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5 Small Cap Software Companies Worth A Look

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In the old days, say 10-15 years ago, small capitalization software companies were the key to riches. We all looked for companies that would be disruptive and markets where none existed before. Today, the market is focused on social networking and it leaves the small cap software company growing quietly into the background. Below, we highlight five small capitalization companies that are doing something right. As with any group of companies such as these, some may be undervalued today, some overvalued and others fairly valued. It is the reader's responsibility to perform due diligence to determine if our conclusions are consistent with their own.

Blackbaud, Inc. (BLKB) is the leading provider of software designed specifically for nonprofit and education sectors. The Company has more than 25,000 customers in over 60 countries that support higher education, healthcare, human services, arts and culture, faith, the environment, K-12 education and other charitable causes. The company offers a variety of cloud-based and on-premise software solutions.

The Company's third quarter ended September 30, 2011. For this period, the Company reported revenue growth of 15%, of which 12%, the Company describes as organic. The Company reiterated full year revenue growth projections in the mid-teens. Blackbaud reported total revenue of $95.5 million for the quarter, an increase of 15% compared to $82.2 million for the third quarter of 2010. Income from operations and net income were $15.7 million and $9.8 million respectively.

The Company made adjustments for how it accounts for amortization expenses. They lengthened the amortization period of the initial set-up fees associated with certain subscription based products. This adjustment reduced third quarter revenue by approximately $700,000 and operating earnings by approximately $400,000.

The Company approved a fourth quarter dividend of $0.12 per share. The dividend yield is presently 1.88%. The Company also has a share repurchase plan with $50 million available.

The Company has a market capitalization of approximately $1.16 billion. It reports free cash flow for every year since 2004 and for the trailing twelve months. However, free cash flow growth is negative which we see as a negative factor. Blackbaud has a long term sales growth rate of about 15% and a sustainable growth rate of 17.4%. Analysts forecast earnings growth over the next 3-5 years to be in the range of 13%-15%. Balckbaud consistently reports strong operating margins. They range from a low of 13.6% in 2004 to a high of 27.3% in 2005. The Company carries no long term debt.

Analysts provide target price estimates ranging from $27 to $34. We are not so optimistic. We believe the payout ratio of 58% will be a drag on growth and price appreciation. We think Blackbaud could trade as low as $16.50. Our target value is about $21.00.

CACI International (CACI) is a fifty year-old business providing IT services in the areas of defense, intelligence, homeland security, and government services. CACI solutions help federal government clients provide for national security, improve communications and collaboration, secure information systems and networks, enhance data collection and analysis. September 30, 2011 represented the close of the Company's first quarter for FY2012.

In 1Q12, revenue increased 10.8% to $924.4 million compared to $834.0 million in 2010. Operating income increased to $75.7 million from $52.1 million, a 45.2% increase. Net income increased by 47.1% from $28.7 million in 1Q11 to $42.1 million in 1Q12. During 1Q12, contract funding orders totaled $1.6 billion; funded backlog was $2.52 billion and total backlog stood at $7.95 as of September 30, 2011.

The Company is a serial acquirer of other companies. Since the beginning of FY12, CACI completed three acquisitions. They acquired Pangia Technologies, Paradigm Holdings and Advanced Programs group. Additionally, CACI repurchased four million shares of its own stock.

The Company has provided guidance for FY12. They project revenues in the $3,850 million to $4,050 million range; net income of $157 million to $163 million and diluted EPS of $5.55 - $5.80. CACI does not pay a dividend.

CACI has a market cap of about $1.4 billion. It reports free cash flow over each of the past seven years and has a FCF growth rate of about 18%. Sales have grown at the rate of 17%. Analysts project 3-5 years earnings growth in the range of 8%-24%. Operating margins are on the low side ranging from a low of 6.2% to a high of 8.8%. Currently, the operating margin is about 7.5%. The Company carries about $536 million in short and long-term debt with just $28.6 million in cash and has a LT debt to working capital ratio of 234.9%. Long term debt to capital is 31.7% and long term debt to equity is 46.4%.

Analysts provide a target price range of $54 to $76. Our own estimate of fair value, $77 is just above the high end of analyst estimates.

EBIX, Inc. (EBIX) is a supplier of On-Demand software and e-commerce services to the insurance industry. The Company provides end-to-end solutions ranging from infrastructure exchanges, carrier systems, agency systems and BPO services to custom software development. It has more than 30 offices worldwide including Brazil, Singapore, Australia, the U.S., New Zealand, India and Canada.

