Buying: ITE Group PLC (ITE)

Improve the portfolio : *As companies grow (or shrink) and as their share prices go up (or down) the attractiveness of the investment changes. If a company's share price shoots up too fast, or if a company falls into a long-term decline, it may be time to sell and replace it with something that appears to offer better value for money.*

Price on 1st Mar 2015	Index	Sector
171p	Small Cap	Media
FTSE Market Cap	**Revenue**	**Pre-tax Profit**
£426 million	£175 million	£60.3 million

"We are one of the world's leading organisers of international trade exhibitions and conferences and specialise in organising events in growing and developing markets. We have many market leading events and well known brands in key industry sectors." (www.ite-exhibitions.com)

Overview

ITE was set up in 1991 to promote trade opportunities in the new market economies of Russia and its Commonwealth of Independent States (CIS). Since then the company has grown rapidly by focusing on emerging markets and is the largest exhibitions organiser in Russia, with a 22% market share.

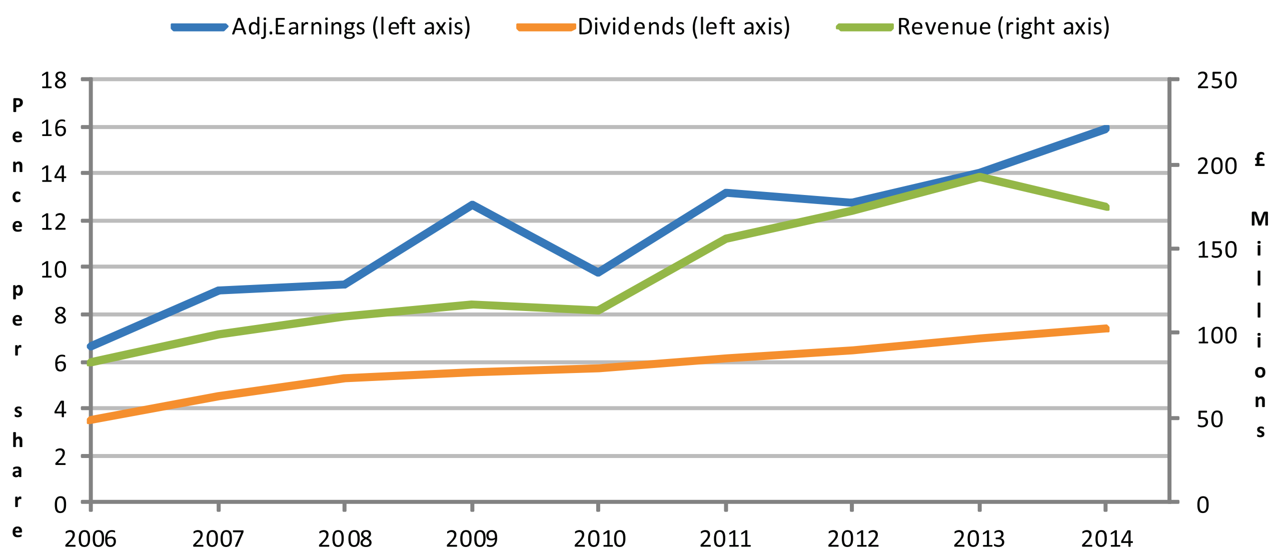
It also has significant operations outside of Russia, with 19% of revenues coming from Central Asia & Causasus, 12% from Eastern & Southern Europe and 10% from Western Europe and Asia. The company leverages this international reach by acquiring local events and then marketing those events to its international network of exhibitors.

The company organises exhibitions in a wide range of industries including Building, Oil & Gas, Food, Travel, Transport and Fashion. In Fashion ITE owns the UK's leading fashion trade event, MODA.

ITE's exposure to both Russia and Ukraine is expected to impact its results in 2015 and beyond, which is the main reason for its current low valuation.

Growth Rate	Dividend Yield	Net ROCE	Valuation (PE10)
9.3%	4.3%	29.4%	14.9
Growth Quality	**Debt Ratio (cyclical max 4)**	**Pension Ratio (max 10)**	**Rank**
83%	1.3	0.0	6 (out of 239)

Green *= Better than FTSE 100;* ***Red*** *= Worse than FTSE 100.*



Investment checklist

Successful investing requires the methodical application of a systematic approach in order to achieve specific objectives, and a checklist is a great aid towards that end. This checklist helps to ensure that the company under investigation is high quality, and that its shares are likely to improve the portfolio in the long-run.

