Company Name: ISS
Company Ticker: ISS DC
Date: 2018-05-09
Event Description: Q1 2018 Earnings Call

Market Cap: 41,014.11
Current PX: 220.9
YTD Change($): -19.4
YTD Change(%): -8.073

Bloomberg Estimates - EPS
Current Quarter: 3.303
Current Year: 14.600
Bloomberg Estimates - Sales
Current Quarter: 19850.167
Current Year: 79350.182

Q1 2018 Earnings Call

Company Participants

- Martin Kjær Hansen
- Jeff Olsen Gravenhorst
- Pierre-François Riolacci

Other Participants

- Kristian Godiksen
- Bilal Aziz
- Aymeric Poulain
- Paul Checketts
- Michael Vitfell-Rasmussen
- Srinivasa Raju Sarikonda
- James Winckler

MANAGEMENT DISCUSSION SECTION

Martin Kjær Hansen

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

I'd like to draw your attention to slide number 2 regarding forward-looking statements.

Presenting today will be Group CEO, Jeff Gravenhorst; and Group CFO, Pierre-François Riolacci. We will open for Q&A at the end of the presentation.

So with that, I'd like to hand over to Jeff.

Jeff Olsen Gravenhorst

Thank you, Martin, and good morning, everyone. If we start with our financial highlights, total revenue growth in Q1 was minus 0.4%, and that's due to the significant currency headwind of 5.6% or negative revenue impact of DKK 1.1 billion in the first quarter. Organic growth ended a bit better than expected at 3.1%, with strong support from non-portfolio revenue. The slowdown from the 3.6% in Q4 is largely explained by the further ramp-down of DXC, HPI and the EMEA region with an international bank as expected.

The operating margin was 4% in Q1, down 0.5 percentage point, including a 6-basis-point impact from the currency, acquisitions and divestments. As such, the margin decline widened compared to Q4 as guided in February. Cash conversion ended strong at 102% as a result of strong cash flow performance across the group as well as timing of collections and payments around quarter-end.

Net profit adjusted was DKK 296 million, a reduction again, as expected, compared to Q1 2017, driven by a mix of currency, operating performance, as well as the increasing grade-related investments especially in France and in

Sweden as also earlier communicated. Our leverage at quarter-end was 2.5 times pro forma adjusted EBITDA, slightly above the 2.3 times a year ago, mainly impacted by the acquisitions of Guckenheimer.

Turning to some of the recent commercial highlights, we continue to see strong growth in our key strategic segments. Global Key Accounts grew 4% in constant currency. In other words, the expansion with existing global key accounts and the launch of LEGO and an unnamed client within the food and beverage segment more than outweighed the further ramp-down of DXC, HPI, and the EMEA region with an international bank.

I should note that as of Q1, we have reclassified a few regional key accounts to Global Key Accounts, accounts which we have successfully grown over the years and where it now makes more sense to take them in with a global approach to the key account management. However, the 4% growth is like-for-like and unaffected by this reclassification.

Integrated Facility Services grew 11% in constant currency, which is an acceleration compared to the 6% in both Q4 and 2017 as a whole. So an acceleration again despite the losses just mentioned. This is clearly very encouraging and reflective of the strong commercial momentum that we've had over the last year.

Momentum has extended into 2018 and the pipeline remains strong. Recent wins include Royal Philips in selected countries, Arriva in the UK, a major international air carrier in the U.S., and a client in the pharmaceutical segment also in the U.S. The total annual portfolio value of these contracts is approximately DKK 400 million.

In about a year from now, we'll be launching the largest contract in the history of ISS, Deutsche Telekom, which will add further growth to the business. However, we're already now starting early delivery of cleaning and security and technical services in a number of retail shops and corporate sites across Germany for a total annual revenue of around DKK 100 million.

Transition and migration is also well on track. And we recently reached an agreement with the incumbent provider, which, among others, means that we will take over 3,000 of their employees, mainly critical technical service staff. Not only does this derisk the transition further, but it also lowers the expected transition and migration cost. And Pierre will give you some more details on that a little bit later.

With this, I would like to turn to slide 4 for regional update. Continental Europe delivered a solid 3% organic growth in the first quarter. Growth was driven by contract launches in Turkey, Austria, and Switzerland as well as generally strong non-portfolio demand. As such, growth remains solid despite further ramp-down of DXC Technology across the region.

The Continental Europe operating margin ended at 4.5%. We continue to see strong margin performance across many countries in the region. However, in the first quarter, this was offset by large key account contract phasing in and out as well as performance in the Netherlands, and the investments in operational improvements in Spain, including investment in our technical service setup.

Finally, I'm pleased to say that the implementation of GREAT in France has been successfully initiated. Expected cost and improvements remain unchanged, and we are confident that our efforts will lead to a healthy return on our investment.

In Northern Europe, organic growth was 1% with only a marginal drag from Sweden. Growth was slightly higher than the 0% in Q4 despite the further ramp-down of DXC Technology and the EMEA region with an unnamed international bank. These headwinds were more than offset by contract launches and non-portfolio demand most notably in Denmark and in the UK and Ireland. Key launches during the quarter includes the Danish Defence and Fulham Road Hospital in the UK.

The operating margin was 4.9%. The decrease compared to Q1 2017 was materially impacted by a large key account contract phasing in and out, especially in the UK. In addition, margins are impacted by ongoing investments in building out our technical services capabilities across the region, Denmark in particular.

