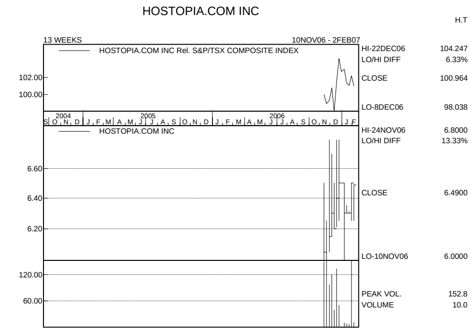

Hostopia.com Inc.

(TSX: H)

Outperform

Speculative Risk

Targeting the Growing SMB Web Services Market…With A Distribution Advantage

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Price:	$6.30	Price Target:	$8.00
Implied All-In Return:			27.0%
52-Wk High:	$6.80	52-Wk Low:	$6.00
Float (MM):	6.4	Debt-to-Cap:	0.0
Shs O/S (MM):	11.9	Mkt Cap (MM):	$65.2
Dividend:	$0.00	Yield:	0.0%
Tr. 12 ROE:	6%	3-Yr Est. EPS Gr:	-21%
Trading Volume (000s):			16
Strategic Shareholders:			Mgmt & Directors (42%)
			Institution #1 (8%)

(FY Mar 31)	2005A	2006A	2007E	2008E
EPS	$0.47	$0.28	$0.23	$0.24
P/E	11.7	19.6	23.8	22.8
Rev (MM)	$14.3	$18.0	$23.1	$29.2
EPS	Q1	Q2	Q3	Q4
2006A	$0.05	$0.08	$0.07	$0.08
2007E	$0.07	$0.07	0.05E	0.05E
2008E	0.05E	0.06E	0.06E	0.06E
Revenue				
2006A	$4.1	$4.3	$4.5	$5.1
2007E	$5.4	$5.6	5.9E	6.3E
2008E	6.7E	7.1E	7.5E	7.9E

All values in U.S. except share price, target and market cap. in C$.
Multiples adjusted for currency.

Priced as of prior trading day's market close, EST (unless otherwise stated).

For Required Disclosures, please see page 5.

Event

Initiating coverage on Hostopia.com Inc., with Outperform, Speculative Risk rating and C$8.00 target.

Investment Opinion

Hostopia is an early stage provider of hosting and web services, targeting the growing SMB (Small and Medium Business) web services market. Its focus on private-label distribution through large telecommunication partners provides it with competitive barriers, higher growth and margins than peers.

- **Attractive SMB Market Opportunity.** The addressable SMB web services market is large (est. 10-11M US SMBs), and growing as SMBs reach out to their consumers and partners via a professional web presence. Distribution via large telecommunication partners provides Hostopia with proprietary access to +5M end-users, over 20% of the addressable market.
- **Private Label Distribution Drives Above-Avg. Performance**. Hostopia's prime advantages over competitors are a) its focus on private-label distribution through large telco partners; and b) its low-cost Ukraine-based R&D strategy. These have provided Hostopia with above-average EBITDA margins (25%, above peers at 4-8%), and growth (54% CAGR, 3-4x faster than peers). Churn has been 24% vs. 50% avg. Revenue is 97% recurring, providing stability.
- **Management are Internet Veterans.** Management (42% ownership) are Internet veterans, and have developed Hostopia's proprietary web technology. Checks validate partner satisfaction with Hostopia's end-to-end solutions, which help get SMB end-users on the Internet in a hassle-free approach, saving the partner significant investment.
- **Risk and Upside.** Hostopia has limited financial and operational history, hence our Speculative Risk rating. Specific risks to growth, profitability and valuation include: competition, distribution partner concentration & power, margin risk. On the upside, should management execute, only 1-2 incremental large partner wins increase FTM revenue growth from 26% to 40%.

Outlook. Our outlook is for F07 revenues of $23.1M (up 29% Y/Y) and GAAP EPS of $0.23 with EBITDA margins of 23%. For F08, we expect $29.2M (up 26% Y/Y) and $0.24 GAAP EPS with 22% EBITDA margins.

Valuation & Recommendation

Initiating Coverage with Outperform, Speculative Risk and C$8.00 target. Valuation appears attractive at 26x FTM P/E and 2.5x FTM P/S, below peers at 33x and 3.7x. Our target valuation of 33x FTM P/E and 3.2x FTM P/S is DCF-based (WACC of 15%, 4.5% terminal rate, FTM net cash of $1.62/share), and in our view reasonable, given 26% FTM growth and 23% EBITDA growth (4% EPS growth).

