Delivering further significant growth in profit and cash

Chris Davies
Group Finance Director

Dear shareholders

I am delighted to be writing to you for the first time as Group Finance Director of National Express. The strength of the financial performance delivered in 2017, and outlined below, demonstrates the Group's strong and stable financial position.

Presentation of results

To supplement IFRS reporting, we also present our results on a normalised basis which shows the performance of the business before intangible amortisation for acquired businesses, US tax reform, profit for the year from discontinued operations and consequent UK restructuring. The Board believes that this gives a more comparable year-on-year indication of the operating performance of the Group and allows the users of the financial statements to understand management's key performance measures. Unless otherwise noted, all references to profit measures throughout this review are for continuing operations for both the current and prior reporting period.

Changes to reporting segments

Following the strategic exit from UK rail operations in February 2017, the UK business was restructured with UK Bus and UK Coach combined under a single UK management structure to drive cost reductions and facilitate better, clearer decision making. To align external reporting with internal decision making structures, we are presenting the UK as a single operating segment. We will continue to disclose revenue separately for our UK bus and coach operations on the Group website www.nationalexpressgroup.com, in order to provide an understanding of drivers of performance in the UK division.

Statutory profit

The Group again delivered a record statutory profit after tax amounting to £128.4 million (2016: £114.9m) driving basic earnings per share of 25.7 pence (2016: 23.0p), an increase of 11.7%.

The strength of the financial performance delivered in 2017 demonstrates the Group's strong and stable financial position.

Statutory profit	**2017 £m**	2016* £m
Normalised profit before tax	**200.0**	168.6
UK restructuring	**(5.6)**	–
Intangible amortisation on acquired businesses	**(38.0)**	(33.8)
Statutory profit before tax	**156.4**	134.8
Tax charge	**(28.0)**	(19.9)
Statutory profit after tax from continuing operations	**128.4**	114.9
Profit from discontinued operations	**5.9**	5.1
Statutory profit for the period	**134.3**	120.0

* Restated in relation to the exit from UK rail

The exit from our UK rail operations with the strategic disposal of the Group's final UK rail franchise, c2c, in February 2017, led to a reorganisation of the UK management structure and a one-off cash inflow of £27.5 million. The aggregated impact of the UK rail exit including the c2c disposal and the consequent UK restructuring has been a small profit after tax, which has been excluded from normalised results. The gross profit on the sale of the c2c franchise and the discontinuation of other direct UK rail costs (£5.9m after tax) is separated on the income statement from the associated costs of restructuring the UK business (£5.6m). Further detail can be found in note 11 to the financial statements.

Revenue

	£m
2016 revenue	2,094
Currency translation	94
2016 revenue at constant currency	2,188
Organic growth	54
Acquisitions	79
2017 revenue	2,321

Group revenue for the period was £2,321.2 million (2016: £2,093.7m), an overall increase of 6.1% on a constant currency basis (up 10.9% on a reported basis with £94 million of foreign currency gains on translation). Revenue growth of £54 million from our existing businesses, representing organic growth of 2.5%, was boosted by a further £79 million from acquisitions, principally in North America and Spain.

Revenue growth has been delivered across the business with performance particularly strong in our overseas businesses. North America delivered 10.1% growth in constant currency, with growth being driven by the full year benefit of acquisitions completed in 2016, augmented by the three new bolt-on acquisitions made in the second half of 2017. Organic growth benefitted from another successful bidding season in which we achieved an average price increase of 2.4% across the entire portfolio and 3.0% on those contracts up for bid and renewal. ALSA also delivered a strong performance, with revenue growth of 3.6% on a constant currency basis. This growth was driven predominantly in Spain, most notably on our Spanish long distance routes where our revenue management system contributed 3.9% to revenue growth on our long haul services. This was augmented by six bolt-on acquisitions made in the year.

We delivered a robust performance in our UK business, despite softer market conditions, with revenue growth of 0.6% and an improving trajectory in the second half of the year. This is the result of a number of decisive management actions taken in the first half of the year which drove an improved performance in the second half. Our UK bus operations grew revenue by 0.3% in the second half following the successful introduction of a number of low fare zones, reversing the declines seen in the first half of the year. For the year as a whole, bus revenue declined 0.5% with concessionary revenue down 1.3%, while commercial revenue was broadly flat despite a 1.5% reduction in mileage. Our UK coach operations delivered revenue growth of 1.8%, where our Revenue Management System helped drive passenger and revenue growth to overcome a reduced propensity to travel over the summer following a number of terror events. We delivered particularly strong performance in the final quarter of the year.

