Rolls-Royce Holdings PLC
Half Year Results Presentation

Thursday, 27th August 2020

Operator's Introduction

Operator

Ladies and gentlemen, thank you for standing by and welcome to the Rolls-Royce PLC 2020 Half-Year Results Conference Call. At this time, all participants are in listen-only mode. After the speaker presentation, there will be a question-and-answer session. To ask a question during the session over the audio, you will need to press star one on your telephone. You may also use the 'Ask a Question' tab, available on your webcast page, to submit your questions online. I must advise you that this conference is being recorded today, Thursday, 27th August 2020 and without any further delay, I would now like to hand the conference over to your first speaker today, Isabel Green, Head of Investor Relations. Thank you, please go ahead.

Welcome and Disclaimer

Isabel Green

Head of Investor Relations, Rolls-Royce

Welcome, everyone, to our 2020 half-year results presentation. With me today are Warren East, CEO and Stephen Daintith, CFO. We will start the slide presentation shortly with an introduction from Warren, followed by a more detailed review of results by Stephen and an update on our plans for the future from both Warren and Stephen. In all, this should take about 50 minutes, leaving time at the end for Q&A.

Before I hand over to Warren, please take note of the safe harbour statement on slide two. This results presentation contains forward-looking statements that involve risks and uncertainties that may cause the actual results or developments to differ materially. Thank you and over to you, Warren.

Chief Executive's Introduction to the Half Year Results

Warren East

Chief Executive, Rolls-Royce

Summary of H1 2020 performance

Thank you, Isabel. Well, it feels as if this year has been all about COVID. Although we came into the year and started with good momentum, COVID-19 arrived in Q1 and has a material impact on the whole of the civil aviation sector and it significantly affected our first half performance and our outlook for the future.

Lower activity in civil aerospace drove a 24% reduction in group revenue and that led us to a £1.7 billion operating loss in the period. When COVID hit, we acted quickly. We acted quickly to keep our people safe, to minimise operational disruption and we provided practical assistance in the countries and communities in which we work.

We acted quickly to strengthen our liquidity position, with new borrowing facilities established. Also, we rapidly responded on costs, driving immediate short-term reductions in

discretionary spend and CAPEX, with £350 million delivered in the first half of the year and we're on track to achieve our target of £1 billion of savings for the full year.

Looking a little bit further ahead, in May we announced the largest restructuring of Civil Aerospace we've ever undertaken, fundamentally resizing to align our capacity with expected future demand and save at least £1.3 billion of ongoing costs across the group.

We also want to take steps to rebuild our balance sheet in the medium term and today we've announced planned disposals to generate more than £2 billion of proceeds. We'll come back to that later on.

Overview

Turning to slide five, this is an outline of what we're going to cover this morning. As you know, we're in the middle of an unprecedented shock to the civil aviation sector and that's going to take a number of years to recover from. We have a clear strategy, however, to lead Rolls-Royce through these difficulties and we're creating a leaner and more balanced company for the future on the other side, so today's presentation is split into four sections. Stephen will talk through the interim results in some detail and our plans to strengthen our balance sheet and I will cover our extensive restructuring programme for Civil and the wider strategic priorities.

So, with that introduction, over to Stephen.

H1 Results Summary

Stephen Daintith

Chief Financial Officer, Rolls-Royce

Thanks Warren and good morning everybody. So, as Warren said just now, although we started the year with positive momentum from a strong 2019, COVID-19 has severely impacted our business.

The worst impact was very clearly in Civil Aerospace, with large engine deliveries and flying hours each down around 50% in the first half of the year. ITP, in the civil aerospace sector, was similarly affected. Power Systems has been less severely impacted, with industrial markets suffering the most and Defence has remained resilient, with good support from ongoing government programmes. You'll see that in the slides attached.

Impact of COVID-19 on Rolls-Royce

So, slide seven, you can see on slide seven the impacts on our divisions in more detail. In Civil Aerospace, looking at that chart there on the top left, flights were grounded around the world from around the middle of March, with April the worst month, when large engine flying hours were down around 80% compared to 2019. For the second quarter as a whole, flying hours were down around 75%. The data since then has shown modest recovery but remained weak as governments tried to find the balance between containing the virus and protecting their own economies. Business jets and regional flights have been less impacted, with fewer cross-border routes.

Now, we have been working closely with our airframe customers, particularly Airbus and Boeing, to reschedule engine deliveries to match their reductions in build rates. We expect to remain at lower levels until at least 2022.

Power Systems was less impacted, industrial end markets were hit by economic disruption but marine and power gen have actually held up relatively well.

Now, as you might expect, our Defence business was resilient, with no material impact from COVID and delivered a strong profit growth in the first half of the year.

Group underlying results

Moving on to the next slide, so here at the group underlying numbers. Firstly, revenue is down in the first half mostly due to the significant reduction in the contribution from Civil, as you can see from the chart. Our underlying gross loss of £967 million included £1.2 billion of COVID-related one-off charges. So, what are these?

Well, these results include significant negative contract catch-ups, £866 million in revenues and £840 million in gross profit. And as a reminder, a catch up happens when there is a change in projections that results in the recalculation of the future value of our long-term service agreements. Now, in this case it was negative because of a decrease in the forecasted engine flying hours over the term of the contracts and these are due to revised assumptions around things like utilisation levels, parkings and retirements.

On average, there has been a modest negative impact on expected contract margins as a consequence of these revisions.

Also in Civil and in addition to the catch-ups, we incurred a £309 million charge for estimated future losses on a small number of contracts. Most of these related to Trent 900 engines and there's also a £95 million charge for specific customer provisions and customer credit rating changes. Now, as a reminder, when we have a contract that moves into a loss-making position, we recognise all expected future losses up front and unfortunately, this period, we have a small number of contracts which have either become loss-making or where expected future losses have actually increased.

Our underlying loss before tax of £3.2 billion also included a £1.46 billion underlying finance charge to reduce our US dollar hedge book. We took the necessary decision to reduce our hedge book because the industry downturn left us over-hedged by around £10 billion. Now, had we not done so, there was a risk that a further weakening in sterling would leave us in a more – much more impacted position. In addition, we were net purchasers of US dollars in the first half of this year and able to utilise our hedge book in the period.

Now, this means that our underlying results are presented at an effective rate of $1.24 to the pound in the first half of 2020. That's the – you know, pretty much the spot rate in the first half of the year. This compared to the hedge rate achieved in the first half of 2019 of $1.53 to the pound. Next slide.

Civil Aerospace

So, a quick run-through of our underlying business results now, starting with Civil Aerospace. Revenue was down 37%, as you can see from the chart, with steep declines in both original equipment, OE and aftermarket services. We reported an operating loss of £1.8 billion and that includes that £1.2 billion that I referenced earlier of one-off charges that mostly came as

a result of COVID-19. Total shop visits were up marginally on the prior year. We eliminated aircraft on ground due to Trent 1000 durability issues and performed scheduled overhauls and check-and-repair visits on high-cycle engines that were mostly booked in before flights were grounded. We continue to expect the final Trent 1000 fix to be certified and ready to fit to the fleet by the end of the first half 2021.

Moving on to time and material profits, now this includes the V2500 flying hour payment. That's reduced, with the lower aircraft utilisation. The benefit to profit from fewer loss-making large engine installed deliveries is more than offset by lower business jet and large spare engine sales and under-recovery of fixed costs.

Now, you'll recall, as announced in early August, we have some signs of wear to IPC blades in some Trent XWB-84 engines at the first shop visit. Now, this was identified during proactive checks we had in place. None of the engines have suffered in-flight shutdowns and none of our customers have been significantly inconvenienced as a result. We've put in place a process now to check all engines over 2,300 cycles on a regular basis and until a permanent solution is found, we'll now replace this part as standard at the first shop visit.

