market is large and growing and allows us to leverage our low cost communications platform for the benefit of ethnic and small business customers that are being charged excessive prices by large carriers or are forced to sacrifice convenience with card-based or PC-only services. We've had good success with Vonage World which includes unlimited calling to 60 countries bundled with unlimited domestic calling and visual voice mail for $25.99 per month. Nearly 1 million customers are now on this plan. International long distance callers now comprise more than 600,000 or 25% of our total customer base. These customers churn at far lower rates than domestic callers. As I discussed during our last earnings call, we've recently implemented an end-to-end Spanish language experience for our customers. From our television commercials and direct mail to online media and through our in-language sales and service, we are focused on meeting the unique needs of our targeted segments of the international calling market. We're very encouraged by the initial results.

The Hispanic population is one of the fastest-growing ethnic segments in the US, now comprised of over 14 million households. According to a recent survey, 36% of Hispanics make international calls and spend an average of $46 per month. During the fourth quarter, the first full quarter, in which we served our targeted Hispanic customers with these comprehensive programs, one-third of our prospects chose to do business with us in Spanish. This positive trend has continued through January. We see significant additional opportunity to grow our share in the large Hispanic market and will leverage our learning from this segment as we target additional under-served ethnic segments.

Mobile represents the second important growth opportunity for us. The rapid global adoption of smart phones and tablets, notably those with Wi-Fi and 4G, create significant opportunities for Internet-based communications services. We introduced our first mobile offering, an outbound long distance calling application, about a year ago and Vonage Mobile for Facebook last August, enabling inbound and outbound calling over Wi-Fi and 3G to Facebook friends. With these applications, we have validated that we can extend our core network capabilities on to new platforms and we've learned a great deal about the mobile applications market. In 2010, our next generation mobile and PC products, which include Vonage Mobile, Vonage Pro and our Softphone, generated nearly $10 million in revenue. Our road map includes making international calling plans accessible to a broad range of mobile phones, not just Smartphones. It also includes alternatives to expensive international roaming services, lower cost domestic and international text messaging services and enhancements to digital community calling, including the use of a customer's existing mobile address book. While mobile is a key driver, we also believe that a fully integrated communications experience that works seamlessly across multiple connected devices, including PC's, tablets, readers, and large screens, will likely be desired by most customers in the future.

The third plank of our growth strategy is to grow our base of customers outside the United States. This strategy is based on the inherit benefits of Internet-based communication which makes distance and location largely irrelevant. We currently have operations in the UK and Canada and launched Vonage World in Canada last September. While it is on a relatively small base, sales have tripled in Canada since the launch. We are encouraged by the potential. In addition to growing our existing properties, we believe that there are opportunities to expand into new geographies. We will leverage our large base of existing customers in the US to reach their international friends and families. Beyond this, we plan to introduce international calling services for Smartphone users living outside of the US and we are evaluating several models to expand our core services, including partnerships and joint marketing agreements. While we are working hard to execute on our growth initiatives our strategy also includes structural initiatives, structural cost initiatives similar to those we successfully implemented during the past three years. The past year alone, we have reduced SG&A by approximately 10%, improved customer care costs by 20% per line and reduced international long distance termination rates by over 25%. Looking forward, we will optimize our cost structure through further enhancements to our online sales and support capabilities and through investment in IT systems and business strategies to further reduce termination rates. These structural cost reductions will fuel our increasing investment in new product development and we will be adding meaningful product development resources in 2011, in both the US and our new development center in Israel.

Let me close by offering a final perspective on our progress and by thanking the people who have contributed so tirelessly to our success. We have come a long way in a short time. Our results are a testament to the loyalty of our customers, the value of our technology and the dedication of our employees. When we had began the journey to transform the Company, our market capitalization was barely $100 million, putting us out of compliance with New York Stock Exchange listing requirements and at risk of being removed from the exchange. Today, our market cap is more than $800 million, our business is stable, our cash flow is strong, and we have a fresh balance sheet. Our senior leadership team has brought renewed focus and energy to our business and the entire Company has rallied to support our objectives. I am proud of our progress and deeply grateful to our employees for the tremendous commitment. And now, I will pass the call to Barry.

