Company Name: ISS A/S
Company Ticker: ISS DC
Date: 2017-11-08
Event Description: Q3 2017 Earnings Call

Market Cap: 47,011.19
Current PX: 253.2
YTD Change($): +14.8
YTD Change(%): +6.208

Bloomberg Estimates - EPS
Current Quarter: 5.307
Current Year: 15.728
Bloomberg Estimates - Sales
Current Quarter: 20755.571
Current Year: 80308.769

Q3 2017 Earnings Call

Company Participants

- [0710ZW-E Nicholas Richard Ward]
- Jeff Olsen Gravenhorst
- Pierre-François Riolacci

Other Participants

- Srinivasa Raju Sarikonda
- Bilal Aziz
- Kristian Godiksen
- Tom Sykes
- Paul Checketts
- James Winckler
- Andrew R. Farnell

MANAGEMENT DISCUSSION SECTION

[0710ZW-E Nicholas Richard Ward]

Ladies and gentlemen, this is Nick Ward, Head of Investor Relations at ISS and I would like to welcome you all to our Q3 2017 results teleconference.

Please be aware that the announcement, the interim report, and the slides used for the call can also be found on our website. Later today, a replay will be available, and we will post the transcripts of the call as soon as it is ready.

I'd like to draw your attention to slide number 2 please regarding forward-looking statements. And presenting today as always will be Group CEO, Jeff Gravenhorst; and Group CFO, Pierre-François Riolacci.

And with that, I will hand over to Jeff. Thank you.

Jeff Olsen Gravenhorst

Thank you, Nick, and good morning, everyone. Please turn to slide 5. With regards to our financial highlights, total revenue growth in Q3 was 2% with an organic growth improving as expected to 2.3%. The Q3 operating margin declined 0.2 percentage points to 6.3%. This included a negative impact from the effect of the acquisitions and divestments and some one-off items.

Cash conversion was 99%, an improvement on the 92% reported in Q2 and in line with our expectations. Net profit adjusted totaled to DKK 764 million negatively impacted by higher restructuring charges. Our leverage at quarter end was 2.7 times. This is above the 2.4 times level a year ago. Principally this due to the acquisition of Guckenheimer.

In terms of commercial development, we continue to see the benefit our focus on integrated facility services and on key accounts. Our growth within the Integrated Facility Services was 4% year-to-date and 4% in Q3. Within global corporate clients local currency revenue growth continue to be strong and remained strong at 12% year-to-date and 16% growth in the third quarter.

During the third quarter, we benefited from the launch of our new global corporate client partnership with Shire but also saw a continued positive impact from a number of local wins. We also saw non-portfolio services return to growth.

As mentioned, our Q3 margin performance has been negatively impacted by the currency, acquisition, divestments, as well as some one-off items. However, we also face ongoing challenges in Sweden and North America. Year-to-date, our operating margin was 5.4%, down from 5.5% in 2016. This includes a negative 10 basis points impact from currency acquisitions and divestments.

Major new contract wins include Deutsche Telekom in Germany, which will become the single largest contract in ISS history when it launches in July 2019. Other recent key contract wins include the Danish Defence in Denmark and Adana Hospital in Turkey, as well as the retention of Fulham Road Hospital in the UK, a new contract with a professional services customer in the UK. All of these are significant ISS contracts secured on the back of our increasingly strong key account focus.

Key developments during the course of 2017 have simply served to strengthen our conviction in the ISS Way strategy. Where we have faced challenges it has typically been outside the key account and Integrated Facility Services divisions. For example, our specialized services business in North America and our cleaning services in Sweden.

Moreover, some of the major successes we have delivered, most notably our new contract with Deutsche Telekom, would simply not have been possible without our dedicated key account focus, the investments we have made, and our organizational structure that allows us to share volume, concepts and talents across the entire globe. We are committed to continue this journey.

We'll continue to make the right investments where needed. This includes new concepts such as our new technology initiatives but it also includes restructuring to ensure that we are positioned to capture good quality growth with our target customers. We will also continue with acquisitions and divestments to further refine our portfolio consistent with our prior communication. On that note, we're very pleased with the development in Guckenheimer, Evantec, and Signal which are all developing according to plan.

So, 2017 has thrown us some challenges but we are addressing them. The underlying business performance has been good. Moreover, each and every year as we deliver our strategic priorities, ISS becomes a better company with a stronger competitive position and 2017 is no exception.

Please turn to slide 6. I'm not going to spend a lot of time in discussing the Deutsche Telekom again today given the detailed presentation we gave last month. Obviously, we are extremely pleased with this very significant new customer for ISS. However, there are some contract developments that will impact our performance in the next couple of quarters, so let me add some color to that.

As previously communicated, our contract with DXC Technology ceased at the 1st of October this year. Approximately 10% of the contract value has now been retained for the next six months principally Cleaning & Support Services in Europe. Today, we expect a negative group organic growth impact of slightly more than 1% in Q4. And a negative impact on our margin given we are losing a mature ISS client.

Our contract with HP Inc is still expected to cease on a phased basis starting from 1st of February 2018. We continue our efforts of securing some ongoing services beyond this timeframe. In prior quarters, we have also made references to – and other global key account customer where our current contract is due to expire before the end of 2017. This retender process is ongoing, and we are – we remain in a competitive situation.

However, decisions are being taken regionally. While we await the decision for the Americas region, we now have been informed that we have retained our existing business in Asia Pacific, the growing portfolio as of 1st of January 2018. We will lose our revenue in EMEA. The pending decision on the America region will not have any impact before the 1st of January 2019. We deliver some existing services for this customer in the Americas, but there will be – this will be an opportunity for us to grow organically subject to the client's final decision.

During the first nine months of 2017, the EMEA operation of this global key account customer, together with the global operation of the DXC and HPA accounted for approximately 2.5% of our group revenue.

