Company Name: ISS A/S
Company Ticker: ISS DC
Date: 2016-11-02
Event Description: Q3 2016 Earnings Call

Market Cap: 46,899.79
Current PX: 252.6
YTD Change($): +3.9
YTD Change(%): +1.568

Bloomberg Estimates - EPS
Current Quarter: 4.660
Current Year: 15.300
Bloomberg Estimates - Sales
Current Quarter: 20527.000
Current Year: 79150.857

Q3 2016 Earnings Call

Company Participants

- Nicholas Richard Ward
- Jeff Olsen Gravenhorst
- Peter Harder Thomsen

Other Participants

- Staffan Åberg
- Jonas Guldborg Hansen
- Michael Vitfell-Rasmussen
- Emily Charlotte Roberts
- Kristian Godiksen
- Srinivasa Raju Sarikonda
- Rory E. McKenzie
- Paul D. Checketts
- Andrew R. Farnell

MANAGEMENT DISCUSSION SECTION

Nicholas Richard Ward

Ladies and gentlemen, this is Nick Ward, Head of Investor Relations at ISS, and I'd like to welcome you to our Third Quarter 2016 Results Teleconference. Please be aware, the announcement, interim report, as well as the slides used for this call can also be found on our website. Later today, a replay will be available and we will post a transcript of the call as soon as it is ready.

I'd like to draw your attention, as always, to slide number two regarding forward-looking statements. Presenting today will be Group's CEO, Jeff Gravenhorst; and Head of Group Controlling, Peter Thomsen. We will open for Q&A at the end of the presentation.

So, with that, I'll hand over to Jeff.

Jeff Olsen Gravenhorst

Thank you, Nick, and good morning, everyone. Please turn to slide number five. During the third quarter, we maintained our steady performance. With regards to our operating performance, organic growth of 3.3%, up in the third quarter and 3.6% for the first nine months of 2016. Total revenue growth was minus 1% in the third quarter with currency effects reducing revenue by 3% in the quarter.

Our third quarter operating margin was 6.5%, in line with Q3 last year. Year-to-date, our operating margin was 5.5% versus 5.4% at the same stage in 2015. This improvement comes despite a 5 basis points negative impact from divestments, principally relating to CMC in Turkey.

Our cash conversion remains strong at 95%. Net profit ended up 9% higher year-on-year at DKK 672 million and 13% higher year-to-date. Our leverage at quarter end was 2.4 times adjusted EBITDA versus 2.7 times of 12 months ago.

Progress within Integrated Facility Services remains very positive. Local currency revenue growth was 15% in the third quarter, driven once more by new contract start-ups and contract expansions. IFS represented 37% of group revenue. Within Global Corporate Clients, local currency revenue growth was 18%. Global Corporate Clients now represent 11% of the third quarter revenue.

We remain pleased with the development of some of our major contract expansions, particularly

Novartis and Nestlé within our Global Corporate Clients, but also with Danske Bank, Danish Railways, and PostNord. We've also create new or extended IFS contracts with Bombardier and John Crane from North America, Royal Mail and Hitachi Rail in the UK, and Heineken in Netherlands.

With regards to our strategic initiatives, it is very much business as usual. I'll give you more details on one of these initiatives later in the presentation. Progress with procurement, business process outsourcing, and other projects remain in line with our expectations. We've also, today, announced a small catering acquisition in the Americas region. Apunto will strengthen our IFS credentials in Chile and/or in Latin America.

So, another steady quarter. We do face certain challenges across the group, but there is nothing new in that. Today, our biggest challenge are Brazil and Australia. But the current performance and outlook for those two countries is in line with our expectations of one quarter ago.

There will, no doubt, be new challenges over the coming months but we remain very confident in our business model and our strategy. We also will remain upbeat about the opportunities ahead as ever. We are highly focused and motivated to deliver.

Please turn to slide six. Our capital allocation policy is unchanged and consistent with our communication since we did the IPO. The graphics on the left-hand side here are taken from our Capital Markets Day in September 2015 and serves here as a reminder of our intentions.

Since the IPO, we've delivered steady organic growth, as we said we would; we've driven a gentle but steady improvement of our operating margin, as we said we would; we have generated consistently strong cash flow and reduced our leverage, as we said we would. We also said that on reaching our target leverage of below 2.5 times adjusted EBITDA, taking the cash flow seasonality into account, we would return surplus funds to shareholders if we could not find compelling, value-accretive investment alternatives. And we promised to maintain an efficient balance sheet.

With this in mind, we are today announcing an extraordinary dividend of DKK 4 per share. This amounts to an extraordinary shareholder return of DKK 743 million and is an addition to the close to DKK 1.4 billion ordinary dividend paid out in April.

With regards to our chosen [ph] methodology (04:59). We have, of course, spoken with our largest shareholders. While there are differences of opinion of amongst them, we believe this approach to be optimal. In short, an extraordinary dividend is quick, simple and cost efficient. Moving forward, we will continue to prioritize investment in our business including acquisitions subject to, of course, strict strategic and financial filters. However, we have no intention of letting our balance sheet become inefficient. If we cannot justifiably reinvest capital, we will periodically look to return surplus funds to our shareholders. Whilst our chosen [ph] methodology (05:41) for now is extraordinary dividends, we do not rule out the possibility of share buybacks.

Please turn to slide seven. When it comes to major investment decisions, our choices will reflect the ongoing evolution of our industry, our strategic priorities and our desire to further strengthen our Integrated Facility Services solutions.

The graphics on the left of slide seven has also been taken from our Capital Markets Day in September last year and was presented by Andrew Price, our Group Commercial Officer. Andrew explained the shift in our industry away from input-driven contracts where the suppliers stipulates the number of hours worked towards output-driven contracts where ISS and the customer determine service level agreements and we then determine how best to deliver the solution.

