September 6th, 2016

ValuFlash Ingenico:
Shares Drop 13% but no Clear Value Yet

- **Today's news reminds us that Ingenico's rent is volatile.** We calculate that the latest operating rent (2015) is 25.8%, but based on history, we estimate a lower (19%) ***sustainable*** level, as the firm is prone to these occasional hiccups.
- **The stock was too expensive for us before today's 13% drop. Disappointingly, it still is.** The balance between the three sources of value is more reasonable now but almost 80% of the market value is a claim on future cash flows.
- **We have modelled a relatively generous Competitive Advantage Period spanning over 3 Investment Cycles.** This means that Ingenico would be able to sustain an excess return (over the cost of capital) over the span of three times its economic life of 7.6 years. This is usually as good as it gets, yet this translates into an asset multiple of 4.4x only, short of the Market Value of 4.7x.
- **Alternatively, at these levels, investors assume a *perpetual* rent of nearly 18%.** Even with a slow normalisation of the firm's returns, this is challengingly high.
- **We are disappointed because we'd love to be able to buy into this good company.** Even with a cyclical fade starting this year, net Free Cash Flow generation should increase over the medium term. We believe that a share price nearer the EUR 70 mark would represent a possible and better entry point.

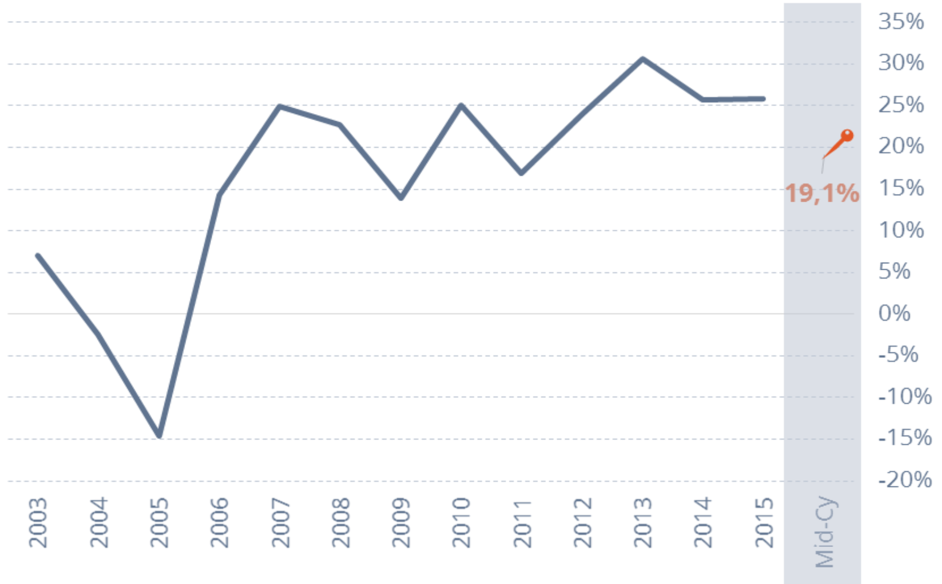
We were hoping that today's drop would put back enough value in this company's shares, but we conclude that the right entry point is closer to EUR 70

The crux of the investment argument is around the sustainable level of rent, we believe. If the company can convince investors that it has repelled some or all of its past cyclicality and persuade them to use a 25% rent (or more) to value the shares, today's drop will soon be forgotten. A bold assumption given the sudden uncertainty around Ingenico's US business, we find.

1. Ingenico's rent: still volatile?

Even ignoring the plunge of 2005, it looks like the sustainable operating rent of Ingenico might be just short of 20%. This is very good by any standards but the chart makes it clear that there are cycles in this return, which ought to have a negative effect on valuation. We believe that it is prudent to stick to this view, but hitherto investors were on a more aggressive approach, implicitly arguing for a less cyclical profile going forward, with perhaps the 25% mark representative of a future sustainable level.

Ingenico's Operating rent



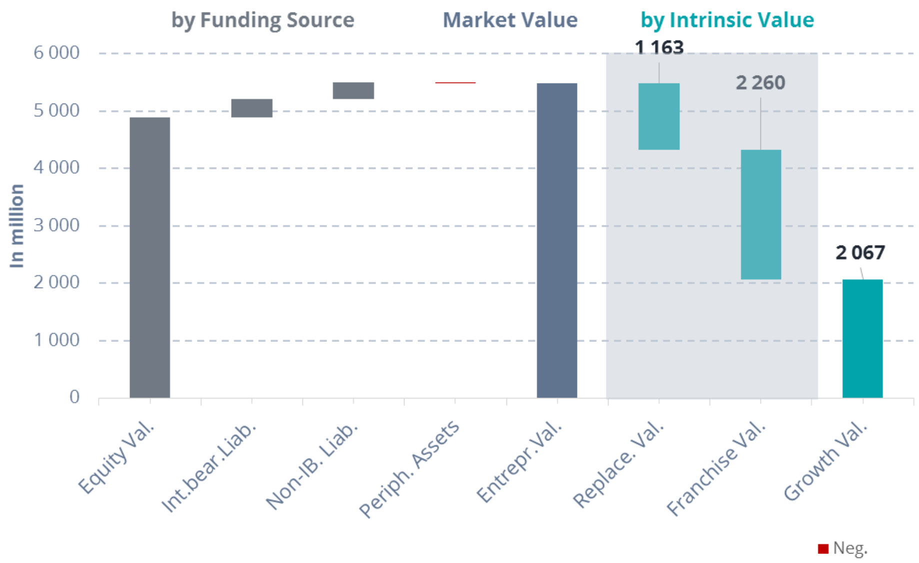
(Accounting data from S&P Capital IQ, Economic adjustments from ValuAnalysis)