The acquisition of GS Hall in UK in 2015 has been a great success and has significantly improved our technical service credentials in the UK. We're now leveraging our setup in the UK to build the capabilities across the region. While we're confident that this is a good way to optimize the return on investment, it does have some short-term implications on the margin.

As expected, the organic growth and margin remained impacted by operation challenges in Sweden in Q1 where turnaround initiatives continue. However, the year-over-year organic growth and margin impact from Sweden was marginal and subsequently better compared to Q4.

Please turn to slide 5. Organic growth in Asia Pacific was 5%, up slightly from 4% in Q4 2017. It's also worth noting that we face the strong negative currency conversion headwind of 10% in the quarter, mainly coming from Australia, Hong Kong and Indonesia. Organic growth was especially driven by contract launches and non-portfolio demand in Australia and Singapore as well as contract launches in Hong Kong. Australia is currently seeing the impact of the commercially strong 2017 with a record high retention rate and a number of local key wins.

Growth was partly offset by expected ongoing negative organic growth in China as a result of our strategic structural adjustments to our operating model. The operating margin in Asia Pacific was 5.8%, hereby delivering the highest margin of all regions in the first quarter as usual. However, it was a decline of 1.9 percentage point, which was to a large extent driven by one-offs; the net impact of one-off income in Singapore in Q1 2017, as previously communicated; and a one-off cost in Q1 2018 in Thailand.

In addition, the underlying margin was impacted by strategic structural adjustments in China and the contract launches and extensions, among others, in Australia, which is partly offset by a soft – solid performance in Hong Kong, Singapore, and India. All in all, the underlying operating margin in Asia Pacific is coming down slightly as flagged from peak levels following exceptional strength for a number of quarters.

Organic growth in the Americas was solid at 4%, while our currency had a 15% negative impact on revenue led by the U.S. dollar. The solid organic growth was driven, among others, by Guckenheimer revenue synergies starting to come through. In addition, North America and Chile was supported by the launch of key accounts.

Growth came through despite revenue reduction from DXC Technology and HP Inc., as well as contract exits and losses in Brazil. The slowdown in organic growth from 8% in Q4 2017 is mainly driven by lower non-portfolio growth on the back of a particularly strong Q4.

The Americas operating margin was flat at 2.5%, supported by Guckenheimer integration synergies and performance in the IFS division in North America. This was offset by large key account contract phasing in and out, and of course the performance in Brazil.

As expected, the Q1 margin remains impacted by operational challenges in the specialized services division in North America, where turnaround initiatives continue. Excluding Guckenheimer, organic growth in North America was flat and margins were stable despite the loss of revenue from DXC and HPI.

With this, I would like to hand over to Pierre on slide 6 for a more detail run-through of the numbers.

Pierre-François Riolacci

Thank you, Jeff. Good morning all of you. I think we've been through the regional performance and we can look now at some of the key components of our financial performance. And of course, start with the organic growth in the first quarter.

You are familiar with the format that we have been using now over the last few quarters. We adjust the Q1 2017 reported, stripping out the discontinued operations, namely Argentina and Uruguay. Then we adjust for the forex conversion effect as well as the net effect of acquisitions and divestments, which give us an adjusted base for Q1 2017 of DKK 18.7 billion.

Out of this, the organic growth for the quarter was plus 3.1%. It does reflect the negative impact from the loss of HPI, DXC, and the EMEA region of an international bank. It's a negative of 1.7%. It is actually slightly less that we anticipated, and this is on the back of a slightly slower-than-expected ramp-down of this contract. The reduction, however, is expected to reach full impact in the second quarter with an amount of about 2.5% negative. So 0.8% incremental in Q2.

The non-portfolio demand was strong and it contributed actually to 1.5% of our overall organic growth. Generally solid level of non-portfolio project across quite a number of countries, especially in Europe, but also a few larger projects, which will not contribute into second quarter, and especially some good projects in Americas, in the U.S. and APAC in Australia.

We do not have, as you know, a lot of visibility of this non-portfolio. They are volatile and we do not count, of course, on the same positive impact going through second quarter.

The rest of the portfolio has been growing by plus 3.3%, has been supported, of course, by the new contract launches that Jeff has referred to during the quarter: that is the Danish Defence in Denmark, the MTR in Hong Kong, also the Global Key Accounts contracts such as LEGO and this food and beverage company we cannot name. Also, we benefited from the revenue synergies from Guckenheimer, but we had also some negative and especially some structural adjustment in our business in China and Brazil that we do not specify anymore because it's getting immaterial, but still, of course, we have some negative in there. The net is positive 3.3%.

So, while organic growth in the first quarter started the year stronger than expected, it did benefit from a few short-term tailwinds, of course, and we're referring to the non-portfolio projects, but also the slightly lower ramp-down of few large contracts. Therefore, our expectations for the second quarter are unchanged. But given that we ended up in Q1 a bit higher than expected, we now expect the second quarter to be the low point for the year. It means that the second quarter is expected to be down in terms of organic growth compared to the first quarter.

With that, I suggest we move to the operating profits review at slide 7. Same format again. So, we adjust for the discontinued operations. You will note that the impact on forex and net M&A on the margin side is 6 basis points, which mean that when we compare the operating profit, it's DKK 834 million with a margin of 4.45%. So, it means Q1 operating margin of 3.95% correspond to a decline of 50 basis points, a decline which is wider that what we had in Q4 as we guided in February [ph] releasing (00:14:48) the full year.

