

Mark Walker of Tollymore Investment Partners presented his in-depth investment thesis on ITE Group (UK: ITE) at Best Ideas 2019.

Thesis summary:

ITE Group is a UK-listed global exhibitions organizer. The investment merits can be summarized as “a very good, very cheap business”. ITE is a capital-light, founder-led business providing high-utility and enduring B2B services. A long track record of delivering ~30% returns on capital has been facilitated by a network effects-based defensible moat. The business model is characterized by double-digit revenue growth, high top-line visibility, strong cash conversion of earnings, and an appropriate capital structure. Non-fundamental selling pressures have contributed to a de-rating of the stock to a 19% FCF yield, leaving the business trading at a fraction of its private business value.

The following transcript has been edited for space and clarity.

It's a pleasure to be presenting again at Best Ideas. I recently launched Tollymore. This is my first presentation to the MOI Global community in that capacity, so I will briefly outline Tollymore's investment philosophy to provide the audience a context with which to judge the investment idea.

Tollymore Investment Partners is a private investment partnership investing in a small number of exceptional publicly listed businesses in order to compound partners' capital over the long term. I have several years' experience in investment research. Prior to forming Tollymore, I was five years on the buy side as a generalist long-term global investment manager and then five years on the sell side.

The first principle governing Tollymore's investment philosophy is its long-term investment horizon. In the short-term, low correlations often prevail between stock and business, but over the long term, that correlation is high. Discipline and patience help us to exploit price-value discrepancies. Our efforts mainly focus on finding companies capable of both preserving and increasing their intrinsic values. We try, as long-term investors, to exploit a time arbitrage afforded to patient investors with patient capital.

Our approach is value-oriented. This community defines “value” in different ways; we tend to apply a private business owner mentality to listed equities. Our effort to focus on maximizing intrinsic value includes employing demanding price discipline and trying to identify companies capable of increasing their own values. The portfolios are concentrated. Excessive diversification prohibits the ability to carry out the due diligence required to think like business owners and, therefore, how to act when the quoted market price of the individual securities changes. Clearly, concentrated portfolios might be more volatile than the market or more diversified actively managed peers. However, we try to collect several investors who share our view that short-term performance is not relevant to long-term wealth accumulation.

We are benchmark agnostic. We don't think a business owner mindset is necessarily consistent with taking a market view. Volatility can help us as public equity investors in

providing opportunity to purchase assets at a discount. We don't consider risk as volatility. Rather, risk is the capacity to lose capital permanently. For us, margin of safety is found primarily in the business and the management quality of the underlying holdings. We concentrate our research efforts on buying companies with strong balance sheets. These are companies capable of preserving and growing their private business value with hopes they trade at a large discount to that intrinsic value or to the capacity to grow that intrinsic value. That is, investment merits are typically accepted in the context of capital structure risk, business value impairment risk, and valuation risk.

What are the principles and the process consistent with our philosophy? A sensible long-term business owner investment philosophy is not useful if the investment ecosystem doesn't allow us to successfully execute a consistent investment process. For us, the key aspect of that governs idea generation, investment research, and portfolio management. Overarching these pillars is that execution is everything. We've tried to construct a low-key physical working environment free from distraction and conducive to independent thinking. In the early days of Tollymore, we worked hard to make sure the investment philosophy and the investor base are matched to my temperament as an investment manager.

A systematic magic formula does not typically generate ideas. We have concentrated portfolios and a global investment arena. Therefore, our challenge concerns rejecting most mediocre investment opportunities crossing our path. The research process is bottom-up, one company at a time. We search for competitively priced, strong businesses which ideally have avenues for profitable redeployment of capital for a long time. These businesses have conservative capital structures, or which are at least appropriate for the business model. Their management teams are incentivized to make capital allocations capable of creating the most long-term value for owners.

With regards to portfolio management, by owning businesses which steadily compound their own per-share economic earnings, we tip the odds of earning a satisfactory equity return in our favor. One great advantage of being a public equity investor, as opposed to a private market investor, lies in our position to exploit stock market volatility and improve upon the underlying compounding business value.

We designed our work environment to help us make good decisions. The working environment must allow us to devote brain power to decisions and not to battling distractions. This environment is the source of a competitive advantage, which is behavioral. In the pursuit of a goal to create value for our investors, we do not take for granted the ability to make good decisions. Typically, that requires inaction. It requires solitude. It requires being epistemologically humble and patient. I have seen those qualities in my career, and they are not typically found within the constraints of large institutional money managers.

