Rolls Royce Guidance Update and Medium-Term Outlook Conference Call and Q&A

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Speakers:
John Rishton, Chief Executive Officer
Mark Morris, Chief Financial Officer

Operator: Hello and welcome to today's Rolls-Royce Guidance Update and Medium-Term Outlook Investor Presentation and Q&A. Throughout this call, which will end by 09.00 UK, all participants will be in listen-only mode and afterwards there will be a question and answer session. And just to remind you, this call is being recorded. Today I am pleased to present John Rishton, Chief Executive Officer and Mark Morris, Chief Financial Officer. Gentlemen, please begin.

John Rishton: Thanks very much, Hugh. Good morning and thanks for joining us at such short notice this morning – a couple of comments from me and then Mark will talk about the numbers. It will come as no surprise, I suspect, to anyone on this call when I say that economic conditions have got worse, in fact they have deteriorated quite quickly and we, like many businesses, will see our revenue impacted. So while in July we believed that we would have growth in 2015 we're now revising and that view and while I'm disappointed at the change, I will continue to keep you informed about what our best view of the future is.

We've also announced today our medium-term outlook; we've recently been through that with our board. It is clear that the fundamentals of the business remain strong and our prospects for medium-term profitable growth are unchanged. The demand for air travel will increase and you will all have seen the most recent Airbus outlook; this is driven by demand from emerging markets and the need for more fuel-efficient aircraft. As you all know, we have a very strong order book.

For our Land and Sea businesses the demand for power will be driven by population growth, increasing economic activity, urbanisation and increasing affluence; energy demand will grow strongly in the future.

These fundamentals are unchanged; we know that there will be growth in the medium term but the road between here and there is going to be bumpier than I had though, which means, of course, that we have to focus even more on the areas that we can control rather than the ones we can't. So we will continue to focus on the four 'C's – customer, concentration, cost and cash – and we are going to accelerate progress, especially on cost. Our strategy is unchanged because the medium-term outlook is unchanged because the fundamentals are unchanged.

Now, Mark, maybe you could take us through some numbers. Thank you.

Mark Morris: Thank you, John. Good morning everyone; I'm going to provide you with a guidance for 2014 and 2015 as well as, for the first time, our medium-term outlook. You'll appreciate that this is a trading update and not a results announcement.

So I'm going to start with the 2014 trading update and go through each of the businesses, followed by a summary for the group. It's fair to say that, at a group level, we're experiencing some softening across all our end markets on revenue.

In Civil our revenue guidance is unchanged but is now towards the lower end of the range; on profits we are now expecting a 15–20% increase, which is driven mainly by an improvement in life-cycle costs. Remember – and as I explained at the Capital Markets Day back in June – these changes, whilst economic in nature, also create a catch-up adjustment to reflect the improved costs that would otherwise have been taken in prior years. This catch up will flatter Civil's 2014 margins. Over the last four years, Civil's margins have averaged around 12% and you should expect Civil margins in 2015 to return to this sort of level.

Similarly in our Defence business, no change to our revenue guidance here but again we expect to be at the lower end of the range. On profits we're expecting some improvement compared to our previous guidance but this is driven by better OE-to-aftermarket mix.

Turning to Marine, we see no change from the guidance which we lowered at the half-year, reflecting the challenges we see in this sector. Our second-half performance is underpinned by good visibility of OE revenue.

In Power Systems, our revenue guidance remains unchanged but, as with the other businesses, we are now trading lower within the guided range. This is primarily due to the impact of Russian sanctions, which has stopped the sale of finished products. In addition, we anticipate lower diesel land power sales than previously expected. Turning to profits, we now expect a 5–10% reduction in Power Systems profits relative to 2013, mainly due to the loss of some high-margin business, along with some warranty costs.

In our Nuclear and Energy business we are experiencing harsher conditions this year in both our oil and gas and power gen. markets. As you know, this business is characterised by relatively low volume but high value units and consequently results can be more volatile. A number of contracts that we expected to conclude have either been deferred or lost and a transitioning process of the sale arrangements has not helped. We're also seeing some customer deferrals, particularly around spares, which carry higher margins and so have a bigger impact on profit. Performance in our Nuclear business remains on track and we continue to expect the sale of our Energy, Gas Turbine and Compressor business to Siemens to conclude by the end of the year.

Now, turning to the Group, we'd previously guided flat revenue but the deteriorating market conditions have clearly required us to lower our revenue forecast for the year. All businesses are down since the half-year to varying degrees, particularly the Energy business which has required a lowering of its guidance. We are maintaining our guidance for profit in 2014, reflecting improved performance in Civil and Defence, offset by lower profits in Power Systems and our Energy business. On cash, we've guided around a 780 million inflow, similar to last year; we are now guiding a 350 million inflow, reflecting the impact of lower revenue, worth about 200 million; lower deposits in Energy, Marine and Power Systems, worth about 100 million; and slower progress on inventory than planned, worth about another 100 million.

Okay, since we are likely to conclude the sale of our Energy, Gas Turbine and Compressor business to Siemens by the year-end, I thought it would be helpful to show – show group guidance excluding our Energy business as this will form the basis for 2015 guidance. The guidance excluding Energy is shown here on the chart.

Okay, now turning to 2015 guidance, since our interim results the economic outlook for 2015 has become more challenging. These conditions are clearly being felt by a number of our customers and may affect the timing of their investment decision, particularly in Power Systems and Marine. In our Civil business we expect some softening in our Trent 700 sales as we move ahead with the launch of the new Trent 7000. We previously said that we expected a resumption of growth in 2015, however, in light of these uncertainties, our current best estimate is that group underlying revenue will be in the range of ±3% and profit will be in the range of 0% to -3%, compared with our expected outcome for 2014.

