

Carry On Babcock

Good businesses do something well. The challenge is finding something that reliably needs doing well as the world changes. Quality management is a balancing act between being successful in the moment, and being prepared for what the world can throw at you. Babcock has focussed on 'Mission Critical' service provision. Their main clients are public bodies whose function is to put the '... and carry on' into the UK's 'keep calm'.

The company started by making boilers and steel tubes, but through the two world wars their heavy engineering skills were shifted to the supply of defence equipment. In the 1960s, they got involved in the development of the Nuclear industry. They increasingly moved to long term service contracts designing, building, operating, maintaining and decommissioning infrastructure and assets that are vital to both private and public customers.

The business's focusses predominantly on three areas. It is the largest engineering support services supplier to the Ministry of Defence, providing technical training across all branches of the armed forces. The Nuclear business operates long-term decommissioning contracts, as well as having the capabilities to design, build and operate new-builds. The third core area provides rotary and fixed wing emergency services (air ambulances, firefighting, search and rescue, etc.) predominantly across Europe.

Given that the services are critical, the income stream is resilient to traditional business cycles. Babcock's ability to work across many areas wherever heavy engineering skills are required further reduces uncertainty. Decommission projects are typically very long term. The Magnox (England) project initial phase stretches to 2028, and Dounreay (Scotland) till 2025. The scope of these projects usually expands. This gives income streams a degree of visibility. Although new-builds are more uncertain, Babcock is well placed should they go ahead. There are also additional international opportunities as countries like France, Germany and Japan look toward decommissioning projects.

Rather than bottom up analysis of companies, markets sometimes look for 'general themes' that oversimplify individual businesses. Babcock may be lumped with broader outsourcing companies that have had a challenging time in recent months, e.g. Capita and Mitie. The trials of Serco and G4S live long in the memory. The general level of outsourcing can be quite volatile. In contrast, as discussed, Babcock has more predictability. This lumping has led to an attractive valuation relative to its history at about 11.5x PE. Average revenue growth since 2006 has been 6%. Earnings growth of c. 8%, and free cash flow yield of c. 6.5% can provide a solid return even absent any re-rating. A strong balance sheet with historically low borrowing gives management the option of returning cash to shareholders, or making acquisitions to supplement organic growth.

The world changes. Investors react in an attempt to predict. Businesses don't change as fast as reactionary impressions. Babcock has recovered from a precipitous sell-off on the day of Brexit. Management has more relevant information than the public, and focus on long term plans. Credo looks to find companies that do this well, with insufficient market recognition.

A long enough investment horizon, together with patience and calm, can allow plans to deliver results.

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