Turning to Shire. This contract was successfully launched in North America in June. We continue to ramp up our services delivery to 20,000 Shire employees across more than 40 countries and have consolidated more than 1,200 subcontractors, a massive project which is rolling out in line with expectations. During Q3, Shire operated at approximately 70% of its full run rate. We expect the contract broadly speaking to be fully operational by year-end. As a reminder, Shire will account for approximately 1% of group revenue at this point.

Finally, we recently announced the successful win of a six-year IFS contract with Danish Defense with annual value of approximately DKK 0.5 billion for the largest Facility Services contract ever outsourced to Denmark. The partnership built on an initial contract, one in 2014 done in Western Denmark. The new contract would cover the entire country and ISS will deliver range of services including technical services, server maintenance, cleaning, and catering across more than 500 sites. And we will almost double our annual value with this client.

Please turn to slide 8 for an update on the regional performances. Organic growth in Continental Europe improved to 4% in Q3, up from 1% in Q2. Growth was driven by contact launches in Turkey and Austria as well as project works in Switzerland. We also saw an uplift in Spain driven by successful expansion within our technical services.

This was partly offset by an ongoing reduction of our public sector exposure in Greece. The new data healthcare contract marks our launch into the Turkish hospital sector. The Turkish government has committed significant investment into its hospital building program. We've been selected with our targets, but the opportunity here is very sizable and over the coming years and a successful initial execution and then puts ISS in a strong position.

Moreover, this is another great example of how we have leverage healthcare expertise from elsewhere in the group to improve our offering. In Austria, organic growth in Q3 was boosted by our expanded relationship with China. As last month, we are now self-delivering catering services for the devices. This is the first ever self-delivery of catering service in ISS Austria and has been achieve organically on the back of a strong relationship with the customer, support from our catering excellence team and global operations, together with the close cooperation with ISS Germany, another fantastic sample of sharing volumes, concepts and talents, leveraging the ISS Group capabilities to drive global success.

The Continental Europe's operating margin improved by 0.7 percentage points, driven mainly by project works in Switzerland and Turkey, as well as improved performance in Spain and in the Netherlands, where we've seen clear benefits from the GREAT implementation. These improvements were partly offset by Israel and Greece as a result of lower activity.

In Northern Europe, organic growth of 1% in Q3, flat versus Q2. The total revenue growth was minus 5%, heavily impacted by FX moves and divestments. Principally, the depreciation of the pound versus Danish kroner and the divestment of the Security Services business in Finland. Organic growth was supported by contract launches, especially in Denmark and Norway, but continues to be offset by contract losses and downscaling within the Industry & Manufacturing segment in Sweden.

As expected, organic growth has slowed in the UK. In Q4, the UK will benefit from the launch of the recent wins, including National Westminster Bank and the South Warwickshire NHS Trust and another major client within Professional Services. However, the contribution from these wins will be offset by other recent losses, including the DXC. We're also cautious on the likely project work in Q4, given uncertainties within the UK financial services sector and the difficult comps from last year. To be clear, our UK organization is strong, most recently evidenced by the Annual Brand Survey conducted by IFM, where we are the clear number one in our markets.

Northern Europe continues to be our most profitable region, with a Q3 operating margin of 8.6%. This amounted to a year-on-year reduction of 0.3 percentage points. We continue to face some operation challenges in Sweden within the cleaning and health care businesses and also of our investments in building out a technical services credential in both Sweden and Denmark.

They are the same issues we explained in the prior calls and at our Capital Markets Day in September. They're not new. Profitability has improved in the third quarter but it's not at the level that we have planned. In Q3, we launched a recovery plan for Sweden which we saw in the restructuring of parts of the business and we'll take further actions in Q4. For the rest of Northern Europe, we've seen year-to-date margin stability and improvement. In Denmark and Norway, we delivered further operational efficiencies linked to the GREAT project.

Please turn to slide 9. Q3 organic growth in Asia Pacific was 1% versus zero percent in Q2. Growth was mainly driven by contract launches in India, Indonesia, Singapore, partly offset by the expected negative organic growth in China and Australia. The slight sequential improvement in organic growth was driven by the ongoing annualization of the 2016 contract losses in Australia, the final loss, CP Mining, annualized in October.

ISS Australia has secured a very strong retention performance in the high 90s during 2017, and we expect a return to positive organic growth in Australia in Q4. In China, we continue to make structural adjustments to our operating model as previously discussed. We are reducing the exposure to certain customer segments that are more price driven and strengthening our efforts with the multinational customers where a broader value proposition is more suited. The recent win of ABP across APAC with significant operation in China is an early indication of this strategy.

The Asia Pacific operating margin declined 0.2 percentage points, but remained very strong at 7.6%, thanks to the good performance from India and Singapore. The slight margin decline was mainly driven by China as a consequence of the structural revenue reduction and further investments in building our key account capabilities across the region.

In addition, the significant revenues retained in Australia are delivering lower margins at the outset which is typical within our business. We clearly expect these margins to improve in due course. But having delivered exceptional margin strength in the recent quarters, we now see margins in the Asia Pacific region or the coming quarters to decrease from peak levels but to remain significantly above the group averages.

Organic growth in the Americas was 3% versus 1% in the second quarter. Growth was mainly driven by strong performance in North America benefiting from the launch of Shire and other IFS contracts. North America also benefited from increased non-portfolio demand, including the [indiscernible] (15:07) relating work in Houston.

Mexico and Chile delivered another solid quarter, but organic growth in Brazil remains materially negative as expected, following the structural adjustments and our business platform towards the end of 2016. The Americas operating margin was materially weaker in Q3.

North America, we can continue to face IFS contract start-up cost and ongoing performance, underperformance within our specialized services position. At the same time, we continue to invest for the long haul.

And North America, as North America is the world's largest outsource FM market and as such represent ISS' single biggest growth opportunity. The margin in Brazil remains negatively impacted the structured adjustment of our business platform. And in addition, we faced certain one-off cost related to contract exit across the region.

With this I would like to hand over to Pierre-François.

