Seeking Alpha α

Why Ebix Still Has Room to Run

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In November, 2010, I presented an investment opportunity in Ebix, Inc. (EBIX) based the gap between stock price ($22/share) at that time and the contemporaneously estimated fundamental value ($25/share).

Since that time, the stock price has risen to close to $29/share. Such movement in price begs the question; is EBIX now fully priced, or is there still room to run?

This article revisits the estimate of fundamental value with an eye on the investment thesis underlying the November value estimate, to see if the thesis has changed, or if it remains valid.

Investment Thesis

Implicit in fundamental value estimates is the rationale that supports assumptions regarding future performance, principally prospective free cash flow.

Let's examine the rationale for the investment thesis from the perspective of EBIX's three business model components.

Client Benefit

The growing client roster, low rate of client losses, and high level of recurring operating revenues (over 70%) provide ready factual support to the notion of great benefit obtained by clients who use EBIX's products. Such benefit validates the company's leadership in backend transaction processing in the insurance industry.

Client benefit provides ample opportunity for growth in the addressable market segment, estimated at $60 billion in the U.S. alone. The need to reduce paper flow and improve efficiency in the insurance industry is a relatively recent phenomenon driven by technology, industry consolidation, and a market context conducive to competition.

Economic Formula

A comprehensive measure of shareholder benefit is ROIC. By my computations, ROIC is consistently in the 20%+ neighborhood, much greater than 10%, the estimated cost of capital. In other words, EBIX produces returns twice as large as the cost of capital.

- Return on Invested Capital (ROIC) = NOPAT / Operating Capital
- Net Operating Profits after Taxes (NOPAT) = EBIT (1 – Tax Rate)
- Operating Capital = NOWC (Net Operating Working Capital) + OLTA (Operating Long Term Assets).

Embedded in ROIC is efficiency in the use of Net Operating Working Capital (NOWC). My figures show that as of Q4'10 NOWC was $6.66 million, or 5% of annualized quarterly revenues ($133.12 million).

Meanwhile, Operating Long Term Assets (OLTA) amounted to $241.15 million, or 1.81 times annualized revenues.

The point: Capital efficient NOWC makes up for the comparatively heavy capital usage by OLTA, due to acquisitions. Such

NOWC efficiency is a rather permanent attribute that enables fast revenue growth and high ROIC.

Management Effectiveness

EBIX has been able to consistently create shareholder value by producing ROIC well in excess of its cost of capital, and to strengthen its franchise within the insurance industry by expanding geographical reach, product breadth, and the client roster.

Technical competence has enabled enhanced productivity by reducing paper flow and related cost savings; benefits enjoyed by the users of EBIX's exchanges. Moat and the growing value of EBIX's exchange network is a beneficiary of its expanded use.

Client benefit and the value of the network are reciprocal beneficiaries, ultimately resulting in healthy operating margins (NOPAT / Revenues fluctuate around 40%), and reliable operating revenues (70% are recurring).

In retrospect, management has been adept at successfully running two distinct and different, but mutually supportive businesses; M&A for strategic acquisitions, and the main-purpose, technically-driven, insurance transaction processing.

Despite inauspicious legacy and historical financial constraints going back a dozen years or so, management has strengthened the firm by constructing and implementing a vision. Progress has become increasingly evident in the last few years. Technology and strategic acquisitions have strengthened moat and expanded shareholder value. Acquisitions have also shortened the time that would otherwise have been necessary for EBIX to achieve current industry prominence.

Recent economic expansion and the ensuing recovery of asset values and corporate valuations add to the degree of difficulty inherent in finding and carrying out strategic acquisitions at attractive prices. On the other hand, the prominence achieved by EBIX in the industry (read: Market coverage, broad product suite, and far-reaching distribution network) provide it with a competitive advantage as an acquirer; industry-capable, financially solvent, experienced in acquisition integration and in producing related synergistic benefit.

Management stability strengthens continuity in purpose, strategy, and execution. Particularly noteworthy is the longevity of the CEO in the company and his alignment with the interests of shareholders evidenced by his significant equity ownership.

Investment Thesis Tally

It is important to distinguish between financial results (or information) that represent steady performance under the investment thesis (even if it is "below guidance, or below consensus"; or even leading to a decline in the price of the stock), and information or financial results (even if "better than expectations") that suggest a deterioration in the investment thesis.

Quarter-to-quarter results may meet expectations, exceed them, or fall short, depending upon many business factors, including some that are not directly within the control of management. A delay in closing a large deal, for example, causing a miss in meeting revenue guidance would not seem to be a sufficient reason to consider the investment thesis as no longer valid.

Investors then, are charged with the task of understanding financial results within the framework of the investment thesis, and distinguishing in financial results those events (e.g. revenue misses, decreases in margins) that can be considered "normal" and conforming to the investment thesis, from those "substantive changes" that represent departures from the thesis, or that invalidate it.

The attributes underlying an investment thesis, such as market opportunity, or the firm's core capabilities, or the attributes of its commercial or investment cycles (read: NOWC or OLTA); are durable in nature and extend beyond 90-day-reporting periods.

It is helpful, therefore, to understand the investment thesis-- the theme encompassing corporate purpose, strategies, and related management actions – as causal to subsequent financial results. How management seizes opportunities, allocates resources, and manages client relationships, do in fact shape ulterior financial results.

With this background in mind, we assess that EBIX's investment thesis remains intact.

The recent appreciation in the price of the stock is a tacit recognition of value by the financial market at large. Summarily, EBIX continues to execute well. Scores in Client Benefit, Economic Formula, and Management Effectiveness are apparently all very good.