Jeff has covered the regions, and I would just highlight a few points. One is that majority of the group margin decline is actually related to the high level of large key accounts contracts phasing in and phasing out. Phasing in, that means that we have a significant chain of contracts that we are starting up with the first-tier margin, which is of course low in the cycle. And on the other side, we are phasing out unusual high amount of contracts in the last year, so fully mature where the margin is, of course, at high end of the cycle.

This is normal business to phase in and phase out contract, but clearly on this quarter and in this first half of the year, it is definitely a higher amount than usual and then there is a margin impact which is significant. This impact is actually spread across our four regions, but the countries which are the most impacted are the U.S., the UK, Australia and Denmark, Denmark mainly for the startup of new contracts.

On top of this margin dilution of the phase-in/phase-out, there are two other factors which are actually impacting our margin in the first quarter. The first one, as Jeff just mentioned, is that we are still investing in our business, in our capabilities. We are building capabilities in technical services in different countries in key accounts and that has a cost which will pay off. And we, of course, stick to this policy.

The second factor is that we have some countries which have been underperforming. And especially in H2 last year, the U.S., Sweden, China [indiscernible] (00:16:32) spillover effect, which mean that the base in first quarter 2018 is lower than the base in 2017. It doesn't mean that there's [ph] variation carry-on (00:16:40) but the base, of course, is different.

The other point I would like to mention is that when discussing the organic growth, we highlighted the impact of the non-portfolio revenues and why this non-portfolio revenues are, as a whole, margin-accretive at a group level. This quarter, the growth was driven especially by these large projects that I mentioned which are, margin-wise, very close to the group average. So no dilutive but no accretive impact from this higher gross on non-portfolio revenues.

The final point final point I would make on the margin in Q1 is that Jeff mentioned we had a net one-off negative in APAC, but it's fair to say that we have also year-on-year a net one-off positive at group level and to a lesser extent to continue into Europe, which means that overall, taken as a whole, the one-off impact year-on-year is neutral on the first quarter.

So that's it for Q1. Of course, I know that you will be peering through the second quarter. As you can expect, a lot of the same underlying drivers would be there in the second quarter. The FX and net acquisition divestment is expected to remain negative in the second quarter. Difficult to say how much, but let's say that what we have in Q1 is a decent proxy.

Then, we have some negatives that we expect to see that will be an incremental impact of phasing in and especially phasing out some of the large key accounts. I mentioned that the rundown was a bit slower than expected, but, of course, it will come fully in the second quarter. So, a bit of an incremental impact there.

And also, you may remember that in second quarter 2017, we had a positive one-off in Continental Europe linked to a pension adjustment, and that's something that you need to factor in the base. There will be, of course, positives that we expect to see coming in the second quarter. We continue to see underlying incremental improvements coming from the implementation of ongoing efficiency initiatives, including the restructuring and also the procurement savings that would be there.

All in all, there is quite a few moving parts in the short term and we expect, as we mentioned earlier, a margin decline in second quarter. It could be of up to a magnitude similar to what we reported in Q1.

Overall, our expectation remains unchanged for group margins. That is that we expect to be down year-over-year in H1. We expect to be up year-over-year in H2, driven mainly by Q4 in order to end for the full year around 5.6%, plus/minus 10 basis points, and this is excluding the impact from forex and net acquisitions and divestments.

I'm done with the operating profit, and we move to slide 8 to go a bit lower in the income statement. I cannot just forget to highlight the impact of the forex and the revenues again, which is minus 5.6%, DKK 1.1 billion in revenues. And of course, it does have an impact on many of the KPIs that we have in the income statement. I guess that you got that point, of course.

On the other income and expense, the negative of DKK 199 million, the bulk of it, DKK 167 million is actually linked to restructuring projects predominantly in France and Sweden. These two countries account for DKK 140 million in the quarter. It is in line with our previous communication and we expect the restructuring in France and Sweden to be around DKK 300 million for the year.

Similar cash-out profile. There is some P&L move from quarter-to-quarter that could be from a year-to-year. And because it relies on some figures which are very precise to recognize the provision, but that's – the plan is in track both on our expectation in cash-out and, of course, our expectation of savings. On top of this restructuring cost, there is a DKK 30 million net loss. This is the cause of first exiting our Greece operations.

Financial income and expenses are negative DKK 150 million, a charge which is up by DKK 39 million. About half of it, DKK 80 million, is actually the variation of forex gains and losses mainly on intercompany account. This is, of course, highly volatile and can change from one quarter to the other.

Then the other part, DKK 21 million is actually a higher interest charge mainly in the back of the Guckenheimer acquisition. For the full year, we expect to be slightly higher than 2017, excluding of course forex variation. This is on the back of the acquisition of Guckenheimer as well as the impact of last year refinancing where we looked more debt in fixed rate and for a longer maturity. You remember that last summer.

On the tax side, our effective tax rate in Q1 is 26% is, of course, in line with our yearly expectation. That's the IFRS rule. And it is broadly stable year-over-year compared to the first quarter 2017.

The adjusted net profit is DKK 296 million in the first quarter. It compares to DKK 546 million in Q1 last year. The decline is mainly driven by the currency headwind, which does have an impact, the operating margin decrease that I just comment and, of course, the increased investment in restructuring especially in France and Sweden.

