Hidden Risk in Key Stakeholder Dependence

Daniel's Perspectives: January 21st, 2020

Not even 6 months ago, on July 19th, 2019, the share price of JSE listed software security company **ISA Holdings** hit its all-time high of R2 per share. At that price the stock market had valued it on an earnings multiple of 10½ and 3 times book value.

Over the past 15 years, ISA grew revenue at a compounded annual growth clip of 19% and earnings per share by 32%, while delivering a consistent average ungeared return on shareholders capital of 30%. In addition, uninterrupted and growing annual dividend payments had been made in every year since 2005. In 2019 it even paid a substantial special dividend and the operating profit margin at 34% was at its highest level ever.

At face value these are impressive numbers for any company in any industry.

However, neither these impressive numbers nor the annual reports or other public information sources appear to tell the full story. It is not even close.

On November 28th, 2019, the company disclosed that one of its strategic vendor partners, Check Point Software Technologies, had "*downgraded its partner status to an entry-level reseller*"

On January 16th, 2020, the company further disclosed that it generates 90% of its revenue from selling Check Point Software Technologies' products.

Quite understandably, ISA's share price has cratered.

Retracing the spoor led me to several valuable clues. Amongst other things, it points to being cautious and circumspect whenever companies are overly reliant on a key stakeholder. It is also a reminder that assessing a long track record of success without considering the risk context thereof is not smart. ISA looked brilliant for 15 years until one day out of the blue it simply ended.

From an analytic perspective it presents an interesting mental challenge as to how an investor should go about valuing any company with such an embedded material uncertainty.

Our work continues…

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