EDISON

Dentsu Group

Simplification to boost growth and margins

Initiation of coverage

Media

Dentsu is making good progress with its plans to streamline its business and integrate its offering to better address the needs of its blue-chip client base, including 95 of the world's top 100 advertisers. The balance sheet has been strengthened by the sale of most of the Recruit shareholding and Dentsu is considering a sale and leaseback of its Tokyo headquarters. A ¥30bn share buyback is intended for FY21. Restructuring inevitably means some short-term disruption, but this should drive revenue growth (targeted at 3–4% CAGR FY21–24) and improve margins. The valuation, while in line with peers, is yet to reflect the programme's likely benefits.

Year end	Net revenue (¥bn)	PBT* (¥bn)	EPS* (¥)	DPS (¥)	P/E (x)	Yield (%)
12/19	939.4	101.3	271	95	13.5	2.6
12/20	835.0	123.5	250	71	14.7	1.9
12/21e	850.0	124.7	271	77	13.5	2.1
12/22e	900.0	149.7	337	100	10.9	2.7

Note: *PBT and EPS are normalised, excluding amortisation of acquired intangibles, exceptional items and share-based payments.

Transformation underway

Dentsu's 2020 comprehensive review resulted in four clear commitments. These are: to simplify the business; to structurally and permanently lower operating costs; to improve the efficiency of the balance sheet; and to improve shareholder value. Clear progress is being made on all these aspects. At Dentsu International (DI), the transformation plan involves concentrating over 160 agency brands down to six, while Dentsu Japan Network's (DJN's) business is being focused into four domains, with greater emphasis on digital, where Japan lags internationally. The total cost of restructuring across the group is put at ¥138bn, of which ¥80bn was taken in FY20. This is designed to achieve savings of ¥76bn, mostly from FY22 on.

Recruit proceeds fund restructuring and buyback

The sale of the bulk of the Recruit holding in December 2020 realised ¥194bn. With the restructuring costs as outlined above, year-end net debt was ¥56bn. The payment for the accelerated buy-in of the Merkle minority, as agreed in April 2020, remains set for payment in Q321. The stronger balance sheet is funding a ¥30bn share buyback, announced with the results and further asset sales may lead to further buybacks, in line with the objective to improve balance sheet efficiency. Dentsu has confirmed it is considering the sale and leaseback of its headquarters. Acquisitions are also on the agenda to drive the group's expansion in Customer Transformation & Technology, targeted to grow to 50% of revenues over time.

Valuation: In line with peers

With strong recent performance on news of the restructuring and asset realisations, the valuation has now caught up with those of the global holding company peers. Successful implementation of management's plans, simplifying the structure and driving profitability, should help drive shareholder value and underpin the rating.

23 February 2021

Price	**¥3670**
Market cap	**¥1,034bn ($9.8bn)**
	¥105/$
Estimated net debt (¥bn) at 31 Dec 2020	56.3
Shares in issue	281.7m
Free float	76.7%
Code	4324
Primary exchange	TSE
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	17.3	9.7	10.4
Rel (local)	12.3	(2.2)	(4.7)
52-week high/low		¥3,800	¥1,870

Business description

Dentsu Group is a holding company with two operational networks: Dentsu Japan Network and Dentsu International. Operating in over 145 countries, Dentsu Group provides a wide range of client-centric integrated communications, media and digital services.

Next events

Q1 results	May 2021

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Investment summary

Company description: Integrated global marcomms plus

While Dentsu is commonly bracketed with the other global marketing services holding companies, the range of activities is broad across media activation, creative, data analytics, systems integration, sports and entertainment. It has a particularly strong position in data analytics and digital transformation, based on the 2016 acquisition of US-based Merkle. Having grown through an extensive acquisition programme to diversify beyond its Japanese home market, the organisation had become unwieldy and inefficient. An integration programme, one Dentsu, was initiated in early 2020 and was progressed in the summer as the accelerated transformation plan. The objective is to simplify the business and make it fit for purpose, reducing structural overheads and allocating capital to growth and innovation. Digital activities accounted for 54% of FY20 group revenues, with Customer Transformation & Technology representing 28%. Management targets this latter category to grow to 50% of group revenues.

Valuation: Lifted by strong recent performance

Dentsu's share price has risen 20% since the start of the year. This partly reflects the improving global outlook for advertising spend (the global sector holding company peer set is ahead by 14% ytd). We would suggest the outperformance reflects moves that Dentsu has made to improve its financial performance and prospects and to strengthen its balance sheet. The intention to have a progressive dividend policy and buy back shares when appropriate will also have contributed. The rating is now roughly on a par with peers for FY22 (beyond the transitional year) on EV/EBITDA. A DCF on a range of terminal growth and WACC assumptions suggests possible further upside.

Financials: Improving returns from capital allocation

FY20 figures reflect the impact of the COVID-19 pandemic, with revenues less passthrough costs down 11.1% and a slight dip in operating margin from 15.0% to 14.8%. This was very slightly ahead of previous Q420 market estimates. The FY20 restructuring charge was ¥80bn and an impairment loss of ¥145bn was also taken. This predominantly reflects a diminution in the carrying value of DI assets, reappraised in light of the pandemic impact. Management is targeting revenue less pass-through costs growth of 3–4% CAGR over FY21–24. Our modelling is at the lower end of this range. The group also anticipates a steady improvement in underlying operating margin across the period. Our published forecasts only extend to FY22 but show operating margin broadly level at 14.7% in FY21, climbing to 16.7% in FY22 as the restructuring benefits start to flow through. As described above, the balance sheet has been strengthened by the disposal of the Recruit shares. The objective now is to maintain an efficient balance sheet with a medium-term leverage target of 1.5x net debt /EBITDA (0.6X in FY20). This should allow for continued investment in organic and inorganic growth (M&A) and a progressive dividend towards 35% of adjusted EPS over the next few years. Additional shareholder returns through further buybacks may follow exceptional asset sales.

