July 21, 2018
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Investment thesis

ECONOCOM

Econocom designs, finances and accelerates the **digital transformation** of large companies and public organizations.

Its origin dates back to 1974, when **Jean-Louis Bouchard founded the company** under the name *European Computer Systèmes* (ECS) in France. In 1985 Mr. Bouchard sold his stake in *ECS France* to Société Générale, but he retained all foreign subsidiaries and **renamed the group *Econocom***. 25 years later, in 2010, they acquired back ECS, becoming the **largest company in Europe** in Technology Management & Financing.

Today the group employs **over 10,700 people in 19 countries** and they implement **projects from A to Z**: consulting, sourcing and administrative management of digital assets, infrastructure services, applications and digital solutions, and project financing.

econocom

Ticker	**EPA:ECONB**
Market cap.	**€675m**
Current share price	**€2.8**
Investment type	**VALUE**
Risk	**LOW**
Volatility	**HIGH**
Investment horizon	**5 years**
Target price	**€9 to €11**
Potential return	**300% in 5 years**
Annual return	**30%**

Business segments

The company divides revenues into **three business lines**:

1. Technology Management & Financing

Econocom offers companies **tailored financing solutions** that will help keep their budgets in check, combining several of its areas of expertise with a linear payment method, resulting in a comprehensive range of **leasing solutions and usage- or unit-based invoicing for services**, ranging from general scalable lease contracts to subscription service agreements. In addition, they deliver effective **asset management services**, offering operational solutions to meet customers' needs and help them manage, monitor and control resources.

2. Services

2.1 Operational excellence

The company uses its infrastructure offerings to **optimize IT services** and put them into an on-demand information system. They also host data and boast four data center hubs in Europe, enabling them to promote customer proximity and improve its performance. They also offer operational services for customers with multi-cloud and non-cloud environments.

2.2 The user experience

Econocom designs and integrates **digital work environments** (digital workplace, unified communications and collaboration) and **digital solutions for user services** (self-help, self-care, service desk, deskside support).

2.3 Dynamic growth

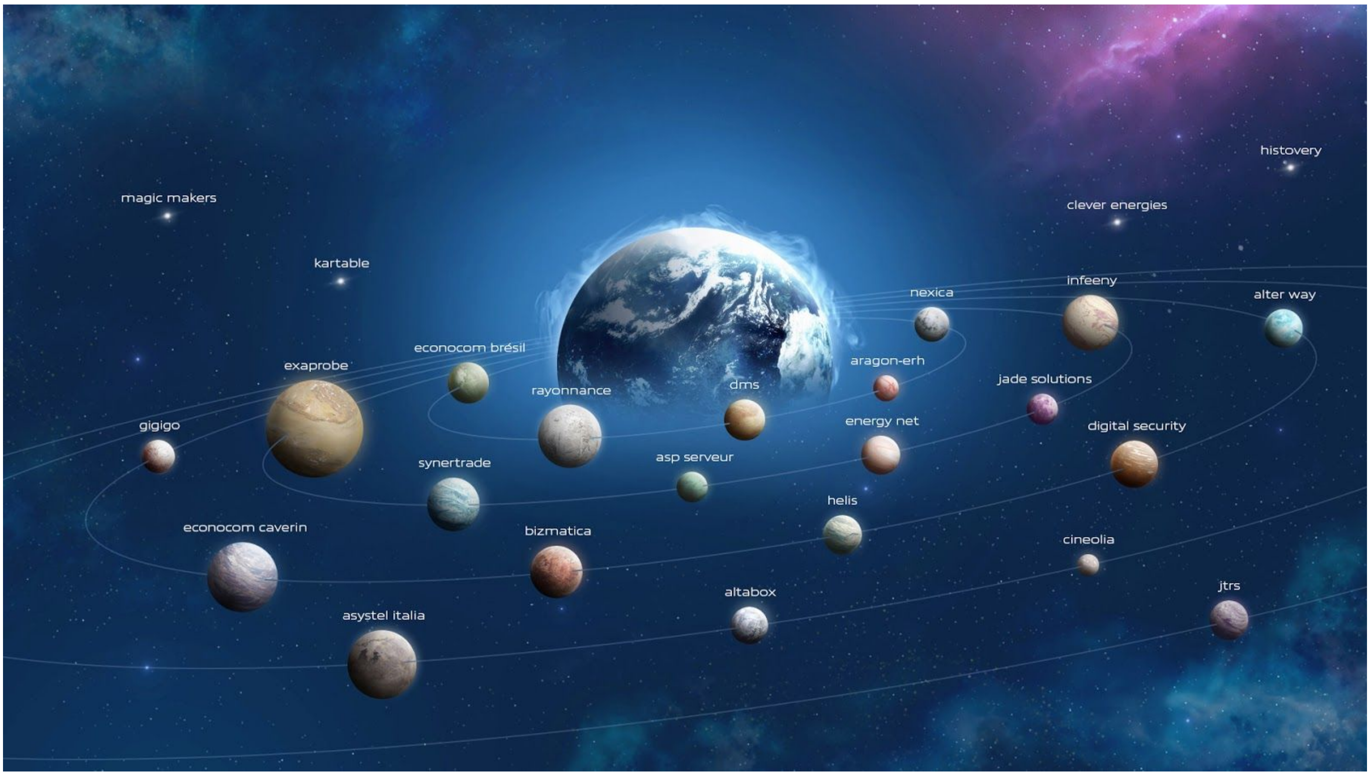
They co-construct the **digital solutions of tomorrow's business models** through advice and support for digital transformation, implementation of proof of concept in its innovation laboratories, and deployment and industrialization of customized and turnkey solutions.

