Costain Group

Full Year Results

9th March 2022

Transcript

Alex Vaughan: Hello. And welcome to Costain's full year results presentation for 2021. I'm Alex Vaughan, CEO for Costain. And following a brief introduction from me, Helen Willis, our group CFO, will present the financial results before I return to provide a strategic update ahead of our facilitated Q&A session.

Alex Vaughan: Now, before introducing the results presentation, I wanted to step back and take a moment to talk about how we have changed our business since I became CEO and to reflect on what we have achieved during 2021. We had another strong year of performance last year, delivering contracts well, securing the right type of new work and increasing our position on consultancy and digital frameworks for our clients. Cementing our position as a valuable strategic partner for our clients.

Alex Vaughan: We have importantly drawn a line under our contract issues. And the last of which had been contracted as far back as 2016. Having learnt the key lessons from these two contract issues and operating very differently, Costain is now a strong, resilient business, as is evidenced from delivering adjusted earnings in line with expectations for the last two years.

Alex Vaughan: Now, last year, we completed an update of our strategy that confirmed our hypothesis for significant growth of profits and margins. And we have a clearer plan built on a really good progress we've made over the past two years, and a clear ambition to significantly increase the value of Costain. The business leadership is a diverse mix of experts, focused on delivering our ambitions and continuously strengthening the business.

Alex Vaughan: Today, we are partners on our client's strategic long term investment programs. We have a broad team of experts. We are a leading modern contractor, a sizeable value adding consultant, and an emerging digital partner, shaping a more productive and greener future. We are the new type of company who is best positioned to benefit from helping our clients meet their changing needs.

Alex Vaughan: Now moving to the results presentation, the key highlights are that we've delivered adjusted profits for full year '22, that have increased by 67% to £30 million and are in line with expectations. We've got strong cash generation and a good net cash position. We have drawn a line under the legacy contract issues. And we have completed a detailed strategy update, reinforcing our opportunity. We have the leadership and strategy to deliver strong growth. And have a positive outlook with a good, secured revenue for the full year '22. Helen.

Helen Willis: Thank you, Alex. I will start by taking you through the headline financial performance for the full year. You will remember from previous results announcements that in order to provide clarity on the performance of the group and divisions, we've reported revenue and operating profit and earnings per share on an adjusted basis, as well as on a reported basis.

Helen Willis: I'll explain the differences between these statutory reported and adjusted metrics as we progress through the slides. For now, I'll focus on the adjusted metrics. Adjusted revenue is up 10% on last year, largely reflecting strong growth in transportation from national highways and HS2. Adjusted operating profit was £30.1 million for the full year, in line with expectations and up 67% on last year.

Helen Willis: We returned a 0.9 percentage point improvement in adjusted operating margin as well, at 2.6% for the year. Adjusted earnings per share was a 9.6p compared to 5.8p last year, a growth of 65%. Year end cash was strong at £119.4 million. And we returned a strong free cash flow of £38.9 million. An increase of 23% over the £31.6 million delivered last year, where free cashflow is defined as our cashflow from operating activities, excluding adjusting items, less capital expenditure.

Helen Willis: Now, turning to slide seven and our revenue walk. Focusing to start on the middle of the slide, you can see adjusted revenue has grown by 10.1% to £1.179 billion. This was driven by transportation division, adjusted revenue growth of 19.3% as we saw good growth in both road and rail, with integrated transport largely flat year on year. This growth in transportation, more than offset in 8.9% adjusted revenue decline in natural resources, reflecting reductions in water and energy, which were partially offset by growth in our defence sector.

Helen Willis: Moving now to the bars either side of the chart, these represent the adjustments made to our reported revenues and relate to significant contract provisions that were taken during the periods. On the right, a revenue adjustment of £43.4 million was taken in relation to the settlement of the Peterborough and

Huntingdon contract during FY21, resulting in a reported revenue of £1.135 billion for the year.

Helen Willis: On the left, you will remember that during the prior year we took revenue adjustments totally £92.1 million on the A465 and Peterborough and Huntingdon contracts as well as against a contract, ASF South, that completed a number of years ago, resulting in a reported revenue of £978 million for FY20.

Helen Willis: Next slide eight and the operating profit walk. Again, focusing on the middle of the slide to start with looking at the dark blue bars, you can see our adjusted operating profit has grown by 67.2% from £18 million to £30.1 million in line with expectations. Growth was driven by improvements across transportation resulting in a £21.3 million increase in divisional adjusted operating profit. Partly offset by the weaker performance in natural resources, which saw a reduction in divisional adjusted operating profit of £8.3 million.

Helen Willis: Central costs were £1.2 million higher year on year. And we benefited to the tune of £0.3 million on our year on year comparatives following the disposal of loss making Alcaidesa in FY20. Adjusted operating margin was 2.6%, an improvement of 0.9 percentage points on last year. The improvement in adjusted operating profit and margin reflects the conclusion of lower margin work and an increased proportion of consulting and digital services.

