Compass Group

2017 Full-Year Results

Presentation

Richard Cousins

Group CEO

Good morning, ladies and gentlemen, and thank you for joining us. Today we have the usual agenda and there'll be plenty of time for questions and answers at the end. Before we get going, I'd like to take the opportunity to re-introduce Dominic Blakemore. As you know, Dominic was recently appointed as Deputy CEO and will take over from me at Easter. I'd like to congratulate him and wish him every success in the future. You will hear from Dominic at the half-year results, in May. I'd like to begin by making a few comments on the highlights for this year, and then Johnny will take you through the financials as usual.

Compass had another strong year. Organic revenue was up by 4%, with growth weighted to the second half, as we expected. Our operating margin improved by 20 basis points, reflecting the generation of efficiencies in the business and the absence of restructuring costs. Free cash flow was up by 7%, due to good cash conversion and FX. EPS, on a reported basis, was up by 18%, but, more honestly, constant currency earnings per share were up by nearly 6%. And we're proposing to increase the dividend by the same amount. The business continues to throw off significant amounts of cash. This year, after investing in the business, we have returned some £1.6 billion to shareholders. On that positive note, I'd like to hand over to Johnny.

Johnny Thomson

Group FD

Thank you, Richard, and good morning, everyone. Let's start with revenue. Working from left to right, sterling's weakness against all of our major trading currencies, benefited revenues by £2.1 billion, which gives us a rebased 2016. North America grew organic revenue by 7.1%. New business wins were very good, particularly in healthcare, vending and B&I, and retention remained excellent, at 96.4%. Like for likes reflected modest price increases and flat volumes. Revenue in Europe grew by 1.6% for the full year. Exciting growth in the UK and Turkey was partly offset by subdued trading on the continent, particularly France and Germany.

We continue to work on improving retention, and like-for-like revenues were up slightly, due to some price increases. Rest of world, excluding offshore and remote, grew by 3%. Strong performances in Spanish-speaking Latin America, India and China were partly offset by challenges in Brazil. Our offshore and remote business contracted by 14%, as expected, due to the impact of the construction cycle in Australia and continued weakness in our commodity-related business around the region. Taking all of these movements together, Group organic revenue grew by 4%.

Starting on the left of the chart, FX was a £169 million benefit to operating profit. The strong performance in North America, and some improvement in Europe, increased the operating profit by £70 million and £5 million respectively. In Rest of World, a decline of £12 million in Australia, offset a better-than-expected improvement of £7 million elsewhere. Finally, the absence of restructuring and other costs added £21 million. Taking all these movements together, the Group's constant currency operating profit grew by 5.6%.

In North America, margins remained strong, at 8.1%. The business generated efficiencies which, together with price increases, offset significant labour headwinds and the continued impact of weak volumes in oil and gas. In Europe, margins were flat, at 7.2%, as efficiencies on pricing were offset by labour cost inflation, particularly in our UK support services business. Our margin in rest of world was better than expected. Benefits from last year's restructuring more than offset the impact of weak volumes in our offshore and remote sector, and in Brazil. The absence of restructuring costs, and FX, also benefited margin this year. Overall, the Group's margin improved by almost 20 basis points.

As you know, FX has only a translation impact for us. Given the recently strengthening of sterling, if current spot rates continue through 2018, FX would reduce full-year 2017 operating profit by around £40 million. And, to give you a sensitivity, a 1% move in sterling against all of our trading currencies would change full-year 2017 operating profit by around £15 million. Further details regarding FX sensitivities can be found in the appendices to the presentation.

Net finance costs were £114 million, slightly above last year, due to FX and one quarter of additional interest incurred on the debt to fund the special dividend. As we've previously indicated, this year's underlying tax rate was up by almost 1%, at 25.4%, mainly due to changes in international tax rules as part of the OECD BEPS project. At this stage, we expect continued upward pressure of around 1 percentage point on the rate for 2018. The impact of any potential changes in US tax legislation remains, at this stage, unclear. Constant currency EPS grew by 5.7%, and we're proposing to increase the full-year dividend by the same amount, in line with our policy.

