Yale
School of
Management

Cordiant Communications Group (NYSE: CDA)

Advertising and Marketing Services Industry

RECOMMENDATION: BUY

December 3, 2001

Market Cap:
$474MM (5 ADRs = 1 share)
Current Price:
$6.50
52-week price range:
$4.14 - $22.00
Dividend Yield:
2.5%
Valuation Price:
$7.50

Summary:
Cordiant Communications Group is a global creative communications group. Known for its expertise in consumer research and understanding, the Group comprises of: Bates Worldwide, one of the largest advertising and integrated communications networks in the world; Scholz Friends, the largest multi-national advertising network headquartered in Germany; HP:ICM, specializing in live communications; Healthworld Corp., the world's 3rd largest specialist healthcare marketing group; and CCG.XM, which provides global e-business solutions worldwide.

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Investment Summary

We are initiating a buy recommendation for Cordiant Communications Group. The stock is currently trading at a 15.4% discount to fair value. We are bullish on this company for the following reasons:

- CCG's renewed emphasis on cutting costs as well as its specific programs to this effect is a positive sign.
- CCG has a growing foothold in Asia and other emerging markets.
- CCG is diversifying its revenue mix.
- CCG is widely believed to be on the verge of merging with or being bought by another advertising giant.

For the above reasons, we believe that the current stock price is unjustifiably low and that investors can buy into distress driven value.

	2001E	2002E	2003E	2004E
EPS	-$0.03	$0.14	$0.54	$0.57

Explanation of Ratings

Strong Buy:	*Valuation Price > 20% of current price*
Buy:	*Valuation Price > 10% -20% of current price*
Hold:	*Valuation Price +/– 10% of current price*
Sell:	*Valuation Price < 10% of current price*

Disclaimer:

Please see the disclaimer at back of this report for important information.

Business and Strategy

A Public Limited Company organized in England in 1977, Cordiant Communications Group (CCG) represents the ongoing businesses of Cordiant PLC post the demerger of Saatchi & Saatchi Group. Its global marketing and communications activities are organized into Bates Worldwide, Diamond Ad Ltd., Sholz Friends, Business Communications International, Branding and Design, CCG.XM, and Zenith Media. Major clients include: Hyundai, Lycos Korea, Mercedes Trucks, Wyeth-Ayerst Laboratories, Vodafone, and Compaq Computer Asia.[1] The Company has approximately 10,000 employees. Its subsidiaries imparted some of life's most important lessons: "M&M's melt in your mouth, not in your hands" and "Certs are two, two, two mints in one," among others. Through its subsidiaries, CCG is committed to pursuing its strategic objectives – to consolidate its leading positions in healthcare marketing, branding and design and business communications and further enhance its total positions in marketing services and specialist communications – by both organic growth and acquisitions. The expertise of its subsidiaries covers:

Bates Worldwide – a leading global communications networks

- Bates is the only agency within CCG that was named as one of the top 15 U.S. agencies by worldwide gross income for 2000[2] and was awarded in international competitions for creative ability.
- CCG heavily relies on Bates for business growth with more than 85% of its sales generated through its Bates Worldwide advertising unit (responsible for slogans for both the colored candies and the breath mints).
- **CCG's strategy is to capitalize on Bates' core strengths to achieve cross-selling between CCG's network to provide a significant opportunity to enhance organic revenue growth. For example, 141 Worldwide and CCG.XM were developed on revenue opportunities sourced from the client base of Bates Worldwide.**
- Bates has a strong presence around the world with emphasis on the North American and European markets. This allowed Bates to achieve tremendous growth before 2001. **But now, its growth is restricted by economic recession in these markets.**

[1] Wright Investor Services. November 23, 2001
[2] Bear, Stearns & Co. Inc.; Advertising Age, July 2001

141 Worldwide – the marketing communications network of Bates with expertise in sales promotion, direct marketing, event, sports and entertainment marketing, customer relationship management and merchandising

- Its global network works for more than 500 clients and generates more than 60% of revenue from multinational clients.
- 2000 was an exciting year with expansion through both new business activity and strategic acquisitions. For example, new offices were establishment and small agencies were acquired in UK, Latin America, Asia and Australia.
- In the first half of 2001, 141 Worldwide invested in seven start-ups.
- **Growth in UK is now restricted by client cutbacks.**

Scholz & Friends – the largest German-based multinational advertising and integrated communications network operating in 14 countries across Europe and Asia

- Known for its creativity, Scholz & Friends has a powerful client network in Europe. One of its biggest accounts is Mercedes-Benz.
- Like other agencies with CCG, it experienced a strong growth in 2000 through new business wins and new acquisitions. But now, it is experiencing setbacks as the European economy is slowing down.
- **The on-going merger with United Visions Entertainment could be a new source of long-term growth for the agency.**

Diamond – Korea's second largest advertising agency by revenue delivering integrated marketing communications to clients.

