QINETIQ

Interim Results for the 6 months ended 30th September 2019

Call Transcript

Thursday 14th November 2019

Steve Wadey

Good morning, everybody, and welcome to our interim results. I'd also like to welcome Neil Johnson, our new chairman, who has joined us here this morning. Welcome, Neil. So, I'll start by mentioning our most recent news, our agreement to acquire MTEQ announced on the 2nd of October. This acquisition strengthens our expertise to rapidly create and field new products and services; creates additional value by combining advanced sensors, robotics, and autonomy that are critical enablers to modern warfare; and more than doubles the size of our U.S. operation, increasing the U.S. to approximately 25% of our Group. This picture represents our first major collaborative opportunity with MTEQ, where we have proposed the integration of an MTEQ sensor package onto one of QinetiQ’s autonomous systems for the U.S. Army, enabling advanced sensing of threats in a contested battlefield whilst keeping the war fighter out of harm's way. Acquiring MTEQ is symbolic of our great strategy in action, driving growth by building an integrated global defence and security company and delivering healthy returns for our shareholders.

So, the agenda this morning is as follows. I'll start by giving you the headlines. David will provide a commentary on our interim results. I'll then come back and give you a strategic update, and we'll then open up for any questions. So, let's start with the headlines. We've had a good start to the year with strong operational performance. Orders are up 38%, 30% on an organic basis, enhancing revenue visibility with a high-quality order backlog of £3.1 billion. Revenue is up 16%, 10% on an organic basis. We've maintained good control of our cost base and delivered profit growth, up 8% on an organic basis after adjusting for non-recurring items. Cash performance remains strong with 129% cash conversion pre-capex and returns are healthy, with EPS s up 14%. The interim dividend will be a third of prior year total.

Our growth has been driven by continued focus on our strategy implementation. We're on track with delivery of the new LTPA contracts signed in April. We have successfully doubled our international revenue from £76 million to £151 million over the past three years. We also won a £67 million secure navigation program for the U.K. MOD, ensuring U.K. armed forces can navigate safely and securely. And as I just mentioned, we announced our agreement to acquire MTEQ. Looking forward, we're in a really healthy position with 96% of our revenue under contract, up from 90% at this time last year. Our key priorities for the remainder of the year are to maintain our strong operational performance through disciplined execution of our bids, program delivery, and acquisition integration; win further competitive contracts and pursue our campaigns globally; and continue our program of investment to maximize returns and drive sustainable, profitable growth. As a result, we are maintaining our expectations for group operating profit.

Overall, through our customer focus, we have made great strategic progress, and I'm confident that we will continue our growth trajectory in the years ahead. I'll now pass it over to David to summarize our financial performance.

David Smith

So, thank you, Steve, and good morning, everybody. I'm going to begin with a summary of our financial performance in the first half. Before going in to some more detail on the drivers. As Steve has already mentioned, we've made really good strategic progress with continued growth in the first half of the year and we've increased our revenue by 16% to £487 million and by 10% on an organic basis. We've delivered underlying operating profit growth of 16% to just under £60 million, assisted by £2.4 million from the acquisition of EIS and investment in Inzpire and a £1.6 million non-recurring trading item. We didn't benefit from any non-recurring trading items in the same period last year. We've delivered a strong 30% organic growth in order intake and 38% overall and including the LTPA amendment our backlog stands at £3.1 billion. We've achieved strong cash performance with 129% underlying cash conversion and EPS rose to 9.2 pence, a 14% increase. We're proposing a half year dividend of 2.2 pence, which is one third of the prior year total dividend and that reflects our previously announced interim methodology.

So, starting with orders, we made very strong progress on orders, as I said, 30% organic growth, 38% overall. The main driver of the orders growth for the period was EMEA Services, which grew organically by £92 million, and that was due to the multi-year £67 million order for the U.K. robust global navigation system, or RGNS and £60 million under the engineering delivery partner contract. In global products, orders were stable when compared to the prior period and the acquisition of QinetiQ Germany and investment into Inzpire contributed a further £21 million to orders in the reported number. So, at the start of the second half, we had 96% of revenue under contract and that compares to 90% at the same time last year and around 74% at the start of the year.

So, turning to revenue, we made very good progress in EMEA Services with 9% organic revenue growth and 14% organic growth in global products. Combined that gave us the overall organic revenue growth of 10% in the period. Our acquisitions of QinetiQ Germany and Inzpire are performing well, contributing to the broader success of the group. During the period, they contributed £21 million in revenue, which resulted in overall reported revenue growth of 16%. Whilst we don't present it here, we continue to maintain progress against our international strategy. We've grown international revenue by £21 million to £151 million and representing 31% of our total revenue.

So, turning to operating profit, overall, reported profit was up 16% and 8% on an organic basis, excluding the impact of the non-recurring trading items, acquisitions and FX. As I said, that non-recurring item of £1.6 million was the result of sales of some aircraft and spares with nil in the prior period. In EMEA Services, profit grew 3% on an organic basis and in global products we saw a 27% organic increase in profit, really driven by high margin product sales and QinetiQ target systems. EIS and Inzpire contributed a further £2 million to the operating profit in the reported number, and that results in a group margin of 12.3% or 11.9% once non-recurring trading items are excluded. We expect to be within the 12 to 13% range at the full year in line with our previous guidance of stable group margins. So overall, a strong performance with organic growth across orders, revenue, and operating profit.

