Seeking Alpha α

Craig-Hallum Research Report Provides Counterpoint to Copperfield Claims

by: David Collins

March 30, 2011 | about: EBIX

In the interests of providing a more balanced base of commentary concerning Ebix, Inc. (EBIX), I am posting the bulk of the text from Craig-Hallum's recent research update which rebuts assertions in the Copperfield Research report from last week. As many Seeking Alpha readers might not have access to the Craig-Hallum report, I requested and received the analyst Jeff Van Rhee's permission to make his comments rebutting the Copperfield claims available here.

Jeff completed two two days of marketing with EBIX management in Boston and New York (March 17/18) giving him recent exposure to the story and EBIX responses to investor questions.

I'm impressed with Copperfield's ability to create a substantial short term trading profit for those, including the author, who were short EBIX shares. However, those of us who have watched the company's disciplined execution of its strategy have done quite a bit better! But for those who are new to EBIX, perhaps this is the gift of an attractive entry point?

Fortunately, the company's track record and small scale within the global insurance industry suggests there is much room for continued growth - be it inorganic or organic.

Bottom line, it pays to know what you own - so I hope this helps balance the playing field.

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March 25, 2011

Jeff Van Rhee, CFA, Senior Research Analyst

Saurabh Paranjape, Research Analyst

Craig-Hallum Capital Group LLC

Ebix, Inc. Buy

Reiterate Buy Rating And $35 Price Target.

Fundamentals Underpinned By Cash Flow Remain Strong.

EBIX Shares Should Be Bought.

FY10A Rev (MM): -- $132.2

FY11E Rev (MM): -- $170.9

FY10A EPS*: -- $1.40

FY11E EPS*: -- $1.52

OUR CALL

Running the same playbook again in a concerted attack on EBIX, an anonymous writer posted an article Tuesday morning, rehashing many of the same talking points of an Oct'09 short note (also posted by an anonymous writer). Notably, while the most recent note was out and in circulation for over two days and longs reviewed the note, the shares reacted very little. This is because these issues have been addressed in detail by management, as recently as the two days of marketing last week in Boston and NYC, in which we participated (and after which the stock was up modestly).

While the short arguments continue to morph as previous mud slung at the wall begins to fall away, we will take some time during this quiet, short-friendly, vacation-heavy week (yours truly included) to address the key points of the short note as well as touch on a few of the takeaways from marketing with the company last week.

The bottom line is that the business is throwing off tremendous cash flow, has strong underlying fundamentals, solid organic growth and big barriers to entry. The prior (lengthier) short note was followed by very strong operational execution and cash flow from EBIX and a rising stock. We believe this dip will be followed by solid integration of ADAM, strong and accelerating organic growth and increasing activity in the leverageable EBIX exchange products.

On the back of these strong fundamentals, we continue to believe $2.00+ in 2012 EPS is a more than reasonable possibility. Should the company attain a 20x multiple that would put the stock north of $40. The past ten years have demonstrated exceptional fundamental progress for the EBIX business and based upon our work, we believe the next ten hold even more promise. We would be buyers of EBIX shares based on the fundamentals of the business and particularly in light of the temporary disconnect between fundamentals and the stock price.

OUR POINT OF VIEW

What Happened?

Tuesday morning an anonymous posting hit Seeking Alpha. Then, yesterday at 1.45pm when cumulative volume for the day was ~550k shares, a wave of extremely aggressive selling hit the shares, driving them down 24% by the close, on over 14.5 million shares in total volume. This is truly extraordinary, given our math which concludes that between insiders and a handful of key holders who we believe were not part of the selling, there does not appear to be enough stock left in the float to drive the kind of volume seen yesterday. By all accounts, it appears to have been a concerted effort on the part of some players, to drive the shares lower and capitalize on short positions which were increasingly becoming a liability for their owners. The action is not without precedent.

