Event: Rolls-Royce Holdings Plc Investor Presentation and Q&A

Date: 31.07.2014

Speakers: John Rishton and Mark Morris

Call Duration: 45:05

Conference Ref No: EV00007545

Operator: Hello, and welcome to the 2014 half-year results conference call for Rolls-Royce Holdings plc. Throughout this call, all participants will be in listen only mode, and afterwards there will be a question and answer session. Just to remind you, this conference call is being recorded, and before we start, some words about safe harbour. Please remember today's call will include some forward looking statements about the Rolls-Royce group and its businesses. These statements are based on the management team's current views and assumptions, but can of course change over time. So you should consider the statements in this light. Today, I'm 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 everyone, thanks for joining us today. It's good to have you listening in. I'm going to give you the headlines, and then I'm going to hand over to Mark who is going to take you through the details. Mark will speak for probably 15 minutes or so, and then we'll go straight to Q&A; we'll wrap the Q&A up no later than 08.25 and then I'll wrap the call up – at 09.25, sorry, I'll wrap the call up.

So, looking at the headlines. First of all, the first half's performance was in line with guidance, and we maintain our full year guidance, and continue to expect growth in 2015. We increased the shareholder payment by 5% to 9p, so I think, you know, off the key financials, we're where we said we would be. In terms of the first half, we delivered our first XWB engines to Airbus for Qatar Airlines', the launch customer, who'll launch later this year. We've run for the first time the larger XWB engine, the XWB 97k that will power the A350-1000 aircraft, and we've also run a Trent 1000-TEN engine for the 787.

And you'll also all be well aware that at Farnborough, Airbus announced the launch of the A330neo, and we are the exclusive engine provider with our Trent 7000 engine that draws on technology from the Trent 1000 and the Trent XWB engines. And I'm delighted that we already have 127 aircraft commitments, and that provides even more confidence about strong growth in the future.

I'll hand over to Mark, who is going to take you through the details of the first half, and our views about the second half. Thanks, Mark.

Mark Morris: Thank you, John, and good morning to you. So we'll start with some of the key group highlights in the first half. Let's just remind ourselves of what we said at the prelims. Revenue and profit for the group would be flat, with a similar free cash flow for the year, and that our performance would be weighted to the second half.

As John has said, our H1results are largely as we expected. As usual, my comments will be restricted to the underlying performance. Now, we will go through these results in a little more detail, but before we do it's worth mentioning foreign exchange, as the pound has appreciated against a number of currencies which has impacted our results. You can find a lot more detail in our press release, but across all our currencies, the strengthening pound has reduced revenue by £226 million, and profit by £21 million.

Turning to our order book, it remains strong and provides good visibility at over £70 billion, although a slight reduction from the year-end. Revenue and profit I will come onto shortly. On cash, we started the year with £1.9 billion, and ended the period with £1.2 billion, a reduction of £762 million which reflects growth in working capital, continued investment, and shareholder payments. And finally, we've increased the half-year payment to shareholders by 5% to 9p, reflecting our continued confidence in the business.

Let's take a look now at group revenue. I've broken down here the three main components of the change in revenue. Original equipment is down around £200 million, driven predominantly by our Defence and Marine businesses. Defence is down 40%, and Marine is down 15%, mainly in Offshore and Merchant. This was partially offset by OE growth in Civil. Services were also down £57 million, with reductions in every business except Defence, which saw good growth of 9%, and finally FX, which I've mentioned already. As we look ahead to the second half, we're looking at around 20% increase in revenue, from both higher OE deliveries, and a higher run rate on services, and we'll come back to this later on.

Turning to group profit. Volume was down 4% at constant FX, and that's reduced operating profit by £89 million. You're aware of the Marine one-off charge, relating to a product quality issue. R&D is 36 million higher, reflecting increased spend in Civil programs, and lower capitalisation as the XWB 84k approaches entry into service. With the other trading, we see the benefit of C&A, as a result of indirect headcount reductions made last year, some trading mix impact and aftermarket life-cycle cost improvements in Aerospace. Restructuring spend was £67 million in the first half, which is a £32 million increase over last year, as we continue to improve operational efficiency and reduce both direct and indirect costs. These costs are mainly severance costs and site restructuring.

Turning to cash flow. As usual, I'll just pick out the major themes in this chart that you're all familiar with. Net Working Capital increased by £634 million, which is about a 200 million low – which is a £200 million lower increase than we saw in the first half of 2013. This reflects higher inventory of £195 million, as we prepare for the increase in H2 volumes. The TotalCare net debtor has increased £165 million, reflecting the sale of engines with linked aftermarket contracts, mainly Trent 700. Deposits were also lower in Defence and Marine, reflecting deliveries in the period.

Cash outflow on capex was £303 million, up £20 million on last year, as we continue to invest in capacity and capability. Intangibles at £239 million primarily includes £40 million of software, £28 million of Contractual Aftermarket Rights –formerly known as 'Recoverable Engine Costs', and again mainly Trent 1000 – £91 million of the participation payments on Civil programs, and £57 million of capitalised development costs. Pensions and tax comprises £109 million of tax, and £80 million of pensions contributions. Which brings us to a free cash outflow of £432 million, which is better than guided. Cash continues to remain an area for significant focus. We continue to expect free cash flow to be similar to 2013.