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**Barry Rowan** - *Vonage Holdings Corp. - CFO and CAO*

Thanks, Marc. I'm pleased to review our financial and operating results for the quarter and the year with you. 2010 was a year in which our turn-around efforts begun in 2008, culminated in strong tangible evidence of Vonage's operational and financial transformation. We stabilized and strengthened our customer base, reducing monthly churn from 3.1% to 2.4% and grew the number of Vonage World customers to approximately 40% of total customer lines from 23% at the beginning of the year. We generated $156 million in adjusted EBITDA, a $200 million turn-around from the $46 million loss in 2007. We focused on driving the cash flow potential of the business throughout the year, generating significant cash from operations, and we negotiated the release of more than $40 million in cash held by vendors based on the sustained improvement in our financial performance. We put this cash to good use, as it enabled us to execute our two-part strategy to recapitalize our balance sheet. First, we retired $41 million of debt at par. Then, in December, we announced a comprehensive refinancing leaving us with low leverage, ample liquidity and a fresh balance sheet unencumbered by the high interest rates and restrictive covenants of the restructuring debt put in place in 2008 at the height of the credit crisis. These results provide a solid foundation to deliver on the important strategic objectives Marc has outlined.

Let's walk through the details of this quarter's financial performance, beginning on slide three. We had strong results across the board. We generated record high EBITDA of $41 million in the fourth quarter, which was slightly above the $40 million range we guided to in January. This is a 20% increase from the year-ago quarter and up 17% sequentially. For the full year, we generated record EBITDA of $156 million, up 31% over the prior year and our third consecutive year of positive and increasing EBITDA. We achieved these results through 3% higher ARPU, improved churn, which saved 170,000 customers, and a focus on operational improvements that reduced marketing and SG&A costs by $56 million, or 11% from the prior year. We also reengineered our telephone adapters, cutting more than 20% out of the cost of our devices. We generated these strong results even as we absorbed a $30 million increase in the cost of telephony services from our targeted international long distance users and increased investment in strategic growth initiatives, including our new development center in Israel.

Moving to slide four, in the fourth quarter, we reported net income of $15 million or $0.07 per share, excluding adjustments, up from $5 million, or $0.03 in the prior year's quarter, and an increase from $8 million, or $0.04 sequentially. We have now achieved seven quarters in a row of positive net income excluding adjustments. The increases in recent quarters have been driven in part by lower interest expense, as we retired $41 million of debt at par during the year. Reflecting one-time charges of $58 million related to the Company's refinancing, GAAP net loss for the quarter was $42 million, or $0.19 per share. This is down from net income of $4 million, or $0.02 per share in the year-ago quarter, and up from a net loss of $55 million, or $0.26 from the third quarter, which also included charges relating to the debt refinancing. The $58 million charge we took in the fourth quarter was very close to the $60 million we estimated in December when we closed on the refinancing.

All costs and fees associated with the debt refinancing have now been reflected in our financial statements with some of these costs capitalized in the new loan. With the third lien notes converted into shares, and replacement of the first and second liens with our new term debt, we have eliminated the need to account for the embedded derivative features of our prior debt. This had created large swings in net income as our stock price changed, creating confusion for some investors regarding the Company's actual financial performance. As a result of the refinancing, we expect higher net income in 2011 due to lower interest expense and cleaner reported net income without these ongoing adjustments.

As you will see on slide five, total revenue for the quarter increased sequentially to $218 million, from $214 million in the third quarter of 2010, reflecting our progress penetrating the Hispanic market with our Vonage World product. Total revenue declined from $224 million a year ago, on fewer lines, as the positive net lines recorded in the fourth quarter did not fully offset the cumulative line losses for the first three quarters of the year. On an annual basis, total revenue declined to $885 million from $889 million in 2009, driven in part by a $9 million reduction in deferred revenues from the accounting for legacy activation fees. This non-operating issue does not impact EBITDA and these fees were largely phased out in mid 2009 to provide more straightforward pricing for our customers. Quarterly telephony services revenue was $215 million, down 2% year-over-year, and up 1% sequentially. Our success in further penetrating the international long distance market led to improvements in rate plan mix, which helped to drive service revenue to $873 million for the year.

We continue to strengthen the quality of our customer base with the acquisition of customers on Vonage World. Since Vonage World was launched 18 months ago, we have added nearly 1 million subscriber lines to this plan. And, as I mentioned, Vonage World customers now comprise approximately 40% of our base. These are attractive customers as they typically have higher credit quality, resulting in lower bad debt, and nearly half of Vonage World customers are ILD callers who churn at a substantially lower rate than domestic callers. Aided by the mix of Vonage World subscribers, we've been able to increase average revenue per subscriber or ARPU over the past three years. In the fourth quarter, telephony services ARPU rose to $29.78, a 1% sequential increase due to lower promotions and improved rate plan mix. On an annual basis, service ARPU increased to $30.06 and is up 8% since 2008, as we have attracted customers on higher rate plans and selectively increased prices as we enhanced the value of our offering by adding features such as unlimited 411 calling and Vonage digital voice mail.

