

Rolls-Royce Investor Relations Update:

Strengthening Our Position in the Mid-Size

Aircraft Sector - 13 October 2011

Speakers: Andrew Shilston, Finance Director, Rolls-Royce & Mark Alflatt, Director of Financial Communications, Rolls-Royce

OPERATOR: Hello and welcome to today's call entitled "Strengthening our position in the mid-size aircraft sector". Throughout the call, all participants will be in listen-only mode and afterwards there will be a question-and-answer session. Just to remind you, this conference call is being recorded. Today I am pleased to present Mark Alflatt and Andrew Shilston. Please begin your meeting.

MARK ALFLATT: Thank you. Thanks very much and welcome to this morning's call. We appreciate you joining, especially at such short notice. My name is Mark Alflatt. I'm Director of Financial Communications at Rolls-Royce. I'm joined this morning by Simon Goodson, our new Director of Investor Relations, and Andrew Shilston, the Group CFO, who will take you through the presentation shortly.

Before we do that, just a couple of bits of admin; this morning's call is to review the announcement that we made last night. You may see that UTX also made a similar statement after the market closed in New York yesterday evening. Hopefully, you'll have a copy of the release, but if you don't you can access our copy via our website at the quick links section on our homepage. In addition, you should be able to find a copy of the slides in the same place.

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I'll hand over to Andrew now and, as the operator's already suggested, once we've finished the presentation there'll be a chance for some Q&A and beyond that Simon and myself will be in the office all day today, so if there are any follow-up questions, we'll be happy to help out. So with that, Andrew, I'll hand over to you.

ANDREW SHILSTON: Thank you very much, Mark. As Mark has said, this was announced in Washington last night and what we're going to do now is just to walk through one or two charts to explain what this means for Rolls-Royce both industrially and financially and we'll have a bit of time for questions at the end. Ordinarily for something like this, Mark King would be alongside to host the presentation because this is an industrial story at the end of the day. Unfortunately, he's in transit. He was in the States with Pratt & Whitney last night to announce the transaction.

So, if we just go to the first chart we have here, there are two key elements to this transaction, the first of which, just in a very high-level form, is that we're forming a joint venture that will allow us to continue our collaboration with Pratt & Whitney and this will really be focusing on technologies and products for future mid-size aircraft. To be clear on what we mean by that, this is aircraft that will replace the A320 and Boeing 737 families and possibly the 757 family as well, but it's got nothing to do with re-engining those existing aircraft.

The second piece of it is that we're going to restructure our existing collaboration with Pratt & Whitney by selling our 32.5% interest share in IAE to Pratt & Whitney and so what I'm going to do now is just give you a sense of how all this works and the impact it will have on us.

This picture here just summarises where we are today. You should be familiar, I think, with most of this. The V2500 programme is a very well-established programme. It stretches over nearly 30 years and still has a few decades left of future operations OE and after-market ahead of it. These engines are assembled in Dahlewitz and that's where our centre of excellence is in Germany and components and modules manufactured across our global supply chain. Most of this physical activity is going to continue after we've disposed of our interest in IAE, so this is really much more about a restructuring than it is actually selling our interest. We'll continue to make components of the engine type.

Although this is a very high-volume programme, as you all know, because our interest in it is through the joint venture and the engine is small relative to the Trent, it does make a relatively small contribution to our Civil Aerospace revenue and profitability. It's worth just remembering that because we don't compete on the Boeing 737 aircraft and that is all powered by the CFM product and we get about one half of the A320 programme opportunities via IAE, our economic interest is effectively at around about 8% to 10% of the overall narrow-body market and that's what we've been enjoying for the last 30 years. So, when you add all that up, the V2500 market for us is about 14% of our total installed thrust, which we use as a surrogate for value, and it equates to about 13% of our Civil revenues or about 6% of total Rolls-Royce revenues, so I think that just gives you a sense of relative importance, which is quite important to understand.

Moving on to the next chart, first of all touching on re-engining, I think we've talked with all of you over some years about re-engining and we were very clear last year with the reasons why we didn't want to pursue the re-engining opportunity. Essentially, it was all about a business case that we struggled to make attractive, so really this for us is a question of how to position ourselves for the future on new aircraft platforms which will have a much longer life and we want to position ourselves to have a greater economic interest in those platforms.

