

QINETIQ

Acquisition of MTEQ
(Manufacturing Techniques Inc.)

Wednesday 2nd October 2019

David Bishop

Good morning everybody. I'm David Bishop, Investor Relations Director at QinetiQ. Welcome to the investor call which covers our exciting acquisition announced this morning of MTEQ. I'm joined by Steve Wadey, chief executive officer, and David Smith, chief financial officer. We'll take questions at the later stages of the call from investors and covering analysts only, please. I'll now hand over to Steve for an overview.

Steve Wadey

Great, thank you David, and good morning. Really pleased that you've joined us on this call, and as David says, to talk through the exciting news that we've announced this morning. So just over three years ago you'll be aware we launched an ambitious strategy to deliver profitable and sustainable growth. In support of that strategy, we've been investing organically and pursuing a thoughtful and disciplined approach to bolt-on acquisitions. Along with this strategy, this morning we have announced the fifth acquisition under this strategy of Manufacturing Techniques Incorporated, or as we will refer to it, MTEQ.

So MTEQ is a company, it's a privately owned business. It employs about 360 people in Virginia in the United States. The business is characterised by having very strong relationships with its customers, particularly the US Army, and supports a number of the key Army modernisation, key programmes. MTEQ is really renowned as a leading provider for advanced sensing solutions, in terms of rapidly developing and fielding those solutions into operationally relevant capability.

It has a particular strong reputation for what we refer to as mission-led innovation, a real customer-centric approach to driving innovation across the full cycle of sensor solutions from rapid creation and development all the way through to operational use. The work that MTEQ does is very aligned and complementary to our value proposition in the area of 'create it', part of the way that we are now expressing our company's value add to our customers.

And really, we look at MTEQ as being part of the way that our customers will have new and disruptive capability to solve their complex issues or operational problems. It really is a strong fit with our strategy due to three primary reasons.

First of all, as a business in its own right, it is growing strongly, and has significant opportunity. Secondly, it accelerates our growth in the United States, the world's largest defence and security market, by looking at the complementary skills that we have in the United States. And thirdly, it strengthens the implementation of our overall international growth and innovation strategy across the whole of QinetiQ.

So I'll now go into a bit more detail of each of those three strategic reasons before handing over to David to take us through the financials. So the first reason that we've agreed to acquire MTEQ is because it is a business that is growing rapidly. The market is growing because of emerging threats, and MTEQ's capabilities, particularly its ability to integrate outputs from multiple sensors provides information and intelligence that are so critical to the advantage of our war fighters in modern warfare.

It also operates in a way that is highly collaborative with its customers to rapidly create and field new capabilities. As I was referring to earlier, mission-led customer-centric innovation. Secondly, the acquisition accelerates our growth in the United States, the world's largest defence and security market. The acquisition of MTEQ will bring our combined US operation to circa \$300 million of revenue in the first full year of operation, and have with it

approximately 750 employees in the US, which will deliver solutions that really are critical to the next generation of war fighting capability, and that will be achieved through the combination of MTEQ's advanced sensing expertise combined with our existing capabilities in the United States of robotics and autonomy.

We'll also be looking at supporting the transition of MTEQ's rapid development of sensing solutions into larger production programmes by leveraging our manufacturing capabilities that we have in the US. And together in the United States, this really does deepen our relationship with the US Army, but also broadens our customer base into a far more diverse portfolio.

And thirdly it strengthens the implementation of our overall international growth and innovation strategy across the group. It's a significant step in building an integrated global defence and security company by more than doubling our US home country presence, and representing now nearly 25% of our group revenue. It builds on our capability as a company to rapidly create and field new products and services, and it also creates further growth opportunities by leveraging our technical capabilities into the United States, and also leveraging routes to UK and international markets from the US.

So overall, a very strong rationale, and complemented by a very attractive financial profile. So at this point I'll hand over to David to take us through the financials.

