Company: Balfour Beatty Plc

Conference Title: H1 Trading Update

Moderator: Steve Marshall

Date: Thursday 3rd July 2014 – 08h00 UK

Operator: Good day and welcome to the H1 Trading Update conference call. Today's conference is being recorded. At this time, I would like to turn the conference over to Steve Marshall. Please go ahead, sir.

Steve Marshall: Good morning, everybody. I'm sure that many of you would have seen today's announcement. We've brought forward our IMS by a few days in order to update the market on the Group's current trading and in particular, the worsening performance of our UK construction business, or part of it, I should say: the Engineering Services business, to be precise. It is the same part of the business that caused us concern at the time of our last interim management statement in May. And I'm sorry to say that a limited number of contracts, around 20, and predominantly in the London area, will reduce our profit expectation within UK construction by around £35 million. To say the very least, this is very disappointing; the more so because aside from this ongoing issue, the substantial majority of the Group is trading in line with our Quarter 1 trading statement and indeed within our expectations. Overall we expect to meet our previous guidance for the year of pre-tax profits between £145-£160 million due to strong gains on the number of both realised and planned disposals from the PFI portfolio.

Alongside me I have Nick Pollard, Chief Executive of our UK construction division. As well as leading the UK Construction Services division as a whole for the last year, eight weeks ago Nick took direct management control over the Engineering Services business and has made a number of management changes. That has improved transparency in this area, and it has become clear that operational delivery in parts of the Engineering Services business leaves much to be desired. Nick will talk about what's driven the £35 million impact and the action being taken to address it.

I am confident that we are addressing this in the right way. We won't be bidding for new work of this type in the London region and we will be allowing the contracting book in that area of the business to run off. Further, we're reducing the scale and the geographic footprint of our UK building services business. Its annual revenues will be less than £200 million as we get into next year. The outlook for the rest of CS UK, and remembering that our major projects and regional businesses represent some £2.5 million of the £2.8 billion in UK revenues is broadly unchanged from previous estimates. This latest UK construction profit shortfall will be offset by increased profit disposals from the PFI portfolio, taking advantage of what is a buoyant market price. So our group target range for profit of £145-£160 million pre-tax remains unchanged. I'm going to ask Nick in a moment to describe the specific actions he's taking. But first let me just touch on a few other matters. At the interims, we're going to be formally changing our director's valuation of the PFI portfolio to provide a much clearer guide as to its realisable market value. We do believe that this will assist investors in forming a proper view of the underlying value of the Group. And on Professional Services, I just want to report that we do have a competitive Parsons Brinckerhoff sale process well underway and that, to date, this is proceeding very much in line with the Board's expectations. So at that point, I'm going to pause and hand over to Nick.

Nick Pollard: Thank you very much, Steve. Morning, everybody. It's clearly extremely disappointing and embarrassing for our company to be back disclosing more bad news from Balfour Beatty Engineering Services, the building services company within our family of businesses. Over the last two months, there's a number of matters relating to the trading of our building services company that have resulted in us forecasting a further profit shortfall in 2014 of £35 million, and this is since the Q1 IMS update of course. Although trading is tough in the M&E sector throughout the UK, these damaging issues predominantly relate to the central London region of that building services business in which we have some two dozen contracts. Now this shortfall, £20 million, relates to further deterioration on the specific contracts identified in the earlier IMS. £10 million comes from commercial issues related to other contracts and £5 million simply from a lack of work won. So what's changed since Q1? The profit expected from work won in the year, as I said, is reduced by a further £5 million. Essentially some bids have been delayed coming to the market for pricing. And on the available workload, we've been bidding with greater rigour, greater selectivity, being applied to the tendering estimating and the margins.

And the consequence of that is little work won, which is the right outcome, of course; we don't want work at unprofitable margins and much prefer a smaller and profitable business.

Contractual advice and reviews have also resulted in adverse variants taken into our forecast on commercial matters related to the contracts that I just mentioned in London. We've also had a number of design changes foisted on us by customers on a small number of contracts where that design responsibility is already in dispute. And the risks have increased on several major contracts where progress has been hampered and the end date of those projects has slipped, with a consequent increased commercial risk for our teams, both from direct costs incurred and also from the prospect of contractual penalties. It's got to be said that the majority of the difficulties that lie in the London area are on contracts where our customers are predominantly Tier 1 contractors and probably hold some hard positions themselves.

In relation to all of this, there are, of course, a number of actions that we've taken to turn us back to profitable ways. So if I just run through those. I've already completely changed the leadership team in this business. That's already having an effect. And of course, one of the things they bring is increased rigour, vigour and a transparency. We've appointed a new finance director, a new commercial director. We've added a brand new chief operating officer, replaced the London regional director and appointed also a new operations director for London underneath him to make sure we get a very firm grip on the necks of the London contracts. And all of that's alongside me taking the helm as the interim managing director at the start of May whilst we conclude the search for a new MD, a process that's already well in train. Those changes have driven transparency in an open environment in which the problems we're talking about this morning have been surfaced more readily and more clearly. We've also driven a far greater degree of vigour, of rigour and of scrutiny to the monthly project reviews by which we control our work. Thirdly, we're fighting hard for our commercial entitlement and will continue to do that remorselessly. As Steve's already mentioned, in being selective in bids, we are no longer bidding for work with others in London. Where this business, Balfour Beatty Engineering Services, will only be working with Balfour Beatty's construction teams where we can forge integrated teams that directly control and influence design, utilise our bin systems and the offsite capabilities in a way that adds value for our customers and shareholders alike.

