Essential Business Services: A Private Equity Strategy Positioned for Downside Protection and Growth

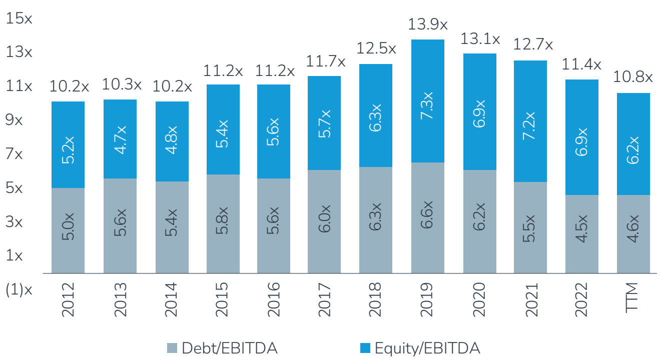
February 2024

Overview

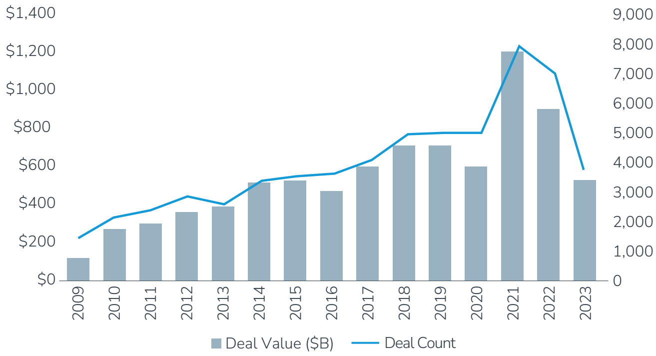
In the ever-evolving landscape of global private equity, the current environment reflects a complex interplay of economic, geopolitical, and financial dynamics. Higher interest rates, less accommodating capital markets, and the search for an economic "soft landing" have cast a shadow across the private equity market, and deal activity has slowed, and valuations have contracted as a result. Against this backdrop, investors have placed heightened emphasis on due diligence and research.

Similarly, in the current environment of higher interest rates and more expensive capital, companies are once more focusing on rationalizing their cost base and exploring ways to concentrate on their core businesses. In this environment, outsourcing non-core but critical functions is growing in popularity, and this in turn offers attractive opportunities for private equity firms powered by operational expertise, rather than financial engineering. In this note we examine the key business drivers in the emerging economic landscape and share our thoughts on the opportunities that arise.

North America & Europe Middle Market Buyout EV/EBITDA Multiples
As of Q3 2023



US Buyout Deal Activity
YTD through Q3 2023



Source: Pitchbook

Key Business Drivers

The global rise in interest rates, driven by the US Federal Reserve, has led to a higher cost of capital for companies, whether privately owned or listed, and across geographies. In response, there is now a widespread focus by companies on their core businesses, prioritizing investment in these areas while simultaneously looking to outsource (or in mature markets, such as the US, further outsource) non-core activities to reduce their cost base and wring out incremental operating margin.

This cyclical dynamic is reinforced by additional, structural changes. Regulation is on the rise worldwide, and its increasing scope and complexity means that functions as diverse as compliance, verification, and fire safety are often now seen as better outsourced to specialists who are equipped to adapt to and comply with the latest regulatory requirements. Equally, in many markets such as the GCC, maturing industries are undergoing a generational shift, with second and third generations of business owners that are focused on increasing margins and maximizing operating efficiencies, thus opening the door to comprehensive discussions on outsourcing non-core services. Finally, the global restructuring of supply chains is also often being applied to service providers to ensure that mission-critical functions are outsourced to service providers that are more resilient to external events. All of these impulses have combined to form an environment that supports sustainable growth in essential services outsourcing.

The Relevance of the Essential Services Opportunity to the GCC

The case for essential business services is no longer limited to the US, with a rising cohort of firms in the Middle East that present a similar value proposition.

