The long-term fortunes of the UK's quoted bus and rail operators can be best described as a rollercoaster ride, with more downs than ups in recent years, as SharePad's **Phil Oakley** explains

TRANSPORT BEASTS: BUS AND RAIL

The privatisation of the bus industry in 1986, followed by the railways a decade later, saw the creation of five big public transport beasts. Of the four that remain (Arriva was taken over by Deutsche Bahn in 2010), only **Go-Ahead's (GOG)** has avoided a major company crisis during the last 20 years.

Stagecoach (SGC) saw its share price collapse in the early 2000s, following its ill-fated acquisition of Coach USA in 1999. Similarly, **FirstGroup (FGP)** overstretched its finances after buying US bus company Laidlaw in 2007 and needed to ask shareholders for fresh money to bail it out.

National Express (NEX) also took on too much debt to enter the Spanish bus market and then made things worse with its disastrous bid to run the East Coast mainline franchise. Its overly-optimistic revenue forecasts meant it couldn't pay the government the money it had promised and it had to hand the franchise back. It also had to go cap in hand to its shareholders to keep itself in business.

Stagecoach managed to get itself back on an even keel and established itself as a firm favourite with investors, but now finds itself out of favour again. FirstGroup and National Express have made investors money during the past year, but Go-Ahead – after being a star performer for the past five years – has hit a sticky patch.

While the companies themselves are dealing with their own specific challenges, the UK bus and rail sector is facing a lot of uncertainty at the moment. So much so that the valuations of some companies are beginning to look a little distressed.

To see if the sector could be offering some bargains for contrarian investors, we are going to look at what is causing investors to worry and whether this is justified or has been overdone.

How the companies make their money

The sector's profitability largely comes from running buses. Go-Ahead's bus profits are almost entirely made in the UK. It is currently operating three rail franchises in the UK as well.

Stagecoach still has a significant US bus business focused on commuters, inter-city and sightseeing services as well as being one of the biggest bus operators in the UK. Its megabus.com business in Europe is not making any money yet. It also has a large UK rail business with interests in four franchises

How they make their money

Profit split	Bus (%)	Rail (%)
FirstGroup	74	26
Go-Ahead	78	22
National Express	99	1
Stagecoach	72	28

'Running buses is a very asset-intensive business. Huge amounts of money have been invested in bus fleets by all the companies and these cost significant amounts of money to maintain'

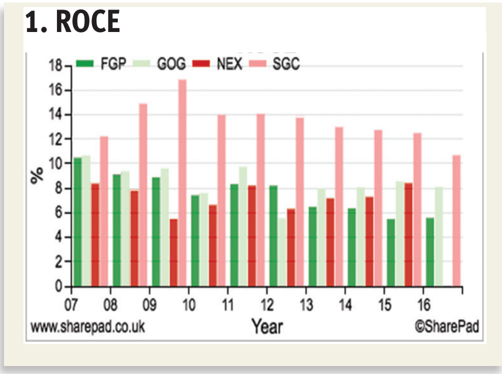
National Express' profits come almost entirely from running buses. It has a significant UK business in the West Midlands as well as its iconic coach business. It also one of the biggest school bus operators in North America and has a big bus business in Spain and Morocco.

FirstGroup has significant bus interests in the UK and two rail franchises. It makes the bulk of its profits from North America where it is the biggest school bus operator, as well as running commuter and long-distance bus services.

Running buses is a very asset-intensive business. Huge amounts of money have been invested in bus fleets by all the companies and these cost significant amounts of money to maintain. Significant fuel and labour costs means that the companies have to work hard to make their money.

Rail franchises are largely financed off-balance sheet with the tracks and the trains being rented for the length of the franchise. This method of financing hides significant assets and debts, and can make rail businesses look quite profitable when in reality they might not be.

A look at the amount of profits the bus and rail operators have made as a percentage of the money invested (including rented assets) shows them to be pretty unexceptional businesses.



