QinetiQ Interim Results for Half Year Ended 30 September 2017

Thursday, 16th November 2017

Transcript produced by Global Lingo
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Headlines

Steve Wadey

Chief Executive Officer, QinetiQ

Welcome

Good morning everyone and welcome to our half-year results. I would also like to thank the board members here this morning for joining us for these results. Before I go into them, I would like to just start by mentioning this great picture on the screen. As many of you will know, this is HMS Queen Elizabeth arriving in her home port of Portsmouth earlier this summer, and she is described by many as a national endeavour, with many thousands of people working up and down the breath of the country to deliver this project. And it is worth reflecting that we, as QinetiQ, contributed so much to this project, from the early hull form design and testing that was done in our Ocean Basin down in Haslar, all the way up to some of the ship helicopter integration trials that are ongoing now, that we designed and planned in Boscombe Down. And, in some ways, I see this picture as quite symbolic of the company that we are building; a company that can have a major contribution to national defence and security capability, not just here in the UK but internationally, where we are investing to grow long-term relationships.

Progress

So, 18 months ago, I set out my ambition to grow the company in the medium to long term by driving both our customer focus and our competitiveness, based upon my observation that the company has inherent strengths that are particularly well matched to the changing world. However, to grow, there were some big issues which needed fixing, including strategic planning, business winning and investment. At the end of FY17, we started to see real change, with the first organic growth for six years. Six months on, I am really pleased with our progress. Whilst markets have got tougher, we have continued our growth trajectory, and the implementation of our strategy is maturing to enable further medium to long-term growth, and I will share more about this later on.

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

Headlines

Solid operational delivery in H1 FY18

So, let us start with the headlines. Overall, we have delivered solid operational performance in the first half of the year. Despite challenging markets, our order intake is stable, and we have maintained a strong backlog. We delivered 3% organic revenue growth, building momentum after our return to growth for the first time in six years at the end of FY17. Our underlying operating profit is stable, enhanced by £6.5 million of non-recurring items. And we delivered 5% increase to our interim dividend.

Strategic progress

We have continued to make good progress implementing the strategy, successfully delivering the largest ballistic missile defence exercise in Europe to strengthen NATO defence capability; winning our first significant test and evaluation contract in Australia to manage mine warfare facilities; announcing a joint venture in the UAE for the manufacture of unmanned targets, leveraging our target systems acquisition and wider Group capabilities; and I am particularly pleased that we have grown our international share of Group revenue from 21% to 26%.

Focus on delivery of FY18

Looking forward, we are focused on delivering the remainder of FY18. I expect the trading environment will continue to change rapidly; this is why driving pace and implementation of our strategy is critical. We start the period with 89% of this year's revenue under contract, broadly similar to the same time last year. So, overall, we are maintaining our expectations for Group performance for the full year.

I will now pass over to David to take us through the financials.

Financial Overview

David Smith

Chief Financial Officer, QinetiQ

Summary Financial Headlines

So, thank you Steve and good morning everybody. I am going to begin with a summary of our financial performance in the first half, before going on to talk about some of the detail in the drivers. As Steve mentioned, we made good strategic progress in the first half of the year. We have got a very strong order backlog of £2 billion, which increased with the amendment of the LTPA in December, providing us with growing revenue visibility, and we have delivered steady order intake broadly in line with the prior period, excluding the £109 million, 11-year NCSISS contract. We have increased revenue by 8% overall to £392.5 million, and by 3% on an organic constant currency basis, and underlying operating profit increased to £57.5 million, assisted by around £6.5 million of non-recurring trading items in EMEA Services, and I will come back to that. In the comparative period, Global Products actually benefitted from a £1.3 million non-recurring trading item. As a result, underlying EPS grew by 15% to 9 pence due to a higher profit after tax and the reduced share count following the completion of the buyback in the last financial year.

Cash

Turning to cash, we continue to maintain a very strong balance sheet and we are using that strength to invest strategically and grow our company. As we guided at the start of the year and in line with those strategic priorities, CAPEX has increased as we invest in the LTPA and other core contracts. We have also seen some unwind of working capital, partially due to timing, and I will talk you through the movements in detail on a subsequent slide. So, overall, at the end of the period we had net cash of £194.7 million, with a reduction from £221.9 million at the 31st March due to a small free cash outflow and the dividend being partially offset by the disposals in property. Looking at the dividend, we are proposing an interim dividend of 2.1 pence, an increase of 5% on the fiscal year interim and in line with our progressive dividend policy.

