

# WHAT do the NUMBERS MEAN?



## FINANCIAL REVIEW

This year's results show a business that's growing well and increasingly profitable. Turnover increased by 16.2% and pre-tax profit before goodwill amortisation was up 26.3%. Earnings per share rose by 16.1%. Cash flow performance was robust. We converted 136% of operating profit and 75% of Group EBITDA into cash.



## 1 PROFIT AND LOSS ACCOUNT

2002 was another year of strong performance which is further analysed in figure 1 opposite.

### 1.1 Turnover

Total turnover increased by 16.2% to £1,325.9m. This includes a contribution of £43.3m (2001 – £12.1m) from Serco Assurance (formerly the nuclear consulting division of AEA Technology), which was acquired in September 2001.

### 1.2 Gross profit

Gross profit of £150m increased by 20.9% and represents a return on group turnover of 13.7% (2001 – 13.6%).

### 1.3 Pre-tax profit

Pre-tax profit before goodwill amortisation increased 26.3% to £57m.

### 1.4 Underlying pre-tax profit

There were no exceptional items in 2002. In order to allow comparison of the year on year results, the growth in underlying pre-tax profit is shown in figure 2 opposite.

Underlying pre-tax profit grew 20.1% to £54.9m. Underlying profits are stated after:

- A £2.1m (2001 – £0.5m) contribution from Serco Assurance
- A prior year adjustment of £1.2m in 2001 made on the adoption of Urgent Issue Task Force (UITF) Abstract 34 in 2002; this is explained in greater detail in *Bid costs*
- A net contribution in 2001 of £0.2m from three one-off items.

### 1.5 Tax

The tax charge for 2002 was £16.6m (2001 – £13.0m), representing an effective tax rate of 34.0% (2001 – 32.5%). The increase in the effective rate is largely as a result of an increased year on year level of goodwill amortisation.

### 1.6 Earnings per share

Taking into account the above and the increased capital base resulting from the equity placing in March, earnings per share before goodwill amortisation grew by 16.1% to 9.58p.

## 2 DIVIDENDS

The proposed final dividend of 1.44p per share gives a cumulative dividend for 2002 of 2.08p, an 11.8% increase on 2001.

## 3 SHARE PLACEMENT

In March £117.4m (net of fees) was successfully raised through an international bookbuilt placing of 39.5m new shares representing 9.9% of Serco's issued share capital. This enabled the Serco Assurance acquisition finance to be repaid and the Balance Sheet to be strengthened to facilitate future growth.

Since flotation in 1988 Serco has raised new equity totalling £161m, roughly equivalent to our acquisition costs of £180m over the same period. Apart from this, we have funded our growth from under £50m to over £1.3bn of annual sales entirely from internally generated resources.

FIGURE 1 PROFIT AND LOSS ACCOUNT

	2002 £m	Restated* 2001 £m	Change %
Total turnover	1,325.9	1,141.2	16.2
Group turnover	1,097.3	913.7	
Joint venture turnover	228.6	227.5	
Gross profit	150.0	124.0	20.9
Other administrative expenses	(112.8)	(97.6)	
Exceptional items	–	5.2	
Joint venture profit	23.9	18.7	
Group interest	(4.1)	(5.1)	
Profit before goodwill and tax	57.0	45.2	26.3
Goodwill	(8.1)	(5.1)	
Profit before tax	48.9	40.1	
Tax	(16.6)	(13.0)	
Profit after tax	32.3	27.1	
Effective tax rate	34%	32.5%	
Average number of shares	421.8m	389.6m	
Earnings per share before goodwill	9.58p	8.25p	16.1
Earnings per share after goodwill	7.66p	6.94p	

FIGURE 2 UNDERLYING PRE-TAX PROFIT

	2002 £m	Restated* 2001 £m	Change %
Reported pre-tax profit before goodwill amortisation	57.0	45.2	26.3
2001 Acquisition: Serco Assurance	(2.1)	(0.5)	
Prior year adjustment: UITF Abstract 34	–	1.2	
Net one-off items	–	(0.2)	
Underlying pre-tax profit before goodwill amortisation	54.9	45.7	20.1

\* The 2001 accounts have been restated after the adoption of UITF Abstract 34 *Pre-contract costs* in 2002 (see *Bid costs* on page 19 for more information).

