EDISON

Solera

FY14/Q115 results

Changing shape

Software & comp services

Through acquisition and investment, Solera is progressively transforming itself from an automotive damage repair estimation company into a broad-based provider of digital solutions for the insurance, claims processing and repair industries. Delivery on the Mission 2020 target now looks very achievable, although investment will continue to weigh on margins and cash conversion in the transition. However, we believe the current operations are worth $65+per share. If Solera delivers on its Mission 2020 targets, substantial upside should be unlocked.

Year end	Revenue ($m)	EBITDA* ($m)	EPS* ($)	DPS ($)	P/E (x)	Yield (%)
06/13	838	371	2.73	0.50	19.6	0.9
06/14	987	415	2.76	0.68	19.4	1.3
06/15e	1,140	465	2.98	0.75	18.0	1.4
06/16e	1,222	503	3.24	0.82	16.5	1.5

Note: *EBITDA and EPS are non-GAAP adjusted measures, excluding acquired intangible amortisation, exceptional items and share-based payments. EBITDA excludes minority interest payments. EPS is diluted.

Changing shape

Solera's investment in Mission 2020 has stepped up of late with the acquisition of SRS and I&S accelerating growth and further diversifying the revenue mix. Non-claims related revenues now account for over 40% of sales and the organic growth rate is expected to reach 7.5-8.0% exiting FY15 vs 4.4% in FY14. The US now accounts for over 40% of revenues (vs 22% in FY10) and is a key growth driver, whereas it once was a laggard. Recent acquisitions also expand the platform for bundling and/or cross-selling, which could benefit organic growth further out.

Estimate revisions

Q1 results provided a level of assurance, following the Q4 EPS miss and apparent drop-off in organic growth, both attributed to one-time impacts. Organic growth stabilised sequentially at 4.7% (+110bp y-o-y), with guidance implying 6.5% for FY15. While a currency headwind reduced sales and EBITDA guidance slightly, excluding currency, the mid-point on both would have moved up. Compared to our August estimates, our FY15 sales, EBITDA and EPS estimates are reduced by 1%, 3% and 11% respectively (the latter reflecting the recent $400m bond issue), but the accelerating growth profile claws back most of these losses in FY16e and a pending acquisition should provide further enhancement.

Valuation: Assets and strategy should deliver upside

Having recently traded at a modest premium, the shares are now rated towards the lower end of peers and a pending acquisition should enhance earnings further. Our DCF analysis suggests the current operations, if the business were put into harvest mode, should be worth $65+ per share. Delivery on the Mission 2020 will require further investment, supressing margins and cash flows in the delivery phase but, if achieved while maintaining price discipline in acquisitions, substantial upside should result.

18 November 2014

Price	**US$53.6**
Market cap	**US$3684m**

Net debt ($bn) at Q115	1.4
Shares in issue	68.8m
Free float	99%
Code	SLH
Primary exchange	NYSE
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	2.8	(17.4)	(17.7)
Rel (local)	(5.0)	(20.9)	(27.5)
52-week high/low		US$70.8	US$51.2

Business description

Solera provides software and data solutions to the automotive repair industry on a global basis. Its solutions are used by insurance companies, collision repair facilities and independent assessors to improve claims processing efficiency and reduce overall repair costs.

Next events

Q215 results	End January 2015

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Edison profile page

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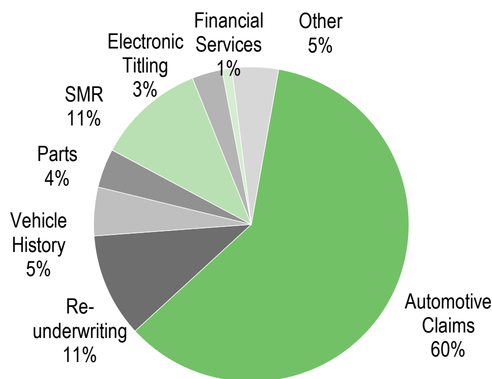
Diversification to drive an acceleration in growth

Investment driving revenue diversification

Solera's investment in Mission 2020 accelerated over FY14 and into FY15, with over $362m spent on acquisitions in FY14 and a further $300m to be invested in I&S, Sherwood and sachcontrol in Q115. As a result, the company's revenue profile has diversified substantially, with 40% of Q414 sales generated from non-claims related revenue streams, down from 94% in 2007. The inclusion of I&S in these figures from Q215 should expand the diversified revenue contribution to over 43%.

