

## BSG Billing Services Group

**The cash is rolling in (and soon will, for the shareholders too)**

- BSG is a complex, but highly attractive cash cow. The figures for 2008 could come out a touch better than expected.
- The CFO has used the recent temporary sell-off to increase his stake to more than 5%.
- With an estimated 2009 p/e of 4.6 and an estimated 2009 EV/EBITDA multiple of 3.4, the share has a low downside risk combined with potential to double during 2009. It seems likely that the company will either be subject to a bid, or start an aggressive dividend payment policy to return some of the excess cash to shareholders (either every quarter or in the shape of yet another substantial special dividend).

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## Why invest into bonds, savings accounts or life insurances – when the equity markets offer opportunities like this?

Dear Reader,

As they saying goes, there is no such thing as a free lunch.

However, some investments do come pretty close to being just that. The problem is, that no matter how sophisticated and accurate an analysis worked out, it usually takes a while before the market catches onto it.

A share might be incredibly cheap and a screaming buy. Yet, if you have a stock market crash, a banking crisis, terrorist attacks or a major election taking place (or all of the above), any company's share price can temporarily get thrown off its course, no matter how good the underlying fundamentals are.

On the stock market, the way from A to B is hardly ever a straight line. A cheap share does not start rising magically just because it's cheap, only to reach exactly its fair value a few weeks later. Instead, it goes up a bit, down a bit, it scratches an old low and flirts with a new high – with trading volumes increasing at times when you wouldn't expect and decreasing at times when you wouldn't expect that either.

It's always been like that, and anyone who is reading this is likely to have experienced it already. In the short-term, the market behaves quite irrationally most of the time!

That's why, as you probably already know, trying to make sense of daily, weekly and monthly fluctuations largely tends to be a waste of time. What's more, it might even be quite dangerous. Once you read too much into every up-tick and down-tick of a share price, chances are that you'll eventually end up making an entirely wrong decision based on emotions rather than facts.

When a share then eventually hits the target that you had always expected, you'll be kicking yourself for having allowed the market noise to distract and mislead you into selling, when as a matter of fact, you should have bought (or, bought more if you were already invested).

### Don't let short-term fluctuations distract you from a company's fundamentals

Judging from the share price movements, the company that this report is all about must have had a hell of a year in 2008. During the course of the last year, the share price fluctuated in a range between 7 Pence and 15.26 Pence.



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In early 2008, the share price hit 15.26 Pence (shortly after a special dividend of 20 Pence per share had been paid). Those who watched this relatively obscure London-listed smallcap share seemed to have their positive expectations confirmed. With the share price doing that well, the idea that the company was doing just fine and that it would eventually be taken over seemed all too credible.

Fast forward 10 months, when the share price had fallen to just 7 Pence. By then, most observers must have had grave doubts about the company's operative business and the prospect of it being taken over – purely because of the share price having fallen by 50% compared to the much higher price of 15.26 Pence. These fears started to creep into the market as soon as the share price fell towards 10 Pence. When the share broke through the 10 Pence barrier, I received lots of emails from investors who were worried about “the entire thing falling apart”. Nothing in particular had peaked their fear, but the share price's movement and the fear that “someone must know more than we do” caused a lot of worry.

Fear begets fear, and thus a downward spiral is born. Investors started to panic and more shares were put up for sale. The price fell to a low of 7 Pence on 5th December 2008. Nota bene, that the company had not made a single negative announcement during that time. It had halved in value without any reason being visible.

And after a few quiet months, the emails were rolling in again last Wednesday! The share price had just risen 23% in a single day, and once more people were wondering “if someone knows more than we do?”

Well, someone does.

And that someone recently upped his stake to more than 5%, based on information that is indeed deeper and better than the information that any one of us has access to. But more on that later. First, let's look at another crucial aspect of investing in general, and in this gem of a company in particular.

### **Why finding an undervalued share is only half the job**

Finding an undervalued share, analyzing it and buying into it, is only one half of the equation. The other, often even harder bit, is to eventually find a way to sell it at the price at which it should have been trading all along.

Seasoned investors know what a “catalyst” is. In the investment world, the term refers to an event that leads to a particular, concrete development. Say you had a share that was trading for 10, but which in reality should be worth 30 because the company has assets that were worth much more than what was reflected in the share price.

