

# Opportunities in Small Cap Stocks: Iervolino & Lady Bacardi Entertainment

## Introduction

In the following article we will shortly analyse the implications of the current macroeconomic environment for equities, and we will propose a trade idea on a small cap stock we have identified in the Italian stock market.

## The Macroeconomic Background

In the last week it has become increasingly clear that higher inflation may be more persistent than it was previously expected. For this reason, central banks will have to decide whether they want to withdraw stimulus and at what pace. However, even if monetary policy is tightened, central banks may face some difficulties in taming inflation, given that it is mostly supply driven rather than demand driven, and the supply side constraints are unlikely to ease in the short-term. As a result, we may experience an economic environment characterized by sustained high inflation and moderate or even slow growth.

In this economic environment, equities will not be a reliable hedge against inflation. The return on capital of companies is generally stable across time; consequently, in an inflationary regime, companies may be able to keep pace with inflation in their costs increasing proportionally their revenues, but they will be generally unable to increase returns on their capital. Consequently, in such an environment, the real return on equity earned by investors will be likely lower. In addition to this, certain equity classes are currently trading at very expensive levels due to the large liquidity inflows that were driven by fiscal and monetary policy stimulus. To preserve satisfying returns, investors will have to adopt a selective approach to equities, to ensure that company's fundamentals justify their valuation.

In this new regime, we are proposing a trade idea based on an Italian small cap company. Generally, small cap companies offer significant alpha to the investor able to dissect between those likely to be successful, and those that will perish. In what follows, we propose a company that is not just cheap looking at its fundamentals. It is a company that has recorded a massive growth in revenues in the past three years (CAGR close to 100%), constantly positive margins and high returns on equity capital (EBIT margin of 18% and ROE of 30% in 2020), positioned in a structurally attractive industry with high profitability and low risk, that, at the same time, trades at very low multiples (P/BV of 1.8, EV/EBIT of 5.9, P/E of 5.7).

## Iervolino & Lady Bacardi Entertainment

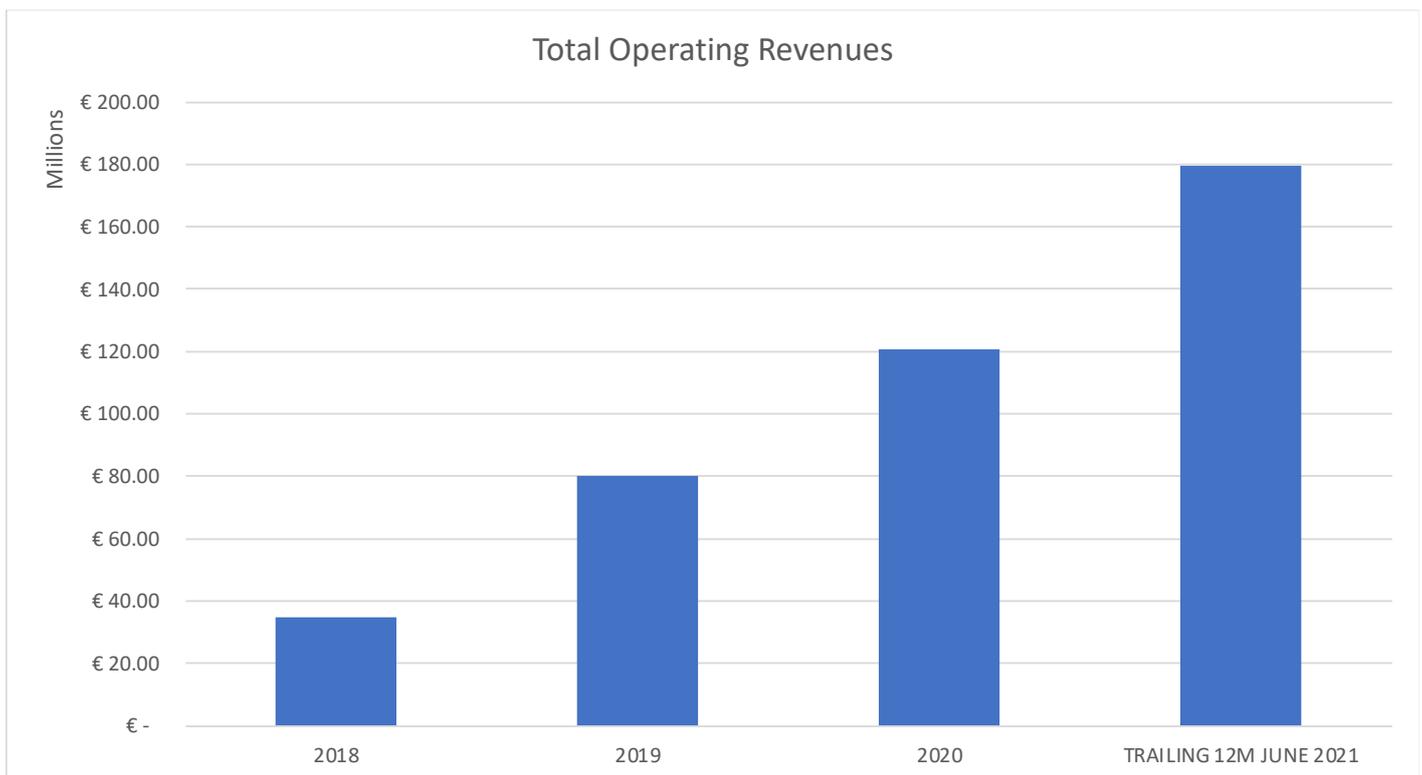
Iervolino & Lady Bacardi Entertainment (ILBE) is an Italian company listed in the AIM, the segment for small and micro-cap companies, with a capitalization of about € 120m.