Sensitivities: Good plan execution central

The key sensitivity to our forecasts is successful implementation of the group's transformation plan. The economic backdrop should improve through FY21, although globally levels of advertising spend are unlikely to recoup all the losses registered in FY20. Dentsu's weighting towards customer experience management (CXM) and digital transformation should help it outperform the broader advertising market. If the Tokyo Olympics do not proceed as planned, advertising spend will be affected. The group also has standard industry sensitivities regarding client retention and reputational risk, along with regulatory risks on matters such as data security.

Company description: Integrated marketing services

Dentsu Group is a global marketing services holding company, headquartered in Japan. It has a full range of services to support its customers' brands, with a particularly strong position in data analytics. It has two reporting segments, DJN and DI.

Dentsu was founded on 1 January 1901 and has therefore a vast heritage on which to draw. It listed on the Tokyo Stock Exchange in 2001, as an international advertising and PR business. In this interview, CFO Yushin Soga gives a brief overview of the group, along with a high-level description of the transformation that management has put in place to simplify the group and improve integration. The objective is to make the group easier to navigate for its clients and help them achieve growth using consumer insights, technology and analytics and in digital transformation.

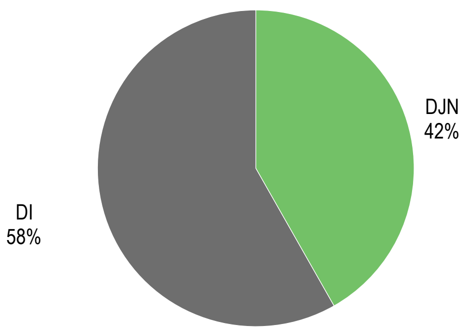
Exhibit 1: Video overview of Dentsu by CFO, Yushin Soga (click to play)

Dentsu Group – executive interview

Source: Edison TV

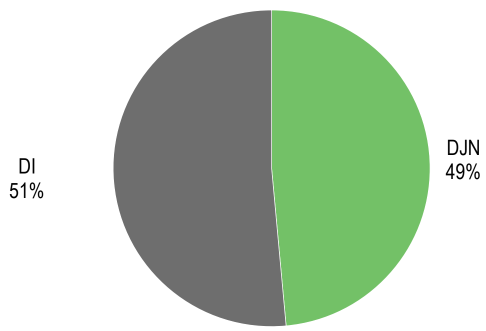
The group reports in two segments, representing its Japanese business and its business outside Japan, now known as DI. The dynamics of these two are different and in the past have been effectively managed separately. DJN is a leading player and has historically enjoyed high operating margins. DI (previously Dentsu Aegis Network) has been built through a fairly aggressive acquisition programme, leaving it with 160 agency brands that it now intends to consolidate into six global leadership brands within two years.

Exhibit 2: Dentsu Group FY20 revenue less pass-through costs



Source: Company accounts

Exhibit 3: Dentsu Group FY20 underlying operating profit



Source: Company accounts

Before documenting and commenting on the restructuring programme, we briefly describe some of the group's main agencies with key clients where appropriate and links to the relevant websites.

DJN

DJN has a prominent position in the Japanese marketing services landscape, with an estimated market share of around 30%. Historically, the Japanese market had been relatively slow to adapt to digital media and DJN was broadly aligned with its market. In FY20, 34.8% of its DJN revenues were derived from digital, compared with 67.5% of those at DI, giving an overall group level of 53.8%. Revenues from customer transformation and technology programmes are around 25% of the division, approximately equal to the proportion in the international business. Until recently it provided services falling into eight broad segments: marketing; digital marketing; creative; promotions; media; content; PR; and global. It is now reframing that offering into four domains: advertising transformation; business transformation; customer experience transformation; and digital transformation.

Its prominent agencies include:

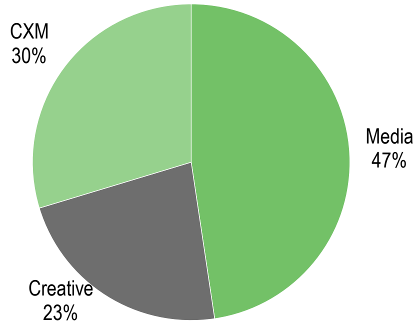
Dentsu, Inc, the largest unit within the Dentsu Group. Founded as an advertising group, it now works across the range of marketing communications, including digital marketing, creative, media, PR, promotions, events, sports and content development. It also works with clients on business and digital transformation and on e-commerce projects and CRM implementations. Activities are increasingly based on advanced data and technology platforms, sometimes collaborating with partners inside and outside the group.

iSiD (61.8% owned and separately listed on the Tokyo Stock Exchange: 4812) is an advanced IT solutions provider, supporting client digital transformation backed with solid technological and creative capabilities. It has particular strengths in fintech, smart enterprises and manufacturing innovations. It also provides the Dentsu group with its underlying marketing platform. It helps drive its clients' programmes with solutions in finance, business, manufacturing and communications/IT. Among other developments, iSiD is also accelerating its service development with cutting-edge technologies such as location based and sensing.

Dentsu Digital (100% owned) is a digital marketing company established in July 2016. It supplies a wide range of services to be a digital partner to its clients in digital marketing IT platform and data infrastructure and digital transformation. Dentsu Digital employs 1,500 people and is based in Tokyo, working with around 600 clients. Its approach is summarised in the phrase 'People Driven Marketing', driven through data and analytics.

DI

Exhibit 4: DI revenue less cost of sales by activity



Source: Company accounts. Note: CXM, customer experience management.

As explained above, DI is a global agency network. It has strong working relationships with key technology partners, in particular Salesforce, Adobe, AWS, Microsoft, Google and Facebook, which are key to building its CXM offering. A fuller discussion of DI is contained in the interview with its CEO, Wendy Clark (Exhibit 14). Wendy joined the company in September 2020 and has brought a clear vision to the business and its potential. She is also committed to the importance of strong ethics in the relationship between the business and all its stakeholders, internal and external, and the need to be mindful of the group's environmental impact. It is proposed that Wendy will be joining the main group Board at the March General Meeting.

