Financial review

The financial year to 31 January **2015 was a significant year in the history of the AA** and the beginning of a new era. The ownership of the AA changed and a new management team took over in June, followed in November by my appointment as CFO.

Martin Clarke
Chief Financial Officer

Revenue

Year ended 31 January	2015 £m	2014 £m
Roadside Assistance	**728.1**	712.5
Insurance Services	**142.4**	148.9
Driving Services	**73.7**	72.6
Ireland	**38.7**	39.6
Insurance Underwriting	**0.6**	0.3
Group revenue	**983.5**	973.9

Revenue growth of £9.6 million to £983.5 million was largely attributed to our Roadside Assistance business. An increase in income per Personal Member and strong retention rates drove an increase in revenue of £15.6 million. Insurance Services revenue was down on the prior year by £6.5 million due to the shift in the mix of Motor sales to lower-value new business. Ireland revenue has fallen due to the weakening of the euro over the year.

The Insurance Underwriting segment consists of the Group's reinsurance vehicle which reinsures certain private motor insurance business that originates within the Insurance Services segment. There has been a small increase in activity during the financial year ending 31 January 2015, although these contracts are expected to expire in December 2015. We are currently developing plans to launch an in-house insurer, as discussed in the strategic priorities section of this report.

Trading EBITDA

Year ended 31 January	2015 £m	2014 £m
Roadside Assistance	**358.9**	348.2
Insurance Services	**83.9**	89.4
Driving Services	**20.4**	15.6
Ireland	**14.8**	15.0
Insurance Underwriting	**(0.1)**	(0.1)
Head Office costs	**(47.8)**	(45.3)
Group Trading EBITDA	**430.1**	422.8
Trading EBITDA margin (%)	**43.7**	43.4

Group Trading EBITDA increased by 1.7% to £430.1 million (2014: £422.8 million) while Trading EBITDA margins increased to 43.7% (2014: 43.4%). This growth was driven primarily by Roadside Assistance revenue growth, offset slightly by the increase in the costs of using garages when our own patrols were unable to provide assistance by the roadside. In July, we renegotiated the terms of our leases for the supply of cars for driving schools and employees resulting in a change in the classification of these leases as finance leases. This increased Trading EBITDA by £3.3 million and depreciation by £3.0 million; therefore increasing operating profit by £0.3 million. Insurance Services Trading EBITDA reduced by £5.5 million, despite flat Motor and Home policies, due to a change in mix between renewals and new Motor policies resulting in more introductory discounts.

Group Trading EBITDA includes £47.8 million (2014: £45.3 million) relating to Head Office costs which include £4.4 million of continuing, incremental expenditure related to being a public company (which is expected to be approximately £8 million in a full year). Excluding this, Head Office costs, including IT, finance, property and other back-office support functions, were £1.9 million lower as a result of a Group restructuring project, delivered in the 2014 financial year, as well as a continuing programme of cost management. This expenditure excludes the impact of share-based schemes that are separately disclosed and are not reported within Trading EBITDA.

Operating profit

Year ended 31 January	2015 £m	2014 £m
Trading EBITDA	**430.1**	422.8
Items not allocated to a segment	**(6.4)**	5.2
Amortisation and depreciation	**(48.3)**	(39.6)
Share-based payments and acquisition earn-out costs	**(1.9)**	(2.2)
Exceptional items	**(47.6)**	(14.6)
Operating profit	**325.9**	371.6

Operating profit reduced by £45.7 million to £325.9 million (2014: £371.6 million). The increase in Trading EBITDA was offset by an increase in exceptional items, principally those arising from the IPO as well as additional costs relating to the reorganisation of Group activities.

Items not allocated to a segment relate to transactions that do not form part of the on-going segment performance and include transactions which are one-off in nature. These principally related to the difference between the cash contributions to the pension schemes for on-going service and the calculated annual service cost. For the year ended 31 January 2014, there was a one-off benefit of £12.4 million relating to the closure of the Irish pension scheme that is not expected to reoccur (see note 25).

Amortisation and depreciation increased by £8.7 million to £48.3 million (2014: £39.6 million). £3.0 million of this increase relates to the reclassification of the driving school and employee car leases from operating leases to finance leases. The balance of the increase in amortisation and depreciation principally relates to the on-going expenditure on IT systems and hardware.

Share-based payments relate to an accounting charge for the management value participation shares and the employee share incentive plan (see note 34).

Exceptional costs of £47.6 million included £33.7 million relating to the IPO and refinancing transactions (2014: £13.8 million). The remaining exceptional items of £13.9 million in the year (2014: £0.8 million) principally relate to cost restructuring activities including the costs of redundancy payments and onerous property costs from the reorganising of Group operations.

