

Summary slide

# Investor Briefing

19 June 2014



# Strategy

**John Rishton**

**19 June 2014**

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# Overview of morning

Strategy

Capital allocation & guidance

TotalCare<sup>®</sup>

Q&A



# Strategy – evolution, not revolution

## Customer

Place the customer at the heart of the organisation

Understand and shape their requirements

Relentless focus on delivering our promises

## Innovation

Value innovation in everything we do

Ensure competitive technology ahead of product requirements

Establish an environment and culture in which innovation thrives

## Profitable growth

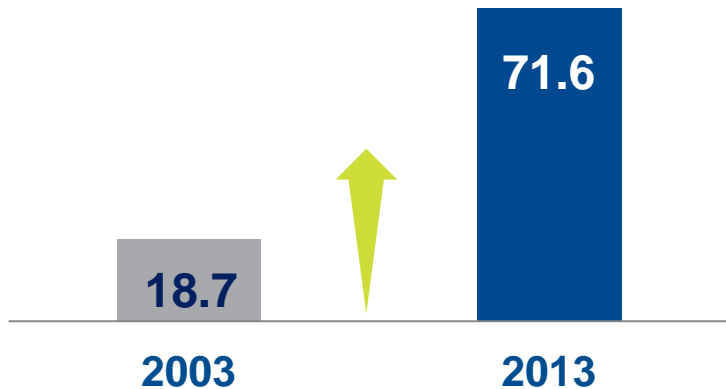
Grow our market share and installed base

Competitive portfolio of products and services

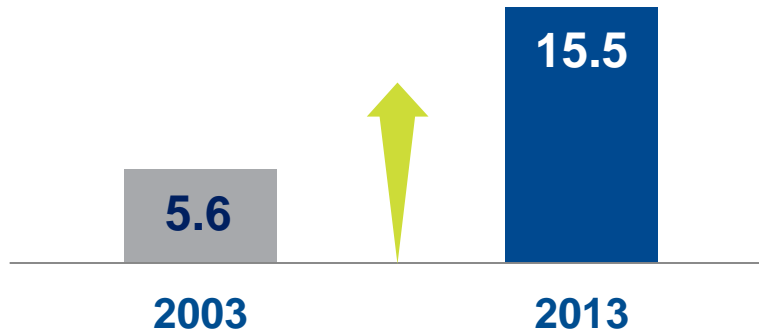
Focus on cost and cash

# Consistent long-term delivery

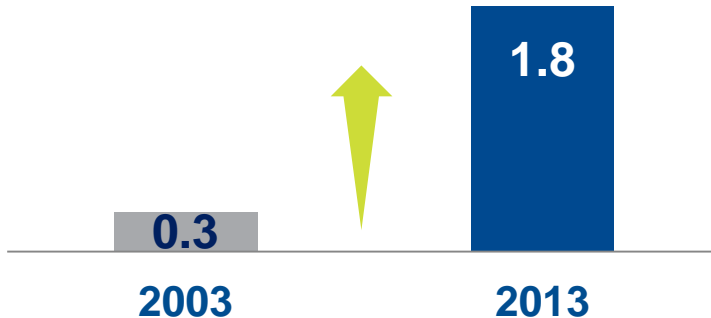
Order book (£bn)



Revenue (£bn)



Profit (£bn)



# Who we are

“ ...for use on land or water or in the air.”\*

**Group**

**Rolls-Royce**  
*Complex power systems & services group*

**Power**

Gas turbines

Reciprocating engines

Nuclear

**Systems**

LiftFan, engine controls, propulsion, deck machinery, I&C

**Services**

Aftermarket services

**Divisions**

Aerospace

Marine & Industrial Power Systems

**Businesses**

Civil  
Aerospace

Defence  
Aerospace

Power  
Systems

Marine

Nuclear

\* from Rolls-Royce Ltd. Memorandum & Articles of Association 1904

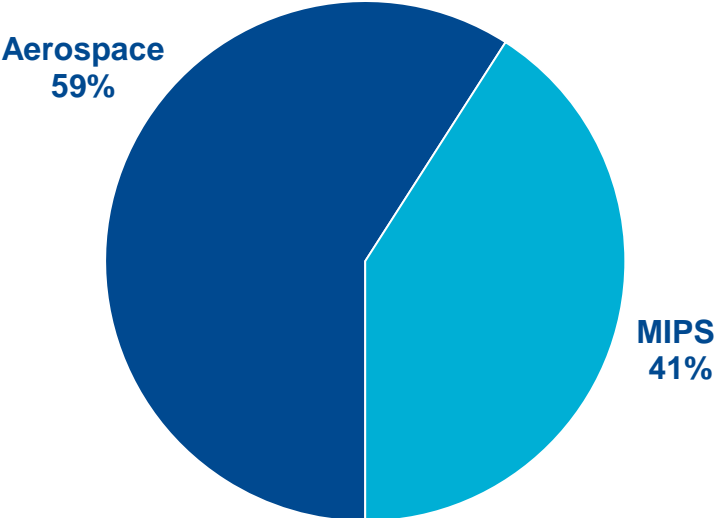
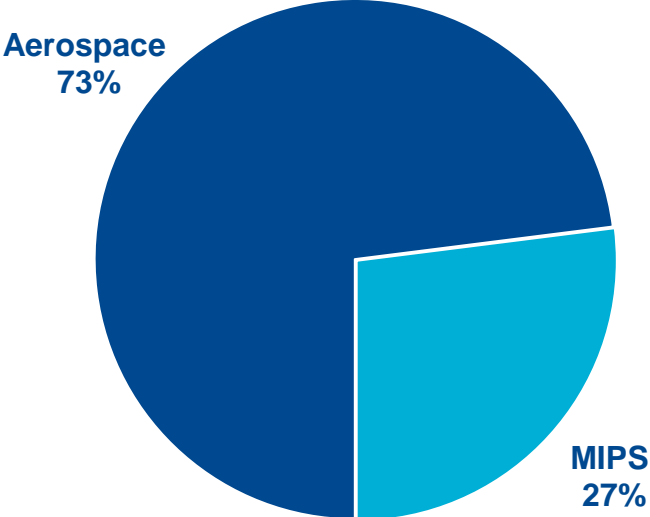
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**Rolls-Royce**

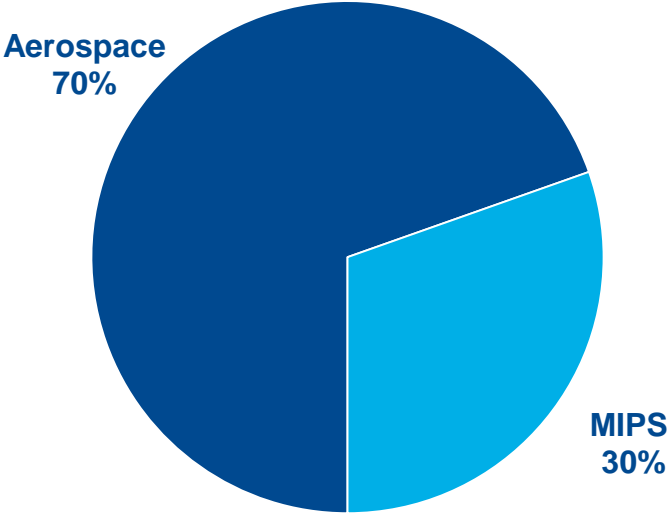
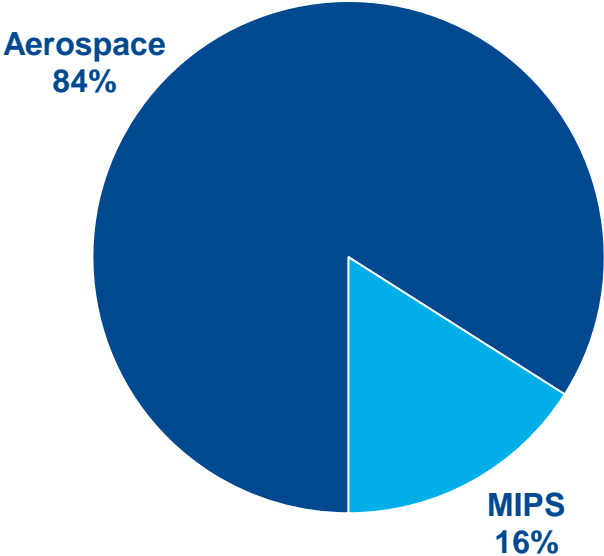
# Strong growth and better revenue balance

2003: £5.6bn — 11% CAGR → 2013: £15.5bn



# Strong growth and better profit balance

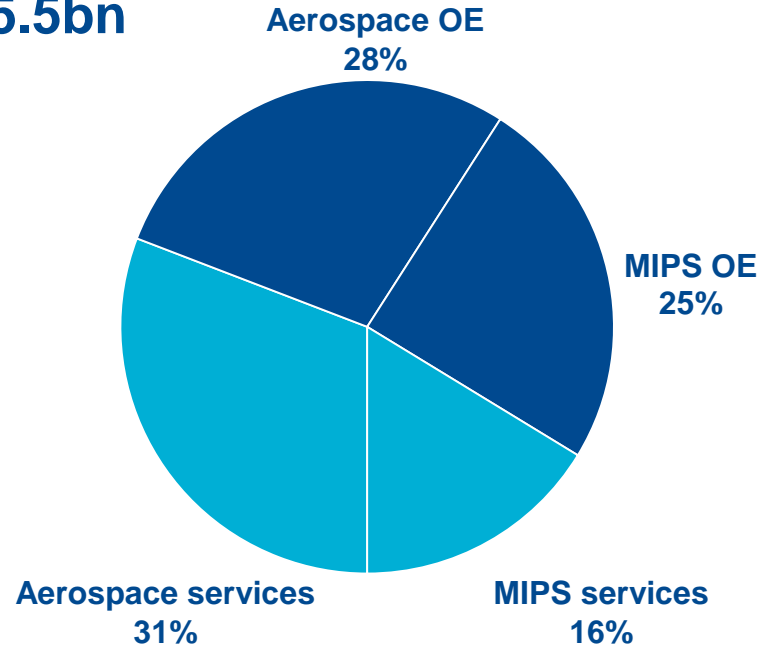
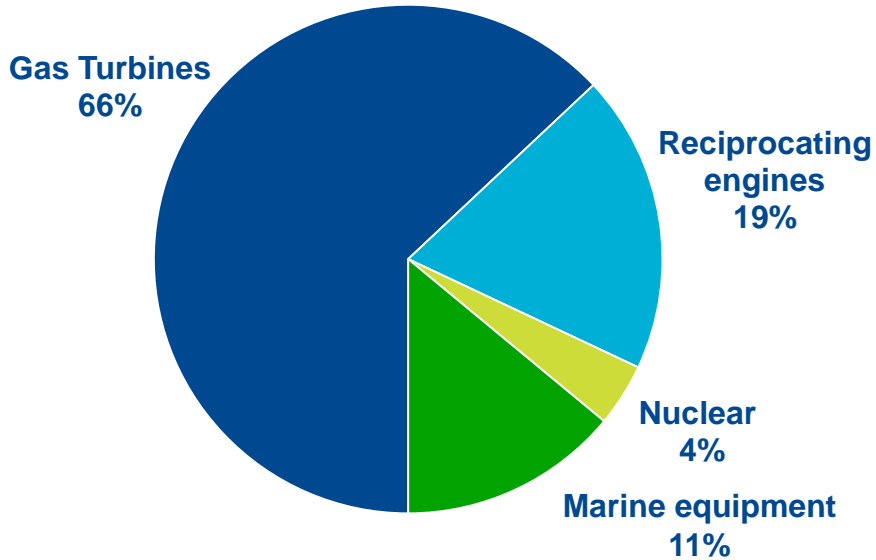
2003: £0.4bn — 17% CAGR → 2013: £1.8bn





# Balanced revenue by product & type

2013: £15.5bn



# Growth and balance driven by portfolio approach

Similar ROCE, complementary profiles

	Civil gas turbines	Reciprocating engines
ROCE*	18% - 23%	25% - 30%
Investment risk	High	Low
Entry barriers	High	Medium
Net R&D spend	~£1bn	~£150m
Capex	~£0.5bn	~£100m
Programme launch to EIS	5 – 7 years	3 - 5 years
EIS to cash neutral	10 - 15 years	3 -10 years

*\* Based on Rolls-Royce and Goldman Sachs analysis*

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**Rolls-Royce**

# Our 5 priorities

Fix the Basics – “4C’s”

Culture

Wide body civil GTs

Narrow body civil GTs

Medium-speed recipis

Bedrock

Investment choices

# Fix the basics: the "4C's"

Customer

Concentration

Cost

Cash



# Customer

On time delivery – trend improving but much more to do

	On time to customer		On time to internal plan	
	2013	2012	2013	2012
Civil Aerospace	100%	80%	25%	4%
Defence Aerospace	93%	88%	39%	7%
Marine	95%	55%	77%	30%

# Concentration

Focus on where we add most value

	When	What	Why
Sold	2014	Energy gas turbine business to Siemens	Scale
	2013	RTM322 helicopter engine business	Non-core
	2012	Tidal Generation, Fuel Cells	Non-core
Bought	2011 - 2014	Tognum	Product
	2011 - 2013	Various Civil Nuclear businesses	Technology
	2010 - 2012	Aero Engine Controls	Technology

# Cost

Area	Action
Product redesign	<ul style="list-style-type: none"><li>• 600 engineers</li></ul>
Structural change	<ul style="list-style-type: none"><li>• LCC sourcing to 40% by 2020</li><li>• 20% lower footprint by 2020</li></ul>
New manufacturing Plants & technology	<ul style="list-style-type: none"><li>• New plants hitting targets</li><li>• 160 new projects via AMRCs</li></ul>
Logistics & inventory	<ul style="list-style-type: none"><li>• Reduce logistics costs - 20%</li><li>• Continue to improve inventory turns</li></ul>
Lean enterprise	<ul style="list-style-type: none"><li>• Substantial reduction in time to market</li><li>• Adopting automotive industry practices</li></ul>
Overheads	<ul style="list-style-type: none"><li>• Indirect headcount down 11%</li><li>• Business Process Optimisation – 20% opportunity</li></ul>

# Cash

Type	2013	Action
Capex spend	£0.7bn	Drive down from current 4.9% revenue to c. 4% in next 3-5 years.
R&D spend	£0.8bn	Ease as % of revenue
Inventory year-end total	£3.3bn	Continue to drive turn times by reducing buffers, improving productivity and increasing manufacturing stability.



# Cash

Inventory turns improving but more to do

	2013	2012
Civil	3.4	3.0
Defence	4.6	3.4
Marine	3.6	3.4
<b>Group</b>	<b>3.4</b>	<b>3.0</b>

# Our 5 priorities

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Investment choices

# Culture

Importance of culture:

“Culture eats strategy for breakfast”

Innovation

Cost

Ethics

# Our 5 priorities

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Narrow body civil GTs

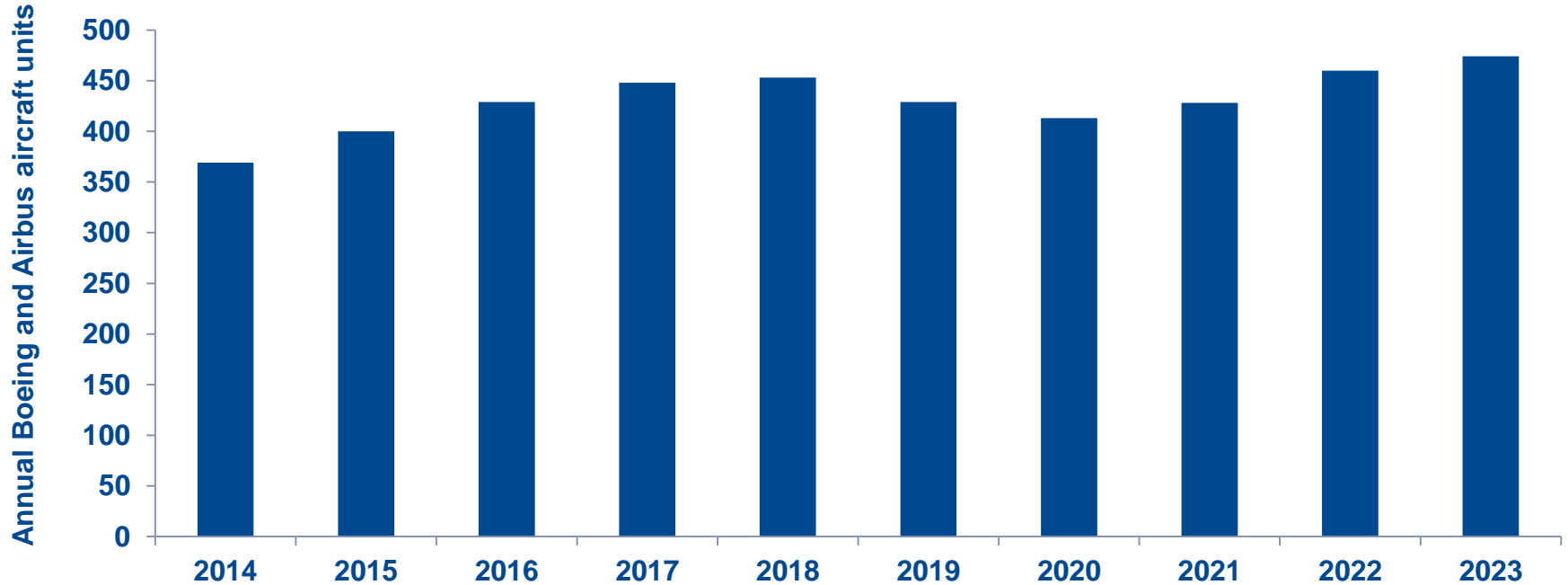
Medium-speed recips

Bedrock

Investment choices

# Wide body aircraft deliveries to 2023

Over 4,000 deliveries vs. over 2,000 in last decade



Source: Jefferies.

