Business and professional services, and real estate

Sector coverage · Business and professional services, and real estate · interview preparation summary

INT.BC.6.a · Business and professional services, and real estate

Classify a business services or property company by revenue model, labour and asset intensity, and say what the label implies for margin, capital and the products to pitch.

A coverage banker's first job is to say what kind of company it is, because the label sets the margin, the capital need and the products worth pitching. Business services sort on two questions: how does the revenue arrive, and what does the company own. Revenue arrives in three ways: under multi-year contracts, in repeat transactions, or in discretionary projects. Outsourcing and facilities management sell contracts, earn thin margins that are often in the mid single digits at EBITDA level, and need little capital beyond working capital and the cost of mobilising a new contract. Testing, inspection and certification earns higher margins, often in the high teens or above, because regulation or insurers require the work and accreditation keeps competitors out. Staffing is transactional and cyclical, and gross profit is its real revenue because most of the sales line is the pay of the workers placed. Consulting and professional services are project based and sell expertise, so they live on utilisation, day rates and the retention of senior people. Data and information services sell subscriptions embedded in a customer's workflow, so margins and retention are high and investors treat them like software. Real estate is different in kind. A property investment company or real estate investment trust (REIT) owns buildings, earns rent, is valued on its assets and is financed by secured and unsecured debt. A developer sells what it builds, so profit is lumpy and the balance sheet matters more than the income statement. Labour is the main cost in most business services, so wage inflation and the ability to pass it on decide the margin. In property the main cost is the cost of capital, so interest rates decide value. Gross versus net revenue is the first accounting question, because costs passed through to the client inflate the sales line and depress the margin percentage. Net revenue = revenue − pass-through costs. Asset intensity matters as much as margin, since a contractor that owns little converts most of its EBITDA to cash while a testing group with laboratories does not. Bankers use the label to choose the product: a fragmented contractor invites bolt-on acquisitions, a data business invites a sponsor sale or a listing, and a REIT invites equity raises, bond issues and portfolio sales. The usual mistake is to apply one multiple or one leverage view to all of them. A good answer names the model first, then says what follows for margin, capital and the transaction.

WORKED EXAMPLE: THREE COMPANIES, THREE LABELS

Three invented companies are described to you in one morning. Brandlow Facilities has revenue of 480.0m, of which 120.0m is subcontractor and material cost recharged to clients at cost, on contracts averaging five years, with EBITDA of 31.2m. Tessaly Staffing has sales of 900.0m, gross profit of 135.0m and EBITDA of 27.0m. Orrin Data has revenue of 200.0m from annual subscriptions, 95% retention and EBITDA of 72.0m. Classify each, compute the margin that tells you most, and say what the label implies. Convention: one year, ignore leases and tax.

Answer: Brandlow is a contracted outsourcer with an 8.7% margin on net revenue. Tessaly is cyclical staffing with a conversion ratio of 20.0% on gross profit. Orrin is subscription data with a 36.0% margin and 95% retention. Each label points to a different peer set, leverage view and product idea.

> **Interview tip:** Say the model first, then the one margin that fits it, then the product. For example: Brandlow is a contractor, so I would use net revenue and look at bolt-ons. Never compare the three on one margin or one multiple.

INT.BC.6.b · Business and professional services, and real estate

Read the metrics that matter in business services and property, say what normal looks like, and say what a departure should make you ask.

Start with growth, and strip it down. Organic growth excludes acquisitions, disposals and currency, and it is the only growth that shows whether the franchise is healthy. Organic growth = reported growth − acquired growth − currency effect. For contracted services, read the renewal or retention rate, the order book as a multiple of annual revenue, and the mix of contracts by length and counterparty. Retention in the low nineties per cent or above is typical of a well-run contractor, and a fall of a few points usually means a lost anchor client or price cuts to hold volume. Read margin by contract, because new contracts are often priced thin to win and mature contracts carry the profit. A rising share of new wins can therefore depress group margin while the book is healthy. In labour businesses, read utilisation, pay inflation against price increases, and staff

turnover. Utilisation = billable hours ÷ available hours. Consultancies typically run in the mid sixties to high seventies per cent, and a few points of slippage can remove a large share of profit. Staffing groups read gross profit, the conversion ratio and the mix of permanent and temporary work, because permanent placement is more cyclical and higher margin. Conversion ratio = EBITDA ÷ gross profit. Cash conversion tests everything. Operating cash flow after capex and working capital, divided by EBITDA, is often 80 to 100 per cent for asset-light services. A persistent gap points to slow receivables, unbilled work or capitalised costs, so check days sales outstanding and the growth of accrued income against revenue. For property, read occupancy, the weighted average unexpired lease term (WALT), like-for-like rental growth, the net initial yield, loan to value (LTV), interest cover and dividend cover. LTV in the mid thirties to mid forties per cent and interest cover above about two times are typical of investment grade property issuers. Dividend cover = recurring earnings ÷ dividends. A cover below one means the dividend is being paid partly from capital. The usual mistake is to quote the headline margin without organic growth, retention and cash conversion beside it. Interviewers want the number, what normal looks like, and what a departure would make you ask.

