



## TIC outlook 2018

Trends and prospects in the Testing, Inspection and Certification sector



# Contents

- 3 Executive summary
- 4 2017: TIC industry resilience
- 6 2018 outlook: trends to watch
- 7 Digital TIC
- 8 M&A: a divided field
- 10 Key takeaways
- 11 About the authors



# Executive summary

Building on strong foundations, the Testing, Inspection and Certification sector is poised to capitalise on a host of potential growth opportunities in 2018.

The TIC industry enjoys some key advantages. Operators generally deliver higher margins and require relatively lower capital expenditure than other business services sectors. And financial performance is typically underpinned by excellent revenue visibility, due to longer-term contracts and framework agreements – supplemented by regulation.

These sound fundamentals ensured the TIC sector remained strong in 2017. In fact, despite much political uncertainty, the entire TIC industry has remained resilient through the economic cycle.

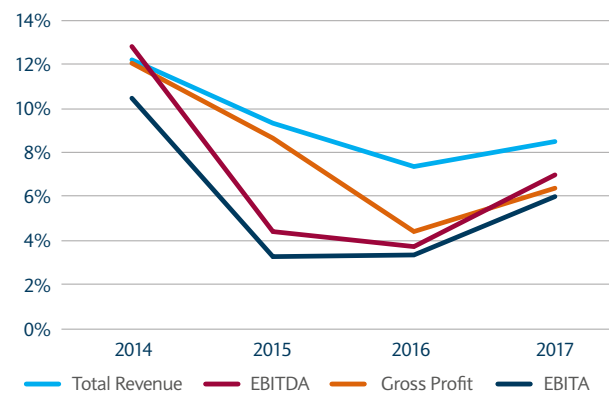
It is true that the previous three years had seen a slowing of CAGRs across the industry. In 2017, however, this trend began to reverse. That coincided with a stabilisation of leverage and an improvement in liquidity – pointing to a positive outlook for 2018 (refer to graph on page 4).

## M&A returns

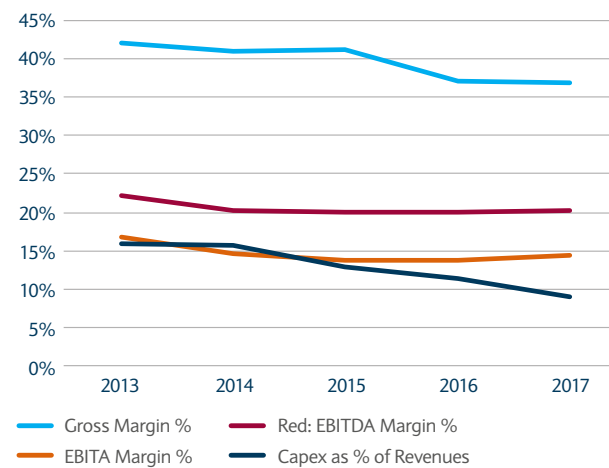
The sector’s merger and acquisition scene had a healthy 2017. The key players continued to support low to mid-teen EV/EBITDA ratios, providing opportunities to drive returns through M&A. We expect that picture to persist.

With no material issues resulting from the larger leveraged buyouts, financing confidence is high. And as a still-fragmented sector able to augment financial performance with strategic acquisitions, the opportunity for returns on investment remains buoyant.

TIC sector trading profile: CAGR%



TIC sector trading profile: Margin analysis



Source: Capital IQ

## Supporting success

In this report we reflect on the events of the past year in the sector and highlight the key factors we see shaping its development in 2018. We consider the opportunities and threats posed by digital advances, and we look in detail at M&A prospects for the next year.

The firms best placed for success will be those with scalable operating models, unique market positioning and a digitally enabled growth agenda – allowing them to deliver fast-paced, integrated solutions for their clients.

We have continued to support TIC investment throughout 2017, and we remain excited about opportunities to support our clients’ growth ambitions.



**Mike Leggo**  
 Director & Head of TIC Sector  
 Barclays  
 M: 07500 953351



**Mark Maunsell**  
 Associate Director  
 Clearwater International  
 M: 07718 521201

# 2017: TIC industry resilience

The TIC sector stayed on course through a year of political turmoil and some challenging economic conditions.