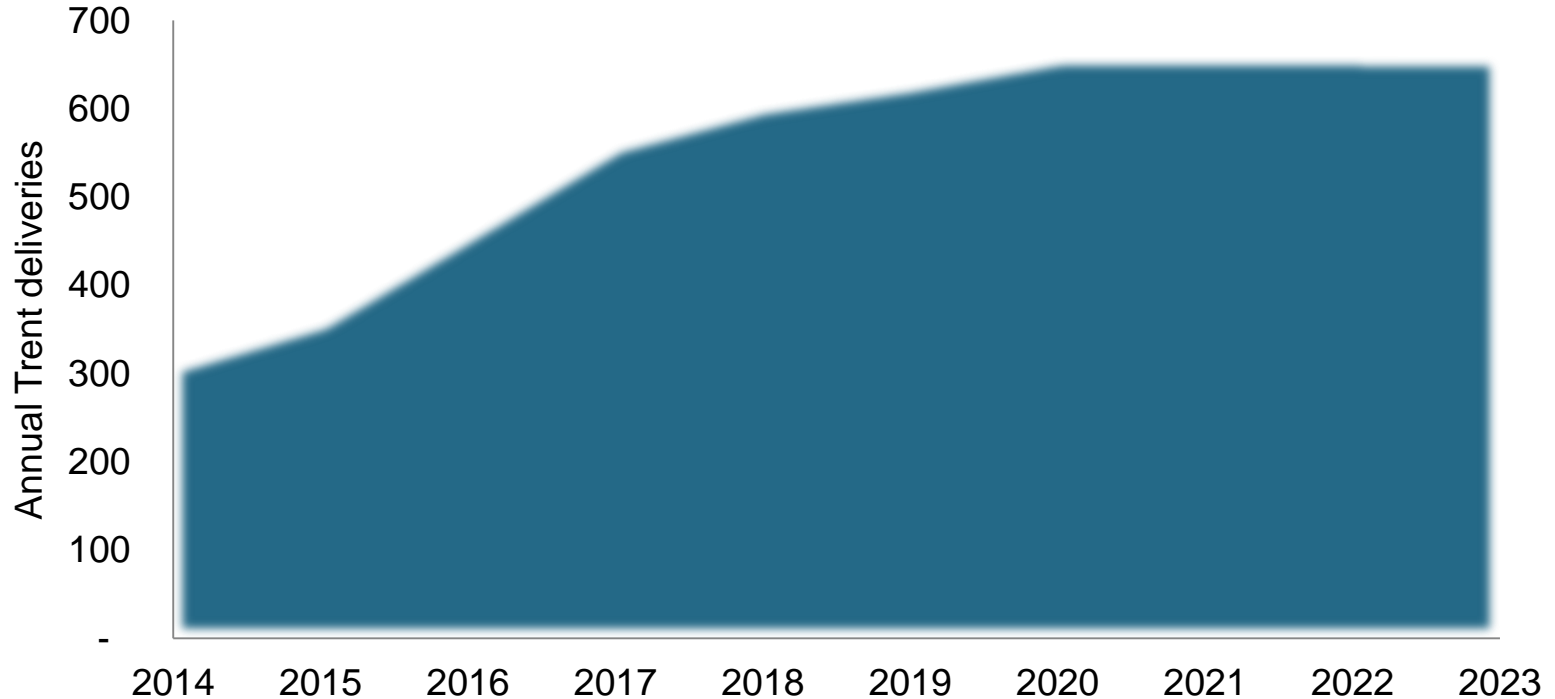
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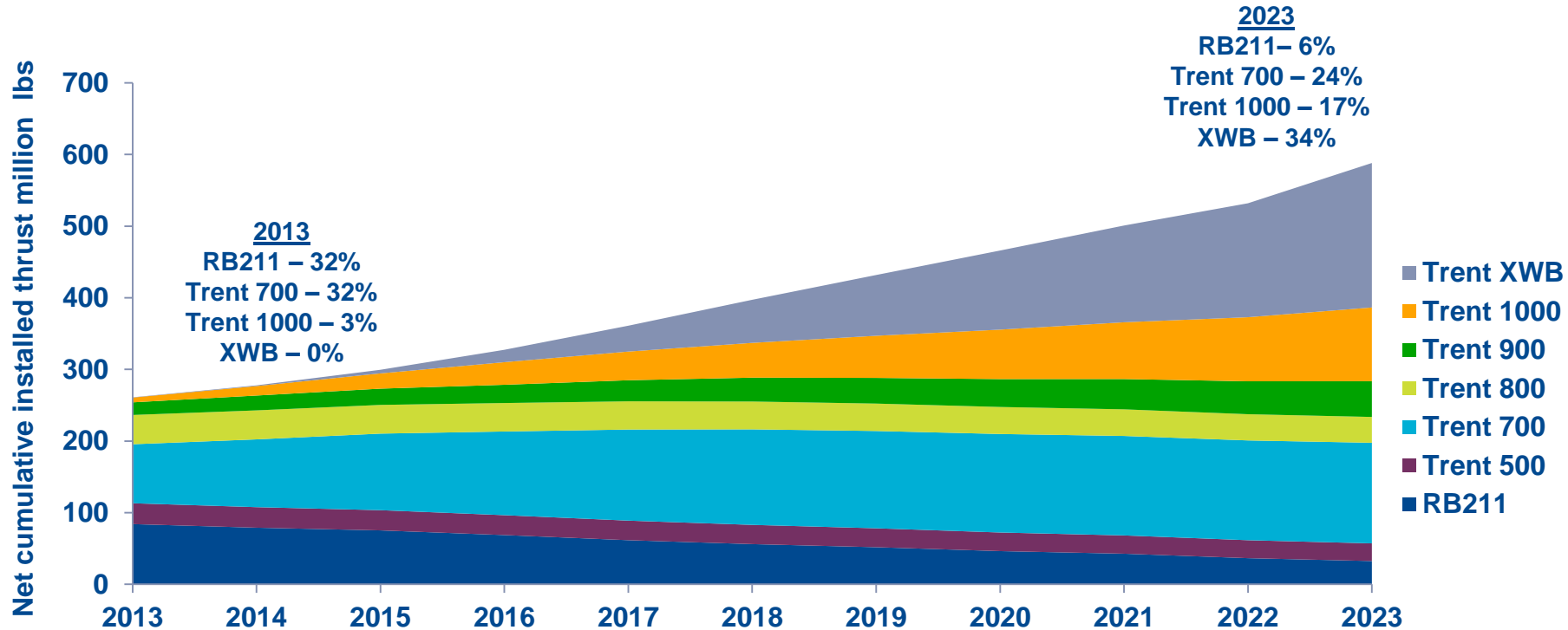
# Projected Trent deliveries to 2023

Over 4,000 deliveries vs. over 1,600 in last decade



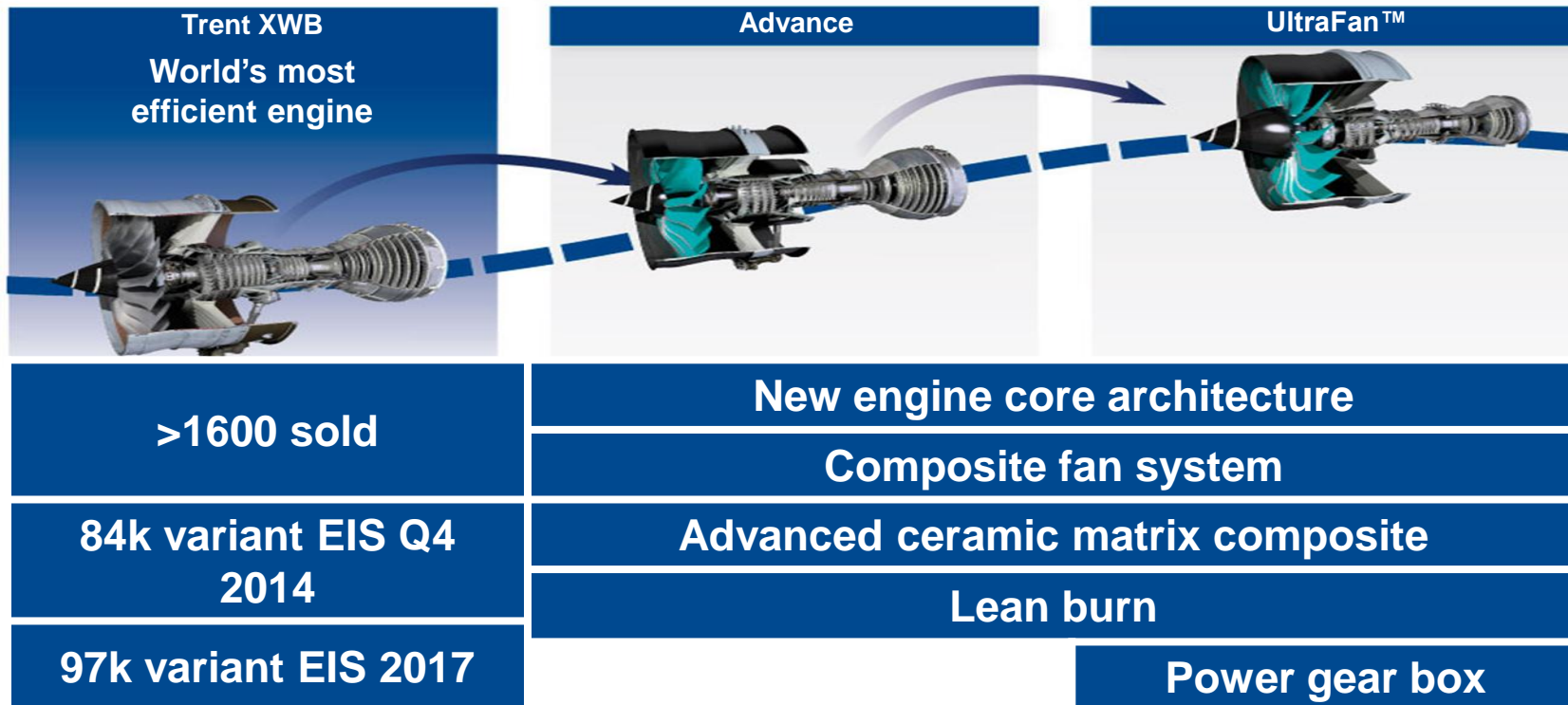
# Rolls-Royce wide body installed thrust

More than doubles in next decade



# Future products

Continuous improvement essential to remain competitive





# Our 5 priorities

Fix the Basics – “4C’s”

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Wide body civil GTs

**Narrow body civil GTs**

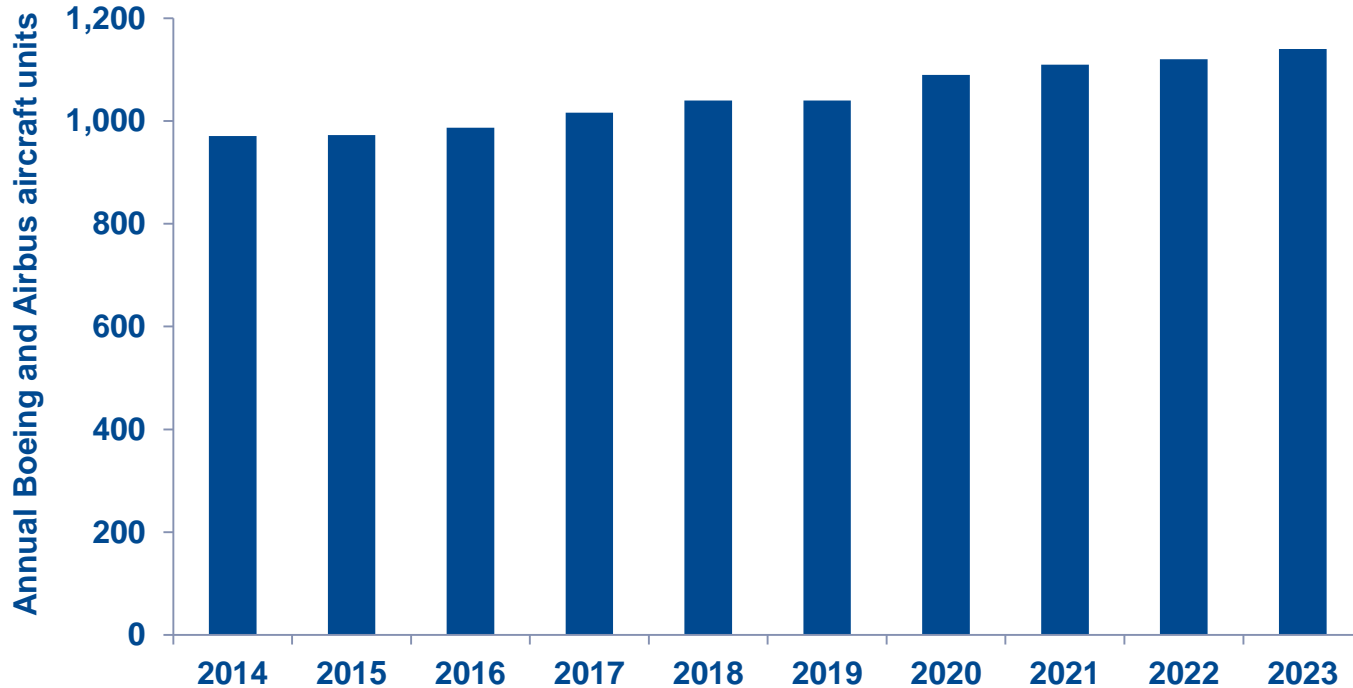
Medium-speed recipis

Bedrock

Investment choices

# Narrow body deliveries to 2023

71% market units, 48% market value



## Benefits

- Customer intimacy
- Technology
- Volume
- Large market

Source: Jefferies

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# Our 5 priorities

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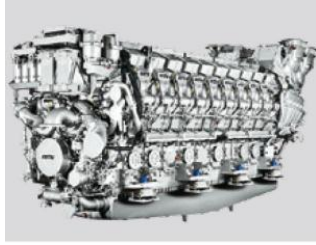

Investment choices

# Low speed recip characteristics

<b>rpm</b>	<b>50 - 300</b>
<b>Power (MW)</b>	<b>3 - 85</b>
<b>Weight (tonnes)</b>	<b>50 – 2400</b>
<b>Length (m)</b>	<b>4 – 24</b>
<b>Fuel type</b>	<b>Diesel (HFO), gas</b>
<b>Competitors</b>	<b>MAN Diesel, MHI</b>
<b>Typical uses</b>	<b>Large merchant vessels</b>



# High speed recip characterisitics

<b>rpm</b>	<b>1000 – 2500+</b>		
<b>Power (MW)</b>	<b>&lt;1 – 10</b>		
<b>Weight (tonnes)</b>	<b>&lt;1 - 40</b>		
<b>Length (m)</b>	<b>&lt;1 - 8</b>		
<b>Fuel type</b>	<b>Diesel (distillate), gas</b>		
<b>Competitors</b>	<b>Caterpillar, Cummins, Yanmar, GE Jenbacher, Volvo Penta, Weichai</b>		
<b>Typical uses</b>	<b>Marine leisure craft, naval, construction, rail, mining, standby PG etc.</b>		
<b>Features</b>	<ul style="list-style-type: none"><li>• <b>Common technologies and shared R&amp;D with medium speed</b></li><li>• <b>Volume production enables lower unit cost</b></li></ul>		