- Diamond benefited from the boom of the Korean advertising market in 2000, as clients increased spending following the recovery from the economic recession of the late 1990s.
- **Sports marketing is becoming an increasingly important revenue driver, especially since Diamond's major client, Hyundai Motor Company, is the official worldwide sponsor for the 2002 FIFA World Cup.**
- **The economic slowdown in Korea in the first half of 2001 induced the agency to reduce headcount. But in the long run, Diamond is positioned to be a significant growth driver for CCG, as the potential for growth in the Korean market remains relatively strong as compared to other established markets.**

Bates Healthworld – an international healthcare marketing and contract sales organization

- **As a new division of Bates Worldwide**, the agency is charged with the responsibility to strengthen CCG's network in the healthcare market.

- **Geographic expansion is expected to continue in Latin America and Asia.**
- **The prospect of developments such as genetically led scientific discoveries, increased consumer demand and the growth of non-pharmacological alternatives will present new opportunities for the agency, driving the growth of CCG.**

CCG.XM – offers a range of Internet-related services including strategic consulting, digital brand creation, website development, systems integration and online marketing.

- Leveraging the existing network of Bates, CCG.XM grew substantially in 2000 in the US, Europe, Asia, the Middle East and Australia. It derives around two-thirds of its revenue from outside the US.
- **However, the meltdown of technology industry, a major client of CCG.XM, limits the growth opportunities, especially in the US and European markets.**
- CCG.XM has been trying to diversify its client base by reaching out to other types of clients. For example, it has won several contracts from the Royal Family and the Government in UK for website development and strategic consulting.
- **In the long run, it could be another strong driver of growth for CCG, as online advertising remains an attractive media options for advertisers.**

Business Communications International – Created after CCG acquired Lighthouse in 9/00, it offers financial and corporate public relations, internal communications, M&A communications and investor relations

- The US and European markets are the agency's key target markets. In 2000, the agency acted for clients in a number of high profile M & A transactions including Vodafone for Mannesmann and Royal Bank of Scotland for Natwest.
- **In 2001, with the overall economic slowdown and the deadlock in worldwide M & A activities, the agency is poised to post weak growth in the near future.**

FITCH – expertise in branding and design

- As part of CCG's strategy of establishing leading positions in marketing communications, CCG consolidated the network under FITCH umbrella brand.
- Examples of the agency's work include new telephone products for Swatch, "Trium" for Mitsubishi and programme identities for Charles Schwab.
- **Significant reduction in the cost base to reflect business slowdown.**

Zenith Media – a joint venture operation owned equally by CCG and Saatchi & Saatchi, part of Publicis Groupe SA offering media communications services: buying, planning, evaluating and coordinating clients' media spending

- CCG holds 25% stake in Zenith Media while Publicis owns 75%.
- It has achieved strong new business performance with revenue increase by 25% in the first half of 2001.
- Some of the strong clients are HSBC, ExxonMobil and Verizon. In Asia, Zenith Media remains the defining media agency with #1 rankings in Australia, China, Malaysia, Singapore and Cambodia.
- Zenith has continued its diversification into new media areas, notably in online and in direct response to provide complete communications solutions.
- **The on-going merger with Zenith and Optimedia creating the world's fourth largest media communications group could be a new source of long-term growth for the agency.**

The September 11th Effect

Following the events of September 11, 2001 shares of CCG fell nearly 40% after widespread cancellations of projects and campaigns from clients including Singapore Airlines and the failed carrier, Ansett Airlines.[3] Group CEO Michael Bungey warned that the company expects revenues to fall 5% for the year. All areas of business and geographic regions are expected to suffer, and some analysts have hinted at a 50% reduction in forecasted profitability for the year.[4] Previously this year, CCG announced a charge of $10MM will result from a cost-reduction plan. This cost-reduction program is in progress. The company will revaluate where it will focus it reductions once clients can better determine their needs in the aftermath of September 11. Around 700 of CCG's approximately 10,000 jobs have thus far been cut.