The annual financial impact is not actually considered to be material. Notwithstanding this matter, the Trent XWB remains the most successful engine launch we have ever had and the early performance of this programme has been successful both operationally and financially.

Now, some of you will have noticed that we've not reported our usual operating metrics today, average OE loss per engine, for example, or the aftermarket margin. Now, we're still tracking these internally and striving to deliver fundamental improvements but the extraordinary circumstances that we're facing have affected the usefulness of reporting them. For example, the benefit of lower losses on the single engine are offset by lower plant utilisation.

Now, as we move into the second half of the year, shop visit activity will start to reflect the drop in fleet utilisation as engines reach service milestones more slowly. Also, the actions we took in the first half to slow down procurement, eliminate non-critical spend and reduce pay will start to offset some of the performance decline, so an important trajectory in the second half of the year.

Power Systems

Moving onto the next slide and Power Systems, looking at the Power Systems numbers, revenue was down 11%, to just under £1.3 billion, with similar falls in revenue for both OE and services. On the OE side, our customers in industrial markets were the most impacted by lower activity levels, particularly those with exposure to oil and gas and mining. We experienced a reduction in demand for smaller yacht engines, with some marine yards closed for much of the second quarter but on the government side, our marine business performed relatively robustly.

Power gen activity started the year well but did experience a slowdown in the second quarter, most notably, in fact, in the US.

Order intake included 40 MTU engines and generator sets. These will be used for main propulsion and onboard power generation for five new Type 31 General Purpose Frigates for the Royal Navy. We've also celebrated a sales success with Irish Rail, ordering 41

hybrid-ready power packs during the second quarter and there's potential there for a further order of around 30 hybrid power packs per year, starting in 2023, so good momentum there.

Services revenues were negatively impacted by lower fleet utilisation, particularly in transport and oil and gas markets.

So, for Power Systems, operating profit was down 79% to £22 million, showing the under-utilisation of the fixed cost base, which was unable to react to the speed of the downturn in demand. It also included, in that number, an inventory write-down of around £20 million on the back of a weakness in commodity market demand.

Now, despite the challenges of the current market conditions, we're still focused on benefiting from structural trends and increasing our share in fast-growing markets. We've added two bolt-on acquisitions to enhance our Power Systems offering, with the addition of Qinous in January and Kinolt in July. Qinous brings electricity storage solutions to enhance our microgrid offering and Kinolt provides uninterruptable power supply systems that are a great addition to help us grow our share of the mission-critical back up power generation market. Our push to expand into China remains high on our agenda and we have expanded our partnership with VPower Group, enhancing the relationship to include distribution of our MTU products in China.

Defence

Moving on to our Defence business now, on the next slide, so our Defence business saw limited impact from COVID-19 and performed well in the first half, delivering another strong set of results. Demand remained resilient and our government customers remained supportive in both our key markets: the UK and the US. Revenue of just over £1.5 billion was marginally higher than the prior year, with increased service revenues relating to a growth in naval repairs and higher spare parts sales. OE revenue was also up, helped by favourable phasing of deliveries. Operating profit was 19% higher, driven largely by mix and benefited from group-wide efforts to cut costs, including salary reductions and lower travel costs.

Mitigating actions to manage the supply chain risk and operational disruption from COVID-19 were successful, with no material impact to us or our customers. Our Defence business is steadily growing and we're investing for the future with investment in facilities and people. We completed the revitalisation of our operations facilities in Indianapolis over the summer and this will be one of the most productive sites enabled by digitalisation and technology.

ITP Aero

And finally, moving on to ITP, ITP has faced the same challenging market conditions, unsurprisingly, as our Civil Aerospace business. Demand for OE and services were severely impacted by the grounding of fleets and the reduction in build rates for our OE customers, particularly for widebody engines. In Defence, ITP saw lower OE volumes on the TP400 and adverse phasing on the EJ200 activity. Operating profit of £10 million was down 70%, despite significant management efforts and actions to cut costs.

Summary funds flow

So, returning to the group results and looking at our cash flow, the summary funds flow, in the first half of the year, which is a really important slide, this one, there are five key drivers that reconcile the underlying operating profit of a loss of £1,669 million to the group free cash

flow, again, an outflow of £2,801 million. There are five key drivers that reconcile those two numbers and let me go through these one by one.

First of all, starting with the – the Civil Aerospace net long-term service agreement balance. Well, that grew by £788 million in the first half of the year. Now, this may seem counter-intuitive, given the significant fall in flying hours that we're highlighting today but this is the result of the £866 million contract catch up to revenues that I referenced a little earlier. Typically, we do see an increase in the LTSA balance. However, if we adjusted out the catch-up effect, we would have seen a reduction in the LTSA balance, as revenues, which are driven by shop visit costs, were larger than the reduced level of flying hours received, so I hope that makes sense.

Secondly, CAPEX on property, plant and equipment was over £100 million – in fact, to be precise – £127 million lower than last year, as we immediately stopped all non-committed spend in March to save more than £1 billion cash costs. That's in total across all of our efforts to mitigate the impacts of COVID. Similarly, on the third point, CAPEX on intangible assets was down by around £100 million, with lower capitalisation of new civil engine programmes, as we reassessed our near-term investment priorities.

The fourth bucket, working capital: now, there's a lot going on here, so we've got a separate slide on that coming up and I'll go through this in detail shortly.

And finally, the movement in provisions. The growth in the provision balance is the net result of just over £300 million of new provisions for onerous contracts – our earlier comments – offset by approximately £500 million due to a reduction in provisions related to the Trent 1000 in-service costs. The lower flying hours this year and in our forecasts means that more of our Trent 1000 engines will be able to have the final fix installed at the next shop visit, reducing forecast shop visits and customer disruption costs and saving around £300 million. The other savings come from an improvement in onerous contracts, with reduced losses as a result of lower engine utilisation.

Working capital

Now, moving on to the next slide and a deep dive on working capital, so starting with inventory build of around £300 million, so that's the top half of this chart, we acted quickly to control our supply chain to mitigate the impact of COVID-19 on our operations. We secured access to all the parts we needed, while minimising the build up of any excess parts. However, some items, as you know, are ordered many months in advance, so a build in inventory was unavoidable. We also saw an increase in finished but undelivered engines, as our customers adjusted their build schedules. We expect a significant inventory unwind to take place during the second half of the year, as we settle down to the new, lower, normal pace.

The change in net receivables and payables includes £1.1 billion from our decision to stop invoice discounting. Previously, we had used this to pull forward cash due from airframers, who have fairly long payment terms. This provided us with short-term liquidity. Now, this year, in light of our drive to cut all unnecessary spend and our strong liquidity position, we decided to stop doing this.

The remaining £400 million deterioration in working capital comes about almost mathematically – mechanically, sorry. In our Civil Aerospace business, it works with a

negative working capital pattern. We are collecting the money owed to us from our customers ahead of carrying out the work. However, if business shrinks, we see an outflow of cash as the situation unwinds. The good news is that this will stabilise when the market starts to recover and reverse when we return to growth.

Recovery scenario

Okay and moving on to the next slide and our expectations for the recovery. We've based our forecasts on a thorough review of all the data. We've included current airframer build rates, industry and macroeconomic forecasts, together with a bottom-up analysis of our own fleet.

Now, we believe the worst is actually behind us in terms of the severity of the impact on widebody engine flying hours. They dropped 80% to the low point in April before recovery to between 70% and 75% down in May, June and July.

