

## Babcock International: Stable Business with High Barriers to Entry

Daniel Gladiš of Vltava Fund presented his in-depth investment thesis on Babcock International (UK: BAB) at European Investing Summit 2019.

*Thesis summary:*

Babcock International is a quality company that operates a relatively stable business with good margins and high market entry barriers. Strong FCF, a solid balance sheet, and historically low multiples make Babcock a compelling investment opportunity. The combination of country-specific, industry-specific, and company-specific negative sentiment is a probable, but also temporary, reason for the recent undervaluation.

*The following transcript has been edited for space and clarity.*

I want to talk about a British company called Babcock International. The reason I have chosen it for this presentation is that whenever I see a share price looking like this, I usually wonder if this is an opportunity. It may have been excessive optimism in 2014 and excessive pessimism now, or maybe it's just a business doing so badly that it's not an opportunity. When I saw that the stock price halved in the last three or four years, I started paying closer attention. I looked at the business, and I think it's quite a compelling investment opportunity. In summary, I view Babcock as a high-quality company with remarkably stable margins. It operates in a business with very high barriers to entry and is especially interesting today because it has very low cyclicality. When everyone is talking about recession and market volatility, this business has excellent long-term visibility and low cyclicality. In addition, it currently trades at multiples close to historical lows.

Let's take a look at the business of Babcock. The company is a leading provider of engineering services for the defense, emergency services, and civil nuclear markets in the UK and internationally. In the UK, it is the second largest supplier of government services after BAE although it is much smaller than BAE. Babcock's biggest strength is the ability to deliver highly complex engineering services to customers around the world.

Its first core strength is technology and expertise. The company operates in a heavily regulated environment that requires very deep sector-specific expertise. It needs to provide highly critical and complex engineering as well as integrate multiple technologies. This is really a very difficult business. Babcock also owns strategic infrastructure and assets. The most important of them are the dockyards that are able to service the entire nuclear fleet of British submarines. The company owns some of the infrastructure and assets directly, and it operates some that are owned by customers. For example, it owns over 500 aircraft in its fleet. Its operating business model is based on long-term collaborative relationships with customers. Some of the programs Babcock is involved in run for decades, and the long-term contracts are a critical part of its business. They give the company visibility and provide low cyclicality.

In terms of the business mix, 75% comprises what Babcock calls "focus markets" (defense, emergency services, and civil nuclear) and the remaining 25% is "adjacent markets" (energy and marine, rail and power, oil and gas aviation, and airports). The business mix itself is shifting a little, with the focus markets expected to grow to about 85% in the medium term,

and the adjacent markets going down, partially through divestitures and partially through less emphasis being placed on them. The company has a leadership position in its main businesses – defense, emergency services, and civil nuclear.

In defense, it is the second largest supplier in the UK. The domestic defense business is quite large – for example, the Ministry of Defense (MoD) equipment plan for 10 years is in the size of £180 billion. The growth comes from long-term programs, and it's also driven by increasing and evolving technology. In international defense, the company has established a presence in Canada, Australia, New Zealand, and France. It has some submarine programs in South Korea and Spain. International defense is where Babcock sees significant long-term growth potential.

In the emergency services, Babcock is the number one aerial firefighting provider in Europe, as well as number one in aerial medical services, with an established presence in Spain, Portugal, Italy, France, and Sweden. It has recently entered Scandinavia, especially Norway and Finland. In the UK, the company provides services like air ambulance, police, search and rescue, working with the Metropolitan police and the London Fire Brigade. In the international market, it is number one in Australia, and it has recently entered Canada. There are significant opportunities for the emergency services business in North America.

In civil nuclear, Babcock does decommissioning of nuclear power stations. There's a large long-term program of decommissioning in the UK. The government forecasts over £100 billion spent over the long term, which includes sites like Dounreay, Magnox, and Sellafield. There's also a fleet of aging AGR nuclear power stations in the UK where Babcock does decommissioning. The company also supports the existing power stations and the building of new ones. There's a newly built nuclear plant called Hinkley Point. Babcock is also involved internationally in several nuclear businesses, especially in Japan, Canada, and Spain.