Turning to slide six, as we announced in January, we added 167,000 gross lines, in the fourth quarter, up 3% sequentially, and up 8% from the 155,000 lines added during the first quarter of 2010. While our quarterly subscriber line acquisition cost was roughly flat sequentially, our marketing yield improved by 5% from the first half of the year, as we made steady progress, increasing gross line additions during the course of the year through penetration of targeted international calling segments. Monthly churn was 2.4% for both the quarter and the year. This is the lowest fourth quarter churn in four years. We continue to benefit from the impact of the better churn profile of Vonage World customers and implemented improvements in the overall customer experience from network operations and customer care. As a result, we've had three consecutive quarters of churn at 2.4% or better. We believe we can hold these gains in churn. Going forward, we expect churn to be helped by an increase in our base of lower churning international callers. This benefit may be offset by the yet-to-be-seen churn impact of our no contract offer, as well as varying churn profiles of newly targeted international calling segments. Taken together, these factors result in an expectation of stable churn during 2011 at approximately 2.4%.

These higher levels of growth line additions combined with continuing low churn resulted in nearly 6,000 net line additions in the fourth quarter. This was our first positive quarter of net line adds in more than two years. With our expectations of continued success, and penetrating targeted international calling segments with Vonage World, we anticipate higher gross line additions in 2011 than 2010 and our first year of positive net lines since 2008. As we discussed, our strong EBITDA for the year resulted from a combination of increasing ARPU and a systematic focus on operational improvements which has substantially improved our cost structure.

If you would please turn to slide seven. In the fourth quarter, cost of telephony services, or COTS, declined to $58 million sequentially, from $60 million, as lower domestic usage and termination costs more than offset the increase in international usage associated with the growth of subscribers on Vonage World. On a per line basis, the cost of telephony services declined to $8.06, from $8.36 sequentially, resulting in an increase in direct margins to 68%. For the full-year 2010, total cost of telephony services increased as expected to $244 million, from $214 million in 2009, from the anticipated higher usage of our growing base of international long distance users. We continue to focus on aggressively reducing international termination rates, and lowered these rates by 25% during 2010. We also continue to implement structural cost improvements that will help to offset the rate of growth in COTS as we add to our base of international callers. Recent vendor consolidation of E911 services, for example, will reduce costs by several million dollars annually beginning in 2011. We expect total COTS to increase in 2011 with the increase in international callers on Vonage World though we will also benefit from the lower churn profile of these ILD users.

On to slide eight. Our focus on driving efficiencies throughout our operations resulted in further improvements in SG&A, which declined 7% to $59 million in the fourth quarter, from $63 million in the year-ago quarter, and was flat sequentially. For the year, SG&A of $239 million was down 10%, from $265 million in 2009. Over the past three years, we have lowered SG&A by $83 million, or 26%, as we've made operational improvements in virtually every area of the business. A substantial portion of these savings has come through improvements in our customer care operations. Customer care costs per line has been reduced by more than 20% in each of the past two years. These gains have come through a disciplined focus on eliminating unnecessary calls into our care centers and reducing average handle time. These two factors improved by 19% and 16% respectively, during the past year, as we improved customer-facing processes and increased online self service. We see further opportunities for gains including, for example, improved call routing strategies and improved call handling efficiency. We continue to invest in IT infrastructure to assist our agents in their work and will drive more customer care to user friendly online support over time.

Moving to nine. Marketing expense was roughly flat sequentially at $50 million. However, we actively managed the components of our marketing to align it with our strategy of tailoring our spend across media and channels based on the buying preferences of our targeted customer segments. For the year, marketing expense declined $30 million, to $198 million, though over half of this reduction was reallocated to promotions which are accounted for as an offset to revenue.

Now, let's move to a discussion of our CapEx, cash flow and balance sheet, headlined by our first full year of positive free cash flow and our comprehensive debt refinancing. If you turn to slide 10, one of the hallmarks of the Vonage business model is relatively low CapEx of 5% of revenue, which compares very favorably to traditional telecom services providers. CapEx for 2010 totaled $40.4 million, in line with our guidance for CapEx to be in the low $40 million range. We're making these investments to support the development of new products and services, improve the customer experience and enable structural cost reductions in customer care and COTS. In 2011, we expect to invest $40 million to $45 million in CapEx, with the majority of these expenditures going toward these kinds of transformational investments.

