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Business Services Outlook 2015

A Deloitte Insight report



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Deloitte foreword



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Welcome to the Deloitte Business Services Outlook 2015 which examines current and anticipated trends likely to affect business services providers in 2015. Its aim is to inform strategic thinking in the sector and explain how the key issues for businesses will evolve over the next year.

The Business Services sector provides a significant contribution to the UK economy, accounting for 9.3 per cent of all UK economic output.¹ In addition, Small and Medium-sized Enterprises (SMEs) continue to play a strong and growing role in the sector. Government is encouraging greater involvement of SMEs and the amount of public sector business undertaken by SMEs has already risen by around £1.5 billion (20 per cent growth) since 2010. This is even more important alongside concerns that some business services providers are 'too big to fail'.

Diversity and longevity remain key strengths for many business services providers but these are offset by a number of challenges – the recurring concerns being how they will deal with pricing pressures, new competition, financing and the impact of change to regulations. In order to succeed, business services providers should focus on strategies relating to:

- evolving business models (through collaboration for delivery of complex services)
- a focus on cost management (to deal with pressures on providers from rising costs and tighter margins)
- the use of software enabled services (through technology-led innovations which help to tackle the skills gap and boost worker productivity).

Overall, we believe that business services providers can mitigate risks and benefit from the significant opportunities that remain by implementing these strategies. And the UK's leading capabilities and experience in the sector means providers are well positioned to export these skills overseas.

We hope you find our Business Services Outlook 2015 useful in your strategic thinking and look forward to discussing our analysis in more detail with you.

Byron Griffin
Partner
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BSA foreword



Mark Fox
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The BSA – Business Services Association – is pleased to collaborate with Deloitte on this comprehensive review of the Business Services sector.

The BSA is dedicated to representing the industry which operates across the private and public sectors. We promote the industry and the positive contribution it makes to the economy and society as a whole.

Business Services is a diverse and expanding sector. It can be broadly split into five areas – facilities management, construction services, business process outsourcing, IT and digital services and outsourced public services.

Although the outsourcing of public services receives the greatest media and political attention, only 30 per cent of the industry operates in this sphere. The remaining 70 per cent is business to business. However, operating across the sectors in this way gives the industry an important perspective allowing it to share best practice and develop expertise.

This is a service sector and is therefore people-based employing 3.3 million people – 10.2 per cent of all UK jobs. The continuous improvement of skills and training, and the trend of increasing professionalisation are central to the industry's success.

