Our Outlook for Business and Financial Services Stocks

The business and financial services sector contains both stalwarts and the highly exposed.

by Brett Horn, Associate Director of Equity Analysis

The gut-wrenching free fall in the markets and economy that we faced last fall and the first part of 2009 has given way to some initial signs of stabilization. Whether this is simply the calm before the next storm or the first buds of economic recovery is a subject of intense debate. Within our business and financial services coverage, we see stalwarts that should hold up even in a more severe environment and industries that are highly exposed to the state of the economy and the second-order impact of the economy's effect on the capital markets.

Most business services companies are asset-light business, in that they don't require much in the way of hard assets. This can be a valuable trait in tough times, as low asset intensity tends to also mean low reliance on debt. Add into the mix a stable top line and solid free cash flow, and you've got yourself a survivor. Take, for instance, the core processors we cover. They serve the banking industry, an unenviable customer base given the carnage in this sector. But most of their revenue is tied to non-discretionary transaction processing services, and this has muted the impact of the financial crisis. The industry has experienced only modest revenue declines, and healthy profit margins remain the rule. While neither are cheap enough for us to recommend right now, we think Fiserv FISV and Jack Henry JKHY—if they revisit previous levels—are worth consideration by patient investors who are skeptical about the economy's near-term direction.

That said, not all business services names offer non-discretionary services; for many there is a material amount of discretionary revenue that will be hard to come by until the economy gets back on its feet. Staffing companies might be the best example. While the pace of job losses has decelerated, the unemployment rate is still rising, and these highly cyclical companies won't see better results until companies start hiring again. While the strongly bullish might think the time is right for cyclicals like staffers, two other employment-related firms look attractive to us as lower-risk options. We don't think Cintas CTAS and Paychex PAYX will see dramatic revenue declines as their sensitivity is to the total level of employment, a much more stable base than the incremental demand for new workers, and the current market valuations on these two wide-moat names look attractive from a long-run perspective.

On the other side of the coin, we have insurers. A weak demand environment has led to a fall-off in premiums for insurers, and tougher economic conditions also tend to lead to increased claims, although natural disasters have a much bigger impact and are an ever-present wild card. But insurers are also leveraged to the second-order effect of the economy on the capital markets, primarily fixed-income markets. A prolonged recession would inevitably lead to a spike in corporate defaults, and even in historically safe areas like municipal bonds there is increasing concerns about defaults. While these concerns currently center on the disastrous condition of California's finances, an ongoing economic decline could create tax shortfalls across the nation.

Though we think it's too early to call a disaster in the muni market, we do share some of the market's anxiety about this potential event, and our uncertainty ratings in the space reflect this and the risks in other areas of insurers' investment portfolios. Property and casualty insurers tend to carry the highest proportion of municipal bonds, and thus have the most to lose. On the positive side, we think the hit to industry capital over the past year should lead to firmer pricing, and spikes in insurance pricing typically follow recessions. So if the economy recovers strongly and their investment losses ceased or reversed, insurers could reap a double benefit, and the particularly bullish might consider the space.

We remain cautious, though, and are generally limiting our recommendations to relatively high-water names. Of special note are the life insurers, whose balance sheets are highly levered and currently reside on the razor's edge. Improvements in the capital markets would be a windfall for these companies and their stocks, and a deeper fall-off would be a disaster. While inclusion in the TARP program gives them a possible lifeline, we feel that most of the names in this industry still carry extreme uncertainty and are inappropriate for most investors until the uncertainty around their capital positions abates.

Valuations by Industry

The recent rally has lifted most stocks, but the accompanying table shows how disproportional the rise has been across industries, and that the market seems to be much less fearful about riskier situations.