German Rail delivered revenue growth of 20.4% on a constant currency basis and up 28.9% on a reported basis to £79.0m. This growth was boosted by the clarification of our revenue position which included latest passenger count data, allowing us to recognise all revenue earned. The 2017 results therefore include an element of catch up from prior years that we were not able to recognise before this year.

Normalised profit	£m
2016 normalised operating profit (as reported)	218
Currency translation	10
2016 normalised operating profit at constant currency	228
Growth	24
Acquisitions	11
Terrorism impact	(7)
Cost inflation	(41)
Cost efficiency	25
Fuel price benefit	5
Other	(3)
2017 normalised operating profit	242

Group normalised operating profit increased by 6.0% to £241.5 million on a constant currency basis, up 11.0% on a reported basis (2016: £217.5m). The Group delivered a strong performance from its existing businesses with a £24 million contribution representing growth of 10.5%. This was supplemented by a strong contribution from the full year benefit of acquisitions completed in 2016 together with the acquisitions made in the second half of 2017.

These results include cost inflation of £41 million, most notably in the form of driver wage inflation in North America. We have retained our disciplined approach to cost management and through a programme of efficiency measures across the Group, including the £10 million of efficiencies delivered through the reorganisation of our UK business, we have generated total cost efficiencies of £25 million.

We also saw a £5 million benefit from lower fuel prices year-on-year as a direct result of our hedging policy.

We have benefitted from £10 million of currency translation during the course of the year, driven by the weakening of Sterling following the result of the 'Brexit' referendum. This benefit was mostly delivered in the first half of the year with year-on-year currency translation broadly flat in the second half as we cycle post-Brexit Sterling levels in the prior year.

Segmental profit performance

	2017 Local currency	2016 Local currency	**2017 £m**	2016 £m
ALSA	**108.3**	103.7	**94.9**	84.7
North America	**121.6**	114.1	**94.3**	84.0
UK			**70.9**	67.3
German Rail	**5.9**	(1.8)	**5.2**	(1.5)
Central functions			**(23.8)**	(17.0)
Group normalised operating profit			**241.5**	217.5

We have delivered profit growth across each of our businesses, with the strongest performance in our North America business, where normalised operating profit increased by 6.6% on a constant currency basis and by 12.3% on a normalised reported basis. Organic growth was boosted by acquisitions made in 2016 and 2017, with those acquisitions made in 2016 achieving returns of at least 15%.

In ALSA, normalised operating profit increased by 4.4% on a constant currency basis, driven by a combination of organic growth, and the benefit of acquisitions made in 2016 and 2017, together with cost efficiencies and lower fuel costs. Reported normalised operating profit increased by 12.0%.

Our UK business delivered normalised operating profit growth of 5.3% with the flow through of management actions on revenue supplemented by a programme of cost saving and efficiency initiatives which delivered £10 million of savings.

Our German Rail operations delivered a strong normalised operating profit contribution of €5.9 million (2016: loss €1.8m), which was boosted as discussed above by the element of catch up on revenue not previously recognised.

Central costs have increased by £6.8 million, reflecting strategic investment in a number of Group-wide initiatives together with a new International Development Team. Central costs also include the amounts expensed for unsuccessful bidding in the Middle East and Singapore.

Summary income statement

	2017 £m	2016* £m
Revenue	**2,321.2**	2,093.7
Operating costs	**(2,079.7)**	(1,876.2)
Normalised operating profit	**241.5**	217.5
Share of results from associates	**(3.5)**	1.1
Net finance costs	**(38.0)**	(50.0)
Normalised profit before tax	**200.0**	168.6
Tax	**(48.0)**	(31.4)
Normalised profit after tax	**152.0**	137.2

* Restated in relation to the exit from UK rail

Group normalised operating profit margin was stable at 10.4% (2016: 10.4%) as margin growth in the UK and ALSA offset a small decline in North America driven by significant inflationary pressure on drivers' wages.

Net finance costs decreased by £12.0 million to £38.0 million (2016: £50.0m), reflecting lower interest costs following the successful bond refinancing in November 2016 and continued optimisation of the Group's funding base as noted below.

