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EBIX and Its CEO Are 2 Class Acts to Follow

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April 11, 2011 | about: EBIX

This article covers three drivers in fundamental value; free cash flow, growth in free cash flow, and business risk. Also discussed is return on invested capital, a measure of comprehensive performance.

This discussion elaborates on previous analyses, emphasizes standing conclusions, and reaffirms estimated fundamental value at $38/share - $40/share (for detail see 3/7/11 article).

Information provided by Robin Raina, CEO, on occasion of investors' day on 4/1/11, is a source of important input.

Ebix Inc. (EBIX) is presented as a business with a compelling combination of attributes –a network that delivers critical value in the core activities of clients, a history of strong economic returns, and management effectiveness in the deployment of resources that grow shareholder value.

Context

Major elements in the estimation of fundamental value are shown in the formulas below.

- EBIT = Operating Income
- NOPAT = Net Operating Profits after Taxes = EBIT (1 – Tax Rate)
- Operating Capital = NOWC + OLTA
- NOWC = Net Operating Working Capital = Operating Current Assets – Operating Current Liabilities
- OLTA = Operating Long Term Assets
- FCF = Free Cash Flow = NOPAT - Net Investment in Operating Capital during the period. (As a practical approximation FCF = Cash Flow from Operations minus Depreciation and Amortization)
- g = FCF Growth Rate
- WACC = Weighted Average Cost of Capital (largely determined by business risk)
- Enterprise Value = Present Value of FCF growing at g, discounted at WACC
- Equity Value (Fundamental) = Enterprise Value + Cash – Debt
- Fundamental Value (share) = Equity Value / # Shares

Free Cash Flow

The metrics below for FYE 12/10 show strong NOPAT, strong FCF, rapid FCF growth, and ROIC well in excess of WACC (see Ebix Table; 3/16/11 article).

- NOPAT = $49.36 million (NOPAT / Revenue = 37%, 40% in FYE 12/09)
- FCF = $46.74 million (FCF / Revenue = 35%)
- Operating Capital = $244.30 million
- g = 56% in 2010, and 27% in 2009
- FCF = $46.74 million (FCF / Revenue = 35%)
- ROIC = 20% (17% in FYE 12/09)
- WACC = 10%.

The business rationale behind NOPAT and FCF is robust gross profit margins and preference for invoice terms no longer than quarterly on contracts that renew automatically annually. Reinforcing such sales terms' policy is short term pricing flexibility and strong client retention.

Ultimately, the utility value of the network in the eyes of clients is the driver of high margins, low client attrition, and relatively low sales and marketing expenses.

FCF Growth

Revenue growth is often used in performance discussions as an interchangeable substitute for FCF growth. Likewise, organic revenue growth is portrayed as preferable to growth-by-acquisition.

Both implications need a qualifier because revenue growth does not always generate FCF growth. It is quite possible for acquisitions, like in the case of Ebix, to contribute to growth in FCF. The key issue on fundamental valuation is FCF and FCF growth, regardless of the revenue source.

Not to belabor the point, the EBIX Table in the previous (3/16/11) article, shows that FCF was $46.74 million in 2010, and that its 5-year average annual growth was112% (including 35% in 2009 and 56% in 2010).

The takeaway –Ebix's track record of FCF generation, and FCF growth, is strong.

Business Risk / Network Effect

The 3/10/11 article presented Ebix's business risk as relatively low, based on reliable growth in EBIT and in Cash Flow from Operations. Here we approach the issue of risk and cash generation from the perspective of the network effect.

What is the network effect?

Network effect is the impact that a user has on the value of the service to other actual or potential users. Additional users make the network progressively more valuable as its scope and reach increases usefulness to all. In this environment prospects doing business with Ebix clients tend to become interested in the benefits of the network and eventually become Ebix clients themselves.

Immediate benefits accrue to Ebix through the network. First, its prospect list is clear and immediate --the aggregation of industry participants that do business with Ebix's clients. Second, client acquisition cost is relatively low. Third, clients continue to transact through the network into the future.