We're currently in the middle of reviewing the geographic spread and organisational structure of the building services company in order that we run a smaller, efficient and profitable business in 2015. Elsewhere, we've determined to merge our Northwest and Midlands regions together under a single regional director and team which will, obviously, help us run that shape of business that is more efficient. And further changes beyond these will go through at a later time in the coming weeks and months as we reconfigure the Engineering Services business for safety, equality and for profitability. So those are the things we've been doing. And I hope all of that helps lend transparency and understanding to the conversation this morning. We're certainly not resting on any laurels and, of course, I'll be pleased to take questions whenever you want, Steve.

Steve Marshall: OK, thanks, Nick. So just to return back to the UK from my perspective, I have been at pains over the last two months to emphasise to all investors that I've interacted with that we cannot guarantee that all contractual issues in the UK construction business have been identified, and I'm afraid, so it is proved. That does not lessen the disappointment of this latest downgrade to any of us. I do reiterate my view that it will take a full 12-18 months from here to secure a full and reliable turnaround of our entire CSUK business given the weakness it's demonstrated in operational delivery and the scale of personnel change that is required and is now well underway. The new management team are doing all of the right things, but construction businesses take time to heal. The market upturn is a gradual one. And so margin recovery will come only progressively.

As far as the broader group is concerned, our priority is to make Balfour Beatty a simpler, more focused and much more effective organisation. And that above all paves the way to create future value for our shareholders. And we're going to talk rather more about that at our interim results in August. So now I would like to take questions; alongside Nick and myself is Duncan Magrath. If you can please mention your name and organisation that you represent, and then please ask your question.

Operator: Thank you, ladies and gentlemen. If you would like to ask a question at this time, please press the star key followed by the digit 1 on your telephone keypad. Please ensure that the mute function on your telephone is switched off to allow your signal to reach our equipment.

Once again, please press *1 to ask your question. And we will take our first question from Olivia Peters with RBC.

Olivia Peters: Hello everybody. It's Olivia Peters from RBC. I have four questions, please. I think my first question's probably best for Nick. I just was wondering, I mean you've obviously now been at Balfour Beatty for a while and it seems to me that, as was Duncan earlier, basically you should be experts at bidding for construction projects. And it seems that, despite having reviewed most of them and even the £20 million worth of projects that you identified, you don't seem to have a lot of visibility on those contracts. So I was wondering, despite changing management and things like that, how much reassurance can you give us that you have reviewed most of the contracts now and you have put in place safeguards to stop things like cost overruns going forward? My second question is around average net debt. It seems, obviously, that the second quarter average net debt increased quite substantially. How happy are you with your targets for average net debt of £375 million for the full year now? Obviously, the Parsons Brinckerhoff disposal is ongoing; can you give us a clue on timing for that? And then on the geographical spread, I'm not sure if you said it, but what are you changing regarding your geographical spread, if you could give us more of an idea on that? Thank you very much.

Steve Marshall: Nick, if you kick off with one and four, then Duncan on net debt, and I'll come in.

Nick Pollard: Sure. Morning, Olivia. It's Nick here. Bidding and controls. I said on the last call, the IMS, eight weeks ago, all bids for this business would come either to my Chief Commercial Officer or myself. They have done. They continue to do that. There is control over them for Engineering Services. There was already control and there remains control for the other parts of CSUK in any case. We made changes last year, and they're effective. So I'm confident that we're bidding the right stuff. What I'm explaining this morning is that in determining that right stuff, we're basically exiting part of the market in London where we are working for others, and focusing solely where we can influence design and avoid the kind of risks that are crystallising here. Of course, those controls instigated over the course of the last 12 months don't change the nature of contracts entered into over the course of the two years prior to that. And all these problem contracts that we're talking about here are in the sort of, you know, the hinterland. Most of them finish this year. Two contracts run over into next year at the moment. That's the forecast.

So I think that gives you an idea of when they were entered into as well. So I'm confident around the fact that we're doing the right things with our bidding teams and I'm pretty confident, too, that when we talk at the interim results, we'll also have further updates for you on what we're doing to improve the efficiency of this small business. I hope that helps.

Four, geographic spread. Geographic spread of this business, well, we talked about central London. The contracts are running off in the Northwest, and we're merging Northwest and Midlands regions together under a single regional director, which will provide us with a more efficient solution. Scotland is a buoyant, yes, it is buoyant actually. We're picking up work there. We've won work there in the last month; there's probably some more to come next month. The Northeast is not as buoyant in the market sense, but it's a good place for us to trade, and the Midlands. We will gently withdraw from the deep Southwest with this business, so I don't really foresee it as a strong market down there, and I don't want to waste anyone's time down there. Does that help?

Olivia Peters: Yes, thank you.

Nick Pollard: OK. Duncan?

Duncan Magrath: In terms of average net debt, yes, it was slightly higher than we expected. Part of that was, obviously, the reduced trading performance, but also part of that was due to delay in investment sales. In terms of target for the full year, I'll probably update at the interim as it will probably go up slightly from the £375 (million), but not significantly.

Steve Marshall: And on Parsons Brinckerhoff disposal, as close as I'll get to forecasting precise timing, as you never know with these things, is that, as we said in the release, it is a competitive, conventional M&A process. We're running, we're in mid-term as far as that's concerned. We know who the runners and riders are and, as I said, the Board is satisfied that the process is going as we would wish. So we'll just have to see how that progresses.