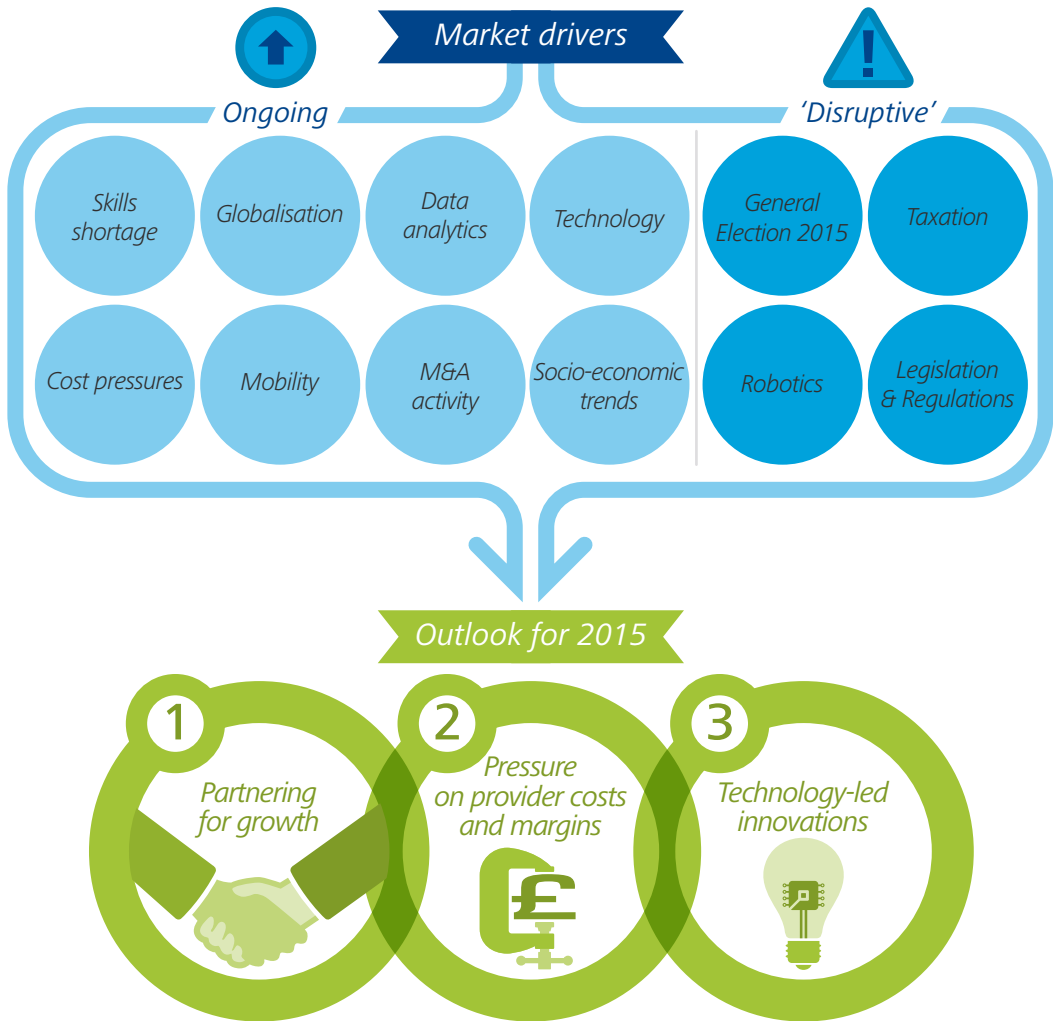
With such a testing economic and political environment, our sector must get used to instability and uncertainty. For businesses, the challenge is to embrace greater transparency and accountability to demonstrate the important role they play in generating wealth, creating jobs and driving efficiency. Business services providers of all sizes are vital to the UK economy and society too.

I believe the Business Services Outlook 2015 sets out clear strategies which will allow companies to help navigate the issues facing business services providers and take advantage of this growing market.

A handwritten signature in black ink, appearing to read 'Mark Fox', written in a cursive style.

Mark Fox
CEO
Business Services Association

Business Services Outlook 2015



The Business Services sector – where are we now?

The UK is a global leader in the provision of business services.² It has the most mature, sophisticated and largest outsourcing markets in the world.³ We have identified four key themes that defined the sector in 2014.

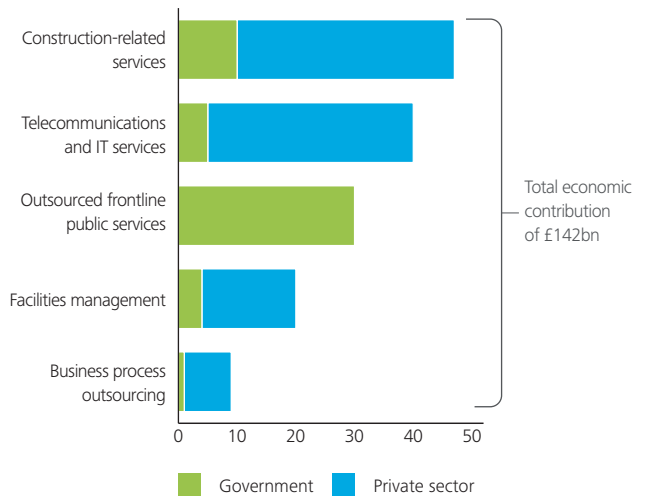
The Business Services sector is a key and growing constituent of the UK economy

Recent analysis quantified the significant economic contribution of the sector. Business Services accounts for 9.3 per cent of all UK economic output (£142 billion) and contributes around £16 billion per year to the Exchequer across the three main business taxes.⁴ The sub-sector with the largest economic value, in Gross Value Added terms, is construction-related services (accounting for 33 per cent of the total economic contribution), followed by telecommunications and IT services (28 per cent) and outsourced frontline public services (21 per cent).