A catalyst is an event that makes this share rise, usually quite quickly. This could be a bid by another company that has realized that if it bid 20 it would get most existing shareholders to sell out (because they are making a 100% gain compared to the most recent price) and at the same time it would still get a good deal (because it buys the assets one third below their actual value).

Ideally, when you buy into an undervalued company you should already have an idea what the eventual catalyst will be. Else, you might get stuck in a so-called “value trap”. A share that is cheap might stay cheap forever, if there is no particular event that changes the valuation. Owning a cheap share that is lacking a catalyst that leads to a higher valuation, can be extremely frustrating. You might have gone to great lengths to analyse and understand the undervaluation of the share, but it's of no use because nothing happens that changes the valuation.

Finding an undervalued share with a catalyst already visible on the horizon, is much more difficult than just finding an undervalued share. You need to find a share that fulfils not just one criterion, but two.

But it's finding a share with several potential catalysts, that is the true crowning glory of an analyst's work. That way, if one catalyst doesn't materialize, you are left with another option for how to realize the company's higher intrinsic value.

Can you still follow?

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The next few paragraphs will make it all a bit clearer, using BSG as a concrete example.

### **No one is always right – which is why having a safety net is key**

To be perfectly honest, BSG is one of those cases where my original expectation for the most likely catalyst has not (yet) worked out. I never featured the share on this website, but I published a few articles about it in Germany.

Those who followed the original story will know, that I placed a bet on someone taking over BSG sooner rather than later. I had identified a number of potential strategic buyers, i.e. buyers from a similar industry that wanted to expand into the area that BSG is working in. Also, BSG represented a good opportunity for a pure financial investor who was looking to buy a business with a solid operation and spectacular cashflow – for a rock-bottom valuation!

Neither option materialized, at least not so far.

Despite all my careful analysis, the market did what it does so often. Some outside event distracted it, which in this case was the worst banking crisis of the past 100 years.

Private equity buyers all of a sudden had all sorts of other issues to deal with, and potential strategic buyers refocused their efforts on their existing operative businesses and how to secure them in a deteriorating economic environment.

All of a sudden, everyone was too busy, too distracted or too hard-up to be interested in making a bid for BSG. Thus, BSG stayed free and single for much longer than I would have expected this to be the case. Plus, the share price came under pressure because just about every stock market on earth tanked and investors started to panic.

The good thing is that in the long run, fundamentals do prevail. Every attractive bride gets married off eventually. In the case of BSG, the bride even looks a bit better with every passing day.

### **A short primer on what BSG is earning its money with**

With BSG, one of the challenges for an investment journalist like myself has always been, that the business is quite difficult to explain.

You can't see the service that BSG is offering. You can't touch their product. And hardly anyone outside this particular industry even knows that such a service is offered by anyone, anywhere. Yet, it's actually a service that touches more than a hundred million people.

Who ever wondered how telephone companies carry out their billing?

To me, it's always been a mystery how a telephone company can send me an itemized bill for each and every phone call I have ever made. And indeed, there seems to be more work behind the billing for telephony services, than is visible to us telephone end-users.

As a matter of fact, handling the billing for telephony services is so complex and laborious a process, that even a large number of telecom companies would rather not do it themselves.

They outsource the entire billing affair, and that's where BSG comes into the fold.

BSG is the United States' leading service provider for telecom companies that outsource their billing. Hence the name, Billing Services Group. It's an invisible service, because end-users practically never even get to know that certain parts of their telephone bills originate not from their telecom company, but from BSG.

Within this niche industry, BSG is the 800-pound gorilla. Of all the outsourced telecom billing in the United States, BSG has captured a market share of 90%. There are only two competitors worth mentioning. It's as near to a monopoly business, as you can get.

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Is it a boring business?

You bet. At least, I never fancied looking into the finer technical details of it all. I tried to, but I fell asleep while doing it. And luckily, I didn't really have to investigate how the IT systems of BSG work and what software they are using. Having been in regular personal contact with BSG's management team, I know that this business is in very safe, capable hands. Their management team in San Antonio, Texas, is superb.

What I instead focussed on, is analyzing the figures behind the operation.

And that's where it became truly interesting.

