

Chairman's statement



Ian Davis
Chairman



Progress in 2016 can be judged by how we have overcome our challenges; we have delivered on our commitments in a difficult year while at the same time embarking on a significant transformation.”

UNDERLYING EPS

30.1p

PAYMENT TO SHAREHOLDERS

11.7p

➔ OTHER STATUTORY INFORMATION P186

Last year I talked about how Rolls-Royce is a business in transition and how important the next few years were going to be, laying the groundwork for future success. In 2016, we have made a good start to the transformation programme, designed to bring significant and sustainable benefits over the coming years.

Our core strengths lie in our product portfolio, admired by our customers and respected by our competitors. This underpins our exceptional order book which will drive future shareholder value. To unlock these benefits, we need to sustain our investment in our key competitive advantages, including our world-leading research & development capability, as we introduce new products, ramp up production and expand our service capability to support our growing aftermarket.

By necessity, the transformation programme targeted simplifying the way we manage the business and reducing our fixed cost base. I have been very encouraged by the engagement across the Group on what is, understandably, a difficult exercise for many and which has seen around 20% of management roles being removed.

There is much more to do in terms of efficiency and behavioural change to achieve greater cost competitiveness. Key to this will be embedding the thinking around pace and simplicity that Warren East, your Chief Executive, has brought to the business. He will talk more about how we are doing this in the Strategic report.

Corporate governance

The recent settlements, with the UK Serious Fraud Office and other authorities, are a salient reminder of how critical it is to 'win right'. As a result of past, unacceptable

conduct we have agreed to pay financial penalties and costs of around £671m. These dishonest acts, some as recent as 2013, are a major blemish on the reputation of the business and we have apologised unreservedly.

Importantly, the Board has taken extensive action to strengthen ethics and compliance procedures across the Group over recent years, so that high standards of conduct are embedded as an essential part of the way we do business. We share a determination to see that Rolls-Royce comes out of this episode as a more trusted, resilient and better managed business that wins right every time. Every employee, from the bottom to the top of the Group, is fully aware of the importance of doing the right thing.

As described in the Nominations & Governance Committee report (see page 70) our governance framework was rolled out in the summer and provides clarity and accountability, providing additional integrity to our business.



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Shareholder payments

Our stated objective in the long term is to progressively rebuild our payment to shareholders to an appropriate level, subject to the short-term cash needs of the business. This reflects the Board's long-standing confidence in the strong future cash generation of Rolls-Royce.

At this stage, the investment needs of the business remain high, reflected in the low level of free cash flow in 2016 and this is expected again in 2017. In addition, the Board sees the need to retain a degree of balance sheet flexibility.

As a result, it is proposed that the final payment for 2016 is unchanged from 2015 at 7.1 pence per share. Taken together with the interim payment, this brings the full year payment to 11.7 pence per share. As with past payments, the distribution will be in the form of C Shares.

Board developments

During the year, there have been a number of important changes to the Board. In March, we appointed Brad Singer, a partner of ValueAct Capital, to the Board, at which time he also joined the Science & Technology Committee. Sir Kevin Smith took over the role of Senior Independent Director from Lewis Booth, who continues as chairman of the Audit Committee, an important role for us at the present time. In May, following the 2016 AGM, Dame Helen Alexander stepped down from the Board. In November 2016, Alan Davies stepped down from the Board.

In addition, we announced in September that Stephen Daintith will join the Board in 2017 as Chief Financial Officer. His record of achievement in change management is particularly relevant to the Group. He will succeed David Smith.

Colin Smith will be leaving the Company after 43 years of service and will be stepping down from the Board after this year's AGM. Colin has made a major contribution to the success of the business over many years, including 12 years on the Board. I would like to thank both David and Colin for their valuable support during their time with Rolls-Royce.

More detail on the changes to the Board are set out in the Nominations & Governance Committee report on page 68.

Overall I believe we have a strong and experienced Board, fully engaged with the business and well able to provide both support and scrutiny in equal measure.

Rebuilding trust and confidence

We made significant efforts in 2016 to improve our communication with stakeholders. The foundations laid in the second half of 2015 were enhanced by a broad range of engagement, including formal events such as the corporate governance seminar in April, which I hosted, and the capital markets' event in November, led by Warren and his team. This latter event brought together senior management from all of our business units with analysts and investors. The event gave our guests the chance to ask questions and improve their understanding of the business.

Despite the challenges we face as a business, we know how important it is to sustain our investment in our people and communities. This has included maintaining active graduate and apprenticeship schemes, as well as investing in our research partnerships and STEM (science, technology, engineering and mathematics) programmes. Internally, we are working hard on employee engagement, including initiatives around diversity and wellbeing (see Sustainable business on page 42 and the Safety & Ethics Committee report on page 109).

During the year, we have also done significant work on the new revenue reporting standard, IFRS 15 *Revenue from Contracts with Customers*. Due to be adopted at the start of 2018, this will go a long way to better align the recognition of profit and cash for our original equipment business in particular, and will help make our performance improvements more transparent. I believe this will be welcomed by many stakeholders, but may take time to be properly understood. As a result, we have undertaken a progressive

communication programme in 2016 to outline the changes, culminating in the capital markets' event in November. You can read more about this on pages 66 and 130.

We have noted with interest the Government's green paper on UK Corporate Governance: The Options for Change and we are actively taking steps to strengthen our interaction with stakeholders, particularly employees. Further detail is included in my introduction to the Directors' report on page 58. I look forward to reporting our progress in our Annual Report next year.

Since taking over as chairman of the Remuneration Committee in May, Ruth Cairnie has undertaken a comprehensive consultation on our proposed new incentive schemes, ahead of this year's AGM. You can read more about our proposed remuneration policy in the Directors' remuneration report on pages 72 to 82.

Feedback from investors suggests that we have improved the level of engagement, transparency and openness in many of our communications. While we can always do better, I believe the team has made a strong start in rebuilding trust.

I know Warren looks forward to introducing Stephen Daintith and Simon Kirby, our new Chief Operating Officer, to the market in the coming months to present their combined views on the strategic priorities for the business, which will define our future path.

Looking forward

2017 will be another transformative year for Rolls-Royce. We continue to operate in uncertain markets and will need to respond to shifting market dynamics, while at the same time make progress on our core priorities both in terms of customer deliveries and internal organisation changes.

Warren has been building a strong and experienced management team to help him achieve his strategic and operational goals. The Board will continue to both challenge and support their actions as they work to ensure we transition successfully over the next few years to a more profitable and cash-generative future.

Ian Davis
Chairman
13 February 2017