FIGURE 3 CASH FLOW

	2002 £m	Restated* 2001 £m
Operating profit before one-off items	29.1	21.3
Non-cash items – Depreciation and goodwill	23.6	18.3
Group EBITDA	52.7	39.6
Working capital movement	(13.1)	(13.9)
Operating cash flows before one-off items	39.6	25.7
Pension payment	(15.5)	–
Exceptional items	–	6.1
Dividends from joint ventures	11.1	9.6
Interest and taxation	(11.9)	(12.0)
Capital expenditure	(23.6)	(17.6)
Disposals of tangible assets	8.1	4.6
Other items	1.9	(7.5)
Free cash flow	9.7	8.9
Acquisitions/disposals	(10.3)	(73.6)
Share issues	117.9	2.0
Other financing	(3.8)	(11.9)
Dividends paid	(8.3)	(6.7)
Net cash flow	105.2	(81.3)
Closing cash/(overdraft)	69.4	(35.8)
Long term loans	(47.4)	(45.6)
Other loans and finance leases	(15.7)	(12.1)
Recourse net cash/(debt)	6.3	(93.5)

\* The 2001 accounts have been restated after the adoption of UITF Abstract 34 *Pre-contract costs* in 2002 (see *Bid costs* on page 19 for more information).

#### 4 CASH FLOW

During the year there was a net cash inflow of £105.2m. This inflow was after a one-off payment of £15.5m into the Serco Pension and Life Assurance Scheme in February and includes £117.4m from a share placing in March. This cash inflow contributed to the reduction in Group net debt/funds, excluding non-recourse PFI debt, from £(93.5)m to £6.3m respectively, as detailed in figure 3 opposite.

##### 4.1 Operating cash flow before one-off items

Operating cash flow, before one-off items, was up 54% to £39.6m (2001 – £25.7m), which converts 136% (2001 – 121%) of our operating profit into cash.

We believe that, as operating profit is calculated after deducting goodwill and depreciation, the appropriate measure for operating cash flow performance is the conversion of Group EBITDA before one-off items into operating cash flows. For 2002 this was 75.1% (2001 – 64.9%).

The working capital movement reflects the strong level of organic growth shown by the Group in 2002 and equates to approximately one month's incremental turnover, reflecting the typical invoicing cycle of our contracts.

##### 4.2 Joint ventures

Serco has two types of joint ventures: those which represent traditional operating contracts, such as the Atomic Weapons Establishment (AWE) and Premier Custodial Group (PCG); and those reflecting Serco's equity stakes of up to 50% in PFI Special Purpose Companies (SPCs).

Dividends received from joint ventures during 2002 of £11.1m (2001 – £9.6m) represents a 67% (2001 – 76%) conversion of profit of joint ventures, after tax, into cash.

##### 4.3 Capital expenditure

Capital expenditure, excluding investment in PFI SPCs, for the year was £23.6m (2001 – £17.6m). As a proportion of Group turnover this expenditure represents 2% and has remained at a similar level to previous years.

##### 4.4 Net debt

In addition to the recourse debt shown in figure 3, the Group has a non-recourse loan to fund the construction of the Traffic Control Centre (see Private Finance Initiatives on page 18). At the end of 2002 this loan was £29.7m (2001 – £14.1m). Non-recourse debt is excluded from the Group's banking facility covenants but is presented as a liability in the Group's Balance Sheet.

#### 5 PENSIONS

In 2002, two of Serco's pension schemes were accounted for as defined benefit schemes.

The total 2002 pension charge for Serco was £29.1m (2001 – £19.5m), with the two UK defined benefit schemes having a cost of £12.5m (2001 – £9.3m).

FRS 17 *Retirement Benefits* was issued in November 2000 to replace SSAP 24 for accounting periods ending on or after 22 June 2003. In July 2002 the Accounting Standards Board delayed the introduction of FRS 17 until 2005, following an

announcement by the International Accounting Standards Board that it would also issue a new standard.

For 2002 we have continued to apply the transitional rules and disclosures. FRS 17 requires the market value of assets and liabilities for defined benefit schemes to be calculated and included in the Balance Sheet. At 31 December 2002 we estimate there was a net deficit of £73.6m in relation to the defined benefit schemes and an asset base of approximately £294.4m, whilst the Minimum Funding Rate (MFR) funding level was 100%. Long term company contribution rates will increase by approximately £9m per annum from 2003.

In February 2003 we merged Serco's two defined benefit pension schemes to achieve cost and investment efficiencies. To assist this process £15.5m was injected into the Serco Pension and Life Assurance Scheme in February 2002 to achieve a similar funding level for both schemes. The investment profile of the merged scheme will be kept under continuous review to match the asset and liability profiles.

## 6 PRIVATE FINANCE INITIATIVES

### 6.1 Disclosure

The document *Our Approach to PFIs*, which was originally issued in 2001, was updated in September 2002 and provides a summary of our accounting for PFIs. It is available on our website [www.serco.com](http://www.serco.com) or on request.