### **A business with a huge moat around it**

BSG is one of those businesses that are extremely difficult to set up. But once everything is up and running, you own a business that consistently throws off lots of excess cash and requires very little additional investment.

As a somewhat simplistic, but suitable example: BSG needs a massive IT system to handle the billing process. But to add a new client does not require another IT system, rather it is added to the existing system and merely adds some admin cost for setting up another client (such as the legal costs for the extremely complex contracts, which in some cases can run as high as \$1m).

On top of that it's also a business with extremely high barriers to entry. Setting up a competitor to BSG is virtually impossible, because this business has large economies of scale, and anyone setting this up afresh could never even remotely compete with BSG's size.

BSG might be a company with a business that hardly anyone understands, but it is without doubt a great business to be in. The figures further down will show you why, and they will also make it clear why BSG is actually profiting from the current financial crisis.

But before we delve into that, let me first answer the most obvious, and most often asked question that anyone who has read as far as this must have on his (or her) mind.

Aren't landline phone calls a dying breed?

### **The first of two facts that are going to surprise you**

People are switching to mobile phones and (more recently) to free Internet-based telephone systems like Skype. What's more, communicating by email has replaced quite a few phone conversations.

This has led to the number of landline phone calls in the US declining gradually. It's hard to come by audited industry figures, but the industry has probably been shrinking by between 3% and 5% p.a. during the past couple of years.

So isn't BSG's business shrinking too – and won't the company disappear in a few years time?

It's an obvious fear. But BSG had 2% revenue growth during the first half of 2008, and the management predicted that the second half of the year would unfold along the same line. And personally, I am a little more optimistic even.

How come?

For once, fears about the death of landline telephony have been blown somewhat out of proportion. The entire issue reminded me a bit of the alleged advent of voice recognition software in 1996 and 1997. When the first software programs came out that could turn human speech into written text on a computer screen, predictions came out that within a few years no one would write on keyboards anymore.

I did myself recently buy yet another generation of voice recognition software (despite having been utterly disappointed by the 1997 generation of voice recognition software, one never gives up hope), and this

technology has now matured to a degree where it's feasible to actually use it. But lo and behold, I am still sitting on a keyboard – happily typing away in a café in downtown Puerto Ayora on the Galapagos Islands, where it'd be way too noisy to dictate a text into a microphone.

New technology doesn't take hold as quickly as predictions would have it. My 88 year old grandmother will never switch to Skype (and instead she uses her landline phone every single day); my office in Switzerland installed landline telephones because they still have a better voice quality and expose you to less radiation than strapping a mobile to your head all day long; and I can think of a good dozen more reasons why landline phones are much better on certain occasions than mobile phones, Internet-based services or similar alternatives.

To predict the imminent end of landline telephones, seems a bit shortsighted.

And as BSG is probably just about to prove, that even in a somewhat declining industry it is still possible to achieve attractive revenue growth. That's because there is another little-known feature to the market that BSG operates in, one that virtually no one has realized yet.

