Q&A: How labor market growth, export of services and horizontalization across verticals are driving opportunity

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The dealmaking market is remarkably dynamic as we head into 2019, especially given the confluence of disruption in key sectors aligned with the drivers of the broader M&A cycle. Business services is no exception; we sat down with Lincoln International professionals Michael Iannelli, Edward Lethbridge and Saurin Mehta to discuss a wide range of topics spanning the entire business services space.

Currently, the business environment is intriguingly dynamic. What's your take on the status of the labor market as it stands now and how its condition is affecting your Services clients?

Michael: In general, whether the services are blue-collar, white-collar or are highly tech-enabled, the skills mismatch in the global economy is as significant a problem as overall employment levels. In the human capital services space, we work with businesses that help other businesses either access, train, assess and retain talent. Those businesses are actually helped by a tight labor market, in many cases. For others, costs become higher and growth becomes more challenging when the market supply and demand dynamics are tighter.

Saurin: US services companies are contending with hiring challenges for certain skills given unemployment is at less than 4%.Finding—and retaining—skilled people is a critical aspect to ensuring that delivery and quality of services to customers are not impacted. Beyond compensation, companies are focusing more on culture and professional development, overall career trajectories and programming to keep the talent they have—as those are the most productive employees. Tangentially, a key driver of growth for services companies will be ongoing supply of human capital, so they are also investing heavily in recruiting and retention.

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Edward: The circumstances across Europe are similar. Finding top-quality talent continues to be the biggest impediment on growth we hear about from professional services firms of all kinds. In fact, with

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nearly full employment in the UK, this issue will only recede when the economy weakens. However, the skills people are looking for are also changing and there is a shortage of what could be described as tech-based experience in the market generally, so I´d expect that tension to remain even in a downturn.

Michael: When you think of business services very broadly defined as some type of outsourcing, it is relatively "cycle resistant". The value proposition in a tight employment market is that companies are likelier to outsource to meet higher demand. In a less certain economy, companies outsource to keep their cost structure more variable. Right now, companies are looking to business services partners to allow them to focus on core functions and keep up with peak demand.

How are professional business services companies grappling with the cost of talent and the disruption of traditional workflows with professional tools? Is that encouraging M&A to a significant degree still?

Michael: In general, what we tend to see across our services clients is those that focus on demonstrable ROI in the form of helping clients increase revenue, manage risks or reduce costs tend to do well. But even with one of those core value propositions, some more project-oriented of these businesses can often see their revenue deferred or down-scoped, especially in a down economy. Many of these, and in fact, almost every service business we deal with, works on developing its own technology tools to not only improve their cost of delivery but also create recurring revenue sources, alternate delivery channels and additional, long-term access to their content. These emerging hybrid models are being deployed more frequently. Disruption can occur as well, particularly where the company's value proposition is predicated on access to lower-cost labor and lower-skilled activities which can may be trumped by wholesale automation of functions.

Edward: We are seeing the emergence of hybrid business models where traditional professional services firms have woken up to the value of the data they hold and looking for ways to monetize that. Also, their often lumpy revenue profiles are being smoothed out by the creation and consequent application of software products and tools which the client can use long after the initial project, assignment, survey or advice has ended. We have had great success in positioning these businesses to trade buyers who often start from a position of skepticism but who can be won around with careful thought.

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Much like how software is more of a horizontal than a vertical at this point, how can one construct a horizontal package of services across sector lines and what does that entail, especially regarding M&A?

Michael: B2B services in general, from our viewpoint, are usually horizontal in nature. Usually they tend to travel across business verticals; the business model attributes drive success as much as the end market which they serve. More often than not, additional services that companies either develop or acquire via M&A will generally be provided to multiple verticals that they currently serve or target for growth. Tweaking the core offerings to create vertical-specific bundles of services can create competitive advantage and growth for providers (Think of third-party logistics for the energy industry vs. the food industry). An even more interesting question is how the ultimate bundle of services and technology offerings of the company looks at maturity. As service companies develop and acquire more software offerings, how are these companies best characterized by the market? When it comes to dealmaking, the latter tend to command higher multiples as they are inherently presumed more scalable and highly profitable. Ultimately, it is often the combination of services and technology that creates value for customers so that has to be clarified for potential buyers.

Edward: In many cases software is simply a way of delivering a service. It won't transform a low quality business into a highly valuable one overnight so it's important assess every situation on its merits. Beyond hybrid business models combining technology and services, I have worked with our Industrials team on industrial services deals and our Healthcare team on healthcare services deals. The ability to draw on expertise across our group is critical for correctly positioning a business.

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In the marketplace, are transaction multiples ultimately predicated on the transformative element then, for hybrid models? Has that recent advent played into the M&A cycle, in the context of the labor market as mentioned earlier?

Saurin: When you look at the demand drivers of cyclical, labor-based businesses—as those are most often affected by the labor market—blue-collar and field-based service businesses tend to see demand related to issues like underinvested infrastructure or regulatory compliance with environmental concerns. In some respects, businesses can see a premium derived from those conditions where the demand is nondiscretionary to a large degree, e.g. utilities that require maintenance and are now, as their traditional workforces are retiring, are increasingly outsourcing as outside contractors can meet safety and compliance standards more swiftly and efficiently than an in-house workforce with associated costs from pensions and healthcare. Consequently, those types of businesses see a much more resilient demand in the current market and are likely to sustain interest for the next three to five years.

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Michael: Typically, a company will align around what a customer's needs really are. If they are solving a real problem better than the client can solve it by itself, then they can grow revenue. If the "how" of solving that problem through its chosen combination of services and technology results in recurring revenue, scalable margins, and high customer retention, the business will be perceived set to be set to achieve, sustainable growth, not only in revenue but in cash flow. This will lead to high multiples.