Helen Willis: Moving to the bars either side of the chart. Again, these represent the adjustments made to our reported operating profit and largely relate to the significant contract provision taken during the periods on the legacy contracts, A465 and Peterborough and Huntingdon. On the right, you can see significant contract provisions were taken in the year, amounting to £39.2 million. As I mentioned before, a provision of £43.4 million was taken in relation to the settlement to the Peterborough and Huntingdon contract, along with £4.6 million of other costs associated with the dispute.

Helen Willis: We also released a provision of £8.4 million on lower than provided final costs relating to the A465, which has now been opened. Other adjusted items of £4 million were also recognised, resulting in a reported operating loss of £9.5 million. On the left, you can see provisions taken last year, total £99.7 million on A465 and Peterborough and Huntingdon contracts, as well as against the contract ASF South that complete a number of years ago. We also recognised £10.3 million of other adjusting items, largely on the impairment of goodwill on our natural resources division, which resulted in a reported operating loss of £92 million for FY20.

Helen Willis: Now let's turn to the performance of each of our divisions in a little more detail. And first on slide nine, transportation. Transportation adjusted revenue growth was 19.3% over FY20. Adjusted revenue for road increased by £93.7 million or 29.7% on the prior year on increased work with our strategic partner, National Highways. Adjusted revenue for rail increased by £50.1 million or 16.3% on the prior year, principally as a result of HS2, which increased in the year as a substantial completion of the enabling works was achieved. And we benefited from the full year impact of the construction phase of the main works program. Our work on the Gatwick Airport station project for Network Rail also increased in the year.

Helen Willis: Integrated transport was largely flat year on year. And we commenced the revitalisation of the A40 Westway for transport for London during the year. Transportation adjusted operating profit grew by 106% in the year, from £20.1 million last year to £41.4 million this year. Returning an adjusted operating margin of 4.8%, up two percentage points on FY20, due to more effective contract management and out-performance on a number of contracts.

Helen Willis: During the year, we secured £248 million of new work. Revenue secured for FY22 for transportation stands at £764 million against a prior year comparative of £762 million. Looking ahead, we continue to see multi-year revenue growth in our work for HS2 and Network Rail, alongside further local government and integrated transport opportunities.

Helen Willis: Moving to slide 10 and natural resources. Natural resources adjusted revenues were 8.9% lower than FY20. Adjusted revenue for water declined by £23 million, or 10.3% on the prior year, driven by lower volumes of activity in the AMP7 water programs, as clients adjusted their year one projects due to COVID-19. As the year progressed, volumes improved as the two year programs commenced and we are encouraged by our exit run rate from the year.

Helen Willis: Adjusted revenue for energy declined by £15.5 million or 17.7% on the prior year. In H1, we saw a number of contract awards deferred into H2. And while H2 saw high demand for our engineering teams, this was not enough to compensate for the year as a whole. We see strong momentum into FY22, building on the success of the second half.

Helen Willis: Adjusted revenue for defence increased by £7.8 million or 22.3% on the prior year, resulting in good growth in the year, albeit from a small base as we grow our footprint in this area. Natural resources returned an adjusted operating loss of £2.6 million against a profit of £5.7 million in FY20, with operating margin for natural resources on an adjusted basis down 2.1 percentage points. Reflecting the lower revenue and increased costs, particularly within the water sector.

Helen Willis: Within the adjusted results for natural resources, we have recognised a £6.2 million provision in respect of a defect in a subcontractor's works for a contract in the water sector. We expect the majority of the rectification costs to be recoverable. During the year, we secured £185 million of new work. Revenue secured for FY22 for natural resources stands at £271 million against a prior year comparative of £278 million.

Helen Willis: Looking ahead, after lower activity in FY21, we expect to deliver growth across our water activities in FY22, as client investment programs are implemented. We see further opportunities for growth across energy, supporting de-carbonisation and a defence where we are broadening our market position to cover all strategic fence and security infrastructure.

Helen Willis: Moving to slide 11 and our balance sheet. The balance sheet has strengthened, with net assets increasing from £156.5 million last year to £199 million at the year end FY21. This strengthening was driven in part by higher net cash of a £119.4 million against £102.9 million last year on our strong cash flows. More on these on the next slide. As well as recognition of a pension surplus of £67.1 million. This represents a movement in the account evaluation from a deficit of £5.6 million last year, primarily due to the re-measurement of financial assumptions.

Helen Willis: The next triennial valuation of the Costain pension scheme has an effective date of 31st of March 2022. Initial results are expected from the trustee’s actuary in July '22. And discussions on these are expected to take place over the second half of 2022. We have until June of '23 to finalise evaluation.

Helen Willis: Other movements of note include a reduction in trade receivables and other assets, driven by a significant reduction in contract assets and an increase in trade payables and other liabilities, mostly driven by the recognition of the Peterborough and Huntingdon settlement provision. Underlying this represents a strong improvement in our working capital position.

