Interim results for the six months ended 30\textsuperscript{th} September 2020

Call Transcript

Thursday 12\textsuperscript{th} November 2020
Key:

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

John Haworth

Good morning. Thank you for joining and welcome to the interim results presentation for QinetiQ Group plc, for the six months ended 30 September 2020. My name is John Haworth. I'm the Group Head of Investor Relations for QinetiQ. The session will be led by Steve Wadey, Group Chief Executive Officer; and David Smith, Group Chief Financial Officer. Steve and David will run through their presentation, after which there'll be an opportunity for you to ask questions.

A few pieces of administration before we start. Your videos have been automatically disabled and your audio is muted. We are not using the chat or Q&A functional on WebEx, but we'll be running a live Q&A session at the end of the presentation. In order to ask a question, we ask that you use the 'Raise Hand' feature. This can be found as shown on screen. For Windows devices, you need to click on the participant’s button. Then you will see a small hand icon. For those who are using iOS devices such as iPads, you need to click on the face icon on the bottom where you'll find the raise hand icon. Once you have selected raise hand, we will then unmute the line to ask your question. These instructions will be shown again at the time of the Q&A session.

Steve, over to you with the presentation.

Steve Wadey

Thank you, John and good morning everybody and welcome. We will present our half year results for FY21. I will tell you how we are successfully navigating the ongoing COVID-19 pandemic and set out an exciting future for our company which will enhance returns for shareholders. In 2016 I launched our vision based strategy to reverse decline and drive growth by focusing on our customers’ needs and our competitiveness. This strategy has worked extremely well and now more than ever I am really proud of all of our people who have pulled together throughout the pandemic to deliver another excellent set of results.

We emerge with strength and agility and are on track to deliver our fifth year of growth. I am therefore pleased to be announcing a further upgrade to our full year guidance.

Today, we find ourselves in a world where the nature of warfare is changing. Our adversaries are harnessing emerging technologies and our customers need to respond within constrained budgets accentuated by the impacts of COVID-19. The world is becoming more global and information centric rather than platform centric. These dynamics play well to our inherent strengths. Building on our success, I'm delighted to be setting out a renewed ambition and launching an evolved strategy designed to meet the needs of this new world and accelerate our global growth.

So the agenda this morning is as follows. I'll start by giving you the headlines. David will provide a commentary on our financial results. I'll come back and give you a strategic and operational update and then open up for any questions.
So let's start with the headlines. We've had an excellent start to the year with strong operational performance through the COVID-19 crisis. Orders are up 37%, and we have good revenue visibility with a backlog of £3.1 billion. Revenue is up 24%, 8% on an organic basis. Profit is up 16%, flat on an organic basis. Returns are healthy with EPS up 10% and we reinstated the FY 2020 full year dividend and our interim FY 2021 dividend will be one third of prior year total.

Our growth has been driven by a number of strategic milestones. By the end of October we secured £500 million of orders through the Engineering Delivery Partner contract signed just two years ago. We are ahead of schedule on the two-year transition program as part of the new long-term partnering agreement signed in April 2019. And we've strengthened our core offerings by acquiring Naimuri and disposing of two non-core businesses; Boldon James and Commerce Decisions. These milestones have been achieved by our employees who have been fully engaged and adapted their ways of working to maintain delivery for our customers.

Looking forward, we are in a healthy position. Based on our strong first half performance and having 93% of revenue under contract we are upgrading our full year guidance whilst proactively managing the potential risks from further impacts due to the pandemic. I'm also setting out our renewed ambition and an evolved strategy to meet the needs of the new world, accelerating our global growth into an addressable market worth more than £8 billion per year that will deliver even greater returns for our shareholders.

I'll now pass over to David for an overview of our financial performance.

**David Smith**

Thank you, Steve, and good morning everybody. As usual, I'll begin with a summary of our financial performance in the first half before going into more detail on the drivers.

So as Steve mentioned, we delivered a very good performance in the first half of the year progressing towards our fifth year of growth. We’ve increased revenue by 24% to £603 million and by 8% on an organic basis. We’ve grown our underlying profit by 16% to £69 million and we’ve delivered a margin of 11.4% in line with our short term guidance of 11% to 12%. The underlying earnings per share grew by 10% to 10.1p, despite an increase in tax rates and our order intake was excellent increasing by 17% organically and 37% overall which maintained our strong order backlog of £3.1 billion. We delivered a strong cash performance with 134% underlying cash conversion and our balance sheet remains strong with net cash of £113 million.

So moving on to some detail I'll start with our orders performance. We made very strong progress on orders as I said with 17% organic, 37% growth overall. The key driver of our strong organic performance was EMEA Services which grew orders by £86 million in the first half. And that was primarily driven by new orders under the engineering delivery partner contract. In global products due to COVID related impacts on QTS and OptaSense we saw an organic reduction of £18 million. The contribution from prior acquisitions MTEQ, NSC and Naimuri completed in July contributed £84 million of orders to the reported number in the first half. At the start of the second half we had nearly £1.2 billion of fiscal 2021’s revenue either delivered or under contract for the second half with 93% revenue cover.

