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Facilities Management

Supplier assessments and effective procurement

Abstract

The aim of this report is to highlight the **prevailing challenges within the FM supplier industry** and its consequential impact on the risks for customers who procure these services.

The recent collapse of Carillion highlights a distinct example of a company that seemed a stable stalwart of the industry on face value but whose underlying economics became less favourable over time. Once a business that benefitted from large contracts with high profile customers across multiple industries both within the public/private sector, its over-diversification amidst economic and industry cross winds ultimately led to its spectacular demise.

This short form paper does not intend to be a post-mortem of everything that went wrong with Carillion – many of these exist within the public domain and do well at describing causal factors. But given this singular and recent event caused shockwaves in the industry and even acted as a catalyst to the development of the outsourcing playbook recently issued by the Cabinet Office, it would be appropriate for this to be considered at the outset. Indeed, as some of the ensuing narrative begins to describe the headwinds in the industry and the fragile nature of low margin long term contracts, one can quickly begin to draw some connections and parallel contributing factors to this particular event in supplier failure.

Business and financial shortfalls aside, an important structural characteristic to draw out from this example is the diversity of business offerings that currently exist across the supply chain within the FM space. Carillion was a construction plus FM business, and ironically it seems the former segment of operations, upon which the business initially based its core competency, contributed greatly to its downfall. But whilst there are similarly structured providers that currently still deliver in the market (whether operating through more optimal delivery, robust contractual management or through a smaller scale) other providers exist as FM plus energy providers, purist "FM only" providers and there are even those that operate using the management model for some/all service competencies.

The disparate nature of this FM supplier market makes assessing the risk of failure for a customer much more challenging. Traditional procurement processes may suit homogenous markets and be successful at gauging the FM service which it seeks to procure. But Carillion has clearly demonstrated that the risks facing these customers from other areas of the supplier's business operations remains prevalent and real. Furthermore, whilst financial analysis of a supplier's balance sheet and performance can still serve to deliver some reassurance on stability and resilience, the retrospective nature of published financial statements, inability to detect revenue recognition mismanagement/underlying impairments and limitations of comparability of aforementioned diverse FM suppliers create additional assessment hurdles.

It may be that in the medium to long term, standard market practice for FM procurement will evolve into an even more rigorous process, not so much by increasing the volume of diligence but making sure tactical initiatives are selective and targeted at the perceived risks. A more strategic partnership with suppliers with sensible decisions around who is responsible and accountable for managing specific risks both at the outset and emerging throughout the term of the contract could be an improvement. But equally, the incorporation of a more dynamic approach will have consequential impacts on commercial pricing and contract length, both of which are likely to shift if flexibility is embedded into the relationship.

In the interim, customers can certainly take tactical intervening action to assess risk, explore additional mechanisms to detect risk and insulate themselves with effective contingency plans.

What has been happening in the FM sector?

Amidst these macroeconomic influences shaping the industry landscape within FM, there have also been interesting dynamics in the composition of the supplier market itself. Low barriers to entry for certain FM service provisions have facilitated multiple SME entrants, some of whom then try to extend beyond the core competency in an attempt to grow at a rapid rate without a full understanding of "strategic fit" and profitability in lateral areas of delivery. These smaller suppliers following a path of aggressive expansion can also underestimate the increasing regulatory and compliance obligations associated with these services.

Challenging industry landscape, **customer demands to maintain cost control whilst generating value** and a difficult labour market has fuelled SME acquisitions in the pursuit of profitability and innovation, **without a full understanding of the risks involved.**