## The state of the market

The global TIC market is valued at around €200bn. It is expected to grow at a CAGR of 5% between 2017 and 2023, with variations by sector.<sup>1</sup> In light of the challenges facing the wider economy, this represents a very positive outlook.

The market is highly fragmented. The largest three players – SGS, Bureau Veritas and Intertek – hold a combined market share of less than 25%. The top 10 players account for less than 40% of the market.

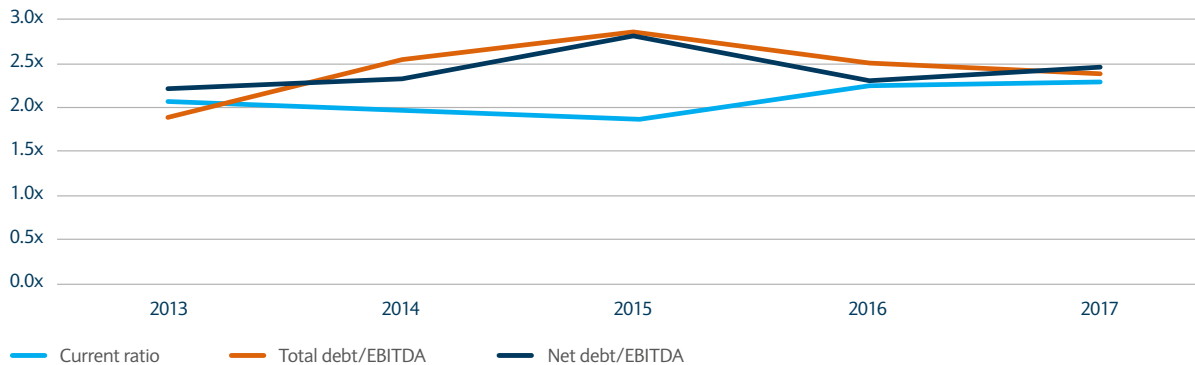
In the last decade, the three top operators mentioned above have expanded swiftly into new geographies and sectors,

becoming diversified global majors. Second-tier companies such as Dekra, ALS and UL have also gathered scale and international presence while remaining more sector-focused. There is a long tail of regional companies operating in niche disciplines.

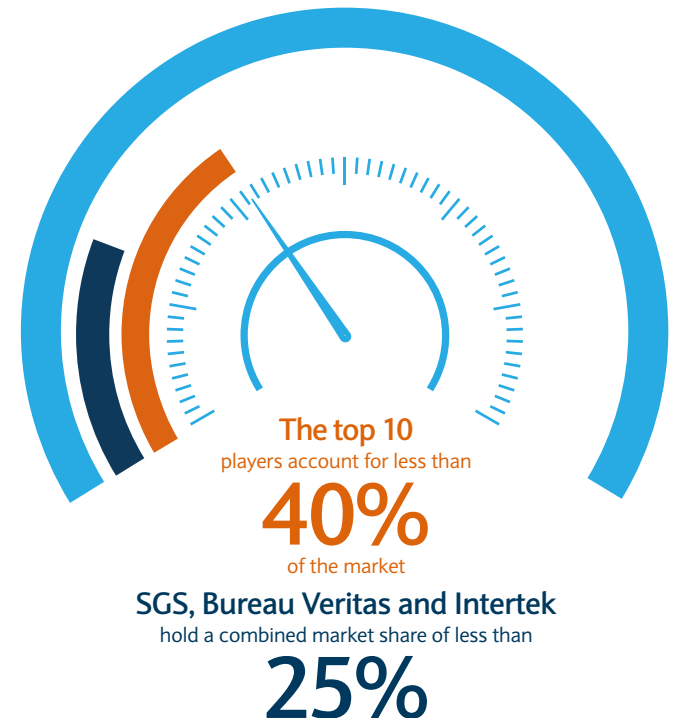
## A challenging start

2017 started with further downgrades of oil and gas related earnings and a relatively challenging outlook. Weak demand and low prices continued to affect the industry. However, living with lower oil prices and a weaker minerals sector was certainly nothing new, and the industry has largely recalibrated itself.

## Credit metrics



<sup>1</sup>Source: Bureau Veritas 2016 Annual Report.



