Zacks Small-Cap Research

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SMTP Inc. (SMTP-NASDAQ)

SMTP: Zacks Company Report – Q4 Evidences High Growth, but Losses, as Company Transforms

Current Recommendation	**Outperform**
Prior Recommendation	N/A
Date of Last Change	10/14/2014
Current Price (03/06/15)	$4.53
Target Price	**$12.65**

OUTLOOK

SMTP is a small growing SaaS provider of email delivery services that bought two other email services companies last year to add marketing automation and a front-end for email creation and tracking. These acquisitions should double revenues this year, while increasing the total addressable market for the company. The smaller one, SharpSpring, is proving to be a formidable competitor to MKTO and HUBS. With an enterprise value to sales of less than 1.5xs 2015 estimated revenues versus peers of 5.6xs, we rate the stock Outperform.

SUMMARY DATA

52-Week High	**$6.66**
52-Week Low	**$4.52**
One-Year Return (%)	**-15.14**
Beta	**-9.80**
Average Daily Volume (sh)	**20,444**
Shares Outstanding (mil)	**5**
Market Capitalization ($mil)	**$25**
Short Interest Ratio (days)	**0.46**
Institutional Ownership (%)	**15**
Insider Ownership (%)	**56**
Annual Cash Dividend	**0**
Dividend Yield (%)	**0**
5-Yr. Historical Growth Rates	
Sales (%)	**21.9**
Earnings Per Share (%)	**N/A**
Dividend (%)	**64.0**
P/E using TTM EPS	**21.6**
P/E using 2015 Estimate	**64.7**
P/E using 2016 Estimate	**11.9**
Zacks Rank	**2**

Risk Level	**Average**
Type of Stock	**Small-Blend**
Industry	**Internet-Services**
Zacks Rank in Industry	**6 of 44**

ZACKS ESTIMATES

Revenue
(in millions of $)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2013	1.4 A	1.4 A	1.5 A	1.5 A	5.8 A
2014	1.5 A	1.5 A	1.6 A	2.9 A	7.5 A
2015	3.1 E	3.3 E	3.8 E	4.0 E	14.1 E
2016					17.2 E

Earnings per Share
(EPS is fully diluted non-GAAP earnings)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2013	$0.15 A	$0.14 A	$0.17 A	$0.14 A	$0.60 A
2014	$0.09 A	$0.06 A	$0.09 A	-$0.02 A	$0.21 A
2015	-$0.01 E	$0.02 E	$0.03 E	$0.04 E	$0.07 E
2016					$0.38 E

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

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WHAT'S NEW

Management Sets Goal on Revenue Growth, not Earnings…

SMTP stock hit a new 52-week low yesterday, and its lowest price since 2012, as after the company reported a loss for its fourth quarter, which disappointed investors. After years of profits and dividends, the company reported its first loss after suspending its dividend a few weeks ago. **This loss was as a result of the strategic plan to seek accelerated growth rather than profits**, combined with large one-time expenses generated by the acquisition of two companies. Revenue growth (which was preannounced) were a bright spot, with the company reporting $2.9 million versus $1.5 million last year (up 91%) and $1.6 million in Q3 2014. This shows what in in store for the next three quarters for revenue growth. The market however was disappointed by the loss of $0.21 reported on a GAAP basis. On a non-GAAP basis, removing amortization, one-time charges and stock-based compensation, the company lost $0.02 per share versus our estimate of non-GAAP earnings of $0.06 per share. So rather than earning $338,000, it lost $88,000 a non-GAAP basis. Most of the difference was much higher sales and marketing than we had modeled. In accordance with its growth strategy, the company plans to continue to operate at or near adjusted EBITDA breakeven, pouring cash flow into increasing marketing and sales as it rolls out product internationally.

After the two acquisitions, the new business model for the company is very different than last year and last quarter, back when it was a slow growth, high margin, and dividend paying entity. The company now must show its stripes as a SaaS marketing company and find investors who understand its value as such. **This turnover in the investor base leaves an excellent opportunity for growth and GARP investors to take over from the yield investors**. We continue to recommend the stock and believe that versus its comparables, the stock is worth over $12.65 per share.