The chart above shows the trend in return on capital employed (ROCE), which highlights that they have struggled to earn decent rates of return on their investments. Stagecoach has made reasonable returns but they have been falling sharply. The others' ROCE can be charitably described as very modest indeed.

If that wasn't bad enough, it would seem that there are grounds for thinking that the sector's profitability isn't going to improve any time soon.

Dark clouds over the UK bus sector

Many bus companies have been struggling recently. The exception to this has been Go-Ahead where profits and profit margins have held up reasonably well.

Elsewhere, bus operators have faced lots of challenges to their businesses. Low fuel prices have encouraged more people to take to their cars while the decline in the popularity of high street shopping has also reduced passenger demand for buses. Rising levels of congestion in towns and cities also seems to be putting people off buses.

As a result, bus companies are struggling to generate more income. Government cuts have also reduced the amount of money coming from concessionary fares (subsidised fares for pensioners and school children). Costs have also increased. By far the biggest cost for bus companies is labour and the introduction of the National Living wage has pushed up costs which have been difficult to recover through fare increases. This has put pressure on profit margins.

Bus profit margins

Bus profit margins (%)	London	Regional	Total
FirstGroup	Not disclosed	Not disclosed	6
Go-Ahead	9.2	13	10.8
National Express	na	13.1	13.1
Stagecoach	7.6	13.3	12.1

But could things be about to get worse for bus operators?

For a few years now there has been a growing concern from some local authorities and politicians that the privatised bus industry is not working as well as it could be. It has been argued that the bus companies are making too much money in return for the services they are providing.

Common criticisms have been that bus operators can stop running buses on unprofitable routes while running too many on more lucrative ones to stop competition. Yet the bus companies have been receiving significant amounts of taxpayers' money from concessionary fares which has led some to question whether they have been providing value for money.

The Bus Services Bill is currently making its way through parliament. If it passes into law then some local authorities will be able to have a much greater say over how local bus services are run. They will be able to set fares, routes and frequencies. This is very similar to how the London bus market works which has been seen by some as offering better value for money and a better service for passengers.

Local authorities would award contracts through franchises to bus companies. The real fear here is that this would lead to much lower profits for the big bus companies. As you can see from the table below, profit margins in regional bus markets are much higher than those typically made in the regulated London market. If lower margins became the norm then profits could fall significantly from current levels.

Another risk is that the incumbent bus operators could lose big chunks of business as a franchising model would allow new entrants into the market. This could leave companies with millions of pounds of bus assets earning no money.

An attempt to introduce franchises in the North East of England has already been seen off by the big bus operators for now. They argue that partnerships work better than franchises and that the cash-strapped local authorities are reliant on the private sector to provide bus services.

That said, the threat to bus companies is significant and can go a long way to explaining why investors have grown wary of the sector.

More risk than reward in rail?

Running a rail franchise used to be a very lucrative business but it is less so these days. The fact that it requires little on-balance sheet investment means that competition for franchises has been fierce, especially on lucrative London commuter and inter-city routes.

This has been a win-win scenario for the UK government which has been looking to reduce the amount of taxpayers' money going into the rail network. As rail franchises remain a significant source of profits for companies, as well as a source of ▶

Passenger and revenue growth is needed to make rail franchises add up for operators Go-Ahead (top), FirstGroup and Stagecoach (bottom)

profit growth – from retaining existing or winning additional franchises – companies have been bidding increasing amounts of money to run them.

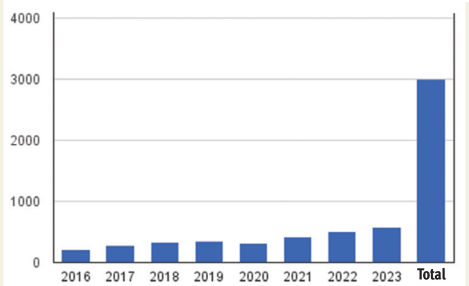
While this has brought more money into the government's coffers it has significantly increased the profit and financial risk for companies. The bigger the bid to run a franchise, the bigger the amount of passenger and revenue growth is needed in the future to make the maths stack up.