We are now seeing a shift towards outcome-driven contracts. We have greater focus around the end-user experiences. For example, the well-beings, satisfaction, motivation, and productivity of our customers' employees, patients or passengers. Andrew talked about ISS becoming a leader in workplace solutions and the importance of technology and data to drive positive change within the working environment.

So, with regards to our current investment priorities, technical services remain a key component of many IFS solutions and a key factor in capturing more project work. We are pleased with the value that we have generated from GS Hall acquisition and we will look to make further acquisitions within technical services to strengthen our offering.

We have been targeting a catering acquisition in North America ever since the IPO and we continue to pursue one or two opportunities in this space. However, we are highly selective with regards to what we are looking to acquire. Any acquisition must complement our geographic and industry focus within North America and must allow us to strengthen our IFS offering with both new and existing customers.

Today, we have announced the acquisition of Apunto, one of Chile's leading catering providers, and I'll give you some more color on this shortly. The partnership with IBM that we discussed last quarter is an important step towards using leading-edge technology, to create differentiated of solution for our customers.

Finally, we're pursuing opportunities to acquire workplace management capabilities as we seek to increase the value of our offering towards selected key account costumers.

Please turn to slide eight. ISS Chile has been one of our best performing countries within the Americas region, delivering strong organic growth and good above group average margins. We have a high proportion of IFS revenue in Chile, but our services are still quite heavily weighted towards cleaning. Hence, there is good opportunity to expand our service offering and strengthen our existing relationships.

Apunto is Chile's fourth largest contract caterer and have a 25-year history and a good growth track record. The business is heavily focused in Santiago area and also heavily focused on some of our target industries, namely, industry and manufacturing and business services and IT.

So, the geographic and the industry overlap is strong, but the existing customer overlap is minimal. The enterprise value including assumed debt and earnout of up to DKK 10 million amounts to DKK 67 million. We see strong scope for revenue synergies and would note that ISS Chile currently subcontracts catering of services for 8 out of its top 20 customers. We expect to deliver very healthy return on this acquisition, and the strategic rationale is entirely consistent with our focus on strengthening our IFS offering and capturing additional client revenue.

Please turn to slide 10. Within our developed markets, Q3 organic growth remained stable at 2% and margins improved to 7.6%. In emerging markets, Q3 organic growth softened very slightly but remained strong at 7%. Margins was slightly lower at 6.2%.

As always, there are some notable variations across certain countries, so let's look at this in more detail as we discuss the regional performances.

So, please turn to slide 11. Continental Europe delivered another very good performance in Q3. Organic growth was steady at 4%. The Q3 operating margin was 6.1%. For the first nine months, the operating margin was 5.3%, which on adjusting for CMC divestment, equates to a slight year-on-year improvement.

Turkey remains the strongest driver of growth for the region, supported by both volume and price. This has been an exceptionally strong year for Turkey given the impact of the general and minimum wage increase. Our business has also proven very resilient in the face of the political unrest. We continue to pursue some interesting growth opportunities most notably within the healthcare sector.

Growth in Switzerland is much lower than in 2015 when the country benefited from both Swisscom and Credit Suisse. However, the expansion of our Novartis relationship and the new contract with the Gotthard Base Tunnel have both helped. Margins remained strong.

Growth in Belgium remained strong in Q3, driven by a positive performance within IFS. We will see a reduction in work with the Red Cross in Belgium in Q4. Revenues in France are broadly flat year-on-year with some good contract wins offset by one or two challenges elsewhere.

Eastern Europe is currently tough. We are consciously exiting contracts where we cannot make sufficient margin or where debtor days are unacceptable, most notably in Greece where we continue to scale back up our public sector exposure. We have seen good margin improvement in France and Germany this year, with Germany clearly benefiting from our great restructuring.

In Northern Europe, third quarter organic growth was 3% and operating margin was firm at 8.9%. For the first nine months, the operating margin was 7.3%, slightly up year-on-year.

Our performance in the UK remains very strong. Organic growth in the UK is above average for the region, driven by IFS wins and strength within both financial services and public sector. As we have said constantly through the year, the April increase in the minimum wage in the UK or national living wage, as it's now called, has not been an issue for us. Thus far, we have seen no meaningful impact from Brexit, either in terms of operational performance or pipeline activity. In recent weeks, we have started to see cost increases within catering business as the pound has come under further pressure, but we do not see this as a major issue going forward.

We are mindful of the weaker economic outlook in the UK and the uncertainty that Brexit brings. And as we've said, we are not immune to these risks. However, we remain confident in our business model, our market positioning and our competitive strength. At this point, we see Q4 project works in UK as being broadly flat in Q4 in 2015, which, as you know, was a strong quarter.

Denmark continues to deliver very strong in 2016, both in terms of organic growth and margin. However, the expanded contracts with Danske Bank and Danish Railways [Danish State Railways] will start to annualize in Q4. Life is currently a bit tougher in our other – Nordic countries in Q4. Sweden was impacted by reduced work, notably the biannual projects in the nuclear segment, which [ph] were flat (13:50) in the past.

Pressure in the oil and gas segment continue to weigh on the Norwegian business, most notably within catering. And Finland continues to see a negative impact from major customer downsizing within the technical sector – technology sector. There you go.

Please turn to slide 12. In Asia, we've seen further growth in organic growth – slowdown in organic growth, largely resulting from contract losses in Australia. Organic growth for the region in Q3 was 1% but the margin remained strong and stable and is comfortable, up year-on-year.

As we have previously highlighted, our Australian business have seen three major contract losses in 2016. We lost the Royal North Shore, healthcare contract from April. We lost Rio in the remote site resource segment in July. And from October, we lost the CP Mining, another remote site resource customer. This is all in line with our prior communication but as a result, we will see further deterioration in organic growth in Q4, as also expected.

Elsewhere, we're seeing revenue reduction within the retail segment in Hong Kong and China. Hong Kong shopping malls are seeing reduced shortfall. And we have seen a reduction in our non-portfolio revenue, for example, some of the deep clean jobs.

