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RR.L - Half Year 2017 Rolls-Royce Holdings PLC Earnings Presentation

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CORPORATE PARTICIPANTS

Warren East *Rolls-Royce Holdings plc - CEO and Executive Director*

John Dawson *Rolls-Royce Holdings plc - Director of IR*

Stephen Daintith *Rolls-Royce Holdings plc - CFO and Executive Director*

CONFERENCE CALL PARTICIPANTS

Charles Armitage *Citigroup Inc, Research Division - Head of European Aerospace and Defense Equity Research and Director*

Christian Laughlin *Sanford C. Bernstein & Co., LLC., Research Division - Analyst*

David Perry *JP Morgan Chase & Co, Research Division - Head of European Aerospace and Defense*

Nick Cunningham *Agency Partners LLP - Managing Partner*

Robert Alan Stallard *Vertical Research Partners, LLC - Partner*

Tristan Sanson *Exane BNP Paribas, Research Division - Head of Aerospace & Defence and Equities Research Analyst*

Gordon Hunting *Fiske - Analyst*

PRESENTATION

John Dawson - *Rolls-Royce Holdings plc - Director of IR*

Okay, I think we're ready to kick off. It's just going up to 9:00.

So thank you all very much for joining us here at the London Stock Exchange and for those of you joining us online.

My name is John Dawson. I'm the Head of Investor Relations at Rolls-Royce. It's my pleasure to welcome you here to our half year results presentation for 2017.

The agenda for today's presentation is as follows. Warren East, our Chief Executive, will share his perspectives on the first half from an operational point of view. Stephen Daintith, our new CFO, will then run through the financial results in a little more detail and share some of his perspectives on the business in his first 6 months. Warren will then return to give you some perspectives on the second half of the year and our challenges going forward. Our presentation should last around 45 minutes. We will then take questions from the audience and also online, so if you wish to ask a question online, please submit that through the webcast service on the webpage. And we will endeavor to answer those if they haven't -- answer those questions if they haven't already been answered in the room.

Finally, if I can ask you all to please turn off your mobile phones and make sure there's no interference in the presentation. We aren't expecting any emergencies this morning, so if the alarms do go, then we just need to exit in the normal way out to the front and Paternoster Square.

Thank you, and I'll now hand you over to Warren.

Warren East - *Rolls-Royce Holdings plc - CEO and Executive Director*

Good. Thank you, John. Good morning, everyone. And as John said, I'll just make some initial comments, and then we'll have Stephen go through the numbers in some detail. And good news, clicker works.

So it was -- I think, for the first half of '17, it's a good set of results. There are clearly positive trends year-on-year in our financial performance, and it's always good to be standing here with that context; and a good performance in terms of revenue and margin, leading to profit growth. I think,



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for me, what's encouraging is that set behind these numbers are some genuine, encouraging operational progress in all parts of our business. And obviously, there are some significant movements, but some of that is the law of small numbers. And for the time being, our board has decided to hold the dividend where it is.

Now let's look at some of the highlights from my perspective, sort of standouts in the first half.

Clearly we're in the midst of, and we've been talking about for some time, a period when we are ramping our volumes of large engines that we deliver. And clearly this has been a question mark: Are we going to be able to ramp up sufficiently, or not? Last year, we grew volumes year-on-year from the previous year. This year, we have a big step-up to do. We're halfway through the year. We are achieving a step-up, volume production's up -- volumes produced up 37%, deliveries up 27%, so I think we're addressing that question. Importantly, behind that, and we've been fairly open, the new engines are still -- or from an OE perspective, we lose cash every time we ship one of those engines out of the door, but there has been good progress, in particular on XWB around the economics there. And that is driven not just by the effect of launch pricing running out, as we said would happen during this year and during next year, but also there are cost-reduction initiatives and cost-reduction results coming through behind that general improvement.

It's particularly encouraging for me to see a strong first half in Power Systems. The new leadership there is addressing some of the issues that we've had and in particular addressing things like the rather skewed seasonality that's been happening in that business over recent years. And that, amongst other things, has led to a strong first half for Power Systems. And at group level, our transformation programme continues. And we are 3/4 now of the way through the 2 years that we set out at the end of 2015, and we're still ahead of plan on that.

Shifting the balance of technology and engineering was important for me. And in the first half of this year, we did some organisation change which shifts that balance so that, as we look to the future, we're feeding our excellent engineering with the best technology. And that's a change which we've made. I'm putting on the slide successful organisation changes, very, very early days at the moment, but I can already see a change in emphasis inside the company, which is quite encouraging. That said, of course, we are continuing to concentrate on engineering delivery and delivering important milestones on our future programmes around Ultrafan, the big gearbox. And later this month, yes, it's August 1, so later this month, we'll be testing our Advance 3, which is the engine that sits behind Ultrafan.

Now it's not all glorious. We do have some challenges. And certainly some of the challenges that the Marine business faces are still very evident in the numbers that we talk about today. And there it's a sort of balance between restructuring and market conditions I'll talk about in a moment. And I think a big issue for us right now is the in-service challenges that we are facing in our Civil Aerospace business. Now this is a scheduled programme of maintenance, particularly around our Trent 1000 engine which is powering the Dreamliner, causing some problems for us and for our customers at the moment. And of course, we regret the problems that that's causing to our customers. You will see some of that in the press, but we are working very hard to minimize any operational disruption that our customers face there with our scheduled program of maintenance.

So a very, very quick summary now looking around the business.

I'll start with Civil Aerospace. Clearly, good to see both OE and particularly aftermarket revenue increasing year-on-year. We've got a long way to go in terms of profit, but it's good to see some improvement. Some of the things that are driving that, of course, is the growing size of the installed base, the fleet that's in operation. And as we grow that with our new engines faster than the older engines that are retiring, we get a growth in the size of the overall fleet, and that's fueling our aftermarket growth. I mentioned before the production ramp in terms of volume. That's very important to us. We'll do more in the second half of the year, but it's been a good start. Balancing that volume production, of course, we've got new engines that we have to get through the final stages of development. And as I look into the second half of this year, the good news is that, the XWB-97 and the Trent 1000 TEN, both on schedule for entry into service before the end of this year. The Trent 1000 TEN, now that was witnessed on its first flight on a 787 by President Trump. And then later in the year, we saw XWB flying at the Paris Air Show, and that was witnessed by president -- new President Macron, so kind of very sort of presidential first half for our new engines. And the Trent 7000, which will enter into service halfway through next year on the new A330, the Trent 7000 engines have now been delivered -- or were delivered in the first half, i.e., before the end of June, to Airbus. And we're expecting the first flight on a new A330 happening in the next month or so.



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So switching to Defence Aerospace, revenue down a little bit. Stephen will summarise the detail there, but notice that profit is up. And that's really due to an emphasis in our Defence business on innovation in the aftermarket because this business is all about attending to customers' needs at the moment. And you can see that with some of our new Service Delivery Centres where we're getting closer to the customers in operation, where we're concentrating on making sure that the deliveries that we do make to our customers come through right on time. One of the things that's helping us in the aftermarket is we, in the first half of this year, also extended a very -- a long-term agreement that we've had with Aviall. Aviall is now actually part of Boeing, but we've had an agreement with them for a long time on spares. And we've extended that now to cover literally thousands of defense engines, and we are benefiting from their extensive network.