[3] Financial Times. September 28, 2001
[4] AFX News. September 28, 2001

Growth Opportunities

Organic Growth

In the advertising industry, new business trends serve as a leading indicator for organic growth. CCG recognizes that new business is essential to its growth and is indicative of the underlying health of the Company's operations. However, **CCG is in a relatively weak position to stay "healthy" in the near term.** According to its interim financial review, net new business for the first six months of 2001 amounted to $300MM, reflecting 0% year-to-year growth.

Exhibit 1: Net new business wins for first half of 2001 and 2000

	H1 2001	H1 2000
Wins	500	380
Losses	(200)	(80)
Net	300	300

Source: CCG's interim results presentation.

For 3Q01 in particular, CCG fared worse than its competitors given the extremely tough advertising and economic climate since September 11. About $20MM new business was lost in the 3Q alone, while Havas and Grey had positive results (**Exhibit 2**). It is also estimated that around $9MM business will be lost in the near future. Therefore it is expected that **the organic growth for 2001 will decrease form -8% to -9% while 2002 will be flat.**[5]

Exhibit 2: New Business Win Compilation for 3Q01 (US$MM)

Rank	Agency	Billings Won/(Lost)	Revenues Won/(Lost)	New Business Won/(Lost)
1	WPP	608	61	404
2	Omnicom	321	81	258
3	Havas	171	17	138
4	Grey	309	20	123
5	Publicis	221	6	43
6	Cordiant	(85)	(3)	(20)
7	Bcom3	(68)	(6)	(38)
8	Interpublic	(530)	(70)	(493)
N/A	Independents	270	24	110

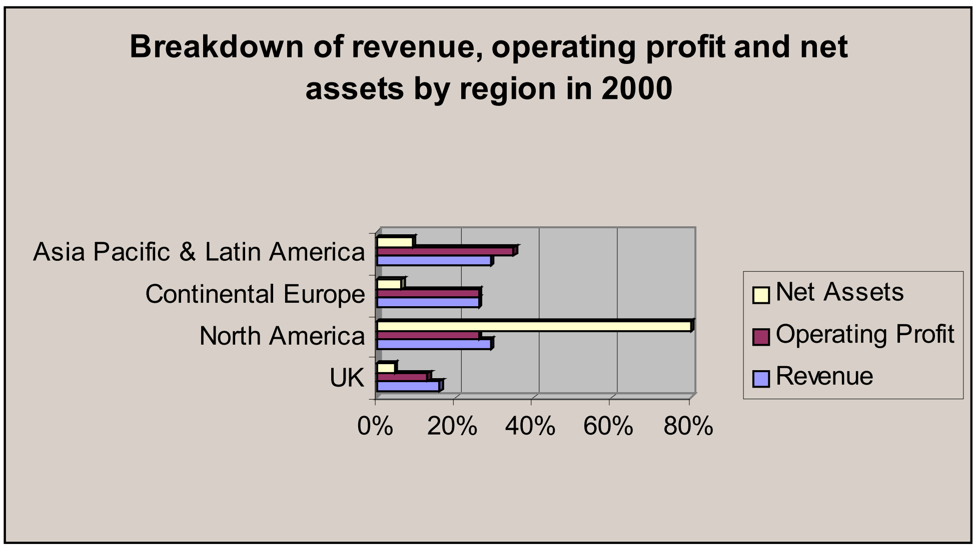
Source: Pile and Company, Morgan Stanley Research.

[5] Merrill Lynch Flash Note, November 6, 2001

International Growth

CCG derives over two-thirds of its revenue and operating profit from the US and European markets (Exhibit 3). According to CCG's annual report, Europe and North America have been the key markets only because they are the world's largest markets for communications but also because an even greater proportion of global spending by multinational clients is controlled from these regions.