What we're planning to do is to form this vehicle with Pratt & Whitney which will focus on the new mid-size aircraft which will likely appear in the middle part of the next decade or thereabouts. There may be one or two smaller platforms that emerge before that. It is a very high-volume sector in terms of sense of scale. Both engine-makers believe that on a 20-year view this market might require something like 20,000 aircraft and that would equate to something like 45,000 engines. That gives you some sense of how large the market could be against the current 4,500 V2500s that are currently in service. So you can see why this is clearly going to be important to us and positioning ourselves for it will be very important for us.

So what is this venture? This venture is going to be shared 50:50 between Pratt & Whitney and Rolls-Royce and it'll focus on high bypass geared technologies, open rotor and other configurations as both companies develop technologies and products that will be relevant for future aircraft platforms. That approach is entirely consistent with our previous approach to this sector. We've always had a strategy of evolving new technologies that we think might be

useful in the future and we can now add those to Pratt & Whitney's capability set and be that much more competitive. It will also, of course, allow IAE to focus on the success of the re-engined A320 and it will enable the old version of the A320 and the new to be marketed through the same vehicle and that will be more efficient for Pratt & Whitney. In order to provide continuity, if you like, between the IAE partnership as it currently exists and the future collaboration between ourselves and Pratt & Whitney, we'll be making a small financial investment in the Geared Turbo Fan programme for the A320 NEO and that will provide us with a competitive return. It is a relatively modest investment but it's really just to provide continuity and demonstrate commitment on both sides.

Turning to the restructuring of IAE and what that means and how that works, it is relatively straightforward here. The intention is to allow Pratt & Whitney to focus on their re-engined A320 and to present to the market one entity to do that through IAE, so we will dispose of our 32.5% interest in IAE, which should yield a consideration of \$1½ billion at close, although there'll be some working capital adjustments. In addition, we will receive continuing payments which will be at a sort of dollar-per-flying-hour rate for each aircraft that's in service at the point we close the transaction. Those dollar-per-flying-hour payments will be received for 15 years from completion. As I've already said, we will continue to fully support the V2500 programme and we'll be fully involved in engineering activities, manufacturing and engine assembly, all of which of course we will be paid for.

So, as a result of all that, we would expect Civil revenues to be slightly lower had we not restructured our position, but profitability will

improve quite significantly over the next few years. That's largely because we are eking our revenues in the programme out over the next 15 years rather than over the full life of the programme. There'll be some modest implications for the Civil order book as we strip out contracted engines but it's relatively small scale compared to our backlog. Of course, there'll be some regulatory approvals that these two transactions will have to go through and we don't anticipate any problems there but it'll clearly be a few months before those approvals are gained. It's quite possible that the two elements of the transaction will complete at slightly different times.

Turning to the financial implications, we have really been through all of this but this just draws it all together in one place. At completion we will receive \$1½ billion adjusted for working capital items which will likely reduce that by \$100 million or \$200 million or thereabouts. We'll receive from completion annual effect of flying hour payments, if you like, or dollar-per-flying-hour payments for 15 years for each aircraft in service and that will carry on for 15 years. Given the number of aircraft in service and utilisation patterns and so forth, we would expect that in the first full year profits would be about £140 million higher. Obviously, that will depend when in the year the deal completes. In years after that, the net benefit to us will be somewhat less. So, if you stand back from all of this, we're getting slightly less than half of the NPV, if you like, upfront in a cash sum and rather more than half in NPV terms through future annual revenues as the installed fleet operates. We believe that this transaction is significantly value and earnings accretive for our shareholders.

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Finally there, as I said, we'll make a modest financial contribution to the GTF programme when the new venture is established.

So, just to summarise all of that, I think we've been through all these points. I think all this financial information you've already had. I won't read it out again. We've been through that once already. But in essence this is in two parts and for us the most significant element of it is forming collaboration with Pratt & Whitney on the new generation of aircraft that will emerge over the coming decades. We see this as not anti-competitive but very pro-competitive. GE already dominates in this sector of the market and this collaboration will allow Pratt & Whitney and Rolls to bring the best of the best capabilities together to be successful to bid for the new platforms in the years to come.

The financial elements of the transactions speak for themselves and we'll just leave that summary up on the screen and turn the WebEx over to questions.