Which other areas of business services are likely to see similar rates of resilience?

Saurin: Business services is very model-driven, so some will be affected by the end market, but within healthcare, the macro drivers are so strong they'll provide positive feedback going forward. Other sectors are seeing positive tailwinds in turn, but healthcare stands out from my perspective.

Michael: From an investment standpoint, business services enterprises are often viewed as lower-risk ways to gain exposure to different sectors and trends. Healthcare stands out in that regard, as does technology. If an investor that wants to gain exposure to the evolution of IT toward the cloud, it could either back an individual portfolio company creating an individual product or instead back a professional services company that integrates or supports that product but also several others. Essentially, via one investment, one could gain exposure to a plethora of cloud-based tools. For example, recently we worked on a transaction with a company that was an integrator of industrial automation technology products which provided buyers with a relatively low-risk way to play the evolution of the Internet of Things which is still in its early stages.

How does strategic acquirers' behavior in business services M&A versus that of financial sponsors?

Saurin: It varies by sector within services, and even to some degree from business to business. Generally, the market has been robust, and PE buyers have enjoyed an advantage in terms of a availability of equity and debt capital. Strategic acquirers, on the other hand, maintain an advantage from the perspective of synergies to be achieved as part of an acquisition. PE is especially competitive when it comes to growth-oriented platforms in fragmented markets where a strong consolidation story can be told, e.g. the investment thesis is predicated on add-ons down the line. If a business model tends to have customer concentration and constrained product suites, strategics can often justify more than a PE group can, as the latter requires more expansion potential in many cases. As an example, we recently worked on a transaction wherein

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a strategic acquirer ended up winning out over a PE group due primarily to customer concentration that ended up as a significant potential hurdle for future growth plans from the PE buyer's perspective.

Michael: Many of the service businesses that are bought by PE groups often see employees garner a larger share of ownership because, in a way, they are the product of the entire enterprise. Some management teams consequently have realized if they participate in a takeover by a PE group, they are able to obtain more upside. In the case of a strategic acquisition, there often isn't as much of an option for management to participate to the same degree post-deal. With regard to today's market, timing is very important to PE as they know they may likely own the company through a potential downturn given the age of the current business cycle and they plan to hold the company for a finite period and then sell it. Strategics are less concerned with timing from that perspective since they plan to own the target indefinitely and are more interested with the ability to obtain growth which may be hard to come by on an organic basis. Consequently, strategics are currently more active than we've ever seen them in the past five or six years.

Saurin: On the other hand, we've seen strategics also tentatively begin to adopt the PE model to the extent the management team is still able to retain some exposure via equity even post-acquisition. A pseudo-"second bite at the apple", in a way, that will keep the management team motivated in the future. All these trends are key to services businesses, as the content, knowledge and delivery are all centered on human beings.

Michael: With business models morphing amid disruption, there is a general acknowledgment that many businesses must reinvest in technology, fundamentally to keep up with customer needs and with their direct and indirect competitors. Much of that investment comes in the form of people on the income statement, so it is harder for a financial buyer to purchase any company undergoing that type of transition. For a strategic with greater existing scale, that investment might be easier to make.

Saurin: The evolution of PE has changed the M&A landscape too. Relative to several years ago, my sense is more PE firms are willing to invest in professional services companies as the overall economy transitions to a services-oriented environment.

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Let's look forward—how will that particular PE investment thesis bear out in the next few years?

Edward: A notable trend over the past three years is UK funds setting up US offices, often to support M&A activity rather than make primary investments. Livingbridge, Bridgepoint, and Inflexion are three examples of well-regarded funds who have done this. This is different to US funds who set up in London. They all do primary investments.

Michael: You can think of this in a secular sense rather than a cyclical sense. From a secular, PE standpoint, many PE firms in the West have embraced more services investing as more manufacturing has shifted out of their economies, which overall have become more services based. In a way, it's a demographics-driven, secular trend that has led investors to learn how to evaluate and add value to more services businesses.

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For our last question, what are the key underrated factors for not only investors in the space but also business services companies as they prepare for 2019?

Michael: Our colleagues in the industrials space are very focused on potential impacts from ongoing trade tensions. Services that serve affected manufacturers may eventually see the impacts of tariffs themselves—the question is at what point they will see it? Brexit remains a an unknown, to speak plainly. Interestingly, most macroeconomic indicators look positive. The concern over any downturn seems to be largely derived from the fact that markets have experienced an upturn for so long now. However, we also have had to manage expectations around the fact that the next downturn is highly unlikely to be as severe as the one experienced in 2008.

Edward: Brexit matters in Europe; however, it does fall into insignificance compared to US-China trade wars. Overall, bank lending is staying strong which does help underpin ongoing corporate M&A activity.

Saurin: The prior eight or nine US recessions, relative to 2008, were all milder in terms of severity, duration and time to recover. The last recession truly was an outlier. So, to some degree there has been reeducation regarding how a potential pullback could be more of a value-creating opportunity than the opposite. Buyers, whether financial or strategic, are working on pricing in a downturn scenario that can potentially be predicated on that occurrence.

Michael: For every services business that operates in a B2B environment, the selling model is very much based on ROI. It boils down to questions like "Did I save my client money?" The ability to measure ROI has really improved with the latest wave of technological tools, so in the future more services businesses will be able to clarify their value-add more explicitly and definitively than before. For example, with interactive marketing and performance tracking, it is much easier to break down demand in increments. Other services businesses will be able to do likewise even further in the future.

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