EBIX: The Improvement In Operating Efficiency With High Return

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Business overview

EBIX is the supplier of software and e-commerce solutions to the insurance industry. EBIX provides a series of application software products for the insurance industry ranging from carrier systems, agency systems and exchanges to custom software development for all entities involved in the insurance and financial industries. The majority of EBIX revenue comes from on-demand insurance exchanges. With the fiscal year of 2010, the on-demand exchanges took around 71% of the total sales.

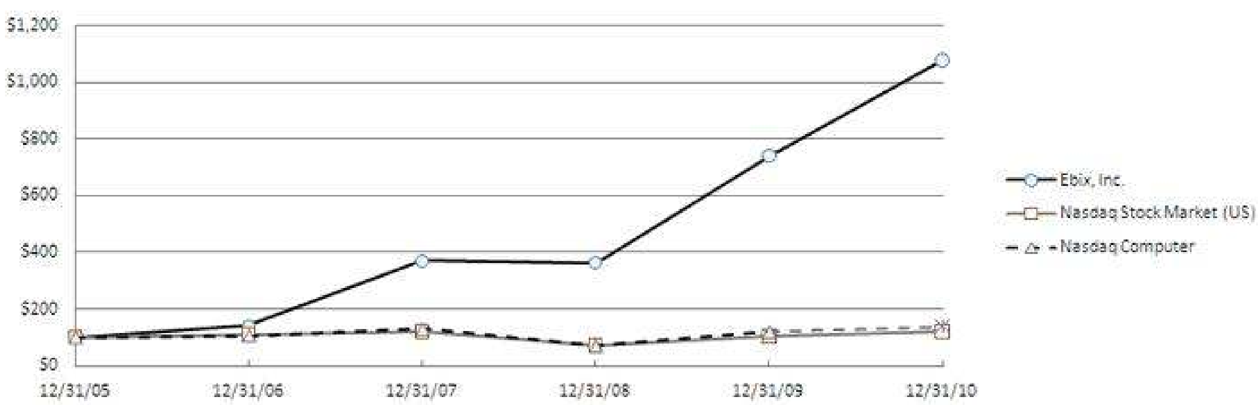
The data exchanges of life insurance, annuities, employee benefits, risk management, workers compensation and P&C insurance. Each of these exchanges connects multiple entities within the insurance markets enabling the participant to efficiently carry and process data from one end to another. Then the insurance companies work with EBIX or third party vendors to interface an exchange with their back-end systems.

The exchange would be built based on industry standards, the interface of the exchange can be built by the company or other vendor depending on client's preference. If EBIX builds the interfaces, then the company can incur more revenue in the forms of professional services.

EBIX derives its revenues primarily from professional and support services, which includes subscription and transaction fees pertaining to services delivered over the company's exchanges or from its own ASP platforms, revenue generated from software development projects and associated fees for consulting, implementation, training, and project management provided to customers with installed systems, and business process outsourcing revenue.

Historical performance

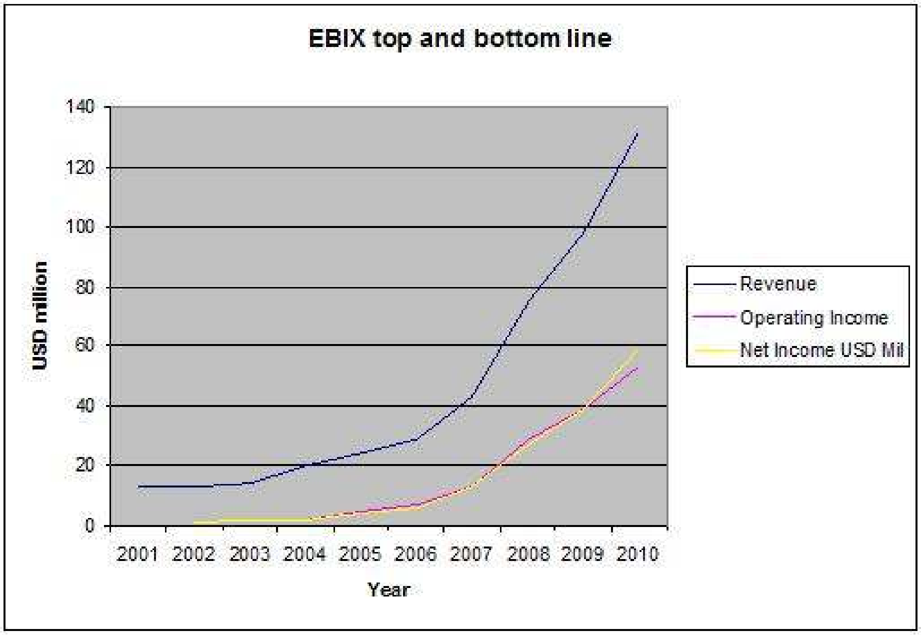
Comparison of Five Year Cumulative Total Return



