

# A Solid Pick at a Fair Price

Written by Jae Jun follow me on Facebook Twitter

March 30, 2015

Boy oh boy.

The markets keep shrugging off any corrections and makes stock picking tougher.

This is why valuation is so important. You make money based on the price you pay.

If you're fully invested, the boat continues to rise with the tide, but if you have cash lying around, it's tough to commit to a company.

Out of the tens of thousands of stocks you can invest in, there's bound to be opportunities though.

What I've found is that it's difficult to get in the groove of analyzing stocks if you stop.

It's a lot like exercise.

After several years away from the gym, I went back the other day and hung my head in shame at the number of (or lack of) push ups I can do.

Stop researching and reading stocks and the "stock analysis muscle" shrivels up and weakens.

But one way to get your "stock muscle" back into shape is to start off with a list.

I always find myself going back to the Forbes Best Small Companies list as I like many of the ideas and the way it's filtered down for me. I just have to put in that extra effort to go through the financials and valuation, but once I've done like 5 or so, I'm back in the full swing of things.

Here's the stock I'm looking at today that I like.

## A Look at Syntel (SYNT)

Syntel's main business is outsourcing. The main type of outsourcing for Syntel is called KPO (Knowledge Process Outsourcing).

I previously wrote about [ExlService Holdings \(EXLS\)](#) which is a BPO (Business Process Outsourcing).

The difference between KPO and BPO is quite simple.

BPO is outsourcing redundant and "easy" work like call centers, payroll, book keeping and data

entry.

KPO is a high level of outsourcing where required skills and knowledge is outsourced. For example, to run Old School Value, I need several developers to do the programming on the website and OSV analyzer. It's not something that I can do on my own and I'm not ready for a full time staff to take over the duties.

I also outsource basic bookkeeping which is a BPO.

Syntel reports their revenue in the following segmentations.

- Banking and Financial Services
- Healthcare and Life Sciences
- Insurance
- Retail, Logistics and Telecom
- Manufacturing

They cover and offer knowledge and skills across a wide variety of industries.

What I like about this industry is that it isn't going to go away.

No one can do everything on their own, and no company can do everything on their own.

Look at Apple, they are just designers and marketers. They don't do any of the manufacturing on their own.

As companies grow, in order for them to be able to focus on their core competence, they need to outsource to improve efficiency and reduce redundant employees.

The industry has plenty of competition.

But as they say, the more the competition, the bigger the market and more profitable it is.

## **Digging Deeper Into the Fundamentals**

What I like about the KPO business model is that it's much more profitable than a BPO.

A company like EXLS offering BPO has net margin between 6-10%.

Syntel has a 5 year net margin average of 24%.

Their fundamentals are super strong in addition to the healthy margins.

- Revenue growth has slowed and now in the low teens

- Cash and equivalents make up 70% of the balance sheet asset
- No inventory to worry about
- Debt is an easily manageable 11%
- Generates huge amounts of FCF – FCF CAGR is 21%. Must faster than the 5 yr revenue CAGR of 11.4%

The great thing is that it's not expensive. These are some really good numbers.