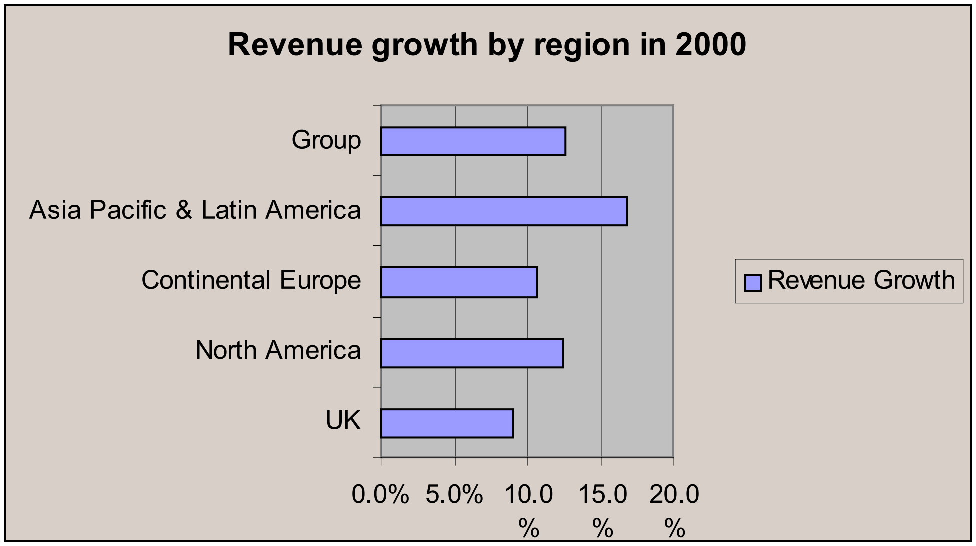
Exhibit 3



Source: CCG's 2000 Annual Report

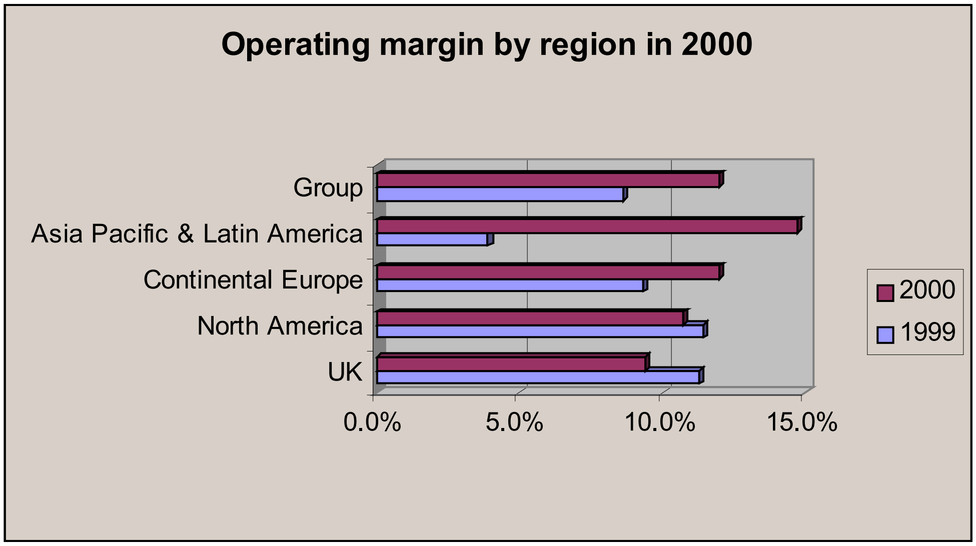
Prior to 2000, such geographical concentration produced satisfactory results. As shown in **Exhibit 4**, all regions except UK posted double-digit growth in 2000 through new business wins and acquisitions. Subsidiaries such as 141 Worldwide, Scholz & Friends, Diamond and CCG.XM, which have a strong presence in either Europe or Asia Pacific, contributed to such growth. **In terms of profitability, however, continental Europe, Asia Pacific and Latin America grew at a faster pace than North America and Europe, where reduction in operating margin was evident (Exhibit 5).**

Exhibit 4



Source: CCG's 2000 Annual Report

Exhibit 5



Source: CCG's 2000 Annual Report

With a heavy concentration in North America and Europe but a slower revenue growth and a narrower operating margin in these regions, 2001 would be a tough year for CCG since these regions are hardest hit by recession. Management has recognized the uncertainties associated with this concentration risk and has initiated cost control in these regions on the one hand, while continued building its franchises in Eastern Europe and Asia, where growth is the strongest. **This strategy may produce potential benefits that will be realized and reflected in the financials in the near term. The long-term growth of CCG will depend on its ability to control its costs effectively and to leverage its existing Bates' network in the emerging markets.**

