

Operating and Financial Review

Financial Review

Year at a glance

We have continued our track record of delivering strong financial results. Profit before tax increased by 44.0% to £149.9m (2006: £104.1m), driven by a 14.6% increase in operating profit to £162.3m (2006: £141.6m). Basic earnings per share from continuing operations improved 39.4% to 73.6p (2006: 52.8p).

Our financial key performance indicators are based on normalised results, which we feel reflect the performance of the business more appropriately. Normalised results are defined as the statutory result before the following, as appropriate: profit or loss on the sale of businesses, exceptional profit or loss on the disposal of non-current assets and charges for goodwill impairment, intangible asset amortisation, exceptional items and tax relief thereon as appropriate.

Normalised group operating profit was up by 11.3% to £205.6m (2006: £184.8m), on revenue of £2,615.4m (2006: £2,525.5m) resulting in an increased operating margin of 7.9% (2006: 7.3%). Normalised profit before tax increased by 13.4% to £177.0m (2006: £156.1m), driving a 9.7% increase in normalised diluted earnings per share to 83.9p (2006: 76.5p).

Reflecting this earnings growth and the Board's confidence for its future prospects, the proposed final dividend per share will be increased by 10.0% to 26.40p (2006: 24.0p). This results in a full year dividend per share of 37.96p (2006: 34.75p), an increase of 9.2%.

Net debt increased by £472.4m to £910.8m (2006: £438.4m), with £481.9m of the increase resulting from our acquisition of Continental Auto in Spain.

Divisional review

Commentary on the divisional results is included in the Operational Review above. Specific financial points to note are included below.

Trains

Revenue decreased 2% as a result of franchises leaving the Group. Normalising the result for franchise exits, revenue increased by 11%.

The business margin has improved to 4.3% (2006: 3.3%). The Central Trains, Silverlink and Midland Mainline franchises expired in November 2007, and as part of the DfT re-mapping exercise, Gatwick Express leaves the Group in June 2008. The settlement of working capital balances in respect of trains franchises that have finished will continue to result in operating cash outflows.

Coaches

The trading results for the start up business National Express Dot2Dot were in line with the business plan, with revenue of £3.1m resulting in an operating loss of £4.8m. This has been reported as part of the UK Coach results. Consequently on a like for like basis the Coach margins increase to 12.2% (2006: 11.4%).

Spain

In local currency, we generated normalised operating profit of €74.3m (2006: €65.0m) on revenue of €434.9m (2006: €365.6m). We are pleased to have maintained our margins above 17%.

The integration of Continental Auto into Alsa is a major project covering the systems for sales, vehicle maintenance and financial reporting. We started this project as soon as the sale completed in October and expect it to be completed by mid-2008. The valuation work on intangibles and key assets will be included in the 30 June 2008 balance sheet in accordance with IFRS 3, "Business Combinations".

North America

In local currency, North America increased normalised operating profit to US\$75.5m (2006: US\$72.3m). Revenue has increased by 18% to US\$617.5m (2006: US\$524.0m).

As reported in last year's results, historic fuel hedges that were in place ended in 2006, which resulted in a US\$13m increase in the cost base in 2007. This resulted in a lower margin of 12.2% (2006: 13.8%).

Following the Group's announcement of the planned sale of the operating lease on Stewart International Airport, the assets and related liabilities of the disposal group were separately identified in the 2006 balance sheet, in accordance with IFRS 5, 'Non-current assets held for sale and discontinued operations'. The business did not meet the definition of a discontinued operation, therefore the results, which do not make a significant contribution, are included within continuing operations in 2007 and 2006.

Fuel

We use fuel swaps to hedge short term movements in the fuel price. These swaps cover a number of different positions including ultra-low sulfur diesel (ULSD) and gasoil in the UK, heating oil in North America and Euro denominated ULSD in Spain. For 2008 and 2009 we have hedged 58% and 31% of our volumes respectively.

Joint ventures and Associates

The Group has a number of associates and joint ventures in Spain and holds a 40% investment in Inter-Capital and Regional Rail Limited ("ICRRL").

The results of the associates and joint ventures in Spain were a profit of £0.6m (2006: £0.2m) and a loss of £0.2m (2006: £0.2m loss) respectively.

The Group's Eurostar contract with ICRRL was designated an onerous contract in 2006. As a result there is no charge to the income statement in 2007, but in 2006 the total charge was £29.6m, comprising our share of the ICRRL result of £3.9m and a £25.7m exceptional charge for the onerous contract. We have provided for the Eurostar losses to the end of the contract in 2010.

