The Enduring Appeal of Business Services

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In a piece featured in Mergers & Acquisitions, Constitutional Capital Partners' Vicente ("Vil") Ramos takes a deep dive into the Business Services segment. While this vertical is widely considered to be a broad category with numerous definitions, Mr. Ramos explains how it is also one that is particularly active and attractive from a private equity investment standpoint.

The business services sector is a category that often struggles with an identity crisis. Within Standard & Poor's GIC classification system, it isn't even listed as its own sector, but rather included as a mere grouping within the larger industrials space. Further muddying the waters, the business services sector can often seem like a "catch-all" category within private equity for deals that don't fit as easily into other, more obvious buckets. But while it can be hard to categorize, business services very much belong as a distinct area of focus for sponsors, with its own drivers and risks, as well as outsized rewards for those who know the space well.

By its strict definition, the business services sector encompasses companies whose core offering is built around supporting the operations of other commercial enterprises. The services can range from industrial applications, such as security, facility maintenance or third-party logistics, to knowledge skills, including marketing, HR, accounting or legal services. The end markets addressed are also as wide and varied as the economy, itself, which is why the lines tend to blur between business services and other sectors.

From a high level, though, the space has been a beneficiary of the trend toward "hyper-specialization," in which corporate functions are increasingly isolated and distilled down into highly focused tasks. As a recent Deloitte survey identified, outsourcing is no longer about simply solving capacity issues or enabling global scalability; it's also about accessing intellectual capital that otherwise wouldn't be available. Executive teams, as a result, can focus on core competencies, while tapping experts for ancillary functions that can perform these tasks far better and at a lower cost than trying to recreate the same capabilities in house.

Key Takeaways

1. Develop an expertise for sectors and subsectors with tailwinds for growth.
2. Identify firms that provide value-added services to large and growing end markets.
3. Recognize where you are in the business cycle, and run your downside scenarios.
4. Pick opportunities with potential for operational improvements and a margin of safety.
5. Identify potential strategic and financial buyers for the exit.

Private equity investors are attracted to the business services sector because they recognize, first hand, the value proposition being offered – a draw that has only become more acute as disruptive change has forced companies to rethink their entire business model. Firms such as 3G, for instance, have helped to reintroduce concepts such as zero-based budgeting, in which portfolio companies are asked to re-examine every single cost and assess what can be rationalized, outsourced, automated or eliminated altogether. As Bain & Company highlighted in a recent insight, organizations can cut as much as a quarter of their overhead, while improving both their efficiency and competitiveness. This trend provides an obvious foot in the door for "specialized" service providers benefiting from economies of scale.

The other factor, not to be overlooked, is that the competitive landscape has become so dynamic – thanks to increasing regulation, ongoing globalization, and emerging digitalization trends – that many businesses simply need to solicit outside domain expertise. This has created an added tailwind for the business services sector at large.

Predictably, the demand for specialization across the business enterprise is driving private equity interest. PE investments in U.S. business-to-business companies reached nearly $140 billion in 2017, according to PitchBook Data, which is more than a third higher than the deal volume of the next highest sector.

The thesis, for many, is to target the more fragmented areas within business services and help these companies both diversify and scale their business through organic growth and add-on acquisitions. Constitution Capital, for instance, co-invested in the buyout of HR outsourcing company CoAdvantage, a regional player in the sector for professional employer organizations (PEOs). The company offers payroll processing, benefit administration, risk management and employee-development services, as well as a customized portal for small- and mid-sized businesses. Their value proposition is in helping smaller companies attract and retain talent without making a disproportionately sized commitment to an HR function that doesn't typically generate revenues.

Avoiding the Pitfalls

The compelling secular trends, however, probably mask some of the more prominent risks for those who are less familiar with the space. Of the approximate 1,300 realized investments that we've tracked in the sector over the past 27 years, more than one out of every five have resulted in the loss of capital or only allowed sponsors to recoup their original investment.

Historically, business services companies have been more susceptible to the economic cycle than most other sectors. During periods when earnings performance wanes, the first area to be scrutinized is typically third-party professional services. This is why sponsors who have experience in the space tend to gravitate to asset-light companies with fewer fixed costs and more flexibility. They're also that much more likely to pursue a deeper level of upfront due diligence to understand potential concentration risk, the strength of client relationships, and whether the services offered are vital or ancillary to the underlying value proposition of the target company – all factors that are often magnified in the small and middle market.

The 2007 buyout of Avaya Inc. provides a case study of what can go wrong. The company helps businesses manage their customer contact centers, while offering other managed services to support the integration and upkeep of its networking products. The economic downturn in 2008 hit the company soon after this transaction closed. For the next few years, the company was affected by a number of factors, including high leverage, an underfunded pension plan, competition from larger rivals, and shifting technology landscape. Avaya ultimately filed for bankruptcy in January 2017.

But just as the business services sector has been a beneficiary of specialization, so too have sponsors that have made a concerted effort to focus on the vertical. According to our proprietary database, realized business services deals have generated a median return of 2.4x invested equity since 1990, while nearly a quarter of the deals have generated return multiples of 4x or higher. The data also shows a positive correlation between the number of investments a firm has made and the weighted average of their return multiple, suggesting that experience does matter.

This is important because at the tail end of an extended upcycle – as valuations approach historic highs – deal pros who understand the nuances of the sector will be positioned to recognize both the opportunities and risks. Those who merely view business services as a "catch-all" category, on the other hand, will be at a distinct disadvantage if they're unaware of the potential landmines.

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