Now, based on our base case scenario, we expect our large engine flying hours in the full year 2020 to be 45% of the 2019 levels and you can see that in the table there, up at the top, before recovering to approximately 70% of 2019 in 2021 and 90% of 2019 levels in 2022. We don't expect a full recovery until 2024.

Now, why do we believe that this will be the shape and timing of our recovery? A few things here. According to the latest IATA forecast, global revenue passenger kilometres, RPKs, are expected to recover to 64% of 2019 levels in 2021 and then to fully recover by 2024, with domestic travel expected to be stronger than international travel.

During the first half, Rolls-Royce large engine flying hours were down 46% and they outperformed those revenue passenger kilometres that were actually down around 58%. There are several explanations for this. First of all, it reflects the impact of falling airline load factors. Now, we're not exposed to how full planes are, it's the flight that matters to us.

Secondly, we've seen resilient demand in freight and domestic travel, which account for approximately 20% of our flying hours and thirdly, we have a greater exposure to China and the Far East, which have seen the fastest recovery to date.

And finally, worth reminding ourselves, we have one of the youngest fleets, with an average age of around nine years: younger, more efficient and more versatile widebody planes, like the A350, where we are the sole engine supplier, with our Trent XWB engines and we're seeing much higher utilisation levels there.

Now, we expect that these factors will continue to benefit our install base, leading to accelerated market share gains, with lower retirements of Rolls-Royce widebody aircraft in the coming years. Now, of course, we all recognise, though, the pace and shape of the recovery is uncertain and no one has a crystal ball. Therefore, in addition to our base case, we've considered a plausible and severe downside scenario to make sure we are ready to take the necessary further actions.

Now, as a guide, we estimate that each percentage point movement in large engine flying hours is worth about £30 million in flying hour cash receipts and I'll come back to this point later. And you can see on the table there how we've highlighted what the downside scenario looks like, in respect of engine flying hours.

Guidance

So, on the next slide, we're expecting to see around £4 billion of free cash outflow in 2020. Now, that implies around £1 billion outflow in the second half of the year. Now, it's a significant improvement from the £2.8 billion outflow we're reporting today in the first half numbers, with a relative benefit from inventory unwinding and an increase in spare engine sales. The £1.1 billion impact from invoice discounting was a one-time hit in the first half and won't reoccur. Our cost mitigations delivered around £350 million in the first half of the year. We're confident in achieving at least £1 billion in total, so that implies at least £600 million of mitigations in the second half of the year.

Headwinds in the second half, however, include lower engine flying hours and a further expected reduction in income from time and materials. Now, in addition to the free cash flow, we expect to incur in the region of £400 million or so of costs related to our restructuring programme. This compares to £87 million in the first half, which most related to the tail end of the 2018 programme.

Now, based on this guidance, we're forecasting therefore around – net debt of around £3.5 billion at the end of 2020, a deterioration of around £5 billion over the year. We do expect further free cash outflow overall, as we look across 2021 but at a significantly reduced level compared to 2020. Helped by a little seasonality, we are targeting a return to positive free cash flow during the second half of next year. Warren will come back to this point later.

We aim to restore annual free cash flow to around £750 million as early as 2022, as we look beyond 2020, driven primarily by our expectations for market recovery, restructuring savings and the non-recurrence of the working capital headwinds that we have in 2020.

Now, both of these targets are before the impact of any potential disposals and they also exclude costs related to the restructuring programme. However, both targets do, as a reminder, including around £300 million in each year of costs related to the reduction of our over-hedged US dollar position that I referenced a little earlier.

So, our 2021 and 2022 targets are stepping stones in our recovery and they do rest on the base case assumptions we have made. If, as is entirely possible, the world takes a little longer to get back to normal then these targets could take a little longer to achieve. But we are confident that the self-help actions we are taking will get us there in the end.

So, I'll pass back to Warren now to talk about the steps we've taken to restore our financial performance. Warren, over to you.

Restoring Financial Performance

Warren East

Chief Executive, Rolls-Royce

Thank you Stephen. Now, I've said before, this crisis is not of our making but it's what we do about it that matters and that's what we're focused on. And that's why we took the decisive actions early on to strengthen our liquidity and that's why we acted quickly to begin the restructure of our Civil Aerospace business. I'm going to talk about that soon.

Free cash flow generation expected to return sustainably positive during H2 2021

I'll start with this slide, however. The phrase 'cash is king' has never been more apt than it has been for us this year. Now, those of you looking for some precise cash flow guidance here, please put your rulers away. This is not a calibrated chart: it's an illustration of our monthly free cash flow based on what we've seen so far and our expectations for recovery.

Our target is for a sustained return to positive cash flow at some stage during the second half of 2021 and it's based on the drivers that are shown on this slide. First of all: a gradual recovery in engine flying hours. Secondly: a stabilisation of the rate of procurement as we adjust from previously-higher levels of production and output to expected lower levels. And thirdly: achieving our planned savings from our restructuring programme.

Of course it's also helped by the usual positive second half seasonality that we see in our business but nevertheless we expect, overall, this recovery to be sustained as we go through in 2022 and this slide illustrates how we expect this to play out over time.

Key FCF drivers

So, let's move on. This slide shows the cash bridge from 2020 to 2022 and it shows, clearly, the three steps in our plan for sustainable recovery. We expect a recovery of our Civil Aerospace aftermarket; we expect to see savings from our restructuring plans materialise and we expect recovery in Power Systems to combine with ongoing resilience in our Defence business.

Stephen has already spoken about the £1.8 billion working capital outflow this year, in the first half and why we don't expect that to recur in 2021 and beyond and similarly, we don't expect a repeat of the in-year mitigating actions to save costs in 2020, with most of these only delivering a one-time benefit. The restructuring benefits will replace that one-time effect.

Civil Aerospace aftermarket

So, now I'll talk about these three things in more detail. Firstly, the recovery of the civil aftermarket.

We expect our large-engine flying hours to recover to 90% of the 2019 levels by 2022, as Stephen mentioned a minute or two ago, as global travel once again becomes a normal part of people's everyday lives and that's supported, as well, by ongoing fleet growth. The chart on the top half of this slide, which I showed with our full-year results in February, reminds us of the relative use of our fleet, which Stephen referred to a moment ago and consequently our expectations of market share growth, as airlines shrink their fleets through retirement. And as flying hours recover generally, this market share is what really matters to Rolls-Royce flying hours and therefore our aftermarket revenue.

However, I should stress the timing and shape of recovery remains uncertain and if the flying hours take longer to pick up then our journey back to £750 million will be slower.

We're assisted a little by the diminishing annual cash costs related to the durability issues that we've had on the Trent 1000 and that diminishing cash cost is a helpful tailwind. These costs are projected to fall as we roll out the fixes and by 2022, we expect the headwind from this to be between £200–300 million, which is £250 million less than what we're seeing in 2020.

Restructuring

The next slide shows the second driver and this is about our restructuring programme. As you know, the world around us has changed and so we're changing too. We're undertaking the largest reorganisation of Civil Aerospace in our history. Net-net, we're shrinking our capacity by about a third. We remain committed to retaining our expertise and our capability and we will continue to focus on the high-value manufacturing and services that differentiate us.

Reduction in number of roles

Now, the severe downturn has caused us to take some difficult decisions and that results in an unfortunate but absolutely necessary reduction in roles. In total, we're proposing the removal of about 8,000 roles from Civil Aerospace and a further 1,000, mainly from central functions. Nobody likes to make compulsory redundancies but we are therefore doing what we can to help support our people as we make these very necessary changes to our business.