Total Funded Order Backlog

So, to provide some context, I have presented here the evolution of our backlog over the last few years. A lot of the strategic progress we are making is evident in the evolution of this backlog, and the increase to £2.2 billion at the end of last year related to the amendment in the first part of the LTPA I have already referred to. And this is in line with our approach to become more strategic in how we contract, moving to larger, multiyear contracts. This approach delivers a number of benefits, allowing us to contract more efficiently, helping our key customers save costs and providing longer-term pricing visibility, which helps us mitigate some of the margin headwinds within our industry. Overall, our backlog currently stands at £2 billion, providing us with good visibility and the platform from which to deliver further growth.

Orders Bridge

Turning now to order intake, as I have mentioned, the main variant as compared to the prior year relates to the £109 million, 11-year NCSISS contract which was contracted last year. Excluding this, the RubiKon acquisition and foreign exchange, other EMEA Services orders reduced by about £30 million. Around a third of that was the result of aggregation of smaller aircraft engineering orders into our Strategic Enterprise contract, which was awarded a couple of years ago, and the remainder relating to lower new MOD commitments during the period. This does mean that the full-year growth will be lower than the 3% we achieved in the first half, but still in line with expectations. In Global Products, orders were up £12.6 million, excluding the impact of the QTS acquisition and FX, and that was primarily due to a €24 million order from the European Space Agency for a spacecraft berthing and docking mechanism.

Revenue Bridge

Turning now to revenue, we made good progress on EMEA Services, with 4% organic revenue growth. In Global Products, we actually had 18% revenue growth on a reported basis, but that was flat on an organic basis, excluding the impact of acquisitions and FX. The two combined gave us an overall organic revenue growth of 3% in the period. The acquisition of RubiKon and QTS contributed a further £15.6 million to reported revenue, and we had about £4.7 million uplift from FX movements. All of this resulted in reported revenue growth of 8% and, as Steve has already mentioned, we have 89% cover for the full year. So, we are making good progress against our strategy of becoming a more international business as well, and this is reflected in our revenue composition. We now have 26% of our revenue outside of the UK, compared to 21% a year ago.

Underlying Operating Profit Bridge

Turning now to operating profit, and you should note that this bridge excludes a couple of specific adjusting items, which I will come back to later. In the prior period, there was a non-recurring item in Global Products that I have already mentioned, relating to a historical contractual dispute. In EMEA Services in the first half, there was actually a £3.6 million organic reduction in profit, excluding non-recurring trading items, around half of which related to the lower baseline profit rate for UK MOD single-source contracts, and that was in line with our expectations. In Global Products, we reported £1 million organic increase in operating profit. The acquisitions we made during the period and positive FX movements contributed a further £2.8 million and £0.2 million respectively. Finally, in EMEA Services we saw positive non-recurring trading benefits of £6.5 million, and that included a £5.3 million credit relating to the release of future engine service obligations as we invest in new aircraft for our test aircrew training and retire the legacy fleet, also included a £5.4 million charge to property and a number of other smaller contract-related releases. So, overall, a stable performance, with business growth and acquisitions broadly offsetting the margin impact of single-source pricing, and with profit enhancements from the one-off trading benefits.

EMEA Services

So, turning to EMEA Services, I have included a new chart here which slows the split by major business within the EMEA Services segment. And, as you can see, the growth is largely driven by our international business, including the acquisitions we made last year. As we did in the full-year 2017 results announcement, we have, again, provided the backlog numbers, both including and excluding the £1 billion LTPA contract amendment from last year. The reduction in orders was due to the 11-year, £109 million NCSISS contract. Organic revenue was 4% and operating profit was assisted by the non-recurring trading items I have already described. So, we continue to benefit from good revenue visibility within EMEA Services, with 91% of this year's revenue contracted as of the 1st October, and that was 93% at the same time last year.

Global Products

Turning now to global products. The orders increase was driven by the €24 million-euro contract with the European Space Agency. Revenue was up 18%, as I said, at £80.9 million, but flat on an organic basis, excluding the QTS acquisition. The QTS acquisition added £9.4 million of revenue; integration into the Group is progressing well and the business is performing as expected, with order intake actually a little higher than anticipated. Global Products operating profit was up £1 million on an organic basis. We have around 80% of Global Products' full-year revenue under contract, and that was higher last year at 98% and that reflects the shorter cycle of QTS and the lumpy nature of the division in general.

Specific Adjusting Items

So, I mentioned there are a couple of adjusting items that are excluded from our underlying profit. Firstly, a £5.2 million gain on the sale of property that relates to the disposal of surplus land at Bincleaves and in Malvern, and we also disposed of some intellectual property during the year for £6.2 million. And then there is a further couple of adjustments of £0.9 million on deferred tax, and that brought the total adjustment to £13 million to our profit after tax.