Helen Willis: Moving now to slide 12 and the cash bridge. Net cash has increased from £102.9 million last year to 119.4 million for FY21. The highlight for me on this bridge is the green cash flow from operating activities of £51 million over the year, excluding pension deficit contributions. This is a result of a relentless focus on cash collection and the resolution of compensation events.

Helen Willis: To the left of this, there are cash flows on adjusting items of £11.6 million, which represent cash out flows in the year on the two legacy contracts. These are essentially further cash costs which we have as expected incurred on the finalisation of these contracts. We make cash contribution payments to the pension scheme of £9.9 million over the course of the year and incurred capital expenditure of £2.2 million. Taking these together with our adjusted cashflow from operations results in our free cashflow for the year of £38.9 million, up 23% on FY20.

Helen Willis: After lease payments of £10.8 million and repayment of borrowings of £8 million over the year, we've ended FY21 at a net cash position of £119.4 million. The prompt payment code continues to be a real focus for us. We've consistently achieved the target of 95% of invoices paid within 60 days. Payment in respect to the settlement of the Peterborough and Huntingdon contract was made after the FY21 year end and amounted to £43.4 million. We remain in a strong net cash position with positive Costain cash balances following this payment.

Helen Willis: Moving to slide 13, we take a look at our cash and banking facilities. As I just mentioned, year-end cash was strong, and the net cash position comprised: cost-end cash balances of £101.3 million compared to £89.8 million in FY20. Cash held by joint operations, which will continue to decrease, were £58.1 million compared to £61.1 million at FY20. And lastly, borrowings of £40 million compared to £48 million at FY20, and these are quoted before arrangement fees.

Helen Willis: During the year, the group's average month-end net cash balance was £107 million as compared to £73.8 million over FY20. Importantly, this was consistent throughout 2021, as you can see from the graph on the slide.

Helen Willis: The group continues to maintain sufficient committed facilities to meet its normal funding requirements over the medium term. And as at the 31st of December 2021, these committed facilities totalled £310 million in contract bonding and bank facilities. Bank facilities of £171 million include a revolving credit facility of

£131 million and a term loan of £40 million. These mature in September 2023, and we are already undertaking refinancing activities.

Helen Willis: The objective of our strategy is to deliver long-term value to shareholders while maintaining a strong balance sheet that underpins our financial position. Cost-end has targeted a dividend cover of around three times adjusted earnings, taking into account the free cash flow generated in the period.

Helen Willis: It's important that we maintain a strong balance sheet that will support investment in the business to drive growth. Given the final settlement payment made after the close of the financial year in respect to the Peterborough and Huntingdon contract, the board does not consider it appropriate to recommend and a final dividend this year, despite the group's improved operating and adjusted cash performance.

Helen Willis: We recognise the importance of dividends to shareholders and will continue to review the timing of the reinstatement of future dividends in the light of the group's performance, cashflow requirements, and the importance of maintaining a strong balance sheet.

Helen Willis: Now moving on to our order book on slide 14. The order book and secured revenue are defined as revenue from contracts which are partially or fully unsatisfied and probable revenue from water frameworks included at the allocated volume.

Helen Willis: Our order book stood at £3.4 billion at the year-end against a prior year position of £4.3 billion, reflecting our client's five-year investment programs, greater discipline in contract selection, and the shorter lead time of consulting and digital work. The order book evolves as contracts wind down and new contracts are added. Therefore, it does not provide a complete picture of potential future revenue.

Helen Willis: In addition to the contracted order book, we have a further £900 million of contracts where we are preferred bidder, and around 50 further secured frameworks for higher margin, consulting, and digital services that will yield meaningful revenue each year. As a consequence, our already secured revenue for FY22 at the year-end is more than a billion pounds. We expect to make further progress in FY22. We're well positioned with more than a billion pounds of group revenue secured already for the year.

Helen Willis: Looking ahead, whilst we've entered the new year with good momentum, we are mindful of the macro economic backdrop, and we continue to monitor and work to mitigate headwinds in commodity and energy costs, as well as challenges in the supply chain. We remain confident in the group strategy and the longer term prospects.

Helen Willis: With that, I'll hand you back to Alex.

Alex Vaughan: Thank you, Helen.

Alex Vaughan: Now I'm going to take you through our forward strategic direction, building in the context of the good progress we're already making. As I've outlined in previous presentations, our national infrastructure is facing enormous change. With challenges such as climate change, resource scarcity, increased performance expectations, and economic and environmental resilience drivers, all more urgent than ever today. Now we have purposely positioned ourselves in those key markets where committed strategic investment is being made to meet critical national needs and where we can true differentiate ourselves.

Alex Vaughan: The UK's infrastructure is being shaped by the need to meet the realities of climate change. To ensure we maintain security of our natural resources, improve the performance of our infrastructure networks by embracing the digital revolution and enable our communities and businesses to thrive.

Alex Vaughan: Now, the UK government, in their National Infrastructure Pipeline, announced over £650 billion of investment in the UK's infrastructure to meet these national needs. Our clients, those blue-chip organisations who are responsible for providing our critical national services in our chosen markets, predominantly operate through underwritten and committed five-year business plans. Importantly, Costain has secured positions on these investment programs to deliver pioneering solutions to ensure that our clients achieve their business plan outcomes.