Power Systems. I said that it was good to see an encouraging first half there. The new management really is revitalizing our business. There's an emphasis that you will see come through in the numbers eventually on taking the service model from our aerospace business and applying that to the large installed base that our Power Systems group has. And so there's been quite a bit of effort on that, and I hope we'll have some news on that in the second half of the year. There's also been progress with joint ventures. It's good to see in the numbers some of the -- some market recovery coming through, so OE sales up 5%. And that results in overall revenue increase, but it's good to see a greater profit increase coming through from some of the cost-reduction initiatives actually bearing fruit. In terms of orders and looking forward to future business, it's been a good first half for orders, as multiple sectors have enjoyed some recovery. I mentioned at the start we're putting quite a bit of effort into trying to address the continued seasonality skew that's been happening over the last few years, obviously the question mark in the right-hand bar on the histogram there because it depends how well we do in the second half, but we absolutely expect to have addressed that skew somewhat.

And looking further ahead to costs. One of the things we've been talking about for some time, in the bottom right hand of the chart there, this is sort of demonstrating the 80-20 nature of the product portfolio where 80% of the revenue has come from 20% of the products. And so we're going to make significant steps in reducing the number of product variants, and that is now under way. We're aiming for a number significantly more than 25%, but we're 25% so far.

Switching to Marine. As I said, the story is one of balance really. As far as the present is concerned, we're trying to balance the continued depression in the offshore market versus the restructuring that we're doing. And hopefully, we'll get fairly close to a break-even situation. Obviously, we're consuming cash still at the moment in that business. And then as I look forward, we look forward at trends around electrification, autonomous shipping, more stringent environmental controls, more stringent safety standards. And so the investments that we're making there are around technologies relevant to those trends in the Marine business, also particularly relevant to some of those trends that apply to other parts of the group.

And in Nuclear, it's been a steady first half to the year; revenue up a little, with increased activity in our submarines business; profit down because we're maintaining R&D investment. And that's been offset by some of the sort of positive transformation benefits, but some of that R&D investment particularly around our small modular reactor initiative in the civil space. The submarine business, we continue to develop that for the future engaging with our U.K. government customer. The focus has very much been on improving the performance for that submarine customer, performance coming out of our components operation. And that's a very, very significant performance improvement versus the first half of 2016, and the challenge now is to sustain and improve on that level of performance. And in the civil space, we've had some good headlines with some orders and achieving preferred bidder status on various projects.

Transformation across the group. We've had a go here at representing graphically the difference between our run rates and achieved savings in the year. We are on track to deliver at the top end of the expectation, i.e. at least GBP 200 million of annualized cost savings versus 2015 -- versus the end of 2015, where the chart starts, by the end of this year.

So I think, first half, good start, focusing on the things that we said we were going to focus on, delivering the things we said we were going to deliver, transformation programme on track.

With that, I'll hand over to Stephen to talk through the numbers in a little bit more detail. Thank you.



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Stephen Daintith - *Rolls-Royce Holdings plc - CFO and Executive Director*

Okay, well, morning, everybody. There's 1 or 2 familiar faces in the room, but I think I'm getting to know many of you for the first time. So I look forward to working with you over the next few years and getting to know you better.

Stephen Daintith. Just joined in early April, so just over or around 4 months or so into Rolls-Royce. I think I've joined the company at a very exciting time actually. Warren has alluded to this in his opening comments, but there's a massive amount of work going on across Rolls-Royce that struck me a lot in my first few months, lots of good energy as well and real ambition across the organisation. And I think we can see a big opportunity ahead. There's lots to do, as Warren has highlighted, but it's all doable, so it's very much around our effective execution. So it's an exciting time to join. And I first got to know the company late last year. And I met Warren around August, September, early August; and then various members of the team. And I started to jot down then what I thought were my priorities were likely to be over the -- over my first sort of 6, 12, 24 months in Rolls-Royce, and so I'm starting the agenda today with just an outline of those priorities. Then I'll move on to the results. And I've got 1 or 2 accounting changes to talk about.

So looking at the priorities. Interesting enough, these 5 priorities I'm about to outline haven't changed since those first early months when I first started gathering my thoughts and hearing what the various executives and board members and so on and management across Rolls-Royce were saying to me, and indeed the external people that I met as well, around the challenges that Rolls-Royce faces and the issues that it needs to tackle. So here are the priorities that we're working on right now: Number one is cash. I'll talk about all of these separately one by one. Two is costs. Three is balance sheet and capital allocation. Number four is clearing the fog, using Warren's terminology there. And five is a strong finance team as well. So going through these one by one.

So cash, first of all. I think it is the best indicator of economic performance. There has been a historic disconnect with profits. And the table down the bottom shows cumulative profit and cumulative cash over a 10-year period, and what it highlights is the stark difference between the two. And I think it's been we've been reminded that, I think, GBP 781 million was our sort of record achievement of cash generation in a single year. And I put there understanding and managing the key drivers as well, which I'll get on to in a second on a couple of other slides, but really understanding what's driving cash flow across Rolls-Royce, across all of our divisions, an understanding of that, and then allowing us to think about where and how cash flow might develop over the next few years. There's been a lot of media and market commentary on the GBP 1 billion of free cash flow by the end of the decade. Just to clarify that: It's not an internal target, but we really do like the focus on cash. We think it's right and appropriate. And indeed we would hope that we can go beyond that number over the next few years. There is a road map to a free cash flow that looks like that and beyond it, but of course, there are lots of operational issues along the way to manage it. What I'm going to try and do here is show you some of those building blocks to a growing free cash flow; and over the course of the next couple of results releases, add a bit more detail to how that is developing and our progression towards a growing free cash flow. But we do welcome the focus on free cash flow, and we're very comfortable with that GBP 1 billion that's being talked about.

So the road map to a growing civil free cash flow. First key driver is the economics around OE. As Warren mentioned in his opening comments, we do sell our engines at a loss. So the cash margin per engine sold, an improvement of that cash margin, in other words a smaller loss, ultimately leading to breakeven for 1 or 2 of our engines, remains incredibly important. The XWB progress in particular is a key indicator for us given the size of the ramp-up that we anticipate in the XWB over the next few years. And again as Warren has mentioned, we've made good progress over the first half of the year. And we see the route to further progress over the second half of the year as well on the XWB.

The aftermarket value and the growth of the aftermarket margin. The growth in the installed engine base, right now just over around 3,000 or so wide-body jet engines, we'd hope to push that beyond that over the next few years as we increase our production ramp-up and deliver around 500 engines or so a year. Growth in flying hours goes with the growth in the installed base but also passenger hour growth as well; and then shop visit efficiencies, how often are shop visits taking place and what is the cost of each shop visit as well. These are key drivers to a growing free cash flow. I'm using civil here as the key example because it is acknowledged, and we acknowledge it too not only externally but also internally, that the civil cash flow is the one that will be the biggest driver of all the drivers to a growing free cash flow for Rolls-Royce.

And then finally, cost management and capital allocation. This is transformation across various buckets. So a focused improvement on operations and commercial and administration costs. We're seeing some of that coming through already in our half year numbers. Disciplined capital allocation



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on CapEx and R&D, I'm going to talk about this subject in a little more detail in a few slides going forward. And then working capital management, always a key part of good financial management across an organisation.

