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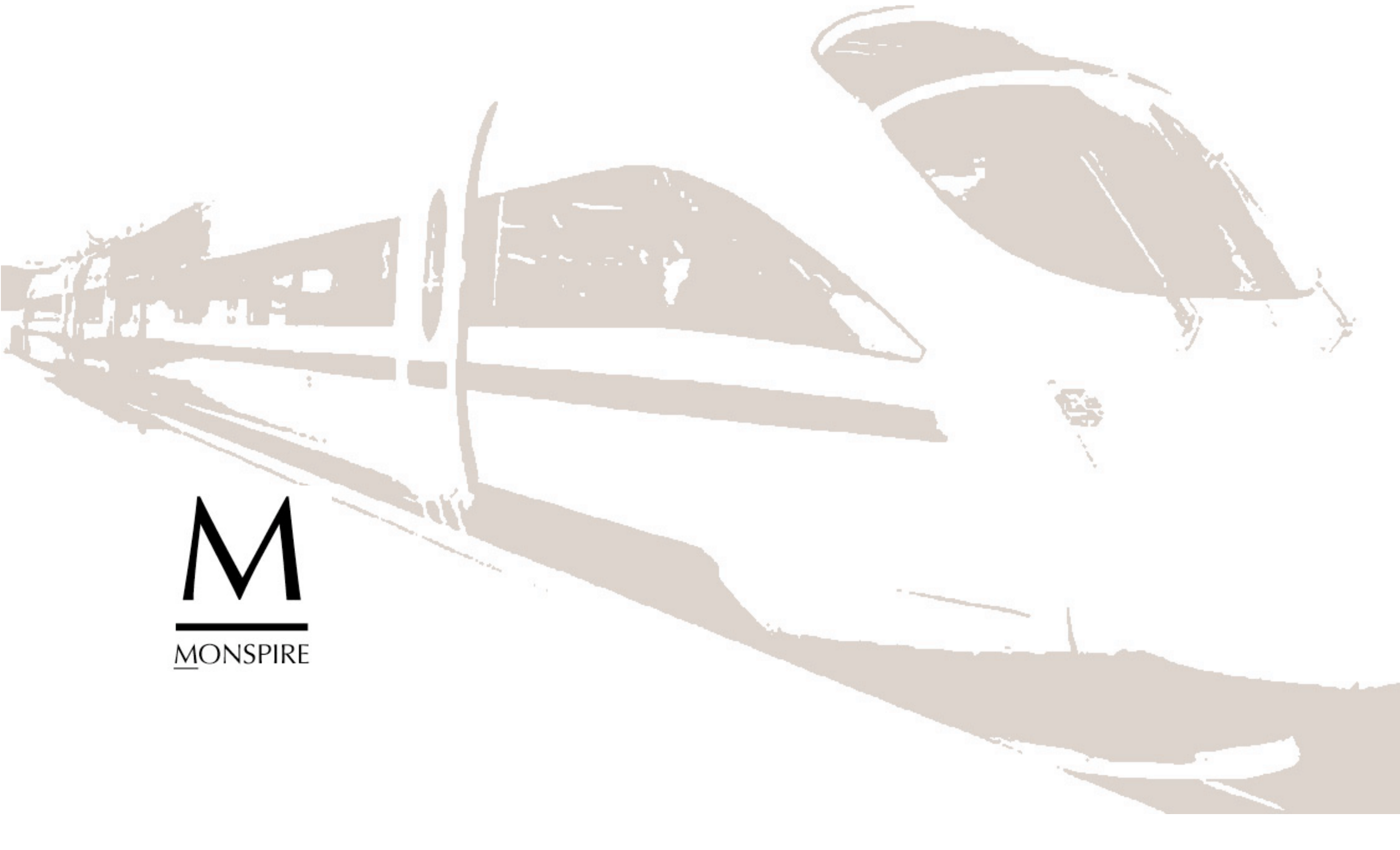

MONSPIRE

Rail XBriefing

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Introduction

A top-level international gathering in London last week witnessed a comprehensive show of support for the expansion of high-speed rail networks in the UK. Both the Government and opposition are however luxuriating in the position of being able to issue definitive policy commitments today, in full knowledge that the expected change of administration next year makes commitments by the current Government academic and the Conservatives attach a ‘spending review’ codicil to all polices.