Now turning to our revenue, despite experiencing some COVID related disruptions in the first half we made a strong recovery in the second quarter. That resulted in organic revenue growth of 8%. In EMEA Services we grew revenues by 13% organically, primarily due to EDP and growth in Australia and an improving result in Germany. And that was partially offset by an 8%
organic decline in Global Products, again due to COVID related impacts on QTS and OptaSense.

The contribution from our acquisitions including MTEQ, NSC, and Naimuri was £80 million resulting in reported revenue growth of 24%. Steve will cover in more detail, our new acquisitions are performing well delivering good growth and profit and whilst not shown on this slide, international revenue has continued to grow and now represents 35% of group revenue with strong growth in the US and Australia.

Turning to operating profit. Overall reported operating profit was up 16% to £69 million and flat on an organic basis excluding the impact of non-recurring trading items, acquisitions and FX. There were some one-time net benefits amounting to around £1.5 million and that was comparable to the previous year. In EMEA Services profit grew by £10 million on an organic basis; that really reflects disciplined execution of our long-term projects. It was offset by a £10 million organic declining global products due to the impact of COVID on QTS and OptaSense.

MTEQ, NSC and Naimuri contributed £9 million of inorganic operating profit resulting in a group margin of 11.4% overall, in line with our short-term margin guidance of 11% to 12%. We expect to be within this 11% to 12% range at the full year in line with our previous guidance, with some lower COVID disruption but higher digital transformation spend expected in the second half. So overall very strong performance with good growth in orders and revenue and stable operating profit despite a challenging operating environment.

So turning now to EMEA Services, the chart here on the left shows the split by business unit within the EMEA Services division. The 31% increase in orders was primarily due to £129 million of orders under the EDP contract. We've made really excellent progress on EDP with the additional £120 million of orders in the first half bringing the total since inception to £360 million at the end of September. And as Steve said since period end that's grown to over £500 million. As a single source contract and given its minimum capital requirements, the margin we make on EDP and other similar contracts is lower than our average group margin, but remains well in line with the defence industry more generally and delivers an appropriate return on capital. We expect EDP to continue to be a growth driver to our UK business in the near to medium-term.

Revenue increased by 15% and by 13% organically, largely driven by new work under EDP. The strong growth in MSP contract and as we said a better result in German. Underlying operating profit increased by 25%, assisted by a £1.9 million contribution from NSC and Naimuri. That resulted in operating margins of 13.6%. And as I said that really reflects disciplined execution on long-term contracts, cost control measures, plus the impact of the acquisitions despite the dilution from the growth of EDP. We've maintained a substantial order backlog following the strong orders performance which gives us really good forward visibility.

Turning now to global products. This division is a shorter-cycle business and performance varies more greatly due to the timing and mix in product sales and in the first half particularly due to the impact of COVID. Order intake however was up 55% with the contribution from MTEQ more than offsetting an organic decline in orders.

Reported revenue was up 51%, again reflecting the contribution from MTEQ. Although on an organic basis revenues declined by about 8% due to COVID disruption. Underlying operating profit was down by 18% with an operating margin of 6.2%. And here organic operating profit was down £10 million offset by a £7.4 million contribution from MTEQ. The organic decline really reflects decreased sales of high margin QTS products resulting in a loss in that business and also a loss in OptaSense. Although we anticipate some disruption of QTS continuing through the second half, longer-term we believe the business remains well positioned, offering
advanced target systems with complete integration into test and evaluation at an attractive price point. And on OptaSense, we still believe in the long-term future of that business and we're continuing to look at ways to improve results in that business.

Operating cash conversion next. So overall our operating cash conversion, at 134%, was strong. We saw a small working capital unwind of about £11 million in the period that was actually primarily due to inventories. In the first half, our customer payments remained prompt. However, we do anticipate there could be some potential for some unwind of the working capital later in the year and we'll have to look how that works. Cash flow associated with capex was £42 million as we continue to invest in our core contracts such as the LTPA and supporting the long-term sustainable growth. After capex we had underlying net cash inflows of £50 million from operations and as we said before we're really looking at our operating cash flow to be able to fund our internal capex and organic investment from our operating cash flows.

So turning on this next side to the movements in net cash, the movement between £84.7 million at the start of the period and £122.7 million at the end of the period. Clearly we talked about the net cash flow from operations of £50 million that was partially offset by tax charges of about £12 million and a small interest charge resulting in free cash flow of £38 million. The disposal of Boldon James generated net cash proceeds of £27 million and the acquisition of Naimuri resulted in around a £25 million cash outflow. And with those we ended the period with that £113 million of net cash.

