QinetiQ Group Plc Preliminary Results

Thursday, 24th May 2018
Headlines

Steve Wadey

Chief Executive Officer, QinetiQ Group Plc

Good morning everybody and welcome to our full-year results. I would also like to thank and welcome the Board members for joining us here this morning. I would like to start our results by mentioning this picture on the slide. This is one of our new Pilatus PC-21 aircraft which will be delivering state-of-the-art test pilot training for the Royal Air Force and international customers from early 2019. Not only is it a great picture but it is also very symbolic of the modernisation that is ongoing throughout the company both in terms of the way that we work and also the new products and services that we are offering to our customers.

Two years ago I launched a new vision-based strategy to grow the business. At the end of FY18 I am very pleased to report that our strategy is building momentum and we have reversed five years of decline delivering a second year of growth. Looking forward our growth potential remains significant and my focus is on continuing to implement our strategy and accelerate further growth.

Agenda

The agenda this morning is as follows. I will start by giving you the headlines. David will provide a commentary on our financial results. I will come back and give you a strategic update on our progress and we will then open up for any questions.

Our Strategy is Delivering – Second Year of Growth

Overall we have had a good year delivering a second year of growth after five years of decline. Revenue is up 6%, 3% on an organic basis, and operating profit up 5%, broadly flat on an organic basis with international growth overcoming a £4 million headwind on UK single source work. Visibility is good with solid orders performance and a £2 billion order backlog. Cash performance is strong with 103% conversion pre-CAPEX and returns are healthy with EPS up 7% and a 5% increase in our full-year dividend.

We continue to make good progress delivering our strategy to achieve growth. Our biggest achievement in the UK is being selected as the engineering delivery partner for the Ministry of Defence where we are leading a consortia of companies to deliver engineering services in support of defence procurement. This programme could be worth more than £1 billion over the next ten years. In the United States our biggest achievement is winning the first phase of a major robotics programme of record. The winner of the next phase will be selected at the end of this year and this programme could be worth approximately $400 million over the next seven years. At a Group level our biggest achievement is that we have grown our international share of revenue from 21% to 27% in just two years. At the end of April we agreed to acquire E.I.S. Aircraft Operations in Germany which will further accelerate our international growth.

Looking forward we start FY19 in a healthy position with more than two-thirds of our year’s revenue under contract, our key priorities are: to conclude the long-term partnering agreement repricing negotiation with the Ministry of Defence, win further campaigns and build on our successful down-selects, accelerate our international growth in key selected countries,
and continue to invest in driving our sustainable growth. In summary we are maintaining expectations for Group performance.

**Financial Overview**

David Smith  
*Chief Financial Officer, QinetiQ Group Plc*

**Strong Financial Performance**

Good morning everybody. Obviously somebody with a sense of humour decided to put a picture of the CFO in action on this slide. Let me reiterate some of the key numbers again. We delivered a strong financial performance in the year resulting in a second successive year of organic growth despite the well-flagged SSRO headwinds we faced in the UK. We have increased revenue by 6% overall to £833 million by 3% on an organic basis. We have grown underlying operating profit by 5% at £122.5 million assisted by £8.7 million of non-recurring trading items. I note that in the prior year we also benefitted from £7.4 million of non-recurring trading items. I will come onto those non-recurring trading items again later.

Overall our underlying operating profit was broadly flat on an organic basis. We have a strong order backlog of £2 billion and we have grown orders by 15% excluding LTPA amendments and the impact of the NCSISS and Strategic Enterprise multi-year contracts on the prior year. As a result with a strong backlog and over two-thirds of our revenue under contract we have good visibility as we enter fiscal 2019.

Strong cash generation in the period continued to support our balance sheet strength and we ended the year with net cash of £266.8 million. Overall our underlying EPS grew by 7% to 19.3p due to higher profit after tax and the reduced share count following the completion of the share buyback in the last financial year. We are proposing a final dividend of 4.2p to give a full-year dividend of 6.3p, an increase of 5% on fiscal 2017 and in line with our progressive dividend policy.

**Organic Revenue Growth Complemented by Acquisitions**

We made very good progress in EMEA Services with 4% organic revenue growth. In Global Products we had a 4% decline in organic revenue reflecting its lumpy revenue profile. These two combined gave us organic revenue growth of 3% in the period, following on from 1% organic growth last year and continued our upward trajectory after five years of declining revenue before that. The acquisition of QTS and RubiKon contributed £30.7 million of inorganic revenue to the reported number. We also had a £1.1 million headwind on revenue due to translational foreign exchange effects. All of this resulted in reported revenue growth of 6%. We continue to make good progress against our strategy of becoming a more international business and that is reflected in our revenue composition where we now have 27% of our revenue outside of the UK compared to 22% in fiscal 2017 and 21% the year before. That is assisted by full-year’s contribution from the QTS and RubiKon businesses.

