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# Ebix: An Assessment of Performance

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November 18, 2010 | about: EBIX


This assessment of Ebix, Inc. (EBIX) encompasses a multi-year history of results. It focuses on value metrics, particularly free cash flow, a driver in fundamental valuation.

The issue to discuss is the extent to which the market is properly pricing the stock. This document examines EBIX's financial performance enabled by substantial acquisitions, and the related issue of sizeable goodwill on the balance sheet.

Significant negative opinion over financial performance is evidenced by the substantial short-interest position in the stock.

**Background**

Ebix is an international supplier of software and e-commerce services to the insurance and financial industries.

As the company explains, its technology strategy is to focus on convergence of all insurance channels, processes, and entities so that data can seamlessly flow once a data entry has been made. The goal is to be the leading backend powerhouse of insurance transactions in the world.

The company's customer base includes over 100 insurance companies, third-party (insurance processing) administrators, banks, financial advisors, and 300,000 broker/agents, in addition to a few hundred corporate clients. Targeting a $60 billion market segment in the U.S. alone, EBIX views ample growth opportunities by leveraging the existing customer base and market reputation.

Consolidation in the insurance and financial industries has driven the need to benefit from economies of scale and scope, as well as improvement on how products are distributed and on process efficiency throughout the insurance transaction; front-end involving consumers; and at the back-end.

EBIX strategy encompasses organic growth and substantial acquisition activity. Embedded in the client offering are solutions that, when adopted, enhance the way clients conduct business. This encompasses automating their processes, advancing operational proficiency, reducing costs, and upgrading the quality of the clients' relationships with their own customers.

By their nature, EBIX's services are integral to its clients' business and operations. EBIX's relationships with clients are sticky, susceptible to cross-sell, and have the potential to offer stable and recurring revenue.

**Performance**

The chart below shows selected measures of performance for the four year period 2008-2010:

**EBIX Chart --Selected Metrics**

| (Amounts in millions of US$, unless otherwise noted) | **FYE 12/07** | **FYE 12/08** | **FYE 12/09** | **FYE 12/10 Estim.** | **4-Yr. Avg. (2007-10)** |
|---|---|---|---|---|---|
| Revenues | 42.84 | 74.75 | 97.69 | 130.00 | |
| Revenue Growth (y-o-y) | 46% | 74% | 31% | 33% | 46% |
| EBIT | 12.80 | 29.26 | 39.26 | 51.54 | |
| EBIT / Revenues | 30% | 39% | 40% | 40% | |
| EBIT Growth (y-o-y) | 91% | 129% | 34% | 31% | 71% |
| Cash Flow from Ops. | 15.04 | 26.83 | 33.88 | 44.20 | |
| CF f/Ops.Growth (y-o-y) | 262% | 78% | 26% | 30% | 99% |
| Free Cash Flow | 12.44 | 23.52 | 29.92 | 44.00 | |
| FCF / Revenues | 29% | 31% | 31% | 34% | |
| FCF Growth (y-o-y) | 429% | 89% | 27% | 47% | 148% |
| Fixed Assets | 49.10 | 115.64 | 215.65 | 307.15 | |
| Fixed Assets Growth | 47% | 136% | 86% | 42% | 78% |
| Revenues / Fixed Assets | 87% | 65% | 45% | 42% | |
| EBIT / Fixed Assets | 26% | 25% | 18% | 17% | |
| FCF / Fixed Assets | 25% | 20% | 14% | 14% | |
| # Shares | 31.60 | 36.78 | 38.01 | 42.48 | |
| # Shares Growth (y-o-y) | 12% | 16% | 3% | 12% | 11% |

| | **Q 9/09** | **Q 9/10** | **Change (y-o-y)** |
|---|---|---|---|
| Revenues | 23.29 | 33.28 | 43% |
| EBIT | 9.78 | 13.08 | 34% |

| | | | |
|---|---|---|---|
| Cash Flow from Ops. | 6.58 | 10.04 | 53% |
| Free Cash Flow | 5.63 | 8.49 | 51% |
| Fixed Assets | 137.19 | 241.15 | 76% |
| FCF / Revenues | 24% | 26% | |
| FCF / Fix.Assets (Ann.) | 16% | 14% | |

