



Event: Rolls-Royce Holdings Guidance Update

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Speakers: Warren East and David Smith

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Operator: Good morning, and welcome to the Rolls-Royce Holdings Plc Guidance Update. Throughout the webinar all participants will be in a listen-only mode, and afterwards there will be a question and answer session. Just to remind you, the webinar is being recorded. And today I am pleased to present John Dawson, Director of Investor Relations. Please begin your meeting, sir.

John Dawson: Thank you very much operator. And good morning ladies and gentlemen, welcome to our call on the Guidance Update we published this morning. My name is John Dawson and I have the pleasure of being the new Head of Investor Relations at Rolls-Royce. With me are Warren East, our new Chief Executive, and David Smith, our Chief Financial Officer. They will be taking the lead on the presentation today. We've allowed around an hour for the call overall, and we'll have plenty of time for questions at the end of the presentation, which should last for around ten minutes. Please wait for the operator's instructions to register for questions at the end of our opening remarks.

So without further ado, let me hand you over to Warren.

Warren East: Good. Thank you John. Good morning everybody. This is the first time I've spoken to you all as Chief Executive at Rolls-Royce, and obviously it goes without saying, this isn't exactly what I had planned for the first communication. I joined Rolls-Royce because I strongly believe in the fundamental strengths of this business, the scale of the opportunities available to it. It's truly a fantastic company with exceptional technology, very deep customer relationships and outstanding long-term prospects, that's why I agreed to take the job.

But let me say, I'm clearly disappointed by today's announcement and the impact that it is obviously having on our investors and our employees. The last 18 months have been very challenging for all our stakeholders as we've managed our way through some important market developments, changes in leadership and so on. That said, notwithstanding market developments, I understand it's our responsibility to build a business that is sustainable and resilient no matter what is thrown at us by the market, and it is a responsibility I take very seriously and it's going to be one of my fundamental priorities for the next few years.

So what's happened? In the near term, we have to manage an important transition from the Trent 700 to the new Trent 7000, and that is having a negative impact on our profit, probably greater than we anticipated, both in 2015 and going forward into 2016 and beyond. We also have to build our capacity to service the new Trent XWB and Trent 1000 programme. In addition, our Land & Sea business has some big challenges at the moment, and in particular needs to overcome challenges in the offshore market and get to rebuild a consistent trend of improving revenues and margins across all of its businesses. As a management team, we do have great confidence in the long-term prospects for the business. In the near term, our immediate priority is to find efficiencies and performance improvements that we need to deliver on these goals.

Beyond that, I am certainly going to be doing a review of the business operations, and when we've done that operational review I'm sure I'll be coming back to you in due course with what we, as a leadership team for Rolls-Royce, are going to be doing to ensure that this world-class business continues to meet the needs of all its customers and its shareholders.

So thank you, and I'm going to hand over to David to take you through today's update in more detail. David.

David Smith: Thank you Warren, and good morning everybody. What I'd like to do today is take you through four things. Firstly, an overview of what's changed in our outlook; secondly, take you through our updated guidance for 2015; thirdly, set out the key items impacting our 2016 performance, particularly in Civil Aerospace; and fourthly, set out the reasons why I remain confident in our long-term prospects.

So, what's changed since the prelims in February? Clearly, there have been some major changes in expected production volumes for the A330, and this has had consequences for us in respect of demand for the Trent 700, not only in original equipment sales, but also importantly, demand for spare engines. In addition, the slowdown in production has increased competitive pressure with a knock-on impact on engine pricing. At the same time, we're seeing weaker demand for our business jets and a softer regional aftermarket, both are relatively recent developments. In addition, already weak offshore markets, exacerbated by the sustained pressure on oil prices, have continued to worsen, and this has had a further effect on our Marine business.

Since February we've been undertaking a rigorous review of our forecasts and the planned assumptions that underpin them. This is effectively a pull-ahead of our ten-year planning process in order to capture the degree of market weakness we are seeing today. The rigour applied to this process gives me confidence that these now represent the best view that we have had for some time of our outlook for the next ten years, and therefore a sensible basis on which to make judgements that underpin our update today.

So let me take you through the update in some more detail. Firstly, our 2015 guidance. Overall, guidance for the 2015 revenue is unchanged for the full year. Reflecting the movement in Marine profit, the Group profit before tax is now expected to be between £1.325 billion and £1.475 billion. Free cash flow for 2015 is now expected to be between negative £150 million and positive £150 million, and of course I'm continuing to work on ways to improve this. Given the weakened near-term cash outlook, we will discontinue the share buyback programme, having completed £500 million of the planned £1 billion programme in the first half of the year.

As we've set out, the profit production primarily reflects a further weakening in offshore markets. As a result, we now expect the Marine profit to be between break-even and £40 million. In addition, we're reviewing further cost actions and restructuring activities in Marine to help improve performance which, including some asset impairments, is expected to result in an exceptional charge of £70 million to £100 million. Guidance for all of the other businesses remains unchanged.

So for Civil Aerospace, it's worth noting that though the Civil Aerospace performance is unchanged, there has been a change in mix of performance, and this will have an impact on the year-on-year comparison with 2016. In particular, we expect the A330 rate change to impact Trent 700 deliveries in the second half of this year. In addition, there will be some impact from lower than expected demand for engines to power business jets and the softening regional aftermarket.