As you know, this is the line on which we base the ordinary dividend payout. And to the extent that this line would be materially impacted by one-off during the year that will not reflect the underlying earnings power of the business, we may choose, of course, to adjust the payout ratio to protect the absolute level of dividend paid as we did last year.

That's it for the P&L, and we move slide 9 to review the cash flow statement. First point, of course, is that the cash generated by operation is down to DKK 901 million and it does reflect the decrease in operating profit and especially, of course, the forex impact that I mentioned earlier.

The change in working capital is a negative of DKK 1.4 billion. The last 12 months' cash conversion is actually quite strong, 102%, benefiting from the timing of collections and payments around the quarter and in Q4 and Q1. And this change in working cap is also including DKK 27 million in transition and mobilization costs related to our Deutsche Telekom project. It's clear that 102% as a conversion ratio is not sustainable each and every quarter, and we cannot commit on that. And you remember that we target to be above 90% each quarter.

On the other expenses paid, it's a cash-out of DKK 70 million, which is mainly driven by the restructuring projects, France and Sweden included, of course. So net interest paid is a charge of DKK 153 million. It is covering, in particular, two annual coupon payments out of four bond issues, which are actually incurred in the first quarter. The increase compared to Q1 is driven mainly by the higher average net debt in line with what I mentioned about the Guckenheimer acquisition.

On the tax side, you know that the first quarter is a seasonal high in terms of cash payment. It is DKK 278 million cash-out, slightly higher than last year due to phasing. And we continue to expect our underlying effective cash tax rates to converge towards the effective tax rate throughout the year and the coming years.

On the investment side, the capital expenditures are running at 1.1% of revenues, which is in the middle of the long-term range, 0.9% to 1.4% of revenues that we have seen over the last few years. It is slightly up compared to the first quarter 2017, which was 0.9% as expected.

There is no Deutsche Telekom-related CapEx in this first quarter numbers. For the full year 2018, we still expect our capital expenditures to remain at the high end of the historical range, driven especially by our investment in Deutsche Telekom to come, also our ongoing investment in technology.

The free cash flow ended up negative DKK 1.3 billion, down DKK 274 million. The biggest drivers being, of course, the lower cash flow from operation, again, driven by this significant forex headwind that we had.

Jeff mentioned a bit earlier that we have reached an agreement with the incumbent provider of – to Deutsche Telekom. We'll take over about 3,000 of their people, mainly critical technical service staff in connection with us taking over the delivery of services on the 1st of July 2019. I think it's a very good deal because it derisk the transaction, but also it does lower the expected transition/migration costs. We had an estimate before around DKK 600 million and now we are closer to DKK 500 million, which, of course, is good news.

So, this reduction would benefit us mainly in H1 2019 because we have less [ph] early highs (00:26:36). And so, the phasing of this spend would be 10% in 2017, 40% in 2018, 50% in 2019. Of course, this is indicative – as you can imagine, it can move again from one quarter to a quarter, but that gives you an idea. That's it for the cash flow.

And just before I hand over back to Jeff, I will [indiscernible] (00:27:00) give you some update on the contract maturity and the renewal that we have in 2018. As you can see, we have actually extended four out of the seven contracts set to expire in 2018. Some of these extensions are actually just short-term extension, which means that the tender process was delayed on the side of our customers, so we had a one-year extension. That's pretty common, actually. The main takeaway is that renewal risk for EMEA revenue in 2018 is now deemed to be insignificant.

In 2019, we have about 6% of our revenues now theoretically coming for – expiring. Then maybe moving forward – moving backward, that's a commercial discussion. And of course, this commercial discussion are gently starting in view of this 2019 renew.

With that, I will hand you back to Jeff with some final remarks and you turn to slide 11.

Jeff Olsen Gravenhorst

So thank you, Pierre-François. While the year has started broadly as we expected and perhaps I'd say a little bit better than expected on the organic growth, we are also managing a few short-term headwinds. As such, our outlook for organic growth, operating margin and cash conversion remains unchanged.

We expect organic growth will be between 1.5 to 3.5 percentage point in 2018. The business environments are generally supportive and we expect continued strong growth from our key accounts, supported by strong commercial progress over recent quarters, which helps offset the revenue reduction from DXC, HPI and the EMEA region with an international bank.

While organic growth in the first quarter started the year slightly stronger than expected, it benefited from a few short-term tailwinds. As such, our expectations for Q2 are unchanged. But given where we ended in Q1, we now expect Q2 to be the low point of the year, so down compared to Q1.

Our 2018 operating margin is still expected to be around 5.6%. Around meaning plus/minus 10 basis points, excluding the impact from FX and net acquisitions and divestments, which is currently set to be broadly neutral to marginal negative for the year.

A number of mature contracts have been re-tended during last year as you know. Some we retained and on some, we faced reduction scope, and some we lost, but be replaced with wins elsewhere. Either way, mature business is being replaced by business which initially will be less profitable. These dynamics are consistent with our long-standing operating model, but the impact is somewhat larger right now and will weigh on our business for the next few quarters.

These impacts will be partially mitigated by our ongoing focus on cost and efficiency initiatives, including expected improvements in a couple of our underperforming countries. As such, our expectation remains unchanged for the group margins to be down year-over-year in the first half of the year and up year-over-year in the second half of the year, driven mainly by Q4. For Q2 especially, the margin decline could be, as Pierre mentioned, similar to Q1.

Finally, the guidance for cash conversion remains above 90%.