In Q3 2011, operating income was $18 million, an increase of 37% on a year-over-year basis, as compared to Q3 2010. Revenues for the quarter were $42.6 million, an increase of 28% over the prior year revenue of $33.3 million. EBIX reported operating margins of 42% for 3Q11 as compared to 39% in 3Q11. The Company reported a slight decrease in net income and a small decrease in diluted EPS in 3Q11 as compared to 3Q10.

The Company does not pay a dividend but it does have a share repurchase program. It repurchased 2.01 million shares in 3Q11 at an average price of $17.28 per share.

With a market capitalization of $697 million, EBIX is the smallest of our companies. At 39.1%, EBIX has a very strong free cash flow growth rate. Free cash grew from $0.09 in 2004 to $1.69 for the trailing twelve months ending September 30, 2011. Similarly, sales grew at the rate of 37.3% over the seven year period from $20 million in 2004 to $132.2 million in 2010. Trailing twelve month revenues are $160 million.

The one analyst that forecasts 3-5 year earnings growth, estimate a growth rate of 20%. Operating margins have improved just about every year since 2004 when the margin was 12%. The operating margin has expanded to 41.2%.

EBIX has $15.6 million in cash and short term investments and $27.2 in both long term and short term debt. Long term debt to capital is 6.3% and long term debt to equity is 6.7%. Analyst price targets range from $17 to $30. Our own estimates range from $30 to $36. These higher estimates are based on strong profit margins and returns on equity.

Progress Software (PRGS) has a market cap of $1.19 billion. The Company offers a portfolio of real-time software solutions. A key offering is the Progress Responsive Process Management (Progress RPM) suite that enables enterprises to achieve business performance. It also provides enterprise data solutions (data access and integration) and application development platforms (for application development and management, and SaaS enablement). The Company has three business units: Application Development Platforms, Enterprise Business Solutions and Enterprise Data Solutions. On January 8, 2010, it acquired all of the equity interests in Savvion, Inc.

The Company’s fiscal third quarter ended August 31, 2011. Revenue for the period was $128.3 million compared to $128.7 million in Q3 2010. Software license revenue decreased 13% to $38.7 million from $44.7 million in 3Q10. Operating income decreased 18% to $13.5 million compared to $16.5 million last year. Net income decreased 7% to $8.6 million and diluted EPS decreased 7% to $0.13.

Looking ahead to 4Q11, the Company expects revenue to be in the $130-$134 million range; diluted earnings per share in the range of $0.16 to $0.21. For the full fiscal year ending November 2011, Progress estimates revenue of $527 million to $531 million; diluted EPS of $0.84 to $0.89.

Over the years since 2004, Progress has experienced erratic free cash flow. It has sunk as low as $0.71 per share and has been as high as $1.93, where it stands now. Sales growth has been at the rate of 8%. Analysts estimate EPS growth for the next 3-5 years to be about 13.5%. Operating margins have improved over the years. Currently at a high point, at 18.8%, margins have been as low as 9.2%. The Company has cash and short term investments of $346.6 million and no long term debt.

Analysts value Progress in the range of $27 to $39. We estimate fair value in the $24-$27 range.

Tyler Technologies (TYL) is a provider of end-to-end information management solutions and services for local governments. Tyler’s client base includes more than 10,000 local government offices throughout the U.S., Canada, the Caribbean and the United Kingdom. The Company has a market cap of about $866 million and does pay a dividend.

Tyler’s third quarter ended September 30, 2011. For 3Q11, Tyler reported total revenue of $77.2 million and net income of

47.5 million. Free cash flow for the quarter decreased to $24.3 million compared to $26.9 million in 3Q10. Total backlog was a record high of $298.7 million, up 17.7% from $253.8 million in Q3 2010.

The Company provides guidance for FY 2011. Revenues are expected to be in the range of $308 million to $311 million. Diluted EPS is estimated to be approximately $0.78 to $0.82.

Tyler has done a good job in growing its free cash flow over the years. Free cash has risen at the rate of 15.7% since 2004 when free cash per share was $0.34. For the twelve months ending September 2011, free cash is $1.29 per share. Sales have been growing at a 10.3% rate. Three analysts follow Tyler and forecast 3-5 year EPS growth in the 15%-20% range. The Company has done a credible job in protecting operating margins. Margins have expanded and contracted over the past seven years ranging from a low of 7.5% to a high of 15.4%. Margins have returned to the 14.5% level. Tyler has about $5.3 million in cash and long term debt of $58 million. Long term debt to capital is 47.2% and long term debt to equity is 89.6%.

Analysts provide a value range of $27 to $39. We disagree. We believe the high level of debt and lack of cash makes Tyler a very risky investment. We would place fair market value in the $5 to $12 range.

Disclosure: I am long EBIX.