THE OC&C 2010 FM INDEX

# SHOW OF STRENGTH

How the Facilities Management sector is facing up to the recession

OC&C
Strategy Consultants

# Introduction

## Twelve months ago we compiled an Index evaluating 50 of the leading FM businesses in the UK, aiming to spark some debate, particularly as FM is rarely seen as a coherent industry – even by many participants.

**Our view is that there are more similarities than differences between Soft FM, M&E and the other sectors, and that examining the strategies and performance of a wide set of business can be instructive about which of them are likely to be the long-term winners.**

**We are updating the analysis now in order to take stock of the industry and to see what differences are emerging between the largest players. Specifically, we have used some financial analysis based on published accounts as a starting point for some investigation of the trends likely to define the market over the next 2-3 years (see Appendix for details of the calculation method used).**

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# Bringing out the best

## FACILITIES MANAGEMENT (FM) HAS NOT BEEN IMMUNE FROM THE EFFECTS OF THE RECESSION.

Despite the hopes of some commentators, who saw hope in the defensive qualities of the industry and the prospects for increased outsourcing, it has been a tough 12 months in almost every sector of FM. In several respects though, the impact has been to accelerate the maturing of FM, and to highlight the strengths and weaknesses of the different businesses. Across FM, there are three messages that emerge from the analysis: (1) Margin pressure, which had been emerging for some time before the recession took hold, has become widespread across FM, and is likely to continue even when the UK economy returns to growth, (2) The pattern of margin pressure has been across much of the sector, with no consistent link to company size, work type or client vertical; what that indicates is that surviving (or even increasing profitability) in the current environment is in the hands of the FM companies themselves, and (3) There are some practical actions that most FM businesses can take to improve their chances of outperforming, even in a recessionary or low-growth environment, and, we believe, things that can be learnt by looking at the success stories in FM, whether they come from hard FM or soft FM.

Of course, what we are showing here is an early read on the impact of the recession, not just because of the timing of annual accounts (meaning that several of the companies examined here have not yet reported full data for 2009), but also because many contracts are only now coming up for renewal, and some pretty tough negotiations are likely. What we hear on the grapevine is that buyers have maintained a tough stance on price into 2010

When we evaluate the financial performance of 50 of the UK's leading FM businesses, it is revealing to see that although the stronger performers recently come from a wide range of sub-sectors, and are a mix of very large and smaller players, there is a common thread: they are pursuing differentiation in an area that customers value, and that cannot easily be replicated by competitors.

COVER PHOTOGRAPHY: PHOTOLIBRARY

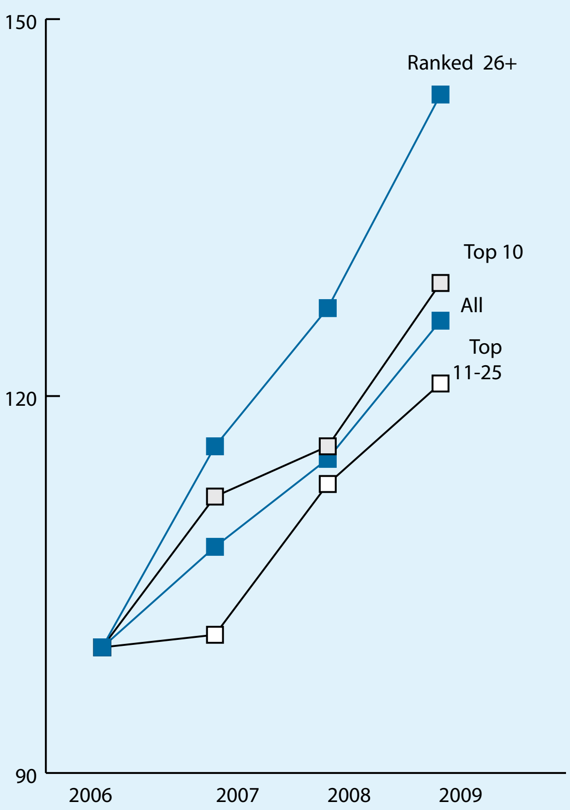
# Reflections on 2009

## THE LAST YEAR HAS SEEN A BREATHLESS SEQUENCE OF RECESSION-RELATED EVENTS COMPOUNDING MANY OF THE COMPETITIVE CHANGES AND BUY-SIDE TRENDS ALREADY UNDERWAY .

