2015 MBA SMF ANALYSIS REPORT

University of Connecticut
MBA Student Managed Fund

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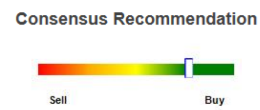
DST Systems Inc. is an American software development firm that specializes in information processing and management. It is the Leading provider of technology, strategic advisory and business processing solutions.

Summary

We issued a "BUY" recommendation to DST with a target price of USD 142 on Oct 18th, 2014.

Significant market position. DST holds significant market positions in the markets in which it serves.



A powerful business model. DST has a strong portfolio of businesses and strong client relationships which are providing stable diversified revenue streams.

Favorable industry trends. DST sees a lot of opportunities to grow in its all business areas, benefiting from the favorable industry trends.

Major Risks: 1) Customer concentration, 2) Dependence on the US, and 3) Competitive pressures.

Company Profile

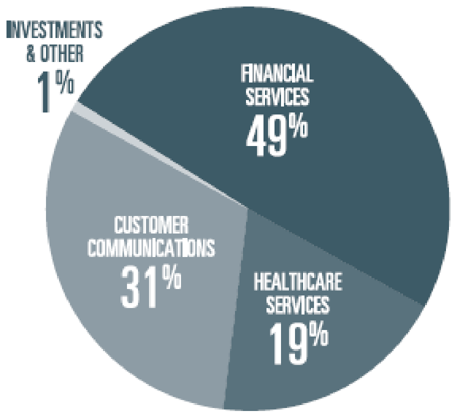
DST Systems, Inc. (NYSE:DST) provides information processing solutions and services to support the global asset management, insurance, retirement, brokerage, and healthcare industries. DST also provides integrated print and electronic statement and billing solutions through DST Output. Its data centers provide technology infrastructure support for financial services and healthcare companies throughout the world.

- Deep penetration in key verticals
  - Financial Services
    - Mutual funds
    - Brokerage
    - Retirement
  - Healthcare Services
    - Medical claims processing
    - Pharmacy claims processing
    - Care management
- Global leader in Customer Communications

The company operates in three reportable segments: Financial Services segment, Customer Communications segment and Healthcare Services Segment. Investments in its real estate subsidiaries and affiliates, equity securities, private equity investments and certain financial interests are aggregated into the Investments and Other segment. The company, together with its subsidiaries and joint venture affiliates, operates in North America, Europe, Africa and Middle East, and Asia-Pacific. DST is headquartered in Kansas, the US.

Business Summary

The company's operations are divided into three major business lines.



Financial Services segment: DST provides investor and asset distribution services to companies within the Financial Services industry.

In the U.S., DST provides services to mutual funds, brokerage firms, retirement plans and alternative investment funds (such as real estate investment trusts "REITs"). In Australia and the U.K., DST licenses software solutions to funds and fund managers.

Healthcare Services segment: uses DST's proprietary software applications to provide healthcare organizations a variety of medical and pharmacy benefit solutions to satisfy their information processing, quality of care, cost management and payment integrity needs. DST healthcare solutions include claims adjudication, benefit management, care management, business intelligence and other ancillary services.

Customer Communications segment: DST offers a full range of integrated print, mail, and electronic solutions to companies in the U.S., Canada and the U.K.

Favorable Industry Trends

DST has an attractive Business model, benefiting from the favorable industry trends. It sees a lot of opportunities to grow in its all business areas:

Demographic trends catalyze the demand for healthcare services

The aging population in the US may result in increased healthcare needs and claims processing volumes. Moreover, the older population is much more likely to have health insurance coverage than younger counterparts.

The older population is growing in the US. The demographic trends represent that the population above 65 increasing at a rapid rate between the 10 year period from 2010 and 2020. In 2010, 25.2 million are in the age group of 60-65 and is expected to reach 40 million by the end of 2020. Further the trends shows that the population of 85 and above in the US to reach 16.9 million from 11.8 million.
Moreover, the older population is much more likely to have health insurance coverage than younger counterparts. According to industry estimates, the uninsured rate was approximately 2.2% in the population from 65 and above. Comparatively, the uninsured rate is approximately 16.3% and 26.6% in individuals between the age groups 35-64 and 26-34 years, respectively, as of January 2014.

