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INTRINSIC VALUE ASSESSMENT OF

OMNICOM GROUP INC. (OMC)

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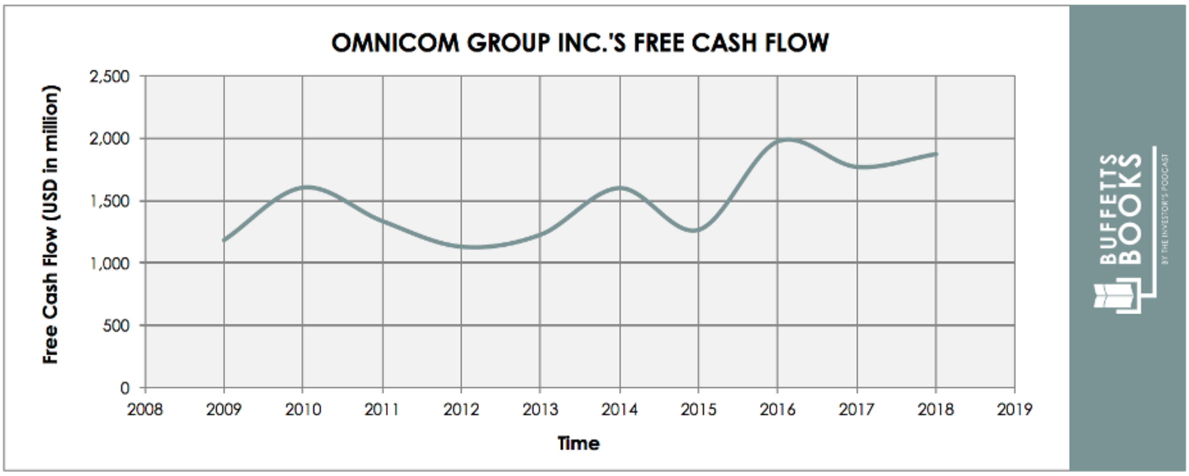
Introduction

Omnicom Group Inc. is an American-based global marketing and corporate communications holding company. Its services include advertising, customer relationship management, public relations, and specialty services. The firm's market cap currently stands at around $16.73 Billion and its revenues and free cash flows for the previous financial year were around $15.3 Billion and $1.87 Billion respectively. The company's common stock has fluctuated between a high of $87 and a low of $65 over the past 52 weeks and currently stands at $71. Is Omnicom undervalued at the current price?

OmnicomGroup

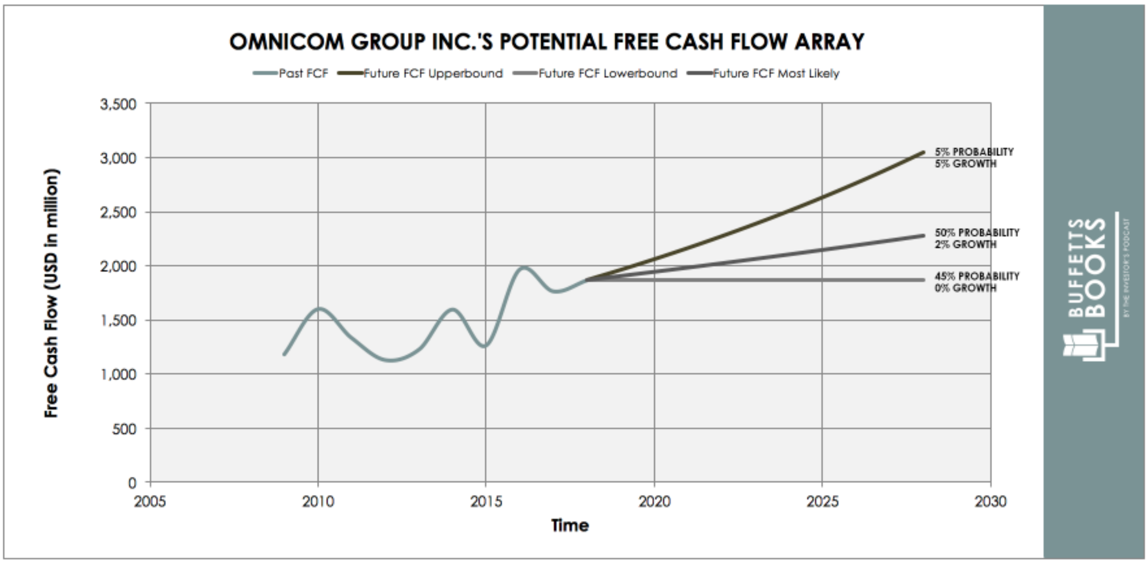
The Intrinsic Value of Omnicom Group Inc.

