REFINITIV STREETEVENTS

EDITED TRANSCRIPT

Q1 2022 ISS A/S Trading Update Call

EVENT DATE/TIME: MAY 03, 2022 / 8:00AM GMT

CORPORATE PARTICIPANTS

Jacob Aarup-Andersen *ISS A/S - Group CEO & Member of the Executive Group Management Board*
Jacob Schmidt Johansen *ISS A/S - Head of IR*
Kasper Fangel *ISS A/S - Group CFO & Member of the Executive Group Management Board*

CONFERENCE CALL PARTICIPANTS

Allen David Wells *Jefferies LLC, Research Division - Equity Analyst*
Bilal Aziz *UBS Investment Bank, Research Division - Associate Director and Equity Research Analyst*
Klaus Kehl *Nykredit Realkredit A/S, Research Division - Chief Analyst*
Madeleine H. Jobber *Morgan Stanley, Research Division - Research Associate*
Michael K. Vitfell-Rasmussen *Danske Bank A/S, Research Division - Research Analyst*
Rahul Chopra *HSBC, Research Division - Research Analyst*
Peter Sehested *ABG Sundal Collier, Research Division - Equity Analyst*

PRESENTATION

Jacob Schmidt Johansen ***ISS A/S - Head of IR***

Good morning, ladies and gentlemen, and welcome to this conference call following the release of ISS Q1 2022 Trading Update. My name is Jacob Johansen from ISS Investor Relation, and I am here at our group headquarter in Søborg, Copenhagen. With me in the room today is our Group CEO, Jacob Aarup-Andersen; and Group CFO, Kasper Fangel as well as Kristian Tankred, my new IR colleague.

Before beginning the presentation, I'll ask every one of you to pay close attention to the disclaimer on Page 25.

With that, I'll hand over the word to Jacob and Slide #3, please.

Jacob Aarup-Andersen ***ISS A/S - Group CEO & Member of the Executive Group Management Board***

Thank you, Jacob, and good morning, everyone. Let me start off with the executive summary. So first of all, Q1 was a good start to the year. The quarter showed a clear trend of increasing activity levels, and it's encouraging to see the strong demand for our core services. Our sustainable portfolio revenue increased by 7% in the quarter and demand for non-portfolio work continue to be high. Customers are investing in their workplace to adapt to a post COVID-19 environment, and they prefer higher flexibility in the FM services.

A key theme is, of course, inflation. We have worked diligently in our management of price increases and are handling inflation well. As you would expect, we have also continued to work through the turnaround plans for our underperforming entities. Today, we've reached a significant milestone in our turnaround as the U.K. has reached its turnaround run rate target. We're therefore reducing the number of hotspots from originally 4 to now 2. Only Deutsche Telekom and France are remaining. The underlying margin improved in the quarter according to plan, and we have successfully handled any margin impact from the cost inflation. On the back of the strong development in Q1, we are today able to upgrade our 2022 organic growth outlook, more on that later in the presentation.

So let's turn to Slide #5 for an update on the strategic development. With the 5 refocused strategic priorities, we strive to improve our execution power. Within the commercial area, we've extended a large number of key account contracts, and our retention rates have increased, which is something I'm going to come back to. As part of our market leadership, we work a lot on data and insights. With the redesigned pulse surveys, we are gaining enhanced data behind the latest FM trends. And we are using that data internally and towards our customers to become a true business partner and utilize our global scale. I'll deep dive on some of the conclusions a little bit later.

The brilliant operating basics are being implemented on multiple sites across the group, which allows us to drive an improvement of our operating model in the coming years. We can never ever lose our focus on the basics that allows us to deliver excellent service levels at the most efficient cost at all of our sites every single day. On the turnaround, the fast improvements in the U.K. shows the structural strength of our customer base and competitive market edge. Full focus is now on France and the Deutsche Telekom contract.

So let's turn to Slide #6 for an update on the divestment program. Another milestone in our turnaround is that we for practical purposes now consider our divestment program completed. So this will be the last quarter with a separate slide on the program. DKK 1.9 billion of the expected proceeds are secured, and the smaller outstanding divestments will take us slightly above the DKK 2 billion target. Since the full year announcement, the divestments of Taiwan and Russia have been completed, both finalizing processes that we initiated in December 2020.

And with that, I'll take a deeper look at the market and business development, and that will mean Slide #8, please. During the first quarter, the commercial activity level has been high. As you can see from the slide, we've extended a very long list of key account contracts. For the last several quarters, we've had a relatively large share of our contracts up for renewal, and it's therefore encouraging to see that we've been able to retain the vast majority in all of the larger ones. This is a testimony to the investments we're doing to enhance our commercial capabilities.

