Smith Micro Software, Inc. (NASDAQ: SMSI)

October 10, 2022

James McIlree, CFA
561-237-2709
jmcilree@dawsonjames.com

Buy: SafePath Demand in an Economic Slowdown.

Over the coming quarters we expect higher gross margin and substantially lower operating expenses given the completion of the integration of the three separate platforms Smith has been maintaining since the acquisitions of Circle and Avast. A significant risk to our estimates is the take-up of SafePath by consumers in a weakening economy. We reiterate our Buy recommendation and $8.30 price target.

In our view, the most significant operational risk for Smith is take-up of SafePath over the coming quarters given the Fed's attempts to bring down inflation with slowing money growth, a sharp increase in interest rates and the resulting expected slowdown of economic growth. In our model we have assumed SafePath sequential growth begins in Q4 at a modest pace, and accelerates in Q2 of next year. We believe our estimates are reasonable, but a sharp contraction could jeopardize our forecast.

In this note we examine ARPU (average revenue per user) of the major wireless carriers before, during and after the recessions in 2001, 2008 and 2020. We use ARPU as a proxy for the willingness of consumers to add additional services like SafePath to their bills. However, there are significant issues with this metric and in comparing the coming cycle with prior cycles.

The challenges with using ARPU as an indicator of demand elasticity for SafePath include differences in how ARPU has been defined (for instance using total subscribers or only postpaid), penetration rates, the use of family plans, financing of phones, data services available, competitive alternatives to wireless services and length of contracts which can cause lags in changes in consumer demand.

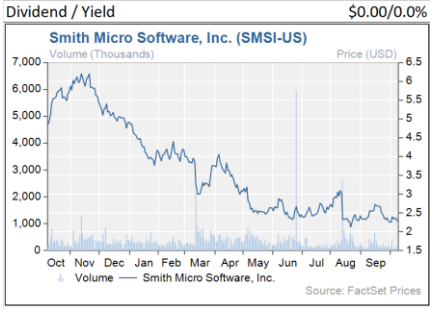
Our expected ramp in SafePath customers for the rest of this year and into the first half of next year is moderate as Smith and its customers work on the roll-out plans and marketing plans of SafePath to their subscribers. This pushes the hockey stick in revenue towards the back half of next year.

The company estimates it can reach 9 to 15 million accounts by 2025 and we estimate this is a revenue opportunity ranging from $270 million to $900 million annually for Smith.

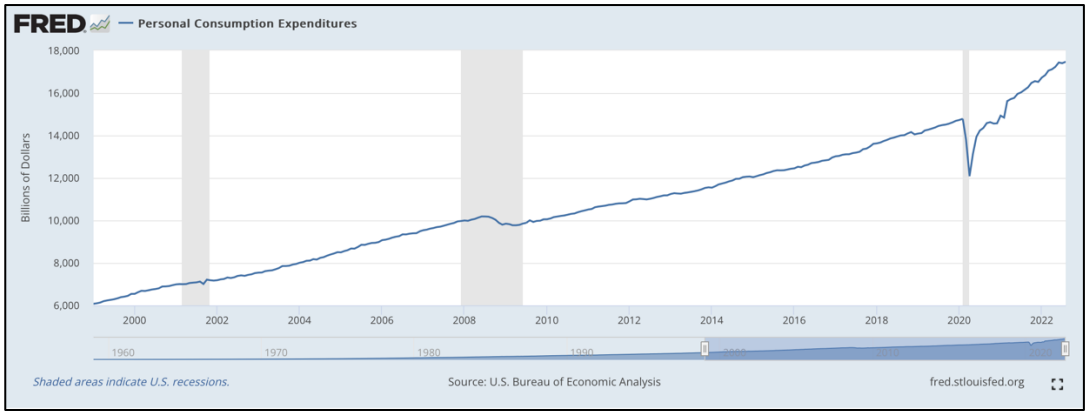
Valuation: Our price target of $8.30 is based on an EV/Sales multiple of 5.5x on a run-rate revenue estimate of $90 million, which should be achieved when SafePath is available and marketed to the subscribers of the three largest domestic wireless carriers. This multiple is consistent with a peer group and far below the 10x multiple of some in the group.

