FEATURE

OUTSOURCERS: CAN IT GET ANY WORSE?

For years, big outsourcing companies were regarded as safe bets to keep growing their profits and dividends. All that has now changed, as SharePad's **Phil Oakley** explains

The fortunes of companies in the public sector outsourcing sector have experienced a dramatic fall from grace. Prior to the financial crisis of 2008 and the recession that followed, these companies were the beneficiaries of lavish government spending and a growing trend in getting the private sector to do more of the jobs that central and local governments used to do. For many years, the big outsourcing companies were seen as bankers to keep on growing their profits and returns to shareholders. That has changed.

Serco (SRP) and **G4S (GFS)** have seen their business strategies come a cropper, while **Capita (CPI)** and **Mitie (MTO)** have both issued big profit warnings in recent weeks. What was once a sector that prided itself in providing investors with highly visible and predictable future profits is now the subject of considerable uncertainty.

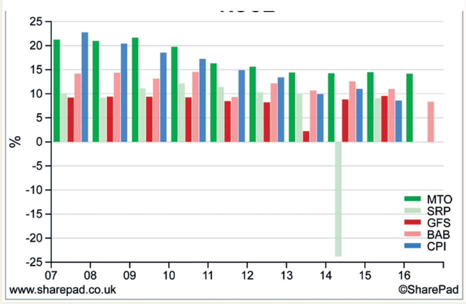
What are investors to make of the current situation? Is it a sector now offering potential bargains or is it still too soon to buy in?

Support services (outsourcing) is a large sector with many shares listed on the stock exchange. In this article, we are going to look at the financial performance history of just five companies – **Babcock International (BAB)**, Capita, G4S, Mitie and Serco – to learn where they have come from and to gain some insight into where their shares might be heading.

Have these companies ever been good businesses?

As I've mentioned in previous articles, one of the best ways to see if a company is a potentially good investment or not is to look how much money it makes compared with how much it has invested. Good companies make consistently good returns on capital employed (ROCE) of over 15 per cent.

1. ROCE



So have these outsourcing companies ever been good businesses?

With the exception of Mitie, which has historically made an ROCE of over 15 per cent, chart 1 shows us that ROCE for these companies has always actually been very modest and has been trending downwards.

Why has this happened?

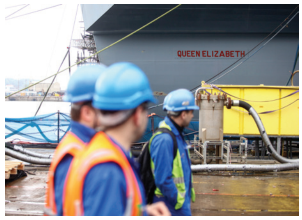
Profit margins are one of the main drivers of ROCE. Low or falling profit margins can often contribute to a low or modest ROCE. As you can see from chart 2 this is not a high-margin sector. Companies such as G4S and Serco have seen their margins fall due to well-publicised problems with their businesses, but Capita has also seen a sharp fall in profitability. Mitie's and Babcock International's margins have been the most consistent.

So, low profit margins can help to explain why these companies don't earn high returns but it seems that there is a bigger factor at play. As chart 3 show,

Capital employed

Name	ROCE	10y ago ROCE	EBIT margin	10y ago EBIT margin	Capital employed	10y ago Capital employed	Capital turnover	10y ago Capital turnover
Babcock Int'l	8.3%	12.7%	9.0%	5.6%	£5244.8m	£459.9m	0.8	2
Capita	8.6%	20.1%	6.7%	12.5%	£4919.5m	£1132.7m	1	1.4
G4S	9.60%	9.3%	5.2%	5.3%	£4219m	£2749.4m	1.6	1.5
Mitie	14.2%	21%	5.2%	4.8%	£935.6m	£256.9m	2.4	4.1
Serco	9.1%	8.1%	3.9%	4.3%	£1803.8m	£2176.2m	1.6	1.3

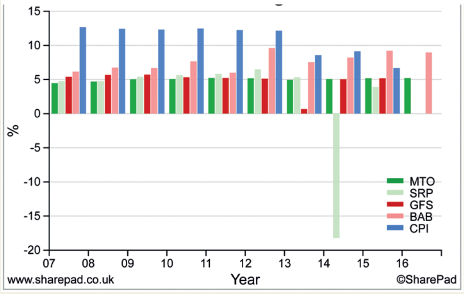
Source: SharePad. Capital employed includes estimated hidden debts



Support services is a large sector with many companies listed on the stock exchange, including Babcock International, Capita and G4S

they've invested a lot of money in their businesses over the years – mainly from buying other companies – and these acquisitions haven't yet provided big enough improvements in profits.

