FY22 H1 Post-Close Trading Update call

Thursday, 14th October 2021

Call Transcript

Key:

Steve Wadey – Chief Executive Officer
David Smith – Chief Financial Officer
John Haworth – Group Head of Investor Relations

Operator: Hello and welcome to the Financial Year 2022 H1 Post-Close Trading Update Call. My name is Judy and I will be your coordinator for today's events. Please note that this call is being recorded and for the duration of the call, your lines will be on listen-only. However, you will have the opportunity to ask questions at the end of the call. This can be done by pressing star one on your telephone keypad. If you require technical assistance at any point, please press star zero and you'll be connected to an operator.

I would now like to hand you over to today's team.

John Haworth: Good morning, everyone, I'm John Haworth, Head of Investor Relations at QinetiQ. Welcome to this morning's investor call, which is covering FY22 H1 post-close trading update that we have released to the market this morning. I'm joined by Steve Wadey, CEO, and David Smith, CFO. Steve and David will provide a short overview of today's trading update followed by an opportunity for you to ask questions. I'll now hand over to Steve.

Steve Wadey: Great. Thank you, John. And good morning everybody and thank you for joining today's call. So QinetiQ has delivered another strong half of underlying operating performance at group level. Our half year results are in line with market consensus, subject to audit. Overall, performance across the group has been good, balanced by a notably strong performance in EMEA services, offsetting short-term weaker performance in global products, particularly in the US. In the first half, we've continued to deliver strategic momentum. We secured more than £700 million of orders, an increase of 25% compared to the last half year. We've won some key programmes for the future in each of our home countries. The US$64 million order for the full rate production contract on the CRS-I robots in the United States; £68 million order for the development of directed energy systems in the UK; and AU$27 million of Australian for Land systems engineering support in Australia.

For the full year, we are expecting to deliver approximately 5% organic revenue growth and underlying operating profit margin at the lower end of our 11-12% expected range, prior to any potential one-time write down I'll cover in a moment.

This expectation includes short-term effects in the US of the customer's priorities shifting from counter-insurgency missions in Afghanistan to emerging near-peer threats in the Indo-Pacific. This also includes COVID-related delivery and supply chain challenges in our legacy QNA business, for example, on the initial production ramp-up of the CRS-I programme. However, as David will cover, we've had excellent order intake providing a solid foundation to deliver a stronger second half, enhanced by changes to leadership and organisation focus. And our US growth strategy remains the same.

As I just referred to, we were experiencing technical and supply chain issues on a large complex programme, which, if are mitigated, could result in the need for a one-off write-down to our short term guidance. We are working closely with our customer and are making progress jointly with our supply chain towards recovery of the programme and mitigating this risk to less than £15 million pounds. And we will report further on this at our interim results on 11th November.

So whilst we're sharing today that we do have a timing challenge in the US and a one-off risk on one of our large contracts, I can assure you that they are being proactively managed. And at the same time, we continue to make good progress, implementing our growth strategy.

I'll now hand over to David to say a few more words on our financial performance.

David Smith: Thank you, Steve. As Steve has said, we had a strong first half with particularly impressive orders across the group, building backlog and future revenue cover. Our EMEA services division has performed particularly strongly, with excellent growth in Australia and the UK. Strong EMEA services performance has offset shorter-term weaker performance in the US which reduced first half revenue, profit and cash flow in global products. US revenue reduced by 15% compared to the second half of fiscal 2021 for the reasons Steve has summarised earlier. However, with excellent order intake in the US in the first half at $184 million compared to $83 million last year, we have a solid foundation to do a stronger second half. Group operating cash flow has been good and we retain a strong balance sheet with net cash of approximately £140 million. Whilst we've experienced a timing challenge and a contract specific risk in the first half, overall, we delivered a strong set of financial results, and I'm confident in the future financial performance of the business.

I'll now hand back to Steve.

