FirstGroup preliminary results for 12 May 2010 – 9am call transcript

SIR MOIR LOCKHEAD: Good morning, everyone. Welcome. Welcome to our presentation on the prelims to year ending 31 March 2010. I'm here with Jeff Carr, our Finance Director. He'll take you through a detailed review of the financials and then we'll get on to questions.

Just the overview of the year. I'm pleased to report robust performance against very tough trading. You all know what the economy looks like and remains like. It's in that context really that I set these results. The continued global economic uncertainty, recession in the UK and in North America has impacted our passenger demand businesses and created pressure on our contracted businesses in North America where the lower tax receipts have led to a tightening of public spending in both state and at local level. In addition, in this year we've absorbed £90 million of additional fuel costs because of the fuel hedge and then, if that wasn't enough, we've had the most difficult weather conditions, severe weather in both North America and the UK in the fourth quarter, and that has impacted our results and Jeff will take you through that.

We have a very clear strategy, however, and through these difficult times we've taken prompt action, we've continued to search for efficiencies to mitigate against the effects of both the economy and the other things that I've mentioned. Our track record, as it happens, on cost management, driving out efficiency has, in fact, stood us in good stead and I'm pleased to report that in these results our cost reduction programme during the year exceeded our target. The target was £200 million and we've exceeded that target and, as I said, Jeff will give you chapter and verse on that.

We've also used the flexibility of our businesses to get us through these difficult times, and particularly with the non-contracted business, the rigorous management of our networks in both UK Bus and Greyhound, route-by-route analysis to ensure that as demand changes, and it changed very, very quickly, that we were able to respond quickly by looking at frequency and looking at mileage and reducing mileage. What we've done in fact is protected our revenue per mile to the extent that it's ahead of last year, and that's both in Greyhound and UK Bus. So the management team have really gone after this and done a fantastic job so I'm pleased that we're able to demonstrate that to you today.

Of course the other priority in this year was to generate free cash and to use that free cash to pay down our debt and again we've come in ahead of our target. You'll remember we set ourselves a target of £100 million in this year. We've achieved £130 million of net cash generation which we'll use to reduce debt.

So I believe that there is still scope to continue this process of reviewing our efficiencies, and we'll talk about that in the business reviews, to continue to drive cash out of business so as to get debt down year on year. I'll now hand over to Jeff so he can take you through.

Before I do that, should I just ... I should mention the dividend. I just didn't turn over the page. The dividend for this year, subject to our shareholders' approval, will be 14 pence, which is an increase of 10% and brings the full year payment to 20.6 pence per share. In addition, today we're announcing a new commitment to increasing dividends by at least 7% per annum for the next three years. So that was a pretty important part of our announcement.

So, despite the difficult year I'm pleased to report resilient performance. Our team have risen to the challenge, as I've said, and now Jeff will take you through the detail. Jeff.

JEFF CARR: Good morning, ladies and gentlemen, and thank you, Moir.

As Moir stated, it has been a difficult year across the group. However, operating profit did come in at £453.9 million, pretty much in line with our expectations. If we put that into context it has been a good performance when faced with the three significant challenges of fuel costs, which rose by £90 million in the year. Our fuel cost was equivalent to about $113 a barrel for the year. Also, like many businesses, we've been impacted by the recession. And lastly, and I hesitate to mention, in the final quarter we did witness some of the most severe weather conditions, both here in the UK and in North America. As we stated in March, we estimate the cost of this disruption to our services to have been around £16 million. Therefore, what has been critical during the year is we mitigated these external factors and we've delivered on our cost targets.

So we are pleased that we've achieved £228 million of cost savings this year, above the target, and there has been a lot of hard work that has gone into those savings but I'm encouraged that the team is continuing in their efforts to ensure that the cost reduction is now seen as a continuous process and not just a one-off project.

In addition to protecting margin, the second key priority has been cash and debt reduction and here we've also made very good progress. During the year improvements in working capital and tighter control over capital expenditure resulted in the generation of £136 million of free cash ahead of our target. As a consequence net debt has been reduced from £2.5 billion to just under £2.3 billion and our ratio of net debt to EBITDA is now just under three times.

