Zacks Small-Cap Research

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Net Element Inc. (NETE-NASDAQ)

NETE: Zacks Company Report – Earnings Update

Current Recommendation	**BUY**
Prior Recommendation	Buy
Date of Last Change	10/15/14
Current Price (11/18/14)	$1.35
Target Price	**$2.13**

OUTLOOK

Net Element is a software and services company, which operates a small merchant processor in the US and a mobile payment processor in Russia that has restructured its operations and should be on the way to growth after divesting all its former entertainment business. Since its acquisition of Unified Payments in June 2013, its new CEO has focused the company on payments. This CEO took his former company from 0 to $67 million in two years in the same business and we believe he can be successful once again.

SUMMARY DATA

52-Week High	**$5.70**
52-Week Low	**$0.97**
One-Year Return (%)	**-53.92**
Beta	**-0.03**
Average Daily Volume (sh)	**373,854**
Shares Outstanding (mil)	**46**
Market Capitalization ($mil)	**$62**
Short Interest Ratio (days)	**0.20**
Institutional Ownership (%)	**0**
Insider Ownership (%)	**25**
Annual Cash Dividend	**$0.00**
Dividend Yield (%)	**0.00**
5-Yr. Historical Growth Rates	
Sales (%)	**N/A**
Earnings Per Share (%)	**N/A**
Dividend (%)	**0**
P/E using TTM EPS	**N/M**
P/E using 2014 Estimate	**N/M**
P/E using 2015 Estimate	**N/M**
Zacks Rank	**3**

Risk Level	**High**
Type of Stock	**Small-Growth**
Industry	**Business Services**

ZACKS ESTIMATES

Revenue
(in millions of $)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2012	0 A	0 A	0 A	1 A	$1.0 A
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	$6.3 E	$22.1 E
2015					$28.0 E

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

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2012					-$0.75 A
2013	-$0.10 A	-$0.11 A	-$0.11 A	-$0.12 A	-$0.44 A
2014	-$0.07 A	-$0.07 A	-$0.05 A	-$0.04 E	-$0.23 E
2015					-$0.15 E

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

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WHAT'S NEW

On November 14, 2014 Net Element reported its September 30, 2104 Q3 results. Revenues were $6.0 million versus $6.5 million in the year ago quarter, down 12% but on target with our estimates. Revenues were broken down by $5.6 million for US merchant processing up 1% from $5.5 million last year, and $0.5 million for Russian mobile payments versus $1 million last year. The mobile payments business in Russia was restructured earlier this year and has begun regain traction by showing sequential revenue growth of 36% from Q2 2014. We believe mobile payment should be up again sequentially next quarter.

Gross margins were disappointing and fell to 21% versus 26% last year and a normalized 25% in Q2. Older portfolios are more profitable and overall margins will decline as they are replaced and supplemented with lower margin more competitive portfolios. Additionally there was less of the high gross margin mobile payments business. Gross margins will be affected going forward by the mix of revenues from card processing and mobile payments. Card processing gross margins were 14% in the quarter while mobile margins were a normalized 95%.

General and administrative expense was almost flat with Q2 if you eliminate the $4.2 million in stock-based compensation that was granted to the CEO in the quarter. G&A would have been $1.9 million without any stock-based compensation or one-time charges.

Interest expense declined to $0.8 million from $1.8 million in Q2 as debt was eliminated in a restructuring and replaced with equity. This reduction in interest expense should by itself cut the companies losses by half in future quarters. Going forward the company indicated that interest expense has been lowered to $40,000 per month or $120,000 per quarter if the line of credit in Russia is not used.

On a non-GAAP basis, taking out all the one-time events and stock-based compensation, the loss was $2.2 million, rather than the $9.1 million loss reported on a GAAP basis. We believe that the major one-time charges should be over and we expect less in the future. The loss is an improvement from the non-GAAP loss of $3.4 million last year. As interest expenses have been virtually eliminated, and revenues in Q4 should be slightly higher we believe the losses could be reduced again next quarter sequentially.