Risks: Risks to achieving our price target include declines in the CommSuite product line, disruptions from the T- Mobile acquisition of Sprint, integration of the Family Safety business, continuing impacts of the COVID pandemic and customer concentration.

Current Price			**$2.29**
Price Target			**$8.30**
Estimates	F2021A	F2022E	F2023E
Revenues ($000s)	$ 58,422	$ 49,833 E	$ 63,988
1Q March	$ 11,381	$ 12,735 A	$ 12,707
2Q June	$ 15,919	$ 12,674 A	$ 14,427
3Q September	$ 16,443	$ 12,357 E	$ 16,927
4Q December	$ 14,679	$ 12,067 E	$ 19,927
	F2021A	F2022E	F2023E
EBITDA ($000s)	$ (1,305)	$ (19,478)E	$ (10,842)
1Q March	$ 887	$ (3,916)A	$ (2,060)
2Q June	$ 25	$ (4,886)A	$ (274)
3Q September	$ 121	$ (5,358)E	$ 2,847
4Q December	$ (2,338)	$ (5,318)E	$ 5,461
EV/Sales	2.2 x	2.6 x	2.0 x
EV/EBITDA	NM	(6.6)	(11.8)
Stock Data			
52-Week Range	$2.11	-	$6.52
Shares Outstanding (mil.)			56.3
Market Capitalization (mil.)			$129
Enterprise Value (mil.)			$128
Debt to Capital			18%
Cash (mil.)			$22
Cash/Share			$0.40
Average Three Months Trading Volume (K)			164
Insider Ownership			12.9%
Institutional Ownership			18.9%
Short interest (mil.)			3.5%
Dividend / Yield			$0.00/0.0%



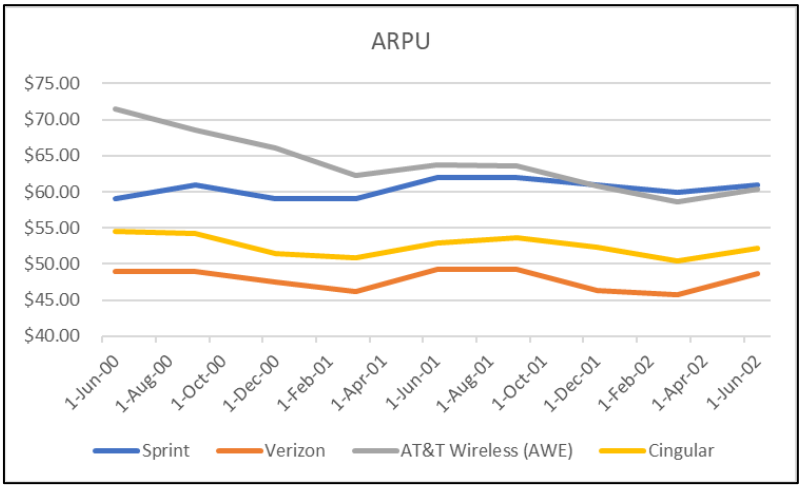
The National Bureau of Economic Research (NBER) dates three recessions in the 21st century. This first from March 2001 to November 2001, the second from December 2007 to June of 2009 and the third from February 2020 through April 2020. For each of these recessions we look at the change in personal consumption expenditures (PCE) from its peak to trough (the peak and trough of PCE differs from the peak and trough of the recession) as a partial guide in examining changes in wireless ARPU.