A major financial highlight of 2010 was our substantial cash flow generation. Strong operating results combined with active cash and working capital management delivered free cash flow, defined as operating cash flow less CapEx, of $154 million for the year. Excluding $65 million in gains from working capital, free cash flow was $89 million for the year, with $19 million in cash generated from operations during the fourth quarter. Our sustained financial performance also enabled us to negotiate the release of cash held on deposit with our vendors. We accessed $43 million in additional cash for these efforts, including $11 million just before the end of the fourth quarter. We reduced the amount of cash held by vendors and in the concentration account required under our previous debt agreements by $73 million from its high in the first quarter, including the $43 million in cash held by vendors and $30 million from the elimination of the concentration account. As of the end of December, just $8 million of our cash was restricted and cash and cash equivalents, including restricted cash, was $87 million.

One final aspect of our cash flow worth reiterating is that we have approximately $885 million in net operating loss carry-forwards that can be used to offset future income. A combination of several important factors contribute to an attractive cash flow picture for Vonage, as we look forward to 2011. An expectation of increasing adjusted EBITDA in 2011 over 2010, relatively low CapEx by telecom company standards, cash interest expense $23 million lower in 2011 than 2010, and substantial NOL's that will shield our future income for a significant period of time.

Moving to slide 11. Let me talk for a moment about our comprehensive debt refinancing completed in December. In connection with that refinancing, we entered into a $200 million five-year term loan facility which replaced the Company's restructuring debt, carrying interest rates ranging from 16% to 20%. The new lower cost facility bears interest at LIBOR plus 8%, with a LIBOR floor of 1 3/4 and is pre-payable at par, allowing us to retire debt with cash flow from operations at any time. As a result of this refinancing and the retirement of $41 million of the previous debt at par during the year, we will achieve substantial interest savings during 2011. Total interest expense is expected to drop by nearly half, from $49 million in 2010, to $26 million in 2011, with the cash portion of interest declining from $42 million to $23 million, assuming constant LIBOR rates. Based on our anticipated continuing strong cash flow from operations, we expect to make an initial pre-payment on our debt by the end of the second quarter of this year. As part of the refinancing, the remaining third lien notes were converted into 8.3 million shares of the Company's common stock, resulting in 222 million shares outstanding at year end. Fully diluted shares are approximately 245 million, assuming the current stock price. We exited this refinancing with a strong balance sheet. Total leverage is 1.4 times debt to EBITDA, and with net debt of $140 million, or 0.9 times, we have ample liquidity of $79 million in unrestricted cash. Importantly, we also eliminated the highly restricted covenants contained in the prior debt agreement, and now have substantially more flexibility to deploy cash generated by the business.

Moving to slide 12. As we look forward to the coming year, let me reiterate our expectations for 2011. Adjusted EBITDA higher than the $156 million achieved in 2010, higher gross line additions in 2011 than 2010 and positive net lines for the year. Growth initiatives meaningfully impacting revenue beginning in the second half of 2010. Monthly churn of approximately 2.4% for the year. CapEx in the range of $40 million to $45 million. In summary, we are very pleased with the progress we have made during this important year of our financial and operational turn-around. With the clean balance sheet, our cost structure in order, and a growing customer base, we have a solid platform on which to build for the future. Thank you again for your interest in Vonage and now, I will turn the call back over to Leslie to initiate the Q&A session.

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**Leslie Arena** - *Vonage Holdings Corp. - V.P. - Investor Relations*

Thank you, Barry. Operator, please open the line for questions.

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## QUESTIONS AND ANSWERS

**Operator**

Thank you. (Operator Instructions) Our first question comes from Michael Rollins with Citi Investment. Please go ahead.

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**Michael Rollins** - *Citigroup - Analyst*

Hi, thanks for taking my questions. A couple of things I just wanted to ask about. The first was, if you look at the cash flow from operations for 2010 and you compare it to EBITDA less cash interest and cash CapEx, there is a fairly substantial difference -- I think I'm calculating for 2010 like $74 million versus the $194 million of cash flow from operations -- so it suggests that there is a very substantial working capital benefit, maybe some other benefits in 2010. How should we be thinking about that difference between sort of the EBITDA less cash interest and taxes versus what cash flow from operations should look like for 2011, if we sort of pick apart the guidance that you provided? And then the second question, if I could, is just a more fundamental question. If you could talk a little bit more maybe about Vonage World and the ILD base in terms of the percent of sales rates -- whether it is gross ads, whether it is upgrades of existing customer -- and where do you think you can end 2011 in terms of the proportion to what, I guess, you would characterize as a higher value international customer? Thanks.