Growth from acquisitions

As with most advertising conglomerates, acquisitions form a key growth component. Amid increasing consolidation in the advertising industry, CCG is widely believed to be on the verge of merging with or being bought by another advertising giant.[6] In the meantime, it is fattening itself through acquisitions. In particular, **during 2000, CCG completed two major acquisitions that have transformed it into a broadly based communications group, adding $625.7MM to intangible assets.** March 2000 saw the completion of the acquisition of Healthworld Corporation, significantly increasing the Company's exposure to the rapidly growing healthcare sector. At the same time, the Company's strategic goal of increasing the business mix in favor of marketing communications led to the acquisition in September 2000 of Lighthouse Global Network. Lighthouse has significantly enhanced the Company's range of services, adding two new global business streams, FITCH and Business Communications International, and strengthening the sports marketing, event marketing and sales promotion capabilities of 141 Worldwide. **It is believed that the 31% increase in revenue versus 1999 was largely attributable to such acquisition activities.**[7]

In 2001, the Company merged Zenith Media Worldwide with Publicis Groupe's Optimedia (CCG owns 25%, Publicis 75%) as well as combined Scholz & Friends with United Visions Entertainment.

[6] Hoover's Online

[7] Wright Investors' Service, November 23, 2001

While new acquisitions have brought stronger growth to the Company over the years, the downside risks are integration charges and cultural issues associated with the acquisitions. Such costs could be significant, as evidenced by Interpublic where huge expenses were incurred in its integration with True North and in WPP, which is struggling with its lawsuit relating to its acquisition of Tempus Group. Increased headcount also significantly rose staffing costs, the largest component of operating expenditure. **CCG's staffing cost/revenue ratio amounts to around 70% at present, which is higher than the industry average of 60%. It is estimated that CCG will need to take a further restructuring charge of around $7MM in the second half of 2001, of which some should be due to the potential integration of CCG.XM into 141 Worldwide.** The attached cost savings of $8.5MM will not be realized until 2002 at the earliest.[8] Management will be challenged to capitalize on growth opportunities generated through acquisitions while keeping additional expenses at a manageable level.

We believe that, despite the above analysis, growth through acquisitions remains to be a viable way for CCG to excel given its weak organic growth. Strategic acquisitions on the marketing services side, which is more cyclical-resistant, should help diversify CCG's revenue streams functionally and geographically. We also view that, through Bates HealthWorld, CCG.XM and Diamond, CCG is well positioned in the long run to take advantage of the continual growth in healthcare marketing, Internet advertising and the emerging markets. The question is whether CCG will be able to translate such growth opportunities into real money in a reasonable amount of time. For now, such growth potential will be reflected in CCG's financial statements on a gradual basis.

Risks

Loss of Key Accounts

Loss of key accounts would have a significant downward impact on agencies' stocks. Clients may shift accounts from agency to agency in order to consolidate costs to one agency (reduced transaction costs) or may spread different products across different agencies (increased bargaining power). They can also shift accounts as a result of dissatisfaction, or to solicit fresh new ideas.

[8] Merrill Lynch, November 6, 2001

There are certain "in review" accounts for CCG that we are aware of (**Exhibit 6**). The accounts that are currently "in review" mean that an advertiser is soliciting new creative ideas from its current agency and from new agencies. Studies have shown that an incumbent agency only has a 5% chance of retaining the account.[9] This makes sense since it would be unlikely that an advertiser would put an account in review if it were pleased with the creative work of the incumbent.

Exhibit 6: Net Potential New Business Wins (US$MM)

			(-)			(+)			(=)
Rank	**Agency**	**Billings in Review**	**Potential Revenue Loss**	**Potential New Business Loss**	**Potential New Billings**	**Potential Revenue Gain**	**Potential New Business Wins**	**Net Potential New Revenue**	**Net Potential New Business**
1	Bcom3	13	0	**3**	1205	14	**94**	14	**91**
2	Publicis	355	15	**101**	755	18	**112**	3	**12**
3	Havas	56	7	**44**	265	8	**56**	2	**11**
4	Cordiant	18	2	**14**	32	1	**5**	(1)	**(9)**
5	WPP	674	17	**94**	220	7	**43**	(10)	**(51)**
6	Grey	155	16	**106**	299	8	**53**	(8)	**(53)**
7	Inter-public	966	51	**283**	1282	20	**126**	(31)	**(157)**
8	OMC	480	46	**304**	1096	23	**145**	(22)	**(159)**
N/A	Other	468	55	**241**	1016	34	**174**	(21)	**(67)**

Source: Pile and Company, Morgan Stanley Research.

