



Rolls-Royce



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Presentation

John Dawson

Good morning, ladies and gentlemen, and welcome to the Rolls-Royce Head Office here at Buckingham Gate.

Our agenda today is fairly straightforward. I'm going to hand you over to Warren in a minute, who will start the presentation with his perspective on the progress we've made to date, and hopefully we'll have time for a few questions before he leaves at 08.45 this morning. The second part of the day, then, switches and focuses on the board, its committees and their agenda, and this will be led by Ian Davis, our Chairman. And with him today, I'm delighted we have Lewis Booth, Head of Audit, who is currently Head of the Remuneration Committee; our Senior Independent Director, Sir Kevin Smith; and Irene Dorner, one of the other Non-Executive Directors. They will be well equipped to share their views on the progress they've been making as a board.

We'll start with some presentations on the two or three key topic areas, and then we'll break into smaller roundtable groups, as we've done last year. It gives you hopefully a better opportunity to ask questions and to explore the areas of interest to you.

With that, let me hand you over to Warren. Thank you.

Warren East

Great, thanks John. Morning, everybody, well, a grand title, Strategy Review, by the way. This is just meant to be a short presentation – most of you have seen the information on the slides before – to tune people in before we get going on the governance later. And I hope anything I don't cover in the presentation, do ask questions, and we'll cover everything we can.

So 2016 was, at headline number level, probably not the greatest year in our history. But I characterise it, actually, as a year of stabilisation in our business – stabilisation and taking us into 2017, where we're now building some foundations for reasonable growth and significant recovery in cash generation. The headline numbers – and by the way, these numbers are in constant 2015 currency terms – headline numbers and revenue margin and so on were significantly down on the year before. And in order to fully understand that, you have to go back some way, and we'll go back in a moment, to the middle of 2015, where we started talking about that. And that's really what's meant by this headwinds comment in the bottom corner.

By the time we announced our results in February, there were two other significant things that rather sort of overshadowed some of these numbers: a resolution with investigating authorities – and I'll talk about that in a moment or two – resulting in a deferred prosecution agreement, and then the numbers on the day were completely masked by this reported versus underlying comment.

We have a large hedge book. It's about \$38 billion – \$39 billion dollars' worth, and as you know, post the Brexit referendum in the middle of last year, sterling has fallen rapidly, and that hedge book had to be re-valued at current market rates. And that resulted in a headline £4.5 billion loss, and that rather sort of dwarfed the real numbers. And the reason I'm mentioning it now is to stress the fact that this has nothing whatsoever to do with cash. It's not a write-down type loss, or anything like that. Every single penny of that £4.5 billion will come back to Rolls-Royce, either when the exchange rate moves and we have a technical adjustment in the other direction, or when we actually conclude the transactions that that hedge book is designed to protect and insulate against, and we conclude the transactions at the real exchange rate, and actually pocket the difference. So it's very much a technicality, but it did rather dwarf the results.

Now those headwinds, to fully understand the profit change from 2015 into 2016, this was a perfect storm, really, of a lot of things going wrong. But the good news is we were able to see these a little bit in advance in 2015, and certainly two days after I joined the business, we first told the market that, actually, 2016 is going to be a significant downturn on 2015, and that's really caused by these factors on the left-hand side of the slide.

Our Trent 700 engine powering the A330, high-volume engine, it's been really the engine of our civil business for the last several years or so, and that's coming to the end of its life as Airbus transitions from A330 to A330neo, and volumes are coming off, and

at the same time we want to catch a reasonable share of the tail-end of those Trent 700s, and we understand that in order to do that we'll have to be selling some of those engines at reduced prices.

And that's what we signalled in the middle of 2015, and that was a significant headwind. Unfortunately, it happened at around about the same time as we have a softening in the corporate jet market, and a softening in the regional aftermarket, as some of the regional jets that are powered by Rolls-Royce engines get used a bit less by airlines who are struggling to find pilots to fly them.

And the third factor affecting our aerospace business – the third headwind – was particular Rolls-Royce exposures. So we're designed into a particular set of smaller regional jets, most of these jets are actually being retired, and large corporate jets, several years ago, we did get designed out of some of those airframes, and now volumes of corporate jet engines, you know, are falling off as a result of that. The good news is that the size of our fleet is still growing and so there's still aftermarket growth potential in that sector, and the legacy, older, larger jet engines are also retiring as things like 747s come to the end of their useful life.

So you put all that together and combine it with a weakening in the marine market and we had some massive headwinds on profit going into 2016. Having established what those headwinds would be, I think the actual performance in 2016 was absolutely on track, and I was happy with the performance because we did manage to deliver slightly ahead of expectations in terms of the numbers on profit. There were some positive one-offs in that outperformance, but there were also some negative one-offs as well that we had to overcome in order to achieve those numbers and that implies there was some actual solid improvement as well.

Sort of things we did within the business, though, we got on with changing, because clearly if you look at those numbers, you've got a £14 billion business with £14 billion coming in through the top, and roughly £14 billion going out through the bottom as well, and that's not a very sustainable position to be in. And so we did start effecting some change. We got on with changing the management structure at the beginning of 2016, and removed some superfluous layers. We carried on investing, because it's important in this business to carry on investing in our R&D, and carrying on modernising our factories to make us more competitive, and that's, as I comment here, over £1.5 billion – actually close to £2 billion – invested. And it's very sensible to carry on investing that in this type of business.

The good news is that we have a very strong order book, and once we go through this transition from older aeroplanes that are powered by things like the Trent 700, to newer aeroplanes powered by things like the Trent 7000 and XWB, then we are on a journey of significant market share growth in large civil. In order to deliver on that, then, we need to ramp our volumes quite significantly. 2015 was a year of delivering about 300 large engines. 2016, we made about 400 large engines, and invoiced 360. 2017 we're aiming to deliver just around 500 engines. So this is a period of significant ramp up, and the good news is that we achieved that ramp up in 2016, and the run rate of engines delivered towards the end of 2016 puts us in a strong position to deliver that ramp-up in 2017.

At the same time, we're actually bringing new engines to market. The Trent 7000 engine I already mentioned, the TEN version of our Trent 1000 engine and the new higher-powered XWB-97k engine – three new engines that all achieved significant development milestones in 2016, and will achieve more milestones in 2017, as two of them enter into service during this year and the final one enters into service, the 7000, in the early part of 2018.

Alongside that, we saw significant improvements in some of the other areas of our business, where delivery was a little slack earlier, and particularly in our nuclear business, where I know we picked up some negative headlines in the early part of 2016. You'll be pleased to hear that our customer, the UK Ministry of Defence, is now very pleased with our delivery performance.

And inside the business, we kicked off a transformation programme to really simplify the way that the business works and drive out excess waste and cost, and on that we're off to a good start. We set goals at the end of 2015 and said that by the end of 2017 we would be at a sustainable annualised run rate of £200 million reduced cost from that simplification exercise, and we estimated that by the end of 2016 we would have achieved £50 million of that cost reduction. The good news was that at the end of 2016 we were able to report that the £50m had turned into £60m, and that gave us confidence that by the end of this year we're absolutely on track for the £200m.

