Selling: Mitie Group (MTO); Small-Cap; Support Services

Managing a portfolio is a lot like managing a garden. In gardening there are regular recurring tasks such as trimming back fast-growing plants and replacing unattractive plants with more attractive alternatives. In a portfolio this means regularly trimming back oversized positions and replacing unattractive holdings with more attractive alternatives.

Purchase price	Current price	Holding period
£2.38 on 16/09/2011	£0.52	9 years 6 months
Capital loss **(including sale of shares in rights issue)** 60%	**Dividend income** 28%	**Annualised return** - 5.3%

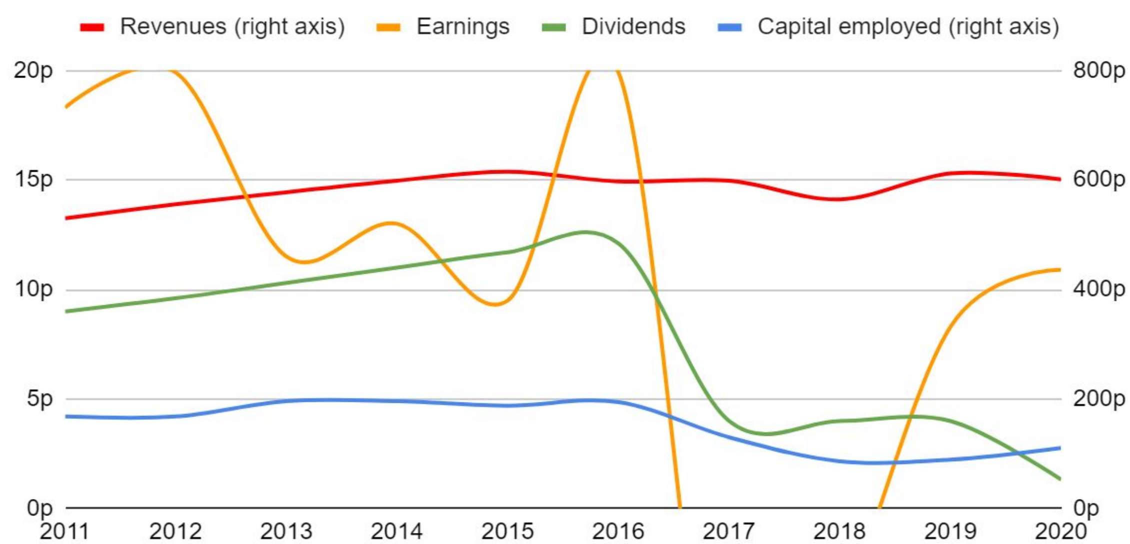
"We are the UK's leading facilities management and professional services company. We manage and maintain some of the nation's most recognised landmarks and work with a wide range of blue-chip private and public sector clients"

Overview

Mitie was one of the first "defensive value" investments I made, way back in 2011. Before that I'd spent several years investing in micro-cap "deep value" stocks, but that didn't suit my personality. What I really like is a decent dividend yield and reliable dividend growth, and as the UK's leading facilities management business that's what Mitie seemed to offer.

In 2011 Mitie had a long history of impressive growth, growing by 18% per year in the decade to 2011 and raising revenues, earnings and dividends almost every year. However, rather than being a steady and dependable dividend growth stock, Mitie was in fact more like a race car being driven too fast on worn out tyres. To the experienced eye (which I didn't have at the time) a serious crash was virtually inevitable.

Price / Buy Price	Dividend yield	PE10	Growth rate	Growth quality
1.8 (max 2.0)	Suspended	11.3 (max 30)	- 7.6% (min 2%)	83% (min 75%)
Return on capital	**Return on sales**	**Debt ratio**	**Capex ratio**	**Acquisition ratio**
6% (min 10%)	2% (min 5%)	9.8 (max 4.0)	79% (medium)	58% (max 100%)



Investment checklist for buy and sell decisions

This investment checklist is designed improve the odds that the model portfolio only invests in quality companies and defensive companies trading at prices which represent good or excellent value. You can access the checklist template as a Google Doc here: ***UK Value Investor Checklist****.*

Quality: Is this a quality company? NO

Q.1. Does it have a focused core business?