The profit effect of these will be largely offset this year by a number of operational performance benefits. Firstly, we expect the reversing a balance sheet provision on the Trent 1000 launch as a result of significant improvements in operating performance. Secondly, we are also in a position to recognise improved retrospective TotalCare contract profitability. Together these items will contribute around £200 million to performance this year, which is higher than we originally expected.

Turning to briefly look at the half year, we will be providing full details of our interim results on 30th July as normal, and our expectations for the first six months have not changed. As outlined in May, we continue to expect 2015 profit before tax to be phased more to the second half of the year, though principally by Civil Aerospace and Power Systems. As a result, first-half profit before tax is expected to be between £390 million to £430 million, or roughly 30% of the full year compared with around 40% in 2014.

While this would seem to leave quite a lot to do in the second half, we have confidence in our ability to do that. In Aerospace we will, despite the Trent 700 reductions, see a higher level of engine deliveries across our small and large engine categories, and in the first half of the year. In addition, we have the continued benefit of growth and service revenues, and a lower level of R&D charges as we start to capitalise several programmes. We also expect to have a significant proportion of the one-off benefits that I discussed earlier. In Land & Sea, Power Systems are expecting a stronger second half as we've

seen in previous years. In addition, we've based our expectations on a new rebased Marine forecast, providing some degree of comfort in our current estimates. Finally, we will benefit from lower commercial and admin costs in the second half, and the early benefits of the Aerospace restructuring programme.

Let me turn to the outlook now for 2016. In our Civil Aerospace business we expect a significantly lower contribution from the Trent 700 engine programme, led by lower revenues from reduced engine sales, including spare engines, and weaker pricing. In total, we expect these changes to Trent 700 demand, which benefits from linked accounting that ties aftermarket margins to engine delivery, to reduce Civil Aerospace profits by around £250 million compared to 2015. Now, it's important to remember that there are still several open campaigns for Trent 700, and we don't yet know how many engines will win. We think this reflects a balanced view. In addition, we expect a further £50 million headwind from lower demand for our business jet engines and softer regional jets aftermarket.

Other factors, including an improved large engine aftermarket, led by a higher install base and the net £90 million benefit of restructuring, should largely offset the likely lower level of provision leases – releases and other adjustments we'll see in 2016. It's worth noting that the cash impact from these headwinds should be much smaller than the profit impact, and therefore we will see cash conversion improve.

Before I hand back to Warren, let me say a few words about our confidence in the long-term. For the first time, we've done a thorough bottom-up review of our ten-year plan and applied a degree of rigour that gives me confidence in the foundations of our guidance update today. While the outcome is not good, I do believe that it does create a base on which can build, barring further major adverse developments. Allied to this, our exceptional order book now stands at £76 billion, led by an outstanding position on leading wide-bodied passenger programmes.

The successful rollout of new engines, led in particular by the Trent XWB and the 1000 and 7000, together with related aftermarket revenues, is expected to drive significant revenue growth over the next ten years, as we build towards a 50% share of the installed wide-body passenger marker. And this is supported by a clear set of long-term megatrends that support profitable growth well into the future. Whilst the impact of the transition to the Trent 7000 has reduced Trent 700 deliveries and held back Civil Aerospace profit in the near term, we are confident the transition to the Trent XWB programme in particular will support this. As we said before, this programme creates significant embedded value with exceptional cash flows that are around double that achieved by the Trent 700. At the same time, we are continuing to strengthen our technology plans and sustain our own investment in the industrial transformation that will continue through to the end of this decade. This is essential to our long-term success.

In addition, initiative stop reduce cost and increase cost focus in the Marine and Power Systems businesses should help drive good performance improvements and support a growing contribution from our Land and Sea business as the company continues to reinforce its role as the leading provider of a better power for a changing world.

Thank you. So I'll hand back to Warren now.

Warren East: Thank – thank you David. I'd like to just remind everybody that, obviously, we are clearly disappointed by today's announcement. David has explained the period of transformation that we're going through in the Aerospace business, transitions there and the headwinds in the offshore market which are driving the announcement today. However, nothing in that does nothing to shake the fundamental confidence that I feel about the long-term prospects for this business, for its market position, for the long-term market trends that David has described.

I will be carrying out a thorough operational review of the business. It's not appropriate for me to speak in too much more detail on my second day in the job about that right now, but I will be back to update you in due course. And with that, I will hand over to John and then we'll be happy to take questions.

John Dawson: Thank you Warren. Operator, if you could open the call to questions please.

Operator: thank you. Ladies and gentlemen if you wish to ask a question, please press 0 followed by the 1 on your telephone keypad. If you wish to withdraw your request, you may do so by pressing 0 and then 2 to cancel. Once again, to ask a question, please press 0 followed by the 1 on your telephone keypad. There will now be a brief pause whilst your questions are being registered.

The first question comes from the line of Olivier Brochet from Credit Suisse. Please go ahead, your line is open.