Operating Cash Conversion

Turning now to cash flows. I have, again, outlined here how we get to our cash conversion figure and the key drivers behind it. The main drivers during the period were a net £6.5 million adjustment on non-working capital because of the non-recurring trading items and EMEA profits, and then a further general working capital unwind of £19.7 million, and that reflected in part a trend in contracting processes with the MOD, essentially resulting in a reduction in levels of advanced billings. It also relates, in some extent, to timing, and therefore we expect some of this to reverse in the second half of this year. But, overall, we therefore anticipate a full-year working capital unwind, excluding non-recurring items of between £15 and £25 million this year. The pensions deficit payment is obviously net of the profit charges. Capital expenditure of £31 million, up from £9.7 million in the prior period, reflects the strategic investment in the LTPA following the contract amendment last year. Historically, the business had a run rate of around £30 million CAPEX per year, and we expect CAPEX this year to be between £70 to £90 million as we invest in those core contracts. So, overall, we had cash inflow from operations of £35.7 million and, after CAPEX, £4.7 million.

Movements in Net Cash

I have presented here the other drivers in the movement of net cash during the period. So, in addition to that £4.7 million operating cash flow, we had a £12.5 million tax payment, resulting in a negative free cash flow of £7.8 million. And then, after the dividend and receipts from property and intellectual property disposal, we ended the half year with net cash of £194.7 million. Overall, with this cash balance, the increased pension surplus I will come to and committed facilities of £240 million, our balance sheet remains robust, with capacity to support our growth plans for the company.

Defined Benefit Pension Scheme – Balance Sheet Position

So, moving on to the pensions in a bit more detail. In 2017, if you remember, the position moved from a deficit of 36.2 million on an accounting basis to a surplus of 124.6 million. In the first half, this increased further to 200.7 million after deferred tax. The increase in the surplus this year is mainly due to a reduction in the assumptions for life expectancy and a small increase in the discount rate.

During the period, we have also further increased the level of hedging, protecting ourselves from this position on winding, and we now have 100% of inflation risk and 72% of the interest risk hedged. We are in the process of the triennial valuation, so this is the actuarial valuation and that was based upon the value at 30th June. We will update you on that in due course.

Capital Allocation Policy

I just wanted to take this opportunity to reiterate our policy around capital allocation. The policy is aligned with our strategy, and intended to ensure we have the financial flexibility to deliver it while also providing attractive returns to our shareholders. But our number-one priority remains investment in our organic capabilities such as the capital we are currently deploying in the LPTA via the contract amendment signed last year. On that contract, we will earn a return on sales based on the SSRO baseline profit rate with additional adjustments for risk and capital servicing, as well as recovering the €180 million capital expenditure over the duration of the contract through depreciation that is included in the cost base.

This contract transforms our facilities. It reduces operating costs and provides us with the platform to undertake additional services for the MOD and to also attract commercial and international customers. We will therefore continue to invest strategically to support our organic growth.

FY18 Outlook – Technical Factors

Turning now to some technical factors, I have updated these for our forecast for 2018, which from what we originally set out in May, just with some small changes. With a positive cash balance, our underlying finance costs are expected to remain minimal, our effective tax rate is going to be around 10.6%. Last year it is expected to be roughly in line with this this year. We anticipate this to increase in the medium term, however, whilst remaining below the UK statutory rate, and that is before any changes in the mix of profits or geographical location. And the principle reason it is below the statutory rate is because of the contribution of R&D credits, although of the medium term the net value of that will decline because of some changes in MOD policy.

We expect the net cash tax outflow to increase in 2018, and be more closely aligned with the profit charge, and we expect a continued partial unwinding of our negative net working capital position, as I have already underlined, in line with changing customer contracting policy. Some of the unwind, excluding non-recurring items of €20 million in H1, will reverse, but we expect the full-year effect to be between €15 million and €25 million.

Pensions contributions will remain fixed in FY18 at €13 million, and we still expect an increase in capital expenditure. But as I have already mentioned, we now expect this to be €70-90 million, so just down about €10 million for our previous expectation with a small deferral into next year.

FY18 Outlook – Trading

So, turning now to our outlook. Outlined here is the outlook from our earnings statement we released. As I mentioned, our focus is on continued strong operational delivery while investing in our growth strategy.

EMEA services

To reiterate that outlook, in EMEA services we have mentioned the mix of opportunities and threats for the industry. We believe we are well placed to support our customers in this environment through achieving greater value for money and improving services. So as a consequence, we do expect some modest revenue growth. However, the lower baseline profit rate for single-service contracts is still a headwind for our operating margins.