Olivia Peters: Thank you.

Steve Marshall: Thank you. Take another question.

Operator: Ladies and gentlemen, if you find that your question has already been answered, you may remove yourself from the queue by pressing *2. And we take our next question, from Joe Brent with Liberum. Please go ahead, sir.

Joe Brent: Yes, from Liberum. Good morning. Two questions, please, and the first one, I think, is quite a big one. I'd love a full explanation. Could you remind us where we are now in terms of M&E, what the scale of that business is and the profitability and what the likely trajectory of that is? Because I think I'm hearing that only a couple of contracts run into next year. So do we get a sort of significant bounce-back in profits? Could you put some numbers around the shape of that business?

Nick Pollard: Yes, sure. Joe, it's Nick. Sorry, I'll just clear up that misunderstanding there. Two of the problem contracts run into next year. I was trying to indicate when the problem contracts ran out by, and when they were bid. The shape of the business this year is around £280 million. It's probably going to trade down now. I would expect that, by the time we get through next year, 2015, this will certainly be a sub-£200 million scale of business, somewhere between £150-£200, I'd have thought, was probably about right next year.

Duncan Magrath: Yes, Joe, if you look at the order book, there's about £80 million of orders we've currently got booked that relate to next year, so to give you some flavour for what's currently booked that will flow into next year.

Nick Pollard: We're after quality, not quantity.

Joe Brent: In terms of profitability, I'm just trying to get a sense in terms of what the bounce back could be next year, in terms of the change – where we are now and what are the losses – are we presuming losses this year?

Duncan Magrath: Correct. I mean, I think in relation to – we've obviously, with today's announcement and the previous trading update, we've had a shift against our expectations of effectively £55 million, and we obviously entered the year expecting to make a 2-3% type margin on just under £300 million business, so we were expecting to be profitable. This has put us into a significant loss-making position. I'll speak for Nick and Nick can comment, but obviously from our bidding and tender process, we're obviously intending to ensure that we bring that business back to at least a break-even position over the next year.

Joe Brent: Great. And the other question related to the PPPs. I mean, can you give us a slight sense of where your thinking is on revaluing those assets. I mean, some of those disposals recently have been sort of 40% plus premium to Director's Valuation. Presumably that would be too aggressive. Are we thinking about 20% increase, that sort of order?

Duncan Magrath: Hi Joe. It's probably worth if I talk methodology, and I think I'm going to leave the actual numbers to the interim statement. Actually, the uplift on the recent ones against DV was 85%. In terms of what we are going to do, is what we are doing, is looking at the cash flows within those models that have probably been, frankly, too conservative, and that's what's driven the increased value that we've got within the disposals. And secondly, I think there is also an issue around the discount rate, given particularly the very buoyant market as to whether the discount rate is too high. So it's effectively a combination of principally around looking at the cash flows but also perhaps down the discount rate which is currently at the 9.5% discount level. In terms of the uplift, I think it's clearly going to be an uplift that probably we just need to wait until we've worked out the mechanics, and we'll talk about that at the interim.

Steve Marshall: Yes, and clearly, Joe, we wouldn't be doing the work and reviewing this if we didn't have a feeling that the full value of the portfolio wasn't reflected in the Group's sum of parts and share price, so that's obviously part of the objective in doing it.

Joe Brent: Thank you.

Operator: Thank you. And we take our next question from Howard Seymour with Numis. Please go ahead, sir.

Howard Seymour: Thank you. A couple of questions from me, if I can. Firstly, I don't think you gave the number in terms of, what's the revenue on the problem contracts, within the context of the circa £280 million that you've got at the moment, Nick?

Duncan Magrath: It's – the problem contracts relate to – effectively the London region is about 40% of the Group and effectively most of the problem contracts are in the London region.

Nick Pollard: They're probably, in aggregate, they're probably about 30% of our revenue at the moment.

Howard Seymour: Thank you. And again, coming back to this on the timing, with most of these contracts coming to an end in the current year, obviously what we're all trying to look for is a bit of assurance that this doesn't happen again, because it's happened so quickly after the last one. In that they are to run off in the second half of the year, can you be more confident about this not happening again because, as you mentioned, Steve, you couldn't guarantee the issues were not already there. Would you be more confident that these have been underlined now, or is this still an ongoing issue for you in terms of these contracts and potentially also in M&E in the wider context?

Nick Pollard: In the wider context of M&E, we won't be entering into contracts on these kinds of terms again. And we won't be running contracts with the weak approach to their management that characterised the last couple of years or more of these particular projects. So that should, effectively, close the door on a lot of the stuff we're talking about at the moment. I mean, contracting always has risks, but here the contracts were entered into in a particularly poor manner, on bad terms, and were run in a poor manner. I mean there's no way to pretend otherwise, no reason to pretend anything. Going forward, you know, as I've said, we are controlling the pipeline for this business now. We are controlling the terms on which we enter into contracts, and we are not doing, not behaving in a suicidal manner in order to secure work, which was probably the characteristic of this sector as you've seen all the way across it from a number of businesses. So I think that answers how it moves forward.

Howard Seymour: OK, sort of related to that, is this number, has this number been around, have you been discussing these numbers with the clients. Because is there not a, is not an issue here that as you put this number out, the client then turns around and says actually, in that you're saying that, I think we can potentially screw you a little bit more for this?

