Zacks Small-Cap Research

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SMTP Inc. (SMTP-NASDAQ)

SMTP: Zacks Company Report – EARNINGS UPDATE– Acquisition Integration- Short Term Pain For Long Term Gain

Current Recommendation	**BUY**
Prior Recommendation	BUY
Date of Last Change	10/14/2014
Current Price (11/13/14)	$6.08
Twelve Month Target Price	**$16**

OUTLOOK

SMTP is a small growing SaaS provider of email delivery services that bought two other email services companies this quarter to add marketing automation and a front-end for email creation and tracking. These acquisitions should be accretive, and double revenues next year, while improving profitability and increasing the total addressable market for the company. With an 8.3% dividend yield and enterprise value to sales of less than two times 2015 estimated revenues, we believe the stock is a BUY.

SUMMARY DATA

52-Week High	**$9.99**
52-Week Low	**$1.43**
One-Year Return (%)	**14.61**
Beta	**-13.52**
Average Daily Volume (sh)	**9,018**
Shares Outstanding (mil)	**5**
Market Capitalization ($mil)	**$31**
Short Interest Ratio (days)	**0.05**
Institutional Ownership (%)	**12**
Insider Ownership (%)	**56**
Annual Cash Dividend	**$0.48**
Dividend Yield (%)	**8.3**
5-Yr. Historical Growth Rates	
Sales (%)	**23.0**
Earnings Per Share (%)	**N/A**
Dividend (%)	**N/A**
P/E using TTM EPS	**16.0**
P/E using 2014 Estimate	**27.6**
P/E using 2015 Estimate	**15.6**
Zacks Rank	**3**

Risk Level	**Average**
Type of Stock	**Small-Blend**
Industry	**Internet-Services**
Zacks Rank in Industry	**16 of 38**

ZACKS ESTIMATES

Revenue
(in millions of $)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2012	$1.2 A	$1.4 A	$1.4 A	$1.4 A	$5.4 A
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	$2.4 E	$6.5 E
2015					$13.0 E

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

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2012	$0.02 A	$0.02 A	$0.02 A	$0.10 A	$0.46 A
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	$0.03 E	$0.22 E
2015					$0.39 E

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

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WHAT'S NEW

During this quarter ended September 30, 2014, SMTP acquired SharpSpring, and after the quarter closed, announced the completion of the acquisition of GraphicMail, two companies that should more than double the company's revenues next year. The company announced **revenues of $1.6 million up 11%** from last year. This included half a quarter of sales from SharpSpring, a small, high growth start up. Even with SharpSpring included, gross margin was 79% in line with the range of high 70s to low 80s the company usually enjoys and we expect that number to potentially go higher next year, as both acquisitions are high gross margin companies. While the GAAP EPS reported was a loss of $0.02 versus a fully diluted GAAP profit of $0.11 last year, the **non-GAAP number of $0.09** was an earnings beat versus our estimate of $0.04 due primarily to the reversal of taxes for the year. Included in the GAAP loss was $166,000 of stock based compensation and $367,000 of one-time expenses due to the acquisitions. This number included accounting and legal costs as well as severance and costs due to the closing of the GraphicMail Miami offices.

Q4 Forecast

Next quarter we expect more one-time charges, but they should be somewhat less than this quarter. Q4 will show a full quarter of SharpSpring and almost two thirds of a quarter of GraphicMail as it closed October 20th. Revenue will be somewhat dampened for GraphicMail as its accrual accounting is adjusted to correspond with the rest of SMTP. We are estimating that to be $100,000 less than usual. Given that GraphicMail closed we are adding its operation to the forecast and are **raising revenue estimate to $2.4 million, up 59% from last year**. We are leaving EPS estimates alone after adjusting for taxes until we get a better idea of where expenses will fall after both acquisitions are included. We expect management to give some guidance when it reports Q4 next year.

For Q4 we are now looking for $2.4 million in revenues versus $1.5 million last year, up 59% and a non-GAAP EPS of $0.06 versus $0.14 last year, down 55%. This should be the last quarter with one-time expenses, as any others for future actions should have been accrued for in Q4.