Firms in the Business and Professional Services sector account for almost a quarter (24.5 per cent) of the 1,000 fastest growing companies with revenues between £30 million and £1 billion. This was a key finding from Deloitte’s latest *Businesses Leading Britain* report, which focuses on medium-sized businesses that have achieved above average growth rates.⁵

The Business Services industry employs around 3.3 million people, equivalent to over ten per cent of all UK workforce jobs.⁶ The sub-sector with the largest share of employment is managed public services which accounts for 10 per cent of all jobs in Business Services. Employees in this industry range from hi-tech engineering workers to operational workers. There are also approximately 30,000 apprentices. Indeed, the broad distribution across the UK has supported regional growth across the entire country.

Figure 1. Economic contribution of the Business Services sector, by sub-sector and buyer (government or private sector)



Source: Oxford Economics, Deloitte analysis

The market remains highly fragmented

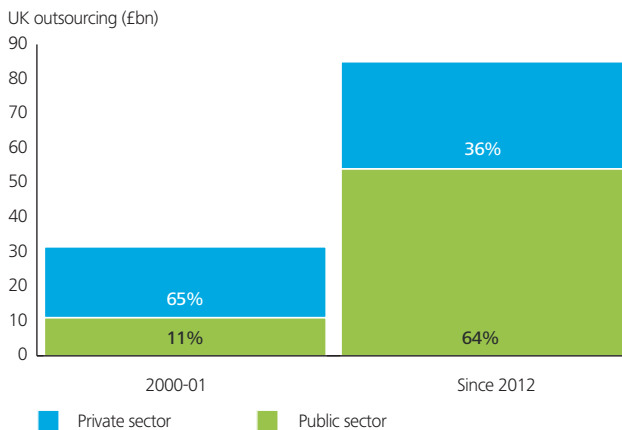
Whilst the market is often characterised by the larger and high-profile suppliers, it remains a highly fragmented market. Small and medium-sized enterprises (SMEs) make up a significant proportion of the industry – directly and through the supply chain. There are over 250,000 SMEs supported by business services activity across the country.⁷ Government is keen to encourage greater involvement of SMEs – the amount of business that government does with SMEs has risen by around £1.5 billion (20 per cent growth) since 2010.

Public sector contracts have driven growth in private sector outsourcing

In our recent report, *The State of the State 2014-15: Implications for private sector outsourcers*, we identified the ever increasing role of the private sector in the delivery of public services.⁸

The total contract value of outsourcing has soared over the past decade, and is now well over double the value in 2000. Growth in outsourcing spending has been driven by public sector contracts, which now account for around two-thirds (64 per cent) of the total market.

Figure 2. UK outsourcing, total contract values (£bn)



Source: Information Services Group, Deloitte analysis

The market for private outsourcing of public services is estimated to be around £90 billion. According to recent data, spending on outsourcing in the UK has doubled to £88 billion under the Coalition Government. Spending on outsourced services by the public sector has increased further in recent years. Indeed, the National Audit Office (NAO) estimated that contracting out now accounts for around half of the £187 billion that the public sector spends on goods and services each year.⁹

The nature of business services required by government is also changing. In future we expect services to cover more complex 'frontline' work.

However, as the nature of government services supplied by the private sector has evolved and grown, concerns that providers have become 'too important to fail' have also increased. This is because of the over-reliance on larger suppliers who are willing and able to take on complex procurement and delivery of public services.

Growth in a challenging market

We have analysed a portfolio of public company analyst reports to identify trends and market sentiment and capture the most common issues facing businesses in this sector. Surprisingly, the challenge of 'achieving growth' in revenues which has been significant in other recent market surveys – such as the *Deloitte CFO Survey*¹⁰ – appears to be less of an issue for these players in the Business Services sector. Although there remains an upbeat view of future revenue growth, there are a number of challenges that businesses face.