About 52% of group revenue comes from defense, 15% from emergency services, and 10% civil nuclear. These are also the areas where the company sees the biggest potential in the future. Adjacent markets contribute 23% to revenues, and the sectors energy and marine, rail and power, South Africa, and airports are likely to see some exits and divestitures.

The group order book has a size of about £17 billion. This is roughly 3.5x annual revenue, which is close to £5 billion. It's nearly equally spread between land, aviation, nuclear, and marine. What's also important is that Babcock has a very large group pipeline. Many companies would say, "Yes, we have a big pipeline of business," and not much of this will materialize. In the case of Babcock, this is an important number because, historically, it has been able to win about 40% of contracts it bids on and over 90% of rebids. Thus, its pipeline is a strong indicator of the future business. Currently, international is about 20% of the order book, but when you look at the pipeline, international is about 40%. You can expect that in the future, the business mix will shift both towards the core businesses and also more towards the international business.

I'd like to offer a closer look at Babcock's business because it's important to understand how difficult it is in terms of performance, how high the barriers to entry are, and how good a visibility some of the contracts are providing. Starting with nuclear, Babcock services more or less the entire fleet of UK nuclear submarines. It's a highly trusted partner to the Submarine Delivery Agency (SDA). In partnership with the Royal Navy, the MoD, and the SDA, it continues to develop strategic naval base infrastructure. Besides that, it explores and develops international markets for nuclear business. There's also a very large land business where it is the British Army's strategic readiness partner. Babcock services vehicles and

tanks and provides training to the army. It continues to service international businesses as well, especially in Australia. In aviation, the goal is to become the largest aerial emergency service provider in the world and to develop the defense business in existing and new international markets. In terms of size, the marine operations provide about £1.1 billion of revenues, which is split about 3/4 in defense and 1/4 in energy and marine. In terms of geography, about 66% is domestic and 34% international. The international business comes mainly from Australia, South Korea, Spain, Oman, and North America.

In UK defense in marine, the company provides surface ship support, training, and systems and equipment services. It maintains 75% of the warship fleet and provides fleet support for warships. Babcock designed, built, assembled, and supports the Queen Elizabeth aircraft carrier, and it also provides extensive training for the Royal Navy. In the international defense market, the company provides submarine support, surface ship support, training, and systems and equipment services. It is responsible for 100% of Canadian submarine refits and services US and UK common missile compartments, offering weapons handling and launch technology. In energy and marine, Babcock provides design, engineering consultancy, complex asset support, and systems and equipment. Its core strengths are advanced technology, technical expertise, and the ownership of infrastructure and assets. Just for illustration, it has more than 5,000 technical staff and a very long heritage of technical authority. The company can deliver critical programs for complex assets in highly regulated environments and provide world class naval training services.

Companies like to talk about their addressable market because it seems like their potential is enormous. As regards Babcock, the 10-year addressable market for UK defense is about £15 billion, while for international defense it's about £12 billion, and the same for energy and marine. The market share is high in UK defense and low in international defense and energy and marine. Regarding the future growth in UK defense, I think it will come from the new programs that would allow the company to grow above the market. In terms of international defense, it expects to increase its market share in the medium term and achieve the same in energy and marine. Overall, Babcock expects this part of business revenue to grow at around 4% annually. The key opportunities are in the Royal Navy platform, training for Royal Navy, and the Canadian and Australian submarine programs.

It's important to keep in mind that some of these programs have been around for decades. For example, the Type 23 frigates that Babcock maintains will be in service until about 2025, after which they would be replaced by Type 31 frigates. The latter will be in service until about 2045, with a potential life extension to 2050. The Albion class ship will be around until about 2025, and there's the potential for extension until 2035. The Queen Elizabeth class carrier is expected to be in service until 2050, with a potential life extension to 2070. Once the company gets involved in some of these programs, the business can run for decades and provide excellent visibility.