David Smith

Thank you Steve. So as I outlined at full year results, we have a very clear financial strategy that supports our growth ambitions. Our capital allocation policy and the rigorous approach to evaluating opportunities to deploy capital are key components of this. We certainly evaluated the acquisition of MTEQ using this same rigorous methodology to ensure that it made financial as well as strategic sense.

As Steve highlighted, MTEQ has a very attractive financial profile, it's been growing rapidly, delivering double digit revenue growth each year over the past three years. In the 12 months to the 31st of August 2019 it delivered revenue over \$167.4 million, EBITDA of \$11.4 million and EBIT of \$11 million. And in its most recent audited financial accounts as of December 2018 it delivered revenue of \$131 million, EBITDA of \$8.4 and EBIT of \$8.3 million. So it's investing to improve profitability at the moment, and long term programmes which will enable it to move away from lower margin cost plus contracts.

And as Steve said, we should be able to enhance margins further over time as we draw on our existing product manufacturing expertise in the US to transition MTEQ solutions to larger production runs.

The consideration we're paying for the business on completion is \$105 million, with a further \$20 million payable in cash and shares dependent on delivering stretching targets over the next three years. This gives an initial EV / EBITDA multiple of 9.2 times, and 12.5 times the audited statements. If the stretching targets are met, we'll expect this to be lower in reality based upon the forecast growth in the business.

We're funding this from our cash resources, and we anticipate remaining in a net cash position post-completion. This will leave us continued headroom for further bolt-on acquisitions, and I would reiterate that we expect to be able to fund our organic investments into the businesses through operating cash flows.

In terms of guidance for fiscal 20 and 21, we expect the acquisition to close towards the end

of the fiscal 20 period, and therefore the impact on this year will not be that significant. For fiscal 21, we're expecting MTEQ to deliver low teens revenue growth, with operating profit margins just over 7%, and we expect the acquisition to be accretive to EPS in fiscal 21, and to deliver a return greater than our cost to capital within the next three years.

As we are carrying US tax losses on our balance sheet, the acquisition will also allow us to use these more quickly, benefiting our effective tax rate. Given the resulting size of our US business, we will likely have to change how we report our segmentals, effectively creating a US segment. We're still working this through, and I'll give you more detail on any changes once the acquisition closes. So as I hope you'll see, the acquisition makes sound financial sense as well as being very well aligned strategically. I'll hand back now to Steve.

Steve Wadey

Great, thank you David. So to conclude, MTEQ is an acquisition that we're really delighted to announce. It really does enhance our capabilities, it's well aligned with our strategy to grow internationally, and it will deliver attractive and sustainable returns to our shareholders. And with that I'll open the floor to take any questions.

Operator

The first question comes from the line of Charlotte Keyworth.

Charlotte Keyworth (Barclays)

Morning chaps.

Three questions from me. Firstly on the very strong revenue growth that you've commented on from MTEQ – has this been purely organic, and how should we think about that going forward in terms of visibility in that US market? And perhaps you could also share with us the average contract length in MTEQ? Secondly, on margins, we've got a relatively low operating margin today of 6.5%, could you give us some sense of the margin opportunity, presumably through volume and perhaps transition on contract pricing, and how QinetiQ can assist with this?

And then finally, why are MTEQ selling now during such a strong growth phase, and perhaps you could comment on the triggers for the earn out? Thank you.

Steve Wadey

I'm thinking, David, maybe I could pick up on the sale point, and then maybe you can come back with the last one. I think it's a good question, Charlotte, why is MTEQ selling? And I think the best answer to that is to tell you what Mary Williams the owner would say, and she would say – and she's proud of what she's done with the business, and there is great opportunity, but she needs scale, she needs support from a wider group, and she needs investment.

And we went through a very, very diligent exercise of interviewing each other in both directions, us understanding MTEQ and MTEQ understanding us, and we had a great strategic business opportunity and cultural fit, and this is an opportunity for Mary to be part of the QinetiQ family, and to take the contribution that she can make in the US market with the other capabilities that we have to the next level, and to another level internationally in the US.