Maintaining and increasing portfolio diversification

1. Will the addition of this company leave the proportion of UK revenues in the portfolio at less than 50%?

YES ITE generates 59% of its revenues from Russia, 19% from Central Asia and Causcasus, 12% from Eastern and Southern Europe, 7% from UK and Western Europe and 3% from Asia. Because ITE is so focused outside the UK its addition would reduce the portfolio's UK exposure.

2. Will the addition of this company leave the proportion of cyclical sector companies in the portfolio at less than 50%?

NO ITE operates in the Media FTSE Sector which is defined in the Capita Dividend Monitor as cyclical. Adding ITE may well take the cyclical portion of the portfolio to more than 50%. However, at current prices the cyclical allocation would be 50.2% and I'm willing to accept it being 0.2% over the 50% limit.

3. Are there less than three companies in the portfolio from the same sector as this company?

YES There are no other Media companies in the portfolio.

Avoiding (or trying to avoid) value traps

Good management

1. Does the company have a clear and consistent goal and strategy and is it focused on implementing that strategy successfully?

YES ITE's goal for many years has been: "to create sustainable growth in headline earnings per share".

Its high level strategy for achieving that goal is: "creating and maintaining sustainable positions of market leadership in the exhibition business in developing markets."

Personally I think it's better for a company to have a goal which is about creating value for its customers rather than just "growing EPS" or "maximising shareholder return". So I think ITE's strategy would be better as the overall goal and the goal of EPS growth should just be a Key Performance Indicator (KPI).

Having said that, I don't like EPS growth as a KPI either because it incentivises executives to retain as much earnings as possible in order to grow, which I don't think is a good idea. I only want companies to retain earnings when they can produce a higher rate of return on those earnings than I could have done if the earnings had been paid out as a dividend and I'd invested them elsewhere. Targeting EPS growth also incentivises companies to take on more debt to boost growth, which can work but only by increasing risk.

Despite my dislike of the company's core goal, what I really want to see is an operational strategy that the company is fully focused on. So in a little more detail, ITE's current strategy is to:

- Target new sectors and regions within existing markets where there is the potential to increase participation from international exhibitors (as an international company ITE has the ability to generate international sales for local exhibitions, which differentiates it from local competitors and allows it to grow newly acquired local events).

- Expand into new sectors and geographies with clear opportunities for strong future growth, and develop exhibition businesses with the potential for strong market positions (emerging markets have underdeveloped exhibition markets and so the potential for growth is higher, while geographic expansion will also help to reduce risk and increase cross-selling opportunities).

- Ensure that new exhibition launches and acquisitions are aligned with existing brands in sectors where ITE has an established strong brand identity. Work to enhance and extend existing brand identities as well as develop new and existing brand identities into other sectors (branding and credibility are important in order to attract major exhibitors and so leveraging existing branding where possible is an efficient way to do that).

- Commit to investing in staff development throughout the Group and in particular the management team (exhibitions are primarily a people business rather than a technology business, so "capex" for ITE comes mostly in the form of developing and acquiring great people).

Although I cannot really comment on whether or not that's a sensible approach (it is management's job to run the business, not mine) it is at least clear, seems to make sense and ITE has been consistently focused on the same strategy for many years with some significant degree of success.

2. Does the company have an obvious core business upon which its goal, strategy and long-term future are heavily focused?
YES ITE is a relatively simple business in that it organises B2B exhibitions, trade shows and conferences to international standards. It is entirely focused on its core business.

Adequate financial control

3. Do the company's KPIs focus on a range of relevant indicators beyond revenue and EPS growth, such as profitability, leverage, liquidity and investment?
NO ITE's KPIs focus on revenue, EPS, profit, free cashflow and a couple of business-specific indicators. There is no mention of profitability or leverage in the KPIs. However, that may be excusable because of the way that exhibition businesses work. Profitability is usually very high (the company had a 24% operating margin in 2014 and a 10-year net ROCE of 29.4%), and very limited borrowings. It would be nice to see these or similar items mentioned as KPIs though.