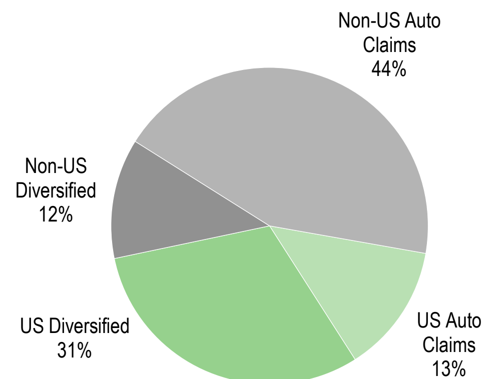
The diversification programme is by far the most advanced in the US, which has been the focus of major acquisition activity. We estimate that non-claims related revenues will account for over 70% of US sales at the current run rate, now that the I&S acquisition has completed. Outside the US, automotive claims still account for the significant majority of revenues, although investment in diversification is contributing to improved growth in key markets such as the UK, Germany and France.

Exhibit 1: Q414 revenue mix



Source: Solera

Exhibit 2: Estimated current (Q215) run rate revenue mix – claims vs non-claims by region



Source: Solera, Edison Investment Research estimates

Growth expectations ticking up

While an apparent drop-off in organic growth in Q4 was a disturbing factor for investors (see Exhibit 45.710), one-time factors contributed to this (see below), the FY14 organic growth rate improved to 4.4% from 3.8% in FY13 and management expects this to expand to 6.0-6.5% in FY15, reaching 7-8% exiting the year. Around two-thirds of the acceleration in expected growth is attributed to recent acquisitions folding into the organic revenue mix, particularly SRS, which is growing at a low/mid-teens rate and should start contributing to organic growth rates in Q315, but also due to other smaller tuck-in deals made over the course of FY14. The remaining acceleration is coming from other non-claims businesses, particularly Explore and TitleTec in the US and HPI in the UK.

Given that the major acquisition activity has been focused on the US, we now expect the US to be growing slightly faster than the overall group (estimate c 8% exiting the year). This marks a substantial turnaround from the situation a few years ago, when growth in the US lagged the group, and reflects the impact of the company's Highly Evolved Markets Initiative (HEMI) investment programme launched in 2010 to reinvigorate growth in the US.

Exhibit 3: Illustration of revenue run rate exiting FY15e

Revenue category	Estimated % of run rate sales, exiting FY15	Estimated constant currency growth rate	Comment
US Diversified	31%	11%	Contribution from SRS (12%+), Explore (c 10%), TitleTec (15%+), other smaller acquisitions (c 15%), I&S (5%).
US Claims	13%	-5%	Near term discounting impact.
Non-US Diversified	14%	12%	Aggregation of smaller, high-growth acquisitions.
Non-US Advanced Market claims	25%	2%	Assumes no significant economic uplift.
Evolving & Emerging market claims	17%	15%	Ongoing growth from growing car pool, increasing percentage of cars insured and increasing claims automation.
Total	100%	7.5%	

Source: Edison Investment Research estimates

Cross-selling across platforms – a future lever

Through the acquisitions made over the past year or so, Solera has significantly expanded its breadth of offering. The company has established a strong position in both US service maintenance and repair (through SRS) and glass (through I&S), while also establishing a presence in pet insurance (through Sherwood – now renamed Valexa) and German property (through sachcontrol). These all complement the company's established businesses in automotive claims, parts and driver behaviour.