Key DI agencies

Merkle is a data-driven and technology-enabled global performance marketing agency with a 32-year track record of working with brands to create personalised experiences through each stage of the customer lifecycle. Merkle joined with Dentsu in 2016 (purchase of 66%) and has since continued to acquire digital marketing and data analytics companies to complement its offer and widen its geographic reach. The outstanding shares were acquired in FY20, taking Dentsu to 100% ownership, with payment in FY21. Merkle employs over 9,600 employees globally. Its FY19 revenues were $1.1bn (¥120bn), over 11% of the group total. It is the fastest growing area of DI and its continuing development is central to the group's ambitions as the market moves further towards greater personalisation.

Exhibit 5: Merkle key clients

Citibank	EmblemHealth	Dell	AARP
AT&T	Target	L'Oréal	Universal Orlando Resorts
American Cancer Society	T-Mobile	Samsung	Kimberly-Clark

Source: Company

In the interview below (Exhibit 6) Merkle's global CEO, Craig Dempster, provides further information on how Merkle has built its offering and how it is positioned within the shifting privacy landscape.

Exhibit 6: Interview with Merkle's global CEO Craig Dempster (click to play)

Source: Edison TV

Isobar describes itself as a digital experience agency that transforms businesses by integrating creativity and technology to create meaningful customer experiences. It is a global agency employing 5,500 people across 85 offices in 45 countries. Its activities fall across both agency work and consultancy, encompassing digital marketing through to experience-led transformation programmes for clients.

Carat was founded over 50 years ago and was the world's first media agency. It has a brand-first approach, using its 'understanding of the passions, motivations and behaviours of real people to bring brands and their customers together'. It employs over 12,000 people in over 100 countries and has a very strong client roster, including those listed in Exhibit 7.

Exhibit 7: Carat key clients

Arla Foods	JDE	Mondelez	Heineken
Coca Cola	Kellogg's	P&G	Microsoft
GM	Mastercard	Philips	Vodafone

Source: Company website

dentsu X is an integrated agency network combining best-in-class communication and media planning services, content creation, technology, data and behavioural insights. It employs c 3,500 staff across 47 markets. Working with the tagline 'experience beyond exposure', the agency looks to deliver fully integrated solutions, working alongside clients' other agencies. These clients include Jaguar Land Rover, LVMH, Kao Corporation and Netflix.

Exhibit 8: dentsu X key clients

Jaguar Land Rover	LVMH	Kao Corporation	Netflix
MAC	Singapore Airlines	Lumix	Huawei

Source: Company website

iProspect (now including **Vizeum**). Announced in November as part of the brand rationalisation programme, the formal merger between iProspect and Vizeum is set to be concluded by end March 2021. iProspect employs around 8,000 people in 126 offices across 93 markets, with the largest number in EMEA. The agency focuses on performance-driven brand building, describing itself as an end-to-end digital-first media agency, with Vizeum adding media strategy and planning.

Exhibit 9: iProspect key clients

General Motors	Gucci	Hilton	Estee Lauder
Procter & Gamble	IKEA	Eurostar	

Source: Company website

Dentsumcgarrybowen is a global creative agency, focused on brand transformation, combining the dentsu agency and mcgarrybowen. The newly-merged entity has around 3,000 employees at 33 locations in 24 markets. The nature of the marketing services industry makes it important the larger providers are able to put choices in front of potential clients, particularly in creative.

Exhibit 10: Dentsumcgarrybowen key clients

Ajinomoto	American Express	Asahi Breweries	Canon
Disney	Hershey	Kao	Marriott
Shiseido	Subway	The Coca-Cola Company	Toyota
United Airlines			

Source: Company website

Exhibit 11: Isobar key clients

Coca-Cola	adidas	Enterprise	P&G
Philips	Volkswagen	KFC	Zwilling

Source: Company website

MKTG is a global lifestyle marketing agency that works to connect brands and people through sports and entertainment marketing, live experiences, digital and social media, retail marketing, enterprise/B2B engagement and sponsorship marketing. Although severely affected by the restrictions enforced by governments worldwide to counter the spread of COVID-19, sports and entertainment is an increasingly important element in the global marketing mix as traditional channels to reach audiences are diluted by the breadth of contact points between content and audiences. MKTG has around 1,300 employees and 7,000 brand ambassadors based in 29 offices in 16 countries across the Americas, EMEA and APAC.

Exhibit 12: MKTG key clients

IBM	Diageo	Nike	FedEx
P&G	Coca-Cola		

Source: Company website

Posterscope is a leading global out-of-home (OOH) communications agency and location expert, with over 1,000 people in 49 offices located in 30 countries worldwide. It books over 30,000 OOH campaigns every year, with billings of over $3bn (¥327bn). OOH is increasingly sophisticated and digital. Posterscope's market proposition includes a leading technology platform with advanced planning tools, strong data and analytics capabilities, an advanced automation programme and a broad and diverse physical offering.

Exhibit 13: Posterscope key clients

BT	Mondelēz	Diageo	Camelot
AB InBev			

Source: Company website

Restructure and simplification underway

In August 2020, Dentsu's management announced the group would be carrying out a restructuring, which it called an accelerated transformation plan. The group is now to be focused on a global client service model, as is employed by other agency holding companies such as WPP and Publicis. There are already relationships with 95 of the world's top 100 advertisers. This gives a clear opportunity to drive deeper and more substantial penetration to build scale and grow the top line. DI is now organised into three lines of business: creative, media and CRM across the Americas, APAC and EMEA. DI is realigning its 160 agency brands into six global leadership brands.

M&A will be focused on the high-growth areas of data, analytics and digital transformation, building on existing strengths and taking advantage of opportunities presented by the structural shift in the market toward first-party data. Deals are likely to be fewer in number but of more significance (Dentsu's average deal size over recent years was around $30m). Merkle's strong positioning in the US makes expansion in other geographic regions more likely.

The culture of encouraging innovation prevalent within DJN is to be emphasised, with more JVs and start-ups with tech companies in areas such as marketing technology, virtual reality and AI.