Finance cost

Net finance costs increased to £29.0m (2006: £24.9m), reflecting the £481.9m increase in net debt following the acquisition of Continental Auto in October 2007.

Included in the net finance cost is a £3.0m (2006: £2.1m) charge to unwind the discounting on provisions, most notably the ICRRL onerous contract. Adjusting for the discounting charge and comparing to normalised operating profit before depreciation and other non-cash items ("EBITDA") of £282.9m (2006: £264.0m), the EBITDA finance cover was 10.9 times (2006: 11.6 times).

Amortisation of Intangible assets

Amortisation of £27.5m (2006: £27.8m) was charged on the intangible asset that arises from the Group's right to operate its rail franchises £1.1m (2006: £1.6m) and on contracts acquired in Alsa £20.2m (2006: £20.1m), UK Bus £1.1m (2006: £1.6m) and North America £5.1m (2006: £4.5m).

Exceptional items

Exceptional charges totalled £15.8m, incurred on the Business Transformation program in North America (£8.2m), UK integration program (£4.2m), the Continental Auto integration (£2.6m) and the NXEC franchise mobilisation (£0.8m).

In 2006, exceptional items totalled a net income of £4.8m, comprising a credit of £6.7m in relation to defined benefit pension liabilities and charges of £1.9m in relation to the integration of Alsa.

The £16.2m profit on disposal of non-current assets arises from the sale of the operating lease on Stewart International Airport in October 2007. The £16.9m profit in 2006 resulted from the disposal of a 14% shareholding in Trainline Holdings Limited (£9.4m) and the disposal of a car park in Sheffield (£7.5m).

Taxation

The total tax charge of £37.6m (2006: £23.6m) on profit before tax of £149.9m (2006: £104.1m) represents an effective rate of 25.1% (2006: 22.7%).

The tax charge on normalised profit of £177.0m (2006: £156.1m) was £48.1m (2006: £39.2m), which represents an effective rate of 27.2% (2006: 25.1%). Reductions in jurisdictional tax rates mean that the expected tax rate on normalised profit before tax decreased by 1.0% to 31.3%. However, the effective tax rate has increased by 2.1% to 27.2% due to the expiry of certain tax efficient financing arrangements.

The total tax charge includes a tax credit on exceptional items of £10.5m (2006: £15.6m) which includes the deferred tax benefit of the Group's non-deductible intangible asset amortisation.

Discontinued operations

An additional provision of £6.3m was recognised in relation to the Group's Public Transit business which was disposed of in 2005. The Group provided an indemnity to the purchaser at the time of the disposal regarding an industry employment issue in California. The issue is close to resolution and this charge reflects the Directors' best estimate of the Group's liability. The charge of £2.9m on the face of the income statement comprises £6.3m of additional liabilities in relation to the disposed operations, offset by a tax credit of £3.4m.

Operating and Financial Review

Financial Review continued

Cash flow

The Group continues to generate strong cash flow with normalised operating profit of £205.6m (2006: £184.8m) converted into operating cash flow before one-offs of £196.7m (2006: £209.7m). Net cash inflow from operations of £300.6m (2006: £297.1m) is then used to maintain high levels of investment across the Group, particularly in North America where capital expenditure is required for contract wins. The Group's operating cash flow by Division is set out in table 1.

The working capital outflow in UK Bus comprises payments to the defined benefit pension schemes in excess of the income statement charge and the losses associated with the onerous contracts in our London business. The working capital inflow in UK Trains arises from a number of items including working capital phasing and non-cash charges at NXEC incurred in the franchise entry. The working capital outflow in Central functions arises from the reversal of prior year working capital inflows and the settlement of foreign currency swaps.

Net capital expenditure was £103.9m (2006: £87.4m) including £0.2m (2006: £20.7m) of additions purchased under finance leases and £15.4m (2006: £6.8m) of proceeds from disposals.

The net operating cash outflow in respect of TOC franchise entry and exits was £31.9m (2006: £27.7m) comprising cash flows in respect of working capital and property, plant and equipment.

Net debt

The Group's reconciliation of net debt is set out in table 2. Payments to associates of £8.4m (2006: £8.4m) represent the annual outflow in respect of the ICRRRL onerous contract. In 2007 £10.7m was received on the redemption of preference shares following the completion of the Channel Tunnel Rail Link.

