Transcript of FirstGroup's pre-close trading update call for the six months to 30 September 2014

Wednesday 8 October 2014

Chris Surch – Group Finance Director: Good morning, thank you for joining the FirstGroup pre-close trading update for the six months to the 30 September. I am joined this morning by Nick Chevis, Rachael Borthwick and Faisal Tabbah. As is our usual practice, I will summarise the trading performance and then I will be happy to take any questions you may have.

Before I get onto the trading, let me say a few words about the separate announcement on ScotRail that you will have seen this morning. Clearly at this stage I can't say much on the details, but the first comment to make is that having operated ScotRail for a decade, and delivered significant improvements on every measurable score during that time, we are very disappointed not to be taking the franchise forward. However, despite that disappointment, today's news does not alter our medium term financial targets or our plans for the UK Rail division. As you know we aim to participate in franchise competitions with the objective of achieving earnings on a par with the last round of franchising, and with an acceptable level of risk. We will continue to operate ScotRail until the handover on 1 April 2015.

Moving on to trading: in summary for the Group in the period, trading was in line with our expectations. Also our transformation plans continued to make good progress and there is no change to our medium term objectives. Each division has performed within the range of our expectations, with First Student and UK Rail towards the upper end, Greyhound towards the lower end; and First Transit and UK Bus where we expected them to be. As you know the financial results are normally second half weighted particularly in First Student and UK Bus and I will return to this later.

Now turning to each division in a little more detail. In **First Student,** we have been encouraged by the outcome of our plans and actions to improve the returns on our contract portfolio. The pricing trends we outlined at the quarter one update continued throughout the whole bid season. For the contracts due for renewal in the 2014/15 school year, which represent approximately one-third of our total bus portfolio, we achieved average price increases of approximately 4.5%. On contracts that had previously produced very low margins, we achieved an even higher rate of price increase. This contrasts with the increase of between 1 and 2% that we saw last year.

You will recall from the Capital Markets Day in January that 36% of our contracts achieved a margin of 5% or less. We expect this percentage to be below 30% for 2014/15 and then, with all things being equal, to reduce this further over the next couple of years as the rest of the contracts come up for renewal. Despite these price increases, we achieved a retention rate of approximately 90% on contracts due for renewal. This is equivalent to approximately 96% on the entire contract portfolio.

As you know we modelled a range of outcomes: at the optimistic end, revenues would be approximately flat compared with 2013/14. More pessimistically, we modelled a decrease of 5%. Taking the bid season results – together with organic growth, share shift wins, and a very small bolt-on acquisition – I expect revenues will be around the top end of this range.

The positive impact of the re-pricing on the contracts rebid this year will be mitigated to some extent by the negative impact of inflation exceeding the contract price inflators on the two-thirds of our contracts that will be rebid over the next two years.

In addition to our focus on bidding, we continue to work on reducing costs through the adoption of consistent best practice across the portfolio of 500 or so locations, and tight overhead control. As you know we are aiming to achieve an additional $50 million per annum of cost savings over the next three years, to add to the $100 million per annum we have achieved to date. As we have previously guided, with revenues at the upper end of our expectations we expect to achieve an operating margin for the full year in excess of 7.5% – in the range of 7.5% to 8% is our expectation. In the medium term, we remain focused on achieving double-digit margins.

I mentioned earlier the first half / second half split and we have previously guided that due to the timing of Easter this year, the normal second half weighting for First Student will be even higher this year. This is the main reason why the first half US dollar revenue is expected to be approximately 1.6% lower than the first half of the previous year.

Turning now to **First Transit,** this business continues to perform well. In the first half, revenue growth was approximately 9% and for the full year I expect it to be 4%, due to the timing of a number of contracts starting up and rolling off in the various periods. I expect full year margins to be in line with our medium term target of approximately 7%. I would remind you that these margins are achieved in what is a relatively low capital intensity business.