Turning to EMEA Services, the chart here shows the split of the major business segments within EMEA services. Revenue increased by 15%, 9% on an organic basis and that was largely driven by new work through the EDP and BATCIS contracts. The significant 57% increase in orders, as I've already said, was due to key orders of RGNS at £67 million and the impact of EDP. We made further good progress on EDP, adding an additional £60 million of orders during the first half, and that brings the total under that contract now to £129 million since it was signed. As a single source contract and given its minimum capital requirements, the margin we make on EDP and similar contracts is lower than average group margin, but it remains well in line with defence industry more generally and delivers appropriate returns. We do expect EDP to be a growth driver of our U.K. business in the medium to long-term.

We're very disciplined and we carefully evaluate these kind of new business opportunities to ensure that we are -- that we are winning appropriate work and we understand the risks we're taking and the returns that we deliver are appropriate for our shareholders. Underlying operating profit increased by 12%, assisted by the non-recurring item and the £2.1 million from some EIS and Inzpire. Excluding the impact of these non-recurring items and foreign exchange, underlying operating profit grew by £1.4 million or a 3% increase, as I've already said.

Our total funded order backlog has increased significantly following the strong performance in the period and the signing of the LTPA amendment in April. We continue to benefit from very good revenue visibility, 98% actually for the second half, compared with 91% at the same time last year.

Turning now to global products. It's worth noting that the performance of global products is more dependent on the timing and a mix of orders than EMEA Services. Orders actually remained stable when compared to the prior period. But revenue was up 17%, driven by QinetiQ Target Systems. Global Products operating profit was up 27% and as I've already said, that was driven primarily by high margin products in QTS. We have 89% of global products second half revenue under contract as at the 1st of October, compared to 86% in the prior period -- sorry -- full year revenue compared 86% in the prior period.

Turning to cash flow, overall, our operating cash conversion at 129% was strong. We saw a further working capital unwind of £5 million and that was primarily due to higher inventories. We continue to expect working capital outflows to be £20 to £30 million for the full year. Cash flow associated with capex was £39 million as we continue to invest in our core contracts including LTPA and other parts of our business. And after capex, we had cash inflow of £38 million. And it's worth reemphasizing that given the cash generative nature of the business; we expect to be able to fund our capex and organic investment from operating cash flows.

I've presented here on the next slide the movements in net cash during the period. Our net cash position £189 million has been restated to reflect the adoption of IFRS 16 on lease accounting, which reduced net cash by £27 million. Net cash flow from operations of £38 million was partially offset by tax charges of £9 million and a small interest charge, and that resulted in free cash flow of £29 million. After the dividend and receipts from property disposals, we actually ended the half year with a net cash position of £174 million. We announced our intention to acquire MTEQ following the period end. And as illustrated in this chart, there will be a reduction in the cash position when that initial consideration is paid. But, with this net cash balance, a pension surplus of £241 million and committed facilities of £275 million our balance sheet remains robust with capacity to support our growth plans for the company. So, as I said before, our financial strategy is to drive revenue growth at stable margins with appropriate returns. And as part of that, we maintain a very rigorous approach to evaluate the deployment of our capital, scrutinizing both organic and inorganic opportunities in the same manner to ensure the returns to shareholders are appropriate for the risk taken. An example of this is clearly the approach and our recent announcement of the agreement to acquire MTEQ.

I wanted to provide a quick recap of the financials before Steve revisits the strategic rationale behind the deal in further detail. So, we evaluated MTEQ with the same rigorous process that we use to evaluate all opportunities to invest capital both organically and inorganically. As some of you may recall, MTEQ is a leading provider of advanced sensing solutions. In the 12 months to the 31st of August 2019, they delivered revenue of $167 million, with an EBITDA of $11.4 million and EBITA over $11 million. We're paying $105 million initially with a further potential $20 million earn-out, which will be paid in cash and shares over a three-year period that's subject to stretching targets. So, that gave us an initial EV / EBITDA multiple of 9.2. It would be 11 times if the stretching targets for the earn outs are met although clearly, we expect this to be lower in reality, based on the forecast growth in the business.

This earn-out both incentivizes and retains a management team for MTEQ. The business has been growing rapidly, delivering double digit revenue growth over each of the last three years, and we anticipate that the acquisition will enhance our earnings per share in the first full year. At the time of announcement, we said we expect MTEQ to deliver low teens, revenue growth and operating margins of just over 7% in fiscal 21, and that's still the case. We expect to be able to improve the profitability of the business over time as we move into higher rate production.

Turning now to my usual technical factors slide. These have been updated, but not very much for the forecast for 2020. We have a positive cash balance and our underlying net finance costs are expected to remain minimal. Our effective tax rate last year was 10.1% and we anticipated this will increase in fiscal 20 due to the high proportion of international revenues. In the first half, the rate was 12.3%. We now expect also the cash flow outflow to increase in parallel to that in the fiscal 20. We continue to see some net working capital outflows and we estimate that during the second half that will reach the region of £20 to £30 million for the full year. Pensions deficit recovery payments have now ceased, although we still do have an asset backed funding scheme and we'll see about a £2.8 million outflow in respect of that this year. And capital expenditure is likely to remain similar to fiscal 19, probably at the upper end of the £80 to £100 million range as we continue to invest in our major contracts. As I said previously, this will remain elevated in the £70 to £100 million range through the next three years.

So finally, on the outlook, in the financial year today, we delivered a strong first half result with organic growth and orders, revenues, and profit driven by good performance right across the business both in the U.K. and internationally. We're maintaining our expectations for full year profit, but with higher single digit revenue growth. Taking a long-term view beyond fiscal 20, we will continue to grow by implementing our strategy and investing in our people, technology, systems, and infrastructure. And by doing so, our objective is to deliver continued organic revenue growth further supported by acquisitions, resulting in sustainable profit growth and stable margins. I'll now hand it back over to Steve, who'll take you through strategic progress.