We recorded a loss of £3.5 million (2016: profit of £1.1m) from associates, reflecting the write down of our investment in a minority stake in Deutsche Touring Group, a German partner in Eurolines, which entered into administration in the early part of this year.

Normalised profit before tax of £200.0 million grew 11.7% on a constant currency basis, up 18.6% on a reported basis (2016: £168.6 million).

The normalised tax charge from continuing operations was £48.0 million (2016: £31.4m), a normalised effective tax rate of 24.0% (2016: 18.6%). The increase in the normalised effective tax rate is largely the result of a mix of profits, with a greater proportion of profits coming from the US where federal corporate income tax rates have been higher relative to the UK and Spain. This was also accompanied by changes in BEPS legislation relating to corporate tax interest deductibility.

On 22 December 2017, the US Tax Cuts and Jobs Act was signed into law representing the most significant change to the US tax system in the last 30 years, reducing US federal corporate income tax from 35% to 21% from 2018. This resulted in a £7.5 million net tax credit on the revaluation of deferred tax liabilities.

Looking forward, we anticipate that the Group's effective normalised tax rate will be in the low 20s percentage range, assuming no further reform in any of our major markets.

Normalised basic earnings per share were 29.1 pence (2016: 26.3p), an increase of 10.6%.

Return on Capital Employed (ROCE)

ROCE is a key performance measure for the Group, guiding how we deploy capital resources and as such is a key component of executive incentives. ROCE is 11.9% (2016: 11.9%), demonstrating our disciplined approach to capital allocation and balance sheet management.

Reconciliation of ROCE	2017 £m
Group statutory operating profit	197.9
Intangible amortisation for acquired businesses	38.0
UK restructuring costs	5.6
Return – Normalised Group operating profit	241.5
Average net assets	1,146.0
Remove: Average net debt	883.0
Remove: Average derivatives, excluding amounts within net debt	2.6
Foreign exchange adjustment	(10.4)
Average capital employed	2,021.2
Return on capital employed	11.9%

This constitutes a strong 61% free cash flow conversion creating a solid platform for investing in growth and paying dividends.

Cash management

Free cash flow	2017 £m	2016* £m
Continuing normalised operating profit	241.5	217.5
Trading profit from discontinued operations	–	6.4
	241.5	223.9
Depreciation and other non-cash items	135.5	120.7
EBITDA	377.0	344.6
Net maintenance capital expenditure	(165.2)	(134.7)
Working capital movement	4.8	(3.1)
Pension contributions above normal charge	(5.0)	(5.5)
Operating cash flow	211.6	201.3
Payments to associates and minorities	–	(1.5)
Net interest paid	(50.6)	(47.6)
Tax paid	(14.6)	(13.6)
Free cash flow	146.4	138.6

* Restated in relation to the exit from UK rail

Our strong and sustainable cash flows support a capital investment programme that maintains fleet age at acceptable levels. Our current target is to invest around 1.1 to 1.2 times depreciation in net maintenance capital expenditure.

Free cash flow improved by £7.8 million to £146.4 million (2016: £138.6m) driven by the growth in EBITDA which was offset by net maintenance capital expenditure, £30.5 million higher than the prior year. The majority of the maintenance capital investment has been in fleet replacement predominantly in ALSA and North America. Continued focus and discipline in the management of working capital resulted in an inflow of £4.8 million (2016: outflow £3.1m). This constitutes a strong 61% free cash flow conversion creating a solid platform for investing in growth and paying dividends.

Reconciliation of free cash flow to net cash flow from operating activities	2017 £m
Free cash flow	146.4
Add: Operating cash flows from discontinued operations (note 11)	(14.8)
Add: Cash outflows from exceptional items in prior years	(2.5)
Remove: Net maintenance capital expenditure	165.2
Remove: Movements in arrangement fees (note 37)	1.2
Net cash flow from operating activities	295.5

Net funds flow	2017 £m	2016 £m
Free cash flow	**146.4**	138.6
Net growth capital expenditure	**(13.2)**	(27.0)
Net inflow from discontinued operations	**27.5**	–
Acquisitions	**(101.5)**	(88.8)
Dividends	**(64.7)**	(58.9)
Other, including foreign exchange	**(4.4)**	(96.4)
Net funds flow	**(9.9)**	(132.5)
Net debt	**(887.9)**	(878.0)

Growth capital expenditure during the period of £13.2 million included investment in digital and e-commerce initiatives in the UK, capital expenditure on fleet upgrades in newly acquired businesses and new contracts won in North America, and costs associated with the mobilisation of our RRX rail contract in Germany.