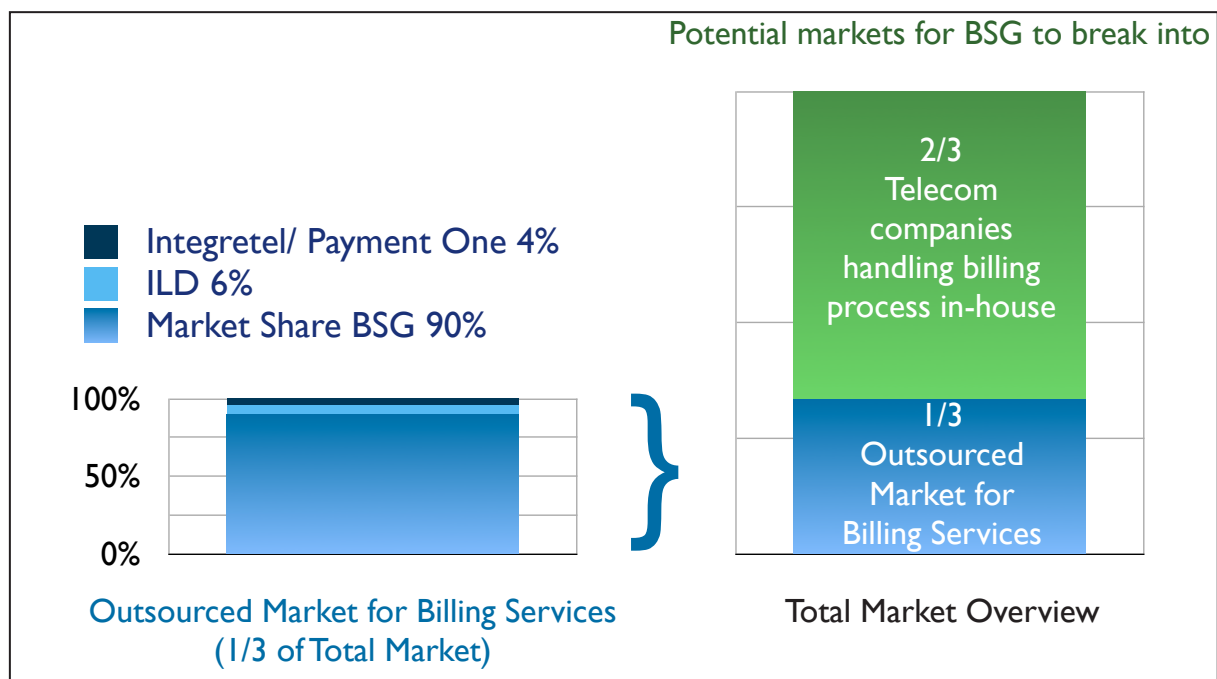
### The second surprise about the market that BSG is operating in

BSG is quick to point out its 90% market share. Most investors read about it and believe that the company has hit the ceiling as far as growing is concerned. One could figure that you simply can't have more than a 100% market share, and that the company has no prospects for growth, given that it controls the market and the market itself is declining.

The truth, however, is that it all needs to be seen in a different context.

The market share figure relates to that part of the telephony billing services market that has already been outsourced. And that's only about one third of the US telecom market (figures about the industry are hard to come by and there are several ways to measure the size of the overall market; that said, this figure should be a good estimate). In other words, the billing for about two thirds of the landline calls made in the US is still handled by the telecom companies themselves.

Or put yet another way, the market for outsourced telephony billing could theoretically grow to three times its current size, if all the US telecom companies decided to outsource this task.



The majority of US telephone billing has not yet been outsourced, leaving BSG ample room to grow (approximate figures).

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Needless to say, it won't ever quite come that far. Some telecom companies will, for some reason, always handle their billing in-house. But with 2008 expected to bring a positive revenue growth in an industry that last year has probably seen 3% to 5% declining revenue, goes to show the massive success that BSG's sales team must have achieved in signing up new customers. And there are plenty more potential new customers out there.

As I set out before, these new customers are massively profitable because they require virtually no additional IT investment.

It's at this point, that things are starting to add up.

### Figures, figures, figures

If you want to spare yourself from reading the boring analytical bit, here is the one key figure that you need to understand.

Last year, BSG had revenue of about \$130m and the company threw off about \$20m in excess cash.

That's a huge amount of cash coming in per Dollar of revenue. And this pretty much sums up BSG – you can buy into an incredibly robust, resilient cash machine at a very low valuation.

My in-house analyst has been crunching the numbers published by BSG ever since we first looked at the company back in Spring 2007. I could drown you in details about the business and the company's balance sheet, because we have taken BSG to pieces over and over again. For better readability I shall just leave you with the table below. It sets out the figures that we expect for 2008 (due to be published in March or April) as well as the estimates for 2009 and 2010.

Both my analyst and I are happy to say that with all likelihood, these figures will turn out to have been too conservative.

BSG has been throwing off lots of cash in 2008 and it will throw off yet more cash in 2009 and 2010. From a valuation point of view, the share is now as cheap as they come. Anyone with even just a basic understanding of price/earnings ratios can tell from the table below that the share is extremely cheap.

However, in the case of BSG it's not actually the p/e that gives the best, most suitable reflection of the company's value. Because of some peculiarities of the company's balance sheet, it's much more telling to check what the available cash per year is. The proper analytical methods for companies that are rich in cashflow, is the so-called Enterprise Value method.

