

Chief Executive Officer's review

Good operational delivery and strategic progress.



Steve Wadey
Chief Executive Officer

Market environment

FY17 was another year in which threats to global security from both state and non-state actors increased. Governments are seeking help with the rapid development of new capabilities to defeat emerging threats and ensure they meet their primary responsibility to protect and safeguard the lives of their citizens. Our expertise in science and engineering is particularly relevant in this context; we also play a vital role in making connections, be they across technologies, domains, supply chains or internationally.

FY17 performance

During the year we successfully achieved both good operational delivery and significant progress implementing our strategy. This was evidenced by the delivery of organic revenue growth for the first time in a number of years. Revenue and operating profit were stable in EMEA Services and up in Global Products, driven by growth in QinetiQ North America. We will continue to prioritise the delivery of sustainable growth with ongoing capital discipline.

Strategy

Our vision is to be: "The chosen partner around the world for mission-critical solutions, innovating for our customers' advantage." To realise our vision we are implementing our three strategic priorities designed to grow the Company by focusing on our primary UK customer, on international customers and on innovation.

Our strategy is inherently outward looking, based on the needs of our customers now and in the future, and I am encouraged that our customer satisfaction scores increased this year. To meet future customer needs, we are prioritising the rapid development of new capabilities to defeat emerging threats by embracing value-creating innovation. We are also driving greater value for money for our customers, improving services and delivering savings in parallel. To do this we connect supply chains and choose the right strategic partners from across industry with complementary capabilities to ours so that we can offer competitive and market-leading solutions. As our total order intake and backlog demonstrate, we have been building positive momentum with the implementation of this strategy during the year.

UK Defence Test & Evaluation

Our first strategic priority is to lead and modernise UK Defence Test & Evaluation (T&E). Delivering strong T&E capability is critical to ensuring reliable, flexible and affordable delivery of military capability to protect national interests. By engaging with our customers, we have made positive progress, signing new agreements which nearly double our order book to more than £2bn and significantly improving revenue visibility and therefore the risk profile of our Company.

In September 2016, we secured an 11-year, £109m extension to the Ministry of Defence's (MOD's) Naval Combat System Integration Support Services (NCSISS) contract under which we lead the T&E, integration and development of mission systems that keep the UK's surface warships at sea and fit to fight. This is an excellent example of our strategy in action, with a focus on partnership with our customers and across the broader supply chain as we look to develop our Portsmouth Technology Park site as the UK Centre of Excellence for maritime mission systems across the entire supply chain.

In December we signed an 11-year, £1bn amendment to the Long Term Partnering Agreement (LTPA), the largest and most significant contract since privatisation, which has significant mutual benefits for the MOD and QinetiQ. For the MOD, it ensures the UK has world-class competitive air ranges and training for test pilots and aircrew, and delivers the capability at less cost. For us, it provides the platform we need for growth by creating more relevant and competitive T&E capability for the UK armed forces as well as governments and commercial customers around the world.

Our focus during FY18 is to re-price the remaining LTPA contract, which is due on 31 March 2018, and to work together with the MOD and industry partners to develop a long-term vision for the UK's T&E capabilities.

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Our strategic pillars

We have refined our strategy in its first year of implementation. It remains built on three strategic pillars:

UK

We will lead and **modernise** the UK defence test and evaluation enterprise by working in partnership with Government and prime contractors.

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International

We will **build** an international company that delivers additional value to our customers by developing our home markets, creating new home markets and exporting.

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Innovation

We will **invest** in and apply our core competences for customer advantage in defence and commercial markets.

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The objective of this vision is to deliver future military capability for the next decade and beyond, addressing current and emerging threats. This will provide a platform for growth in the UK T&E market, which we estimate to be double that which we currently access, and improve our ability to win work with customers outside the UK.

International

At the beginning of FY17, we established an International business focused on developing and securing growth opportunities in prioritised territories around the world. This new International business has been established as an 'enabler' for the Group, bringing greater coherence and focus to our activities internationally in relation to both organic and inorganic efforts, and encouraging a more global mind-set.

In December 2016 we acquired Meggitt's Target Systems business, now renamed QinetiQ Target Systems (QTS), both to reinforce our core T&E value proposition and accelerate the delivery of our strategic priority to drive international growth. The business generates 90% of its revenues from outside the UK and is well aligned with our capabilities in the management of complex exercises and provision of test, evaluation and training services, thus expanding our core capability overseas. We are now uniquely placed to meet growing demand for mid- and high-fidelity targets to test defence capabilities against a greater diversity of threats. The acquisition also opens up new routes to market to promote our wider service offerings to QTS's international customer base.

