

# Jones Lang LaSalle Inc JLL | ★★★★★

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## JLL's broad platform and competitive advantages will benefit shareholders well into the future.



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### Analyst Note 06/14/2016

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We are reinitiating coverage of our wide-moat real estate services firms as a result of an analyst change. We are assigning fair value estimates per share of \$40 and \$144, respectively, to CBRE Group and Jones Lang LaSalle. These fair value estimates imply 2016 estimated earnings multiples of 17.5 and 14.3 times and 2016 estimated EBITDA multiples of 11.6 times and 9.0 times, respectively. We currently view shares

of both CBRE and JLL as approximately 15%-25% undervalued, based on current market prices. We acknowledge the likelihood of ongoing and meaningful volatility in the near term as the global commercial real estate markets journey through the economic cycle, but we think that investors are currently pricing the stocks assuming a challenged commercial real estate market well into the future and underestimating the long-term value each firm creates.

That commercial real estate markets are cyclical comes as no surprise. As general economic conditions weaken, market participants--namely tenants, owners, and investors--prefer to wait for more positive outlooks before making significant capital decisions. And when market sentiment does turn positive, previously pent-up demand for new supply and capital deployment can lead to periods of dramatic growth and investment returns. While these boom-and-bust cycles influence results over the shorter term, we believe both CBRE and JLL are set to win a disproportionate share of the fragmented global market through organic growth, strategic hiring, and acquisitions, and are likely to deliver substantial shareholder value in the long term. In the near term, however, each company continues to determinedly shift its respective business mix toward steadier annuitylike income streams, which will help to positively insulate their operations relative to the most recent economic downturn.

### Investment Thesis 01/27/2016

That the commercial real estate (CRE) markets are cyclical comes as no surprise. As economic conditions weaken, market participants--namely tenants, owners, and investors--prefer to wait for more positive outlooks before making significant capital decisions. And when market sentiment does turn positive, previously pent up demand for new supply and capital deployment can lead to periods of dramatic growth and investment returns. While these "boom-and-bust" cycles influence results over the shorter term, however, we believe well-respected real estate services firm Jones Lang LaSalle (JLL) will be able to leverage its fully integrated, global platform to capture disproportionate market share through organic and external growth.

JLL has built a familiar brand name within commercial real estate. With expertise shared among its 60,000 employees around the world across its five interconnected service lines and investment management arm, JLL is well positioned to serve local market clients. However, it is also one of just a few firms that can also serve as a

### Morningstar's Take JLL

Analyst		
Price 07-01-2016	Fair Value Estimate	Uncertainty
95.9 USD	144 USD	High
Consider Buy	Consider Sell	Economic Moat
86.4 USD	223.2 USD	Wide
Stewardship Rating		
Exemplary		

### Bulls Say

- JLL is one of just a few truly international one-stop-shops, which is particularly attractive among large global clients looking to consolidate service providers.
- As urbanization expands the demand for commercial real estate services globally, JLL should be able to leverage its recognizable brand and infrastructure to win increased market share.
- JLL's business--while subject to the cyclicity of the commercial real estate industry--is geographically diversified, with more than half of its revenue from locations with a functional currency other than the U.S. dollar.

### Bears Say

- While also an opportunity, JLL's market position could be vulnerable to continued consolidation and strategic M&A activity within the industry, especially among large competitors.
- Advances in technology, internet-based services, and access to information could diminish the value and expertise that JLL provides its clients.
- JLL's investment funds are not only subject to the CRE cycle but also to the fundraising environment and structural limitations, including a limited duration and investment strategy. Compounding these various dynamics can result in particularly volatile performance.

### Competitors JLL

More...

Name	Price	% Chg	TTM Sales \$ mil
<b>Jones Lang LaSalle Inc</b>	<b>\$95.90</b>	<b>-1.59 ↓</b>	<b>6,099</b>
The Wharf (Holdings) Ltd ADR	\$12.27	1.20 ↑	5,268
The Wharf (Holdings) Ltd	\$5.83	10.88 ↑	5,268
Henderson Land Development Co Ltd ADR	\$5.62	0.18 ↑	3,047
Henderson Land Development Co Ltd	\$5.28	-2.94 ↓	3,047
Vonovia SE ADR	\$17.62	3.76 ↑	1,436

one-stop shop to increasingly global clients that are further outsourcing and consolidating their noncore CRE-related needs. And as urbanization continues globally, we expect CRE demands to similarly expand; fueling growth for trusted and recognizable institutional firms such as JLL.

