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INTRINSIC VALUE ASSESSMENT OF

MIND CTI LTD. (MNDO)

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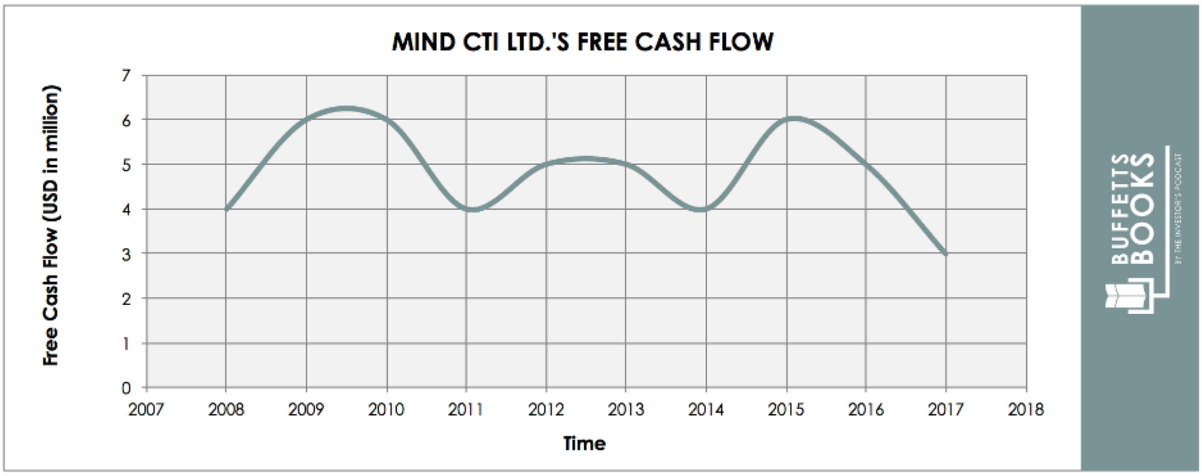
Introduction

Mind CTI Ltd. is an Israeli-based I.T. company whose principal business involves providing billing and customer care solutions for voice, data, video, and content services. At the time of writing, the firm's market cap stands at around $43.4 Million and its revenues and free cash flows for the previous financial year were around $18 Million and $4.7 Million respectively. The company's common stock has fluctuated between a high of $2.87 and a low of $2.08 over the past 52 weeks and currently stands at around $2.25. Is Mind CTI Ltd. undervalued at the current price?

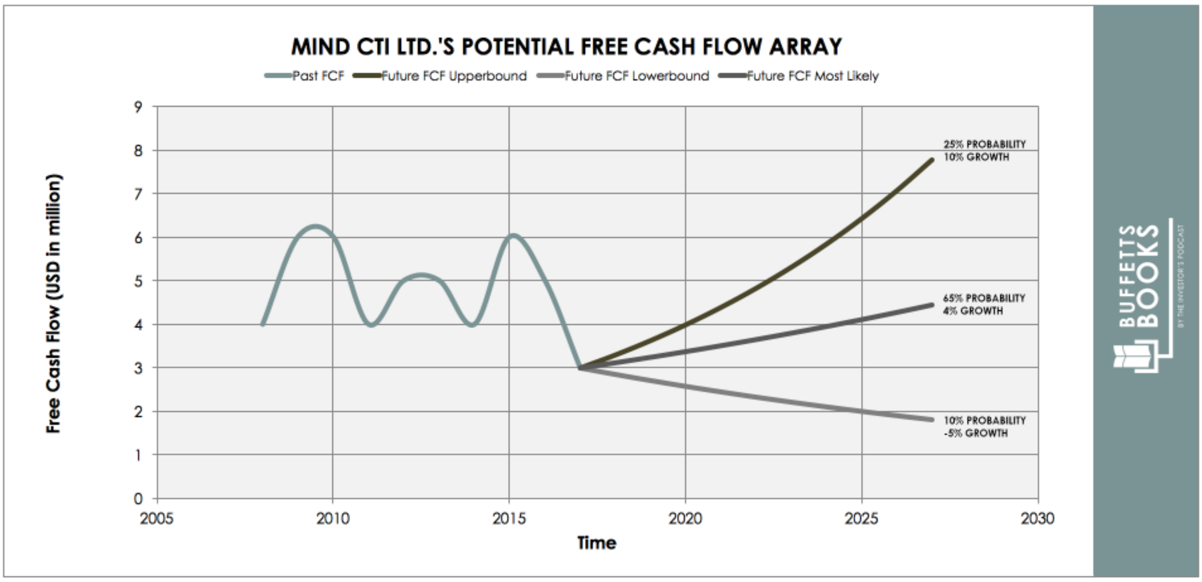
MIND
Billing & UC Analytics

The Intrinsic Value of Mind CTI Ltd.