Trends	Opportunities
Retirement Wave	• 10,000 retirees every day through 2030 • Retirees and near-retirees control vast majority of investable assets
Retirement Savings Adequacy Gap	• Generations X and Y need to increase retirement savings
Changing U.S. Retirement System	• Fundamental change in how corporate defined benefit (DB) plans are managed • Increased reliance on defined contribution (DC) plans
Longevity	• A 65 year-old has a 26% chance of living to 90, and an 11% chance of living to 100

Source: Prudential Financial Investor Presentation, Jun 18, 2013

To better capitalize on the favorable trend in the healthcare industry, its Healthcare Services segment was separated from other business 2 years ago. Now, **i**t is seeing a double-digit growth in operating revenues as demand expands for healthcare solutions and services. Its operating revenues increased 12.4% year over year. The improvement was mainly due to higher pharmacy claims and increase in Medicare and Medicaid members, expansion of existing clients and new pharmacy discount card services.

Growth in the defined contribution market
The defined contribution market provides significant growth opportunity for DST's services and products. The defined contribution market continues to experience significant expansion as more employers shift away from defined benefit programs and the federal government has policies that encourage the same. According to industry estimates, the defined contribution market is expected to double by 2015, to reach roughly $7.5 trillion to $8.5 trillion in assets under management. Moreover, defined contribution is forecasted to become three times larger than the market for private defined benefit pensions. Furthermore, the retirement industry aims to expand coverage to include more Americans who currently are not a part of any retirement savings program. The potential participation is likely to increase further as retirement plan sponsors adopt auto enrollment and guaranteed income features for new employees. Growing end market will positively contribute the company’s growth in coming years.

Mutual fund industry provides growth prospects
Investor attraction to a wide array of mutual fund investment products with increasingly specialized features has increased the number of mutual fund shareowner accounts, the volume of transactions and the complexity of recordkeeping. In addition, new technologies have changed the service requirements and distribution channels of the mutual fund market.
DST made significant investments in computer capacities and systems functionality to handle the increasing marketplace demands in order to maintain its market position. Furthermore, the company aims at tapping into the international markets. As the mutual fund investing continues to take root abroad, the company will benefit due to its presence in other regions like the UK, Australia and Asia. These trends will enable DST to drive top line growth from the core mutual fund clients.

Leadership Positon and Strengths

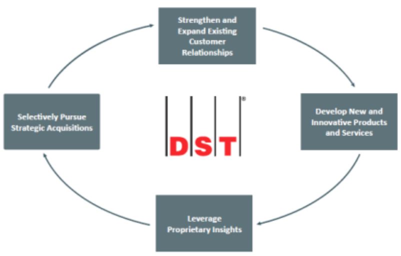
The company holds a significant market position in the markets in which it serves.

- The largest third-party provider of mutual fund shareholder recordkeeping services in both the US and the UK.
- The leading provider of defined contribution recordkeeping services

DST’s TRAC retirement solution is the second largest defined recordkeeping platform on the market. Similarly, its Vision and Vision HomeOffice solutions are the most widely used web-based account aggregation sources for advisors and broker-dealers. Moreover, DST offers the second largest sub-accounting platform. In addition, DST is the one of the largest first-class mailers in the US and has the world's largest inkjet systems printer.

The company's strong market position indicates the appeal that its products and services enjoy within the segments it operates in. The company's broad product portfolio enables it to cater to varied requirements of its customers. This market presence will create favorable competitive environment fueling DST's ability to invest and defend market position.

Powerful Business Model (support the leadership position)



Strong portfolio of businesses and Diversified Revenue Streams

DST has a strong portfolio of businesses, offering various range of services. The company includes the operations of Argus, Boston Financial Data Services, DST Health Solutions (DSTHS), DST Output, DST Realty, DST Retirement Solutions, DST TASS, International Financial Data Services, MC Realty Group.

All these businesses enable the company to offer various services including investment medical processing solutions, management and business process management software solutions, integrated print and electronic statement and billing output solutions, facilities management services, retirement plan servicing options, and real estate development and property management services. So, DST is well diversified in terms of its revenue generation through various industries that it serves.

In addition, a strong portfolio of businesses enhances the company’s image and supports its topline growth. So, DST has earned a reputation as an industry leader in providing integrated solutions and delivering quality service to its clients.

