Acquisition Plan

Project Blue Sea

STRICTLY PRIVATE & CONFIDENTIAL

BUSINESS DEVELOPMENT DEPARTMENT, KCL

ACQUISITION PLAN

Kier Construction Ltd

"PROJECT Blue Sea"

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Executive Summary

Strategy

The big area for Kier's future growth, according to a recent *nce* interview with Paul Sheffield, will be civils and infrastructure which currently only accounts for around £200M of Group turnover. This workload is based largely around frameworks with Network Rail, BAA and Bristol International Airport and United Utilities in water. "There is no real reason why it is only 20% of our total construction revenues," he said.

With the new Government's commitment to spending cuts, construction related areas, from the schools building programme to Crossrail, will be vulnerable to both explicit spending cuts and to cuts by stealth as protracted 'policy reviews' push back planned spending into future years. Competition will be fierce and there will be a downward pressure on future margins for competitively bid public works.

At a time when future orders in the industry are uncertain, many listed contractors are boasting large secured order books, secured in some cases before the downward pressure on costs in the supply chain. With depressed share prices/ Market Capitalisations acquisition opportunities become an attractive option for increasing secured work while seeking to reduce overall overheads as a percentage of turnover.

Competitors/ Targets

Some of the mainland European Companies have grown into major construction forces via Merger and Acquisition during the last Economic downturn in the early 1990's. Examples are ACS, FCC, Ferrovial, of Spain and Skanska of Sweden. The trends also show clearly how in the UK Carillion and Balfour Beatty over the last 5 years have achieved Turnover, Market Capitalisation and Compound Annual Profit Growth without diluting Margins by pusuing major M&A strategies. Furthermore Cash Flow and Cash Balances have remained strong by investing in new cash generators, despite continued investment in both Acquisitions and PFIs.

The Kier Group has remained a very successful cash generator with impressive growth statistics since the MBO, but has not invested aggressively in acquisitions outside Housing/Land. With the shift away from speculative private housing development, Kier now has the option to look at different investment options.

In the UK, Galliford Try and Morgan Sindall are seen as potential Kier Group merger/acquisition targets based on Valuations (Market Capitalisation v Net Assets); but Costain emerges as the primary target for KCL because of its Cash & Order Book and attractive positions in Civil Engineering and Process Contracting market sectors as well as PFI/Cash Assets . The company could be acquired for a relatively small cash net investment of c.£50m. Costain is a long-established and respected British business group that looks well positioned to sustain progress during the recession; hence the kind of share to consider buying when prices remain depressed.

Costain

The small cap is capitalized at £120 million (18/05/2010) and has a strong net cash position of £120.5 million, with no material borrowings. If you strip out the cash, it gives the group an enterprise value today of £zero million and with expected cash from operations of c.£20m pa, and a further £10m savings from synergies with Kier, it puts the company a 4 year pay-back even if the company was acquired at a 100% premium to toady's share price. In any event it is vulnerable to a takeover, particularly as four shareholders own a controlling share of the business, and all are potential sellers.

Today, Costain operates three broad divisions, namely Civil Engineering (roughly 60 per cent of sales), Building, and Oil, Gas and Process (COGAP), boasting a forward Oder Book of £2.6bn. It also operates a property arm focused on residential and leisure complex development in Spain.

There are several areas of sector strength attractive to KCL. Significantly, 'COGAP', involved in the design and construction of underground gas storage and floating liquefied natural gas (LNG) storage, has won work in the buoyant nuclear sector. Costain has already delivered a number of nuclear contracts (including at Sellafield), and with much of the work in this sector involving process and civil engineering, the company is well placed for growth here.

Costain is additionally making inroads into the growing waste management industry, having secured a £397 million contract with the Greater Manchester Waste Disposal Authority, the biggest such authority in the UK.

Other major recent contracts secured include a ten-year deal with Severn Trent, worth an estimated £400 million, further £220 five year maintenance work for the Highways Agency and work won under the Building Schools for the Future education programme. The company has had several AMP5 successes including significant work won with Southern Water and United Utilities, as well as underscoring its credentials in nuclear with a contract worth £297 million at Sellafield, related to the 'Evaporator D project', one of the biggest nuclear projects in the UK.

Costain is seen therefore as complimentary to Kier Construction in adding strength in the following core sectors:

Infrastructure - particularly Highways, Rail and Airports

Environment - particularly Water and Waste

Energy & Process - particularly Nuclear, Power, and Hydrocarbons & Chemicals

Its weaknesses lie in loss making Regional Building and its Spanish Land Management in a depressed Spanish Housing market. These activities would be assigned to other parts of the Kier Group. Costain also has a PFI Portfolio valued by Directors at £44m, which is not recognized on the Balance Sheet.

The acquisition "poison pill" of £105m Pension Fund Deficit is however seen as manageable over time. Given the strength of Cash Flow underpinned by Kier's Balance Sheet, the Trustees would likely look favourably at a take-over.

Shareholders

The top 4 shareholders of Costain control 53% of the shares:

- Mohammed Abdulmohsin Al-Kharafi & Sons WLL 138,544,915 21.84%
- York Place Limited 138,108,505 21.78%(UEM Builders Berhad owns 100% of York Place Limited).
- Gartmore Investments Limited 32,148,621 5.07%
- Legal & General Group PLC 25,858,465 4.08%

While the Lodon Stock Exchange (LSE) rules will not allow negotiation with any major shareholder that might affect minority shareholders' interests, there is still opportunity to talk with the 4 shareholders who own a controlling the majority share to assess their aspirations. Al Karafi & Sons have been shareholders since the rescue plan in 1992. They are a successful diversified Middle East Conglomerate, and major construction company in their own right.

UEM are a Government owned Malaysian construction group which inherited its shares in Costain from Intria, after its nationalization. Its Holding Company (Khazanah) is seeking to divest its shareholding, and UEM failed to take up its full entitlement of shares during the 2007 Costain Rights Issue, choosing to "swallow its tail" and dilute from a 33% holding down to 21.8%. The Carrying Value of Costain's shares on UEM's balance Sheet are at historic cost so any divestment comes with an accounting profit. Although the Costain contribution to UEM in terms of cash dividend and Associate company profits have improved over recent years, UEM is still considered a willing seller of shares.

Gartmore Investments limited are Institutional Investors who entered the stock via the take-up of UEM Rights at the time of the above mentioned Rights Issue, at an Issue Price below current levels, and could well profit take if the bid premium was attractive.

The strategy should be to first "sound-out" Kharafi and UEM, and build a small stakeholding in Costain shares, prior to a General Offer, based on pointing out Costain's poor operating cash flow performance, and Kier's ability to sort out its Building Division problems; leverage its Heavy Civil Engineering and Process Order Book; and offer strong management and synergies, and comfort over the long term given its ability to manage the Pension Deficit.

Synergies

Costain has a full Listed Plc Corporate Structure costing c.£6m in central Costs/ Administration including Corportae HQ, Non-Executive Directors, Committees/Audits, etc. These costs would be saved following take-over/ delisting. The Executive Board Structure would be absorbed within KCL and there would be duplications in all Function Support functions as well as some operational/sector roles and regional offices which would render further estimated savings of c.£4m. There are an estimated 20 duplicated roles at Main Board/ Executive Board senior director levels which would require a controlled redundancy programme.

Costain commands a strong Brand, being the oldest contractor in the UK with a reputation for landmark major projects. It is ranked in the 2010 UK Top Brands. Its Brand extends internationally, and is particularly strong in its core UK heavy Civil Engineering sectors.

KCL would absorb all Costain's Building operations within Kier Regions, and its Civil Enginnering & Process contracting businesses within KCL. The PFI and Land Development businesses would transfer to Kier Developments. KCL would have the option to retain the Costain trading name and logo, or drop it. Kier Group might also decide to retain or merge the brands. There are various options to consider.

Summary

Overall Costain would add £1bn Turnover and contribute Profits before Tax of £20-30m after savings. Its market positions and £2.6bn Order Book in target UK civil engineering and process contracting sectors, and brand recognition overseas make it an attractive acquisition target. Currrent depressed share price Capitalising the company at just £120m, with £120m of cash in the business, make it a potentially cheap cash purchase, if the 4 major shareholders can be convinced to sell.

GJM/ 20/05/2010

Section 1. Strategic Overview

1.1 Kier Strategy

Paul Sheffield (source: New Civil Engineer)

The recession may be officially over for the Office of National Statistics but according to Kier's new chief executive Paul Sheffield, the next 12 months will continue to be a testing time for contractors. The big area, he says will be **civils and infrastructure which currently only accounts for around £200M of turnover**. This workload is based largely around frameworks with Network Rail, BAA and Bristol International Airport and United Utilities in water. "There is no real reason why it is only 20% of our total construction revenues," he explains. It is a business he knows well, having joined Kier in 1983 as a graduate civil engineer and then progressed, first to run the construction division in 2001 and then to take over responsibility for all construction activities in 2008. There are some big schemes coming along. They will help us to change that. **Major infrastructure is where the big prizes are**" he adds.

Frameworks have been key to the company's success and they are certainly at the heart of the strategy going forward. With up to 75% of work now coming from frameworks in water, education, airports, prisons, health, rail and retail, these agreements are key to meeting Sheffield's desire to boost Kier's profitability.

"I think the framework market is better quality because the clients are more focused on working with the contractor to drive down cost. It's very much a two tier economy – frameworks and not frameworks," says Sheffield, pointing out that, for Kier, being closely aligned to clients' needs is crucial. "We are on 52 different frameworks and that means that we have access to a much bigger market than many others."

The regional network of 32 UK offices means, he says, that there is virtually nowhere that is not local. And since 1 July 2009 all eleven of its divisional businesses now operate under the Kier brand. So there are plenty of challenges ahead as Sheffield prepares for the top job at Kier. And in the short term, he says his goal is simply to come out of the current recession stronger than his peers. But beyond that it is really about building a future based on delivering higher and better quality margins.

1.2 Government Spending

Following the post-election negotiations, the UK is now in unfamiliar political territory with a formal coalition between the Conservatives and the Liberal Democrats.

The full implications for the construction industry, along with the rest of the country, will take time to emerge with the planned emergency Budget and the subsequent Comprehensive Spending Review. However, key messages are already clear, with the tackling the Budget deficit the most pressing priority.

The new Government is committed to implementing the £6 billion of additional cuts this year promised in the Conservatives manifesto. Whilst this may in part be delivered by the axing of cherished Labour programmes such as ID cards, public sector capital expenditure programmes are likely to be regarded as a relatively easy target. Construction related areas, from the schools building programme to Crossrail, will be vulnerable to both explicit spending cuts and to cuts by stealth as protracted 'policy reviews' push back planned spending into future years.

Longer term the squeeze on the public sector investment is likely to be less severe than would have been the case under a simple Conservative majority government. Nevertheless given the pressure on Government finances, the new Government is likely to be keen to develop private sector funding models to secure deliver planned projects.

In addition, changes in Government policy are set to block specific areas of private sector investment. Given both Conservative and Liberal Democrat opposition, BAA's plans for a third runway at Heathrow and the expansion of airport capacity in south east England appear cancelled. In other areas, such as the need for new nuclear generation capacity, the Liberal Democrats are at odds with the Conservatives and progress is likely to be slow at best.

The Conservative party has argued for effective action to cut public spending and tackle the budget deficit in order to reassure financial markets and nurture a private sector lead recovery. The new Government will have to demonstrate to financial markets that it will have the strength and longevity to deliver the promised overall reduction in the budget deficit. Furthermore there is a risk that continued political uncertainty could undermine consumer and business confidence and hamper the pace of economic recovery

1.3 Secured Order Books

The cloud hanging over the UK building industry is darkening. Last year was the worst for the sector since records began in 1955, as private sector clients cut back in the recession. Any signs of recovery in private sector activity will be more than cancelled out by the looming threat of cuts in public sector spending after the forthcoming general election, as the Conservatives/Liberal Coalition attempts to cut debt. Construction companies have been steadily more dependent on state-backed projects during Labour's 13-year term in government. Although both private and public sector investment into the construction industry has grown since 1998, there has been a clear shift by building companies towards taking on more public sector work.

Kier generates 75 per cent of its construction revenue from the public sector, and lower public spending will inevitably affect the group going forward. Most of Kier's competitors are in a similar position (Balfour Beatty, Carillion, Costain, Galliford Try). Costain and Galliford Try has offset some of the declines in construction by having a strong exposure to regulated services, such as water and railway maintenance. Galliford Try is pushing ahead with a move to focus back on house building, which it sees as the main driver of future profits; and with a £119m cash call at the end of last year it is well-placed to buy land and expand its share of the house building market, a strategy that Kier is shying away from.

At a time when future orders are uncertain, many listed contractors are boasting large secured order books, secured in some cases before the downward pressure on costs in the supply chain. Where Market Capitalisations are depressed and undervalue the secured profit earning streams, acquisition opportunities become are attractive.

Competitor	**12 Month Construction Orders to March 2010 source: cnn**	**Secured Order Book (including Support Services) source: annual reports/ press releases**
Balfour Beatty	6,170	14,100
Skanska	2,962	1,540
Costain	2,155	2,600
Morgan Sindall	2,037	3,600
Kier	1,727	4,500
Carillion	1,660	17,700
Galliford Try	1,206	1,800
Laing O Rourke	965	11,000
Interserve	859	6,000

1.4 Competitor Comparisons

Global Competition

With expanding markets home and abroad and cross-border acquisitions the ENR's Top 225 Global Contractors list includes 21 companies with more than US$10 billion in revenue, 130 firms over US$1billion. Balfour Beatty ranked Number 1 in UK was ranked 23rd in the ENR Rankings (prior to its purchase of Parsons Brinckerhoff). The Top Ten are:

Vinci (France)	$32.7bn
Bouygues (France)	$25.0bn
China Railway Engineering Corp (China)	$21.3bn
Hochtief (Germany)	$19.8bn
Grupo ACS (Spain)	$18.5bn
China Railway Construction (China)	$17.3bn
China State Construction (China)	$16.1bn
Skanska (Sweden)	$15.7bn
Bechtel (USA)	$15.4bn
China Communications (China)	$14.7bn

Source: ENR

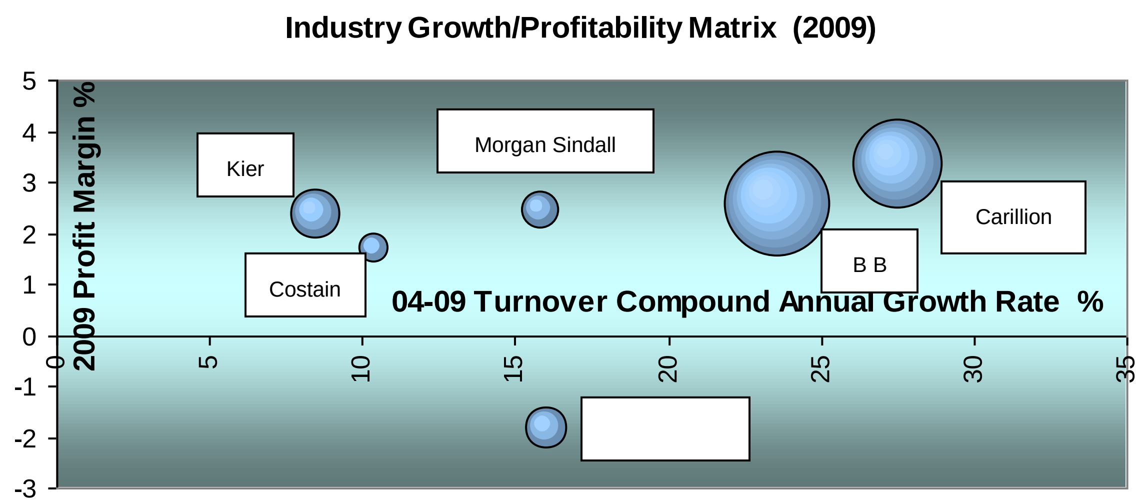
Some of the larger European Companies have grown via Merger and Acquisition during the last Economic downturn in the early 1990's. Examples are ACS of Spain formed from the amalgamation of construction groups OCISA, AUXINI, Huarte, Abertis, Dragados. Ferrovial, Cubiertas, Entrecanalas, Agroman were all medium sized contractors in the late 1980's and early 1990's which became part of leading Spanish/European Groups through M&A. ACS itself now also holds a 25% stake in Hochtief. China Railway & Bridge and CHEC also merged to form China Communications Company, now ranked Number 2 in terms of Turnover. The message has been one of consolidation.