Building upon these trends, JLL is purposefully shifting toward its segments with more stable, annuity-like income streams. While leasing and capital markets have recovered since 2009, these businesses, representing more than 50% of JLL's fee revenue, are highly sensitive to the CRE cycle. Instead, the necessity-based property and facilities management business proved resilient through the last downturn as outsourcing has grown, increasing at double-digits. Not only is this business stickier, but it also allows JLL to develop its relationships and cross-selling opportunities over time, driving organic growth and fortifying its wide moat. Given this and the ability to win incremental share due to its global reach, broad capabilities, and respected brand, we believe JLL is in a position to create meaningful long-term value.

#### **Economic Moat** 01/27/2016

We believe JLL has built a wide-moat business with intangible assets stemming from its well-respected brand, broad capabilities, and infrastructure, which altogether attracts clients and talent and creates switching costs that keep them with JLL. Given the scale to which the company has been able to construct and maintain its competitive advantages, it will be challenging for competitors to disrupt JLL's position, and we think JLL will be able to create shareholder value for years to come.

At the heart of JLL's intangible assets is a brand and reputation built upon a history of effective but ethical service. We feel this validated track record makes the firm an especially trusted option among service providers, an intangible asset for JLL, that is important in influencing prospective clients' purchasing decisions. This should ultimately help steer a client's potential lifetime value toward JLL in an industry that is particularly relationship-focused.

Like most service businesses, though, the level of value that JLL can deliver to its clients is highly dependent on its employees and its ability to entice and retain talent. Many of the services that JLL provides are based on specific local market and asset expertise that is supplied by its professionals in context to broader market knowledge. Highly effective teams will oftentimes become dominant within local markets, winning a progressively greater share of client work, which, in turn, makes these teams even more proficient and qualified, and so on, helping create intangible value for market leaders to provide greater value to clients and increase pricing power. That said, as a leader in many markets, JLL is attractive to employees who are able to leverage the firm's strong brand recognition, extensive shared knowledge base, and far-reaching service platform, ultimately building upon the company's success.

Additionally, JLL continues to expand its business through both organic growth and strategic acquisitions, further developing its range of services and geographic offerings. Not only does this create highly synergistic cross-selling opportunities for the firm and its employees, who are sometimes compensated based on production, but at this point we think it makes JLL among just a handful of firms that can realistically satisfy larger and broader real estate service mandates, giving it access to a wider market than smaller competitors. And although difficult to quantify, we also think JLL's scale allows it to leverage certain valuable but costly pursuits, such as market and economic research and integrated technology systems that smaller peers would be challenged to replicate cost-effectively, allowing the firm to achieve relatively higher profitability and to bid more aggressively for complementary strategic acquisitions. We would expect additional effects as the firm continues to grow and gain market share. Furthermore, we believe these dynamics naturally increase switching costs for its employees who benefit from JLL's platform and resources in order to more effectively compete.

As JLL has expanded its property management and especially its integrated facility

management businesses over recent years given outsourcing trends, we also think its customer switching costs have increased. When JLL wins this business and essentially takes over the real estate functions from its client, sometimes representing millions of square feet across multiple geographies, it enjoys client retention rates that exceed 90%. We believe this particularly sticky business demonstrates not only the potential disruption for clients of frequently changing service providers but also the value that JLL provides through specialized, comprehensive day-to-day property management.

ROIC (including goodwill) for JLL has averaged more than 17% over the past decade, a period with both cyclical high and low points for the commercial real estate markets. In the stronger parts of the cycle, the firm's employees share in the upside, essentially capping margin expansion potential and ROIC growth for the firm. However, in weaker environments, its professionals share in the pain as the firm is able to significantly cut costs, helping preserve reasonable profits, cash flow, and ROIC. Over the long term, though, we expect JLL to maintain a spread between its estimated cost of capital and ROIC given its competitive position.