Olivier Brochet: Yes, good morning gentlemen. I will have two – two questions please. The first one is on the transition from Trent 700 to Trent 7000 and – which you say has an impact which is greater than expected on the profit. Can you come back a bit on that and explain how this can be a surprise? And was it pricing impact which was not well appreciated, was it linked to how you look at TCP contracts and there has been a change in the way you look at them?

And the second one is on the business jets. For the mid-term prospects, you have a lack of new platforms. Can you tell us when you expect to reach volume trough for business jets please?

Warren East: Okay. David would you like to –?

David Smith: Yes, let me take the Trent 700 question first. The profit effects that we're talking about here, which as I described were £250 million incremental in 2016 compared to 2015, reflect both lower engine volumes, and clearly that is a combination of what Airbus have described in terms of their own rate changes, but also our balanced assessment of where we think we are likely to win in terms of competitive situations for those engines with particular airlines.

So, although Airbus have made some announcements about A330ceo's in the recent past, in fact none of these engine competitions have taken place yet, so we are trying to make an assessment of that additional impact on ourselves.

You're right, pricing is a big factor here, and that's probably where all of us have probably underestimated the – this impact as we thought about it. But the detailed work that we've done leading up to the announcement today basically suggests to us that there is a significant risk on the – on the pricing side. both obviously on the OE engines, but also on the aftermarket as well. And a clear important thing about the Trent 700 is, being a linked engine, it also carries a lot of profit at the sale that's associated with the aftermarket as well. So lower – lower aftermarket pricing impacts on that.

The third element that probably most people won't have thought is that significant, but actually it's fairly significant, is a reduced requirement for spare engines going forward, essentially because the installed base will be smaller. And these do tend to be more profitable, and therefore that has a disproportionate impact on those engines within the build as well. So it's unfortunate, but our assessment of the overall impact, as I said, is about a £250 million impact beyond what we've already seen in 2015.

On the businesses, I didn't quite hear your question I'm afraid. Could you just repeat that again, Olivier?

Olivier Brochet: Yes, certainly. It's basically the – when you look at new platforms, you've –you don't have many if any over the next few years coming online. And looking at these mid-term prospects in business jets, I was wondering when you would reach the volume trough for these business jets?

David Smith: Oh, I see. Well I think we will see reductions, clearly from the fact that we haven't one a couple of key platforms over the last few years, and that will come progressively over the next five or six years. You know, we're still very confident about this market, it's an important market for us. We have still a very strong position and we are intent on continuing to invest in the technology, and to make sure that we have the right route to market for those products in the future. So we are very confident about the long term about this, but clearly you will see a dip in the short term from the market share reduction.

Olivier Brochet: Good, thank you.

Operator: The following question comes from Christian Laughlin from Bernstein. Please go ahead.

Christian Laughlin: Okay, thank you. Good morning everyone. Just a couple of questions from me please. Warren, I was just wondering if you wouldn't mind elaborating a little bit on the process – just in general terms the process and rough timeline of your review of the business operations? For example, do you expect to be largely complete by H1 earnings, or do you expect that this detailed and thorough review will take much longer, and with respect to updates we shouldn't expect much before much later in the year?

And then secondly, somewhat related to that, just coming back to the medium-term outlook that was initially released towards the end of last year or so. The calendar at the time called for regular updates annually in November or so: should we still expect that or is everything kind of on hold until your review is complete, and then kind of a communication calendar is reset, if you will?

Warren East: Okay. I must say that, coming into this job, I fully anticipated doing a fairly thorough review of the operations on the operational side of the business anyway. And, you know, what today's announcement is causing me to do is simply approach that with possibly a slightly greater degree of vigour than I might otherwise have done. And I don't think we're going to be setting a particular timeline for output, and we're not going to have any special communications as a result of that review. We're going to be communicating according to the normal timetable, and I will be updating you in due course in those normal communications as to how we're going with reviewing the operations and any changes that I think we need to make as a result of that.

And in that context, then the timeline that we set down for medium-term guidance: you know, right now we don't anticipate changing but, you know, obviously as a result of that operational review there may be some changes. I do hope – to take the question a little more probably, I do first of all fully understand that there have been some issues around communication with the investment community in Rolls-Royce and, you know, I do intend to make sure that, you know, we do a better job at that. And that may involve some changes to the timetable, but right now on my second day in the role I can't tell you what those changes to the timetable are likely to be. But we'll put our heads together and we'll certainly be back with the regular communications. I expect you'll hear some more from me on this at the end of July.

Christian Laughlin: Okay, thanks.

Operator: The following question comes from Nick Cunningham from Agency Partners. Please go ahead with your question.

Nick Cunningham: Good morning, gentlemen, and welcome on board, Warren.

Warren East: Thank you.

Nick Cunningham: I'm afraid I'm going to follow that up with a perhaps slightly unkind question, but there have been several profit warnings in the last 18 months. So the question really is: how confident are you that this is it as far as 2015/16 is concerned, and where do the risks lie?

And then a much more specific question: I believe we're due to see an A380neo launch around the end of this year; Airbus is becoming increasingly explicit about that, and it seems fairly natural that it will be a – say, a Trent 9000 that will end up being the exclusive engine on that. So – so does that end up being a zero-margin engine, and also can you afford it? Thank you.

Warren East: Okay.