We move on to the idea. I encourage viewers to think about what they might be willing to pay to own a privately held company with the following economic characteristics: This company is a simple business. It's a founder-led business. It's a provider of enduring service, reflecting a business practice which is hundreds of years old. The business offers a high utility to cost ratio for its customers. It is headquartered in the U.K., and it is

geographically and industrially diversified. It is a capital-intensive business with typically 2% of revenues. Free cash flow conversion of earnings is strong, aided in part by deferred income balances which range between 50% and 70% of annual sales. The average through-cycle returns on capital would be around 30%. The business owns a defensible moat, which is predominantly provided by two-sided network effect barriers to entry. Revenue visibility is high. Around two-thirds of next year's sales are typically forward-booked. The capital structure is conservative and appropriate for the business model. Organic revenue growth has recently been around 11%.

The company is London-listed ITE Group. What does ITE do? It's involved in just one business activity: Organizing exhibitions and conferences globally. The nuts and bolts of the business concern hiring venues and gathering groups of exhibitors and visitors. It monetizes the exhibitor side of the network by charging companies for floorspace. ITE Group operates across several sectors including construction, food, energy, travel, and tourism in predominantly emerging market geographies. It is labor intensive but has a capital-light business model. Venue hire and staff are around 3/4 of the cost of organizing a typical event.

The end markets are cyclical but diversified. While multi-year agreements can be struck to secure venue capacity, these agreements typically have the flexibility to modify capacity commitment ahead of changes in demand. Forward bookings enable good visibility on revenues. Operating margins have been stable thanks to the moderate operating leverage used to organize an event. Operating profitability equals about 22%, and that is around 5 percentage points below mid-cycle levels. Some of that margin runoff comes from deferred revenue increases. Exhibitors secure their participation at a future event at a more competitive rate. What, therefore, might be surrendered in terms of income statement profitability is recovered via working capital inflows and free cash flow conversion. Despite that, the management team has a plan to restore the business to operating margins in the high 20s.

ITE Group is appropriately capitalized given its high revenue visibility, strong repeat business, and multi-year agreements with vendors. This is despite approximately £50 million of debt-funded M&A in FY '18 and net debt around £80 million, which is around 1.4x EBITDA. The business has about two years of free cash flow and about 1/4 of ITE's equity. Deferred revenue comes because revenue is recognized at the completion of an event, whereas ITE received the cash in advance from exhibitors. The deferred revenue characteristic converts to a costless source of finance for ITE, and it represents a working capital inflow when revenues grow. Of course, it can be a drag when free cash flow and revenues decline as they did a few years ago. This deferred income flow has typically been 40% to 50% of sales. The founder of the business left the business and has since returned as CEO. He has grown the deferred revenue float to two-thirds of annual sales, strengthening the cash conversion of the business.

The main evidence supporting existence of an economic moat lies in a long track record of super-normal profit which seems to emanate from two sources of competitive advantage. One source is network effects. Visitors are needed in order to attract exhibitors and vice

versa, making it difficult for non-established players to gain traction. The second source is intangible assets in the form of trademarks and licenses to operate at venues, databases of consumers, and brand reputation. All elements render participants reluctant to move away from tried and tested events.

ITE facilitates pricing power by the fees charged to exhibitors, which represent low levels of the cost of the businesses. Pricing power factors also include venue homogeneity and ITE's position as the anchor tenant with many venues.

ITE's suppliers have continued to grow despite competition from the growth in lower cost VoIP and video conferencing. Some elements of ITE's business model are clearly enduring.

ITE typically competes with small mom and pop individual tradeshow. In competition with larger global players, a niche geographic or sectoral focus characterizes the market. ITE focuses on construction, energy, food and tourism. Some of the larger competitors have their own niche sectors. Tarsus, for example, focuses on the medical sector. UBM is a large competitor but typically competes in the U.S. and China sectors of fashion and jewelry. Also, some competitors are geographically limited operators. For example, MCH is Swiss-only and Fiera Milano is Italy-only.

The key element to think about in this value chain is this competitive symbiosis within the value chain. Customers in this industry do not want more choice. They do not want competing tradeshow. They want to know their customers will attend the events that year or the events they attend once every two years. That characteristic creates an efficient scale with space for only a handful of profitable operators within each region and industry niche.

