Balfour Beatty

2022 Half Year Results Presentation

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Balfour Beatty

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Video Played

Introduction & Highlights

Introduction

Leo Quinn, Group Chief Executive

Morning everybody. It's quite interesting actually the future of our industry and especially the next five to ten years is all going to be predicted on our ability to attract the best and the brightest. It's not about the demand, it's about the ability to actually supply and satisfy that demand, which is a nice place to be.

It was quite interesting, as I talk to apprentices and graduates and people within the company what I talk about is engineering is really cool and more specifically what we do within Balfour Beatty is even cooler. And this photograph really sums that up, because what you're looking at here is actually one of the tunnels that will feed that cold water from the Bristol Channel and cool the reactor at the new Hinkley Power Point Station. So if ever there has been a good picture to talk about a cool industry this is the one.

Good morning, I'm Leo Quinn, Balfour Beatty's Chief Executive and I am going to talk about the Group's first half performance for 2022.

If you look at the financials, it's a really strong performance for the first half, it doesn't matter what measure you look at, whether it be profit, the value of the investment portfolio, the order book, cashflow, whatever. However, the numbers are flattered by the fact that when you compare it to the first half of last year we did have the long tail of COVID, so that didn't actually give us the best performance that we would have liked. But I think even in light of that this is a strong performance.

What you can't see in the number is really the fact that the underlying momentum in the business is extremely strong. And I can take you to the takeaway on this slide, is that really gives us confidence in upgrading the full year. So it is a really good position to be in.

I'm also very pleased to say that we have repositioned the portfolio over the last two or three years and it's a larger portfolio, but it's significantly de-risked. And that de-risking makes us more confident that we can actually deliver the returns within it.

The portfolio is underpinned by a set of capability, which – I'll present a slide in the next section – which shows a decade of infrastructure growth. And all those things that you've seen in the video, how they come to bear in making us probably the preferred choice of supplier in that market.

We have got a very attractive portfolio of Investment assets, which does two things. One is it's actually a store of value and coupled with that it is also a good future growth pipeline that we've got.

Anyway, if you put all that together it gives us an awful lot of confidence, so we've raised the dividend to 3.5p and a 17% increase.

So why are we confident? Well, if you look at Construction Services, there are a number of things that are going on here which actually allows us to take ourselves back to the 2 to 3% margin, or average margins that we see in this sector. The first is that we've pivoted the business towards infrastructure. And that has two benefits, one is the market is very, very large and it has a very sensible customer, and we have terms and conditions which are much more manageable.

The second thing is, is that in the US over the last three years we have been looking very strongly at the Federal market. And that moves us away from – in times of high interest rates, it moves us away from the developer market, so therefore it mitigates some of the risk

And then thirdly we announced last time that we were suspending developer work in high rise buildings in London. And again, that has given us another fill up. So we feel very confident about the 2 to 3% industry average margins that we've talked about in the past.

If I look at Support Services, again, we've transformed that business where we completed the framework in gas and water, those have now largely been concluded and tied out. That leaves us with three businesses, in terms of Road, Rail and Power. All three businesses are performing very well at this moment in time and therefore as a result what we are talking about is moving to the upper end of expectations in terms of the 8%. And we are pretty confident about that for the full year.

And then thirdly, if you look at our infrastructure portfolio – what a superb asset to have actually in the books. Not only is the valuation of it increased by some £200m and we can be confident about that, the exchange rate has helped, inflation has helped, but if you look the divestment of Purdue and you look at the other assets we've got they are all being sold at significantly above the Directors Valuation. So again another store of value and also a store of future growth. All businesses are sort of performing well at this time.

Now I always talk about the cash doesn't lie and here is our cash flow performance. And although it irritates Phil my Finance Director enormously that I should talk about cash, because he feels it's his domain, if you look at how we've progressed over the last five year period here it is year on year consistent performance. And that does come from operating profit, but it also comes from the management and the effective management of working capital.

If I compare the first half of 2022 with the first half of 2021, we are up by some £200m. and that is despite the fact that we have done a share buyback of some £180m and we have actually done a dividend as well. Put those two together and the cash we have spent on buybacks and dividends is some £227m to date since the beginning of 2021. And there is also a material cash expenditure in the second half of this year.

So cash performance is strong, that gives me a lot of confidence in terms of underpinning future returns and our capital allocation model.

Phil over to you and you can take them through the facts.

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Financial Review

Phil Harrison, Chief Financial Officer

Thanks Leo and good morning everyone. Let's start with the headline numbers.

We have reported strong financial performance for the first half of 2022, with total underlying profit from operations of £85m, being 42% higher than the first half of 2021, with all businesses performing well.

Profit from operations from the earnings based businesses was also £85m and up 42%, with UK Construction returning to profitability and improved underlying margins at Support Services.

Earnings per share at 12.9 pence is significantly ahead of the 7.7 pence delivered for the same period last year.

Our total orderbook at £17.7bn has grown by 10% in the first half, or 4% excluding foreign exchange movements, with increases across all construction geographies.

While the Directors' valuation increased to £1.3bn, up from £1.1bn at year end, of which nearly half was due to the weakening of the pound.

Average net cash at £811m and period end net cash at £742m continues to underpin the Group's competitive advantage and support our long term capital allocation framework.

As a result of this strong performance the Board today is announcing an interim dividend per share of 3.5 pence.

Moving on to the business units and let's start with Construction Services. Underlying profit of £49m reflected higher contributions from each of the three geographies. In the UK profit from the operations of £18m with an achieved margin of 1.5% represents a return to profitability, compared to a loss in the first half of 2021. Profit at US Construction and Gammon were both slightly up with margin percentages in line with the first half of 2021.

In the second half of the year we expect the profit margin in UK Construction to improve as our remaining fixed price residential property projects in Central London move towards completion and the proportion of revenue earned from public sector infrastructure projects increases further. We currently forecast full year margin for UK construction in the range of 2 to 3%.