Steve Wadey: Great. Thank you, David. So our strategy to build an integrated global defence and security company remains unchanged, through both organic growth and strategy-led acquisitions. I can assure you that we are proactively managing both the timing challenge and the contract specific risks that we've shared today, and have continued strategic momentum towards our goal of more than 70% growth over the next five years. Our track record, our strong underlying performance, and our focus gives me confidence that we are continuing to make steady progress towards our ambitious goal.

And with that, I'll open the floor to take any questions.

Operator: Thank you so much. As a reminder, if you would like to ask a question on today's call, please press star one on your telephone keypad. To withdraw your question, please press star two. I would then introduce you by your name. Again, it is star one on your telephone keypad if you would like to ask a question on today's call.

Okay, there are no questions in the queue at the moment. So as another reminder, it is star one on your telephone keypad to ask the question. The first question in the queue is coming from the line of Ross Martin from Border to Coast Pension Partners. Ross, you are unmuted and may go ahead.

Ross Martin: Good morning guys, just a question on the contract that you're having some problems with. What degree of visibility have you've got the £15 million could be the maximum level of the hit on that particular contract? And could you just give me an idea of what mitigation means, please?

David Smith: So, as we say in the statement, we're actually working very closely with both the customer and our main supplier on the contract. And clearly, there have been some technical challenges and we're working very hard with our supplier to overcome those and obviously, discussing that progress with the customer as we go along. So I think over the next few weeks, we're confident we'll find solutions for this. But we are flagging now that, as a result of those, that there may be some revenue and some cost implications of that, which would require that write-down. We were pretty confident we can keep that lower than £15 million and obviously, we're trying to reduce it to the minimum possible, but I wanted to flag that at this point in time, and we will give an update at the 11th November trading report.

Steve Wadey: And I think Ross, if I could just add a couple of words, I think David's covered the visibility and the rationale around the £15 million. I think in terms of mitigation, really, there are three primary areas of mitigation. First and foremost, we have put additional effort and resource onto the programme since the issues that David described have emerged. And that internal effort is, secondly, supplemented by an exceptionally close working relationship with the supply chain where we're seeing the specific issues. And the relevant suppliers themselves are putting additional focus and additional senior management support. And then thirdly, collectively, ourselves and our suppliers are working intimately with our customer.

So a combination of our internal supply chain and customer engagement really is the primary mitigation. And as we've said in the statement, at this point, we're making progress in overcoming the issues, but until we've actually got through them, and at the other side, there is a risk. And as David said, given the level of exposure that has opened up here, we've needed to disclose that today.

So hopefully that gives you some assurance around the proactive management and mitigation strategy that we're adopting here.

Ross Martin: That's great. Thank you for that. Can I ask just one more, please? Just on Afghanistan and the parts of the business affected there, clearly there was a relatively quick about-turn in your strategy there. Did you have much in previously for ongoing growth from that particular arena?

Steve Wadey: Well, I think, I mean, a couple of points that I would pick up immediately. First of all, our strategy remains exactly the same. There's no change to our strategy in the US. In fact, we remain – for some of the changes that I may come on to, remain even more focused at the moment on delivering performance and seeking future growth. So the strategy hasn't changed.

In terms of the shift from Afghanistan, I mean, the change has been ongoing now for a number of years. But it's absolutely true that in the last six months, there's been an acceleration of some of the impacts of that, with what we've seen with events over the summer. And we did have a number of projects that we were pursuing, which were contracted, where we've had stop-work notices from the customer and that accelerated the impact. And as you've seen in the statement, we came into the half with a very low order intake because of COVID and these various transitions.

The good news is that we had a very strong half in terms of order intake; $184 million of US order intake in the first half - more than $100 million more than the second half of last year. And that gives us real confidence now that we have a much stronger half to come.

Beyond that, and I've just come back from two weeks in the US, continuing to engage with customers and the internal teams on this, I would reinforce that our core sensors and autonomy capability and the number of the key contracts that we have and that we are shaping for the future, are absolutely key to this shift towards the Indo-Pacific threat. So whilst this is an impact that we've had coming through the end of last year with low order intake and seeing the revenue impact this year, we are in a strong position with our capability set to meet these future needs.

