Facilities management

Time for a shift change
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Part 1
The profitability challenge

The facilities management sector has experienced low margins for some time, with no sign of improving.
Margins are not improving

Margins in the UK facilities management (FM) sector are low, with very few companies showing an improvement. A review of the available accounts for 22 facilities management firms with operations in the UK, revealed that the average EBITDA margin has remained stagnant around 7% during the last three years. In comparison, revenue grew at an average of 14% from last year, which implies that facilities management providers have not been able to take advantage of scale whilst growing.

**Figure 1: Margins for 22 UK FM companies**

Source: Capital IQ, Annual Reports

Revenue has grown substantially from last year, whilst margins have remained stagnant or fallen

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Facilities management  Time for a shift change
Competition and cost inflation are squeezing margins

The struggle to improve margins is largely due to input cost inflation as well as customers’ price squeeze (in response to their own cost pressures). It is also partially a result of the fragmented and competitive landscape in the sector, with a high number of SMEs entering the sector, which creates even further pricing pressure.

The cost base of FM companies has recently been impacted by a number of regulatory changes such as the National Living Wage, Apprenticeship Levy and pensions. The introduction of the National Living Wage in April 2016 resulted in a cost increase for FM companies since labour is a significant proportion of their overall cost structure. A study from the Office of National Statistics shows that Cleaning and Hospitality were two service sectors most impacted by the National Living Wage prior to its introduction (see figure 2 below).

**Figure 2: % of workforce impacted by National Living Wage**

<table>
<thead>
<tr>
<th>Sector</th>
<th>% of workforce</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cleaning</td>
<td>41.9</td>
</tr>
<tr>
<td>Hospitality</td>
<td>33.2</td>
</tr>
<tr>
<td>Hairdressing</td>
<td>27.2</td>
</tr>
<tr>
<td>Childcare</td>
<td>21.2</td>
</tr>
<tr>
<td>Textiles and clothing</td>
<td>20.3</td>
</tr>
<tr>
<td>Employment agencies</td>
<td>19.1</td>
</tr>
<tr>
<td>Social care</td>
<td>17.4</td>
</tr>
<tr>
<td>Retail</td>
<td>16.6</td>
</tr>
<tr>
<td>Leisure, Travel and sport</td>
<td>15.4</td>
</tr>
<tr>
<td>Food processing</td>
<td>14.2</td>
</tr>
<tr>
<td>Agriculture</td>
<td>11.3</td>
</tr>
</tbody>
</table>

Source: Annual Survey of Hours and Earnings, ONS

The biggest threat to our business has been consistent wage inflation.

**CEO of an engineering services company**

- National living wage (2016)
- Large portion of new SME competitors
- Customer cost pressures
Part 2
The profitable strategy

Carefully selecting the strategy for your firm can improve profitability
Mapping corporate strategies

FM companies face a strategic choice in terms of focus in two ways:

1. Customer’s sector: focus on one specific sector (e.g., government or automotive) or have complete sector coverage
2. Service offering: specific service offering (e.g., security or cleaning) or broad service offering providing total facilities management (TFM)

The diagram below shows how FM companies can be mapped based on their corporate strategy. Niche players will service a specific sector and typically provide a narrow range of services. Diversified niche players will, on the other hand, provide a narrow range of services across multiple customer sectors. Specialist Total Facilities Management players provide a broad range of services to a specific sector while Diversified Total Facilities Management players will do the same across customer sectors.

- **Service Specialist**
  - Specialist service provider to a number of sectors
  - **Example:** A specialist security product and services provider to a number of sectors

- **Diversified Total Facilities Management**
  - Provide range of services to a number of sectors
  - Managed solutions linked to outcomes and transfer of risk
  - **Example:** Complete suite of facilities management offerings ranging from Mechanical and Electrical ('hard' FM) to cleaning and catering ('soft' FM), across sectors

- **Niche Player**
  - Provide narrow service to a specific sector
  - **Example:** Household repair and heating installation services to the household customers

- **Sector Specialist Facilities Management**
  - Provide range of services to a specific sector e.g., public sector
  - **Example:** A full range of FM services for the public sector

- **Complete sector coverage**

- **Specific service offering**

- **Broad service offering**

- **Sector specific focus**
Corporate strategy impacts profitability

Being niche vs. broad based has its own set of advantages and disadvantages. Being sector or service focused enables a company to become a specialist in a narrow area, something that is particularly relevant when the service being provided has regulatory ramifications. On the other hand, providing end-to-end facilities management services rather than point solutions enables a company to develop more strategic relationships with its customers. Our review of EBITDA margins indicated that Diversified Total Facilities Management have the highest EBITDA margins of the 22 companies that were reviewed.