Touching on the UK Construction orderbook quickly, which has increased by £200m to £5.8bn in the first half of the year and has continued to de-risk. As you know we are actively

pursuing a shift away from fixed priced projects and now have a much higher proportion of target cost and cost plus work in our UK orderbook. Similarly we're reducing our exposure to private developers and at the half year, 92% of the UK Construction orderbook was from public and regulated clients. This is aligned to Balfour Beatty's focus on selectively bidding for contracts where it holds expert capability and can achieve improved contract terms. This has resulted in a higher quality of orderbook, with enhanced risk protection, providing more predictable outcomes.

In comparison in the US our orderbook has grown 17% to £6.3bn. The US market is predominantly bid on a fixed price basis, which we manage through early sub-contractor buyouts, typically within 30 to 60 days. The supply chain is then covered by bonding insurance, mitigating the risk in the business.

Moving on to Support Services, as Leo said the impact of repositioning the business to focus on Power, Road and Rail maintenance can be seen in the results delivered for the first half.

Revenue declined by 28% in Utilities, following the Group's strategic decision to exit Gas and Water and focus on the more profitable Power and Transportation markets.

After adjusting for £20m of prior year one offs reported in the first half of 2021, profit from operations increased by £2m, despite the reduction in revenue. This represented a 7.2% profit margin in the top half of the targeted market margin range of 6 to 8%. And we have now upgraded our expectations for the full year with margins forecast to be at the top end of this range.

Support Services is underpinned by long term frameworks in Power, Road and Rail Maintenance, giving us visibility and confidence that we can remain in the top half of our targeted range in the medium term.

Turning to Infrastructure Investments. Predisposal operating profit increased by £2m to £10m as a result of increasing returns on projects as income has increased with inflation. We also realised a gain on disposal of £7m, following the sale of a multifamily housing project in Houston in June, with the transaction above Directors' valuation.

The business continues its disciplined approach to target a two time return on its invested capital. As we continue to see good market opportunities. During the period the Group invested £17m in new or existing projects, including a multifamily housing project in San Antonio. The Directors' valuation increased to £1.3bn in the first half, however we would expect this number to reduce by year end as the previously announced Purdue disposal completed last week. And we anticipate at least one further disposal in the second half. We now expect full year profit on disposals to be in the range of £55m to £65m.

Looking briefly at our track record on investment disposals as I've just covered. With the disposals in Houston and Purdue University we now have two further investments sold above the Directors' valuation. These disposals further demonstrate the strength of the secondary market for infrastructure assets and the value which our Investment portfolio brings for the Group. We will continue to time disposals to ensure we maximise value for shareholders.

Let me know talk you through the valuation. The £190m increase in the Directors' valuations since year end, the first four items largely net out, so I'll focus on the final three blue columns. The valuation has benefitted from a weaker pound in the first half, 57% of the portfolios value was in North American investments at the start of the year and the shift in exchange rates has driven an £86m increase.

Furthermore, higher inflation than forecast has led to an increase in the value of some UK projects, totalling £52m. And I will cover this in more detail on the next slide.

Finally, there was an additional £41m increase, largely driven by the revaluation of various projects, including those disposed to date. Giving us a half year Directors' valuation of £1.3bn.

Let me cover inflation now and the impact which we're seeing across the Group, starting with the Investments portfolio, which is benefiting from the increase. In the UK most of the contracts are linked to RPI and recent rises in inflation have resulted in a £52m increase in the Directors' valuation. In the US the portfolio is also positively correlated with inflation, but indirectly through the link to the rental market. So you would expect income to increase over time.

However, in the Construction and Infrastructure markets we are seeing inflationary pressures in relation to both labour and materials. Whilst the Group is not immune to these pressures, we are currently mitigating these risks through contractual protection and early buyout using the Group's scale and supply chain management. As a result, we do not expect to see a material impact from inflation in 2022.

Moving on to cash flow, which has once again been strong in the first half, average month end net cash of £811m was £140m higher than 2021, although the closing balance was £48m lower than year end. As forecast in March we have seen a working capital outflow in the period, while all other items have largely been in line with expectations.

Our share buyback programme started in mid-March so will be second half weighted, with £47m of our stated £150m target completed in the first half.

Our consistent cash flow performance gives me confidence that our full year average net cash will be in the range of £740m to £780m, this includes a further working capital outflow in the second half, prior to a more material working capital outflow in 2023, as we move towards our long term 11 to 13% of revenue range.

Turning to our multiyear capital allocation framework that we launched last year. We continue to see a wide range of opportunities to invest in organic growth and Leo will touch on the scale of this in his section. I have just mentioned two great examples of us realising value from the Investments portfolio and we'll continue to do this, with a higher Directors' valuation demonstrating the opportunities available.

The balance sheet remains strong, and we have raised new US private placement debt in the first half in anticipation of repaying debt falling due early next year. The refinancing has extended the debt maturity profile of the Group.

These factors give us confidence to grow the dividends with 3.5 pence per share recommended for the half year.

And our 2022 £150m share buyback programme is on track to complete in the second half.

We expect this framework to be in place for a number of years to come and to give our shareholders confidence in the returns available. This is underpinned in the short term by our full year guidance which I'll recap now.

We now expect UK Construction to deliver profit in the industry standard margin target range of 2 to 3% for 2022. This is an improvement on the first half. At US Construction and Gammon we remain in line with expectations for the full year. We are upgrading our expectations for Support Services, to the top of its range of 6 to 8% above the 7.2% achieved in the first half. And in Investments, profit on disposals for the full year is expected to be in the range of £55m to £65m.

Moving on to cash, we will complete the remaining £103m of the 2022 share buyback in the second half. And we now expect average cash at year end to be in the range of £740m to £780m. And that includes a further outflow in the second half on working capital.

We are pleased with the financial performance to date and to be able to upgrade expectations for the full year. On that note I'll hand you back to Leo.

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Business Update

Leo Quinn, Group Chief Executive

Thank you, Phil. Who's got the clicker. Got it.

Thank you, Phil, that was very instructive. The thing I would point out is that it's great to show and demonstrate a set of numbers, but what's really important is what's behind it and what differentiates us and what actually makes it repeatable, because you know one off events are not bankable. And this is really what makes it repeatable, we've got highly differentiated capability in the company, built around our infrastructure assets. And these are just some examples, and they are really quite stellar.