Greyhound continues to grow, with like-for-like revenues up approximately 2.7% – which was at the lower end of our expectations. For those of you who follow the headlines in the US, we are seeing the same as the likes of Wal-Mart, Target, and the dollar stores, who have similar customer demographics to Greyhound: although the US economy is growing as a whole, this is not yet the case for the specific market sector relevant to us. As in previous periods, our point-to-point brands continued to perform well, with like-for-like growth of approximately 6%.

As we have previously described, we are now much more able to flex our costs in line with the economic situation, and we expect to hold first half margins broadly flat year-on-year. The plan to transform the Greyhound model with increased use of mobile apps and the implementation of airline-style yield management, real-time pricing, loyalty discounts, smart ticketing and so forth continues on track. We remain confident that all of this work will support the achievement of our margin target of 12% in the medium term.

UK Bus is on track to deliver positive revenue and volume growth in the half, with both just over 2% on a like-for-like basis. Within that commercial volumes are growing faster than the overall figures in the 3% to 4% range. Concession volumes year-on-year were up a little in the first quarter and down slightly in the second quarter. We are also seeing a continuing trend towards increasing sales of weekly and monthly tickets. Although the yield is a little lower than day tickets in the short-term, they demonstrate increasing passenger loyalty, which is obviously good news for our longer term success in UK Bus.

We continue to see variability in the underlying economic strength of our individual markets, with parts of Scotland and other local communities having had a disappointing second quarter, while Bristol and Manchester, for example, were particularly strong. Overall we are in line with our expectations for revenue growth and margin improvement in the first half. We expect to make more progress in both of these measures in the second half as inflationary fare increases are implemented on anniversary dates. Also, there are expected to be less one-off restructuring costs impacting operating profits in the second half.

Turning now to **UK Rail**, which continues to perform very well with strong passenger volume growth and good financial performance. Like-for-like revenues for the first half are expected to be up around 6.5%. First Great Western returned to more normal commercial terms from effectively a nil contribution in the first half of 2013/14.

Apart from this morning's ScotRail news, the other franchising update since quarter one was our shortlisting for the TransPennine Express competition. You will remember we are currently contracted to run TPE through to March 2015, and we are negotiating a direct award with the DfT [UK Department for Transport] to run it until February 2016. We are also in discussions with the DfT concerning a potential longer term direct award on First Great Western, beyond the current end date of September 2015, and of course we await the outcome of the East Coast competition, which is expected in November.

On cash, there is no change to our previous guidance for a cash outflow of £100m for the full year, principally driven by the working capital outflow at the end of the First Capital Connect franchise.

In summary, trading during the first half has been in line with our expectations for the Group. The continued challenging economic backdrop in Greyhound and parts of UK Bus were a bit of a headwind, but the First Student pricing and cost efficiency progress, and good performances from First Transit and UK Rail offset this.

On a business of this size, and clearly with the bus businesses going through major transformation programmes, there will inevitably be some divisions performing at the higher end and some at the lower end of our expectations, so I am pleased that as a Group we are on track in the half. I'm also pleased we are making good progress with all of our transformation plans and we're on track to achieve our financial targets over the medium term. Now I will hand it back to the operator so we can take any questions. Thank you.

Questions and Answers

Edward Stanford – Lazarus: Good morning everybody. Just two questions please on UK Rail: you've been very clear that you are targeting for the Rail earnings to be in line with previous bid seasons. Looking back over the profits FirstGroup has made in rail, that seems to be about £100m: is that the right number to think about as a target for the medium term? Secondly, could you refresh my memory on the working capital implications of the loss of ScotRail when you have to hand it over to the new operator? Thank you.

Chris Surch: Morning, Edward. The simple answer to your first question is yes, £100m of profit is our target. That's effectively equivalent to two large franchises and one small franchise – and that remains our target despite this morning's news. Clearly ScotRail was in the smaller category, and with all of the franchises coming up for renewal and obviously our existing portfolio, that's why we remain confident of getting to that target.

