Danger Zone: Bottomline Technologies (EPAY)

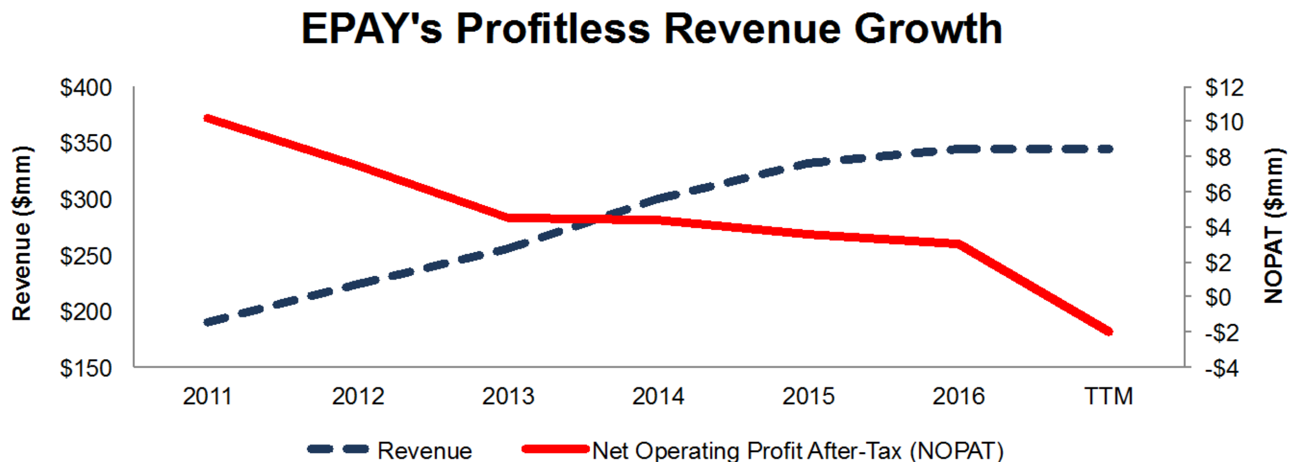
Check out this week's Danger Zone interview with Chuck Jaffe of Money Life and Marketwatch.com

There's no denying that the future of technology rests in "the cloud." However, red flags appear when a firm sacrifices profitability to join the cloud and transitions to a business model with negative margins. Add in significant competition and an overvalued stock price and investors should be running for the hills. Nevertheless, this stock is up 20% over the past two years. Bottomline Technologies (EPAY: $25/share) is in the Danger Zone this week.

Profitless Revenue Growth Doesn't Create Shareholder Value

Since 2011, Bottomline Technologies' after-tax profit (NOPAT) has declined by 21% compounded annually to $3 million in 2016 and -$2 million over the last twelve months (TTM). This deterioration in profits occurred despite revenue has growing 13% compounded annually during the same period, per Figure 1. Revenue growth means very little if the business cannot convert it to meaningful profits.

Figure 1: Profits Decline Amidst Impressive Revenue Growth



Sources: New Constructs, LLC and company filings

The issues do not end with declining NOPAT. Bottomline's NOPAT margin has fallen from 5% in 2011 to -1% TTM while the company has burned through a cumulative $240 million in free cash flow (FCF) over the past five years. Across multiple key metrics, Bottomline's business is showing significant signs of deterioration.

Destructive Acquisitions Cannot Be Overlooked

Over the past five years, Bottomline Technologies has acquired 19 separate companies at a cost of over $361 million. Management touted the importance of the acquisitions to revenue growth and growing the business as a whole. While these acquisitions appear to be accretive (to EPS), due to the high low fallacy, more rigorous research reveals these acquisitions did little to earn a quality return on invested capital. Bottomline's ROIC has fallen from 5% in 2011 to a bottom-quintile 0% TTM. Management must be held accountable for its capital allocation decisions. Per Figure 2 below, it's clear Bottomline's acquisitions have been a poor use of capital and led to the decline in the firm's overall ROIC.