With only two and a half months of GraphicMail in the quarter, the company has yet to show a completely normalized income statement. Q1 will show higher revenues from the additional month negated somewhat by a seasonally weak quarter that shows less revenue from, for example, the newsletter customers. Q1 revenues are however expected to be higher than Q4. In Q4, gross margins came in at 76% versus 82% last year and in 79% in Q3 2014. The company expects gross margin to remain above 75% and increase, as high margin SharpSpring revenues become a larger portion of overall revenues.

Two large non-cash expenses hit GAAP earnings this quarter due to the acquisitions. Amortization expense was $259,000 alone. Added to that, was the change in earn-out liability for the two acquisitions that totaled $682,000. This later expense arises as the two acquisitions reach their thresholds for the earn-out. SharpSpring is the major driver of this. In order to earn its earn-out, it needs to reach a $5 million run rate based on the month of December 2015. As it grows closer to that goal, the company has to adjust its reserve for paying out the amount. As a result the next three to four quarter are expected to have this expense line. The earn-out will be paid at the end of Q1 2016.

On a dollar basis, expenses should increase from Q4 levels as a full quarter of GraphicMail is recognized. In Q4 sales and marketing expenses were 36% of revenues, high for SMTP, but not extremely high in an industry where its major competitors-- Marketo and HubSpot spent 64% and 71% respectively on sales and marketing in their most recent quarters.

On a **non-GAAP** basis, taking out all one-time expenses and stock-based compensation of $197,000, the company **lost $88,000 or $0.02 per share**. In Q1 there will be another one-time expense related to the adjustment to the earn-out liability. Should SharpSpring reach its earn-out threshold the company will owe its former shareholders another $2.3 million and some portion of that total will probably be recognized in each of the quarters this year. The exact amount is to be determined by how close SharpSpring is to its goal. For the 2015 quarters we are using $575,000 per quarter for this acquisition-related expense.

Given what we know about expenses, we expect **Q1 to show a non-GAAP loss of $0.01 per share**. The GAAP number will contain the both amortization charges as well as stock-based compensation and that number could be a loss of $0.22, similar to Q4. In 2015, the amortization charge is expected to jump to $375,000 per quarter from $259,000 while the change in earn-out liability will vary based on SharpSpring's sales. We are estimating a flat number of $575,000 per quarter versus $682,000 in Q4, but this number could be anything from zero to $2.3 million.

The earnings reported overshadowed the success the company is having in new sales and the eager adoption of the SharpSpring product that is a direct competitor to Marketo and HubSpot. SharpSpring was founded to provide an easier alternative to Marketo, which shows in its product design, but can be as little as a third the price of Marketo. In fact, as partial proof of its success, the company actually raised prices in the US for the product and is pricing the product higher internationally in most regions. Not only did this not hurt sales, but they accelerated despite the increase. SharpSpring acquired 100 new customers, mostly marketing agencies, in Q4 bring the total number of agencies over 250, and they started international direct sales and have already landed five customers.

Given its current sales level we expect SharpSpring could contribute $2.3 million in revenues to the company in 2015 after only being launched mid-2014. We are currently conservatively modeling 10% growth for the SMTP and GraphicMail businesses and 60% growth for SharpSpring in 2016 but that could be easily surpassed given the large number of resources and resellers devoted to the product.

2015

For the full year 2015, we are expecting revenue of $14.1 million, up 89%, while earnings remain near or slightly above EBITDA breakeven as the company invests in growth where investors should get a better return, as sales multiples remain high for SaaS companies. We are estimating $0.07 non-GAAP EPS, a loss of $0.77 GAAP and an adjusted EBITDA of $325,000 for the year.

2016

In 2016, we expect the company to continue to grow 20%+ as the base business increases 10% and SharpSpring at least 60%. Coming off such a small base this rate could be easily exceeded and we believe this is where the big upside to revenues could be. However the newly invigorated product line could be a boon all around and given the market growth, the company's complete offering and the law of small numbers, this could be exceedingly conservative. For now we expect revenues of $17 million up 22%, GAAP breakeven EPS and non-GAAP EPS of $0.38.