David Smith: Yes, I think on – this is David. So I think on your profit warnings question: you know, essentially what we're talking about is – is two segments today. Firstly, the offshore market within our Marine business. So if you look at our overall Marine business, the Naval business and Commercial Marine business is sound. The market that's being impacted is essentially that affected by the oil exploration business and – and really that has been a fairly dramatic tail-off in capital investment activity right throughout that sector, which is impacting on us and the shipyards and other players in the sector as well. So we are not alone; in fact, you know, I think you can see a lot of this throughout that sector.

So what we've tried to do today is to provide a – a further update on – on the outlook we see there. None of us, however, can predict how long this trough is going to go on. What we've been absolutely insistent on is taking the right actions while we're going through this difficult period to readjust capacity within the business, and to make sure – at the same time, actually – that we're increasing investment in some areas that we all think are critical to our technology going forward. So I – I can't with assurance say that we won't see any more problems on the offshore market, but we have re-based our forecast for this year, and obviously that carries through into next year, based on all that we can see around us at the moment.

On the Civil market, what we're dealing with actually in a way is the – the negative effects of a very successful outcome last year of the Trent 7000 win that we had for the A330neo. The unfortunate thing is, however, that to bridge between that product launching in 2017 and the run-out for the A330ceo over the next four years, because they – they go on through – beyond 2017, we have seen a – you know, Airbus have been attempting as best they can to sell those aircraft, but it's been a very difficult process. And the Commercial situation is very keen, and clearly both they and the engine manufacturer who is going to sell into the A330ceo, are seeing the impact of that. We've made the earliest and best assessment that we can of the – the impact, which we're assessing as £250 million to £300 million total Aerospace headwinds that we've talked about. I think that, you know, from all the work that we've done very intensely that is a very balanced assessment for what we will see 2016. But clearly, this will not be just a 2016 issue; we'll see it carrying on further years as well.

So – so I think on those two issues, as I said, that – that we've provided, you know, very full assessment based on all the facts that we have around us. There are some other issues within the business that we've mentioned on Business Jets and Corporate Jets. Whether those will be shorter or long term, it's hard to say.

On your second question on – on A330 – sorry A380neo: the – the thing that we said all about – all along on this product is of course we were very interested in participating in – in such a product, but it is Airbus's decision about whether they have a business case to proceed with that. And clearly they've had a, you know, fairly long conversation with their customers now, and key customers around that product. We – we will also only participate in that product if we see a business case and, you know, by definition therefore they will probably only proceed if we see a business case. So this has to work for all parties here: ourselves, Airbus and the – the key customers. Beyond that we can't really say, because they are in control of the timing. But that's our – that's our view on that product. So we won't go ahead with it if there isn't a proper business case.

Nick Cunningham: And just briefly – thank you for that. Briefly just follow up on the risks issue. There's been very little mention of the Tognum business. That has some of the same exposures as

Marine, although obviously it's much a broader business. Is that still trading in line with expectations and do you see any risks residing in that? Thank you.

David Smith: Yes. They're – they all have a weaker first half on profits than last year, and I think that that's part of our bias on the profits. But actually that represents an expectation that we had around mix of business anyway. They're certainly trading in line with delivering their full-year results and they're – they've actually had some good order intake in the last few months. Their – their offshore business is a relatively small part of the overall business, as you've said, and there are other sectors that are developing more positively at the moment for them.

Nick Cunningham: Thank you very much.

Operator: The next question comes from Ben Fidler from Deutsche Bank. Please go ahead, your line is open.

Ben Fidler: Thank you, yes. I actually have three questions please. The first one is just, I guess coming back to 2015 for Civil Aerospace and just to – getting your view and take as to what it says about control visibility, whether you're content with the control systems you have, predicting the performance of that – of what should be a very visible business? Trent 700, low spare engines, biz-jet delivery declines; weren't those issues you, theoretically, or the business should have foreseen at the start of this year? And I know your overall Civil guidance has been maintained, but clearly it's been helped a little bit by the Trent 1000 provision release. So just wanted to get a feel for, in your view as managers of the business, in Civil Aerospace, do you feel that you've got the information systems that enable you to – to know what's truly going on in that business on a 12-months forward basis?

Second question was just around Trent 700. I'd clearly done my maths slightly wrong in terms of the drop-through margin effect for 2016 with the volume decline, and should we assume a similar drop-through margin effect for 2018 from when the A330ceo programme effectively all but finishes? Or will that be overestimating the next leg down in Trent 700 in 2018?

And then the third question: just for 2016, your revised guidance for Civil profits, if we adjust out some of the accounting issues like TCP net debt, a growth of – I mean, it implies you do about £600 million of Civil profits. You've got probably – take your guidance, a £300–400 million growth in TCP net debt as reasonable growth in contractual aftermarket rights, an ~~inaudible~~ IAE earn out of £200 million; it implies the underlying Civil profit in 2016 is close to nothing, and yet for the mid-term you're guiding to Civil margins up to 15%. That seems like a lot of growth in the out years. Are you still confident with that? Thank you.

