

SMTP, INC.: HERE COME EMAIL DELIVERY NETWORKS

SMTP - \$7.90

Research^{2.0}

Boston | New York | Paris

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HIGHLIGHTS

- **SMTP, Inc. (SMTP) is a cloud service provider** that specializes in the increasingly challenging task of sending email on behalf of their clients by providing **intelligent engine to power successful email delivery**. In this regard SMTP is more akin to a technology service provider like Amazon or Rackspace rather than an email marketing company like Constant Contact.
- **Volumes of email continue to increase and the cost, complexity and ever-shifting nature of what is required for successful delivery is driving the majority of organizations to outsource** all or part of their email delivery.
- Over time **we expect this market to evolve in a similar fashion to the content delivery space** and include some dedicated providers (like CDN players Akamai & Limelight) and the large general players offering some level of service (like Amazon and Rackspace.)
- SMTP is a small but rapidly growing company that is very capital efficient. **The company generated \$2.7m in revenues for 2010 (an increase of 76%) with 27% operating margins**. Our **market size estimate for the services SMTP provides is approximately \$500m/year**. SMTP is growing faster than the overall market but is unlikely to hit any market limitation for some time.
- The company recently completed a “direct to market” IPO process and is just now accessible to public investors. **Our intrinsic valuation (IV) suggests a share price of \$3**. The shares just started trading and as the float is limited the shares will fluctuate more sharply than normal. Both our IV and peer analysis are attached.

BACKGROUND

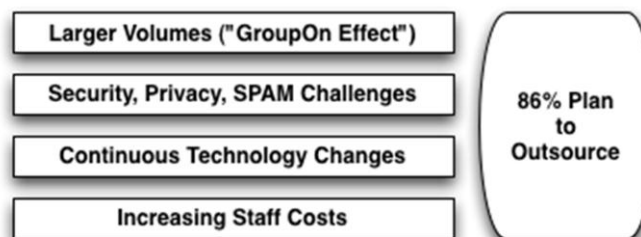
Sending email has become a major industry problem thanks to both the massive growth of legitimate sending mixed with an enormous amount of SPAM. Much as it is in online security, there is no one “silver bullet” to efficiently and effectively deliver large amounts of email.

Email remains the dominant form of electronic content distribution for most people and organizations. We manage more types of content now (short messages, “tweets,” posts and “pokes”, to name a few. Email is a common denominator and continues to be the building block for new services like Groupon.

For small organizations the typical answer has been one of the many email marketing service providers. This includes companies like Constant Contact

(NASDAQ: CTCT), MailChimp, VerticalResponse, ExactTarget, and many others. Most relationship management solutions like Salesforce (NYSE: CRM), Responsys (NASDAQ: MKTG) and Unica (acquired by IBM) include email services as part of their solution.

Forces in Corporate Email Outsourcing



Source: Forrester, Gartner, Research 2.0

Large organizations don't need or want the content creation and management features of these marketing tools and they need to send far more email than these solutions are built to handle. Large-scale applications require a “sending platform” to deliver the emails, which can reach into the millions.

There's also a big difference between internal company email and external consumer email. Thanks to new rules and regulations, many types of emails

have become legal documents. There's now a significant compliance burden on company email for retention, discovery, content management, etc. Large external email distributions simply don't belong in this environment and are better handled externally with a service provider.

Sending large volumes of emails effectively requires infrastructure, technology, tools and expertise. To make it even more challenging, SPAM has become such an issue that large senders of email are viewed as "guilty until proven innocent" which means their sent email may never reach the intended destination. Senders must develop an online infrastructure reputation.

These dynamics favor specialty cloud infrastructure service providers like SMTP. Over time we expect this market to evolve in a similar fashion to content delivery networks and financial market technology. Institutions use purpose-built online infrastructure for services like video asset management, funds transfer, stock trading and transaction processing.