In Oct’09 a very lengthy negative note was circulated and saw the short interest rise from ~1 million shares in Oct’09 to ~10 million shares by the end of the year, only to be followed by strong stock performance on the back of impressive fundamentals. It may never come to light who this anonymous publisher and any related players are, but it seems very likely that this panic will in hindsight prove to have been managed in such as way as to serve their interests well in the short term, but to have had very little relevance to what happens in the underlying business or to longs who stay the course.

We recently traveled with the company and came away with very high conviction on the story

On March 17 and 18, we traveled with the company on a two day nondeal roadshow in Boston and NYC. We walked away from those meetings with a very high degree of conviction around the health of the EBIX business (record bookings quarter, shrinking sales cycles, signings of pivotal industry players, etc.) and are firm believers in their vision of global SaaS based exchanges for the Insurance world.

Much like the Ariba Supplier Network which built off of Ariba’s strong initial presence within buyer and seller customers using their software to become a dominant player with their exchange offering where the parties could meet and conduct commerce, EBIX is attacking the Insurance market in a similar manner (starting with brokers and carriers initially and now moving into exchanges).

Exchanges are in their early days, with ~7% of global insurance premiums being processed in an electronic exchange of any kind. As this number moves higher in the coming years, we believe EBIX has carved out a dominant and defendable position to capture that shift and drive significant value for shareholders.

In addition to the fundamental drivers above, the company also spent time addressing many of the typical concerns raised by prior short notes (and largely repeated in the note on Tuesday), namely organic growth, tax rate, auditors and a rotating mix of lesser issues. We felt the company addressed them in a very direct manner and to the satisfaction of most attendees, resulting in the shares trading higher in the days following those meetings.

Responding to the points raised in the anonymous Seeking Alpha posting:

1. Organic growth remains healthy.

The majority of acquisitions have been accompanied by 8-K’s, giving us the necessary color to back into the organic growth rate for the core business. The acquisitions without 8-K’s were the very small ones for which we have to make independent estimates based on historical acquisition multiples and other data we were able to gather regarding the acquired companies.

Based on that data, we commented in our initiation report that the company was growing 10% +/- 200 bps in FY'10. In the recent 10-K and quarterly call, management noted that they put up 11% organic y/y growth in FY'10 (and noted they would be disappointed if they didn't grow at least 10% in 2011).

The Seeking Alpha piece contends that organic growth for the core business is in the low-mid single digit range, and that company filings inflate reported organic growth by including results from acquisitions in periods when the company did not own the acquired businesses (which is standard format for pro-forma comparisons in SEC filings).

Given that EBIX completed only one major acquisition in FY'09 & FY'10, namely the Oct.'09 acquisition of E-Z Data for $50.4 million, any organic growth comparisons are largely driven by assumptions around E-Z data revenues. In this respect, we would point out that the numbers on E-Z data revenues used in the Seeking Alpha piece imply a 33% y/y growth rate for the EZ Data business in FY'10, to then come to the conclusion that the core business did not grow materially.

After the EZ Data business was down organically (per 12.17.09 8-K) in the first 9 months of FY'09 over the first 9 months of FY'08, it would appear to be a stretch to see the business suddenly grow 33% y/y in '10. Interestingly, the author appears to incorrectly use Q4'09 seasonally strong revenues, as the go forward run rate for FY'10. So, in sum, we believe the data is being manipulated to tell the story the author has in mind.

Taking things one step further, let's consider what it would mean if the author were correct. It would mean that EBIX acquired the EZ Data business which was growing the top line 33% y/y, for 1.8x forward revenues. [Notably, the EZ Data business brought over 250,000 recurring CRM customers to EBIX.

While this in itself is attractive, the acquisition gets even more interesting when you consider that plugging those CRM users into the exchange enables EBIX to cross-sell those customers many other products and also makes those core CRM seat much more sticky in and of themselves.]

2. The tax rate is low and will remain so for some time.

EBIX relies on E&Y for International Tax advisory work and has been able to keep their tax rate very low (8% expected tax rate in '11, going to 10-12% over the next several years). Before we talk about the long-term tax strategy, it is important to note that the company had $28.5 million in NOLs remaining at the end of FY'10 and is likely to add $20 million plus through the ADAM acquisition (which closed in Feb'11).

