

Chief Executive's review

Sir John Rose



Our steady evolution as a global company based on our own state-of-the-art technology, a robust business model and a consistent strategy was evident in many encouraging respects during 2004.

1995	7.6
1996	7.7
1997	10.1
1998	12.6
1999	13.2
2000	14.5
2001	16.7
2002	17.1
2003	18.7
2004	21.3

Order book firm and announced £bn

1994	27,000
2004	54,000

Installed base of gas turbines in service

1995	3,220
1996	3,887
1997	4,323
1998	4,471
1999	4,634
2000	5,864
2001	6,328
2002	5,788
2003	5,645
2004	5,939

Sales £m

1995	1.4
1996	1.6
1997	1.8
1998	2.0
1999	2.1
2000	2.6
2001	2.9
2002	3.0
2003	3.4
2004	3.8

Service sales £bn

includes 100 per cent of repair and overhaul joint ventures

1995	75
1996	91
1997	101
1998	106
1999	113
2000	126
2001	146
2002	148
2003	156
2004	169

Sales per employee £000

Our business performance in 2004 improved our financial position across the board. We continued to win new orders and to enhance our existing customer relationships in ways that augur well for our future growth, as we contemplate a worldwide market worth perhaps US\$2 trillion over the next 20 years. And we kept up our constant drive for technical innovation and greater operational efficiency.

Continuing progress

I am particularly pleased to report that, in what was our centenary year, we grew our total sales by five per cent to £5.9 billion and lifted our underlying profits before taxation by 21 per cent to £345 million. There was also a strong cash flow performance: we generated a cash inflow of £243 million, which resulted in a reduction of our year-end net debt to £80 million from £323 million at the end of 2003. Average net debt for the year, at £560 million, was at its lowest level since 1998.

Across our four operating businesses, we booked £8.7 billion of firm new orders and announced a further £2.4 billion that will go into the order book in due course. This was a record intake for the Group, as was the year-end firm order book that closed at £18.9 billion. Our order book has now grown in each of the past ten years, at a 12 per cent compound annual growth rate.

Solid progress was made across all four of the Group's target markets:

- in civil aerospace, the Trent 1000 engine was adopted by Boeing for its new 787 Dreamliner programme, and was selected for the purchase of 50 aircraft by All Nippon Airways, ensuring that Rolls-Royce will be the launch engine for this programme;
- in defence aerospace, the European governments participating in the Eurofighter Typhoon confirmed Tranche 2 of the programme, resulting in an order worth more than £750 million for the Group;
- in the marine sector, the MT30 derivative of the Trent engine was selected for the Lockheed Martin version of the US Navy's Littoral Combat Ship, complementing our earlier success with the demonstrator programme for the DD(X) US destroyer; and
- in the energy sector, important contracts were won for the West-East China Pipeline Project and in the Middle East for the Dolphin Energy Limited gas pipeline, which is the first oil & gas application for the industrial version of the Trent engine.

These and other successes during the year ensured that Rolls-Royce continued to enhance its strong market position in each of its four chosen sectors. In civil aerospace, we won 40 per cent of all new orders placed – our best ever performance. In the oil & gas sector, the success of the industrial Trent enhanced our position in the market for aero-derived engines.

Every time that Rolls-Royce sells an engine, we have significant opportunities to secure future revenues for services that will add value for our customer and add predictability to our own future earnings. The Group continued to build up this aspect of the business in 2004. Revenue from services grew by 14 per cent to £3.2 billion, which represented 55 per cent of total sales and brought the compound annual growth rate for this side of the business to 12 per cent for the past five years. Orders for future services accounted for £7.3 billion or 39 per cent of the year-end firm order book.

Innovation

Innovative technology and engineering are at the core of our business, and we pushed ahead with various important initiatives during the year. Rolls-Royce last year prepared 250 applications for new patents, a record total for the Group in any one year.

Many initiatives involved partnering with research and development centres overseas. Indeed, we have now set up an international network of technology-oriented relationships and more than 50 per cent of the Group's total spending on technology programmes will be directed outside the UK. Partners based in Asia are increasingly important to us. Towards the end of the year, we signed a Technology Agreement with a number of research institutions in Singapore covering a range of research activities. Further links of this kind are sure to follow.

As a global business we are in the fortunate position of being able to recruit the most able students in all the countries in which we operate and conduct research. However, my colleagues and I cannot fail to be concerned over the contrast evident in the UK, where fewer students study the sciences each year. If we are going to sustain our leadership in an intensely competitive marketplace, then we will need to ensure a reliable supply of talented young engineers and scientists.