To determine the intrinsic value of Omnicom, we'll begin by looking at the company's history of free cash flow. A company's free cash flow is the true earnings which management can either reinvest for growth or distribute back to shareholders in the form of dividends and share buybacks. Below is a chart of Omnicom's free cash flow for the past ten years.



As one can see, the company's free cash flow has followed a moderate upward trend over the past decade growing at an average rate of 5.22%. In order to determine Omnicom's intrinsic value, an estimate must be made of its potential future free cash flows. To build this estimate, there is an array of potential outcomes for future free cash flows in the graph below.

When examining the array of lines moving into the future, each one represents a certain probability of occurrence. The upper-bound line represents a 5.22% growth rate which is based on the company's historical free cash flow growth rate. This has been assigned a 5% probability of occurrence due to the fact there is an increased risk of creative destruction disrupting the business models of traditional advertising agencies with the emergence of Google and Facebook as competition.



The middle growth line represents a 2% growth rate which is based on the firm's historical revenue growth. Revenue tends to be far more stable over time and is a suitable proxy for a conservative estimate of future free cash flow growth. Given the increasing competitive pressure from Google and Facebook, this growth rate has been assigned a 50% probability of occurrence.

The lower bound line represents a 0% rate in free cash flow growth and has been assigned a 45% probability of occurrence. This lower bound rate assumes that the company's future free cash flow growth stagnates due to both competitive pressure and increased obsolescence through creative destruction.

Assuming these potential outcomes and corresponding cash flows are accurately represented, Omnicom might be priced at an 11% annual return if the company can be purchased at today's price. We'll now look at another valuation metric to see if it corresponds to this estimate.

Based on Omnicom's current EV/EBIT ratio, the company is currently priced by the market at 8.62x. This is below the firm's 10-year historical median of 10.10x and the industry median of 14.30x, suggesting that the company may be undervalued relative to the historical and industry comparisons. If we invert this ratio, Omnicom currently has an earnings yield of 11.57%. Finally, we'll look at Omnicom's Price-to-Median P/S ratio, a metric based upon the firm's current P/S ratio relative to its historical median average, to see if it supports the assertion that Omnicom is undervalued. At present, the company trades at a Price-to-Median P/S ratio of 0.96 which is below the company's 10-year historical median of 1.10 and the industry median of 1.00 suggesting that the firm may indeed be undervalued.

Taking all these points into consideration, it seems reasonable to assume that Omnicom may be undervalued relative to its peers and the market's historical valuation for the company. Furthermore, the company may return around 11% at the current price if the estimated free cash flows are achieved. Now, let's discuss how and why these estimated free cash flows could be achieved.

The Competitive Advantage of Omnicom Group Inc.

Omnicom Group Inc. has various competitive advantages outlined below.

- **Oligopoly Status.** Omnicom is one of the largest advertising agencies in the world and operates in a market which is dominated by the 'Big 5' which also includes WPP, Publicis, Interpublic, and Dentsu. Collectively, they control around 30% of the global advertising agency market which has historically been one of the most stable oligopolies in existence. This stability can be seen in the chart below which outlines the market share of combined total billings for the 3 largest advertising agencies between 2004-2014.