Concerning growth opportunity and avenues for profitable redeployment of capital, I've classified this business as a legacy moat business rather than a reinvestment moat or a capital-light compounder. The industry has a lack of greenfield and organic opportunities to build new exhibitions around the world. However, ITE enjoys a strong foothold in several emerging markets including India and China. ITE has established market-leading positions through fully-owned subsidiaries and has a controlling interest in locally dominant exhibitions brands including joint venture partners. It has a controlling stake in the market-leading conferences business; ABEC in India runs around 20 to 25 exhibitions across the country. ITE has offices in Beijing which it operates through JVs with Hong Kong-based Sinostar. It also runs conferences across Indonesia via JV partners and wholly owned subsidiaries.

The organic growth trajectory has inflected positively in the business partly because of economic stabilization and a business improvement program ITE put in place since the founder of the business returned to ITE in 2016.

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

ITE's improvement in top line organic growth should meaningfully increase underlying cash generation. Management has improved cash collection for conference pre-bookings, though the market implies the exact opposite will happen. That is, the sustainable tracks the business can generate will wither significantly, and the stock has continued to move in the opposite direction for the business to progress. Given our classification of the legacy moat business and its cash-generating capacity, an opportunistic M&A agenda presents itself. Opportunities for organic growth from building new shows are limited. M&A will always occupy a place on management's capital allocation agenda. Therefore, it's important to understand the management team, their track record, and their incentives for allocating capital.

The founder of the business, Mark Shashoua, returned to ITE with a plan to improve organic growth potential and profitability of the current portfolio. He has divested the least profitable sub-scale events. He executed this playbook when he ran i2i Events, his previous company. Under his five-year leadership period, i2i Events doubled revenues and profits before its acquisition by Ascential Events.

Mark founded ITE in 1991. He left the business and worked as CEO of several other companies then returned to ITE in 2016. In 2018, ITE announced the acquisition of Ascential Events based on an enterprise value of £300 million. The target assets comprise two global exhibition brands and several U.K. exhibition brands across a range of sectors. The CEO and the COO of ITE Group are familiar with these assets because they ran the companies together between 2011 and 2016. They describe their rationale in terms of both top line growth potential and some operating synergies.

Related to growth potential, ITE management believes the acquired assets had been mismanaged and produced suboptimal revenue growth. When the current ITE management ran these assets, performance was superior to its current state. They treat the essential assets as non-core, so the business performance as it relates to cash conversion, retention, and revenue growth deteriorated at the time.

As for operating synergies, ITE has an implementation plan seeking to eliminate obvious sources of cost duplication and to generate cost savings from economies of scale. The acquisition will also reduce Russian exposure. This is not a rationale explained by management for the deal, but the Russian exposure of the business will go down from around half of revenues to around a quarter.

Management incentives have improved mostly since the management change; they are reasonable but do not stand out. Base salaries for the CEO and CFO are low to mid six-figures. Bonuses are a function of pre-tax earnings, organic revenue growth, cash conversion, and qualitative targets. The LTIP is a function of earnings per share and relative TSR. Targets that are in place for the current LTIP to 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 earnings per share of £14.4 by September 2020, which is almost treble their recently reported FY '18 EPS. That indicates about a 25% yield of current share price. All measures were only introduced in 2017. While the cash conversion is a sensible target, some measure of returns on capital will be a welcome addition to the incentive

program given the high cash generation of the business and the limited obvious long-term redeployment opportunities. Minimum shareholding requirements are based on 2x base salary, but insider ownership is given the short tenure of the management team.

To summarize the stewardship of the business, the track record of the new leadership and some of the incentive framework progression improve the stewardship of a demonstrably wide moat business. However, it is wide moat business which has suffered some macro headwinds. The headwinds have shown signs of dissipating. This is not a turnaround. Rather, this is already a fantastic, highly profitable business. It can benefit from macro mean reversion in the end market and from structural portfolio improvement driven by this positive management change. It can also potentially benefit from a re-rating of the shares to reflect those former drivers.

ITE completed its acquisition of Ascential. That was a \$300 million enterprise value funded predominantly by a rights issue. It presents a feasible risk. The acquisition tapped shareholders to fund the empire building of this business. Management equity interest, unfortunately, is insufficient to act as any material safeguard against this risk. However, during the CEO's tenure, he has performed asset rightsizing, which should mitigate the risks somewhat.