Business and Financial Services Industry Valuations

Segment	Average Star Rating	Price/Fair Value*	P/FV Three Months Prior	Change (%)	Uncertainty** (%)
Asset Management	2.86	1.06	0.71	49	83
Business Services	3.58	0.78	0.71	10	65
Education & Training Services	4.01	0.82	0.75	9	35
Insurance - Brokers	4.26	0.69	0.53	30	25
Insurance - Life	2.85	1.39	0.65	214	100
Insurance - Property & Casualty	4.19	0.72	0.61	18	49
Insurance - Specialty	2.61	1.22	0.73	67	92
Personal Services	4.36	0.68	0.51	33	19
Reinsurance	3	1.25	0.93	34	67
Waste Management	3.09	0.96	0.73	32	59

Data as of 06-12-09.

*Market-Weighted Harmonic Mean

**Ranks the industry's fair value uncertainty (most uncertain =100) based on the aggregate market-weighted uncertainty ratings of all industries under coverage.

When we look at the increase in price to fair value over the last quarter, the two largest increases have come from the most uncertain industries we cover, life insurance and specialty insurance (which is mainly financial guarantors and mortgage insurers). While we had previously believed that the market had gone too far in weighting the downside case, it now looks to us as if the market is a bit too sanguine about these companies' prospects. Bottom line, though, we still think the uncertainty in these industries makes them areas to avoid for most investors.

We also saw a big rise in the asset management space, which is no big surprise as a rising market has a real impact on asset managers, and one that is multiplied by their operating leverage. This has brought valuations in the sector back in line with our fair value estimates.

Going forward, the more stable companies we cover look like relative bargains at this point. The insurance industry is the best case in point. We think the highly risky life segment looks a bit overvalued, the less risky property and casualty space (which carries large equity cushions to cover investment losses) looks more attractive, and the brokers, which are only exposed to overall premium levels, look like the best bet.

Top Business and Financial Services Sector Picks

Company	Star Rating	Fair Value Estimate (USD)	Economic Moat™	Fair Value Uncertainty	Price/ Fair Value
Cintas	★★★★★	35.00	Wide	Medium	0.64
Fair Isaac	★★★★★	28.00	Narrow	Medium	0.57
White Mountains	★★★★★	425.00	None	High	0.49

Data as of 06-18-09.

Fair Isaac FIC

Fair Isaac, known primarily for its FICO credit scores, has seen revenue decline substantially as the financial crisis has crimped demand for its products and services. While we don't believe volumes will ever reach their peak levels again, the FICO score has become so entrenched at banks and other lenders that we don't think it will disappear anytime soon. Furthermore, there are few competitors to FICO scoring, and switching would be a risky proposition for a lender, given that historical reliability is critical to the product. Bottom line, we think Fair Isaac looks very cheap at current market levels. Even as revenues have declined, the company has been able to right-size costs and still generates substantial free cash flow. The company's current market capitalization provides over a 10% free cash flow yield based on our expectations for 2009.

Cintas CTAS

Uniform rental and restroom sanitation are not the most glamorous businesses, but Cintas has consistently produced solid returns providing these core services. The efficiency of its distribution network has built a wide economic moat for the firm; however, strong short-term headwinds have challenged Cintas to a degree it has rarely experienced. Small business closures and reduced headcount for the firm's customers have impaired revenue and profitability materially over the past year, and the weak labor market has given the stock market plenty of opportunity to drive Cintas' stock price down. However, the firm's dominant position among its peers should help it stay afloat through this storm. The stock currently trades at an 11 price/earnings ratio on a trailing basis, substantially below historical averages.

White Mountains **WTM**

White Mountains' deep value acquisitions strategy continues to pay off as demonstrated by the turnaround in OneBeacon OB, a troubled property and casualty insurer it bought in 2001. White Mountains reinsurance subsidiaries are expected to benefit from improved industry pricing resulting from recent catastrophe losses that have constrained industry capital. Even Esurance, White Mountains' push into the online auto insurance business, has shown better results recently. Our uncertainty rating is high due to White Mountains' investment portfolio exposure to mortgage-backed securities, although it's mostly government agency backed. But we think the company has enough equity (33% of investments) to withstand all but the most dire credit market events, and White Mountains currently trades at about 60% of book value, less than half of its five-year average.

Brett Horn has a position in the following securities mentioned above: FIC