Zacks Small-Cap Research

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Net Element Inc. (NETE-NASDAQ)

NETE: Debt Negotiations Are Underway

Current Recommendation	**BUY**
Prior Recommendation	BUY
Date of Last Change	10/15/14
Current Price (08/18/15)	$0.18
Target Price	**1.40**

OUTLOOK

Net Element is a software and services company, in global online payments. It operates a small merchant processor in the US and a mobile payment processor in Russia. It just acquired PayOnline, a market leader in the Russian Federation in online payments.

The company is looking to restructure its current debt at more favorable terms, which could aid its valuation.

SUMMARY DATA

52-Week High	**$5.70**
52-Week Low	**$0.14**
One-Year Return (%)	**-89.8**
Beta	**0.30**
Average Daily Volume (sh)	**3,640,015**
Shares Outstanding (mil)	**67**
Market Capitalization ($mil)	**$12**
Short Interest Ratio (days)	**1.15**
Institutional Ownership (%)	**1**
Insider Ownership (%)	**26**
Annual Cash Dividend	**$0.00**
Dividend Yield (%)	**0.00**
5-Yr. Historical Growth Rates	
Sales (%)	**254.3**
Earnings Per Share (%)	**N/A**
Dividend (%)	**0**
P/E using TTM EPS	**N/M**
P/E using 2015 Estimate	**N/M**
P/E using 2016 Estimate	**N/M**
Zacks Rank	**2**

Risk Level	**High**
Type of Stock	**Small-Value**
Industry	**Internet Commerce**
Zacks Rank in Industry	**8 of 28**

ZACKS ESTIMATES

Revenue
(in millions of $)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2013	0.9 A	5.6 A	6.5 A	5.8 A	18.7 A
2014	4.8 A	4.9 A	6.0 A	5.4 A	21.2 A
2015	5.5 A	6.9 A	8.3 E	8.8 E	29.5 E
2016					39.1 E

Earnings per Share
(Non-GAAP EPS before non recurring items)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2013	-$0.10 A	-$0.11 A	-$0.11 A	-$0.12 A	-$0.44 A
2014	-$0.11 A	-$0.07 A	-$0.05 A	-$0.00 A	-$0.19 A
2015	-$0.04 A	-$0.06 A	-$0.06 E	-$0.05 E	-$0.21 E
2016					-$0.14 E

Zacks Projected EPS Growth Rate - Next 5 Years **25%**

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Company Seeks to Revise Debt Terms Before September 4, 2015

Company filings show the Net Element is now renegotiating its debt and that is why the cash is still in escrow and not available to the company. If nothing is resolved, by September 4, 2015, the deal will be automatically cancelled and the $5 million returned. We hope that the company will soon able to negotiate a change that is beneficial to common shareholders, and the stock price. For the first six months of this year, the company is burned cash at approximately $480,000 a month and if this continues it would need to find other financing to operate if the cash is returned.

In addition, in our opinion, the issuance of preferred stock to fund the PayOnline acquisition has wreaked havoc on the company's stock. We believe the preferred stockholders, who get the stock and the ongoing dividends that are paid in kind at a discount, have been sellers the moment they get their distribution. Since they get it at a discount to the prevailing price, they seem to be price insensitive and seem to be just trying to capture the discount. According to filings, the company has now restricted their selling to less than 10% of the trading volume per day for each of the two parties involved, or 20% total.

Between these two instruments, there has been significant dilution to the common stock and there is considerable risk to the common shareholders as share count predictions are a moving target. If the debt is cancelled and another solution to cash is found, the solution may or may not be beneficial to common holders and believe only investors with a high tolerance for risk should be involved.

Q2 Revenues Beat; Expect Sequential Growth Going Forward

Net Element reported revenues of $6.9 million versus $4.9 million in 2014, up 41%. This beat our estimate by $200,000 mainly by better credit card processing revenues. The company was only able to capture $0.3 million of the $1.2 million that PayOnline generated for the full quarter from its closing date of May 20th. Most importantly the company predicted that revenues across all three businesses should be up sequentially for the foreseeable future.

Gross margin improved sequentially to 20.8% from 16.7% in Q1 and but down from 31.9% last year due to product mix as well as age of credit card portfolios. The company expects the gross margins to sequentially improve as PayOnline begins to contribute more to the mix.