On working capital, the ring-fenced cash will leave us on the 1 April 2015, so on the first day of the new [financial] year; that does move around, but we expect that [outflow] to be of the order of £50m. Then there is an additional, probably around £20m that relates to a maintenance bond, where we've been given money to perform maintenance; for any of that not conducted, we will hand that back, so the overall impact will be around £70m.

Edward Stanford: Can I just ask one follow up, if I may. With the ending of First Capital Connect, were there any benefits from the termination contract decisions and discussions that take place at the end of every contract?

Chris Surch: You're absolutely right, those conversations do happen but those are happening exactly as we expected them so there's no change in guidance.

Edward Stanford: OK, thank you.

Gerald Khoo – Liberum: Morning everyone, Gerald Khoo from Liberum here. A few questions and starting maybe with First Student: what percentage of contracts are up for bid next year? One-third this year seems to be quite large.

Secondly on First Student, how does the better than expected out-turn in the season that's just gone change your strategy for next year? Or what are your thoughts on the trade-off between the retention rate and the price?

Finally, on First Great Western, can you just clarify what sort of extension you're potentially talking to DfT about? What's the risk that that might end up going to open tender? And what's the timeline for a decision there? Is there a risk that that gets caught up in any sort of pre-election shutdown? Thanks.

Chris Surch: Thanks very much – just trying to write those down, I'm sure you will tell me if I miss anything! On First Student, the average length of our contract portfolio is just over three years, so I'd expect broadly a third of contracts to come up for renewal each year. I wouldn't say that a third this year was typically large; I'd expect it to be broadly the same amount next year.

In terms of the overall [bidding] policy, clearly this year it has been successful both in terms of retention rate and pricing. We're in the process of reviewing all of that because there are lots and lots of individual contracts, and different approaches in different markets as you would expect: we're reviewing the outcome of all that, and that will flavour how we approach next year's bidding season. It will also depend upon what market conditions are at that stage, and probably more specifically what happens in each individual market, which is different. As I'm sure you'd expect, I'm not going to give away our commercial bidding strategy in any great detail but broadly, we were very pleased with this year and that will feed into next year.

In terms of rail, First Great Western: there are currently discussions going on for an extension of anything up to five years and clearly, its up to the DfT on that decision. In terms of timeline, these discussions are ongoing; we would expect the DfT at some stage soon to put out their re-franchising timetable; they put that out every six months and the last time they did that was around March time. In terms of the absolute detail of the contract under the franchising rules, that will be next March 2015 because the PIN [Prior Information Notice] was put out last March and under the rules, you then have to go out 12 months. I'm trying to think of your last question!

Rachael Borthwick – Group Corporate Communications Director: The risk of [FGW] going to open market – I think you'd have to say that's quite low, given the DfT have already stated their intent.

Chris Surch: Yes. Gerald, did we cover all of your questions?

Gerald Khoo: Yes. Just a slight follow up: at five years isn't that getting a bit on the long side – DfT may have stated their intentions but someone could potentially challenge that and say that they would be willing to bid against that spec?

Chris Surch: Yes, and that's obviously one for the DfT. The key is the £7.5bn worth of investment on that railroad that is going to happen during the period and clearly, with our knowledge of running that railway – and obviously what is required with such a major infrastructure change – that's one of their considerations. Obviously what the government is looking for is stability during that period.

Gerald Khoo: Sure. But just to clarify, that's Reading, or was there something else going on in Great Western?

Chris Surch: It's new trains, it's the electrification, all of the signalling; there's a whole remit. Reading has obviously been going through a major change but it's far, far bigger than that.

Gerald Khoo: Right. OK, thanks.

John Lawson – Investec: Good morning, everyone. I've got three questions, if you don't mind. Firstly, can you just refresh us what you're assuming on rail bid costs for this year and perhaps any guidance for next year?

Secondly, you obviously flagged that Greyhound has been disappointing, I just wondered whether you could update us with any thoughts on what you might think like-for-like revenues in constant currency terms might grow out this year? Should we assume first half or do you think it might weaken further? And perhaps any guidance on where you think the margins might be in the scheme of things compared with the 12% longer term target? Perhaps you would also comment whether you think you are behind or ahead in the progress on that?

