QinetiQ Half Year Results 2022 | London Stock Exchange | November 10, 2022

John Haworth:

Good morning and welcome to QinetiQ's FY '23 Interim Results Presentation. Welcome to those joining both online, but also those that have made it through the tube strike to join us here today in person at the Stock Exchange in London. I'm John Haworth, I'm the Group Director of Investor Relations for QinetiQ. I'm joined by Steve Wadey, our Group CEO and Carol Borg, our Group CFO. Steve and Carol will run through the presentation after which there'll be an opportunity for you to ask questions. Thank you. Steve, over to you.

Steve Wadey:

Great. Thank you John, and good morning and welcome to our Interim Results for FY '23. And as John said, great to see some of you in person today to despite the tube strike.

Six weeks ago, I was privileged to be on board HMS Queen Elizabeth in New York with 400 political, military, and industrial leaders to discuss global challenges focusing on security, trade, macroeconomics, and skills. Within this context, the ongoing conflict in Ukraine continues to reinforce the vital importance of a technologically advanced defense industry. More importantly, this conflict along with the heightened tensions in the Indo-Pacific, has increased the needs of our customers for differentiated solutions that are directly aligned with our strategy. I'm immensely proud of how our people have supported our customers at this time of need and delivered a really strong first half performance across the group.

As a team, we are fulfilling our company purpose and contributing to global and national security. The agenda this morning is as follows: I'll start by giving you the strategic and operational highlights. Carol will provide you with a commentary on our financial results. I'll come back and give you a strategic update of the company, and we will then open up for questions.

So let's start with the headlines. We've delivered strong and consistent operational performance across the group. Orders are up 11%, maintaining a robust backlog of 3 billion pounds. Revenue is up 8%, and profit is up 7% on an organic basis. Cash performance remains strong with 106% conversion up from 89% last year, and returns are healthy with earnings per share up to 11.4 pence, and our interim dividend is maintained at one third of prior year total. We've also made excellent progress, executing our multi domestic strategy. We have delivered strong program performance across all our major contracts. Achieved good order intake across the group at 800 million pounds, responded to the challenging economic environment by increasing investment in our people and capabilities that are critical to the future, and significantly secured a step change in our global growth through two strategic acquisitions in the US and Australia. Looking forward, we start the second half in a very healthy position with more than 95% of our revenue contracted, we are increasing revenue guidance and we'll deliver profit in line with expectations for FY '23. We are focused on proactively responding to the increasing demand for our distinctive offerings, closing the Avantus and Air Affairs acquisitions over the next few weeks, and mobilizing the integration plans which are prepared and ready to execute.

Overall, we are on track to deliver our five year strategic ambition within an addressable market worth more than 20 billion pounds per year. By growing our company to more than 2.3 billion pounds revenue at stable margins, we will deliver even greater returns for our shareholders.

Our strong financial results are underpinned by a number of strategic and significant operational highlights across our six distinctive offerings in each of our three home countries. In the UK, we have seen increased support operations, including delivering the RAFs mass missile firing exercise at our world class test and evaluation range in Scotland, building upon our successful investment in the long term partnering agreement. We've also recently won a 60 million pounds contract with the home office to provide the next two years of the accelerated capability environment known as ACE, to co-create digital solutions for frontline law enforcement through Information Advantage.

Our US sector has performed particularly well and shifted focus onto larger, longer term programs. We've successfully completed the initial production of the CRS-I Robotics Program and are ramping up production to full rate over the coming years. We've also successfully completed trials of our electric drive technology on the Bradley Fighting Vehicle, leveraging our capability from the UK and positioning us for a key role within the US Army's optionally manned fighting vehicle program of record.

In Australia, we continue to deliver strong growth across the business with $77 million of new orders for engineering services through the major service provider contract known as MSP. In addition, we secured a new five year Mind Warfare Center contract to sustain and enhance the Royal Australian Navy's training and mission rehearsal capability, which will leverage our T and E skills in the UK.

Finally, in Germany, our flying operations continue to perform well for our customers, and our target systems business has also seen high demand with 28 million pounds of new orders. So we've had a really excellent first half, and of course, these are just few of many operational highlights across the company where we are delivering high value solutions that are critical for our customers contributing to global and national security. I'll now hand over to Carol for an overview of our financial performance.

Carol Borg:

Thanks, Alice. Thank you, Steve, and good morning everyone. In this section of the presentation, I will provide more detail on our financial performance in the first half of FY '23. Like Steve, I have been extremely pleased with our performance. We've delivered strong and consistent operational performance in the first half, continuing to deliver good revenue growth at stable operating margins, consistent with our short term guidance. Today, we are increasing our revenue guidance and reaffirmed that we are on track to deliver profit in line with current expectations for FY '23.

So firstly, our key financial highlights. In the first half, we have delivered good order intake at 798.8 million pounds, growing 18% on a reported basis, demonstrating high demand for our distinctive offerings. Strong revenue at 673. 4 million pounds, growing 12% on a reported basis, delivered through good program execution across all our major contracts. Good underlying operating profit at 74.1 million pounds, growing 39% on a reported basis, which at 11% margin is within our short term guidance range.

Strong cash performance with underlying net cash flow from operations at 106.8 million. This results in a cash conversion rate of 106% due to good underlying cash performance, and continued focus, and discipline on working capital management. Underlying basic earnings per share of 11.4 pence, increasing by 41%. Overall, good underlying performance in the first half of FY '23 at a group level, with all metrics showing an increase over the same period last year, which as you know was impacted by a 14.5m pound profit write down.