The asymmetry between revenue and profit guidance is mainly due to us having reduced our 2014 revenue guidance but having kept our profit guidance flat. So, all else being equal, revenue growth for 2015 will be higher than profit growth because it's starting from a lower base. On profits, we also expect some adverse mix effects since previously guided.

So we've talked about the short-term challenges, but let's remember that this is a long-term business and the fundamentals remain compelling. Back in June we said we would provide a medium-term outlook to give some directional context around our expected progression on a few key metrics. A number of important assumptions underpin our expected progress. To the extent they change, this will change the rate of progression; it is the characteristics of our maturing Civil business that will influence most progressively the movements at a group level too. The key drivers of change are the relative mix of new engine sales to aftermarket sales, the maturity and size of the installed base and new programme opportunities. We currently expect new engine deliveries to level off around the 2018 timeframe; this inflection point will start to see a greater weighting towards more aftermarket revenues from the larger installed base as we move into a period of harvest, which will drive up margins and improve cash conversion. Based on our current view and assumptions we expect performance in this period for the following metrics as shown in the chart.

The medium-term prospects for our Land and Sea division remain attractive and are supported by the investment in power, transport and infrastructure that will be required to support population growth and increasing affluence. Key growth drivers include global trade, regulation and capital investment in the oil and gas, mining and construction industries. We are confident in the future growth of revenue and profit in this division but the timing, given its shorter cycle, is difficult to predict. Consequently, we've decided not to provide a medium-term outlook for group revenue.

Just turning to the TotalCare – net debtor, you'll remember that there are a number of drivers that will influence whether the debtor is increasing or decreasing, as I explained at the Capital Markets Day back in June. The ramp-up in OE deliveries, where linked, will naturally increase the debtor, as do shop visits, which reduce the creditor. So the key point to note is that the peak debtor will start declining as OE deliveries level off and cash conversion will improve. The build-up in contractual aftermarket rights, formally known as RECs, reflects rising unlinked engine sales, which we discussed back in June.

With that I will turn it over to Q&A, thank you.

Operator: Thank you. Ladies and gentlemen, if you wish to ask a question could you please press 0 and then 1 on your phone keypad now in order to enter the queue and then after I announce you, just ask your question. And if you find your question has been answered before it's your turn to speak, please press 0 and then 2 to cancel. And there'll be a brief pause while questions are being registered.

Our first question is from the line of Rob Stallard of RBC. Please go ahead with your question, your line is now open.

Rob Stallard: Thanks very much, good morning. Just a couple of questions on the 2015 guidance you provided: I was wondering if you could comment on what your expectation might be for cash-flow next year and also if your profit guidance includes any additional costs for restructuring or whether that would be classed as a non-underlying item. Thank you.

Mark Morris: Good morning Rob, thank you. No, we haven't given cash-flow guidance for 2015; we will be giving that guidance when we, obviously, get to the prelims next year. We haven't given it earlier this year and we're not planning to give it now. In relation to the additional restructuring, that is excluded from the results we've given at the moment.

Rob Stallard: Can you give us an idea of how much that might be?

Mark Morris: When we're ready to talk about it, we will discuss it.

Rob Stallard: Okay and then just finally on the medium-term outlook, obviously some uncertainty on the shorter cycle areas but do you expect the profile from here to 2018 to be more like a J-curve – that we see, say, material improvement in 2017 into '18 and so the profile in '15 and '16 is pretty similar?

John Rishton: I think it's very difficult to answer the question on the shorter cycle business, so if I split the business into two – into two parts; the Land and Sea business, the Marine and Power Systems – clearly it affected one of them by a shorter cycle and two more directly by what's going on, particularly in certain industries: the oil and gas industry, mining and construction industry as well as government spend. So, trying to predict that is – is extremely – extremely difficult but, you know, Mark has talked to you a little bit about what we see in terms of '15 in total and going out – going out beyond that is – is very, very difficult. I mean trying to forecast exactly, you know, what the economic environment's going to be and how things are going to change is – is extremely difficult.

Rob Stallard: Okay, thanks very much.

John Rishton: I think the point that I would make though is, again, as I said my introduction is the fundamentals underlying that business are strong but exactly when they return we'll see. The world's going to need energy, you know, if you look at anybody's energy forecast for the next ten, 15 years, it shows significant growth and it shows the growth because of population growth – there are going to be another people on the Earth by the middle of 2020s; there's going to be 100 million more people joining the middle classes each year between now and then, so increasing affluence: all of those factors lead to more power and if we need more power, it's got to come from somewhere and that's where we play.

Rob Stallard: Okay, thank you.

Operator: Our next question is from the line of Harry Breach at Westhouse Securities. Please go ahead with your question, your line is open.

Harry Breach: Morning John and Mark, can I ask you just two questions? Mark, can I just ask you to just recap on what you said about Civil margins, I think, beyond this year? Just to re-clarify, I think you said return to around the 12% level, is that – was that accurate?

Mark Morris: That's accurate, yes. That's correct.

Harry Breach: Yeah, good, great. And the second question was: just in terms of the economic impact that you referred to in the release and the conditions deteriorating and clear mention of delay or cancellation of orders; I was just wondering, when we think about the changes to your guidance, I suppose, this year and next year, sort of, is it possible for you to give us a sort of sense of how much of this is existing deferral activity you can see in your order books right now and how much is anticipatory?

