Support Services Sector Review

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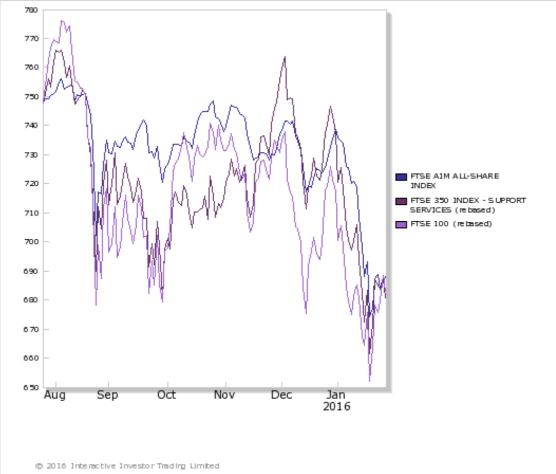

FTSE 350 Support Services	CY2016	CY2017
PE (x)	15.3	13.9
P/Book (x)	3.9	3.3
EV/Sales (x)	1.1	1.0
EV/EBITDA (x)	9.3	8.6

Source: Bloomberg

Support Services, a cornucopia of companies

Support services can mean many things to many organisations but essentially the sector can be seen as a lubricant that helps the wheels of the economy continue to turn. A common thread is outsourcing activities that are most economically and effectively performed by a specialist rather than keeping in house. Companies in the sector tend to provide business critical services to their customers, thereby providing an element of stickiness. The sector benefits when the economy grows, but also offers an element of defensiveness as client companies and public sector bodies strive to keep their own fixed cost bases down. However given the broad range of businesses within the industry it is difficult to apply a broad brush description, and stock selection according to one's investment criteria is vital.

The final quarter of 2015 saw a raft of corporate activity across the sector. This was spearheaded by a bidding war for business processing, technology and procurement services provider **Xchanging (LON:XCH).** The likely winner now appears to be the American bidder **Computer Sciences Corp (NYSE:CSC)** with 190p or circa £450m in total (an 81% premium to the preceding three month average) offer which usurped **Capita's (LON:CPI)** initial offer of 160p.

Smaller deals included the £3.95m acquisition by **VP (LON:VP.),** the equipment rental specialist of Test & Measurement Group, a company engaged in the hire and sale of specialist electrical instrumentation and environmental test equipment to the utilities, electrical engineering and oil and gas sectors across the UK. Elsewhere on 8 January, **Acal (LON:ACL),** an electronics supplier announced, on 8 January, the £17m acquisition of Contour Holdings Limited and its affiliate Contour Electronics Asia Limited.

Despite a quieter year for the primary issuance as a whole. 2015 saw eight IPOs in the sector raising £1.4bn across AIM and the main market, more than four times the amount raised in 2014. The funding was dominated by the main market **IPOs Equiniti (LON:EQN) and Worldpay (LON:WPG)** which accounted for £1.26bn collectively, both which could also arguably be categorised as Fintech companies, an area where we see disruptive technologies as presenting attractive investment opportunities.

In terms of secondary issuances on the junior market, fundraising levels were strong at £641m (up from £285m) second only to the Pharma & Biotech sector. The likes of **Bilby (LON:BILB)** (gas electrical and building services) **and Premier Technical Services (LON:PTSG)** (a niche specialist service provider) have been kind to investors up 150% and 67% from their IPO prices respectively. The lack of volatility in the sector which is not especially prone to speculative bubbles and commodity price fluctuations, could be one explanation for the relatively healthy activity levels.

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HYBRIDAN LLP
20 Ironmonger Lane,
London, EC2V 8EP
Website: www.hybridan.com

Tel: 020 3764 2341
Email: enquiries@hybridan.com

There have been strong returns generated by more established sector names as well. **Penna Consulting (LON:PNA),** a global people management business is up 141.5% over the last twelve months. Best known as the UK's leading provider of outplacement services, the company could be expected to do well in times of a shrinking employment market. However this side of the business is picking up customers undergoing major restructuring (think the big supermarket chains and banks) and the recruitment side of the business is going from strength to strength. **Macfarlane Group (LON:MACF)** a leading distributor of packaging materials in the UK, is riding the internet retail wave. Consensus forecasts are looking for revenue growth of 8% to £166m and EPS growth of 27%. The shares are on a sub 10x PE multiple and 3.9% yield for 2016. FY 2015 results are due 25 February. The shares are up 53% on a twelve month view. **Aukett Swanke (LON:AUK)** an international group of architects and interior designers which has continues to execute a successful buy and build strategy has recently released strong FY Sep 2015 results. Revenues grew 8.1% to £18.7m with EPS up 53.8% to 1 pence. The shares are on just 6.5x historic earnings and yield 3.7%.