Orders. We have good order growth securing 798.8 million pounds in the first half, growing 18%, 11% on an organic consistent currency basis, excluding the impact of the write down last year. As Steve has and will further elaborate. This includes 193 million pounds of engineering delivery partner EDP framework orders in the UK, orders totaling 77 million Australian dollars through the major service provider MSP contract in Australia, and orders totaling $173 million US dollars in the US.

It is pleasing to see our continued success in winning new business with our distinctive offerings as I'm illustrating on the charts on the right hand side. The upper bar chart illustrates the realization of the previously stated strategy of moving towards larger, longer term contracts. In the first half of FY '23, 45% of our orders were greater than 5 million pounds in contract value, an increase from 29% in the same period two years ago.

The lower bar chart shows the order backlog. Despite the naturally reducing impact of the long-term partnering agreement, it is a significant achievement to maintain order backlog at 3 billion pounds as at the 30th of September, which has been driven from good order growth across all three of our home countries.

Onto revenue, we've delivered strong revenue at 673.4 million pounds, growing 12%, 8% on an organic consistent currency basis, excluding the impact of the write down last year. This has been driven by 7% organic growth in EMEA services primarily due to ongoing EDP growth and work delivered under the MSP contract in Australia. Global products grew by 14% organically, excluding the impact of the write down last year due to good growth in both the US and our target systems business QTS, the investment we have made in recent years into our business winning capabilities across our three home countries is delivering results, driving this impressive level of continued revenue growth across the group.

We start the second half of FY '23 with 95% of our in year updated revenue guidance under contract compared to 90% at the same time last year. This reflects strong performance and delivery on our key framework contracts, and provides a greater level of confidence in delivery of our FY '23 results.

We have delivered good underlying operating profit at 74.1 million pounds, which is 11% operating profit margin within our 11 to 12% short term guidance range. This represents an increase of 39%, 7% on an organic consistent currency basis, excluding the impact of the write down last year.

Here I would like to provide some additional detail on two specific topics, foreign exchange rate movements, and our strategic operating investments. Firstly, the impact of foreign exchange rate movements on operating profit has been minimal in the first half of the year. Should foreign exchange rates remain static, we expect the full year benefit for FY '23 to be in the region of 2- 3 million pounds. Secondly, and more importantly, our strategic operating investments. As we have previously communicated, we are continuing to invest in our people and capabilities in the order of a hundred basis points of our margin to enable our step change to deliver our five year growth ambitions.

The chart on the right hand side illustrates the impact that our strategic operating investments have on our short-term margin. Fundamentally, our long-term ambition remains to grow revenue to more than 2.3 billion pounds by FY '27 with operating profit margin of 12 to 13%. Today, we announce an additional investment of 5 million pounds in response to the cost of living pressure, predominantly to support our lower paid employees, bringing our total committed strategic operating investments in FY '23 to approximately 20 million pounds. This additional investment has the effect of marginally shifting our investment period to the right, but represents no change to our short term or long term absolute profit guidance. Whilst investment brings short term pressure on margins, investing in our innovation platform, comprising of our people, technology, and digital transformation will ultimately increase competitiveness and drive efficiency in the long term. Steve will provide further detail on our strategic operating investments later in the presentation.

Therefore, whilst we are investing in the short term, our operating profit margin for FY '23 will remain at the lower end of our 11 to 12% short term guidance range. We remain confident in our ability to improve margins to deliver sustainable operating profit of 12 to 13% in the mid to long term.

Now turning onto the segmentation split of the group performance. Firstly, here we have EMEA Services. EMEA Services has delivered significant year on year growth driven by investment and successful implementation of our strategy to win larger, longer term contracts, giving greater visibility and margin stability. We've increased orders by 19% and revenue by 7%. A notable example is the LTPA contract uplift demonstrating our ability to partially mitigate inflationary pressures in our large contracts. Operating profit has declined by 8% organically driven by both a strong prior year comparator period and the short term strategic operating investment in our people and capabilities to support our growth, as I've just described.

Operating profit margins remain strong at 11.7%, consistent with the second half of FY '22. With a book to bill ratio of 1.4 times excluding the LTPA, we have maintained a substantial order backlog, which gives us good forward revenue visibility.

Next onto Global Products. Global Products has had a number of notable achievements in the first half. In the US, we won orders totaling $173 million US dollars, and have won two large multi-year framework orders, and have delivered strong performance in QTS.

We have increased orders by 16% and revenue by 34%, largely driven by good US performance with operating profit margin at 8.5%. We have modified our order recognition criteria to align with industry best practice. This results in a one off catch up in the US of 48 million pounds for orders under recognized in the past and is aligned with our strong revenue performance in the US. In the US, orders, revenue and profit in the first half of FY '23 are above the second half of FY '22, both before and after the order recognition policy change. Demonstrating greater stability, resilience, and consistent performance, giving us confidence of a strong foundation for future growth, both organically, and inorganically with the upcoming integration of Avantus. Global Products, whilst on a shorter order cycle than a EMEA Services has a book to bill ratio of 1.3 times and a growing order backlog, which again gives us good forward revenue visibility.

We've continued to deliver strong cash generation in the first half. Underlying net cash flow from operations is at 106.8 million pounds, which equates to a cash conversion ratio of 106% up from 89% in the same period last year. This strong cash conversion is a result of our good underlying cash performance, and continued focus, and discipline on working capital management. As you can see on the chart, with a net improvement in working capital in the period, we've invested 49 million pounds in capital expenditure, predominantly driven by the ongoing LTPA commitments, which peak in FY '23 and '24.