So looking at Civil Aerospace. This is the trading cash flow for 2016, as previously presented in a traditional format for reconciling profit with trading cash flow, with various entries in between. And I am hoping that we can move to looking at cash flow under a different lens by looking at those key drivers that I've just run through on that previous slide. So an alternative view of free cash flow for civil, and I'll take a little while on this slide because there's a lot happening in here, is to get to the same outcome of basically a break-even business but to show what's happening across the various lines. And don't take this as any sort of audited, precise set of numbers. I'm trying to give you a shape and a direction and a feel for how the model currently works. And we -- and then going forward, back -- in March next year, I can add a bit more precision to this when we talk about the 2017 numbers and the outcome there.

So looking at the OE economics, 320 engines delivered last year on wide-body at a average margin loss of around GBP 1.6 million cash each, getting us to an outflow of GBP 500 million; 11 million engine flying hours, generating an aftermarket cash margin of GBP 1 billion. So the -- looking at the top number, the original equipment, clearly we're hoping for progress on the GBP 1.6 million over the next few years, XWB in particular. And then the 11 million engine flying hours ought to grow as well as we grow the installed engine base, as Warren has mentioned in his opening comments. The sale of some spare engines on the wide-body fleet, they go in as well. And they get us to a wide-body cash margin of GBP 0.7 billion. And we add in then the cash flows for the business and regional engines of GBP 600 million, the V2500 royalty around GBP 300 million; gets us to a gross cash margin of GBP 1.6 billion. You may be wondering where the additional factory costs and the sales-related costs, the AFCs and the SRCs, have gone. We've allocated that GBP 1 billion that you might be familiar with across 3 buckets. GBP 300 million of it is amortization, depreciation, which is noncash. So then you're down to GBP 700 million. And then operations and engineering is -- makes up the balance of the GBP 700 million of what is -- we called AFCs and SRCs. GBP 300 million of commercial and admin costs takes us down to an operating cash margin of GBP 600 million. And then we're spending around GBP 600 million in R&D and CapEx in the civil business, a bit of working capital improvement. And we get to the position that we see today.

So I'm showing this model to show you where we think the dynamics -- or the key dynamics are going to be over the next few years, largely in the OE economics and the AM value line. There's some good progress also on cost management and capital allocation, developing the building blocks to that GBP 1 billion of free cash flow over the next few years.

Costs, a relentless focus on costs across Rolls-Royce. And this is one of the areas that struck me most in my first few months. It's how much activity is taking place in every division across Rolls-Royce and across all the functions in Rolls-Royce as well.

Just highlighting a couple of specific examples across these areas: The XWB-84, we have stated before and we repeat this ambition to be breakeven by 2020, good progress in the first half of this year and anticipated progress in the second half as well. I think we'd be more explicit about the progress that we've made here in March next year.

Footprint and factory utilisation, we are targeting a 20% reduction in footprint by 2020. And at the same time, we're looking for factory utilization of at least 80% by 2020. Right now, it's about 65%, so good improvements in factory utilization. That's on a 24/7 basis.

Life cycle cost reductions, we continue to look at how we can make our shop visits more efficient across our fleet, targeted engineering to reduce costs over the life of a contract. And then process efficiency, simplification, a lot of simplification opportunities across Rolls-Royce being pursued. And this this does free up time. Theoretically, productivity will improve. Rolls-Royce likes its processes. And we have enjoyed making what ought to be simple things quite complex and complicated. And I think there is, as have been mentioned previously, a lot of opportunities to improve and simplify the way we look at and manage the business.

And finally, commercial and administration management of those costs, tight headcount control in particular. We put in place a headcount freeze, I think, around 6 weeks or so ago. That's working well across the business. And we do see in the first half results, as I'll show in a second, some good improvement on commercial and administration costs over the half year.



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Balance sheet and capital allocation. Rolls-Royce, as you know, is a long-term business. We build engines for the long term. We enter long-term contracts. Delivering a strong free cash flow is not just important in its own sake as a successful, growing business, but it's with disciplined capital allocation gives us then flexibility for investments. And it will be good to have a sort of business where we have a strong free cash flow and disciplined capital allocation so that we are -- we do have a position whereby we can invest for the future and place some of the biggest stakes where we see opportunities for growing cash flows in the future in new engine programmes. That disciplined capital allocation is very important: that we are sensible and disciplined around setting return on capital targets, cash return on capital targets over not short-term cycles but medium, long-term cycles, so 5-, 10-, 15-year cycles; and being public about what those expectations are and what those targets are.

So we would hope that putting all of these three together will lead us to be secure as investment grade and ultimately delivering a pathway to a sustainable A rating. And indeed, in my meetings with Moody's and with S&P, they too are looking at a free cash flow, a growing free cash flow, as the key indicator that they will be looking for to secure our investment grade and then return to an A-rating status.

Return on capital targets, I've talked about but taking that long-term perspective.

Clearing the fog. I think there's an opportunity. This is not just an external but also an internal focus as well. I think we can help ourselves and improve the way internally we look at the business and the drivers of performance on what all of those key performance indicators and where the accountability lies and having clear measures that we're measuring and managing ourselves against. So understanding and explaining the performance of the business internally, I think we can improve but also externally as well. I think we're very strong on financial accounting. And I think we can probably get a bit better on the old-fashioned management accounting.

Clear metrics and accountability, including group KPIs, we'd hope to develop those over the balance of this year, and in March next year, share with you some ideas around what sort of group KPIs we ought to be looking at. Greater clarity on cash flow, I've talked about that. So rather than reconcile a profit number with a cash flow number, try and explain cash flow on a driver basis not just for civil but our -- for our other businesses as well. And then IFRS 15 helps enormously. We welcome IFRS 15. I think it will allow for a purer and clearer view of the business. And whilst long-term contracts accounting adjustments have been the way we have accounted appropriately over the years, I think the removal of those and moving to IFRS 15 will help enormously, all giving greater transparency.

Group KPIs, possible items that are under review: return on capital employed that I've talked about, free cash flow per share, cash conversion and cash margin, a strong focus on cash. And I think it's a language that is growing across Rolls-Royce, becoming increasingly part of our language of success. A growing free cash flow very much sort of matches our ambitions.

I just had a specific topic on clearing the fog. There was quite a bit of commentary and indeed questions from the market around our hedge book. And so over the next couple of slides, I'm trying to shed a little bit of light on why we have in place what we have in place and explaining a little bit about our hedge book that we have today and the shape of our hedge book and therefore the likely trajectory of the achieved rates over the next few years.

So the headline statement, our hedging policy is to reduce FX volatility on cash and profit. We're a long-term business, take a long-term view. We have long-term contracts. And moving down to the final 2 bullets, we receive about \$6 billion a year to offset our sterling and euro costs. So to be sure about what we're going to be translating those dollars out, we sell those \$6 billion forward over the next few years. And what these 2 lines show are the policy that defines, effectively defines our maximum hedge book, so these are maximum and minimum bands for the flows that we anticipate in each year. The purpose of the hedge book is not to be precise within these bands. It's to determine the maximum size of the hedge book. And then we allocate the hedges broadly in those lines, but this is more around determining the size of the hedge book rather than the actual shape of the hedge book itself.

Having said that, this is what our hedge book looks like over the next few years. So the dark blue-shaded bits show the hedged portion on a percentage basis of our anticipated dollar flows. And then the forward rate shows if we were to buy today for hedges in those years, selling our dollars at the rate that we would purchase at. And then the blue line in the middle there, the sky blue line that's sloping down, shows the likely trajectory of our achieved rates over the next few years. So 2017, around \$1.54. And then moving down, you can see through to around sort of



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around just above \$1.40 or so, \$1.40, \$1.44, in that range, over the next few years, depending of course how the forward rate moves and at what rate we replace the hedges that we use in 2017 with new hedges in the outer-years.