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**Barry Rowan** - *Vonage Holdings Corp. - CFO and CAO*

Yes, Mike, it is Barry. Let me take your first question. And as you very accurately point out, we released substantial cash flow in 2010 from operations as well as working capital. About $65 million of the cash flow from operations was generated through working capital, as we aggressively managed that during the year. Coming into the year, there were reasons to have working capital managed more conservatively. As we went through the year, we saw opportunities to release that. As we look forward to 2011, we certainly want to be clear that we do not expect that kind of continuation of working capital benefit in 2011. I think the expectation I would set for you is that we would expect working capital to be basically neutral for 2011, but there are some quarterly variations of cash intensity, for example, the first quarter tends to be a little bit more cash intensive as bonuses are paid out then, for example. But on an annual basis, I think we would have an expectation that working capital should be basically neutral going forward. So if you take the -- as a result, the EBITDA expectations less the CapEx, less the interest expense that we've guided to, no taxes obviously, that that would get you to a free cash flow number for 2011, post debt service.

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**Marc Lefar** - *Vonage Holdings Corp. - CEO*

Hey, Mike, it is Marc. Let me take the second question on Vonage World. So, for perspective, as a percentage of gross line additions, Vonage World represents about 80%, a little bit north of that, of our total inflow of new customers. Within that Vonage World number, roughly 50% or more are active users of international long distance. Difficult to forecast forward, what that percentage use would be, we expect it to be roughly consistent. We are seeing that in our Hispanic ethnic marketing efforts we were actually pleasantly surprised by the number of domestic only customers we're getting which suggests that that segment really has been under served. So, it's difficult to be precise, but I think it's reasonable to guesstimate that probably about half of the mix of those coming in would be on Vonage World rate plans. And if we then account for the churn differentials between the higher churn rate of domestic only customers and our legacy base, offset by the lower ILD churn profile, we expect to finish 2011 somewhere north of 50% of our total customer base on Vonage World.

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**Michael Rollins** - *Citigroup - Analyst*

And just two other quick things. First I want to correct myself. I think I was compared the $74 million as sort of the EBITDA less interest to CapEx. And I think I misspoke. I think I said it was versus the cash flow from operations of $194 million. It should be compared to the free cash flow that you guys reported on slide 10 of $154 million. So I don't want to confuse anyone by myself mixing up those numbers. And then, Marc, just one other thing. Back to mobile and the applications environment, can you talk a little bit more about your latest thoughts in monetizing further mobile and the apps, and as you think about the levers for growing revenue better, particularly in the back half of 2011, how important is the contribution from the mobile and application side versus just all of the blocking and tackling that you're doing in terms of international long distance from the core of what you're selling today?

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**Marc Lefar** - *Vonage Holdings Corp. - CEO*

Let me try to break that down for you. As we've talked in previous earnings calls and at some of the conferences that we've been attending recently, we've talked about our focus being on going after existing large revenue markets. Those that have what we consider to be outsized margins, being charged largely by the incumbent carriers, wireless carriers, where the technology fundamentally does not require the cost to deliver those services -- can be greatly reduced through the use of technology. We think there is a lot of artificial barriers and the penetration of Smartphones, open OS, Wi-Fi access and 4-G, and customers willingness to download applications provides a lot of opportunity for disruptive kinds of products and services. All of those need to be very easy to use from a consumer standpoint. But the -- as we look out over the next few years, it is our very strong belief that the markets of international roaming, which is in the mid $30 billion range today, SMS, which is in the US alone $28 billion, we estimate it to be more than 2X of that on a global basis, as well as just international long distance calls being made from mobile, as enormous opportunities for pricing compression and where good margin can still be made by simply using software-based solutions over broadband. We have not specifically broken out the contribution of individual mobile applications, nor will we.

