



Rolls-Royce

**Rolls-Royce Holdings plc 2013 Half-Year Results Conference Call
Investor Presentation and Q&A Transcript**

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Speakers:

**John Rishton, Chief Executive
Mark Morris, Chief Financial Officer
Jilinda Crowley, Assistant Director - Investor Relations**

OPERATOR: Good morning, and welcome to the Rolls-Royce Holdings plc 2013 half-year results conference call. Throughout this call, all participants will be in listen-only mode, and afterwards there'll be a question and answer session. Just to remind you, this conference call is being recorded.

Today, I am very happy to present Jilinda Crowley, Assistant Director of Investor Relations. Please begin now.

JILINDA CROWLEY: Good morning, everyone, and a warm welcome to everybody to our half-year 2013 results webcast. Just regarding the materials for today, we issued the results via a stock exchange announcement earlier this morning. The presentation slides for this call are available both via the WebEx and also via our website. As always, elements of this presentation contain forward-looking statements and are based on our view of the world and our businesses as we see them today. Clearly these elements can change as the world changes, so please consider them in that context.

For today's webcast I'm pleased to be joined by our Chief Executive, John Rishton and our CFO Mark Morris.

John?

JOHN RISHTON: Thanks, Jilinda. Good morning. Thanks very much for joining us on the call. I'm going to make a few comments about our performance in the first half of the year and then Mark will take you through the detail.

At first glance I think that these are very impressive results, but I suspect many of you have already stripped the numbers apart and you'll have realised that there are some significant one-off benefits and the true picture is rather more complicated.

So while there are some strong elements of the group's performance, our profit continues to be held back in my view, our view, by a lack of progress on unit cost, and our cash flow is unacceptable. Fortunately we have significant opportunities to improve both. As you will have seen, we've consolidated Tognum for the first time, and you can see that the contribution has made quite an impact on the results. The order book is up 15%, or 12% excluding Tognum. Underlying revenue is up 27%, or 9% excluding Tognum. Underlying profit is up 34%, or 32% without Tognum. We've increased our payment to shareholders by 13% and maintained our full-year group guidance.

To measure this first half performance against our priorities, I would say the following. In terms of delivering on our promises we've made progress. We were

all very pleased to see the first flight of the Airbus A350 powered by our XWB engines. The A400M military transport aircraft has achieved certification and is about to enter service powered by our TP400 engines. And we have delivered our first Environship that's now in service off the coast of Norway.

The second priority, deciding where to grow and where not to, we've continued to invest in capacity around the world, for example in the UK. We are close to completing a turbine blade facility in Rotherham and an advanced disc factory in Washington, Tyne and Wear. In the USA we're building a new turbine machining facility at Crosspointe in Virginia. In terms of where not to grow, I'm sure you know that we've decided to sell our 50% stake in the RTM322 military helicopter programme, to Turbomeca.

On improving financial performance, as I have said, there is plenty of scope for improvement. Our profit increased by 34% in the first half, but as you'll have seen this includes a contribution of £112 million from the IAE restructuring as well as benefits from volume growth. Whilst progress has been made in some areas on cost, we need to do much more.

In terms of cash, an outflow of £460 million is not acceptable and we must do better, particularly on inventory performance. This will take time and a firm resolve to deliver.

I look forward to taking your questions later, but for now Mark will take you through the details.

MARK MORRIS:

Thank you, John, and good morning. As usual, I will draw out the main highlights of the Group's financials for the period. Tognum has been consolidated for the first time, but I've shown our main trading figures including and excluding Tognum in this chart. You will recall from the prelims that I said we would provide guidance for Tognum separately from the rest of the Group this year, because at the start of the year we could not guide for Tognum whilst they were listed. We will continue this way for the remainder of 2013.

So the Group excluding Tognum first, and I will come back to Tognum later. Over all the figures show good progression at group level on orders, revenues and profits. But as John said, we have more work to do around cost and cash. The order book is up 12% after booking £14.1 billion of new orders, predominantly in Civil, and the order intake in the first half was up 54% compared to 2012. Revenue, up 9%, reflects good growth in OE and services, with all segments displaying overall growth, ranging from 6% to 16%. Overall growth includes a 1.5 percentage

points benefit from favourable exchange rates. Profit increased by 32%, which I will cover on the next slide.

Turning to cash, we started the year with £1.3 billion and ended with £921 million of net cash, a reduction of £396 million. This predominantly reflects a growth in working capital and continued investment, which I will cover in more detail shortly. We have increased the half-year payment to shareholders by 13% to 8.6 pence, reflecting our continued confidence in the business.

So, turning to profit, what are the key components of growth? Increased volume is worth around £103 million with IAE revised trading arrangements contributing £112 million. Within the £24 million other movements, there are a number of positive and negative items around trading mix, R&D, restructuring, foreign exchange and entry fees. Entry fees increased by £76 million relating to where we are on the development of the Trent 1000-TEN and the Trent XW 97K programmes. We expect a similar benefit over the full year. Restructuring costs are up £25 million in the first half, which includes severance payments relating to the indirect cost reduction and site restructuring activity. The group profit before Tognum was £787 million, up 32%. Our profit from Tognum of £53 million reflects full consolidation compared to our share last year which was equity accounted.

