THE STAHL REPORT

The Contrarian Series

March 10, 2020

The Interpublic Group of Companies, Inc.

(BUY)

Price: $17.75
52-Week Range: $17.43 - $25.20
Shares Outstanding: 393m
Market Capitalization: $6,976m

Ticker: IPG
Dividend: $1.02
Yield: 5.8%

Valuations within this text are based on a $17.75 share price

Exclusive Marketers of The Stahl Report

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Investment Thesis

Interpublic Group is a provider of advertising and public relations services to some of the largest corporations in the world. Through a gradual consolidation strategy, the company has assembled a diversified business that serves most customer industries across a variety of advertising mediums (e.g., television, print, digital, etc.).

Given the increasingly sophisticated customer identification platforms, Interpublic acquired Acxiom in 2019, which is a customer data analytics firm. Interpublic will be able to apply these customer data capabilities to all of its traditional advertising channels, providing its clients with a more targeted campaign designed to reach the specified audience. The convergence of data analytics and marketing has been rapid over the last five years, particularly due to the growing presence of digital advertising platforms such as Facebook and Google. The Acxiom transaction could be rather transformative, allowing Interpublic to provide a modernized and highly customized advertising solution to its clients.

However, this is a mature and economically sensitive business. While generally stable, advertising budgets are correlated with corporate profits, declining substantially during recessions. For instance, Interpublic's operating income declined by 42% in 2009. During the period of economic expansion since, the company's revenues have increased anywhere from 1% to 6% a year.

This reasonably low growth rate, as would be expected, does not attract the attention of most investors. The company is expected to earn $2.04/share this year, implying a P/E ratio of only 8.7x. After adding back the non-cash depreciation and acquisition-related goodwill amortization expense, the shares trade at only 6.5x these cash earnings.

This low valuation really underappreciates a business such as this that generates considerable cash flow. With only $199 million of likely capital expenditures in 2020, Interpublic will produce roughly $882 million in free cash flow. A little less than half of this is paid out in dividends, creating a 5.8% dividend yield. Historically, the balance was used to repurchase shares; however, the company has abandoned this policy to repay debt associated with the Acxiom acquisition.

If the remaining annual free cash flow, or $481 million, were used to retire debt outstanding of $3.3 billion, this repayment would amount to 6.9% of the present market capitalization. Within the overall enterprise value structure, this debt repayment would in theory create a proportionately higher equity market value, thus keeping the enterprise value constant[1]. Hence, based on this share price increase and the dividend yield, one's going-in economic return would be 12.7%. However, Interpublic is growing, having organically expanded revenues at an average rate of 4.5% since 2014. If this expansion can be repeated over the

[1] Based on the Modigliani-Miller Capital Structure Invariance Theorem

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next couple of years, the prospective total return, assuming margins remain constant and with no consideration for a possible expansion in the valuation, would reach 17.2%. Phrased alternatively, the company need not expand at all and still deliver a mid-double-digit return to investors. Given the relative stability of the business, it appears quite possible that one can receive a more than reasonable return, absent much of the current S&P 500 valuation risk, from this well-managed company. Thus, the shares are recommended for purchase.

Company Description

Interpublic creates marketing solutions both on a national/global scale as well as on a smaller regional or local basis. It has a diverse client base, while some of the largest industries served are the automotive, pharmaceutical, and technology sectors. The company provides a full range of services that include consumer advertising, digital marketing, communications planning, media buying, public relations, and data management.

Most of the Interpublic's advertising and public relations services are conducted through a number of individually branded agencies, many of which were acquired over the last few decades. These include McCann Worldgroup, Foote/Cone/Belding ("FCB"), MullenLowe Group, Healix, Octagon, Jack Morton, Weber Shandwick, Golin, Hill Holiday, and Carmichael Lynch. Interpublic operates a holding company structure, owning more than 100 individual agencies (each specializing in different industries or clients), while centralizing control at the parent company.

With its international presence, the company has the ability to serve both domestic and international markets. This provides the advantage of not only being the international marketing component of domestic customers but also serving foreign clients directly. In 2019, the Interpublic produced $5.4 billion in net revenues in the United States, and $3.2 billion internationally.