The top left is actually the Hong Kong Airport it's the new terminal building we're building there. And that roof is assembled on the ground and jacked into position. Again, nothing revolutionary about that, but it's safer. But the scale and size of it is quite incredible and the logistics to do it.

If that wasn't impressive enough the top right here is what's going on at Hinkley as we speak. The two cranes either side are the size of a football pitch, just to get your eye into this. And that little white concrete thing in the middle is 5,000 tonnes and it's a tandem lift to the seabed where that head will then be connected with the cooling tunnels that I showed you earlier in this industry of ours, which is cool. And that will then form the mechanism for

the water to flow into the reactor to cool it. Just an absolutely major engineering feat to pull this off and I think it's almost a world first.

Up in Boston we're just completing the Green Line we've opened the first section; I think the second section will open shortly. And that is where we're connecting to an existing trainline, we are building 5kms or 5 miles of track with 5 new stations and refurbishing two existing stations. Again, a real challenging engineering project.

And then the bottom right, High Speed 2, this is the first tunnel that has been completed on HS2 and what you see here is the tunnelling machine breaking through. That tunnel is about a mile, it's under an ancient wood and again it was completed about two weeks ago. So again, really interesting stuff. And not only do we do this for a living we actually get paid to do this for a living, so how exciting can it get.

This is probably the most important slide in the pack for me and really what it is doing is now describing how that capability that I've shown you is going to demonstrate and create recurring value over what effectively is the next decade. And if you look at HS2, just as an example, you can see that the revenues are starting to peak, in '23, '24 and then it will be coming off.

You can see that the HS2 track and OCS, that's effectively the track that the train will run on and the cabling that will provide the electricity in terms of the catenary above. And 2A is the extension to Crewe and then 2B is up to Manchester. So you can see that this revenue stream is going to go on for a long, long time.

We sometimes don't make a lot about it, but we are doing all of the northern section around Birmingham, N1 and N2, but also, we're doing the Old Oak Common down in Acton and that actually for us is a fee based contract. So we get a fee on whatever we spend and the risk and the cost flows through to the end customer. So that in itself is really exciting.

If you look at Hinkley where we are doing the mechanical and electrical, we're doing the heads that you've seen, we've done the tunnel boring there as well. And you can see that is going to peak in about '23 and then actually tail off after about '24.

Coming then, you've got – coming on stream you've then got the likes of Sizewell and although Sizewell at this point in time is talked about in terms of whether it will or won't go ahead, if you look at energy security, invariably Sizewell or something equivalent to it has to actually go ahead. So Sizewell you can see is a sizeable project where we'll have a major stake. And then, you know, modular reactors will also come into play as well, whichever offering it is, whether it's Rolls Royce, or Westinghouse or General Electric, it doesn't really matter, but there is going to be a market for that as well.

If you then start to look at some of the new areas, which effectively are supported by government, but they are not necessarily funded by government, this is your net-zero Teesside, your hydrogen Humberside and they are going to have a material play for us in the future. Then you've got also your offshore wind. If I think about these as actually major fiscal expansion, effectively funded by government, it's a very different game to play with private development. And so there is a lot more security.

The good news is that provided you follow the right processes you get paid, and the client actually has the money to pay you, which is not always the case in other markets.

This actually, this growth sits atop of what effectively is our core business. And our core business in the likes of Rail and I will touch on this more later is CP7, which is the maintenance. You've got your Highways whether it's your RIS or your smart motorways. We have got our CPS, which is our 25 year – sorry 40 year M25 maintenance.

You've got the power contracts. And then you've got our regional work, whether it's through our defence, whether it's through the SCAPE framework and the likes of that. So all in all you've got this growth opportunity here sitting really on top of what is our core business. And this for us will designate a decade of infrastructure growth for Balfour Beatty and for the UK industry.

Offshore wind is a really important area, because not taken into account in what you see here is this next slide and the UK energy security and the net zero, the size of the opportunity is about £20bn. And that is actually making sure that our infrastructure onshore is effectively resilient enough in order to take what are all the new mixture of cocktails of power, coming onto the grid. So whether it be wind from the East Coast or the Irish Sea, all of that has to come onshore, it has to be connected and that actually has to be to a robust and reliable infrastructure.

And if you look at our experience, you know ElecLink is where we took an interconnector from France through the Channel Tunnel and connected up to the UK grid. Littlebrook, we have just recently upgraded and serviced the sub-station here which serves 1.5 million customers. Our work in Hinkley. Net Zero Teesside and the idea of how we put sub-stations in place to take offshore wind. All of those represent quite unique capability. And this is all founded on top of what are our specialist engineering areas, whether it be design, ground engineering, mechanical, power transmission. This is a highly differentiated end to end solution, which makes us I believe quite invaluable to our customer base. So really, really encouraged by the future that I see spelt out for our industry, but in Balfour Beatty in particular.

If I move to the United States for a few minutes and have a look here. First and foremost it's a very interesting six months. The first three months was quite stark, there wasn't a lot going on and in then in the second three months it was almost like a tsunami of orders actually hit us. It was quite important because in the first quarter of the year we stayed away from getting caught in a market where everybody was bidding to get volume. So we held our nerve and then in the second quarter the market came back and normalised.

We have had – I suppose a record first half in terms of bookings and what we call awarded but not contracted. So we know awards that we're going to receive and that gives us very, very good visibility in terms of 2023 and 2024, which is quite important.

The second thing is we have two businesses in the United States or two business models. There's the Building business and then there's the Civils business. About 80% of our

portfolio is buildings. And the way Buildings work is that we will effectively go out and look at a job with the supply chain, we will cost it up and then we will add a 4 plus percent fee to that job. When the job is awarded, it is immediately passed down to the supply chain and then contract it with their supply base.

What this does is it means that the inflation risk is actually in the estimate, or it's contracted back into the supply chain, it doesn't sit with us. And then our fee of 4% plus is virtually guaranteed. Now when you take overhead off that that means that your operating profit is around between 1 and 2%. So it may not sound like a big profit, but effectively it's a mitigated risk profit because the risk lies with your supply chain, or ultimately your end customer because our fee is guaranteed. That represents about 80% of the volume you see in the United States, and I'll touch on that volume in a second.