David Smith: Thanks very much, Ben. So I would say on the visibility within Civil, I think the Trent 700 has actually been quite a difficult issue for us to assess. As I said, none of the engine allocations for the – for the A330ceos is clear yet, so we've essentially had to look at this airline by airline and work out where we think our position is on those in quite an uncertain environment, because we haven't been exactly clear also where ~~A3—where~~ Airbus will be selling into as we've been going through this process. So it's a – it's – it has been a more difficult issue for us to assess than normal I would say.

On – on the biz-jets, this is a relatively new issue that really was emerging over the last couple of months, and it's – it's, I think, well-known who the ~~—who—~~ who the player is who's ~~—who's~~ been seeing some weakness in their own demand. And I think, you know, we've been working with them very hard in terms of that to adjust our volumes to – to suit their requirements. Again, you know, this is probably a combination of – of market share and particular market environments, and we may well see some of the factors that are impinging on that market, in terms of demand in China etc., improving again over the next year, but we're trying to be realistic about the fact that we think this will probably not just be a one-year effect but that it will probably impact on 2016 as well.

In terms of Trent 700, I just want to make something clear on drop-through margins. So, when we think about the £250 million, it is made up of three components: the volume effect, which, as you know, is linked and therefore includes an element of OE and aftermarket; the pricing effect, which – and both of those two effects are roughly the same size, within the 250, and the pricing effect actually represents the fact that we've been selling these engines at lower prices than we have previously on Trent 700. And then the spare engines, which, although smaller, is essentially the loss of volume of relatively higher-profit engines.

So that effect into 2016, which is – obviously will continue into 2017 and 2018 as well, as you said, is – you need to think of it, I think, in those three parts in terms of doing any calculations you want to do on drop-through effects. Clearly, as you said, there is a further reduction in rate as you get into 2018, I think. I can't quite remember the Airbus schedule at the moment, but I think it's a smaller reduction in 2018 as well.

Ben Fidler: Thank you. And the third question, just on – am I completely off-beam with my maths for the sort of implied underlying Civil profits in 2016 –

Warren East: Yeah.

Ben Fidler: – and the steepness of that recovery?

Warren East: Yeah, so, you know, the good thing about this planning process is it's identified – enabled us to identify and put numbers around some of the – these things early, so we've actually been able to get out to you, I think, with a view for 2016, in terms of the headwinds that we are facing, much earlier than we would have done normally in our process.

The positive thing for me, actually, is it's actually reinforced my view about the long-term ability of the business to generate the kind of margins we've been talking about. We've done some very extensive work on the XWB and the impact of that. I showed – very briefly, I know, but showed you that slide which shows the cumulative cash flow for XWB, which is significantly higher than Trent 700, so I've actually come away from that process much more confident about the ability of the portfolio regeneration and the industrial restructuring we're doing actually to give us a very good, long-term, sustainable business for the wide-bodied engine market.

And the elements of the – you know, how we're going to improve margins, really hasn't changed; it's around delivering improved engine costs and customer pricing after we get through the launch phase; it's about getting the capacity utilisation up as we're increasing the ramp, and that will be progressive through the rest of this decade; it's about the industrial restructuring that we're doing, which will give us much more flexible capacity; and most importantly, it's about the aftermarket margin that comes with a 50% installed base. We're still in the 30s in installed base today, but will be beyond 50% as we get through 2020. So these are really the impacts that will continue to drive this margin improvement over the medium term.

Ben Fidler: Thank you very much.

Operator: The following question comes from Zafar Khan from Société Générale. Please go ahead, your line is open.

Zafar Khan: Thank you very much; good morning everybody. John and Warren, welcome to both of you, into the sector –

Warren East: Thank you.

Zafar Khan: I have two questions, please, if I may; the – and they're both, really, directed at you, Warren, if that's okay? The first one is just on – I know it's only your second day in the job, but you've

been non-exec, you know, on the board of Rolls for a little while now, and also the announcement of your succeeding Mr Rishton happened a few months ago – I just want to know how much you've been involved in this trading review, if I can call it that way, and the guidance that's been given for 2015 and more particularly for 2016; how much has been your involvement in that? That's the first question, then maybe I can follow up afterwards with the second one?

Warren East: Yeah, certainly. Well, you're right, I have been on the board and as a non-exec director. I was very supportive of David's appointment last November and very supportive of David's rigorous review of the business which, as he said a few moments ago, has enabled us to bring this information to the market much sooner than might otherwise have been the case.

Following the announcement that we made in April that I would be joining the business, then in the middle of June I was involved in the latter stages of David's process there, and saw the output as it started to emerge as part of the company's regular long-term planning process. And certainly, even though I joined the business on Friday, I've been involved over the last week as numbers have been coming out, and it became evident over the weekend when we got the final numbers together that – the magnitude of this impact, in particular on 2015 and 2016, and therefore that we would have to be making this announcement today.

As I said at the start of the call, it's not how I envisaged my first communication with the market, and even up until half way through last week or so I was not really imagining that we would be, necessarily, talking quite so soon in my tenure, but I think it's absolutely inevitable we had to have this communication today. Obviously it's a little bit scanty on the detail and, by the end of July, then I hope to be in a better position with some of the information. And your next question?