According to EBIX annual report of fiscal year 2010, the cumulative return of EBIX compared to NASDAQ computer and NASDAQ has been pleasing investors of EBIX early in 2005. For the past 05 years, if the bench mark is the $100, at the end of 2010, the stock price stands at 1,076, with the gain of astonishing 60.8% compounded annual return.

How can the stock price of EBIX be that rewarding to the investors, and whether the trend could continue for the investors of EBIX in the future? We can have a look further on historical performance and judge on the sustainability of the earnings and return on investment.

Operating performance



As it can be seen from the chart of top line and bottom line for the business, for the last 10 years, and especially the previous 05 years, the growth are quite breathtaking in terms of revenue, operating income and the net income. The revenue shot up from US$20 mil to US$132mil within just 05 years, whereas the operating and net income from $5mil growing more than 10 times, of around $50mil.

And the EPS experienced the same growth over the last 10 years. Over the 10 years period, the annual compounded growth rate of EBIX stays at 65.5%.

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
EPS (USD)	0.01	0.02	0.08	0.08	0.15	0.21	0.4	0.76	1.03	1.51

Operating margin

%	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Gross Margin	66.4	69.2	70.8	72.7	75.5	79.8	83.4	81.1	78.2	77.6
SG&A	49.1	48.9	48.4	39.7	37.2	32.8	29.7	25.5	22.4	23
Operating Margin	1.5	6.28	11.7	12	19.3	22.9	29.9	39.2	40.2	39.7
EBT Margin	1.95	4.66	12.2	11.9	19.2	22.7	30.8	38.4	40.8	45.1

We can clearly see the improvement in the operating performance of EBIX over the years, including gross margin, operating expenses, operating margin and pre-tax margins.

The gross margin is increasing along with the operating expenses, representing by Selling, General and Admin, is decreasing at the very rapid rate, now standing just around 23% while it was like 49% in the previous 10 years. The upward trend in gross margin combined with the decreasing operating expenses has lead to the higher operating margin over time.

Return on Equity

As recommended by Warren Buffett, a single year performance does not dictate anything. Rather, he would prefer the 05 year rolling period. And the great business is the business which does not have a lot of assets, meaning having high return on equity

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Net Margin %	0.92	3.97	11.56	11.21	17.93	20.39	29.57	36.54	39.74	44.65
Asset Turnover	1.52	1.24	1.32	0.92	0.81	0.78	0.55	0.6	0.48	0.47
Financial Leverage	2.68	2.11	1.79	2.32	1.6	1.81	1.8	2.01	1.54	1.31
Return on Equity %	37.4	11.65	29.24	22.18	27.88	27.32	29.36	41.94	32.23	29.36

On the Dupont model, the return on Equity is the results of net margin, asset turnover and financial leverage combined. What pleases investors the most is to see the net margin increase in the rapid rate, and they expect same thing with the asset turnover. With the case of EBIX, the net margin keeps increasing and now standing at the very high rate of 44.6%. Whereas the asset turnover has been declining due to the rise in sales can't catch up with the rise in asset. Nevertheless, the return on equity of EBIX over the last 10 years has been very pleasing, ranging around 20-40%, at first because of high net margin and higher financial leverage. But then the financial leverage ratio has been controlled down. Over the last 10 years, the average return on equity of EBIX stands at 28.8%.