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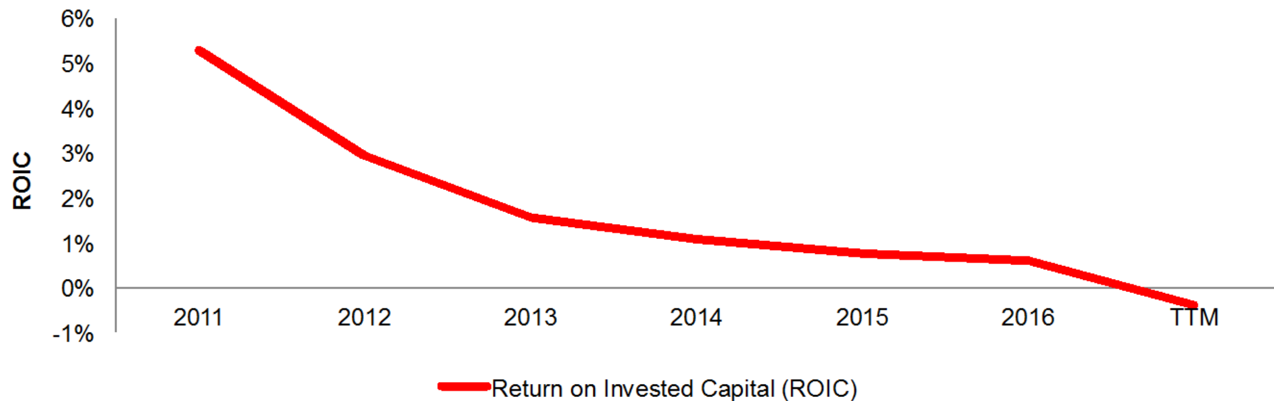
Figure 2: Acquisitions Fail To Earn A Quality Return



Sources: New Constructs, LLC and company filings

Compensation Plan Incentivizes Destructive Acquisitions

Misaligned executive compensation plans help line the pockets of executives at the expense of shareholders. Bottomline Technologies' executive compensation plan, apart from base salary, rewards executives for meeting revenue and non-GAAP operating income targets. Each of these metrics does not align executive interests with those of shareholders.

As shown in Figure 1, Bottomline Technologies has been able to grow revenue, largely through acquisition, and meet the bonus goal. At the same time, non-GAAP operating income conveniently excludes expenses such as acquisition and integration related costs and restructuring expenses, which are quite meaningful for a firm that's done 19 acquisitions in five years. Ultimately, Bottomline is able to meet revenue goals through acquisition, and by excluding key costs related to acquisitions, also meet non-GAAP operating income goals.

As we've demonstrated through multiple case studies, ROIC, not revenue or non-GAAP income, is the primary driver of shareholder value creation. Without major changes to this compensation plan, preferably to emphasize shareholder-creation-friendly metrics (e.g. ROIC), investors should expect further value destruction while management continues to get big payouts.