The company's increased growth expectations mainly reflect the contribution from higher-growth acquisitions and strengthening trading from other diversified businesses acquired in years gone by. At some stage, a further uplift is possible if the company succeeds in leveraging synergies between its different platforms. For example, the company recently announced that it had entered into an extended partnership with Allianz, the world's largest insurance company, extending the partnership to cover new countries, products and services from Solera. In the US, the company is now the only US claims solutions provider with accident repair, mechanical repair, parts and glass offerings. In this price-competitive market, the broadened portfolio gives the company scope to eventually offset price pressure and grow through cross-selling or bundled offerings.

Investment into diversification also enhances the company's ability to cross-sell into other geographies. For example, Identifix (which accounts for circa two-thirds of SRS revenues) has recently been launched in Mexico, which shares c 70% of the car parc with the US, and expansion into other geographies is planned in the future.

Financials

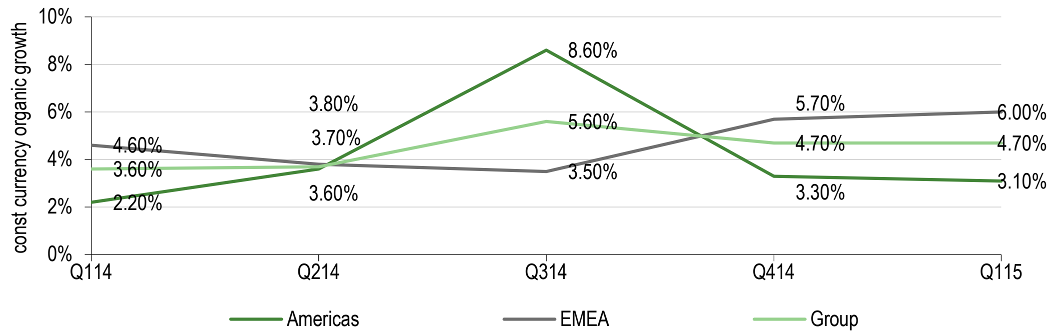
Underlying growth trend upward, despite near-term volatility

FY14 revenues of $987m represented an increase of 17.8% y-o-y, of which 4.4% was due to organic growth, up from 3.8% in FY13. Q115 organic growth of 4.7% was flat on Q414, but as discussed previously, we expect this rate to continue ticking upwards over the course of this year. The drop-off in growth from Q314 (5.6%) to Q414 (4.7%) had created uncertainty, but this was mainly due to one-time benefits in the third quarter (particularly the recognition of three quarters of revenue with one US customer), as well as some more benign weather and more difficult year-on-year comparators in Q4.

As ever, there are a number of puts and takes in the numbers. Suppressing factors in Q1 included the impact of economic deterioration in Brazil, as well as ongoing challenging conditions in the Netherlands, Spain and Switzerland. Trading in Brazil has been further affected by acquisitions of customers by an insurer that uses an in-house technology platform instead of Solera's. Discounts to

secure the renewal of a US customer are also factored in. Key organic drivers include, positively, the increasing penetration of new services and some harsh weather in Belgium.

Exhibit 4: FY14 constant currency organic growth



Source: Solera

The key trigger for the expected acceleration in growth will be SRS (c 10% of sales growing at 12%+), which will start contributing to organic figures on the anniversary of the deal closing on 14 November. I&S is not growing as rapidly (c 5%), but is still above the current run rate for the US and will start to contribute to organic estimates during Q116 next year, as will sachcontrol, which is smaller but growing at a strong double-digit rate.