Note the following:

- Impressive annual growth in Revenues (averaging 46%), EBIT (71%), Cash Flow from Operations (99%), and Free Cash Flow (148%). In the chart, FCF computation is based on Cash Flow from Operations adjusted by a CAPEX replacement figure represented by depreciation and amortization.
- Rapid annual growth in Fixed Assets (averaging 78%). FYE 12/10 Fixed Assets estimates account for the A.D.A.M. (ADAM) acquisition, currently in process of closing.
- Not shown in the chart is the sizable amount of Goodwill, Intangibles, and Indefinite-lived Assets ("acquisition assets") originated by multi-year acquisition activity. As of Q 9/10 such acquisition assets amounted to $232.10 million, or 96% of total Fixed Assets, vs. $43.73 million and 89% respectively, on FYE 12/07.
- Average FCF growth (148%) exceeds the growth in Fixed Assets (78%). However, the elevated FCF growth figure is due to a spike in FCF growth (429%) in 2007, when earlier FCF absolute amounts were relatively very small, particularly in comparison with most recent levels. The point to be made here is that, as far as current performance is concerned, we should not conclude that FCF per unit of Fixed Asset is improving. In fact, the decrease in the ratio of both Revenues/Fixed Assets (from 87% to 42%) and FCF/Fixed Assets (from 25% to 13%) suggest that the opposite is true (more in Cash Flow, below).
- Rapid growth in Fixed Assets, and in "acquisition assets," from $43.73 million in FYE 12/07 to $232.10 million in Q 9/10, depicts the magnitude of acquisitions and their importance in financial performance.

The question remains: What is the assessment of EBIX performance, particularly given substantial acquisitions and related accounting issues?

Let's discuss some performance issues.

**Strategic Acquisitions**

We consider that, by and large, acquisitions are strategic in content. (See recent announcements here and here.) This means that, as an aggregate, acquisitions are intended to enhance the competitive position of the firm by (a) strengthening the value proposition (enhancing client benefit with solutions that improve the businesses of clients) by expanding the scope, depth, sophistication, and modular complementarities in the product suite; (b) enhancing risk-adjusted economic returns by expanded market coverage and cross-sell opportunity; and (c) reinforcing and/or exploiting the core competency of the firm (technology, knowledge, industry specialization).

Broadly, in the role of acquirer, EBIX seeks to strengthen competitiveness by the timely expansion of product capability and market coverage, and in so doing preempt actual and potential competitors from achieving favorable market positioning or client gains.

**Cash Flow**

The fundamental measure of the value of an asset is based on the prospective inflow of cash (amount, timing, and risk) relative to the initial capital outlay. Relatively less important is how the acquired asset is accounted for in the balance sheet. In other words, cash generation is what matters. This argument should appropriately shift the focus of discussion regarding corporate performance from goodwill accrual accounting to value metrics results (principally FCF) and to the adequacy of strategic acquisitions.

The chart shows declines in the Revenues/Fixed Assets and FCF/Fixed Assets ratios over the four-year period. One likely reason is that acquisitions have, in time, gotten more expensive relative to Revenues and FCF. Conversely, earlier acquisitions were made in times of weak global conditions and discounted assets prices. Under those conditions earlier prices paid were favorable to the buyer.

Declines in the ratios remind us of the law of diminishing marginal returns: One gets less FCF output per each additional unit of capital invested, other things remaining equal. Among the plausible explanations for the declines is that acquisition pricing could elevate as the profile of the acquired companies becomes increasingly prominent (in business mass, competitive position, and client and synergy opportunity) in a world of slow asset prices recovery. Substantial acquisition targets are less likely to sell at discounted pricing.

Incidentally, acquisitions are of all sizes, but it appears that larger acquisitions (dollar price per company acquired) are becoming more frequent than in earlier years.

