GRANVILLE BAIRD NETWORKING CONFERENCE
The World of Business Services – Some Personal Reflections

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Introduction

Good morning. I am delighted to have been asked to share with you my thoughts and observations on the vast and varied world of business services.

It is a difficult and depressing time for many companies in this sector and things look like they could get worse before they get better.

The economists tell us we are heading into the trough of a deflationary cycle. For those of us born after the War, this is a new phenomenon – falling prices, profits. A time when it's better to pay off debts than save or invest. Indeed for many companies there is a lot of debt to be written off before they can climb back up the growth curve.

But as a Yorkshireman, it was bred into me at an early age that out of adversity springs opportunity and over the years I have witnessed many examples of this.

So putting away for the moment worries about the world economy and Iraq, I have taken an inspirational theme for my presentation today and borrowed a quote from a man who's wit I've always admired. (Any physical resemblance between us I assure you is purely coincidental).

So what does it take to become a star in the often fragmented and complex world of business services?

> **"We are all in the gutter but some of us are looking at the stars"**
>
> **(Oscar Wilde)**

It's not possible in 20 minutes to give a detailed analysis of such a diverse sector so I hope you don't mind if I limit myself to some brief generalisations.

To start with I will attempt to define what I mean by business services. I would suggest there are three 'primary' business activities, although of course many providers either claim to or do offer all three.

Primary Business Services

ADVICE - out-Thinking

SUPPORT - out-Tasking

OPERATE - out-Sourcing

In each of these 'primary' revenue sources the relative importance of human and technological capital in the client delivery process can vary considerably.

So what are some of the 'current' market characteristics of each of these three 'primary' business service activities.

Advice / out-Thinking

- Usually high level of intellectual and/or creative content
- Increasing client doubts about 'paper' strategies and 'value for money'

Advice / out-Thinking (cont'd)

- Traditionally high margins - but eroding due to downturn and low barriers to entry
- Search for added value via (a) consolidation, (b) segmentation, and (c) downstream integration

Support / out-Tasking

- Myriad of different combinations of advice/support ranging from market research to facilities management
- Variable barriers to entry depending on degree of human/technological intensity

Support / out-Tasking (cont'd)

- Margins under pressure particularly in the lower skill 'contracting' arena
- Search for critical 'client' mass to secure diversity and sustain profitability

Operations / out-Sourcing

- Client and supplier doubts about set-up costs and longer term benefits, viz price/service
- Limited 'pure' models involving equity and employee transfer to out-sourcing joint-venture

Operations / out-Sourcing (cont'd)

- High incidence of 'framework' contracting agreements or PSAs dressed up as managed services
- Increased competition means critical mass and client diversity essential for sustainable margins

As I said earlier, the diversity of this sector makes meaningful generalisations difficult, but having advised on a number of investments, acquisitions and mergers in this sector, I would offer a few highly personal observations. The first concerns the market proposition:

Some Observations

We're Selling But Who's Buying and Why?

Entrepreneurs are always keen to tell you what they make or sell. But while the motive for selling can be reduced to 'making money', the motives for buying business services of all kinds are far more varied, complex and more particularly they are highly changeable. For the supplier, once a formula has become successful the focus can all too easily become 'more of the same'. Selling the same service to as many clients as possible. Horizon watching and marketing slip down the agenda.

Case Profile A

Some years ago this more-of-the-same approach to growth prompted a major UK general insurer to spend £65m buying a smaller version of the same business from another UK composite. It was only after we were asked to orchestrate a post-acquisition customer market research and broker segmentation programme that the buyer realised that while they now had 2,000 brokers on their books generating £400m in commercial premiums from SMEs, there were only 400 brokers who dominated the market, the buyer only had 6% of this market and they were not seeing any new business because they had become too lazy about identifying changing market opportunities and new product development. This is an example (of which there are many in business services) where the acquisition cost is often significantly greater than the replication or start-up cost (organic growth). The problem was compounded a year later when the whole business was acquired by another insurer with subsequent write-offs, closures and redundancies.

My next observation relates to the forecasting of revenues and margins.

Some Observations

Margins Often Move in Mysterious Waves

As a confirmed bon viveur I would like a lunch at The Ivy for every business plan we have reviewed where forecasted revenue is presented as a straight line moving up at least 30° in relation to the horizontal axis and gross margins are predicted to remain stable for at least 3 years.

More and more the reality is that demand in the B2B sector can shift sharply and often at relatively short notice due to changes in fashion, regulations and/or competing ideas and technologies.

While confidence in the future and single-mindedness are positive managerial qualities there should be wider recognition (amongst managers, investors and their advisors) of the fact that things sometimes have to go down before they can go back up.

Case Profile B
Some years ago we reviewed a business plan prepared by PwC for a leading IT contractor. This plan displayed proudly the usual straight-line extrapolation of revenue through Y2K and beyond into the stratosphere. Needless to say due diligence revealed the need to severely re-adjust the revenue forecasts to take account of IT budget cutbacks after Y2K and more importantly a switch away from IT contracting to outsourcing and vendor management, which the company had not addressed. In this case the need to re-position the business and move up the value chain was accepted and the business was sold shortly after to a trade buyer at a significant premium.

