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ACM - Q2 2017 AECOM Earnings Call

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OVERVIEW:

ACM reported 2Q17 YoverY revenue growth of 1.1% and adjusted EPS of $0.89. Co. expects 2017 adjusted EPS to be $2.80-3.20.

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PRESENTATION

Operator

Good morning, and welcome to the AECOM's Second Quarter 2017 Earnings Conference Call. I would like to inform all participants this call is being recorded at the request of AECOM. This broadcast is copyrighted property of AECOM. Any rebroadcast of this information in whole or part without prior written permission of AECOM is prohibited. As a reminder, AECOM is simulcasting this presentation with slides at the Investors section at www.aecom.com. Later, we will conduct a question-and-answer session. (Operator Instructions)

I will now turn the call over to Will Gabrielski, Vice President, Investor Relations.

Will Gabrielski - *AECOM - VP of IR*

Thank you, operator. I would like to direct your attention to the safe harbor statement on Page 1 of today's presentation. Today's discussion contains forward-looking statements about future growth and financial outcomes. Actual results may differ significantly from those projected in today's forward-looking statements due to various risks and uncertainties. Please refer to our periodic reports filed with the SEC for more information on our risk factors. Except as required by law, we take no obligation to update our forward-looking statements.

We are using certain non-GAAP financial measures in our presentation. The appropriate GAAP financial reconciliations are incorporated into our presentation, which is posted on our website. Please note that all percentages refer to year-over-year progress, except where otherwise noted. Our discussion of financial results and guidance excludes the impact of acquisition and integration-related expenses, onetime financing charges, the amortization of intangible assets and financial impacts associated with expected and actual dispositions of noncore businesses and assets, unless otherwise noted. Today's discussion of organic growth is on a year-over-year and constant currency basis.

Beginning today's presentation is Mike Burke, AECOM's Chairman and Chief Executive Officer.

Michael S. Burke - *AECOM - Chairman and CEO*

Thank you, Will. Welcome, everyone. Joining me today are Steve Kadenacy, our President and Chief Operating Officer; and Troy Rudd, our Chief Financial Officer. I will begin with an overview of AECOM's results and discuss the trends across our business. Then, Troy will review our financial performance in greater detail. Steve will conclude with financial guidance before turning the call over for a question-and-answer session.

Please turn to Slide 3. We began the year with a great deal of momentum across our diverse business and our confidence continues to grow. Since the start of the year, over $200 billion of infrastructure-focused ballot measures were passed in the November elections. In early April, California's legislature approved the $52 billion Road Repair and Accountability Act. And just last week, Congress reached a budget deal that included $21 billion of additional defense spending and fully funded the FAST Act, which is an important step towards providing long-term certainty for our clients. In addition, a number of key political priorities continued to advance, including a $1 trillion domestic infrastructure bill, comprehensive tax reform and a pro-growth regulatory environment and sustained increases in defense spending.

Importantly, nearly 70% of our profits are generated from infrastructure and defense markets that are poised to benefit as these initiatives gain traction. It is also becoming clear that our design, build, finance and operating capabilities, our scale and key investments in growth are resulting in meaningful advantages. This is apparent in our recent successes on large pursuits such as the San Onofre nuclear decommissioning project and a new NFL stadium in Los Angeles. In addition, shortly after the quarter ended, we were awarded a $3.6 billion U.S. Air Force contract, which is currently under incumbent protest and is expected to be added to our backlog upon resolution.

I am also pleased to report that we have now closed on our first AECOM Capital property sale, which will contribute $0.17 to our third quarter EPS. This project generated a nearly 30% IRR on our equity investment and marked a significant milestone in advancement of our DBFO vision as we profited from both our investment and Construction Services revenue.

Turning to our second quarter results. We generated positive organic revenue growth for a second straight quarter. Underlying operating performance exceeded our expectations, and we delivered solid margins across all 3 segments. Importantly, all these accomplishments reinforced our significant optimism across our markets.

Please turn to Slide 4 for a discussion of our business and market trends. Beginning with Management Services segment, over the past 2 years, we have embarked on a strategy to leverage our tremendous execution track record, differentiated capabilities and strong reputation with key clients including the U.S. Departments of Defense and Energy to position Management Services for growth. As a result, we entered the year with a nearly $50 billion pipeline of pursuits including $25 billion of bids under client evaluation. Our year-to-date book-to-burn ratio was 1.1 and does not yet include the $3.6 billion award previously mentioned. In addition, the capabilities within our Management Services segment were pivotal in winning the over $1 billion San Onofre nuclear decommissioning contract.