WORKED EXAMPLE: TESTING GROUP: GROWTH AND CASH

Ardent Assurance is an invented testing group. Last year revenue was 400.0m and this year it is 436.0m. Acquisitions contributed 20.0m and currency added 4.0m. EBITDA is 62.0m, capex 14.0m and the increase in working capital 10.0m. Receivables were 80.0m last year and are 98.0m now. Is the growth healthy and is the cash real? Convention: year-end figures, 365 days.

Answer: Organic growth is 3.0%, not 9.0%. Cash conversion is 61.3% and days sales outstanding rose by 9.0 days, so the first question is receivables, not the margin.

> **Interview tip:** Give the three numbers in order: organic growth, cash conversion, and the cause of the gap. Then say what you would ask the client for. Do not quote the headline growth first.

INT.BC.6.c · Business and professional services, and real estate

Choose and defend the valuation measure for a services or property company, say which multiples mislead, and build the comparable and precedent sets.

Valuation starts with the earnings that really recur and the cash they turn into. For contracted business services the core measure is enterprise value to EBITDA, cross-checked on enterprise value to EBITA (earnings before interest, tax and the amortisation of acquired intangibles) and on free cash flow yield. EBITDA flatters acquisitive and capital-hungry companies, so EBITA or EBITDA less capex is fairer where a company leases vehicles, equips laboratories or capitalises software. Lease treatment must match across the set, because enterprise value under IFRS 16 includes lease liabilities and EBITDA excludes rent, and a peer reporting under another standard will not look the same. Staffing at a trough is better compared on enterprise value to gross profit or on normalised mid-cycle earnings, because trough EBITDA produces a meaninglessly high multiple. Consulting is valued on EBITA and price to earnings, usually at a discount to data and software because revenue depends on people. Data and information businesses earn premiums for retention and margin, so the right comparables are other data groups, however similar the customers look. Multiples follow organic growth, cash conversion and visibility. A company that buys smaller businesses at lower multiples than its own is partly earning a roll-up arbitrage, and the market may not pay its own multiple for that acquired earnings. Precedent transactions carry a control premium, often 25 to 40 per cent over the undisturbed share price, but bolt-ons of small private companies trade below platform deals, so mixing them distorts the range. Property needs different tools. Investment property is valued by capitalising net operating income at a yield and checking against net asset value. Net asset value (NAV) per share = (property value − net debt − other liabilities) ÷ shares. The share price against NAV gives a premium or discount, and the yield the market is implying can be backed out from the share price. Dividend yield and price to recurring earnings matter to income investors, but recurring earnings exclude revaluation gains, which are not cash. Developers are valued on NAV with a margin on the pipeline, or on price to book, because their earnings are lumpy. The usual mistake is to apply one EV to EBITDA multiple across a set that mixes a staffing group, a testing group and a data business.

WORKED EXAMPLE: BACKING THE YIELD OUT OF A REIT DISCOUNT

Marlowe Square Estates is an invented REIT. Its portfolio is valued at 1,000.0m with net operating income of 50.0m. Net debt is 400.0m, there are no other liabilities, and there are 150.0m shares. The shares trade at 340p. A bidder is considering 380p. Work out NAV per share, the discount, the yield the market implies, and what the bid means. Convention: NAV is on the book value of property, ignore costs and tax.

Answer: NAV is 400p and the shares trade at a 15.0% discount, implying a yield of 5.49% against 5.0% on book. A 380p bid is an 11.8% premium to the price but 5.0% below NAV.

> **Interview tip:** Say NAV, discount, implied yield, then the bid in terms of both the premium to price and the discount to NAV. Never value a REIT on EBITDA in an interview.

INT.BC.6.d · Business and professional services, and real estate

Explain what drives M&A, equity and debt market activity in business services and property, who buys and sells, and which pitch ideas follow and fit the leverage capacity.

