Balfour Beatty

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2019 Full Year Results Presentation

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Balfour Beatty

Leo Quinn, Group Chief Executive

Phil Harrison, Chief Financial Officer

Questions From

Joe Brent, Liberum

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Introduction & Highlights

Leo Quinn, Group Chief Executive

Good morning, everybody. Leo Quinn from Balfour Beatty, Chief Executive. We're going to present our full year results for 2019, but before we do, we've got a two-minute video, because I think it's really important to understand, there's an awful lot of stuff that this company does, really complicated, intrinsically valuable stuff that we do. And it's good just to be reminded of that, and then understand it's this which actually delivers the numbers that we're going to talk about in a few minutes' time.

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Video Played

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Leo Quinn, Group Chief Executive

Truly inspiring stuff, if you think about it. And it's great, when you look at the future for Balfour Beatty, and you think of infrastructure spend across the globe, this is a great place that you should be thinking about your kids crafting their careers, because we do many inspiring things, including teaching people how to do the Mexican Wave.

So, Leo Quinn, Balfour Beatty Chief Executive, this is the 2019 full year results, and our Build to Last programme is now starting to accelerate and to deliver the benefits that we've talked about.

During the year, we've had some fantastic financial performance, and for me, the true measure of our business in our sector is really around the cash generation, and our average cash over the last year is actually increased by some 68%, to £325 million. We finished the year with half a billion pounds of cash on the balance sheet.

Our profits from our earnings-based businesses were up some 22%, and overall we delivered about £221m, which includes the asset sales on top of our earnings-based businesses.

So, generally speaking, a very, very strong performance.

We also were really encouraged by our order book growth, which grew some 13%. Phil will take you through that. The US was the largest growing market for us this particular year, but come next year, when we actually add on HS2, the UK backlog will actually double. So, a very strong booking performance.

And again, we're very encouraged by the strength of our balance sheet, gives us confidence in actually increasing the dividend by some 33%, and we have lots of headroom within the balance sheet now. So that's encouraging for the future.

Moving on and looking at the indicators behind Build to Last - we've always talked about Lean, Expert, Trusted, and Safe, and for us, Lean is about cash in, cost out, but more importantly investing in the platform for the future, and I'll take you through that in great detail later on in the presentation.

We've used a measure of cash, and you can see, back in 2014, the peak of the cash outflow was minus £600 million. You can see, this year, in 2019, for the first time the actual cash flow has been sinusoidal around the zero mark. So we're now starting to generate cash, which backs our profits from our earnings-based businesses. So, generally speaking, really encouraged. This is always the true measure of how the business is performing.

If we look at Expert, which we define as creating a great place to work and employee satisfaction, again, the trend has continued in that area and we've had another improvement.

It is interesting, when you look at all the things that we're doing across the organisation, that we are actually investing a lot in recruiting, bringing on new graduates, new apprentices, training and retaining our employees, and again, I think this actual measure will accelerate next year, because I feel the whole atmosphere within the company continues to improve.

Trusted is about no surprises and doing what we say we would do. You know, I think we take it for granted that there should be no surprises, but it's quite interesting, in this industry over the last 3 years, there's been more surprises than there has been good news. We measure this via customer satisfaction. We take 95% as our goal, so we're not surprised to be at 94%. So, good performance in that area.

And then, finally, Safety for us is our licence to operate. And you can see that we've halved our Safety statistics over the last 5 years. We've managed to hold those gains in 2019, and this is really important to us, because it's not only about our employees; it's about members of the public and our customers. So, Safety is the number one measure of the business, today and also in the future.

I think the thing that's interesting about this chart is that we can look at 2019, but fundamentally, if you look at the 5-year trend, it's a really impressive trend, and these are really the leading indicators. This gives me confidence that, when we look to '20 and '21, we're going to continue to see more improvement.

If I then look at what I regard as the lagging indicators, and this is effectively what you can go to our balance sheet and you can see these numbers and you can see this performance, we have a 5-year performance of improvement year-on-year.

So, if I look at our average net cash, we were overdrawn in 2014 to the tune of £371 million. We're now actually in net cash in our bank of £325 million. That's a nearly £700 million difference, which accords with the graph that you saw of Lean.

In terms of our earnings-based businesses, we were at a loss in '14. We're now in a profit of £172 million, and again, I think this is going to start to accelerate.

When I look at overhead, that's a corporate overhead for the global operation, that's all of it, we have effectively reduced that by £200 million. £465 million down to £267 million.

Now, that's interesting in itself, but the real thing that's interesting is what's happened underneath this. This £267 million is probably the most productive resource that we have in the company today, and I'm going to talk about this in a little more detail, because this is really a source of competitive advantage for us, and is the future lever that will actually see our returns accelerating.

And then, ultimately, we employ people and we want to keep them in the business. We were at 16% attrition back in '14. We're now down at 11%. We measure this on a monthly basis, and we're now down below 10% on a monthly basis as we go through this year.