A key element of our international strategy is to build our presence and capability in our home markets outside the UK, notably the US and Australia. QinetiQ North America delivered very good orders and revenue performance in FY17. With growing defence ambitions and close to the rapidly evolving Asia Pacific region, Australia is a particularly attractive market and our business there had a record year for orders. In January 2017, we also acquired RubiKon Group which brings integrated logistics support capabilities to QinetiQ Australia. RubiKon strengthens our ability to offer integrated whole programme solutions that are often required for 'strategic partner' style contracts which are being used increasingly by the Australian Government.

In FY18 we intend to build on the progress we are making in our existing home markets by increasing our sales presence in regions such as the Middle East and Asia Pacific. Negotiations over the UK's exit from the EU add complexity to our strategy for growth in Europe. However, many government relationships for defence and security, particularly in Europe, are underpinned by bilateral and multilateral agreements.

Innovation

As customers demand more capability, and as the boundaries between defence and commercial technologies become increasingly blurred, value-creating innovation is vital to maintaining our distinctiveness in the marketplace. Technical innovation has been at the heart of QinetiQ's success to date, and will remain a key source of growth into the future. However, turning creativity and technical innovation into tangible value for our customers increasingly requires innovative thinking across the broader range of activities.

In FY17, we established business winning campaigns supported by Internal Research and Development (IRAD) to drive commercial innovation, new processes, and innovative business models. For each campaign we consider the people, investments and partnerships we need to be successful. For example, to support the campaign to exploit our world-class capability in secured navigation receivers, we signed a global alliance agreement with Rockwell Collins, the market leader in secure military GPS receivers.

We have identified more than 30 growth campaigns in pursuit of material opportunities, all of which are worth tens of millions of pounds and in some cases more.

We are not going to win every campaign, but the scale of the total opportunity is significant over a five to 10-year time period. We will pursue these campaigns with vigour in FY18, as well as extending our focus to more international markets.

Transformation

We are on track to transform QinetiQ to improve customer focus and competitiveness. During the year we successfully introduced a new operating model based on matrix working to improve our responsiveness and operational effectiveness. We have also driven £20m of productivity savings that we have reinvested in business winning and IRAD to support our future growth. I appreciate that this period of significant change has been difficult for many of our employees, and this is reflected in our engagement score which fell last year although employee turnover remains low. Moving into FY18, supporting and developing the culture required to deliver our transformation is a particular goal.

Air accident

In July 2016, an air accident involving a contracted-in Yak aircraft operating in support of the Empire Test Pilots' School (ETPS) sadly resulted in the death of an RAF pilot and serious injury to the contractor pilot. We are actively supporting the subsequent official inquiries and will respond to all recommendations made.

Outlook – FY18

In EMEA Services, revenue under contract for FY18 is in line with the prior year, and the division is expected to deliver modest revenue growth this year although the lower baseline profit rate for single source contracts represents a continued headwind for operating margins.

The Group's Global Products division has shorter order cycles than EMEA Services and its performance is dependent on the timing of shipments of key orders. As a result of its contracted orders and pipeline of opportunities, as well as the anticipated full year contribution from the Target Systems acquisition, the division is expected to continue to grow in FY18.

FY18 cash flow will reflect increasing investment, with capital expenditure of £80m to £100m, to support the amendment to the Long Term Partnering Agreement announced in December 2016.

Overall for FY18, we are maintaining expectations for steady progress excluding the non-recurring benefits in FY17, supported by revenue growth and consistent with our strategy.

Outlook – longer term

Rapidly changing dynamics in defence and security markets are presenting both opportunities and challenges for our industry. We are well placed to help customers both develop capabilities to defeat new threats and achieve greater value for money by improving services and delivering savings in parallel. The initial progress we have made, combined with our ongoing assessment of the market environment, and, in particular, feedback from customers reinforce that we have the right strategy in place to drive future growth.

Over the longer term this strategy will create and sustain value for all our stakeholders. Our customers will benefit from better products and services, increased responsiveness, and improved value for money. Our shareholders will benefit because we will deliver sustainable growth in revenue, operating profit, and high-quality earnings. And our employees will benefit because they will be able to utilise their experience more widely across QinetiQ, working in integrated teams and enhancing professional satisfaction.

Steve Wadey

Chief Executive Officer
25 May 2017