OPERATOR: Thank you. Ladies and gentlemen, if you wish to ask a question please press 01 on your telephone keypad. If you wish to withdraw your question, you may do so by pressing 02 to cancel. There will be a brief pause while questions are being registered. Our first question comes from the line of Nick Cunningham. Please go ahead. Your line is now open.

NICK CUNNINGHAM: Thank you. Good morning, gentlemen. I've got a couple of questions. First of all, why now and not the GTF under IAE, given that the GTF has sold well on the NEO? Secondly and more

technical, if you like, what are the mechanics behind the profit rises? Are you booking more revenue upfront or does this reduce your costs? Just how does that come about and, roughly speaking, what's the shape of the tail? Does it go down in a linear way or is there a curve? Thank you.

ANDREW SHILSTON: Let me take those two or three questions in order. I think the question "why now" is always difficult. We've been talking about our interests in this market for some time, both amongst ourselves and with Pratt & Whitney. I suppose one of the catalysts for bringing these debates to a head was Boeing's decision to proceed with re-engining the Boeing 737 and I think that really staked out the landscape and made it clear that both Boeing and Airbus were going to re-engine their products. It really became obvious then that the new aircraft types to replace those would be some way off, so that was really the catalyst for doing the transaction now.

In terms of why the profit rises and why we have guided that to be the case, the key to that is that we'll be taking these continuing revenues on a dollar-per-flying-hour basis over a 15-year period. Obviously, there are going to be V2500s flying around in the skies for much, much longer than 15 years and we wanted to have an economic interest in those revenues, but we are going to take that economic interest over a shorter period of time of 15 years. So that is essentially why you get the profit pickup.

In terms of what the tail looks like, as I said, we've guided for a roughly £140 million uplift in profits in the first full year and that will gradually taper off over a five- to six-year period.

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NICK CUNNINGHAM: Thanks very much.

OPERATOR: Our next question comes from the line of Jason Adams. Please go ahead. Your line is now open.

JASON ADAMS: Hi there. I'm just limiting myself to two questions to allow some others. The first one is, on the new joint venture with Pratt & Whitney, do you see any incremental impact to the R&D plan? My second question is you noted that part of the mechanics of allowing increasing profitability are now you're effectively booking profits over 15 years as opposed to the entire life of the engine. Can I ask what the assumption previously as to what an engine life was in your plan?

ANDREW SHILSTON: Let's take the R&D question first. This won't have any effect on our R&D programme. We look forward all the time to new technologies whether it's for large engines or medium-sized engines, so this won't really have any effect at all.

In terms of profit, to be clear, I'm not saying that we're assuming that every engine goes into service with a 15-year life. It's not quite like that. What we're saying is that if you look at the totality of that installed base, the whole fleet, we will take the profit. We'll get cash receipts from Pratt & Whitney over a 15-year period and that will define the time over which we take profits.

JASON ADAMS: Okay. Thanks.

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OPERATOR: Our next question comes from the line of Ben Fidler. Please go ahead. Your line is now open.

BEN FIDLER: I had a couple of questions. The first is coming back to just the rate of tail-off of this £140 million profit benefit. I'm slightly bemused as to why it tails off quite so rapidly when, based on my assessment, the after-market flying hours on the V2500 will continue to grow quite materially over the next few years. Is this just due to a declining rate of dollar-per-flying-hour and it's not a fixed rate over a 15-year period? Is that what is driving that impact?

ANDREW SHILSTON: No, it's a fixed rate but I think you need to recognise that we're carrying on making components for Pratt & Whitney, so we'll carry on supplying the compressor, the fan blades and the discs and we'll get paid for manufacturing those components as well. So our economic interest going forward is a composite of those two things and that's really why, when you add the two together, you get some tailing off in the impact of the dollar-per-flying-hour.

BEN FIDLER: Sorry, I'm still slightly confused. You said the dollar-per-flying-hour doesn't change at the start of your answer.

ANDREW SHILSTON: Correct.

BEN FIDLER: But at the end of your answer your last sentence was that we do see a reduction.

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ANDREW SHILSTON: But I think we're clearly anticipating that the OE side of the equation will taper off reasonably quickly as the NEO goes into production, so the call on us to provide OE components will clearly reduce.

