CHIEF FINANCIAL OFFICER'S REVIEW

"Reported profits in 2017 were impacted by significant non-underlying items and cash flow was weaker in the second half of the year."

NICK GREATOREX, CHIEF FINANCIAL OFFICER

Capita has early adopted IFRS 15, the new revenue recognition standard, and this report on our performance in 2017 against the comparative period in 2016 is under the new standard. The adoption of the standard has impacted our underlying results, introducing a number of one-off items, detailed below in the summary of financial performance. Following the adoption of IFRS 15, the Board has adopted a policy to separately disclose the operating profit/loss in-period from significant new contract wins and significant restructuring within underlying profits in order for users of the financial statements to obtain a proper understanding of the financial information and the performance of the business.

Effective from 1 January 2017, we restructured our organisational structure to simplify our business model, resulting in a reorganisation from 11 divisions into six market-facing divisions. Following the disposal of Capita Asset Services in the year, we are currently reporting under five divisions. In addition, we modified segmental reporting to align it with our management view of divisional performance. This includes allocating only direct overheads, such as payroll administration, pension and insurance costs, to the divisions, and showing central costs separately.

Underlying profits were in line with expectations, with improved profitability in the Private Sector Partnerships, Public Services Partnerships and IT Services divisions partially offset by lower profits in the Digital and Software Solutions division and higher central costs. However, reported profits were impacted by a number of significant non-underlying items, including goodwill and other asset impairments and the Asset Services settlement provision in relation to Connaught. There was a significant gain on the disposal of the Capita Asset Services businesses, which was treated as a discontinued operation.

CHIEF FINANCIAL OFFICER'S REVIEW CONTINUED

FINANCIAL HIGHLIGHTS

	Reported results – continuing operations			Underlying results – continuing operations		
	Reported 2017	Reported 2016	Reported YOY change	**Underlying[1] 2017**	Underlying[1] 2016	Underlying[1] YOY change
Revenue	**£4,234.6m**	£4,368.6m	(3)%	**£4,167.9m**	£4,357.3m	(4)%
Operating profit before significant new contracts and restructuring				**£465.3m**	£391.8m	+19%
Operating profit/(loss)	**£(420.1)m**	£(16.1)m	2,509%	**£447.4m**	£334.6m	+34%
Profit before tax before significant new contracts and restructuring				**£400.9m**	£325.7m	+23%
Profit/(loss) before tax	**£(513.1)m**	£(89.8)m	471%	**£383.0m**	£268.5m	+43%
Earnings/(loss) per share	**(80.14)p**	(14.27)p	462%	**45.61p**	31.68p	+44%
Total dividend per share	**11.1p**	31.7p	(65)%	**11.1p**	31.7p	(65)%
Free cash flow	**£37.7m**	£367.3m	(90)%	**£38.0m**	£397.3m	(90)%

1 Refer to Alternative Performance Measures on pages 202–204. Further details on our underlying performance are contained in our Consolidated income statement and in notes 3, 6 and 10 to the consolidated financial statements.

The Board has adopted a policy to separately disclose those items that it considers are outside the underlying operating results for the particular year under review and against which the Group's performance is assessed. Items within non-underlying include intangible amortisation, asset impairments, acquisition contingent consideration movements, the financial impact of business exits or businesses in the process of being exited, acquisition expenses, movements in the mark-to-market valuation of certain financial instruments, and specific non-recurring items in the income statement. In the Directors' judgement, these need to be disclosed separately by virtue of their nature and size and/or incidence, in order for users of the financial statements to obtain a proper understanding of the financial information and the underlying performance of the business. In 2017, specific non-recurring items include impairment of assets related to the life and pensions business, impairment of goodwill and impairment of other non-current assets following a comprehensive review of the recoverability of tangible and intangible assets, resulting from changes in client and Capita strategy in the second half of 2017.

The Alternative Performance Measures (APMs) disclosed on pages 202–204 provide more detail on the criteria that the Board believes give relevant information on the Group's financial performance, position and cash flows. These measures provide useful information which is not otherwise readily available from the financial statements. Further disclosure of the reporting of underlying and non-underlying presentation is included in note 2 to the financial statements – Summary of significant accounting policies (pages 96–108).