Let's talk about cash. Depreciation and amortisation increased to £483 million, due, in equal parts, to currency and our investments in CapEx. Gross capital expenditure was 3.1% of revenues. In 2018 we expected CapEx to be, again, just over 3%, and includes an investment in an exciting long-term partnership with the LA Dodgers in the US. Working capital was a £62 million outflow. The lumpiness of the last two years was generated by timing differences. In 2018 we expect working capital to be an inflow of around £40 million, as the impact of the extra payroll in 2016 reverses. Operating cash grew by 9.7% and operating cash conversion was 83%.

Post-employment benefits were £14 million. And we expect to pay around £20 million in 2018. The cash tax rate was 20.9% and, for 2018, we again expect the rate to be between 20% and 23%. Our free cash flow, therefore, grew by 7.3% and, at 57%, our conversion was in the middle of our target range of 55% to 60%. Looking now at the balance sheet, again, starting on the left of the chart, opening net debt was £2.9 billion. And the business generated cash of £1.7 billion before CapEx. We reinvested £760 million to support our long-term growth, including £77 million on M&A. We returned £1.6 billion to shareholders, including the £1 billion special dividend, paid in July. FX and other items were £84 million, and so, on 30 September 2017 net debt to EBITDA was 1.6 times, as we continue to de-lever following the special dividend.

Our priorities for uses of cash remain unchanged. We continue to be excited by the structural growth opportunity in our sector and invest in the business via CapEx and M&A to support our long-term growth ambitions. To that end, we have just purchased, subject to regulatory approval, 80% of Unidine in the US for $280 million. There are a pure-play food services provider, predominantly in healthcare, with revenues of around $220 million. This acquisition significantly enhances our capability in the fast-growing senior living sector, and meets our returns criteria. Our aim is to maintain a strong investment grade credit rating and we will continue to return any surplus cash to shareholders through share buybacks or special dividends, to target a full-year net debt to EBITDA ratio of around 1.5 times. As usual, I've pulled together some of the key 2018 full-year assumptions on one page, as reference for your modelling.

A word on phasing. I'm optimistic about our outlook for 2018. We expect full-year revenue growth to be in the middle of our 4% to 6% range, with modest margin improvement. However, revenue, margin and free cash flow generation will all be second-half weighted. In terms of revenue, we are expecting an acceleration in our growth in Europe and rest of world as the year progresses. And don't forget that Easter will have an impact, albeit less than last year. On margins, we're taking actions to offset labour cost headwinds, particularly in Europe, which will yield benefits towards the back end of the year. Finally, our free cash flow in the first half will be impacted by our investment in the LA Dodgers.

In conclusion, we're pleased with our results. The business is performing as expected and we continue to deliver strong organic growth, improve the margin, generate significant amounts of cash, invest in the business and, finally, return cash to shareholders. Back to you, Richard.

Richard Cousins

Group CEO

Thanks, Johnny. New business wins were 8.7%, driven by strong performances in all regions. Lost business was 5.7% and like-for-like revenue was up a bit, with sensible price increases around the world partly offset by weak volumes in our commodity-related businesses. As a result, organic revenue growth was 4% for the year. We remain focused on margins. The business generated some margin improvement as we successfully offset headwinds, particularly in labour, through efficiencies, overhead leverage and pricing. And the absence of restructuring costs this year increased margins further.

Let's now turn to the regions, beginning with the most important one. North American, the Group's core growth engine, continues to perform exceptionally well. New business wins are strong, retention is high and like for likes are good. Efficiencies are offsetting labour cost pressures and our margins remain strong, at 8.1%. Our sectorisation and sub-sectorisation approach continues to drive growth across the board, with the exception only of DOR. We've been able to innovate and sharpen our offer to win and retain business with several flagship organisations. In addition to the LA Dodgers in sports and leisure, we have won the Mayo and Cleveland Clinics in healthcare, the University of Houston in education, and Qualcomm in B&I. It's also resulted in a nicely-balanced business across the four main sectors.