Targeting the Growing SMB Web Services Market…With A Distribution Advantage

Initiating Coverage with Outperform, Speculative Risk and C$8.00 target. Hostopia is an early stage $26M (FTM est.) provider of Web hosting and Web services, targeting the growing SMB (Small and Medium Business) web services market (est. 10 -11M US SMBs). Hostopia's prime advantages over competitors are a) its focus on private-label distribution through large Telco partners; and b) its low-cost Ukraine-based R&D strategy. These have provided Hostopia with above-average EBITDA margins (25%, above peers at 4-8%), and growth (54% CAGR, 3-4x faster than peers). Valuation remains attractive below peers, and, should management execute, we see upside to our C$8.00 target. Hostopia has limited financial and operational history, hence our Speculative Risk rating.

Investment Thesis

1. **Attractive SMB Market Opportunity.** The addressable SMB web services market is large (est. 10-11M US SMBs), and growing as SMBs reach out to their consumers and partners via a professional web presence. Distribution via large telecommunication partners provides Hostopia with proprietary access to +5M end-users, over 20% of the addressable market.

2. **Private Label Distribution Drives Above-Avg. Growth**. Hostopia's focus on private-label distribution through large telco partners is a competitive advantage over other B2C web services vendors. By signing marquis partners like Verizon, Bell, BT, Hostopia has grown 54% CAGR, 3-4x faster than peers. Churn has been 24% vs. 50% industry average. **Should management execute, only 1-2 incremental large partner wins increase FTM growth from 26% to 40%.**

3. **Margins Above Peers.** Hostopia has been consistently profitable since early 2004; EBITDA margins have averaged 25% (23% Q2/F07), above industry peers at 4-8%. Its focus on private-label distribution reduces marketing and customer acquisition costs (S&M expenses are 22%, below industry average at 25%). R&D costs are kept low (12% vs. 20% industry average) via its multi-year supply relationship with Ukraine-based GFL (GeeksForLess). The GFL cost advantage contributed 6% of Hostopia's 27% F06 EBITDA margins or $0.10 to F06 EPS.

4. **Recurring Revenue Provides Stability.** Revenue is 97% recurring, providing stability and visibility. Distribution partners typically sign longer-term contracts (2-3 years average), and integrate themselves tightly to Hostopia's offerings, raising exit barriers within a highly competitive market.

5. **Management are Internet Veterans.** Management (42% ownership, aligned with investors) are Internet veterans, and have developed Hostopia's proprietary web technology. Checks validate partner satisfaction with Hostopia's end-to-end solutions, which help get SMB end-users on the Internet in a hassle-free approach, saving the partner significant investment.

6. **Valuation.** Valuation appears attractive at 26x FTM P/E and 2.5x FTM P/S, below peers at 33x and 3.7x. Our C$8.00 target valuation of 33x FTM P/E and 3.2x FTM P/S is DCF-based and is in our view reasonable, given 26% FTM growth and 23% EBITDA growth (4% EPS growth).

Management

Management are Internet veterans, having founded and sold previous web services businesses. Mgmt ownership is 4.7M shares or 42% of total outstanding, implying strong alignment with shareholder interests. Hostopia has 191 employees: 176 located in Canada, and 15 in US.

1. **Colin Campbell, CEO & COO.** Colin Campbell co-founded Hostopia in 1999; he has been CEO/COO since April 2006, and COO from 2001 to 2006. Prior to joining Hostopia, Mr. Campbell was SVP, Internet Services at Look Communications from 1999 to 2000, COO of TUCOWS Interactive from 1997 to 1999 and COO of Internet Direct from 1994 to 1999 (overlap because related businesses). Mr. Campbell holds a Bachelor of Arts in Commerce from the University of Toronto, and owns 1.4M shares or 13%.

2. **Bill Campbell, President.** Bill Campbell co-founded Hostopia in 1999 and has served as President since April 2006, and CEO from 2001 to 2006. Before that, he was CTO of TUCOWS Interactive from 1997 to 1999 and CTO of Internet Direct from 1994 to 1999 (overlap because related businesses). Mr. Campbell has a diploma from Control Data Institute. Bill Campbell owns 1.5M shares or 14% of total**.**

3. **Mike Mugan, CFO.** Mike Mugan joined Hostopia in May 2000 as its CFO. Before that, Mr. Mugan was VP, Finance at George Weston Limited and ran a consulting business focused on the high tech industry. Mike Mugan holds a CA and a Bachelor of Commerce (Honors) Degree from the University of Windsor. Mike Mugan owns 0.1M shares or 1% of total.