REPORTED OPERATING LOSS BRIDGE TO UNDERLYING OPERATING PROFIT

Reported operating loss	**£(420.1)m**
Impairment of goodwill	£551.6m
Impairment of other non-current assets	£63.5m
Impairment of life and pension assets	£61.2m
Claims and litigation provisions	£30.0m
Amortisation and impairment of acquired intangibles	£124.3m
Business exits	£14.7m
Other	£22.2m
Underlying operating profit	**£447.4m**

Whilst leverage (adjusted net debt to adjusted EBITDA[1]) at 31 December 2017 was 2.27 times, free cash flow was constrained by the partial normalisation of seasonal cash management and a reduction of deferred income in the second half of the year. As announced on 31 January 2018, following completion of the 2018 business planning process, the Group has set a plan, focusing on investment in people, sales capability and its transformation plan. We expect a free cash outflow in 2018, which will be impacted by a number of known non-underlying payments and working capital items. The Group holds cash and undrawn committed facilities to enable the Group to manage its liquidity risk. At 31 December 2017, the Group held cash and cash equivalents net of overdrafts of £478.4m, and has available to it a committed Revolving Credit Facility of £600m. Our plan shows that whilst the business can operate in compliance with the adjusted net debt to adjusted EBITDA covenants, downside scenarios indicate that the available headroom is not sufficient to operate within these covenant tests.

Given the Board's view of appropriate leverage for Capita discussed in the Chief Executive Officer's review, the short-term outlook, level of indebtedness and need to invest for the long-term benefit of the Group, the Board is not recommending the payment of a final dividend and has suspended dividends until the Company is generating sustainable free cash flow. In addition, the Board has announced its decision to dispose of a number of non-core businesses, and has announced the launch of a Rights Issue. Post the Rights Issue, and the disposal programme, Capita will be well positioned with a sustainable level of debt. This will enable us to provide confidence to all our stakeholders, including key clients.

In determining the appropriate basis of preparation of the financial statements for the year 31 December 2017, the Directors are required to consider whether the Group can continue in operational existence for the foreseeable future. The Board has concluded that it is appropriate to adopt the going concern basis, having undertaken a rigorous assessment of the financial forecasts and with consideration of the anticipated net proceeds from the announced Rights Issue which the Board is confident will be approved. The Board's assessment is set out in more detail on page 97.

As discussed, the Board has initiated a transformation plan to improve the performance of Capita over the medium- to long-term and to address a number of business imperatives. The costs of delivering this plan will entail costs such as restructuring and professional adviser fees, and will be disclosed separately within underlying profits. This is in line with the Board's policy to separately disclose the operating profit/loss in-period from significant new contract wins and restructuring in order for users of the financial statements to obtain a proper understanding of the financial information and the performance of the business.

The major items contributing to 2017 performance are detailed in the following summary of financial performance.

1 Refer to Accounting Policies in note 2 to the financial statements.

IMPACTS OF IFRS 15

KEY IMPACTS:

Revenue more evenly distributed over the life of contracts and active software licences – timing of profits re-profiled.

Potentially lower profits or losses in early years on contracts where there are significant upfront restructuring costs or higher operating costs prior to transformation – compensating increase in profits in later years.

Balance sheet includes
- New contract fulfilment assets created in the process of transforming services
- Deferred income in relation to contracts where payments have been received from clients to undertake transformation in advance of delivering planned outcomes.

NO IMPACT ON:

Lifetime profitability of contracts

Cash flow of contracts

Majority of transactional businesses

IFRS 15

We have adopted IFRS 15 from 1 January 2017 using the full retrospective method, thereby restating the 2016 comparatives, to provide investors with clarity on the impact of the new accounting standard in a transitional period for Capita, in line with our strategy of simplifying the business and improving transparency. This was a significant project and I would like to thank all concerned for delivering it.

