

Capita, Carillion & Contract Accounting

‘Could Capita be the new Carillion?’* (‘The Week’, 1 February 2018)**‘Capita: What does the company actually do? And is it another Carillion in the making?’
(‘Independent’, 31 January 2018)**

On 31 January Capita fell 47%, following a profit warning and rights issue announcement, with a minus 2.3% performance impact on the VT Cape Wrath Focus Fund. People who trust us with their money are poorer as a result. As the Advisor to the Fund, and the largest investor, I will work to ensure that what I have learnt from this loss will improve future performance.

A well-known UK equity manager recently wrote of his Capita investment:

‘By the way, they are both outsourcers but the only other similarity between Capita and Carillion is the first two letters of the name.’

Capita’s new boss agrees. When the comparison between Capita and other troubled UK outsourcers was made on the conference call following the rights issue announcement, Jon Lewis was unequivocal. ‘We shouldn’t be compared to them, we are not a blue-collar outsourcing business.’

So, is Capita another Carillion?

How Capita and Carillion are similar

Companies involved in long-term contracts, like outsourcers, have a degree of subjectivity around how they recognise revenues and profits. Capita and Carillion typically recognise contract revenues under the percentage of completion method, with revenues matching costs. This method requires the company to have a reliable estimate of the lifetime revenues and costs (and therefore profits) of the contract, and to recognise revenues and profits over time in proportion to the costs as those costs are incurred. A simplified five-year contract, with an initial ‘transformation’ phase (more on this later), might look as follows.

	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Revenue	£500	£250	£150	£50	£50	£1,000
Costs	(£400)	(£200)	(£120)	(£40)	(£40)	(£800)
Profit	£100	£50	£30	£10	£10	£200

The key risk with accounting under the percentage of completion method is making incorrect cost estimates.

If the company realises at the start of year four that costs for the remaining two years of the contract are going to be higher than expected, while lifetime contract revenues remain fixed, then any lifetime contract loss must be recognised in the current year, along with the write-off of historic profits. If the new lifetime cost estimate is £1,200, then the total loss is £200, and in year four the reversal of cumulative historic profits (from years one to three) of £180, plus the lifetime contract losses of £200 must be put through the income statement, resulting in a loss in year four of £380, versus the expectation of £10 profit. With the new cost estimates, the simplified example (without restatement of years one to three) might look like this:

	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Revenue	£500	£250	£150	£50	£50	£1,000
Costs	(£400)	(£200)	(£120)	(£430)	(£50)	(£1,200)
Profit	£100	£50	£30	(£380)	£0	(£200)

This example illustrates the accounting behind the £845m contract provision that Carillion announced at its half-year trading update in July 2017. Although the timing of cash usually differs from profits (more on this

* For non-UK readers of this Broadside, Carillion was a construction-focused outsourcing firm that had a market capitalisation of over £2bn in 2015 and went into liquidation in January 2018.

later), the new cost estimate ultimately has a cash impact. Hence the spiralling debt that finally wiped out Carillion's equity holders.

The root of Carillion's mistake was winning contracts based on unrealistic cost estimates. These cost estimates showed that the contracts would be profitable and allowed Carillion to account for the contracts on that basis for a period of time, while also triggering management bonus pay-outs (the wording around executive bonuses was changed in 2017, meaning that bonuses could not be clawed back in the event of corporate failure). However, the economic reality was that many of these contracts were loss making, and in a low-margin business (in 2016 Carillion's underlying operating margin, pre-restatement, were 3.8%), even small cost overruns can have existential consequences.

While Capita has also suffered contract write-downs, these have not been at the scale of Carillion's, and the company also differs in having double-digit operating margins, making it more resilient in the event of cost overruns. The nature of contract accounting makes some write-downs a fact of life, and it is worth noting that the £39.6m of accrued income write-downs that Capita booked in 2016 were treated as underlying.

Why Capita is not Carillion

If revenue recognition points to some underlying similarities between Capita, Carillion, and outsourcers generally (see the accounting restatement from Mitie last year, issues at Interserve and the demise of Connaught in 2010), the accounting also highlights a critical difference.

The table below shows summary financial data from Carillion (note, the 2016 numbers are from before the restatement, numbers include minority interests where applicable, and 'BAIT FCF' is a free cash flow measure that includes certain adjustments that are common across our models at Cape Wrath Capital).