The other area we've got, which is the remaining 20%, is our Civils business and that's largely fixed price lump sum. It can be the area of some of the completion of the Waterworks that we do, in Rail and also in Roads. That is a higher risk model because it is an at risk lump sum fee. So what we decide is how much of that we want in our portfolio at any one time. And we can moderate that up or down depending on the bids that we see.

Where do we operate in the United States, we've said this 100 times before, we operate largely in the Southern Smile, which you can see really is the yellow on the graph. And if I do a quick whistle stop tour around the geographies what we're seeing, in the Northwest, Washington, Oregon, Portland, around there, highly dominated by tech companies. So what we have seen is a really softening of the tech market and the associated commercial office space with that. Not surprising given tech stocks are down, and they are starting to lay people off.

If I go to Southern California, really robust business in that we're the largest provider of schools. We have recently received five school awards. So a really strong business there that keeps turning out schools. And funnily enough some of the schools are over $100m which is astonishing in terms of value.

In this area on the Civils side we have got the Los Angeles Airport where we're doing the people mover and we have got the Caltrain, we're electrifying the trainline from San Jose to San Francisco, two very large contracts and going well at this moment in time. Caltrain, as I said last time, we've renegotiated the fee from I think it was about $700m to about $1bn.

In terms of Texas, what we're seeing in Texas is Texas is benefitting from really from what is a population move. There are a lot of people and corporations moving to Texas. So we haven't seen the downturn in the commercial market. What we have seen is very strong growth both in commercial office space, hospitals, but also there is a number of banks moving to the area. We've actually got the largest pipeline we've seen in a long time at about $7.5bn.

Our challenge I think in Texas is going to be how we actually manage the demand that's coming through in '23 and '24.

If I move to the Southeast, this is a $10bn pipeline of opportunities. And this is large hospitality, entertainment. I think Disney recently announced with its theme park, sort of a record first half of the year. And we are now seeing that projects that they'd mothballed during COVID are now coming back out again. Now these were previously awarded to us, and they are looking to actually continue for us to implement. So what we see here is this market is coming back and coming back very strongly.

And then the last area I'd touch on would be the Mid Atlantic and the Mid Atlantic does have the developer market, but we have been moving away and reducing our exposure in that area towards federal. And we were hoping to get one federal project, we ended up getting two major federal projects and over $1bn of orders.

The other thing I would say that is in these numbers as well or in this picture is that we have received our first instruction around military housing to actually do a demolition at Fort Carson of some of the old properties there which are really beyond maintaining and repair. And that is very encouraging in like of the history with the DoJ. So we are seen to be a valued supplier going forwards in the future.

Hong Kong, we won't spend a lot of time on Hong Kong because there is really no change except this orderbook, flattered by exchange rate is up by some 20%. We see Hong Kong as being a very robust market going forward with good reliable, consistent performance. Again, the growth is going to be in the Northern Metropolis where they are going to be building out more cities. MTR is terms of its infrastructure is a big customer of ours and somewhere we want to stay very close to and play with. They have still got their hospital programme, we're not a big player in that, although we're trying to participate.

But the one thing I would say is that there is a great emphasis, and it comes from the recent visit and the 25 year anniversary of Hong Kong on young people and getting them to stay in Hong Kong and ensuring that they've got the right sort of housing and accommodation. So there is a big thrust here around attracting young people, particularly to do start-ups and keep the entrepreneurial spirit, whether that will be successful or not I do not know. But this is going to continue to be a strong market for us.

Let's move to Support Services where we have announced that we're going to be performing at the upper end of expectations. If I look at Rail, Road and Power for a few seconds and if I add all this up it's about £1bn of turnover. So for us it's a material business.

If I look at the opportunity, you know if we double that business in terms of percent of market share increase in this opportunity it wouldn't even be negligible. So there's plenty of growth to be had in this area.

The challenge is to get the people to capitalise on the growth. So again, we're not constrained in this market by opportunity, we are constrained by capability.

If I look at the Rail business, really exciting, we're performing very well on CP6 and CP7, challenging, demanding, but we are actually doing a very, very good job. We are bidding other areas, which potentially in 2024 could see that business double. Now that depends on

awards, but if we were to get another award of another area it would double our market share.

In the meantime what we're doing is we're looking to drive the business for productivity improvement, because if you can't get more people you've got to become more productive. You've got to use modular manufacturing, you've got to use digitisation, so that is where we're driving and we're looking to see increased productivity in this area.

In terms of road maintenance, there is a number of local authorities will be coming out with their road maintenance for tender, this is usually a five year contract. We have bid three or four, we have been successful on one and in the case of Buckinghamshire it's worth £176m, which will actually show a 5% approximately growth next year as that contract comes online. So again, a big market here - a lot of opportunity.

Also within Road maintenance we have our CPS contract, which is the maintenance of the M25. We can't actually change the revenue on that, so what we're doing is we're driving productivity. So in the next timeframe what we're going to see is productivity improvements from the CPS contract and then growth in '23 and beyond in the council road maintenance.

In the area of Power, I think I've described the offshore and the wind power, the resilience and how robust our network is. This is a highly differentiated offering of ours. We have got tremendous capability; the challenge is it takes five years to bring people up to speed in this area. So this is all about how do we drive productivity in order to satisfy the increase in demand.

Again, I think you can comfortably see why we're talking about the upper end of margin expectations.

We are often asked the question about our Infrastructure Investment pipeline as to is it actually simply a store of value as in a battery, or is it actually something that can be supercharged in order to drive growth? Well fundamentally it's both. If you look at the divestment track record as Phil has described very ably, we have done extremely well in terms of the divestments themselves, but also exceeding the book value that we have. And I don't see that abating.

In terms of the other question, in terms of is it a growth engine? Well if you look at the UK very, very quickly, there hasn't been an effective P3 or PPP market in the UK for ten plus years and in effect our only real growth is around student accommodation. We have got 3,500 rooms tied up between the Royal Holloway and the University of Sussex, so they are good projects and there are other ones in the pipeline. But then again, it's not really a dramatic growth market for us.