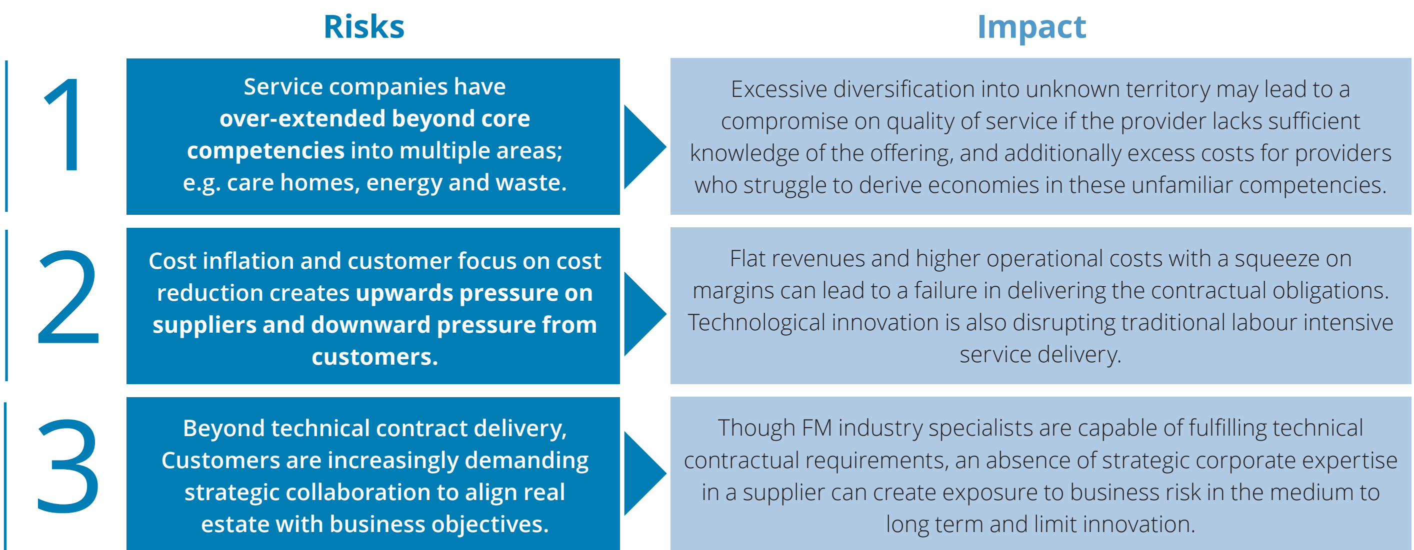
Consequently, the destination often leads to one of two outcomes; either the gradual stagnation of the business or its acquisition by larger providers in the market.

Ironically, whilst larger suppliers have the capacity to absorb and support the critical operations of SMEs using their internal business operating model, they too have fallen victim to the same cyclical trap of over diversification in an attempt to increase profits in a challenging landscape. For large contracts with labour intensive services, rising living wages that have not been negotiated into legacy long term contracts are particularly damaging, and have been exacerbated by the fall in the value of sterling. Continued political uncertainty has further stemmed the flow of labour into areas where it is needed most. These factors combine to generate pressures in the cost base within an environment where customers reaching cost maturity after second/third generation outsourcing are now demanding value generation in addition to cost control.

Value generation and innovation in delivery can require distinct corporate strategic leadership skills that are not always prioritised over technical FM leadership, who have historically been good at cost control.

Supplier business risks, impact and mitigations

Having discussed how the changing environment of the supplier landscape has created pressures and led to absorption of risk into the operating model, it is important to briefly describe these inherent risks associated with larger providers and how they impact the delivery of services to the customer:



Qualitative analysis across the following areas can help to understand if further diligence should be applied as part of a supplier review during procurement:

Stagnant organic growth: Whilst healthy profit margins are critical, earnings growth is also important to combat the effects of cost inflation and can act as an indicator for the FM provider's current reputation in the market. A lack of growth could be a reflection of their inability to secure new contracts, or an inability to retain contracts.

Aggressive acquisitions growth: The nature of the FM industry is highly acquisitive with high levels of consolidation. Whilst some of these acquisitions can prove successful for the businesses, these can often take up significant time, or can be difficult to integrate within the business. Furthermore, synergies often take too long to crystallise, or never materialise at all.

Over diversification: A number of FM providers have diversified their services across a range of sectors through mergers and acquisitions, often leaving the organisation lacking focus and specialism.

Size does not always mean stability: Large providers are synonymous with large contracts, often due to minimum revenue requirements specified under customer led procurement. Larger contracts attracting high levels of competition inherently have lower margins when compared to the smaller contracts and often suppliers hope that future delivery efficiencies can be realised to improve commerciality.

