Seeking Alpha α

Salesforce.com and Ebix: A Value Comparison

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In my previous article in Seeking Alpha, I presented Ebix (EBIX) as an investment opportunity based on the gap between stock price and fundamental value ($38/share - $40/share). This article compares Salesforce.com (CRM) and Ebix as alternatives for investment.

Fundamental valuation and a multi-year record of performance provide the context for the comparison. Focus is on free cash flow, a determinant of fundamental value.

The popularity of CRM due to reasons such as the fast pace in product innovation and revenue growth, elevated premiums embedded in the price of the stock, and widespread following by stock analysts and market pundits provide the impetus for fact-finding and examination.

Feeding analytical curiosity is the puzzlement, particularly from co-investors, regarding Ebix's stock sub-par market pricing relative to Salesforce.com.

Similitude and Contrast

Both firms develop and use technology to improve processes and decision making in businesses globally. CRM services firms across industry verticals. In contrast, Ebix focuses on a specific vertical, the insurance industry. In either case, the respective addressable markets appear sufficiently large so as to allow continuation of a rapid rate of growth.

Both firms deliver software-as-a-service (SAAS); that is application or platform services over the internet as needed. Both are global businesses servicing large enterprises and smaller-sized clients.

Ebix's products automate, expedite and improve processes for the insurance industry. They currently support insurance agencies, brokerage and clearing firms, and operations centers at over 100 of the leading insurance carriers and their affiliates. Solutions cover the spectrum of client relationship management, order-entry platforms, quoting engines, risk administration, loss reporting, compliance and more.

Salesforce.com improves processes and decision making in firms worldwide. It provides customer and collaboration relationship management (CRM) services, and offers a technology platform to build and run business applications. CRM enables customers and subscribers to record, analyze, share and act upon business data and to enable businesses to manage customer accounts, track sales leads, evaluate marketing campaigns, and provide post-sales service.

Strategically, Ebix relies on organic growth and on strategic acquisitions to gain time in expanding the predominance of the network (read: more clients and more volume transacted), and in augmenting shareholder value. Competition is diffused among many providers. Customer retention is excellent.

CRM has grown internally and with some acquisistions, largely focused on furthering market share gains and top line growth. Client churn has been an issue to contend; as it has seen keen competition with Oracle (ORCL) and SAP (SAP), particularly for large business clients.

One can characterize Salesforce.com as a successful venture, driven by information management technology and leveraged by the power of the web. Salesforce.com achieved steady progress since its early days, and reached notoriety as an early adopter of the web to distribute sales force automation services that had been delivered by physical means, such as in compact discs.

Both revenues and net profits grew fast - from less than $100 million in revenues and net income of $4.00 million in 2004, to $1.66 billion in revenues and $64.47 million in net profits in FYE 1/11.

During the least decade the company rose to prominence in industry leadership. In later years it expanded into neighboring services within the customer relationship management umbrella dealing not only with sales planning and development, client profitability and sales effectiveness, but also with client retention, after-sale customer maintenance and customer service.

Product expansion now encompasses the company's development platform, on-line chatter, and the capture of popular social channels as a source of ubiquitous interaction, customer information and service feedback.

Salesforce.com's CEO, Chairman of the Board and co-founder is Marc Benioff. As the company explains, Mr. Benioff founded the company in 1999 with a vision to create an on-demand information management service that would replace traditional enterprise software technology. He is a 30-year veteran of the software industry. Mr. Benioff owns close to 10% of the company's equity.

Ebix, in comparison, is a turnaround story; where success did not prove easy, or followed a predictable straight line. In the early days survival was, in fact, a pressing concern.

Going back to FYE 3/1998; annual revenues were $22.47 million, the net loss was $3.41 million. Revenues had followed a decreasing trend from earlier years. According to my own count, the company had a net loss in each of the preceding six years, with the exception of FYE 3/1993 when it had a net profit of $531,000 on $51.61 million in revenues.

The cumulative net loss for the seven year period was $40.25 million. Stockholders' equity had reached its fiscal-year-end lowest at FYE 3/1996 when it was negative $3.35 million.

