

Chief Executive's review

Our strategy

In last year's annual report, I set out our strategy for continuing to deliver the reliable, responsible growth which shareholders have enjoyed over recent years.

During 2005, we undertook an in-depth analysis of our business and the markets which it served and established a clear strategic context for the future development of the Group.

Our analysis demonstrated that market leadership was critical to sustained success. We have positions of leadership in many of our markets, excellent people, a strong portfolio of long-term customer relationships, well-developed supply chains and a very substantial order book – a powerful basis on which to build. We also have the cash resources to invest in growth and to ensure that we continue to have a dynamic organisation.

We remain confident that our growth ambitions can be satisfied over the next two to three years from the momentum inherent in the business mix as it was at the start of 2006. Double-digit compound growth is not, however, an inherent characteristic of most of our markets, which grow in line with GDP at 2-4%.

Our chosen markets are almost all experiencing steady growth – with some specific sectors developing at or above double-digit pace. We, in turn, are deliberately focusing on the faster moving segments of our markets and on strong, successful customers who, themselves, are setting the pace for expenditure in their sectors.

Last year, we identified four areas in which we intended to develop our business to ensure that we will be able to maintain our target growth rates over the medium and longer term.

These were: UK regional infrastructure contracting; professional and technical services; the extension of our investment business into new markets; and establishing strong domestic businesses in selected overseas markets based on our UK model.

Ian Tyler Chief Executive



Last year, we identified four areas in which we intended to develop our business to ensure that we will be able to maintain our target growth rates over the medium and longer term.



UK infrastructure

The majority of the businesses in which we make our best and most reliable margins are in UK infrastructure markets, many of which have strong positive growth momentum, including major public building, social housing, utilities contracting and regional civil engineering. In these areas we are already well positioned, and anticipate vigorous demand growth over the medium to longer term.

Birse acquisition strengthens our market position

In July 2006 we substantially strengthened our regional presence in UK civil engineering with the £32m acquisition of Birse Group plc.

The acquisition of Birse takes us a significant step forward in our aim to expand our UK regional presence. Birse, which has annual revenues of over £300m, provides a range of civil engineering services, with regional strengths complementary to our existing network. Integrating Birse into our regional operations, which has now been substantially achieved, will accelerate growth, improve performance, broaden our geographic coverage and take us into some specialist civil engineering markets in which we have previously had little or no presence.

It will give us greater strength in coastal engineering work for local authorities, and in civil engineering for the rail industry. It brings us additional engineering and project management skills in water and other process activities. It also gives us a successful building business focused on the education sector in the North of England, which has become a part of Mansell, our regional building business.

Strategic developments

-
- Birse acquired for £32m
-
- Strong further growth in Mansell
-
- Leading position in complex building market consolidated
-
- Other regional targets identified
-



Professional and technical services

There is a clear trend amongst our key customers to demand a broader and more proactive role from us, in addition to that represented by our long-established construction and maintenance services. To do this, we are building our upstream capabilities in programme management and technical consulting. We have been making good progress in this market since forming our professional services division, Balfour Beatty Management, in 2003. Progress accelerated in 2006.

Balfour Beatty Management is an increasingly important differentiator

Balfour Beatty Management is one of the UK's fastest-growing consultancies. Formed in 2003, it increased its professional staff from 200 to 350 during the year. In 2005 it was instrumental in securing a £380m alliance with National Grid to replace gas mains in Greater Manchester. In 2006 it played a key role in securing another National Grid alliance worth up to £550m to upgrade and repair the overhead electricity line network on the eastern side of England, and a major contract for United Utilities.

Balfour Beatty Management enables the Group to offer customers an integrated, high-quality consulting and contracting package. When we bid for large and complex projects, its expertise in programme and project management, alliances, value engineering and business improvement processes gives us considerable competitive advantage. Its expertise is also highly sought-after in its own right: it generates some 50% of its business independently from the rest of the Group.

