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FirstGroup upgraded on West Coast hopes

By Rose Jacobs

Investors in UK public transport companies are taking a fresh look at FirstGroup as anticipation mounts that the UK's biggest operator in the sector stands to win the first significant rail franchise in a busy period of renewals.

Analysts at four investment banks have upgraded the company in recent weeks, ahead of a decision expected on Tuesday by the Department for Transport over which of four shortlisted bidders will win the lucrative West Coast mainline franchise.

FirstGroup is understood to be the leading contender after tendering a bid that, according to people close to the process, offers a 15 per cent premium on its nearest rival. The shortlist also includes Virgin Trains, the incumbent, and two foreign, state-backed groups, Keolis of France and Holland's Abellio.

Oliver Neal at Goldman Sachs argued last week that a win would boost FirstGroup's earnings by 20 per cent in the second and third years of the franchise and "lead to significant upgrades to consensus estimates", while JPMorgan analysts estimated the business was worth about 100p per FirstGroup share.

Shares closed up 3.5 per cent on Friday at 256.5p, capping a 35 per cent rise over the past month.

A West Coast victory would help the company cope with balance-sheet strain after disappointing performances at two of its biggest divisions, UK bus and UK school bus. But other analysts argue that, even if FirstGroup does prevail, the terms on which it wins could yet spell longer-term trouble.

"We're deeply sceptical of the DfT's ability to alter the rail system," said Mark Manduca at Bank of America Merrill Lynch, citing the problem of reducing costs in the face of union resistance.

David Putura at JPMorgan Cazenove agreed that much of the risk lay in cost-cutting: "We believe the new West Coast franchise could generate [operating] margins of 7.5 per cent but we assume 6 per cent margins in deriving its value, to take account of the higher risk of an aggressive bid based on cutting costs," he said.

Virgin Trains is understood to be considering taking the unprecedented step of requesting a judicial review if it loses the contest. The company, a joint venture between Virgin Group and Stagecoach, is said to be concerned that the government did not adequately take into account the risks to the taxpayer of hiring an operator with a weak balance sheet.

However, Stagecoach might be reluctant to damage its relationship with the government, given it runs a number of franchises independent of Virgin and will bid for others independently, too. “[Virgin Trains] would have to go to shareholders to ask if they thought it was worth it,” said one observer.

Contracts for five rail franchises are set to be decided in the next 12 months. According to Liberum Capital, together they offer annual revenues of £3.7bn.