So to wrap up, our commercial progress is very encouraging, the pipeline remains strong, and the market opportunities are considerable. In about a year from now, we'll be launching the largest contract in the history of ISS, Deutsche Telekom, which will add further momentum to the business.

Our conviction in the ISS strategy has never been stronger and last month, we were once again recognized by the International Association of Outsourcing Providers (sic) [Professionals] (00:31:01) in their review of the world's best outsourcing companies where ISS, for the sixth year in a row, achieved the highest possible ranking.

Our transformation is making us a stronger and more focused business. With this, we're confident that we are striking the optimal balance between managing risk and optimizing performance for the long run, increasing quality of revenue, and ultimately enabling us to capture high organic growth and robust margins.

With that, we would like to open up for questions-and-answers. With that, we would like to open up for questions-and-answers.

Q&A

Operator

Thank you. We will now begin the question-and-answer session. [Operator Instructions] And our first question comes from Kristian Godiksen from SEB. Please go ahead. Your line is now open.

<Q - Kristian Godiksen>: Thank you, and thank you for elaboration. Three questions from my side. Firstly, what is it that should make your margin expand, your view in Q3, as you have all the same headwinds in Q3 as you have in Q2 where the margin could be down around this 50 bps?

And then, secondly, I was wondering if you could give some – or elaborate a bit on your – how much visibility you have on the growth contribution from the non-portfolio business in the coming quarters. You have boosted – or the non-portfolio business has boosted our organic growth by 1.5% in Q1 and 1.2% in Q4. So was wondering if there are some visibility into the coming quarters.

And then, thirdly, if you could elaborate a bit on the magnitude of the organic growth in the next quarter, Q2 2018, which is now to be the low point. You will have further headwind from the three loss contracts of around 80 bps in Q2 versus Q1, and you had tailwind of 1.5 percentage points from the non-portfolio business. And I guess that mean, all else equal, that organic growth could go below the 1%. Am I correct in that? Thank you.

<A - Jeff Olsen Gravenhorst>: Okay. Thank you, Kristian. On the Q3 margin development, the key drivers for starting to see improvements in the margins, of course, the big thing is in Q4, as you know, but also in the ongoing phasing in, not so much the phasing out. But the phasing in of new contracts where we have a lot of extra cost when you open up new contracts. Of course, that starts to sort of phase – get to the normal base when you get to the third quarter. So that's one of the main reasons.

The other one is that we did have some exit costs and ramp-down costs into Q3 last year also on some of the big losses. Then, we'll have the turnarounds of the Swedish business and of the U.S. business that starts kicking in also in the second half year. It will come through Q3 and then, of course, have impact on Q4. So those are the main drivers for the improvements in Q3 and, of course, particularly in Q4.

Yeah. On the visibility of the non-portfolio work, there is some visibility now, of course, for the second quarter. We don't guide on growth targets for quarter-by-quarter. But of course, there is some visibility on that. It's more difficult when you go through, of course, the second half year and particularly the fourth quarter.

Last year, as you remember, we didn't expect to see the flooding coming through and then the flooding came through bigger than the flooding the year before. I don't know whether that flooding is going to come through again this year.

We had some of that flooding spillover into this year. We also had that last year. This is where it becomes a little bit difficult to predict.

So with the organic growth for second quarter, maybe, Pierre, if you can take that.

<A - Pierre-François Riolacci>: Yes. Definitely, we expect some headwind on this loss of contracts. So I mentioned an incremental negative 0.8.

Now, on the non-portfolio, as Jeff pointed out, we don't have a lot of visibility. However, what we have been doing with – are focusing more on our key accounts and IFRS contract is definitely improving gradually our potential in non-portfolio. And you're right, I mean, there is an overall trend being positive; it's just that we don't know. And definitely, we don't know up to the end of the quarter what can be the final number.

And, of course, if we wipe off everything, then that could be zero on non-portfolio. That's down 1.5% compared to Q1. That's a big drop.

And then on the other portfolio, the 3.3%, I think it's robust. It's fueled by good start-up, which are there and which we'll carry on in Q2. And we have some other coming in, so there is no reason to believe that that should decelerate.

So, I think that we are in Q2 – the 1% that you mentioned is definitely a very low scenario that we don't believe in. But we do not guide on a quarterly basis. I think we have been very transparent at the moving parts, and I guess that you can use your judgment to get to a decent number.

<Q - Kristian Godiksen>: Yeah. Thanks a lot. You definitely have it. I just have one follow-up on – and I'm sorry that is on the quarters. Just to be precise, so you expect the margin dilution in H1 and then you expect expansion in H2, primarily in Q4. But should we expect that the margin is around flattish in the third quarter or is that a magnitude of improvement you're seeing or could it even swing to positive?

<A - Pierre-François Riolacci>: I think that – you see that we have a few moving parts. And I think that it's already, I think, a go-to guide on the full year with 10-basis-point range. I think that we should try to avoid to be too precise on a quarterly basis.

But you're right, Q3 will be sort of midpoint between Q2 and Q4. That's for sure. And midpoint, I'm sure that you have already worked out, is close to what you say. Now, will we be ahead? Will we be behind in Q3? At this stage, we don't know. We have too many moving parts on the short term.

<Q - Kristian Godiksen>: Okay. Thanks a lot. Much appreciated.

Operator

Thank you. Our next question comes from the line below Bilal Aziz from UBS. Please go ahead. Your line is now open.