Carol Borg:

We retain a strong balance sheet to support investment in our long-term growth strategy. After paying tax of 18 million pounds and dividend of 29 million pounds, we delivered a net cash position of 264 million pounds as at the 30th of September 2022.

We maintain a rigorous approach to the deployment of our capital, scrutinizing all opportunities in the same manner to ensure returns to our shareholders appropriately reflect the risks. We have a clear and concise capital allocation policy that we continue to deploy for the benefit of all our stakeholder groups, our shareholders, our employees and our customers.

As mentioned previously, we invest in our capabilities organically, which are continuing to deliver good revenue growth at stable operating margins. Inorganically, we have committed to two acquisitions, both of which are expected to complete by the end of the calendar year. We continue to maintain our balance sheet strength, evidenced by our strong and consistent cash performance and the disposal of our Space N.V. business in Belgium.

Following the completion of the two acquisitions, we will move into a modest net debt position representing leverage of circa 1.3 times as previously guided, working to deleverage to less than one time following the first full year of Avantus integration. We have continued to execute our disciplined treasury risk policy, which has resulted in a significant benefit from the FX and interest rate hedges that have been put in place as a result of the Avantus acquisition, as you can also see on this slide. We have announced an interim dividend of 2.4 pence per share and have made dividend payments of 29 million pounds during the first half of FY23.

The following slide shows the other technical factors for FY23. Effective tax rate reduces and all other factors are consistent with our prior guidance. Our net finance expense is forecast to increase with the drawdown of the new debt to fund the acquisition of Avantus in December. Effective tax rate and cash tax is expected to reduce due to the Single Source Regulations Office determination on the research and development expenditure credit. Yeah, expenditure credit. Say that loud. Sorry. The effective tax rate will reduce to circa 11.5% organically, and then increase with the effect of the Avantus acquisition.

Networking capital is expected to realize a modest cash outflow as a result of our growth ambition. Capital expenditure is expected to increase modestly to within the 90 to 120 million pound range as we continue to invest in our customer-facing propositions, our employee value proposition and our business infrastructure. Whilst the expectations we set out at the time of Avantus and Air Affairs announcements remain unchanged, we will update for the combined effect of the acquisitions following completion.

And finally, our outlook statement. We enter the second half of FY23 with confidence, a healthy order book and positive momentum, with 95% revenue under contract. We are increasing our revenue guidance and are on track to deliver profit in line with expectations for FY23. Given our strong growth in the first half, we will deliver high single-digit percentage organic revenue growth with underlying profit margin at the lower end of our 11 to 12% short-term expected range due to the increased investment in our people and capabilities to enable growth, as I explained earlier.

In the longer term, our ambition remains to grow revenues to more than 2.3 billion pounds by FY27. With our recently announced acquisition, this means that we are targeting mid to high single- digit percentage compound revenue growth over the next five years with further strategic acquisitions enhancing this growth. We are targeting an operating profit margin of 12 to 13% in the mid to long term. Return on capital employed is forecast to remain strong at the upper end of 15 to 20%. And with that, I will now hand back to Steve.

Steve Wadey:

Great. Thank you Carol for that update. So move on to the strategic update.

QinetiQ is a purpose-driven company which is protecting lives and securing the vital interests of our customers. Our purpose drives our strategy to build an integrated global defense and security company operating in attractive markets with distinctive offerings to deliver growing returns for our shareholders. To ensure that our growth is sustainable, we've adopted this simple framework as part of our environmental, social and governance responsibility to guide the execution of our strategy and ensure balance across our primary stakeholders.

Our customers mission is to respond to the rapidly changing threat environment as we are seeing day by day in Ukraine, whilst not forgetting the rising tensions with China. Our strategy is to co-create and deliver cost- effective solutions that enable our customers success.

Our people are at the heart of delivering our strategy and are passionate about our customers, whilst also experiencing significant cost of living pressures. Our strategy is to invest in our skills and capabilities so that we retain, attract and reward the best talent to create a safe and secure environment for all of our people to thrive and deliver innovative solutions for our customers with greater agility and pace.

Our purpose and strategy have never been more relevant and have provided a clear focus for our business decisions, such as the US and Australian acquisitions, and our investment choices, including our response to the cost of living pressures. By focusing on our customers mission and investing in our thriving people, we will deliver sustainable growth and enhanced shareholder return.

The global security situation continues to worsen and tensions remain high. Threats in Europe and the Indo-Pacific are driving budget prioritization and defense modernization. Although the global economic outlook is challenging, global defense budgets are increasing as NATO countries seek to strengthen their capabilities. Our major focus is on our three home countries. The UK remains committed to 6.6 billion pounds of investment in research and development over the next four years. The US is seeking a 16% increase in its research, development, test and evaluation budget to $130 billion. And the new Australian government has recommitted to nearly doubling their defense budget to $74 billion by the end of the decade.

These three countries have a shared defense and security mission and recently formed a new trilateral partnership known as AUKUS. Their objective is to work together on a range of advanced capabilities and technologies critical to the future warfare, such as advanced cyber and directed energy weapons. These areas align well with our strengths and provide attractive opportunities for long-term growth.

The chart on the right shows our total addressable market, worth more than 20 billion pounds per year, and our current market share. We are growing our share through execution of our multi-domestic strategy with targeted organic and inorganic investment decisions to build solutions that meet high-priority customer needs. These favorable market conditions are increasingly in demand for our high-value solutions and strengthening confidence in our growth strategy.