So, yeah, no change of strategy. Please do think about this as a short-term effect as these transitions are going through, but long-term strategy remains the same and focus now on delivering a much stronger second half than we had in the first half.

Ross Martin: That's great. Thank you for that.

Operator: Thank you, Ross, for your question. The next question in the queue is coming from the line of Rory Smith from Investec. Rory, you're unmuted, please go ahead.

Rory Smith: Good morning. Thank you for taking my question. You've largely answered it on Afghanistan. So I was just wondering if we could – apologies for labouring the point, but just drill into what – if you'd be able to give some examples on what kind of work was stopped at the last minute there, and clearly that will have had an impact on efficiency. But I think the revenue performance looks strong as well so, if there's a mixed impact from EMEA services, what's gone well in EMEA services. That would be my question. Thanks.

David Smith: Rory, well, I mean, I think within the US funding, there was funding for overseas contingency operations, which is primarily around force protection on the ground. And we were quite involved in that and obviously that's come to a pretty quick halt. There was also some training going on that we were involved in as well, for things like pilots and stuff like that. So those are the sorts of things, Rory, that have just come to a very quick halt.

On the other side of the equation, as we said, actually we had a really strong period, both for revenue and orders across most parts of the EMEA services business. Australia had a very good first half and the UK business also had very strong order intake. So, we've actually been able to fully offset those US headwinds. And without them, we actually had a really strong results in the first half but it's unfortunate that we've had to deal with those issues, and deal with them as quickly as we can. And as Steve said, we do believe we will have a stronger second half in the US, probably not back to where we were last year yet, but by the end of the year, we should be.

Rory Smith: Okay. If I could just – sorry, if I could just add a follow-up to that. I noticed that an Australian order was received. Would you be able to just add a bit of colour to that, more of the backdrop in Australia more generally?

Steve Wadey: Yeah, I mean, our Australian business, Rory, as you'll know, has gone from strength to strength over the last four to five years, with record performance every year. So we have a recurring record performance, but the team there is doing extremely well. About three years ago, we signed a contract called MSP, the major service provider contract, with some partners, one of several consortium's supporting the Australian Defence Force. And this is just another example where we've been able to take that relationship to the next level, a huge win for us at AU$27 million. And this is all about engineering services, engineering support for the DOD in the way that they go about designing and procuring future land systems projects. So, yeah, it's completely in our wheelhouse, it's on our focus.

And, of course, it really does demonstrate, one of the big pieces of news of the last half is the announcement around the Aukus relationship – the Australian, UK, US – alliance that's being formed. And, I think we're very pleased – and I'll be talking a lot more about this at our results on 11th November – the strength of relationship that is now forming between those three countries is directly aligned and supportive of our multi-domestic growth strategy, as you know, that it's focused around those same three home countries.

So yeah, really, really good news, really good progress in Australia and directly on point with our long-term strategic ambition.

Operator: Thank you, Rory, for your question. And the next question in the queue is coming from the line of Charlotte Keyworth from Barclays. Charlotte, you're un-muted and may now go ahead. Charlotte, your line is now un-muted. If you have your line muted locally, please unmute it.

Charlotte Keyworth: Apologies. I did have a follow-up question actually, just on the US front. So we started the half with a lower backlog, and yet the order intake has been exceptionally strong. Was that the result of timing around when these tenders were expected to be put to the market? Or do you see that – looking at your order pipeline for next year, is that a trend you'd expect to continue now into 2023?

Steve Wadey: Yeah, I mean, I think as we said, Charlotte, I'll try to bring more colour to it. I think it absolutely is a timing issue. I really would think about what we've said as far as timing. So we had £83 million in the last half last year. And as you said, that meant that we entered this half with lower backlog coverage of the US. And if we step back and think about why we came into the half at that position, it's down to three effects. There was some really significant effects of COVID during that last half year; there was the transition to the new administration; and compounded with this shift in the customer's mission. And those three effects without doubt led us to the point of starting the year with the lower backlog.