Otherwise, the performance in Asia remains generally very strong. Singapore is having an excellent year in 2016, and organic growth in Indonesia is also very encouraging, driven by a highly successful startup of our new contract with Jakarta Airport. Growth in India is also very strong. So, despite the revenue weakness, we have been proactive at driving both on-site and overhead efficiencies within our Australian business, and our nine-month operating margin is up year-on-year.

We have seen good margin progress in Singapore, but we've had – we made some operational investment in Indonesia to further strengthen our business.

Within the Americas, we're seeing very strong growth in the U.S., which is extremely encouraging. Not least giving, it has driven – been driven by a large extent, by the IFS contract wins. Clearly, we're still a long way from where we aim to be in this market, but the pipeline is encouraging. Global Corporate Clients has been an important driver of growth, but we are winning local businesses as well now. Margins are also moving in the right direction.

The story in Brazil has not changed. We're seeing a material reduction in our revenue as we structurally downside this business on purpose. This will take another few quarters to unwind as we reposition ourselves in this market as a small and more focused and more profitable player, we reduce the risk exposure.

ISS Chile is having a slightly slower growth this year, but the outlook, as we discussed earlier, remains very encouraging. Finally, Mexico is having a very good year with strong growth supported by our Global Corporate Clients. For the region, as a whole, the nine-month operating margin of 4.1% is stable year-on-year, consistent with our commentary last quarter.

With that, I would like to hand over to Peter to take us through the financials.

Peter Harder Thomsen

Thank you, Jeff, and good morning, everyone. Please turn to slide 14. In Q3 2016, our revenue decreased by 1%. This comprised, firstly, a negative impact of 1% from divestments; secondly, a negative impact of 3% from currency; and, thirdly, a positive impact of 3.3% from organic growth. The main currencies impacting our revenue growth in Q3 were the British pound, the Argentine peso and the Chinese RMB.

3.3% is the lowest organic growth rate we have delivered for six quarters. However, as the chart on the right illustrates, it is consistent with our historic performance. Moreover, our organic growth can prove lumpy, reflecting the timing of some of our larger contract launches and the level of non-portfolio services. Our confidence in the structural drivers of our growth is unchanged.

Please turn to slide 15. Our Q3 2016 operating margin was 6.5% in line with Q3 2015. In the first nine months of 2016, the operating margin was 5.5% versus 5.4% at the same stage of 2015. There was a negative impact from divestments of only 2 basis points during the quarter, reflecting some seasonality in the profitability of those businesses sold. Year-to-date, the negative margin impact from divestments has been 5 basis points. As we have said repeatedly, there are a number of timing differences that can impact profitability within countries or regions in any one quarter.

Looking at the operating profit development on a last 12 months' basis arguably gives a better picture of the underlying progress. As you can see from the chart on the right, we have faced a negative profit impact from both currency moves and divestments in the past 12 months. However, with the exception of the Americas region, all of our regions have contributed positively to our operating profit development, most notably, Asia Pacific.

Corporate costs are broadly unchanged over the past 12 months. In Q3, corporate costs amounted to 0.7% of revenue. Our full-year expectation remains for corporate cost to be approximately 0.8% of revenue.

Please turn to slide 16. Let me highlight some additional points from our income statement. Firstly, we incurred DKK 37 million of other income and expenses net in Q3, bringing the year-to-date figure to DKK 125 million. The Q3 charge mainly comprises further structural adjustments of our business platform in Brazil, together with restructuring projects related to the implementation of project GREAT in Argentina, Iberia, Finland and Belgium.

Secondly, our financial income and expenses net of DKK 144 million for the quarter was negatively impacted by DKK 16 million FX loss, principally due to the movements in the Danish kroner-euro exchange rate. Thirdly, our effective tax rate was 28% in the quarter, in line with our expectations for the full year.

Please turn to slide 17, [ph] and (20:05) some additional points to the cash flow statement. As I highlighted on the Q1 and Q2 call, our depreciation charge has fallen year-on-year, consistent with the reduction in our tangible fixed assets, i.e. property, plant and equipment. Once again, factors behind this include divestments, FX and other mix effects.

We've also seen a shift from owned assets, i.e. vehicles, to operationally leased assets as a result of our procurement initiatives. I would add that investment in fixed assets, and hence depreciation, can be linked to the launch of new contracts. So, subject to the timing, size and nature of future contract wins, we may see investments pick up again. However, as with all other costs we face, this will be reflected in the structure of our bids and the associated revenue profile over the lives of the contracts.

The working capital cash outflow, seen in Q3 2016, are again a little higher year-on-year. Our LTM cash conversion of 95% remains very strong and comfortably ahead of our 90% outlook commentary and consistent with our expectations. As a reminder, the year-on-year swing and changes in provisions, pensions and similar obligations, reflects a sizeable positive impact in Q1 2015, related to the pension obligations assumed with the Vattenfall contract.

Our net interest paid received varies from quarter-to-quarter, subject to the timing of annual interest payments on our three bonds. These annual interest payments are made either in January or December. Consequently, cash outflows are lower in Q2 and Q3. Cash flow from investing activities, in the first nine months, is comprised mainly of DKK 467 million from investments in intangible assets and property, plant and equipment net.

This equates to 0.8% of group revenue, which is still below our usual run rate for the reason that I just highlighted when explaining our depreciations. Cash flow from investing activities in the nine months of 2015 included the acquisition of GS Hall.

Please turn to slide 18. Finally, we have illustrated again how our free cash flow has been allocated on an LTM basis. Net financial expenses remain as a modest source of cash consumption, thanks to the reduction in our borrowings and the low interest rates and margins we currently face. We have made no acquisitions in the 12-month period, ending September 2016. The most meaningful divestment was CMC in Turkey, completed back in October 2015. The dividend payment relates to the ordinary dividend of DKK 1.4 billion paid in April.