More than 2,500 voluntary severance and early retirements have been agreed in the UK and we've moved some of those people who've been working in at-risk roles successfully over to our Defence business, which has continued to see strength on the back of its large installed base and high levels of order intake that we've seen recently.

And so, as of today, with more than 4,000 departures this year, globally, with another 1,000 expected by the year end, the cash cost of restructuring is expected to be about £800 million with – in total, with £400 million this year, £300 million in 2021 and the remainder in 2022 and that roughly mirrors the pace of these departures. We don't expect to see OE demand recover for several years, so a consolidation of our manufacturing facilities in inevitable.

As part of our detailed analysis to establish the right balance, we're moving certain activities to fewer sites in order to optimise utilisation and that will help us be more efficient and productive. The first phase of the proposals includes consolidations shown on this slide from three sites to one for widebody engine assembly and test, from two sites to one for fanblade production, from two sites to one for advanced turbine blade machining and from three sites to two for blisk production.

Now, not all of the sites losing work will close completely; some will continue with other activities but by the end of 2022, we expect to save a total of £1.3 billion in costs from our restructuring programme, £700 million from headcount reductions and the rest from lower indirect costs and CAPEX.

Further actions to reduce capital intensity

Moving on, our restructuring is not just about job losses and consolidation. A lot of our parts are made in house and we get most benefit from owning the supply chain, where our engineering and experience is a differentiating factor, especially where we have design and manufacture that are closely related and we're reviewing our manufacturing activities to explore further outsourcing opportunity and that would lower our capital intensity and increase the flexibility of our cost base.

And it's not just in OE that we're making changes. In our maintenance, repair and overhaul, or MRO, shops, we're driving efficiencies to adapt to the post-COVID world. We have a

growing fleet of young engines, so despite the near-term shock to flying, we will actually need to grow our MRO capacity over the coming years and we plan to maintain that capability, consolidated into fewer locations and meet the future growth by enlarging our external network.

As well as overhauling engines, an important part of our total care package for airline customers is the provision of spare engines and we typically spend between £50–100 million each year on spare engines, which support our customers when their engines are off wing. And we're looking at a number of possible ways to reduce the number of engines that we hold on our balance sheet and therefore reduce our capital intensity.

All of these actions are supporting a more flexible cost base with lower capital intensity, better returns for our shareholders. Historically our investment in CAPEX in proportion to sales has underperformed that of our peers and through these changes, we believe that we can narrow the gap.

Power Systems and Defence

So, stepping away now from Civil Aerospace, for the third key driver of the recovery, on slide 23. Diversity in our business has helped us to weather this crisis and that continues to be a key pillar of our strategy for overall group resilience.

Our Power Systems business, on the top of the slide – our Power Systems business is exposed to a broad range of sectors and whilst it also has suffered from the impact of COVID-19, that is to a lesser degree than in our Civil business and we're forecasting a faster recovery.

In Power Systems, we expect most of our end markets to recover by the end of 2021 and we're targeting a full recovery to 2019 revenue levels by 2022.

Switching to Defence, Defence has been a resilient sector throughout the whole COVID-19 disruption so far and shows every indication of continuing that way. We're benefiting from strong order intake over the last five years and we've got an installed base of more than 16,000 engines and still growing that we have to maintain.

Now, I'll be back to talk about our strategy expectations for the future in a moment but before I do, Stephen is going to lead you through our plans to strengthen the balance sheet. Stephen?

Strengthening Our Balance Sheet

Stephen Daintith

Chief Financial Officer, Rolls-Royce

Thanks Warren. So, let's get back to the numbers. So, as Warren said earlier, cash is king and we have an important journey ahead of us to make sure we maintain our strong liquidity and to restore our balance sheet.

Group funding under our recovery assumptions

Now, this slide shows our sources of and uses of cash and the actions we've taken to ensure we have enough liquidity. We started the year with £6.9 billion liquidity and we used about

£3 billion of it in the first part of the year. We pre-emptively drew on our £2.5 billion revolving credit facility and we added a new revolving credit facility for £1.9 billion that remains undrawn.

We also used the government's COVID commercial financing facility scheme to draw £300 million of loan notes and we're thankful again for the government's support, not just on that facility but also as they partly guaranteed our new, undrawn, £2 billion term loan facility.

So, taking all that into account, we had £6.1 billion of liquidity at the end of June, plus the new £2 billion term loan, so near-term liquidity is strong.

Now, looking ahead for the next 18 or so months, let me take you through the key factors influencing our liquidity. So, taking our starting point of just over £8 billion, over the next 18 months, we have £3.2 billion of debt maturities. You can see those in the chart below. We have, in aggregate, £800 million of restructuring costs, that's most Civil Aerospace related and we have the last of our deferred prosecution agreement payments, as well as our expected free cash outflows in 2020 and 2021 that I outlined a little earlier.

Now, as you might expect, both in our base case and downside scenarios, we're taking several actions so that we can maintain appropriate headroom. Now, these include a programme of potential disposals to generate at least £2 billion, the reassessment of Civil Aerospace's make versus buy strategy, which will reduce our capital intensity, that Warren talked about a little earlier. We're exploring new forms of industrial collaboration and finally, we continue to review a range of additional options to further strengthen our balance sheet and liquidity and this includes the refinancing, of course, of the debt and RCF maturities that are on the horizon.

We will come out of this downturn with considerably more debt than we started with and as such, it won't surprise you to know we're pursuing a number of potential actions to strengthen our balance sheet.

Taking actions to strengthen our balance sheet and further improve liquidity

Now, moving on to my last slide, slide 26, a strong balance sheet is essential in our line of work and strengthening it is one of our top priorities. This is why we remain committed to our ambition of an investment-grade credit profile in the medium term and consider – and are considering a number of options to help us return to a net cash position.

Further to the self help that is behind our free cash flow recovery and going back to my earlier comments, we've identified more than £2 billion of proceeds from potential disposals that could be achieved within the next 18 months. One of the potential disposals we're considering, that we're announcing today, is ITP Aero. As part of this process, we're exploring options that would enlarge the scope of ITP's capabilities, increasing its value prior to disposal.

Now, whether or not a sale takes place, ITP Aero is a key partner and we will retain a long-term relationship with it across our Civil and Defence programmes. Now, as you'll recognise, I can't go into too much detail at this stage on this, or indeed any other, potential disposals as we're still in the early stages and I wouldn't want to impede the consultation that will be needed before we reach any certainties and of course, all disposals are subject to

finding the right buyer and most importantly, the right price but I'm confident we can achieve substantial proceeds and at the appropriate value.

And with that, I'll hand back to Warren. Thank you.

Our Strategic Priorities

Warren East

Chief Executive, Rolls-Royce

Thank you Stephen. Now, just a few more slides on our strategy before we open up the call for your questions.

We will emerge as a different, stronger group

So, starting on slide 28, we know COVID has changed the shape and the future of the civil aerospace market and some of the changes are obvious today and plain to see and others will only become apparent over the years, as the world begins to recover but we have to make some fundamental changes too. So we've taken this crisis as an opportunity to really rethink and accelerate some of the ways in which we do business, from manufacturing, to what we outsource, to the facilities we need and how we collaborate with partners for the long term to reduce our future capital costs and risks.

Taken together, these measures should mean much improved operational gearing, as the market recovers and we return to growth. It will be a very different Civil business in future.

Looking forward, we see lower-carbon technology as being essential. If anything, the changes over the last few months have accelerated the drive towards better, cleaner power solutions. The world is demanding cleaner energy and we need to find the right approach, that enables us to continue to lead the way in our markets, without taking on unacceptable costs and risks.

Three key Civil Aerospace focus areas

Slide 29 shows the strategic focus areas to improve returns in Civil Aerospace, to really benefit from the large installed base we've built and growing market share, as we continue to build it.

