

## Taptica: Underfollowed, Profitable Ad Tech Company at Discount

Alejandro Estebaranz of True Value presented his in-depth investment thesis on Taptica (UK: TAP) at European Investing Summit 2018.

### *Thesis Summary:*

Taptica is one of the leading ad-tech companies. The company has 15% growth (organic plus M&A). It has a net cash balance sheet. The business is well run and the management has generated significant value since going public. The shares are cheap at 8x EV/FCF and 6x EV/EBITDA (2018E); and less than 7x EV/FCF and 5x EV/EBITDA (2019E). Insiders own ~20% of the shares and have a history of good capital allocation. The outlook for the sector is favorable, and comparable companies trade at much higher valuations. Private deals have also been consummated at high multiples. This GBP 200 million market cap company is cheap, likely because it is underfollowed and trades in the second segment of the London Stock Exchange.

*The following transcript has been edited for space and clarity.*

True Value is a five-star Morningstar fund that has grown from €3 million up to €210 million. Since the launch five years ago, we have generated a compounded annual growth rate of around 13%, net of fees and net for the client. We are focused primarily on small- and mid-caps, looking for good companies, high insider ownership, and low debt. We tend to favor growing businesses, and one of the most important features is that it should be trading at low prices. This is probably the main reason we have outperformed the S&P, the MSCI World, or the Euro Stoxx. We are very happy with our performance.

I'm the co-investment advisor. The other founding partner, José Luis Benito, is an economist who ran a family office before True Value. We are also an EFPA member.

My presentation focuses on Taptica, which we consider a highly compelling opportunity. This is an obscure small cap (around £300 million) operating in the advertising technology space. Taptica is in the right place: it does mobile, branding, and performance-based marketing for companies. It has excellent organic growth (about 15% to 20% per year), a robust net cash position, and returns on capital employed of around 60%. There is also good insider ownership (15% of the company), and Taptica expects to grow more than 25% over the next several years. There is also great capital allocation and a highly experienced team on M&A.

Since the company went public around 2013, revenues have grown from \$20 million to almost \$300 million. The share count has increased a little, but much less than revenue growth. EBITDA has been very good over the years, and free cash flow generation is up almost 10 times since the flotation.

There are a couple of things to note. In 2015, EBITDA declined, and sales went down almost 40% because the company transitioned the business into mobile. Originally, it was doing advertisement technology for display, or desktop, but the management saw the future is mobile advertisement and changed the business. That took one year, and in 2016, the performance was excellent. Taptica also has great capital allocation. When the share price went down during the turnaround period in 2015, it bought back almost 10% of total shares. But when the price recovered, it issued shares to buy other companies. The management understands that when shares are cheap, they should buy back, and when shares became expensive, they issue stock, mainly to do M&A.

What is the price we have to pay today for this kind of company? It's trading at only 8x free cash flow for 2018, but if we look one year forward, the multiple should be probably around 6x. If we look five years forward, this company will become very cheap.

Let's explore the business in more detail. Performance-based marketing generates 50% of revenues, with Taptica getting paid only if a client completes a purchase, installs an app, completes a tutorial, registers in a particular database, or takes some other action specified by the brand. The other half of the business is what is called DSP, which is the future of online advertising. This is like a stock exchange for online advertisements where publishers and clients place their bids and offers, and the highest bid and volume for the offer wins the placement. The ad shows automatically in the platform of the publisher.

Taptica stepped into DSP performance marketing in 2017, when it bought Tremor Video, which was a great acquisition for several reasons. First, the price was low. It paid only \$50 million, but this amount included \$10 million to \$20 million of positive working capital, so the net price is roughly \$30 million, or around 3x EBITDA. Second, after some cost-cutting and cross-selling activities, this business is expected to generate around \$11 million in EBITDA this year.

Taptica bought the business from a forced seller, publicly traded Telaria. This is the typical tech company generating almost no profit. It decided to exit a low-growth business, and the sale was also driven by the fact that Telaria is focused in the opposite side. The D in DSP is for the demand side, while Telaria was positioned in SSP, the supply side of the advertisement technology. It had a highly inefficient cost structure – for example, offices in the most expensive places, like New York, in the best buildings and the best areas. Taptica decided those costs were unnecessary, so it took them out. In the first half of 2018, Tremor Video was growing nicely, at around 10% to 12%.