Retailing contracts is a focus area for us, and we aim to structurally improve our retention rate, and we see a strong potential improvement. There's no doubt that the best sale is to retain a good customer. It's encouraging to see that our retention rates are higher in Q1 than historically, which is evidence that our work to structurally improve retention is showing some initial results. We now have 3% of group revenue outstanding for renewal for the remainder of 2022, and those are in good progress.

One new contract with annual revenue above DKK 100 million has been one and the pipeline is developing well. We see some commercial decisions among our customers are dragging out, which is not surprising given the current dynamic development of the workplace and the geopolitical volatility in recent months. But it's not a concern, and we're comfortable.

Please turn to Slide #9. Throughout our more than 120 years history, we managed inflation. For a company in a low-margin industry with the vast majority of costs being wages, it's an integrated part of our business. In most of our contracts, we have clear legal clauses, which allows us to pass on the cost inflation to the customers. This slide shows an illustration of a specific real-life manufacturing key account contract. It highlights the relationship to our customers, and this also shows our opportunities to work with the customer on an ongoing basis and develop the contract.

Besides wage inflation, we also faced with increasing food prices, which improved our close dialogue with the customer are managing through a combination of adjusting the offering and operational efficiencies. This also goes for the annual glide path and efficiencies promised as part of the contract, which you know is the usual business. All in all, adjusting prices towards customer is a key parameter to manage inflation, but there are, of course, several additional opportunities to offset the effect.

Please turn to the next slide for a status on COVID-19 recovery. For the first time since the outbreak of the pandemic, our quarterly revenue is now organically above the pre-COVID-19 level, i.e., above Q1 2019. The development is also helped by the startup of the Deutsche Telekom contract and the different seasonality above-base work. But it's a very clear proof point of the structural demand for our core services also in a post-COVID-19 environment. On a group level, organic revenue in Q1 2021 is 3% higher as revenue for both cleaning and technical services are well above the level in 2019. The return to office trend is an important driver, most visibly within our food services. They improved from index 72 to 80 in the quarter.

Please turn to the next slide for a look at our Pulse survey. So we have redesigned our ISS Pulse survey as part of our work to enhance our data-driven insights. With this enhanced survey, we gained valuable in-depth insights to the latest trends in the facility and management industry. The data here covers 1 million office workers all over the world and therefore, gives quite unique insights. The focus is on the office-based segment, which accounts for around half of our business, as you know. For the non-office based customers, we continue to see structural growth. Health care and production revenue is not exposed in any material sense to potential changes in the workplace environment.

From the survey, it's clear to see that a majority of our customers are investing more in their workplace and not planning to reduce real estate footprint. We have previously communicated that the office footprint could reduce by 10% to 15% based on our best estimates. Based on the development in recent quarters, customers continue to focus on the workplace and data from this survey, we're now confident that, that will be less. If we are assuming that the net 16% that you're seeing up here of office-based customers that are reducing footprint are reducing, let's say, on average, 20% of their footprint, then that translates into maybe 3% to 4% reduction in total square meters for us.

And that's only in half of our business. So that will easily be more than offset by higher quality and content per square meters as we've also talked about in the past. The conclusion is that even though square meters are reduced slightly, demand for high-quality services have increased. With our self-delivery model, several opportunities arise, and we can support our customers in creating the workplace of the future.

But the priorities and demands for facilities management has also changed. And let's look at the next slide to deep dive on that. Because another highlight from our Pulse survey reveals that the customers' priorities have changed. Before the pandemic, the main priority was operational efficiency, but now focuses on bringing employees together and back to the offices. Employee engagement is now a top priority and improving sustainability and talent attraction is more important than pre-COVID. Furthermore, it's interesting to see that cost savings is no longer a top 5 priority.

This concludes my part of the presentation, and I hand over the word to Kasper to go through more details on the financials. And I think that means Slide #14, please.

Kasper Fangel ***ISS A/S - Group CFO & Member of the Executive Group Management Board***

Thank you, Jacob, and good morning all. Our growth momentum from Q4 last year did not slowdown in Q1 as organic growth was 5.4% in the first quarter of 2022. The growth was driven by accelerated return to office trends in several large countries and price increases implemented globally. The price increases implemented in Turkey contributed with around 1 percentage points to the group's organic growth. It is encouraging to see that the portfolio revenue, the sticky and sustainable part of our revenue grew organically by around 7%. The demand for projects and above-base services was also maintained at a high level as increased demand for workplace investments and regular project work almost offset the decrease in deep cleaning and disinfection. Non-portfolio organic growth was negative 1%, having a minimal negative impact on the group's organic growth.

Please turn to the next slide for a review of the regional development. Despite very different developments, not least from COVID-19, all regions reported positive organic growth in Q1. In Europe, the improving return to office trend combined with price increases were the main drivers of the growth. Specifically in Norway due to the ramp-up of the contract with Equinor and Turkey with underlying growth and price increases. In Asia Pacific, the development was very different from country to country. Australia reported strong organic growth with increased activity across customers.

