

QinetiQ secures £1.3bn LTPA amendment

Analyst and Investor call – 8 May 2019

Speaker Key:

IB Ian Brown

SW Steve Wadey

DS David Smith

IB Good morning everyone. I am Ian Brown, part of the investor relations team at QinetiQ, and welcome to our call this morning. With us on the call is Steve Wadey, our Chief Executive Officer, and David Smith, our Chief Financial Officer. We're also joined by Steve Fitzgerald and Cathy O'Carroll who Steve will introduce you to in more detail shortly.

As you'll have seen, we were very pleased to announce on Friday afternoon the signing of an amendment to the second part of the long-term partner agreement, the LTPA, and the plan for the call is Steve and David will walk you through the amendment in more detail, and then we'll open up the line for questions from our covering analysts and investors only, please. We will make a playback of this call and transcript available shortly afterwards, and with that I will hand you over to Steve.

SW Thank you, Ian. Good morning everyone. As Ian just said, I'm joined this morning by David Smith, our CFO, who many of you already know and, as Ian said, I'm also joined by some of my team members who were key in securing this amendment but also the subsequent delivery of the amendment. Steve Fitzgerald is the managing director of our maritime land and weapons business unit, as well as having overall responsibility within the company for the LTPA, and Cathy O'Carroll is our group director for test and evaluation and she was an absolutely critical member of the team who led the negotiation.

As Ian said, I'm really delighted that on Friday we signed a ground-breaking agreement with the UK Ministry of Defence to modernise and operate 16 of the country's critical defence facilities. This is a significant moment in QinetiQ's history for our customers and for our shareholders. This major deal positions us as a world leader in the generation and assurance of military capability.

Under the agreement, we secure £1.3 billion of revenue over the next nine years to provide state-of-art environments to create, test, and train UK defence and security capabilities, thereby maintaining our customers' operational advantage. Through the agreement we will invest £190 million in modernising our ways of working, infrastructure, and equipment to enable the delivery of UK MoDs major

future programmes, such as the Queen Elizabeth class aircraft carriers, Dreadnought submarines, and future combat aircraft.

The modernisation will also allow us to attract international customers into the UK and work with overseas customers to modernise their own facilities. This is good news for our shareholders, too. In addition to securing revenues, we will also make an appropriate return on investment. We also have the opportunity to enhance this return further by driving greater utilisation from both UK and international customers.

I'm really excited about what we have achieved because this deal enhances the contribution we make to the UK Armed Forces and because of the outcome it will deliver for QinetiQ, our customers, and our shareholders. This is also the most significant achievement since we launched our new vision and strategy to grow QinetiQ three years ago, and represents a major platform for future growth. I'll now hand over to David to run you through the key financial details of the amendment.

DS Thank you Steve. So the financial detail is broadly consistent with the guidance that we gave you at our interim results in November. Firstly, we've applied the same rigour when evaluating the investment into the LTPA as we do with all of our opportunities. We generate a contract return over the life of the LTPA on our investment that's appropriate and above our cost of capital, and this gives us clear visibility on our returns over the life of the contract.

We can enhance that return further by driving greater utilisation of the facilities, both by doing more work with the UK MoD and attracting international customers to them. With the investments we're making, these facilities become world-class and internationally competitive, and that should support us in our ability to attract international customers.

In terms of the level of investment, as part of the amendment we will be investing around 190 million into modernising capabilities across the LTPA portfolio and, together with the amendment we made in December 2016, we'll be investing around 50 to 60 million per annum in capex in the combined LTPA over the next three years.

In line with the December 2016 amendment, we'll depreciate those assets over the lifetime of the contract. Depreciation is an allowable cost under the contract and is reimbursed back to QinetiQ, plus a margin. Any assets that haven't been fully depreciated at contract maturity would be reimbursed back to QinetiQ.