3. Products & Solutions

Econocom offers companies effective solutions to optimise their response to digitization, by (1) **distributing hardware and software**, and IT, telecom, mobile, audiovisual and IoT products, and (2) **implementing fully integrated solutions** for digital, display, printing, mobility, server consolidation and virtualization equipment.

The Galaxy

Econocom has created an innovative model for their organization: it's called *One Galaxy*. It consists of the *Econocom Planet* (historic core businesses, wholly-owned by the group and constantly expanding), around which *Satellites* gravitate; these are **small and medium-size companies** which are highly successful in their areas of expertise, and in which the heads and often the founders maintain a significant share of the capital.



Satellites

So we can see Econocom as a holding company in which their subsidiaries interact and work together with the parent in many of their projects. Here it is the complete list of satellites by the end of 2017:

CYBER SECURITY	DIGITAL.SECURITY • EXAPROBE
MICROSOFT	INFEENY
WEB APPS, SAAS & CLOUD	ALTER WAY • ARAGON-ERH • ASP SERVEUR • ECONOCOM BRAZIL • NEXICA • SYNERTRADE
INFRASTRUCTURE & NETWORKS	ASYSTEL ITALIA • ASP SERVEUR • EXAPROBE • NEXICA
MOBILITY	BIZMATICA • ECONOCOM BRASIL • GIGIGO • JADE SOLUTIONS • JTRS • RAYONNANCE
DIGITAL SIGNAGE & MULTIMEDIA	CAVERIN • CINEOLIA • ENERGY NET
CONSULTING SERVICES	HELIS

Econocom Inside

And just in case you still didn't understand very well what the company really does, here there is a series of corporate videos that explain their work using real cases. Click and enjoy!

Markets and competitive environment

Since Econocom participates in several IT markets, the company examines each of them separately, as it's natural:

- Leasing market: The trend of **consumption based on use rather than ownership is gathering strength**. While traditional consumption patterns are still present, a mixed model of ownership and leasing is emerging. This trend is likely to be strengthened in the coming years.

- Distribution market: 2017 was the **fifth consecutive year of market contraction in terms of PC sales**, resulting in shipments slipping back to 2007 levels, as consumers have switched to different types of terminals. Buyers, including those in the business sector, appear to be holding on to their equipment for longer. **Sales of ultrabooks have helped to slow the decline** in global PC deliveries. The smartphone market, although still growing, is experiencing a marked slowdown. The tablet market is also encountering some difficulties that will continue to intensify.

- Services market: The market for digital services enjoyed **good momentum in 2017, which is expected to continue** at least until 2020. Companies continue to invest massively in digital transformation projects, and the development of new service offerings and areas of expertise (IoT, Big Data, Mobility, DevOps, etc.) is driving the growth of digital service companies.