Potential new business that could be at risk in 4Q01 for CCG is relatively modest. It potentially has about $9MM in net account losses going forward. This further confirms our belief that the Company will not achieve attractive organic growth in the short term.

Purchase versus Pooling Accounting

FASB Statement No. 141 concerning "Business Combinations" effective June 30, 2001 and FASB Statement No. 142 concerning "Goodwill and other Intangibles" effective January 01, 2002 eliminates pooling accounting in stock-swap mergers. While once able to avail themselves of amortizing goodwill and bit-by-bit earnings write-offs, this will no longer be the case. Private bidders, including LBO firms, will now be able to bid on a "level playing field"[10] perhaps causing CCG and other companies to lose potential acquisition targets as they will have to lower their bids in anticipation of earnings hit from the amortization of goodwill created. Growth from acquisitions may slow down.

[9] Morgan Stanley Research
[10] "The end of pooling", The Daily Deal, August 30, 2001.

Decelerating ad spending

Stocks in this sector track with broader indices (**Appendix 1**) and the US GDP (**Appendix 2**). Bleak macroeconomic conditions including reducing consumer spending (**Appendix 3**) may adversely affect CCG.

Currency Fluctuation

The effects of currency fluctuations, currently hedged using forward foreign exchange derivative contracts, may become problematic. Changes in the foreign exchange value of the US$ may impact revenue growth given that CCG derives around one-third of its revenue from US.

Cyclicality

Some level of volatility comes as a consequence of higher revenues in the second and fourth quarters pursuant to the requirements of corporate clients. Investors should expect some degree of cyclical movement through the calendar year.

Loss of accounts due to consolidation activities

Increasing size may bring some limitation to the company's potential for securing new business, mainly because clients prefer not to be represented by an agency that also represents a competitor.

Legislation

Representatives within certain government bodies, both domestic and foreign, continue to initiate proposals to ban the advertisement of specific products and to impose taxes on or deny deductions for advertising, which if successful, may have an adverse effect on advertising expenditure.

Ratio Analysis

Ratio Analysis: Where should the focus be?

	CDA	IPG	WPP	OMC	HADV	Industry
Return on Equity	1.49	-22.44	13.01	30.88	1.84	10.81
EBITDA Margin	3.2	-0.87	14.27	17.79	9.98	12.46
Operating Margin	2.62	-2.67	14.15	14.03	6.97	4.31
Net Profit Margin	1.68	-6.49	8.83	7.74	1.84	0.79
Receivables Turnover	5.94	1.33	4.96	1.86	1.52	3.08
Debt/Equity (MRQ)	0.44	1.02	0.24	1.29	0.34	1.15
Cash per Share	0.94	Neg.	2.89	4.15	0.55	N/A
1999 to 2000 growth	39.5	-0.46	59.39	14.81	46.18	8.09

Source: Business Browser

CCG's relative low ROE indicates that there may be an opportunity to drive return by improving company profitability. First, CCG is using leverage relatively well. WPP's cash per share is almost three times CCG's although its Debt/Equity is roughly half of CCG's. We would call into question any attempt by management to increase its debt. Second, CCG is using its assets relatively efficiently. Receivables turnover, one indicator, is more than four times IPG's. Where CCG falls short is in its profitability, especially in its relatively low EBITDA margin. Although COGS expense does not vary much across advertising companies, SGA expense does. Any improvement in SGA expense would directly feed into the bottom line, and there is considerable room for improvement. CCG's renewed emphasis on cutting costs as well as its specific programs to this effect is a positive sign. **We expect management to deliver on its cost cutting targets through to 2004, ensuring steady long run return for investors.**

Stock Performance and Volatility

<u>Summary</u>
Price (November 30, 2001): $6.5
52-week range: $4.14 - $22
1-Year Performance: -61.68%, S&P500 –12.21%, S&P specialized services +3.68%
Dividend: $.17 per share
P/E: N/A