2. The Three Sources of Value

With today's drop, Ingenico's market value moves to about EUR 5.5bn, with hardly any leverage. The three sources of value are shown to the right of the following chart.

The three sources of value are well distributed but Growth value is high (38% of market value) and vulnerable, given today's news

INGENICO'S THREE SOURCES OF VALUE – EUR

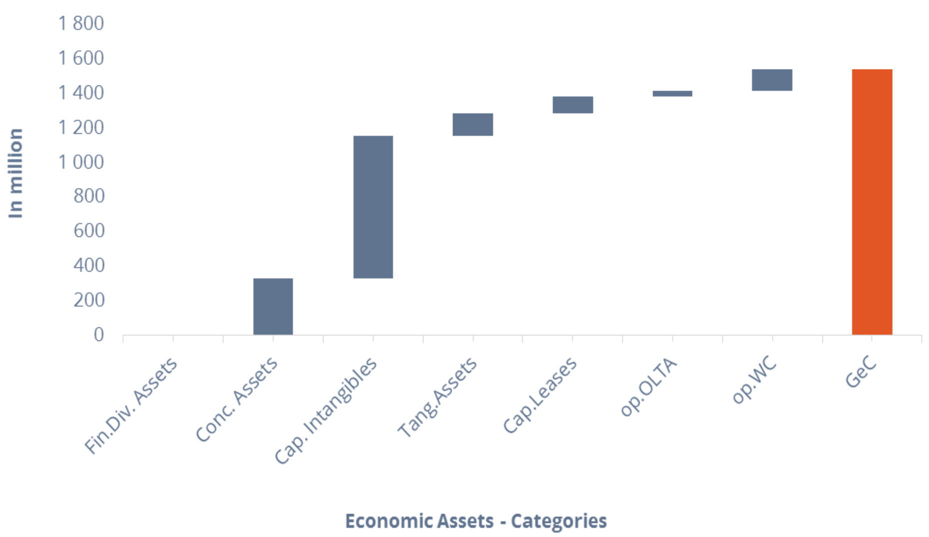


(ACCOUNTING DATA FROM S&P CAPITAL IQ, ECONOMIC ADJUSTMENTS FROM VALUANALYSIS)

2.1. Replacement Value

We calculate gross economic capital to be in the region of EUR 1.5bn, broken down in the following manner:

GROSS OPERATING ECONOMIC CAPITAL BY CATEGORY - EUR



(ACCOUNTING DATA FROM S&P CAPITAL IQ, ECONOMIC ADJUSTMENTS FROM VALUANALYSIS)

We are happy to keep a chunk of accounting intangibles in economic capital, representing customer relationships with an average life of 8 years (the company suggests 5 to 20, which does not mean much).

The bulk of economic assets comes from capitalised intangibles. We believe that 7% of sales are spent on R&D each year, to which we ascribe an economic life of 7 years.

Depreciated economically, net capital amounts to EUR 1.1bn, which is Ingenico's Replacement Value.

2.2. Franchise and Growth Values

Using a sustainable rent of 19% and a Competitive Advantage Period of 3 life cycles (economic life is 7.6 years) gives a Franchise Value of EUR 2.3bn. This leaves a residual Growth Value of slight more than EUR 2bn. We are struggling with this, as it represents almost twice as much as Net economic Capital.

Being more aggressive on the firm's franchise requires a fair dose of optimism; using three investment cycles as a Competitive Advantage Period is at the top end of what is usually assumed by investors. As for the sustainable level of rent, it would need to be pushed up to at least 25.5% to justify comfortably the current valuation. In other words, there would be an assumption of "no cycle", which may be defensible in the medium term but at odds with what the firm has announced today. This would reduce the Growth Value to slightly over EUR 1bn, or less than 20% of market Value.

2.3. Perpetual Rent

If we ascribed a fixed amount to the Growth Value, say a maximum of 25% of Market Value, or EUR 1.4bn, the corresponding ***perpetual*** operating rent that Ingenico is expected to extract from the market is 17.7%[1]. Even taking into consideration the early hump of higher returns, this perpetuity is a high expectation.