The economies of the Gulf Cooperation Council (GCC) are rapidly diversifying and dynamic relative to the rest of the world. Forecasts point to the region's GDP growth significantly outpacing the global rate, due in no small part to a resurgence in non-oil aspects of the economy, including renewables, sustainable finance and tourism. This is a direct result of national development strategies that are prioritising the diversification of regional economies beyond hydrocarbons, and which growth metrics show are already having a substantial impact.

The best essential business services firms provide technology and support for the operations of these fast-expanding industries. Many are also undergoing a generational shift where successful young entrepreneurs are seeking to expand and internationalise, creating more room for investors in the process. This second and third generation of business owners is more open minded and less emotionally attached to their businesses, which opens the door to more comprehensive discussions on selling non-core assets, or outsourcing non-core services for the business in general. Discussions on valuations are also becoming more realistic.

These firms benefit from similar regulatory tailwinds as their US peers, and are often a dominant presence in mandatory, tech-enabled services that are set to see a surge in demand in line with government policy, such as identity verification for foreign healthcare workers.

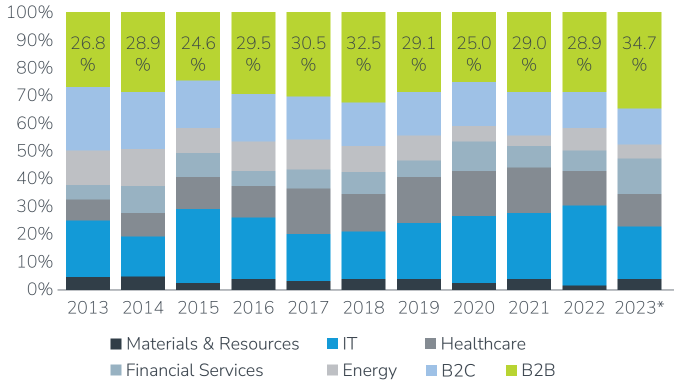
Investors may wonder why end-customers don't simply develop their own back-office solutions, eliminating the need to outsource them altogether. But just as in the US and globally, most large organisations decide based on analysis that the resources required to build the necessary know-how, infrastructure and teams would far exceed the benefits. They typically prefer to concentrate on their core business, and leave these services to dedicated experts who can provide them in the most efficient and effective way, at a relatively low cost.

Essential services sectors in the GCC are typically highly fragmented with a number of specialist businesses serving a limited geographic area, making the strongest natural candidates for regional expansion. Yet the unique conditions in markets like Saudi Arabia mean this expansion needs to be accompanied by strategic advice and guidance. Some recent transactions provide instructive examples of how well-positioned GCC enterprises can be developed into regional and even global powerhouses of a level that attracts international investment and buyers.

We see many such opportunities to come, with a substantial pipeline of potential essential business services targets already under consideration. Their appeal lies in the downside protection that they offer. Because they're asset-light, they can control variable costs, increasing OpEx as the business scales, and quickly reducing expenses to cater to environmental changes, maintain margins and stay recession-resistant. We're excited about the opportunity to transform these regional players into the kinds of companies whose success and strong business models attract the interest of international capital.

Essential Business Services

Share of US PE Deal Value by Sector
YTD through Q3 2023

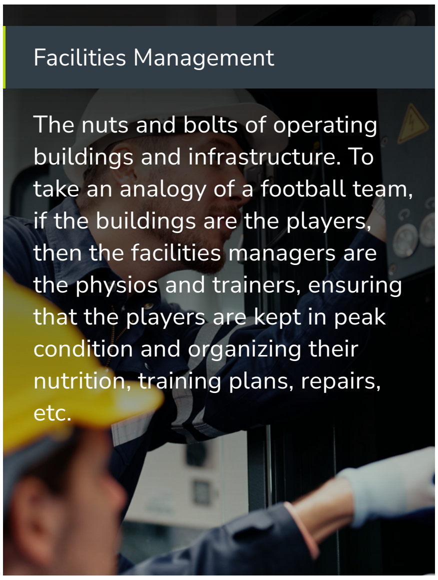


Source: Pitchbook

In particular, we foresee a highly favourable dynamic for what we term 'essential business services'. These do not form a specific segment of the economy as such, but rather a range of businesses that share key characteristics, and which can be considered the indispensable plumbing of an economy. In our view, their key characteristics are as follows:

- Their clients are businesses, not consumers;
- They outsource critical functions from businesses;
- The functions may range from basic to high value add, but are non-discretionary – they need to be performed come what may;
- Revenue is typically based on contracts, not transactions;
- The businesses are cash generative;
- They are often asset light services;
- The sectors are often fragmented, but bigger clients seek bigger providers.

Examples of essential business services include:

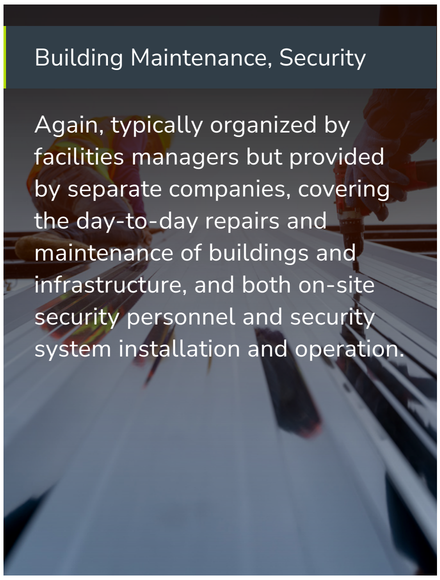


Facilities Management

The nuts and bolts of operating buildings and infrastructure. To take an analogy of a football team, if the buildings are the players, then the facilities managers are the physios and trainers, ensuring that the players are kept in peak condition and organizing their nutrition, training plans, repairs, etc.

Building Engineering Services

The maintenance, repair, and upgrades of the Mechanical and Electrical (M&E) services vital to the functioning of buildings and infrastructure: HVAC systems, lift and escalators, building management systems (BMS), electrical distribution networks etc. Typically organized by facilities managers but provided by separate companies.



Building Maintenance, Security

Again, typically organized by facilities managers but provided by separate companies, covering the day-to-day repairs and maintenance of buildings and infrastructure, and both on-site security personnel and security system installation and operation.

Fire Safety

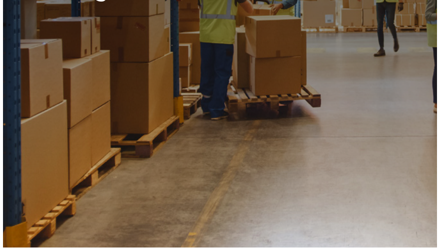
Specialist provision of fire safety systems, testing and advice. With tightening regulation and increased insurance scrutiny in many countries, fire safety is seen as a critical issue for building and infrastructure owners, occupiers and financiers.

Waste Treatment and Disposal

Covers everything from typical landfill-bound waste disposal to highly regulated, highly specialized hazardous waste handling, recycling, and treatment of wastewater created by manufacturing processes.

Transportation and Logistics

This addresses third party logistics and fulfillment as well as the asset-light supporting technology, including warehouse inventory management, route planning, and truckload demand management.

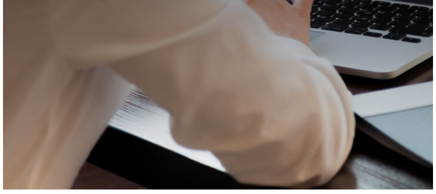


IT Services

Third party companies provide turn-key IT management services, including hardware selection, procurement, and maintenance as well as continuous, around-the-clock IT support for issue resolution and break-fix.