Steve Wadey

Thank you, David. So, recent events underscore that the world around us is becoming more uncertain and the pace of change continues to increase with political uncertainty, security threats, economic pressure, and technological change. Three and a half years ago, I launched our vision-based strategy to proactively respond to such dynamics and drive growth by transforming our customer focus and competitiveness. This strategy has driven our successful growth to date. Whilst our vision and strategy remain the same we have made two important refinements, which will drive our focus and choices for future growth. First, we are creating a high performance inclusive culture to ensure our growth strategy is both profitable and sustainable, built upon simple values and behaviours where everyone in our company feels valued and included and wants to deliver the highest environmental, social, and governance standards. Engaging and empowering our people in driving our strategy, is an area where we're making great progress, increasing our engagement score by 8% over the past year. And finally, improving our operational performance by incentivizing and rewarding all employees to deliver profitable growth.

Second, we are creating greater focus for our strategy led decisions and investments through a customer value proposition that is relevant to the emerging needs of our defence and security customers. Create it, developing cutting edge technology and rapidly turning into capability. Test it, testing and assuring the capability will work when it is critically needed. Use it, enabling our customers to be trained and operationally ready. Also, we create value at each stage of the life cycle. We have a unique ability to create additional value by driving innovation across the whole lifecycle at pace. Our customer value proposition is far more than a description of what we do. Central to our growth strategy, it is a strategic tool to drive the decisions in what we choose to do, what we invest in, and how we work across the company.

To help bring our value proposition to life, I would describe an example of how we integrate our investments, including acquisitions with our teams across the U.K., Canada, Germany and Australia, collaborating to deliver value for our customers. For Create it, we acquired QinetiQ target systems to fill a capability gap in threat representation. We have subsequently invested in the U.K. and Canada to create two new state of the art targets to represent threats cost effectively and drive further international sales. We are also integrating all of QinetiQ target systems targets into our U.K. ranges to attract U.K. and international customers and deliver a new service that has only been realized as a result of this acquisition. For test it, we're investing in the long term partnering agreement with the U.K. MOD, known as the LTPA, to modernize our U.K. ranges to be more competitive and relevant, thereby attracting further U.K. and international customers, such as the U.S. Navy undertaking their ballistic missile defence exercises known as formidable shield at our Hebrides range. And finally, for use it, we acquired QinetiQ Germany to fill a capability gap in airborne special missions and training. We have subsequently invested to develop with support from Australia, a highly innovative maritime patrol aircraft to ensure safe clearance of our U.K. ranges. Again, a new service that has only been realized as a direct result of this acquisition.

The integrated and synergistic nature of our value proposition creates new products and services that drive additional value and growth by enabling our customers to develop and field new capabilities at pace to respond to emerging threats. Also, we've made great progress over the last three and a half years growing our company. We have significant further growth potential. Our addressable market defined by our core offerings and selected target markets is worth more than £8 billion per year, as shown in the graphic. We will expand into this market by building an integrated global defence and security company that provides coherent products and service offerings in our chosen markets. Our growth will be driven by our strategy led investments focused on creating value for our customers, winning engaging work for our people and delivering returns for our shareholders. These investments will continue to be underpinned by our rigorous financial approach and be mutually supportive, covering organic investments to grow existing contracts such as the LTPA, winning new contracts such as the RGNS program and pursuing our campaigns globally. And finally, investments to mature our company, such as developing our people, new technology, state of the art systems, and modernizing infrastructure. With an order backlog of more than £3 billion will continue to be disciplined in delivering our commitments by maintaining control of our costs through productivity and efficiency improvements and focusing on the effectiveness of our bidding, program delivery, and acquisition integration. Our growth ambition remains high and we continue to build our company through customer focus and disciplined execution of our strategy. As David said, converting revenue growth into sustainable, profitable growth at stable margins, thereby increasing returns to our shareholders. When I launched our vision and strategy in 2016, the first priority was to lead and modernize U.K. defence testing and valuation to ensure that the capabilities we delivered through the LTPA were relevant and competitive to meet future U.K. defence needs and be attractive to our international allies.

The LTPA is our largest contract, contributing approximately £320 million revenue per year through to 2028. In December 2016, we secured the first £1 billion contract amendment to modernize and operate air ranges and test air crew training, underpinned by £180 million of investment with appropriate returns for our shareholders. We have delivered major modernization, which is now realizing growth from U.K. and international customers. The first students from our state-of-the-art cost-effective test at crew training program will graduate next month, and we are now seeing strong demand for our new courses, particularly from international customers such as Australia, Netherlands, Switzerland, and Singapore. We're also nearing completion of the modernization of our air ranges, which will enable our customers to test and train defence capability in more realistic and complex scenarios against more demanding threats. As a result of this investment, we've now secured U.S. Navy commitment to the formidable Shield series of life fire exercises through to 2025.

I'll now show you a short film that brings to life the benefit of our investment in modernizing our air ranges that enabled the formidable shield exercise earlier this year.

In April 2019, we secured the second £1.3 billion contract amendment, underpinned by further investment of £190 million, again delivering appropriate returns for our shareholders. This amendment also gives us greater commercial flexibility to upgrade our test capabilities across the whole of the LTPA contract to enable increased capacity and growth. We are delivering a two-year transition program to put in place new processes and modernize our way of working to deliver additional value to our customers. Six months into this transition program, we are working in close partnership with the U.K. MOD, and have successfully delivered the first two major milestones on schedule, as well as launching the next phase of investment projects. The modernization of test and evaluation enables us to support the delivery of major U.K. defence programs and put new military capability into the hands of the war fighter faster.