Dentsu's accelerated transformation plan is underway and progress is on track. The key objectives are to deliver the following:

- **A simplified structure, benefitting both clients and internal operations**. As outlined above, Dentsu has a significant number of operating and reporting entities, across many different geographies and activities. Some are distinct but most have a degree of overlap with portfolio peers. This has led to a lack of clarity in client account and new business management and considerable inefficiencies. Shaking this complexity down into a coherent and integrated go-to-market strategy should help with new and existing client relationships. It should also improve the messaging to the investment community, more clearly articulating the group's expertise in customer experience and digital transformation, backed up by a strong creative offering.
- **Structurally and permanently lowering operating expenses.** Due to the way it had been built through acquisition, DI employed large numbers of people in C-suite roles. There are also a lot of duplicated functions between subsidiaries that had not been addressed through a systematic integration programme historically. With the update to the transformation plan in December, after Wendy Clark took up her role as CEO of the international business, the reduction in headcount envisaged in the plan was quantified at 12.5%, equivalent to just below

6,000 people. The cost of the DI rationalisation process was estimated at ¥87.6bn, of which ¥56.1bn was taken in FY20, with the balance of ¥31.5bn falling into FY21. The rationalisation is targeted to achieve annualised savings of ¥54.7bn. In DJN, the ¥50bn cost of structural reform falls ¥24bn into FY20, ¥23bn in FY21 and ¥3bn in FY22. Property requirements are being re-evaluated globally, with the understanding that working practices are unlikely to revert to the same patterns as they were before the pandemic. Along with the further use of near- and off-shoring (which was up around 20% in FY20) for certain activities, the overall impact should be to equip the group with a much more flexible cost model, better suited to a dynamically changing business environment.

- **Enhancing the efficiency of the balance sheet**. Marketing service companies are, in general, cash generative. Dentsu has historically channelled much of its cash flow into M&A, with the acquisition of Aegis in 2013 and Merkle in 2016 (acquisition of 66% interest for ¥170bn), its most prominent deals in building up its international activities. As per management, Merkle has doubled in revenue since its purchase. Numerous smaller deals have since added capability and geography. The buy-in of the remaining Merkle shares was agreed in April 2020, with payment scheduled in Q321 (as per originally stated). December 2020's sale of the stake in Recruit Holdings realised a total of ¥194bn, representing a gain of ¥179bn, considerably strengthening the balance sheet. Management has indicated a medium-term leverage target (non IFRS) of 1.5x net debt to EBITDA (FY20: 0.6x). This gives the group the necessary headroom to continue to invest in new technology, product innovation and M&A. Merkle's activities are likely to continue to be a focus, buoyed by the structural market shifts to first-party data.
- **Maximising long-term shareholder value.** The most effective way to deliver shareholder value is to deliver growth for Dentsu's clients, in turn leading to higher growth for Dentsu. Value is being realised through asset sales, with further disposals on the cards. Management has indicated that proceeds from substantial transactions would be shared with shareholders via a buyback mechanism. Dividends are also a key element of the value proposition. Our modelling assumes a pay-out ratio of 29% for FY21, building towards 35% over the next few years.

Exhibit 14: Interview with DI CEO, Wendy Clark (click to play)

Source: Edison TV

Social impact integral to management plans

Dentsu's management regards the group's social impact as a core element of its responsibility. As Wendy Clark points out in her interview above, acting with environmental and social respect is increasingly effectively a social licence to operate. Consumers are ever more vocal in their demands that the companies they buy from act responsibly and Dentsu is part of that supply chain. Being on the front foot in this respect can translate into a commercial advantage over other suppliers with less of an ESG commitment.

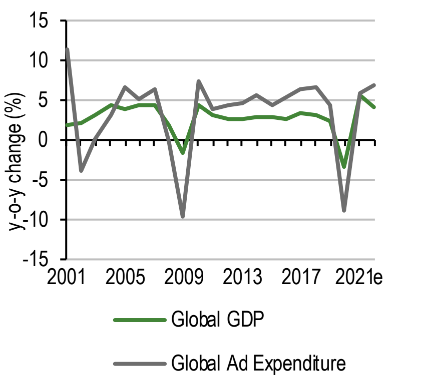
The group has resolved to implement a 46% absolute reduction in CO_2 usage and be 100% net zero by 2030, with the balance offset by certified green gas. The COVID-19 pandemic will have had a marked impact on the carbon footprint in 2020, with travel obviously curtailed and office occupancy reduced globally. While some of this will resume as restrictions lift, we would not expect levels to revert to pre-pandemic volumes.

Restructuring programmes are inevitably unsettling and staff relations are more of a focus than they may have been historically. Improvements in employee engagement are a key part of the group's revised positioning, along with a commitment to gender diversity across all levels.

Shifting contextual landscape

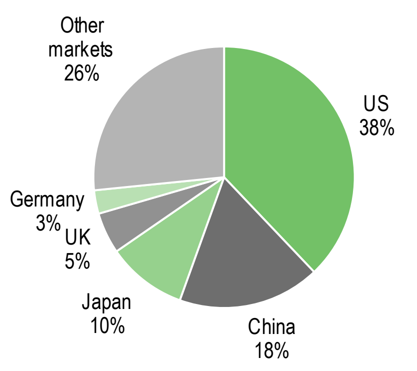
Global advertising spend has a correlation with GDP, as shown below. The US market is the largest by value (see Exhibit 16, below) and Dentsu forecasts it will have outperformed global markets over FY20 with a decline of 7.6% versus the market at -8.8%. This reflects the prevalence of digital in the mix and the acceleration of growth of e-commerce in the face of the COVID-19 pandemic and its impact on consumer behaviour. The fastest growth over the next couple of years is forecast to come from Central and Eastern Europe as their economies shift further to digital, albeit off a much lower base.