In third quarter 1999, Robin Raina was appointed CEO and President; and Chairman of the Board in 5/2002. He had joined the company in October 1997 as VP, and quickly promoted to intermediate positions of increased responsibility.

In 1999 the name of the company was changed from Delphi Information Systems Inc. to the current style. Strategic emphasis shifted from selling software to the development of a transaction exchange for the insurance industry, capable of ongoing transaction fee-based revenue generation. The commercialization of the company's web site became integral to the new thrust. Fast forward: For FYE 12/10 revenues are estimated at $130.00 million and free cash flow $44.00 million. (Mr. Raina currently owns some 10% of the company's stock).

How similitude and contrast translate into financial performance from the perspective of performance metrics relevant to fundamental value is studied below.

Financial Performance

The tables below show metrics for Ebix and CRM for each one of the last five fiscal years. The vertical columns at the right show the averages for the period under review.

EBIX Table --Selected Metrics

(Amounts in millions of US$, unless otherwise noted)	FYE 12/06	FYE 12/07	FYE 12/08	FYE 12/09	FYE 12/10 Estim.	5-Yr.Avg. FYE06-10
Revenues	29.25	42.84	74.75	97.69	130.00	
Revenue Growth (y-o-y)	21%	46%	74%	31%	33%	41%
Revenue per Sh. ($/Sh.)	1.04	1.36	2.03	2.57	3.33	2.06
EBIT	6.71	12.80	29.26	39.26	51.54	
EBIT / Revenues	23%	30%	39%	40%	40%	34%
EBIT per Sh.($/Sh.)	0.24	0.41	0.80	1.03	1.32	0.76
Cash Flow from Ops.	4.15	15.04	26.83	33.88	44.20	
CF f/Ops.Growth (y-o-y)	-24%	262%	78%	26%	30%	75%
CF f/Ops.per Sh.($/Sh.)	0.15	0.48	0.73	0.89	1.13	0.68
Free Cash Flow	2.35	12.44	23.52	29.92	44.00	
FCF / Revenues	8%	29%	31%	31%	34%	27%
FCF Growth (y-o-y)	-44%	429%	89%	27%	47%	110%
FCF per Sh.($/Sh.)	0.08	0.39	0.64	0.79	1.13	0.61
Cash & Mkt. net of Debt	-6.93	-12.10	-42.26	-39.30	-26.92	

Cash Growth (y-o-y)	nm	nm	nm	nm	nm	nm
Cash per Sh.($/Sh.)	-0.25	-0.38	-1.15	-1.03	-0.69	-0.70
# Shares	28.26	31.60	36.78	38.01	39.02	
# Shares Growth (y-o-y)	1%	12%	16%	3%	3%	7%
StkPrice(PPS) 3/9/11					28.87	
Revenues per Sh./PPS					0.115	
EBIT per Sh./PPS					0.046	
CF f/Ops. per Sh./PPS					0.039	
Free CF per Sh./PPS					0.039	
Cash per Sh./PPS					-0.024	

Salesforce.com Table --Selected Metrics

(Amounts in millions of US$, unless otherwise noted)	FYE 1/07	FYE 1/08	FYE 1/09	FYE 1/10	FYE 1/11	5-Yr.Avg. FYE07-11
Revenues	497.10	748.70	1,076.77	1,305.58	1,657.14	
Revenue Growth (y-o-y)	60%	51%	44%	21%	27%	41%
Revenue per Sh.($/Sh.)	4.14	6.12	8.60	10.19	12.13	8.23
EBIT	-3.60	20.31	63.74	115.27	97.50	
EBIT / Revenues	nm	3%	6%	9%	6%	6%
EBIT per Sh.($/Sh.)	-0.03	0.17	0.51	0.90	0.71	0.45
Cash Flow from Ops.	111.22	204.28	229.56	270.91	459.08	
CF f/Ops. Growth (y-o-y)	16%	84%	12%	18%	69%	40%
CF f/Ops per Sh.($/Sh.)	0.93	1.67	1.83	2.11	3.36	1.98
Free Cash Flow	98.72	180.06	193.59	217.73	383.33	
FCF / Revenues	20%	24%	18%	17%	23%	20%
FCF Growth (y-o-y)	10%	82%	8%	12%	76%	38%
FCF per Sh.($/Sh.)	0.82	1.47	1.55	1.70	2.81	1.67
Cash & Mkt. net of Debt	401.11	667.67	874.94	1,263.36	909.53	
Cash Growth (y-o-y)	36%	66%	31%	44%	-28%	30%
Cash per Sh.($/Sh.)	3.34	5.45	6.99	9.86	6.66	6.46
# Shares	120.15	122.42	125.23	128.11	136.60	
# Shares Growth (y-oy)	1%	2%	2%	2%	7%	3%
StkPrice(PPS) 3/9/11					127.71	
Revenues per Sh./PPS					0.095	
EBIT per Sh./PPS					0.006	
CF f/Ops.per Sh./PPS					0.026	
Free CF per Sh./PPS					0.022	
Cash per Sh./PPS					0.052	