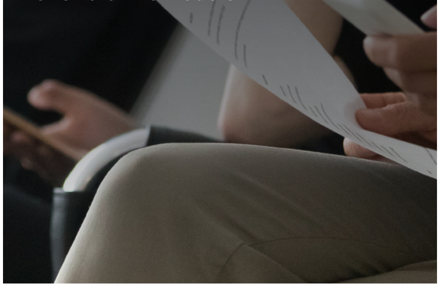
Verification and Compliance

Companies in this sector ensure compliance across multiple regulatory jurisdictions and frameworks, including verification of credentials and certifications for highly specialized, skilled labour, such as medical professionals, engineers, and architects.



Staffing

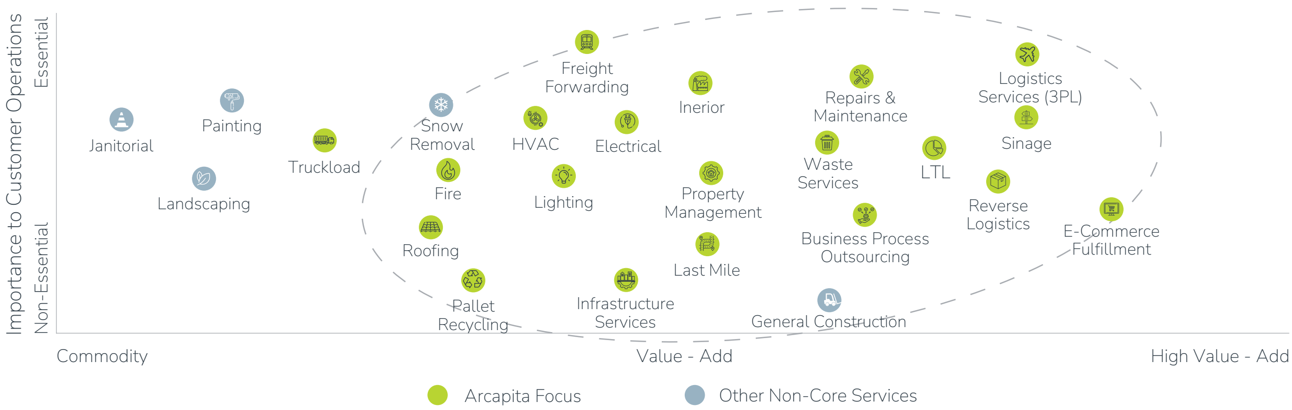
Staffing companies provide staff augmentation solutions to their customers, either on a perpetual basis due to difficulties finding qualified labour or on an ad-hoc, event-driven basis.



> “All of these industries are going to perform well, because they’re non-cyclical and non-discretionary. And where you’re going to see the best performance are the largest, most sophisticated providers that can grow faster than the industry, because they’re taking share from the less sophisticated ‘mom and pop’ type operations.”

Taylor Morris,
Managing Director, Business Services
Harris Williams

Essential Services Examples



Arcapita's Focus

Within the essential business services universe, we have developed a clear focus on key characteristics in our investments:

1 Downside Protection

We target non-cyclical businesses with contractually recurring revenue, delivering critical functions that need to be provided come what may: "selling shovels in a gold rush".

2 Asset-Light, Cash Generative

We favour returns that are generated by, and can be enhanced through, cashflow conversion and where inflation can be mitigated through increased costs being passed onto customers.

3 More Value Add, Less Commoditized

We focus on more valuable or more specialist services where increased capabilities can be rewarded through better pricing power, rather than commoditized services that see competition based on the lowest cost to delivery.

4 Customer Diversification

We place higher value on businesses with high degrees of revenue diversification and avoid opportunities that have concentrated exposure to a single customer, sector, or geography.

5 Fit For Growth

We prioritize investing alongside high-quality management teams to help them grow and develop their business by improving efficiencies, achieving scale over cost bases, and increasing customer and geographic reach.