IFRS 15 gives rise to changes in the timing of revenue and cost recognition but will not impact upon the lifetime profitability of contracts, the cash flow of contracts or the majority of our transactional businesses. The main changes for Capita from the adoption of IFRS 15 are on its long-term contracts and software businesses, in particular:

- Revenue is more evenly phased over the life of contracts and active software licences in line with the delivery of outcomes to clients and, consequently, the timing of profits is re-profiled.
- We will potentially recognise lower profits or make losses in the early years of contracts where there are significant upfront restructuring costs or higher operating costs prior to transformation, with a compensating increase in profits in later years. The total net impact at Group level is a function of the balance of contracts in the early or late stage of their life cycle at transition to IFRS 15 and in subsequent years. As a result, contract profits, and in certain cases contract losses, are now reported in the prior periods.
- The Group's balance sheet includes new contract fulfilment assets created in the process of transforming services; and a significant increase in the level of deferred income in relation to contracts where payments have been received from clients to undertake work prior to the recognition of revenue and planned outcomes being delivered. For some contracts, in particular the Life and Pensions business, there are instances where this creates future profits in excess of future cash inflows. The majority of deferred income will unwind within the following 12 months and Capita aims to replace this with similar advanced payments subject to additions or changes to the Group's contract portfolio.
- The net impact of the recognition of the deferred income balances, contract fulfilment assets and other movements has resulted in the Group recording consolidated net liabilities, which were £929.8m as at 31 December 2017 (2016: net liability £552.9m).
- Contract terminations arising in the normal course of business may give rise to the disposal of a contract fulfilment asset and/or a true up of revenue recognised, which if material, may give rise to one-off gains or losses. Such amounts are included in underlying operating profit and separately disclosed if considered material.
- Due to the changes in the pattern and timing of revenue and cost recognition under IFRS 15, and the recognition of a deferred income liability and contract fulfilment assets on the balance sheet from 1 January 2016, the principles of IAS 12 give rise to a movement in deferred tax, primarily an increase in the deferred tax asset recognised.

The adoption of IFRS 15 will increase our focus upon efficiency and performance within the business, better aligning our financial results with the value delivered to its clients.

SUMMARY OF FINANCIAL PERFORMANCE IN 2017

Revenue

Reported revenue decreased by 3% to £4,234.6m (2016: £4,368.6m) and underlying revenue decreased by 4% to £4,167.9m (2016: £4,357.3m). Underlying revenue on a like-for-like basis, excluding results from businesses exited in both years, decreased by 0.6% including 1.5% organic decline and 0.9% growth from acquisitions.

Revenues increased in the Private Sector Partnerships division, which benefited from new contracts with Tesco Mobile and mobilcom-debitel and growth in TV Licensing and The Co-operative Bank. This was slightly outweighed by declines in the Public Services Partnerships division, due to weakness in real estate and central government services, and the Digital and Software Solutions division, due to licence attrition. Our revenue mix in 2017 was 70% long-term contractual, 16% short-term contractual and 14% transactional.

CHIEF FINANCIAL OFFICER'S REVIEW CONTINUED

Operating profit

Underlying operating profit

Following the adoption of IFRS 15, the Board has adopted a policy to separately disclose the operating profit/loss in-period from significant new contract wins and significant restructuring within underlying profits in order for users of the financial statements to obtain a proper understanding of the financial information and the performance of the business.

Underlying operating profit before significant new contracts and restructuring increased by 19% to £465.3m (2016: £391.8m). Profits increased as a result of improvements in the performance of a number of major contracts in the Private Sector Partnerships and Public Services Partnerships divisions, an improvement in the performance of our IT Services division, which included benefits from our actions to reduce costs and a one-off £9.2m settlement from a supplier, and a lower level of contract fulfilment asset write-offs in 2017 compared to 2016. This was partially offset by a decline in profits in the Digital and Software Solutions division, an increase in central costs and a decrease in property commercialisation, as set out in note 8 to our consolidated financial statements. We concluded discussions with the Ministry of Defence in relation to the Defence Infrastructure Organisation (DIO) contract and the results include a £22.0m benefit from the re-shaping of this contract, arising from the recognition of previously deferred income, which is not expected to recur in 2018.

