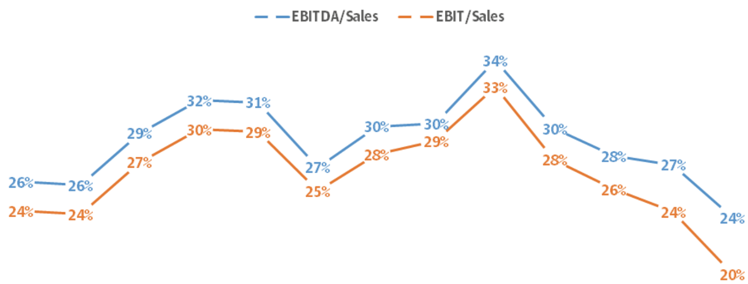
SINGULAR DILIGENCE

HomeServe (HSV)

HomeServe (LSE: HSV)
Stock Price: 298p



	EV/Sales	EV/Gross Profit	EV/EBITDA	EV/EBIT	EV/Owner Earnings
Centrica PLC	0.89	3.79	5.24	8.32	8.32
Life Time Fitness	2.73	6.55	8.51	12.47	10.55
Ituran Location and Control	2.89	5.85	9.40	13.76	13.76
ADT Corp	3.45	5.91	6.72	15.06	15.06
Lifelock	4.77	6.71	56.04	68.11	11.39
Minimum	0.89	3.79	5.24	8.32	8.32
Maximum	4.77	6.71	56.04	68.11	15.06
Median	2.89	5.91	8.51	13.76	11.39
Mean	2.95	5.76	17.18	23.54	11.82
Standard Deviation	1.25	1.04	19.48	22.40	2.38
Variation	0.43	0.18	1.13	0.95	0.20
HomeServe	1.64	NMF	6.93	8.28	10.28

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	Min	Max	Median	Mean	Standard Deviation	Variation
Sales	43	56	81	100	128	161	192	263	284	379	467	535	547	43	547	192	249	181	72%
Gross Profit																			
EBITDA	11	15	24	32	40	44	57	79	97	113	130	145	129	11	145	57	70	48	68%
EBIT	10	13	22	30	38	41	54	76	92	104	119	128	108	10	128	54	64	42	66%
Receivables					89	108	143	176	200	221	241	269	292	89	292	200	193	70	36%
Inventory					4	4	6	8	9	5	1	2	1	1	9	4	5	3	60%
PP&E					20	25	34	40	39	34	36	38	35	20	40	35	33	7	20%
Working Liabilities					87	107	147	181	204	206	215	227	237	87	237	204	179	54	30%
Net Tangible Assets					27	30	37	43	44	53	64	82	92	27	92	44	52	23	44%
MARGINS																			
Gross Profit/Sales																			
EBITDA/Sales	26%	26%	29%	32%	31%	27%	30%	30%	34%	30%	28%	27%	24%	24%	34%	29%	29%	3%	0.10
EBIT/Sales	24%	24%	27%	30%	29%	25%	28%	29%	33%	28%	26%	24%	20%	20%	33%	27%	27%	3%	0.12
TURNS																			
Sales/Receivables					1.43	1.49	1.34	1.49	1.42	1.72	1.94	1.99	1.87	1.34	1.99	1.49	1.63	0.25	15%
Sales/Inventory					28.90	41.96	29.67	34.75	32.61	72.61	316.68	305.54	420.38	28.90	420.38	41.96	142.57	157.50	110%
Sales/PPE					6.49	6.53	5.59	6.51	7.34	11.25	13.08	14.07	15.44	5.59	15.44	7.34	9.59	3.85	40%
Sales/NTA					4.80	5.44	5.22	6.13	6.49	7.09	7.30	6.50	5.96	4.80	7.30	6.13	6.10	0.84	14%
RETURNS																			
Gross Profit/NTA																			
EBITDA/NTA					151%	147%	156%	184%	223%	211%	203%	177%	140%	140%	223%	177%	177%	30%	0.17
EBIT/NTA					141%	138%	146%	176%	211%	195%	186%	156%	117%	117%	211%	156%	163%	31%	0.19
GROWTH																			
Sales		30%	44%	23%	28%	26%	19%	37%	8%	34%	23%	14%	2%	2%	44%	25%	24%	12%	0.50
Gross Profit																			
EBITDA		29%	64%	33%	27%	8%	31%	38%	23%	15%	15%	12%	-11%	-11%	64%	25%	24%	19%	0.78
EBIT		29%	66%	33%	27%	9%	31%	42%	22%	13%	14%	8%	-16%	-16%	66%	24%	23%	20%	0.88
Receivables					-2%	44%	24%	22%	6%	14%	5%	18%	1%	-2%	44%	14%	15%	14%	0.98
Inventory					-71%	188%	27%	9%	20%	-90%	111%	-25%	-27%	-90%	188%	9%	16%	87%	5.55
PP&E					-10%	64%	24%	13%	-19%	-5%	17%	-3%	-11%	-19%	64%	-3%	8%	26%	3.29
Working Liabilities					-13%	65%	21%	25%	2%	0%	8%	4%	6%	-13%	65%	6%	13%	22%	1.71
Net Tangle Assets					13%	9%	37%	2%	2%	42%	4%	53%	-15%	-15%	53%	9%	16%	23%	1.38

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SINGULAR DILIGENCE

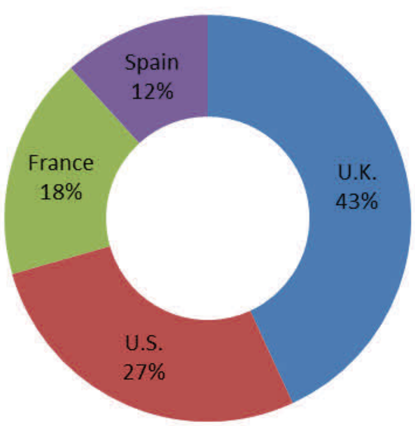
Geoff Gannon, Writer | Quan Hoang, Analyst | Tobias Carlisle, Publisher

HomeServe (LSE: HSV): A Direct Marketer of Plumbing Insurance

OVERVIEW

HomeServe provides plumbing and drainage insurance. When a policyholder has an emergency such as a burst pipe or a blocked drain, HomeServe arranges for a plumber to arrive at the policyholder's home and fix it. HomeServe also offers insurance on pipes running from the street to the policyholder's home. These pipes rarely need to be replaced. HomeServe is only able to market this product by informing customers that pipes running from the street to their house are the homeowner's responsibility rather than the town's responsibility. HomeServe informs potential customers of this fact mostly through direct mailings.

HomeServe is not an insurance company. HomeServe sells an insurance product, but the company keeps no insurance risk on its own books. Instead HomeServe handles the non-financial aspects of an insurer's business. HomeServe manages a repair network made up of its own employees, franchise employees, and third party contractors. The company performs its own claim handling. And, most importantly, HomeServe handles its own marketing. Although HomeServe appears to its customers as an insurance company, the economics of the business are really that of a direct marketer and claims handler. Customer behavior is similar to that of many insurance products. The customer acquisition cost is high. The cost to maintain a customer is very low. And the retention rate is extraordinarily high. The retention rate of a HomeServe policyholder depends on the way in which the premium is billed. Retention rates average about 80%. However, retention rates are as high as 90% when HomeServe's customer is billed directly on the statement of the utility partner HomeServe uses to market its service. These utility partners are critical to HomeServe's business. That is why HomeServe needed South Staffordshire Water as its first investor. It is also why the company takes such a long time to profitably enter a new market. The initial problem is never signing up new policyholders. It is signing up the utility partners that will provide HomeServe a way of marketing to those potential policyholders. HomeServe's home market is the U.K. It remains HomeServe's biggest market. Utility partners are the reason for this success. HomeServe calls the households a utility they partner with serves an "affinity partner household". These homes are the targets of HomeServe's huge direct mailing campaigns. They also provide the call lists for the company's and its partner's outbound call centers.



Only 43% of HomeServe's customers are from its home market

HomeServe divides its business along country lines. The company has an established business in 4 countries: the U.K., U.S., France, and Spain. HomeServe is trying to develop new businesses in Italy and Germany. The company recently exited Belgium after failing to sign up the partners it needed there. HomeServe expects to lose 6 million Pounds a year for at least the next several years on its efforts to enter Germany and Italy. These initial losses are not surprising. HomeServe now has profitable businesses in France and the U.S. It took the company 4 years to break even in France. The U.S. business lost money for 6 years. Last year, France contributed 22 million Pounds of operating profit and the U.S. contributed 10 million Pounds of operating profit. It could have delivered a lot more profit if HomeServe were not determined to grow that American business. This is the most important fact for an investor to understand about HomeServe.

