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SERVICES SECTOR REPORT
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HIDDEN IN PLAIN SIGHT

The numbers that revealed the potential hazards of investing in the Services Sector

- Short selling warnings
- Balance sheets
- Business mix

INTRODUCTION

A SECTOR EXPOSED

OVER THE PAST TWO YEARS THE SERVICES SECTOR HAS BEEN IN CRISIS...

Carillion's failure in January 2018, having been heavily short sold in 2017, crystallised long-standing concerns about the health of companies in the sector. This led to a parliamentary inquiry and scrutiny of the role of investors.

Interserve also struggled throughout 2018 and early 2019. Attempts to keep the company afloat could not command the support of all shareholders and after a refinancing plan was rejected and it went into administration in March 2019.

Kier Group, another target of short sellers during 2018, undertook an emergency rights issue in December 2018 that saw only 38% of the new shares taken up, reflecting concerns about its future. In early 2019 the company underwent a leadership change, but short positions in Kier Group surged again this summer.

Company failures and ongoing concerns about some of those that survived have raised fundamental questions about the sector, including the outsourcing model that has dominated in the public sector in recent years. But they also raise questions about the extent to which investors have a strong grasp of the financial position of these companies.

In some important ways, including the potential risk to government posed by company failures, what has happened in the services sector has parallels with the banking sector a decade ago. Therefore it is critical that asset owners are aware of potential risks, both within companies and in respect of asset manager analysis of them.

In this briefing we set out PIRC's views on what investors might have spotted, and where they should look in future.

It includes: PIRC's capital stewardship service, provided PIRC voting reports.

PIRC Capital Stewardship analysis

PIRC's capital stewardship service was developed following the financial crisis. It addresses flaws we identified in mainstream analysis of the failed banks:

- **Lack of understanding of balance sheets** -
- **Lack of appreciation of dividend restrictions** -
- **Poor quality accounting standards masking value destroying** (i.e. consuming capital not creating a surplus) -
- **Little/no attention to holding company balance sheets** -
- **What appear to be profitable enterprises cease to be going concerns** -

Out of that arose the question, do diversified portfolio fund managers understand balance sheets? What about short sellers? PIRC's view is that there are some fundamental differences in approach. Why is someone selling at a substantial risk to them, when others are buying?

Here are some observations setting out very different approaches to looking at companies. Things aren't hidden, but different people are looking in different places

Valuation – focus, diversified portfolio fund management

Earnings and industry comparable multiple.
In crudest form:-
Price = P/E x earnings
In other words, "Look at earnings and comparable market multiples". Essentially, using the market still to value shares. The balance sheet at best is a secondary factor.

Balance sheet focus – short sellers

Less formulaic, not necessarily concerned with "valuation" as a number. Looking down as well as up! And, most fundamentally, operating on the assumption that their own analysis may be ahead of the market. Understanding the balance sheet may be key to whether a company is in a precarious position or not.

Why look at the services and construction sectors?
Because of the insolvency of Carillion and then Interserve. Companies with significant short selling activity.
Two areas of focus which is part of PIRC's 'Capital Stewardship' approach, is the structure of the balance sheet itself and as part of that goodwill. Then there is the balance sheet of the holding company.

At their peak in Summer 2017, disclosed short positions in Carillion (meaning those over 0.5%) represented just over 25% of the issued share capital. For Interserve the level of disclosed shorts peaked at a little over 9% in early 2018, a year before it went into administration. At Kier Group disclosed shorts hit just under 14% in November 2018, just before the company's rights issue. After falling back substantially in late 2018 and early 2019, disclosed shorts in Kier Group increased throughout this summer and currently stand at 11.2%. At Serco disclosed shorts hit over 6% in September 2018, but have subsequently declined and there are currently no notifiable short positions. At Capita disclosed shorts peaked at over 8% in May 2018, and currently stand at 3.7% It should be noted that total short positions could be significantly higher than those disclosed by the FCA.

"Balance sheet structure" where is the capital?

Again, the case of Carillion picks up risk that may have passed many investors by. The discrepancy between, the static holding company balance sheet and the goodwill but the declining net assets of the group as whole

Goodwill versus the holding company balance sheet – why is it relevant?

