Balfour Beatty

2010 Half-year results

Duncan Magrath presentation script, Wednesday, 11 August 2010

SLIDE 1
(Name Slide)

Thank you, Ian, and good morning everyone.

Firstly, before we get into the results I would like to announce that Basak Kotler is joining our team as Head of Investor Relations and starts at the beginning of September. Basak has worked in Investor Relations for both Cadbury and Rexam and, prior to that, worked as a sell-side analyst here in London. I am sure she will be contacting you in her first few weeks to get to know you and get your views on Balfour Beatty.

Secondly, just to quickly point out that as we did in March we have quoted constant currency figures on the slides. This time the average rate for sterling:dollar, to which we are most sensitive, has moved little between the two half-years, and so has only had a small effect on the Profit and Loss account. The spot rate did weaken over the six-month period, which has had a favourable impact on the assets in the balance sheet and order book compared with December 2009. Obviously movements since the half year have reversed this effect.

So, on to the results….

SLIDE 2

[BUILD] Revenue increased by 3% to £5.2bn for the period, and included the benefit of acquisitions, principally Parsons Brinckerhoff, without which there was, as anticipated, an underlying decline of approximately 12%. As highlighted in our July trading statement, this was due to lower construction volumes in the US, Middle East and UK, together with some timing issues, such as AMP5 start up.

[BUILD] Profit from operations, before exceptional items and amortisation grew by 34% to £151m. This was 35% growth at constant currency, or 3% growth excluding acquisitions, showing continuing good operational performance and control of costs.

[BUILD] Pre-tax profits, before exceptional items and amortisation, rose to £141m a 32% increase.

[BUILD] Adjusted earnings per share are 4% up on last year at 15.5 pence. EPS rose more slowly than PBT principally due to the effect of the Rights Issue in October to fund the acquisition of Parsons Brinckerhoff, which I will refer to as PB from now on.

The effective tax rate of 35% has reduced from the 39% effective tax rate last year, principally due to favourable profit mix from the acquisition and subsequent reorganisation of PB. Whilst the tax rate is sensitive to the mix of profits I would anticipate the full year tax rate to be similar to the half year.

[BUILD] The interim dividend will be increased by 5% to 5.05 pence, ahead of earnings growth, reflecting our confidence in our ability to deliver growth over the medium term.

[BUILD] Cash used in operations was £21m, partly due to the timing of the half year cut-off, but also reflecting some of the anticipated PB unwind [BUILD] which resulted in net cash of £500m at the period end.

[BUILD] More importantly, we had a better than expected average cash position which increased to £436m for the six month period.

[BUILD] The order book has grown by 17% over the last twelve months to £14.6bn, and has grown since last year end, and provides good coverage for future years.

[PAUSE]

Turning to the segmental analysis.

SLIDE 3

Just a quick reminder that the Professional Services segment includes, all of PB, BB Management in the UK, and the professional services element of Heery in the US which have now been integrated into one business. The integration has gone well and Ian will talk about this in more detail later.

The segment prior year figures do not include PB, as this was only acquired in the second half last year.

PB, as acquired, had a strong first half, with profits of £35m at a margin of 5%, which is a slightly stronger margin performance than we currently anticipate for the full year.

Both Heery and BB Management performed well in the period in a competitive environment. BB Management, in particular, had a very strong first half with favourable gainshare income accounting for the £8 million year on year increase in profits for the old BB business.

Given the strong first half PB performance and gainshare payments in BBM, we expect the second half margin performance to drop back from the first half, but overall we anticipate a margin of circa 5% for the full year.

SLIDE 4

This slide shows the split of the order book on the left hand side and revenue on the right hand side, by geography.

Orders and revenue have very similar splits with just over half the activity based in the US.

To aid comparison the growth figures are against prior year proforma data, which includes PB as if we had owned it from the start of the year.