At its heart, HomeServe is a direct marketing and claims handling business. A customer pays a premium. Part of this premium goes to paying the sales tax in that country. Part of the premium goes to paying an insurer to underwrite the risk. Another part goes to the utility partner as a commission. This commission which is often 5% of the premium is risk free from the utility's perspective. The utility gives HomeServe the ability to use its customer list, to use the utility's brand in communications with the customer, and in some cases to bill the customer as part of the regular utility bill. When all of these factors are present at once the result is a powerful marketing combination. Retention rates are around 90% when the policyholder is billed directly on their utility statement. Across all of HomeServe's businesses the retention rate now averages 82%. This means the average HomeServe customer stays with the company for five years. The company targets a maximum customer acquisition cost payback of 3 years. To understand the case for HomeServe stock, you must understand these figures. HomeServe's existing customers are very valuable. However, HomeServe's potential customers are very expensive to acquire. The revenue per customer in the U.S. is now well over $100 a year. HomeServe reported 9% of this U.S. revenue as income last year. In other words, HomeServe reported it was making no more than $10 per customer per year in the U.S. The reality is that they are probably making about $30 per existing customer per year in the U.S. and then spending most of that profit on getting additional American policyholders. Because the payback period for customer acquisition is much longer than one year, HomeServe reports much faster revenue growth than operating profit growth during rapid customer growth in a national market. The U.S. is now the country where HomeServe is adding the most new customers each year. Last year, HomeServe added 700,000 new policies in the U.S. Due to normal customer attrition this gross gain of 700,000 policies led to a net gain of just 400,000 policies. The greatest expense of these added customers is the initial customer acquisition cost. Actual loss expense is less than half the cost of a policy.

HomeServe is not an insurer so it does not report a combined ratio, expense ratio, or loss ratio. However, if HomeServe did report its results in that way, it would show a loss ratio under 50. A low loss ratio combined with high customer retention rates makes the acquisition of new customers a good long-term investment. For that reason, HomeServe plows most of the money it makes in a market like the U.S. right back into additional marketing. This leads to high rates of customer growth. However, the customer acquisition cost is expensed entirely in the year the customer is added. The high profit contribution comes in later years as the customer renews without any marketing expense required to keep them. Last year, HomeServe grew its U.S. customers by 25% while increasing the number of "affinity partner households" by just 3%. This increased penetration rate is very expensive to achieve at first and very profitable to have in later years as customers renew.

HomeServe once had an EV/EBITDA ratio over 15. Today, that number is closer to 7. This 50% reduction in the company's price is due to HomeServe's shrinking U.K. business. HomeServe combines two businesses: direct marketing and claims handling. The direct marketing business has been effectively frozen in the U.K. because HomeServe is under investigation by the Financial Conduct Authority. When HomeServe committed its violations in the U.K. it had about 3 million customers. That number has now shrunk to 2 million customers. The loss of 1 million customers is almost entirely due to HomeServe stopping its marketing in the U.K. while it negotiated with the Financial Conduct Authority and retrained its staff in new procedures it felt the Financial Conduct Authority approved of. HomeServe has been in "daily contact" with regulators in the U.K. The company has set aside reserves to repay customers who were mistreated and to pay a fine to the Financial Conduct Authority. Those are small problems compared to the cost of almost entirely shutting down its marketing while it developed new procedures that would not violate U.K. rules. While the U.K. business was shrinking the U.S. business grew. As a result, HomeServe now has more customers outside the U.K. than inside the U.K. In 2015, HomeServe will get most of its profit from outside the U.K. Two years from now will be the first time that happens. It will not be the last.

DURABILITY: *HomeServe is an Aggressive Direct Marketer with a History of Regulatory Problems*

HomeServe sells an insurance product that most households will never have nor will they ever want to have it. This is similar to the home security alarm business. In the United States about 19% of households have a home security alarm like ADT. Most do not. And most never will. But this penetration rate of around one fifth of households is more than enough to support a very profitable market leader in ADT. HomeServe's penetration rate across the U.K. is about 9%. In the U.S., HomeServe averages an 11% penetration rate among customers of its water utility partners. These are the companies that allow HomeServe to use their brands, customer lists, and (sometimes) billing to approach and then charge customers.

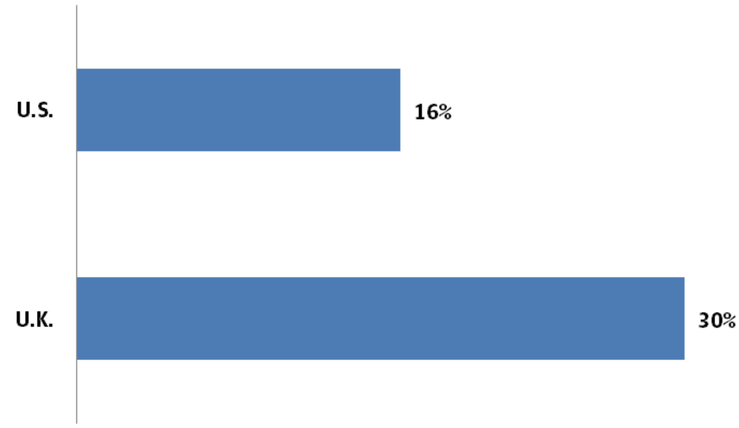
Customer awareness of home emergency repair insurance is low. Only 16% of American households have home emergency coverage. In the U.K. that number is 30%. Again, this is comparable to a home alarm system where about 19% of households in the U.S. have coverage. The service must be pushed on customers. It has to be marketed directly to them. That is why HomeServe markets through utility partners. The most profitable way for HomeServe to add customers is simply to add its insurance product on to the utility bill of a water or electricity customer. In most countries, HomeServe sells more water coverage than anything else. Its most effective sales tactic is sending direct mail to customers of a utility partner. The high cost of acquiring new customers shows the lack of demand from the public generally.

HomeServe has to educate potential customers about the service and what it can do for them.

Direct marketers often face problems with regulators because of their aggressive marketing. Over the last few years, HomeServe lost 1 million customers in the United Kingdom while trying to sort out its violations. The same problem could happen in other countries. In the United States, HomeServe has been contacted by the Attorneys General of several states. In the U.S., HomeServe is likely to deal with regulators on a state by state basis because of the service they provide and the way it is regulated. The biggest risk to HomeServe is not the direct costs of this regulation. The kinds of fines HomeServe expects to pay in the U.K. and the costs of compliance and refunds to customers are small relative to the long-term value of a strong market position in the U.K. HomeServe's U.K. business is asset light, cash generative, etc. It can easily handle the direct costs of consumer protection. That is not the problem. The problem is the loss of a million customers. That problem occurred for a very simple reason.

HomeServe froze its direct marketing in the face of regulatory pressure. The plan is to resume that marketing in a different way. The company is already ahead of schedule in adding gross U.K. customers again. However, this episode highlights the biggest issue when discussing the long-term durability of HomeServe's business. The service itself is durable. Existing customer relationships are durable. Even when there was significant negative publicity in the U.K., the company never retained less than 78% of its existing customers in any one year. Retaining customers is very easy. Adding customers is hard. It is only possible to add customers at all because of the way HomeServe markets its coverage.

The 2 big risks HomeServe faces are the loss of key utility partners and severe restrictions on direct marketing. HomeServe is not immune to either risk. However, the company is now diversified against both risks. Regulation is done country by country in most of the world. In the U.S., the regulation of a direct marketer of insurance products is handled state by state. Any changes forced on HomeServe in the U.S. will come from agreements with state Attorneys General or as a result of class action lawsuits. The chance of severe national restrictions on the company's marketing tactics in the U.S. is low.



HomeServe's U.K. marketing led to a 30% rate of home emergency coverage

HomeServe's business model is durable if its marketing is sustainable. The marketing certainly works the way it had been done in the U.K. It also worked in France and the U.S. The U.S. is probably the most durable or at least the most certain market for HomeServe over time because of how large and disorganized the U.S. is. Utilities are not consolidated nationally in the U.S. Water companies are very local. There are 21 water utilities in the United Kingdom. In the U.S. there are more than 1,300. HomeServe has utility partners in the U.K. that give it access to 92% of British households. The company now has access to just 17% of American households. And yet the absolute number of households they can now sell to in the U.S. is roughly equal (at 22 million) to the households they can reach in the U.K. So HomeServe's business is more durable to the extent it has diversified across more countries and more utility partners.

Marketing is a different story. HomeServe has been fined before. The company paid a 750,000 Pound fine to the U.K. communications regulator for excessive cold calling. In 2011, just 3 days after a visit from the Financial Services Authority, HomeServe suspended all of its telemarketing staff in the U.K. for 6 weeks. HomeServe's U.K. problems fall in two categories. One, the company overpromised and under delivered in the very cold winter of 2010 to 2011. This left some policyholders without heat, with frozen pipes, etc. There were many complaints. This shows a failure of the repair network. This problem was severe for the customers who were left without the quick emergency repairs they needed. However, it is a small and fixable problem long-term. HomeServe was a fast growing company at the time. It was an unusual winter. A mistake like that damages the HomeServe brand. But it does not threaten the basic business model. The company's retention rate stayed above 78% throughout all these problems. And much of HomeServe's business around the world is delivered under the names of utility partners. As long as those partners choose not to drop HomeServe and existing customers choose to stick with the service, these kinds of problems are one time errors. Repaying customers is costly. But it is not a threat to HomeServe's future. Many customers do not associate their coverage with the HomeServe name. The marketing problem is the biggest threat to HomeServe's future. This service has always been marketed aggressively. Attempts at cross-selling additional policies to existing customers are especially open to abuse. HomeServe cross sold policies that double billed customers. The company has especially made changes to how it attempts to add more policies to customers who already have a policy with the company. These changes could result in fewer policies per customer. This could lead to lower revenue per customer. These are minor issues compared to any increase in the initial customer acquisition cost. Changes to how customers are first contacted would be a bigger problem. HomeServe's problems have not centered on direct mailing. The problems have mostly been focused on the company's telemarketing centers.