Driven by improving profitability of the US operations, non-GAAP EBITDA margins expanded from c 30% in 2007 to 45% in 2012. More recently, the step-up in investment for growth (organic development, integrating lower-margin acquisitions) has resulted in some compression, with the FY14 margin of 42.1% compressed by c 200bp due to incremental investment in growth. The Q115 EBITDA margin of 40.8% is in line with the company's EBITDA guidance for FY15 of $466-480m (40.5-41.7% EBITDA margin), which reflects continued investment in growth and c 80bp drag from recent acquisitions. Given the Mission 2020 targets ($2bn revenues by 2020), investment in growth is likely to continue to compress margins in the medium term, although management has now raised the Mission 2020 EBITDA target from 40% to 42%. If management reversed its strategy and put the company into harvest mode, with a focus on margins over growth, we believe EBITDA margins could re-expand to the 44-45% level.

Non-GAAP EPS growth expected to resume

The impact from investment in executing Mission 2020 has been more significant further down the P&L. While EBITDA has grown at an annualised 8% growth rate from 2012 to 2014, non-GAAP EPS has remained broadly flat. The lag was exacerbated in Q414 by a non-recurring increase in minority interest and deferred tax charges relating to an accounting true-up on the SRS acquisition reflecting its strong profitability performance since acquisition. The resultant increase in minority interest expense from $0.4m in Q314 to $7.2m in Q414 contributed towards FY14 adjusted EPS of $2.76 (Edison $2.90), falling short of the $2.83-2.90 guidance range.

We expect EPS growth to resume this year and forecast EPS growth of 8% and 9% for FY15 and FY16 respectively. These estimates include the net 12c per share annualised dilution from recent debt transactions. A dual cross-currency swap and a fixed-to-floating swap is expected to benefit non-GAAP EPS by $0.14 per diluted share on an annualised basis, while additional interest payments on the pending $400m senior note offering dilutes EPS by 26c, at least until this capital is deployed.

Cash flow and balance sheet

Net debt at Q115 stood at $1.4bn, up from $1.0bn reflecting the I&S acquisition. Net debt to trailing 12-month EBITDA stands at 3.1x. The recently announced bond issue is being made to fund a potential $450m+ acquisition, which is in the late stages of negotiation. Completion of the acquisition for which the bonds are being issued will almost certainly push net debt/EBITDA well above 3x, but management is prepared to increase gearing above this comfort level for a short period of time to support key strategic acquisitions. A pause for breath in major M&A activity will therefore likely follow this deal. We feel that this should benefit the share price as investors get a clearer view of the underlying business fundamentals.

The underlying business continues to generate robust cash flows, but this has to some extent been masked by investment and financing costs to deliver the Mission 2020 goals. On an unlevered basis, free cash flow was $320m, 77% of EBITDA, in FY14, and $70m, 61% of EBITDA, in Q115. These figures take into account non-recurring deal-related costs, restructuring and litigation costs. More recently additional capex is also being invested to integrate/restructure SRS.

After including interest payments, Q115 free cash flow of $52.8m equated to a 46% conversion rate, versus 52% in FY14 and 60% in FY13. This decline is largely due to the higher interest charge and the investment in SRS facilities and exceptional compensation expenses paid in the quarter.

Estimate changes

The changes from the forecasts in our outlook note published on 4 August are shown below. Our FY15 sales and EBITDA estimates are in the middle of guidance issued by management with the Q115 results, where the mid-point of sales and EBITDA guidance was reduced by $20m (1.7%) and $8m (1.7%). This reflects the currency headwind from the strengthening dollar offset by a slight operational upgrade (revenues $14m, EBITDA $4m). This followed minor downgrades to guidance at the FY14 results.

Our 2016 income statement estimates are largely unchanged, with the acceleration in organic growth (to 7.1%) offsetting the currency downgrade. This growth rate is below the 7.5-8.0% rate to which management is guiding at year end, reflecting our conservative stance on the economic outlook and factoring in I&S, which is growing at c 5%.

The increase in net debt reflects a higher FY14 level than we forecast, as well as rising capex charges as acquisitions are integrated.