The TIC sector was influenced by a complex political landscape. The Trump election victory suggested a shift towards protectionism in the US and the growth of anti-regulation sentiment. And on a global scale, the rate of change and the impact of government policy was uncertain, with any dilution in standards naturally having an impact on growth prospects. Despite all of these headwinds, though, the sector continued to thrive and the prospects in 2018 and beyond remain good.

### The fog of Brexit

In the UK, uncertainty over the European single market and the Single Standard model continued after Article 50 was triggered. The consensus was that European and UK regulation would continue to lead the world, but the UK's role has the potential to vary significantly across sector verticals.

Those firms dependent on the UK being the default centre for European operations had to take a hard look at the road ahead. Meanwhile, the underlying uncertainty about public infrastructure spend and currency volatility was also high on the agendas of TIC boards.

Looking through a wider lens, the Brexit vote has undoubtedly caused a moderate slowing of the UK economy. A pattern of subdued consumption and investment activity has emerged amid higher inflation. However, sterling depreciation, healthy net exports and improved global trade momentum have offset the impact. Brexit scenarios will of course have different economic consequences.

The slow progress in the EU-UK negotiations will mean further uncertainty in 2018. Again, this is something the sector has weathered previously, and we see no reason why TIC businesses will not continue to perform well in the short and medium term.

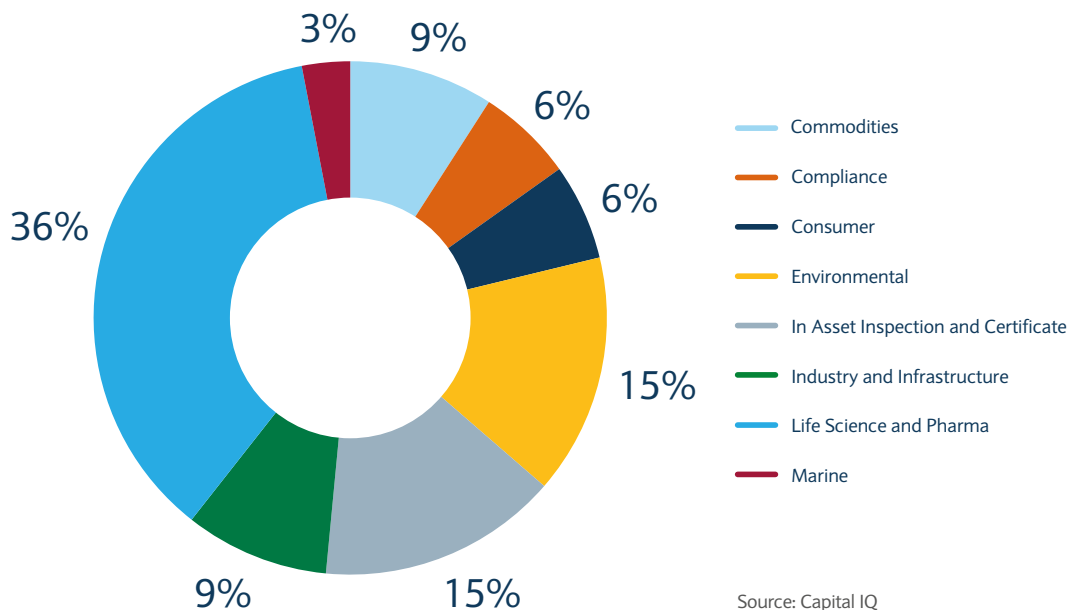
### Major deals

2017 continued to be active on the M&A front. In the second half of the year, the completion of Element/Exova was followed by the announcements of Eurofins/EAG; Applus back on the acquisition trail (both Eurofins and Applus raised equity on the back of their acquisitions); DNV Foundation buying back in the Maryland minority; and continued sponsor auctions for Asiainspection and Atesteo, among others.

There was healthy private equity investment in firms of all sizes, driven in part by some generally favourable financing markets and willing bank support for TIC.

Given the broadly benign macroeconomic and financing backdrop, it is reasonable to expect the M&A scene in the sector to remain busy in 2018.

### M&A across sector verticals (2017)



Source: Capital IQ



# 2018 outlook: trends to watch

A rise in outsourcing of TIC functions and ever-tightening regulation are among the key trends that will shape the sector this year.