If a company gets its calculations wrong then the results can be disastrous. National Express's promise to pay £1.3bn to run the East Coast franchise over 10 years back in 2007 came a cropper when the recession hit and it could not earn enough money to make good on its promises. FirstGroup similarly overbid to run the West Coast franchise in 2012.

High bids to win and retain franchises are putting profit margins under pressure. They make it more difficult to absorb downturns in passenger demand and/or increases in costs. Go-Ahead has told investors that its London Midland and Southeastern franchises will only make wafer-thin profit margins of around 1.5 per cent over the length of their contracts instead of the 3 per cent which was expected previously.

The big worries are reserved for Stagecoach's East Coast franchise where it has promised to pay the government over £3bn in premium payments between 2016 and 2023. The payments ramp up from just over £200m in 2016 to nearly £600m in the year to March 2023 with the big increases in the last couple of years of the franchise.

2. East Coast Franchise Payments (£m)



Growth in passenger volumes and revenues has been slowing and is less than the company expected at the time of its bid. Stagecoach still expects the franchise to be profitable over the life of the contract as it expects to reap the benefits of faster trains and more capacity being added.

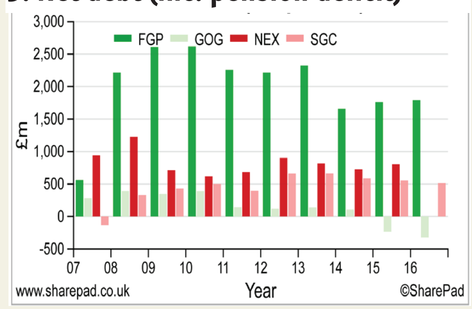
However, a downturn in the economy could see the franchise move into losses and possibly big losses. This is a big risk for investors in Stagecoach shares.

The risk for the other companies in the sector is that a large number of their franchises are up for renewal over the next few years. They may not be retained or the profits might be lower than they are making now. With the exception of National Express, there is significant profit risk here.

Franchises

Company	Franchise	End Date
FirstGroup	Great Western	Apr 2019
	Trans-Pennine	Mar 2023
Go-Ahead	London Midland	Oct 2017
	South Eastern	Jun 2018
	GTR	Sep 2021
National Express	Essex Thameside	Nov 2029
Stagecoach	South West	Jun 2017
	West Coast	Mar 2018
	East Midlands	Jul 2018
	East Coast	Mar 2023

3. Net debt (inc. pension deficit)



Company finances are not that strong

With the exception of Go-Ahead, all companies have significant debts and the problem of final salary pension schemes to deal with. FirstGroup and National Express still have quite high levels of net debt to Ebitda – a closely watched measure of indebtedness.

Investors need to be wary when scrutinising the finances of rail companies, especially the net debt (debt less cash) number. This is because the companies often have significant cash balances – such as from annual season ticket purchases – which don't belong to them. If these are excluded then net debt – and the net debt to Ebitda ratio – will be higher than initially thought.

As rail franchises involve lots of off-balance sheet debts – commitments to lease trains and tracks for the length of the franchise – the key measure of a company's ability to cope with its total debts is its fixed charge cover. This compares a company's profits with the annual interest and rent bills. Anything below 1.5 times is starting to move out of the comfort zone.

Despite apparently having net cash on its balance sheet, Go-Ahead's finances look particularly stretched

Fixed charge cover

Name	Fxd chg cover	Interest cover	Net debt to EBITDA	Adj Net debt to EBITDA
FirstGroup	1.3	1.9	2.9	3.2
Go-Ahead	1.1	5.7	-1.9	1.4
National Express	2	3.3	2.7	2.7
Stagecoach	1.4	5	1.6	2.5

Source: SharePad

Net debt includes pension deficit.