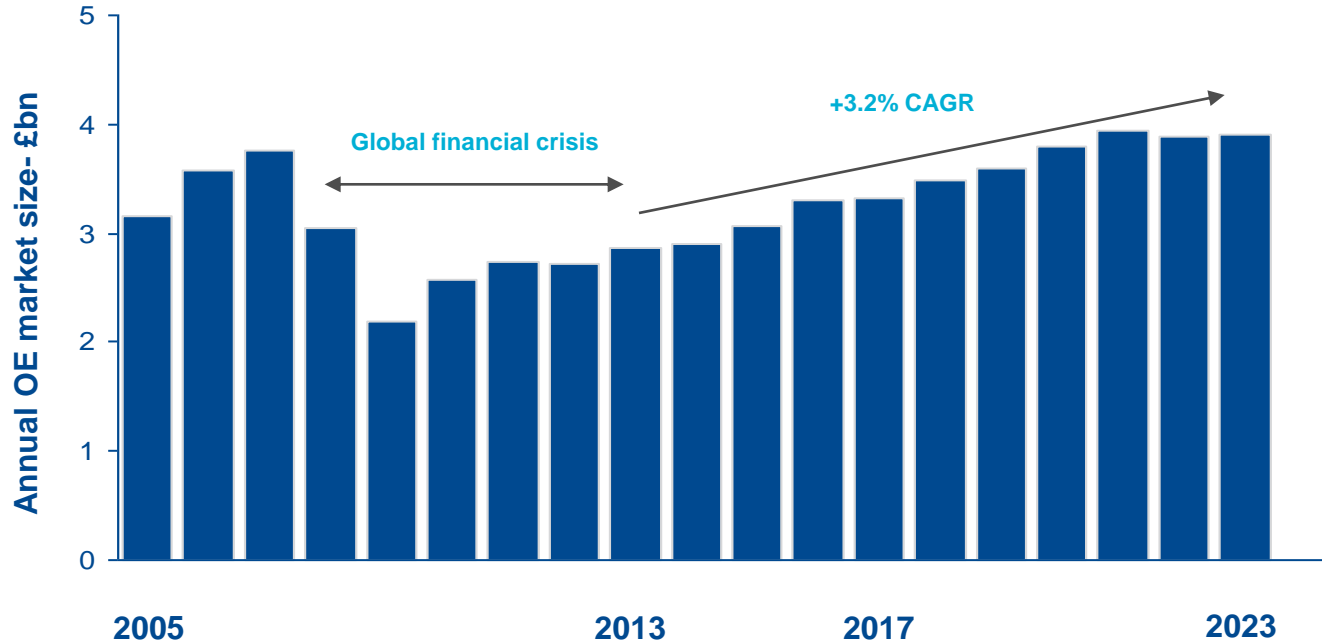
# Medium speed recip characteristics

rpm	300 – 1000
Power (MW)	1 – 25
Weight (tonnes)	18 – 350
Length (m)	3 – 14
Fuel type	Diesel (distillate, residual/HFO), gas
Competitors	Wärtsilä, MAN Diesel, Caterpillar, Hyundai, Niigata
Typical uses	Offshore, small-medium merchant, distributed PG <ul style="list-style-type: none"><li>• Extensive use in Offshore industry (complex, mission-critical etc.)</li></ul>
Features	<ul style="list-style-type: none"><li>• Opportunities in land PG</li><li>• Access to larger merchant marine market enables pull through</li></ul>



# Medium speed market

## Growing marine and land power forecast



### Market growth drivers:

- GDP
- Population growth
- Emerging markets power generation demand
- Environmental legislation
- Oil price
- Gas price / availability
- £35bn market to 2023

Source: Rolls Royce - data excludes Marine auxiliary engines

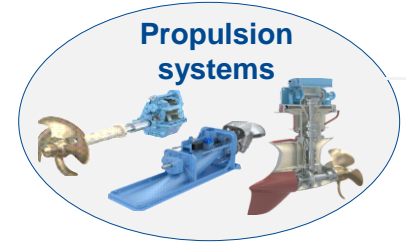
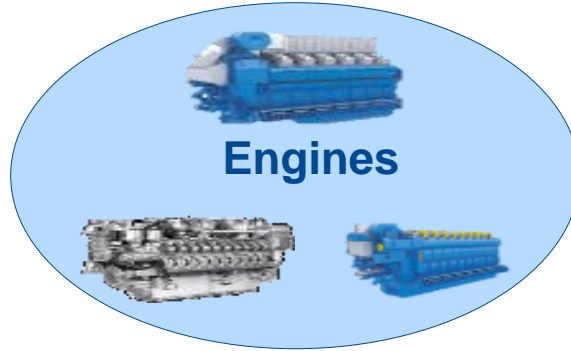
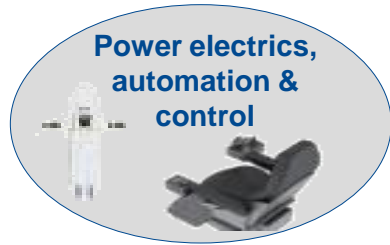
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# Portfolio pull through

Each product gives access to others

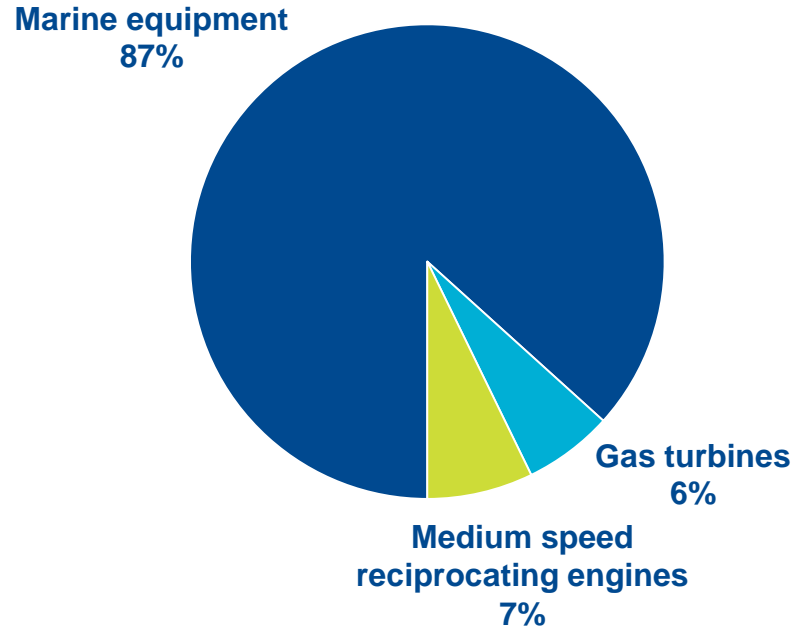


- Early customer engagement
- Access systems integration opportunities
- Portfolio helps pull-through of other equipment



# Marine revenue strong in by product type

2013: £2.0bn\* - strong in marine equipment



\* pro-forma excluding Submarines revenue to be reported in Energy & Nuclear from FY14

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# Our 5 priorities

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Investment choices

# Summary

**Strong position in growth markets**

**Concentrating on what we know**

**Significant opportunities**



# Financial framework

Mark Morris - CFO

19 June 2014

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# Agenda

- Linking strategy to our financial decision framework
- Capital allocation drivers
- Future guidance framework



# Strategy: evolution not revolution

Measured steps to improvement

**Our strategy**

**Customer**

**Innovation**

**Profitable growth**

**Delivering shareholder value**

- **Execute on organic growth programmes**
- **Exit non-core and underperforming assets**
- **Drive financial performance (the 4C's)**
- **Integrate RR Power Systems (Tognum)**
- **Clear strategy two pillars – Aerospace and MIPS**
- **Disciplined M&A**

# Our decision framework

## Where we invest

### Strategic framework

Growth markets



Technology  
Products  
Routes to market



Capex/R&D investment  
M&A

### The balancing act

Strategic vs. financial  
Short-term vs. long-term  
Growth vs. profitability

Maximising long-term value creation

## How we invest

### Financial framework

#### Growth metrics

- Revenue growth
- RoS
- EPS

#### Capital efficiency

- ROCE
- ROIC
- IRR/NPV

#### Financial strength

- Credit rating
- Net debt/EBITDA
- FCF



# Importance of credit rating

## Considerations

- Long cycle capital intensive business
- Long term contracts
- Provide confidence to customers and governments
- Access to long term finance (debt capital markets)

## Criteria

- Maintain an investment grade credit rating
- Normal target range: A- to A+ through the cycle

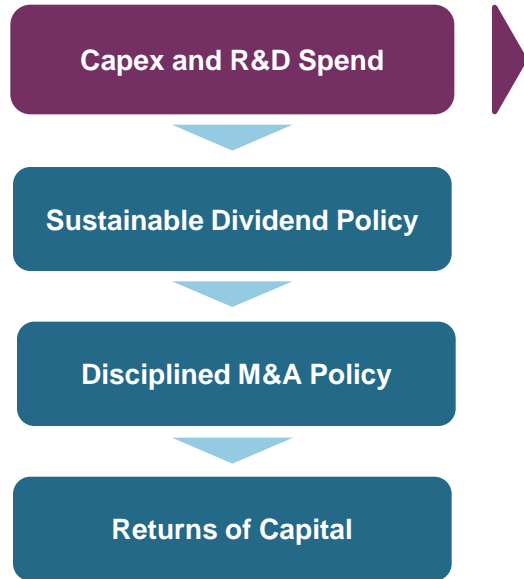
## Current rating

S&P:           A  
Moody's:       A3



# Disciplined approach to capital allocation

Investing for growth



## Net R&D spend

- Currently 4.9%
- Ease as a % of revenue as business grows

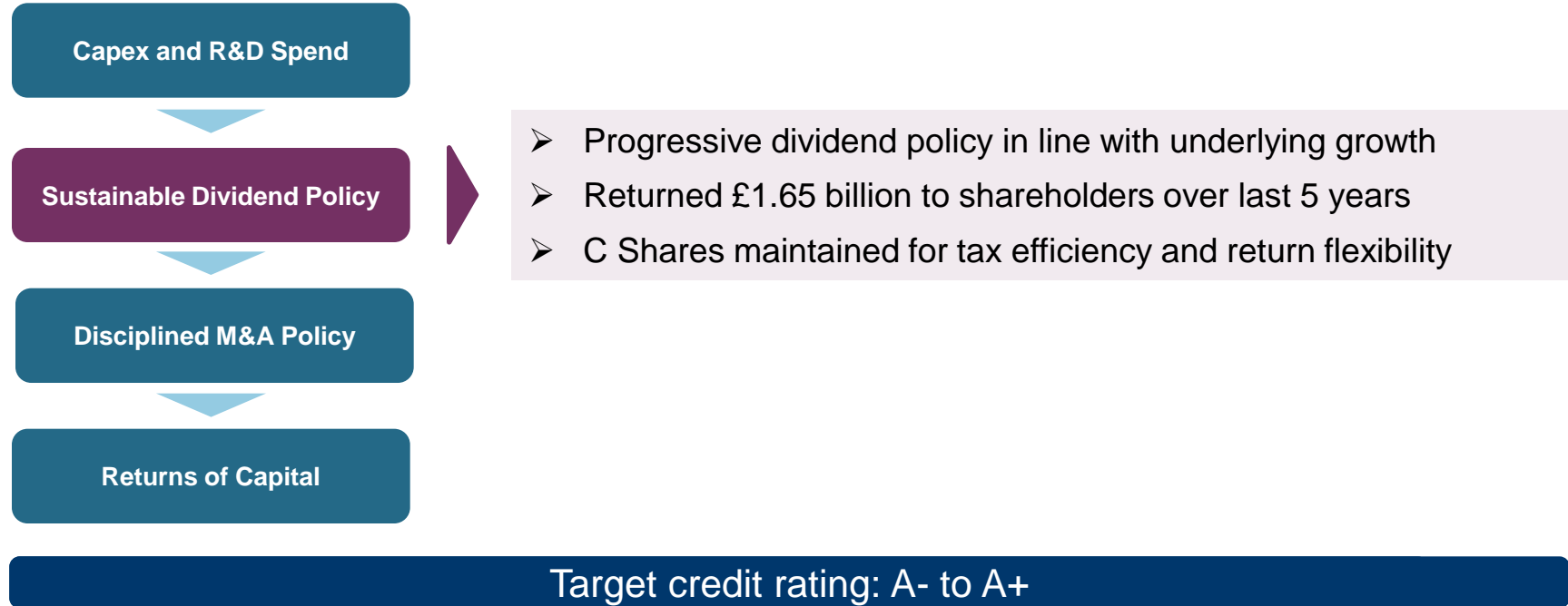
## Capex spend

- 3% - 5% of revenue through cycle
- Driving to 4%

Target credit rating: A- to A+

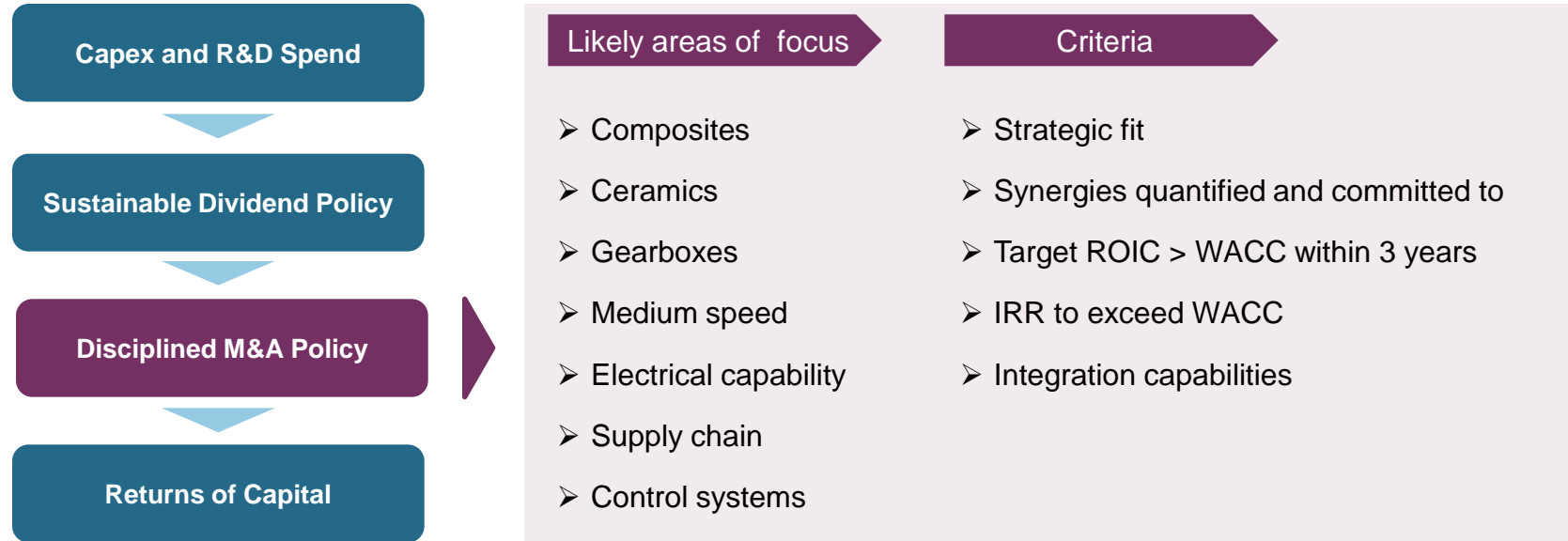
# Disciplined approach to capital allocation

Investing for growth



# Disciplined approach to capital allocation

## M&A focus and criteria



Target credit rating: A- to A+

# Disciplined approach to capital allocation

Maintaining balance sheet flexibility and efficiency

Capex and R&D Spend



Sustainable Dividend Policy



Disciplined M&A Policy



Returns of Capital

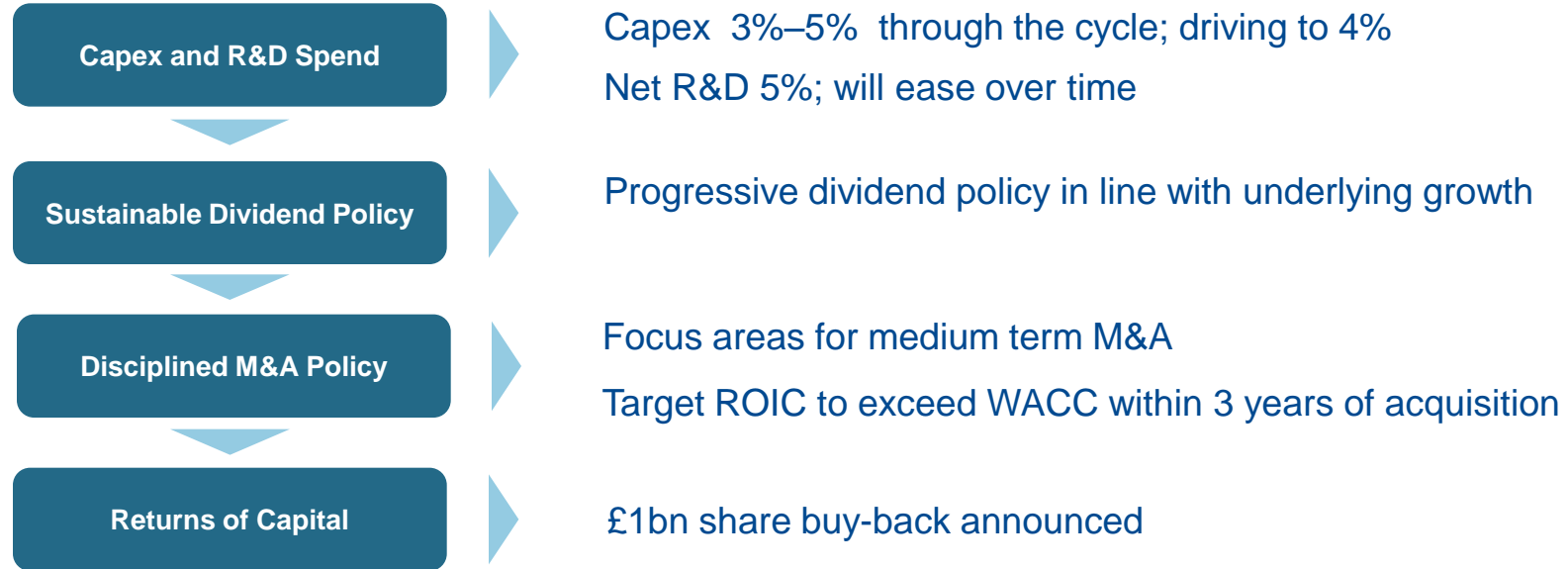


- Strong and efficient balance sheet
- Net Debt/EBITDA  $\leq 1.5x$  through cycle
- Surplus capital to be returned to shareholders
- £1 billion share buy-back planned from proceeds of Energy sale
- Board will regularly review other capital return opportunities