It is pleasing to note that the order book in the core US market increased, even after excluding the impact of exchange, despite the current delays to funding in the US transportation market which Ian will discuss later.

Revenue growth in the rest of the world was partly driven by exchange although about half the increase came from Australia, which has experienced a comparatively stronger economic environment, and still with good prospects going forwards.

[PAUSE]

Now moving onto Construction Services

SLIDE 5

There was a 2% increase in the order book since this time last year or a 2% reduction at constant currency. The phasing of the order book is shown in the appendix to your slide pack.

Revenue was down 13% on the same period last year, with the biggest reduction being in the US building market following the drop in its order book of about $1 billion last year, and in Dubai where we have shrunk the building and infrastructure business.

Profit however was up strongly by 17% to £83m. Let me talk you through the detail.

Margin delivery in the US building markets was particularly strong with successful completion of a number of projects and also had a small benefit from the acquisitions of RT Dooley and SpawMaxwell in 2009.

There was a good performance in the UK, with strong operational performance from the building business, a good overall performance from civils work offset by a reduction in the UK and International Rail projects.

Performance of our Gammon joint venture was good, with very strong order book growth in civil projects in Hong Kong.

In the Middle East profitability was in line with last year, with growth in the M&E business particularly outside Dubai offsetting significant reductions in Dubai building and civil construction.

Given the particularly strong margin performance in the US in the first half, performance is more first half loaded than in previous years and so for the year as a whole we continue to anticipate a similar level of performance to last year.

One of the key factors in our performance, despite declining revenues, has been the success of our businesses in proactively reducing costs where necessary, a process that is deeply embedded within our organisation. Over the last 12 months, for example, we have incurred over £15 million of reorganisation costs, which are reflected within our normal trading numbers. From the peak our overhead cost within our construction businesses has reduced by over £50m per annum.

SLIDE 6

We are, however, now looking to see how we can leverage our scale across our individual businesses, beyond simply 'right-sizing' our organisation. In the UK we are looking to achieve a step change in levels of efficiency, through rationalisation of procurement and back office support.

We propose to establish a UK Support Centre in Newcastle, which will be responsible for managing and delivering transactional accounting, administration and payroll processes which currently reside within individual operating companies. We are currently in consultation with the affected employees.

The centre would be run as part of our support services division in the UK. It is intended to start initial operations by the end of Q1 2011.

While Balfour Beatty's operating companies will be their first customer, we anticipate that delivering efficiency benefits and high service levels through the Support Centre may eventually become an additional capability as part of a broad BSO external service offering.

[BUILD]

We anticipate annual cost reduction from efficiency and procurement savings will be at least £30m per annum by the end of 2012, of which around £20m will directly impact our structural cost base and a further £10m will improve our competitiveness and so benefit our customers directly.

Of the anticipated £20m of annual structural cost saving we expect around half will be realised in 2011.

We estimate that total one-off implementation costs over this period will be around £25m, plus further IT investment of £10m.

SLIDE 7

Turning back to divisional performance. Let's look at the left hand side at the order book. The strong growth in the rest of the world order book is largely driven by the successful winning of projects by Gammon in a strong Hong Kong market.

On the right hand side, the US revenue is down 22% as a result of the decline in the order book last year. There has, however, since year end been some recovery in the underlying orders and, in addition, not shown here, awarded but not contracted revenue.

And finally, on the right you can see the UK represented 53% of our construction revenue, although looking forwards it only represents 41% of the order book.

[PAUSE]

Turning now to Support Services.

SLIDE 8

The order book is up 15% since a year ago and has remained stable in the six month period with good contract wins and extensions with customers including Royal Mail, Anglian Water, North East Lincolnshire Council and, in July, Southampton City Council.

Revenue increased 1% in the period, with growth in roads and BSO and FM offset by reductions in rail renewals and power and a slow start to AMP5 water contracts.

