

FirstGroup plc

South Western rail franchise award

Analyst and investor call transcript

Tim O'Toole (Chief Executive, FirstGroup): Thank you. Good morning, and thanks for joining us on this conference call to review the DfT's decision to award the South Western rail franchise to our joint venture with MTR. I'm joined on the call by Matthew Gregory, our CFO, and I should just point out that the two of us are not in the same location, so just bear with us when we get to the Q&A. We shall be speaking to the summary slides that can be found in the reports and presentations section of our investor website, before opening up to questions.

So, let me start by saying that obviously we are delighted with today's news. We put together a bid that was based on quality – that is, improvements in every aspect of the passengers' experience. We believe that approach, combined with the realistic growth assumptions underpinning our bid, and the DfT's efficient allocation of risk and sensible bonding requirements for this franchise, will produce a great outcome for passengers, taxpayers and us.

You'll see on page 3 we've set forth basic facts about the franchise with which I know you'll already be familiar. This is a significant franchise with a huge commuter base, but also substantial leisure and long distance services, and we're delivering improvements for all of those markets.

I want to direct your attention to the following pages, where we summarise the improvements we shall deliver for the travelling public. It starts with a significant uplift in capacity for the commuter market by way of the introduction of 750 new state-of-the-art carriages, which will mean a 30% increase in seats for the peak at Waterloo. We're also shortening journey times across the network, reintroducing regional services and increasing the frequency of services.

On page 5, you can see that many other benefits for passengers will be delivered, starting with flexible ticketing, simpler smart ticketing and a seamless 'delay repay' scheme. Passengers will also have the benefit of an app that can bring all of those features together in one place, along with travel and planning information. We'll be improving stations, car parks, community engagement and introducing the country's biggest rail operator apprenticeship scheme.

Matthew will now provide more detail on the franchise process and terms. Matthew?

Matthew Gregory (CFO, FirstGroup): Thanks Tim. As you know, on this bid we partnered with the highly-respected transport operator MTR, and have set up a joint venture to do so. The JV is owned 70% FirstGroup and 30% MTR and as a result, all costs, risks and rewards will be shared on that basis. We will be reporting 100% of the P&L and cash flow of the JV in the FirstGroup consolidated accounts, with MTR's share being reported as 'non-controlling interests'; this is in line with what we've done in the past.

From a process perspective, we managed and ran this bid in the same manner as our previous bids, albeit with the addition of MTR's expertise alongside ours at each step of the way. Significant modelling and sensitivity analysis was undertaken, as you'd expect, with a rigorous governance process to stress test and challenge our plans. The bid was also reviewed and approved independently by each partner's Board.

In line with previous processes, the DfT has assessed this bid based on a combination of price and quality, though quality carried a higher weighting than in some recent bids.

Looking at the key franchise terms: this is a seven-year franchise starting from 20th August 2017, with the option to extend for 11 months at the DfT's discretion. In this franchise we will be on revenue risk, but the franchise does have what we believe to be reasonable protection in the event of movements in exogenous factors. This protection is both on the upside for the DfT and the downside for us, and provides better risk mitigation than seen in recent times. These mechanisms apply to both the movement in GDP and also Central London Employment [CLE], from a fixed

baseline throughout the life of the franchise. As you'd expect, the franchise has a profit share arrangement in the event of significantly higher margins than expected, and overall the total premium paid over to the government will be £2.6 billion in real terms.

Moving on to the franchise financial commitments on page 8, the structure is in line with recent awards and the amounts that the JV is expected to provide are as follows: A shareholder loan of £30 million must be paid into the franchise – this is to provide a minimum funding level as the franchise starts up, and this gets paid back during the life of the franchise. The JV parent companies must provide £88 million of contingent loan facilities to fund the franchise in the event of a significant cash shortfall, and of this, 50% must be backed by bonds; a performance bond of £15 million must also be provided. Finally, the franchise is required to provide a bond to cover the cash received from season ticket payments, and this is expected to be in the region of £80 million. All of the above amounts are stated at the 100% franchise obligation, and FirstGroup and MTR will provide separate bonds in line with the 70/30 split.