So, fundamentally, Build to Last has delivered 5 years of progress, and we see it accelerating into the future.

Phil's now going to take you through some of the financial facts, and then I'll come back and tell you a little bit more about how the business has performed.

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Financial Highlights

Phil Harrison, Chief Financial Officer

Thanks, Leo. Good morning, everyone. Let's look at the headline numbers. As Leo said, these results demonstrate the financial strength being delivered through Build to Last.

We will deal with all these figures over the coming slides, but I'm particularly pleased, as Leo said, with the average net cash, up 68% at £325 million. In this industry, you need to run with average net cash, and this result underpins the strong financial position we have built.

The order book, which excludes HS2 orders, is up 13% at £14.3 billion, and all the profit metrics show improvement, with profit from operations increasing 8%, profit before tax by 10%, and earnings by 4%. Earnings have been affected by a higher tax charge. The increase in tax has been driven by geographic profit mix and US investment disposals.

Going forward, the effective tax rate you should use for the US is around 27%, and for the UK, half the statutory rate. Given this performance, the Board has recommended a full-year dividend of 6.4p, a 33% increase on prior year.

We are now operating from a position of strength, with the financial flexibility to take advantage of the market opportunities we see ahead of us, which Leo will talk about later. Now let's look at the results in detail.

Underlying profit from operations, in the earnings-based businesses, there was an increase of 22% to £172 million, which contributed to the overall 8% increase in the Group's underlying profit, at £221 million.

Looking at the constituent parts - the highlight was Construction Services, which improved by 32% to £125 million, helped by 68% improvement in UK Construction, to £47 million. As expected, Support Services was in line with prior year, whilst, following significant disposals in 2018, Infrastructure Investments profit from operations decreased to £82 million.

If we move to the order book, overall it has increased by 13% in the year, with a strong order rate at US Construction driving this performance. The most notable award was in the US, a $1.7 billion road project, LBJ East in Dallas, for which Balfour Beatty Civils business has a 45% share in the Joint Venture.

The Buildings business order book also increased, with the Northwest Division booking more high-tech office work and the Florida Division winning a contract for the expansion of the Broward County Convention Centre.

Importantly, the quality of bookings is consistent with our policy of selective bidding for those projects that best align to our capabilities.

In the UK, the HS2 Main Civils Works and Old Oak Common Station contracts are not yet included within the order book. They will only be added on the final signing of the Main Civils Works contracts, which, following the recent UK Government approval, is now expected in the first half of 2020. The Group expects to book over £3 billion of orders relating to these HS2 awards, and their inclusion will more than double the UK order book.

At Support Services, the order book increased 14%, to £3.2 billion, following growth in the transportation sector, namely the award of the Central Track Alliance by Network Rail, where we have booked £0.2 billion to date, and the re-award of the London Underground maintenance contract.

Now let's look in more detail at each segment, starting with Construction. In the UK, revenue increased 16%, the first time it has increased under Build to Last. Profit from operations increased to £47 million, with an associated PFO margin of 2.1%.

In the US, revenue increased 13%, 8% at constant exchange rate, following the increase in the order book during 2018. Profit from operations increased to £52 million, with an associated PFO margin of 1.4%.

At Gammon, revenue was broadly flat, but importantly the profit from operations increased to £26 million.

Now, turning to Support Services: Support Services revenue decreased by 7% as expected following lower volumes in the power transmission and distribution business, and the conclusion of the Area 10 highways maintenance contract. Importantly, profit from operations was stable at £47 million, with PFO margin for the year increasing to 4.6%.

Breaking down the constituent parts in a little bit more detail - in Power, the business is now accelerating following significant restructure and cost removal, and it won notable new contracts in the year, including Hinkley Point overhead lines and the Viking Link interconnector project.

In Gas, the Group continues to manage long-term gas contracts in the RIIO-1 period, which historically underperformed. The Gas market is no longer considered viable to the Group, because of the unfavourable working capital and onerous terms and conditions. On this basis, Balfour Beatty will not be rebidding these contracts under RIIO-2. With a decision resulting in a non-cash, non-underlying goodwill impairment of £58 million in 2019.

The Water business is now coming towards the end of the current UK water regulatory cycle, with bidding under the new AMP7 regulatory period under way. Again, the Group will only bid for work assuming the terms and conditions meet the Group's minimum expectations.

In Transportation, the underlying highways market is good, with multiple local authority contracts coming to market, whilst at rail, as previously mentioned, our track partnership contract with London Underground was renewed at the start of 2019, and in March the Group was selected for the 10-year £1.2 billion Central Track Alliance contract.

Moving to Infrastructure Investments: this business continues its strategy of optimising value through the disposal of operational assets, while also continuing to invest in new opportunities. Following significant disposals in 2018, underlying profit from operations decreased to £82 million, with both predisposal operating profit and profit from disposals lower than the prior year.

