Ebix's HealthConnect Acquisition: Strengthens Its Network, Creates Shareholder Value

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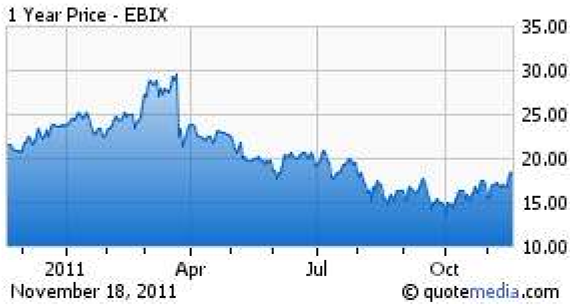

On November 16, 2011, Ebix (EBIX) announced the acquisition of online health exchange HealthConnect Systems.

A leading supplier of on-demand software and e-commerce services to the insurance industry, Ebix provides end-to-end solutions and facilitates transactions across diverse entities like employers, brokers, general agents, third party administrators, and insurance companies.

This article discusses the implications of the acquisition.

Vision and Execution

In many occasions in the past, Ebix has announced its strategic view, actions, and prospective priorities that support and realize aspirations. Central to such strategy is the construction and strengthening of the network in the insurance industry.

The announced acquisition is another important step in strengthening the power of network, and in growing revenues and free cash flow.

Strategic Acquisition

In the announcement, HealthConnect Systems CEO Peter Everett said, “This combination is a compelling, ‘hand in glove’ fit that will substantially increase the value proposition we provide to our combined client base. The transaction will accelerate our product development through utilizing Ebix’s existing capabilities and leveraging their significant resource base. We will also augment Ebix’s capabilities in targeted areas and together create the first end-to-end health and benefits network in the U.S. providing a complete range of functionality for all industry constituents – carriers, agents, general agents, employers, employees, TPA’s et al.”

The strategy behind the acquisition is compelling; HealthConnect will bring new clients, expand the product suite, and enhance the effectiveness of product development of the combined entity. Its impact on the network is self-evident.

The acquisition is intended to enhance the competitive position of Ebix by (i) strengthening the value proposition (enhancing client benefit with solutions that improve the client’s own businesses) by expanding the scope, depth, sophistication, and modular complementarities in the product suite; (ii) enhancing risk-adjusted economic returns by expanded market coverage and cross-sell opportunity; and (iii) reinforcing and/or exploiting core competency.

The acquisition also enhances competitiveness by the immediate expansion of product capability and market coverage, and in so doing preempts competitors from achieving favorable market positioning or client gains.

The Network: a Source of Power

Ebix’s on-demand software and e-commerce services to the insurance industry enable and facilitate information flow and transactions throughout a network of diverse entities like employers, brokers, general agents, third party administrators, and insurance companies.

Network effect can be understood as the contribution that users bring to the value of the service used to other actual or potential users. At the margin, additional users make the network progressively more valuable as its scope and reach increases usefulness to all. As the scope and influence of the network expands, prospects doing business with Ebix clients tend to become interested in the benefits of the network and eventually become Ebix clients themselves.

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.

Growing competitive power and economic benefits accrue to Ebix through the network. First, the prospect list is clear and immediate. Prospects are those industry participants that do business with Ebix’s clients. Second, client acquisition costs are relatively low. Third, clients expand the volume of repeat transactions into the future.

Acquisition Drivers

The HealthConnect Systems acquisition rests upon, and reinforces, the power of the network. Below are some of the attributes of Ebix’s existing network.

- High client retention, high level of recurring revenues, and low cost in prospect/client conversion
- High predictability in gross margins, Net Operating Profit after Taxes (NOPAT), and Free Cash Flow (FCF)
- Low business risk driving low Weighted Average Cost of capital (WACC)
- A strong 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.