Recent Acquisitions

SharpSpring, a new start up, was purchased for $5 million in cash plus an earn-out of cash and stock. To qualify for its earn-out, SharpSpring must reach a $5 million run rate by the end of 2015, at which point it would receive an additional $10 million in cash and stock. The deal closed on **August 15, 2014**. It only launched its product this year, and exited 2014 at a $2 million + annual run rate. SharpSpring's product is a marketing automation and call-tracking platform that is a direct challenger to Marketo in the small and medium business market. Marketing automation helps marketers track the web traffic of potential customers visiting its site and tracks phone contacts with customers and prospects. It is an excellent add-on service offering for SMTP's current customer base, as SMTP's deliverability services will allow SharpSpring to upsell to larger customers. SharpSpring also offers a customer relationship management module or a customer can bring their own system. This past quarter the company added its first international direct sales operations in the UK and in South Africa where it has already made five sales.

GraphicMail is a ten-year-old integrated email solutions company based in Cape Town, South Africa that was purchased on **October 17, 2014**. It operates in 14 countries and provides service in 13 languages. It was purchased for $5.1 million in cash and stock with a possible $0.8 million earn out. It had approximately $5 million in billings in 2013, and was profitable. In Q4, not a full quarter, it had $1.1 million in revenues. GraphicMail has a robust front-end email platform that competes with products like MailChimp and Constant Contact (CTCT).

INVESTMENT THESIS

- Its recent acquisitions of SharpSpring and GraphicMail should more than triple the companies' addressable market opportunity, make it much more competitive against larger players. It also expands its geographic reach internationally where it has had limited exposure.

- SharpSpring is less expensive, more fully featured direct competitor to Marketo and HubSpot. As investors become more aware of this and compare valuations we believe the stock could appreciate based on the comparison to this highly valued companies. Marketo trades at 4.9x enterprise value to sales and HubSpot 6.3xs.

- With these acquisitions and internal growth, the company may be able to double revenues to $14 million in sales. Should the company achieve these numbers we believe the stock would be worth considerably more in the next twelve months.

- The company is trading at 1.4 times enterprise value to sales, well below its peers, which trade at an average enterprise value of 5.6 times sales. We are reiterating our BUY, but have lowered our target price of $12.65 due to the decrease in the valuations of comparable companies. This is still 180% above the current stock price.

INDUSTRY

Until its recent acquisitions, SMTP competed only in the $800 million email delivery segment of the email marketing industry; this segment has an average compound growth rate of 9.9% according to Forrester Research as shown on the graph. With the acquisition of SharpSpring and GraphicMail, SMTP has increased its total addressable market (TAM) closer to the $2 billion opportunity for all aspects of email marketing spending.

VALUATION

SMTP can be valued against other public SaaS companies. Many of the highly valued SaaS companies are not yet profitable, so we are looking at valuation based on a multiple of sales. As shown on the chart below company valuations range from a low of 1.4 times enterprise value to forecasted 2015 revenues for the money-losing Jive Software (JIVE), to a high of 12.5 times for $14 billion Workday, which provides a SaaS platform for human resource information systems (HRIS). The group yields an average of 5.6 times forecasted 2015 revenues and 7.2 times trailing twelve month. The valuation of the group has moved down somewhat since we last ran the comparables. Using this current metric, if we plug in SMTP's estimated 2015 and trailing 12 month revenues, we can see the stock moving to $12.65 by next year if the revenue forecasts are reached.