Steve Marshall: That's a good question.

Nick Pollard: That is always a risk, and I'm afraid was part of the discussion ahead of this call. But I prefer transparency with you guys on this to the degree that we're able. It is a fine line that we walk. We believe we have contractual entitlements. We are fighting hard to recover them, but in relation to guidance for you and investors, I think it is important that we recognise the risk in those positions. And I think we're duty bound to do that, and I think that's what we're doing. I hope you agree that it's the right choice. I think we have no other alternatives at PLC.

Howard Seymour: OK, I understand there's commerciality as well. And the last question from me, apologies for taking a few, just sort of first half/second half split, because clearly last year all the issues would have appeared to be in the first half. Given that you're still on run off from these contracts, how do we look at Construction Services on a first half/second half basis, because clearly it's going to be nigh unto impossible for us to forecast how this feeds through in terms of that split.

Duncan Magrath: Howard, it's Duncan. As you'd imagine, all this has come up to us reasonably quickly and therefore we've had to make this sort of unscheduled announcement. I'm not going to be able to give you a huge amount of clarity around the first half/second half split because we have to work through that. I think some of this is clearly the second half issue in relation to things like the work winning, where we're obviously downgrading existing loss-making contracts that will fall in the first half because you have to book it immediately. Where it relates to a reduction in expectation of profitability that will be over the life of the contract. So I'm afraid at the moment, if you bear with us, we'll have to look at the first half/second half split when we've had a little more time than we've had to react to this news.

Howard Seymour: Yes, that's fine, Duncan. So obviously there could be some impact and probably will be some impact into the second half. It wouldn't all probably just be first half.

Duncan Magrath: Yes, that's definitely true. It won't all be first half.

Howard Seymour: Great, thank you very much.

Operator: Thank you, and we take our next question from Andrew Gibb with Investec. Please go ahead, sir.

Andrew Gibb: Morning guys, it's Andrew at Investec. Just a few from me. Nick, just on M&E, I believe I saw in the last IMS you talked about sort of persisting with the business and the brighter prospects further downstream. Clearly suited today's issues suggest that's pushed a little bit further to the right. Are you still comfortable that, you know, for a £200-odd million business losing what it is, is it still worth running with it at this present state?

Nick Pollard: Sorry, Steve's grinning at me, of course, yes, because it is inevitably a right question to ask. This market is still slow. It will recover as the rest of the sector is starting to. It is the last carriage on the train that comes out of recession. And a lot of competitors have died on the vine during the course of the recession in the last couple of years. If I was to just sort of add a little more colour to that kind of picture, we can see that a number of Tier 1s have bid for their jobs and are struggling to get M&E services away as a package, by splitting it down into separate little subcontractors and buying it at Tier 3 or Tier 4. That will lead to commercial problems for them downstream, inevitably. We've seen this cycle before. And therefore, there will be a move back to using the Tier 2s, which is where we are positioned. So there will be a market there downstream. We're not there yet. It is a market, and there's competence, and we have historic competence and technical strength in this area. Then there is a business of value and worth there. The fact that we have led it and managed it poorly in part of the country and caused ourselves and you this kind of pain doesn't mean that the downstream business doesn't have intrinsic worth. It does.

Andrew Gibb: OK, fine, so. You've obviously talked a lot about sort of changes to management. Steve, I wonder if you could give us an update on the one outstanding management gap to be filled in terms of how the search for a new CEO is going. Is it going at all? And any sort of timing update on that, please?

Steve Marshall: Yes, it's definitely going. We've got head hunters commissioned and it's underway. Rather like the Parsons Brinckerhoff process, I hope it's competitive and has high quality participants. But it is too early to make any projections about the timing. Obviously, high quality people don't grow on trees and you have to identify them and they're probably in other jobs. So we'll have to see how it goes, but I can certainly be clear that we are searching and we believe we will attract somebody of very high quality.

Andrew Gibb: OK, great, thanks. And just on sort of, no one's asked it so I'll do it, just on the dividend, clearly, whatever happens with Parsons and the potential impact that has on the dividends going forwards, but just generally when we get to the interims, what are the thoughts on about ability to hold the dividend at the moment? Is that the right policy?

Steve Marshall: Yes, I won't directly answer one way or the other because I'm probably not supposed to. But I think I will reiterate what we have said. And it's not remotely changed by today's announcement, which is that the time the Board would formally look at dividend and all of the rest of it would be when we've got a concluded Parsons Brinckerhoff transaction on the table at a good price and then, in the round, we'll have to look at all of the elements which will naturally include the ongoing dividend and return of value and strong balance sheet. But that will be the time to review that, and until that, we're in holding pattern.

Andrew Gibb: OK, no problem. And then just finally, sorry, last one from me. Just on the decision behind the director's valuation. Is that a function of just, in terms of secondary markets, as you said, the growth returns you've been getting out there, is there pressure from investors or is it, it does nicely balance the equation, I suppose, of where the deficit is and the average debt and the PPP, or is it a function of all sort of three of those?

Steve Marshall: I'll allow myself a one-line response, because Duncan is looking at me forbiddingly in case I say more than I should. But I will certainly volunteer that the particular pressure is from me, because I've been obsessed with the fact that I don't think the full value of the portfolio is reflected in the Group's sum of parts valuation. But beyond that, I will restrict myself and allow Duncan to say something.

Duncan Magrath: I always do what Steve tells me to do.

