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December 2016 | Recommendation: Long SSNC | 50% upside in Base Case

SS&C Technologies: Debunking the Short Thesis, Again

A recent short report on SS&C Technologies (SSNC) is making its way through the pitch circuits, and investment idea boards (most recently at the Robin Hood Conference and on the Value Investor Club, VIC). The pitch argues two key points on why SSNC is a short now:

1) Hedge Funds are facing secular challenges and given SSNC's reliance on hedge funds, they are a way to play this theme.
2) SSNC is engaging in accounting shenanigans to boost overall "organic" revenue growth and that by Q4 they will need to "fess up" and admit not only that they overstated organic revenue growth but that organic growth going forward is unsustainable and is likely to go negative.

The short reports then slap a multiple on the stock that gives them 30% downside, although they do not discuss how they came to this multiple (that we can find), simply stating it's a "more modest multiple."

We believe the recent sell off in SSNC has created a tremendous opportunity to be long over the next 12-18 months and would make the following counter-points:

- **Secular Challenge is Overblown**: Despite the author's repeated claims and a general narrative that hedge funds are secularly challenged, there is little to no evidence this is true.
- **SSNC has low L/S Concentration**: Only about 10% of SSNC's total revenues are tied to Long/Short equity hedge AUA, which is at the center of the redemption controversy.
- **Author Flip-Flopping:** The same presenter who gave the pitch just two weeks earlier proclaimed that the Trump election constitutes a "regime change" that would be great for hedge funds and stock pickers. Well…which is it? If L/S hedge fund returns improve, will SSNC still be "secularly challenged?"
- **Accounting Issues Greatly Exaggerated:** We believe the accounting "issues" are drastically overstated by the author and will show in detail why the assumptions the report makes about future growth are questionable at best, specifically surrounding a Q4 miss and a large deferred revenue drawdown in Q4. Additionally, the short author claims the "only way" they can make their numbers is via a large acquisition, which we find disingenuous at best.
- **Valuation is Attractive:** The stock now sits at all time low valuations relative to the S&P 500 (10% discount on P/E NTM) despite having a far superior financial profile. A more direct trading comp group with similar business characteristics, reveal SSNC trading at a 25% discount.

Is the Hedge Fund Industry Secularly Challenged?

When we think "secularly challenged," we think of industries that are showing multi-year declines and have **little hope of reversing those declines.** For instance, newspapers, proprietary hardware, print photography, etc.

There is certainly a narrative out there that hedge fund returns in the aggregate have been relatively poor, and daily reports of select funds facing major redemptions or pension funds lowering their hedge fund exposures. There is also the narrative out there that passive investments are the future and that active management will continue to be marginalized.

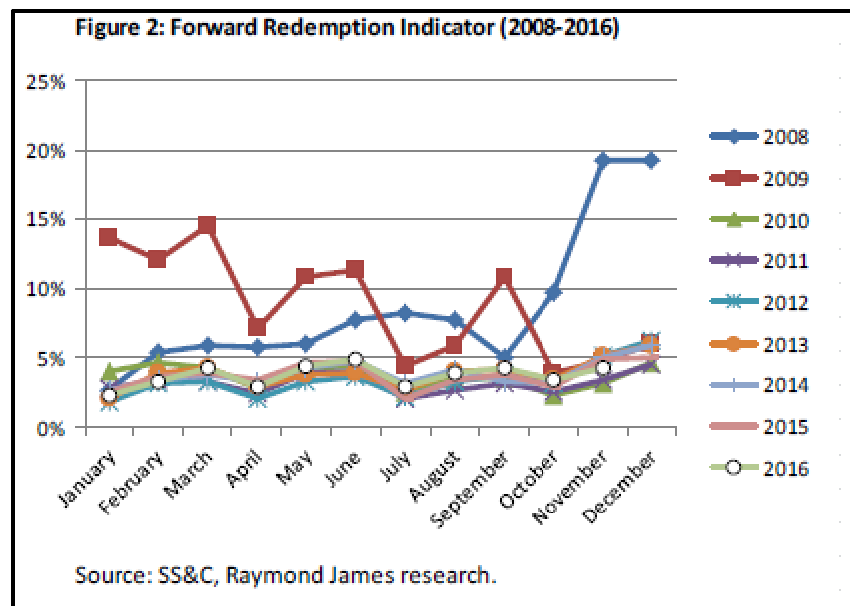
While this makes for an easily digestible story, and there have been net outflows from hedge funds in 2016 (for the first time since the financial crisis), we find it hard to say that there are any obvious secular challenges. At best, hedge funds current challenges strike us as cyclical. Hedge fund returns have been poor, so some shops, including several high profile Tiger Cub funds lately, are throwing in the towel. A recent article in IPE.com highlights this pretty well:

> *"Data from Hedge Fund Research (HFR), the industry data provider, shows that assets under management grew from about $1.6trn (€1.2trn) in 2010 to just shy of $2.9trn as of the second quarter of 2016. This year's first-half headline figure is just 2.4% down from the all-time record of $3.0trn recorded in Q2 2015. AUM growth has been volatile, but the industry has recorded net inflows every year from 2010 to 2015. Net outflows are a novelty of the past three quarters."*

We believe the newspaper industry would love to have shown that kind of growth! Is three quarters enough time to deem an industry secularly challenged?

More appropriate to SSNC, their GlobeOp platform actually reports redemptions and future redemption indicators that have been very accurate over time. Through November, **2016 redemptions had tracked 2014 and 2015 almost identically**.

In fact, in November redemptions were lower than 2015. The chart below shows how 2016 is in no way like 2008 or 2009.



The short thesis author states that SSNC's "customer base is facing **unprecedented redemptions.**" This is clearly not true and is more than a bit sensationalist, demonstrating either intellectual dishonesty or making up inaccurate facts/information to bolster the short case.

Where Will Institutional Investors Put Their Money?

As both equity and bond valuations have risen over the last several years, we wonder where large funds (like pension funds) are likely to allocate their money to try and achieve a 6-8% return mandate, when equity and bond forecasted returns are materially lower. We believe the temptation will continue to be to work towards higher absolute returns, and that will favor alternative asset classes like hedge funds and private equity, both of which are in SS&C's wheelhouse.

The recent election of Donald Trump seems to have the short report author agreeing thing do not look so dire. Two weeks before pitching SS&C as a short due to secular challenges in the hedge fund industry, the author announced that Trump's economic plans are "pretty clearly a positive for active stock picking" and that this is a "regime shift."

In his Q2 letter, the author states:

"As interest rates rise, the stock market on the whole often suffers — and that's when active managers shine. As rates fall, the average outperformance of active funds declines, and indexing looks better." News flash: interest rates are rising and single stock correlation is hitting multi-year lows and return dispersion is high, the perfect environment for L/S funds.

So if active stock pickers start doing well, will the dreaded "secular decline" in hedge funds continue, or might pensions and large institutions begin to reaccelerate allocations to hedge funds?

As a side point, if hedge funds do have great returns because of this positive "regime shift," the AUM they manage will naturally gravitate upwards due to performance, even with moderate outflows. This is the primary reason that AUM for Hedge Funds has stayed relatively constant despite net outflows this year. Not everyone is down big this year.