<Q - Bilal Aziz>: Good morning, everyone. Just three quick questions from me, please. Sorry to press on the margin guidance again, but given Sweden is a critical building block within that guidance, can you perhaps update us exactly where you are within your restructuring program in that region? Where margins are today versus the fourth quarter, I believe you briefly touched on it, and your expectations for margin in Sweden for the full year relative to previous levels?

Second question on UK, appreciate that the revenue slowdown in the fourth quarter already tied to HP. Can you perhaps suggest how the business is performing excluding these contract losses?

And very finally in Asia Pac, what was the one-off related in Thailand? And can you perhaps help us quantify that cost base? Thank you.

<A - Pierre-François Riolacci>: Okay.

<A - Jeff Olsen Gravenhorst>: Yeah. So in Sweden, just to remind ourselves, there are three main topics in Sweden and then the whole re – turnaround, I'm sorry, for Sweden is around those three points.

So, one, we had some mispriced contracts within the hospital sector. So that will ramp up. Some of them have already left and that will be impact in the second half of this year, that we don't have the negative drag from that. The last part of the hospital sector turnaround happens in the 1st of January, where we will exit the last of these contracts.

It is a loss-making contract, but we made the provision for that last year. So, it just drags us down to 0%. So that's, of course, a drag on our margins in Sweden. So that's the hospital sector. So we're pretty far with that and we're pretty satisfied with that level.

The second one is a little bit more complicated. This is the commercial conditions under which that the training has happened in Sweden, because this is where we have a competitor and the competitor is called [ph] Samhall (00:39:43) and that's pretty public. [ph] Samhall (00:39:45) is owned by the state and has had subsidies, which they have been deemed by EU not to be okay.

They do have 2018 to react to that and to make corrective actions, and those corrective actions is that they can give the same subsidies to the rest of us – so non-state, but privately held companies – or to actually stop doing the subsidies. They have six or seven different parts they have to go through. So the exact timing of that is a little bit more difficult, but we expect that the commercial conditions on the specialized services will, of course, change or it will change come midyear and starting next year.

On the last part, it is the restructure of our Cleaning business because of the lower volume. Then we're taking our cost, we're doing that as we speak, and we're on plan to do that. And that, of course, is again where we'll see the margin pick up from the second half in 2018. So that's the Swedish part.

If I understand your question right on the UK, it was – if we stripped out the big ticket losses – so the HPI, DXC and the EMEA banking – how's the business doing in the UK underlying? And with that, answering that question, I can tell you they're doing quite well and that we have landed a lot of new contracts, Arriva, as you can also see in the account, and we've also taken over T3 in Heathrow. We have taken over professional services business that we actually had some services with. That's converting from a single service business to an integrated service business. So very, very encouraging development on the UK market.

Just as I said and as a note to that, we, of course, can see that there are Brexit discussions and then security, but we don't see a big impact on our business.

The pipeline is very good. And, of course, there's a lot of competitors out there who are – yeah, has had some challenges over the year. Right now, we can just see that this also creates opportunities, albeit that there are some strange behavior once in a while. We actually see very good healthy development in our UK business.

So on the last part, Pierre?

<A - Pierre-François Riolacci>: Yes. On Thailand, I mean it's not a big number. I mean, we are talking a mid-single-digit million kroners. It is actually labor-related issues and that does include the cost of exiting some senior people of this organization.

In previous time, it could have been in restructuring, but we do not accept this in restructuring. So, it's charging to the operating profit. We just mentioned it because it does have an impact at the level of Thailand. And we mention it to you as well because we had a positive last year in APAC and that's a negative. So, it does widen the difference of the one-off in the region and that's why we mentioned it, but that's part of the normal stuff that you will have in any country in ISS. That's the business life.

<Q - Bilal Aziz>: Thank you.

Operator

Thank you. Our next question comes from the line of Aymeric Poulain from Kepler. Please go ahead. Your line is now open.

<Q - Aymeric Poulain>: Yes. Good morning. Thank you for taking my questions. First question is on organic growth. I was wondering if you could quantify the impact of LEGO and the new food and beverage customer that were mentioned on the organic growth in Q1, and how much it could contribute to Q2.

As well as a question on calendar effect. Some of your competitors have mentioned some significant negative calendar effect in Q1, which are set to reverse in Q2, but you don't mention any of those. So, I'm just wondering if there were any calendar effect to think about.

On the margin question, I wanted to follow up on what you said. So, I understand the moving part, but the range of 10 basis points, plus or minus, is quite wide especially in respect of the very stable margin base that you displayed in the past. So, is that to do with this cautionary margin range? Is that to do with the phasing effect that for you remain an uncertainty or is that to do with the non-portfolio contribution that you had last year? And if so, could you provide more clarity on this margin impact of the non-portfolio business you had in the second half, in particular?

And last but not least, you had a pretty significant restructuring charge in the French business, which 2.5-year payback. Is that still the case or should we see some improvement in the margin from that significant restructuring effort in 2019? Thank you.

<A - Jeff Olsen Gravenhorst>: Okay. Yeah. Sorry. So, I'm just getting this all straightened out here. So we have first the impact of LEGO and the [ph] online (00:45:03) food and beverage and so forth. We don't give guidance on the individual contracts unless they are as we've had it with HPI and the EMEA bank where they're really significant also on the margin part.

I think the both contracts are gradually starting up. There are other contracts, of course, we already mentioned: the Arriva part, the airport – or the air carrier in the U.S. was also mentioned in the release. So the best we can do now on the – is to give you further guidance for the year that this is what we believe. This is the reason why I believe, and it's up to 3.5% organic growth for the year.

