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WATCHLIST THE GLOBE AND MAIL

This small cap's cash flow reveals its true earning power

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DirectCash Payments Inc. currently operates more than 20,000 ATMs worldwide, in convenience stores, restaurants, airports, casinos, bars and other venues.GETTY IMAGES/ISTOCKPHOTO

Prolonged bull markets such as the present one make finding bargains exceedingly difficult for value investors. The opportunities that do exist are generally not obvious. Our recent investment in DirectCash is a case in point.

DirectCash Payments Inc. currently operates more than 20,000 ATMs worldwide, in convenience stores, restaurants, airports, casinos, bars and other venues. It is the largest non-bank branded ATM provider in Canada and Australia, and the second-largest provider in Britain. DirectCash makes a small fee on each transaction that it processes. Multiply that small fee by over 100 million transactions a year and it starts to add up.

DirectCash is exactly the type of opportunity that we look for. The business is easy to understand, earns high returns on capital employed and generates significant free cash flow.

Given the company's small market capitalization and very limited following by the analyst community, DirectCash remains largely unknown by investors. The company earned virtually nothing in 2013, according to its audited financial statements. Yet, this doesn't tell the whole story. A look at DirectCash's cash flow reveals the company's true earning power.

DirectCash's path to becoming a major international ATM player included several major acquisitions over the past few years. While it bought ATM machines, the more valuable assets acquired were the thousands of existing customer contracts. As a result, the vast majority of the assets acquired were intangible assets that are amortized over the remaining life of the contracts, typically four years. The value assigned to the contracts is written off entirely. However, DirectCast has a historical renewal rate well in excess of 90 per cent, with minimal renewal costs. Therefore, there is still value in the contracts. We believe that most of the $52-million of depreciation and amortization expense incurred in 2013 did not truly represent a real expense.

Rather than the audited number, we prefer to look at the company's owner earnings, which require the use of considerable judgment. We arrive at that figure by starting with the company's projected EBITDA and deducting maintenance capital expenditures, interest expense and cash taxes. (EBITDA represents earnings before interest, taxes, depreciation and amortization.)

We estimate that DirectCash's owner earnings will exceed $2.10 a share in 2014. With the stock currently trading at $13.26, this translates to a price to earnings ratio of about 6.3 times. Its current dividend yield is 10.4 per cent, with a payout ratio of less than 65 per cent of owner earnings.

Like any investment, DirectCash does have a few risks that we have considered and are monitoring. The company's debt levels are slightly higher than we prefer, which is directly attributable to the financing of the recent acquisitions. Its debt trades at a premium, reflecting the bondholders' confidence.

In a pinch, DirectCash could reduce its dividend and redirect cash flow to paying down debt more aggressively. We don't expect a dividend cut to happen, but it is a nice escape hatch if the need arises.

DirectCash also has a prepaid card business, from which it earns transaction fees without taking any credit risk. However, the company's largest prepaid customer, Cash Store Financial Services Inc., is experiencing severe difficulties and may soon disappear. Fortunately, prepaid cards are only about 10 per cent of gross profit, a smaller part of the company's profitability than some have speculated.

As is often the case with smaller companies, key man risk is real at DirectCash. The company's CEO, Jeff Smith, is an excellent operator and the business is heavily reliant on his talents. He is the company's largest shareholder and uses equity-based awards sparingly. Mr. Smith appears to make decisions based on long-term cash flows, not on the short-term impact to the company's accounting earnings. In other words, he thinks and acts like an owner.

If you believe that we are rapidly becoming a cashless society and ATM transaction volumes will drop off precipitously, you are better off avoiding an investment in DirectCash. For us, we are comfortable having Mr. Smith and his team as our business partners. We believe that they will continue to deliver impressive financial results. In time, the market will figure out that the stock is currently mispriced. It always does.

Michael McCloskey is the founder & president of GreensKeeper Asset Management. GreensKeeper, its affiliates, and certain accounts managed by them may hold long or short equity positions of a profiled company and may from time to time trade in these securities.