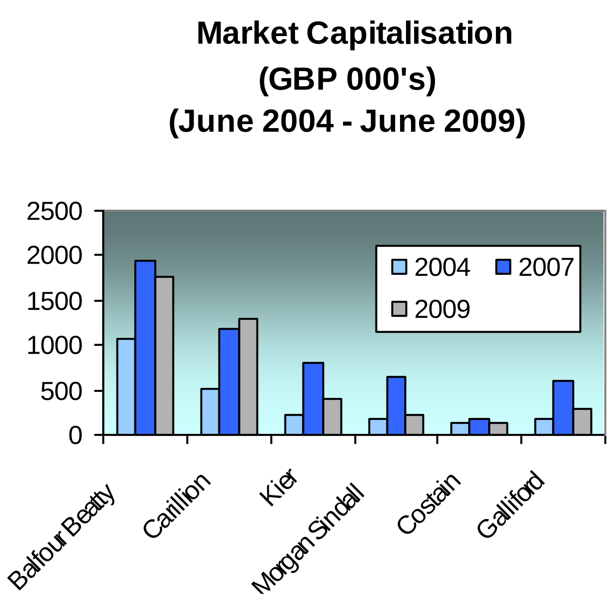
UK Civil Engineers

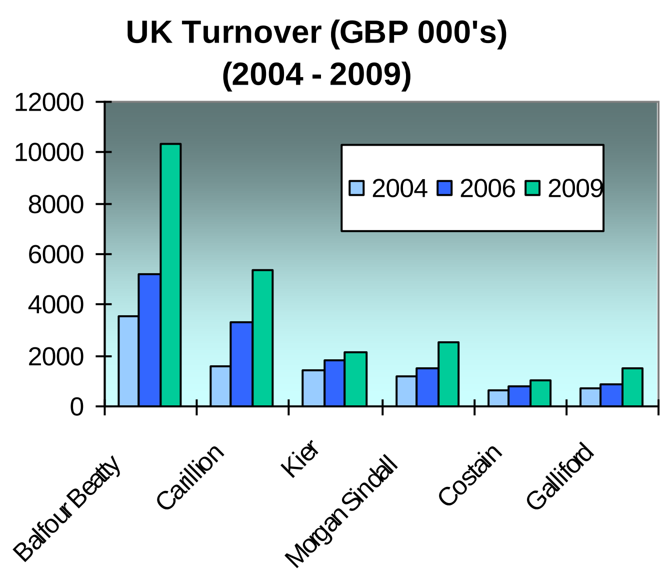
	Firm	Civils Turnover 2009 (£m)	Total Turnover 2009 (£m)
1	Balfour Beatty	2,576	n/a
2	Laing O'Rourke	2,149	4,236
3	Carillion	1,400	5,206
4	Amey	1,174	1,493
5	Galliford Try	1,136	1,832
6	Morgan Est	799	799
7	BAM Nuttall	650	650
8	Costain Group	620	996
9	Skanska UK	575	1,481
10	J Murphy & Sons	433	455
11	VINCI Construction	393	1,962
12	Kier Group	381	2,374
13	Black & Veatch	347	2,237
14	Tarmac Limited National Contracting	312.5	312.5
15	Birse Civils	255.09	255.09
16	VolkerFitzpatrick	223	448
17	Clancy Docwra	202	202
18	Colas Limited	201	242
19	Sir Robert McAlpine	200	1,187
20	Interserve Project Services	183	770.7

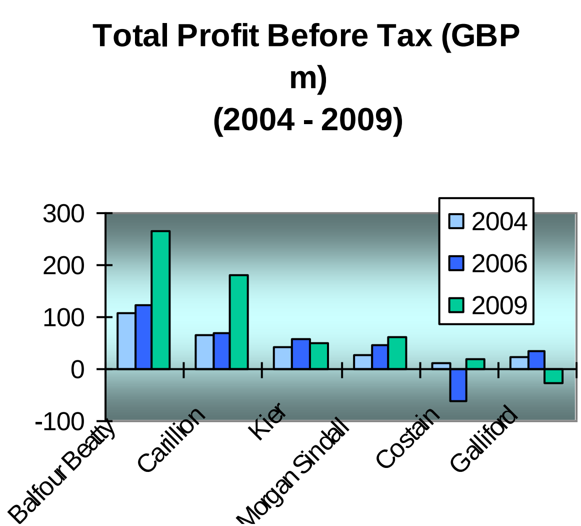
The key competitors to track seem to be Balfour Beatty, Carillion, Morgan Sindall, Costain, Galliford Try, Taylor Woodrow/Vinci, Laing O'Rourke and Interserve.

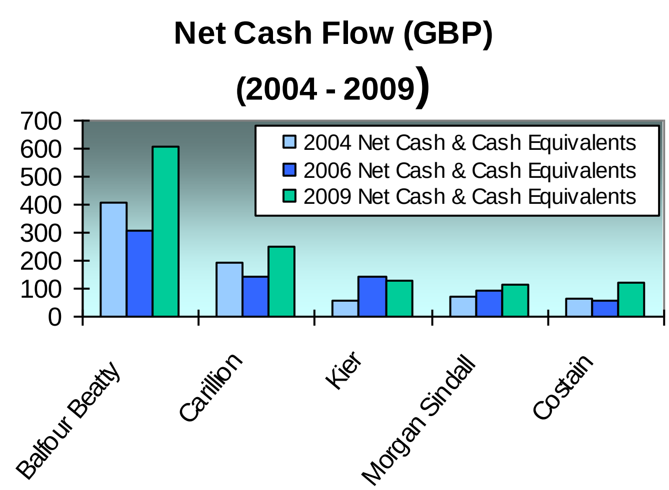
Competitor Trends











The trends show clearly how Carillion and Balfour Beatty over the last 5 years have achieved Turnover, Market Capitalisation and Compound Annual Profit Growth without diluting Margins. Furthermore Cash Flow and Cash Balances have remained strong despite investment in Acquisitions and PFIs.

Kier Group remains a cash generator but has not invested aggressively in acquisitions. Galliford Try had a profit hit in 2009 linked to Land Bank write-downs, but now has substantial cash balances, post its 2009 Rights Issue, to re-invest in its House Building operations as the market begins to rise.

It is perhaps time for Kier to explore its acquisition options as some companies have strong Oder Books but Market Capitalisations remain depressed given the public spending outlook and market sentiment.

Competitor Listed Plc's (all figures as available 12/05/2010)	**Market Capitalisation** **source: annual reports**	**Enterprise Value (Mkt Cap -Cash +Debt)** **source: annual reports/ statements**
Balfour Beatty	1,772	1,448
Costain	135	14
Morgan Sindall	226	195
Kier	402	271
Carillion	1288	1,263
Galliford Try	293	259
Interserve	264	301

Additional Information
Costain has substantially more likely Profit in its Order Book than its prevailing Enterprise Value

Competitor	**Balance Sheet- Net Assets** **source: annual report**	**Balance Sheet- Pension Deficit** **source: annual reports**
Balfour Beatty	1,006	586
Costain	-4 (Excludes NPV of PFI)	105
Morgan Sindall	209	3
Kier	76	113
Carillion	777	294
Galliford Try	408 (Recent Rights Issue)	28
Interserve	222	95 (Recent transfer of PFI Assets)

Competitor	**Cash Flow- Operating CF** **source: annual report**	**PFI- Directors' Valuations** **source: annual reports**
Balfour Beatty	294	610
Costain	-17	44
Morgan Sindall	25	38
Kier	25	56
Carillion	268	115 (Recent £100m+ disposals)
Galliford Try	47	19
Interserve	25	62 (Transferred to Pension Fund)

Ratios %	**Order Book/ Enterprise Value** *Future Cash Flow/ PayBack*	**Op Cash Flow/ Enterprise Value** *Historic Cash Flow/ PayBack*	**(Mkt Cap – Net Assets) / Net Assets** *% Goodwill*	**Pension Deficit/ Net Assets** *Relative Pension Burden*	**PFI/ Net Assets** *Understated Balance Sheet*
Balfour Beatty	973.76%	20.30%	76.14%	58.25%	60.64%
Costain	18571.43%	na	na	na	na
Morgan Sindall	1846.15%	12.82%	8.13%	1.44%	18.18%
Kier	1660.52%	9.23%	428.95%	148.68%	73.68%
Carillion	1401.43%	21.22%	65.77%	37.84%	14.80%
Galliford Try	694.98%	18.15%	na	6.86%	4.66%
Interserve	1993.36%	8.31%	18.92%	42.79%	27.93%

Summary Ranking (as Acquisition Targets)

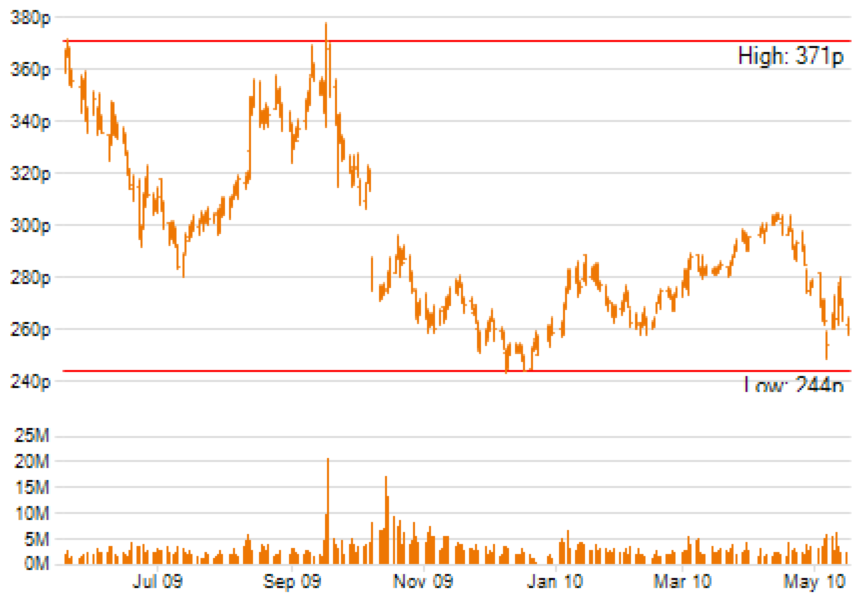
Goodwill	**Payback**	**Understated Balance Sheet**
Galliford Try (negative!)	**Costain**	**Costain**
Morgan Sindall	**Carillion**	**Kier**
Interserve	Balfour Beatty	Balfour Beatty
Carillion	Galliford Try	Interserve
Balfour Beatty	Kier	Morgan Sindall
Kier	Morgan Sindall	Carillion
Costain	Interserve	Galliford Try

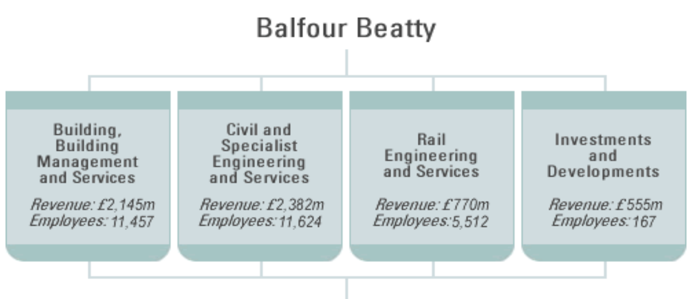
Conclusion

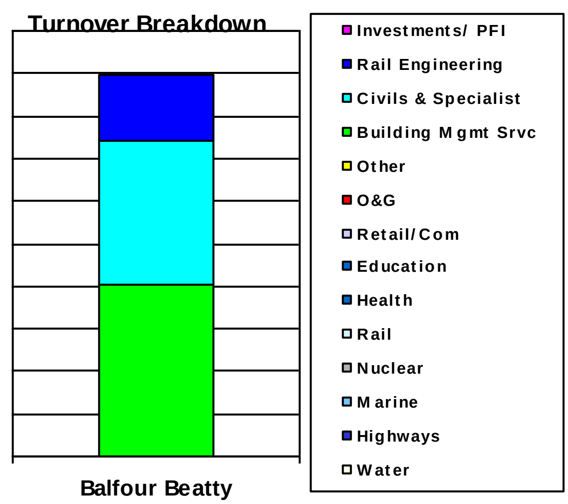
Galliford Try and Morgan Sindall are potential Kier Group acquisition targets based on Valuations (Market Capitalisation v Net Assets); Costain is a primary target for KCL because of its Cash & Order Book and attractive market sector positions including PFI/Cash Assets . Further operational analysis is required.

1.5 Competitor Profiles

Balfour Beatty





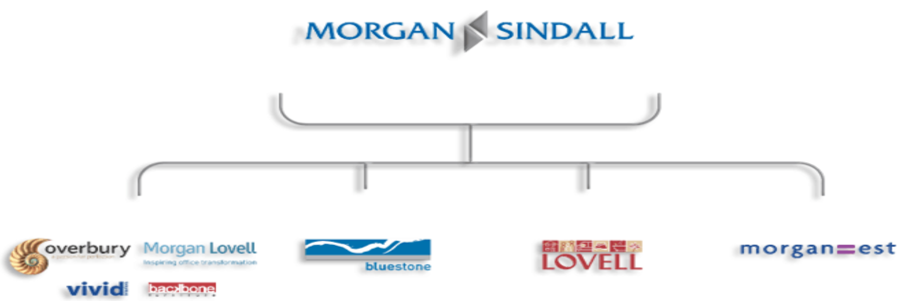


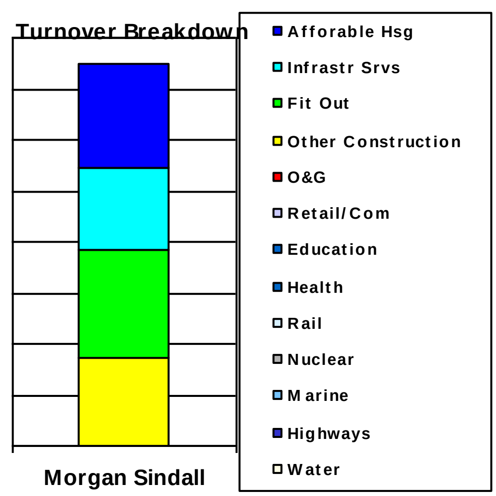
Balfour Beatty is the industry leader with an Order Book over £14bn, Net Assets over £1bn, c£300m Operating Cash Flow and a PFI Portfolio worth over £600m. It recently funded its acquisition of Parsons Brinkerhoff through a Rights Issue netting £352m.

It paid £184m for Centex in the USA in 2007, and £32m for Birse in the UK the year before. Since being unleashed from the Corporate ties of BICC Plc and via its reverse takeover of the listed company, it has had the internal cash generation and resource to the markets to fund its aggressive acquisition strategy in recent years.

Its poison pill is a £586m Pension Deficit, and as the UK's largest Construction company it is very much a role model, and not acquisition target for its UK rivals.

