

My Investment Thesis on ITE Group

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Replay Mark's [session on ITE Group](#) at Best Ideas 2019.

What should a demanding investor be willing to pay for:

- A simple, founder-led business.
- A provider of an enduring service, reflecting a business practice which is hundreds of years old with a high utility to cost ratio.
- Geographically and industrially diversified end markets.
- UK headquartered and listed enterprise.
- Capital intensity of 1-2% of annual revenues.
- Strong FCF conversion of earnings due to deferred income balances 50-70% of revenues.
- Average through cycle returns on capital of around 30%.
- Defensible moat facilitated by two-sided network effects barriers to entry.
- Revenue visibility, with two thirds of following year's sales forward booked.
- Conservative capital structure.
- Organic revenue growth of 11%.

ITE is involved in one business activity: it organises exhibitions and conferences. ITE hires venues and gathers a group of exhibitors and visitors, monetising the exhibitor side of the network by charging companies for floor space. The company operates across several sectors including construction, food, energy and travel and tourism and predominantly emerging market geographies.

While multi-year agreements can be struck to secure venue capacity, these agreements have the flexibility to modify capacity commitments ahead of changes in demand. There is good revenue visibility thanks to forward bookings.

Operating margins have been reasonably stable due to moderate operating leverage, but current levels of operating profitability of c. 22% are around 5ppts below mid-cycle levels. Some of the margin run off has come as a result of deferred revenue increases, with exhibitors securing their participation at future events at more competitive rates. What therefore may be surrendered in terms of income statement profitability is recovered via working capital inflows and FCF conversion. Despite this, as we will discuss, management has a plan to restore the business to operating margins in the high twenties.

ITE is an appropriately capitalised business given high revenue visibility, strong repeat business and multi-year agreements. Despite £50mn of debt funded M&A in FY18, net debt = £80mn, 1.4x EBITDA, two years of FCF and around one quarter of ITE's equity. Revenue is recognised at the completion of an event; cash is received from exhibitors in advance and booked as deferred income. This is a costless source of finance and represents a working capital inflow when revenues are growing (but a drag on FCF when revenues decline, as they did FY15). This deferred income float has typically been c. 40% of sales, but since the founder of the business returned as CEO this has grown to two thirds, strengthening cash conversion.

A long track record of supernormal profits seems to emanate from two sources of competitive advantage: (1) Network effects: visitors are needed in order to attract exhibitors and vice versa, making it difficult for a non-established player to gain traction. And (2) intangible assets: trademarks and licences to operate venues, databases of consumers and exhibitors, brand reputation that makes participants reluctant to move away from a tried and tested event. The value chain is symbiotic: customers do not want competing trade shows; they want to know that their customers are going to be at the event they are attending that year. This is a form of efficient scale; there is only space for a handful of profitable operators within each region and industry niche.

I have classified this as a legacy moat business (rather than a reinvestment moat or a capital light compounder) due to the lack of greenfield organic opportunities to build new exhibitions around the world. However, ITE does have a strong foothold in several emerging markets including China and India. ITE has established market leading positions through fully owned subsidiaries and controlling interests in locally dominant exhibition brands. For example, it has a controlling stake in the market leading conferences business ABEC in India which runs 20 exhibitions across the country. ITE has offices in Beijing and Shanghai, operated through a JV with Hong Kong based Sinostar. ITE also runs conferences across Indonesia via a JV partnerships and wholly owned subsidiaries.

The organic growth trajectory has inflected positively, partly due to the economic stabilisation in a number of ITE's end markets, and partly due to a business improvement programme put in place as a result of a change of CEO in 2016.

A series of macroeconomic and geopolitical shocks have beset ITE's end markets and impeded business progress in the three or four years prior to 2017. These included the Russia-Crimea crisis and resulting trade sanctions at a time when Russia was a much larger part of ITE's business, and a 70% collapse in the price of oil harming business in ITE's energy-dependent central Asian markets.

This improvement in top line growth should bode well for the capacity of the business to meaningfully increase underlying cash generation, especially given the strides management is making in collecting cash for conference pre-bookings. As we will discuss, the market implies that the exact opposite will happen; that the sustainable cash the business can generate will wither significantly, and the stock has continued to move in the opposite direction to the business's progress.

As legacy moat business with limited opportunities to build new shows organically, M&A will always be part of management's capital allocation agenda. It is therefore important to understand the management team, their track record and incentives. The founder Mark Shashoua has returned to the business with a plan to improve the organic growth potential and profitability of the current portfolio. He is divesting the least profitable, sub-scale events. He has executed this transformation playbook at i2i Events, which enjoyed a doubling of revenues and profits before being acquired by Ascential Events under his five-year leadership prior to returning to ITE, the company he founded in 1991.