Alex Vaughan: Now, through a strategy update last year, we have confirmed our hypothesis that these markets and our clients committed investment programs through a broader offer provide a significant opportunity for us to continue to drive growth in profits and increase the value of Costain.

Alex Vaughan: Addressing these challenges presents a huge opportunity, and in my mind, that requires a new kind of company. Now, we bring together a unique mix of experts and we act as construction, consulting, and digital partners. We are not defined by the service we provide, but by being wholly focused on meeting the broad needs of our chosen blue-chip clients.

Alex Vaughan: I genuinely believe we are different, and that that difference is valuable. We have aligned our business to meet our clients' changing needs, and to truly do this, you need to be able to offer a broader solution.

Alex Vaughan: Now, we are a business that influences and shapes the solutions to meet new needs. For example, we are developing a first of a kind hydrogen storage facility solution for HyNet to support the UK's energy transit. Now, the facility is to enable excess hydrogen to be stored underground in salt caverns during low demand periods and discharged into the gas network during peak periods. It will store enough gas to heat 750,000 homes for a year.

Alex Vaughan: Now, we also support clients with their wider business needs. For example, leveraging our rail delivery expertise in now helping Network Rail with their strategic infrastructure planning, identifying new approaches, which are both faster and more efficient. We're doing this through our positions on two consultancy frameworks that we hold with Network Rail.

Alex Vaughan: We're also expertly supporting the delivery of capital investment programs. Primarily as a leading contractor on programs such as HS2, National Highway programs, water frameworks, Tideway, rail infrastructure, et cetera. However, we are also now one of the leading delivery partner or program management organisations. Where through our growing consultancy role, leveraging our delivery expertise, we oversee capital investment programs for AWE, Cadent, and Babcock.

Alex Vaughan: Increasingly important, we're helping our clients optimise the performance of their business operations. For example, where we're helping United Utilities to transform their asset maintenance programs, or where we are supporting EDF to extend the life of their existing nuclear generation freight, or even where we're helping three water companies to optimise their existing network performance and avoid regulatory failures. And where our digital infrastructure provides highway safety and resilience, as well as where we are supporting central government in their infrastructure resilience planning.

Alex Vaughan: Now, by being a truly strategic partner, not shaped or constrained by a particular service offer, who supports its clients across the full value cycle of their business, we will broaden our services, grow our business through an increased addressable market, and increase our profits and margins.

Alex Vaughan: Sadly, we have had two problem contracts. And while I'm glad we're putting them behind us, I want to reinforce that since becoming CEO, I have transformed the way we secure the right type of new work and effectively deliver our operational activities.

Alex Vaughan: Now, two years ago, we undertook a root-and-branch review of our work winning and contract management processes. And in winning the right type of new work, we've made a number of changes.

Alex Vaughan: Now, following an early identification of opportunities within our pipeline, we actively work with our clients to shape the nature of their contract strategy, leveraging the government's construction playbook to ensure we have a fairer and reasonable risk or reward environment.

Alex Vaughan: Now, one example of the success of doing this is transforming one of our energy client's approaches from a traditional EPC form of contract to a more collaborative Project 13 Alliance contract with a significantly reduced and balanced risk transfer.

Alex Vaughan: We've also put in place a clearer contract framework of our commercial expectations, against which we govern every new work opportunity, being selective in the work we wish to secure. Now, we are robust in declining opportunities that vary from this framework, where for us, the opportunity just has an unacceptable risk profile. And we recently rejected a significant five-year framework for one water company where, quite frankly, the contract would've committed us to take the risk on their business plan with little recourse for any errors in that plan.

Alex Vaughan: Now, once we agree to progress with a tender opportunity, all of our contracts and tenders have a risk review undertaken by a team independent of that bid team. This has been invaluable in ensuring that we have a fresh set of eyes reviewing every opportunity. And this is all supported by a restructured legal function, which with senior commercial lawyers now embedded in the divisions and therefore involved throughout the contracting process to ensure that our contracts are adequately reviewed and managed.

Alex Vaughan: In summary, we work to shape the contract to meet our expectations. We're highly selective. We strictly police the risk and terms of any contract. We independently ensure and verify the tender approach and have put in place the right team to ensure we are legally well protected.

Alex Vaughan: Now, importantly, not only do these actions protect us, but they are also increasing the number of opportunities we can pursue and are improving our risk return position. Now, once a contract has been signed and is operational, there are a further series of measures in place to ensure that our delivery is assured and unlocks upside potential.

Alex Vaughan: Two years ago, we implemented our Operational Excellence model across all new and long-term contracts. This encompasses all the functions of change management, design management, project management, commercial management, et cetera, and is our best practice framework for contracts to adhere to with monthly assurance reviews to ensure that we are working to these brilliant basics.