Overheads: It is important that large FM providers take adequate measures to periodically reduce overheads. Consolidating sites, reducing staff numbers, disposing of surplus assets and underperforming subsidiaries are indicators that the business is taking the right steps to reduce costs. However, examining the drivers behind cost cutting is critical to understanding if there is cause for concern beyond good management of the cost base. Often, where contracts are absorbed from acquisition, they are delivered within contract silos and not combined to optimise costs.

There is no exact science to help understand a supplier's complete exposure to these risks. Nonetheless, a supplier can be reviewed **qualitatively** and **quantitatively** to help understand and identify the extent to which these may be applicable.

Financial diligence as a customer mitigation

Though quantitative analysis has historically been part of a procurement phase involving qualitative analysis too, it has not necessarily been applied with the same robust focus and depth in comparison to the diligence on supplier capability and/or the commercial mechanisms of contract remuneration. With this in mind and beyond a traditional high level review of revenue and profitability, there are a number of initial financial ratios that can be reviewed in order to understand if there are any immediately identifiable red flags. A selection of these are noted below as Illustrative examples:

	Ratio	Formula	Description
1	Quick Ratio	Quick ratio = (Current assets − Inventory − Prepayments) / Current liabilities	**Measures ability of supplier to meet short term obligations with liquid assets.**
2	NET Debt: EBITDA	Net Debt to EBITDA = (Total Debt −Cash & Equivalents) / EBITDA Debt is the sum of both long and short term debt and EBITDA is the total earnings before interest, tax, depreciation and amortisation.	**Determines a supplier's ability to pay its debt.**
3	Return on Capital Employed	ROCE = EBIT / Capital Employed EBIT is earnings before interest and tax. Capital employed is total assets less current liabilities.	**Determines how efficiently capital is deployed to generate profits.**
4	Operating Cashflow: Sales	OCF / Sales Ratio = Operating Cash Flow / Net Sales (Revenue)	**Determines how well the supplier turns sales into cash, which is important to meet working capital requirements.**
5	Free Cashflow: Operating Cashflow	FCF/OCF Ratio = Free Cash Flow / Operating Cash Flow	**Helps to understand how well a supplier can generate cash beyond its capital commitments to maintain competitiveness.**

At the minimum, numerical outputs can be followed up with a supplier to understand if financial viability is a concern. Indeed, if applied against Carillion, rising net debt: EBITDA, increasing operating costs, poor liquidity ratios and limited free cashflow all combined to form a bleak picture. Line items such as goodwill from acquisitions are also vulnerable in an industry with profitability challenges, where write downs can cause significant losses.