Andrew Gibb: Great. I'll say that is answered. Thanks.

Operator: Thank you. And we take our next question from Mark Howson with Canaccord. Please go ahead, sir.

Mark Howson: Good morning, gentlemen. Can I ask two questions today? Can you hear me? Just on the valuation of the PFI portfolio, I remember a couple of years ago when, it may seem like the last time we came in here, but John Laing was being acquired, part of a thing they put up in terms of its overall value what the business was worth, was some sort of view on its pipeline and what converting that could be potentially worth, obviously less the costs of putting the money in to achieve that value. Is that something that you could be interested in, or is that a pipe dream at the moment?

Duncan Magrath: In terms of the valuation point, do you mean?

Mark Howson: The valuation of your PFI portfolio.

Duncan Magrath: It's a very good question. Certainly at the moment, all we were contemplating doing was effectively updating the process that we'd previously done which takes the cash flows inherent within the what's already effectively won. It's a good point about how you value the pipeline. We have had some thoughts internally around it. It is quite difficult to come up with a number. I will think further as to whether we can give any guidance around that. There's a number of different ways we've thought about contemplating that. Your fundamental point of your question is right, which is the value of that business is in excess of simply just the Director's

Valuation of the individual concessions. How you value the incremental bits, I think, is difficult, but there is definitely value there. All ideas gratefully received.

Mark Howson: Because otherwise there's no goodwill full of team that you've got in place to create future value, it's just the assets, it's already created nothing for what they can deliver.

Steve Marshall: I couldn't agree more.

Mark Howson: Secondly, just on the point we've been making in terms of realising the value of the portfolio of the Group, it's not recognised in the share prices, I understand where you're coming from. But just looking at, take an example, realising more from the PFI portfolio, again, that recognising the share price, one of the problems that people have is looking at the level of bonding requirements that only US construction business put on the Group and how much cash and resources and assets are required to remain on the balance sheet to balance all those risks out is such a – could selling the US construction business, particularly the part that gives you – I know the US is in an upcycle now and maybe not the greatest time, etc, etc, but longer term, is that something that you could consider in order to help flush through the value that's in the PFI portfolio?

Steve Marshall: I think that the key thing, you don't have to actually sell all of the PFI assets in order to recognise the value in the Group share price. There are several reasons why we actually recycle capital in and out of our PFI and investment portfolio. The constraints of US sureties and bonding so that we can trade with the government in the United States in construction are certainly there, and you've referred to them. But that is not to say that the intelligent thing to do if those constraints weren't there would be to try and sell the whole PFI portfolio tomorrow. You know, it's much more complicated than that. And investments are best sold actually in bite-sized chunks at the point they reach a reasonable point of maturity. And you've got a whole continuum of different investments, from very new ones to quite mature ones, in the portfolio. So it's about value maximisation as well, in the broadest sense. So I think, if I carry on talking long enough, I'm ducking the broader strategic question you asked. But you know, as I said a couple of months ago when we made our previous announcement, the current mission of the Group is to simplify and strip it back to principally its Anglo-American construction core with an overarching investment business. And you can touch and feel the synergies that that sort of structure provides a much more focused group. In the long run, you can speculate on all sorts of things, but that is our mission for the foreseeable future and whilst we are doing that, a) we want to release significant capital by a successful sale of PB at a great price and b) we want the full value of the PFI portfolio adequately realised in investors' assessment of the sum of the parts of the Group. And if we can achieve those two things over the coming months, I do think alongside the improvement plan for our UK construction business, that will make a real difference and move the game on.

Mark Howson: Finally just from me some more mundane stuff. Can you give us a feel for, well more for you, Duncan, some traditional things like give us a feel for the shape of the first half/second half split, given the mix of profits that we're looking at here.

Duncan Magrath: I think I sort of tried to say with Howard, I think for the time being, it's going to be difficult to give a split clearly it's going to be second half weighted given the previous and current announcements around the construction business. I think there always is a skew. I think the skew is going to be pretty heavily to the second half of this year, particularly as we've got some investment disposals coming in there as well. More than that's going to be difficult to give. We'll have to reflect back on that, I'm afraid.

Mark Howson: Thank you.

Operator: Thank you, and we take our next question from Daniel Porter with UBS. Please go ahead, sir.

Daniel Porter: Good morning, guys. Just a couple of questions. You said earlier that the problem contracts really related to London. I know it was about 30% of the Group. And they're slightly older contracts. Just wondering how it took so long to identify those issues on such a big proportion of the order book? And then secondly, what have you changed in terms of your risk management, specifically in terms of how you incentivise your management in terms of how they're bringing work into the business, were they incentivised on a revenue basis or more of a profitability basis before or and how has this changed from how it was previously?