John Rishton: Well, I mean, Harry, there's a combination of both. I mean, 2014 – there is obviously some element of deferment on OE, but actually services revenue again, which is much shorter-cycle and especially on the spare parts lead times can be anything from sort of 24 hours to 30 days. So it's more prevalent in our Energy, Marine and Power Systems businesses because of the shorter-cycle nature that John was talking about. But actually, when any areas looking at preserving cash, they will try and delay activity where they can. I mean, obviously, as we go down to 2015 I think the fact that we've widened the guidance and at least for the first time provided for some ranges around the guidance earlier than we would do normally, I think that's reflecting current lower level of visibility and greater uncertainty that we have and like I said, nothing's a foregone conclusion and that really reflects the range that we've highlighted.

Harry Breach: And just wondering guys if you can – if I can just touch a little bit more on the Civil side there; are you seeing overhaul deferrals at the moment?

Mark Morris: Well, like I said, in 2014 Civil remains within its guided range, so it's like all things – there are always puts and takes on anything when we look; you can't land exactly on a dollar amount or a pound amount. But –

John Rishton: Yeah, what I would say Harry is it's not significantly and as you know, in our model we have the TotalCare model, which is driven by flying hours. Flying hours are fine at the moment so my overview would be: no, we're not seeing any particular issues in terms of servicing associated with TotalCare or anything unusual on the Civil side. As Mark said, on the shorter-cycle side we are seeing and we have been seeing the services – and we talked about this before – being weaker than certainly we had expected.

Harry Breach: Great, that's very clear. Thank you very much, gentlemen.

John Rishton: Thank you.

Operator: Our next question is from the line of Ben Fidler at Deutsche Bank. Please go ahead, your line is open.

Ben Fidler: Yes, good morning, thank you. I had a couple of questions, the first of which was if I could just drill down again a little bit more into Civil margins, maybe between the 2015 and 2018 period. So your guidance is Civil margins sounds like around about the 14% or so level in '14, drops to 12% in '15 and then we're back up to 15% or so by 2018. It's – the first question is to understand that – if you can help me with the trajectory at all between that 12% point in '15 and the 2018 number. Is it quite back-end loaded or should we see it as relatively linear?

The same question around cash conversion – that 80% cash conversion which again am I – am I correct in understanding that is a 2018-type of number in your mind-set? Just to understand what the path looks like for cash conversion – again, how linear that looks as we go through the sort of '16, '17 period?

And then actually – sorry, another question that's come to mind, a sort of quick third one; it may be a rather dull accounting one – but just to understand a little into what OE growth is coming on unlinked contracts? I was surprised that the growth in RECs is relatively low and at the same time surprised that the growth in TCP net debtor is so high. The TCP debtor is probably doubling from the current level. My assumption is the OE losses these days on XWB and Trent 7000 engines will be put into RECs; have I misunderstood that?

Thank you.

John Rishton: Thanks, thanks for your questions. Let me make a couple of observations – a couple of comments about margins and – and cash conversion. The first is: as Mark outlined, as we outlined, I think very clearly in the press release and as I explicitly said in the June investor meeting, the improvement – the sustainable improvement in Civil margins is the consequence of the products maturing, OE levelling off, the balance between aftermarket and OE shifting – all a combination of those kinds of factors and at the moment we forecast that to be happening around 2018. So the first thing that I just want to be absolutely clear with everyone is – it's that combination of factors that drives the margin and at the moment 2018 is the date that we – we've indicated and we're – that's what I showed you in June. That was our – this is our best view, that was our best view and that's what drives it. The cash conversion is similar, though it's driven by those events, not the date. The date is when we think that's going to happen, but it's the events that drive the outcome.

So the – the second part of that is the trajectory in terms of margins. So, what Mark said is what we've seen, if you look back over recent history and you take an average – the average Civil margin is running at around 12% with variations, obviously, amongst that; this year's going to be stronger. So in '15 what we're saying is we're seeing a return towards the more average levels that we've seen in Civil margins – so, nothing, you know, in my view particularly surprising.

I'm not going to get drawn into '16 and '17 because, you know, I – we kind of keep getting sucked into, 'What, what, what, what, what?' But the point I'm – I'm trying to make is: the reduction in '15 is a combination of the factors that have driven '14 higher and then all the other things that are going on, whether that's launch cost, launch pricing, unlinked – you know – offset by cost reductions, etc., etc. But I'm not going to get into a trajectory from there into '16 and to '17 and then into '18 at this – at this point in time. The key thing, for me, for you to think about is events that relate to the sustainable improvement in Civil margins are the ones that I've outlined and our belief that that is in 2018, as we've explained on that chart, and to understand that '14 is strong and we're going back to more normalised levels in that period of time and then in '15.

Mark, anything – you want to talk a little bit about the TCAs [inaudible]?

Mark Morris: You give me the easy one, yeah?

So, let me try and – there was a couple of sub-questions to your third question, Ben, so let me start with the easiest one first. Trent XWB and Trent 7000 are predominantly unlinked and I think that's just – that's the easy part of the question. On the growing TCA net debtor and RECs, remember there's a lot of moving parts here; so Trent 7000 in the timeframe that we're talking about really doesn't have a lot of impact, in terms of its ramp up will only start – this is starting to come into service in 2017. So what you've got is just a movement of existing Trent 700s and shop visits which obviously, naturally, drive an increase in the debtor. So OE deliveries plus shop visits, plus of course any improvements we plan to make or assess in our thought process around improving life cycle costs – be it extra time on wing or continue to take cost out, the natural retirement of estimation risk – and again another area that we talked about back in June – those will drive the debtor. So that's the mass that we're seeing currently and the reason I've given a range is, as you said, because there are such – many moving number of parts, it's difficult to sort of pinpoint it, so I've got to give a bit of a range around that.

On the RECs side, again, it will – sorry, the CAR side, should I call it, contractual aftermarket rights – that again is driven by unlinked and as we make – continue to make progress on costs, particularly on OE, that will help to supress the amount of CARs – or slash RECs – that we take on. So I think that's the sort of broad background, Ben.