Target credit rating: A- to A+

# Disciplined approach to capital allocation

In summary



Target credit rating: A- to A+

# Future guidance framework

What we will give

	In year	Next year	Medium term outlook (3-5 years)
<b>Group</b>	Revenue PBT Cash flow FCF	Revenue PBT	Revenue RoS Cash flow
<b>Segments</b>	Revenue PBFCT		Civil RoS
<b>Other</b>	Capex R&D spend/charge Civil TCA net debtor FX Tax rate		Civil peak TCA debtor + REC and year

# Future guidance framework

How we will give

	In year	Next year	Medium term outlook (3-5 years)
<b>Group</b>	Banded range of figures (Xm to Ym etc.)	Banded range of figures (Xm to Ym etc.)	Banded range of figures or %s
<b>Segments</b>	Banded range of % (X% to Y%)		Banded range of % (X% to Y%)
<b>Other</b>	Approximate figures or banded range		Approximate figure and year

# Future guidance framework

When we will give

	In year	Next year	Medium term outlook (3-5 years)
February Prelims	✓	-	-
May IMS	✓	-	-
July Interims	✓	-	-
November IMS	✓	✓ (Annual Budget cycle)	✓ (Annual 10 year planning cycle)



# Summary

- Clear on our strategy
- Clear on our priorities
- Disciplined approach to capital allocation
- More guidance going forward



# Break

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# TotalCare®

**Tony Wood**

**19 June 2014**

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# Agenda

## 1. TotalCare<sup>®</sup>

- Business model
- Programme life cycle
- Embedded value – risk transfer and growth
- Managing TotalCare<sup>®</sup> – revenue and cost drivers

## 2. Accounting for TotalCare<sup>®</sup>

- Commercial arrangements and accounting principles
- Accounting mechanics
- Portfolio dynamics

# Group business model

Complex power systems, long service lives, strong positions in growing markets

## Aerospace

### Civil Aerospace



### Defence Aerospace



## Marine & Industrial Power Systems

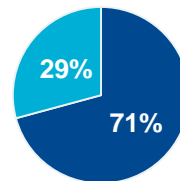
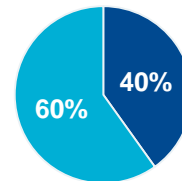
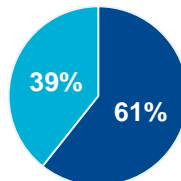
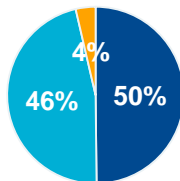
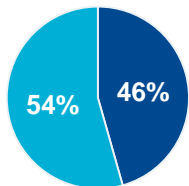
### Marine



### Energy & Nuclear



### Power Systems



- 47% of FY13 total revenue (£7.3bn) from services
- 47% of FY13 services revenue from Long-Term Services Agreements

▪ OE ▪ Services ▪ Development

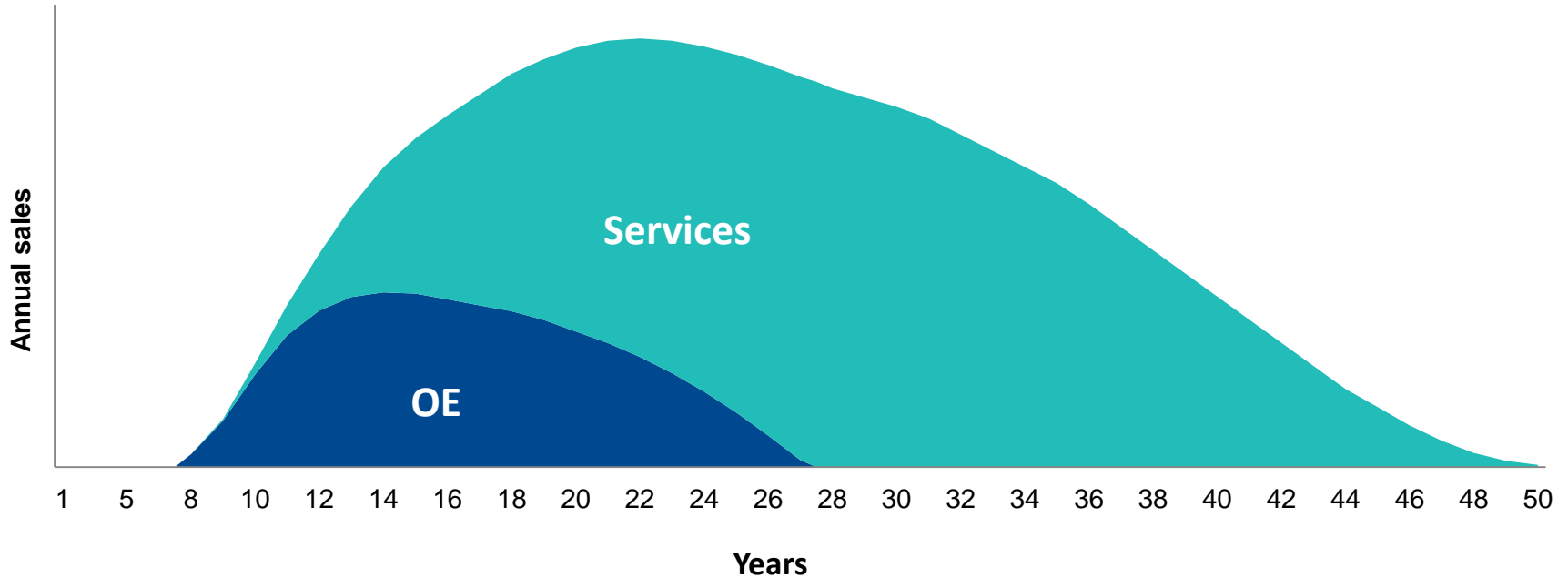
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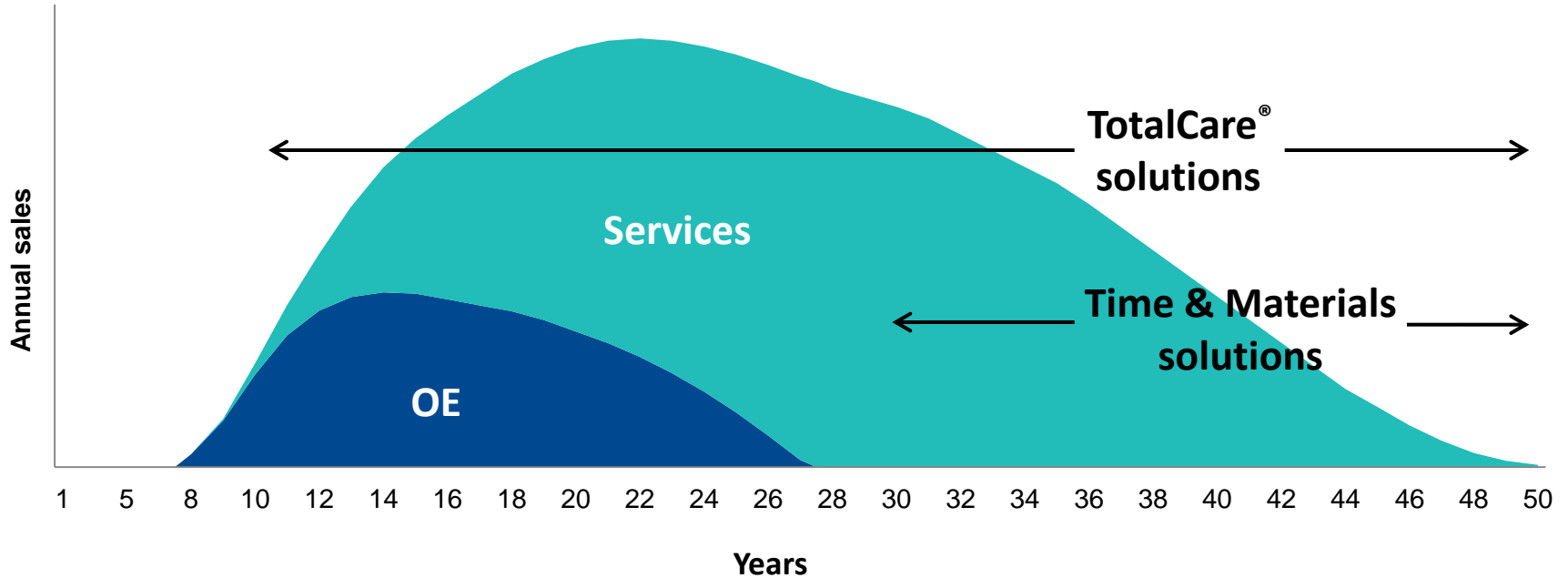
# Typical programme life cycle

Services revenue is at least 4 times net OE selling price



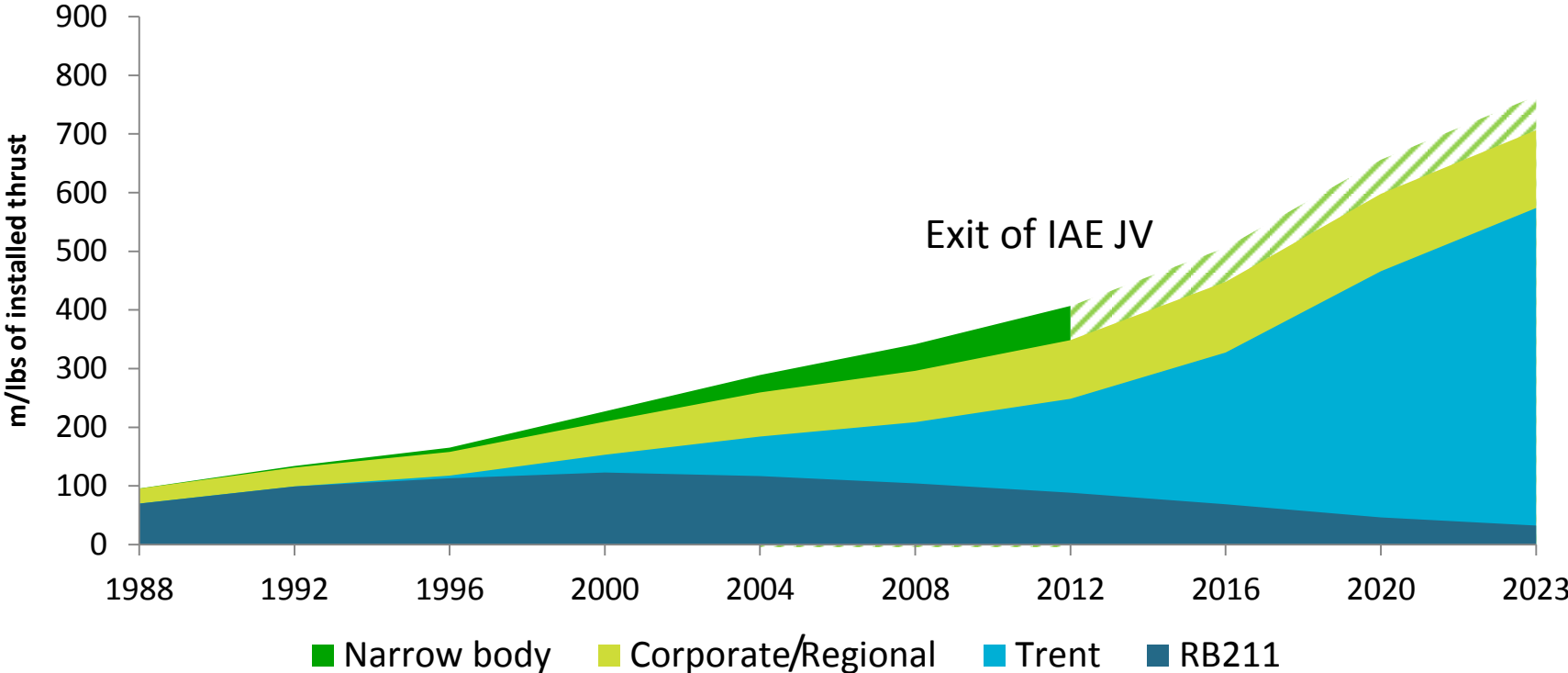
# Typical programme life cycle

Value from both TotalCare<sup>®</sup> and Time & Materials



# Embedded services value driven by thrust

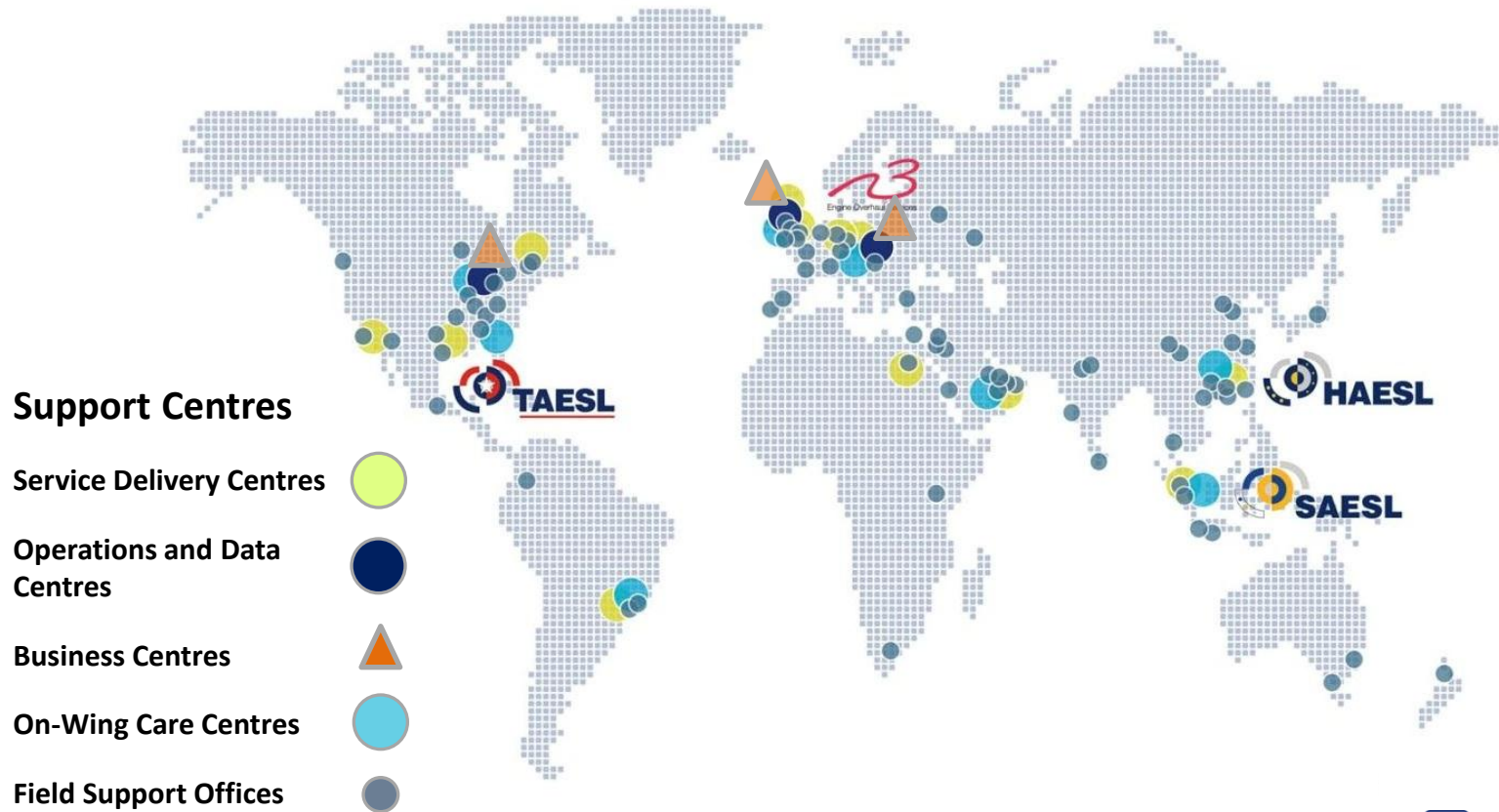
Installed thrust doubles by 2023\*



\*Excludes Narrow body



# Global Service Capability



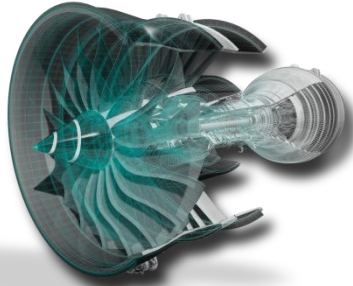
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# Deep knowledge of our engines as OEM

As Designed



Validation



Service  
experience



In Service



Feedback



Feedback



# Airline perspective

Selecting the appropriate support model

- Line maintenance
- Initial provisioning
- Spare engines
- Lease engines
- Rotable assets
- Powerplant engineering
- Engine overhaul
- Maintenance logistics
- Fuel burn optimisation



**Balancing risk, capability & cost**

# TotalCare<sup>®</sup> – value from risk management

Predictable engine service costs through risk transfer to Rolls-Royce

	TotalCare <sup>®</sup>	Time & Materials
Engine overhaul	✓	X
Engine reliability improvements	✓	X
Engine Health Monitoring	✓	Basic
Fleet management	✓	X
Warranty	✓	Basic
Guarantees	✓	✓

# Revenue drivers

TotalCare<sup>®</sup> revenue generation = hours flown x rate per hour

## Hours flown

- Global RPK growth
- ~4000 hrs per engine p.a.
- Minimum utilisation



## Rate per hour

- Customer mission and service level
- Operational price matrix (de-rate and stage length)

# Cost drivers

TotalCare<sup>®</sup> lifecycle costs = number of shop visits x cost per shop visit