Cash inflow from discontinued operations of £27.5 million is the result of the exit of the UK rail business and is broken out below.

Net inflow from discontinued operations	£m
Proceeds from disposal	71.8
Cash in the business	(14.9)
Outflow relating to costs of disposal	(14.1)
Net cash inflow from c2c disposal	42.8
Outflow relating to discontinued operations	(15.3)
Net cash inflow	27.5

We have continued our strategy of making selective bolt-on acquisitions where the returns and strategic fit justify the investment, and we completed nine such investments in the year, three in our North American division and six in ALSA. Total cash consideration for these acquisitions, net of cash and debt held, was £52.5 million with a further £75.0 million of consideration deferred into future years. £49.0 million of deferred consideration relating to acquisitions completed in prior years was settled in 2017, resulting in a total net funds outflow in the period of £101.5 million. We continue to deliver strong performances from our acquisitions, delivering returns on invested capital of at least 15% in the first full year after acquisition.

Net funds flow for the period was an outflow of £9.9 million (2016: outflow £132.5m), resulting in year-end net debt of £887.9 million.

Dividend

National Express' dividend policy, agreed in 2015, is for dividend cover at normalised earnings per share of at least two times. In considering the level of the dividend to declare, the Board considers three principal factors, in addition to level of cover:

1. Available distributable reserves

2. In-year free cash flow generation

3. Company gearing and indebtedness

With £290 million of distributable reserves, strong free cash flow of £146.4 million and gearing reduced to 2.3 times, and in line with the interim dividend, the Board has proposed a 10% increase in the final dividend to 9.25p, to give a full year dividend of 13.51p at 2.2 times cover.

Treasury management

The Group maintains a prudent approach to its financing and is committed to an investment grade credit rating. The Board's policy targets a level of debt that allows for disciplined investment and ample headroom on its covenants, with net debt to EBITDA at a ratio of 2.0x to 2.5x in the medium-term. The Group continues to maintain investment grade ratings with both Moody's and Fitch.

The Group's key accounting debt ratios at 31 December 2017 were as follows:

- Gearing ratio: 2.3 times EBITDA (31 Dec 2016: 2.5x; bank covenant not to exceed 3.5x);
- Interest cover ratio: EBITDA 10.2 times interest (31 Dec 2016: 6.6x; bank covenant not to be less than 3.5x).

To underpin delivery of its strategy, the Group has a strong funding platform across a diversified range of funding sources with a balanced maturity profile. Through 2017, the Group has put in place a number of new facilities, further diversifying the sources of funding and providing additional liquidity until 2020 in a low interest rate environment. In July 2017, the Group entered into a $130 million term loan maturing in April 2018. In November 2017, the Group issued a €250 million 2.5 year Floating Rate Note (FRN) maturing in 2020 with a coupon of Euribor +40bps, representing the Group's debut issuance in the Eurobond market. In December 2017, the Group entered into an additional unsecured revolving credit facility (RCF) totalling £32 million. This new facility is on the same terms as the Group's £512 million of bank facilities and matures in November 2021.

At 31 December 2017, the Group had £1.7 billion of debt capital and committed facilities, comprised of the $130 million term loan maturing in April 2018, a £225 million Sterling bond and the €250 million FRN both maturing in 2020; a private placement of €78 million maturing in 2021; £544 million of RCF maturing in 2021; a £400 million Sterling bond maturing in 2023 and £173 million of finance leases. At 31 December 2017, the Group's RCF was undrawn with £858 million in cash and undrawn committed facilities available.

At 31 December 2017, the Group had foreign currency debt and swaps held as net investment hedges. These help mitigate volatility in foreign currency profit translation with corresponding movements in the Sterling value of debt. These corresponded to 1.9x EBITDA earned in the US, held in US Dollars, and 2.4x EBITDA earned in Spain and Germany, held in Euros. The Group hedges its exposure to interest rate movements to maintain an appropriate balance between fixed and floating interest rates on borrowings. It has therefore entered into a series of swaps that have the effect of converting fixed rate debt to floating rate debt. The net effect of these transactions was that, at 31 December 2017, the proportion of Group debt at floating rates was 43% (2016: 24%).