Group cash flow. As usual I'll just pick out the major themes in this chart that you're all familiar with. Firstly, net working capital, which increased by £803 million, reflects a number of moving parts. The main items are inventory, which increased by £261 million due to volume with no improvement in our turns was disappointing and is receiving intense focus. And Civil TotalCare debtors, which increased by £240 million, representing a combination of new deliveries and shop visits, Capex and intangibles were up £402 million and includes £261 million of capital expenditure and £141 million of intangibles. Remember, intangibles are capitalised development costs, certification costs, recoverable engine costs and software. The trading outflow of £208 million is before payments of £250 million to our main stakeholder groups, pensioners, taxes and our shareholders. Tognum's trading cash flow of £62 million is after paying a £60 million dividend to Daimler. Looking to the full year, we continue to expect cash flow, excluding Tognum, to be around breakeven.

Turning to the business segments, Civil has seen strong order flow during the period. The order book increased 14%, with intake of £10.9 billion that included orders for Trent engines for over 200 wide-body aircraft. Trent engines now make up over 90% of Civil's order book as our market share continues to grow.

OE revenue increased by 8%, which reflects an 11% increase in engine deliveries, partly offset by adverse mix. Services revenue was up 3%, broadly in line with the growth of the installed thrust base. Profit increased by 59%, reflecting the benefit of increased volume, £112 million for the IAE restructuring and £76 million higher entry fees, partially offset by higher restructuring and product launch costs. Remember that the IAE benefit is a first-half effect compared to 2012, because the deal was completed in the first half of last year. Profit performance in the second half will be lower than the first half, due to the phasing of entry fee receipts and R&D. Consequently, for the full year we continue to expect modest growth in Civil's revenue and strong growth in profit.

Defence has performed slightly better than we anticipated, but there remains a lot of uncertainty regarding sequestration and broader austerity measures which governments have to contend with. This is evident in the order book, which contracted by 4%, and the low growth in service revenues as a consequence of reduced flying hours. OE revenue increased while engine deliveries were unchanged, benefiting from a favourable mix and increased export sales. Profit increased by 10%, reflecting OE volume growth, favourable revenue mix and a lower R&D charge. A good first-half performance now gives us the confidence to improve guidance for Defence for the full year from a modest reduction in profit to broadly flat.

Our Marine business is a mixed story in terms of performance in the first half. Order intake was strong at £1.7 billion and included a £0.8 billion enabling contract for the MoD which contributed to the order book increase of 10%. Excluding submarines, order intake was up 4%. Top-line growth was also good. Revenue increased by 16%, reflecting OE volumes in the Offshore sector and services growth in Offshore and Naval. Foreign exchange benefits made up 3% of the growth.

Profit performance was disappointing, having decreased by 8% due to adverse revenue mix, pricing pressures, warranty costs, partially offset by cost reduction and a foreign exchange benefit. Bid activity remains encouraging and good order cover for the second half gives us confidence to remain the full-year guidance for a modest growth to Marine's revenue and profit.

In Energy there are some large percentage changes, but remember numbers are small in the context of the group. We are clear that the performance of this segment is unacceptable and we continue to explore avenues to improve the returns in the segment. OE growth of 6% was driven by increased demand in Oil & Gas and the 12% services growth was driven by higher spare parts sales and better

capture of market share. Losses reduced by £3 million and we expect some improvement in Energy's profit for the full year.

Finally turning to Power Systems, our new segment. Let's just remind ourselves that Power Systems, which was formally known as Engine Holding, comprises of our Bergen business and Tognum. This chart illustrates the relative size of the two businesses and the impact of Tognum moving from being equity accounted in 2012 to full consolidation in 2013. As you can see, Tognum had no impact on revenues in 2012 and its profits contribution represented our share of profits after tax.

This chart shows the performance of Power Systems as if Tognum had been fully consolidated in both years so as to provide a trading comparison. Power Systems order book increased by 14% and new orders were up 8%. OE revenue was down 9% due to weak sales in onshore oil and gas, where the US fracking market is reducing gas prices, resulting in lower investment in new projects. Similarly, in the aftermarket, weak commodity prices are resulting in reduced activity in mining, where lower use of equipment is depressing spare part sales. Profit reduced by 45% as a consequence of the revenue fall, higher R&D and some warranty adjustments. We expect the second-half performance to improve, based on the strong order cover, and continue to guide Tognum's revenue and profit performance as broadly flat for the full year.

Turning to financial strength, we continue to place considerable importance on maintaining an investment-grade rating, given the long-term nature of our business, and having strong liquidity. During the period we took advantage of favourable market conditions to raise £1 billion of new funds, which provides a combination of refinancing and capital for general corporate purposes.

So, to wrap up, we've continued to see good order flow and top-line growth across the company. Profit growth reflects the benefit of volume in the IAE restructuring with other, largely one-off, impacts broadly offsetting each other. While some progress has been made on cost, there is still much to do, as there is around cash generation, particularly working capital. We are maintaining our full-year group guidance of modest revenue growth and good profit growth and a cash flow of around breakeven.

So with that, I'll hand back to John.

JOHN RISHTON: Thanks very much, Mark. We're now very happy to take any questions that you have. Over to you.

OPERATOR: Thank you. Ladies and gentlemen, if you wish to ask a question, could you please press 01 on your phone keypad now in order to enter the queue. After you're announced just ask your question. If you find your question has been answered before it's your turn to speak, simply press 02 to cancel. There will be a brief pause while questions are being registered.