So now if I look forward to this year, there's a lot going on in the business. Civil is in a stable condition. I talked about the ramp up a moment ago, and that's the major event in our civil business for this year – the ramp up and those new engine introductions. From a financial point of view, that ramp up will drive higher OE revenues. One of the serious volume increases is on the Trent XWB 84k. We still currently make a significant cash loss on that engine, and as that volume increases, then overall OE profit will not rise in line with the volume. And that's with the comment about adverse mixes.

Again, in the aftermarket, the aftermarket is stable. As of now we're on track for the number of hours that we expect our fleet to fly this year, but there are mix changes as some of our older engines retire. The corporate jet space that I mentioned a moment ago with some design-outs that happened several years ago, we're continuing to see adverse effects from that as the volume of corporate jet engines continues to decline. Many of you already know that.

However, on the other side of the equation, we're working quite hard to improve the operational effectiveness within the civil aerospace business, and in 2016 we saw significant improvement in our life cycle costs, and we expect to see that continue in 2017. And Civil accounts for about 50% of group revenue, and we expect that that will be a significant contributor to making stable cash flow in 2017 versus 2016.

Power Systems, I think we outperformed our competitors in 2016, and we expect that trend to continue. We do have an order book in a good place. I'll talk about some new leadership in a moment in that business, and one of the key roles that – key challenges that we have and the key role of that leadership is to linearize that business a little, and de-risk some of what's going on there. But we expect modest growth in 2017.

Nuclear is largely stable, Defence is largely stable. In Marine we don't expect any heroic sort of switches of the cycle there. Clearly, our marine business – many of you know I've been talking about the fact that several years ago, we clearly had fixed costs just too high in our marine business, too high by about 30%. We are moving towards the end of a period of restructuring in that business, where we're removing about 30% of the fixed costs, so that this business will be sustainable, break-even at the trough of the cycle, which is where we are now. And so our outlook on Marine remains a bit cautious, no heroic assumptions, but we're not anticipating any further negative shocks either.

So looking at the group as a whole, and our overall financial strength, we are going through a period of continuous investment. I mentioned that it was good to continue investing in our R&D pipelines, we have the new engine architectures coming after all these new engines that we're bringing into service now. We have to keep our capex investments going, to make our facilities more competitive, and so there's a little bit of a balancing act. We need to keep this period of investment going during a phase when the operating performance of the business is not actually generating that much cash. It's very close to break-even cash at the moment as a group. But many of you will have read that we do believe we can generate sufficient and significant cash over the next several years.

So, as well as that, we have reduced our dividend. Our dividend policy remains as we said about 15 months ago, that we will return the dividend to a sensible level subject to short-term cash needs. When the businesses barely break even, the short-term cash need is continuing to strengthen the balance sheet. So we expect and hope that we can maintain the dividend, but obviously that's a Board decision at every period.

Looking at the graph here, you can see that our liquidity is good, with over £5 billion. The leverage is at a tolerable level. Clearly, we have some headwinds, and I'll talk about the deferred prosecution agreement in a moment, and for that we have to find £300 million this year. But, on the other side, you can see from the timing here that there's no significant refinancing required until 2019, by which time we hope the cash generation coming out of the operating business will be in a significantly different place.

The rating agencies are quite realistic about this. We maintain a good dialogue with the rating agencies. There was a one-notch downgrade from Moody's and from S&P, after the deferred prosecution agreements were announced; absolutely reasonable. And when we start reporting numbers under IFRS 15, then the profit ratios are going to change a little. That's inevitable, and the rating agencies are thinking about that.

The important point with IFRS 15 however is of course that there is no significant change to cash, and this is something that the rating agencies have to square: the profit ratio's going to change and look very different, but actually, in terms of real liquidity and balance sheet strength, there is no change to cash. We're not in the strongest position we could be, but this is stable, we're managing the risk, and it's tolerable.

Now, I talked about deferred prosecution agreements. In January, we announced that we'd reached agreement with the Serious Fraud Office and the Department of Justice, around investigations that had been ongoing for some time. Actually, I think the agreements that we reached, and Mark Gregory's in the room, he is a key driver of this - I think we achieved a pretty good result.

The important points are, we don't have any costly monitors that we have to fund, we clearly have to pay the fines and we are continuing to have assistance from Lord Gold, who has helped us with our ethics and compliance activity over the last several years.

Actually, we're making significant changes inside the business as far as culture is concerned in this respect. I can claim no kudos for this, this is something which has been started in the company some time ago, and we've been continuing to train people so that I was able to say, when we made our announcement in January about reaching agreement [and as the core message on the slide], we're doing an awful lot of training. We are making sure that people, particularly in senior positions, are seen to lead by example.

We're putting that into the way that people get appraised, so part of your individual component is how you act as a leader, and how you act as a leader with respect to ethics and compliance. As part of actually a wider picture of employee engagement, we are monitoring and measuring senior managers and leaders in the business around employee engagement and we're using that employee engagement activity to drive home these messages about ethics and compliance. So that's what we're doing on it.

One of the significant tasks for me during 2016 was reshaping the executive leadership team, and I'm very pleased with the four new external appointments we've brought in. I've been seeking a balance of continuity, some internal promotions and some fresh blood and fresh ideas, and an external perspective from outside. And these are four characters who have come in from outside who joined our executive team around the end of the year. We had our first executive team meeting in December, with all four players sat around the table, and I have to tell you, the result is transformational. I'm very pleased with these new appointments.

Looking forward, we are going to talk a little bit more about strategic priorities, but I don't intend to go into that now. This is a framework that we put up at our Capital Markets Day in November. There's no rocket science here: it's think about the market, it's think about what we're really good at and what we're not good at, and what we need to change in order to get better at the things that we're not good at, and what sort of investment is required. If you translate that into a sort of high-level business model, again, there's not a lot of rocket science in this.

We are an engineering- and technology-led business, and we need to get a little bit more technology-led than engineering-led, so that we have the right ingredients for our excellent engineering. So you can start at the top with securing excellent leading-edge technology, you can have an open mind about how we turn that technology into products. Some of the engineering we do ourselves, some of the intellectual property we might secure from outside, some of the engineering talent we might secure from outside. But that's all about working with the businesses to create really compelling customer propositions.

Now, the trick is to actually transform from that being a break-even activity to that being an activity that generates lots of money and, clearly, the piece across the bottom is where we need to work hard on improving our execution. So that's about driving sensible returns out of that, and then those sensible returns are shared between our investors and investing back into the business to make it sustainable, seek the next generations of technology and move on.

The very fact that we're having this event today, I hope is part of an objective that we set ourselves a while back to really rebuild the trust and confidence amongst our internal and external stakeholders. And here are some of the things that we did during 2016 that I hope were steps on the way to improving that trust and confidence. Some interesting facts and figures: we have an IR team that I can assure you works very hard and gets around, and we've done quite a lot of engagement with investors over the last 12 months, and I've been doing a bit of that as well, and hopefully we'll continue to gain your trust and your confidence.

Looking forward to 2017: what we have to concentrate on is delivering 500 large engines and making sure that we secure all our other deliveries that we need to make as well. If we do that, and we do it according to the plans we have, then I think we will see at the group level a modest improvement in performance. Some of the cash flow positive surprise in 2016, as I've said, was sustainable, and we don't expect that to be a rob from 2017 into 2016 exercise. The cash flow that we originally expected in 2017, we still expect in 2017, and that will be similar to what was actually achieved in 2016. And our priorities for the team are pretty clear, and I think overall I remain optimistic that the business is exposed to growing markets with growing market share, everything that we're doing is around growing profitability, and therefore, we're in a pretty good place.