We are making good progress in building our integrated global defense and security company. Our customer focus and upskilled business winning capability continues to enable us to be competitive and win larger, longer-term programs. Working in partnership with our customers and suppliers, we continue to grow our position on major contracts, such as EDP in the UK and MSP in Australia, as well as achieving significant awards in the US. Momentum continues to build with 800 million pounds of new orders, up 18% from last year.

In response to the conflict in Ukraine, we have seen increased activity across many of our countries to support operations. We've responded to our customers evolving needs as a top priority whilst maintaining consistent delivery across all major programs. As a result, we've achieved strong year-on-year revenue growth across the group with the UK up 6%, the US up 19%, and Australia up 16%.

I am particularly pleased with the excellent progress in the US where we are seeing a return on the investment in our new leadership team. We are delivering programs that are relevant to our customers future mission, such as high- altitude flight testing of our next generation hyperspectral sensor and production of email subsystems for the latest US aircraft carrier.

In addition, we have refreshed our US strategy and expanded our pipeline to focus on larger programs to drive organic growth, such as the US Army Robotic Combat Vehicle Program, known as RCV-Light. By both strengthening our existing business and acquiring Avantus, we are creating a platform for growth and are on track to more than double our US sector. Across our global company, we are delivering consistent operational performance.

Underpinning this strong operational performance, we continue to focus on partnering with our customers to deliver mission-led innovation through the six distinctive offerings shown on this slide. As part of our multi-domestic strategy, we optimize these capabilities internally by leveraging our skills, technology and engineering solutions across the company so that we can maximize opportunities externally through single routes to market. Applying this business model, we create operational advantage for our customers mission and enable growth.

Let me give you a current example from the test and evaluation distinctive offering shown by the picture in the center of this slide. In our target systems business, we are world leaders in threat representation. We are currently leveraging these skills and technology into the US market, winning a $10 million contract to deliver enhanced supersonic target with onboard laser-sensing technology. This innovative capability will enable US customers to test and evaluate the next generation of laser-directed energy weapons against supersonic missile threats. This is a really great example of us co-creating high-value solutions that are increasingly relevant to national defense and security challenges and driving growth.

To stay ahead for our customers advantage, we are investing in our people, technology and digital transformation. As Carol mentioned, we have increased our investment to approximately 20 million pounds this year to enable a step change and deliver our five-year growth ambition. Ensuring we are internationally competitive to retain, attract and reward the best people across the whole company is critical to our performance and growth.

In response to ongoing cost of living pressures, we have committed a further 5 million pounds into our reward offering focused on supporting those on lower pay. We've also built a highly capable leadership team in the US consistent with our long-term ambition, and are expanding the skills of our Australian business through our T&E Sovereign Skills Program, leveraging our UK experience.

To deliver operational advantage for our customers, we must remain at the cutting edge of technology and create innovative solutions at pace. Project Vampire is an excellent example of partnering with the Royal Navy to develop their future maritime aviation force through rapid prototyping, the novel application of uncrewed systems, and offers the potential to experiment with new technologies from our internal research and development program, such as swarming and teaming.

As we scale the company globally, our digital transformation program is building a secure interoperable digital workspace with modern systems and tools to adapt new ways of working and harness the diversity and creativity of our global teams and supply chain. We're also establishing new digital design and assurance techniques to ensure our competitive advantage by reducing the time and cost of major customer projects, such as OMFV in the US and the LTPA in the UK. By strategically investing in this innovation platform in the short term, we will increase our competitiveness and efficiency, ensuring our growth is sustainable in the long term at 12 to 13% margins. Our strategic business plan is guiding these business decisions and strategic investment choices as we create a global leader in mission-led innovation. We are driving organic growth through our distinctive offerings by building local capability, such as our new $7 million technology center in Australia, and collaborating across countries through our global campaigns, such as robotics and autonomous systems. The breadth of our current offerings in our home countries is shown on this slide in blue.

To complement our organic growth, the two strategic acquisitions in the US and Australia strengthen these capabilities, extend our customer base and build scale. The capability acquired in the US with Avantus, shown in green, will enable our long-term growth in the largest defense and intelligence market in the world. The business is rapidly growing and is at the heart of the customers mission in cyber, data analytics and software development solutions. The customer relationships, contract vehicles and capabilities are complementary to our existing US sector and create a strong platform to drive further growth.

Avantus has a very similar capability and risk profile to our successful UK intelligence sector and is therefore low operational risk to the group. Integration is fully prepared and ready to execute, and we're on track with regulatory approvals to close the transaction before the end of December.

Similarly, the acquisition of Air Affairs in Australia, shown in orange, will accelerate our growth in test and evaluation and airborne training services. The deal strengthens our long-term strategic partnership with the Australian Defense Force and underpins our market leading position in threat representation. Integration is also prepared and we expect to complete the transaction by the end of November.

By coherently growing an integrated global company relevant to the dynamics of the new world, we are making significant progress to realize our five-year strategic ambition. So let's step back and look at the progress in delivering our five-year plan.

Over the last six years, we have built a company delivering strong operational performance as shown from the first graphic on the left to the second, growing revenue by 75% to 1.3 billion pounds and growing operating profit at 6% per year. By focusing on our customers' needs, we are driving profitable, organic growth and building strong momentum with increased forward visibility. Our order book has doubled to 3 billion pounds and our forward orders pipeline has nearly tripled to 7 billion pounds.

In May, I explained that we are at an exciting stage in the development of the company with world events reinforcing the short and long-term needs of our customers for our distinctive offerings. And as a result, we increased our five-year ambition to grow to more than 2.3 billion pounds of revenue at stable margins as shown by the fourth graphic. The third graphic shows the FY22 proforma revenue for the combination of QinetiQ with Avantus and Air Affairs. As you can see, group revenue grows by 25% to £1.6 billion with US revenue more than doubling to approximately 25% of the group and Australian revenue increasing by 40% to nearly 10% of the group.