Growth Strategy

I. **Acquire New Distribution Partners.** Hostopia has to date acquired 237k end users (up 38% F06) and 330 distribution partners. 40% of growth comes from acquiring new distribution partners including notable wins with Verizon and British Telecom. We expect Hostopia to sign approx. 3-5 distribution partners/quarter, with large (10K+ end-users) as upside to our outlook. Should management execute, only 1-2 incremental large partner wins would increase FTM revenue growth from 26% to 40%.

II. **Penetrate Existing Distribution Partners' End-user Base.** 60% of Hostopia growth comes from incremental penetration into partner end-user bases (approx 5M+ users). Should management increase overall penetration from 5% (typical for newer partners) currently to 10% (typical for legacy partners), its user base could double to 500k users. Each 1% incremental penetration within the 5M end-users base equates to 4.8M revenue or $0.05 EPS.

III. **Increase ARPU.** Over 50% of Hostopia end-user customers are currently on $20/mo/user bundled packages, for which Hostopia receives 40% or $8/month. Hostopia is focused on the opportunity to expand ARPU via upselling higher priced end-user packages, for which Hostopia is targeting 10% of end-users. We are conservatively modeling ARPU to rise from $7.59/mth Q2/F07E to $7.78/mth Q4/F08E on modest uptake of higher-priced packages and uptake of new services.

IV. **Acquisitions.** Hostopia may seek to improve its competitive position through selective acquisitions, including other private label Web hosting providers to boost its end user base or enter new geographic markets or other Web service developers to expand its offering.

Outlook

Consistent Record of Growth and Profitability. Hostopia has grown consistently and profitably F02-F06, with CAGR of 54% over that period. Total revenue was $18M in F06, up from $3M in F02. 40% of end user/revenue growth in F06 was due to adding distribution partners and migrating their end user websites. Hostopia has been profitable for 11 consecutive quarters; EBITDA margins have averaged 25%, above peers at 4-8%, and churn has been 24% vs. 50% avg. EBITDA margins declined during 1H07 to 23%, due to investment in R&D and Support for development/deployment of new services, but are expected flat (and healthy) 2H07 and through F08. Please see Exhibit 1 for RBC estimates.

FTM Growth Driven By New Distribution Partners. We expect 26% F07/F08 revenue growth, driven largely by end-user migrations at BT and other partners, new partner contracts, and increased penetration of existing partner user bases. End-users are expected to grow to 24%, to 330k by end F08 (from 266k Q4/F07)

Margins Expected Flat on Ongoing Investments For Future Growth. Increased investment in S&M, R&D for new products/services as well as migration and infrastructure costs to accommodate new distribution partners, are expected to maintain EBITDA margins at 23% in F07 and 22% in F08.

Cash, Balance Sheet. Hostopia has been cash flow positive since 2003, with average $1M annual FCF over last 3 years. Hostopia raised $22M from its November 2006 IPO, to close Q3/F07 with $24M cash ($2.09/share) and no debt. Hostopia intends in F07/F08 to deploy $14M of proceeds towards infrastructure expansion in US and UK markets.

Exhibit 1: RBC Estimates (for Y/E March 31)

Year End Mar 31	F2005	F2006	F2007E	F2008E
Revenue ($MM)	**$14.3**	**$18.0**	**$23.1**	**$29.2**
Y/Y Growth (%)	61%	26%	29%	26%
EBITDA ($MM)	3.3	4.8	5.3	6.5
Y/Y Growth (%)	327%	47%	9%	23%
EBITDA Margin (%)	23%	27%	23%	22%
Net Income (GAAP) ($MM)	3.2	2.0	2.0	2.8
Shares Outstanding - Diluted (MM)	6.6	6.7	8.5	11.9
EPS (GAAP)[1]	**$0.47**	**$0.28**	**$0.23**	**$0.24**

1. The 4.8M shares from Hostopia's November 2006 IPO increases outstanding shares to 11.9M, distorting F07E/F08E EPS growth. We expect 23% Y/Y growth in F08E EBITDA vs. 4% EPS growth. Slower EPS growth in the short-term may constrain valuation until the dilution overhang is overcome.