ITE's share price collapsed since 2014 due to a series of geopolitical events including Russia and Crimea, the oil price collapse, and the Ruble depreciation. However, over the last year or so, the share price fell another 50% in part due to non-fundamental selling pressure as the portfolio has become less focused on emerging markets. Thus, the company's stock price has moved in the opposite direction of the business's performance as profit margins stabilized. This performance shows a sharp inflection in organic revenue growth and qualitative improvements to management and stewardship.

This company does not screen well. ITE's cash flow and owner earnings are materially higher than reported earnings per share due to the large deferred revenue float, impairment of prior management capital allocation decisions, and amortization of quasi-permanent assets such as customer relationships and internally developed brands. It is important to keep these things in mind when in consideration of the normal free cash flow generation for the business. Adjusting for some of the one-off costs associated with the business improvement program and adjusting for biennial events - those events that don't recur every year - the trailing 12-month free cash flow of the business is around £30 million. That's around 25% of ITE's equity and debt funding, and it's almost 20% of the core group revenues. That excludes the small contribution of the Ascential acquisition.

The business generates double-digit organic revenue growth. How is the market pricing that growth? The current market cap is around £420 million. The market cap accounts for the rights issue-funded acquisition of Ascential completed in the summer. That rights issue was £265 million. Share prices are around £58 today. That price implies the market values ITE's pre-acquisition cash flows at a 19% yield. It also implies material free cash erosion in the core business, or zero or even negative free cash margins in the newly acquired asset. It could also imply ITE management is under earnings, or perhaps that ITE massively overpaid for Ascential.

Does evidence or logic support any of these things? The core business recently recorded 11% organic revenue growth, and the acquired asset generates 31% EBITDA margin. Capital intensity is around 1%. It is unlikely ITE operates a free cash flow-negative business.

Did ITE overpay for the deal? Management believes it paid 11.5x EV/EBITDA for an ungeared business capable of double-digit revenue growth. That seems reasonable. In the case of zero revenue or cost synergies ITE referred to, it pays 12.5x EV/EBITDA. For a high-quality business with high entry barriers and capital intensity of about 1%, that was not expensive. It is possible ITE is a better owner of this business than the seller because it is a core asset versus non-core for the manager. That is not a contentious argument; rather, it is consistent with the comment Ascential made about the deal. It is consistent with Mark Shashoua's comment to me before the acquisition when we talked about various competitors and how Ascential was not considered a strong competitor for ITE. Its non-events business is a data and analytics business.

I conclude the market is not paying attention. I've spoken with some of the large institutional owners of the shares, and they say ITE is a small part of a diversified portfolio. In certain cases, their understanding of the deal and appreciation of management's prior history of the asset reflected that.

What is ITE worth? A conservative appraisal of a private business value would imply north of 70% upside to the current price. We would get there by capitalizing the trailing free cash generation of the core business at a 6% rate. That is a 4% growth rate. The global industry is growing revenue, so that's 4% to 5% per year. You would assume ITE's sustainable free cash flow growth is lower than the industry revenue growth. Assuming the Ascential acquisition was value neutral, the rights issue capital would be added to that number, which would lead to an owner's value of around £750 million to £800 million.

The global industry is projected to grow at 5% a year. Many of ITE's markets are expected to grow high single digit, which is conservative. It would also imply management missed its own goals and LTIP targets substantially. Management targets and has overachieved high single-digit revenue growth. They target market expansion and putting in place measures to ensure large working capital inflows. Those drivers would then result in free cash flow compounding around 1.5x revenue growth.

In conclusion, as it relates to the deal, several senior ITE people ran these assets for years. They paid a no-growth multiple for a high-quality asset, yet they have a track record of growing the same asset double digit. They have a track record, albeit short, of turning ITE from negative organic growth to plus 11% since they arrived. That empire risk is mitigated by reasonable management incentives, a history of less profitable asset disposal, and the familiarity of the asset they intend to incorporate into the core business. From an economic value-added perspective, the idea that the EVA that can be created in this business after the deal needs to be larger than before the deal because the asset to which the returns improvement from the business improvement program can be applied have increased meaningfully. Additionally, there may be other non-fundamental benefits to the share price in the form of better liquidity, better shareholder communication, and a larger market cap leading to broader analyst coverage. But mainly, the investment merits of this business can

be summarized by saying ITE is a good and cheap company.

