

## FINANCIAL REVIEW

### CENTRAL COSTS

Central costs, before one-off items, increased by 6.3% over the prior year. This primarily reflects inflation and the accounting costs of the new long-term incentive plan. Savings have been implemented in a number of head office functions although these will be offset in 2007 by the initial set-up costs of a UK shared service centre and other initiatives. Over the medium-term, these offer the prospect of improved administrative efficiency in many UK businesses.

In 2006, the principal one-off item was a £14.0 million curtailment credit arising out of the closure to future accrual of the UK defined benefit pension scheme at the end of August. In 2005, one-off costs largely related to defence of the approach from Raphoe. This had been treated as an exceptional cost but was reclassified this year as a one-off item to improve comparability. One-off items also included redundancy and restructuring charges in both years.

### PROFITS

Operating profit from continuing operations before one-off items and amortisation of intangible assets reduced by £22.2 million to £298.6 million. Amortisation of intangible assets of £25.9 million (2005: £20.2 million) and one-off items of £23.6 million (2005: £30.5 million) resulted in operating profit of £249.1 million (2005: £270.1 million). At constant 2005 exchange rates, before one-off items and amortisation of intangible assets, operating profit fell by 4.4%.

### EXCEPTIONAL ITEMS

Exceptional items recorded in the first quarter relating to the closure of the UK linen and workwear business in April 2006 have now been transferred to discontinued operations. In the year ended 31 December 2005, the costs of defending the takeover approach from Raphoe amounting to £10.9 million were treated as an exceptional item. This and other items shown in 2005 as exceptional items have also been transferred to discontinued operations or included as continuing operations and reclassified as one-off items as appropriate in order to improve comparability.

### ONE-OFF ITEMS

One-off items primarily relate to the group's restructuring programme and consist of the profit on the sale of the former head office, consultancy, reorganisation and redundancy costs and a pension curtailment credit. These have been separately identified because they are not considered to be "business as usual" expenses and, although many of them are small, they are numerous and have a varying impact on different businesses and reporting periods. Whilst not large enough to be classified as exceptional items, in aggregate they make it difficult to understand underlying trends in performance unless they are separately identified.

Across the group, the net cost of one-off items in 2006 was £23.6 million compared with £30.5 million in 2005. In 2006, the closure of the UK defined benefit scheme to future accrual resulted in a reduction of the scheme's liabilities by approximately 1.4% with the resultant non-cash credit of £14.0 million taken to operating profit in the second half of 2006 and treated as a one-off item. Excluding this credit, one-off items in 2006 totalled a net charge of £37.6 million, the bulk of which were incurred in the Textiles and Washroom Services division. This relates primarily to restructuring activities in UK Washroom and German Textiles. In addition, the Pest Control division incurred one-off costs of £6.8 million in 2006, mostly relating to redundancy and reorganisation activity in the UK.

Rationalisation costs of up to £10 million may be incurred during 2007 on initiatives underway or under consideration. This includes £1.5 million for the completion of the changes in UK Washroom and UK Pest Control. In addition, around half of the £12 million Target Express anticipated integration costs will be incurred in 2007, although synergy benefits will not be realised until 2008.

**DISCONTINUED OPERATIONS**

Discontinued operations primarily represent the UK linen and workwear business plus the UK, Canadian, Belgian and US Manned Guarding businesses. Trading from these operations, together with a small adjustment for prior year disposals, produced losses after taxation of £3.1 million in the year. These were offset by profits on disposal of £95.9 million, leaving profit for the year from discontinued operations at £92.8 million (2005: £166.4 million).

UK linen and workwear was closed on 30 April 2006.

The discontinued business incurred a trading loss of £3.8 million in the year net of profit on sale of surplus properties. The 2006 loss was reduced by some £3 million as a result of the reduced depreciation following the asset impairment charge recognised in 2005.

The sales of the four Manned Guarding businesses were completed during the year for a gross consideration of £150.0 million. These businesses made operating losses of £7.2 million up to the dates of disposal and produced a profit on disposal of £95.9 million.

**INTEREST**

The group's net interest charge for 2006 was £52.0 million compared with £54.9 million in 2005. Net interest on bank and bond debt and finance leases was £50.2 million compared with £52.0 million for the prior year. Average net debt in 2006 was £149 million lower than 2005 reflecting the proceeds from the sale of Style Conferences at the end of 2005 and the sale of Manned Guarding in the first half of 2006, although these proceeds were offset by the £200 million special contribution into the pension fund in December 2005. The purchase of Target Express for £213 million in November 2006 had only a limited impact on the interest charge for the year, although it will have a more significant effect in 2007. The effect of lower average net debt was offset by an increase in average interest rates as a result of the ten year sterling bond issue in March 2006 and the general upward trend in interest rates over the course of the year. This latter effect was, however, mitigated by the interest rate hedges that were in place during the year but the cost of debt is expected to rise in 2007. The balance of the interest charge reflects the notional net interest on pension scheme assets and liabilities and various mark-to-market adjustments on treasury transactions. Further details are given in notes 6 and 7 to the income statement.