## Outsourcing

An estimated 40% of the market is currently outsourced, with the remainder of TIC services carried out in-house. These services are often non-core business for the company. The push towards outsourcing – and in specific instances, the privatisation of state-owned laboratories – will continue to be a strong driver of growth. It's not all one-way traffic though, and the outsourced model cannot rely solely on its third-party accreditation capability as justification for continued growth. There are instances of TIC services attributable to some government agencies moving back in-house, reflecting the pressure on public spending.

## Regulation

Increasing levels of regulation have triggered a transition from a voluntary-based risk management approach to mandatory testing services – for example, after the recent high-profile vehicle emissions scandal. Additionally, the tragic Grenfell Tower fire highlighted the critical need for standards and certification in the construction and maintenance of public infrastructure. An evolving regulatory landscape is an intrinsic part of the TIC industry and will continue to generate new opportunities for firms – matching their clients' needs.

## Emerging market growth

The next year will see multinational TIC players expand further into new markets and developing economies, chiefly through acquisition, and deal with new cultural, tax and legislative regimes. China will continue to be a prime growth territory for the sector.

## Globalisation

TIC firms continue to be called on to scrutinise international supply chains as a result of trends towards lower sourcing and procurement costs. The sourcing of raw materials from jurisdictions with different quality control procedures, for instance, will require more TIC input. Additionally – given the proliferation of firms deploying products on a global scale, often simultaneously, and involving complex manufacturing and supplier arrangements – globalisation is a major growth element of the TIC industry.

## Brand protection

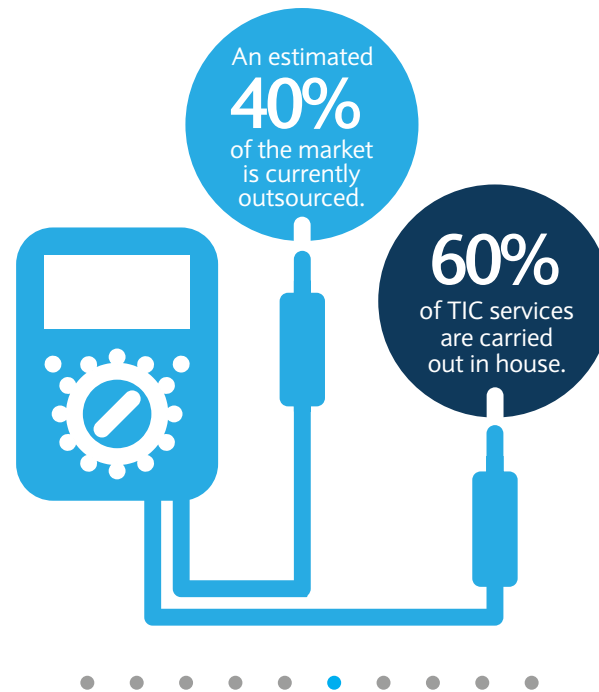
The rise in conscious consumerism will continue on a major scale, piling pressure on brands to protect their reputations. This is moving the needle from TIC services being seen as obligatory, to being able to provide real competitive advantage. Consumers expect more choice, lower prices and better quality – hence, the trust provided by certification is increasingly important. The proliferation of social media networks and the speed of information sharing will drive further growth in the TIC sector. General increases in global wealth will have the same effect, through raised expectations of safety and quality.

## Protectionism

The recent rise of protectionist policy and trade barriers has been one of the 'handbrakes' on the soaring growth trajectories previously seen in TIC. If followed through, this trend has the potential to limit global trade growth, with a natural dampening effect on the sector. However, we remain confident that the resilience and strength inherent in the industry will compensate for the challenges faced.

## Cost savings

Boards will be looking to achieve further efficiencies in staffing, procurement and general operating models, to save on costs and grow margins. TIC has an increasingly important role in helping all industries achieve these cost targets.



# Digital TIC

From drones to Big Data, recent advances are being embraced by TIC companies keen to offer new capabilities to their clients.

2017 saw further leaps in the digitisation of the industry. Digital inspection, predictive maintenance and integrated sensors are replacing physical inspection. These advances provide growth opportunities and help operators to raise margins, enter new markets and embed client relationships.