ILBE is a global production company focused on cinema and television content for an international audience. It was founded in 2011 by Andrea Iervolino and Lady Monika Bacardi, both are successful entrepreneurs in the cinema industry and experienced film producers. Their knowhow and relationships in the cinema industry have enabled the company to produce "Hollywood Style" movies and web series, starring famous actors including Morgan Freeman, John Travolta, and Johnny Depp.

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The company is only involved in the production activities of movies and web series; in addition to this, before the beginning of production activities for movies or web series, it already sells the content to international sales agent, which grant the company a “minimum non revocable guaranteed amount”, the agent will then distribute the content worldwide across several platforms. Consequently, ILBE transfers most of its performance risk to the sales agents. In addition to this, once the agent has recovered all distribution costs, ILBE still has the right to receive a certain percentage of the profits (the so-called “back-end”). Moreover, ILBE maintains the ownership of the IP rights related to its content, consequently, it has the right to make sequels, prequels, and to sell related products. Overall, this suggests that the business model of ILBE is intrinsically characterized by low risk and high profitability.

The main production activities of ILBE began in 2018 and in 2019 there was the IPO in the AIM. Since then, the company has recorded a staggering revenue growth, with a CAGR close to 100% over the past 3 years, as shown in the picture below.

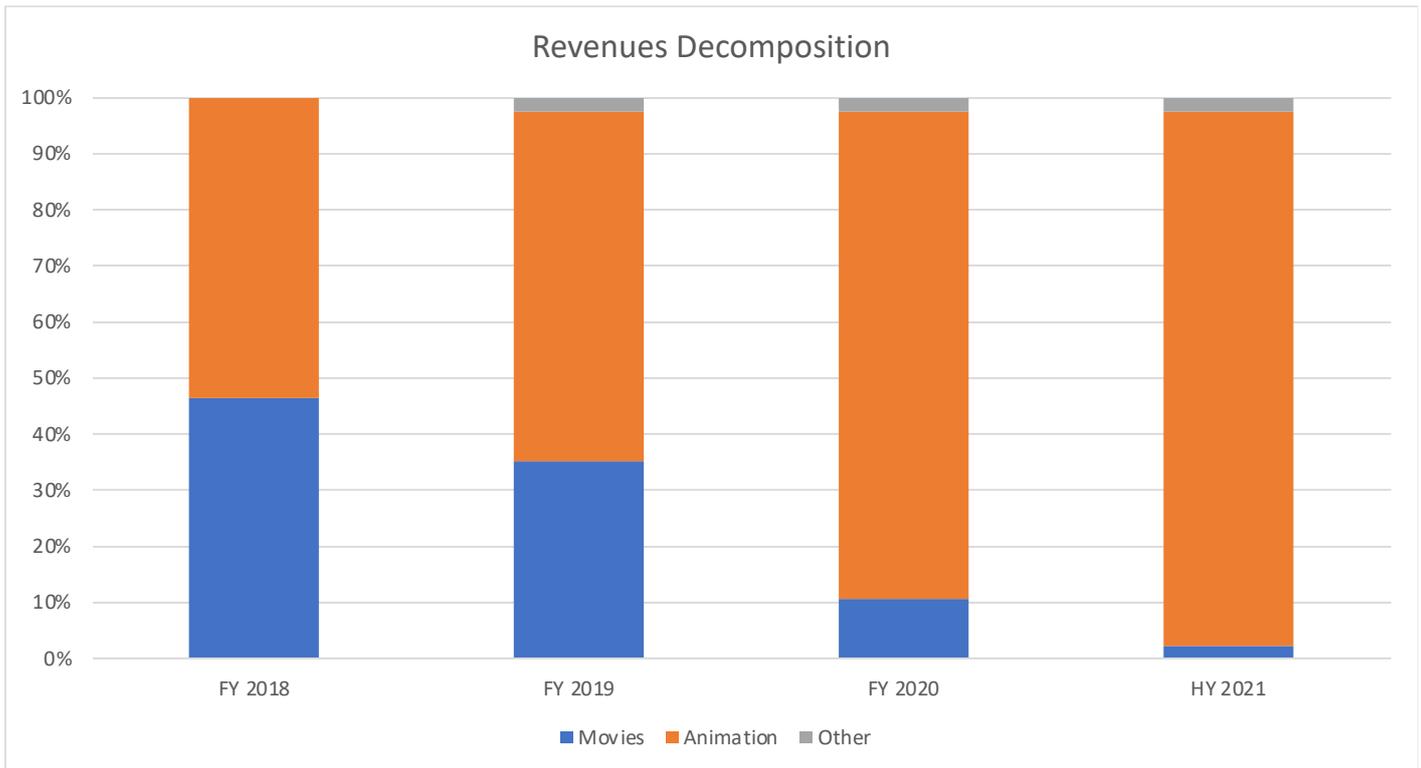


The company’s expansion has been driven by its animation business line, which during 2020 accounted for 85% of its overall revenues. This business line is involved in the production of short web series, whose episodes last about 5 minutes and adopt a universal language of sounds which does not necessitates dubbing in local languages. Consequently, the content is ready to be distributed at an international level. These production activities began in 2018 with a web-series called “Arctic Friends” which was extremely successful at a worldwide level; since then, the company has capitalized on its success producing sequels, prequels, and spin-offs that have been similarly successful.

In addition to this, ILBE has been diversifying its revenues in cinema content, producing movies starring famous actors. Moreover, the company has been involved in services related to its production activities like celebrity

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management. Nevertheless, the company is still very dependent on its animation business, whose share of total revenues has increased over the years, as shown in the figure below.



Since the start of its operations ILBE has enjoyed large profit margins thanks to its peculiar business model, as displayed in the table below.