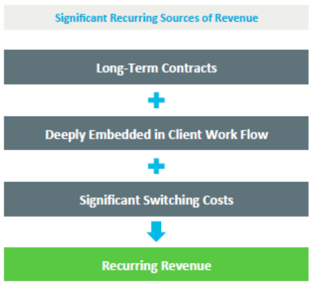
Flexible Service Options

In today's environment, investment management companies are making dynamic strategy shifts that require implementation timelines. Offering a flexible service model is critical to supporting the strategies of DST’s clients. Because DST's broad client base represents a range of product and distribution strategies, DST has experience in supporting a large variety of technology and service requirements. DST’s systems and staff are ready to handle a wide range of recordkeeping or servicing scenarios without disruption or lengthy development.

Commitment to investment
Service flexibility, automation and integrated technology are all possible when the service provider retains its core focus on technology and operations. DST has a track record of driving technology and process standards, and continues to invest in new development, even during challenging times.

Strong client relationships provide stable revenue streams

DST's revenue stream is stable and has visibility owing to the strong client relationships that the company enjoys. The company being a market leader in several segments caters to large companies. The company’s customer base includes world’s largest healthcare and financial services companies.



For instance, the company provides insurance-related services to 23 of the top 25 US life insurance carriers. Large companies enjoy strong end markets and thereby DST has access to a customer base with stable market positions. Large companies are also risk averse and do not switch vendors. Additionally they look for consolidation of vendors exposing DST to significant cross selling opportunities. DST effectively cross sold its offering to the clients. Most of DST's customers have been with the company for more than five years. Longevity of client relationships provides DST with a strong recurring revenue base and good revenue visibility.

DST enjoys high loyalty from these clients.

Most of DST's revenues is derived from long term clients and is recurring in nature.
The average length of the customer relationships includes 30 years for top five financial service companies, 21 years for top five healthcare companies, and 13 years for top five customer communication companies. Such revenue streams provide stability and visibility to the growth prospects. Furthermore, the company's service offerings are core to a mutual fund company. Due to this, switching to another service provider will lead to potential disruption of services and also will lead to higher costs.

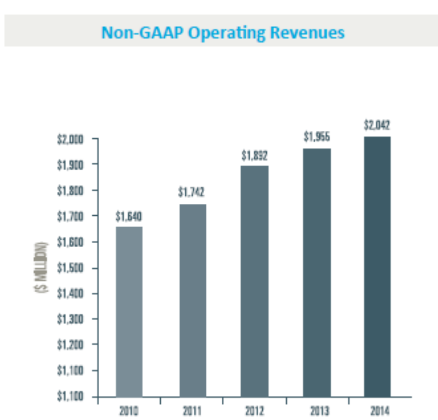
Recent Price Trend

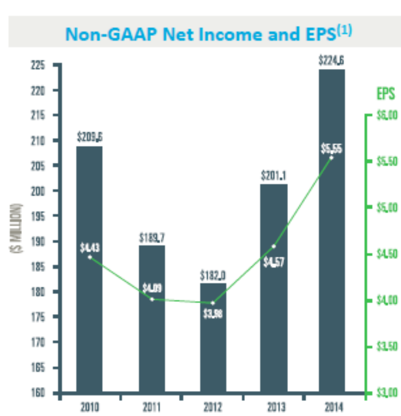
In the past 5 months, we have seen two big jumps in its stock price, following consecutive better-than-expected quarterly results.

The favorable industry trends, its powerful business model and its leadership position have been supporting its financial performance, and eventually supports its stock price.

These are also our investment thesis on DST.

Historical Financial Performance





Latest Financial Performance

Last year, higher client additions and favorable market conditions as well as growth at ALPS, Retirement Solutions and DST Brokerage Solutions drove its revenues.

Key Financial Highlights (on a non---GAAP basis)
• Consolidated operating revenues (excluding out of pocket Reimbursements) increased $87.4 million or 4.5% compared to 2013
• Consolidated income from operations increased $12.3 million or 3.9% vs. 2013
• Diluted EPS increased $0.98 or 21.4% from 2013
• Weighted average diluted shares outstanding for 2014 decreased by 3.6 million shares or 8.2% from 2013 to 40.5 million