### 6.2 PFI profile

For 2002 PFIs contributed £154m to turnover and £17.7m to profit before tax for the year, of which £110.4m of the turnover and £6.4m of the profit related to the operating contracts, and £43.6m of the turnover and £11.3m of the profit to Serco's share of the SPCs.

### 6.3 SPC funding

SPC funding is via long term loans which are non-recourse to Serco.

- Our share of non-recourse debt of joint venture SPCs at the end of 2002 is £206.7m. This is included as a liability within investments in joint ventures on our Balance Sheet.
- Traffic Information Services (TIS) Limited is the first SPC where Serco has chosen to own 100% of the equity. This SPC has the contract to deliver the Traffic Control Centre contract. A non-recourse loan of £29.7m to fund the asset, currently in the course of construction, is included in long term creditors in the Balance Sheet. Construction completion is anticipated in early 2004, when the non-recourse loan will equate to approximately £60m.
- In June 2002 the lenders to the Joint Services Command and Staff College PFI agreed to change the terms of the senior debt. This transaction had no effect on profit but allowed £6.7m of cash to be paid from the SPC to Serco by way of dividend and loan.

## **7 REVIEW OF JOINT VENTURE ACCOUNTING AND CONTROLS**

In March 2002, in recognition of the perceived uncertainties arising from certain joint venture accounting practices in the US, the Board undertook a specific review, including asking Deloitte & Touche to undertake an independent review of our accounting procedures and internal controls over our joint ventures. This review confirms the Board's view that all our joint ventures exist for genuine commercial reasons, are correctly accounted for and that our controls and disclosures are appropriate.

## **8 BID COSTS**

UITF Abstract 34 *Pre-contract costs* was issued in May 2002 for accounting periods ending on or after 22 June 2002. UITF Abstract 34 requires all bid costs to be expensed up to the point where award of a contract is 'virtually certain'. Bid costs incurred after this point may be capitalised. At 31 December 2001 we had £1.2m of bid costs capitalised in relation to contracts for which we had not reached preferred bidder status. Applying the Abstract has resulted in a small prior year adjustment to treat these capitalised costs as expensed in 2001. Having made this adjustment, our accounting policies now fully comply with UITF Abstract 34.

## **9 DEFERRED TAXATION**

Financial Reporting Standard (FRS) 19 *Deferred Taxation* was issued in December 2000 for accounting periods ended on or after 23 January 2002. FRS 19 requires full provision to be made for deferred tax assets and liabilities arising from timing differences between the recognition of gains and losses in the financial statements and their recognition in a tax computation.

The tax charge for the year has been calculated in accordance with FRS 19. The adoption of FRS 19 has not had a material effect on the tax charge, as the Group did not have a material level of unprovided deferred tax liabilities or unrecognised deferred tax assets.

## **10 TREASURY POLICIES**

### **10.1 Treasury management**

The Group's tax and treasury function is responsible for managing the Group's exposure to financial risk. It operates within policies approved and reviewed by the Board, which include controls on the use of financial instruments. The Group reviews the credit quality of counterparties and limits individual aggregate credit exposures accordingly.

**10.2 Liquidity management**

The Group funds its operations through bilateral bank credit facilities and a long term US Private Placement of loan notes ('the US Notes'). Borrowings under the bank facilities are floating rate, unsecured obligations with covenants and obligations typical of these types of arrangements.

At the end of 2002 committed bank credit facilities totalled £50m, a further £111m annually renewable uncommitted bank facilities were undrawn. The committed bank facilities mature in November 2005. The US Notes mature in December 2007.

**10.3 Foreign exchange risk**

Due to the nature of the Group's business, which in general does not involve a significant amount of cross-border trade, the Group is not exposed to material foreign currency transaction risk, as sales and costs are approximately matched within overseas operations.

The Group does not hedge the sterling equivalent of the net assets of its overseas operations on the grounds that the market value of these businesses does not represent a significant proportion of the market value of the Group and because foreign exchange differences are unlikely to have a material effect on the consolidated net asset value of the Group.

The US Notes were issued in US dollars but the principal obligation has been swapped into sterling consistent with the risk profile set out above.

**10.4 Interest rate risk**

The Group's exposure to interest rate fluctuations on its borrowings and deposits is selectively managed, using interest rate swaps. The element of the US Notes that has not been swapped into floating rates is considered to offer adequate protection from interest rate fluctuations in the current market and given the Group's current low level of net debt. All shorter term debt is maintained at floating rates of interest.