**Order Growth, Excluding Multi-Year Orders in 2017**

Turning to our order intake, the main variance relates to the £109 million 11-year NCSISS contract and £55 million of Strategic Enterprise orders which was secured in the prior year. Excluding the impact of those prior year multi-year contracts we saw a 15% increase in
orders in fiscal 2018. In EMEA Services orders reduced by around £13 million and that primarily reflected lower MOD commitments during the year. Despite this, after a slower first-half we saw a much stronger second-half with orders up £20 million versus the comparator period. In Global Products orders are up £56 million excluding the impact of the QTS acquisition and FX. That was primarily due to orders for Maritime Systems in the US and a €25 million order from the European Space Agency for a spacecraft berthing and docking mechanism. There was a strong orders performance from the acquired QTS and RubiKon businesses at £32 million. We have around 69% revenue cover for the full year compared with 74% at the same time last year. That change reflects lower value of shorter-dated orders secured in fiscal 2018, increasing international mix in the business and an overall increase in expected revenues.

**Profit: International Growth Offsetting UK Single Source Headwinds**

Turning to underlying operating profit you should note that this bridge excludes some specific adjusting items, details of which can be found in the supporting schedules in the presentation materials. Overall we have a 5% increase in reported underlying profit, a 4% increase excluding the impact of non-recurring items and broadly flat on an organic basis. Moving from left to right, in the prior period there were non-recurring items of £7.4 million relating to the release of engine service obligations and resolution of some historical contract disputes. A comparator basis for fiscal 2017 was £108.9 million. In EMEA Services this year there was a £3.4 million organic reduction excluding non-recurring trading items. That was really due to the lower baseline profit rate for UK MOD single source contracts which was in line with our expectations. In Global Products we delivered a £2.7 million organic increase in operating profit assisted by improving profitability in OptaSense and higher margins in the QTS business at the end of the year. This inorganic contribution from the QTS and RubiKon business was £6.6 million, and there was also £1 million headwind from foreign exchange movements at a Group level.

So that took us to a corporate profit of £138.8 million, excluding the non-recurring trading items. Finally, therefore, we saw some positive net benefit from them of £8.7 million, and this accreted a further £5.3 million credit relating to the release of engine service obligations; a £4.7 million credit relating to the settlement of an historic contract dispute and £2.7 million relating to property charges and some smaller contract-related releases.

So overall at £122.5 million, a good performance with global products, organic margins, offsetting the margin impact of single-source profit in the UK, and with profit enhancement from one-off trading benefits and acquisitions totalling 5% growth overall.

**Strong SSRO Headwind in FY19, Expected to Reduce Thereafter**

The SSRO headwind that we experienced over the last couple of years is expected to increase in FY19, as we reprice the remaining part of the LTPA contract. Consequently, we do expect a headwind to EMEA services profit this year of approximately £6 million.

Going forward for FY20 onwards, this headwind will reduce as we put much more of our single-source work into longer-term contracts. Also longer term, there is some evidence of a potential stabilisation in the BPR, with the last two data points showing an increase over the 6.1% of 2016/2017. So although the moving average reduced this year, the current low point of 6.1% will drop out of the calculation next year.
It is important to note that the baseline profit rate is not the rate we actually contract at. A series of adjustments are made to this, including for capital deployed and risk to reach a contracted profit rate, which is clearly higher.

**EMEA Services – Encouraging Organic Revenue Growth**

For EMEA services, I have again included this new chart we introduced at the half year, which shows the split by major business within the EMEA services segment. As you can see, the growth is predominantly driven by our international business, including the acquisition we made last year, and Maritime Land and Weapons MOD business in the UK. As we did in the FY17 results announcement, we have again provided the backlog numbers, both including and excluding LTPA contract amendments.

As I have already explained, the reduction in orders we saw was primarily due to the 11-year, £109 million NCSISS contract and £55 million of strategic enterprise contracts contracted in the prior year. We saw a good second half to FY18 with strong orders offsetting some of the weakness we reported at the half year.

Overall, revenue increased by 6%, including 4% on an organic basis. Operating profit was assisted by about £7.7 million of non-recurring trading items. Excluding those, operating profit decreased by £3.4 million, and as previously mentioned, this was due to the lower profit rate for single-source work and was as expected.