In any event, acquisitions have enabled exceptionally rapid growth, in Revenues and in FCF, particularly during times of global economic distress and weaknesses in the insurance and financial industries. The alternative of pure organic growth at much reduced rates of Revenue and FCF would have been unpalatable.

**Business Risk**

By my own count, EBIX acquired 13 businesses during the three year period (2008-2010). This figure includes the acquisition of ADAM, announced in September and still in the process of closing. The aggregate investment amount for the period is estimated to be in excess of $270 million.

To reinstate what we already know, EBIX's business model relies on operating ability to manage the business of the firm, and on investment expertise to make good acquisition decisions.

By its nature mergers and acquisitions ((M&A)) is a different activity than organically supplying software services to clients in the insurance and financial industries. The skills and organizational requirements in these two activities is different: Origination of transactions is different, as are deal structuring, pricing, risk, and allocation of capital and other resources. The decision-making processes are very different.

Results suggest that the firm is capably running these two major and complex businesses.

They are carried out separately, yet are appropriately coordinated to achieve the overall corporate vision and sustained growth without unduly stretching the financial and skill resources of the firm. (Even if some portion of M&A activity is outsourced to outside parties, such as investment bankers and outside counsel, ultimately EBIX manages the process and makes the investment decisions.)

Client familiarity, industry knowledge, and software technology expertise in the firm provide a powerful insight that facilitates the assessment of acquisitions -- products to be acquired, markets to be served, modularity to be constructed, and contributions to the solutions clients need.

Such perspective and knowledge is conducive to making informed acquisition decisions, and to maintaining both operational risk (absorbing, rationalizing, and integrating acquired businesses) and investment risk (valuating potential acquisitions, structuring transactions, and sourcing capital), within the boundaries of the firm's core competence.

Based on the foregoing, we consider that the business risk attached to the overall business is moderate. Diversification of revenues among clients and geographies, and recurrence of revenue streams (75%-80%), provide a stable and expanding source of EBIT and cash flow from operations (see chart). Adding strength is a client roster that includes many respected names in business (a sample list of the clients who signed contracts with the company during Q 9/10 is available here). Regarding financial risk, the use of financial debt use is also moderate and well within the company's ability to manage it.

**Return on Invested Capital (ROIC)**

According to our calculations, ROIC ranges between 15% - 20% for the four-year period. These ROIC returns exceed 10% estimated cost of capital. They reflect steady and substantial growth in shareholder value.

- NOPAT = Net Operating Profit after Taxes; NOPAT = EBIT (1 –Tax Rate)
- ROIC= NOPAT/Operating Capital
- Operating Capital = Net Operating Working Capital (NOWC) + Operating Long Term Assets (OLTA). Operating Capital includes all the capital used in the business, including NOWC and in OLTA. OLTA includes all fixed assets, goodwill, and all other "acquisition assets."

As discussed earlier, the overall business risk attached to the combined activity (organic growth + growth by acquisitions) and ROIC is perceived as moderate, and well within the boundaries of risk management competence.

**Fundamental Value**

EBIX's fundamental value is conservatively estimated at $25/share. This is based on $44 million of FYE12/10 FCF, 14% annual FCF growth in the three years following 2010, and 5% growth in perpetuity thereafter. The cost of capital estimate is 10%.

The growth assumptions are conservative in comparison with historical results; the prospective 14% FCF growth is only a relatively small percentage of 54%, the average FCF growth for the last three years (2008-2010). Such relatively slow growth assumption substantially relaxes the requirement of continued fast-paced acquisition activity.

Implicit in the value estimate is moderate risk resulting from a business model that emphasizes recurring revenues and produces ROIC consistently above the cost of capital.

To put fundamental valuation in perspective, we should examine the goal (not guidance) reinstated by the CEO during the last earnings conference call: EBIX would like to be at a $200 million+ revenue run rate by Q4 of 2011 with an operating income of around $80 million. These figures compare with $130 million in revenues and $48 million in operating income estimated for FYE 12/10. The goal puts annualized FCF at well above $60 million, in accordance with our computation. This is a notable increase of over $44 million in FCF estimated for FYE 12/10.

