Outsourcers' struggles in the UK are an opportunity for the mid-market

Blog post by Practice Lead Tom Smith, 1 February 2018

Capita's profit warning is yet another sign of the growing fragility of the large, generalist outsourcing sector in the UK. That no bail-out was forthcoming for Carillion showed that such firms are not too big to fail. Indeed, the question seems to be whether they are too big to survive. This should imply significant opportunities for smaller, specialist firms, and therefore for investors, considering the raft of non-core asset sales the big outsourcers will undoubtedly be rushing into this year. There are, however, some considerations to be taken into account before jumping into the world of outsourced public services.

An overly complex web of contracts across ever more sectors, combined with high dividend expectations and growing debt piles, have made this a questionable business model for larger firms. The prominence of public sector contracts ensures this is an avowedly political matter. British governments, which have long paid lip-service to the SME market, may now have a chance to embrace the creative destruction unleashed by the collapse of Carillion and humbling of Capita to put SMEs in the driving seat, shaping not only public sector outsourcing but also the wider economy. Many in government are keen to replicate the German Mittelstand, where firms have a propensity to specialise, innovate and focus on long term sustainability. Such a model flourishes only if it avoids over-consolidation and there are already some examples of sub-sectors of UK outsourcing where this is succeeding.

Serious questions are rightly being asked about the role of government. Both locally and nationally in the UK, policymakers have embraced private sector delivery of services, but this was not accompanied by the requisite investment in commercial skills within government, or an awareness of the vast market shaping powers commissioners now wielded. There will always be a need for some degree of outsourcing, so the question for ministers is how to do it more effectively. This could encapsulate new governance rules, closer control of prices and margins for contracts and a more interventionist Crown Commercial Service. Some firms will inevitably cope better with more rigorous oversight than others.

This raises a range of pertinent questions for investors and operators seeking to exploit this opportunity, especially when acquiring business units from the big outsourcers. Firstly, for a sector increasingly exposed to hostile public opinion and the ire of the Corbyn-led Labour Party, there is clear reputational risk. For some particular services – such as hospital cleaning and catering - there is a danger that government of any colour may wish to in-source to satiate public hostility or ideological preference. Secondly, there will almost certainly be a new culture, and therefore new rules, around holding public sector contracts - creating new regulatory requirements. For those taking on legacy contracts from the likes of Carillion, there will be further complexity as the government tries to avoid the mistakes of the past.

Most crucially, firms tend to flourish where the management team has an appreciation for and resilience to the particular risks of high profile government services. Providers such as Atos and G4S have foundered on complex contracts in the UK, such as work capability assessments of probation services, but this does not mean that such work cannot be effectively outsourced. A smaller, specialist operator, more attuned to the scrutiny afforded by the government and in the public sphere can also be sufficiently nimble to navigate the shifting sands of the public sector procurement landscape, seeking out profit where larger operators are too unwieldy to thrive.