NO Mitie provides a diverse array of facilities management services to public and private sector clients to help them get the most out of their buildings. These services are organised into the following groups:

- **Technical services (45% of profits):**
  - Maintenance (electrical, heating, cooling, lighting, decoration, repair etc)
  - Engineering projects (e.g. building design, construction, refits etc)
- **Business services (35% of profits):**
  - Security (manned guarding, equipment installation and technology-based security services)
  - Cleaning (general, specialist and technical cleaning services)
- **Specialist services (20% of profits):**
  - Care & Custody (services for prisons, immigration centres, police forces etc)
  - Waste (waste prevention, reduction, reuse and recycling)
  - Landscaping (indoor and outdoor plant maintenance, plus snow clearing etc)

Having such a diverse range of businesses under one roof no doubt makes Mitie a more complex and difficult to manage business, so there needs to be some benefit. Possible benefits include:

1. It makes Mitie one-stop-shop so clients such as Rolls-Royce can get all their security, cleaning, maintenance, landscaping and waste management services from a single services provider.
2. It allows Mitie to get a foot in the door with new clients through a single service, such as security or cleaning. If Mitie proves itself to be a reliable partner, the client may switch more of its facilities services to Mitie as a single supplier would be simpler and more cost effective.
3. It gives Mitie economies of scale through (for example) greater buying power and more efficient use of central services such as human resources.
4. It insulates Mitie from the ups and downs of the more cyclical parts of its business, such as engineering projects.

Those are sound arguments and such diverse operations may be the best way to run a large outsourcing business. But given Mitie's history of losing money on non-core businesses (which we'll look at shortly) I think the company is bordering on being a jack of all trades rather than a master of one.

In addition, Mitie's recent and very large acquisition of Interserve Facilities Management (IFM), which mostly provides services to the UK government, is likely to further dilute what little focus there is.

Q.2. Has it had the same core business for over a decade?

YES Mitie has been through an extensive restructuring programme over the last decade, offloading underperforming businesses such as power plants, plumbing and care for the elderly. That was followed by several acquisitions, mostly to build Mitie into the UK's largest intelligence-led security business.

Despite all these changes, and despite the fact that I don't think Mitie is a very focused business, it has at least stayed true to its two "core" businesses of building services (maintenance, repair, engineering projects etc) and support services (security, cleaning, receptionists etc).

Q.3. Has it had broadly the same goal and strategy for more than a decade?

YES and NO Mitie doesn't really have a neatly defined goal, but the general idea is clear and consistent across many years of annual reports. The company's goal is first and foremost to be a leading UK facilities management business, providing value to its clients, employees, shareholders and (more recently) wider society.

As for Mitie's strategy, that has definitely not been consistent over the last ten years. Instead, Mitie's strategic history can be broken into two parts: Before Brexit and After Brexit.

Before Brexit: This covers the period from Mitie's founding in 1987 up to and shortly after the 2016 EU referendum. During this period Mitie was fantastically successful, including a 20 year period where revenues grew by an astonishing 40% per year.

This success was made possible by Mitie's very unusual and possibly unique business model, known as the MITIE Model. MITIE stands for Management Incentive Through Investment Equity, and that's a good description of how Mitie fuelled its impressive growth.

Basically Mitie would look for people who wanted to start a small facilities services business, perhaps a cleaning or security business, or a painting and decorating business. Mitie people would check out the entrepreneurs and their plan, crunch the numbers and if they liked what they saw, Mitie would make the startup team an offer: Mitie would put up 51% of the funding for 51% ownership of the startup. In addition, if certain targets were met over the first five or ten years, Mitie would buy out the team using a valuation of ten-times the business's most recent two or three-year average profits. The deal would also typically include a lock-in period where the founders had to continue working for Mitie for a pre-agreed period.

So if a two-person security startup grew to £200,000 profit in ten years, Mitie would buy out the founders for 49% of £2 million, giving each founder almost £500,000. And they got to keep their well-paid jobs too. That's a huge incentive for the founders to work incredibly hard, and that incentive, spread across more than 80 Mitie Model startups, effectively drove Mitie's growth for decades. But there are downsides.