Non-GAAP Financial Results	Year ended December 31, 2014	2013
Operating Revenues	$2,042.0	$1,954.6
Y-o-Y Growth	*4.5%*	
Operating Income	$328.2	$315.9
Y-o-Y Growth	*3.9%*	
Diluted EPS	$5.55	$4.57
Y-o-Y Growth	*21.4%*	
Segment Details		
Financial Services Operating Revenues	$1,054.2	$998.3
Y-o-Y Growth	*5.6%*	
Operating Margin	*19.8%*	*20.9%*
Healthcare Services Operating Revenues	$382.2	$333.3
Y-o-Y Growth	*14.7%*	
Operating Margin	*14.9%*	*15.7%*
Customer Communications Operating Revenues	$650.5	$660.5
Y-o-Y Decline	*(1.5%)*	
Operating Margin	*8.8%*	*7.6%*

Consolidated total revenues (including out-of-pocket (“OOP”) reimbursements) increased $90.7 million or 3.4% during the year ended December 31, 2014 as compared to December 31, 2013 (3.2% 2013 vs. 2012).

The operating revenue growth in 2014 compared to 2013 was primarily attributable to increased operating revenues in the Financial Services and Healthcare Services segments, partially offset by a slight decline in operating revenues in the Customer Communications segment.

Financial Services segment total revenues for the year ended December 31, 2014 were $1,105.7 million, an increase of $57.0 million or 5.4% as compared to 2013. Financial Services segment operating revenues of $1,054.2 million reflect an increase of $55.9 million or 5.6% in 2014 as compared to 2013.

Healthcare Services segment total revenues of $389.0 million during the year ended December 31, 2014 reflect an increase of $49.5 million or 14.6% as compared to 2013. Healthcare Services segment operating revenues of $382.2 million reflect an increase of $48.9 million or 14.7% in 2014 compared to 2013.

Customer Communications segment total revenues were $1,309.6 million and $1,315.2 million for the years ended December 31, 2014 and 2013, respectively. Operating revenues decreased $10.0 million or 1.5% to $650.5 million for the year ended December 31, 2014 as compared to 2013.

Intrinsic Value Analysis (Please see Appendix A)

1. Basic assumptions:
We assume the 10 yr. US Treasury rate of 2.42% to be the risk free rate with the risk premium of 7.26% , DST’s beta is 0.95, leading to a cost of equity of 9.3% and a WACC of 8.72% .
2. Historic Growth Rates:
We calculated historical growth rate of from different perspectives over the last ten years. And we got an average historical growth rate of 11.86%. We also calculated future expected growth rate by multiplying ROE by Retention rate. We got a rate of 15%.

3. Intrinsic value calculation:
Based on DST's business model and current market, we think a conservative projected growth rate in next 5 years would be 8%. According to the global and the US economic trends, we projected that the long term stable growth rate would be 4%. We collected free cash flow data from the value line. The free cash flow (free cash flow per share – Capex per share) belongs to the equity holders. By using DCF model, we got the intrinsic value per share: $139.

At the same time, we used the free cash flow data from Bloomberg, which is the free cash flow for the whole company. Then we got the intrinsic value per share: $92 by using WACC as the discount rate. The average of above two results is $115.5.

We also performed a sensitivity analysis (Please see Appendix A) to see the range of intrinsic values While the projected growth rates were changed. So, the intrinsic value should be between $104 and $143, given current economic situation. The median value is $121, which is close to $115.5. So, considering the DST's lower-than-average PE and PEG, DST is undervalued.

The price of DST was $89.83 on Oct 27, 2014. Now it is $ 113.46 (April 6, 2015).

Corporate Social Responsibility

DST states, "As a responsible business we believe that the long-term future of the business is best served by respecting the interests of all our stakeholders: employees, customers, suppliers and the wider community. We look actively for opportunities to improve the environment and to contribute to the wellbeing of the communities in which we operate ". DST has an above average ESG score.

Risk Factors

Customer concentration
DST's revenues are highly concentrated. The financial services segment's five largest customers accounted for 29.7% of segment operating revenues in FY2014, including 10.4% from its largest customer. Similarly, the healthcare services segment's five largest clients accounted for 49.3% of segment operating revenues in FY2014, including 17.1% from its largest client. The customer communications segment's five largest clients accounted for 21.5% of segment operating revenues in FY2014, including 10.2% from its largest client. The company's huge dependence on few customers makes it vulnerable to the dynamics of the customer's business and affects its sales. High dependence on few customers also reduces the bargaining power of the company.