#### **Valuation** 06/13/2016

We are decreasing our fair value estimate to \$144 per share from \$172 to adjust for an updated growth outlook and increased estimation for the company's weighted average cost of capital. We still think JLL faces a long runway of long-term organic and external growth, but we are incorporating in our forecast a period of relative weakness, coming off historical highs amidst building global economic uncertainty. We don't mean to call the timing of a potential downturn but rather reflect in our longer-term outlook the likelihood that JLL's cash flows will be under pressure at some point as we journey through the cycle. Our \$144 fair value estimate implies a 14 times multiple of our 2016 adjusted earnings per share estimate and a 1.1 times and 9 times multiple of implied enterprise value, based on our 2016 revenue and EBITDA forecast. Although we see short-term volatility moderating CRE activity from recent cyclically high levels, we expect JLL's revenue growth to normalize near 8%-10% on average during our forecast period, driven by overall market growth and pricing growing in line with inflation and market share gains due to strategic hiring and acquisitions. We currently project average EBITDA margins on fee revenue to be relatively flat across our forecast as scale benefits in traditional brokerage service lines are offset by a return to lower, more normalized levels of high-margin incentive fee revenue, the shift in business mix toward the lower-margin but faster-growing corporate facilities outsourcing business, and potential wage pressure as the industry consolidates and matures. We also model acquisition spending as roughly 50% of free cash flow on average, per management guidance, over our forecast period. We estimate future acquisitions priced at 8 times EBITDA, slightly higher than pricing of its larger deals historically to represent the potential for increased competition for accretive opportunities. However, we acknowledge that acquisition activity is difficult to accurately forecast, as are the other volatile, non-contractual aspects of the business. Given the uncertainty of cash flows, along with possible country risk premiums from its international operations, we have increased our estimate for JLL's weighted average cost of capital to 10.4%. However, we think JLL's cost of capital and valuation could benefit as it shifts toward more stable business lines and decreases the firm's overall volatility.

#### **Risk** 01/27/2016

Although we believe the firm will continue to create value in the long run, JLL's performance is nonetheless strongly tied to the cyclical CRE market. In particular, its leasing and capital markets businesses, which represent more than 50% of the firm's revenue and are transactional in nature, tend to both positively and negatively magnify the volatility in the overall CRE markets and can swing by double-digit percentages in either direction. Additionally, roughly half of JLL's income is earned in international markets and foreign currencies; foreign exchange rate fluctuations or country-specific risks can meaningfully affect the firm's financial results. While we don't see these factors irrevocably harming the

company, we acknowledge the substantial volatility they can produce in combination.

As we have seen in the past, firms that rely on their reputations and trustworthiness are especially vulnerable to the possible unethical or illegal activities of their employees. JLL has defined professional standards and has consistently been recognized for its business practices. However, there may always be an inherent conflict of interest between its employees and clients given potential transaction-based compensation structures. Such a goodwill-damaging activity could be devastating to JLL, especially if competing firms were able to entrench further with increased market share from lost clients or key employees in the aftermath.

#### **Management** 06/13/2016

We are maintaining JLL's stewardship rating at Exemplary. JLL's strategic acquisitions and technology investments have broadened its capabilities and extended its footprint globally, all while adding benefits of additional scale. Plus, the firm's use of deferred payments allows it to pay out the deal's price over time, so long as the target's performance expectations are met, helping limit the possibility for JLL to overpay. Since 2005, JLL has announced approximately 90 acquisitions worth \$2.5 billion, and other than the bottom in 2009, the firm has produced ROICs in excess of its cost of capital by mid-single-digits. Altogether, this gives us comfort that JLL has a history of effective capital allocation. Additionally, JLL pays a dividend and has largely avoided dilutive equity issuances in a cyclical industry. And while we question the firm's optimal capital structure, we appreciate its focus on financial health and conservatism.

CEO Colin Dyer has been with the firm since 2004, having come from nearly 20 years in executive management positions, and Christie Kelly, with extensive commercial real estate and finance experience, joined the firm as CFO in July 2013. We like that the firm's directors are largely independent, serve one-year terms, and come from successful and diverse backgrounds. We are comfortable that JLL has sufficient and effective management, supported by robust in-place corporate governance.

#### **Overview**

##### **Profile:**

Jones Lang LaSalle, commonly known as JLL, provides a wide range of real estate-related services to owners, occupiers, and investors worldwide, including leasing, property and project management, and capital markets advisory. Additionally, JLL's investment management arm, LaSalle Investment Management, manages more than \$50 billion for clients across diverse public and private real estate strategies.

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