So it is a transitory change. And as we've demonstrated in this half, £184 million in the first half. So lower orders means the revenue impact that we've had, but we've had strong orders and we've got a healthy pipeline for the second half. And, as we rebuild that performance and deliver a stronger second half, I think we will just see ourselves return to the trajectory that we've been on, in the past few years, through our US growth ambition.

So I think you're right to think about it as a timing and a transitory period. And I guess the additional point that we've had is also what we were just discussing with Rory, around some of the stop-work impact that we had with the Afghanistan situation. So yeah, I mean, transitory and we're now into a much stronger second half position with £184 million orders.

Operator: Thank you, Charlotte, for your question. And as a reminder, if you would like to ask the question on today's call, it is star one on your telephone keypad. Again, it is star one on your telephone keypad. The next question in the queue is coming from the line of Avi Hoddes from SAM. Avi, you're unmuted and may now go ahead.

Avi Hoddes: Hi, gents, it's Avi here from Sandbar. Just a few questions from my side, I'll wrestle through them. The focus on the lower end of the 11-12% margin comment, is that all H1 and is that all under recovery in US global products? And so therefore, there's no relevance to next year, given the orders? Just checking where that margin impact is coming from. If you could give us some commentary on the non-US side to global products, that would be great. And then finally, if you could just discuss any cash impact from the different elements of today's news, that'd be very helpful. Thanks so much.

David Smith: Yes, it's David, CFO. So, the impact on margin is driven by the US and clearly, significant in the first half. I think we'll still see some in the second half as well but we'll be recovering back. The EMEA services division has performed very well and I think will continue to do so. So it really is from the US and the global products. And it doesn't change our view on fiscal 2023 onwards. This is, as we said, an issue we think will be contained within this year.

In terms of non-US parts of global products, space business, our QinetiQ target systems business both had a decent first half. So it is really focused around the US business.

Cash, I mean, we had a reasonable cash position at the half year, £140 million. I think it'd be a bit stronger at the end of the year. The US clearly has had an impact on cash in the first half of the year, which has been somewhat offset elsewhere. The complex technology programme, the write-down itself won't have a cash impact. We will have effectively – already you've seen a lot of that cash impact come through already. So that's not going to have an incremental impact on cash. So, as I said, I think the outlook for year-end is still pretty positive in terms of where we'll end up on net cash at the end of the year.

Avi Hoddes: Thanks very much.

Operator: Thank you so much, Avi, for your question. And the next person in the queue is coming from Johnnie Smith from Tellworth. Johnnie, you're unmuted, please go ahead.

Johnnie Smith: Hi guys. I know people asked a few questions about this problem contract already, but I just want you to understand a bit more about the nature of it. What is that – what exact services were you providing, and I guess why is there a fixed cost or a promised element to it? Thanks.

Steve Wadey: Yeah, Johnnie again, thank you for the question. I'm afraid for various commercial reasons, we really can't go into the specifics. It is highly sensitive, but as we've said, it's due to some very complex technical and supply chain issues that we've been managing. And COVID has really not helped in terms of travel and engagement between our teams, between the supplier and between the customer. And it's been about managing these technical and supply chain issues. So we can't get into the specific nature of the technology or the service that we're providing, but I can just reinforce the points that I was making earlier. We do have a portfolio of large contracts that we manage. We've developed our project management and our risk management capability.

And in this instance, as I said, the risk exposure's raised to a level where we've needed to disclose it today. But we all making every effort that we can in terms of engaging additional resources internally with the supplier and very close dialogue with the customer. And clearly, everything we're doing is to overcome and mitigate that risk as quickly as we can. And I'm afraid Johnnie, I can't really say a lot more than that, at this instance, and we'll obviously say more when we get to the full results on the 11th November.

Johnnie Smith: And I guess – I appreciate, I guess, the sensitivity of it. Are you able to say whether it's a – is it more of a product contract versus a services?