As I've said before, innovation is not only about the glamourous consumer-facing activities. Our American colleagues are doing some exciting and innovative things in labour. They developed a tool to source hourly associates in a more efficient way. It reduces the amount of time the unit manager spends on this activity and improves associate retention rates, and the quality of our hires. They are also undertaking a [significant] simplification project to reduce non value-added tasks. Both examples reduce cost and free up the unit manager's time, to focus on our clients and consumers.

Europe is performing as expected, with organic revenue growth in the year of 1.6%. Whilst the creation of the business units continues to deliver efficiencies, this was partly offset by labour cost pressures. Passing all of these increases on to support services' clients in the UK has been particularly difficult. Performance in continental Europe remains a little subdued. And in the North Sea, weak prices and high extraction costs have made for difficult trading. The UK and Turkey were the main engines of growth in 2017 and they also offer the greatest European potential in the New Year. The UK will accelerate nicely during 2018 and 2018, with mobilisation of defence and sports contracts. The strong Turkish pipeline is underpinned by our leading market position and the expansion of our footprint into education.

Performance in the rest of the world is beginning to improve. Excluding offshore and remote, revenue was up by 3%, driven by strong performances in Spanish-speaking Latin America, India and China. Margins improved as a result of the restructuring generating better-than-expected savings. As you know, our commodity-related business turned a corner in the first quarter of this year. I remain excited about the rest of the world as a whole. While we're not going to get back to growth levels of, perhaps, five years ago, we believe the top line will return to reasonable growth in 2018, and continue to accelerate from that base. In the medium term, Latin America, India and China all provide exciting opportunities.

I would usually, at this moment, talk about our future strategy. However, as I've only got four months to go, I'd sooner focus on why I remain excited about the future of Compass Group. There's a large structural growth opportunity, with significant potential for first-time outsourcing and share gains. Importantly, we're focused on food. It's our core strength. Our scale gives us a cost and competitive advantage, and we remain focused on efficiencies and operational performance. Finally, we have a hugely experienced and talented management team. Given these strong fundamentals, I'm confident Dominic will lead Compass from strength to strength.

And so, to summarise, it's been another good year. North America is in great shape, Europe's performance is reasonable, and rest of the world is improving. With our strong cash flow, we've been able to return £1.6 billion to shareholders. And, as we look forward to the New Year, 2018 will see modest expansion in the margin and, importantly, exciting growth on the top line. Before we take your questions, I'd just like to make a quick personal comment. This is my last results presentation with Compass and I'd like to take this opportunity to thank you, and others in the investment community, for your support over the last 11, or nearly 12, years. It's been a privilege to run Compass and it's been fun, most of the time.

Thank you for your time and attention. We'd now like to take your questions in the normal way. If you'd wait for the microphone and, of course, introduce yourself, we'd be grateful.

Q&A Session

Jamie Rollo - Morgan Stanley

Actually, perhaps before I ask my question, Richard, just to put you on the spot a bit. As you say, it's your last set of results, so I think we, in this room, should recognise the remarkable achievement that you've made over the last 12 years. Thank you very much. It's not in our nature to congratulate CEOs, as analysts, but thank you very much and best of luck for your retirement.

I had a question on the competitive environment and your first-half sales guidance. Clearly, we've had a lot of fairly weak comments from numbers two to four recently, on outlook, on both sales and margin. Has there been any change in the environment, firstly? And, secondly, why are you expecting a pickup in sales in the second half of the year? What gives you that confidence, particularly, as your comps are much easier in the first half of the year?

Richard Cousins

That's an interesting question. Firstly, thank you for your comments, Jamie. I don't think there's been any change in the industry. Obviously, I'm only going to comment about Compass. We feel very good about our position. I think the H1 and H2 phasing in terms of revenue won't be that marked. H2 will be stronger than H1, but I still think H1 will be stronger than the number we just reported, i.e., 4%. If you exclude offshore and remote, which has clearly been completely rebased over the last two or three years, in 2017 we grew at just over 5%. And as we look over the next 12, 18 months, with Brazil moving back positive, Australia in particular, and offshore and remote in general also going back positive, I feel really very bullish about our top line. North America, specifically the US, let's be honest, US is a great, great business and the momentum we see at this moment is as strong as I can recall. We feel very good about Compass and that's all I care about.

