Credit Opinion: Go-Ahead Group plc (The)

Global Credit Research - 11 Jul 2014

United Kingdom

Ratings

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<th>Category</th>
<th>Moody’s Rating</th>
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<td>Outlook</td>
<td>Stable</td>
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<tr>
<td>Bkd Senior Unsecured -Dom Curr</td>
<td>Baa3</td>
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Contacts

<table>
<thead>
<tr>
<th>Analyst</th>
<th>Phone</th>
</tr>
</thead>
<tbody>
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<td>Raffaella Altamura/London</td>
<td>44.20.7772.5454</td>
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<td>Neil Griffiths-Lambeth/London</td>
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<td>Monica Merli/London</td>
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Key Indicators

<table>
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<tr>
<th>Go-Ahead Group plc (The)</th>
<th>28/12/2013(LTM)</th>
<th>29/06/2013</th>
<th>30/06/2012</th>
<th>02/07/2011</th>
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</thead>
<tbody>
<tr>
<td>Revenues (GBP mln)</td>
<td>2,645.2</td>
<td>2,571.8</td>
<td>2,423.8</td>
<td>2,297.0</td>
</tr>
<tr>
<td>EBITA Margin</td>
<td>4.0%</td>
<td>3.8%</td>
<td>4.3%</td>
<td>4.7%</td>
</tr>
<tr>
<td>EBITA / Average Assets</td>
<td>8.3%</td>
<td>8.0%</td>
<td>8.9%</td>
<td>9.7%</td>
</tr>
<tr>
<td>Debt / EBITDA</td>
<td>4.2x</td>
<td>4.5x</td>
<td>4.2x</td>
<td>4.1x</td>
</tr>
<tr>
<td>EBITA Interest Coverage</td>
<td>4.0x</td>
<td>3.6x</td>
<td>3.8x</td>
<td>3.8x</td>
</tr>
<tr>
<td>FFO Interest Coverage</td>
<td>6.6x</td>
<td>5.8x</td>
<td>6.0x</td>
<td>6.5x</td>
</tr>
<tr>
<td>FFO / Debt</td>
<td>20.0%</td>
<td>16.8%</td>
<td>18.8%</td>
<td>22.9%</td>
</tr>
<tr>
<td>RCF / Net Debt</td>
<td>14.7%</td>
<td>12.2%</td>
<td>13.1%</td>
<td>19.9%</td>
</tr>
</tbody>
</table>

Note: For definitions of Moody’s most common ratio terms please see the accompanying User’s Guide.

Opinion

Rating Drivers

- Focus on the UK bus sector with a strong competitive position in the low risk but low margin regulated London bus market

- Sizeable UK rail business characterised by volatile and declining profitability mitigated by a bias towards London commuter services

- Additional cash generation from Thameslink expected to support financial profile

- Conservative corporate development strategy with modest on-balance sheet debt burden but sizeable contingent liabilities

Corporate Profile

The Go-Ahead Group plc ("Go-Ahead", rated Baa3, stable) is a listed UK-based bus and rail operator focused on the domestic market. The UK bus business comprises interests in both the regulated London bus market, where Go-Ahead is the largest operator, and the deregulated regional bus market, where Go-Ahead is one of the smaller
UK national bus companies. Go-Ahead's rail interests, which currently comprise three franchises (Southern, Southeastern and London Midland), are held through a 65% owned subsidiary, Govia, the remaining 35% being owned by Keolis (a subsidiary of the French railway operator SNCF).

Rating Rationale

Go-Ahead's Baa3 rating reflects: (i) the stable UK bus business with a strong focus on the regulated London market, characterised by low risk but also low margins; (ii) a sizeable UK rail business which has historically exhibited volatile and declining profitability, mitigated by a bias towards London commuter services; (iii) the company's conservative corporate development strategy and the modest on-balance sheet debt burden; (iv) its sizeable contingent liabilities and restricted cash balances, mainly associated with rail operations; and (v) the additional cash flows generation expected to be associated with the operation of the new Thameslink rail franchise, which will support organic growth and/or shareholder distributions.