Pierre-François Riolacci

Thank you, Jeff and good morning everyone. I will start with slide 11 please. So, our overall revenue in Q3 was up 2%to DKK 19.8 billion. And this increase reflects net divestment acquisition positive of plus 2% in the quarter which is driven of course mainly by the Guckenheimer acquisition which had a full quarter impact for the first time.

For 2017 full year, we expect the net impact from divestment and acquisition as completed by at the end of October to be approximately 1% positive. There was also a net currency impact that was negative by close to 3% mainly driven by the British pound and the Turkish lira for half of this top line impact but also as our currency.

For the full year, we expect this base on the average forward rates we expect this negative impact to be around 2% on our revenue. Finally, the Q3 organic growth increased as expected from a low point of 1% in the second quarter to a 2.3% in the third quarter. Of course, we are going to move into more details.

Please turn to slide 12. So, you are familiar now with that bridge that we used on the last quarter. And this is to provide you with the key components which are driving our organic growth year-on-year. So, first we stripped out the discontinued operations that is Argentina and Uruguay from the reported Q3 Argentina and Uruguay on reported Q3 2016 revenues.

Then we show impact on last year with the news if we were calculate it at today's ForEx rate, that's a negative of DKK 0.5 billion. And then we make the adjustment for acquisitions and divestments. This gives us an adjusted 2016 revenue of DKK 19.3 billion. When we look at analytically to what's happening, we still have the Australian contract losses that were in 2016, originated in 2016, which continued to annualize. And as such, are less of an impact in Q3, 0.3% negative compared to the 0.7% negative that we have in the second quarter. Of course, this negative impact would be smaller – even smaller in Q4 and actually immaterial.

Sweden remains challenging and even if the drag on the group organic growth is definitely better on Q3 compared to Q2, it is still too early to conclude that organic growth will continue to improve from here on. There is a negative impact coming from us downsizing our operation in Brazil and China, which remains material, minus 0.7%, as expected. So good news is coming from the non-portfolio revenue, which is picking on a weak second quarter and as just mentioned has been in particular driven by some good project work in North America but also Spain.

The rest of the business is contributing to 3.2% to organic growth, of course supported by the launch of Shire in June. If you try to look a bit further into Q4, these drivers, as I just mentioned and with the comments I made, will be there. You need to factor in also the loss of DXC from October 1, with an expected impact on Q4 organic growth slightly more than 1% and you need also to remember that we had a very strong non-portfolio Q4 2016 performance that we flagged at that time and which is making a tough comparison for 2017. On the other hand, of course, we have a number of good contracts starting up such as the Adana Hospital in Turkey. Also the North West and the South Warwickshire NHS in the UK and ABB in APAC. So, we have also a [indiscernible] (20:13) contracts which of course, will help us in Q4.

Based on this revenue analysis, I suggest we move to margins and we go page 13. And even if we are not extremely pleased with this downturn on the graph, you can see that after 15 quarters of consecutive improvement in our last 12 months operating margin, we see somewhat of a reduction. This reduction is reflecting of course, the considerable headwinds that we face from forex and M&A. The negative mix effect on our net acquisition and divestments. That also reflects the operational challenges that we have in Sweden and in North America.

Of course, it's worth to enter into details and we move to page 14. Again, it's a format that now you are familiar with, same graph that we used from H1 and you know that when we look at margins, we have to look at the year to date to give some perspective to short-term goals. So, again we adjust the first nine months to reflect the discontinued items – discontinued operations and we restate same thing with to the FX rates 2016 contribution. Same giving the full year impact of acquisition and divestments as completed. This gives an restated operating profit base of DKK 3,112 million in the first nine months of 2016. And you can see quite clearly that there is a negative headwind coming from ForEx and net acquisition divestment of 10 basis points on these nine months. We end up at 5.35%.

Looking at the original drivers, you will not be surprised to see the impact as the comment suggest just made on the region. There is definitely a strong profit improvement coming from Continental Europe including the positive impact from the decreased extension obligation mentioned in the second quarter. But also the early benefits from GREAT implementation in Netherlands and a solid performance in important countries like Spain, France or Turkey.

We have a lower contribution from Northern Europe which is reflecting, of course, the challenges that we have in Sweden. But it's good to note that the margin are either stable or higher in all remaining countries of the region. The improvement in APAC, Asia Pacific, is driven by a strong performance of [ph] international performance (22:42) especially in Singapore which is running at historical highs and supported by strong operation efficiencies and cost savings.

Reduction in operating profit from the Americas is driven, as mentioned, by significant ISS contract start-up costs, continued underperformance in the specialized services business in North America, as well as some one-off costs which are related to contract exists, demobilization costs across the region. The corporate costs fell slightly and amounted to 0.8% of revenues which is in line with our expectation. I just mentioned one-off just to be clear, the year-to-date one-off item contribution is basically neutral. It was a slight net positive of DKK 20 million to DKK 30 million in H1, so slightly negative in Q3.

So in conclusion, if we adjust for the forex and the net acquisition divestment impact, our first nine months operating margin has improved from 5.35% to 5.41%, which is a fair reflection of our underlying year-to-date margin performance, which is flat to slightly higher.

I just mentioned that the margin development in a single quarter can be misleading but I know it's also very important for you to flag the latest development. So we decided to bring in another slide on Q3 only operating profit driver, that's page 15, where we have made some same adjustments that's also year-to-date. And here, on that one, we start with Q3 2016 adjusted DKK 1,244 million, which is a margin of 6.44%. You can see also that there is the same headwind on forex and M&A for about 9 bps on that quarter.

Looking at the regional drivers, you see basically the same sort of developments that we had in year-to-date and as commented by Jeff. I just mentioned that the one-off item in Q3 was a negative of about DKK 30 million, driven [indiscernible] (25:03) by severance and asset-related cost and the demobilization of some contracts and businesses across a number of countries.