Goodwill can be overcomplicated, but it is merely an accounting transformation of the same transaction, an acquisition. One treats it as an acquisition of assets (the group accounts) the other treats it as an acquisition of shares (the holding company accounts).

Why do companies go bust?
UK insolvency courts refer to the point of no return, and negligence cases may need to determine that point.

As Capita and Kier in the sample here did have rights issues, the question arises why could Carillion and Interserve not.

The simplest description of failure is that new investment fails to make return – good money after bad.

- either the business model is broken – not achieving sufficient returns or
- the balance sheet is broken, and new capital will be firstly reconstructing that, making good losses
- or both, even merely doubts that either or both are applicable.

How invested capital appears in two different places

1. The subsidiary capital is invested in business assets
2. The holding company capital is invested in its purchase of the subsidiary

Stressful scenarios

From the point an aquisition occurs both balance sheets may become out of synch - that is something worth looking out for. It can be a sign of stress.

From the point of acquisition onwards the following scenarios 1-8, together with various accounting reactions (or lack of) can occur to cause the two balance sheets to come adrift numerically. Holding company net assets = Group accounts net assets @the point of acquisition.

Essentially the cost of the investment remains the same but the assets acquired go up or down. However, had the acquisitions not taken place, then the share price of what was acquired would have changed. A hazard is where the value of what has been acquired goes down, but the value is held in the holding company at the acquired amount. That can be seen in the case of Carillion where there [page reference] has been a problem for all of the period in reference.

Some of the ways in which the two balance sheets can become out of synch

Outcome	Accounting response
Group (i.e. subsidiaries) + Holding Company	**Holding Company**
1. Makes a profit – net assets rise	Stays still – net assets stay same
2. A dividend is paid to the parent . Net assets say same (as merely a transfer from a subsidiary to the parent).	Receives dividends from subsidiaries – net assets rise
3. Makes a loss – net assets fall	Stays still – net assets stay same
4. Write down goodwill – net assets fall	Stays still – net assets stay same
5. Makes a loss and writes down goodwill – net assets fall	Stays still – net assets stay same
6. Makes a loss – net assets fall	Writes down investment in subsidiary – net assets fall
7. Write down goodwill – net assets fall	Writes down investment in subsidiary – net assets fall
8. Makes a loss and writes down goodwill – net assets fall	Writes down investment in subsidiary – net assets fall

3-8 raise issues for distributions (dividends and buybacks) as well as covenants and going concern status.
6-8 suggest an appropriate response to the circumstances.
3-5 may be at risk of inappropriate – even illegal distributions.

Balance sheet risk

The following companies in the service sector have been examined using the PIRC model for signs of balance sheet risk. Carillion (insolvency), Interserve (insolvency), Keir, Serco, Capita

Outcome	Accounting response
Group (i.e. subsidiaries) + Parent	**Parent Company**
1. Makes a profit – net assets rise None in sample under review	Stays still – net assets stay same
3. Makes a loss – net assets fall Carillion	Stays still – net assets stay same
4. Write down goodwill – net assets fall None in sample under review	Stays still – net assets stay same
5. Makes a loss and writes down goodwill – net assets fall Interserve Keir Serco Capita	Stays still – net assets stay same

Business models

Broadly there are two different economic models within the sector:

- Managed services "contracting out"
- Construction

Clearly any contract carries non-performance risk, however, construction contracts are inherently more risky in-terms of balance sheet risk, i.e. more risk to the capital as well as the income. Because, and similar to banks, the capital of the company is invested in risky projects themselves in the development phase.