With both parties not planning to allocate significant public finances to the project before 2015 at the earliest, Lord Adonis has made clear in policy discussions that the ‘constrained finances for the next few years’ should not impact on the delivery of the ‘long-term project’ – a suggestion echoed to us by Conservative officials.

Though the question of capital budgets beyond 2015 is a relatively distant one, we expect that towards the end of the next parliamentary term an urgent backlog of infrastructure schemes likely to be scaled back or postponed from 2010 – such as electrification expansion and Crossrail - will be at the top of the budget allocation list for 2015 and beyond. This could impact on the funding timelines for HS2. The envisaged public-private-partnership funding models favoured by both parties are also looking increasingly ‘ambitious’ given their woeful past performance.

The tragi-comic drama of National Express nears conclusion. Two weeks ago we issued the advisory that: ‘We anticipate further buyout submissions to be made before the 11 September deadline and expect a submission closer to 500p a share will win the formal backing of the Board. Under such circumstances, we would expect Lord Adonis to abandon plans to strip the Group of the East Anglia and c2c franchises.’

And so it has come to pass. With the DfT withdrawing its cross-default threat should National Express Group be taken over, the Cosmen/CVC consortium has now signed ‘an agreement of principles’ with Stagecoach to break up the transport group. We expect a formal offer of £765m to be made on 25 September.

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BRIEFING REPORT 1

HS2 | Political consensus backing high-speed rail expansion – funding models remain ambiguous

SUMMARY

A top-level international gathering in London last week witnessed a comprehensive show of support for the expansion of high-speed rail networks in the UK. Both Government and opposition officials stressed the issue facing HS2 planners was one of timing rather than principle. This briefing summarises the key policy statements reiterated last week before highlighting the strategic factor that remains opaque: funding.

1.1 SUMMIT CONSENSUS

The two-hundred attendees at the High-Speed Rail Summit at St Pancras International in London last Wednesday witnessed a cross-party endorsement of the need to push ahead with plans for High Speed rail expansion in the UK. At the event organized by the independent transport advisors Steer Davies Gleave, the UK Secretary of State for Transport Lord Andrew Adonis used his keynote speech to emphasise that the question facing policy makers was 'no longer one of principle but one of dates.'

From the other side of the party-divide, Theresa Villiers, Shadow Secretary of State for Transport, also expressed a certainty of purpose regarding the Conservative Party's support for high-speed rail links north, promising that 'if elected, our plans will go ahead'.

Sir David Rowlands, Chairman of High Speed Two, the company set-up by the Department for Transport to develop and manage plans for high speed rail expansion, told the gathering that by the end of the year his company would submit to the Government 'an engineered buildable route from London to the West Midlands', with options for other lines further north.

Lord Adonis stressed the need to 'completely rethink routes - there was no need to be ‘imprisoned by the past’, describing existing East and West coast main lines as ‘artefacts of history’. The Transport Secretary noted that there was a ‘golden opportunity’ to align planning for HS2 with the £16bn London Crossrail project.

SUBSTANCE

We did not anticipate any clarification of the Government’s plans for HS2 to be provided at the summit - route and financing proposals for HS2 Ltd remain to be assessed by the DfT at the end of the year. With routes, development schedules and – enormously significant – the funding models for HS2 still at a discussion stage, Lord Adonis confessed that he was ‘very alive to the quite long list of issues on which we have to reach a conclusion’.

On the Conservative side, Shadow Transport Secretary Theresa Villiers had described her Party’s backing for new high speed rail links north in September 2008 as the ‘environmental solution’ to the debate over a third runway at Heathrow[1]. We have extensively analysed the environmental claims made to justify this policy shift by the Conservatives and found them to be flawed[2].

We concluded at the time: 'The arguments for high speed rail expansion north are strong enough to stand on their own merits and are only weakened by Ms Villiers' presentation of rail as solution to obviate a Heathrow fix.'[3]

Little new of substance was advanced in regard to the either the Government or Conservative policy plans last week. The one area we anticipated more significant scrutiny, especially given the attendance of Tsutomu Morimura, Executive Director of Japan’s JR Central, David Azema, Director of Strategy & Finance at SNCF, and Giuseppe Sciarrone, CEO of Nuovo Trasporto Viaggiatori S.p.A. (NTV), among others – was the financing model for such major infrastructure developments. It is to this funding issue and the acute financial constraints on UK public finances that we now turn.