Balfour Beatty Management is building a reputation for innovation with projects such as the new King's Cross St Pancras Underground Station, where it has significantly reduced project costs, and work for BAA at Heathrow Terminal 5. It is further enhancing Balfour Beatty's reputation for handling large and complex projects successfully.

Strategic developments

-
- King's Cross St Pancras Underground Station programme management – a key reference project
-
- Consultancy partners in long-term gas and electricity alliances
-
- Key component of airport bids and preparation of Exeter International Airport development plan
-



Chief Executive's review (continued)

Private finance

Our UK PPP business, Balfour Beatty Capital, has substantial skills and in-built growth momentum. The experience and expertise represented in its team of over 200 professional staff put the business in a strong position to expand. The PPP market remains healthy in the UK, and new markets are emerging overseas – notably in the US, Western Europe, South-East Asia – and in the UK.

We have committed equity of over £300m in a portfolio of public sector concessions, for which we have raised over £7bn of funding. These are largely concentrated in the healthcare, education and transport sectors. Six further projects are at preferred bidder stage, with 21 bids submitted during 2006.

In education, the £40bn Building Schools for the Future (BSF) programme is providing new opportunities alongside more traditional PPP schemes. We recently secured the pathfinding project at Knowsley on Merseyside and are currently bidding more schools projects. The social housing market is growing strongly and is a significant area of opportunity in conjunction with Mansell.

We are also a major participant in PPP road projects and have been shortlisted for the £1.5bn M25 road widening and maintenance PPP scheme.

Developing the South West's airport of choice

Balfour Beatty Capital is now extending its reach into non-PPP investments. Since 1993 we have been a 25.5% shareholder in Barking Power, which owns and operates Barking Power Station. In January 2007 our specialist subsidiary Regional and City Airports acquired Exeter International Airport. We have significant experience in the design and construction of airport assets and aim to make Exeter the airport of choice for the South-West. Other airport opportunities are being pursued.

We are also pursuing PPP opportunities internationally. In the US we are part of the bbm AIRail Transfer consortium that has been shortlisted for a new rail connection between Oakland Airport and the Bay Area Regional Transport system in California. We have bid for Bremen Hospital in Germany and for an extension to a Further Education facility in Singapore.

Strategic developments

Two new UK PPP concessions and three new preferred bidder positions secured

Exeter airport acquired in January 2007

Short-listed for Oakland Airport Connector

Offices established in the US, Germany and Singapore

Overseas markets

In the longer term, maintaining our growth targets will require the development of broadly-based domestic businesses outside the UK. Our key target markets are the United States, Western Europe and South-East Asia. We will focus on the sector markets with greatest long-term potential, combining organic growth from our existing positions of strength with selective acquisitions.

Our international expansion will be judicious, and progressive. Our choice of territories is based on four key criteria:

- the markets we address must be large enough to make a substantial difference;
- they must offer an acceptable business environment which does not discriminate against foreign ownership;
- they must be sufficiently endowed with sophisticated customers who will pay for superior levels of quality, safety and innovation; and
- they must offer us the opportunity to achieve a leading market position without undue risk.

Within the territories which fit these requirements, we will apply another set of criteria for building our presence. Our businesses will have to have high-quality, long-term sustainable earnings; a market presence at the core of Balfour Beatty's existing competency range; be complementary to other Balfour Beatty businesses in the territory; have a proven, successful management team; and see project delivery, risk management and customer service as their key differentiators.

Becoming a major builder in the US

The acquisition of Centex Construction, the \$2bn annual revenue US building company, agreed in February 2007, will create critical US mass in a core Balfour Beatty business and add substantial new business development opportunities, including in PPP. Centex has strong market positions in Texas, Florida, Washington DC and North Carolina and is a leading player in the military housing market. It is anticipated that this acquisition will be immediately earnings enhancing and will accelerate our penetration of US growth markets.

Strategic developments

Acquisition of Centex Construction in the US agreed

Acquisition of Charter in the US

Profit growth in Hong Kong and Dubai

Small, strategic acquisitions planned for Balfour Beatty Rail