Recurring concerns for business services providers include how they deal with competition, how they manage financing and the impact of changes to regulations. The worry about competition includes coping with changes to the competitive landscape as well as pressures from competitive bidding. The second concern – financing – includes management of high debt levels, limited liquidity as well as lower returns from contracts. And, the concerns relating to regulations and compliance include the impact of stringent regulations, tighter legal issues and reforms in the sector.

Our view on the sector outlook is that business services providers should focus on strategies relating to evolving business models (through collaboration for delivery of complex services), a focus on cost management (to deal with pressures on providers from rising costs and tighter margins) and the use of technology (through innovation which help to tackle the skills gap and boost worker productivity and other areas).

Outlook 1: Evolving business models with more opportunities for collaboration in delivery of complex services

- There will be more opportunities for delivery of UK public services by the private sector.
- Application of new business models will be important to succeed in the evolving procurement process.
- Further consolidation in the market may be offset by the drive from government for greater involvement of SMEs.

Our recent report, *The State of the State 2014-15: Implications for private sector outsourcers*, identified an opportunity in applying new business models to succeed in the evolving procurement process in the public sector. This will involve collaboration to support reconfiguration of public services. Government should build on successful partnering models to manage the public sector's assets and services. Innovative hybrid models are already emerging: for example, new companies with employee ownership are being spun out of Government, based on private capital injections.

The outcome of the 2015 General Election will also have implications for how public services are delivered. The government elected in May 2015 will face an immediate choice of whether to continue the consolidation programme or offer an alternative, credible routemap to improve the public finances. More generally, there are concerns among organisations that government may not be able to cope with continued austerity beyond the May UK General Election.

Given the drive from government for greater involvement of SMEs and the voluntary sector in the delivery of public services, there is a growing opportunity for SMEs in this market. Greater competition may also be introduced to deal with the worry that some contractors are 'too big to fail'. There are already currently over 45,000 SMEs supported through the supply chain and this could increase if government continues to place importance on the role of SMEs and competition.¹¹

The next 18 months

Government has identified the importance of strong partnerships between the Professional and Business Services sector and the public sector. The Professional and Business Services Industry Council was set up to support UK growth and reinforces the benefits of working together.¹² Opportunities to collaborate should be maximised to benefit all and demonstrate value for money to end-users and the public purse. There are likely to be more opportunities for business partnering, although the appetite for this will be subject to the outcome of the May General Election given differences in the political stance of each party. Government is likely to continue reviewing the limits on the size and duration of contracts. Government will also need to make choices, considering the trade off between options for internal cost reduction, outsourcing, stopping services or allowing the deficit to continue.

Businesses will need to work with government to build on successful partnering models to manage the public sector's assets and services and will also need to assess the most effective ways to collaborate with other organisations. The Payment by Results model has been applied in many areas already, including housing services for older adults, employability, drug recovery and offender rehabilitation. Government will need to continue working with suppliers to develop outcome-based commissioning, especially through evaluation and best practice.

Although outcome-based pricing would provide greater transparency, it also presents additional risks which only the larger providers are willing and able to take on. At an extreme, the so-called 'death spiral' in the form of an ongoing price war could also erode margins and prevent others from entering the bidding process. However, the efficiency of large scale procurement and an increasing use of Payment by Results conflicts with the SME agenda and the desire to have a balance in the provider base.

Greater SME inclusion would be achieved through arrangements where there is a leading or managing agent who directly contracts with the client and is responsible for delivery on the contract terms through SME execution. This allows firms to formally collaborate – jointly bidding for and delivering work but without collectively forming a new entity.

“2015 will be a critical year for the new government as they manage the public sector's assets and services for best value. Business services providers will need to collaborate with government, and with other complementary organisations, in order to maximise their contribution to this agenda.”

David Merritt
Consulting Partner, Public Sector Outsourcing

Outlook 2: Pressures on providers from rising costs and tighter margins

- The biggest squeeze on margins will be due to input costs which we expect to increase further in 2015. This includes staff wages as well as broader cost inflation.
- Pressures will be partly offset by growing revenue opportunities.