DETAILED RATING CONSIDERATIONS

FOCUS ON THE UK BUS SECTOR WITH A STRONG COMPETITIVE POSITION IN THE LOW RISK BUT LOW MARGIN REGULATED LONDON BUS MARKET

Go-Ahead is solely concentrated on the UK domestic transportation market, having a strong historical strategic focus in London and the South East of England. The group maintains a material presence in the bus segment, which incorporates both a regulated London bus business, where Go-Ahead is the market leader, and an unregulated regional UK business, where Go-ahead is one of the smaller operators. Although the London bus segment had historically been the more significant generator of the group's operating profit (40% of total as of H1 2014), the two are now more balanced (UK bus regional activities accounted for 39% of operating profit as of H1 2014).

Go-Ahead's London bus operations are subject to regulation. The city's transport authority, Transport for London, bears the revenue and volume risk and agrees to pay Go-ahead a specified sum per mile to provide the specified service for a specified period (typically five years plus a two-year extension, if performance targets are met). Contract terms vary depending on how competitive contract tendering is. Given the lack of exposure to variations in passenger volumes, London bus activities generally exhibit stable revenues and relatively low margins and focus on cost control and contract retention rates are therefore critical to support profitability. Go-Ahead's established track record in the segment and the fact that it owns around 85% of its London depots capacity on a freehold basis help to protect its market share upon contract renewal, but competitive pressures in the London bus market are strong and could cause margin pressure going forward.

Go-Ahead's regional bus services are predominantly focused within a number of urban areas in the South of England. Regional bus operations are fully deregulated and, generally, Go-Ahead maintains the flexibility to set its own fares and timetables and withdraw unprofitable services. Given the nature of the segment, a balanced management of service frequency and fare levels, in conjunction with focus on costs, are key in terms of driving cash flows generation. Go-Ahead has historically added to this business through small bolt on acquisitions which have increased revenues and cash flows. The bus business has evidenced an element of counter-cyclicality in recent difficult economic circumstances and cost pressures have been reasonably well managed, but some margin pressure has been evident.

Although the UK bus market outside London is generally deregulated, a material portion of revenues is received from local authorities by way of statutory concessionary fares, whereby local authorities reimburse a percentage of the full fare to bus operators for each journey taken by elderly or disabled passengers. Local authorities may also provide support for concessionary fares outside of the statutory system. In addition, bus operators may operate tendered services on behalf of, and supported by, local authorities, where provision of such services would not be economically viable for a commercial bus operator.

Concessionary revenues represent approximately 20% of Go-Ahead's regional bus revenues. In addition, a further 10% of regional bus revenues is received from local authorities in respect of tendered services. Over the past few years, there has been a progressive revision of the level of support towards the bus sector in the UK. In Moody's view, revisions to support levels pose one of the most significant risks for the sector, in light of local authorities' budget constraints and, more generally, the political risk and sensitivity associated with the concessionary fares system. Moody's notes the recent materialisation of these risks for Go-Ahead in North East England, where the local transport authority is considering the future shape of bus services in the area, including a potential reduction in concessionary fares or the implementation of a bus system more in line with the London framework, whereby bus operators do not retain revenue risk, thus leading to a potential compression in profitability. Moody's notes that
Go-Ahead generates approximately 10% of its operating profit in the area.