Accounting Issues

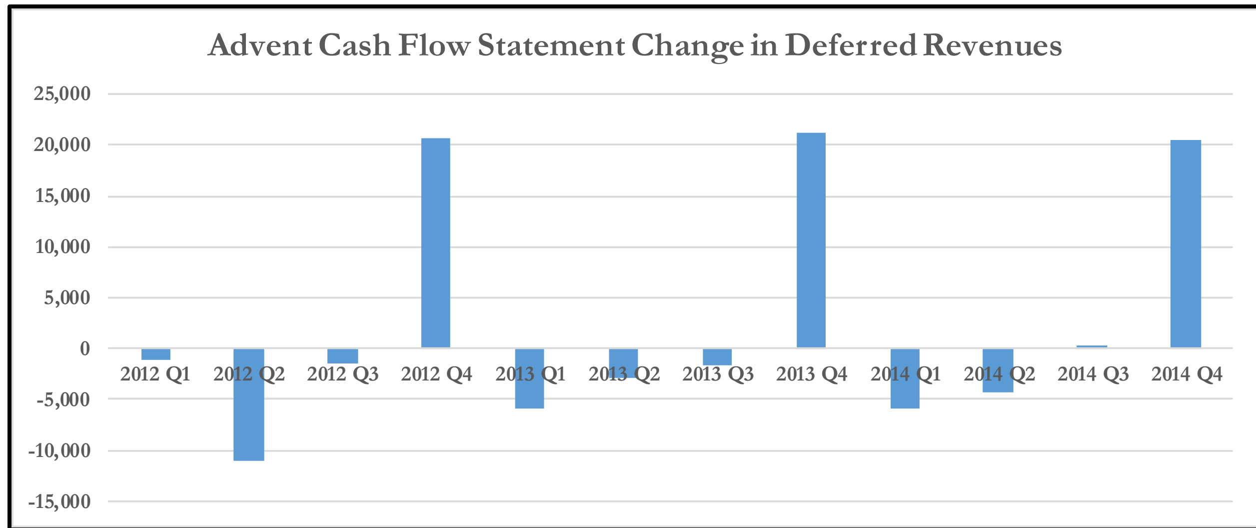
The author of the report states the primary catalyst for the short case is that in Q4 SS&C will need to "fess up" and say their organic growth is overstated. Whereas they have guided to 4.65% organic growth at the midpoint, the author suggests to achieve that:

> *"An additional $50+ million will need to be drawn down in order to meet organic revenue growth expectations for Q4/2016. This would leave an astonishing one day of net deferred revenue on the balance sheet for a business that purportedly gets paid upfront for approximately one third of its revenues. Driving revenue growth through balance sheet draw-downs is simply not sustainable."*

The drawdown they are referring to is net deferred revenues, which takes Days Sales of Deferred Revenue (DSDR) and subtracts it from Days Sales Outstanding (DSO). They note that in the last three quarters this number has moved from 30 to 17, and they say that number will need to go to one for them to hit their organic revenue targets.

Our primary issue with this analysis is that when they say "$50 million needs to be drawn down", they are assuming that the deferred revenue is not replenished. In fact, there is good reason to believe that deferred revenues will rise (perhaps substantially) in Q4 and that their net DSDR thesis will be, for all in intents and purposes, immediately debunked.

It's important to note that Advent makes up the majority of deferred revenues. When SSNC acquired them, Advent had nearly $197 million in deferred revenues while the rest of SS&C had only $67 million (~$264 million combined). We took a look at the seasonal characteristics of Advent's deferred revenue balance before it was acquired. Can you spot the seasonality? You might have to look closely:



In 2015, the combined companies had a net increase of ~$14 million in deferred revenues, a bit below seasonal average, but still an increase. Note since Advent still needs to burn about $12 million in "haircutted" deferred revenue in Q4, the actual Q4 increase for SS&C will be materially larger.

It appears core SSNC (non-Advent) also has some deferred revenue seasonality in Q4 (positive), although not as pronounced.

All in all, we expect net deferred revenues to rise (potentially materially) in Q4, busting the main crux of the short thesis.

The A/R side of the equation (remember, DSDR-DSO= net DSDR) has also contributed to the decline in net DSDR. It's not clear to us how relevant, if at all, this is. For one thing, the company has commented on two consecutive calls that the Citi acquisition has hurt the overall DSO number. In Q2, the CFO stated:

> *"The Citi fund administration receivables continue to adversely impact the overall DSO of the company, but we expect them to improve over the next several quarters."*

And then in Q3:

> *"The Citi Fund Administration receivables continued to adversely impact DSO, but we expect them to improve over the next several quarters."*

Now we understand the short report accounted for this to some degree by backing out the original acquired receivables from the Citi acquisition. However, it's impossible to know, as far as we know, what the current A/R from Citi is.

