Digital Turbine Research (9/10/19)

Description: Digital Turbine, Inc., through its subsidiaries, provides media and mobile communication products and solutions for mobile operators, application developers, device original equipment manufacturers (OEMs), and other third parties worldwide. It provides Ignite, a software platform that enables mobile operators and OEMs to control, manage, and monetize devices. The company offers other products and professional services directly related to the Ignite platform. Digital Turbine, Inc. is headquartered in Austin, Texas.

Ticker: APPS
Price: $6.81
Market Cap: $565M
Performance: +272% YTD

Analysis

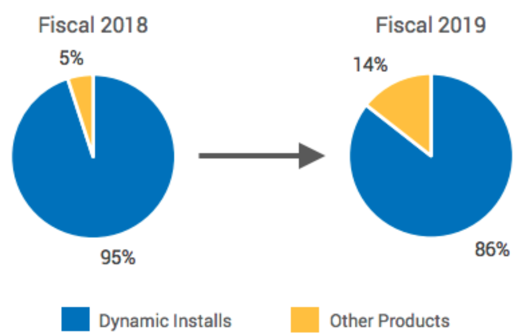
Digital Turbine is a small cap stock that has been on quite the run this year. The stock opened the year around $1.70 per share and has slowly but surely creeped up all the way to $7.61 which was made just the other week.

Before we jump into why APPS has run so hard this year let's first discuss the nature of their business.

At its core, Digital Turbine is helping developers get their apps downloaded more. APPS has locked in partnerships with mobile carriers and OEM's (manufacturers) to help developers get their apps in the hands of more users as there are currently over 3M apps in the world and its extremely difficult for developers to distinguish themselves without spending a boatload on advertisements.

There are several ways APPS does this:

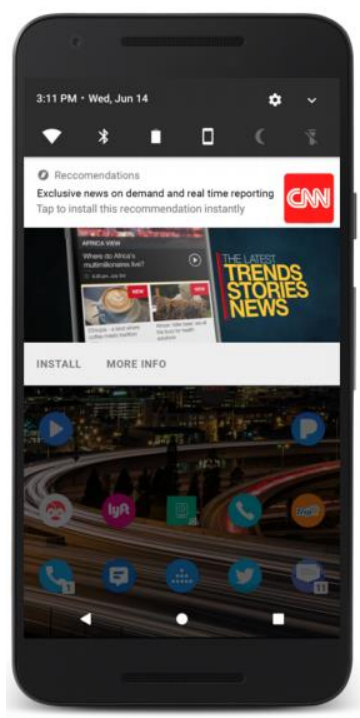
1. Pre-Download
    a. The ignite platform allows apps to be pre-downloaded on phones when the customers purchase it. By locking this deal down for the developer, APPS collects a fee.
    b. These dynamics preloads used to make up all of APPS revenue but that has now changed this year



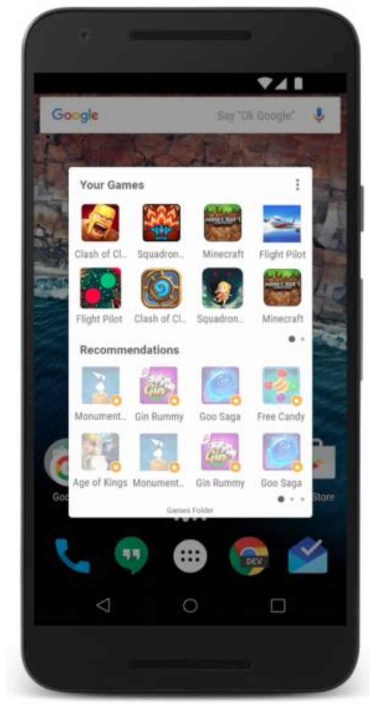
    c. Investors have been a big fan of the diversification of revenues from dynamic installs making up 95% of revs down to 86% Y/Y
    d. This is a recurring revenue model for APPS because every time a new phone is purchased, even if by the same person, the developer gets charged. Right now the average length of time someone uses is a smart phone is a little over 2.6 years