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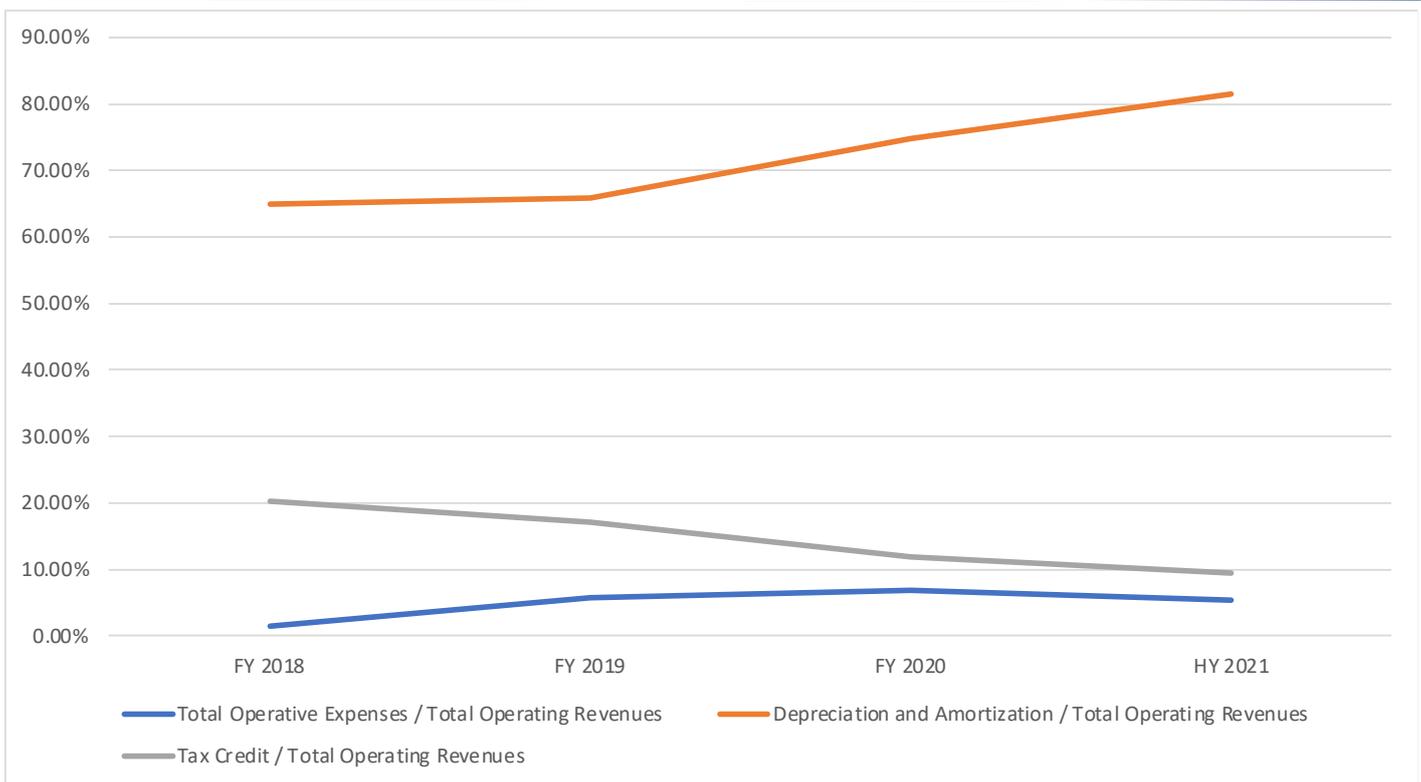
All numbers in thousands	2018		2019		2020
Total Operating Revenues	€	34,626	€	80,008	€ 120,735
EBIT	€	11,642	€	22,647	€ 22,042
Net Income	€	10,194	€	20,249	€ 19,501
FCFO		€	(11,278)	€	(14,811)
FCFE		€	(8,679)	€	(4,328)
Change in Cash		€	7,801	€	(4,439)
Net Working Capital	€	(5,475)	€	(4,638)	€ 5,919
Net Invested Capital	€	22,270	€	53,173	€ 77,346
Capital Employed	€	16,795	€	48,535	€ 83,265
Equity	€	10,923	€	47,650	€ 67,041
Cash & Equivalents	€	151	€	7,952	€ 3,513
Gross Debt	€	6,023	€	8,837	€ 19,737
Total Financing Sources	€	16,795	€	48,535	€ 83,265
Market Capitalization		€	202,200.00	€	138,000.00
Net Debt		€	884.56	€	16,224.00
Enterprise Value		€	203,084.56	€	154,224.00
EBIT Margin		34%		28%	18%
Turnover on Invested Capital		1.55		1.50	1.56
Profit Margin		29%		25%	16%
Non-Cash ROE		95%		51%	31%
ROE		93%		42%	29%

It is common practice in the industry to capitalize content production as intangible assets and then amortize it over time, as the content is exploited. Consequently, the main measure of profitability and value capture for the industry is the EBIT margin. We can notice that such margin has hovered close to 20% in the past three years; moreover, the asset turnover ratio, a key indicator of value creation, has been close to 1.5 during the entire period. Such values are in line with those of other players in the industry that, just like ILBE, are focused on production activities, as shown in the table below.

