

Agreement to acquire EIS Aircraft Operations

Analyst and Investor call – 24 April 2018

Speaker Key:

DB David Bishop

SW Steve Wadey

DS David Smith

DB Good morning everybody. I am David Bishop, Group Director of Investor Relations. Welcome to our conference call this morning, following the announcement of the acquisition of EIS Aircraft Operations. The plan for the call is that Steve Wadey, CEO, and David Smith, CFO, will take us through the details of the acquisition. There will then be time for Q&A for our covering analysts and investors only, and we will make a playback and a transcript available later today. Steve, over to you.

SW Thank you, David. Morning everyone. Over the last two years we've been implementing our growth strategy, underpinned by a strong capital allocation policy, which has prioritised organic investment, complemented by bolt-on acquisitions where there is a strong strategic fit.

In line with this strategy, we are really pleased this morning to announce the acquisition of EIS Aircraft Operations, based in Germany, the third acquisition in my time here as CEO. It is a strong fit with our strategy because it's a business that is growing strongly, it provides an entry point into Germany and the broader European defence market, and it strengthens our core offering, providing opportunities to provide additional services to our customers, in particular in the area of military training.

Now, there are four key components of the strategic rationale, and I will just run through each of those. So, first of all, Aircraft Operations has a strong track record of growth and further growth potential. If I just describe what the business does in essence, just over half of its FY17 revenue is from airborne training services.

The company operates a highly cost effective fleet of 14 leased Pilatus, PC-9 and PC-12 aircraft, flown by a specialist team of 20 pilots, who deliver military training in support of both German and international customers. This enables it to provide a very cost effective and therefore disruptive training offer, and it has strong relationships with its customer base.

It has been an exclusive provider of low speed aerial training services to the German armed forces since 1999, and it also provides similar services to the United States Air Forces in Europe at its test school in Germany. Just under half of its FY17 revenue is from its special mission aircraft modifications business. It has a range of technical

capabilities integration of intelligence, surveillance and reconnaissance capabilities, such as sensors and digital systems onto the aircraft.

It is a certified specialist in the modifications to Pilatus Aircraft, of which there are many hundreds of operations in military use around the world, and once it has made these modifications, the company is then very well placed to deliver the associated training services.

The second component of the strategic rationale is that it supports our strategy for growth. The company is exposed to sustainable and growing end markets, driven by the increasing demand for more cost effective training. It's well positioned to do this because it is significantly more cost effective in the way that it delivers its training, rather than jet engine aircraft alternatives provided by other suppliers, and as a result of this strategy, the company has delivered an average annual revenue growth rate of some 17% over the past three years.

The third component of the strategic rationale for the acquisition is that it accelerates our international growth. The acquisition provides an entry point into the growing German test and evaluation and training market, it enhances our access to the broader European defence market, and we will also enhance Aircraft Operations potential under our ownership through our wider access to the international markets that we are developing, such as areas in the Middle East.

Fourth and finally, it strengthens our ability to deliver on our strategy in areas of threat representation and operational training for our customers. It enhances our capabilities in live and synthetic training. It complements our capabilities in the UK in the aerial test air recruit training and engineering services, and it supplements the acquisition of Meggitt Target Systems at the end of 2016, so that we can now provide both manned and unmanned airborne test and training services.

So overall, it's a strong fit with our strategy, and it's also supported by a compelling financial rationale, which David will take you through.

So, over to you David.

DS

Thank you.

So, as Steve said, the business has a very attractive financial profile, growing revenue at a compound annual growth rate of 17% over the last three years. In the year to the 31st of December 2017, the business generated €20.1 million of revenue, and approximately €5.4 million of EBITDA, and that represents an EBITDA margin of 27%.

The average margin over the last three years has been over 20%.

In addition, the business is highly cash generative. So, we're going to be paying €70 million from our existing cash balance.

On the FY17 numbers, this represents an EBIT to EBITDA multiple of 12.9x. That multiple will fall further, based on expected revenue growth.

So, we would expect revenue to be in the 23 to 25 million Euros range for the 18 calendar year, and EBITDA of around six million for this year as well.

We believe that that therefore represents an attractive valuation for the business that's growing faster than QinetiQ, and has higher margins and strong cash flow. We also expect the acquisition to enhance earnings per share this financial year. So we ought to see 2% to 3% for this financial year, so QinetiQ FY19 and then over 4% for FY20.

SW Thank you, David. So, overall, an acquisition of a growing business that is a great fit with our strategy, and we firmly believe that under our ownership we will be accelerating the delivery of its growth, as well as enhancing the overall capabilities of QinetiQ into wider markets. So that's the summary of the acquisition, happy to take any questions.

