Chief Executive's report

Tim O'Toole
Chief Executive

> **"Although we are not satisfied with our progress this year, the Group delivered stable adjusted earnings per share and strong cash flow, despite operating challenges for some of our businesses. We have also strengthened our balance sheet through the bond refinancing and further deleveraging.**

Performance in the year

First Student's continued progress from the fourth year of our 'up or out' contract pricing strategy and cost efficiency programmes was offset by continued driver cost inflation and shortages in parts of the US, a lower contract retention rate than targeted and the effects of the severe weather in the second half. We have had an encouraging start to this year's bid season as we continue to factor the driver cost inflation being experienced in many parts of the US into our contract pricing.

First Transit continued to grow and to win net new business, though our shuttle bus operation in the Canadian oil sands did not renew two contracts towards the end of the year, which will have an impact on the margin of the division going forward. The business delivered a 5.5% margin for the year, with a 7% margin in the second half as planned, despite ongoing cost pressure from driver shortages in certain regions, higher medical costs and some costs in relation to certain poorly performing contracts which were resolved during the year.

Greyhound's significant short haul and Express growth was more than offset by declines in long haul demand as a result of intensifying competition from the ultra low cost airlines, which are bringing significant additional aircraft capacity into operation while also connecting to a growing number of secondary airports. The growth in these businesses represents a meaningful shift in US travel patterns. Our ability to mitigate these revenue challenges through further cost efficiencies is limited by ongoing increases in fleet maintenance and driver costs, resulting in a significant reduction in Greyhound's margin. We are currently investing to support Greyhound's growth opportunities while continuing to trim our timetables, and the Group is conducting a full external review of Greyhound's business model and prospects to help determine the most appropriate response to this long term structural challenge. We have also updated our view of the carrying value of the division's goodwill and other assets in light of these issues, impairing them by a total of $387.3m or £277.3m accordingly.

We are encouraged that like-for-like passenger revenue growth in **First Bus** accelerated in each quarter of the financial year, though market conditions for the industry remain uncertain and vary by local market. We would have had an even better outturn for the year had several of our local businesses not been forced to shut down for several days in the face of the severe weather conditions in the final quarter of the year. We are pleased that stabilising volumes, the cumulative effect of our actions to tailor our network, fares, depot footprint and other costs and a fuel tailwind have resulted in a significant improvement in our margin. We shall maintain this momentum in order to meet our ambitions to catch up with the most efficient in the industry.

Year in review

April 2017
Investing in First Bus fleet
First Bus commits £71m to introduce 284 new low emission buses in Leeds by 2020.

May 2017
Greyhound route information integrated with Google Maps
Our Greyhound customers can now plan their journeys more efficiently through a partnership with Google Maps.

June 2017
Shortlisting for West Coast Partnership
FirstGroup is shortlisted alongside our partner Trenitalia to bid for the West Coast Partnership franchise which will include initial HS2 operations.

July 2017
Hull Trains tops passenger survey
Scoring 97% for satisfaction, Hull Trains is named the best long distance operator in the National Rail Passenger Survey for the fourth year running.

August 2017
First Student acquires Falcon Transportation in Illinois
This transaction extends our relationship with the Chicago public school system and offers synergies with our other First Student operations in the city.

September 2017
South Western Railway launched
Having taken over SWR operations during the Waterloo upgrades in August, Transport Secretary Chris Grayling formally launched the new franchise at a Waterloo station event on 4 September.

Although **First Rail**'s like-for-like passenger revenue growth accelerated over the course of the year, we must acknowledge the slower rate of overall industry growth that currently prevails. The overall financial result from our Rail division was solid in the year, with contributions from Great Western Railway (GWR) and SWR (which we began operating in August 2017). However TPE's like-for-like passenger revenue growth, though very substantial at 10.0%, is lower than our projections at the time of the bid, resulting in an operating loss of £6.5m for the year to March 2018. Our plans to increase capacity by more than 80% and create a true intercity railway for the North over the remainder of the franchise are the right ones for our passengers and communities, and we are confident that they will drive a considerable acceleration in TPE's annual patronage and revenue growth over time. However our assessment is that this growth will be short of our bid assumptions due to current market conditions, and we have therefore taken the decision to provide for forecast losses of up to £106.3m over the remaining life of the TPE contract.

