FICO (FICO)

Baird Facts

Please refer to Appendix - Important Disclosures and Analyst Certification.

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<td>2019</td>
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<td>2020E</td>
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<th>FY Sep</th>
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Company Description

Fair Isaac Corporation, or FICO, is a data/analytics company focused on predicting consumer behavior through re-sellable algorithms ("Scores"), and software. It has three reporting segments: (1) Scores, of which ~70% of revenue is generated from B2B solutions with the remaining ~30% from B2C; and, two segments that we consider "software" businesses: (2) Applications, and (3) Decision Management Software (DMS). During F'19, Applications accounted for 52% of consolidated revenue, Scores for 36%, and DMS for 12%. However, on a fully allocated basis, essentially all profitability is generated by the Scores segment, while management is choosing to operate the software business around break-even. By geography, North America accounts for ~70% of total F'19 revenue, with international revenue primarily coming from its software businesses. The company was founded by Bill Fair and Earl Isaac in 1956, and completed its IPO in 1987. It is headquartered in San Jose, CA.

Revenue Profile

FICO generates revenue from two primary businesses, its Scores segment and software operations (comprised of the Applications and Decision Management Software segments). The Scores business (~36% of 2019 consolidated revenue) provides a singular numerical score corresponding to an applicant's credit risk, using credit file data run through FICO's proprietary algorithm. Revenue is recognized as each score is generated (with the average B2B score ~$0.02 based on F'18 revenue). ~70% of segment revenue is B2B, while B2C revenue is generated through myFICO fees and scores provided on a partnering D2C platform (primarily EXPN-LON).

The software business (~64% of revenue) consists of individual applications and decisioning tools for clients to manage fraud, customer communications/management, account originations, and marketing, among other functions. Revenue is reported by transactional & maintenance (~60% of F'19 revenue), professional services (~25%) and license (~15%) revenue.
Competition
Among its Scores business, FICO primarily competes with in-house analytics departments and Vantage Scores (a joint venture between Equifax, Experian and TransUnion). However, FICO enjoys a unique role in the market as the leading provider and an industry-wide benchmark while being required for conforming mortgages in the US.

Competitors to FICO's software business are largely dependent on the applications use, with Experian, Pegasystems, Equifax, TransUnion, SAS, Adobe, and Salesforce.com competitors to its marketing applications; Experian, Equifax, TransUnion, Moody's, Meridian Link and CGI competitors for customer origination; and Experian and SAS within customer strategy. Fraud applications are further subdivided by vertical, with Experian, SAS, ACI Worldwide in financial services; Emdeon, OptumInsight, VIPS, Verscend Technologies, and IBM in healthcare; and Verisk and SAS in P&C claims fraud solutions. Among its DMS platform, IBM, Experian, SAS, Pegasystems, and Angoss are the primary competitors.

Quick Summary
Outperform rated on significant Scores pricing opportunity. Recent results were strong, aided by: (1) Scores special pricing, (2) strong mortgage origination trends, (3) lower incentive compensation accruals, and (4) ongoing share repurchases, partially offset by (1) weaker software bookings in late March, and (2) weaker non-mortgage refi consumer credit end-market trends in late March. However, FICO remains our preferred consumer credit information stock and our preferred offensive quality growth stock. Scores has exceptional unit economics with pricing power, and it has an under-earning software business. In the short term, we like that it has material positive pricing in Scores, Scores is less origination/marketing sensitive vs. bureau peers, and it continues to repurchase stock.

Our $400 price target reflects 43.3x our 2021 adj. EPS estimate. Over the last two years, FICO's NTM P/E has ranged from 23.3x-48.2x, averaging 38.5x. We assume an above average multiple given that we are valuing off of a cyclically depressed year and given that relative valuation multiples for quality growth companies like FICO have generally expanded in recent years.

Investment Thesis
Scores segment generates exceptional economics, which should be defensible/sustainable. FICO Scores serve as a benchmark "currency" in the U.S. consumer credit industry that are embedded in both industry processes and regulation, and in financial institutions' systems and workflows. We believe this uniquely attractive market position enables FICO to capture the extremely attractive economics (high margin and strong cash flow with minimal capital required to operate or grow) of a business that is essentially a math formula sold at significant scale (very high gross margin) by third-party resellers (minimal selling expense).