In addition, the company is on a tax holiday in India until 2015, at which time their tax rate in India should increase from 0% to mid-teens. Further, the company is currently paying 10% tax on the profits generated by their Singapore operations, which house all of their IP. This rate is the subject of upcoming discussions between EBIX and Singapore, in which the company is walking through their belief that they meet all of the requirements outlined by the Singapore government to qualify for the lower 5% tax rate offered in certain circumstances.

With respect to their longer term tax strategy, the following discussion should be helpful. The company has 45% of their employees in India, where all of their R&D work is done. The IP is then transferred to Singapore, using transfer pricing rules based on arms length pricing between un-related parties. The US and Australian operations are considered distributors of this technology, which was developed and is housed off-shore.

This results in the majority of the profits accruing to offshore entities. Technology acquired from domestic businesses, which developed the technology in the US has never been transferred outside the country, despite the fact that virtually all code acquired is aggressively re-written in the companies very robust CMMI Level 5 R&D center in India.

Notably, other tech giants like MSFT, AAPL and HPQ use a similar strategy with lesser impact than EBIX, given the fact that these players have very material US developed IP, whereas EBIX does not. This arrangement has been the subject of extensive independently contracted research, with independent forensic accounting experts considering the strategy.

These and other opinions repeatedly come to the conclusion that this strategy is not only legal and much less provocative than suggested, but also sustainable. Anecdotally, we recently traveled with another $1 bln+ market cap SaaS name that is currently undertaking a similar strategy (without the benefit of the IP having been developed off-shore) and are expecting a roughly 1000 basis point reduction in their tax rate, as a result.

3. Auditor changes are always worthy of consideration and we have taken the time to investigate them

Over the past decade, the company changed auditors on four occasions, starting with a shift from KPMG to BDO Seidman in FY'04, followed by a shift from BDO Seidman to Habif Abrogeti & Wynne (HAW) in FY'07, and finally a shift from HAW to Cherry Bekaert & Holland (CBH) in FY'08. CBH is in their 4th year of auditing EBIX, issuing clean opinions in each of those years.

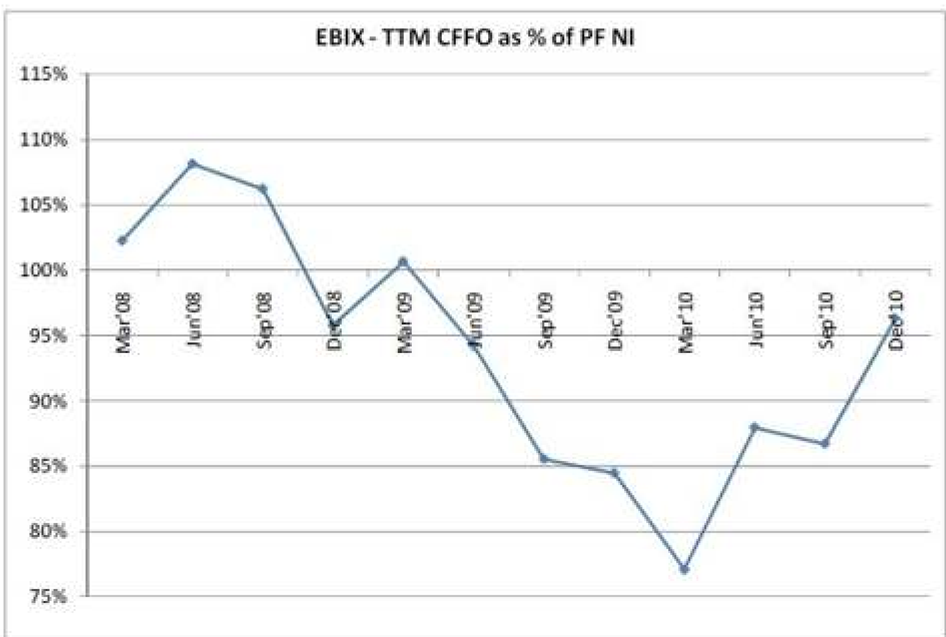
The prior auditor HAW is noted in the Seeking Alpha piece to have "resigned" from the EBIX account. We would note that this is the way relationships are terminated when the audited company informs the auditing firm they are going to make a change. Had there been any disagreement between the parties around accounting issues, they would have been disclosed. Notably, HAW recently nominated the EBIX CFO for CFO of the year in addition to continuing to perform a variety of services for EBIX. This is hardly the behavior of a disgruntled auditor. The article further goes on to note that the only big four auditors to audit EBIX, found the firm lacking adequate financial controls. Notably the audit in question took place back in 2003, which was not mentioned.