Overall the mixed performance in our divisions resulted in 1.0% Group revenue growth and a reduction in adjusted operating profit of 10.4% in constant currency (before SWR and the 53rd week in the Road divisions), with lower finance and tax charges resulting in an increase in adjusted EPS of 3.4% in constant currency. Principally as a result of the Greyhound goodwill and other asset impairments and the TPE onerous contract provision, the Group reported a statutory loss before tax of £326.9m (2017: profit of £152.6m) and EPS of (24.6)p (2017: 9.3p).

We are however encouraged that we were able to sustain a strong cash flow performance of £110.5m (2017: £147.2m including proceeds from sale of a Greyhound terminal). This excludes the £88.5m of start of SWR franchise cash flows; taken together we generated £199.0m of free cash flow, helping to reduce our net debt: EBITDA ratio from 1.9 times to 1.5 times in the year, or from 2.3 times to 2.1 times on a Rail ring-fenced cash adjusted basis.

Balance sheet

In the year we reached an important milestone with our long-dated bond portfolio beginning to mature, allowing us to significantly reduce our future interest burden by starting to refinance and rebalance the Group's debt. We are pleased by the support shown in the credit market for our improved resilience and financial profile. We raised $275m in February 2018 at a weighted average cost of 4.25%, and in March we used the proceeds and other monies to redeem the £300m 8.125% coupon bond due September 2018. This action will generate interest savings of an estimated £14m per year from the next financial year.

Investing in our passengers' needs

We have continued to invest in passenger convenience including initiatives to promote contactless payment, online and mobile ticketing and travel information improvements and other technology to streamline and enhance our operations and responsiveness to customers and other stakeholders. Meanwhile our commitment to the safety of our passengers, our employees and all third parties interacting with our businesses remains unwavering. Our approach to safety is a combination of innovative technology, external assurance and our behavioural change programme, Be Safe, all of which have made further progress in the year towards ensuring we are always operating to the highest standards. With increasing focus on local air quality and emissions we are constantly striving to improve the performance of our vehicles and introduce even cleaner engines.

Group outlook

Overall, we expect Group earnings in constant currency to be broadly stable in the year ahead. The Group is expecting an overall improvement in the Road divisions' margins and returns, underpinned by the momentum in the First Bus turnaround and First Student's growth plans in the year ahead. We expect First Transit's continuing growth to be tempered by the loss of high margin Canadian oil sands business, and that sustaining Greyhound's earnings will be challenging given the changes in the long haul competitive environment. The overall progress of the Road divisions is, however, expected to be offset by a smaller contribution from our First Rail portfolio in the year ahead, reflecting the slower rate of industry growth and the rebasing of our margins under new contract terms. We also expect higher free cash generation from the Road divisions after the disciplined investment required to support our passengers' needs, offset by a lower contribution from Rail in the year ahead.

Tim O'Toole
Chief Executive
31 May 2018

October 2017
Intercity Express Trains enter service

GWR's new Intercity Express Trains carried passengers for the first time, marking the next stage in the biggest fleet upgrade for a generation.

November 2017
GWR franchise extended announced

The Department for Transport (DfT) announced its intention to exercise a 12 month extension option of our GWR franchise to run to the end of March 2020.

January 2018
Autonomous vehicle trials

First Transit tests autonomous vehicles in winter conditions in Minneapolis, while FirstGroup announces the first trial of such vehicles on UK roads.

February 2018
Charity partnership beats target

Our donations to our charity partner Prostate Cancer UK reach £1.5m in value, easily surpassing our original target. A new partnership with Action for Children began in April 2018.