EPS on a non-GAAP basis, excluding currency adjustments was a loss of $0.05 per share versus our estimate of $0.04, and it is less than half the non-GAAP loss of $0.12 reported in the year ago quarter.

In the quarter, debt was converted to equity and the share count has gone up accordingly. Added to the shares granted to the CEO, weighted average primary shares outstanding grew to 39.6 million, up 40% from last year. The fully diluted number is now 48.6 million up 48%.

Events in Q3

In Q3 Aptito launched a new version of its software, Aptito 2.0 with a number of enhancements. The most significant is the ability to locally cache transactions if there is no access to the internet so a business can continue operating. Other features included a stand-alone kiosk for ordering, a digital menu module and tableside ordering capability. There was also an enhancement of the data dashboard allowing merchants to get more insight into the purchasing behavior of their customers outside of their establishment.

Q3 Financial Changes

As part of the makeover of the company, the debt has been restructured to create a sustainable business by swapping it for equity. In the quarter the following transactions occurred:

On September 11, 2014, the company awarded Oleg Firer 1.4 million restricted share of common stock. Added to the 1.4 million shares of stock he acquired by selling Unified Payments to Net Element last year he now owns 2.85 million shares of Net Element.

On September 17, 2014, the company exchanged $15,876,860 in notes, owned by a subsidiary of Crede Capital Group, for common stock. This added 5.8 million shares to the outstanding. Terren Peizer owns Crede Capital.

On September 23, 2014, the company's Russian subsidiary, TOT Money renewed and increased its line of credit with Alpha-Bank to the equivalent of $11 million to support growth in Russia and the Commonwealth Independent States.

All of these actions taken together increased the primary shares outstanding to 45.7 million from the 38.4 million at the end of Q2 on June 30, 2014. It has increased the fully diluted share count to 56.4 million. It has also reduced the debt from $17.1 million to $3.4 million dollars.

INVESTMENT THESIS

- Net Element is growth company in the payments industry that should benefit from the adoption of mobile payments in the US and Russia.
- 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.
- Management has been restructuring operations and finances and we believe the fruits of these efforts will show in 2015 and beyond.
- The integration of Unified Payments and Aptito provide a unique offering to merchants and should allow the company to capture market share in the SMB merchant acquirer market in the US.
- We believe the company could grow to $28 million in revenues in 2015 through a combination of internal growth as well as portfolio acquisitions and reach non-GAAP breakeven in 2016.
- If NETE achieves our forecasts, we believe its common stock could be worth $2.13 per share twelve months from now based on an industry average valuation of approximately 5xs enterprise value to sales, up 58%.

OVERVIEW

Net Element (NETE) is the US-listed public company that owns TOT Group, a value-added merchant payment processor and point of sale (POS) software-as-a-service (SaaS) provider in the US, and a mobile payment processor in Russia. It is located in North Miami Beach, FL. It currently has 58 employees, half in the US and half in Russia.

Today, TOT Group consists of two main segments:

- US merchant processing and mobile POS platform (Unified Payments and Aptito)

1. **Unified Payments** contributes the bulk of the revenues for Net Element. It is a merchant processor for

US customers. Based on last quarter's revenues it is at an $18.3 million annual run rate. Its prime processing vendor is Total System Services (TSS).

2. Aptito is a cloud-based Point of Sale (POS) platform and restaurant management service that, combined with the services of Unified Payments, offers small and medium sized businesses (SMBs), merchants and restaurants, a full front and back office solution. Its low priced service offers differentiation to the company's merchant processing offering and its value added should ultimately inch margins upward.

- Mobile payments in Russia (TOT Money)

TOT Money a carrier-integrated mobile payments platform is a Russian-based business that allows mobile phone customers to pay bills and make purchases through all types of mobile phones— both feature phones and smartphones.

VALUATION

There are a number of public companies in the merchant acquiring/processing business. The largest is Cielo with a $24 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 $1.1 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 4.8 to 5.0 times sales and apply it to the revenues we expect Net Element to generate next year, and turn that back to price per share we get a share value of $2.13.