The size of the email market in general and the slice for SMTP in particular is not well-documented. The largest segment of the market is internal email, which is estimated to cost about \$20 to \$25/month in the enterprise. If outsourced to Google this cost can drop to about \$8/month but companies give up considerable flexibility and integration by doing so.¹

These high costs are forcing companies to move their high volume emails to clients, customers and prospects outside of their internal systems. In addition, there are large organizations without substantial internal infrastructure (like non-profits) that want to reach millions, tens of millions and in some cases hundreds of millions of email subscribers. Estimates for external email volumes are notori-

ously flawed due to the high percentage of SPAM in the raw numbers. However, many would agree that the figure is "around" 300 billion email messages sent per day with about 3 billion email accounts. The line between SPAM and that subtle opt-in when someone checks the "I want to receive updates from American Airlines" box is a blurry one.

The fact is that almost every successful consumer-focused organization is likely to need this service. This is as true for the Catholic Church as is for Groupon, Patron Tequila, Budweiser, American Airlines, or Coca Cola. One fairly simple back-of-the-envelope way to get at the size of the market opportunity for SMTP and other high end email

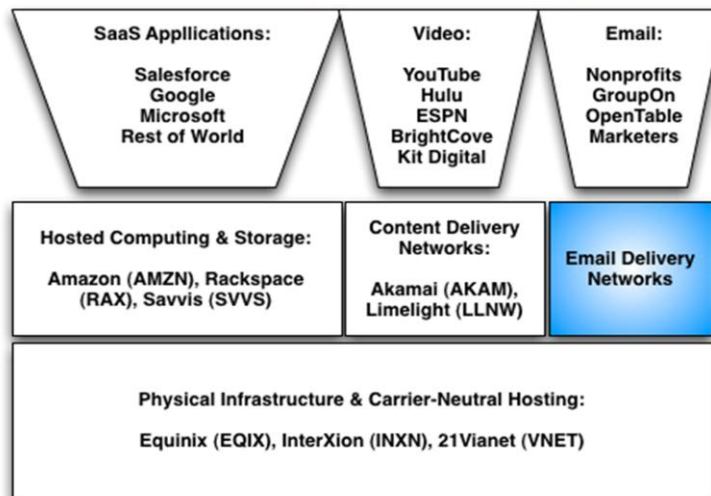
outsourcing companies is to base it on volumes. We'll assume that just 1% of the daily volume is bona fide consumer marketing email sent to large lists by big organizations. That's 90 billion messages per month to parse into potential revenue. We used a typical power law distribution of customer email volumes to segment the market and determine how many customers are in each segment. Then it's a matter of applying the normal pricing to come up with the current market size of just over \$500M per year.

COMPANY OVERVIEW

SMTP is headquartered in Greater Boston and has their development, operations and support staff in the Ukraine. Having technical talent at very low cost tends to be a critical success factor in infrastructure markets. We've seen it many times before with companies like NetBeans and Systinet. Places like the Ukraine still offer material competitive advantage in infrastructure software where technical quality and cost are the key criteria versus domain knowledge or end-market access.

SMTP is still a small company with 2010 revenues of just \$2.7m and the equivalent of 30 employees.

Email Delivery Network Positioning



¹ Estimates by Forrester published in "Should your Email Live in the Cloud? A Comparative Cost Analysis." SMTP, Inc.

But they are growing fast (76%) and are very profitable (27% operating margins.)

SMTP's core service offering is email delivery for large volume senders. Although they offer services to smaller senders the real value proposition is for companies sending over 1m emails per month. In addition to the scale and complexity of the service they also offer a number of related services like tracking and reporting, reputation management, statistical analysis and expert support. The cost for large customers sending between 1m and 10m emails is typically from \$1,000 to \$5,000 per month.

The company has followed mostly an online lead generation and telesales approach in building the business so far. As their client size has increased they have started to provide more customer care and account management to grow existing customers and compete for larger pieces of business.

CULTURE AND MANAGEMENT

SMTP is best described as a small, focused, scrappy company that has been targeting this delivery infrastructure service for some time. They have built the business without the aid of external capital (no VCs) and have demonstrated the ability to be extremely capital efficient and drive high growth and margins. Furthermore, the company employed an innovative and low-cost process to become a public company without paying investment banking fees and commissions to professionals that tend to add minimal long-term value.

