Company Name: ISS
Company Ticker: ISS DC
Date: 2018-08-16
Event Description: S1 2018 Earnings Call

Market Cap: 40,401.41
Current PX: 217.6
YTD Change($): -22.7
YTD Change(%): -9.447

Bloomberg Estimates - EPS
Current Quarter: 4.276
Current Year: 14.449
Bloomberg Estimates - Sales
Current Quarter: 19888.857
Current Year: 79567.333

S1 2018 Earnings Call

Company Participants

- Unidentified Speaker
- Jeff Gravenhorst, Chief Executive Officer
- Pierre-Francois Riolacci, Chief Financial Officer

Other Participants

- Srinivasa Raju Sarikonda, Analyst
- Bilal Aziz, Analyst
- Paul Jessen, Analyst
- Unidentified Participant
- James Winckler, Analyst

Presentation

Unidentified Speaker

Ladies and gentlemen, this is Martin Hansen, Head of Investor Relations at ISS and I'd like to welcome you to our Results Teleconference Call. Please be aware that the announcement, the report as well as the slides used for this call can be found on our website. Later today, a replay will also be available and we will post a transcript of the call as soon as it's ready as well.

I'd like to draw your attention to slide number two regarding forward-looking statements. Presenting today will be our Group CEO, Jeff Gravenhorst; and Group CFO, Pierre-Francois Riolacci. We'll open up for Q&A at the end of the presentation, and in this respect, I request that you ask one question each at a time. If you have further questions, please queue-up again.

With that, I'll hand over to Jeff.

Jeff Gravenhorst, Chief Executive Officer

Thank you, Martin, and good morning, everyone. If we start with our financial highlights, total revenue growth of second quarter was minus 1.6%. This was due to another quarter with significant currency headwinds of 4.4% or negative revenue impact of almost DKK900 million in the quarter. Organic growth ended up somewhat better than expected at 3.2%, driven by strong commercial momentum, as well as demand for non-portfolio in general.

The operating margin was 3.8% in the second quarter, down 0.6 percentage points. This includes a negative 5 basis points impact from currency appreciations and divestments. As such, the margin decline was similar to Q1, in line with out expectations as communicated in May. Cash conversion ended up strong at 97% as a result of strong cash flow performance across the Group, as well as timing of collections and payments. Net profit adjusted was DKK407 million, a reduction compared to the second quarter '17, driven mainly by a write down of discontinued operations in Argentina and Uruguay.

Net profit reported was a loss of DKK315 million in the second quarter compared to a profit of DKK395 million second quarter last year, a reduction, driven by a 638 million goodwill impairment linked to a remeasurement of business classified as held for sale, mainly in the Netherlands.

Net debt ended at 14.3 billion, it's down from DKK14.7 billion a year ago. However, our leverage increased 0.1 turn over the same period from 2.8 times in Q2 '17 to 2.9 times in Q2 '18. While second quarter is always seasonally higher and leverage currently is above our leverage target of 2.5 times, we will be within our leverage target during the course of second half.

In any case, let me stress that we are committed to maintain the nominal ordinary dividend that's at least equal to the DKK7.7 per share this year.

Turning to some of the recent commercial highlights, we continue to see growth with key accounts, which now represents 53% of our total revenue. Global key accounts grew by 1% in constant currency in the first half. In other words, growth within existing global key accounts and the launch of LEGO and the unnamed client within food and beverage segment more than outweighed the ramp down of DXC, HPI and the EMEA region with an international bank. Given the circumstances, I think that we could be very pleased with this.

Integrated Facility Services grew 9% in constant currency in the first half of 2018 and now represents 39% of our total revenue. In addition to growth from global key accounts, growth was driven by local key account customers such as MTR in Hong Kong, Adana and Kayseri hospitals in Turkey, ABB in APAC and the expansion of the Danish Defense contract in Denmark.

Commercial momentum continues to be strong and recent wins during the second quarter includes Aviva in the UK, and two new hospitals in Turkey, Ernst & Young in Netherlands and Victoria Schools covering more than 200 schools around Melbourne in Australia.

In terms of strategic highlights in the second quarter, we launched further cost cutting initiatives enabling -- enabled by standardization and simplification of country organizations through GREAT. Our focus would be on overhead cost through consolidation, centralization and automation. We have started to incur costs and expect to see early benefits from the fourth quarter this year.

Separately, with the acquisitions of SIGNAL in February 2017, a global center of excellence for strategic workplace management and design at ISS was established. Over the last year, SIGNAL has managed a number of high profile projects. As a consequence of the growing demand for workplace management and design, we earlier this week opened an additional SIGNAL office in the UK.

Implementation of GREAT in France is going according to plan and as a natural extension of this process, we recently entered into exclusive discussions to divest non-core hygiene and prevention activities in France. In the Netherlands, we're also in active negotiation with a couple of interested buyers to divest certain non-core activities in order to sharpen our focus on key accounts.