Taking out last years one-time provision for loan losses, operating expenses went from $3.2 million to $3.9 million, all on the G&A line. This included on a partial quarter of PayOnline expenses so we expect them to increase next quarter. Operating losses (ex-one time charges) went from a loss of $1.3 million to a loss of $2.5 million this year.

Other expenses totaled $729,000. That was comprised of $1.3 million in interest expense down from $1.8 million the year before, and $2 million in expense for the conversion derivative, much of which is one-time.

Adjusted non-GAAP EPS came in at a loss of $0.06 versus a loss of $0.04 last year. We expect losses to continue as the company pursues revenues growth over profits.

Valuation Is Based on Fully Diluted Shares

Given the complicated financing, shares outstanding each quarter will vary greatly depending on share price, we can only look to the end point shares outstanding some time in March 2015. With what we know, we expect the fully diluted shares outstanding to be **approximately 80 million shares** at that time. At $0.23 a share this is a **market capitalization of $18 million**. Based on 2015 estimated revenues Of $30 million, that is or **1.3 times market cap to sales-- an inexpensive valuation based on comparables trading at 4.6 times.** By 2016, revenues could be as high as $40 million for another 30% increase.

If the company could reach the average valuation of its peer, its common stock could be worth $1.40 per share twelve months from now based on an industry average valuation of approximately 4.7xs enterprise value to sales.

Q3 2015

We expect the company to continue to grow revenues sequentially and improve margins. The company will benefit from a full quarter of PayOnline revenue. In Q2, the company booked only $0.3 million in the quarter due to the timing of closing the deal. In Q1 a full quarter would have showed revenues of $1.2 million for PayOnline. We are therefore forecasting a contribution of $1.4 million in Q3 for PayOnline. Total revenues are estimated to be $8.3 million versus $6.0 million in 2015, up 37%. More revenues from that business should also improve gross margins via product mix.

We expect continuing losses as the company invests to grow the business as shown in our model. In addition, if the company does cancel its debt, there will be a reversal of the $2 million gain taken in Q2 for change in fair value and settlement of beneficial conversion derivative and another possible $2 million in balance sheet adjustment resulting in large one time non-cash loss.

A Recap on PayOnline—A Major Mobile Payment Company in Russia

On March 17, 2015, the company announced it entered into a binding offer letter to purchase PayOnline based in Moscow from SD Ventures, for $3.6 million in cash, $3.6 million in restricted stock, plus the possibility of another $1.28 million in stock based on earn-out hurdles. PayOnline financials were consolidated with Net Element as of May 20, 2015. The earn-out is based on PayOnline reaching a certain EBITDA for certain post-closing periods, multiplied by 1.35, and will be paid in March 2016 based on 2015 results. The cash was funded by the sale of stock backed up with $7 million of its $10 million line of credit. There are a number of synergies between the two companies and each hopes to expand geographically into each other's current business territories.

PayOnline is a processor of online payments and works with four or five major banks in Commonwealth of Independent States, Europe and Asia. It has 10 million active customers and more than 3,000 merchants. It has a high level of fraud protection, works with MasterCard and Visa and is integrated into travel platforms such as SABER, Galileo and GDS. In addition to online web-based payments the company also has a mobile app that provides a wallet that can be used for person-to-person payments.

INVESTMENT THESIS

- Net Element is growth company in the payments industry that should benefit from the adoption of mobile and online payments in the US and Russia and ultimately globally.
- The new CEO took his former company, Unified Payments, from 0 to $67 million in revenues in two years. We believe he has the experience and drive to replicate this success with Net Element.
- The company has an increasingly robust platform to create a global payment system complete with merchant from end and should be able to expand geographically.
- We believe the company could grow to $30 million in revenues in 2015 through a combination of internal growth as well as acquisitions and partnerships.
- If NETE achieves our forecasts without further common stock dilution than that already predicted and no incremental debt, we believe its common stock could be worth $1.40 per share twelve months from now based on an industry average valuation of approximately 4.7xs enterprise value.

VALUATION

There are a number of public companies in the merchant acquiring/processing business. The largest is Cielo with a $25 B enterprise value located in Brazil. The smallest is we are using is Qiwi, who runs payment systems in the Russian Federation and is based in Moscow and has a $1 billion enterprise value. The rest are located in the US. All are profitable and we expect that NETE will have to meet that hurdle in order to be awarded a comparable value. If we take the average enterprise value to sales of this group of companies of 4.7 times sales and apply it to the revenues we expect Net Element to generate next year, and its fully diluted share count next year, and turn that back to price per share we get a conservative share value of $1.47.