As outlined in the context section, opportunities are set to increase for business services providers alongside growing demand in the UK and overseas. However, there are cost pressures that providers will need to face to protect margins while maintaining quality of service delivery.

This year is likely to see the first year of growth in real wages since 2009, according to the Office for Budget Responsibility.¹³ This will add to cost pressures in businesses across the economy but has bigger cost implications for organisations in this labour intensive Business Services sector. In addition, there is a skills gap that has developed. According to the *Chartered Institute of Purchasing and Supply*, there has been 15 months of sustained employment growth in Business Services – the longest since 2006-08 – which suggest a major skills shortage. There is also growing global mobility which means greater competition for a limited talent pool and therefore additional pressures on salaries. The ramifications of new regulation and other government policies relating to travel and subsistence schemes and holiday pay schemes will also have an impact on costs and other pressures among business services providers.

Providers' revenues are at risk as competition grows – with more suppliers and restrictive pricing structures from the public sector – and activity slows around the 2015 General Election. However, we anticipate that growth in potential revenue opportunities in the UK and overseas will offset these risks.

The next 18 months

Limited budgets and underlying cost increases will put further pressure on providers over the next year. Cost pressures mean that some businesses will struggle to innovate and invest and may face operational risks, which in turn could be exacerbated by tighter regulations. Some businesses will feel this squeeze on margins more than others so the risk of business failure may increase as it becomes harder for businesses to maintain healthy profits. However, in aggregate we believe that the volume of demand for business services will increase both in the UK and overseas. Therefore, we expect that these risks can be mitigated through effective cost control measures. The need for continued improvements in cost control and optimisation, particularly due to ongoing wage increases, will require businesses to focus on potential areas of synergies across the portfolio of contracts. This could be, for example, through measures focused on labour productivity and centralisation.

The growth in real wages and the impact of the 'living wage' may also adversely affect margins. This pressure means that even the bigger businesses in this sector will need to consider how best to deal with margin erosion and heightened contract risk through expansion of services while demonstrating value for money to clients. Nevertheless, with energy prices being a material element of business services providers cost base, the recent fall in oil prices, if sustained, could protect margins. Further to this, the use of the open book accounting methods – providing transparency and accountability for all parties – could also help to support margins in the short term.

Businesses will also need to assess their exposure to risks. They should consider which risks are/will be relevant, how much of the business they affect, what the potential impact could be, and how the business strategy should be amended. They should also consider how cost uncertainty could also be overcome by working in new ways such as focusing on higher value contracts or bundling contracts together to deal with lower margins.

This year we expect to see further consolidation in the market with further M&A activity. Many corporates have been performing well but with ongoing margin pressure and opportunities for global growth; M&A delivers scale, capability and geographic footprint and the resultant attractions of revenue and cost synergies.

“We expect to see more M&A activity within the sector. This will generate revenue and cost synergy benefits by delivering greater scale, capability and geographic footprint, easing the ongoing margin pressure and maximising opportunities for global growth.”

James Yearsley
Consulting Partner, Supply Chain

Outlook 3: Technology-led innovations help to tackle skills gap and boost worker productivity

- The UK's leading capabilities and experience in outsourced services means that UK businesses are well-positioned to export skills to the global market.
- There will continue to be greater use of data analytics or 'big data'.
- The potential for use of 'digital services' by businesses in this sector is growing.

There will continue to be greater use of data analytics and 'big data' across the Business Services sector. Computers can analyse and replicate thought processes of the human brain. They can also analyse much larger quantities of data. In addition, computers are less prone to error, and can operate 24 hours a day, every day. As organisations accumulate vast amounts of unstructured data, the processing power of computers can be used in a cost effective way. As well as these 'cheaper fingers' being used to generate efficiencies, they can also support the skills gap by supporting businesses in areas of limited capabilities and capacity.