MORGAN SINDALL



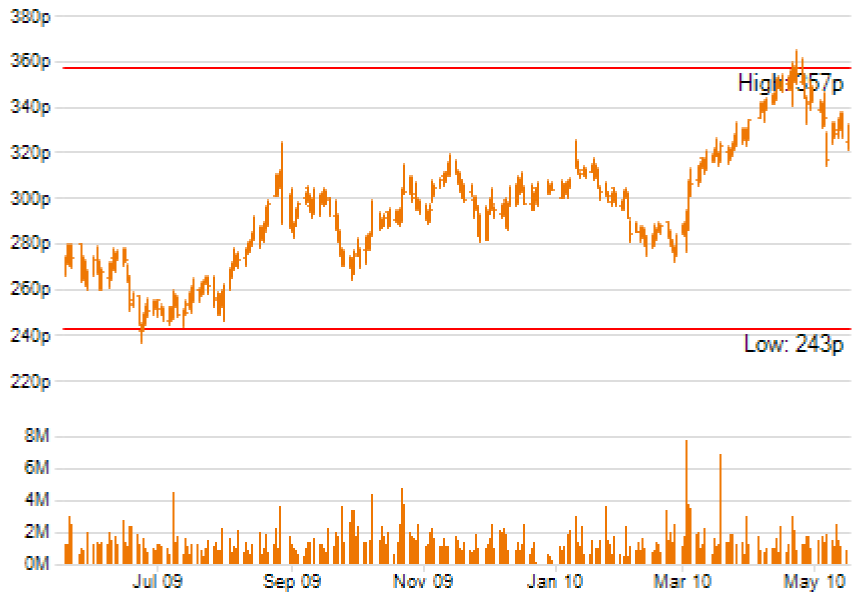


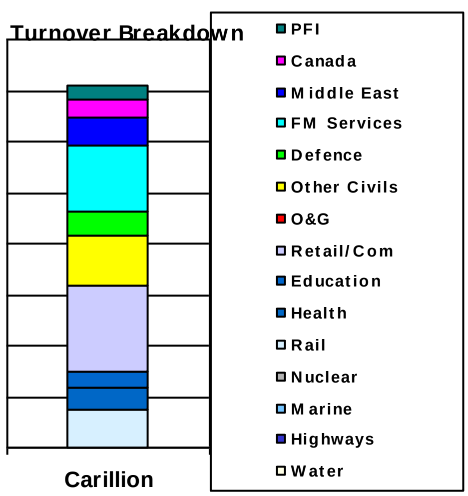
Morgan Sindall is a leading UK construction and regeneration business with a turnover of £2.5 billion, employing over 8,000 people and operating in the public and commercial sectors. Their offering comprises Affordable Housing, Construction, Fit Out, Infrastructure Services, Investments, Professional Services and Urban Regeneration.

The Group was established around the acquisition in 2007 of the ailing construction business from AMEC. While its Order Book is robust at £3.6bn, its year end cash balance of £118m was not substantiated by an average cash balance of £31m over the year. Its Net Assets at £209m and Operating Cash Flow of £25m seem attractive given a Market Capitalisation of just £226m and a low exposure to Pensions deficits, only £3.2m. Such a low Goodwill figure of £17m make it attractive in accounting terms also.

Morgan Sindall is therefore a potential Acquisition or Merger target for the Group, albeit not strongly enough represented in infrastructure market sectors to be attractive to KCL. With a Market Capitalisation of £226m and Enterprise Value of £195m, it is also outside the sights of KCL as a sponsor division.

carillion





Carillion is a major player in UK contracting and support services markets. Following the demerger from Tarmac Plc it was blessed with a cash balance of over £400m upon floatation and set about two major acquisitions of competitors- Mowlem and Alfred McAlpine. It is outside the reach of Kier as an acquisition target, with Market Capitalisation of £1,772m representing £772 Goodwill over Net Assets. Its pension deficit is running at £294m and it recently sold off over £100m of PFI assets. Operating Cash Flow in 2009 was strong at £268m. Carillion made an underlying pretax profit in 2009 of 182.2 million pounds, against analysts' consensus forecast of 176.9 million pounds, according to a company poll of 14, and 157.5 million reported in 2008.

Revenue increased 4 percent to 5.4 billion pounds, boosted by a strong performance in the Middle East and contract wins in the UK, including a one-billion-pound contract from BT Openreach (BT.L), and over 1.5 billion pounds of work from the Building Schools for the Future programme. Carillion ended the year with net cash of 24.9 million pounds, compared with net borrowing at the end of 2008 of 226.7 million pounds, and is paying a dividend of 14.6 pence, up 12 percent.

KIER

GallifordTry

Galliford Try specialises in construction and house building. It provides construction services across the UK to a wide range of public and private sector clients and has regional house building businesses that specialise in individually designed developments across the South of England and the Eastern Counties.

The Group's Building Division specialises in education, health, leisure, commercial, interiors, affordable housing and facilities management. Galliford Try's Infrastructure Division encompasses work for the water, highways, rail, remediation, flood alleviation and renewable energy sectors. The Group's PPP Investments Division develops and invests in public/private partnership projects.

The House building Division operates through five regional brands: Linden Homes, Linden London Developments, Stamford Homes, Midas Homes, and Gerald Wood Homes. Concentrating on brown field sites and individually designed developments, the business completes around 1,800 homes annually. The Group's rapidly growing Affordable Housing & Regeneration Division specialises in the creation of sustainable communities.

Galliford is a similar profile company to Kier Plc with the exception that its recent strategy has been to raise cash (£119m) via a Rights Issue to re-invest in its housing landbank, which it sees will benefit from a turn-around in the housing market. Its Contracting Order Book stands at £1.8bn and while it has a position in the AMP5 Water Frameworks it is not a prime target for KCL. It declared a £26.9m loss in 2009 due to an exceptional write-down of housing land bank. Its underlying profit was £24.5m

With Net assets of £408m following its Rights Issue, declared £190.8m cash at the Half year, and Market Capitalisation trailing at £293m, Galliford Try seems an enigma and on the face of it an Acquisition opportunity to buy assets and strip it of its cash. The write-down of 2009 £48.7m is behind it and the Balance Sheet contingent liabilities of £113m seem normal trading bonds/warranties. The only questionable Asset item on the Balance Sheet is £115m of Goodwill. There are some post balance Sheet transactions that need auditing, but nevertheless Galliford Try seems an attractive Kier Group acquisition target in its current position, and with a pension Deficit of just £27.5m carries no stigma there either.
Certainly worthy of further Kier Group investigation.

Interserve

Interserve is a partner to Kier in KMI Water Framework for United Utilities. It is a Contracting/ Support Services hybrid like Kier, and as such would be a Group Acquisition target rather than KCL. It recently transferred £61.5m of its PFI Equity investments into its Pension Fund (declaring a £35m paper profit). Its Pensions deficit was rumoured to be heading toward £200m by year end, but following the PFI transfer and an upward Actuarial re-Valuation of assets/liabilities, the Deficit at Half Year was declared as £95m.

The Company's recent Trading performance was published as below (May 12th 2010)

"Trading has continued well overall, in line with expectations. The Group is also benefiting from the impact of continued weakness of sterling with respect to overseas earnings.

The public and privatised sectors in the UK, which account for around two-thirds of our revenue, remain robust and continue to offer opportunities for which we are well-placed. As previously highlighted the private sector remains weak and we have a number of cost reduction measures in place to mitigate the reduced demand from our clients in this sector.

Our Middle East operations continue to win new work with long-term customers, benefiting from the strength and influence of our local partnerships. Our associates' future workload remains stable compared with the year-end position albeit there is some evidence of project delays, particularly in Dubai. Payment cycles have lengthened across the region since the year-end and as indicated previously we continue to review closely and, where appropriate, increase our level of debt provisioning whilst maintaining anticipated trading performance.

Our equipment services business is trading well and benefiting from the investments made in prior years. We have adjusted capital expenditure and operating costs in anticipation of a reduction in activity levels and we are focusing on sustaining equipment utilisation.

We continue to manage our PFI portfolio actively, adding new projects and generating cash from the more mature projects. During the period we were named preferred bidder on two new projects, the Derby waste-treatment contract and the Sandwell Council Building Schools for the Future (BSF) programme. Separately, cash amounting to £15m has been released from the portfolio via the sale of our equity and loan stock interests in the Sheffield Schools project and the repayment of the majority of our subordinated debt in the University College London Hospital project

Since the year end we have won a number of important contracts across a diverse range of sectors, notable amongst which were:

Waste: Preferred bidder, in conjunction with United Utilities, for the £500 million PPP Derbyshire waste-treatment contract;
Health: One of the five Principal Supply Chain Partners on the £600 million Frameworks Scotland healthcare programme;
A £20 million contract to design and build a community hospital in Dover, procured via the ProCure21 framework programme;
A 19-year contract to deliver facilities management services on behalf of Leeds Partnerships NHS Foundation Trust;
Education: Preferred bidder on the Sandwell BSF project, providing facilities management and construction services worth over £280 million;
The design and build of Kingswood School, worth £20 million;
Local Authority: A ten-year contract worth £5 million a year to deliver facilities management services to Ealing Council;
Commerce: A four-year framework agreement involving construction, refurbishment, fit-out and life-cycle works across Mapeley's UK estate; and
Middle East: Six construction contracts won by our associate companies with existing clients in Qatar and the UAE and servicing the infrastructure, industrial and commercial sectors. These are worth c. £215 million in total.

These contracts further underpin our future workload, which stood at £6.5 billion including our share of the Middle East associates at the year-end."

Interserve's Enterprise Value of £301m is probably unattractive to Kier Group given the uncertainties in current trading. The jewel in Interserve's crown is its Middle East businesses, which are well established in growing markets like Qatar.

Analysts Views (2009/2010)

1. NUMIS

On such a rationale it is interesting to consider and follow the progress at **Costain** (COST), the infrastructure engineering group in diversified industries such as water, rail, highways, retail, nuclear and oil and gas. The 'top down' investment rationale here is the group's high exposure to essential public services which should benefit from increased public sector spending on infrastructure to limit the wider effects of recession on the economy, see **costain.com** to get more insight into operations.

Costain is a long-established and respected British business group that looks well positioned to sustain progress during the recession; hence the kind of share to consider buying when out of favour.

The shares are listed under Construction and Materials in the FTSE SmallCap index and de-rated from over 50p in 2006/07 below 20p in December but have recovered some poise to about 23p after a firm trading statement on 8 January. This capitalises the group at about £145 million.

The latest update has affirmed a group with genuine financial substance compared with the usual sense of smaller companies struggling. Progress is in line with expectations and there is a strong cash position significantly above £100 million. At end-December, the group's forward order book was a record £2 billion, up 20% year on year and with over £700 million of work secured for 2009. Contracts include Tesco Gerrards Cross, Gloucestershire Royal Hospital and a five-year maintenance contract for the Highways Agency. The group has also increased its preferred bidder positions to over £1 billion, which ought to translate into higher quality earnings hence (in principle at least) a decent multiple of earnings per share.

In a low 20p range, Costain shares trade on about nine times the market consensus expectation for 2.6p earnings per share for 2008, based on pre-tax profit of about £22 million as shown in Company REFS. The apparent gulf here is explained by 633 million shares in issue, which puts Costain in the 'penny share' league typically associated with weak firms.

Obviously, the question is how earnings may pan out over a recession. The stock market is understandably cautious of assuming double digit earnings growth (just) for 2009 as brokers anticipated last autumn. Yet genuine potential remains, to deliver this. Costain has announced a £220 million five-year joint venture contract from the Highways Agency to carry out maintenance on motorways and trunk roads in the East Midlands. This is an example how Costain is well placed to benefit from infrastructure spending during the recession, with more opportunities ahead.

At the interim stage there was a 0.25p per share dividend covered over 5 times by earnings and if this is followed by another 0.50p per share payout (as forecast) after prelims then the shares' prospective yield is in the order of 3% - nothing special but worth noting as a sign of proof of cash generation and financial control. If the payout can expand, again according to forecasts, Costain's yield creeps up to 4%.

The balance sheet looks fair enough. At end-June 2008, trade receivables accounting for £158 million also cash of £134 million bolstered total assets to £381 million with negligible capitalisation of intangibles or goodwill. On the liabilities side there were £280 million trade creditors and £67 million retirement benefit obligations but Costain has avoided material borrowings. Again, however, the extent of shares in issue dilutes the net asset value per share to about 3p, so although the balance sheet has a satisfactory profile it is not as if Costain's asset backing implies a 'margin of safety' in relation to the share price.

An issue to be aware of in relation to the balance sheet, however, is a likely de-valuation of pension fund assets (with the fall in stock-markets) reducing net asset value, something that looks likely to appear with prelims in March.

Dresdner Kleinwort has set a price target of 53p implying an earnings multiple in the mid-teens, which frankly looks hopeful in these cautionary times. However the trading statement looks to have established a support level and the shares ought to respond to news of infrastructure spending. The Government will doubtless publicise its efforts to mitigate the recession and such 'news flow' be potentially positive for Costain shares as investors spot the link.

Arbuthnot has likewise published an attractive target in the order of 40p per share based on sum of the parts and anticipation of cash flows from infrastructure projects. This was last year however and many shares currently languish at big discounts to what brokers thought previously. Yet it is possible that Costain's lows around the 20p mark reflect very poor sentiment in the stock-market generally and in long-term context a 40p target looks eminently reasonable, given time.

Numis however is more cautious, effectively saying the shares are fairly priced given a 22p target. This broker regards 85% of Costain's revenue as secured and the share price should be sustained both by cash and the portfolio of public works.

There have been no directors' dealings in the shares lately, perhaps a tad disappointing relative to various examples of concerted buying elsewhere, although management does own equity.

If the stance by Numis and the directors looks less enticing, at least it suggests (and is strongly backed up by fundamentals) that downside risk ought to be limited at current levels hence in a long-term context the risk/reward profile looks attractive.

There is quite a tight market given 55% of the shares held by four institutions, so the normal market size may only be about 11,000 shares. Usually, this may not present a problem when buying yet is an issue to bear in mind for selling shares. Thin markets can also accentuate volatility, a plus point if you are on the right side of the swings.

2. SIMPLE INVESTMENTS

Costain Group (Epic: COST) is one of the UK's leading construction companies and is listed on the main market. The group reported strong full year results on the 11th March, which showed a 30% rise in the order book to a record £2.6 billion for the year ended 31st December, making it one of the best order books in the sector. Operating profit also grew by 14% in 2009 to £20.8 million, which was comfortably ahead of forecasts.

Costain has refocused its operations away from health and retail, towards higher margin infrastructure, environment and energy and process work. Although the prospects for public spending continue to cast a shadow over the sector, around 70% of the order book is in safe looking regulated or maintenance related sectors.

The small cap is capitalized at £149 million and has a strong net cash position of £120.5 million, with no material borrowings. If you strip out the cash, it gives the group an enterprise value of around £29 million and with operating profit of £20.8 million for last year, it puts the company on sub 2x earnings for 2010, making it vulnerable to a takeover.

Furthermore, earnings are expected to grow by 16% this year and an announced 10% increase in the dividend to 3.4% gives an indication of confidence in its future prospects.

As can be seen from the above chart of Costain the shares have drifted off a 35p high in August 2009 and appear to be finding support around current levels.

The oscillators have been trending lower and appear to be bottoming-out in oversold territory. The stochastic appears to be turning higher and the fast line has intersected the slow line, indicating a change in momentum.

The moving average convergence divergence (MACD) histogram has also just stepped higher for the first time in 15 sessions, which could be an early indication of a change in trend.

A 1-for-10 share consolidation is planned in May, which should reduce volatility and make them psychologically more appealing to investors. A record order book, strong balance sheet and close proximity to technical support make me a buyer of the stock at current levels.

At the time of writing the share price is 24p and near term targets are seen at 25.5p, 26.3p and 28.25p. I shall set a stop loss marginally below significant support at 21.75p.

3. JAMES CRUX

COSTAIN

Growth Company Recommendation – Buy

Ticker: COST
Sector: Construction & Materials
Listing: Full List
Mid-price: 27.75p
Spread: 27.75p-28p
Market cap: £175.89m
12-month high/low: 29p/19p
Normal market size: 10,000
Average sector p/e: 9

RESULTS	Turnover (£m)	Pre-tax profit (£m)	EPS (p)	p/e
2008 (A)	902.6	23.1	2.9	9.6
2009 (E)	845.5	17.4	2.1	13.2
2010 (E)	858.3	18.5	2.2	12.6

SECTOR PEERS	Ticker	Market cap (£m)	Pre-tax profit (£m)	Forecast p/e
Keller	KLR	375	113	8
Rok	ROK	89	5.9	6

Construction and engineering contractor Costain offers investors high earnings visibility through its £2.4 billion order book. Armed with balance sheet strength and having lately secured a number of important contract wins, it is a company worth considering for tough economic times.

Since 2005, the fortunes of Maidenhead-headquartered Costain, famed for its refurbishment work at London's St Pancras station, have been revitalised by CEO Andrew Wyllie, a former high-flyer at Taylor Woodrow, who has restructured the company and implemented a strategy entitled 'Being Number One'. This involves focusing on blue-chip customers increasingly wanting to work with fewer contractors on a longer-term basis, building a high proportion of repeat revenues into Costain's business.

Costain has also looked to partner with larger public sector clients or customers in regulated sectors including highways, water, health, education, energy and waste, where spend is far more secure, helping the group to weather recessionary storms.

The year 2007, during which a £60 million rights issue significantly strengthened the balance sheet, proved a landmark one, with all group operations returned to profit for the first time since 1990 and Costain announcing a return to the dividend list for the first time in 17 years.

