

1 Financial performance

The first half of 2003 has been another period of strong performance. Further analysis is provided below:

Six months to 30 June	2003 £m	2002 £m	Change
Total turnover	722.6	625.9	15.4%
Group turnover	608.6	522.0	
Joint venture turnover	114.0	103.9	
Gross profit	83.2	71.1	16.9%
Administrative expenses	(61.8)	(50.4)	
Exceptional items (net)	(0.5)	–	
Joint venture profit	11.8	10.1	
Net Group interest	(1.4)	(2.4)	
PROFIT BEFORE GOODWILL AND TAX	31.3	28.4	10.2%
Goodwill	(4.3)	(3.9)	
Profit before tax	27.0	24.5	10.0%
Tax	(9.2)	(8.3)	
Profit after tax	17.3	16.2	
Effective tax rate	34%	34%	
Average number of shares	429.6m	414.1m	
Earnings per share before goodwill	5.15p	4.84p	6.4%
Earnings per share after goodwill	4.14p	3.91p	5.9%

1.1 Turnover

Total turnover in the six months to 30 June 2003 increased by 15.4% to £722.6m. This includes £114.0m of turnover relating to joint ventures, an increase of 9.7%. Group turnover increased by 16.6% to £608.6m.

1.2 Gross profit

Gross profit of £83.2m increased by 16.9% and represents a return on group turnover of 13.7% (2002: 13.6%).

1.3 Pre-tax profit

Pre-tax profit before goodwill amortisation increased 10.2% to £31.3m.

1.4 Exceptional items

Two exceptional items during the period result in a net charge of £0.5m.

The sale and leaseback of the remaining rolling stock belonging to our Great Southern Railway (GSR) business in Australia generated cash of £5.8m and profit of £4.0m.

We have also undertaken a fundamental review of our support office and underperforming operations, resulting in a number of redundancies, office closures and relocations. The £4.5m cost of this restructuring has been charged to the profit and loss account in the first half of the year.

1.5 Pensions costs

As disclosed in our 2002 Accounts, to address the net deficit on our UK defined benefit scheme we have increased our long term contribution rates. For 2003 we have increased our pension contribution by £9m, which is accounted for evenly over the year. Excluding this additional cost, our first half profit before goodwill and tax increased by 26%.

1.6 Tax

The tax charge of £9.2m (2002: £8.3m) represents an effective rate of 34% (2002: 34%).

1.7 Earnings per share

Earnings per share before goodwill amortisation grew by 6.4% to 5.15p. The average number of shares increase reflects the impact of a share placement in March 2002.

2 Dividends

The proposed interim dividend of 0.72p per share is a 12.5% increase on 2002.

3 Cash flow

During the six months to 30 June 2003 we generated free cash inflow of £14.2m against an outflow of £11.5m in the first six months of 2002.

This is further analysed below:

Six months to 30 June	2003 £m	2002 £m
Operating profit before exceptional item	17.1	16.8
Exceptional item: Reorganisation costs	(4.5)	–
Operating profit	12.6	16.8
Non cash items: Depreciation and goodwill	13.7	11.5
Group EBITDA	26.3	28.3
One-off pension fund contribution	–	(15.5)
Working capital movement	(10.9)	(16.6)
Operating cash flow	15.4	(3.8)
Dividends from joint ventures	4.6	6.2
Interest and taxation	(5.1)	(5.4)
Capital expenditure/disposals of assets	(7.6)	(7.9)
Exceptional item: GSR sale and leaseback	5.8	–
Other items	1.1	(0.6)
FREE CASH FLOW	14.2	(11.5)
Acquisitions/disposals	(5.3)	(3.2)
Share issues/other financing	(1.5)	116.0
Dividends paid	(6.2)	(5.5)
Net cash flow	1.2	95.8
Closing cash	70.6	60.0
Long term loans	(48.2)	(45.3)
Other loans and finance leases	(22.2)	(17.5)
Net cash/(recourse debt)	0.2	(2.8)
Non-recourse debt to fund PFI assets	(117.8)	(19.7)
Total net debt	(117.6)	(22.5)

3.1 Operating cash flow

There was an operating cash inflow for the period of £15.4m (2002: outflow of £3.8m). This converts 122% (2002: n/a) of our operating profit and 59% (2002: n/a) of Group EBITDA into cash.