Merchant Acquring/Processing

Company	Ticker	Revenue 2015E	Revenue LTM	EBIDTA Margin	Enterprise Value / Sales 2015E	Enterprise Value / Sales LTM	Included in Average?	Enterprise Value
Cielo	CIOXY	NA	$2,650	48%	NA	9.5x	n	25,070
Vantiv	VNTV	$1,650	$2,920	24%	5.6x	3.2x	y	9,320
Total System Services	TSS	$2,710	$2,610	29%	3.6x	3.8x	y	9,810
Global Payments	GPN	$2,357	$2,770	21%	3.9x	3.3x	y	9,240
EVERTEC	EVTC	$372	$365	46%	5.6x	5.8x	y	2,100
Heartland Payment System	HPY	$806	$2,480	13%	3.5x	1.1x	y	2,800
Qiwi	QIWI	$183	$169	32%	5.8x	6.3x	y	1,060
Average				**28%**	**4.7x**	**3.9x**		**$5,722**

	Projected Revenue 2015E	Projected Revenue LTM	EBITDA Margin	Enterprise Value / Sales 2015E	Enterprise Value / Sales LTM	Valuation Range Low	Valuation Range High
Net Element	**$29**	**$24**	**NM**	**4.7x**	**3.9x**	**$93**	**$138**
YoY growth							

Conclusion of Enterprise Value	**$115,709,789**
Market Value	**$117,873,498**
Shares Outstanding	80,000,000
Price per Share	**$1.47**

RISKS

- We believe it is possible holders of preferred stock have been avid sellers regardless of stock price or valuation and are a risk to market pricing.
- The company is losing money and may not be able to reach profitability or maintain positive cash flow.
- The company is involved in a number of lawsuits with former management.
- The Russian mobile and online payment market is still in its infancy and there is no assurance the country will adopt this method to pay for goods and services.
- Future acquisitions may not be successfully integrated operationally or technologically. Purchased portfolios may not yield expected profits.
- The merchant acquirer market in the US is competitive and larger companies have an advantage due to economies of scale.
- Operations in Russia and the United Federation face considerable political risk and may be prohibited from certain transactions by governments.
- Currency, particularly the ruble, has fluctuated dramatically and could affect reported earnings and operations.
- It is currently impossible to predict Net Element's future shares outstanding either primary or fully diluted due to the methodology used to issue dividends to the preferred holders, which is based on stock price. We have made an attempt, but actual number may vary greatly as the stock price fluctuates.

PAYONLINE HISTORICAL INCOME STATEMENT

		Q1 2014	Q2 2014	Q1 2015	Q2 2015	2013	2014
Net Revenues	$	1,390,235	1,815,570	1,202,878	1,205,310	5,997,495	6,729,228
Yr-to-yr				-13.5%	-33.6%		12.2%
Direct expenses:							
Bank commissions		947,362	NA	802,092	NA	4,047,877	4,595,623
Employee salaries and related benefits		249,875	NA	139,276	NA	966,162	814,121
Technology consulting and maintenance		22,431	NA	19,817	NA	46,586	86,475
Professional fees and other consulting expenses		17,171	NA	42,300	NA	96,101	225,598
Marketing expenses		9,411	NA	44,048	NA	306,613	201,176
Lease expenses		68,050	NA	34,019	NA	298,651	216,876
Communications		8,996	NA	6,191	NA	49,165	38,938
Depreciation expenses		5,416	NA	3,908	NA	16,528	20,112
Amortization expenses		12,522	NA	14,729	NA	37,506	65,714
Other direct expenses		58,305	NA	22,024	NA	54,151	36,075
Total direct expenses		1,399,539	NA	1,128,404	NA	5,919,340	6,300,709
Yr-to-yr				-19.4%			6.4%
Net Revenues less Direct Expenses	$	**9,304**		**74,474**		**58,155**	**428,520**
Yr-to-yr				700.5%			636.9%