Syntel, Inc. (SYNT) 3/30/2015 %old school value

Enter Ticker Refresh Save as PDF

	2010	2011	2012	2013	2014	TTM	5YR Min	Median	5YR Max
<b>Financial Statistics &amp; Ratios</b>									
<b>Valuation Ratios</b>									
P/E	18.89	14.89	12.54	17.69	15.41	17.63	12.54	16.52	18.89
P/E (cash adjusted)	16.37	12.28	10.27	14.65	11.94	14.16	10.27	13.22	16.37
EV/EBITDA	13.78	9.73	8.64	11.92	10.97	12.92	8.64	11.45	13.78
EV/EBIT	15.42	10.92	9.22	12.57	11.63	13.70	9.22	12.10	15.42
P/S	4.03	2.85	3.21	4.71	4.22	4.83	2.85	4.13	4.83
P/BV	4.75	3.71	4.11	5.38	4.06	4.65	3.71	4.38	5.38
P/Tang BV	4.76	3.72	4.12	5.39	4.06	4.65	3.72	4.39	5.39
P/CF	16.04	11.90	11.63	16.71	16.18	18.52	11.63	16.11	18.52
P/FCF	23.47	25.84	14.87	21.66	17.97	20.57	14.87	21.11	25.84
FCF/S	17.2%	11.0%	21.6%	21.8%	23.5%	23.5%	11.0%	21.7%	23.5%
FCF Yield	4.3%	3.9%	6.7%	4.6%	5.6%	4.9%	3.9%	4.7%	6.7%
Magic Formula Earnings Yield	6.5%	9.2%	10.8%	8.0%	8.6%	7.3%	6.5%	8.3%	10.8%
ROE	25.2%	24.9%	32.8%	30.4%	26.3%	26.3%	24.9%	26.3%	32.8%
ROA	20.8%	20.6%	25.6%	22.0%	20.4%	20.4%	20.4%	20.7%	25.6%
ROIC	22.7%	22.3%	26.6%	23.7%	19.3%	19.3%	19.3%	22.5%	26.6%
CROIC	20.3%	14.4%	25.4%	20.7%	19.7%	19.7%	14.4%	20.0%	25.4%

Syntel Valuation Ratios – Some Great Numbers | Enlarge

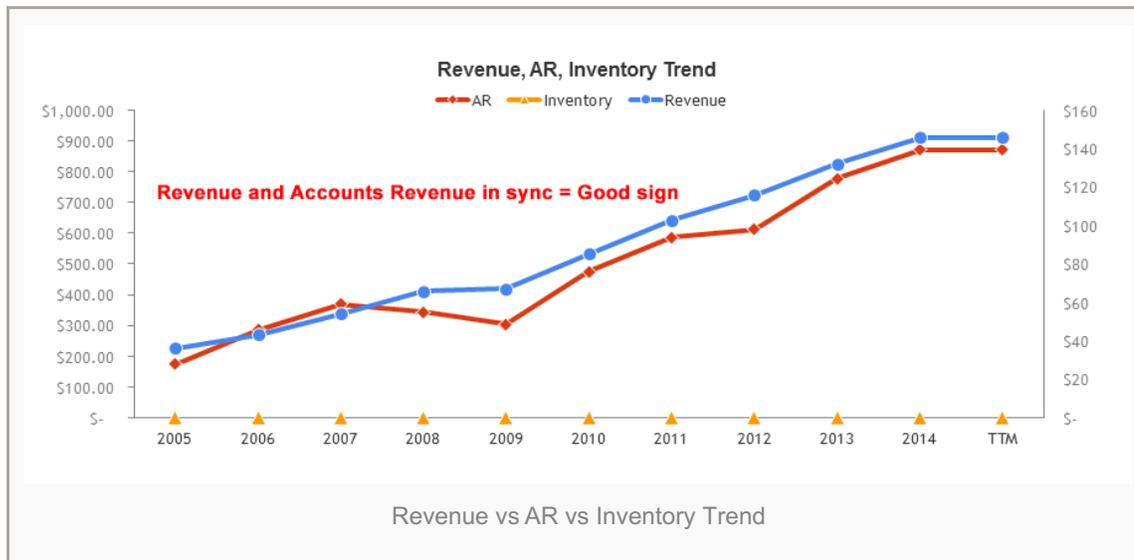
- Syntel has been able to turn every dollar of sales into 23.5c of FCF.
- EV/EBIT is below competitors with less impressive fundamentals.
- What I love is the consistency the management team has done with the assets that they have to deploy.
- Digging deeper into the ROE to make sure things are as it seems, the DuPont analysis shows that the drop in ROE from 2 years ago is due to a lower asset turnover.

With the cash pile building up, it's not something to be worried about. Activists and many investors complain about having too much cash on the balance sheet. As a small business owner, I couldn't disagree more.

Having a ton of cash provides options.

Buffett is known for having a huge elephant gun. Without the cash, he would be carrying around a water pistol.

Another check I like to perform is to make sure revenue and accounts receivables are in sync.



It's a red flag if AR shoots higher than revenue as it means that the company isn't collecting money or offering unfavorable terms to book revenue.