Exhibit 5: Estimate changes

	2012	2013	2014			2015e			2016e		
$m (per-share data in $)	Reported	Reported	Estimate	Actual	Change	Old	New	Change	Old	New	Change
Revenue	790.2	838.1	989.0	987.3	0%	1,147.3	1,140.0	-1%	1,228.0	1,221.7	-1%
EBITDA (ex-minority interest	356.9	370.6	418.5	415.4	-1%	478.5	465.2	-3%	515.7	502.8	-3%
EPS - normalised and diluted ($)	2.69	2.72	2.90	2.76	-5%	3.35	2.98	-11%	3.66	3.24	-11%
Dividend per share ($)	0.40	0.50	0.68	0.68	0%	0.75	0.75	0%	0.82	0.82	0%
Closing net debt/(cash)	637.6	683.1	938.7	1,030.1	10%	1,091.5	1,308.5	20%	937.6	1230.0	31%

Source: Company data, Edison Investment Research

Valuation

Peer discount should dissipate as Q4 concerns addressed

Having recently traded at a slight premium, Solera's P/E ratio is now towards the lower end of its peer group, both on an EV/EBITDA and P/E basis. The 16.5x FY16 P/E is towards the middle of the company's 24-month forward P/E range of 12.6x to 21.6x with the average around the 17.7-18x level. With a potential +$450m acquisition in late-stage negotiations, the deployment of this capital should enhance EPS and bring the rating down further.

We believe the recent de-rating reflects a number of factors including concerns over the ROI of acquisitions, the lack of EPS growth in recent times and rising debt levels. Concerns over the company's exposure to a slowdown in Europe is also likely to be a factor, although it is worth noting that recent M&A has significantly reduced exposure to European claims (c 25% of revenues) when compared to the 2008 downturn.

If the company's financial performance progresses as expected, we believe these concerns should wane and justify a re-rating back upwards, especially given the anticipated acceleration in revenue growth to 7-8% (which is towards the higher end of peers). This re-rating could be on a higher earnings number if the pending acquisition is completed.

Exhibit 6: Valuation versus peers

	Reporting currency	Share price (local)	Market cap (local m)	Current EV/S	Next EV/S	Current EV/ EBITDA	Next EV/ EBITDA	Current P/E	Next P/E
Data and software providers									
Solera Holdings Inc	US$	53.6	3,682	4.4x	3.7x	10.7x	9.0x	18.0x	16.5x
CoStar Group Inc	US$	160.6	5,194	8.9x	7.7x	27.4x	24.3x	49.4x	46.2x
Dun & Bradstreet Corp/The	US$	125.1	4,491	3.4x	3.4x	11.3x	10.9x	16.8x	16.0x
FactSet Research Systems Inc	US$	136.4	5,696	5.6x	5.2x	15.1x	14.1x	23.7x	21.6x
IHS Inc	US$	131.6	8,972	4.9x	4.6x	15.8x	14.2x	22.7x	20.4x
MSCI Inc	US$	47.9	5,366	5.8x	5.3x	14.3x	13.6x	24.0x	22.2x
Thomson Reuters Corp	US$	38.4	30,837	3.0x	2.9x	11.1x	10.2x	20.2x	17.4x
Verisk Analytics Inc	US$	62.9	10,369	6.6x	5.9x	14.3x	12.8x	26.3x	23.3x
Median				5.6x	5.2x	14.3x	13.6x	23.7x	21.6x
Automotive repair/salvage									
Copart Inc	US$	34.2	4,315	3.6x	3.5x	11.0x	10.1x	20.0x	17.9x
Dealertrack Technologies Inc	US$	45.9	2,479	3.0x	2.5x	14.3x	12.0x	29.9x	24.5x
LKQ Corp	US$	29.0	8,782	1.5x	1.3x	12.2x	10.2x	21.6x	17.5x
Median				3.0x	2.5x	12.2x	10.2x	21.6x	17.9x
Insurance software									
Guidewire Software Inc	US$	51.1	3,554	8.2x	7.5x	56.3x	39.5x	113.9x	82.1x
Innovation Group PLC	£	26.8	323	1.3x	1.2x	8.5x	7.1x	16.7x	14.1x

Source: Company data, Bloomberg consensus data. Note: Prices as at 17 November 2014.

