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SOFTWARE BUSINESS FLYING UNDER THE RADAR

Growth At a Reasonable Price ("GARP") opportunity for a strong moat business

Key data

Ticker	**NASDAQ:SPNS**
Market cap	USD630.3mn
Price	USD13.29
Cash	USD100.0mn
Debt	-
Cash/debt as at 30 Jun 2016	
Intrinsic value	USD16.06
S/O	49.5mn
YE	31 Dec

Core Business – Sapiens International Corporation provides software solutions to the insurance industry to manage customers' core business functions such as policy administration, claims management and billing. Disparate components within legacy core systems limit a customer's geographical and business expansion. By replacing it with Sapiens' modular and scalable solutions, it increases customers' operational efficiency. Customers include Aviva, Tokio Marine, AXA, RSA and Directasia.com. It also has a small but growing software business (Sapiens DECISION) that automates manual corporate processes. It has presence in the US (largest FY2015 revenue contributor: 34%), the UK, Israel, Europe and APAC.

Moat – Switching costs: Once Sapiens' core system software is installed and customers are trained on it, it is hard to rip out and switch providers. This enables Sapiens to earn recurring after-sales services revenue – about 85% of customers have been with Sapiens for more than 5 years. The typical life of a product engagement is about 10 – 15 years. Intangibles – Brand: Installing a mission-critical system requires large investments and ongoing effort. These lead customers to prefer working with a reliable and established brand. Economies of scale: Fixed cost of organically/inorganically developed software modules spread across current/new customer base, with incremental customisation expenses.

Quality of Financials and Business – Low risk of accounting gimmicks as operating cash flow exceeded net profit by wide margins in the past 5 years while depreciation/amortisation exceeded capex/software capitalisation in 4 out of the past 5 years. The USD44.0mn jump in FY2012 revenue was due mainly to 2 major acquisitions (FIS and IDIT) worth USD81.1mn in FY2011. While these were executed through share issuance (always suspicious due to dilution), it was really a reorganisation/consolidation of insurance software businesses residing within the parent company. Growth in profit and cash flows per share far exceeded dilutive effects of shares issued for 2011's acquisitions. Sapiens achieved an impressive 17.7% CAGR in revenue between FY2012 to FY2015 largely through a mix of organic software R&D (USD20.1mn) and capex (USD9.7mn), and to a lesser extent, small acquisitions totalling USD16.2mn over the period. Profit margins also rose, from 8.5% in FY2011 to 10.9% in FY2015. It is also likely helped by the industry's significant barriers to entry (reputational) and since cost is unlikely to be the customers' top consideration, it dissuades irrational market share grab and pricing by industry players.

Sapiens required relatively low levels of invested capital to gush cash – a potent quality that contributes to rising ROICs. It essentially generated a total of USD98.1mn in operating cash flows between FY2011 to FY2015 while invested capital declined to USD 87.8mn as at 31 Dec 2015 from USD88.8mn as at 31 Dec 2011. The feat stemmed from good working capital management, which led ROIC to rise upwards from single digits to 23.1% in FY2015. A similar trend was reflected in adjusted FCF ROICs. A key ingredient for profitable growth requires ROICs to exceed cost of capital. In this case, it surely has. Sapiens has a fortress of a balance sheet – USD100.0 mn in cash (30 Jun 2016), making up 39.6% of total assets and exceeding total liabilities of USD 66.0mn, providing significant operational downside buffer.

Risks and Mitigating Factors

- Management ownership not ideally aligned – CEO's share count unchanged since 2010; diluted from 4.7% (2010) to 2.1% (2016)
  - While 2.1% appears small, it represents USD13.2mn – fairly large compared to overall compensation of management's annual pay at just USD1.6mn shared between 8 directors/management team. As such, CEO likely to still feel compelled to perform
  - CEO and CFO with Sapiens since at least 2007
- Non-sensible M&As – Wasting excess cash and/or ownership dilution by issuing shares or transactions forced upon by holding company
  - Track record of integrating M&As well (2011); shown restraint through smaller deals thereafter
- Brexit exposure (24% of FY2015 revenue from UK)
  - Currency fluctuations outside of management's control; geographical segment percentage largely stable over past few years

Variant Perception and Catalysts – FCF and profit obscured by capex and capitalisation of software, bulk of which are for reinvestment in growth. Overall true profitability also hidden due to DECISION being loss-making. While a small segment, likely to boost margins flows when scale/profitability reached.

Valuation – Trades at a TTM 1H2016 adjusted FCF (maintenance capex) / EV yield of 6.9% or a multiple of 14.5x. Through a simple DCF under 3 cases, we have an expected intrinsic value of USD16.06. Compared to the current price of USD13.29, we have a margin of safety ("MOS") of 17.2%. While not at a wide MOS, Sapiens appears to be a high quality business and a GARP opportunity that can reinvest capital at a relatively good rate. The bear, base and bull cases' equity prices are USD11.93 (downside: 10.2%), USD15.47 (upside: 16.4%) and USD24.12 (upside: 81.4%) respectively.

Comparing Sapiens to its insurance software provider peers, Ebix and Guidewire – both larger than Sapiens, their TTM operating cash flow / EV yields are 3.5% and 2.6% respectively vs Sapiens' 7.6%. Operationally, Ebix and Guidewire's TTM ROIC are weaker at about 16% and 9% respectively vs Sapiens' 24.3%, while revenue growth rates for the 2 companies have been slower than Sapiens' over the last few years.

Historical Financials (USD '000)	TTM 1H2016	FY2015	FY2014	FY2013	FY2012	FY2011
Revenue	198,306	185,636	157,450	135,377	113,909	69,927
Growth	*19.0%**	*17.9%*	*16.3%*	*18.8%*	*62.9%*	*33.9%*
Operating profit	25,181	24,350	14,906	11,883	12,045	5,624
Growth	*29.3%**	*63.4%*	*25.4%*	*-1.3%*	*114.2%*	*-16.2%*
Net profit	20,849	20,300	14,576	11,592	11,803	5,958
Growth	*20.3%**	*39.3%*	*25.7%*	*-1.8%*	*98.1%*	*-3.4%*
Net profit margin	*10.5%*	*10.9%*	*9.3%*	*8.6%*	*10.4%*	*8.5%*
Operating cash flow	39,607	40,440	21,561	17,266	18,792	8,413
Growth	*24.7**	*87.6%*	*24.9%*	*-8.1%*	*123.4%*	*-30.5%*
ROIC	24.3%	23.1%	14.9%	11.6%	13.2%	6.7%
Adjusted maint. FCF (excluding stock-based compensation)	36,533	37,455	18,579	12,304	18,102	7,386
Growth	*19.0%**	*101.6%*	*51.0%*	*-32.0%*	*145.1%*	*1.0%*
Adjusted maint. FCF Margins	*16.0%*	20.2%	11.8%	9.1%	15.9%	10.6%
DCF growth assumptions using TTM 1H2016 adj. FCF as base **DCF period: 2H2016 – FY2025** ***Discount rate: 9%***	Bear case 20% probability | **USD11.93** Growth rates: -5%, -8%, -3%, 0%, 3%, 4%, 5%, 5%, 4%, 3% (terminal discount: 3.0%)		Base case 65% probability | **USD15.47** Growth rates: 5%, 8%, 12%, 0%, -5%, -10%, 5%, 8%, 6%, 5% (terminal discount: 3.5%)		Bull case 25% probability | **USD24.12** Growth rates: 5%, 10%, 15%, 12%, 10%, 8%, 8%, 7%, 7%, 6% (terminal discount: 4.0%)	

** Growth as compared to TTM 1H2015*