**Summary**

Performance, as measured by the value metrics discussed and by the expanded infrastructure, is given a very high passing grade. The CEO's emphatic and exacting strategic message is fully backed up by results.

EBIX has maintained a high rate of growth during trying economic times, while serving both the insurance and financial industries, who are themselves in the process of recovery. Acquisitions have enabled rapid growth while creating substantial shareholder value (ROIC > Cost of Capital).

Characterizing EBIX performance are rapid growth in revenues and FCF, ROIC returns in excess of the firm's cost of capital, a client roster of prominent names in the marketplace, modest operational risk (stable, predictable, diversified and recurring source of revenues and cash flow), modest financial risk (relatively low use of debt, stable balance sheet), and an expanded infrastructure well suited to retain clients and support organic growth as the pace of global economic activity recovers.

Expanded infrastructure deserves special mention. It is a capability that enhances the firm's competitive position and amplifies market relevance (product suite; geographic reach; skills and technology). The resulting market position is in line with EBIX's strategies and supportive of the company's vision and goal.

EBIX's current market price (currently under $22/share) is below the conservatively estimated fundamental value ($25/share).

**Disclosure:** Long EBIX.

# Comments on this article

### Frank Lind

Great article!

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### Gino Verza

Author's Reply Thank you, Frank Lind.

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### ozzfan1317

I agree well run and very compelling valuation. I already have a substansial amount of my net worth invested in them.

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### ari5000

so do you own this?

Not much margin of safety... 10% upside? Why bother?

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**Gino Verza**

Author's Reply ari5000,

Thank you for the questions.

I confirm the information in the disclaimer; I own EBIX.

The estimated fundamental value is based on certain assumptions, as noted in the article. One of the assumptions, for example, is 14% FCF growth rate. As noted, this figure is very conservative when compared against recent history.

If we were to change that assumption to, say 17%, the estimated fundamental value would increase to from $25/share to $27/share. A 20% FCF growth rate would produce a fundamental value in excess of $29/share.

Keep in mind that all the assumed FCF growth rates are still well below the 54% FCF average growth rate for the last three years (2008-2010).

The goal (not guidance) of $80 million in operating income run rate by 4Q 11 mentioned in the article corresponds to a FCF figure for FYE12/12 that is even higher than the FCF for FYE 12/12 corresponding to the 17% or 20% FCF growth rates mentioned above.

In my opinion, all in all, the story and big picture behind EBIX is compelling, including the moderate level of risk attached to FCF generation and ROIC. This is discussed in the article in some detail.

Best wishes.

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**Contheon**

EBIX has been recently featured in IBD's New America, which tends to be based on "observation" and marketing materials. Morningstar takes the valuation view, but often their analysts are out of touch and miss the business the link between business strategy and execution. This report has more insight, information and logic then IBD and Morningstar combined.

It's good to see other investors that take the time to explore the difference between fair value and stock price and share the critical assumptions.

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**Gino Verza**

Author's Reply Contheon,

Appreciate your opinion. Thank you.

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**Neat_Gent**

Was pleased to stumble across this article. I have a passion to learn
Fundamental Analysis and was ecstatic as I started to read this article. Well articulated and detailed (analysis of facts).

I shall prowl around for similar articles of this nature (and quality).

OBTW, do you have any recommended books or articles
that follow this thread of analysis?

Well Done !

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**Gino Verza**

Author's Reply Wow, Neat_Gent; thank you, thank you.

I do also enjoy fundamental valuation. By now, it is second nature.

There is an article by distinguished Professor Robert A. Howell that I'd like to send you, if you give me your e-mail address. He is a proponent of free cash flow accounting disclosure, since free cash flow is a driver in fundamental value.

I believe Professor Howell is still teaching at the Tuck School of Business. Perhaps you can also search for his work in the internet.

Best wishes.

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