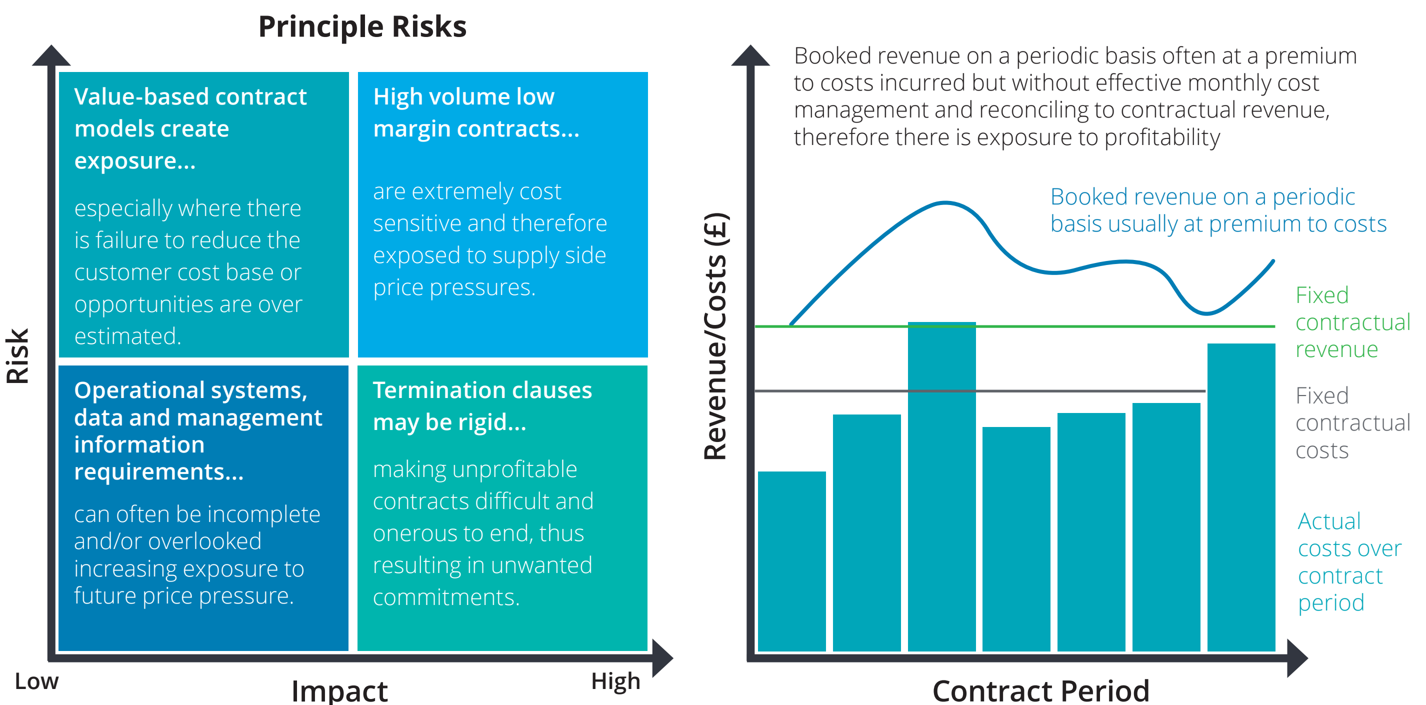
It is important to note that not one single ratio in isolation is enough to determine the financial viability of existing operations. For example, some suppliers may show more favourable liquidity ratios but equally have weaker solvency ratios where a high degree of leverage has been used to finance investment in assets. Such analysis should be broad and involve specialisms alongside procurement that have the ability to understand holistic views of financial metrics.

Equally, in drawing inferences from financial assessments, there must also be a degree of caution. Backward looking performance may reveal historical trends but consideration should also be given to the future outlook. Outliers of financial ratios are less contentious but when trying to compare FM providers, ratios can look materially different depending on the nature of the business.

Whilst some **financial ratios can highlight potential distress** for a supplier, they are not all encompassing and should be reviewed alongside (a) **qualitative factors**, (b) an understanding of the **individual supplier operations** given business diversity, and (c) some type of **forward looking perspective.**

Customer mitigation: Contract diligence and management

Given the external and inherent business risks, underlying profitability of contracts are particularly exposed where there are fixed price contracts (exacerbated if low margin) or where part of the contract involves diversification into service areas beyond a supplier's core capability. In addition, a number of FM providers can fail to reconcile revenue recognition in line with underlying contracts, potentially creating an accumulation of aged debt that is unrecoverable.



Depending on customer and supplier relationships, there may be an opportunity for customers to request ongoing reporting obligations on cash flow, lender covenants and segmental profitability analysis across the business. Beyond these tools deployed to assess supplier exposure, there are a number of actions customers can also take for their own individual contract:

Effective contract management
Ensuring appropriate mechanisms are in place within contracts such as shared incentives, robust pricing models measurable KPIs and performance management frameworks. These are all necessary in ensuring that service levels are adhered to by a supplier. Reviewing the profitability of contracts (if possible) can also act as a good sense check to determine profitability of a supplier under contract. In order to determine profitability of contracts, suppliers could report under quarterly account health checks where they may provide some transparency around revenues, fees and margins of anonymised similar sized contracts? Commercials should be aligned with what other clients are being charged - a profitable supplier with good margins and sufficient headroom for cost overruns is less likely to go into administration.

Some of a supplier's contractual exposure can manifest through a combination of financial trends, however **actual financial management is difficult to unmask**. In this instance, it is important that **customers take individual actions to insulate against these risks.**

Customer mitigation: Contract diligence and management

Compliance and in-contract audits

Performing periodic internal audits of billings and performance management fee mechanisms could help to ensure that customers are not overpaying for services. Audits and periodic value-for-money assessments ensure the service being provided is aligned to what was envisaged at the outset of contractual formation.