At the full-year results in February next year, this analysis will capture the DKK 743 million extraordinary dividend we have announced today. Most of the remaining cash flow has been used to reduce debt except for the DKK 149 million treasury share repurchase completed in Q1 2016. Given this cash allocation, our leverage has fallen from 2.7 times at the end of Q3 2015 to 2.4 times at the end of Q3 2016. As Jeff articulated earlier, our leverage objectives and capital allocation policy remain unchanged.

With that, I'd like to hand back to Jeff.

Jeff Olsen Gravenhorst

Thank you, Peter. Please turn to slide 20. As I mentioned on slide 7, we are transforming our business from input-specified to outcome-specified contract. With this in mind, we are well underway to becoming a key account-focused organization. We define three different types of key accounts in the organization today. One is global key accounts; these are the Barclays, the HPs, Novartis and Citi of the world. The regional key accounts, which are – accounts the like of Nordea, Danske Bank, PostNord, Telenor, Philip Morris. And then, of course, the country-specific key accounts, which are UPS, SwissCommerce Switzerland, Vattenfall in Germany, and so on.

In 2015, key accounts generated around 60% of our revenue. However, we continue to refine our key account definition. And in 2017, we will likely intensify our focus on a smaller number of our major customers.

But what really are the benefits that a key account customer should expect when partnering with ISS? We categorize these benefits in three areas. First, it's volume. We launched our group-wide procurement initiative in 2015, and have achieved quite great success in the subsequent years. However, this is – there is more to go for and we strive to leverage the strength of our supplier relationship to ensure that customers get the full benefit of product cost, quality and innovation at all size – at all sites.

Secondly, it's concept. Across the [ph] ISS (24:52) Group, ideas are being generated each and every day. And we seek to improve the way we operate. However, the scale of our business – with the scale of our business, there is a risk that these ideas get lost and don't get the support they need, and that they simply become inefficient in the way we commit time and resources.

So, some of our leading concepts are driven centrally. For example, the recent partnership with IBM. However, many are driven locally. An example being [ph] that of (25:23) technology in ISS Singapore, which have been developed within the healthcare business.

We seek to capture our strongest ideas, help support and develop them, and then ensure these best practices are shared across the group. And third, we have talent. We remain a people-intensive business. And the motivation, development and retention of our best talent is key to our future success.

We must ensure that our colleagues have the right tools and information they need to deliver, and the opportunity to expand their careers. By delivering on the volume and on the concept and on the talents, of course, allows us to ensure cost-effective solutions across the customer base and a consistent and compliant service offering across all sites, supporting our customers and focusing on their core needs.

But we need to have the right organizational structure and the right training in developing of our key account managers to do this. So, let's explore this a little bit further on slide 21. We illustrate our geographical blueprint for countries at last year's Capital Markets Day. Today, countries generating some 70% of ISS revenue have this organizational structure in place and are in the final stages of implementation. Best practices within countries are driven from a [ph] service (26:44) excellence centers. In addition, best practice is fostered within country key account segments and across countries.

When it comes to training and development, we introduced our Key Account Management Certification program, or KAMC, as we call it, in late 2013. This is another step towards ensuring the full benefit of volumes, concept and talent are realized at each of our customer sites. We do this by bridging the gap between ISS' senior management and the key account managers, and ensuring our strategy and initiatives are effectively communicated and understood. Account development is supported through sharing and implementation of best practices, and accountability is ensured.

Moreover, we have a great opportunity to assess the commercial capability of our key account managers and hence ensure our top people are matched with our top accounts.

The program spends six months and comprises three distinct modules and ongoing home assignments. We've rolled out the program globally and increased the number of annual certifications. The feedback we received is excellent, and we'll cite a small number of examples here. KAMC is an important component of our people [ph] account (28:02) strategy as we seek to attract development and retain the best talent in the industry.

Please turn to slide 23. With regards to our 2016 outlook, we now expect an organic growth of around 3% and operating margin that is above 5.7% realized since 2015, and cash conversion above 90%. We've narrowed our organic growth outlook to reflect the increased visibility on full-year performance. We have achieved solid organic growth in the first nine months of 2016.

For Q4, we are impacted by a negative organic growth in Brazil and Australia as well as the annualization of some larger contracts as expected. We remain cautious on the level of non-portfolio services for the remainder of 2016. Our margin and cash conversion commentary is unchanged. So, in summary, we remain pleased with our progress that we made in the first nine months of 2016. We continue to deliver against our expectations. We remain confident in our capabilities and our opportunities, and our ability to execute.

With that, I would like to start the Q&A.

Q&A

Operator

Thank you. [Operator Instructions] Our first question comes from Staffan Avery (sic) [Åberg] (29:32) of Handelsbanken. Please go ahead, sir. Your line is open.

<Q - Staffan Åberg>: Thank you. As I understand, Barclays is one of your largest clients, especially in the UK. Now, Barclays looks to cut 25% of its London office space. So, how large is that contract and how will that affect you?

<A - Jeff Olsen Gravenhorst>: Barclays is certainly one of our larger clients, but it's not only in the UK. Barclays is a global client, and that we have, over the years, actively reduced a number of the seats in the UK [ph] to gather Barclays (30:05), but we also expanded in India as one of the main investment areas. So, it does have an impact, of course, when they reduce on space and footprint in the UK, but we can also pick that up somewhere else.

At the same time, we actually have picked up more services. So, over time, we have also expanded our presence and revenue with them also in the UK. So, we don't comment on the specific size. We have never given out that number for competitive reasons, but it is one of our major sites, but we are also growing revenue with them.

<Q - Staffan Åberg>: Okay. Thank you. And I know you won't comment on the 2017 guidance and how that will look, but can you please give us your view of the set up for 2017? I mean, given that you implicitly guide for an organic growth in Q4 of around 1%, which would be lowest in 2016 quarters, the momentum going into 2017 will not be that strong. So, for example, is it more likely that the 2017 guidance on organic growth will be 0% to 2% rather than 2% to 4%?