So saying in conclusion, if we adjust for ForEx and net acquisition divestment, our Q3 operating margin has declined by about 12 basis points. If you adjust further for the one-off cost, gross margin is broadly flat – underlying margin is broadly flat in Q3. Looking into Q4, and I know it will be a very important for you. What are the key drivers? Of course, many of the same drivers that are operating in Q3 will be there and we expect continued pressure in Sweden and North America in particular.

Of course, we need to factor in the loss of some major contract and I'm talking about DXC, of course. You know that this IFS and key accounts are margin expertise to the group and it's a nice story, a nice headwind, when we are ramping as a margin in the earliest of the new contract. But of course, it also hurts short term when we lose one.

As we have lost most of DXC from October 1, we see a negative impact on organic growth but also on the margin primarily in North America and the UK where we have the biggest exposure to the contract. In addition, I will highlight the margin headwinds that we expect from forex in Q4 is currently said to worsen on the back of current [indiscernible] (26:36) assumption of course.

That's it for the operating performance. I suggest we move to page 16 and focus our attention on what's below the operating profit before other items. Let's start with other income and expenses. You can see that we have a charge of DKK 81 million in Q3, that is a year-to-date of DKK 292 million, it's DKK 292 million. You remember includes the DKK 212 million of remeasurement of the business held for sale in Northern Europe.

So, the DKK 113 million expenses are actually related to restructuring project in the quarter. Year-to-date, DKK 220 million. Out of these DKK 113 million expense in the quarter, we are about 50% which are restructuring book mainly in Sweden and marginally in Brazil.

As mentioned by Jeff, we would take some transaction in Sweden next quarter. Another 50% are actually linked to the GREAT implementation in some countries and mainly in Netherlands for this Q3. Most of these countries, we see significant margin improvement on the back of the implementation of that product.

A part of this DKK 113 million expenses are actually offset by DKK 26 million, coming from a prior year's acquisition which is related to a final settlement of the contingent consideration related to the acquisition of GSO in 2015.

That's it for other income and expenses. Let's move to financial income and expenses, which in Q3, are pretty flat, compared to the second quarter. Despite higher average net debt on the back of the Guckenheimer acquisition and also a DKK 7-million accelerated amortization of financing fees, which is related to the refinancing Term Loan B , with a procedure of the issuance of a 10-year bond in last August.

In addition, in early November, we successfully refinanced our ISS which was extended to €1 billion. And this will lead to a DKK 20 million accelerated amortization of financing fee that will be booked in Q4.

The annual net impact of the recent refinancing in August is about DKK 30 million to DKK 40 million higher net interest expenses, but of course with current low interest rates that are now fixed for long in the future. The annual amortization of financing fees will be around DKK 25 million, and has a new capital structure versus DKK 35 million previously or DKK 10 million lower.

On the tax side, so Q3 and the year-to-date effective tax rate at 25.5%. It is impacted positively by a non-taxable gain on divestments. And for the full year, we expect the [ph] ETR (29:42) to be broadly in line with what we have at year-to-date, including the gains and benefit from non-taxable gain. However, we see an underlying run rate close to 26%, around 26%, which is quite an improvement compared to previous years.

Moving to adjusted net profit, which is of course the addition of all these items, it's DKK 764 million in Q3. It is an important line and the line on which we calculate our 50% ordinary dividend payment. I mentioned if we'll adjust then the profit before discontinued operation. In the second quarter, you remember that the adjusted net profit was negatively impacted by a non-cash write-down on the asset held for sale. But we clearly stated that we will not let this impact our 2018 dividend payment. And again, for clarity, we are committed to maintain an ordinary dividend in 2018 at least equal to 2017.

That's it for the P&L. I suggest move to the cash flow, that's page 17. And here, we would focus mainly on the year-to-date to avoid the swings from quarter to another. We just mentioned that EBITDA before other items is up 1% to DKK 3.7 billion. But you can also on that header that the cash generated by operation year-to-date is flat to DKK 3.6 billion. This is a subtotal of the first table on page17, and it is flat 3.6%. One point I would like to mention on that line is that the net cash impact of the one-off item is, as you know in the P&L, is [indiscernible] (31:33) but in the cash, it is negative, and the main reason being that the cash benefit from the approximately DKK 60 million net pension gain that we recalled in Continental Europe forum. Second quarter, will be spread over years to come. That's an important point.

On the working capital, you can see that we have DKK 87 million lower cash outflow in the nine months of 2017. It is, of course, reflecting the timing of both payment and correction that we were pleased to deliver in Q3 an LTM conversion rate of 99%, which is significantly higher that the 92% of Q2 that we flagged at the time. That 92% was not reflecting the normal, the normal run rate. But, of course, we cannot expect to be in the high-90s each and every quarter, and that's why we guide on being above 90%. There is some volatility in there.

On the other expenses paid, we have in fees a restructuring in 2017. So, you see this impact, it does include a great program as a Swedish restructuring, as well as some exit cost in Argentina and Uruguay.

It is definitely for us an investment in the business and we do expect to see a healthy payback from these cost structuring investments both in the acceleration of our IFS strategy, the implementation of GREAT, but also more intense focus on the key account customers. As these other expenses in [indiscernible] (33:09) saw a marginal about DKK 20 million of integration cost which are linked to Guckenheimer and Evantec.

The net interest paid is higher based on the average net borrowings. But the DKK 60 million increase is mainly due to the first coupon that we paid in January on the 2021 five-year bond, so that was in the first quarter. The Q3 cash interest is slightly lower. This is a result of the refinancing of a Term Loan B reaching through the quarterly interest payment where the new bond is based on the annual interest payment.

On the income tax, just know that the cash taxes are slightly up year-on-year, converging towards the effective tax rate as expected that the cash tax rate is expected for the full year to remain below the [ph] ETR (34:01) for the full year.

On the investment side, cash flow from investing activities negative by [ph] DKK 2.1 billion (34:09). I would highlight two points. Of course, the DKK 1.7 billion which are – of acquisition which are mainly related to Guckenheimer production in April, but also the capital expenditures which are running at 1.1% of the revenues for the first nine months which is in line with our long-term average, but also up compared to 2016 which was unusually low 0.8%.