Source: https://fred.stlouisfed.org/series/PCE

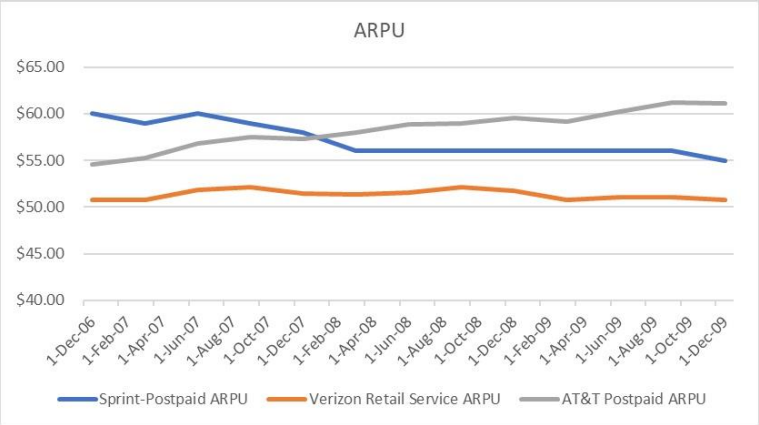
For the 2001 recession PCE declined 1.6% from peak to trough. In the 2008 recession PCE declined 4.1% and PCE declined 18% in the short-lived 2020 recession.

Wireless ARPU was declining for the four major carriers prior to the start of the recession in 2001 and the simple average of the four dominant carrier's ARPU declined from $56 in Q4 2000 to $55.09 in Q4 2001, a decline of 1.6%, similar to the peak-to-trough decline in PCE.



Source: Company filings with SEC.

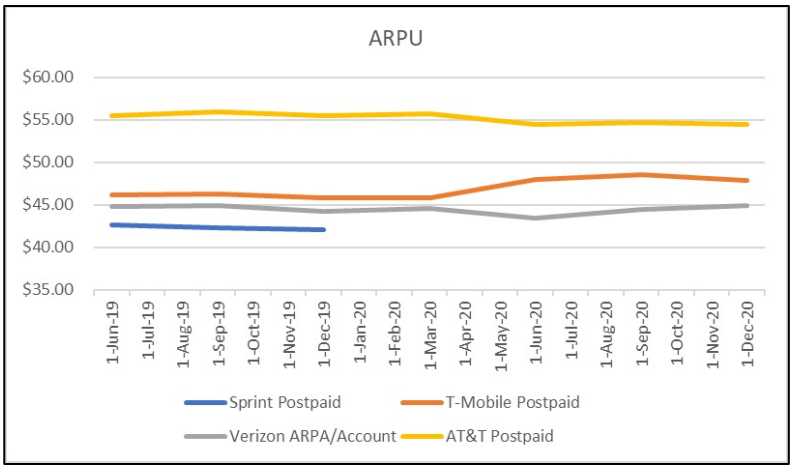
The 2008 recession was lengthy, 18 months, and severe, with PCE dropping 4.1% from peak to trough. However, ARPU for the three dominant carriers was much more stable. On average, ARPU was relatively unchanged from December 2007 to December 2008 and to December 2009. Measuring from June of 2007 to June of 2008 there was a 1.3% drop but a 0.5% increase from June of 2008 to June of 2009.



Source: Company filings with SEC.

One major difference in the ARPU measurements between the two recessions is the use of postpaid subscribers in the second period. Other major differences are the greater wireless penetration, the greater penetration of smartphones, and the increased use of data services in the latter period. All of these, we believe, lead to robust demand for wireless services.

The short-lived recession of 2020 saw an 18% decline in PCE but ARPU for the group increased from the end of 2019 to the end of 2020 for the three major carriers: T-Mobile, Verizon and AT&T. For Verizon, we used average revenue per postpaid account divided by the number of users per account.



Source: Company filings with SEC.

The 2020 recession was unusual in its short length, significant decline, rapid bounce back and extreme measures by the Federal Reserve and U. S. Government to maintain consumer spending and employment. Even so, ARPU seemed to be unaffected by the downturn.