To determine the intrinsic value of Mind CTI Ltd., we'll begin by looking at the company's history of free cash flow. A company's free cash flow is the true earnings which management can either reinvest for growth or distribute back to shareholders in the form of dividends and share buybacks. Below is a chart of Mind CTI Ltd.'s free cash flow for the past ten years.



As one can see, the company's free cash flow has been erratic over the past decade which is, in part, a result of the fact that Mind CTI Ltd.'s customers must first commission third-party contractors to install the network infrastructure required to run the firm's software before orders can be placed and revenue thus recognized. Since the installation of these infrastructures is often subject to delays, this results in both revenues and earnings fluctuating from year to year. In order to determine Mind CTI Ltd.'s intrinsic value, an estimate must be made of its potential future free cash flows. To build this estimate, there is an array of potential outcomes for future free cash flows in the graph below.



When examining the array of lines moving into the future, each one represents a certain probability of occurrence. The upper-bound line represents a 9.75% growth rate which is based on Mind CTI Ltd.'s free cash flow growth rate for the period 1999-2017. This growth rate has been used instead of the 10-year historical rate to smooth out the fluctuations above and has been assigned a 25% probability of occurrence to account for a number of factors including the unpredictability of future cash flows and the potential for heightened competitive pressure.

The middle growth line represents a 4.48% growth rate which is based on the company's historical revenue growth rate for the period 1999-2017. This future growth rate is more conservative and reflects the fact that revenue growth tends to be a more accurate measure of future economic performance over the long-term, as such it has been assigned a 65% probability of occurrence.

The lower bound line represents a -5% rate in free cash flow growth and assumes that the company suffers a contraction in earnings due to competitive and cyclical pressures. This growth rate has been assigned a 10% probability of occurrence.

Assuming these potential outcomes and corresponding cash flows are accurately represented, Mind CTI Ltd. might be priced at an 8.5% annual return if the company can be purchased at today's price. We'll now look at some other valuation metrics to see if they correspond with this estimate.

Mind CTI has an unusual dividend policy for an I.T. firm which involves a yearly dividend being paid which is equal to EBITDA plus financial income (expenses) minus taxes on income. This results in the firm sporting a high dividend yield which currently stands at 13.33%. If we take dividends which fluctuate from year to year, omit a special dividend of $0.80 which was paid in 2009 and normalize them for the previous ten years, we get a normalized dividend yield of around 12% at the current price.

Now, we'll apply the zero growth dividend discount model to try and establish a fair value for Mind CTI Ltd. Taking a 12% discount rate, which is based on the long-term S&P 500 return plus the long-term inflation rate, and applying it to the current dividend yield, we get a fair value of $2.50 per share. Using the average dividend for the past ten years, we get a fair value of $2.17.

Finally, we'll look at Mind CTI Ltd.'s free cash flow yield, a metric which assumes zero growth and simply measures the firm's trailing free cash against its current market price. At the current market price, Mind CTI Ltd. has a free cash flow yield of 10.74%. If we take the average free cash flow for the previous ten years as normalized free cash flow, we get a normalized free cash flow yield of 11%

Taking all these points into consideration, it seems reasonable to assume that Mind CTI Ltd. may currently be trading in a range of reasonable, fair value. Furthermore, the company may return between 9-12% at the current price if the estimated free cash flows are achieved. Now, let's discuss how and why these estimated free cash flows could be achieved.

The Competitive Advantage of Mind CTI Ltd.

Mind CTI Ltd. has various competitive advantages outlined below.

- **Cost Advantage.** While Mind CTI Ltd. is based in Israel, its R&D, professional services, and customer support operations are all based in Romania with over 85% of its total workforce based there. This gives the company a cost advantage from lower labor costs which allow the company to outperform the Global Software & Infrastructure Industry on a number of key performance metrics which can be seen in the table below.