Global products

In global products, the division has a shorter order cycle than EMEA services, and therefore the performance is dependent on the timing of shipments on key orders. As a result of its contracted orders and the pipeline, as well as the anticipated four-year contribution from the Target Systems acquisition, the division is expected to grow this year.

Group performance

Therefore overall, at a group level, we are maintaining expectations for group performance in FY18.

Strategic Update

Steve Wadey

Chief Executive Officer, QinetiQ

Introductory Remarks

Thank you, David. In the first half of FY18, we have delivered solid operating performance, continued our growth trajectory with 3% organic revenue growth, and are building momentum through the implementation of our strategy. I will now share my views on the overall trading environment, the relationship between how we relate value, our core offerings, our addressable market, our growth potential and our vision and strategy, our plan to secure that growth, as well as giving you some tangible examples of recent progress.

Trading Environment

United Kingdom

While in the last six months we have seen the pace of change accelerating, in the UK defence spending is under pressure due to wider economic factors. In response, the new government has launched a National Security Capability Review to look at adapting the full structure to the times we are in. We believe this environment will prevent both challenges and opportunities, requiring us to be agile and innovative to help our customers with their dual challenge of security and economic pressures.

United States

In the United States, defence spending is expected to increase in line with the continued focus on the Third Offset Strategy, where we believe we are well positioned with key disruptive technologies such as autonomy and robotics.

Australia

In Australia, defence budget has grown rapidly and has expected to reach 2% of GDP three years earlier than the government's 2013 pledge. The focus on equipment recapitalisation and the development of the indigenous industry makes Australia an attractive home country for further investment to grow.

Rest of world

In the rest of the world, we see defence and security spending increasing, particularly in the Middle East and Asia Pacific, where customers are procuring their capability through the development of in-country partnerships.

Overall environment

Our market shave been challenging over the last six months, and the UK market in particular has been tough. The pace of change is only going to get faster, and this will present us with opportunities as well as challenges. This is why we set out our strategy, building on our inherent strengths and enabling us to respond positively to these changes and drive growth in the medium to long term. I am encouraged by the overall progress we have made, which I will come to later in the presentation.

Realising Growth Potential

First, I wanted to take you through three slides that describe our approach to realising our growth potential, which provide greater clarity on what we do. With that clarity, we define the addressable market. Given that addressable market, we describe our strategy and plan to grow.

How we create value

So, the first slide describes what we do. It is critical that we understand how to create value to deliver the growth potential. This is something that is not often understood about QinetiQ. So here is our value proposition, a refinement on the model that I developed and shared with you 18 months ago. In essence, we are very clear on our inherent strengths and how we take them to market to create value, not only today, but increasing value in the future.

Starting at the bottom of the chart, we are an information, knowledge and technology-based company with the breadth and depth of more than 4,000 scientists and engineers, and a wide array of unique facilities. Our inherent strengths are deep domain knowledge and experience through close customer relationships, combined with core science and engineering expertise and the ability to develop and manage broad academic and industrial partnerships.

Next, our value chain applies these strengths through three core offerings to customers, which are increasingly relevant to provide solutions in today's rapidly changing security and economic environment. The first layer is our technology base, where we specialise in the creation of technology that is disruptive to give decisive advantage. The middle layer is our services and products, bringing together our own and others' technology and knowhow to provide distinctive specialist services and products. Finally, the top layer is our unique position that is integrated across the lifecycle, where we undertake creative research and development, enabling test and evaluation and deliver readiness through training and rehearsal and enduring critical role to capability generation and assurance for our customers. These three core offerings allow us to deliver operational advantage in the military context, or competitive advantage in the commercial context to our primary defence, security and critical infrastructure customers. In simple terms, not only can we develop technology into capability for a customer, we can also tell you if that capability will work on that day that it is needed. Our key to success in the model is to proactively understand our customers' current and future needs and our agility and innovation to create and enable solutions at greater pace to meet current threats, adjacent threats and emergent threats.

Defining our Addressable Market

Second, given that greater clarity on how we create value and our core offerings, this slide provides a high-level definition of our addressable market – something that QinetiQ has never done before. We have defined our addressable market by first focusing on our core offerings: research and development and test and evaluation, combined termed RDT&E, training, as well as services and products and disruptive technology. Second, by focusing our target markets in terms of sectors and geography, with our primary sectors being defence, security and critical infrastructure, our home countries being the UK, the US and Australia and selected new countries in Europe, Middle East and Asia Pacific, where we see credible paths to access those markets in the medium to long-term.