Zafar Khan: Yeah, this is – I hope you'll indulge me, it's a slightly philosophical question but I think many of us would like to ask this, so let me ask it; it will save David having to ask a question later on. But, as Nick said, there have been a number of profit warnings now, for 18 months or so. The stock is a pretty big underperformer against the rest of the aerospace – Civil aerospace stocks; there's a lot of money sloshing around, very cheap money, and you may have noted Airbus issued a convertible at a negative yield to maturity, so clearly a lot of money around the place. You've put forward a very compelling case for the long-term prospects of this company but it looks like, in the medium term, I think the shareholders are going to suffer a little bit of this kind of transitioning issue. And I think you know equity markets are pretty kind of unforgiving, but the longer-term view is often taken by industrial players. So, I know it's your second day in the job but, given today's warning, given the kind of numbers down next year and maybe flat in 2017 on 2016, if somebody were to make an approach, how do you think the board would view that? Do you have the stomach to try and turn this thing around? It's a supertanker, really. Or, you know, if you were given tomorrow's money today, do you think the board would be amenable?

Warren East: Well, obviously, I can't answer for the whole board, and the whole board has duties to shareholders to consider, but certainly the reason I joined this business, as I said at the start of the call, was because I believe it's in a great position; it has excellent relationships with the customer base, and I joined the guys at the Paris Air Show and witnessed some of that first-hand, and I can see tremendous value in those relationships. I can also see tremendous value in the R&D which is in train in this business and which is translating into products. And if I look at the newer products that are coming to market – the Trent 1000 and all its variants, the Trent XWB and the follow-on products that we have in the pipeline – and if I think about those and I think about those and the – what the company has previously described as 'megatrends' and I see those products becoming more mature and more profitable, I see us occupying the new facilities that we've been investing in over recent years, then actually this business is very well-positioned for the future to take advantage of those megatrends.

So that's why I took this job on, and you know, what happens with other players in the market we'll deal with as and when we have to, but I certainly intend, as I said at the start of this call, to make a sustainable and resilient business a priority and I think we're in a great position to get there.

We do have some severe headwinds which are affecting the business today, in terms of relative to where we thought – or where the business thought it might be in 2016, and we've explained those headwinds today and that's why we're having this communication. But it doesn't shake my fundamental confidence in the future of the business.

Zafar Khan: Could I please just ask one of David?

David Smith: Sure, Zafar, yes.

Zafar Khan: David, there was a – effectively a £300 million release to the numbers last year on the Civil side, you know, from the long-term service contracts because – I think it was on the Trent 700 in fact, where the provisioning – there was an overprovision on that –

David Smith: Yeah.

Zafar Khan: – and you're talking about a £200 million release this year; that's a cumulative £500 million release. Is the accounting under control? I mean these are big numbers that you're releasing; how rigorous was the analysis in taking these provisions in the first place? What are you guys doing about this?

David Smith: So, Zafar, just a couple of points: firstly, it was £150 last year, and the main driver of that was aftermarket cost improvements. What we're talking about within the £200 million this year are a couple of different things. We took a deliberate decision when we launched the Trent 1000 to actually take provisions against the launch programmes there, so essentially the operating costs of those launch customers. And we did that very deliberately at the time because, I think as is well known, the early versions of the aircraft and the engines had further engineering programmes associated with them. As we're now assessing that – and we haven't quite completed the technical reviews, which is why I described this as something we expect to do in the second half – that we're actually seeing a lot better operational performance. So we don't believe that we need to continue to write down that asset and we'll reverse that asset, or that write-down, in the second half of the year, which is about £100 million.

So this has purely been generated, actually, by improved technical performance. We have one or two tests left to do and they will happen over the next two or three months, but we're actually very confident in the outcome of those tests.

The third element, actually – sorry, the second element within the £200 million – so that's about half of the £200 million. The second element actually relates to our valuation reserves. So at any point in time we hold our reserves against primarily credit risk, but other kinds of risks in terms of the airlines that we operate with. And we essentially do an assessment each year. That overall situation has improved quite a bit over the last year and therefore we can reduce the level of contingencies that we take on those contracts. Again, exactly following the normal procedures, we're just taking the benefit of – essentially of improved trading conditions for those as well.

So I absolutely assure you that the policies we're using are sound; we have continued to review those. What we're actually seeing is the benefits of good things that are going on, allowing us to hold lower contingencies against these things because we're seeing, on the one hand, operational performance improvements, on the other hand, improved trading prospects for our customers.

Zafar Khan: That's very good, thank you.

Operator: The next question comes from Jaime Rowbotham from Morgan Stanley. Please go ahead.

Jaime Rowbotham: Morning gents. Three quick questions from me, all keeping in mind Rolls' desire to give better communications. The first one is: David, I appreciate your comments on Trent 700 demand being hard to predict, but could you give us at least a rough idea as to where you were and where you now are in terms of expectations around deliveries of Trent 700 engines, compared to the 184 delivered in 2014? Because without that it's going to be very difficult for people to judge whether your latest guidance is sensible or not, whilst with it we can then perhaps draw some conclusions on the pricing element of the moving parts there that you mentioned.