2015

In Q1 we will see the first normalized quarter for the combined companies. We expect margins to improve throughout the as SharpSpring ramps revenues and offices are combined. Additionally, GraphicMail customers will be migrated over to SMTP and expenses at GraphicMail will be reduced. As the sales force is trained and products integrated we should see economies of scale in sales and marketing. There are even plans to translate software to other languages to expand the market opportunity and give the company a competitive advantage in certain regions. Currently we are forecasting revenues of $13 million, up 85% and EPS returning to more historic levels. We are looking for operating margins of 22% and project a lower than historical tax rate of 32%. The share count should be 7.6 million shares versus 5.5 million in 2014, reflecting the shares issued in the acquisitions. This would result in non-GAAP EPS of $0.39, up 30% from the year before. Keep in mind if the company is able to get back to its historical operating margin in the low thirties, the EPS could be 50% higher.

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, and lower the combined company's tax rate.

- The company's 8.3% dividend yield makes it attractive to both growth and yield investors and increases investor's ROI as well as limiting the stock's downside risk.

- With these acquisitions and internal growth, the company may be able to double revenues and increase earnings next year to $13 million in sales, up 85% and an EPS of $0.39, up 30%. Should the company achieve these numbers we believe the stock would be worth considerably more in the next twelve months. Were the company to get back to historical operating margins, earnings could be 50% higher than that.

- On next year's earnings, the stock is trading at a PE 15 times estimated 2015 EPS, with projected earnings growth of 30%. Combining that with an 8.3% dividend yield, investors could enjoy an ROI of 38% even without multiple expansion. It is also trading well below its peers on an enterprise value to sales basis at 4.2 times versus 6.8 times for the industry. We are reiterating our BUY and target price of $16.

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, but as of August it was bringing in business 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.

GraphicMail, is a ten-year-old integrated email solutions company based in Cape Town, South Africa, It operates in 25 countries and provides service in 13 languages. It employs about 50 people and has 9,000 direct customers who sell to 35,000 end users. It was purchased for $5.2 million in cash and stock with a possible $0.6 million earn out. It had $4 million in billings in 2013, and was profitable. SMTP believes it will be immediately accretive to earnings. GraphicMail has a robust front-end email platform that competes with products like MailChimp and Constant Contact, but needs help scaling for larger customers. SMTP on the other hand was looking for a front end but had the back end scaling capabilities. Together, the two should create an impressive offering for customers as well as expand the sales force and market reach for SMTP and SharpSpring. The GraphicMail acquisition, which was more complex due to its international operations, closed on October 17, 2014.

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 2.0 times enterprise value to forecasted 2014 revenues for the money-losing HubSpot (HUBS), to a high of 21 times for $16 billion Workday, which provides a SaaS platform for human resource information systems (HRIS). The group yields an average of 6.8 times forecasted 2014 revenues and 7.7 times trailing twelve month. Using this metric, if we plug in SMTP's revenues, we can see the stock moving to $15.95 by next year if the revenue forecasts are reached.

SaaS CRM

	Ticker	Revenue		EBIDTA	Enterprise Value / Sales	
Company		2014E	LTM	Margin	2014E	LTM
Callidus Software	CALD	$134	$129	NM	5.4x	5.7x
Concur Technologies	CNQR	$728	$668	3%	9.8x	10.7x
Salesforce	CRM	$6,660	$4,770	4%	5.8x	8.2x
Constant Contact	CTCT	$331	$319	13%	2.9x	3.0x
Ellie Mae	ELLI	$157	$145	18%	7.0x	7.5x
Hubspot	HUBS	$110	$104	-33%	2.0x	2.1x
Jive Software	JIVE	$178	$170	-35%	2.3x	2.4x
LogMeIn	LOGM	$221	$207	9%	4.8x	5.2x
Live Person	LPSN	$209	$199	5%	3.2x	3.4x
Marketo	MKTO	$149	$136	-33%	8.3x	9.1x
Netsuite	N	$554	$513	-9%	9.2x	10.0x
Realpage	RP	$405	$396	9%	4.2x	4.3x
Syncronoss Technologies	SNCR	$456	$424	27%	4.2x	4.5x
Solarwinds	SWI	$428	$407	33%	8.5x	8.9x
2U inc.	TWOU	$110	$104	-27%	5.8x	6.1x
Textura	TXTR	$63	$64	-19%	8.7x	8.5x
Ultimate Software	ULTI	$506	$482	14%	8.4x	8.8x
Workday	WDAY	$772	$616	-25%	21.0x	26.3x
Average				**-2%**	**6.8x**	**7.5x**