Activity in business services is driven by fragmentation, recurring revenue and the cost of debt. Fragmented sub-sectors such as facilities, testing and specialist consulting invite buy-and-build, where a platform buys smaller companies at lower multiples and gains density and purchasing power. Buyers are listed consolidators, private equity sponsors and, for data assets, larger information groups. Sellers are founders, sponsors reaching exit and conglomerates shedding non-core divisions. Typical pitch ideas are bolt-on programmes, carve-outs of divisions that do not fit, sponsor-to-sponsor sales, separating contracted and project arms, and defence work when a bidder appears. Value creation is not automatic, since a buyer paying seven times for earnings that the market values at eleven times gains only if the market gives the acquired earnings the group multiple. Multiple arbitrage = group multiple − purchase multiple. In equity capital markets, a sponsor-owned services group can list if it shows organic growth, cash conversion and visible contracts. Investors ask about customer concentration, margin sustainability, wage pass-through and the quality of adjusted EBITDA. Follow-ons and accelerated bookbuilds fund acquisitions, and the leverage target is the usual reason. In debt markets, contracted services with strong cash conversion often sustain leverage of two to three and a half times at investment grade or crossover, and sponsors go higher with leveraged loans and high yield bonds. Rating agencies focus on organic stability, the quality of adjustments, the pace of deleveraging and covenant headroom. Property activity looks different. Transactions are portfolio sales, joint ventures, take-privates of REITs at a discount, mergers for scale and equity raises when shares trade near or above NAV. REITs issue unsecured bonds when rated investment grade and secured loans or commercial mortgage-backed securities otherwise, with loan to value, interest cover and the unencumbered asset ratio as the limits. Issuing equity below NAV destroys value per share, so the equity window depends on the discount. The usual mistake is to pitch an acquisition without testing leverage and the rating. A good answer links the sub-sector's fragmentation or discount to a product, and then to the capacity to fund it.

WORKED EXAMPLE: A BOLT-ON AND THE LEVERAGE CEILING

Pennick Group is an invented facilities company with EBITDA of 100.0m, net debt of 220.0m and an enterprise value of 1,100.0m, which is 11.0 times EBITDA. It can buy Wexford Cleaning, with EBITDA of 20.0m, for 7.5 times. Run-rate synergies are 3.0m. The board's leverage ceiling is 3.0 times. Compare funding the price all in debt with a mix of 60.0m of new equity and 90.0m of debt. Convention: pro forma EBITDA excludes synergies, the share price is unchanged, ignore fees and tax.

Answer: The deal costs 150.0m for 20.0m of EBITDA. All debt takes leverage to 3.08 times, above the 3.0 times ceiling, while a 60.0m equity and 90.0m debt mix gives 2.58 times. The 70.0m paper gain depends on the market paying the group multiple.

> **Interview tip:** Say price, arbitrage, leverage test and funding mix in that order. Add the caveat on the arbitrage before the interviewer asks for it.

INT.BC.6.e · Business and professional services, and real estate

Place a services or property company in its cycle, spot the accounting traps and rebuild earnings and debt conservatively, then run a compact end-to-end analysis and choose the product.

Cycles differ sharply inside the sector. Staffing and recruitment move first and furthest, because hiring freezes hit permanent placement within a quarter and temporary volumes follow, so gross profit can fall sharply while overheads lag. Consulting follows corporate budgets, with discretionary projects cut first and regulatory work last. Outsourcing, facilities and testing are defensive because contracts run for years and compliance is mandatory, but they are exposed to wage inflation, rebids and the

loss of a large client. Data and information services are defensive but face disruption from new technology and from customers building in-house. Property follows interest rates, credit availability and tenant demand, and values usually fall before income does because leases roll slowly. Operating leverage = % change in EBITDA ÷ % change in gross profit. Accounting traps recur. Adjusted EBITDA may add back restructuring that repeats every year, acquisition costs for a serial acquirer, and share-based pay. Revenue is recognised gross when the company acts as principal and net when it acts as agent, so a change of judgement can move reported sales without changing profit. Accrued income or contract assets rising faster than billings suggest revenue recognised ahead of cash. Earn-outs and deferred consideration are debt-like and sit outside reported net debt unless added back. Capitalised software or contract costs lift EBITDA. Leases move rent below EBITDA under IFRS 16, so debt must be measured consistently. In property, revaluation gains inflate profit without cash, development costs and interest may be capitalised, and lease incentives are spread over the lease so cash rent is lower than reported rent. Always rebuild net debt, recurring earnings and cash conversion before quoting a multiple. A compact analysis runs in order: classify the company, strip the growth, test the margin and the cash, rebuild leverage on a conservative basis, stress a downturn, then choose the product that fits the capacity.