In quarter, it really depends a little bit on whether they're ready to start up, [ph] whether they're not ready (00:45:48). As an example, we've won ABB last year in Asia. It does take a while to actually ramp up the entire business, so we're still ramping that business up in China. It really depends on when they're ready to go and sometimes it's got to do with the labor transition as well. So it's a little bit difficult to say exactly what that is, and that's why we guide on the full year and not individual quarters.

On the Easter impact, just to make sure, we of course have the same calendar as everybody else has. And that means Easter has hit into the first quarter as opposed to the second quarter. That has some timing on the number of working days and can have some timing impact on the expenses and so forth on labor. Overall, though, we don't have a major impact whether the holiday sits one period or another. One country can have – it can have a little bit of a regional impact, but overall, it's not a major reason for any of our results in the first quarter in 2018.

The margin range for the year, actually, I think...

<A - Pierre-François Riolacci>: Yeah. I think that when you asked the question, you are already bringing the answer because that's right. I mean, among the moving parts, we have this phasing of a large magnitude of contracts in and out. We have the non-portfolio growth, which is, of course – does have an impact potentially. And then we have the turnaround of our operations in Sweden, in the U.S. and in China. And of course, as you can imagine, we have an uncertainty on quarterly basis to know if they are going to kick in or not on a few months. It can make a difference.

The reason why we want to keep this [ph] minus 10%, plus 30% (00:47:35) that given the magnitude of these moving parts, if they all go into the wrong direction, then it's minus 10%. If they all go into the right direction, it can be plus 10%. And that's the reality that we have to face this year.

I'm not telling you that's now a constant feature, but definitely when we have so many moving parts, we need also to share with you this uncertainty and we try to be as transparent as possible. And of course, every quarter, we'll come back and tell you where we are on these three dimensions.

We have also given you some indication in Q2, so we really try to share with you all the information. But that's the fact, we have a few moving parts in 2018, which is a year of transition. And that's a fact.

<A - Jeff Olsen Gravenhorst>: And for the French restructuring, you're absolutely right. I think that the plan is still the same – or the plan is exactly the same as it was originally. We'll start seeing the positive impact from 2019. And it is around a 2.5-year payback.

<Q - Aymeric Poulain>: Okay. Thank you.

Operator

Thank you. Our next question comes from the line of Paul Checketts from Barclays. Please go ahead. Your line is now open.

<Q - Paul Checketts>: Morning, everyone. I've got a few questions, please. The first is, have you seen an acceleration in wage inflation in any of your geographic segments, please?

And the second relates to 2019 rebids. I know it seems a long way away, but there are some bigger ones in there. And I'm wondering if any of the negotiations would be concluded this year or if that will all be a 2019 effect.

And the next is a point of clarification on the margins. When you say that they are – the margins are non-portfolio work similar to the group average, do you mean that they're similar to the Q1 margin average or on the full-year number?

And the last one is coming back to the French restructuring. I presume you have had negotiations with the unions with regards to the head count reductions. Can you give us a feel for how they're going so far, please? Thanks.

<A - Jeff Olsen Gravenhorst>: Paul, you have to help me out on one of your questions here, but I'll just start. The wage inflation, we do see that in Europe, we see a little bit more salary increases than we've seen in the past. We have to remember though that we have also gone through some major increase in salaries in the emerging markets in the past also.

So, at the same time, there's been a lot of emphasis on minimum wages. So you know that the UK, for example, has had minimum or living wage increases in the past over the last two years. So, every year, there will always be something within our area where there is an emphasis on improving the living standards for the lower income group.

So, we are used to work with this. You know that. We also used to pass this on to our clients either as a increase in salaries or straight through, which is covered by contract, or it is through scope reductions or efficiency improvements. That's the way we work with it.

So I'll say, of course, there is some more movements on salaries as we could see [ph] Europe heal (00:50:47) a little bit more. But at the same time, we've also already dealt with a lot of these increases over the past few years because of the living wage and the minimum wage increases in a lot of countries. So, that is more or less business as usual.

On the rebids, clearly, we don't sit here and open up a lot of dialogue for competitors to get into, of course. But as we said, we are, of course, negotiating already now on the ones for 2019. Exactly how and when that concludes, nobody knows.

I will remind you, though, that even with the two ones that we are now ramping down, we actually continue to kind of have a contract with them now. It's big impact on that gross reductions. On HP, very special case. It's a case where you split the company into three.

We continue to have the contract with HPE. We continue to have the contract with the bank. And we continue to – and renew the contract with Barclays last year as we also announced. So we have a very good track record on the renegotiation of our major clients throughout the entire world, actually. So, very optimistic from that perspective, particularly also given our commercial development over the last few quarters.

Then on the French, maybe if – Pierre on the negotiation with the unions in France...

<A - Pierre-François Riolacci>: Yeah. You know that we are in the frozen period, which means that in France, the law has changed a bit, which mean that when you come with a restructuring, you start the frozen period as before. But now, there is a maximum timeline of four months, which has been imposed by law.

So, we are exactly at that moment. It's clear that we will not comment, but that's exactly in line with our timeline. That's exactly where we had to be. So we started the formal process in February. So, the clock is ticking and we are going through the four months. And so far, the discussion are as we could expect. I will not say that there is a great enthusiasm on the restructuring, but also I think there is a good understanding of what we are doing. And I think so far – and I am knocking wood, so far so good.