The management team is comprised of six key executives. Full descriptions can be found at the company website but here is a quick summary:

Semyon Dukach is the Chairman and CEO of the company. Semyon has a decidedly technical bent and is a natural entrepreneur keen on disruptive uses of technology both in and outside of IT. Semyon takes the lead in building company management, business strategy, major product, technology and acquisition decisions. [aka "**the boss**"]

Richard Harrison is the President and COO. He brings more traditional business and client relationship skills to the table. We also expect that public market investors will find Richard easy to work with. Richard has a background that includes two decades of industry experience which includes firms like CA and Motorola. His education is in

accounting and he has an MBA. [aka "**business guy**"]

Heath Morrison is the VP of Engineering and brings the key discipline of product management to the team. He's been building technology in this field for years and is a smart specialist in this demanding infrastructure software field. [aka "**product guy**"]

Ruslan Bondarev is the CTO had is a deep technical and scientific type who was at SMTP from inception in 2002. Ruslan is based in the Ukraine and his degree in computer systems and machine learning speaks to his role as "**technology scientist.**"

Ron MacDonald is Director of Sales and is responsible for the evolving sales process at SMTP. As the company scales up, the buck of managing lead generation, qualification, and closing across multiple customer types stops with him. [aka "**sales guy**"]

Maxin Ilin is the Support Team Manager and has risen through the ranks of the client support operation in the Ukraine to run the organization. His background is in science, math and IT. [aka "**support guy**"]

Generally speaking, the current team is complete and there are no missing or weak spots. The group spans the gamut from day-to-day customer support through sales, product management, business operations, technology development and company strategy.

The Board of Directors is comprised of Semyon Dukach as Chairman and four outside directors. Their backgrounds can also be found on the website. The short description is that they are all solid but a bit tilted toward the technology side of the house. Three of the four bring knowledge of software, email technologies and system design. Only one, Brad Harkavy, would be described as having expertise around business development and marketing. Over time the board should be expanded with executives who have different backgrounds to balance the mix between technology and business.

STRATEGIC INITIATIVES

It's expected that SMTP will be continually investing in core technology that improves the sending and deliverability of emails. Beyond that there are

a number of key initiatives underway and to be taken further in the coming months.

First of all, the company has revamped their internal infrastructure for key operational tasks like customer support, subscription management and billing from solutions developed in-house to industry standards like Salesforce.com and Aria Systems.

SMTP is also making investments in building improved reporting, management and analytic tools to help customers understand the dynamics of both email delivery and recipient behavior.

The new subscription and billing platform will allow SMTP to provide clients with a mass customizable and flexible subscription management and billing platform. For example, customers with periodic heavy sending needs can be kept on the SMTP platform with a monthly cost that automatically adjusts based on how much email they send. This enables them to retain the IP address that they have carefully cultivated for reputation and trust without being locked in to a fixed monthly fee. The improvement in customer retention translates into higher margins for SMTP, which avoids the customer acquisition costs of onboarding of new clients to replace those who churn off.

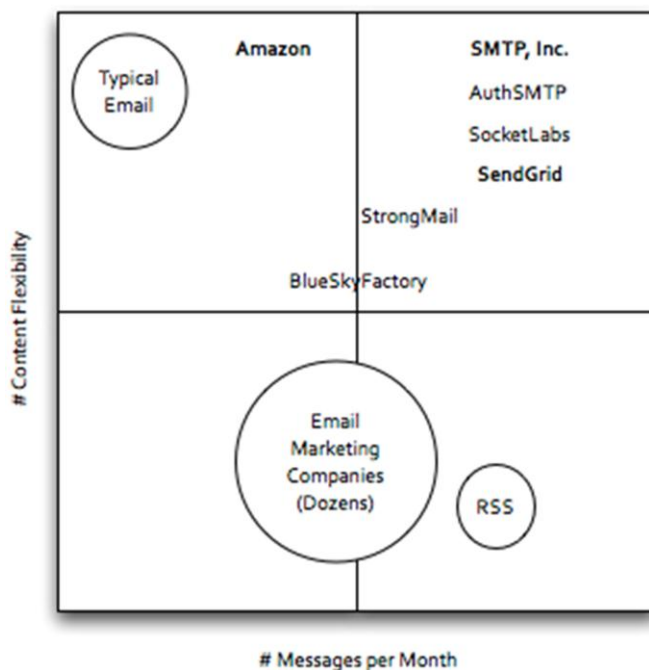
These initiatives improve operations and also free up substantial resources for SMTP to continue to develop the proprietary elements of their solution.