It has also won some big clients recently, their largest now being Alibaba. Taptica has some other widely known brands as clients, and they are in the branding segment, which is like traditional advertising but on the internet. This is a more recurring business and higher-margin business, and Taptica wants to grow in this segment because it is huge.

M&A has played a major part in value creation over the last four or five years. This company was originally called Marimmedia, and Taptica was its first acquisition since going public. It bought the business for around \$15 million. Net income was negative at the time, but three years later, in 2017, the company was generating more than \$100 million in sales and more than \$20 million in EBITDA. If we took the purchase price after four years, it equals 1x EBITDA. One year later, it bought AreaOne, also for \$15 million. This company was doing around \$7.5 million revenues, but within three years, it was generating net revenues of almost \$25 million and around \$5 million in EBITDA. That equals 3x EBITDA for the business after synergies and some growth. In 2017, Taptica bought Adinnovation. This was a great platform to grow in Japan and Asia because it's really difficult to do it from scratch in Japan due to the language barrier and the different culture. Since Taptica has a rather conservative approach to M&A, it decided to buy 57%, but it has a call option for the rest of the business at a P/E ratio of 8x. Adinnovation had 2017 sales of around \$13 million and is performing really well since the acquisition.

Taptica is also doing business in a growing sector. Digital video advertising is expected to grow almost 70% over the four years to 2021, and Tremor Video is strongly positioned to capture some of this growth. The mobile advertising market is also expected to expand in the next two or three years. Desktop accounts for a tiny portion of revenues for Taptica now, only about 1%.

As value investors, we should ask ourselves what the reasons for this bargain are. Why is it trading so cheaply? One of the reasons is that we have an Israeli company trading on the London Stock

Exchange, in fact, on its second segment, which is called AIM (Alternative Investment Market). This is a cheap place if you want to float a company, but the small investor base can sometimes create a bargain. The company also has low liquidity – around £800,000 a day. It is only covered by two small regional brokers, FinnCap and Berenberg, and those have a price target of around £6.

Another reason is the fear of the GDPR (General Data Protection Regulation) and all the internet regulation in Europe. However, only 13% of Taptica's revenues come from Europe, and the first-half results published in September showed no impact at all. This is truly important, but Taptica's small retail investors are weak hands – they sell fast and also come by fast when they feel the company should perform well. The GDPR affects only third-party data and has no effect on Taptica because it doesn't rely on such data. There was also the Facebook scandal in the first half of 2018. All the small caps in the advertising space went down. People were afraid of new revelations and decided to sell their shares. The stock went down almost 40%, and while it has recovered a bit, it remains well off the highs.

We could add to the reasons the capital raise Taptica did in the beginning of 2018. The company issued some shares because it was planning to do a big acquisition. However, the management team told us they didn't like what they saw during the due diligence process and decided to walk away. This is a good reason, but again, small retail investors were expecting the company to make a new acquisition. It didn't happen, so the market decided not to buy its shares. In August, the management team told us they had a new potential big acquisition they expected to close in the second half of the year. Managers also sold some shares at peak levels in January, but since then, they have been active buyers in the open market at around £3.

There are some other reasons, like the fact that the company doesn't hold quarterly conference calls, only a capital markets day one time a year. It doesn't have investor presentations, and the investor relations (IR) section of its website is unfriendly, with very little information. It only features links to the London Stock Exchange, the annual reports, and the IR contact. The company doesn't have an IR department; it wants to keep costs low and feels that it doesn't need it. The IR person is actually the chief financial officer.

UK equities have been the most underweight asset class in recent months, which is another reason for this bargain. Also, the British pound has been hugely underweight over this period, and people have Brexit anxiety. It doesn't matter for Taptica because it does most of its business outside the UK. The company reports in US dollars and trades in pounds, so if the pound goes down, you are going to suffer if you are a foreign investor, but Taptica's profit will go up.