Merchant Acquring/Processing

Company	Ticker	Revenue 2014E	Revenue LTM	EBITDA Margin	Enterprise Value / Sales 2014E	Enterprise Value / Sales LTM	Included in Average?	Enterprise Value
Cielo	CIOXY	$3,100	$2,870	51%	7.9x	8.5x	y	24,360
Vantiv	VNTV	$1,400	$1,930	25%	5.5x	4.0x	y	7,650
Total System Services	TSS	$2,460	$2,460	28%	3.0x	3.0x	y	7,290
Global Payments	GPN	$2,780	$2,630	21%	2.6x	2.7x	y	7,110
EVERTEC	EVTC	$363	$360	47%	6.5x	6.5x	y	2,350
Heartland Payment Systems	HPY	$666	$617	12%	3.6x	3.9x	y	2,380
Qiwi	QIWI	$191	$228	27%	6.1x	5.1x	y	1,160
Average				**30%**	**5.0x**	**4.8x**		**$7,471**

	Projected Revenue 2015E	Projected Revenue LTM	EBITDA Margin	Enterprise Value / Sales 2015E	Enterprise Value / Sales LTM	Valuation Range Low	Valuation Range High
Net Element	**$28**	**$22**	**NM**	**5.0x**	**4.8x**	**$103**	**$141**
YoY growth							

Conclusion of Enterprise Value	**$122,268,519**
Market Value	**$120,281,761**
Fully DilutedShares Outstanding	56,400,000
Price per Share	**$2.13**

RISKS

- The company is losing money and may not be able to reach profitability or become cash flow positive
- The company is involved in a lawsuit with former management in Russia.
- The company has recently restructured operations and there is no assurance these efforts will be successful.
- The Russian mobile payment market is still in its infancy and there is no assurance the country will adopt this method to pay for goods and services.
- The merchant acquirer market in the US is competitive and larger companies have an advantage due to economies of scale.

PROJECTED INCOME STATEMENT & BALANCE SHEET

Forecasts

Q4 Forecast

For Q4 we expect revenues to be up year over year and sequentially despite the loss of the FDR portfolio. We are estimating revenues of $6.3 million versus $5.8 million last year. We expect revenues to be flat sequentially with Q3 in the credit card business, and up in mobile payments. Given the big reduction in interest expense, the losses should narrow. We are keeping our non-GAAP loss per share estimate at $0.04 versus a loss of $0.12 a year ago.

2014

In 2013, the company generated $18.7 million in revenues with only three quarters of the Unified Payments acquisition. That alone should add between $4 and $5 million to revenues in 2014 but is negated by the loss of the FDR portfolio in June 2013. We are expecting the company to end the year with $21.2 million in revenues versus $18.7 million last year, up 18%. The company could show a loss of $13.7 million or GAAP loss of $0.32 per share and non-GAAP loss of $0.23 based on a share count 32% higher.

2015

After all the restructuring in 2014, we believe in 2015 Net Element should be able to focus and grow its revenues organically as well as through judicious acquisition of portfolios. The Russian operations should recapture lost business and thrive as it markets its new products and the market for mobile payments grows. We are forecasting revenues of $28 million next year up 28%. This includes growth of 20% for the credit card business, and an almost doubling of the Russian business to $3 million. We think this is possible because of the small base the company is coming from as well as the CEO's experience in previously growing Unified Payments to $67 million in two years. 2015 operations should still result in non-GAAP losses but that should be reduced to $0.15 per share or $0.17 GAAP EPS. We expect the primary share count for the year to be up 17% to 45.6 million from 39 million in 2014. Fully diluted shares should be 54.6 versus 47.9 million.