Direct mail is the main source of new customers for HomeServe. In the U.S. and elsewhere, direct mailing has increased over time and the results have been good. HomeServe will change the way it markets its policies. This could slow the company's growth. However, the approach the company is currently taking is working well in the U.S. So the threat to growth would have to come from additional regulation. This is very possible. Investors should expect a direct marketer like HomeServe to face constant pressure from regulators. This is not a stock for investors who want to avoid negative headlines. HomeServe will probably be plagued by such headlines throughout its future. Direct marketing is by its very nature manipulative. In some countries, there are limits to the amount of consumer manipulation a company is allowed to engage in. This will not be the last time HomeServe pays a fine.

MOAT: *Home Emergency Coverage Requires 3 Areas of Expertise: Direct Marketing, Repairs, and Claims Handling*

HomeServe is a wide moat business. This wide moat comes from two sources. One, the service they sell – home emergency coverage – is complex. Two, their partners and end users are both sticky. Partnership contracts with utilities run an average of 5 to 15 years. The average customer lifespan of a policyholder is 5 years (82% retention rate). When a customer is billed directly on their utility company statement this lifespan increases to more than 7 years (90% retention rate).

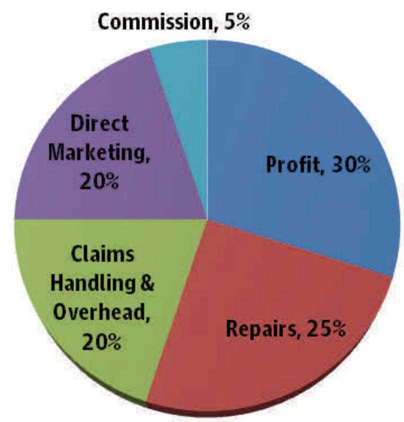
After a utility has been a partner of HomeServe for 5 to 15 years and signed up a lot of its customers, it is unlikely to take the gamble of switching to a different home emergency coverage provider because it would risk losing the base of customers on which it collects a 5% commission. The average utility partner in the U.S. now collects more than $5 a year risk free from HomeServe on each policyholder in its coverage area. So a local water utility with 250,000 customers that partners with HomeServe and manages to get 25,000 of those customers (a 10% penetration rate) signed up risks losing the more than $125,000 a year it is being paid essentially risk free. Since the average customer lifespan is more than 5 years the risk to the utility in switching away from HomeServe would be at least $625,000 of future income on a newly signed up customer. For a water utility serving just 250,000 customers the loss of $625,000 in what is essentially risk free profit that takes no assets to produce nor any special effort on the utility's part to generate is a bad deal. When a utility allows HomeServe to bill the home emergency coverage directly on the water utility statement, the average customer lifespan is greater than 7 years. The average customer pays more than $110 a year in premiums. So, the average HomeServe customer is expected to provide more than $5.50 a year in commissions to such a utility partner for each of the next 7 years. This is an expected $38.50 of profit to the utility company that comes purely from renewing its agreement with HomeServe. A utility partner can eventually expect HomeServe to sign up about 10% of its customers to a home emergency coverage policy. The added contribution of one in 10 of your company's customers paying an additional commission to you of more than $5 a year is meaningful. This is especially important when the lack of demand growth for utility services like water and electricity is considered. In the U.S., residential customers are now (in 2013) consuming a little less electricity than they were 12 years ago (in 2001). In the United States, selling electricity to households is a no growth business at best and a slowly decaying business at worst. The water consumption of households in developed economies does not grow either. Utilities are monopolies that can not depend on any growth in physical demand. All they can do is charge more to keep up with inflation. This pricing power is offset by their need to spend a little more on physical assets to maintain infrastructure during inflation. HomeServe offers partners a small, but slightly rising risk free profit stream that increases with inflation without requiring any capital spending from the utility.

The obvious question is why utilities can not tap this profit source on their own. The answer is that utilities are not marketers. Home emergency coverage is a complex product. Three things are required to offer the product: claim handling, repair, and marketing. Utilities are monopolies. They provide a passive service and bill continually. It is very easy for utilities to monitor consumption. The amount of consumption is not in dispute. Billing is simple. Marketing is irrelevant. That means utilities have zero expertise in either claims handling or marketing. In fact, utilities have the least practice in marketing of any type of business. They are monopolies providing a needed service. Many utilities do not need to educate customers about choices because the customer has no choice of provider. And utilities do not need to educate customers about the need for water or electricity. The head of every household knows they need both electricity and water. There is no need to push these products on the household. The service HomeServe sells is similar in its marketing requirements to home security alarms or life insurance. No one needs a home alarm system or life insurance in the way they need water, electricity, or car insurance. Today, in the United States, there are very strong legal incentives that push both car insurance and health insurance on people. So those kinds of insurers do not need to educate anyone about the need for car insurance or health insurance. They just need to argue they are the best choice. Life insurance and home alarms are different. They must be marketed like HomeServe. The marketing is direct and focused on increasing the penetration rate of the service – explaining why you should want it – rather than explaining why any specific provider is the best choice.

So the second obvious question is why insurance companies do not dominate this business. Insurers are experts when it comes to claims handling. And some life insurers are good at direct marketing. However, insurers lack expertise in managing repair networks. In fact, insurers who do compete with HomeServe tend to rely on a company like HomeServe to do the actual repairs. They can handle claims and they can market. But they outsource doing background checks and drug tests on repairmen, signing up sub contractors, granting franchises, and hiring an in house repair staff.

The U.K. offers good examples of who does enter this business. Strong entrants are those with customer lists, a trusted brand name, and a good way to approach customers. In the U.K. the 3 players in home emergency coverage that matter are: HomeServe, Centrica (British Gas), and the Automobile Association (similar to the American AAA). Entrants then bolster their marketing position by acquiring claims handlers and repair companies so they can create the complex trio of: direct marketing, claims handling, and repair.

HomeServe already meets these 3 requirements in the U.K., U.S., France, and Spain. They failed to sign up partners in Belgium and had to leave that country. They have yet to reach critical mass in either Italy or Germany. It took HomeServe 4 years to break even in France and 6 years to break even in the U.S. It takes 2-3 years to payback the initial customer acquisition cost even in countries where HomeServe is established. These are the barriers for any new entrant to overcome. They are high. And even if they can be cleared, new entrants always target customers without policies because



At no growth, HomeServe's business model plans for a 30% profit margin

an 80% retention rate makes the cost of convincing a customer to switch providers prohibitive.

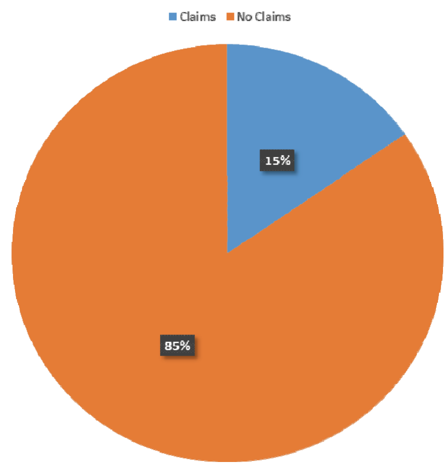
The economics of an existing customer are about 50% or more in profits, 20% claims handling, and 20% to 30% in repair costs. The 50% profit is required to payback the very high customer acquisition costs. Scale is required to keep the claims handling and repair costs manageable. And utility partners are absolutely essential to getting customers through direct mailing. Billing through a utility also increases customer lifespan from 5 years to 7 years. This adds over $100 of profit per customer. Home emergency coverage is a very attractive business. The product economics are excellent. But profitable entry is complex. It requires 3 areas of expertise. It takes up to 3 years for each customer to payback the cost of acquiring them. And it can take more than 5 years for a new national market to turn profitable. Finally, even when new entry is successful, established players do not target each other's customers. It costs too much to convince a customer to switch. So everyone focuses on households without home emergency coverage. As a result, competition in the home emergency market is mostly irrelevant. In this business, marketing determines profit margins. Competition does not.

QUALITY: *An Immature Insurance Product Means Less Competition for Low Premiums*

HomeServe's product economics are excellent. They are much better than conventional accounting shows. The way accounting works causes HomeServe to recognize expenses early on in a customer's lifetime and delay the recognition of the benefits that customer will eventually create. The key cost for HomeServe is the cost of customer acquisition. This is a marketing expense. The expense is charged directly when the marketing is done. For example, when HomeServe sends out a million pieces of direct mail, it expenses the cost of those million pieces of mail immediately. This is not a small expense for HomeServe. In 2011, the company sent out 34 million pieces of mail in the United States alone. The company's retention rate is 80%. That means the average life of a HomeServe customer is about 5 years. HomeServe targets a 2 to 3 year payback period on its customer acquisition cost. All of the economic profit in a customer comes in years 4 and 5 when HomeServe spends very little to retain the customer. HomeServe probably generates about 40 cents to 65 cents of free cash flow for every one dollar of premiums it collects on a mature customer. That is because it only costs the company between 35% and 60% of a customer's payment to take care of the commission paid to the utility partner, cover company overhead, pay for claims handling, and finally pay for actual repairs as they are needed. The price HomeServe can charge for its service is much, much higher than the actual cost of offering the insurance product it provides. Most insurers have much higher loss expenses. They cannot charge as high a price as HomeServe does for its premiums relative to the cost of the claims the customer will eventually make.