Steve Wadey: I'm sorry, Johnnie, I can't say any more than I've said.

Johnnie Smith: Okay, cool. Thanks guys.

Operator: Thank you Johnnie, for your question. And the next question in the queue is coming from the line of Jack Barrett from Man Group. Jack, you're unmuted, please go ahead.

Jack Barrett: Good morning, everybody. Thank you for taking my question. I appreciate you can't talk about the details of the contract specifically. Could you maybe just reassure us that that is going to be bounded within this year, or that you're confident by the end of this, that it's a fiscal 2022 issue, not one that's going to drag onto fiscal 2023 and beyond?

Steve Wadey: Yeah. I mean, – hi Jack yeah, absolutely, I think that from our perspective right now, we absolutely see that we will be able to manage this situation to a definitive position within our full-year period. Whether that's in weeks or months, we'll see, we'll give an update of it on the 11th November, but absolutely, we don't see this dragging on for a long period of time at this stage. So, sorry, we can't go into more details, but you'll understand the sensitivity of it for reasons that you can work out, but we hope to be able to give you a more full update on the 11th.

David Smith: Jack, sorry, so the intent is the contract itself extends beyond this year. However, we'll make sure we take the necessary financial provision, if needed, this year.

Jack Barrett: Okay. Thank you. And just to follow up, because I guess I was very reassured to hear that it was non-cash, because you've talked about it as a write-down today rather than a downgrade, or, I guess, it will be a profit impact, but it's a non-cash one. So just again, can we just try and understand that, I guess to Avi's earlier question, so I'm reassured that it's going to be a non-cash impact or the cash impact as it would have been seen.

David Smith: Well, that's what I'm saying. Most of the cash impact has already been seen. It's really writing down, I will use the word a bit broadly, but investments in the project to date.

Jack Barrett: Okay. Okay. And I guess, if it is written down and the project extends beyond this initial year, would there be any impact on group margins going forward? I.e. look, it's a contract that's provided for, that's not loss-making any more, that's going to be at zero margin. I mean, I guess –

David Smith: Yeah, well, that's what I'm saying, Jack, that we'll take the necessary financial provision this year to treat it then as at least a breakeven project going forward.

Jack Barrett: Okay. Very, very clear. And that is within the £15 million guidance?

David Smith: Correct, yeah.

Jack Barrett: Very clear. And given you reiterated medium-term targets, we can take that to mean that that is within that going forward, that thought process was taken into account when we look towards the medium term as well?

David Smith: That's correct. Yep.

Steve Wadey: Hence the one-off expression, Jack.

Jack Barrett: Yep. No, reassuring. Thank you very much, indeed. Thanks guys.

Operator: Thank you, Jack, for your question. And as another reminder, it is star one on your telephone keypad if you would like to ask the question. Again, it is star one on your telephone keypad if you'd like to ask a question. We do have a follow-up question coming from the line of Avi Hoddes from SAM. Avi, you are unmuted, please go ahead.

Avi Hoddes: Hi, it's Avi again. I'm sorry to labour a little point, I hope not too pedantic but on the prior question. If you have revenues coming through in 2023, I assume they'll be on a zero margin because they're fully provided for. Would that not be a margin drag on the group just because you've got an enforced breakeven margin on a positive revenue number? That's all. Thank you.

David Smith: You're right. I think what the question Jack asked me is, does it change our margin outlook, and we've already effectively, taken that into account in that margin outlook.

Avi Hoddes: Very clear thank you very much.

Operator: Thank you, Avi, for your question. There are no further questions in the queue. So, final reminder, it is star one on your telephone keypad to ask the question.

We do have another follow-up question from the line of Rory Smith from Investec. Rory, you're unmuted, please go ahead.

Rory Smith: All right. Thank you. I thought if Avi had a follow-up, I'd jump in with one as well. Could you just talk about the current issues, temporal issues, notwithstanding in the US the more medium to longer term evolution of that business. I mean, I note that Mary Williams has stepped back, I guess, that wasn't too unexpected. But actually, it looks like there's some strategic shift there as well with new business units being named. I was just wondering if you could add a bit of colour to your thinking on how that helps.