Our first question is from the line of Rupinder Vig at Morgan Stanley. Please go ahead with your question, your line is now open.

RUPINDER VIG: Good morning, everybody. I've just got two questions, perhaps one for John, and one for Mark. John, first, just a question around the four Cs. You've talked about the progress that needs to be made on cost and cash. Can you just give us a bit more colour around what's happened in terms of the concentration, if you like? Are you now happy with the portfolio post the disposals in Energy? And in terms of customers, what progress has been made there?

And second question perhaps for Mark. On the IAE, what should we be now thinking for the full year in terms of the IAE payment? And are there any expectations, at this stage, of any RSPs in the second half of the year? Thank you.

JOHN RISHTON: Thanks very much. I'm very pleased that you've asked me about the other Cs rather than cost and cash. That's always a good start to any discussion. I think we made good progress on customer. The organisation is really starting to get that. We're starting to measure things well and the feedback that I'm hearing from our customers has improved, which is always welcome and reassuring.

In terms of our performance I'd just highlight Civil large engines. We've been on purchase order 100% all of this year on all the products. Marine, which was a drag, as I think you're all well aware, the performance of purchase orders has improved significantly and we're now well over 70% on time. You may remember that I've said in the past that if you went back two years we were about 10%. Last year we were running at 55%, we're now running at close to 75%. So, good progress in terms of customer, in terms of delivery. Good performance I think in terms of quality. I think we've still got much more work to do in what I would call responsiveness to issues. The nature of our business is such that there are always going to be issues. We need to respond much more rapidly and effectively to those issues, and we're turning our attention to those. But, over all, I'm very pleased with the progress that we've made in terms of customer and the attention it's getting within the organisation.

In terms of concentration, I think that for me there were two parts to that. The first part is the one that you referred to, which is, if you like, around the portfolio. I've been long clear, I think, that the Energy portfolio didn't make much sense to me. It's quite clear from the results again this half that we've still got more work to do on that. The good news within Energy is they've made lots of progress in terms of the product, in terms of the customer. They're starting to really get to grips with their cost base. We've got much more work to do there, so we haven't finished our thinking on that yet. More thinking to do. As in all businesses, we'll continue to address portfolio issues as we see them, and as opportunities arise, and I think the sale of our 50% holding in the RTM322 helicopters is just evidence of opportunism, in some ways, and a view that that wasn't something we wanted to invest in at this point in time.

So there are always going to be those kind of activities going on, but I think Energy would be the area that I'm still most concerned about from the overall financial performance within the group. Again, nothing new for you there, and in fact you're probably bored of me saying that, but I can assure you lots of work going on behind the scenes.

The other thing that concentration means within the group is I want people to concentrate on doing their job to the best of their ability and not be distracted by other things. So there are two elements to it and I think we're seeing some progress there.

Mark, do you want to talk about IAE and revenue-sharing partners?

MARK MORRIS: If I have to. Rupinder, I think I've got your question, which really was just looking I guess at H1 and then the full year and trying to sort of gather to the guidance when we look at profits at the group level of 32%, and obviously in Civil even higher. The IAE question really is a phasing issue and of course an impact of comparing H1 with H1, so if we go back to 2012, we were under, as I refer to them, the old trading arrangements. Of course, if you recall back then, we originally guided, and I guess the estimation has gone up from then, about £140 million for the full year and obviously when we updated it became £92 million for the half year. Of course, this year I've given you some numbers of £112 million for the first half. As I think I said in my presentation, expect a similar benefit for the full year. In terms of just looking at the phasing of how we bring those profit numbers back to where our guidance was, really what you've got are some phasing issues. You've got the IAE impact that only happens in the first half and impact much less in the second half, and then phasing issues of entry fee receipts, which are front-end

loaded and R&D charge which rises in the second half. Those will bring those profit number more in line with the guidance that we've given.
Hopefully that answers your question, Rupinder.

RUPINDER VIG: Yes, thank you.

OPERATOR: Our next question is from the line of Ben Fidler at Deutsche Bank. Please go ahead, your line is now open.

BEN FIDLER: Yes, good morning, guys. A few questions if I could, please. Firstly, just to understand within Civil Aerospace some of the moving pieces driving the profit performance there. I guess specifically, if you're able to just give us a bit more detail on what the level of product launch costs were in Civil Aerospace, and the restructuring costs there, just to try and get a view of the true underlying progress that you're making, John, on the unit cost base.

JOHN RISHTON: Do you want to read off your questions and then we'll take them one at a time or is that it?

BEN FIDLER: Yes, no, no, I'm afraid there's some more. The second one is I suppose just to understand your confidence level as to why Tognum's profit performance will be so second-half loaded this year, and why there's such a second-half improvement, just to understand your confidence around that. And the third question that I had is just around how -- your opening statements clearly talk about the progress you're making on cost and cash, but, as you say in the press release, this will take time and firm resolve to deliver. What sort of timescale are we looking at to deliver those benefits, in your mind?

JOHN RISHTON: Okay, let me maybe hand over the Civil question to Mark, and maybe, Mark, if you talk about Tognum as well, and then I'll talk a little bit about cost and cash.

