Building the platforms for growth

"We have made progress this year, particularly on taking cost out, but there is more to do to deliver growth and complete our transformation."

Patrick Butcher
Chief Financial Officer

Overview

2019 was the second year in Capita's multi-year transformation and a lot has been achieved. There are many signs of progress on our journey towards becoming a simpler, stronger, more successful company generating free cash flow in a sustainable, predictable manner. However, as these results show, progress has been slower and more expensive than we had hoped, partly because we have chosen to invest for the long term and partly because some of the challenges could not have been fully scoped in early 2018.

Revenue and profits were in line with expectations, with cost reductions offsetting investments, lost revenue and lower margins on some contract renewals. Some of the benefits of the transformation work, such as profit improvements on the three 'challenging' contracts, are reflected in the results. While our core businesses have largely shown growth in the second half, it has been slower than we had hoped. As in 2018, the results have benefited from some one-off items, as expected in a complex group in transition. These included contract related items arising on contract terminations, settlements and modifications, and other Group-wide items, including lower bonuses compared to the prior year.

The cost and cash management controls and programmes implemented over the last two years give us a better base and will continue to provide positive returns in 2020. Interest has reduced following the deleveraging in 2018.

The balance sheet was significantly strengthened in 2018 but net debt is at the top end of our range as a result of lower conversion of EBITDA to cash, and more investment being required to fix contracts and lay the foundations for growth. The group has the liquidity it needs to continue the transformation journey. We expect this liquidity to further improve following the introduction of new funds to replace the current debt that matures over the next 18 months. As part of our drive for simplification, we decided recently to seek to dispose of a number of non-core businesses, the proceeds from which will be recycled to strengthen the Group.

However, as we said at the half year, securing returns on our investments in the form of positive revenue growth and cash generation growth is the priority for 2020.

Simplified reporting

We have simplified the presentation of our financial statements for 2019 to better align to the needs of our stakeholders. The changes are designed to enhance clarity, aid a deeper understanding and provide a more meaningful integration of our reported results, while making the narrative more concise. To achieve this, the notes have been grouped into sections, with the relevant accounting policies, and any key judgements and estimates applied. It also includes an analysis of the key drivers compared with key metrics and/or the previous year's results, to make it more user friendly.

Summary of financial performance

	Financial highlights					
	Adjusted[1] results – continuing operations			Reported results – continuing operations		
	Adjusted[1] 2019	Adjusted[1] 2018	Adjusted[1] YOY change	**Reported 2019**	Reported 2018	Reported YOY change
Revenue	**£3,647.4m**	£3,814.7m	(4)%	**£3,678.6m**	£3,918.4m	(6)%
Operating profit	**£306.1m**	£334.4m	(8)%	**£0.4m**	£34.9m	(99)%
Profit/(loss) before tax	**£275.0m**	£281.2m	(2)%	**£(62.6)m**	£272.6m	(123)%
Earnings/(loss) per share	**13.09p**	16.33p	(20)%	**(4.18)p**	17.99p	(123)%
Free cash flow	**£(61.3)m**	£(78.8)m	22%	**£(213.0)m**	£(260.5)m	18%
Net debt*	**£790.6m**	£466.1m		**£1,353.2m**	£466.1m	

* Net debt in respect of adjusted results is headline net debt[1]

Adjusted results

Capita reports results on an adjusted basis to aid understanding of business performance. In 2019, International Financial Reporting Standard 16 Leases (IFRS 16), which has a material impact, especially on net debt, has been adopted. However, to aid comparison with the prior year, the primary adjusted measures used by the Board for evaluating performance are before the impact of IFRS 16. Reconciliations between adjusted and reported operating profit, profit before tax and free cash flow are provided on the following pages.