EMAIL KEEPS EVOLVING

Despite all the growth in new message types like instant messages, status updates and collaborative workspaces, email volumes continue to climb. Email still represents the single common denominator for online distribution. Email is also a utility that allows for communication without regard to system type, user type, latency, and information type. So it still remains the most universal electronic distribution technique by far.

There are also distinct classes of email now defined with very different characteristics and uses. For example, internal email for a company is important but looks quite different from emails the marketing department might be using to contact customers and prospects.

The Groupon phenomenon has created a rush to create special-purpose transactional emails that go to millions of recipients. **Today, every online player (Amazon, OpenTable, Yelp, etc.) is using this form of email and even most small organizations are planning Groupon-like email offers to their constituents.**



Lately we have also seen the advent of emails that aggregate activity across social and professional networks, blogs and instant messaging systems. Updates from a wide variety of systems are packaged into a single email, which many users find more

efficient.

Another recent trend has been an escalation in the battle against SPAM, which has ended up making it much harder for companies to send email. In some cases users forget they opted-in to a list and then they report incoming mail as SPAM. If more than a few do this it creates significant problems. Better tools and analytics can help control and manage these situations.

COMPETITION

SMTP, Inc. faces competition in three major forms: 1) companies following the “do it yourself” approach, 2) integrated solutions from companies that focus on email marketing and 3) a few direct competitors that provide a pure infrastructure service.

Companies doing their own email infrastructure are increasingly separating the needs of their internal email systems and those that send email to clients, prospects and larger groups of people outside the company. Increasingly large distribution of external email is seen as a bad use of company resources and is on the short list to outsource.

Next up are integrated solutions from so-called email marketing companies like Constant Contact, VerticalResponse, ExactTarget, and MailChimp, to name a few. There are dozens of them in the market and they are very effective for smaller companies. These are mostly all-in-one offerings that include email templates, list management, marketing tools, survey tools, and some have added event marketing and management as well. Technically, most of these services limit the size of lists, number of emails that can be sent, and put all of their customers on shared IP addresses. There are some “enterprise class” email marketing solutions out there like StrongMail and Blue Sky Factory but they are actually aimed at large marketing departments and often include a substantial amount of consulting to help organizations plan and implement their email marketing efforts. Although they have features like dedicated IP addresses, they still tightly link their own content management with email delivery. That’s a non-starter for many large customers.

For large customers there are several key players; Amazon most recently entered this market with their “Simple Email Service.” The Amazon service allows users of the Amazon infrastructure to incorporate emailing services directly in their application. Amazon validates the market but technically is providing what is a do-it-yourself solution but with their infrastructure. Amazon is the cost leader but end users, even those in IT, will not be able to take advantage of the Amazon solution since it lacks tools, services and support.

On the smaller and more focused side there are a few companies like SocketLabs, AuthSMTP and SendGrid that are direct competitors. Of the three, SendGrid is probably the most similar and offers services and pricing that closely resemble SMTP. Since they are a private company we don’t know how their cost structure compares, but in terms of features and price they are roughly equivalent.

SendGrid has a very different heritage and culture than SMTP. The company has raised substantial amounts of venture capital and Foundry Group is the lead investor. Foundry invested in Postini (ac-SMTP, Inc.

quired by Google) and Return Path, which is the leading solution focused on email deliverability reporting. Other investors include Matt Mullenweg (WordPress), VC gadabout Dave McClure and painfully omnipresent and voluble Jeff Clavier of SoffTech.

