Is the most valuable perspective the one you don’t have?

UK Business Services Industry Survey 2017

The better the question. The better the answer.
The better the world works.
Introduction

State of the Union 2017

A lot has happened in the sector since we published our last survey in November 2016. While some constituents have battled profit warnings, covenant breaches and balance sheet restatements, others have delivered top and bottom line growth and seen their valuation climb. The vast majority have reported an increase in unit cost largely driven by increases in the cost of labour, a result of several well-known policies.

In addition to this, those businesses with a significant public sector portfolio have found top line growth very hard to come by with uncertainty and inertia prevalent. Interestingly the consensus opinion on the impact of Brexit on the next 12 months has changed little in the year.

So, with challenging top line growth (particularly at the large cap end) and upward pressure on costs, how has the sector responded? Focusing on existing contract performance and actively managing costs. Spend on technology is broadly the same as last year and many respondents report innovation in the delivery of their services. However, they find it difficult to fund it out of working capital and there is a consensus that more needs to be done.

With regard to managing costs, many organisations have looked at their back and middle office support functions for opportunities to innovate; significant advances in automation and robotic process automation are key drivers, although the services sector still lags other segments of the UK economy.

The next year will no doubt throw up many opportunities and challenges for the sector, testing the ambition and resilience of businesses and leadership alike.

Martin A Scott
Business Services Sector Lead
Continued profitable growth despite challenges

Overall, survey respondents reported revenue growth in their UK business of 5% over the last year. Across sub-sectors, revenue growth is in a relatively tight 4.2% to 5.5% range, indicating similar performance despite the different challenges faced by people-heavy vs. technology and asset-heavy sub-sectors. By size, smaller businesses have let this growth at 6.3% on average.

From a margin perspective, respondents stated that operating margins have expanded by 1.4pp on average, aligning with their predictions about 2017 performance in last year’s report. Largely, margin expansion has been driven by SMEs (£0–20M), with mid-sized and large businesses achieving more moderate gains.

The Business Services sector has generally had a positive year with 74% of respondents reporting 5% or greater revenue growth across the sector, similar to the findings in 2015-16.

Growth in revenue vs. growth in Margin 2016-17 by Sub-sector
A focus on new products and services

The most important driver of revenue growth is cited as new products and services. Businesses are seeking ways to innovate and, in some cases (arguably not enough), investing in technology to change their service or product proposition in order to grow.

On the flipside, regulatory change and government inaction has led to a negative impact on revenue growth, the biggest negative swing relative to 2016.

**Key drivers of change in revenue 2016 vs. 2017**

<table>
<thead>
<tr>
<th>Negative factors</th>
<th>2017</th>
<th>2016</th>
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</thead>
<tbody>
<tr>
<td>Market exit</td>
<td>13</td>
<td>28</td>
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<tr>
<td>Contract losses</td>
<td>8</td>
<td>19</td>
</tr>
<tr>
<td>Volume decrease</td>
<td>7</td>
<td>12</td>
</tr>
<tr>
<td>Product/service exit</td>
<td>6</td>
<td>30</td>
</tr>
<tr>
<td>Divestment</td>
<td>10</td>
<td>6</td>
</tr>
<tr>
<td>Decreased outsourcing</td>
<td>-13</td>
<td>-1</td>
</tr>
<tr>
<td>Pricing decrease</td>
<td>-6</td>
<td>2</td>
</tr>
<tr>
<td>Unfavourable regulatory change</td>
<td>-23</td>
<td>-3</td>
</tr>
<tr>
<td>Unfavourable economic conditions</td>
<td>-22</td>
<td>-41</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Positive factors</th>
<th></th>
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</thead>
<tbody>
<tr>
<td>Market entry</td>
<td></td>
<td></td>
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<tr>
<td>Contract wins</td>
<td></td>
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<tr>
<td>Volume increase</td>
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<tr>
<td>Product/service entry</td>
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<tr>
<td>Acquisition</td>
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<tr>
<td>Increased outsourcing</td>
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<tr>
<td>Pricing increase</td>
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</tbody>
</table>

**Logistics & Distribution**

“We are developing managed services for our clients so they can focus on what they are good at, and let us take care of all their logistics needs. As a new service, it has driven revenue growth for us and better outcomes for our clients.”