Today, Costain operates three broad divisions, namely Civil Engineering (roughly 60 per cent of sales), Building, and Oil, Gas and Process (COGAP). It also operates a property arm focused on residential and leisure complex development in Spain.

Significantly, 'COGAP', involved in the design and construction of underground gas storage and floating liquefied natural gas (LNG) storage, has lately won work in the buoyant nuclear sector. Costain has already delivered a number of nuclear contracts (including at Sellafield), and with much of the work in this sector involving process and civil engineering, the company is well placed for growth here.

Costain is additionally making inroads into the growing waste management industry, having secured a £397 million contract with the Greater Manchester Waste Disposal Authority, the biggest such authority in the UK.

Earlier this summer, a trading update reassured investors on a number of fronts, with Costain stating it had traded in line with expectations in the year to date. Highlighting the Greater Manchester waste deal, management also drew attention to a number of other major new contracts secured since the start of 2009. They included a ten-year deal with Severn Trent, worth an estimated £400 million and beginning in 2010, further maintenance work for the Highways Agency and work won under the Building Schools for the Future education programme.

Following this raft of wins, said Costain, its order book had expanded to an all-time high of £2.4 billion, including more than £900 million of work secured for 2009 alone. Unfettered by borrowings, Costain maintained its strong net cash position at 'significantly in excess of £100 million'.

And with tendering activity levels in its chosen markets remaining high, contract momentum has continued to gather pace in the weeks since, with the company announcing significant work won with Southern Water and United Utilities, as well as underscoring its credentials in nuclear with a contract worth £297 million at Sellafield, related to the 'Evaporator D project', one of the biggest nuclear projects in the UK.

For 2009, analysts have prudently pencilled in a temporary pullback in profits from last year's £23.1 million to £17.4 million, pegging earnings back to 2.1p. However, for 2010, Costain should deliver improved profits of £18.5 million, as turnover climbs from £845.5 million to more than £858 million.

Based on forecast earnings, Costain trades on prospective multiples of 13.2 and 12.6, but bearing in mind its considerable cash, the true rating is far more modest and the shares also offer investors a 3.6 per cent yield, based on the 1p dividend forecast. Moreover, house broker Arbuthnot says its sum-of-the-parts analysis values the business at 36p per share at the very least. We consider the shares worth buying ahead of the forthcoming interim results.

Author's Comment:

Costain is seen as complimentary to Kier Construction in adding strength in the following core sectors:

Infrastructure - particularly Highways, Rail and Airports

Environment - particularly Water and Waste

Energy & Process - particularly Nuclear, Power, and Hydrocarbons & Chemicals

Its weaknesses lie in Regional Building and Spanish Land Management. These activities would be assigned to other parts of the Kier Group.

1.6 Acquisition Options

Firm	Order Book (£m)	Mkt Cap (£m)	Net Assets (£m)	Yr End Net Cash (£m)	Pension Deficit (£m)	Operating Cash Flow (£m)	PFI Directors Valuation (£m)
Galliford Try	1,800	293	408	133	28	47	19
Morgan Sindall	3,600	226	209	118	3	25	38
Costain Group	2,600	135	-4	121	105	-17	44

Galliford Try (Undervalued Share price/ Merger Option)

Galliford Try has a similar profile to the Kier Group, with the exception of its strategy to keep investing in Housing Land acquisitions. It has recently secured £119m via a Rights Issue to do so. Its recent trading performance was hit by a write down on existing land banks, rendering an accounting loss of £26.9m in 2009. However, its Market Capitalisation (£293m) seems not to reflect its new Asset Base (£408m net Assets) including £133m of Cash(although it also includes £115m of goodwill). Rather like Morgan Sindall, Galliford Try is not an attractive acquisition prospect for KCL, because of its low exposure to heavy civil engineering sectors. Nevertheless, with Net Assets at a premium to Market Capitalisation, free cash in the business, and considerable synergies with Kier, the company is an attractive acquisition opportunity for Kier Group to consider. The company's **Enterprise Value is currently £149m less than its Market Capitalisation**. Given Galliford's depressed share price, either an acquisition via a kier Share Placement or Rights Issue, or Merger might be favoured acquisition strategies. Pension deficit is a modest £19m. the Balance Sheet however includes £115m of Goodwill yet to be amortised.

Morgan Sindall (Low Goodwill, Asset backed Acquisition Option Shares or Cash)

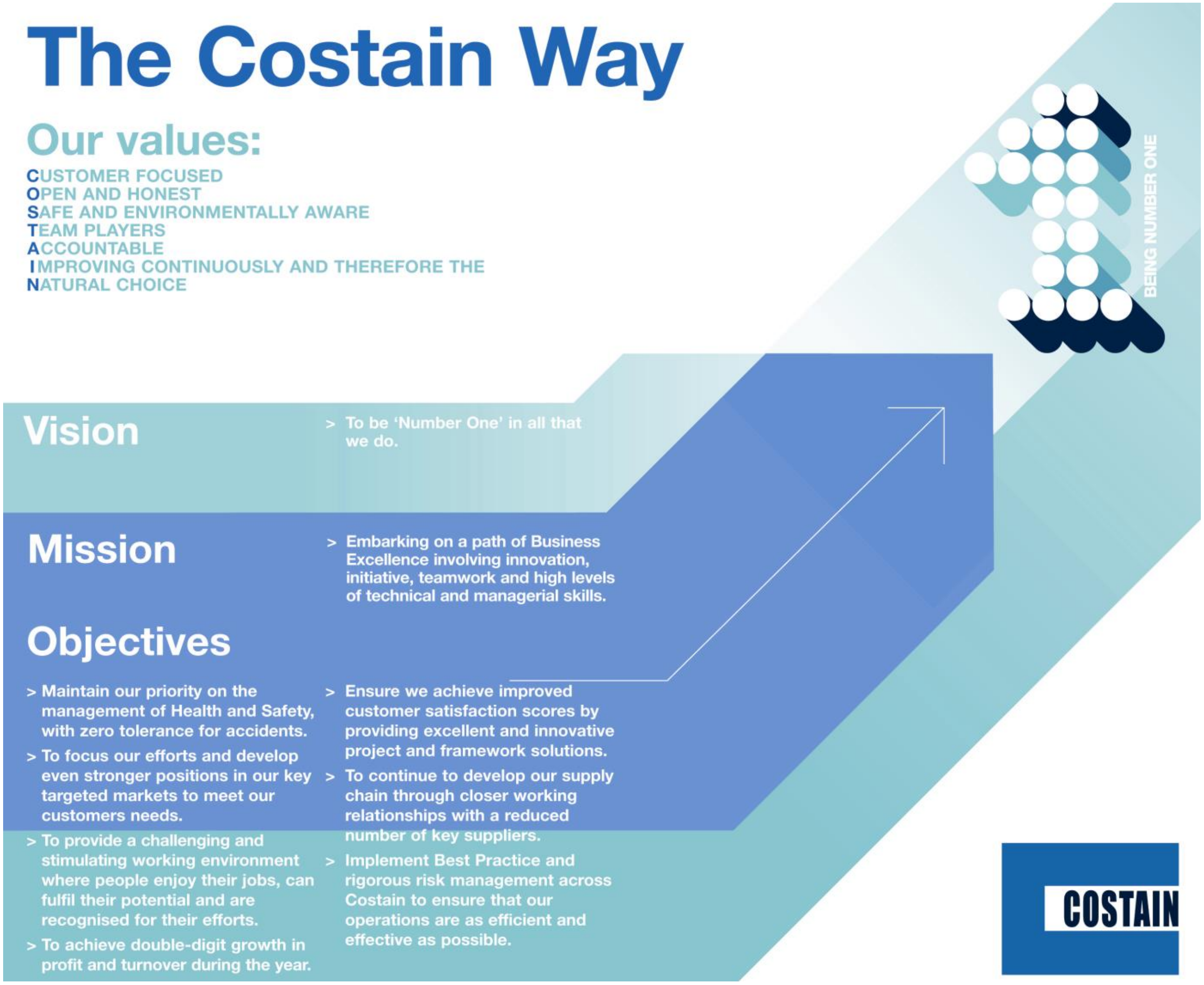
Year End Cash was not maintained throughout the year, averaging £31m, as contracting struggled. However its **Market Capitalisation is at a small £17m premium to Net Assets, and the Enterprise Value is at a £14m discount to Net Assets.** It did not inherit a large Pension Deficit which stands at just 33.2m in the accounts. The Order Book is strong at £3.6bn, but the Product Mix of Morgan Sindall is not attractive to KCL which seeks heavy civils sector strengths, not Fit-Out and Affordable housing (Lovell). Nevertheless, the company is a potential target for Kier Group. Operating Cash Flow as a percentage of the current Enterprise Value is 13%, suggesting a 8+year payback, depending on the bid premium, and growth and synergy potential.

Costain Group (Good Cash & Order Book, Cheap Cash Purchase- 3 Shareholders control majority)

Costain offers KCL strong complimentary positions in Water, Roads, Waste, Nuclear and Oil & Gas/Process.
Its Building Business has been haemorrhaging cash, and if Kier Regional could turn the project portfolio around, Costain's Operating Cash Flow should improve. Of most interest to KCL is its Order Book of £2.6bn and minimal net cash requirement to acquire. **The company's Enterprise Value (Market Capitalisation less Net Cash) is just £14m, making it a cheap net cash purchase**. Kharafi Group would probably take shares in Kier as its shareholding in Costain is not strategic; and UEM recently "swallowed its tail" on the 2007 Rights Issue reducing its shareholding to less than 22% and relinquishing a place on the Board. Costain has an understated Balance Sheet because of its £44m of PFI Assets and Spanish Land Bank, and although its Pension Fund deficit remains at £105m, the synergistic savings across the Kier Group (Plc) and KCL operationally are significant. Costain is an attractive opportunistic acquisition option for KCL, because of its product mix and Order Book, subject to due diligence on the position within its Building Division.

Section 2. Target Company

2.1 A Profile (Source Superbrands Report 2010)



Costain is an international engineering and construction group with a reputation for innovation and technical excellence founded on more than 140 years of experience. As one of the UK's premier engineering and construction companies, it boasts one of the strongest 'Brands' in the industry.

Market
Costain is at the forefront of the construction industry's effort to meet the challenges facing Britain today. With a rapidly increasing and ageing population, Britain's frontline services, energy and transport infrastructure are being overhauled to provide the necessary capacity for future generations. Costain's ongoing success in securing numerous high-profile and sector critical projects, such as the £297 million Evaporator D project at Sellafield, one of the largest nuclear projects in the UK, and the £397 million Greater Manchester Waste contract, the largest waste service contract in Europe, continue to strengthen its brand and market position within this highly complex and competitive sector.

Product

Costain's primary markets are water, highways, rail, energy and processing, nuclear, waste management, health, education, retail, marine and airports. Costain anticipates future investment in major infrastructure, and environment-related projects and is well placed to seize the opportunities that will be presented by these, including Crossrail, high speed rail links, new nuclear power and waste schemes, and airport expansions. Across all sectors the Costain product is defined by excellent design and the quality of its workmanship. Costain succeeds in delivering challenging projects through an uncompromising adherence to specification and procedure and by utilising its experiences
and extensive knowledge at all stages of a project. Innovation, initiative and teamwork combined with high levels of technical and managerial skills have kept the company ahead in a complex and competitive marketplace, ensuring that Costain has become 'the construction brand'.

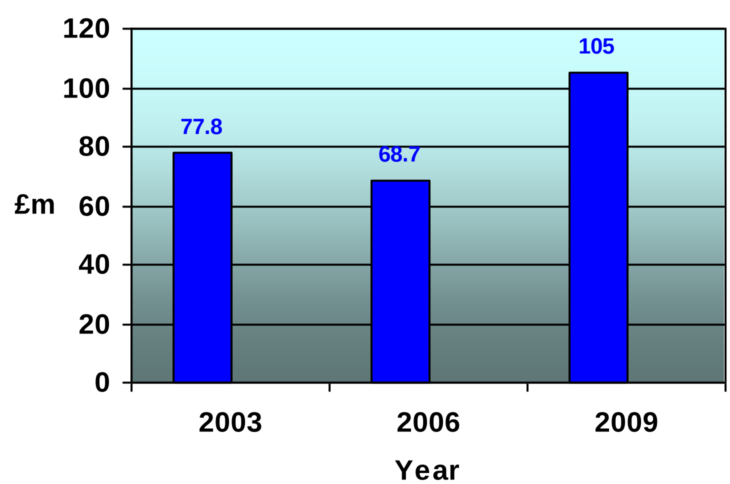
Achievements

The signs of growth in 2009 were positive, with three major Highways contract wins and the securing of the Severn Trent Water AMP5 contract from 2010 to 2015. The Costain Group was named 2009's Major Contractor of the Year by New Civil Engineer magazine, retaining the prestigious award that it had won the previous year. The Costain Group also won the Supreme Award at the Construction News 2009 Quality Awards which is given to the construction company that records the best overall Awards performance. Costain was short-listed six times and won
two categories – Training and Corporate Social Responsibility. As organisation's ethical and environmental credentials come under increasing scrutiny, Costain has embraced Corporate Responsibility (CR) as defi ning the way it does business. It has demonstrated its commitment towards CR through the continued work of its own CR committee and as a member of Business in the Community (BITC), a HRH Prince of Wales charitable organisation which inspires, engages, supports and challenges businesses to operate responsibly. In 2009 Costain achieved a Silver ranking in BITC's CR index with a score 15 per cent above the sector average.

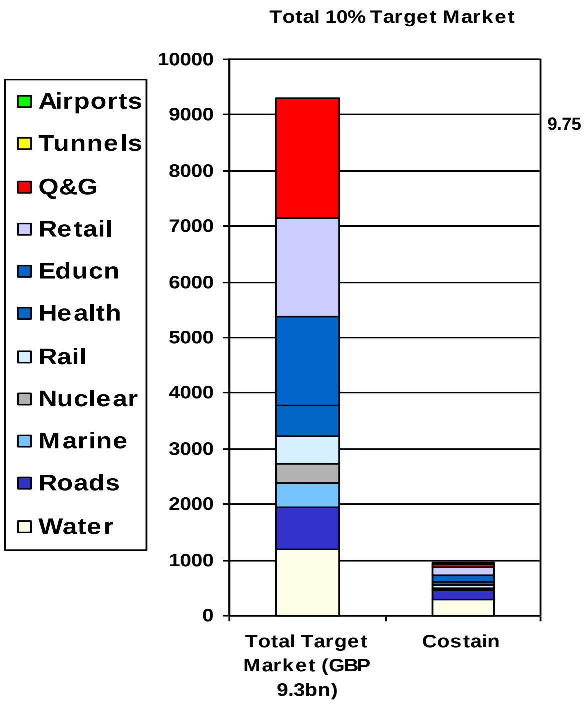
Recent Developments

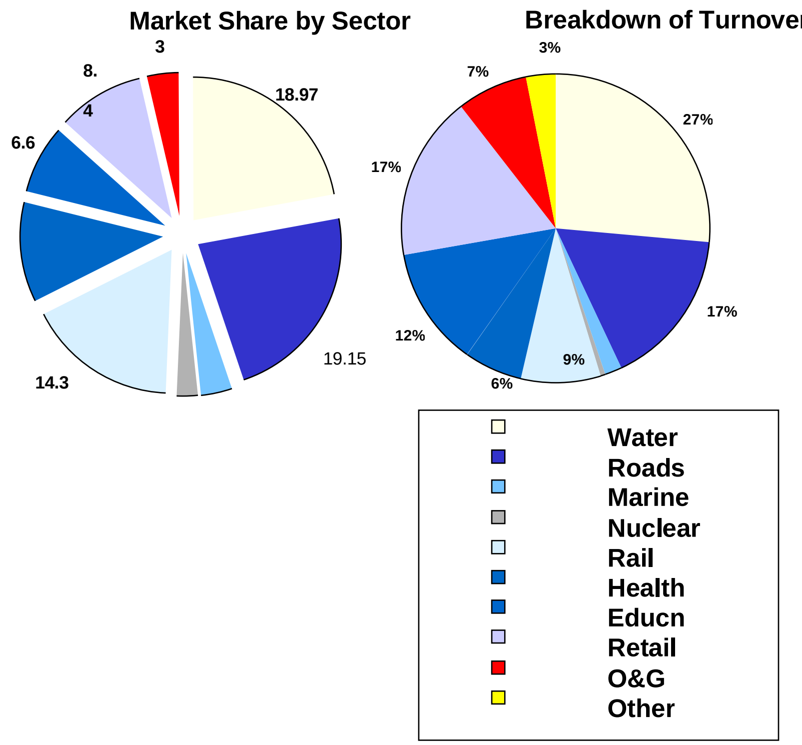
Costain has become the market leader in highways operations and maintenance in the UK and is now responsible for maintaining approximately a third of the UK's motorway network. Signifi cant highways projects which Costain is currently undertaking include the M25 Bell Common Tunnel refurbishment, the A34 Wolvercote Viaduct replacement and the M53 Bidston Moss Viaduct refurbishment. Costain's energy and process division has continued to deliver specialist expertise in nuclear design, process modularisation, and underground gas storage at complex projects such as the Stublach Underground Gas Storage Facility in Cheshire.