With that cash balance and our committed facilities of £275 million our balance sheet remains robust with the capacity to support our growth plans for the company and proactive strategic acquisitions. The previously declared final dividend and interim dividend announced today will result in cash outflow of around £38 million in the second half. And as we've also announced this morning the sale of Commerce Decisions for £10 million will result in about an £8.5 million cash flow in the second half.

Our financial strategy is to drive revenue growth at stable margins with appropriate return on capital. I think we're demonstrating that we're doing that. And as part of that we continue to apply a rigorous approach to evaluate the deployment of our capital, scrutinizing both our organic and inorganic opportunities in the same manner to ensure returns to our shareholders are appropriate for the risks that we're taking.

Turning now to some technical factors, I've updated these positive cash balance means that our underlying net finance costs are expected to remain minimal. Our effective tax rate was 14% last year, that increased at the half year to 15.4%, as we saw a greater proportion of international revenues and higher UK tax rates. We are continuing to benefit obviously within that from R&D grants in the UK. Because of that higher effective tax rate, we'll see some increase in our cash outflow this year.

Working capital outflows were £11 million in the first half as I've already said, we anticipate that could increase to £15 million to £25 million through the balance of the year depending on what we see on working capital unwind. And our pension deficit payments have now ceased, although we will continue to make the £2.8 million a year contribution to the asset backed funding scheme. And capital expenditure is projected to remain in the £80 million to £90 million range this year as we continue to invest in our major projects.

So finally, turning to our revised outlook. As Steve said we have upgraded this and delivered of a strong first half result with good growth in orders revenue and profit despite the impact of COVID. With our revenue visibility being close to £1.2 billion, we're increasing our full year guidance by around 5%. Now we're expecting to deliver low double digit revenue growth or low to mid-single digit organic growth. We expect margins to be consistent with first half
performance within our short term range of 11% to 12%, reflecting lower COVID disruption in the second half, but higher digital transformation spend.

Taking a long term view beyond 21, as Steve is going to describe, we've renewed our ambition and strategy to accelerate our growth at stable margins. That will be supported by a high performance culture investment in our people, technology, systems and infrastructure and further proactive strategic acquisitions.

We're maintaining our medium to long-term margin guidance of 12% to 13%. However, in the short-term, we expect margins to be around 100 basis points below this level due to COVID disruption and into next year increased digital investment and the evolution of our business mix with growth from EDP and MTEQ.

I'm going to hand you back now to Steve to take you through our strategic and operational update.

**Steve Wadey**

Great. Thank you, David. The COVID-19 pandemic has had a profound impact on society and global economies. As the scale of the pandemic became apparent, we established a strategic response to the crisis coherent with our long-term growth strategy. Our strategic response focused on three priorities; protecting the health and well-being of our employees, continuing to deliver for our customers and sustaining our company for the long-term.

During the first quarter of the year, we took necessary and decisive action to boost resilience and ensure that we retained critical skills and capabilities. We implemented a series of short-term temporary actions ranging from stringent cost control to deferral of the full year dividend decision. These actions were very successful in maintaining a strong balance sheet.

As we entered the second quarter, we shifted up a gear into our recovery phase. Our people did an amazing job adopting an innovative mind set and embracing new ways of working to deliver for our customers safely, despite COVID-19. As a result, our performance improved and at the end of the half year, we were able to release the majority of our temporary actions including reinstating the full year guidance and confirming payment of the deferred dividend.

Moving into the second half of the year, we are entering our renewal phase as a stronger and more vibrant company. We are ready to drive our full year performance and learning from the pandemic has helped crystallize an inflection point for our company. We have launched a renewed ambition and evolved our strategy to accelerate our next phase of global growth, an exciting opportunity, which will enhance returns for our shareholders.

The new defence and security paradigm presents us with strong growth opportunities. In the UK, the Integrated Defence and Security Review is likely to reinforce the importance of information, emerging technologies and the need for greater innovation. In the US, Joe Biden has won the Presidential election and despite new policy and budgetary pressures, we expect defence priorities to remain focused on modernization. In Australia, we see continued support across the government for increasing defence budgets to accelerate new capabilities and build domestic supply chains.

In broader markets, competition is also increasing as customers wrestle with critical capability modernisation and national protectionism. COVID-19 has triggered a strategic shock across the world and the ensuing economic impacts will increase pressure on macro defence and security budgets. This dynamic coupled with evermore demanding threats will result in our customers seeking a major shift in the agility and pace of their in country industry. Given we are not a major platform provider, the dynamics of this new world play to our unique strengths.
which are increasingly relevant. Our close customer relationships and domain knowledge enable us to understand our customers’ needs and be proactive to address their challenges. Based on our distinctive offerings, partnering and innovative mind set we can rapidly create solutions to respond to the evolving threats and drive efficiencies. In summary, we are well positioned to meet the dynamics of this new defence and security paradigm and grow into an addressable market with more than £8 billion per year.

To respond to new threats and budgetary pressures we have a clear value proposition that we call mission-led innovation; create it, we develop cutting-edge technology and turn it into capability; test it, we assure that capability will work when critically needed; use it, we ensure our customers are trained and operationally ready.