However last time I presented I talked about P3 in the United States. And although it is early at this moment in time, if you just look at all the clutter that is up here there is an awful lot of things going on and an awful lot of people exploring the opportunity. And interestingly enough we are starting to engage – I talked about schools last time in Prince George's County in Washington DC, Virginia – actually Maryland, but you're seeing also Bridges and Roads now coming into play. And with some of our customers we have been able to sort of

combine offerings to say, well why don't you put your Road and your Rail bridge together and start to create some real value, so rather than building two separate structures you can do it on one.

We are looking at a lot of civil halls, civic offices and the like, student housing is still a big deal. But fundamentally I see this as a – over the next three to five years - as a considerable amount of growth will actually come through this channel and that will then underpin our US construction business. So I'm very optimistic about the strong pipeline and it will emerge over time.

In terms of for us Building New Futures, you know really, really important that we buy into this, not only because the Government says so, but this is sort of the right thing to do. And the way I think about it and characterise it, it's a little bit like safety. But we have already laid out our ambitions for 2040, zero carbon, zero waste – beyond zero carbon, zero waste and positively impacting a million people. We have laid out our Science Based Targets for 2030. And we have also prepared and are in the process of preparing for submission the waterfalls as to how we are going to do that step by step. And that will be really important.

But the real thing that I want people to take away here is I talk about – we run a safe company because we design for safety. So we think about at the front end as we're doing design. The sustainability, decarbonising and whatever is actually the same context. You have got to do it by design, you can't retrofit it.

So for example we have dedicated carbon and energy teams, I think we are one of the few companies in our sector that actually has that. So you hear about the green washing, we have really got people whose full time job is to get this right. And if we actually design for sustainability, it impacts such things as water, in terms of how do we recycle it and use the minimum amount. So on that tunnel that you saw built at the beginning that actually uses high pressure water to cut out the earth. And that is actually recycled, and we reuse 70% of that.

In the case of mass haul, if you've got your design early you cut the material wants and you place it where it will rest for the rest of its life. We don't believe in double touching materials.

So if we get all these things right in the same way we get safety right, we'll end up with a business that actually is at the forefront of decarbonisation and achieving our Science Based Targets will be, I think, fairly comfortable. But very important and a big differentiator for us.

So fundamentally, in summary and the outlook, Phil's given you every single possible combination of numbers so that even the less numerate of us can actually work out how bright the future looks. But fundamentally the first half performance gives us confidence in the full year and that actually underpins our upgrade.

Our unique capability, which I've emphasised all the way through this, talks to what is a decade of infrastructure growth. I mean we really couldn't be in a better position than we are in today. In the short term, the way we've moved our order book in terms of the example of federal infrastructure, how those contracts and terms and conditions are put together leave us with a much more de-risked position than we've ever had in the last six or seven years.

Our Investment portfolio, up £200m, yes, it's flattered by exchange rate and inflation, but what an asset to actually have, almost equal to the market capitalisation if it wasn't for the sharp rise in the share price this morning.

And as Phil has talked to ad nauseam our capital allocation model gives us confidence that we are going to continue to give future returns back to shareholders, underpinned by the cash flow which I showed you. So net-net a good set of results, optimistic about the future and our positioning in infrastructure I think gives us real confidence that this is going to continue for the next few years. Thank you.

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Questions and Answers

Moderator

So Leo and Phil, we're going to start with Q&A in the room and then we'll go to the phones.

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Pam Liu, Morgan Stanley

Thank you very much. I have one question but it's quite a big one. So, it's on the infrastructure Investment portfolio. So, first of all, on divestment, so if I think about what are remaining to divest, is it fair to say that out of the sort of, remaining portfolio, the operating, or operational assets are mostly US military housing and UK PFI? If that's the case, then UK military housing, I think in this sector in general, there has been very limited secondary transaction in terms of equity stake. And in UK PFI, I assume the reason you haven't sold them is probably because you have operating interests and therefore, you're probably not likely to sell them.

And then that will leave it to some sort of assets still under construction, which are probably related to US housing or student housing, which, again, may not be right for divestment. So, the first bit of this question is what you can you sell in the next three years? Will you have a void of not having sufficient assets to sell at attractive timing?

The second bit of the question with that is, obviously, we are in an environment with rising interest rates, so how do you see that affecting investors' appetite, their costs of funding and therefore the price they're willing to pay?

And then, on the investment side, so it's really great by the way to see the pipeline being put on the charts, so thank you very much for that, but I'm interested in the return profile, so can you give us a bit of a guidance on how attractive are these P3 investments and who are you competing with? Thank you.

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Leo Quinn, Group Chief Executive

Wow! [Laughter] I thought you were going to ask why Phil wasn't wearing a tie! [Laughter] The story behind that is we've only one tie, and he wore it last time, I'm wearing it this time.

So, where do we start? I'm going to give some general points and Phil will sort of fill in with some facts. It's a really interesting question you ask, what is available for sale, and, as I look at the portfolio and we talk about it day to day, I think the number of assets in the portfolio available today, as asset items, are that the highest level in terms of the fact that they're coming to maturity, and I'll give you one example.

I won't give you the specifics of it, but we recently had an asset which was unperforming for the last three years. We recently enacted upon cutting out seven kilometres of cable under the ocean and replacing that cable with a new cable. That asset is now operating at 100% of its capacity where it was operating at, sort of, sub-50%. The reason I make this point is that, at sub-50%, we weren't going to sell it. Having paid for the upgrade, and we will hopefully be refunded for that payment through the regulator, that asset is now available for sale. So, you know, sometimes there are operational issues around them which we then endeavour to improve.

So, I'm not sure exactly what the question is, but I would just say that we have more choice today in terms of the number of assets that we can sell than we have had for the last three or four years, which is good news, and that comes back to ensuring that the performance is at a level where we can actually ensure the return. Do you want to say anything on that?

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Phil Harrison, Chief Financial Officer

Look, we typically, in our forecasting and budgeting, we look at a three-year plan, we look at that in terms of what we think we're going to maximise our value on divestments there. We are going to continue over the next three years divesting at the right time for those assets. So, I don't see us having a void period. We may have a smaller period at a given time, but I can't see us having a year where we aren't disposing of an asset.