The same can be said about its nuclear business. Babcock has been supporting the entire fleet of British nuclear submarines for 50 years and also takes a leading role in all civil nuclear, from building to operations support and decommissioning. The nuclear sector provides about £1 billion of revenues per year, and it's split into about 70% UK defense and about 30% civil nuclear. The company owns some critical infrastructure. It manages and operates two of the three UK naval bases and owns the Devonport and Rosyth dockyards, which are used for design and delivery of critical complex projects for nuclear submarines. The company also is involved in AWE (Atomic Weapons Establishment). It can handle service, design and decommission systems that involve nuclear weapons, including things like the decommissioning of redundant plutonium, handling facilities, and waste management. This is

all highly technical engineering staff.

In civil nuclear, the company does decommissioning of power stations which are going out of business. It provides nuclear services related to concept, design, engineering, and building of plants and the manufacture of equipment and radioactive waste packages. Babcock provides operations and maintenance support and site licenses and also has some specialized radiological laboratories and radiometrics. In addition, it provides design and implementation to fit out Hinkley Point C, which is a new build, and it is positioning itself for future nuclear UK projects.

The company's core strengths here are technology and expertise. It has around 5,000 nuclear-trained specialists, a highly skilled program, and project management capability, as well as significant embedded nuclear knowhow and experience in complex nuclear engineering. The Devonport and Rosyth naval dockyards, which are Babcock's two most important infrastructure assets, give the company a monopoly position in this business. It also owns some dry docks and nuclear processing, handling and storage facilities. Some of these programs are also very long-term and give the company excellent visibility.

The 10-year addressable market for submarine support is estimated to be about £23 billion, for naval base about £2 billion, for infrastructure £2 billion, for submarine defueling and dismantling about £8 billion, and the AWE around £9 billion. The company's market share is high in submarine support and naval base, and it expects to grow with the market, especially by getting involved in the long-term programs. Infrastructure and submarine defueling and dismantling are new markets for Babcock. It is running some programs in Devonport for infrastructure, an SDP program for submarine defueling and dismantling. These are new opportunities for the company. There are about 20 out-of-service submarines to be dismantled, plus some in-service submarines and future classes of submarines coming into service. Babcock expects this part of business to grow also at around 4% annually.

The 10-year addressable market in civil nuclear is about £10 billion for the UK decommissioning, about £4.5 billion for UK new build, and £6 billion for nuclear services. Internationally, the market size is estimated at about £20 billion. Babcock's share is low in UK decommissioning and UK new build. Its decommissioning programs run in Dounreay, Magnox, and EDF stations. For UK new build, its program is related to Hinkley Point C. Its growth will come with the market, but the greatest potential in civil nuclear comes from the international business. Babcock is already involved in Japan, Canada, and Spain. In Japan, it does some business in Fukushima and wants to build on its UK expertise and get some more international business. It is a new entrant in the civil nuclear international market and expects to grow significantly there. For the civil nuclear market, the company expects to grow revenues at around 4% annually. The current order book is approximately £4 billion, split at about 57% defense and 43% civil nuclear. The pipeline is roughly £2 billion, with civil nuclear providing about 2/3.

It is important to note that multiple UK submarine programs also have longevity. For example, the Vanguard class will be in service until 2023, then get a life extension of 10 years and spend another 10 years in decommissioning. The Dreadnought class will take over around 2030, remaining in service until about 2065 before life extension and decommissioning. The currently used Trafalgar class, which will be in service until 2025, is being transitioned to the Astute class, which will be in service until 2050 and then replaced by another service set to run for even longer. Among all these programs, there is a submarine disposal program going on. Babcock is servicing the entire fleet of UK nuclear submarines. This is a program which runs for decades and gives exceptionally high visibility.

and stability to Babcock's business. Regarding the UK civil business, the main market opportunities I see are the EDF power stations and operations, the Magnox reactor decommissioning and dismantling, the new bases at Hinkley Point and potentially Sizewell, Bradwell, and similar sites.

