



2023 Half Year Results

Thursday, 3rd August 2023

Welcoming Remarks

Isabel Green

Head of Investor Relations, Rolls-Royce Holdings Plc

Hello. And welcome everyone, to our 2023 Half Year Results Presentation. I'm Isabel Green, Head of Investor Relations, and I'm joined today by our CEO, Tufan Erginbilgic; and also Panos Kakoullis, our CFO. Our presentation today will take around 30 minutes, leaving plenty of time at the end for Tufan and Panos to answer your questions.

And welcome to UBS, first time we've been here in a while (Operator Instructions). Moving on, before we begin, we take note of the safe harbor statements on Slide 2, as always. The results information can be downloaded from our website with the full risks and disclosures. I will now hand over to Tufan.

Half Year 2023 highlights and financial metrics

Tufan Erginbilgic

Chief Executive Officer, Rolls-Royce Holdings Plc

Half Year 2023: Highlights

Thanks, Isabel. Good morning, and welcome. I will start by presenting the highlights of our first half before handing to Panos to cover the financials in detail. I will then talk about transformation progress. We pre-released our results headlines a few days ago. So the key messages of today's presentation should not surprise anyone.

First, improved operational delivery is helping us deliver stronger financial results. In Civil Aerospace, OE deliveries and LTSA shop visits rose year-on-year by 26% and 24%, respectively. Our planned time on wing improvements are progressing well. This is one of the six levers that we are pulling to improve LTSA margins. We have applied for certification for the latest Trent 1000 fix, which will more than double the time on wing of that engine.

Our order book has grown in all three businesses. Our large engine backlog grew for the first time since 2018, including a large order from Air India in the first half. We also performed the first successful test of UltraFan demonstrator engine. The first time all the technologies have been tested together. This program will position us well for the next generation of aircraft. Technologies from UltraFan will also improve the time on wing of existing engines.

In Defence, the AUKUS submarine agreement builds on our already strong pipeline, underpinning the long-term outlook for profitable growth in the business. And demand remains strong in Power Systems. Revenues grew more than 20% in the first half, with record level of order cover for '23 and '24. Transformation delivered strong initial results and helped

us raise the guidance for the full year, even though our February guidance already included some expected benefits from transformation without which it would have been a lot lower.

Commercial optimization is driving commercial actions and pricing improvements across all divisions. We are tightly managing costs across the group as revenues have grown and improving the productivity of our operations. We are also making choices and allocating capital at the group level to the most profitable projects. Our transformation program is progressing at pace, but we still have a lot more to do.

Our early interventions have had a significant and sustainable benefit on our financial results. This is actually in-line with my experience of past transformations. That suggests the rate of improvement is higher in the early stages. Finally, our financial results. We delivered a 9.7% margin in the first half of '23, with the improvements driven by Civil Aerospace and Defence. The strong results in the period reflect end market growth and transformation benefits, notably from commercial optimization and cost efficiencies.

As a result, we are expanding the earnings potential of the business and accelerating financial delivery. They also support the increases to guidance we announced last week.

Financial metrics

We are transforming Rolls-Royce into a high-performing competitive, resilient and growing business. Our progress in the first half was delivered, despite a challenging environment. Large engine flying hours recovered as expected to 83% of 2019 in the first half of the year. But the supply chain remains challenging, particularly in Civil Aerospace, where we have also been impacted by the two supplier fires.

Inflation remains high, but we have managed to more than offset the impact at the group level through cost efficiencies and pricing increases. Interest rates are rising. All our debt is currently fixed, but deleveraging and returning to an investment grade credit rating is a priority. This slide shows some of the metrics that we presented to you in February.

All metrics show significant progress versus last year. Operating profit was £673 million in the first half with a margin of 9.7% and Civil Aerospace margin of 12.4%. These margins are the highest delivered in both the group and Civil Aerospace since the introduction of IFRS 15.

This demonstrates expansion of earnings potential and accelerated delivery. Free cash flow in the period was £356 million. This compares to an outflow of £68 million in the first half of 2022. The next TCC/GM, i.e., total cash cost to gross margin. This is a measure of the operating leverage of the business, and its resilience.

Our TCC/GM ratio was 0.6 in the first half of 2023. This compares to a ratio of 0.8 in '22 and 0.9 in 2019, pre-COVID. We are already making Rolls-Royce much more competitive and fit for the future. Finally, our credit rating. This year, Moody's and Fitch, both raised their outlook on Rolls-Royce to positive, and S&P also raised our rating from BB- to BB.

Our net debt has fallen from £3.3 billion to £2.8 billion. We are happy with our first half results, which show a significant improvement in the underlying performance. What

encourages us is that these results demonstrate the interventions that we are making are working.

However, we still have a lot more to do to continue to expand the potential of the business. With that, I would like to hand over to Panos.

Financial Results

Panos Kakoullis

Chief Financial Officer, Rolls-Royce Holdings Plc

2023 Half Year underlying results

Good morning, everyone, and thank you, Tufan. In the first half of 2023, group revenue increased by 28% year-on-year to £7 billion. Revenues increased across all divisions, with Civil Aerospace up 38%, Power Systems up 24% and Defence up 15%. Operating profit increased from £125 million to £673 million with a margin of 9.7%. This was driven by continued revenue growth, coupled with early transformation benefits, notably cost efficiencies and commercial optimization across the group.

The increase in operating profit was driven by 3 things: higher aftermarket profits in Civil Aerospace; increased large spare engine sales compared to the prior period, again, in Civil Aerospace; and revenue growth and margin improvements in Defence. Free cash flow improved from an outflow of £68 million in the prior period to an inflow of £356 million, and that reflected higher operating profit in both Civil Aerospace and Defence and increased large engine flying hour receipts, and that was partly offset by a working capital outflow in the period.