As expected, adjusted revenue[1] reduced year on year by around 4%. The adjusted revenue[1] bridge details the movements, many of which we have communicated previously:

- One-off gains in 2018 on the termination of the Prudential and Marsh contracts;
- Contract losses, which includes the flow through from contracts lost in 2018, of £105m, such as the Prudential, Marsh and Defence Infrastructure Organisation contracts, and a further £109m of contract losses in 2019, including in local government and in some other divisions. Delays in local authorities taking back work meant that the impact of these losses were lower than expected in 2019, but the majority of these have now come to an end;
- Scope and volume change revenue has decreased due to high competition and market pressures in Technology Solutions, and lower volumes in our Life and Pensions contracts and Real Estate and Infrastructure business;
- Lower transactional revenue, mainly in Specialist Services;
- Contract wins which included £67m from the annualised impact of previous wins and £40m of new contract wins in 2019. This however was not as much as expected, particularly in the second half of the year, which explains the emphasis we put on the importance of revenue growth in 2020; and

Adjusted revenue[1] bridge by key driver

	£m
Year ended 31 December 2018	**3,814.7**
One-offs	(48.0)
Year ended 31 December 2018 rebased	**3,766.7**
Contract losses	(213.6)
Scope and volume changes	(21.2)
Transactional	(30.5)
Contract wins	106.7
One-offs	39.3
Year ended 31 December 2019	**3,647.4**

Adjusted profit before tax[1] bridge by key driver

	£m
Year ended 31 December 2018	**281.2**
One-offs	(15.2)
Year ended 31 December 2018 rebased	**266.0**
Contract wins	14.0
Contract improvement	31.5
Net contract movements	(97.2)
One-offs – contract related	28.2
Transformation cost savings	105.0
Cost change	(40.2)
Investments	(73.7)
One-offs – other Group cost items	41.4
Year ended 31 December 2019	**275.0**

1. Refer to alternative performance measures on pages 187–188.

Adjusted operating profit to adjusted free cash flow[1]

	2019 £m	2018 £m
Adjusted operating profit[1]	**306.1**	334.4
Add: depreciation, amortisation of intangible assets, impairment of property, plant and equipment and share of earnings in associates	88.4	90.9
Adjusted EBITDA	**394.5**	425.3
Contractual movement (deferred income, contract fulfilment assets and accrued income)	(228.7)	(217.0)
Cash from trading operations *	**165.8**	208.3
Other working capital and other movements	(7.2)	(26.4)
Cash generated by operations before non-recourse receivable financing	**158.6**	181.9
Non-recourse receivables financing cleared	–	(110.0)
Cash generated by operations	**158.6**	71.9
Interest	**(32.7)**	(39.0)
Taxation	**(5.4)**	26.6
Net capital expenditure	**(181.8)**	(138.3)
Adjusted free cash flow[1]	**(61.3)**	(78.8)

* Cash from trading operations defined as adjusted EBITDA less contractual working capital movements

Adjusted[1] to reported profit bridge

	Operating profit		(Loss)/profit before tax	
	2019 £m	2018 £m	2019 £m	2018 £m
Adjusted[1]	**306.1**	334.4	**275.0**	281.2
Amortisation and impairment of acquired intangibles	**(49.9)**	(143.5)	**(49.9)**	(143.5)
Impairment of goodwill	**(41.4)**	(33.8)	**(41.4)**	(33.8)
Net finance costs	**–**	–	**(6.3)**	(18.8)
Contingent consideration movements	**1.4**	5.0	**1.4**	5.0
Business exit – trading	**(16.7)**	17.7	**(16.7)**	17.7
Business exit – non-trading expenses	**(52.1)**	(29.7)	**(52.1)**	(29.7)
Business exit – (gain)/loss on disposals	**–**	–	**–**	309.7
Significant restructuring	**(159.4)**	(110.0)	**(159.4)**	(110.0)
Impact of IFRS 16	**11.7**	–	**(14.0)**	–
Other	**0.7**	(5.2)	**0.8**	(5.2)
Reported	**0.4**	34.9	**(62.6)**	272.6

1. Refer to alternative performance measures on pages 187–188.

- As happened in 2018, a number of one-offs arose from termination payments and deferred income releases associated with contract terminations and modifications (detailed further below).