Alex Vaughan: Now, this not only ensures we deliver our contracts effectively, but has also increased our contract margins, and as a direct result of rigorously working to OEM. For example, one of our highway contracts recently completed significantly ahead of program, below budget, and secured a number of our clients upside incentives.

Alex Vaughan: The financial performance of every contract is reviewed monthly with an increased holistic assessment of the potential performance outcomes, risks, and opportunities. This ensures that we avoid any confirmation bias and challenge ourselves as to what the potential outcomes could be, both good and bad, and what actions we can take to address them. Such a review ensures we create the right environment and opportunity to openly discuss both those opportunities and challenging and ensures that senior management are engaged, and actions taken at pace.

Alex Vaughan: Now positively, not only are these change is protecting the performance of the business, but they're also unlocking better performance. Now all of these measures were put in place two years ago and have been operating effectively over that time. And they have supported our inline performance and will continue to do so moving forwards.

Alex Vaughan: Now with our clear market focus, differentiated offer and assured delivery, I want to talk about three levers in how we are going to deliver growth in both profits and margins.

Alex Vaughan: Firstly, over the past two years, we have now built a very strong core to our business. We have secured and are working on the majority of the five-year investment programs for our clients across transportation and water, including HS2, regional delivery partner programs, CP6, and AMP7. We have built a leading position as a business shaping the energy transition, and have a growing defence business. And we have secured positions on over 50 consultancy and digital frameworks from which we will now grow our services. And a measure of that is we've now been recognised by the Financial Times for the third year as one of the UK's leading management consultancies.

Alex Vaughan: Secondly, through our strategy update, we have identified four primary growth areas; returning to being a top 10 partner for Network Rail through their CP7 programs which we're currently active tendering, taking vantage of the growing investment in green energy, leveraging our strong position, shaping that market and we're seeing an increased momentum in this area this year, targeting the increased investment through local and devolved governments which aims to support regional growth and connectivity and this includes investment as part of the integrated transport plans, and building our digital expertise with our new leadership team to become a leader in the digital transformation of infrastructure performance.

Alex Vaughan: And thirdly, through increasing our margins through a better and broader mix of services. We have an ambition to deliver operating margins of between 5 and 6%. And as we continue to upgrade the execution of our construction contracts and complete the old lower margin contracts, we will increase our construction margins to a range of 3 to 5%. We're going to continue to grow the volume of our consultancy contracts as we increase the scale of energy and defence and our other market positions and increase the margins as we work through our now secured frameworks, which have net margins above 5%, and we're going to build the scale in our higher margin digital services, delivering returns over and above the current cost base in line with our updated plans and under our new leadership team.

Alex Vaughan: The above three levers for growth will enhance both profitability and margins, and we're also targeting 90% cash conversion of this profit into cash.

Alex Vaughan: So, coming back to where I started, our national infrastructure is facing enormous change with challenges that are more urgent than ever. We have purposefully positioned sales in those key markets where committed strategic investment is being made to meet critical national needs and where we can truly differentiate ourselves. Our clients in our chosen markets operate through underwritten and committed five year business plans, and importantly cost and secured positions on these investment programs to deliver pioneering solutions, to ensure that our clients achieve their business plan outcomes.

Alex Vaughan: We are operating a strong and effective business and through our strategy, we have a significant opportunity to continue to drive profit growth and increase the value of costing. Thank you. And I wonder if we can open the lines for the Q and A.

Call Operator: Thank you. Ladies and gentlemen, if you would like to ask a question, please signal it by pressing star one on your telephone keypad. If you're using a speakerphone, please make sure that your mute function is turned off to allow your signal to reach our equipment. Once again, that is star one for your questions today. Our first question today comes from Joe Brent from liberal. Please go ahead.

Joe Brent: Good morning. Good morning.

Alex Vaughan: Morning, Joe. Sorry. I thought ... It's Alex. How are you?

Joe Brent: Very well, thank you. Three questions if I may. Firstly, could you tell us a little bit more about the water contract where you've made the 6 million provision and when it was signed? Secondly, could you tell us if that was a target cost reimbursable contract and kind of what target cost reimbursable means for you, because I think it does mean slightly different things to different people? And then thirdly, could we talk about the changing nature of highways work, which I think the national highways is now insourcing some and clear there are other opportunities coming out of it as well.

Alex Vaughan: Okay. Well morning again, Joe. It's Alex, and thanks for that. So let me take those three in turns. So, the water contract, just the way we've decided to recognise the revenue on that contract. So, we've got on that contract one of our suppliers, there are questions around the design of what they delivered and whether it meets the outcome requirements. We are very confident that we've got roots to recover that money. However, just looking at IFRS 15 and how you would recognise the revenue, we've decided to make a provision for what we believe the risk to be. And I think as we've guided, we expect to recover the majority of that provision this year. So, we don't anticipate this being an issue that we'll be left with.

Alex Vaughan: This is a contract on a framework and it was entered into about three years ago. So, from an IFRS 15 point of view, we believe it's a very prudent way of recognising revenue. And we are very confident that will recover. So, it isn't an issue and it's not an issue in what we've been delivering.