Ben Fidler: Okay. Thank you very much.

Operator: Our next question is from the line of Ed Stacy of [inaudible]. Please go ahead with your question, Ed, your line is now open.

Ed Stacy: Hello, just one for me, which is the Energy and Nuclear Business – wondering if you could just give us a bit more colour on who's cutting what? You know, which industries, which geographies, you know: where is the weakness coming through from, in terms of this year and as we look into 2015? That's it.

John Rishton: Yeah, I think – I think – sorry, on the energy business it's where is the weakness, I think is the question?

Ed Stacy: Yeah.

John Rishton: I think there's been sort of three elements at – as far as I'm concerned. First of all, orders are down in total and what we're seeing is deferral of orders. So, whilst our business in Russia is small in total, I think around – for the sake of argument, around 100 million a year.

Ed Stacy: Yeah.

John Rishton: So the direct consequences of Russian trade sanctions have been fairly small and actually primarily focused around our Power Systems business. The indirect consequences are that, you know, some customers are deferring orders for their Russian projects because they're subject to the same sanctions. So what we've seen is the level of business dropping, pipeline and oil and gas business being deferred and your guess is as good as mine as to whether that – you know, when that will happen.

My view is it will happen because the pipelines are there; they've been built but exactly when is the challenge. So we've seen quite a number of deferrals – so we've seen the total business down and deferrals moving – coming in as well in that business. But don't forget our – our energy business, as Mark said, is one – it's a small business and it's – for us, it's low-volume, high-value, you know, relatively few contracts.

So I – you know, that's what we're seeing. You would need to talk to some of the bigger companies to get a better overview about what's going on in energy in total, but you're well aware that oil and gas companies have cut back significantly on their capex and you're also well aware about Russian sanctions and some of the implications of those. But that's what – that's what I'm seeing.

Ed Stacy: If I could have a quick follow up, actually – as we look into 2015, it's Power Systems, so I guess, in the forward-looking way, I need to think more about Power Systems rather than Energy?

John Rishton: Yeah, that's right because Energy – Energy, you know, as we said – you know, we hope to complete that by the end of the year; I think it's likely we'll complete by the end of the year.

Ed Stacy: And so then in Power Systems, as we look to 2015, you're saying the worsening conditions are being felt and may affect investment decisions, particularly in Power Systems and Marine. So, in Power Systems, you know, is that the sort of – off highway, is it the industrial or is it a pretty broad spread, what – anything particular we should note?

Mark Morris: I think, again, it's a shorter-cycle business and they go into a lot of vertical markets – you know construction, rail, mining, naval, oil and gas, agriculture, etc. Again, you know, I think John summarised quite neatly at the front of this conference call the general macroeconomic pressures that we're seeing and you read about the in the papers every day, you know – be it deflationary areas in Europe, in South America, lower raw material prices, etc., etc. And of course that ripples its way through as people look to understand what it is and of course, generally, we are providing equipment that goes into some other equipment – it's a power system of some kind, particularly, obviously, in the Power Systems business – diesels and gas engines that are going into various applications. And whilst there's a big install base that will drive spares and where we see there may be some softening, I mean, absolutely, there are some uncertainties. And across all of those markets they are being affected, you know: rail, mining, construction, etc.

Ed Stacy: Thank you. Thanks.

Operator: My next question is from the line of Christian Osmond[?] at Bernstein. Please go ahead with your question, your line is open.

Christian Osmond[?]: Hi, good morning gentlemen. Just taking it back to Civil margins, if I could please, I was interested in – or trying to draw you out on the exact margin trajectory over the next few years but in terms of just – operationally speaking, if you could just talk about the mix, in the sense of the operational drivers that bridge from where we are now in Civil margins to the medium-term guidance? In the sense of – so, obviously, clearly there's been defined some near-term mix headwinds from delivering new engines, but if you could talk a bit about the timing, the phasing, the magnitude of contribution from various investments and initiatives you've taken now to improve the cost base, manufacturing costs and supply chain costs and improvements in capacity utilisation, etc. If you could speak a bit about how you expect these – these benefits, or positive offsets if you will, to phase into – to get to your medium-term guidance, please?

Mark Morris: Okay, well look, as far – this goes in context: this is a trading update and an outlook about the medium term so I'm going to keep this relatively high-level; we're not going to get drawn into quantifying every piece. I mean, you've highlighted a significant number of – of the drivers as I covered off really in particularly explaining what were the key drivers around the sort of thing that would get us into the sort of margins that we're talking around, around the 2018 timeframe which is when engine production starts to sort of level off. And again, that's the key thing to recognise, which is those three drivers that I talked about – which is the OE, the aftermarket sales, the maturity of the install base –

which obviously drives higher numbers of engine flying hours which have much better cash margin and that drives the cash conversion as well as the profit margin – and of course new programmes. And the reason I mention new programmes – new programmes naturally, certainly at the front end, because we're spending money on capex and R&D but nonetheless, where we see there's a good business case and again if I go back to what I said in June – you know, think about the life cycle of an engine; we get about 20% of the revenue on the OE and it's much lower margin; 80% of the revenue at much higher margin on the aftermarket. So that makes attractive sense; when we see those opportunities we'll continue to – to make those investments.

On the cost side of – you know, we continue to talk about and you know, John's been very clear and I'm very clear that we have got to accelerate cost. We're making good progress in cost; better in some areas than in others and we're focusing on those other areas as well, and we've talked and clearly indicated already that as we start to look at restructuring and rationalisation; that is all about improving efficiency and capacity in our factories.