The international market provides the greatest potential. Babcock has a UK leadership position in high hazard defueling, decommissioning and waste management, and it wants to sell this expertise abroad. It is already involved in Japan, Canada, Spain, and many more other countries where business can be found. Babcock also has a very large land sector, which is split into land defense and adjacent markets. In land defense, it provides long-term contracts focused on vehicle support and military technical training. The adjacent markets are contracts like those in South Africa, where the company provides some short cycle work and other services. The land sector revenues are about £1.6 billion annually, with about 70% coming from defense. Most of the rest comes from other countries.

The other adjacent markets include some emergency services for the London Fire Brigade and the Metropolitan Police. Babcock also provides firefighter training, and it has a rail and power business where it is the leading provider to the national grid, doing track renewal and signaling work. The company also offers baggage system operations for airports. In defense, it provides support for mobility vehicles up to the main battle tanks. It procures, maintains, and repairs about 2,000 army heavy construction vehicles and provides excellent training to about 21,000 soldiers every year. In this business, its core strengths are again technical expertise, infrastructure and assets, and the operating model based on partnership with its main customers.

The addressable land defense market is about £8 billion for UK vehicle support, £8 billion for UK training, maybe more than £20 billion for international vehicle support, and more than £10 billion for international training. Babcock's market share is high for UK vehicle support and medium for UK training, and it expects to grow slightly faster than the market as news programs come online and the scope of its business expands. In the long run, however, the biggest opportunities are in the international business where there are new entrants. Babcock has a small position in international vehicle support in Australia and basically no positions today in international training, but it sees long-term opportunities both across Europe and in other countries. The land defense market is expected to grow around 3% per annum in the long term.

In aviation, the company saves lives with aerial emergency medical and special rescue services. It protect communities with firefighting operations and supports defense by assisting air forces in the UK and overseas. Its businesses are typically based on long-term contracts. For example, the Canada firefighting program and the Norway ambulance program run for 10 years. Babcock has 530 aircraft and more than 1,300 pilots. It has built a certain size and scope that impedes entry for competitors. The company aims to become the largest aerial emergency services provider in the world. It wants to grow the business in established countries and also enter new countries and regions. In the defense business, it want to become a world leader in flight training and build a significant pipeline of opportunities.

Besides the UK and Ireland, it operates in Scandinavia, Portugal, Spain, France, Italy, Canada, and Australia. The core strengths here are again technological expertise, infrastructure and assets, and an operating model based on long-term contracts and strong customer relationships. In terms of the size, the 10-year addressable market is about £7.5 billion for aerial emergency medical services, £5 billion for aerial firefighting, and £3 billion for aerial search and rescue. Babcock's market share is medium in the first two and low in the last one.

New growth should come mainly from new geographies across Europe and Australasia, as well as Canada.

The aviation defense market is another business of those. Babcock expects it to grow by about 5% per annum. The company provides flight training in the UK and aircraft support in the UK and internationally. It has UK air station support and maintenance and repair overhaul. Again, this is a market where it expects to grow, especially internationally, at about 5% per annum. The whole business model includes long and short cycle work. Long-term contracts represent about 80% of Babcock's business, and they provide a very high level of visibility, especially in defense. These services are also of great strategic importance to customers. Margins here are over 11%, so it's the key of the company's business. It does some short cycle work, which represents about 15% of its business. The level of visibility here is only medium because the longevity is shorter, and the margins are smaller, around 5%. The last 5% of operations is represented by procurement-related businesses which have a very low level of visibility and margins typically less than 5%. This segment is seen as an enabler, allowing Babcock to get long-term contracts with high margins and high visibility.