Adjusted profit before tax[1] declined in 2019, in line with expectations. The adjusted profit before tax[1] bridge breaks out the revenue and cost impacts on profit. The margin from contract wins and the benefits from improved performance on three 'challenging contracts' are offset by the combined impact of contract losses and scope and volume reductions described earlier. The cost savings were offset by cost inflation (mainly inflationary pay increases focused on lower paid staff), and investment in strengthening functions, such as growth. A range of other Group-wide actions, such as lower bonus accruals, resulted in adjusted profit before tax[1] being in line with expectations.

The cost competitiveness programme delivered £105.0m of savings in 2019, and cumulative savings of £175m, which were used to increase investment in strengthening functions and build the platforms for growth as well as to partially offset the decline in revenue. The savings have been generated through simplifying the organisation, reducing management layers and rationalising the IT and property portfolios. We are leveraging investments of more than £10m that we have made in automation and our existing offshore capabilities, and there is more to come.

The adjusted revenue[1] and adjusted profit before tax[1] declines were offset by a number of one-off benefits. These items are not excluded from adjusted results as they are normal course of business, not associated with the transformation plan. These included:

- One-off contract related items (£28.2m) relating to release of deferred income and write-off of contract assets arising on contract terminations, settlements and modifications. Where a contract is terminated early, all deferred revenue is recognised in the year of termination, which would have been deferred over the expected life of the contract in line with the Group IFRS 15 policy. Similarly, any associated contract assets are written off in the year of termination, unless there are alternative uses on other contracts. In addition, exit fees were paid to Capita on the termination of customer contracts which contained provisions to compensate the Group for exit costs and future profit in the event of early termination.
- Other Group-wide items benefiting profit (£41.4m) included lower bonuses compared to the prior year (£24.4m) and other Group items.

Adjusted to reported free cash flow

	2019 £m	2018 £m
Adjusted[1]	**(61.3)**	(78.8)
Pension deficit contributions	**(71.1)**	(46.9)
Significant restructuring	**(148.5)**	(100.8)
Business exits	**(19.4)**	(10.3)
Impact of IFRS 16	**90.0**	–
Other	**(2.7)**	(23.7)
Reported	**(213.0)**	(260.5)

Adjusted free cash flow[1] in 2019 was an outflow (£61.3m). This outflow was affected by the decline in adjusted profit before tax[1] explained above. There are also a number of items that can lead to significant differences between profit and the generation of free cash flow, including:

- Timing of profits compared to the cash received. Typically, cash receipts are aligned to costs incurred. Whereas, under IFRS 15, revenue is more evenly distributed in the early years on the contract. This typically results in lower profits in early years on contracts with significant restructuring costs or higher operating costs prior to transformation. The cash received is deferred and released as we deliver against our obligations to provide services and solutions to our clients.
- Contract terminations and modifications, which can lead to major gains or losses in the year of termination or modification, and where cash inflows/outflows have occurred in prior years.

We have analysed working capital between 'contractual' – being those balances which relate to contract unwinds of deferred income, accrued income and contract fulfilment assets to derive cash from trading operations – and 'other working capital' which represents routine normal working capital items such as trade receivables, trade payables and prepayments. Cash from trading operations is a more helpful way to think about these movements rather than describing them as working capital outflows and provides a more stable and consistent view of operating cash flows.

Cash from trading operations declined to £165.8m (2018: £208.3m) due to reduction in adjusted EBITDA. Contractual working capital movement increased with an outflow of £78m (2018: outflow £70m) relating to contracts which were terminated or renegotiated in the year, which is not planned to reoccur in 2020; and an outflow of £150m (2018: outflow £147m) relating to continuing contracts expected to reduce in 2020 due to additional payments on account (DFRP) and reduction in transformation spend. Other working capital related cash reflected actions taken to improve working capital which will continue in to 2020.

Taxation has moved from a cash inflow in 2018 to an outflow in 2019, reflecting corporation tax repayments received in 2018 following the adoption of IFRS 15.

As expected, net capital expenditure increased in 2019 in line with the transformation objectives as the investment in property and IT infrastructure increased, and investment in technology and growth ramped up.

Period-end cash management, including non-recourse receivables financing, fully unwound in 2018.