Based on these core offerings and target markets, the graphic on the right-hand side uses external market forecast data to illustrate the size of the market broken into key segments, predicted growth rate over the next five years and our market share of those segments based upon our FY17 revenue. The dark blue illustrates where we already have significant market presence and the purple shows our opportunity. You can see in the bottom left our position of strength. We are the UK's leading provider of RDT&E, with an addressable market of £1.5 billion per annum. We currently have around 30% market share, generating approximately £450 million per annum of revenue.

From this position of strength, we see leverage into attractive near-adjacent markets that are addressable. UK training, approximately £1 billion per annum and international RDT&E at approximately £5.9 billion per annum. Beyond these two segments, international training as well as the wider market for our distinctive service and products. Our RDT&E offering is at the heart of defining our addressable market and is also the key to our competitive advantage, both in the UK and in international markets. This is why we are investing in our core RDT&E offering, because it gives us the opportunity to drive growth by increasing market share in our existing markets and leveraging our offerings into attractive near-adjacent markets. Based upon these core offerings and our target markets, we have defined the total addressable market at QinetiQ at much greater than £8 billion per annum, providing us with significant growth potential to orientate and focus our growth strategy.

Delivering Our Vision and Strategy

So, I have addressed what we do and our market potential. This is our strategy and plan to grow into that market potential. To recap, it was 18 months ago that I set out our new vision-based strategy for the group, the key strategic priorities being leading and modernising UK Defence Test & Evaluation, building an international company and innovating for our customers' needs by harnessing our strengths and setting out a clear plan for where we wanted to be in the next five to ten years.

Each of these elements are mutually reinforcing. For example, progressing the UK market underpins international growth by developing our core capabilities and providing a reference point for international customers. To further drive the pace and implementation of this strategy, we have defined eight crosscutting objectives that span our three strategic priorities. Our performance over the coming years will be intrinsically linked to our ability to deliver against these objectives, and we will also drive the focus and prioritisation of resources across the company. Overall, I am extremely pleased with the progress that we have made in delivering you strategy in the first 18 months, and I will now share with you some further examples of progress in the last six months.

Delivering Modern UK Defence Test & Evaluation

Our first strategic priority is to lead and modernise UK Defence Test & Evaluation. This is our core business, and the platform from which we will grow. In September 21016, we announced the £109 million, 11-year contract for naval combat system integration support services to provide mission system integration and testing for the Royal Navy surface fleet. In the period we have grown this contract by more than £8 million, through the addition of the Type 26 Future Frigate programme.

The long-term partnering agreement, known as the LTPA, with the MOD is our largest contract through we deliver unique skills and facilities that are critical to enable the generation and assurance of defence and security capability at a national level. In the last six months we are really proud to have enabled two projects of critical national importance: the first Brimstone 2 firing from Typhoon to deliver critical RAF precision strike capability by 2018, thereby enabling the retirement of Tornado in 2019, and the first Sea Ceptor missile firings from HMS Argyll, a major milestone for the Royal Navy to deliver upgraded Type 23 frigate air defence capability.

Our most significant achievement last year was the £1 billion contract amendment to the LPTA to modernise and deliver world-class air ranges and test aircrew training to meet our customers' future needs. As part of this contract, we are on track delivering our major capital expenditure programme purchasing new aircraft radar equipment and instrumentation. This investment positions us to attract additional test and evaluation business from the UK MOD, industry partners and further international customers.

To bring to life the importance of the LPTA and our associated capital expenditure programme at both national and international level, we have recently delivered Formidable Shield 2017, the largest ballistic missile defence exercise in Europe at our Test & Evaluation range in the Outer Hebrides. This exercise enabled eight NATO countries to demonstrate state of the art allied interoperability in a live-fire training and rehearsal environment, using the NATO command control structures. Now, I just am going to show you a short video to bring that to life.

[VIDEO PLAYING]

This is a great example of how our investment provides a strong foundation to meet the changing requirements of not only existing customers, but to allow us to grow our customer base.

Building an International Company

Our second strategic priority is to build an international company. Although this is a long-term objective, we have made considerable progress over the last six months – all the more notable as the international business unit was only established in April 2016.

Australia

In Australia our business continues to growth with record order intake. We achieved a major Test & Evaluation milestone, winning our first contract to run the mine warfare facility at the Australian Navy's Waterhen base, leveraging our UK experience into an adjacent home market.

I am also pleased that our recent acquisition, RubiKon, has been successfully integrated and made significant progress in expanding the value of its strategic partner contract to support the procurement of new maritime patrol aircraft.

North America

In North America the business has performed well and grown. We have won a further contract for our aircraft launch and recovery equipment, and we successfully delivered upgrades to our core TALON robot family. Although we lost the first programme of record, we are still well positioned and continue to compete aggressively for the remaining robot programmes of record and other emergent opportunities.