MARK MORRIS: Okay. In Civil, like I highlighted, again we had volume growth, you've got the IAE restructuring and we've got a number of things that we put in "other". Product launch costs are in the low tens of millions, and on unit cost-- I mean, we've had some progression on what I'll call indirect and C&A, which will be around the sort of £10 million mark, but I'm not getting into breaking out all the other components that

we've got in here. We'll just go down a rabbit hole, frankly. But I think the key point to say is we're seeing progression.

BEN FIDLER: Thank you for some of those numbers you've shared. Again, I'm not expecting you to give full disclosure of that. My question is really coming from you had 6% revenue growth in Civil. If we strip out the increase in the IAE effect, and the increase in partnership receipts, arguably neither of which are trading items, you could argue, we had 6% revenue growth and the underlying profitability fell, even before we start looking at what you put on the balance sheet on TotalCare, etc. It was just to understand what's going on in driving some of those unit costs; hence, my question about was it a big warrant, was it a big product launch cost, was it a big restructuring cost? Because it looks like unit costs have clearly gone up quite significantly in Civil Aerospace.

JOHN RISHTON: What I would say, Ben, is that there's a raft of one-offs in the negative 24. We've broken out the IAE, you can clearly see the RSPs, but my perspective is pretty simple. We've got volume growth, we had the IAE benefit that we've broken out and there were a whole raft of broadly one-offs that broadly offset each other, which, if you take from what I've just said, what it says is that we didn't make much progress on unit cost or costs within Aerospace. We made some progress in other areas, but the biggest issue that I have, if I pick up your last question in terms of cost and cash, really centres around the Aerospace area and in particular centres around Civil. Defence actually did make some progress on cost and it's working hard on it.

If I narrow down where I am least pleased with the progress, it is Civil Aerospace in terms of cost. There are areas in Civil Aerospace where I was very pleased with the progress and I gave you some examples in the response to customers.

So in broad terms, cost progression in Aerospace is virtually nothing, and we have to address that because it is our biggest cost base and our biggest issue. As I think I've said to a number of you at various times, when you get into why is that, in part it's just human nature, I'm afraid.

Let me just talk a little bit about what's been going on. My simplistic story is that when you announce record profits, which we've just done again, when you announce record order book, which we've just done again, when you announce record everything, then people have a difficulty understanding why it is that I'm talking about cost. They really do have a difficulty. Now, you guys kind of get it

immediately, but you look at things from a slightly different perspective to most people.

If I break our company down, the Defence guys kind of get the cost issue because there's something called sequestration in the US and they've been through the spending review in the UK and they kind of get it and their world has changed. The Energy guys get it because of the environment that they're operating in. Our Marine guys are starting to get it and are making progress in terms of their cost reduction, as we have to, because we've got a very high cost base, largely been based in Scandinavia, which is uncompetitive. So they get it.

The area, understandably, that is struggling the most is the area where the growth and the benefits are all flowing through, which is Civil Aerospace, because Civil Aerospace is in a boom period. So what we did, again as you're well aware, is I got a group of six senior managers to go away and look at this and come up with a whole load of ideas. They finished their report, we've had a great discussion with those guys, we had a great discussion with Civil management. Civil management are quite clear on the opportunities that exist within their business, and there are significant opportunities. We're now grappling with the hardest part. So I've got people's heads at the management team in the right place, we've done a lot of work in terms of identifying opportunities, we're now moving to delivering the opportunities.

Now, in some businesses, and I've worked in some, it's pretty easy. I would suggest in the banking industry it's usually pretty easy to reduce costs. You kind of know what your costs are and you just get rid of them. In our industry, particularly in Civil Aerospace, when you're dealing with gas turbine engines and the biggest part of those costs are the engines, it isn't quite as easy. It takes engineering resource, it takes time, energy, effort, you've got to go to regulatory reviews. Some of the cost benefits are associated with how can you get longer on-wing service to reduce servicing costs. Some of the benefits are around how do we drive repairs into our services business rather than replacement, which is something we are comparatively weak at relative to our competition, and there's lots of opportunity there, but it takes time.

Other areas, and Mark mentioned one, our indirect cost-reduction programme, we're making good progress on that, but frankly you don't see any benefit of that because we've got a restructuring cost which offsets the financial benefits at this point but they'll flow through at some point in the future.

So in simple terms, if you're looking for cost benefit, cost performance in Aerospace, you're not going to find much, and that's a long answer to your very simple question.

BEN FIDLER: Yes, it's a very interesting answer. Thank you very much. I guess, just drilling down a bit further with that question, so in terms of timescale, how long does that take to push through that scale of cultural change, and the inevitable scale of restructuring change in what is a very complex business, and supply chain in Civil Aerospace? Is it two years, is it five years? When do you think you start to really see benefits come through?

JOHN RISHTON: Were you sitting in my board meeting yesterday?

BEN FIDLER: I was actually, yes. I'm small, so I'm easily missed.

JOHN RISHTON: As you would expect, similar questions are getting asked there. Of course, rather perversely, as the guy who sort of has a reputation for cost and cash management, it's puzzling to people why it's not happened overnight.

I think the answer, Ben, is back in what I was saying about the complexity of the change that we need to make here that will determine the time. As you might well expect, I'm not going to get hung up on a timescale on this. What I can do is absolutely assure you that it has a lot of attention at the moment and we are determined, I am determined, Mark is determined, the management team in Aerospace are determined, to make progress, because it is affecting what we can do and where we can invest, as is the cash performance. People are starting to understand that, they're starting to understand that if we don't improve our cost and cash performance, we can't invest as much as we want in new products and do the things we want to do in terms of people, training, infrastructure, products, all those kinds of things. So I'm not going to get on a hook in terms of a week on Friday, but it's going to take us some time. It's hard.