The reaction of ARPU to the declines in PCE in the 2008 and 2020 recessions provide some comfort relative to ARPU, and that the demand for SafePath can hold up for potential declines in the economy and PCE.

The company is nearing the end of a multi-year migration effort to consolidate all subscribers on one platform. This will have two major benefits for margins. First, gross margin should improve from the current 71% level to the 80%-90% range the company achieved in 2018-2020. On current revenue, this is a $5 million annual improvement in free cash generation. Second, the development costs that have been incurred to migrate customers from the legacy platforms is nearing its end and will result in a $12 million annual reduction in cash operating expenses. Combined, this is an almost $20 million annual improvement in free cash generation.

The other major benefit will be a resumption of revenue growth. With all development and migration work complete we expect Smith and its carrier customers to begin actively marketing the family safety services to its customer base. This is a large opportunity for Smith and the carriers. Before Sprint's acquisition by T-Mobile, Smith was generating $30 to $35 million in annualized revenue

from Sprint, the smallest of the then-major carriers. Since then, Smith has consolidated the industry and now serves the three major domestic carriers, whose combined post-paid subscriber base is 7x the number of post-paid subscribers served by Sprint. This suggests a revenue opportunity of at least $200 to $250 million annually.

Smith estimates the number of multi-line accounts served by each of the three carriers at between 15 and 20 million and the number of accounts that could be served by Smith at between 3 and 5 million per carrier. This equals 9 to 15 million accounts each paying on average $10 per month, or a revenue contribution to the carriers of between $1.1 and $1.8 billion annually. Smith's contract terms with its carrier customers are proprietary but we estimate Smith takes between 25% and 50% of the total revenue. At 25%, this is a revenue opportunity of $270 million to $450 million annually. This is consistent with the revenue opportunity estimate derived by comparing Smith's revenue from Sprint and applying that to the much larger base now served.

Smith is the sole provider of family location and safety services to the three largest U.S. wireless carriers serving 230 million postpaid phone customers. As stated above, we believe this is a $270 million to $450 million opportunity far in excess of current run rates. And in our view, even this potential is too low since SafePath is a platform that can expand into the home. And that is just the domestic market. We believe the international market is at least equal in size.

Outlook

Our revenue estimate for this year reflects the roll-out of SafePath 7 to the carriers in Q4. The company expects T-Mobile and AT&T to begin marketing this year and Verizon next year. Assuming lags between marketing and subscription as well as trial periods common to the industry, we expect modest SafePath Q/Q revenue growth through the first half of next year and a more aggressive growth rate in the second half.

EBITDA and margins should follow revenue growth. Gross margin is modeled to improve near year-end and is estimated to achieve 80% by the end 2023 and expand further into 2024. EBITDA and EBITDA margin should grow as revenue scales, and we expect EBITDA margin to exceed 20% exiting 2023.

Valuation

Our price target of $8.30 is based on an EV/Sales multiple of 5.5x on a run-rate revenue estimate of $90 million, which should be achieved when SafePath is available and marketed to the subscribers of the three largest domestic wireless carriers. This multiple is consistent with a peer group and far below the multiples of many in the group.