So there's a number of things as to why we're confident that we can get to those sorts of margins, driven by what we're doing on cost and efficiencies but also the mix of product and where we are relative to, sort of, sewing versus harvesting, if I was to use an agricultural phrase. And I think that's about as far as I'm prepared to go at this stage.

Christian Osmond: Okay, thanks.

Operator: Our next question is from the line of Nick Cunningham from Agency Partners. Please go ahead with your question, your line is open.

Nick Cunningham: Good morning gentlemen – yeah, a couple of questions. First of all, in terms of giving that – that medium-term guidance for the margin expansion, given the headwinds that you've got from the – from the OE mix moving to XWB and Trent 7000, I assume that you're – you are assuming some unit cost reductions on a continuing basis? Is that the case and how do those unit cost reductions compare to your, let's say, track record over the last five or ten years.

Second question, we've focused very much on Civil but are you looking for margin delta in the other businesses as well when you're looking into medium term and is there any – are there any big features in terms of where you expect that to come from?

And then, final point, you talk about OE flattening off in 2018 but that's very early in the ramp-up of A350. The 787 is still supposed to go from ten to 14 rate and Neo will only have just – A330 Neo will only just have entered service. So I'm wondering – that doesn't seem to accord with the way the airframers see it, so I'm wondering where this outlook is coming from. Thank you.

Mark Morris: Yeah. Let me try and answer the first two questions.

Unit cost: let's just be careful that we talk about all the costs that we look at; it's not just unit costs. Of course we expect to make progress on unit cost, we've got about 600 engineers at the moment working purely on unit cost reductions and generally we know we have very good payback on those and of course while you have to make an investment up front, on average we see an IRR in many cases in excess of sort of 40% and payback in sort of – within two to three years. But just as importantly, when we talk about product costs, about half of it is unit costs and half of it is what we refer to as life-cycle costs, which is the aftermarket: improving reliability, being clever about the work-scopes, sweating the asset, using serviceable-used material and basically ensuring that we utilise all of the remaining life on our parts more efficiently. And there's a lot that we can do there and much of the improvements that we're seeing in our cost is all about being much cleverer and smarter around how we put work-scopes, how we drive up grades and things that are keeping engines on-wing for longer.

So there's two elements to that part, as well as, obviously, what I'll call the other stuff around efficiency of the fixed overhead in terms of better utilisation of factories, keeping control in place on C&A and so forth. So all of those – and again, we said right up front of this conference call that we are going to go hell for leather on the cost side, fix the things and control our costs, which are the things that we can control when we have a less certain revenue environment, given the market conditions at the moment. But the fundamentals are good, so on unit costs I think we're confident we'll continue to make way.

Your, then, second question was switching from Civil to our other businesses. Of course they are no exemption, we are looking to take the same sorts of costs and make improvements there. So we're expecting margin improvements in those businesses and some of that will come from the integration as we start to move power systems in Marine and exploit the opportunities we've got there for both revenue and cost synergies.

Now, your third question, I must admit, I didn't quite understand it, Nick. Can you just say it again?

Nick Cunningham: Yeah, sure the – you're saying that you expect OE volumes to level off in 2018, however 787 is still supposed to be ramping, A350 will be quite – you know, probably only half way through its ramp and A330 Neo only enters service in Q4 of '17, so one would – one would suspect Airbus would hope that their volumes would be going up, so –

Mark Morris: Yeah, I – yes, sorry Nick, just to make – of course when we talk about OE deliveries we don't make, in general, distinction in descriptors between value and the unit. You've got – within our Civil business you've got all our corporate and regional sector as well; so you've got maturing products in some areas that have, you know, volume that is retiring and you've got volume that is increasing. So that's reflecting currently where we see our OE levelling off at the moment. And that reflects, obviously, the Trent 700 which will be retiring and slowing down as the 7000 starts to ramp up.

Nick Cunningham: Okay and so the implication would be that, say, the Tays go because Gulfstream's moving on and the VR's –

Mark Morris: Correct.

Nick Cunningham: – forward in volume? Right, okay, thank you. Thank you very much.

Operator: Our next question is from the line of Olivier Brochet of Credit Suisse. Please go ahead with your line is open.

Olivier Brochet: Thank you very much. Good morning gentlemen, I have two questions. The first one is to ask you how comfortable you are that current trading will not lead to further cuts to your 2015 view. And basically the idea is: what assumptions have been baked in there, in terms of the main drivers you look at, like, for instance, oil price? That's the first one.

And on – the second one is: how – you sound confident that Siemens does not walk away from the Energy deal. How confident are you that the price conditions will not change to reflect the current trading that you've disclosed today and that the price is revised down?

Mark Morris: Okay, I'll answer the first question and John will take the second one.

So, on 2015, I mean clearly in laying out the guidance we've given, we've reflected our latest view of the markets and the underlying assumptions that would underpin that. I think it's not quite as pointed that, you know, you can just point to an oil price or a – or a point in GDP and sort of say, 'Well, if it moves by delta basis points, we need to revise it downwards,' because there's always a lead lag on these things and whilst there are drivers, they are – and you know, the correlation may be positive, it's not 100%.

So I think what I would say is that we've thought long and hard about where we have order cover as we look at the business and again, some parts of our business have a higher order cover than others. Of course, we haven't got to the beginning of 2015; we're still three months to run in 2014 but this is our best view at the moment and again it's reflected – it's reflected a lowering from where we were previously: we said a resumption to growth and now of course we've given some guidance around those numbers of 2014 expected outturn.

So that's the first question. John, do you want to –

John Rishton: Yeah, I think the – I think the, you know – the point that Mark makes is exactly right, which is it's our best view and that's what we're trying to make sure you're clear on – our best views – and that's why we wanted to bring the update today ahead of where we – we planned to do it.