Profit decreased by £7m, due to the volume reductions in rail renewals and AMP5, along with start up costs on new contracts and an investment in the National operations centre for our BSO and FM business. Timing of contract settlements also affected the split last year, so overall we expect results this year to be more second half weighted than last year.

Underpinned by a good order book we continue to expect that the segment overall should achieve a similar level of performance for the full year as last year, and is well positioned for growth beyond that.

SLIDE 9

As this segment is principally in the UK, instead of splitting it by geography, I have split the order book and revenue into the end markets. These comprise our businesses in Facilities Management, Business Services Outsourcing, Highways management and Rail renewals and water and power utilities. I have shown the year on year growth rates on the slide which are in your pack. I will highlight a couple of issues for you.

Firstly, you will note the impact of winning the AMP5 contracts on the order book, but given the slow start this has not yet fed through to revenues, and hence profits.

Secondly, you can see the strength in our BSO and FM business with growth in orders up 16% and revenues up 6%.

Turning now to infrastructure investments.

SLIDE 10

Before turning to the income performance of our Investments business, which doesn't necessarily reflect the value created by the business, I wanted to give you a brief update on our Directors PPP Valuation.

The value of the PPP portfolio has continued to increase from £610m on the left hand side to £624m on the right hand side.
We have used the same project models and discount rates we used for the year end but rolled forward for events in the six month period. I am not going to take you through all the detail on this slide, but just to highlight that despite the disposal of stakes in two UK PPP concessions for £24m, and also a bond related to one of the military housing concessions in the US for £15m, the Directors Valuation before exchange at £611m is just ahead of £610m last year end.

[PAUSE]

Turning now to reported performance …..

SLIDE 11

PPP concession profits in the UK and Singapore were exactly in line with last year despite the sale of Aberdeen Environmental Services and the sell down of our stake in Edinburgh Royal Infirmary, due to increased profits on completed hospital projects and the M25.

[BUILD]

Profits in US PPP concessions reduced by £1m in the period as some projects as scheduled came out of the construction phase and less fee income was earned,

[BUILD]

Total infrastructure profits of £5m were £4m down on last year.

As forecast last year end, profits in Barking Power station were lower than last year, and will drop lower as a result of the ending of the original Offtake and gas input contracts.

Barking Power has reviewed the carrying value of its plant's fixed assets in the light of the ending of the contracts, and based on current expectations of future prices for power and gas has concluded that it should take a write-down charge. We have reflected our £27m share of that write-down as a non-cash exceptional charge in our books which is shown on a later slide. This results in a book value for the investment of £53m.

[BUILD]

Profits have also been impacted by an increase in bid cost expense compared with last year. Also included were the costs of PPP pursuits in the US and also bidding for the OFTO licenses in the UK, our success on one of these which was announced last week.

[BUILD]

Subordinated debt income of £9m was up £3m on last year principally due to the increased injection of debt, on the M25 and other projects at the end of their construction phase, giving an overall result of £23m, £8m down on last year.

SLIDE 12

So to summarise the key highlights in Infrastructure Investments, we have:

- Reached financial close on three projects, which includes our first US non-military housing PPP project in Florida.
- Appointed preferred bidder on North West Fire & Rescue and Thanet offshore high-voltage transmission.
- We are also preferred bidder on three BSF schemes for which the go ahead was given last week for the sample schools.
- Disposed of two investments for a significant book gain, and proceeds in excess of the Directors Valuation.
- Recorded a non-cash impairment on our investment in Barking Power.

Overall, the reduction in Barking Power profitability, the modest decline in fees on US PPP concessions, and increased bid cost expense we anticipate will result, as previously indicated, in reported profits this year being significantly behind 2009. Clearly from an income perspective this business has held back Group profits, despite the increased value it has generated.

[PAUSE]

Turning now to Investment income and Finance costs.

SLIDE 13

There is a lot of detail on this slide, but the bottom line shows net finance costs of £10m, have increased from £6m last year, which includes a £3m increase in the net finance cost for pension schemes.