As I'm sure many of you will have seen in the recent BBC documentary series, Britain's Biggest Warship, preparing the ship for service is a huge undertaking and requires many months of testing to ensure all systems operate effectively together. Building on the work that we have previously undertaken, we are pursuing a number of opportunities to prepare and deliver integrated testing through the LTPA on the Queen Elizabeth aircraft carrier with the F-35 aircraft and its associated weapons systems to ensure the U.K.'s carrier strike group is ready to deploy in 2021. Beyond this example, we are also pursuing a number of further growth opportunities with U.K. and international customers, enabling them to rapidly develop their military capability in an agile way to respond to both current and emerging threats.

My long-term ambition and our second strategic priority remains to build an international company with 50% of our revenue beyond the U.K. over the next five to 10 years. To achieve this outcome, we are investing to drive organic growth in the U.K., U.S., and Australia, our home countries, and selected priority countries, such as Germany, Canada, and our joint ventures in the Middle East. We're also investing in inorganic growth through strategy led acquisitions, which are performing well. QinetiQ Germany and Inzpire both delivered revenue and profit growth and QinetiQ target systems has delivered 50% growth through outstanding export performance, as well as launching two new target products to enable future growth.

Our business in the United States continues to perform well and grow. Since winning the $164 million CRS(I) program for the U.S. Army in March, we have successfully completed the first set of small robot deliveries under the production contract. And we're also pursuing further growth opportunities in robotics and autonomous systems, including bidding for the U.S. Army's Robotic Combat Vehicle Program for both the light and medium variants. The business in Australia has successfully grown into larger engineering services programs, such as the major service provider for the Australian DoD, resulting in record order intake up 40% compared with last year. Looking forward as part of our global campaigns, we're pursuing a number of test and evaluation opportunities in Australia, including the development of an unmanned air system test range and support to Australia's 50-year sovereign shipbuilding program.

Focusing on this strategic priority has enabled us to win competitive programs, acquire businesses which enhance value to our customers, and integrate organic and inorganic capabilities to deliver new services. I'm pleased to see that as a result of these synergistic actions, we have doubled our international revenue over the past three years. As I mentioned earlier, at the beginning of October, we agreed to acquire MTEQ, which we expect to complete before the end of the financial year. A strategy led investment that will provide value to our customers and deliver healthy returns for our shareholders, as mentioned by David. MTEQ create and field new sensing solutions at pace to deal with emerging threats. Working in collaboration with their customers, they integrate outputs from multiple sensors to provide information and intelligence, which is critical to gaining advantage in the modern battle space. That business is growing rapidly in an expanding market with significant potential. The acquisition accelerates our growth in the United States, the world's largest defence market, and will bring our combined U.S. operation to approximately $300 million revenue per year and 750 employees.

We will drive additional value by combining MTEQ's advanced sensing capabilities with our existing robotics and autonomous systems capabilities, enabling us to generate solutions that are critical to modern warfare. And we will also improve profitability by supporting the transition of MTEQ’s sensor capabilities into larger production programs by leveraging our manufacturing in the U.S. Finally, the acquisition strengthens the implementation of our international growth and innovation strategic priorities. As part of the creative element of our customer value proposition, it builds our capability to rapidly field new products and services and creates further growth opportunities by leveraging our technical capabilities and routes to international markets across the group. In summary, acquiring MTEQ is a major step in building an integrated global defence and security company with a great management team and more than doubles our U.S. home country to represent approximately 25% of our group.

Our third strategic priority is to focus on commercial and technical innovation. Our campaign-based approach launched in 2016 has enabled us to win a number of competitive contracts, and I'm pleased to see that we have successfully delivered these contracts and grown them further over the first half of the year. In October last year, we won the engineering delivery partner where we are the lead -- where we are leading an ecosystem of more than 80 SMEs and private contractors to provide specialist engineering services such as the development of safety cases to support all U.K. MOD defence procurement. I expect this contract to be worth more than £1 billion over the next 10 years, and we are successfully delivering and have grown the overall contract value to date to £129 million.

In the period, we won £160 million of new orders, including £11 million to support the F-35 aircraft safety case. Twelve months ago, we won the battlefield and tactical communications program, where we deliver specialized engineering trials and safety management services to support the development of next generation communication systems. I expect this contract to be worth up to £95 million over the next five years. Again, in partnership with industry, we are successfully delivering the program, including £4 million of customer savings and have secured £5 million of new orders in the period. And finally, whilst we haven't been able to discuss this publicly before, in 2017, our first major competitive win from our campaign based approach, was the accelerated capability environment known as VIVACE for a variety of security customers. Jointly with the U.K. home office, we are leading an ecosystem of more than 180 SMEs and academia to access the best thinking and latest technology in the U.K. to solve digital challenges for frontline enforcement at pace.

This successful model is also gaining recognition within other government departments as a new way of delivering mission impact in an agile and innovative delivery environment.

Over the past six months, our campaign-based approach has also delivered a number of new competitive wins with further growth opportunity. We won the £67 million secure navigation program, which delivers sovereign capability to U.K. defence platforms, systems, and users. Our role in the program is to develop state of the art encrypted satellite navigation receivers. This program has significant potential for commercial exploitation through our strategic global partnership with Collins Aerospace that we signed in 2017. We've also won a £20 million contract for the U.K. emergency services air communication system, the world's first 4G network to enable rotary wing emergency services aircraft to deliver air to ground communications using capabilities from the LTPA. This win provides us with the opportunity for further exploitation with other emergency service customers.