Our net debt position decreased from £3.3 billion to £2.8 billion. We've got £7.4 billion of liquidity, comprising cash and cash equivalents of £2.9 billion, and undrawn facilities of £4.5 billion. Our strong liquidity position enabled the cancellation of a £1 billion bank facility in the first half that we deemed surplus to requirements.

Our net debt maturity is a €550 million bond loan note in 2024, which we expect to repay with underlying cash flows.

Civil Aerospace

Now moving on to performance by individual business unit and starting with Civil Aerospace. Operating profit and cash flow improved significantly. This was driven by an underlying recovery in large engine activity and continued growth in aviation, coupled with cost efficiencies and commercial optimization.

Large engine flying hours were 83% of 2019 levels in the first half of '23, that compares to around 60% in the prior period. We delivered 188 engines, including 115 large engines, of which 18 were spare engines. We carried out 591 total LTSA shop visits, including 144 large engine refurbishments. So that compares to 477 total shop visits and 113 large engine refurbs in the first half of '22.

Civil Aerospace revenue was 38% higher at £3.3 billion, with OE and services up 58% and 30%, respectively. Revenue is higher across our portfolio, with growth in large engines, business aviation, regional and V2500. Civil Aerospace profit of £405 million compared to a loss of £79 million in the prior period, with an operating margin of 12.4%.

That increase in operating profit is driven by 3 things: Firstly, higher aftermarket activity, that included more shop visits, greater individual shop visit profitability and a greater contribution from both large engine T&M and also from business aviation aftermarket growth; secondly, increased large spare engine sales; and thirdly, cost efficiencies, notably the tight control of indirect costs.

Targeted contract improvements were £105 million in the period compared with £270 million in the first half of last year. That included contract catch-ups of £70 million compared with £219 million in the prior period. But you remember that prior period benefited from strong inflation-driven price escalation. Onerous contracts improved by £35 million in the period compared to £51 million in the prior period, again, due to our actions on commercial optimization.

Trading cash flows improved from £63 million to £401 million, primarily driven by a £479 million improvement in operating profit. In addition, the LTSA balance grew by £727 million in the period compared to £433 million in the prior period. That growth reflected EFH growth and our commercial optimization actions, notably improved average rate per flying hour, driven by escalation and customer pricing negotiations.

It also reflected the anticipated collection of overdue debts that we previously provided for. A portion of our LTSA receipts are payable to our risk and revenue-sharing partners and that reduces the amount of cash retained by Rolls-Royce. So of that £727 million LTSA balance growth, approximately £500 million benefited our cash flows in the period. Those improvements were partly offset by increased working capital outflows. We expect inventories to fall in the second half of the year, reflecting the normal seasonality of the business as well as the impact of our working capital initiatives coming through on the transformation.

We expect Civil Aerospace's operating profit in the second half of the year to be broadly similar to the first half.

Defence

Turning now to Defence. We've had major contract renewals in both combat and transport and are focused on commercial optimization to support profitable growth. Our successful run of new orders continued. The AUKUS agreement benefits us as we are the sole source provider of power and propulsion system for the U.K. nuclear submarines.

Work has now begun on the V-280 Valor program this year, and we secured funding for our global combat air program activities. The robust forecast of Defence budgets in most Western geographies underpin the long-term outlook for the business. Revenue growth was strong, up 15%. This reflects increased underlying demand and a first half weighted delivery profile. OE revenue was up 17%, helped by the increase in funded development programs in both combat and submarines.

Services revenue increased 13% with growth in all four segments. Operating profit grew by 33% in Defence and was driven by strong revenue growth and product mix. Operating margin of 13.6% compared to 11.7% in the prior period, with the increase driven by pricing actions, a more favorable product mix due to the timing of high-margin spare parts in the first half and cost efficiencies.

Trading cash flow was £76 million, which compared to £89 million in the prior period. Higher operating profit was offset by the absence in advanced payment from one of our customers in the prior period. For the full year in Defence, we expect modest revenue growth with a slightly lower operating profit in the second half of the year. And we expect stronger trading cash flow in the second half of the year as a result of two things: key milestone payments on newer programs and our actions to reduce inventory.

Power Systems

Moving now to Power Systems. Our order inflow remains robust, with a book-to-bill of 1.1x and a record level of order cover with revenues fully covered for the remainder of 2023 and 32% covered for 2024. Revenue growth was up 24%, driven by stationary power gen equipment and continued strong sales of mobile power solutions in both marine and mining.

Operating profit was £125 million, which is broadly flat versus last year. Margins were lower than in the prior period with the initial benefit of pricing increases, offset by the negative impacts of both product mix and higher costs. We expect margins to increase in the second half of 2023, due to the second half weighting of pricing actions and seasonally higher volumes. So we expect full year margin to be higher than in '22.

Trading cash flow was an inflow of £22 million compared with an outflow of £76 million in the prior period. That was driven by operating profit broadly flat versus the prior period. There was an increase in inventories, reflecting strong volume growth in the first half of the year, so a bigger business, and the expectation of seasonally higher revenues in the second half.

We expect improved cash conversion in the second half as we unwind those inventories to meet demand and also due to the impact of the working capital initiatives coming from the transformation.

New Markets

Finally, new markets, reported an operating loss of £78 million. That's in-line with our expectations and compares with a loss of £48 million in the prior period. In Electrical testing has begun on a new small gas turbine to power hybrid electrical flight as part of a turbo generator system for advanced air mobility.