Firstly, we need to improve our manufacturing efficiency. Post-COVID, our consolidated footprint and smaller fixed cost base will do just that. Secondly, we see a substantial opportunity for improvement in our aftermarket returns by extending the time on wing and working with MRO partners, as our base of over 5,000 installed engines grows. And that's where we have real alignment with the needs of our airline customers and it's key for us to benefit from the annuity-like characteristics of our model.

Thirdly, we're looking to reduce the amounts that we need to invest to get new technology to market. We already have a number of risk and revenue-sharing partners in manufacturing but, as technology develops, we need to think more broadly and work with more industrial partners to accelerate those developments and to share the upfront investments.

Driving broader growth across the group

Moving on to slide 30, there are, of course, exciting opportunities in Power Systems and Defence as well. In Power Systems, we have structural growth opportunities, as we increase our share in growing regional markets, like China and India and right across all the sectors in which we operate, we look to build on the large installed base we have and increase our services penetration, with long-term service agreements, similar to those that we've successfully deployed in our Civil business and we have the right products too for the mission-critical power generation market and we're leading the energy transition with our hybrid and microgrid solutions.

Power Systems also has the potential for even better margins, as we shift manufacturing to some lower-cost locations.

Moving to Defence, in Defence we've been well supported through this period by our government customers and we've seen commitment from them on new programmes. In the UK, we've welcomed new partners to Team Tempest, where we continue to make good progress. In the US, there are two very exciting opportunities on the horizon, with a combined estimated lifetime value of £7 billion.

We submitted our proposal for the B52 re-engine-ing to the Department of Defense this year and we look forward to submitting our future vertical lift proposal with Bell in 2021.

Long-term strategy to be a global power company based on low-carbon technologies

Longer term, being pioneers of lower-carbon power remains at the heart of our long-term strategy and earlier this year, you will have seen us join the UN's Race to Zero campaign. Our breadth of activities uniquely positions us to develop and delivery solutions that will change the way people travel and access power. We believe our work on sustainable aviation fuels, which is developing momentum, is the fastest way to achieve net-zero long-haul travel. It can be adopted without any change to the existing engine architecture and infrastructure. And we're also looking at hybrid and electric solutions, with an ambition to pave the way for regional hybrid aircraft by the 2030s.

In Power Systems, we aim to be the leader in hybrid Power Solutions. We were the first to market with our hybrid rail packs and we've a yacht system under development. Our environmentally-friendly mobile gas engines entered service this year, powering a passenger ferry and a second ferry is currently under construction and scheduled to enter service at the end of the year.

Our small modular reactors are gaining traction. Now, these are really game-changing and could materially accelerate the transition away from fossil fuels for both grid power and standalone applications. We also see a significant opportunity for SMRs to generate carbon-free electricity and create sustainable aviation fuels. Combined with the appropriate carbon capture, this, which would be a truly net-zero carbon solution, potential producing SAFs on a scale and cost that will accelerate their adoption.

Summary

So, a slide to summarise: we started 2020 with good momentum but external events quickly overtook us in Q1 and placed us on a very much more difficult path. However, we've taken

some fast, decisive actions, strengthening our liquidity, launching our largest-ever restructuring of Civil Aerospace to step-change our performance and we believe that the worst is behind us, in terms of the severity of the impact on widebody-engine flying hours. We're now looking at a range of options to repair our balance sheet, led by self help, with potential disposals already identified. And we're absolutely unwavering in our commitment to improve returns.

We're well placed in each of our markets, where each remain attractive over the long term and we're looking forward to continuing the path to becoming a broad power group, leading the way to a lower-carbon future.

And with that, I will stop and hand over to Q&A.

Q&A

Operator: Thank you. Ladies and gentlemen, we will now begin the question and answer session. If you wish to ask a question, please press star one on your telephone keypad and wait for your name to be announced.

Your first question comes from the line of Chloe Lemarie from Exane BNP Paribas. Please ask your question.

Chloe Lemarie (Exane BNP Paribas): Yes, good morning, Warren, Stephen and Isabel. Thank you for taking my question. I had a couple. The first one is on the ambition to return to investment grade over the midterm. Can you give more colour on the timing, I mean when you feel you absolutely need to return to investment-grade? And would that mean that you need to return to a net cash position, or is it actually more driven by EBIT performance?

And the second set of questions is related to Civil operating profits. So, if we exclude the COVID-19 one-offs, you recorded about £300 million loss in H1 and that was about the same – the level of cash flows that you recorded last year, just on the large engine OEs, so how should we think of the H1 2020 OE losses in the rest of the business? Should we think stable OE losses and the rest was due to lower volumes, or any colour on this would be really helpful.

Stephen Daintith: Okay, thank you. So, Stephen here, I'll cover the first question around return to investment grade. Return to investment grade is important to us, given the industry that we're in. Our customers are committing to us when they place orders, making long-term commitments around engine programmes that will be on their aircraft, so that's an important commitment that we're giving them and our credit rating is an indication of the health of Rolls-Royce, so returning to that investment grade is important.

I think, right now, it's not as important as perhaps it has been, given that we're unlikely to see big new engine programme orders over the next two or three years, given the markets but also given where we are in our engine programme development at the moment. So it's a priority but not as important a priority as it has been.

On the question around what is it about, well I think returning to net cash is important to us. We referenced that today. We'd like to get there over the next two or three, four years, similarly growing our profitability and cash flows is an important lever as well. And of those two, the second one of those is the most important one. We have highlighted today that we

are targeting to return to free cash flows of around £750 million as early as 2022. That will be driven, really, by the pace of the restructuring programme that we're driving today – that we are – that we're going through at the moment, sorry and it will also be driven by the pace and the shape of the recovery in engine flying hours over the next 12–24 months. So, both of those factors will be important for us, as we look to get back to investment-grade status.

Warren East: Okay and the other question was about Civil operating margin, or operating profit in the half. I mean, there are fundamentally three reasons here. We've got lower activity and that lower activity is driving things like lower V2500 payments, lower time and materials and so on. There's a little bit of a lower spare engine sales, too, to sit alongside those lower levels of activity.

And then, because we've been able to unable to right-size our fixed cost base as quickly as the change in activity levels, then we have got some under-utilisation as well, in our facilities, which has pulled things down, so under-recovery of those fixed costs. And I think that just about summarises it.

Chloe Lemarie: Right, thank you very much.

Operator: Your next question comes from the line of George Zhao from Bernstein. Please ask your question.

George Zhao (Bernstein): Good morning, Stephen, you talked about getting to 70% of the 2019 engine flight hours by 2021, you know, partially based on the outperformance on production. The 64% recovery forecast from IATA you cited refers to total passenger traffic, not just international, so how much contribution of your fleet is intra-China, you know, that gives you confidence that, despite the all-widebody fleet, with 80% exposure to commercial traffic, that you can still outperform the total passenger trends?

And second question, related to that, you know, we talked a lot about the trend of the flying hours but the other side of the equation is the dollar-per-hour rate and given the airlines may be flying the aircraft but at much lower load factors, you know, have they tried to negotiate for lower rate on existing contracts, or looking to pay lower rates on the newer contracts? Thanks.