Alex Vaughan: If I come back to it is a target cost contract, so target cost contracts effectively, we work with the client. We develop a target cost that we believe will be the outturn cost for the contract. We then enter into that contract. We deliver that, we get paid our costs on a reimbursed basis monthly up to the level of that target. And then once you reach that target, if you are below it, in other words, your outturn cost is less than the target, then there will be some mechanism between us and the client that we share in the benefit of that.

Alex Vaughan: And if the outturn cost is above that, then again, there's a mechanism that we share the downside pain on the outturn cost. Just to be very clear, we also have caps and collars on that pain. So, we don't have an open ended risk. We've got a pretty good way of controlling what the downside risk is on these contracts. So hopefully that gives you a feel for what costing talks about when we talk about target cost contracts.

Alex Vaughan: Just looking at highway Sorry?

Joe Brent: I wanted to say the caps and collars are obviously critical. Critical for the management of the downside risk.

Alex Vaughan: Yeah. So, the contracts we are entering into, we have very conservative caps and collars under the contracts. So, we certainly don't have any open ended risks on that downside. And just to give you a feel about that concern of it's a direct link between risk and reward. So, what we're trying to do is have a much better balance between well, what risk are we taking and what reward are we getting? So that's certainly improved. And I think the construction playbook which you've talked about quite extensively Joe, has been a big influence in terms of setting those targets and setting those caps and collars.

Alex Vaughan: If I can move to the changing nature of highway work, look, I think what's great is for two road investment strategies now, risk one risk two, national highways have now got five year budget programs and positively what they've done is appointed partners to work with them on their regional delivery strategies. So that's all of their road networks for the major upgrades and a lot of that is about improving connectivity, both for business and for the population to increase economic activity and improve the safety and resilience and performance of traveling on the road network. And those are 10 year programs and Costain has secured a place on that regional delivery program and on the smart motorway program as you know.

Alex Vaughan: The way those contracts work is that we get selected on a performance basis. So based on your performance in delivering prior schemes, you then get allocated work under that framework. And we then develop a target cost for the scope of work with the client. We agree that target cost, and then we get appointed to then deliver that work. So that's the type of work we're involved in.

Alex Vaughan: We are not involved in the highway maintenance work at the moment. And certainly, the highway maintenance work has changed significant where national highways are using more tier two suppliers as opposed to the tier one suppliers in the delivery of those frameworks. Does that answer your question, Joe?

Joe Brent: Absolutely. Thank you very much, indeed.

Alex Vaughan: Thank you.

Call Operator: Thank you. We now move on to our next question from Andrew Nussey from Peel Hunt. Please go ahead.

Andrew Nussey: Yeah. Good morning, everyone. A couple of questions from me please. First of all, in terms of rail, could you just give us a feel for where HS2 is in terms of ramp up and levels of activity? And then sort of in terms of Network Rail, Alex, you mentioned targeting CP7 opportunities. Could you just expand on that? Because I think historically, Costain has had exposure to major stations' upgrades and larger the projects, just kind of where you see the specific opportunities for Costain?

Andrew Nussey: And then just in terms of more broadly, you highlighted there's continuing margin dragging construction from older frameworks and contracts. Could you just expand on that in terms of timelines in which they should start to drop out and be replaced with better margin activity, please?

Alex Vaughan: Okay. Well, good morning, Andrew. Good to speak to you. What I'll do is I'll take the first two of those, and then I'll ask Helen to respond to the margin drag question. So, look, if we come to rail and HS2, so our HS2 contract, we are now ramped up and operating probably at the peak level of output on that contract. And that's going to continue for at least another three years. So, we've got a lot of work. We're launching our tunnel boring machines this summer. So yeah, so certainly a lot of activity going on on the HS2 contracts. And as you know, for HS2, the enabling works contract that we've had will come to an end this year. So, we've had that contract whilst the main works contract has ramped up and we're also still advising the client on the hybrid bill works as well. And we're actively tendering three other contracts on HS2 at the moment. So, we'd look for that activity to continue you and to grow moving forward.

Alex Vaughan: Just on Network Rail, so you're absolutely right. Under CP5, control period five investment, Costain was extensively involved in London Bridge station, Redding station and then a lot of the overhead line electrification works. During CP6, there's been a lot less of that work. So, our volume of work with Network Rail has subsequently declined, but during CP6, we've been delivering Gatwick station and actually we've been doing a lot of consultancy work for them, helping them in their forward thinking and strategic plans of future network upgrades.

Alex Vaughan: And for CP7, we are targeting two regions; the south and the east. And those are going to be more of a framework type of procurement, so you'll be appointed for a five year framework and then you'll be delivering a number of schemes and upgrades through that framework. So that's where we want to target. And look at my ambition. We used to be, we used to be Network Rail's largest supplier predominantly because of the amount of work in CP5 that suited our capabilities. And I'd like to build us back to being certainly a top 10 supplier with Network Rail an important strategic client for us. Helen, can I hand it over to you?