- **Service Specialist**
  - Ave. Margin: 6.6%
  - Pros: Easier to build scale to improve margin
  - Cons: As point solutions provider, pricing can be challenging

- **Diversified Total Facilities Management**
  - Ave. Margin: 7.1%
  - Pros: More strategic and value-additive to customers, consequently better price point; Easier to build scale to improve margin
  - Cons: Challenge of focus

- **Niche Player**
  - Ave. Margin: Varies widely
  - Pros: As a specialist service provider, can obtain better price point
  - Cons: Higher risk as high dependency on specific sector and service

- **Sector Specialist Facilities Management**
  - Ave. Margin: 4.2%
  - Pros: More strategic and value-additive to customers
  - Cons: Can suffer lower margins linked to customer’s sector price sensitivity

Facilities management has traditionally been seen as a non-strategic service by customers, but Diversified Total Facilities Management (TFM) providers are trying to change that with bundled services and outcome based contracts that transfer risk to the vendor. Customers value such contracts more and consequently these contracts often have higher margins, which partially explains the higher EBITDA margins for these firms.

Niche players also benefit from higher margins mainly due to their unique service offering which TFM providers do not want to or lack the technical capability to support. However this can be a more risky strategy as these players are heavily dependent on the overall success of their focus sector and service. There will also be a cap on the scale they can reach, and they run the risk of being outmuscled or acquired by a TFM provider.
Part 3
Pressure surge

Recent events will exert additional pressure on the EBITDA margins of FM firms
Geo-political events will put further pressure on profitability

Recent geo-political events have also had, and will continue to have, an impact on both revenue and costs in the FM sector. The vote to leave Brexit had an immediate impact on all UK companies with the fall of Sterling against the Euro and US Dollar (see figure 3 below). The FM sector is not as heavily dependent on material imports, compared to the construction sector, for example. However, the falling value of Sterling will possibly make the UK market less attractive for the labour force from the EEA.

The FM sector employs a number of workers from the European Union (EU) and changes to immigration policies resulting from Brexit could impact labour availability from EU countries. A survey by the Social Market Foundation suggests that as much as 14% of labour in accommodation and food services and 9% in Admin and support services were born in the EEA (see figure 4 below). Depending on the terms of the UK’s withdrawal from the EU, FM firms could face increased costs to hire labour.

![Figure 3: GBP index (2005 =100)](image)

Source: Bank of England

![Figure 4: % of EEA employees by sector](image)

Source: Social Market Foundation (SMF)
Due to Brexit, we expect the number of lower-educated immigrant workers to decrease, with the risk of scarcity in the labour market.

Cleaning services FM firm, Annual Report 2016

The UK economy has remained stable and buoyant for the last few years, however the full impact from Brexit and other geo-political events is starting to become more apparent, with a cooldown expected in 2018-19 (see figure 5 below). FM has been known to rise and fall with macro-economic growth and contraction, often being viewed as a ‘non-strategic’ cost element of a business and scaled back in a downturn. Therefore it is expected that FM firms will feel the impact on revenues especially in the next two years.

As the pressure increases both on cost and revenue fronts, FM firms should review their corporate strategy in order to ensure they are prepared to deal with this politico-economic uncertainty.

Figure 5: Annual growth in the UK economy

![Chart showing annual growth in the UK economy from 2012 to 2020.]

Source: EY ITEM Club

Future pressure

- UK economy slowdown in 2018-19
- Changes to immigration laws impacting labour availability
- Continued increases to National Living Wage
- Technological advancements

General election, changes in government policy, China, the oil price and the Brexit referendum have had a negative impact on sentiment and reduced the levels of discretionary spend from our clients, as well as cause some project works to be delayed, deferred or cancelled.