Pension Deficit Problem



Product Mix



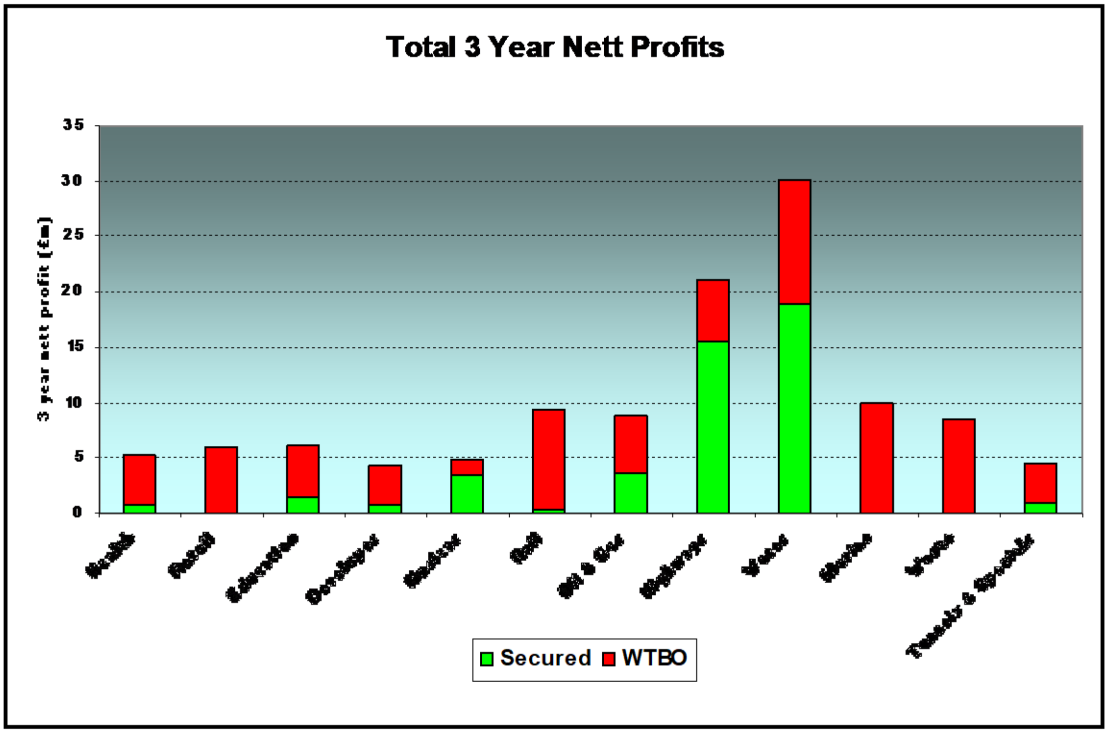


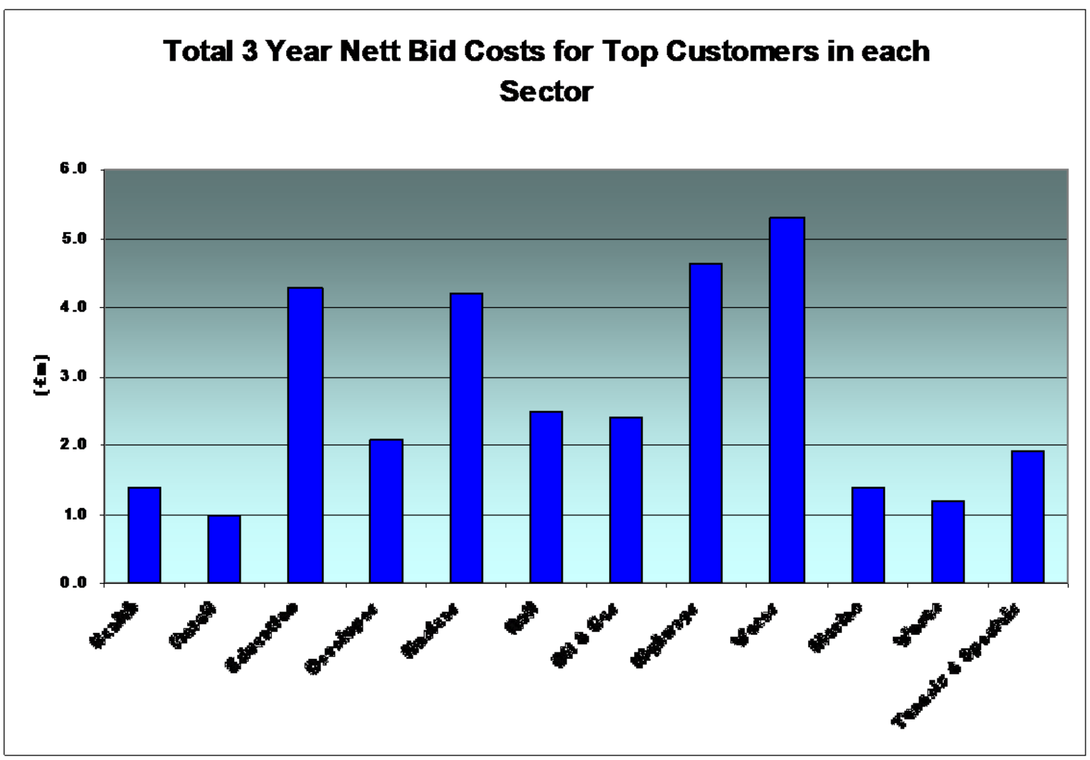
Costain Key Account Customers (Source Costain 2008)

Rank	Customer	Anticipated 3 yr net contribution (£M)
1	Southern Water	13.7
2	LUL/DLR	13.4
3	BNG Sellafield	10.0
4	HA	8.4
5	Tunnels	8.3
6	AWE	6.8
7	Viridor Waste	5.5
8	Severn Trent	4.7
9	Waste (Others)	4.9
10	BSF/DFES	3.8
11	Hutchison	3.7
12	Thames Water	3.6
13	United Utilities	3.6
14	DoH P21	3.6
15	Crossrail	3.5

Rank	Customer	Anticipated 3 yr net contribution (£M)
16	CCE	3.3
17	Magnox	3.3
18	Yorkshire Water	3.1
19	INEOS	3.0
20	Tesco	3.0
21	TfL	2.8
22	ADMA	2.5
23	Quintain	2.5
24	DPW	2.5
25	WAG	2.4
26	Sainsburys	2.0
27	Shearer	2.0
28	ODA	1.9
29	New BSF	1.9
30	Thames link	1.9

Forecast 3 Year Net Profits (Secured/WTBO) v. 3 Year Net Bid Costs (2008)





Costains profits are derived from its Strong positions in the Water & Roads sectors. Its overhead and work winning expenses incuured in its Building sectors are disproportionate to returns and has resulted in a reduction of targeted Building work since 2008.

2.2 Performance

Valuations

Independent Analyst Valuations regularly state that the prevailing Market Capitalisation is at a discount to the Sum Of The Part (SOP) Valuation.

Current market value £135m

Sum of parts valuation (approx.):

>	Construction	£140m
>	Oil & Gas	£21m
>	Property Development	£30m
>	PFI equity	£44m
		£235m

Net asset value (31/12/09) (£4m)

2.2.2 Recent Operating Trends

	2007	2008	2009
Turnover (£m)	878	996	1061
PBT (£m)	19.8	23.1	18.1
Net Assets (£m)	27.4	33.6	(3.8)
Net Cash (£m)	132.8	146.6	120.5
Operating Profit (£m)	16.5	18.3	20.8
Operating Cash Flow (£m)	20.3	23.3	(16.1)
Op CF (Before WC Changes)	12.7	23.6	26.7

Operating Cash Flow and Working capital Changes need further investigation. Increases in Receivables have been (£13.3m); £24.7m; £32.7m in 2007/8/9 respectively. Net Cash has dropped and comparison of Operating Profit and operating Cash Flow, once again cast a shadow over Work-in-Progress valuation. Building Division remains a major problem in terms of Cash Flow and profitability.

See references in further Accounts Analysis.

Historic Performance

The 15 Year Historic Performance Analysis (over page) demonstrates the problems Costain Plc has had as a Group to survive since its near demise in 1992, caused principally by losses and poor investments made in US Coal Mining at the time.

Four subsequent CEO's have failed to re-build the Balance Sheet to sufficient levels to underpin investment outside pure contracting activities since. Kharafi Group and UEM have been long suffering shareholders and received little pay-back in terms of dividends or capital gain.

Meanwhile the Group continues to support a PLC overhead structure, including all the costs associated with maintaining a listing on the stock exchange. There are significant cash savings that could be made via a delisting and amalgamation within a larger Grouping which could manage its flagging Building business and grow its core competences in heavy civil engineering and process contracting in Water, Roads, Waste, Nuclear and Oil & Gas. There have been recent presentations to Analysts in Waste/O&G/Nuclear.

Presentations to Analysts

Analyst Site Visit 2/3 July 2009 - Welcome (PDF 1.42mb) ; Analyst Site Visit 2/3 July 2009 - Waste (PDF 372kb) ;Analyst Site Visit 2/3 July 2009 - Greater Manchester Waste Disposal Authority (PDF 1.4mb); Analyst Site Visit 2/3 July 2009 - COGAP (PDF 4.0mb); Analyst Site Visit 2/3 July 2009 - Nuclear (PDF 945kb); Analyst Site Visit 2/3 July 2009 - EVAP D (PDF 2.68mb)

15 year Case History

Section 3 Acquisition Approach

3.1 Acquisition Strategy

Major Shareholders/ Non Executive Directors

The top 4 shareholders of Costain control 53% of the shares. The issued share capital of the Company as at 31 December 2009 was £31,712,435.65, consisting of 634,248,713 ordinary shares of 5 pence each. As at 9 March 2010, the Company had been notified, in accordance with the Disclosure and Transparency Rules issued by the Financial Services Authority, of the following interests in its ordinary share capital:

- Mohammed Abdulmohsin Al-Kharafi & Sons WLL 138,544,915 21.84%
- York Place Limited 138,108,505 21.78%(UEM Builders Berhad owns 100% of York Place Limited).
- Gartmore Investments Limited 32,148,621 5.07%
- Legal & General Group PLC 25,858,465 4.08%

A non-executive director is nominated by major shareholder, Mohammed Abdulmohsin Al-Kharafi & Sons WLL. Until 4 December 2009, a non-executive director was nominated by York Place Limited, a subsidiary of UEM Builders Berhad, the other major shareholder. UEM Builders Berhad have not yet taken advantage of the right to nominate a successor to the non-executive director who retired on 4 December 2009.

While the LSE will not allow negotiation with any major shareholder that might affect minority shareholders' interets, there is still opportunity to talk with the 4 shareholders who own a controlling a majority share. Al Karafi & Sons have been shareholders since the rescue plan in 1992. They are a successful diversified Middle East Conglomerate, and major construction company in their own right. Contact can be made direct to its owner Nasser Al kharafi as to his price aspirations for sale of his shares over the LSE. His interest in a back-to-back purchase of Kier shares and appointment as a Non Executive Director on Kier Board in return for wider cooperation in international joint ventures may be negotiable.

UEM are a Government owned Malaysian construction group which inherited its shares in Costain from Intria, after its nationalization. Its Holding Company (Khazanah) is seeking to divest its shareholding, and UEM failed to take up its full entitlement of shares during the 2007 Costain Rights Issue, choosing to "swallow its tail" and dilute from a 33% holding down to 21.8%. The Carrying Value of Costain's shares on UEM's balance Sheet are at historic cost so any divestment comes with an accounting profit. Although the Costain contribution to UEM in terms of cash dividend and Associate company profits have improved over recent years, UEM is still considered a willing seller of shares.

Gartmore Investments limited are Institutional Investors who entered the stock via the take-up of UEM Rights at the time of the above mentioned Rights Issue.

It is anticipated that the above Shareholders would accept a Cash Offer, or possible combined Cash/Share offer that values their Costain shares at a premium of c.60% to current Market Value.

The strategy should be to "sound-out" Kharafi and UEM, and build a small stakeholding in Costain shares, prior to a General Offer, based on Costain's poor operating cash flow performance, and Kier's ability to sort out its Building Division problems; leverage its Heavy Civil Engineering and Process Order Book; and offer comfort over long term ability to manage the Pension Deficit.

3.2 Evaluation/ Return on Investment

Best Scenario ROI

CASH FLOW NPV VALUATION										
Net assets	-3.8									
Current Market Capitalisation	121.4									
33% Premium	161.5									
Best scenario	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**
Kier Cash Investment	-161.5									
Cash transfer from/(to) Balance Sheet	120.5	-10.0	-10.0	-10.0	-10.0	-10.0	-10.0	-10.0	-10.0	-10.0
Cash from Costain Operations	29.4	32.3	35.5	39.1	43.0	47.3	52.0	57.2	63.0	69.3
Changes in Working Capital	-4.4	-4.8	-5.3	-5.9	-6.5	-7.1	-7.8	-8.6	-9.4	-10.4
Cash from Investing Activities	-2.9	-3.2	-3.6	-3.9	-4.3	-4.7	-5.2	-5.7	-6.3	-6.9
Tax	-4.8	-5.6	-6.4	-7.3	-8.4	-9.7	-11.2	-12.8	-14.8	-17.0
Payment/Contributions to Pension Fund	-5.0	-5.0	-5.0	-5.0	-5.0	-5.0	-5.0	-5.0	-5.0	-5.0
Overhead/Synergy savings	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0
Extraordinary/Redundancy Costs	-8.0	-1.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net Cash Flow	**-26.8**	**12.7**	**15.3**	**17.0**	**18.8**	**20.8**	**22.9**	**25.1**	**27.4**	**29.9**
NPV	77.2									
IRR	58.95									
Goodwill	-157.7									
Net cash Investment (Yr 1)	-26.8									

Worst Case Scenario ROI

CASH FLOW NPV VALUATION										
Net assets	-3.8									
Current Market Capitalisation	121.4									
60% Premium	194.2									
Worst Scenario	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**
Kier Cash Investment	-194.2									
Cash transfer from/(to) Balance Sheet	110.0	-15.0	-15.0	-15.0	-15.0	-15.0	-15.0	-15.0	-15.0	-15.0
Cash from Costain Operations	20.0	22.0	24.2	26.6	29.3	32.2	35.4	39.0	42.9	47.2
Changes in Working Capital	-4.0	-4.4	-4.8	-5.3	-5.9	-6.4	-7.1	-7.8	-8.6	-9.4
Cash from Investing Activities	-3.0	-3.0	-3.0	-3.0	-3.0	-3.0	-3.0	-3.0	-3.0	-3.0
Tax	-3.0	-3.3	3.6	4.0	4.4	4.8	5.3	5.8	6.4	7.1
Payment/Contributions to Pension Fund	-5.0	-5.0	-5.0	-5.0	-5.0	-5.0	-5.0	-5.0	-5.0	-5.0
Overhead/Synergy savings	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0
Extraordinary/Redundancy Costs	-10.0	-2.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net Cash Flow	**-79.2**	**-0.7**	**10.0**	**12.3**	**14.8**	**17.6**	**20.7**	**24.0**	**27.7**	**31.8**
NPV	3.1									
IRR	12.06%									
Goodwill	-190.4									
Net cash Investment (Yr 1)	-79.2									
Critical Variable Cash Flow from Operations	min 2%									

Evaluation

Costain is a Cash Rich/ Contract Rich opportunistic acquisition target with a strong Brand and Skills Set in heavy Civil Engineering and Process contracting.