	2008e	2009e	2010e
EBITDA	US\$34.8m	US\$35.0m	US\$36.0m
Depreciation & Amortization	US\$12.8m	US\$12.8m	US\$12.8m
Restructuring Expenses	US\$2.4m	US\$0.0	US\$0.0
Stock-based compensation	US\$1.0m	US\$0.0	US\$0.0
Operating Income	US\$18.6m	US\$22.2m	US\$23.2m
Interest Expense	US\$8.9m	US\$6.3m	US\$4.9m
EBT	US\$9.70m	US\$15.9m	US\$18.3m
Income Tax (35%)	US\$3.4m	US\$5.57m	US\$6.41m
Net income	US\$6.31m	US\$10.34m	US\$11.9m
Earnings per Share (GBP)	GBP0.015	GBP0.025	GBP0.029
Earnings per Share (US\$)	US\$0.023	US\$0.037	US\$0.043
Price/Earnings Ratio (pe)	7.7	4.6	4.0

e= estimate

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The Enterprise Value is the company's stock market value plus its net debt. This figure is then divided by the EBITDA figure (which is effectively the amount of cash that the business is throwing off every year). The lower the resulting figure, the cheaper the share.

Even based on the 2008 EV/EBITDA figure of 4.0, the share is already extremely cheap. In 2009, the EV/EBITDA figure decreases to 3.4 and in 2010 it goes down to 2.8. As anyone who has ever spent a bit of time working on mergers and acquisitions will confirm, these figures are almost too low to be credible anymore. To give you a more tangible, real-life example how low they are, let's compare the situation to buying a house using a mortgage and then gradually paying off the mortgage using the rental income. BSG is similar to a rental property that throws off such a high rent that you can pay off the entire house in less than 5 years (possibly even a bit faster than that). This compares to rental properties usually requiring 12 to 18 years to get the mortgage paid off.

	2008e	2009e	2010e
Enterprise Value*	US\$140m	US\$120m	US\$100
EBITDA	US\$34.8m	US\$35.0m	US\$36m
EV/EBITDA	4.0	3.4	2.8

e = estimate

\* = based on a share price of 11.5 Pence

### Shareholders will learn to love the fact that BSG has some outstanding debt

The comparison to a rental property is slightly simplistic, but it illustrates what we are dealing with.

What's more, there is an aspect that does actually make BSG quite comparable to purchasing a property. That's because the company's management is using the cashflow to pay off debt – and for anyone who likes a bit of financial voodoo, this is by far the most interesting part of the entire story!

Most people currently shriek when they hear of debt, but in this case, it's a safe and clever use of debt to maximize the returns to shareholders.

Here is how it works...

In December 2007, BSG's management team closed a \$112.5m bond issue. The company raised \$112.5m in debt with a 2014 maturity and a "LIBOR + 4.25%" coupon (LIBOR = London Inter Bank Offered Rate). In other words, it took on \$112.5m in debt for 7 years. During these 7 years, the company has to use a certain, pre-agreed part of its cashflow to pay down a bit of debt every year. With where LIBOR is currently standing, BSG is probably paying between 7.5% to 8% of interest on its debt.

Recently, BSG has made several announcements that it bought back millions of Dollars worth of these bonds – ahead of their maturity, and with the debt repurchases being much higher than the pre-agreed gradual pay-back. In other words, BSG is voluntarily, and earlier than planned, returning cash to its creditors.

Why's that?

It's because this early retiring of debt is the surest way BSG currently has to making an extra buck without taking on any risk.

Thanks to the current chaos in the world's banking and debt markets, the prices for corporate bonds have fallen sharply across the board. Even BSG's debt has come back in price, despite there not being the slightest visible risk that BSG will have trouble paying back the debt on time. Just as with stocks, everything and anything was put up for sale - and prices declined.

Sensing an opportunity, the company's CFO, Norm Phipps, used some of the excess cash to approach bondholders. Those investors who decided (for whatever reason) that they'd rather sell their bonds now, instead of waiting until 2014, sold their bonds back to the company. The clue is, that BSG paid less than

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the face value of these bonds. In other words, the company issued bonds for a price of X in December 2007, and it bought back these bonds at a lower price Y throughout the second half of 2008. The difference between these two prices is an extra profit that BSG can book into its balance sheet.