		Price	FTM EPS	P/E	TEV (in M's)	FTM Sales (in M's)	EV/ Sales	FTM EBITDA (in M's)	EV/ EBITDA
ADBE	Adobe Incorporated	$ 285.91	$ 15.30	18.7	$133,126.2	$ 19,569.2	6.8x	$ 9,538.8	14.0 x
ASAN	Asana, Inc. Class A	22.54	(1.06)	NM	4,616.4	656.5	7.0x	(230.1)	NM
TEAM	Atlassian Corp Class A	223.70	1.90	117.4	58,043.9	3,885.9	14.9x	723.5	80.2 x
DOCU	DocuSign, Inc.	46.91	1.82	25.8	9,463.2	2,651.9	3.6x	531.8	17.8 x
DBX	Dropbox, Inc. Class A	20.55	1.68	12.2	8,410.5	2,431.9	3.5x	890.6	9.4 x
HUBS	HubSpot, Inc.	270.83	2.75	98.4	13,063.7	2,008.7	6.5x	250.7	52.1 x
NTNX	Nutanix, Inc. Class A	20.53	0.16	125.3	5,107.6	1,830.7	2.8x	131.9	38.7 x
ONTF	ON24, Inc.	9.17	(0.38)	NM	101.1	199.6	0.5x	(15.7)	NM
RNG	RingCentral, Inc. Class A	36.45	2.36	15.5	5,331.0	2,348.3	2.3x	399.6	13.3 x
SMAR	Smartsheet, Inc. Class A	33.77	(0.37)	NM	4,339.8	902.8	4.8x	(21.0)	NM
TWLO	Twilio, Inc. Class A	72.56	(0.03)	NM	10,936.7	4,683.8	2.3x	335.1	32.6 x
WDAY	Workday, Inc. Class A	148.98	4.11	36.2	37,261.8	7,019.7	5.3x	1,827.6	20.4 x
ZM	Zoom Video Communications, Inc. Class A	73.26	3.63	20.2	17,368.7	4,676.4	3.7x	1,574.7	11.0 x
	Median			25.8			3.7x		19.1 x
SMSI	Smith Micro Software, Inc.	$ 2.29	$ (0.33)	NM	$ 130.8	$ 60.8	2.2x	$ (12.8)	NM

Source: FactSet and Dawson James Securities estimates.

Risk Analysis

Risks to achieving our price target include declines in the CommSuite product line, disruptions from the T- Mobile acquisition of Sprint, integration of the Family Safety business, continuing impacts of the COVID pandemic and customer concentration.

Exhibit 1. Income Statement

$ in 000's	FY2019	FY2020	FY2021	Q1 22A	Q2 22A	Q3 22E	Q4 22E	FY2022E	FY2023E
Revenue	$ 43,346	$ 51,300	$ 58,422	$ 12,735	$ 12,674	$ 12,357	$ 12,067	$ 49,833	$ 63,988
COGS	3,927	5,190	12,698	3,637	3,617	3,769	3,439	14,462	14,796
Gross Profit	39,419	46,110	45,724	9,098	9,057	8,588	8,628	35,371	49,192
	91%	89.9%	78.3%	71.4%	71.5%	69.5%	71.5%	71.0%	76.9%
SG&A	7,148	9,090	11,581	2,985	3,720	3,720	3,720	14,145	15,889
R&D	11,119	17,759	26,197	7,402	8,213	8,213	8,213	32,041	34,993