## Number of shop visits

- Time on wing
- Hours flown
- Mission type

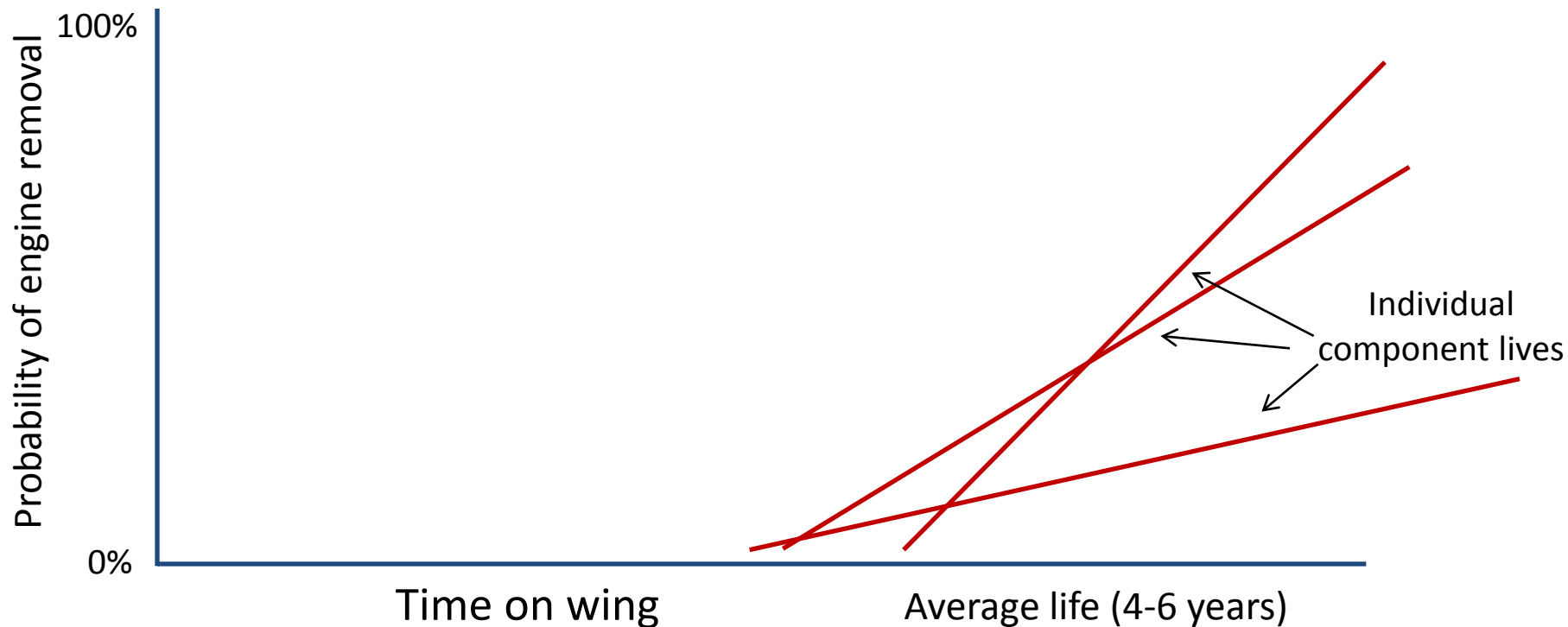


## Cost per shop visit

- Workscope
- Parts re-used, repaired, replaced
- Overhaul labour

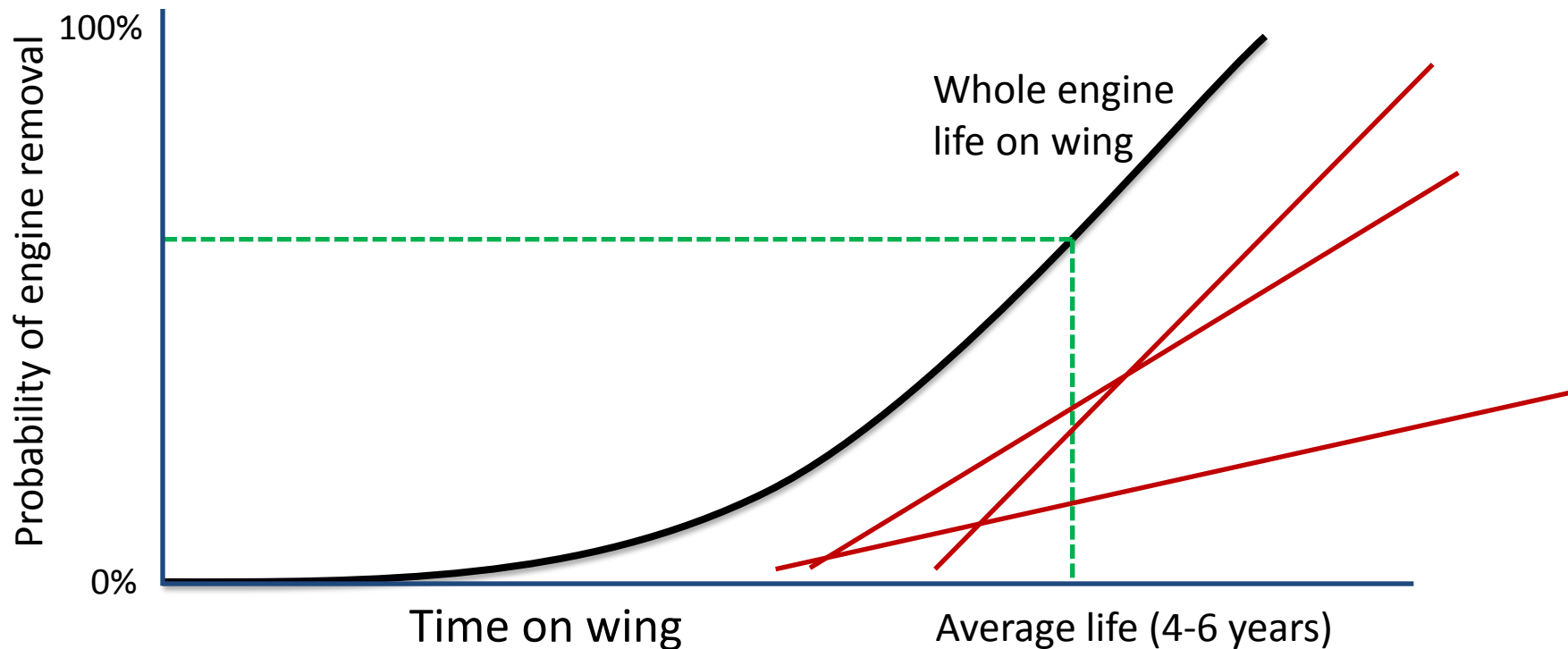
# Time on wing – engine life

Deep design knowledge enables optimisation of engine life



# Time on wing – engine life

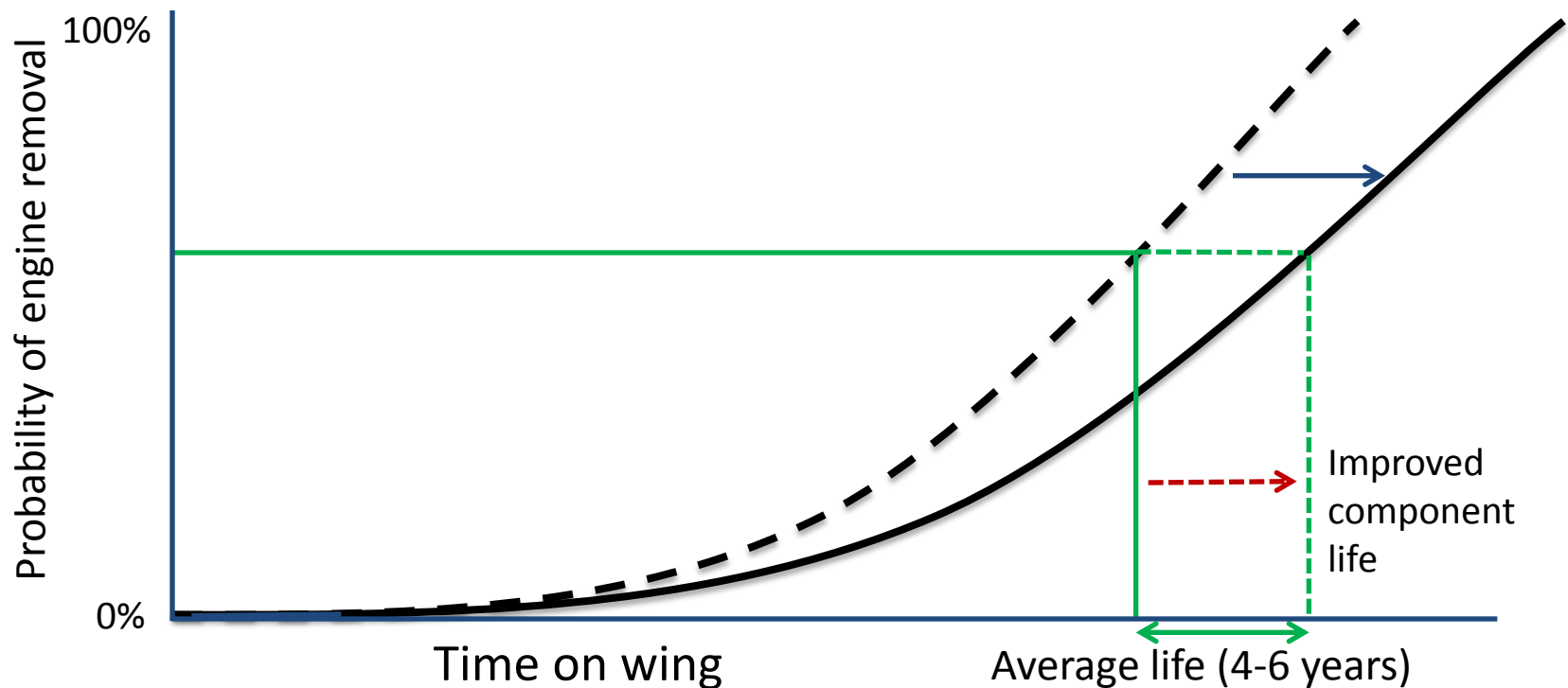
Deep design knowledge enables optimisation of engine life





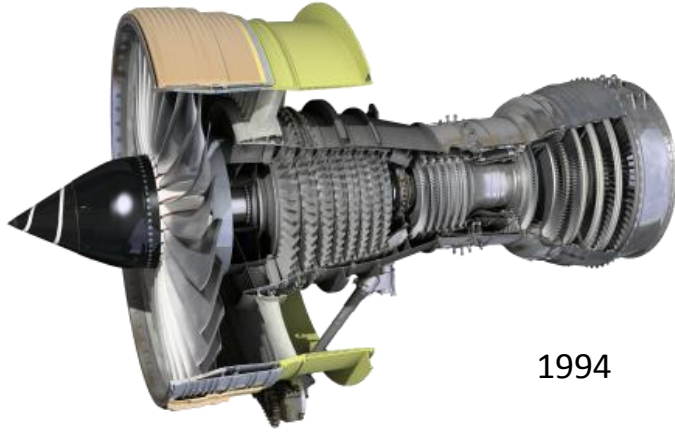
# Time on wing – engine life

Deep design knowledge enables optimisation of engine life



# Time on wing – engine life

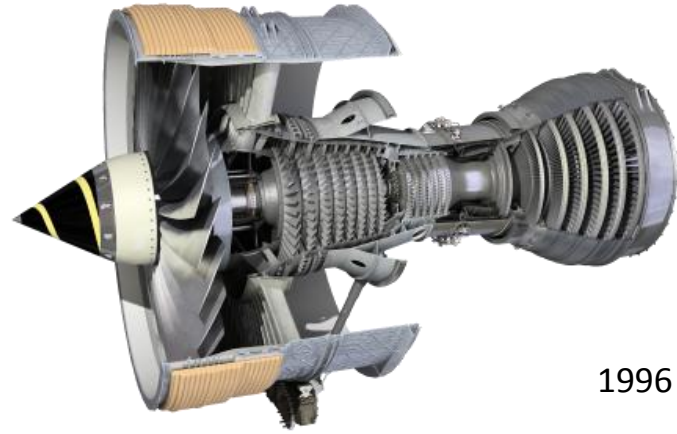
Delivered improvements since EIS



1994

Trent 700

**x2**



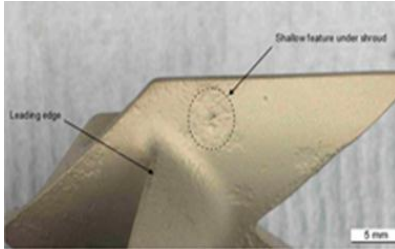
1996

Trent 800

**x2**

# Cost focus

Driving value through cost reduction

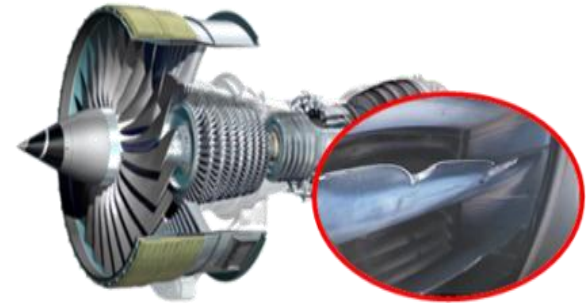


## Improved inspection criteria

- Life extension

## Engine Health Monitoring

- Deeper understanding of performance



## Repair technology

- Better component re-use

Trusted to deliver excellence



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# Summary

- Growing installed base, long services lives, growing markets
- Services at least 4 times net OE revenue through life
- Installed thrust doubles over the next decade
- Best placed as OEM to take on risk and extract value via TotalCare<sup>®</sup>
- Deep design knowledge enables optimisation of engine life and minimum customer disruption
- Nearly 2 decades of success with TotalCare<sup>®</sup>



# TotalCare<sup>®</sup> Accounting

**Mark Morris**

**19 June 2014**

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# Agenda

## 1. TotalCare®

- Business model
- Programme life cycle
- Embedded value – risk transfer and growth
- Managing TotalCare® – revenue and cost drivers

## 2. Accounting for TotalCare®

- Commercial arrangements and accounting principles
- Accounting mechanics
- Portfolio dynamics

# Our commercial arrangements

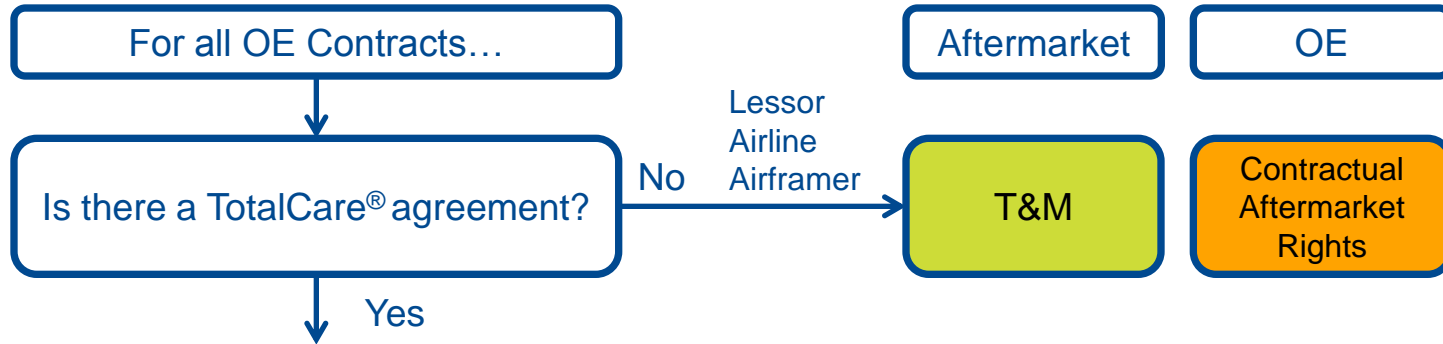
OE commercial terms are agreed with one of 3 parties:

1. Airline
2. Lessor
3. Airframer

Aftermarket commercial terms are agreed with the Airline, either as:

- Time & Materials (“T&M”); or
- TotalCare<sup>®</sup>

# Linking commercial arrangements to accounting



\*formerly known as Recoverable Engine Costs (REC)