Despite the decrease, I would like to highlight the £69 million of profit on disposals, which were sold at or above Directors' valuation. Timing of asset sales is always uncertain, and the outperformance in the last month of the year boosted 2019 results. Concluding more deals in 2019 could potentially knock on to the impact to 2020.

We remain focussed on maximising shareholder value through the full investment portfolio life cycle, rather than on the timing of individual transactions. We will have a clearer view of the expected 2020 disposals at the half-year results in August.

It is worth remembering that the investment portfolio is integral to the Group, a constantly regenerating asset base that interlinks with our Construction and Support Services businesses. The Group continues to see opportunities to invest in high-quality projects with good returns.

In the US, the focus is on student accommodation, multi-family housing, and public/private partnerships. In the UK, the focus is primarily on student accommodation.

We turn to the Directors' valuation. Looking at the moving parts - we invested £64 million in new and existing projects, whilst cash yield from distributions amounted £65 million. The proceeds of £102 million from 10 asset sales were broadly offset by the discount unwind, such that the driver of the overall reduction in the Directors' valuation to £1.1 billion was due to the operational performance in the Group's military housing portfolio.

Let's now look specifically at US military housing. We recognise that we have faced operational challenges within the portfolio. We have agreed with the Air Force a performance improvement plan for Tinker Air Force Base, and the wider portfolio, and we are making progress on resolving those operational issues.

There are a number of initiatives set out in the plan that have already been completed, including implementing a significant management restructuring, to better align technical support and resident services, and appointing a Transformation Director.

Last year, the Department of Justice commenced an investigation, which is still ongoing. Therefore, the Group is not able to provide an indication of outcome, including timing or any quantum.

With regards to the Directors' valuation of the military housing portfolio, assumptions, including future rental income, project costs, and incentive fees, have been examined on a project-specific basis. The valuation has been impacted by two items.

Firstly - operating costs. Increased costs have been agreed with the military, partly to improve the military family housing experience, and partly to cover higher insurance costs. Higher costs lead to lower equity cash flow splits and renovation and development fees for the Group.

And secondly - incentive fees. The prospective incentive fee matrix includes a higher discretionary portion than the historical agreements. Without a clear track record in the current environment, the Group has taken a conservative view with regards to the assumptions for the discretionary element of incentive fees.

In combination, these two items resulted in a £69 million reduction in operational performance, which contributed to the overall year-on-year valuation of the military housing portfolio, reducing by £79 million.

Moving on to the next slide - this slide shows our track record of disposals since 2015. We have shown this before. This is an updated slide, just to remind everybody. Each bubble represents one disposal. The size of the bubble represents the sale proceeds received. Colour of the bubble represents whether the asset was sold at above or the Directors' valuation. Dark blue is above Directors' valuation. On the left-hand side of the graphic, we have the end-to-end multiple for each project at the point of disposal.

The graph demonstrates that the Group continues to see a strong secondary market for its investment assets. We will continue to invest to create future asset sales where we see the opportunity to achieve the historic multiples from the portfolio. The portfolio remains a long-term source of value, as you can see on the next slide.

This slide shows the expected annual cash flow from our investment portfolio. Left-hand actually shows the forecast cash distributions to the Group over the next 20 years, in blue, and the committed equity investments over the next 5 years in orange. Right-hand actually shows the projected Directors' valuation of the portfolio at each point in time.

Two things that strike me around this graph. Firstly, the long life of the assets within the portfolio, with cash distribution back to Group of over £70 million for the next 20 years, and if we do nothing, i.e. no new projects but also no disposals, the Directors' valuation is expected to remain above £1 billion for the next 20 years.

As I said earlier, we will continue to manage this business with regard to investing to maximise Group return. In 2020, we will invest circa £50 million, and will continue to make the appropriate timings on disposals through 2020 and beyond to maximise value.

Now, if we move to cash flow - as I mentioned in my opening remarks, I'm particularly pleased with our cash performance in 2019. As you can see from the waterfall, in 2019 we have generated a total cash flow of £175 million, increasing the Group's net cash position to £512 million. The increase is driven by £213 million of operating cash flows, with working capital, as expected, broadly neutral.

I said previously that working capital would be plus or minus £20 million to £30 million in 2019, and I'd expect a similar outcome in 2020.

In these current uncertain times, our strong cash position and balance sheet provides a level of comfort that we have the financial flexibility to manage through this uncertainty.

Thank you. I'll now hand you back to Leo.

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Business Update

Leo Quinn, Group Chief Executive

Thanks, Phil. As we all know, we embarked upon Build to Last some 5 years ago, and Build to Last was really about creating a platform for what I say is the next 100 years. It's not a sprint, it's a marathon, and it's about how do we improve every day within the Company. And that really is the basis on which we've built what I regard as a scalable platform for the future of the business.