1.2 FUNDING AMBIGUITY

All speakers at the policy gathering were unanimous that the Government would be the major funding provider of the proposed multi-billion pound development. While the current Transport Secretary Lord Adonis asserted that ‘I simply take it for granted that any high speed line project will require a substantial state contribution’, he asserted that future revenue projections from high speed rail services could be securitised, therefore opening the door to private sector funding. (The track record for utilizing future revenue estimations as investment collateral is poor at best – the predicted volume levels for HS1 proved to be far in excess of actual performance, with the state intervening several times to financially rescue the project, until the final bail-out and nationalisation of the infrastructure and service operator in June this year).[4]

Current policy debates within the UK suffer from multiple levels of unreality – with a

1 For an assessment of Conservative high-speed rail plans see ‘High Speed Rail Expansion: The Fix For Heathrow?’, XBriefing, 10 November 2008. For a review of *Conservative Party’s rail policy review see* ‘Conservatives Outline Plans To Restructure The Rail Industry’, XBriefing, 16 February 2009.

2 Rail policy formulated as an environmental solution to air-capacity constraints at Heathrow we found to be fundamentally flawed in two respects: it makes an exaggerated selection of over 60,000 existing air journeys a north-south high speed rail link would compete with; it takes this exaggerated flight group and assumes a 100% modal shift from air to rail.

3 ‘High Speed Rail Expansion: The Fix For Heathrow?’, XBriefing, 10 November 2008. The ‘green rationale’ has been subsequently pushed to the background, with the Conservative Party’s rail policy review in February

4 See ‘LCR: Nationalisation – a legal prerequisite for market liberalisation’, XBriefing, 15 June 2009.

general election within the next nine months and the incumbent Government languishing in the polls, the hemorrhaging of authority from the current administration is palpable. In addition to this common ailment, Prime Minister Gordon Brown's Government continues to exhibit a phobic public avoidance of any serious engagement with the budgetary reductions urgently required to bring a degree of control to the continuing escalation in state debt levels.

As we recently observed when reviewing the Government's strategy documents for 'decarbonising the rail industry'[5], 'the elephant in the room during all current Government policy announcements remains the unsustainable levels of Government spending deficits and borrowing levels'. Despite a public reluctance to clarify its spending plans to the electorate, the Labour Government currently forecasts significant cuts to departmental spending over three years from April 2011[6]. Such a prolonged and significant squeeze on public finances following the next election makes all current and proposed spending commitments uncertain.

FUNDING TIMELINES

Neither the Government nor the opposition have any detailed funding models for HS2 (though the Conservative Party has published its estimated costs). The DfT plan to review the options submitted by HS2 Ltd before making route and funding announcements in 2010. Lord Adonis has already made clear in policy discussions that his HS2 vision 'is a long-term project' and that 'we won't be spending serious money on it for at least five years'. Therefore the conceded 'constrained finances for the next few years' should not impact on delivery.[7]

Both Conservatives and Labour are not currently looking to introduce public spending budgets for new high-speed lines before 2015. The Conservative Party policy calculates the total cost of a new high-speed corridor connecting Leeds, Manchester, Birmingham and London to be around £20bn (€22.7bn, $33.2bn), with guideline proposals last year suggesting the tax-payer contribution would be £15.7bn. Such a policy represents a public spending commitment of £1.3bn a year for 12 years from 2015 to 2027.

Alternative planning proposals published by Network Rail last month would link London to Scotland via Birmingham and Manchester by 2030. Planning would take at least another five years and cost an estimated £34bn (€38.6bn, $56.5).

Treasury sources within the Conservative Party have indicated to XBriefing that as their high-speed spending plans do not start for six years, 'the scheme is if anything more secure than immediate spending budgets, such as Crossrail'. The question of capital budgets beyond 2015 will not be addressed by either political party in detail for several years. Despite the distant timeframe, the reduction in capital budgets we anticipate the next administration to introduce next year would result in the postponement or cancellation of several infrastructure projects – electrification expansion and Crossrail to name but two we anticipate will suffer from the 'hard choices' of cuts at the DfT.