So these policies work very well for us. When you look at these rates over the next few years, they are comfortably below our long-term planning rates. So we're very comfortable with this policy. We think it's sensible. It's worked well for us; and just to repeat as well, below our long-term planning rates.

The finance team helping drive the change, 2 recent additions that's worth highlighting in respect of the strengthening the finance team. Sarah joined us in September. Sarah is sitting here in the middle of the room. Sarah has joined from Shell; with just over 25 years or so with Shell, in various countries, in Finance Director roles and Regional Finance Director roles and various operations roles as well. Delighted to have Sarah on board and currently our Group Financial Controller and Deputy CFO. And Sarah is doing a cracking job, so far. Thanks, Sarah. And then we have Ben Fiddler joining us in early September. You all know Ben. What we are looking for in Rolls-Royce is to face up to the sort of the brutal facts around the performance of the business in recent years and the area that we need to improve. And we do need rigor and we do need challenge within the organisation, and we think Ben will bring that rigor, that challenge but also that industry expertise as well; and will help us not just in sort of financial planning and analysis in the sort of short term but also thinking about capital allocation and strategic planning and so on as well. So we're delighted to have Ben on board, that -- and we think he's going to be a great addition to the team.

And I expect there'll be 1 or 2 more changes on the horizon as well, but getting a strong finance team to really drive the outcome across Rolls-Royce rather than report the outcome, I think that's the key thing that we're looking for from a strong finance team in Rolls-Royce, providing that insight and analysis but helping us all make better decision-making across the group.

So the half year results, running through the numbers.

It's been a solid start to the year. It's always good to see revenue growth in a business and civil growing 14%, underlying growth rate; Power Systems up 3%; Marine, operating though in tough markets, down 15%; but overall a 6% revenue growth for the group and a solid start to the year. Profit, again decent start on profit. Group revenue, we've highlighted. Commercial and admin costs are GBP 38 million lower than this time last year. GBP 16 million or so of that is down to the normal piece of legal costs associated with the Deferred Prosecution Agreements, but putting all that together, we have an improved operating profit, GBP 345 million over GBP 158 million last year; and an improved margin, although I wouldn't want to boast at all around the 5% margin. There is still a lot, lot to do on improving our operating profit margin. But a solid start to the year.

I'm going to run through all the divisions one by one now -- putting all that together, you can see the profits there, civil and Power Systems the big driver, Marine operating in tough markets and a GBP 17 million decline half year on half year.

Free cash flow -- sorry. I forgot the free cash flow slide. Free cash flow GBP 75 million better than last year. We have pointed out that there's a lot happening in working capital, around GBP 180 million in receivables in particular which I'll talk about later. I'm sure we'll do as we go through the Q&A. And that's been the driver of a free cash flow performance that's slightly higher than last year's number. We are not changing our outlook on free cash flow. Indeed, I should have said, neither on profits either, just to repeat Warren's comments. At this stage, we're very comfortable where the outlook is, our outlook for the full year that we gave back in February of last -- of earlier this year.

So looking at operating cash, cash outflows from a higher installed engine production. We invoiced 202 wide-body engines during the first half of the year, so a good ramp-up from last year's numbers. That was offset by increased cash revenues from the aftermarket growth which, as you saw, grew nicely. Free cash flow was an increased level of capital investment; higher level of working capital management, that GBP 180 million that I talked about, principally in receivables. Other than this, the cash flow performance was largely as expected.

So running through our divisions one by one.

Civil Aerospace, 12% growth in OE driven by that 202 growth in the civil wide-body engines. That's excluding the leased engines that we sold. And there are 7 or so there. Aftermarket revenues growing by 15% year-on-year. And -- whoopsie-daisy. Sorry. And then you see that translating down to a nice healthy growth in operating profit from -- GBP 173 million this year, sorry, and GBP 31 million in the first half of 2016. To make the point,



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there is a benefit there in those numbers of long-term contract accounting adjustments that does help about -- there's a net GBP 33 million gain, but it's about GBP 56 million higher than it was this time last year where there was a GBP 23 million loss. I think this next slide goes into that in a little bit more detail.

So underlying revenues. 85 Trent XWB engines were produced -- were invoiced in the first half of the year, 41 in the prior year. Aftermarket growth, led by flying hours were -- which were up 15% for the in-production Trent fleet, so good growth in the in-production Trent fleet half year on half year; and the business aviation market as well, 21% growth in that, reflecting the success of CorporateCare.

Gross margin improvement, highlighting there that positive benefit of GBP 33 million from the contract accounting adjustments. And that included a one-off GBP 77 million credit risk assessment benefit in respect of one of our customers, where we have taken a view, after we provided -- several years ago, in respect of that customer, when their trading was in some -- let's say, some choppy waters, improved trading have allowed us to remove this provision that we took in earlier years. Our outlook for the year is unchanged, and we're comfortable where it stands. Just for a couple of other bullet points there, we're expecting further improvements on the XWB, higher costs related to increased maintenance activity in respect of the Trent 1000, which Warren talked about in his opening comments.

Defence Aerospace, 4% revenue decline, as expected. We expect that to pick up in the second half of the year. And then the aftermarket, down slightly as well. Second half production will grow in the second half, and that will drive some OE growth we anticipate in the second half as well.

Looking at the underlying revenue. The lower EJ200 OE sales following completion of the Saudi contract is a key driver of the underlying revenue decline half year on half year. Gross margin, we benefited from the nonrepeat of the TP400 charges that you may recall this time last year of around GBP 31 million. And we have lower C&A costs in Defence, a key driver of the 7 -- a small but a GBP 7 million improvement in operating profit for our Defence business half year on half year. The outlook remains solid, with -- full year expectations are unchanged. And just pointing to there the second half growth in the AE engine production. But margins and profits are expected to soften from last year's numbers.

Power Systems. I think Power Systems is the one business that's recovered, and its markets have recovered at -- or earlier than we anticipated when we put our outlook together. What -- it doesn't change our overall group outlook, but I think Power Systems is the one business that's performed a little better than we expected in the first half of the year, growing at 5% on its OE business and 3% when you put its services business together. Operating profit, up nicely to GBP 66 million. So it's an encouraging start to the year in a slowly improving market, but as you recall from last year, Q4 is a big quarter for Power Systems in respect of its services revenue, so there's still a lot to be done in the balance of the year on Power Systems.

Looking at the drivers and the outlook for Power Systems. Underlying revenue, good OE growth. The rapidly expanding Chinese telecoms market, particularly data centers, is leading to some good OE sales into China for Power Systems, but also signs of recovery in several industrial markets, including construction and rail; lower though, half on half year government and marine activity.

Operating margin, GBP 6 million lower C&A costs, again lots of transformation activity going on in Power Systems, but also there, final bullet point, strong working capital management. Power Systems is one of the key contributors to that outperformance in working capital in the first half of the year. The outlook for Power Systems remains cautiously positive. Q4, just to highlight that again, is key for the service revenue growth, as it was indeed in 2016.

Marine. Marine continues to operate in a very tough offshore market, 15% decline for the division, with 22% decline in OE and 6% in services; operating profits suffering accordingly. It's a tough offshore market. Having said that, a lot of restructuring taking place in Marine, as indeed it has been over the last couple of years. And you'll see in the statement today talking about further headcount reductions planned for the second half of the year.