Fundamental valuation

Solera's acquisition-driven growth strategy poses a challenge to valuing the company on a fundamental basis. Consequently, we have carried out two alternative scenario analyses – one looking at the value of the company's operations as they stand, ie if the business was put into harvest mode focusing on margins and free cash flow, and another where we look at the valuation implied if the company meets the Mission 2020 targets under different organic growth and acquisition scenarios.

Reverse DCF – current operations

A DCF sensitivity analysis of the current operations suggests that the current share price factors in a slowdown in organic growth to 4% with EBITDA margins maintained at the 40-41% level. If H214

organic growth rates are maintained and EBITDA margins trend towards 42%, then a share price of $65 could be justified. If the company sustains the 7-8% revenue organic growth rate expected on exiting FY15 and achieves 42% EBITDA margins, then a valuation above $70+ looks justifiable.

Exhibit 7: DCF sensitivity analysis – current business operations ($/share)

		Organic growth FY16-20					
		4%	5%	6.0%	7%	8%	9%
EBITDA margin	38%	49.4	53.7	58.3	63.1	68.1	73.4
	40%	55.0	59.6	64.4	69.5	74.8	80.4
	41%	57.8	62.5	67.5	72.7	78.2	84.0
	42%	60.6	65.5	70.6	76.0	81.6	87.5
	43%	63.4	68.4	73.7	79.2	85.0	91.0
	44%	66.1	71.3	76.7	82.4	88.4	94.6

Source: Company data, Edison Investment Research. Note: WACC 8%, terminal growth rate 2%. Assumes $606m paid for the remaining stake in SRS/Identifix in FY17.

Exhibit 8: DCF sensitivity to WACC and terminal growth rate ($/share)

		WACC					
	70.9	6%	7%	8%	9%	10%	11%
Terminal growth rate	1.5%	107.3	82.2	64.9	52.3	42.7	107.3
	2.0%	121.0	90.7	70.6	56.3	45.6	121.0
	2.5%	138.6	101.1	77.3	60.9	49.0	138.6

Source: Edison Investment Research. Note: Assuming 6% mid-term growth and 42% EBITDA margins.

Delivery on Mission 2020

In this scenario we start with the assumption that Solera delivers on its Mission 2020 goal, then look at the implied valuation depending on different organic growth rates and average EV/sales multiples paid for acquisitions to achieve this. The analysis does have flaws, for example it does not factor in any acceleration in growth that may result from buying higher-growth companies and assumes EBITDA margins remain constant at 41% (42% beyond 2021). However, it suggests that substantial value should be generated in most scenarios.

Exhibit 9: DCF sensitivity analysis – delivery on Mission 2020 ($/share)

		Average P/S multiple of acquisitions								
		3	3.5	4	4.5	5	5.5	6	6.5	7
Assumed organic growth rate	3.00%	87.0	83.9	80.9	77.9	74.9	71.9	68.9	65.9	62.9
	4.00%	89.2	86.6	83.9	81.3	78.7	76.0	73.4	70.8	68.1
	5.00%	91.4	89.2	86.9	84.6	82.4	80.1	77.9	75.6	73.3
	6.00%	93.7	91.8	89.9	88.0	86.1	84.2	82.3	80.4	78.6
	7.00%	95.9	94.4	92.9	91.3	89.8	88.3	86.8	85.3	83.8
	8.00%	98.1	97.0	95.8	94.7	93.6	92.4	91.3	90.1	89.0
	9.00%	100.4	99.6	98.8	98.0	97.3	96.5	95.7	95.0	94.2