The main thing I want to show is the comparisons between competitors.

I mentioned that the company is much smaller than most of its competitors, but you wouldn't think it when you look at their fundamentals.

[optim ratios]

This side by side comparison also helps to show the picture.

- Green means that it's the best among the list of competitors
- Red means that the numbers are the worst

	A	B	C	D	E	F	G	H	
1	<b>Syntel, Inc.</b>								
2	<b>(SYNT)</b>								
3	3/30/2015								
4	<input type="button" value="Enter Ticker"/>		<input type="button" value="Update"/>	<input type="button" value="CLEAR"/>	<input type="button" value="Save as PDF"/>				
6								You can get a list of	
7	<b>Manually Enter Competitor into Yellow Cells</b>							<a href="https://www.google">https://www.google</a>	
8		<b>SYNT</b>	<b>CTSH</b>	<b>WIT</b>	<b>IGTE</b>	<b>INFY</b>	<b>VRTU</b>		
27	P/E	17.66	26.95	24.48	537.38	20.45	29.81		
28	Forward P/E	16.49	18.62	22.33	16.83	19.09	23.50		
29	PEG	1.18	1.58	1.75	35.80	1.43	1.19		
30	P/S	4.82	3.76	3.29	2.74	4.69	2.66		
31	P/B	4.64	4.98	5.29	6.06	4.98	2.96		
32	P/Cash	5.07	10.23	7.47	18.62	7.63	6.71		
33	P/Free Cash Flow	20.51	30.63	42.91	79.19	0.00	40.63		
34	Dividend Yield	0.00%	0.00%	1.17%	0.00%	1.37%	0.00%		
35	Payout Ratio	0.00%	0.00%	28.60%	0.00%	13.80%	0.00%		
37	EPS (ttm)	2.97	\$2.35	\$0.56	\$0.08	\$1.75	\$1.40		
38	EPS growth this year	13.40%	16.30%	13.30%	-100.80%	1.30%	14.40%		
39	EPS growth next year	9.99%	15.48%	8.29%	17.26%	6.54%	22.48%		
40	EPS growth past 5 years	15.70%	21.40%	15.30%	-15.10%	6.20%	20.50%		
41	EPS growth next 5 years	15.00%	17.06%	14.00%	15.01%	14.33%	25.00%		
42	Sales growth past 5 years	16.80%	25.60%	11.10%	45.70%	12.10%	18.10%		
43	EPS growth quarter over quarter	6.30%	11.30%	7.70%	-260.00%	12.20%	14.30%		
44	Sales growth quarter over quarter	5.40%	16.40%	6.40%	10.80%	5.60%	21.80%		
46	Return on Assets	21.60%	15.20%	16.10%	1.00%	20.40%	8.90%		
47	Return on Equity	28.30%	20.00%	23.20%	7.10%	24.80%	10.50%		
48	Return on Investment	18.30%	14.90%	16.90%	11.00%	16.50%	8.30%		
50	Current Ratio	8.20	2.60	2.80	1.80	4.30	5.10		
51	Quick Ratio	8.00	2.60	2.70	1.80	4.30	5.10		
52	LT Debt/Equity	0.14	0.12	0.03	1.09	0.00	0.00		
53	Total Debt/Equity	0.15	0.21	0.17	1.33	0.00	0.00		
55	Gross Margin	41.40%	42.40%	31.90%	36.00%	37.80%	36.80%		
56	Operating Margin	29.40%	20.70%	20.00%	17.40%	26.20%	10.90%		
57	Profit Margin	27.40%	14.00%	18.50%	1.30%	23.20%	8.80%		
59	Shares Outstanding	83.75	609.62	1,782.84	80.87	1,133.97	29.60		
60	Shares Float	31.52	606.66	889.31	58.21	1,006.03	27.08		
61	Insider Ownership	34.10%	0.20%	0.00%	12.00%	0.00%	9.40%		
62	Insider Transactions	-0.03%	-29.39%	0.00%	-0.97%	0.00%	-7.23%		
63	Institutional Ownership	33.60%	92.90%	2.00%	73.80%	20.30%	86.60%		
64	Institutional Transactions	-2.00%	0.28%	4.42%	54.04%	13.88%	0.96%		
65	Float Short	2.60%	1.11%	0.91%	2.75%	4.42%	2.00%		
66	Short Ratio	5.3	1.7	13.6	4.7	17.7	5.3		
67	Performance (Week)	-0.08%	-0.91%	-1.79%	-0.74%	-0.58%	-0.67%		
68	<input type="button" value="Dashboard"/> <input type="button" value="Statements"/> <input type="button" value="Statements%"/> <input type="button" value="Ratios"/> <input type="button" value="Quality"/> <input type="button" value="Inventory"/> <input type="button" value="Charts"/> <input type="button" value="Competitors"/> <input type="button" value="DCF Valuation"/> <input type="button" value="Graham Valuation"/> <input type="button" value="EBIT"/>								