Regarding the contract type, the marine and nuclear business is usually done on target cost or shared risk contract type. The land and aviation businesses are usually on fixed-price contracts. The capital intensity is the highest in aviation because Babcock owns a lot of aircraft, and it's the lowest in land, where it provides services and needs to own the least infrastructure. The capital intensity in marine and nuclear is medium, especially in marine, where the company owns dockyards and dry docks. The margins are highest in marine. In 2019, the EBIT margins in this segment were about 13.8%, followed by 13.1% in aviation, 11.2% in nuclear, and 7.8% in land.

A look at some basic numbers shows that the company is growing, not very fast but steadily. The exception was last year, when revenues declined because Babcock sold about £150 million worth of businesses, and there were also some program exits. The business is also characterized by very stable margins. The lowest in the last seven years was 10.6% (in 2012 and 2014) and the highest was 11.5% (in 2013, 2015 and 2018). The combination of good visibility due to long-term contracts and steady margins make Babcock a predictable, non-cyclical, and stable company. The adjusted EPS exclude amortization of goodwill, and we also excluded last year some write-down in the oil and gas business. The adjusted EPS were about 83p in 2018 but have now dropped to the low 70s. The dividend is about 30p.

As regards its financial priorities, the company wants to keep the margins at around 11%. I think it can do that because it just needs to continue the business as it is. It also wants to keep reducing net debt. The debt was elevated due to an acquisition seven years ago, but it has been steadily going down. Babcock wants to focus on improving return on invested capital and also pay a sustainable dividend. As the debt continues to decline, there will be further space to increase shareholders' return.

When it comes to the balance sheet, the most important thing for us is to look at the debt. The company did the last large acquisition in 2014 for about £900 million. It was financed through a combination of a rights issue and debt, but the debt has been going down since then. At the end of fiscal 2019, it was around £1.1 billion, or about 1.6x EBITDA. According to JPMorgan estimates, it's expected to decrease to about 1x EBITDA in 2022. There's certainly space for further shareholder returns in terms of buybacks, increased dividends, or maybe acquisitions, hopefully smart ones. It's also important to understand that 95% of the business Babcock does is either with government or blue-chip organizations, so it has very strong counterparties. The average age of the order book is eight years, which gives the business

excellent visibility. In case you're wondering how skewed the order book is towards large contracts, it isn't because the top 10 contracts represent about 25% of the business, so it's quite well -pread across its various sectors and customers.

The net debt was £1.3 billion in 2015 but is now down to £1.1 billion and continues to decline. The company expects to generate about £1.4 billion free cash flow over the next five years, and that's after pension contributions, which are about £60 million a year. Babcock is trading at quite decent free cash flow multiples. The change in the IFRS 16 accounting treatment of operation leases requires its capitalization on the balance sheet. It has the effect of increasing net debt-to-EBITDA by 0.5. In terms of capex over depreciation, it is typically at around 1.1x. In the medium term, Babcock expects its revenue to grow by around 4% every year.

Let's take a look at the valuation ratios. When I prepared the presentation, the share price was 555p, with the stock trading at around 7.7x this year's earnings, dividend yield of about 5.4%, and nearly 9% free cash flow yield. The stock price is now a bit lower, so the multiples are even lower. When you look 20 years back, these multiples are at historical lows. You might be wondering why a company that is not dynamic in its growth but still growing steadily should trade at 7x earnings and a free cash flow yield approaching 10%. When I ask myself this question, I come up with several reasons.

The first one is related to the country. Brexit on the horizon means that the UK market has been one of the most undercrowded trades for maybe two years now because investors tend to wait for Brexit to be behind us. This is one of the reasons why I find many investment opportunities today in the UK market. There are also some industry reasons. Last year, there was a large bankruptcy in the UK. In fact, it was the largest ever trading liquidation in the UK, and it began in January 2018. The company was Carillion, a British multinational facilities management and construction services provider. Although its business is quite different from Babcock's, it raised questions about the whole scheme of UK government outsourcing businesses to the private sector. Many companies working for UK government in various sectors were downgraded by the market, Babcock included.