With this, I would like to turn to slide five for regional update. Continental Europe delivered a solid 5% organic growth in the second quarter, a further improvement from 3% organic growth in the first quarter. Growth was among the -- one among others, driven by remarkable strong volume growth in Turkey, driven especially by the healthcare sector as price increases on the back of wage inflation also supported organic growth locally. As a result, our Danish kroner revenue in Turkey is growing high single-digit.

Growth in the region was also supported by contract launches in especially Germany and Austria, and we continue to see solid demand from non-portfolio work across several countries in the region. As such, growth in Continental Europe improved despite further ramp down of DXC Technology and the International Bank in EMEA, very pleasing indeed.

The Continental Europe operating margin ended at 5.8%. We continue to see strong margin performance across many countries in this region. However, the region continues to be impacted by large key account contract phasing in and out, as well as underperformance in Netherlands, which we are firmly addressing and we'll get back to that in a few slides.

The implementation of GREAT in France is on track, and in less than a year from now, Deutsche Telekom will be launched. As in all, solid underlying performance across most parts of this region.

In Northern Europe, organic growth was flat. All countries though in the region delivered positive organic growth, except for the UK, as expected. Growth was particularly strong in Denmark, driven by non-portfolio demand, as well as contract launches such as the Danish Defense and LEGO.

In the UK, solid underlying organic growth was more than offset by the revenue reduction from DXC Technology, HP Inc., and the EMEA region with the international bank and the UK Ministry of Defence. Excluding these losses, the bulk of the UK operation continued to deliver a solid performance, both in terms of organic growth, margins and commercial momentum in general. As these few but large losses annualize, the solid underlying performance will become visible.

The operating margin was 5.6%. Again, year-over-year reduction was materially impacted by large key account contracts phasing in and out, especially in the UK and in Denmark for reasons just mentioned. In addition, we continue to invest in our technical services capability across the region, which is initially a drag on margins.

As expected, underperformance in Sweden continued in the second quarter. Organic growth and margin development was broadly flat year-over-year. The turnaround plan in Sweden is being executed according to plan, but it's now clear that some of the benefits previously expected to gradually kick in during the second half of '18 will be delayed into 2019.

The part of the turnaround plan that has to do with cost, is largely been finalized with cost savings as expected. Part of these savings are currently being reinvested in upgrading our technical services and commercial capabilities to help get commercial momentum going again. While we have come second place in a number of significant local opportunities, we have not made it over the finish line. We have been up against various competitors, but importantly, it is our view that it no longer has to do with our cost base or our pricing. With the investments and the upgraded commercial organization, we are confident that the momentum will start to turn.

Finally, the Swedish Government has yet to change practice in terms of the current subsidizing of the state-owned competitor as required following an EU ruling earlier this year. While the delay is clearly disappointing, we remain confident that the market is there and that ISS Sweden would get back on track.

Please turn to slide six. Organic growth in Asia Pacific was also 5%, mainly driven by Australia, Hong Kong, India and Indonesia. In Australia, we continued to benefit from record high retention rate and a significant number of local key wins. In addition, growth was supported by launch of MTR contract in Hong Kong, as well as ABB across several countries in APAC. Growth was partly offset by revenue reduction from DXC Technology and HP Inc., as well as our structural adjustments within retail sector in China.

The operating margin in Asia Pacific was 6.3%, thereby, delivering the highest margin of all regions in the second quarter as usual. However, it was a decline of 0.8 percentage point compared to the last year, which was to a large extent driven by contracts phasing in and out. In addition, the margin was impacted by performance in Indonesia and expected normalization of margins in Singapore and our structural adjustments in China. This was partly offset by solid performance in especially Hong Kong.

Organic growth in the Americas was solid 5% as well, which is a pickup from 4% in the first quarter. As a side note, the currency impact on revenue in the region was a negative 9% in the quarter, led by the development in the US dollar. Organic growth was mainly driven by Guckenheimer, delivering more than 20% organic growth where revenue synergies from in-sourcing of catering contracts continued to come through, as well as successful new sales to new and existing Guckenheimer clients. In addition, especially Chile, continues to deliver solid growth. The 5% organic growth came through despite revenue reductions from DXC Technology and HP Inc., as well as the limited new sales in Brazil.

The Americas operating margin ended at 2.6 percentage points, down from 3.6% last year. Performance was mainly driven by contracts phasing in and out, as well as performance and one-offs in Brazil. However, the solid underlying improvement from Guckenheimer delivering margin above 5%, driven by synergies coming through.

As expected, the second quarter margins remains impacted by operation challenges in the specialized services division in North America, where turnaround initiatives are progressing according to plan. The first step of the plan executed in the first half was to exit loss-making contracts equivalent to an annual revenue of approximately DKK40 million. The second step is to exit or renegotiate low margin contracts during the second quarter.

Reducing our exposure to small clients also enabled us to adjust our cost base at both country level and within specialized services specifically. Among others, we are reducing the number of branches from currently 30 to around five to 10. Together, these are some of the initiatives will support the margin improvements in North America, especially in the fourth quarter.