Source: Company data, Edison Investment Research

Exhibit 10: Financial summary

$m	2012	2013	2014	2015e	2016e
Year end June					
PROFIT & LOSS					
Revenue	790.2	838.1	987.3	1,140.0	1,221.7
Cost of Sales	(246)	(261)	(313)	(360)	(384)
Gross Profit	545	578	674	780	838
EBITDA	356.9	370.6	415.4	465.2	502.8
Operating Profit (before amort. and except.)	318.6	329.1	342.0	379.4	415.4
Acquired Intangible Amortisation	(76)	(75)	(86)	(91)	(91)
Share based payments	(18)	(26)	(38)	(40)	(40)
Exceptionals	(16)	(34)	(49)	(55)	(55)
Minority interest (add back, excluded from adjusted figs)	(11)	(11)	(11)	(11)	(14)
Operating Profit	208	196	193	216	262
Net Interest	(54)	(70)	(107)	(121)	(146)
Profit Before Tax (norm)	265.0	261.9	258.5	280.1	301.3
Profit Before Tax (GAAP)	153.6	124.7	21.3	78.9	100.0
Tax	(46)	(31)	(30)	(26)	(30)
Profit After Tax (norm)	190.8	188.6	191.3	207.3	224.3
Profit After Tax GAAP)	107.9	93.9	(8.7)	53.0	69.6
Average Number of Shares Outstanding (m)	70.2	70.2	68.8	68.8	68.8
EPS - adjusted ($)	2.72	2.74	2.78	3.01	3.26
EPS - normalised fully diluted ($)	2.71	2.73	2.76	2.98	3.24
EPS - (GAAP) ($)	1.54	1.35	(0.13)	0.77	1.01
Dividend per share ($)	0.40	0.50	0.68	0.75	0.82
Gross Margin (%)	68.9	68.9	68.3	68.5	68.6
EBITDA Margin (%)	45.2	44.2	42.1	40.8	41.2
Operating Margin (before GW and except.) (%)	40.3	41.6	40.8	38.4	36.4
BALANCE SHEET					
Fixed Assets	1,463	1,599	2,342	2,525	2,485
Intangible Assets	1,330	1,452	2,160	2,370	2,293
Tangible Assets	59	62	77	78	78
Investments	74	86	106	77	114
Current Assets	689	658	1,058	1,226	1,676
Stocks	0	0	0	0	0
Debtors	129	140	153	181	189
Cash	508	464	838	960	1,401
Other	52	53	67	85	85
Current Liabilities	(179)	(217)	(283)	(276)	(279)
Creditors	(101)	(202)	(254)	(264)	(266)
Other	(75)	(12)	(29)	(12)	(12)
Short term borrowings	(3)	(3)	0	0	0
Long Term Liabilities	(1,197)	(1,208)	(2,038)	(2,428)	(2,428)
Long term borrowings	(1,143)	(1,144)	(1,868)	(2,268)	(2,268)
Other long term liabilities	(54)	(63)	(170)	(160)	(160)
Net Assets	776	833	1,080	1,047	1,454
CASH FLOW					
Operating Cash Flow	322	327	386	362	384
Net Interest	(54)	(70)	(107)	(121)	(146)
Tax	(46)	(31)	(30)	(26)	(30)
Capex	(32)	(41)	(56)	(56)	(56)
Acquisitions/disposals	(16)	(141)	(362)	(307)	0
Financing	(83)	(45)	(47)	(45)	(45)
Dividends	(37)	(45)	(70)	(64)	(64)
Net Cash Flow	56	(45)	(286)	(258)	43
Opening net debt/(cash)	673.3	637.6	683.1	1,030.6	1,308.5
HP finance leases initiated	0.0	0.0	0.0	0.0	0.0
Other	(20.1)	(0.7)	(61.0)	(20.2)	(1.0)
Closing net debt/(cash)	637.6	683.1	1,030.6	1,308.5	1,230.0

Source: Company data, Edison Investment Research

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