Accounting Returns on Net Assets are an inappropriate measure as Net Assets are negative. A better ROI assessment is an IRR analysis on expected cash flows after the investment.

The likely worst case is a 10 year pay-back scenario but the best case scenario shows a nominal net Cash £27m first year investment and a 3 year pay-back. The middle ground would be a 50% premium to current share price which would render a **NPV of £58m, an IRR of 34%, a pay-back of 3 ¼ years, and a net acquisition cost of £50m** (including £3m transaction fees). However a bid in excess of 50% premium maybe required to secure long suffering shareholders’ acceptance (ie. Kharafi/UEM).

Accounting Goodwill at £160-190m (depending on bid premium) including a £105m Pension Deficit on the Balance Sheet (before deferred tax) and losses in the Building Division (£11m) are the downside to an otherwise very cheap acquisition opportunity for KCL to achieve critical mass in its target civil engineering market sectors.

Also of note is the Negative Working Capital (-NA) associated with the Building Division of -£42m, which would involve a large cash outflow from the Balance Sheet should the Division close down, or get transferred to Kier Region’s Balance Sheet.

Contractors’ Financial Accounts are never fully transparent with sometimes subjective WIP valuations hiding reserves, or lack of them. An unsolicited General offer for Costain Plc would not allow for any agreed due diligence. Checks can only therefore be done on published accounts. Comparison of Operating Cash Flow to Operating Profit is always a key item to check. The most critical variable is Costain’s ability to generate cash from its order book and future operations. If an Operating Cash Flow of £23m (eg. 2008) is sustainable/achievable (despite Building losses), and coupled with £10m overhead savings, the returns look good. However, in 2009, Cash Flow after Working Capital Changes was -£16.2m, which may signify both operational losses in Building and a build-up of Receivables on Long Term Contracts (ie. Reserves may be low).

Costain’s Order Book contains some long term Framework contracts (eg. Water), and Maintenance (Highways) in traditional sectors of strength; but also some higher risk forays into EPC risk, like the Manchester Waste project.

Overall Costain has a good cash position, substantial secured contracts portfolio, proven operational management expertise in its core Civils & Process contracting divisions, an unnecessary Plc overhead burden, and potentially a low price tag. It presents an acquisition opportunity of considerable value to KCL.

Section 4 Company Strengths & Weaknesses

4.1 Financial Strengths/Weaknesses

Five-year financial summary

	2009 £m	2008 £m	2007 £m	2006 £m	2005 £m
Summarised consolidated income statement					
Revenue (Group and share of joint ventures and associates)	**1,061.1**	996.0	877.9	886.3	773.20
Less: Share of joint ventures and associates	**(67.7)**	(93.4)	(130.3)	(137.9)	(95.1)
Group revenue	**993.4**	902.6	747.6	748.4	678.1
Group operating profit/(loss)	**22.0**	19.5	9.7	(58.4)	8.7
Profit on sales of investments	**-**	-	2.7	3.6	-
Profit on sales of interests in joint ventures and associates	**2.0**	2.7	3.2	-	3.5
Amounts written off loans to associate	**-**	-	-	(2.7)	-
Share of results of joint ventures and associates	**(3.2)**	(3.9)	0.9	(7.0)	13.4
Profit/(loss) from operations	**20.8**	18.3	16.5	(64.5)	25.6
Finance income	**26.0**	34.8	29.6	26.7	23.5
Finance expense	**(28.7)**	(30.0)	(26.3)	(23.9)	(24.1)
Net finance income/(expense)	**(2.7)**	4.8	3.3	2.8	(0.6)
Profit/(loss) before tax	**18.1**	23.1	19.8	(61.7)	25.0
Income tax	**(3.5)**	(4.9)	(3.8)	7.7	(1.4)
Profit/(loss) for the year attributable to equity holders of the parent	**14.6**	18.2	16.0	(54.0)	23.6
Earnings/(loss) per share - basic	**2.3p**	2.9p	3.6p	(13.2)p	5.8p
Earnings/(loss) per share - diluted	**2.3p**	2.9p	3.5p	(13.2)p	5.7p
Dividends per ordinary share					
Final	**0.55p**	0.5p	0.5p	-	-
Interim	**0.275p**	0.25p	-	-	-
Summarised consolidated statement of financial position					
Property, plant and equipment	**11.5**	7.7	3.5	5.7	5.9
Intangible assets	**1.0**	1.8	2.7	3.4	3.5
Investments in equity accounted joint ventures and associates	**44.1**	42.7	40.1	35.1	35.4
Other non-current assets	**47.3**	24.9	27.9	40.7	41.3
Total non-current assets	**103.9**	77.1	74.2	84.9	86.1
Current assets	**325.1**	329.2	285.7	219.4	243.7
Total assets	**429.0**	406.3	359.9	304.3	329.8
Current liabilities	**320.5**	312.1	273.2	280.1	238.8
Pension liability	**104.7**	50.2	50.6	68.7	99.3
Other non-current liabilities	**7.6**	10.4	8.7	10.7	14.2
Total liabilities	**432.8**	372.7	332.5	359.5	352.3
Equity attributable to equity holders of the parent	**(3.8)**	33.6	27.4	(55.2)	(22.5)

The jump in 2008-2009 Pension liability and increase in Current Assets (Work-in-Progress) are significant changes to note. Operating Cash Flow before changes in Working Capital were £23.6m and £26.7m in 2008/9 respectively, whilst overall Cash Flow from Operations were £23.3m and 9£16.1m) respectively.

Analysts predict an increase in Operating Profits in 2010, as losses in the Building division are stemmed.

Published Year End Financial Statement (31st Dec 2009)

Year ended 31 December	2009	2008
Revenue	£1,061.1m	£996.0m
Profit from operations	£20.8m	£18.3m
Profit before tax	£18.1m	£23.1m
Net cash	£120.5m	£146.6m
Earnings per share	2.3p	2.9p
Full year dividend	0.825p	0.75p

Highlights

· Revenue of £1,061.1 million (£996.0 million) exceeds £1 billion for first time in 16 years

· Profit from operations increased by 14% to £20.8 million (2008: £18.3 million)

· Profit before tax of £18.1 million (2008: £23.1 million)

· Strong net cash position of £120.5 million (2008: £146.6 million)

· Record year-end forward order book, up 30% at £2.6 billion (2008: £2.0 billion)

- repeat order customers account for 84%

- includes c. £900 million of secured work for 2010

· In addition, preferred bidder positions at year-end of over £400 million

- increased to over £600 million since year-end

· Banking and bonding facilities recently extended to 2013 and increased by 20% to £345 million

· IAS 19 pension scheme deficit of £75.4 million, net of deferred tax, a similar level to the half-year (2008: £36.1 million)

- defined benefit pension scheme closed to future accrual during the year

· A commitment to delivering a full-service offering, from front-end engineering consultancy and design, through construction to maintenance

· Focussing on the Infrastructure, Environment, and Energy & Process markets where we will place emphasis on those blue-chip customers with repeat order commitments who are looking for solutions for each phase of the 'life cycle' of their assets

Pension

As at 31 December 2009, the deficit in the UK Pension Scheme recorded in the Group's balance sheet in accordance with IAS 19 was £75.4 million, net of deferred tax (31 December 2008: £36.1 million).

During the year, the pension scheme asset value has increased as a result of a recovery in the global equity markets. However, this has been more than offset by an **increase in liabilities due to an increase in inflationary expectations and a reduction in the liability discount rate**.

The most recently completed actuarial valuation of the scheme was performed by the Scheme Actuary as at 31 March 2007. The current monthly Company contribution of £0.9 million towards funding the scheme's deficit will continue until the next formal actuarial valuation of the Scheme, as at 31 March 2010, is finalised.

Divisional Performance

The Environment division incorporates activities in the water, waste and marine sectors. The division's order book increased by 66% to £1.3 billion as a result of securing a number of major long-term contract wins. With significant legislation and regulation in these markets, we expect a high level of investment to continue in these sectors over the coming years.

In the Infrastructure division, which incorporates our activities in the highways, rail and airports sectors, we continued to increase our highways maintenance activity which accounts for the majority of the Group's growing maintenance related activities which, in turn, now represent 13% of the Group's total Order Book. The division has a substantial pipeline of future work opportunities, including the Crossrail project in London.

The Energy & Process division, which undertakes work in the hydrocarbons and chemicals, nuclear processing and power sectors, had an excellent year. We secured further work on the major EVAP D nuclear decommissioning project at Sellafield. There is a growing recognition of the need to invest in UK energy infrastructure and, as a consequence, we see potential for further growth in this sector.

Our Land Development activity in Spain, which is a joint venture with Santander Bank, continued to be subject to very difficult market conditions and, as anticipated, no land transactions were completed. Meanwhile, construction of the marina, near Gibraltar, is nearing completion and, with the first berth sales having been secured, the facility will be operational by mid-2010.

The Community division, which encompasses our activities in the health, education and retail sectors, has been intentionally scaled down as we continue to allocate resources to more attractive opportunities. In line with our policy of trading our PFI equity portfolio to reinvest in bidding for new projects, we disposed of two equity stakes in the year.

Order Book

The Order Book includes £1.6 billion of new orders comprising a range of major contract wins across the business. Of particular note was the contract for the Greater Manchester Waste Disposal Authority, AMP 5 contracts for Severn Trent and United Utilities, the Evaporator D nuclear contract, and a further Highways Agency five-year Management Agent Contract (MAC) contract.

Given our strategic focus on blue chip customers with long-term or multi-project investment programmes, our repeat order level has remained well over 80%. We were also delighted to secure a number of major new customers during the year including Severn Trent Water.

The Order Book includes circa £900 million of work to be carried out in 2010, which is ahead of the equivalent figure at the start of last year. The larger, longer-term contracts being awarded to us by our customers provide significantly enhanced visibility of future revenues.

Since the year-end, we have continued to secure major new contracts and preferred bidder positions, including Welsh Water AMP 5 and, in various joint ventures, the A8 highways project in Northern Ireland, the Royal Oak tunnel portal for Crossrail, appointment to the £2.0 billion Highways Agency Major Project Framework and the MAC 14 five-year highways maintenance contract. As a consequence, the order book has been maintained at £2.6 billion and our preferred bidder position has increased to over £600 million.

Market conditions are expected to remain challenging but, as a result of our strategy, we have a good pipeline of opportunities and our bidding teams remain fully occupied.

Finances

We maintained a strong net cash position, which at the end of the year was £120.5 million. The average month end cash balance increased to £125.3 million, up from an average of £117.4 million in 2008. The Group has no significant borrowings.

Our banking and bonding facilities have recently been extended to 2013, and increased by 20% to £345 million. We therefore have the necessary headroom available to capitalise on market opportunities as they arise and achieve our longer-term strategic objectives.

Health, Safety and the Environment

Costain places the highest priority on the effective management of Health, Safety and the Environment. The Group has a policy requiring all staff and supply chain partners to possess an appropriate safety competency card and members of the Board demonstrated leadership in this respect by obtaining their CSCS card.

Further improvement in performance was achieved in the year, with the Group Accident Frequency Rate (AFR) reducing from 0.17 to 0.16, which continues to compare favourably with our major contractor peer group. We remain fully committed to continue to achieve improvements in this performance in the future.

Consolidated income statement

Year ended 31 December

	Notes	2009	2008
		£m	£m
Revenue (Group and share of joint ventures and associates)	2	1,061.1	996.0
Share of joint ventures and associates	7	(67.7)	(93.4)
Group revenue		993.4	902.6
Cost of sales		(949.2)	(861.3)
Gross profit		44.2	41.3
Administrative expenses		(22.2)	(21.8)
Group operating profit		22.0	19.5
Profit on sales of interests in joint ventures and associates		2.0	2.7
Share of results of equity accounted joint ventures and associates	7	(3.2)	(3.9)
Profit from operations	2	20.8	18.3
Finance income	3	26.0	34.8
Finance costs	3	(28.7)	(30.0)
Net finance (expense)/income		(2.7)	4.8
Profit before tax		18.1	23.1
Income tax expense	4	(3.5)	(4.9)

Consolidated statement of financial position

As at 31 December

	Notes	2009	2008
		£m	£m
ASSETS			
Non-current assets			
Property, plant & equipment		11.5	7.7
Intangible assets		1.0	1.8
Investments in joint ventures		27.2	32.2
Investments in associates		1.6	0.1
Loans to joint ventures		12.8	9.5
Loans to associates		2.5	0.9
Other receivables		12.7	6.0
Deferred income tax assets		34.6	18.9
Total non-current assets		103.9	77.1
Current assets			
Inventories		2.4	1.6
Trade and other receivables		201.9	180.3
Cash and cash equivalents	8	120.8	147.3
Total current assets		325.1	329.2
Total assets		429.0	406.3
EQUITY			
Share capital		31.7	31.7
Share premium		1.9	1.7
Foreign currency translation reserve		7.0	10.6
Hedging reserve		(9.0)	(12.7)
Retained earnings		(35.4)	2.3

Total equity attributable to equity holders of the parent		(3.8)	33.6
LIABILITIES			
Non-current liabilities			
Retirement benefit obligations	9	104.7	50.2
Other payables		4.5	2.4
Provisions for other liabilities and charges		3.1	8.0
Total non-current liabilities		112.3	60.6
Current liabilities			
Trade and other payables		313.3	305.0
Income tax liabilities		1.7	1.7
Overdrafts	8	0.3	0.4
Interest bearing loans and borrowings		-	0.3
Provisions for other liabilities and charges		5.2	4.7
Total current liabilities		320.5	312.1
Total liabilities		432.8	372.7
Total equity and liabilities		429.0	406.3

Consolidated cash flow statement
Year ended 31 December

	Notes	2009	2008
		£m	£m
Cash flows from operating activities			
Profit for the year		14.6	18.2
Adjustments for:			
Depreciation of property, plant & equipment		2.7	2.1
Amortisation of intangible assets		0.9	1.0
Finance income	3	(26.0)	(34.8)
Finance costs	3	28.7	30.0
Share-based payments expense		1.1	0.6
Income tax	4	3.5	4.9
Profit on sales of interests in joint ventures and associates		(2.0)	(2.7)
Share of results of joint ventures and associates	7	3.2	3.9
Amounts written off equity and loan to associates	7	-	0.4
Cash from operations before changes in working capital and provisions		26.7	23.6
(Increase) / decrease in inventories		(0.8)	0.4
Increase in receivables		(32.7)	(24.7)
Increase in payables		9.1	35.5
Movement in provisions and employee benefits		(18.4)	(11.5)
Cash from operations		(16.1)	23.3
Interest paid		(0.5)	(0.7)
Income tax received		0.1	-
Net cash from operating activities		(16.5)	22.6
Cash flows used by investing activities			
Interest received		2.6	6.5

Dividends received from joint ventures and associates		0.6	0.7
Additions to property, plant & equipment		(7.2)	(5.8)
Additions to intangible assets		(0.1)	(0.1)
Proceeds of disposal of property, plant & equipment		0.4	-
Proceeds from sales of interests in joint ventures and associates		8.7	5.0
Additions to investment in joint ventures and associates		(0.2)	-
Loan repayments by joint ventures and associates		0.7	-
Additions to loans to joint ventures and associates		(9.7)	(11.7)
Net cash used by investing activities		(4.2)	(5.4)
Cash flows used by financing activities			
Issue of ordinary share capital		-	0.7
Ordinary dividends paid		(4.7)	(4.5)
Repayment of borrowings		(0.3)	(0.3)
Net cash used by financing activities		(5.0)	(4.1)
Net (decrease) / increase in cash, cash equivalents and overdrafts		(25.7)	13.1
Cash, cash equivalents and overdrafts at beginning of the year	8	146.9	133.4
Effect of foreign exchange rate changes		(0.7)	0.4
Cash, cash equivalents and overdrafts at end of the year	8	120.5	146.9

Notes to the financial statements

Pensions

The Group operates a defined benefit pension scheme in the United Kingdom and a number of defined contribution type pension plans in the United Kingdom and overseas. Contributions are paid by subsidiary undertakings and employees. The total pension charge for the Group in the Consolidated income statement was £11.5 million (2008: £8.4 million).

Defined benefit scheme

The defined benefit scheme was closed to new members on 1 June 2005 and from 1 April 2006, future benefits were calculated on a Career Average Revalued Earnings basis. The scheme was closed to future accrual of benefits to members on 30 September 2009. A full actuarial valuation of the scheme was carried out at 31 March 2007 and was updated to 31 December 2009 by a qualified independent actuary.