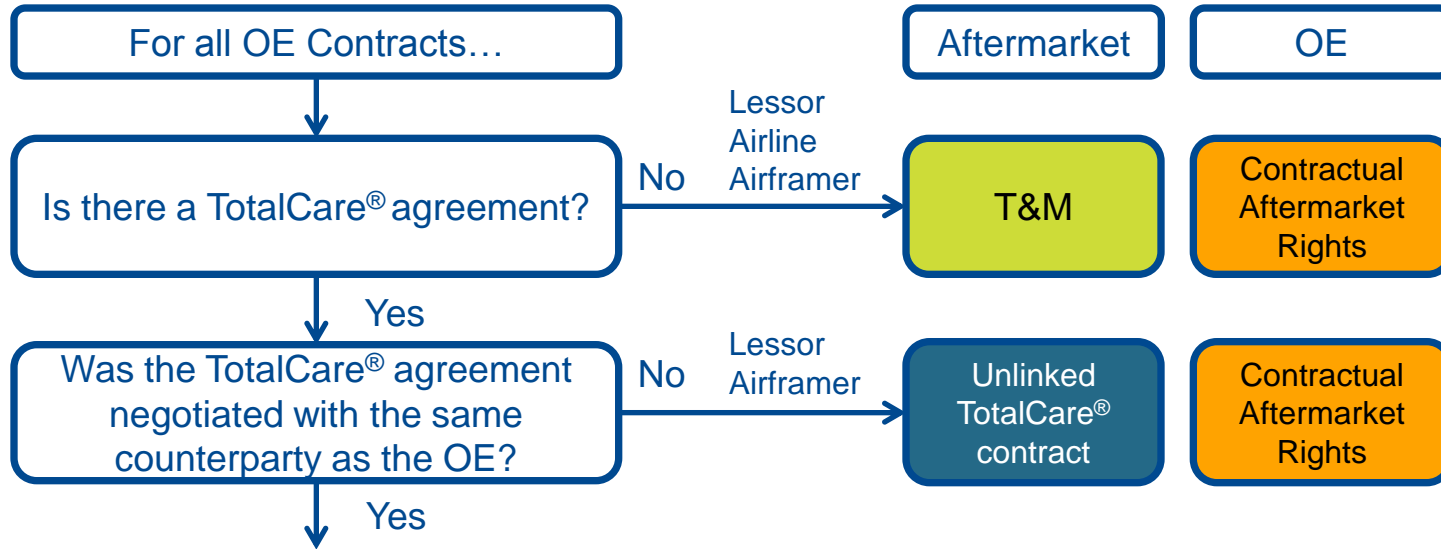
Trusted to deliver excellence



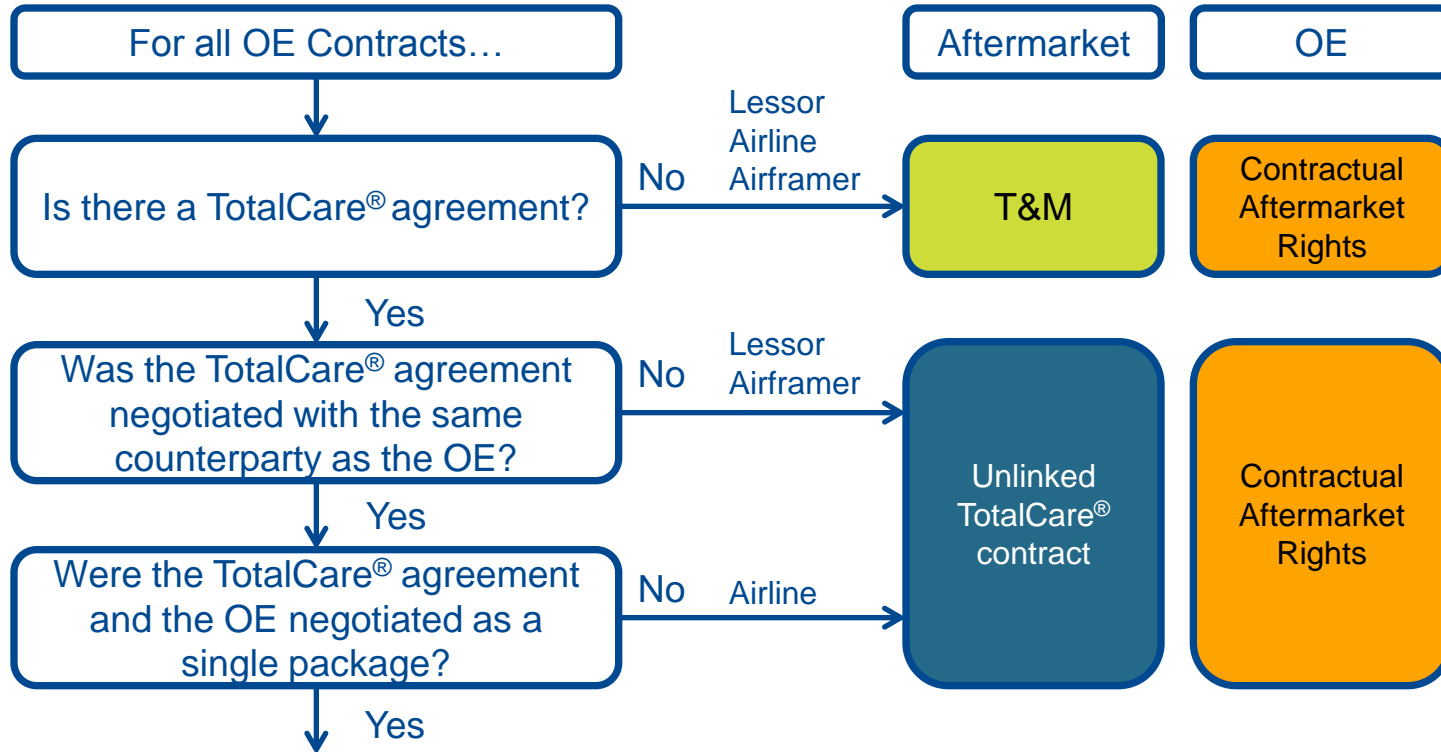
Rolls-Royce



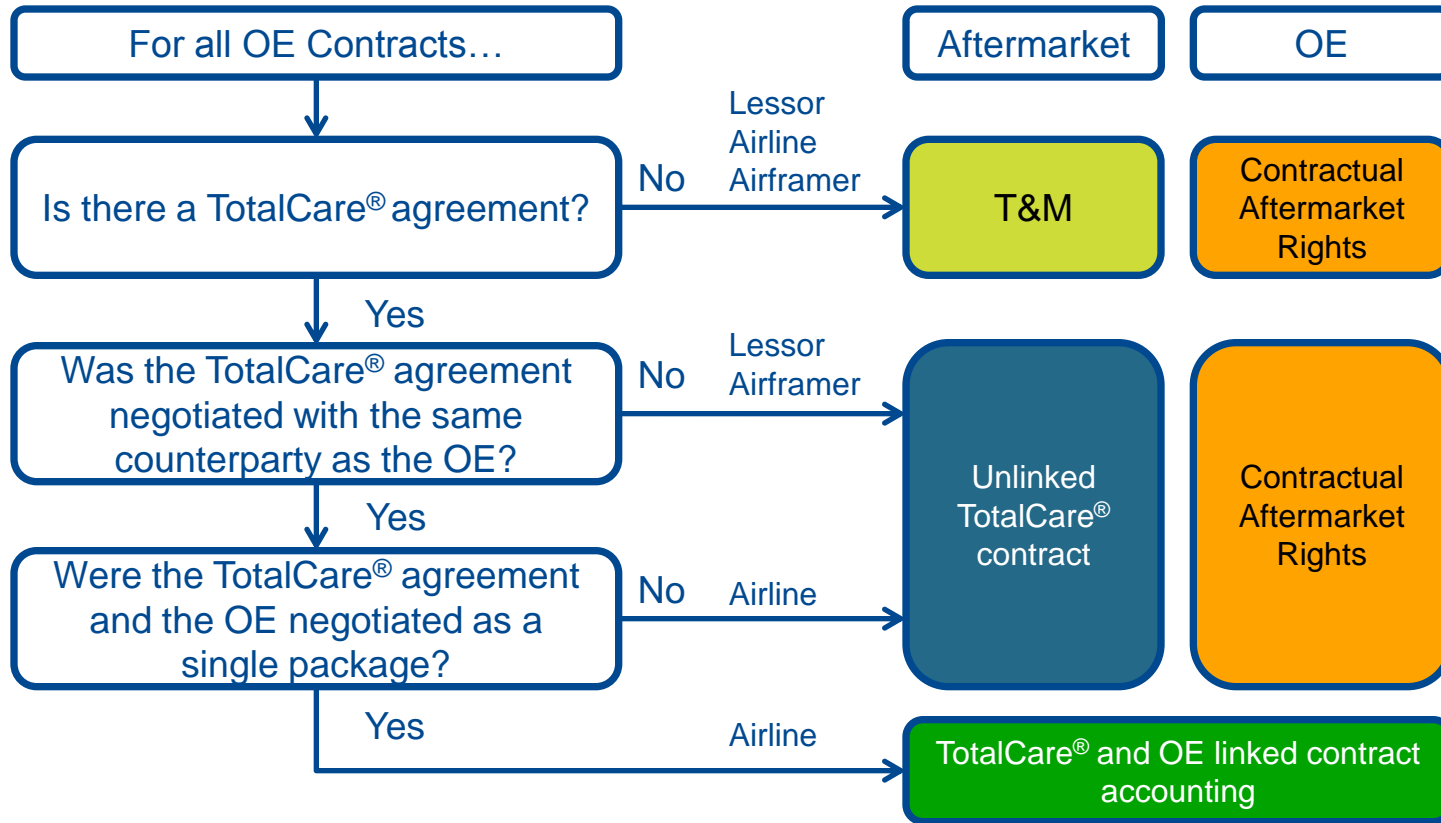
# Linking commercial arrangements to accounting



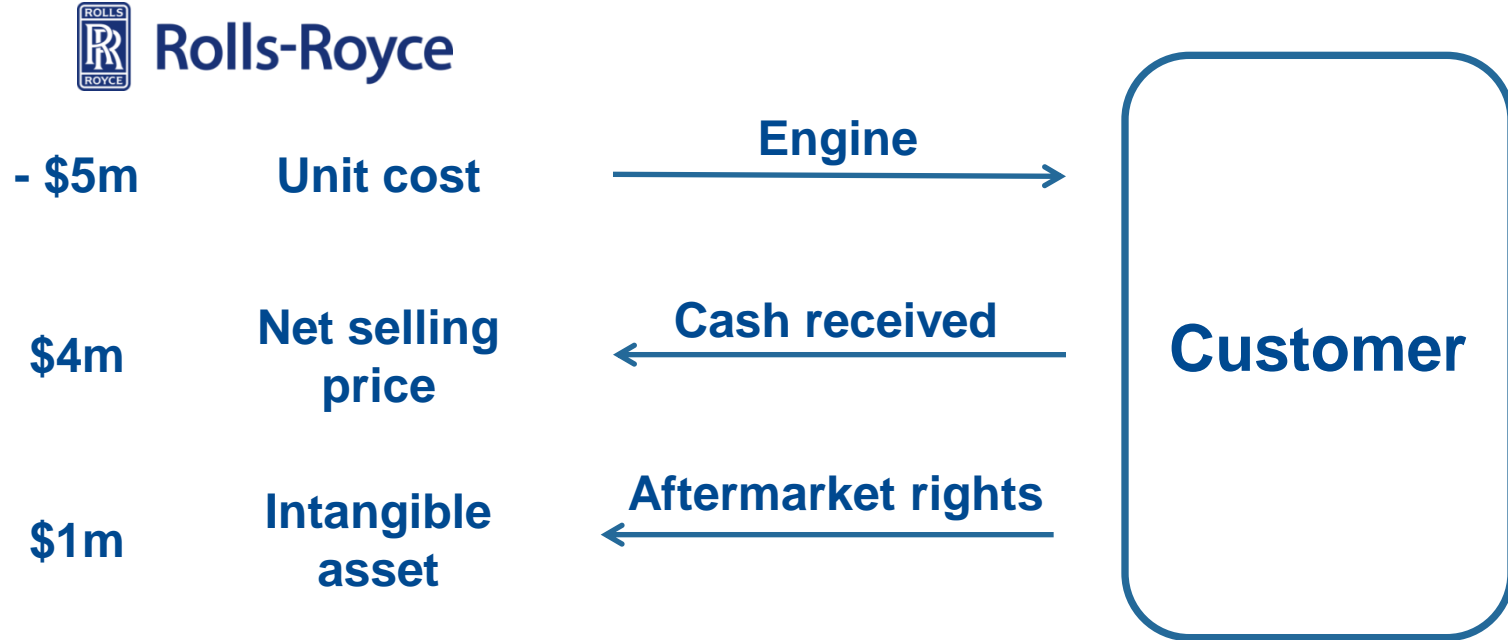
# Linking commercial arrangements to accounting



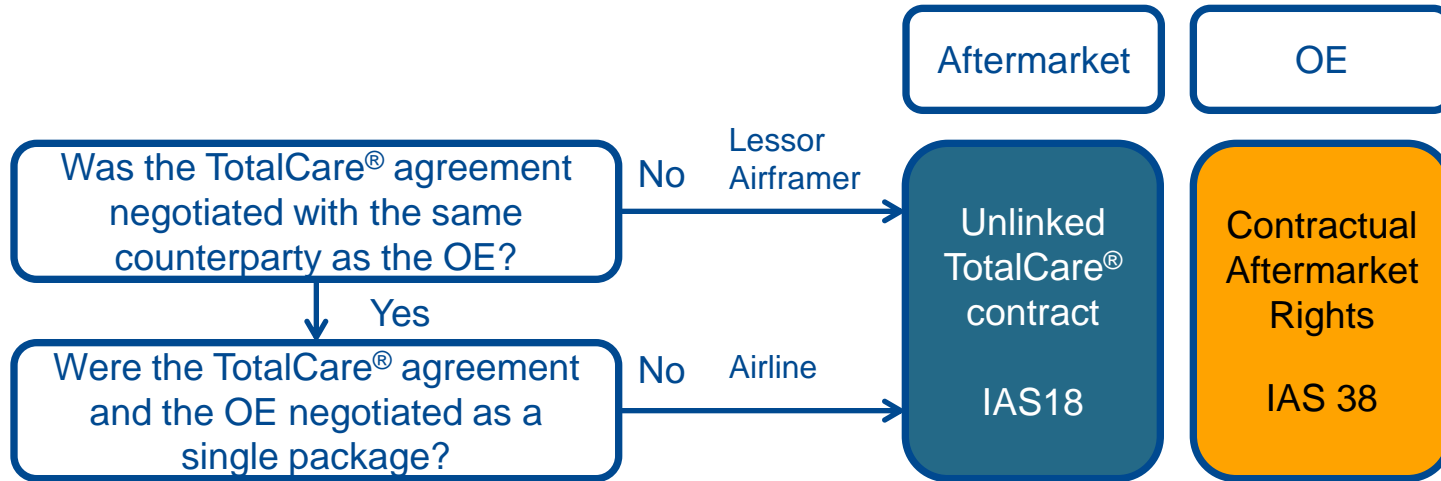
# Linking commercial arrangements to accounting



# Contractual Aftermarket Rights



# Unlinked TotalCare®



Cannot link as not negotiated as a single package as required by IAS11

# Unlinked TotalCare®

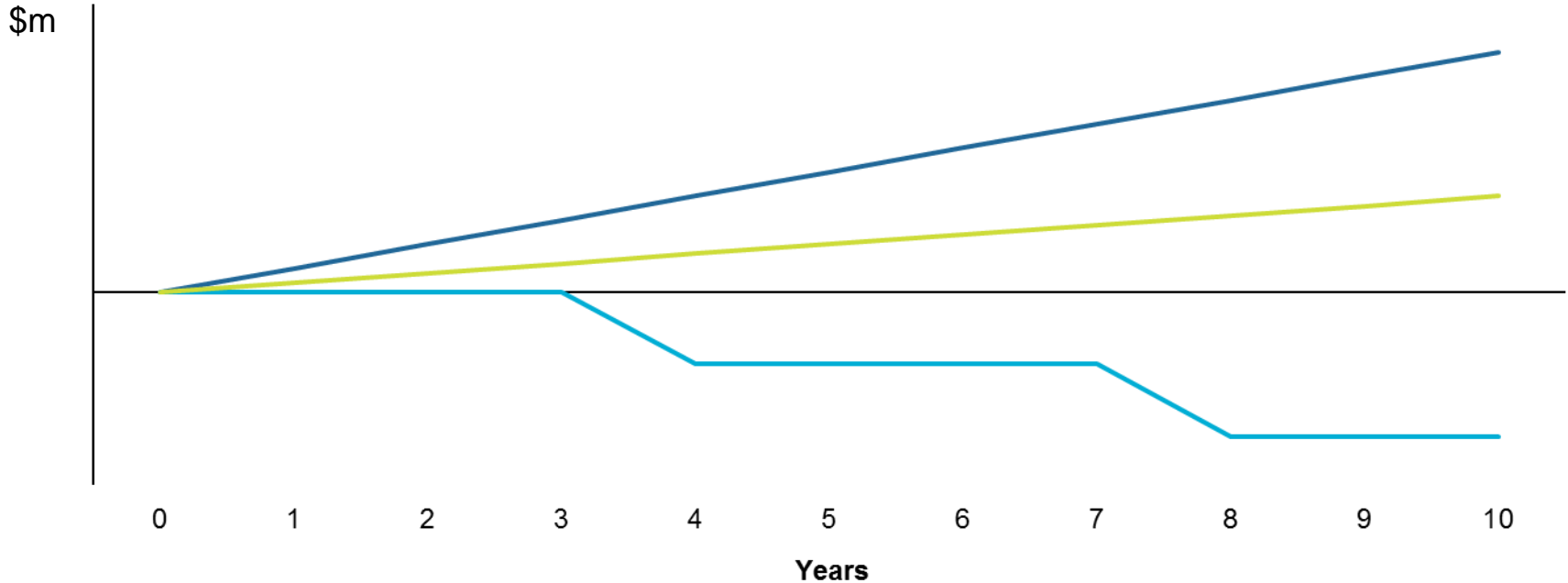
## Single engine example

Example	Length	Flying hours	Revenue	Cost	Margin
Contract expectations	10 years	40,000	\$10m	(\$6m)	\$4m
Rate per flying hour \$/hr			\$250	(\$150)	\$100
<b>At end Year 1</b>	<b>1 year</b>	<b>4,000</b>			
Revenue			\$1m		
Cost accrued				(\$0.6m)	
Margin					\$0.4m