13.8
NATIONAL EXPRESS'S FORECAST PE RATIO

Forecasts

Name	Close	Forecast PE	Forecast yield	Forecast dividend cover	P/FCF	Lease-adj Ebit yield
FirstGroup	105.4p	8.9	2.3	5	-297.1	7.5
Go-Ahead	2,061p	9.2	4.8	2.3	13.3	7.9
National Express	350.2p	13.8	3.5	2.1	20.3	6.4
Stagecoach	200.8p	8	5.8	2.2	29.4	8.7

Source:SharePad

on this measure. National Express – due to its small exposure to rail – looks to be the strongest.

Valuations and outlook

At first glance, the sector looks to be lowly valued because of the concerns that have been highlighted earlier. FirstGroup, Go-Ahead and Stagecoach trade on single-digit forecast PE ratios, with the latter two offering chunky and well covered dividend yields. However, just as ownership of rail franchises distort cash balances, they distort PE ratios as well. This is because rail profits, while significant, only last as long as the franchise which might end in the next couple of years.

Put simply, all the rail profits are in EPS (the 'E' bit of the PE ratio) but theoretically their temporary and perhaps short-term nature means they only make up a small part of the share price (the 'P' bit of the PE ratio). This means that companies with significant amounts of rail profits might not be as cheap as they look. It also explains why National Express – with tiny rail profits – looks more expensive than its peers.

Forecast EPS

Given the risks associated with UK bus regulation and rail profits, National Express is probably the pick of the sector from a risk/reward point of view. While its UK bus and coach business is not growing, two-thirds of its revenue comes from outside of the UK. Its Spanish and Moroccan business is doing well, while its US school business is renewing business at higher profit margins.

Its high overseas earnings are also a positive given the devaluation of the pound means that they will translate into higher sterling profits. The efficiency measures being taken and the growth prospects of its overseas businesses are expected to see a healthy uptick in profits over the next few years. Free cash generation is strong at £100m a year and will help pay down debt and allow a growing dividend.

FirstGroup still has a lot of debt, an underperforming UK bus business and a degree of rail profits risk. Its school bus business in the US is performing well and profit margins are expected to improve.

Two-thirds of National Express's revenue comes from outside the UK

Given its patchy track record on free cash-flow generation, the company's statements about improving cash generation bode well. It is also a beneficiary of a depreciating pound but its high US debts negate that effect somewhat.

The outlook for Go-Ahead's short-term earnings looks reasonable but longer term is less certain. Its rail profits risk looks high. Its GTR franchise, which includes Southern Rail, is experiencing problems with labour relations and poor network performance. Its Southeastern franchise is making very large profits – as indicated by its maximum profit share status with the government – which are unlikely to be maintained even if the company retains the franchise.

Stagecoach could be a buy for brave investors. The earnings risk it faces from its East Coast rail franchise and the potential loss of its South West Trains franchise is a clear concern as is its exposure to UK regional buses. This pessimistic outlook looks to be at least partially reflected in City analysts' earnings forecasts. That said, its shares are trading close to five-year lows while the 5.8 per cent yield looks safe for now. A lot of concern could already be reflected in the share price.

Earnings per share

TIDM	Name	Norm EPS	fc Norm EPS	2y fc Norm EPS	3y fc Norm EPS
FGP	FirstGroup	7.7	11.9	13.1	14.6
GOG	Go-Ahead Group	166	223	220.9	175.4
NEX	National Express	20.5	25.4	28.3	31.4
SGC	Stagecoach Group	21.9	25.2	21.7	19.4

Source:SharePad

Phil Oakley is a stock analyst for Ionic Information, maker of SharePad and ShareScope investment software. Read more from Phil, including his excellent Step-by-Step Guide to Investment Analysis at www.sharepad.co.uk/philoakley.