One downside is complexity. A company that grows rapidly by bolting on dozens of startups is eventually going to turn into a very messy ball of spaghetti. There will be dozens of different cultures, IT systems, HR processes and so on.

That may be okay if each startup works independently, but eventually Mitie started going after large blue-chip clients, and they wanted a smoothly integrated service across the whole UK. Mitie simply wasn't set up for that sort of nationwide contract. Its internal complexity made it very inefficient, especially when compared to competitors that had grown organically with integrated and efficient internal systems.

Another problem with the Mitie Model was scale. It's easy to grow by bolting on a few more engineering or cleaning startups when you're small, but after you become very large, bolting on another handful of startups adds yet more complexity but not much more scale.

To fix that problem Mitie started making fairly large acquisitions, but I'll leave that topic for later.

After Brexit: Mitie had grown incredibly quickly for decades, but the speed and nature of that growth left the company extremely fragile. Even before Brexit the signs of strain were becoming apparent, such as the almost £50 million of exceptional charges that were caused by its failing power plant construction business.

But as long as the economy remained benign, problems like that could be absorbed without derailing the Mitie growth train.

And then there was Brexit. The 2016 EU referendum caused public and private organisations to become more cautious, deferring or cancelling project work and demanding lower prices on new or renewing service contracts. The subsequent reduction in gross profit margins was about the worst thing that could happen to a relatively inefficient and over-indebted company as Mitie was back then. Mitie's response was to initiate an efficiency improvement program, but it was too little too late.

Spectacular losses followed through the rest of 2016. These were largely due to Mitie's elderly homecare business which had its value written down to zero (it was eventually sold for just £2), but the damage was widespread enough to cause Mitie's CEO to leave.

The new CEO (Phil Bentley) brought in a new five year plan to fix the multitude of issues that had built up in Mitie over the years. Chief among these were: (1) trimming away non-core businesses to focus Mitie on facilities management, (2) investing heavily in standardising culture, processes and technology across the company and (3) cleaning up the accounts by reducing average debt and being less aggressive with "revenue recognition" (where companies can record revenues that aren't guaranteed to actually appear).

Overall I think Phil has done a good job, but Mitie is a classic case of "you can't make an omelette without breaking a few eggs". Mitie's results these past few years have been terrible because the company had to focus on making structural investments which should have been five, ten or even twenty years ago. As a result, recent profits have been small and inconsistent, the dividend has been cut and then cancelled and in 2020 a very dilutive rights issue was required to pay down excessive debts.

Q.4. Has it earned consistently good returns?

NO Over the last decade Mitie's average net return on capital averaged 6%, which is very poor. Its profit margins have also been very weak at just 2%, although that is somewhat typical of outsourcing businesses.

In the decade leading up to 2011 its net ROCE was much better at 14%, but it was an illusion. Its returns were only that high because management were systematically underinvesting in the company.

It would have been much better if management had invested more into making Mitie a robust and fully integrated business, but that would have increased expenses, increased capital employed and therefore reduced performance indicators such as earnings and returns on capital. But it would still have been the right thing to do for the long-term benefit of the company, its employees and its shareholders.

Q.5. Has it produced consistent and sustainable growth?

NO Over the last ten years Mitie has produced no growth as the new CEO has quite rightly focused on cleaning up the mess left by years of overexpansion and underinvestment.

Q.6. Has the company avoided the need for large transformation projects?

NO Over the last few years Mitie has been forced to carry out several major projects to transform itself into a single unified business, rather than a network of dozens of largely separate Mitie Model businesses. By late 2020 this transformation process was almost complete, but it is now likely to last several more years following the recent and very large acquisition of Interserve Facilities Management.

Q.7. Has the company avoided excessively rapid expansion?

NO In the decades leading up to 2016, Mitie grew very rapidly and very consistently. As I've already mentioned, this growth was unsustainable and in my opinion, foreseeably dangerous.

For example, from 2001 to 2011 Mitie grew around 18% per year with almost perfect consistency, which sounds great. Meanwhile, its average return on capital was an also impressive 14%.