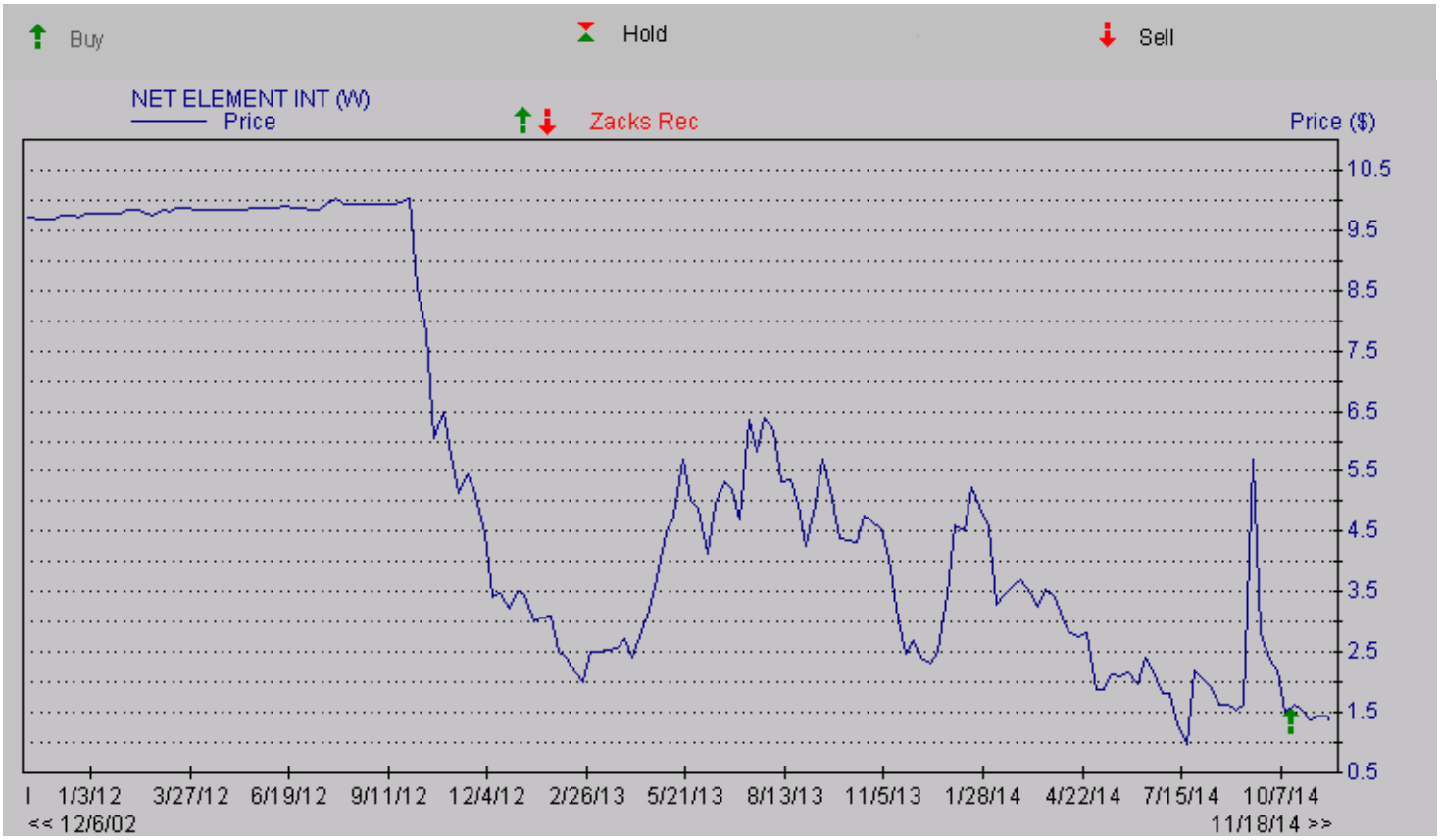
INCOME STATEMENT

Dollars in Millions	2013				2014					
	31-Mar-13	30-Jun-13	30-Sep-13	31-Dec-13	31-Mar-14	30-Jun-14	30-Sep-14	31-Dec-14 (est.)	2014E	2015E
Credit card processing	$0.0	$4.6	$5.5	$4.7	$4.1	$4.6	$5.6	$5.6	$19.8	$25.00
Yr-over-yr Growth					NM	-0.6%	1.0%	20.4%	NA	26.1%
Mobile payments	0.9	1.0	1.0	1.1	0.5	0.3	0.5	0.7	2.0	3.0
Yr-over-yr Growth					-44.9%	-66.3%	-54.4%	-30.8%	NA	51.7%
Total revenues	0.9	5.6	6.5	5.8	4.8	**4.9**	**6.0**	6.3	**22.1**	**28.8**
Yr-to-yr Growth					457.9%	-12.4%	-7.6%	9.5%	17.8%	30.3%
Costs and expenses:										
Cost of revenues	0.3	4.1	4.6	4.3	3.5	3.3	4.7	4.9	16.4	22.2
Gross Margin	0.6	1.5	1.9	1.4	1.3	1.6	1.3	1.4	5.6	6.6
% of Sales	68.3%	26.3%	28.7%	24.9%	27.1%	31.9%	21.7%	23.0%	25.5%	22.8%
						1.8	1.9			
G&A	2.8	3.5	2.9	19.0	3.1	2.5	6.5	2.4	14.6	11.5
Provision for loan losses	0.4	5.8	0.5	0.9	0.1	(1.5)	0.1	0.1	(1.2)	0.0
Depreciation and amortization	0.0	0.6	0.8	0.8	0.6	0.6	0.7	0.7	2.6	2.0
One-time charges	0.0	11.2	0.0	0.9	0.0	0.0	0.0	0.0	0.0	0.0
Total operating expenses	3.5	21.1	4.3	21.5	7.4	1.6	7.4	3.2	19.5	13.5
Loss from operations	(2.6)	(19.6)	(2.4)	(20.1)	(2.5)	(0.1)	(6.0)	(1.8)	(10.4)	(7.0)
Loss from operations ex-one time	(2.6)	(8.4)	(2.4)	(19.2)	(2.5)	(1.3)	(6.0)	(1.8)	(11.6)	(7.0)
Interest expense, net	(0.1)	(0.9)	(1.0)	(0.9)	(1.1)	(1.8)	(0.8)	(0.2)	(3.8)	(0.7)
Other expense	(0.1)	(0.0)	(0.1)	0.0	(0.0)	(0.0)	(0.1)	0.0	(0.1)	0.0
One-time charges	0.0	0.0	0.0	0.0	0.0	3.2	(2.2)	0.0	1.0	0.0
Total non-operating expenses	(0.2)	(0.9)	(1.1)	(0.9)	(1.1)	1.4	(3.0)	(0.2)	(2.8)	(0.7)