	Revenue		EBITDA	Enterprise Value / Sales	
	2015E	LTM*	Margin	2015E	LTM*
SMTP	**$13**	**$10**	**16.20%**	**6.8x**	**7.5x**
YoY growth					

Conclusion of Enterprise Value	**$81,454,736**
Market Value	**$87,330,061**
Shares Outstanding	5,473,993
Price per Share	**$15.95**

* Pro forma

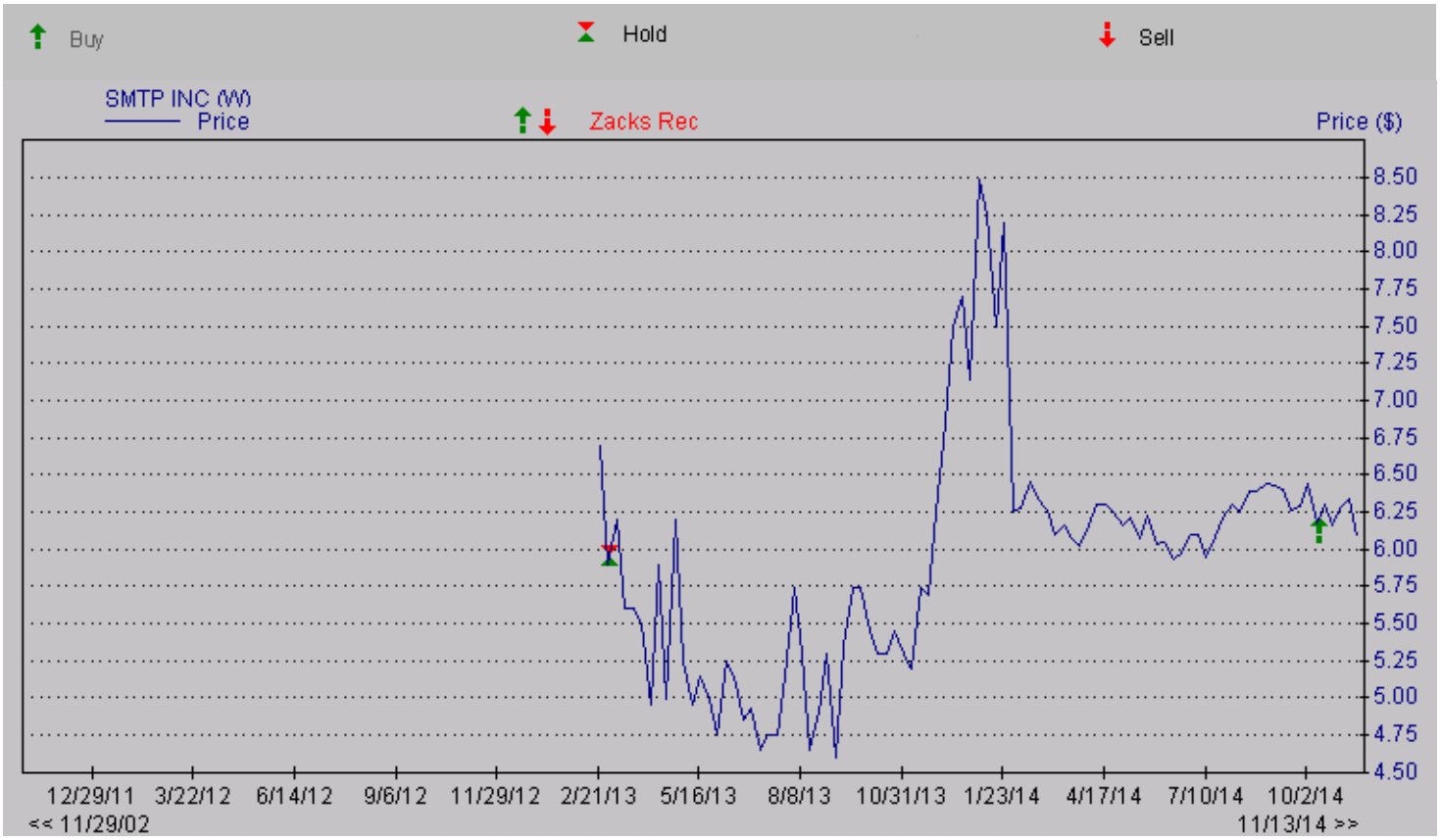
PROJECTED INCOME STATEMENT

	Q1 2013 31-Mar	Q2 2013 30-Jun	Q3 2013R 30-Sep	Q4 2013 31-Dec	Q1 2014 31-Mar	Q2 2014 30-Jun	Q3 2014A 30-Sep	Q4 2014E 31-Dec	2012	2013	2014E	2015E
Net revenue	**$1,369,438**	**$1,395,147**	**$1,468,962**	**$1,520,382**	**$1,490,054**	**$1,480,770**	**$1,631,244**	**$2,410,000**	**$5,353,550**	**$5,753,929**	**$7,012,068**	**$13,000,000**
Yr-to-yr Growth					8.8%	6.1%	11.0%	58.5%	25.1%	7.5%	21.9%	85.4%
Cost of services	274,558	253,196	255,095	$266,476	288,370	351,153	340,649	490,000	1,081,330	1,049,325	$1,470,172	2,700,000
Gross profit	1,094,880	1,141,951	1,213,867	1,253,906	1,201,684	1,129,617	1,290,595	1,920,000	4,272,220	4,704,604	5,541,896	10,300,000
Gross Margin	80.0%	81.9%	82.6%	82.5%	80.6%	76.3%	79.1%	79.7%	79.8%	81.8%	79.0%	79.2%
Operating expenses:												
Sales and marketing	202,767	179,594	295,005	$140,605	148,672	228,013	380,172	440,000	775,073	817,971	$1,196,857	2,584,604
General and administrative	466,293	334,404	358,788	$551,449	583,764	563,786	973,016	1,100,000	1,380,242	1,710,934	$3,220,566	2,750,000
Research and development	52,532	52,438	81,226	$48,385	77,111	101,387	141,923	450,000	403,303	234,581	$770,421	2,100,000
Amortization expense							25,667	50,000				
Total operating expenses	721,592	566,436	735,019	740,439	809,547	893,186	1,520,778	2,040,000	2,558,618	2,763,486	5,187,844	7,434,604
Operating income:	373,288	575,515	478,848	513,467	392,137	236,431	(230,183)	(120,000)	1,713,602	1,941,118	354,052	2,865,396