6 Invest In Platforms

We favour companies where there are opportunities to invest in technology, to improve customer experience and efficient operations, and where we can leverage underutilized data to enhance the company's understanding of their customers and how they can further serve them.

In addition to these focus points from a top-down thematic perspective, we believe that returns are also driven by bottom-up investment selection and operational improvements, not financial engineering. For this reason, we emphasize careful underwriting and forming robust, conservative business plans, to ensure that we are confident each investment meets our criteria and that there is a clear, actionable roadmap to operational gains that can deliver investor results.

Case Study:
Waste Harmonics

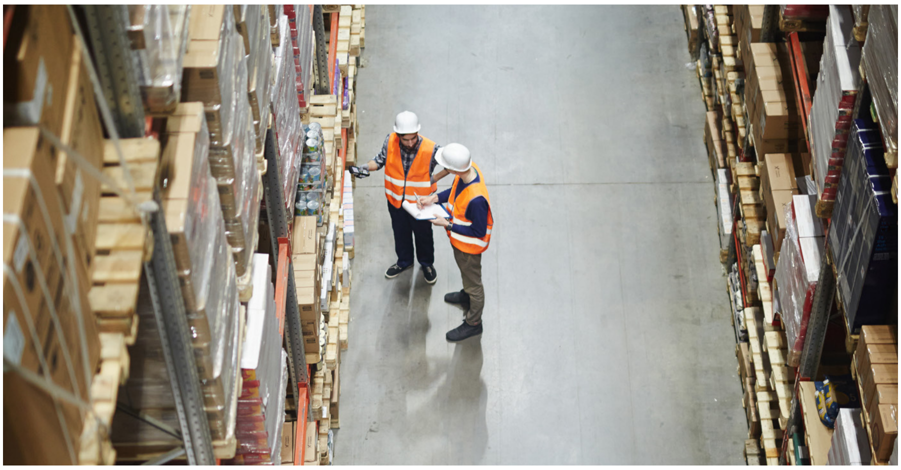
In December 2019, Arcapita acquired Waste Harmonics, a leading provider of managed waste services in the US. This acquisition represented a clear expression of our focus on essential business services, with the transaction fitting our key characteristics:

1. **Downside protection:** commercial waste management and disposal is a mission-critical function for businesses, and backed by recurring contracts
2. **Asset-light, cash generative:** by not owning the truck fleet or waste recycling or disposal plants, the company benefited from an asset-light model and strong cash conversion
3. **More value-add, less commoditized:** the company offered tailored, fully integrated packages to corporates, as opposed to a simple waste collection service
4. **Customer diversification:** the firm already had a diversified customer base by company type and geography
5. **Fit for growth:** we worked with company management on organic growth, securing additional client locations, and on inorganic growth, executing four strategic add-on investments

6. **Invest in platforms:** we worked with company management on developing a cutting edge technology platform, to offer clients proprietary waste monitoring solutions and in turn higher service levels and cost efficiencies

Through management initiatives in these key focus areas under Arcapita's ownership, Waste Harmonics' annual revenue almost quadrupled to $400 million. In 2023, Arcapita exited its investment through a sale of Waste Harmonics to Keter Environmental Services, which is backed by TPG, a leading global alternative asset management firm.

Arcapita's Approach



In summary, a higher cost of capital and structural changes in regulation, supply chains and generational shifts have created an environment that drives outsourcing of essential business services. These services form the, perhaps unglamorous, indispensable plumbing of the economy and cover business-critical areas ranging from building maintenance and waste disposal through to compliance. The combination of the defensive positioning of these services, sustainable returns driven by contractual cashflow and lower entry multiples at present, reinforce our view of essential business services as an attractive asset class for private equity investors.

Amid the dynamic economic landscape, our strategic focus remains on essential business services sectors that align with the key investment characteristics we seek (contractually recurring revenue, asset-light, value-add services and diverse customer bases), where we can work with management to grow the company and invest in the platform. Notably, we identify attractive sub-sectors that fit these criteria across both the US and the GCC, and a consistent pipeline of opportunities that underlines our confidence in this investment focus.