My third observation concerns branding.

Some Observations

Name Awareness Versus Brand Value

The confusion between names and brands is pervasive. Many B2B companies talk as though they have a brand but in reality they are lucky if they have anything more than some unprompted name awareness.

When someone says I have a ‘brand’ I grab our in-house dictionary and read out **“a brand is something that people will buy even though the same or similar product or service is readily available at lower cost.”**

With the exception of some firms such as IBM or, dare I say it, McKinsey, very few B2B companies meet this test for the simple reason that they are probably operating in a segment of the market where the barriers to entry are small and difficult to sustain – often despite what they see as a significant and unique investment in IT to develop ‘killer applications’.

Case Profile C
Some three years ago on the advice of McKinsey a leading quoted construction company spent nearly £100m in acquiring a collection of FM businesses to create ‘an integrated building services business’ in the hope that this would boost flagging investor interest and raise the P/E ratio. Our branding study earlier this year, which for the first time, researched client opinion revealed that the parent company had contributed zero additional value to the acquisitions which in turn had been significantly over-valued. So much so, that one major PFI investor suggested the parent company would do better if it went back to concentrating on its building business.

My final observation relates to the quality of management.

Some Observations

Exploding the ‘Big Man’
Theory of History

Henry Ford, Charlton Heston, AJP Taylor and John Wayne have one thing in common – namely a belief in the big man theory in history.

How often have we heard that what this business needs is a strong leader which is then followed by a call to the head hunter – who simply re-shuffle the cards from the same pack of CEOs that’s been doing the rounds for several years. Leadership is important but all too often I feel investors (a) expect too much from one individual and (b) understate the importance of collective leadership and collective goals.

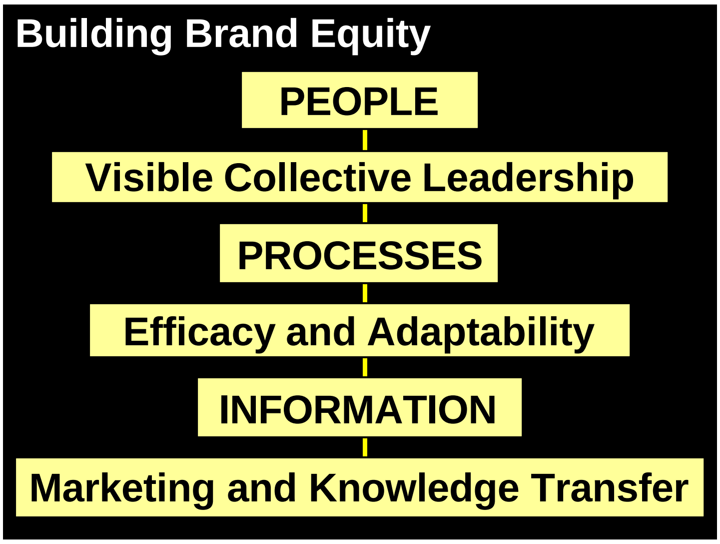
Case Profile D
We are advising the US subsidiary of a UK quoted marcoms group who wish to establish a major presence in Europe for a new ‘brand’ of business services covering business intelligence and risk management. This would involve acquiring several businesses in the UK and somehow appointing a leader. Our advice to them so far is make sure the earn-outs for the existing CEOs relate to the overall performance of the new business (and not to make the mistakes agencies/consultancies made in the ‘80s) and appoint a CEO who understands and can manage basic human behaviour and build teams.

According to Professor Nigel Nicholson of London Business School there are seven which feature prominently in business, namely:

- Making snap judgements based on emotions;
- Letting one piece of bad news drive out a hundred pieces of good news;
- Taking big risks when threatened and avoid risks when comfortable;
- Allowing confidence to conquer realism to get what we want;
- Creating opportunities for display and competitive contest;
- Classifying things and people, dividing groups into “us” and “them”;
- Practising gossip and mind reading as key survival tools.

The key to success is to find a CEO who can inspire and overcome the worst aspects of human behaviour to orchestrate a management team within which there are a collection of leaders who are both resilient and adaptable.

So, in conclusion, what makes for a successful business in the B2B environment? In my view there are three fundamental components of brand equity and to create long-term shareholder value for a business.



To be successful a company needs to demonstrate and sustain competitive advantage in 2 out of the 3 components. To be a star a business needs all three.

Finally, I would like to end on a call to action. With market values at realistic levels now is the time for investors to seek out and acquire cost-effective strategic stakes in businesses with significant future potential. If economic history has taught us anything it is that there are no prizes for sitting still and ‘Waiting for Godot’. I leave you therefore with a quote from a man who helped change the lives of millions.

“Doing Nothing is the Greatest Risk of All”
(Nehru)