<A - Jeff Olsen Gravenhorst>: First and foremost, we're guiding around 3%, so that is not a guidance of 1%, but there's – of course, there's a range in that number. And you probably know that as well. But it's around 3% for the full-year. Now, for next year, we are not giving guidance yet. I will say that there is no structural difference to our business. The individual quarters can be different depending on a few things.

Number one, of course, what was the growth last year? So, we had a very strong growth the fourth quarter last year. And that means, of course, that a stronger growth comes for the fourth quarter this year. We are impacted by some of the strain and losses that we have mentioned for a few times now and the Brazilian reduction in scope. That, of course, will also annualize next year. So that will have a positive impact during the year on the organic growth number next year.

So, there are a number of things here, but I think overall, our pipeline is strong. We have a couple of big tickets that we are negotiating at the moment, which couldn't come in on this quarter. It was postponed for various reasons; working with employee relationships and so forth from client's perspective. So, of course, it is a little bit of a coincidence whether it hits one quarter or the other. So, structurally, there is no difference to the future, to what we've seen in the past.

<Q - Staffan Åberg>: Okay. That's very helpful. I have one final question. And I heard your arguments to go with the extraordinary dividend. But still, at the [ph] CMD (32:37), you mentioned valuation as a factor when deciding whether to go with buybacks or extraordinary dividends. You chose clearly to go with extraordinary dividends. So, the natural question is, do you think the valuation of the share is too high right now?

<A - Jeff Olsen Gravenhorst>: As a starting point, I don't actually comment on the valuation. And the valuation, this time, has not been a factor. The factor here is that we've spoken to our largest investors. And there are difference of opinions on this, obviously, what is the best or the preferred method? But what we have deducted from that is the decision to go for dividend also because it is the simplest way to do it. And it's quick, and it's also cost-effective. So, that is the main reason for this. This does not mean that we will not do buybacks at another time.

It just means that this time, we've chosen to do it this way because it is effective, it's simple, and it's cost-effective and it is, by and large, what the larger investors want.

<Q - Staffan Åberg>: That's very helpful. Thanks so much.

Operator

Thank you. Our next question comes from Jonas Guldborg of Carnegie. Please go ahead, sir. Your line is open.

<Q - Jonas Guldborg Hansen>: Thank you and good morning. Firstly, looking on slide 7, this industry evolution chart, maybe you could just shed some light on how your revenue is split between these three types of contracts: the input-driven, the output-driven and the outcome-driven?

<A - Jeff Olsen Gravenhorst>: Yeah. Thank you. We don't actually disclose those numbers because it's not that straightforward to do. But I can give you some highlights to how to look at it. If we continue to look at the growth we have in Integrated Facility Services, for example, those contracts are predominantly either output or outcome, or a combination of both.

There can be still certain elements of input, i.e. number of meals served or something. That depends on the contracts, right? But typically, they'll have an element of what are we trying to achieve for the customers, so that could be improved behavior or uptime or whatever it is at their assets.

So, I would look at it and give some guidance on this by saying the 37% is predominantly within output/outcome-related measures. Then in the single service business, it is a little bit of a mix but there's still a number of inputs, big contracts in there. So, that's the [ph] best, by (35:06) guidance, I could give you on that. But that also means that you can see that we are increasing our output and outcome part of the business.

<Q - Jonas Guldborg Hansen>: Sure. Then on this surplus fund – return on surplus fund, [ph] then (35:20) you state that you will look at it periodically. What should we – what is, periodically, is it every quarter, every year or is it every five years?

<A - Jeff Olsen Gravenhorst>: Well, I don't want to be sort of promising exactly when we do it. I think we're going to do it ongoingly because it depends a little bit on if we make a divestment or whatever, how the cash flow situation sits. I think the key thing is, here, we have the same allocation – capital allocation policy as we stated when we [ph] enlisted (35:51). So, number one is, we want to have an investment-graded balance sheet and debt.

That means we then want to defend, of course, the ordinary dividends, so you can count on that as we talked about. And then we'll look to invest in the company as and when we see value-accretive businesses that will make sense. And then if there's surplus cash, then we will look to return that. When it's relevant to return it, i.e. meaningful, then, of course, that's when we will look at it. That's the best way I could guide on it.

<Q - Jonas Guldborg Hansen>: Okay. Then my last question, it is on this depreciation and amortization and CapEx side. I fully understand your explanations for why they are lower year-to-date. So, my question is more – should we expect the same level of both depreciation and amortization and CapEx in Q4 as what you've reported for Q3?

<A - Jeff Olsen Gravenhorst>: Yeah, you're right. We are at the lower end of our historical range at the moment. We do – I mean – and it does depend on, as I talked about before, the investments that we make. And if [ph] there are (36:55) any assets that are fully depreciated that can impact debt. So, we don't give, you could say, exact guidance on where we will be going forward. But it, of course, impacts on the investments we make. It depends on that, sorry. And what I can say is that we are currently at the low end of our range, between the 0.9 to 1.3, and that's where we would expect to be going forward within that range.

<Q - Jonas Guldborg Hansen>: Okay. Thank you very much.

<A - Jeff Olsen Gravenhorst>: We just have to bear in mind [ph] that that's (37:20) Peter saying is that it depends a little bit on the setup of the client. Whether we make the investment or they make the investment, or whether it's leased or it's owned. And that can differ, and on the size of the contracts, the types of contracts. And then, of course, also the technology investment we're making for it going forward can also have an impact.

So, on the guidance that Peter is saying, for now, that's it. But for the future, it can be different. What we're looking at is that whatever cost we have there is cost like any other cost. We need to get that in through the price of the client, of course, and that's why we are focusing on EBITDA.

<Q - Jonas Guldborg Hansen>: Okay. Thank you very much for your help.

Operator

Thank you. Our next question comes from Michael Rasmussen of ABG Sundal Collier. Please go ahead, sir. Your line is open.