Helen Willis: Sure. Morning, Andrew. So, on the margin drag question for complex program delivery, all of our new contracts, new and recent, as Alex said in this presentation, go through our OEM process and are operating as we would. With the new measures in place, there are some older contracts that are coming towards the end of their existence, call it that, so we have a margin drag. And so, for example, the like of Crossrail, so those are coming to an end. And I think by the end of this year, we will really rule most of those out. So, it's not much longer to go.

Helen Willis: And the focus is absolutely on OEM, making sure we initiate contracts well and we monitor them well through their life. And that's where all focus is. Does that answer your question?

Andrew Nussey: Okay, great. That makes sense. Yep. Thank you.

Call Operator: Thank you. We now move on to Jonny Coubrough from Numis with our next question. Please go ahead.

Jonny Coubrough: Good morning. Thanks for taking my questions. Two for me, please. Firstly, a broader question around the strategy update. I'd just be grateful if you could bridge for us how we should expect that 5 to 6% group EBIT margin ambition would be delivered in terms of the mix of business between the three and a half percent OEM margin business and then 5% consultancy in digital. And then also, I think you pulled out that the consultancy in digital target more margins should be about 5%. Just keen to hear, I mean, that seems to be a bit lower than the level set up of 8%. So, I'd be grateful if you give a bit of detail around what's driving that. And then the other question would be on natural resources and interest here. What costs have increased in that division chip sharing year? Thanks very much.

Alex Vaughan: Okay, so morning, Johnny. I'll take the first two and then I'll let Helen do the natural resources one. So, look, just on the strategy update, so look, what we wanted to do last year was stress test the hypothesis that we had that the government investment and private investment going into our markets and the challenges the clients were focused on and what they wanted to achieve, did that give us ample opportunity to significantly grow the business and its returns? And the outcome of that update, and we stress test and we looked at all the other markets, ranked those, came back and said yes, and as you've said, we've put together a consistent strategy, but with clearer focus now to deliver those 5% to 6% margins.

Alex Vaughan: So, as I outlined in the presentation just now, there are three real growth drivers for Costain coming up the strategy. One is to leverage the position that we've worked hard on over the last two years to build. So, we are secured on a significant number of long-term frameworks that give us at least another five to eight years visibility and work, as well as the 50 consultancy and digital frameworks that we've worked really hard to win. And I think that's a tremendous success. To grow our digital and consultancy services we need to, we needed to get on those frameworks, and we're now on those frameworks with our clients. And that's great. So, we've got a plan to grow our construction activities, and as Helen said just now, through the OEM, we're seeing the margins on that work going up and we're confident that we'll be able to deliver in the 3% to 5% range for the construction activities.

Alex Vaughan: And then on the consultancy in digital, we've just highlighted that as being above 5% and that's quite variable. It will certainly be, and that's a net return, and we certainly see that being significant. There's a significant range above 5%. So, some of the consultancy services that we are providing are earning significantly ahead of that, into double digit net margins. And certainly, we'd be looking for a lot of our digital services, certainly where it is more data-based services as opposed to product services. So, product services in digital will be at a lower margin, but then where it's data-led services and we're providing some of those at the moment, they'll be at much higher margins.

Alex Vaughan: So that's how the strategy, so I think what's positive coming out of the strategy, we've got real confidence in what the clients are going to spend, where they're going to spend it. Last month I had 10 meetings with the chief executives of some of our major clients and we really understand where they're going to spend the money, what the propensity is to buy, and that's reinforced the strategy that we've got. We've made really good progress in securing positions and building our capability and it's now about delivering it. And we're very confident that we'll be delivering group operating margins of between 5% and 6%.

Alex Vaughan: Helen, can I hand over to you on the natural resources?

Helen Willis: Sure. Morning, Johnny. So natural resources results are clearly not where we would like it to be. So, a loss of 2.6 for the year. I think there's a couple of important factors to consider there. One is the provision that Alex referenced just a while ago in one of Joe's questions. So, the provision of 6.2 million pounds leading to the loss of 2.6 from the supplier design issue that we were just explaining. We are confident that we'll get a significant proportion of that back and therefore you should consider that it's an imbalance, I guess, between having to take the provision on cost before we can recognise the asset that will be resulting during next year. So, 2.6, consider some portion of that to add back, it takes, I think, a more underlying position into profits.

Helen Willis: We did talk at the half year on the slow start for water and energy. And we're certainly seeing energy coming back in the second half as we expected and really good momentum coming into 2022. It's all consultancy and we are busy with agencies, in fact, to fill the demand. So that's going really well. The water sector, the clients will need to ramp up their spend on amp seven. We anticipate that that will grow through '22 and in fact, the second half was slightly better.

Helen Willis: So, I guess three main factors within the results for the year and we continue to drive that business part with new leadership and hope for a more successful 2022.

Alex Vaughan: Okay Johnny.

Call Operator: Thank you. If there are no further telephone questions, I would like to hand the call over to take any questions from the webcast.