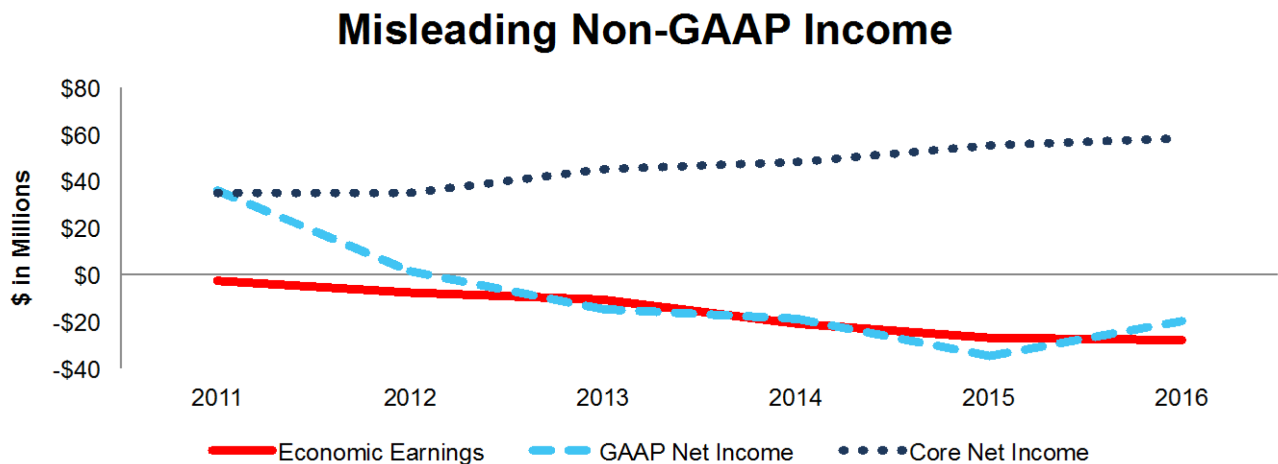
Non-GAAP Metrics Mask Economic Reality

Non-GAAP metrics should be a red flag for investors because they often mask the true economics of the business. Bottomline Technologies uses non-GAAP metrics such as "core net income" and adjusted EBITDA to "better represent the business." We can agree that these metrics "better" represent the business, in that they make the firm look profitable when it is in fact losing money, but these metrics are certainly not more accurate. Below are some of the expenses EPAY removes to calculate its non-GAAP metrics:

1. Stock-based compensation expenses
2. Acquisition and integration related expenses
3. Restructuring related costs
4. Global ERP system implementation costs
5. Minimum pension liability adjustments

These adjustments have a significant impact on the disparity between GAAP net income, "core net income", and economic earnings. In 2016, EPAY removed over $30 million in stock-based compensation expense (9% of 2016 revenue) to calculate "core net income." This adjustment allowed Bottomline Technologies to report "core net income" of $58 million," compared to -$20 million GAAP net income and -$28 million economic earnings, per Figure 3.

Figure 3: Disconnect Between Non-GAAP & Economic Earnings



Sources: New Constructs, LLC and company filings

Lagging Profitability In A Fragmented Industry

Bottomline Technologies provides cloud-based business payment, digital banking, fraud prevention, and financial document services. Ultimately, Bottomline facilitates the transfer of money between businesses and vendors. EPAY faces competition from many different angles, including firms that offer "one-stop solutions" and those that provide more customizable services that facilitating only one subset of payment transactions. Competitors include Wells Fargo & Company (WFC), Fiserv Inc. (FISV), American Express (AXP), NCR Corporation (NCR), Infosys (INFY), and even ACH capabilities offered by banks, such as direct deposit and money transfers. Per Figure 4 below, Bottomline Technologies lags the profitability of its peers within this fragmented industry.

Most notably, the firms with the highest profitability in the industry are those that have business lines apart from payment facilitation. Firms such as Oracle (ORCL), Wells Fargo, and American Express each have NOPAT margins above 18% and can support payment processing through resources derived from main business lines. Bottomline Technologies on the other hand, with its -1% margin, faces significant competitive disadvantages without a profitable segment to bolster its payment services.

Figure 4: Bottomline Technologies' Bottom Barrel Profitability

Company	Ticker	Return On Invested Capital (ROIC)	NOPAT Margin
Oracle Corporation	ORCL	20%	28%
Wells Fargo & Company	WFC	10%	26%
Fiserv Inc.	FISV	12%	19%
Infosys Ltd	INFY	27%	18%
American Express	AXP	14%	18%
Jack Henry & Associates	JKHY	17%	17%
International Business Machines	IBM	10%	14%
Nice Systems	NICE	15%	14%
Fidelity National	FIS	5%	10%
NCR Corporation	NCR	8%	8%
ACI Worldwide	ACIW	1%	2%
Bottomline Technologies	EPAY	0%	-1%

Sources: New Constructs, LLC and company filings

Bull Hopes Rest On Profitable Cloud Transition

As noted above, the transition to the cloud and subscription-based revenues has not been a profitable venture for Bottomline Technologies. We've covered many unprofitable cloud companies in previous Danger Zone reports. Bottomline is unique in that prior to its transition to subscription-based products, the firm was able to generate positive NOPAT, albeit a small one.

In transitioning to the cloud, EPAY prioritized revenue growth, in hopes that investors would put faith in the firm's ability to regain profitability sometime in the future. However, as shown in Figure 5 below, this profitability seems far off, if not impossible.

Per Figure 5, Bottomline Technologies' operating expenses are growing faster than revenues. Product development & engineering, sales & marketing, and general & administrative costs have grown 17%, 16%, and 13% compounded annually respectively since 2011. Meanwhile, revenue has grown only 13% compounded annually over the same time period.