With that, I'll take a few questions.

Speaker

What are the significant dates in 2017 for the two new engine launches?

Warren East

There's basically third quarter and fourth quarter, and in terms of tying it down to individual months, then that's between the air framers, the lead customers, and it isn't all entirely within our control, but we expect to see those engines in the third and fourth quarter this year, and we expect to see the Trent 7000 *[corrected from 97k]* in the first part of next year.

Speaker

Have you got to the point now where the delivery risks are low, or are there still risks?

Warren East

There are still risks because, until it's done, it's never done. And there's always something that can go wrong. However, I would say over the last six months, some very significant milestones have been passed on both of those – well, on all three programmes, actually. So we are now flying 97k – or Airbus is flying 97k on three aircraft, and they're probably two thirds, three quarters of the way through their flight testing programme with the engines on the plane. The Trent 1000 TEN is in a similar position with Boeing, on the 787s, and the 7000, we are flying as well, but it's not flying on the final aircraft just yet.

Speaker

What does it actually mean to be technology led, rather than engineering led?

Warren East

I think it means forward looking. If you imagine yourself climbing up a mountain, then it's very important that you don't fall off the mountain, but you need to look at where you're going. And engineering, a lot of our engineering programmes, I mean, what I was just talking about there, delivering the engines, it's about the mechanics of walking along the path up the mountain and making sure you don't fall off. But if that's all you do, you might well never walk right up the mountain, because you might take the wrong path. And what I mean by being technology-led is to have a little bit more emphasis on what are the technologies of the future?

Because we can deliver these engine programmes just fine now, and we can deliver the next engineering project that we have in place, Ultrafan - I mean there are quite a lot of risks associated with that, there's a lot of engineering to be done - but we know pretty much what we have to do. The question is, we don't want to get to 2025 and have a nice new Ultrafan engine out there and nothing to follow it. And in order to get at that 'what comes afterwards', we have to be much sharper at looking for the right intellectual property around materials, the right intellectual property around chemistry and combustion technology, the right intellectual property perhaps around electrification, and electrification is a key trend that's going across a lot of industrial sectors right now. We're getting there in some of our marine applications, but we need to put a little bit more effort into some of the more weight-sensitive areas around electrification, if we're not going to get left behind on things like that in aerospace.

Speaker

What do you think were the root causes of the issues which led to the Deferred Prosecution Agreement?

Warren East

I think it's very hard for me to talk about the root cause, but what I would say is that we're doing an awful lot more than training, at the moment. I talked about people engagement, and leadership, and leading by example, and having people actually see their managers and their more senior leaders behaving in the right way. And by making sure that you do more than training - it starts here and it starts with the Board - then I think you stand a better chance of making sure that the training actually sticks.

I don't pretend that any sort of culture change is easy, and let's face it, we have quite a bit of culture change to do in the company. Not just around making sure that people behave in the right way from an ethical point of view, but also making sure that people aren't stuck in the past, and that if we are going to be a competitive business in the 21st century, then some of the things and the way in which we go about our business does need to change. And this isn't something you can just throw a switch, but it's something that you can achieve over time, and you can achieve it with leadership and with engagement of the people, and it was only one bullet on the slide, but that one bullet on the slide about engagement reflects a lot of effort that we're putting in as a leadership team, that the individual leadership teams are doing, and that our HR function is driving across the group. I think that's about it, John, so looks like you're off to a prompt start. Thank you.

John Dawson

Thank you. As per our agenda, I'll hand over to Ian in a moment, but before I do I'd also like to take this opportunity to thank a couple of people who have been involved in putting this event together. Firstly, one of my assistant directors, Ross Hawley, couldn't be here today. He's been working behind the scenes with the presenters to make sure that all of the materials and the subjects that we're addressing today meet your needs, and hopefully that will come across during the course of the next two to three hours. And secondly, if I may, to thank Jacinta Francis, who's not in the room, which is a shame, because Jacinta's leaving my team in a couple of weeks to pursue a career opportunity outside the company, and she is instrumental in making sure the logistics and organisation of these events work very well, and, publicly I'd like to thank her for her contribution to my team over the last two years that I've been involved in making it all as efficient and as effective as it has been.

So thank you, I'm now going to hand you over to Ian, who will take you through the second half of the proceedings.

Ian Davis

Well, thanks John, and Warren had to slip away. He has had to go away for personal reasons. He's hoping to be back later on in the morning. Well, thank you all for joining us. I think I know many in the room, which I'm pleased about. Those that I don't, I hope I'll get to know over the course of the morning.

What I'd like to do, and what we'd like to do from a governance and board perspective, is two things: firstly, we'd like to continue the momentum that we started at last year's Governance Day and give you a refresh of what we do on governance, what we do on the Board, and give you a feel for how it works. And secondly, and perhaps even more importantly, a chance for you to meet some of the Board members and get to know how we actually operate. And governance can become a procedural, structural thing, but in the end, while those are important, it's a human activity. And I do hope that you'll get a chance to get a sense of us as Board members, talk to us, get a feel about it.

As always, I just do want to reaffirm, we have really tried over the last two to three years to be more open, more transparent and more accessible, and this is an invitation – if you'd like to see more of us, any of us on the Board, please, just one phone call will do that. I think it's a really, really important part of it.

So let me just start off here talking a little bit about the Board. There's been quite a lot of change on the Board over the last few years. There's been a spirit of rotation and regeneration. We do have some long experience on the Board, primarily in the form of John McAdam, but it is essentially a Board that's predominantly new over the last three years. I put in the bottom right – I said it's a strong Board. I suppose I'm not going to stand up here and say it's a weak Board. And I'll try and talk about that. But I do think that there is a lot of experience on this Board, and I'll just show the backgrounds of the people on the Board.

Ten of our Board have been Chairmen, CEOs or CFOs. So people have been on Boards. They've participated on Boards, they've led them. I think it has a good mix of related experience. 60% of the Board has engineering backgrounds, by education. I don't want to stress that too much because the primary challenges for Rolls-Royce at the moment are not engineering; they're operational and commercial. We've got to turn our engineering excellence and products into money. And we know that and that's the focus. But nevertheless understanding the mind-set of engineering technologies is a very, very important part of that. We continue to look very strongly at safety. We don't always talk about that as much. Absolutely crucial to what we do and we've got strong safety and regulatory experiences on the Board, and financial and remuneration as well.

Incidentally, just going back, I'm quite often asked by you and certainly other chairmen – "what's it like having an activist on the Board"? And the honest answer is, I don't know. I know what it's like having Brad Singer on the Board, and he's great. He's just great. ValueAct and Brad are adding a lot to the company. They're pushing hard. But what they want, what we want, what you want are totally aligned. So a lot of discipline, a lot of challenge. But all I can say, it's just been a great experience to have them on the Board.

