Investing in a professional firm

Most investors are unfamiliar with the key drivers behind a successful professional firm, and unsure what measures to track. Neasa MacErlean explores current attitudes amongst investment professionals towards investing in the professions.

Professional firms may rank at the top in the terms of career status, but as investment prospects they are currently outstripped by spare parts manufacturers, copper miners and other companies that fall neatly into the usual stock exchange business sectors.

And those pioneering firms that have decided to present themselves to the capital markets by listing have sometimes paid a price for their daring. "There are some investors who got burnt a few years back who say they are never going into those stocks again," says one analyst. He is referring to a firm which overstretched itself in its first couple of years after listing, giving its investors something of a white knuckle ride as its profits went south (before getting a grip on itself again).

There are too many question marks about professional firms in general to make them an easy group to invest in from a professional investor's point of view. "The firms tend to be smaller companies listed on AIM," says Adrian Lowcock, senior investment adviser at Bestinvest, a firm which speaks to managers of 400 investment funds a year. "Then the question is whether they can grow, as well as being professionals in their field. At the moment there is still a long way to go before there are any special funds for them."

Independent financial adviser Hargreaves Lansdown administers £10billion of investment assets on behalf of private clients but it looks very little at the professional firm sector. Investment analyst Ben Yearsley says: "Professional firms are probably quite different. It is quite hard assessing them. They are very people-centric. Ultimately, it doesn't matter massively who works in Sainsbury or Tesco. But if half the people decide to go from a firm of architects it could ruin the business."

But despite all these negative points, there are encouraging signs ahead. Some of the listed firms are doing well – even now in the midst of the recession. "Tenon and Vantis are perceived reasonably well," says Ben Archer of the top-ranking AIM analysts team at stockbroker Charles Stanley. He talks about both these accountancy businesses knowledgeably and obviously thinks it worth his while to stay up to date on them.

Accountancy firms obviously should have a natural ability to deal with some of the financial demands of being listed. Vantis has a record of accurately predicting its income – something which it has done for all its 13 six-monthly reporting periods since listing. This kind of consistency of projection is taken by analysts as a sign of a well-run firm and is respected. Analysts agree that professional firms (albeit with the obvious exception of property professionals in property crashes) could have extra value as counter-cyclical stocks. "They are recession-proof to some extent," says Laith Khalaf, pensions analyst at Hargreaves Lansdown. "The number of people divorcing goes up in a recession."

Pension funds are obvious potential investors in firms. The Royal Mail Pension Trustees own 3.33 per cent of Vantis, for instance. About 55 per cent of funds held in employers "defined benefit" pension schemes are held in equities. Although that proportion is decreasing (as pension funds are becoming more cautious), pension funds "are

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looking for diversification”, says Khalaf. For example, they got into hedge funds fairly rapidly as a way of hedging their risks when that market opened up (even if they might regret it now). Stocks which could be seen as cautious are attractive to them. Khalaf expects an increase in pension investment soon – as employers will be required to enroll all staff (except those who actively ask to opt out) into pension schemes from 2012. Khalaf says: “An estimated seven million new workers will be investing in a pension; that money will be invested in a managed fund and will need to be parked somewhere.” Professional firms could be an interesting home for some of the extra annual £13billion of pension contributions which are likely to come from these seven million employees.

A lot will depend on whether fund managers and their advisers believe the likes of Paul Jackson of Vantis when he says “Accountancy firms do have high quality earnings”. John Cowie, head of AIM in the corporate finance team of fellow accountant Smith & Williamson, certainly agrees: “This is a particularly interesting sector. These are very solid businesses.” Het Marsh, ISIS fund manager for the Baronsmead AIM VCT (Venture Capital Trust) is a much-watched investor in small listed businesses. She says: “Many professional services businesses are working in areas of long term growth, driven by increased complexity of the global economy and regulation. These are attractive attributes for investment.”

If the professional firms sector stayed as it currently is – 70 firms in total spread across various different ICB (industry classification benchmark) categories in the FTSE – then it would take a long time to attract new investors. But two things about those firms are going to change. The first is that a Professional Services Index will clearly help them be analysed as a group. Currently their Price/Earnings ratios range from 3.01 for PR and advertising company Chime Communications to 40.09 for online data research company Toluna, with a median of 9.14. Most of their PEs are in the range of 5 to 20 but Alex Magni, head of research at Noble Group which has compiled the Index, thinks that that this will “very possibly” narrow. He explains: “Professional firms are still looked at by analysts in different sectors. That is one of the bits of inertia that the Index may help to overcome. It is important to catch the imagination of fund managers.”

The second change is that, as time goes by, more professional firms can expect to be listed. That will make this sector a group that can become understood in its own right, rather than just being the appendages of other sectors. “There is always value in having more peers to compare companies to,” says Ben Archer of Charles Stanley. Adrian Lowcock says that more companies have to list before professional firms will be a coherent group. “You need a range of firms that are reasonably large,” he says. “You probably need consolidation in the industry.”

With the Clementi reforms expected to come through in the law from 2011 or 2012, that kind of restructuring in the legal profession will begin to occur. John Cowie of Smith & Williamson says: “That will be a very exciting time. The investment community should be licking its lips and seeing who is going to come to the market first.”