On the financing activities, of course, you have the DKK 1.4 billion ordinary dividend that was paid in April, and the repayment of a Term Loan B in August of €300 million, but this is more than offset by the proceeds of our new bond €600 million in August.

At the end of the day, the free cash flow on the nine months is about zero compared to about DKK 500 million last year, at the same end of September. The main differences are coming from higher CapEx, so about DKK 200 million, higher other expenses mainly restructuring for another DKK 170 million, and then you have about DKK 100 million which are more into timing differences on cash and net interest payment With that, I would like to hand back to Jeff.

Jeff Olsen Gravenhorst

Thank you, [indiscernible] (35:33) Pierre-François. Please turn to slide 11 – slide 19, sorry. Our 2017 organic growth outlook is narrowed to around 2%, having previously been 1.5% to 2.5%. As discussed, we will see a negative impact in Q4 from the loss of the revenue with DXC, double amount to slightly more than 1% of the group level.

In addition, we remained cautious over non-portfolio activity in Q4, not least given the tough comps. On the partner side, we expect to see growth boosted by new contract launches including ABB, National Westminster, South Wilshire, and Adana Hospitals. Together with the continued rollout of China and the analyzation of the contract losses in Australia.

Our 2017, operating margin guidance is now in line with 2016 level excluding the impact from FX and net acquisitions and divestments. Our operating margin performance year-to-date has been negatively impacted by currency and M&A activity. As you've heard from Pierre-François, we currently expect these headwinds to increase in Q4.

We had expected he performances in Sweden and North America to recover during the second half but this is not happening at the pace that we assume. We have made some progress in Sweden but are in the midst of a restructuring plan and we continue to face challenges in North America not least with the specialized services division.

Finally, we are facing a near-term change in the mix of our contract portfolio which will impact us in Q4 and into 2018. A number of mature contracts that we attended during the year and we have – some we have retained, some we have phased the reduction and scope, and some we have lost because – but replaced with wins elsewhere. Either way, mature business is being replaced by business which initially will be less profitable. This development is consistent with our long-term operating model but is somewhat larger now and will weigh on the business for the next few quarters.

Finally, the guidance for cash conversion remains above 90%. So, as I said at the outset, 2017 has provided some challenges but the key developments during the year, both good and bad, had simply strengthened our conviction in the ISS Way strategy.

Recent commercial success is extremely encouraging with new wins during the latter stages of 2017 at record highs. Obviously, our sales pipeline is smaller after successfully converting these customers but remains very healthy. We are confident in what we can achieve and we – as we highlighted at our recent Capital Markets Day, the market opportunity is considerable. Now, progress is never achieved in a straight line. There are always setbacks along the way. However, the direction of travel for ISS is absolutely the right one. We're a stronger company today than we were a year ago and we'll be stronger still in one year's time.

So with this, I would like to open up for the Q&A.

Q&A

Operator

Thank you. [Operator Instructions] Our first question comes from Srini Sarikonda of HSBC. Please go ahead your line is open.

<Q - Srinivasa Raju Sarikonda>: Hi. This is Srini from HSBC. First couple of questions on guidance, please. When you give the guidance of 2% organic growth for the full year, what assumptions you have put in for non-portfolio business growth in Q4? Is it back to the level similar to the last year or are you expecting negative impact from that?

And on the margins guidance, you have said that it will be stable on an adjusted basis, adjusted for FX, acquisitions and divestments. If you look at the first nine months margin, the margins were up by 6 basis points on an adjusted basis. So to be stable margins, there should be 24 basis points around margin decline in Q4. And we have 12 basis points decline in Q3. So, where do you expect the further margin declines coming from in Q4?

And one last one on wage inflation. Some of the peers has indicated that there is a high wage inflation and labor scarcity particularly in the sector. This is similar conditions and how will that impact margins? Thank you.

<A>: Okay. Thank you very much. Let's just start with the 2% guidance. What we are saying with the 2% around 2%. So because it's a narrowing of the guidance that we gave earlier. As you know, we don't actually guide on the individual lines and we have not done in the future – in the past, and we're not guiding on that either right now. What we are saying is that we have taken the comps into account, and we've also taken the prudency of the development in the project work, in particular, the UK for the fair financial sector into account.

So, that's on the first part. If you just take on the margin side, Pierre-François?

<A - Pierre-François Riolacci>: Yes. Sure. And thank you for making this rough calculation that we were expecting. Actually if we need to wipe off a 6 basis points advance in one quarter, it's indeed about – it's a minus 18 basis points, minus 20 basis points that you would expect excluding of course spikes on M&A.

So, we start with the Q3 which is flattish. That's what I explained. So, yes, we do expect some dilution in margin in Q4 compared to Q3, and this will be on the back of the dilutive impact of changing in contract mix. I mean, that phasing out some mature ISS contract which are in the last year which is significantly margin-accretive to facing new contracts is of course has an impact on margin, and we see that especially in North America, in the UK and Australia. So, we expect that to happen.

You need also to remember in Q4 last year, we had a very strong APAC margin including one-off in Indonesia that was significant. So, we also expect to have a tough basis of comparison on APAC. I think the two main criteria that explain that we have a different view in Q4 and Q3.

<A>: And if we take the weight inflation, of course, we are facing the same labor market that everybody else is – and we will of course, as always, experience in inflation in this, and it will depend on what market you're in. It's the same thing as every other quarter and year that – this is all about passing on weight inflations Either to the client or to become efficient. We are seeing a trend in the marketplace where we can go more and more towards output, stroke outcome base contract, i.e., solutions to the clients where we can use efficiency to offset the labor increases.

And I think as we will see it also in Asia that the more we see inflation on wages, the more expensive wage has become, of course the more interest than there is in the smarter ways of working and that means of course also including machines and eventually also better technology.

So, it's the same answer that you have to pass it on or you have to find the efficiencies. And if that's doable when you go to the client then you start doing scope changes on what services can be delivered for the price that is being paid.