Stephen Daintith: Okay, thank you for your question. Yeah, so on flying hours, I'm glad you pointed this out. The geographical mix of our engine flying hours is really important. And when we look at our sort of top five markets, we have China, Japan and South Korea are all in our top five markets. The other two are the USA and the UK. So, you know, we are well placed there, given the shape of – and stage of recovery in those markets. China, in itself, is around 20% of our coverage and around 6% sort of – you know, 6% out of the 20%, that is – is domestic China. So that's helpful for us and this goes to my earlier comments, during the presentation just now, around it's important to look at the granularity of engine flying hours for us: the engine programmes that we're in, the geographies that we're in, the routes that we're flying, the age of our fleet. All of those are important factors. So it may be misleading to look at an average across an IATA statistic on revenue passenger kilometres and it's perhaps better, we believe, to look at engine programme by engine programme and route by route and so on, so that's how we've arrived at our numbers today.

Warren East: Yeah and your second question was a little bit about, well, are people trying to ask us to compensate them for lower load factors, effectively? I mean, of course, we recognise the fact that some of our customers are under severe pressure and you know, there is an ongoing commercial discussion but, you know, to balance that sort of thing, you know, in many of these contracts we have minimum utilisations and so on and so I don't think there's been any material impact whatsoever from actual renegotiations.

I mean we're trying to support our customers through this phase as much as we can but we've also got our own business to run.

George Zhao: Thank you.

Operator: Your next question is from the line of Celine Fornaro from UBS. Please ask your question.

Celine Fornaro (UBS): Yes, thank you. Good morning everyone, I'll have three questions, if I may. The first one is regarding your 2022 cash outlook, which is now guided for £750 million, whereas before probably it was more at least £750 million. But in this number you're now benefiting from a £330 million cash sale win, I would say, on the 787 lower costs incurred. So what has gone worse, or do you already know, early July, that you would have, you know, lower 787 costs? That's the first question.

The second question is regarding the sizing of your disposal, approximately £2 billion plus. I know Stephen adjusted some of it in the presentation. However, I'm not really sure how I understand how you get to that number, given the slump in performance in ITP. So how do we think about, you know, how we get to £2 billion and is it a lot of small divestments or a big, large chunk? So maybe you can help us and if you think of selling any MRO participation in your JV?

And my final question would be regarding the shape, or the timing, of the shop visit costs and the timing of those, I guess, beyond 2020. So, in 2021, do you expect more shop visits than in 2020? So if you could compare that, that would be great, in your actual scenario. Thank you.

Warren East: Thanks Celine. Okay, well I'll kick off with the £750 million. And just as a reminder, we've said as early as 2022. Very much, you know, still significant uncertainty around the shape and pace of the engine flying hour recovery, so just to put that qualification around it.

So if I just sort of go through the sort of key building blocks to how we get to that number, well, first of all, in 2020, you will have seen that £1.1 billion one-off impact from ceasing invoice discounting, so there's a benefit there in 2022 that won't be repeated. We're also going to see the benefit of the £1 billion large working capital outflow that we're going to see in 2020, across inventory but also receivables and payables movements. Rolls-Royce Civil Aerospace in particular is a negative working capital flow business, given that we often receive cash from our customers in advance of activity. Now, when activity starts to wind down and reduce, that impact goes the other way, so we've seen a headwind from that this year which we don't expect to see in 2022.

At the same time, we're expecting – and this is the single biggest driver – an improvement in the Civil aftermarket, driven by engine flying hour recovery, largely of in excess of £2 billion.

We also are going to see, to your question, lower Trent 1000 costs and we're going to see time and materials improvements as well. We're expecting to see our Trent 1000 costs around £300 million lower than 2020 numbers, which is about £100 million lower in 2022 versus the old guidance.

By the way, when we gave our £750 million in July, we already knew that impact of the Trent 1000. That was actually implicit within that number when we gave you that number in July as well, just to explain that one.

We're going to see a modest benefit in Civil OE, as average losses continue to recover, that's another part of the bridge and we're going to see higher profits in each of Power Systems, Defence and ITP, particularly Power Systems and ITP versus the 2020 number that we're highlighting today and it will be there for the full year as well. And then at the same time, we're going to see an improvement in the cost base as well, the restructuring that we're doing in Civil Aerospace, the pace that we can get through that. We're highlighting today 4,000 headcount reduction already this year, with a further 1,000 to follow before the end of the year and certainly I think by the middle of next year, we'll be well through that restructuring programme at Civil Aerospace to give us good confidence about that £1.3 billion of restructuring savings that we're expecting for 2022.

So those are the key drivers that get us to that £750 million. Just flagging again: there still remains uncertainty around our flying hours profile over the next couple of years.

Warren, you want to take the next question?

Warren East: Okay, so the next question was around the £2 billion. I think the first thing to note is that, actually, the price at which we bought in, or bought back, the share of ITP that we didn't own was quite a good price. And so, you know, I think the difference – although the valuation might be down a little as a result of COVID, where you start from is quite important. But of course, our target of £2 billion comes from a series of potential disposals here. There are other assets involved. We're not being specific this morning and we can't be specific this morning about other assets but I'd draw your attention to, you know, track record and as an example, the disposal of L'Orange a couple of years ago, where we weren't talking about a whole chunk of activity that we regularly report on. We were talking about an asset that sits within one of our businesses, where we thought it was time to do an intelligent recycling of capital and that's the sort of thing that we're looking at.

So there isn't a small list here, there's a list of several potential assets that we're looking at, at the moment and as and when we're in a position to talk about something specifically, we will. But, you know, the statement we made this morning is we're confident of more than £2 billion over the next 18 months or so.

And I think the third question, about shop visits and shop visit timing and what happens over the next couple of years with shop visits: yes, we do expect this to grow beyond 2020 because, you know, our fleet that is continuing to fly is growing and it is maturing. So shop visits had slowed in 2020 simply because of the depressed levels of flying activity but we will see that recovering and of course we will see the engine flying hours recover as well, so the actual aftermarket margin will grow as well.

I think that's –

Celine Fornaro: Thank you.

Warren East: – the three questions. Yeah.

IG: Hi, we've got a couple of questions coming in online now, which I shall read out for management. So, Jeremy Bragg is asking for a little bit more detail on the timing of when we're looking to restore the balance sheet by and in particular, if or when a rights issue might be needed, is it better to wait for things to get better or risk that they get worse?

Warren East: Okay, well I'm not going to be drawn on any speculation about a rights issue. So, on the balance sheet, so are we waiting for it to get better? This is our key message: we have strong and adequate liquidity today. More than adequate, in fact, when we look at our base case scenario, as you'll see is highlighted in there.

Long term, we have an ambition to return to a net cash position, going back to my comments just now, that question from Celine.

The drivers of returning to a net cash position? What are the key things that are going to get us there? Well, first of all, self-help stuff that we're doing on costs: the £1 billion of cost mitigations this year that we announced as early as April. The £1.3 billion of restructuring savings that we've announced in May, on 20th May. There will be an unwind of some of the cash mitigants in 2020, of course, around sort of, you know, pay deferrals and so on and some of those items will unwind going forward and pay cuts and so on. At the same time, we're anticipating that – a significant recovery in the aftermarket that will help our net cash position.

The disposals that Warren just talked around, at least £2 billion. We have good confidence and conviction around those and delivering proceeds there over the next 18 months and we continue to assess a range of other options as well, so that's how we're thinking about balance sheet at the moment.

IG: And another question we've also got on the webcast here from Ben Heelan. He would like to ask if we can give some more information on the industrial partnerships we've talked about.

Warren East: Yeah, I don't think there's anything specific that we can give about that. Of course, if you look at our history, we've always done a certain amount of partnering. We have a handful of risk and revenue-sharing partners that are part of our existing Civil programmes. But as we look forward, you know, these new products that we contemplate, things like UltraFan and beyond, have a greater range of new technologies within them and developing those technologies to make them really ready to put into engines is a lengthy exercise and it's a risk exercise and so we'll be continuing to look for new partnerships, perhaps a little bit more at the development end, around new technologies, to share some of that risk. And also, frankly, accelerate some of those technology developments, so that we can get the benefit of them sooner rather than later and that's the direction of travel that we're talking about. So nobody specific but probably a wider range of players than we've historically been involved with.

