JCAP

Global Short Ideas

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Coverage Update

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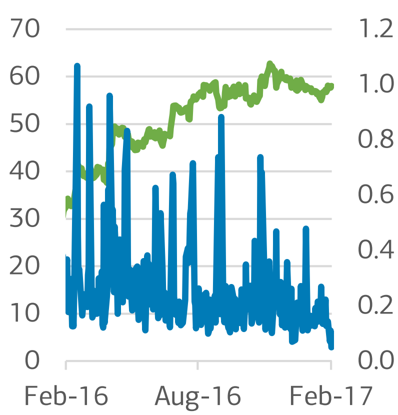
Ebix (EBIX US)

Price	USD 58.00
Market cap	USD 1.88 bln
Target Price	**USD 13.69**
Rating	**SELL**
Difference	76%
P/E	21.38x
Gross Yield	0.52%
S/I	26.47%

Ebix (EBIX US) last share price in USD (green) and volume (blue, in mln shares)



Source: Bloomberg, February 15, 2017

Ebix (EBIX US)

Stone Soup

- **Acquisitions needed:**
  Ebix will struggle to meet Q4 2016 revenue and earnings targets of USD 75.3 mln and USD 0.67 when it reports in early March, unless the company managed to make a new acquisition in Q4 that has not been reported.

- **Expect USD 100 mln in borrowing:**
  Going forward, "earnings" and revenue growth will continue only if Ebix borrows to make new acquisitions. We estimate the company will need USD 100 mln in the coming 12 months to maintain the appearance of growth.

- **Core product in decline:**
  Core business revenues have been flat to declining for two years and are starting a steeper decline. But in Q3, Ebix wrung targeted "earnings" from its accounts by re-evaluating goodwill from acquisitions.

- **Slow erosion:**
  Revenues are deteriorating but not falling off a cliff. Provided access to capital, Ebix is likely to erode slowly over the next 12 months. After that, deferred revenues will run out and core business deterioration will show up.

- **Rating: SELL**
  We maintain a SELL rating with a price target of USD 13.69 based on a 10x multiple on our estimated profit for 2016. We assign the low multiple based on our assessment that Ebix's core business is in decline.

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Less than Meets the Eye

Ebix has regularly used its acquired companies' financials to eke out apparent revenue and earnings growth.

The deadline for completing the Patriot National acquisition came and went, but Ebix still made its Q3 numbers. How? Not with honest-to-God revenues.

Just as in the folk story an enterprising stranger enlists a community to make soup from a stone, so Ebix has regularly used its acquired companies' financials to eke out apparent revenue and earnings growth. In the most recent quarter, Ebix reported QoQ revenue growth of USD 2.04 mln and YoY growth of USD 7.8 mln. All that growth came from 1) consolidating a JV and 2) writing up goodwill.

What's yours is mine

Without Patriot National's accounts, Ebix had to come up with something new, and it did: the company bought up from its 40% share to 51% in order to consolidate revenues from its joint venture with IHC. That gambit brought in USD 3 mln, accounting for the whole of the growth in Exchange revenues for Q3 2016.

Ebix had contributed USD 8 mln to the JV while IHC contributed USD 12 mln. EBIX also held a call option. On July 1, 2016, Ebix purchased shares from IHC for USD 2 mln—failing to disclose the deal in the "subsequent events" section of its Q2 2016 financials even though the deal was completed before the financial statements were released. From July 1, 2016, EBIX began consolidating the JV's financials.

Both companies have reported that the revenue impact of the JV was USD 3 mln. If so, the JV allowed EBIX to avoid showing continued revenue decline in its most important customer segment, Exchanges.

Table 1. Revenues with and without the JV (USD mlns)

	Q3 2015	Q4 2015	Q1 2016	Q2 2016	Q3 2016
Reported Reveues	66.8	70.2	71.3	72.6	74.6
Exchange Revenues	46.2	51	50.1	49.3	52
Revenues from EBIX JV with IHC					3
Exchange Revenues w/o YV					49

Source: Ebix financial statements

Without the additional USD 3 mln, EBIX would have reported USD 49 mln in Exchange revenues, continuing a quarterly decline that extends back to Q4 2015.

The revenue from the JV had the added impact of increasing EBIX's reported net income and EPS. Assuming a 30% net income margin, in line with FY 2015, EBIX recorded an uplift of USD 0.9 mln or USD 0.03 per share.