Loss from continuing operations before tax	(2.9)	(20.5)	(3.4)	(21.0)	(3.6)	1.3	(9.1)	(1.9)	(13.2)	(7.7)
Income tax provision	0.0	0.0	0.0	(0.2)	0.0	0.0	0.0	0.0	0.0	0.0
Loss from continuing operations	(2.9)	(20.5)	(3.4)	(21.2)	(3.6)	1.3	(9.1)	(1.9)	(13.3)	(7.7)
Minority interest	(0.2)	0.6	0.3	0.5	0.0	0.0	0.0	0.0	0.0	0.0
Discontinued operations:										
Loss from operations of discontinued entities	(0.4)	(0.3)	(0.4)	(0.0)	0.0	0.0	0.0	0.0	0.0	0.0
Loss on sale of assets of discontinued operations	0.0	0.0	(0.3)	0.0					0.0	0.0
Total discontinued operations	(0.4)	0.0	(0.7)	(0.3)	0.0	0.0	0.0	0.0	0.0	0.0
Net loss	(3.2)	(20.0)	(3.9)	(21.7)	(3.6)	1.3	(9.1)	(1.9)	(13.2)	(7.7)
Foreign currency translation gain (loss)	(0.0)	0.2	0.2	(0.8)	1.3	(0.1)	0.3	0.0	1.4	0.0
Comprehensive loss	(3.3)	(20.2)	(3.7)	(21.6)	(2.3)	1.2	(9.3)	(1.9)	(12.3)	(7.7)
Earnings ex-one time charge	(2.9)	(3.2)	(3.2)	(19.8)	(2.2)	(2.9)	(9.3)	(1.9)	(16.4)	(7.7)
Stock-based compensation	0.0	0.2	0.1	16.3	0.1	0.7	4.6	0.2	5.6	1.0
Non-GAAP Earnings	(2.9)	(3.1)	(3.4)	(3.5)	(2.2)	(2.2)	(2.2)	(1.7)	(8.3)	(6.7)
					-24%	-28%	-34%	-51%	-33%	-20%
GAAP EPS	**($0.10)**	**($0.71)**	**($0.11)**	**($0.73)**	**($0.09)**	**$0.04**	**($0.23)**	**($0.04)**	**($0.32)**	**($0.17)**
Non-GAAP EPS	**($0.10)**	**($0.11)**	**($0.12)**	**($0.12)**	**($0.07)**	**($0.07)**	**($0.05)**	**($0.04)**	**($0.23)**	**($0.15)**
									-48%	-36%
Share outstanding	28.2	28.1	28.2	28.2	32.4	32.3	39.6	45.6	37.5	45.7
Yr-to-yr Growth					15%	15%	41%	62%	32%	22%
Fully diluted shares	37.2	37.1	37.1	37.1	41.3	41.2	48.6	54.6	46.4	54.7
Yr-to-yr Growth					11%	11%	31%	47%	24%	18%