Both acquisitions achieve a major step change in delivering our long term strategy. By making disciplined investment choices in both organic opportunities and strategic acquisitions, we are creating a powerful and differentiated company delivering mission advantage for our customers globally and compelling returns for our shareholders as we drive further profitable growth. We're on track to deliver our five year strategic ambition.

So in summary, I'm extremely proud of how our people have supported our customers and delivered a really strong first half performance across the group. We achieved 11% orders growth, 8% revenue growth, and 7% profit growth on an organic basis. And maintained good revenue visibility with a healthy order book of £3 billion.

We've also continued to execute our multi domestic strategy with focus and discipline. Whilst we've maintained strong operational performance, we've responded to the challenging economic environment by increasing our investment in our people and capabilities that are critical to the future. And achieved a major step change in our global growth by securing the Avantus and Air Affairs deals in the US and Australia.

Our purpose and strategy have never been more relevant. With increasing demand for our distinctive offerings driven by the threat environment and an addressable market worth more than £20 billion per year, we are on track to deliver our five year strategic ambition to grow to more than £2.3 billion of revenue at stable margins. By growing our global company, we are directly contributing to global and national security and will deliver sustainable growth with enhanced returns for shareholders.

Thank you. And Carol and I will be happy to take any questions.

John Haworth:

Great, thank you, Steve and Carol. We'll take questions here in the room first, followed by those online. For those of you joining online, you'll need to use the phone line provided. And the spotlight platform has now been updated to reflect that phone line. So you'll need to refresh your browser and you'll see the phone line so you can dial in for your question. And when you call in or in the room, please do introduce yourself by name and by company. Thank you. We'll start in the room here first.

Great. Microphones please. Have we got any microphones please? Thank you.

Richard Page:

Morning, Richard Page from Numis. I think it's going to be three from me unfortunately to be regular on that number. First of all, just on these long term contracts, obviously the main one, LTPA. Can you just remind us your ability, or on the broader, longer term contracts, your ability to call back inflationary pressures and over what timeframe? And whilst we're on those, just a reminder, when the LTPA becomes cash positive? I'm assuming it's FY25. Just to check on that point.

Secondly, just on QTS recovery, looks like it's come through very strongly in the first half, continuing momentum from the second half. Where are we relative to pre-Covid positioning on that one and performance?

And then third, a more general broader question around how agreements such as Aukus are really helping you transfer technology and operate as a business across the three territories and how that's aiding growth please?

Steve Wadey:

Great, thank you, Rich, three good questions.

What I suggest Carol is, I'll take the second and the third. And then if you could take inflationary pressures and cash positive on the LTPA.

Carol Borg:

Sure.

Steve Wadey:

So first of all on QTS. You are right and I'm very, very pleased with the performance. You will have heard I mentioned £28 million of new orders in QTS. And I think it really does demonstrate the relevance of our targets business, whether that's the current range of targets or the investment that we're putting into the next generation.

In terms of volumes and levels. We are through Covid, I think we said that at the full year. So we're seeing new levels of demand on orders and seeing good revenue contribution from the business. So a very positive performance, full recovery of Covid. And now I think we see further and growing demand going forward. So I think you'll see even more contribution from QTS in the years to come.

If I take the third question. Aukus is an interesting question. As you'll know, Rich, when we set out our strategy in 2016, our strategy was focused on three home countries, UK, US, and Australia. And the reason for that back then was this view that those three countries had shared security and defense mission in the world. And they were already collaborating as countries on intelligence, security, partnerships on programs reinforced by at that time the five eyes community. So I think our strategy was sound back in 2016 on three countries that would long term always work together.

So as you know, the partnership was formed or created and announced 12 months ago, and it went through a modernization or an upgrade in beginning of this year where it basically is now focused on two major capability areas. The first and foremost that it was launched around was the need for the Australian nuclear submarine program. And the second is more around advanced capabilities and technologies.

I would say that at this particular point, direct opportunity from that customer alignment, we're at very, very early stages. But of course there are some really great examples where the alignment between those countries has already given us benefit and just shows that we're on the right trajectory going forward. I mentioned six months ago an example of our laser directed energy program. You've probably seen yesterday there was an awful lot in the press about Dragonfire. This is our UK laser directed energy weapon that we're doing in partnership with industry and the UK customer. It's achieved first trials in the UK. And that core technology, we've been working in partnership with our Australian team and customer, leveraging into a new program in Australia. And we'll hear more about that in the coming months.

So I think there are some real practical examples where the alignment between those customers is building opportunities because we're focused on the right customers and we're focused on the right areas of priority for them. But I think it's a runway that's got a long way of support for us.

So that's the last two questions, if you want to pick up on LTPA, Carol.

Carol Borg:

Yeah, I can take the inflation question. Thanks, Rich.

So as you know, QinetiQ is largely a people based business, so it's wage inflation really that is the thing that's on my mind. And we have continued to invest as a result of today with the additional announcement of the 5 million to address the cost of living. The LTPA contract specifically has an ability to vary the price as we could see in the order recognition numbers this half, of additional £26 million. And I think as a whole, given our diversified contracting portfolio, we're about 50% covered in terms of either ability to change price through variation of price or pass on through to the customer. So, that hasn't changed.

Another good example is in the EDP contract if you like, which is a framework agreement which is based on pricing at the time of when we actually contract the works.