Large UK based FM firm, Annual Report 2016

Facilities management Time for a shift change
Part 4
How to protect and improve margins

Expanding sector coverage and service offering through acquisitions, including for digital capabilities, will drive the capital agenda.
Adapting your strategy for the future

The first area we would expect FM firms to review in order to improve (or even maintain) margins is their corporate strategy. Although there is no one right answer, we expect more FM firms to move towards being Diversified Total Facilities Management providers – the top right in our quadrant. This will allow firms to build scale through diversification, as well as mitigate risk from over exposure to a certain sector or service line. As a TFM provider, firms will be able to offer managed services and outcome based contracts, thereby moving higher up on their clients’ overall strategic agenda.

Not surprisingly, many recent M&A transactions have been by players adjacent to the mainstream facilities management sector in order to build bundled capabilities, leading to what we call ‘sector blurring’. Consider as an example, construction companies foraying into building management services.

“We have focused on demonstrating the increased value for our clients and increasingly they are willing to reward us for it.

CEO of a major UK soft FM services provider

"
What will be the capital agenda in the FM sector?

There are four areas to consider in reviewing and planning the capital agenda for your firm:

1. **Raising capital**: how to win the competition for scarce capital?
2. **Investing capital**: how to seize growth opportunities that others may be unable to?
3. **Preserving capital**: how to better anticipate and adapt to market conditions as they change?
4. **Optimising capital**: how to increase and maintain investor confidence?

The quadrant FM firms operate in or aspire to move to will determine their capital agenda. As more companies move to the Diversified Total Facilities management quadrant, we expect consolidation in the FM sector in order to acquire capabilities and scale. Simultaneously, portfolio reviews will drive decisions to divest non-core assets.

73% of executives say they have increased the frequency of their portfolio review to capitalise on disruptive forces in their sector.

EY Survey, Global Capital Confidence Barometer, April 2017
Become the trailblazer

The second area that FM firms will need to consider in order to tackle margin pressure is innovation. This sector is heavily labour dependent, an input that is becoming increasingly expensive and scarce. Any innovations that reduce reliance on labour and improve labour productivity have a direct impact to EBITDA margins. Digital innovations like The Internet of Things (connected devices that collect and transmit a vast range of valuable data), as in many other sectors, have substantial potential for disrupting the facilities management sector. As an example, smart energy meters have greatly reduced the need for site visits by meter readers. It is not far fetched to imagine drones being used for remote security monitoring and autonomous vehicles sweeping streets in the near future.

Big Data can also provide FM providers with a competitive edge. A great example is predictive analytic insights generated from energy data for a building, that allows building management companies to substantially reduce energy consumption. Those FM providers that can harness big data, particularly for outcome based customer contracts, will gain an edge in the sector. Our partnership with GE Digital’s Predix application allows collecting and analysing granular energy data to develop insights that can reduce energy consumption.

Investments in digital in this sector have so far been an afterthought. We expect this to change and FM companies to make internal investments and acquisitions to acquire mature digital capabilities of other players in the sector. There have been recent examples of acquisition of companies with digital energy management expertise by FM providers. FM companies, like their peers in other sectors, will need to evaluate how to access and foster innovation in the shortest possible time frame – organically or inorganically.

FM firms need to review their long-term strategy and innovation agenda now, in order to ensure they are at the forefront of an ever increasingly competitive sector. If firms remain stagnant, they run the risk of being disrupted and pushed out of the market.

#1 item on the boardroom agenda: Impact of digital technology on business model.
EY Survey, Global Capital Confidence Barometer, April 2017
Contacts

Russell Gardner
UK&I Head of Real Estate, Hospitality & Construction
E: rgardner1@uk.ey.com
T: +44 20 7951 5947

Adrian Browne
Partner & UK&I Markets Leader, Transaction Advisory Services
E: abrowne1@uk.ey.com
T: +44 20 7951 0465

Mathieu Roland-Billecart
Partner, UK&I Head of Real Estate, Hospitality & Construction Transactions Advisory Services
E: mrolandbillecart@uk.ey.com
T: +44 20 7951 5206

Ian Marson
Director, UK&I Transaction Advisory Services
E: imarson@uk.ey.com
T: +44 20 7951 3596

Tim Wainwright
Director, UK&I Transaction Advisory Services
E: twainwright@uk.ey.com
T: +44 20 7951 6880

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