G&A	9,921	12,801	17,920	4,045	4,026	4,026	4,026	16,123	17,204
Amort. of Intangible asset	932	2,920	8,100	1,645	1,577	1,577	1,577	6,376	5,874
Restructuring/Other	194	19	12,864	0	0	0	0	0	0
Asset Impairment									
Opex	29,314	42,589	76,662	16,077	17,536	17,536	17,536	68,685	73,960
Operating Income	$ 10,105	$ 3,521	$ (30,938)	$ (6,979)	$ (8,479)	$ (8,948)	$ (8,908)	$ (33,314)	$ (24,768)
Interest Income	228	96	34	0	2	2	2	6	8
Interest Expense	0	0	(2)	(4)	0	(113)	(225)	(342)	(563)
Other Income (Expense)	469	708	78	0	15	15	15	45	100
Pretax Income	10,802	4,325	(30,828)	(6,983)	(8,462)	(9,043)	(9,116)	(33,604)	(25,222)
Taxes	80	160	215	19	31	25	25	100	100
Net Income	10,722	4,165	(31,043)	(7,002)	(8,493)	(9,068)	(9,141)	(33,704)	(25,322)
Preferred Dividends	(120)	0	0	0	0	0	0	0	0
Net to Common	$ 10,602	$ 4,165	$ (31,043)	$ (7,002)	$ (8,493)	$ (9,068)	$ (9,141)	$ (33,704)	$ (25,322)
Basic Shares	34,490	40,808	51,232	54,501	55,183	57,854	58,195	56,433	59,721
Diluted Shares	36,968	42,764	51,232	54,501	55,183	59,854	60,195	56,433	59,721
Basic EPS	$ 0.31	$ 0.10	$ (0.61)	$ (0.13)	$ (0.15)	$ (0.16)	$ (0.16)	$ (0.60)	$ (0.42)
Diluted EPS	$ 0.29	$ 0.10	$ (0.61)	$ (0.13)	$ (0.15)	$ (0.15)	$ (0.15)	$ (0.60)	$ (0.42)
Stock Comp	1,494	3,063	4,848	1,065	1,689	1,689	1,689	6,132	6,756
Amortization	932	2,920	8,100	1,645	1,577	1,577	1,577	6,376	5,874
Other	(212)	918	15,852	0	0	0	0	0	0
Non-GAAP Net Income	12,816	11,066	(2,243)	(4,292)	(5,227)	(5,802)	(5,875)	(21,196)	(12,692)
Non-GAAP EPS	$ 0.35	$ 0.26	$ (0.04)	$ (0.08)	$ (0.09)	$ (0.10)	$ (0.10)	$ (0.38)	$ (0.21)
Operating Income	10,105	3,521	(30,938)	(6,979)	(8,479)	(8,948)	(8,908)	(33,314)	(24,768)
Depreciation & Amort.	1,341	3,582	9,338	1,998	1,904	1,901	1,901	7,704	7,170
Stock Comp	1,494	3,064	4,848	1,065	1,689	1,689	1,689	6,132	6,756
Other	194	927	15,447	0	0	0	0	0	0
EBITDA	$ 13,134	$ 11,094	$ (1,305)	$ (3,916)	$ (4,886)	$ (5,358)	$ (5,318)	$ (19,478)	$ (10,842)
Margin	30.3%	21.6%	-2.2%	-30.7%	-38.6%	-43.4%	-44.1%	-39.1%	-16.9%