There's a lot of green for Syntel and its fundamental metrics.

Wipro (WIT) is 6x bigger than Syntel but their margins are lower by close to 10%. Even more for Cognizant (CTSH).

I also like the commitment by insiders in eating their own cooking at 34.1%.

## What is Syntel Worth?

I work in valuation ranges.

There will be a low end and a high end based on a conservative and bullish view.

## Low End Valuations

### Discounted Cash Flow:

- Based on the consistent FCF growth, I'll use a FCF figure of \$240m, 15% growth rate and 9% discount rate. **Fair value of \$53.**

### Graham Valuation:

- Based on 10% growth and EPS of \$2.89, **the fair value is \$60.**

### EBIT Valuation:

- Based on revenue estimate of \$1110m and a EV/EBIT multiple of 12x, **the fair value is \$56.**

### Absolute PE Valuation:

- Based on an expected 10% EPS growth rate, this equates to a PE of 14. Include the ratings for business safety, financial safety and earnings safety and **the fair value is \$54.**

## High End Valuations

### Discounted Cash Flow:

- Based on the latest year FCF figure of \$214m, 10% growth rate and 9% discount rate, a **valuation of \$75.**

### Graham Valuation:

- Based on 10% growth and EPS of \$2.89, **the fair value is \$77.**

### EBIT Valuation:

- Based on revenue estimate of \$1110m and a EV/EBIT multiple of 12x, **the fair value is \$68.**

### Absolute PE Valuation:

- Based on an expected 10% EPS growth rate, this equates to a PE of 14. Include the ratings for business safety, financial safety and earnings safety and **the fair value is \$69.**

## The Valuation Range

Putting all that together, here are my numbers.

SYNT Price	\$ 52.46			
<b>Valuation</b>	<b>Low</b>	<b>High</b>	<b>Average</b>	<b>Margin of Safety</b>
DCF	\$ 53.00	\$ 75.00	\$ 64.00	22.0%
Graham Valuation	\$ 60.00	\$ 77.00	\$ 68.50	30.6%
EBIT Valuation	\$ 56.00	\$ 68.00	\$ 62.00	18.2%
Absolute PE	\$ 54.00	\$ 69.00	\$ 61.50	17.2%
Average	\$ 55.75	\$ 72.25	\$ 64.00	22.0%

Syntel Valuation Ranges

These numbers look good, but the one thing that isn't on here is the desired margin of safety.

My valuation range is between \$55 and \$72 so the stock is in fair value territory. Based on the average fair value of \$64, it has a 22% margin of safety. If you seek a larger margin of safety, then be patient and wait a little longer until Syntel goes on sale.