Further, for those that were following tech in 2003, this kind of commentary coming on the heels of the 2002 passing of Sarbanes – Oxley rules, was not nearly as uncommon at that point as it is now. The company has always been very cost conscious and in the selection of auditors has been consistent in this regard, with one of the changes in auditor partially driven by the desire to avoid an upcoming price increase. We would note that the Seeking Alpha piece points to EBIX spending ~0.4% of revenues on audit fees as a sign that audit fees are too low.

However, compared to our software coverage group (ARBA, LPSN, NUAN, JDAS, AKAM, etc.) as well as several of the comps used in the Seeking Alpha piece, we would point out that this level of spend is quite normal, with a typical range of audit fees being 0.3-0.6% of revenues. LPSN, a more comparable sized company, paid ~$522K in audit fees in FY'09 (to BDO Seidman LLP), vs. EBIX spending ~$343K (to CBH). We believe the hiring of a big four accounting firm for audit, regardless of price, would be a wise move here. We expect the company will do so in the next few years.

4. A few other, less meaty points that also warrant debunking.

- **ADAM and how could it possibly be accretive** – Looking back at the past ten years of results, EBIX has been outstanding at executing on acquisitions. The team is ruthless on costs, taking all R&D and moving it to India immediately, retaining necessary sales personnel and eliminating the rest, often on day one. The 10-year track record of this company making deals accretive should speak for itself in this regard.
- **Operating expenses and why they seem too low –** Compared to SaaS peers in our coverage group (SPSC, LPSN, IL, ARBA), the EBIX G&A expenses as a % of revenue are above the group, while the S&M expenses are well below. With respect to the S&M expenses, EBIX has a defined target group of potential customers and does not rely on trade shows and other non-targeted marketing. Further, the company has proven adept at bringing on senior talent at reasonable pay and meaningful equity compensation, which has proven important in attracting and retaining talent. We would note that in light of what we know of private competitors in this space, we do not believe the company's operating margins are out of line with their scale.
- **Cash flow and why it is not a pressing issue any more** – Prior negative attention on the company had been focused on cash flows. We pay very close attention to this number for all of our companies and in particular for those that are very acquisitive such as EBIX. In that light, it is notable that in the trailing twelve months the company's CFFO is now on par with Pro forma Net Income. This match puts the company in the upper tiers of earnings quality. This strong cash flow has been a key to improving perceptions and has been instrumental to the retirement of debt as well as funding the



Source: Craig-Hallum Capital Group LLC

acquisition strategy.

- **The comparison of the profitability for the Domestic and the International operations in the Seeking Alpha piece is also flawed**. In those calculations, the article attempts to show that the International Operations have a profit margin over 100%, adding to the argument that the tax strategy cannot be legitimate. This calculation is flawed in its logic, as it compares apples and oranges. A very large majority of worldwide revenues (including U.S. revenues) are derived from selling technology based on IP housed in Singapore and/or developed in India. Thus a large majority of profits are earned by the Singapore/India operations (i.e., could be considered ‘International’ profits) even though a large majority of revenues are being earned in the U.S., making the article’s point fundamentally inaccurate.