There are also some company-related issues. One of them had to do with the accounting. A change was recently introduced regarding the accounting treatment of long-term contracts. The market was questioning whether Babcock was using fair accounting for its contracts, and it turned out that it was. Some other companies had to restate their figures because their accounting treatment for contracts were too aggressive. It was not the case with Babcock, whose accounting treatment I deem reasonable and quite conservative. Also, there's an overhang from its largest acquisition ever. In 2014, Babcock bought a helicopter transport services company called Avincis for £920 million. Given Babcock's size, this was a huge acquisition. Its annual net income at the time was between £300 million and £400 million, so it paid 2x, 2.5x its annual income, partially financing the acquisition via a fully underwritten rights issue. If you look at a chart of Babcock's stock price, you will see that it peaked at the time of the acquisition, so the market clearly took the deal very negatively. We can consider this a good view because I think the acquisition was overpriced, it has brought some debt, and it has diluted the other better business with lower-quality business.

Nearly six years later, Babcock has divested some of the acquired operations. It has worked down through a big part of the debt, and the stock price is less than half what it was at the time. Hopefully, the management heeded the lesson and would not attempt to do large acquisitions in the future.

I think these reasons explain why the stock is so cheap today. There is also the matter of Neil Woodford Funds, which owned 5% of Babcock when they were closed, and there's currently some overhang because these funds have to be sold and liquidated. There are several reasons people can argue that Babcock deserves to be cheap. I can argue that some of those reasons are invalid or short-term, and I think the business is quite good. If you're looking for something that is cheap and provides low cyclicality, good visibility, and a solid, steady business, then Babcock might be the stock to look at.

*The following are excerpts of the Q&A session with Daniel Gladiš:*

**John Mihaljevic:** How will you be monitoring this idea over time? Are there any key items or data points you'll be looking at?

**Daniel Gladiš:** Not really. The business doesn't move in jumps or change very fast. A lot of these things are highly predictable. The only important data points or surprises, either positive or negative, could come from the management. In a negative way, they can decide to use the finances available to do another set of acquisitions, which would certainly be very bad. However, they can also decide to return more of the cash to shareholders because the company can generate so much cash, the debt is approaching 1x EBITDA, and the stock is trading at 7x earnings. They also indicated that they would look at buybacks, which should be highly accretive at these valuations.

The downside risk also comes from potential deterioration of public sector budgets, particularly in the defense sector. The UK has traditionally been a big spender on defense – I think it's one of three NATO countries that spend the agreed 2% of GDP on defense, and I expect this to continue. The downside can also come from an increased level of bidding competition, but this can be said for any business. I'll also be watching closely for a potentially sustained push against the involvement of the private sector in the public sector, but I cannot really imagine the government would take over these businesses. That will probably be a disaster.

**Mihaljevic:** What companies do you consider to be the closest comparables one could look at as well?

**Gladiš:** The leader in the UK is BAE. It's much bigger, but the mix of services is different. Babcock doesn't have a very close peer, but BAE comes closest. You can look at many other government suppliers around the world, but they differ because many of them produce weapons.

*About the instructor:*

Daniel Gladiš, based in the Czech Republic, has amassed a market-beating track record since starting VLTAVA Fund in 2004. VLTAVA Fund is a value-oriented, research-driven investment fund focused on investing in good companies run by quality management. Previously, Daniel was Director and Chairman of the Board of Directors of ABN AMRO Asset Management (Czech) from 1999–2004. He was also Director and founder of Atlantik finanční trhy, a.s., a member of the Prague Stock Exchange. Daniel is a graduate of VUT Brno and has authored the best-selling books *Naučte se investovat* (Learn to Invest) and *Akciové investice* (Stock Investments).