Net finance costs

Net finance costs increased to £265.1m in the year (2014: £179.2m). This increase is due to the full year impact of the Group's financing activities that completed on 2 July 2013 and includes an exceptional write-off of debt issue fees of £20.7m (2014: £20.3m) due to the refinancing of £913m of debt in May 2014 and the repayment of £175m of PIK notes in December 2014 as well as a PIK note early repayment fee of £3.5m (2014: £nil). Also included in net finance costs are the on-going amortisation of debt issue fees of £8.9m (2014: £9.0m) and pension interest costs of £10.7m (2014: £6.8m).

Taxation

The tax credit for the period is £8.3 million (2014: tax charge of £39.4 million). This includes a credit of £22.0 million relating to the recognition of tax losses that are forecast to be utilised against future taxable profits following the IPO. Excluding this credit and the impact of costs relating to the IPO of £14.7 million that are non-deductible for corporation tax, our underlying effective tax rate is 18.1% (2014: 20.4%).

Profit and earnings per share

Profit after tax reduced by £84.3 million to £69.1 million (2014: £153.4 million).

Basic earnings per share reduced by 19.4p from 32.7p to 13.3p. This reduction is due to the full year impact of the finance costs from the Group's financing transactions in 2014, exceptional costs relating to the IPO and an increase of 84.7 million in the number of shares that were issued at the time of the IPO.

Cash flow and liquidity

Year ended 31 January	2015 £m	2014 £m
Cash flow from operating activities before exceptional items and taxation	**430.5**	433.0
Exceptional items and tax paid	**(59.7)**	(45.6)
Cash flow from investing activities	**(30.0)**	(24.5)
Cash inflow from IPO	**199.2**	–
Repayment of PIK notes	**(175.0)**	–
Cash flow from other financing activities	**(265.5)**	(193.1)
Net increase in cash and cash equivalents	**99.5**	169.8
Cash conversion (%)	**100.1**	102.4

The AA's cash generation has remained strong with net cash flows from operating activities before exceptional items and tax of £430.5 million (2014: £433.0 million) and cash conversion of 100.1% (2014: 102.4%). These cash flows include £15.4 million of proceeds from sale of vehicles (2014: £nil) following the change in lease terms for driving school vehicles and employee cars.

During the year, the Group raised £199.2 million from the IPO. These proceeds were principally used to repay £175.0 million of PIK notes in December 2014 and partially funded some of the exceptional IPO costs.

The increase in cash and cash equivalents for the year of £99.5 million was £70.3 million lower than in the previous year (2014: £169.8 million). This reduction was due to exceptional IPO costs, an increase in investment in IT and the full year impact of the interest costs on the Group borrowings.

Financial review
continued

The AA has a cash balance of £301.5 million invested in AAA money market funds, giving overnight access and high liquidity. In addition, we have access to a £150 million Working Capital Facility. The Working Capital Facility was undrawn save for a £10 million ancillary facility, which has been used to issue letters of credit to certain corporate insurance providers. We do not currently envisage needing to draw on the Working Capital Facility for the foreseeable future.

We are required to hold segregated funds as "restricted cash" in order to satisfy regulatory requirements governing our Insurance Underwriting business and Irish subsidiaries. These restricted cash balances were £24.2 million (2014: £23.7 million). In addition we had £18.5 million of pre-funded cash to pay PIK note interest (2014: £55.4 million).

Net debt, financing transactions and whole business securitisation

In July 2013, more than £3 billion of debt was raised in the banking and capital markets, and an investment grade secured corporate financing structure, commonly referred to as a Whole Business Securitisation (the WBS) was put in place. At the same time a high yield offering of £655 million of Class B secured notes was completed. Through a combination of the repayment of intercompany balances and the payment of dividends, these proceeds were passed to the Acromas group.

Subsequently, a number of financing transactions have taken place whereby additional Class A notes have been issued and the Senior Term Facility has been repaid. During the financial year, in May 2014, we issued £250 million of Class A4 notes and partially repaid the Initial Senior Term Facility. At that time a New Senior Term Facility of £663 million was also put in place with the AA's key relationship banks to replace the Initial Senior Term Facility. Following this, the AA wrote off £17.9 million of debt issue fees relating to the Initial Senior Term Facility. The margin on the new facilities has been set at 2% per annum over LIBOR and additional interest rate swaps have been entered into, fixing LIBOR at 1.98% until 31 July 2018 and then at 3.00% until 31 January 2019.

In addition to the WBS structure, £350.0 million of PIK notes were issued in November 2013. These PIK notes are outside the WBS and the high yield offering and have no recourse to the assets secured by the WBS and the high yield offering. In December 2014, we prepaid £175.0 million of these PIK notes, using most of the proceeds generated from the IPO. As part of this transaction, we incurred an early repayment fee of £3.5 million and wrote off £2.1 million of debt issue fees relating to the PIK notes.