With entry multiples for these companies at a cyclical low, we believe the current environment offers an opportunity to build an attractive portfolio of such investments, that will benefit from a highly favourable combination of strong, contractual income, and business growth through active management and operational improvements. We have conviction that this strategy presents the most compelling private equity investment opportunity in the US and GCC over the coming years.

Case Study: DataFlow

DATAFLOW

In 2023, Arcapita acquired Dataflow, the leading provider of primary source verification (PSV) services in the GCC. Dataflow provides verification services for the degrees and accreditations of skilled workers (e.g. doctors, nurses, and engineers) prior to employment.

Dataflow fits well into Arcapita's essential business services approach, driven by the "mission-critical" nature of the service it offers, and with the need for PSV services increasing through structural trends including a shortage of high skilled professionals, macro digitization trends, mobility of labor, and the rise of fraud. PSV is also a good example of a non-discretionary service driven by regulation and required across economic cycles, as regulators in the GCC and internationally typically require degrees, employment history, and/or professional qualifications of employees in certain high-skilled professions to be verified prior to employment due to the high cost of failure, potential malpractice liability and litigation, and reputational damage that could arise from hiring workers with fraudulent qualifications in such professions.

Dataflow aligns well with the key characteristics that Arcapita seeks in our essential business services investment strategy:

1. **Downside protection:** regulation-driven, mission-critical function for businesses and government departments, backed by recurring contracts
2. **Asset-light, cash generative:** principal assets are centred on proprietary software, with EBITDA to free-cash-flow conversion of 80%+
3. **More value-add, less commoditized:** the company offered tailored, fully integrated packages to customers
4. **Customer diversification:** the firm already has a diversified customer based, including several GCC regulatory authorities
5. **Fit for growth:** substantial opportunity for organic and inorganic growth in the global PSV market, across both customer sectors and geographies
6. **Invest in platforms:** opportunities to build on the company's existing proprietary systems and solutions to enhance customer outcomes and insights

Contributors

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Neil is a Managing Director and the Head of the US Private Equity Investment team at Arcapita. Neil has over 18 years of private equity experience, including ten years at Fortress Investment Group where he was an investment professional in the Credit Funds. In this role, Neil oversaw origination, underwriting, negotiation, and management of middle market private equity and private credit transactions across multiple industries. Prior to Fortress, Neil worked at Goldman Sachs focused on M&A in the Consumer and Retail industries. Neil holds an MBA and Bachelor of Science in Commerce from the University of Virginia, USA.

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Yousif is a Managing Director and the Head of MENA Investment at Arcapita. He is responsible for the origination, structuring and management of private equity Investments in the region. Previously, he spent 18 years originating, structuring, analyzing, monitoring and closing transactions in the real estate, private equity and asset-backed security sectors at various financial institutions including Al Salam Bank – Bahrain, Capital Management House and Gulf Finance House. Yousif is a CFA charterholder and a Fulbright Grantee, obtaining his MBA from Fairleigh Dickinson University, USA and Bachelor's degree from the University of Ottawa, Canada.

