20%+ ROIC, Year After Year? Look At Ebix's Capital Allocation

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Making good capital investment decisions, optimizing working capital, and achieving a balanced capital structure, are the most important financial roles of management.

This article focuses on capital allocation at Ebix (EBIX). The purpose is to examine the importance of capital allocation in creating shareholder value, measure results, and discuss how management is able to generate 20% on ROIC, year after year.

Metrics

- ROIC (Return on Invested Capital) = NOPAT / Operating Capital
- NOPAT (Net Operating Profit after Taxes) = EBIT (1- Tax Rate)
- OC (Operating Capital) = NOWC (Net Operating Working Capital) + OLTA (Operating Long-Term Assets)
- Capital Allocated = Increases in OLTA (principally due to strategic acquisitions)
- WACC (Weighted Average Cost of Capital)
- EVA (Economic Value Added) = NOPAT – (Operating Capital x WACC)

The objective of capital allocation is to achieve ROIC in excess of WACC. Management expands OLTA based on prospective NOPAT generation. OC and NOPAT, together, shape ROIC.

Performance Assessment

EBIX Table --Selected Metrics

(Amounts in millions of US$, unless otherwise noted)	FYE 12/06	FYE 12/07	FYE 12/08	FYE 12/09	FYE 12/10	5-Yr.Avg. FYE06-10	Q 9/10	Q 9/11
Revenues	29.25	42.84	74.75	97.69	132.19	75.34	33.38	42.60
Revenue Growth (y-o-y)	21%	46%	74%	31%	35%	42%	43%	28%
Revenue per Sh. ($/Sh.)	1.04	1.36	2.03	2.57	3.39	2.08	0.86	1.05
NOPAT	6.04	12.29	27.80	38.08	49.36	26.71	12.56	16.87
NOPAT / Revenues	21%	29%	37%	39%	37%	33%	38%	40%
NOPAT per Sh.($/Sh.)	0.21	0.39	0.76	1.00	1.26	0.73	0.32	0.42
Increases in OLTA	16.15	15.65	66.54	100.01	26.87	45.04	103.96	85.47
Incr. in OLTA / NOPAT	55%	127%	239%	263%	54%	148%	311%	201%
Incr. in OLTA per Sh.($/Sh.)	0.57	0.50	1.81	2.63	0.69	1.24	2.66	2.11
NOWC	-0.07	0.54	-2.29	6.08	1.78	1.21	6.66	-5.48
OLTA	33.45	49.10	115.64	215.65	242.52	131.27	241.15	326.62
Operating Capital	33.38	49.64	113.35	221.73	244.30	132.48	247.81	321.14
Incr. in Operating Capital	18.34	16.26	63.71	108.38	22.57	45.85	98.21	73.33
ROIC	18.09%	24.76%	24.53%	17.17%	20.20%	20.95%	20.27%	21.01%

WACC (Estimated)	13.00%	12.00%	11.00%	10.00%	10.00%	11.20%	10.00%	10.00%
# Shares	28.26	31.60	36.78	38.01	39.02	34.73	39.02	40.45
# Shares Growth (y-o-y)	1%	12%	16%	3%	3%	7%		4%

The chart shows the following:

- ROIC averaged in excess of 20% over the last six years, or so, well above 10%, estimated WACC. This means that Ebix consistently increases shareholder wealth.
- High ROIC was achieved even in the face of increasing larger capital allocation decisions and concomitantly larger execution challenges --OLTA increased rapidly every year, except in FYE 12/10.
- Deployment of capital in NOWC was very small relative to OLTA. Thus, management of working capital contributed significantly to high ROIC.
- EVA for FYE 12/10 was $24.93 million (49.36 – 244.30 x 10%). This amount is net of all business expenses and after deducting the cost of OC.

By way of a reminder, EVA is not a GAAP term. According to GAAP Net Income, or Net profits, is the surplus earned after deducting business expenses from revenues, but without deducting the cost of shareholder capital used. GAAP P&L does not deduct the cost of shareholder capital.

- WACC is conservatively estimated at 10%, currently (and higher in earlier years, when the business was less certain and less robust). Favorable internal performance measures, such as rapid growth in revenue, EBIT, and NOPAT, reflect low business risk, and contribute to lowering WACC. Activity measures such as diversification of clients, high level of recurring sales to existing clients, and low client loss, also contribute to low business risk and low WACC.
- Year after year allocation of capital is substantial relative to the size of the firm. Increases in OLTA, principally representing acquisitions aggregated in the neighborhood of $300.0 million over the last six years or so.

The point, not to be lost, is that capital allocation is one of the most important management roles at Ebix. Based on results we conclude that management is very good at translating sizeable investment decisions into high ROIC. To be sure, ROIC performance points to two specific management competences –capital allocation and execution in acquisition integration.

