Sharemarket darling Vocation hits some speed bumps

Australian Financial Review, Michael West, August 21, 2014.

There's good money in government grants. Of the $7 billion which Australian governments shell out for vocational education and training, Vocation Limited expects to pick up around $100 million this year.

Vocation is a sharemarket darling. Having floated last December at an issue price of $1.89 its share price has shot up to $3 as the company embarked on a fast-growth "roll-up" strategy; that is, snapping up rival businesses in the vocational education and training (VET) sector across the nation.

The market has seen many a roll-up before. Suburban accounting practices, sleep clinics and digital marketing businesses mightn't look like they've got much in common. But any broker with enough lunches under the belt will regale you with stories of fortunes won and lost in rollups, where the promise of turning a collection of small businesses into a corporate powerhouse went off the rails.

Some make it. Toll Group in transport or QBE in insurance – veteran, prolific merchants of the takeover and bed-down of acquisitions. Juniors such as Greencross and G8 Education have gone from strength to strength in veterinary practices and education services respectively.

Yet the path to success is littered with the corpses of roll-ups: ABC Learning, Ion, Stockford and Austrim but to name a few. Quick-fire acquisitions can blow up a company as surely and quickly as they can ramp up a stock price.

The rollup formula is to identify a nascent industry; ideally one awash with easy taxpayer dollars to snag or a sector dotted with family businesses likely to change hands on low earnings multiples. Next, the trick is to pull the collection of small businesses together and convince institutional investors that every one of them is a sure enterprise which is destined to thrive in a listed company structure. Once listing is accomplished on the ASX, the slather of acquisitions on low multiples fuel the perpetual growth story.

The growth story is often compelling and the market can price the roll-up on a ritzy multiple due to anticipated growth. On its pro-forma net profit estimates of $19.6 million for 2014 for instance – the annual result is due today – Vocation is now valued by the share market at more than $600 million. Clearly 2015 is expected to be a humdinger.

There is quite a bit that can go wrong though for any stock which is on a non-stop acquisition trajectory. If the spending binge is fuelled by debt, a decent credit crunch can bring things crashing down. Sometimes the problem is that small businesses which relied on an "owner driver" don't do so well once the owner has sold and hit the golf course.

For Vocation, the critical question is whether taxpayer largesse for vocational training will continue. This neat little IPO promoted by Macquarie and UBS, and backed by former Macquarie bankers John Prendiville and Michael Carapiet, was pulled together late last year. They raised $253 million in the float, IPO costs came to an eye-boggling $21.6 million and some $225 million went to the founders.

Vocation is a rollup of Registered Training Organisations (RTOs) and its earnings come by wringing every drop out of government policies to invest in a job-ready population. In Victoria, student fee contributions are low – sometimes approaching zero – and the state chips in the lion's share of course costs when students sign up. Government payments are received monthly pro rata with completion of modules. It makes for an enticing working capital profile.
Key to the IPO pitch was that stellar growth from Vocation's star Victorian business, BAWM – itself a roll-up of three VET businesses - could be replicated across the country as other states followed the

Victorian contestable ‘demand driven’ funding model. That there were some 500 vocational training businesses receiving government funding in Victoria alone presented endless acquisition opportunities.

Under the Victorian model, government-supported places in vocational training courses such as warehouse operations and process manufacturing are uncapped. Students can take up to two vocational education courses to improve their employment prospects, largely funded by the taxpayer.

Thanks to government funding contracts, the BAWM business has grown exponentially in recent years. It seemed the only constraint on growth was the business’s ability to persuade students to fill out their enrolment forms - not a herculean ask when students didn’t have to reach into their own pockets.

In 2012 alone BAWM increased Higher Education and Skills Group (HESG) and Victorian Training Guarantee revenues from $2 million to $27 million. Since then this number may have more than doubled. The business delivers substantial operating leverage with very fat margins as revenues ramp up, particularly without the need for heavy investment in headcount and infrastructure.

Despite the stellar growth - the chatter in the Victorian training sector is that BAWM’s founders led the industry with their extensive knowledge of how to get the best out of government regulations and subsidies – there is speculation the group may be encountering some speed bumps.

The HESG put in place new rules during 2013 and early 2014 to try to improve the quality of outcomes for students undertaking courses which were largely funded by the taxpayer. A massive blow out in the Victorian government’s budget for funded vocational training was also a concern along with ‘tick and flick’ and ‘channelling’ by savvy providers knowing how to game the system.

In 2012 Victorian funding contracts allowed “auspicing” (subcontracting) arrangements which meant BAWM could essentially rent its funding contracts to non-Registered Training Organisations (RTO) which would conduct the training courses. The RTO holding the funding contract and the service provider – many of these being non-RTO’s – would share the spoils of the government subsidy. In doing so, BAWM would not incur large fixed costs as its revenues ramped up. Auspicing allowed BAWM to expand its business and grow revenue far more quickly than would otherwise have been possible if it had to provide the training courses itself internally.

According to the Vocation prospectus, auspicing was expected to deliver 36 per cent of the group’s earnings in financial year 2014. Interestingly, auspicing (in the funded VET sector) is banned in South Australia while NSW and QLD have adopted a cautious stance towards the practice.

The rules on auspicing in Victoria however have since been tightened. From 2014, the HESG closed a loophole that allowed unlimited subcontracting to non-RTOs. Now, prior written approval of the HESG is required for any non-RTO providing a course that was supported by taxpayer funded subsidy.

But with Vocation delivering its first full-year result as a listed company today, investors would do well to ask how the rule-changes around auspicing are affecting BAWM, and whether BAWM’s auspicing has been compliant. Shareholders are likely to ask for certainty as to whether there has been any investigation into the practice and whether any of BAWM’s funding contracts have been suspended. The informed speculation in the sector is that there may be issues with BAWM’s auspicing.

Some of BAWM’s auspicing partners such as Edge Workforce’s websites have been recently taken off the air, according to google searches yet further searches of its other partners such as Skillstowork, 3vtraininggroup, thetrainingbase and nei.net.au suggest auspicing remains rife. Nobody from the company was available to respond to questions from Fairfax Media yesterday and the relevant government departments such as Victoria’s Department of Education and Early Childhood Development and the Commonwealth’s Australian Skills Quality Authority offered no comment.

Compounding any issues BAWM might have, only two weeks ago it was left off the list of approved providers of Victorian government subsidised Foundation Skills training for disability specific courses under the 2014 VET funding contract. This program is one of the highest subsidised programs on a per hour basis and unlike most of BAWM's other courses it offered in 2013, this was one of the few courses which had suffered no material cuts to its subsidy in 2014. BAWM's course offerings have generally suffered a 25 per cent subsidy cut this year according to stockbrokers who follow its parent Vocation.

Without the state and federal subsidies it is almost impossible to enrol new students in courses. Are there any more opportunities for BAWM to evaluate, or as one broker put it "loopholes to exploit"?

If the group's funding had been cut in this area could they have approached reputable 'not for profits' to rent their funding contracts and feed BAWM's students through them? This is the rumour and it would equate, effectively, to a reverse in its business model that is said to have drawn the interest of supervising government agencies in the first place.