Scott Bannerman: Thanks very much for that. We've had a number of questions from the webcast. The first question is from Terry Sweeney. The dividend policy indicates earnings cover of three times. Is it reasonable to expect this to apply from 2022 onwards given the completion of all legacy issues and the net cash position of over 75 million after payment of the P&H liability in early 2022?

Helen Willis: So, good morning, Terry, I'll take that question. So yes, we've restated our dividend policy as of three times, as you say. For us, what's really important is the strength of the balance sheet, as well as our ability to invest in the growth of the business. And having suffered the payment to Peter & Hunting at the beginning of the year, we really feel that we need to take a cautious approach here to make sure that we bolster the strength of the balance sheet, unless the options open for ourselves to invest.

Helen Willis: I think important to underline here that our balance sheet is not an impediment to tendering. We're busy tendering and pre-qualifying for the bids that we would like to be involved in. So, keeping that strength in that balance sheet really important for us, but we recognise the importance of the dividends, and we'll keep under review when is the right time for us to reinstate with those considerations in mind.

Scott Bannerman: Sweet. Thank you for that, Helen. Next question is from Jonathan Makin. How are Costain mitigating inflation risk? Are you looking to incorporate inflation adjustment clauses in contracts for example?

Alex Vaughan: Okay. Well, I'll take this. So, thank you, Jonathan, for the question, a very important question. Look, inflation risk is a combination of Brexit and the bounce back from the pandemic, and now the very sad situation in Ukraine, which we all hope is resolved very quickly, is creating a challenge in the marketplace. It's about labour availability. It's about material availability, and it's now massively about energy prices. And the way that we're dialling into this is that it's about greater collaboration.

Alex Vaughan: So what we learned from the pandemic is actually by collaborating and getting a lot closer with clients and suppliers, we can deliver great services in a very different way and we're using that learning and that experience and the relationships that we've honed to work with our clients to come up with new approaches to achieve the outcomes they need that allows us to offset and manage some of those inflation risks. So, this isn't a problem we're just giving to the clients, we are actively working with them to try and mitigate it the best we can. And I think we're really helped in doing that because a lot of the work we've got, we've got long-term visibility. So, we've got the ability to work with our supply chain and our clients well ahead of the curve and really think about how we're going to mitigate some of these costs.

Alex Vaughan: But just coming to the protections that we have under our contract. So, the majority of our contracts have provision to protect us from the escalation and inflation, which is good. And on the other contracts where we agree a target cost, then obviously those tend to be shorter-term contracts where we built in allowances and risks into those contracts to be able to cover these costs. So, I think it's a more holistic approach to working with clients because we've got to achieve the outcomes for the best possible value possible and that's what everyone's working really hard on, but thank you for the question, Jonathan.

Scott Bannerman: Thanks very much, Alex. We've got our final question from Andrew Blain for Investec. Please can you give us an update on the latest situation regarding smart motorways and the implications for the order book?

Alex Vaughan: Okay. Morning, Andrew. Thank you for your question. So smart motorway program. So, look, it's been publicly broadcast. So, obviously the government has sought to suspend the smart motorway program pending a review of the actions being taken to increase the safety and address the concerns with the smart motor ways. For the short term, we are very busy on that framework delivering the smart motorways that we've already got started, which the government has agreed we'll continue and be completed. So, we're working on those. We're also very active in installing additional refuge points, so safe areas on the existing smart motorway program. So, we're going in and retrofitting those. And we're also putting in place upgrades to the stopped vehicle detection, so the technology that helps identify cars that have broken down so that they can be met and taken care of as quick as possible. So, in the short term, there's a lot of work that we're still doing so it won't affect us over the next couple of years.

Alex Vaughan: And then I think if I look at it, National Highways has a road investment strategy that they're embarked upon whilst we will work with them to find a solution to the smart motorways, because the smart motorways was the answer to, how do we increase capacity on the motorway network without building more road? So, we've still got to work and do a lot of work on how we're going to answer that question. But also, in the rest of the RIS2 program, there's a lot of work to be done and a lot of opportunities that is a longer list than the budget that's available. So, we're pretty confident that the overall road investment strategy will be prioritized to target the improvements that are the most important and positively for us, we've secured a place on all of those frameworks for National Highways. So we will be their partner of choice to help them deliver those outcomes.

Alex Vaughan: So, I don't foresee it creating any longer-term, medium-term or longer-term issue for us. I hope that answers your question, Andrew.

Scott Bannerman: Good. Thanks very much for that, Alex. We've got no further questions from the webcast just now. So, I'd like to hand back to yourself for closing remarks.

Alex Vaughan: Okay. Well look, thanks very much, everyone, for your time. Last year was a year for us of putting in place all of the enablers to unlock our future success and to draw a line under the legacy contract issues. And I think we've done that well and we're nearly well placed. So as a business, we are looking forwards with confidence and look forward to updating you on the further progress that we make as we transform Costain. So, thank you very much. Have a good rest of the day.