So, this is what we've done for the past 117 years and we will continue to stay focused on that.

<Q - Srinivasa Raju Sarikonda>: I understand. A follow-up on the non-portfolio business thing. But where do you see the levels right now for – compared to Q3. Do you see a similar level? I know you have the non-portfolio, one-off non-portfolio business from North America last quarter. But how is this quarter so far.

<A>: I think I know – I mean the thing is that with if we're going to the detail [indiscernible] (44:40) of guidance it's going to be a little bit complicated. So, I'll say way that what we've seen this year is that we continue to see growth from above base work. And particularly because we are seeing a growth in our key account sector in our IFS business.

So, underlying clearly we have a good opportunity to continue to grow our above base work. Also with the investments that we've made in technical capabilities across the piece. Lately also in Sweden and in Denmark which is of course also impacting the margin. So, we are there and we can pick it up and we are picking it up.

What we have seen in Q3 and we'll have a part of that in Q4 is you can say unfortunately for the U.S., replete of the Houston flooding. So that gives us some additional work. But we also note that we have some very tough comps from last year and we know that the banking sector and the financial sector is not going to spend the same as it did last year. So, that's the best guidance I can give you right now from the above base work. But the underlying trend clearly is it's a good trend and we continue to grow above base over the cycle.

<Q>: I understand. Thank you.

Operator

Thank you. And our next question comes from Bilal Aziz of UBS. Please go ahead. Your line is open.

<Q - Bilal Aziz>: Good morning, everyone. And just two quick questions from me, please. Firstly, apologies, I don't think I perhaps heard you correctly, Jeff. Early on your clarification on the progress of another GCC contract you are currently negotiating and I don't think I caught clearly what perhaps is being negotiated, what could have been lost and when that may impact the numbers potentially. If you could kindly clarify that, I will be very grateful.

And secondly, just on North America margins and there's quite few moving pieces there from acquisitions, one-off cost and weakness in the non-ISS business. Can you perhaps help us understand what proportion of the weakness is temporary in nature and what otherwise is more structural? Thank you.

<A - Jeff Olsen Gravenhorst>: So, just I guess a clarification of what I said earlier. But what we say is that we've had, I think also an [indiscernible] (46:51). We have two contracts that was being renegotiated this year for next year, and this is another financial services contract. We're not allowed to say the name. We are still in negotiation. The retender process is ongoing but it's a contract where it's decided region by region. So, what has been decided by now is the Asia Pacific region and the European region outstanding is all of the Americas. So, the decision is that we have remained the provider for the growing part of the portfolio which is the Asia Pacific part. We have lost the EMEA part of this portfolio and we are still in contention for the Americas part. Now, for the Americas, that will not be effectual until 1st of January 2019. We have some business there with them, but it will not be effectual if we – we have a growth opportunity there but that will not be effective until 2019. The EMEA part will have an effect from 2018. Right, so that's what we said.

So, together with the DXC news and the HPI news, this is altogether a 2.5% of our revenue that has an impact. Now, that started some of it in the fourth quarter and some of it during the first quarter of next year and then it will annualize over that the additional five quarters.

Some of it we will – so, on some of this we retain so far as we I mentioned here, we've retained 10% of the DXC part for six months and we're still negotiating on the two other ones.

<Q - Bilal Aziz>: Thank you.

<A>: And then so, on Americas, yeah. If we start with the ones off, we have some demobilization cost in the quarter. Clearly, when you are in the U.S., the DXC contract is quite a large part of our ISS business. So, when you are demobilizing, it's the same sort of transition work that needs to go into it. So, we have cost related to the a proper hand over to the new vendors or the new suppliers in the region and of course, that cost us some money in the third quarter. Some of that will continue into the fourth quarter as we supported.

The underlying issue in the Americas is one that we have talked about for a long time is that on our specialized service business we are little bit too scattered throughout the U.S. and we are right now closing down some branches and consolidating our positions within the midsized smaller contract. And thereby not spending as much on brand structure cost as we're doing right now. And that is the underlying reason why it's not a particularly good business. We are not losing money on it. But it's not – it is diluted to overall margin.

<Q>: Brilliant. Thank you very much.

Operator

Thank you. Just in interest of time if participants can limit themselves to one or two questions that would be appreciated. The next question is from Kristian Godiksen of SEB. Please go ahead. Your line is open.

<Q - Kristian Godiksen>: Thank you. So, first of all, can you explain why the margin situation was not indicated in connection with the Q2 results on the recent CMD? I guess you should have known the effects from mix of contracts portfolio and impact there from FX and M&A. And in addition to that, could you elaborate on the effect from these items both FX, M&A and mixed of contracts going into 2018 especially now as the latter is higher in Q4 and Q3? And then just last question on how large a share the contract for the HP Inc. are you targeting to retain? Thank you.

<A>: Yeah. On the timing of the adjustment of the guidance which is always a good question. I think that to be very transparent and to make the long story short, for us the disappointment is coming from the turnaround of a difficult business mainly the U.S. and Sweden which is not coming as quickly as we expected. And this has an impact in Q4, and that's part of the disappointment. And then we also mentioned some other items because we want to be transparent and that you can make a call on what is one-off, what is the situation of business, and what is other items that could spill over. But I think that asking – ask about the timing, it's clear that the disappointment on the U.S. and Sweden is definitely the key point.

<A>: On HPI...

<Q - Kristian Godiksen>: Okay. Yeah, sorry.

<A>: On HPI, it's, of course, very difficult to say but you would expect that like we're seeing the 10% under DXC. It will not be the bulk. The bulk will actually go out during the first, second quarter next year.

<Q - Kristian Godiksen>: Okay. And just on the effect into 2018 from the FX, M&A, and mix of contract.

