

Smith Micro Software, Inc. (NASDAQ: SMSI)

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Buy: Q3 Preview.

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Smith is scheduled to report Q3 results on November 9th after the close. 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.

Our Q3 revenue estimate of \$11.8 million and EBITDA loss of \$5.7 million are below consensus and in line with company guidance. We have modeled Q3 as the trough quarter in Family Safety revenue and expect sequential growth beginning Q4. This top-line growth combined with expense reduction, now that the integration of the three separate platforms Smith has been maintaining since the acquisitions of Circle and Avast is complete, should result in significant growth in margins.

Postpaid subscriber growth and ARPU remains healthy for AT&T, T-Mobile and Verizon. For the three dominant U.S. carriers, postpaid net subscriber additions in Q3 were 1.5 million, up from 0.5 million in Q1 and 1.2 million in Q2. Postpaid ARPU for AT&T and Verizon rose year-over-year and quarter-over-quarter, and for T-Mobile postpaid ARPU was down slightly quarter-over-quarter in Q3.

We believe the most significant operational risk for Smith is the 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.

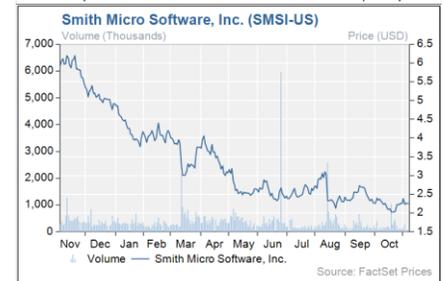
Our expected ramp in SafePath customers for the rest of this year and into the first half of next year is moderate as Smith and its customers work on the roll-out plans and marketing plans of SafePath to their subscribers. This pushes the hockey stick in revenue toward the back half of next year.

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 where multiples range as high as 8x.

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	\$2.26		
Price Target	\$8.30		
Estimates	F2021A	F2022E	F2023E
Revenues (\$000s)	\$ 58,422	\$ 49,293 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	\$ 11,817 E	\$ 16,927
4Q December	\$ 14,679	\$ 12,067 E	\$ 19,927
	F2021A	F2022E	F2023E
EBITDA (\$000s)	\$ (1,305)	\$ (19,853)E	\$ (10,842)
1Q March	\$ 887	\$ (3,916)A	\$ (2,060)
2Q June	\$ 25	\$ (4,886)A	\$ (274)
3Q September	\$ 121	\$ (5,733)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	(6.4)	(11.7)
Stock Data			
52-Week Range	\$1.97	-	\$6.52
Shares Outstanding (mil.)	56.3		
Market Capitalization (mil.)	\$127		
Enterprise Value (mil.)	\$127		
Debt to Capital	18%		
Cash (mil.)	\$22		
Cash/Share	\$0.40		
Average Three Months Trading Volume (K)	266		
Insider Ownership	11.7%		
Institutional Ownership	18.9%		
Short interest (mil.)	3.6%		
Dividend / Yield	\$0.00/0.0%		



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 where multiples range as high as 8x.