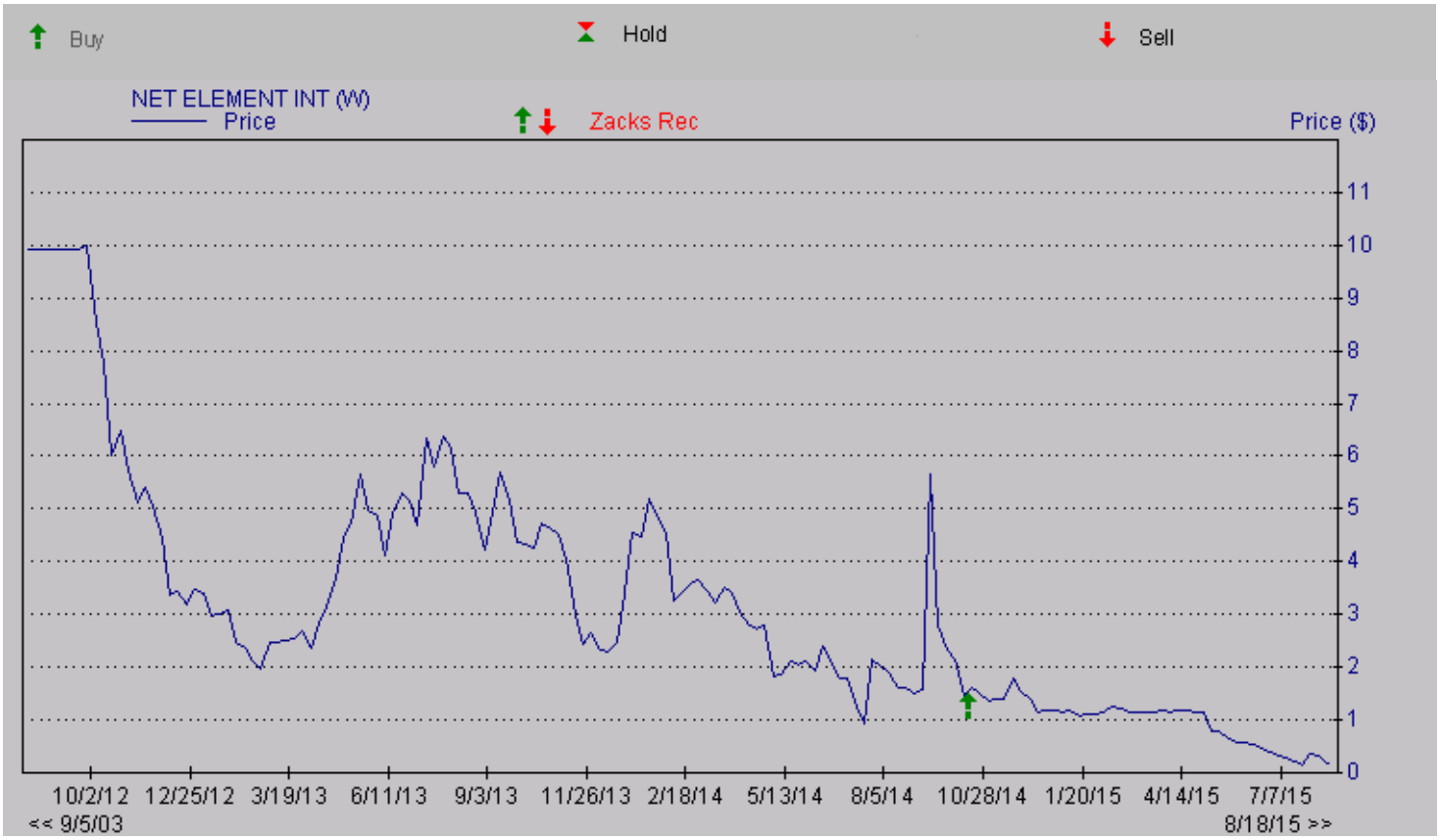
BALANCE SHEET

	June 30, 2015	March 31, 2015	% Change
Current assets:			
Cash	**$675,231**	**$766,279**	-12%
Funds in Escrow	**$5,000,000**	**$0**	
Accounts receivable, net	3,493,939	3,275,720	7%
Advances to aggregators, net	113,841	0	
Prepaid expenses and other assets	768,663	755,674	2%
Total current assets	10,051,674	4,797,673	110%
Fixed assets, net	137,583	60,850	126%
Intangible assets, net	8,651,527	2,273,695	281%
Goodwill	6,671,750	6,671,750	0%
Other long term	288,283	225,189	28%
Total assets	25,800,817	14,029,157	84%
Current liabilities:			
Accounts payable	$3,217,611	$3,398,814	-5%
Deferred revenue	241,304	437,625	-45%
Accrued expenses	2,747,967	2,372,425	16%
BCF deriative liabilities	368,571	**0**	
Warrant derivative liability	3,623,182	**0**	
Short term notes payable (net of discount)	**277,778**	**0**	
Notes payable (current portion)	**318,405**	**318,405**	0%
Due to related parties	**83,257**	**125,000**	-33%
Total current liabilities	10,878,075	6,652,269	64%
Notes payable (non-current portion)	3,646,595	3,646,595	0%
Total liabilities	14,524,670	10,298,864	41%
Series A Convertible Preferred stock	2,832,082	0	
STOCKHOLDERS' DEFICIT			
Common stock	5,761	4,618	25%
Paid in capital	144,416,472	137,290,970	5%
Stock subscription	(1,111,130)	(1,111,130)	0%
Accumulated other comprehensive income (loss)	(1,475,981)	(1,359,628)	9%
Accumulated deficit	(133,645,034)	(131,355,552)	2%
Noncontrolling interest	253,977	261,015	-3%
Total stockholders' deficit	11,276,147	3,730,293	202%
Total liabilities and stockholders' deficit	25,800,817	14,029,157	84%
Net Cash	4,995,791	322,874	1447%
Current and Quick Ratio	0.9	0.7	28%
Working Capital	(826,401)	(1,854,596)	-55%