<A>: That one is difficult to tell. I mean, on the FX, it's definitely too early. M&A is always uncertain because we are talking about transaction completed at the end of October, and this is not, of course, what will happen at the end of the day. For sure, from what has been completed, we see the headwind on M&A, of course, reducing, one, because the acquisition are improving their margins, and that's the plan. So, it will be reducing. But also because, of course, they will join the portfolio and they would not be treated anymore as net impact of acquisition divestment, so you have anyway both timing and improvement in margin effect. That's what I can say on the FX and M&A at this stage for 2018.

<Q - Kristian Godiksen>: And on the contract mix?

<A>: Then if you try to – well, we don't want to guide on 2018, guys, and I'm sure you know.

But if we try to take the main highlight, what we can say is that the operational turnaround in the U.S. and Sweden will be there, and it will definitely support our 2018 performance. It doesn't mean that we'd be able to catch up the full decrease in margin that we had in 2017, but it will improve of course. Timing now is the key issue. When do we start really kicking in some significant turnaround. That's the uncertainty that we have today and that we have to manage.

I mentioned this is a stronger basis of comparison of APAC, and you know that APAC has been performance very well all over the year at historic highs. So, that would be a tough basis of comparison. And the pressure from the contract mix, well, you know that we still have HPI and European part of this global key account. We cannot disclose that with [indiscernible] (53:59). We are mentioning that all these DXC plus HPI plus this Europe part, all together on the first nine months, we are talking about 2.5% of the revenues. So, these are 2.5% of revenues which are definitely accretive to margins. So, we'll have, in the first half, a significant impact. But of course, it will fade away throughout the year.

Now, of course, on the face of that, we have all this great investment, all the programs, all the maturation of existing contract which is of course supporting margin improvement in 2018. That's – in that stage, I don't think we can tell much more. That – these trends.

<Q - Kristian Godiksen>: Okay. Thanks a lot, Pierre.

Operator

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

<Q - Tom Sykes>: Yeah. Good morning, everybody. Wondered if you could just give a view on the operating environment in the UK. I mean, I know you obviously pick out DXC and lost some of that HP in the financial services. But maybe given the importance of the country, could you just maybe give a bit more granularity on the demand and cost side there? And then when we look at the maturity of contracts below the headline level, is there anything to particularly pick out about rates of renewal that might be higher in 2017 or something to think about in terms of 2018? Obviously, you're highlighting some of the moments to your contracts for a higher margin. So, therefore, is there anything to particularly pick out of the vintage contracts that may be rolled off – whether possibly roll off in 2018, please?

<A>: Yeah. To think the UK margin overall, I think we have a very strong organization in UK. We have a very good brand customization and we have very good quality delivery capability. So, the business is strong, strong as ever, and underlying good quality. Clearly, when you get hit by the DC and there's a 25% of our business that is depending on financial services, then there is a little bit of uncertainty of how the UK market will perform. If we look at the opportunities, they're clearly there. We won the Natwest Bank, the RBS this year. Exponentially, we won other financial advisory service. I would say that this is quite significant also, and we won the good progress also in our hospital sector. So, overall, I'm very – I'm actually not. I'm optimistic on the British or the UK business from an ISS perspective.

Having said that, we will go through a year where the impact of the loss of the global accounts will have an impact on it. And so, we don't expect a lot of growth as we see right now from the UK, and we still need to work on what growth to look out when we come up with a guidance for the year. But it will be impacted by this particularly in the beginning of the year. That's for sure.

And they are mature. So, if we talk about – of the maturity of these contracts, of course, when it hits with a proportion in the UK, then of course they also get a high proportion of the margin impact from these contracts because it's a high proportion from the country. But you have to remember that this is the way it works with a large account, that we start out with low margin, and you can see that in the U.S. now, and then we end up with higher margins.

This is what we said all along. That also means that there are other contracts that goes from an earlier stage into the next stage. So, there are other contracts that will start producing higher margins next year also in the UK compared to this year. And that's the way it works. And there's nothing more – there's nothing significantly coming up for renewal in the UK other than what we said. There is something within the military of defense which is also going out of the portfolio. But overall, we also see a good pipeline of opportunities coming in.

<Q - Tom Sykes>: Thank you. And just on the view of – I mean, obviously, you gave a view that we can see the larger contracts and when those fall out. When you're looking at the kind of the layer below, is there anything particularly to point out about immaturity of contracts and what that might happen and renewal of those and whether that's a 2018 margin factor at all, please?

<A>: No. I don't see anything major that has an impact on that. I think here, it's out of the norm within HP. I think other than that, we have to remember that we haven't lost all of HP and we have not – and actually we have still seen a 12% growth on our global corporate lines overall. So, we do have a healthy pipeline and we have a healthy development than this, of course generally underpinned by large accounts like Deutsche Telekom and Defence. So, the HP situation is a little bit out of the norm.

<Q>: Okay. Thanks very much.

Operator

Thank you. And our next question comes from Paul Checketts of Barclays Capital. Please go ahead. Your line is open.

<Q - Paul Checketts>: Good morning, everyone. I've got two questions, please. The first, can you just elaborate on the contract loss for the financial services client in EMEA? What reasons have they given to you not being successful on retendering?

And the second question is more a bigger picture one. We're talking about negative effect as material work and new work ramps up. If you look at the new work coming in to the business now and the pipeline of work compared to work that was signed several years ago. Would you say the margins over the lifetime of the contracts have reduced? Thanks.

<A>: If we just start with the last one. What makes you seeing the opposite, it's – you mean when they start off or while we have them? I just want to make sure, Paul.

<Q - Paul Checketts>: I mean if you looked at the profitability over the course of the entire contract, how's that been a reduction in that with new work compared to work that was signed five or so years ago? Has the market profitability reduced?

<A>: The answer to that is a no. You can always find examples of one or the other, but the general picture is the same as what we've all seen. If you might recall that when we started the relationship with HP, we actually had a negative impact on the group margin part, and we said that we will both move this margin up as we move along and that we've actually done and that's of course why you could see the impact now. It's the same picture as we see it also with our newer contracts. Some of them stabilize quicker and that means they stay at a certain stable level throughout the contract. That depends on how we put it together. But overall, no, I don't see that way into lower margin.