SendGrid is the classic Silicon Valley, venture-backed, well financed and connected star of the space. However, we estimate that they trail SMTP in terms of both revenues and profitability. So far, more of SendGrid’s customers are other startup companies, which tend to have smaller volumes and fall into much lower pricing tiers. Last year SendGrid said that most of their clients were able to get by with their \$80/month service.

We will be watching this space closely as it develops. A new competitor may emerge using Amazon’s offering as a back-end. At the same time many large infrastructure services companies will want to offer these services as well. We expect to see companies like Rackspace and InterNAP want to be in this market. Some will build and some will buy. Right now SMTP is not constrained by competition but as the market matures it may become more of a factor.

BUSINESS MODEL & VALUATION

SMTP fits the model of “Infrastructure as a Service,” or IaaS. Leads often come via online contact and start with a phone conversation to jumpstart the sales process. From a business operations standpoint the sales and marketing side resembles most corporate email marketing firms (Constant Contact, Vertical Response or ExactTarget) but includes more pre-sales support and technical marketing. The latter is more akin to what Rackspace or Zix would provide once a prospect becomes a “serious” potential client.

The acquisition of new clients often requires some education and includes an “onboarding” process that includes “warming up an IP address,” which is the foundation of building an online reputation.

Unlike other IaaS providers, SMTP does not have to own the majority of their infrastructure. Their services and value add can “piggyback” on what’s already out there. This is why the business model is so capital efficient.

One public company in the peer group is Zix Corporation, which is a secure email solution designed

for the internal email needs of large companies. So far they are most directly comparable company that is publicly traded. They have an analogous position in an adjacent market, similar business model with 80% gross and 19% operating margins, and are fairly small at \$33m in revenues and 123 employees.

In building the Intrinsic Valuation (IV) model we have factored in slowing revenue growth, a 40% tax rate and a 17.5x multiple on future earnings. In particular, the multiple is conservative given the growth rate and profitability but this figure is likely to expand as the company becomes more established. As the table below indicates our IV for SMTP stands at \$3/share.

INVESTMENT CONCLUSION

SMTP is a small but scrappy company in a fairly large market with some serious obstacles to entry. Rapid growth, attractive margins and high capital

efficiency will allow the company to continue to grow without having to rely on external capital.

The direct-to-IPO approach is another example of how the company manages to “do more with less,” and that model has proven very effective as the availability and cost of external capital has tended to fluctuate.

In the near-term there will be a very limited float of public shares and they may trade sporadically until the company develops more of a following and gets a few quarters of solid execution behind them.

We also expect the company to begin to be opportunistic in terms of making acquisitions and taking advantage of investment interest and increase the amount of shares trading.

A journey of a thousand miles begins with a single step.

	2009	2010	2011	2012	2013	2014	2015	2016		
Revenue	\$1,549	\$2,736	\$3,900	\$5,500	\$7,500	\$10,000	\$13,250	\$16,500	SMTP	Ticker
YoY Growth		76.6%	42.5%	41.0%	36.4%	33.3%	32.5%	24.5%	Nasdaq	Exchange
Gross Margin%	73.0%	76.6%	75.0%	74.0%	73.0%	72.0%	71.0%	71.0%	46%	Rev Growth
Gross Profits	\$1,131	\$2,097	\$2,925	\$4,070	\$5,475	\$7,200	\$9,408	\$11,715	\$1.00	Current Price
S&M%	9.3%	10.1%	10.0%	10.0%	10.0%	10.0%	10.0%	10.0%	13,440	Shares Out
S&M	\$144.0	\$276.0	\$390.0	\$550.0	\$750.0	\$1,000.0	\$1,325.0	\$1,650.0	1%	Avg. Dilution
G&A%	45.3%	31.2%	28.0%	27.0%	26.0%	24.0%	23.0%	22.0%	\$13,440	,000
G&A	\$701	\$853	\$1,092	\$1,485	\$1,950	\$2,400	\$3,048	\$3,630	\$591	Cash
R&D%	11.4%	8.2%	10.0%	27.0%	26.0%	24.0%	23.0%	23.0%		
R&D	\$176	\$225	\$390	\$1,485	\$1,950	\$2,400	\$3,048	\$3,795		
Net Operating Margin	7.1%	27.2%	37.0%	37.0%	37.0%	38.0%	38.0%	39.0%	\$0	Debt
Operating Income	\$110	\$743	\$1,443	\$2,035	\$2,775	\$3,800	\$5,035	\$6,435	\$0.04	Cash/Share
Interest Income	\$0	\$1	\$1	\$1	\$2	\$2	\$3	\$4		
Taxed Net Income	\$66	\$446	\$866	\$1,222	\$1,666	\$2,281	\$3,023	\$3,863	40%	Tax Rate
Market Value Using P/E	\$1,155	\$7,812	\$15,161	\$21,380	\$29,155	\$39,924	\$52,899	\$67,608	17.5	P/E Multiple
Cash Position	NA	\$591	\$866	\$1,221	\$1,665	\$2,280	\$3,021	\$3,861	15%	Discount Rate
Shares (M)	13440	13440	13440	13574	13710	13847	13847	13986		
Period Share Price	\$0	\$1	\$1	\$2	\$2	\$3	\$4	\$5		
PV of MV 4 Years Out	\$16,669	\$22,827	\$30,245	\$38,655					\$3.01	Intrinsic Value
PV of Cash 4 Years Out	\$952	\$1,304	\$1,727	\$2,208					201%	Up/Downside
PV MV + Cash	\$17,621	\$24,130	\$31,973	\$40,863						
PV Value Per Share	\$1.31	\$1.80	\$2.38	\$3.01						