2. Single Tap
    a. Pretty straight-forward, APPS runs single-tap download pop ups so this way the user can download the app without leaving the page they are on
    b. According to APPS, Single Tap Installs reduce friction and improve web to app conversion rates by up to 30%
    c. Below is an example of a Starbucks Single Tap advertisement

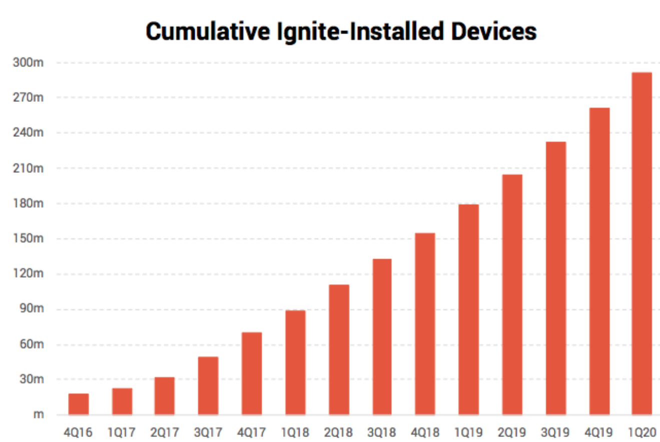
3. Post-Install Notifications
   a. In addition to app installs, notifications can be sent for a variety of actions, such as: promotions, post-install engagement or any other item in order to stay engaged with the user throughout the life of the device.
   b. Post Install Actions may be instant or delayed – ex. 48 hours or 30 days
   c. Example below



4. Smart Folders
    a. The Smart Folder organizes a users installed apps and seamlessly recommends other relevant titles, all in one convenient hub.



You may be wondering who APPS has deals with currently. From the carrier standpoint, Digital Turbine has a 2-year agreement with AT&T that runs through 2020 and a 4-year agreement in place with Verizon that runs through 2022. In addition, the company has contracts with 28 other domestic and international carriers to provide its software on their networks.



The company currently has their Mobile Delivery Platform installed on more than 300M total devices to date and was installed on more than 30 million new devices worldwide during the June quarter.

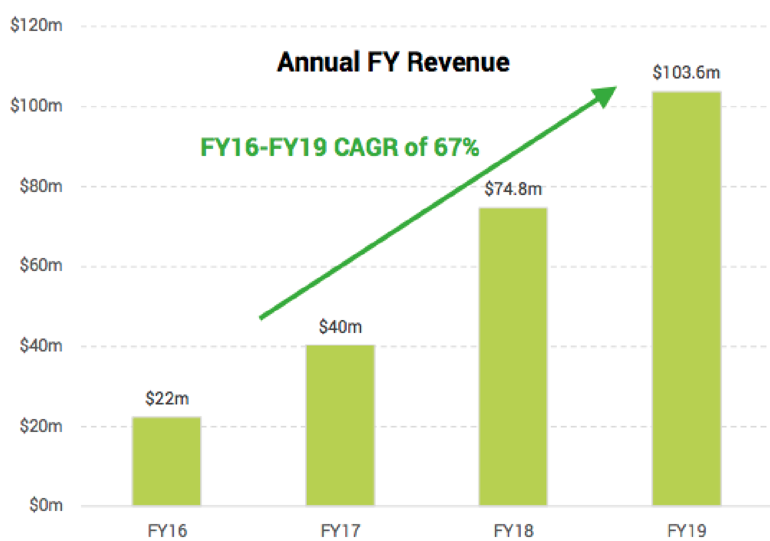
APPS is filling a gap in the market and helping out companies and developers tremendously and this is seen by the growth in their business and subsequent rise in stock price.

Side note: I must say for most small cap stocks, the financials are usually pretty ugly but the business is growing. APPS is a pretty rare case where the financials actually look pretty solid.

On August 5th, Digital Turbine reported Q1 Non-GAAP EPS of $0.05 beating estimates by $0.02 on revenue of $30.55M (+38.2% Y/Y) beating by $2.24M.