	2009	2008	2007
	£m	£m	£m
Present value of defined benefit obligations	(560.5)	(435.8)	(511.1)
Fair value of scheme assets	455.8	385.6	460.5
Recognised liability for defined benefit obligations	(104.7)	(50.2)	(50.6)

Movements in present value of defined benefit obligations:

	2009	2008
	£m	£m
At 1 January	435.8	511.1
Current service cost	1.7	4.7
Past service cost	1.2	1.2
Interest cost	28.2	29.3
Actuarial losses /(gains)	113.7	(94.6)
Benefits paid	(23.1)	(19.8)
Contributions by members	3.0	3.9
At 31 December	560.5	435.8

Movements in fair value of scheme assets:

	2009 £m	2008 £m
At 1 January	385.6	460.5
Expected return on scheme assets	23.4	28.3
Actuarial gains/ (losses)	46.3	(105.1)
Contributions by employer	20.6	17.8
Contributions by members	3.0	3.9
Benefits paid	(23.1)	(19.8)
At 31 December	455.8	385.6

Expense recognised in the income statement:

	2009 £m	2008 £m
Current service cost	1.7	4.7
Past service cost	1.2	1.2
Interest cost on defined benefit obligations	28.2	29.3
Expected return on scheme assets	(23.4)	(28.3)
Total	7.7	6.9

	2009 £m	2008 £m
Cost of sales	2.6	5.2
Administrative expenses	0.3	0.7
Financial income	(23.4)	(28.3)
Finance costs	28.2	29.3
Total	7.7	6.9

Principal actuarial assumptions (expressed as weighted averages):

	2009 %	2008 %
Discount rate	5.70	6.60
Expected rate of return on scheme assets	6.51	6.07
Future salary increases	3.50	2.85
Future pension increases	3.50	2.85
Inflation assumption	3.50	2.85

The expected rate of return on scheme assets is determined by reference to relevant indices. The overall expected rate of return is calculated by weighting the individual rates in accordance with the anticipated balance in the scheme's investment portfolio.

Weighted average life expectancy from age 65 as per mortality tables used to determine benefits at 31 December 2009 and 31 December 2008 is:

	2009		2008	
	Male (years)	Female (years)	Male (years)	Female (years)
Currently aged 65	20.3	23.2	20.3	23.1
Non-retirees	21.3	24.1	21.3	24.0

The discount rate, inflation and pension increase and mortality assumptions have a significant effect on the amounts reported. Changes in these assumptions would have the following effects on the Group's defined benefit scheme:

	Pension liability £m	Pension cost £m
Increase discount rate by 0.25%, decreases pension liability and increases pension cost by:	(21.2)	0.1
Decrease inflation (and pension increases) by 0.25%, decreases pension liability and pension cost by:	(18.2)	(1.0)
Increase life expectancy by one year, increases pension liability and pension cost by:	15.5	0.9

Critical Analysis of Historic 2007 Accounts

AUTHOR- Greg Malpass, Abu Dhabi

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1. There remains uncertainty about the profitability of the Building Division's Work-in-hand and whether current Provisions are adequate to cover losses on Bradford and Lewisham PFIs D+B contracts and now St Paul's in Birmingham. The division does not produce operating profits sufficient to carry its true level of overhead and work winning costs. The viability of this business and its ability to attain industry average margins of 1% is questionable. Nevertheless its GBP41.8m negative assets/working capital contributes to the Group's cash balances and a loss of volume would result in a large cash outflow. The declared "Strong Performance" and Profit "in all operations" are not substantiated in the analysis. The Building Division showed a GBP2.3m loss from operations, and there is also a level of the GBP6.4m unallocated overheads attributable to Building and PFI [Note 2]. International lost GBP0.2m The analysis raises further questions about Profit taking, movements in Contract Reserves/Provisions and Working Capital, and investments in Joint Ventures. Claims of "a strong recovery in performance" and "looking forward with great confidence" appear overstated, have not contributed to strengthen the share price greatly, and expose the Group if 2008 targets are not achieved.
2. The evidence is that 2007 results were underpinned by a reliance on non-operating cash flow and profits-Rights Issue funds, Sale of Assets and Investments, and unexplained movements in Trade and other receivables. These may be explainable by the timing of cash flows and project cycles, but the questions which the analysis raises are:

QUESTIONS:

- Why have Trade Receivables changed by GBP24m? What's the detail of GBP 22.7m drop in Building Assets & GBP 6.5m increase in loans to Joint Ventures during the year?
- Why have 'Amounts due from customers for contract work' risen by GBP10.1m, despite a reduced turnover and reduced level of retentions? The imbalance in changes in receivables/recoverables is GBP8.3m and a cash analysis is required to rule out the conclusion of non-prudent profit taking.
- Why have extra loans of GBP10.1m been made to Joint Ventures? The declared Net Assets of JVs have risen by just GBP2.7m. Are these loans fully recoverable?

ANALYSIS NOTES:

A. Little evidence of strong operating cash flow to justify dividend payment with GBP36.4m pension deficit.

B. Full allocation of overheads would disclose further losses in Building, International and Oil & Gas divisions.

C. Description as "Lean Business" with Group overheads at over 6% are not justified when comparison with Peer Groups is made.

D. Executive Bonuses based on Profit and Order Book performance seem excessive when Operating Cash Flow does not support the Profits declared, and the Share Price performance has been poor.

E. Cash from selling PFI assets should be focused purely on "Re-bidding" PFIs to warrant tabling their sale as operating profit. PFI investments and directors' Valuations should be separately analyzed in the Annual Report. Overall Profit contribution from sale of PFIs and investments (Bridge End, Sirhowy Enterprise Way, CWA) total GBP5.9m and provided GBP9.4m cash [Note 3]. The subsequent successful Cash Call (Rights Issue & Secondary Offering) by CWA in Lagos of GBP30+m dwarfs this contribution from selling assets.

F. The low level of interest receivable on Bank Balances and JV accounts over the full year [Notes 6,11] are indicative of the low cash balances which forced a Rights Issue (See Emperors' Clothes Analysis)

G. Overall Negative Net Assets/ Working Capital of the operating divisions is -GBP99.8m [Note 2]. The high year end cash figure is from a combination of the Rights Issue proceeds, timing of cash flows on projects, movements in working capital, squeezing debtors, and sale of assets and investments. Profit recognition on Work in Progress needs further scrutiny.

H. There remains uncertainty on several contracts as to final outturn and if estimates are wrong further write-downs may be necessary? GBP6.1m of Provisions were utilized in the year and only GBP1.7m remain [Note 17]. Costa Azul and Pemex are cited as projects at risk but fully provided for [Note 25], but Lewisham, Bradford and St Paul's are not mentioned. Weaknesses in the Building business is a risk for the company going forward that requires further attention.

I. Declared GBP12.7m of operating Cash Flow backing a GBP9.7m Operating Profit runs in parallel with GBP9.3m of extra loans to Joint Ventures. Is there any link in the two in any way?

J. In WIP retentions are down GBP4.7m yet amounts due from customers is up GBP10.1m, and there is no allowance for bad debts. Doesn't seem prudent/ conservative?

NUMBERS:

Operating Profit

Declared Operating Profit	GBP9.7m	GBP 6.1m Provisions utilized
Profit from Asset Sales	GBP5.9m	
Movements in Amounts due from Customers on Contracts [Note 12]	GBP9.9m	Cash Flow v. Profit Analysis required. Are Contract Valuations conservative?

Operating Cash Flow

Declared Operating Cash Flow	GBP20.3m	[Consolidated Cash Flow Statement]
Cash Flow before Working Capital changes	GBP12.7m	
Movements in Trade Receivables	-GBP24.0m	[Note 12]
Extra Loans to Joint Ventures	GBP10.1	Any link to declared Operating Cash Flow?
Working Capital Changes	Require further analysis/	Explanation.

Cash Balances

Net Interest on Bank Balances	GBP2.9m	[Note 11]
Net Interest on JV Bank Balances	-GBP0.3m	Why are having to fund/loan to these?
Changes in Trade Receivables	GBP24.0m	[Note 12]
Changes in Trade Payables	-GBP6.0m	The imbalance needs explanation
Overall Movements in Cash	GBP78.4m	[Consolidated Cash Flow Statement]
Rights Issue (Gross)	GBP65.0m	
Net Cash generated	GBP13.4m	
GBP12.7 Operating Cash	Flow declared	GBP9.3m Loan to JVs?

End ”

Comment on Accounts 2008/9

The major Balance Sheet change is the jump in the Recognised Liability for Defined Pension Benefit Obligations from £50.6m in 2007/8 to £104.7m in 2009. The actuarial losses are very sensitive to discount rate, inflation and pension increase and mortality assumptions.

Building losses have increased from £8.5m in 2008 to £11m in 2009, but have probably peaked. Operating Cash Flow was strong in 2008 at £23m and stronger in 2009 at £27m (before the £43m spurious changes in Working Capital of Provisions and changes in Contract Receivables). Over the year the free cash fell £26.4m, so it is indicative of the negative Cash Flow.

The strength of Costain lies in its Order Book, and ability to generate good operating profits moving forward, augmented by the savings that can be made through merging operations with Kier.

4.2 Sector Strengths complimentary to KCL

Environment

The Environment division accounts for 50% of the Costain's Order Book, which includes Costain's water, waste and marine activities. Revenue (including share of joint ventures and associates) for the year was £426.1 million (2008: £417.0 million), with an operating profit of £11.7 million (2008: £11.6 million). The division's year-end order book was £1.3 billion (2008: £0.8 billion), an increase of over 60%.

In **Water**, Costain continues delivery of major AMP4 programmes of clean and waste water schemes for Yorkshire Water, Welsh Water, United Utilities, Thames Water, Bristol Water and Southern Water. In terms of securing major contracts under the fifth five-year Asset Management Programme (AMP5) which runs from 2010 to 2015 Costain has continued to be successful in renewing and securing new AMP 5 contracts. During 2009 it renewed the relationship with United Utilities for another five years and secured a £400 million 10-year framework for new AMP customer, Severn Trent Water. Since the year-end they have also renewed the relationship with Welsh Water for a further five years. This compliments Kier's NW Framework with United Utilities and would make Kier the largest Water Framework contractor in the UK.

During 2009, Costain, in joint venture, was also awarded the £225 million Brighton & Hove waste water treatment works contract for Southern Water.

In **Waste**, continued growth and expansion was underlined in the first half of 2009 with the award of the £400 million Greater Manchester Waste Authority contract, the largest waste services contract in Europe. This was secured by leveraging Costain's complementary skills in waste and process engineering and provides a firm platform for future growth. Costain is currently actively engaged in submission of PFI proposals for major waste facilities and further opportunities in this growing sector. While an excellent lead in the Waste sector where Kier has yet to secure a major order, it also represents PFI/EPC risk that requires due diligence.

In **Marine**, the Felixstowe South Reconfiguration project is well advanced and is due to be completed in December 2010. This project, for a 730m deepwater container quay, will also provide 32 hectares of associated container yard and port service areas. St. Germans pumping station is now entering the commissioning phase, with the main building completed, representing the second largest pumping station in Europe. With Kier's major project experience on Hook in Milford Haven, this places Kier/Costain as the best qualified contractor in the sector.

Infrastructure

Costain's Infrastructure division accounts for 38% of the Group's Order Book and includes Costain's **highways, rail and airports** activities. Revenue (including share of joint ventures and associates) was £364.8 million (2008: £208.7 million), with an operating profit of £16.9 million (2008 £14.4 million). The division's year-end order book increased by 10% to £1.0 billion (2008: £0.9 billion).

Costain continues to build on its strong market leading position in infrastructure and demonstrates a good delivery record and also provides confidence that Costain is in an advantageous position to secure continued progress in these sectors on schemes such as Crossrail, the Highways Agency's Managed Motorway Programme, London Underground's station enhancement programme and new Nuclear Power Stations to support the continued and growing investment by customers in the infrastructure markets.

Roads is a new/ add-on sector for Kier, and combined strength in Rail and Nuclear will provide competitive advantage. Also significantly in roads, Costain's Highways Operations and Maintenance joint venture is now the leading supplier to the UK's Highways Agency and currently is responsible for maintaining approximately one third of the Agency's UK motorway and road network. The Group also commenced the first of the Highways Agency's Managed Motorway Programme projects on the M1 between Junctions 10 to 13 following on from the its Early Contractor Involvement contract to develop the scheme.

In **Rail**, Costain successfully completed the refurbishment of the Grade 1 listed King's Cross Station Eastern Range for Network Rail and achieved all 'key output zero' deliverables at Farringdon Station on the ambitious Thameslink programme. The Group delivered a major part of London Underground's 'Cooling the Tube' programme on the Victoria line including fans to remove some 120m^3 of warm air per second.

In **Airports**, Costain is a preferred contractor at Gatwick and working on site at the airport's North Terminal. The Group has secured the renewal of its successful five-year framework with the Manchester Airport Group.

Community

The Community division includes the Group's reduced health, education and retail activities and is in disarray and responsible for substantial losses and cash outflow at Costain. Revenue (including share of joint ventures and associates) for 2009 was £167.8 million (2008: £285.6 million), with an operating loss of £8.4 million (2008: loss of £5.2 million).

The increased loss reflects additional costs necessary to complete a number of projects together with restructuring costs and reduced overhead recovery as the operations are scaled down. If Costain were to be acquired by Kier, KCL would assign all Costain Building projects to Kier Regional for completion, reducing losses.

In **Education**, Costain, in joint venture partnership, achieved financial close on four further secondary schools in Bradford under the Government's 'Building Schools for the Future' ('BSF') programme. Two schools under the Lewisham BSF have been completed and delivered and the first Phase 2 school has commenced on site. These and future projects would be assigned to Kier’s stronger Regional business network in Education.

Energy & Process

This is a welcome addition to the KCL skill set. Costain’s revenue in the Process sectors (including share of joint ventures and associates) for 2009 was £101.2 million (2008: £83.6 million) with an operating profit of £9.3 million (2008: £5.5 million). The division's order book increased 57% to £180 million (2008: £115 million). The division comprises three core activities including Hydrocarbons & Chemicals, Nuclear and Power.

In Nuclear, Costain has made significant progress on the engineering and construction of the Evaporator D project at Sellafield, one of the UK's largest nuclear decommissioning projects. The Group continues to build its capability in this sector and currently has in excess of 300 specialists based in Manchester. The operation in Abu Dhabi continues to undertake a number of contracts on the Das Island oil and gas facility.

Costain's ability to bring innovative and effective solutions to complex problems is a significant attraction to Kier in the energy and process market. Additional key resources have been added to the team as part of Costain’s continued investment to significantly grow their activity in this area.

Land Development

The real estate market in Spain has been significantly impacted by the global recession. The Group's joint venture development company, Alcaidesa, continues to secure infrastructure development planning consents on its land bank. This process adds long-term value to the land bank and will facilitate land sales to developers as the market improves. The business is non-core and would be transferred to Kier Developments for disposal in due course, realizing up to £30m cash.

4.3 Risks - Costain Business

Generic

There are a number of generic potential risks and uncertainties which could have a material impact on the Kier Group's business, financial condition or results of operations due to an acquisition of Costain's work in progress and assets and liabilities. The principal risks and uncertainties faced by the Groupin general are:

General economic and political activity, including the extent of any governmental regulation, taxation and interest rates; the Group's ability to undertake accurate due diligence, and retain highly skilled management and personnel; the risk of non-compliance with laws, regulations and standards relating to health and safety and the environment; the pension deficit and the risk that contributions may have to be increased to cover funding shortfalls; change in the UK Government's policies with regard to improving public infrastructure, buildings and services specifically in areas where the Group would expect to compete for work; the risk of incorrectly budgeting/costing long-term contracts; failing to win contracts including the failure to close-out contracts because funding was not available for the project; a failure to meet schedule requirements within contracts which could adversely affect the Group's reputation and/or expose the Group to financial liability; financial failure within the supply chain or the supply chain being responsible for late or inadequate delivery or poor quality of work on a project which damages the Group's reputation and/or causes it to suffer financial loss; a loss of IT systems; claims that exceed the limits of insurance or are uninsurable and procurement delays.