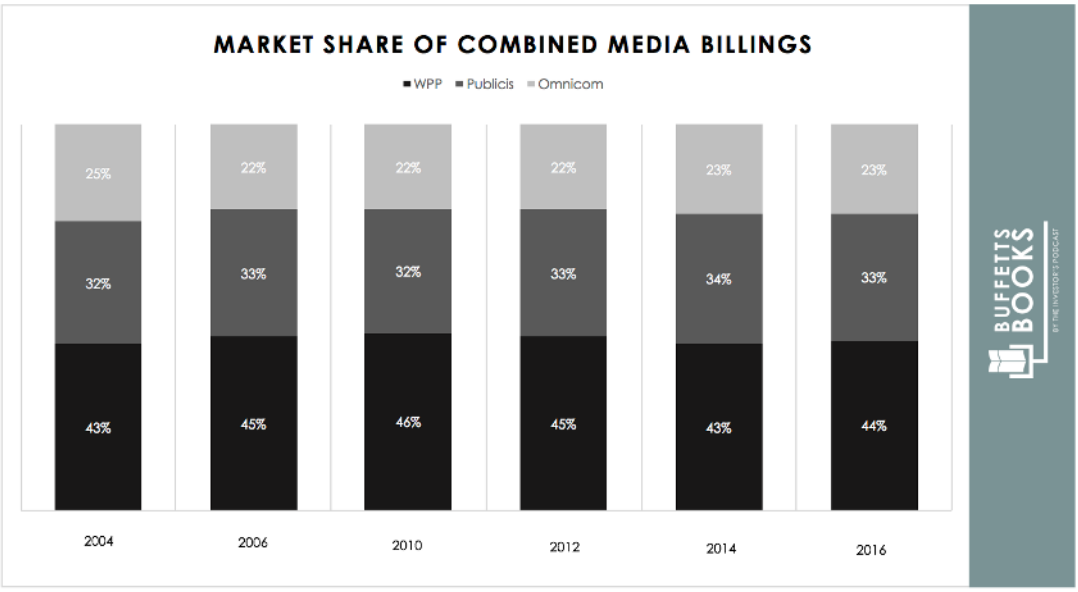


Figure 1: CS Investing; Singular Diligence, Gannon & Hoang

As one can see, market share between the 3 companies was extremely stable over the period. There are no other industries in which the 3 industry leaders can maintain such a stable market share over an extended period of time.

- **Sticky Business Model.** Advertising agencies possess some of the highest customer retention rates of all companies. Examples include DDB, a subsidiary of Omnicom, which reported retention rates of between 98-99% between 2001-2003. Another advertising agency, Grey, reported a retention rate of 95% in 2014. While the large advertising agencies don't regularly report, retention rates analysts have calculated, based upon the figures which are occasionally published, that the industry average retention rate ranges from a conservative estimate of 90% to a more realistic rate of 95%. The reason why these rates are so high is that rival firms almost never challenge one another for market share and only pitch for business once a customer puts a contract "in the review." How often do customers put a contract "in review?" The answer is, not very often. The chart below shows the contract period for a number of Omnicom's customers.

Company	Customer Contract Period with Omnicom
Visa	1985 - Present
Clorox	1996 - Present
State Farm	1930 - Present
Wrigley	1995 - Present
Wells Fargo	1996 - Present
Discover Card	1987 - 2006
Gillette	1930's - 2013
Pepsi	1960 - Present
Mars	1993 - Present

As you can see, Omnicom's clients do not switch to competing firms very often, and this is true throughout the industry as a whole. This means that investors can make reasonable projections about future revenues and earnings and be confident that the firm will be able to make money regardless of the economic environment.

- **Pricing power with customers.** Omnicom, along with the other large advertising agencies, possesses strong pricing power over its customers. Firstly, clients are primarily interested in quality over cost. This means they are unlikely to haggle with advertising agency giants due to the value they add to their brands and products. Secondly, it is easier for the 'Big 5' to protect their pricing by announcing their intention not to accept weaker rates of payment. It is much harder for their clients who are in many different sectors and industries to coordinate and insist on better terms. This pricing power allows Omnicom to outperform the Global Advertising Agency Industry on a number of key metrics outlined below.