In contrast, some countries in Southeast Asia reported negative organic growth due to reinforced COVID-19 restrictions. The improved return to office trend had a significant effect in the Americas region due to our relatively higher exposure to food and the office segment. Even though organic growth for food services was above 70%, revenue is still at index 60 compared to before the pandemic. And that obviously means that there is still more upside from the continued return to office in the U.S.

Please turn to Slide #16 for the status of the turnaround. In 2022, we are still in a turnaround mode. We continue to have a strong focus on improving the underlying margin further from the just above 3% level at the end of 2021. And here in Q1, the margin improvement is developing according to plan. As we continue to improve the underlying margin, we have seen no setbacks from the elevated cost inflation. On a group level, the operating margin is unaffected. 9 months ahead of plan, the U.K. has reached the turnaround target of a low single-digit run rate margin. Focus is, therefore, on the 2 remaining underperforming areas, France and the Deutsche Telekom contract. In both areas, the gradual improvements continued, but needless to say, there's still a lot of hard work ahead of us.

Please turn to the next slide for comments on the upgraded 2022 outlook. The organic growth in the quarter was stronger than expected, and we have also experienced a more encouraging development of key factors, such as the pace of return to office as well as the continued strong project and above-base work. We are, therefore, comfortable in upgrading the 2022 outlook relatively early in the year. Organic growth is now expected to be above 4% compared to previously above 2%. The underlying margin improvement is on track and with the implemented price increases, we expect a negligible effect on margin from inflation. We're therefore confirming the outlook for operating margin to be above 3.5%. The outlook for free cash flow is also confirmed at above DKK 1.3 billion.

Please turn to the next slide, where I'll go through the main building blocks behind the outlook for organic growth. In a very simplified illustration, we see 4 main building blocks behind the outlook for organic growth of above 4%.

Firstly, we expect a positive contribution from price increases net of efficiencies of approximately 2 percentage points. We've already seen a positive effect in that ballpark here in Q1. A large part of this year's expected price increases has already been implemented.

Secondly, we expect the gradual return to office trend to continue, and we expect this to contribute with 2 to 3 percentage points, mainly driven by food services. This was slightly more in this quarter.

Then thirdly, we expect a positive effect from net contract wins and losses. We still expect this to contribute with up to 1 percentage points, including the exit of the Danish Defense contract, which is expected to be fully exited in May.

And then finally, we expect a negative contribution from lower projects and above-base work. In 2021, demand was high, driven by deep cleaning and disinfection during the pandemic. In Q1, demand continued to be strong, but we do not expect it to continue to the same extent throughout the year.

With that, I've covered the financial part of the presentation, and I hand the word back to Jacob for some closing remarks on Slide 19, please.

Jacob Aarup-Andersen ***ISS A/S - Group CEO & Member of the Executive Group Management Board***

Thank you, Kasper. And just to round this off, Q1 was a good start to the year. So when we look at the demand for our services, it clearly continued and price increases were implemented. We're therefore able today to upgrade our outlook for organic growth and with confidence, confirm the margin and cash flow guidance. We are well on track to deliver on our turnaround targets by the end of this year, and we will continue our laser focus on delivering on our recovery.

As employees are getting back to the offices, the importance of the workplace becomes even clearer. Customers are increasing spend on quality and facilities management, and we can help our customers form the workplace of the future and which clearly creates several opportunities for us. Finally, I want to give a heartfelt thank you to all of our more than 350,000 employees around the world. Your contribution to ISS and support to our customers really, really make a difference every single day. People truly do make places.

With that, I will open up for the Q&A session.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) The first question is from the line of Bilal Aziz from UBS.

Bilal Aziz ***UBS Investment Bank, Research Division - Associate Director and Equity Research Analyst***

3 for me, please. And firstly, Jacob, you talked about a bigger focus on retention rate. Perhaps you could pin you down to some numbers over there. What do you think is a reasonable target for a retention rate? Some of your peers operate somewhere between 93% to 96%. So keen to hear your views on that side and particularly around commercial momentum. Number two, you've upgraded the organic growth today. Can you perhaps help us with the phasing of that for the rest of the year with respect to above-base and contract ramp-up? And lastly, clearly, the organic growth upgrade all reached quite positively for margins and free cash flows. You've left that unchanged. Perhaps you could help us with the thinking on that side, please.

Jacob Aarup-Andersen ***ISS A/S - Group CEO & Member of the Executive Group Management Board***

Thank you, Bilal. I'll start with the first one. You addressed that directly to me. So just on the commercial side, your first question within that question was on retention. So if you look at it historically, we've been averaging 92%, 93% retention. And the last couple of years, it's more been 91%, 92%. We are now back last 12 months at 93%, and we're seeing that continue to improve. I'm not going to give you a target. I'm not going to announce the retention target here. But the aim is that we improve on the historic 92% to 93%. We improved that. Let's -- when we get back and also talk about longer-term aspirations, it would be natural for us to give you more firm views on where retention should be.