We are confident this momentum will continue. We submitted another $6 billion of bids in the second quarter, and we anticipate decisions on nearly $20 billion of pursuits by the end of the year. Importantly, our strong backlog and pipeline provide for several years of visibility in our highest margin business.

Turning to the Construction Services segment. We are seeing strength across our commercial building, stadia construction and power markets. Revenue growth in our building construction business accelerated to 21% this quarter. We are firmly on track for a third consecutive year of double-digit growth, driven by a portfolio of large iconic projects with several years of visibility such as One Vanderbilt in New York City, and the new NFL stadium in Los Angeles. Growth in our power business is also accelerating, driven by a strong backlog and over $2 billion of wins we announced over the past year, including the Alliant Riverside Gas Power Plant and the San Onofre nuclear decommissioning contract. These wins, which were a direct result of the investments we made to grow the leading capabilities we acquired with URS, provide us with solid visibility for the next several years.

Turning to the DCS segment. Beginning in the Americas, near-term market conditions remained uneven, and our clients are not yet benefiting from the increased FAST Act funding or the large infrastructure ballot measures approved in last fall's election. However, our backlog is at an all-time high level, and a number of recent developments give us confidence in the future. First, last week's federal budget agreement removes uncertainty around FAST Act funding, which is now fully funded for this year and should become a more significant contributor to our markets.

Second, both the President and Congress remain supportive of a $1 trillion federal infrastructure bill. Comments from the administration and Congress are encouraging, and significant funding mechanisms remain on the table, such as enabling greater private investment in infrastructure assets.

Third, the California market, which is one of our largest, is set to benefit from the $52 billion Road Repair and Accountability Act that was passed on April 6. This bill will increase transportation spending in California by 75% over the next decade and is an addition to the over $120 billion of voter ballot measures that passed in the state last November.

Finally, we are also encouraged by trends in Canada where our revenue and backlog increased in the quarter. Funding from the federal government's $150 billion infrastructure plan is entering the market. In addition, the government's latest budget proposal, including plans to create a $25 billion infrastructure bank emphasizing public private partnerships, which we are ideally suited to address.

Across the Americas, our leadership position was reaffirmed last month when ENR ranked AECOM as the #1 design firm for the eighth consecutive year, including top rankings in key transportation and environment markets.

Pivoting to our international design markets, the outlook for U.K. infrastructure funding remains robust. Several substantial transportation projects continued to advance, and we were selected for numerous such projects in the quarter. Furthermore, transformative infrastructure initiatives across the country, including the over $600 billion national infrastructure and construction pipeline are creating visibility for the next several years.

In the Asia Pacific region, our backlog increased, led by continued strength in the Greater China market and from large transportation wins in Southeast Asia. This was highlighted by our selection to provide design services for several of the region's most iconic infrastructure projects.

Finishing with AECOM Capital, the financing arm of our DBFO vision. To date, AECOM Capital has been nothing short of a tremendous success. Our first AECOM Capital property sale closed on April 28, and we generated a nearly 30% IRR on our equity investment. In addition to our substantial equity return, we also profited from the development and construction management services we provided on this project. We currently have 15 other active investments, having committed approximately $240 million of capital to date, representing over $4 billion of total development value. This will drive over $2 billion of revenue through our Construction Services segment as we work towards establishing ourselves as the development partner of choice in the real estate, P3 and infrastructure markets.

Our many accomplishments since the start of the year form the clearest evidence yet that our intense focus on business development and our commitment to our DBFO strategy are driving results. We are better positioned than ever to capitalize on the unprecedented momentum in our markets.

I will now turn the call over to Troy who will discuss the quarter in more detail.

W. Troy Rudd - *AECOM - CFO and EVP*

Thanks, Mike. Please turn to Slide 6. Revenue in the second quarter increased by 1.1%. Year-to-date, total revenue has also increased. This outcome is a result of momentum across our markets and positive returns on our business development investments.

Adjusted EPS was $0.89. This included $0.33 from the net impact of the reversal of a deferred tax asset valuation allowance that was included in guidance for the year and a slightly higher quarterly tax rate than we expected. After adjusting for the impact of these items, our earnings were ahead of the expectation we set for the quarter. On April 28, we closed our first AECOM Capital property sale, which will contribute $0.17 of EPS to our third quarter and total cash proceeds of approximately $80 million.

Please turn to Slide 7. Revenue in the DCS segment decreased by 3%. This was comprised of growth in the EMEA and Asia-Pacific regions, offset by a slight decline in the Americas. We exited the quarter with a record backlog in the Americas, and we are confident in the trajectory of the business, as funding from the ballot measures and the FAST Act benefit our markets. The adjusted operating margin of 6.4% was an improvement from the last 2 previous quarters due to solid execution underlying our business. We also continued to invest in business development to best position ourselves for improving market conditions and opportunities for growth.