So certain other key drivers and the outlook. Revenue declines reflect the lower OE order intake and the tough offshore market. We are not anticipating a recovery or a rebound in any event, and we continue to take costs out of the business. C&A costs are GBP 12 million lower. We expect the second half reported loss to be similar to the second half in 2016. So Marine, tough markets and no reasons for optimism at this stage. We do believe, though, the amount of costs that we've taken out of the business, we are well placed when the offshore markets eventually start to recover, as we expect them to at some point.

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Nuclear, good revenue growth, as we've managed our submarines contracts particularly well; underlying revenue growing at 8%; operating profits slightly down on last year. And that is largely driven by the GBP 10 million investment in small modular reactors, which you'll see in our numbers. So solid performance across both the submarine and the civil nuclear activities, as Warren mentioned in his opening comments. Operating margin impacted by the investment in the small modular reactors, GBP 10 million or so in there. The outlook for the year, the long-term outlook is unchanged. And there's no reason to change the outlook that we have in place in our models for 2017.

Accounting changes, a couple of items that are on the horizon. As you know, with effect from the 1st of January 2018, we move to IFRS 15. And indeed, we are hoping that for the March results next year we can show you the '17 results on a current basis but also the full results on an IFRS 15 basis as well so you can see that fair comparison, probably spend quite a lot of time on that. And that will then allow you to think about how you want to think about 2018 on an IFRS 15 basis.

Looking at the numbers, back in November of last year, we gave you an early view, and we stressed at the time that it was an early view, on 2015. We've settled down now on the numbers for 2015, which show an underlying operating profit adjustment restatement of GBP 933 million. The number for 2016 is a little lower. I think we guided that we expected it to be a little lower on the 2015 number, GBP 823 million. Just to repeat again, there's no cash impact. Cash remains the same. This is a restatement of accounting numbers. For 2017, we'll share the detail of that with you in March, but if anything, we're expecting the 2017 number to be again slightly lower on the 2016 number.

Sorry. Skipped one area there. IFRS 16 comes into play on the 1st of January 2019, and we'll be taking operating losses onto the balance sheet. Again, no impacts on cash. That's around GBP 1 billion of operating losses. These principles are already used by our rating agencies in the way that they assess the health of Rolls-Royce. So just as a flag that that's on the horizon. And again, we'll share more of that with you in March next year.

So to summarise. Clear priorities for the way ahead, a particular focus and emphasis on cash. It's been a solid first half. There is much to do in the second half, Power Systems, civil, Defence. Around our divisions, there's much to do in the second half. So it could be tempting to get carried away with the first half numbers, but there's a lot to do in the second half of the year, and I would -- really would reinforce that point. And accordingly, our outlook for the full year is unchanged.

Thanks very much. Over to Warren.

Warren East - *Rolls-Royce Holdings plc - CEO and Executive Director*

Thanks, Stephen.

A few comments just to close, and then we'll move to Q&A.

I was chatting with the board last week because I've actually been doing this for a couple of years now. Sometimes, it feels like 5 minutes. Sometimes, it seems like about 22 years, but some of you who've been following me doing this for a while will note that, in days of yore, I didn't need to use glasses to look at the slides. Anyway, the slide sort of breaks into 2 halves. There's what we're really concentrating on in the short term versus what we're building, on the right-hand side of the slide, for the longer term. And I think, in 2016, I was really concentrated around some of the structural changes that we're making with what I called operational hardware back in 2015. And we're really seeing the positive effects of that now, particularly the direct line of sight of the senior team right into the businesses. It's -- it feels a lot easier to get a grip on what's really happening in the businesses. But as we've moved into 2017 on the operational hardware, then it's really encouraging to see we now have a new, balanced senior team around the table. And I think you can see in the energy that Stephen is bringing to the finance function a measure of the changes that are happening at that level in Rolls-Royce.

I'm also encouraged by the changes that we're making around engineering and technology. That's the most recent change we've made. That's very much a 2017 change, but that puts us in a great place for the future. You will see technology appearing in a couple of the other boxes as well. Stephen talked about the fact that we love our processes and complexity, and you've heard me talk about this before. I suppose, if there was one area that we're on reflection after 2 years, I do need to -- it's part of my job to be more impatient. And I think we can always move a bit faster here in terms of improving the simplicity of our organisation. However, I would say that, in 2017, particularly now as we're getting that team established,



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I can see a pickup and a building in the momentum which is happening in that direction. And I'm confident that we will deliver on what I'd previously called the operational software in due course.

But looking forward, events happen in business all the time. And the important thing for Rolls-Royce is to establish some resilience so that we can really achieve sustainability. And behind that resilience, that's why it's so important that we deliver on the operational software side of our transformation so that we can really strengthen the balance sheet, so that we can establish some breadth and depth in the technology that sits behind our portfolio. And that's what we're concentrated on right now, and I can see that we are starting to make progress there. But to make it stick: Stephen talked about disciplined capital allocation. And that's what's really necessary to be able to sustain the expenditure, the investment in R&D for the future; and to create a winning platform so that, when we've got this real execution machine, it's built on a winning platform. But I think we're making reasonable progress in all of those 4 boxes actually, and so after 2 years, I'm quite satisfied with where we are.

Coming back to the present, though. The priorities for the second half of the year are really very, very simple. We need to deliver what we say we're going to deliver. And in 2017, as Stephen just mentioned, there is no change this morning to our expectations in terms of financial results. We've got a lot to do in the second half, but I believe that we're well positioned to do just that. From a day-to-day point of view, very much concentrated on engineering, on operational matters and on looking after the aftermarket. And it's a balance. And the balance is -- a good example, good place to see that is in our civil business. We clearly have a balance from an engineering point of view in terms of delivering the new products to large new engines' entry into service before the end of this year, another one coming along 6 months behind, balance that against -- or from the operational point of view, the ramp-up that we need to do. Just over 200 engines invoiced in the first half of the year, we need to get that up towards 500 engines for the end of the year, and we're reasonably placed to do that. And I mentioned at the start of the presentation how we're working hard with our civil customers to minimize disruptions caused by the in-service support that we're doing with a scheduled maintenance programme in particular on our Trent 1000.

So there's quite a lot of challenges there in the second half of the year. Behind all those challenges, I've talked for quite a while about the future; and the need -- whilst we are focusing on the present, the need to consider the future and make sure we have a thorough review of our vision, the strategy and the technology that sits behind that. And we do hope to share that view before the end of the year.

So with that, I'll hand over to Q&A and leave you with that summary. So we've got the first one in the middle there. The microphone is coming around. Stephen and I will share the Q&A.

QUESTIONS AND ANSWERS

Charles Armitage - Citigroup Inc, Research Division - Head of European Aerospace and Defense Equity Research and Director

Charles Armitage, Citi. Three questions. First of all, 320 engines delivered last year, going to, I don't know, 480, 490 excluding spares. There are quite a lot of -- and minus GBP 1.6 million each. There are quite a lot of moving parts. You've got bigger losses in the XWB. You've got more of those coming through. You've got presumably the overall cost per engine coming down, but you're delivering more engines as well. So presumably the losses will probably get bigger this year, but at one -- some point it'll flip when the losses coming down will be faster than the number of engines going up. Can you just sort of talk through that dynamic, please?