But 18% is more than 14%, so even if Mitie retained all its earnings it couldn't have fuelled that 18% growth rate simply by reinvesting its 14% annual return (it's like reinvesting interest back into a 14% interest account; you can't generate an 18% return with 14% interest). However, Mitie didn't retain all its earnings. It paid about a third of them out as a dividend, so in reality its retained earnings only averaged about 11% of its capital base.

The rest of the fuel for its rocketship 18% growth rate came from external sources including increasing debts (from zero in 2001 to £200m in 2011) and increasing equity (rights issues to fund acquisitions increased the equity base by 24% over those ten years).

Fuelling growth with large amounts of external funding from debt and equity is like turning up the turbo boost in a race car. It's a risky business because the company is expanding faster than its maximum natural growth rate. There are more new people, new IT systems, new processes and new clients than the company can reasonably cope with. If a race car hits a bump in the road when it's already at the limit of adhesion, a crash is virtually certain. For Mitie, that bump in the road was the 2016 referendum.

Q.8. Has the company grown organically rather than through acquisition?

NO Mitie's whole business model was built on acquiring many startup businesses using the Mitle Model. When that stopped working the company switched to larger acquisitions, many of which turned out to be very bad deals.

In recent years acquisitions have thankfully stopped, but within the last year Mitie made its largest acquisition ever, buying Interserve Facilities Management for £271m. That's about eight-times Mitie's average earnings over the last decade and that makes it an extremely large and potentially risky acquisition.

Q.9. Does the company benefit from network effects?

NO Some aspects of Mitie's business have the potential for mild network effects, where adding more clients creates a direct benefit to existing and new clients. This mostly relates to the collection of data.

For example, as more heating and cooling systems have sensors built into them, Mitie can collect more data on how these systems are operating immediately before a fault appears. This helps Mitie's "machine learning" IT systems alert engineers to potential problems before they occur.

This predictive maintenance becomes more accurate as more data is collected by more sensors, so adding a new client with yet more sensors can directly benefit existing clients.

This use of data and technology is now a core part of how Mitie intends to compete in the future, but for now I'm not sure it gives the company a material or durable advantage.

Q.10. Does the company benefit from unique and hard to replicate assets?

NO Mitie doesn't really need much in the way of physical assets. Its main assets are its brand, its clients, its market leadership position, its operational capabilities and the expertise of its employees. Given Mitie's mixed results in recent years, I'm not sure the company has any assets which are both valuable and hard to replicate or substitute, other than its position as market leader (which on its own is a weak advantage).

Q.11. Does the company benefit from core market leadership?

YES Mitie is the UK's largest facilities management company, and with huge problems at competitors like Interserve, Carillion and to some extent Capita, Mitie's market position is perhaps stronger than ever before. The economies of scale and reputational advantages that come from being the market leader are definitely useful in a market as brutally price competitive as facilities management.

Q.12. Does the company benefit from switching costs?

YES As a supplier of integrated facilities services including security, cleaning, front of house, maintenance and heating/humidity/lighting optimisation, Mitie often has a fairly deep relationship with its clients.

The depth and complexity of these integrated services relationships make it relatively costly (in terms of time, money and effort) for clients to change to another supplier of security guards, cleaners, receptionists, maintenance engineers, vetting managers and so on.

Still, clients do switch if they are dissatisfied or if they find a materially better alternative, so although this is a helpful barrier to exit there's no clear evidence it allows Mitie to significantly raise prices or reduce costs.

Defensiveness: Is this a defensive company? NO

D.1. Is the company's core market defensive?

NO Some aspects of Mitie's business are fairly defensive, such as cleaning, security or services for public sector clients. This is offset to a large extent by the 45% or so of Mitie's operating profits that come from more cyclical services. For example, Technical Services such as maintenance work and engineering projects are much easier for clients to reduce or defer during recessions.

This cyclicality showed through when the pandemic forced management to suspend the dividend and raise £200 million through a rights issue to strengthen the balance sheet.

D.2. Is the core market expected to grow over the next ten years?

YES The facilities management market in the UK is generally expected to grow in line with the broader economy over the longer-term. That means a long-term growth rate of perhaps 2-3%. COVID-19 and the current boom in homeworking have increased the level of uncertainty around how companies will use office space in the future, but for now a 2-3% long-term growth expectation still seems reasonable.