Scores segment under-earning despite exceptional economics today, because of underpriced solutions and appears likely to achieve strong organic growth as FICO optimizes pricing. Importantly FICO has gained pricing control and has been successfully pursuing material pricing adjustments in a transition towards value-based pricing (following an extended period with almost no pricing increases despite a materially improved market position for FICO). Given the low price and high value of FICO Scores, its market position, materially increased pricing control, and demonstrated ability to pass through material pricing increases since the beginning of C'18, we believe FICO is well positioned to continue to pass through material special pricing adjustments that should drive strong organic revenue growth with extremely high incremental margins and minimal capital required, and which should buffer natural end market cyclicality.

Software businesses under-earning because of recent aggressive investment. We view FICO’s current software business as a pretty good software business today that includes several strong franchises that support mission-critical client processes with deeply embedded software. FICO has been aggressively investing in re-architecting its software business, which has meaningfully reduced its software margins (on a fully allocated basis, FICO management is essentially choosing to operate its software business around break-even). In addition to improving its current applications, FICO has also been investing to integrate and enhance its analytical capabilities and data platform, which could materially expand FICO's addressable market. In a reasonable base case, FICO has optionality to temper aggressive software investment and materially increase software margins. In a reasonable bull case FICO can not only increase software margins but can also materially grow software revenue if its recent aggressive initiative spend in the software business successfully positions FICO as a market leader in a very large addressable market consistent with FICO's vision (broader data and analytics software provider for consumer-facing businesses).

Capital allocation, which has been focused on aggressive share repurchases in recent years, has been highly value additive. Since 2005, FICO has reduced its sharecount by 59%, as roughly 90% of cumulative FCF has been used for repurchases. We believe these repurchases have been highly value additive from an intrinsic value per share perspective, especially on a risk-adjusted basis (our most important criteria). They have also driven material adj. EPS accretion (less important to us). Going forward, the company’s ability to continue to add material shareholder value through capital deployment will be more difficult given material valuation multiple expansion that more accurately values its ability to capture its Scores re-pricing opportunity, and increased equity grants. That said, we have appreciated the company's historical discipline regarding acquisition activity and management's track record adding material value through capital allocation.

Management is strong and has been highly value additive. We believe current management deserves significant credit for improving the growth profile and potential of the Scores business through the Open Access initiative, indirect channel partnerships (most notably with Experian), and most importantly by gaining significantly greater control over Scores pricing. We also believe that they have added substantial value through capital allocation. Last, we believe the company's software strategy makes sense, appears
to be a good use of capital, and may be nearing a positive inflection, although outward signs of success have been more limited to this point (at least as measured by fairly tepid software bookings trends relative to the amount FICO has been investing in the business).

**Risks & Caveats**

**Stewardship of sensitive data.** FICO has access to, and stewardship responsibilities for, sensitive consumer data including personally identifiable information. As a result, it is subject to various regulations and could be a target for data and cyber-security attacks. It also creates potential liability from fines, lawsuits, and indemnity obligations, as well as reputation and brand risk. We also consider potential new consumer data privacy regulation and/or legislation an important risk factor, which in turn can make FICO shares subject to political and election risk.

**Solutions based on data for which FICO lacks data "control."** While FICO has stewardship responsibilities for sensitive data, its analytic solutions including FICO Scores are generally based on data that FICO does not own or "control." While we believe this is unlikely given its market position, should FICO lose access to key sources of data, including from the credit reporting agencies, it would have a highly material negative impact on its business.

**Reliance on third-party distribution.** FICO profitability is largely generated from solutions that are sold/distributed by third parties, not a direct sales force. Distribution partners include the credit reporting agencies, B2C scores "indirect" channel partners (including Experian), and payment card processors. FICO also recently entered a partnership with Equifax to sell its decisioning software in conjunction with Equifax data. While this go-to-market model is highly efficient from a selling expense as a percentage of revenue perspective, it can result in challenges selling new solutions and result in less direct interaction with its customer. It can also subject FICO to the risk of partner consolidation (including among payment card processors). Finally, this creates client concentration risk (revenue flows through partners), as does its sizable Experian DTC scores partnership.

**Macroeconomic sensitivity.** FICO revenue is primarily a "recurring transactional" model that is heavily tied to consumer credit activity including origination and marketing, especially for credit cards, which can be materially impacted by macroeconomic conditions including employment, wages, and consumer confidence.