Our SMR business is progressing well through the regulatory process in the U.K. and has now entered Stage 2 of the GDA process. We saw a trading cash outflow of £42 million compared with £30 million in the prior period, with SMR costs continuing to be largely covered by third-party funding.

Summary funds flow

Now the next slide sets out our summary funds flow. In the first half of '23, we had a £356 million free cash inflow compared to an outflow of £68 million in the first half of 2022. This can be broken down into three broad categories. Firstly, our operating performance has improved by £0.8 billion compared to the prior period. This was driven by higher profits in both Civil Aerospace and the increase in engine flying hour receipts ahead of shop visit costs, which resulted in our LTSA balance growth.

Secondly, working capital was an outflow of £600 million, which is around £300 million higher than the prior period. That increase was driven by an increase in inventories of approximately £600 million, due to continued supply chain constraints and anticipated higher revenues in the second half. There was a net outflow of around £300 million from receivables and payables, offset by net inflow from advanced payments receipts.

Finally, other impacts change by a net £100 million outflow compared to the prior period. With that, I'll hand back to Tufan.

Our philosophy, transformation programme, guidance and outlook

Tufan Erginbilgic

Chief Executive Officer, Rolls-Royce Holdings Plc

Our philosophy

Thanks, Panos. In February, we set out the Rolls-Royce proposition based on three pillars: First, creating a high-quality and competitive business with a focus on profitable growth and operational efficiency with higher EBIT margins and returns; second, growing sustainable free cash flow with growing cash from operations and disciplined capital investment; third, building a strong balance sheet and growing shareholder returns.

Our immediate priority is to return to an investment-grade credit rating, then resume shareholder distributions. We also talk about priorities we are focusing on to deliver the Rolls-Royce proposition, which are shown on the slide here. Of this, safety at the top remains our first priority, taking care of our people and products.

These priorities all have an underlying philosophy, which is what I would like to focus on today. This is how we are now running the business. This is different to the past and is helping us to improve our financial delivery and strategic progress. This is shown in bold on the slide. First, we are primarily focusing on the quality of earnings and cash, not market share. This impacts how we approach new and existing orders and contracts.

This is a change in mindset. We are concentrating on profitable growth. However, I still expect our volumes and market share to grow as we continue to improve our operations and our service to customers. We are aiming to achieve best-in-class operating leverage levels. Again, this is a change in mindset in terms of driving higher gross margins and driving cost efficiency to ensure that our business is more competitive and resilient to the external environment.

Our TCC/GM improved materially in the first half of '23. But there is still more work to do to achieve best-in-class ratio. Next, we will target cash as an input, not as an outcome. This is another important philosophical difference. Previously, group cash flow was an outcome based on the expectations by divisions. Now group cash flow is an input into a framework, which is used to inform the divisional targets.

Our strategy and annual planning is done on this basis. Choices are made to invest in profitable projects and growth opportunities. This leads us neatly to capital allocation. We are allocating capital to the best projects on a group-wide basis, before we allocated capital by division. This new approach enables us to allocate resources more effectively and efficiently to the highest priority areas strategically and for profitable growth.

We are prioritizing projects based on their strategic and financial value and execution risk. Finally, we remain committed to becoming a net zero company by 2050 and advocating for policies that support the industry sectors we operate in. We continue to progress our energy transition activities. A stronger Rolls-Royce will play a more powerful role in the energy transition.

Transformation programme

Our transformation program launched at the start of this year with seven work streams to deliver a step change in performance. We are in action. Initiatives have been identified for delivery in '23 and beyond. But we still have a lot more to do. The early interventions that we have made in 2023 have given us the most immediate and significant impact. This is why we talk about accelerating financial delivery.

I would like to talk to you about three of these work streams and how they help our financial delivery in more detail. First, efficiency and simplification. We are getting clearer on the operating model for the group, focusing on synergies across divisions and functions, optimizing spans and layers and simplifying the organization. At the start of the year, we intervened to reduce indirect costs and tightly control headcount and we made some activity choices.

We are also improving productivity in our operations. We will manage all indirect third-party costs globally to leverage synergies across the group. By doing so, we expect to achieve a material reduction in indirect third-party costs. We are taking the same approach with direct procurement, where around half of the categories overlap between the divisions. Again, this will enable us to capture economies of scale and optimize commercial opportunities.

An example of direct cost synergies relates to castings and rings. Previously, these were procured separately by Civil Aerospace, Defence and Power Systems. A cross-divisional team was formed to find ways to reduce the cost of these items, which have identified potential procurement savings of up to \$20 million per year.

Second, commercial optimization. The objective of this work stream is to improve contract profitability and take appropriate commercial actions. We are focusing on three main areas: wide-body margins, business aviation and Power Systems pricing.

In Civil Aerospace, we are pulling on six levers to improve our LTSA margins, three of which relate to revenues and three to costs. These are time-on-wing improvements, reducing the number of shop visits will drive up our LTSA margins.

Shop visit cost reductions. We are focusing on driving down the cost per shop visit by optimizing our overall process, reusing and repairing parts. Product costs. We redesigned parts to lower the cost of building and servicing engines. Fourth, rigorously enforcing our contractual terms to ensure that we are paid what we are owed. Fifth, we have a new pricing framework in place to ensure that all new and renewing contracts have a satisfactory level of profitability.

All new and renewing contracts are now reviewed by the Investment Committee. Finally, engaging directly with the customers to address onerous and low-margin contracts. We have an onerous contract provision of £1.4 billion. We must rebalance these contracts. A strong Rolls-Royce will be a much better partner to our customers and deliver superior service. I have personally spoken with each and every customer with which we have an onerous contract. Our immediate focus has been on the six most onerous airline customers, who represent more than half of the onerous contract provision.