Net interest paid of £23.4m (2006: £20.6m) comprises the cash outflow of £22.5m (2006: £19.7m) adjusted for loan fee amortisation of £0.9m (2006: £0.9m). The increase in interest paid follows the acquisition of Continental Auto in October 2007.

As disclosed last year, the 2006 tax payments were reduced by the receipt of tax rebates in respect of prior years.

Acquisitions and disposals in the year increased net debt by £482.1m, principally due to the £481.9m increase resulting from the acquisition of Continental Auto. Three bolt-on acquisitions in North America and the acquisition of the Kings Ferry Travel Group and Hotelink in the UK were funded by the disposal of Stewart Airport in North America.

Movements in foreign currency exchange rates increased net debt by £55.4m principally due to the strengthening of the Euro. The increase in net debt due to exchange is hedged by a corresponding increase in our net investment in Euro denominated assets.

Table 1: Operating Cash Flow

	UK Bus £m	UK Coach £m	UK Trains £m	North American Bus £m	Europe £m	Central functions £m	Total £m
Normalised operating profit	43.5	23.1	63.3	37.7	50.9	(12.9)	205.6
Depreciation	17.0	4.8	15.9	25.9	15.4	0.6	79.6
Amortisation of leasehold property prepayment	0.1	–	–	–	–	–	0.1
Amortisation of fixed asset grants	(0.1)	–	(0.8)	–	(0.4)	–	(1.3)
Profit on disposal	0.1	(0.2)	(2.8)	(0.6)	(0.8)	–	(4.3)
Share based payments	0.3	0.2	0.6	0.4	0.2	1.5	3.2
EBITDA	60.9	27.9	76.2	63.4	65.3	(10.8)	282.9
Working capital movement	(9.5)	(0.1)	43.1	(3.6)	1.5	(13.7)	17.7
Net cash inflow from operations	51.4	27.8	119.3	59.8	66.8	(24.5)	300.6
Net capital expenditure	(22.3)	(9.6)	(6.1)	(45.1)	(20.3)	(0.5)	(103.9)
Operating cash flow before one-offs	29.1	18.2	113.2	14.7	46.5	(25.0)	196.7
UK Train franchise entry and exits							(31.9)
Operating cash flow							164.8

Operating cash flow is intended to be the cash flow equivalent to normalised operating profit. To reconcile the operating cash flow to the statutory cash flow the following items are included: "Cash generated from operations" plus "Proceeds from disposal of property, plant and equipment" less "Finance lease additions" and "Purchase of property, plant and equipment" as set out in note 38 and the cash flow statement. The non-operating items are then excluded which comprise £8.4m payment to associates and £11.3m payments in relation to other exceptional items.

Dividend

A final dividend of 26.40p per share will be paid in May 2008, bringing the total dividend for the year to 37.96p. This is a 9.2% increase in total dividends declared compared to 2006 reflecting the 9.7% increase in normalised diluted earnings per share. This dividend is covered 2.2 times (2006: 2.2 times) by normalised profits after tax.

In light of the consistent nature of our rail portfolio for the medium term and based on the Board's confidence in the Group's future prospects, it is proposed to announce a three year commitment on dividend growth of 10% per annum.

Financial position

The Group looks to adopt efficient financing structures that enable it to use its balance sheet strength to achieve the Group's objectives without putting shareholder value at risk. The Group's balance sheet is set out in table 3.

The Group's capital structure comprises its equity and its net debt. During 2007, the Group issued 792,659 shares to meet obligations under its employee share schemes, for consideration of £5.5m. The increase in the Group's net debt from £438.4m to £910.8m is explained in the Finance Review above. The Group's principal gearing ratio is net debt to EBITDA. At 31 December 2007, based on the reported EBITDA of £282.9 (2006: £264.0m) and net debt of £910.8m (2006: 438.4m) the ratio was 3.2 (2006: 1.7) with the increase driven by the acquisition of Continental Auto.

The Group's treasury objective is to manage the risk for potential loss of shareholder value from certain financial risks. The Group's financial risk management objectives and policies are described in more detail in note 30 to the Annual Report and Accounts.

Liquidity

At 31 December 2007, the Group had two bank debt facilities: an £800 million revolving credit facility maturing in June 2011 and a €500m term loan facility expiring in April 2008. At 31 December 2007, the headroom under the facilities was £199.4m (2006: £247.8m). The Group has complied with all of its banking covenants in the year. Since year end we have replaced the €500m term loan facility with a €540m term loan facility expiring in February 2009 with a one year extension to February 2010 at the Group's option.

