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Donnelley Financial Solutions, Inc.
(NYSE: DFIN)

Executive Summary

Spun out from R.R. Donnelley & Sons in 2016, regulatory and compliance solutions company, Donnelley Financial, is the number one SEC Filing Agent for both corporations and investment companies. Included amongst its clientele is over 60% of the S&P 500, 70% of the Fortune 1000, and 80% of the top 50 global fund complexes. Donnelley's solutions assist corporations and money managers with the creation, formatting, filing, and distribution of required compliance documents, such as 10q's and fee disclosures. In addition to recurrent compliance needs, the company's clients utilize its solutions in a similar manner for transactional activities, such as M&A, Debt-Offerings, IPOs, and SPAC/De-SPAC transactions.

Operating as the dominant player in a niche industry, Donnelley is well-managed, and runs a high-margin capital-light business model. However, upon reviewing the firm's recent financial results, one would be forgiven for thinking otherwise…

#'s in 000's	
Share Price	$ 35.14
Shares Outstanding	29.7
Market Cap	$ 1,044
Net Debt	269.9
Enterprise Value	$ 1,314
TTM Revenue	957.7
TTM EBITDA	297.5
EV/EBITDA Multiple	**4.4x**

#'s in 000's	2018	2019	2020	2021	2022E	2023E
Total Revenue	**963**	**875**	**895**	**993**	**899**	**914**
% Growth	-4.2%	-9.2%	2.3%	11.0%	-9.5%	1.7%
Total Gross Profit	**376**	**332**	**399**	**580**	**498**	**518**
% Growth	-2.0%	-11.6%	19.9%	45.6%	-14.1%	3.9%
Gross Margin	*39.0%*	*38.0%*	*44.6%*	*58.4%*	*55.5%*	*56.7%*
EBITDA (adj.)	**155**	**137**	**173**	**295**	**235**	**238**
% Growth	7.3%	-11.6%	26.6%	70.0%	-20.2%	1.1%
EBITDA Margin	*16.1%*	*15.7%*	*19.4%*	*29.7%*	*26.2%*	*26.0%*
FCF (adj.)	**$ 29.2**	**$ 9.7**	**$ 123.1**	**$ 137.7**	**$ 126.4**	**$ 154.4**

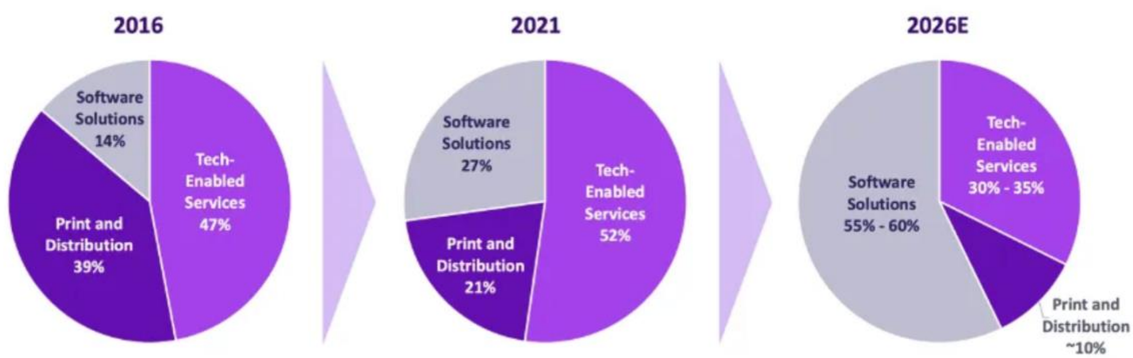
The above financial summary paints a picture of an efficiently priced, low growth, cyclical business, momentarily reaping the benefits from a record stretch for M&A/De-SPAC/related activities in the capital markets. Despite decent analyst expectations and an amazing 2Q earnings report only weeks ago, the stock has been thrown out with all the other cyclicals as investors flee the space, digesting an ever-increasing stream of bad economic news.

However, what cannot be comprehended by simply observing Donnelley's recent financial record, is an **approaching inflection point**: The company's low margin, capital intensive print-based operation (and its 100% variable cost structure), is soon to be rendered obsolete by Donnelley's fast growing, capital-light software segment. Furthermore, as 63% of the software revenues are from compliance sales, Donnelley's future is far less cyclical than investors think. The shift from print to majority SAAS will help generate operating leverage, benefiting margins, working capital cycle, and crucially – free cash flow conversion.

Variant Perspective

After being spun-off, Donnelley's new management team committed to a long-term turnaround plan that they hoped would result in the changes mentioned in the previous paragraph: Donnelly's cyclical print-based operations were to become superseded by its fast growing (15% CAGR 2016-2021) higher margin (~61% 2021), recurring software sales. Additionally, management divested non-core assets such as the legacy language business, using these proceeds and FCF to pay off debt (net leverage reduced from 3.4x in 2016 to 0.2x in 2021, guiding for a positive net cash balance by '24).

- The plan has been implemented successfully thus far, as software solutions recently surpassed print-enabled operations
- Software's emergence has already boosted gross margins by 19.4% and EBITDA margins by 13.6%
- Original guidance was for software sales to be = 44% of total revenues by 2024
- Management now expects to exceed this goal, guiding software sales to be > $500m by 2026 (14% CAGR) and represent 55%-60% of 2026 total sales mix



- As previously mentioned, it's not just print-based sales the company is looking to shift away from, they are also focused to reduce dependency on transactional revenues
- Management is guiding for an increase in compliance sales to >70% of software revenues by 2026
- This will decrease volatility in y/y results, leading to increased revenue & earnings visibility

The market has not yet realized nor priced in the effects that this turnaround will have. Instead of receiving a multiple that reflects its future prospect, Mr. Market has assigned Donnelley with a 6x forward EBITDA multiple. This multiple would be fair if the company's historical EBITDA to FCF conversion was to continue (5yr avg. 36%), but I am confident that will not be the case. For example, the present multiple on 2022E EBITDA is 6x, assuming a 36% FCF conversion gives Donnelley ~$82m 2022 FCF. Or in other words, a not so unreasonable 16x FCF multiple. Meanwhile, management is guiding for an FCF conversion rate of over 50% during the next five years – using this conversion rate implies a multiple of only 10x 2022E FCF.