Please turn to slide eight for a brief update on the recent commercial development. I'm very pleased with our commercial momentum evidenced by another quarter of solid wins. This slide provides details on more material ones. I will not go through all of them in details, but just mention that Ernst & Young in the Netherlands is a great example of how strong key account capabilities locally in the Netherlands combined with our track record with Ernst & Young in both Denmark and in the UK, ultimately led to further expansion of this client in an additional country. And the development of the healthcare segment in Turkey is a good example of how we are able to capitalize on the expertise and the reputation we've built within healthcare segment globally, and recently, also locally by leveraging existing strong capabilities across borders.

Both examples illustrate some of the commercial and operational benefits of being an international service provider. The combined annual portfolio value of these five key contract wins amounts to approximately DKK500 million. In addition to these significant local key account wins, we also continue to see strong demand for large international IFS contracts such as LEGO, which was won earlier this year.

Please turn to slide nine. We continue to see demand for large international and local integrated facility services contracts and we are well advanced in building capabilities to serve this market. While this slide has an international focus, I would like to highlight that contracts don't necessarily need to be global to be large and attractive. Deutsche Telekom, the Danish Defense and the hospitals contracts in Turkey are very good examples of this.

ISS was a first mover when we identified the emerging demands for self-delivered and bundled solutions and decided to refine our strategic direction accordingly Through the years, I believe, we have found the right balance between being capable of winning and operating large international contracts, yet keeping a strong focus on the individual service lines.

Today, we are not only the world's largest cleaning company, we are also the world's 5th largest contract caterer and one of the world's largest companies within most of our service lines. Through this, we not only realize scale benefits within the service lines, but in addition, we are able to generate efficiencies through integration between the service lines.

As such, we are a global leader of self-delivered integrated facility services and we continue to see strong demand for international contracts as exemplified by existing global key accounts, as well as the 10 most recent global key account request for proposals.

On practical speaking, all existing global key accounts as well as all 10 RFPs facilities management and support, cleaning, property services were in scope, most also had an element of catering and/or security.

As a final remark and as illustrated by the revenue split across services, it is clear that technical services is the key service line. This is one of the reasons why we are currently investing in building our technical service capabilities. You may also note that catering has made up a somewhat lower percentage of global key account revenue until now. This is a consequence of two things, catering is not always a part of IFS solutions.

Services which tend to be bundled first is the facilities management support, the cleaning and the property services, and often, but -- not often, but sometimes a little later catering and security is added. In reality, it's down to the individual customer and the individual customer segment. Services delivered to current global key account is an illustration of this.

In addition, we have also recently had a self-delivery white spot within catering in North America, which is a key region for many of our global key accounts, a white spot, which has now been closed. In summary, we are confident that our strategy is the right one and that the market potential is huge. As such, we continue to take steps to shape the asset base according to the ISS Way strategy.

Please turn to slide 10. We cannot be everything to everybody everywhere, and as such, we continue to sharpen our focus and reinvest where we can create most value for our customers and where we are already among the strongest players in the industry. As you know, the ISS Way strategy has choice making at its call, choices related to customers, to services and to geographies.

We've taken a number of important steps to shape the business, so in terms of which customers we want to serve. We continue to take steps to become a predominantly key account focused business. We've been impacted by organically exiting non-core activities in parts of Brazil and China in order to sharpen our focus on key account customers locally. And as part of the turnaround plan in North America, we started to trim our portfolio of contracts in the underperforming specialized services division as covered earlier.

Finally, we are in the process of divesting certain non-core activities in the Netherlands, activities that have been underperforming for a number of years. Implementing -- implementation of the GREAT sales structure in Netherlands in 2017 significantly improved visibility and understanding of key challenges which we now are addressing. Performance in the key account organization remains solid as evidenced by our recent wins of Ernst & Young, and as part of winning the international food and beverage client.

However, performance in the non-core business unit have lately deteriorated further. We are in active negotiation with a couple of potential buyers and expect the divestments to close during the fourth quarter of 2018.

In terms of which services we want to provide, we've continued to divest services, which are not suitable for integration and in many cases, services which are more root based in nature. During the last year, we have divested landscaping activities in the UK and as a natural consequence of the implementation of GREAT in France, we are in the process of divesting our hygiene and prevention activities.

Instead we have eliminated our most significant self-delivery white spot within catering with the acquisition of Guckenheimer in North America and invested in our technical services capability through a mix of organically building our capabilities combined with selective acquisitions such as GS Hall in the UK and Evantec Germany.

Finally, in terms of which geographies we want to operate in, we are divesting activities in Greece, Argentina and Uruguay, countries where market conditions are difficult, which has the insignificant locations for most of our International key accounts and where the local markets is still too immature to fully embrace the IFS model. So, in summary, our transformation under the ISS Way strategy will continue to make a stronger and more focused business.

And with this, I would like to handover to Pierre to cover the financial performance in more details. Please turn to slide 12.