On the other question that was on the – elaborating on why. Clearly, sometimes when we simply don't want to – as I said before, we have to defend the pricing position. We have a very, very good relationship. The quality of the delivery is very high. We've agreed on all the reports. And the client, of course, that wants to work with us. That's for sure. So, at the end of the day, this was an opportunity that they've taken price was the decisive factor, and the price where we could not and would not participate in.

<Q - Paul Checketts>: Thanks.

<A>: It is a minor – it's not a significant contract size. It's of course – it's – it all adds up when you put it together with the HP side.

<Q - Paul Checketts>: Has it gone to on a arrival that self delivers the services?

<A>: One of them – one that is partly self delivery.

<Q - Paul Checketts>: Okay. Thank you.

Operator

Thank you. Our next question comes from [ph] Henry Crullan (01:01:57) of Kepler Cheuvreux Please go ahead. Your line is open.

<Q>: Yeah. So, good morning. The question from Guckenheimer acquisition, and the contribution to organic growth in Q3, and as you're ramping up the insourcing of some of the catering service with your existing client, what do you expect the impact to be in Q4?

<A>: Yeah. Well, let's take the storyline. Well, clearly, Guckenheimer has been proven to be a very, very good acquisition. It's a very strong quality product, and the testimony of that of course, is the way that we have been able to convert our existing subcontracting, but also the development of the underlying business that we took over. So, when we came out with the acquisitions, we had some 40-odd million dollars that we wanted to convert, and we've taken 75% of that and convert it already. So, that's pretty quick. And this is because of the reputation, and the standard of delivery. That the conversions has been extremely successful. We have not only converted what we have, but in certain cases, we doubled up the revenue over the till. So again that is and half the time of operation actually. So, from ordering to delivery. So, that's quite an impressive case. So with that, we expect that that will be of course, also be a positive contributor to our growth in the fourth quarter and also into next year.

<Q>: Okay. But in terms of how you consolidate organic growth, I think Guckenheimer itself before the insourcing of some of the catering business with the existing ISS clients was growing at quite a high rate even double-digit rates if I remember. Did it add an extra organic growth to the Q3?

<A>: No. I think the way we – we do not – we only count the growth of the business after the date that we've taken it over. And it's – and if we gain revenue with existing clients, of course, that also is gains. It's not revenue that we had already.

<Q>: Thank you.

Operator

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

<Q - James Winckler>: Hey, guys. I'm just wondering if you could provide some more context on the ongoing environment in Brazil and the China retail and whether the weakness there is continued intentional downsizing? And you guys [indiscernible] (01:04:41) that's just kind of [ph] annualization (01:04:43) of past decisions and restructuring that you've made. And maybe the status and outlook for how much longer you guys see that affecting the business. And then just on top of that, just curious about the revenue growth in IFS. Is that 4% relative to about kind of a history CAGR about 12%. I'm wondering if that's just maybe some less new contracts this year year-to-date combined with the loss Australia contracts or if there is anything else that contribute to that being lower. Thanks.

<A>: I'll just start with the last one first if you don't mind. So...

<Q - James Winckler>: Sure.

<A>: ...the 4% is impacted by the Australian loses this year and also by the annualization of the start-up of that those contracts from last year like [indiscernible] (01:05:32) Norwegian Armed Forces, et cetera. So, you're absolutely right. that's the reason why. It will of course be impacted now also by the HP account going forward. So, but underlying it's still a very healthy growth. Brazil and China, in Brazil that stabilized. We still we've seen some negative growth numbers from there in the first nine month. We'll continue throughout Q4 but then I'll see stabilization on the growth side for next year. On the market side, it's stable. It's been stable for a while now. So, I'm quite happy with that part. Yet it is still not at the level where it should be from an income perspective or net profit perspective. We will see some improvement in that next year. We are not being too optimistic on that. I think it's being prudent in building a proper organization for the future for Brazil. This is an area where we want to remain with our footprint in Latin America.

So, we are patient there and allowing investments to go in that are probably a little bit bigger than what the revenue can take. But that's the decision we made. So, it will be better next year. Organic growth will better. And the margin will be better. However, it still takes another year before I can see the margin side really creeping up. On China, the retail business is the same [indiscernible] (01:06:52). So, what is going well in China is the other segments where we are having customers like Huawei, we have customers like Lego, we got customers like ABB coming onboard now, which, of course, will offset some of the reductions that we see from the retail sector. It is our intention to continue to decline or to decrease the business in retail in China. So, overall, it's got to turn into a flat to positive organic growth next year [indiscernible] (01:07:20) again there we are making investments into our key account structure. So, it won't be a flattering margin next year, but this definitely will be a good business for the future.

<Q>: Okay. Thank you.

Operator

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

<Q - Andrew R. Farnell>: Hi there. Just a quick one and apologies if I missed this. But could you just talk about where the non-portfolio work actually come through in terms of where the most [indiscernible] (01:07:50) was by region, if possible?

<A>: It came from the U.S. Some of it is – last year, if you remember, we had the flooding from Houston. This year, we have had another flooding in Houston. You can say unfortunately, but that gives, of course, extra work. And then it's also from our [indiscernible] (01:08:16) start-up in the U.S. We also have it in Spain. We also have more above base work that we have seen last year. And then in Switzerland. Sorry. Yeah. In Switzerland, we also have seen more project work this quarter.

<Q - Andrew R. Farnell>: Okay. And then just on the margins, the guidance in line with 2016 [indiscernible] (01:08:31) FX and M&A, that includes your full expectations for any dilution from [indiscernible] (01:08:37) HP.

<A>: Yes, it does.

<Q - Andrew R. Farnell>: Okay. Thanks.

Jeff Olsen Gravenhorst

Great. Okay.

Thank you, everybody. Thank you for listening. Thank you for your interest and your questions. if you have follow-ups, please don't hesitate to contact the Investor Relations team.