Operator: Your next question comes from the line of Chris Hallam from Goldman Sachs. Please ask your question.

Chris Hallam (Goldman Sachs): Yeah, morning everybody, just two quick questions from me. So, first, on the 2022 free cash flow guidance, you sort of already answered my question with your earlier response to Celine but is it fair to say that the only working capital assumption you're including in that £750 million number is no working capital outflow, i.e. a non-repeat of the big 2020 outflow? But given you're a negative working capital business, wouldn't you expect to be seeing some degree of inflow as activity improves? That's my first point.

And then, secondly, on disposals, again, you've already covered some of the ground on this topic but given the outsourcing comments, I suppose it's fair to say the revenue number for ITP is going to look different. So how should we think about the push and pull between higher revenues at ITP due to more outsourcing from Rolls-Royce versus lower revenues due to lower overall activity in the Civil world and where would you expect the net to shake out relative to 2019? Thanks.

Stephen Daintith: Okay, thanks – yeah, thanks for your question. So, on working capital assumptions for 2022, the assumption that you stated, the answer is broadly yes, we could see a modest, positive contribution from working capital in 2022. It is a very modest assumption, though, in our modelling. It's not a material number.

One item that I should have referenced whilst I've got the opportunity to talk about 2022 as well, that's within our £750 million model that I just ran through, there is also the headwind of the £300 million of hedge cost as we settle those – that over-hedged position for that particular year and that's at the spot rate. And that's around – at the – sorry, through the FX forward contracts that we've taken and that's about a £300 million hit. So that £750 million number is after that exposure. So that's a good – a good way of looking – of thinking about it. And the question, next, Warren for you on ITP?

Warren East: Yeah, I mean I don't think we can be specific, I'm afraid, on our revenue number for ITP in 2022. I mean I think the question is basically correct in terms of pushes and pulls, when you look at ITP and call ITP a partner. But, you know, what matters to us is overall profitability and you know, we talked about make versus buy. It's a constant question that we're asking about make versus buy. We have to recognise that you can't just make snap changes and have them effective within a matter of months because obviously these parts have to be – have to be – go through a qualification cycle, when they move from one manufacturing location to another, so it's far too complex, really, for us to be, frankly, misleading people with guidance on specific numbers. But your question is right, there will be a little bit of a balance there and the number will be what it will be. I just can't give you the answer right now.

Chris Hallam: Okay, thanks very much.

Operator: The next question comes from the line of Nick Cunningham from Agency Partners. Please ask your question.

Nick Cunningham (Agency Partners): Yes, good morning, thank [inaudible] is sort of famously W-shaped, with an outflow in between the reporting dates. Presumably, with the factoring gone and Civil smaller, it will be less [inaudible] so what I wanted to ask was if we could remove the overlay [inaudible] because of how much you need – liquidity you need to have at the beginning or end of a period to be comfortable to get through that normal

seasonality. What is it? How much headroom do you need [inaudible]? I think a less important question but presumably you've [inaudible] during the first half because you've been doing the shop visits but the flight hours haven't been undertaken, so that's some cash that should come back. Is that relatively near term and therefore built into [inaudible] in the sort of beyond 2022 period?

Stephen Daintith: Yeah, okay. Thank you – thank you for your questions. I – you were cutting out quite a bit but I think that we heard enough of the first question to answer it and you might have to have another go at the second question. But I'll do the first question to begin with, the W shape, no, I mean I for one will be quite pleased to see the back of this, that W shape. I think the cessation of invoice discounting means that it should go away. I mean, you know, there should not be material seasonality in our business, so that will be a consequence of that. Your question was then around, you know, sort of the cash flows and the – I was trying to recall the second bit of it now, yeah, I think it's sort of the headroom area. I think you should be thinking about sort of low-single-digits of billions of pounds for what is meant by comfortable headroom and that's what we've used in all of our statements and modelling. So it's not a zero case, it's very much a low-single-digit – so £1–2 billion or so of comfortable headroom. That's the sort of number that we've used in our modelling. Warren?

Warren East: Look, I'm afraid, on the second question, you just broke up too much, so can you have another go at the second question?

Nick Cunningham: Yes, I apologise. If you can't understand me, stop me. The question is have you been, effectively, banking [inaudible] and so therefore either [inaudible] place where you [inaudible] anyway and so therefore that's effectively cash to come back in at some future date and is that already in the near-term cash flow forecasts or is that to come back later?

Warren East: Yeah –

Stephen Daintith: Not –

Warren East: – I think we're still slightly struggling. It's – well, I think the point is on this – we're struggling to hear the question, really.

Nick Cunningham: Sorry.

Warren East: But I think the question is around is there a big benefit from the lower number of shop visits and I think that's what it is, in terms of cost. The answer is not really in that we have fixed costs that are part of our MRO network that don't go away and so there's a cost in that in itself in any event. So I don't – we shouldn't really regard it as being a material benefit. I think that's the gist of your question. Sorry if I'm not answering your question, it was just very difficult to hear it, that's all.

I think another point, just to reinforce, is that shop visit, you know, volumes have not fallen materially in the first half in any event. So there, although the mix has changed, the volume has remained pretty much flat year on year.

Nick Cunningham: Thank you.

Warren East: Well if you've still got a question then maybe take that as a call with our Investor Relations team offline after the event.

Operator: Your next question comes from the line of Mr Khan from Societe Generale. Please ask your question.

Zafar Khan (Societe Generale): Thank you very much, good morning everybody. I have three questions, please. The first one is just on the JV and associates contribution, which is quite encouraging. Could you just tell me where that's coming from? Presumably MRO and leasing, or is there something else there? That's the first question. The second is just on the tax charge and the cash out on tax this year and perhaps next year, because of the mix of profits and losses is geographically quite skewed towards Germany and the US. I just want some idea on that.

And then the old topic, I'm sorry to come back to this but the long-term service agreement contract balance change. I've been looking at this for a couple of years now but I still cannot get my head around this and I would have imagined in the first half of this year that would have been a big negative number, yet it's a very big positive number. Is that just backing out the losses that are in the line above in the underlying operating profit, so it's kind of cancelling that? How does it actually work?

I know, Stephen, you touched on this in your presentation but you were going quite fast for my brain to process all of that.

Stephen Daintith: Alright.

Zafar Khan: So if you could just please help me and tell us what that that looks like for the full year and you've said in the past that, as an ongoing number, that should be around £300 million positive per annum but that's not been the case.

Stephen Daintith: Right, well why don't I do the LTSA balance first and sorry if I went too quickly in the presentation. So, this actually grew by £780 million in the first half of the year, so that's a credit to that balance in the year. Now, just as a reminder, though, the contract catch-ups that take – that have taken place, or when they do take place, they are a revenue adjustment and the double entry, in the case of a sort of negative contract catch up is a debit to revenues and a credit to the LTSA balance and that number that we're highlighting today in the first half is £866 million and that's down to that sort of reassessment of engine flying hours around our engine programmes. And I should also point out at this stage that the £700 million and the £900 million were the two biggest contributors to that £866 million and that makes sense, given the – number one, for the 700, the amount of revenues that have already flowed through that mature engine programme, the materiality there and number two, the Trent 900, which is the most impacted engine programme when you think about future engine flying hours and you'll have read all the press around the Trent 900 retirements and so on.