Reported results

Adjusted operating profit[1] and adjusted profit before tax[1] excludes a number of specific items, including significant restructuring of £159.4m, the amortisation and impairment of acquired intangibles, including goodwill, of £91.3m, business exits of £68.8m and the impact of IFRS 16, to aid understanding of business performance.

The Group has recognised an impairment of goodwill, of the Network Services cash-generating unit (CGU) within the Technology Solutions division. As detailed in the divisional strategy and performance section of the strategic report, post the half-year results announcement and as the market continues to change, forecast margins were impacted by high competition and market pressures, which was then reflected in the 2020 business plan. While we continue to win new revenue, albeit not at the expected level of growth, the margin pressure is expected to continue until we move to provision of our digital transformation propositions. As a consequence, the starting base from which we expect this CGU to grow is lower than expected at 30 June 2019.

Business exits are businesses that have been disposed of or exited during the year, or are in the process of being disposed of or exited. During 2019, the Group took the decision to exit a business. The exit is in progress and expected to complete in 2020. At 31 December 2019, the Group was also in an active process to dispose of a business which met the held-for-sale criteria and therefore treated as a disposal group held for sale. In accordance with our policy, the trading results of the businesses were included in business exits and therefore excluded from adjusted results. To enable a like-for-like comparison of adjusted results, the 2018 comparatives have been restated to exclude 2019 business exits. Further disposals are planned in 2020 as part of the simplification agenda. As these disposals did not meet the definition of business exits or assets held for sale at 31 December 2019, their trading results were included within adjusted results.

In 2018, the Board launched a multi-year transformation plan to support the objectives of simplifying and strengthening Capita. The plan includes property rationalisation, procurement centralisation, transformation of support functions, including investment in growth, an organisation-wide customer relationship management system, a new human resources system (Workday) and transformation of finance, and operational excellence, including investment in automation. These activities are designed to improve the cost competitiveness of the Group, secure Capita's position in the markets it serves, and strengthen governance and control. The costs of the transformation plan, including redundancy costs, are excluded from adjusted operating profit[1] as significant restructuring. Refer to note 2.4 to the consolidated financial statements for further analysis of the spend.

The aim of the finance transformation is to improve the Group's financial reporting systems, processes and controls, by increasing standardisation, automation and the quality of available data. The new financial systems were due to go live in the second half of 2019. While progress was made, we took the decision to defer the go-live as more work is required on the core processes and procedures before the system can effectively be implemented. We have reviewed the costs capitalised and assessed that £12.3m is impaired, representing areas that we expect to redesign before going live. The carrying value of the investment at 31 December 2019, post impairment, is £58.6m. Further impairment may arise should there be a material change to the Group's operating model ahead of any go-live. This impairment is included within significant restructuring. We have continued to invest in shared service centres and offshoring, and in making improvements to the Group's existing reporting systems, processes and controls.

The Group adopted IFRS 16 from 1 January 2019. The Group holds a significant number of operating leases and therefore adopting IFRS 16 has had a material impact to the Group's financial statements. The accounting standard has introduced a single lessee accounting model which requires assets and liabilities to be recognised for leases (refer to note 6.4 to the consolidated financial statements). Rental costs previously recognised in operating profit have been replaced by depreciation of the assets and net finance costs on the liability. The total cash outflow for lease payments has not changed. However, payments related to the principal liability have been presented as cash outflows from financing activities, as opposed to cash outflow from operating activities under International Accounting Standards 17 Leases in our reported results.

Further detail of the specific items charged in arriving at reported operating profit for 2019 is provided in note 2.4 to the consolidated financial statements.

Reported free cash flow was an outflow reflecting spend in relation to known commitments, including pension deficit contributions (which the directors consider to be debt-like in nature), restructuring costs, professional fees, contingent and deferred consideration, litigation and other items. In 2019, this was offset by the adoption of IFRS 16 as rental payments previously included in free cash flow were reclassified as financing cash flows, being repayment of the lease liability and interest.

Continued investment

Investment over three years outlined in the rights issue prospectus in April 2018 was split between targeted investments of £500m and £220m in respect of the transformation plan, a total of £720m. The table below details the cumulative investment to the end of 2019.