I think we have got, if I look at Purdue, which we've been successful on, we got that asset in 2018, we're turning it now, you know, three or four years later. I see quite a few of those assets that will come up in that timeframe as we go forward in the next two to three years. I can see some UK assets that we will sell, so don't just think it's going to be US assets, we think there's some UK assets that will go to market as well.

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Leo Quinn, Group Chief Executive

You know, just in terms of the emergency housing asset, there have been transactions which have happened in different ways. There haven't been outright sales as the whole portfolio. Some of them have monetised part of the revenue stream, and I can't remember the exact details, but it was something like 25 times the earning value or whatever, but you can look that up, and you probably know better than I do.

So, I do think those assets are extremely attractive where they've got 30 to 40-years cashflow, and the market is, at this moment in time, paying a premium for such cashflows, in our experience.

You asked about interest rates, there's no doubt that interest rates are having an impact on the market, especially if you're looking at some sort of private development. You know, cap rates, they're at an all-time beneficial level and so, therefore, they're looking to describe better valuations than we had anticipated in our model. So, with cap rates where they are at the moment, we're looking to be a divestor rather than necessarily a buyer, but then these things change over time as well.

It is more difficult to get financing around projects, there's no doubt, and even when you go to the banks, they're looking for more onerous terms, but the fact is the money is still out there, it's just a little bit more challenging to get. I don't know if you'd like to say anything on interest rates at all.

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Phil Harrison, Chief Financial Officer

No, I think you've covered that. I think, on the return profile, what I would say is that we take a very disciplined approach, we're looking at two times return, that's our goal. That typically equates to, you know, a 15% IRR kind of hurdle rate for us.

So, as we look forward, we are seeing attractive things in this space, but we're disciplined. The Investment Team has been very good at selecting and keeping with that discipline, and we've benefited from it, as you can see, in terms of our divestments and actually we're still sitting at £1.3bn of value there, even after all of these divestments.

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Leo Quinn, Group Chief Executive

Yeah, and one of two things we're looking at is we're looking at a little bit more of an innovative approach in terms of some of the things we're investing in, and, at the full year, we'll announcing some of these things. But we are just about to launch a £10m investment fund around start-ups' innovative technologies which are, sort of, a departure from our more traditional PPP assets, but I think, when you see what we're talking about, you'll find it quite innovative.

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Pam Liu, Morgan Stanley

Who are your competitors in the US P3 space?

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Phil Harrison, Chief Financial Officer

P3s, you'll find other contractors, let's call them Europeans, that's probably the way I'd have them, and then a combination of some infrastructure funds teaming up with contractors is what you typically see. So, they're the kind of people we've seen in the market. But you've got to be careful, that's it in the P3 space. Then, when you move into student accommodation, a different set of competitors in that market. So we do vary in terms of the competitors we see.

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Leo Quinn, Group Chief Executive

Yes, sometimes those competitors are people that actually buy our assets as well, yeah.

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Jonny Coubrough, Numis Securities

Thanks. So, I've got the mic, so I'll carry on if that's okay. Thanks for taking my questions. Firstly, on Support Services, I mean, you've spoken previously about how the improved margins are being driven by exiting the Gas and Water markets. Keen to also hear if you're seeing improved contract terms or improving contracts as a result of demand, particularly within Power and Rail.

And also you spoke a few times there about, you know, about the challenge around human resources. Could you give us an update on where you are with salary reviews and, within Support Services, what the impact on the margin would be there and ability to pass that through?

And then the final question is around the multi-year capital returns. You referenced there, Leo, the sharp rise in the share price today, so just keen to hear what your appetite is in future years to continue with buybacks versus special dividends. Thanks very much.

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Leo Quinn, Group Chief Executive

Great. I'll let Phil do the last one and I'll do the first two. First and foremost, if you sit down and you read the contracts carefully, you would never sign up to the Gas and Water terms and conditions, especially when you look at the tail that comes with them which could run for several years after you actually finished the work. So, just a relative comparative basis, we're in a far better position around the contract T&Cs.

The other thing is is that, you know, the contract T&Cs need to be managed, but sometimes it's not the terms and conditions, it's actually the technical specification that you sign up for and how difficult that can actually be to achieve. So, we, in our Gtech process, have now gone back and we can't change the contracts but, as each order would effectively come out and you would be tendering for it within the framework, we're very careful to look at what's the technical scope that we're taking on so that we don't expose ourselves to risks that we can't actually manage.

So, fundamentally, the terms that we've negotiated in the new frameworks, we've pushed back on certain items that we're not prepared to accept. That's in the master framework. But then, on each job, we've pushed back in terms of the technical scope. So, I think we've in a far better position, which allows us to make the returns.

When we get those technical specifications wrong, and we delivered one job recently, a large job in London in the Power business, we actually lost money. So, the point being is being aware of that, learning from it so it doesn't repeat itself is really, really important. That loss was last year, by the way, so no need to worry about that.

The Rail business, again, you know, the terms and conditions are well understood. I don't see big risks there provided you perform in line with the contract.

In terms of salary review, this year our salary review was in January. We went out with 3.5%. We had four in-year changes, another 1%, so that's where we are.

You know, we all realise just how difficult it is for people with the rising energy costs and all of these sorts of things, so we're, sort of, remaining constantly vigilant about it and see what's required.

If you go back to COVID, you know, if you look at how we responded in COVID, I don't regard energy as the same crisis as COVID, but the fact is, you know, we're a responsible employer and we want to make sure that we look after our people.

In terms of, we do have some unions, we have quite a lot of unions as part of our business, and we're looking at discussions around 4%, maybe as high as 5% in some of those direct labour areas, and we're very much in line with what National Rail will be doing and our other end customers. So, we're not stepping out and saying we're something different, it's all part of a negotiated agreement. So we'll follow what Government, and the major customers actually supply because, ultimately, they pay of it. It does flow through back to them, so there we are.