	27.3%	41.3%	32.6%	33.8%	26.3%	16.0%	-14.1%	-5.0%	32.0%	33.7%	5.0%	22.0%
Other income:												
Interest income	0	0	0	0	0	144	367	200	0	0	100	0
Total other income	0	0	0	0	0	144	0	100	0	0	100	0
Loss on disposal of fixed assets							(10,172)	0				
Income before income taxes	373,288	575,515	478,848	513,467	392,137	236,575	(239,988)	(119,800)	1,713,602	1,941,118	354,152	2,865,396
Provision for income tax	147,718	190,079	159,261	$171,097	168,765	85,367	(142,160)	(47,920)	643,995	668,155	64,052	916,927
Tax rate	39.6%	33.0%	33.3%	33.3%	43.0%	36.1%	59%	40%	37.6%	34.4%	18.1%	32.0%
Net income	$225,570	$385,436	$319,587	$342,370	$223,372	$151,208	(97,828)	(71,880)	$1,069,607	$1,272,963	$290,100	1,948,469
						-60.8%	(1)	(1)		19.0%	-77.2%	571.7%
Adj for Non-GAAP	$247,127	$34,115	$209,000	$86,580	$156,052	$131,379	533,000	420,000	$268,538	$576,822	$1,240,431	$192,000
Non-GAAP Income	$472,697	$419,551	$528,587	$428,950	$379,424	$325,587	435,172	348,120	$1,338,145	$1,849,785	$1,488,303	$2,140,469
Yr-over-Yr	35%	30%	36%	28%	25%	22%	27%	14%		38.2%	-19.5%	43.8%
Net income per share:									31%	39%	27%	21%
Basic	$0.08	$0.13	$0.11	$0.11	$0.05	$0.03	-$0.02	-$0.01	$0.37	$0.42	$0.06	$0.36
Diluted	$0.07	$0.13	$0.10	$0.11	$0.05	$0.03	-$0.02	-$0.01	$0.37	$0.41	$0.06	$0.36
Non-GAAP Diluted	**$0.15**	**$0.14**	**$0.17**	**$0.14**	**$0.09**	**$0.06**	**$0.09**	**$0.06**	**$0.46**	**$0.60**	**$0.30**	**$0.39**
					-40.4%	-53.2%	-48.5%	-53.4%		31.6%	-50.3%	30.4%
Shares												
Basic	2,958,113	2,973,928	3,026,032	3,059,000	4,239,363	5,016,461	5,020,005	5,426,461	2,882,437	3,004,541	4,925,573	5,426,461
Diluted	3,194,072	3,056,061	3,139,993	3,140,000	4,302,443	5,063,993	5,020,005	5,473,993	2,922,310	3,069,274	4,965,109	5,473,993
					34.7%	65.7%	59.9%	74.3%		5.0%	61.8%	10.2%