Warren East - Rolls-Royce Holdings plc - CEO and Executive Director

Yes, well, I think you've talked through it actually. It's, in terms of what we're actually delivering, we're delivering to meet customer requirements. And so that's the airlines that have scheduled deliveries. And you are right. You mentioned XWB. We pulled out. We're very encouraged by the first half performance. That's where it's the biggest loss at the moment, but it's also the biggest improvement in terms of closing the gap. So exactly when that transition happens, we've been fairly clear it's not happening this year. The absolute cash loss is going to be bigger this year because the volume increase is more significant than the closings of the gap, but as we look forward beyond this year, then we're certainly going to come to that point.



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Stephen Daintith - *Rolls-Royce Holdings plc - CFO and Executive Director*

Yes, yes, I think you're right there to highlight a key inflection point for us will be when we get that to start going the other way when we're making as many, if not more, but the cash drag on the business, so to speak, moves in a positive direction. That will be a key inflection point for some time over the next few years, but that will become obvious, I guess, as we make progress on -- particularly on the XWB.

Charles Armitage - *Citigroup Inc, Research Division - Head of European Aerospace and Defense Equity Research and Director*

Next question. Thank you for Slide 28. That's very useful, the FX one. Can we just try and make so I understand the -- I'm colour blind, the pale blue band, I think? The -- if you just look in, I don't know, 2022, so I can see the numbers, 60% is hedged, the forward rate's quite a lot lower than that. Could one assume that, if one hedged at the current rate, you would be towards the bottom of that band but you're not so there's a degree of uncertainty?

Stephen Daintith - *Rolls-Royce Holdings plc - CFO and Executive Director*

Yes, you kind of could. I mean I wouldn't want to be precise about the answer because you just don't know how the rates are going to move and so on, but that math is broadly right, your -- that assumption, but it will depend, of course, on how the forward rate curve changes and spot rates develop over the next couple of years.

Charles Armitage - *Citigroup Inc, Research Division - Head of European Aerospace and Defense Equity Research and Director*

Perfect. And the final question, long-term accounting changes and particularly that GBP 59 million of technical costs. Could -- what is that? And secondly, how on earth can I forecast this? Or do I just forget about it because it disappears in under IFRS 15?

Stephen Daintith - *Rolls-Royce Holdings plc - CFO and Executive Director*

That is the single largest component there is the Trent 1000 issues that Warren covered in his opening slides. It is essentially provisions around increased costs that we're anticipating across our engine programmes and the Trent 1000 being the largest. On a go-forward basis, we'll clearly have those costs. And we will still be providing the most appropriate for in-year provisions and so on, in -- is the short answer to your question.

Charles Armitage - *Citigroup Inc, Research Division - Head of European Aerospace and Defense Equity Research and Director*

Does it get less under IFRS 15?

Stephen Daintith - *Rolls-Royce Holdings plc - CFO and Executive Director*

Well, no. They will vary, of course, depending on what issues take place in respect of our engine programmes. Clearly, we would hope for a small increase or negligible or even declining provision every year, but -- so it will really just depend on how those operational issues unfold over the next few years.

Warren East - *Rolls-Royce Holdings plc - CEO and Executive Director*

We've got one in the middle here -- or sorry. The microphone at the back.

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Gordon Hunting - *Fiske - Analyst*

Gordon Hunting from Fiske. It might be a question for your new head of technology. GE have got problems with the TP400, Pratt with the geared fan. And you seem to have no problems with the F-35 gearbox and, hopefully, not with the Ultrafan. Is it because you use this technology called curvic coupling?

Warren East - *Rolls-Royce Holdings plc - CEO and Executive Director*

I don't actually think it is either. I mean, the challenges that were faced around the TP400, I think there was a significant volume ramp-up and that one facility was required to produce gearboxes for lots and lots of different engines. The geared turbofan from Pratt & Whitney, we can't really comment on other people's business, but these things are very difficult things to do. And of course, we will try to learn from other people's experience, -and we believe that we have a design of gearbox that is going to be successful. But we're very, very early. We only just started testing it under power. And I would really hesitate for any of our spokespeople to comment on it's going to be glorious because we've got a programme over the next several years of extensive testing. And I'd stress that, all of us companies, this is difficult stuff, particularly to make it safe and reliable. So I really can't comment on other people's challenges.

Christian Laughlin - *Sanford C. Bernstein & Co., LLC., Research Division - Analyst*

Christian Laughlin from Bernstein. Two questions from me. Both are related actually in a way, I guess. So firstly, Warren, if you think about 2 years ago or even 18 months ago, how has your confidence evolved with respect to confidence in the visibility of what you see and the quality of data that's being presented to you and how deep that goes into the organisation or the divisions? And what has been driving that? Has it been changes in people and processes? Or also, have you started to see some fruits of some of the system updates initiatives that you talked about previously? And then secondly, related to that too, if you could clarify some of the comments that were reported into the press over the weekend about the GBP 1 billion in free cash flow around 2020 or so just with respect to how you actually are thinking about that in terms of defining that as an internal objective or as a marker on a trajectory over the next few years and how that shape of improvement from 2016 looks.

Warren East - *Rolls-Royce Holdings plc - CEO and Executive Director*

Okay, let me just sort of comment on improved confidence. I am a lot more confident in the quality of information that I'm seeing today versus where we were 2 years ago or even 18 months ago. Part of that is in the layering that we did in 2016 and getting closer to the businesses. Part of it is in the reengineering of the finance function that Stephen is spearheading and which is the sort of #1 goal. And I think in some of Stephen's slides, hopefully, you saw clear business-driven derivatives of the numbers. And so Stephen, you may want to comment on where it's going in the future. Before you do, I'll just talk about the weekend press and the GBP 1 billion. So speaking with a colleague about this, this morning, he had a great analogy for me. He said, "You know, I can have a target to have 1 -- sorry. He might have a target for that but GBP 1 million of cash in his deposit account. And that might be a target, but exactly when or if ever it's going to be achieved is debatable. So this is a very healthy objective for us to have. And Stephen calls it a great rallying cry within the organisation. We sincerely believe and hope that this business will generate a lot more than GBP 1 billion of cash in a year at some stage in the future. We think it'll be around about GBP 1 billion around about 2020. And whether that GBP 1 billion threshold happens before 2020 or after 2020 depends on a myriad of different events. It depends on the level of flying hours that are done, the rate at which we grow our fleet, the number of in-service issues we have. If all of that moves in the right direction, we'll probably get to GBP 1 billion before 2020. If some of those turn into headwinds rather than tailwinds, then it'll probably be a little bit later, which is why we're really not going to get hung up on fixing actual target quantum of money to a particular point in time. But it's a very, very realistic number to be talking about in that sort of time frame.

Stephen Daintith - *Rolls-Royce Holdings plc - CFO and Executive Director*

I've used it a lot in presentations that I have given internally because it's very useful just to get that focus on cash. And in fact, we're going through a little bit of an education process because most business managers in most businesses talk about sort of revenues and profits, but understanding your cash flow and drivers of cash flow, it sounds strange but it's true, is not often that great. So there's that. There's the education around it, but



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then there's also the drivers of that cash flow, going back to sort of the first part of your question. And I would hope that we can start talking in our releases around those drivers and those building blocks, particularly in the aftermarket cash margin because that's the big cash driver. And when you think about it, it's not hugely dissimilar from a subscription business once you get -- and how subscription businesses report their cash flows in terms of sort of yield and ARPU growth or revenue per -- well, revenue-per-customer growth, that sort of thing. And that then becomes very helpful because you've got a very reliable, dependable and strong cash flow which is an increasing proportion of our group revenues. So I would hope that we can move in that direction and really get that good understanding of those drivers of aftermarket cash margins.