But it is a big focus for us. And we're seeing it pay off. And as I say, it has an arrow upwards now having hit the 93% again being back at that level and expecting it to increase from here. I said it on -- in my speaker notes, I think we all understand how much better a sale, a retention is versus a new sale in terms of risk profile, in terms of ongoing cost management, et cetera. And then you said broader commercial momentum. So we're not seeing a negative change in commercial momentum. The only thing we're seeing is there are some of the big processes that are just taking a bit longer. Some organizations just had to find themselves again with the recent geopolitical turmoil, which has led to some delay in some deadlines, et cetera. But we're not seeing any 1 pool processes or anything like that.

So it's more a slight delays in some processes and the pipeline is looking good, like we also mentioned last time around. Nothing has changed on that. We won 1 sizable key account in the quarter as we reported. We have some very, very important negotiations going on at the moment, and we feel confident that we can be able to bring some of that news to you within the next quarter or 2. So -- but as always, I will not commit to anything that is in a process. Then I'll pass it over to you, Kasper, on the phasing of the revenue.

Kasper Fangel ***ISS A/S - Group CFO & Member of the Executive Group Management Board***

Yes. Absolutely. Bilal, so on the phasing on organic growth, we are guiding organic growth above 4% for the full year. So with the reported 5.4% in Q1, we do not expect massive phasing throughout the remaining 3 quarters. And as you will appreciate, we do not guide for the quarters in isolation, but I'm happy to provide more color on the phasing of the growth components that I mentioned in my presentation. So we expect COVID-19 recovery, as I said, to be between 2% and 3%. Remember, comparison gets tougher in the second half of the year. Our net price increases, approximately 2% growth contribution broadly the same throughout the year.

And net contract wins and losses, including the exit of Danish Defense up to 1% positive growth contribution. Danish Defense has started to the demobilization and we expect that to be fully out of the portfolio in May this year. The last part is above-base and projects up to negative 1%. However, the key determined factor is the end of the year where, as you know, we traditionally have seen a spike in project revenue in Q4. That is obviously still uncertain. However, it is pleasing to see that project work did not decline in Q1 against Q1 2021, which was a year where we saw a constant high level of project work.

And on the margin side, your third question, of course, it is positive for margins when top line increases. And there are pluses and minuses for the margin this year compared to the initial expectations. On the pluses, the high level of project work is margin accretive, and we also expect to get more revenue and therefore, also more profit from COVID-19 recovery. We've also managed to get price increases pass through without any margin hits. On the negative side, we have seen additional costs related to temporarily higher sickness rates in Q1. But in summary, with Q1 margins secured, we are very well on track to deliver on the full year outlook of above 3.5%. But it's too early to narrow the margin guidance at this point in time.

Operator

The next question will come from the line of Michael Rasmussen from Danske Bank.

Michael K. Vitfell-Rasmussen ***Danske Bank A/S, Research Division - Research Analyst***

Yes. And very well done, both of you or all of you guys. 3 questions from my side. So first of all, on just thinking a bit on 2023, I know it's not just around the corner. But if you could just share how you think about growth opportunities as such now when 2022 looks to be a rather good year. So will the negative potential from above-base, I think you've talked about 2.5 percentage points in the past, it just be pushed into 2023? Or do you think new contracts, first time outsourcings, further food recovery will mean that we'll get a 2023 also rather solid in terms of organic growth?

My second question is just on the turnarounds. First of all, any change in how you work with both Deutsche Telekom and the turnaround in France? Is this something you need to change now? Is this something that you need to accelerate? Or has your thinking been changed in the past few months? And then finally, on the U.K. market. So you've now reached the turnaround margins. And we know that from historical, the U.K. market, obviously, was a very high-margin market. What's next process on the U.K. just now because I guess that you're definitely not satisfied with what you've done so far?

Jacob Aarup-Andersen ***ISS A/S - Group CEO & Member of the Executive Group Management Board***

Thank you, Michael. Why don't I start out? So on '23, well, you prefaced it yourself. It is -- we just delivered Q1 '22. So there's a limit to how detailed, I can be around how we see '23 at this stage. I know you appreciate that. But if we stay in the helicopter and that's also what you're asking. We -- as I said, we are seeing good commercial momentum, and we would expect some good commercial wins this year. That -- those wins will, as you know, given that it takes time to mobilize and fully start up, et cetera, they will have an effect in '23, a bigger effect in '23 than in '22. So there should be a positive contribution from new wins in '23 versus '22.