Jamie Rollo

If I could have one more. In terms of the CapEx going over 3% and your depreciation is about 2% of sales, are those two going to align, because the depreciation charge is moving up much faster than the sales? It's a 10 to 15 basis points headwind over the last couple of years. How should we see that as having a P&L margin impact?

Johnny Thomson

The first thing I'd say, in terms of trends, the depreciation to CapEx ratio has remained fairly stable of the last five to 10 years, at around 70%, so that hasn't changed much, Jamie. And, as you know, we feel very good about reinvesting in the business. Whether it's 3.1%, or 3%, or just under, around about that mark seems like a good balancing point for us. Of course, as long as it continues to generate industry-leading growth with industry-leading returns, then that's where we should put our cash, so we feel good about it.

Richard Clarke - Bernstein

The first one, just on cash returns. Your finishing the year at 1.6x net debt to EBITDA. We know that the pound is going to be a bit of a headwind going into this year. And then you make the comment about how your - in the release about how your distributable reserves at the parent company are only around £1.1 billion. How could we think about special dividends this year, going forward?

Then a second question on the acquisition you've announced today, Unidine. I think I've got that name right. You've said in the past that you like to buy management teams, not just scale, so can you comment on what expertise, what technology they bring to Compass as a whole?

Richard Cousins

Before we get into that, you say we know FX. Well, we don't know anything. We're only 15% of the way through the year.

Richard Clarke

[Inaudible] where you are now.

Richard Cousins

Johnny?

Johnny Thomson

Look, we're continuing to de-lever. Since we did the funding for the special dividend we are at 1.6 times. We are coming off quite quickly, because we're highly cash generative, as you know. We're always reviewing, at the Board, when is the right time to be returning, and what format, because, of course, we've done buybacks and special dividends. I would say, at this stage, that having done the Unidine acquisition, or just about to complete it, I would expect, therefore, the consideration of when we start to do returns to push out into back half of the year as a result. Probably, we'll come back to you in the half with a better understanding of exactly when that might be and in what format.

Richard Cousins

In terms of Unidine, as Johnny said, it's largely senior living and other healthcare, a strong management team, excellent growth characteristics, good margin. Looks an excellent business.

Tim Ramskill - Credit Suisse

Thanks, good morning. Tim Ramskill from Credit Suisse. Just specifically on the US trends by sector, Sodexo have been pretty honest that they've dropped the ball in the healthcare and education arena, so to what extent has that benefitted this year? Or have you got some more to come from that next year? Have you been a winner in that area?

Then the second question, Richard. When you talked about UK support services and the challenges passing through labour inflation, does that have a particular read through in terms of your views on food versus support services, and the merits of being in that more labour-intensive segment?

Richard Cousins

In terms of the US or North American growth, we've seen par growth rates in B&I and education, which would be around about 6-ish. We've seen strong growth in canteen, sports and leisure and healthcare, and then, obviously, negative in DOR. As usual, I'm not going to comment about competitors, but when we sat down with North American management the other day, their pipeline is excellent, it really is. Do we feel good about 2018? I've just answered the question.

UK support services? We're better at food. We really improved our UK business over the last two or three years. I think we've got our food mojo back in the UK. Quality, service, innovation, growth, retention, are all moving in the right direction. It's a better business than support services, so we'll see.

Next one please. Come on. You're not allowed to go yet. Yes, Jeffrey.

Jeffrey Harwood - Stifel

It's Jeffrey Harwood from Stifel. Two questions. First of all, on the Unidine acquisition, can you give some idea as to the profitability, or what it might make this year?

Richard Cousins

No. I just thought I'd save your breath. It's a good business, satisfies our investment criteria, which, as you know, is to get above WACC by the end of year two. Looks a good business.