Average revenue growth was 41% for both companies. Ebix's average free cash flow (FCF), however, grew 5.5 times CRM's (Ebix Avg. FCF Growth / CRM Avg. FCF Growth = 110%/20% = 5.5).

One important reason for such difference is the comparatively greater content of Operating Profit (EBIT) in the revenues of Ebix than in CRM's. CRM's emphasis in market share explains the softness in its EBIT/Revenue ratio.

The substantial source of funds derived from CRM's Deferred Revenues (amounting to $934.94 million on FYE 1/11) explains the relatively robust FCF revenue content (FCF/Revenues average 20%) despite relatively low EBIT revenue content (EBIT/Revenues average 6%). The funds generated by Deferred Revenues (embedded in the NOWC computation) serve to substantially decrease Operating Capital and elevate FCF.

The formulas below are arranged to show progressive computations leading to FCF, and then to the Equity Value.

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

To recap; Ebix metrics overall compare favorably with CRM's, as follows:

- Revenue growth is a tie (41%)
- EBIT content in Revenues is much stronger for Ebix (34%) than for CRM (6%)
- FCF content in Revenues is greater for Ebix (27%) than for CRM (20%)
- FCF is growing faster in Ebix (110%) than in CRM (38%)
- Cash and Marketable Securities, net of Debt are substantial at CRM
- Ebix is a net debtor, due to ongoing acquisition activity

Performance at a Price

Let's now assess the connection between performance, particularly FCF and FCF growth, and the price of the stocks.

The lower section in each one of the tables shows the price of various metrics implicit in the price of the respective stocks. The tables show ratios quantifying metrics per dollar of current stock price. At current stock prices the tables show the following:

- Each dollar in the stock price of Ebix buys 11.5 cents of revenues, 4.6 cents EBIT, 3.9 cents of cash flow from operations, 3.9 cents FCF, and 2.4 cents of debt (net of cash).
- Each dollar in the stock price of CRM buys 9.5 cents of revenues, 0.6 cents EBIT, 2.6 cents of cash flow from operations, 2.2 cents FCF, and 5.2 cents of cash.

Notice that each dollar of stock price buys 3.9 cents of Ebix FCF, and only 2.2 cents of CRM FCF. Conversely, the price per dollar of Ebix FCF is $25.64 (1/0.039 = 25.64) vs. $45.45 (1/0.022 = 45.45) per dollar of CRM FCF.

Thus, the price of a unit of CRM FCF is 1.77 times the price of a unit of Ebix FCF.

Given the discussion so far, which stock would you rather own?

Would you pay 77% more for a unit of CRM's FCF than for a unit of Ebix' FCF, notwithstanding Ebix's more favorable FCF revenue content and rate of FCF growth?

The analysis suggests that, based on performance, investors should be inclined to pay a premium for Ebix's FCF relative to CRM's FCF, instead of the other way around.

Nonetheless, let's withhold the answer. First, let's take a look at how risk compares between the two firms.