	EBIT Margin	Turnover on Invested Capital
Mondo TV Spa	27.52%	0.39
Xilam Animation SA	22.55%	1.03
Thunderbird Entertainment Group	8.47%	1.02

Nevertheless, it can be noticed that ILBE has experienced a compression in its margins over time, this is not due to increasing operating expenses, but mainly due to an increase in the cost of depreciation and amortization, as shown below.

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This increase is attributable to the decline of the share of revenues made up by movies which are characterized by higher margins compared to web-series, and to a general increase in the cost of both contents. The first factor will likely persist over time, as we expect the company's revenues from movies to stabilize at 2020 levels. The second factor is mainly related to the company's current high-growth phase; thus, we expect that it will fade as the company's growth stabilizes.

In addition to this, the compression in margins is attributable to the decline in tax credits with respect to revenues as shown above. These tax-credits have been awarded since the beginning of the 2000's in Italy to cinematographic companies producing content within Italy. This reduction is partially due to a slow procession of tax credits by authorities, in fact, ILBE has on its balance sheet about € 24m of tax credits.

Overall, the factors impacting the company's margins are related to its current high-growth phase, and they are likely to fade over time; it is probable, that the company's margins will then stabilize slightly above 20%, as for its peers.

Moreover, it is noticeable that ILBE has been recording a very high return on equity over the past years, standing close to 30% in 2020, even though it has massively expanded its operations. This implies that the high growth of the company is leading to a massive value creation for its shareholders. In fact, shareholders cannot fully enjoy on their direct investments the company's ROE because they are purchasing the equity slightly above book value (currently the P/BV ratio is at 1.8), but thanks to the company's high growth, shareholders can earn that 30% on their earnings reinvested in the equity capital of the company at book value. Under these conditions, the company's high growth is clearly positive in the long-term, even though in the short run it is leading to negative cash flows from operations.

## **Multiples Valuation**

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In order to value the company, we proceed first with a multiples valuation, then we carry on a DCF analysis to verify our results.

In the table below we show the multiples for two sets of comparable companies.

Production focused companies							
	Forward EV/Revenues 2021	Forward EV/Revenues 2022	Forward EV/EBIT 2021	Forward EV/EBIT 2022	Forward Price to Earnings 2021	Forward Price to Earnings 2022	
Mondo TV SpA	2.1	2.0	6.4	5.4	9.7	7.4	
Xilam Animation SA	5.0	4.2	19.3	15.9	24.7	19.8	
Thunderbird Entertainment Group	2.4	2.1			31.5	23.6	
Average	3.2	2.8	12.9	10.7	22.0	16.9	
Median	2.4	2.1	12.9	10.7	24.7	19.8	
Italian content providers							
	Forward EV/Revenues 2021	Forward EV/Revenues 2022	Forward EV/EBIT 2021	Forward EV/EBIT 2022	Forward Price to Earnings 2021	Forward Price to Earnings 2022	
Mondo TV SpA	2.1	2.0	6.4	5.4	9.7	7.4	
Lucisano Media Group SpA	1.0	0.6	8.1	8.1	5.5		
Notorious Pictures SpA	1.7	0.9	9.4	7.9	8.1	7.0	
Leone Film Group SpA	1.3	1.0	34.8	13.8	27.4	7.9	
Average	1.5	1.1	14.7	9.0	12.7	7.4	
Median	1.5	1.0	8.8	7.9	8.9	7.4	
Iervolino & Lady Bacardi Entertainment							
	0.82	1.02	5.86	7.27	5.69	6.96	

The first set is made up of companies that carry-on only production activities, like ILBE. The second set is made up of Italian companies that produce content, and that partially distribute it. The first group of companies is structurally more profitable and asset light than the second, in fact, they generally enjoy higher multiples. We also list multiples for ILBE computed with our expected forward revenues, EBIT, and earnings.

We then proceed to compute the share price of ILBE implied by the median multiples of the two groups of companies, the results are listed in the table below.