There is an opportunity for greater use of 'digital services' in the provision of business services, using technology to change the way businesses operate. Deloitte research suggests that 88 per cent of UK citizens are open to conducting more of their interaction with the state online and the Government Digital Service continues to push the Digital by Default strategy forward. Government has more to gain from embracing digital and software enabled services than any other sector.¹⁴

We expect that computers and, over time, robotics will be used to take over repetitive and routine functions in the workplace where business services functions can be automated and where multiple technology systems are difficult to integrate. Developments in robotics and Artificial Intelligence are already transforming business operations and have the ability to take greater control of office processes. Use of Building Information Modelling is an example of efficient and appropriate collection of data for projects and collaborative working which involve employees in facilities management at the early build stage. It enables smarter working through off-site manufacturing support as well as identification and reduction of on-site delays, reducing costs and improving services.

More broadly, technology-led innovations have the potential to transform the way business services providers operate. We expect technological applications and robotics to gain momentum and become vital components in a number of applications within this sector, transforming the way the sector operates in the long term.

“Technology-led innovations have the potential to transform the way business services providers operate.”

Colin Clarkson-Short
Consulting Partner, Technology

The next 18 months

In the longer term, these innovations will evolve more radically. For instance, the concept of 'innovating to zero' – creating fail-proof systems that reduce the probability of unnecessary or unwanted outcomes to zero – could be applied across the Business Services sector.¹⁵ But in the short term we expect that further declines in production costs and advancements in technology will make these applications more accessible and more widely used across the sector. In the short term, it is unlikely that technological applications will dramatically affect worker productivity or pose a significant risk to jobs. However, employee skills requirements are likely to change substantially in the future.

Organisations will need to consider the potential of intelligent automation as a way of improving operational efficiency and quality standards, innovating and remaining competitive. However, they will also need to understand the implications of pursuing and prioritising technology investment as well as the impact in the workplace on future jobs, skills required and the likely return on investment.

The Business Services sector is an industry that could benefit significantly from technology-based innovation. Deloitte's *TMT Predictions 2015*¹⁶ predicts that, following several years of the consumer being the main force of technological change, there will be more enterprise-first adoption of technologies in 2015. We expect that business services providers that focus on this in the next year will outperform competition in the long term.

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Endnotes

- 1 *Economic Contribution of Business Services*, BSA and Oxford Economics, January 2015.
- 2 The Business Services sector includes organisations and employees focused on economic activity in the following areas: business process outsourcing, construction and infrastructure services, facilities management services, information and communication technology and managed public services.
- 3 Speech by Suzanne Baxter, Business Services Association (BSA), at the BSA Annual Dinner November 2014.
http://www.bsa-org.com/uploads/article_attachment/file/69/BSA_Annual_Dinner_Speech_2014.pdf
- 4 *Economic Contribution of Business Services*, BSA and Oxford Economics, January 2015.
- 5 *Businesses Leading Britain 2014. A new lens on growth*. See <http://www2.deloitte.com/content/dam/Deloitte/uk/Documents/uk-futures/deloitte-uk-a-new-lens-on-growth.pdf>
- 6 *The UK Market for business services*, BSA and Oxford Economics, January 2015.
- 7 *Outsourced Services Industry – An Engine for Sustainable Growth*, BSA, November 2011.
- 8 *The State of the State 2014-15: implications for private sector outsourcers*, Deloitte, November 2014.
- 9 *The role of major contractors in the delivery of public services*, 2013. See also: <http://www.nao.org.uk/wp-content/uploads/2013/11/10296-001-Delivery-of-public-services-HC-8101.pdf>
- 10 The Deloitte CFO Survey is a survey of major corporate users of capital that gauges attitudes to valuations, risk and financing.
See <http://www.deloitte.co.uk/cfosurvey>
- 11 Based on BSA research of suppliers to full BSA members – see BSA Policy Manifesto.
- 12 *Growth is Our Business: A Strategy for Professional and Business Services*, Department for Business, Innovation and Skills, July 2013.
- 13 *Office for Budget Responsibility*, see <http://budgetresponsibility.org.uk/>
- 14 *Making Digital Default*, Deloitte LLP, April 2014.
- 15 See <http://government-2020.dupress.com/driver/robotics-technology/>
- 16 *Technology, Media and Telecommunications Predictions 2015*, Deloitte, January 2015.

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