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Summary

- CSVI is an incredible company with a strong moat to protect from competition.
- The company will benefit significantly from the Tax Cut and Jobs Act.
- The company has steadily increasing free cash flow and should be able to deliver strong returns to shareholders.

Business Summary

Computer Services, Inc. ($CSVI) began operations in 1965 with a computer meant to read and sort checks and deposit slips for client banks. The company now provides banks with IT infrastructure resources crucial to their operations. Some of their services include core bank processing software and hardware handling deposits and withdrawals, transactions, etc., regulatory and compliance tools, mobile banking, and electronic and print distribution of statements and other media.

Essentially, CSVI serves as an outsourcing of many bank processes. Whereas larger institutions would accomplish many of these solutions in-house, smaller community banks do not have the resources, financial or otherwise, to build out these services themselves.

The company's common shares trade over the counter, and thus do not glean very much attention from professional analysts. Although, some investors have written excellent articles on Seeking Alpha and I suggest that you read them as well when considering investing. Investors should note that the market cap of the company is approximately $632MM as of this writing meaning the company would be well within the Russell 2000 should it choose to list its shares on a major exchange. This should not be included in an investment decision as it is entirely speculative.

Four-Point Analysis

Competitive Moat

CSVI has seen truly outstanding results due in large part to its competitive advantages. The company operates with a fairly significant economy of scale serving several thousand clients. There are also few to no competitors that can offer the breadth of services that CSVI can. This also allows for an abundance of cross-sell opportunities to existing clients.

Computer Services has also created a strong culture among its employees achieving a very low turnover rate. Employees among its Customer Resource Center and Relationship

Management teams have been with the company an average of over 15 years (supplemental info to 2017 annual report).

Lastly, the most vital advantage the company possesses, and the one that gives it a moat not easy to cross, is the high cost and low incentive for clients to switch to another firm. The majority of the company's revenue, about 63% as it was last reported in their 2015 annual report, is derived from its core processing unit where the services they provide are both mission-critical and engrained into the operations of almost every department of a bank. In addition, clients who work with CSVI do so on a contract basis. In fiscal 2017, clients who renewed their contracts did so for a period of 8 years on average. A client would not only have to incur employee training costs, possible service interruptions, and poor client experiences in order to change to a new provider, but they would also pay a not insignificant contract termination fee.

This assumes that they have a reason to leave CSVI. Along with the high cost and inconvenience of switching from the company, Computer Services is laser focused on high customer satisfaction. This is undoubtedly tied in with the high employee satisfaction and results in very positive experiences for clients. In fiscal 2016, the company had a 100% retention rate on core contracts up for renewal (except for banks that were acquired and no longer needed service).

Management

The company was founded by John Williams who served as CEO until 1999 when he took the role of Chairman. He retired from the board last year leaving the current CEO, Steven Powless, who took over from John in 1999, as the chairman as well. Steven has been with the company since 1987, and as CEO has navigated the company to significant growth.

The employee retention seems to have manifested itself in management as well seeing as the CFO has been with the company since the President and CFO have each held executive roles since 1995. The management team is clearly focused on both innovation and profitability as free cash flow is consistently excellent, yet new products and services are released every few years.

Together, officers and directors own an approximate 7.2% of the outstanding shares of the company for a rough market value of $45MM. The company does not offer the breakdown between the different officers and directors, but it would be ideal to see a higher ownership percentage given the three executive officers are paid on average just short of $900k each in cash and stock (supplemental info to 2017 report).

That being said, the officers and the board have produced great results for shareholders. Fiscal 2017 marked the 45th year of consecutive dividend increases. To compound this, the company has also been steadily buying back shares with just under $10MM to spend as of November 30, 2017 (most recent quarterly report).

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Financial

CSVI has been able to compound top line revenue 6.6% per year over the past 10 years and 5.7% for the past 5 years. Earnings per share has compounded at 8.9% for the past 10 years and 5.1% for the past 5 years. The company has a clean balance sheet with no long-term debt, and a net current asset value of $1.50 per share.

The business does not take very much in the way of capital expenditures in order to maintain their operations, so the majority of investment CSVI does make is for growth. This leads the company to generate substantial free cash flow, something I consider to be the most important part of any business.

It's also important to note that the company paid taxes in 2017 and 2016 at effective federal rates of 30.2% and 27.3%, respectively. The new tax law will lower their federal rate to 21%.

Valuation

The easiest method for giving an intrinsic value to the company is a DCF calculation including the new tax changes. In doing the math, an average of the past three years of FCF would give a fair normalized number. After changing each year to reflect what the FCF would have been at a 21% effective federal tax rate, the normalized amount was $33.27MM. A short-term (5 year) higher growth rate of 5% (conservative compared to top and bottom-line growth) and a perpetuity rate of 3% should represent the future prospects with some degree of safety. With a 10% discount rate, this gives the company a value of just about $533MM or $38.18 per share.

Given the shares are currently trading about 18% over that value, I will be waiting to acquire them but the company is one I am keeping a very close eye on. I would not oppose initiating the first leg of a position at some small premium to the intrinsic value calculation as my calculation has an inherent small margin of safety and the firm checks many of the boxes of a fantastic business.

At the current price of $45.30, the dividend yield is 2.7%. Using my intrinsic value of $38.18, the yield would be 3.2%. It is unlikely the dividend will be cut any time soon as it is only ~30% of cash flow from operations. So perhaps the market has taken note of the quality of CSVI and will not allow the shares to trade with that high of a yield.

Conclusion

Computer Services is a dream for a value investor. The company enjoys an advantage from their scale, their low employee turnover, but especially from high client switching costs and outstanding service. It is a rarity to find a company with all these attributes where almost all clients are renewing and with 8 year average contracts.

Management has led the company to generating great returns for shareholders through effective use of capital and innovation. This has continued for 50 years, and there is no reason to expect it will not continue going forward.

Some would cite the risk of the consolidation of the banking industry as being a headwind to CSVI. The truth of the matter is the US has always been over-banked and will be for the foreseeable future. Consolidation in the banking industry has been happening for a very long time, and CSVI has continued to grow. I don't believe that it will create much trouble for them in the future.

With the company's outstanding cash flow, the intrinsic value is not far from where the shares trade. But, caution should be exercised at these prices as it leaves the company less room for error for a shareholder to achieve great returns.

Disclosures

I/we have no positions in any stocks mentioned, but may initiate a long position in CSVI over the next 72 hours.

I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it. I have no business relationship with any company whose stock is mentioned in this article.

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