		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	\$ 285.75	\$ 15.25	18.7	\$131,722.2	\$ 19,315.2	6.8x	\$ 9,422.3	14.0 x
ASAN	Asana, Inc. Class A	17.21	(1.04)	NM	3,310.5	664.4	5.0x	(231.8)	NM
TEAM	Atlassian Corp Class A	123.73	1.55	79.8	31,399.9	3,790.3	8.3x	663.6	47.3 x
DOCU	DocuSign, Inc.	40.86	1.84	22.2	8,063.7	2,666.8	3.0x	535.3	15.1 x
DBX	Dropbox, Inc. Class A	21.40	1.71	12.5	8,421.5	2,439.4	3.5x	899.1	9.4 x
HUBS	HubSpot, Inc.	265.69	2.71	98.0	12,358.4	2,008.2	6.2x	245.6	50.3 x
NTNX	Nutanix, Inc. Class A	26.94	0.20	137.1	6,316.0	1,853.2	3.4x	140.7	44.9 x
ONTF	ON24, Inc.	7.32	(0.37)	NM	13.8	197.8	0.1x	(15.1)	NM
RNG	RingCentral, Inc. Class A	29.75	2.39	12.5	4,416.2	2,370.4	1.9x	402.7	11.0 x
SMAR	Smartsheet, Inc. Class A	26.51	(0.37)	NM	3,076.9	915.2	3.4x	(23.7)	NM
TWLO	Twilio, Inc. Class A	42.74	0.05	798.3	4,921.2	4,386.8	1.1x	335.6	14.7 x
WDAY	Workday, Inc. Class A	132.63	4.18	31.7	32,077.8	7,105.3	4.5x	1,851.0	17.3 x
ZM	Zoom Video Communications, Inc. Class A	77.46	3.60	21.5	17,627.7	4,674.3	3.8x	1,579.1	11.2 x
	Median			27.0			3.5x		14.9 x
SMSI	Smith Micro Software, Inc.	\$ 2.26	\$ (0.36)	NM	\$ 126.8	\$ 61.8	2.1x	\$ (12.2)	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	\$ 11,817	\$ 12,067	\$ 49,293	\$ 63,988
COGS	3,927	5,190	12,698	3,637	3,617	3,604	3,439	14,297	14,796
Gross Profit	39,419	46,110	45,724	9,098	9,057	8,213	8,628	34,996	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)	\$ (9,323)	\$ (8,908)	\$ (33,689)	\$ (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)	(9,419)	(9,116)	(33,980)	(25,222)
Taxes	80	160	215	19	31	25	25	100	100
Net Income	10,722	4,165	(31,043)	(7,002)	(8,493)	(9,444)	(9,141)	(34,080)	(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)	\$ (9,444)	\$ (9,141)	\$ (34,080)	\$ (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)	\$ (0.16)	\$ (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)	(6,178)	(5,875)	(21,572)	(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)	(9,323)	(8,908)	(33,689)	(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)	\$ (5,733)	\$ (5,318)	\$ (19,853)	\$ (10,842)
EBITDA-Calculated	13,134	11,094	(1,305)					(19,853)	(10,842)
Margin	30.3%	21.6%	-2.2%	-30.7%	-38.6%	-48.5%	-44.1%	-40.3%	-16.9%

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

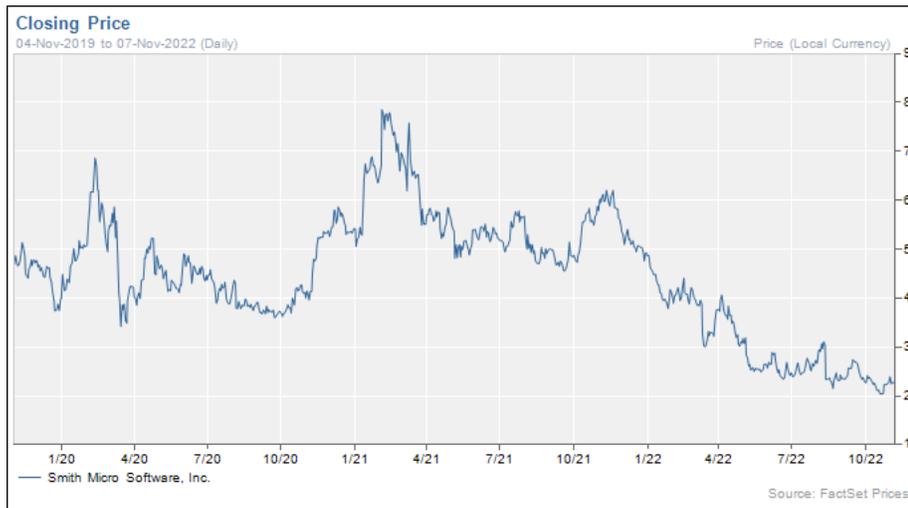
Exhibit 2. Balance Sheet and Cash Flow Statement

(\$ in 000's)	FY2019	FY2020	FY2021	FY2022E	FY2023E
Cash	28,268	25,754	16,078	11,916	14,938
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	\$ 24,228	\$ 34,177
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	\$ 102,338	\$ 106,117
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	\$ 73,846	\$ 87,120
Total Liabilities & Equity	\$ 61,197	\$ 72,903	\$ 115,356	\$ 102,338	\$ 106,117
	FY2019	FY2020	FY2021	FY2022E	FY2023E
Net Income	10,722	4,165	(31,043)	(34,081)	(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)	\$ (21,693)	\$ 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)	\$ (4,162)	\$ 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
 Update – Buy – November 7, 2022 – Price Target \$8.30

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- 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.

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Current as of 28-Oct-22

	Company Coverage		Investment Banking	
Ratings Distribution	# of Companies	% of Total	# of Companies	% of Totals
Market Outperform (Buy)	24	80%	3	13%
Market Perform (Neutral)	5	17%	1	20%
Market Underperform (Sell)	1	3%	0	0%
Total	30	100%	4	13%

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