Though any assessment of the financial environment and public sector borrowing levels in several years time remains highly speculative, we expect that towards the end of the next parliamentary term an urgent backlog of delayed infrastructure schemes will be at the top of the budget allocation list for 2015 and beyond. This of course could impact on the funding timelines for such long-term projects as HS2.

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5 'DfT: Lord Adonis plans for the 'decarbonisation' of rail', XBriefing, 20 July 2009.
6 See 'Economic Review: Rail programmes in jeopardy from fiscal squeeze', XBriefing, 29 June 2009.
7 'UK High-Speed: Transport Secretary 'warns' PM over spending cuts', XBriefing, 13 July 2009.

1.3 OUTLOOK

Both the Government and opposition are exploiting their current favorable position of being able to promise large public sector spending plans for high-speed rail. Labour Transport Ministers are likely to be out of office by next summer and the Conservative team admit sotto voce that all future spending ‘commitments’ are subject to a ‘hard review of the public finances’ should they be returned to office.

We welcome the political consensus now backing high-speed rail expansion in the UK. We remain cautious however both with regard to the impact of a sharp tightening of public spending on current proposed timelines and the currently vague public-private partnership funding models for the large-scale infrastructure project.

BRIEFING REPORT 2

National Express | Cosmen & Stagecoach prepare for break-up of National Express Group

National Express: livery soon to disappear from the UK rail industry?

SUMMARY

With the DfT withdrawing its cross-default threat should National Express Group be taken over, the Cosmen/CVC consortium has now signed 'an agreement of principles' with Stagecoach to break up the transport group. The Board of National Express gave the go-ahead on Friday to financial scrutiny by the takeover group following a revised £765m (€868.8m, $1.28 billion) proposal, with a formal offer deadline agreed for 25 September.

We maintain our forecast from April that the indebted National Express Group will be broken up with no rights issue being made by the current Board. We expect Stagecoach to take over the c2c and East Anglia rail franchises together with the UK bus operations, with the Cosmen family retaining the UK coach business and US school-bus operations. The Alsa coach firm will also be brought back within the Cosmen business portfolio, sold to National Express in 2005[1].

[1] The Alsa purchase by National Express entailed the issue of 13.5 million shares, representing 9.9% of the Group's

2.1 CROSS-DEFAULT WITHDRAWAL

Following the Board of National Express Group Board rejecting earlier acquisition bids, two weeks ago we issued the following advisory:

> 'We anticipate further buyout submissions to be made before the 11 September deadline and expect a submission closer to 500p a share will win the formal backing of the Board. Under such circumstances, we would expect Lord Adonis to abandon plans to strip the Group of the East Anglia and c2c franchises.'[2]

On Tuesday UK Government sources confirmed to XBriefing that any potential bidders for National Express Group would not be forced to relinquish the c2c or East Anglia franchises – with the DfT granting the transfer of the contracts to Stagecoach (or another third-party) in a £100m 'transfer deal'. Department for Transport officials have made clear to us however that should National Express Group remain as an independent entity, they would continue to seek the implementation of a cross-default clause and seek to strip the group of all its rail franchises following its failure to honour the terms of its East Coast contract.

This confirmation from the Government comes after several weeks of 'clarification discussions' with senior executives from Stagecoach Group and was an essential condition that paved the way for the revised bid from Cosmen/CVC last week.

The DfT concession allowed a further 'agreement of principles' to be clarified between Stagecoach Group and Cosmen/CVC under which the Perth-based transport Group would take-over the c2c and East Anglia franchise contracts. The removal by the DfT of a significant variable for would-be bidders allowed Stagecoach chief executive Brian Souter to proceed with his preferred plan of secondary acquirer following a principle Cosmen/CVC takeover rather than submit his own offer for National Express.

2.2 DUE DILIGENCE

The Board of National Express Group agreed on Friday to open the company's accounts to the consortium of the Spanish Cosmen family backed by private equity group CVC Capital Partners[3]. The Cosmen family are the largest single shareholder in National Express holding 18.5% of the company's shares. The consent to due-diligence follows the revised 500 pence per share offer and the withdrawal of a number of offer pre-conditions.