Q: What have been the primary drivers of your company's UK revenue change?
Productivity and better contracts are key to face cost inflation

In terms of profit margin, a continued and relentless focus on productivity increases in a low-margin environment is increasingly critical for the sector.

Developing new products and services is leading to more profitable contracts. There has been a marginal increase on better portfolio management of contracts as some have successfully exited less profitable relationships: this was a notable source of negative pressure in last year’s survey. Pricing pressure has also been managed more effectively relative to last year (improved from -23% to -5%) but is nevertheless still a source of concern.

Ultimately though, the greatest pressure on margins relates to unit cost increases (-2% to -28%). Labour costs have continued to climb domestically with the minimum wage, living wage and apprenticeship levy and the depreciation of the pound particularly impacting those businesses reliant on offshore labour, or importers of equipment or materials.

Key drivers of change in operating margin

What have been the primary drivers of your company’s UK operating margin change?

<table>
<thead>
<tr>
<th>Negative factors</th>
<th>Positive factors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Productivity decreases</td>
<td>Productivity increases</td>
</tr>
<tr>
<td>Less profitable new contracts</td>
<td>More profitable new contracts</td>
</tr>
<tr>
<td>Unit cost increases</td>
<td>Unit cost decreases</td>
</tr>
<tr>
<td>Exiting more profitable contracts</td>
<td>Exiting less profitable contracts</td>
</tr>
<tr>
<td>Unfavourable regulatory change</td>
<td>Favourable regulatory change</td>
</tr>
<tr>
<td>Price decreases</td>
<td>Price increases</td>
</tr>
</tbody>
</table>

Net % of mentions

2017 2016
Business environment

The cycle of uncertainty needs to be broken by businesses

"We have seen a continuation of the slow down since the Brexit vote in 2016. Our corporate clients are spending less on discretionary services and margins are under particular pressure in several of our markets."

Business Process Outsourcing

Businesses are reacting to this economic and political uncertainty by further reducing spend and delaying decision making – this diversionary effect of Brexit is the primary lag of growth going forward.

Clients are delaying their investment plans in the UK until there is greater clarity on the economic and policy outlook. 95% of respondents are concerned about new business negotiations and 51% about the ability to serve EU-wide customers, a 15% jump on 2016 results.

"People are uncertain and are not taking steps yet. Government has not been explicit/clear – they are managing their negotiations – it is a guessing game so people are choosing to do nothing rather than commit one way or the other."

Logistics & Distribution

"We have seen a continuation of the slow down since the Brexit vote in 2016. Our corporate clients are spending less on discretionary services and margins are under particular pressure in several of our markets."

Business Process Outsourcing

While government focuses on Brexit, spend decisions are delayed, impacting Business Services and the broader economic environment.

"Government is delaying contract renewals while strategic reviews on spend are complete"

Facilities Management

"People are uncertain and are not taking steps yet. Government has not been explicit/clear – they are managing their negotiations – it is a guessing game so people are choosing to do nothing rather than commit one way or the other."

Business Environment

67% need to prepare for disruption

53% feel Brexit causing headcount cutbacks

40% rely on automation to drive productivity increase

To break out of this negative cycle, the government needs to be drafting legislation that enables further investment in skills and technology. The Business Services sector in turn can take the opportunity to act as a catalyst for change, assisting government on the upskilling and training of labour. The sector also needs to be taking a lead increasing investment in technology and productivity.
Technology

Technology is key but more needs to be done

Businesses are clearly striving to innovate, which may partly be due to greater incidence and risk of disruption from smaller tech-led rivals. Of the respondents we surveyed:

42% believe technology will disrupt how they operate and service their clients.

39% invested substantially in the last 12 months, spend is flat.

38% see technology as a core part of their business.

34% see technology as an important opportunity to do more.

“We can use technology and sensors to recast how the police or NHS utilise their buildings and estates. The most radical solutions that tech can offer would free up much needed space and funds for local government, but too many clients are risk averse and aren’t willing to support and, importantly, fund innovation.”

Facilities Management

Views on disruptive technology

Q: How is disruptive technology viewed within your organisation?

Net % of mentions

- A core part of our business
- An opportunity for us
- A challenge/threat to our business
- Not a concern
- A distraction for the business
Low technology investment puts the sector at risk of disruption

Given the current pressure from regulation and skills shortages, the obvious benefit technology offers businesses is monitoring and improving employee productivity.