Moving on to the key financial highlights, and as you can see revenue grew to just over £6.3 billion for the year, up 2.1% in real terms but in constant currencies, after adjusting for a slightly stronger US dollar, revenues were down a little, about just under 1%. EBITDA for the year was £770 million and EBITDA margins were 12.2%. So it's only 30 basis down from last year.

Operating profit declined by 8.2% for the reasons we've stated and the margins, operating profit margins, therefore, were 7.2%

compared to 8% last year. Finally, profit before tax was down 19.1% from £326 million to £264 million, the key issue being the higher financing costs as a result of the stronger dollar and the increased costs related to the bonds.

As you can see from the next chart, our non-recurring items were reduced in the year from £93 million to £49.7 million, the key reason being the fact that we've completed the spend on the integration and in the year we also finalised our restructuring costs which delivered the cost savings which cost about £25 million in the year. Again, neither of those will recur next year so we expect next year to be very little spend on the non-recurring lines. Finally, adjusted EPS was down 18.7% to 39.5 pence a share.

Very quickly looking at the operating performance, operating profit performance by division, and it's clear to see that the main drop has been at Greyhound where operating profit was down £25 million versus the prior year. Now, clearly this is largely an impact of the reduced revenue related to the recession and as we are seeing revenues recover in 2010-11 I'd expect to see a significant recovery in profit at Greyhound. Rail profit you can see was broadly in line with last year and profits at UK Bus and North America were down £9 million and £12 million respectively. We'll look at the causes of those in a bit more detail but basically the message is similar that it's tough trading conditions and higher fuel costs being offset by a good effort on cost reductions.

Now, looking at the same bridge but this time looking at it by cause of variance and the key variances, we can see here the tracking from last year's profit of £498 million to £454 million. The key variances, obviously we've had the cost reductions of £228 million offset by four main categories: fuel at £90 million, which we've talked about, and then we've identified the impact of the recession. Now, bear in mind this is a little bit of an estimate, at £71 million, but I think it's a pretty reasonable estimate. Next we've seen a net increase in our rail premium which has increased by £54 million. And then the effect of inflation net of a few other things, and that's mostly inflation on wages at £57 million.

Thinking ahead as we look to next year, fuel costs will obviously largely reverse. For next year we currently have 86% of our fuel hedged at an average cost of around $82 a barrel. Therefore we anticipate the benefit of about £90 million coming back. That being said, we have other challenges, not least the increase in the rail premium, which is more significant next year, and an increase in pension costs.

Just looking at the management actions, just to summarise, we've talked a lot about the cost reductions so just to summarise where we came out for the year. Looking at the breakdown of these by business we can see actually most of the benefit came in in UK Bus, there you can see £55 million, and UK Rail at £70 million, which quite frankly is not totally surprising since North

America had just gone through the programme of delivering on the synergies with the integration.

In UK Rail we had significant headcount reductions. These were in many areas, including the back office areas, finance, IT and HR, as well as reductions in areas such as catering and the booking office staff. Engineers and driver numbers were largely unchanged. At UK Bus a total of £55 million, as I've said, of cost reductions were achieved and over 1,100 positions have been eliminated. Operating efficiencies again came from a variety of areas, not least improved driver efficiency and improved fuel efficiency contributed to those numbers. In North America good progress has been made reducing overhead costs and there is more still to be done, and again we continue to improve our driver efficiency.

Specifically, the Focus project that we've talked about links driver hours and route management and enables us to cut out waste and maximise efficiency in terms of utilisation of our drivers. Now, although delays in this project did come in in the second half of the year, which meant our savings were lower than we originally planned, Focus has now rolled out across approximately 30%, about a third of our student locations, and we're confident that as we complete this rollout further savings will follow. We're certainly seeing significant savings in the areas that we've put Focus in.

At Greyhound an example of the overhead reductions has been in our terminals where terminal staff generally have been reduced by about 20%. This, as well as the contribution from cost reductions due to the integration of the Dallas administration function into Cincinnati, has generated the savings that you see here.