Dependence on the US for major portion of revenues
The company depends on the US for majority of its revenues. Though the company has presence across the UK, Canada and other countries, it derives approximately 82.5% of its revenues from the US. It derives only 17.5% of its revenues from the other geographic locations. The company's high dependence on the Americas and the US in particular makes its operations vulnerable to fluctuations in the US economy and restricts its growth opportunities.

Competitive pressures may affect market share
The company operates in a highly competitive environment. DST faces competition from established service providers in all industries it serves. The company's primary competitors include Communisis, EMC, First Data, Fiserv, GE Healthcare, Hewlett-Packard and International Business Machines.

Some of these competitors are able to bundle service offerings and offer more appealing pricing structures. Some of the company’s clients may develop in-house capacity to perform the transaction processing, recordkeeping and output services which further reduces the demand for company’s products and services. Additionally, some of its competitors and clients have greater financial and human resources and access to capital than DST. Competition could also affect the revenue mix of services it provides, resulting in decreased revenues in lines of business with higher profit margins. Competitive pressures due to any of the above mentioned reasons may severely impact the company’s revenues in the coming years.

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Appendix A

1. DCF Model analysis:

$ In millions

Method 1		**Data: Valueline**	
Beta	0.95	Long term growth rate	8%
Risk-free rate	2.42%	Long term growth rate	4%
Equity risk premium	7.26%	Free Cash Flow (t+1) per share	6.42
Cost of Equity	9.30%	Terminal Value per share	171.76
		Present Value of Terminal Value	113.1
		Intrinsic Value	$139
Method 2		**Data: Bloomberg**	
Cost of Debt	6.47%	Long term growth rate	8%
Tax Rate	37%	Long term growth rate	4%
Mkt Cap	3,600	Free Cash Flow (t+1)	169
Long term debt	464	Terminal Value	5,071
E/EV	88.58%	Present Value of Terminal Value	3,340
D/EV	11.42%	Enterprise Value	4,107
WACC	8.72%	Equity Value	3,643
		Shares Outstanding	39.7
		Intrinsic Value	$92

2. Growth Rate analysis

Sensitivity analysis of Method 1

Long term growth rate	2%	3%	4%	5%
Short term growth rate	Intrinsic value per share			
10%	114	129	148	177
9%	110	125	143	171
8%	107	121	139	166
7%	104	117	134	160
6%	101	113	130	155

Appendix B

Consolidated Balance Sheet
(Dollars in millions, except per share amounts)

	December 31, 2014	December 31, 2013
ASSETS		
Current assets		
Cash and cash equivalents	$ 151.7	$ 62.5
Funds held on behalf of clients	356.2	316.3
Client funding receivable	43.4	50.2
Accounts receivable (includes related party receivables of $19.7 and $14.6)	349.6	343.4
Other assets	71.0	70.0
	971.9	842.4
Investments	656.6	881.3
Unconsolidated affiliates	298.7	288.1
Properties, net	403.6	445.2
Intangible assets, net	122.5	137.4
Goodwill	414.7	423.7
Other assets	74.9	72.4
Total assets	$ 2,942.9	$ 3,090.5
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities		
Current portion of debt	$ 167.3	$ 283.6
Client funds obligations	399.6	366.5
Accounts payable	101.8	86.7
Accrued compensation and benefits	168.0	154.3
Deferred revenues and gains	53.9	71.6
Income taxes payable	17.6	—
Other liabilities	113.7	110.1
	1,021.9	1,072.8
Long-term debt	385.6	399.4
Income taxes payable	80.1	124.2
Deferred income taxes	186.4	255.4
Other liabilities	32.5	54.9
Total liabilities	1,706.5	1,906.7
Commitments and contingencies (Note 16)	—	—
Stockholders' equity		
Preferred stock, $0.01 par, 10 million shares authorized and unissued	—	—
Common stock, $0.01 par, 400 million shares authorized, 50.0 million shares and 95.3 million shares issued, respectively	0.5	1.0
Additional paid-in capital	114.4	187.3
Retained earnings	1,682.9	3,777.7
Treasury stock, at cost	(748.3)	(3,090.4)
Accumulated other comprehensive income	186.9	308.2
Total stockholders' equity	1,236.4	1,183.8
Total liabilities and stockholders' equity	$ 2,942.9	$ 3,090.5

Appendix C

Consolidated Statement of Income
(In millions, except per share amounts)