**PROFIT BEFORE TAX**

After interest of £52.0 million and one-off items totalling £23.6 million (2005: £30.5 million), pre-tax profit reduced by £18.3 million to £199.1 million.

**TAX**

The income statement tax charge for the year was £44.8 million (2005: £59.4 million) representing an effective tax rate of 22.5% compared with 27.3% for 2005. However, the reported tax charge for both years was affected by the release of tax provisions in respect of previous periods which are no longer required following agreement of the relevant liabilities with fiscal authorities. The underlying effective tax rate, before such provision releases, was 29.9% in 2006 compared with 32.7% in 2005, the decrease mainly due to a reduction in disallowable costs.

The weighted headline tax rates appropriate to the countries in which the group operated was 30.7% for 2006 compared with 30.9% in 2005. It exceeds the UK rate of 30% as substantial profits are earned in France, Belgium and Germany where tax rates range from 34% to 38%.

**EARNINGS PER SHARE AND DIVIDENDS**

Profit for the year attributable to equity holders was £245.1 million (2005: £321.5 million). At 8.43 pence, basic earnings per share for continuing businesses were 2% lower than 2005. Basic earnings per share for total operations were down 24% on 2005 at 13.57 pence per share.

An interim dividend of 2.13 pence per share was paid on 27 October 2006. A final dividend of 5.25 pence per share will be proposed at the Annual General Meeting in May 2007, maintaining the full year dividend at 7.38 pence per share. This is in line with the statement made in the 2005 preliminary results announcement and subsequently that a cautious approach would continue to be taken to dividend growth until it was clear that the recovery in the businesses was well established.

**CASH FLOW**

Operating cash flow for the year of £211.0 million (2005: £287.0 million) was £76.0 million below last year with operating profit before depreciation, amortisation, impairment charges and non-cash items accounting for £95.2 million of the reduction. Working capital outflows accounted for another £11.0 million with a large part of this due to the higher level of business in the last quarter. Capex was £30.2 million below last year, reflecting the disposal of the Manned Guarding businesses earlier in the year, the relatively capital intensive Style Conferences business sold in the fourth quarter of 2005 and the disposal of surplus properties following the closure of the UK linen and workwear business.

Lower tax cash flows, as a result of lower profits and pension payments, partly compensated for the lower operating cash flows to leave free cash flow £31.8 million below last year at £128.6 million. Net debt increased by £247.9 million over the year reflecting the relatively high acquisition spend primarily for Target Express, JC Ehrlich, the Asia Pacific division and the acquisition of City Link franchises.

#### **SHAREHOLDERS' FUNDS**

Consolidated equity shareholders' funds at the end of 2006 were negative £540.0 million, compared to negative £666.6 million at the end of 2005. The principal cause of this movement was the profit for the year attributable to shareholders of £245.1 million offset by dividends paid to ordinary shareholders of £133.3 million.

#### **FINANCIAL RISK MANAGEMENT POLICIES**

The board has approved the following financial risk management policies. These policies cover those financial risks that are material to the company's operations and financial results. The board has set appropriate delegated authorities, treasury financing parameters and reporting procedures to ensure compliance with such policies at all times. The effect of the company's treasury activities is reflected in the disclosures in notes 17, 22, 23 and 24.

#### **CAPITAL STRUCTURE AND FINANCING STRATEGY (LIQUIDITY RISK)**

The board has set the following policies so as to minimise the company's exposure to liquidity risk and thus ensure that the company is able to meet its liabilities as they fall due.

The company is committed to maintaining a debt/equity capital structure that is sufficiently robust so as to ensure the continued access to a broad range of financing sources and thus be able to maintain sufficient flexibility to pursue commercial opportunities, in a timely manner as they present themselves, without the imposition of onerous financing terms and conditions.

The company will maintain a minimum financing headroom of £200 million, when measured against its latest forecast/anticipated cash flows over a rolling nine-month time horizon.

The company's sources of finance should be structured in a manner so as to minimise potential refinancing risk particularly arising from a bunching of debt/note facility maturities.

The company's financing sources should be diversified, across the international banking and capital markets, so as to avoid the over-reliance upon a single source, or disproportionately large source, of funds from an individual capital market note issue or bank finance provider.