I referred to the fact that we spent £260 million in corporate overhead, and the efficiency and effectiveness of that actual spend. The kind of things that we include within that, and what we've achieved over the last 5 years to make that possible, is, for example, we now run our US and our UK organisations on a single instance of Oracle, or JD Edwards in the US, Oracle in the UK.

We put into play what effectively is a standard risk and estimate review process, which we call a GTIC, and that then culminates in a project on a page, and today we have 1,200 projects within the company which are managed through the touch of a screen, and you can see the financial performance of that. So, quite often, I know via the data analytics if a job is going wrong before I'm actually reviewing with the staff on the job.

In terms of our supply chain, we've embarked upon some aggressive reduction of suppliers. We're also putting into effect platforms like Jaeger, so we have software procurement at a very advanced level, and again, this is driving efficiencies across the organisation.

I've touched before on our IT organisation. Today, we spent about £48 million to keep it functioning. We didn't have numbers before 2015, but our estimate was about £110 million worth of cash a year we were spending, and the one thing we were all very aligned on was the fact that it didn't work. Today it works seamlessly and very effectively.

All of this leads to the fact that we have a platform that, as the business grows; our revenue will actually incrementally fall through to the bottom line at a greater rate than it does today, and this is going to be key as I start to point out what our growth opportunities are.

If I look at the UK performance, the UK has had a good year, you can see from the profit almost doubling in the last 12 months. But we continue to focus on what effectively are some very strong clients, and building and deepening our relationship. Clients like the Scape platform, which allow a single action tender so that the client is able to do an ECI and to actually work with us directly on negotiating the final outcome of the job.

Highways England is still one of our largest customers, and we were the winner of two areas in the RIS, which is the Road Investment Scheme programme, the North and the South, and that will yield a number of road projects over the next few years. All of these are very enlightened customers.

The other thing that we're seeing is, not only are we continuing to win major contracts with very stable, reliable clients; we're also seeing that the industry has changed slightly over the last few years.

And in particular with the loss of Carillion, or the demise of Carillion, what we're seeing is that we've lost, effectively, a competitor to the whole industry that was actually a low-price bidder, but also with a very weak balance sheet. We're now seeing that the prices are normalising, and the terms and conditions are improving.

With respect to Balfour Beatty, we've benefited directly from the loss of Carillion two years ago. We took over their Joint Venture share of the A14. We've won road projects in Leeds, the Orbital Road. We recently closed on the Midland Met Hospital, which was a Carillion PPP, for £267 million. We're not doing it on a PPP basis, and we've got a far more sensible contract.

So, generally speaking, the orders that we continue to invest in and win are with clients that we have very great confidence in, strong, reliable brands.

If we look at the future prospects and we look at Heathrow, there's a lot of debate about the third runway. If we put that to one side at the moment, because that will be determined over the next few months or years, but Heathrow's going to spend another couple billion in the next few years around Terminal 4 or Terminal 2 upgrades, so they're a very, very big client. We've had a framework agreement with them for some 16 years, so we're well ingrained and supportive of their efforts and what they're trying to do, and we're considered to be a really good supplier.

Other infrastructure projects, such as the Lower Thames Crossing, we're doing currently the ground investigation, and that project will likely proceed in the next couple of years, so we're in a good position there.

But the pièce de résistance for us is largely HS2, and what I'll do is, I'll go into this in a little bit more detail and describe to you what I think are the benefits but also some of the risks.

HS2, as you know we've said before, we've been awarded two sections on the programme to date. These are the Birmingham sections, N1 and N2, and the Old Oak Common section here just outside London, or in London.

N1 and N2 will be approximately £6 billion, where we're the construction deliverer, so we are the construction company that will do the work. It's a joint venture with VINCI, 50/50, and in the case of Old Oak Common, we're actually the construction manager, so we get a fee for service, which is a slightly different contractual position, a slightly lower fee, but also much lower risk.

As we think about these particular contracts, we have to be wary of one very important thing, and I think it is a risk. And that is that we run an £8 billion organisation today, and what we're going to do is stand up a £6 billion contract with a Joint Venture partner. That's not done without a lot of work.

This is where, in effect, the scalable platform that we've put in across the company is actually going to show great benefits, because it will be basically taking what we do today and then duplicating that in a completely separate instance, and then setting that up as a standalone company.

While we're doing that, we have to be very careful. We had a meeting a couple of weeks ago, and it was interesting. There were 9 of my reports around the table, and we were all looking at how we support the mobilisation of N1, N2. And the thing that struck me was, we were all focused on the new growth opportunity and the shiny thing that sits in front of us, but those 9 people run an £8 billion company today very effectively, so we have to be careful that the best business we have is the business we have today, and we need to stay focussed on that. And we've got to set this up in a separate way.

The great news is, because of the standardisation of processes, systems, and governance; I think we're able to do that with relative good confidence in that area.

If I also think about the future, we've got capability in our rail division around the track and the catenary and the electrification, probably worth another £300 million to £500 million, which we will actively be tendering for. And then, beyond that, you can see the road up to, or the rail up to, Leeds and to Manchester. We will certainly have an interest in that, but I think the first instance is getting delivery started on the projects that we've won today.