- Revenues jumped 38% to $30.6M, and on a non-GAAP basis the company swung to a gain of $4.2M from a year-ago loss of $0.6M.
- Gross margin was 39% on a GAAP basis (up from 29%), and non-GAAP gross margin as 40% vs. a prior-year 31%
- Revenue per device rose more than 30% Y/Y
- EBITDA rose to $4.2M from a prior-year $0.2M
- Cash provided by operations was $5M
- Free cash flow totaled $4.3M
- Cash balance came to $16.2M vs. last quarter's $10.9M
- Zero debt

The company is guiding Q2 revenue of $31M-$32M and EBITDA of $3.2M-$3.7M vs. last year's $23.85M in revenue and $1.6M in EBITDA thus implying revenue growth of 32% and EBITDA growth of 116% Y/Y.



At the current revenue run rate, APPS should finish the year with around $120-130M in revenue as compared to $103.6M in FY19 and $74.8M in FY18.

In addition to this:

(in millions)	Fiscal Q1 '19	Fiscal Q1 '20	Change Y/Y
Revenue	$22.1	$30.6	38%
Non-GAAP Gross Profit[1]	$6.9	$12.3	78%
Cash Operating Expenses[2]	$6.7	$8.1	20%
Adjusted EBITDA[3]	$0.2	$4.2	25x
Adjusted EBITDA Margin	0.7%	13.8%	+1300bp

So not only has top-line been growing but APPS has also turned virtually all of their other metrics around by growing adjusted EBITDA a whopping 25x through a 78% increase in gross profit.

Another thing that is interesting about the company is that they are completely debt free and free cash flow positive. One little blemish is that their cash on hand isn't too crazy at $16.2M but it has been growing steadily each quarter and is the highest in years, if not ever dating back to as far as 2015.

So how do we interpret the stock from a valuation standpoint after this big run up? Well, first and foremost the run up is most certainly deserving. The company has improved its fundamentals considerably.

From a P/S ratio, APPS trades at around 4x this year's sales which isn't too expensive given their growth, rock solid balance sheet, growing margins, and positive free cash flow. While this isn't a pure SaaS company, many trade at well over 10x sales but that has a lot to do with their gross margins of 80%+. APPS, on the other hand, is around 40% gross margins which means it will be a little more difficult for the company to get a multiple that rich.

We believe somewhere in-between at 6-7x would be fair though for this young growth company. A good comparison is to look at a company like The Trade Desk (TTD), they currently trade at 13x sales but are also growing revenues around 42% Y/Y with nearly 78% gross margins – both of which are superior to APPS.

From a P/E perspective, analysts are expecting APPS to finish the year with $0.15 in EPS which is wild because most small cap stocks are nowhere near profitability and don't have P/E (price to earnings) ratios. At $0.15, this implies a forward P/E of 46x.

In our view, this is completely fair because this number can easily multiply from here as the company continues to grow their business and margins. I personally wouldn't rely on a P/E ratio too much in valuing APPS at this stage of the company.

Looking ahead here are some pros:

1. The company can work itself into more devices aside from just mobile like smart watches, tablets, etc.
2. IoT and 5G will be a strong tailwind for the company as new devices are brought online and more of them become connected which equals more downloads and more revenue opportunities
3. Strong international market growth especially in emerging markets like that of India and Africa

Some risks to keep an eye on:

1. Contracts with major carriers set to expire in the next few years unless they are renewed which could hurt device count
2. Revenue sharing agreements hinder margins
3. Cash on hand of $16M, while healthy with no debt, is still a small amount and restricts the company from investing heavily in marketing, R&D, etc. without raising debt and/or doing a share offering which is something I fear may happen after this big run up

Technical Analysis

After the recent pullback, the area we are looking to make sure holds is this one right here. If you're long the stock, I was hoping it would hold $6.83 today but it didn't. I say this because it was the pivot point on the Fibbonaci sequences and the stock also wasn't able to hold its 20-day moving average of $7.06.

RSI, MFI, and W%R have all come down to a fair level from their overbought levels but are not considered oversold in anyway.

I think the long-term trend remains upward, but I believe APPS tests the $5.81 - $6.03 range (fib support level – 50 day moving average) before starting its move back up simply because it didn't hold some key areas. We can't even blame people for taking profits after the run its been on and this is completely normal. It would have been nice to have seen a little bit better support but the next couple of areas should be good areas to bounce off of.