Inspection Services is a good example. Traditionally very labour-intensive, the service is now being transformed by the use of technology such as drones to help with crop management and asset integrity.

Some in the industry fear these developments may also lead to disintermediation and additional competition. However, the requirement for human technical expertise to interpret and use data will always make it difficult to fully automate the process.

## Trading multiples

	P/E		EV/EBITDA		EV/EBITA	
	2017E	2018E	2017E	2018E	2017E	2018E
Applus	17.5x	15.5x	11.3x	10.1x	15.0x	13.1x
Bureau Veritas	24.5x	23.2x	14.5x	13.4x	16.5x	15.8x
Intertek	27.5x	25.9x	16.6x	15.4x	20.2x	18.8x
SGS	26.8x	23.9x	15.1x	13.7x	19.8x	18.0x
<b>W. Average</b>	<b>26.5x</b>	<b>24.2x</b>	<b>15.2x</b>	<b>14.0x</b>	<b>19.2x</b>	<b>17.1x</b>

Source: Capital IQ

## Investing in the future

Many firms are still assessing their investment strategies to capitalise on the emerging technological opportunities. Intertek, for example, has said that “superior technology, increasing productivity and giving added value to customers” are the key enablers for its growth strategy.<sup>2</sup>

Leading players are introducing a range of initiatives in a bid to enhance productivity and customer experience. Rather than developing proprietary software, they often pursue strategic partnerships with specialist technology providers. Bureau Veritas, one of the most active in this area, has ongoing initiatives involving analytics, simulation and workflow.

## Harnessing the potential

New developments in automation, robotics and artificial intelligence are affecting the entire business services industry. TIC is no exception.

TIC players who can harness Big Data and digital processing improvements to pull data from many disparate sources, without the integration challenges of the past, are best placed to offer a premium service. Ownership and protection of data is a growing theme and could be an opportunity or threat as TIC digitisation gains momentum. New technology is also improving analytical methods and lowering detection limits.

All these advances are helping TIC companies keep pace with growing demands for better reporting and analytics techniques, and greater accuracy.

<sup>2</sup>Intertek Annual Report 2016.



# M&A: a divided field

While the biggest players are scaling back their acquisitions, the healthy appetite of second-tier firms is driving an active M&A scene.

Key players have all pledged significant funding for M&A and announced ambitious short-term targets. For example, SGS completed 12 transactions in 2017, moving it closer to its strategic plan of acquiring revenues of CHF 1bn (c. €867m) by 2020. And RINA is looking to spend around €200m ahead of an IPO in the next three years.

M&A has, however, become more challenging. The largest listed companies are mainly focusing on small tuck-in deals. This partly reflects the lack of sizeable targets in a fragmented sector, but also the premium price of large-scale transactions, which offer less scope for value creation. In addition, some high-profile acquisitions – such as Bureau Veritas's purchase of Maxim at the top of the oil and gas market (10.7x EV/EBITDA) – have underperformed.

**Private equity groups are increasingly open to looking at smaller platforms, provided they help build sector leadership with a strategic geographic footprint.**

Meanwhile, however, second-tier and private equity-backed businesses are still highly acquisitive. These companies are often better placed to justify the price of larger deals, through expansion of their geographical and sector reach. A good example is Netherlands-based ACTA Holding BV's purchase of Helsinki-headquartered Inspecta Group Oy for €200m (14.0x EV/EBITDA).

## The power of PE

Private equity groups are responsible for many notable transactions. In the last two years, high-profile deals have included PSP and Partners Group's investment in Cerba (12.0x EV/EBITDA), Apax's buyout of the remaining stake in Unilabs (11.8x EV/EBITDA) and BPAE's public to private purchase of SAI Global (9.4x EV/EBITDA).



Private equity groups are increasingly open to looking at smaller platforms, provided they help build sector leadership with a strategic geographic footprint. Inflexion's recent investment in Cawood Scientific, a specialist in the food, environmental and veterinary segments, is an example of investors' appetite to acquire niche operators.

A key attraction of the sector is the potential for multiple exit options. In the main this comes in the form of a sale to a larger private equity fund or a well-capitalised trade purchaser. This was the case with 3i's disposal of ESG to SOCOTEC, and US-based Incline Equity Partners' recent disinvestment of AmSpec Holding Corp, a petroleum specialist, to Olympus Partners (12.0x EV/EBITDA).