Table 2. EPS Uplift from the JV (USD mlns)

EBIX JV with IHC	Q3 2016
Revenues consolidated	3
Assume NI margin of 30%	30%
Net income impact	0.9
Shares outstanding	32,688,000
Fully diluted shares outstanding	32,969,000
EPS impact shares outstanding	0.03
EPS impact fully diluted shares outstanding	0.03
Reported EPS	0.74
Reported Fully diluted EPS	0.74
Adjusted EPS	0.71
Adjusted Fully diluted EPS	0.71

Source: Company financials

The acquisition that keeps on giving

IHC provided USD 3 mln to the quarter. Changes to goodwill and intangibles provided what appears to be another USD 4.3 mln. Here is how that worked:

EBIX's acquisition just before the IHC JV was PB Systems. The deal was completed with EBIX providing USD 12 mln in cash up front and agreeing to an USD 8 mln earn-out based upon revenues. PB Systems was the only acquisition of any size in 2015. EBIX is allowed to change allocation of the purchase price for up to one year following the acquisition. Therefore, only changes resulting from PB Systems should have any impact on the Q2 2016 figures. Net changes to goodwill in the quarter were USD 4.3 mln.

Historically, companies have used increases to the goodwill entry as a method for keeping expenses off the income statement. We suspect that the intangibles and goodwill changes suggest that EBIX has used purchase accounting to improve its reported net income.

Total uplift to earnings: USD 0.16

If EBIX has used the entire USD 4.3 mln as part of this scheme, it may have lifted the company's reported EPS by USD 0.13 per share.

Table 3. Possible Purchase Accounting Adjustments

EBIX JV with IHC	Q3 2016
Purchase Accounting adjustments for acquisitions previously recorded	USD 4,298,000
Shares outstanding	USD 32,688,000
Fully diluted shares outstanding	USD 32,969,000
EPS impact shares outstanding	0.13
EPS impact fully diluted shares outstanding	0.13
Reported EPS	0.74
Reported Fully diluted EPS	0.74
Adjusted EPS	0.61
Adjusted Fully diluted EPS	0.61

Source: EBIX reports and J Capital

In fact, combining the impact of the change in control at the JV and the purchase accounting adjustments to goodwill could have provided EBIX with a total uplift to EPS of USD 0.16.

Table 4. EPS Uplift

	Q3 2016
Reported EPS	0.74
Less: impact of EBIX JV with IHC	-0.03
Less: impact of purchase accounting adjustment	-0.13
Adjusted EPS	0.58
Consensus EPS	0.63

Source: EBIX reports and J Capital

Without these two accounting manipulations, EBIX would have reported EPS of USD 0.58 per share; consensus estimates for Q3 2016 were for USD 0.63 per share.

Don't trust the cash

Some will point to the impressive growth in cash flow as validation of

EBIX has historically fallen well below the minimum expected cash-flows-from-operations to net-income ratio of 1.0.

EBIX's stellar performance, but the cash is not as impressive as it seems.

A gauge of the quality of earnings is the ratio of cash flows from operations to net income. We view companies that generate cash in line or better than reported net income as having better quality of earnings. EBIX has historically fallen well below the minimum expected level of 1.0. In fact, for the nine months ended September 2015, EBIX reported a ratio of 0.45. While the 0.77 for the nine months ended September 2016 is an improvement, it too has been juiced.

Table 5. Cash Flow from Operations vs. Net Income (USD thnds)

Net Income	9 mos ended 9/30/2016	9 mos ended 9/30/2015
CFFO	69218	57604
CFFO/NI	53050	25663
CFFO	0.77	0.45
Less: impact of extending payments	53050	25663
Adjusted CFFO	-5215	
Adj CFFO/NI	0.69	

Source: Company statements and J Capital

EBIX seems to have dramatically slowed its payments to vendors in the most recent quarter. Had EBIX maintained payment terms in line with the same period last year, the company would have reported USD 5.2 mln less in the payables and accrueds balances, resulting in USD 5.2 mln less in reported cash flow from operations.