Now in terms of Board topics, what were we focusing on in 2016? I hope it won't be dull for me to say we were focusing on what you'd expect us to focus on. I mean, it's absolutely really focusing on transformation, operational improvement. This is number one, two and three priority for the Board and for the company: to really focus on operations. We dealt big back in 2008, 2010. That was when we made the massive decisions on the new engine programmes, and we're right now in the process of delivering those, which as you know is a huge operational challenge, ramping up production and then turning those into the money that they should be generating. This is absolutely the number one, number two focus.

We've spent a lot of time, as you can imagine, dealing with the investigating authority SFO. That's been a big cloud over the company for the last three or four years. And those who've been through it, it's very time consuming and it's morale sapping. There's no point pretending it isn't, internally, as well. We spent a lot of time on that and, on the whole, I think that's gone as well as it could have done. There's never any prizes on this sort of thing. But I'll talk a little bit more about that.

A lot of work around – Warren talked about changes in the executive team. Nearly two thirds of the ELT will have changed or rotated in the last 18 months. That's a part of it. Obviously the Board has been involved in that. We continue to review strategy. We don't talk about that too much and there's a reason for that. It's very difficult for those of you who managed business, to really focus on operations and cash and also strategy at the same time. But we haven't forgotten it and we'll come back and talk to you about it when there are things to be talked about. And then we've been through an auditor change process. Again, time consuming. Appointed PwC. KPMG have been our auditors since time began. So this is a big change for us. It's quite a big process, again, most of you would know that. And we've continued to try and engage very, very actively with our stakeholders, of which you are clearly a critical component. We've also significantly ramped up our interaction with governments. That should be significant activity for the Board and for the Executive. And we're also – Ruth will be talking about this in due course – looking strongly at remuneration.

For those of you that are interested, we don't just stay here in London. We do get around. All Board members are encouraged and expected to visit operations. So those that are travelling on other business encouraged to visit the Rolls-Royce sites. I just say this to just remind you how international our footprint is. We have 55,000 people. Over half of them are not in the UK. We employ over 15,000 in Germany, for example. Sometimes people forget that, we're seen as such a quintessential British company. Which we are in many ways, but we're a lot more than that. The Germans think of Rolls-Royce as a German company and they think it should be a German company because they'd love to be associated with Rolls-Royce. But just to get the point over, we do try and meet outside. We encourage people to do field visits, and I hope this illustrates that this is an active Board.

Warren talked about the investigating authorities. I just want to say this has obviously been a huge focus for me and the Board. It was a toughly worded judgement but that was not all bad news. The judge did acknowledge that we've taken some very fundamental steps going back to 2012 and 2013 to really overhaul. Warren answered the question [earlier] and we've seen from other companies, particularly the banking sector, starting to think about culture and compliance. But there are other things to do. One thing I would point out is we have really, really overhauled our distribution arrangements in Civil Aerospace. We used to use agents a lot. We had 150. We're now down to under 20. So some of it is structure as well, and a lot of our problems came in the dealing with distributors in Asia – agents, particularly in Asian markets. So it's not just culture and compliance, there've been some real structural changes. Big changes in incentives, and if people want to talk more about that, happy to do that as well.

And again, don't want to spend perhaps too long on this with you as you get the message but I'm just saying it again: we know it's really important. We cannot have anything like this happen again and we're absolutely determined that it will not. So ethics is a very, very important part of the company. I am absolutely in the camp that good companies have strong ethics, they have strong safety; they all link together as a standard of behaviour. And I still believe that expectations on behaviour is the absolute key to all of this. And that's what we're pushing very, very hard on.

Now in terms of priorities for 2017, top left is at the core of this. Its operations. You'll see the same slides in 2018 and you'll see the same slides in 2019. I tell you that now. This is about operations. I talk about monetising the incredibly significant investments that we – that you – we know it's your money – have made in the last seven or eight years - we've got to generate the cash returns on those investments we made. And as I hope Warren mentioned, we're in a very, very good position to do that.

Risk is a very important factor of that. This is an industry, a business with a lot of risk in it. You don't have things with 16,000 components going overhead at 2,000 degrees centigrade without risk, for example. So we're always thinking about risk. Our general approach to risk is that we identify the core risks, the 12 risks, and then where we can we allocate them to the relevant committee. So, for example, if you take disruptive technologies, one risk that we look at, we know, and Warren particularly knows with his background – that what gets you is what you don't see. And we're really focused on looking at disruptive risk, particularly around data. Artificial intelligence: that would be one of the technologies that we're looking at. And that's handled by the Science and Technology Committee and it's reported to the Board.

Some risks we take as a Board. Geopolitical risk we do take as a Board because it's so huge, and if I'd just picked two, just to give you a sense, one will be Iran – what risk can we take in Iran? The answer is none. We have to go through all the US authorities in particular, but we would look at that as a Board. And another would be for example the border adjustment tax in the US. That would be huge for us if it happened; not necessarily good. So I'll just give you a flavour of some of the things that we look about. So some risks handled at Board, most are delegated to the relevant committee. Again we can talk more about that.

Succession organisational strengthening obviously is a very important topic. We've had a lot of change in executive ranks, also some changes in the Board. We continue to look at that. We're very, very focused now on C-1, C-2. Both in terms of diversity but also in talent. And also continue to work the long-term vision. It's easy to use the v-word – the vision word, and I sometimes have said that the line between vision and hallucination is quite narrow. But it is a very, very important industry to know where you're going.

This is an industry that's changing very fast and Warren touched on it when he talked about engineering and technology. I just give you an illustration: ten years ago, 10% by value-add of an engine were components, mechanical parts. Now, 90% was component mechanical parts. Now, 25% is electronics, software and data. And it's going to get up to 50%. It's going to be data services software. We've got to move and keep ahead of the changes and what is our product, and a lot of it is going to round as data machine. And you will have read about AI and data. In a sense, this sector has been way ahead of this, as indeed has been the rocket industry in terms of data that's there and we're going to capitalise on that. So that will give you a flavour of when we talk about vision and strategy. You'll hear more about that over the years ahead from Warren about what we're thinking about.

So those are the key Board priorities. I'm simplifying a lot of other stuff. But that's really what we're about and how well we do on operational prioritising and the management gets on with it. That's their job, really making sure we're grasping the risks, putting in place good organisation succession planning and really getting a clear strategic narrative. And we still don't think it's as clear as it needs to be for the investors, possibly for the company as well. So more work to be done there. We know that. We've had a lot of distractions over the last two to three years but we really want to get on the front foot strategically and operationally. And that's very, very much our ambition for the next couple of years.

Now, moving on quickly to just the structure of governance and just to remind you of the committees that we have. We have five committees of the Board. You will know that more time is spent in committee than in Board meetings and in some ways when you're building a Board and designing a Board you're designing around committees as much as the Board itself. The Nominations & Governance Committee is what it says on the tin. It is nominations and governance. That is the non-executive directors, the independent non-executive, that's ten people, quite large, but I personally feel it's very important that all Board

members are directly involved in the shape of the Board, recruitment of Board members and indeed the design of Board governance processes.

Science & Technology Committee was introduced last year. It reflects the priorities under the chairmanship of Kevin who many of you will know and who's here with us. That is really particularly focusing on technology development, looking at technologies of the future. That would include digital. Personally I think digital's a technology of the present. If you're not dealing with digital you're going to be out of business. But we're looking at longer technologies particularly around data, around materials and big investment decisions there. And it was just too much for the Board to get their arms around that. We needed a specialist committee with Board members steeped in engineering and technology. So that's what its remit is.