INCOME STATEMENT

Dollars in Millions	2014				2014						
	31-Mar-14	30-Jun-14	30-Sep-14	31-Dec-14	31-Mar-15	30-Jun-15	30-Sep-15 (est.)	31-Dec-15 (est.)	2014	2015E	2016E
Credit card processing	$4.1	$4.6	$5.6	$5.2	$5.2	$6.3	$6.5	6.6	$19.4	$24.59	$30.10
Yr-over-yr Growth	NM	-0.6%	1.0%	10.9%	26.5%	37.1%	16.8%	28.6%	31.0%	26.8%	22.4%
Mobile payments	0.8	0.3	0.5	0.250	0.363	0.331	0.4	0.5	1.8	1.5	2.0
Yr-over-yr Growth	-13.6%	-66.3%	-54.4%	-75.2%	-51.6%	-2.1%	-24.1%	99.7%	-54.4%	-14.2%	29.5%
PayOnline	1.4	NA	NA	NA	0.0	0.3	1.4	1.6		3.3	7.0
Total revenues	4.8	**4.9**	**6.0**	**5.4**	5.5	6.9	8.3	8.8	**21.2**	**29.5**	**39.1**
Yr-to-yr Growth	457.9%	-12.4%	-7.6%	-5.9%	14.4%	40.6%	36.9%	62.2%	13.0%	39.1%	32.6%
Costs and expenses:											
Cost of revenues	3.5	3.3	4.7	4.3	4.6	5.5	6.2	6.5	15.9	22.8	26.0
Gross Margin	1.3	1.6	1.3	1.1	0.9	1.4	2.1	2.3	5.3	6.7	13.1
% of Sales	27.1%	31.9%	21.7%	20.7%	16.7%	20.8%	24.8%	26.0%	25.1%	22.7%	28.0%
G&A	3.1	2.5	2.4	3.2	2.6	3.2	3.6	3.6	11.4	13.0	15.8
Provision for loan losses	0.1	(1.5)	0.1	0.1	0.0	0.1	0.0	0.0	(1.2)	0.1	0.0
Depreciation and amortization	0.6	0.6	0.7	0.5	0.4	0.6	0.6	0.6	2.4	2.3	2.4
One-time charges	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total operating expenses	3.8	1.6	3.3	3.8	3.1	3.9	4.2	4.2	12.6	15.5	18.2
Loss from operations	(2.5)	(0.1)	(1.9)	(2.7)	(2.2)	(2.5)	(2.2)	(1.9)	(7.2)	(8.8)	(5.1)
Loss from operations ex-one time	(2.5)	(1.3)	(1.9)	(2.7)	(2.2)	(2.5)	(2.2)	(1.9)	(8.4)	(8.8)	(5.1)
Interest expense, net	(1.1)	(1.8)	(0.8)	(0.1)	(0.1)	(1.3)	(1.3)	(1.3)	(3.7)	(4.0)	(4.0)
Other expense	(0.0)	(0.0)	(0.1)	(0.1)	0.0	(0.0)	0.0	0.0	(0.2)	(0.0)	0.0
Gain on asset disposal	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gain on change in converstion derivative	0.0	0.0	0.0	0.0	0.0	2.0	0.0	0.0	0.0	2.0	0.0
One-time charges	0.0	3.2	(2.1)	(0.1)	0.0	0.0	0.0	0.0	1.0	0.0	0.0
Total non-operating expenses	(1.1)	1.4	(3.0)	(0.2)	(0.1)	0.7	(1.3)	(1.3)	(2.9)	(1.9)	(4.0)
Loss from continuing operations before tax	(3.6)	1.3	(4.9)	(3.0)	(2.2)	(1.8)	(3.5)	(3.2)	(10.1)	(12.8)	(9.1)
Income tax provision	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Loss from continuing operations	(3.6)	1.3	(4.9)	(3.0)	(2.248)	(1.8)	(3.5)	(3.2)	(10.2)	(12.8)	(9.1)
Minority interest	0.0	0.0	0.0	(0.0)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net loss	(3.6)	1.3	(4.9)	(3.0)	(2.2)	(1.8)	(3.5)	(3.2)	(10.2)	(12.8)	(9.1)