A further 10 customers have been identified as key opportunities. We have set up joint task forces with the customers to work together for a win-win solution. In business aviation, we have almost 70% of the installed base of large cabin business jets. Our market share is growing based on our position on new jets. We are working on customer segmentation on the aftermarket with a view to offering customers a premium aftermarket offering. Time on wing and cost improvements in business aviation drove contract catch-ups in the first half of the year.

In the first half of the year, we also raised time and materials pricing for large engines by 12%. This contributed to first half results significantly. We also continue to improve the profitability of our OE business.

In Power Systems, we have applied a similar approach to Civil Aerospace with detailed analytical work by business segment on the pricing of OE and spare parts. We have enacted price increases across the portfolio that had provided some benefit in the first half, with much more to come in the second half. We have also benefited from this in Defence, where we had major contract renewals in both the combat and transport segments. We have focused on commercial optimization to improve profitability.

Third, working capital. We have identified opportunities to deliver a sustainable improvement by optimizing each of the components of working capital as part of a multiyear program. Progress on this so far has been slower than I would have liked due to the challenging environment. We are increasing our focus on this now.

In the first half, working capital deteriorated, as you heard from Panos, by £600 million, driven by higher inventories, reflecting continued supply chain challenges, including the impact of the two supplier fires and in anticipation of higher volumes in the second half. This is largely as expected, and we still expect to release inventories in the second half.

We have already made some encouraging progress with overdue debts and collecting customers' advances. This is based on rigorous data analysis and new digital tools to analyze overdue debt by customers. We have more to do on working capital in the second half of the year, and this will continue into next year and beyond as this is a multiyear program.

Guidance and outlook

Finally, let's look at our guidance for 2023. As you will know, we communicated our upgraded guidance on 26th July. The external environment is largely as we predicted in February. We still expect large engine EFH at 80% to 90% of 2019. Our guidance for shop visits and deliveries are also unchanged. The supply chain remains challenging, notably in Civil Aerospace. And we expect that to remain to be the case into 2024. We delivered strong first half results, helped by transformation and performance management.

We are accelerating our financial delivery and our upgraded guidance reflects this. We now expect operating profit of £1.2 billion to £1.4 billion in '23 versus our old guidance of £0.8 billion to £1 billion. This factors in targeted contract improvements of £200-£250 million, including catch-ups and onerous provision releases. We now expect free cash flow of £0.9 billion to £1 billion in '23 versus our guidance of £0.6 billion to £0.8 billion.

This guidance includes an LTSA balance change of £1 billion to £1.2 billion, of which £0.8 billion to £0.9 billion is expected to benefit our cash flows in the period. Our free cash flow also factors in £200 million of legacy Boeing concession outflows, a £150 million impact associated with supplier fires and new £100 million relating to a legal judgment.

To summarize before we go to Q&A. We have delivered strong results in the first half, helped by transformation and rigorous performance management. These have been achieved despite the challenges associated with inflation and supply chain. We are accelerating our financial delivery and have raised our full year guidance. We are working at pace on our transformation plan, but there is still much more to do.

We will come back to you in November to present the outcome of strategic review and set medium-term targets. Before we open for questions, I would just like to take the opportunity to thank Panos for his hard work and contribution over the past two years and wish him the best for the future. Thank you. We look forward to your questions.

Q&A

Ross Law (Morgan Stanley)

Ross Law from Morgan Stanley. Firstly, on pricing. Clearly, a key pillar of the transformation plan. Can you maybe give us some context on how this benefited in the first half and also maybe some color by segment.

Secondly, on supply chain, where are the bottlenecks currently? You mentioned two fires, but where else are you seeing issues?

And lastly, on Power Systems. You also mentioned negative mix. Can you maybe give us some details around the margin delta between, for example, marine and power gen?

Tufan Erginbilgic

Okay. So I'll take it in that order. I think pricing question, that is what I tried to give you sort of color there. But effectively, what we did, we were very focused with that work stream. And that works the way you should think about it. It works together with the line management, obviously. So they are the same in that sense.

But effectively, we thought widebody and LTSA but also time and material was a focus area because, for obvious reasons, we thought potentially is big there. Business aviation was a big focus because I was very public on that, that business aviation, we have a great platform, but we haven't commercially leveraged that platform. Therefore, that was an obvious area to focus on.

And both on OE level as well as aftermarket, by the way. And then the third one, Power Systems pricing. And one word on that. Yes, first half was weak in Power Systems, but we knew. And frankly, that should tell you how we intervene because when we actually started our program, which was almost as January as you know sort of, it was already first half -- to a great extent first half pricing or lack of pricing was locked in. And Panos talked about higher costs also in terms of hiring, et cetera. They already hired people, people were coming in.

Therefore, our interventions will play out on both dimensions second half, right? So I think -- and then what we did, frankly, we didn't deploy that work stream on Defence. But what we did is because the opportunity set was smaller. But what we did is we transferred the learnings pretty quickly, and they applied that. Actually, Defence numbers include both on OE as well as aftermarket, pricing and commercial actions. I hope that gives you a sense on that one.

Supply chain question is, I think I said it, frankly, industry, everybody is talking about it. As you know, airframers talking about it. Right now, limitation in the industry is supply chain. And we have the same issues. And our issue was a little bit multiplied because of two supplier fires. And that actually, we talked about £100 million, £150 million impact. But actually, initial impact was going to be a lot more than that when we analyze.