Pierre-Francois Riolacci, Chief Financial Officer

Thank you, Jeff, and good morning, everyone. And maybe before we jump into the second quarter organic growth waterfall, I think, it's worth to put performance into perspective. And as you can see, ISS has a very long track record of solid and resilient organic growth throughout the cycle. During the last 25 years just one year was negative in organic growth in 2003.

For sure 2017 and 2018 are both big transition years with unusually sizable contract term, but we're glad to see that '18 is now catching up with the long term average at 3.2%. It will be supported further by the launch of Deutsche Telekom in the 2019. So we are all set to enter into a couple of years with above leverage organic growth. And in the medium term perspective, we're also confident that our strengthening key accounts focus will enable us to capture higher organic growth.

Please go to slide 13 to look a bit closer to Q2. So you're familiar with the format now and you see that we adjust Q2 '17 for currency and acquisition divestments. By the way, it is worth noting that we face a very strong negative currency impact of DKK854 million, and that gives us an adjusted Q2 revenue base in '17 of DKK19.1 billion. Out of this, organic growth for the quarter was plus 3.2%, broadly in line with the first quarter. The combined impact of the loss of HPI, DXC and the EMEA region of international bank is increasing as expected from Q1 to Q2 to minus 2.3%, getting close to the full annualized impact, still expected to be around 2.5%. For Q3, that's where we expect to be -- before the impact starts to annualize from the last quarter of the year.

In terms of non-portfolio revenue, it was clearly another good surprise this quarter, with a strong quarter contribution of plus 1.4 percentage point to Group organic growth, supported by all four regions as well as our global key accounts. When you look forward, you should not forget that we have a strong and demanding comparison from H2 2017, which was impacted by significant floating revenues related to project work.

The thing also is the momentum that we have in the rest of our portfolio business, which is strong and contributed to 4.2 percentage point in Group growth, up compared to the 3.3 that we had in Q1. We are pleased that within organic growth was among others driven by the roll out of our new IFS contacts, such as (inaudible). And as we go into Q3, you should also remember that while we still continue to have a solid list of new contracts ramping up and launched, we have also a few large contracts that have now been up and running for a year and as such, they will no longer contribute to organic growth. The most significant one to note, of course, is Shire which was announced from June 2017 with an annualized organic growth impact of about 1% -- percentage point.

So in summary, our commercial momentum remains encouraging and given our performance in H1, we may end up delivering a full year organic growth in the high end of our outlook of 1.5% to 3.5%.

Please go to slide 14 to talk about margins. Same as that for organic growth, it's worth to put some -- to put our short term margin performance into perspective before looking at the quarter. Again, we have a long track record of very stable margins within a tight range of about 40 basis points from top to bottom over the last decade.

For sure, we are currently facing a number of short term headwinds, but we are confident that none of them are actually structural, holding that ISS will remain a stable margin business with an upside, of course, relative to current performance.

If you go to page 15, to the -- again this waterfall you are used to. First, and once again, I would like to highlight that we face a material negative impact from Forex on the absolute level of operating profit. So, it does decrease our operating profit. Of course, not necessarily in terms of margins, but in terms of nominal amount.

Of the year over year decline of DKK130 million, DKK52 million was driven purely by currency headwinds and conversion. Now if we adjust for 5 basis points in terms of margin from Forex and M&A, second quarter operating margin declined year-on-year by 52 basis points, in line with expectation communicated in May.

Jeff has already covered all the regions, so I will try to look in another way and give you some insight on the key drivers of the margin drop. First, I would like to highlight that year-on-year the one-off impacts that we have in margin are neutral -- slightly positive, about DKK40 million, but they are neutral quarter-after-quarter.

Similar to Q1, the majority of the Group margin decline in the second quarter was actually related to the current unusually high level of large key account contracts phasing in and phasing out also being extended. The impact is actually spread over four regions, but it is particularly tough in the UK, in Australia and in the US, and to a large extent it does explain the drop in operating profit in these respective regions.

Of course, in addition, the margin is also currently impacted by the underperformance in a couple of none key accounts business unit, United States, Sweden and Netherlands, and also the exit of our non-key account unit in China. That's the second big part. Then we should add that the margin is also impacted by investments in building out of technical services footprint, especially in Northern Europe.

Clearly, the uncertainty around short term performance in the Netherlands was one of the factor that led us to indicate that the operating margin decline could be similar to what it was in Q1, a risk that ended up materializing with an impact on Group margins in Q2 of about 10 bps.

That's it for the key drivers. As a side note, you may remember that Continental Europe in second quarter of last year benefited from a decreased pension obligation secured on the back of reduced interest rate. As a result of successfully being able to carry out a similar initiative in Q2 2018 again, the year-over-year impact is neutral and for the Group as a whole, one-off impact on the margin development in Q2 versus last year, as I mentioned earlier, was also broadly neutral.

In addition to this one-off I just mentioned, we have also some phasing impact which were negative in H1 and they do not help us clearly in H1, but we expect them to be more positive towards the end of the year. And of course, as they are phasing, they would be broadly neutral for the year taken as a whole.