Renegotiation landscape

At the renegotiation stage, customers can demand preferential rates for long term contracts which will often further depress margins. Assessing how the supplier addresses these demands in a way which minimises the potential impact can act as an indicator of its business strength in the market and/or its willingness to accept lower margins. Though sometimes the emphasis on a customer is to demonstrate that a subsequent round of procurement delivers cost benefit to their organisation, there should be an equal focus on other value levers aside from cost reduction, such as strategic support to the business and additional risk management.

Public sector focus

Performing an assessment of what proportion of revenues come from government contracts will help validate whether or not the forward order book is realistic and reflective of any impact of potential public sector cuts. It is important that the business is diversified enough to counter its exposure to any public sector cuts whilst ensuring that the delivery and contractual risks of pursing a diversified strategy are fully understood.

It can often be difficult to build an internal case to deploy further resources aimed at managing contractual risk, particularly where the likelihood and impact of risks are somewhat subjective. Nonetheless, the **prevailing headwinds** in the industry and **recent casualties** suggests that **there is value in intervention to mitigate potential disruption.**

Investor market publications

Supplementary to financial diligence, real time investor/broker reports are often a useful reference to highlight current issues or major business developments. Any short selling on publicly listed suppliers can highlight a weak outlook for the supplier in question.

Review of termination provisions and business continuity planning

Customers should be in a position to fully understand its ability to release itself from contractual obligations and, in the event of a critical failure, what steps it can take to minimise business disruption. Business continuity planning is the process of creating a framework to prevent and recover from any potential threat to the business. There is a broad spectrum of options on the breadth and depth of continuity planning from alternative supply to consideration of in-house delivery through TUPE and shell company structures. The plan should ensure that staff, assets and operations are protected and are able to continue to operate in the event of a disaster.

In any scenario, a critical component is data and systems which can often be difficult to migrate if they are disparate and/or across bespoke systems. Other key considerations include:

- How to invoke reserve supplier services
- Determining the point at which reserve suppliers should be called upon
- Time taken to invoke reserve suppliers
- Key contacts
- Communication plans

Concluding remarks

The FM supplier industry remains structurally diverse and prevailing economic headwinds are leading to pressures that can cause:

- Deterioration in the existing services provided by the supplier to mitigate cost challenges
- Acquisitions and/or over diversification into less understood services by suppliers in the pursuit of additional profitability
- Unfavourable contract profitability and subsequent financial mismanagement from the commercial intentions at contract inception

Ensuring a customer is as fully prepared against these supplier business risks should involve the following multi-dimensional approach:

01. Focused financial diligence
Financial analysis of a supplier is a solid foundation upon which to build. EBITDA, debt levels, liquidity ratios and working capital ratios/cashflows are all useful and proven indicators to show whether a supplier is facing more difficult times.

However, financial diligence on past performance alone isn't enough to understand how deeply rooted some potential exposures can be. This, combined with the disparate nature of the FM supply chain, therefore requires an overlay of a more qualitative assessment and the development of a FM risk management framework to apply to FM contracts on an ongoing basis.

02. Effective supplier monitoring and contract management
No risk can be completely eliminated: rather it is a case of being able to identify the risks and work alongside the strategic supplier to determine how best to mitigate the likelihood and impact of these risks. Importantly, there should be a pragmatic dialogue between customer and supplier on each risk and which party is best placed to take the lead to control it. Traditional mindsets expecting a supplier to manage all risks is somewhat outdated and largely set for failure, particularly where a supplier has no ability to influence the root cause.

03. Procurement contingency planning for service continuity
It remains important that customers implement various strategies in order to insulate themselves against the risks. If principles as described previously can be embedded into the contract formation at procurement stage, then this is ideal but with the premise that this remains an area of ongoing focus with updates to risk management frameworks.

For those customers currently in-contract, several strategies of effective contract management, risk identification and business continuity planning can be deployed. In a supplier environment that has already claimed large casualties and doesn't appear to show any respite, it is not inconceivable for other suppliers to fall victim to the same outcome, whether this is due to same pressures and/or a combination of different adverse circumstances.

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