There are two primary segments, which are Integrated Agency Networks ("IAN") and Constituency Management Group ("CMG"). IAN contains the larger integrated agencies as well as the recently-acquired Acxiom. Acxiom, with over 2,000 corporate clients, provides Interpublic with an extensive customer data identification function, which has become increasingly important within the more targeted digital marketing platforms. Interpublic will be able to not only more effectively promote its services with the additional digital customer data capability, but also modestly diversify revenues due to the separate longer-term contracts Acxiom has with its own customers to identify and manage target audiences. At the time of the transaction in 2018, Acxiom represented 8% of the total post-acquisition Interpublic revenues, so this was a meaningful and clearly strategic purchase.

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The CMG segment contains the smaller, more specialized advertising/marketing agencies (for example, sports marketing), in addition to the public relations agencies. It is a less significant component of overall sales, producing 14.8% of total net revenues in 2019.

Operating profitability is reported on an "EBITA" basis, which is effectively operating income plus acquisition-related goodwill/intangible asset amortization expense. As shown below, both operating segments manifest similar profitability, generating an EBITA margin in the 12%-15% range.

Table 1: Interpublic Segment Profitability

Integrated Agency Networks ("IAN")

Year	Net Revenue	EBITA	EBITA Margin
2019	$7,348	$1,110	15.1%
2018	6,768	1,042	15.4%
2017	6,267	892	14.2%

Constituency Management Group ("CMG")

Year	Net Revenue	EBITA	EBITA Margin
2019	$1,277	$163	12.8%
2018	1,264	180	14.2%
2017	1,207	194	16.1%

A Consistent Growth Strategy

In the most general sense, Interpublic operates in an industry that is almost always in demand. By and large, advertising/marketing is a necessary business for obvious reasons – nearly all producers of products and providers of services need to promote in some fashion in order to obtain additional consumers. Within advertising, many firms specialize in certain industries, or concentrate in specific channels – such as radio, television, print, digital, etc. Interpublic has chosen to consolidate these types of firms which, collectively, now form a broad group of smaller agencies that can serve many different markets – both domestically and internationally. This allows it to leverage the collective resources and operating scale to target the largest multi-national corporations in the world, as well as devote the individual time required to design campaigns for small businesses or products with narrow markets.

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To illustrate the nature of this gradual consolidation, in 2016 Interpublic acquired 10 advertising firms for a total of $66 million ($6.6 million per acquisition). In 2017, it acquired 10 small agencies for an aggregate $37 million ($3.7 million per acquisition).

This is not to say that the focus is only on small scale acquisitions. The purchase of Acxiom in 2018 involved total consideration of $2.3 billion – one of the company's largest acquisitions ever. This merely implies that the advertising industry is highly fragmented, populated by scores of boutique firms that all provide Interpublic with an ongoing opportunity to selectively acquire different specialties and achieve important strategic scale.

Despite this strategy, Interpublic also must maintain focus on generating internal or organic growth – acquisitions, as a long-term growth supplement, always have limitations. Given its present position as one of the largest advertisers in the U.S., it is reasonable to assume that annual growth, to the extent accomplished, will be similar to the industry expansion rate, which is in the low single digits. This is logical for a mature industry highly dependent on the discretionary spending budgets of most U.S. corporations, which is a function of corporate revenue and profit growth.

On an organic basis, revenue growth in recent years has been as follows:

Table 2: Interpublic Organic Revenue Growth

Year	Growth Rate
2019	3.3%
2018	5.5%
2017	1.5%
2016	5.0%
2015	6.1%
2014	5.5%

The aggregate result of the company's dual growth strategy has been a reasonably robust rate of operating and net profit expansion. Over the last five years, operating profit has increased from $875 million to $1.1 billion, an annualized rate of 6.4%. Over a longer period of time (to include, for a normalized approach, the year preceding the 2008/2009 Credit Crisis), operating income has risen at a 10.3% annual rate. Similarly, net income expanded by 9.6% annually during the last five years and by 14.4% since 2007.

These growth rates make evident that Interpublic benefits quite noticeably from both acquisition-oriented expansion and the efficient integration of these operations into the overall operating structure.