The reason HomeServe can charge so much relative to the cost of the expected claims is that the customer is paying for more than the financial aspect of insurance. Customers want the problem fixed. HomeServe is not an insurer. HomeServe is a repair service that collects premiums from its customers. The profit potential for HomeServe comes from the peace of mind of a hassle free repair being paid for in advance. Customers are willing to pay a lot for that. In fact they are willing to pay so much that HomeServe and other companies like HomeServe can make a huge profit on the customers they get. The problem is the cost of getting the customers in the first place. But because customers are retained for more than the 2 to 3 years it takes to pay back the customer acquisition, HomeServe can generate a lot of free cash flow. Margins are highest when growth is slowest. That is because the EBITDA margin on retained customers is much higher than the company's EBITDA margin of around 28%. That margin includes the cost of marketing. Marketing is often 20% of Home Serve's sales. So, a 28% EBITDA margin is the result of a close to a 50% EBITDA margin on retained customers and then the loss on new customers. New customers do not recoup their acquisition cost for a few years. So, the more direct mail HomeServe sends out and the more customers it wins in a single year, the less profit HomeServe shows in that year.

That is why it is best to ignore conventional accounting when looking at HomeServe. If an investor pays too much attention to reported results, he will make the mistake of thinking that low growth is a good result and fast growth is a bad result because it creates losses in the year in which the new customers are added. This is short sighted. Once a customer is added, retention rates



Claims run at an annual rate of 1.6 million repairs on 10.4 million policies

are quite stable around 80%. A customer can be counted on to stay for 5 years. So the loss shown in year 1 will be followed by 4 years of profits. This is a very confusing way of looking at HomeServe. It is the way the company reports results. But it is not the way the company's business model should be understood.

The best way to understand HomeServe is to think of the customer acquisition cost as an investment that must be earned back. In many ways, it is simply an intangible equivalent to buying a plot of land and developing it into a new store. HomeServe is buying a customer through a huge amount of direct mail. The cost of the mail that must be sent out to win just one customer is the investment that must be earned back over the customer's lifetime.

Like many insurance products, the peace of mind HomeServe provides is not a good bet for the policyholder on probabilities alone. It only makes sense if the policyholder feels better knowing a repair is paid for in advance than saving for the repair themselves. The 2013 numbers for the United States provide a good illustration of how HomeServe has the house odds in this situation and the policyholder is not making a good bet on the probabilities. In 2013 in the U.S., HomeServe had 1.3 million customers with 2.1 million policies. HomeServe performed 270,000 repairs. The average HomeServe customer in the United States will get only one repairman visit under their HomeServe coverage every 4.8 years. That is with an average of more than one policy per customer. Each policy only results in one claim every 7.8 years. The average HomeServe customer stays with HomeServe for 5 years. The average policy only results in one claim every 8 years. So the average HomeServe customer will never make use of a service they are paying more than $500 for over a period of 5 years. That is the insurance aspect of HomeServe's business. It is very strongly in Home Serve's favor, because of the willingness of some homeowners – mostly the older, more insurance minded homeowners who respond to scare tactics in direct mail by filling out and returning the response cards – to pay high premiums relative to the loss expense that these risks create.

The same situation probably exists in many kinds of insurance. But it is masked by the subsequent price competition between insurers once the market is saturated, when everyone wants or needs an insurance product – like car insurance or health insurance – price competition causes premiums to tighten very close to the cost of the losses causes by the risks that are being covered. If it is too easy to convince every potential policyholder they need coverage for a risk, the next step will have to be competition between insurers. Insurance is difficult to differentiate on anything but price. So in such a market the insurers will end up making price concession to policyholders. The result is often narrow to non-existent underwriting profits for the insurers. In markets where competition is focused on convincing people they need a certain kind of insurance, the product economics are much different – and much more favorable for the insurers. Competitors try not to compete on price because it is easier to compete for new customers. In car insurance the only option open to insurers is price competition because uninsured drivers who can be convinced to get insurance are a very small group of potential customers.

In home emergency coverage the situation is reversed. The best ways to achieve success are to be an effective direct marketer or to retain customers longer. About 40% of Home Serve's customers are billed on their utility bill. This increases the retention rate of those customers to 90%. That increases the average customer lifespan to more than 7 years. On average, HomeServe will only have to provide one repair during that customer's lifetime. The lack of price competition leads to great product economics. Few homeowners are likely to want this type of insurance, so HomeServe's product economics should remain closer to those of a home security company like ADT than an insurer. The difference is that ADT is mature while HomeServe is immature outside the U.K.

CAPITAL ALLOCATION:
HomeServe's Free Cash Flow Growth Has Fueled Annual Dividend Raises

HomeServe's capital allocation record is mixed. Since 2005, HomeServe has generated 420 million Pounds of free cash flow. The company has spent 275 million Pounds on acquisitions. During this time, HomeServe still managed to pay out 196 million Pounds in dividends. The company has increased its dividend payments. In every year since 2006, HomeServe raised its dividend. The smallest increase was 7%. The median increase was 18%. A dividend growth rate of more than 15% a year is much faster than what most public companies did over those same years. HomeServe's business model generates a lot of free cash flow. The stock's dividend yield is just below 4% right now. It could easily be much higher. HomeServe has generally kept a low debt load while also making acquisitions. The company dilutes shares by a very small amount. The dilution is caused by stock options granted to employees rather than mergers done with shares. Acquisitions are normally paid for in cash.

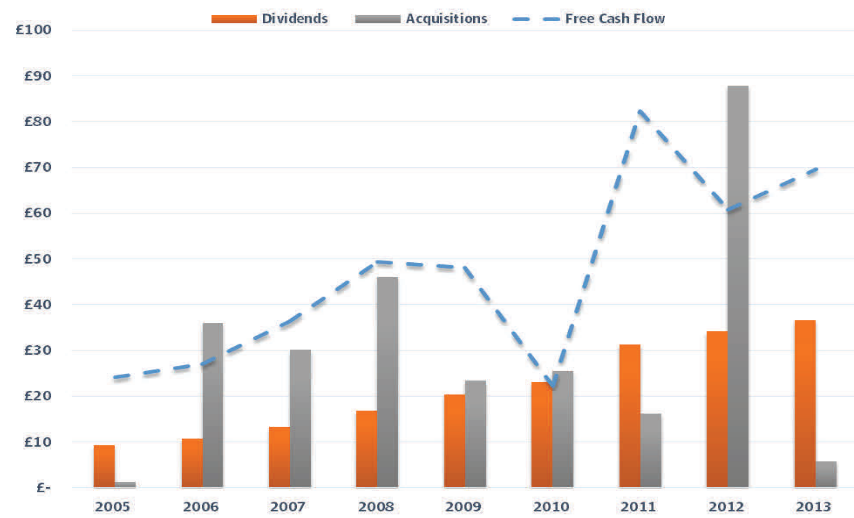
When free cash flow is not great enough to fund both dividends and acquisitions in a given year, HomeServe borrows the difference. However, the level of net debt has always been low relative to EBITDA. Throughout the company's history, interest coverage has usually been in the double digits. In other words, HomeServe has usually had at least 10 times more operating income than needed to meet its annual interest payments. Ten years ago, HomeServe had net debt of about 95 million Pounds and operating profit of 59 million Pounds. That is about the most indebted the company has ever been. In 2011, HomeServe's CFO said: "I think if you looked at an EBITDA-to-net-debt multiple, looked at our peers, of which there's not many, but a multiple of 1 to 2 times would be a position we'd be comfortable with." For a company with HomeServe's customer retention rate of 80% this is a low net debt to EBITDA multiple. Banks will often lend at multiples as high as 3 times EBITDA. HomeServe has never had that much debt. And even when discussing the matter hypothetically, management gave a range of 1 to 2 times EBITDA. This is not a business that is likely to be leveraged up under current management. HomeServe might one day be a target for additional leverage. But debt is not a concern at the moment.

The one area of concern in HomeServe's capital allocation history is spending on acquisitions. The return on these mergers has been mixed. However, the acquisitions have been done with cash rather than HomeServe shares. This is an important point because HomeServe is a very high quality business. The core business has essentially infinite returns on capital. Once a customer is acquired, that customer does not require any investment of tangible capital to maintain. The customer is simply a source of future free cash flow. This makes HomeServe's core business a very valuable one. It would be almost impossible for HomeServe to create value in mergers by issuing stock. There are not target companies with the kinds of economics HomeServe has. Also, timing mergers would become especially risky if shares were used. At different times, the market has valued HomeServe very differently. Before HomeServe's regulatory problems, an EV/EBITDA multiple of 12 to 16 was typical. Since the company froze its U.K. marketing, an EV/EBITDA ratio of 4 to 8 has been the new range. This is a huge difference considering the fact that U.K. stocks – like stocks in most of the world – have returned to the very high price multiples that were common before the financial crisis. HomeServe has not. The company is much cheaper now than it was before the crisis. If the company was in the habit of issuing stock to do deals, it could do serious harm to shareholders by mistiming an acquisition. So far, this has not been a problem because HomeServe has kept its share count fairly stable. Since the share count hit a low 8 years ago, HomeServe has increased its shares outstanding by just 0.8% a year.