So all in all, I think we are in maybe a slightly advantageous position where we can have a little bit of protection through our contracting structures. Having said that, our investment that we have announced previously and we continue to announce today, we are expecting that to deliver two other things, to drive competitiveness and to also drive efficiency where we will also recover that.

So my view in terms of our inflationary effect, Rich, is that this is a timing effect onto our margins, which is why we're maintaining within the 11% to 12% in the short term.

Richard Page:

Just the cash positive LTPA FY25 because obviously the CapEx in the flow back from that.

Carol Borg:

The peak of the CapEx is in FY24. So I'd imagine it is becoming ... That's about the period of time where we generate the ... because it really tails off post that.

Richard Page:

Thank you.

David Farrell:

Hi, David Farrell from Jeffries. I'll reduce it to two questions.

First question on Avantus. Can you explain in a bit more detail what you're doing ahead of time to facilitate the integration? And then once Avantus is in, what is being put in place to ensure that you retain the personnel that are required there?

And then my second question, I see within EMEA services you've reorganized some of the subdivisions. Assuming UK intelligence is the same as cyber and information, that only grew at 4% year on year, it seems slightly underwhelming. So maybe a bit of explanation there. The offset to that being that international grew at double digits. You maybe can explain why that's growing so strongly. Thanks.

Steve Wadey:

Great, thank you, David. I'll take the first one, Avantus. And then Carol if you can bring up the point between the sector year on year growth.

So we've used the time wisely since the acquisition back at the beginning of August, and as I said, integration is prepared and ready to execute. There are probably a couple of points that I would share about philosophy first of all, which I think are really positive about the relationship that we've built with the Avantus team. And bear in mind that Avantus itself has completed a number of acquisitions in its history.

First of all, an overall principle we've adopted as a combined team is we're seeking the best, we're seeking the best in terms of talent, we're seeking the best in terms of processes and we're seeking the best in terms of capabilities. So we've jointly sat down and looked at our people, our processes and our capabilities and designed a way of integrating that takes the best of breed if you like from each area. We've also through joint dialogue been very thoughtful in the preparation of the integration plan in terms of the pacing and timing to make sure that we don't push change too quick, but it actually is aligned with what our customers and employees need. I'll come back to customers and employees.

And we've also been very focused in planning in terms of accountability and clarity. So we have a clear plan that is laid out for the first hundred days and the first 12 months to complete full execution. And we have accountable leaders and a clear plan that we will be able to manage, review, and enable for success.

That plan itself covers organization, it covers processes. So that's all fully prepared. But the overarching principles of where the benefits will come from are really about focusing on customers, making sure that we really look for delivering continuity for our customer deliveries, both Avantus's current customers and our current customers.

But then specifically looking at opportunities that we can add value on. And we've done some early work on that, but really that will kick off in earnest once we close.

And then in terms of your point about employees, and I think this is a really important point, I go back to my philosophy issue around being thoughtful. Avantus, like us, is a people based business. So making sure that they understand the focus on our customer's mission, the focus on them, it's really important. So the communication and engagement, which is all prepared and ready to go for close, will reinforce that. We're retaining all of their benefits. There's no change to benefits.

And in fact, when I talk about best of breed, there are some practices inside of Avantus in terms of their resourcing strategy, their talent management, it's called integrated talent management, which actually we are going to reuse as a best of breed item and bring into aspects of QinetiQ.

So overall, I really feel that we and the Avantus leadership team have had a real shared philosophy in how you go about integration. We've also been able to bring our experience and learning of the seven acquisitions that we've done. And we have a very thoughtful and structured integration plan, which as I said in the presentation, is ready to execute as soon as we get through to close.

And if I could just take your question as an opportunity. There are three regulatory approvals that we needed to achieve for closure. The first one of those was the Hart-Scott-Rodino clearance. We've achieved that one. So, that is done. The second one was around technology control, that's the ITAR clearance. That is done. And we've been fully engaged with the CFIUS process, which is the last one. And all of the direction from that is positive. And we expect to clear that CFIUS and then announce the completion of the transaction before the end of December. So we're well on track and everything is pointing in the right direction for closure. And then we get on with integration and execute, add value to customers and employees. That's where we are on Avantus.

David Farrell:

Perfect. Thank you.

Carol Borg:

So maybe in terms of segmentation, David. You're right, we have reorganized internally and the UK business is now demonstrating UK defense and UK intelligence. UK intelligence is a little more than the old C&I, but fundamentally it's the C&I business. And EMEA services in the half has grown revenue by 7% and has delivered margins consistent with the second half of last year.

Which when you think about the population, our people based population, about 80% of our individuals, our employees, are in the EMEA services business. So that therefore gets the lion's share of the investment when we're talking about investment in our people and our capabilities.

So I think still very strong EMEA growth in the half. I think what's also, and maybe just a slight extension to your question, global products, 14% organically is really demonstrating, and I think I said this time last year, that we would see double digit growth in global products demonstrating the recovery as well.

So I hope that answers your question in terms of the EMEA services classification.

David Farrell:

Yep. Great. Thanks.

Carol Borg:

Thanks, David.

Sam Burgess:

Morning guys. Thanks very much. Sam Burgess from Citi.

So obviously post-Ukraine and with tensions mounting in the Indo-Pacific, there is an increasing focus on gray zone conflict and sub-threshold competition. In terms of your cyber and information business, do you think there are opportunities to sell outside of the defense community and outside of defense markets into civil markets? I know recently the MOD and GCHQ have emphasized the need to take a whole society, whole nation approach to cybersecurity. And I just wondered if there are opportunities there and sort of confining to purely defense markets might be a sort of more blanket approach.