Exhibit 15: Long-term global ad spend trends versus GDP



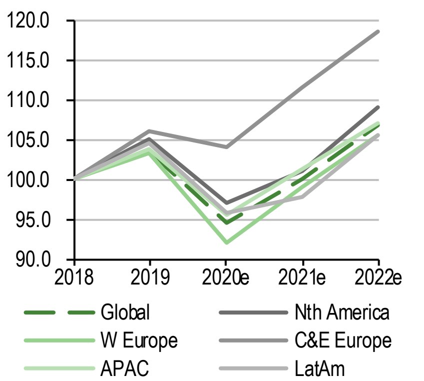
Source: World Bank, Dentsu

Exhibit 16: Largest advertising markets FY21e



Source: Dentsu

Exhibit 17: Regional growth variations



Source: Edison Investment Research, Dentsu

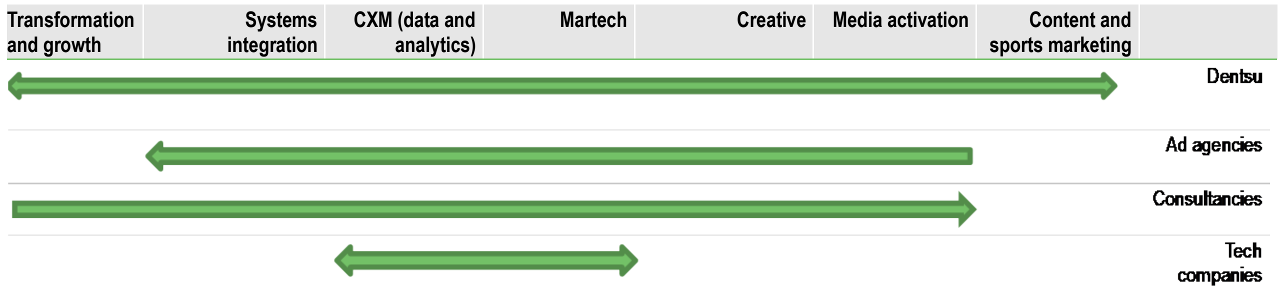
The Japanese advertising market is still far behind the digital transition curve, with TV prominent at a 26.8% share (FY19, source: Dentsu). The digital share of the Japanese market is slightly ahead at 33%. Japan had a very difficult year in FY20, with the postponement of the planned Tokyo Olympics contributing to a year-on-year decline of advertising spending of 16.6%. Forecast recovery in ad spend of 5.3% in FY21, broadly in line with the global GDP growth assumption, is based on the delayed Olympics taking place as currently scheduled.

Large agency groups still dominate

The marketing services industry remains heavily influenced by the large global agency holding companies, listed below. Over recent years and as digital transformation has become a central theme, the traditional industry heavyweights have been joined by the large global consulting companies. In the more data-led, tech-driven space, key competitors would commonly include

Accenture Interactive, Deloitte Digital and PWC. Of these, only Accenture makes partial disclosure of its marketing-based activities. WPP, Omnicom and the others (as listed below) are all keen to push their digital credentials, with the range of activities and direction of travel highlighted below.

Exhibit 18: Comparative market positioning



Source: Dentsu, Edison Investment Research

As an industry, marketing services has traditionally been 'people heavy', although with a degree of flexibility through the extensive use of freelancers. The pandemic has drawn attention to the companies' relative cost bases in terms of payroll-related costs but also for property costs, where historically flagship premises were part of the client marketing effort.

Exhibit 19: Large global agency groups by FY20 revenue

Agency group	$m	Employment costs/net revenue %
WPP	13,653	65.4
Omnicom	13,078	73.5^
Publicis	11,093	62.5
Accenture (Communications, Media & Technology practice)	8,883	Not disclosed
Dentsu	8,808	61.9
Interpublic	8,175	64.5
Hakuhodo	3,051*	55.3

Source: Company accounts, Refinitiv for those not yet published. Note: Translated at average FX rates for 2020. *Year-end March. ^Calculated against gross revenue

Sensitivities

We briefly outline some of the key issues that may affect financial performance.

- Economic. As described above, ad spend is related to GDP. The COVID-19 shock to global economies had a major impact on ad spend in Q220, with the worst fears for the industry not realised as the year closed.
- Tokyo 2020 (2021). The postponement of the Olympics had a major impact on ad spend in Japan as previously allocated budgets were withdrawn. At the time of writing, the games are scheduled to take place in summer 2021.
- Currency. Dentsu's key exchange rate is the US dollar to Japanese yen, although with subsidiaries globally, other currencies are also relevant.
- The accelerated transformation plan involves a major reconfiguration of the business. To deliver on management's top-line growth ambitions and margin improvement, the plan must be executed as envisaged.
- Reputational risks can occur because of internal issues, client problems or controversy. Particular risks arise over the handling of data and its security. Regulatory risks are also relevant in this context.
- Competition will always be a factor and clients review their relationships with their agencies as a matter of course. The shift in the nature of the work being carried out is leading to a wider peer set, with the major global consultancies vying for the digital transformation business. In-

housing by clients has been a feature of the market over recent years and may remain so. Close partnership relationships can mitigate here.

- Client loss is another perennial issue, closely tied to the competitive landscape.

Valuation

The exhibits below show how Dentsu's shares trade compared to their historical ranges since 2015. As can be seen, across the key valuation metrics of EV/revenue, EV/EBIT and P/E, the trend has softened with current levels close to historical lows.