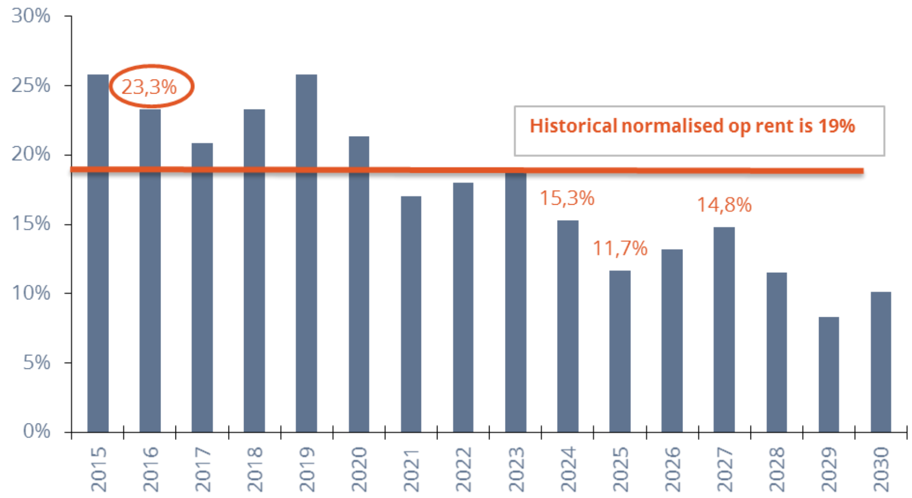
1 This is calculated by subtracting from Market Value (EUR 5.5bn) the Replacement value (EUR 1.2bn) and the EUR 1.4bn of defined Growth Value, leaving EUR 2.9bn of discounted Franchise value. Assuming a discount rate of 5%, this translates into a single Economic Profit flow of EUR 148m, or a rent of 17.7% (148/1163) + 5%.

3. Ingenico's Competitive Advantage

We frame a firm's implicit Competitive Advantage with the help of an inverse DCF model, which extracts a likely profile of rent and growth from the market value. The assumptions are minimal, and, in this case, we only assume that 2016 will be softer than 2015 in terms of operating rent, such that a "fade" can be applied immediately to the firm's cash return going forward. Given the historical profile of Ingenico, we have modelled a cyclical (rather than linear) fade. On the basis of the firm's historical pattern, the rent profile which currently fits the market value might look like this for the coming years:

INGENICO MAY HAVE A CYCLICAL FADE

This profile of cash rent is the result of an inverse DCF where all variables are given (based on history) except for the "fade", or the rate of normalisation to the cost of capital



(ECONOMIC ADJUSTMENTS FROM VALUANALYSIS)

Note that in the earlier years, say from 2016 to 2023, the current valuation does not allow us to impose any stress on the level of cash rent, just a gentle cycle. On this implicit profile, only one year is clearly below the 19% mark (the historical average) during this period, which we believe may be too optimistic. Yet this profile (and the corresponding fade for the growth rate) produces a valuation of 4.4x net assets, against a market price of 4.7x.

Glossary

Competitive Advantage Period (CAP). The period during which a firm can generate a return (see Rent) above the cost of capital.

Economic Depreciation. The correct way to take into account the obsolescence of an asset, according to the economist Harold Hotelling. Typically, an asset produces n cash flows over its economic life and is valued as the net present value of these cash flows. Depreciation is the recognition of the loss of cash flow(s) as the asset is ageing, such that, at the end of its life, an equal amount of capital has been put aside to renew it. If L is the economic life of the asset and d its cash yield, depreciation in year y is calculated as: $\frac{CF_y}{(1+d)^{(L-y)}}$.

Economic Profits. Cash profits minus the notional cost of capital.

Excess Return. The level of return above the cost of capital.

Fade. The rate of normalisation of the competitive position of the firm, defined as its level of Rent and growth rate. By construction, an excess return cannot be assumed to be perpetual, and the market always assumes an eventual normalisation towards the cost of capital.

Franchise Value. One of the three sources of value, defined as the net present value of a firm's sustainable level of Economic Profits over its Competitive Advantage Period.

Gross economic Capital (GeC). The sum of all operating capital used by the firm pre-depreciation, including all tangible assets, capitalised intangible assets and operating leases, Other Long Term Assets (OLTA) and concession assets.

Growth Value. One of the three sources of value, defined as the residual of: Market Value minus Replacement Value and Franchise Value.

Intrinsic Value. The sustainable value of a firm, defined as Replacement Value plus Franchise Value.

Net economic Capital (NeC). The depreciated value of GeC, according to the principles of economic depreciation.

Net Free Cash Flow. Gross cash flow minus all capital spending.

Operating Free Cash Flow. Gross cash flow minus maintenance capital spending.

Rent Yield. The ratio of FCF over Net economic Capital. We refer to it as "cash yield" or "cash return" as well.

Replacement Value. One of the three sources of value, equal to Net economic Capital.

Residual Income Model. A valuation framework defining the price of an asset as the net (depreciated) value of this asset plus the net present value of its sustainable level of economic profits.

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