BSG is making an extraordinary gain at the expense of its bondholders making an extraordinary loss. If it buys back \$1,000,000 in debt for \$900,000 (10% discount to nominal value - just as an example), then the company makes an extra \$100,000 purely from using the current market distortions in the debt market to its advantage.

What all this boils down to is – in a credit crisis like the one we are experiencing now, cash is king! And BSG is generating \$600,000 of cash every single week.

Or to put it yet another way, BSG is not only operating a highly successful and lucrative operative business, it is also operating a lucrative financial operation around its bond issue.

Nice work, if you can get it. All this came about, because of BSG's cunning CFO.

### **For a quick assessment, simply look at the recent insider trading**

By this time, I have probably lost half of my readers. Telephony billing, bond issues and the repurchase of debt below par value is enough to put most people to sleep.

Others, however, have their senses awakened when they hear such a story.

One of the people among them, must be Norm Phipps, the CFO of BSG since 2003. He seemed quite unimpressed by the entire financial crisis, and instead used the opportunity to increase his stake.

It's not often that you see the employed CFO of a company buy up a stake of more than 5% in the company that he helps to manage. A 5% stake is quite a massive stake to own, and it's even more noteworthy, when a CFO takes his personal cash to buy shares (rather than to only be issued free shares through an employee options program). Yet this is exactly what has happened with BSG during the past few months. Outside investors panicked and drove the price down to 7 Pence. Several insiders, primarily Norm Phipps, kept a cool head and bought more shares when they were offered at an outrageously low price. He did also get shares through stock options, but he also decided to buy more shares using his own cash.

They have realized that BSG is as close to owning a printing press, as you can get. BSG will continue to throw off lots more cash, and with the advent of 2009, the question will now come up what else to do with all this cash – besides buying back debt.

There is no reason for BSG to buy back all this debt. Compared to the size of its cashflow, BSG isn't very highly indebted. Put another way, if you have a monthly income of \$20,000 then you can easily afford to put a few thousand Dollars onto your credit card – nothing wrong with that. Debt is no bad thing if you have the earnings and the cashflow to easily pay interest and to gradually repay the principal. What's more, BSG has taken on this money for an interest rate of currently probably between 7.5% to 8%. The interest rate is low enough, that unless the bonds can be bought back at a price below par value, buying back too much debt doesn't actually make sense. Using other peoples' money to run a business can make a lot of sense when someone is willing to lend you money for an attractive interest rate.

That's why the large shareholders are likely to put a preference for a dividend payment onto the agenda. Now that BSG has already reduced its debt from \$112.5m to currently \$91m (including the voluntary debt repurchase that was done in early January 2009), the company can start to think about just how much of its cashflow is supposed to be paid out as a dividend in the future.

Quarterly dividends, that is! Or, as you will see a bit later, possibly even a large special dividend as an advance payout of the company's future cash flow. The original idea of a number of the large BSG shareholders was, that the company would eventually become the subject of a bid. But for as long as private equity companies and other potential purchasers are struggling with the difficult market situation, such a bid can drag out further. Someone might launch a bid tomorrow (who knows, given that there are,

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after all, people with cash out there). But with the delays experienced since I first bought into this company in the expectation of receiving a quick bid, I'd currently be much more inclined to work out what's in it for me, even if no bid was ever received.

What's the worst that can happen to my investment, i.e. where is the likely bottom and how large exactly is the upside even if no bid was received? In other words, how much risk do I need to take on and how large an opportunity do I get in turn?

Yet again, anyone willing to dig deep into BSG's complex figures is in for a surprise find.

### **The bizarre effect of the US Dollar's strength versus the Pound**

Check back to the cashflow and earnings predictions, to get an idea of just how much of a dividend investment this share can turn into. To make a concrete example, BSG will probably be able to afford to pay out a 2.5 Pence dividend for 2009 and a 2.75 Pence dividend for 2010. That compares to a share price of currently 11.5 Pence.

Take into consideration that dividends can be paid out quarterly (so that you don't have to wait 12 months), and you start to get an idea why the share temporarily shot up 23% to more than 10 Pence last Wednesday (and since then, it has risen further, to currently 11.5 Pence). Even at the current higher price, there is a realistic prospect for getting a 22% dividend yield for this year– and even more for the years thereafter. Besides, you probably won't even have to wait until 2010 to see some of the cash earned in 2009 being passed on to shareholders.