Group tax policy

We pursue a cautious approach to our tax affairs which are aligned to business transactions and economic activity. We have a constructive and good working relationship with the various tax authorities in the countries in which we operate and there are no outstanding tax audits in any of our main three markets of the UK, Spain and the US.

The Group's tax strategy has been published on the Group website in accordance with recent UK tax law.

Pensions

The Group's principal defined benefit pension schemes are all in the UK. The combined deficit under IAS 19 at 31 December 2017 was £94.5 million (Dec 2016: £88.2m).

During the year, the principal UK Rail defined benefit scheme was transferred to Trenitalia as part of the disposal of NXET Trains Limited on 10 February 2017. In addition, with effect from 30 June 2017, the assets and liabilities of the Tayside Transport Fund (a defined benefit pension scheme for certain past and present employees of Tayside Public Transport Company Limited, a subsidiary of the UK Bus division) were transferred into the Tayside Pension Fund (a fund administered by Dundee City Council).

The two principal plans are the UK Group scheme, which closed to new accrual in 2011, and the West Midlands Bus plan, which remains open to accrual for existing active members only. We have completed the triennial valuation of both schemes and expect that the overall level of deficit contributions will remain at around £10 million in total per annum until 2020.

The IAS 19 valuations for the principal schemes at 31 December 2017 were as follows:

- WM Bus: £133.8 million deficit (2016: £128.5m deficit);
- UK Group scheme: £43.2 million surplus (2016: £44.5m surplus)

Fuel costs

The Group consumes approximately 225 million litres of fuel each year for which it is at risk (ie there is no direct fuel escalator in the contract or concession price). Fuel costs represented a total cost to the Group in 2017 of £178 million (approximately 8% of related revenue), at an average fuel component cost (ie excluding delivery and taxes) of 44.4 pence per litre. The Group has adopted a forward fuel buying policy in order to secure a degree of certainty in its planning. This policy is to hedge fully a minimum of 15 months addressable consumption against movements in price of the underlying commodity, together with at least 50% of the next nine months' consumption in the contract businesses. Currently, the Group is 100% fixed for 2018 at an average price of 34.3 pence per litre, 75% fixed for 2019 at an average price of 33.8p and 42% fixed for 2020 at 32.9p. Based on this, year-on-year fuel costs for the same mileage will be around £20 million less in 2018.

Where businesses have the freedom to price services, this hedge provides sufficient protection to recover fuel price increases through the fare basket. In contract businesses, where price escalation may be restricted by a formula independent of fuel costs, extended cover may be taken, subject to availability and liquidity in the hedging market.

Impact of new accounting standards – IFRS 9, 15 and 16

Three new accounting standards are to be introduced, two of which came into effect on 1 January 2018 (IFRS 9 and IFRS 15), with the third, IFRS 16, coming into effect on 1 January 2019.

IFRS 9 'Financial Instruments' addresses accounting for our financial assets and financial liabilities. As part of this, it introduces new rules for hedge accounting and a new impairment model for financial assets. The Group has reviewed its existing financial assets and liabilities accounting and expects to make a number of transitional adjustments, including an increase in the impairment provision for trade and other receivables.

IFRS 15 'Revenue from Contracts with Customers' is based on the principle that revenue is recognised when control of a good or service transfers to a customer. We have reviewed a sample of contracts from across the Group and do not envisage a material impact from the adoption of this standard.

IFRS 16 'Leases' will primarily effect the accounting for the Group's operating leases and will result in an increase in the number of leases being recognised on the balance sheet as the distinction between operating and finance leases is removed. The new standard will be adopted on 1 January 2019. An assessment of the impact is ongoing and we will formally conclude on this in 2018.

See note 2 of the financial statements in the Annual Report 2017 for further detail of the new accounting standards.

Summary

The strong financial performance delivered in 2017, coupled with the additional financing facilities and continued prudent balance sheet management, further augment the Group's robust financial position. We remain confident about the prospects for the year ahead.

Chris Davies
Group Finance Director
1 March 2018

With £290 million of distributable reserves, strong free cash flow of £146.4 million and gearing reduced to 2.3 times, and in line with the interim dividend, the Board has proposed a 10% increase in the final dividend to give a full year dividend of 13.51p at 2.2 times covered.