Using cash as the funding source for acquisitions has been a good choice. The choice of targets to acquire has been mixed. HomeServe's single biggest acquisition was also its best. In December 2011, HomeServe spent 82 million Pounds to buy the 51% of Domeo it did not already own. Domeo is the joint venture HomeServe runs in France. In 2012, Domeo earned 10.5 million Pounds of operating profit. That means HomeServe spent just 7.8 times EBIT for complete control of a joint venture it had previously owned just 49% of. From a purely financial perspective paying 7.8 times EBIT for a business of Domeo's quality and stability – Domeo's customers are billed directly on their water company bill so the customer retention rate is 90% in France – was a great deal. Domeo is a slow growth business for HomeServe because the company has not added utility partners in France. Even if HomeServe fails to add utility partners, Domeo will – as a mature business – be worth more than 7.8 times EBIT as part of a publicly traded HomeServe.

The other 193 million Pounds HomeServe has spent over the last 9 years has not gotten the same good returns. In 2007, HomeServe spent 18 million Pounds to buy Reparalia. Reparalia is a leading claims handling and repair company in Spain. Spain is now a profitable market for HomeServe. It grew 50% last year. HomeServe also acquired U.K. contractors. As a result, HomeServe employees now perform 90% of the plumbing and drainage repairs for its customers.

Other purchases were mistakes. HomeServe has reversed some of them. In 2008, HomeServe bought a Belgian claims handling company for 9 million Pounds. HomeServe failed to sign up utility partners in Belgium and has since exited that country. A few acquisitions turned out to be examples of diversification. HomeServe bought a fire, flood, and upholstery cleaning business. It also bought some companies that did not serve homeowners directly. HomeServe's excellent product economics come from homeowner's willingness to pay high premiums relative to likely future losses under their policy. When you attempt to perform repairs for insurers or other corporate clients, that willingness to accept high premiums vanishes. The margins in these businesses turned out to be way too thin. A separate expansion into furniture and home appliance warranties was a bust. Customers who signed up for these policies had lower values over their lifetime than HomeServe expected. They simply were not worth the customer acquisition costs. Attempts at cross selling added too much marketing complexity. Today, HomeServe's business is much like it originally was. It is emergency home coverage for plumbing, electrical, and water heater problems.



Since 2005, 47% of HomeServe's free cash flow has gone to dividends

The most important acquisition in HomeServe's history was the one it did not make. In 2007, HomeServe wanted to buy Domestic & General. At the time, D&G's market cap was 448 million Pounds. Before the announcement, HomeServe's market cap was about 1.2 billion Pounds. So the deal would have been transformative. D&G is the leading domestic appliance insurer in the U.K. There was speculation that the financial crisis deterred HomeServe. The market's reaction – an 18% stock price decline – probably did not help. The official explanation was that: "...after analysis of D&G's books and discussions with management, (HomeServe) concluded the bid was not logical. Sources close to the negotiations said HomeServe had decided any deal would not be earnings enhancing enough."

HomeServe has not been especially skilled at making acquisitions. The company has a consistent record of keeping share dilution to a minimum while increasing the dividend. There is plenty more room for HomeServe to increase its dividend. Despite a 20% decline in operating income caused by the U.K. problems, HomeServe still covered its dividend twice over last year. With low interest requirements and strong free cash flow relative to reported income, HomeServe should be able to raise its 4% dividend yield faster than most companies over the next decade. A large part of a buy and hold investor's return in HomeServe will come from dividends.

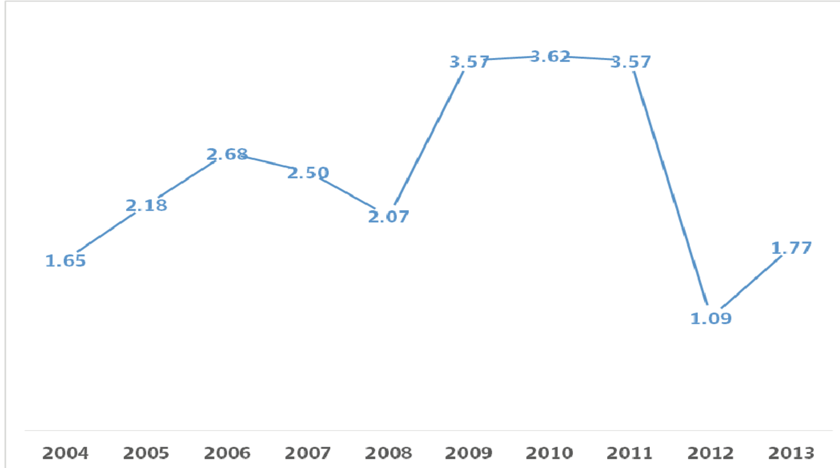
VALUE: *At Maturity: HomeServe Should Trade for 3 Times Sales*

The market has valued HomeServe very differently depending on its growth prospects. When the company was growing earnings per share by 20% a year in 2005, 2006, and 2007 – HomeServe traded at an EV/EBITDA multiple of 12 to 17. When earnings per share were declining 10% to 20% a year in 2012 and 2013, HomeServe traded at an EV/EBITDA multiple of 4 to 7. Most companies trade in between those two ranges. They are valued higher than 4 to 7 times EBITDA but lower than 12 to 17 times EBITDA. HomeServe has never been "normally" valued by the market. Instead it has been valued as a fast growing business or a dying business. Today, HomeServe is not a fast growing business. But neither is it a dying business. The company's U.K. customer count is expected to stabilize very soon as the company begins marketing there again. Operating profit will not stabilize as fast. It will lag the recovery in customers, because acquiring new customers costs more money up front than it produces in profit for HomeServe. For that reason, operating profit will begin growing about 2 years after customers start growing in the U.K.

If the U.K. business does stabilize around 2 million customers, HomeServe is clearly undervalued. The company trades for less than 8 times EBITDA. Growth at HomeServe is more certain than at most companies because of the way customer acquisition costs and retention rates interact. HomeServe has grown its U.S. customer count rapidly over the last couple years. This costs the company money. It only generates reported profits in later years when those customers no longer cost anything to be acquired – they simply need to be maintained – but continuing paying premiums. Right now, the U.S. business has an operating margin that is only about one-third of what its operating margin would be at maturity. Continued customer growth will hold this margin down.

That is the most important point to understand when valuing HomeServe. A movie producer like DreamWorks Animation capitalizes the costs of creating a film. The company then releases the film and only expenses the sunk cost of the film through the income statement as it receives the revenue associated with that film. The company must estimate the ultimate amount of revenue it will generate on the film and then attempt to match each portion of the expense of the film with an equal portion of the revenue. So, if a film cost $100 million to make and is expected to generate $150 million in revenue, the company will expense $1 million of production costs when it receives $1.5 million in revenue. In this way, it will be matching the costs and benefits of the economic asset it controls. It will charge off 1% of the capitalized cost of the movie when it receives 1% of the expected benefit from that film.

HomeServe does not report its results that way. If it costs HomeServe $112 to acquire one U.S. customer, the company records the full $112 as an expense in the year the customer is acquired. If that customer generates $112 in revenue,



Over the last 10 years, HomeServe's EV/Sales ratio has averaged 2.5

the company will record that revenue as it receives it. The margin on a retained customer is very high. It is not unusual for HomeServe to generate about $56 of free cash flow each year on a U.S. customer. That means it would take about two years for the company to earn back its customer acquisition cost. However, the customer will generally stay longer. The average HomeServe customer will stay for a little over 5 years. That means the company will generate $56 per year in free cash flow for years 3, 4, and 5 of the customer's lifetime. That profit comes after the marketing expense was earned back fully in years 1 and 2. If the customer is billed directly on their water bill, they tend to stay for 7 years. This leaves HomeServe with 5 years of profit with no further investment in the customer. Economically, that customer has become a 5 year revenue source with a 50% operating margin.

These economics make HomeServe look worse than it really is when the company is growing. The number that should be relevant to investors is not how much HomeServe reports in earnings per share. It is how much HomeServe would generate in free cash flow if it kept the overall customer count steady from year to year.

The U.K. business has been a true drag on the economic value of HomeServe. That is not just an impression created by accounting. It is an economic reality. The company has failed to get new customers to replace customers who do not renew, because it has basically stopped its marketing in the U.K. This may not be a one time issue. But it is wrong to assume it will continue. The retention rate in the U.K. is now up to 80% again. It is the same as in much of the rest of the world. So the U.K. is now just a no growth business. It is no longer decaying. It would be speculative to assume the U.K. business can ever grow to its previous customer count now that the company has to market its product differently. However, it is not very speculative to assume that the U.S. business will one day be bigger than the U.K. business ever was.