United Arab Emirates

In December, we announced the acquisition of our new Target Systems business to support our international growth strategy. This week, we have announced that we are establishing a new joint venture in the UAE for the manufacture of unmanned targets. This is another brilliant example of leveraging a long-term relationship that we inherited with our targets business to access the UAE market, where there is demand for our wider Test & Evaluation capabilities.

Leveraging strengths

Finally, we continue to focus on creating other new home markets and exports through leveraging our core offerings and investing in building a strong export team.

So overall, I am particularly pleased with our progress on our international strategy. Early results are showing that we have grown our international share of group revenue from 21% to 26%.

Winning for Our Customers' Advantage

Leading and modernising UK Defence Test & Evaluation and building an international company are underpinned by our focus on innovation.

Campaigns

To drive medium to long-term growth, we are pursuing over 30 business-winning campaigns where we see major government-funded programmes aligned with QinetiQ's core offerings. Critical enablers for success are choosing strategic partners with complementary capabilities and applying focused investment.

To give you a sense of the scale of our ambition, each campaigns material. They are all worth £10s of millions, with some being worth £100s of millions. These campaigns will take a number of years to mature, and we will not win them all. However, I am pleased to report that we have continued to make good progress over the past six months.

Internal Research and Development programme

Our campaign approach is underpinned by our £10 million Internal Research and Development programme. One example of success in developing disruptive technology is our recent breakthrough in underwater data and communications networks critical to enable the next generation of military and commercial capabilities.

Another example is the use of IRAD to create a distinctive service with the opening of our new test facility to support the UK MOD's laser directed energy weapons programme.

International Berthing & Docking Mechanism contract

At the next level of our investment strategy, this has enabled us to win a €24 million contract from the European Space Agency to develop a low-impact docking mechanism for both large and small spacecraft. This product has now been baselined as the docking mechanism for Sierra Nevada's Dreamchaser space aircraft, and establishes a new product line for QinetiQ, enabling us to compete for future production sales into commercial space missions.

Pipeline

Beyond these organic investment actions, we continue to develop and pursue a pipeline of bolt-on acquisitions where there is a strong strategic fit.

Overall, our approach to innovation underpins the delivery of our growth strategy, driving our customer-focused campaigns, supported by our IRAD programme and complemented by bolt-on acquisitions, positioning the company to win longer-term programmes and contracts, both in the UK and internationally.

Concluding Remarks

In summary, it was only 18 months ago that I set out our new vision and strategy. Our strategy was deliberately developed to grow the company in a rapidly changing market environment, where we expected both challenges and opportunities. The accelerating pace of change in that environment means that this strategy is even more relevant today than it was then.

As I look back year on year, we have made considerable progress and it is very pleasing to see our overall group performance developing in line with our strategy, building momentum on last year's return to growth. We have grown the total order book through focusing on those longer-term programmes and contracts, underpinned by good investment discipline. We have delivered solid operating performance over the last six months in challenging markets with stable order intake and increased revenue by 8% through our organic and acquisition actions. I am particularly pleased that we have grown our international share of group revenue from 21% to 26% through the focus on our core offerings and those addressable target markets.

Future

Looking forward, defence and security markets will continue to change rapidly. This is why driving the pace and implementation of our strategy is critical. In the short-term our focus is to deliver consistent operational performance, and therefore we are maintaining our expectations for group performance for the full year. Yes, there will be challenges, but there will also be opportunities and I believe we have the right strengths as well as the right strategy to drive medium to long-term growth. We are already seeing the results from delivering our strategy and investing for growth.

David and I would be happy to take any questions.

Q&A

Charlotte Keyworth (Berenberg): Good morning. Just three questions from me. The first is on the very helpful addressable market slide, which sets out your strategy, really, for capturing extra market share. If I just take your closest adjacency, which is UK training, taking a slightly pessimistic view, it does not really appear to be growing. You have a 1% CAGR there, which I guess would imply that you have to dislodge some incumbents to grow your share. In the backdrop of all the media commentary around the UK defence budget are you at risk of having to trade profit for revenue? I am just wondering your thoughts on what is the competitive advantage there for growing that market.

Second question is on pension. You are in the throes of a triennial review at the moment, and I think going back three years you were actually net surplus. Given that the UK gilt rates have almost halved since then, I just would be interested in your thoughts on the impact on cash flows from 2019 onwards.

Finally, on the repricing of remainder of the LTPA, this is a very material contract for you. We know the base line profit rate is a step down and I think you previously said your ability to outperform the margin is largely related to execution. Firstly, if you could just comment on steps taken to improve performance and how that might translate to an LTPA-wide margin. Secondly, just around payments, really, and whether there is any change from six months ago on how you might view cash flows moving forward once that contract is signed. Thank you.