Please turn to Slide 8. Revenue in our Construction Services segment increased by 12%. Building Construction revenue increased by 21% and is on pace for a third consecutive year of double-digit growth. In addition, power revenue increased by 42% due to the large wins over the past year that are now getting underway and from our strong backlog.

The adjusted operating margin was 1.9%, which is an increase of 80 basis points over the prior year. Our power business typically has mid- to high-single-digit margins, which will benefit our margin mix as revenue continues to grow.

Please turn to Slide 9. Revenue in the Management Services segment declined by 8%. The adjusted operating margin was 7.9% and included solid contributions across our diverse portfolio of projects. Recall that revenue and operating income in the prior year included a $45 million benefit from the acceleration of a cost recovery on federal contract pension entitlements that resulted from harmonizing our benefits programs. Importantly, our backlog is growing and our pipeline remains robust, which is creating substantial visibility into our highest margin segment.

Please turn to Slide 10. Free cash flow was negative $64 million. This marks only the second quarter in the past 5 years that our free cash flow has been negative. Cash flow phasing for the year has been impacted by a few items. First, we made a $60 million payment for a legal settlement that was disclosed in the first quarter. Second, our first AECOM Capital property sale occurred in the third quarter and will contribute approximately $80 million in cash. We are confident that we'll make up ground in the second half of the year and achieve our full year cash flow guidance.

I also want to spend a minute highlighting the highly successful $1 billion bond offering we completed in February. This transaction capitalized on historically low interest rates, allowing us to operate with greater balance sheet certainty. We used the proceeds to pay down a substantial portion of our variable-rate debt, and we further improved our secured leverage ratio.

I will now turn the call over to Steve to discuss our financial guidance.

Stephen M. Kadenacy - *AECOM - President and COO*

Thanks, Troy. Please turn to Slide 12. We are off to a strong start to the year with substantial momentum in our pipeline, reflecting the benefits of our business development investments and improving fundamentals across many of the markets that we serve. Importantly, our business performance remains consistent with the operating plan and the guidance we've provided at the start of the year.

As a result, we are confident in achieving our 2017 adjusted EPS guidance range of $2.80 to $3.20. Our guidance includes revisions to interest expense and tax that offset one another. We anticipate our third quarter adjusted EPS will approximate 25% to 27% of our full year guidance, which include $0.17 from AECOM Capital.

With that, I will now turn the call over for Q&A. Operator, we are now ready for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Andrew Kaplowitz from Citi.

Andrew Alec Kaplowitz - *Citigroup Inc, Research Division - MD and U.S. Industrial Sector Head*

Mike, can you give us a little more color on the state of the environment for your MS business? You said last quarter that you thought $17.5 billion of bids will be awarded this year. I think you reiterated that this quarter. You did win the $3.6 billion award, but you talked about it being under protest from the incumbent, and your organic growth has decelerated a bit in the quarter, although it was up sequentially. Ultimately, my question is, when do you think the increased level of MS work will translate into organic growth? Do you have confidence that FY '18 will be the big revenue growth driver -- year for MS?

Michael S. Burke - *AECOM - Chairman and CEO*

So I do have great confidence in growth in FY '18. And let me just give you a little more color on that, Andy. We started off the year saying we had a $50 billion qualified pipeline. We had $25 billion of bids under evaluation, with almost $20 billion of those decisions being made in 2017. So we started off $25 billion of bids and evaluation. $5 billion of those bids have been decided already through the first 2 quarters. And we won 40% of that, right? So we added, in Q1 and Q2, we added a little over $2 billion. So we had a 40% win rate on the first $5 billion that was decided, which is as you know, Andy, in this space, a 40% hit rate is exceptional. That does not include the $3.6 billion RSS win that we had just after the quarter closed in the first week of April. So on top of that, during Q2, we submitted another $6 billion of bids that are now in evaluation. So we started with $25 billion. We took $5 billion out of there because we won $2 billion of the $5 billion. We added $6 billion of new bids during the quarter. So now we have $26 billion in bids under evaluation going into the quarter. And we, as you saw the press release, on the $3.6 billion one that was won right at the beginning of the quarter. So we feel really good about the pipeline. We've invested over $100 million in business development in the last 2 years alone. We are taking prime positions on these contracts, in many cases, where, in some cases we were subcontractors previously. So we're taking a bigger share. We're bidding on bigger projects. We've increased our win rate. And all of that leads me to have a very bullish view on growth in FY '18.