CLLN (£m)	Underlying Net Income	BAIT FCF	Cash as % Profit	Dividend	Dividends as % of FCF
2013	155.3	(87.4)	-56%	(75.7)	N/A
2014	151.9	110.5	73%	(76.7)	69%
2015	157.0	77.3	49%	(80.0)	103%
2016	157.0	61.6	39%	(82.7)	134%
TOTAL	621.2	162.0	26%	(315.1)	195%

The table highlights two issues. Firstly free cash flow averaged 26% of profits over the period. This weak conversion of profit to cash is one indicator of aggressive accounting. Secondly, dividends averaged 195% of free cash flow during this period. While profits are technically paid out of retained earnings (an accountant's measure of accumulated historic profits), ultimately they must be funded by cash. Any shortfall between free cash flow and the dividend payout is funded by borrowing. In effect Carillion's board was paying today's dividend based on the expectation of future cashflows, which in turn were based on unrealistic contract cost and profit estimates.

Looking at Capita on the same metrics highlights some important differences (note, all numbers shown here are before the implementation of IFRS 15).

CPI (£m)	Underlying Net Income	BAIT FCF	Cash as % Profit	Dividend	Dividends as % of FCF
2013	384.7	303.1	79%	(159.1)	52%
2014	436.6	342.8	79%	(180.5)	53%
2015	477.2	304.1	64%	(200.5)	66%
2016	387.4	409.2	106%	(219.0)	54%
TOTAL	1,685.9	1,359.2	81%	(759.1)	56%

Firstly, the dividend payout over the period is 56% of the free cash flow, suggesting that the company has been comfortably able to fund distributions to shareholders. Furthermore, cumulative free cash flow was 81% of profits. In our experience this is a healthy figure. As a single measure this would indicate robust accounting (however, looking across a number of measures paints a more nuanced picture as we will see later). On their own these numbers don't explain why Capita needs to raise fresh equity, but including acquisition expenditure gives a fuller picture.

CPI (£m)	BAIT FCF	Dividend	Net Acquisitions	Net Cashflow
2013	303.1	(159.1)	(300.9)	(156.9)
2014	342.8	(180.5)	(364.8)	(202.5)
2015	304.1	(200.5)	(438.9)	(335.3)
2016	409.2	(219.0)	(96.3)	93.9
TOTAL	1,359.2	(759.1)	(1,200.9)	(600.8)

Acquisitions have consumed considerably more cash than dividends, and these combined outflows exceed free cash flow by £601m. Put another way, if you include non-underlying items which are not included in the BAIT FCF calculation, from the start of 2013 (i.e. year-end 2012) to the end of 2016, Capita reported a £763m increase in net debt.

This analysis suggests that acquisition expenditure is the principal reason behind Capita's cash crunch, rather than the aggressive cost estimates and over-distributions that sank Carillion.

Adding IFRS 15 to the mix

On 7 September 2017, we attended Capita's IFRS 15 teach-in. The main impact of IFRS 15 is to move Capita (and other companies involved in long-term contracts) from the revenue and cost-matching percentage of completion method outlined earlier, to one that matches revenue with the delivery of an outcome. In the case of contracts with an initial transformation phase that are an important part of Capita's business (such as taking over a contact centre and reducing operating cost through technology), the outcome to the client (i.e. the operation of the contact centre) does not change over the contract life, although the initial technology and re-platforming expenditure means that Capita's costs are front-end loaded.

Taking the same cost profile that we used in the first example, and applying IFRS 15 yields the following profit profile.

	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Revenue	£200	£200	£200	£200	£200	£1,000
Costs	(£400)	(£200)	(£120)	(£40)	(£40)	(£800)
Profit	(£200)	£0	£80	£160	£160	£200

And the profit profile from the earlier example reproduced below for comparison.

	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Profit	£100	£50	£30	£10	£10	£200

Although there is no impact on the annual cashflow, or lifetime profitability of the contract, we can see that the profits are now significantly back-end loaded. With contract cashflows likely to mirror costs (i.e. to be phased in advance of IFRS 15 revenues), the difference between cashflow and revenue is recorded as deferred income (cash which has been received but not yet recorded as revenue).