	Forward Revenues 2021	Forward Revenues 2022	Forward EBIT 2021	Forward EBIT 2022	Forward Earnings 2021	Forward Earnings 2022
	€ 171,443.35	€ 138,661.57	€ 24,085.62	€ 19,424.06	€ 20,996.35	€ 17,168.16
	Forward EV/Revenues 2021	Forward EV/Revenues 2022	Forward EV/EBIT 2021	Forward EV/EBIT 2022	Forward Price to Earnings 2021	Forward Price to Earnings 2022
Median Multiples for Production focused companies	2.4	2.1	12.9	10.7	24.7	19.8
Share Price	€ 11.13	€ 7.69	€ 8.22	€ 5.29	€ 14.81	€ 9.71
Median Multiples for Italian Content Providers	1.5	1.0	8.8	7.9	8.9	7.4
Share Price	€ 6.72	€ 3.14	€ 5.40	€ 3.76	€ 5.34	€ 3.63
Current Share Price	\$ 3.41					
Target Share Price	€ 6.49					

Overall, we believe that the first group is more relevant to obtain a proper multiple to price ILBE's shares: these companies have EBIT margins and asset turnover ratios far more similar to those of ILBE than the second group does. Then, to obtain our target share price, we have used the average of the prices implied by the EV/EBIT 2022, and the EV/Revenues 2022. We have chosen these multiples to be conservative given that the P/E 2022 and all the 2021 multiples suggested very high prices. Overall, our target price is 6.49, suggesting that there may be a potential upside close to 90%, with respect to the current price of 3.41.

We have been very conservative also in the computation of the forward revenues, EBIT, and earnings. We have used the company's current backlog for the period 2021-2024 to project its future revenues. However, the company's current backlog is estimated using the "minimum non revocable guaranteed amount" of projects that are being currently developed. Thus, we have also included conservative estimates for tax revenues and for revenues from other activities. Then, we have been conservative in all our assumptions regarding the evolution of operative expenses, investments, and others; in fact, these assumptions lead to a further decline in the EBIT margin to 14%.

In conclusion, in reaching our target price, we have been conservative in the choice of the multiples, in the estimation of future revenues, and in the margins that the company is likely to achieve.

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## Asset-Side DCF Check

We now carry on a reverse DCF asset-side analysis to understand what the current market price of ILBE (3.41 €), and our target price (6.49 €) are discounting.

We compute the PV of FCFOs for the years 2021-2024, using the assumptions mentioned above. So, we estimate revenues with the company's current backlog, and we obtain a 14% EBIT margin with our other assumptions. Then, we compute the company's enterprise value under the market price and the target price. We subtract from the enterprise value the PV of FCFOs for the years 2021-2024, obtaining the premium to the current pipeline of projects. Under our assumptions regarding the evolution of operative expenses, investments, and other items, we compute the long-run revenues (and the relative EBIT) that in a scenario with no growth, have a present value that corresponds to the premium to the pipeline. The results are shown in the table below.

	Market Price		Target Price	
Share Price	€	3.41	€	6.49
Market Capitalization	€	119,405	€	227,276
Net Debt	€	21,752	€	21,752
<b>Enterprise Value</b>	<b>€</b>	<b>141,157</b>	<b>€</b>	<b>249,028</b>
PV of FCFOs for already defined projects 2021-2024	€	54,762	€	54,762
<b>Premium to the Pipeline</b>	<b>€</b>	<b>86,395</b>	<b>€</b>	<b>194,266</b>
<b>Implied long run Revenues</b>	<b>€</b>	<b>37,329</b>	<b>€</b>	<b>172,540</b>
<b>Implied long run EBIT</b>	<b>€</b>	<b>5,015</b>	<b>€</b>	<b>24,242</b>

We notice that at the current market price, ILBE needs long-run revenues of about € 40m to match the market's expectations. Instead, to match the expectations of our target price, it would need revenues of € 170m. We notice that in the first half of 2021 ILBE recorded revenues for € 110m (with an EBIT margin of 14%), and the management team has declared that they expect to further expand in the following years. We conclude that our revenues assumptions are quite reasonable considering that they stand close to expected 2021 revenues.

Concerning the EBIT margin, the company declared that the current compression is mostly due to its high growth and to non-recurring items. We conclude that our assumptions, that lead us to a 14% EBIT margin, are very reasonable given that we have applied the EBIT margin to a scenario without any growth, a scenario in which the company would likely experience an expansion of such margin.

We conclude noticing that it is quite difficult to explain the current market price of ILBE; our target price of € 6.49 has been reached using reasonable and conservative assumptions, and the track record of the management team suggests that there may be more upside than we are currently estimating. Overall, we believe that ILBE's equity can be an investment with quite limited downside, but with a significant upside potential.