Without as clear definition of its activities as sectors such as software and engineering, support services can be mistakenly viewed as a catch all sector for companies that don't entirely fit one sector or the other. For this reason it is not always appreciated that companies in this sector can possess significant intellectual property (IP), and skilled workforces with years of accumulated know how and technical specialism. This may be one reason why the sector tends to attract less favourable valuation multiples than certain others as can be seen below.

CY 2016	PE multiple	P/B	EV/Sales	EV/EBITDA	Dividend Yield
Aerospace and Defence	13.85	2.63	1.04	8.08	3.80
Construction and Materials	14.92	1.65	0.58	7.10	2.90
Support Services	15.30	3.34	1.07	9.30	2.67
Fixed Line Telcos	15.71	17.99	2.52	7.56	3.16
Industrial Engineering	16.94	1.90	2.36	11.86	3.39
Electronic & Electrical Eqpt	17.10	3.09	2.16	11.19	2.63
Software	19.60	5.15	2.72	13.15	2.38

(Source: Bloomberg Ftse 350 Indices)

Indeed a number of companies in the sector could arguably be categorised elsewhere. **Vipera (LON:VIP), Mi-Pay (LON:MPAY), and Universe Group (LON:UNG)** offer Fintech related platforms enabling mobile banking, payment, and retail/loyalty solutions, all driven by proprietary software platforms, a sector with a PE multiple 28% higher than support services.

Petards Group* (LON:PEG), through its eyeTrain carriage surveillance systems, and specialist engineering division has a strong design led offering to the likes of Siemens, Bombardier and the Ministry of Defence. Increasingly proprietary software is becoming an important part of its business mix. Arguably its activities span electronics, engineering and software which all attract higher multiples than support services. **Similarly Pennant International (LON:PEN)** with its advanced part task trainers (replicating highly engineered systems) and computer/virtual reality based training systems, is a business with a strong technological and engineering pedigree.

Reviewed by: Derren Nathan

Economic Review - Support Services

Equity markets got off to an ugly start in 2016 with oil price shocks and the fallout from Chinese economic concerns coming to a head; or maybe not yet come to a head. However the impact of these macro factors to the small cap support services companies is nowadays largely limited to sentiment.

Reliable numbers out of China are hard to come by, but it does not seem contentious to suggest that the world's largest economy cannot grow at 10% forever; or even 7%. The "easy" growth has been had: that is to say catching up with more developed economies from a low base was inevitably easier than pushing on from here. The migration of cheap labour from the country to the cities is pretty much done, and a population of single children is beginning to exaggerate the age demographic that developed countries are already experiencing. The debt fuelled growth and undisclosed inflation of recent years needs to be worked through, which inevitably will drag on future growth further. There is plenty of talk of deflation being exported from China, and indeed there has been mutterings of deflation at various intervals since the credit crunch of 2008. But deflation is in no-one's interest whatever side of the Pacific they live so – in my opinion - there will be more fudge, obfuscation and can-kicking, and ultimately very little growth (positive or negative) for the foreseeable future both globally and in China.

Regarding oil, there is a rational argument that oil consumers will benefit from a low oil price; already most of us will feel the benefit when we fill our cars. This should balance the woes of the oil producers, but there is not an easy crossover between dismantling the oil industry and building up the sectors that will benefit from the consumer windfall. It will take decades to complete such an overhaul, and will almost certainly be overdone in the short term, counteracting the consumer benefit.

Down at the small cap end of the market the impact of all this is mixed. Of course poor sentiment cascades down the markets much more freely than good sentiment, but the impact to funding of tech based companies is perhaps muted. Funds raised in 2015 for US technology start-ups reached the highest level since 2000 and the UK tech venture cap sector also had a knock-out year with much of the $3.5bn of capital raised still looking to be utilised this year and next (a similar story to the biotech market). One feature of this funding bonanza is that it is primarily focussed on private companies, but there will be flow through into the listed markets if valuation differentials expand.

That said, since 2008 most small growth companies have had to learn to run on vapours, and those that survived are now pretty good at it. Of course lack of capital can easily be correlated with lack of growth, and no doubt some could have grown faster with more capital (and I dare say some would have blown up with more capital) but growth is perhaps a relative rather than an absolute concept. If a small company can grow at 10% when GDP is 1 or 2% and interest rates are ½% then that is surely a very decent return.

The small cap survivors and start-ups have been taught to manage their costs and stretch their capital resource. They have had to develop products and services that they can sell even in these straightened economic times. The ability to transfer technology into a product or a service that improves efficiency, cuts costs or prevents fraud, or reputational damage is the starting point, and the ability to sell it and scale it up is the next challenge. The support services sector is a broad church, but the companies within it are right at the heart of the process of delivering such products and services and in turn providing comparatively good growth in an on-going low growth environment.

Reviewed by: William Lynne

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