But team has done a great job to minimize the impact to £150 million that we are sharing with you. But the gross, without interventions, actually number was a lot because I've been heavily involved. I did at least five reviews with the team on that. So therefore, I know pretty well our starting position. But supply chain, frankly, unfortunately, because of this V-shape, supply

chain issues, I don't think Civil Aerospace supply chain, gas turbine supply chain will stabilize anytime soon.

I definitely expect that definitely next year, maybe beyond. So -- but we also see other supply chains. So there are some overlaps, obviously, between Power Systems and Civil and so on. But Power Systems supply chain after COVID had this similar issues of COVID recovery, but it is stabilizing because they didn't have V-shape that industry, they had more like U-shape, if you like. So that is stabilizing.

Your last point on Power Systems sort of margin, I'm not going to give you specific numbers. But yes, marine business margin profile because your specific question marine versus power gen, marine business power -- margins profile is much better than power gen. And we are actually improving power gen this year, even with the numbers you see and second half more, we are actually improving power gen margins. But structurally, that margin structure differences like that. There is one question there. I'll come to you David after that.

Nick Cunningham (Agency Partners)

Nick Cunningham, Agency Partners. Obviously, you have substantially beaten expectations, to say the least, both in the half and in guidance. And that, as you said, is despite the fact that the external inputs are not really changed in terms of what you're expecting. So obviously, a large component of that is cost and pricing.

First question is, what's the risk that you're getting the inflationary benefits in your pricing before you suffer the adverse impacts of inflation in your cost? So, is there a danger that you're going to end up giving back some of this gross margin benefit that you've seen so far?

Second question, you've been generating a lot of cash despite inventory increases. So you're obviously carrying I presume much more inventory than you think it should be. Is it possible to put any kind of quantity on that inventory? And finally, normally, even in a good year, Rolls-Royce uses a lot of cash in the first half, I mean, typically hundreds of millions and then gets a lot more than that back in the second half. This year is completely different than that. Is that a structural change? Should we expect that to be the case going forward? Or would there something special happen in '23 to shift that balance?

Tufan Erginbilgic

There are three questions. I'm going to let Panos answer the second one around working capital. But let me tackle the inflation question. I don't think so because, actually, in a way, what is going on here is we already got big inflation impact in our numbers, if you think about it from last year onwards.

And then this year, we continue to see that. The way to think about it, now this is I'm giving you a 30,000 feet view. The way you may want to think about these results, you are absolutely right, commercial actions and cost efficiency self-help drivers here. The way you should -- we effectively neutralize with our cost efficiencies, neutralize inflation impact.

And we actually all the pricing actions, not only pricing because commercial actions, multi. I'll give you a commercial action example, right, beyond pricing. I think pricing, everybody understands. But in our LTSA balance, we talk about sort of, Panos talk about debt that we

actually provided for. Basically, that's the debt we've written off because we, the company thought we would never get it back, COVID and so on and so forth.

Therefore, everybody focused on what we do. I'm not denying what we do is not important, very important, but how we do is equally important because I've been involved in, as I said, all the onerous contracts. But on this one, I wasn't. But the tone you set, the framework you create, what team did, they look for opportunities. They thought, yes, I'm going to go and negotiate this because I know if they call Tufan, probably, he is going to defend me.

Suddenly, these things come through. And that is £100 million, right? It's not a small change. That's £100 million we never had, frankly. I mean reality is we written off by definition. We never had. So therefore, when you think about, I call commercial optimization, everybody says, he's talking about pricing, including pricing, but I am thinking about commercial actions because in business aviation, we are doing customer segmentation. And that is creating value.

So you need to think about commercial actions wider than that. So I think your last question, then I'm going to pass it over to Panos for working capital. So there are in our business, there are some structural reasons why first half, second half play out. But there are some reasons that we make it that way. So what we tried to do this year, tried to push on some of those things, you will say, why Tufan? Because it actually reduces the risk profile of your delivery. That's why that was a focus area. We didn't do anything sort of -- but we effectively whatever in our power that in normal sustainable business improvement sense we can do because I cannot overemphasize all our improvements here, sustainable improvements. That is what we are interested in because this is initial results, we want to continue to build on it. So over to you.

Panos Kakoullis

Yes. I'd probably add one little thing to the first answer as well. Just from a profit perspective, LTSA margin recognition is based on forecasting your future costs. So that will have though your inflation concern would be built into those future costs. So that's the basis of that being recognized that's built in.

In terms of your cash point, you're right. The cash performance in the first half was driven by that increase in operating profit across Civil and Defence, as we highlighted. The LTSA balance increase, again, as we highlighted, together with those commercial optimization actions that are in there that drove some of the areas that Tufan was covering.

It was offset by £600 million negative outflow on working capital. Then when you work through it, you'll see inventory went up £600 million. We expected it to go up in the first half, partly as a result of that seasonality because Power Systems is heavily second half weighted in terms of unwind of inventory. Civil Aerospace, we've got more shop visits and more OE deliveries in the second half, again, some of that seasonality, but also some of that impact of supply chain is bumping up. We do expect an unwind but think of that as an unwind from H2 -- H1 into H2, not from year-to-year.

David Perry (J.P.Morgan)

David Perry from J.P.Morgan. I've got so many questions. I know I'm going to have to decide which are the most important. So can -- let me choose these three. First of all, the EBITDA guide. You've given us the year for the group and you've given us Civil Aero at double H1 800 It doesn't imply a particularly good performance for the rest of the group. It's 400 to 600 in aggregate for the rest of the group, which is either equal to last year or well down on last year. So just at a high level, can you comment on that, please?

The second question is the free cash flow guidance for the year, to me, looks quite low, given the LTSA inflow. Are you assuming a very big outflow in other working capital ex LTSA? So you just speak to that.