Preferred dividend	0.0	0.0	0.0	0.0	0.0	(0.5)	(0.5)	(0.5)	0.0	(1.6)	0.0
Net loss to common stock		1.3	(4.9)	(3.0)	(2.2)	(2.3)	(4.0)	(3.8)	(10.2)	(12.3)	(9.1)
Foreign currency translation gain (loss)	1.3	(0.1)	(0.3)	(2.0)	(0.1)	(0.1)	0.0	0.0	(1.1)	0.0	0.0
Comprehensive loss	(2.3)	1.2	(4.6)	(4.9)	(2.3)	(1.9)	(3.5)	(3.2)	(11.3)	(12.8)	(9.1)
Earnings ex-one time charge	(2.2)	(1.9)	(2.7)	(3.0)	(2.3)	(3.8)	(3.5)	(3.2)	(11.2)	(12.8)	(9.1)
Stock-based compensation	0.1	0.7	0.5	3.0	0.6	0.6	0.5	0.5	4.3	2.2	2.0
Adjusted Non-GAAP Earnings	(3.6)	(1.2)	(2.2)	0.0	(1.7)	(3.2)	(3.0)	(2.7)	(6.9)	(10.6)	(7.1)
Yr-to-yr Growth	25%	-62%	-34%	-101%	-51%	172%	33%	-7999%	-64%	52%	
GAAP EPS	**($0.09)**	**$0.04**	**($0.12)**	**($0.11)**	**($0.05)**	**($0.04)**	**($0.07)**	**($0.06)**	**($0.27)**	**($0.26)**	**($0.18)**
Total loss per share	($0.11)	$0.04	($0.12)	($0.11)	($0.05)	($0.04)	($0.07)	($0.06)	($0.27)	($0.26)	($0.18)
Loss per share ex-one time	($0.07)	($0.06)	($0.12)	($0.11)	($0.05)	($0.06)	($0.07)	($0.06)	($0.27)	($0.26)	($0.18)
Fully dil. Loss per share ex-one time	($0.05)	($0.05)	($0.10)	($0.09)	($0.04)	($0.06)	($0.05)	($0.04)	($0.24)	($0.19)	($0.11)
Non-GAAP EPS	**($0.11)**	**($0.04)**	**($0.06)**	**$0.00**	**($0.04)**	**($0.06)**	**($0.06)**	**($0.05)**	**($0.19)**	**($0.21)**	**($0.14)**
Yr-to-yr Growth									-73%	14%	-33%
Share outstanding	32.4	32.4	39.3	44.8	46.1	49.7	51.3	52.7	37.3	49.9	49.9
Yr-to-yr Growth	15%	15%	40%	53%	42%	54%	30%	18%	31%	34%	0%
Fully diluted shares	41.3	41.3	48.3	53.7	55.1	67.8	75.0	76.5	46.3	68.6	80.0
Yr-to-yr Growth	11%	11%	30%	40%	33%	64%	55%	42%	24%	48%	17%

HISTORICAL ZACKS RECOMMENDATIONS



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Buy/Outperform: The analyst expects that the subject company will outperform the broader U.S. equity market over the next one to two quarters.
Hold/Neutral: The analyst expects that the company will perform in line with the broader U.S. equity market over the next one to two quarters.
Sell/Underperform: The analyst expects the company will underperform the broader U.S. Equity market over the next one to two quarters.

The current distribution is as follows: Buy/Outperform- 16.3%, Hold/Neutral- 77.4%, Sell/Underperform – 5.9%. Data is as of midnight on the business day immediately prior to this publication.