And as you know, I was about to say that there is a lot going on in France in terms of labor issues. And the good thing is that ISS is definitely out of the radar screen because there is plenty of other stuff and that's good because we are not on the – we do not have any communication issue. So, I think we are moving forward in – along what we expected.

Maybe under non-portfolio margin, just – I mean I mentioned in line with average, this is linked to the large projects that I've just mentioned. And of course, it depends on the contract itself and the countries in which they are. So it is not on the quarter margin; it is more on the contract margin. Whatever quarter it is, it's more on the contact side and it depends again on the profitability of the contract.

So, it depends where it does happen, whether it is in U.S. or in Australia or in which contract and how, as a contract, it's profitable or not.

<**A - Jeff Olsen Gravenhorst**>: Just as a note on that. The flooding project is, of course, one of a large contract nature so there is a cap to the percentage, which is [ph] above before (00:54:15), but definitely not at the high-margin contracts.

<**Q - Paul Checketts**>: Okay. That's clear. Thanks very much.

Operator

Thank you. And as another reminder, please limit yourself to question at each time. And your next question comes from the line of Michael Rasmussen from ABG. Please go ahead. Your line is now open.

<**Q - Michael Vitfell-Rasmussen**>: Yeah. Thank you very much. So just limiting myself to one question, could you please talk a little bit about what impacts we should expect in the full-year margin guidance from M&A and FX? I think at the Q4 results, you said at that stage, those two were netting each other out, i.e., a flat impact. Has that changed? Thank you.

<**A - Pierre-François Riolacci**>: We expect the full-year impact of M&A and FX to be broadly neutral, maybe slightly negative. It will be negative in H1 definitely as we expect it to be flattish in H2. But we are talking about very few basis points. That's what we see today.

<**A - Jeff Olsen Gravenhorst**>: Yeah. The first quarter is 6 basis points, right? So, we just can't remember in pounds that's why we make a higher margin on average in Swiss francs as well. But just using the forward-looking guidance here and that means it's broadly neutral.

<**Q - Michael Vitfell-Rasmussen**>: Thank you.

Operator

Thank you. Our next question comes from Srani Sarikombi (sic) [Srini Sarikonda] (00:55:47) from HSBC. Please go ahead. Your line is now open.

<**Q - Srinivasa Raju Sarikonda**>: Srini from HSBC. A couple of questions from me, please. First, in the UK, one of your peers has profit won on the back of the inability to pass through the higher living wage inflation. I understand you've been able to pass through the wage inflation in the past and – but relatively, do you see more pressure now in passing through the wage inflation given the acceleration in wage inflation?

And on second, when you say that you are seeing a strong wage inflation and you're able to pass through, is it fair to assume that most of your organic growth is coming from price increases and your volumes are slightly negative to low-single-digit growth?

<**A - Jeff Olsen Gravenhorst**>: Okay. So if we take just a little bit of a repeat, but just to give you a little bit more proof points on this, I think if you take the minimum wage and the living wage in UK, this is our largest market. That actually increased 12% over the last two years. So over the last two years, we had to deal with this.

That does not mean that you just get a 12% increase in revenue, but it does mean that you have a right either to pass it on or to discuss. And it typically ends up in a discussion and it typically ends up in a negotiation where you put in higher efficiencies and you re-scope.

And one of the reasons why IFS is such a success for us, so the Integrated Facility Services, is that when we integrate services, we can take out synergies. And those synergies are compensating for some of this increase in salaries. So this is what we do year-on-year is to find new methods, better ways of working and with that, give some offsetting of the price increases or the salary increases.

And then, obviously, as they put on the price or even sometimes have a light pathway to lower price next year. So all in all, we manage it not by just giving the bill to the client, but managing the costs for the client by becoming more effective and more efficient. So that's the way it works. It always worked. And the IFS solution gives us more opportunities to do that, hence the growth in IFS year-over-year every year.

On the inflation, as I've just said, yes, we do see inflation but I see that every single year. Maybe not in the same way as everybody sees it now, but we've seen it in the minimum wage increases and the living wage increases. So no difference on that.

Then, is it just inflationary revenue growth? No. As I said, we don't just get the pass-through; we have to negotiate it. So the volume here is increasing. Our number of contracts is increasing. And so, basically volume is the basic answer to your question of saying it is actually coming from volume.

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

Operator

Thank you. [Operator Instructions] And our next question comes from the line of James Winckler from Jefferies. Please go ahead. Your line is now open.

<Q - James Winckler>: Yes. Thanks. Apologies if I missed comments on this, but I was just wondering, you had about a 15-basis-point benefit from lower corporate costs and I'm just wondering what the main drivers behind these were and whether it's sustainable on a full-year basis. Thank you.

<A - Pierre-François Riolacci>: Yeah. You're right. I mean, the corporate costs are a bit lower in the quarter. It's phasing, so don't take us granted that we would be capable to extend that. It's fair to say that we do have some savings in corporate cost. I mean, we are – of course, we see the margin pressure and we are doing utmost to get there. But you should not take that it will be as the same for the full year. We're still guiding 0.8%, which is what you are used to.

<Q - James Winckler>: Okay. Thank you.

Operator

Thank you. And as there appeared to be no further questions, I'll return the conference to you.

Jeff Olsen Gravenhorst

So thank you very much and thank you for the questions. Thank you very much for attending today and have a nice day.