An internal company briefing written by National Express Chief Operating Officer Ray O'Toole on Friday confirmed that he had received an approach last week to pay £5.00 per share for the company, though 'this is not yet a formal bid'. After consultation with 'our major shareholders and advisers', the Board have consented to allow the Cosmen/CVC team to conduct due-diligence with access to the company's accounts. Mr O'Toole confirmed in the internal memo that:

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existing share capital, to a company under the control of the Cosmen family and the payment of £149m (€217m) in cash, to be funded through a new bank facility. As part of the transaction, the Group also assumed debt of approximately £199m (€289m).

2 'National Express: Stagecoach poised to enter bidding war with Cosmen consortium over National Express takeover', XBriefing, 1 September 2009.

3 CVC Capital Partners, founded in 1981, is a global private equity and investment advisory firm, headquartered in Luxembourg. CVC owns a controlling stake in Formula One and Debenhams.

> 'The process will take four weeks after which the Consortium will either go ahead with a formal offer of £5.00 per share or walk away. Its important to note that, under the rules of the Takeover Panel, the Consortium will not be allowed to reduce their offer below £5.00 or increase it above £5.00 as a result of the due diligence work they are about to undertake. Their only options are to make a formal offer at £5.00 or to walk away...If a formal offer is submitted, the Board will decide on its final recommendation'.[4]

The UK Takeover Panel confirmed to us that it has extended the deadline for the consortium to make a formal offer or walk away from a deal by just two weeks, to 5pm (1600 GMT) on Friday 25 September.

Sources connected with the takeover bid have indicated to XBriefing that the revised 500 pence a share offer – increased from previous approaches valuing National Express at 400p and 450p per share - is backed by significant shareholders and is expected to receive formal backing by the Board should a formal proposal be issued to the company next week.

INDEPENDENT STRATEGY

Mr O'Toole, did indicate on Friday that 'If a formal offer is not received, the Board plans to continue its independent strategy and to execute our own equity finance plans,' though as we have briefed for several months, we consider the group's future as an independent entity to be highly challenging.

As we note above, an independent National Express Group faces being stripped of all its UK rail franchises and with debts of £977m, it is danger of breaching existing loan covenants and faces additional short-term debt refinancing problems. Investors have been sounded out for several months now on injecting more cash into the troubled business, with the Board currently looking to a £350m rights issue to pay down its borrowings.

We would see little option but for the Board to conduct its own break-up of the Group to pay-down debt should any takeover fail to emerge – a task all the more challenging with no chief executive in place following Richard Bowker's exit earlier this year. In these circumstances, we fully expect the Board and shareholders to support the £765m Cosmen/CVC bid, should it be forthcoming next week.

Investors have indicated that the Cosmen/CVC consortium pressed upon them last week that National Express faced 'significant risks' as an independent entity – risks that their offer would remove.

2.3 OUTLOOK

In April we exclusively advised of a 'reverse takeover by National Express Group Deputy Chairman and largest shareholder Jorge Cosmen …with rivals Stagecoach identified as performing due diligence on a takeover bid'.[5] We anticipate the break-up of National Express Group will be formalised by the end of the year.

With the takeover being conducted by deputy chairman Jorge Cosmen and with the completion of the first half of the financial year much of the accounts have already been audited, we do not anticipate due diligence to expose any material preventing the formal submission of a 500 pence a share offer by Cosmen/CVC next week.

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4 Ray O'Toole, 'Approach to National Express by Consortium', Internal Memo, 11 September 2009.
5 See 'National Express: Financial uncertainty fuels takeover speculation', XBriefing 20 April 2009.

We fully expect the Board and institutional shareholders to support the take-over.

Following acceptance, with Stagecoach in an ‘exclusive agreement’ with the bidders, we expect them to quickly acquire the c2c and East Anglia franchises, together with the UK bus division. As we noted earlier in the year when Stagecoach executives were already ‘examining the financial benefit’ such an acquisition could make, they were:

> ‘assessing the break-up value of National Express and which divisions could be incorporated into a larger transport entity without falling foul of the Competition Commission.’ [6]

We expect a number of UK bus service to be off-loaded in order to comply with Competition Commission concerns, though we do not anticipate any impact on Stagecoach’s rail franchises.

[6] Ibid.