We do know that they have received significant revenue from some departing customers, as the CFO explains:

> *"It is going to – I mean, I think you have to remember, we've said that – I think we've said that we bought about $187 million of annual run rate revenue when we acquired the Citi fund administration business. And there were*

some clients that we are going to continue to have revenue for in the first couple of quarters that have not come off the platform yet."

Although management has not said it flat out, based on their commentary on elevated receivables with Citi, along with customers who are rolling off the platform, the A/R may have increased, potentially materially. If this were the case it would explain the relative rise in receivables and the seemingly higher DSO of the core business.

We estimate for Q4 that deferred revenues rise $20 million (which will show up as over $30 million on the cash flow statement), and that A/R is roughly flat. Given this dynamic, assuming the company hits the midpoint of their adjusted sales forecast ($399 million), we calculate the net DSDR would rise from 17 back to 22, not go down to 1 as the short report suggests:

	2015 Q4	2016 Q1	2016 Q2	2016 Q3	2016 Q4E
DSDR (by my calc)	81.9	79.8	73.7	68.2	69.9
DSO (by my calc)	51.0	58.1	52.0	50.8	48.0
Net DSDR	31.0	21.8	21.7	17.5	21.9

We would note that this fits with management's cash flow guidance. The implied FCF guidance for Q4 is $133 million vs. $91 million guidance for Adjusted Net Income (a $42 million delta). While there are many ways to bridge this number, the most obvious is a change in working capital, and we suspect a majority of the discrepancy will be bridged by an increase in deferred revenues.

Valuation

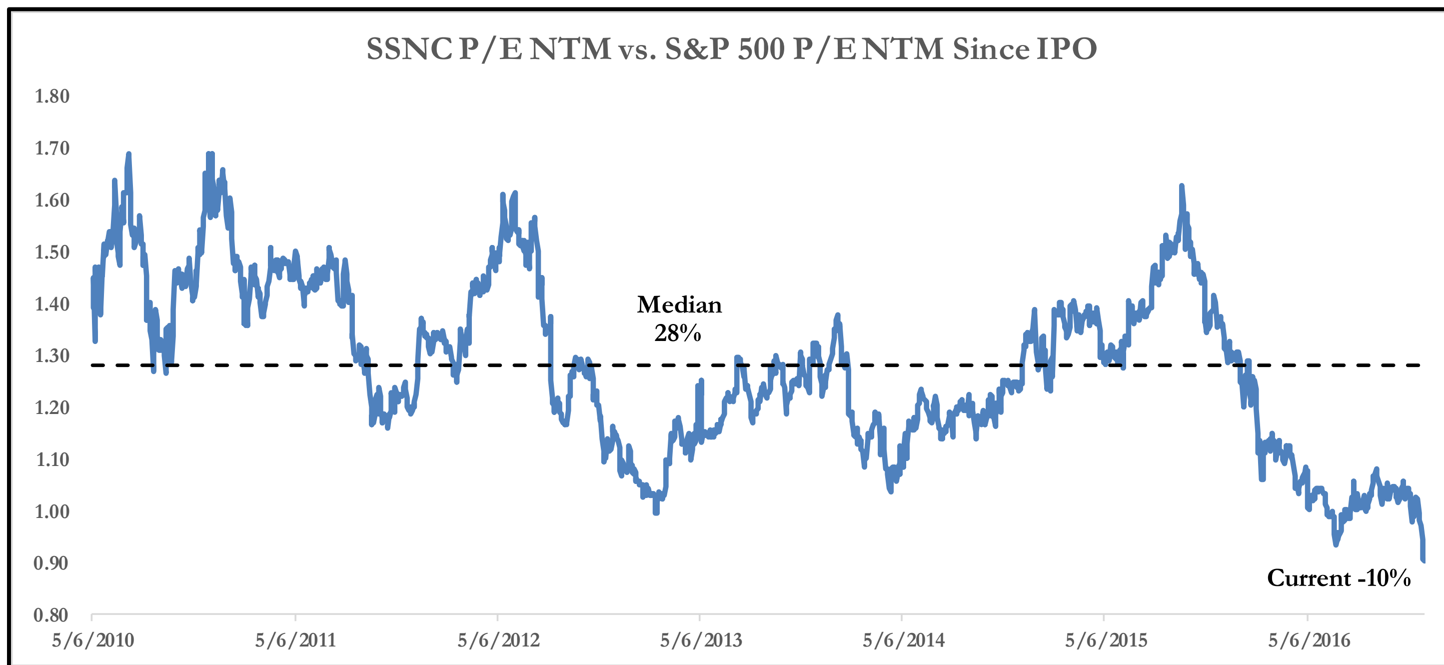
The short report targets a "more modest multiple" of 11x EBITDA and 13x Earnings. They also claim that on the basis of EV/EBITDA, the company is "not a cheap asset"- neither by historic nor relative standards. In recognition of the valuable business model and premium the stock has commanded, in the past private equity (Carlyle Group) has bought SSNC out for 15x NTM EBITDA and 30x forward P/E.

