Sector structure

BPO/Consulting
- Capita
- Experian
- Serco
- Xchanging

Distributors
- Bunzl
- Electrocomponents
- Premier Farnell
- Wolseley

Staffing
- Adecco
- Hays
- Michael Page Intl
- Randstad
- SThree
- USG

Rentals
- Aggreko
- Ashtead
- Northgate
- Regus

Security
- G4S
- Securitas
- Prosegur

FM & Hygiene
- Berendsen
- Mitie
- Rentokil Initial

TIC
- Bureau Veritas
- SGS
- Intertek

Source: HSBC
Sector price history

- End of recession
- March 1991
- US Economic recession
- March-November 2001
- Lehman collapse
- October 2009
- US employment rate at 10.1%, the highest since 1983
- December 2007
- Great Recession in US

Source: BLS, Thomson Reuters Datastream, HSBC
12-month rolling PE multiple (3M average) versus mark-up over labour (average of 2009-11)

Source: Company data, HSBC
Sector description

Business services firms can be generally classified as enablers or intermediaries. The sector includes businesses such as staffing, distributors, testing & inspection, and BPO/consulting firms.

BPO/consulting firms have a broad variety of business models. At one end of the spectrum there are pure outsourcing firms, which work on a cost arbitrage model, and at the other end, there are consulting firms providing engineering and design services to their clients.

Distributors purchase items, store them and re-sell to a client base. The distributors sub-sector has a very diverse client exposure, ranging from builders and grocery stores to janitors and research scientists.

Staffing includes firms which provide permanent and temporary workforce to organisations, and is primarily categorised as general staffing business, focusing on positions requiring general skills, and professional staffing business, focusing on positions requiring professional skills.

Rental services is a heterogeneous sub-sector, where companies broadly work on renting a variety of assets. The different rental companies are distinguished from one another by factors such as asset type, geographical exposure, capital structure and economic sensitivity.

Security services provide a wide array of security services such as manned guarding, prison management, alarm monitoring and security assessment. The industry is fragmented and services are offered to the client either directly or through a facilities management contractor. The latter is more common in the UK and the US, the former in Europe.

FM and hygiene offer a range of diverse services at the premises of their clients, ranging from facilities management, pest control and reception services to work-wear and linen, among others.

Testing & inspection firms serve a wide range of industries, testing, inspecting, auditing, and certifying products, commodities and services based on regulatory or voluntarily adopted standards.

Key themes

BPO/consulting
Outsourcing companies tend to have less cyclical cash-flow streams than the rest of the sector. However, the most pertinent question is how far individual companies are less cyclical, or indeed whether they respond differently to different cycles. For valuations to be attractive, the companies must show more defensive growth than is in the price. This will depend upon three issues: (a) whether non-public expenditure is non-cyclical; (b) whether business revenues are affected by the tax receipt cycle; and (c) how margins are affected by the cycle.

Distributors
Distributors suffer or benefit from the cyclicalty of their clients. They have an arsenal of efficiency measures to offset pricing and volume pressures. One option is to aim to use fewer, larger and better-stocked centres – which can reduce staff costs and free up property. This process has been under way for some time and is now largely complete, although additional options remain. Costs may also be reduced by managing the number of stock-keeping units (SKUs). By focusing on a smaller list of SKUs, a distributor can focus its purchasing power on fewer suppliers and reduce input costs. Another cost-
reduction strategy is the use of private labels or own brands. This enables a distributor to buy large quantities of a product from a supplier and offer them to clients at a discounted rate, enhancing their gross margins. However, if distributors engage in cost-cutting measures that cut capacity in a downturn, this can reduce the medium-term upside during the ensuing recovery.

The distribution business lends itself to acquisitions because of the fragmented nature of the market. Another increasing trend among distributors is to move towards web-based sales. Typically, web sales are not only higher margin but also result in better inventory management and higher cash conversion.