So from a strategic point of view it really did fit. So there was really clear rationale as to why

it was right for her and her team to join us as a family. And in terms of what that links into in terms of your question about earn out. Again, I think it's a great point, because I'm really delighted, I really am pleased with Mary and her leadership team, they are so bought in and committed not just to MTEQ but the vision and strategy that we have as a group.

And that's why I'm really pleased that we've been able to agree an earn out not on a one or two year basis, which is the norm, but actually on a three year basis, an earn out that is split on cash and shares, which creates even greater alignment, not just with MTEQ performance but overall group performance. And as we've said in the press release, we've got some pretty stretching financial targets that that leadership team is committed to. It's a simple earn out based on a profit profile, and based on their achievement of that profit profile over the three year period so they will earn the earn out. David, first two.

David Smith

So in answer to your first question, the revenue growth has been primarily organic. There was a small acquisition a couple of years back but that was relatively small. So it genuinely is being driven by organic growth. And visibility is probably what you'd expect in a product type business. The contract lengths are typically shorter than we would see in a services business, so in the six months to two years sort of range, although they do have some framework contracts which they're delivering on which are longer, but they won't be booked into the backlog because they're framework arrangements.

Certainly the opportunity for them, I think, going forward, is actually to do more longer term work, and particularly the equivalent of what we've been doing in QNA in the programmes of record is absolutely one of the things that the business is targeting at the moment. And that really comes through into the operating margin question.

You're right, at sort of mid 6% the operating margin is lower than the QinetiQ business margin at the moment, and that's primarily because they've essentially been delivering prototype solutions at low volume, really on a cost plus basis into their main customer. Going forward, they have the opportunity to start developing this on a more firm contract base for larger production runs, and certainly contracting mechanism, and the ability I think then to have a more efficient supply chain and manufacturing solution as they start ramping up volume will provide margin opportunity.

So we said next year we should get over 7%, and we'll continue to drive that. It probably will never get to the sort of level of margin we have across QinetiQ, but it's a relatively low capital business, so actual in terms of return on capital it's actually a very attractive business. So I think that the growth story is really very compelling here. The margin story there's definitely upside, and we can help that process to accelerate as well, and the team is really focused on how they can deliver that improving margin over time.

Steve Wadey

And I'd just add to what David said there, Charlotte, if you look at what we've done over the last three years of our strategy is that we've progressively migrated much of our business onto longer term programmes. Mary and her team were on exactly the same trajectory, so we now have an opportunity to share experience and help deliver exactly what David's just said.

Charlotte Keyworth

That's good. Thank you very much.

Operator

The next question comes from the line of Jack Barratt.

Jack Barratt (GLG)

Good morning guys, thank you for taking my questions. Three hopefully quite brief ones for me. First of all, have you dealt with them before? So how did you find them, have you worked in collaboration, have you used them before, that's my first question. The second question is in terms of the actual process, was it just you and them discussing it, was there a process run, and were there other bidders? And then my third one, just in terms of their revenue split, you talk about them as mainly a products business, but from what I can see on their website this morning, manufacturing is only one of the six things they say they do on their website, including designing, analytics, sustainment, etc.

So just a bit of a breakdown of their revenue base in terms of how much is just building and selling things at a price, and how much is either on-going data or R&D or time and materials or testing learning, things like that. That would be great, thank you.

Steve Wadey

Okay, thanks Jack. So first of all, in terms of have we dealt with them before, the answer is yes. Our CIT business in the UK actually is collaborating and working with them on a number of security projects into US customers. I wouldn't say that that is a high volume relationship, but it does mean that there has been a relationship before, and that also says that we've established similar ways of working, and it's been a nice test point for how this has developed into the acquisition that we've announced this morning.