Source: RBC Capital Markets Research; Company reports

Q3/07 Preview

Q3 Preview. Hostopia reports Q3/F07 results the week of Feb 12 (est). We are expecting revenues of $5.9M (31% Y/Y and 5% Q/Q). New subscribers are expected at 13k for a 250k total, up from 237k Q3. EPS is expected at $0.05 (including 40% dilution from IPO done Nov 10). EBITDA margins are expected at 22% with 6% Y/Y EBITDA growth. Focus is on BT migration progress (deal announced Q3); we are conservatively modeling slow migration Q3/07 with ramp-up Q4/07 and Q1/08.

Valuation

Valuation appears attractive. Valuation appears attractive at 26x FTM P/E, 2.5x FTM P/S and 0.6x PEG (adjusted for dilution), below peers at 33x FTM, 3.7x P/S and 0.8x PEG. Our target valuation of 33x P/E and 3.2x P/S appears reasonable given 26% expected F08 revenue growth, solid 25% margins (vs. 4-8% industry avg.) and 23% EBITDA growth (4% EPS growth). The release of 5.5M (50%) shares from IPO lockup may create an interim share overhang (May 2007).

Initiating Coverage with Outperform, Speculative Risk rating and C$8.00 target. Distribution partner additions, end-user growth are expected expand Hostopia's valuation multiple. Our C$8.00 is DCF-based (WACC of 15%, 4.5% terminal growth, and FTM cash of $1.62/share) and equates to 33x FTM EPS and 3.2x FTM P/S. Based on the implied 27% return to our 12-month price target of C$8.00 we rank Hostopia Outperform. Investment risks include competition, customer concentration, and the risks associated with an early-stage business with limited track record, hence our Speculative Risk rating.

Exhibit 2: Comparables Table

			Market	Net		Price/Earnings			Price/Sales			EV/Sales			Rev.
		Share	Cap.	Cash /	Rev.										Growth
Company	Ticker	Price	$MM	Share	FTM	FTM	FY1	FY2	FTM	FY1	FY2	FTM	FY1	FY2	FTM-TTM
Internet Infrastructure:															
Concur Technologies	CNQR	$17.19	$622	($0.01)	$132	55.5x	57.3x	40.9x	4.7x	5.0x	3.9x	4.7x	5.0x	3.9x	22.9%
Liveperson	LPSN	$6.26	$255	$0.49	$45	34.8x	52.2x	31.3x	5.7x	7.7x	5.3x	5.3x	7.1x	4.9x	51.9%
Q9 Networks	Q	$13.90	$281	$3.31	$57	nmf	nmf	35.6x	4.9x	4.9x	4.0x	3.8x	3.8x	3.1x	22.4%
Ultimate Software	ULTI	$24.44	$588	$1.14	$133	39.4x	62.7x	35.9x	4.4x	5.2x	4.2x	4.2x	4.9x	4.0x	24.3%
Web.com	WWWW	$4.71	$79	$0.73	$52	nmf	nmf	nmf	1.5x	1.6x	1.5x	1.3x	1.4x	1.2x	7.0%
WebSideStory	WSSI	$14.00	$277	($0.01)	$85	21.2x	25.9x	19.4x	3.3x	4.0x	3.1x	3.3x	4.0x	3.1x	43.2%
Website Pros	WSPI	$9.09	$154	$2.36	$67	17.8x	21.1x	16.8x	2.3x	3.0x	2.2x	1.7x	2.2x	1.6x	42.9%
Hostopia.com (1)	H	C$6.30	$65	$2.22	$26	26.1x	23.8x	22.8x	2.5x	2.8x	2.2x	1.5x	1.7x	1.3x	26.5%
Average						32.5x	40.5x	29.0x	3.7x	4.3x	3.3x	3.2x	3.8x	2.9x	30.1%

(1) Hostopia.com values converted to a U$ basis at C$/US$1.15.
Note: Estimates for Hostopia.com are RBC CM estimates; all other estimates are consensus.

Source: RBC Capital Markets estimates; Thomson Baseline (consensus); company reports

DCF Sensitive to Assumptions. Our C$8.00 price target is sensitive to material changes in assumptions. As shown in Exhibit 3, 100 bps change in discount rate impacts valuation ~$0.50 (5%) and 100 bps change in terminal growth rate has $0.13 (1%) impact on valuation. Additionally, we estimate 100 bps change in EBITDA margins impacts valuation $0.25 (2%).