But there are other **promising fast-growing markets**, where Econocom has already his piece of market share. These are good opportunities to grow in the near future:

- Security market: Cyber security has become a critical component of digital transformation and is **one of the fastest growing segments of the IT market**.

- Mobility market: According to a PAC-CXP survey, the average **annual growth rate for the mobility segment will be 20%** for the 2017-2021 period.

Main competitors

Econocom is currently the only provider—**independent of manufacturers, operators, software vendors and banks**—in Europe that can design, steer and finance digital transformation projects for other companies. While none of the competitors replicates the full range of those businesses, we can highlight the main competitors in each of the business lines:

- Services: Capgemini, Atos, Sopra Steria, CGI, Gfi, Devoteam and Neurones.

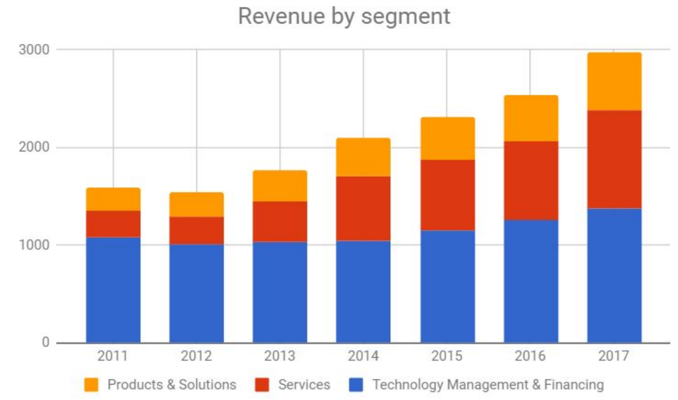
- Products & Solutions: Computacenter, SCC and RealDolmen.

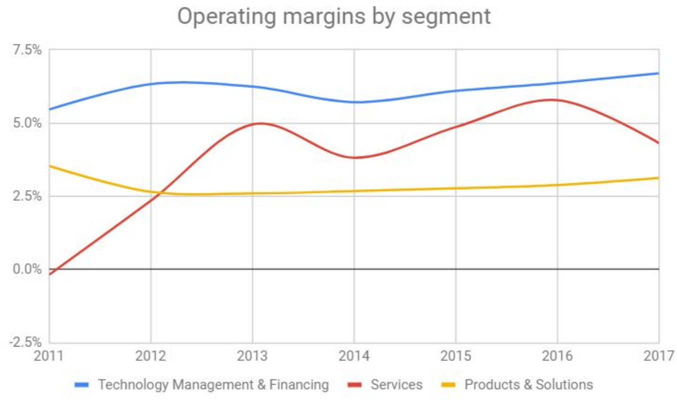
- Technology Management & Financing: Econocom has **no direct equivalent**, because most competitors are either broadline companies, subsidiaries of banks, specialized subsidiaries of manufacturers (IBM, HP, Dell) or leasing companies owned by banks (Arius—BNP Paribas Rental Solutions, Etica—Crédit Agricole Leasing).

Historic growth and margins

In the following table and charts are shown the revenues, operating margins and recurring operating profits of each segment. We can see that **all business segments are growing** in a healthy way, and their margins are quite stable. Revenues during the last 7 years grew around 11% on a compounded annual rate. It is worth noting that an important part of that growth is external, through acquisitions, but **organic growth was still around 8%** in average, year-on-year, during the last 3 years.

	2011	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**
Technology Management & Financing	1,080	1,003	1,028	1,045	1,149	1,259	1,379
	5.5%	*6.3%*	*6.2%*	*5.7%*	*6.1%*	*6.4%*	*6.7%*
	59.0	63.5	64.2	59.7	70.1	80.2	92.4
Services	275	286	416	663	730	802	1007
	(0.2%)	*2.3%*	*5.0%*	*3.8%*	*4.9%*	*5.8%*	*4.3%*
	(0.5)	6.7	20.6	25.3	35.5	46.4	43.4
Products & Solutions	229	249	323	385	437	475	594
	3.5%	*2.7%*	*2.6%*	*2.7%*	*2.8%*	*2.9%*	*3.1%*
	8.1	6.6	8.4	10.3	12.1	13.7	18.6
Total	**1,584**	**1,538**	**1,767**	**2,093**	**2,316**	**2,536**	**2,980**
	4.2%	***5.0%***	***5.3%***	***4.6%***	***5.1%***	***5.5%***	***5.2%***
	66.6	76.8	93.2	95.3	117.7	140.3	154.5





