Let me get this out of the way first: I'm not enamored with **Korn/Ferry** (KFY) as a company. Cross a level of cyclicality with the best way to blow up a professional service firm – i.e., empire-building M&A – and I wouldn't fault investors for passing on KFY.

But to paraphrase Howard Marks, for almost every business, there's a valuation at which it makes sense. While there are things to dislike about Korn/Ferry, there are also things to like – its increasingly diversified business, its "earnings buffer" in the form of yet-to-be-realized (but pretty slam-dunk) synergies, its history of strong free cash flow generation, and its clean balance sheet. At the current price around ~$23, shares trade at under ~6.5x run-rate EBITDA, or under ~11x EV/NOPAT (which is, functionally, equivalent to P/FCF). This is a valuation that suggests a significant imminent pullback in b2b economic activity, which is not being priced in by professional service firm peers, much less the rest of the market. Counting the to-be-realized synergies (a roughly 10% buffer to earnings), KFY would have to see forward EBITDA fall by 30% or more to justify the market price at a run-of-the-mill 15x FCF multiple (again, with a clean balance sheet, and arguably great long-term growth prospects from that tragic point given that we'd then be talking about recovery from a recessionary environment.)

With the market pricing in extreme macro bearishness that just isn't reflected by the rest of the market, KFY shares offer an interesting opportunity to earn 20% compounded returns over three years if the economy doesn't implode, and likely hold up pretty well even if we hit a significant economic speedbump.

Business Basics: If You Haven't Looked In A While, You Should Look Again

Everyone knows Korn/Ferry as the big executive search firm, and indeed, that continues to comprise a significant portion of their business. Executive search is a cyclical business that is turbocharged to economic growth / employment for obvious reasons – when times are good, good executives are hard to find; when companies are laying off executives rather than hiring them, demand for executive recruiting services is usually harder to come by. Korn/Ferry offers executive search on a retained basis, i.e. they get paid even if the position isn't filled for whatever reason.

Due to the timing of the Hay Group acquisition, financials in the 10-K don't perfectly describe the business mix, which looks something like this:

- Executive Search - ~$625MM revenue @ mid-20s segment-level EBITDA margins (lower after corporate expense allocation)
- Hay Group - ~$775MM revenue @ mid-high teens segment-level EBITDA margins (lower after corporate expense allocation)
- Futurestep - ~$200MM revenue @ mid-teens segment-level EBITDA margins (lower after corporate expense allocation)

Note that the presentation of financials is a bit confusing, as what Korn/Ferry refers to as "Hay Group" as a segment is the actual Hay Group, plus some other similar businesses they stuck in with it.

Executive search, comprising ~40% of revenues and ~50% of pre-corporate EBITDA, does what it says on the tin. Hay Group, comprising ~50% of revenues and ~40% of pre-corporate EBITDA, offers human capital advisory services around pay, talent, and engagement. Futurestep, comprising ~12% of revenues and ~10% of pre-corporate EBITDA, provides recruitment process outsourcing and some other stuff.