Andrew Alec Kaplowitz - *Citigroup Inc, Research Division - MD and U.S. Industrial Sector Head*

All right, Mike. That's helpful. Last quarter you said your DCS business was still pretty choppy, and this quarter's decline in organic revenue seemed to confirm that. What do you think is going to think to get more consistent DCS organic growth? Do you think the passing of this year's federal spending bill, including the FAST Act funds that you mentioned, removes a bigger hurdle that was holding spend back? Are there any other catalysts you need to see to really push DCS organic revenue to more consistent growth? And how much can the new California bill really help you, and in what time frame?

Michael S. Burke - *AECOM - Chairman and CEO*

Yes. So Andy let's -- Steve and I will tag team that question, because, again, it is a very important question. So let's start with the big macro issues that we've been waiting on and how those might contribute to a catalyst here. So you mentioned the California bill. Certainly, that was encouraging. If you think about California, if California were a country, it would be our largest international market. And the fact that they passed the $52 billion infrastructure spending bill last month is very encouraging. You add that to the $120 billion of the transportation ballot measures that passed in November in Los Angeles County, this is a market where we are very strong. It's our home market. We have $700 million-plus of revenue already in this state. We feel really good about that as a significant catalyst in California. When we look to the recent activities in Washington with the omnibus appropriations bill that passed just last week, FAST Act is now fully authorized at the levels that we've been talking about. There's a new almost billion-dollar highway obligation ceiling that was added. And so all of that gets us quite comfortable that we have catalyst for spending at the California level, at the federal level. We've seen increases in gas tax across the country. We're delighted that President Trump said last week that he was receptive to an increase in the gas tax. The gas tax is a very important component here. It's just one arrow in the quiver. We haven't raised the gas tax since 1993. And every $0.01 increase in the gas tax is about $1.5 billion of revenue dedicated to transportation. So those are the big macro issues, but maybe Steve can comment on some more of the specifics that are affecting our business.

Stephen M. Kadenacy - *AECOM - President and COO*

Yes. Well in the Americas, we're winning quite well. So our book-to-burn was over 1. Again, we're seeing a tremendous pipeline. The difference in the pipeline, I would say, relative to prior year is that the projects are more complex. They're larger, and they take a lot more time to get awarded. So as Mike said in his prepared comments, we haven't seen our clients getting the benefit of the ballot measures or the FAST Act money yet, but it's clear they're expecting to get it, and it's clear they're building that into their own CapEx planning. So you're seeing -- I mean, you look at P3s alone and integrated deliveries. So between P3s and design build, we have $36 billion of CapEx in the pipeline that we're chasing, that these are real opportunities that are AECOM, AECOM Capital, Construction Services, and/or DCS are having pieces of. So the pipeline is growing dramatically, but they take a long time. I mean, you look here in L.A. alone, with the ConRAC facility at the airport, the APM these are long-range projects that take a while to hit the ground. Despite that, we're operating on plan. We're hitting our numbers on the bottom line. We're pretty close to our expectations on the top line as we ramp into the second half. And we do expect organic growth in the second half.

Andrew Alec Kaplowitz - *Citigroup Inc, Research Division - MD and U.S. Industrial Sector Head*

Okay. That's helpful. And Steve or Troy, maybe just a very quick follow-up. You obviously amended your credit agreement in the middle of the quarter. Is there anything you can do to give yourself maybe a little more cushion versus your covenants. So that you're not having to do that? You just -- what can you do to give yourself a little bit more leeway here? We know you can generate a lot of cash in the second half of the year. But is there anything more you can do to help yourself out in that sense?

W. Troy Rudd - *AECOM - CFO and EVP*

So Andy, I guess first point on that is we'll generate the cash that we said we would for the full year. So even though we were challenged in the second quarter, primarily as a result of a payout of a settlement, we still are going to hit our full year guidance. And as Steve pointed out across the business, we've been delivering against our earnings expectations. So we had adequate cushion in the quarter and delivering on cash and delivering on the earnings performance of the business will have us where we want to be.

Operator

Our next question comes from Tahira Afzal from KeyBanc Capital Markets.

Tahira Afzal - *KeyBanc Capital Markets Inc., Research Division - MD, Associate Director of Equity Research, and Equity Research Analyst*

You guys, if I were to look at some of those other opportunities you have in terms of investments, the 15 active ones you've talked about, and maybe the others you are looking down the road. Do you know how -- can you talk a little more about how broad-based they are? Could they potentially have the same return profile as what you've seen recently with AECOM capital?

Michael S. Burke - *AECOM - Chairman and CEO*

Yes, Tahira. Certainly we have 16 investments. They are very broad-based in cities from New Jersey; New York; Washington D.C.; Austin, Texas; Nashville, Tennessee; Los Angeles; Silicon Valley; San Diego; and I'm probably missing -- what?