BEN FIDLER: Well, best of luck with it.

MARK MORRIS: You had one other question, Ben. I think we've ambled around probably 1 and 3. You had a question about --

BEN FIDLER: It was just Tognum, the confidence level around -- obviously, there's a very big improvement that needs to be delivered in H2. You mentioned R&D phasing. It was just about understanding why you're so confident in what has got to be a big step up in the second half, that it will be delivered.

MARK MORRIS: Again, this is a much shorter-cycle business. They've got good order coverage to go into the second half. Again, this is a very much higher-volume business that obviously helps on the overhead recovery. We've got some phasing on R&D and obviously we had some warranty adjustments in the first half which weren't repeated in the second half. Those are the sort of things as to why we're confident that Tognum will end up consistent with the guidance that we originally gave.

JOHN RISHTON: Ben, what we've seen in that business is the first part of the year was dreadful and it's been improving ever since, so the trend gives us confidence as well. That's what you've seen if you look at the direct competitors with Tognum, if you look at their results, you saw the same kind of thing in their first quarter and second quarter results. So the trend is positive. Order book, order coverage, is high. The management team at Tognum I think understood the realities that they we're facing at the start of the year, which means that we don't have to change guidance because I think we got it right the first time around.

BEN FIDLER: Thank you very much.

OPERATOR: Our next question is from the line of Robert Stallard at RBC. Please go ahead, your line is now open.

ROBERT STALLARD: Thanks very much, good morning. I've just got a couple of questions on the aftermarket, if that's okay. In Civil, I was wondering if you give us some idea of what Trent was up in the quarter, and how that contrasted with the RB211 aftermarket?

JOHN RISHTON: We don't sort of break out individual engine programmes. I think, as you'll take from the numbers, the aftermarket was up 3%, broadly in line with our thrust base. Within that, obviously in aftermarket revenues we've got a combination of T&M and Long-Term Service Agreements. And within that, of course, we've got a product range, some of which are new and young coming on and building up in terms of

LTSA's and so forth, and some which are coming naturally to the end of their lifecycle, and you've referenced to some of them in the RB211.

What I would say on RB211 is that the 535 continues to perform well and of course, as you'd expect, we try and manage the lifecycle to extend life. Whilst as aircraft get parked and engines come off, we also have a part of our business which we call parts trading, which will buy up parts to help reduce overhauls and extend the life. On the RB211 767 fleet and the old 747 fleets, of course, they are older and much smaller fleets so the impacts are much smaller. But by and large, and as we've guided, when you look at H1 versus H2, Civil as well as every other division will see growth in revenues in H2 both at the OE level and at the aftermarket level.

ROBERT STALLARD: So do you expect that aftermarket growth rate to accelerate in the second half, or be similar to what we've seen in the first half?

MARK MORRIS: Well, I think we've given revenue guidance for the year. I'm not going to start breaking out. All I've said is that it's higher than the first half in terms of absolute revenues.

ROBERT STALLARD: Okay. And then on the Defence side, you mentioned that there's a lot of uncertainty here, but the Defence aftermarket here, how do you expect this to progress given this lack of visibility? Is possible to say do you expect this to be similar in the second half, or could it possibly be down?

MARK MORRIS: Well, like I said, all of our divisions we are expecting for H2 to have higher revenues for H1, both at the OE and aftermarket level. Again, I don't want you to assume they're massive swings but we generally tend to have a bit of a bias in general between H1 and H2. In certain cases, particularly when we're dealing with government bodies and quasigovernment bodies, we tend to find that there tends to be some behavioural activity. They start with their budgets at the beginning of the year and they're very cautious and then they try and make sure they spend them by the end of the year, so you get a little bit of that behaviour in some areas and defence, I guess, is no exception. Of course, with the continuing uncertainty around sequestration and just general austerity measures in defence, I think, and as I alluded to in our results, maybe some suppressed flying hours in the first half that may change slightly in the second.

ROBERT STALLARD: Okay. And then just finally on Energy, you mentioned that there's still work to be done. Are you contemplating some relatively radical action here, like potentially selling, or spinning off, or joint-venturing some of the businesses here?

JOHN RISHTON: I'm not going to get drawn into any specifics, but what I've said and what you've all told me and what everybody knows is that the financial performance of that segment is totally unacceptable and we need to address that. There are a whole raft of things, as I said, that we've already done in terms of improving the product, including our customer position, reducing our costs, improving deliveries, all these kind of things are going on. We have to address those issues. You could break the Energy down into its two main parts that are the issues. Oil and gas is a good business, as I've said a number of times, but it's small. We have a good market share, it's basically us and GE. Power generation is much more troublesome for us in terms of financials, where we are tiny, tiny, tiny player. We're looking at what we should or shouldn't do, how we could or couldn't do it, and when we've got our minds around that, we'll let you know.

ROBERT STALLARD: Great. Thank you very much.

OPERATOR: Our next question is from the line of Nick Cunningham at Agency Partners. Please go ahead with your question, your line is now open.