<Q - Michael Vitfell-Rasmussen>: Thank you, and thanks for taking the time to answer my questions. I would like to start up with just a little bit more detail on the new guidance because what I'm basically hearing you're saying is that Brazil is weaker as expected. Also, in the fourth quarter, Australia, the contract losses, nothing is changed here.

The UK, nothing really has changed here yet. So, am I right in assuming that the slowdown in organic growth in the fourth quarter, whether that's 1% or 1.3%, or 1.5% growth, is that purely due to this delayed startup of this big ticket that you talked about, Jeff?

My second question being on margins. Last year, Q4 was rather strong. So, should we be a little bit more cautious here looking at the fourth quarter this year, in terms of, kind of, the normal run rate of 5 to 10 basis points, given also the slower growth in non-portfolio?

And then, finally, can you please discuss the potential margin impact from the higher apprentice costs in the UK in 2017? Thank you.

[Inaudible] (39:20-39:29)

<A - Jeff Olsen Gravenhorst>: Thank you, Michael. Let me see. The first in guidance on the fourth quarter. And you're right, Australia, we knew. On Brazil, we know. And they were, of course, also annualized. So, at some point in time next year, that will also [ph] pull away (39:41). I think the key thing is to look at, is it a slowdown in growth or is it a pickup in comps? There's an element of that, obviously. There's an element that we've grown on [ph] DSP (39:53) and so forth. So, they are annualizing coming into Q4.

So, it's really not the business deteriorating, it's a matter of that we have, within the range that we gave last time, the startup of a number of big ticket items actually has been postponed for next year, so that's one part. And other part is that we're still cautious on the once-only jobs that come through mainly as a result of the macroeconomic development.

So, I think from a business perspective, we're pretty much where we've been all along. It's a good development. Apart from the fact that we are being drawn down on the Australian and Brazilian situation and negative organic growth in Greece, which we also choose to do. So, that's the key driver for that. And that again, just reiterates that structurally, there is no difference to where we were a quarter ago or where we've been all along. So, we have a strong pipeline, good opportunities and good prospects also for next year's growth.

That's the first question. On the margin side, clearly, we're guiding in the same way as what we've done all year. We see that we can do better in 2016 than we did in 2015. And I don't want to be covering more specifically on the individual quarter, but [ph] as we see (41:08) it has been as we've seen so far.

And then on the levy – sorry – in the apprentice levy in the UK. Yeah, Peter, will you take that?

<A - Peter Harder Thomsen>: Yes. I'll take that, Jeff. So, the apprentice levy will apply from 1st of May, 2017. So, we expect to see an eight-month impact next year, although not all details are clear at this stage. We expect a 0.5% levy on our wage bill on the UK, or approximately a bit over £3 million on a full-year basis, which we will need to mitigate going forward.

<Q - Michael Vitfell-Rasmussen>: Great. Thank you very much.

Operator

Thank you. Our next question comes from Emily Roberts of Deutsche Bank. Please go ahead. Your line is open.

<Q - Emily Charlotte Roberts>: Hi. Good morning. A couple for me, please. Firstly, a bit more color on the pipeline. And how does that compare in terms of number of contracts that you're looking at versus last year? And then how much of your pipeline is the UK, and how much is existing customers?

Secondly, looking at 2017 margins, now I know you won't give any guidance today, but is there a risk given the UK levy and perhaps lower levels of non-portfolio work? Is there a risk that 2017 EBITDA margin will be lower than 2016?

And then, finally, on Asia. Looking at your organic growth and how it's trended through the year in Asia Pacific, if we take out Australia and Singapore, could you give us some color on how that has trended? Thank you.

<A - Jeff Olsen Gravenhorst>: Yes. Thank you. On the pipeline, the pipeline, if you compare it to a year ago, a month ago or two years ago, it actually is as strong, if not stronger. The number of contracts, we don't actually disclose – or the value of it, we don't disclose, but it is in the same and even stronger area. [ph] There are some (43:12) big ticket items. There are some normal, mid-sized contracts, but also country-by-country good opportunities.

With the key account focus, the growth with existing customers are also becoming more and more important, and you can see part of that were the Global Corporate Clients' growth as we've seen it this year of around 18%. Actually, it's driven by Novartis expansion as one, but also expansion of scope with existing customers.

So, it is quite a big source for future growth as well, which is extremely – which is exactly why we today spend some time on Key Account Management Training and Certification because that's actually how you get those additional sales coming in. So, pipeline comes from existing clients, that's for sure, but also from a strong opportunity and a strong pipeline, both in number of contracts but also in value terms. So, that's the close I can get to that.

Again, I will just reiterate structurally, we're in at least the same situations before, if not even stronger because of the setup and the development of the company but also the demand for integrated facility services as we see it in the market.

On the margin side, I will not be guiding on 2017 yet, but on the levy side, I can just add on to what Peter said. Yes, we will have the apprentice levy next year, and it will have an impact, but the impact is like any other impact. This year, we managed the salary increase, the national or the living wage in the UK. The same thing will happen next year. The way to deal with this is efficiency improvements, and it's cost us price increases with the clients, and I don't see that impacting the margin for 2017.

On the once-only jobs for next year, I don't see it declining from this year. So, I don't see a margin impact from that. Whether we see an uptick or not, we'll come back to that when we get to the outlook. But from those two specific questions, I don't see any negative impact. That's for sure.

On Asia growth, it's a little bit of a mixed picture. If you take out Australia, obviously, has a significant impact on the numbers here. So, it's good positive growth of around 7% year-to-date organically. Where Singapore and Indonesia are really doing well, Hong Kong is in the – is about average for the group, a little bit better than that, but that's also a very – what we consider a mature country. Where Indonesia and Singapore is doing extremely strong, China is a little bit slower this year and mainly that is a result of retail. Hong Kong also, as a result of retail, where there's a little bit of a slowdown on demand.