And also where we don't -- in '23, we don't have the negative effect of Danish Defense falling out like we have this year. So I think the net wins should be a positive. And you're also right that the food business, we are not assuming in our guidance for this year that food goes back to index 100. So there is an upside in '23 from food continuing to return to normality, which is also a positive. So those 2 are the big positives. You mentioned above-base. Listen, at this stage, talking about above-base in '23, I think it's too early.

You can have many schools of thoughts out there. You can have views that we will return to pre-COVID levels. You can also have views that there is a more permanent structural investment cycle now in the workplace in the coming years, and that will drive more above-base. And I'm not going to comment on that here. But what I can say is when I look at '23, I don't see a reason why we shouldn't see good growth in '23 versus -- in the same way as we've seen in '22. But you're not going to get a number out of us, and I know you know that.

Just on the second one, which was on the turnaround, in terms of DTAG and France, we're not seeing any changes in our approach to them. But if I take the 2 -- they are different, as you know. On DTAG, there's a lot of work going into gap closing work, finalizing our approach to some of the bigger drivers within the DTAG accounts such as the capital project side, et cetera. So making sure that the system implementations are yielding the benefits on an efficiency perspective that we expect, et cetera, et cetera. So the DTAG is very much around driving a more efficient and effective operation. And that plan is not changing. There's a very strong plan there that is being executed by the team. We said it many times, it's a big contract. And as you know, it's been quite loss-making. And therefore, it is a big task. But of course, for every month that goes by where we execute on the plan, we move towards the target. So nothing has changed on that one.

France, it's a different thing in France. You know that there, it's not just about gap closure and driving a more efficient operation. There is also an element here that we are hit by the fact that we are more COVID-hit in France than we are in other European countries due to our business mix. You know we have exposure to clients that are more hit from COVID than average. And that means that there's also an element here that we need to see more volume growth in France to truly deliver a full turnaround in France. And therefore, it's a mix of both focusing on the internal plans, but also focusing on driving top line in France. So those 2 elements. But overall, the conclusion is that we're not changing our approach to any of those 2 as such. Kasper, do you want to speak about the U.K.?

Kasper Fangel ***ISS A/S - Group CFO & Member of the Executive Group Management Board***

Yes, definitely. Michael. I mean, indeed, we are happy with the acceleration and momentum in the U.K., but that does not mean that it stops here. And it's clear that we have more potential in the U.K., and that's both in terms of commercial momentum, so on top line, but also on profit by driving further efficiencies on the direct cost, but also overhead synergies. And of course, we will keep pressing and push for that. The good thing about our U.K. business is that 90% of the revenue, actually, more than 90% of the revenue is purely key accounts. And we have managed to get full transparency all the way down to site level in the U.K. business, which means that we can drive efficiencies very fast and very effectively. I think it's too early to commit to a new target. But again, needless to say, we are pressing with full horsepower to squeeze further efficiencies out of our U.K. business.

Michael K. Vitfell-Rasmussen ***Danske Bank A/S, Research Division - Research Analyst***

I'm glad to hear that really looking forward to some new plans, perhaps later this year.

Operator

The next question is from the line of Allen Wells from Jefferies.

Allen David Wells ***Jefferies LLC, Research Division - Equity Analyst***

I think when -- a couple of extras for me. I think the first half to second half profits, I think we were looking at 65-ish percent of profits in the second half due to stronger margins, et cetera. With the above-base work, I guess, above what we were expecting in Q1, does that change anything in terms of the first half, second half phasing of profits? That's my first question. Secondly, on the U.S. food side, I think you said still indexing at 60. You said it won't be back to a 100. But based on the current expectations to current guidance, what sort of level do you expect that to be at year-end, maybe 80 or 90? Just to try and get an understanding there.

And then finally, just following on from that on the catering side, some of the other listed peers have obviously talked about strong activity from first-gen outsourcing of customer struggle to manage complexities with flexible working and supply chain inflation, et cetera. Is that something you're also seeing in your food business as well, where there might be some upside and maybe for seeing something in the pipeline of contracts that are coming through as well? Just to understand.

Jacob Aarup-Andersen ***ISS A/S - Group CEO & Member of the Executive Group Management Board***

Okay. Thank you, Allen. I will let Kasper talk about phasing of profits between H1 and H2 and the impact that the above-base could have on that. So let me talk about the 2 others. On the U.S. food side, you indeed correct that that's index 60 in the U.S. And when we talk about food, I'm not going to give you a target for where we see U.S. food end the year because that would be too specific. But we are assuming that we exit food in general at index 85 at the end of the year here. And of course, U.S. is the biggest food market we have. We've said before that the U.S. is indexing a bit lower than the rest of our food business, simply because it's been a later return to office where you also know we are especially quite West Coast heavy, and there's just been a slower return there. And we're seeing that return now as also described. So that's good. So 85 on the overall food business, which would entail that the U.S. is a bit lower.