	Year Ended December 31,		
	2014	2013	2012
Operating revenues	$ 2,042.0	$ 1,960.6	$ 1,892.4
Out-of-pocket reimbursements	707.3	698.0	684.2
Total revenues (includes related party revenues of $195.3, $200.7 and $201.8)	2,749.3	2,658.6	2,576.6
Costs and expenses	2,309.4	2,202.1	2,202.9
Depreciation and amortization (including goodwill impairment)	131.0	143.3	216.4
Income from operations	308.9	313.2	157.3
Interest expense	(26.6)	(34.5)	(43.5)
Gain on sale of business	100.5	—	—
Other income, net	373.5	243.2	373.5
Equity in earnings of unconsolidated affiliates	35.4	23.0	32.2
Income before income taxes	791.7	544.9	519.5
Income taxes	198.4	192.3	195.5
Net income	$ 593.3	$ 352.6	$ 324.0
Weighted average common shares outstanding	40.0	43.2	44.9
Weighted average diluted shares outstanding	40.5	44.1	45.8
Basic earnings per share	$ 14.82	$ 8.15	$ 7.22
Diluted earnings per share	$ 14.66	$ 8.00	$ 7.08
Cash dividends per share of common stock	$ 1.20	$ 1.20	$ 0.80

Appendix D

	Year Ended December 31,		
	2014	2013	2012
Cash flows—operating activities:			
Net income	$ 593.3	$ 352.6	$ 324.0
Depreciation and amortization (including goodwill impairment)	131.0	143.3	216.4
Net gains on investments	(281.8)	(195.2)	(280.7)
Gains on sale of properties and businesses	(101.6)	(5.4)	(2.8)
Amortization of share-based compensation	21.0	16.9	25.5
Equity in earnings of unconsolidated affiliates	(35.4)	(23.0)	(32.2)
Cash dividends from unconsolidated affiliates	1.8	129.4	4.5
Gain on contract to repurchase common stock	(18.1)	—	—
Deferred income taxes	2.4	(10.9)	(11.0)
Changes in accounts receivable	(18.0)	15.8	(34.1)
Changes in other assets	2.6	(7.9)	(24.3)
Changes in client funds obligations	(6.9)	6.4	1.2
Changes in client funding receivable	6.9	(6.4)	(1.2)
Changes in accounts payable and accrued liabilities	16.0	(20.7)	(14.5)
Changes in income taxes payable	(23.2)	(12.8)	56.0
Changes in deferred revenues and gains	(1.9)	4.1	(33.7)
Changes in accrued compensation and benefits	10.2	6.3	16.5
Other, net	14.2	2.7	6.4
Net cash provided from operating activities	312.5	395.2	216.0
Cash flows—investing activities:			
Capital expenditures	(113.4)	(102.8)	(98.0)
Investments in securities	(76.4)	(105.5)	(302.5)
Proceeds from sale / maturities of investments	419.4	438.4	683.8
Net decrease (increase) in restricted cash and cash equivalents held to satisfy client funds obligations	(44.9)	71.5	(126.9)
Proceeds from sale of properties	32.6	14.0	15.7
Proceeds from sale of business, net of $8.1 million of cash and cash equivalents sold	77.4	—	—
Other	10.0	(5.5)	5.6
Net cash provided from investing activities	304.7	310.1	177.7
Cash flows—financing activities:			
Proceeds from issuance of common stock	13.0	30.6	61.9
Principal payments on debt	(133.5)	(126.5)	(19.5)
Repurchases of convertible debentures	—	(122.8)	—
Net proceeds (repayments) - accounts receivable securitization program	(30.0)	15.0	—
Net increase (decrease) in client funds obligations	39.9	(82.6)	126.2
Payment for acquisition of non-controlling interest	—	—	(17.7)
Net borrowings (repayments) on revolving credit facilities	33.9	(127.7)	(361.6)
Common stock repurchased	(406.4)	(276.4)	(104.5)
Payment of cash dividends	(47.6)	(51.8)	(36.0)
Excess tax benefits from share based compensation	6.1	11.4	5.5
Other	(3.4)	(0.3)	(0.6)
Net cash used for financing activities	(528.0)	(731.1)	(346.3)
Net increase (decrease) in cash and cash equivalents	89.2	(25.8)	47.4
Cash and cash equivalents, beginning of year	62.5	88.3	40.9
Cash and cash equivalents, end of year	$ 151.7	$ 62.5	$ 88.3