	Omnicom Group Inc.	Global Advertising Agency Industry Average
ROA (ttm)	4.74%	3.03%
ROE (ttm)	46.44%	7.34%
Operating Margin % (ttm)	7.13%	2.81%
Net Profit Margin % (ttm)	13.49%	4.58%

Omnicom Group Inc.'s Risks

Now that Omnicom Group Inc's competitive advantages have been considered, let's look at some of the risk factors that could impair my assumptions of investment return.

- While Omnicom and other advertising agencies possess large moats, their business is somewhat cyclical as their revenues and earnings are driven by the advertising budgets of their clients. In the event of a recession, Omnicom's earnings would likely be impacted by a contraction in their client's advertising budgets as advertising spending rates tend to track GDP growth. Readers should note that, even in a recessionary environment, the margins advertising agencies achieve are well above those of the average company.

- Omnicom and other traditional advertising agencies are facing an increasing risk of disintermediation. This is basically 'cutting the middleman out.' At present, Omnicom's clients use them as an intermediary to secure advertising with Google and Facebook who now collectively control around 60% of the digital advertising market share. There is a real risk that companies will decide to contract directly with Google and Facebook thus rendering the traditional advertising agencies obsolete.
- Omnicom also faces another type of risk associated with disintermediation if its clients decide to 'in-house' certain activities related to digital advertising campaigns. These campaigns have historically generated the most dollars of revenue for advertising agencies per dollar going to the media company which hosts the adverts. Historically, the advertising agencies could earn 2-3 times more revenue from the same client spending if it went on digital advertising rather than TV. If Omnicom's clients decide to move the labor-intensive work associated with digital advertising 'in-house,' this could have a negative impact on the company's future revenues and earnings.

Opportunity Costs

Whenever an investment is considered, one must compare it to any alternatives to weigh up the opportunity cost. At present, 10-year treasuries are yielding 2.78%, if we take inflation into account, the real return is likely to be closer to 1%. The S&P 500 Index is currently trading at a Shiller P/E of x31.6 which is 88.1% higher than the historical mean of x16.8. Assuming reversion to the mean occurs, the implied future annual return is likely to be -2.6%. Omnicom, therefore, appears to offer a much better return for investors at present, but other individual stocks may be found which offer a similar return relative to the risk profile.

Macro Factors

Investors must consider macroeconomic factors that may impact economic and market performance as this could influence investment returns. At present, the S&P is priced at a Shiller P/E of x31.6, this is 88.1% higher than the historical average of 16.8 suggesting markets are at elevated levels. U.S. unemployment figures are at a 30-year low suggesting that the current business cycle is nearing its peak. U.S. private debt/GDP currently stands at 199.6% and is at its highest point since 2009 when the last financial crisis prompted private sector deleveraging.

Summary

Omnicom is currently the subject of pronounced pessimism from the market due to the increasing competitive pressure which Google and Facebook are placing upon the advertising agency industry. The threat of creative destruction is not without merit, given the increased risk of disintermediation which could see the old oligopoly of the traditional advertising agencies supplanted by the new tech duopoly.

There are, however, reasons to believe that this may not be as likely as the market is assuming. Companies do have an incentive to outsource the creation and purchasing of advertising to agencies such as Omnicom since the latter has the talent, expertise, and scale advantages drawn from its entire client roster to implement a more effective advertising campaign. Thus, clients can essentially aggregate their buying power and get better deals on advertising space.

Omnicom's clients also need more than just advertising; they require public relations work, brand consultancy, direct & event marketing, and many other services which often must be coordinated. Omnicom possesses the knowledge, experience, and capability to deliver the kind of comprehensive campaign that its clients are unable to do on their own.

Regarding management's capability and shareholder friendliness, Omnicom has a great track record. Over the past ten years, the firm has achieved an average return on invested capital of 15% and an FCF/Sales of 10.58%. Omnicom has also increased its dividends for the past ten years at an annualized rate of around 16% and reduced its share count through buybacks over that period at an annualized rate of 3.25%

In summary, the author considers the market's pricing of Omnicom to be overly pessimistic and based on a misjudgment of the durability of the firm's moat. Based on the conservative assumptions used in the free cash flow analysis, Omnicom may return around 11% at the current market price.

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