Good progress in Germany and strategic disposal of c2c

Tom Stables
Managing Director, Rail

Market overview

The UK rail market is a regulated market and is broadly dispersed between UK private train operators and overseas state-backed market participants. Recent awards of franchises have seen some aggressive bidding activity by train operators which has resulted in the UK rail market looking less attractive in the short term. At the same time the number of state-backed operators participating in the UK market has increased. In February 2017 we disposed of our c2c franchise to Trenitalia and now have no rail operations in the UK.

Meanwhile the German rail market is liberalising and offering good growth opportunities, with over 30 contracts coming up for bid in the next three years. The German rail market is also the largest in Europe, worth €19 billion, and within that the regional and urban market is worth around €9 billion. Contracts are awarded by regional Passenger Transport Authorities.

German rail contracts are typically much smaller in size than in the UK with a lower risk profile and generally lower capital requirements.

Market size

€9bn
currently accessible German regional and urban market

- Our first two German rail contracts commenced operations in December 2015 for 15 years with two more commencing in June 2019 and December 2020 for 14 years and 13 years respectively
- Growth through further bid wins in Germany
- Liberalisation of Spanish rail market a future opportunity

Year ended 31 December	**2016 m**	2015 m
German Rail		
Revenue from continuing business	**£61.3**	£2.4
Operating loss	**£(1.5)**	£(0.1)
Revenue from continuing business	**€75.0**	€3.3
Operating loss	**€(1.8)**	€(0.1)
Operating margin	**(2.4)%**	(0.3)%
c2c		
Revenue from c2c	**£175.5**	£166.0
Operating profit	**£4.9**	£1.7
Operating margin	**2.8%**	1.0%

Overview of 2016

On 10 February 2017, we announced the completed sale of the c2c franchise to Trenitalia, receiving £108 million through a consideration of £72.6 million and the settlement of £35 million of inter-company loans.

2016 itself saw c2c outperforming other UK rail franchises many of which are experiencing notable slowdowns in passenger growth. Last year was also the first full year of our Rhine-Münster Express ('RME') contracts in Germany.

Revenue from the continuing RME business rose to €75.0 million, with a small operating loss of €1.8 million. We are engaged in discussions with the local transport authorities in Germany to clarify certain aspects of our subsidy revenue entitlement. We have taken a prudent approach: our revenue policy is to only recognise revenue where these discussions are suitably advanced and where amounts are considered highly probable. We are still targeting a small profit in 2017.

c2c delivered an operating profit of nearly £5 million, giving the rail division's combined profit of £3.4 million.

Cash and returns

In 2016, our Rail division saw an outflow of £18.6 million of operating cash, reflecting: the build-up of our German rail operations; the bid costs for the East Anglia franchise; and capital investment in c2c.

Delivering operational excellence

Our relentless focus on safety delivered an improvement of over 60% in the Fatalities and Weighted Injuries Index score for the year for c2c. These high standards were recognised with a five-star rating from the British Safety Council and we were also delighted to be awarded its prestigious Sword of Honour. In September 2016 the German Rail Authority (EBA) conducted its first safety compliance audit, passing us with no material findings.

c2c's strong performance in the year demonstrates that our focus on operational excellence again helped it outperform similar franchises. Driven by a combination of December 2015's new timetable, enhanced marketing and fare offers, and supported by the subsequent arrival of 24 additional carriages at the end of 2016, c2c saw passenger growth of 6.7%, well ahead of the industry.

We have taken our expertise and approach developed at c2c and applied it to our German operations. In a successful first year of RME services, we carried over 20 million passengers, more than achieved its punctuality targets and delivered operational improvements compared to the previous operator. The mobilisation of our second German rail franchise, the Rhine-Ruhr Express ('RRX'), is under way, drawing on our experience with the mobilisation of RME and providing the opportunity for cost efficiency given the complementary locations.

Deployment of technology
c2c has pioneered technological innovation, such as the industry-leading Automatic Delay Repay compensation scheme for smartcard customers and a flexible season ticket aimed at part time commuters. We have also led the industry with over 40% of season ticket holders using smartcards. We drove revenue growth through sophisticated marketing and the success of new fares and products such as online advance sales increasing by over 70% and Senior Rover sales rising by 50%.

We are taking the lessons from c2c and applying them to Germany where this customer-focused approach is less apparent. There are currently two priority areas. Firstly, enhanced marketing helping to drive sales, including online and digital. Secondly, we are developing enhanced live customer information across our various digital channels, including use of social media.

Drawing on our emerging Group strength we have also made further improvements to our digital platforms in the past year, with faster connections and improved search and navigation enhancing the customer experience and driving higher conversion rates. The launch of our new mobile app, c2c Live, with journey planners, live travel information, special offers and additional services such as payment for station car parking, enabled engagement with customers in a more personalised way, driving customer loyalty and incremental demand. The improvements to our digital platforms have driven an increase of 88% in online transactions over the past year, with a doubling of revenue now transacted through these channels, delivering both revenue and cost benefits.

Creating new opportunities
The sale of c2c has both removed significant potential liabilities from the Group and provided resources to invest in our fastest growing markets. The UK rail market is undergoing a downturn, with passenger growth in London and the South East train operating companies of only 0.3% in 2016. While c2c was significantly outperforming this, we were concerned that the remaining obligations of over £30 million of capital expenditure and lease payments for over £100 million of new trains to generate sufficient revenue to repay around £900 million of franchise premiums were looking increasingly challenging. With recent franchises won on anticipated double digit compound annual revenue growth and average costs of around £5-10 million per bid, we felt this was also an increasingly unattractive market.

The sale of c2c presented the opportunity to remove these potential liabilities in an increasingly unattractive market and generate £108 million of cash – through a consideration of £72.6 million and the settling of £35 million of inter-company loans – to invest in our fastest growing markets that are generating returns of between 15% and 20% on recent acquisitions. We believe this approach is much more likely to generate shareholder value in the coming years.

We remain fully committed to German rail and believe there is further opportunity in this market. Our second German rail contract, RRX, will see the first of its operations commence in June 2019, with the second starting in December 2020. Both contracts run through to 2033. We are planning to submit a number of German rail bids in 2017. We continue to view the German rail market as attractive, with franchises being smaller and lower risk than in the UK, and with many franchises requiring relatively low levels of capital investment. With at least 30 contracts coming to market in the next three years, we see a strong pipeline of opportunities and we will continue to be selective in our bidding approach in order to drive the best returns. Our presence in Germany also provides the opportunity to enter other, complementary, markets nearby.

We will continue to bid in a disciplined manner. Our decision in October 2016 to inform the local Bavarian authority that due to delay in its award we were not able to proceed with the Nuremberg S-Bahn contract demonstrates that we maintain a disciplined approach to bidding. While not ruling out further UK rail bids, our immediate focus will be in these markets.

Our 2016 Strategic Report, from page 1 to page 57, has been reviewed and approved by the Board of Directors on 23 February 2017.

Dean Finch

Dean Finch
Group Chief Executive
23 February 2017