So now we're going to take a look at each of the businesses. The following figures and commentary in this section reflect the underlying performance at constant foreign exchange, unless otherwise indicated.

In Civil Aerospace, whilst the number of engine deliveries was down 1% in the period, OE revenue grew 5%, reflecting 16% higher Trent deliveries, partially offset by 10% lower business jet engine deliveries. Services were down £38 million, and there are a number of moving parts here. On RB211s, we're seeing a combination of lower utilisation as aircraft are converted to freighters, and more retrials. Revenue is down about £70 million, and we expect an overall reduction in RB211 revenue of about 25% for the full year.

Life Limited Parts were also down, also known as LLPs. LLPs are high value parts, and many of them are not covered by TotalCare, so we get this as incremental T&M revenue at the shop visit. As mentioned at the recent investor briefing, we continue to improve the reliability of our engines, which increases the time on-wing, and delays the overhaul. This improves overall margins, but delays the LLP sale, creating a short-term timing issue. This was particularly relevant to the Trent 700 in the period, with a number of shop visits deferred. Importantly, our wide-body LTSA revenue continues to grow, and is up 9%.

On profit, we're seeing a small benefit from volume, with the majority of the trading improvement coming from better life cycle costs and lower C&A. As guided, the R&D charge was higher, as a result of higher spend and lower capitalisation.

Looking to the second half, we expect higher OE deliveries – particularly Trent engines – supported by 95% order cover. We have a 100% order cover from stored engines, and a few open orders for spare engines. Better aftermarket driven by higher LLP sales and higher T&M, further cost reduction benefits, particularly in the after-market, and lower restructuring costs.

Turning to our Defence Aerospace business. On revenue, we've seen a 40% decline in OE, mainly on engines to power the Typhoon, Hawk, C130J and V22. Services increased 9%, with growth from the list system as it enters service, and continued to mark demand for parts and services from our large installed base of 16,000 engines.

Turning to profit, with trading – within trading we see the impacts of Defence having done a good job taking cost out of the business, and this will continue. Defence reduced headcount by 900 since the year end; we've also made good progress on life-cycle cost reduction. Margins also benefited from higher aftermarket sales, which were 62% of Defence's revenue in H1, up from 47% this time a year ago. This proportion will be lower in H2, as OE deliveries increase, particularly on the TP400 and the LiftFan system. So we'll see some downward pressure in the second half, but in line with guidance.

So, moving onto our Marine business. We've had a challenging first half in Marine. OE revenue was down off the back of lower order intake in 2013, mainly in Offshore, and we had a disappointing performance in services, which is down 9%. Some of this was down to deferrals, and vessel utilisation was also down. On profit, in addition to the negative impact of volume, we also booked the £30 million product quality charge in H1.

Looking to the second half, we've reduced our services outlook, based on the lower run rates we've been experiencing, but this has been offset by a higher order intake of OE. We have 98% OE order cover, so our confidence there is good, and our guidance reflects a mixed shift towards OE. That's why our revenue guidance is stable, but we have reduced our profit guidance. We are making progress on cost reduction in Marine, but it's been slower than we would have liked, so that's also reduced our expectations for full year profitability. Consequently our full year guidance has been reduced downwards for a 15-25% reduction in profit prior to the £30 million one-off. This now makes it consistent with the way we have framed group guidance.

Next, let's take a look at our Nuclear & Energy business. OE revenue was higher as we completed several major programmes. We had higher deliveries in Oil & Gas and nuclear Subs. Aftermarket revenue was down 5%, largely driven by reductions in our Oil & Gas business. Profits were lower, driven by adverse mix between OE and services. The small trading benefit includes some product cost reduction and C&A improvements, offset by £10 million charge in the first half to resolve contractual close issues.

In the second half, we expect higher OE and aftermarket sales, in line with traditional phasing. On OE, we are at 73% order cover. Aftermarket is an area where we have less visibility. We have about half of this covered on the Energy side and about 85% coverage on the Nuclear side. As you know, we've announced the sale of the gas turbine compressor business to Siemens. We are making good progress but there is a lot of work to do to prepare the business for separation. We expect this to close around the year end so our guidance still assumes full-year contribution from this business. Following the sale, the retained business will represent around 40% of underlying revenue and profit.

And finally our Power Systems business. Power Systems have a similar first half to last year, with OE sales up 5% and aftermarket sales down 6%. Naval and defence sales were higher, while oil and gas and power plant sales were lower. Profits were lower in the fast half due to a small mix effect and higher restructuring costs. Looking to the second half, we expect higher OE deliveries, particularly coming from higher sales in oil and gas mining and power generation, supported by 80% order cover. Better aftermarket reflecting the traditional second half waiting to spares and firm orders from naval and defence customers, and cost reduction benefits and lower restructuring costs.