SIZEABLE UK RAIL BUSINESS CHARACTERISED BY VOLATILE AND DECLINING PROFITABILITY MITIGATED BY A BIAS TOWARDS LONDON COMMUTER SERVICES

Go-Ahead is one of the largest players in the UK rail segment and owns three train operating companies (TOCs) providing rail services into London (the Southern franchise, the Southeastern franchise and the London Midland franchise). In common with the other operators in the UK rail industry, Go-Ahead has experienced volatile and declining margins as franchise-bid revenue forecasts have not been met in certain cases. Nevertheless, the characteristics of each of the Go-Ahead TOCs has helped to mitigate the full effect of this trend. Given that Go-Ahead has a somewhat concentrated geographical exposure, London’s economic prospects significantly affect Go-Ahead’s own. Nevertheless, London’s economy remains among the most robust in Europe. The geographic location of its rail activities means that Go-Ahead is dependent on commuter traffic trends, which Moody’s considers to be more reliable and less volatile over the longer term than those of leisure or business traffic. More generally, the regulated commuter fare revenue is less volatile in terms of prices obtained for services delivered.

The Southeastern franchise runs through to October 2014 and is likely, in Moody’s view, to be extended to June 2018 in some form agreed with the Department for Transport (DfT), after which a new franchise is expected to be awarded following a competitive tender. This franchise has benefited from a revenue support mechanism since April 2010, which provides for payments from the UK Government to compensate for some loss of revenue (so called revenue support), which reduces revenue risk materially. Nevertheless, the declining subsidy profile will pressure profitability given that fare revenue growth, albeit good, is unlikely to keep pace with the declining subsidy profile.

The newest franchise is the Southern franchise (successfully retained by Go-Ahead in September 2009), and in common with other franchises awarded around that time, revenue growth assumptions had assumed a better economic environment than has proved to be the case. In fact, passenger volumes have declined. Revenue support on this franchise started in April 2014, which mitigated declining profits, but overall the franchise exhibits weak profitability. This franchise will terminate in July 2015 when it will be incorporated into the larger Thameslink franchise (see below).

The London Midland franchise, which commenced in November 2007 and runs through to September 2015 (although expected to be extended to June 2017 in some form agreed with the DfT, after which a new franchise is expected to be awarded following a competitive tender), is smaller and has a modestly declining subsidy profile which implies that small revenue growth was anticipated in this franchise. In fact, actual revenue earned has been fairly close to bid assumptions. Nevertheless, the franchise has had its problems, as it has a high cost base and suffered from industrial action in the past. However, management has taken remedial action and the franchise has now returned to profitability.

Overall, Moody’s believes that the UK rail business is exposed to greater downside risks than the Go-Ahead UK bus business. However, Moody’s expects that the visibility associated with rail operations will somewhat improve in the context of the ongoing re-franchising process and that, given its material presence in the segment, Go-Ahead is well positioned to take advantage of this trend.

ADDITIONAL CASH GENERATION FROM THAMESLINK EXPECTED TO SUPPORT FINANCIAL PROFILE

In May 2014, the DfT awarded the seven-year management contract for the Thameslink rail franchise to Go-Ahead. The Thameslink franchise management contract combines several existing rail franchises: the Thameslink services connecting Bedford with central London, Gatwick Airport and Brighton; Great Northern services from London King’s Cross to Cambridge; and Southern services from London to the south coast. Go-Ahead currently runs the Southern franchise, while FirstGroup plc (unrated) currently runs the Thameslink and Great Northern franchises. Go-Ahead will assume the combined franchise on 14 September 2014.

The DfT, which will collect revenues over the life of the franchise and retain full revenue risk, will transfer franchise payments that Go-Ahead estimates will total GBP8.9 billion over the life of the franchise to cover operating costs, plus approximately a 3% margin over the franchise term (4% when excluding the non-cash effect of applying IAS 19). Assuming the delivery of targeted margins, the operation of the Thameslink franchise is expected to result in additional cash flows, thus underpinning Go-Ahead’s financial position and increase the company’s ability to support future shareholders distributions and/or the growth of its core businesses.

Given that the DfT retains Thameslink’s revenue risk, Go-Ahead’s rail operations’ risk profile will decrease compared with the current framework. Go-Ahead’s main risk from the Thameslink franchise is from cost
increases: franchise payments covering operating costs are contracted at 30 September 2014 prices and only rise based on the Retail Price Index thereafter. Any adverse deviation in actual costs from the estimates at the time of the bid are therefore at the operator's risk and would decrease its profitability. This risk is mitigated by Go-Ahead's expertise and track record in the sector.