UNDERLYING REVENUE

£4,167.9m

2016: £4,357.3m

UNDERLYING PROFIT BEFORE TAX

£383.0m

2016: £268.5

The DIO contract is expected to end in 2019. This re-shaping arises as a result of our new revenue recognition policy under IFRS 15. We now defer revenue over the expected life of a contract. Where a contract is terminated early, all deferred revenue is pulled forward and recognised in the year of termination. Similarly, any associated contract specific assets that were being amortised over the expected life of the contract are written off in the year of termination, unless there are alternative uses on other contracts. This will be a feature of our accounting going forward when terminations occur prior to the expected life of the contract. As noted above, IFRS 15 has introduced the recognition of contact fulfilment assets. Such assets are reviewed for impairment based on an assessment of the current and projected performance of the associated contract. During 2017, this resulted in the impairment of contract fulfilment assets with a charge of £14.1m (2016: £nil) recorded within underlying operating profit.

Underlying operating profit after significant new contracts and restructuring increased by 34% to £447.4m (2016: £334.6m). Significant new contracts and restructuring costs were £17.9m (2016: £57.2m), relating to professional adviser fees associated with the broadened transformation plan and, separately, the restructuring of a small number of businesses. There were no significant new contracts in the year.

Underlying operating profit is before charging a number of specific non-underlying items. This is consistent with prior years, to allow a better understanding of the business performance in-year.

Reported operating loss

Reported operating loss for the year was £420.1m (2016: loss £16.1m), including a charge for specific items of £852.8m (2016: £353.5m). The significant movement from 2017 arises from the impairment of goodwill, intangible assets, other non-current assets, and investment loans as at 31 December 2017. Further detail on the separately recorded items in 2017 is provided below:

- Impairment and amortisation of intangible assets (including goodwill): These amounted to £689.9m (2016: £229.2m) The Group carries on the balance sheet significant balances related to acquired intangible assets and goodwill. The amortisation of the acquired intangible assets, and any impairment charges, are reported separately due to the size of the annual charges and because the performance of the acquired businesses is assessed through the underlying operational results which, for internal purposes, excludes any amounts associated with the acquired intangible assets. During the year, impairment charges have been recorded in relation to businesses of £551.6m (2016: £66.6m). As reported in the Chief Executive Officer's review, significant actions are required to address recent operational and external challenges and a major transformation plan has been launched. Actions were taken in the prior year to implement a new simplified market-facing organisation structure, and at the time of the half year results Capita announced an improved win rate against the backdrop of a quiet market. Since that date, Capita has continued to experience a higher level of revenue attrition than expected, and continued to experience delays in client decision making and weakness in new sales. As announced in January 2018, Capita has shifted its strategy, and set a plan, which focuses on investing in people, sales capability and its transformation plan. The business plan for the divisions, produced between December 2017 and March 2018, indicates there is likely to be a significant negative impact upon profits from contract and volume attrition. In addition, this plan indicates a significant deterioration in new business opportunities from earlier positions. These events and circumstances have led to the recognition of the impairment charge as set out in note 16 to the consolidated financial statements.
- Impairment of life and pensions assets: The Group's life and pension business had developed a platform to support an existing life and pensions contract, but which could provide services to multiple clients in the future. The Group's strategic review has identified there is no longer a market for this platform and accordingly the carrying value of this and associated assets has been written off. The impact on the financial statements is a non-underlying charge of £61.2m representing the write-off of the non-current assets which have no further value to the Group and are redundant.

1 Refer to Alternative Performance Measures on pages 202–204.

- Other and disposals of non-current asset impairments: As part of its year-end close process, Capita has undertaken a comprehensive review of the recoverability of its tangible and intangible assets. Following the review, management has taken a decision to impair, at 31 December 2017, a number of assets relating to specific programmes resulting from changes in client and Capita strategy in the second half of 2017. Non-current assets amounting to £63.5m have been written off as a non-underlying charge consistent with prior year treatment, as the assets have no future use to the Group and accordingly are redundant.
- Impairment of loan and investment: the Group has fully impaired a historical loan and investment in the year totalling £9.0m (2016: £2.6m). The charge is reported separately due to its historical nature and to be consistent to the treatment applied for similar items in prior years.
- Fair value movements on financial instruments: including those that do not meet the criteria for hedge accounting £(2.1)m (2016: £7.7m): certain of the Group's financial instruments do not qualify for hedge accounting and accounting standards require these to be mark-to-market at each reporting date with any movements recorded in the income statement. Such charges or credits are dependent on external market factors and are not related to the underlying performance of the Group. For that reason, the amounts are reported as non-underlying items and therefore are not considered by the Board in assessing the performance of the Group.
- Other legal provisions: significant litigation costs relating to two claims were provided in the year (£30.0m). The claims were in respect of: a contract within the real estate and infrastructure business and was notified to the Group during 2017, and the related contract began in 2007; and a contract within the employee solutions business where more information on the progress of the claim has become apparent, and the related contract was delivered from 2009. The amount provided in respect of these two claims has been recognised in non-underlying specific items due to their age and significance.
- Acquisition-related costs: costs of £1.7m (2016: £9.0m) – IFRS requires certain costs incurred in connection with acquired businesses to be recorded within the Group income statement. These charges are not included in the internal assessment of business performance which, as above, is based on the underlying operational results. These charges are therefore separately disclosed as specific items.

