CREDO WEALTH

Individual Stories

ServiceMaster's core businesses are Terminix, a Pest Control Services provider, and American Home Shield, a Home Warranty Plan provider. Both are the largest in their respective sectors in the United States. We consider these to be fantastic businesses – highly profitable, cash generative, with a high proportion of recurring revenues (via customer retention) and decent growth potential. Both are industries where the largest players enjoy significant advantages.

The Pest Control market is highly fragmented, consisting of some 10,000 companies with fewer than 100 employees each on average. Two large companies have dominant market share (c. 40%). ServiceMaster's Terminix (with a c. 21% market share), and its nearest competitor, Rollins (c. 19%), have been slowly buying up the smaller competitors, consolidating the market. They benefit from better brand awareness and lower costs because of their scale advantage. Being bigger allows greater route density (shorter travel time between jobs saving costs), the ability to sell guarantees alongside preventative termite treatment contracts, cheaper access to capital (both debt and equity markets), purchasing power (e.g. chemicals) and investment in technology through process standardisation. Scale also makes it easier to ensure consistent service levels when trying to win larger corporate clients.

ServiceMaster's other core business, American Home Shield (AHS), protects homeowners against costly repairs or replacement of household systems and appliances. Rather than replacing the items (as a form of insurance), it helps in their maintenance, with replacement (or cash) the last resort. Contracts are renewed on an annual basis, and high renewal rates (c. 66%) lead to a stable business. AHS is four times the size of its nearest competitor (with c. 40% market share), which gives it an advantage when negotiating with contractors, who are prepared to offer discounts for bigger volume and the improved route density that comes with being in their preferred network. Similarly, being a larger business plays to the advantage of the customers of AHS in that the company can offer broader coverage areas and reduced waiting times. As much as 90% of the time, AHS successfully assign a contractor to a job within 15 minutes or less. They are a trusted brand providing an essential service.

Having said all of this, there is no clear rationale for these businesses to be together, from an operational or cost perspective or for any other synergies. In practice, the market often penalises "conglomerates", preferring "pure plays". Simplicity and clarity are rewarded. Splitting up often realizes value, with the market valuation of the two separate parts being greater than that of the conglomerate.

This isn't just smoke and mirrors. The rerating can have merit. Separation allows for distinct management teams, enhancing strategic focus and accountability. Moreover, pure plays make more attractive targets because you don't have to pay a premium on the bits you don't want.

ServiceMaster have recently announced the intention to spin off AHS into its own publicly traded company through a tax-free distribution to shareholders. As part of the transition, a new CEO, Nikhil Varty, will take the helm. Mr Varty joins having three decades experience in Mergers & Acquisitions, and managing large, complex organisations.

The aim of the separation is to allow the two core businesses to better implement capital structures and strategies appropriate to their specific needs. Economies of scale do exist (within each of the respective businesses), however being bigger just for the sake of it (by combining these two disparate businesses) is not rewarded.

Rather than different chapters in one combined story, we are of the view that these businesses will indeed read better as individual books.

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