We maintain good revenue visibility within EMEA services with 75% of FY19 revenue under contract. As at 1st April, that compares with 79% of the prior year; some reduction, I know, but that reflects a lower level of value, shorter dated orders secured in FY18 and an increasing international mix in the business.

**Global Products – Strong Orders Performance**

Turning now to global products, the orders increase was driven by maritime-related contracts in the US and the €25 million contract with the European Space Agency. In line with its more lumpy profile, revenue is up 7% at £181.6 million, but actually declined on an organic basis, excluding the QTS acquisition. The QTS acquisition added £20 million of inorganic revenue. Integration into the Group is progressing well, and the business is performing as expected, enhancing the overall margins of the division.

Overall, global products operating profit was up £2.7 million, after adjusting for acquisitions and FX and £1 million of non-trading items. As I have already explained, that reflected increased profits in OptaSense and higher margins in QTS in the final quarter of the year. We have about 51% of the global products revenue under contract as of 1st April compared with 55% the same time last year.

**Strong Cash Generation**

*Cash conversion*

Turning now to our cash flows, I have again outlined here how we get to our cash conversion figure and the key drivers behind it. Overall, our operating cash conversion at 103% was strong. The main drivers during the period were a net £6.8 million working capital movement relating to the non-recurring trading items, a general working capital unwind of £7.4 million and £12.4 million of pension deficit repair payments. And these will be reducing next year, as
I will discuss on a later slide. That resulted in a net cash inflow from operations of £126.5 million and the cash conversion ratio of 103%.

**CAPEX**

As previously advised and in line with our strategy, capital expenditure increased in the year to £80 million, and that is up from £32.9 million in the prior year as we invest strategically in the LTPA following the contract amendments announced in December 2016. £25.9 million of this CAPEX spend will be settled in cash in FY19. After CAPEX we had cash inflows, therefore, of £72 million.

**Balance Sheet Supports Growth Strategy**

So I have presented here on the next slide the drivers of our net cash during the period. In addition to the £72 million of operating cash flow I have already worked through, we had a £15.7 million tax payment resulting in a free cash flow of £56.3 million. Then after the dividends and receipts from property and intellectual property disposal, we ended the year with net cash of £266.8 million.

Overall, with this net cash balance, an increased pension surplus, as I will come to, and committed facilities of £237 million, our balance sheet remains robust, with capacity to support our growth plans for the company.

**Confirmed Pension Surplus**

So moving on to the pension surplus in a bit more detail, in 2017 we actually saw the net position move from a deficit to a surplus of £124.6 million. In 2018 that surplus has increased further to £257.7 million, and all of these figures are net of deferred tax. That increase in the surplus in 2018 was mainly down to reduction in the assumptions around life expectancy and a lower rate of inflation.

During the year, we have also had a further increased level of hedging, protecting ourselves from this position unwinding, and we now have 100% of inflation risk and approximately 85% of the interest rate risk hedged. Following the triennial valuation and discussions with QinetiQ’s pension trustees, the company had an actuarial as opposed to an accounting pension surplus of £139.7 million, as at 30th June 2017. Based on that, we have ceased making cash deficit repayments of approximately £10.5 million a year from this March.

**Capital Allocation Policy**

I just wanted to take the opportunity at this point to reiterate our policy around capital allocation and how it fits with our growth ambitions. The policy is aligned with our strategy, and it is intended to ensure that we have the financial flexibility to deliver it while also providing attractive long-term returns to our shareholders. The number-one priority is investment in our organic capabilities, as demonstrated by the capital expenditure I discussed on the cash slide. The £80 million CAPEX in 2018 will support the development and modernisation of capabilities for long-term UK MOD contracts and enable our expansion into higher-growth international markets.

We will continue to invest strategically to support our organic growth, and also to retain the necessary capital to make acquisitions where there is a strong strategic fit. And clearly the example of this is the recent announcement on EIS aircraft operations.
FY19 Outlook – Technical Factors

So turning now to some technical factors, I have updated these for the forecast for 2019. With the positive cash balance, our underlying net financial costs are expected to remain minimal. Our effective tax rate was £10.7 million in 2018. That is anticipated to rise somewhat in 2019, due to a greater proportion of international revenues, while remaining below the UK statutory rate and subject to any changes in tax legislation.

The reason we are below the UK statutory rate is principally because of this contribution of R&D credits, although over the medium term the net value of those will decline because of changes in MOD policy. We expect the cash tax outflow to decrease in 2019 due to the anticipated step up in capital investment in FY19 and the increased RDEC rate from 11% to 12%.