It is our firm belief that the international long distance market, which is largely established, and some proprietary research we field, tells us that 57% of everybody that makes international long distance calls in the US are exclusively using either their mobile carrier for that ILD, and/or their wire line traditional service provider. What that means is, there is tremendous opportunity here that has not been touched by any form of VoIP player or calling cards user at all. You can also equate that to their pricing is anywhere from 4 to 5X, to popular destinations. What we might be able to provide we're already providing in Vonage World, and we can certainly extend to in a mobile environment. Many of the social community applications, many of the discussion points around leveraging the existing address book and how we bundle text messaging and international roaming, may well include ILD outbound types of calling services. For competitive reasons, I prefer not to get into the details on exactly how we will build each type of application, which element will be monetized, but rest assured our technology team's approach is going after these large revenue streams where existing customer behavior already exists and it can be more easily ported into a mobile environment. So, we think that the monetization is really quite straightforward. It's charge less for a high quality product that people are already buying today.

In terms of your last point around the blocking and tackling of ILD versus the mobile application specifically, it's both. We've obviously been successful in driving the blocking and tackling in ILD. We think doing more of that into ethnic segments and actually expanding that on to mobile phones for outbound is probably the more straightforward of the applications and probably more predictable in terms of the rate of penetration in terms of trends. You can see value proposition, ease of use, penetration of different devices -- that probably gives a little more visibility than perhaps cracking into some of the newer markets like international roaming and domestic and international text messaging.

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**Michael Rollins** - *Citigroup - Analyst*

Thanks a lot.

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**Leslie Arena** - *Vonage Holdings Corp. - V.P. - Investor Relations*

Next question, operator?

**Operator**

Our next question comes from William Vogel with Merlin Securities. Please go ahead.

**William Vogel** - *Merlin Securities - Analyst*

Yes, thank you. I was wondering if you could elaborate a little bit on the run rate, the extent to which it has been established for the 25% improvement in termination costs that you talked about? I know it is an ongoing battle with the various correspondent entities around the world. But could you help us get a little sense of the extent to which that run rate has been established already and will just continue? Or just how it will relate from 2010 to 2011?

**Marc Lefar** - *Vonage Holdings Corp. - CEO*

Let me take a first swing at that and I will turn it over to Barry to maybe talk about how we're handling it going forward. Up until the last year, we had never really had a formalized supply chain organization. We established that just before Barry's arrival and he has helped to enhance the skills and effectiveness of that organization. Now that we have a substantial level of minutes that are available, we can retire those across multiple carriers. We have a pretty robust process -- a request for proposal process, where we will literally put our minutes out to bid with certain levels of SLA's across different major countries. So, a significant portion of our total international long distance termination is constantly being refreshed and rebid. So the 25%, we think, is quite stable and I'll call that in the bank. Notwithstanding the fact that certain regulatory environments and regulators have the ability to, at various points in time, take unilateral price increases that could affect any US-based carrier, we do have an established process to constantly take all of our minutes, put them out for bid and ensure we're getting best competitive rates. And as our volume increases, as you would expect, we get better economies of scale and it's our belief that we have pricing that is unsurpassed relative to other providers of international services. We also believe that in some of our core countries like India, we are probably among the -- if not the market leader, among the top handful of folks that are actually bringing minutes to those terminating providers. We have not provided specific forecasts forward for how much additional reduction in COTS rates we expect to get, but as I mentioned in my opening comments, we are pursuing more structural kinds of programs that would allow us to take advantage of the minutes that are terminating on our network, the ability to wholesale minutes and the ability to actually move minutes off net -- I'm sorry -- to move minutes on network by providing points of presences or even consumer level adaptors where high traffic connection go peer-to-peer. So, we do have a number of tactics in mind to continue driving costs down. Barry, do you want to add anything else to that?

**Barry Rowan** - *Vonage Holdings Corp. - CFO and CAO*

Yes, I think you covered it well. Let me add just a couple of quick points. I think it really has been a two-step strategy in driving the costs down, as Marc pointed out. The first one is really to be aggressive on negotiating rates and our volumes have clearly enabled us to do that very well, and you've seen a lot of the benefit of that. The second piece is really looking at structural cost reductions, as Marc described. So, it's not just pushing hard on carriers but it's really looking at where we might make investments in IT infrastructure, for example, that gives us more sophisticated capability. We certainly have traffic going back and forth between a number of carriers, so as we look at that traffic, and can take more sophisticated looks at that, it will enable us to really look to where the natural owners of telephone numbers are, for example, and see how we might be able to benefit from that as we continue to invest in those IT systems. And we also are looking across the board, not just international. As I mentioned in my part of the discussion, we have consolidated E911 vendors, for example, so we are looking at across the board ways to be able to drive the costs down and certainly have been successful with that, internationally as well as domestically, based on the increased volumes that we're procuring.