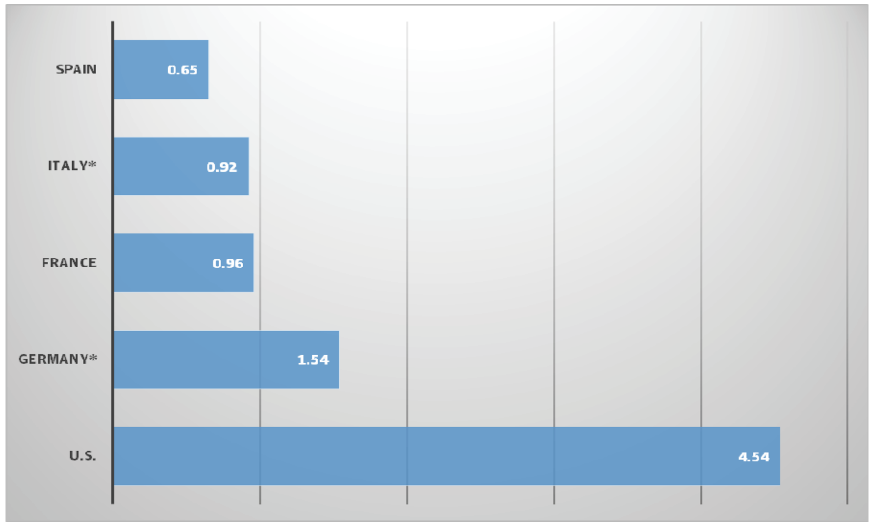
The company's highest reported EBIT was 128 million Pounds in 2012. With U.S. and Spanish growth and a stable U.K. business, HomeServe will eventually pass that high water mark. Recent EBIT has been as low as 87 million Pounds excluding losses on attempts to enter new countries. These attempts will drag down EBIT by about 6 million Pounds a year. However, the company can stop these losses at will, so an acquirer would view these as temporary losses. A good range of owner earnings estimates is between 90 million and 130 million Pounds. Net debt is very low. A couple years after the U.K. problems are fixed, HomeServe will be a growth stock again. With nearly infinite returns on capital and the ability to grow, HomeServe should be valued at more than 10 times pre-tax profits. That implies a minimum range of about 900 million to 1.3 billion Pounds in enterprise value. As a growth stock, the company was routinely valued at about 15 times pre-tax profits. That gives a top end of the range of 1.4 billion to 2 billion Pounds. That number is probably the right range for the intrinsic value of the company. But it may not be reached until HomeServe shows EPS growth again. That could be as late as 2016 or 2017. In the meantime, a buy and hold investor will collect a 4% dividend yield that is likely to rise during the 3 years it takes the company's results to turn around.

In 2012, private equity firms Cinven, KKR, and Apax offered 1 billion Pounds for HomeServe. That worked out to about 285 pence a share. The board rejected any talks saying that would be "selling the company on the cheap".

One way to check the value of HomeServe is to look at a price-to-sales ratio based on profit at maturity. HomeServe's business model provides 30% operating margins at maturity. Customer count can be maintained at those margins. And the company has reached a 30% companywide margin before. A 30% operating margin combined with a valuation of 10 times normal pre-tax profits, suggests the EV/Sales ratio should be 3. It is now 1.84. At 3 times sales, HomeServe would now be worth 1.64 billion Pounds. That works out to a value of 485 pence per share. That is a simple method for valuing HomeServe. An investor who is certain revenue will grow may be willing to pay more than 485 pence. However, an investor who is certain revenue will not shrink, should be safe paying less than 485 pence. A current price of less than 300 pence provides an adequate of safety.

GROWTH: *HomeServe's American Expansion Will Turn it Back into a Growth Stock*

HomeServe has great growth prospects. The company is now established in the United States. It took 6 years for that country to become profitable. This investment will pay off for HomeServe in the years ahead. Right now, HomeServe



The U.S. has 4.5 times more households than the U.K.

has 2.2 million policies in the U.S. Those 2.2 million policies come from 1.4 million customers. The average revenue per customer – after sales tax and utility partner commission – is $109. HomeServe's most mature market is the U.K. The company has 5.2 million policies and 2.2 million customers in the U.K. right now. That customer number is expected to decline to 2 million and then stabilize. Net revenue per customer is 106 Pounds in the U.K. At a stable customer count of 2 million customers, HomeServe would generate 212 million Pounds in U.K. sales each year. HomeServe's business model allows for a 30% operating margin at maturity. The U.K. business has been losing customers lately. The unit has also been restructured several times. As a result, the operating margin is much lower than 30%. For the first half of the year, HomeServe's U.K. operating margin was 17%. At that margin, 2 million customers each paying an average of 106 pounds a year would generate 212 million Pounds in revenue and 36 million Pounds in operating profit. The easiest way to analyze HomeServe's growth prospects is to look at other countries relative to the U.K.

The U.S. will eventually become HomeServe's biggest market. HomeServe now has 1.4 million customers in the U.S. The company expects to stabilize its U.K. business at 2 million customers. The U.S. has 4.54 times the number of households as the U.K. Customer behavior is not different in these countries. So, the theoretical maximum potential customer count in the U.S. is probably around 9 million customers. That is 4.54 times the 2 million customers in the U.K. At current revenue levels per customer, the U.S. would have a maximum sales potential for HomeServe of $990 million. That is 9.08 million possible households times $109 in revenue per customer. At a 17% operating margin, this would provide EBIT of $168 million. If more policies could be sold per customer, HomeServe could increase profit in the U.S. at maturity to an amount closer to 170 million Pounds rather than 170 million dollars. If the company could ever reach the peak operating margin it once had of 30%, this number would be a potential profit of 300 million Pounds in the U.S. alone.

That is all speculative. The important point to keep in mind is that the U.S. is 4.5 times bigger than the U.K. If HomeServe achieved the same competitive position in the U.S. as it now has in the U.K., that position would be 4.5 times more valuable in the U.S. This leaves a lot of room for HomeServe's U.S. business to fall short of the penetration rate HomeServe has in the U.K. and still deliver excellent operating profits. It is possible HomeServe's U.S. business will one day be more valuable than HomeServe's present day market cap. Last year, HomeServe added over 200,000 net new American customers. The number of U.S. customers grew 17%. The number of policies grew 16%. HomeServe's ability to grow in the U.S. will depend on signing up new utility partners. The American electricity and water industries are much more fragmented than those in other countries. For example, there are 1,200 U.S. water utilities with 20,000 or more customers. There are only 21 water utilities in all of the U.K. This fragmentation provides plenty of opportunities to sign up smaller utility partners. The biggest utility partners to add in the U.S. are electricity companies, because U.S. electric utilities tend to be much larger than U.S. water utilities. It is unclear how large HomeServe's U.S. business will get. It has the potential to one day have 21 million policies if HomeServe achieves the same success in penetrating the market and then cross-selling policies that it did in the U.K.

The U.S. is HomeServe's most important growth market. All the other countries HomeServe is established in – the U.K., France, and Spain – combined amount to just 58% of the number of household in the U.S. For this reason, the U.S. could – at maturity – provide more operating profit than those 3 countries combined.

HomeServe is hoping to enter 2 new markets: Italy and Germany. HomeServe has a deal with Enel in Italy. The company also has a pilot program in partnership with BS Energy in Germany. These should be viewed as experiments. HomeServe had to pull out of Belgium when it could not attract utility partners. The same could happen in Italy and Germany. Italy is about the size of the U.K. in terms of total households. Germany is a little over 50% bigger. HomeServe expects to lose 6 million Pounds a year trying to enter these markets.

HomeServe is already established in France and Spain. HomeServe has 900,000 customers in France. This market has not grown recently. HomeServe manages to sign up the 100,000 customers needed to offset the 11% of customers who do not renew in France. Until HomeServe can sign up new utility partners, this market will not grow. The company has tried to market outside of its partner's service area. HomeServe's French business is called Domeo. It was created in partnership with Veolia. HomeServe then bought out Veolia's share of the joint venture. HomeServe has been able to use the Veolia name to sell to some customers of Suez (another water utility) in France. However, the return on investment of this marketing is lower because the conversion rate of the direct mailing is worse when the customer is served by a different utility than the brand HomeServe is contacting them under. Right now, France is a free cash flow producing market that is not growing.

Spain is a very fast growing market for HomeServe. The customer count increased from 300,000 last year to 600,000 this year. Most of the policies are for electrical emergency repair coverage rather than water.

The number that matters most in determining the maximum growth potential for HomeServe is the number of households in a country. The U.K. has 26 million households. France has 25 million households. Spain has 17 million households. The U.S. has the greatest potential with 118 million households. The new markets of Germany and Italy have 40 million and 24 million households respectively. HomeServe's product will always have a low penetration rate. For this reason, it is best to gauge the opportunity in a country using its relative size versus the U.K. At 4.5 times the size of the U.K, the United States will one day be more profitable than HomeServe's home country. Even if HomeServe can only achieve half the success in the U.S. that it did in the U.K. – the company should be able to quadruple its customer count in the U.S. There are certainly more than 4 million homes in the U.S. that are not yet HomeServe customers, but could one day become customers. HomeServe already has about the same number of American households in a utility partner's service area as it does in the U.K. Even without adding utility partners, HomeServe should be able to increase its U.S. customer count from 1.4 million to 2 million. And it is almost certain HomeServe will add U.S. utility partners each year.

HomeServe can usually raise premiums along with inflation. That was not true this past year in the U.S. or France. Prices declined about 1% in France. The U.S. is fast growing, so revenue per customer can be held down by customers the company has not yet started cross-selling additional policies. In 2013, the company's CFO said this about inflation: "I think it's probably true to say that we will expect to keep our price increases relatively modest…about the level of inflation." Once the U.K. business stabilizes at 2 million customers, under penetrated markets like the U.S. will turn HomeServe back into a growth stock.