In Autumn 2005, the group's credit rating from Standard & Poor's was reduced from BBB+ with negative outlook to its current level of BBB with stable outlook. This reflected the group's weaker than expected business risk and financial risk profiles following weakened operating performance over the past few years.

We continue to target a stable BBB+ rating in the medium-term as we believe that this strikes an appropriate balance between an efficient capital structure (as represented by a low weighted average cost of capital), liquid access to the capital markets and reasonable pricing. The board believes that a key priority must be to retain sufficient financing flexibility to fund its business turnaround strategy. Therefore, over the short to medium-term we do not have surplus capital that could be returned to shareholders if a minimum BBB credit rating is to be maintained with an appropriate degree of headroom to avoid further ratings pressure.

At 31 December 2006, the group had approximately £274 million of undrawn committed bank credit facilities. The company is in compliance with the financial and other covenants within its committed bank credit facilities as well as all obligations relating to the notes issued under the Euro Medium Term Note (EMTN) programme.

In 2006 the group lengthened the maturity profile of its debt. This was achieved through the successful issuance of a £300 million ten year bond in March and the establishment of new £500 million five year syndicated bank credit facilities in October. Both financing transactions were well received by the market, having been well over subscribed.

The company's credit rating from Standard & Poor's has remained BBB with stable outlook throughout 2006. This rating was most recently reaffirmed on 30 November 2006 following the company's announcements that it had both acquired the Target Express parcel delivery business for £213 million and decided to undertake a strategic review of its Electronic Security business.

**MARKET PRICE RISK**

The company and its reported results are exposed to financial market price movements. These risks principally arise from the interest and foreign exchange rate markets. In addition, through its UK defined benefit pension scheme (“the scheme” – see note 26), the company also has exposure to equity market price movements. The trustee directors are responsible for setting the risk management strategy for this scheme. During the year this scheme’s exposure to equity market price movements has markedly reduced. In early April 2006 the scheme’s assets were switched from being predominantly in equities (80%/20% equities/bonds) to being mostly in corporate bonds (20%/80% equities/bonds). A 10% movement in equity prices in any one year would give rise to a +/-£20 million movement in scheme assets and thus a corresponding movement in the underlying scheme deficit. Shortly after this asset switch, the scheme also undertook inflation and interest rate hedging actions. These actions, together with the closure of the scheme to future accrual with effect from 31 August 2006, were undertaken so as to increase the likelihood that the scheme’s assets (together with the company’s agreed future contributions) would be sufficient to meet its anticipated financial commitments to existing and future pensioners.

The company remains committed to funding the scheme’s existing IAS 19 pension scheme deficit, which at 31 December 2006 stood at £108 million (2005: £170 million). The company agreed a schedule of future company contributions with the scheme’s trustee in December 2005 that would eliminate this deficit by 2012.

**INTEREST RATE RISK**

The policy is to manage interest rate exposures on a 12-month rolling basis (measured quarterly). Unless otherwise agreed by the board, a minimum of 50% of the company’s estimated future interest rate exposures should be fixed (or capped) for a minimum period of nine months forward. Additionally, in the event that the company’s interest cover (measured by the ratio of adjusted operating profit to net interest payable) is forecast to fall below five times, any remaining un-hedged interest rate exposures for the forthcoming 12-month period should be immediately fixed (or capped).

Some 98% of the group’s net borrowings are currently at fixed rates of interest for 2007. Thereafter, in the event that interest rates rise or fall by 1% p.a. simultaneously across the group’s borrowings, the net interest payable by the group would then correspondingly increase or reduce by approximately £12.9 million on an annualised basis.

**FOREIGN EXCHANGE RISK**

Foreign exchange risk can arise as follows:

1. from retranslation of overseas business profits into the sterling functional reporting currency of the company;
2. from retranslation of assets and liabilities of overseas companies into the functional currency of the company;
3. from cross-border trading transactions of group companies; and
4. from the use of currency denominated borrowings and financial instruments used to finance business operations.

The company has a policy of not hedging foreign exchange translation risks outlined in 1 and 2 above. Further, the company has a policy of not hedging foreign exchange risks arising from cross-border trading activities given that these are immaterial.

The company policy is to fund its business operations centrally with borrowings that are substantially denominated (90% or greater) in the same actual or effective currencies\*, and in the same proportion as the group’s forecast cash flows generated by the business.

\*Actual or effective currency. The use of either actual currency borrowings or currency swaps is permitted. Currency swaps economically change the actual currency of borrowing into an effective amount, borrowed in a different currency. Currency swaps will be used in preference to actual currency borrowings when the all-in cost is cheaper than the alternative currency borrowings and/or they enable a closer match to the company’s debt maturity calendar.