In terms of Siemens, we believe that we'll complete that transaction by the end of the year and the price is agreed. And you know, I know that in the short term there's ups and downs in any business; the purchase is really, for them, a long-term – a long-term – you know, based on a long-term outlook.

Olivier Brochet: So no risk there?

John Rishton: Well the price is agreed and we believe that we'll complete; we see no reason why we shan't – we shouldn't complete, really, by the end of this year.

Mark Morris: And we think, you know, Siemens will be a great owner for this business going forward.

Olivier Brochet: Thank you so much.

Operator: We now go to the line of David Perry at J.P. Morgan. Please go ahead, your line is open.

David Perry: Yes, morning gents. I've got a bunch of questions please. The first one is just your reluctance to give revenue guidance in 2018; I mean you knew you had 30% of your portfolio in short-cycle businesses back in May, nothing's changed there, so at that time you committed to give revenue and margin guidance and now you're saying you won't. Can I not push you and say: why not? And why not give us a range, at least?

Shall I give you all the questions at once or do you want to take that?

John Rishton: Give them all at once, David.

David Perry: Okay, well, Civil aero – sorry, Mark, at the very beginning of your speech I was sort of scrabbling to keep up with you and I wasn't quite sure – if you could just repeat the explanation you gave for why the Civil aero margin is better in '14; I wasn't quite sure I understood. And then if you could just tell me the sort of main things that would explain the 2% drop in '15, I'm still not sure I – I fully understand that?

And then my third question is, just to be absolutely clear – I know that a questioner asked it earlier, at the beginning – are you suggesting there could be restructuring charges below the line and – because that's something that you haven't done for, probably, a decade and what would be the scope – you know, or potential scope of those if that's what you were suggesting? Thank you.

John Rishton: Thanks – thanks David, let me take the first one. You're right, we said in June that we would provide some group revenue guidance and I have to say, as we stared at that, because of the challenges particularly associated with predicting the revenue on the shorter-cycle businesses related to economic recovery, my conclusion was that we were not going to provide anything that would be in anyway helpful to you because the range that we would provide would be very large and the provisos that we put on it probably wouldn't – wouldn't – wouldn't help.

So that was – that was my decision. We probably got a little bit ahead of ourselves, on reflection, in June in terms of committing to do that, for which I apologise. But I genuinely don't think it's something that would – we can provide anything that's going to help you – help you with – because of the variabilities around the economic environment. So what we try to do is to provide a level of help around the other areas and in particular around the civil, where we've tried to give as much as we – as we can in [inaudible], so the events that tie to that. It's much more difficult to do that, as I'm sure you – you will understand. That's really why we haven't – why we haven't done it.

Mark Morris: Okay, so if I pick up your next three questions, David – Civil aero – and I think you wanted me to explain the sort of flattering of margin in 2014 versus where we may head back to in 2015 being sort of more to normal levels.

So, again, this comes back a little bit to the stuff we went over in the TCA presentation in June and if you recall, when we do TotalCare contracts and look at any particular contracts, or indeed contracts, but mainly programme over time we get experience as to what the cost and maintenance schedules of those engines are. And obviously the more evidence we get – and of course we're not just standing still, we're looking to make improvements, be it through cost reduction, improving reliability and time on wing and so forth. And when we get to a point where we are confident that it meets all the required gates and hurdle process that we've – we're sufficiently confident that we've captured that and going forward we will have a lower cost of accrual, effectively, or lower cost rates going forward; we need to make an adjustment in terms of the margin that we take. And again, if you remember how the contracts work, in effect what we're doing is we're balancing out the margins between OE and aftermarkets and if we think we're going to make a margin of x, but actually when we look at our cost base it's got – it's improved and now we're going to make a margin of y, which is higher than x, then of course we need to collect that difference on all the previous years that we would have collected if we would have been bang on it, day one. But again this is a sort of – it's a bit like a pension fund: as you get more actuarial experiences, you make fine adjustments as you're going through.

So we get – so this is an economic benefit, so going forward we're forecasting lower costs through improved reliability. So we get the benefit in-year, we'll also get the benefit next year but, importantly, we have to look backwards over the previous years and say, 'Right, now we need to make an adjustment,' so we call that a – we pull the – we call that a catch-up and we take it in the year that we recognise it. So that gives you a sort of – a benefit bump in the year that doesn't then repeat because you only get the catch up once, effectively, unless there's another round of improvements and then of course you'd get it again.

You're probably going to ask me, 'Well, what is that for 2014?' I'm not going to give you the number today because, first of all, we haven't concluded the usual process that we go through, we just know that it's coming and of course we've got the full year to run before we can lock down the numbers. But that's the main reason as to why we've got the flattering in '14 and we'll return to more usual levels for '15, along with a reversal of R&D capitalisation. And again, if you remember, this is another one of these tools that creates a bit of accounting P&L volatility, which is, when you're capitalising it effectively embellishes your profit and the moment you stop capitalising you go straight back to expensing and you carry the amortisation with it and that switches it the other way round so you automatically get a headwind.

So those are the two main driving features why you see that return to margins over the last few years that we've seen. So I think that covers two and three and I think your question four was about restructuring and would it be below the line.

So, let me just sort of step back. So, first of all, restructuring is restructuring and we can debate whether it's above or below the line. That's really driven by a set of clear accounting rules and what's defined – whether it's above or below the line; how you choose to interpret it is obviously up to you. What we've said is that we're looking at additional restructuring as we seek to rationalise and control our costs and when we're ready, later this year, we will – we will come back and tell you what they are and whether it's below or above the line, effectively.

David Perry: Good, but just to be clear then: it is not in the guidance?

Mark Morris: It is not in the guidance, no.

David Perry: Okay, thank you.