£ m	Carillion		Interserve	
Construction	941.8	37.7%	1,048.2	35.5%
Support	1,423.5	57.0%	1,670.2	56.5%
PPP	132.6	5.3%		0.0%
Other		0.0%	237.7	8.0%
Total	**2,497.9**		**2,956.1**	

Capita £m		
Software	396.4	10.3%
People solutions	498.3	13.0%
Customer management	794.2	20.7%
HMG	745.5	19.5%
IT & network	404	10.5%
Specialist	992.2	25.9%
Total	**3,830.6**	

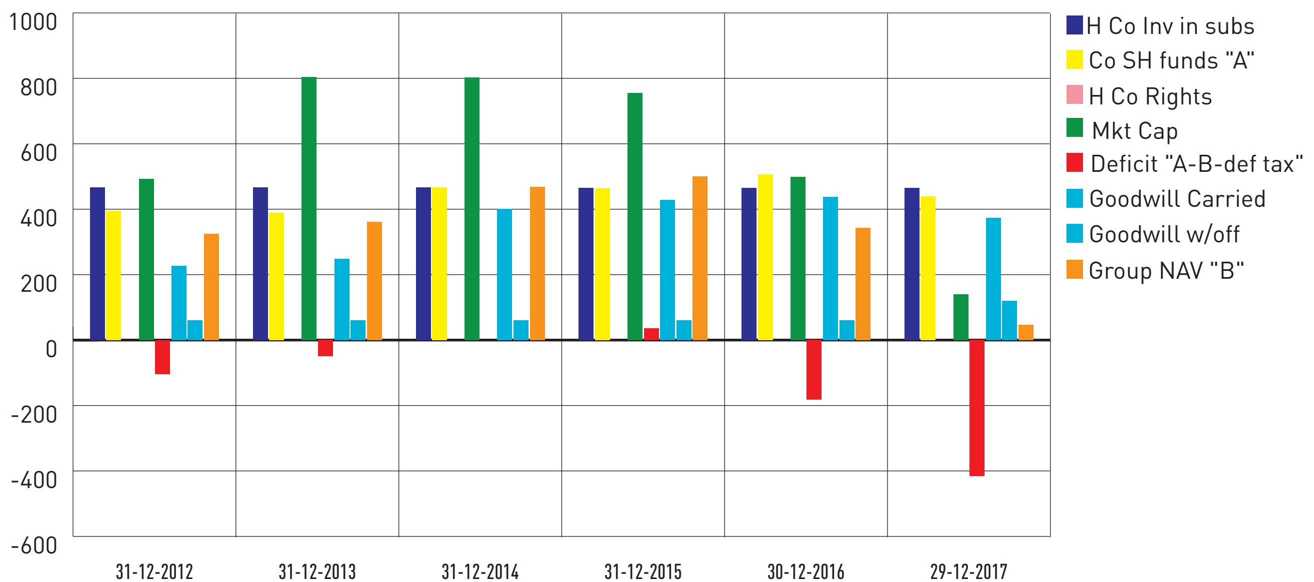
Serco only shows revenue by geography.

Companies in focus

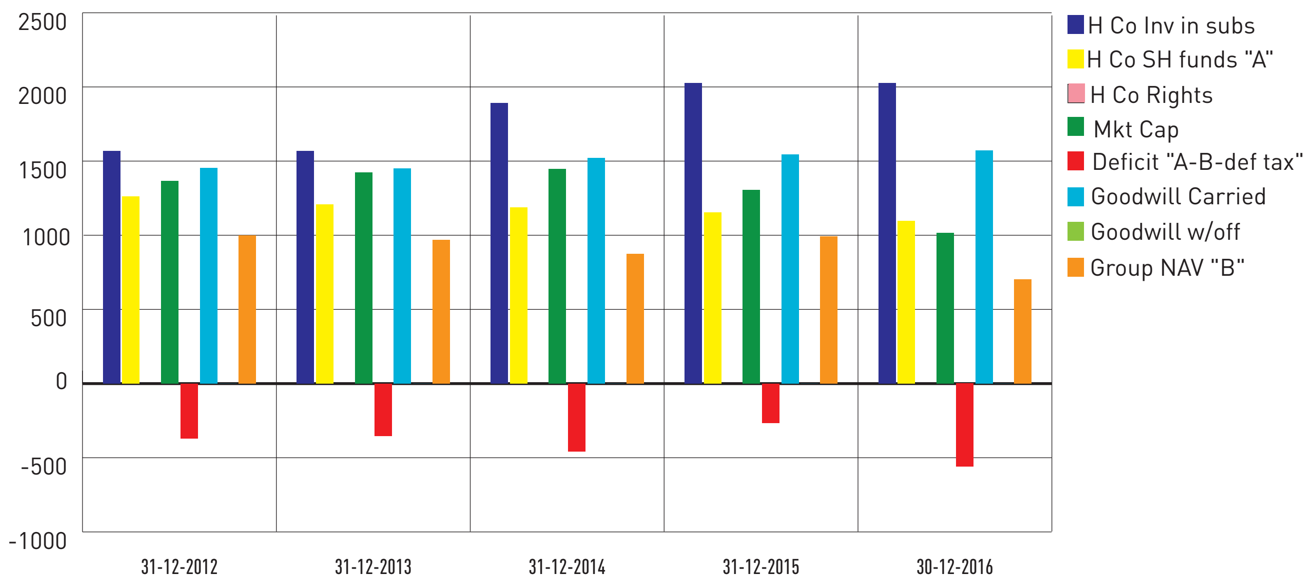
This analysis shows key balance sheet items and the relationship between numbers in the holding company and group accounts.