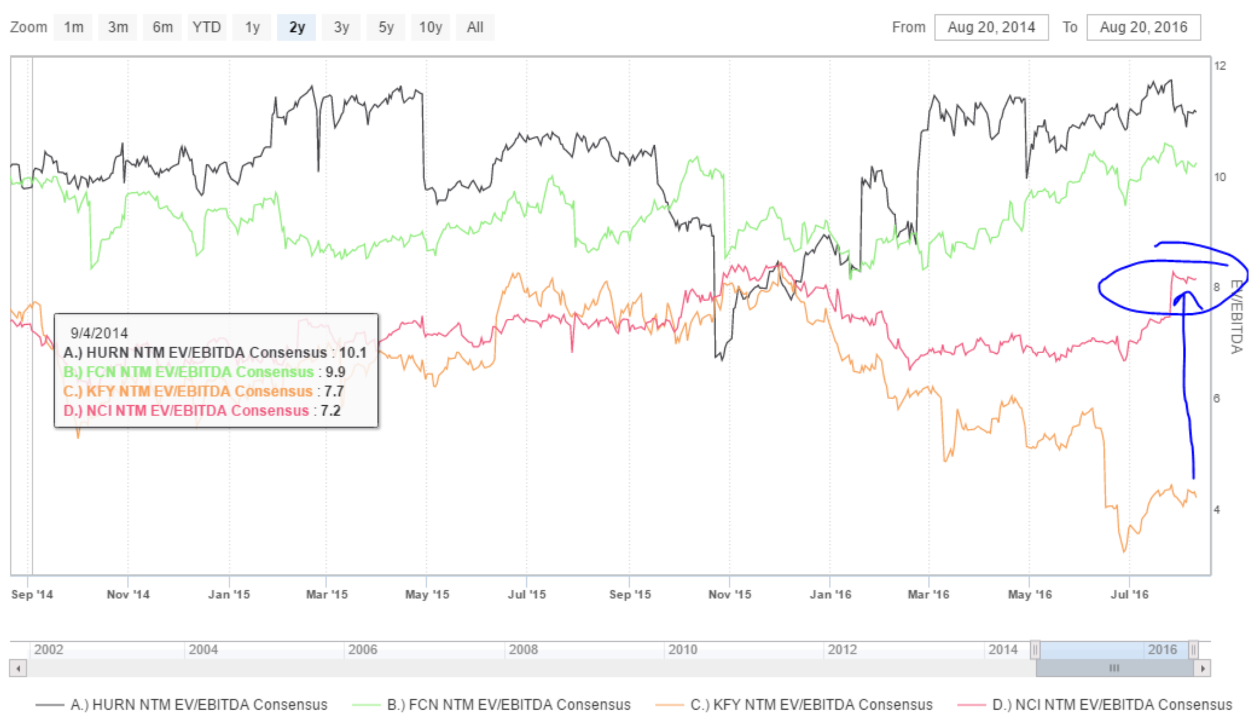
Macro: Issue Or Non-Issue?

Reading the tea leaves, the market's fear on KFY is that weak near-term trends in search reported by both them and peer **Heidrick & Struggles** (HSII) portend the start of another vicious downcycle for search, notwithstanding that employment continues to be robust.

What you'll notice is that roughly half the business is significantly less cyclical than typical executive search, and significantly more aligned with other consulting / professional service firms like **Navigant** (NCI), **Huron** (HURN), **FTI Consulting** (FCN), or so on. Indeed, Futurestep and Hay Group saw revenue declines of 20% during the 2008-2009 cycle, versus a roughly 40% top-line decline for the executive search business (although the impact to EBITDA was magnified – roughly double.)

As a result, even if we were to go through another downcycle (which would, in all likelihood, be nowhere as severe as 2008), the impact on the business would not be as severe as it once was, and at the very least, half of Korn/Ferry's business deserves to trade at the same multiple as professional-service peers. Moreover, Korn/Ferry is in the process of combining Hay Group and Korn/Ferry offices and support staff, which will drive an incremental $20 million of EBITDA savings (or just under 10%) of current run-rate EBITDA. While I'm not explicitly building this into my valuation calculations, this serves as a "buffer" – even if the macro were to go south and KFY's consolidated EBITDA fell, say, 30% peak-to-trough, those synergies would help offset some of that, meaning the current market price would still represent somewhere in the neighborhood of a palatable ~15x multiple to that trough free cash flow.

But again, this is the downside scenario – in the more likely "muddle-along" economic scenario, given KFY's decent organic growth, it wouldn't seem to be a stretch for it to trade at around ~8 – 8.5x EBITDA / ~14 - 15x EV/NOPAT. While I arrived at this valuation on a fundamental basis, as a quick sense-check, that kind of multiple is reasonable for a respected professional service firm with a good brand in its practice areas.



Empire-Building: The Other Issue…

The other idiosyncratic risk with Korn/Ferry is that CEO Gary Burnison is an empire-builder. There's no way around that, nor any way around the plain, simple fact that the history of M&A in the professional service firm industry has been… spotty at best. I've spent a significant amount of time studying this industry and talking to professionals within it, so believe me when I say that I am extremely cautious/skeptical about active acquirers in this space. (One of the reasons I was attracted to **Charles River Associates** (CRAI) earlier this year is because of management's unique philosophy of devoting pretty much all cash flow to accretive capital return.)

Indeed, one of the reasons I would be cautious projecting too much growth out of Hay Group is that I expect some exodus after the three-year lockup on shares issued as part of the acquisition (i.e. two years from now). Glassdoor reviews corroborate the usual culture clash issues are indeed occurring.