We expect to see a continued unwinding of our negative net working capital position in line with our changing contracting policy, and that is estimated to be in the order of £15 million to £25 million this year, excluding any non-recurring items. As previously mentioned, the £10.5 million deficit on recovery payments will now cease, though we also have about £2.5 million in respect of an asset-backed funding scheme.

Capital expenditure will increase further to £80 million to £100 million, in line with our strategy and growth plans, of which the cash impact is likely to be around £100 million, including the reduction in our FY18 year-end CAPEX creditor.

Outlook Statement

So turning now to our outlook, outlined here are the outlooks from the preliminary results released this morning. Our focus remains on continued strong operational delivery while investing in our growth strategy. For overall Group performance, we are maintaining expectations in FY19, excluding non-recurring trading items, with an approximate £6 million profit headwind on UK single source revenue.

We anticipate continued further modest organic revenue growth in FY19 with the associated profit impact largely offset by the impacts of FX rates.

   Longer term

Longer term, we expect a reduction in the headwind to EMEA services profitability in FY20 and onwards. That will enable revenue growth momentum to drive increased profitability.

Strategic Update

Steve Wadey
Chief Executive Officer, QinetiQ Group Plc

Market Drivers – Defence, Security and Critical Infrastructure

Themes

I am going to start with the key drivers that we are seeing in our primary markets of defence, security and critical infrastructure.

Recent events underscore that our world is becoming more uncertain and complex. The poisoning of a former Russian agent on British soil, allied strikes on Syria following the
regime's use of chemical weapons and continued uncertainty on the Korean Peninsula, to
name but a few.

The changing nature of our threats and a persistent drive for budgetary efficiency are
changing the character and scope of how our customers are deterring, preparing for and
responding to threats to our society. These themes have been highlighted through both the

*Enablers*

The response to these themes requires a set of enablers that differ from the past:

- The ability to deploy integrated capabilities at lower cost by linking platforms, systems
information and humans;
- Exploiting disruptive technologies to maintain edge;
- Using digital information for competitive advantage;
- Testing training and rehearsing against real-world threats; and
- Operational readiness will increasingly require enhanced interoperability with other
forces, government actors and international allies.

*Creating opportunities through inherent strengths and strategy*

Our strategy was designed to proactively respond to these market drivers, as our inherent
strengths are very well aligned and creating opportunities for growth. I will provide examples
of this later in the presentation.

Our inherent strengths help our customers to achieve operational and competitive advantage
by delivering greater capability at lower cost, enabling faster transition from concept through
to capability and providing assurance throughout the lifecycle. By working closely with our
customers to address their current needs, we are also able to understand their future
requirements. This is the mission of more than 4,000 scientists and engineers with a wide
variety of unique facilities.

How We Create Value

*Capability Generation and Assurance*

At the highest level of our value chain, we call this overall approach Capability Generation and
Assurance, our unique value proposition developing, enabling and assuring capability across
the lifecycle based on three distinct reinforcing activities: first, capability integration, the
optimisation and integration of all critical components that form a capability; second, threat
representation, the testing of a capability against real-world threats, whether they are live,
virtual or cyber; and finally, operational readiness, assuring that a capability at team and
force level is operationally ready to deploy.

Greater clarity of our unique value proposition forms the basis of our strategy and allows us
to focus on creating more value for our customers in our home countries, as well as creating
value in our selected target markets for growth.

Delivering Our Vision and Strategy

As a reminder, this is the vision-based strategy that I launched two years ago to drive our
growth, underpinned by a transformation programme to improve our customer focus and our
competitiveness. The vision and strategy has not changed. However, there are two areas of progress behind the scenes that I would like to share with you.

Refined precision in business planning process
First, within our business planning process, we have refined the next level of precision to our strategy. This is an important step as the similar customer requirements that we are seeing across our target markets require even more coherence and leverage of our internal capabilities across the Group. This refinement provides even greater focus and discipline to our investment decision-making which will drive further growth.

Transformation programme
Second our transformation programme has been a key enabler to our performance improvement over the last two years, major highlights being: building a stronger leadership team; improving performance management discipline; and undertaking focused cost-reduction actions where the benefits have been reinvested into our growth initiatives.

Whilst we have made great progress, I still see many more opportunities to improve our performance which will enable us to further accelerate growth.

Expanding into Our Addressable Market
Last year, I defined eight cross-cutting strategic objectives that span all three components of our strategy to drive and measure progress. I will now share highlights of progress against them.

Focus on core offerings and target markets
Fundamental to our growth is expanding into our addressable market worth more than £8 billion per annum. Our addressable market is defined by our core offerings and our selected target markets. The graphic illustrates the size of the market and our market share. Dark blue illustrates where we have significant market presence and purple shows the significant growth potential.