The item “deficit” represents the difference between the net assets of the holding company and the net assets of the group, a negative number show the amount by which subsidiary net assets have fallen after acquisition.

INTERSERVE

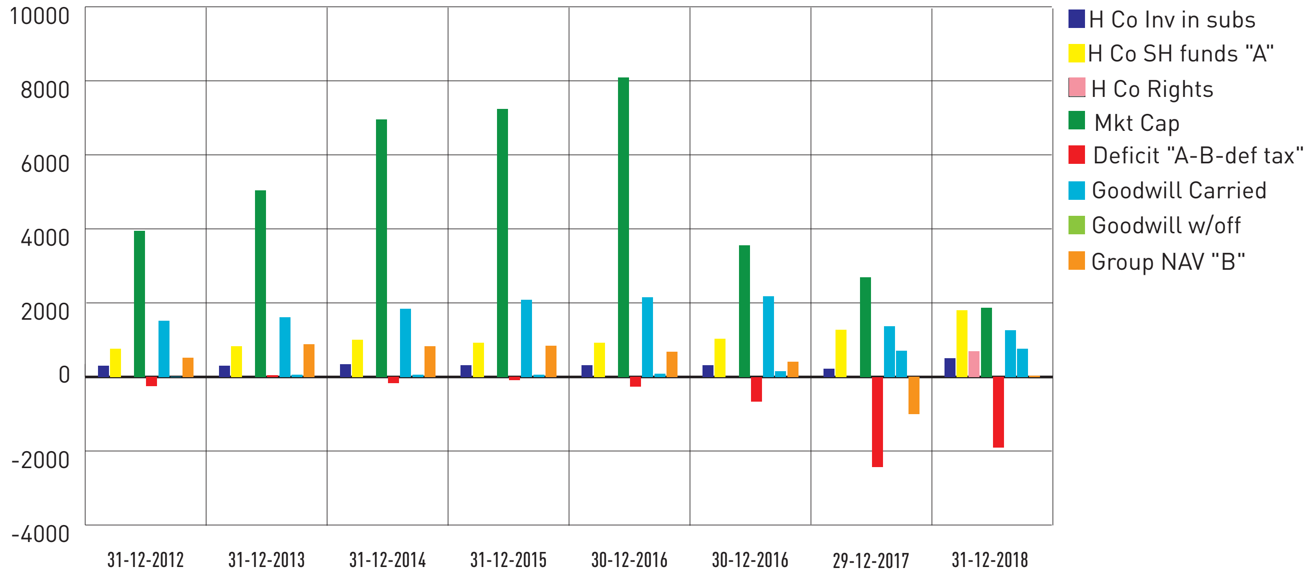