Resilience to economic crises

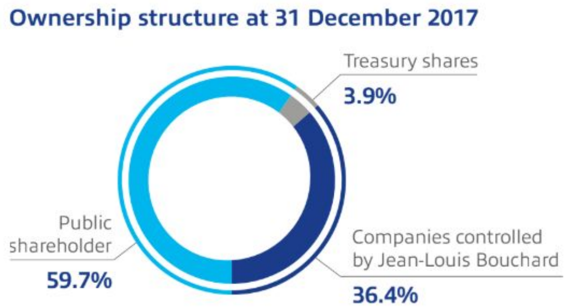
Looking a bit backwards into the revenue numbers we can notice that Econocom wasn't really affected by the financial crisis of 2008, and it also weathered the European debt crisis of 2010-2013 without difficulties:

	2006	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**
Revenue	589	701	717	759	1,021	1,584	1,538	1,767

Management

Econocom is a **family enterprise**. Founded by Jean-Louis Bouchard in 1974, he stayed as CEO of the company until 2017. The new CEO is his son, Robert Bouchard, appointed on May 2017. Jean-Louis remains as Chairman of the Board and he still holds over 35% of the stock and voting rights:

Shareholder	%
Jean-Louis Bouchard	**36.4%**
Walter Butler[1]	**5.9%**
Kabouter Management LLC	4.7%
Econocom Group SE	**3.9%**
Norges Bank Investment Management	1.6%



Remunerations

Executive and non-executive directors received **reasonable remunerations** during the last 3 years, and those were even decreasing: Around €5m in 2015, €4.5m in 2016 and €3.5m in 2017, in total.

Stock options

Apart from those remunerations, **some directors benefit from stock option plans** and/or free shares. At 31 December 2017, unexercised free shares and options entitling their holders to a total of 8,550,000 Econocom shares represented 3.5% of the number of shares outstanding at the end of the year:

Plan	Grant year	Number of stock options and free shares	Number of corresponding shares	Expiry date	Exercise price (€) per option	Exercise price in € thousands
Options	2013	875,000	1,750,000	Dec. 18	5.96	5,215
Subscription options	2014	1,812,500	3,625,000	Dec. 19	5.52	10,005
	2015	237,500	475,000	Dec. 20	7.74	1,838
		120,000	240,000	Dec. 20	7.61	913
	2016	60,000	120,000	Dec. 21	9.57	574
		45,000	90,000	Dec. 21	13.60	612
Free shares	2016	160,000	160,000	May 18	–	–
		140,000	140,000	May 19	–	–
Options	2017	1,950,000	1,950,000	Dec. 23	6.04	11,778
Total	–	–	**8,550,000**	–	–	**8,550,000**

The exercise of all these options would result in a **capital increase of €30.9m**. However, considering that all options listed have a strike price of minimum €5.52 and the current share under €3 after the profit warning, options expiring in 2018 and 2019 shall not be executed. Options expiring after 2020, with strike prices over €6, should be a good motivation for directors to drive the share price as high as possible.

Strategic plans

Every 5 years Econocom launches a new strategic plan in order to set some long-term objectives for themselves and to provide some guidance to investors. These strategic plans have been a good way to thrive into the future, although the **targets have not always been met**:

[1] Walter Butler, second largest shareholder, is an independent director of Econocom.

2003-2007: Share Five

Although the watchword of this strategic plan was in some way ambiguous (*"Regain leadership through innovation in each of our activities"*), the primary objective in terms of numbers was to reach a 5% operating margin. The company **fell short of this target**: €700m of revenue in 2007 and only €24.5m of recurring operating profit (i.e. 3.5% operating margin). However, **the share price doubled** during those 5 years.