Finally, on the UK Bus margins, any guidance for this year? I obviously appreciate you've got a longer term target, but any thoughts for this year please?

Chris Surch: Good morning, John. OK, bid costs for this year: there's no change to the guidance that we have given previously which is around £15m. Going into next year, it will very much depend upon the bidding timetable as to what we spend but generally, if you look at last year, it was £20m so hopefully that will give you broad guidance; next year it's in that sort of broad range, maybe a little lower.

You're absolutely right on Greyhound: as I said when I was speaking, it was at the lower end of our expectations and that was principally driven by the economy. You asked for more thoughts, so the way I look at this is if you go back to quarter four last year, the revenue growth was 2.4%. It increased to 3.4%

in quarter one and then in quarter two it was 2.4%. So the outlier, if anything, was the first quarter and the reason that was higher, as we talked about at the time, was the very low comparatives in the first quarter of the previous year, you'll remember that was a particularly difficult period. In terms of margins and how we look forwards, as I mentioned in my comments I'd expect margins to be broadly flat in the first half. I'd expect to see some improvement in margins in the second half; not least as you'll remember, the second half last year margins were impacted by the severe weather – obviously I'm assuming normal weather conditions.

And then going forwards, again I see no change to 12% medium term targets. Obviously the economy is not helping us at the moment, but in due course, one would assume that it naturally would. More importantly it's about our yield management systems – so far the early stages of what we're doing there has gone well. If you look at what's happened in the first half, we've continued to increase the amount of sales of tickets on the web. Now more than 50% of our sales come through the web. More importantly is that we've seen a significant increase in mobile ticket sales: so of the web sales, mobile ticket sales have gone from around 10% to north of 25%, which is obviously key and I think reflects modern society. That part of it is going well, but the key is the new yield management systems, which as you know will be coming in over the next 12 to 18 months. For those of you who attended the Capital Markets Day back in January, you'll remember the slide that Dave Leach put up which showed that an additional one passenger across our fleet adds $11m to our profits. Obviously, that is a straight drop through: so that's why we remain very confident of getting to our 12% over the medium term.

Then on UK Bus, no change to the guidance that we previously had for a slight improvement on margins year-on-year in the [first] half and then that increases. If you look at where consensus is, there's just over 1% increase in margin from last year as we drive forwards: from the fare increases that we've talked about in the second half, and also, as mentioned when I spoke, there was some one-off restructuring costs that hit the first half that will not be repeated in the second half; so around 6%, or a little bit less than 6% margin, for the second half of the full year.

John Lawson: Thank you.

Anand Date – Deutsche Bank: Hi, and morning, everyone, I've just got one question, actually: the First Student pricing performance seems to be very, very good and you couple that with the retention rate, which to me feels extremely good at 99%: I'm just curious as to how you've been able to put through such a big price increase, and retain the contract? Is it that property taxation means the School Boards are feeling better about life? Is it that competition from some of your slightly weaker peers has lessened? How have you been able to put through such strong numbers?

Chris Surch: Anand, morning. First of all let me be absolutely clear on the retention rate: the retention rate is 90% and not 99% as you just commented.

We get back to effectively flat revenue by taking that 90% retention and then the other effectively 10% comes from share shift, we continue to see organic growth on our routes, from a small bolt-on acquisition in New York: that's how we get back to flat. That 90% is of the contracts that were up for bid – I know different players quote different numbers: I also said that if you look at out across our overall portfolio, i.e., including those *and* the two-thirds that were not out for bid, that's how you get to 96% [retention], so I hope that's clear.