Source: Smith Micro Software, Inc. and Dawson James Securities estimates

Exhibit 2. Balance Sheet and Cash Flow Statement

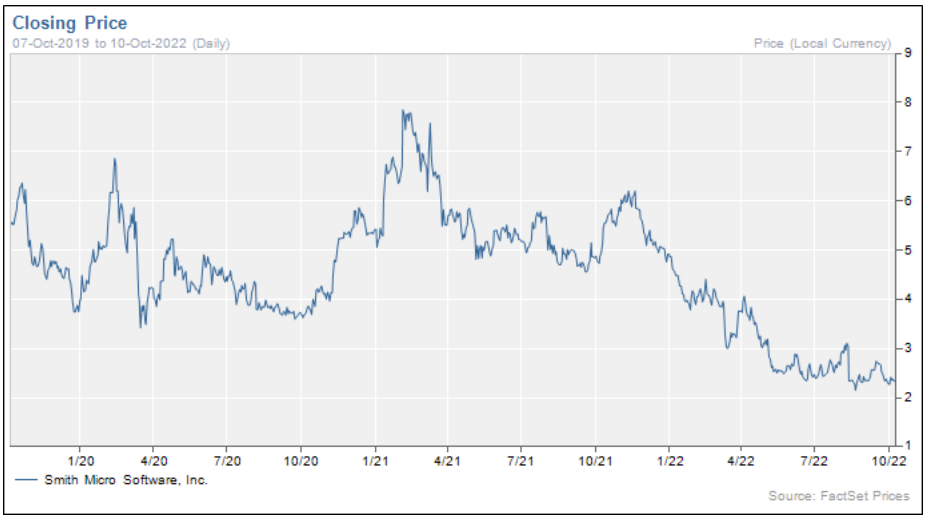
($ in 000's)	FY2019	FY2020	FY2021	FY2022E	FY2023E
Cash	28,268	25,754	16,078	12,292	15,314
A/R	10,894	12,347	10,590	9,918	15,286
Prepaid Expenses & Other	802	1,189	1,988	2,394	3,953
Current Assets	$ 39,964	$ 39,290	$ 28,656	$ 24,603	$ 34,553
Equipment & Improvements	2,109	2,170	2,698	1,981	1,685
Right-of-use asset	6,464	5,785	5,710	4,291	4,291
Deferred Tax Assets	94	0	0	0	0
Other	234	694	620	541	541
Intangible Assets	4,535	12,698	42,631	36,256	30,382
Goodwill	7,797	12,266	35,041	35,041	35,041
Total Assets	**$ 61,197**	**$ 72,903**	**$ 115,356**	**$ 102,713**	**$ 106,493**
A/P	2,050	2,282	3,301	3,593	5,934
Accrued Payroll & Benefits	2,107	2,867	4,055	3,579	5,910
Operating Lease	1,221	1,433	1,400	1,400	1,400
Other Accrued Liab.	244	216	436	1,168	1,929
Deferred Revenue	98	1,572	176	0	0
Current Liabilities	$ 5,720	$ 8,370	$ 9,368	$ 9,740	$ 15,173
Lease Liabilities	5,774	4,805	4,467	3,640	3,640
Cv. Notes due 2023	0	0	0	15,000	0
Deferred Rent	885	887	844	0	0
Other LT Liabilities	134	125	117	111	184
Equity	$ 48,684	$ 58,716	$ 100,560	$ 74,222	$ 87,496
Total Liabilities & Equity	**$ 61,197**	**$ 72,903**	**$ 115,356**	**$ 102,713**	**$ 106,493**

	FY2019	FY2020	FY2021	FY2022E	FY2023E
Net Income	10,722	4,165	(31,043)	(33,705)	(8,507)
Depreciation & Amortization	1,341	3,582	9,338	7,704	7,170
Stock Comp	1,494	3,064	4,848	6,132	6,756
Working Capital & Other	(3,569)	(2,887)	3,941	(1,448)	(1,422)
Operating CF	**$ 9,988**	**$ 7,924**	**$ (12,916)**	**$ (21,317)**	**$ 3,997**
Capx	(1,659)	(1,323)	(830)	(612)	(1,000)
Acquisitions	(3,974)	(13,500)	(56,865)	0	0
Other	370	142	192	83	0
Investing Activities	**$ (5,263)**	**$ (14,681)**	**$ (57,503)**	**$ (529)**	**$ (1,000)**
Equity	11,503	4,214	60,743	2,125	15,025
Debt	0	0	0	15,900	(15,000)
Other	(119)	29	0	35	0
Financing	**$ 11,384**	**$ 4,243**	**$ 60,743**	**$ 18,060**	**$ 25**
Change in Cash	**$ 16,109**	**$ (2,514)**	**$ (9,676)**	**$ (3,786)**	**$ 3,022**

Source: Smith Micro Software, Inc. and Dawson James Securities estimates

Important Disclosures:

Price Chart:



Price target and ratings changes over the past three years:
Initiated – Buy – May 4, 2021 – Price Target $11.10
Price Target Change – Buy – May 6, 2021 – Price Target changed from $11.10 to $11.40
Update – Buy – July 21, 2021 – Price Target $11.40
Update – Buy – August 5, 2021 – Price Target $11.40
Update – Buy – November 11, 2021 – Price Target $11.40
Price Target Change – Buy – March 11, 2022 – Price Target changed from $11.40 to $8.30
Update – Buy – April 4, 2022 – Price Target $8.30
Update – Buy – May 5, 2022 – Price Target $8.30
Update – Buy – August 12, 2022 – Price Target $8.30
Update – Buy – October 10, 2022 – Price Target $8.30

Dawson James Securities, Inc. (the "Firm") is a member of the Financial Industry Regulatory Authority ("FINRA") and the Securities Investor Protection Corporation ("SIPC").