**U.S. Department of Justice, Antitrust Division, civil investigation into potential exclusionary conduct by FICO.** The U.S. DOJ has opened a civil investigation into FICO. We lack details regarding what specific conduct DOJ plans to investigate, and given the lack of detail find it difficult to handicap the potential magnitude of this risk. However, we believe a potential adverse ruling could potentially result in fines to FICO, and the investigation could result in changes to future FICO business and pricing practices.

**Reliance on pricing increases as a key source of growth.** Since 2FQ18, FICO has been generating material revenue and profit growth through "special" pricing increases in its B2B scores business and we believe that the current stock price/valuation embeds an expectation of continued material pricing increases. While we believe that it will likely be successful realizing material future pricing increases, it may be more difficult to realize material increases in use cases where a FICO score represents a greater percentage of the transaction value or data/analytic package (relative to special pricing increases that it has realized to date in mortgage and auto). Further, even though a FICO score costs an extremely low amount, the cumulative cost can still be material for a financial institution, which could limit the amount of pricing increase that FICO is ultimately able to realize in its B2B scores business.

**Potential Scores competition, including FHFA third-party credit score model(s) final rule.** We believe that FICO has an extremely attractive market position in its Scores business, and a fairly attractive market position for its key software franchises. However, recent material pricing increases, FHFA rules to evaluate alternative score providers for conforming U.S. mortgages, and a viable competitive analytic in Vantage Score (and FICO's compelling economics) create potential competitive risks.

**Relatively weak software bookings growth considering the level of investment.** While we believe that FICO's software strategy makes sense and it should be able to control its level of spend on its software initiatives, we consider its recent bookings trends/growth to be fairly tepid relative to the amount of investment, and we expect that FICO will likely continue to aggressively invest in its software initiatives.

**Potential increased software competition including from large and well resourced software companies, especially as FICO targets the broader market of data/analytics software solutions for consumer-facing businesses, could inhibit payback on FICO's recent aggressive software investment.**

**Increasing stock-based compensation expense and widening spread between GAAP and Adj. EPS.** FICO stock-based compensation expense has increased materially in recent years and there is now a fairly wide spread between its GAAP EPS and its "Adjusted EPS." We consider stock-based compensation expense an economic cost, and believe that some investors may be overlooking the size of the recent grants and the growing add-back between GAAP EPS and adj. EPS. Coupled with an increased valuation multiple, the increased stock compensation expense will also likely serve to reduce EPS growth/accretion from repurchases, which has historically been a material driver of EPS growth.
Increasing days sales outstanding. DSO has been increasing materially over the last two years. While we consider FICO's Scores business incredibly capital efficient, the increase on a consolidated basis appears driven by its software business. One factor appears to be the adoption of ASU 2014-09 (606) and the specific requirement to recognize revenue upfront from contract minimums. Given that the cash is collected over the life of the contract, this dynamic reduces FICO's FCF conversion and results in what we consider a lower quality revenue and adj. net income relative to FICO's historical results.

Regulated industry and end markets. FICO primarily generates revenue from solutions that are sold into the financial services industry. Given that it is a heavily regulated industry, regulation and other factors that impact the financial services industry can in turn impact FICO. This dynamic can also make FICO shares subject to political and election risk.

International risk/FX rates. Approximately one-third of revenue was generated in countries other than the U.S., which subjects it to financial exchange risk, and other risks of doing business in international jurisdictions (especially for a "data" business that serves a heavily regulated industry). Further, FICO does not transparently report constant currency growth rates by business, which we believe increases the risk of investors not being fully aware of the implications of FX rates on FICO's business at times.

Long sales cycles with inherent volatility in high margin license software revenue. FICO's software solutions can have long sales and implementation cycles, which can amplify bookings and revenue volatility. Further, given that a portion of FICO's revenue is sold on a license basis which can entail upfront revenue recognition with high incremental margins, this volatility can have a particularly large impact on quarterly profitability.
1 Robert W. Baird & Co. Incorporated makes a market in the securities of FICO.

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- **Neutral (N)** - Expected to perform in line with the broader U.S. equity market over the next 12 months.
- **Underperform (U)** - Expected to underperform on a total return, risk-adjusted basis the broader U.S. equity market over the next 12 months.

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