This is going to be transformative, not only for the UK but also for Balfour Beatty, but also for our industry. So there are going to be some very interesting challenges here, and it's not without risk. I think the important thing is actually being aware of those risks and anticipating them, but I think we're in a good position too to meet the first hurdle very effectively.

If I move on to our UK Support Services, I think Phil's filled you in on a lot of the detail here, but what I would say, and think is a really important note, is that the business that we've won here is largely with customers that we have a longstanding relationship: Network Rail, London Underground, National Grid - and that our relationship with those customers, and the way we work and deliver, is very effective. And I think they would probably regard us as one of their best suppliers, if not their best supplier. So I'm really buoyed by the future here.

The thing we need to think about is exiting the gas market. Phil touched on it, but we've effectively won that contract 6 years ago, and we've had £30 million to £50 million of working capital tied up in that, and our economic value added after the cost of money has been zero. So effectively it's been a bad contract from day one for us, and therefore we won't be continuing with that.

The good news is that, once we get beyond 2020 into 2021, we talk about average industry standard margins of 3% to 5%. I can see this business moving beyond the upper level of those limits, and I think it will be a very strong contributor to the Group, so I'm encouraged with what we're doing in this business.

If I look at the US, this is a real transformation story. US is about £4.5 billion of revenue. About £4 billion of it is actually in our Buildings business, and our Buildings business this year has probably had the best year it's had since 2013. It's effectively delivered on every parameter. It's grown the business substantially, the revenue is up, the profitability is up, the cash flow's improved, so, generally speaking we're certainly gaining market share and doing it very effectively.

All of the branches, whether it be Seattle in the Northeast, and Portland, whether it be San Diego, Dallas, Florida, the Carolinas, or Washington, each one of the branches has delivered against, at or above their budget. So, a very encouraging picture.

Now, it is a tale of two cities, because on the one hand as our Buildings businesses perform very well, our Civils and Construction business has performed in the opposite direction, I'd say, in a very poor year.

The challenge that we've had within that business is, we have a number of contracts, approximately 18. They are large in nature, and we have sort of failed to deliver on the schedule of the job. As a result of being behind on schedule, we're then behind on profitability and profit recognition, so our Civils business has had a very challenging year.

We have taken a number of corrective actions which will see that improve next year. We closed down our local rail support business, which was a small business but a big distraction for management, and we're now focussed on the half dozen jobs which are going to have the most effect in terms of delivering profit for the future. But overall the net outcome in the US is a very encouraging year with a very encouraging outlook.

In terms of Hong Kong, as you know, this is our Joint Venture with Jardine Matheson. It's 50/50. This is a business that does characterise itself around large infrastructure projects. It's split 60/40 between Buildings and Infrastructure.

There's an awful lot of building going on here, connections through to China, there's a big hospital programme going on at the moment, and then the airport is under constant development. There are two terminals that we're bidding for in the course of the next year or two. So we're very keen in terms of maintaining our presence and the returns that we make from China.

We've had success in winning the Advanced Manufacturing Centre and then the 10-year Residential Programme Development in the New Territories. Generally speaking, this is a business which is well managed, continues to generate returns of 3% after tax, but does actually handle very large projects. And obviously there's always a challenge in a few large projects, as opposed to lots of little ones.

Just to remind everybody, we do have sort of a risk-adjusted portfolio, in that we are diverse operationally and geographically. In terms of our Construction business, today just under half of it is from the UK, but over half is actually dollar-denominated.

That will change over the next year or two with HS2 in the UK, and we'll see the balance move back more in favour of the UK.

In terms of our investment portfolio, again, over half of it is dollar-denominated within the Group. So, fundamentally, we're strong in three markets: Hong Kong, UK, and the USA, and that gives us some comfort that we do have a diversified geographical and operational portfolio.

Looking, finally, at where we are - Build to Last has been a programme that's with us for the last 5 years. It's going to stay with us for the next 5 years, and it is continuing to deliver the returns. The scalable platform that we put in place has yet to accelerate those returns, but we're confident in light of the top line revenue we're going to see coming through that the proportion of profit dropping through to the bottom line will now be greater.

We have a culture which is designed around managing risk in commercial terms, which means that we don't take on what we feel in the first instance is a contract that we can't deliver and make the required returns from.

We're facing into what I regard as a rising tide, with a strong infrastructure market in all of our geographies, so I'm really encouraged around what's going to happen with the top line.

And the only thing we really look at is cash. It's the only thing in the business that doesn't lie, and we've been actually delivering what I think is improving cash returns, which gives us confidence around our dividends, and gives us sufficient headroom within the balance sheet to review what future cash distributions we'll be making as a company.

So I think, to date, Build to Last has been extremely successful and we're now starting to see the returns accelerate.

So, a good year result, and I'll hand over to you for questions.