Stephen M. Kadenacy - *AECOM - President and COO*

London.

Michael S. Burke - *AECOM - Chairman and CEO*

Oh, and London or Manchester. Manchester. So a wide variety from real estate projects from hotels, residential, rental. We have 2 more projects that are in the hydroelectric space. And we have a number of bids outstanding in the P3 space. And so it's fairly broad-based geographically. It's broad-based by market sectors. And we had, as we announced, a 30% IRR on our first project. That is not counting the profit we earned on the construction revenue. So it's -- there is -- there is certainly built-in gains in that portfolio. We have not tried to disclose the total gains that we think might be appropriate. We'll disclose those in our guidance as we move forward. We do have some more gains that we expect throughout this year, and we'll update you with our 2018 guidance of what we expect. But suffice to say, we are very happy with the progress of AECOM Capital. We're very happy with the returns of our first transaction. And we expect there to be built-in gains in all these assets that we currently have.

Tahira Afzal - *KeyBanc Capital Markets Inc., Research Division - MD, Associate Director of Equity Research, and Equity Research Analyst*

Got it. Okay. And just as a follow-up, and I might be pressing my luck here, but given the strength you're seeing in all your core markets, and really what you potentially could see on the Federal Services side, do you feel that you are still confident about really looking out into the next year and seeing some revenue growth coming back, maybe, in the mid-single digits? Is it -- you're not at the stage that you can do that? And to the extent you are driving sort of mid-single-digit revenue growth, could that be enough, alongside this better utilization and execution to really start hitting EPS growth that is growing at a faster clip?

Michael S. Burke - *AECOM - Chairman and CEO*

Yes we do, Tahira. It's -- we have been executing, I think, very well. We've been investing very well in business development opportunities in hot markets. When we look at our markets today, 2/3 of our profits are in markets that are experiencing significant increases in funding, funding like the FAST Act, the $200 billion of ballot measures we talked about, the expected $1 trillion infrastructure plan out of the federal government, the Department of Defense growth. So we are focused in the right markets. we've been investing heavily and growing our backlog, which you're seeing. And as we have previously said, our financial targets through 2021 is we expect a 5% compound growth rate in our revenue. We expect a greater than 10% compound growth rate in our earnings per share over that 5-year period of time. And we expect to produce cumulative cash flow, free cash flow of $3.5 billion over that 5-year period of time. So we are still very committed to those financial targets that we put out at the beginning of the fiscal year. And I think all the indicators that you're seeing on adding to the backlog, executing better and getting all -- getting the noise of the integration behind us as we're turning our attention to growing the business and getting all of the integration work behind us, which is behind us at this point.

Operator

Our next question comes from Steven Fisher from UBS.

Steven Fisher - *UBS Investment Bank, Research Division - Executive Director and Senior Analyst*

Steve, you mentioned that you expect organic growth to be positive for the -- in the second half. I guess I'm just wondering how balanced do you think that is going to be across the segments. As we were looking back a quarter or so, I think we were thinking that every one of the segments could be positive contributors for the year. So how are you thinking about how balanced that could be and the confidence that you will be able to deliver overall organic growth for the whole year?

Stephen M. Kadenacy - *AECOM - President and COO*

I think it's going to be pretty balanced, Steve. DCS, as I was speaking to when I made those comments, we're expecting the ramp. We're already growing in EMEA and APAC. Those businesses are solid. Americas was slightly down in the quarter, but we're expecting a rebound. we're already growing in transportation and water in the Americas. And then, when you look across to CS, we expect organic growth largely driven by a ramp in Building Construction in the second half; a pretty significant ramp in power, which grew over 40% in the quarter; and a stabilizing oil and gas market. MS, the wins in MS are very large wins and bode extremely well for FY '18. Our modeling for MS for the second half is about flat, ramping into '18.

Steven Fisher - *UBS Investment Bank, Research Division - Executive Director and Senior Analyst*

Okay. And if I could just ask you about cash flow. Just to get a sense of your confidence in being able to deliver on the targets for the full year, given the significant back half weighting. And I guess, really, my question is I know you can point to historical balances between first half and second half. But your mix is different now than it has been historically. How do you think that changing mix is going to affect the timing and the potential volatility around cash flow and collectability and timing of it? And is there anything you can do to kind of ensure that things don't slip?