Operator: Our next question is from the line of Christian Sasson[?] of Exane. Please go ahead with your question, your line is open.

Christian Sasson[?]: Yes, thank you very much for the [inaudible] and good morning gentlemen. A couple of follow-up questions on the life-cycle cost improvement on your Civil businesses – I would like just to understand, without having a total number, can you tell us, on the 2014 improvement that you are seeing today – both what you had in H1 and the further one you are now seeing today – how much is recurring improvement and how much is a catch-up effect on the revenues already booked on your TCA contracts?

And second, as I understand, the increase – or the additional improvement that you're booking, reflecting the progressive revision of your assumptions on all your Trent 700 contracts – so can you tell us how far you are in this – in this process and are there further contracts to be revisited next year that could drive further life-cycle cost improvements [inaudible]?

Mark Morris: Okay, I mean, like I said to David – or the – or one of the previous questions that we had – I'm not going to break out at the moment what the catch-up adjustment is. When we've got the full year and we've got the numbers and we get to prelims, we'll highlight what that is. Generally, as a sort of rule of thumb, it really depends where we are on these programmes. Normally, when we look at any uptake, including the up-year, typically about a third will be the in-year and two-thirds – but it really where we are – where we are in the processes; that's just currently where we are but – so –

Christian Sasson: Sorry, [inaudible].

John Rishton: But it – that – it depends on the nature of the cost reduction as well.

Mark Morris: It does.

John Rishton: So there's no – I [inaudible] –

Mark Morris: So what I think it says – you know, when we get to year-end, then we'll have where – you know, where we are.

Christian Sasson: Okay and the assumption of having further life-cycle cost improvements going forward – is that a possibility or are you doing another process?

John Rishton: Yeah, [inaudible] absolutely – look, as Mark has said, we've got 600 engineers working on cost reduction and we're looking to how we can extend the life on wing of our products, which is obviously what our customers would like and what we would like as well. So we've been pretty successful on that, as you reminded everybody, in terms of the Trent 700 and we've talked about that – in fact Tony Wood talked about that a little bit in June. So we're seeing good progress on the Trent 700 during the course of – course of this year, we continue to work on that all the time and we have a – you know, all of these engineers that are – are helping us to do that. But as you also know, it isn't a – it isn't a linear thing; these things take time, energy and effort and we need to make sure that we're doing the right thing in right way all of the time. So it isn't possible to say, 'Well, we're getting [inaudible] more next year and the year after,' what it is is we continue to work to improve the life on wing; we continue to improve the life of life-limited parts so that we extend the life on wing; we continue to look at how we repair, rather than replace, parts; we continue to look at how we can use serviceable material; etc., etc. And that's just ongoing, Christian, all the time.

So, you know, one of the earlier questions was around, you know, driving further cost savings in this area and clearly that's important to us. Someone was asking about unit cost reductions and Mark was saying, you know, that's exactly what we're trying to do. And I guess what I would say is, based on – you know, on the level of improvement that we've had this year, you know, certainly we have got increasing confidence about our ability to drive these cost savings. You know, I think one of the – one of the realities – and we've talked about this a couple of time on calls in the past – is the progress that we've made across the group, in terms of cost, has been variable. So you're all aware that, you know, Defence has made good progress on cost, so I think there was some level of surprise when we announced that the revenue and the profits would be down by similar percentages this year, which clearly meant that the margin was unchanged, which clearly meant we'd done a lot of work on costs on Defence. So the Defence business has done a lot of good stuff on cost, so we've made progress there.

We've made less progress in the past on the Civil side and the Marine side. What I'm encouraged to see is we've started to make more progress in those areas and certainly on Tuesday we'll talk a little bit more about that in Marine. My suspicion is that, with the outlook – not my suspicion, my knowledge is that with the outlook that we've got now, in terms of the economic environment, that will really capture everyone's attention and we'll probably – I'll have more momentum, in terms of cost reduction, than I have done in the past. So what I – what I've been saying is – and why I'm confident we can accelerate cost reduction in total across the business is that because of the deterioration in the economic environment I – you know, everyone kind of gets that and understands that and therefore the urgency and the need to see ways to change what we do and how we do it becomes apparent to everybody, therefore we'll make good progress as opposed to where we've been in the past where we've seen mixed progress.

So, for me, we're going to have accelerated cost reduction in the future as a consequence of the confidence that we're creating across the business with the successes that we've had to date and as a consequence of the deteriorated economic environment in the short term, which brings this into even sharper focus and makes it more obvious to everybody. So I think that there's a whole – you know, that's the good news as far as I'm concerned about this. That's the area that I and we can control and we're really going to get attention onto that as a consequence of those things: improving levels of confidence about the success we've had and the deterioration in the economic environment, which is really making people clear on the urgency and the need for this.

Christian Sasson: So do we just – sorry, to be totally clear – does that mean that your total portfolio of Trent 700 contracts has been currently revisited under your current assumption for maintenance costs for these and any improvement will come from new cost savings? Or does it mean you still have more Trent 700 contracts to analyse and to see whether you can recalculate your recurring profitability on this?

Mark Morris: Yeah, okay, just – I mean, it's not programme-specific, I mean of course we're looking at programmes where we can take cost out; it's an ongoing – I mean, as John's just alluded to, it's ongoing. We only make those adjustments when we are confident that we've gone through all our processes, that we can deliver and we've got some experience and track record that supports it. And of course that doesn't happen, sort of, every time. You know, when we get it we see a step down in terms of the costs that we've got and we're confident about it, then we'll recognise it.