In essence, we deliver high value-added work for our customers, co-creating efficient solutions at pace across the capability lifecycle. Here are two examples. RCV-Light is a signature program for us in the United States – secured this year providing a demonstrator of the next-generation robotic combat vehicle for the United States Army.

We recently delivered the first system on schedule and we'll deliver three more, combining our distinctive robotics, autonomy and sensor expertise, these platforms will be as instrumental in assessing the operational use of robots on the battlefield to meet new threats. And more importantly, inform the future acquisition program which could be worth several hundreds of millions of dollars to us.

EDP is an innovative industrial partnership that we signed two years ago to provide unique engineering services to UK MOD with a supply chain of more than 120 companies. To date we have secured more than £500 million of orders and delivered every milestone on the journey to full operational capability in 2021. Over 1,000 tasks have been contracted from short-term provision of expertise to multiyear engineering services driving significant savings for our customers. EDP complements our Long Term Partnering Agreement, known as the LTPA, giving the customer choice to rapidly access engineering and test services across the lifecycle.

Our mission led innovation value proposition has increasing resonance with our customers and will drive our global growth by co-creating solutions with greater agility and pace. Focus on meeting our customers’ needs was at the heart of our vision based strategy that I launched at the beginning of FY 2016. Based on achieving today’s upgraded guidance for FY 2021 we have delivered strong operational performance over the past five years, growing our revenue by 60%, increasing the international share of revenue from 21% to 35%, and growing operating profit by 28%. Doubling our order book to £3.1 billion has given us good forward visibility and for the first time we are disclosing two key indicators of forward momentum in our future growth as shown on the top right of this slide.

We have tripled our qualified five-year orders pipeline to over £6 billion and our revenue contracted for the next two and a half years has increased by 55% to £1.5 billion. With the changing dynamics of the new world and an addressable global market of more than £8 billion, plus a multi-billion pound opportunity in the United States, now is an exciting and appropriate time to build on our success and set out a renewed ambition for the future of our company.

Our ambition is to accelerate our growth trajectory to FY 2026 and beyond by building a global company over the next five years that is renowned for delivering mission led innovation, with international revenues of more than 50%. A company with major presence in the United Kingdom, the United States and Australia, making a difference to global and national security.

Our objective is to grow by at least the same level over the next 5 years to 10 years. This will
be driven by continued customer focus and disciplined execution of our strategy, underpinned by our capital allocation policy and rigorous financial discipline.

Based on this renewed ambition and our growing maturity, we will convert revenue growth into sustainable profitable growth at stable margins of 12% to 13% in the medium to long-term, thereby enhancing returns for our shareholders. To deliver this ambition, we have evolved our vision-based strategy to drive even greater focus in our business decisions and our investment choices. Some elements of the strategy are the same and some have been refined.

Our vision and mission-led innovation value proposition which I’ve already described remain the same. The crucial refinement to our customer-focused growth strategy is greater clarity on where, what and how we deliver value for our customers. Where, by building an integrated global defence and security company through leveraging our unique skills and capabilities into our six home and property countries; what, by sharpening our focus on developing distinctive offerings that add value to our customers differentiated from the competition; and how, by applying disruptive innovation to accelerate solutions for our customers with greater agility and pace.

To ensure our growth strategy is both profitable and sustainable we are maturing our high performance inclusive culture, built upon living simple values and behaviours where everyone in our company feels respected and included. Whilst engaging and incentivizing our people, 80% of whom are now shareholders in driving growth, whilst at the same time adhering to the highest environmental, social and governance standards.

This is really important to me and all of our stakeholders; the ethics of defence taking responsibility for who we do business with and the projects that we undertake, such as protecting lives and reducing collateral damage. The impact of our business operating sustainably, such as a commitment to a science-based target to reduce our carbon emission footprint by 25% by 2025. This public commitment is an integral part of our evolved growth strategy. I look forward to sharing more details with you at our investor seminar early in 2021.

Great progress is already being made implementing our evolved strategy. We are successfully building a global company through our multi-domestic business model with clear focus on six countries and developing in-country industrial capability to meet the needs of our customers. We currently deliver 95% of our revenue from within these countries which is not subject to cross-border trade and have more than doubled our international revenue in the past four years on top of 37% growth in the UK.

We’ve also sharpened our portfolio by disposing of two non-core businesses, Boldon James and Commerce Decisions for £40 million and we’ve strengthened our core offerings by investing £266 million in seven strategy-led acquisitions. To support our global growth and win larger organic opportunities, we will continue to proactively explore further complementary acquisitions. Another key enabler of our growth strategy is our ability to modernize and leverage our skills and capabilities globally as exemplified by the LTPA. Over the last four years, we have committed £400 million of capital investment to modernize the LTPA's key capabilities and create a strong platform for growth.