Company	Ticker	Revenue 2015E	Revenue LTM	EBIDTA Margin	Enterprise Value / Sales 2015E	Enterprise Value / Sales LTM	Included in Average?
Callidus Software	CALD	$165	$137	-2%	4.0x	4.8x	y
Salesforce	CRM	$6,510	$5,370	6%	6.6x	8.0x	y
Constant Contact	CTCT	$388	$332	13%	3.1x	3.7x	y
Ellie Mae	ELLI	$206	$162	18%	7.0x	8.9x	y
HubSpot	HUBS	$161	$116	-37%	6.3x	8.8x	y
Jive Software	JIVE	$197	$179	-22%	1.4x	1.5x	y
LogMeIn	LOGM	$262	$222	13%	4.2x	5.0x	y
Live Person	LPSN	$266	$210	4%	2.2x	2.8x	y
Marketo	MKTO	$206	$150	-31%	4.9x	6.7x	y
NetSuite	N	$722	$556	-10%	10.0x	13.0x	y
Realpage	RP	$456	$405	8%	3.4x	3.9x	y
Syncronoss Technologies	SNCR	$570	$457	26%	3.2x	4.0x	y
Solarwinds	SWI	$522	$429	36%	6.7x	8.1x	y
2U Inc.	TWOU	$110	$104	-27%	5.8x	6.2x	y
Textura	TXTR	$90	$63	-30%	6.7x	9.6x	y
Ultimate Software	ULTI	$617	$506	15%	7.5x	9.2x	y
Workday	WDAY	$1,140	$788	-20%	12.5x	18.1x	y
Average				**-2.3%**	**5.6x**	**7.2x**	

	Revenue 2015E	Revenue LTM	EBITDA Margin	Enterprise Value / Sales 2015E	Enterprise Value / Sales LTM	Valuation Range Low	Valuation Range High
SMTP	**$14**	**$7**	**-1.80%**	**5.6x**	**7.2x**	**$54**	**$80**
YoY growth							

Conclusion of Enterprise Value	**$66,705,719**
Market Value	**$69,531,239**
Shares Outstanding	5,497,500
Price per Share	**$12.65**