The following are excerpts of the Q&A session with Mark Walker:

Q: As a follow-up on the management incentives, you mentioned the founder no longer owns a significant amount of stock.

A: Yes, he sold his equity when he left the business. Since his return he has not been a material owner, though he has been acquiring shares.

Q: Oh, but he has been a buyer of the stock in the open market?

A: Yes, he's been buying the stock in the open market, but I wouldn't say at a considerable level. He will easily surpass the 2x base salary holding requirement, but he won't appear on the register for quite some time.

Q: Let's talk more about the Russia portion of revenue. Do we know the profitability of that piece? Do you see hidden risks?

A: Yes, profitably recently exceeded the overall growth level of profitability. A vast majority of the Russian business is in Moscow, and that business has fully rebounded to a profitable level. Some of the other Russian exhibitions they run outside of Moscow still lag. However, the prospect for markets with a history of depressed conditions is not based on any macro forecasting other than the observation that they are currently below pre-cycle levels. ITE's Russian exposure is about 25% of the business. I would consider that a directional positive, whereas it triggered a lot of selling because the emerging market fund is no longer in stock.

Q: And Mark, going forward, what would be the key data points to keep an eye on to either validate or challenge your thesis?

A: Capital allocation is one key data point. So far, evidence suggests empire building was mitigated. The biggest ITE acquisition is Ascential Events, and it paid a reasonable price. It was a unique circumstance, and they know these assets inside out. Evidence exists supporting the idea that underearning assets can improve from an already decently performing level. ITE divested several events without affecting EBITDA much. If management uses most of the cash-generation business to support inorganic revenue, it would be a capital allocation red flag.

In terms of the businesses, I'd like to see management continue building their equity interest in the company. I'd also like them improve their incentive framework by introducing incremental cash returns and capital metrics into their incentive framework.

In terms of the business's progress, management operates with clear targets for the organic revenue growth potential of the business. That growth rate is high single digit, and it recently generated double-digit organic revenue growth. If the organic growth suddenly deteriorates meaningfully, that would be inconsistent with the view that this is a business with a high level of revenue visibility.

Margins have stabilized. I would expect to see several costs taken out of the normalized free cash flow number as relating to the business improvement program; I would expect them to disappear in a couple of years, not right away.

If we see recurring non-recurring items, then that would cause me to reevaluate my view of the sustainable free cash flow generation of the business as well.

The valuation of the business assumes a level which implies free cash flow erosion. Margins provided by the entry price are quite significant here. In this business, high barriers to entry mitigate business risk. A 19% free cash flow yield mitigates valuation. Higher levels of revenue visibility and a net debt level mitigate the balance sheet. The net debt level is consumed by free cash flow in a couple of years.

Q: To clarify, does the 19% free cash flow yield apply to the entire enterprise, or does it exclude the acquired piece?

A: It excludes the acquired piece. That free cash flow yield takes the normal free cash flow of the core business and divides it by the current market cap adjusted for the rights issue. Ascential has been in ITE's financials for 2.5 months of FY '18, the year ending in September 2018. I removed an estimated free cash flow contribution from the Ascential Events. That is why I say the valuation core free cash flow, which is a 19% yield to the rightly adjusted market cap, will materially erode, or Ascential Events will negatively contribute to free cash flow. The combined free cash flow of the business will decline, or ITE will have materially overpaid for Ascential assets. I've discussed why I don't think of that as an obvious conclusion.

Q: And Mark, how cyclical is this business?

A: The end markets are cyclical, but ITE's sector and geography diversification dampen revenue volatility. The low operating leverage of the business and the large financial leverage of the business render stable profit margins. Operating margins range from low to high 20s; recently they fell in the low end of the range. Free cash flow volatility will then be higher than operating volatility because of significant negative working capital influence attributed to whether organic revenue is growing or declining.

About the instructor:

Mark Walker serves as managing partner of Tollymore Investment Partners, a private investment partnership for long term investors. Previously, he was a global equity investor at Seven Pillars Capital Management, a long term value-oriented investment firm based in London. Mark has fifteen years of investment research and financial analysis experience. He joined Seven Pillars from RWC Partners, where he was part of a two-person team managing a long term global equity fund. Prior to that Mark worked as an investment research analyst on the sell-side for Goldman Sachs and Redburn Partners.