W. Troy Rudd - *AECOM - CFO and EVP*

So Steve, I guess, first of all, we are highly confident in our ability to deliver on the full year result. And as you dig into that a little bit, confidence can be gained by, as you said, our past history. And our past history is driven by the underlying fundamentals of the business. It's a large diverse portfolio where people are rewarded to collect, and those conditions don't change. So there isn't something that stands out that drives cash flow, with the exception of one thing, which is a tailwind for us, which is AECOM Capital. So having AECOM Capital close at the beginning of the quarter creates a significant tailwind in the second half of the year, on top of just the fundamentals of the business, which remain unchanged.

Stephen M. Kadenacy - *AECOM - President and COO*

And Steve, just to add on, because you asked about the mix. The mix helps. So if we more than double our MS backlog with A+ credit rating client, the cash flows are very predictable. And in CS as you know, our working capital commitments in CS tend to be significantly lower than our DCS business. So the mix will help.

Operator

Our next question comes from Jamie Cook from Credit Suisse.

Jamie Anderson - *Credit Suisse - Analyst*

This is Jamie Anderson on for Jamie Cook. I just wanted to get a little more color on the $17.5 billion of MS pursuits. Could you guys clarify, on a dollar basis, what percentage of these are recompetes versus new business? And then, when we're thinking about the new competes, I understand that some of those could be where AECOM is switching from a prime to a sub or -- or excuse me, from a sub to a prime. Just how do you guys think about win rates between new business and recompetes on a dollar-weighted basis? And what does that kind of bode for MS top line into '18?

Michael S. Burke - *AECOM - Chairman and CEO*

Yes, sure. So the $17.5 million number I don't think was quite right. So we have $26 billion of bids under evaluation right now. And we have another $24 billion or so of bids that we are working on submitting, right? So we have $50 billion qualified pipeline. $26 billion have been submitted already under current evaluation. The hit rate that we have experienced so far, excluding RSS, has been 40%. If you add RSS, it's obviously enormously larger than that. And so when I look at the wins that we've had so far to date, they've been predominantly new wins, takeaways from other -- almost exclusively takeaways from other companies. If I look at the rest of the bid, there's only one big one -- off the top of my head now. There's only one big one that is a recompete. And so what's important about that, the recompete, we are recompeting as a prime instead of a sub. So we're recompeting to take a bigger share. But our hit rate is slightly better. Typically, if I look at it historically, slightly better on a recompete than it is on a new bid. But so far year-to-date, our hit rate on new business has been 40%. So we're feeling really good about that.

Operator

Our next question comes from Anna Kaminskaya from Bank of America.

Anna Kaminskaya - *BofA Merrill Lynch, Research Division - VP*

Sorry to beat the dead horse on the MS segment, but just thinking about all the protests and how long it takes, is there a risk of some of the big projects and the backlog growth slipping into 4Q and maybe even to 2018? Kind of look, if I think about the cadence of new wins in your big pipeline of MS projects, I mean, how should I think about it 3Q to 4Q, and again, risk of some of the awards slipping into 2018?

Michael S. Burke - *AECOM - Chairman and CEO*

So the typical protest period is a 100-day period. So that RSS one, we announced it over a month -- a little over a month ago. So we're 30 days into that 100-day period, to give you a sense. And I think nowadays, you expect more than half of projects to get protested. It's just a natural. And if it's a takeaway from another firm protesting for 100 days, that means they get another 100 days of revenues. It's fairly typical. And we feel pretty good about the odds of success on protests. Sometimes you go through a technical period where you resubmit some information to help them with the protest determination. But we feel pretty good about our position and the outcome of those awards. And so we're still on track to hit a target that we set out at the beginning of the year, which was we were hoping to double our backlog during the year. We started the year with just about $8 billion of backlog in the Management Services segment. That's of course more than 2x our annual revenue run rate. We're expecting to double that this year. And we're on track to do that, finishing the year with $16 billion of backlog in MS. So all of the investments we've made have been paying off so far, and we don't expect that to change.

Anna Kaminskaya - *BofA Merrill Lynch, Research Division - VP*

Great. And maybe just a follow-up on your power business. I know you're in the early stages of some of -- big construction projects. And unfortunately, quite a few of your E&C peers had some execution hiccups. Maybe are you doing anything differently on project control or subcontracting labor, just mitigating the risk down the line? And I know it's a new growth platform for you for AECOM. So what do you do differently?

Stephen M. Kadenacy - *AECOM - President and COO*

Well, Anna, we're not doing anything differently than the legacy power team that we acquired with URS did historically, and as you recall, having tracked this space. I can't recall of any combined cycle project hits that this team has taken that they reported. So this team is highly tested. They are working in their sweet spot with clients that they know. So we're relying on our project managers that have delivered for these clients like Alliant, for instance, that we discussed in our prepared comments. We are adhering to the risk procedures that we've always had in that group, which is at a much higher level than fixed-price work elsewhere in the company on the design side. It's at a level of detail that is extremely high. And we approach those projects with great care on the contracting side. We don't sign up for deals that we can't manage the risk through. And then, we're conservative on how we recognize revenue on these projects. So we're -- we continue to follow that and -- on these projects that are performing well.

