

Chief Executive's Review

In 2005 we delivered substantial profitable growth and with the acquisition of Mowlem laid the foundations for a step change in the development of our business

In our 2004 annual report, I said that 2005 marked the beginning of a new phase of growth for Carillion. Having completed our programme of major disposals and built a well-balanced, customer-focused business, delivering good quality earnings backed by strong operating cash flows, we were ready to accelerate the development and growth of our business. That growth will continue to be driven by implementing our consistent and effective strategy through customer-focused businesses, supported by a culture based on “living” our core values in everything we do.

Strategic development

Over the past few years we have been seeking acquisitions to fill capability gaps in order to improve the scope and quality of our integrated services solutions and also to deliver a step change in the development of our business. We apply the same criteria to all potential acquisitions, namely that they must be consistent with our strategy for delivering sustainable, profitable growth and deliver financial returns equivalent to those we expect from other investments.

Acquisition of PME

The acquisition of PME, one of the largest privately owned mechanical and electrical (M&E) engineering maintenance businesses in the UK, for approximately £47 million (including a £10 million payment to the PME pension fund) in March 2005 filled an important capability gap. M&E maintenance accounts for up to 40 per cent of a typical building management and support services

contract. Having an in-house M&E maintenance capability has therefore considerably strengthened our integrated service offering for both new and existing customers. PME is performing well as an integral part of our business, with cost synergies now expected to reach approximately £3 million by the end of 2006, exceeding the £2 million originally identified.

Acquisition of Mowlem plc

Carillion announced its cash and shares offer for the acquisition of Mowlem in December 2005. It was recommended by the Mowlem Board and received the overwhelming support of Carillion and Mowlem shareholders. The acquisition valued Mowlem's share capital at £313 million and was completed successfully on 23 February 2006. 65.8 million new Carillion shares were issued on 23 February 2006 as a result of the acquisition.

Mowlem is an outstanding strategic fit, particularly in support services and private finance, and we are confident that it will deliver a step change in the development of our business and materially enhance our earnings in 2007, the first full year after acquisition.

The addition of Mowlem's complementary skills and market strengths in support services makes Carillion one of the largest support services businesses in the UK and significantly enhances our ability to provide customers with high quality, integrated solutions in our key market sectors.



John McDonough
Chief Executive

Chris Girling
Finance Director

Roger Robinson
Executive Director

Chief Executive's Review *continued*

The addition of Mowlem's portfolio of Public Private Partnership (PPP) projects to Carillion's own substantial portfolio will create a very large and valuable portfolio of equity investments. Mowlem also has a large pipeline of new PPP projects for which it is the preferred bidder or shortlisted, with the potential to add considerable further value to our investment portfolio. Furthermore, the acquisition of Mowlem will increase the number of specialist people we have with private finance skills, which has been the main constraint to our growth in this market.

Mowlem's considerable strengths in construction services will add to the breadth and scale of our own construction capabilities. Going forward, Mowlem's approach to construction will be subject to the same selectivity criteria that we have consistently applied to our own construction activities. Furthermore, our rigorous and proven risk management policies and processes will underpin every aspect of the enlarged group's operations.

On 18 January 2006, Carillion announced that it had agreed to sell two Mowlem businesses, Charter, the US construction management company and Edgar Allen, the UK rail track products manufacturer to Balfour Beatty plc for a total consideration of approximately £20.5 million, subject to due diligence by Balfour Beatty. Completion of these sales is expected in the second quarter of 2006.

In early March 2006, the Office of Fair Trading (OFT) visited two Mowlem offices. We have fully co-operated with the OFT and will continue to do so as appropriate.

The integration of Carillion and Mowlem is being led by a dedicated team comprising senior people from both companies to ensure we achieve the synergy benefits we have identified and create a business that will deliver accelerated growth, materially enhanced earnings and strong cash generation. We expect to deliver cost savings at a running rate of £10 million per annum by the end of 2006, rising to £15 million per annum by the end of 2007. The one-off cost of delivering these savings is expected to be £10 million in 2006.

Our business model for the enlarged group will continue to be based on delivering our existing strategy through market focused business units, each equipped with the skills and resources necessary to provide customers with solutions tailored to meet their specific needs.

Business performance

Total revenue in 2005 increased by 15 per cent to £2,284 million (2004: £1,985 million), including revenue from joint ventures of £259 million (2004: £126 million).



01 Carillion is using its specialist skills and resources to provide integrated solutions to the NHS, including PPP hospitals and Independent Sector Treatment Centres.

02 The acquisition of PME, a mechanical and electrical engineering maintenance business, in March 2005, has significantly strengthened our ability to provide fully integrated solutions for building maintenance and services.

Financial reporting segments

| Investments | Support Services | Construction Services |
|---|--|---|
| In this segment we report the equity returns on our investments in Public Private Partnership (PPP) projects. | In this segment we report the results of our activities in rail infrastructure, roads maintenance, facilities management and other support services. | In this segment we report the results of our UK building and construction activities and our International Regional businesses. |

Underlying* profit before tax also increased by 15 per cent to £55.5 million (2004: £48.1 million), with underlying earnings per share of 20.4 pence (2004: 18.6 pence). Underlying earnings per share grew by 10 per cent, after the Group's effective tax rate returned to a more normal level of 27 per cent, having reduced temporarily in 2004 to 21 per cent, due to a number of one-off tax settlements.