	Mind CTI Ltd.	Global Software & Infrastructure Industry Med. Average
ROA (ttm)	20.49%	3.19%
ROE (ttm)	27.46%	6.75%
Operating Margin (ttm)	27.97%	5.13%
Net Profit Margin (ttm)	28.31%	3.84%

- **High Switching Costs.** The implementation of Mind CTI Ltd.'s software requires its customers to have the necessary infrastructure installed. This involves a large investment of both time and resources in the form of hardware, installation costs, training, and consultation. This significant investment on the part of customers leads to high switching costs as they are less likely to switch to an alternative product given the costs they have already incurred and those which would be required to switch. This captive customer base ensures that Mind CTI can earn consistently high returns on invested capital over time. This is evidenced by the fact that Mind CTI Ltd.'s average ROIC over the past ten years is 22.63%.
- **Strong Corporate Culture.** Mind CTI was founded in 1995 by Monica Iancu who has held the position of President and CEO from inception to the present. The CEO's interests are aligned with those of shareholders since she currently owns around 17% of the shares outstanding. Management has also determined to distribute virtually all earnings to shareholders in the form of dividends which included a special dividend of $0.80 paid in 2009 after a successful legal settlement. The company had also

implemented an ongoing share buyback program but has chosen to execute it at favorable periods such as 2008-2009 when it was determined to be an effective use of capital.

Mind CTI Ltd.'s Risks

Now that Mind CTI Ltd.'s competitive advantages have been considered, let's look at some of the risk factors that could impair my assumptions of investment return.

- Mind CTI Ltd. faces competition from both local billing companies and larger global billing companies such as Oracle and Amdocs. Given that some of these companies possess greater brand recognition and financial, technical, and marketing resources, the possibility exists that Mind CTI Ltd. could be challenged for market share leading to lower revenues and earnings.
- Mind CTI Ltd.'s revenues and earnings tend to fluctuate on a quarterly and yearly basis due to the timing of orders which are dependent on the implementation of network infrastructures by third parties. This means that future predictions of operating results are difficult to forecast and there is no guarantee that analyst estimates will be met leading to volatility in the share price.
- Mind CTI Ltd.'s wireline & wireless billing and customer care products are targeted at small to medium carriers in the second and third-tier markets. As such, the company's growth is largely dependent on the continued growth of its clients who may experience competitive pressure from larger telephony carriers should a trend of consolidation emerge within the market.

Opportunity Costs

Whenever an investment is considered, one must compare it to any alternatives to weigh up the opportunity cost. At the time of writing, 10-year treasuries are yielding 2.81%. If we take inflation into account, the real return is likely to be closer to 1%. The S&P 500 Index is currently trading at a Shiller P/E of 32.8, which is 94.1% higher than the historical mean of 16.9. Assuming reversion to the mean occurs, the implied future annual return is likely to be -3%. Mind CTI Ltd., therefore, appears to offer a much better return for investors at present, but other individual stocks may be found which offer a similar return relative to the risk profile.

Macro Factors

Investors must consider macroeconomic factors that may impact economic and market performance as this could influence investment returns. At present, the S&P is priced at a Shiller P/E of 32.8. This is 94.1% higher than the historical average of 16.9 suggesting markets are at elevated levels. U.S. unemployment figures are at a 30-year low suggesting that the current business cycle is nearing its peak. U.S. private debt/GDP currently stands at 202.80% and is at its highest point since 2009 when the last financial crisis prompted private sector deleveraging.

Summary

Mind CTI Ltd. appears to be selling at a discount to its peers for a number of reasons including the lack of growth in recent years and the fluctuations present in its revenues and earnings on a yearly and quarterly basis. Investors should also be mindful that dividends paid from companies based in Israel are subject to withholding taxes which vary from country to country depending upon whether a tax treaty exists between the countries in question. At present, the withholding tax from U.S. residents in 25% and 15% for UK residents though exemptions may exist. This should be taken into account when calculated the potential yield which may be expected from this potential investment.

Over the previous ten years, Mind CTI Ltd. has returned $3.13 to its shareholders in the form of dividends which includes a special dividend of $0.80 paid in 2009. Should this dividend policy continue, investors may have the opportunity to earn a reasonable return on investment despite the issue of withholding taxes. Since the founder and CEO are also a significant shareholder owning 17% of shares, outstanding investors can be confident that management's interests should remain aligned with that of shareholders.

At present, Mind CTI carries no debt and has an equity-to-asset ratio of 0.77 including $4.23 million in cash & equivalents which equates to around 57% of assets. It also has a strong liquidity position with a current and quick ratio of 4.13 and 3.99 respectively.

In summary, Mind CTI Ltd. appears to be a financially robust company run by a capable CEO whose interests are aligned with that of shareholders. The firm currently possesses a narrow economic moat stemming from cost advantages and high switching costs which are likely to be maintained in the near-to-mid-term, but which may begin to erode if consolidation occurs within the telephony carrier market.

Investors should assume that fluctuations in revenues and earnings will continue and that volatility in share price is likely to occur given the variation in operating performance on a quarterly and yearly basis.

Based on the conservative assumptions used in the analysis of the company, Mind CTI Ltd. may return around 8.5% at the current market price.

Disclaimer: The author holds fractional ownership in Mind CTI Ltd. at the time of writing.