**William Vogel** - *Merlin Securities - Analyst*

Barry and Marc, superb job executing and superb job in really getting that competitive advantage that you have on an increasing basis out to folks who just really, I think, are now resonating with your marketing offers. So a job well done.

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**Marc Lefar** - *Vonage Holdings Corp. - CEO*

Thank you.

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**Leslie Arena** - *Vonage Holdings Corp. - V.P. - Investor Relations*

Next question, operator?

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**Operator**

Our next question comes from Mike Latimore. Please go ahead with your question.

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**Mike Latimore** - *Northland Sec - Analyst*

Great, thanks. Good morning. Just on the cost of telephony services one more time, Barry did you say that the biggest impact, at least sequentially in the quarter, was on the domestic side? So, if that is right, basically do we think about international cost of telephony service per line kind of stable with domestic coming down? Is that what happened? Is that the trend that might continue?

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**Barry Rowan** - *Vonage Holdings Corp. - CFO and CAO*

Yes, that was what happened in the fourth quarter. We got some benefits on the domestic side. And I think it is important, Mike, to break out usage and rate as you think about both international and domestic. So, clearly, we expect usage to go up for the international callers as we add more people on Vonage World. And it's part of what makes them so sticky and leads to lower churn with the people who are using the phone internationally is that they do use a lot, they churn lower. So we expect usage to go up. We are continuing to work at driving ILD rates down on a per-minute basis. Domestically -- domestic usage across the country, really, has been declining over the last number of years. So we do see some benefits from that. We continue to work, as I said, on the domestic cost side of the house and have made progress there. So, I think looking forward to 2011, the reason, obviously, that we guided for increased COTS overall is that we expect it to be driven by higher international usage, but then offset by the work we will continue to do to bring rates down both internationally and domestically.

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**Mike Latimore** - *Northland Sec - Analyst*

And then at least in the near term, is the focus going to continue to be on Hispanic and Indian communities? Or are there other kind of ethnic groups you would target in the first half of the year?

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**Marc Lefar** - *Vonage Holdings Corp. - CEO*

Both the Asian-Indian and the Hispanic communities are our top two ethnic segments. Hispanic, actually, has just recently caught up to Asian-Indian, and will likely surpass in the first half of the year. I expect for the foreseeable future, those will be the two largest segments in the Hispanic market, just because it has been so under served and it is so large in the absolute. There are other additional ethnic segments that we are pursuing, we will be launching a couple of stand-alone rate plans for ethnic markets. I've talked in previous calls that one of the markets we think, although it is somewhat small, actually does represent one of the top five outbound calling destinations from the US, and that's the Philippines. And you will expect to see something on that from us in the near future.

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**Mike Latimore** - *Northland Sec - Analyst*

Great. And then in terms of the guidance for interest expense for the year, does that assume this pre-payment is made in the end of the second quarter?

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**Barry Rowan** - *Vonage Holdings Corp. - CFO and CAO*

That guidance that we gave you was based on the existing debt that is outstanding, Mike. So again, I don't want to overset expectations there, but if you just take the current debt levels, at LIBOR -- and I would just add one clarification too, we said assuming constant LIBOR -- there is a 1 3/4 floor on the $200 million debt facility, so, clearly at LIBOR rates where they are, it would have to go up substantially in order for us to increase the actual interest rate on that debt. So it is important for me to clarify that as well.

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**Mike Latimore** - *Northland Sec - Analyst*

And just one last question. You mentioned some investments in product development. I guess, can you help quantify that? And also maybe clarify whether that would show up in OpEx or CapEx?

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**Marc Lefar** - *Vonage Holdings Corp. - CEO*

So the primary investment really is in people. You're talking largely about software development. Any additional CapEx that we would incur is included in the $40 million to $45 million guidance we've already provided. We're not providing specifics on how many people we will staff, except that we fully expect to be able to exceed last year's EBITDA and absorb the current year expense of those additional engineers that we will be adding both in the US and in Israel.

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**Mike Latimore** - *Northland Sec - Analyst*

Great. Thank you.

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**Leslie Arena** - *Vonage Holdings Corp. - V.P. - Investor Relations*

Next question, operator?

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**Operator**

Our next question comes from Hugo Miller. Please go ahead with your question.