2. Ebit margin



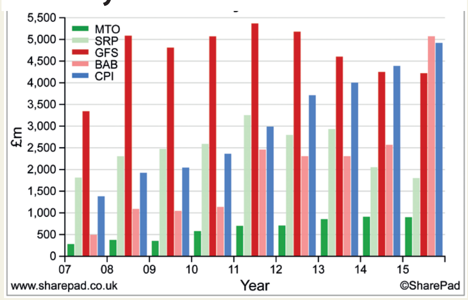
The amount of money that Capita and Babcock have invested (their capital employed) has soared over the past decade. Serco and G4S also invested lots of money but are now shedding assets to improve their profitability. Mitie is the standout here. Compared with its peers, it has not splashed its cash as much and this might go some way to explaining why historically it has been able to earn higher returns than them.

The capital turnover figures – which show the amount of sales generated per £1 of capital employed – in the table (above) shows why ROCE has been so modest or has been declining. With the exception of Serco and G4S, capital turnover has fallen significantly. The extra amount of money invested doesn't seem to have been very well spent.

Weak finances are an issue

As well as having fairly mediocre profitability, debt is an issue for some of the companies. The table below shows a number of debt ratios and debt numbers. The key figure to look at is fixed charge cover, which looks at how many times a company's trading profits can pay the interest and borrowings and the rents on leased assets, which are a form of hidden or off-balance sheet debt.

3. Money invested



A fixed charge cover of less than two is a sign of a company whose finances are or are beginning to look stretched. G4S and Serco fall into this camp. Although Mitie's profits are expected to decline slightly in 2016-17, it has a relatively high fixed charge cover from 2015, which suggests that it will not have any problems paying its interest and rent bills at the moment.

The other closely-watched ratio in this sector is Net debt to Ebitda. Any value of over three times for a non-financial or non-utility company is a sign of high indebtedness. Capita, after its recent profit warning, is looking weak on this measure. This is a company that has accumulated a lot of debt – including its pension fund deficit. It also has substantial off-balance sheet debts. G4S still has some work to do to get its debts down as well.

Cash-flow performance

Babcock and Capita have been by far the best cash-flow performers (see table on page 32). They have consistently turned their operating profits into operating cash flow – operating cash-flow conversion of more than 100 per cent – and have also been able ▶

Debt

Name	Total borrowing	Gross gearing	Net debt to Ebitda	Fxd charge cover	Hidden debt
Babcock Int'l	£1,736m	74.20%	2.7	2.7	£807.1m
Capita	£2,693.4m	396.50%	3.7	2.4	£1078.7m
G4S	£2557m	379.90%	4.3	1.9	£693m
Mitie	£321.3m	77.90%	1.4	3.7	£191.8m
Serco	£425.7m	151.70%	0.6	1.7	£730.8m

Source: SharePad. All calculations of debt include pension deficit

Cash conversion

Name	Op CF conv.	Op CF conv. 10y avg	FCF. conv	FCF conv. 10y avg	FCF div cover	FCF div cover 10y avg	Capex to dep. 10y avg
Babcock Int'l	141.2%	124.7%	81.1%	101.3%	1.7	2.2	57.1%
Capita	208.5%	139.9%	150.2%	109.2%	1.4	2	90.2%
G4S	142.1%	285.6%	25.0%	31.0%	0.3	0.7	91.7%
Mitie Group	95.4%	121.6%	74.6%	79.4%	1.4	1.7	96.6%
Serco Group	4.2%	88.1%	-143.5%	40.6%	–	2.6	94.0%

Source: SharePad

to turn their earnings per share (EPS) into free cash flow per share – free cash flow conversion of more than 100 per cent.

The ability to turn profits into free cash flow is a key test of profit quality, particularly in a sector with lots of contracts that come with the scope for creative accounting. Yet, G4S, Mitie and Serco have been very bad at doing this. What's even more concerning is that they have had capex-to-depreciation ratios averaging less than 100 per cent over the last decade which usually boosts free cash flow. This may mean that more cash flow has been required for working capital. Any investor looking to invest in this sector would be well advised to scrutinise company cash flows very carefully.

Are the shares cheap?

The outsourcing sector is exposed to a lot of pessimism at the moment. Poor sentiment can often present a buying opportunity for those prepared to be patient and wait for things to get better. If the forecasts of City analysts are anything to go by (treat these with care as human beings are usually not very good at predicting the future), then the outlook is far from disastrous. Profits are not expected to collapse and some modest growth is expected.

Looking at the valuation table (below), it is fair to say that valuations for some shares are not particularly demanding. Let's look at each company in turn.