Steve Wadey:

I think you're absolutely right. I think Ukraine, there's what we see on the TV and then there's what we don't see on the TVs, and the cyber world is very active. And as you'll know from our performance in the last four or five years, our cyber and information business we were just talking about has actually grown exceptionally well. And actually it's achieved some very strategic wins during the last half that we can't talk about.

But you are absolutely right to reinforce that Ukraine and tensions in Indo-Pacific reinforce that cyber related capability are critical to future warfare. And when you look at our six distinctive offerings that we've really focused building the strategy around, yeah, one of those is all around cyber and information advantage. And that strategic focus on those six and that item led us to the strategic decision around Avantus. It's a really significant cyber solution company.

In terms of your question about going beyond the defense and security, or in the US the defense and intelligence market, I'm sure there are opportunities, but my answer at this particular point would be to maintain our focus and our discipline. We're a defense and security company. I think that discipline that we have brought in over the last five or six years is why we're seeing the strong performance, the consistent performance of the company. And when I look at how the market is evolving, particularly in the Aukus countries, the magnitude of opportunity for us to grow by the way that we work and those six areas of capabilities, our runway is very, very significant.

So I'm sure you're right that there are opportunities and sometimes, from time to time, where it's a relevant adjacency and it's a sensible thing to do and we can execute it well, we will go there, and we have gone there. But I think our core is our defense and intelligence or defense and security markets in those three countries. But I do expect you'll see continued rapid growth in this particular offering that you are highlighting.

Sam Burgess:

Great. Thank you very much.

Annabel Hewson:

Hi there. It's Annabel from Stifel. I think two questions is the going average, so I'll go with that please. First one-

Steve Wadey:

Have as many as you like, Annabel.

Annabel Hewson:

10 questions. No, firstly just on the US, and thank you again for the detail you've given us, again reminding us of the management change and how you've restructured there, and obviously the deal to follow. But could you give us a bit of colour around the market at the moment, budgetary pressures, how conversations with customers are going around sort of timeliness? The second, another home market we don't talk about very much is Germany. We've talked about improvement in flying hours there, but any sort of more thoughts on that space? Is there any more to do there or could we actually see perhaps a scaling back on that side?

Steve Wadey:

Yeah, first of all, the US market, whilst defense and security is a positive market to be in at this particular time for reasons that we all know, every market will continue to have its day to day. So pressures and tensions in the US as we know is now in a continuing resolution. We went through that experience last year, we learnt from that. We're prepared, we're engaged, we know how to navigate through that based on the experience. The things that I would really draw out that are different, and you alluded it to it in your question, is the significant change of our new US leadership. We have a large experience team with very strong customer intimacy that are leading the team well, are engaging the customer well. And you will have seen in the half we've announced two significant, Carol listed them specifically, two significant new awards. You based on that intimacy and that customer focus and then bringing forward the capabilities that we've got, particularly around intelligence, surveillance and reconnaissance.

So yeah, it's a tough market but it's a large market, and therefore our strategy is to have great leaders, great people, great capability so that we can then discriminate from our competition and grow. And the performance in the US in the first six months, as you can see, is really, really strong. In terms of Germany, I agree we don't talk about it a lot. It's really because if you look at the way that the focus has changed the dynamics of the company, I think we are 92%, 93% of our revenue now is focused in those three countries. So if you just look at it on real estate, we don't have a lot of time to talk about it.

But the German business is going well. It renewed its slow speed aerial training services contract. I was there maybe four weeks ago. We're seeing a number of training services, opportunities in Europe, strength by the fact that we've strengthened our capabilities. If you look in social media, you'll see we've referred to here several times the investment that we've been putting into new aircraft. And you can go on social media, you can see that the new DA62s that arrived four, six weeks ago were immediately revenue earning the day after they were delivered. So the team there is focused on its customers, it's performing. And its own scale, it's doing well.

Speaker 2:

Thank you.

John Haworth:

Great, thank you. So I know we've got a few questions queued up on the phone line, so we'll move on to the phone line if that's okay. So just as a reminder for those on the phone, if do refresh your browser and you'll see the phone line provided to dial in to ask your question. So I'll pass over to Christophe, our operator for questions from the phone line please.

Speaker 3:

Thank you. We're going to now begin questions from the phone lines. To ask a question on the phone line, please signal by pressing star one on your telephone keypad. We will pause for a moment to assemble the queue. We will take our first question from Charlotte Keyworth from Barclays. Charlotte, please go ahead.

Charlotte Keyworth:

Morning everyone, thanks for taking my questions. I've just got two actually. One relates to the strategic investments on the margin. Just for clarity, this additional 5 million on cost of living, is this going to be a one off payment to staff or is this something that becomes embedded in your ongoing cost structure? That's the first question.

Related to that, I think one of the other packets of the investment is technology. Perhaps you could just help us understand how these operational efficiencies are related in terms of driving margin improvements. And then my final question and actually is just on top line growth. With the raise guidance today, pre acquisitions quite comfortably at 1.4 billion. I overlay that then with Avantus and Air Affairs, you are comfortably quite somewhere beyond that. Are you going to achieve that 2027 target for 2.3 being early?

Steve Wadey:

The line was very bad. I couldn't quite hear the last question, Charlotte. Do you want to pick up, do want to pick up the first one around, particularly around the cost of living and then I'll go into the broader strategic in investments and talk about ambition?