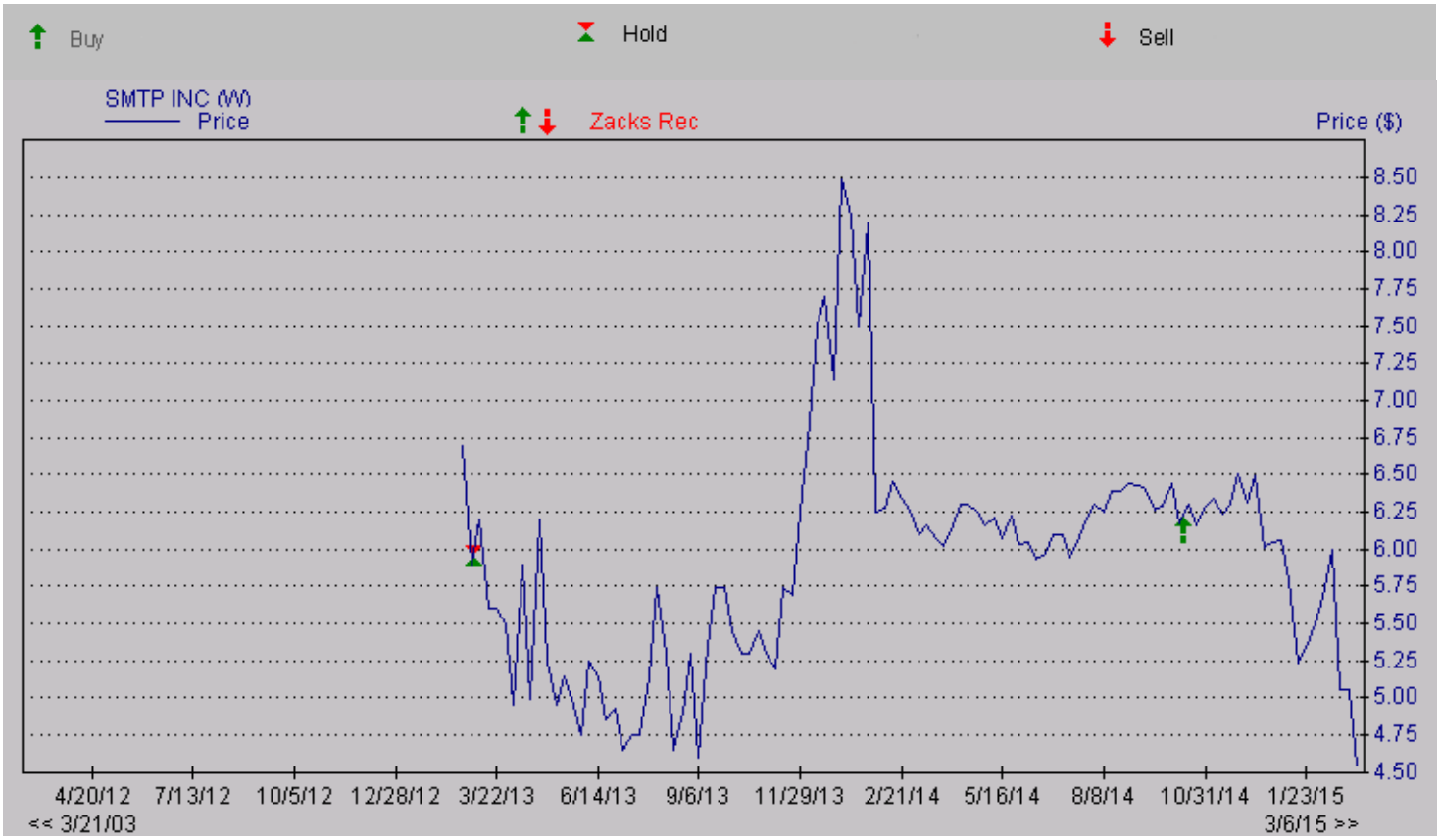
INCOME STATEMENT

	Q4 2013R	Q3 2014	Q4 2014	Q1 2015E	Q2 2015E	Q3 2015E	Q4 2015E				
	31-Dec	30-Sep	31-Dec	31-Mar	30-Jun	30-Sep	31-Dec	2013	2014	2015E	2016E
Net revenue	**$1,520,382**	**$1,631,244**	**$2,897,429**	**$3,115,054**	**$3,330,770**	**$3,750,000**	**$3,950,000**	**$5,753,929**	**$7,499,497**	**$14,145,824**	**$17,239,886**
Yr-to-yr Growth		11.0%	90.6%	109.1%	124.9%	129.9%	36.3%	7.5%	30.3%	88.6%	21.9%
Cost of services	$210,179	340,649	696,581	735,000	750,000	860,000	900,000	1,049,325	$1,715,613	$3,245,000	3,700,000
Gross profit	1,310,203	1,290,595	2,200,848	2,380,054	2,580,770	2,890,000	3,050,000	4,704,604	5,783,884	10,900,824	13,539,886
Gross Margin	86.2%	79.1%	76.0%	76.4%	77.5%	77.1%	77.2%	81.8%	77.1%	77.1%	78.5%
Operating expenses:											
Sales and marketing	$140,605	380,172	1,056,481	1,100,000	1,150,000	1,250,000	1,300,000	817,971	$1,832,966	$4,800,000	5,200,000
General and administrative	$607,746	973,016	1,115,996	1,170,000	1,200,000	1,250,000	1,290,000	1,710,934	$3,136,613	$4,910,000	5,000,000
Research and development	$48,385	141,923	441,495	450,000	460,000	475,000	480,000	234,581	$803,427	$1,865,000	1,865,000
Amortization expense	$0	25,667	259,404	375,000	375,000	375,000	375,000	0	$285,071	$1,500,000	1,500,000
Total operating expenses	796,736	1,520,778	2,873,376	3,095,000	3,185,000	3,350,000	3,445,000	2,763,486	6,058,077	13,075,000	13,565,000
Operating income:	513,467	(230,183)	(672,528)	(714,946)	(604,230)	(460,000)	(395,000)	1,941,118	(274,193)	(2,174,176)	(25,114)
	33.8%	-14.1%	-23.2%	-23.0%	-18.1%	-12.3%	-10.0%	33.7%	-3.7%	-15.4%	-0.1%
Other income:											
Interest income	0	367		0	0	0	0	0	0	0	0
Total other income	0	367	(6,627)	(6,600)	(6,600)	(6,600)	(6,600)	0	(16,278)	(26,400)	0
Change in earnout liability	0	0	(682,000)	(575,000)	(575,000)	(575,000)	(575,000)		(682,000)	(2,300,000)	0
Income before income taxes	513,467	(239,988)	(1,361,155)	(1,296,546)	(1,185,830)	(1,041,600)	(976,600)	1,941,118	(972,471)	(4,500,576)	(25,114)
Provision for income tax	$171,097	(142,160)	(243,230)	(90,758)	(83,008)	(72,912)	(68,362)	668,155	(131,258)	(315,040)	(5,023)
Tax rate	33.3%	59%	18%	7.0%	7.0%	7%	7%	34.4%	13.5%	7.0%	20.0%
Net income	$342,370	(97,828)	(1,117,925)	(1,205,788)	(1,102,822)	(968,688)	(908,238)	$1,272,963	(841,213)	(4,185,536)	(20,092)
Yr-to-yr Growth		-131%	-427%	-640%	-829%	890%	-19%	19.0%	-166.1%	398%	NM
Adj for Non-GAAP	$86,580	533,000	1,029,925	1,147,000	$1,147,000	1,147,000	1,147,000	$576,822	$1,858,000	4,588,000	2,288,000
Non-GAAP Income	$428,950	435,172	(88,000)	(58,788)	87,178	178,312	238,762	$1,849,785	$1,016,787	402,464	$2,267,908
Yr-over-Yr	28%	27%	-3%	-115%	-73%	-59%	-371%	38.2%	-45.0%	-60%	463.5%
Net income per share:											
Basic	$0.11	(0.02)	(0.21)	(0.22)	(0.20)	(0.18)	(0.17)	0.42	(0.17)	(0.77)	(0.00)
Diluted	$0.11	(0.02)	(0.21)	(0.22)	(0.20)	(0.18)	(0.16)	0.41	(0.17)	(0.76)	(0.00)
Non-GAAP Diluted	**$0.14**	**$0.09**	**-$0.02**	**-$0.01**	**$0.02**	**$0.03**	**$0.04**	**$0.60**	**$0.21**	**$0.07**	**$0.38**
Yr-to-yr Growth		-48.5%	-112.1%	-112%	-75%	-63%	-364%	31.6%	-65.7%	-64.6%	414.4%
Shares											
Basic	3,097,017	5,020,005	5,370,813	5,460,000	5,460,000	5,460,000	5,460,000	3,004,541	4,913,903	5,460,000	6,022,500
Diluted	3,168,748	5,020,005	5,370,813	5,460,000	5,510,000	5,510,000	5,510,000	3,069,274	4,913,903	5,497,500	6,022,500
		59.9%	69.5%	26.9%	8.8%	9.8%	2.6%	5.0%	60.1%	11.9%	9.5%
Adjusted EBITDA	$646,000	360,000	(52,000)	(89,946)	20,770	165,000	230,000	2,620,000	1,326,000	325,824	1,524,886