Exhibit 20: EV/revenue FY15–22e

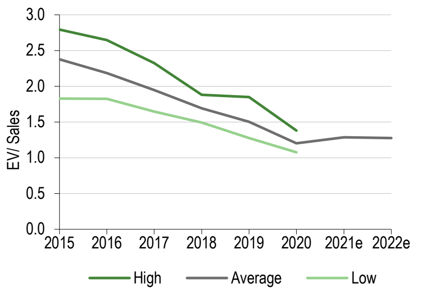


Exhibit 21: EV/EBIT FY15–22e

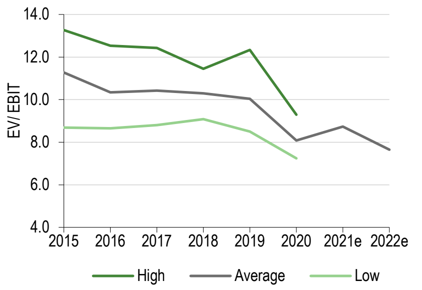
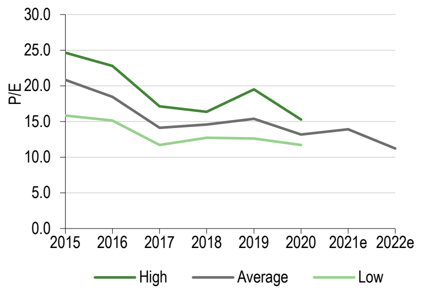


Exhibit 22: P/E FY15–22e



Source: Refinitiv

Peer comparison

The strong rise in Dentsu's share price year to date has more than recouped the fall that it suffered in 2020. Our view is that reflects several factors, but notably the stronger balance sheet post the partial sales of the Recruit holding, buoyed by expectations regarding the potential sale and leaseback of the headquarters building (now confirmed as under consideration). We appraise Dentsu's valuation compared with the other key holding companies and its largest Japan-based competitor.

Exhibit 23: Global holding company and Japan-based peers

	Price	Market cap	YTD	EV/sales (x)	EV/EBITDA (x)			P/E (x)			Dividend yield
Company	**(local CCY)**	**(US$m)**	**(%)**	**CY20**	**CY20**	**CY21**	**CY22**	**CY20**	**CY21**	**CY22**	**(%)**
Omnicom	US$68	14,546	8.5	1.1	7.4	6.7	6.5	13.7	11.9	11.0	3.8
WPP	843p	14,472	5.3	1.4	9.5	8.2	7.4	14.7	11.9	10.1	0.0
Interpublic	US$26	9,969	8.7	1.4	9.4	7.7	7.2	15.3	13.3	11.9	4.0
Publicis	€48	14,163	17.1	1.5	7.2	6.6	6.4	12.2	10.8	10.2	4.2
Hakuhodo	¥1818	6,440	28.5	2.0	12.2	10.6	9.1	26.6	27.4	21.7	1.7
Peer average			**13.6**	**1.5**	**9.2**	**7.9**	**7.3**	**16.5**	**15.1**	**13.0**	**2.7**
Dentsu	¥3670	9,700	19.7	1.3	12.0	16.4	6.8	14.8	13.6	11.0	1.9
Premium/(discount)			**6%**	**-13%**	**31%**	**106%**	**-8%**	**-11%**	**-10%**	**-16%**	**-29%**

Source: Refinitiv, Edison Investment Research. Note: Prices at 17 February 2021.

On an EV/EBITDA basis, Dentsu's shares are valued broadly in line with its peers for calendar 2022. For 2021, viewed by management as a transition year, it is trading ahead of the pack.

DCF points to higher value

As shown in the exhibit below, a DCF at various WACCs and terminal growth rates would mostly indicate higher values. Selecting an industry-typical terminal growth rate of 1% and a WACC of 10%, the DCF derives a value of ¥4,199, 14% above the current level.

Exhibit 24: DCF at various WACCs, terminal growth rates

		Terminal growth rate				
		0.0%	1.0%	2.0%	3.0%	4.0%
WACC	11.5%	3,254	3,419	3,619	3,867	4,180
	11.0%	3,461	3,651	3,884	4,174	4,547
	10.5%	3,690	3,910	4,181	4,524	4,972
	10.0%	3,944	4,199	4,517	4,925	5,470
	9.5%	4,227	4,524	4,900	5,391	6,061
	9.0%	4,544	4,892	5,340	5,937	6,773
	8.5%	4,900	5,312	5,850	6,585	7,646
	8.0%	5,304	5,795	6,449	7,366	8,741

Source: Edison Investment Research

Financials

With the FY20 results, Dentsu's management set out a clear financial framework to drive shareholder value over the four years from FY21 to FY24 inclusive. This includes three key earnings-based targets:

- Revenues derived from Customer Transformation & Technology to grow from the 28% achieved in FY20 to 50% of group.
- An organic growth rate of 3–4% CAGR for the four years FY21–24.
- Year-on-year improvement in operating margin across FY21–24.

FY20: A difficult trading year

Exhibit 25: Organic % growth by quarter, FY20

Segment/ region	% group revenues less passthrough costs	Q120	Q220	Q320	Q420	FY20
DJN	**42**	**+2.1**	**(12.6)**	**(14.7)**	**(9.9)**	**(8.4)**
Americas	26	+1.2	(17.1)	(15.3)	(13.0)	(11.3)
EMEA	22	(0.4)	(20.2)	(12.9)	(14.4)	(12.4)
APAC	10	(19.5)	(26.4)	(16.4)	(10.9)	(18.0)
DI	**58**	**(3.3)**	**(20.0)**	**(14.6)**	**(13.2)**	**(13.0)**
Dentsu Group		**(0.8)**	**(17.3)**	**(14.8)**	**(11.6)**	**(11.1)**

Source: Company accounts

Q220 was the most difficult trading quarter for the group, with an easing across the rest of the year, albeit with regional variations. At DJN, revenues were supported by strong demand for digital solutions, with both iSiD and Dentsu Digital growing revenues organically by double digits. At DI Americas, the digital and customer experience practices performed well (where investment is being focused, including at Merkle) but there was weakness in media spend and the creative practice. The EMEA performance remained soft as the year progressed with gains in CXM and creative more than offset by COVID-19-related weakness in demand for out-of-home and experiential campaigns. The smaller APAC region varied by geography but again had a good contribution from CXM.