Carol Borg:

Sure. Yeah, Charlotte. So with regards to the additional investment that we're announcing today, the 5 million is as a result of our response to the cost of living pressures. And we've elected to do that in terms of a salary review of our lower paid employees. So it does have enduring capabilities. However, having said that, we do expect that we will recover that, to your question about recovery of margin, through three areas: through driving increased competitiveness, driving efficiencies, which was your part B of that first question, and also through our contracting model that allows some pass through of those areas. So I think the way I would phrase it is think of the strategic investments as a timing issue, which has a delay lag in terms of recovery of that, which is why we still feel confident that we'll get back to the 12 to 13% with by FY 27.

Steve Wadey:

Okay. And if I take the back end of that into your wider question, so if we step back and look at the strategic investments, and you refer to technology, Charlotte, the investments are in three areas: people, technology and our digital transformation. And the combination of all of those allows us to go after higher value areas of work. So there's an opportunity to go for higher margin work, but also will, as Carol and I both referred to in the presentation, it will allow us to increase our competitiveness and our efficiency. So you'll have an effect of the investment itself beginning to taper off. You'll have an effect of securing relative higher margin work because we're going for higher value market segments. And then you will have inherent efficiency. So as we said a couple of years ago when we launched this yield, our performance improvement to the long term, 12 to 13% margin. So happy for you to come back on that, but the combination of our two answers sort of gets you to the long term ambition at 12 to 13%.

Now, in terms of the timing of that ambition, and it's a great question, I just make a couple of comments at this stage. First of all, we don't own, as of today, either Avantus and Air Affairs. So the first step, in answer to your question, is that we do need to close both of them. And as I said, confidence is high and a few steps to complete to get through that. But in the near term, our focus is all going to be on integration and execution. We're prepared, we're ready to go, but we need to deliver that execution and ensure that we honor our commitments to customers, employees, and shareholders. You're absolutely right that that might yield enhanced timing of achieving that target, but now isn't the time to talk about when that will be or whether the target should change. For us, now the time is to close, integrate and execute. That's our focus at this point, Charlotte.

So hopefully that picks up on each of your three questions, but more than happy for you to come back and seek any clarifications.

Charlotte Keyworth:

That's fine. Thank you.

Steve Wadey:

Okay, thank you.

Speaker 3:

Thank you. The next question is coming from Sash Tusha from Agency Partners. Sash, please go ahead.

Sash Tusha:

Thank you very much. Good morning. I've just got one simple question about Avantus, which is do you plan for there to be any integration costs in the current year or is it possible Avantus, assuming that you do complete it at the end of December, might actually make a positive contribution for the current financial year? And then a slightly longer question, but it's more comprehensive question. I just tend to understand the R&D tax credits issue, and I wondered whether you could explain it for one more time why the tax goes down on a single source contract, or I may have completely misunderstood it. Thank you.

Steve Wadey:

Do you do the R&D?

Carol Borg:

Yeah, so Sash, I can take the R&D tax credit. This is basically an accelerated tax credit that you get when you invest in research and development. And just by sheer nature of the work that QinetiQ does, we are eligible for that tax credit. So that has the effect of driving down our effective tax rate. When you apply the normal core UK, predominantly in the UK, R&D tax credits or innovation credits from in my part of the world, in Australia, exist in a lot of different tax jurisdictions.

So it's not necessarily that we've got R&D on sole source contracts, it's the fact that we do do R&D. It enables us to get an accelerated tax deduction for the works that we do. And the reason why I reference the SSRO or the Single Source Regulation Authority Office, is that they announced a determination that any R&D credits that QinetiQ gets, we don't have to pass that on to the customer. So that's why we have a short term impact of a reduction in our effective tax rate. I think if you are modeling, Sash, on an organic basis, we had previously guided 15 to 16% ETR. We think that that's 11 and a half percent in the short term, but that'll get back up when the UK changes its corporate tax rate from FY 24.

So happy to take further questions, and John can speak to you offline for more detail on modeling, but that's effectively the R&D tax credit implication.

Sash Tusha:

Okay, thank you. That's terribly generous for the SSRO. That's remarkably unusual.

Carol Borg:

Yeah. Yeah, we agree.

Steve Wadey:

Okay, thanks Sash. That's the first one. On the second one, in terms of Avantus, so integration is funded within the guidance we've already given, and when we close, as we've said in the statement today, we will come back and reconfirm that guidance, and that will make a positive contribution. Assuming it closes in December, we'll have a quarter of complementary contribution from Avantus.

I might just take the opportunity, again whilst Avantus is in the room, to make two additional comments. First of all, as we've been working on that preparatory phase, its also very pleasing and I can confirm that the business is trading in line with our expectations. So trading of Avantus since we announced the acquisition has been positive. And in fact, they've achieved a number of new awards that are quite significant and in line with our expectations, so trading has been good.

The second thing, which isn't really integration but I'll, again, widen your question, the team is also prepared and ready to go post-close on areas of driving complementary revenue synergy. So we're looking at opportunities between our current existing customer base and the Avantus customer base where we can increment our business development focus and where we can increment our focus on complementary technologies so that we can go after even larger programs together. So that's a part of our thinking, that's part of our plan, and as soon as we complete, we'll be looking for that to support our ongoing growth in the US. So Sash, hopefully that covers both of your questions.

Sash Tusha:

Yes, thank you very much indeed.

Speaker 3:

Thank you. There are no further questions on the conference line. I will now hand back over to the room.

John Haworth:

Great. Well thank you very much for attending the presentation this morning. If you have any further questions, feel free to reach out to me and we look forward to seeing you again.

Steve Wadey:

Great. Thank you everybody.

Carol Borg:

Thank you.

John Haworth:

Thank you.