**Staffing**

Staffing companies’ growth is linked to labour market gross volumes and velocity. The market closely watches industry data about the number of vacancies, as well as the hours and wages of temporary and permanent placements. In addition, time-to-hire has a major impact on organic growth and operational gearing. Time-to-hire measures the speed at which vacancies are converted into sales. Ceteris paribus, if vacancies grow and the time taken to convert each vacancy into sales declines, that should boost staffers’ organic growth rates and operational gearing. Analysis based on pure vacancies is problematic as it does not capture the time lag between the vacancy being posted and the actual filling of the vacancy. One of our preferred lead indicators to analyse underlying demand for the staffing sector is “vacancies adjusted for time-to-hire”, as it directionally leads both vacancies and organic growth rates for staffers, numbers of temps, multiples and share prices.

The key distinction between staffers stems from the temp:perm mix, and geographical diversity. Blue-collar temps are a largely low-margin business with limited operational gearing, but during economic recovery they grow before white-collar temps. In the early stages of a recovery, temp tends to recover earlier and more quickly than perm, since permanent staff are expensive and carry more employment risks. However, during initial phases there is frequently a spurt of catch-up hiring in the labour market. When an early spurt in perm subsides, gross profit growth becomes subdued as temp constrains the value per sale and the gross margins. However, growth in overheads tends to be more correlated to volumes. Indeed, this effect particularly bedevilled the profit recovery during the early part of this decade, and in the early 1990s. Evidence that operational gearing is a later-cycle phenomenon is powerful, given that wage growth happens in the later stages. In previous recoveries, there has been emergent pricing pressure on certain key sections of the market. The effect was significant in the blue-collar markets and the UK IT market in 2001-04.

**Rental companies**

Despite its cyclical end-markets, the rental business model permits an unusual degree of flexibility in controlling cash flows. The capital base in a rental business is not fixed and can be expanded or shrunk quickly in response to changing end-markets. Rental companies are also notorious for their gearing, which exaggerates profit and share price behaviour at turning points in an economic cycle. The nature of this gearing is more nuanced than it first appears, though. Consolidation is a long and ongoing structural trend in these fragmented markets, and rental companies’ ROIC profiles tend to approximate their cost of capital across a cycle.
Security firms
The business is widely viewed as late cyclical, and has historically shown margin pressure late in the cycle. This is because the upward pressure to raise wages clashes with clients’ desire to reduce costs. In developed markets, guarding is a reasonably mature market and outsourced service appears to be a stable proportion of the market. Advances in technology have extended the scope of security to electronic surveillance and monitoring. These services are normally a mark-up to labour charges. Security firms nowadays provide integrated technology services, offering bundled services of access control, alarms and monitoring services, for example.

Testing and inspection
The stocks are seen as global trade plays with limited cyclical downside, well positioned to benefit from a recovery in global trade and likely to continue to outperform in a downturn, both in terms of organic growth and share prices. As most contracts have wage inflation escalators, rising wages are a significant element of organic growth, and are highly correlated to it. Broadly, wage rate inflation is fastest in the emerging markets, as is organic growth, and this is where margins, and returns, are highest. We would argue that geographic mix is an equally important factor to consider in addition to business mix. At least half of the organic growth of testing companies over the past decade has been the result of passing through wage inflation, which is higher in emerging markets. Our industry analysis suggests that emerging market operating margins for the sector are significantly greater than in the developed world. The difference in growth rates between the two halves of the world should support testing companies’ margins and return profiles over the next five years.

FM and hygiene
FM and hygiene businesses provide a host of diverse services, and the various businesses face different markets and challenges. Given this diversity, some of the companies in the sector have complex margin drivers. Spot-contract mix is one of the key determinants of margins. Historically, spot sales have been around 8-10% of sales at the peak of the cycle and have disappeared in recessions; however, they held up in the latest downturn.