Anna Kaminskaya - *BofA Merrill Lynch, Research Division - VP*

And then, just impact to your margin. Where can the margin go as those projects ramp up? Can it be north of 2% this year? Or kind of how should I think about margin profile in the business, in the construction (inaudible)...

Stephen M. Kadenacy - *AECOM - President and COO*

Yes. It definitely has a positive impact on the margins because the margins in the power space run 6-plus-percent. And as I mentioned, the mix of power is growing, because we had over 40% growth in the quarter. And in the second half, we would expect a marginal increase in the margin because of that ramp-up.

Operator

Our next question comes from Michael Dudas from Vertical Research.

Michael Stephan Dudas - *Vertical Research Partners, LLC - Partner*

Regarding your 3 distinct businesses, as you look ahead, which one or which ones will have better opportunity to show operating leverage, to the bottom line as some of these revenue flows and absorptions really start to kick in, given your expectations, say, in 2018 and '19? Do they all kind of contribute equally? Are there ones that can provide more incrementals to the bottom line?

Stephen M. Kadenacy - *AECOM - President and COO*

Well, I think that all will benefit from a ramp on the top line. MS will benefit significantly, although they're in a space that has a lot of cost-plus contracts. So long run, the overall margin, also because they're taking prime positions could -- will be probably more consistent with where we guided in the 7% to 8% range. DCS is -- should benefit greatly from leverage. But of course, it's not going to have that kind of dramatic growth that we'll see, for instance in the power segment. On the power segment, we think, next year, will be 3x what it is in FY '17. So overall, we're not going to have to increase our core G&A to support these businesses. We have room to ramp, and growth, in general, will be -- will benefit our overall margins.

Michael Stephan Dudas - *Vertical Research Partners, LLC - Partner*

Troy, on your debt that you guys placed earlier in the year, remind me on that, how long and what kind of prepayments or what kind of covenant flexibility there will be as you guys continue to delever and further want to recapitalize the balance sheet?

W. Troy Rudd - *AECOM - CFO and EVP*

Yes. So Mike, I think you're referring to the bond offer we did, which was a $1 billion bond offering at 5.125% with a 10-year duration, which puts us to 90% of our debt being fixed rate. It does still leave us to the room to pay down $1.2 billion in variable rate debt. So that's where we sit today, and that seems like a good place for us to be at this point in time.

Michael Stephan Dudas - *Vertical Research Partners, LLC - Partner*

That's what I was getting at. My final question is for Mike. Not that you don't have enough macro catalysts, but I just saw something on the paper the other day about the L.A. bid for the Olympics. Any thoughts or update? Is there real potential there? And is that something that could be positive benefit flows for AECOM if that happens?

Michael S. Burke - *AECOM - Chairman and CEO*

So it would be an enormous benefit. Obviously we're leading the preparation of the bid package and have been for quite some time. The International Olympic Committee happens to be in Los Angeles this entire week doing their final assessment of our bid. The decision will be made in September of this year at the IOC meeting in Lima, Peru, which is down to us and Paris right now. I don't know. I don't want to handicap it here, but I do sit on the board of the L.A. Olympic Committee. So we're excited about it. It would be a real catalyst for this market, and would be a very good commercial opportunity for us also. As you know, we have been involved in the last, at least dozen Olympic Games, leading the design of the Olympic Village in Rio, the master plan for London. We're working on Tokyo 2020 right now also. So it's an important part of our business.

Operator

Our next question comes from Chad Dillard from Deutsche Bank.

Charles Albert Edward Dillard - *Deutsche Bank AG, Research Division - Senior Research Analyst*

Can you spend a moment talking about your future bidding prospects in your building construction business? There's been some number of headlines out with talking about the slowing commercial activity, weakening C&I loans, and I was just curious whether you're starting to see a pullback from any of your customers in the space at all.