And then I guess the third one would be, if I just pick up what Panos just said, which is LTSA profit is based on a forecast of future profits. And your comment, Tufan, about the rate of progress at the beginning of your program is much faster than later. How much of the journey on the Civil Aero margin improvement have we just seen already this year or in the first 6 months? I mean should I take a 9% margin this year and now dream of 20%? Or am I thinking it's 9%, but a lot of the goodness has happened and is just a bit more to go?

Tufan Erginbilgic

Thanks, David. As usual, good questions. So first of all, operating profit guidance, your first question I think. Is £1.2 billion to £1.4 billion. Yes, I can totally see why it may come across sort of conservative. I think let me reiterate what we said in that write up, we said Civil will have similar operating profit second half. And that should tell you, frankly, first half benefits when I look at it, they are all sustainable benefits. And second half, frankly, similar profile. I cannot see there anything that I would say this is one-off. So that is how you should hold Civil. I think that will play into your last question as well.

And then we said, in Defence, we expect operating profit lower second half and Power Systems, the other way around. Then you look at the environment, we have lots of uncertainties in the environment, especially supply chain challenges and uncertainties. And because supply chain challenges, frankly, they -- because of this V-shape that we talked about was bad, but it was actually coupled by some other world events like interest rate increases and funds flow getting tightened to the supply chain, some of the companies. When you are in V-shape trying to expand your capacity, funds flow sort of tightened, I'm talking about smaller companies, right, that is actually creating lots of issue.

So we effectively in our guidance reflected some of the risk profile of external environment. So if I move to your free cash flow point, I'll say a few things, but I might Panos to say what he would like. But here is how I hold it. I think take our operating profit guidance, which is around £400 million better than our previous guidance, give or take £100 million of it comes from onerous and catch-up. So that means £300 million coming from operating profit and another £200 million cash coming from LTSA.

So £500 million upside, then we highlighted two items there, which are new they weren't in our February guidance. One is we said supplier fire impact is now £150 million, not £100 million. And second thing is this new legal judgment. Frankly, we are going to appeal that.

That is, I think it is public, I can tell you, that's the Collins court case, which goes back to, I don't know how many years, but it's not a new court case, but the judgment came in July.

So -- and we provided that for in income, but obviously not in cash. So that is -- that's creating. So that is your £350 million. So if you look at our increase £200-£300 million in cash, the difference is we are a little bit more conservative on working capital release than we were in February. I hope it sort of math works there for you.

Panos Kakoullis

The only thing I'd add to that the Collins provision that you referred to was made in prior years. So it's not in -- it doesn't hit this year's profit.

Tufan Erginbilgic

Yes. That's what I -- we provided in previous years because, frankly, to the team, obviously, I'm new. But to the team, this wasn't a surprise. Anyway. And your margin improvement, I mean, this is one of those questions, you when I won't answer, but a good question, nevertheless. So I think -- what I said is true I think. I really -- because when you're around 250 miles an hour, so you don't think about it every day. But I went back one week and once sort of everything must coming together, I said, okay, let me see how it compares with my previous experience.

And two experiences, I can tell you, almost identical, almost identical. I know you got surprised why these results. In that sense, I'm not. And the thing that, rate of improvement is really high early on. And I talk about why that is the case because you analyze the business and you make obvious interventions. When I say obvious, I don't mean easy because if it was easy, somebody else would have done it.

But obvious interventions based on your analysis, and then that creates that sustainable, which is all good because sustainably, you are getting to a new level. But from there, I really caution you guys to extrapolate it on a linear basis or anything like that rate of improvement will be different at different stages.

So last thing I'm going to say, David, I think when we come in November, obviously, with strategy review outcomes, we will then talk about midterm targets. But I should say one other thing because some of you were still probably thinking this is too good to be true. But one other data points always help in this kind of conversations, right? one data -- two data points for you when we talk about operating profit margin. One is 12.4% and 9.7%, both of them actually the best on record since IFRS 15 change.

And if you make IFRS15 change adjustments to the history, you may actually find most likely that they are also the best on record when the flying hours still 80%. So why am I saying that is one data point should tell you how much self-help improvements there. But second data point is equally important, and David, you will relate to this.

Almost a year ago, Rolls-Royce set a midterm target of single digit for Civil Aerospace, probably they were thinking that is '25, '26 in terms of years when you say midterm at that time. We obviously overachieved that by a margin. So those are two data points tells you rate

of improvement is high, and it is self-help because when they set those targets, I'm sure they assume full recovery on the flying hours and so on and so forth, right?

So I think that should tell you the self-help improvement here. But never forget about my caution that rate of improvement will be different going forward.

George Zhao (Bernstein)

George Zhao from Bernstein. First one on the collection of the overdue debt. Is that mainly behind you? Or how much more of the opportunity from that is still ahead of you? And second, on the increased pricing in Civil Aero. Is the contribution more from new contracts or revisiting older contracts? You mentioned the 12% T&M price increase. Is that comparable for the LTSA's? And how much portion of the LTSA contracts have been able to -- have you been able to renegotiate?

Tufan Erginbilgic

I'll let Panos to answer the overdue question. On your pricing question, I think, frankly, it is coming from everywhere a little bit. But time and material is important in this because we always talk about LTSA contracts, et cetera. When I say time and material, some of you may be thinking, but 80% to 90% of your stuff is LTSA contracts, how do you actually make that much impact by time and material price increase?

Remember, almost 50%, these are rough figures. Almost 50% of our LTSA contracts, actually LLPs in a way unbundled, therefore, the customer pays for them separately. When you make a price increase 12%, half of with the shop visit increase because time and material, obviously, more shop visits more need for that, that actually makes an impact.