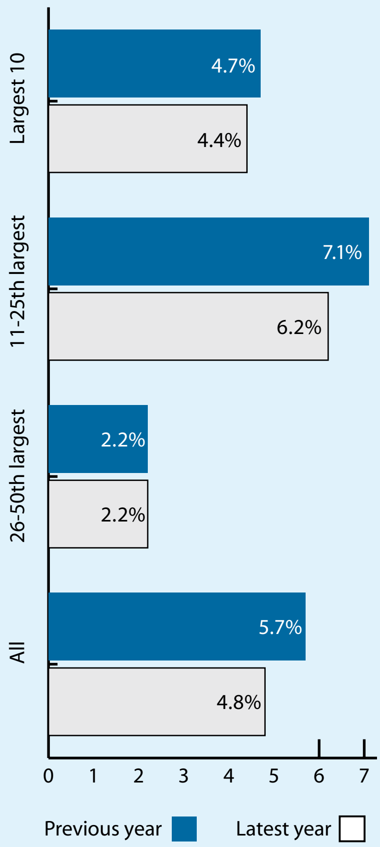
All sectors of FM have had to continue maturing in some of the toughest market conditions imaginable, and if there was ever going to be a rigorous test of the strategic and operational qualities of a business, then 2009 was it. At the start of the year, some commentators were still optimistic that even in recession, FM players could thrive, since corporates' drive to reduce costs would lead to more outsourcing, and therefore more revenue. We were sceptical about this view, partly because of the trade-off likely to come with purely cost-driven contracts – margin pressure – but also because we believe that as a rule, negotiating primarily with procurement departments is not the right answer for FM businesses; attractive as a revenue boost might be, in the long term FM needs to be positioned as a value-adding activity where the provider has some form of differentiation other than cost, otherwise margins will only trend downwards.