Nick Pollard: Yes, sure, Daniel, Nick here. Morning. It didn't take us so long to understand that these contracts were problematic. We noted back at the turn of the year that we had some issues relating to a handful of contracts in this business. We traded them forwards and we said in the IMS at the end of Q1 that those problems had clearly worsened and that we would be changing the management team and doing some things all around controlling that. We've now traded a further eight weeks. Those contracts have moved on in their positions. So have our gaps in understanding of the risks that are entailed. We've had further changes on those contracts driven by some customers. And we're reporting this morning, I think quite rightly, that we can see that there is a deepening divide between where we think our entitlement lies and where some of our customers might want to settle with us. It doesn't mean to say we won't pursue that entitlement; we will. But we're absolutely right to recognise that risk, and we have some other contracts, you know, I mentioned 10 of the 35 this morning relate to issues that are developing we can see on some rather difficult contracts in the similar neck of the woods. So that's because we have tightened up our risk management processes which, for live contracts, principally hinge around their monthly reporting and review cycle. And it's through tightening that review process that we have this deeper and correct understanding of the trajectory of those jobs. So we have tightened up on risk. We have tightened up on management oversight. And we have also, in a separate game, tightened up on our bidding so that we don't enter into contracts that put us into this kind of territory and dispute. In terms of incentives, during the course of this year we have put into place clear management incentives related to a number of factors including project-level profitability and business-level profitability for our middle and senior management teams. And in the instance of some specific contracts, we've incentivised the project teams as well. It's been a significant step for some of our people, I think, from where the business was in the past. It's a direction of travel, reward for results, that I personally believe in and that we intend to continue promoting over the course of the coming months and years. Does that answer your question, Daniel?

Daniel Porter: Yes, that's very helpful. Thank you very much.

Operator: Thank you. And we take our next question from Kevin Cammack with Cenkos. Please go ahead, sir.

Kevin Cammack: A couple of mine have been addressed, but I have got a few, if that's OK. Firstly, I think, just, I'm trying to mentally tie up some of the numbers that you've given today. Am I right in thinking the aggregate loss in the M&E part of the Engineering Services division is of the order of 45 (million) and everything you've said today would lead anyone to the conclusion that there's going to be some downsizing of the division going forward. And as a consequence of that, I guess, you know, the overhead needs to be addressed, offices, etc. Are any of the presumed costs of that within the numbers that you have given today, or are they yet to be seen? That's the first one. Secondly, I think you used, I'm sure you used the words, that you'd taken, some of the provision that you've taken was on the basis of contractual advice which presumably is over the variations and the outstandings. Can I ask, when you refer to that, are you saying externally you took advice as to the position on some of these outstanding, or the existing contracts but the outstanding differences to completion costs, etc? Was this external advice? And if that's the case, was this what you actually did when you did the review on the regional business a year or so ago, whenever it was, when you had the situation there, is this the same process that you've adopted or is it somewhat different? And on a related point to that, you've now had, well visibly we've been told about two if not three areas within Construction Services UK that have now had this much more rigorous process and forensic examination adopted, which has a) highlighted the losses or the lack of profit that you expected. I just want to be clear; is there any other part of the UK construction division that has not yet had the same vigour addressed to it that the two that we know about have? And my very final question, which is one for the chairman, I wonder if you could enlighten us at all as to, you made the point about having been round to see institutions, etc. Can I just ask, has there been any question that selling Parsons Brinckerhoff is the right policy to be adopting? Has there been any reply that actually there are other alternative strategies that could have been adopted, or is there, in your view, a general consensus that what you end up with is a business, you know, this sort of transatlantic construction business with the PFI attached. Is your view that the institutions are happy in principle with that as a Balfour Beatty going forward?

Steve Marshall: Alright. I'll respond on that at the end. Duncan will kick off on the first of your questions, and then Nick will pick up the running from there.

Duncan Magrath: Yes, I mean, in terms of your comment around the numbers, yes, the loss is round about what you said, perhaps slightly higher than that. But yes, you're in the right ballpark. I can't remember the follow up question in terms of the numerical question.

Kevin Cammack: Well, clearly, you're going to have to downsize the business, I mean, are there any of the costs of that in this number or would we be yet to see that?

Duncan Magrath: They're not in this number, although clearly, Nick is still developing his plans. We're not anticipating that they would be huge. But as yet, they're not included in that.

Nick Pollard: If I pick up the running from there. So Duncan's right. We're working through that at the moment. I think I've given you an indication this morning of kind of the, where we believe the strength of the business lies in the internal service in the London market, in the northeast, in Scotland, and when the market returns perhaps back into the northwest. So we'll come back to you, at the interim statement, I'm sure we'll be able to tell you then fairly clearly the changes we're making. I don't think you should assume that this is kind of hoards of people; it's not that scale of business. You know, this isn't Construction Services UK we're talking about here; this is Engineering Services, a £250 million turnover business. In terms of, now you asked about contract advice. Yes, it would be normal for us, where we, or it is normal for us, where we have disputes over contractual matters, to take external advice on that. And in fighting our corner, also to take external advice in terms of engaging experts to assist with delay analysis and things of that nature. And yes, we've had all of that kind of advice in relation to supporting and fighting for our just entitlement. On the matters that we're talking about this morning, that have caused us to revise our view of risk and change our forecast. That's a very different type of advice from the external reviews that happened in relation to the regional business a year or so ago. So please do disconnect those very clearly in your mind.

In terms of the businesses, have we crawled across the whole of CSUK now? Look, I think Steve was quite clear at the start: trading in terms of the regional business, trading in terms of major projects let alone the rest of the Group, is doing what we expected it to do the last time we talked like this. It is this Engineering Services business, the building services part of our offering at Tier 2 that is giving us a problem at the moment, and that's the part of the business that we're busy fixing. Of course, as we get it fixed and get it into rehab, as the rest of Construction Services in the UK is at the moment, we will keep a close eye, close controls running, not only across Engineering Services but across regional and major projects too. It's construction. You can never say never that there will never be another bump in the road somewhere, and Steve's been clear on that as well.