Figure 5: Costs Outpace Revenue Growth

Operating Item	2011	2016	CAGR
Product Development & Engineering Cost	$22	$47	17%
Sales & Marketing Costs	$39	$84	16%
General & Administrative Costs	$20	$39	15%
Revenues	$189	$343	13%

Sources: New Constructs, LLC and company filings.

These rising costs undermine any revenue growth EPAY has achieved through acquisition or organically. Soaring costs, industry lagging margins, and the poor executive compensation structure outlined above make it rather hard to keep the faith that EPAY will return to profitability anytime soon.

Making matters worse, any bull case rests on the hope that EPAY will not only return to profitability, but earn significant market share and grow profits at unrealistic growth rates, as we'll show below.

EPAY Is Already Priced To Perfection

Despite deterioration in business fundamentals, EPAY is up 20% over the past two years, which outpaces the S&P 500, which is up only 13%. The significant price increase without a subsequent improvement in the business's cash flow leaves EPAY priced to perfection.

To justify its current price of $25/share, EPAY must achieve NOPAT margins of 5% (highest ever achieved by firm in 2011, compared to -1% TTM) and grow revenue by 13% compounded annually for the next 14 years. In this scenario, Bottomline would be generating nearly $2 billion in revenue (14 years from now), which is greater than the combined revenue of competitors ACIW and NICE from Figure 4 and greater than Jack Henry & Associates (JKHY) fiscal 2016 revenue. In other words, the expectations baked into the stock price imply EPAY taking significant market share moving forward.

Even if we assume EPAY can achieve 5% NOPAT margins and grow revenue by a more realistic rate of 9% compounded annually for the next decade, the stock is worth only $11/share today – a 56% downside. Each of these scenarios also assumes EPAY is able to grow revenue and NOPAT/free cash flow without spending on working capital or fixed assets. This assumption is unlikely but allows us to create very optimistic scenarios that demonstrate how high expectations in the current valuation are. For reference, EPAY's invested capital has grown on average $38 million (11% of 2016 revenue) per year over the last ten years.

Is EPAY Worth Acquiring?

The largest risk to our bear thesis is what we call "stupid money risk", which means an acquirer comes in and pays for EPAY at the current, or higher, share price despite the stock being significantly overvalued. Accordingly, we only see an acquisition as possible if an acquiring firm is willing to destroy substantial shareholder value.

Below we show just how expensive EPAY remains after assuming an acquirer can gain significant synergies.

To begin, EPAY has liabilities of which investors may not be aware that make it more expensive than the accounting numbers suggest.

1. $26 million in off-balance-sheet operating leases (3% of market cap)
2. $21 million in deferred tax liabilities (2% of market cap)
3. $21 million in underfunded pensions (2% of market cap)
4. $2 million in outstanding employee stock options (<1% of market cap)

After adjusting for these liabilities we can model multiple purchase price scenarios. Even in the most optimistic of scenarios, EPAY is worth less than the current share price.

Figures 6 and 7 show what we think Fiserv (FISV) should pay for Bottomline Technologies to ensure it does not destroy shareholder value. Adding Bottomline Technologies could bolster Fiserv's payments and banking services. However, there are limits on how much FISV would pay for EPAY to earn a proper return, given the NOPAT of free cash flows being acquired.

Each implied price is based on a 'goal ROIC' assuming different levels of revenue growth. In each scenario, the estimated revenue growth rate in year one and two equals the consensus estimate for 2017 (2%) and 2018 (8%). For the subsequent years, we use 8% in scenario one because it represents a continuation of 2018 expectations. We use 14% in scenario two because it assumes a merger with FISV could create revenue growth through cross selling platform opportunities.

We conservatively assume that Fiserv can grow Bottomline Technologies' revenue and NOPAT without spending on working capital or fixed assets. We also assume EPAY immediately achieves a 9% NOPAT margin, which is the average of EPAY and FISV's TTM NOPAT margins. For reference, EPAY's TTM NOPAT margin is -1%, so this assumption implies immediate improvement and allows the creation of a truly best case scenario.

Figure 6: Implied Acquisition Prices For FISV To Achieve 6% ROIC

To Earn 6% ROIC On Acquisition		
Revenue Growth Scenario	EPAY's Implied Stock Value	% Discount to Current Price
7% CAGR for 5 years	$14	45%
10% CAGR for 5 years	$17	32%

Sources: New Constructs, LLC and company filings.