I'm delighted to say that we are currently ahead of schedule on the modernization of our capabilities and have won two significant new contracts from international customers that will enhance further the return on our investment. The picture on the left is the new unmanned air systems test range designed and built in Australia by exporting LTPA skills and experience from the UK. And the picture on the right is a US Air Force F-15 from Lakenheath, which illustrates importing international users to our unique LTPA ranges in the UK. We are
becoming a truly integrated global defence and security company and are on track to grow our international revenue from 35% to more than 50% over the next five years and beyond.

I’m extremely proud of how we have delivered innovative solutions for our customers over the past six months. In Australia, our performance remains strong including winning the renewal of a $100 million 10-year contract to provide unique engineering services to the Defence Science and Technology Group. Following the impacts of COVID-19, our business in Germany has stabilized with flying activity resuming in the second quarter and securing a €10 million contract extension for slow speed aerial target services. Despite the short-term impact of COVID-19 on our targets business we remain confident in the long-term outlook based on future customer demand. A recent highlight in Canada was producing a 500 Hammerhead next-generation target and delivering it to the Royal Australian Navy.

In the United States our special security agreement with the US government has been formalized enabling us to integrate our operations following the acquisition of MTEQ. This has enabled us to leverage technology from the UK and win a $10 million contract from the US Army to integrate our hybrid electric drive into their Bradley vehicle. Our business in Belgium continues to perform well securing a €9 million contract from the European Space Agency to develop experiments for the International Space agency. We have a number of relevant capabilities in the space domain which are becoming increasingly relevant to the importance of this domain to defence and security.

In the UK we are rapidly growing our relevance to intelligence and defence customers with our cyber, communications, and data analytics capability. Recently bolstered by our acquisition of Naimuri, specialists in software development and data analytics. Our growth is being delivered by more than 350 people across our company and we have now been recognized as a strategic partner to UK defence and intelligence.

These are great highlights and show how we have transformed from a UK company to a global company delivering distinctive offerings in our six countries. To ensure our growth is sustainable we need to stay ahead by continuing to innovate for our customers’ advantage. As I’ve mentioned before the threat environment has become increasingly complex with adversaries taking alternative approaches to warfare by rapidly exploiting emerging technologies ranging from hypersonics through to the use of information.

This means our customers can no longer rely on technological advantage alone to stay ahead of the threat especially when the opposition doesn’t play by the same rules. Pace and agility to counter these threats will be the overriding factor. Our response is to put the mission of our customers first and build a culture in our company that co-creates and delivers innovative solutions at pace. COVID-19 has been a catalyst to accelerate our cultural transformation providing the opportunity to step ahead and increase our investment in our people, systems and tools.

We’re also adopting new technologies and flexible ways of working to harness the diversity of our global teams and supply chain. To ensure that we are even more relevant to the changing nature of warfare, we’re also investing significantly in digital systems and techniques to enable the rapid development of next generation products and services. By taking an information-centric rather than a platform-centric approach, we can leverage our skills and data globally to accelerate our growth. This investment underpins our ability to win and deliver major opportunities in our qualified orders pipeline now worth more than £6 billion over the next five years.

Tempest, the UK’s next generation fighter is a great example of where we will apply new digital techniques to provide capability assurance, increasing the pace of development and reducing
cost to the customer. Investing to stay ahead in our distinctive offerings will accelerate our
global growth and provide benefit to our customers, our people and our shareholders.

So in summary, I'm extremely proud of all of our people who have pulled together through
COVID-19 to deliver an excellent start to the year with strong operational performance. We
achieved 37% orders growth, 24% revenue growth and 16% profit growth and maintained
good visibility with a healthy order book of £3.1 billion. As we move into the second half of the
year we emerge from the first half with strength and agility and are on track to deliver our fifth
year of growth.

With a further upgrade to our full year guidance we are focusing on delivering our full year
performance despite COVID-19. Mindful of the potential risk of further impact from the
pandemic we are continuing our resilience actions where appropriate. The changing nature of
warfare drives a new defence and security paradigm with evolving threats and increased
budgetary pressures, due to COVID-19. Learning from the pandemic has helped crystallize
an inflection point in our growth strategy to meet the changing needs of our customers.

As a result we have set out an exciting new phase for our company, a renewed ambition and
an evolved strategy, to meet the needs of this new world and accelerate our global growth into
an addressable market with more than £8 billion per year. Growing an integrated global
company at stable margins will deliver even greater returns for our shareholders.

David and I will now be more than happy to take any questions. Thank you.

Sean Stewart. Sean, if you want to come off mute, we'll try and take your question.

Sean Stewart (JP Morgan)
Hi. Good morning, Steve. Good morning, David. Can you hear me?

Steve Wadey
We can, yes. Fire away, Sean.

Sean Stewart (JP Morgan)
Great. So I just wanted to ask maybe one for David, just on the margins. Obviously EMEA
Services margin very strong in the first half, and even if we were to remove the £2 million non-
recurring trading items that you have its still margins of over 13%. Given that you’ve said on
your margins you expect to be broadly in line with the H1, could you perhaps give us some
colour on what we should be thinking in terms of split between the two divisions in the second
half in terms of margin?