Low costs

4. Scale: Is the company in the leading group in terms of market share within its chosen markets?
YES ITE was the fifth largest international B2B exhibitions organiser in the world in 2013. It is also the largest in Turkey and Russia and has an even stronger position in Central Asia where it is the dominant international B2B exhibition organiser. It is a Small Cap but was in the FTSE 250 last year when the share price was higher.

5. Experience: Has the company had the same core business for many years?
YES ITE has been in the exhibitions business since it was founded in 1991 to promote trade opportunities in and around Russia.

Caution with big projects

6. Is the company free of "bold" projects which, if they failed, could push it into a major crisis?
YES There are no large projects currently underway.

7. Is the company free of the need for large capital expenditures (i.e. was total capex less than total EPS over the past 10 years?)
YES There are almost no capital expenses in running an exhibitions company. The venue is hired, exhibitors bring their own display "furniture" and most remaining costs are revenue expenses such as advertising and staff, rather than capital expenses. In the last decade ITE's capex has amounted to just 5% of earnings.

8. Are revenues generated through the sale of a large number of small-ticket items rather than through major one-off contracts?

NO Revenues come primarily from exhibitors and to a smaller extent, visitors. For exhibitors an exhibition may be a once-a-year event and can be quite expensive, so the exhibition fee is definitely a large and infrequent purchase for the customer.

Caution with acquisitions and mergers

9. Has the company avoided mergers or large acquisitions in the last few years (i.e. cost more than a year's profit)?

NO Over the past decade ITE has spent about half its profits on acquisitions, so this is definitely a company looking for acquisition-based growth. I am not keen on acquisition-based growth but at least it seems – to me – that exhibition companies are relatively easy to integrate compared to more complex technical companies. 2011 was the stand-out year in which acquisitions exceeded my definition of "large", i.e. more than post-tax profits, where cash paid for acquisitions was £47 million while post-tax profits came to £31 million.

10. Has the company avoided acquisitions that have little to do with its core capability?

YES Although ITE has made many acquisitions as part of its strategy over the years, these acquisitions have all, as far as I can see, been exhibition businesses and therefore closely related to ITE's existing core business.

Ability to adapt to changing market demand

11. Does the company operate in defensive markets?

NO ITE is in the Media FTSE Sector which is defined in the Capita Dividend Monitor as cyclical. In terms of ITE's actual business it is perhaps at the less cyclical end of the spectrum. It runs many "number one, must do" exhibitions which exhibitors would be wise not to miss, even when the economic environment is weak.

12. Does the company operate in markets where the pattern of demand (whether cyclical or defensive) is expected to stay the same?

YES As far as I can see there does not seem to be any significant expectation that demand in the exhibition industry is likely to change anytime soon. Of course it is possible to picture scenarios in which exhibitors and visitors do everything virtually through some sort of online social network-type event, but this seems unlikely, at least for the foreseeable future.

13. Does the company operate in markets where demand is expected to grow?

YES One of ITE's key growth strategies is that it focuses on emerging markets where GDP is growing quickly and where the exhibition industry in those countries is small relative to GDP. This gives a potential "double whammy" from fast GDP growth as well as growth in the exhibition market as a percentage of GDP.

Competitive product, service and price

14. Does the company generate most of its profits from products or contracts that do not need to be replaced in the next 10 years?

YES Unlike pharmaceutical companies that need to periodically replace old drugs with new ones, or technology companies that need to constantly invent better, faster, cheaper computers, exhibitions can run for years and even decades without needing to be replaced or reinvented.

Obviously from year to year exhibitions change and over time they may improve, but once an exhibition becomes "established" it can run for many years in essentially the same format, i.e. a large venue filled with exhibitors and visitors.

In my opinion most of ITE's existing exhibitions, as long as they are reasonably successful, should be able to run for more than 10 years without needing to be replaced.

15. Does the company sell differentiated products that do not compete purely on price?

YES Exhibitors do not choose exhibitions primarily on price. Of far more importance is the returns that the exhibition will produce for them, and that is largely a function of the quality and quantity of exhibitors and visitors that attend.