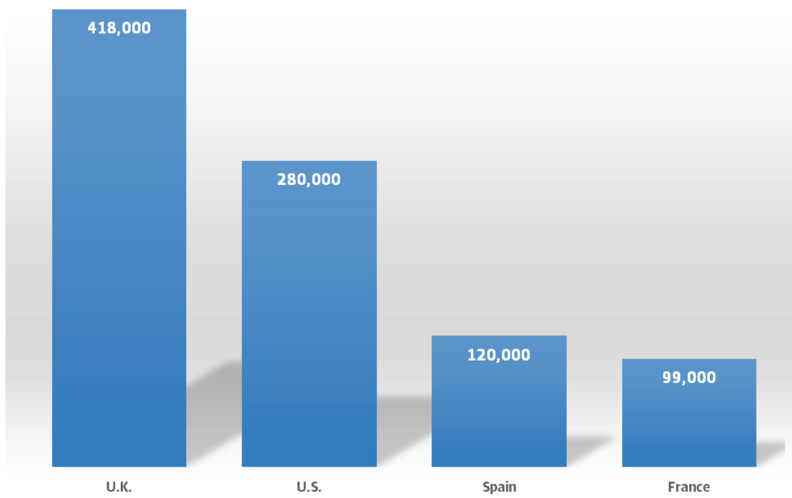
MISJUDGMENT: *Avoiding Further Fines May Make HomeServe a Less Aggressive Marketer*

The biggest risk to an investor who plans to hold HomeServe shares for the long-term is the risk of changes to the company's marketing. HomeServe just agreed to pay a 34.5 million Pound fine. That is equivalent to $56.87 million. The fine was imposed by the United Kingdom's Financial Conduct Authority. This is not the first time HomeServe has been fined by a U.K. regulator. In 2012, the company was fined 750,000 Pounds by Ofcom. Ofcom is the U.K.'s telecom regulator. That fine was based on "allegations that (HomeServe's) call center staff were calling customers and then abandoning the calls, leaving potential clients with a silent line." The much larger 34.5 million Pound fine from the FCA is for "mis-selling practices". The 34.5 million Pound number assumes a 30% discount for early settlement. The actual fine – if not settled early – would be just under 50 Million Pounds.

The actual amount of the fine makes little difference in valuing HomeServe. The company has almost no debt. It can easily support another 34.5 million Pounds of debt. The fine does not endanger the company's solvency. It reduces the intrinsic value of the stock by about 10 pence. HomeServe trades just above 290 pence. Based on the company's high returns on capital and future growth prospects, it should trade for a price at least 50% higher than it currently does. So this fine does not put much of a dent in the wide margin of safety an investor gets when he buys a share of HomeServe.

The problem is not the fine. The problem is what HomeServe does to avoid future fines. In the U.K., HomeServe pretty much froze all of its marketing during the FCA's investigation. This caused the customer count in the U.K. to drop dramatically even while the retention rate stayed very high. This can happen in any country where HomeServe freezes marketing. In the U.K., HomeServe has traditionally had about an 80% retention rate. During the period of negative publicity that came with this investigation, the retention rate dropped slightly. But it never fell below 70%. It recovered quickly. HomeServe's retention rates in different countries have been very stable. The company's retention rates are the one thing an investor can rely on. This is a relatively low cost product that is bundled under a utility company's brand name. Especially when it is billed on the utility bill, retention rates are very high. Generally speaking, HomeServe's retention rates are as high as any insurance company's retention rate. When the premium is billed directly on a water bill, HomeServe's retention rate is actually higher than the retention rate for car insurance in the United States. That is why HomeServe can afford to spend so much on marketing. It has the same business plan as GEICO. It can afford to have a customer acquisition cost that is not paid back until year 2. It is willing to lose money in the first year of a customer's life and then only start to turn a profit in year 3. This is also GEICO's approach.

A key difference between HomeServe and GEICO is the way they market. GEICO does a lot of television advertising. HomeServe does a lot of direct mail. The company also has inbound and outbound call centers. Allegations of mis-selling generally involve direct mail and outbound calls to potential customers. They can also involve attempts – by call center employees – to cross-sell additional policies to existing customers.



It would take 418,000 new U.K. customers each year to keep sales steady

HomeServe uses scare tactics to sell its product. For example, the company warns customers that they are liable for repairing the main waterline that runs from the street to their home. Most homeowners do not realize this is true. They believe the town will repair the main waterline into their home. This is usually not true. In most cases, the town is responsible for the pipes running outside the homeowner's property. The homeowner is responsible not just for pipes in their home – which all homeowners know they are responsible for – but also the pipes running under their property. In the United States, HomeServe does a lot of marketing about this risk. The company mentions that it can cost over $2,000 to make this repair. What the company is saying is probably true. However, HomeServe is omitting some key points. Many of these pipes are meant to be replaced once every 30 years or so. It is possible to own a home for half a lifetime and not need to make such a repair. HomeServe does not mention these facts. This is typical of insurers. If HomeServe reported its results the way an insurer did, it would have a loss ratio of about 50. In other words, for every one dollar the company collects in premiums it only needs to set aside 50 cents to pay for the repairs probability suggests will be needed each year. HomeServe is not charging customers a lot of money. The U.K. is the place where HomeServe has the highest revenue per customer. And even in the U.K., HomeServe is collecting less than $15 a month (9 Pounds). HomeServe is able to turn a large profit because it is insuring homeowners against risks that occur with less frequency than the homeowner may imagine. On average, HomeServe only has to handle claims on 15% of its policies each year. On each policy, there is about an 85% chance the customer will simply pay premiums all year long and never file a claim with HomeServe.

The heart of HomeServe's problem is that most homeowners do not want the product. HomeServe is in a similar position to a home security company like ADT. About 80% of homeowners have no interest in a home security system. Companies like ADT are only successful because they manage to have very high renewal rates for their service. They achieve this through contracts and through high switching costs. Almost no one switches from ADT to a different security provider. Likewise, almost no one switches from HomeServe to a different emergency repair coverage provider. People who leave simply cancel the service altogether.

HomeServe is a very effective direct marketer. That is the key to growing the business. But it is also the key to maintaining the business. HomeServe must find enough virgin households that have never had an emergency home repair service before to keep their customer count steady. The requirement HomeServe has to meet is equal to the cancellation rate times the number of customers. For example, HomeServe's business in France is Domeo. Domeo has 900,000 customers. French customers have an 89% retention rate. So, each year, 11% of Domeo's 900,000 customers will cancel. That means HomeServe's direct marketing must convince 99,000 new households to sign up for the service each year. In France, HomeServe has always been able to do this. While marketing was frozen in the U.K., cancellations were not offset by gross customer additions. This led to a lower customer base. HomeServe believes the U.K. business will stabilize next year. It is already getting some gross customer additions as it restarts marketing.

If HomeServe is less aggressive in its marketing to avoid suits from state Attorneys General in the U.S., regulators in the U.K., etc. it may not achieve either the same level of gross customer additions or cross-selling success that it did in the U.K. This problem is most serious once a market has become fairly saturated. It will not be a problem in the U.S. for a long time, because HomeServe does not need to market that aggressively – it can simply sign up more and more new utility partners in parts of the country it has not marketed in before.

Investors should watch HomeServe's number of policies per customer in the U.S. versus the U.K. to see if it is using less aggressive cross-selling. It is also important to watch gross customer additions even in mature markets like France. HomeServe needs to be an aggressive direct marketer to succeed. This is a service that must be pushed on potential customers.

CONCLUSION: *HomeServe's Aggressive Marketing Makes the Stock Too Risky for Some Investors*

The question of whether or not to invest in HomeServe has little to do with price. HomeServe is very cheap relative to its future growth prospects in the U.S., Spain, and France. The company can grow customers in the U.S. and Spain. It can also cross-sell more policies to its customers in the United States. The company's CFO noted that demand is "relatively inelastic". That makes it easier for HomeServe to raise prices in line with inflation. Inflation has been low in the company's established markets, so this has not been a source of revenue growth. But price increases are possible during periods of higher inflation. Renewal rates are very stable. They average 80%. When customers are billed directly on the utility bill, this number rises to 90%. HomeServe will attempt to use this kind of billing wherever possible. Digital payments for utility bills and HomeServe's emergency home repair coverage offered under the utility company's name would probably result in slightly higher renewal rates than other forms of payment. So there is little reason to believe HomeServe's retention rate will decline. There is also little reason to believe the company will be unable to maintain the same real prices during normal levels of inflation. HomeServe requires no tangible capital to grow. So the only constraints on the company's growth are signing up utility partners and successfully marketing its products. Utility partners did not abandon HomeServe when it was being investigated for mis-selling practices in the U.K. During this period of turmoil in the U.K., HomeServe was able to rapidly expand its business in the United States and Spain.

The only reason not to invest in HomeServe is the risk of problems with the company's marketing. HomeServe is a very aggressive marketing company. It sends out tens of millions of pieces of direct mail. It contacts potential customers using another company's brand name. It uses scare tactics. HomeServe does not provide much detail about its typical customer. However, there is good reason to believe that the average HomeServe customer is not just more interested in an insurance product than the average head of a household. There is also good reason to believe HomeServe's marketing success is partially based on response rates from old people. HomeServe's marketing may cause the company problems with state Attorneys General in the U.S. In the last 3 years, the Better Business Bureau has received 281 complaints about HomeServe. HomeServe failed to deliver on its promises during one especially bad winter in the U.K. Otherwise, complaints about the company and investigations of its conduct have been focused on HomeServe's tactics as a direct marketer.