In some situations, an IPO is a credible alternative. However, the post-float performance of Exova (IPO'd 12.0x EV/EBITDA, taken private at 9.4x) and Applus raises questions over the operational gearing while a company is listed on the public markets.

Private equity-backed trade platforms will continue to be a key source of deals in the next two years. The investment by 3i and CITIC Capital in Germany-based Formal D, a specialist TIC provider to the automotive sector, is a prime example. The business will look to build presence in the US and Asia and to reduce its reliance on Europe, which still represents 75% of revenues. Other 2017 examples include LLC's platform FlexXray, and Spectrum Equity's purchase of Ireland-based The Digital Marketing Institute.





## Towards convergence

The last few years have seen increasing convergence as instrumentation and controls manufacturers have looked to augment products and access faster-growing, higher-margin activities by buying services businesses.

One of the best examples is Spectris plc, which built on its acquisition of Millbrook Group (12.0 – 13.0x EV/EBITDA) in 2016 through the purchase of Concept Life Sciences in January 2018 for £163m (c. €185m). The deal is seen as highly complementary to the activities of Malvern Panalytical, which forms part of Spectris's test and measurement division. Other examples include Horiba – which purchased Mira Ltd (14.0x EV/EBITDA) – as well as Danaher and ITW Inc.

## Global growth paths

Emerging markets, especially China, present significant opportunities for M&A. These territories have become attractive through the development of indigenous industries and subsequent acceleration in exports, the introduction of stringent standards and rapid urbanisation.

In addition, the rise of the middle class has led to an increase in private consumption and a demand for both safety and product quality. This in turn offers growth opportunities in areas such as food and consumer goods testing. A prime example is the acquisition of TÜV Rheinland's food analysis laboratories in China and Taiwan by Germany-based Tentamus Group.

Overlapping M&A strategies among several of the global consolidators are likely to influence pricing in the coming year. Virtually all of the Europe headquartered TIC players are still subscale in the US relative to global footprint, and are also keen to build presence in the fast-growing Chinese market. Food, consumer, agriculture and automotive markets will be particularly attractive.



# Key takeaways

- The TIC sector is well placed to display continued resilience and growth in the face of political and economic uncertainty in 2018
- Capital expenditure is set to increase further as TIC players take advantage of the potential of new technologies to transform the sector, often by forging partnerships with specialist providers
- Other factors triggering growth in 2018 include further outsourcing of TIC functions by industry, tightening regulation in many fields and a growing need to ensure brand protection
- Multinational TIC operators are set to expand further into developing economies, chiefly through new acquisitions, with China a prime target
- Second-tier players are likely to be more acquisitive than the biggest businesses, which are now finding it more challenging to create value from new transactions
- Private equity-backed platforms will continue to be a prime source of new deals over the next two years
- With construction output earmarked to be broadly flat in 2018 and in the wake of the Carillion liquidation, TIC volumes will be impacted.



# About the authors



## Mike Leggo

Director & Head of TIC Sector  
Barclays

Mike Leggo is Head of TIC at Barclays Corporate, where he supports the growth strategies of clients in the sector via structured financing solutions and global treasury support. He has 10 years of experience covering the Business Services sector and has completed a number of key sector transactions involving both public and private companies. In Mike's role as a key Client Coverage Banker at Barclays he works with management teams looking to raise capital via Bank and Capital Markets. He is committed to the TIC sector and utilises industry expertise and a focus on long-term relationships to drive results.

M: 07500 953351\*  
[mike.leggo@barclays.com](mailto:mike.leggo@barclays.com)



## Mark Maunsell

Associate Director  
Business Services Market Intelligence  
Clearwater International

Mark is an Associate Director at Clearwater International, a market leading independent corporate finance house specialising in mergers and acquisitions, management buyouts and fundraising transactions. He has worked in M&A for over eight years and has been involved in a number of deals involving private equity, owner-managed businesses and corporates.

M: 07718 521201\*  
[mark.maunsell@cwicf.com](mailto:mark.maunsell@cwicf.com)



[barclayscorporate.com](http://barclayscorporate.com)

[clearwaterinternational.com](http://clearwaterinternational.com)

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