How difficult is to allocate capital to produce 20% in ROIC, year after year, while maintaining (business) risk at a relatively low level?

Very difficult, I would say, particularly in the early days, a decade or so ago, when resources available to management were very scarce, business struggled, and survival was a real question mark. Under any circumstances, consistent generation of 20% in ROIC is a tall order, particularly when consider the low single rates exhibited by treasury obligations.

Perhaps a more interesting question is how does Ebix do it?

Strategy and Execution

Ebix's capital allocation competence incorporates vision and capacity.

Vision is the ability to see direction and destination of the firm within the context of market opportunity. Capacity is ability to use and organize resources effectively to provide valuable service in the eyes of clients and create shareholder value.

Vision translates into strategy. Capacity is managerial effectiveness, of which capital allocation and execution are critical components.

Good capital allocation decisions without a strategy are for all intents and purposes loosing propositions. Likewise, lack of competence in execution renders capital allocation no more than questionable bets. Beyond a requirement, a coherent strategy is an enabler in adept capital allocation.

Ebix has a clear and well articulated strategy; a Network Strategy –the construction of a network within the insurance industry. Below are highlights of such strategy paraphrased from the company's presentations.

- The network capitalizes on the convergence of all channels in the insurance industry, with the goal of taking data across all entities in the industry and across all product lines seamlessly.
- The network is an infrastructure based-served business (like an airport) with relatively little competition, and where a large percentage of revenues are recurring in nature. Products and services are available on demand, charged on a utility-like fashion.
- The focus of service is enterprise-wide; providing all insurance services and deploying front-end, exchanges, and back-end systems, across all product lines, while taking responsibility for the enterprise-functionality of the end client.

- Technological development is agnostic. Preference is to take advantage of open architecture standards; to expand functionality and take advantage of latest advancements. Emphasis is on the cutting-edge and staying years ahead of competition.
- The focus is on building a solid business where clients pay on an ongoing utility-basis, and where margins and the revenue cash content are robust.
- Consistency is an all around focus; on recurring revenues and overall financial performance, and on how to be seen by stakeholders in general, including clients and shareholders.

Capital Allocation is Network Development

How does the Network Strategy enable capital allocation?

The functionality of the network provides clients with a valuable service, retains clients and expands the client base at a low acquisition cost. Client acquisition is susceptible to a natural evolution whereby customers of clients, seeking low cost processing benefit, represent immediate prospects that turn into clients themselves. These attributes translate into economic benefit for the firm and its shareholders.

The strength of the network hinges on how prevalent is the network as a standard of exchange among industry players, how unique are the services provided in terms of scope, and how comprehensive is the end-to-end transaction facilitation provided. The Ebix story highlights continuous network development to strengthen the franchise.

New acquisitions add to the value of the network exponentially through mutual re-enforcement of clients, products, skills, roles, and process. Acquisitions add clients and product capability to the network; the network in turn synergizes new clients and new products over the existing client base and product suite. The same can be said about skills, roles, and process. The synergistic benefit that accrues to network-enhancing acquisitions rests on the power of the network itself, and builds with every additional acquisition.

Predominant networks exhibit mutually-reinforcing attributes, such as the following:

- High client retention
- Low cost in prospect/client conversion
- High level of recurring revenues
- High predictability in gross margins, NOPAT, and FCF
- Low business risk
- Low WACC
- High cost of entry to potential competitors
- Competitive advantage over competitors with insufficient scope or scale (who prefer to sell in exchange for stock in the predominant network)
- Acquisitive networks can shorten the capital recovery cycle by acquiring existing clients and capabilities, rather than developing them from scratch
- Synergy in the integration of potential acquisitions.

Summary

Capital allocation rests on seizing market opportunity by means of a sensible strategy; and on the capacity to strengthen the network. At Ebix capital allocation is particularly important, given the large size of OLTA expansion relative to the size of the total firm.

Ebix's business model (i) adequately provides benefit to clients through the power of the network, (ii) achieves substantial economic benefit to shareholders; high ROIC, on a risk-adjusted basis, and (iii) exhibits a high level of management effectiveness in articulating a clear and reasonable strategy, and in execution --organizing skills, roles, and process.

The combination of the right strategy, the right capital allocation, and the right integration of acquisitions, is very difficult to attain. Performance measures and exceptional ROIC, year after year, support the view that Ebix excels in execution –one strategy, one acquisition, and one business integration at a time. As I have indicated in previous articles, the performance of Ebix management and CEO Robin Raina is nothing short of extraordinary.

In my opinion, the price of Ebix's stock does not truly reflect management competence or the fundamental value of the firm.

Disclosure: I am long EBIX. The views expressed represent a personal opinion, not an investment recommendation. The methodology of analysis, including financial computations, presentation, and views, also reflect personal preferences. Presentation and computations entail a probability of error, which is entirely possible. Please do not rely on this analysis; do your own due diligence.