Our relentless focus on cash management has again resulted in a strong cash flow from operations of £84 million. Average weekly net cash was £37 million, net of finance lease liabilities of £31 million. At 31 December 2005 Carillion had net cash of £90.8 million, net of finance leases of £37.7 million (2004: £128.8 million net of finance leases of £24.2 million), having invested approximately £47 million in the acquisition of PME.

Delivering improved results in 2005 was a particularly significant achievement, given the impact of transferring to Network Rail during 2004 profitable maintenance contracts that contributed around £150 million of revenue in 2004.

We continue to report our financial results in three segments – Support Services, Construction Services and Investments – in which we group together activities of a similar type and risk profile to make it easier for the Market to value our earnings on a consistent basis. Our performance in each of these segments is summarised below and a more detailed explanation follows later in this review.

In Support Services, revenue (including joint ventures) increased by over seven per cent to £989 million, with the effect of losing £150 million of rail maintenance revenue more than offset by the acquisition of PME and organic growth. An increase in operating profit of two per cent, to £40.6 million, lagged growth in revenue, reflecting the loss of rail maintenance contracts, which had higher than average margins in this segment.

In Construction Services, revenue (including joint ventures) increased by 22 per cent to £1,230 million, driven mainly by growth in our International Regions, particularly the Middle East and Canada, UK Building and our Developments business. Operating profit in this segment increased by 35 per cent to £16.9 million.

Investments contributed revenue of £65.4 million. Operating profit increased by 36 per cent to £8.3 million, due to an improved performance across our portfolio of equity investments in PPP projects and reductions in bid costs and overheads. As explained later in this review, we are also creating long-term value by investing in these projects and the Directors' current valuation of our portfolio is £89 million, based on discounting at 10 per cent

the cash flows that will be generated by these investments over the next thirty years or more.

Total operating profit from our three financial reporting segments was £65.8 million, including joint ventures. After corporate centre costs of £10.4 million, net financing income of £5.1 million and tax on joint venture profits of £5.0 million, underlying profit before tax was £55.5 million. Non-operating items, amortisation of intangible assets and goodwill impairment amounted to £3.6 million, leaving profit before tax of £51.9 million. Profit after tax was £40.8 million and basic earnings per share were 18.7 pence.

2005 was an outstanding year for new orders, which increased the value of the Group's order book and framework contracts at the year-end by some 40 per cent to around £7 billion (2004: £5 billion). Despite converting a high proportion of potential new orders into contracts in 2005, we also maintained a healthy pipeline of probable orders, worth up to £1.6 billion at the year-end (2004: £2.2 billion).

Our strategy for growth continues to be reflected in our order book, with Support Services and PPP concession contracts accounting for some 84 per cent of order book value (2004: 78 per cent). The longer-term nature of these contracts also significantly improves the visibility of future revenues, with around 74 per cent of our order book expected to generate revenues in 2007 and beyond. At the same time, through our selective approach, we have continued to improve the quality of our construction order book and focused on long-term relationships with key customers. For example, in 2005 our UK building business generated around 84 per cent (2004: 80 per cent) of its revenue from 20 key customers.

Risk management

The rigorous policies and processes we have established to identify, mitigate and manage risk are a cornerstone of our business. Our Group Head of Risk is responsible for advising on all risk issues, including our policies and processes and their application to all our business activities.

We address strategic risks and risks specific to individual businesses and contracts, including social, environmental and ethical risks. Our risk management processes apply to every aspect of our business, from choosing the markets in which we operate to the contracts we bid for and the selection of our suppliers and sub-contractors. They apply to every stage of a contract from inception to completion, in order to deliver the cash-backed profit we expect and a service that meets or exceeds the expectations of our customers.



*Underlying profit and underlying earnings per share, which are defined on page 60, are used to report our financial performance in 2005 on a comparable basis to that of 2004.

Order book 2004-2005

Our order book at 31 December 2005, increased by 40% to £7.0bn.

Chief Executive's Review *continued*

The more significant areas of risk, where our failure to perform well or changes to macro economic or market specific environments that would adversely affect our business, are summarised below:

- ▲ Integration of Mowlem. The efficient and professional integration of Carillion and Mowlem is essential to the success of this acquisition and to the delivery of cost synergies, sustainable, profitable growth and materially enhanced earnings;
- ▲ Attracting, developing and retaining excellent people. The success of our business depends primarily on the quality of our people;
- ▲ Management of major contracts. Completing contracts on time and to the required standards, avoids financial penalties and damage to our brand and reputation;
- ▲ Closing out existing contracts. Settling completed contracts and collecting the cash we are owed is essential to reducing debt and delivering the earnings growth we expect;
- ▲ Pension scheme management. The cost to Carillion of funding its pension schemes depends on the macro-economic environment, equity market stability and regulatory requirements;
- ▲ Government investment and outsourcing. With a substantial proportion of our business and future growth dependent on planned investment and outsourcing of services, it is important to maintain an effective presence in a number of growth sectors to support the resilience of our business;

A more detailed description of our risk management structure can be found in our Corporate Governance Report on page 33.