Clients benefit by access to the network as convergence of all the channels takes hold and a growing number of participants in the insurance industry adopt the network as a standard operating procedure. Increased transaction expediency and reduced operating costs are strong motivators.

The network is also explained as a utility; an essential service with widely accepted standard features. In this model, prospects who become clients expand revenues and also the value of the network to clients and prospects alike.

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 lacking scope or scale (who prefer to sell in exchange for stock in the predominant network)
- Synergy in the integration of potential acquisitions.

Given the strength in the business and relative low risk, is there anything that can go wrong?

The short answer is yes.

There is always risk in business, and plenty that can go wrong --low-probability-and-major-impact events can cause serious damage to enterprise value (not included in this discussion is the investor's investment risk due to market events). Thus, a history free of risk events does not preclude occurrence of future negative risk events.

Business risk in this article does not include all the conceivable events that could potentially be disruptive to the business model of the firm (see 3/10/11 article for additional detail).

Having said this, Ebix's tight adherence to its purpose and strategy suggest that risks assumed fall well within management's scope of competence and within the firm's financial wherewithal.

ROIC / Acquisitions

Capital investments that generate ROIC in excess of WACC contribute to shareholder value. ROIC for FYE 12/10 was 20%. ROIC for FYE 12/09 was 17%. Estimated WACC is 10%. (FYE 12/10 Performance section in the 3/16/11 article contains additional detail).

If an acquisition generates a pro-forma ROIC higher than alternative internal development projects, and ROIC > WACC, then management should pursue the acquisition (assuming same risk). The guiding rationale in making capital investments is to expand NOPAT while deliberately deploying Operating Capital.

Why is Ebix so successful in generating attractive ROIC through acquisitions?

Benefit results from the combination of the attributes of the acquired company, on one hand, and those of the existing Ebix network, on the other hand.

The value of the resulting network is expanded by an increased product suite (a new product belonging to the acquired company that can be sold to existing clients), enlarged client base (new clients from the acquired company who are candidates for buying products from the existing network), expanded presence (in reach and as a the standard of transaction processing in the insurance industry), or by a combination thereof.

Acquired companies bring with them non-core supporting functions and infrastructure that is already available in the acquiring company, such as like HR, legal counsel, sales and marketing, information technology, and geographical presence. Streamlining processes and eliminating duplication strengthens NOPAT.

The combination of revenue expansion, cost reduction, and sensible acquisition price, provide a legitimate head start in bolstering pro-forma free cash flow of the combined company.

To sum up, Ebix's acquisition strategy is validated by a history of successful acquisition integration, and robust FCF and ROIC.

Summary

This work adds weight to existing analysis and expands confidence in the conclusions previously discussed.

Ebix is presented as a business with a compelling combination of attributes –a network that delivers critical value in the core activities of clients, a history of strong returns, and management effectiveness in the deployment of resources that grow shareholder value.

Supporting an estimated fundamental value of $38/share - $40/share is strong free cash flow, rapid growth in free cash flow, and a relatively low business risk. Just to be clear, prediction of short term performance, or short term market action, is beyond the scope of this analysis or fundamental valuation.

The CEO presentation was broad in scope and useful in practical detail, covering much more than what is referred to in this article. By the way, the CEO's substantial ownership in Ebix (about 4 million shares) adds confidence in the effective alignment between the role of management and the interest of shareholders at large.

I'd be remiss in neglecting to mention the values expressed by the CEO as his own --integrity, truth and sincerity; or his passions; his family, his company and his foundation. Beyond valuable information regarding strategy and execution, the presentation was a relevant expression of the essence of the man and a measured reaffirmation of the character of the firm.

Disclosure: I am long EBIX.

Disclaimer: Careful attention has been given to accuracy. Nonetheless, computations entail a probability of error, which is entirely possible. Please do your own due diligence.