Table 2: Reconciliation of net debt

	2007 £m	2006 £m
Operating cash flow	164.8	182.0
Exceptional cash flow	(11.3)	(2.0)
Exceptional property proceeds	–	13.0
Payments to associates	(8.4)	(8.4)
Receipt in respect of investments	10.7	–
Net interest	(23.4)	(20.6)
Dividends paid to minority interests	(0.1)	–
Taxation	(18.8)	(9.0)
Free cash flow	113.5	155.0
Share buy back	–	(11.6)
Financial investments & shares	5.5	15.8
Acquisitions and disposals	(482.1)	(16.8)
Dividends	(53.9)	(49.7)
Net funds flow	(417.0)	92.7
Foreign exchange	(55.4)	32.3
Funds flow post exchange	(472.4)	125.0
Opening net debt	(438.4)	(563.4)
Closing net debt	(910.8)	(438.4)

Table 3: Balance sheet

	2007 £m	2006 £m
Intangible assets	1,173.9	697.6
Property, plant and equipment	678.7	501.9
Other non-current assets	34.3	37.2
Current assets excluding cash	311.9	322.3
Net debt	(910.8)	(438.4)
Non-current liabilities excluding borrowings	(186.4)	(209.7)
Current liabilities excluding borrowings	(660.5)	(583.1)
Disposal group net assets	–	17.7
Net assets	441.1	345.5

As explained in note 23 to the Annual Report and Accounts, the Group's net debt includes cash balances totalling £55.2m (2006: £33.5m) which cannot be withdrawn from our TOCs. This is because the franchise agreements with the DfT restrict the withdrawal of cash to ensure a TOC is able to meet its working capital requirements. Cash can only be withdrawn by loan or dividend to the extent that certain financial ratios are complied with.

Pensions

The Group's principal defined benefit pension schemes are all in the UK.

There are two Bus schemes, the West Midlands Passenger Transport Authority Pension Fund and Tayside Transport Superannuation Fund which have 1,078 and 120 active members respectively. Both schemes have been closed for some years. The National Express Group Staff Pension Plan has 286 active members predominantly from

Coaches, and it was closed to new members in June 2002. New employees in Buses and Coaches are offered membership of a defined contribution pension scheme. In the Trains business approximately 6,200 employees are active members of the Railways Pension Scheme ("RPS").

The balance sheet includes provision for the deficits of the defined benefit schemes in the Group. For the RPS, our main obligation is to pay the contributions agreed with the scheme actuary over the life of our train franchise. The IAS 19 deficits have decreased as a result of the strong return on scheme assets in recent years coupled with higher discount rates used to value the scheme's obligations. In the Coach scheme the deficit decreased to £4.9m (2006: £12.7m). In the Bus schemes the deficit has decreased to £5.1m (2006: £17.3m) and the RPS deficit decreased to £18.8m (2006: £21.1m).

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Principal risks and uncertainties

In addition to the opportunities we have to grow and develop our business, the Group faces a range of risks and uncertainties as part of both its day to day operations and its corporate activities. The processes that the Board has established to safeguard both shareholder value and the assets of the Group are described in the Corporate Governance Report.

The narrative below describes those specific risks and uncertainties that the Directors believe could have the most significant impact on the Group's long term value generation. The risks and uncertainties described below are not intended to be an exhaustive list.

Risks inherent in bidding for contracts

One of the principal methods of increasing shareholder value is winning new contracts. Inherent in bidding for new contracts is a risk that assumptions are made in the bid model that turn out to be undeliverable for any number of reasons. To take a Trains bid as an example, if underlying economic growth falls short of the growth assumed in the bid, the passenger revenue target may not be achievable.

Additionally, when a business is based on winning contracts, there is a requirement for the business to win a minimum number of contracts to retain its existing scale of operations. If that minimum number is not achieved, that division's revenue and profits would be affected.

The business most exposed to this risk is Trains, where a robust process is followed to ensure that all bids are subject to sufficient challenge. In addition, Buses, North America and Spain bid for contracts on a regular basis, but no one contract is material to those businesses.

Competition

With the exception of North America, our businesses are competing with alternative modes of transportation, primarily the car. Our Coaches, Trains and Spain businesses face competition from a mix of long distance coaches, trains, low-cost airlines and the car. The principal alternative to our Buses business is the car, and with the cost of owning and operating a car at an all time low, it remains imperative to create a more positive customer proposition on our services.