The first-half report for 2018 shows strong performance. Revenues more than doubled, with organic growth coming at around 15%. The share count was up only 10%, which is good, especially considering that EBITDA went up 65%. Cash flow generation was also up 65%, and the net cash position was equal to 15% of the total market cap. The company confirmed that Alibaba was its new top client and said it had won big clients in the US. The legacy business declined 66%, but it only represents \$3 million in revenues against around \$300 million for this year.

Taptica doesn't say it explicitly, but it has won WPP as a client. This is one of the biggest advertising agencies in the world, but it has a weak presence in the digital space. We think WPP could be a potential buyer of Taptica, and the management team and the insiders are open to selling the company. The CEO has said that if somebody offers a good or fair price, a sale would be considered.

This is also a highly cash-generative business. As value investors, we like to focus on high cash flow generation. One of the reasons this business generates a lot of free cash flow is because its capex levels are very low, typically around \$2 million to \$3 million a year. Cash taxes are also very low –

Israel tech companies get special treatment in the federal tax code and only pay around 15%. There is also a tax shield due to amortization as a result of M&A activities. The second half of the year tends to be better in terms of cash flow generation, so we expect Taptica to conclude 2018 with around \$40 million in free cash flow.

There is also high insider ownership, with around 20% of total shares held by insiders. The base salaries and bonuses for the management team are okay for a tech company with this kind of performance. The share-based compensation went up a bit in the first half of 2018 because the stock price performed really well in 2017. The CEO, Hagai Tal, bought over 120,000 shares between February and April 2018, which is positive for the company and the stock.

In addition, the sector is consolidating. There is a lot of M&A activity, and the space is trading at really high multiples. Sizmek bought Rocket Fuel for almost \$300 million, including debt. This company had around \$400 million revenue but no profit, unlike Taptica. Also, KKR invested in AppLovin early in 2018, paying around 4x sales. AppLovin is also not generating any kind of profit, so these companies usually get valued by sales. AT&T bought AppNexus in June in a deal valued at \$2 billion. AppNexus had revenues of around \$400 million, growing 20% a year.

Taptica is growing at almost the same rate, 15% to 20% a year, but it is trading at a valuation of \$300 million, not \$2 billion. There is a publicly traded company on the NASDAQ called Trade Desk. It is better than Taptica. It is the market leader and is growing at more than 40%, but it is trading at 40x EBITDA. If you exclude stock-based compensation, it is trading at around 80x price/free cash flow, which is an insane multiple. Taptica is still trading at around 5x EBITDA, 8x free cash flow, and 1x sales and has 50% organic growth, with no debt. Management has said that if the market doesn't reward the stockholders, a sale of the company would be an option. We have asked the leadership team about potential buybacks, which they have done in the past, and they are open to the idea if no new M&A target emerges.

We have modeled three valuation scenarios. The bull case has the company growing by 15% organically plus another 15% inorganically due to M&A, and EBITDA margins stay at 19%. In the base case, we consider 10% organic and another 10% inorganic, with EBITDA margins a bit lower at 17%. In the bear case, we assume organic growth slows down to 5%, there are no M&A or buybacks, and EBITDA margins stay at today's level, but the company generates a lot of cash over the next three to five years.

Regarding the bull case, Taptica has grown from \$20 million to \$200 million in the last year and expects to generate around \$45 million to \$50 million in EBITDA for 2018. We have modeled some dilution due to stock-based compensation. There are 10 million stock options, but the average strike price is around £2.5, so the real dilution after proceeds should be lower. We have used around 18x to 20x free cash flow. In our opinion, the most important metric in this business is EV/EBITDA and free cash flow. If the company continues to grow by more than 25% per year, which is likely given its past performance, the projected multiples are okay. If the company performs as we expect in this scenario and the market starts paying a fair multiple, the compounded annual growth rate would be huge. We are talking about more than 40% annually over the next three years, with the stock price tripling over this time.

For the base case, we have made projections with 20% growth, around 17% EBITDA margins, and some dilution in the future. We have used very conservative multiples, taking into account those for other public or private companies. Here, we also expect to make 3x our investment over the next three to four years. In this scenario, we assume Taptica can deploy \$50 million to \$60 million on average a year in M&A at 6x to 7x EBITDA after synergies. Net debt should stay at zero or close to zero because it can grow easily by 20% a year without using any kind of debt.

