It’s Time to Buy the Ultimate Service Stock No One’s Heard of

Description

A little over a year ago **FirstService Corporation** (TSX:FSV)(NASDAQ:FSV) and **Colliers International Group Inc.** (TSX:CIG)(NASDAQ:CIGI) were split into two publicly traded companies. Colliers would handle the sexier commercial real estate services and advisory business, while First Service would be responsible for its residential property management division and the various property services franchises it owns across North America.

FirstService’s management and board felt at the time that investors would be better served if the two companies were separated to focus on each of their businesses—free to pursue their own strategies.

Since the separation, FirstService’s stock has delivered a one-year return of approximately 80%, while Colliers, its former stablemate, has been relatively flat over the same period. If you were a FirstService investor before the split, I hope you kept your shares because you would have done very nicely indeed.

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If you didn’t hang on to your shares or never owned FirstService stock in the first place, it’s not too late to get in on the action, despite its stock being relatively expensive from a valuation standpoint. Quite simply, it pays to be of service.

Recurring revenue

Approximately 80% of FirstService revenue is generated by its property management division, whose revenues in fiscal 2015 were greater than US$1 billion—or more than double its nearest competitor. At last count, FirstService Residential had management contracts with 7,500 residential communities in the U.S. and Canada, representing more than 1.6 million units ranging in property type from condominium to lifestyle community to master planned single-family home communities.

The most important thing about this business? More than 95% of the management contracts are retained from one year to the next, providing an extremely stable cash flow.

Home improvement market is still hot

Try telling a homeowner in Toronto or Vancouver that home improvements aren’t an important part of maintaining and increasing the value of your house and you’ll likely get laughed off the premises. Whether here in Canada or in the U.S., homeowners are spending their disposable cash on renovations on their homes now more than ever. Investors need to look no further than **Home Depot’s** recent results for evidence of this.

FirstService Brands’s companies, such as CertaPro Painters, participate in huge markets where industry consolidation hasn’t taken hold as of yet. In the U.S., commercial and residential painting is a US$40 billion market annually, and CertaPro is number one in market share—with just 1%. There’s a lot of opportunity for growth here. With its current business model skewed toward company-owned operations, which generated 68% of its US$340 million in revenue in 2015, acquisitions immediately accretive to earnings could become the norm.

Drive higher margins

Given its ability to drive top-line growth in both businesses, investors will be glad to know that its size and overall competitiveness also enables it to extract greater efficiencies and cost reduction from both segments of its business. In its first quarter ended March 31, FirstService generated a 36% year-over-year increase in adjusted EBITDA on a 13% increase in revenue.

FirstService Residential, the segment generating 80% of its overall revenue, managed to increase adjusted EBITDA in Q1 2016 by 25.8% on an 11% increase in revenue. FirstService Brands delivered a 146% increase in adjusted EBITDA on a 25% year-over-year increase in revenue.

While FirstService Brands is clearly the smaller of its two segments, it could be the engine that drives growth in the future should the right acquisition opportunities come along. In the meantime, its two segments are generating growth organically and, more importantly, profitably.

Why pay 20 times EBITDA?

That’s a very good question.

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FirstService currently has a market cap of $2.1 billion based on approximately 36 million shares outstanding. In 2015 it had an adjusted EBITDA of US$103 million—hence, a multiple of 20 times. However, that US$103 million was in American greenbacks. At the end of December that translated into CAD$143 million, or a much more amenable multiple of 15 times adjusted EBITDA.

Organically and through acquisitions, I don’t see why it can’t double its adjusted EBITDA over the next five years to US$200 million or more. Management sees low double-digit revenue growth in 2016 and high single-digit adjusted EBITDA. If it does this for five consecutive years—let’s say 12% compound annual revenue growth and 9% adjusted EBITDA margins—FirstService will hit US$200 million right on the number.

If so, the odds are good its market cap will double as well.

CATEGORY

1. Investing

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1. TSX:FSV (FirstService Corporation)

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