Despite differing treatment of rail income and bonding by our rating agencies, we do not expect any adverse impact to our credit rating; indeed, this should be positive.

Moving on to our assessment of the financial returns of this franchise, we're expecting to achieve margins comparable to the recent overall industry average. Cash flow after capex is expected to be slightly positive in year one, and thereafter cash flow should largely track operating profit over the course of the franchise. As ever, the timing of capital expenditure may affect that relationship in any one year.

Of the capital invested, about £80 million will be funded directly by the franchise, and this mainly relates to investment in stabling, gate lines and car parks. These projects will drive improvements to the service and will also benefit from a residual value at the end of the franchise.

Finally, we expect a working capital inflow of approximately £100 million during the first year or so, principally related to season ticket money. But as a reminder, season tickets are treated as restricted cash.

And with that, I shall hand you back over to Tim.

Tim O'Toole: Thank you, Matthew. Finally, we've included a franchise timeline. I just want to make two points about this. First, you'll notice that the Waterloo improvements will be virtually complete when the new franchise starts. The extra capacity at Waterloo that will be delivered in 2018 with the additional platforms from the old international part of the station will not involve significant interruptions to service to the station as a whole. The second point I'd make is how quickly we'll be delivering the franchise improvements, starting in 2018 and a second batch in 2020.

Let me conclude by noting we are subject to the usual 'standstill period' and CMA review, but in the meantime we continue to work with our partner MTR on preparations.

Rail has been an important part of our business since privatisation, and we have a track record of delivery that compares favourably to anyone in the industry, so we are pleased that the patience and discipline we've shown in restocking our portfolio has been justified with this franchise award.

And with that, Matthew and I would be happy to answer any questions.

Gerald Khoo (Liberum): Morning all, a few questions from me. Firstly, you talked about – I think you said 'realistic' growth assumptions: I was wondering whether you could give an indication as to what sort of average revenue growth you've assumed over the life of the franchise in the bid, and how that compares with the total increase in capacity? I think you mentioned 30% in relation to the new trains.

Secondly, obviously you did mention that you'd take over the franchise in the middle of the three-week blockade at Waterloo this August. What measures are you putting in place to mitigate that risk? Clearly, that feels like quite a challenge.

And finally, are there any commitments in terms of transitioning to driver-only operation within this franchise?

Tim O'Toole: Okay, thank you. I'm going to let Matthew comment on the growth assumptions, but I would just say by way of introduction that you can tell by the timing of when we put this bid in that we were very cognisant of current economic conditions facing the rail industry – with the Brexit vote etc. – but we also have the benefit of the protections. And we also note that so much of this franchise was based on quality, because I think there's an appreciation that this has been a very stable franchise, and you're not going to be looking at some giant step change in volumes here. So I think that our assumptions are actually quite sensible. Matthew, do you want to comment?

Matthew Gregory: Yes, I'd agree with all of that Tim. We've set out that over the last franchise from the period from 2007, the franchise grew at around 6.9% CAGR. We've looked at all the economic forecasts and the information we have and, as you said, there's the additional seat miles that are going into that – *[LINE CUT OFF]* – too dissimilar from what we've seen in the past.

Tim O'Toole: Matthew, the last sentence kind of dropped off, if you could just repeat that?

Matthew Gregory: Sorry, yes – I was just going to say it's not going to be too dissimilar from what we've seen in past.

Tim O'Toole: Okay. Your other questions, Gerald. First, measures on the blockade, and the supposition in your question that we take over halfway through; that's not exactly correct. We take over in the last week, so about a week to go in the works when we take over. We have had sight of the work that South West Trains and Network Rail have done to plan this out. You know, it's an excellent management team at South West Trains, and we have complete confidence in them that they are going to execute these works on time. And then when we move into the international terminals: most of those five platforms when we bring those on, that can be behind-hoardings work for the most part, and so we're comfortable that these projects are well in hand.

