

CEO 2014 AGM Speech

Thank you Ian, good morning and thank you for joining us today.

As you would expect, I will review our performance in 2013. But a good deal has happened since the year end, and I would like to break with tradition and begin by saying a few words about the current year

For reasons that I will explain, 2014 will represent a pause, after ten years of uninterrupted growth in revenue and profit. And it is important to understand that this is a pause in growth, not a change of direction.

You will have heard me say before, and the Chairman made the point again this morning, this is a long term business. We have proven technology, deep customer relationships, a strong balance sheet and outstanding prospects for long term profitable growth. We are confident that we shall return to growth in 2015 and beyond.

So turning to 2013.

Our full year results reflect, for the first time, the acquisition of Tognum, now part of our Rolls-Royce Power Systems business. This acquisition has strengthened our reciprocating engine portfolio by contributing additional scale, capability and market access. The business is well positioned in long-term growth markets and we are confident that Rolls-Royce Power Systems will prove a good investment.

For Rolls-Royce Group, at the end of 2013;

Our order book stood at £71.6 billion, up 19%.

Group Revenue, at £15.5 billion was up by 27%.

Profit, at £1.8 billion was up 23%.

The 13% increase in payment to shareholders, to 22 pence a share, reflects the belief we have in the fundamental strength of the business as well as its future prospects.

Our performance in 2013, resulted from the hard work and application of a great many people. So I would like to say thank you to everyone at Rolls-Royce, to our partners and suppliers who play a critical part in our success, and to our customers who continue to place their trust in our technology.

Because this is a long term business - the best way to understand it is to measure performance over a period of years, looking back as well as forward. During the last ten years, our revenue has more than doubled, our order book has more than trebled and profit has more than quadrupled and we have increased our payment to shareholders from 8 pence to 22 pence a share.

And although recent movements in the share price have been disappointing, taking a long term view, the share price has increased from £1.78 at the start of 2004 to £10.50 at yesterday's market close.

So let me now explain in a bit more detail why there will be a pause in 2014, and then perhaps more importantly why we are confident that growth will resume in 2015.

The first reason is that, after two record years, we will see a contraction in our Defence business, reflecting cuts in government spending and the phasing of two major export contracts.

The second reason is that we expect to generate less revenue from the our Marine business because of deferred customer investment decisions and weaker services revenue.

This morning we issued our regular trading update, and informed the market that: Excluding adverse foreign exchange translation effects (estimated at £40m on profit and £300m on revenue at current exchange rates), and a one-off charge in Marine (estimated at £30m) to rectify a product quality issue, the Group continues to expect revenue and profit to be flat for the full year, with free cash flow similar to 2013.

Looking beyond 2014, we continue to see opportunities for our Defence business. The \$1.46b of defence contracts we have signed since the beginning of the year and

our strong market position, underpins our confidence in future growth. While in Marine, the requirement for long-term investment in offshore oil and gas has not diminished and will drive demand for our technology and services.

Above all our £71.6bn order book provides visibility of future revenue growth. This includes a doubling in thrust of our civil aerospace engine fleet as production of the Trent 1000 for the Boeing 787 Dreamliner ramps up and the Trent XWB enters service, powering the new Airbus A350. To give you some idea of the scale of this growth, we expect to deliver fewer than 30 Trent XWB engines this year, rising to more than 300 engines in 2018. Accompanying the sale of these engines is the opportunity for long term service contracts that will generate secure streams of income for decades to come.

You may recall from previous presentations that our business is focused on delivering 4Cs: Customer, Concentration, Cost and Cash – Each of these is a journey, rather than a destination, and our mind set needs to be one of continuous improvement.

On Customer, we have made big improvements – with plenty more to do. To give you just a few examples; in 2013, we achieved 100% on time delivery in Civil Large Engines for the first time ever. By the end of the year, our Corporate and Regional jet business also achieved 100% on time delivery, and in Marine, delivery was 96% on time; up from 55% in 2012 and just 10% the year before that.

There has also been progress on quality – for example in civil aerospace, Airbus has praised Rolls-Royce for significant continuous improvement since 2010, with the 'Award for Best Improver' for our A380 programme. In Defence, the US Naval Air Systems Command has formally recognised a quality programme that more than doubles the time on wing of engines on the Osprey V-22 aircraft.

Improving delivery and quality strengthens customer relationships and makes discussions about future business much easier. It is also an essential first step to achieving better financial performance, because delivering product on time and at the right quality reduces inventory and lowers cost.