Moving on very quickly to talk about each of the divisions in turn and starting with Student, you can see that revenues were down in total by 3.2%. However, within the core revenues, the core contract revenues, we were broadly flat year on year, after adjusting for Canadian dollar and a slightly lower number of operating days. Now, as we've discussed the most significant fall has been in ancillary revenues, so charter revenues and route consolidations resulted in around $40 million of lost revenue during the year. As you'll be aware, this is incremental business and therefore of a higher profit margin. However, it's pleasing that the cost reductions have been able to absorb a lot of this loss in ancillary revenues and the cost of the severe weather and that EBITDA margins finished the year at 20%. Additionally, Student margins which you can see finished the year at 11% which remain best in class, and we'll continue to focus in the new year on cost management and driving operating efficiencies to ensure we offset any further revenue pressures.

Now, this year we split out Transit from the Student business - and we've shown that separately - because although both are contract-driven businesses they have some key characteristics which are quite different. So, for example, margins are lower than Student, however cash flows are strong since there's a very limited capital expenditure required in this business. You can see revenues grew fairly strongly at 4.6%, largely as a result of new contract wins. As you can see operating profits increased from $60 million last year to $84.4 million in the current period. Looking at Greyhound, we've talked about the effect of the recession at Greyhound and it was quite sharp. Revenues were down; finished the year 13.5% down. Now, to offset the falling demand management did act quickly at Greyhound to reduce the mileage and in total 11.3% of our mileage was taken out, mostly in the extra sections that we put on. This has allowed us to protect the load and the revenue per mile and to minimise the effect of the downturn. This, along with the cost reductions, has resulted in operating profit falling from $91.7 million to $39.6 million, which on reflection is a pretty good result and one that leaves us pretty well placed as we see revenues recover to see a recovery in profitability. As we've discussed, we are seeing good growth. We saw some growth in the fourth quarter and that is continuing into the new year.

In Canada, which has traditionally operated at lower margins than the US, we haven't been able to act as quickly. This is largely due to the fact it's a more regulated market. However, as we begin the new year we're confident that agreements have now been reached with the Canadian provinces which means we'll be able to significantly improve the performance of the Canadian business.

Like Greyhound, at UK Bus we've been able to flex our mileage to match demand. Overall we've taken out 5% of our mileage by adjusting our networks on a route-by-route basis. This action, along with aggressive cost reductions, means that margins have finished the year 70 basis points down from last year at 10.6%. Considering the significant fuel impact, which a lot of the fuel impact has been in UK Bus, and the extraordinary weather conditions in the final quarter this is a pretty good performance. Obviously we'll see the benefit of the fuel price reversing next year and we are confident we'll see some margin improvement in UK Bus next year. In total, passenger numbers grew during the year by 1.9%, slightly ahead of the forecast we gave in March, but we remain cautious on volumes for next year and to date there's little evidence of any recovery in passenger numbers on UK Bus.

Looking at UK Rail, operating profit benefited from excellent cost performance and these reductions and the benefit of revenue support at First Great Western and First Capital Connect pretty much offset the impact of the reduced subsidies and the fuel cost increases. As you can see, EBITDA grew in the year to £147.6 million and operating profit was broadly in line with last year at £92.6 million.

For the full year, passenger revenues, this is the like for like passenger revenues, grew 2.3%, obviously down from the higher growth rates last year of over 7%. However, the fourth quarter trend is very encouraging. The fourth quarter grew at 3.7% and indicates a positive trend which we continue to see in the new year, the new financial year. This is a trend mostly driven by passenger volumes. We've seen very little pricing in this current year.

I move on now to talk about our other key priority which is obviously the cash and debt and our priority remains to accelerate the reduction in net debt levels. It's therefore very pleasing to see our net cash inflow for the year increase from last year, where we had £51 million, to £136 million, as Moir said above our target of £100 million. We've shown here the year-on-year change in net debt in the form of a waterfall chart, starting with last year where, as you can see, our net debt stood at £2.5 billion. This year we've generated £770 million of EBITDA and the cash impact you can see there of each of the key categories, starting with restructuring and provision costs at £53 million and £42 million respectively.

Working capital shows an outflow of £70 million in the year and this is clearly an area we've talked about and need to focus on going forward. Although the £70 million is a large outflow in the period, it's significantly better than our expectations and it does include, just to be fair, a £40 million charge in Rail related to the change to the CP4 charging regime and the timing of cash receipts from revenue support. That said, I expect a cash inflow from next year of working capital of around £30 million and that's an improvement of £100 million year on year in terms of cash flows.