Kevin Cammack: Sorry, Nick, I wasn't trying to ask for any assurances on what can happen day to day operationally on contracts in the business. I was specifically asking whether there was any part of Construction Services UK which had not had this rigorous process applied to it as of now.

Nick Pollard: Sorry, Daniel, sorry, Kevin, I misunderstood that. There are three parts to the business. We have dealt with the other two parts previously. This is the third part that we're dealing with at the moment, and that's all of CSUK.

Kevin Cammack: OK, thank you, thank you.

Steve Marshall: Let's come on to your final question, Kevin, which is sort of shareholders' attitude to the PB disposal, and it's timely, because I'm acutely aware that in a sense, the more we come up with surprises, as we've done today on our UK business, the more it focuses the mind on the residual group versus the planned sale of Parsons Brinckerhoff. So the logic behind asking the question is obvious and reasonable. Let the full picture of how certainly I see the dialogue we've had with institutions, Duncan, jump in by all means, is, at the point we announced it a couple of months ago, I think certainly on the initial discussions, the quick calls over the telephone that you tend to do when an announcement's out, there were a number of shareholders that kind of thought it was a bit counterintuitive selling the higher margin crown jewel – why are you doing that? And so on and so forth. My strong sense by the time we had got round and had one-on-one conversations with really one way and another all of our major shareholders, is that when you take shareholders through the logic and, in our strategic review we looked at every which scenario and shape and mix of the Group as I described last time we did one of these calls. And when you go through the logic and go through in the end the objective which is to just force out some shareholder value from this group because it hasn't created any for a long time, generally I wouldn't characterise it, it would be wrong to characterise it as everybody is accepting and thinking it's a great thing. I do think there's general acceptance. But I think, as every in these things, the proof of the pudding is in the eating. And what people are looking for is a disposal at an excellent price. We have not characterised at any point in the discussion that with one leap we have all of the strategic answers and solutions to the Group merely by selling Parsons Brinckerhoff. As I said last time, what we're doing is firstly simplifying the Group so we can manage it better in a more focused way and make real progress in our current areas where we need to improve, and we're opening up optionality for the Group going forward. So it's not the strategic solution, but it's a very important stepping-stone. And that, alongside getting right value for the portfolio, the PFI portfolio in price, getting the proceeds in and moving the game on in terms of UK construction, would make a significant difference. And I do think there is acceptance of that amongst our major shareholders.

Kevin Cammack: OK, can I just ask one, I probably know the answer to this, but have you, I mean, I can understand where you're coming from in terms of ultimately, you've got to demonstrate value to shareholders that exists within the business and crystallise that as best you can. Would I be wrong in thinking, therefore, that there is a commitment to return some of that value to shareholders when Parsons is sold?

Steve Marshall: I'll repeat what we said. Sorry, Kevin, did you finish your question?

Kevin Cammack: Yes, pretty much.

Steve Marshall: Sorry. I mean, I'll repeat what we said last time, which is that, at the point we have a transaction on the table and the price on the table, we will look at the needs of the balance sheet. Obviously dividend has to be looked at as the ongoing business would be smaller. And return of value will be considered alongside that also. But we haven't taken any views on that, and we have got to look as we judge it at the time at the forwards cash flows and the recovery profile of having UK business in construction in the meantime. And there will be some leakage of proceeds into the pension plan, not too much for tax, but certainly into the pension plan, we'll have to take into account as well.

Kevin Cammack: OK, thank you very much.

Operator: Thank you, and we take our next question from Alastair Stewart with Westhouse Securities. Please go ahead, sir.

Alastair Stewart: Hi, it's Alastair Stewart from West House Securities. Hi, Nick, you've given a lot of detail on the M&E business. I wonder, can I just drill down a bit more to the nitty-gritty? First of all on the numbers, I think it was Duncan that said the aggregate loss was a bit higher than 45; I kind of worked out £48 million, £48.5 million. The problem contracts were about 30% of the overall revenue of £280 million so that's £84 million. Were the 70% that weren't the loss making contracts – was there any profit in them or were they break even? Because there wasn't anything near the 2%-ish margins you're talking about for that business. It sounds like the actual loss making contracts, the problem contracts pretty much were at minus, 50-100% minus margins. So just want to look at that. Then the actual nature of the contract: how many were there? How many problem contracts, the sort of, we can work out the average contract size, but what was the sort of range of sizes of contracts? Were they offices, residential towers? What were the main types of end product? And then the sort of, sorry to go on a bit, but the contract terms: were they lump sum, fixed price, there was uncertainty about where the design responsibility lay. And then a bit more nebulous, but of your estimated loss, how much of that is, if you like, a hard loss that you can quantify in terms of the costs you've run up to date? And how much of that is the assessment? And how long could this legalistic process…?

Steve Marshall: Alastair, I think we'll have to divide you into bite-sized chunks, because otherwise…

Alastair Stewart: You see where I'm going, I'm just trying to, what I'm trying to find out is just, how long can this take to sort out and what's the worst, worst situation? Is it significantly worse than £50 million loss and how long will it be until you actually draw a line under it?

Nick Pollard: Alastair, there is some great stuff in there. Listen…

Alastair Stewart: Sorry, but I think it has to come out, really.