If, for example, an oil and gas executive was looking to expand into the BRIC countries (Brazil, Russia, India, China) then they would probably consider exhibiting or at least visiting ITE's Moscow International Oil & Gas Exhibition (MIOGE). It is the largest oil and gas trade event in Russia and attracts thousands of visitors and exhibitors from around the world, including the non-Russian BRIC countries. The cost of the show is not important (within reason), at least when compared to the relationships that can be built and deals that can be struck after attending.

Not all of ITE's shows are so important and some do compete on price, but in those cases ITE will generally sell the shows to another company in order to focus on more dominant, high-margin events.

Indifferent to commodity prices

16. Is the company relatively immune to commodity price movements?

YES There are very few material inputs to running an exhibition and so commodity prices are not particularly relevant. ITE does have some exposure to commodity prices indirectly, as some of the industries in which its shows run are impacted by commodity prices. However, I don't expect this to be significant.

Sound financial policy

17. Does the company have a target rate of return on investment (ROCE or similar) of more than 10%?

NO – ITE doesn't have a public target for profitability (although it may have one internally). This may be because exhibition businesses usually produce high margins and high returns on capital employed, and so little focus on those metrics is required. For example, ITE had gross margins of 46% and operating margins of 24% in 2014, both well above average for most companies. Its median net ROCE (using post-tax profits) over the last 10 years is just under 30%, also well above average.

18. Is the company's use of leverage conservative enough given the potential for its earnings to decline?

YES ITE has borrowings of £42.9 million while its Current Earnings Power (5-year average adjusted post-tax profit) is £32.2 million. That gives the company a Debt Ratio of just 1.3 which is conservative, even given the potentially cyclical nature of its industry and any headwinds it may be facing.

19. Are the chances of this company being a value trap acceptably low (and if so, why are the shares cheap at the moment)?

YES None of the preceding questions have uncovered any obvious evidence that ITE is a value trap. However, its shares have dropped from about 310p in January 2014 to 171p today and there must be some reason. The timing of that decline correlates almost perfectly with the Russian/Ukrainian crisis and the reasons are fairly obvious: ITE generates around 60% of its revenues from within Russia and about 7% from Ukraine, although revenues from Ukraine halved in 2014.

The impact in Ukraine is for very obvious reasons; most of ITE's Ukrainian exhibitions are in Kiev which is uncomfortably close to a war zone. The Russian business is also impacted because of sanctions imposed on Russia by the US and EU which are weakening the Russian economy and its currency (most exhibitors and visitors pay in local currencies, which creates a currency risk for ITE). The crisis had little effect on ITE in 2014 but is expected to have a greater impact in 2015, although to what extent is not clear.

On top of that the oil price decline has affected the share price because the Russian economy is relatively dependent on oil exports. A weak Russian economy could in turn weaken the environment for business exhibitions in that country.

The key question is whether these two situations will cause a permanent decline in ITE's ability to generate revenues, earnings and dividends, or at the very least a significant reduction in its ability to grow over the long-term, or whether they are unpleasant but temporary.

The consensus among analysts is that ITE will not cut its dividend, although it might be forced to hold it steady for a few years. Revenues and earnings are expected to decline, perhaps for a handful of years, but longer-term growth is expected to return.

For my two pence-worth, I think that's a reasonable ballpark guess. The 40% of the business that operates away from Russia has good prospects for growth, so if Russia and Ukraine decline then the rest of the company's exhibitions should act as a counterbalance.

Also the Ukraine crisis is likely to be a temporary situation, although it could of course last a few years. Sanctions and the weakness of the Russian Ruble would also be temporary in that case, or at most medium-term problems rather than long-term ones. I think the same argument applies to the oil price decline, where we could easily see oil prices back above $100 per barrel by the end of this decade.

But those are just my opinions and the consensus opinion of some professional analysts, and none of us has a crystal ball. However, I think ITE is a world-class business and is positioned well for growth, and that the current headwinds it is facing are quite serious, but not permanent. All companies must face up to challenges at various points in their lives and value investors must expect to buy into these situations occasionally if they are to buy good companies at attractive prices. On that basis I think the risk that ITE is a value trap is acceptably small.

Uncovering competitive advantages

1. Does the company have any intangible asset advantages (e.g. brand names that command pricing power; patents; regulatory barriers)?