Jeffrey Harwood

Secondly, then, on the tax charge. Other things being equal, is 26.5 the new norm, or might it rise further?

Johnny Thomson

I think the tax environment is very difficult to predict right now. I'm deliberately, year on year, giving one-year guidance only for that reason, because, as I'm sure you're all aware, it is very volatile out there. For the moment, 1% increase is right. What it looks like beyond that, I think it's too difficult to say. The US legislation, as we all know, is ongoing and under discussion. For us, actually, I would not assume a big upside from that. It's funny that both the House of Representatives and the Senate bills are both very different and would have different impacts on us, so at this stage we just don't know. I can't really give you guidance beyond 2018. I just do want to emphasise not to assume significant upside from the US legislation.

Angus Tweedie - Merrill Lynch

Angus Tweedie from Merrill Lynch. Could you talk more about labour inflation across the different regions, and the fact you've pulled out cost inflation as a risk in 2017?

And then, Johnny, if you could help us on the CapEx figure. If you didn't have the LA Dodgers in there, could you give us some idea of the quantum on that?

Richard Cousins

Why don't you do the CapEx one first, Johnny, and then I'll talk about labour.

Johnny Thomson

As I said before, we'll be in the - just over 3%, I would estimate at this stage, so you can take from that what you want. I would guess we'd be just under 3% if it wasn't for the LA Dodgers, so [it's at] the margins.

Richard Cousins

In terms of inflation, if we just talk about western world inflation, because it's easier, obviously, food and labour generally goes with CPI, RPI. On average - UK, obviously, we've got weak sterling. On average in the western world, I would say food inflation is slightly below par at the moment, but labour inflation is slightly above it, because the UK, Spain and, in a different way, a more local way, the US, all have significant minimum wage pressures. Sometimes we pay well above the minimum wage, but there's still a relationship between the two. Yes, we are noticing that. I think in the short term it is a headwind. We have to work harder on productivity and pricing and so on.

However, in the long term, if you look how the US healthcare system has reacted to Obamacare, which, of course, is a significant increase in labour costs, then there's clearly been an acceleration in outsourcing, and we've benefitted from that. Whilst, as I say, in the short term it is a headwind, we can't whinge too much, because I think it will - these labour pressures will drive more outsourcing.

Mark Irvine-Fortescue - Panmure

Thanks, good morning. Mark Irvine-Fortescue from Panmure. Just one on DOR, please, and the oil price, I suppose. Is there a level of the oil spot price where you start to see confidence in oil and mining companies starting to invest again from the last cycle? Or is it different every cycle?

Richard Cousins

We have a department of 100 analysts, forecasting the price of oil.

Mark Irvine-Fortescue

That's more than us.

Richard Cousins

I pause for comic effect. How clever do you think we are? The business doesn't work like that? In the end, of course, we reflect activity in the industry - exploration, construction of sites, production and so on. Of course, there is a correlation, but short-term movements in the spot price of oil are not really what our business is about. Of course, it's not just oil. Iron ore has been a terrific business for us, copper in Chile, and those cycles have changed. I think what really matters is, as we look at 2018, we're going to bottom. Perhaps the fourth - third or fourth quarter of 2018 we'll turn. And then in 2019 we expect modest growth. We're reporting 4% top line today. Underlying, underlying, I think it's over 5% because of the offshore and remote pressures. I actually feel we've weathered the two to three-year storm quite well.

Tim Barrett - Numis

Morning. Tim Barrett from Numis. Richard, given what you just said on costs, could you talk particularly about the third of your business where you don't have automatic pass through of costs, and how pricing power feels to you at the moment around the world? Specifically, I was just interested in the support services business in the UK, what that is, what the issue is.

Richard Cousins

That's a good question. I'm going to hand that one onto Johnny.