Our people

Our people are the key source of competitive advantage and it is through their efforts each day that we meet or exceed our customers' expectations.

The success of our business and the value of the Carillion brand depend primarily upon the performance of our people. We therefore remain totally committed to attracting, developing and retaining excellent people by becoming an employer of choice and have a wide range of measures in place to make this a reality across all our businesses.

Above all we strive to communicate well with all our people and to listen to and act upon what they tell us. We do this through a structured approach to communication, including individual performance and development reviews, monthly Team Talks and regular surveys through which everyone can share their views openly and frankly, in line with our core value of 'Openness'. These surveys culminate annually in "The Great Debate" in which around 1,400 people from across the Group took part in 2005.



01 Part of the new Westwood Cross retail development in Thanet, Kent, which opened in 2005. This 20 acre site, which is home to 35 retail outlets, was developed by the Carillion/Richardson partnership and built by Carillion.

02 Carillion manages and maintains the Royal Parks for the Royal Parks Agency.

This enables us to monitor and measure our progress on a wide range of issues, including how well we engage with our people to recognise and value the contributions they make to our business, to help them develop and fulfil their potential.

Specifically in response to feedback from the Great Debate, in 2005 we redoubled our efforts to improve the way we communicate, beginning with around 250 of our senior managers attending workshops designed to demonstrate the "Power of Engagement". By the end of 2005 around 2,000 managers and supervisors had attended these workshops. Good two-way communication must be the hallmark of our business leaders and the benefits of this are increasingly evident in the satisfaction and performance of our people.

Health and Safety

Carillion has an absolute commitment to ensuring that all our people can work safely at all times, wherever they are. This commitment extends to those who work with us and those who could be affected by our activities, including members of the public. This requires the continual vigilance and commitment of everyone involved in our activities to ensure that safe working practices are always used. This is supported by rigorous reviews, inspections, training and education, all of which are actively promoted and led by the Board.

At the end of 2004, we launched a radical new initiative, Target Zero, aimed at eliminating reportable accidents by 2010. This is an ambitious target, but we are determined to create a culture of zero tolerance to accidents, not only within Carillion, but also within our stakeholders, including customers, suppliers and partners. Tragically, five people were killed while working on projects under Carillion's management control during 2005. These accidents reinforce our commitment to make Target Zero a reality and its benefits are already evident. Our Accident Frequency Rate (AFR), reduced by 35 per cent in 2005 to 0.24 (2004: 0.37). The number of RIDDOR accidents (Reporting of Injuries Diseases and Dangerous Occurrences Regulations 1995) for the Group reduced by 27 per cent in 2005 to 255 (2004:348). We say more about Health and Safety in the Corporate Social Responsibility section of this report on page 26. More detailed information can also be found in our 2005 Sustainability Report, which has been published on our website at www.carillionplc.com/sustainability.

Sustainability

We believe that our commitment to responsible business practices that create positive impacts on the environment and on the communities in which we operate, is not only good for our own people and for society in general, but also makes good business sense. It is fundamental to delivering sustainable, profitable growth.

Our commitment to becoming a more sustainable company began over ten years ago. Today, we are one of the recognised leaders in developing and adopting socially responsible business practices and

for demonstrating that these practices can have measurable business benefits. We benchmark our performance in a number of ways, including participating in Business in the Community's Corporate Responsibility Index, an independent annual survey of sustainability performance. Since its inception in 2003, Carillion has each year been ranked first in its sector and in the top quartile of all companies participating in the Index.

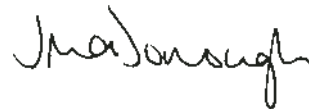
Our strategy model, which helps us to map and quantify the links between our business objectives and our impacts on the environment and society, continues to form the basis for our sustainability programme by identifying the areas where we need to improve our performance.

You can read more about this programme and the benefits it delivers for our business in the Corporate Social Responsibility section of this report on page 26. More detailed information can also be found in our 2005 Sustainability Report, which has been published on our website at www.carillionplc.com/sustainability.

Strategic objectives

In order to build on our success in 2005, we have set the following strategic objectives for 2006:

- ▲ Attract, develop and retain excellent people, by becoming an employer of choice;
- ▲ Successfully integrate Carillion and Mowlem;
- ▲ Achieve cost synergies at a minimum running rate of £10 million per annum by the end of 2006, and be on course to achieve a minimum running rate of £15 million per annum by the end of 2007;
- ▲ Reduce net debt to circa £200 million by the end of 2006 and be on course to reduce it to below £100 million by the end of 2007;
- ▲ Be on track to deliver materially enhanced earnings for the enlarged Group in 2007;
- ▲ Be the recognised leader in the delivery of safety and sustainability.



John McDonough
Chief Executive
8 March 2006