In terms of how we did it, there was a very detailed process that I've talked about before, with a team from the [Group] centre, from Student centre, and also the individual businesses – that's what I found so pleasing about the whole process, it really just demonstrated the strength of the Group, that we all work together. It was a massive exercise as we went through each and every contract. We looked at the value of that contract to our customers and I think it's well known that we are a very high quality supplier, our customers really value what we do, we have the best safety statistics and we use that when we were discussing with our customers, so that was part of how we got the price increase. The other element was that – I think it's fair to say that the market has improved, if you look at School Board finances, and obviously it varies by region, but they are now back to pre-recession levels – so that certainly helps. It doesn't mean the discussions were always easy but I think it was that. I think also, if you look back to the issue that effectively arose last year, the fact that price rises in previous years had been on the low side and were not covering inflation. It was all a mixture of those different elements that fed into the equation that allowed us to achieve the success that we did.

Anand Date: OK, thank you.

Gerald Khoo: Hi, just a quick follow up: On UK Bus, there's been some talk about quality contracts in West Yorkshire. I was wondering if you could update us on what the current situation there is please?

Chris Surch: Yes, quality contracts have been talked about for quite some time. We much prefer – and I know the terminology is somewhat confusing, but – Quality Partnerships: where we're working alongside the local authority to provide the best service, the best package, the best value for customers. When we look at what we've seen in South Yorkshire: that has gone down extremely well. Certainly if you look in the North East in particular, and to Nexus and so on who talk about quality contracts – obviously that doesn't directly affect us because we're not directly in that area – but again, those people who have been looking at that have also been looking at what we've been doing with Quality Partnerships and looking at how they propose [to work with] that. So our argument has not changed at all during this period, its been the same for quite some time now: as you would expect it is to work on a partnership basis that will drive the best value for that customer.

Gerald Khoo: So, just to clarify in West Yorkshire, is this just the usual talk or is there a formal process or consultation underway?

Rachael Borthwick: Well, Gerald, there have been discussions in the past as you know and there was interest from West Yorkshire to look at an alternative structure, but we believe that the operators have made a good case for Quality Partnerships. As Chris said, we're using South Yorkshire as an example. We do seem to be in a reasonably good place there and, of course, all of the work we're doing in transforming our Bus operations – our commercial proposition becoming much more responsive to local markets and the work we've done on fares – has all helped to support that. So I don't think there is any particular move in West Yorkshire and no particular update at the moment.

Gerald Khoo: OK, thanks.

Joe Spooner – Jefferies: Morning guys, I guess there's been three rail decisions that unfortunately have been decided against you over the course of this year. When you look back at that, have you got any sense of what aspect of those bids you've been beaten on? I guess as a follow up to that, did you change the approach that you had to that bidding when you put your East Coast submission in? Thank you.

Chris Surch: Joe, morning. Each franchising competition is different. If you put ScotRail aside, I think the very simple answer to your first question was price: there was a significant difference between the price that we bid and what the eventual winners did. Again, just on our general approach, and we've said this on many occasions in the past: we bid very hard, we bid ambitions plans, we bid ambitious prices, but we are very disciplined in our approach. We need to be absolutely clear in our minds that we can deliver on our commitment, and that is the basis of [our] bidding.

ScotRail is slightly different and in that case obviously the news is very, very new. We were told late last night by Transport Scotland and it appears from what we've seen so far that the price of the various bids was very, very close, there wasn't a wild card [bid] out there. Clearly, until we've looked at our bid versus the winning bid, and looked at what was put in there in terms of investment in trains, alliancing, costs, and so on, it's hard for us to actually say yet what the differences were on that particular bid.

In terms of your question on East Coast: we put the East Coast bid in in the middle of June; that was put in before the more recent outcomes. Our position on the East Coast is exactly what I had said in my opening comments on this; we put in an ambitious bid and we want to win it, but we have put in a bid on a disciplined basis and one that we are very, very confident of delivering should we win.

Joe Spooner: Bearing in mind your comments that you want to build a £100m rail business, but at an acceptable level of risk, are the prices that you're being beaten on – is the market at a level of risk that is acceptable to you? Or is there the risk here that actually others are prepared to have a little bit more risk appetite around these things?