D.3. Is the core market relatively free from regulatory risk?

YES Regulatory change is not a major concern in facilities management.

D.4. Is the core market unlikely to be disrupted?

YES The UK facilities management market is gradually moving from a model of Total Facilities Management (TFM, where suppliers provides multiple FM services like security and cleaning to a single client) to Integrated Facilities Management (IFM, where FM teams are fully integrating into the day-to-day management of client facilities) and now to Strategic Facilities Management (SFM, where FM suppliers help clients maximise the productive output of their buildings by minimising waste, optimising heating, ventilation, lighting and so on).

This is quite a shift, but I'm not sure I'd call it disruptive. As the UK's largest FM business, and one which has had the relative luxury of spending the last five years upgrading its internal structure and systems, Mitie is perhaps better placed than most to take advantage of this shift to strategic FM.

D.5. Is the company free from significant concentration risk?

YES and NO Mitie's current strategy is focused on generating additional profits from its largest clients. These large clients want multiple services provided across a large national footprint of various facilities. They also want the very latest technology, whether that's for optimising the use of maintenance engineers or optimising the temperature, humidity and lighting of an office or factory to maximise productivity.

The downside is that focusing on the largest clients can leave a company too dependent on one or a few clients, which is not a strong position to be in. Mitie seems to have avoided this fate so far, with the largest single client making up less than 10% of the company's revenues.

However, I've also answered this question "no" as Mitie does get more than 10% of its revenues from various UK government departments, and that will be significantly more true once Interserve Facilities Management is fully integrated. There is a risk that a serious enough problem with one government department could lead to Mitie being explicitly or implicitly banned from working with other departments.

D.6. Is the company free from significant product or patent risk?

YES Mitie doesn't have products as such and patents are not a key part of its business strategy. Instead, it provides services, and services like security and cleaning are unlikely to be made obsolete by technology anytime soon (robot cleaners of the future are still likely to be managed by Mitie and other FM companies).

D.7. Is the company largely unaffected by commodity prices?

YES Facilities management is not especially sensitive to commodity prices.

D.8. Does the company have prudent financial liabilities?

YES and NO Mitie's profits and debts are in a state of flux so it's hard to say how prudent its debts are. For example, Mitie currently has excess cash having raised £200m in a rights issue. Some of that will be used to fund the acquisition of Interserve Facilities Management, but it's reasonable to expect that some, perhaps £100m, will be used to further reduce debt.

If that happens then Mitie's debt to average earnings ratio (the Debt Ratio) will be around four, which I think is just about prudent.

Value: Is this company good value? NO

V.1. Is the company free from problems which are likely to materially damage its long-term prospects?

NO Although I don't think Mitie is necessarily about to run off a cliff, I do think the uncertainty around its turnaround efforts and its recent acquisition of IFM are high enough to say that I don't think the company is free of major problems.

What do I mean by this? I mean that Mitie's valiant and correct efforts to standardise, systemise and optimise its processes and technology are still ongoing. It would have been nice to see the post-turnaround Mitie operate in a fairly normal environment for a few years so that we could see how well all those improvements fed through to revenue and profit margin growth.

But we haven't had that yet. The turnaround is almost complete but not quite, and now Mitie has made its largest acquisition ever, which is likely to take several years to fully (and hopefully successfully) integrate.

So Mitie is like a cake which is halfway through being mixed. It hasn't even made it into the oven yet so we really don't know how it's going to turn out in the end.

V.2. Is dividend growth very likely over the next ten years and beyond (and how much)?

NO Following on from the previous question, my answer to this is that I just don't know and I can't even have a very sensible opinion on how Mitie's dividends might progress over the next decade.

Having said that, creating a dividend discount model is still worthwhile because it's an excellent way to pull together your thoughts about a company's future potential.