On the -- in terms of first-gen outsourcing, I think that's a great question. And actually, there's no doubt that we're seeing that in food. When you look at the -- if you put yourself in the shoes of a real estate head or workplace owner, where is the most volatile -- where have you seen the most volatility in the last 2 years in terms of the different service lines. Well, it's clearly been on the food side. So there is a push for more outsourcing of food services, and that's also something that we see as quite an interesting opportunity in the coming years. And as we see pipelines build at the moment, part of that is also on food business. So when you look at growth beyond '22, I think first-gen outsourcing food will have a larger proportion of that compared to what we've seen in the past given the experiences here. So I think you're spot on from that perspective. Over to you, Kasper, on the phasing.

Kasper Fangel ***ISS A/S - Group CFO & Member of the Executive Group Management Board***

Yes. On margin phasing, Allen. So on margin, we are progressing according to plan, and we continue to see underlying improvements in Q1 against the exit position in 2021. We still expect that margins in the first half will be better than 2.5%. And in the second half, higher than 4.5%, which will give you a margin for the full year, which is better than 3.5%. And of course, it's pleasing to see that the Q1 is following the plan as that obviously derisks the margin outlook for the full year. And specifically on the impact on project volume, we are not depending on -- of the high level of project volume to continue throughout the year. So we are expecting that to decrease and have a negative impact on top line up to negative 1% for the full year.

Operator

The next question is from the line of Klaus Kehl from Nykredit.

Klaus Kehl ***Nykredit Realkredit A/S, Research Division - Chief Analyst***

Yes. A couple of questions from my side. First of all, if we start with the Danish Defense contract, you said that it will end here in May. But what will that mean for your organic growth after May? And secondly, also in respect to this contract, you have made a provision. Is it still, yes, your best guess that this provision is big enough to exit the contract? And then another question about the inflation. You have mentioned it a couple of times that you have raised prices in Q1. But just to be perfectly clear, is that across all geographies? And does it mean that the risk from margin pressure from rising inflation in the coming quarters is more or less eliminated? That would be my questions.

Jacob Aarup-Andersen ***ISS A/S - Group CEO & Member of the Executive Group Management Board***

Thank you, Klaus. Let me start on the inflation piece and then Kasper can speak to Danish Defense in terms of the growth impact and the -- whether the provision is adequate. On the inflation side, so yes, when we talk about the price increases that we put through in the quarter, we are broadly referring across geographies. It's not like that is exactly the same proportion across all geographies as you would appreciate. But a large proportion of our contracts in terms of the labor element, the yearly wage increases are coming through in the first half of the year and not in the second half of the year.

So if we take step 1, you know the large part of -- the vast majority of inflationary pressures in ISS, that's on wages. Two, 70% of our wage cost is in Europe. And in Europe, our employees are mainly on collective agreements. And that means that here in the beginning of the year, the largest proportion of wage changes happens. That is also why you can say we feel quite confident around the fact that we have derisked this significantly because a large proportion of those yearly wage increases have now come through with associated price increases. Then there is some -- there are some contracts where wage increases will come through later in the year, depending on the contract or the geography. And then on top of that, there are -- there's some food inflation that continues.

On the food, you also know that the majority of our food contracts are what we call "cost plus", which means we can pass on the food inflation to the customer with the margin on top. And therefore, say, food inflation is also something that we are comfortable with. Of course, there are customer situations where it's tough conversations, and it's not always that the contract is 100% clear, and then we'll have a commercial discussion, et cetera. But the mandate is very clear to our team that is that margin has to be preserved in these negotiations. So we've been through a large part of the inflationary pressures, but no one is letting down their guards for the rest of the year. And let me hand over to Kasper on Danish Defense.

Kasper Fangel ***ISS A/S - Group CFO & Member of the Executive Group Management Board***

Yes. Klaus, so in isolation, the exit of the Danish Defense contract is going to give a growth impact of a little less than 1%. But remember that the exit is phased, and we are actually seeing a very small impact on revenues. So a very small volume in Q2 on top line from Danish Defense. So it is starting to move out and fully exited in May. And combined, just want to make the point that on the portfolio in totality, including the exit of Danish Defense, we do expect up to 1% positive growth contribution this year. And in terms of the provision on the balance sheet, we are comfortable with that, and we do not expect any adjustments going through the P&L as a consequence of us exiting with Danish Defense.

Klaus Kehl ***Nykredit Realkredit A/S, Research Division - Chief Analyst***

Okay. Just a follow-up question. So it means that your organic growth will improve by approximately 1 percentage point after May when you have exited this Danish Defense contract?