NICK CUNNINGHAM: Thank you, good morning. I think it falls to me to ask some of the nerdy rather than philosophical, questions. An elephant issue, as far as the margin outcome in Civil is concerned, is the mix between the linked and unlinked engine sales. And judging from the big rise in the TotalCare receivable and the very small rise in capitalised engine costs, it was mostly linked in the first half. Is that going to continue to be the case for the rest of the year? And is there any indication as to how that's going to look next year?

And also, just to clarify on IAE and the entry fee receipts, I think what you're saying is that you've had most of them for the year and there'll be only a little bit in the second half. I just want to make sure I got that right. And then final detail question, just I've sort of lost track of what the basis is for Tognum in saying that you're going to do something similar this year compared to last year, so would you just be able to clarify what last year's basis was? Thank you very much.

MARK MORRIS: Let me just take those answers in reverse order for a second. The Tognum stuff is actually on the charts. We've showed you I think the second-to-last chart which shows Power Systems, what were Tognum, at 100% trading. What we've said is that we were guiding revenues and profits broadly flat. If you want I can give you the breakout for those. Revenues, I mean, broadly they're around about £1.3 billion. Sorry, for the full year. Are you looking at the full year?

NICK CUNNINGHAM: Yes, yes.

MARK MORRIS: Just give me one second here. Let me get this for you in a moment and I'll answer the other questions.
What was your second question?

NICK CUNNINGHAM: I was looking at just clarifying the IAE and entry fee receipts that --

MARK MORRIS: Yes. Your assumption was right on question 2, yes. Just changing in the first half

NICK CUNNINGHAM: And then the linked and unlinked ratio.

MARK MORRIS: Yes, okay, so in terms of the net TCA debtor, yes, it's risen. Again, if you remember, there were two components of that. We've got a combination of more engine deliveries. Again, with the linked we get the benefit or we get the impact of clearly revenue ahead of cash, which builds up a debtor. But on the flip side of that, shop visits will obviously drive down the trade creditor, and it's really a combination of those. I think your question was relating to has there been a bias towards linked versus RECs, and the answer in the first half is yes. I don't want to get into specifics of what happens in H2 and then what happens next year. I think you're aware, Nick, that obviously in relation to XWB as the volumes grow there, that will tend to be REC accounted rather than linked accounted, just because of the nature of the contract we have with Airbus there. Obviously as those grow then you can expect some increases in RECs versus linked.
Just to give you some broad picture on Tognum's revenues, last year they were about €3 billion and profit of around about €300 million, and again we've guided flat for the year, so the same again for Tognum at 100% level.

NICK CUNNINGHAM: Thanks very much.

OPERATOR: Our next question is from the line of Andrew Gollan at Investec. Please go ahead with your question, your line is now open.

ANDREW GOLLAN: Good morning. Two questions, really. First on Civil aftermarket, and to extend, I think, what Rob was asking earlier on. The growth year on year was 3% Civil aftermarket. Could you perhaps give us the split between, or a rough split between, time and materials and LTSAs? That would be quite helpful. That's the first one. Second one, again, clarification on the IAE guidance for the full year. Are we talking about roughly £200 million versus the £140 million that you talked about a year or so ago? And the other sub-question to the IAE number, can you explain what's exactly going on relative to your expectations, I guess, in terms of supplying parts into the V2500 build program, or parts into the spares system, just to explain why it is outperforming by so much?

MARK MORRIS: Okay, so a couple of questions. The issue around IAE - again, I've given you sort of guidance or indicators for the full year. A similar effect for the full year, so I guess around about £200 million will give you the flavour. Sorry, your last question was ...?

ANDREW GOLLAN: The last question related to IAE was why that is so outperforming where we thought we were a year and a half ago, in the context of what's going on in the build programme and the spares environment.

MARK MORRIS: Okay. All this reflects is the amount of part sales and the type of part sales and therefore the type of margins that we make. We make estimates, but obviously spare-part sales are relatively short term. They're typically on 30-day lead-time, even less. So it's just a question of what's happening in T&M and the LTSA market as to what can drive that. In effect, we've sort of under-called in the past what those are. Of course, the other part of this is there are some transfers that are ongoing between us and UTC, and we've assumed a timeline for that and some of those timelines have sort of moved a little bit to the right, so there is some stuff we're doing more that eventually we won't be doing. But again all of those are factored in. Really it's a combination of the volume has been a little higher, the types of parts we've sold have made slightly better margins, and some of the work transfer that was destined to go on a certain schedule was delayed a little bit.

ANDREW GOLLAN: Sorry, can I just ask then, do we expect a similar rate of fade from the £200 million or so annual number that we were talking about?

MARK MORRIS: I'm not going to give multiyear guidance, but when we originally raised the IAE effect, what we said is we were going to get an uplift in profit reflecting the revised trading arrangements. Again, just clarifying what they are, in effect, we've gone from being an equity partner to a supplier. We continue to make parts, we continue to assemble engines and we've received a value of dollars per engine flying hour on the installed fleet at the point of sale. So those are the sort of revenue sources. What we've said is, yes, eventually it will start to drift down but for the first few years it will remain relatively flat.

Your first question, just to come back to it, because I did write it down, was a split between T&M and LTSA. I'm not going to get down into individual breakdowns, but what I will say is that our T&M and LTSA between them, if I look at H1 to H1, was slightly up on T&M in the first half. I expect it to be slightly less in the second half, but it will be more than compensated by LTSA revenue in H2. That's why we continue to see revenue growth and higher revenues in H2 on aftermarket for Civil.