SLIDE 14

Overall, therefore after corporate costs, profit from operations before exceptional items and amortisation rose 34% to £151m.

[BUILD] The increase of £4m in net finance costs results in pre-tax profits of £141m, up 32% on last year.

Moving onto exceptional items.

SLIDE 15

As previously disclosed we have booked a £20m gain on the sale of the two PPP interests we announced earlier this year.

The trading results have lost the earnings from the disposed investments and have not benefited from the gain on sale, which if included would have added nearly 3p to EPS.

As described earlier for our associate Barking Power we have shown our share of their exceptional non-cash write-down.

Post acquisition integration and reorganisation costs of £11m pre-tax, or £8m post tax were incurred in the first half virtually all due to the integration of PB.

SLIDE 16

Cash from operations, shown here in bold, was an outflow of £21m. Any movement in cash between two points can be susceptible to timing effects, hence we tend to focus more on average cash, which as I will discuss later was better than we expected.

Looking however at the working capital outflow of £134m on the row above, this was impacted by an early cut-off in the month i.e. 26 June, some anticipated unwinding of PB cash positions, and the consequence of the reduction in revenue and therefore absolute level of negative working capital in the construction business.

In the period we also had £16m of pension deficit payments which was part of total DB pension contributions of £36m which you can see on the next slide.

[PAUSE]

SLIDE 17

Turning to pensions, at December 2009 the deficit was £586m pre tax, £420m post tax and this has increased by £43m to £629m, or £451m post tax.

Asset prices have slightly recovered since the year end, but the gain of £27m is offset by an increase of £76m in the liabilities due to a further reduction in the real discount rate [BUILD], which, at 2.05%, is 60 basis points lower than the last 10 year average, which equates to an impact of approximately £260m on our liabilities.

The 31 March 2010 valuation of the Balfour Beatty pension fund is underway. We are currently making cash deficit payments of £36 million pre-tax per annum. Given the increase in the deficit since the last valuation in 2007, it is probable that the final agreed deficit payments will be higher than this.

Finally you will have seen the recent announcement from the government on changes to pension legislation which will change the basis of general pension indexation from RPI to CPI. Note 11 to the accounts gives some details. The impact depends on what you assume the difference will be between CPI and RPI. Assuming that CPI is lower than RPI by 0.5% to 0.75%, we estimate that if scheme specific rules are not overridden our liabilities would be reduced by between £52m to £80m.

[PAUSE]

Now looking at balance sheet cash movements

SLIDE 18

We started the year with opening net cash of £572m. Cash from operations, excluding PPP projects, was a £39m outflow. Capex and financial investment of £61m, included £20m of net financial investments, of which £10m was subordinated debt in the M25 concession.

The PPP disposals generated proceeds of £24m which were offset by £2m spent on a small UK acquisition, Multibuild Interiors, and £3m on deferred consideration.

The retranslation of our USD and other overseas net cash balances totalled £8m.

Turning to average cash, perhaps a more important measure than year-end cash.

SLIDE 19

Average cash in the half at £436m was very good, and better than we expected.

Given the remaining outflows that are likely to occur on PB as described at the time of the acquisition, plus a shift in business mix, and opportunities for some small financing of construction projects where the returns and risk make sense, we anticipate that average cash for the second half of 2010 will be broadly in line with the second half of 2009.

SLIDE 20

So, let me summarise our performance in the first half of 2010.

We have continued to perform well overall despite difficult markets, helped by the resilience and diversity of our business. Where necessary operating companies have acted swiftly to reduce costs and we are considering further measures in the UK to improve our efficiency.

Overall, for the Group, profit from operations was up 34%, pre-tax profits up 32% and we are paying an interim dividend, up 5%, reflecting our confidence in the medium term growth prospects for the Group.

We achieved average cash levels of £436m. Our order book has increased to £14.6bn and we believe we are well positioned to benefit from long term growth in infrastructure expenditure.

Ian.