The Board has considered FRC guidance on what should be excluded from GAAP numbers and concluded that it is appropriate to disclose the above items as specific non-underlying items.

We exited a number of businesses in 2017, including the majority of our specialist recruitment businesses, and were in an active process to sell a non-core property business at 31 December 2017. The loss from these business exits was £45.4m (2016: £3.4m gain). Business exits are also disclosed separately as non-underlying.

Discontinued operations

The disposal of the Capita Asset Services businesses has been treated as a discontinued operation as stipulated by IFRS 5. The profit on the disposal of these businesses was £445.4m. This profit is specific to the disposed businesses and is therefore excluded from both the underlying and reported results of the continuing operations.

The costs of £66.0m in relation to reaching a full and final settlement with the Financial Conduct Authority (FCA) regarding the Connaught Income Series 1 Fund, as detailed in note 27 to the consolidated financial statements, are separately identified as a non-underlying specific item attributable to the discontinued operation due to the significance and nature of the claims to which they relate.

Financing

The underlying interest charge in 2017, excluding the fair value movement on mark-to-market fixed rate swaps, was £64.4m (2016: £66.1m) and interest cover was 8.6 times for the year (2016: 8.8 times). Capita terminated its higher coupon fixed rate interest rate swaps in the first half of the year.

Cash flow

Free cash flow from continuing operations before non-underlying expenses was £38.0m (Restated 2016: £397.3m) and free cash flow after non-underlying expenses was £37.7m (Restated 2016: £367.3m).

Capita's free cash flow in 2017 was impacted by two changes in our working capital profile. Firstly, there was a partial normalisation of seasonal cash management, having historically optimised the working capital position at the end of reporting periods. Secondly, there was a reduction of deferred income in the second half of the year, which reflects the relatively low level of new business signed in 2016 and 2017, which meant that we received less cash payments from clients to undertake work than revenue recognised in the period. These items were largely responsible for a £311.8m working capital outflow from continuing operations.

Net capital expenditure on continuing operations was £114.1m in 2017 (2016: £139.7m), including an increase in discretionary spend in areas such as software and employee solutions and lower contract related and maintenance spend.

Net debt

Net debt at 31 December 2017 was £1,117.0m (2016: £1,778.8m), reflecting the receipt of the proceeds from the disposal of the Asset Services businesses which was partially offset by the aforementioned working capital items.

Consistent with prior years, the Group makes use of non-recourse trade receivable financing arrangements provided to it by a number of its relationship banks. £110.0m of receivables had been sold under these arrangements and had not been settled as at 31 December 2017 (2016: £133.6m). As these trade receivables have been sold without recourse, the Group does not consider them to be part of its core capital.

At 31 December 2017, our adjusted net debt to adjusted EBITDA[1] covenant ratio was 2.27 times. This ratio includes contingent obligations under bonds and guarantees and excludes our non-recourse receivables financing, which was a balance of £110.0m at 31 December 2017.

At each reporting date we assess the calculation of the Group's debt covenants, both for that period and subsequent ones. These covenants are calculated based on the underlying performance of the Group in that they exclude exceptional items. The Group has been consistent with previous years in its treatments of these items.