Sector drivers
Leading indicators: The broad lead indicators for the sector include the TCB leading indicator, OECD leading indicators and ISM. Each sub-sector has a different lead indicator specific to the dynamics of the business. For distributors, key leading indicators are industry shipments, book-to-bill ratio and inventory-to-sales ratio. The clients’ lead indicators are also important for analysing distributors. As with building distributors, the key leading indicators are private housing starts, housing price and inventory, and plumber man-hours, for example. The US employment market has historically been a leading indicator for the rest of the world. The best leading indicator for labour markets remains US temp numbers. For the rest of the blue-collar general services, man-hours are among the key indicators, eg security man-hours, alarms man-hours and uniform supply man-hours for security firms, and pest control man-hours, grocery man-hours and janitorial man-hours for FM and hygiene.

Outsourcing
Government spending: Companies in this sub-sector have varying exposure to government contracts and are directly exposed to local and central government spending, driven by government revenue, fiscal
deficit and tax receipt cycles. Government tax receipt cycles play a key role, and growth in the companies exposed to the public sector has weakened in the wake of a fall in government tax receipts in previous cycles.

**Contract mix:** Margins of BPO and consultancy companies are largely determined by the contract and are applicable for long periods. Although contracted revenues are indexed to inflation, the key driver of margin is mix: the more complex the contract, the more margin variation is possible. Spot business generally attracts higher margins while longer-term contracts usually have lower margins.

**Distributors**

**Cyclicality of client:** Distributors have a diverse client exposure, ranging from builders and grocery stores to janitors and research scientists. These clients exhibit a degree of cyclicality, which either hurts or benefits the distributors. The more cyclical the client base, the more cyclical a distributor’s business.

**Inflationary or deflationary environment:** Distributors are beneficiaries of a mildly inflationary environment as there is a lag of a few weeks or months between their purchase and sale of a product. Generally they are able to pass on most of the inflationary price rise to their clients, giving them holding period gains. The effect is magnified lower down the P&L because much of the SG&A is volume related. Ceteris paribus, in a period of ‘accepted inflation’, sales rise faster than volumes, gross margins may nudge up, and SG&A costs grow with volume. In a deflationary period, the inverse is true.

**Staffing**

**Temp/perm mix:** Temporary staffing is a lower-margin business than permanent placement as the wages of a temporary worker form part of the agents’ sales and cost of goods sold, whereas no such cost exists for a permanent placement. A decline in the perm mix has a magnified impact on margins.

**Wage rate mix:** A lower wage rate implies a lower gross margin. The wages of candidates are a product of the scarcity of their skills at any point in time. This same scarcity tends to drive the gross margin that a staffing agency can charge for sourcing candidates. A fall in the average wage rate reduces the value of sales more than a fall in volume, and also affects the gross margins or conversion of gross margin into operating profit.

**Rental companies**

**Size** is a key driver for rental companies given low entry barriers and service differentiation. Large, diversified fleets help broaden the customer base, give negotiation power and help to achieve economies of scale. Long-run returns are driven by: (1) rental rates; (2) utilisation; (3) cost of delivery (sales, purchasing, maintenance, distribution and services); and (4) the cost of funds. Scale helps in all four.

**Testing and inspection**

TIC stocks have a strong structural story to support their obvious growth: trade globalisation, product diversity, outsourcing and regulation all drive testing and inspection volumes. A further important factor is pricing driven by the pass-through of wage inflation. The organic sales growth of the TIC stocks is driven by: the number of testers, inspectors, certifiers and billable hours. Pricing growth is largely driven by wage inflation for front-line staff – explicitly in many contracts, implicitly in others. Pricing power causes increases in wage costs to be passed through on the whole of the contract amount. Other costs grow slower than wages, providing a mechanism to support and drive margins. As wage rate inflation is
fastest in the highest-margin geographies, the pass-through of wage inflation supports margins, and
margin expansion is more feasible than many believe.

Other businesses sector
The other businesses sector covers a host of largely blue-collar general services. These tend to be
contract-backed but volume-dependent. If a client wishes to clean its facilities less frequently or engages
less security, both sales and margins are likely to come under some degree of pressure. Most such
services are cyclical and can be tracked through employment numbers. The core economics of the
security business is the mark-up over the cost of labour. Gross margin risk can frequently come from
rising wage rates, which cannot be passed on to customers in a recession.