In terms of the process, it was a competitive process that was being run. Mary, the founder of the business, got to the point, as I was describing to Charlotte, that it was the right time for the reasons I expressed to seek what she would say – a strategic partner to help her take the business to the next level. So yes, it was a competitive process, but it was very thorough, it was very disciplined, it wasn't just about the numbers, it was about strategy, it was about cultural fit, and you'll have time, in the future, to meet her.

We'll have one of our investor events, and I think she would be playing back exactly what I'm saying now, and actually was very seized by the vision and strategy of what we're trying to do in the world, and she saw that alignment. And therefore I think that the relationship that we developed, and the strategic fit that we saw in some ways – and I can say this – overtook the process, and got us to jointly the right outcome.

In terms of the revenue stream, I don't know if David, you would like to say a few words on this?

David Smith

I think, Jack, I think if we've given the impression it's a products business, I don't think that's correct at the moment. They're providing a prototype solution, which is then put into operational capability, and they provide a service wrap around that. So the actual element of product within it is still quite small, as you said the manufacturing is relatively small. But it's more of a sort of research and development, with then an operation solution and a service capability around that, at the moment.

We do expect the product content within this to grow over time, which is why we're referring

to the fact that as they move out of literally single figure types of solutions into tens and maybe hundreds of solutions then product will become more significant in it, but it will remain really focused on that sort of creator end of the spectrum of what's done. And really finding sort of disruptive and innovative solutions to the customers' specific issues around the sensing environment.

Steve Wadey

And therein lies the opportunity, Jack. In some ways it's got lots of similarities to – let me take the cyber and information part of QinetiQ. We've got some really, really bright, brilliant scientists and engineers in MTEQ, they do do design, they do do development, they do do integration, and as David said, at this stage they do low volume production and rapid deployment of those low volume productions, and therein lies the opportunity. And that was what Mary was seeking, and we saw as the complementary fit with our strategy, that we can exploit that brilliant front end R&D as part of the creative phase of our value proposition, and start to migrate that into longer programmes and higher production runs that will then start to build up revenue cover and additional margin.

Operator

The next question comes from the line of Sean Stewart.

Sean Stewart (JP Morgan)

Hi, good morning guys, it's Sean Stewart from JP Morgan. Just one question from me. On the tax, I just wanted to know the size of the US tax loses that are currently unused, and over what sort of time period you expect to be able to use them, and what impact that may have on the group tax rate next year?

David Smith

Yes, the operating losses that we're not recognising at the moment are about \$20 million roughly. I think there is a table in the accounts with that, but it's about \$20 million. So we would be able to accelerate the usage of those. So there will be a small percentage change on the group tax position, but it's not hugely significant, but it's just an advantage of the deal, I think.

Operator

The next question comes from the line of Chris Leonard.

Chris Leonard (Credit Suisse)

Hi guys, yes, Chris Leonard from Credit Suisse. A few quick ones if I may. I just wondered if there's – I mean, you've spoken on it, but if there's any more examples you could give on the particular areas that you can see where there would be capability that can be added to QNA and robotics, and any particular examples where you feel that maybe there was capability that was lacking, that obviously these guys can bring through for you.

And secondly if there's any particular programme of record that you might now be targeting which you maybe couldn't have targeted previously, or where this maybe now could enhance your bid going forward. And equally, looking at the website, it looks like there are a few sizeable framework contracts that MTEQ has exposure to currently, and I don't know if you've looked through them, but if you could maybe speak on what you think could be the most important, or areas where you think you could add to them to enable them to secure

higher orders through on those contracts or framework contracts.

And then lastly if you could maybe try and scope what type of CAPEX investment you think could be necessary for this business going forward next year, given that you commented that there was maybe more investment that needed to be done here. Thanks.

Steve Wadey

All very good questions, Chris. My mind just – to be open with everyone – we've got really good answers to all of them, but some of what you're asking is quite competitive in the US market, and I think you'd understand that I'm not going to be able to answer some of that because it might jeopardise our competitive advantage. But in terms of areas of capability that are complementary, I do think there are a number.