Finally, we also show in the tables below the full computations relative to our asset-side DCF analysis that has been done to verify our target price.

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All numbers in thousands	2018	2019	2020	2021	2022	2023	2024	2025	2026
Total Operating Revenues	€ 34,626	€ 80,008	€ 120,735	€ 171,443	€ 138,662	€ 138,662	€ 138,662	€ 172,540	€ 172,540
EBIT	€ 11,642	€ 22,647	€ 22,042	€ 24,086	€ 19,424	€ 19,424	€ 19,424	€ 24,242	€ 24,242
Net Income	€ 10,194	€ 20,249	€ 19,501	€ 20,996	€ 17,168	€ 17,514	€ 17,514	€ 21,867	€ 21,867
FCFO	€	€ (11,278)	€ (14,811)	€ (6,816)	€ 36,195	€ 17,552	€ 17,552	€ 2,639	€ 21,906
FCFE	€	€ (8,679)	€ (4,328)	€ 3,710	€ 20,811	€ 4,014	€ 17,514	€ 2,601	€ 21,867
Change in Cash	€	€ 7,801	€ (4,439)	€ 3,710	€ 20,811	€ 4,014	€ 17,514	€ 2,601	€ 21,867
Net Working Capital	€ (5,475)	€ (4,638)	€ 5,919	€ 500	€ 3,147	€ 3,147	€ 3,147	€ 411	€ 411
Net Invested Capital	€ 22,270	€ 53,173	€ 77,346	€ 111,346	€ 90,055	€ 90,055	€ 90,055	€ 112,058	€ 112,058
Capital Employed	€ 16,795	€ 48,535	€ 83,265	€ 111,845	€ 93,202	€ 93,202	€ 93,202	€ 112,469	€ 112,469
Equity	€ 10,923	€ 47,650	€ 67,041	€ 88,037	€ 105,206	€ 122,719	€ 140,233	€ 162,101	€ 183,968
Cash & Equivalents	€ 151	€ 7,952	€ 3,513	€ 7,223	€ 28,034	€ 32,048	€ 49,562	€ 52,163	€ 74,030
Gross Debt	€ 6,023	€ 8,837	€ 19,737	€ 31,031	€ 16,031	€ 2,531	€ 2,531	€ 2,531	€ 2,531
Total Financing Sources	€ 16,795	€ 48,535	€ 83,265	€ 111,845	€ 93,202	€ 93,202	€ 93,202	€ 112,469	€ 112,469
Market Capitalization	€	€ 202,200.00	€ 138,000.00	€ 119,404.56					
Net Debt	€	€ 884.56	€ 16,224.00	€ 23,807.98					
Enterprise Value	€	€ 203,084.56	€ 154,224.00	€ 143,212.54					
EBIT Margin	34%	28%	18%	14%	14%	14%	14%	14%	14%
Turnover on Invested Capital	1.55	1.50	1.56	1.54	1.54	1.54	1.54	1.54	1.54
Profit Margin	29%	25%	16%	12%	12%	13%	13%	13%	13%
Non-Cash ROE	95%	51%	31%	26%	22%	19%	19%	20%	20%
ROE	93%	42%	29%	24%	16%	14%	12%	13%	12%

WACC	8.20%					
Perpetual Growth	0.00%					
Valuation date	November-2021					
	November-2021					
FCFO	€ (6,816)	€ 36,195	€ 17,552	€ 17,552	€ 2,639	€ 21,906
Discount Factor	0.99	0.91	0.84	0.78	0.72	
Present Value of FCFO	€ (6,727)	€ 33,016	€ 14,797	€ 13,676	€ 1,900	
Terminal Value				€	€ 267,141	
Present Value of Terminal Value	€	€ 192,366				
<b>PV of FCFOs for already defined projects 2021-2024</b>	<b>€</b>	<b>54,762</b>				
<b>PV of FCFO 2025 and of TV</b>	<b>€</b>	<b>194,266</b>				

TAGS: Iervolino and Lady Bacardi Entertainment Spa, ILBE, IE.MI, Value Stocks, Small Cap Stocks, Equities, Inflation

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