Here are the underlying assumptions I've used to generate Mitie's dividend discount model:

(1) After the IFM acquisition is complete, the company will have revenues of around £3.5bn, profit margins of 2.5% and 1400m shares in issue.
(2) No earnings or profits in 2021 due to COVID-19 and expenses relating to the IFM acquisition.
(3) 2022 earnings are 3.1p per share. That's just 50% of a 2.5% profit margin because of ongoing acquisition expenses. A cautious dividend of 1p is paid.
(4) 2023 earnings of 6.2p reflect a 2.5% profit margin on revenues of £3.5bn. Dividend cover remains cautious at around 3, giving a dividend of 2.2p.
(5) Beyond 2023 growth is driven by retained earnings and a return on capital that gradually reverts to 10%, which is average for UK companies. Dividends grow faster than earnings, shrinking dividend cover and producing 7% dividend growth over the next decade, albeit from a low starting point.
(6) Beyond 2030 Mitie grows by 3% per year, in line with the expected growth of the UK economy.

Dividend Discount Model (GBp)	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030+
Estimated net return on capital		*7.2%*	*13.7%*	*13.0%*	*12.3%*	*11.7%*	*11.1%*	*10.6%*	*10.0%*	
Estimated earnings ps	0.0	3.1	6.2	6.4	6.6	6.7	6.8	6.9	6.9	
Estimated dividend cover	0.0	3.0	2.9	2.7	2.6	2.4	2.3	2.2	2.1	
Estimated dividends ps	0.0	1.0	2.2	2.4	2.6	2.7	2.9	3.1	3.3	48.6
Estimated capital employed ps	43.2	45.2	49.2	53.3	57.3	61.3	65.1	68.9	72.5	
Discount factor	*91%*	*83%*	*75%*	*68%*	*62%*	*56%*	*51%*	*47%*	*42%*	*39%*
Discounted dividends	0.0	0.9	1.6	1.6	1.6	1.6	1.5	1.5	1.4	18.7
Estimated future growth	ST growth	*7.3%*	LT growth	*3.0%*	Target rtn	*10.0%*	Buy Price	30.3	Price / BP	**1.7**

V.3. Are the risks and expected returns from this investment satisfactory?

NO Based on that dividend discount model, which I think is both reasonable and conservative, Mitie's current share price of 52p is 1.7-times its Buy Price of 30.3p. That means the expected rate of return is below my target of 10%, so I don't think the shares are especially good value.

From a share price of 52p the expected long-term return from Mitie is 7.5%. That's not bad, but it's not significantly better than the expected return of the UK market.

In addition, Mitie is still in a very precarious position, partway through a major turnaround and just at the beginning of digesting a very large acquisition. The dividend is also currently suspended, so Mitie doesn't meet either my tolerance for uncertainty or my preference for steady dividend growth stocks.

Overall then, the potential risks and returns of Mitie are not what I'd call satisfactory.

Final Decision: Are you happy to own this company at this price?

NO Mitie joined the model portfolio almost a decade ago when the company seemed to be doing incredibly well and when my investment process was considerably less mature.

Back in 2011 I was unable to see that Mitie's rapid growth was reckless and unsustainable, and that it would almost inevitably lead to serious problems at some point in the future. The fact that its growth had been driven by debt-fuelled acquisitions made both the magnitude and the likelihood of those problems even larger.

Those problems started to appear from 2013 and grew exponentially after the 2016 referendum. Since them, Mitie has been working hard to make itself into a lean mean efficiency machine, and that job was perhaps 80-90% done. But then Interserve went bust and Mitie's management saw an opportunity to pick up a rival FM business for a bargain price, which would diversify Mitie's client base and give it dominant scale.

Unfortunately the scale of the IFM acquisition makes Mitie's future even more unclear, and given the lack of obvious Quality, Defensiveness and Value, I don't think Mitie is a suitable holding for the model portfolio.

I will therefore be removing Mitie from the model portfolio and my personal portfolio a few days after this issue is published. The proceeds (around 0.5% of the portfolio) will be reinvested into one of the two holdings being topped up this month.

Other potential sales	Reason for not selling
Petrofac, Standard Life Aberdeen	These lack Quality and Defensiveness so I expect to sell them soon unless something happens to make me think they're Quality companies (unlikely).
XP Power	XP is a Quality business but its share price is well above its Sell Price. I expect to sell XP soon unless its price falls significantly or its Buy Price increases significantly.