So first of all, to repeat, MTEQ has got huge strength, really huge strength in that rapid development create it phase, of really disrupting the way, from a mission customer-centric approach, sensing solutions are designed and developed in very short order to allow the US war fighter to extract what it needs from sensing into information that it can then take to an advantage in the battlefield. That is a real strength of MTEQ.

A real strength of QNA is the ability to go through really strong mature product development and manufacture. It is a products business. And I'm just trying to keep it simple. Those actually become very complementary capabilities in a business in terms of process and approach.

The second real complementary nature that I'll bring out is the complementary nature between a technology base that is rich in terms of sensing, and all of the capabilities that go around sensing, such as analytics, data fusion – all of the technical capabilities that allow for disruptive sensing to add value in the battlefield, and the capability in QNA around robotics and autonomy. And if you look at the nature of how warfare is migrating, the ability to bring autonomous platforms or robotic platforms with autonomy and sensing that draws together intelligence in manned, unmanned teaming is a huge growth opportunity not just in the biggest defence market in the world, but across the whole world in terms of defence.

So if you look at the core technical capabilities of sensing, robotics and autonomy, we have a real platform to actually grow beyond it. And those are the process and technical complementary natures that we see between MTEQ and QNA, and that's really before we've got into the conversation about how, as we look at combining our operations in the US, we can leverage those strengths not only in the US for the US war fighter, but then take that to international markets, and also bring in some of the strengths that we have outside of the US into the US market.

And I think that's the sort of kernel that we're trying to express to you of the growth opportunity. To your specific point about programmes of record, the answer is yes, we do have specific major programmes where we can see that those complementary processes and technical capabilities will allow us to put together disruptive offerings that we think the US customer will be really seeking.

I really won't name them today, because they are competitive processes, and I wouldn't want to sort of jeopardise our position in those programmes. But we've looked at the strategic case not just in abstract but in specifics about how we would leverage into real programmes.

And in terms of your last point about frameworks, so yes, I mean, it sort of goes back to a

number of the previous questions that we've had. So MTEQ is in a very good place on a number of framework programmes, which is great because it has an opportunity to grow into those frameworks. But MTEQ is also on a path of actually migrating to longer programmes that are fixed price in nature, and actually we will see the complement of both of those dynamics occurring in the years ahead.

David Smith

And just to your CAPEX question, I think the investment requirements are actually relatively small, so they're sort of single digit type dollars of investments. The main thing that they're going to have to work on is productionising their existing floor space in terms of just ramping up production capacity, and we will look at the opportunities also to share some of that manufacturing effort with other facilities that we own in the US.

And then clearly there will almost certainly be some investments that we need to make on the IT and knowledge management side, but we're not talking about huge numbers here. We will absolutely provide the right investment to provide the platform for growth.

Steve Wadey

And just on that point, it really makes me think – and I'd like to sort of reinforce to all our shareholders and investors that are listening – David did explain, we've applied exactly the same disciplined approach that we've applied to all four of our acquisitions, which you can see are really bearing fruit. It's been absolutely strategy led, from number one perspective. Number two, the economics have had to make great sense in their own right, with – as I often describe – multiple leverage opportunities on top of the core financial case.

And thirdly, we've really been thoughtful about the integration and execution to ensure that what we announce today isn't just about what we've announced today and maybe in the close period that David said in three to six months' time, but actually is going to be delivered and give our shareholders enhanced return in the years to come.

And it really has been a very thorough process, it's lasted over six months to get to what we've announced today, and we're really excited about what it brings to the group in terms of overall globalisation and making a difference in the defence and security market for our customers.

Operator

There are no further questions in the queue.

David Bishop

Thank you very much for joining this call this morning. Please to contact Ian Brown or myself, David Bishop, his details are on the bottom of the RNS this morning if you have any further questions during the day. Thank you again, and goodbye.