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SMTTP Peer Analysis

3-May-11

COMPANY	Segment	Ticker	Price	1 year change	3 month change	TEV	LTM Rev	LTM Growth	Gross Margin	Oper Margin	TEV / Revenue	Emps	Rev / Emp
Constant Contact, Inc.	Email Marketing	CTCT	\$26.83	5%	-7%	676	185	31.6%	70.8%	1.0%	3.7	734	251,723
Zix Corp.	Secure Email	ZIXI	\$3.22	24%	-31%	189	35	9.6%	80.4%	122.2%	5.4	123	283,398
VeriSign Inc.	Online Infrastructure	VRSN	\$37.14	34%	9%	4,894	701	11.6%	77.0%	11.8%	7.0	1,036	676,177
Selectica Inc.	Sales Configuration	SLTC	\$5.05	-12%	7%	2	15	-12.7%	64.0%	-6.4%	0.2	58	251,621
Marchex, Inc.	Online Infrastructure	MCHX	\$7.15	31%	-27%	225	98	4.6%	41.0%	-3.1%	2.3	364	268,037
LookSmart, Ltd.	Online Advertising Tech	LOOK	\$1.93	21%	8%	10	47	-8.3%	39.3%	1.3%	0.2	52	913,058
Akamai Technologies Inc.	Content Delivery Network	AKAM	\$34.23	-14%	-29%	5,834	1,060	19.1%	71.8%	17.1%	5.5	2,200	481,595
Limelight Networks, Inc.	Content Delivery Network	LLNW	\$6.35	53%	-2%	646	183	39.2%	56.2%	-11.1%	3.5	689	266,077
Internap Network Services Corp.	Hosting & Content Delivery	INAP	\$7.54	24%	-3%	384	240	-6.1%	39.7%	-2.0%	1.6	416	577,411
Rackspace Hosting, Inc	Hosting	RAX	\$44.42	132%	24%	5,767	781	24.1%	68.0%	5.9%	7.4	3,262	239,287
SAVVIS, Inc.	Hosting & Content Delivery	SVVS	\$39.27	96%	19%	2,921	973	12.0%	46.4%	-4.6%	3.0	2,440	398,950
Epicor Software Corporation	Back Office SW Services	EPIC	\$12.48	26%	15%	884	453	10.5%	54.5%	-1.7%	1.9	2,571	176,308
Average				35.2%	-1.4%			11.3%	59.1%	10.9%	3.5		398,637
SMTTP, Inc.	Email Delivery	SMTTP	\$3.00	na	na	13	2.7	76.0%	77.0%	27.0%	4.8	30	90,000