Steve Wadley: I am glad you liked the slide, and we have deliberately done that to try to explain to everyone what is the addressable market; understanding the clarity, the core offerings and with the strategy where we are trying to lever into adjacent markets and what the scale of the potential is. Taking your example of UK training, I think the first observation to look at is if you look at the scale of that market, our current share is very small, so the opportunity for partnering and relating to other companies that are operating in that is quite significant, based upon the competitive advantage that we can bring. I think therein lies the core of your question, and in fact an example is outside of these doors right now about the use of some of our commercial technology and applying it in a defence domain to deal with the pressures, economic pressures and the need to enhance training. So, I think that from our perspective, there is a big opportunity there in training. Yes, there is pressure on that market, but we have distinctive technology and relationships with various companies, and we believe that we can increase that market share.

David Smith: On pensions, as you mention, the trustees are in the middle of the actuarial triennial update, and the numbers I showed you are clearly the accounting numbers, which are showing a pre-tax surplus of 250 million. I suspect the actuarial number will be a bit lower than that, but will still be a surplus. So there absolutely is an opportunity to cease the deficit funding that we are making, which is about 10 million a year at the moment, once we have completed that discussion. But it is a discussion with the trustees and we obviously have to go through that process.

In terms of the LTPA, there are ongoing actions within the LTPA obviously to improve efficiency, so I would say that is a common theme and within the existing arrangement there are clearly gained share opportunities there. And as we look at the next 10 years of those contracts, we clearly believe that there are opportunities to do things differently. It is very much in line, actually, with some of the investment opportunities we have already made around the test aircrew and the radar facilities. There are absolutely opportunities to change the way that we do things, digitise things, and run those ranges more efficiently. So that will be part, I am sure, of the next level of negotiation.

In terms of cash flow, I was not quite sure about your question. If it is a question of, 'are the cash flows running as they should be?' Yes, they absolutely are. We have put a lot of work in with the MoD around cash collection. You probably know that they changed to a new system eight months ago. We worked really hard with them to try and optimise that, and we are actually in quite a good position, I think, in the cash flow on those transactions, so certainly it is operating as it should do.

Rami Myerson (Investec): Three questions. Can you talk a little bit about the MoD trading environment? You talked about order intake, and there was about 30 million down, of that about two thirds, 20 million of short cycle contracts that have not come through in H1, which based on the statement, you had expected to come through. When do you expect some of those short cycle contracts to come through, if at all? Also, David, you mentioned there was a change in payments from the MoD and the payments policies. Was that related to the software issues that you talked about to Charlotte?

The second question is on international revenues, where roughly it is a about a 30 million year-on-year increase. How much of that is organic? How much of that is the acquisitions that you have made recently? And how much of that 100 million of international revenues circa is generated from your UK facilities? And how much is actually generated out of country?

Lastly, on robotics and robots, there is a large UK contract which Harris won a few months ago, there has been a decision in the US recently, have you been debriefed by the partners? Do you know why you were not chosen for those contracts? Thanks.

David Smith: There is no doubt that we have seen a slowdown on shorter or smaller shorter cycle orders over the last six to eight months. We did refer to that earlier in the year. We have been able to offset that in terms of our overall audit intake, so our actual overall order intake for the first half, although you would not have known this, was actually slightly ahead of our expectations. But clearly, there has been a changing mix, and I think fairly clearly, it relates to the budgetary issues that are fairly well known within the MoD. Will that change very soon? I do not know. We simply do not know when that situation is going to change. Clearly, there is work that needs to be done there, but what I would say is the materiality of that 20 million against a two billion order book is something that we are concerned about because of the short-term impact, but it is not really a long-term structural issue; it is not that material against the overall order book. In terms of payment policy, what I was actually referring to is kind of a longer-term trend that the MoD has become more commercial in its contracting processes, so there is less upfront payment available than they used to be, and that is really unwinding as those contracts go through their lives.

On international revenue, I think from memory, and I can doublecheck this, but I think our increase in the first half was about 25 million, of which 15 or 16 is from the acquisitions, and the rest is a combination primarily of growth in our Australian and US businesses and obviously, the acquisitions of both QTS and Rubicon, which both contributed to that.

Steve Wadey: On the robots, you are right, Rami, so there are two programmes here, there is the Harris win and then there is the recent competition in the US. Yes, we have undertaken a full ‘lessons learnt’ exercise, as you do in all competitions. I think I would just remind you that we are in a really strong position in robotics. I would argue we are number one or two in the world as a provider. We still see that as a strong position for the company. We are continuing to invest in next-generation technology and platforms from a robotics point of view, and we are competing aggressively in the ongoing competitions, not just those that are the public programme on record, but there are also emergent opportunities where we see alignment with our capability, not just in our home markets, but also internationally. So, we still see it as an area of strength, it is still an investment, and we are still going to compete aggressively in those market opportunities.