Concentration means deciding where to invest for future growth and where not. We clearly have a strong Civil Aerospace business that is already assured of substantial growth. So, while we will keep investing in gas turbines, we will also look for opportunities to expand in reciprocating engines; the acquisition of Tognum provides a good example.

As we seek to concentrate our resources on areas where we can add most value, you may also have read this week that we are in talks with Siemens regarding the possible sale of our Energy gas turbine and compressor business. These talks have not concluded and we will make a further announcement in due course.

Turning to Cost. It is worth remembering that the aerospace industry is, quite rightly, strictly regulated. That means it takes both time and tenacity to drive cost out from the business. You will not be surprised to hear me say that we are not where we need to be. But, while the pace of change may be slower than we would like, there are a number of areas where progress is being made:

- We reduced indirect headcount by 11% by the end of 2013.
- In 2013, unit cost fell in Marine, Energy, and Power Systems, although it was slightly higher in our Aerospace divisions. We expect to make progress on unit cost reduction across all our segments in the current year.
- We are building new, more efficient facilities and capacity that will support a doubling in production of Trent engines.
- We are moving production away from high cost countries, negotiating terms with our suppliers and consolidating our supply chain.
- We are improving productivity and designing cost reduction into our engines.

Our Cash inflow during the year was £359m. We have put great focus on inventory, so it was good to see stock turns improving from 3 to 3.4. There is more to do, but by way of context, this is among the largest one year improvements recorded, and the highest stock turn we have yet achieved.

All of these actions, and others that I have not described, will deliver benefits but, as I have said in the past, will take some time.

A year ago I reported that we had passed a file to the Serious Fraud Office, detailing concerns about bribery and corruption in overseas markets. In December 2013, the SFO informed us that they had commenced a formal investigation, this is continuing and I suspect will take some considerable time. We are cooperating with the SFO and with other authorities.

I have repeatedly made explicit that neither I nor the Board will tolerate business misconduct of any sort and will take all necessary action to ensure compliance. This includes the progressive strengthening of our ethics and compliance procedures.

In January 2013, we appointed Lord Gold, an expert in ethics and compliance, to review our current process and controls. In July 2013 he presented an interim report to the Ethics Committee. This report recommended action in three areas:

- To develop and implement an integrity and values communication strategy.
- To provide integrity and values training for all employees. And
- To reorganise the compliance function.

The ethics committee, the Board and the Executive Leadership Team have agreed with these recommendations and are implementing them.

In the past year, we have appointed a new Director of Risk who has strengthened and restructured our compliance team.

We have published a new Code of Conduct that sets out very clearly the behaviours we require, and the consequences of non-compliance. This is being rolled out to every member of staff across the company. Every employee is required to certify that they have received a copy, that they have read it, understood it and will abide by it.

We have invested in our ethics help line, providing a confidential channel for anyone who wishes to raise a concern. Today we have contact numbers in 48 countries alongside an online service that gives access to employees 24 hours a day wherever in the world they are based. We are committed to creating an environment where

anyone can ask questions and raise concerns without fear of retaliation. We take all reports seriously and investigate every case that is raised.

We have sharply reduced the number of intermediaries used by our business in overseas markets and revised terms and conditions applying to the intermediaries we continue to employ. At the same time we have invested greater resource into our own in country teams.

We continue to revise and strengthen our compliance policies, procedures and training. All of these make it clear that we have a zero tolerance approach to bribery and corruption and make an unequivocal commitment to compliance.

These and other actions will strengthen our corporate governance, and I hope demonstrate to you how seriously we take these matters. This is a company with exceptional prospects and I will not accept any behaviour that undermines its future success.

2014, marks one hundred years since Rolls-Royce produced its first aero engine. It is also the year in which our best-selling and most advanced Trent engine, the XWB, will enter service, powering a Qatar Airways Airbus A350 into the skies. The XWB has proved itself the most fuel efficient large jet engine flying in the world today.

For more than a century, Rolls-Royce has been at the forefront of technology; harnessing innovation in ways that benefit our customers. Our values are Trusted to deliver excellence. This powerful phrase both reflects the achievements of the past and the scale of our ambition for the future. It applies to everybody in the company, everywhere, every day. The trust that we have earned from our customers is reflected in a record order book that grew 19% in 2013, and underpins our confidence in the long term success of our company.

Thank you.