So, yes, of course, we expect and we continue to focus that we'll continue to drive cost out of all of our products, including the Trent 700, as we go forward. It's not just about at what point do we decide we want to – think we feel confident we can just – you know, there has to be the underlying backing and supporting evidence behind that that says, 'Yes, we've got the improved reliability, we've got the improved costs, the upgrades are improving reliability,' etc., etc. But it's across all our programmes and the Trent 700 is no exception.

Christian Sasson: Okay, thank you guys.

Operator: We now go over to Harry Breach again at Westhouse Securities. Please go ahead with your question, your line is open.

Harry Breach: Guys, just two quick ones: Mark, you said earlier Civil aerospace revenue this year, 2014, the range maintained at 2–5% but I think you then said it maybe towards the lower end of that range. Can you just clarify is that just due to the cumulative impact of currency this year? Is there something else going on?

And then just secondly, just on – on TNM spares flow that we've seen in the third quarter and going into the fourth; is that what you'd expected six months ago or is the sort of – the demand pattern, the flow rates have changed negatively?

Mark Morris: Yeah, look – so, not to do with currency effects; it's constant FX. This is more to do – I mean the trading range is just the basic ebb and flow that we have, that we can't land on a sixpence. And that – you know, let's not forget we're talking about large, expensive pieces of capital goods here. Some might deliver before the end and some might not deliver before the year-end and some might deliver before the year-end but we don't get paid for them until slightly after the year-end. So there's always some balancing movements that we've got that we need to understand. So that's just what I would call sort of wiggle room in terms of the RECs – that we can't predict to the dollar or the pound exactly what it's going to be. But there is nothing – I mean, like I said, there's been some softening but there's nothing specific that would take us out of our guided range. So, you know, I guess that's the comment.

Sorry, your question two – I've completely forgotten what it was.

Harry Breach: Sorry Mark – question two was just to understand, in the time and materials, spares revenue stream, is it sort of following the trajectory that you would have expected sort of three, six, nine months, maybe – beginning of the year sort of trajectory, particularly the – you know, RB211524 coming down being maybe the dominant influence this year? Or has that sort of trajectory, as we've gone through the last quarter – has it deteriorated in the time, materials, spares side?

Mark Morris: Yeah, no, generally its performed as we've said. I mean, I think we – we highlighted at H1 we saw a – a bigger reduction in RB211s, but actually for H2 it's performing pretty much as planned.

Harry Breach: That's very reassuring. Thank you very much, Mark. Thanks John.

Operator: We now go back to David Perry at J.P Morgan. Please go ahead, your line is open.

David Perry: Yes, thanks for taking another call. So, two questions – the first one you may be reluctant to answer but I'll try – in 2018 in Civil aero, could you just tell us what you're assuming your payment out of IAE will be, in terms of the royalties you're getting?

And the second one was just: your guidance implies another record high in 2014 for Defence margins – clearly above 17% – I just wondered if you could give your view of what may happen in 2015 there? Thank you.

Mark Morris: Okay, well you're right: I'm not going to answer the question one. First of all, I haven't looked out that far on that particular piece just to tell you what it would be, even if I was prepared to tell you that. I mean, like I said before, the – on the B20-500, that continues for many years to come on the royalty and obviously the OE piece will steadily slow down as the new Neo comes in and I don't think there's any surprises about that, but I'm not going to get into breaking out on that.

On Defence, look – I think, as John said, look Defence – you know, austere times in terms of governmental expenditure on defence budgets; business, I think, has done well in terms of keeping its costs under control and maintaining its margins on the lower revenues compared to last year. I think, as we've said before, we continue to expect some downward pressure on defence margins – probably, you know, to around the mid-teens, I think – but I'm not going to get drawn into '15 at this stage as to exactly what the margins will be, other than to say that, you know, the Defence business is working hard to maintain its margins and take cost out and we've got good evidence of that when we look at both what we've seen last year and this year.

David Perry: Okay. Thank you.

John Rishton: Thanks David. I'm going – I'm going to wrap the call up now, as we are just about at 09.00 and we said we would go for 09.00. Look, I really appreciate everyone joined the call this morning at such short notice. We are working hard – and at times, I'm sure, it doesn't seem that way – to provide you with our best views on the outlook for the future in a way that we hope you will find helpful.

I recognise that we are at the start of that journey, not at the end of it and I recognise that at times we are inevitably going to appear slightly defensive whilst we're not even trying to and I – you know, I apologise for that. We are in a transition period here between providing only in-year guidance – and we're now trying to provide guidance in-year, following-year and for the medium term. And whilst that may seem a straightforward exercise, it clearly isn't as straightforward when you get into it as – as maybe it first appears.

So we are working as hard as we can, really, to try to provide the information that is helpful to you and our investors in a way that is helpful to and investors and at a time that is helpful for you and our investors. I am sure that you would all like more; I am sure that you would all want more details but we are working hard on this. So, thank you again for joining us.

Operator: This –

John Rishton: I'm just going – I'm just going to repeat what I said at the start, which is: the fundamentals of the business are unchanged. We know that there'll be growth in the medium term and we know that the drivers behind that are sound; the growth in the air travel and the growth in the demand for energy. And that means that the strategy's unchanged because the medium-term outlook is unchanged because the fundamentals are unchanged. And whilst we're going to have a bumpier time in the short term, that doesn't change those fundamentals.

Now, because we've had a call this morning, we will not be having a call on Monday morning, but we will have a session on Monday evening up in Norway that Mark and I will host which will be WebExed. We're looking forward to seeing you in Norway and Mark and I are looking forward to welcoming you there on Monday evening. On Tuesday we will have a complete day on Marine, which I hope you will all find very useful, helpful and the team are looking forward to hosting you. Bring your sea legs. Thanks very much for joining us this morning. We'll speak to you soon.

Operator: This now concludes the WebEx. Thank you all very much for attending. You may now disconnect.