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Questions and Answers

Joe Brent, Liberum

Three questions, if I may. Firstly, on the budget today, I mean, no one knows what's in it, but what would you like to be in it, and what should we watch out for?

Secondly, on High Speed 2, talked a little bit about the risks. Do you know anything more about the contract terms, and how it's likely to be structured in terms of working capital and risk-sharing?

And thirdly, could you give us the sales in the gas business, please?

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Leo Quinn, Group Chief Executive

Right. What we'd like to see in the budget. I mean, first and foremost, the single most important thing for us is a 10-year runway. That allows us to invest in assets, capability, people. So if we can get some assurance around the level of spend, and the type of spend, that would be very, very reassuring. I think that's all I'd really ask for from the budget, and I'm optimistic that it will be delivered.

In the case of HS2, I'm glad you asked that question, because I meant to mention it. I have to say that HS2 in my view is quite an enlightened customer. What they've managed to realise is that there's the budget they're trying to build HS2 to, and that in order to do that they can't roll down the risk, or all the risk, associated with that. Because if you want the contractor to price risk, it's going to put the price up considerably. So I think they've got a very balanced approach to where the risk is assigned.

From our point of view, the contract for N1, N2 is effectively a guaranteed fee, and if we perform early, deliver early or under budget, that fee can go up by a couple of points. If we are actually late or above budget, it can go down by a point. So there is actually a ceiling of a guaranteed return that we've got.

So, from our point of view, we think it's a very balanced contract. I think it's very mature, and it is going to rely very much on a close working relationship between the client and the contractor. So I would say that's favourable for the industry.

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Joe Brent, Liberum

Just to follow up - when you say 'go down a point', is that one percentage point?

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Leo Quinn, Group Chief Executive

One percentage point. So if you say the fee was, pick a number, 20 – it isn't, but if it was 20, you could go down 19 and go up to 22.

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Joe Brent, Liberum

So that's good?

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Leo Quinn, Group Chief Executive

Yeah.

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Phil Harrison, Chief Financial Officer

He's dreaming again.

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Leo Quinn, Group Chief Executive

But if it was 8, it would go to 10 and down to 7, or something like that. I don't think we've announced what the fee is.

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Phil Harrison, Chief Financial Officer

We're not going to.

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Joe Brent, Liberum

As for the third question, on the gas sales?

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Leo Quinn, Group Chief Executive

Yes, gas revenues?

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Phil Harrison, Chief Financial Officer

About £100 million, circa £100 million, £120 million.

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Leo Quinn, Group Chief Executive

And just one clarification: it's only the UK gas business. We're very supportive of what is going on with GNI, which is the Irish gas business.

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Joe Brent, Liberum

Thank you.

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Leo Quinn, Group Chief Executive

Howard?

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Howard Seymour, Numis Securities

I've got three, if I may. First one, just noting that you allude to the central costs that have come out fantastically in terms of where we are at the moment, but as we now are starting to see the revenue increase, would we expect to see some element of increase in that area as well? Now, you clearly mentioned you expect the drop through to be good, but would you expect to be able to contain those costs against what is now a growing company as opposed to a shrinking company?

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Leo Quinn, Group Chief Executive

Two more?

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Howard Seymour, Numis Securities

Second one, on the DV valuation, you alluded to the two dynamics on military housing. The first one, you said, effectively we're in discussion with military. The second one, incentive fees, I was just wondering if that was also, is that what you perceive is going to happen on incentive fees, or is that also something that has been discussed with the client?

And then thirdly, just a point of clarification, Leo. You mentioned the civils corrective actions would have an improvement next year. Is that next year, 2020, or next year, 2021? Thank you.

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Leo Quinn, Group Chief Executive

I'll do one, three, you do two?

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Phil Harrison, Chief Financial Officer

Yes.

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Leo Quinn, Group Chief Executive

Okay. One. We've successively, and it's no aberration, we've taken literally £200 million out of the overhead. You can't save your way to success, but the point I would make is that, as our revenue improves, we do not see a need to increase the corporate overhead to support that. So effectively we're going to get a larger fall through to the bottom line.

Now, obviously, if you're going to actually deliver a £6 billion Joint Venture job, there's going to be some increase, but as far as I'm concerned it is a marginal level, it's not substantial. So I think that sees us in very, very good stead.

And the reason we can do that, by the way, is that we've automated a lot of the systems. And so, by automating, it doesn't cost you that much more to put another thousand invoices through, or to process another five, six hundred people.

In terms of the Civils one, I think we'll see some of those improvements definitely coming through in 2020, with even more coming through in 2022. And they will come from the fact that we'll have caught up in our schedule, we'll be able to recognise the profitability associated with those points, and also the points of dispute will also be resolved in 2020. So I see that coming through in a marginal sense in 2020, and a bigger way in 2021.