And finally, we supported the first successful large-scale maritime autonomy experiment for NATO in Portugal. We delivered our command control capability, overall exercise management, and ensure its safe range operation, demonstrating our overall strength in operational experimentation by bringing together disruptive technology and collaborating with industry to prototype new military capability at pace. Beyond these successes, we continue to pursue our campaign-based approach to win major government funded programs aligned with our inherent strengths to drive medium to long term growth. Critical enablers to the success of these campaigns are focusing on our customers' needs, choosing the right strategic partners with complementary capabilities, and investing in innovation to win.

So, in summary, I'm delighted that halfway through this year, our group performance continues to develop in line with our strategy. In the first half of the year, we have delivered strong operational performance. We achieved 10% revenue growth and 8% profit growth on an organic basis. We have successfully doubled our international revenue from £76 million to £151 million over the past three years, and won significant new orders, further enhancing revenue visibility with a backlog of £3.1 billion. For the remainder of the year, we are focused on implementing our strategy to make clear investment choices underpinned by our rigorous financial approach and driving operational performance through winning bids, successful delivery of our programs, and effective integration of our acquisitions. Our strategy has enabled us to grow in a world that continues to be uncertain by adding value to our customers. Looking forward, we will continue our growth trajectory by building an integrated global defence and security company. Leveraging our strengths across the group to grow into our £8 billion addressable market, we will see growing revenue at stable margins, deliver sustainable, profitable growth and returns to our shareholders. Overall, it's been a great start to the year. David and I'd be happy to take your questions. Thank you.

Okay, we have a live webcast, but we'll take questions from the room first and then once we've completed in the room, we'll hand over to the webcast. So, first question.

Richard Page (Numis)

Morning, Richard Paige from Numis. Two questions, if I may, please. Firstly, on the LTPA, this transition to the output-based model. By the time that happens shall we expect to see much in terms of financial performance and will we see it through EMEA services, as that happens, please? And then secondly, on QTS, obviously, standout performer in terms of the numbers here on top of a good performance last year. I understand there is new products coming as well so that should bode well for the output of the outer years as well. How has that gone so well? Could you just go through the process as to why that has delivered so well against the objectives, please?

Steve Wadey

Okay. Thanks, Richard. I'll take your second question first. I'll make a comment on the LTPA and maybe ask David to bring some more colour to the financials. I think the first thing I would say why has QTS gone well? It's gone well because we strategically chose the right company and have integrated it the right way in line with our value proposition. We saw a capability gap, and we saw a business that had complementary capabilities to fill that capability gap; and it was directly in line with our value proposition. And then we chose beyond the acquisition, to invest in modernizing its products, integrating it with U.K. ranges, leveraging our international routes to market. And as you say, the businesses performed exceptionally well since we acquired it at the end of 2016, and we haven't even started to see the benefits from this new product range that we are launching.

And I'd also say I remember discussing this at the last results. It's not just taking a view about what is the next product range. We're also looking at the generation after next. So already on the drawing board, we're looking at the cycle of next generation products that will be coming after those that we've launched. So, really looking forward and seeing the value that our customers need from that representation. So, I think in a nutshell, that's that longer-term view. It's about investment and it's seeing it as an integrated part of our value proposition and linking it to our other test and evaluation capabilities and international routes to market. On the LTPA, I mean, you're quite right. We signed the contract in April, and you may remember that we previously described the LTPA as what I termed an input-based contract, where we provided our test capability and a volume of people available to undertake testing at certain times of the day. And we're migrating it to an output base contract, where we effectively are paid for the services and the outputs that we deliver for our customers. That entails significant changes to processes, ways of working beyond the investment in modernizing the core infrastructure. And we jointly set out with the MOD a two-year period to transition, as I said in the presentation. We're really, really pleased with the way that we're partnering with the customer. And six months into that two-year period, you are absolutely on track, 100 percent customer acceptance of all deliverables to date. In terms of starting to see the benefit, I would say we're starting to see, you know, albeit in early signs, we're starting to see the benefits of that already. You even heard that the leader of our Hebrides range speaking on the video and seeing the customer reaction, the discussions around formidable shield with the U.S. Navy already out to a roadmap of building capability based on the way that we're working with them out to 2025. You know, David can comment specifically on when we'll start to see the benefits of that financially. But I think there was early indicating signs that this was the right decision, the right investment, and we're starting to see the growth. You can see that from what we're covering. But David, do you want to sort of out a few facts?

David Smith

Yeah, I mean, maybe it's a bit of context in here in that clearly, you know, we're also now three years into the first part of that contract in terms of the arrangement and modernization of ETPS. And I know some of you saw ETPS in the site visit to Boscombe recently. So, that's -- there's already evidence that we're attracting further business, I think, from that, which was exactly why we're doing the modernization. I mean, technically from an accounting point of view at the moment, we're just booking the LTPA contract in line with what we contracted. The opportunity for us over time, as we've discussed previously, is to both to deliver further efficiencies through that contract as we implement that, and clearly that's our intent. And then bring new business as we actually make those investments, investments really, are just starting phase amendments. So, it's probably going to be a couple of, two or three years before we see much from the investments. But there is certainly opportunity as we go through time to deliver upside versus that contract. That's really what we're about in terms of exactly what we've done on the arm and the test aircrew training project to do something similar on our LTPA as well.

Steve Wadey

I apologize, Richard. I didn't mention David's good point, linking some of the future programs on the test and evaluation, slide I pointed to carrier strike group, dreadnought submarines, and future combat aircraft, illustrations of the sort of opportunities that we'll be pursuing that'll bring value and growth through the LTPA contract.