David Smith
We will still see a good margin in EMEA Services in the second half, probably a bit lower than
13%, but as you say there were some one time effects also in the first half. And the cost
actions that we took in the first half particularly benefit EMEA Services. So a little bit lower, but
it's still a good level. Most of the improvement in our guidance is really in EMEA Services.

On global products, there's going to be a couple of effects. I think we'll see better result from
QTS in the second half. We are obviously losing both the Boldon James and Commerce
Decisions revenue and profit in the second half now from today.

But I think we will be better than the 6% margin that we had in the first half, probably back up
to closer to 10% sort of margin in global products I think or maybe slightly below, but with that
sort of level. Overall as I said I think the 11.4% that we did in the first half I think is about right
as a group level for the second half. We'll see hopefully less COVID disruption, but we're also beginning to ramp up on our digital transformation spend that Steve was describing earlier. And that's probably going to be a £3 million to £5 million sort of cost in the second half of the year.

**Sean Stewart (JP Morgan)**

Okay, very helpful. Thank you very much.

**Steve Wadey**

Okay. Next, Richard, we're going to try you again.

**Richard Paige (Numis)**

EMEA Services, the margin at 13.6% in the first half. Obviously a lot of that growth driven by a lower margin contract in EDP, obviously EIS has rebounded in Q2, but obviously had tricky Q1. So just want to understand the sort of underlying dynamics of that business and how that's been achieved?

And, the second one just more broadly on your growth strategy, obviously talking about accelerating revenue growth. I guess a broad question, what do you see as the key challenges and opportunities in delivering that on the long-term basis? Thanks.

**Steve Wadey**

Okay. Thanks Richard. David maybe if you can just pick up the drivers around margin in EMEA then I'll pick up the drivers of margin and then I'll pick up the question about growth strategy.

**David Smith**

Yeah, couple of things on EMEA. First, so the first thing is, yes, you're right. EDP is a revenue growth driver and I've said before EDP margins are lower than our group average. But, at the same time, I think I've also described previously as we get more maturity in EDP, we're actually trying to move a lot of the contracts up in terms of what's called the mode complexity of those contracts, which actually do attract stronger margins. So we're actually improving the EDP margin as well as growing the business, which is obviously a double positive effect from our point of view, but at the same time delivering better savings into the customer.

On the rest of the EMEA margin story, I mean it's a combination of some really good performance as I mentioned in Australia, you're right. Germany had a much better second quarter. And then in our longer term contract space, what we're doing around for instance the LTPA contract, but also other contracts that we have in the Cyber & Information business, we've actually been driving really good cost improvement in those and that is improving our underlying margin on those contracts that we're actually delivering. So these are all positives because we are absolutely delivering what the customer needs in terms of cost efficiency and delivering great service into them, particularly during COVID which has been challenging. But, also from our points of view, we're able to drive an improvement against the originally contracted margins by driving further cost improvement as well.

**Steve Wadey**

Thanks David. And actually just before I go on to the question on strategy Richard I mean, just a comment about EDP and EIS that you both mentioned. I mean first of all, I'm absolutely delighted with EDP and the fact that we're more than £500 million of business in just two years since we signed the contract is a great testament to the strategy and very much about how
we can respond to the economic pressures of our customers. And whilst you said it's lower margin it's bringing appropriate margin in supporting our growth strategy within that stable range for the medium-term to long-term. So we're really delighted with EDP and it's a great example of our innovative approach in action.

Secondly, with EIS. Yes EIS did have that impact that David described in the first quarter, but the team are doing exceptionally well there. We have a new managing director in Germany who's got a very clear strategy with his team and actually he's pursuing a number of growth opportunities. So we see some significant prospects in the training area building on our capability in Germany.

Specifically in terms of your question about the growth strategy and the key challenges and opportunities. I'm going to take this opportunity to talk about our global campaigns which we've talked about in recent years. And that's really driving our focus on our big long-term opportunities in the area of information, test, and training. And they are three areas that we want to really become famous for in the world. And we see significant specific opportunities within that £6 billion orders pipeline that I mentioned. So those are the big areas of opportunity and we see those opportunities directly related to the countries of our focus.

In some ways the challenge that I see is the breadth of opportunity and keeping you know extremely disciplined in the way that we select those many opportunities to pursue the right ones and then we are disciplined in the execution of them. So we have a high range of opportunities. It's about how we get to pursue and win the right ones and get the right complimentary bolt on acquisitions as we pursue that accelerated level of growth. They are the main drivers for us.

Does that answer your question Richard?

Richard Paige (Numis)

Yeah very comprehensive. Thank you.

Steve Wadey

Okay we have one more question coming in from Sash Tusa. Sash, if you want to ask your question.