Safety & Ethics, chaired by Frank Chapman who sadly cannot be with us today, he has a hospital visit. But that is very, very much focused on our safety processes. Really important when you're going through significant executive changes that you keep absolute rigorous focus on safety. This is human safety and product safety, ethics obviously are very, very important, and also environmental sustainability is on the agenda of this committee. I'll touch on that in a few seconds. And then we have Audit, chaired by Lewis, and Remuneration Committee, chaired by Ruth. You'll hear from them in just a few minutes, so I won't talk any more about that.

Just on Nominations & Governance, and you may want to ask me about this, we've done a lot of work on reviewing our governance structure both formal number of entities, number of legals, what the responsibilities and policies are. This is all in the background sort of work. Pamela Coles, our Company Secretary, has been leading that but there's been a lot of work to tie that up. Rolls-Royce has grown a lot through acquisitions of small companies over the last 20 years. It hasn't all necessarily been integrated in a governance sense and we're doing that. I've talked to you about engagement of stakeholders. This is a big focus of the Board. It's a stylistic thing and I hope you're feeling it from meetings like this. We want to be accessible. Even if you're going to beat up on us, which is fine, we want to be accessible. So you can do that. If you've got ideas and suggestions we want to hear them. And just one idea, for example, after the AGM this year we're having an employee one – it's called an employee AGM but we're having the shareholder AGM but then we're having in the afternoon an AGM which all employees can join in [with] – it's going to be in Derby. Again, it's just this idea. It's an experiment. We'll see how it works but just trying to engage in a way.

As you can imagine, employees, it's been a tough year for them and they have not enjoyed at all, all that's been going on with the SFO and the authorities. In some way the biggest constituency for these things is internal, so there's been a lot of anxiety around the company. This is to try and engage with them, talk to them. I'm very, very pleased how strong our retention rates have been, by the way, on this. We continue to look for new directors. I think the idea is to refresh – to keep refreshing the Board. John McAdam will be leaving at the AGM, having completed his nine years. Alan Davies resigned from the Board four months ago and Colin Smith will be retiring from the Board as well. So we had three departures and over the next year we're looking for a couple of new non-execs. Almost certainly finance, accounting skills, IFRS and all the rest of it. We need to strengthen that even further. We've got deep skills. But also Aerospace and Airline experience on the Board to get that perspective in. So that's the brief for those two searches which are ongoing. And at least one of them hopefully, at least one female too, very, very good progress on that. And then finally, as I said, continue to work on transparency internally and externally. So that's broadly the agenda of the Nominations & Governance Committee which I personally chair. We normally meet four or five times a year.

I'll talk about Science & Technology as we're not having a break-out on it, but do please ask Kevin about this if you want to get into details. I talked about – a little bit on the left about what we're doing on that. Science & Technology is exactly what you expect it to be. It's focused on future investments, very, very big-ticket items. I don't want to gloss it over. We're investing over £1 billion a year in R&D. We've kept that going through the very, very difficult time over the last two or three years. It is absolutely crucial but this is long, long stuff. Just to give you an illustration, there is no prospect of the money that we're spending on new engine development will come into service in ten years, within ten years. And you know as well as I know that then to turn that into money is another seven years. This is truly a long-term business but so getting the risk and the dimensioning of that right. So we're investing your money over 15 years effective before you get return. Are we really understanding the risks, the likelihoods and the probabilities? I hope this is something we can gauge even more closely with you on. It is genuinely long-cycle stuff. You know it; you wouldn't be in this room if you didn't sort of get that. But it is genuinely long-cycle stuff. And equally we've got a responsibility to be very thoughtful about it. Predicting what's going to be the case in

15 years' time, which is when the money comes in. That's what you're interested in. That's what I'm interested in. It's that sort of timeframe.

On the right-hand side the Safety & Ethics. Again I think I've touched on this. It's something we spend a lot of time on. It's not just product safety, by the way. One area where we need to strengthen our game a bit is on personal safety as well. We're okay but we're not great, and I think if you're going to be a top safety company, which we are, you've got to be top in every dimension. So I'll highlight personal safety and wellbeing. You may say that's not a key performance measure. I think it's a good indicator actually of what sort of culture and style that you have. So I want to flag that up to you.

Just a few words on sustainability. We think about sustainability in a holistic sense, not just environmental sustainability. This chart is in the Annual Report. I won't spend too long on it but we do think about it as people. Have we got sustainable talent? Are the operations sustainable for the future? Are our suppliers – we haven't spent enough time with our suppliers, you know, making them feel as genuine partners of the company as opposed to suppliers to that. And of course the engineering, can we keep delivering? Just a highlight on the people side, as you think about sustainability is there a sustainable career? Are we building the right culture? Can we do more to improve diversity and gender? This is a big focus. We're making progress. As always with diversity and particularly gender diversity, it's two steps forward, one step back. But if any company can do it in engineering in the UK, we can. The name Rolls-Royce, the fact that we are the premier engineering and technology employer, we really, really can. But not easy. For example, 6% of electrical engineering PhDs in the UK were female. 6%. I mean, it's 55% in medicine, medical sciences. So as an industry we've got to start competing for female talent before we even start doing any – we need electrical and software engineers increasingly, that's what we're looking at. The government are saying, 'We need to get more people into engineering software.' It's sort of true but for a company like us we do not want somebody with a 2:2 in electrical engineering from a third-rate university. They've got to be PhDs or near to that to really add value in this business. So this is a tough challenge.

Just a little bit on our environmental footprint. I think – I'd be interested to hear your feedback - we're getting quite good sections in the Annual Report now on our environmental footprint and this is an industry which is obviously environmentally very, very sensitive. We're making progress in reduction on all key environmental metrics with the one – the one I'll highlight, just to show that we're not just being glib about it. On waste we're going in the wrong direction. We don't fully understand why but we're absolutely determined to eliminate that. But otherwise in terms of waste and landfill, GHG emissions which are a crucial part of our product offer by the way – people always talk about fuel efficiency being number one, which is true. And costs too. But we believe that environmental emissions are going to be a big factor. With or without – this will be way beyond Donald Trump; this is a 15-year thing. We believe that a low emissions on engines is going to be absolutely fundamental in certain countries in the world. And it only takes a few countries in the world to insist on it and it has to be normal for all countries. So we see this as being an important product feature as well as just something that's right for the planet and right for the world.

So I've wittered on a little bit but let me just summarise at least my view of where we are as a Board and then take some questions. And please do find me during the rest of the morning or any time subsequent to this meeting. I do feel that we've got a good Board, it's operating very well. Unbelievably committed, I can absolutely say to that. It's very difficult to be involved in Rolls-Royce and not get fascinated by it. Frustrated, yes, too, I acknowledge that but fascinated by it. But the time that the Board members are putting in, all of them, is extraordinary and I've been on – around a number of different boards. They really, really engage and I do think we are getting on top of the key issues. We've got to be careful on this because the key issue is operational and when boards start getting on top of operational issues you've got to be careful that you don't start treading into management territory. When you're dealing with external issues it's easier for Board and management responsibilities to align. So this is something we've got to – I talk to Warren a lot about this but getting the right balance. Because as I've said, operations is the key issue so we're trying to get that right balance there. And I think generally speaking pretty well.