And as far as bringing in the new trains, let me just say we think we have so much exciting news – exciting for the passengers but exciting for the employees as well. The uplift in service that we're going to be able to provide is going to make their jobs easier and better. Naturally, to the extent that any of these innovations, these introductions, involve change to the employees, we'll consult in the normal course. The machinery of consultation is well understood, it doesn't involve this call –

Gerald Khoo: Sure.

Tim O'Toole: – and in time, we will address it. I would just point out, unless you're wondering: the bid, the ITT, did not mandate DCO operations here, and I think we all believe that we want to make sure that this is a franchise that is able to continuously serve the public and that's our intent.

Gerald Khoo: Okay. Thank you very much.

Joe Thomas (HSBC): Morning, congratulations on the franchise win. Just a few bits and pieces that I was hoping you could fill us in on the detail: Matthew, you referred to the contingent loan facility, which at first glance perhaps looks a little bit lower than we've seen on some of the other rail franchises. Can you just tell us what's been going on there – is that some sort of change in DfT methodology?

Second thing is the risk-sharing mechanism: when does that begin? Does that begin from day one?

Third thing, and this relates I suppose to the first question: you said that this is ratings positive. I'm not clear how you'd get to that calculation, but perhaps you can give us some detail there?

And then finally I'm struggling to reconcile your NPV for the premium over the franchise life with what we know that Stagecoach are paying already, or at least what they've said they're going to be paying. Perhaps you could just give some sort of indication about what you're going to be paying in year one, and how that moves over time?

Tim O'Toole: Okay Matthew, if you want to take those, as requested by Joe?

Matthew Gregory: Yes. I'll take all four of those, that's fine. So, let's make sure I've got all those down. So, the contingent loan: there's no particular change in the DfT methodology, I think I would say that we have been fairly vocal around the levels of bonding and loans required, and I think this is reflecting the fact that the DfT have listened to that. So no real change in the methodology, I think they've just understood our comments around the high levels in the past.

The risk-sharing mechanism: yes, that does come in from day one, and that's fairly clear how that mechanism works.

On the ratings: clearly we're only just about to start having conversations with the rating agencies. We know how our rating agencies look at rail, and they both treat them differently. We've looked at how they've treated rail in the past, and our take is that – well, I think my first comment was that this would not be treated negatively, so this isn't going to have a negative impact on our rating, and we believe that overall it will be considered positive to the rating. But, again, we'll go into more detailed conversations with the rating agencies and we'll see where we get to with that; we're not going to get ahead of ourselves or try and assume where they're going come out. But again, we think that will be overall positive to us.

And then on the NPV: I mean, we don't and we can't reconcile the premium to the past franchise, because this is a totally different franchise. So we both bid on the basis of the ITT information, and this is the premium that's come from that bid, so we're not reconciling to what's been paid before. And again, if you look at the premium, it grows in a relatively linear manner across the franchise; not really wanting to get into the details of specifics in each year.

Joe Thomas: Thank you for that. I know you don't want to get into specifics of particular years, but you do have these lumps of capacity coming in; does that cause a distortion midway through the franchise?

Matthew Gregory: Not hugely is what I'd say on that Joe. I think, as we've said before, this is more of a stable franchise, and the growth is coming in the capacity relatively early on in the franchise, so I think this is a relatively linear approach to the premium.

Joe Thomas: Okay, thanks.

Damian Brewer (RBC): Good morning everybody. Apologies, several questions from me as well. Just first of all, one point of clarification: you mentioned in the presentation that cash flow would reflect the operating profit after the first couple of years. Implicitly in that are you saying effectively, the D&A level in the contract is similar to the tax, or is there anything else that's missing there? Is the cash tax level lower? If you could clarify that, that would be very helpful.

Second question: in a sense, I guess, looking at this contract, it looks like the ITT and the GDP and CLE debt bands would have been set at the time of the ITT, so before the Brexit referendum. So, in

a sense, it feels like discussion about the revenue CAGR is somewhat moot – but could you tell us a little more and elaborate on how those dead bands work; what's the percent dead band and, when you're out of that, how much of the revenue shortfall or windfall is made good or given back to DfT? So, a little bit more detail on those would be very helpful.