Rami Myerson: Just a follow-on, slightly on LTPA, so the negotiations are currently ongoing, but the UK MoD and Cabinet Office are currently conducting a strategic review. Has that had any impact on your LTPA negotiations?

Steve Wadey: Overall, I touched a lot on the LTPA. First of all, the amendment that we delivered or secured last year is going extremely well and we are very pleased with that. The highlight for capital expenditure programme is on track; we have bought our new aircraft, we are designing with the customer the new syllabus, and we will be ready for 2019 to deliver a new standard of world-class test pilots training. You saw in Formidable Shield; the Hebrides range is really now starting to modernise and provide state-of-the-art capability. So, the foundation of the LTPA is going extremely well, and the customer is pleased with progress, and you have seen some of that in the video.

The balance of the LTPA, we are in the midst of the negotiation. I will remind you that it is a 25-year contract. It goes all the way out to 2028 and we have a reprice point at the end of March. We are in the midst of that negotiation right now, which I would expect to conclude positively with further modernisation to make sure that – you heard one of the customers talking there, this is a critical and enduring need for defence and security capability. So, the negotiation we are going through is completely relevant to make sure that we have got those future capabilities aligned with future customer programmes.

David Perry (JP Morgan): Steve, what stands out to me in the presentation is just a huge change in emphasis from your predecessor, and it is a little bit ironic to me that the growth that you got in each one is coming out of EMEA services, which is great, and yet global products, where a few years back there was hope for growth, was flat. It looks like the coloured blocks you gave us, what you call 'other EMEA', all these little start-up businesses have gone backwards a bit. Just talking to the global product portfolio as a whole, do you have any sort of view on what that could grow up potentially in the next few years?

Steve Wadey: I think what we have tried to do here, David, is to be really clear on how we create value. As I described, I see our value proposition really having these three layers: technology-based, services and products, as well as this unique position about generating capability and assurance, which as I was just saying to Rami is an enduring need for any major defence and security customer, not just here in the UK but internationally.

I think the best way of answering your question is to go back 18 months ago, as to why and how we set out our strategy to grow the company. We had an understanding of the global market environment for defence and security. We had an understanding of the core strengths of the company. And the strategy was all about how do we connect those strengths into that market, and what we have tried to show in the addressable market is the scale of runway. The growth potential for this company is significant. The challenge in growing any companies how you focus effort, resource, people, relationships to lever that growth. And I think that is what comes out clearly in this addressable market, and it also comes out clearly in our strategy, and whether it is about services, whether it is about products, whether it is about UK/International, we have got an overall integrated strategic business plan and tool now that is running in the company day by day in terms of our effort and our focus.

That is why we are starting to see results, because it is that type of top-down strategic planning in driving the alignment of our strengths to the market that is why we are growing. We always have the question about balance of services and products. I think for me it is about driving the capabilities or the offerings that we have interviews addressable market areas, and that is why you see the share of international, for instance, increasing in the last six months.

Annabel Houston (Edison): Just a question on the international side. You talk about the importance of that business and it has been considered a home company in that sense, so is geography a key part of strategic M&A perhaps more than technical? Or is it a balance? And how much of that international market can be served from existing businesses as it stands?

Steve Wadey: Geography has always been part of our consideration. If I go back to my definition of a home country, it is where we have an indigenous industrial capability of scale and where we have a direct customer relationship. That is how we have defined our three home countries that we currently operate in. M&A has always been part of the strategy; now we have a strategy that is clear and articulate in terms of offering addressable markets, where we can use bolt on acquisitions that are a strategic fit, i.e. aligned with that strategy, whether that is geography, whether that is about technology leverage, that is absolutely part of it. The acquisition of the Target Systems business is an example, because 90% of the revenue of the Target Systems business that we acquired was outside of the UK, and approximately 30 to 40% of the industrial capability that we acquired in that Target business was in Canada. So, it starts to give ourselves a real industrial footprint in Canada, which is one of our targets new home countries, so there is absolutely relationship between geography, technology and our strategy.

Annabel Houston: Overall, do you have a target of where you want international to be as part of the group versus the UK?

Steve Wadey: I think it would be good to have a 50:50 balance in the medium to long term. I think that would be a sensible international balance for a group of our scale.

Thank you very much for your time this morning. Thank you.

[END OF TRANSCRIPT]