Chris Surch: I think that the reality is that we've had a small number of bids so far, there's still a lot of bids to go. It is early to say, but I don't think we have seen a trend anyway. There's always the argument that if you're incumbent, you'll never win but certainly when you looked at what's happened so far in the first three bids, that's not the case. I just don't think we have seen a major shift in that. Obviously, we'll see what happens in the future but in terms of your implied question of can we get to £100m [profit objective for Rail] – I go back to what I said earlier: that's two big TOCs [Train Operating Companies] and then a small- to medium-sized TOC. Obviously any extension on First Great Western: that's clearly a very big TOC. Should we win East Coast: clearly a very big TOC, and then we've got TPE, which has got an extension that we're talking about [with DfT] as I said through to 2016. Then there's all the other franchises that are coming up. Although we are very disappointed to lose ScotRail, it is towards the lower end of a small TOC, and there are these other opportunities out there which is why, although disappointed, we are not changing our medium term targets, because we're confident of delivering them.

Joe Spooner: Thanks very much.

Mike Stoddart – Brown Shipley: Good morning, apologies if I missed this at the start of the call: have you given us any guidance as to the profit contribution from ScotRail in its last year? That's one, and secondly, what is the likelihood of a ratings downgrade because of the loss of ScotRail? Thank you.

Chris Surch: Morning, Mike, thanks. No, we didn't say that at the start. We tend not to be very specific on individual franchise profitability, but on ScotRail it was very low teens in terms of profit, which is why I say that although we're disappointed, it doesn't really move the dial in terms of our overall targets.

In terms of rating, that's obviously clearly for the rating agencies to speak for themselves, but the way the rating agencies look at the cash that's in these contracts is the ring-fenced cash is not generally counted for their calculations, So in our view this does not change the overall ratings.

Mike Stoddart: Right, but surely the loss of the profit contribution will have some bearing on their view?

Chris Surch: Again, I come back to, Mike: it's a very small number in the context of the overall profitability for the Group and you have to look at what will happen in the future.

Mike Stoddart: Right, thank you.

Alexia Dogani – **Goldman Sachs:** Good morning, I just had two quick questions. Firstly, can you update on your fuel hedging position for this year and FY 2016 in particular? And in the context of the recent oil price moves, are you looking to lock in some of that benefit earlier perhaps?

And then, is it possible to explain the direct award process at the moment? Is it fair to expect that we will hear more on First Great Western or TransPennine post the General Elections? Or is it your working assumption that we find something out on this side of the year? Thanks.

Chris Surch: OK thanks Alexia, and good morning. Yes, on fuel hedging, our policy is that we are [almost] fully hedged out one year and then we have a rolling hedging process for the second year as we hedge out into the subsequent years; and we do that on a rolling basis, so every month we increase the amount that we hedge. So overall at the moment we are more or less fully hedged for 2014/15, and for 2015/16 we would be north of 75% hedged in the UK, that's on UK Rail and Bus fuel costs; and then in the US in 2015/16 a little bit less than 60%. Obviously while very cognizant of the fact that fuel costs are relatively low at the moment and that goes into our thinking – but just to be very clear, our focus is on stability and we are not speculators in different hedging rates.

In terms of First Great Western and TPE, those will be announced before the election.

Rachael Borthwick: That's our expectation.

Alexia Dogani: OK, great, and thank you.

Kanli Zhu – Citigroup: Hi, most of my questions have been answered but just going back to your response on the ScotRail operating profit in the low teens: that sounds rather high, I would have thought low single digit is where you would be in general. So if you could maybe give a bit more detail?

Chris Surch: I don't know how to answer that: it is what it is, each individual contract is different but low teens is the profitability.

Nick Chevis – Director of Finance: You tend to make profit on the passenger revenue part of the franchise; ScotRail has a passenger revenue of around about £300 million so a 3-5% margin on £300 million will give you a number in that sort of area.

Kanli Zhu: I see, I'm sorry: I was thinking that the low teens was percentage rate, which it seemed enormously high!

Chris Surch: Sorry, OK, I understand your question now, I was talking in millions of pounds.

Kanli Zhu: OK, great, thanks very much.

Chris Surch: OK, and thank you everybody. Speak to you soon, thanks, and bye.