BALANCE SHEET

	Sept. 30, 2014	Jun. 30, 2014	% Change	Dec. 31, 2013	% Change
Assets					
Cash and cash equivalents	$5,875,325	$11,453,404	-48.7%	$1,731,243	239.4%
Accounts receivable	74,561	19,489	282.6%	25,024	198.0%
Deferred income taxes	340,681	237,226	43.6%	183,435	85.7%
Income taxes receivable	453,446	219,907	106.2%		
Other current assets	174,319	110,169	58.2%	116,522	49.6%
Total current assets	6,918,332	12,040,195	-42.5%	2,056,224	236.5%
Property and equipment, net of accumulated depreciation of $205,395 and $145,261	282,455	269,324	4.9%	327,342	-13.7%
Goodwill	8,407,227	0		0	
Other intangible assets	3,544,333				
Deferred income taxes	60,598	70,432	-14.0%	50,099	21.0%
Deposits	38,645	29,995	28.8%	29,995	28.8%
Total assets	**19,251,590**	**12,409,946**	55.1%	**2,463,660**	681.4%
Liabilities and Shareholders' Equity					
Deferred revenue	478,883	373,065	28.4%	334,328	43.2%
Income taxes payable	0	0		144,280	-100.0%
Allowance for refunds and chargebacks	2,799	2,067	35.4%	2,965	-5.6%
Accounts payable	262,434			79,574	229.8%
Accrued expenses and other current liabilities	164,096	119,935	36.8%	106,748	53.7%
Total current liabilities	908,212	495,067	83.5%	588,321	54.4%
Shareholders' equity:					
Preferred stock, $0.001 par value, 5,000,000 shares authorized, no shares issued or outstanding at June 30, 2014 and December 31, 2013					
Common stock, $0.001 par value, 50,000,000 shares authorized, 5,017,433 and 3,127,598 shares issued and outstanding at June 30, 2014 and December 31, 2013, respectively	5,022	5,017	0.1%	3,126	60.7%
Additional paid in capital	11,375,356	11,909,862	-4.5%	2,241,749	407.4%
Accumulated deficit				-369,536	
Total shareholders' equity	11,380,378	11,914,879	-4.5%	1,875,339	506.8%
Total liabilities and shareholders' equity	$19,251,590	$12,409,946	55.1%	$2,463,660	681.4%
Current Ratio	7.6	24.3	-68.7%	3.5	118.0%

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