Question Thank you. Good morning gentlemen. Just two questions from me. The first one, does the company have a firm backlog contract with the German Airforce, with the United States Airforce, or is this an on-going business, and what type of visibility do you have for the growth that you are forecasting for the next two or three years?

SW Okay, that's the first question. Second question?

Question The second is just the depreciation, appears to be a capital light business. It's mainly using leased aircraft, so what do you expect depreciation charges to be this year and next year?

SW Okay David, do you want to start on the second question and make a comment on that about the visibility, and then I'll make a broader comment?

DS Yes. So, the business actually has been leasing its main operational assets, both the aeroplanes and the hangars it uses. Its depreciation is actually quite low. It's in the region of two or three hundred thousand. So it's not a major part of the business, and fixed assets are also quite low at the moment. It is possible that we will make further investments there in the future, but at the moment it is a very capital light business.

In terms of the contracts, Steve will speak to that, but it has two types of business, the airborne services business and then the special modifications. So Steve, do you want to just talk to that?

SW Yes, I mean, it has a pretty healthy backlog. It has long term contracts that will progressively go through renewal. Those are the main programmes that it delivers for the German Airforce and the United States Airforce, and then it has also a range of long term and short term contracts so it wins on a progressive basis. So I would just describe it as healthy backlog, and through due diligence, we have seen reasonable visibility about the revenues going forward.

Question Have you taken a view on the outlook for German defence spending over the next few years? Do you expect that to grow faster than the UK, or slower?

SW Well again, it's similar to the comment that I use often on these questions. You know, it's a relatively small company in a pretty large defence market. So whilst there might

be macro trends in German defence, which as you know is positive, the most important thing for us to do will be to focus on the service that we provide, make sure there is good continuity to our German customer and look at how we can enhance the offering that we provide into that customer to look at whether there are opportunities to grow in

Germany and then use that as a reference to take into other nations, not just only in Europe, but in other regions that we are focussing on, such as the Middle East.

DS I will just add that as we said in the press release, they've been growing at 17%. We actually expect growth will be higher in this calendar year. They are benefitting both from bringing on more planes into the fleet, which is taking up unfulfilled demand for their training and simulation services. They also there is a lot of work in the backlog at the moment around special mission modifications that they are working through over the next year or so. So, that's actually going to provide quite a boost to their revenue in the short to medium term.

Question Morning guys. Well done on the deal. I was just wondering about the integration process. Anything on costs, and in that way hopefully we can feel that you guys are taking it and it's two businesses coming together, and hopefully, as I say, moving forward with regards to revenue synergies ahead. I'd just be interested on the timeline of those things.

DS Yes, I think there could be some limited cost synergies, but I think this is mainly for us a growth play, both in terms of the growth potential of the business itself, which is unfulfilled. It still has quite a lot of room to grow, and then as we have outlined, the linkages to our own strategy, both giving us stronger entry into the European market, and Germany in particular, but also allowing us to take some of their skill base and complement that to other things that we are doing in the UK and the Middle East for instance. So, this is really around growth synergies longer term, rather than costs, particularly.

Question Okay, and then just the integration process when you feel it will be fully within the QinetiQ stable as it were?

SW Well, the completion is now really going to be in the hands of the regulatory approval, which could take us through to our half year, so in September. I mean, we hope to see it conclude faster than that. As David says, the integration process, we know how we're going to integrate it into our business. It will be integrated within our international business, and that's for pretty clear reasons that go back to David describing our focus on growth and revenue synergies.

It will be looking to supplement the skills of our international team about how we can enhance not only the operations of this acquisition, but how we can take the various services that it provides into other international markets. So, it will be the lighter integration into the international business and very much focussed on the external markets where we can grow.

Question Then I guess finally, just given that it's a small company that has clearly grown very strongly, I guess smallish companies will have a teething problem around maybe

perceived financial strength. Do you think that the size of the company, if you like, has been an impediment to its growth with regards to order of wins? Do you think your financial strength can bring benefits in that regard, or is that too harsh, if you like, on the company, and they have done a very good job?

SW I certainly think that considering this acquisition as a core component of our strategy, it is. It is absolutely in the sweet spot of the strategy and the growth markets that we are pursuing. I think that's a key component that we believe we can add value to it, not only as a growing business in its own rights, but expanding it into other markets. That is one of the key rationales for pursuing with this acquisition.

Question Okay. Well done again. Thank you guys, and see you soon no doubt.

TO There are no more questions coming through at the moment.

DB Right, thank you ladies and gentlemen for joining the call this morning. As I have mentioned already, we will make a playback facility and a transcript available later on today, and Ian Brown and myself are around if you have any further questions following the call. Thank you.