The contract value is 1.3 billion running until March 2028 and under this tranche of the LTPA we'll be making approximately 120 million per annum of revenue, with overall LTPA derived revenues at about 320 million. There is some phasing on revenue over the life of the contract which reflects the timing of investment, and also adjustments for inflation so that revenue will gradually increase over the

life of the contract. These numbers are already in our guidance so we don't anticipate any changes in forecast as a consequence of the announcement.

The pricing was agreed using the latest 2019-2020 SSRO baseline profit rate but, as a reminder, that baseline profit rate is not the rate that we contract at; it's a starting point in a formula that provides a number of adjustments. Then the 85 million of savings which I mentioned to the taxpayer are achieved by cost efficiencies that the new investment will enable.

You'll recall we also agreed a 12-month extension to conclude the negotiations which covered the last year of operations. The six-million headwind to operating profit that we guided in our preliminary results in May 2018 and that we reiterated at the interims in November 2018 is primarily the consequence of the step down in pricing on this tranche of the LTPA.

Beyond the updated capex guidance around the LTPA I've provided, we're not anticipating any change to forecast as the impact of the change in pricing was already in our guidance. We'll cover the financials in more detail at the investor seminar on April 24th, details of which will be made available on our website. I'll hand back to Steve now.

SW Great. Thank you, David. So, to conclude, we're very pleased with this amendment that was announced on Friday. It fulfils a major part of our strategy to lead and modernise UK defence test and evaluation, and supports our growth ambitions. We've been able to support the UK MoD in securing this vital capability for UK defence, and we've been able to secure a fair return for our shareholders in line with our capital allocation policy.

Finally, as David mentioned, we will be holding a seminar on Wednesday 24th April covering our strategy around leading and modernising test and evaluation. This will be an opportunity to go into a lot more detail about the LTPA amendment, as well as seeing how it fits within our overall group strategy.

I'll be hosting the seminar in London and there'll also be a webcast, and during the seminar I'll be joined by David, Steve Fitzgerald and Cathy O'Carroll. Space will be limited, so if you do want to attend in person, please do email the investor relations team as soon as possible. With that, I'll open the line for any questions that you may have. Thank you.

Operator Absolutely. So if you'd like to ask a question, please press star one on your telephone keypad. Ensure your line remains unmuted locally and I'll then prompt you when to ask your question. That is star one. The first question comes from the line of Rami Myerson from Investec. Please go ahead.

Question A few questions. I'll be starting with one for David. Can you talk about the level of total capex you expect? You talked about 50 to 60 for LTPA and I think you also talked in the past about investing in the various sites in addition to that, so what level do you expect over the next few years?

DS So, Rami, I gave capex guidance for fiscal 19 at 80 to 100 million and obviously we'll update you in May. I think at the half year I also indicated that fiscal 20 would be in a similar region and I'll confirm that in May. I'm not going to give capex guidance beyond that, but obviously in giving you an indication of the level for LTPA, that does tell you that fiscal 21 and fiscal 22 will also be at an enhanced level with that capex around the LTPA.

Question Thanks. The next question is on the recovery of the initial LTPA from 2016. Have you already started to recover the cash from that investment from the MoD?

DS You mean have we reached a breakeven cash flow point on that?

Question Yes.

DS No, I don't believe that we will have done yet. That will be over the second half of the contract.

Question Thank you. Just thinking about trading, there hasn't been any statement trading for Q4 in the contract, in the statement. How is trading, if you can provide any comment on that, to the end of 2019?

DS Well, I think you can take the fact that we haven't made a comment that it's in line with what we previously said, and we'll obviously update you in May when we do that.

Question Thank you very much.

SW Thanks, Rami.

Operator We have Chris Leonard from Credit Suisse next. Please go ahead.

Question Yes, hi there. Could I just ask two questions, if I may? Firstly, in terms of generating organic growth from third party overseas customers coming and using the LTPA assets, can you comment further on the statement that you made in terms of receiving greater operational freedom and financial incentives from the MoD to encourage the use of the facilities? Is there anything that's changed from the 2016 amendment, and any colour you can give on that would be good?