3.1 *Operating cash flow (continued)*

The working capital increase of £10.9m (2002: £16.6m) reflects the continuing strong level of organic growth shown by the Group in 2003 and equates to approximately one month's incremental period on period turnover, reflecting the typical invoicing cycle of our contracts.

3.2 *Joint ventures*

Dividends received from joint ventures in the first six months of 2003 of £4.6m (2002: £6.2m) represent a 56% (2002: 88%) conversion of profit after tax of joint ventures into cash. Dividends received in 2002 included a dividend of £3.3m from a refinancing of the Joint Services Command and Staff College PFI.

3.3 *Capital expenditure*

Capital expenditure, excluding investment in PFI Special Purpose Companies (SPCs), for the six months to 30 June 2003 was £12.5m (2002: £8.2m). As a proportion of Group turnover this expenditure represents 2% and has remained at a similar level to previous years.

3.4 *Pensions*

A £15.5m pension payment in 2002 was made to assist the merger of Serco's two defined benefit schemes by achieving a similar funding level across both schemes.

Operating cash flow for the six months to 30 June 2003 includes an additional £4.5m of pension costs as a result of the increased pension funding requirement referred to in 1.5.

3.5 *Non-recourse debt*

At 30 June 2003 non-recourse loans totalled £117.8m (2002: £19.7m). These loans fund the construction and development of the Traffic Control Centre and the National Physical Laboratory.

The completion of the acquisition of our partner's share in Premier Custodial Group in July, together with the funding of the Ontario driver examination services franchise payment, will lead to additional non-recourse loans being included in our balance sheet, along with the related assets at the end of 2003.

Non-recourse debt is excluded from the Group's banking facility covenants but is consolidated on the Group's balance sheet. The corresponding asset is included within 'Debtors: amounts due after more than one year' in the balance sheet. The loans are secured on those assets held within the SPC to operate the PFI concessions and not on the assets of Serco Group.

4 **Pensions**

We continue to apply the transitional rules and disclosures of FRS 17 *Retirement Benefits*. This required the market value of assets and liabilities for defined benefit schemes to be calculated and disclosed in a note to the 2002 Group accounts. At 31 December 2002 we identified a net deficit of £74m in relation to the main UK defined benefit schemes and an asset base of approximately £295m, while the Minimum Funding Rate (MFR) funding level was 100%. While we are not required to undertake a full actuarial valuation of the scheme at 30 June 2003, it is estimated that the net deficit is approximately the same.

4 Pensions (continued)

As noted above, the two principal defined benefit schemes in the UK were merged in February 2003. The investment profile of the merged scheme will be changed such that equities will become a smaller proportion of total assets to help achieve a closer matching of the asset and liability profiles.

5 Treasury

5.1 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.

5.2 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. The US notes mature in December 2007.

At the end of June 2003 bank facilities totalled £160m, of which £50m was committed funding. The committed bank facilities mature in November 2005.

On 20 August 2003, the Group completed a private placement for £117m sourced from a number of institutions. This private placement is designed to lengthen the maturity profile of the Group's debt, with a final maturity of 12 years and an average term of 10 years. The placement will be used to refinance the debt used to acquire Premier Custodial Group and to help position the Group for future growth. The debt was issued in Sterling and US Dollars at a fixed average coupon of 5.7%. The debt issued in US Dollars has been swapped into Sterling.

6 Auditors

While there is no statutory requirement to do so, the financial statements and notes in this Interim Report have been reviewed by our auditors, Deloitte & Touche LLP. Their review conclusion is included on page 23.

7 Events after 30 June 2003

On 2 July we completed the acquisition of Wackenhut Corrections UK Limited's 50% share in Premier Custodial Group ('Premier'). Serco paid £48.6m for the shares, which represents 90% of their fair market value, as determined by independent valuation.

In the year ended 31 December 2002 Premier's turnover was £127.4m and profit before tax was £10.0m. The net assets employed in Premier at 31 December 2002 were £25.0m, which included non-recourse debt of £179.2m. Serco's share of Premier's gross assets and liabilities is included within the share of joint venture assets and liabilities shown on Serco's balance sheet. The acquisition of Premier will result in 100% of these assets and liabilities being consolidated for the second half of 2003.