Chris Leonard

Hi there. Chris Leonard from Credit Suisse. A couple, if I may, please. Can you maybe give us an update on CRS(I) - I know you said that you've delivered the first deliveries already, but I just wondered what the ramp was going to look like the next few years, particularly if we see a continuing resolution in the U.S. and then what impact that could have for you guys. Secondly, how will the process for the bidding of work on the robotic combat vehicle that your teaming up with Pratt and Miller, I think, work? I just wondered if that will be the same as how CRS(I) works. I'd be interested to hear comments on that, please. And then lastly, going back to QTS. Typically, what sort of contract length would you see when you book contracts there for the targets -- QTS targets. And equally, how quickly can you ship those once you once you get in an order, is it a fast business or does it take a bit longer? Thank you very much.

Steve Wadey

Okay. So, maybe first of all, I take the RCV program. So, if everyone's not aware, RCV is part of -- so it stands for the robotic combat vehicle. It's part of the U.S. Army's major modernization activity and looking at the introduction of autonomous capability into a fleet of capabilities to improve military effectiveness. And you're absolutely right. There are three contenders in the RCV Light program, and we're teamed with a company called Pratt and Miller and the bids are going in right at this point in time. So, the bidding is happening right now. So commercially, I won't be exposing any secrets at this point.

But what all three of us are bidding for at the moment is effectively a demonstration phase. And we expect based on what's in the public domain, the U.S. army to select potentially one or two contenders to go forward into that demonstration phase, certainly before the end of this financial year. And we're putting our best foot forward to be one of those companies that is selected for that. It is quite a significant program opportunity, which we're taking it very seriously. The public record has the overall research, development, and test and evaluation customer budget line at about $100 million. And if formed formally into a program of record, it could be worth from a production point of view, at least the size of the CRS(I) program that you mentioned. So, it is a very important program for us as part of investing and expanding into modern robotic autonomous systems for us. And then that links me back to the CRS(I) program. As you know, back in March, we won that program again following a similar pattern to that that I just mentioned, a very successful bid phase in demonstration, and then getting into the final selection of the contenders for the production phase. And then we won that production contract in March.

As you repeated, as I mentioned in my speech, that program is going exceptionally well. We have achieved the first small robot deliveries under that production contract, and we're starting to ramp up in line with our customer requirements. In terms of any impact on any continuing resolution, that's probably not appropriate to comment on that right now. I think we need to wait to see what actually comes out of the U.S. government over the next couple of months. But from our perspective, we're totally focused on the customer and delivering the commitments that we have under the contract.

Would you like to talk about QTS?

David Smith

Yeah, I mean, I mean, QTS delivers to a lot of customers now across the globe and typically they're delivering I would say in the six to 18 months sort of period in terms of the projects they're working on, in some cases it's just sale of targets. In some cases, it's more actual delivery of targeted exercises and more involved in the operational side as well. But you know, the improvement in their revenue, which has largely at the moment, as we've said, been around their existing product portfolio. So, we haven't really seen the significant impact yet from Rattler and next generation projects that they've shown. But that has really been about the customer, to be honest, and getting into new markets. They've now got their first U.S. contract and we've been selling into India. I believe they've got some work in Indonesia recently. So, they've just been able to develop their network quite effectively with our support over the last 18 months. So, it's a combination of developing that route to market for them and also then putting in place the new products are going to generate future growth as well.

Sean Stewart (JP Morgan)

Hi. Good morning, Steve. Good morning, David. Sean Stewart from J.P. Morgan. Two questions, please. The first one is you had very strong growth in the order book and you had a slight revision to your revenue expectations for this year. I just wondered if there's been any -- if you have any colour on what you expect for organic revenue growth in the medium term. And the second question is on the adoption of IFRS 16. I just wondered if there's any impact on the reported free cash flow from the adoption of IFRS 16, or whether you include the capital element of the lease repayment within the net capex. Thank you.

Steve Wadey

Okay, if I just kick off with a couple of comments on order book, and then I'll ask David to finish that question and talk about IFRS 16. We're really pleased with the progression on order intake and the situation that we have on the order book. And there is sort of two points that I'd like to reinforce that come from our position on order intake. The first is that this growth has come from focusing on our customer. If you go back to 2016, we really set out as part of our underpinning transformation program that we would fundamentally change the way that we focus on our customers' needs and also transform the competitiveness of the company: the relevance, the timeliness and the price of what we offered. And I think what we are seeing now is evidence that that transformation is really changing the culture inside the company. You know, the way that we collaborate within the company, the way that we partner with our customers and add value to our customers, which is why we're seeing the orders. The second point is very important around our order book is that our growth has not just come by focusing on the major programs. We have been focusing on the major programs, and I've described many of those today. And many of those programs are larger and longer-term programs. But we're also focused on the high volume of smaller contracts and that gives us a very balanced and resilient order pipeline as we look forward, which we're progressively converting at a good rate into our order book, which gives us confidence in our revenue. So, I just put that colour around the order book for you. But David, finish that last part.

David Smith

Yeah. So, the main impact of IFRS 16, as we've -- because we've provided some more detail tables in the statements is on the balance sheet in terms of creation of essentially a right to use asset and debt liability on that. And the liability effect is £27 million. There's a small effect in profitability in terms of moving our EBITDA number up and increasing our depreciation. And then from a cash flow point of view, you're right, there will be over time some timing changes because we'll effectively reflect the capex side of the lease acquisition as opposed to having it come through opex. So, there will be some timing effects, but actually I think it's fairly minimal in terms of the net effect on free cash flow.