Market expansion strategy
There are four main levers to our market expansion strategy, which build upon our positions of strength as the UK’s leading provider of RDT&E, Research, Development and Test & Evaluation, where we have approximately 30% market share and generate £450 million per annum of revenue.

- The first lever is growing our international RDT&E footprint. Focusing on our home countries and prioritised export markets, we have had early successes in Australia and are pursuing various opportunities aimed at building our reputation as a global leader in Test & Evaluation.
- Second, growing our UK training footprint, focusing on opportunities that are highly synergistic to our activities in Test & Evaluation.
- The third lever is expanding into international training where we are leveraging our UK credentials and building in-country capability where appropriate.
- Finally, exploiting our distinctive services and products that form part of our unique value proposition such as unmanned systems, or have grown from our research in differentiated or disruptive technologies.
We have made progress across all fronts of our market expansion strategy through driving our campaign-based approach, establishing joint ventures and pursuing acquisitions.

**Delivering Modern UK Defence Test & Evaluation**

Our success of this market expansion strategy is founded on our core RDT&E offerings in the UK, where we are investing to increase our market share.

*Long-Term Partnering Agreement (LTPA) with UK Ministry of Defence*

This is why our first strategic priority is to lead and modernise UK Defence Test & Evaluation. At the heart of our Test & Evaluation business is the Long-Term Partnering Agreement, known as the LTPA, with the UK Ministry of Defence. This is our largest single contract which runs through to 2028 and today contributes approximately £300 million per annum revenue to our Group.

*Delivering critical skills and facilities*

Under the LTPA, we deliver a wide range of critical skills and facilities that are essential to the generation and assurance of defence and security capability at a national level. The capabilities we deliver are required on an enduring basis and span the complete spectrum of defence equipment.

A key example is ensuring that our submarines operate quietly, where our ranges and engineering expertise are used before any deployment to measure the noise of the submarine and advise how to further reduce the noise level in order to prevent detection by our adversaries.

*£1 billion contract amendment to modernise*

As defence equipment is modernised to respond to the evolving threat, so our skills and facilities require upgrading to ensure that they remain relevant and competitive in meeting our customers’ future needs.

This is why in December 2016, we agreed a £1 billion contract amendment with the UK MOD to modernise and operate the air ranges at Aberporth and Hebrides, as well as modernise test air crew training at Boscombe Down. As part of this contract, MOD and QinetiQ are jointly investing £180 million, recovered over the life of the contract, to meet the requirements of our UK customer, securing revenues of £100 million per annum through to 2028 and enabling growth through attracting new UK, international and industry customers.

*Programme to modernise air ranges and test aircrew training on track*

The Air Range Modernisation programme is making good progress with new infrastructure, radars and instrumentation, which will enable us to design and deliver larger and more complex exercises that meet our UK and international customers’ needs.

As an example, this upgrade programme will enable and directly support the next Formidable Shield exercise in 2019 and has also allowed us to open discussions with other new international customers.

The new test aircrew training programme is also proceeding well. As I mentioned at the start of the presentation, we take delivery of our new aircraft into MOD Boscombe Down later this year. We will be ready to train the next generation of RAF test pilots from the beginning of 2019.
As a direct result of this investment, before we have even begun operating this service, we have also been able to secure our first ever multi-year international contracts to train Dutch and Swiss test pilots. We are also in close dialogue with a number of other potential customers.

**HMS Queen Elizabeth release to service expedited**

One of our outstanding achievements of the year was another project led by our team at MOD Boscombe Down using both our maritime and aviation skills. As you may have seen in the recent BBC documentary on HMS Queen Elizabeth, one of the most complex tasks is landing an aircraft on the deck of a moving ship.

Working closely with our customer, we led the design and delivery of a combined Chinook and Merlin helicopter trials programme to assure the safe operating limits of the aircraft. The innovation of this combined trials programme eliminated the need for further sea trials later in the year, saving money and ultimately expediting the release to service of the carrier.

**Constructive LTPA repricing negotiations with MOD**

The value this project has added to the Queen Elizabeth Class carrier programme is just one example of how our test and evaluation skills and facilities are essential to the generation and assurance of defence and security capability at a national level.

This is why we are working closely with the UK MOD to conclude the LTPA repricing, which will ensure the full breadth of our Test & Evaluation skills and facilities remain relevant and competitive, thereby enabling the delivery of overall UK defence and security needs for years to come.