**Changes due to technology**

**Q:** How is technology affecting your business?

- It is changing the service itself and/or how we provide it: 39
- We are able to monitor performance better: 38
- It is changing customer expectations: 36
- It is helping us improve employee productivity: 31
- It is increasing competitive pressure: 26
- It is changing the supplier relationships/business value chain: 22
- It is reducing competitive pressure: 16
- None of the above: 2
- Other (please specify): 1

**Challenges when dealing with disruptive technologies**

**Q:** What are the biggest challenges your organisation faces when dealing with disruptive technologies?

- Cost of implementation
- Cyber-security
- Financial restrictions
- Lack of time
- Ability to prove ROI
- Achieving customer buy-in
- Achieving board buy-in
- Legacy/existing tools and infrastructure
- Modifying applications
- Lack of relevant skills
- Lack of knowledge of the new technologies on the market
- Sourcing technology suppliers
- Sourcing support services/consultancy
- Net % of mentions

**Net % of mentions**

- Cost/time constraints: 
- Different business case: 
- Legacy investments: 
- Knowledge gap: 

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**Introduction**

Performance

Business environment

Technology

Outlook

How can EY help?
Despite widespread acknowledgement that technology is reshaping the Business Services sector, the 4.4% growth in spend on technology is still below the 5% rate of revenue growth.

Over the past 12 months, approximately 60% of respondents reported spending the same or less on technology. Its enhanced importance might merit overinvestment in technology ahead of revenue, but this does not appear to be the case. This may also leave opportunities open for smaller, more disruptive firms that view technology as their key to differential growth.

**Spending on Technology**

Q: What proportion of revenue did your organisation spend on disruptive technology in the last 12 months?

<table>
<thead>
<tr>
<th>Percentage</th>
<th>Last 12 months</th>
<th>Next 12 months</th>
</tr>
</thead>
<tbody>
<tr>
<td>8-10%</td>
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<tr>
<td>5-8%</td>
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<td>3-5%</td>
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<tr>
<td>1-3%</td>
<td></td>
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<tr>
<td>Stayed the same (-5 to 5%)</td>
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<tr>
<td>Decreased (5-20%)</td>
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<td></td>
</tr>
<tr>
<td>Increased (5-20%)</td>
<td></td>
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</tr>
</tbody>
</table>

**Change in Spending**

Q: How has your organisation’s investment in disruptive technologies changed over the last 12 months?

- Increased significantly (>20%)
- Increased (5-20%)
- Stayed the same (-5 to 5%)
- Decreased (5-20%)
- Decreased (5-20%)
- I don’t know

<table>
<thead>
<tr>
<th>Change in Spending</th>
<th>Last 12 months</th>
<th>Next 12 months</th>
</tr>
</thead>
<tbody>
<tr>
<td>Increased significantly (&gt;20%)</td>
<td>8-10%</td>
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<tr>
<td>Increased (5-20%)</td>
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<tr>
<td>Decreased (5-20%)</td>
<td>1-3%</td>
<td>1-3%</td>
</tr>
<tr>
<td>I don’t know</td>
<td>0%</td>
<td>0%</td>
</tr>
</tbody>
</table>
Outlook

Meet changing customers’ needs? Growing the bottom line?

The likelihood is that pipeline growth in the domestic market will remain challenging for many. Add to this the theme of customers ‘wanting more for less’ and sustained increases in employment costs, it is easy to see reasons to be pessimistic. That said, as the sector continues to clean up balance sheets and extracts itself from onerous contracts, legacy issues will continue to unwind. During our interviews it was clear that there is now a far more robust approach to the allocation of risk, pricing, and contracting, which should lead to better outcomes for all parties.

Margin pressure will continue to drive innovation in the delivery of services. The pace of change and the role of Artificial Intelligence, Internet of Things, automation and machine learning – the third industrial revolution – will inevitably take some by surprise. We expect many more organisations to start transforming their finance and HR functions, a first step response to advances in technology and the internal demand for more for less.

M&A activity is likely to remain robust as the weaker pound, portfolio re-alignment and search for pipeline growth in international markets are highlighted as catalysts for action.
EY can help you

- Improve performance through technology-centric strategy
- Ensure value creating investments in new markets, services and businesses
- Gain a competitive people advantage
- Tackle market disruption and digital innovation
- Deliver bookkeeping, accounting, and tax services with EY Absolute

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