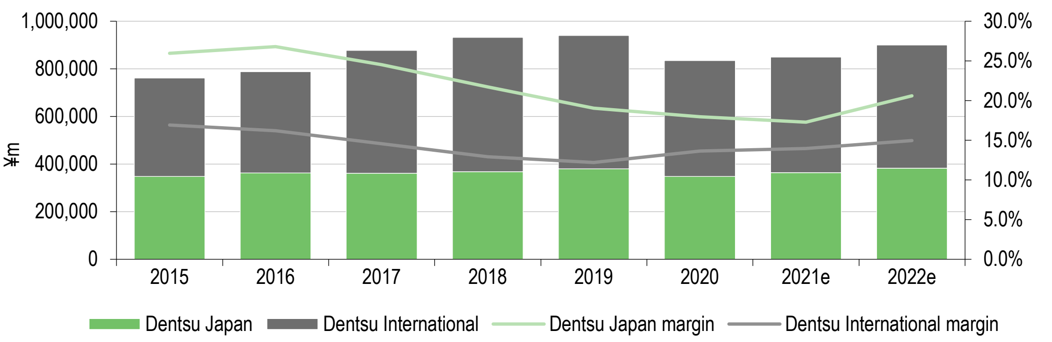
We expect Q121 to continue to be difficult, given stronger comparatives, with like-for-like growth rates then starting to improve. Our modelling suggests revenue less cost of sales growing by 3.6% over FY21, with DI growing slightly faster than DJN. Management guidance is for organic revenue growth at a CAGR of 3–4% over the period FY21–24. Our modelling is slightly more conservative, given the number of moving parts and uncertainty regarding the shape of the post pandemic economic recovery.

Route for growth and margin expansion

As shown in the exhibit below, DJN historically benefited from high operating margins, reflecting its dominant market position and its business mix, with a heavy weighting to television. These margins were self-evidently not sustainable as the Japanese market moves into closer alignment with other markets. Management is now targeting ¥21bn of annualised cost reductions through to FY22, at a cost of around ¥50m, spread ¥24bn in FY20, ¥23bn in FY21 and ¥3bn in FY22 There are two elements to this programme: an HR element, focused on a voluntary early-retirement scheme and other HR initiatives designed to give greater flexibility to the cost base; and a property element that will look to optimise working practices, including at the headquarters in Shiodome, Tokyo. It is this flagship building that is being considered for sale and leaseback.

The restructuring is more substantial at DI, as outlined in the transformation plan published in December 2020. The earlier acquisition programme was designed to build the group's competencies but was not sufficiently focused on integrating those acquisitions with any coherence. The published plan is to reduce ex-Japan headcount by 12.5%, equating to around 6k people. Annualised savings of ¥55bn from the end of FY21 are expected, at an estimated cost of ¥88bn, of which ¥56bn was taken in FY20, with the balance of ¥32bn falling into FY21. This should enable the underlying operating margins to expand as illustrated below, with our model indicating a broadly flat margin FY21 on FY20 at 14.7% versus 14.8%, increasing to 16.7% in FY22, as the benefits of the cost cutting and the reorientation of revenues toward higher-margin activities start to kick in.

Exhibit 26: Revenue less passthrough costs and margins by segment, FY15–22e



Source: Company accounts, Edison Investment Research

Strengthened balance sheet

The group remains well capitalised, with a strong balance sheet and a AA- credit rating from Japan's Rating and Investment Information. While a full balance sheet for FY20 has not yet been published, the group cash flow statement shows a reduction in net debt of ¥155.7bn from ¥209.9bn at end FY19 to ¥56bn at end FY20. Key changes include an adjustment arising from the disposal of the majority of the stake in Recruit Holdings, initiated by the strategy to unwind holdings in non-trading security assets. We have also adjusted intangible assets in our model for the reported impairment charge of ¥145bn, mostly against DI assets.

Full details of the balance sheet will be available when the full accounts are published (expected in March 2021). Our balance sheet and cashflow estimates modelled in Exhibit 27 incorporate the selected figures already published. Although management has announced the intention to buy back shares up to a value of ¥30bn, we will only include this in our modelling when it happens.

Capital allocation between investment and shareholder returns

The group intends to maintain a strong balance sheet, with a medium-term average leverage target of 1.5x net debt/EBITDA. Our modelling puts this ratio at under 0.7x for the next couple of years but, as indicated, this does not account for the buyback, which would lift the ratio to 1.0x. This implies there is still plenty of potential to increase levels of investment in the business, both to fuel organic growth and drive further acquisitions. We would expect these would be fewer and larger than most of the activity over the last few years in the light of the group's structural simplification strategy. Given the ambitions to grow Customer Transformation & Technology towards half of group revenues, it seems likely this area will be the focus for transactions.

Management is adopting a progressive dividend policy (to grow the payout ratio to 35% of adjusted EPS over the next few years); our modelling shows a pay-out ratio on this basis of 29% in FY21 and 30% in FY22.

In 2019, Dentsu carried out share buybacks of approximately ¥30bn. The newly announced programme targets the same sum. Additional shareholder returns would be likely to be made after exceptional asset sales, for example in the case of any capital realisation from the sale and leaseback of the headquarter building.