Warren East - *Rolls-Royce Holdings plc - CEO and Executive Director*

I don't -- the microphone must be over that side now. And we need to remember the microphones to the middle.

Robert Alan Stallard - *Vertical Research Partners, LLC - Partner*

It's Rob Stallard from Vertical Research. A couple of questions. Maybe to follow up on Charles' question on large aircraft, large engine OE cash margins. The loss of GBP 1.6 million per engine last year -- sorry, what we might be expecting for this year per engine. And then secondly, there's been a lot of conversation about whether Boeing will or won't launch a middle-market aircraft. Is this a platform that Rolls-Royce might be interested in powering? And if you were successful in achieving that position, what the sort of costs and timing could be.

Warren East - *Rolls-Royce Holdings plc - CEO and Executive Director*

Yes. Do you want to talk about GBP 1.6 million?

Stephen Daintith - *Rolls-Royce Holdings plc - CFO and Executive Director*

Yes, I'll do the cash losses, yes. I wouldn't expect a number significantly different from last year's number. And the very early question is -- guided as why that is. It's in that the XWB production is significantly higher in '17 than it was in '16. And we know that, that carries an initial larger cash than the average of all the others, but again we expect that to come down. In March, we'll be more explicit about the progress that we're making on the XWB, but it is good progress. And we have that ambition by 2020 to get to breakeven, which will only help the average margin going forward. So GBP 1.6 million, I expect to be pretty much flat in '17, but then '18, hopefully, we'll see improvements on that.

Warren East - *Rolls-Royce Holdings plc - CEO and Executive Director*

Okay. And on the NMA, well, we're in the business of supplying large engines. And so if there's a sensible commercial opportunity around NMA, then of course, we're interested in going after it. We're developing new architectures at the moment. Our Advance engine is about getting greater efficiency out of the engine. Our Ultrafan is about making that engine propel the aircraft more efficiently. And we're developing those new architectures for new wide-body applications at the back end of the decade. If there's an opportunity to create from that architecture another engine variant that we can do economically and start having some return on all the investment that we're making in that architecture development a few years earlier, because that might be the timing for NMA, then that sounds like a good idea, but it will be dependent on whether we can get a sensible business case on the individual project. And that depends on where Boeing end up with the specifications for their aircraft and the requirements for the engine and where we are with our architecture developments at the time. All right. And we have to go to the middle now. I'm afraid we're sort of getting the microphone -- thanks. Thank you, yes.

Nick Cunningham - *Agency Partners LLP - Managing Partner*

Agency Partners sat in the wrong place. Nick Cunningham from Agency Partners. I wanted to ask about Trent 1000 because you're talking about sort of headwinds, if you like, potential headwinds. And it's difficult for us to see, I think, the Trent 1000 impact because it gets lost in warranty



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provisions or within long-term service agreements and so on in the P&L, so I was wondering if you could give us an idea of what the scale of cash issue has been; and also, beyond that, whether you now have a permanent fix and how much that fix is going to cost. In other words, how much is it going to cost in cash terms to close it out? And then final part of that: Is there any systemic issue around the sulfidation which is going to apply to other engines like XWB or Trent 7000 or whatever?

Warren East - *Rolls-Royce Holdings plc - CEO and Executive Director*

Do you want to talk about cash? And then I'll come back.

Stephen Daintith - *Rolls-Royce Holdings plc - CFO and Executive Director*

So, yes, -- there is a GBP 59 million technical provision in respect of a variety of engine programmes. The 1000 is the single largest. And you should be thinking around sort of just less than half or so of the total is the 1000. That's what we provided for and that we think is sufficient at this stage. And it will depend on how the operational issues unfold over the balance of this year, but right now, we think we're adequately provided. So that's the answer on the 1000.

Warren East - *Rolls-Royce Holdings plc - CEO and Executive Director*

Yes. And on the 1000 and getting it under control and tying it down, there are a handful of issues with the current Trent 1000. There are about 400 to 500 engines affected. And basically, some parts of the engine are turning out not to last as long in service as their original design lives. It's, as with any mechanical components, they wear out. And you have a design life and you expect to replace those components, and it turns out on inspection that we had to replace them sooner rather than later. And that's what causes the extra costs. It's the extra cost of physically the parts and also the operational cost of putting them in. We understand the issues. We have a scheduled programme for the fleet of engines that's out there. And we believe that, with the Trent 1000 TEN, the one that is coming into service at the end of this year, then -- we have addressed all the issues that have been identified. But if you look across our fleet of large gas turbines, there are issues with pretty much all of them. And this is a bit like the question I was answering on the gearbox. This is difficult stuff. And you start off and you have a design life and you have in-service experience, and you change the design or you change the life-ing that you're putting on particular components. And over the course of years, we get better at making these things last longer in the air. So instead of having to have engines that typically would return every sort of 2,000 cycles, now it's sort of 5,000 cycles or even 7,000 cycles. And the sulfidation issue you mentioned is something that all of these products are prone to. And we experiment with different cooling, different materials, different coatings to try to create an optimum balance of performance out of the engine versus life, but I'm afraid it's just a feature of how these things work, that you're always going to have those issues. And what you try and do is steer away from the bumpy boundary conditions where you run into operational problems. Sometimes, in trying to achieve better performance, we bump into one of those boundaries, and that's what's happening with Trent 1000 at the moment.

Nick Cunningham - *Agency Partners LLP - Managing Partner*

Can I just ask a quick follow-up on that perhaps? The circa GBP 25 million, I guess it is, the half of the adjustment, does that actually encompass cash costs? Or is other...

Stephen Daintith - *Rolls-Royce Holdings plc - CFO and Executive Director*

Yes, it does.

Nick Cunningham - *Agency Partners LLP - Managing Partner*

Right, so there's no warranty utilization or whatever going through.

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Stephen Daintith - *Rolls-Royce Holdings plc - CFO and Executive Director*

No. I believe that covers the cash costs, yes. I will get back to you if not, but I believe that's the case.

Warren East - *Rolls-Royce Holdings plc - CEO and Executive Director*

Yes. I think we've got some more in the middle here.

Do you want to just pass it along and then we nip up the back?

Tristan Sanson - *Exane BNP Paribas, Research Division - Head of Aerospace & Defence and Equities Research Analyst*

So it's Tristan Sanson from Exane BNP Paribas. Three questions. The first one, I wondered whether, Stephen, you could give us a bit more details on working capital evolution than the GBP 180 million balance that you mentioned earlier? Second, you increased the CapEx guidance for this year by GBP 100 million, I think, but not changing the overall free cash flow guidance. Can you tell us where this extra GBP 100 million will be spent or what type of project, which division? And the third one is on TotalCare transitions. You transitioned a number of A330s over the past 12 months. Can you give us a feel for what should be the average contribution per hour flown of these new TCAs compared to initial TCAs, including the life-limited parts? So if you calculate the kind of all-inclusive contribution, these extended TCAs are traditionally acquired. Will they bring the same, less, materially less than initial TCAs?

Warren East - *Rolls-Royce Holdings plc - CEO and Executive Director*

Okay, if I do the TCA one, do you want to do the working -- the -- yes.

Stephen Daintith - *Rolls-Royce Holdings plc - CFO and Executive Director*

Yes, I'll do it, yes.

Warren East - *Rolls-Royce Holdings plc - CEO and Executive Director*

Okay, if you kick off on the first one...