Valuation
Companies in this sector trade on traditional metrics, with a few exceptions. PE is the most widely used
multiple, but EV/EBITA and EV/EBITDA are also used (mainly for rental firms), EV/sales, FCF yield
and FCF to EV. Where pension liability is a concern, analysts prefer EV/EBITA (adjusted for the
pension). Some prefer a blended valuation based on relative valuation, historical multiples and DCF.
However, use of DCF should be viewed with caution – particularly during periods of economic
uncertainty and poor earnings visibility.

The average 12-month rolling forward mid-cycle PE multiple (2006-07) for the business services sector
was 15x (range of 12x to 20x), versus 12x in the last downturn (range of 7x to 21x). However, PE
multiples in the sector tend to range widely whatever the economic climate, due to the differing growth
and margin profiles. Security firms generally trade at the lower end of the spectrum (average mid-cycle
multiple of 12x); testing and inspection companies command a higher premium (18x) owing to their
better margin and return profile.

Accounting notes
Companies in the sector report their profits differently, despite sharing nomenclature such as trading
profit, operating profit, EBIT and EBITA. The key differences stem from the classification of
amortisation arising from acquisition intangibles, the share of profit from associates and exceptionals. The
comparison of multiples across companies should therefore be approached with caution, to ensure that
they convey the same economic content. It is also important to keep track of changes in regulation and the
resulting impact on accounts. For instance, a change in regulation requiring a reclassification of French
business tax from COGS to tax has boosted gross margins for staffing companies without affecting
EPS/operating cash flow.
### Staffing sector: growth and profitability

<table>
<thead>
<tr>
<th></th>
<th>2010</th>
<th>2011</th>
<th>2012e</th>
<th>2013e</th>
</tr>
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<tbody>
<tr>
<td><strong>Growth</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sales</td>
<td>13.6%</td>
<td>11.1%</td>
<td>2.0%</td>
<td>6.3%</td>
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<tr>
<td>EBITDA</td>
<td>68.0%</td>
<td>11.9%</td>
<td>8.2%</td>
<td>18.7%</td>
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<tr>
<td>EPS growth</td>
<td>95.0%</td>
<td>14.0%</td>
<td>12.8%</td>
<td>25.4%</td>
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<tr>
<td><strong>Margins</strong></td>
<td></td>
<td></td>
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<td></td>
</tr>
<tr>
<td>EBITDA</td>
<td>5.4%</td>
<td>5.3%</td>
<td>5.5%</td>
<td>6.2%</td>
</tr>
<tr>
<td><strong>Multiples</strong></td>
<td></td>
<td></td>
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<td></td>
</tr>
<tr>
<td>PE</td>
<td>15.1</td>
<td>13.0</td>
<td>11.9</td>
<td>9.5</td>
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<tr>
<td>EV/EBITDA</td>
<td>8.2</td>
<td>7.4</td>
<td>6.6</td>
<td>5.1</td>
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<tr>
<td>FCF/EV</td>
<td>7.9%</td>
<td>9.0%</td>
<td>9.1%</td>
<td>13.6%</td>
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<tr>
<td>ROE</td>
<td>14.8%</td>
<td>11.2%</td>
<td>14.5%</td>
<td>16.4%</td>
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<tr>
<td>Mark-up over labour</td>
<td>55.4%</td>
<td>37.9%</td>
<td>38.3%</td>
<td>42.3%</td>
</tr>
</tbody>
</table>