ANDREW GOLLAN: Okay, thank you.

OPERATOR: Just to remind all participants that if you have a question could you please press 01 on your telephone keypad, and if you wish to withdraw that, press 02 to cancel.

We go over to the line of Olivier Brochet of Exane BNP Paribas. Please go ahead, your line is now open.

OLIVIER BROCHET: Good morning, gentlemen. I would like to focus on three questions, if I may. The first one is on warranties. You mentioned that a couple of times in the prepared remarks. Could you put some more flesh on that for Marine and Tognum? Is there any lump that we should be aware of there?

Second question is on Tognum. Can you update us on your view on the synergies and business opportunities that you've found now that you are in complete control of the company? Any good or bad surprises there? And third on inventory and working capital. You clearly look displeased, or even upset about the performance in H1. What has exactly been sleeping that -- what has been missed? What will you be doing different now?

JOHN RISHTON: Let me take a couple of those and maybe ask Mark to comment as well. In terms of inventory, you're correct. Here's what I would say: there are a number of elements to it. First, and I think in some ways most important, we've been driving to improve our customer performance, and our customer performance has been poor in the past. I gave two examples to an earlier question, where Civil large engines is 100% and Marine increasing from 10% to 55% to over 75%.

One of the ways that we've achieved that is inevitably the obvious way, which is we've put more inventory into the system to make sure that we don't let our customers down. So that's part of it. What we were unable to do is to drive the performance better so that we have more confidence at the moment in the supply chain. So we're getting there. Supply chain performance has improved significantly but it hasn't reached the tipping point whereby the inventory is starting to flow through the system more efficiently and effectively.

So in simple terms, I've put more inventory in to protect the customers. Supply chain performance has improved but it isn't yet at a point where we can reduce the inventory buffering and so protect our customers, but we're getting closer to it.

The second point is the overall management of inventory within the company, if I could take that as a big bucket. So we set up an Aerospace organisation and we're still working through that. So whilst we announced that some time ago at the beginning of the year, anybody who has been involved in large organisation changes know they take some time. We're getting down to some of the really important elements in terms of inventory control and the actual individuals responsible for ordering and managing stocks within each individual plant and we're going to centralise that because at the moment that's still done at a plant level. In my experience, if that's the case, you've never got control over inventory and you need to get control over it at a central level, because all the plants really are still interested in is making sure they don't get beaten up for non-production, so they buffer on the buffer on the buffer. In simple terms, those are some of the main issues that are going on and that's why it takes time to get to and why it requires my patience.

In terms of Tognum, on the synergy side, yeah, we have been through the synergy side. I think what I would say, and I'm not sure I said this before, is it's clear that there are more benefits in terms of Marine than there are on the Energy side. We're comfortable that there are synergies and we're comfortable that the acquisition is a sensible one. We are pleased with the programme and the progress that they're making. Clearly they have a lot to do with the integration of Bergen into their business. We're already getting benefits from their expertise associated with our

Bergen engines, in terms of R&D, in terms of knowledge of emissions, in terms of that technical expertise, and we're starting to see some benefits in terms of sales. We've still got a lot more work to do on that area. Whilst Tognum has been around for two years, management control has only been for six months, but we're working hard on that now and that's going I think as well as I would expect. Warranties, Mark, I don't know if you want to make any comments on warranties?

MARK MORRIS: No, not really. We don't break out individual components of warranty. What I did allude to obviously in the presentation were the two areas where we had increased warranty loss were really around Tognum.

OLIVIER BROCHET: But there is no big lump that we should be aware of?

MARK MORRIS: No. Look, it contributed to the movements in profit in terms of affecting adversely, but, no, I don't want you to think there was some sort of material overly-sized adjustment, but there was an increase. As is quite normal, you know, warranty costs rise and sink and that's just part of the business cycle.

OLIVIER BROCHET: Yes. What I was aiming at is, is it something that we should be thinking of continuing in the future, or ...?

MARK MORRIS: I hope not.

OLIVIER BROCHET: Okay, thank you very much.

JOHN RISHTON: If you want the real answer to that, it's how do I improve my performance to customers. And one of the ways I do that is by making sure that the products are the right quality and it works right first time, so hopefully we should get some benefits, but, again, they take a long time to flow through.

OPERATOR: Our next question is from the line of Celine Fornaro of Bank of America. Please go ahead, your line is now open.

CELINE FORNARO: Good morning everybody. Thank you for taking the question. My question will be on the Marine weak performance on this first half of the year, because even if we compare it historically, you used to have the Bergen business, which was slightly below that division margin, and now it's being carved out. So how should we think

about the margin progress in the H2? And also, when I look at the big increase in the order book in this division, how is the pricing? Is there a risk that you have been trading sales for pricing? And shall we see that coming through quicker because these orders, or this order book, is not as lengthy as it used to be two or three years ago? Thank you.

MARK MORRIS: The first thing to say, and as I said in the presentation, we're disappointed with profit performance in Marine in H1. There are a number of reasons for that that I alluded to. There's a combination of adverse mix, warranty charges, as we've just talked about, against, interestingly, some foreign exchange benefit and unit costs. But again, a better mix in the second half, good order cover, some non-repeats of some of the one-offs gives us the comfort that that's where we'll be.