Kasper Fangel ***ISS A/S - Group CFO & Member of the Executive Group Management Board***

For the full year, we expect -- including the exit of Danish Defense that we will get up to 1% organic growth from net contract wins and losses.

Operator

The next question is from the line of Rahul Chopra from HSBC.

Rahul Chopra ***HSBC, Research Division - Research Analyst***

I have 2, if I may. One is on the capital allocation and M&A. Now given your disposals has largely been completed, how you're thinking in terms of capital allocation? And just -- should we think in terms of M&A versus further divestments? Or how should we think about those elements there? And my second question is in terms of employee turnover has been quite -- has been beneficial for margins quite recently. So I just wanted to understand the kind of which labor scarcity are you seeing in Europe and North America. And just wanted to understand your thoughts on labor scarcity and what kind of wages are you looking at those numbers?

Jacob Aarup-Andersen ***ISS A/S - Group CEO & Member of the Executive Group Management Board***

Yes. Thank you, Rahul. Let me start on the capital allocation and M&A. No change there. We have made it very clear that as part of our turnaround until end of '22, the focus is on deleveraging our balance sheet below 3x net debt EBITDA and nothing has changed there.

We are confident that we will deliver on that target, as you know, and so nothing has changed from that perspective. We are -- as we get to that level, we will then communicate around capital allocation. But for now, the only capital allocation that we focus on is making sure that we deliver on the leverage targets that we have promised you.

Then on the turnover -- employee turnover, I'm not sure that if I may just push back a little bit. I'm not sure turnover has been beneficial in terms of margins, et cetera. But we are constantly working on reducing our turnover. It's a KPI for our management that we reduce our employee turnover in general. There's no doubt that when we look at the current market environment with the labor shortage, as you pointed out, there is -- it's generally a very, very tight market, and it is harder to recruit. And that's also why we have stepped up our efforts quite massively. We've invested both on the systems side. I've previously on all the calls talked about how we use artificial intelligence in our large markets, et cetera.

So there is a lot of initiatives from our side in terms of making sure that we counter that tighter labor market there. We have more vacant positions than we had pre-COVID. I think unfortunately, most companies can make the same statement, but we are managing it. Due to the size of the company with more than 350,000 employees, we are able to be flexible and move our workforce around and deliver on the commitments to our clients. So I will definitely agree to your statement that it is tough. It is -- it requires a lot of work and our very, very good P&C colleagues have been driving that very well. So we don't see it as an increased risk factor going forward.

You mentioned wages, wage increases. Well, the wage increases we are seeing predominantly our workforce is under collective agreements. And hence, it's multiyear agreements, and we know with quite well in advance what increases will be, and therefore, we can handle them. And there are areas, of course, where there are high wage inflation in -- where it's more temporary labor, when it's more loosely affiliated labor, but we can also handle that. It's on the vast majority of contracts, we can pass it on. But we are, of course, also trying to be as intelligent and efficient around how we use those resources. So nothing new on that account. This is part of the overall inflation narrative I started out with today, and we are handling that, as you can see from the numbers.

Operator

(Operator Instructions) The next question is from the line of Madeleine Jobber from Morgan Stanley.

Madeleine H. Jobber ***Morgan Stanley, Research Division - Research Associate***

Just a couple for me because I think most you already answered. On the above-base work and the kind of continuity of it, would you be able to quantify what you think the kind of sticking rate will be going forward? I mean, are you really expecting to go back down to pre-COVID levels or kind of more realistically sustain this current run rate? And secondly, on your ability to push further price increases through in case of further cost escalation, what kind of flexes do you have in your margin guidance potentially for higher inflation going forward? Just what kind of considerations would you take into account there? And then finally, on just free cash flow guidance, is just small one. Is that including or excluding the exit costs from the Danish Defense contract?

Jacob Aarup-Andersen ***ISS A/S - Group CEO & Member of the Executive Group Management Board***

All right. Thank you very much, Madeleine. Let me do the first 2 ones and then Kasper will do the cash flow. That's his favorite topic anyway. On above-base, so I think you're asking definitely the right question there. So you can say when you look at it, there's no doubt that our above-base and project work has been higher throughout the COVID years than they were -- than the level pre-COVID. And you know that we've been quite clear that we think this year that the contribution will -- that we will see a somewhat of a drop off compared to last year. You are, though raising a very, very important debate. And we will not be firm on that, but there is -- there's clear signs that there is an increased amount of investments in the workplace globally. And there's also a sign that some of that will be structural for the coming years.

And therefore, you can make a case for why above-base should not just fall back to the levels pre-COVID. We would like more data points. We would like to be further pass COVID before we can conclude on that. But there's no doubt that we're seeing a good activity level, both on above-base and projects. And one element could also be that some clients do prefer the flexibility of moving some of the spend into above-base and above-base. So I think you may have a point. I think it's too early days for us to give an estimate on where -- what level we will be at permanently post-COVID. I also want to avoid the arrogance of talking post-COVID given that we still have a number of countries that are suffering from COVID at the moment. So -- but I think you have a very fair point.