The second question, if I may, would be on the terms and the associated margin. In contrast to the 2016 amendment, have we seen any material change in the risk adjustments or incentives that you have agreed with the MoD versus 2016? Thanks.

SW Okay, maybe shall I pick up the first one in terms of organic growth and then maybe, David, if you want to pick up on some of the terms? I think, Chris, the best way to talk about the organic growth is actually to talk about the test aircrew training example that was part of the signature in December 16 which, as you'll remember, was about bringing in modernised test aircrew training not only to be

attractive to the Royal Air Force, but also then attract in overseas students at a higher rate and on a multiyear basis.

On Wednesday, I had the pleasure of being in Boscombe Down and actually was blown away by the level of modernisation that has been achieved in such a short period of time. State-of-the-art facilities, digital training material, full commercial fleet in a modernised building and, as I was there, a full first international course going through the test aircrew training programme.

We have capacity within those facilities and within the programme to progressively increase the throughput from international customers and therefore drive organic growth. Why am I using that example? I'm using that example because the injection of investment to modernise has actually already started to bring benefits on that programme, and what you'll see in this amendment is more of that approach. The more attractive we make it, the more throughput we will bring.

Within the contract in terms of commercial freedoms, that is a joint objective, it's a joint intent, and there are a number of specific changes that will enable us through the core investment and the flexibility by which we can modernise and operate the sites that will allow us to be progressively more attractive to customers. Hence, we make that point in the statement that it will be a platform for future growth. David, do you want to pick up on terms and risk?

DS Yes. So there's a great parallel between the two contracts in terms of the whole objective, which is actually to move much more to investment that modernises the facilities and to make sure that we have more flexibility in delivering outputs rather than an input based focus to the contracts. The margin on the new contract is lower than the December 16 one, primarily because the base profit rate has come down since that earlier contract was agreed.

However, we do have, as I've already indicated, the ability to enhance those returns, both by delivering cost efficiencies and also by attracting other work into the LTPA system, and that's primarily the incentive that we have to overachieve on the contracted returns on both of those things. We've taken a very detailed review of risk and agreed that with the customer, and we believe that we've taken a balanced level of risk consistent with the scope that we've agreed the contractual terms and obviously the quality of our customer.

Question That's great. Thanks very much.

SM The next question comes from the line of Rami Myerson from Investec. Please go ahead.

Question Hi, just two follow-on questions. The cancellation of the ASDOT contract, did that have any impact on the LTPA amendment? Thinking about the margin profile of your EMEA services business, I think following this you aren't providing specific guidance, but should we expect margins to remain broadly in line with where

they are at the moment or do you expect any margin pressure based on the new contract?

SW Well, David, I'll take the first one because it's really simple and easy. The answer is no. David, if you want to pick up the second one?

DS Yes, I think we already gave the guidance within the fiscal 19 guidance of a six-million headwind, which is primarily around this contract and the lower margin impact on this contract. As I indicated previously, that hopefully will be the last year of significant headwinds that we get on margin from this. The level that we've got in this year's consensus, and then next year already really reflects the pricing in this contract.

Question Okay, thank you.

SW Sorry, Rami, there wasn't honestly anything else to say about ASDOT. I didn't mean to be short, but there was no impact.

Question Okay.

IB Are there any further questions at this time?

Operator No, we do not have any more questions so I'll turn the call back to you.

IB Great. So, look, thank you all for joining us this morning. As I mentioned, a playback and a transcript will be made available shortly. As Steve mentioned, we are hosting a seminar on 24th April; if you are considering attending in person, do please let us know by emailing investors@qinetiq.com as we are limited on space. The seminar will also be webcast and you will be able to ask questions online, and we'll be publishing more details on how to do this in due course on our website. With that, I wish you good morning. Thank you.