Although the report does not state it, we don't believe they have assumed any debt pay down in 2017, despite the company having a long history of repeatedly de-levering after large acquisitions. Management is targeting 3x leverage at the end of 2017 vs. 4x now. By our estimates, they could spend about $200 million on acquisitions from their cash generation (adding roughly $12 million in EBITDA, conservatively), and still pay down debt to get to around 3.25x leverage.

Even on a very conservative $660 million in EBITDA (way below current estimates of $690), you get the stock at 12x EBITDA. On the report's own assumption of $1.80 in 2017 EPS, you are currently paying 16x earnings. Is this expensive relative to comps? Is some of this doom and gloom perhaps already priced in?

If you look at SSNC going back to its IPO, the stock has never been cheaper than the aggregate S&P 500. In fact, they now trade at a 10% discount to the S&P despite having a clearly superior growth and margin profile, due to a great business model.

SSNC relative to S&P P/E NTM multiple below:



Using consensus numbers, we would argue SSNC is rather cheap compared to its FinTech peer group as well (NTM consensus values below):

	EV/EBIT	P/E
SS&C Technologies Holdings, Inc.	12.9x	15.8x
Fidelity National Information Services, Inc.	13.7x	17.8x
Jack Henry & Associates, Inc.	17.5x	26.9x
Fiserv, Inc.	17.0x	21.2x
Temenos Group AG	26.2x	29.5x
FactSet Research Systems Inc.	15.9x	22.2x
Black Knight Financial Services, Inc. Class A	13.1x	28.3x
Median	**15.9x**	**22.2x**
Mean	**16.6x**	**23.1x**
Median Discount	**-18.7%**	**-29.1%**