The bear case assumes only 5% growth and some dilution of the share count over the next years. In this scenario, as Taptica grows, the balance sheet gets more and more cash, so the net cash position grows over time, making the company a little cheaper year by year. We have used very low multiples here, around 9x to 13x EV/EBITDA. But even in this bad scenario, which we consider quite unlikely, the internal rate of return for the next three years is almost 20% annually. We're pretty sure if M&A becomes expensive, the company can perform buybacks and generate a lot of value in this way.

There are some risks to this investment. As always with technology companies, there can be disruption. We don't see it right now, but this can change over the years. Today, however, it is a low risk. M&A execution is another risk for this kind of company, but Taptica's past performance in this space has been really good. Regulation has some impact, but this is also a low probability because Taptica doesn't rely on third-party data to conduct its business. There is also some minor risk in the exchange rate between the US dollar and the British pound.

In summary, we have an excellent company in a growing sector that has high trading multiples. This is a small, unknown business followed by only two small brokers. It has high insider ownership and great capital allocation skills. It is cheap for several reasons, but we think those reasons are outside of the business of the company.

*The following are excerpts of the Q&A session with Alejandro Estebaranz:*

**John Mihaljevic:** Could you comment a little more on the management's incentives in terms of how compensation is determined on the cash side?

**Estebaranz:** The company has a great incentive scheme that is aligned with shareholders. It is based on EBITDA per share or total growth per share. It is true that the share-based compensation went up a bit during the first half of 2018, but the company has to keep middle management in place as it grows, so it needs to increase the share-based compensation to retain talent. On the other hand, the base salaries and bonuses at the top level are okay. They are not ultra-low, but they are okay.

**Mihaljevic:** What data points are you tracking to either validate or challenge your thesis over time?

**Estebaranz:** First is organic growth, which should be above the market average. The online advertising space is growing at around 10% or 12% per year, and we like that the company achieves growth above that rate. The second point is M&A activity. We like it to pay low multiples for its acquisitions. We also focus on cash flow generation and capital allocation. If it doesn't do any M&A, we'd want it to buy back shares. These are the four performance indicators.

**Mihaljevic:** Could you elaborate on the technology-related risks? In other words, could there be a superior technology that would quickly take market share and threaten this business?

**Estebaranz:** When Taptica was operating in the display advertising segment, it experienced low growth, so it decided to transition to mobile. We think it is now in the right space because mobile is the future of online advertising. Half of Taptica's revenues come from the branding side of the business, and these tend to be very stable. This is like a traditional advertising agency but on the internet. You have to build a big agency on the internet to win important clients, and this is what Taptica is doing right now. It is aiming for a global presence because if a client like Guess, Whole Foods, Nike, or Electronic Arts wants to work with you, they want to have a global solution for all the areas they operate in. The management team believes that's where the big money is, which is why the company is making these acquisitions in Asia and the United States. For the next acquisition, it wants to focus on Europe because its presence is the weakest there.

The second business segment is performance-based marketing, which relies on algorithms, among

other things. This space could change in the future, but following our conversations with the company, independent analysts, and other sector players, we have come to believe Taptica's position is quite good. It's not as strong as Trade Desk's on the DSP side, but it is solid. Still, you have to watch carefully for changes in the industry. Now, we don't see any kind of disruption, but a new technology may appear in five years. Taptica has been great at adapting to new changes and trends.

According to the CEO, the real job is to look forward to the next big thing. He doesn't want to run the company day to day. He's focused on M&A, the next big thing, trying to anticipate changes in the sector, and maintaining the strong corporate culture of the company.

*About the instructor:*

Alejandro Estebaranz has served as the co-investment advisor of the True Value fund (ISIN: ES0180792006) since its inception. True Value, based in Spain, is a long-only equity fund founded in 2014. It focuses on underfollowed small- and mid-cap public companies, seeking good businesses with good management teams. Prior to True Value, Alejandro worked as an analyst for private investment partnerships. He holds a degree in mechanical engineering and a degree in industrial engineering.