**Building an International Company**

Our second priority is to build an international company. Two years ago, we established a long-term objective to develop our home countries, create new home countries and drive exports. We have made significant progress in a short period of time.

**North America business continues to grow**

Our business in North America has continued its growth trajectory and achieves strong order intake. Of particular note, we have won an order to upgrade a sub-system on the Virginia Class submarine, a strategically important programme of record to modernise the US fleet.

As I mentioned at the start, we are one of two companies selected for the engineering and manufacturing development phase of a major robotics programme of record. The winner of the production phase will be announced in early 2019 and could be worth approximately $400 million over the next seven years.

**Australian business growing rapidly with record order intake**

In Australia, we have delivered over 30% increase in revenue and achieved record order intake for the third successive year.

The acquisition of RubiKon has gone well, achieving a $16 million increase in our contract to provide support to the procurement of maritime patrol aircraft. In partnership with Nova Systems, we have been selected by the Australian DOD as one of four major service providers enabling us to bid for larger and more strategic contracts.
Established joint ventures in Middle to develop local capabilities

In the Middle East, our strategy is to develop new home countries by leveraging our core Test & Evaluation skills and experience with our UK customer. To enable this outcome, we have created three joint ventures. I am pleased to report that in the first year of operation, we have won more than $30 million of business across air, land and maritime domains.

QinetiQ Target Systems performing and growing

As David explained, the first priority of our capital allocation policy is to invest in our organic capabilities, complemented by bolt-on acquisitions where there is a strong strategic fit. 18 months ago, we acquired Meggitt Target Systems, now known as QinetiQ Target Systems. I’m really delighted to report that we have integrated the business well, and it is performing in line with our expectations. QTS is a market leader in the growing target systems and services business, and the largest supplier of unmanned systems in the UK with more than 40 customers around the world.

During the last year, we secured two new international customers and achieved major production milestones, with our Hammerhead and Banshee products now becoming the most widely-sold maritime and aerial targets in the world. We have also committed in the area of further investment to develop the next generation of targets, which will be launched later this year, by leveraging wider capabilities across the company.

Post-year-end we announced the acquisition of E.I.S. Aircraft Operations, which will establish a test, evaluation and training base in Germany. This will further enhance our international business by providing access to the wider European market. The business exhibits strong financial performance and offers significant potential for the future.

Beyond these acquisitions, we continue to develop and pursue a healthy pipeline of bolt-on acquisitions, as well as export opportunities, in line with our strategy.

Overall, I am particularly pleased with progress on building an international company. The combination of our organic and inorganic actions has increased the international share of Group revenue from 21–27% over the past two years. That is a really significant achievement in such a short period of time.

Innovating for our Customers' Advantage

Leading and modernising UK defence test and evaluation and building an international company are both underpinned by our focus on innovation. To drive medium- to long-term growth, we are pursuing a number of business-winning campaigns based upon major government-funded programmes aligned with QinetiQ's inherent strengths. Critical enablers to the success of these campaigns are choosing the right strategic partners with complementary capabilities and applying focused investment to win. I am pleased with the progress we are making across a wide range of our opportunities and our pipeline is growing.

During the course of the year we have been down-selected to a shortlist of potential suppliers for a number of longer-term competitive programmes, as shown in the table. Our objective is to build on this momentum and secure these programmes. Whilst we may not win them all, being down-selected is a very important step in our improved business-winning maturity and builds confidence in our ability to deliver further organic growth.
Our campaign approach is underpinned by a £10 million per annum investment in internal research and development. This investment is not about putting technology on the shelf. It is rather a focused programme to develop the next generation of products and services which position us to win these longer-term programmes, both in the UK and internationally.

**Summary Remarks**

In summary, I set out our vision-based strategy to grow the business in a rapidly-changing market. As I look back over the last two years, our strategy is working and I am pleased that we have reversed five years of decline and delivered a second year of growth. Last year our operating performance was strong. We delivered 6% revenue growth, 3% on an organic basis, supplemented by our strategic acquisitions through the good deployment of our capital. We have good visibility, with an order backlog of £2 billion and I am particularly pleased with the international growth, now at 27% of Group revenue, which enabled us to offset the UK single-source profit headwind.

Looking forward, in the short term, our strategy remains focused on building momentum to drive continued revenue growth. Whilst we will see a strong profit headwind on UK single-source work in FY19, we expect that headwind to reduce in FY20 and beyond. In the medium term, the scale of our growth potential remains significant. Our strategy will drive further revenue growth and improve profitability through leveraging our strengths into the addressable market, which is more than £8 billion per annum and continuing our investment for growth.