# Unlinked TotalCare<sup>®</sup>

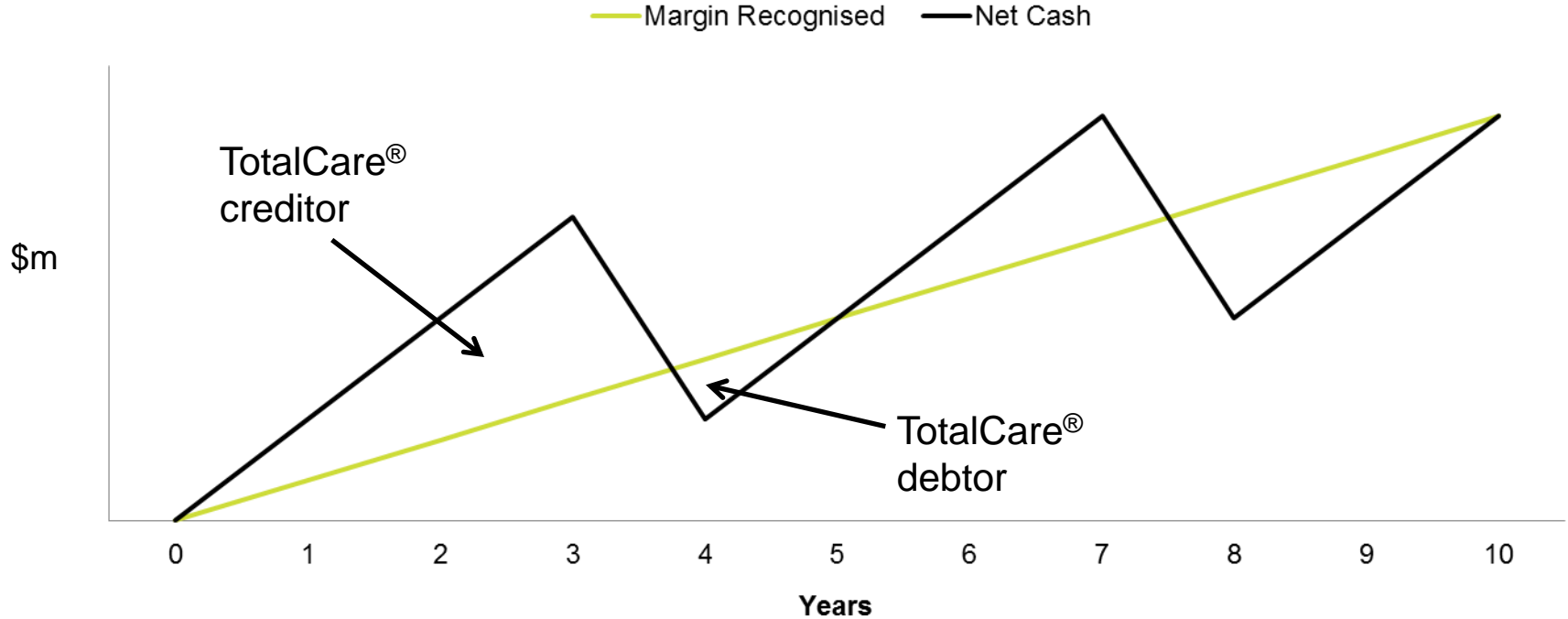
## Cash vs. margin recognised

— Cash Revenue — Cash Costs — Margin Recognised



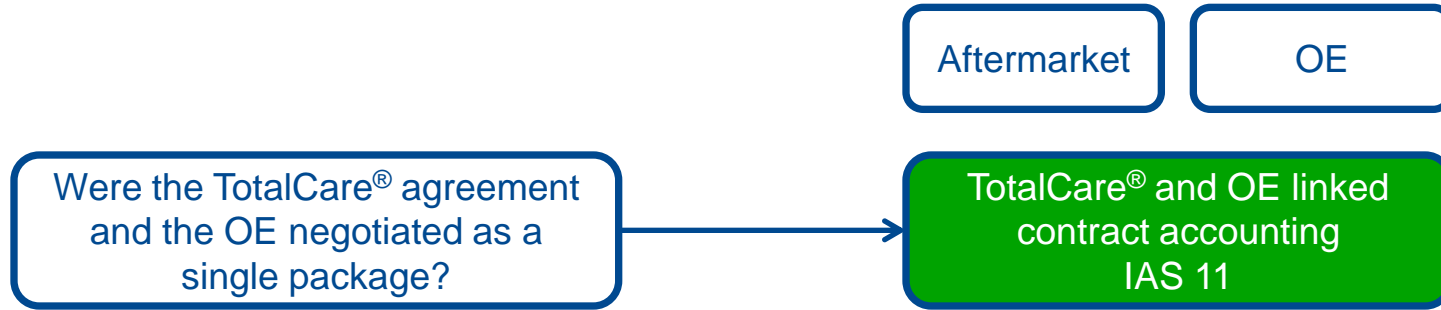
# Unlinked TotalCare<sup>®</sup>

## Net cash vs. margin recognised





# Linked TotalCare®



Satisfies IAS11 criteria for accounting as a single contract

- Negotiated as a single package
- Closely interrelated – part of a single project with overall profit margin
- Contracts performed concurrently

# Linked TotalCare®

## Single engine example

Example \$m	OE	TotalCare® (say 10 years)	Linked
Revenue	10	8	18
Less concessions	(6)	-	(6)
<b>Net revenue</b>	<b>4</b>	<b>8</b>	<b>12</b>
Cost	(5)	(4)	(9)
<b>Cash</b>	<b>(1)</b>	<b>4</b>	<b>3</b>
<i>Overall margin %</i>			<i>25%</i>

# Linked TotalCare<sup>®</sup>

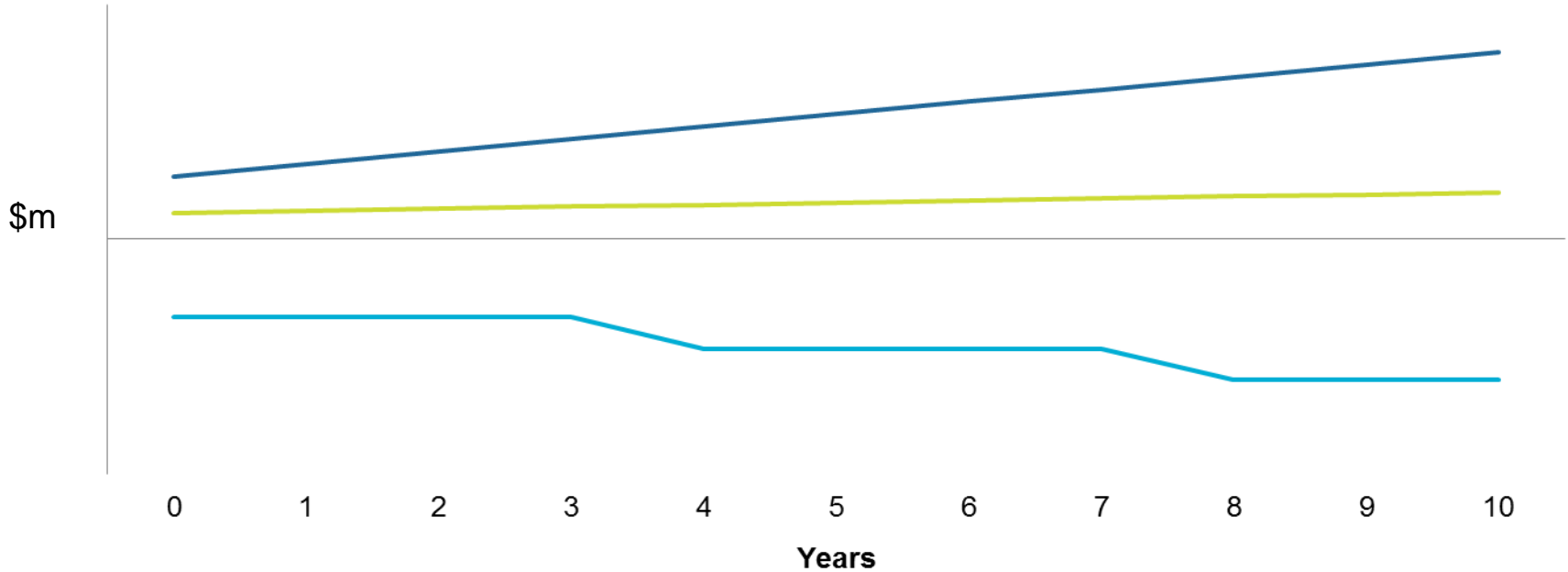
## Single engine example

Example \$m	OE	TotalCare <sup>®</sup> (say 10 years)	Linked
Cash net revenue	4.0	8.0	12.0
Margin adjustment	2.7	(2.7)	-
Net revenue	6.7	5.3	12.0
Cost	(5.0)	(4.0)	(9.0)
Profit recognised	1.7	1.3	3
Overall margin %	25%	25%	25%
Cash flow	(1.0)	4.0	3.0
Profit vs. cash	2.7	(2.7)	-

# Linked TotalCare<sup>®</sup>

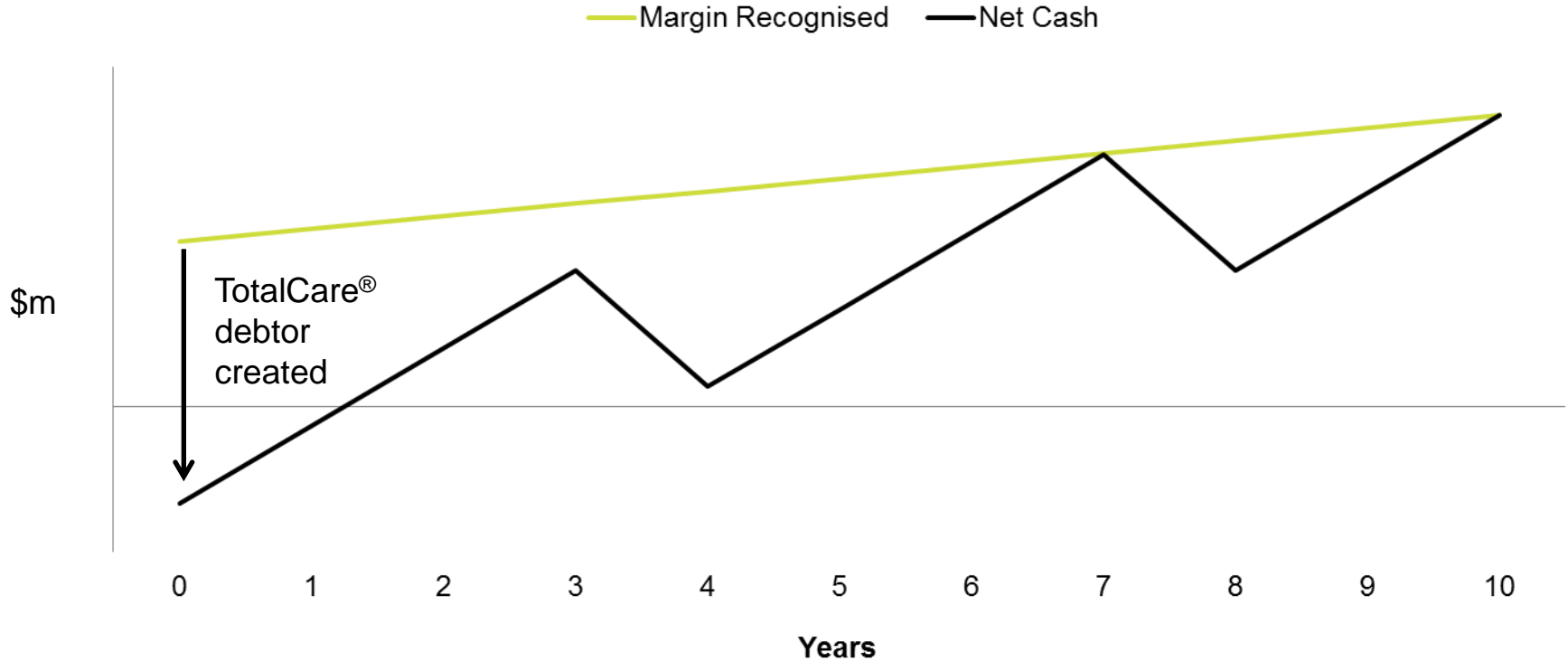
## Cash vs. margin recognised

— Cash Revenue — Cash Costs — Margin Recognised



# Linked TotalCare<sup>®</sup>

## Net cash vs. margin recognised



# What can change the forecast margin?

## Revenue forecast

- Stage length
- Utilisation

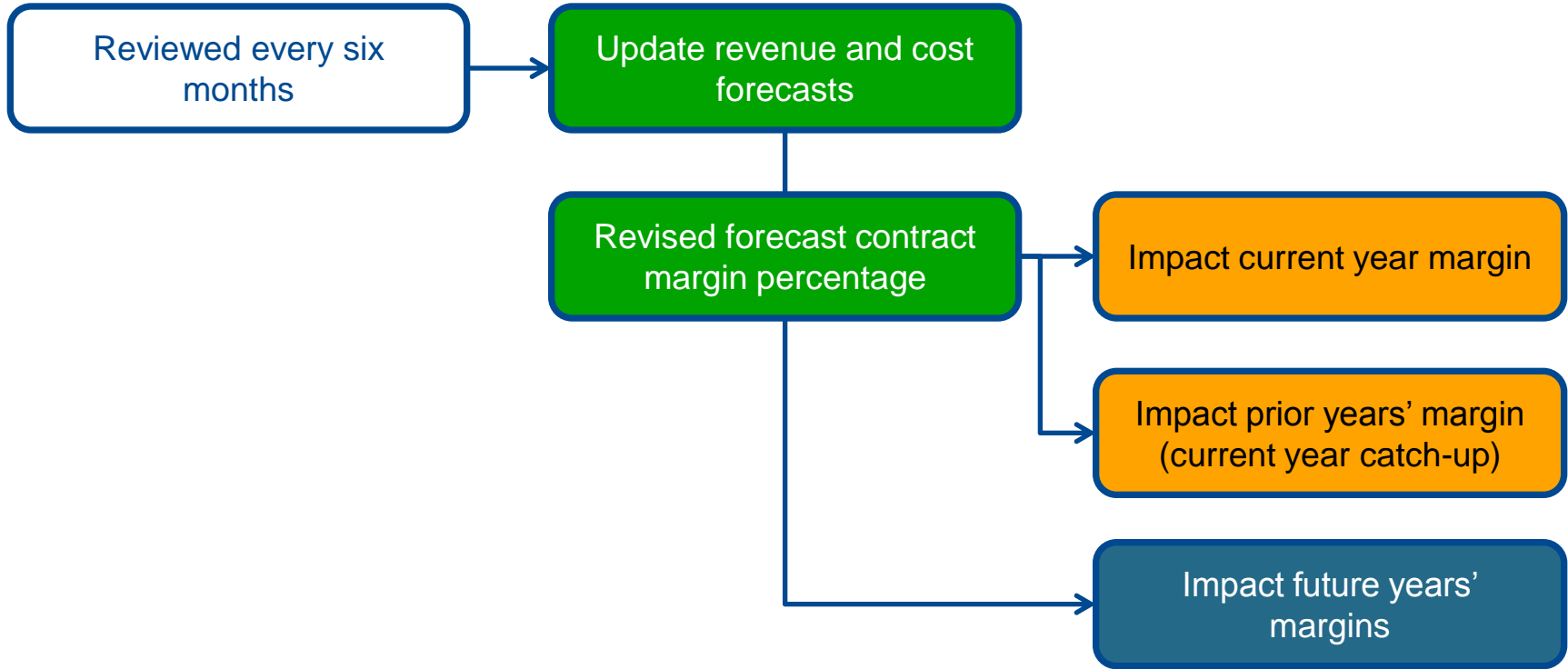
## Cost and reliability forecast

- Time between shop visits – time on wing
- Cost at each shop visit
- “Estimation Risk” – best estimate of cost

## Asset recoverability

- Counterparty risk – credit rating
- Fleet fit
- “Valuation Allowance”