I hope you're getting the sense of movement, change and innovation coming. I mean, it is one thing to describe it, and of itself change and innovation is nothing. It's what happens as a result of it so this is a leading indicator and in the end we know this is all about delivery. But I hope you're getting a sense from that. I hope you're getting from me and from Warren, the Board members you talk to, about that we really, really are focused on ethical behaviours. Not just within the company, as you'd expect, but the people that deal with us; the biggest challenges for us are actually on our suppliers and distributors, and our biggest risk. And it's not something that's talked about when people talk about sort of ethics. It's really our supply chain has to be brought in and we've got a lot of work to do with some of our contractors, particularly in Asia as well on that. And the other

thing is we really, really are trying to get around the executive team to help them. One of the Board's jobs is to oversee the management but in my view another one is to support them and help them. And that's something we're really, really trying to do as a Board.

So I hope that just gives you a little flavour or a tone of how I, we, think about the Board, what we're doing in terms of composition, focus, priorities. And I hope most of all we're going back to my real objective, this idea we'd like to be accessible to you and open to a lot of you – I do want to just say many of you in this room have been really helpful to me as well and the Board. If we can keep this two-way, we're all trying to do the same thing here and that's the truth here. We know we've got to get the cash flows up; we know you deserve the return. We want that return as well so we're looking for ideas and suggestions, some of which you see here, from you as well as just talk to you about. So, John, over to Lewis talk about the riveting subject of Audit.

Lewis Booth

And IFRS 15, right? Thanks Ian, and good morning. Just as I did last year, I'm going to try and talk about the core activities of the Audit Committee and some of the key decisions we made in 2016. It's the present cast of characters. Our present committee members are Irene Dorner and Lee Hsien Yang. Alan Davies stepped down from the Board in November, and as Ian implied we'll be looking to add another committee member later this year. I think together the team brings good business experience and strong financial expertise. All other directors can and do attend our meetings. The Chairman, the CEO and the CFO are always at the meetings, as well as key members of the Finance team and KPMG. But for example, Ruth and previous to Ruth, Dame Helen, almost always attended the Audit Committee so that we kept Remuneration and Audit close together.

I discuss Audit Committee matters privately with the committee members to make sure that I'm not missing any of their observations that they're not going to express in open court. And I have private meetings with the Finance team and with KPMG before every committee meeting. Jimmy Daboo, our lead audit partner, is here representing KPMG today and he'll be joining me in the break-out sessions later on. And ask him anything you like. I think he'll demonstrate he truly is an independent auditor.

So turning to the agenda, I'm going to cover the following topics, primarily focused on the changes since last year rather than the committee's terms of reference, which you can find in the Annual Report. Firstly the appropriateness of accounting policies and judgements in financial reporting. And in particular I'm going to focus on the implications of IFRS 15 and how we're preparing for its implementation in 2018. Then we'll also look at risk and the control environment. We'll look at internal and external audit including the audit tender process and the selection of PWC as our new auditor. And finally our improvements to management information and forecasting. And then I'll close with just touching on our plans for this year.

So turning to financial reporting. Key to the effectiveness of the Audit Committee is the review of the accounting judgements that the Company makes. There are several important ones last year including our long-term contract accounting methodology. Judgements around impairment on acquisition of our Marine business given how the Marine business had been in a tough period. A review of goodwill at Rolls-Royce Power Systems. The restructuring of our post-retirement benefits and the recognition of deferred tax assets. And, as will keep coming up, the review and the planned implementation of IFRS 15. We also conducted within the company a substantial review to ensure consistent applications of our policies which resulted in some minor changes to ensure complete consistency. And overall we're now confident that the accounting policies, key judgements and estimates are appropriate and balanced. The FRC did conduct a review of the 2015 Annual Report and did not identify any questions or queries which they wished to pursue. And we've taken their comments into account as we prepared this year's report.

Now the slide you've all been waiting for. IFRS 15 has been a significant project for the Audit Committee and particularly for Rolls-Royce as a whole. We engaged EY to support us and built a core IFRS 15 team which at its peak was over 25 people. The Audit Committee has been heavily involved with four specific meetings and an all-day review once the initial results were available. At the 2016 interims we introduced our initial views on how the principles of the new standard would affect us and followed this up with the November Capital Markets Day with the workshop looking at the impacts and 2015 figures. The content of the meeting and videos from the meeting are available online so if you really want to – if you weren't at that meeting, if you really want to get into that, I really recommend you take a look at the videos and the material. We've been leading I think on public disclosures in terms of our engagement, appropriately so because of the big impact it has on Rolls-Royce. And as I said earlier, it's required a major effort within the Group and in particular within Civil Aerospace.

In 2016 we focused on the principles of the new standard and our interpretation, together with an initial view based on an analysis of our 2015 results. This year we'll roll that forward to 2016 results so people have a two-year view. And in 2018 we'll initially report that our 2017 numbers under current GAAP and then the interims for 2018 will be under IFRS 15. We're targeting to provide 2017 IFRS numbers early in 2018 ideally at the full-year results. I'm sorry, that's a bit of a mouthful, which is why we've tried to lay it out on a time chart.

This slide was showed at the Capital Markets Day because the material impact is in Civil Aerospace where around half of original equipment and two thirds of aftermarket revenues will be affected. The basic conclusions of our review to date are threefold. Our OE accounting, the way we recognise profit and revenue on the sale of an engine will move to a more cash-aligned system where we recognise only the engine revenue and cost at point of sale. This will adversely affect our revenue and profit recognition, particularly if we continue to make loss on our engine sales. For aftermarket revenues the position unfortunately will be less effective in aligning profits and cash as we will not be able to fully recognise revenues and profits until we incur related cost events even if we receive the cash. And thirdly, as a result of that, we expect to have a significant build-up of creditor balances as we bring in cash from the growth in our installed base. The consequences of these changes will result in the significant set of transition adjustments to our balance sheet as we remove the impact of the old standards and accrue the effects of the new one. And it will take some time to catch up in terms of reported profit with the existing standard, particularly for our OE business. But as we've continued to say and as Warren mentioned this morning, cash flows remain completely unaffected by the change in standards.

Turning briefly to risk and the control environment, we continue to increase the robustness of our processes, having strengthened Board oversight during 2015 and included a revised risk management policy at the beginning of last year, which included the assessment of risk as part of the Board's Annual Strategy Review. We've also ensured that the outputs of these risk processes have been properly reflected in our accounting judgements, our assessments for growing concern, and in the viability statement. We continue to keep a high level of vigilance for cyber security threats and ensure that appropriate procedures are in place. And we continue to make progress in looking forward, and our guidance on the likely outcomes for 2016 were substantially better than in previous years. On internal control the process continues to be refined. Improvements in 2016 included the issuance of the governance framework included for entity level controls. After a robust review of the effectiveness of the controls we conclude they meet the requirements of the corporate governance code although of course they can always be improved.