Stephen Daintith - *Rolls-Royce Holdings plc - CFO and Executive Director*

So working capital. So GBP 180 million in -- largely in receivables, it's a real mixed bag of activities. I mean, first of all, it's good, old-fashioned improved cash collections and reduced debtor days. Particularly in Power Systems, there's been a sterling -- piece of work in the first half of the year. Timing and phasing of customer deposits, the timing of concession payments when they follow the original engine sale. There will be times where we -- contract payments get restructured with our customers as well. That can cause an inflow of cash. And then a key component there is also the Aviall deal that we announced earlier this year where we're outsourcing logistics and supply of spare parts to the AE engines to Aviall. That had about-- GBP 55 million or so that was part of the GBP 180 million. So it's a real mixed bag of items. I think I would make the point that I wouldn't regard all of this as permanent. And indeed, most of it is sort of AE-timing related, hence our keeping our outlook for cash unchanged year-on-year. And then CapEx, a slight increase in CapEx, this is kind of a noncash item, but effectively, we're capitalizing certain engines that go into our spare engines for our customers, and that's a key driver in what we're doing there. So that's the CapEx explanation. And then Warren, TotalCare (inaudible)?



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Warren East - *Rolls-Royce Holdings plc - CEO and Executive Director*

So on TotalCare, there isn't really a material difference between TotalCare rates sort of the second and third time around versus first time around. If there is a rule, then actually we typically achieve a higher rate for a second contract than we do for an initial contract. When you get into TotalCare Flex and TotalCare select, these are the sort of towards the end-of-life variants, then you can think about that as if TotalCare is a kind of insurance policy. Then these variants are where you choose particular things, like on an insurance policy you might choose to pay a higher level of excess and a lower premium. And there's this -- that type of impact, so you will find a lower premium effectively because customers are choosing pieces out of the menu. However, none of that really affects the rule of thumb that we talk about, which is a large engine is going to generate \$1 million or so of flying hour revenue per annum. That's a combination of the flying hours and the rate. And it's a rule of thumb based on the size of fleet and where we are at the moment. Hopefully, that's enough colour. We've got an -- we've got some online ones that we need to cover as well.

John Dawson - *Rolls-Royce Holdings plc - Director of IR*

Yes. Conscious of time, so I just wanted to make sure that the online questions had a chance to be asked. Really the 2 questions that have come in focus really on cash flow outlook for this year based on the increased CapEx outlook, working capital and also the increased level of shop visits. Do we expect to be changing our free cash flow guidance this year and also next year? If we're not changing them, what are the moving parts to leave it all pretty much staying the same?

Warren East - *Rolls-Royce Holdings plc - CEO and Executive Director*

(inaudible)...

Stephen Daintith - *Rolls-Royce Holdings plc - CFO and Executive Director*

The same answer really, yes, unchanged. I mean, coming in new, sort of looking at Rolls, one of the things that struck me is a GBP 15 billion revenue business and a -- and a GBP 100 million cash flow. It's sort of that is very, very precise, that degree of magnitude. And I would hope we can get to the days where that sort of number becomes -- varies around a much larger number then becomes less relative and material. So this is a fine art, and so -- but having said that, I pointed to the fact there were 1 or 2 quite lumpy items in our working capital which impacted the improvement half year on half year. I wouldn't read too much into that. Outlook unchanged on a full year basis is where we are when we put -- run all our maths together. And so that's the short answer to the question.

John Dawson - *Rolls-Royce Holdings plc - Director of IR*

We've probably got time for one more question from the audience before we...

David Perry - *JP Morgan Chase & Co, Research Division - Head of European Aerospace and Defense*

I -- can I take it? Because we can't be seen here at the back.

Warren East - *Rolls-Royce Holdings plc - CEO and Executive Director*

All right.

David Perry - *JP Morgan Chase & Co, Research Division - Head of European Aerospace and Defense*

Yes, David Perry at JPMorgan. A few questions, please, one on FX and then just a series of mini questions on the aftermarket. Just on the Slide 28 that you've given us, which is new, it's somewhat different to how in the past Rolls has explained its FX cover. I mean this looks like a very conventional



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FX strategy almost identical to, say, Airbus would use. And it implies that your hedging is with forwards; and that you have pretty much locked in rates for '17, '18 and '19, whereas previously we were always told Rolls used swaps with multiple fixing dates and that it had a lot of flexibility to sort of smooth the rates over time. So can you just talk to that? I mean, is this as rigid as it looks?

Stephen Daintith - *Rolls-Royce Holdings plc - CFO and Executive Director*

Yes, I will talk to that. I -- probably should have highlighted that the hedged, the dark blue is a mixture of fixed and flexible. What I'm showing is what I think is how I think this is likely to evolve. I mean it may change but by degrees, so you're correct in -- your assumption was the right one.

David Perry - *JP Morgan Chase & Co, Research Division - Head of European Aerospace and Defense*

So there is potential for the actual rates in '18, '19, even '20 to be better than you're showing here, or...

Stephen Daintith - *Rolls-Royce Holdings plc - CFO and Executive Director*

I would doubt it. I don't think -- when you think about it, sort of why would -- if we were to do that, we'd -- effectively we'd be pushing hedges out into outer-years. And then the consequence of that would be then you'd start to move up in outer-years because you've moved those hedges further forward, which I don't think will be a good thing to do. So I would doubt that. Look, it remains a possibility, but I would doubt it. I think this is a good shape actually. So when I say good shape, I think this is a reliable shape for the next few years.

David Perry - *JP Morgan Chase & Co, Research Division - Head of European Aerospace and Defense*

Okay. And then just a series of questions on the aftermarket. They're all related and quite quick. The 15% growth that you reported was very strong. Can I just check? Is that a genuinely -- in your view a genuinely organic number? Or are there some one-off items? And perhaps another way of asking is, if IFRS 15 existed today, would it have been 15%?

Warren East - *Rolls-Royce Holdings plc - CEO and Executive Director*

Well, I mean the -- embedded in that aftermarket, some of it is the size of the fleet and more hours. And some of it is long-term cost reduction that we anticipate because of changes that we make to how we're servicing the engines and intend to service those engines going forward. So have we got the number on the slide of how much is the long-term adjustment?

Stephen Daintith - *Rolls-Royce Holdings plc - CFO and Executive Director*

Yes, but -- there is some detail later on in the pack. And I won't get into those details specifically, but if you look at sort of '15, there was a GBP 208 million revenue adjustment for civil aftermarket. And 2016, it's GBP 474 million, so you can see there's a GBP 266 million difference. So that explains a fair chunk of it, but that is well explained in the detail in the appendixes that you have, that have been handed out.

David Perry - *JP Morgan Chase & Co, Research Division - Head of European Aerospace and Defense*

So does that imply it wouldn't be 15% under IFRS 15?

Stephen Daintith - *Rolls-Royce Holdings plc - CFO and Executive Director*

It would be a lower number, clearly, because you've got that GBP 266 million adjustment going forward.



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David Perry - *JP Morgan Chase & Co, Research Division - Head of European Aerospace and Defense*

Okay. And any chance of guidance for the full year on the aftermarket growth perhaps on both bases?

Stephen Daintith - *Rolls-Royce Holdings plc - CFO and Executive Director*

No. We're not giving specific guidance line by line at this stage. We're just giving group guidance, as we have done previously; and modestly ahead of last year in cash flow, in line with last year.

Warren East - *Rolls-Royce Holdings plc - CEO and Executive Director*

Yes. With that, I think we're out of time, so we're going to have to finish the Q&A, but thank you all very much for coming along. And thank you for your questions.

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