Business Risk

Risk is the probability of a negative event. In extreme cases, the impact of a negative event is so major as to cause insolvency, perhaps bankruptcy. Financial default occurs when operational sources of funds and back-up liquidity are insufficient to meet debt obligations.

In finance, risk implies volatility in earnings and unpredictability regarding the timing or amount of future cash flows. Uncertainty increases the cost of capital to the firm, as investors require greater return commensurate with greater risk. Both, volatile cash flows and elevated cost of capital reciprocally reinforce each other and weaken the fundamental value of a firm.

Two components define business risk: Operational risk and financial risk.

Operational risk is volatility in the metrics measuring the activities of the firm. Operational risk is embedded in the operating relationships between the firm and its stakeholders such as clients, employees, strategic partners, suppliers, etc. These relationships involve benefits, obligations and uncertainty regarding performance.

Financial risk derives from the use of debt. Figuratively speaking, financial risk is superimposed on the firm's operational risk. It is additive, and to some extent discretionary. In contrast, operational risk is intrinsic to the business.

Business risk is the combination of operational risk and financial risk. It is the relative sufficiency in available cash to meet ongoing business requirements and discharge debt obligations. Default occurs when such available cash flow is insufficient to meet upcoming debt service obligations.

Operational risk is relatively low for both companies. EBIT and Cash Flow from Operations are substantial and generally track stable growth throughout the period under review.

Examples of causes underlying such low operational risk are low revenue concentration risk given the diversified client roster in both companies, stability in revenues due to high percentage of recurring operational revenue in the case of Ebix, and substantial Deferred Revenues in the case of CRM.

For CRM, business risk and likelihood of default are very small due to substantial Cash Flow from Operations; and sizable cash, net of debt.

Ebix business risk, in turn, is perhaps comparatively higher due to the net debt position and absence of surplus cash, but mitigated by low operational risk.

The main point: From a practical point of view the business risk in both firms is low and well within their financial and managerial capacity. (For Ebix, one year of FCF - $44.00 million - exceeds total net debt - $26.92 million).

Having said this, this assessment of ex-ante risk, based on historical performance, is not a script for future events. Prospective risk includes events not envisioned in this analysis that can be disruptive to the business model of either firm.

An example of such disruptive event is discontinuity in management. This generic example can take a variety of forms, each with its own degrees of uncertainty regarding prospective performance. Another example is a major disruption in CRM's hosted platform managed by parties outside the company.

From the perspective of the firms themselves, their risk management processes ought to encompass a broad spectrum of envisioned risks to appropriately identify risks that need to be avoided (e.g. service outsourced instead of asset owned), those that need to be mitigated (e.g. sprinkler system against fire), transferred (e.g. insurance protection, financial futures, swaps), and assumed (accepted).

The basis for risk acceptance is core competence. Core competence encompasses institutional skills and experience embedded into the firms' mainstream processes essential to their purpose.

The apparent adherence by the firms to their respective business purpose and strategy suggests that risks assumed by them fall within their respective scope of competence and financial wherewithal.

All in all, balancing pluses and minuses, the analysis suggests that business risk in both firms is relatively low and not a factor in explaining the premium differential investors pay for CRM's FCF relative to Ebix's FCF.

Comparative Valuation

The foregoing analysis suggests that the market is not adequately pricing Ebix's revenues, or EBIT, FCF, or growth history, relative to CRM's.

Keen competition by major market players, rapid revenue growth, thin EBIT margins, and expensive marketing and selling costs, represent structural issues in Salesforce.com's business model.

Continuing to achieve annual revenue growth in excess of 20% for a firm of the size of CRM ($1.66 billion in annual revenues) is an increasingly difficult task; and at some point implausible. Rapid growth is particularly thorny when accompanied by soft EBIT margins, and when requiring major upfront expense (in marketing and sales). Remember, CRM's FCF generation (and FCF revenue content) requires growing deferred revenues, which in turn require growing marketing and sales activity.

CRM's Q1/11 results show a Loss from Operations (minus $0.39 million) on $456.87 million in quarterly revenues, after an expense of $233.22 million in Marketing and Sales. Thus, Marketing and Sales amounted to 51% of revenues.