Sash Tusa (Agency Partners)

I've just got I think a fairly simple follow on question about the costs of digital transformation. You were very clear that margins for FY 2022 are going to be similar to this year. So is the digital transformation program essentially a one and a half to two year program. And then that costs of let's say £6 million to £10 million a year drops out entirely. Or if this the new normal cost of just staying competitive?

And, tied to that are all the digital transformation costs broadly proportional to the revenues of each division or do they fall more heavily on one than the other?

Steve Wadey

David, it's for you.

David Smith

Yes. So it will be a longer term program and therefore the drag will be longer but there will be other things I think that the balance as we get into fiscal 2023 to 2025. So that that's why I'm not saying that we will be lower than the 12% beyond that. That that program is quite extensive.
There are various work streams to it. We have custom-focused work streams, which are really looking at how we first enable better collaboration with our customers, accelerate the way where for instance developing new software tools, how we handle information, data analytics, test range, operational data, that sort of thing.

Those are going to be available across our divisions. So they're not really division specific to your second question. But they're sort of a common capability we're trying to develop that will be available across our divisions. We also have some other more internal tools for instance to improve resource management, our HR systems, finance systems, ultimately as well. And again those will be across.

So I don't think it's really a particular divisional story here. What we're trying to do is actually increase our ability to provide the best service possible to our customers by digitizing as much of that as we can and then obviously working on our own internal capability as well to streamline what we're doing internally.

**Steve Wadey**

And, David if I might add to your question. So I think one thing I'd really ask everybody to consider when we're talking about investment in digital is don't think of it as a cost. David has described the short-term drag on our margin. But medium to long-term, we're very clear that we're targeting a 12% to 13% margin hence our stable margins. And it's an investment. It's an investment to make our differentiated offerings even more attractive to our customers and accelerate this growth trajectory that we've been talking about. So, David's described the short-term effect on margin. But think of it as an investment that will bring us back to those stable margins and accelerate our overall revenue growth, because we are adding more value to our customers by stepping ahead. So, that's the way I have asked you to think about digital transformation.

Does that answer your questions Sash?

**Sash Tusa (Agency Partners)**

Great. Thank you very much.

**John Haworth**

Steve, I've had one coming from Charlotte on e-mail. Just thinking of the cash inflection point in 2023 as the LTPA capex goes off. How do you think your capital allocation policy might evolve given the continued reshaping of the portfolio an evolving threat landscape? Would you consider a larger acquisition at this point for other forms of shareholder returns?

**Steve Wadey**

Okay, David, you want to first start off talking about capital expenditure and cash inflection in 2023 and capital allocation policy.

**David Smith**

Yeah. I mean this is something that we are continuously considering and we did – we have set our capital allocation policy in terms of priorities and clearly we believe that organic investment in the business and strategic acquisitions still is a very fruitful area for us.

I think there will be other projects that come to, for instance a good example actually is this Australian project we have on the Queensland range that we've been working on. We have
now got a contract to operate that as well as design that. And, we would certainly be very open to considering some investment in that and maybe some other facilities in Australia over time.

So where we can find good investment projects particularly when they're contractual where we're reducing the risk by making sure that we have a good contractual recovery mechanism on that investment, I think those are still things that we're very open to. And, as you asked Charlotte I mean we've done a series – I think we've done seven acquisitions. There's still I think the opportunity to look at further acquisitions over the next two or three years.

One of them – one or two of them may be a bit larger than we're looking at, but we will take those decisions as rigorously as the ones we've taken already looking at strategic fit, our ability to integrate and obviously the financial returns on those strategic acquisitions.

I know that the question of return of capital is sort of comes up from time to time. I personally feel that given the opportunities to continue to invest at a good return on capital in the business that's going to continue to be our priority over the next two or three years. I don't think it's likely that we'll need to look at returning capital but it is clearly an option that we always think about but I believe both organic investment and continued strategic acquisitions will probably be the way that we deploy our balance sheet over the next few years. And, as I pointed out earlier, we have a lot of firepower essentially both with our net cash position which we’ve strengthened now with some disposals as well, but also the ability to make use of our revolving credit facility as well if we wanted to do a larger deal.

**Steve Wadey**

Yeah I mean I think it's a good question Charlotte. And, just to sort of build upon David's comments from a business strategy point of view I think the capital allocation policy underpinning our great strategy works exceptionally well and how we use our balance sheet to accelerate our growth trajectory by looking at both organic and inorganic investments.

So I refer you back to sharing that we've now built our qualified orders pipeline to more than £6 billion over the next five years. That's a very significant scale of opportunity to make sure that we're investing in the right technologies and capabilities that would differentiate us from our competitors and enable us to win those programs. And I've – as I’ve described in previous sessions by thinking through exactly our focused countries and where we might pursue acquisitions that can give us what I call multiple leverage points, not just for inorganic growth but to accelerate those organic growth opportunities is where we will get great returns from our investment. So the overall philosophy really will remain the same and we'll continue to use our balance sheet to accelerate growth.