Table 6. Slowing Payments (USD thnds)

	9 months ended 9/30/16	9 months ended 9/30/15
Accts Payable	30,353	23,043
Accrueds	6,127	4,932
AP + Accrueds	36,480	27,975
Revenue	218,242	195,278
Days Payable Outstanding (DPO)	45.1	38.7
Impact on Cash Flow	5,215	

Source: Company statements and J Capital

The adjusted ratio of cash flow from operations to net income falls to 0.69. Moreover, the improvement in cash flow from Q3 2015 to Q3 2016 is primarily a result of the consolidation of the JV. The question then becomes what is the true relationship between IHC and EBIX. Was the series of transactions between IHC and EBIX done at arms length or was the JV used to enhance EBIX's sagging financials.

Is that another acquisition I see?

Just when we've gotten over the loss of Patriot National and started challenging the accounting for the IHC JV and PB Systems, EBIX announces yet another acquisition. EBIX is now the owner of WDev of Brazil. We know that WDev currently has annual revenues of about USD 11 mln. Thus far, there has been no information provided on purchase price or even preliminary allocations. We expect that, whenever they are released, there will be sizeable and frequent adjustments in the months to follow. EBIX, quite literally, can't live without acquisitions.

Why core revenues don't grow

Ebix's greatest competitive advantage is that no service provider in this space is popular, and few customers we spoke with report even moderate levels of satisfaction with the status quo, whether they are using Ebix, its major competitor iPipeline, a smaller competitor, or combination of services. For carrier-facing products, like Ebix's AnnuityNet, the carriers use all three options: Ebix, iPipeline's Blue Frog Solutions, or the recent addition to the market, Insurance Technology's (IT) Firelight. A former senior manager in the accounts division from iPipeline told us that there is no incentive to choose among them. The relative costs of maintaining the systems (~USD 125,000 per year flat, plus transactions fees tied to policy revenues) are low in comparison to the market lost by not reaching brokers who may only operate on one of the corresponding systems. "The carriers have to be like Switzerland," he said.

Table 6. Carrier Fee Structures by Service Providers (USD)

Carrier (product)	Install cost	Yearly maintenance	Transaction fees	Renegotiation period
IT (Firelight)	USD 50,000–90,000	USD 10,000–20,000	USD 5	3–5 years
iPipeline (BFS)	USD 25,000–175,000	USD 50,000	USD 10–35	3–5 years
Ebix (AnnuityNet)	USD 150,000	USD 30,000–100,000	USD 5–15	3 years

Source: J Capital interviews with account managers

Ebix is acquiring companies to win back transaction revenue it lost, rather than increasing the value proposition of the company.

Low entry barriers

Within four years of entering the market, IT's Firelight has become a major player in the variable annuities contract market. IT demonstrated that, with just three or four referenceable clients, small service providers can break into this market and start eating away at the entrenched institution's transaction revenue—the bulk of margin for most segments. Interestingly, we could find more referenceable clients for IT than we could for iPipeline and Ebix in this segment, and former account managers at both companies confirmed it is very difficult for them to secure client references when trying to market products. There was near unanimous agreement that the disruptors found it easier to attract new clients for this reason. The revenue pressure comes from the price-sensitive and selective broker-facing products. But any cut in carrier-related transaction revenues is significant—carriers account for over half of both iPipeline and Ebix's revenues.

Buying back your customers

Ebix is particularly vulnerable to more disruptors stealing share, because they have spent so little on R&D for the past half dozen years. Both Ebix and iPieline are acquiring as many small service providers as possible in order to capture their customers. A former account manager at Aplifi explained that after several major clients across the annuities space left Ebix for Aplifi, they became an acquisition target for both Ebix and iPipeline. iPipeline acquired Aplifi in 2013, and existing clients became dissatisfied, as the ongoing R&D they had been accustomed to seeing in their products as part of their contracts disappeared—it was back to the model of iPipeline pitching new features as paid add-ons rather than continually building out the software.

Ebix has been trying to meet the R&D model of disruptors by slashing costs and increasing margins in the wake of acquisitions. This leaves customers wholly unsatisfied and open to competitors. At this point, Ebix is acquiring companies to win back transaction revenue it lost, rather than increasing the value proposition of the company.

Valuation

We value EBIX at USD 13.69 based on a 10x multiple on our estimated profit for 2016.

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Risks

- Uptick in industry demand for software as a consequence of health insurance reform
- Decline in competition from iPipeline and others
- Appointment of a new CEO

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