- **Deferred revenues and why they do not form a larger % of forward revenues** – The Seeking Alpha piece makes the point that based on the minimal deferred revenue balance EBIX could not be a SaaS player and therefore must be lying. This again is inaccurate as the company bills quarterly, not annually, meaning the balance of the contract with customers does not reside on the Balance Sheet (see SaaS vendor LPSN for similar characteristic).
- **CEO Robin Raina’s charitable efforts –** The Seeking Alpha piece also attacks CEO Robin Raina’s charitable foundation, whose stated goal is to provide 6,000 homes to the underprivileged in India who are currently homeless. The alleged evidence of this was two-fold. The first was a table showing the foundations assets from 2004 to 2008, with Net Assets ending at $1.6 million up from $250k the prior year. The argument appears to be that any foundation with such grand goals would have more Net Assets. We would note two factors. Firstly, based on the closing price of EBIX stock yesterday, we estimate the correct foundation balance to be north of $4 million, but more importantly, the Raina Foundation, like many other non-profit foundations, is not a parking place for asset accumulation, but rather a conduit through which assets are supposed to pass and as quickly as possible be spent on the charity in question. Secondly, the article appears to suggest that Bollywood entertainment was purchased through foundation assets for the personal enjoyment of the CEO. We would note the event in question was a fundraiser, for which tickets were sold and for which a net profit accrued to the foundation.

In sum, we believe EBIX is sitting on a very large open-ended opportunity to consolidate and own the insurance software space, while delivering industry leading margins (operating margin of ~40%) and cash flows. CEO Robin Raina has indicated continued confidence in the company’s prospects, not just with words, but also actions, as the most recent Form 4 on file with the SEC shows Raina holds ~3.9 million shares and 2.6 million options (including a recent 1.1 million share option exercise in which he held the underlying stock).

With a tailwind of record bookings, improving insurance premium volumes in target markets (as opposed to the 20% reduction in premium volumes experienced industry wide in FY’10), and some game-changing customer wins behind it, EBIX is poised for solid outperformance in the coming quarters.

Yesterday’s sell-off creates a very attractive buying opportunity, as the stock now trades at just 15x FY’11 EPS, with room for material upside to our published numbers. We use a 23x EV/FY’11 EPS multiple to arrive at our $35 price target, which represents a material discount to SaaS peers trading at 32x and does not take into account the potential upside to those numbers. We reiterate our Buy rating.

STOCK OPPORTUNITY

We use a 23x EV/FY’11 EPS multiple to get to our $35 target. This is a discount to SaaS peers trading at 32x. Balancing the slower growth at EBIX (~11% y/y organic in FY’10) compared to the SaaS peer group (~19% y/y growth in FY’10, including acquisitions) with EBIX’s strong competitive position and execution over the past 10 years, and the magnitude of organic and acquisition related upside, we conclude that a 23x multiple is a reasonable starting point.

Using some public statements from the company as far as rough goals for the next few years, we believe $2.00 to $2.50 in EPS for FY’12 is a real possibility. A 23x multiple on that range of EPS could put the stock well north of $50. While we are not going there just yet with our published numbers, our point is clear: we believe there is material upside from here and we would be buyers of EBIX shares.

RISKS

We believe an investment in EBIX involves the following risks:

- Insurance exchanges are a greenfield opportunity with few comparables in other sectors. A failure on the company’s part to estimate the size of the opportunity or to execute on their stated strategy could materially affect results and forward prospects.
- Determining the true organic growth rate is difficult and acquisition related charges / benefits can make y/y compares on revenue and EPS difficult, as well as affecting the quality of earnings. *CEO Robin Raina has been a key driving figure in EBIX’s turnaround and losing him would likely be perceived as a material disruption.
- DSOs / Cash Flow have historically been an issue. DSOs adjusted for deferred revenues have been on a modest upward trend, and in the past there was a ~20% gap between PF Net Income and CFFO. This gap has been narrowing and is becoming less of a street focus.
- Given the acquisition driven growth strategy, a failure to find or execute accretive acquisitions could adversely affect results and forward estimates.

This one is my addition - not Jeff's:

- Risk that anonymous posts on a financial blog can cause wholesale terror in the stock!

Disclosure: I am long EBIX and have been a shareholder since April 2003. My firm represented EBIX in its investor relations effort from 2004 to 2006; we parted company as EBIX "in-sourced" the IR function to existing personnel in order to reduce costs.