**EXHIBIT 1**

**Revenue and profit growth in the top 50 UK companies**




**PBT Margin by size of company**



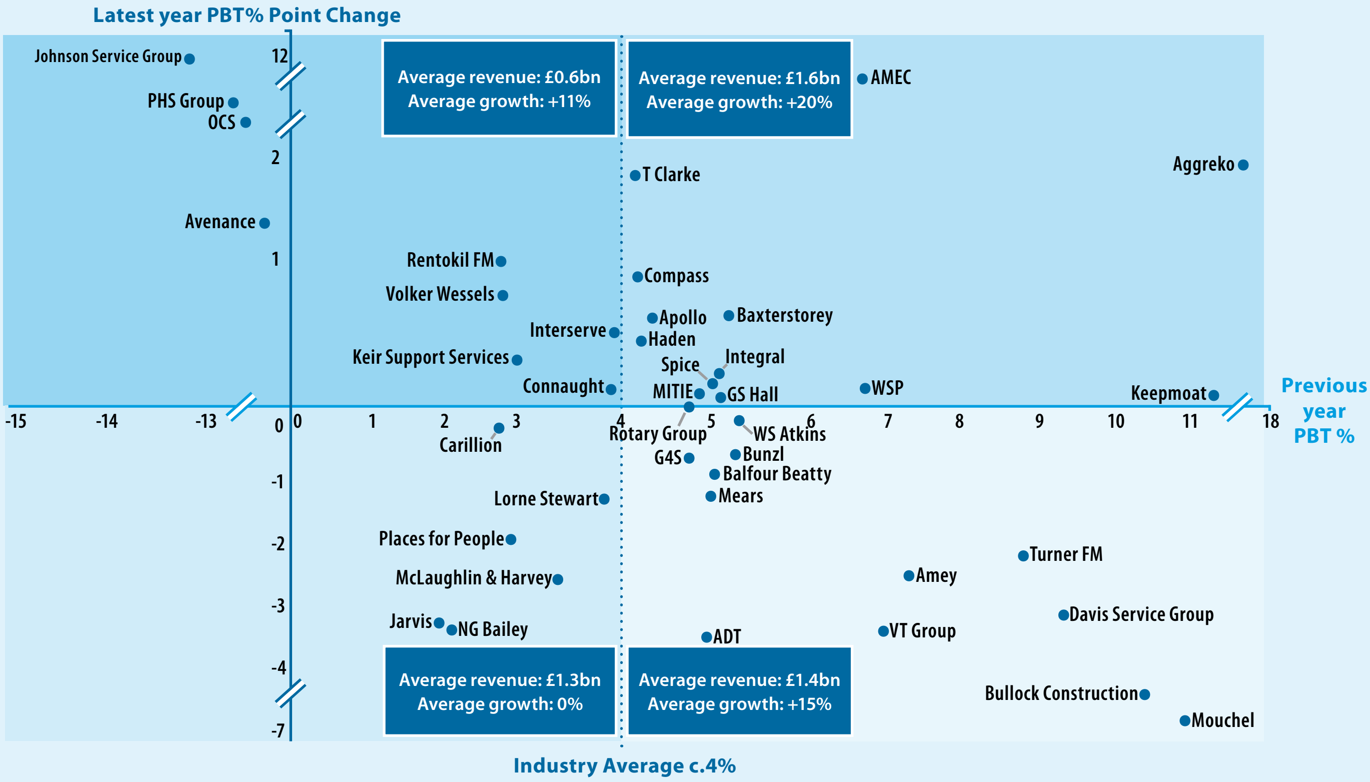

Overall there are four major market trends:

- More outsourcing
- Increased scrutiny by corporate of their spend on FM – a greater volume of work might be outsourced but the procurement exercise is likely to be demanding
- Greater sophistication in buyers' thinking about bundling, where a discount will be demanded unless FM companies can make a compelling case
- Fundamental shifts in public sector attitudes to FM, where after years of more talk than action, it appears that a sea-change is underway and some major opportunities are opening up for private-sector FM players

All of these are likely to continue after the recession, so recognising them and adapting business models to take advantage is essential.

These trends have already had an impact on the financial performance of the UK's FM companies – taking the 50 included in our Index as a group, we can see two very distinct patterns: the first is that revenue growth continued into 2009, at very similar rates to previous years, meaning that existing contracts being renewed at lower prices were more than offset by the scope of those contracts being expanded, plus additional work coming to market; the second trend is that margins have been squeezed, and while the top-line growth means that the aggregate profit pool is roughly the same size as the previous year, most businesses are having to run hard just to stand still, and for those already on thin margins the stakes are increasingly high.

## EXHIBIT 2: LATEST YEAR CHANGE IN PROFITABILITY




### PERFORMANCE OF THE LEADING FM COMPANIES

Not all FM Companies are equal. There have been some very different responses to changes in the economy and the nature of customer demand – and as a result, some swings in the performance of the businesses we've examined.

The chart below shows some of the financial performance of the companies we analysed, with the group of 50 divided into 4 groups, depending on whether they increased margins or not, and whether they started from above- or below-average profitability. The breadth of the scatter is itself revealing, of an industry where performance varies considerably between competitors. Several other points emerge: quite a few FM companies showed increasing margins, against the wider trend; those who increased margins are not radically different - in terms of size or type of work – from those who showed weaker performance. The drivers of outperformance seem to be the quality of strategy, and its execution, not scale advantage or a legacy of presence in a particular sector of FM.

### AND THE CURRENT WINNERS ARE...

The strongest performers financially tend to be those with a clear strategy that they are pursuing efficiently – regardless of which area of FM they operate in, or the scale of their business. In most cases, a distinct point of differentiation can be identified, eg:

- AMEC scores highly for the clarity of its strategy, and as well as having demonstrated an ability to trade successfully in a difficult year, it has a cash pile that should help it make acquisitions where useful to reinforce its market positions
- Aggreko, who have consolidated an already high margin position by latching onto the structural trends in power requirements (both in the UK and overseas) and areas where customers value high-quality service; in parallel, the business is exploiting scale economies that are clearly contributing to margin improvement-
- BaxterStorey, a small insurgent in Catering only a couple of years ago, up against some much larger competitors with scale advantages and well-recognised brands, but a business that has continued its very strong revenue growth trajectory at the same time as maintaining a clear focus on clients interested in differentiated high-quality catering
- GS Hall, somewhat smaller but proving that M&E work need not be low margin, by deploying technology intelligently and finding ways of differentiating itself from competitors (crucially, in areas that matter to their clients)
- MITIE, already one of the heavyweights of FM, spanning Soft and Hard FM activities, steadily improving above-average margins by making the transition from multi-service to genuinely integrated FM propositions

**Note: Taylor Woodrow and Land Securities Trillium are included in the averages but not shown above as results were outside of the scale presented above**

The pattern here is not about scale, or working in specific areas of FM, but much more about how these businesses go to market – the more successful ones have not just traded well through a difficult period but have also been more tightly focused on finding ways to stand out from the crowd in offering a clear value-add to their customers, and in targeting certain types of contract where that value-add translates into more attractive terms. Conversely, there are several FM Cos who have fared less well, and whose recent performance reflects some difficulty in convincing customers that they are more than commodity providers.

# Outlook

The UK FM industry is at an important point in its development. Concerted pressure on margins has emerged, and is likely to persist wherever buyers perceive that they are paying for commodity services. No part of FM is immune from that, but some businesses are better able to defend their position, or even to grow margins, and most players in FM (regardless of size or sub-sector) would benefit from taking a close look at how that is being achieved. When management teams review their business plans, they can assess the robustness of their ambitions partly by which parts of their business serve markets with at least some of these qualities:

- Scope for value-add by solving some reasonably complex client problems (eg carbon footprint management) …
- … scope to deploy technology as well as blue- and white-collar workers
- Few dominant scale players (particularly when viewed internationally)
- A history of relatively unsophisticated delivery, leading to a plethora of single-service or single-site contracts that can be consolidated

Boards must have clarity about the propositions they are offering, and the strategic marketing plan that will communicate the right messages to the market. Underpinning this – and not to be forgotten – is excellence in service delivery.

We are bullish about the long term potential of FM, in that there should be scope for profitable growth achieved through differentiation that is based on genuinely customer-centric solutions. The market is maturing fast, on the buy-side as well as the sell-side, and is gradually gaining a higher profile in board-level discussions and amongst financial investors. However, the development path is unlikely to be smooth, and most likely there will be something of a shake-out. We expect some – but not all – of the present leaders to expand significantly, and suspect also that there will be some smaller players who rise to prominence in the next 3-5 years.

Although the world looks like a different place to 12 months ago, our view is that the decisive factors for success in FM have not changed. Moreover, however important price appears to be, we are convinced that – for virtually all FM businesses - competing primarily on cost is not an attractive long-term option. Much more defensible, and profitable, positions will be reached by concentrating on tailoring propositions to specific customer needs, delivering consistently, and finding areas of differentiation that cannot easily be replicated by competitors.