# Process overview



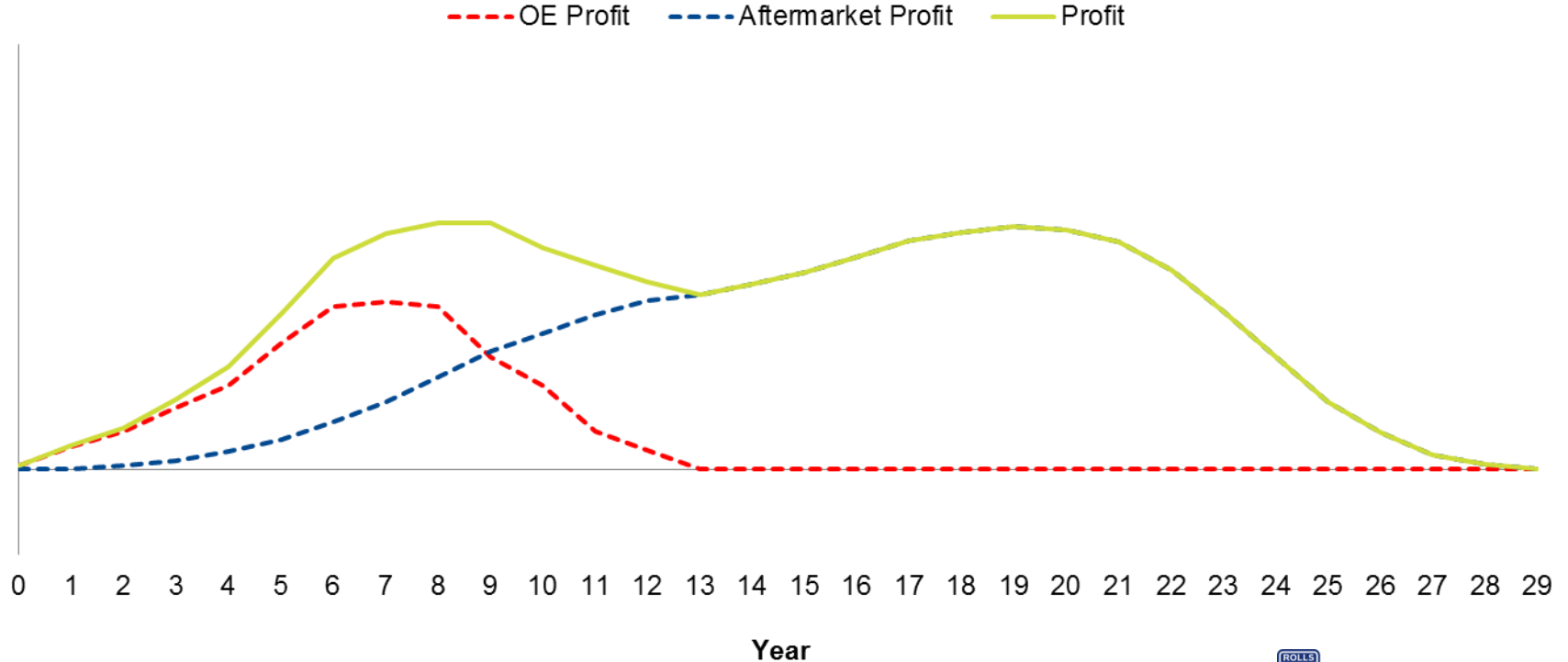
# TotalCare<sup>®</sup> accounting summary

- **Unlinked TotalCare<sup>®</sup>:**
  - **Recognise revenue and accrue costs in line with flying hours**
- **Linked TotalCare<sup>®</sup>:**
  - **Recognise revenue in line with engine delivery and flying hours**
  - **Accrue Aftermarket costs in line with flying hours**
  - **Equalised margin percentage across OE and Aftermarket**
- **Estimation risk and valuation allowances factored into margin**
- **Relevant standards: IAS 18; IAS 38; IAS 11**
- **RECs renamed “Contractual aftermarket rights”**
- **Accounting treatments agreed with the FRC**



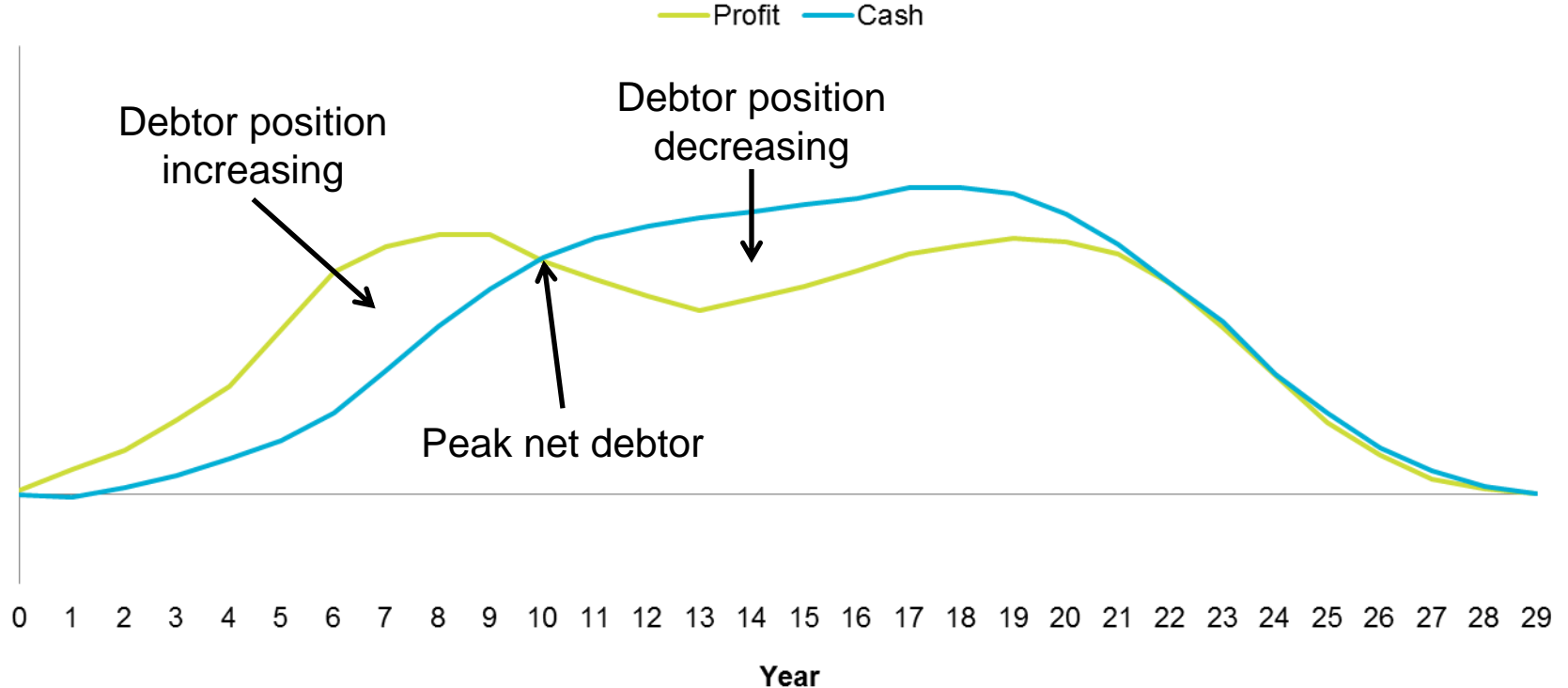
# Linked TotalCare<sup>®</sup> programme

## OE and aftermarket profit



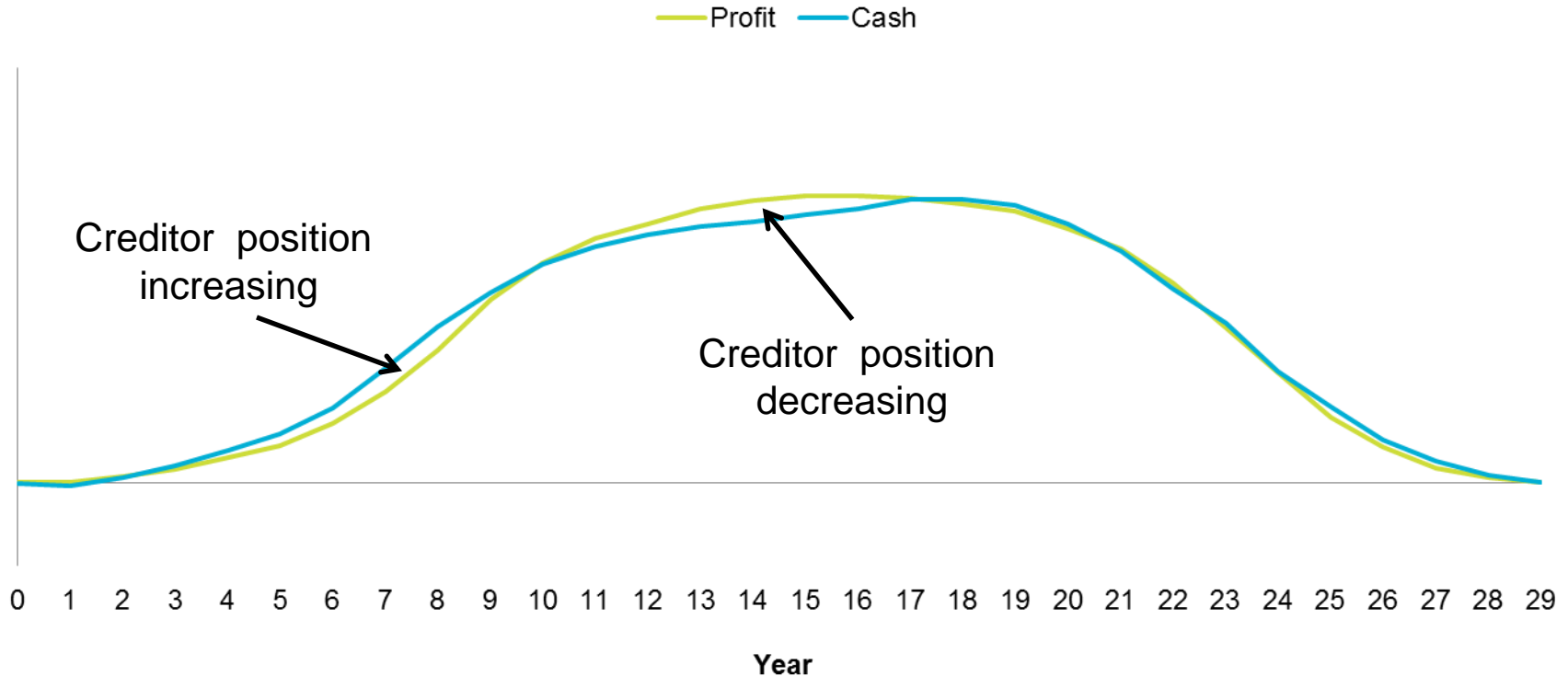
# Linked TotalCare<sup>®</sup> programme

## Net cash vs. margin recognised



# Unlinked TotalCare<sup>®</sup> programme

## Net cash vs. margin recognised



# Drivers of the TotalCare<sup>®</sup> net debtor

## Debtor rises due to :

- **Linked OE deliveries**
- **As shop visits take place**
- **When contract outlook improves i.e. lower forecast costs improved overall profitability**

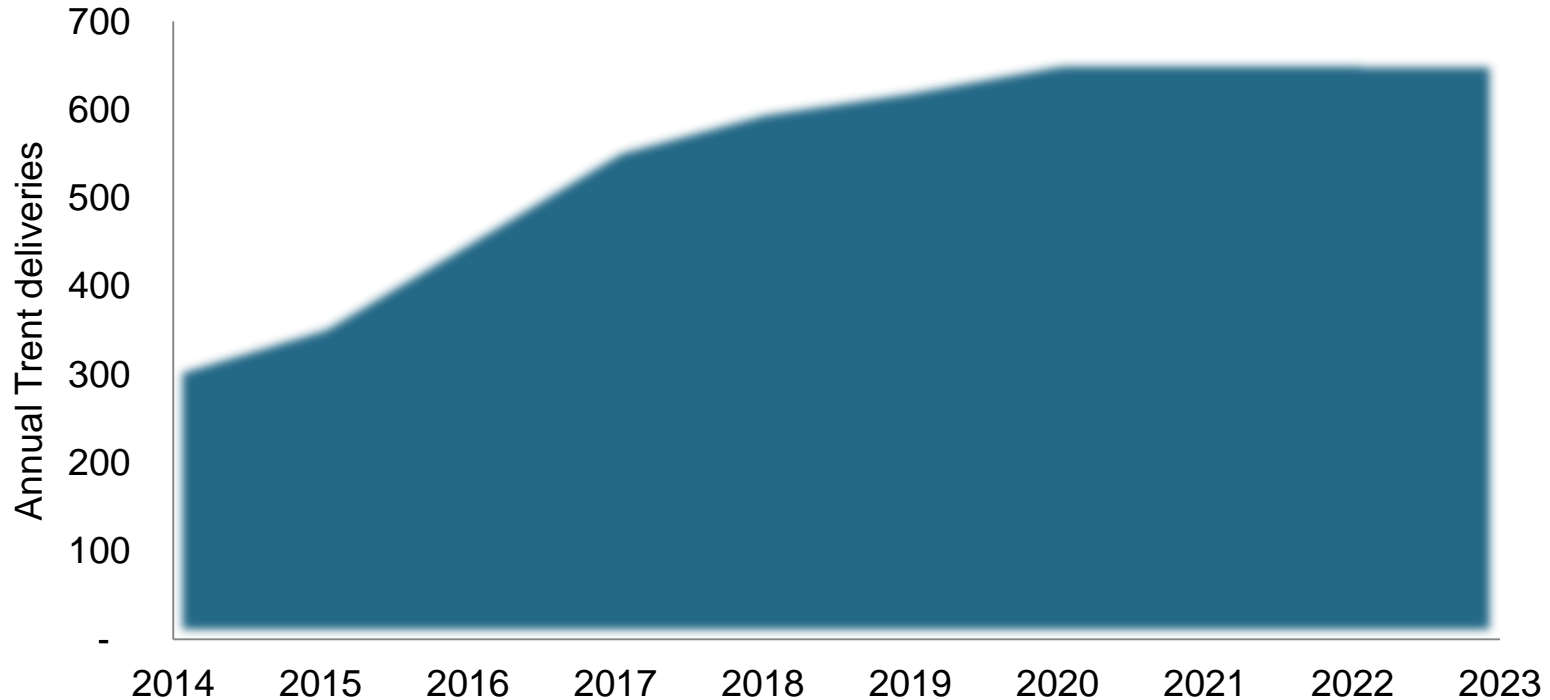
## Debtor falls due to :

- **Flying hour receipts**
- **When contract outlook worsens i.e. higher forecast costs**

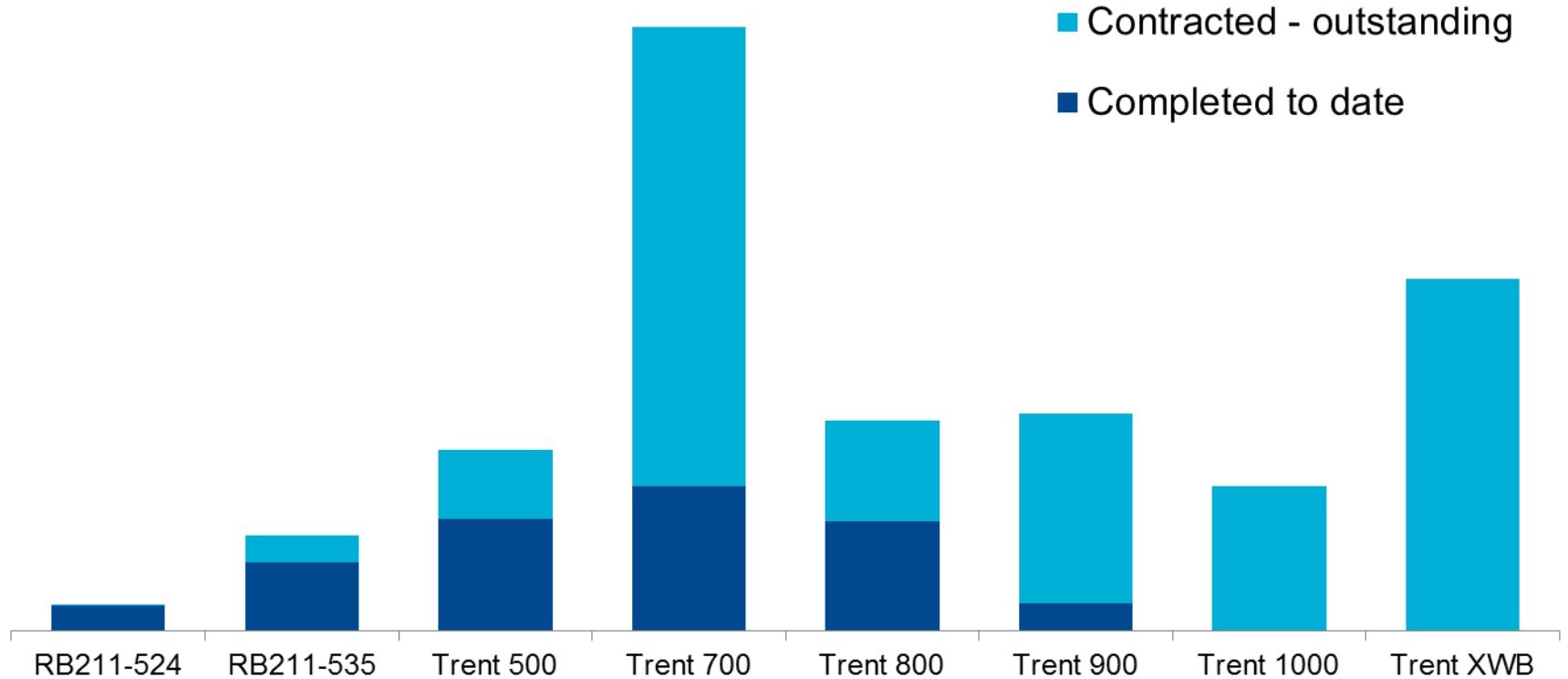
Valuation allowance changes can result in a rise or fall in the debtor

# Projected Trent deliveries to 2023

Over 4,000 deliveries vs. over 1,600 in last decade



# Status of TotalCare<sup>®</sup> contracts



# Accounting for TotalCare®

**Earnings are ahead of cash whilst OE is growing**

**Significant embedded value in the aftermarket**

**Strong focus on cost reduction and improving reliability to drive margins and realise the embedded value.**

**Accounting follows the substance of the commercial arrangements – treatment agreed by the FRC**

...

# Summary

**Strong position in growth markets**

**Concentrating on what we know**

**Significant opportunities**





# Q&A

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