<u>Beta</u>
Vs. S&P 500 = 1.4

Valuation Model

DCF Analysis

	Probability	2001E	2002E	2003E	2004E	2005E	2006E	2007E	2008E	2009E	2010E	2011E
High Growth Model	**10%**											
Revenue Growth Rate		-5.00%	5.00%	7.00%	10.00%	10.00%	7.00%	7.00%	7.00%	6.00%	5.00%	4.00%
Gross Margin		3.00%	6.00%	11.00%	15.00%	15.00%	15.00%	15.00%	15.00%	15.00%	15.00%	15.00%
EPS		$0.09	$0.31	$0.69	$1.05	$1.10	$1.13	$1.16	$1.19	$1.21	$1.22	$1.22
Value per share		**$12.15**										
Moderate Growth Model	**20%**											
Revenue Growth Rate		-6.00%	4.00%	5.00%	6.00%	7.00%	6.00%	6.00%	6.00%	6.00%	4.00%	4.00%
Gross Margin		2.00%	5.00%	10.00%	10.00%	13.00%	13.00%	13.00%	13.00%	13.00%	13.00%	13.00%
EPS		$0.02	$0.23	$0.59	$0.60	$0.83	$0.84	$0.86	$0.87	$0.88	$0.88	$0.88
Value per share		**$8.26**										
Slow Growth Model	**70%**											
Revenue Growth Rate		-7.00%	3.00%	4.00%	5.00%	6.00%	6.00%	6.00%	6.00%	5.00%	4.00%	4.00%
Gross Margin		1.00%	3.00%	9.00%	9.00%	12.00%	12.00%	12.00%	12.00%	12.00%	12.00%	12.00%
EPS		-$0.06	$0.08	$0.50	$0.50	$0.72	$0.72	$0.73	$0.75	$0.75	$0.75	$0.75
Value per share		**$6.62**										
Fair value per share		**$7.50**										

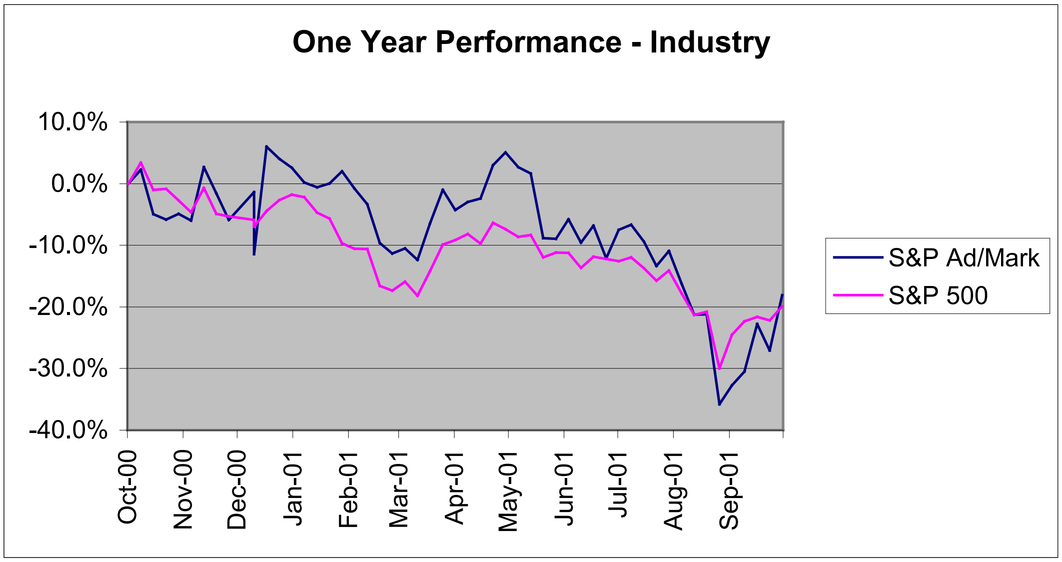
		Weight
Cost of equity	13.05%	0.69
Cost of debt	7.61%	0.31
Tax rate	32.50%	
Risk-free	4.65%	
Avge. Historical risk premium	6.00%	
Beta of equity	1.40	
WACC	10.60%	

Comparable Companies Analysis

	Mkt cap. ($ billion)	Price/sales	Price/earnings
Selected Comparable Companies			
WPP	11.3	1.8	21.5
IPG	8.3	1.1	131.1
Havas	2.1	1.1	33.5
OMC	15.7	2.4	32.5
	Average	1.6	54.6
	Implied Price per share	**$ 18.38**	**$ 48.08**