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Table 3: Historical Interpublic Earnings

Year	Operating Income	Net Income
2019	$1,120	$656
2018	1,009	619
2017	938	554
2016	936	605
2015	875	455
2014	788	477
2013	659	259
2012	678	435
2011	687	521
2010	549	271
2009	341	94
2008	590	265
2007	344	131
Annl'zd %: 2007-2019	*10.3%*	*14.4%*
Annl'zd %: 2015-2019	*6.4%*	*9.6%*

To conclude this section, it is also no doubt observed that, despite an attractive growth record, Interpublic is cyclical. In 2009, operating income declined by 42% and net income by 65%. Certainly, during periods of broader corporate profit contraction, discretionary spending such as advertising/marketing indeed declines. Interpublic is not capital intensive, but it is employee-intensive. Its operations are conducted via its creative directors and departments. While these service personnel might be narrowly considered to be a variable expense base, in practice this is not the case, since these are skilled employees for which it is uneconomic to dismiss during periodic spending contractions that have proved to be transitory and relatively brief. Those skilled employees are necessary to maintain both the business relationships with customers and to be immediately available to act upon any new engagements. Well capitalized companies such as Interpublic are able to withstand the cyclicality and eventually resume a normal growth rate.

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Valuation

For the most part, Interpublic has been increasing its earnings steadily since the low point reached in 2009. In the present year, the company is forecasted to earn $2.04/share, which creates an 8.7x P/E ratio relative to the current share price. Although this is not a high growth business, it is rather remarkable that the shares trade at a substantial 46% discount to the S&P 500. This unmistakable divergence in valuation/investor perception, as noted below, almost entirely ignores the return potential that incidentally comfortably surpasses the long-term return from the S&P 500.

Nonetheless, since 2009 Interpublic has traded anywhere from 13x-26x reported earnings, as presented in the following table. If one reasons that the normalized multiple should be closer to even 15x, the current price represents a 42% discount to the past average – implying a normalized $30.60 share price and 72% potential return based on this year's estimated earnings.

Table 4: Interpublic Historical P/E Ratio

Year	P/E
2019	13.5x
2018	14.3x
2017	15.6x
2016	15.9x
2015	20.6x
2014	17.8x
2013	26.8x
2012	12.9x
2011	10.4x
2010	22.7x

One of the company's most notable competitors is Omnicom, which has $15 billion in revenue and a $17 billion market capitalization. Omnicom is a well-managed advertising and corporate communications company with a global client base, providing many of the same services as Interpublic. It is expected to achieve a 3.3% increase in revenues in 2021 over the 2020 sales figure, and currently trades at 9.4x the current year profit forecast.

Similarly, WPP, with $14 billion in sales and a $17 billion market capitalization, is a well-respected global advertising firm operating in many of the same markets as Interpublic. WPP might generate revenue growth of 2%-3% in the next year, and now trades at only 8.1x the current year earnings estimate. As has been noted in a number of prior publications,

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there are several large, liquid S&P 500 companies with sub-5% recent revenue growth rates that trade at 50%-100% premiums over the multiple of Interpublic (and the other advertising firms) – many of which have fierce competitive or declining consumer demand risks that, in turn, creates the additional S&P 500 valuation risk.

The general sentiment towards the industry, as represented by an 8.7x earnings multiple (the inverse of which, importantly, is a 11.5% earnings yield, versus the 6.2% earnings yield of the S&P 500) appears to disregard the considerably superior cash flow characteristics of these businesses. For instance, Interpublic historically used the vast majority of free cash flow to repurchase shares and pay dividends. The dividend has risen over four-fold from $0.24/share in 2011 to the current $1.02/share,[2] while shares outstanding have declined from 541 million to 393 million, or by 27.4% during this time – the share contraction rate was not a small contributor to the per share dividend value development.

Table 5: Interpublic Cash Flow Distribution

Year	Dividends	Shares Outstanding	Dividend Yield
2019	$0.94	391	4.1%
2018	$0.84	389	3.7%
2017	$0.72	397	3.3%
2016	$0.60	408	2.5%
2015	$0.48	416	2.1%
2014	$0.38	425	1.9%
2013	$0.30	430	1.8%
2012	$0.24	481	2.0%
2011	$0.24	541	2.3%

Following the $2.3 billion Acxiom acquisition, which was funded mostly with debt, Interpublic has suspended the share repurchase program and is instead using this amount to deleverage the balance sheet. This should not imply that the company is heavily indebted – it generated $1.12 billion in operating income against $199 million of interest expense in 2019. It has $1.2 billion in cash and $3.3 billion of total debt, relative to $2.8 billion of shareholders' equity (although there is negative tangible shareholders' equity due to $5.9 billion in acquisition-related goodwill and intangible assets).