YES The company has a competitive advantage in some geographies and in some industries thanks to its strongly branded exhibitions. Some examples are: Mosbuild, the largest building exhibition (or international exhibition of any kind) in Russia; TransRussia, the largest transport and logistics exhibition in Russia, or MODA, the UK's leading fashion trade event. This brand advantage exists primarily because of the "network effect" advantage detailed below.

2. Does the company gain an advantage from "switching costs", i.e. the effort required for customers to switch to another supplier (e.g. bank accounts or computer software)?

NO Exhibitors and visitors can switch to other trade shows in a heartbeat and at no up-front cost.

3. Do the company's products or services have a "network effect", i.e. become more attractive as more people use them (e.g. Facebook, eBay)?

YES Exhibitions become more appealing to visitors as the quantity and quality of exhibitors (and speakers at any included seminars) increases. Exhibitions also become more appealing to exhibitors (and seminar speakers) as the quality and quantity of visitors increases.

This creates a virtuous circle where more and better visitors will attract more and better exhibitors, which will attract more and better visitors, and so on. Once an exhibition becomes the "number one, must do" event it becomes difficult for smaller events to attract either exhibitors or visitors in sufficient number to compete.

This advantage is low cost, in that it just happens in and of itself; it doesn't require additional spending to create it or maintain it. It's also durable, as once an exhibition has the "number one, must do" status it can often hold that position for many years or longer.

All of ITE's events have the network effect but not all of them are the "number one, must do" event, so this advantage works against the company in some instances, although it does work in the company's favour for its biggest revenue generators.

One point to mention here is that ITE is able to buy up existing, local shows that are not "must do" events, and which have exhibitors and visitors who are mostly local to that geographic region. It can then leverage its international network in order to get exhibitors and visitors from its similar shows in other regions to attend the newly acquired show. So for example it could buy an Oil & Gas show in China that caters to local businesses and then market that event internationally, leveraging the brand and contacts of its Oil & Gas shows in Russia and other countries.

This opens the new show up to an international audience which increases the quantity and quality of exhibitors and visitors. Hopefully the network effect then kicks in, driving the previously small show into "number one, must do" territory over a few years, at which point it has larger profits and a defendable competitive advantage.

4. Does the company have any durable cost advantages (e.g. unique location, unique low cost source of raw materials, greater scale)?

NO ITE does not have any ability to run events more cheaply than its competitors.

Making the trade - Are you happy to own these shares for at least 5 years?

YES On the basis of that analysis I think ITE is likely to be a good addition to the model portfolios (any my personal portfolio). I will be buying it a few days after this issue is published and the initial position size will be approximately 3.3% (1/30th of the portfolio), although it may be more in the accumulation portfolio as there is some excess cash to reinvest.

My expectation is that the shares will be held for somewhere between one and ten years, depending on future events.

> ***"Stock prices will always be far more volatile than cash-equivalent holdings. Over the long term, however, currency-denominated instruments [e.g. cash or bonds] are riskier investments – far riskier investments – than widely-diversified stock portfolios that are bought over time and that are owned in a manner invoking only token fees and commissions. That lesson has not customarily been taught in business schools, where volatility is almost universally used as a proxy for risk. Though this pedagogic assumption makes for easy teaching, it is dead wrong: Volatility is far from synonymous with risk. Popular formulas that equate the two terms lead students, investors and CEOs astray.***
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> ***It is true, of course, that owning equities for a day or a week or a year is far riskier (in both nominal and purchasing-power terms) than leaving funds in cash-equivalents. That is relevant to certain investors – say, investment banks – whose viability can be threatened by declines in asset prices and which might be forced to sell securities during depressed markets. Additionally, any party that might have meaningful near-term needs for funds should keep appropriate sums in Treasuries or insured bank deposits.***
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> ***For the great majority of investors, however, who can – and should – invest with a multi-decade horizon, quotational declines are unimportant. Their focus should remain fixed on attaining significant gains in purchasing power over their investing lifetime. For them, a diversified equity portfolio, bought over time, will prove far less risky than dollar-based securities."***
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> ***- Warren Buffett, 2014 Letter to Berkshire Hathaway Shareholders***