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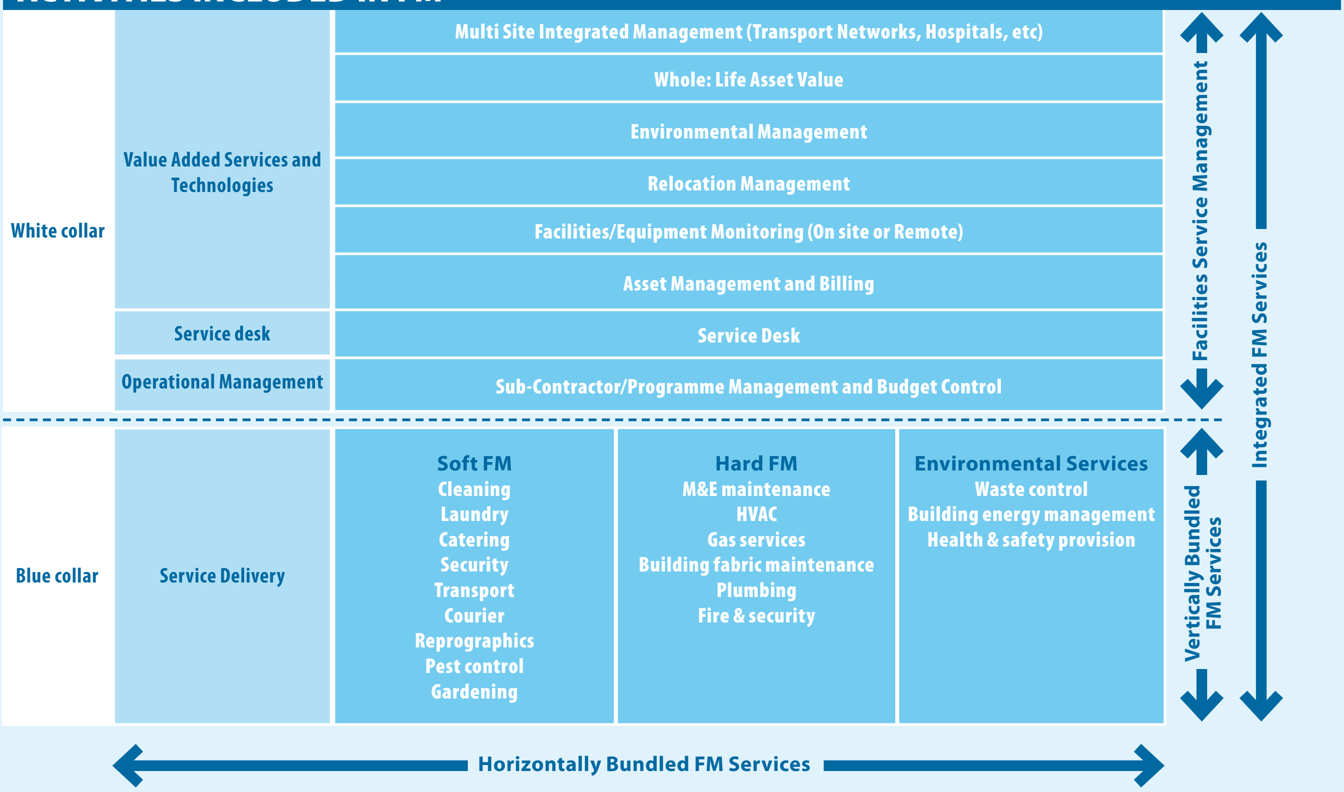
## ACTIVITIES INCLUDED IN FM



# Appendix

## WHICH COMPANIES ARE INCLUDED IN THE INDEX?

What one person would call an FM company is a builder or consulting engineer to someone else. We have decided to focus on players with exposure to a spectrum of blue- and white-collar work in hard FM and soft FM. We believe construction and engineering companies face very different market conditions – but this is not an exact science as a large range of players consider themselves to be participants in the FM market.

On this basis we have excluded businesses that work predominantly in consulting, engineering or construction (and pure play BPOs). We include companies regardless of whether their customers are in the private or public sector. To keep our analysis consistent, our focus is the UK, and on businesses with over £100m in revenue – roughly 50 in total. Applying these parameters generates a list of companies from various parts of the FM universe: Catering, Cleaning, Security, Mechanical & Electrical, Social Housing and Multi-service FM.

Having used a composite scoring system last year, calculating a score for each company's Strategic Position and Financial Performance, we repeated that analysis, but chose not to show it here given the interesting patterns evident in other – and more readily comprehensible – measures. Our view remains that the ideal FM company will demonstrate both strong financial performance (in both P&L and balance sheet terms), and strategic differentiation. What we have tried to highlight this year is that some of these themes are particularly evident in the companies that have maintained (or even improved) above-average profitability.

## HOW DID WE SCORE THE INDEX?

Our aim is to be as objective as possible, judging all the companies considered against the same set of criteria, and basing the scores on publicly available information. In a few cases, where group-level financials do not separate the FM parts of the business from other activities, we have left that company out.

There are of course some differences in financial year-ends, and rather than make assumptions about run-rates, we have not adjusted reported figures to align better with a calendar year. In a handful of cases, where there has been a delay in filing full accounts, we have again excluded that company rather than make a comparison between entirely different periods – particularly important when we are trying to assess the initial impact of the recession.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