By the end of 2019, we had invested £649.5m through a mix of operating, restructuring and capital expenditure. Looking forward to 2020, we expect to continue to invest although as the mix of work changes, capital expenditure will be a lower proportion. Overall this will result in investment nearer £800m before including 2020 investment in operating costs. We will also make the final payment in the agreed three year deficit reduction plan on our pension scheme.

Impact on net debt

The Board's view is that the appropriate headline leverage ratio for Capita over the medium term should be between 1.0 and 2.0 times headline net debt to adjusted EBITDA[1] (prior to the adoption of IFRS 16). At 31 December 2019, the ratio was at the top of our range at 2.0 times (2018: 1.1 times) as a result of trading cash flows and higher investment.

The impact of IFRS 16 adoption on the Group's adjusted net debt to adjusted EBITDA[1] debt covenant ratio is neutral, as the Group covenants are on frozen GAAP, with the exception of the US private placement loan notes. The US private placement loan notes covenant test includes the income statement impact of IFRS 16 but not the balance sheet impact, and therefore adoption of IFRS 16 is favourable on this covenant measure. At 31 December 2019, the US private placement loan notes ratio was 1.7 times.

Interest cover[1] covenant was 11.2 times for the US private placement loan notes and 10.8 times for other financing arrangements (2018: 8.2 times).

As the comparatives have not been restated on the adoption of IFRS 16, the December 2018 ratio is only comparable against the other financing arrangements and therefore no comparatives are shown for the US private placement loan notes.

Capital and financial risk management

Liquidity remains a key area of focus for the Group. Financial instruments used to fund operations, including the transformation plan, and to manage liquidity comprise US private placement loan notes, euro fixed-rate bearer notes, a Schuldschein loan, a revolving credit facility (RCF), backstop liquidity facility, leases and overdrafts.

The Group does not rely on sources of funding that are not contractually committed. To mitigate the risk of needing to refinance in challenging conditions, the Group is diversifying its sources of committed funding and is planning to spread debt maturities to November 2027. In addition, the Group's RCF of £414.0m at 31 December 2019 (2018: £600.0m) provides flexible liquidity available to fund operations and a reasonable liquidity buffer allowing for contingencies.

"Our priority for 2020 is to secure returns on our investments in the form of positive revenue growth and cash generation growth."

Cumulative investment*

	Operating costs £m	Restructuring £m	Capital expenditure £m	Total £m
Maintenance	22.0	70.2	158.7	**250.9**
Organisation	34.5	117.1	34.7	**186.3**
Technology	21.7	61.6	108.7	**192.0**
Other	1.9	0.4	18.0	**20.3**
Total	**80.1**	**249.3**	**320.1**	**649.5**

* Cumulative investment represents spend in 2018 and 2019

Net debt

	2019 £m	2018 £m
Opening net debt	**(466.1)**	(1,117.0)
Cash movement in net debt	(241.2)	654.1
Non-cash movements	(2.0)	(3.2)
Adoption of IFRS 16	(643.9)	–
Closing net debt	**(1,353.2)**	(466.1)
Remove closing IFRS 16 impact	562.6	–
Headline net debt	**(790.6)**	(466.1)
Cash and cash equivalents, net of overdrafts	122.8	642.7
Debt, net of swaps	(913.4)	(1,108.8)
Headline net debt/adjusted EBITDA[1]	**2.0x**	1.1x

1. Refer to alternative performance measures in section 8.2.

In December 2019, the facility was extended to 31 August 2022, extendable for a further year to 31 August 2023 with the consent of the lenders by 31 August 2021. The addition of a further bank to the facility in February 2020 resulted in the facility increasing to £452.0m.

In addition to the RCF, in February 2020 the Group agreed a backstop liquidity facility of £150.0m. The backstop liquidity facility has an initial maturity in February 2021, and is extendable at the option of the Group to a final maturity in August 2022.

At 31 December 2019, the Group had £122.8m of cash and cash equivalents net of overdrafts, and £990.7m of private placement loan notes, fixed-rate bearer notes, and Schuldschein loan. These debt instruments mature over the period to 2027, with repayment of £232.5m, £240.5m and £230.5m in 2020, 2021 and 2022 respectively. We are taking steps to extend the average term to maturity of our debt, and thereby reduce refinancing risk, by issuing new long-term debt instruments.

