

Seeking Alpha α

DJSP Enterprises: Small Cap Value in a Weak Economy

by: Andy Fligel

July 05, 2010 | about: [DJSP](#)

As a value investor, I like to find fundamentally sound businesses with strong free cash flow generation that are out of favor and/or underfollowed, and where the interests of management are well aligned with shareholders. DJSP Enterprises ([DJSP](#)) fits this criteria and appears poised to deliver strong returns for many years, irrespective of whether the economy plods along or slips back into recession.



DJSP is the leading provider of processing services for the real estate industry (foreclosures, bankruptcy, REO liquidations, etc.) with the largest market share (~20%) in Florida and expanding services in additional states. The company has an unusual history, having been acquired by a special purpose IPO entity initially set up to pursue an acquisition in China. Instead it purchased DJSP's operations from the Law Offices of David Stern, and Stern serves as both CEO of DJSP and sole owner of the law firm. In effect, the transaction separated the legal work performed by the law firm from the non-legal work performed by DJSP in handling its real estate cases. It also provided a backdoor IPO of DJSP. Stern's law firm is the designated counsel for Fannie ([FNM](#)) and Freddie ([FRE](#)) in Florida, and both firms maintain long standing relationships with nearly all of the major mortgage loan servicers in the US.

Since DJSP benefits from the growing volume of foreclosures, it is not surprising that the firm has experienced rapid growth in recent years with gross revenues increasing from \$40M in 2006 to \$260M in 2009, and net revenues (net of client reimbursement costs) growing from nearly \$24M in 2006 to \$121M in 2009. I expect the company will continue to deliver solid growth and strong investor returns for the next several years.

Here is the case:

1) The current share price irrationally reflects temporary issues.

DJSP has fallen 63% from its 52-week high of \$13.65 in April to as low as \$5 recently after the company missed Q1 expectations and lowered guidance for 2010. Two temporary issues are to blame. First, government programs to encourage loan modifications slowed the pace of foreclosures in Q1, but given the high rate of re-defaults for this ineffective strategy and the overall growing number of underperforming loans, I expect the pace of foreclosures will inevitably increase, especially if we see renewed weakness in the housing market in the second half, as I expect.

Second, a large bank client began a system conversion in April that will significantly reduce foreclosure referrals during the year, but has indicated that volumes will revert to historical levels once the conversion is complete. Compounding these factors, DJSP committed the cardinal sin of missing a quarter and reducing estimates early in its life as a reporting company and now finds itself in the proverbial penalty box. Bad for the company, but a unique opportunity for investors willing to look past these temporary issues.

2) DJSP has a compelling valuation and looks capable of producing annual share price appreciation greater than 50% over the next 2-3 years.

At the July 1 closing price of \$5.45, DJSP has a \$134M market cap and \$233M enterprise value. Current guidance is for ~\$60M in EBITDA and ~\$33M net income, so the business trades for only 4x EBITDA and also has a P/E of 4x. This fundamentally sound business generated over \$40M in free cash flow in 2008 and nearly \$46M of FCF in 2009. If DJSP maintains \$40M or higher of FCF in 2010 and beyond, the stock currently sports a 30%+ FCF yield.

To see how this could play out, let's assume \$65M-\$75M in 2012 EBITDA (relative to \$69M in 2009) at a 5x-8x multiple for an EV of \$325M-\$600M. If DJSP produces \$100M in incremental FCF through 2012 and eliminates its current net debt, the implied market cap would also be roughly \$325M-\$600M, or \$11-\$20 per share, for a CAGR of 30%-95% over the next 2-3 years. Continued growth combined with multiple expansion could easily produce greater than 50% annual returns.

3) The CEO is highly incented to deliver returns for shareholders.

As part of the compensation for selling DJSP's operation, Stern took a \$53M seller's note, which will be repaid from DJSP's cash flow. Additionally, he received 3.9M Series B shares which effectively vest in five tranches based on sustaining share prices above \$10, \$12.50, \$15, \$17.50 and \$20 for 10 out of 30 days before the end of 2015. More recently, on June 9, Stern filed his intent to purchase up to \$5M of shares and warrants, and since that filing has already purchased 448K shares for nearly \$2.8M. It's always nice to see a CEO put his money where his mouth is, and while there are many reasons why insiders sell, there's generally only one reason why they buy.

4) DJSP has opportunities to grow within and beyond Florida.

Already the market share leader in Florida, DJSP has indicated that it can continue to take share. The large customers it serves will require a proven servicer with a broad range of services that can handle growing volumes, making it difficult for smaller players to compete, even if they offer lower prices. DJSP also recently acquired Timios, a national title insurance agency operating in 38 states, broadening both its capabilities and geographic footprint. It seems reasonable that DJSP could leverage its existing customer relationships to gain incremental share in Florida and replicate its growth strategy across additional states.

5) Reasonable risks.

The biggest risks appear to be customer concentration and government intervention. The top 3 customers accounted for over 50% of revenues in each of the last three years, although the absolute % has been trending lower. While losing any of the largest customers would hurt results substantially, the long standing relationships mitigate this risk. A resumption of referrals from the lender undergoing the system conversion would also alleviate this concern.

A bigger and more unpredictable issue might be if the federal or state governments take actions to stem the tide of foreclosures in a way that reduces the volume of foreclosures and/or the fees that DJSP is able to collect. But given how ineffective the loan modification programs have been to date, it seems more likely that any new government intervention would delay but not significantly reduce the ultimate number of cases for DJSP.

In summary, DJSP appears significantly underpriced relative to its growth prospects and FCF generation. The CEO has been actively buying more shares in the open market over the past several weeks. An added bonus is that DJSP provides a natural hedge against greater than expected economic deterioration, and even if the economy finds its legs, the level of foreclosures will remain elevated, making DJSP shares a compelling opportunity. More aggressive investors could also consider buying the publicly traded warrants which have a \$5 strike price. More conservative investors could wait for the Q2 results and updated guidance to get a better handle on whether the earlier issues are abating or mounting.

For those wishing to do more research, DJSP's investor presentation (pre the Q1 miss and forecast reduction) can be found [here](#).

Disclosure: Author is long DJSP and DJSPW