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Compass Group

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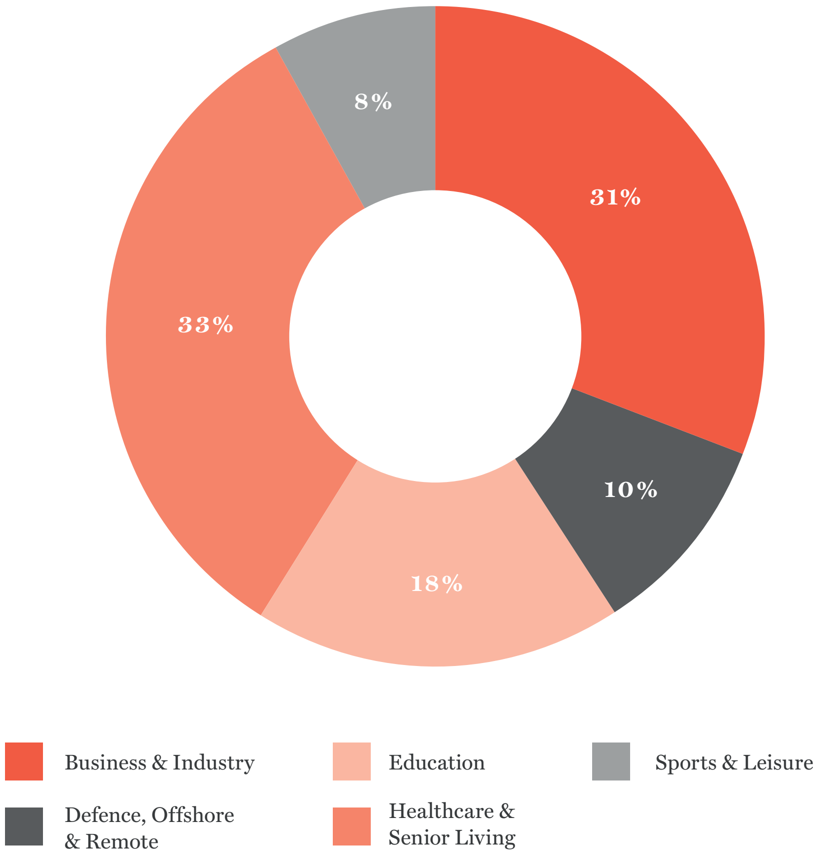
The impressive recovery of Compass Group from the nadir of the Covid-19 pandemic highlights not only the importance of many of the business attributes prized by Walter Scott, but also the merits of in-depth company analysis and patience during periods of market upheaval.

When the Covid-19 pandemic struck in early 2020, shares of Compass Group, the world's largest contract food service provider, plummeted. The near-universal closure of much of the global economy was little short of disastrous for a company that makes its money providing food and other outsourced services to businesses, sport and leisure facilities, hospitals, schools, and universities.

FRASER FOX
Investment Manager

COMPASS: MUCH MORE THAN JUST OFFICES



To many observers, Compass looked like a business in serious trouble: revenues had collapsed, the business was burning through cash, and there was no end to the Covid crisis in sight. Longer-term, the working-from-home (WFH) revolution was seen by some as a grave threat to the company's growth prospects. Against such a grim backdrop, it was perhaps little wonder that many investors headed for the exits. We took a different view, however, believing that Compass could not only successfully navigate the immediate challenge of Covid-19 but even emerge in a stronger position than before.

As long-term investors in Compass, we were well-acquainted with the business, its management team, and the space in which it operates. Fundamentally, we knew from our research that this was a financially resilient, high-quality company, led by an experienced and proven management team that had guided the business through tough times before. During the global financial crisis, for example, a rapid adjustment of the company's cost base had offset the margin impact from falling revenues.