Capital management and dividend

Following completion of the 2018 business planning process, the Group has set a plan, deciding to invest in people, sales capability and its transformation plan. We expect a free cash outflow in 2018, which will be impacted by a number of known restructuring costs presented within underlying results, non-underlying payments and working capital items. We expect around £300.0m spend in relation to known commitments, including £66.0m cash costs on the Connaught settlement, £51.0m in relation to the separation of Capita Asset Services (including a pension contribution), £40.0m costs in relation to realising cost savings and efficiencies from the transformation plan, £26.0m restructuring costs relating to Capita's previously announced cost reduction plan, contingent and deferred considerations, professional fees in order to create and implement the proposed transformation plan, litigation and other items. In addition, we expect a £130.0m cash outflow from the final normalisation of period end cash management activity, and a £130.0m cash outflow on continued reduction in deferred income, reflecting the ongoing low level of new business wins. Our plan shows that whilst the business can operate in compliance with the adjusted net debt to adjusted EBITDA covenants, downside scenarios indicate that the available headroom is not sufficient to operate within these covenant tests. The Group's policy is to hold cash and undrawn committed facilities at a level sufficient to fund the Group's operations and its medium-term plans. The Group holds cash and undrawn committed facilities to enable the Group to manage its liquidity risk. At 31 December 2017, the Group held cash and cash equivalents net of overdrafts of £478.4m, and has available to it a committed Revolving Credit Facility of £600m.

As discussed in the Chief Executive Officer's review the Board is reviewing the capital structure of the Group. The Board's view is that the appropriate leverage for Capita over the medium term should be between 1.0 and 2.0 times adjusted net debt to adjusted EBITDA (prior to the adoption of IFRS 16).

Given the short-term outlook, level of indebtedness and need to invest for the long-term benefit of the Group, the Board has decided upon a number of actions. Firstly, we are pursuing 'self-help' options, including the aforementioned cost actions and non-core disposals. Secondly, the Board is not recommending the payment of a final dividend making a total of 11.1p for the year (2016: 31.7p). However, the Board recognises the importance of regular dividend payments to investors in forming part of their total shareholder return, and will consider the payment of dividends once Capita is generating sufficient sustainable free cash flow. Finally, the Board has announced it is raising equity by way of a Rights Issue this year. The Company has entered into an underwriting agreement of £701m with Citigroup Global Markets Limited and Goldman Sachs International.

Capita has reached a comprehensive arrangement with the holders of its US Private Placement Notes in order to address certain issues which arose from the early adoption of IFRS 15. The arrangement provides increased headroom and flexibility under Capita's financial covenants, and thereby sets up a robust framework to support the new strategy. In return for this increased flexibility, Capita has agreed (i) to prepay £150m of principal of the US Private Placement Notes (plus an estimated make-whole payment of £7m) from the proceeds of the Rights Issue; (ii) to apply 50 per cent of the net proceeds from future disposals to the prepayment of principal of the US Private Placement Notes, with payment of make-whole, until such time as an estimated £315m of US Private Placement Notes have been pre-paid; and (iii) to pay a coupon uplift of 75 basis points, representing approximately £5m of incremental costs through 2018.

We set out in note 26 to the consolidated financial statements our future minimum rental payments under our lease arrangements that highlight gross commitments of £833.0m. In prior years we had presented these on a present value basis, but have changed the presentation to disclose the gross commitments as we believe this is more helpful in the context of assessing our future liability. The prior year comparative has been re-presented and the impact of this grossing up is £112.9m. Our lease arrangements have been reviewed extensively as part of the work we have initiated in preparing for the adoption of IFRS 16 Leases. This identified certain property leases that had been omitted in the prior year analysis, and we have corrected the comparative to include these gross commitments (£165.1m). The main adjustment related to our new head office property that we will occupy later in 2018, and which was under construction as at the end of the prior year.

Pension

As announced on 31 January 2018, Capita intends, as a matter of good corporate responsibility, to reduce the remaining pension deficit in its defined benefit scheme. The current deficit is supported by an asset backed funding arrangement of £69m at 31 March 2017, the value of which is not included in the last disclosed IAS 19 deficit of £407m as at 31 December 2017. The triennial actuarial valuation of the scheme as at 31 March 2017 is due to be completed by 30 June 2018. In addition to Capita's current annual contributions, further contributions totalling £21.5 million were paid in January 2018. Capita is fully committed to addressing the remainder of the deficit in the medium term.