**CREDIT RISK**

The company utilises financial instruments to manage financial risks that arise naturally from its business operations. Only group treasury personnel are authorised to deal such instruments on behalf of the company. The board has set strict policies for the use of such instruments. The company’s policy is to ensure that their use shall be:

- strictly limited to the management of known or anticipated financial exposures which arise from the company’s existing or planned commercial operations;
- only undertaken by suitably qualified or experienced group treasury staff;
- undertaken only after efforts have been taken to avoid the need for use of such derivative instruments to manage the group’s financial exposures;
- limited to the management of interest rate or foreign exchange exposures (i.e. no equity related or commodity hedging shall be undertaken without specific board approval);

- undertaken only after the preparation of clear documentation which explains the purpose for the use of the specific derivative and its proposed financial accounting treatment;
- capped by the maximum approved counterparty limit for that transaction; and
- subject where relevant to detailed “hedge effectiveness” testing by group treasury, through to maturity of the transaction, if designated and documented as a “hedge” at the outset of the transaction.

The company further limits its exposure to credit risk on financial instruments by ensuring, where appropriate, that instruments used are subject to International Swaps and Derivatives Association market standard legal documentation.

The board also sets maximum counterparty approval limits for individual financial counterparties. These limits are reviewed and varied to take account of changes to the underlying credit rating of individual credit counterparties as required.

## ACQUISITIONS

The group acquired 71 businesses in the year for a net consideration of £429 million.

Details of the businesses acquired and the revenue and operating profit therefrom are set out in note 32 to the accounts. By consideration value, the most significant transactions undertaken during the year were:

- J.C. Ehrlich Co. Inc., the fourth largest pest control company in the USA, for a consideration of £75.0 million.
- The washroom businesses of CWS (Asia) and SGS Pink in Asia Pacific for £12.9 million and £25.3 million respectively.
- The purchase of the next day parcel delivery business Target Express for £213.3 million.
- Nine City Link franchises for total consideration of £51.2 million.

## PENSIONS

The IAS 19 pension deficit was £118.8 million at the end of 2006 compared with £182.3 million in December 2005. The group has a number of small defined benefit schemes but the principal liability relates to the UK Scheme (the “Scheme”) which had a deficit of £108 million at December 2006 compared with £170 million a year ago. The principal reason for the reduction in the deficit is the £14 million reduction in the Scheme’s liabilities following the cessation of accrual and an increase in the value of the Scheme’s

assets as a result of favourable market movements in the early part of the year. During 2006, a series of interest and inflation rate hedges were executed by the Scheme and its investment mix changed from approximately 80% equities/20% fixed interest to the new asset allocation of 20% equities/80% fixed interest. The effect of the hedging will be to reduce the exposure of the Scheme’s assets and liabilities to market movements by linking the cash flow profile of the bond investments to the Scheme’s liabilities. In addition, an interim review by the Scheme’s actuaries resulted in an £11 million increase in the Scheme’s liabilities to reflect the differences between some valuation assumptions made previously and recent experience.

At 30 June 2006, the UK Scheme’s IAS 19 deficit was estimated at £76 million. The £32 million increase in the deficit since that date reflects the impact of updated actuarial assumptions following the interim review performed in the second half, the scheme closure effects and changes to IAS 19 interest and inflation assumptions.

## ACCOUNTING STANDARDS

The financial statements included in this annual report have been prepared and presented under IFRS as adopted by the EU. The group’s accounting policies are set out on pages 61 to 71.

Amendments to IAS 21, “The effects of changes in foreign exchange rates”, IAS 39, “Financial Instruments: Recognition and Measurement”, IFRIC 4, “Determining whether an arrangement contains a lease” and IFRIC 6, “Liabilities arising from Participating in a Specific Market – Waste Electrical and Electronic Equipment” have been implemented in 2006 with no material effect on either the current or prior periods.

Amendments to IFRS 1, “First-time adoption of International Financial Reporting Standards” and IFRS 6, “Exploration for and evaluation of Mineral Resources” and interpretation IFRIC 5, “Rights to interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds” have become applicable in the year but are not relevant to the group’s operations.

Certain new standards, amendments and interpretations to existing standards have been published that are mandatory for the group’s accounting periods beginning on or after 1 January 2007 or later periods but which the group has not early adopted. We have identified IFRS 7, “Financial Instruments: Disclosure” (effective 1 January 2007) and IFRS 8, “Operating Segments” (effective 1 January 2009) as being relevant to its business. The impact on the group’s operations is currently being assessed.