As shown below, the company repaid $403 million of debt last year (12% of the current outstanding), leaving $363 million for dividend payments.

[2] The quarterly dividend was recently raised to $0.255/share, resulting in an annualized figure of $1.02/share in 2020.

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Table 6: Recent Interpublic Debt Repayment

Year	Debt Repayment	Share Repurchases	Dividends
2019	$403	$0	$363
2018	105	117	322
2017	325	300	280
2016	2	303	238
2015	2	285	196

Going forward, it appears the magnitude of this capital allocation policy can continue rather easily. If Interpublic achieves the $2.04/share profit estimate this year, it will have $1.081 billion of cash earnings, after adding back the non-cash depreciation and amortization expense of $279 million. Relative to the $7 billion market capitalization, the shares trade at only 6.5x these adjusted earnings.

Since the business requires only $199 million per year in capital expenditures, the cash flow available for debt repayment/share repurchases/dividends would be $882 million. At the current distribution level, Interpublic will pay $401 million in dividends (a 5.8% dividend yield), leaving $481 million for debt repayment or share repurchases. The stated near-term objective is to reduce debt, so if the entirety of this free cash flow were used for this purpose, 14.5% of total outstanding debt could be repaid this year. After tax, this would reduce interest expense by $23 million, adding $0.06/share to net earnings – expanding overall per share earnings by 3% in the first year alone.

In addition, the $481 million equates to 6.9% of the current market capitalization. If this amount of debt were retired every year, the market capitalization should rise commensurately to maintain a constant enterprise value, all else equal. This alone, added to the 5.8% dividend yield, could produce an overall return of 12.7% annually.

Of course, Interpublic is growing modestly. Revenues, on average, over the last six years have increased by 4.5% per annum, while the forwarding-looking consensus growth estimates are between 3% and 4%. If margins remain constant, this could elevate the annual return to 15%-17%, not counting any earnings/share benefit from lower interest expense. Ultimately, a more than reasonable return seems possible even if Interpublic were to grow at a rate not much higher than normal inflation.

In conclusion, it should be highlighted that the company's shares ended 2014 at a price of $19.94. At the recent close of $17.75, the shares have provided a modest loss over the last five years, excluding the few percentage points from the dividend yield. However, earnings

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per share rose by 50% during that time and, potentially, could be 82% higher should the company achieve this year's profit forecast.

Table 7: Interpublic Earnings vs. Share Price Comparison

Year	EPS	Year End Share Price	P/E
2019	$1.68	$22.70	13.5x
2018	1.59	22.75	14.3x
2017	1.40	21.89	15.6x
2016	1.48	23.53	15.9x
2015	1.09	22.44	20.6x
2014	1.12	19.94	17.8x

At some point, the valuation – now at only an 8.7x earnings multiple – should begin to reflect the company's consistently improving earnings profile.

Conclusion

Interpublic Group is a leading advertising and corporate communications company not only in the United States, but globally as well. Despite ordinary cyclicality, Interpublic is a relatively stable company, expanding revenues at an inflation-type rate every year, that operates in a modestly growing industry. The company has produced consistently higher earnings since the economic recovery began in 2009, and going forward appears well capable of generating an annual return of at least 12% merely through the effective deployment of its considerable cash flow. Nonetheless, it trades at only 6.5x cash earnings, and pays a dividend equivalent to a 5.8% yield. It therefore appears one can establish a position, absent much of the valuation risk, and earn a 10%-15%-type annual return without having to commit to overly aggressive growth assumptions. Thus, the shares are recommended for purchase.