Like I think John alluded to when he gave a broad overview of Marine, there are three basic segments in there - Offshore, Merchant and Naval. Offshore, we're seeing some encouraging signs in terms of bid activity and certainly as we look into H2.

Services revenue growth has got a good opportunity, we've ramped up more networks there and that gives us more access. The merchant business still remains pretty much in the doldrums but it's only about 20% of the total size of Marine. Naval - interestingly, whilst you'd argue that it sits in terms of defence behavioural patterns, it's performed slightly better, certainly in terms of what we've seen this year and for the rest of the year that we're looking for. I think that's a quick summary of Marine, both in terms of where we see profit progression and revenues.

CELINE FORNARO: But in Offshore, do you continue to see pricing pressure on the offshore environment?

MARK MORRIS: Absolutely. It's a tough market. We're seeing, interestingly, a move, certainly on things like OSVs (Offshore Supply Vessels) to slightly larger ones, which gives us the opportunity to quote for more types of equipment on those vessels. But, yes, it's a tough environment and I would say that actually price pressure more than offsets unit cost, even though they made good progress on unit cost.

CELINE FORNARO: And my second question would be if you could split looking at, you've done that in the past, on the service growth in the Civil Aerospace division. If you could give us an idea on how much was time and material and on how much was TotalCare on the 3% growth number.

MARK MORRIS: Again, we don't normally break that out and I haven't actually got it to hand, but I'm sure we can give you that number if you need it.

CELINE FORNARO: Thank you.

OPERATOR: Our next question is from the line of Sandy Morris at Jefferies. Please go ahead with your question, your line is now open.

SANDY MORRIS: A slightly simplistic question, but if I look at Civil Aerospace, and I look at engine deliveries in this first half, what we appear to have is nice volume growth on BizJets, and so Dahlewitz in Germany. When you say there was a £103 million, whatever it was, volume benefit, I'm assuming that's where it arises. In the meantime, in terms of large engines, we're marking time. Is that the right way to look at it, that a big chunk of the business is doing just fine and enjoying strong volumes growth and the rest of it is still sitting there poised to go at some point? Or is that just too simplistic?

MARK MORRIS: No, I think, as you say, Sandy, there's an element of truth there. We've talked about XWB, and certainly in terms of when you look at our investments we're looking to double capacity for Trent. The XWBs haven't come on line yet, and of course you know there's a huge order book. So this year has been one where, yes, of course, in some divisions we've got more growth in units, but Trents totally for the year will be similar numbers to last year. Of course, we're just getting ready for the growth that we'll see that starts in 2014.

JOHN RISHTON: I think you summarised it very well, Sandy, and Mark's point is right. You break it down to the engine types and you see Trent 700s continuing to do well. You're seeing slow and good growth coming in Trent 1000, XWB yet to come and a slowdown in Trent 900s, which is exactly what you'd expect based on the aircraft sales. The growth that we're going to get in Trents, which is evident from the order book and, as Mark said 90% of the order book relates to Trents, is yet to come, and it will come as the volume of Trent 1000s for the 787 grows as the aircraft sells more. I'm sure it will and it will come even more when the A350 comes on line and starts to sell, as it will.

So that's what really drives the volume growth, so one of the issues that we as the company grapple with in terms of costs is managing the preparation of significant

growth in large civil engines, which hasn't happened yet but will happen, while we're trying to manage our costs against the future work we've got to do in the current environment. So the summary you describe as simplistic is exactly right.

SANDY MORRIS: I'm not trying to be glass half-full, or empty here. It's just your comments about driving cash and costs I think are generally welcome, and I think we appreciate it takes time. How happy are you, though, that when the volumes go up they won't just absorb cash to keep the comfort zone? And do you think costs are getting to the right place? I understand that you want to keep the pressure on, but is it a worry, or is it just ...?

JOHN RISHTON: I don't lie awake worrying about it, if that's what you mean. I think we'll make progress. I think if you work in a company that's shrinking, getting costs out is one thing, because people see a clear and present danger. Getting them out in a growing company is about how do you manage the cost expansion relative to the growth. As I said to someone earlier today, what we have been doing, which was not smart, was allowing our costs to grow ahead of our volume increase. In some areas that's inevitably the case. Building Singapore, I don't need much of Singapore at the moment. We'll build 50 engines there this year, but at some point in the foreseeable future we'll be building there at one a day, so I have to let those costs increase ahead of the volume, because otherwise I haven't got capacity. But some of what I call fixed costs apparently weren't fixed in this company and we've got to make sure that we nail those down.

We've got to get ourselves into this cost mentality, is what I would say, Sandy, which is what we're grappling with, particularly in the Civil business, as I was explaining earlier, so that we are well placed to be much more efficient, much more cost-competitive and therefore much more profitable so that we can invest in people, products, infrastructure, price, whatever it happens to be. That's what we're trying to do.

SANDY MORRIS: Okay, great. Thanks ever so much.

OPERATOR: As there are no further questions, gentlemen, may I please return the conference to you to close?

JOHN RISHTON: Thanks very much for joining us this morning. I hope you found the call useful. It's always a pleasure to talk to you every half year or so on the results. We look forward to speaking to you early in the next year about the full-year results.

OPERATOR: This now concludes the call. Thank you all very much for attending. You may now disconnect your lines.