2008-2012: Horizon 2012

The new motto was: "*Reinforce our leadership by uniting our talents in the scope of bundled offerings*." Again in terms of numbers, the targets were to reach €1 billion in revenues and €60m of recurring operating profit (ROP). This time things went better and those objectives were **surpassed by far** in 2012: €1.5b in revenues and €75m of ROP, although operating margin was again lower than expected. The **share price almost tripled in this period**. Worth remembering this is the period of the financial crisis and debt crises in Europe!

2013-2017: Mutation

The mission statement was *"To be the European pioneer in integrating and financing digital solutions."* The target was to double both revenue and ROP (i.e., €3b and €150m respectively) and **again the share price doubled**. But were those targets reached? Somehow, but **they cheated at the end of 2017** to reach them:

- First, **they added €30m to their "recurring" EBITDA** by significantly increasing their *calculated* "residual interest in leased assets," from 2% to 2.5% of the purchase price. Such a coincidence to do this update in 2017! Of course this manipulation had to be later adjusted in the cash flow statement:

in € millions	*Notes*	**2017**	**2016 adjusted**
Profit for the year		90.7	32.7
Elimination of share of profit (loss) of associates and joint ventures	*18.1.1*	-	0.2
Provisions, depreciation, amortisation and impairment	*18.1.1*	32.2	8.2
Change in fair value of the ORNANE embedded derivative component	*18.1.1*	(4.1)	37.9
Elimination of the impact of residual interest in leased assets	*18.1.1*	(31.8)	(7.7)
Other non-cash expenses	*18.1.1*	0.8	2.1
Cash flows from operating activities after cost of net debt and income tax		**87.8**	**73.3**

- Second and even worse, it seems that **they pushed revenues way too far, at the expense of working capital**, at the end of 2017. This caused the results of the first half of 2018 to be disappointing and the consequent **profit warning sent the share price back to 2012 levels**! Not the best way to treat the shareholders.

2017-2022: *'e'* for excellence

So now they have a new strategic plan and the targets are to **double their ROP again and to achieve a revenue of €4b**. That is an annual growth rate of 6.5% in revenues and operating margins of 7.5%. That ROP is quite ambitious considering they fell short of improving operating margins under their previous plans, but we will see! Of course we will pay extra attention to their *accounting techniques*…(!)

Financial strength and cash generation

Debt is high but not wild. Last report on net debt (half-year results of 2018) was €395m, that is around **2.5x 2017 EBITDA**. However they say that it is a normal spike due to the "seasonality of the business." During the last few years net debt was contained at around 1.5x EBITDA. It is fair to assume the will try to keep that ratio of 1.5x in the near future.

On March 1, 2018, the company issued *OCEANE* bonds convertible into new shares or exchangeable for existing shares. **The issue was for a total of €200m, maturing in 2023**, and the bonds carry a nominal coupon of 0.50% payable annually. The par value of the bonds (and hence the initial conversion price) was set at €8.26. It is not the first time they finance themselves using this kind of bonds. Econocom does not have any other material loans or borrowings falling due in either 2018 or 2019.

The statement of cash flows is a bit unpredictable due to wild swings in working capital (negative and positive), but assuming no changes in working capital we can infer a normalized **free cash flow of around €50-60m in 2017**.

Capital allocation

The company invests most of its generated cash on organic growth and acquisitions:

all units in €m	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**
Acquisition of property, plant and equipment and intangible assets	7.9	7.3	14.8	17.1	20.2	33.1	44.2
Acquisition of companies and businesses, net of cash acquired	0.5	10.9	18.0	47.2	59.0	21.9	60.5

Returns on capital

ROCE is high and stable. During the last 5 years it has been moving **between 17% and 27%** using real EBIT (not the "recurring" one that the company loves to report):

all units in €m	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**
EBIT	46	71	78	65	108	124	130
Net income	21	47	45	31	57	34	87
Equity	136	157	260	281	281	279	483
- Cash and cash equivalents	145	80	150	207	210	349	238
+ Total debt	145	111	219	313	396	534	517
Capital employed	**136**	**188**	**329**	**387**	**467**	**464**	**762**
ROE (Net income/Equity)	15%	30%	17%	11%	20%	12%	18%
ROCE (EBIT/Capital Employed)	**16%**	**38%**	**24%**	**17%**	**23%**	**27%**	**17%**