So when you take off that £866 million, you're then into a reduction in the LTSA balance from that £788 million that I referenced earlier. That's an £80 million, also, reduction. Now, one might have expected it to be larger than that but I just think it's worthwhile just highlighting the difference between invoiced engine flying hour receipts and but also the cash receipts that

come in as well and there can be a disconnect between the two and I think that's just another factor to take into account.

So hopefully I've given you some of an explanation there around that one. We don't expect more catch-ups in the second half and in fact they could actually shrink in the second half as well. So in – I think that's – it's – that's an important factor to bear in mind.

I'll very quickly cover the cash tax item as well. Just as a reminder, we don't pay cash tax in the UK, where we have, number one, sufficient, you know, accumulated losses to offset any future profits and at the moment, our UK business remains an unprofitable, loss-making business. We pay cash tax in the US and Germany. We're expecting that it will be – well, in 2019, it was about £175 million. The first half of this year, £34 million and that's largely driven by the reduced profits in our Power Systems business that we've highlighted today.

And then, going forward, I think, for 2020, across 2021 and 2022, as the US and German businesses grow, I think you should be thinking about £250 million or so as a good guide of cash tax in each of those two years. And then, Warren, do you want to cover the first question that was asked in this one?

Sorry, this is about, sort of the JVs and so on.

Warren East: The JVs. Yeah, I mean I think the – our MRO networks have sort of continued to operate, you know, in spite of the depressed environment. As we said a moment ago, shop visits have essentially been flat in the first half of the year and that's really the driver of the performance from those JVs.

Zafar Khan: Okay, thank you very much. And Stephen, just on the tax rate that we should be looking at for 2021–2022, any kind of an underlying rate that you can guide us to?

Stephen Daintith: Yeah, that's a – it's a really tricky question because it's very much driven by the sort of – the mix of profits across territories, so it's hard to be precise. I would think of the tax rate as being a low negative number. There's no deferred tax assets, so there's no credit on the UK loss that we'll have seen in previous years because you'll recall last year we stopped adding to the deferred tax asset and this year, in fact, we de-recognised some of the deferred tax asset in light of a revised view of when UK profits are likely to flow through.

So, for your modelling, on effective tax rate, I would assume a low-negative percentage number.

Zafar Khan: Sorry, a low negative percentage number means a tax credit?

Stephen Daintith: Sorry, so, for the full year, 20%, same as in the first half.

Zafar Khan: Yeah, okay, that's helpful, thank you.

Stephen Daintith: I think that's what the – yeah.

Zafar Khan: Yeah, thank you.

Stephen Daintith: Okay.

Operator: Our last question is from the line of Andrew Humphrey from Morgan Stanley. Please ask your question.

Andrew Humphrey (Morgan Stanley): Thank you. Just a couple from me. I wanted to ask about the kind of make-versus-buy decisions that you were making and specifically what benchmarking exercises you've done, versus peers, to work out what the optimum level might be on that. And secondly, you've given us some benchmarking versus peers on tangible CAPEX. I wonder if you could give us a bit more detail on, say, overall investment levels, including intangible and R&D. I mean I know that's an area you've focused on in recent years, to give us an idea of, you know, where overall investment ratios might turn out in the medium term compared to some of the peer group.

Stephen Daintith: Yeah, okay. Well, look, on the make-versus-buy, I can't go into specifics at the moment. This is a constant exercise. I think all we're highlighting is that the changes we're making, the restructuring that we're doing in terms of site consolidation that we announced this morning, in terms of overall headcount reduction, creates a catalyst for looking at that make-versus-buy again and saying, 'Are we really doing what's right for us?'

Now, what's right for our peers might be, you know, completely different. We're seeking to look at make-versus-buy from the point of view of profitability and deployment of our capital and you know, we'll come out which is the answer which is right for us.

I expect that that will probably mean some – a little bit more buy and a little bit less make, which is essentially being less capital intensive, transferring more of, essentially, our fixed costs into variable costs, giving us a bit greater flexibility.

The comment we made on the slide a little while ago in the presentation about making our capital intensity a bit closer to the range of our peers was simply meant to illustrate the fact that, you know, if you see us move in that direction, this is a healthy direction, it makes us more competitive but I think you can see from the first part of my answer, you know, obviously it's making our business more competitive.

And then, on the investment question, so you'll recall that over the last few years, we've actually ramped up investment levels across both R&D and CAPEX. Number one is we've brought several new engine programmes to the market and number two, as we've increased our capacity for the volume we were anticipating, particularly OE volume and Civil Aerospace.

Coming out of that, for natural reasons around engine programme development but also COVID-related: R&D cash spend, £1.1 billion cash spend in 2019. I think you can expect to see that decline modestly as we get towards 2022. I think, maybe, declines may be £100–200 million reduction in R&D cash spend. I think, CAPEX, I think that's where you're more likely to see a material change in profile. We spent around £750 million in 2019. That number, for 2020, is more likely to be about £600 million, so quite a material reduction. And then, again, I think if you're thinking around 2022, you're probably looking at a number of somewhere between £400–500 million in 2022. I think that's a decent guide on capital expenditure, where, having built the capacity, we think we can manage at those lower capital expenditure levels that I've just highlighted.

Andrew Humphrey: Great, thank you very much.

Stephen Daintith: Thank you.

Warren East: Yeah, I think what's important – just to sort of add a little bit of context on that capital expenditure is, you know, Stephen has talked about the quantum there on R&D

and CAPEX. One of the things we are doing is thinking about the shape of that CAPEX over the next several years. And if I look at the shape by business, you know, we are emerging from a period where we've spent a huge amount of investment on our Civil Aerospace business, created a portfolio of relatively new and – new engines. You know, now is the time to capitalise on those new engines and over the next several years you will see us going a bit less capital intensive in Civil. But now is the time, you know, we can free up, then, some of that investment, to target these zero-carbon areas which are showing up in our Power Systems business initially, in some of the electrical activity that we're doing for the future in Aerospace and for some of the new, exciting opportunities that we've got ahead of us in Defence.

So, as well as the quantum, it's important to think about the shape of that R&D and CAPEX. With that –

Andrew Humphrey: Thank you.

Warren East: – I think that was actually, I'm being told, the last question, so we'll thank you all for your questions. Before we disappear, I just wanted to take this opportunity to quickly summarise. I'll start by talking about our other announcement this morning, so Stephen will be leaving us, so I want to say thank you very much to Stephen for being a great colleague and a great influence on our business over the last several years. He's overseen great change to our finance team, built a very strong finance team over the last few years and injected some rigour here. The executive team will miss him and wish him well. He has overseen or helped us drive very significant changes in our business and that has actually manifested itself in, you know, if you look over the last several years, a big improvement in free cash flow generation, coming from negative through to getting on for £1 billion of free cash flow last year. So thank you very much, Stephen.

Stephen Daintith: That's alright.

Warren East: And actually, I'll start my summary, then, with that point. You know, that was a great position to come into 2020 with some good momentum. Unfortunately, the COVID crisis has struck fairly fast in the first quarter, so, you know, we have acted quickly to secure liquidity. We've acted quickly with our very significant spend mitigations for 2020. We've recognised the market outlook and undertaken the largest restructuring of our Civil Aerospace business to date. We do think that that is going to deliver a step change in performance for our Civil Aerospace business, so that we can really capitalise with great operational gearing on that installed base that I talked about just a moment ago.

And looking a bit further forward, we have the self-help actions underway to make our – repair our balance sheet, after this crisis, as we look beyond the crisis, so that we can really maximise value from those existing positions and secure our long-term ambitions. So I think that's the summary and thank you all very much for your interest.

Operator: That does conclude our conference for today. Thank you for participating, you may all disconnect.

[END OF TRANSCRIPT]