Steve Wadey: Yeah, of course, Rory, we're very pleased to. And as you said, maybe not unexpected, but Mary took the personal decision and chose to step back. And she remains committed and she remains part of the company. I mean, she's continuing as a strategic advisor to me and given her technology-based experience, I'll be drawing upon that. And, also her insights into the industry as part of supporting our long-term growth ambitions and supporting thinking through acquisition-related strategies. So yeah, that's Mary's decision and she's chosen to take that position at the moment.

And then with the Special Security Arrangement Board, and David and I, we chose to consider that situation and say, well, okay, how do we use this as an opportunity to create a platform, to really enhance the focus on both our performance and build the capability that we need for all future acquisitive growth. And that's why we've gone through the reorganisation that you've seen described in the note.

So what we've done is we're in the process now of actively recruiting a new CEO, and we're in the market place looking for an individual that has the experience and the capacity to really lead that strategic step of growth. You know that our ambition – I think I reinforced it earlier – is to more than double the size of the business over the next five years, through both organic and acquisitive growth. So we're looking for that individual.

And working into that individual, we've now organised the business into two business units. We have what we've called C5ISRS Solutions. That is what was formally known as the MTEQ business. And we've appointed a president directly to lead that P&L, working into the new CEO. And then secondly, we've renamed what was formally the QNA business, Technology Solutions. And again appointed a direct president to lead that. And those two leaders are – they're empowered and focused, driving those relevant P&Ls both on performance and organic growth. And then we've got the new CEO coming in to lead the overall business and how we would develop the strategy.

But as I said earlier, I think it's been a good time to put that alternative structure in. But it absolutely does give us the platform now to create the right capacity and capability to drive the next stage of growth for the business. And the key capabilities that we have in those two business units now are fundamental to the shift that the customer is seeing.

The other thing that you will have noted in the announcement is that at PLC board level, we've also strengthened the experience and the capability of our board. We've recruited Larry Prior. Larry joins the PLC Board with huge experience both in the US but globally around the aerospace defence and government services sectors. So that brings a new dimension of experience to the PLC Board. And that will also support us looking at fulfilling our strategic ambitions not just globally, but also specifically within the US.

So a whole host of changes really, which are quite exciting, to be honest, and again, directly coupled into the point that I was making in response to Rory's question about Australia. Again, the company strategy is built around three home countries: US, UK, Australia. And we were very pleased to see the announcement of the Aukus Alliance that really does show that we're on exactly the right focus, on exactly the right trajectory to build from that future arrangement.

So hopefully, Avi, that just gives you a little bit more colour about our future US plans.

Rory Smith: It was Rory, but that was very clear, thank you.

Steve Wadey: Rory, sorry. Very sorry.

Operator: Thank you, Rory, for your question. And that was the final question in the queue. So I would now like to hand it over to the team to conclude today's call.

Steve Wadey: Okay, great. Well, thank you everybody and appreciate you joining. I mean, just to summarise the key points. Number one, overall, we delivered a really strong set of half one results, and I just want to draw out here excellent order intake at more than £700 million pounds. And that gives us a really great platform to deliver a strong second half. In that half one results, really exceptional performance and growth in our UK and Australian businesses.

Secondly, yes, we have a timing issue in the US and we have a contract-specific risk. Both of those are being actively managed by the team, and I can assure you they're transitory and they don't detract from our third point, which is our long-term strategy remains exactly the same. We're in a good position to deliver our second half and continue to focus on long-term sustainable growth and we'll talk more about that on the 11th November.

So with that, thank you for joining. And of course, if you do have any other follow-up questions, please reach out and contact John Haworth accordingly. Okay, thank you everybody and look forward to catching up on 11th November.

Operator: Thank you everyone for joining us on today's call. You may now disconnect your handsets. Hosts, you may please stay connected.

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