Operational

Costain has struggled to generate a sustainable positive operating cash flow for the last 15 years so its Net Asset base, impaired by its Pensions deficit, remains low. While many Business Improvement measures have been implemented, Costain has sustained significant intermittent losses on overseas and UK building projects.

Costain has also struggled to retain staff, with a high staff turnover rate in recent years, leading to succession planning problems. Its Brand remains very strong overseas and in core UK sectors, but its management has not generated a solid platform for earnings growth. Nevertheless the Group should benefit greatly from being a member of a financially stronger conglomerate that seeks to capitalize on its core skills set, and secure cost savings via realized synergies in combined support structures.

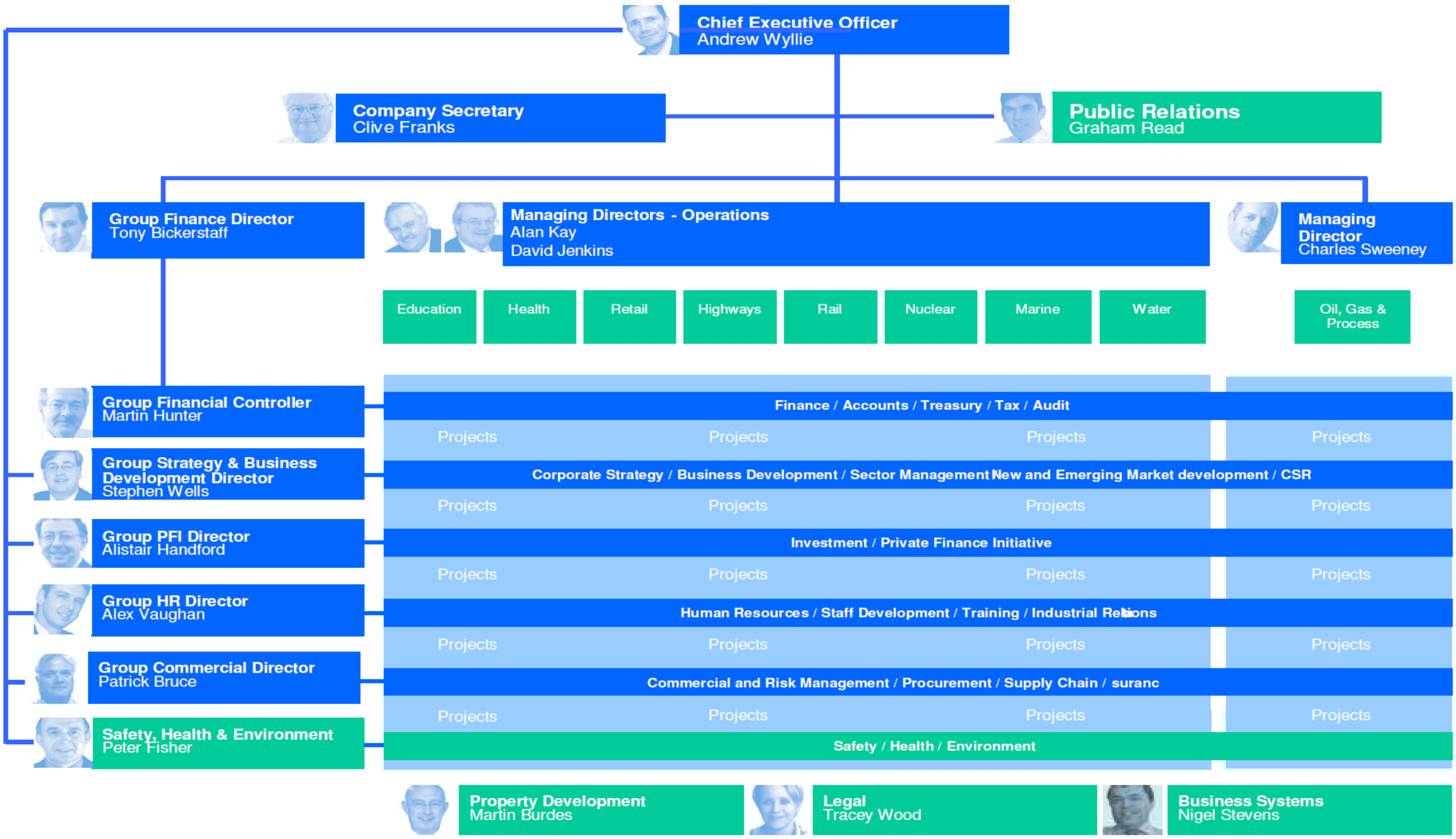
Accounting

The Group believes the most critical accounting policies and significant areas of judgement and estimation arise from the accounting for defined benefit pension schemes under IAS 19 Employee benefits, the accounting for long-term contracts under IAS 11 Construction contracts and assessments of the carrying value of land. Defined benefit pension schemes require significant judgements in relation to the assumptions for inflation, future pension increases, investment returns and member longevity that underpin the valuation. Each year in selecting the appropriate assumptions, the directors take advice from an independent qualified actuary.

The majority of the Group's activities are undertaken via long-term contracts and these contracts are accounted for in accordance with IAS 11, which requires estimates to be made for contract costs and revenues. In many cases, these contractual obligations span more than one reporting period. Also, the costs and revenues may be affected by a number of uncertainties that depend on the outcome of future events and often need to be revised as events unfold and uncertainties are resolved. Management bases its judgements of costs and revenues and its assessment of the expected outcome of each long-term contractual obligation on the latest available information, this includes detailed contract valuations and forecasts of the costs to complete. The estimates of the contract position and the profit earned to date or the forecast loss are updated regularly and significant changes are highlighted through established internal review procedures. The impact of any changes in accounting estimates is then reflected in the ongoing results.

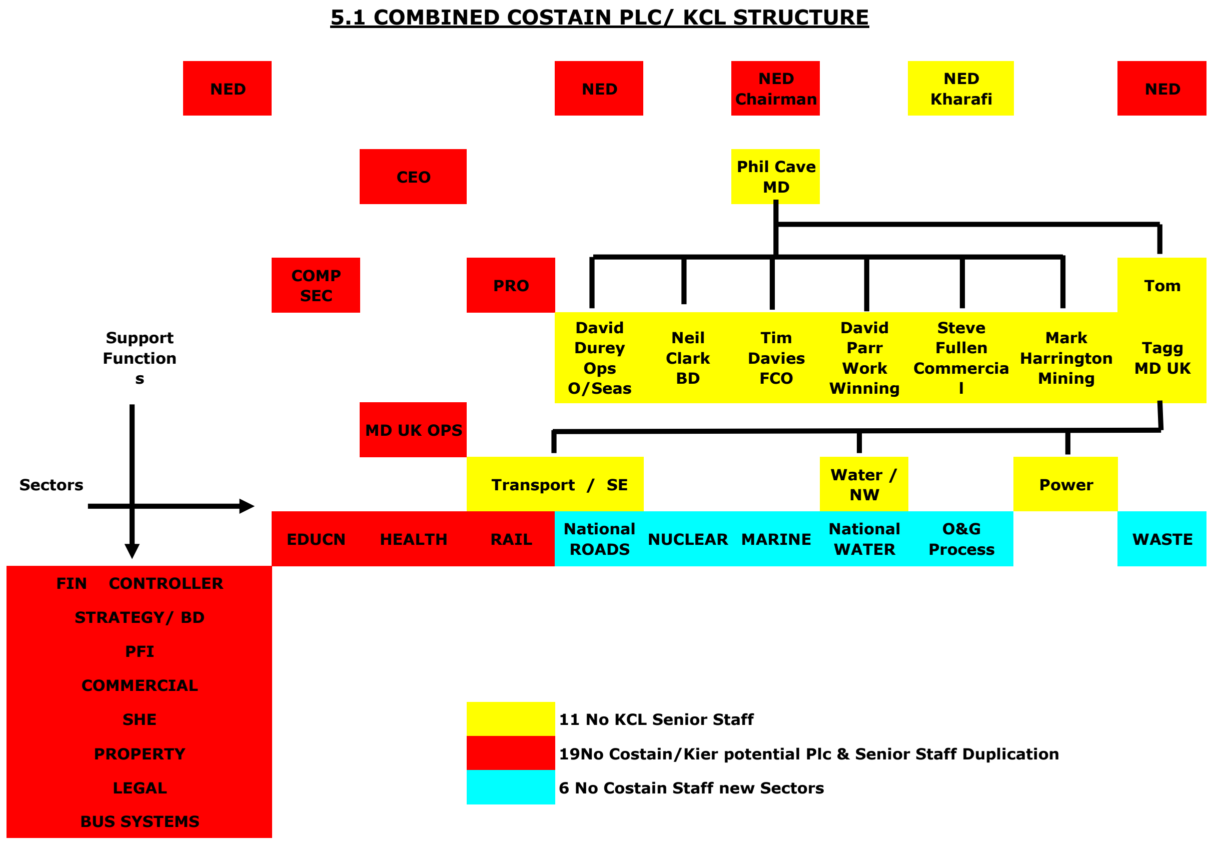
The construction contracts undertaken by the Group may require it to perform extra or change order work and this can result in negotiations over the extent to which the work is outside the scope of the original contract or the price for the extra work. In addition, many contracts specify the completion schedule requirements and allow liquidated damages to be charged in the event of failure to achieve that schedule; on these contracts, this could result in the Group incurring liquidated damages. In assessing the result to be included in the financial statements for each contract, the directors consider the status of negotiations with the customer and the reliability with which the estimated recoverable amounts can be measured.

5. Management & Human Resources



Costain has a full Listed Plc Structure costing c.£6m including Non-Executive Directors, Committees/Audits, etc. These costs would be saved following take-over/ delisting. The Executive Board Structure (above) would be absorbed within KCL and there would be duplications in all Function Support functions as well as some operational/sector roles and regional offices which would render further estimated savings of c.£4m.

5.1 Combined Structure/Savings



Corporate Savings

Costain's Building Division declared a £11m loss in 2009. It also reported Negative Working Capital of £42m. It would be a core strategy of the acquisition to transfer the entire business to Kier Regions. With its revenue of £167m. The remaining revenue £791m (Civils) and £101m (Process) would sit with KCL.

Total overheads within Costain totaled £51m, with a declared £22m "Administrative expenses" in the Consolidated Income Statement.

Of Central Corporate overheads associated with Plc Listing, Main Board Directors, On-costs and associated Accommodation, it is anticipated that a conservative estimate of Corporate Saving is £10m:

Corporate & Senior Staff Savings - £3m; Corporate Plc related Savings- £3m; Accommodation & Support Functions- £4m

5.2 Main Board

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David Allvey FCA, ATII Non-Executive Chairman (2008)

Age 65. Director since 2001 and Chairman since January 2008. With a career that started in civil engineering and subsequently as a Chartered Accountant, he has held positions in major international businesses including Group Finance Director for BAT Industries plc, Barclays Bank plc and Chief Operating Officer for Zurich Financial Services. He is currently Chairman of Arena Coventry Ltd, Senior Non-Executive Director of Intertek Group PLC and William Hill PLC and a Non-Executive Director of Thomas Cook Group plc and Friends Provident Group. He is a former board member of the UK Accounting Standards Board.

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Andrew Wyllie FREng, BSc, MBA, FICE, CEng Chief Executive (2005)

Age 47. Non-Executive Director, Scottish Water. Formerly Managing Director of Taylor Woodrow Construction Limited (2001-2005) and a member of the Taylor Woodrow plc Executive Committee. Joined Taylor Woodrow in 1984 and worked on major contracts in Africa, the Middle East, the Far East and the UK.

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Anthony O Bickerstaff FCCA Finance Director (2006)

Age 45. Formerly Finance Director of Taylor Woodrow Construction Limited (2001-2006). Joined Taylor Woodrow in 1982 and undertook a number of senior roles both in the UK and overseas including Divisional Operations Director prior to becoming Finance Director in 2001.

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Samer G. Younis BSc, Commander of the Knights – Italian Solidarity Star Non-Executive Director (2009)

Aged 48. Vice Chairman and Managing Director of Kharafi National Group; Board Member of ABJ Engineering and Contracting Co KSCC (Kuwait), Utilities Development Company (Kuwait), Kuwait Jordanian Holding Company (Jordan), SSH Consultants (Kuwait), Global Clearing House Systems (Kuwait), Emirates Utilities Company Holding (UAE) and Heavy Engineering Industries & Shipbuilding Co (HEISCO) (Kuwait); and is a Trustee of the Arab Forum for Environment and Development.

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John M Bryant MA (Cantab), FREng, FIM, CEng, DSc (Hon) Non-Executive Director (2002)

Age 66. Non-Executive Director, Welsh Water Plc and Glas Cymru Limited since 2001. Formerly Chief Executive of Corus Group Plc (1999-2000), Chief Executive, British Steel Plc (1999), Executive Director, British Steel Plc (1995-1999) and Non-Executive Director, Bank of Wales Plc (1996-2001).

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Mike Alexander BSc, MSc, FIChem.E, FIET, FIGM, CEng, CSci Non-Executive Director (2007)

Age 62. Chairman of TGE Marine AG; Independent Non-Executive Director of the UK Payments Council; Executive Director of Lexican Limited; European Advisory Board member Landis & Gyr. Formerly Chief Executive, British Energy PLC (2003-2005); Executive Director, MD British Gas Trading and Chief Operating Officer, Centrica PLC (1994-2003); Non-Executive Chairman Goldfish Bank Limited (2002-2003); and Non-Executive Director of the Energy Savings Trust Limited (1994-2001).

James Morley BSc, FCA Non-Executive Director (2008)

Age 61. Non-Executive Director, the Innovation Group PLC, Clarkson PLC and Speedy Hire plc. Formerly Chief Operating Officer, Primary Group Limited (2006-2007), Group Finance Director, Cox Insurance Holdings Plc (2002-2005), Group Finance Director, Arjo Wiggins Appleton Plc (1999-2001), Group Executive Director Finance, Guardian Royal Exchange Plc (1990-1999), Deputy Chief Executive and Finance Director, Avis Europe Plc (1976-1989) and Non-Executive Director, the Bankers' Investment Trust PLC (1994-2008) W S Atkins PLC (2001-2009), and Trade Indemnity Group plc (1991-1996).

5.3 Executive Boards

Andrew Wyllie (CEO)	Phil Cave (MD)
Tony Bickerstaff (Finance Director)	Tim Davies (Finance Director)
Patrick Bruce (Group Commercial Director)	Steve Fullen (Group Commercial Director)
Clive Franks (Company Secretary)	Hugh Ranen (Company Secretary)
Alistair Handford (PFI Director)	**Kier Investments**
Martin Hunter (Group Financial Controller)	Anita Harris (Group Financial Controller)
Alan Kay (Chief Operating Officer)	Tom Tagg (MD UK)
Darren James (Managing Director Infrastructure)	Peter Bimson (Transport/ SE)
Charles Sweeney (Managing Director– Oil, Gas /Process)	**New post**
Alex Vaughan (Managing Director- Community)	**Kier Regional**
Stephen Wells (Group Strategy and Business Development Director) Tracey Wood -(HR and Legal Director)	Neil Clark / Dave Parr (KCL Strategy, WW and Business Development Director Vicky Baron/ Tony Passon -(HR and Legal)
Mike Sawyer -(Ops Environmental)	Kevin Cottam (Water / NW)

5.4 Business Units

Education	Health	Rail	Roads	Nuclear	Marine	Water	O&G Process	Waste
(Kier Regional)	Kier Regional)							

Overseas

None other than CADCO (Abu Dhabi)	David Durey (Ops)
	Greg Malpass (Intln Business Development)
	Andrew Keir (Regional Director UAE)

Costain has an excellent International Brand and no current Overseas Liabilities. Kier would leverage the Brand in the Middle East, Far East, and Africa, possibly, where appropriate, in joint venture with Costain's strategic shareholder Kharafi.

5.5 Branding

Costain commands a strong Brand, being the oldest contractor in the UK with a reputation for landmark major projects. It is ranked in the 2010 UK Top Brands. Its Brand extends internationally, and is particularly strong in its core UK heavy Civil Engineering sectors.

KCL would absorb all Costain's Building operations within Kier Regions, and its Civil Enginnering & Process contracting businesses within KCL. KCL would have the option to retain the Costain trading name and logo, or drop it. Kier Group might also decide to retain or merge the brands. There are various options to consider.

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6. Financial Results Presentation 2009

7. Sector Presentations

8. Sector/ Project Portfolio