BEN FIDLER: Okay. Thank you. The second question was just again to understand if you can help me and just share with all of us your thinking about, I suppose, the bigger picture strategy here, which is sort of sending a message that we're clearly very committed long-term to the narrow body sector but we're just not terribly committed in the short term and we've made a change to say we're sort of seemingly less committed in the short-term by exiting our shareholding in IAE but we're increasingly committed in the long-term by doing this deal with the equal partner JV structure. I just want to understand your strategic thinking around that decision.

ANDREW SHILSTON: Yes. I think your terminology is probably right in a purely financial context. I don't think it's right in an industrial context. I think we are committed to that sector of the market full stop. It's just that the particular vehicle that's on offer to participate in the market today is not very attractive because we can't make a business case. It doesn't mean that we don't think the middle of the market is a good place to be. It's very high volume and, if you get the product right, you can be successful. So we're committed to the market. It's just that the re-engining as a business case didn't make any sense for us.

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BEN FIDLER: Although this decision is not about not participating in the re-engining. This decision and announcement today is about exiting on the existing programme.

ANDREW SHILSTON: Yes, but I think you have to see the transaction as a whole and that we clearly made the decision about re-engining a little while ago. Having made that decision, I think it became rather obvious that it would be much better for Pratt & Whitney to be able to offer the NEO through IAE and to have continuity between the old and the new and customer continuity. I think that was a logical consequence of the decision we took not to participate in re-engining.

BEN FIDLER: Andrew, thank you very much.

OPERATOR: Our next question comes from the line of David Perry. Please go ahead. Your line is now open.

DAVID PERRY: Good morning, gents. Congratulations. This looks very elegant for all. I've got two questions. The first one is you now have the same problem you had six or seven months ago with a lot of cash on the balance sheet. I just wondered if you can make any comments on what you might intend to do with that.

The second one is just a technical one. On the annuity, I just want to check, are you going to book any revenue on that or just take it purely as EBITA? I guess, related to that, I don't know if you have a pro forma idea of 2011 and if this transaction had been in place what

your sales and margins would have been in civil aero. Thank you very much.

ANDREW SHILSTON: First of all, what are we going to do with the cash? It won't have escaped everybody's notice that we spent quite a lot of money earlier this year buying our interest in Tognum together with Daimler. To an extent you could say we've just returned the balance sheet back to where it was at the beginning of this year. Admittedly that's reasonably strong and, in today's world with all the uncertainties confronting us, having a strong balance sheet is a good position to be in.

In terms of pro formas for 2011, we haven't done it. You can get more information from Mark Alflatt after the call but we will be booking revenues and taking profit. It won't simply be a profit interest that we'll be booking.

DAVID PERRY: Okay. Shall we assume it's 30% or 40% kind of margins till we sort of back up the revenue? The annuity number you've given us is profit, I think, so do we assume it's a 30% or 40% kind of margin thing?

ANDREW SHILSTON: I fully understand you want to populate the models with revenues and margins and profits, but this is a transaction which is reasonably commercially sensitive and putting all those details into the public domain is something we'd rather not do. We've gone about as far as we want to by disclosing what the effect on profitability is going to be. To be fair, we've said here that the revenues are based on a dollar-

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per-flying-hour rate. Obviously we haven't told you what that rate is and it's something we would choose to keep confidential. I'm not sure what more value it's going to add for you by expanding it out over the different P&L components, but the P&L component is as we have stated it.

DAVID PERRY: Okay. Thank you very much.

OPERATOR: Our next question comes from the line of Ed Stacey. Please go ahead. Your line is now open.

ED STACEY: Hello. Two questions. Firstly, on again the question of being out of the existing Geared Turbo Fan but back on the next generation, is there a particular technology that Pratt & Whitney have decided they need to get from you after all that they didn't think they needed on the Geared Turbo Fan that's going out in a couple of years' time?

The second again is trying to fish for more details for my model. I just want, in terms of thinking of my net income impact, to make sure I've got all the right components to think about. There is £140 million of additional EBIT in the Civil Aerospace division and then I take off what I used to book in the associate's line from IAE and then I add the interest on my \$1½ billion. Is that the right three things that I have to do and then I'm getting sort of 30 or 50 of net income benefit? But tell me anything you can comment on that, please.