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**Hugo Miller** - *- Analyst*

Good morning. One of my questions was already answered but my second one -- is there a leverage target that the Company wishes to achieve? Or do you think you will continue to just pay down the entire $200 million of debt over the course of the next few years with cash flow from operations?

**Barry Rowan** - *Vonage Holdings Corp. - CFO and CAO*

We have not established formally a target that we have stated publicly. Clearly, having this refinancing behind us now gives us more flexibility to think about the balance sheet in successive improvement areas. Let me tell you how we think about that. The way we think about it is clearly at 9.75% interest now. There is a reasonably substantial arbitrage benefit from being able to prepay debt as we get comfortable with the cash flows and also having enough for operating cash as well as cash on hand, were we to do acquisitions and that kind of thing, for example. So the first piece would be to pay down debt at an appropriate level based on our expectations of cash needs. As we go forward, and kind of taking a page out of my previous life, as the Company, assuming sustained financial performance which we have certainly guided to, that we would expect to be able to borrow at lower rates over time. So the way we would see that playing out would be to be able to take advantage of that over time, and we would look at the interest rates and term structures we're able to achieve and have that help drive the overall capital structure. I think if you look out for the next year, we would expect to continue to have the debt in place. We can prepay it, as we pointed out, and expect to make an initial prepayment by the second quarter of this year. But then we are -- we will actively look at what kind of financing we should put in place and at what level we should have that financing in place. The other thing to think about is the difference between actual debt and debt capacity. So, I think, clearly at our leverage ratio where it is, we have substantially more debt capacity that we could take on if we thought that was necessary. So again, we don't have plans to do that, but I think it is an important piece of the whole picture as we think about it going forward.

**Hugo Miller** - - *Analyst*

Thank you.

**Leslie Arena** - *Vonage Holdings Corp. - V.P. - Investor Relations*

Next question, operator.

**Operator**

(Operator Instructions) Our next question comes from William Vogel. Please state your question.

**William Vogel** - *Merlin Securities - Analyst*

Just very quickly, have you seen any material competitive response from major incumbents during the course of the last 18 months, since you folks have launched? And in particular, have there been any sort of counter measures in the Hispanic market, any win-back programs of any materiality that you've been able to observe?

**Marc Lefar** - *Vonage Holdings Corp. - CEO*

Well, Bill, we live in a competitive environment. We clearly see promotional domestic pricing from the bundles. That's been something that we've seen for the past few years. We have not seen that accelerate or decelerate in any significant or material way from what the trends have been the last couple of years. On the international front, clearly, you've seen a couple of folks like Metro PCS offer some alternatives for international long distance calling on the mobile phones. We don't see and have not seen any material impact of that in our business. Again, it is a very large market and our market share is still relatively small. So we wouldn't expect to see it. I would say that many of those require you to make some hard choices, like only having a single carrier as your provider. It doesn't include all locations within a country when you're calling to it. And it is difficult to use in terms of knowing exactly what rates you get. You don't have a flat rate to every place, in all places in those countries. I would anticipate that we will continue to see some price sensitivity, particularly among the smaller players, where there is not a pent-up revenue and margin base. We saw some pricing from some calling card folks when we launched the Asian/Indian market as people tried to match offers with smaller range of countries for promotional periods of time. But none of that really has had a large material impact. For the large carrier, the folks who have the dominant share of the international long distance market, we have not seen significant moves. Occasionally, you will see promotional products or bolt-on enhanced service offerings which will buy down the rate, but they are still largely uncompetitive with what we and some of the IP providers would offer. One of the reasons, I think, for that -- and I'm speculating -- but having been there in my previous life I believe it to be true, is the re-rate costs. There are such large revenue streams at such extraordinary margin sitting on the books that the traditional telcos, it becomes very difficult or risky to take material price declines that would require 50% to 60% reductions to even become competitive because of the kind of cash it would drain from the operations. So we think it is going to be -- never say never -- but quite a while before we see any dramatic response on the ILD front.

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**William Vogel** - *Merlin Securities - Analyst*

Great. Thank you so much.

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**Leslie Arena** - *Vonage Holdings Corp. - V.P. - Investor Relations*

Thank you, operator. We would like to conclude the call.

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**Operator**

Okay. Ladies and gentlemen, thanks for your participation in today's conference. This does conclude the conference. You may now disconnect. Good day.

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**Leslie Arena** - *Vonage Holdings Corp. - V.P. - Investor Relations*

Good day.

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