And then, apologies, but the third and final question: with the focus on quality, I assume there's more of an operating performance bonus and penalty mechanism within the contract; again, could you elaborate a little bit more on that? And if you do very well and beat that, what's the maximum revenue you could gain on top of the basic bid, and if you underperform that, what's the biggest size penalty that would be payable on that?

So, cash flow clarification, how the debt bands work and can you tell us how the operating performance mechanism works and what the financial risk is? Thank you.

Tim O'Toole: I'll take the third one, and then Matthew can take the first two. There's nothing extraordinary about the performance regime Damian. It's just – we have committed obligations: we naturally have to deliver TOC [Train Operating Company]-on-Self PPM [Public Performance Measure] requirements; we have to hit certain NPS [National Passenger Survey] and passenger satisfaction scores. If we should fall below any of those marks, we would be obligated to come forward with further investment to make sure we get there. This is a regime very similar to what we've encountered in the past, so there isn't any kind of special penalty payments of the nature you're alluding to.

Matthew, I'll ask you to take on the two first questions.

Matthew Gregory: Sure. So, on the cash flow point, obviously we're factoring in major capex into our numbers, so I don't think there's any particular fluctuation coming from the D&A side or from the capex which is why we think that in the first few years we can get this cash flow-positive position. There aren't any differences, particularly in the cash tax and what will go through the P&L tax. So that's the answer to the cash flow point.

On the GDP and CLE mechanism, all I'd say on that is that the banding is narrower than we've seen in the past, and the protection, particularly on the downside, is better than we've seen in the past. But at this stage, we're not going to get into a lot of detail, working through line by line what each of those mechanisms are; all we'd say is they're better than we've seen recently Damian.

Damian Brewer: All right. Can you – in that respect, obviously, it's quite important on this franchise – could you tell us when you will be in a position to let us know; will that be after the standstill and once the contract's signed?

And then, secondly, coming back to Tim's answer: could you tell us what the PPM requirements are, then? If you can't tell us what the financial bonus or penalty could be, could you tell us some of the thresholds at which you would be triggering either a bonus or a penalty?

Tim O'Toole: They rise over time, Damian, the requirements, obviously as we continue to bring in the innovation and perfect the operation. We have a rising schedule we have to meet.

Damian Brewer: Can you tell us what they rise from?

Tim O'Toole: It's from 90 to 93.

Damian Brewer: Okay, thank you.

Sam Bland (JP Morgan): Oh, hi. I was just wondering, based on what you can see at the moment, with the revenue trends across the industry – you allude to an industry average margin over the franchise. Would you be fairly confident in saying that that will be in each and every year – there's not some ramp-up in profitability as the franchise goes on?

And then also, if you could talk about the level of pricing flexibility you have in this franchise? I would guess that a lot of the revenue is season tickets, and therefore maybe regulated fares: just wondering what kind of flexibility you've got there on pricing? Thanks.

Tim O'Toole: I'll let Matthew take the margin number, although it is a fairly steady performance. Matthew?

Matthew Gregory: Yeah. That's the point, it is relatively steady across the life of the franchise. There isn't any great swing upwards, for example, on this; it's pretty flat, that margin level.

Tim O'Toole: And on the pricing issue, you're right: I mean, this is such a huge commuter market that a lot of these prices are going to just simply follow the specifications of the government. But naturally, as we bring in all this capacity and want to do more with the leisure markets, you could expect to see more advanced purchase opportunities across the entire franchise than have been seen in the past, because we will be looking to fill up the available capacity with all of these new trains. And we're doing things like we're making child fare discounts available to 16–18 year olds, which we've already announced. So, we'll be looking to deliver what is perceived by the public as much greater flexibility in the pricing and the fares opportunities in almost every respect.

Sam Bland: Okay, thank you.

Tim O'Toole: Well, thank you all very much. We want to congratulate Stagecoach; they had a great run, but things move on. This is a new franchise, new terms, and we are excited as we and MTR get an opportunity to execute on our plans. We think, as we said, it will be a very good thing for passengers, for taxpayers and for the partnership. So, thank you very much for joining us.