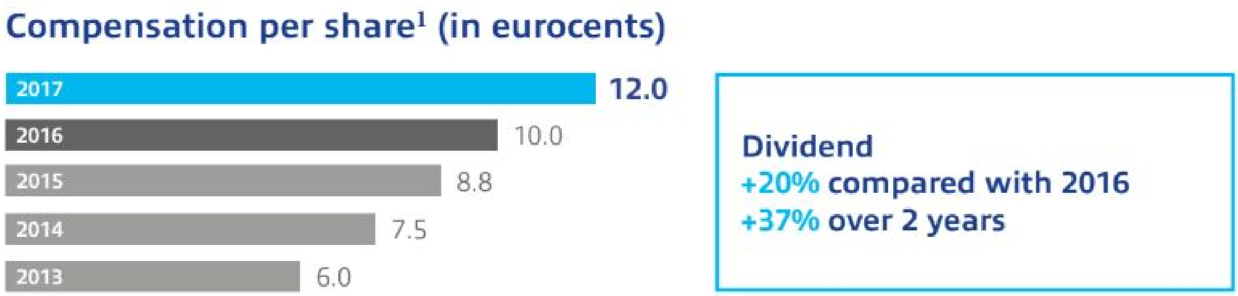
Buyback program

Econocom has a share buyback program and currently holds around 3.9% of the stock as *treasury* shares. They have authorization to purchase shares up to 20% of the outstanding stock, being the minimum purchase price €2 and the maximum unit price €10.

During the period 2006-2010 **they aggressively repurchased shares**, reducing the number of shares outstanding from from 28.6m to €23.4. It is likely that they will repurchase a big amount of shares given the current share prices. Indeed, in the most recent press release of July, 2018, they have **mandated to buy back of up to €30m before May 2018** (that will be around a 4% of the current number of shares outstanding. i.e., 10 millions of shares).

Dividends

For dividend lovers, the company offers (historically) a juicy yield of around 2%. Of course, after the dramatic slump in share price, the dividend yield has doubled and now over 4%. The compensation per share has **augmented about 20% annually** during the last 5 years:



Investment thesis and valuation

We suspect that **the management went too far** last year to reach their strategic goals: They basically emptied the pipeline of 2017 and they advanced some projects that belonged to the first half of 2018, even if not getting paid yet, which caused working capital to skyrocket in 2017 and the consequent slowdown of the business at the beginning of 2018 and the profit warning. Apart from that, we assume **the business will regain normal speed in 2019**.

For the valuation we will consider that the company will buy back 20 million of its own shares before 2020 (i.e.,just 8% of the current number of shares outstanding):

millions of shares	**2015**	**2016**	**2017**	**2018 (e)**	**2019 (e)**	**2020 (e)**	**2021 (e)**	**2022 (e)**
Shares outstanding	112.50	112.5	245.1[2]	235.0	230.0	225.0	225.0	225.0

To calculate enterprise value (EV), we will take into account the last reported net debt figure, €395m in the 2018 half-year report, even if **this figure could be inflated** due to the "seasonality of the business," as they explain in the report. We will assume that this net debt figure is **reduced by €10m every year**:

We will also be take the following assumptions:

[2] The number of shares outstanding doubled in 2017, due to the split 2:1

- They will easily reach the target of €4 billion of revenues in 2022.
- However, considering past performance, we think that a 7.5% target in operating margin is too optimistic. We will assume therefore a much lower margin (**reaching 6% in 2022**).
- We use **real EBIT**, and not the "recurring" EBIT reported by the company, which is always higher.
- Tax rate flat at 25% and minority interest set to zero.