Execution in line with the investment thesis ought to augment revenues, earnings, and free cash flow.

ADAM Acquisition

The closure of the ADAM acquisition was reported on February 8, 2011 here.

By my count, this is one of the largest, by cost, if not the largest in the long string of strategic acquisitions made by EBIX over the last few years.

Financially, ADAM's impact is noteworthy. According to my figures, ADAM represents about 21% of EBIX's revenues, and 30% of NOPAT. Pro-forma aggregation of both company's figures expands free cash flow and provides the impetus for the revision of the fundamental value estimate, discussed below.

Having said this, the acquisition event by itself does not guaranty the fulfillment of its greater purpose. Much of the hard work in integrating ADAM into the total EBIX vision still remains to be done.

Objectives, metrics, products, and processes of the acquired firm need to be integrated and organized into those of EBIX so that the combined entity, as one, takes advantage of the attributes of both firms. Roles and accountabilities, and reward for performance need to be realigned so that the appropriate skills are brought to bear in adequately formed teams to respond effectively to various aspects of client needs.

Fundamental Value

Fundamental value is estimated at $38/share - $40/share. The formulas and assumptions are shown below.

- Enterprise Value = Present Value of FCF growing at g, discounted at WACC
- Free Cash Flow (FCF) = NOPAT - Net Investment in Operating Capital during the period
- Net Operating Profits after Taxes (NOPAT) = EBIT (1 – Tax Rate)
- Operating Capital = NOWC (Net Operating Working Capital) + OLTA (Operating Long Term Assets)
- FCF Growth Rate (g)
- Weighted Average Cost of Capital (WACC)
- Equity Value (Fundamental) = Enterprise Value + Cash – Debt
- Share Fundamental Value = Equity Value / # Shares.

Assumptions: Base FCF is $66.39 million, g is 6%, and WACC is 10%.

- Base FCF is computed based on the pro-forma financial statements containing both EBIX and ADAM, (see here).
- Growth of FCF at 6% seems reasonable in comparison with rates of 89% in 2008, 27% in 2009, and 47% expected for 2010. The assumed rate takes into account prospectively decreasing dependency on strategic acquisitions and increasing reliance on organic growth.
- WACC is estimated conservatively at 10%.

- Growing FCF at 6.0% and discounting it at 10% represents a heavy mathematical load, leading to a conservative fundamental value estimate.

The current price, $29/share, represents a substantial discount from the estimated fundamental value.

Different Challenges

In recognition of the medium term view implicit in fundamental valuation, it is useful to mention that business growth is accompanied by magnified complexity.

Managing a diverse roster of clients globally, appropriately delivering solutions (involving dispersed subsidiaries), and adequately assembling the pieces from an expanded product suite, represent a growing and ongoing management challenge. From pricing and deal negotiation to contract documentation; timely solution delivery, and ongoing customer service support, all are necessary and important in managing client relationships. Specific processes are required to appropriately manage relationships, do deals, and deliver ongoing customer service. Clear roles and accountabilities need proper alignment with reward compensation for the individual and for the teams.

The implication for EBIX is that growth in business mass connotes evolution in operations management; from control-and-command to a team-focused, value-based, model that empowers decentralized decision-making within a context of shared principles, processes, metrics, and rewards. Without going into unnecessary detail, suffice it to say that this is a feat difficult to accomplish- everyday, one deal and one client at a time.

Economic recovery entails improvement in the general level of asset prices, an important factor in the execution of attractive strategic acquisitions. This means that EBIX acquisitions at low price/value ratios will be increasingly difficult to achieve.

These new challenges are different, not necessarily more difficult than those faced by the EBIX in the past. Expanded moat and proven management effectiveness provide a strong foundation for continued expansion in shareholder value.

Summary

EBIX's investment thesis remains intact. Management performance has been nothing short of exemplary.

With modest resources management and under the forceful and unequivocal leadership of its CEO, the performance of EBIX has been successful. The company has transformed from a modest business into a major industry force --in the convergence of distribution channels and backend processing of insurance transactions. Result: An expanded franchise moat and growing shareholder value.

Reiterated here is the investment opportunity in EBIX based on the gap between the revised fundamental value and the current price of the stock.

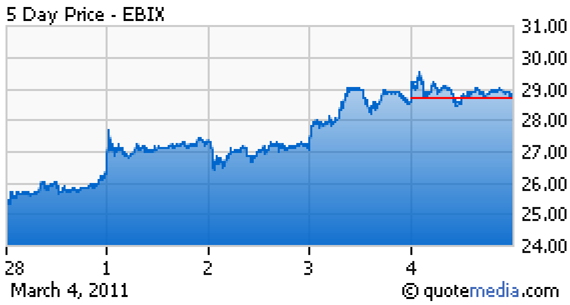
A cautionary note: Fundamental value estimates are useful guides over the medium term, but not necessarily for predicting short term stock price movement. In other words, the odds favor fundamental value estimates when coupled with a medium term horizon. Conversely, the odds become adverse when using fundamental value estimates as short term predictors.

By construction, fundamental value envisions a steady progression of free cash flow over the medium term. In reality, intervening short term blips (e.g. unfavorable, or below expectations quarterly financial results) are almost inevitable.

The onus is on the investor to set the investment horizon consistent with the notion of fundamental valuation, and to assess ongoing financial results mindful of the distinction between (information that represents) normal performance, on one hand, and financial results or other data that voids the investment thesis, on the other hand.

All in all, EBIX is not fully priced; the stock still has lots of room to run.

Disclosure: I am long EBIX.



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