CARILLION

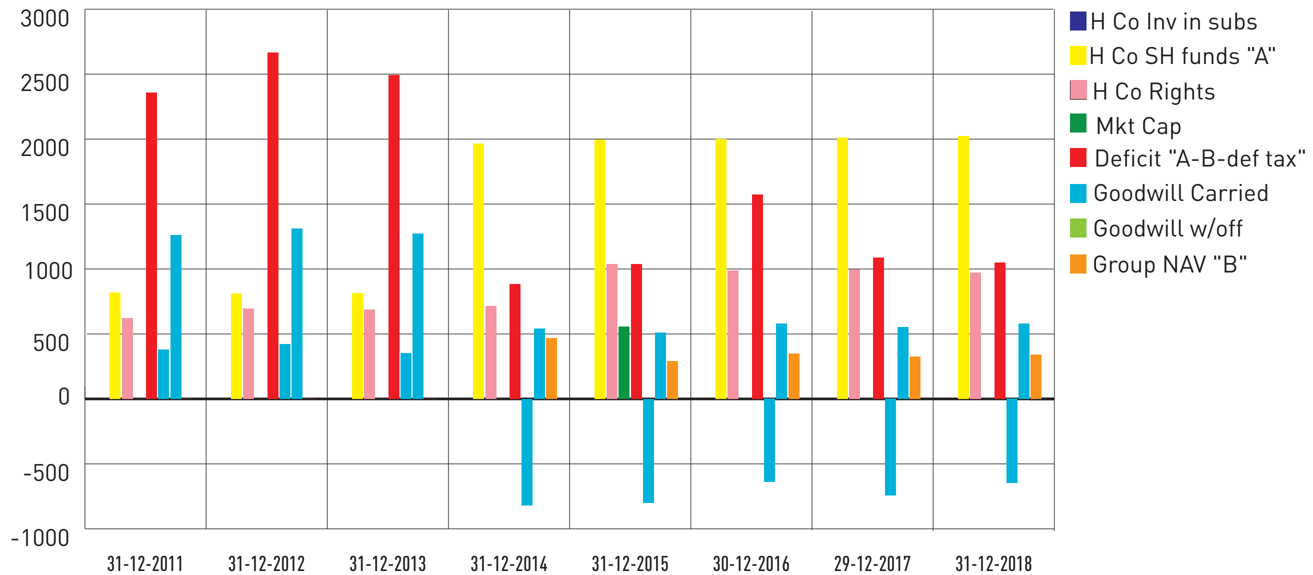


BALANCE SHEET ANALYSIS

CAPITA

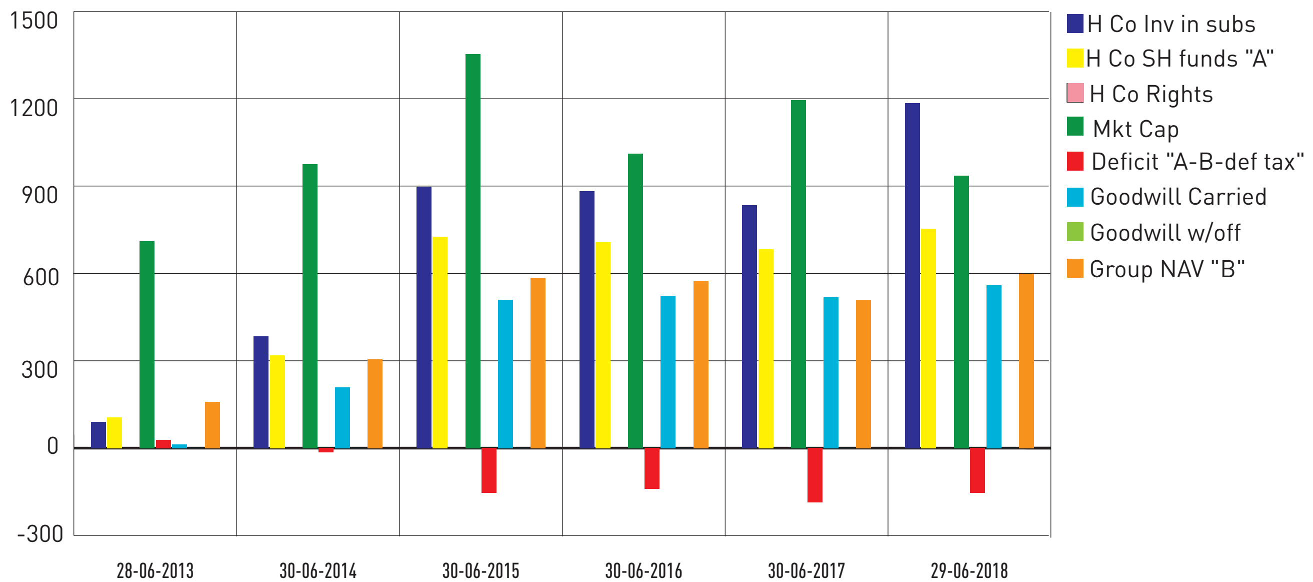


SERCO



BALANCE SHEET ANALYSIS

KIER



Gearing

PIRC has also ranked the companies by their debt (total liabilities) to equity ratios.