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Phil Harrison, Chief Financial Officer

On number two, DV valuation incentive fees, we have had discussion with the service branches. They are at different stages in getting their incentive metrics. Some are further ahead, and actually we've agreed them. Others are slightly behind. So we've taken what we believe will be the outcome of those discussions. But yes, there has been dialogue with the military.

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Andrew Nussey, Peel Hunt

A couple of questions. First of all, when we look at the UK Construction margin, in terms of progression from here, how much is reliant on really scaling that cost base that you were talking about, i.e., growing the top line as opposed to what can still be achieved in terms of better bidding and operational focus?

And secondly, just in terms of capital allocation, what external events are sort of influencing your thinking there, in terms of moving forward? That's both in terms of what might go into the Investment portfolio, but also what might come back to shareholders.

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Leo Quinn, Group Chief Executive

We'll just divide those. I'll do the first one; Phil can do the second one. Why don't you do the second one first? It's the more interesting one.

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Phil Harrison, Chief Financial Officer

No, you do the first one first. Give me a chance to get my answer right.

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Leo Quinn, Group Chief Executive

In terms of the UK Construction business, when you look at it, we've actually grown bookings this year, with the exception of highways, and the only reason we haven't grown highways is, the awards were the prior year, so they'll be coming through a lean year in '19 and then a better year in '20.

We've grown the revenue across the piece, and my disappointment is, I'm really focused on - I'd rather be a small profitable business than a large medium-profitable business. So the focus we want is really around improving our returns, and that comes down to signing better contracts, getting better pricing, and actually better delivery.

So what I see is, the improvement in our UK Construction business across the board comes from those three factors.

The cost base that supports it, I think there are some improvements that can be made there, but I think that's more in the margin. So I think, you know, we're getting to, you remember we had 89 distressed projects a number year 89 distressed projects - 85 distressed projects. I think we've got 2 or 3 lying around, which hopefully will disappear, I think there's 4, which will disappear in the next 12 months. And I think that's where you're going to start to see the improved returns. It's going to be in the margin area.

And the growth, we're not limited by growth in any way. We could take on lots of business. The key is taking on the right business.

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Phil Harrison, Chief Financial Officer

Capital allocation.

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Leo Quinn, Group Chief Executive

You go first, I'll get it right.

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Phil Harrison, Chief Financial Officer

Okay, I'll lead in, you can correct me. On capital allocation, clearly if we look at our performance over the last couple of years, we've fixed the balance sheet now in terms of the debt; we've got some prefs to take out at the half year in July. So we're pleased with our performance on cash, and where we've got the balance sheet.

Clearly, we've said that we want to continue to invest, and we will continue to invest, in our Investments business. We see that as a great way of increasing our returns and increasing the returns to shareholders. So there is still going to be an element of allocation to that.

And then, what we've said in our press release is that the Board wants to review the capital structure after we get through this little bit of uncertain times with COVID, and look at that in the round in terms of how much capital do we need, how much capital would we consider it may be possible to redistribute? So that's our current thinking.

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Andrew Nussey, Peel Hunt

Thank you.

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Leo Quinn, Group Chief Executive

The other side of it is, I'd just like to remind people of the Aberdeen Peripheral road. It was a PPP which was sold for £533 million, I think, delivered for £1.2 billion. It's not hard to pick up bad contracts. So we've been very, very cautious in terms of how we enter into PFIs and PPPs, and there's lots of them out there.

So you'll understand, I think, in the US at this moment in time we've got the LAWA, which is the LAX People Mover, we've got the student accommodation in Raleigh, North Carolina. So we've got a few where we think we can actually work with the client in an effective way to deliver a good outcome for both parties.

So all the capital we need to invest in those, we've got, and we're using it. But we're not going to use our capital, just rush in and pick something up for the sake of growing the business. If it's not on the right terms and we can't see the right return, we're not going to do it. And we have a few selective projects in the UK where we're executing them very successfully.

I can go back 5 years, and I can show you a list of PFIs and PPPs which made fantastic investment returns, but they were just horrible construction projects. And today we make sure that the wall-to-wall is profitable for us, because of course if you lose money in the construction of a PPP, all you're doing is putting in extra equity, aren't you? So your equity terms aren't what you think they are.

So, I think you're going to have to put us down to sort of erring on the side of caution. I'm sure we'll make mistakes, but at the end of the day we'll just make less of them.

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Phil Harrison, Chief Financial Officer

Which puts us ahead of the rest of the competition.

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Gregor Kuglitsch, UBS - via webcast

We've had a couple of questions come through the webcast. The first is from Gregor at UBS. There's four questions. The first one is, 'What is the run rate of your annual revenues from HS2 and what is the expected margin within the 2%-3% range?'

The second is, 'How do you quantify your excess capital position? What average cash do you need to hold, in your view?'

The third is, 'What do you expect your average net cash position to be in 2020?'

And lastly, he asks, 'What is your worst-case outcome with regards to the US military housing situation?'

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Leo Quinn, Group Chief Executive

Well, that's sufficiently difficult.