As noted earlier, as part of our simplification drive, we also decided recently to dispose of a number of non-core businesses in 2020. The anticipated disposal proceeds will provide additional liquidity headroom with options available to fund future investments and reduce the Group's debt.

My priority is to manage our cash to support the transformation of Capita to the point when it is generating sustainable predictable adjusted free cash flow[1].

Going concern and viability assessments

In determining the appropriate basis of preparation of the financial statements for the year ended 31 December 2019, the directors are required to consider whether the Group can continue in operational existence for the foreseeable future. The Board has concluded that it is appropriate to adopt the going concern basis, having undertaken a rigorous assessment of the financial forecasts to 31 August 2022 being 29 months from the date of approval of these financial statements and aligned with the expiry date of the RCF and backstop liquidity facility. The Board's assessment is set out in more detail in section 1 of the consolidated financial statements.

In addition, as is usual, in assessing viability the Board has taken into consideration plans to introduce new funds to the Group to replace the current debt that matures over the next 18 months, with an extended maturity profile that supports the transformation programme, and disposals, both of which the directors are confident will conclude successfully in 2020.

Pensions

The next triennial valuation of Capita's main defined benefit pension scheme is due as at 31 March 2020. The previous valuation as at 31 March 2017 included the payment of deficit repair contributions totalling £176.0m, which will be fully paid by early 2021. In line with our expectations, it is anticipated that these additional contributions, along with longer-term investment returns, will eliminate the shortfall in the scheme as identified by the Trustees during that valuation. Looking forwards to the 2020 valuation, where we conclude will be dependent upon the timely delivery of the transformation of the Group. The Company and Trustees will continue their commitment to an open dialogue between them, ensuring the financial health of the scheme is maintained in a proportionate way with all other stakeholders.

Balance sheet

The reported loss for the year combined with the actuarial loss on the Group's defined benefit pension schemes and the adoption of IFRS 16, has resulted in the Group recording consolidated net liabilities of £64.0m at the 31 December 2019 (2018: net assets £103.3m).

Contingent liabilities

The Group has been notified under a supplier contract of a potential liability relating to past services received. The basis of any liability is currently being discussed with the supplier, focusing currently on the method of any settlement. The preferred approach is to settle the potential liability, if any, via future committed spend with the supplier and accordingly the Group has not made any provision at 31 December 2019 for a future outflow of funds that might result. Refer to note 6.2 of the consolidated financial statements for the contingent liability disclosure note.

Financial outlook

In light of the investment that has been made in building platforms for growth, we expect that revenue growth in our core businesses will translate into modest organic revenue growth for the Group in 2020. Contractual working capital outflows will reduce by more than £120m as a result of known contract movements, and our planned focus on the management of debtors and creditors will generate further benefits. Capital expenditure, as discussed earlier, will reduce significantly in 2020 and so adjusted free cash flow is expected to be at least £160m. As a result of planned restructuring, and the last of three agreed payments towards our pension deficit, net debt will rise modestly. All of these items are before taking account of the impact of potential disposals and the impact of IFRS 16.

Financial KPIs

Adjusted profit before tax (£m)[1]

2019	275.0
2018	281.2
2017	383.1

Adjusted operating margin (%)[1]

2019	8.4
2018	8.8
2017	10.9

Adjusted earnings per share (p)[1]

2019	13.09
2018	16.33
2017	27.99

Adjusted free cash flow[2]

£(61.3)m

(2018: £(78.8)m)

Return on capital employed

13.3%

(2018: 17.9%)

Headline gearing: headline net debt to adjusted EBITDA[3]

2.0x

(2018: 1.1x)

1. Refer to alternative performance measures on page 187–188.
2. Refer to note 2.10 of the consolidated financial statements.
3. As announced in January 2019, the Board's view is that the appropriate headline leverage ratio for Capita over the medium term should be between 1.0 and 2.0 times headline net debt to adjusted EBITDA[1] (prior to the adoption of IFRS 16).