Year-over-year growth in Marketing and Sales was 38%. Year-over-year growth in revenues was 29%. The push for sheer revenue growth is evident.

Slowing down Marketing and Sales would lower the rate of revenue growth. This would impact negatively EBIT margins and FCF. A decline in the rate of growth in Deferred Revenues (source of funds embedded in Cash Flow from Operations) would put pressure on FCF. Such pressure would intensify if Deferred Revenues stop growing, or even worse if they decline.

In FYE 1/11, Deferred Revenues contributed $230.59 million, Year-over-year, to Cash Flow from Operations (growing from $704.35 million in FYE 1/10 to $934.94 million in FYE 1/11). This source represented 50% of $459.08 million, Cash Flow from Operations in FYE 1/11.

If we consider that at the minimum, the FCF of Ebix should be priced at parity with CRM’s FCF, then the price of a Ebix share would be $47.27 (Ebix’s $1.04 FCF/share divided by CRM’s $0.022 FCF per share/PPS = $47.27/share), or 1.64 times its current market price ($28.87/share).

At $47.27/share for Ebix and $128.02/share for CRM investors would be equally pricing each dollar of FCF generated by either company. Note that $47.27/share, the computed price for Ebix is substantially higher than $28.87/share, current market price; and also higher than $38.00/sh. - $40.00/sh., a realistic fundamental value previously estimated (that includes the benefit of the ADAM acquisition that closed in 2011).

Summary

This analysis adds to the backlog of evidence supporting Ebix's investment thesis and the fundamental value presented in my previous article.

The stock market is not adequately pricing Ebix’s revenues, or EBIT, FCF, or its growth history; nor is it giving appropriate consideration to prospective growth opportunity, low business risk, or economic moat.

Ebix’s proven performance advances confidence in management. The transformation of a money-losing, high-risk business into a leading global enterprise, over the last dozen years or so, supports the conviction that growing recognition along with rational expectations and risk/benefit arbitrage, will promote the value attributes of Ebix, and in so doing build momentum to close the price/value gap.

By design, the scope of this analysis is circumscribed by the context and boundaries of fundamental valuation. Thus, a medium term investment horizon is inherent in the values and opinions expressed here.

From a practical investor’s point of view, the odds favor the fundamental value estimates within a medium term investment horizon. Conversely, the odds become adverse, when such estimates are used as predictors of short term movement in stock prices.

Disclosure: I am long EBIX.

Additional disclosure: Careful attention has been given to the accuracy of the information presented in this analysis. Nonetheless, the large amount of information used, data manipulated, and computations involved, entail a commensurate probability of error, which is entirely possible.

Comments (4)
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Nicholas Southwick Levis

well done... EBIX is an interesting stock... maybe a good pairs trade with a bear call spread on you know what

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Gino Verza

Author's Reply Hi Nicholas,

Happy you like it.

Best wishes.

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ozzfan1317

Absolutely love your article great work. I have been long Ebix since November 2009 and so far doubled my money. The market may be concerned with the expiration of tax loss carry forwards and low effective tax rate as well. I posted a blog with some thoughts on the company. Why the market is demanding a bigger premium for CRM no clue maybe its the bigger size and percieved higher safety?

Gino Verza

Hi ozzfan1317,

Thank you for the good words. Comments like yours uplift my spirit. Thank you.

High EBIT margins (see how they compare with CRM's) and high NOPAT margins make of the Ebix tax issue only a medium to low priority concern. For more information on taxes please refer to the commentary section on my first EBIX article.

Regarding risk and perceived safety, there are many operational risk attributes that mitigate EBIX's financial risk and overall business risk.

Strictly speaking, EBIX risk is higher than CRM's. However, in my opinion, from a practical standpoint, there is only a marginal distinction. In other words, neither company is anywhere close to facing a possible default (As I recall, Ebix annual FCF is sufficient to be able to service the entire amount of debt, net of cash, in less than one year)

Therefore, risk is not a differentiating factor that supports the magnitude of CRM's stock price premium relative to Ebix's.

For more detail please refer to the Business Risk section in the article.

Best wishes.