The remedy will have to include stimulating more interest in science at the classroom level, which is why, in July, we launched the Rolls-Royce Science Prize. It is a £1 million award programme that has been designed to act over a number of years as an incentive to encourage excellence in science teaching. We hope it will also inspire more young people to look at the possibility of a career in our industry.

A highly-skilled workforce, of course, demands a best-practices workplace. Investing in people and technology means investing also in our infrastructure and manufacturing capabilities. One of the most visible signs of this is our factory renewal programme. Last October, we opened our new compression systems facility at Inchinnan in Scotland. It is one of a number of facilities that will be developed and opened over the next few years, reflecting a total investment of more than £200 million.

As well as rationalising our manufacturing facilities, we remain focused on improving our manufacturing processes, simplifying our supply chain and reducing the lead-time involved in component delivery. This process delivered a five per cent reduction in our unit costs in 2004, and we are targeting continuing cost reduction in 2005.

Prospects

The four sectors of the power-systems market on which Rolls-Royce is focused – civil aerospace, defence aerospace, marine and energy – all enjoy strong demand trends stretching well into the future.

Rolls-Royce is well placed to benefit from this demand, having invested heavily in new products. Taking advantage of the common technological base underpinning all four sectors, the Group has directed its investment into the development of a robust portfolio of products that can be adapted and applied to respond to new market opportunities. Thus, the investment in the Trent family of engines provided the technical foundation for us to bid successfully last year on the new Boeing 787 and has also formed the basis for new products in other sectors, such as the MT30 in the marine sector and the industrial Trent in the energy sector.

The potential for service revenues is similarly encouraging. The growing number of Rolls-Royce engines in service and their long service lives promise to ensure attractive returns over many years. This aspect of the Group's business is evolving rapidly with a significant level of investment being made in support capabilities such as engine repair and overhaul facilities, engine leasing and predictive data management. We expect to see a steady rise in the number of long-term service agreements with our major customers.

Across its four sectors, Rolls-Royce has now established a sound position within programmes that will shape the power-systems market for many years to come:

- in civil aerospace, conditions remain difficult for some airlines but Rolls-Royce has a broad spread of products and customers. The Trent engine family has secured a 50 per cent share of the engine market serving wide-bodied aircraft. Trent engines will power the launch of the Boeing 787 and Airbus A380 aircraft. The Trent 900 was certified on time, paving the way for the first flight of the A380 in 2005. We also offer a competitive range of engines for the regional airlines and corporate aircraft sectors;
- in defence aerospace, our position on a broad range of mature and new programmes enables us to mitigate the impact of volatility on individual programmes and provides a stable outlook;
- in the marine sector, our naval business is well positioned on a number of important new programmes and orders in the offshore market recovered strongly in the second half of 2004; and
- in the energy sector, our oil & gas business has a strong order book and the industrial Trent is well placed to secure a growing share of the power generation market. Earlier this year we established a joint venture with a consortium of companies in Asia as a further step in the process of bringing to market our solid-oxide fuel cell technology.

The Group is exposed to exchange rate movements on foreign currencies, particularly the US dollar which continued to weaken relative to sterling throughout 2004. We have, however, continued to pursue our strategy of hedging future net dollar revenues and at the end of 2004 had approximately US\$9 billion of forward cover.

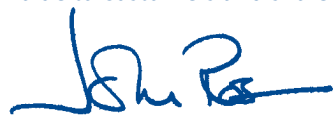
Our strong order book, the long-term services revenue stream and our focus on operational performance underpin the Group's expectations of continued growth in profits and reduction of average net debt in 2005. We continue to target a ten per cent return on sales over the medium term, across all our businesses, as the business model develops and our operational efficiency continues to improve.

A memorable year

We celebrated our centenary in 2004 with a huge variety of events, from Highland games (in Derbyshire) to open-air concerts and air shows, including an aerobatics display by the Red Arrows. Employees enjoyed the opportunity to entertain their families in the workplace at all of our main sites around the world. We also sponsored many special events – notably a series of concerts in Singapore, Hong Kong and Beijing by the London Symphony Orchestra, which, like us, was celebrating its 100th year.

So it was a year in which the unique character of Rolls-Royce was more than usually apparent to all of those who work in the Group, a fact we were proud to acknowledge by presenting every employee with a copy of a beautifully produced book tracing the history of the company's first 100 years.

As we set out on the next 100, I would like to thank all our employees for the huge contribution that they made in 2004. It is only through their dedication and co-operation that the Group can look forward to retaining its competitive vigour and delivering value to customers and shareholders.



Sir John Rose
Chief Executive



Our strategy for future success consists of five key elements:

- Address four global markets
- Invest in technology, capability and infrastructure
- Develop a competitive portfolio of products and services
- Grow market share and installed product base
- Capture substantial aftermarket opportunities