Last week, BSG put out another announcement about a voluntary debt repurchase (i.e. another extraordinary profit to be booked into its account, courtesy of some distressed debt owner that needed to sell). This finally woke up some market participants.

After months of chaotic zigzags, the market has started to make some sense again and the share has moved a bit closer to its much higher intrinsic value.

Then start to factor in what has happened on the currency front during recent months, and you finally get a clear idea of just how powerful the numbers backing this investment case are. That's all due to the incredibly weak Pound, which massively lost value compared to the US Dollar.

And it's the US Dollar, that BSG is booking all its revenues and profits in.

With the Pound decreasing in value and the US Dollar increasing in value, the value of BSG's US business division has increased in value relative to the currency that its London stock price is in. This is a bit difficult to grasp for my investors, because the share price of BSG is denominated in Pounds while the business is run in the US Dollar zone. What this slightly bizarre set-up boils down to, is the fact that even without any improvement in the actual business, the US business operated by BSG would have gained about 30% in value during the past 5 months simply because of the changing exchange rate between the US Dollar and the Pound.

Yet another way to put this is, that you can now take out 30% more Pounds in dividends from BSG, than you could have some five months ago. Add to that the continuing improvement to the business' actual operative performance, and you can figure out why the share price drop was a temporary distortion – from the business actually gaining in value while the market was suggesting the opposite!

### **Is there no catch?**

Not everything is all sunny and bright at BSG.

E.g., the company started a few growth initiatives in areas outside its existing core business. Services such as credit card processing and Internet-based payment services were supposed to massively add to the company's overall growth.

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So far, these growth initiatives have been lagging behind and they disappointed expectations. Luckily, they didn't gobble up too many resources. And even if you assumed that these small growth divisions were worth Zero, you'd still be left with a company that is worth much more than the share price currently suggests.

Overall, BSG has probably mastered the exceptionally difficult year 2008 with flying colours. Not everything it touched turned to gold, but where it did take risks it made sure these were limited. It's operative business performed as if nothing much had happened, i.e. the number of landline calls was virtually unaffected by the economic downturn in the US. If anything, some people might have shunned their mobile and gone back to cheaper landline calls.

The share price temporarily dipped, and investors from the Euro zone suffered under the Pound's sharp drop compared to the Euro. Overall, however, you could have done a lot worse during 2008 than holding BSG shares.

### **Even at double the current price the share would still be relatively cheap**

The entire story can be summed up quite quickly.

The CFO of a company building up a 5%+ stake is no ordinary event, even in the United States where insiders tend to be much more involved with the shares of their company. Don't forget, that the CFO just put up his own personal cash to buy more shares. He did so at prices between 7.41 Pence and 10 Pence. This compares to the current share price of about 11.5 Pence, i.e. you can still get in at a price that is not much higher than the price at which the CFO seemed entirely happy to invest some of his family savings.

Actually, just printing this one fact should have been enough for this report. It speaks for itself, and there is hardly a stronger signal than the CFO of a company buying lots of shares in the open market.

Everything else that I am writing really is only designed to make sense of the CFO's actions. I can't know what exactly is going on in his head, but what I can do, is to crosscheck his actions against the company's figures.

He most likely did the maths around the company's cashflow, its ability to pay dividends, and the fact that such a cashcow will eventually (when the world has regained its sanity) attract a bid from someone. This could simply be a financial player keen on adding a highly cash generative company to its portfolio. Actually, one such investor, Utilico, has already taken a large position in BSG.

Once my expectation that BSG has achieved surprisingly positive revenue growth in 2008 has been confirmed, such a bid will become yet a bit more likely. At least some topline growth is what most private equity buyers will want to see. Once the preliminary figures are published as part of the annual reporting (due in March or April), the market should catch on to the opportunity.

Where will the share price be at the end of the year?

Even assuming as low a p/e as 5, the share would have to rise to 15 Pence by the end of 2009 (when the market starts to anticipate the 2010 figures). A p/e of 7 would translate into a share price of 21 Pence.