1 Refer to Alternative Performance Measures on pages 202–204.

Taxation

Capita has an open and positive working relationship with HMRC, has a designated customer relationship manager, and is committed to prompt disclosure and transparency in all dealings with HMRC and overseas tax authorities. The Group does not have a complex tax structure, nor does it pursue any aggressive tax avoidance activities and in recognition of this and the aforementioned relationship it enjoys a low risk rating from HMRC. Due to client requirements and also due to the location of some of our businesses, the Group has operations in a number of countries outside of the UK. All Capita operations in non-UK jurisdictions are trading operations and pay the appropriate local taxes for these activities. Further detail, regarding the tax strategy, can be found on the Policies and Principles area of the Capita website.

In total, Capita contributed £204.8m (2016: £273.0m) in taxes across its UK operations in the year. This consisted of a net refund of £12.7m (2016: payment £48.6m) of UK corporation tax; £21.4m (2016: £23.9m) in irrecoverable VAT payments; £155.5m (2016: £163.7m) in employer NIC; and £40.6m (2016: £36.8m) in other levies including business rates, import duties, apprenticeship levy and environmental taxes. Additionally, the Group collected and remitted to the UK Government £409.9m (2016: £463.6m) of VAT and £367.7m (2016: £399.1m) of Capita employee PAYE and NIC. Capita entities in overseas jurisdictions paid £6.4m (2016: £15.1m) of tax on local profits.

STRATEGIC INITIATIVES

We continued to progress a number of short- and long-term initiatives to reduce our cost base, work more efficiently and enhance our financial reporting, which will now form part of Capita's broader transformation plan discussed in the Chief Executive Officer's review:

Restructuring

- Major restructuring activities, including reductions in overheads, headcount and related property costs. The net benefit from these cost initiatives was £38.0m in 2017.

Procurement

- Centralising more of our procurement. Capita's central procurement team has a wide ranging brief to find value, working with the divisions, through increasing the proportion of centrally controlled spend, consolidating our supplier base and leveraging our purchasing power.

Property

- Engaging our property expertise to rationalise and increase the utilisation of Capita's property estate, in metro centres and regionally. This includes a consolidation of our sites in London which is planned for 2018.

Finance transformation

- Improving Capita's financial reporting systems, processes and controls, through increasing standardisation, automation and the quality and availability of data. We are investing in an upgrade of our financial system and increasing the use of offshoring and shared services.

ACQUISITIONS

In 2017, Capita acquired a number of small businesses to build capability in existing markets, enter new markets and enhance our existing services and solutions. We spent £20.0m in acquiring five niche businesses in software, voice and data, IT, e-commerce and travel and events.

DISPOSALS

At the end of 2016, we announced our intention to dispose of the Capita Asset Services businesses and our standalone specialist recruitment businesses to increase the focus on technology-enabled business process management and reduce leverage. Both disposals were completed in the year, and contributed to the reduction in leverage at the year-end.

The disposal of the Capita Asset Services businesses has been treated as a discontinued operation and the comparatives have been restated, as detailed in note 5 of the consolidated financial statements on page 111.

FINANCE INITIATIVES

RESTRUCTURING

Major restructuring activities, including reductions in overheads, headcount and related property costs. The net benefit from these cost initiatives was £38m in 2017.

PROCUREMENT CENTRALISATION

Our central procurement team has a wide ranging brief to find value, working with the divisions, increasing the proportion of centrally controlled spend, consolidating the supplier base and leveraging our scale.

PROPERTY RATIONALISATION

Engaging our property expertise to rationalise and increase the utilisation of Capita's property estate, in metro centres and regionally. This includes a consolidation of our sites in London which is planned for 2018.

FINANCE TRANSFORMATION

Improving our financial reporting systems, processes and controls, through increasing standardisation, automation and the quality and availability of data. We are investing in an upgrade of our financial system and increasing the use of offshoring and shared services.

FINANCIAL RESULTS

The financial statements have been prepared under IFRS and the Group's accounting policies are set out on pages 96–108. Management also presents revenue, operating profit, profit before tax and earnings per share excluding non-underlying items to provide additional useful information on underlying trends to shareholders. More detail on the Alternative Performance Measures can be found on pages 202–204.

REPORTED RESULTS

Reported revenue

Reported revenue decreased by 3% to £4,234.6m (2016: £4,368.6m).