Final point in terms of corporate costs, the reduction is partly driven by timing, partly by good procurement savings and partly by the fact that we are starting to see the benefit of certain cost savings at Group level, which is expected actually to take corporate costs relative to revenues to approximately 0.7% for the year, down from 0.8% last year.

Please note that the corporate cost in Q3 '17 was already somewhat below the run rate at the time, and as such, you should not extrapolate the year-over-year savings into Q3, but we expect to see some of these savings coming back in Q4 2018.

So to make a long story short, margin performance in the quarter at Group level was in line with our communication in May. And overall, the first half is in line actually with our initial expectation when going into the year. As such, we see no need to change the outlook for the year.

Please go to page 16 to give you some more flavor about our margin development in H2. Before we go into these details around the expected shape of margin recovery during H2, I would like to stress a couple of points. One, we do not see an overall pressure on margins. For sure, competition is high, but this is not new. And two, we continue to see underlying operational improvements, driven by a strengthening key account focus and by the implementation of GREAT locally and by our procurement savings across the Group.

These initiative were key drivers of reported margin uptick during 2014 up to the first half of last year. And while reported margins during the last four quarters have been impacted by these short-term headwinds I mentioned, the underlying improvements have continued to come through and will eventually start to become visible again on reported margins.

It is clear for us that the a short-term headwinds have in fact peaked in H1 2018 and that performance will gradually turnaround during the second half. Unfortunately, it is also clear that we are facing a delayed turnaround in Sweden and the underperformance in the non-core business unit classified as held-for-sale in the Netherlands. On that latter, we expect divestment to complete during Q4 2018, which would benefit margins in the last months of the year.

Still, of course, we see very strong drivers improving profitability during H2 2018. We see our productivity plans developing well and many business units are improving their margins on the back of our key account strategy according to plan. That's the underlying improvement. Also the margin impact from Fx and M&A is currently set to be broadly neutral for the year, which means that with a headwind of 6 bps in H1, the average impact for H2 is set to become a tailwind of about 5 bps. So the delta H1 to H2 positive 10 bps.

Then, as expected, the impact from large contracts phasing in and out will now start to ease. The number of large launches are moving closer to run rate margins. And in addition, the loss of DXC Technology will start to annualize from Q4. We have good visibility on this phasing. Also, as expected, the turnaround in North America is being executed according to plan, with visible improvement expected to be seen from Q4 2018, driven among others by a simplification of the organizational structure and contract trimming of the legacy business as covered by Jeff a few minutes ago.

In addition, we have launched since Q4 last year, further consolidation, centralization, automation initiatives targeting overhead costs, which are enabled by the standardization and simplification of country organization through GREAT. This initiative are focused in part of Northern Europe, as well as Group level. And of course, depending on the initial success this initiative may spread to other countries.

We have so far incurred mainly costs both in operating profit before other expenses and income, but also in restructuring, but these benefits I expect that to start materializing before year end during H2. Some improvements will be run rate improvements, some will more be related to phasing during the year and as such, not all the improvement of margin expected in Q4 will be run rate. And in the same way, our low margin in H1, are not going run rate either.

So, in summary, we are confident that headwinds have peaked in H1. We are confident that Q3 will be the last quarter of declining margins and less than H1. And we are confident that reported margin will show strong recovery in Q4. On that last point, please remember that Q4 margins last year were down 35 bps compared to the year before, and of course, we are supported, helped by a comparison basis, which is a bit easier.

Based on the margin recovery in H2, we keep our guidance of margins around 5.6% and change, meaning 5.5 to 5.7 range, and to be very candid, more likely to be below 5.6 than above, with an expected recovery towards the end of the year. As of note, on run rate, the scene is set for a decent 2019.

I suggest we move to page 17 to look at the other lines of the P&L, which by the way are still impacted by the Forex conversion on revenues. It goes all through to the very bottom line. On the other income and expense line, which is a charge of 70 million, it's mainly the 650 million of restructuring projects, mainly related to the continued implementation of GREAT predominantly in France and Sweden, which together amounted to approximately 40 million in Q2 and 180 million for the first half.

If we take an updated view on the year as a whole, we have previously communicated that we expect the GREAT related restructuring in France and Sweden to be around 300 million for full year. We are comfortable with that number. In addition, there will always be a sort of co-restructuring [ph] charge, could be within DKK100 million, DKK150 million as we see over here. And finally, there can always be a gain or loss on the divestments, including the restructuring impact of the divestment and with a couple of divestment on the agenda it cannot be ruled out that there will be a little there, if nothing really material.

On the financial income and expenses, minus 159 million. They have increased by DKK21 million. Adjusted from the Forex impact which explains 5 million of the year over year change. This deterioration of financial income and expense is about DKK60 million. It is s driven by two things. First, it comes from last year refinancing where further euro debt was looked into fixed rate for longer maturities; and two, it is linked to the acquisition of Guckenheimer, with also some slightly higher interest from a greater part of our debt effectively denominated in US Dollar and carrying a variable interest which has increased over the last few months.