Financial Health

EBIX keeps making series of strategic acquisitions over the years. During the last 03 years, it has made around 11 acquisitions in software and technology solutions to insurance industries. That is why it's understandable that the largest assets in EBIX is the amount of goodwill. By June 2010, the amount of goodwill has amounted to more than 60% of the company's total assets.

On the liabilities side, the company got very little debt. Long and short term debt only takes around 6% of the total assets. It adds up to the total liabilities of around 16.6%.

Free cash flow

USD million	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Operating cash flow	-3	-1	3	3	5	4	14	27	34	53
Capital expenditure	0	-1	-1	0	0	-1	-2	-1	-3	-2
Free cash flow	-3	-1	3	2	5	4	13	26	31	51

The free cash flow figure is quite amazing, and it's trending upward. EBIX business does not have to reinvest into the capital expenditure a lot, otherwise it would use the operating cash flow to make the acquisitions of insurance software solutions provider. With the market capitalization of $537million, it's trading at 10.5x of the free cash flow 2010.

Comparables

There are several software solutions companies out there which relates to insurance companies including Ebix, Inc. (EBIX), Solera Holdings, Inc. (SLH), and InsWeb (INSW), Salesforce.com (CRM)

	P/B	P/E	P/CF
EBIX	1.7	8.8	10.5
Salesforce.com	13.2	357.1	37.7
SLH	5.1	25.3	18.7
INSW	2.3	20.8	27.7

Following the comparable valuation, we can see that EBIX is quite undervalued in every matrix of Price to Books, Price to Earnings and Price to Cash Flows. The discount is quite significant; some is even double, or even nearly triple in terms of valuations.

Management

What I'm typical looking for the quality of management is that the key executives should have big stakes in the company, so that he/she got the incentives to walk in the investors' shoes. What I have found somewhat pleasant is the amount that Robin Raina, the Chairman, the President and CEO of EBIX hold more than 10.5% in the company. Raina studied engineering in India and joined the company since 1997 and has been the CEO of the company for 11 years since 1999.

Valuation

DCF

The growth of EBIX has been quite magnificent. From 2003 to 2010, the FCF has been growing from $3mil to $51 mil, at the compounded rate of nearly 50%/year. Along with the low rate of Treasury, Benjamin Graham often suggested using the discount rate of 10%, but the Gordon Growth model cannot be applied if the growth rate is more than the discount rate.

Even with that, if we assumed the growth rate for the next 05 years of FCF only 8%, then stay forever at 2% per year, with the discount rate of 10%, the total value of EBIX businesses would stay at around $2.4 billion, 5 times of the current market value.

	2010	2011	2012	2013	2014	2015	Terminal value	Present Value
FCF	51	55.1	59.5	64.2	69.4	74.9	3,821.7	2,398.7

And if doing the reversion valuation, the current market price indicates that at the discount rate of 10%, it implies the growth rate of 1% year on year from 2011 continue forever, such a very low figure.

Relative Valuation

Seeing the table of comparables, EBIX seems to stands at very low valuation. If talking about the cash flow, the next highest figure is with Solera Holdings, at 18.7, and the average of P/CF ratios for 04 companies is at 23.6. So with the CFO of $53 million, the value of EBIX would stays at the lowest of $991 millions, on average of $1.25 billion.

Conclusion

For valuation, even with the wide range between two methods of relative valuation and discounted free cash flow analysis, we come to the conclusion that EBIX market price is quite undervalued. The business of insurance exchanges solutions with improving operating efficiency and profitability over time as well as high return on equity is very intriguing. Besides, the chairman and the CEO got quite meaningful stakes in the company of 10.5%. EBIX can be considered the target for any patient value investor in the basket of value positions.

This is the subjective viewpoint of the author, and it is not the recommendation to buy, hold or sell the stocks mentioned in this analysis. Anyone who wishes to buy, hold or sell the stocks has to do his/her own analysis at his/her own risks

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