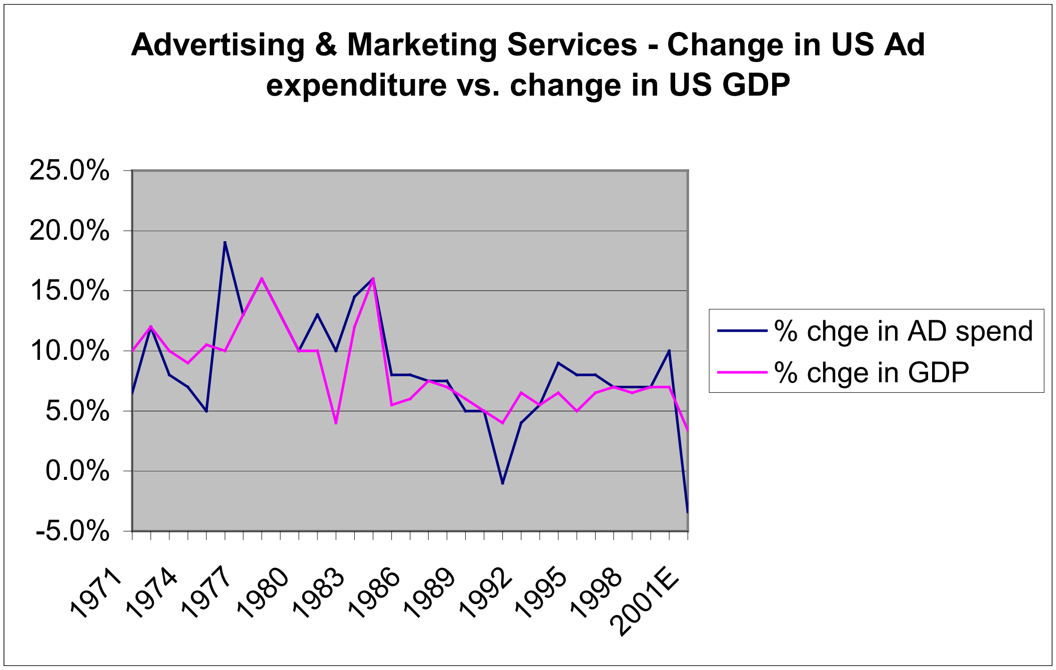
Appendix

Appendix 1



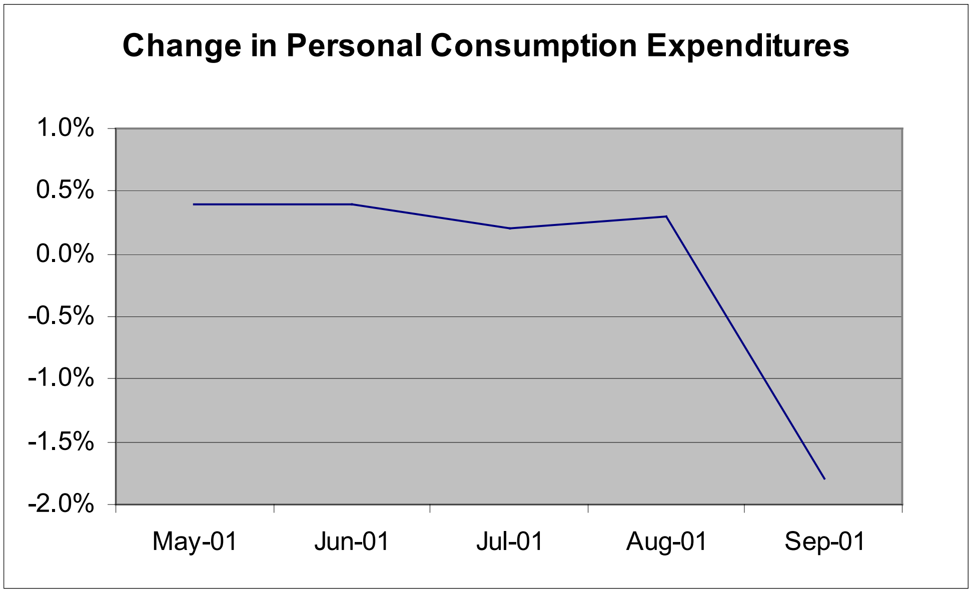
Source: Yahoo! Finance

Appendix 2



Source: Bear, Stearns & Co. (July 2001).

Appendix 3



Source: Bureau of Economic Analysis

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