Taylor Morris
Managing Director,
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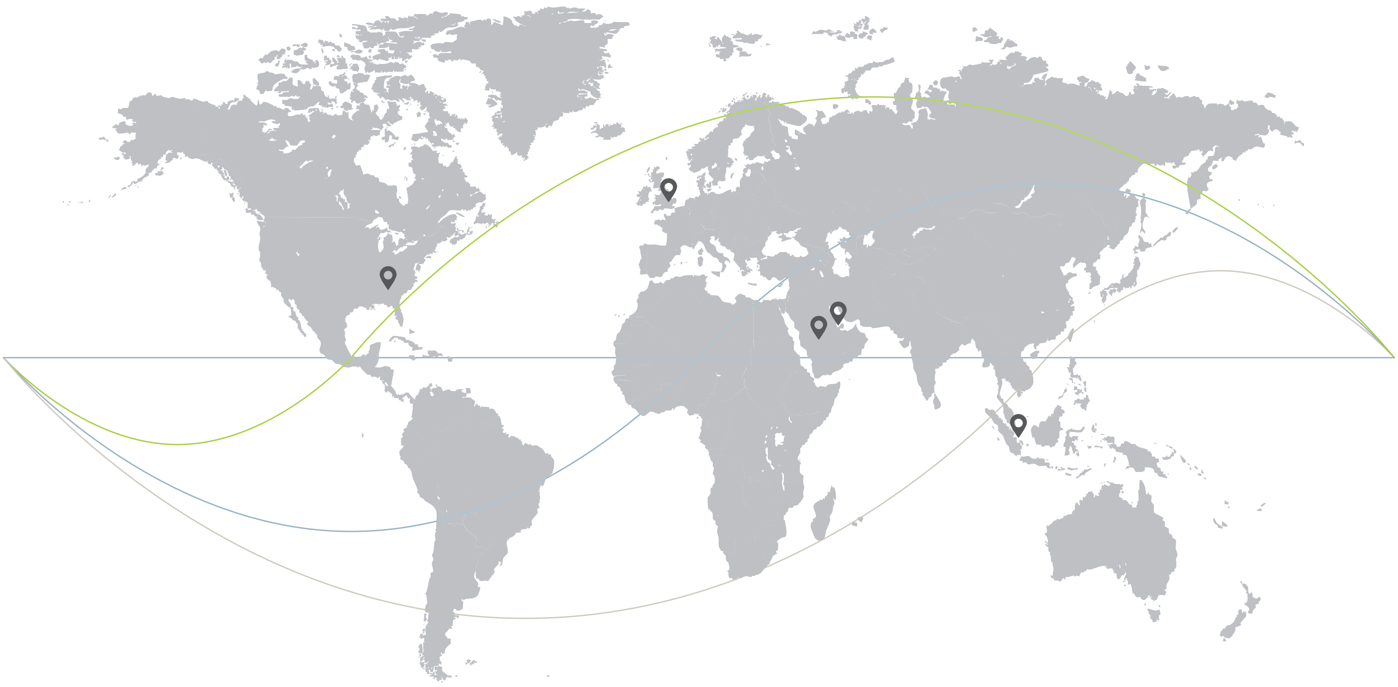
Taylor Morris is a managing director at Harris Williams in the firm's Business Services Group. He has experience advising clients across sectors with a particular emphasis on commercial and industrial services and environmental services. Taylor has over 10 years of experience advising clients on mergers and acquisitions and strategic advisory assignments, including divestitures, financings, and capital raising. He is based in our Richmond office. Taylor has an M.B.A. from the Darden School of Business Administration at the University of Virginia and B.S. in Commerce from the McIntire School of Commerce at the University of Virginia.

ARCAPITA

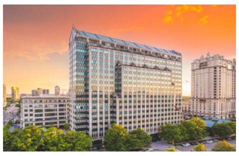
Overview

Arcapita is a premier asset manager offering diverse investment opportunities, focusing on private equity and real estate. At the center of one of the fastest growing wealth markets in the world, Arcapita's management has been serving an exclusive group of investors in the GCC region over the past two decades. With offices in Bahrain, US, UK, Saudi Arabia, and Singapore, Arcapita's management team has completed transactions worth a total value of approximately $30 billion and possesses a footprint to invest on a global scale. Arcapita focuses on defensive and counter-cyclical sectors supported by long-term macroeconomic and demographic trends.

With two decades of experience, Arcapita's management has built a global investment platform to access the opportunities that exist in our core markets of the US, Europe, Middle East and Asia.



United States



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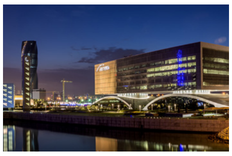

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