So that's how you should hold it in your mind. Obviously, it is both profit and cash in that case, unlike sort of LTSA improvement. So it is everywhere, frankly. We also increased our onerous contract and catch-up numbers, as you know, from February guidance, roughly, roughly £100 million, I'm rounding. So that's how you should think about it. Overdues?

Panos Kakoullis

Overdues, we talked about this at the February announcement. There was a collection of some overdues in last year's numbers in the second half. We said there was more to come. Some of that came through in the first half, but there is still more to come. And there is -- there are some elements that even -- won't even recognize this overdue as Tufan highlighted earlier on, where we previously provided around some minimum utilization that we didn't think we would get that is now being billed and will be collected.

Chloe Lemaire (Jefferies)

Chloe Lemaire from Jefferies. The first one I was going to ask about what surprised you in the pace of transformation. But based on your prior answers, I'm going to ask you, what actually delivered in-line with what you expected, but pretty fast compared to our, I guess, expectations? Was it the willingness of customers to come back to the table and renegotiate contracts? Was it the actual leverage that you could get on some of the transformation plan or just the cost -- other cost savings benefits?

The second question I had was on the LTSA invoicing. We're now in H1, well above the 2019 levels, £2.3 billion compared to, I think, around £1.7 billion. So could you explain what drives that significant improvement when we just -- we're still below the 2019 volumes? Or maybe going forward, how should we think of the pound amount for incremental flight hours?

Tufan Erginbilgic

Okay. Two good questions. So I think -- I mean, one -- I'll specifically answer that question. But one thing I really want you guys to think about how these three divisions -- and some of you are saying Power Systems is sort of disappointing or whatever your wording is. Effectively, this is -- these results are not one thing. Don't look for a silver bullet, okay? And that's my experience. And that makes these things more powerful because you mobilize the whole organization with a clear purpose, with a clear framework and then interesting things happen.

And that is the stage we are at, right? Therefore, it is -- I'm saying to you, we haven't deployed commercial optimization work stream in Defence. Frankly, they know what they did. They call the commercial optimization team. And we didn't do it. One reason we didn't do it, price was smaller. The other reason was confidentiality. Frankly, you need to get lots of clearance to go in there. And we didn't have time. We were in rush. But they call the commercial optimization. They sat down with them, then they went and took OE and after pretty tough OE and aftermarket actions.

So that's how you should care. But specifically, I always talk about six levers, right? I talk about in my script. Therefore, our LTSA improvements will not always come from because customers are coming forward. But I can tell you this. Those six levers are there, and we will drive them in a very rigorous way, okay, number one.

Number two, we are partner to customers. If you think about partnership because you may be thinking, why are they even entertaining you, right? Because there isn't one I can tell you, which didn't agree to establish a joint workforce. There isn't even one OEM or aftermarket sort of i.e., airline, I should say. And you may think what is going on here? Thinking about what we do.

We are a long-term partner, more than airframers are, right, because you sell the plane at least for that transaction you have done. You sell the plane, our engagement is still another 15 to 20 years on that plane, right? We are a true partner. If my true partner comes to me and says, this is really one sided contract, Tufan. So you got two options, you call us not a partner and transactional, then I deal with you next 15 years on that basis or you come to the table, we resolve this. We create win-win, then we build on it together and create even a much better future.

That actually brings people to the table, right? That is the sort of -- your second question, LTSA and Panos, please jump in. But here is how I hold it. We gave you a rule of thumb in the past. We won't give you another one. Do you know why? For two reasons. Because we are in transition and industry is in transition. What do I mean by that? Industry in transition because new engines like XWB coming. Without any doubt, they are better engines, fuel efficiency, et cetera, but they cost more.

Therefore, they are priced differently on EFH level, right? Therefore, mix changes, your EFH rate is going up. We are in transition because we are taking commercial actions and pricing actions that is also increasing that. So therefore, we won't give you a rule of thumb because it is going to be a moving target. One thing you should expect it will continue to go up because of those two factors, right? Per rate -- per unit will continue to go up.

Ian Douglas-Pennant (UBS)

Ian Douglas-Pennant at UBS. So just continuing on that answer you were just giving, I guess, on pricing. To what extent do you need to go back and have conversations with Airbus themselves? To what extent is that kind of base contract that you've built on need to be negotiating in some way?

And secondly, on cost reduction. In Civil business at least, the commercial and admin and R&D costs declined in absolute terms in H1. How did you achieve this in such a short time frame? You have a heavy unionized workforce. I mean, is there just no travel going on? Is it stuff as basic as that? Or like how do you even do that?

Tufan Erginbilgic

Okay. Very good. On Airbus, I won't comment on individual conversations. You shouldn't expect that to happen. But I would say Airbus is a great partner. And obviously, we have had long and good relationship and that will continue going forward. I think on cost efficiencies, it is sort of what we did, obviously, industry is in the recovery, right, i.e., you are scaling up sort of more OE, more shop visits and so on.

Therefore, you want to invest, if you look at our first half capital spend is higher than first half last year. I think Panos shared that. Why is that? Because we are investing in that recovery, right? Because R&D and capital, we will do the right things for the company for sustainable growth of the company.

So -- and we are increasing first half towards first half because, actually, when recovery is coming, we didn't want any of our machinery to fall apart while sort of scaling up sort of that was the reason. But for the same reason, we also increased direct labor, but our eye has been on productivity improvements when that happens. Therefore, no cost reduction there.