BALANCE SHEET

	30-Sep-14	30-Jun-14	Mar. 31, 2014	Dec. 31, 2013	% Change Dec-Sept
Current assets:					
Cash	$1,405,371	$1,271,716	$777,031	$126,319	1013%
Accounts receivable, net	3,958,769	4,374,431	6,492,892	10,619,289	-63%
Advances to aggregators, net	92,767	4,246	1,023,039	1,109,538	-92%
Prepaid expenses and other assets	941,888	831,058	737,683	834,025	13%
Total current assets	6,398,795	6,481,451	9,030,645	12,689,171	-50%
Fixed assets, net	44,758	63,234	115,002	137,267	-67%
Intangible assets, net	2,523,172	3,052,847	2,488,225	2,964,424	-15%
Goodwill	6,671,750	6,671,750	6,671,750	6,671,750	0%
Other long term	143,133	308,299			
Investment in affiliate	0	0	0	46,113	-100%
Total assets	15,781,608	16,577,581	18,305,622	22,508,725	-30%
Current liabilities:					
Accounts payable	2,739,886	2,609,509	$2,887,403	$3,190,215	-14%
Deferred revenue	265,708	158,012	267,705	239,398	11%
Accrued expenses	2,413,418	2,713,911	2,816,992	3,484,963	-31%
Short term loans	2,939	256,402	7,421,795	8,478,810	-100%
Notes payable (current portion)	98,493	98,493	1,566,423	3,816,093	-97%
Due to related parties	77,129	318,301	318,300	1,451,357	-95%
Total current liabilities	5,597,573	6,154,628	15,278,618	20,660,836	-73%
Notes payable (non-current portion)	3,216,507	16,635,581	19,634,348	17,255,531	-81%
Total liabilities	8,814,080	22,790,209	34,912,966	37,916,367	-77%
STOCKHOLDERS' DEFICIT					
Preferred stock	0	0	0	0	
Common stock	4,563	3,836	3,233	3,229	41%
Paid in capital	137,768,404	116,455,522	104,804,856	103,486,144	33%
Stock subscription	(1,111,130)	(2,320,102)	149,707	329,406	-437%
Accumulated other comprehensive income (loss)	716,852	990,531	1,112,748	(170,550)	-520%
Accumulated deficit	(130,235,221)	(121,176,387)	(122,524,155)	(118,930,828)	10%
Noncontrolling interest	(175,940)	(166,028)	(153,733)	(125,043)	41%
Total stockholders' deficit	6,967,528	(6,212,628)	(16,607,344)	(15,407,642)	-145%
Total liabilities and stockholders' deficit	15,781,608	16,577,581	18,305,622	22,508,725	-30%
Net Cash	1,226,810	598,520		(13,619,941)	-109%
Current Ratio	1	1		1	86%
Quick Ratio	1	1		1	86%
Total Debt	8,392,129	17,052,375		22,522,981	-85%
Debt / TA	22%	104%		138%	-84%

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Sell/Underperform: The analyst expects the company will underperform the broader U.S. Equity market over the next one to two quarters.

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