The net outflow from capital expenditure, moving on, was £202 million and that's lower than the additions. If you look at our capital additions it was £252 million, mostly due to the timing of some payments at the year end falling outside of the year and some finance leases taken in the year. With interest payments and dividends, therefore, you can see the total of £136 million which, in addition to the favourable foreign exchange rate, ended up with net debt being reduced to just under £2.3 billion.

As we reported at the half year, our successful bond issuances now mean we have an average debt maturity which is now over six years. We have no refinancing due until February 2012 and this, plus the strong liquidity headroom which is over £1 billion at the end of the year, gives the group significant flexibility. But we're not relaxing. We plan to accelerate our plans further and improve leverage and expect net debt to EBITDA by the end of next year, March 2011, to be around 2.5 times.

So, in summary, in the medium term we remain focused on tough cost control and debt reduction. We're pleased with the £228 million of cost reductions that we've made this year but we remind ourselves it's not a one-off effort, rather an ongoing process and we'll continue to ensure that we're the most efficient operator in each of our markets, looking at our overheads, our organisational structure, procurement operation, procurement opportunities and operational efficiencies to protect margins and deliver shareholder value. We've made good progress on debt but there's more to be done and I'm confident that we can meet the increased targets that Moir mentioned of £150 million for next year.

Thank you, and now I'll hand back to Moir.

SIR MOIR LOCKHEAD: Great, thanks for that. Now, we're going to go through each of the divisions and sort of highlight the things that we've seen in the year.

If we look at Student first, the core provision of our business here remains very resilient and retention of contract was about 90%, so it's a good result in the year. I mentioned at the beginning we've seen this continued focus at the local level, at the school board level, to look for savings. I don't remember seeing anything quite like this during the last recession that we had in America. So I think we're all having to live through it, the whole sector is managing costs in a much more efficient way than we did before, and probably the truth is we should have done it anyway. Our central costs in America are still getting our attention. We think that we've now got to a position where in Cincinnati we can take more costs out of there because we've now got the structure in the divisions much more consistent and much more efficient. So I think during this whole period and we'll continue, as Jeff said, just continue to become more efficient and take out costs as we can see that. Managing these costs and getting the margins under control and continue to grow is our clear focus and as the economy starts to recover we will see, we're absolutely convinced, revenues recover and profits recover.

We continue to win new business. It has been a tough market, it is a tough market, it's highly competitive as you know, but we won a very good contract in Wichita during the year, 600 buses, which was a share shift, and then we had probably our biggest conversion in Detroit, 300 buses coming out of the public sector into the private sector. So, again, good signs but, as we've said many times, although it's a fantastic opportunity, only 30% of the market is outsourced, it's slow, it's difficult, it's political, it's hard work. But never mind, we've got a pipeline; we'll continue to focus on that as well as winning in the bidding market.

As market leaders and able to monitor the trends and customer requirements across the industry we have focused our attention -- and I've repeated so many times you must have the message now that we're getting costs under control, we're giving some of that back to the customers so as to make sure that they're able to live with their budget constraints. We've introduced things, like you've heard Jeff say, Focus with a GPS system which allows us to track the drivers to be able to measure their scheduled hours against their attended hours so we get a much more efficient use of them. You've heard for many years we talk about wheel turning time as a measure of efficiency against paid time and that's how we do that. In fact, our revenue spend on labour, on driver costs, is very similar to the prior year. So we've managed to keep that under close control and one of our key KPIs is we monitor that on a monthly basis to make sure that we're not seeing any more spend than we'd anticipated in our budgets.

The reason for the margin being at 11% is that continuous focus. It's just relentless. We keep our people really focused on that and despite all the other things we've talked about - the weather, the economy - the one thing we can do is manage our costs more effectively than anyone else.

We've been in this market for a long time - I keep repeating that but it's true - and over time we've seen different bidding behaviour. Right now the bidding behaviour in some areas is very, very aggressive. What we won't do in FirstGroup is we won't go in for low margin and high capex. We're seeing some companies providing new bus fleets at very low margins and it's a short win but over time they'll live to regret that. So, just to be clear, we won't see our margins dilute because we're winning business that we can't afford.