But then indirect labor and indirect headcount, we -- and the activity choices, I talk about indirect sort of -- let me talk about both of them separately. I think indirect by definition, that's not your variable cost, right? So -- but some companies don't manage that rigorously. And frankly, Rolls-Royce has been in that journey. That's why I made the comments I made about Power Systems. So -- and -- but I think when you rigorously manage that and we put a system in place, really, system in place for indirect headcount and cost management.

And that actually made sure that we did the right things, but we didn't do unnecessary things. Second thing is, when I talk about granular strategy, some people are saying, this guy is talking textbook language. It's not textbook language. It is my experience. I didn't learn strategy in textbooks, but I did it by doing. So I think when you are that clear with strategy, you are not here, you are here. You can make activity choices because you are here, right?

You can make activity choices. It tells you what you will do what you want to. So combination of both has been driving. Obviously, activity choice, you make it, that activity is gone because I don't like options management in business. If you don't have choices, you don't have a strategy. So I don't know if it answers your question, but that's what I would say.

Isabel Green on behalf of Phil Buller (Berenberg)

We're pushing it a little bit on time, and we are -- but I do have some fairly couple of questions online, probably more than questions we've got time to answer. But if I might, just take two of them as the -- to answer if I may ask you, if I may, Tufan. The first one comes from Phil Buller, Berenberg. It's a two-part question, I'm afraid. So I'll probably talk the question for maybe longer than the answer.

But the first one, thank you for the comments on philosophy, including the focus on quality of earnings, not just cash. Philosophically, do you believe earnings are as important as cash or as a function of each other for Rolls-Royce as they are typically for other industrials? And related to that, how should we think about the LTIP frameworks. Is it cumulative cash concept likely to be deemphasized in favor of clean earnings?

He also asks -- we talk about being well positioned for the next-gen aircraft with UltraFan. Rolls-Royce has always been well positioned from a technology standpoint. The issue has always been extracting positive returns on the technology. So is it a must to do? And how do you think about the payback period you would be happy with on a new platform? And I'm sorry, the question probably too longer than the answer.

Tufan Erginbilgic

No, no -- there are three questions there I think, let's deal with it. So first, earnings versus cash. Frankly, I'm a guy I want all of the above. So I think that's what I would say. I think -- and even in Rolls-Royce, I know our accounting sort of makes it a little bit timing-wise different. But even in Rolls-Royce, I think both earnings and cash are important. So -- and they are actually a function of each other in a way.

Therefore, I'm not going to say I like this more than that. But obviously, for any company, cash generation is critical. I mean at the end, that is -- earnings is a proxy of your cash generation, if you like. And therefore, they should go hand-in-hand. But obviously, cash generation has to be there as sort of -- if you really push me, I said, "Oh, I want both of them."

But if you really push me, I think I will go for cash because that's effectively the value creation. LTIP, I'm not going to comment on it right now. As you know, we are at the stage that our remuneration policy is expiring. So there is a work that Board leads, obviously, Remuneration Committee leads on the new remuneration policy, and it's not right for me to comment at this point in time.

And UltraFan, there are -- even within UltraFan, there are multiple questions there. But I would say the following. I think first of all, UltraFan team has done a very good job. And it is a technology demonstrator. You need to think about that way, okay? And it has two purposes. One is to position us well for the next generation of engines, and it does exactly that.

Second purpose is -- but I'm going to come back to the first purpose. Second purpose is actually because we test the technologies there, we are going to use them right now, especially on time-on-wing improvements in the -- for the existing engines. And we have a very systematic program to improve time on wing for all the engines we have. I talk about Trent 1000 today. But all the engines in the next four years, frankly, we are going to get all the engines to what I call their destination level. That's our program.

So -- but if I go back to first purpose, UltraFan, it is built, if you have seen it, in fact, in my first slide, there is a picture, nice Tiffany colors. By the way, that's part of IP. So -- but that is a big engine. So -- intentionally because we will scale down to wide body even to narrow body. It is scalable. And that's how you should hold it in terms of profitability, absolutely. I'm not going to give you a payback period right now because next-generation aircraft is not going to happen before 2030, and we need airframers, obviously, to go there first. But I will say this. We won't do anything not profitable. I will say that categorically.

Isabel Green *on behalf of Ben Heelan (Bank of America)*

And just one last question, I'm going to squeeze in because it's come up on from a number of questions have come in, but it actually is Ben Heelan at Bank of America, who I'll read out, which is asking, with the cash flow improving materially, how are we thinking about the time line of getting to investment grade and adding on for a couple of the other investors online, if we've got any plans to reintroduce the dividend this year and our preference for dividends versus buybacks, if you have any comments on those, please?

Tufan Erginbilgic

Okay. Good question, Ben. So I think we said it in February, I think we want to get to investment grade at pace. And given the progress we are making, I think I believe that will be reality. We will get there at pace. I don't want to give a time because, as you know, you hit the investment-grade metrics, then rating agencies need to get there. So therefore, our first task is to hit the metrics, and we are making excellent progress towards that.

And therefore, I won't give timing, but it is our first priority, which goes into the second question, dividend. And frankly, our first priority is to get the investment grade. After that, yes, we would like to reestablish dividend, absolutely. Dividends versus buybacks, we are now doing some work on the -- frankly, until you get to investment grade, it's a little bit sort of not important point.

But once we get the investment grade, it is a important point, what kind of capital structure we want and what's the cash framework for the company. We are already doing that work as we speak. And obviously, that will play into whether it is buybacks, dividends, et cetera. It is too early, Ben, to comment on anything like that.

Isabel Green

Thank you. We'll call it there because I know we have other meetings to start at 10:30. Thank you very much.

Tufan Erginbilgic

Thank you. Thanks for coming.