Michael S. Burke - *AECOM - Chairman and CEO*

We are not seeing a pullback. The Building Construction business will have our third consecutive year with double-digit organic growth. In Q2 alone, our contracted backlog increased 6%. And we are not only seeing significant growth in our historical dominant market of New York, but we are spreading that out to markets across the country that are very active. In fact, we started investing in the California market just a few years -- just 2 years ago. We spent a lot of money building up our Construction Service business in that market. We now have $6 billion of projects that we're pursuing in Los Angeles alone, not to mention the significant $2.5 billion construction project for the new NFL stadium here in Los Angeles. We are also -- there's been some press reports about a very large project in London, and that will be officially decided shortly. It's the tallest residential project in all of Europe. So we're seeing strength across our traditional core markets as well as the markets that we're expanding into. We're seeing it in sports. We're seeing it in airports. We're seeing it in commercial construction. We're seeing it in urban infill residential high-rise that matches the urbanization trend that we've been following for quite some time. So we feel really good about that. It will be, like I said, another year of double-digit organic growth, and our backlog is supporting that to continue.

Charles Albert Edward Dillard - *Deutsche Bank AG, Research Division - Senior Research Analyst*

Sounds good. And then, just really quickly, on the MS segment, you guys posted margins a little bit higher than that. I think the 7% guide that you originally had at the beginning of the year. Just curious, were there any onetime items? Or is that just kind of -- just steady as she goes?

Stephen M. Kadenacy - *AECOM - President and COO*

It was mostly steady as she goes. I believe there were some award fees, but that is somewhat consistent during the year. We had them forecasted in our guidance. They did pop in the quarter.

Operator

Our next question comes from Brent Thielman from D. A. Davidson.

Brent Edward Thielman - *D.A. Davidson & Co., Research Division - VP and Senior Research Analyst*

It strikes me that design consulting margins are still expanding, despite the fact this infrastructure work hasn't really come in for you yet. Question is, these larger kind of more complex projects you talk about that -- still waiting on. Do these typically come with much better margin profile than what we see in that segment today?

Stephen M. Kadenacy - *AECOM - President and COO*

No, not really. They're competitive, and they require as much execution as we've seen in the past. We don't see a lot of volatility, other than the operating leverage in the margins as those come to fruition.

Operator

Our final question comes from Andrew Wittmann from Robert W. Baird.

Andrew John Wittmann - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

I heard a comment earlier that you're expecting more gains from AECOM Capital this year. I was just wondering if the $0.20 guidance that you guys laid out for investment gains this year is changed or unchanged?

Michael S. Burke - *AECOM - Chairman and CEO*

Just to be clear, $0.20 was the midpoint of the range that we provided, and we're not changing that range.

Andrew John Wittmann - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

Okay. And then, I guess my second question was on, I guess, cash flow. I think later this year, the covenant steps down another point. If you could just refresh us what the next date and level is, and where you expect to hit -- or where you expect to be in terms of your leverage at that point? And just is -- was the financing of receivables a factor in the quarter? Or did you do any of that, or unwind that in a positive or negative direction in the quarter?

W. Troy Rudd - *AECOM - CFO and EVP*

So I'll work backwards. First of all, we still maintain our program where we sell receivables. It's a fairly consistent part of our overall management of AR. And it did provide a headwind during the quarter. And in terms of where we expect to end the year, it's consistent with where we said we'd be. We're going to be, on a net basis, in the low 3s. And that's going to be driven by our ability to, as I said earlier in the call, to continue to drive our cash flow the way we have guided, and our early -- and our earnings being consistent through the remainder of the year.

Operator

I will now turn the call back over to CEO, Mike Burke, for closing comments.

Michael S. Burke - *AECOM - Chairman and CEO*

Well thank you, operator. So first of all, the first half of the year kind of reflects what we believe are the key inflections in our business and markets. And we've been talking about those for quite some time. But importantly, our Management Services business, which is our highest margin business, is off to a very strong start in converting that $50 billion of pipeline that we've been talking about for quite some time now. And that didn't just happen. That's the result of 2 years of bringing together the combined strengths of URS and AECOM investing $100 million in business development. And we're seeing the results of that hard work from our team there in our investment.

But also in our infrastructure markets, as I mentioned earlier, we are seeing a number of catalysts from the -- for the $200 billion of ballot measures, whether it's the fully funded FAST Act, whether it's the new California $52 billion highway bill, these are all real tangible catalysts for increased funding that will help us for many years to come. And I know we've said it in the past, but it's worth repeating here is that almost 70% of our profit is tied to markets benefiting from all these policy initiatives underway, whether it's infrastructure, whether it's defense spending. And it's a great time to be in our business. And we're certainly excited about where we are today and how well we are positioned for the future. And we couldn't be more pleased with where we are right now.

So we look forward to seeing many of you over the coming months as we're getting out on the road talking to many of you. And we look forward to the continuing dialogue, and we'll be talking to you next quarter. So thank you, again.

Operator

Thank you. And thank you, ladies and gentlemen. This concludes today's conference. Thank you for participating. You may now disconnect.