CONSERVATIVE CORPORATE DEVELOPMENT STRATEGY WITH MODEST ON-BALANCE SHEET DEBT BURDEN BUT SIZEABLE CONTINGENT LIABILITIES

Go-Ahead has historically maintained a conservative approach to acquisitions, preferring to concentrate on developing its UK operations through organic growth. Opportunities for acquiring UK regional and London bus companies are pursued but these have historically been of modest size. Moody's expects Go-Ahead to target other UK rail interests in the future and, more generally, explore additional opportunities in its core businesses, also in light of the additional cash flows generation expected to derive from the operation of the Thameslink rail franchise.

Go-Ahead currently has a moderate amount of on balance sheet debt (approximately GBP330 million of debt and finance leasing obligations as at December 2013), a result of its policy of largely organic growth, but previous share buy-back strategy.

In the context of Go-Ahead's debt position, and given the terms of the franchise obligations, Moody's does not treat the operating lease charges for the TOCs rolling stock as debt equivalents when calculating financial metrics, but treats the cash charges pertaining thereto as operating expenditure. However, Moody's treats the contingent liabilities that Go-Ahead has to support the TOCs obligations as debt equivalents. Moody's believes this gives a more accurate measure of the true debt burden of Go-Ahead. In addition, a relatively material portion of Go Ahead's cash balances is restricted.

Structural Considerations

The bonds issued by Go-Ahead are rated Baa3, reflecting the senior unsecured nature of the rated debt and the fact that the bonds benefit from guarantees from the following Go-Ahead group companies: (i) Go-Ahead Holding Limited; (ii) Go-Ahead Leasing Limited; (iii) Go North East Limited; (iv) London General Transport Services Limited; (v) Metrobus Limited; (vi) Go South Coast Limited; (vii) Brighton & Hove Bus and Coach Company Limited; and (viii) City of Oxford Motor Services Limited. The provision of these guarantees ensures that the holders of the bonds are not structurally subordinated to providers of the current bank loan facilities to the Go-Ahead group and are an important factor in the current rating.

Liquidity

The liquidity profile of the group is good, underpinned by expected reasonably stable cash flows and access to committed bank credit facilities. As at March 2014, Go-Ahead had undrawn committed banking facilities available of GBP170 million and unrestricted cash of approximately GBP47 million.

The main source of standby liquidity is the GBP275 million medium-term syndicated revolving credit facility due in February 2016 (GBP105 million drawn). This facility contains performance covenants (both a Net Debt to EBITDA covenant and EBITDA to net interest payable covenant). Moody's understands that Go-Ahead is in compliance with these covenants. Nevertheless, the facility is subject to a MAC clause, whereby any material adverse effect on the group as a whole would cause an event of default under the facility.

Over the next 12 months, the group is expected to generate reasonable operating cash flow, enabling the group to fund its capital expenditure programme and meet those contractual debt maturities within the period, which are modest bank loan and leasing facility repayments.

Rating Outlook

Go-Ahead is reasonably well positioned within its rating category and the stable outlook on the rating reflects the expectation that the company will exhibit a financial profile comfortably aligned with Moody's guidance for the rating, which includes retained cash flow (RCF)/net debt of between 15% and 20% and funds from operations (FFO) interest cover in the range 4.0x-5.0x times.

What Could Change the Rating - Up

A rating upgrade could result from Go Ahead's credit metrics improving to a level consistently above the range for the current rating, namely RCF/net debt comfortably over 15% and FFO interest cover of over 5.0x times.
What Could Change the Rating - Down

Downward rating pressure would develop if Go Ahead's credit metrics were to deteriorate to a level consistently below the range for the current rating level, namely RCF/net debt of less than 10% and FFO interest cover of less than 4.0x times.
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