BALANCE SHEET

	Dec. 31, 2014	Dec. 31, 2013	% Change
Assets			
Cash and cash equivalents	$2,825,520	$1,731,243	63%
Accounts receivable	393,922	25,024	1474%
Deferred income taxes	0	183,435	
Income taxes receivable	628,889	0	
Other current assets	197,745	116,522	70%
Total current assets	4,046,076	2,056,224	97%
Property and equipment, net	281,555	327,342	-14%
Goodwill	8,901,106	0	
Intangibles	7,895,238	0	
Deferred income taxes	612,941	50,099	1123%
Deposits	30,172	29,995	1%
Total assets	21,767,088	2,463,660	784%
Liabilities and Shareholders' Equity			
Accounts payable	397,263	79,574	399%
Deferred revenue	1,006,031	334,328	201%
Income taxes payable	14,622	144,280	-90%
Accrued expenses and other current liabilities	355,796	30,139	1081%
Deferred income taxes	61,578	0	
Total current liabilities	1,835,290	588,321	212%
Earn out liabilities	7,679,311	0	
Total liabilities	9,514,601	588,321	1517%
Shareholders' equity:			
Preferred stock			
Common stock	5,447	3,126	74%
Additional paid in capital	13,248,992	2,241,749	491%
Accumilated other comprehensive income	-177,767	0	
Accumulated deficit	-824,185	-369,536	123%
Total shareholders' equity	12,252,487	1,875,339	553%
Total liabilities and shareholders' equity	$21,767,088	$2,463,660	784%
Current Ratio	2.2	3.5	

HISTORICAL ZACKS RECOMMENDATIONS



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