And in terms of the capital allocation…

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Phil Harrison, Chief Financial Officer

Look, we've always said we'd use the most appropriate method to return surplus to shareholders at some point. If that's not a share buyback, then it'll be something else. But we'll get to that when we think the share prices are not as attractive to buy back on. I don't think that's yet.

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Leo Quinn, Group Chief Executive

We have enjoyed a particularly low period for the last six months, so we've been trying to buy back as many as we possibly could. But we keep that under constant review.

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Joe Brent, Liberum Capital

Good morning. Two questions, if I may. Firstly, you've reduced the amount of fixed price contracting, but you've got some single stage contracting in there. Do you expect to reduce that further?

And then, secondly, on Rail, rail transport has declined quite a lot, which has led some people to think that CP7 could be a reduction in revenue spend, so just your thoughts there.

And then, finally, I'm sure this one is for Phil, working cap absorption is trending down but actually the first half trended up or went up at a Group level, so I'm interested in why working capital went up for the first half.

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Leo Quinn, Group Chief Executive

Okay. Look, we're always going to have some fixed price work in our portfolio. The important thing is is that we're set up to handle that and, clearly, the fact that we've done it historically in the US Civils business means it's an area we can manage. You know, we do get surprises on the upside, we get disappointments on the downside, but, in balance, it's a business worth staying in and we have that capability.

In terms of Rail, you know, if we think of London Underground, which is not Network Rail, but I think it's back up at about 75% to 80% of where it was. Weekends are 100% recovered. You know, if they do cut back on it, you know, I don't think we're going to be too concerned because you can't not maintain the network, and your CPS is about the maintenance. If you cut back, you'll cut back on capital programmes.

One thing I forgot to say on my slide was, by having that capability footprint in Rail, we are very well-positioned, and we've bid for the work on HS2, the track slab and the catenary. That's over and above anything that we're actually looking at in our Services business. So, the same people that do the work on the maintenance side, we would then move to the capital side. So, I don't really see there's a risk in that at this time. I may live to regret my words, but I'm pretty confident that it's underpinned. And then, Phil…?

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Phil Harrison, Chief Financial Officer

The working capital one in total on negative, that's exchange rate that's pushed that up, and the table we show on the working cap is pre-exchange rate.

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Moderator

Okay, so I think we're going to Gregor on the phone.

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Telephone Operator

Thank you. Our next question comes from Gregor Kuglitsch from UBS. Gregor, please go ahead.

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Gregor Kuglitsch, UBS

Hi. I hope you can hear me. If not, please shout. So, the first question is on Support Services. I want to clarify some of your comments. I think you said you thought there was an opportunity to double I think the size of the overall business if I'm not mistaken, and I guess I understand and I appreciate that's more of an ambition than perhaps, you know, a guidance, but what do you think you can realistically do, say, growth wise over the next few years considering, you know, the constraint that you're facing?

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Leo Quinn, Group Chief Executive

Yeah, look, first and foremost, we're not doubling the business. That was really to point out the market is so large that, if we actually did double the business, we wouldn't necessarily be having a big impact on market share.

If you look at the business, these things are always one or nought. So, if you look at the Rail in particular, we currently, under CP6, CP7, run one of the regions. If we were to run another region, you would see that business potentially double in volume. So, there is that potential, but it's always going to be one or nought.

In the Roads area, we said we'd grow that by 5% next year, and I could see another 5%, 10% in the years going ahead. We have a very, very capable Group.

And then, in the Power area, it's really around how do we drive more productivity? And I always look at that and think we should be thinking about how do we get 5% to 10% growth there?

We're not restricted in any circumstance by the market, it's really around keeping the people we've got and how do we drive up more productivity through digitisation and modular manufacturing and better work practices?

So, if you wanted to put a number in there, you know, if you put single-digit growth for '23, I think that would be a sensible range. And if you look at that at the upper end of the target margin range, I think it was there or thereabouts in the right place. Now Phil might contradict me because he's always less optimistic than me.

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Gregor Kuglitsch, UBS

I don't hear a contradiction, so I'm guessing he doesn't.

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Phil Harrison, Chief Financial Officer

No, I'm not commenting, Gregor.

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Gregor Kuglitsch, UBS

So, from that comment, I guess what you're suggesting is that the 8% is, sort of, sustainable. I guess what I'm asking is if there's anything, sort of, non-underlying in there that's flattering the results this year or do you think that can be sustained, sort of, going forward?

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Leo Quinn, Group Chief Executive

No, far from it. I don't think there's any one time and one-off underlying thing in it. I think we are looking at sustained upper end of that margin expectation.

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Gregor Kuglitsch, UBS

Okay. Thank you. The second question is on your Slide 24, which is the pipeline, you know, what's interesting is that, on the sort of PPP, some of your peers, you know, actually exited that market, and some of the European peers in fact, because, you know, although they're essentially fixed-priced contracts on the contracting side, so while you're making good return on the, you know, equity, on the investment side, you lose, or you have quite a high risk on the contracting side.

So, I want to understand what you see differently there, and I know that your US business hasn't agreed that P3 focus yet, but there's been some comment, so I wanted to understand your risk appetite, I guess, to grow there and how you manage that considering your comments on, sort of, fixed price, you know, contract appetite that you've got at the Group level.

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Leo Quinn, Group Chief Executive

Gregor, just to clarify, you were dialled into the Balfour Beatty conference, were you? [Laughs] What I don't recognise is, sort of, the exit and the fixed price, and I can't remember the context in which I made that comment.

What this slide is, it's the infrastructure investment pipeline slide, is really pointing out is that, in the UK, there's very little, there's no PPP in effect. There hasn't been a vehicle for doing that for a decade plus, and so therefore there's really no growth on that side of the portfolio.

In the US, what we're seeing is a large appetite for people to find alternative ways to fund their needs, whether it be municipal buildings, whether it road, rail, bridge contracts, and so the market is starting to grow and become very vibrant.

Not all of these things will ultimately come to fruition but, as we look at where we're going to put our dollars, we're going to put it all into the US, or that's going to be our primary focus for growing the Investment part of the portfolio. Did that answer the question, or did I miss something?

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Gregor Kuglitsch, UBS

Well, obviously, I was referring specifically, for instance, you know, the Skanska thing a few years ago, exited that market because they lost so much money on, you know, the contracting side, you know, so that's kind of the question.