For the same reasons and as previously communicated, we expect financial income and expense for the full year 2018 to be higher than 2017. We expect this full year amount to be around DKK550 million excluding potential Forex, which again was a negative 18 million in H1.

On the tax side, second quarter ETR, effective tax rate, is 26%, which is slightly higher than the 24.5 that we had in the second quarter in '17. This year-on-year increase is driven by certain negative one-off in Q2 '18, and we had also some positive one-off in Q2 '17 where we had some non-taxable gains on divestments. The underlying effective tax rate is actually coming down gently and is expected to be around 25% going forward, will hover [ph] around 26. So we expect actually that given where we ended in H1, that full year 2018 should end up between 25% and 26%.

The adjusted net profit from continuing operation is DKK533 million in the second quarter, down from 554 in the second quarter last year. So reduction of 21 million of discontinued business. The decline was mainly driven by negative currency impacts and also the operating performance, partly outweighed by lower other income and expenses net.

The adjusted net profit is 407 million in second quarter compared to 510 million last year, a reduction of about 100 million, mainly driven by a write-down of discontinued operation in Argentina and Uruguay, on the back of a fair value adjustments. The divestment is expected to be completed by year-end and is now fully covered. As you know, this is a line on which approximately 50% ordinary dividend payout is based so it's very important line.

As a result, the adjusted net profit is currently impacted by a number of one-offs and non-cash impact, which are not reflective of the underlying earnings power of the business. So as such. I would like to highlight that we are committed to adjust the payout ratio if required to maintain the 2018 ordinary dividend paid in 2019, at least, equal to the DKK7.7 per share paid this year.

On the reported net profit, it is a loss of DKK315 million in Q2 compared to a profit of 395 last year, down 700 million. And the main driver, of course, is an impairment of goodwill of 638 million, as a chunk of it coming from Netherlands. This Netherlands goodwill adjustment for a large part is not linked to the deterioration of trading, but to the decision to sell part of the business that triggers a separate valuation testing based on different methodology with two units instead of one.

Please go to slide 18 for the cash flow. Total cash generated by operation is down at DKK1.028 billion, it does reflect while a bit less decrease in operating profit, again, driven by the mix of currency headwinds on one side and operating performance on the other side. On the changes in working capital, as you can see that the last 12 months cash conversion remains quite strong at 97%, which is definitely tracking above our outlook for the year to be above 90%, cannot commit we will deliver that level, but it's very good that we are at 97 at mid-year.

When you look at the valuation itself and the cash inflow/outflow, it is impacted, of course, by the timing of collections and payments, and bear in mind that the change in working capital is also including for the quarter DKK36 million in transition and mobilization costs related to Deutsche Telekom.

The other expenses paid, 71 million, are driven by restructuring projects, mainly in France and Sweden. On the income tax side, our tax payment actually slightly lower than last year and this is on the back of timing. We continue to see a good management of our cash tax with effective cash tax rate converging in the long run with effective tax rate in P&L.

On the investment side, cash flow from investing activities, capital expenditures are running at 1.3% of revenues in the second quarter, 1.2481. It's going to the high end of the long term range, 0.9 to 1.4 as expected. There is actually no Deutsche Telekom related CapEx in Q2, there maybe in H2. For the full year 2018, capital expenditure is likely to remain at the high end of the historical range, driven among others by transition and mobilization on Deutsche Telekom, but also ongoing investments in technology innovations.

Last but not least, our free cash flow, it is an outflow in H1 '18 of DKK1.4 billion, down by about 500 million compared to last year. It is driven, of course, by somewhat lower cash flow from operation, including a currency impact of about 100 million, but also working capital variation and timing and be aware that we compare variation of working cap to variation of working caps, always a bit complex.

I'm getting close -- and going to page 19 getting close to the end. And before I hand over to Jeff I would like to finish off with this brief update on the maturity of contracts. We have now successfully extended six out of seven large key accounts otherwise set to expire in '19. And on the last one, we have actually signed ahead of term for the new period as well. Needless to say, we are very pleased with this outcome and it is a good example of the fact that we tend to see a higher retention rate with key accounts.

In '19, we have about 6% of the revenues DKK5 billion with large key accounts, which are set to expire with about a dozen contracts. However, as a bulk of these maturities are actually placed in the end of the year, so effectively still 1.5 years to go. It also means that even if we are unsuccessful in extending some of these, it is more of a 2020 impact on revenues than '19. Dialog around some of these contracts, as you can imagine, is slowly starting now and we'll keep you posted of further development.

With that, I will hand you back to Jeff for some final remarks. Please go to slide 21.

Jeff Gravenhorst, Chief Executive Officer

Thank you, Pierre-Francois . While we continue to manage the number of short-term headwinds, the second quarter ended up largely as expected in May, and perhaps a little bit better than expected on the organic growth. As such, our outlook for organic growth, operating margin and cash conversion remains unchanged.