The opportunity exists because as a small (~$1b market cap) underfollowed company, few sophisticated investors have taken notice. Due to size, most funds on Wall Street are unable or unwilling to spend time on a company of this size, particularly one that has been generally viewed as a "melting Ice-cube". Lastly, only four analysts cover the stock, a fraction of the coverage its peers receive. As a result, apart from bargain hunters and retail investors, there are not a lot of eyes on Donnelley Financial. These facts are not lost on the company, who in February authorized an increase to its previously approved stock repurchase program up to $150m. Actions speak louder than words (or authorizations) though, and the company's have been deafening, repurchasing 2.18m shares for $64.4m this past quarter. Combine this with activity in the 1Q and only halfway through the year Donnelly has repurchased 3.41m shares for $106.5m. Due to the increase in February, there is still a remaining authorized amount totaling $58.6m.

Competitive Positioning

Donnelley's services are integral to reporting companies, SEC filing requirements are complex and convoluted – these firms don't have the time or interest to do it themselves. Furthermore, ensuring all filings are submitted with accuracy and efficiency is of paramount important to Donnelley's customers, who want to keep shareholders happy. Thus, these firms aren't incentivized to go hunting for the lowest price. They simply want the job done correctly and in a timely manner. For many years, Donnelley was the dominant provider of these services through its print-based operations, in doing so they developed top notch brand reputation. As a result, Donnelley has been able to convert its legacy print-based clients to its new software offerings with competitors unable to encroach.

Still, they face formidable competition, including Broadridge Financial, Issuer Direct, Workiva, Intralinks (SS&C), and Confluence. However, while each of these competitors has an equivalent service (or multiple) to one of Donnelley's, none of them offer the complete suite – making Donnelley the obvious choice for customers seeking a one-stop shop.

Valuation Model

Below is a summary review of management's revenue guidance:

- Software Solutions = 44% of Total Revenues in 2024
- Software Solutions = 55% of Total Revenues in 2026
- Print & Distribution Solutions = 10% of Total Revenues in 2026
- Software Solutions Growth Rate = Mid-teens %
- Annual Sales Growth 2022-2026 = Low single-digits %

Referring to the analyst projections on the first page, analysts appear to be placing a lot of weight into Management's guidance, as following the projected -10% decline in total revenues, the consensus is that revenues will bounce back 2% in 2023. I think it's only reasonable to continue using the 2% number for sales growth in the following three years, giving us revenues of $932m in 2024, $950.5m in 2025, and $969.5m in 2026. Assuming software sales are at least 44% (I predict 46%) of revenues in 2024 ($428.7m), and 55% in 2026 ($533.2m) gives us a CAGR of 14.6% for software sales, in line with management's "mid-teens %" guidance. Analysts expect the company to convert 26% of 2022 & 2023 revenues into EBITDA. The conversion from EBITDA to free cash flow is estimated at 54% in 2022, and 65% in 2023 ($126.4m & $154.4m). Since analysts have EBITDA margin at 26% in 2023 and management believes it will be around 30% in 2026, I've assigned a 28% margin in 2024, and 29% margin in 2025. Full model below:

Modeling					
	2022E	2023E	2024E	2025E	2026E
Tech-Enabled Services					
Revenue					339.3
% of total revenue					35%
Software Solutions					
Revenue			$ 428.7		$ 533.2
% of total revenue			46.0%		55.0%
Print & Distribution Solutions					
Revenue					$ 97.0
% of total revenue					10%
Total Sales	**$ 898.6**	**$ 913.6**	**$ 931.9**	**$ 950.5**	**$ 969.5**
Growth Rate	-10%	2%	2%	2%	2%
EBITDA	**$ 235.3**	**$ 237.8**	**$ 260.9**	**$ 275.6**	**$ 290.9**
EBITDA Margin	26%	26%	28%	29%	30%
Free Cash Flow	**$ 126.40**	**$ 154.40**	**$ 130.46**	**$ 137.82**	**$ 145.43**
FCF Conversion	54%	65%	50%	50%	50%

Discounting back at 10% and using an exit EBITDA multiple of 10x in 2026, making the net debt adjustments, etc., results in a value per share of ~$76.4. I don't love presenting this valuation using a DCF, but I think the Company is bought out at some point in the next few years for a decent multiple. Furthermore, on a competitor comparison basis, this stock looks even more undervalued, as its peers are assigned much higher multiples across every metric. Though Donnelley certainly doesn't deserve the 20x multiple some of its peers have, 6x is unduly low. Needless to say, I believe the market is significantly mispricing Donnelley, no matter how you look at it. Furthermore, I am confident the downside is limited as the company is already valued at a level that assumes management fails to reach their goals.

<u>Catalyst:</u>

The stock exploded upwards after 2nd Quarter results destroyed estimates, so each earnings release is a potential catalyst, as investors get a fresh look at managements progress. Especially since estimates are particularly low. However, the biggest catalyst is a potential sale, which some activists have already been pushing for. Given the present market environment, it's difficult to use historic takeout multiples in the industry, to value Donnelley in a potential M&A deal. However, management has stated that they will avoid a sale that doesn't reflect the future economic value of the company, post turnaround – giving me confidence they won't cash out at an inopportune time, or unattractive valuation.