Overall we have made good progress and we are well positioned for sustainable and profitable growth. David and I would be happy now to take any questions. Thank you.

**Q&A**

**Rami Myerson (Investec):** Good morning. A question on LTPA, can you just explain why that deferral, why the contract negotiations were extended into 2019? Are you confident that you will be able to complete those negotiations this year? I am thinking also about the financial implications. I appreciate it is still being negotiated. However, do you expect a similar outlay of capital as you have done with the previous LTPA contract extension and an impact on cash flow?

The second question is on the SSRO headwind, £4 million in 2018, another £6 million in 2019 and you are talking about that coming down in 2020. Is that a £2 million headwind, £5 million headwind; just try and quantify that? Thank you.

**Steve Wadey:** Thank you Rami. I will pick up the first one and pass over the financial implications of the LTPA and the SSRO to David. I think the first thing to say is that with the long-term partnering agreement, the ongoing delivery of our services and the management of all of the capabilities are going on. Business is normal and we continue to deliver those customer services.

When the contract was established back in 2003, the customer and QinetiQ agreed to, effectively, what was called ‘reprice’ the contract every five years. When we looked at the repricing exercise, we consciously agreed that it was right to review the underpinning services and activities that we provide to make sure that they are relevant and competitive for the future. This is what we did with the contract amendment back in December 2016, making
sure that we understand the long-term need. We have effectively started the equivalent exercise with the balance of capabilities. As you will have seen from the slide, there are a wide range of sites. We have 15 sites, 1,800 people that are delivering these ongoing services that we needed to review. It has taken us longer than we expected because of the scale and complexity. However, the negotiations are very constructive. I think the fact that we are in these constructive negotiations, looking at what the long-term services are to meet the UK defence plan and making sure they are relevant is very encouraging.

We have proven, with the December 2016 amendment, it was the right thing to do. We are now delivering, on track, the modernisation of test aircrew training and air range modernisation. We are more aligned now with our UK customer and those services will be designed to meet their needs. As I have mentioned, it is also providing a great platform for growth. We have won new international business before we have even started operating the test aircrew training services.

I think that we are confident that we will get through it. It is a very constructive set of conversations and we look forward to reporting progress before the year end.

In terms of financial implications, David?

**David Smith:** Maybe just adding a little bit to what Steve said, one of the key things that really happened in the December 2016 agreement was we reached a framework which enabled very important long-term investments to be made that really addressed capability and modernised those ranges and the test aircraft fleet. That model is actually one that works for both of us. It enables us over time to get a good return on that capital investment because the depreciation on it is part of the pricing formula. However, it also enables the funding of those investments up front, which were difficult for MOD within their budget constraints otherwise. It was a win-win situation. Therefore very much what we are trying to do is do something quite similar for the other 15 sites around the UK. They have different kinds of needs but the general theme of modernising and increasing capability in those is something that we are trying to do. There will be capital implications of that. The degree to which there are will depend on the result of those negotiations.

In terms of the SSRO headwind, the step-down that we have seen in the last couple of years has been driven both by the repricing of the contracts and by the reduction in the SSRO's BPR rate. As I indicated on the slide that I put up, there is some indication that BPR rate may be about to stabilise although clearly we are not in control of this. However, the key point for us, actually, is that we are now essentially having that pricing in the repricing arrangements that we are making. That is why we are pretty positive about this being the last year of a large headwind. There may be smaller headwinds in the future but they are going to be in the £1 million or so sort of range, not in the £4–6 million range that we have been seeing. That is the basis; it is a combination of the fact that we will have far more of our single-source work on longer-term contracts and then some indication, although we will have to see what happens, that that BPR rate may have stabilised as well.

**David Perry (JP Morgan):** Hi, apologies; I missed a bit of the presentation. However, can you just talk a little bit about the visibility you have on orders in the various markets over the coming year, please? Thank you.
**Steve Wadey:** I make a number of comments on visibility. As I said in the presentation, the first point is that we have a very strong order backlog; you see just over £2 billion. As we look at progression of the strategy over the last two years, that is one of the big improvements that we have seen, in that backlog. That really comes from the strategy about focusing on larger and longer-term government-funded programmes and making sure that we are looking at developing the right strategic partners to complement the capabilities that we have.

Our order pipeline is growing. We are progressively identifying more opportunities, both in our domestic and in our export markets. As you will know from the strategy that we launched two years ago, we have been investing in our business winning capability to support the development of our pipeline. That is really what I was indicating on the presentation around the business winning campaigns building momentum. We are very pleased to have achieved the down-selects that we have reported, these financial results because they are a real indication of our growing business winning capability. Being down-selected into these shortlists is an important step and our focus now is making sure that we convert those to wins. As I said, whilst we may not win them all, it is a step of maturity. The backlog is strong; the pipeline is growing and in terms of revenue cover, we have more than two-thirds cover for this year.