The second is: David, you flagged slide 12, where you suggest cash from XWB can be double the cash flow from Trent 700 but, as you probably gathered from some of the questions, I'm not sure any of us really have a clue what cash from Trent 700 is, or indeed what you think it is. So I just wondered, can you add any colour there, and do you anticipate being able to add some financial figures to the axes on some of these charts in due course, or will that always remain difficult, due to commercial sensitivities?

And thirdly and finally – and apologies for taking so much time – but perhaps missing from the guidance is any specific outlook on cash in 2016. I do, though, take the point in the statement on cash conversion, i.e. the bit of the profit that you're downgrading is largely forecasted non-cash profit on Trent 700 sales, accounted on a linked basis, so the cash impact shouldn't be as big. Does that mean free cash at Rolls can improve next year, and if so what can you say to give us comfort on that, given that in 2015, the cash downgrade is actually bigger than the one for profit? Thanks.

David Smith: Thank you, Jaime. So, taking your first question first. You're right, 184, I think, was the number for 2014. I think we're – we're likely to see that drop to around the 140 level this year, maybe slightly higher than that.

Next year, what we've done for 2016 is, we've essentially taken a number of scenarios in coming up with our number of £250 million. So it's not necessarily one volume scenario only, we've taken a number of different volume and pricing scenarios and sort of mixed out what we think is the effect of that. But we're likely to see it drop to sort of between 80 to 100, I would say, next year, and a similar number for 2017. Exactly how that build schedule happens between 2016 and 2017 is much more likely to be depending on which airlines, what the GE build schedule within Airbus looks like. It's a little bit difficult to predict, but those kind of volumes for 2016 and 2017.

Jaime Rowbotham: Thanks.

David Smith: In terms of the colour on XWB cash flows: yeah, I mean, I'm not going to put numbers on that axis, I'm afraid, because it is very commercially sensitive. I would say to you that if you go back through Rolls-Royce's history, Trent 700 has been an incredibly successful engine for the business. I'm not sure I'm particularly qualified a historian to say it's been the most successful engine ever, but probably it's got a good shout at having been the most successful engine ever, probably alongside the RB211. But the – you know, that engine has gone on for – it's still selling 20 years later on an OE, and has at least another 20 years of aftermarket to give. What I'm trying to do by that graph is saying the indications on XWB on all of the work that we've done, all the analysis we've done, says that the XWB will be twice as successful as the previously most successful engine. So, you know, I think that – I'm trying to give you a qualitative view of how strong I think that embedded value is, because I do think it's very significant.

And then it terms of cash: yes, we didn't provide any specific guidance for cash, although we did, as you say, suggest that because of the unlinked – sorry, the linked accounting on the Trent 7000 – Trent 700, sorry, and the transition to unlinked accounting on the XWB, that the – the Civil profit effects are going to be more difficult than the – our cash effects, which will be, I think, quite a bit smaller. So compared to the revised guidance that we've given for cash flow this year, we should see sort of flattish cash flow in terms of that Civil effect, at worst, I would say. So it's – it's something that I would absolutely expect cash conversion to improve but I'm – I haven't given a cash outlook at this moment. But certainly I think that there should be opportunities to improve it.

Jaime Rowbotham: Great, helpful, thanks.

Operator: The next question comes from Rami Myerson from Investec. Please go ahead.

Rami Myerson: Hi, good morning, gentlemen. Just trying to stress the guidance for this year, next year and following on from Nick's question on the A380: you mentioned, David, that you were expecting a reduction in R&D this year and potentially next year as well. But given there are a number of programmes in the pipeline, do you not expect R&D to increase? Also, based on the comments previously from the Chairman, who talked about re-entering into the narrow-body market. Thanks.

David Smith: So, let me just restate what we said about R&D. So when we gave our guidance in February, we said that R&D spend would come off a little bit this year but would still be at a relatively good level in terms of coming off the 5.8% peak we saw last year, but coming down a bit but still at a good level. What happens between the first and second half of this year is that we have an increased number of programmes actually going through the capitalisation phase, because they – essentially what we had at the end of last year is the XWB coming out of capitalisation and we're coming into some new programmes now for next-generation product that we will start capitalising. So although spend is coming down a little bit, the net R&D charge between the first and second half is more biased to – towards the first half than it is the second half, just because of the way the capitalisation versus amortisation is working.

Ongoing, we will continue to ramp up within our R&D spend our spend on technology investments. We've talked about our new technologies before. These are all really developing around the advance in ultrasound concepts. Those will step up in spend within our total R&D spend over the next few years. What we'll find, therefore, is the balance changes a bit between technology spending and new engine programmes.

Rami Myerson: So you would expect R&D expenditure to grow or do you expect it to come down over the next few years?

David Smith: We said it will probably come down a little bit in percentage terms over the next few years.

Rami Myerson: Okay, thank you.

Operator: The following question comes from Jeremy Bragg at Redburn Partners. Please go ahead, your line is open.