The Board or Board committees undertake annual deep dives into each of the company's principle risks. During 2016 the Company identified the new principle risk of disruptive technologies on business models and that's overseen by the Science & Technology Committee. Management also recently presented to the committee a detailed review of the effectiveness of our risk management system and we've approved a programme of enhancements for this year. And on the viability statement, in 2015 we prepared our first five-year viability study. We felt that was an appropriate timeframe for what is inherently a long-term business. This looks across both individual and multiple risks on the business and its financing. This year we extended the review to include the mitigating actions the Group could take in extreme circumstances, and overall we're satisfied the viability statement has been prepared on an appropriate basis.

The effectiveness of the internal audit function is key to the monitoring of the Group's processes and controls, and we're pleased with the progress made in the year. In particular the time to complete all audit actions has reduced significantly and is now in line with expectations. And our root-cause-and-answers methodology is now working well. The Sector Audit Committees 2016 was the second full year of implementation, and they're now well-established and proving effective in making sure that the operating management is fully engaged and supporting the remit of the Audit Committee.

Overall I think internal audit is working well but it will continue to drive improvements in areas such as data analytics. At the start of the year we undertook a review of the quality of the external audit team which provided useful input and good preparation for our audit tender. The external audit review process worked well this year and we continue to support the extended auditor's report in our accounts. The structure of this report provides users with a clear signposting of key changes and key risks, and a useful commentary around how they engage with management to test the assumptions and evidence. This underpins the robustness and transparency of our reported financial results. The FRC in their recent AQR for KPMG noted only limited areas for improvement, which were factored into the 2016 process, and the FRC considered the auditor's report to be of a

particularly high standard. I'd like to thank Jimmy for his real push on this because I think it really has added to some transparency of our business.

As I mentioned last year we are required to appoint a new auditor no later than 2020. We plan this process to coincide with the mandatory rotation of our lead KPMG partner Jimmy Daboo, and formally tendered the audit in 2016 for the appointment of a new external auditor in 2018 when Jimmy would've rotated off. We reached out to major firms together with some of the second tier and undertook an eight-month process focusing on their relevant experience, comprehension of our business issues and the quality of their audit offering. Unsurprisingly, there was little to differentiate between the major audit firms in many areas. Where PwC scored highly was on demonstrating their understanding of our business, its industrial context and its complexity. They also clearly grasped both the business and accounting issues faced by us in the forward years. The team put forward by PwC had real bench strength across all of our sectors and key territories, combined with a strong lead partner and a highly capable second partner. Both Audit Committee and Executive team were in agreement as to the choice, and in December we concluded that PwC should be our new auditor from 2018 and have recommended that the Board proposes this to the 2018 AGM. And just to confirm by the end of this year PwC will be fully compliant with EU rules on non-audit services.

Historically, there have been issues around the quality of the long-term planning and the timely analysis and communication of market events. What has been the real challenge is our forward-looking assessment. This is partly understandable given the dynamics of long-term contract accounting. The work undertaken by David Smith during his time as CFO to improve the flow of management information will continue under our new CFO, Stephen Daintith. I know Stephen is very focused on addressing this long-term forecasting challenge, looking to identify and report on the business metrics which are key drivers of cash performance. The move to IFRS 15 will help this to some degree, but unfortunately it's not a panacea.

In addition, Warren's organisation changes made in 2016 have added clarity and management accountability, particularly in Civil Aerospace. And then, looking forward to 2017, we have a number of specific activities including reviewing the support and the introduction of IFRS 15, the effect on this environment of improving management information systems, and ensuring the seamless transition to PwC as our auditor. Further ahead, another accounting standard, IFRS 16, on leases, will become relevant to the Group for 2019, and we'll review during 2017 the Group's plans to address this. We'll also monitor other relevant matters arising from Lord Gold's recommendations, and from the agreements with the investigative authorities, anything that's outside the remit of the Safety and Ethics Committee, principally the risk and controls.

So in summary, I think the Audit Committee's providing effective financial oversight on behalf of the Board, and the meetings are a healthy blend of scrutiny, robust challenge and support and guidance for the executive team. And I'll be happy to go into any of these activities or anything else you want to talk about in the breakout sessions. And with that I'd like to hand you over to Ruth Cairnie who's going to introduce the Remuneration Committee.

Ruth Cairnie

Good morning to you all. I'm delighted to have this opportunity to talk about the workings of the remuneration committee. I'm just completing my first year as Chairman of the committee and I'm delighted to have been able to meet many of you during our consultation process. So, looking at membership – so I'm very pleased that we've recently welcomed Lewis to join the Remuneration Committee, which makes that linkage even stronger between audit and remuneration.

In this short session I'm going to talk about the main areas of focus in remuneration during 2016, particularly about the thought process that the Committee's been through in formulating our new remuneration policy, which will be proposed to shareholders at the AGM in May. And I'll also talk particularly about the 2016 incentive outturns. First though, probably useful to have a reminder of the terms of reference for the committee. These are unchanged since last year. And a word about the sort of conversations we have at remuneration: they are very open, they are very thoughtful, and they are very robust. We're very well supported by our Reward team. Natasha Rice, our Head of Reward, has also met with many of you. She's not here today but Claire Sykes from her team will be joining me in our breakout sessions. And we've been advised by Deloitte again throughout the year.

Coming to the areas of focus in 2016 – we did have a number of executive team changes. And as mentioned – David Smith has left the Board and he's been replaced as CFO by Stephen Daintith. We've also recently announced that Colin Smith would be stepping down after the AGM. Payments to both David and Colin are in line with their contractual entitlements. Neither will

participate in 2017 incentives, and any PSP awards that pay out, that will be done on a pro-rata basis. Stephen Daintith's package was announced on his appointment. His salary will be lower than he received at the *Daily Mail*, but his long-term incentive opportunity will be higher. The long-term incentive that we have set - we have used the headroom that we have had in our existing remuneration policy on recruitment - the level is in line with the new proposal for the new policy.

Other topics for the year – so I'm coming back to the outcome on incentives. We reviewed executive base salaries, and of course the major exercise for the year was the new policy which will form a large part of what I talk about now. But I would note straightaway that we did very much go back to first principles. We looked at a whole range of issues, we looked at different potential structures for reward. And we did seek a genuine consultation at different stages through our development of the policy, so we did not wait and come up with all the answers and then go out to engage.

Coming to 2016 awards which has been receiving a certain amount of attention in the press, it is the first time in three years that we are paying any bonus, and that's not just to executives; that's to the entire workforce. And it's because we did outperform, as Warren has talked about, against both our cash and profit metrics. I need to say a bit about target setting for 2016. Warren has talked I think very clearly about the factors that led to 2016 performance being lower than 2015, of which many are structural and about where we are in this business. Given those reasons we decided it was appropriate to set bonus targets that were lower than 2015 performance, but we put our focus in ensuring that there really was significant stretch in the targets that were set. The underlying company performance in 2016 exceeded those targets both on cash and profit, and so the Committee felt that it is appropriate to pay a bonus for the year.

The Committee looked very carefully at the outturn at the numbers. We inspected them and we concluded that it was appropriate to make some adjustments for unbudgeted elements that we felt appropriate to exclude. For bonus purposes we reduced the cash outturn from £100 million to £48 million and we reduced profit by £100 million. But with those adjustments the outturn was still above target level. The Committee then decided to stand back and look at that outturn in the round to decide if it felt appropriate, looking at all factors in the business performance and also taking account of the factors that drove the reported numbers as well, which Warren has talked about.