So, and hopefully you've got the flavour from today's presentation about that renewed scale of ambition and greater clarity of focus around our countries and the organic capabilities that we'll be looking to invest in using that capital allocation policy. Hopefully that answers your question, Charlotte. We can't get a reply because you sent in on e-mail.

Shall we go back to Chris Leonard to see if Chris has now got a stable line and can ask his questions again. Chris, you online?

**Chris Leonard (Credit Suisse)**

Hopefully online and hopefully a better connection. Let me know if it's not good. Just to keep it really brief, I just wanted to hopefully get an expansion, you might have mentioned earlier in the presentation, but on Australia and what is the sort of scope is and the size of this major service provider contract, MSP?
And then second question back to EDP, you keep surprising us. I just wanted to get a flavour of how much growth of that £130 million order book expansion from September, how much is on sort of longer duration contracts if I could? Thanks.

**Steve Wadey**

Okay. David, do you want to start off, maybe on Australia, I'll maybe pick up on EDP?

**David Smith**

Yeah. I mean, Australia we have, for many years, really been more on sort of advisory work for the Australian forces more generally. But we're extremely keen to look at opportunities for more operational work. So the MSP contract has been a good contract for us, but going beyond that into operating ranges or operating facilities on behalf of the Australian company.

So some of the growth that we've seen this year is three things like the Queensland range that I have already mentioned and Australia actually had a really strong first half and I believe we'll continue to grow well in the second half, but we really do see a big opportunity to grow our business on Australia. If you sort of glance at Steve's pie charts on the earlier slide we're pretty ambitious about where we can get to in Australia.

That will probably require a combination of further contract work, organic investment as I've already mentioned and potentially some inorganic investment there as well. But it is a big opportunity for us.

On EDP, I mean – you're absolutely right. I mean it continuously – it continues to provide good news for us both as I've described in terms of orders and revenue growth, but actually also in margin improvement as well. And there's no reason why we can't get to over £100 million of revenue on EDP. In the first half we probably saw we had something like £35 million improvement on EDP revenue. So, that was a big contributor to the revenue growth in EMEA Services. And I would absolutely hope that we can get to a stable position over £100 million.

We're continuing to evolve that. We are working at the moment to expand the supply chain to make sure we are tapping into the really best capability to deliver engineering services into the MOD working with two partners on that as well as working with the MOD on how we can be more effective on using that contract. And as Steve mentioned which is quite an important point I think so I'll just repeat. The flexibility that the MOD now has between the LTPA contract and the EDP contract is very useful to us, because it allows us to apply a flexible range of solutions, contractual solutions to meeting the requirements further there for engineering or for Test and Evaluation services.

**Steve Wadey**

Thank you, David. And in fact on that last point, you sort of – so exactly where I was going to go because Chris, you used the phrase the EDP keeps surprising us.

Well, it hasn't kept surprising me and if you go back to the October announcement and the discussion around EDP in the November call back in 2018, I was asked what EDP meant for the company on the long term. And I said, I see EDP being as strategically important to the company in the long term as the long term partnering agreement contract and said that it could be worth well over a £1 billion to the company over 10 years.

And I think what we've demonstrated in the last two years, that we are well on track to achieve that scale and Dave has just said it could be well over £100 million per annum revenue in the years ahead. And I think we're more than on track for that and we've had
further wins on EDP since the end of the half. So EDP is going exceptionally well in terms of winning orders and contributing revenue and profit to the company.

I think the second thing that I'd like to bring out about EDP is that we're expanding the scope of services. We're moving up the value chain, providing less individual expertise support and moving more of our activities on to longer term provision of services because that's the way that we can integrate that supply chain that David talked about, add more value to our customers by helping them deliver their programs on time and save money.

And, the third thing I'd like to bring out is exactly the point that David reinforced that was in my presentation. EDP and LTPA are very, very complementary and they allow us to provide really rapid access for our customers to a whole range of services from front end experimentation through test and through into training. And those two big contract frameworks really do support the need of the UK MoD at a time where pace and agility are going to be key to respond to the threat and reduce the pressure on their budgets. And therefore these two strategic frameworks in the UK are going to be key to our ongoing growth within the UK.

And my final point links back to your question about Australian building upon all of David's comments both the ability to undertake EDP and LTPA in the way that we are in the UK, we're mindful with this integrated global strategy about how we leverage that approach, that skills, that thinking into our other countries. You've seen that happen to date with the win on the Australian test range and we have other areas under experimentation test and training that we are pursuing in other countries by leveraging the way that we've been able to establish that growth engine on EDP and LTPA. So hopefully that isn't as surprising Chris and it puts us on a really strong position for medium-to-long term growth. Hopefully that answers your questions.

Okay. More than happy, anymore questions if you use raise hand or just come off mute and say your name. Okay.

It looks like we have no further questions. So thank you for time this morning and joining the call. If you do have any follow up questions, please contact the IR team and we'll be more than happy to follow them through for you. Okay, great. Thank you everyone. Bye.