Thank you.

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ANDREW SHILSTON: First of all, there's a technology question. I'll pick that one up first.

There's no doubt that we have some technologies that we think are very, very competitive, particularly in the compressor area. We clearly don't have a Geared Turbo Fan at the minute but the gearbox technology is not new. There is a gearbox that sits inside the Joint Strike Fighter, there's a gearbox that sits inside the European military transport aircraft and we've been doing research into Open Rotor technologies which in turn use gearboxes. But obviously, in terms of having a product that's available to go to market, Pratt & Whitney has got one although we're clearly aware of the capability set. So these technologies inevitably evolve at different paces in different companies and the strength of this joint venture is that both companies can bring to the table at some point in the future, which may be some time off, the very best technologies that they've got. As to the ins and outs of what the line-by-line effects are on the profit-and-loss account, I suggest you have a chat with Mark after the call. I don't think we want to give any more guidance in a growth sense than we've given on the call.

ED STACEY: Okay. Thank you.

OPERATOR: Our next question comes from the line of Charles Armitage. Please go ahead. Your line is now open.

CHARLES ARMITAGE: Hi there. A couple of questions. First of all, can you give us any feel going back to that £140 million of what proportion of that is from the production of parts versus the fixed rate? The second one is that

you have effectively traded somewhere in the order of \$3 billion of value to Pratt & Whitney through this transaction. What causes Pratt & Whitney to want this more than you, so much that it creates value for you?

ANDREW SHILSTON: In terms of the P&L split, we're not intending to break that out, as you describe. It's all commercially confidential. In terms of the value that we've traded, as we've said, the upfront payment of \$1½ billion represents somewhat less than half of the NPV that we're trading with Pratt & Whitney. So, yes, the value that we would recognise is in excess of \$3 billion.

Why would Pratt & Whitney want that to the extent they do? That's a question you must ask them. But in some ways the answer's reasonably obvious. They are competing in the re-engined market with GE which has massive benefits of incumbency on both the A320 and the Boeing 737. I think this transaction puts Pratt & Whitney in a very similar position, so they have incumbency that they can use to facilitate selling the engine for the new aircraft and it'll be much easier for them to present one route to market to the customer for both the old engine and the NEO when it goes into production.

CHARLES ARMITAGE: Okay. Thank you.

OPERATOR: We have time for one more question which we will take from the line of Rupinder Vig. Please go ahead. Your line is now open.

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RUPINDER VIG: Morning, everyone. Andrew, just one quick question around the new JV; given how far away the next generation planes will be, practically how much will actually be carried out in the JV in the near term? What kind of activity is there going to be? Can you give some idea of scale of what amount of work will be done by yourselves and Pratt? Ultimately, at what point do we see potentially some of the older IAE members also join the new JV? I guess that's something that would also be under consideration. Thank you.

ANDREW SHILSTON: Yes. We haven't given any details to the market about other applications that might precede a total new aircraft to replace the A320 and 737 but you guys talk to all of the aircraft makers. You know who has aspirations in this part of the market and you can be sure we'll be talking to them. Which one of those comes forward first, if any, remains to be seen. It's not inconceivable that there are earlier applications than applications to replace the A320 and the 737. We'll just have to see. But generally speaking you're right. There's not going to be a huge amount of activity in the very short term within that new joint venture.

RUPINDER VIG: Thank you.

OPERATOR: As there are no further questions, I'll hand back to Mark Alflatt and Andrew Shilston for closing comments.

ANDREW SHILSTON: Thank you very much indeed. I apologise that this came out very late last night. We were to some extent influenced by Pratt &

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Whitney's desire to make their announcement after their market shut in New York. But hopefully overnight and this morning we've made clear the key elements of this two-stage transaction which I think are very good for both companies. We feel very good about it. We're maintaining our collaboration with Pratt & Whitney for the long term. We've clearly taken some value out of our existing participation in IAE and I think put Pratt & Whitney in a good position to give their NEO a good start. So we see this as a win-win and look forward to collaborating with Pratt & Whitney in the future.

I think that concludes our remarks. I think we'll close the call at that point. Thank you very much.

OPERATOR: This now concludes our call. Thank you for attending. Participants, you may disconnect your lines.