

Snapshot
Quote
Analyst Research
Morningstar Rating
Options
Data Interpreter
Valuation Ratios
Financial Statements
Key Ratios
Charts
Dividends & Returns
Company Filings new
Insider Trading
Formatted Report
Print

FactSet Research Systems, Inc. FDS

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by [Swami Shanmugasundaram](#)

Analyst Note 09-22-2010

FactSet Research Systems **FDS** closed its fiscal 2010 on a solid note with a notable uptick in all its fundamental growth drivers, including client count, user count, and annual subscription value. On an absolute basis, all three metrics registered their highest sequential gain in the past eight quarters. We are increasing our fair value estimate to account for the company's improved growth prospects.

FactSet reported fourth-quarter revenue of \$168 million, an 8% increase from the same period last year. Excluding the impact of the Market Metrics acquisition, revenue grew 6% year over year. The company benefited from the gradual rebound of employment in the financial sector and an increase in technology spending by both buy-side and sell-side clients over the past few quarters. FactSet's annual subscription value grew 6% sequentially and 10% year over year, to \$684 million. During the quarter, the company had a net addition of 35 clients, which took the total number of firms that use FactSet's products to 2,110. User count increased by 2,400, taking the total number of users to 42,800. Investment banks and asset-management firms normally bring in their new hires during FactSet's fourth quarter, which we believe is mainly responsible for this large increase in user count. During the quarter, FactSet's margin declined by 90 basis points to 34.1%. Margin compression was mainly driven by Market Metrics, which had a lower-margin profile than FactSet.

Thesis 09-22-2010

FactSet Research Systems is a leading provider of financial data to the global investment industry. The company capitalized on the demand for financial information by consolidating and distributing financial data to various end users. While the volatile market conditions that have existed over the past couple of years would portray a gloomier picture for FactSet's growth, its long-term prospects remain bright as investors' insatiable appetite for data is unlikely to diminish, in our opinion.

Although FactSet operates in the highly competitive financial information industry, it possesses a couple of distinct business advantages, which we believe should help it grow at an attractive pace and with high profitability. FactSet's business model is built on its ability to aggregate data from more than 50 third-party vendors and allows users to gain access to more than 200 databases, including its own proprietary data, through a single online platform. We believe FactSet's ability to offer simultaneous access to disparate data sources in a flexible format, which effectively lets users slice and dice the data, provides a long-term competitive advantage. It has also helped FactSet protect itself from new entrants, as it would be extremely difficult for another firm to replicate the scale and scope of FactSet's

Morningstar Rating

★★★

Stock Price

As of 09-22-2010
\$80.56

Fair Value Estimate

\$71.00

Consider Buying

\$49.70

Consider Selling

\$99.40

Fair Value Uncertainty

Medium

Economic Moat

Narrow

Stewardship Grade

C

Bulls Say

- FactSet enjoys recurring revenue from 95% of its client base. It continuously focuses on enhancing its client relationships, giving it substantial recurring revenue opportunities.
- The company's unleveraged balance sheet gives it the financial flexibility to pursue acquisitions as a means of expanding service offerings and plugging gaps in the product and service portfolio.
- Almost a third of FactSet's revenue in fiscal 2010 came from its international operations, providing a good source of diversification against a downturn in any individual economy.

Bears Say

- Although FactSet has carved a leadership position in the financial information market, it still faces significant competition from larger players (Thomson Reuters and Bloomberg) with greater resources.
- Some of FactSet's customers are still affected by the downturn in the financial services sector, potentially hindering the firm's growth

agreements with third-party content and data providers.

Because of the embedded nature of its products in clients' daily activities, FactSet's offerings have become an indispensable information source, resulting in a very sticky business. Further, as FactSet's products and services get deeply entrenched in investors' processes, they would be difficult for clients to replace, leading to high switching costs. Its annual subscriber renewal rate, in excess of 95%, is a testament to the must-have nature of its products. These high barriers to entry and switching costs have helped FactSet create a narrow economic moat around its operations, in our view.

While we feel confident about FactSet's prospects over the long term because of the strength of its business fundamentals, we remain cautious about its short-term growth opportunities, owing to the current state of the economy and financial markets. FactSet derives more than 20% of its revenue from sell-side financial institutions, and recent changes in industry dynamics could soften demand for its products. Overall, though, we continue to believe that FactSet is well positioned, with its well-respected brand name, high barriers to entry, and significant switching costs setting it up to generate a long, profitable stint as a provider of financial information.

Valuation

We are increasing our fair value estimate to \$71 per share from \$62 to account for the improvement in demand for the company's services in the past few months. As the economy has gradually recovered from the recession, FactSet has benefited from new client additions and incremental subscriptions from existing clients. The company also witnessed steady growth in its subscription fundamentals, which include annual subscription value, client count, and user count. We expect these trends to continue. As a result, we now forecast revenue to grow at a compound annual rate of 10% over the next five years. Over the past five years, revenue increased steadily at a compound annual rate of 15%. Additionally, through effective cost control and from increased use of proprietary data content, FactSet continues to maintain its strong operating performance. Given the operating leverage in the business model, we believe margin expansion is sustainable in the long run. We project operating margins to expand from the 34.5% reported in fiscal 2010 to 35.5% by 2014. This compares with the company's historical average of 33% over the past five years.

Risk

The greatest risk facing our fair value estimate is FactSet's ability to maintain its growth rate amid a sustained economic slump that could affect the company's core client base in the financial services sector. Turmoil in the financial services industry has forced some Wall Street firms to trim their staffing needs, and this could hurt demand for FactSet's products. The company could also be affected by consolidation among banks and other financial service organizations.

prospects.

- FactSet derives about a third of its revenue through soft-dollar arrangements with investment managers. Increased regulatory scrutiny of this form of payment could have a detrimental impact on FactSet's business.

Close Competitors	TTM Sales \$Mil	Market Cap \$Mil
FactSet Research Systems, Inc.	628	3,797
BLOOMBERG:USA	NA	NA
* Thomson Reuters Corporation	12,929	32,023

* Morningstar Analyst Report Available

Data as of 06-30-10

Strategy

Unavailable

Management & Stewardship

Chairman and CEO Philip A. Hadley has been at the helm since 2000. A company veteran of more than 20 years, Hadley has held several executive positions, including vice president of sales, senior vice president, and director of marketing and sales. Most of the company's senior management team consists of insiders with long employment tenures. We view this depth and record as positive attributes. Directors and executives collectively own around 3.9% of FactSet's outstanding shares. This excludes the 5.8% stake held by cofounder and director Charles J. Snyder. In our opinion, this should be a sufficient enough stake to align their interests with other shareholders'. We do, however, have some issues with FactSet's governance and stewardship policies. We'd like to see Hadley's roles of chairman and CEO split between two individuals, and we believe FactSet's staggered board elections are not in the best interests of shareholders. We also think that FactSet's disclosure regarding how bonuses are determined could be more insightful.

Profile

FactSet is a leading provider of financial and economic information to the global investment industry. The company collates data related to tens of thousands of companies from stock exchanges, research firms, and other data providers and then reformats the data and furnishes it to money managers, research analysts, and other financial professionals. It serves a sizable base of about 42,000 users at more than 2,100 firms. FactSet's strategy is to expand its portfolio of products and services through in-house developments and acquisitions.

Growth

Profitability

Financial Health

FactSet's balance sheet is very healthy. The company has no debt and more than \$195 million of cash sitting on its balance sheet. Its ability to generate strong cash flow should keep the company unleveraged.

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