Deferred income is recorded as a liability on the balance sheet (because it reflects cash that does not 'belong' to Capita until the associated revenue is booked). **With the IFRS restatement, Capita's deferred revenue in 2016 swings from £331m to £1.6bn.** This increase in liabilities, combined with some other moving parts, has the net effect of reducing Capita's retained earnings by around £1bn, and swinging equity from £483m to minus £553m. **In effect we have £1bn of profit that was recognised in the past which is being written off in order to be re-recognised in the future, and replaced in the meantime with a balance sheet liability that will amortise over the life of those contracts.**

The implications of IFRS 15 on the investment case for Capita are not clear cut. On the one hand we have a business which now appears to have generated much lower profits historically than previously was accounted for. On the other hand, under the new standards, Capita could be seen as having an additional £1bn of future profits 'locked-in'. In summary, our view of the investment case after attending the IFRS-15 teach-in was 'no change'.

So why did we invest in Capita?

The path to progress begins by remembering why we made the decision we did, given the information that we had available at the time. For this exercise we refer back to our Initiation Note, which helps to prevent hindsight bias. We bought our first tranche of Capita shares in June 2017 at 560p. **Our investment thesis was based on a number of factors including strong cash generation, the opportunity to drive margins by focusing on selling software 'platforms' (versus bespoke projects), a cyclical recovery in the business process outsourcing market, £84m of cumulative restructuring benefits by 2019 (following a £59.4m restructuring charge taken in 2016), and improved value creation through a greater focus on organic growth.**

Having completed our analysis, our process boils all of these factors down to two things: **what is Capita worth, and what margin of safety makes it an attractive investment?**

We talk in terms of 'Approximate Value' (AV), which reflects the fact that our 'target price' is simply the mid-point in a range of possible scenarios. Our AV for Capita was 726p, derived from a FCF yield valuation of 752p and normalised earnings of 700p. Our normalised earnings calculation assumed sufficient revenue growth over the next 4-years to 'fill-in' the disposal of the Asset Services business (which was underway at the time), combined with some EBIT margin recovery to normalised levels of 10%.

On this basis we saw 30% upside to Capita's share price at the time, with further upside if the business returned to high single-digit organic growth. **We also saw the business as relatively low risk, not least because although the balance sheet was starting to look a little stretched with net debt / EBITDA at 3.3x in 2016 based on BAIT adjusted numbers (or 2.9x on company reported numbers), with the Asset Services disposal due to raise around £700m (in the event the transaction raised £816m after costs), organic cashflow would quickly push debt down to a very modest level.** On this basis we were happy to buy Capita with a low Margin of Safety, implying entry points at 558p, 484p and 427p (we typically invest in three tranches based on valuation).

Poorer but wiser?

A few months after our initial investment Capita gave an IFRS 15 teach-in, followed a few weeks later by its interim results. Both of these should have raised more alarm bells than they did. Firstly, **the creation of £1.3bn of additional deferred income hinted at why Capita had enjoyed such strong cashflow.** A large portion of the cash that Capita had paid out as dividends or spent on acquisitions had not yet been earned, and might yet be required to cover costs associated with contract delivery. Secondly, **a large drop in the orderbook meant that there would be fewer contracts (with upfront cash payments) to plug the 'gap'.** Bearing these things in mind makes Capita look a bit more like Carillion; both were spending cash that did not 'belong' to them, except in Capita's case this cash was already on its balance sheet.

With these new facts in hand, we should have recognised that Capita was much riskier than it had previously seemed, and adjusted our Approximate Value and Margin of Safety accordingly. That we did not points to various behavioural factors: endowment effect, anchoring, and regret aversion to name a few. There is probably a little hubris in there too. We pride ourselves on the quality of our accounting analysis; how could a new accounting standard, which in itself did not change the cashflow or underlying economics of the business, prove us wrong?

We grow as people and as investors by admitting our errors and learning from them. We have made some additions to our Checklist of Mistakes, and we will spend more time thinking about these things before making future investments.