Mitigating this to some degree, Hay Group offers a lot of "productized services" – proprietary benchmarks and data on compensation and employee engagement and so on. So unlike generic commodity accounting or IT consulting where if Bob the Consultant moves from Firm A to Firm B, he can just port his clients and expertise with him, I believe Hay Group's revenues are "stickier" than many professional service firms without this data-driven component. Finally, Korn/Ferry is working on cross-selling bundled package deals of executive search (legacy KFY) with RPO (FutureStep) and human capital advisory (Hay Group). Given that there isn't a clear brand leader in the human capital space the way you have MBB in strategy or the Big Four in accounting, I do think there's some merit to Burnison's strategy of making Korn/Ferry the predominant end-to-end provider of human capital services. If you read HBR/Deloitte University Press/etc, there is clearly an increasing focus on employee engagement and productivity of knowledge workers, and the CYA nature of executive search and compensation benchmarking likely has a brand halo – I imagine Korn/Ferry has pretty good unaided brand awareness in the Fortune 500 and can utilize that over time.

From a capital allocation standpoint, then, while I don't know that I view M&A here as tremendously value-creative, I also don't view it as tremendously value-destructive. This is a substantively different strategy than, say, rolling up a bunch of local consultancies with no proprietary IP and no real reason to coexist; I think Korn/Ferry will be able to extract enough cost and revenue synergies to make it worth shareholders' capital. In the meanwhile, this is a functionally infinite-ROIC business, so growth doesn't consume capital and free cash flow will continue to be strong. The balance sheet is clean, too – while you have to offset the reported cash with the to-be-paid bonus liabilities, the company still comes out pretty much net-neutral on debt (no more than a third of a turn.)

Valuation: 20%+ Compounded Base Case Returns

While I've touched on valuation a lot throughout the course of this article, the core idea is that professional service firms convert EBITDA to FCF very well, so as long as they don't light all the cash they generate on fire, even modest growth is enough to support a decent multiple. In the case of Korn/Ferry, I've assumed:

- 2% long-term capex-to-revenue
- $220 million in run-rate Adjusted EBITDA (per management guidance on the Q4 call)
- No credit given for achievement of synergies in 2017.
- Notably, KFY does not appear to "adjust" for stock-based compensation – good for them.
- Long-term organic growth rate of 3%.
- 10% cost of equity capital.
- Net-neutral balance sheet.

These assumptions lead me to believe a valuation in the range of 14 – 15x EV/NOPAT, or 8.0 – 8.5x EV/EBITDA, is roughly reasonable. Your mileage may vary as to how you prefer to value companies (DCF, relative multiples, etc), but I don't think any of my assumptions are particularly unreasonable. On these assumptions, then, I believe KFY shares are worth a little over $30 today (vs. a price under $23.) Over a 2-3 year holding period, fair value of shares should approach the mid-to-high $30s, offering 20%+ compounded return potential.

For what it's worth, if you include the synergies I mentioned and hold all else the same, my fair value jumps to ~$33 per share – over 40% upside from today's price. All in all, this seems to be an investment with meaningful margin of safety – even assuming a meaningful macro setback or significantly value-destructive acquisition, it's hard for me to generate a fair value at or below the current price. At the very least, if your macro assumptions are bearish enough to call for a 20%+ overnight revenue decline for KFY, then you should probably be blowing out of all your longs because the rest of the market won't be pretty either…

Conclusions

While some investors would disagree with me, I think it's important to hit singles and doubles while you're searching for home runs. As of right now, Korn/Ferry doesn't seem like a "fantastic" business, but its company-specific outlook simply doesn't justify it trading at ~11x run-rate FCF while the market trades at all-time highs. I'm cognizant of the risks and am sizing this modestly, but KFY seems like very cheap exposure to decent-quality equity in a market where that's quite hard to find.

Small note - I would note that I think RPO will likely see margin pressure over time because it seems like an utterly commoditizable business that doesn't deserve mid-teens EBITDA margins relative to, say, generic staffing at low-single-digit margins. That said, at the moment it's growing quite rapidly, and it's a small portion of the total company anyhow so it's not really a significant model input (if you're into that).

Additional disclosure: I am also long Charles River Associates (CRAI), though it is now a de minimis position.