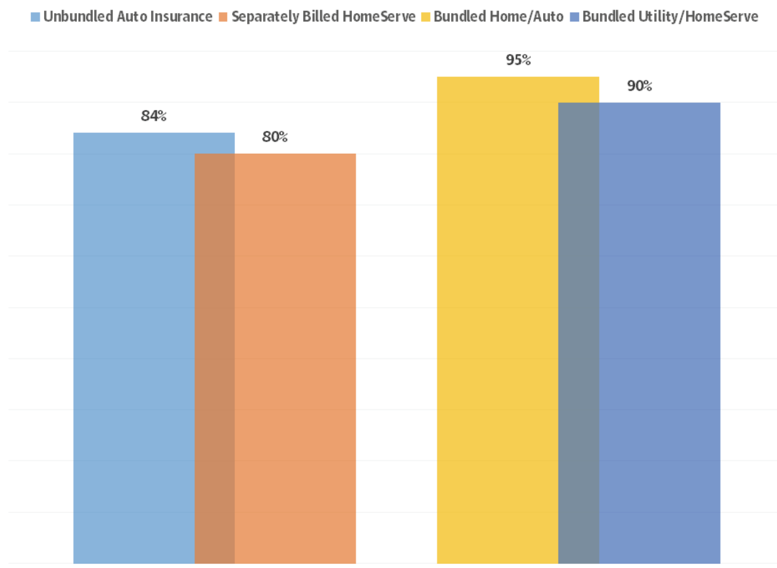
The one reason not to invest in HomeServe is its aggressive marketing. This aggressive marketing can create 3 problems. One is that it can lead to unsustainable customer levels and growth rates. In HomeServe's case, this is not a problem. Most direct marketers who burn through customers quickly and then run into problems are selling one off items or have very low retention rates. HomeServe's retention rates are comparable to car insurers like GEICO and Progressive. The economics of customer acquisition and eventual profits over the customer's lifetime are similar for HomeServe and for these companies. There is a huge difference though. GEICO and Progressive sell an insurance product that is needed by most drivers. Only a handful of U.S. states allow people to drive without insurance. Car insurance is mandatory everywhere else. This means that companies like GEICO and Progressive have no reason to attempt a hard sell. Meanwhile, HomeServe must market its product more like a home security company. It has to frighten potential customers into believing they need coverage for a risk most people do not worry about.

HomeServe's customer base is sustainable even if it changes its marketing over time. The U.K. experience is not a good test of what happens to

HomeServe when it reaches the saturation point in a market. HomeServe froze its marketing in the U.K. while it was under investigation. It did very little marketing because it was not sure what marketing would be acceptable to its regulator. It is unclear whether changes to HomeServe's marketing will greatly reduce the effectiveness of that marketing. It is also unclear how much HomeServe will change its marketing. This is especially true outside the U.K. Failure to sign up enough new customers each year to keep a stable customer count might become a problem for HomeServe if it takes a cautious approach to marketing. However, if the company can move more customers towards direct billing on their utility statement, the need for successful marketing just to stay in place will be greatly reduced. HomeServe has 900,000 customers in France. However, the company's retention rate is so high in France that HomeServe only needs to add 99,000 customers a year through its marketing. When American customers are billed the same way French customers are – the retention rates are identical at around 90%.

Finally, HomeServe could choose to remain a very aggressive direct marketer. If it does that, it may face further fines. The company was just fined $57 million for mis-selling by its U.K. business. If the company uses similar tactics in the U.S. as it did in the U.K., HomeServe may be sued by some state Attorneys General. This would create a lot of bad publicity for the company. That will mostly influence investors. The negative publicity in the U.K. caused a big change in investor attitude but almost no change in customer attitude. HomeServe's retention rate blipped down from 80% to 74% for just one year. It has already returned to 80%. The company has very high retention rates and very high customer satisfaction. Both numbers are very similar to the numbers at GEICO and Progressive.

The first risk from HomeServe's direct marketing is the risk of



HomeServe's renewal rates are 5 percentage points below auto insurers

burning through customers. Because of the company's very high retention rate and the low penetration rate for this product, this is not a serious risk. It can be ignored. The second risk is being fined because of continued marketing misconduct. That is a very big headline risk. It is of greatest concern to short-term owners of the stock. Buy and hold investors will not find this to be as big a problem. It is speculative to assume there will be more or larger fines in the future. The fine imposed by the Financial Conduct Authority in the U.K. was about 35 million Pounds. HomeServe had an operating profit of 128 million Pounds in the year the investigation began. The fine is only about 27% of HomeServe's pre-tax profit. It is equivalent to about 3 months of earnings. Even if the company is hit with several similar fines at different points in the future, they will not happen every year. The reduction to earning power over time will be small. Fines are a possible concern for investors. Anyone who is afraid of investing in a stock that is constantly the subject of bad publicity should avoid investing in HomeServe. For long-term investors that do not mind a little negative publicity in their portfolio – the fines themselves are a small risk. The biggest risk is HomeServe changing its marketing in a way that makes it difficult to repeat its past results. There is a lot of room to grow in the U.S. and even in Spain. It should be easy to add new customers even with less aggressive marketing. But it may not be possible to cross-sell as many policies as HomeServe did in the U.K. Right now, that would mean U.S. customers could be worth almost 30% less than U.K. customers.

The one valid reason for an investor to avoid HomeServe is discomfort with this kind of aggressive direct marketing. For investors who are comfortable owning a direct marketer, the decision to buy HomeServe at 300 pence should be an easy one.

HomeServe (LSE: HSV)
Appraisal: 346p

Margin of Safety: 15%

Owner Earnings	(in millions)
2013 Operating Income (As Reported)	£ 107.60
+ Loss in New Markets	£ 4.80
+ Marketing Investment in the U.S.	£ 9.70
- Downside in the U.K.	£ 35.00
= Owner Earnings (before Interest and	£ 87.10

Business Value
HomeServe's business value is £1,218 million.
- Pre-tax owner earnings are £87 million
- Fair multiple = 14x pre-tax owner earnings
- £87 million * 14 = £1,218 million

Fair Multiple
HomeServe's business is worth 14x pre-tax owner earnings
- Quan thinks: "At 14x pre-tax owner earnings, investors can expect at least 7% return even if HomeServe wastes ½ of its free cash flow"

Share Value
HomeServe's stock is worth 346 pence a share
- Business value is £1,218 million
- Net debt is £74 million
  - Debt: £134 million
  - Fine: £35 million
  - Cash: £94 million
  - £169 million - £94 million = £75 million
- Equity value is £1,143 million
- £1,218 million - £75 million = £1,143 million
- Equity Value = 346 pence/share
  - 330 million outstanding shares
  - £1,143 million / 330 million = 346 pence

Margin of Safety
HomeServe stock has a 15% margin of safety.
- Business Value = £1,218 million
- Enterprise Value = £1,030 million
- Discount = £188 million (£1,218 million - £1,030 million)
- Margin of Safety = 15% (£188 million / £1,218 million)

	EV/Sales	EV/Gross Profit	EV/EBITDA	EV/EBIT	EV/Owner Earnings
Centrica PLC	0.89	3.79	5.24	8.32	8.32
Life Time Fitness	2.73	6.55	8.51	12.47	10.55
Ituran Location and Control	2.89	5.85	9.40	13.76	13.76
ADT Corp	3.45	5.91	6.72	15.06	15.06
Lifelock	4.77	6.71	56.04	68.11	11.39
Minimum	0.89	3.79	5.24	8.32	8.32
Maximum	4.77	6.71	56.04	68.11	15.06
Median	2.89	5.91	8.51	13.76	11.39
Mean	2.95	5.76	17.18	23.54	11.82
Standard Deviation	1.25	1.04	19.48	22.40	2.38
Variation	0.43	0.18	1.13	0.95	0.20
HomeServe	1.64	NMF	6.93	8.28	10.28
HomeServe (Appraisal Price)	2.23	NMF	9.42	11.26	14.00

ABOUT THE TEAM

Geoff Gannon, Writer

Geoff is a writer, blogger, podcaster, and interviewer. He has written hundreds of articles for Seeking Alpha and GuruFocus. He hosted the Gannon On Investing Podcast, The Investor Questions Podcast, and The Investor Questions Podcast Interview Series. He wrote the Gannon On Investing newsletter in 2006 and two GuruFocus newsletters from 2010-2012. In 2013, he co-founded The Avid Hog (the predecessor to Singular Diligence) with Quan Hoang. Geoff has been blogging at Gannon On Investing since 2005.

Quan Hoang, Analyst

Quan is a stock analyst. Quan won first prize in Vietnam's National Olympiad in Informatics in 2006. He graduated from Manhattanville College in 2012 with a B.A. in finance and a minor in math. In 2013, Quan co-founded The Avid Hog (the predecessor to Singular Diligence) with Geoff Gannon.

Tobias Carlisle, Publisher

Tobias Carlisle is the founder and managing director of Eyquem Investment Management LLC, and serves as portfolio manager of the Eyquem Fund LP and the separately managed accounts.

He is best known as the author of the well regarded website Greenbackd, the book Deep Value: Why Activists Investors and Other Contrarians Battle for Control of Losing Corporations (2014, Wiley Finance), and Quantitative Value: a Practitioner's Guide to Automating Intelligent Investment and Eliminating Behavioral Errors (2012, Wiley Finance). He has extensive experience in investment management, business valuation, public company corporate governance, and corporate law.

Prior to founding Eyquem in 2010, Tobias was an analyst at an activist hedge fund, general counsel of a company listed on the Australian Stock Exchange, and a corporate advisory lawyer. As a lawyer specializing in mergers and acquisitions he has advised on transactions across a variety of industries in the United States, the United Kingdom, China, Australia, Singapore, Bermuda, Papua New Guinea, New Zealand, and Guam. He is a graduate of the University of Queensland in Australia with degrees in Law (2001) and Business Management (1999).