Jeremy Bragg: Morning, gents. I've got a couple of questions, the first one being on the medium-term guidance. So I appreciate that these were set by a management team who aren't here anymore, but you set quite specific cash flow and margin targets for around 2018, and that was subject to no new programme starts, but today's statement, I would say, has got quite mixed messages. Firstly, there's the comment that these will be achieved later than previously indicated. But then, David, you've talked quite positively about the long-term potential for margins on wide-body. I suppose my question with this is: when they were issued, these targets were the subject of a detailed bottom-up review, which, I think, you stood behind, David, as CFO of the Civil business and then later of the Group. But today, you know, we've got a sort of, quite a chunky downgrade to 2016, which, you know, I can appreciate, but what would you say to make people confident in the ability to actually achieve those targets, if indeed you still stand by them? And when could they be achieved?

And you'll be glad to know, the second questions are shorter. Question two: there's a £300 million sort of downgrade – net downgrade to Civil in 2016 and you say that that's mostly non-cash. Is this an attempt to re-base the accounting to something, sort of, more akin to cash and more simple, or you know, am I being – reading too much into it?

And then the third question is – I think Ben asked this in a much more clever way, but I didn't really understand the answer – could Civil profits be lower in 2017 than 2018 as the Trent 700 volumes and pricing continue to fall and deteriorate, respectively? Thanks.

David Smith: Thank you, Jeremy. On the medium-term guidance: as Warren said, I think we need to give Warren a little bit of time also to take a look at the business over the next few months. I've just completed, you know, from my perspective, a very detailed review, which as I've indicated has actually given me more confidence than I had before in the ability to deliver the cash conversions and margins improvements that we need to make longer term. It's just inevitable, I'm afraid, that this Trent 700 impact on the business for the next three or four years is going to – is going to delay the ability to deliver on both of those, although less so on cash, but certainly on margins as we get through this period. Therefore, I know people were – and my predecessor talked about a specific date, I know – but I did try and encourage also that we think about this in terms of when the new programmes are going to be delivering, both in terms of their launch curves, their volume ramp-up and the aftermarket delivery. So – so it is a two-edged sword here, because the review has really shown me – and I'm very positive about the fact that we absolutely will get the improvements that we require and expect over a period of time – but our ability to deliver those early is, unfortunately, not helped at all by the fact that the Trent 700 to Trent 7000 is proving more difficult than probably we had previously anticipated.

In terms of, is this, sort of, a clever way of doing the accounting trend: actually, I'm not sure about that. Unfortunately it's just the real world in terms of the – the outlook for that aeroplane and the engines that we sell on to it and the pricing considerations. It is exacerbated, obviously, by the transition from linked on the Trent 700 to the fact that the engine that's going to be growing fastest, the XWB, is unlinked. And I guess, in a way it pulls ahead what I know a lot of you would like, which is that we reduce the timing difference between cash and profit, because this essentially reverses that trend somewhat.

And – can you just remind me your third question? Oh, the third, that was –

Warren East: Yeah, will they be worse –

David Smith: Yeah, I wouldn't take that conclusion. I think that the impact that we're seeing on 2016 is significant; it will be significant again on 27, but —on 2017, but we will over time start getting the benefits of the XWB installed base. And clearly, the volume ramps up on that; it ramps up in the second half of this year, and again next year as well. So I don't want to get into, you know, trying to pick a bottom here, because I don't think that that's what we set out to do today. What we set out to do today is to give you, as quickly as possible, a view on the headwinds we saw in 2016. But no, I think that, you know, we will see a couple of difficult years here, and then hopefully we'll start improving as we start seeing the benefits of the XWB.

Jeremy Bragg: Thank you. So when you say 'significant impact in 2016 and 2017', I mean that – just to be clear, are you talking about a significant incremental year-on-year impact in 2017 on 2016, on Trent 700, which you hope that will be countered by other things going better? Or are you just saying, '2016's going to be bad; 2017's also going to be bad, but perhaps not much worse than 2016'?

David Smith: So I think that was a different way of asking me the same question.

Jeremy Bragg: Yeah, probably!

David Smith: What I'm saying is the £300 million headwinds we'll see in 2016, we'll a similar effect in 2017 as well, because it's the same – it's basically the same effect. But not –

Jeremy Bragg: Okay, fair enough.

David Smith: – but not incrementally so, if you see what I mean.

Jeremy Bragg: No, I do, understood. Thank you very much.

Operator: As the question and answer session is now over, I will hand the conference back to you for the final comments, sir.

David Smith: Well – Warren, do you want to maybe –?

Warren East: Yep. So I'll jump in with that. Thank you all very much for your patience this morning. I wanted you to take away, essentially, three things from the call this morning. First of all, the facts: we wanted you to be in possession of the data that we're in possession of as soon as possible. I wanted you to take away the fact that we are concerned about what we've found, and the management team and I will be addressing that. And my goal is definitely over the next several years to make this a sustainable and resilient business, to try to minimise the effects of these sorts of market conditions in future. Thirdly, and very importantly, I wanted you to take away our unshaken confidence in the long-term prospects for this business, as David's just been talking about: the new engines, the greater profit- and cash-generating potential of the new engines, the market position and so on. I appreciate we haven't answered all of the questions; I'm sure many of you had questions that we didn't get round to. We will be reaching out over the next day and – the next day or so as a team, and I will be following up with many of you over the next weeks and months I'm sure, and we'll be back at the end of July with our half-year results. So, thank you very much everybody.

Operator: Ladies and gentlemen, this concludes today's conference call. Thank you all for attending, you may now disconnect your lines.