In addition to modal competition, the competitive environment between transport companies remains intense. This is seen both in competition for passengers and when bidding for contracts.

It is important we differentiate ourselves in the marketplace and a number of the initiatives explained in the Chief Executive's statement set out our progress in this area.

Energy costs

All of our businesses incur energy costs to power their transport operations with Buses, Coaches, Spain and North America exclusively using diesel, and Trains using either gasoil or electricity. All energy prices are subject to significant changes driven by international economic and political factors. In recent years, weather patterns such as mild or cold winters and hurricanes have also had an effect on energy prices.

We seek to limit the effect diesel and gasoil costs have on our year on year profitability through a risk management programme using fuel price swaps. In Trains we have negotiated with Network Rail to reach a new agreement on electricity pricing.

Political and regulatory changes

Our businesses are subject to varying degrees of regulation and as such, there is a risk that political and regulatory changes could impact their future prospects. In recent times, the highest profile political and regulatory uncertainty is around the Buses business where the debate around quality partnerships and quality contracts continues through the Local Transport Bill.

To mitigate the risk from political and regulatory changes, the Group looks to service the needs of its stakeholders and lobbies national, regional and local government in addition to passenger, employee and environmental bodies.

Labour costs

Our aim to offer high quality services is dependent on recruiting and retaining the right calibre of employees. For each of our businesses, local economic prosperity, employment levels and our image as an employer affect our ability to deliver this aim. Additionally, we incur significant other employee staff costs such as recruitment and training.

Staff costs are the largest single component of the Group's operating costs. We seek to mitigate this risk by securing competitive wage deals that maintain the profitability of our businesses.

Major incidents

Safety is an inherent feature of transporting people. We take our safety responsibilities very seriously however there is a risk that any incidents that the Group is involved in, directly or indirectly, could result in injury to our passengers or employees. The potential impact on the Group is wide ranging and includes possible damage to our reputation with passengers, financial loss from claims for damages and our ability to bid successfully for contracts.

To mitigate this risk, the Board operates a Safety and Environment Committee which reviews the Group's safety practices, procedures and record as described in the Corporate Governance Report. For our staff, this translates itself into our culture of operational excellence that seeks to ensure the safety of all our passengers.

The cost of damages claims is managed through the Group's risk management processes. The current policy is to self-insure high frequency claims with the businesses and then provide protection above these types of losses by purchasing insurance cover from a selection of proven and financially strong insurers. A risk remains that the number or size of the self-insured claims could be higher than expected.

Economic conditions

Changes in economic conditions have an effect on the ability of our customers to pay for our services. For example, the Trains division's historic growth has been closely correlated to the growth in the overall UK economy.

We look to mitigate this risk by closely monitoring the affordability of our services and varying the cost where appropriate and possible.

Organisational change

The number of significant organisational change initiatives in the business at the present time is higher than usual, including UK integration, North America Business Transformation, Continental Auto integration and NXEC franchise start up. As with any organisational change, risks are created.

These risks are being actively managed by the Group leadership team through robust management processes and close monitoring of the businesses where change is occurring.

Corporate Responsibility

National Express Group's commitment to corporate responsibility is at the heart of the Group and it is very much integral to the operations that we run. This has been explained in more detail on pages 34 to 35, together with a review of what has been accomplished in 2007.

Understanding the OFR Statement of Compliance

The 2007 OFR is intended to meet many of the requirements of the statutory OFR as laid out in the Accounting Standards Board's 'Reporting Statement of Best Practice on the OFR'. This ensures compliance with the legal requirement under the Companies Act to provide a Business Review and is referenced from the Director's Report.

We note that this is the second year that UK companies have been required to produce a Business Review and therefore best practice is still emerging. We will continue to review the narrative disclosure we provide in the Annual Report and Accounts to ensure that the disclosures provided meet the requirements of our stakeholders.

Cautionary Statement

The OFR is intended to focus on matters that are relevant to the interests of the shareholders of the Company. The purpose of the OFR is to assist the shareholders of the Company in assessing the strategies adopted by the Company and the potential for those strategies to succeed. It should not be relied on by any other party or for any other purpose.

Where this OFR contains forward-looking statements, these are made by the Directors in good faith based on the information available to them at the time of their approval of this report. Shareholders will understand that these statements should be treated with caution due to the inherent uncertainties underlying any such forward-looking information.