In 2018 ITE announced the acquisition of Ascential Events Limited from Ascential plc, based on an EV of £300mn. The target assets comprise two global exhibitions brands, Bett and CWIEME, and several UK exhibitions brands such as the Spring and Autumn Fairs and Pure. The CEO and COO of ITE Group are very familiar with these assets; they ran them together 2011 - 2016 as CEO and CFO.

Management incentives have improved with the management change and are reasonable but not standout. Base salaries for the CEO/CFO are £450k/£250k. Bonuses are a function of headline PBT, organic revenue growth, cash conversion and qualitative strategic targets. LTIP awards are based on recurring EPS and relative TSR versus a combination of the FTSE Small Cap and FTSE 250 Index constituents. What is interesting is that ITE's earnings per share need to grow by 75% over the next two years for any of the LTIP to vest. For 100% of the LTIP to pay out ITE needs to generate EPS of

14.4p by September 2020, almost treble the FY18 EPS, and a 25% yield to the current share price.

All these measures were only introduced in 2017. While cash conversion is a sensible target, some measure of incremental returns on capital would be a welcome addition to the incentive programme, given the high cash generation of the business and the limited obvious long-term redeployment opportunities. I would say that the track record of the new leadership and some incentive framework progression are improving stewardship of a demonstrably wide-moat business that has suffered macro headwinds which have shown signs of dissipating. This is not a turnaround thesis; this is a fantastic, highly profitable business already, and one that can benefit from three tailwinds: (1) cyclical/macro mean reversion, (2) structural portfolio improvement driven by positive management change, and/or (3) a potential re-rating of the shares to reflect the former drivers.

The share price has collapsed since 2014 due to a series of macro and geopolitical events including the Russia/Crimea crisis, oil price collapse and rouble depreciation.

The share price has fallen by 50% in the last year to a 52-week low. More recently the company has suffered non-fundamental selling pressure as the portfolio has become much less emerging market focused. In my view the company's stock price has moved in the opposite direction of the business's performance and private business value.

ITE's cash flow and owner earnings are materially higher than reported earnings per share due to a large deferred revenue float, impairments of prior capital allocation decisions and amortisation of quasi-permanent assets such as customer relationships and internally developed brands.

Trailing FCF of the business is c. £30mn (adjusting for restructuring costs and biennial events); this is 25% of ITE's equity and debt funding and 19% of core Group revenues, excluding the contribution from Ascential. Organic revenue growth is running at double digit levels.

So that is what the business is generating. How is the market pricing that? The current £450mn market cap accounts for a £265mn rights issue-funded acquisition completed in the summer. So, the market is valuing ITE's pre-acquisition cash flows at a 16% yield. This implies material FCF erosion in the core business or zero or negative FCF margins in the newly acquired assets. Or that ITE has massively overpaid for Ascential.

This despite the core business recording 11% organic revenue growth in 2018 and the acquired assets, which ITE's management believe have been poorly managed, generating 31% EBITDA margins.

So, did ITE overpay for the deal? They believe they are paying 11.5x EV/EBITDA for an ungeared business that can grow revenues double digits. That seems reasonable. In the case of zero revenue or cost synergies they are paying 12.5x EV/EBITDA for a business with high barriers to entry and capex intensity of 1%. I don't think that is expensive. It may just be the case that ITE is a better owner of this business because it is a core asset for them vs. non-core for Ascential. This is consistent with the comments Ascential have made about the deal (and with Mr. Shashoua's prior comments to me about Ascential not being a strong competitor as the company focuses on its data and analytics businesses).

The market is not paying attention; I have spoken with large institutional owners of the shares appearing near the top of the register; for them ITE is a small part of a diversified portfolio and their understanding of the deal and management's prior history with the assets reflected that. A conservative appraisal of private business value would imply 70% upside to the current price.

That is if we capitalise the trailing FCF generation of the core business at 6% and add the rights issue capital we arrive at an owner's value of £750-800mn. The global industry is projected to continue to grow at 5% pa, with many of ITE's markets expected to grow high single digits. This would also imply

that management miss their own goals and LTIP targets substantially, as previously discussed. In fact, management is targeting (and is over-executing) high single digit revenue growth, margin expansion and large working capital inflows; this would result in FCF compounding 1.5x revenue growth.

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