So, overall, happy with the development in Asia, albeit that China is little bit slower.

<Q - Emily Charlotte Roberts>: Thank you very much.

Operator

Thank you. And our next question comes from Kristian Godiksen of SEB. Please go ahead, sir. Your line is open.

<Q - Kristian Godiksen>: Thank you. Just a couple of questions from me. Firstly, can you comment on when will the downsizing in Brazil annualize and should we then expect the organic growth to pick up from there?

The second question is I was wondering which margin should you have settled with to keep both the Rio and the CP Mining contracts where we know there has been quite a lot of price competition.

And then, thirdly, Jeff, you gave an update on potential catering acquisitions in the U.S. Maybe you could also give a status on potential acquisition of technical services in the U.S. or North America in general? Thanks.

<A - Jeff Olsen Gravenhorst>: Yeah. Brazil is still ongoing. As we also said, there's a few quarters where we still will be reducing. Specifically on Brazil for next year, I think it will slow down – the organic growth impact will slow down during the year next year. That's the closest I'd get to it right now, Kristian. And apart from that, on the – was it the catering part? The second part? Yeah. On the catering acquisition...

<Q - Kristian Godiksen>: It's more on the technical...

<A - Jeff Olsen Gravenhorst>: I think I missed your second part of question here, Kristian. I'm sorry.

<Q - Kristian Godiksen>: The second was regarding which margin you should have settled with...

<A - Jeff Olsen Gravenhorst>: Yeah. Sorry. Yeah. That was a mining resource business in Australia specifically. Obviously, we don't want to lose money, that's for sure. And that means there is a certain breakeven where we need to make a profit from the contracts that we enter into. We are defending and making sure that we create value. Top line with no bottom line does not create value. So, that is always very key to us, that we will never sacrifice our bottom line just to get some volume in.

And when we look at these businesses, we have a limit to how far down we go on the margin side. We will, of course, not disclose that to the world, so that depends on how your setup is in individual country and region. But I just want to reiterate that we are really always looking at, that we want to be value accretive for everything that we do and not just volume. That's clearly the statement from me.

On the catering acquisitions in the U.S., we do have some we work with. I can't comment any closer on that on timing. It is always difficult to know exactly when that will happen. We are looking at technical services acquisitions, as we speak, both in North America but also in Europe. We are looking basically across the piece to see whether there are businesses that can enhance our technical offering across the world, as we also mentioned before. That is one of the areas where we can definitely increase and expand our service offering within IFS. So, that's a key point. Trust we are in talks with some there but, again, we don't know timing and/or whether it's going to happen, but we'll let you know as soon as we are closer to it or as it happens – sorry.

<Q - Kristian Godiksen>: Okay. Sounds good. Thanks.

Operator

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

<Q - Srinivasa Raju Sarikonda>: Hi. This is Srini from HSBC. I just have a quick question on CapEx. If you look at this year's CapEx, so far it has been around 23% lower than last year. I understand that it is arising from FX, divestments and even the procurement initiatives. Can you give us, like, what part of it is from the reduction? And how much is because of the current year contracts? Or put it in other words, shall we take it as the base going forward?

<A - Peter Harder Thomsen>: Yeah. I'll answer that. No, as Jeff pointed out before, you can't take it as a base going forward. We have a historical range we've been in between, and you could say, depending on the investments or new contracts, that is going to be a key driver. You heard about technology as well. So, that could be drivers going forward of CapEx.

We don't guide specifically on this measure, so I'll let you – the comments that we made before saying it will depend on the investments that we make, either with customers or in technology as an example.

<A - Jeff Olsen Gravenhorst>: I think we have to look that...

<Q - Srinivasa Raju Sarikonda>: Okay. Thank you.

<A - Jeff Olsen Gravenhorst>: ...at the moment, it is also a matter of where can clients get the cheapest financing obviously, and it's a little bit different today. So, sometimes, they'll choose to make their own investment as opposed to we'll make it. So, that is one of the parameters in this. I think going forward, as Peter say, we need to look at the historic numbers.

<Q - Srinivasa Raju Sarikonda>: Okay. Could you give us some flavor on this year's – like in the 23% reduction, what is it – what percentage of it is due to customers taking the investments and not ISS?

<A - Jeff Olsen Gravenhorst>: No. We don't have here. We don't disclose that number.

<Q - Srinivasa Raju Sarikonda>: Okay. I understand. Thank you.

Operator

Thank you. And our next question comes from Rory McKenzie of UBS. Please go ahead, sir. Your line is open.

<Q - Rory E. McKenzie>: Yeah. Good morning, all. Firstly, [ph] to label the (51:49) point on the growth slowdown in Q4, can you help us by quantifying how much Brazil was down in Q3, how much Australia was down in Q3, and what the year-on-year contribution within Danske and DNB was?

And then secondly on growth. On the UK, you referenced good growth in financials. I guess, obviously, the UBS contract might have a material benefit to that. So, what will be the underlying trends ex UBS? I promise I'm not just asking to find out how much we're paying for our new building.

<A - Jeff Olsen Gravenhorst>: Yeah. I mean, these are very specific numbers, obviously, and the guidance we give here is, of course, not as granular. So, there is no doubt that the impact from Australia is a double-digit negative growth number, so there is a significant impact from the three contracts. We don't actually disclose the numbers on them individually because it's very few contracts.

In Brazil, of course, it's a smaller part of the business, but it's also quite a significant reduction of the business. So, 25% reduction of the business or thereabouts, that's the closest I can get to the numbers here. But it just means that it does have an impact also on the group, albeit, not significant on the group but it does have an impact on the growth number.

With regards to the financial sector in the UK, yes, of course, UBS is a new contract that started up, particularly this year when you moved in to the building. So, we don't see a slowdown. We keep, of course, very close to this financial industry in the UK and what are the movements and so forth. But so far, of course, there is no slow down. There is still a lot of good opportunities in the UK particularly within the segment, but also continued growth during next year with UBS as it ramps up.