Johnny Thomson

Well, as you know, or as you correctly point out, a third of the business is fixed price, and that is the one where it takes us a fraction longer to pass it on. We have, across the world, different negotiation clauses, contract clauses et cetera, which allow us to do that. It generally takes some time, but for the most part we're able to get it through. I would say, particularly in food, and particularly, actually, in higher inflationary environments, that are more accustomed to it, we tend to move it through quite quickly. Now, you're right to point out that, in general right now, the corporate environment just seems to be under a little more pressure from a margin perspective. Therefore, with labour inflation as it is, then perhaps it's a fraction tougher than it has been, particularly, I would say, in Europe.

Then, of course, you layer on top of that the support services element, where we have less pricing power, and, therefore, it becomes tougher still. I guess, to the point, my answer would be that Europe is a little tougher right now on the fixed price contracts, and support services specifically. That's why we're taking action as we are right now. And we are taking some costs out which - the cost of which will affect our margin in the first half. The benefits will rebound in the second half. As a Group, therefore, from a margin perspective, just to give clarity on this, our margin in the first half will be flat, perhaps a fraction negative, but it will rebound strongly in the second half, such that our margin overall will show some modest improvement. To my point earlier, just to finish, Europe, of course, is particularly acute in this sense and, therefore, what I've just explained in profile will be a bit exaggerated in the European region.

Tim Barrett

Is it possible to quantify the restructuring piece, or too early?

Johnny Thomson

I wouldn't say it was restructuring. I think that's a strong word. What we're really doing is unit level productivity here. To call it restructuring is a little much. It's almost our daily business in a more difficult environment. At this stage I'm not going to quantify it, because it's ongoing.

Vicki Stern - Barclays

Hi. Vicki Stern from Barclays. Just following that on, could you then talk a little bit about the medium-term margin growth of - I think you've talked in the past 5 to 10 bps. Is that still relevant, or is it just a little bit more challenging to think about that now?

Johnny Thomson

No. I still think the longer-term margin progress is very much possible and we have the opportunities to be able to deliver on that. I think probably 10 basis points would be a little toppy, to be honest with you, for the longer term. Certainly, mid-single digits' margin progress in the longer term is very much within our grasp. As we're about today, I think 2018 just looks a fraction tougher, so it may be a few bps less than that in this year.

Richard Cousins

I think this is a really important point. Modest margin expansion is very much part of the model. I know that Dominic will talk to you about that in May. Not massive amounts, but steady margin expansion matters.

Any more questions? Whilst you think about it, is there one in the space? I can't see [anybody].

Operator

You do have one question on the phones. This is from Erik Karlsson of [IEP]. Please go ahead. Your line is open.

Erik Karlsson - IEP

Thanks for taking my question. You talked about the European margin challenges. Could you just help us, whether there are any other tailwinds or headwinds to the business in fiscal 2018 when it comes to EBIT margins, aside from the European phenomenon?

Johnny Thomson

Yes. Let's just go to the other two regions there. North America, we have to say, when we're growing at these kinds of rates we do not expect significant margin progress, as you can imagine. The costs of mobilisation et cetera mean that, at 7% growth, we wouldn't expect margin improvement. We're very happy with 7% and 1 or 2 bps. Margin labour pressures are still quite significant in the US, so we shouldn't underestimate the work that has to go on, on efficiencies and on pricing, to offset that.

For the moment, we would see the continuation of that 7% growth with a few bps in North America. When you go to rest of world, as I said earlier in the presentation, we've been really pleased with the rest of world's margin in the old year, in 2017.

Some of the restructuring we've been doing over the last couple of years has really come through strong, so that's great from a margin perspective there. And we see that carrying on into the New Year. I would expect 10, maybe 20, basis points of improvement in rest of world. Don't get me wrong, there are still pockets of labour inflation and, indeed, food inflation in some of our rest of world margins, but I think also we have the opportunity in some of our smaller businesses by - through creation of scale to continue to generate efficiencies and, therefore, margin improvement.

Richard Cousins

Any more questions on the phone?

Operator

None at this time. (Operator Instructions).

Richard Cousins

Any more questions in the room? In that case, thank you, ladies and gentlemen, for coming. Have a good day.

[End]