So that's the Student business: good shape, a lot more to come.

Transit. This business now is over $1 billion of revenue. It's the second largest division in North America. It's good business. It's good because it's got margins of 7.3%. It grew in this year by 4.3%, revenues grew in US dollar terms. It requires very little capex so the return on investment even brings a smile to Jeff's face. It really is a good business and we continue to grow that business.

Contract retention in this year was over 90%, so that's good news, and we won a very large conversion in San Diego, California, as well as New Jersey and Oregon. We're winning in the para-transit business and we're winning at a level where we're offering discounts where in the past there were multi-providers, in other words two or three small operators providing the contract. The customers have come to us and said, "Look, if you can give us a bit more discount on the contract, we'd be able to ..." and that of course improves our margin, gives us more absorption of our overheads. So it's good to see that and in New Jersey and Oregon that's what we achieved, we became the sole operator.

With minimum capital investment this is a business we will continue to see growth coming out and in this next year we would expect that. Pressures are on them, don't take it that there's no pressure on these transit authorities, there certainly is, but we're able to manage that by looking at giving them cost efficiencies that they've not had in the past.

Greyhound, this is probably the toughest year Greyhound has ever had. We saw revenues fall by 13.5%, not just the fact that the revenues came off but they came off so quickly, and I have to say that an operating margin of 4% wouldn't normally get my approval but in this case margins at 4% under these conditions was a fantastic outcome. Our team just lived - you heard Jeff say, the extra sections, the duplication - almost by the hour taking out resources to match changing demand and that's the reason we're in such good shape. Revenues were more positive in Q4 and that trend remains. So it's an encouraging trend but we're not -- you know, we're being very cautious. Mileage reduction, making sure the route-by-route analysis was effective has meant that revenue per mile is ahead of last year and that's the real measure for us in looking at the KPIs. A great result and the team have worked very hard and delivered on that.

Greyhound US continues to deliver good operating margins. It was around 7%. The Canadian business wasn't in good shape. It is getting better. We've got agreements now with the Canadian provinces to reduce mileage and in some cases to get revenue support for those routes that are just not viable during this recession. There's further scope, we think, to take cost of sales down. You'll probably remember when we acquired Greyhound the cost of selling our own tickets was about 16% of revenue. That's now down to 12% and really getting people to buy online is becoming a real focus for us and I think there's a lot more to come there in getting costs down.

So the flexible model is the strength of this business but alongside that running the business more effectively. The on-time performance continues to improve. It's still too low at 88%; we're not happy with that but it's a hell of a lot better than it was when we started. So, making sure that the networks run effectively and alongside that we've taken out a lot of the very old fleet because we've reduced the fleet size. We said last time we met that we would then, as we come out of recession, see new fleet coming in to top that up and that's what we'll intend to do but in the meantime we're refurbishing 250 coaches this year that will enhance the customer offering and improve, of course, operational performance.

BoltBus, which is our new model in the northeast of the country, does average loadings of 38 passengers per journey. These are 50-seat buses and that exceeds the traditional Greyhound average loading. The brand recognition is very high. It includes -- some of our customers include some of our investors in the US who in growing numbers tell us, as mystery shoppers when we go round to meet them, how well they like the service that we're providing. So it is a really positive story from Bolt. We're providing another 38 buses to support our growth plans for this year in targeting City Pairs.

While it has been a tough year for Greyhound, we've been able to drive through a number of changes to create a stronger base and we estimate that for every dollar of new revenue we'll get 65 cents flow to the bottom line. So it's in stronger position than it has ever been and as we come out and when we come out of recession we'll be able to take advantage of that.

UK Bus. I am pleased with the very steady, resilient performance here. It has absorbed very heavy fuel costs in the year and that's had an impact, of course it has. The margin is 10.6%. We'll continue to focus on that margin during this new year but I think in the circumstances it was a good result for the team in UK Bus. Jeff mentioned we reduced mileage by 5%. I think we were ahead of the sector in recognising we needed to make some changes and to enable us to protect revenue per mile. As in the Greyhound case, revenue per mile is in line with last year and that's got to be the best measure, so we can restore capacity. The one thing that we've said to our partners in the local authorities is as this recession -- as we see passenger numbers and footfall in the cities we serve improve we'll simply put back frequency to support that.