£m	Total liabilities	Equity		Tangible equity	
Serco Group plc	1,166.8	971.8	83.29%	-647.3	-55.48%
Capita PLC	3,990.4	1,805.6	45.25%	-1914	-47.97%
Kier Group PLC	2,208.3	752.9	34.09%	-153.5	-6.95%
Carillion PLC	3,703.2	1,096.9	29.62%	-559.6	-15.11%
Interserve PLC	1,674.7	439.7	26.26%	-415.8	-24.83%

It is interesting that the two companies with the highest debt (though they may also have had the most overstated balance sheets) are the two that collapsed into insolvency.

Summary

In line with the prior analysis, the key risks in this sector would seem to be:-

• **The mix of the business model,** with long-term construction type contracts being a particular problem, the risk of negative margins in outcomes essentially, with resultant effect on the balance sheet.

• **Balance sheet stress.** The parent company not reflecting that it is invested in subsidiaries with less net assets when they purchased it, and relatedly not writing down goodwill in consequence.

A problem with any imprudent profit acceleration is that as the ultimate profit will be lower, then there is risk of under-pricing contacts, with assets overvalued and which are then written down. The result is double financial stress, loss of profits and the balance sheet is hit at the same time.

There are accounting issues similar to banks given that contracts will be executed across more than one accounting period. Profit is only crystallise at the end of the contract but transactions will be taken into the accounts prior to completion.

The pre and post IFRS accounting models are set out in the Appendix. Broadly:-

- pre-FRS UK GAAP was predicated on the uncertainty of profitable outcomes.
- IFRS has been driven by processes concerned with aligning to "milestones" in line with budgeted outcomes. Which carries the risk of cheerleading the project not looking forward at outcomes, its similar in concept to the backwards looking "incurred loss" model of bad debt provisions in banks.

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Accounting provisions

Pre-IFRS contract accounting (SSAP 9)

“Where the outcome of long term contracts cannot be assessed with reasonable certainty before the conclusion of the contract no profit should be reflected in the profit and loss account in respect of those contracts.”

“If it is expected that there will be a loss once a contract as a whole all of the loss should be recognised as soon as it is foreseen.”

“Where the business carries out long term contracts and it is considered that their outcome can be assessed with reasonable certainty before their conclusion, the attributable profit should be calculated on a prudent basis and included in the accounts for the period under review. The profit taken up needs to reflect the proportion of the work carried out at the accounting date and to take into account any known inequalities of profitability in the various stages of the contract.

IFRS accounting – it’s all about process not outcome

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Per IASB) To recognise revenue under IFRS 15, an entity applies the following five steps:

1. identify the contract(s) with a customer.

2. identify the performance obligations in the contract. Performance obligations are promises in a contract to transfer to a customer goods or services that are distinct.

3. determine the transaction price. The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer. If the consideration promised in a contract includes a variable amount, an entity must estimate the amount of consideration to which it expects to be entitled in exchange for transferring the promised goods or services to a customer.

4. allocate the transaction price to each performance obligation on the basis of the relative standalone selling prices of each distinct good or service promised in the contract.

5. recognise revenue when a performance obligation is satisfied by transferring a promised good or service to a customer (which is when the customer obtains control of that good or service). A performance obligation may be satisfied at a point in time (typically for promises to transfer goods to a customer) or over time (typically for promises to transfer services to a customer). For a performance obligation satisfied over time, an entity would select an appropriate measure of progress to determine how much revenue should be recognised as the performance obligation is satisfied.

No mention of prudence, profitability or losses!!