CPL: Owner-Operated Steady Grower in Workforce Services

Jeffrey Stacey of Stacey Muirhead Capital Management presented his in-depth investment thesis on CPL Resources (UK: CPS) at Best Ideas 2020.

Thesis summary:

CPL Resources is a global provider of talent and workforce solutions with over 13,000 employees across 47 offices worldwide. It operates through distinct specialist brands in a wide range of sectors including technology, finance and legal, healthcare, pharmaceutical, life sciences, sales, engineering, HR, light industrial and office administration. It has a diverse range of clients from market leading multinationals to small and medium sized enterprises and it operates across the full talent spectrum from permanent, contract and temporary recruitment to the provision of managed solutions. The key business strategy in building the company is to avoid overdependence on any one service, sector or geography.

CPL has steadily grown revenue and earnings since an IPO in 1999. In the fiscal year ended June 2019, CPL grew revenues by 8%, earnings by 32%, and EPS by 37%. It also increased the dividend per share by 41%. The business is well managed relying primality on organic growth although it has allocated capital to small acquisitions on occasion. The company has repurchased almost 30% of its shares outstanding shares since 2011 and the dividend per share has increased from €0.085 per share to €0.19 per share over the last six years.

The CEO, Anne Heraty, founded the business in 1989 and she and her husband own about 35% of the total shares outstanding.

Replay Jeff's session on CPL from Best Ideas 2018.

The following transcript has been edited for space and clarity.

Let me start with a brief overview of how we identify investment opportunities. There's nothing truly original here. We think about answering three questions in every opportunity we look at. First, does it possess outstanding business economics? Second, does it have honest and capable management? If we can answer the first two questions in the affirmative, we then ask the third one: Can we purchase this investment at an attractive price? We like to use the phrase "great business, great people, great price."

In terms of outstanding business economics, some of the things we look for high returns on shareholder equity, a strong balance sheet, minimal or no debt or net cash, and attractive operating and profit margins. Significant brand recognition would be great. Maybe it has pricing power for its products. We certainly want to see growing revenue, earnings, and cash flow over time. It doesn't have to grow every single year, but you'd want to see pretty consistent growth in revenue and earnings over a five- or ten-year period. Another important thing is consistent free cash flow generation. I'm sure many consider similar things in their investment strategy.

In terms of honest and capable management, by far the biggest one for us is the management teams of the companies we invest in having skin in the game. I always like to say options and restricted stock units can be a part of a compensation program that can work into how management gets compensated, but we want to see they made an investment with their own money. Where there's pay for performance, we want to see measurable pay for performance and understand how it is generated. Obviously, we want people of integrity and owner mentality. A big one for us is the capital allocation record over time – how much money they return to shareholders versus acquisitions. We try and make a judgment about the skill they're bringing to that. Finally, our experience has shown that great businesses tend to have a unique corporate culture, so we look for that as well.

On the final parameter – can it be purchased at an attractive price? – we use all the same measurements as everybody. There is a quote from Buffett that speaks to me: "Your goal as an investor should be simply to purchase at a rational price a part interest in an easily understood business whose earnings are virtually certain to be materially higher 5, 10, or 20 years from now." Like other investors, we look at dividend yields, price-to-earnings ratios, and free cash flow yields, trying to make judgments about how much those earnings, cash flows, or revenues can grow over time.

My best idea for 2020 is CPL Resources. Since I'm Canadian, some may think I have picked an oil and gas stock or a mining company. That's not the case. CPL is an employment services firm. Full disclosure: I talked about this company at the Best Ideas conference in 2018, two years ago. Since I presented it, the share price has moved up, but the business has actually performed even better. It is cheaper today than it was two years ago, and I hope to successfully make that case now.

What is it? CPL is a leading employment services group based in Dublin, Ireland. It's a full-service shop around all things related to the acquisition and retention of human talent. Services include recruitment, (both temporary and permanent), workforce management, training, outsourcing, and outplacement. It has a relatively new initiative called Covalen, which is a managed services business. For example, it might take over management of a technical support unit and be responsible for all the hiring and management of that. It's relatively new, but it's more of a comprehensive approach to managing the HR function. The company's key business strategy is to avoid overdependence on any one service, sector, or geography. This is an ongoing initiative. A little over a decade ago, most of this company's revenues came from within the Republic of Ireland, so it has this strategy to continue to seek out new services, new sectors, and new geographies.

The company was founded in 1989 and IPO-ed in 1999. A side note: This is a fiscal year ending June 30, so unless otherwise indicated, all the data is as of the most recent fiscal year-end, which was June 30, 2019. CPL has 12,493 flexible staff headcount. These are people employed by CPL but working in its various client businesses. The company also has 567 recruiters, 23 brands in 11 countries, 47 offices, and 19 specialist sectors.

When I was putting this presentation together, the share price was €7.50, and it's up about 4% since then. There are 27.4 million shares outstanding, so at the €7.50 price, we have a €206 million market cap, which definitely makes this a small-cap company.