**Note:** based on all HSBC coverage of Staffing sector (market cap weighted)

**Source:** Company data, HSBC estimates

### Testing and Inspection sector: growth and profitability

<table>
<thead>
<tr>
<th></th>
<th>2010</th>
<th>2011</th>
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<tr>
<td><strong>Growth</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sales</td>
<td>6.2%</td>
<td>10.9%</td>
<td>12.4%</td>
<td>11.3%</td>
</tr>
<tr>
<td>EBITDA</td>
<td>7.5%</td>
<td>6.6%</td>
<td>11.9%</td>
<td>15.0%</td>
</tr>
<tr>
<td>EPS growth</td>
<td>5.0%</td>
<td>4.5%</td>
<td>15.0%</td>
<td>18.7%</td>
</tr>
<tr>
<td><strong>Margins</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>EBITDA</td>
<td>20.9%</td>
<td>20.1%</td>
<td>20.0%</td>
<td>20.7%</td>
</tr>
<tr>
<td><strong>Multiples</strong></td>
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<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>PE</td>
<td>24.5</td>
<td>23.5</td>
<td>20.4</td>
<td>17.2</td>
</tr>
<tr>
<td>EV/EBITDA</td>
<td>11.5</td>
<td>11.0</td>
<td>9.8</td>
<td>8.3</td>
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<tr>
<td>FCF/EV</td>
<td>4.4%</td>
<td>3.2%</td>
<td>4.2%</td>
<td>5.6%</td>
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<tr>
<td>ROE</td>
<td>36.5%</td>
<td>32.4%</td>
<td>32.1%</td>
<td>32.3%</td>
</tr>
<tr>
<td>Mark-up over labour</td>
<td>51.6%</td>
<td>46.9%</td>
<td>49.4%</td>
<td>54.1%</td>
</tr>
</tbody>
</table>

**Note:** based on all HSBC coverage of testing and inspection sector (market cap weighted)

**Source:** Company data, HSBC estimates
**Sector snapshot**

**Key sector stats**

**Business services**  % of MSCI Europe US Dollar not meaningful*

**Trading data**
- 5-yr ADTV (USDm) 473
- Aggregated market cap (USDm) 121,463

**Performance since 1 Jan 2000**
- Absolute* 128%
- Relative to MSCI Europe US Dollar 149%

3 largest stocks
- SGS, Experian, Wolseley

Correlation (5-year) with MSCI Europe 0.64

US Dollar **

* Due to the nature of the sector, other indices are used to demonstrate its structure.
** Correlation of Europe Business Services Price index with MSCI Europe Source: MSCI, Thomson Reuters Datastream, HSBC

**Top 10 stocks: Bloomberg EMEA Commercial Services Index**

<table>
<thead>
<tr>
<th>Stock rank</th>
<th>Stocks</th>
<th>Index weight</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>SGS</td>
<td>8.49%</td>
</tr>
<tr>
<td>2</td>
<td>Experian</td>
<td>8.30%</td>
</tr>
<tr>
<td>3</td>
<td>Wolseley</td>
<td>n/a</td>
</tr>
<tr>
<td>4</td>
<td>Bureau Veritas</td>
<td>5.57%</td>
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<tr>
<td>5</td>
<td>Aggreko</td>
<td>5.37%</td>
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<tr>
<td>6</td>
<td>Adecco</td>
<td>4.49%</td>
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<td>7</td>
<td>Intertek</td>
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<tr>
<td>8</td>
<td>Capita</td>
<td>3.52%</td>
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<td>9</td>
<td>G4S</td>
<td>3.58%</td>
</tr>
<tr>
<td>10</td>
<td>Bunzl</td>
<td>3.09%</td>
</tr>
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</table>

Source: Bloomberg

**Country breakdown: Bloomberg EMEA Commercial Services**

<table>
<thead>
<tr>
<th>Country rank</th>
<th>Country</th>
<th>Index weight</th>
</tr>
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<tbody>
<tr>
<td>1</td>
<td>UK</td>
<td>32.9%</td>
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<tr>
<td>2</td>
<td>France</td>
<td>19.5%</td>
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<tr>
<td>3</td>
<td>Switzerland</td>
<td>13.3%</td>
</tr>
<tr>
<td>4</td>
<td>Ireland</td>
<td>8.7%</td>
</tr>
<tr>
<td>5</td>
<td>Spain</td>
<td>7.6%</td>
</tr>
<tr>
<td>6</td>
<td>Italy</td>
<td>6.0%</td>
</tr>
</tbody>
</table>

Source: Bloomberg