all units in €m	2015	2016	2017	2018 (e)	2019 (e)	2020 (e)	2021 (e)	2022 (e)
Revenues	2,316	2,536	2,980	3,174	3,380	3,600	3,834	4,083
Y/Y growth %	*10%*	*9%*	*18%*	*6.5%*	*6.5%*	*6.5%*	*6.5%*	*6.5%*
EBITDA	**120**	**135**	**158**	**149**	**189**	**212**	**245**	**281**
- D&A expense	12	11	28	28	30	32	34	36
EBIT	**108**	**124**	**130**	**121**[3]	**159**	**180**	**211**	**245**
Operative margin %	*4.7%*	*4.9%*	*4.4%*	*3.8%*	*4.7%*	*5.0%*	*5.5%*	***6.0%***
- Interest expense	19	55	8	15	16	17	18	19
Pretax income	89	69	122	106	143	163	193	226
- Income taxes	31	36	31	26	36	41	48	56
Tax rate %	*35%*	*52%*	*25%*	*25%*	*25%*	*25%*	*25%*	*25%*
Consolidated net income	58	33	91	79	107	122	145	169
- Minority interest	1	(1)	4	0	0	0	0	0
Net income	**57**	**34**	**87**	**79**	**107**	**122**	**145**	**169**
Share price if:								
P/E = 12				**€3.9**	**€5.5**	**€6.4**	**€7.7**	**€9.0**
P/E = 15				**€4.8**	**€6.8**	**€8.0**	**€9.6**	**€11.3**
EV/EBITDA = 8				**€3.4**	**€4.9**	**€5.9**	**€7.1**	**€8.4**
EV/EBITDA = 10				**€4.6**	**€6.5**	**€7.7**	**€9.3**	**€10.9**

And now to calculate the free cash flow we take maintenance *capex*, **we ignore the unpredictable changes in working capital** and we will assume no significant changes in the residual interest in leases assets:

all units in €m	2015	2016	2017	2018 (e)	2019 (e)	2020 (e)	2021 (e)	2022 (e)
EBITDA	**120**	**135**	**158**	**149**	**189**	**212**	**245**	**281**
- Capex	19	22	26	28	29	31	33	36
- Interests	19	55	8	15	16	17	18	19
- Taxes	31	36	31	26	36	41	48	56
- Δ Working capital	10	(41)	147	0	0	0	0	0
Free cash flow	**41**	**63**	**(54)**	**80**	**107**	**123**	**145**	**170**
Share price if:								
P/FCF = 12				**€3.9**	**€5.5**	**€6.4**	**€7.7**	**€9.0**
P/FCF = 15				**€4.9**	**€6.9**	**€8.0**	**€9.7**	**€11.3**
EV/FCF = 14				**€2.9**	**€4.8**	**€5.8**	**€7.4**	**€9.0**
EV/FCF = 17				**€3.9**	**€6.1**	**€7.4**	**€9.3**	**€11.2**

[3] €20m non-recurring expenses due to restructuring charges.

So no matter how conservative we are, the current share price is inexplicable considering that in a normalized scenario, like 2019, the value should be around €5 to €7 (that is, the price before the profit warning was fair). The only explanation would be that the leasing segment were really deteriorating, **which seems unlikely**.

If it is just a temporary slowdown, it might be one of the best investment opportunities of the year.

Conclusions

- Econocom is a **family business, created more than 40 years ago**, that designs, finances and accelerates the digital transformation of large companies and public organizations.
- The founder Jean-Louis Bouchard still owns around **35% of the stock**. He is still Chairman of the Board while his son Robert is acting as CEO now.
- They have three main business lines which are: (1) IT product **leasing** and project financing, (2) **distribution** of hardware and software, and (3) **IT services** and solution development. There is no other company in the market that combines these three segments.
- **Cyber security and mobility** are fast-growing markets and good opportunities to grow in the near future. That is especially important if other segments deteriorate.
- The company has an **unstoppable record of growth** in revenues and profits, even during the worst years of the recent crises, in all three segments.
- Comfortable financial position, net debt at 1.5x EBITDA during the last few years, and **ROCE over 16%** during the last 7 years.
- The **share price plunged after the profit warning** of July 6, 2018, and it is now down more than 50% year-to-date.
- We believe that the **management is directly responsible** of the slowdown of the business in the first half of 2018. This behavior is certainly one of the weakest points of the thesis. Obscure account techniques should be watched carefully.
- Under the new strategic plan they expect to double their recurring operating profit by 2022. Even if this target were only partially met**, the share price could be worth over €10** within 5 years.
- If they manage to attain the strategic plan targets, especially the 7.5% in operating margin, **the share price could be worth even more** than that.