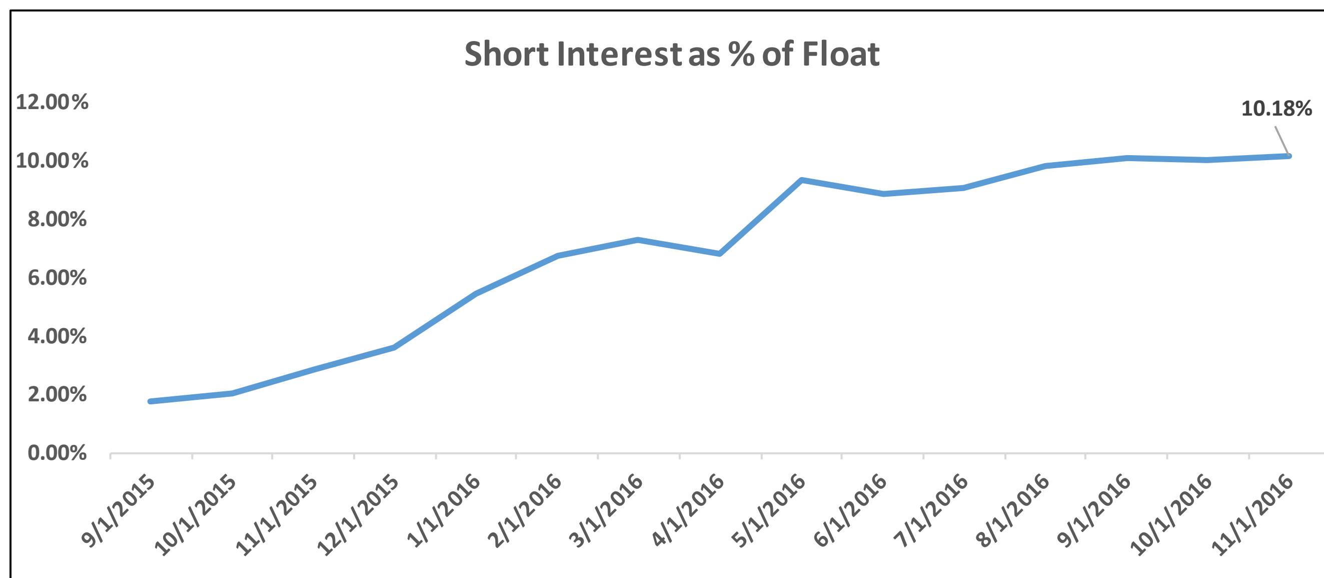
These companies are not growing earnings at SSNC's pace, and are generally mid-single digit revenue growers over the past three years.

We can quibble about the true organic revenue growth, but the fact is **in the latest quarter, where most of the business was organic, they grew EBITDA, EBIT, and Net Income all by 20%+**. The inorganic piece is primarily raising margins of acquired businesses materially, not just tacking on acquired EBITDA. FCF more than quadrupled in the quarter and is expected to grow more than 25% in Q4. Is this really an average business? I suspect most slow growth consumer staple names would love to have growth profiles like this, yet they already get 20x+ P/E's despite their own "secular challenges."

On an absolute basis, is a company pumping out $400-$500 million of unlevered FCF relative to an EV of $8.4 billion really expensive? Using the basic annuity formula (majority of revenue is recurring, ~92%) at $450 million, and

assuming just 2% perpetual FCF growth along with 7% WACC gives us 7% upside to the EV. If you want to be just a bit more generous and assume 3% perpetual growth and 6.5% WACC (yes, the debt does help out here) there is 53% upside to the EV (even more to the stock).

The short report seems to be angling for about 10-15% more downside if they are absolutely right about secular challenges and a decline in organic growth, a very poor risk-reward set-up for a short, or any trade. With the growing short interest (from 2% of float to 10%, and 16 days to cover) and suspecting most of the shorts are hot money Tiger Cubs, we suspect a squeeze is now an additional risk:



Conclusion

SS&C is an industry leader providing mission critical software, with 92%+ recurring revenue, 95%+ customer retention, EBITDA margins above 40%, high FCF conversion (>70% of EBITDA), and strong management with a long track record of superb execution, in a consolidating industry that will ultimately give the company further scale and pricing power. Fear of asset outflows are consistently overblown. Accounting questions are embellished. Q4 earnings could provide a hard catalyst to entirely disprove the main crux of the short thesis in one fell swoop. We expect the stock to gradually return to its historical median 30% valuation premium to the S&P 500 as FCF grows at 15-20% the next several years.

The demise of long/short equity hedge funds is greatly exaggerated. Then again, if shorting SSNC is the best idea (of all the stocks with bad business models and crazy valuations eight years into a bull market) from a star hedge fund manager with ~$4 billion of AUM, maybe the hedge fund industry is screwed, after all.

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