Babcock has been a very reliable share to own and has rewarded long-term investors handsomely. Its focus on value-added, engineering support services has allowed it to differentiate itself from those companies that perform more mundane – and more competitive – tasks such as cleaning. Its profit margins reflect this, although some big acquisitions in recent years mean that the company's ROCE remains modest.

Its cash-flow performance has been good and this has allowed it to grow its dividend for 15 years in a row, a trend that should continue into a 16th year.

Valuations

Name	Close	fc PE	fc yield	P/FCF	EBIT yield
Babcock Int'l	990p	12.4	2.9	22.9	5.7
Capita	598.5p	9.1	5.6	13.5	5.2
G4S	230.2p	15	4	71.1	6.2
Mitie	199p	9.7	6.2	11.7	12.3
Serco	130.6p	27.8		-12.3	8

Prices as of close 10/10/16

Current trading is good as the company has kept on winning new contracts. Debt levels are nothing to worry about as evidenced by the company recently being able to issue a £250m 10-year bond at a very low interest rate of 1.875 per cent. Cash conversion is also improving and debt is coming down.

Capita's shares are facing a wall of worry at the moment. A profit warning at the end of September has sent the share price crashing down. The company cited customers being increasingly reluctant to commit to new orders and blamed the outcome of the EU referendum on making business more difficult. Capita also highlighted that its new congestion charging contract in London was experiencing some teething troubles which would cost it £25m of lost profit.

'Babcock has been a very reliable share to own and has rewarded long-term investors handsomely'

As a result, expectations for 2016 pre-tax profit have come down by 13 per cent. This will make Capita look even more stretched on the closely watched net debt to Ebitda measure of indebtedness. This increases the financial risks faced by shareholders.

One potential ray of sunshine is Capita's track record as a cash generator, which suggests that the dividend and 5.6 per cent forecast yield are safe for now. That said, investors will worry that another profit warning might follow. On top of that concern there is scepticism that the company has been too reliant on acquisitions to grow, which has masked weak underlying growth.

Things are getting better at G4S. Its first-half results back in August showed a good pick-up in profits, as well as a good cash-flow performance. Profit margins have improved, but there is still a lot of work to do to improve profitability and get debt levels down. Both targets will be helped by the continued shedding of underperforming businesses. It will also need to keep on taking working capital out of the business to boost a very poor cash flow track record.

The fact that the half-year dividend was maintained has cheered up investors and gives the shares a decent yield. The return to dividend growth is another matter, though, and could be a little way off.

Mitie has got itself into a mess. A profit warning in the middle of September and a change in chief executive this week has created a huge amount of uncertainty about the company's future prospects.

Serco carries on cycling – new bikes and more innovations for the London Cycle Hire Scheme, and Mitie (below) has landed in a mess and there's uncertainty about the company's future prospects

The nature of the profit warning has spooked investors. The company cited public sector spending pressures and rising wages along with less higher-margin project work. Profit margins have taken a hit and there is a fear that worse may be to come.

Its facilities management business is holding up reasonably well, but its healthcare business is being plagued by lower social care budgets and a very competitive market for contracts, which has led to very low bidding prices. Mitie has hinted that it may exit this business which would probably be taken well. Property management is also being hit by budget cuts and lower social housing rents, which has left a smaller pot of money for Mitie's repairs and maintenance business.

> **'At Mitie, profit margins have taken a hit and there is a fear that worse may be to come'**

The shares have been hammered and are trading close to multi-year lows. This might make them seem like a bargain but they could as easily be a value trap for the unwary tempted by the high dividend yield. It seems as if the company has a lot to prove.

The quality of its end-markets in competitive and low-margin sectors is a concern as is the company's poor track record of turning profits into cash. That said, its finances look to be in reasonable shape, which gives the new chief executive some breathing space to try and put the company back on the right track.

Like G4S, Serco looks to be turning itself around. It has been getting out of loss-making contracts and cutting costs and debts. This, combined with a lower tax rate, has seen analysts upgrade their profit forecasts in recent months, which explains why the shares have performed well.

As well as sorting itself out, the company is getting on with trying to grow again. This is good news, but analysts still expect earnings per share to keep on falling for the next two years. Given that backdrop, the valuation of the shares – on 27 times forecast earnings – looks high and suggests a lot of good news might be already priced in.

Phil Oakley is a stock analyst for Ionic Information, maker of SharePad and ShareScope investment software. Read more from Phil, including his excellent Step-by-Step Guide to Investment Analysis at www.sharepad.co.uk/philoakley.