Investment Policy

EBIX fixed asset acquisition policy is indifferent between (a) internally-developed projects, or (b) acquisitions. The criteria is (deploying funds that produce strong FCFs, that result in) achieving a Return on Invested Capital (ROIC) that exceeds WACC. By way of reference, Q 9/11 annualized ROIC was 21% despite substantial year-over-year increase in Operating Long Term Assets (OLTA) due to previous acquisitions.

Implicit in the current acquisition is conviction in the economic viability of the network model, as described above. Embedded in the economic equation is a focus on FCF, important driver in the Fundamental Value (FV) of the firm; and on NOPAT, driver of ROIC.

- FV = Present Value of future FCF discounted at WACC
- FCF = NOPAT minus increases in NOWC and in OLTA
- ROIC = NOPAT / Operating Capital
- NOPAT = EBIT (1- Tax Rate)
- OC ((Operating Capital)) = NOWC (Net Operating Working Capital) + OLTA (Operating Long-Term Assets)
- WACC (Weighted Average Cost of Capital)

A collateral effect of such investment policy is a substantial amount of goodwill and intangibles on the balance sheet that results from acquisition accounting. Such concentration in goodwill has an apparent chilling effect on the price of the stock in the marketplace.

From this perspective, one must argue in favor of an investment policy which drives ROIC beyond WACC, even in the face of expanding goodwill on the balance sheet. In the case of Ebix, goodwill expansion is not inconsistent with, or precludes, creation of shareholder value. The acquisition underlines prioritization in allocation of capital to (strategic acquisitions to) fuel continuing rapid growth.

Ebix’s ongoing financial performance supports such investment policy.

Noteworthy in Q 9/11 results is continuing and sustained rapid growth in revenue, EBIT, Cash Flow from Operations, and FCF -- FCF grew 48% YOY to $20.31 million. Thus, operating cash generation supports organic growth, acquisitions, debt reduction, and dividend payments. For Q 9/11 annualized ROIC was 21% despite the substantial year-over-year increase in operating long term assets due to acquisitions.

Financing Decision

Ebix announced that it will finance the acquisition, 100% with debt, without issuing common stock. Last April two banking facilities were increased from $35.0 million to $55.0 million, reflecting the increase in the company's ability to service debt, due to reliable EBIT and growth in OCF. Thus, the ability to service growing debt is amply supported by cash flow generation. In other words, debt financing does not perceptibly increase financing risk.

Likewise, the operational risk of the combined business is also maintained in check due to the commonality of both firms' activities within the broader context of the same insurance industry risk.

Mergers & Acquisitions

The announcement of the acquisitions mentions that no investment bankers were involved in the transaction. This detail points to an otherwise invisible competence worth exploring.

EBIX's business model relies on operating ability to manage the business of the firm, and on the expertise to make good acquisition decisions. By its nature mergers and acquisitions (M&A) is a different activity than organically supplying software services to the insurance and financial industries.

The skills and organizational requirements in these two activities are quite different: Origination of transactions is different, as are deal structuring, pricing, risk; and allocation of capital and other resources. The decision-making processes are also very different. Favorable financial results incorporating a history of multiple acquisitions point to M&A as a valuable and distinct core competence belonging to Ebix.

Summary

The acquisition is an important step in strengthening the network, expanding FCF and ROIC, and reducing the gap between fundamental value and the price of the stock.

The broader context for the acquisition is relevant; Ebix has shown a steady hand in the unambiguous communication of vision, strategy, actions, and in achieving continuing robust financial results in recent history.

Specifically the company has shown adept at allocating capital efficiently, adequately balancing conflicting demands between organic and non-organic growth, debt servicing, stock repurchases, and dividends. In so doing, the company has kept an eye on the ball, adequately acting on matters under its purview, without allowing for distractions by noise external to the business.

In my opinion, the performance of the Ebix team, and CEO Robin Raina, is nothing short of extraordinary.

Disclosure: I am long EBIX. The views expressed represent a personal opinion, not an investment recommendation. The methodology of analysis, including financial computations, presentation, and views, also reflect personal preferences. Presentation and computations entail a probability of error, which is entirely possible. Please do not rely on this analysis; do your own due diligence.