We continue to drive out efficiencies through new initiatives such as DriveGreen which is a technology we use for our drivers to be able to drive more effectively, more comfortably, more safely but, as important, using less fuel. That helps our carbon footprint and our plans going forward to making sure that we contribute to the climate change strategy. Developing new initiatives for revenue. Because we've spent all of this presentation focusing on cost efficiency, we haven't relaxed on driving new opportunity to grow bus passengers and the FTR development in Swansea last September, we launched a new service there, revenue volume growth is up 10%. We've a number of new fare initiatives in various parts of the country but in particular places like Bristol, Travel Plus smartcards in partnership with the West of England Joint Transport Committee; in Greater Glasgow providing a new ticketing discount regime for young travellers which will increase loyalty in this key demographic group. So we're all of the time looking at how we can stimulate growth and as the cost of petrol continues to climb we expect to see that benefit come through in the future.

Driver turnover rates is something we've mentioned in these presentations many times. It's not that long ago I'd have been telling you we were 30% of our staff left us every year. It's now down at 17%, the best I've ever seen. I think it's because of the general economy, the labour market, but there's also some things that we've done on selection and training that have helped with that and I think it's a good sign. Quality is improving and against that, even with the mileage reductions that we've made, punctuality levels have improved and so has customer satisfaction. So, two very clear messages there for the future.

Railways, you heard from Jeff, better than expected, ahead of expectations. Encouraging signs in the second half of the year, almost 4% growth compared with about 2% in the early part, but we're not counting our chickens. We're taking a very cautious approach to that. Margins have held up. We've taken a lot of cost out. I've repeated this many times, without recession we probably would have found that difficult. In recession you do things that you just wouldn't have contemplated and you do them more quickly, which is what has happened here.

Operating performance has continued to improve with punctuality now over 90% for First Great Western, First ScotRail and TransPennine Express. First Capital Connect's operating performance, as you'll remember, continues to recover after well publicised difficulties earlier in the year and that was because of the unofficial dispute that we had and the damage that was done to our rolling stock because of the severe weather in the last quarter. That railway is now running at over 90% punctuality for the Thameslink route, which was the one that was most affected. We will continue to work hard to gain and restore customer confidence in that railway. We're market leaders in the UK Rail with an established record of prudent bidding and profitable growth. As a long term player in the industry I think we're well positioned to continue to benefit from the exciting opportunities that will emerge from the next round of franchise renewals.

So then to the outlook. While we continue to draw strength from the diverse business portfolio that we have and that we're established as market leaders in those segments, looking ahead in this new financial year we're encouraged by the growth trends in UK Rail and Greyhound and the continued stability in UK Bus. We've said that we expect to see continued pressure in public spending budgets in North America and I think we do that. I think we've got to be very cautious, we've got to understand how that market has changed, and when it might come back is for others to decide. We've got to manage our way through it and that's what we intend to do.

So, despite those uncertainties, I'm confident that the group will return to earnings growth in the coming years and our priorities are very clear. Firstly, we remain firmly focused on margin maintenance and improvement throughout the group. We see scope for further cost reduction and operating efficiencies and we'll continue to drive these over the next year. You've heard from Jeff it's a way of life now, it's not just a one-off target. It's us continually revisiting what we've already done to see if we can improve that.

The second clear strategy will be to continue to pay down debt. We have increased our target from £100 million of cash generation to £150 million for this next year and we're confident that the opportunities exist with that to accelerate our deleveraging plans. We'll continue to focus on growing revenue. Although we've spent a lot of time in this presentation and our managers are continuously reviewing efficiency we are still looking to see how we can grow our business through acquisitions, small acquisitions in America, but the clear focus is to take the debt down.

We will continue to establish positions where our critical mass in locations will give us a competitive advantage. I think there is clear evidence that our business sectors have got potential for long term growth. The work we've done this year will ensure that when the economic recovery comes we will benefit from that.

Looking ahead, our board is confident of the inherent strength and resilience of our group. An expected return to earnings growth, together with strong cash generation, supports our commitment to dividend growth of at least 7% per annum for the next three years. We've created a stronger, more efficient base which will ensure that the group is well placed to continue to deliver long term value to our shareholders.