Andrew Gollan (Berenberg)

Hi, Andrew Gollan from Berenberg. Three questions. The first one is around margin. I think, Steve, you said your outlook is for revenue growth and a stable margin. What is that the profile for, say, the next three years? We've got quite a lot of moving parts with acquisitions and dilution, which you've outlined today. So, can we expect the current rate to be a stable for next couple of years just for modelling purposes? Second question is on -- it's a technology question really in the domain of missiles and missile defence. We have a lot coming out of the U.S. on hypersonics and huge amounts of investment and development going on there. Is that an area of opportunity for QinetiQ? Is it a big deal for the U.K. MOD? We don't hear quite so much about the plans there. So that was a question on that topic. And the final point was on -- you mentioned high-performance culture is really starting to show through in the numbers. Is there anything you can give us on metrics within the business that -- I mean, you talk about incentivizing your staff to improve operational performance. What does that mean? I mean, it's just interesting for us to know what's going on in the background.

Steve Wadey

Yeah. Okay. Let me take the technology and high-performance culture and give David time to think about your margin question. I think that the technology question is a good question because it sort of gets to the heart of what customer needs are and market trends. And hopefully are sort of conveying, as I was just mentioning, we've really changed in the last three or so years our focus on really trying to think through and I deliberately use the word customer needs, not customer requirements. And understanding a customer need is being ahead of the requirements and looking at trends and gaps and underpinning technology opportunities to respond to those gaps. I would say that hypersonics is one of a whole range of technologies that are important, not just in U.K. but in the global defence and security.

And just to maybe pick out three autonomy, you know, is a fundamental game changing technology in the way that defence and security capability will move forward. Hypersonics definitely, you know, speed and stealth and the combination of speed and stealth is a very important way of achieving advantage in a modern battle space. And it also means that you need to really understand that from a defensive capability too. It's not just about offensive perspective of hypersonics. And the final one I would mention is directed energy. The use of energy-based systems as opposed to kinetic with a K based systems again, is a fundamental and disruptive technology and there are others. But I would use your point about hypersonics to say yes, there are many technologies that will change the landscape of modern warfare.

And I think back to why we've acquired MTEQ, or why we're going through the process of acquiring MTEQ. What I've tried to express is when we look at the modern warfare and the way that our customers need to prepare for modern warfare, the combination of advanced sensing with robotics, with autonomy will get to the heart of how you enable customers to achieve future capabilities. And that's a very deliberate, strategic-led decision to yield growth by getting ahead of that curve. And secondly, which I tried to express about MTEQ. It's not just the technology and aligning it with customer needs. It's the way of working. And MTEQ very much brings to our group, not just in the U.S., the ability to do real rapid development and respond to a customer need at pace. And if you then go back to your broader question. That is what I mean by building an integrated global defence and security company, that that can really be agile, that can really be innovative across that lifecycle, because our customers are going to need to build new capabilities at a real pace to respond to the varied threat.

So, my answer to your question on technology. In terms of the high performance, inclusive culture, I'm pleased to have a question on this in our results, because it's a very important part of building this company that I've just described because what we're really trying to achieve through this is to build a culture where the whole company genuinely feels valued and included and everybody can bring their strengths to bear on the problem that I've just described. And it's not something that you can build overnight. It needs to be led, but it also needs to be empowered. And yes, there are a number of metrics. There isn't one golden bullet on this, but there are a number of things by which I would measure that. The first and the most obvious to say when we're in results is actually the financial results. These results are actually delivered by our people. So, you know, look at those financial indicators. I'd also linked to -- I know I haven't described it at length this morning, but in our full year results we described that we'd introduced for the very first time in QinetiQ's history an all employee incentive scheme, where we directly aligned shareholder and employee objectives to reward profitable growth. And in the first year of operation, which finished the full year, we were delighted to pay out to every single employee across the entire group, our stretch bonus level for them. And that's about creating association of their personal performance with our company performance. And I think that's a that's a real metric and it's real cash. And it links to the results point that I previously made. And thirdly, again, I haven't mentioned it at length today, but I did it at the full year. We really want to make sure that our employees understand that we're a company that is listening as part of responding and making sure that they're valued and included and to support that, and it's just a tool, we introduced a very modern state of the art digital tool called Peakon. It's a way of rapidly listening and responding, empowered at a local level, but also giving us systemic trends that are at a group level. And that's what I refer to in terms of measuring our engagement. We've seen an 8% increase just in the first six or eight months of the year, which is an incredible level of improvement on that. So, it's important. I think you're starting to see the benefits. And we also see continuing to nurture and grow this culture as part of enabling exactly the company we're trying to build to respond to those threats and those challenges and bring , you know, the best to bear not just in our company, but the wider industrial partnerships that we work through. So, that's the technology and culture, and hopefully you've got an answer by now on margins.

David Smith

Of course. So, margin is a complex issue, clearly. We've said that we want to try and grow revenue with stable margins, and by that we mean margins in the 12 to 13% range, which is quite challenging. It's above the industrial average for our sector. So, you know, we're not setting ourselves a light target there. And clearly, our portfolio is varied. We've got products, we've got services, we've got short term delivery contracts, we've got longer term delivery contracts, we've got U.K. contracts, international, capital light contracts like EDP, higher capital contracted capital contracts, like the LTPA contract. So, there's quite a wide variety of things to try and manage. And what we're trying to manage is that portfolio and over time make sure that we're commercially competitive, because clearly if you're not commercially competitive and adding value for customers, then you'll lose business. So, we do need to maintain that focus on commercial competitiveness.