Exhibit 27: Financial summary

¥'m	2018	2019	2020	2021e	2022e
Year end 31 December	IFRS	IFRS	IFRS	IFRS	IFRS
INCOME STATEMENT					
Revenue	1,018,512	1,047,881	939,243	954,424	1,010,255
Cost of Sales	(85,832)	(108,496)	(104,201)	(104,424)	(110,255)
Revenue less pass through costs	932,680	939,385	835,042	850,000	900,000
EBITDA	171,404	160,279	90,061	65,966	159,866
Normalised operating profit	153,229	140,751	123,979	125,000	150,000
Amortisation of acquired intangibles	(35,123)	(34,806)	(31,877)	(31,877)	(31,877)
Exceptionals	(2,149)	(99,733)	(229,629)	(54,500)	(3,000)
Share-based payments	(4,313)	(9,568)	(3,094)	0	0
Reported operating profit	111,638	(3,358)	(140,625)	(20,000)	73,900
Net Interest	(17,714)	(42,103)	(1,419)	(290)	(290)
Joint ventures & associates (post tax)	2,699	517	910	0	0
Exceptionals	52,128	2,175	0	0	0
Profit Before Tax (norm)	190,342	101,340	123,470	124,710	149,710
Profit Before Tax (reported)	148,751	(42,769)	(141,134)	(20,290)	73,610
Reported tax	(51,250)	(30,136)	(11,162)	7,304	(25,764)
Profit After Tax (norm)	107,321	86,653	78,177	79,814	97,312
Profit After Tax (reported)	97,501	(72,905)	(152,296)	(12,986)	47,847
Minority interests	(7,185)	(7,987)	(7,299)	(2,500)	(2,500)
Discontinued operations	0	0	0	0	0
Net income (normalised)	97,420	76,122	69,891	76,314	94,812
Net income (reported)	90,316	(80,892)	(159,595)	(15,486)	45,347
Basic average number of shares outstanding (m)	282	281	279	282	282
EPS - basic normalised (¥)	346	271	250	271	337
EPS - diluted normalised (¥)	346	271	249	269	335
EPS - basic reported (¥)	320	(288)	(571)	(55)	161
Dividend (¥)	90	95	71	77	100
Net revenue growth (%)	6.3	0.7	(11.1)	1.8	5.9
EBITDA Margin to revenue less pass-through costs (%)	18.4	17.1	10.8	7.8	17.8
Normalised operating margin to revenue less pass-through costs (%)	16.4	15.0	14.8	14.7	16.7
BALANCE SHEET					
Fixed Assets	1,702,899	1,862,033	1,470,891	1,449,925	1,428,959
Intangible Assets	1,036,772	1,000,313	800,551	776,674	752,797
Tangible Assets	199,207	315,116	318,027	320,938	323,849
Investments & other	466,920	546,604	352,313	352,313	352,313
Current Assets	1,935,586	1,933,691	1,864,322	1,969,055	1,963,896
Stocks	28,580	21,007	25,574	25,629	27,060
Debtors	1,368,728	1,424,127	1,149,481	1,242,059	1,291,269
Cash & cash equivalents	416,668	414,055	602,123	614,223	558,423
Other	121,610	74,502	87,144	87,144	87,144
Current Liabilities	(1,785,608)	(1,859,224)	(1,864,722)	(1,979,585)	(1,927,545)
Creditors	(1,341,461)	(1,390,778)	(1,014,420)	(1,214,493)	(1,162,453)
Tax and social security	(42,981)	(17,689)	(13,171)	(13,171)	(13,171)
Short term borrowings	(104,879)	(184,816)	(141,342)	(141,342)	(141,342)
Other	(296,287)	(265,941)	(695,789)	(610,579)	(610,579)
Long Term Liabilities	(742,129)	(883,971)	(844,138)	(844,138)	(844,138)
Long term borrowings	(433,979)	(439,110)	(517,081)	(517,081)	(517,081)
Other long term liabilities	(308,150)	(444,861)	(327,057)	(327,057)	(327,057)
Net Assets	1,110,748	1,052,529	626,353	595,257	621,172
Minority interests	63,129	77,556	63,483	65,983	68,483
Shareholders' equity	1,173,877	1,130,085	689,836	661,240	689,655
CASH FLOW					
Op Cash Flow before WC and tax	208,490	47,198	(55,168)	65,676	159,576
Working capital	7,866	(28,254)	(22,540)	107,440	(102,681)
Exceptional & other	(35,011)	148,452	183,007	290	3,290
Tax	(48,296)	(87,439)	(47,825)	7,014	(26,054)
Net operating cash flow	133,049	79,957	57,474	180,420	34,132
Capex	(31,322)	(31,000)	(19,947)	(15,000)	(15,000)
Acquisitions/disposals	(50,555)	(47,860)	(37,477)	(103,210)	(18,000)
Net interest	0	0	0	0	0
Equity financing	(12)	(20,008)	(10,004)	0	0
Dividends	(32,055)	(30,031)	(29,575)	(18,110)	(24,932)
Other	10,768	(35,674)	158,065	(32,000)	(32,000)
Net Cash Flow	29,873	(84,616)	118,536	12,100	(55,800)
Opening net debt/(cash)	154,752	122,190	209,870	56,300	44,200
FX	(18,281)	1,490	11,730	0	0
Other non-cash movements	20,970	(4,554)	23,304	0	0
Closing net debt/(cash)	122,190	209,870	56,300	44,200	100,000

Source: Company accounts, Edison Investment Research. Note: FY20 Recruit share disposal proceeds included in ‘Other’.

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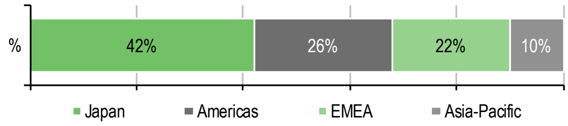
Revenue by geography



Management team

President and CEO: Toshihiro Yamamoto

Toshihiro Yamamoto was appointed president and CEO in January 2017, having previously held the positions of senior vice president from 2016 and executive officer from 2011. He is the first Dentsu president to have led all of the previous domestic business domains.

Executive vice president and director: Tim Andree

Tim Andree first joined Dentsu in 2006 as CEO of Dentsu America and was named Dentsu's first non-Japanese executive officer in 2008. Tim has led a number of acquisitions and played a key role in the acquisition of Aegis Group in 2013, Dentsu's largest transaction to date. He has also held senior marketing positions at Toyota, Canon, BASF and the National Basketball Association.

Dentsu International CEO: Wendy Clark

Wendy Clark joined as global CEO for the international business in September 2020, having previously held senior leadership positions at DDB Worldwide, Coca-Cola North America and AT&T. Described as 'one of the most important women in advertising' by Advertising Age, Wendy has earned numerous recognitions over the course of her career.

Director and CFO: Yushin Soga

Yuhsin Soga has been a director at Dentsu since March 2017, bringing operational experience in the contents sector as well as in finance and accounting. Since he was appointed CFO, Yushin has contributed to the improvement in corporate value and promotion of corporate reforms.

Principal shareholders	(%)
The Master Trust Bank of Japan	12.8
Kyodo News	6.9
Japan Trustee Services Bank	59
Jiji Press	5.8
Japan Trustee Services Bank (Trustee Account 9)	3.2

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