As I outlined in my letter in the Remuneration report on the hedge book; Warren talked very clearly I think about what the hedge book's mark to market is all about. We felt very strongly that that it should not impact remuneration. And we thought hard about the SFO and DOJ issues and penalties. In Ian's slides he showed the quotes from the judge. The judge himself very clearly separated the previous actions from current management. And so again our conclusion was that that should not be coming into remuneration. But nonetheless taking all of the above into account, we did decide to apply discretion and we reduced the bonus level from 'above target' to 'on target', which we felt was a better balance overall.

For LTIP awards, these continue to fall short of the targets that were set. So in 2017 there was no vesting of the 2014 awards. We expect the same to be the case for the 2015 awards in 2018. And that will mean three consecutive years of zero pay-out on the LTIPs.

For salary reviews, the average increase for our employees is 2% this year, and Warren will receive the same increase. But for all of our managers we are deferring salary increases until 1st September.

The rest of what I'm going to talk about is the new policy. We identified four key things that have really underpinned and driven our development and our thinking. So they are: supporting transformation; talent; stewardship; and simplification. Starting with supporting transformation, this is really that critical linkage between remuneration, reward, and strategy. Rolls-Royce is at a pivotal stage in this transformation of the business. Warren has talked a lot about the ramp up in engines, the improvements in the manufacturing footprint, the critical organisational and cultural transformation that we're undergoing. And we believe that there must be a really strong link between reward and delivering that transformation, that's a key driver for us.

Turning to talent, in 2016 we sought to recruit into a number of senior positions. Warren talked about those at the executive leadership team level, but at other levels in the senior leadership group we've been seeking to bring in talent, strengthening leadership capability, and bringing in experience of significant change from other sectors. And in this we encountered real evidence of our reward packages not being competitive. Not sufficiently competitive to secure some key talent that could make a real contribution to the transformation in Rolls-Royce. We were at the time very conscious of the attention being paid to

executive pay, and the sensitivity of proposing any increase, but we also felt that we must address this shortfall in our remuneration package. The LTIP was the primary focus here. That was where we found that we were most challenged. Stephen's package is one example of this, but there were other examples of this at levels below. And so through our consultation we were really seeking to test views on quantum, and we're looking very carefully to the feedback.

On stewardship – we recognise the continuing importance of aligning executive and shareholder experiences. This was supported by our extensive consultation and also some specific choices in the policy design. And finally, on simplification – we recognise that our reward package must be transparent and it must be simple to communicate and understand if it's going to be effective for – as an incentive.

Now looking at consultation – we did consultation in three rounds – three waves with our largest shareholders. And this chart summarises the key feedback and support that we heard. There was good understanding of the level of challenge that we faced in delivering our transformation and a real recognition that Rolls-Royce has been very modest in the incentive opportunities we've been operating, compared with our peers, and that this is now impacting our talent agenda. A clear majority of the shareholders we spoke to were aligned with our views that we need to link reward strongly to performance and in particular to delivery of our transformation. And there was also support for a simpler approach. We consulted widely on measures and we received a very strong message from most of our shareholders that they see cash flow as the most important performance measure.

Several asked us to consider a long-term returns measure in the mix, but on reflection we feel that that would be too opaque as a Group measure, given the different natures of our businesses, the differing sources of R&D funding, and the very long-term investment cycles. Some shareholders were quite ambivalent about including TSR as a measure. But we do want to maintain a portion of our incentives that is linked directly to the in-period value being delivered to shareholders and which also reflects the wider industrial context.

Coming to quantum, the vast majority of shareholders we spoke to were supportive of our need to increase the LTIP opportunity. Some favoured a significantly more highly geared approach with higher incentives than we were suggesting and on balance we've opted for an operational LTIP maximum which is an increase – a significant increase – but it is not as high as was suggested to us by some of our shareholders. And finally there was a clear message from the consultation that any increase in LTIP must be linked to appropriately stretching and increasingly stretching targets. And I'll come back to this.

Coming to the final proposed design for 2017, the overall structure – salary, benefits, annual bonus and long-term incentive plan – remains unchanged. And that is very much our continued focus on reward for performance. The annual bonus and LTIP structures are simplified. We've moved away from some multiplicitous structures, kickers and hurdles, and we're going for simpler, additive components in the incentives. The performance measures of CPS, EPS and TSR remain unchanged, but we've given very careful consideration to the weighting of the measures, particularly for the LTIP, and we are proposing 60% weighting on cash flow growth, reflecting the importance placed on cash by both us and shareholders. We're proposing an increase to the maximum level of LTIP to 250% of salary for our CEO, and 225% for executive directors, to enhance our ability to attract and retain talent in very competitive markets. We're proposing additional head room for the LTIP, but this will only be available for recruitment, and at the same time we are removing existing additional headroom on the annual bonus for recruitment. So we're taking something away there and simplifying.

The increases to overall LTIP maximum are balanced by a couple of other changes. We're reducing the amount of LTIP that vests at threshold from 30% of maximum to 20% of maximum, and we're introducing a two-year holding period that will run after the three-year performance period in the LTIP. The executives falling under this scheme are the executive directors and Warren East's direct reports, but if you go further down the organisation there are some 800 employees under the LTIP, and 8,000 employees under a management bonus structure that is parallel - similar to the one presented for the executive directors.

And finally, some comments on metrics. We have very much taken into account the need for stretching targets, particularly in the context of an increased LTIP opportunity. Our 2017 targets represent a significant increase over 2016 - they've been derived from a range of possible outcomes from our medium-term plan. Both EPS and CPS will be based on cumulative performance over three years, and TSR will be measured against both the FTSE 100 and the S&P Global Industrials index to reflect the fact that this is an increasingly global business. We believe that these targets represent an appropriate balance, so executives can see a

realistic prospect of reaching to threshold. At the same time, significant rewards can be earned should the team drive performance up to the upper levels of the range.

The target levels for maximum vesting intentionally include significant stretch in the context of current and forecast business performance. So for example on cash, taking a three-year view, maximum pay-out of the LTIP would imply around £2 billion of cash flow, cumulative, over the three years, which I think everyone in the room would probably recognise would be a fantastic performance.

Taking everything together I believe we've struck a good balance given all the aspects of these proposals. We continue with a philosophy of paper performance. Our design is clearer and simpler and it reflects the invaluable views of shareholders from our wide consultations. So I hope for your support for this at the AGM in May and I look forward to further discussion in the breakouts.

The plenary session finished and the programme moved to smaller breakout sessions which were not recorded.

Wrap up following the return from breakout sessions

There were no further questions from the audience and John Dawson concluded with the following:

Thank you very much for taking part, and we welcome your feedback. I'll send out a little note in a couple of days' time probably just to capture your feedback and make sure you've got what you wanted out of the session. And if there are any outstanding questions either on an IR basis, please contact a member of the IR team, or as the Chairman has said in his different discussions, the Board is here to be open to you and accessible to you, so if you wish to meet with them, please don't hesitate to contact us and we will facilitate that. Thank you all very much for taking part.