In other words, you don't even need to assume any kind of aggressive projections to come up with good reasons why the share will likely double over the coming 12 months. The same goes for valuing the company on the basis of EV/EBITDA (which is actually the more appropriate figure to use, because earnings figures can more easily be distorted by balance sheet technicalities), where you can just as easily derive a target price of 20 Pence or even more. Actually, one simply should not sell for anything less than 25 Pence.

This is based on projections that are actually quite conservative. Personally, I wouldn't be surprised if the EBITDA projections used in this report proved a touch too conservative.

All that is missing then, is that crucial catalyst – the event that leads to the share price rising towards the much higher intrinsic value of the company.

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Luckily, the company isn't necessarily depending on an outside force – such as a bid – coming into play. We might just see BSG creating its very own catalyst to get the share price to move up.

Once debt markets return to sanity, BSG could quickly find itself in a position where it can refinance its existing bonds and issue another set of bonds. The technicalities of this would be enough to write another report of the same length, but it boils down to BSG potentially making an advance payout of its future cashflow.

Such a special dividend, could be around 10 Pence per share. That'd be a dividend nearly as high as the current share price.

A pipe-dream, or financial voodoo yet again?

Actually, neither of the two. Such a special dividend would merely be a clever use of financing methods that in the Anglo Saxon world are not all that unusual. With debt markets currently still sputtering and stuttering, this move couldn't be done straight away. What's more, there'd be some tax implications to deal with, and the company's future earnings projections would be slightly less attractive after the dividend because the interest rates payable on the corporate debt would rise. But come Spring or Summer 2009, such a measure could be instituted.

### **Where will it go from here?**

Is the prospect of a 10 Pence dividend payout the reason why our CFO was recently loading up shares when they were trading as low as 7 Pence?

Again, we can't know for sure what his motivation was. But gradually, it all starts to fit together. Buying a share, receiving more than the purchase price as dividend half a year later, and then keeping a stake in the company – sounds almost too good to be true.

But a 23% rise in share price in a single day, because of an announcement about a 4.3% reduction to the company's long-term debt, might also be too good to be true. Is there more in the making, than is currently visible?

What I am sure about, is that 2009 will bring quite a lot of good news for listed companies in general. Last year, everyone went into shock and pulled down the blinds. With the new year having started, companies will start to reveal adjusted plans and newly thought out strategies.

Investors will start to notice, that the world doesn't quite come to an end and that there are ways to creatively leverage the changed times to your advantage.

That's why I believe that in the next 2-3 months (ahead of BSG publishing its annual results), we might see a few more days like that, when the share price rose massively. It was almost like someone breathing in after holding his breath underwater for a long time. The markets have been so massively oversold, that a correction is now overdue – and it could be quite a violent one. I bet there is more to come. Now that some market participants have started to realize that BSG is not just surviving the crisis, but actually profiting from it, the share should get back to an upwards trend. Sanity is starting to creep back into the market, even though no one yet believes it.

The payback in forms of crunchy dividends is likely to start in 2009. The dividends might even be done in the form of a super-sized special dividend based on a cunning refinancing deal - and the expectation of an eventual bid for the company will linger in the air, given that it's majority controlled by pure financial investors. Just check the shareholder register to find out that 8 financial investors control 82% of the shares (not even counting the more than 5% held by Norm Phipps). These people aren't invested because of a love for the telephony business, but because they expect this investment to yield them a handsome profit.

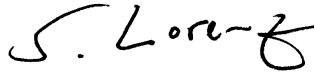
A prospective special dividend equivalent to the current share price, a potential bid that is unlikely to succeed at less than 20 Pence per share, and an insider team that seems keen to mop up more of their employer's shares...

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Does it all add up to an opportunity that is too good to be missed?

You be the judge, now that you have had the relevant bits nicely laid out to you. I can't do more than spelling out my opinion, and providing some light along the way in these dark, difficult times for investors. For all else, you need to make your own decisions.

With best regards,

A handwritten signature in black ink, appearing to read "S. Lorenz" with a stylized flourish at the end.

Swen Lorenz  
Undervalued-Shares.com

P.S. As to me, I have already teamed up with an investor who controls a total of 23% of the company. I am either totally biased, or very well informed. Or both. Again, I leave this up to you to judge.

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