Let's consider CPL in terms of the three questions. First, does it possess superior business economics? Over the last five or six years, revenues and earnings have been growing, double digits most years. In the most recent fiscal year, the company grew its top line by 8%. Net income has been rising steadily over time — it went from €10.7 million in 2013 to €21.3 million in 2019. EPS in the most recent fiscal year was €0.773, up 37% year-over-year. This EPS growth is due to the company repurchasing about 12% of the shares outstanding, so the difference between the topline and the bottom-line growth is primarily due to the reduced share count, although CPL is improving margins as well.

Does it have high returns on shareholder equity? CPL has delivered consistent high teens to 21% on that count. That's including a pretty heavy cash balance on its balance sheet at all points in time. If you adjust and take the cash out of the equity component and take the interest income after tax out of the earnings piece, the returns on shareholder equity, or adjusted shareholder equity, if you will, go up quite dramatically into the 20s, reaching 34% in the most recent year. The company had approximately €40 million in cash as of June 30, 2019, total equity of €110 million, no non-current liabilities at all, and a healthy working capital component.

It's important to mention brands because it's different in this industry from thinking about large consumer packaged goods, like Procter & Gamble or Unilever. These are all small companies, relatively speaking, but they are highly regarded in the niches where they recruit. One example is RIG Healthcare, a specialist in locum recruiting of physicians in the UK and one of only a handful approved by the National Health Service to undertake this activity. It recruits temporary doctors, technicians, and nurses to fill various healthcare gaps in the UK. Even though RIG is relatively unknown to most people in that narrow niche of the health services medical field in the UK, it would be really well-known among people wanting to find employment in the UK in the temporary physician market. It's a different way of thinking about brands, but these are all very powerful brands in small niches.

Regarding dividends per share, CPL has a steady record of increasing those. In the most recent year, the payout increased to €0.19 a share, going up 41% following a 17% dividend increase in the prior year. This is healthy dividend growth. The company has also repurchased a significant number of shares over the years. Typically, CPL does it through tender offers. In 2011, it did a €20 million tender offer and repurchased almost 6.7 million shares at €3. In the fall of 2017, it spent €25 million to purchase another 3.7 million shares at €6.75 per share. It has bought back about 30% of the shares outstanding in a little over eight years. Just for perspective, over that same period, it spent about €22.9 million on acquisitions. I don't think there's any magic to the 2:1 ratio, but the company has spent twice as much on repurchasing shares as on acquisitions, and it has also increased the dividend.

Does it possess superior economics? Yes — it checks the boxes on revenues and earnings growth, returns on shareholder equity, solid financial position, significant brand recognition in its niches, increasing dividends per share, and opportunistic repurchases.

Does this business have honest and capable management? The CEO and founder is Anne Heraty. She and her husband, Paul Caroll, own 9.7 million of the 27.4 million shares outstanding, or just over 35%, so they clearly have skin in the game. It's a unique corporate culture, in my judgment. CPL consistently wins "Great Places to Work" awards. You can look on YouTube, and you'll see people talking about what a great place CPL is to work, so we think it does have a unique corporate culture. I don't have anything particularly insightful to add with regard to a reasonable shareholder-oriented board. The company has had some longtime board members, but it also keeps bringing in new members, so there is a good balance. The compensation that both the board and senior management get seems quite reasonable to me. You have consistent return of capital to shareholders through share repurchases and dividends, and that's where a board can certainly be a driver of value by holding management to account to look to returning capital to shareholders.

Anne Heraty has won many awards over the years and is an extremely accomplished executive. To sum up, I feel CPL does have honest and capable management. There is skin in the game, reasonable compensation practices, and a good capital allocation record. It also strikes a great balance in acquisitions versus share repurchases versus dividends and has a unique corporate culture.

Can it be purchased at an attractive price? When I presented this two years ago, the share price was €6.22. If you look at the cash per share, in 2018, coming off the tender offer in the fall of 2017, it was down €0.30, so €6.22 less €0.30 gives us €5.92. That cash per share is right back up to almost €1.50. Even though CPL is raising the dividend consistently, it hasn't done a tender offer. I think that's likely again sometime soon, but we'll see. The share price net of cash had moved just marginally, from €5.92 to €6.04. At the same time, dividends, earnings, and cash flow are going up. Back in 2018, the trailing P/E, excluding cash, was 13.5x. Today, at €7.50 share price, it's 7.8x. The price has moved up, but the dividend yield is actually higher today because of the increased dividends per share. Return on shareholder equity excluding cash was 25% two years ago, and it's now up to 34%. I do think the share price is quite attractive.

When CPL went public 19 years ago, it was a tiny company. Since then, it has compounded just about any of the metrics you would want to consider at least at a double-digit rate. I'm not saying it has done so every year – it has had some single-digit revenue years, including last year, when it was up only 8%, but it's been 10% over time. I can't point to anything obvious that would lead me to conclude the company can't continue to grow more or less at these rates into the future.