Exhibit 3: DCF Valuation

Discounted Free Cash Flow to Equity - Sensitivity Analysis

		Discount Rate				
		13%	14%	15%	16%	17%
	4.0%	C$9.27	C$8.49	C$7.86	C$7.33	C$6.89
Terminal	4.5%	C$9.50	C$8.66	**C$7.98**	C$7.43	C$6.97
Growth	5.0%	C$9.75	C$8.85	C$8.12	C$7.54	C$7.05
Rate	5.5%	C$10.04	C$9.06	C$8.28	C$7.65	C$7.14

Note: Values converted to a C$ basis at C$/US$1.15.

Source: RBC Capital Markets Research

Investment Risks

Competition: Hostopia operates in a highly competitive, fragmented market with numerous vendors of varying size and business models, from independent contractors to global portals like Yahoo!. Hostopia could face competition in efforts to achieve its objectives, which could impact growth and margins. However, its private-label distribution strategy raises switching barriers for its distribution partners.

Margins: Margins may come under pressure if opex rises faster than expected, such as higher costs incurred to sign up and migrate larger customers, or as Hostopia's expands its US presence and/or moves into UK markets. The loss of the GFL cost advantage could impact 6% of Hostopia's 27% F06E EBITDA margins, equivalent to ($0.09) to F08E EPS. GFL however has a multi-year agreement with Hostopia, and management control of GFL may help maintain low rates upon contract renewal.

Uptake of Web Services and Churn: adoption of value-add Web services and ARPU expansion is uncertain within the SMB sector, and end-user uptake of basic or advanced services may be lower than forecast. SMB customer churn, typically larger than big enterprises, could be higher than expected. Doubling churn to 48% would reduce F08E end-user growth to 0% from 24%.

Operations: Interruption of, impact to Hostopia's normal business or customer experience on operational issues could impact business momentum and valuation. Hostopia leases its hosting from Class 1 Hosting partners, same vendors used by Google (Miami) and TELUS (Mississauga). Hostopia may also face litigation risk from competitors, partners or customers.

Customer Power and Concentration: Customer concentration exists with Hostopia's top 20 distribution partners accounting for 63% of revenue and top 2 distribution partners (Bell, Register.com) accounting for 20%. Large distribution partners are sometimes bureaucratic, may delay or undermine migration, product or marketing initiatives, or may exert undue power over Hostopia, which could impact growth and/or margins. The loss of a large customer could have adverse impacts on growth and valuation. The loss of 1-2 incremental large partners could decrease FTM growth from 26% to 14%.

Early Stage company: As an emerging company, Hostopia has limited financial and operational history, which means incurring the risk associated with early stage companies.

IP Risk: With few patents and limited legal resources, Hostopia faces litigation and IP risk typically associated with launch of new technology products.

GFL Structure: Hostopia's management arrangement with GFL, or GeeksForLess (personal ownership/control of a key supplier who provides Hostopia with significant margin advantage above industry average) is unusual, and may create some risk to valuation.

Price Target Impediments

Risks to our target include: A general tech market pullback; general competition and pricing pressure; pricing erosion and market share loss from the entrance of large diversified Internet companies such as Google, Yahoo and Microsoft; inability to sign new customers; poor customer promotion and re-selling of website hosting and other services; lower than expected uptake of new web services; unforeseen challenges and costs migrating customer websites; higher than expected development and support costs for new web services; greater sales & marketing costs to support US and UK expansion; disruption and/or cost inflation of outsourced services located in Ukraine; protracted execution issues; and departure of key management personnel.

Company Description

Founded in 1999, Hostopia is one of the leading providers of private-label Web hosting and other Web services for the SMB market. Hostopia's services are resold through telecommunications carriers, cable companies, Internet service providers, domain registrars, and Web Hosting service providers. Some of Hostopia's services include Website hosting, managed email with virus and spam protection, e-commerce application services, Website creation, and customer communications and Website promotion applications. Hostopia offers marketing, support, systems and integration services to aid its customers (resellers) in the promotion, delivery, and quality of Web services. Hostopia has 191 employees based at facilities in Toronto, Ontario and Fort Lauderdale, Florida, and outsources a portion of R&D, customer support and other functions to Ukraine-based GeeksForLess Inc. Hostopia had 213k end users, $18M revenue (up 26% Y/Y) and $5M EBITDA in F06.

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Outperform (O): Expected to materially outperform sector average over 12 months.

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Underperform (U): Returns expected to be materially below sector average over 12 months.

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Rating	Count	Percent	Count	Percent
BUY [TP/O]	416	43.33	154	37.02
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