**David Perry:** Can I just ask one more? David, just what were the PPE disposals and is that going to be an ongoing thing, going forward?

**David Smith:** They related to surplus land we had at three or four sites around the UK. There are some other, smaller sites where we may do some more transactions but they are under appraisal at the moment. However, those were the main drivers last year of PPE assets. So good news but we are not counting it in our core results because we think that is a bit of an exceptional return.

**David Perry:** Okay, thanks.

**Rami Myerson:** Two more from me. I have a question on depreciation; this is slightly technical but are you expecting a pick up in depreciation in 2019 given all the investments, or is there some different way of accounting because it comes through the LTPA and SSRO agreement?

**David Smith:** There will be a pick up in depreciation and amortisation from, I think, about £28 million up to about £34 million in 2019 and it is really driven by the investment, as we capitalise things and they come on stream.

**Rami Myerson:** I have one for Steve on Galileo. Given all the recent press and QinetiQ has some contact on that –

**Steve Wadey:** There is a hot topic. Galileo is an important programme. It is a programme that we have been part of for a very long period of time. We provide a really critical set of design and testing capability around the PRS signal. As we have read in the press, this is a major topic between the UK government and the EU at the moment. Certainly I would say our preference is to make sure that we continue within the Galileo programme, given those long-term roles that we have provided and the history. However, ultimately, if we do have a UK national programme and we are not part of Galileo I am very confident that with the skills
and capabilities that we bring to the work that we do on the PRS signal, we would be part of an ongoing UK national programme.

I would also add, from a context point of view for QinetiQ, the volume of activity that we do in this area is modest to small. So whilst it is particularly important, given the skills and capabilities we provide, it is not material in terms of our financial performance.

**Thomas Beavers (StockViews):** Hello, just two questions from me, one on the timing of the CAPEX. It seems like, from the original guidance you gave on the amendment, you were expecting £70 million incremental CAPEX in 2018. It seems like some of that may have been pushed out to 2019. I was just wondering if you could comment on that.

Then, secondly, on the DOD programme of record it seems like you have been selected, obviously, for one to go through to the production phase. I was just wondering if you could comment on the other programme of record? Thank you.

**Steve Wadey:** Maybe I will pick up on the second question first, on US robotics and then pass over to David to do the timing of CAPEX.

In the second part of your question you referred to a second programme of record. Yes, at the half-year results we communicated that we had not been selected as the winner for a programme of record called MTRS, the medium robotic system; that went to another competitor. However, we have continued to focus on our medium-scale robotics activity. In fact, we are doing very well in there. We have secured significant orders during the course of the year. We see continued product development in the medium weight of our robotics platforms and see further growth opportunities both in the US and internationally.

Coming to the programme of record that I mentioned, this is called the Common Robotic System (Individual), so this is a small calibre robot. What has happened is that the DOD has run a competition for what is called the engineering, manufacture and development phase. They have contracted with two companies, us and one other. That contract is now in place; it was let at the end of March 2018. We now running into that engineering manufacturing phase, where we will be both delivering a small number of robots that will effectively go into a head-to-head competition towards the end of this calendar year. Based on the performance and the pricing of the two offers, the DOD will then decide to select one of the two contractors for the production phase. If we win that production phase, which we are now well-positioned for, that is a programme where there is a customer budget of approximately $400 million over the next seven years.

It was a disappointment for us six or nine months ago to lose the MTRS programme. However, we have responded well to that and continued to develop that breadth of product. We are very pleased with the small robot down-select that we have achieved and our focus is really going to be making sure that we are competitive and positioned to win that competition at the beginning of 2019.

Those are the robots. If, David, you can pick up on CAPEX?

**David Smith:** Yeah, you are right, I think, versus the levels that we announced in December 2016. The programme itself, in terms of the physical programmes that are being delivered, both for the aircraft fleet modernisation and the air range modernisation, are physically pretty well on track. The spend profile is a little bit slower than we originally
anticipated; I think about half of our CAPEX spend, last year and this year, in fact will be associated with that programme. However, the timing, you are right, is a little bit slower, which is advantageous from a cash flow point of view. What I wanted to stress is actually the physical programme is pretty well on track, in terms of what we are trying to deliver physically.

**Steve Wadey:** Thank you very much.

[END OF TRANSCRIPT]