WORKED EXAMPLE: HALBURY STAFFING END TO END

Halbury Staffing is an invented staffing group with sales of 1,200.0m, gross profit of 210.0m (17.5% of sales) and reported EBITDA of 30.0m. Management adds back 8.0m of restructuring (the third year running) and 4.0m of acquisition costs, giving adjusted EBITDA of 42.0m. Net debt is 105.0m and there is an earn-out of 15.0m to pay. A banker has been asked to pitch a debt-funded acquisition. Test it. Convention: year-end figures; in the downturn sales fall 8%, gross margin slips to 17.2% and overheads fall 5%.

Answer: On a conservative basis Halbury has EBITDA of 34.0m and leverage of 3.53 times, not 42.0m and 2.5 times. A modest downturn takes EBITDA to 22.7m and leverage to 5.3 times, so debt is the wrong funding for a purchase.

> **Interview tip:** Run the order: classify, rebuild EBITDA and debt, stress, then product. Say the difference between management's number and yours in turns of leverage, which an interviewer can see at once.

INT.BC.6.f · Business and professional services, and real estate

Map the eight main sub-sectors of business services and real estate and, for each, say how it earns, what drives demand, which metrics you read first, what is most often misread and which products fit.

The sector has eight sub-sectors, and a candidate asked about a company in it should first say which one it is. The first six are service businesses whose margin depends on people, and the last two are property businesses whose value depends on the cost of capital and the asset. Outsourcing and business process services run client functions on multi-year contracts, demand follows cost pressure, bankers read renewal rate, order book and margin by contract first, thin early margins are misread, and bolt-on M&A and leveraged loans fit. Facilities and support services provide cleaning, security and catering on labour-heavy contracts, demand follows outsourcing, bankers read organic growth, retention and net revenue margin first, pass-through revenue is misread, and buy-and-build and high yield fit. Testing, inspection and certification earn fees for regulated checks, demand follows regulation and safety, bankers read organic growth, margin and capex first, acquired growth is mistaken for organic, and sponsor sales and listings fit. Staffing and recruitment earn a margin on placed workers, demand follows employment, bankers read gross profit, the conversion ratio and the permanent mix first, peak earnings are misread as normal, and M&A with cautious leverage fits. Consulting and professional services sell project advice, demand follows corporate budgets, bankers read utilisation, day rates and attrition first, growth from hiring is misread as productivity, and M&A and partner-owned deals fit. Data and information services sell subscriptions embedded in workflow, demand follows compliance and decisions, bankers read retention and cash conversion first, capitalised development cost is misread, and sponsor sales, listings and leveraged loans fit. REITs and property investment companies own and let buildings, demand follows tenants and interest rates, bankers read NAV, yield, WALT, loan to value and interest cover first, revaluation profit is misread as earnings, and bonds, secured loans, equity raises and take-privates fit. Property developers and operators build, sell or run property, demand follows housing and commercial demand and credit, bankers read profit on cost, land bank, pre-lets and gearing first, lumpy profit is misread, and equity, project finance and joint ventures fit. The misread is the fact interviewers most want to hear, because it shows you have looked at real accounts and not only a textbook. In an answer, name the sub-sector first, then the driver, then the numbers, and finish with the product.

WORKED EXAMPLE: THREE COMPANIES ON THE MAP

Three invented companies come up in one week. Garnet Advisory has 300 fee earners, 250 available days each, 70% utilisation, a day rate of 800, a cost of 95,000 per fee earner and 6.3m of other costs. Fenwick Industrial REIT has property valued at 800.0m, net operating income of 44.0m, debt of 320.0m, net interest of 14.4m, WALT of 6.2 years and 97% occupancy. Kestrel Inspection has revenue of 300.0m, EBITDA of 66.0m and capex of 24.0m. Place each on the map, compute the first metric, and say what is most often misread. Convention: all figures in £, one year, ignore tax.

Answer: Garnet is consulting, read on utilisation, where five points of slippage cut EBITA by 41.7%. Fenwick is a REIT at a 5.5% yield, 40.0% loan to value and 3.06 times interest cover. Kestrel is testing with a 22.0% margin but only 63.6% of EBITDA left after capex.

> **Interview tip:** Name the sub-sector, then the driver, then the two numbers and the misread. Keep the product for the end and tie it to the capacity the numbers show.

Summary of the Charta interview-preparation topic. Companies and figures in the examples are invented. Draft content, not yet expert reviewed.