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Phil Harrison, Chief Financial Officer

We have no appetite for toll roads in the US under P3. I think Skanska was involved in those, but, you know, I don't want to say any more than that. But we've never played in that area because we didn't think we can make money from a contractor point of view.

So, when we look at, you know, the forward pipeline, it's clearly, we look at the end to end. So, what we can achieve on the contractor side and what we can achieve from an equity investment, and clearly, we have to think about that risk to the contractor. So, we balance that all up, and that will be part of our selection character of which of these we'll do and which we don't touch to be fair. Does that help?

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Gregor Kuglitsch, UBS

That's clear. Thank you. Yeah, that helps, thank you. And then, finally, I think there's a triannual evaluation ongoing, and this year I think you're around close to clearing £60m or so into the pension. So, I want, sort of, better sense of what you think the claim from the pension will be in the next few years in that context, please.

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Phil Harrison, Chief Financial Officer

Well, we're in the midst of the triannual. We've not seen any numbers from the actuaries or the trustees yet, so it's a bit early to say that. We're hoping, by the year end, or clearly as we get to March next year, to have concluded on that, and we'll be able to give some greater clarity to people. But, at this point, we're still in process, so it's a bit difficult to comment on that.

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Gregor Kuglitsch, UBS

Okay, brilliant. Thank you.

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Leo Quinn, Group Chief Executive

Thank you. Any other questions?

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Telephone Operator

Thank you. Our next question comes from Andrew Nussey from Peel Hunt. Andrew, please go ahead.

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Andrew Nussey, Peel Hunt

Hello, yeah, good morning. A couple of questions from me. First of all, following on from Gregor's question on Support Services' margins, the sort of 6% to 8%, can you just give us a little feel for how business mix might influence that moving forward given the comments you made in terms of potential revenue opportunities?

And secondly, on the UK Construction margin guidance of the 2% to 3% which, Leo, I think you classed industry standard, when you look forward now, given your order book mix opportunities for efficiency skill advantage, should we be beginning to think about you beginning to build on that margin ambition?

And thirdly, if I could as well, just in terms of inflation, you've obviously highlighted it being manageable, I'm just curious what clients are now, sort of, thinking in terms of their projects and how they're managing cost inflation. Are you seeing, you know, continuous hesitancy in terms of contract award or is that beginning to, sort of, normalise? Thank you.

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Leo Quinn, Group Chief Executive

Okay, right. Let me just have a think. If I think about mix, it's a difficult one when you start to look at '23/'24 only because some of these things are very binary, they're one or nought, but I would see, you know, low single-digit growth, you know, for the Roads business as these contracts come out for tender.

Rail will, in the short term, drive for improved margins with no growth. If the other regions come into play, you know, it could lead to a doubling of the business by 2024/'25. So, it's very difficult to forecast because you don't quite know what you're going to win.

Power, I think is going to be consistent, steady performer, both in terms of, you know, a slight tick up on its top line, which will come through, ultimately, productivity growth which will hopefully see an improvement on the bottom line.

I don't know if that helps. It's very difficult to be more clear except to say, you know, it's a great business to own and hold, so I'm opportunistic about the outlook. Does that help?

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Andrew Nussey, Peel Hunt
I guess my question was, sort of, aimed more at, sort of, the relative margins between those three segments. I've always, sort of, thought the Power as being a higher margin activity than Road and Rail. I just really kind of want to get a bit of comfort around that.

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Leo Quinn, Group Chief Executive

Yeah. [Break in audio for six seconds]

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Phil Harrison, Chief Financial Officer

So, you're right, Andrew, in that, if we have a higher proportion of Power [audio jumping] come to fruition for us, then that mix would probably drive margins because then we have a better margin in Power, yeah.

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Leo Quinn, Group Chief Executive

Yeah, it's interesting. This is totally counterintuitive, but I think it was four years ago, if not three years ago, we consistently lost money in Power for three years in a row. I mean, when you think of the barriers to entry in that business, it was just ridiculous. We sorted that out and, you know, our margins are now starting to improve, but actually there's not a lot of differentiation between the three areas now.

Power should be, by far and away, double what it is today, but it's a very challenging customer base because it's effectively you're selling to an oligopoly. There are only like three customers, and those are the big network holders, and they're very commercially astute and very tough to deal with. So, I think that's answered that question.

Your second one around the 2% to 3%, basically are you going to do better? You know, I read a book a long time ago and it said to me first achieve what you set out and then, second, look to exceed. So, let's, sort of, get the 2% to 3% nailed down and have a consistent level of performance and then hopefully we can surprise you with something better.

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Andrew Nussey, Peel Hunt

Okay.

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Leo Quinn, Group Chief Executive

But the mix of business that I've pointed out in terms of the decade of infrastructure growth should be favourable in the long term to margins.

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Phil Harrison, Chief Financial Officer

Inflation.

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Leo Quinn, Group Chief Executive

And on inflation, the fact is that inflation is causing new business prices, or costs, to rise, and that is causing people to reassess whether or not they can get the return on those projects. So, you used the word 'hesitancy' and 'delay', I think that is creeping into the market. However, our exposure to that element is less material than others because the projects we're concentrating on really rely on, you know – you can't afford not to do them. If you think about Sizewell and you think of the others, it's not a question of if, it's just a question of when.

So a lot of that critical national infrastructure, the upgrading and the robustness of the onshore network and the resilience of it, you can't delay that forever. So, in that area, I'm not concerned about delay.

Obviously, developer-type work in the US, and a little bit here in the UK, you could see some delays as interest rates rise. But, you know, given that it's on the supply side that's driving the inflation, I could see a path where that actually abates and, all of a sudden, things in the next two to three years start to normalise back to where they were. But it really depends on how the next government manages that.

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Andrew Nussey, Peel Hunt

Got it, great. Thank you very much.

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Leo Quinn, Group Chief Executive

You're welcome. Is that it? Great. Well, that concludes the first half results. Thank you very much for attending and appreciate all of your questions and we'll see if we can organise for Phil to have a tie next time! Thank you.

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END

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