Nick Pollard: If you send me your CV, I'll probably take you on as a commercial director at this rate. I think it's excellent. Look, you're probably not going to like my answer, and if Duncan slaps me, that's OK. For straight reasons of commerciality, there is absolutely no chance that I'm going to answer that range of questions on this phone, I'm afraid. If I start going into work types, if I start going into contract types, if I start going into timings, this that and the other, any time at all I'm going to have those clients knocking on my door saying, Thanks a lot, but that's just worsened our position. So I'm sorry, there's just far too great a range of detail there around the contracts for me to move forward.

Alastair Stewart: Can you just give something, I mean, how many contracts are there? The two things: how many contracts were they, the problem contracts? And the 70%, were they making any sort of margin at all?

Steve Marshall: Yes, Alastair, I'll touch on it at a high level. There's about 20 problem contracts.

Alastair Stewart: Sorry, how many was that? I didn't hear that.

Duncan Magrath: 21. Three quarters of those are in London. There are some outside London, but by far and away the majority of the issues and those contracts sit within London. In terms of the rest, there are, and just to give you some flavours, around 45 live contracts at any point in time in this business. In terms of the other contracts, they are profitable, but clearly they have to cover an overhead, and that's where you get into the, and in this business, we have slightly higher overhead than some of the other businesses because of things like the off-site manufacturing where you have, effectively, a higher level of fixed cost. You know, your points around margins, it is, in this business, unfortunately, if you get it wrong, entirely possible to have a minus 100% margin. And when you can end up with your costs being double what you expected and depending on the contractual terms, that is incredibly painful. So I think sort of analysing it by margin percentage on individual contracts is difficult but clearly, in terms of cost control and the responsibility for design, surely your questions, etc, getting all that right up front and getting schedule right and starting the projects correctly is all part of managing within that. So I think yes, I mean I guess yours and a number of the other questions, the thrust of the questions is, this is a pretty small business, is a very large loss. You're absolutely right, and I think that's where the discipline around the original big process and the operational delivery of them is fundamental. Nick, is there anything else you want to add to that?

Nick Pollard: No, there's nothing. I think that's a pretty good summary.

Alastair Stewart: Alright, thank you. One last, very short question. In terms of the range of bidders for PB, you said it's commercial, but is it, are there trade bidders, are there financial bidders in there?

Steve Marshall: As far as I will go is that all flavours of bidder type are involved.

Alastair Stewart: Great. Thanks very much.

Operator: And we take our next question. It's a follow-up question from Joe Brent with Liberum. Please go ahead, sir.

Joe Brent: Yes, from Liberum. So thank you. Just from a very detailed question to a very general one from me. You've given clear guidance on 2014. Is there any guidance on what we should be doing for 2015, my thinking being that there's no reason in here to increase our disposal gains, and yet I guess my view of profitability of M&E is lower now than it was when I woke up this morning.

Duncan Magrath: Yes, I think in terms of, obviously the two moving parts today, you're right: M&E. I think I said earlier, we'd like, obviously, to get this back to at least a break-even position, which may well be slightly less than the numbers you pencilled in for 15. But obviously on a not a huge amount of revenue so it should be a reasonably small number in terms of the PPP at the moment. I wouldn't change anything you've got baked in for next year because really, the overperformance this year is largely a function of the excess we achieved on the original disposals, and the extra disposals we're targeting this year always could have happened and were sort of originally planned, obviously, we delivered what we needed in the first half.

Joe Brent: So maybe a £10 million hit to 2015?

Duncan Magrath: Obviously depends what, Joe, you mentally factored in for the M&E business for next year.

Joe Brent: OK, and just another one quickly if I may. Central costs. Clearly as the business gets smaller with your disposals, there presumably will be a greater focus on the fairly chunky central costs numbers. How can you manage those and over what time frame?

Steve Marshall: Yes, I mean we will certainly, the important piece of the work at the moment is to see that we can deliver the PB disposal at that point. Inevitably we will look at the Group's central costs, sure. That's normal course of business.

Joe Brent: Thank you.

Operator: Thank you.

Steve Marshall: Can we just take one more question, perhaps? I'm conscious of everyone's time.

Operator: Thank you, and we have another follow-up question from Mark Howson with Canaccord.

Mark Howson: Good morning again, gentlemen. In this, and obviously this is a, as you've gone on you've unearthed these things in the processes you've put in. There's some sort of degree of masking that's been going on by the local management, etc. But other than the sanction of obviously firing people, is there any other sanction you're looking at if you believe there's been some sort of deliberate attempt to hide things? What can you do?

Nick Pollard: I wouldn't say it's the deliberate attempt to hide things. I think it's about people not having recognised risk correctly when they've entered into agreements. And I think it's about people, it is about people not having recognised risk correctly and it is about people not having recognised risk and the need for contractual procedures to be followed during the execution of work. So I don't think this is about some deliberate masking. This is much more around competence. I'd just like to correct that. Yes, of course we have removed people, you're quite right. Typically the people who have been responsible for the management oversight and should have been using the company procedures to ensure that the controls were in place and understood by their front line teams. This isn't an issue related to some excellent workers on the front line. This is related to the managerial oversight and control of the operations of the business.

Mark Howson: Very good, thank you.

Operator: Thank you. And that will conclude today's Q&A session. I would now like to turn the call back over to Mr Steve Marshall for any additional and closing remarks.

Steve Marshall: Yes, the only thing I'd say is thank you for a whole series of high quality questions. We'll leave it at that point and obviously be available during the day for any follow-up calls and discussions you want to have. Thanks very much.

Operator: Thank you, and that will conclude today's conference call. Thank you for your participation, ladies and gentlemen. You may now disconnect.

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