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Life in the Old Dog Yet

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Capita might not be a household name, but most of you will likely have used their services, whether it be to pay your TV license or when entering a car park with automatic registration plate recognition.

The company was founded in 1984 to take advantage of increased outsourcing opportunities created by Margaret Thatcher's Conservative Government. Capita floated in 1989 and flourished to become one of the Government's largest contractors, as successive Governments embraced the larger role private companies could play in the provision of public services. Interestingly, Labour Governments have actually been the largest source of outsourcing work, as opposed to Conservative Governments.

Contract wins came in thick and fast across industries including defence, education, health, and transport. Recruitment contracts for the British Army and customer service contracts from private companies, such as Carphone Warehouse, fuelled growth at seemingly impressive margins. As Capita expanded, overzealous management went on a merger and acquisitions (M&A) spree to accelerate growth even further.

Everything seemed rosy and Capita's share price rocketed. The shares were a darling of the market; £100 invested at IPO (initial public offering) in 1989 was worth £36,900 at their peak on 20 July 2015[1]. Revenues reached a heady £4.7bn and Capita's market capitalisation climbed to £8.8bn[2]. But they do say that the bigger they are, the harder they fall.

Fast forward seven years to 20 July 2022 and Capita's market capitalisation was just a mere £493m[3], despite having tapped shareholders for £700m in the interim, in order to repair its stretched balance sheet. That equated to a total shareholder return of minus 96% over those seven years[4].

Capita was generating a lower but still healthy amount of revenue (£3.2bn in 2021), had a new management team, and a clear plan to further strengthen its balance sheet, stabilise revenues, improve margins, and generate cash flow. Needless to say, that perked our interest.

Our analysis was relatively simple but suggested significant upside to the share price. Importantly, we thought there was a high probability that Jonathan Lewis (the new CEO) could successfully execute on the Board's turnaround plan. We believed there was life in the old dog yet.

On 20 July 2022, the last reported net debt figure (ex-leases) was £431m, but the company had declared disposal proceeds of £203m since then, and an undisclosed sum for the sale of a specialty insurance business (we assumed £18m which was six times profit before tax). This alone meant that net debt (ex-leases) actually now stood somewhere in the region of £210m and the company still had businesses earmarked for sale that were generating revenues of £338m.

If Capita could achieve a price to sales multiple of 0.7x then this would generate £237m of further disposal proceeds and leave the company with no net debt (ex-leases) if it chose not to accelerate scheduled deficit pension payments that totalled £105m. If the company chose to accelerate those pension deficit payments, then net debt (ex-leases) would still only be £78m. Last reported leases stood at £448m and assumed to be just £387m after planned business disposals.

Prior to Capita's share price collapse in 2015, the business generated operating margins of 13.7%. These proved to be unsustainable, but in our analysis we assumed operating margins of just 6% were achievable. On a revenue base of £2.6bn (after business disposals) this meant Capita should have been capable of producing operating profits of £156m.

Placing an undemanding 12x multiple on those profits yielded an enterprise value (equity plus net debt and leases) of £1.9bn. Subtracting the negligible £78m of net debt (ex-lease) and £387m of leases left the equity theoretically worth £1.4bn in the future. This represented upside of 209% on the current market capitalisation of £493m.

Since our investment, Capita have completed several disposals, some at very attractive multiples. Revenue has started to grow and was £2.85bn in 2022 (£2.6bn post disposals), whilst management for the first time reported that in the medium term (three years) the company should be able to achieve at least double the operating margins it did in 2022. Capita generated operating margins of 3.0% in 2022 and so our assumption of 6.0% in the future will likely prove conservative.

There have been no material positive earnings surprises since 20 July 2022 (we first invested on 22 July 2022), yet the shares have rallied 41%[5], already making good progress towards the 185% upside we believe there ultimately is. All that has actually happened since 20 July 2022 is that the company has started to deliver on the strategy it had previously laid out.

We undertake rigorous fundamental analysis on all of our new investments and often find the best opportunities present themselves when others are fearful and sentiment has forced share prices adrift from their fundamentals. This was evidently the case with Capita. There's life in the old dog yet.

Sources:
1 Bloomberg Finance L.P. 30/05/89-20/07/2022
2 Bloomberg Finance L.P. 20/07/2015
3 Bloomberg Finance L.P. 20/07/2022,
4 Bloomberg Finance L.P. 20/07/2015-20/07/2022
5 Bloomberg Finance L.P. 20/07/22-08/03/23

All Capita figures from Capita PLC Financial Statements and RNS releases https://www.capita.com/investors
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