I tried to extrapolate some numbers going forward. Taking the share price from December 19 and the trailing 12-month earnings of €0.77, and if we compound that at 10%, five years out, earnings will be €1.24 a share. We put a 15x multiple on that. Many people might say that's too high, but it is below a market multiple. That would make the market price almost €19 five years out, which would be a 19.9% compound, excluding dividends. If you generated cash and retired shares at a quicker rate, you might get some pick-up there as well, but in my judgment, this is setting up an attractive rate of return. Just using the current yield of 2.5%, we're talking north of a 20% compounded rate of return. If the company can keep growing at 10%-plus, and the market maybe gives you a bit of a multiple pick-up from where it was two years ago, it would be a multiple enhancement from where it is today.

CPL is a great business, run by great people, trading at a great price.

The following are excerpts of the Q&A session with Jeffrey Stacey:

John Mihaljevic: Thank you for revisiting this idea. Even though the price has gone up a bit, those valuation metrics look better than they did when you presented it the first time. It sounds like this growth rate of just about 10% has been organic growth of the company over the long term. Is that right?

Jeff Stacey: It has never done anything big in terms of acquisitions. Where it does an acquisition, it's usually small and a tuck-in acquisition. There are some modest acquisition numbers reflected in that 10% growth rate, but it's fair to call it mostly organic.

Mihaljevic: In terms of the growth going forward, do we have a sense of where it will come from? Is that simply by virtue of the markets the company is in growing at about that rate, and maybe CPL getting small share gains here and there? Or are there adjacent markets that

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might be of interest? How does the future growth look, and what does it consist of, in your mind?

Stacey: I would say all of the above. Clearly, CPL would like to get share, and there's organic growth in the base business. The company will likely grow geographically by setting up new offices in new geographies, and it will also push out into new but related services. Covalen is a new initiative bringing together some parts that were already within the company, and it's a managed services business. If you go on the website, you can see a couple of case studies. The one I liked was about it taking over the IT support center for a technology company, assuming responsibility for staffing it and managing it, and the company in question turned that role over to CPL. I think you might see some broader gains and business away from traditional recruitment, whether that's executive, permanent, or temporary recruiting.

Another reason I like CPL is that although it has been getting growth in both permanent and temporary recruitment, the real growth is in temporary. Historically, that has had lower margins than permanent recruitment, but CPL has been able to improve its margins over the last several years. If you look at this whole mix, the company wants to grow the base business, expand geographically, and possibly push into some adjacent sectors, so it's going to come from all of the above.

Mihaljevic: In terms of risks to the thesis, is there anything that is top of mind for you, something that could upset the apple cart, particularly over, let's say, a five-plus-year time horizon?

Stacey: The big one is a recession or poor business conditions. I'm not going to claim that if business conditions were lousy, the company could continue to grow at above-average rates. With that said, I must also tell you that this has been a very resilient business. If you go back to the depths of the financial crisis, when CPL was about 90% an Irish-based business, and you had 28% unemployment in Ireland, this company still made money. Admittedly, breakeven might be a better way to describe it, but that's quite powerful. It has also been able to manage its cost structure. If you got into extremely poor business conditions which, in turn, impacted hiring, the company has had a good track record of adjusting its cost structure as well.

I don't want to either overplay or underplay the recessionary comment. CPL has had a good history of adapting and moving forward regardless of business conditions. Of course, you could argue that if we got a business pickup, that would be helpful to CPL on a number of scores. There be more hiring going on. You haven't had a lot of price inflation in salaries and wages over the last decade, so a lot of the company's revenue improvement isn't coming from the flow-through from that. Yes, it would be cyclical if we got into a severe business downturn, but the company has also shown it can manage its way through that.

Mihaljevic: On the capital allocation side, is there anything you'd like to see prioritized differently from what the management has been doing?

Stacey: Not really. The cash has built back up to a record level, so we might see share repurchases again in some form. Although its history has been to grow organically, if the right opportunity came along to acquire something, I'm not adverse to CPL doing that. When it does acquire things, they tend to be smaller bolt-on where maybe it likes the people, or it's a close adjacency in terms of a sector or a service. I'm reasonably satisfied with how the company goes about it. The cadence might change in one area or another over time based on the opportunities it finds, but I have no quibble with the overall capital allocation record,

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and I’m not concerned about that.

About the instructor:

Jeffrey Stacey is the founder of Stacey Muirhead Capital Management Ltd. Jeff has over 30 years of investment industry experience. Prior to starting Stacey Muirhead Capital Management Ltd., he was employed with a boutique Toronto investment firm where he was also a shareholder. Jeff has an Honours Bachelor of Business Administration degree from Wilfrid Laurier University and is a Chartered Financial Analyst. He is a former member of the Finance and Investment Committee and a current Advisory Board Member of the student managed School of Accounting and Finance Investment Fund at the University of Waterloo. He is also an Advisory Board Member of the student managed Ivey Value Fund at the University of Western Ontario and a member of the Board of Trustees at Parkminster United Church. He previously served as a member of the Dean’s Advisory Council at the Wilfrid Laurier University School of Business and Economics and as a director of Rainmaker Entertainment Inc. He also previously served on the Board of Trustees and Investment Management Committee at the University of Guelph.