<Q - Rory E. McKenzie>: Okay. And then, just one more strategic question. Anything you can say about how you're finding the IBM Watson program so far? I know you – I think you got that at your head office at the moment. And also, what other areas of workplace management do you think you're kind of targeting for investment in that kind of more long-term investment and savings area?

<A - Jeff Olsen Gravenhorst>: Yeah. The correlation corporation with IBM, so far, is doing well, very well. We have it in three different buckets, if you might recall. The number one is the sort of the business as usual but a better program, which is called TRIRIGA. That TRIRIGA program is being rolled out as we speak, and you're quite right, it's being rolled out in the head office as we speak, but also with some of our major clients. TRIRIGA is a better help desk preventive maintenance system where we have all of the asset registers and we can actually optimize on the preventive maintenance cost.

Second part is the integration part, which is still being piloted. We're expanding the piloting and we'll do that during this year and next year. So, we'll see benefits coming through during next year and into 2018, but we'll see some of that already in second half of 2017.

And then on the last point, which is the Watson part, that's the artificial intelligence part. But that, of course, we are testing also here in the head office now. That will roll out slowly but surely over the coming years. It's a little bit more of testing, I have to say, of how far can we actually go with this. So, conclusion is, its rolled out completely according to plan, and we are expecting a lot from that.

Further investments into workplace management, of course, it's all about this outcome-related development. Customers, we can help our customers to become better banks, more efficient banks, or we can help it to become better work spaces and more attractive workplaces because of the higher efficiency on footprint and, actually, focusing better on what matters to the end users being that passengers, being it patients, being it employees.

So, that's the area where workspace is important to us. That's where we'll invest and that's also where we're looking for acquisition targets and expansions. That means it could be internal architects, but it can solve the planning of space but also technology of heat mapping and intelligence on what's being used and what's not being used and what matters and what does not matter to end users.

<Q - Rory E. McKenzie>: Okay. Great. Thank you.

Operator

Thank you. Our next question comes from Paul Checketts of Barclays Capital. Please go ahead, sir. Your line is open.

<Q - Paul D. Checketts>: Good morning. I've got three questions, please. The first, Jeff, can you say whether or not there are any large bids in Q3 that you had tendered for but were unsuccessful on? That's number one.

And then the second here relate to the UK. There has been some quite negative commentary from some of your competitors. Have you seen any change in how your competitors are behaving and how your customers are approaching negotiations? That's the first UK part. And the second one, I suspect that's quite a low number, but can you give us some sense for how much of your cost base in the UK would be exposed to currency-led inflation? Thanks.

<A - Jeff Olsen Gravenhorst>: Number one is, we always have bids, of course, of where we win and we also have some where we don't win. So, if you specifically ask for the one where we didn't win in the UK, there is a hospital area, which we've also highlighted earlier, which is a smaller part of the existing business but could have been an expansion, which is the Barts consortium or trust which went to Serco, and that has also been announced. But we have the small part of that today which is the Newham Hospital.

That's the only one that I know of, of larger bids anywhere that we've lost. We have actually won some good bids also, which was announced in the Royal Mail as an example and also on – we have already gone through that. So, I think – and Bombardier that we started off in North America and so forth. But that's the one that I can highlight. It would not have a significant impact on our organic growth for the future but, of course, it goes into it.

On the UK impact on currency-led cost, it really has a minor impact. As you know, most of our cost is in local currency and that means, of course, [ph] levy (58:29), that's where we self-deliver and that's why most of the cost that we have has the same swings as the revenue will have. Of course, there are some catering-led cost increases that we can see right now, but that we can always manage and have to manage, both on pricing and on different menus and putting things together. So, we don't expect that to have an impact on this year or next year either. That could be managed.

So, overall, no significant impact from that in UK. I know there has been some comment out from some others on the levy, but it was the same last year on the national living wage. I think we're good at, actually, managing this both by efficiency improvements and by price increases.

<Q - Paul D. Checketts>: So, this doesn't really mean you're not seeing an increased intensity in terms of pricing in the UK on bids?

<A - Jeff Olsen Gravenhorst>: Not as I see it so far. No.

<Q - Paul D. Checketts>: Okay. Okay. Thanks very much.

<A - Nicholas Richard Ward>: Time for one more question. I know we got two or three hanging online. But if we'll just take one final question, please, operator and then, we'll have to move on.

Operator

Thank you. Then our final question comes from Andrew Farnell of Morgan Stanley. Please go ahead. Your line is open.

<Q - Andrew R. Farnell>: Hi there. I just wondered if you could about some of the large IFS and key account contracts that you signed this year. When do you expect them to be contributing revenue as you move into 2017?

<A - Jeff Olsen Gravenhorst>: Yeah. When we look at a few other ones that we have announced, Orange, of course, in France came in the first quarter. This year, Jakarta Airport came in, both in first quarter and, again, expanded in the third quarter. Rolls-Royce came in the second quarter. PostNord came in second quarter. We have got Royal Mail coming in here in the fourth quarter. We have a big logistic company in the UK that came in July. And Bombardier starts off here in December. So, those are some of the larger IFS contracts' timing.

<Q - Andrew R. Farnell>: Okay. And just on some of the new contract opportunities that you've mentioned in the UK. Are you able to talk about which sectors they're in, if it's outside of financial services or just remain within that?

<A - Jeff Olsen Gravenhorst>: It's financial services and business services and IT predominantly. There are, of course, always an element within the public sector particularly, within government to business or MOD and the likes.

<Q - Andrew R. Farnell>: Okay. That's great Thanks.

Nicholas Richard Ward

Okay. Thank you, everybody. Thanks for your questions and your time. Thank you to Jeff and to Peter. And for any outstanding questions, please don't hesitate to contact either Martin or myself. Thank you.

Operator

Thank you. This now concludes the conference. Thank you, all, very much for attending. You may now disconnect.

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