A summary of the AA's financing transactions since July 2013 is shown below:

	Initial Senior Term Facility £m	New Senior Term Facility £m	Class A1 notes £m	Class A2 notes £m	Class A3 notes £m	Class A4 notes £m	Class B notes £m	PIK notes £m	**Total £m**
Issue date:									
2 July 2013	1,775.0	–	300.0	325.0	–	–	655.0	–	**3,055.0**
27 August 2013	(362.0)	–	175.0	175.0	–	–	–	–	**(12.0)**
7 November 2013	–	–	–	–	–	–	–	350.0	**350.0**
29 November 2013	(500.0)	–	–	–	500.0	–	–	–	**–**
2 May 2014	(913.0)	663.0	–	–	–	250.0	–	–	**–**
19 December 2014	–	–	–	–	–	–	–	(175.0)	**(175.0)**
Total	**–**	**663.0**	**475.0**	**500.0**	**500.0**	**250.0**	**655.0**	**175.0**	**3,218.0**

A summary of the AA's borrowings with maturity date and effective interest rates are outlined below:

	Expected maturity date	Interest rate %	Principal £m
Senior Term Facility	31 January 2019	3.98	663.0
Class A1 notes	31 July 2018	4.72	475.0
Class A2 notes	31 July 2025	6.27	500.0
Class A3 notes	31 July 2020	4.25	500.0
Class A4 notes	31 July 2019	3.78	250.0
Class B notes	31 July 2019	9.50	655.0
PIK notes	6 November 2019	9.50	175.0
		5.90	**3,218.0**

The weighted average interest rate for all borrowings of 5.9% has been calculated using the effective interest rate and carrying values on 31 January 2015.

Net debt

Year ended 31 January	2015 £m	2014 £m
Senior Term Facility	**663.0**	913.0
Class A notes	**1,725.0**	1,475.0
Less: AA Intermediate Co Limited group cash and cash equivalents	**(261.2)**	(144.7)
Net senior secured debt[1]	**2,126.8**	2,243.3
Class B notes	**655.0**	655.0
Finance lease obligations	**50.4**	20.0
Net debt excluding PIK notes[2]	**2,832.2**	2,918.3
PIK notes	**175.0**	350.0
Less: AA plc Group cash and cash equivalents[3]	**(40.3)**	(58.5)
Total net debt	**2,966.9**	3,209.8
Net debt ratio[4]	**6.9x**	7.6x
Class B leverage ratio[5]	**6.6x**	6.9x
Senior leverage ratio[6]	**4.9x**	5.3x
Class A free cash flow: debt service	**3.5x**	3.3x
Class A free cash flow: debt service	**2.2x**	2.2x

1 Principal amounts of the Senior Term Facility and Class A notes less AA Intermediate Co Limited group cash and cash equivalents.

2 Principal amounts of the Senior Term Facility, Class A notes, Class B notes and finance leases less AA Intermediate Co Limited group cash and cash equivalents.

3 Total cash and cash equivalents for the Group excluding the value reported as the AA Intermediate Co Limited group cash and cash equivalents.

4 Ratio of Total Net Debt to Trading EBITDA for the last 12 months.

5 Ratio of Net Debt excluding PIK notes to Trading EBITDA for the last 12 months.

6 Ratio of Net Senior Secured Debt to Trading EBITDA for the last 12 months.

We have achieved deleveraging owing to improved profitability combined with net cash generation after debt service and primary proceeds from the IPO. At the period end, net debt was 6.9 times Trading EBITDA and net senior secured debt was 4.9 times Trading EBITDA.

Finance lease obligations have increased by £30.4 million due to the reclassification of the leases for driving school and employee vehicles as finance leases. The Group also recognised an asset of £27.9 million relating to these vehicles.

Under the terms of the AA's borrowings, there are two covenants in place which measure the ratio of the Group's debt service costs to free cash flow. Class A free cash flow was 3.5 times debt service and Class B free cash flow was 2.2 times debt service showing substantial covenant headroom versus the requirements of 1.1 and 1.0 times respectively. The Directors do not envisage this situation changing in the foreseeable future.

Pensions

At 31 January 2015, the IAS19 net retirement deficit increased to £434.4 million (2014: £265.5 million). This increase is due to a reduction in the corporate bond yield used as the discount factor in determining the present value of our future pension liabilities.

The most recent actuarial revaluation of the UK pension scheme was carried out at 31 March 2013 and showed a deficit of £202 million. Subsequent to this, the AA Group implemented an asset-backed funding scheme whereby an annual deficit reduction contribution of £12.5 million, increasing with inflation, is made over a period of up to 25 years secured on our brands. This also generated a one-off £198 million tax deduction that we had fully utilised by 31 January 2015. This compared favourably to a traditional deficit reduction plan that would have required the deficit to be reduced over a substantially shorter period.

In addition, during the year ended 31 January 2014, the AA closed its pension scheme in Ireland for the future accrual benefits, replacing it with a defined contribution scheme for employees.

Martin Clarke
Chief Financial Officer