Then on price increases, obviously, I appreciate you asking for what flex we have in the guidance. I'll not go into that. But we've said a number of times on this call today that we are confident with our margin guidance. We -- when we do that, we obviously assess the inflationary risks to that margin guidance. And with a good deal of our inflationary pressures for the year having been dealt with already due to the timing of wage increases, et cetera, I think that confidence is at the right place. If we do get unexpected further inflationary pressures later in the year, we will be using the same mechanisms that we've been using so far. So nothing will change there. No one here has suddenly stopped focusing on inflation. It will continue to be -- we'll continue to be very vigilant around the theme to make sure we don't see any setbacks. So I'm quite confident around that margin guidance also in an inflationary environment.

Kasper Fangel ***ISS A/S - Group CFO & Member of the Executive Group Management Board***

Yes. And real quick on your question on cash flow. In the above DKK 1.3 billion, so the full year free cash flow guidance for this year, we do have the DKK 500 million of one-off cash exceptions included. And a part of that DKK 500 million is the exit fee to Danish Defense. So it is included as an exceptional in the above DKK 1.3 billion. That, of course, also means that the underlying free cash flow is above DKK 1.8 billion.

Operator

The next question is from the line of Peter Sehested from ABG.

Peter Sehested ***ABG Sundal Collier, Research Division - Equity Analyst***

It's Peter from ABG. It pertains to your ISS Pulse survey and have a bit of a difficult time reconciling the results here with your guidance for above-base work to actually decline because what you're noting is a change after COVID and unless those changes have been implemented in portfolio contracts, it should actually come from above-base work. So could you put some color on that one? And also, with respect to these changes that you are seeing here, are you fully capable to deliver on those? And what are those investments needed to deliver on these changes at the client side?

Jacob Aarup-Andersen ***ISS A/S - Group CEO & Member of the Executive Group Management Board***

Thank you, Peter. I'm glad to see you reading the survey. We think it's a very good survey. I think you have to be -- we have to be careful to draw a conclusion. It's not a business plan or a budget from our side. It is a survey amongst a number of customers. And there's no doubt that it's encouraging to see that there is a high proportion of those customers that will invest more in workplaces. We do not -- we cannot pin that down to when they will invest. So all we can do is that we can look at what we have in our pipelines and take a perspective on that.

So I'm not going to make a direct one-to-one link between the survey and how our guidance is formed. It is one of the elements or one of the data points that comes into our work as we put together the guidance. And of course, it gives some comfort that above-base is not about to drop significantly. I think that comfort we get out of the survey, but we don't want to be too specific around it. I think then we would risk over interpreting the data. But of course, it's a positive sign around potential of above-base spending.

You asked whether we have the capacity and whether we need investments. No, we don't need investments. We do have the capacity to deal with this. As you know, the vast majority of above-base and project work is being done by existing employees that we deploy into these situations, whether above-base is ranging from anything from customer events where we are providing additional catering and you say, extra services to a customer event to us doing HVAC system repairs and plumbing and heating, et cetera. And project work is typically smaller office refurbishments and other types of changes in the workplace, et cetera.

So it ranges across a number of issue of topics, but all of it is something that we do with our own -- predominantly do with our own workforce, our own technicians, our own catering staff, et cetera, et cetera. And that capacity we have.

Operator

The next question is a follow-up from Klaus Kehl from Nykredit.

Klaus Kehl ***Nykredit Realkredit A/S, Research Division - Chief Analyst***

Yes, just a little bit nerdy question perhaps. But on the currency side, you say that you still expect a negative impact of between 0% and minus 1%. And according to my currency model, it indicates a positive impact of slightly above 1%. So is it near my model that is wrong? Or are you just being a little bit conservative on the currency side?

Kasper Fangel ***ISS A/S - Group CFO & Member of the Executive Group Management Board***

But I think Klaus, why don't we reconcile models after the call? We are indicating between the 0% and the 1% using the forward rates. I'm not sure whether you're using anything else. But of course, we can connect through IR and reconcile after the call.

Operator

As there are no more questions, I will now hand it back to the speakers for any closing remarks.

Jacob Aarup-Andersen ***ISS A/S - Group CEO & Member of the Executive Group Management Board***

Okay. Thank you very much. Thank you, as always, for great questions and good dialogue. Our very competent IR team is sitting ready at the phones to continue the dialogue with many of you. Looking forward to seeing and speaking to many of you in the coming days. And then with that, we wish you a great day. Thank you.

Kasper Fangel ***ISS A/S - Group CFO & Member of the Executive Group Management Board***

Thank you.