The Firm does not make a market in the securities of the subject company(s). The Firm has not engaged in investment banking relationships with the subject company in the prior twelve months, as a manager or co-manager of a public offering and has not received compensation resulting from those relationships. The Firm may seek compensation for investment banking services in the future from the subject company(s). The Firm has received other compensation from the subject company(s) in the last 12 months for services unrelated to managing or co-managing of a public offering.

Neither the research analyst(s) whose name appears on this report nor any member of his (their) household is an officer, director, or advisory board member of these companies. However, Dawson James Securities does employ a Registered Representative who serves on the board of the company. This individual does not beneficially own 1% or more of any class of common equity securities of the subject company(s) of this report. The Firm and/or its directors and employees may own securities of the company(s) in this report and may increase or decrease holdings in the future. As of September 8, 2022, the Firm as a whole did not beneficially own 1% or more of any class of common equity securities of the subject company(s) of this report. The Firm, its officers, directors, analysts, or employees may affect transactions in and have long or short positions in the securities (or options or warrants related to those securities) of the company(s) subject to this report. The Firm may affect transactions as principal or agent in those securities.

Analysts receive no direct compensation in connection with the Firm's investment banking business. All Firm employees, including the analyst(s) responsible for preparing this report, may be eligible to receive non-product or service-specific monetary bonus compensation that is based upon various factors, including total revenues of the Firm and its affiliates as well as a portion of the proceeds from a broad pool of investment vehicles consisting of components of the compensation generated by investment banking activities, including but not limited to shares of stock and/or warrants, which may or may not include the securities referenced in this report.

Although the statements in this report have been obtained from and are based upon recognized statistical services, issuer reports or communications, or other sources that the Firm believes to be reliable, we cannot guarantee their accuracy. All opinions and estimates included in this report constitute the analyst's judgment as of the date of this report and are subject to change without notice.

Information about valuation methods and risks can be found in the "Valuation" and "Risk Analysis" sections of this report.

The securities of the company discussed in this report may be unsuitable for investors depending on their specific investment objectives and financial position. This report is offered for informational purposes only and does not constitute an offer or solicitation to buy or sell any securities discussed herein in any jurisdiction where such would be prohibited. Additional information is available upon request.

Ratings Definitions:

1) **Buy**: The analyst believes the price of the stock will appreciate and produce a total return of at least 20% over the next 12-18 months;
2) **Neutral**: The analyst believes the price of the stock is fairly valued for the next 12-18 months;
3) **Sell**: The analyst believes the price of the stock will decline by at least 20% over the next 12-18 months and should be sold.

The following chart reflects the range of current research report ratings for all companies, followed by the analysts of the Firm. The chart also reflects the research report ratings relating to those companies for which the Firm has performed investment banking services.

Current as of 20-Sep-22

	Company Coverage		**Investment Banking**	
Ratings Distribution	# of Companies	% of Total	# of Companies	% of Totals
Market Outperform (Buy)	25	83%	3	12%
Market Perform (Neutral)	4	13%	1	25%
Market Underperform (Sell)	1	3%	0	0%
Total	30	100%	4	13%

Analyst Certification:

The analyst(s) whose name appears on this research report certifies that 1) all of the views expressed in this report accurately reflect his (their) personal views about any and all of the subject securities or issuers discussed; and 2) no part of the research analyst's compensation was, is, or will be directly or indirectly related to the specific recommendations or views expressed by the research analyst in this research report; and 3) all Dawson James employees, including the analyst(s) responsible for preparing this research report, may be eligible to receive non-product or service-specific monetary bonus compensation that is based upon various factors, including total revenues of Dawson James and its affiliates as well as a portion of the proceeds from a broad pool of investment vehicles consisting of components of the compensation generated by investment banking activities, including but not limited to shares of stock and/or warrants, which may or may not include the securities referenced in this report.