In the weeks immediately after the onset of Covid-19, similarly swift action was in evidence, as management moved quickly to secure cost efficiencies, drive productivity enhancements, and renegotiate client contracts. While the business already had sufficient liquidity to withstand a further two years of existing restrictions, by suspending the dividend and raising equity this was extended to three-to-four years, easing any short-term liquidity concerns.

While this quick and decisive action gave us comfort that Compass was taking the steps necessary to stabilise the business at a time of unprecedented uncertainty, we were also of the view that the threat posed to the company by WFH was overblown. A common misconception about the Compass business model was that it was heavily dependent on providing catering services to 'white collar' offices, where home working would significantly reduce long-term demand. This ignored the fact that a far larger proportion of revenues came from sectors where in a normal environment most employees must be on site. By our analysis two-thirds of Compass's revenues were completely immune from WFH, with the remaining one-third only partially exposed.

Building on this analysis and looking through the short-term turmoil enfolding Compass at that time, we took the view that the disruption engendered by the pandemic would in fact play directly to the company's strengths. Covid-19 would, we believed, lend greater impetus to the long-term global trend towards outsourcing, and few would benefit more from this shift than Compass.

The rationale for outsourcing is simple: by handing responsibility for non-core activities to a third party, customers are free to focus on their core operations, leaving it to their service provider to deliver a higher quality, more efficient, sustainable, and cost-effective service. At present, around half of all food and business support services are still performed in-house, despite the acknowledged shortcomings of this approach. In the "new normal" however, more and more organisations would likely embrace outsourcing, whether due to financial pressures, the difficulties of

complying with best-practice health & safety protocols, or the need to ensure supply chain resilience. This "flight to trust" would, in our view, prove good news for Compass, by some distance the highest-quality company in the space, with a scale and balance sheet strength that sets it apart from its peers.

Furthermore, the upheaval of Covid-19 would fuel consolidation of what is still a highly fragmented industry. While Compass might be the largest player, serving some 5.5 billion meals every year prior to Covid-19, it still only has a 10% share[1] of a market that is replete with sub-scale operators and small 'mom-and-pop' shops. If the pandemic was proving painful for a large, diversified company like Compass, then it would be devastating for many of these smaller players. The result would be fewer operators, whether through bankruptcy or acquisition, and greater market share for Compass.

Fast forward almost two years, and our confidence in Compass has to-date been vindicated. In early February, the business released excellent first-quarter results for fiscal-year 2022. Revenues have now recovered to 97%[2] of pre-pandemic levels, with four of its five business lines now above those of 2019. Even the Business & Industry segment, expected to be most heavily impacted by WFH, has returned to 77%2 of peak revenues, with swathes of workers yet to return to the office. The balance sheet is in excellent shape and the dividend has been reinstated.

And as we expected, Compass is fast capitalising on the disruption of the last two years, with the company taking on more first-time outsourcing clients than ever before and recording record business wins across regions. Management is correspondingly optimistic, with the CEO announcing that "I've never seen more opportunity, and we've never been stronger or better placed in such an exciting market".

Of course, challenges and uncertainties remain. Covid-19 is far from being consigned to the dustbin of history, while food and labour costs have both risen sharply in recent months. The recovery in business volumes has gone some way to offsetting inflation, however, and the business has pulled several other levers to further mitigate its impact, including digital initiatives, inflation-plus contracts, menu management, food-waste reductions, and automation. Margins approaching pre-pandemic peaks are testament to the efficacy of such measures.

This operational excellence, reflective of the assuredness with which Compass has navigated the pandemic so far, instils in us even greater confidence in the quality of the business, its inherent advantages, and the management team at its helm. The company's journey from the nadir of early 2020 to the optimism of today underscores the importance of certain principles that have long been central to our investment approach: there is no substitute for rigorous analysis; take a long-term view; and always be patient.

[1] Compass Group. 2019 Full-Year Results
[2] Compass Group. Trading update for the quarter ending 31st December 2021.

IMPORTANT INFORMATION

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