We expect organic growth will be between 1.5% to 3.5% in 2018, with a somewhat stronger than expected first half, and given the continued strong commercial momentum going into the second half, we are likely to end the year in the high end of the range. Our 2018 operating margin is still expected to be around 5.6%, around meaning, plus-minus 10 basis point. So 5.5% to 5.7%, excluding the impact from the Fx and net of acquisitions and divestments, which is currently set to be broadly neutral for the year.

I think the margin drivers on the expected shape of recovery have already been covered in a sufficient level of detail, so in summary, I will just reiterate that headwinds peaked in the first half, third quarter 2018 will be the last quarter of declining margins and we remain confident that the reported margin will show a strong recovery in Q4 2018. We see no need to change our guidance of around 5.6%. However, as a consequence of the late turnaround in Sweden and the underperformance in parts of Netherlands, we are likely to end the year below the midpoint rather than above. Finally, the guidance for cash conversion remains above 90%.

So to wrap up the presentation, our transformation is making us a stronger and more focused business. With this, we are confident that we are striking the optimal balance between managing risk and optimizing performance for the long run, hereby increasing quality of revenue and ultimately enabling us to capture higher organic growth and robust margins.

So with that, we'd like to open up for Q&A.

Questions And Answers

Operator

Thank you. (Operator Instructions) Our first question comes from the line of Srini Sarikonda of HSBC. Please go ahead, your line is open.

Srinivasa Raju Sarikonda, Analyst

Hi. Srini from HSBC. Good morning. Actually one question, but a follow-up as well. First, are you seeing any scarcity in labor market and if you could give some color region-wise it will be helpful? And just to follow up on that, like, are you seeing any increase in employee churn or could you give us some color on how the employee churn is, and what are the related costs for churn?

Jeff Gravenhorst, Chief Executive Officer

Yeah. Thank you. So just on the scarcity in the labor market, there's no doubt that we are operating in -- across the entire world. So it's hard to give you one answer on that. Every single year there'll be a market with some scarcity. But if you're talking about Europe, there is a little bit of a movement there. We still have free-floating labor markets in most of Europe and that, of course, helps us to have workers enough to perform the services that we're doing. Within white collar though, we do see some more scarcity, but at the moment, we are okay.

This is, of course, driving a little bit on the inflation on the salaries in Europe, but you have to remember that we've been used to this inflation part for a long time, particularly also in the UK, where we had 12% increases in salaries over '16 and '17, plus the levy that came through. So, again, this is something we are used to manage.

The churn, we don't see any major development on the churns from this perspective. We are working very diligently at reducing our churn and particularly, because of the move towards the -- move towards the key account businesses. And within key account, we see a churn around 25% in our staff and we also expect that to lower over the coming years.

Operator

Our next question comes from the line Bilal Aziz of UBS. Please go ahead, your line is open.

Bilal Aziz, Analyst

Good morning, everyone. And two quick questions from me, please. With respect to the full year guidance, and I believe the phasing out of contracts is relatively well understood with respect to HP and DXC. But what visibility do you have on phasing in of the contract? It's really quite crucial for the full year guidance. And perhaps, can you give us some numbers there, with regards to the ramp up in the margin you've seen versus the first quarter and currently in the third quarter as well?

And secondly, Netherlands has clearly weakened through the quarter, particularly in the non-core business. You still have some significant non-core exposure in some of your other European regions. So should we just expect this as ongoing business where you could continue to divest portions across Continental Europe through the rest of the year, which could underperform over time? Thank you.

Pierre-Francois Riolacci, Chief Financial Officer

Thanks. Yeah, of course for the phase out we have strong visibility, but actually at this time of the year, we are now in August, we also have some good visibility on the phasing-in process for the remainder of the year, so we are talking about the next four, five months. So in terms of revenues and ramp up, I think that the uncertainty around ramping up this contract is getting away.

The other thing that I can mention is that in terms of margins, we see these new contacts developing as expected. So -- and especially the start-up cost that we had to face at the very end of last year also at the beginning of the year they have been -- we have been through. So now we see margins improving gently month after month. So we see developments which are in line with our expectation. And of course, there is always a risk that we can be delayed in a couple of countries, but I think that this risk is getting really nominal.

On the non-core activities and the risk, which is attached to that in the second half, I think, that definitely, we are delayed in Sweden and we touched on that. We expect to complete the divestment of some non-core in Netherlands. That's definitely something that needs still to be executed. So that's potentially a Q4 event. And we do expect that we'll have turnaround, yes, but again with good visibility.

Now it's fair to say that the margin recovery that we have in H2 is relying not on anything big, but a series of actions and plans, which require execution. And we cannot guarantee that we are going to cover or to execute all of them. Of course, we do not bet that all of them will be a success, but we have a few things going on. I think we have been very pretty transparent in the different assumptions which are there and definitely fixing the non-core is part of the assumption.