Figure 6 shows the 'goal ROIC' for FISV as its weighted average cost of capital (WACC) or 6%. Even if Bottomline Technologies can grow revenue by 10% compounded annually with a 9% NOPAT margin for the next five years, the firm is worth less than its current price of $25/share. It's worth noting that any deal that only achieves a 9% ROIC would be only value neutral and not accretive, as the return on the deal would equal FISV's WACC.

Figure 7: Implied Acquisition Prices For FISV To Achieve 12% ROIC

To Earn 12% ROIC on Acquisition		
Revenue Growth Scenario	EPAY's Implied Stock Value	% Discount To Current Price
7% CAGR for 5 years	$5	79%
10% CAGR for 5 years	$7	72%

Sources: New Constructs, LLC and company filings.

Figure 7 shows the next 'goal ROIC' of 12%, which is FISV's current ROIC. Acquisitions completed at these prices would be truly accretive to FISV shareholders. Even in the best-case growth scenario, the most FISV should pay for EPAY is $7/share (72% downside). Even assuming this best-case scenario, FISV would destroy just over $880 million by purchasing EPAY at its current valuation. Any scenario assuming less than 10% CAGR in revenue would result in further capital destruction for FISV.

Fundamentals Matter: Investors Tire of Profitless Revenue Growth

During stock rally's, such as the recent "Trump Rally" stock valuations can often soar to levels that are simply unjustified by the underlying economics of the business. When these rallies end, investors are left holding overvalued firms with poor fundamentals. The stocks with the worst fundamentals are discarded accordingly.

As the Trump Rally comes to an end, the time to evaluate EPAY on its fundamentals has arrived. As shown above, those fundamentals do not justify the current valuation, and even in the best case scenarios, the stock faces significant downside.

Something as simple as an earnings miss could be a catalyst for the market to re-evaluate EPAY. We've seen competitor ACI Worldwide (ACIW), placed in the Danger Zone in June 2016, fall 10% since we published our report (compared to S&P up 9%) as revenue failed to meet expectations in two consecutive quarters.

The same fate could befall EPAY as investors tire of the constant revenue growth the subscription model generates and begin to hold management accountable for the lack of profits at the firm.

Insider Action and Short Interest Is Minimal

Over the past 12 months, 312 thousand insider shares have been purchased and 247 thousand have been sold for a net effect of 65 thousand insider shares purchased. These sales represent less than 1% of shares outstanding. Additionally, there are 2.4 million shares sold short, or 6% of shares outstanding.

Impact of Footnotes Adjustments and Forensic Accounting

In order to derive the true recurring cash flows, an accurate invested capital, and a real shareholder value, we made the following adjustments to Bottomline Technologies' 2016 10-K:

Income Statement: we made $25 million of adjustments with a net effect of removing $23 million in non-operating expense (7% of revenue). We removed $1 million related to non-operating income and $24 million related to non-operating expenses. See all the adjustments made to EPAY's income statement here.

Balance Sheet: we made $238 million of adjustments to calculate invested capital with a net decrease of $20 million. The most notable adjustment was $38 million (7% of reported net assets) related to other comprehensive income. See all adjustments to EPAY's balance sheet here.

Valuation: we made $355 million of adjustments with a net effect of decreasing shareholder value by $133 million. The largest adjustment to shareholder value was $199 million in total debt, which includes $26 million in off-balance-sheet operating leases. This lease adjustment represents 3% of EPAY's market cap.

Dangerous Funds That Hold EPAY

The following funds receive our Dangerous-or-worse rating and allocate significantly to Bottomline Technologies.

1. Nicholas Limited Edition (NNLEX) – 1.5% allocation and Dangerous rating.
2. Frontier Netols Small Cap Value Fund (FNSVX) – 1.3% allocation and Dangerous rating.
3. Kalmar "Growth-With-Value" Small Cap Fund (KGSAX) – 1.3% allocation and Dangerous rating.

This article originally published here on January 16, 2017.

Disclosure: David Trainer, Kyle Guske II, and Kyle Martone receive no compensation to write about any specific stock, style, or theme.

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2. Standard for all companies.
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