We've lost some of the pressure from the single source regulatory BPR has abated now. That may change in the future, but for now, that's a more stable thing for us. But clearly what we've got to do is really, A, make sure that we are trying to drive customer value and enhance contracts by adding things to those contracts that add further value that hopefully we can get better margins on. And also driving efficiency over time as well and managing that over overall portfolio. So, I'm not saying it's straightforward because actually it's quite complex this, but that's absolutely what we're trying to do to maintain margins with that aim in mind. Now, you mentioned the acquisition and clearly, MTEQ provides an immediate challenge for us because as we've said, next year, we think their margin will be about 7%. So, clearly that's quite a bit below our group target and it will be dilutive roughly three quarters of a point, I think, of margin dilution. And we will be working with them to work out the best way to improve that over time as we scale up their production and they're able to take advantage of improvements in manufacturing capability and building material and things like that over time. But it is a challenge in the short term that we'll have to work our way through. But, you know, that's the whole point of acquisitions in a way that the reason you're buying them is because you can see the potential to grow them and improve the profitability of those businesses with the right development, customer channel work, and end product investment. And, you know, we think there's a great opportunity with MTEQ.

Harry Breach (MainFirst)

It's Harry Breach from Main First. Can I possibly ask you maybe three. Just firstly on dividend, I appreciate that the stated methodology of one third of prior year, but with earnings up 14% in the first half, the source, the optics, if you will, of the dividend increase being a third of that just look a little strange. Is that, sort of, an opportunity you think to sort of adjust the methodology to make it more progressive? Second, maybe on QTS. I think, Steve, if I remember, you said earlier that most of the growth was not yet driven by the new products. Can you give us a flavor on maybe a little bit more colour of sort of whether the growth is about new geographies? Any particular sort of customer, any sort of sense of what the drivers are? And third coming is something David said about SSRO pressure abating, and my memory is rubbish at the best of times, but last time I looked at the SSRO documents, allowable margins were on a sort of improving track this year. And I'm just wondering whether it was that the case and was there, in fact, a sort of slight margin tailwind in first half from allowable margins SSRO. Thank you.

Steve Wadey

Great. I'll take the QTS questions clarifying, then leave David with dividends and the SSRO. Right. Sorry, David. You were right in what I said. I mean, we invested in the new products only last year. In fact, the next generation Banshee target was launched in September this year. We have had first orders on the rattler supersonic target, and we're close to first orders right now on the next generation Banshee. But in terms of transitioning that into revenue growth, we haven't seen that yet. So therefore, you're right to point out that the QTS revenue to date has actually come from our existing products and services and the ability to have actually increased scale and volume of those to a whole range of customers. And I think that is the answer. It isn't to a specific customer. It is the range of products that we in services that we currently have. And to my point to Richard, about why it's gone well. It's been the integration of QTS to make use of wider capabilities route to markets of the company. And yeah, we've been able to use customer relationships, channels to market to take products and services to increased volumes. And there is no specific product or customer that I would pull out. It is a genuine volume increase across a whole range of customers and geographies. David, dividends.

David Smith

Yeah, I mean, the dividend question is, one, that the board will clearly have a further debate when we come to do that. And in May before the full year results are announced. And clearly, there are things that the board will have to consider there in terms of investment requirements in the business. We set out the capital allocation methodology. And, you know, we've had a progressive dividend policy for a number of years. And I think I don't see particularly any reason why we would want to change that at the moment. But equally, certainly in the short term, there's a lot of investment requirements around the business as well. And I think that's probably going to be the answer in terms of our main focus from the debate. But I won't pre-empt debate, which will happen properly in May. On SSRO, you're right. I mean, we're in a bit of a transition phase at the moment because on a single source where there is a bit of an upside, we still have some things rolling off that were contracted in the past. And I think in the first half it was actually a fairly neutral effect in terms of just the impact of the BPR rolling through. So, we've certainly lost the negative effect that we had over the last two or three years. And in the first half it was pretty neutral for us.

Steve Wadey

Okay, I know we have a question on the webcast, so Ian, if you could relay it, please.

Ian Brown (QinetiQ)

Two questions from Tom Bossett from Stockview. First question, I think has been answered during the conversation here. The second question relates to global products. Traditionally revenues in global products have been quite lumpy. What kind of visibility do you have in the business today? And should we expect a degree of lumpiness still?

David Smith

Yeah, I mean, visibility is actually not bad in global products for the second half, I think it's just going to get this number wrong, but I think it's 89%. So, I think that's up a little bit from where it was last year. But it does drop off as we go into next year because typically those contracts, as we've already said with QTS has delivered in a sort of six to 18 months contract, where we are clearly really focused in the U.S. at the moment is, for instance, the programs of record. Steve's already described on top of CRS(I) looking at the robotic combat vehicles. Those could really provide a lot of more visibility in terms of future revenue for our Boston-based business. So, you know, it's very much like the story of EMEA Services, that we think the further we can get longer term contracted relationships, so on the product side, actually that's better for us because it gives us more visibility. We can plan better. We can plan of manufacturing capacity and supplier relationships better. And clearly, that's the way that we want to go as a business and equally the way we'll be taking MTEQ forward as well.

Steve Wadey

And if I might add to what David's just said and it's what links back to the first QTS related question, if I look at global products more generally and consider our strategy, over the last few years we've been through focusing on our customers, aiming to secure a much longer term contracts. So, that helps reduce what you term as lumpiness. And also, as I mentioned, by looking at the customer need in the medium and long term, we're also investing not just in the current generation or generation, the next generation, but the generation after next. And that gives us, say, a forward cycle of new products that we will bring to market. We're applying the same method, not just in terms of targets, but robots and other products that will reduce what the company has seen historically as lumpiness. And then complemented with what David said in terms of visibility and margins, gives us a far more healthy outlook in the area of global products.

Any more questions? Okay, great. Thank you very much. Thank you.