Jeff Gravenhorst, Chief Executive Officer

Just on the exposure to what we call sort of specialized services, we have a lot of very strong specialized services across the Group, which is not part of any divestiture plan or anything. We are very focused on single service, single service catering, single service technical services, as well as our bundled services.

Operator

Thank you. Our next question comes from the line Paul Jessen of Danske Bank. Please go ahead, your line is open.

Paul Jessen, Analyst

Yes. Thank you. A question about the one-offs that you had in the second quarter. You had this positive 33 million on the pensions. Has there been any negative which neutralized it or what is the net impact on the quarter?

Pierre-Francois Riolacci, Chief Financial Officer

Yeah. Yes, there were some negatives. I mean you know that's the part of life of ISS is that, we have -- in a few countries each month, each quarter, we have a few positive and negative. Here we had this big positive, but we had a couple of negatives mainly related actually to labor, which is not so surprising given it's about 70% -- 65% to 70% of our cost. So -- and they were mainly in Americas, South Americas and actually APAC, and the amount of one-off was broadly in line with last year, as I mentioned. So, the positive is in line with last year and the negative, also in line with last year. So, net is about 30 million

Operator

Thank you. Our next question comes from the line of Daniel Hoppin [ph] of Credit Suisse. Please go ahead, your line is open.

Unidentified Participant

Cool. Thank you very much. Looking at your Q2 organic growth and obviously 4.2% in the portfolio revenue, I was just wondering, are you able to split that down between volume driven growth and growth driven by passing through wage inflation, please?

Jeff Gravenhorst, Chief Executive Officer

I think it's very difficult to break it down like that because everything that we do on wage inflation is that sometimes you pass it on straight and most times you need to negotiate better on the bigger ones, so you negotiate scope. So, either you increase scope or reduce scope and with this, of course, you offset. At the same time you will increase, you will improve the efficiencies. So at the end of the day, typically, we get something like 1 percentage point to 2 percentage point of price increases through, but it really depends on orders and contracts and so forth. But -- so overall, it's very, very difficult to say exactly how much it is, but it's the proven around 1% on price increases.

Operator

Thank you. Our next question comes from the line of James Winckler of Jefferies. Please go ahead, your line is open.

James Winckler, Analyst

Hi, guys. I was just wondering if you could provide a little insight into Turkey? And obviously, the currency is gotten worse there in the current quarter. And I'm wondering, is how the kind of offset of the price increases and how you have protected your margin in the division and how you see the current trading within that market at the moment? Thanks.

Jeff Gravenhorst, Chief Executive Officer

First of all, Turkey is a very, very strong ISS country and we are doing really well and particularly also on rolling out according to our segmentation. So the healthcare sector within the PFI structures, so we also finance privately, is coming through very, very nicely and that's part of our organic growth. So net, despite the headwind on the currency, we're actually growing our business in Danish kroner. So that's quite a staggering segment result.

Now, having said that, I think it's important that we all remember that the hedging in ISS is a natural hedging that income and expenses are in the same currency. So we don't have the normal exposure as you would see it in a training or import-export business. I guess you all know that, but just to reiterate. So in the country, though, of course, it's not nice for an inflation as the one they are looking at now with the devaluation of the currency and that of course we monitor very, very closely. So we have a management team in Turkey, we are very close to the individual customers, looking at what type of customers could potentially run into problems, should we shorten their payment terms and so forth. That is something that we do in a controlled manner.

Overall, still I want to reiterate that it's a very strong operation and we have good ways of actually getting opportunities out of the situation that we see in Turkey now, but it is of course very serious with this kind of changes in currencies.

Pierre-Francois Riolacci, Chief Financial Officer

And Turkey is a bit more than 3% of our revenues.

So the exposure of course is limited.

Operator

Thank you. Our next question comes from the line of Srini Sarikonda of HSBC. Please go ahead, your line is open.

Srinivasa Raju Sarikonda, Analyst

Yeah. Hi. Just a follow-up on the labor scarcity we were talking about. Could you give us some color on Americas as well, please? We spoke about Europe earlier.

Jeff Gravenhorst, Chief Executive Officer

About Americas, sorry, was that the question?

Srinivasa Raju Sarikonda, Analyst

Labor scarcity, how is that and the churn as well as there?

Jeff Gravenhorst, Chief Executive Officer

How do we see that in Americas? Okay. So, I just couldn't hear you quite right. Okay. Within the US, we see an inflation which is around 2%, 2.5%, 3% this year, which is not -- it is not a high -- or sorry, in '17 and this year it might be a 3% to 4%, which is something we can manage. On the scarcity, we don't have an issue as it stands today. We are capable of launching the contracts that we are due to launch and then to grow the contracts in the way that we actually see fit to grow.

So within our Guckenheimer business, for example, where we've had very high organic growth, we've been capable of actually launching the contracts with full manpower.

Operator

Thank you. (Operator Instructions) As there are no further questions at this time, I'll hand back to our speakers for the closing comments.

Jeff Gravenhorst, Chief Executive Officer

Thank you all for participating. This is all for today and thanks.

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