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THE INTERPUBLIC GROUP OF COMPANIES, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
(Amounts in Millions, Except Per Share Amounts)

	Years ended December 31,		
	2019	**2018**	**2017**
REVENUE:			
Net revenue	$ 8,625.1	$8,031.6	$7,473.5
Billable expenses	1,596.2	1,682.8	1,574.1
Total revenue	10,221.3	9,714.4	9,047.6
OPERATING EXPENSES:			
Salaries and related expenses	5,568.8	5,298.3	4,990.7
Office and other direct expenses	1,564.1	1,355.1	1,269.2
Billable expenses	1,596.2	1,682.8	1,574.1
Cost of services	8,729.1	8,336.2	7,834.0
Selling, general and administrative expenses	93.8	166.5	118.5
Depreciation and amortization	278.5	202.9	157.1
Restructuring charges	33.9	0.0	(0.4)
Total operating expenses	9,135.3	8,705.6	8,109.2
OPERATING INCOME	1,086.0	1,008.8	938.4
EXPENSES AND OTHER INCOME:			
Interest expense	(199.3)	(123.0)	(90.8)
Interest income	34.5	21.8	19.4
Other expense, net	(42.9)	(69.6)	(26.2)
Total (expenses) and other income	(207.7)	(170.8)	(97.6)
Income before income taxes	878.3	838.0	840.8
Provision for income taxes	204.8	199.2	271.3
Income of consolidated companies	673.5	638.8	569.5
Equity in net income (loss) of unconsolidated affiliates	0.4	(1.1)	0.9
NET INCOME	673.9	637.7	570.4
Net income attributable to noncontrolling interests	(17.9)	(18.8)	(16.0)
NET INCOME AVAILABLE TO IPG COMMON STOCKHOLDERS	$ 656.0	$ 618.9	$ 554.4

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Earnings per share available to IPG common stockholders:			
Basic	$ 1.70	$ 1.61	$ 1.42
Diluted	$ 1.68	$ 1.59	$ 1.40
Weighted-average number of common shares outstanding:			
Basic	386.1	383.3	389.6
Diluted	391.2	389.0	397.3

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THE INTERPUBLIC GROUP OF COMPANIES, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(Amounts in Millions)

	December 31, 2019	December 31, 2018
ASSETS:		
Cash and cash equivalents	$ 1,192.2	$ 673.4
Accounts receivable, net of allowance of $40.2 and $42.5, respectively	5,209.2	5,126.6
Accounts receivable, billable to clients	1,934.1	1,900.6
Assets held for sale	22.8	5.7
Other current assets	412.4	476.6
Total current assets	8,770.7	8,182.9
Property and equipment, net of accumulated depreciation and amortization of $1,116.4 and $1,034.9, respectively	778.1	790.9
Deferred income taxes	252.1	247.0
Goodwill	4,894.4	4,875.9
Other intangible assets	1,014.3	1,094.7
Operating lease right-of-use assets	1,574.4	0.0
Other non-current assets	467.9	428.9
TOTAL ASSETS	$ 17,751.9	$ 15,620.3
LIABILITIES:		
Accounts payable	$ 7,205.4	$ 6,698.1
Accrued liabilities	742.8	806.9
Contract liabilities	585.6	533.9
Short-term borrowings	52.4	73.7
Current portion of long-term debt	502.0	0.1
Current portion of operating leases	267.2	0.0
Liabilities held for sale	65.0	11.2
Total current liabilities	9,420.4	8,123.9
Long-term debt	2,771.9	3,660.2
Non-current operating leases	1,429.6	0.0
Deferred compensation	425.0	422.7
Other non-current liabilities	714.7	812.8
TOTAL LIABILITIES	14,761.6	13,019.6
Redeemable noncontrolling interests (see Note 6)	164.7	167.9

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STOCKHOLDERS' EQUITY:		
Common stock, $0.10 par value, shares authorized: 800.0 shares issued: 2019 – 387.0; 2018 – 383.6 shares outstanding: 2019 – 387.0; 2018 – 383.6	38.7	38.3
Additional paid-in capital	977.3	895.9
Retained earnings	2,689.9	2,400.1
Accumulated other comprehensive loss, net of tax	(930.0)	(941.1)
Total IPG stockholders' equity	2,775.9	2,393.2
Noncontrolling interests	49.7	39.6
TOTAL STOCKHOLDERS' EQUITY	2,825.6	2,432.8
TOTAL LIABILITIES AND EQUITY	$ 17,751.9	$ 15,620.3

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