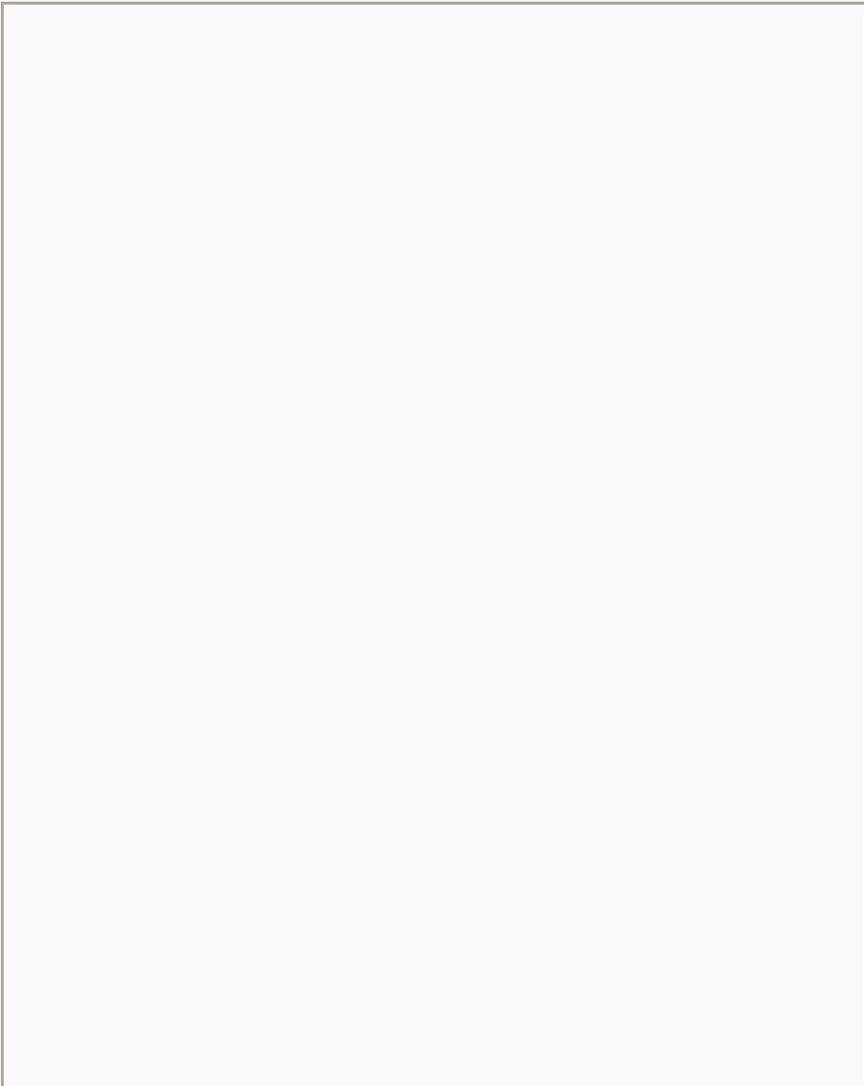
Finally, here's a quick visual recap of my thoughts on Syntel.

There's extra work that I need to do on Syntel before making a final decision, but numbers wise, a wonderful business so far.

If the qualitative aspects match up well, this is a solid pick.

**Disclosure**

No position (so far)



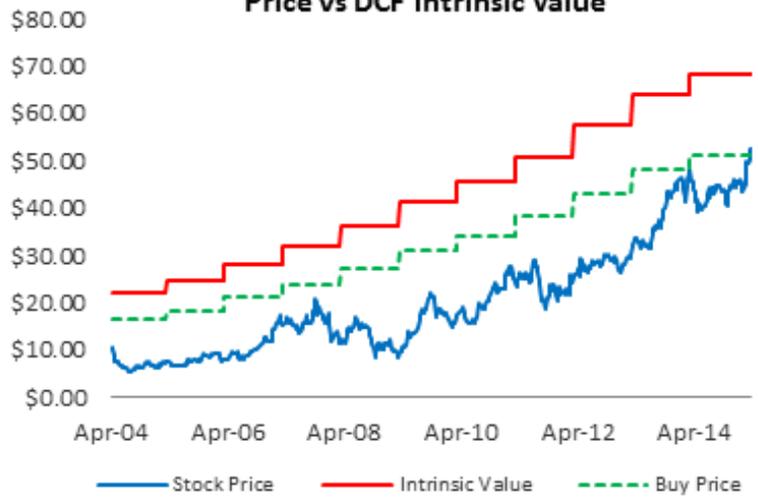
# Syntel (SYNT)

# %old school value

Figures in Millions except per share values



## Price vs DCF Intrinsic Value



Overview of Syntel