Reported profit before tax

KPI

Reported loss before tax in 2017 was £(513.1)m (2016: £(89.8)m), reflecting the impact of non-underlying charges as detailed in note 4 and note 6 of the consolidated financial statements on pages 110 and 112–113.

Reported earnings per share

Reported loss per share in 2017 was (80.14)p (2016: (14.27)p), reflecting the impact of non-underlying charges as detailed in note 4 and note 6 of the consolidated financial statements on pages 110 and 112–113.

UNDERLYING RESULTS

Underlying revenue

Underlying revenue[1] decreased by 4% to £4,167.9m (2016: £4,357.3m). Underlying revenue on a like-for-like basis[1], excluding results from businesses exited in both years, decreased by 0.6% including 1.5% organic decline and 0.9% growth from acquisitions.

Underlying operating profit and margin

KPI

Underlying operating profit[1] increased by 34% to £447.4m in 2017 (2016: £334.6m). Our underlying operating margin[1] was 10.7% (2016: 7.7%).

Underlying profit before tax

KPI

Underlying profit before tax[1] increased by 43% to £383.0m (2016: £268.5m) and underlying profit before tax[1] before significant new contracts and restructuring costs increased by 23% to £400.9m (2016: £325.7m).

Underlying earnings per share (EPS)

KPI APM

Underlying earnings per share[1] increased by 44% to 45.61p in 2017 (2016: 31.68p).

Dividends

The Board is not recommending the payment of a final dividend (2016: 20.60p), making a total of 11.10p for the year (2016: 31.70p). The Board will consider the payment of dividends once Capita is generating sufficient sustainable free cash flow.

Free cash flow

Free cash flow before non-underlying expenses[1] was £38.0m (2016: £397.3m) and free cash flow after non-underlying expenses was £37.7m (2016: £367.3m).

Capital expenditure

We aim to allocate capital efficiently, focusing upon opportunities that generate the best return for shareholders and avoiding tying up too much capital in long-term projects.

In 2017, net capital expenditure was £114.1m (2016: £139.7m), reflecting lower contract specific and maintenance spend. Investment will continue to be made on the basis of returns on the value of capital being deployed.

Gearing

APM

Net debt at end December 2017 was £1,117.0m (2016: £1,778.8m). As at 31 December 2017, we had £1,484m of private placement bond debt (net of currency swaps) of which £153m matures in 2018 and the remainder matures over the period up to 2027. In addition, we have £100m of bank debt which matures in 2019, and an undrawn £600m revolving credit facility of which £81m matures in August 2020 and £519m in August 2021.

In 2017, our adjusted net debt to adjusted EBITDA ratio[1] was 2.27 times and interest cover[1] was 8.6 times.

Debt maturity profile as at 31 December 2017 (£m)

Year	Bond debt[2]	Bank debt	Total
2018	153	–	**153**
2019	101	100	**201**
2020	294	–	**294**
2021	283	–	**283**
2022	309	–	**309**
2023	89	–	**89**
2024	–	–	**–**
2025	101	–	**101**
2026	46	–	**46**
2027	108	–	**108**
Total	1,484	100	**1,584**

Return on capital employed (ROCE)

KPI

ROCE reflects how productively we deploy capital and is incorporated into senior managements' long-term incentive schemes, which are 25% based upon performance against ROCE targets.

ROCE is calculated as underlying net operating profit after tax[1] (NOPAT) divided by average capital employed. Capital employed[1] (CE) is the total of equity shareholders' funds, net debt, pension deficit and cumulative equity impact from non-underlying items such as amortisation.

We have calculated our WACC by weighting the cost of our debt and equity financing in line with the amounts of debt and equity that we use to finance our activities, assuming a risk-free rate of 1.23%, a market risk premium of 13.89% and a beta of 0.57 times.

In 2017, our ROCE[1] was 19.2% (2016: 12.8%), which compares to our estimated post-tax WACC of 7.46%.

Nick Greatorex
Chief Financial Officer
23 April 2018

KPI This symbol is used to indicate our KPIs throughout the report.
APM This symbol is used to indicate our APMs throughout the report.

1 Refer to Alternative Performance Measures on pages 202–204.
2 Bond debt shown at face value after the effect of currency and interest rate swaps.