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Phil Harrison, Chief Financial Officer

We're not doing webcast questions any more, are we, after that? That's clear.

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Leo Quinn, Group Chief Executive

I was about to say those are sufficiently easy enough for Phil to answer. Unfortunately, they're long questions. On the HS2 one, I would say, if you're looking at the average revenue, I would say we will start off the first year in the range of about £500 million. We will then progress by Year 3 to £1 billion and run at £1 billion for 2 or 3 years. So that's roughly the level we'll be at for HS2. That's actually at the Joint Venture level, so we're sort of half of that.

In terms of the returns, I think, industry standard margins are 2%-3%, I'd say the bottom line range would be in the 3%-4% level, if we can get the benefits of our scalable platform, which we're confident of doing.

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Phil Harrison, Chief Financial Officer

Oh, sorry, what were the other ones?

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Facilitator

We talked about excess capital, but specifically, what average net cash do you need to hold, in your view, and what do you expect your average net cash position to be in 2020?

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Phil Harrison, Chief Financial Officer

It's too early for the first question. Clearly the Board is going to determine with the capital structure review, that will take into account average net cash that we'll need to hold. As I continue to say, we will always hold a level of average net cash. That's how this business needs to be run, with average net cash, so we'll get the appropriate thing, but that will be reviewed with the capital review.

On average net cash this year, with the pref coming out, clearly that will have an impact, because that's not in our average net cash numbers. So I would say we're currently thinking 300, 330 is the range.

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Leo Quinn, Group Chief Executive

I think another thing one wants to be aware of is, with the growth in infrastructure, and that's largely treasury-type money, there is a propensity to move towards project bank accounts. When you move towards a project bank account, your free cash flow is only the profit on the job, because effectively the cash comes in and goes out. So I think it's a little bit of a moving feast. We've just got to be careful that you do need the headroom.

Because I think, today, if you look at most people in our sector, you'll have a cash flow or a net cash figure, but then you'll have net cash which is available for you to spend, and it probably is in the order of 65/35, i.e., almost two-thirds of it tied up, it's in project bank accounts, Joint Ventures, and things like that. So your cash flow is a little bit more complicated than meets the eye. But being cognizant of that means you just manage to it.

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Facilitator

And then the final one was worst-case outcome for the US military housing.

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Phil Harrison, Chief Financial Officer

We don't know. The answer to that, it's impossible to quantify.

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Marcin Wojtal, Bank of America - via webcast

Thank you. Another question, from Martin Wojtal, Bank of America. He's got three questions. The first you may have covered already, but I'll ask it anyway: 'Do you expect the HS2 contract to be accretive to margins in UK Construction?'

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Leo Quinn, Group Chief Executive

The answer is yes.

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Marcin Wojtal, Bank of America - via webcast

Next question: 'Was the US Civil Construction business profitable in 2019?'

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Leo Quinn, Group Chief Executive

The answer is no.

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Marcin Wojtal, Bank of America - via webcast

Third question: 'What actions are you taking to ensure business continuity in the event of potential destruction due to COVID-19?'

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Leo Quinn, Group Chief Executive

Do you know, we've rehearsed this one for about a week, and I'm glad somebody asked it. First and foremost, we take the virus, the COVID virus, very seriously, and we have to applaud the Board, because we had a very, very interesting discussion around the capital structure of the company, and what was going on in the markets, and the likes of that.

We have a standing committee which meets on Tuesdays and Thursdays, which is really to look at all the things happening around the Coronavirus, any impact on the supply chain, and the like. We're looking at any shortage of supply.

At this moment in time, all of our sites are open, they're all working. We see no shortage of supply, except, and this is quite interesting, in two cases at the moment. One is actually on a power job, where the pylons are coming in from China, but that's fairly far out ahead of us, so we're not worried about that. And the other is actually shipping testing engineers from India - sorry, from Italy - in order to test the cable that we're connecting to France.

So it's quite interesting that we've got it down to a level of granular detail which, actually, we know where some of the risks are. Other risks will appear sooner rather than later. Most of our supply chain in the UK is sort of local, because if you're doing roads and concrete and earth moving, you don't import most of that stuff. Although, having to say that, in the case of Hong Kong, we are having trouble with aggregate imports at this time, so that is a challenge.

And in order to make Phil look really, really good, Phil can actually quote to you the number of contracts we have, in terms of the UK/USA, whereby the force majeure - force majeure is 76% of our contracts in the UK, if we are forced to close them, we will get time but we won't get money. In the United States, I think it's 85% will get time and not money.

So we've gone through and looked at this. But for all the work we've done, I'm sure that what will actually arise is something we haven't planned for. But we're light on our feet and we will respond appropriately.

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Facilitator

Thank you. There's no new questions on the webcast. Are there any others in the room?

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Leo Quinn, Group Chief Executive

Can I thank you all, then, for your time and continuing support. Thank you.

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