- Explicitly include deferred income in our BAIT adjusted net debt calculation
- Understand that negative working capital flatters cashflow when a business is growing but becomes dangerous when that business shrinks
- Knowing that a 'kitchen sink' is round the corner doesn't mean that it's already in the price
- Be cautious around companies with contract accounting – even (especially?) when the cashflow is strong
- There are always people who know more than we do – be more vigilant when a company has rising levels of short interest

From a macro perspective, it is worth considering that we are coming to the end of a decade of easy credit. We will see an impact not only in terms of cost of debt, but also in the risk premium attached to companies with high financial leverage. This in turn will influence the behaviour of management teams, it may even tip the balance in a situation where a new CEO is considering a rights issue. I also recognise that there are risks that cannot simply be quantified and reflected in an Approximate Value or Margin of Safety calculation.

Where forward from here?

While our comparison with Carillion shows Capita in a relatively favourable light, the business is not without issues of its own.

Firstly, given Capita's reduced earnings guidance, we believe that a portion of the £1.3bn of deferred income on its balance sheet is at risk of write-down. In other words, some of this profit which has been written off in order to be re-recognised may never materialise.

Secondly, we believe that Capita's record of acquisitions creates a risk that intangible assets and goodwill will be impaired. Thirdly, we mentioned earlier that while Capita's cashflow has been strong, other metrics paint a more nuanced picture of earnings quality. The table below helps to illustrate our (pre-IFRS 15) view on these last two points.

CPI (£m)	2013	2014	2015	2016
Capitalisation of intangibles (£m)	16.9	40.8	85.1	72.2
<i>as % underlying EBIT</i>	4%	10%	18%	20%
Amortisation of intangibles (£m)	3.3	9.1	13.2	17.4
<i>as % underlying EBIT</i>	1%	2%	3%	5%
Total intangibles (£m)	2,330.7	2,619.4	2,810.0	2,754.2
<i>as % equity</i>	260%	286%	373%	570%

Capitalised intangibles are cash costs (such as software development) which are not charged through the income statement, but instead added to the balance sheet as an asset and then amortised over the useful life of that asset. The table shows how capitalised intangibles have grown ahead of this amortisation charge. This is common when a technology-enabled business is growing (new software is required to capture that growth), however when the business shrinks (as Capita has been recently), we would expect to see the amortisation charge move to align with capitalised intangibles, either through a gradually increasing amortisation charge and decreasing capitalisation rate, or through a write-down of the asset. The more sudden the slowdown, the greater the risk of a write-down.

Total intangibles on the balance sheet reflect both the capitalisation outlined above and also the increase in goodwill resulting from Capita's acquisitions. As the business goes through transition, and the rationale behind historic acquisitions is reviewed, this goodwill is at risk.

While this paints a rather bleak picture, **we are optimistic about the investment case.**

Firstly, the new CEO is carrying out the actions necessary to realise Capita's potential, including business simplification and disposals, reduced focus on acquisitions, and increased focus on small number of key markets. We believe that many of Capita's subsidiaries are high quality businesses, operating in markets with secular drivers, like automation and shared platforms, and that the strengthened balance sheet gives Capita the opportunity to invest properly in these businesses. Despite this investment, management expect the business to generate free cash flow in 2019.

Secondly, it is important to remember that investment returns are in part a function of the price you pay. Following the rights issue announcement, we have updated our valuation.

- A £150m operating cash outflow in 2018, offset by £700m new equity raised at 140p/share, leading to a 2018 net debt position of £600m
- PBT inline with the mid-point of management guidance (£270m - £300m), then adjusted for reduced interest payments following the rights issue
- Long-term margins adjusted down to 7.5% from our previous expectation of 10.0%
- 2018 adjusted EPS of 20.8p, rising modestly to 22.6p in 2020

On this basis, our discounted recovery earnings model implies 262p AV (54% upside on the current share price which is 170p at time of writing), and on a medium Margin of Safety (we have increased the risk associated with earnings outlook and industry cyclicality, but reduced the balance sheet risk, given the company's likely position post-rights issue) this analysis suggests entry points at 175p, 154p and 138p.

Add or Exit?

Our approach to position sizing is to add in tranches on weakness, unless we believe that our investment thesis is broken, in which case we would typically exit the position in full. **We have added to our Capita position since the last profit warning** and at the time of writing it represents 4.1% of the portfolio. **We expect this weighting to increase when we participate in the rights issue.**

Adam Rackley

Cape Wrath Capital

April 2018