Turning to financial strength. As you know we continue to place considerable importance on maintaining investment grade rating and strong liquidity. There's been no change to our credit rating during the period.

Now, turning to the guidance. Group guidance is maintained; excluding foreign exchange translation effects and the one-off charge in Marine, we expect revenue and profits to be flat for the full year, with free cash flow similar to 2013. The impact of foreign exchange at current rates will be around £500 million on revenue and £70 million on profit. It's worth mentioning the EPS impact from our purchase of the remaining 50% of Power Systems, which we expect to complete towards the end of the year.

Daimler relinquished its economic interest on 25th March, when it exercised its put option. Underlying earnings per share includes 100% of Power Systems profits from that date. In the first half, this improved the underlying EPS by just under 1p.

Turning to segment guidance. As I said at our recent investor day, we will provide a new format for guidance that gives ranges for revenue and profit. Segmental guidance is maintained expect for Marine profit, which we have lowered as mentioned earlier. The change in Marine profit will be compensated at the group level by improvements in the other businesses.

So some final thoughts to leave you with. Our H1 results are as expected. We continue to make progress on the 4Cs, with more to do. The reasons we're confident about a much better second half are: a high order OE cover; higher OE services – higher OE and services volumes, that we see across every business. Traditional second-half weighting and further benefits from cost reduction. Finally, shareholder payments are up 5% to 9p, reflecting the continued confidence we have in the business.

With that, I'll turn over to Q&A.

Operator: Thank you. Ladies and gentlemen, if you wish to ask a question could you please press 01 on your phone keypad now in order to enter the queue. After I announce you, simply ask your question. If you find that question has been answered before it's your turn to speak, just press 02 to cancel. And there'll be a brief pause while questions are being registered.

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

Robert Stallard: Yeah, great, thanks very much. Good morning. First of all I wonder if we could start with the Aerospace aftermarket on the RB211 and these other Life Limited Parts. What gives you the confidence that these will recover or stabilise in the second half?

Mark Morris: Well – thank you, Robert. I suspected this would be a question. Some of it is just phasing: so we know when we look going forward we have a higher number of shop visits scheduled, and that's why we have the confidence and the impact from both if about 50/50 from LLP sales and the RB211 revenue.

Robert Stallard: And I was wondering if you could you also give us, what the Trent aftermarket on TotalCare did in the first half in terms of revenues.

Mark Morris: Well we don't break them down by various programs but the Trent wide-bodies generally continue to grow reflecting the growing installed base.

Robert Stallard: Okay. That's it from me. Thanks very much.

Mark Morris: Okay, Robert, thank you.

Operator: Our next question's from the line of Christian Laughlin of Bernstein. Please go ahead with your question; your line is open.

Christian Laughlin: Good morning, gentlemen, thank you for taking my question. Just one question or a couple questions, Trent 7000. If you could just provide some additional detail on the amount of incremental R&D spend in phasing for the engine – my understanding is it's on the order of £200-300 million or so. I'd just like to understand how that's overlays from – I guess the spend begins in 2014 though EIS in 2017.

And then also as a kind of corollary to that, if can you give any colour on some of this R&D spend diverted from other planned work in the future – in other words, it's not truly incremental beyond what was already in your R&D budget plans or outlook for several years.

Mark Morris: Okay, so first question, at a high level: it's not incremental to our R&D plans. If you think about how R&D operates, it's predominantly people and it's a question – you know, we have a finite number of people that are working to consume the bulk of what our R&D spend is. As we go forward obviously to the extent there's no programmes, what would happen is obviously we free up, obviously, load or capacity in terms of what we can do.

So this has been factored in the bounds of our affordable R&D. It's worth saying that this is not a completely new centre-line engine; we're taking a lot of Trent 1000 architecture. And as you rightly said, we've said that R&D will be around 200-300 million between now and EIS and very little capex other than for tooling. So we're looking in the tens of millions for that. And again, that's factored to our guidance both for next year and for this year.

Christian Laughlin: Okay, that's helpful. 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, a few questions, please. Just the first one on the – the level of confidence, I suppose, and what gives you that confidence over the recovery, specifically in the industrial businesses where Marine and Power Systems have both got a lot to do in the second half. I know you stepped through some of the drivers of that, but just still struggling to understand what gives us that scale of H2 weighting in those businesses this year.

The second question was, on the specific guidance – and thank you for the increased clarity at the division-by-division level. Obviously I don't know what your old growth rates were, in terms of the profit growth; we only have the old language to refer to. But I'm just struggling to see – the cut that you've made to your Marine profit guidance – what else has gone up significantly on the other side to counterbalance once that? I'm struggling a little to see that, but I'm cross referencing percentages with language before, so you have the privilege of more information.

And a third question, I know you're no longer what the IAE benefit was, but are you able to share, even if not the absolute number, just the directionality of that IAE benefit in the first half of this year from the – the earn out payment?

John Rishton: Thanks, Ben, thanks for your questions. When I talk about the first couple and maybe ask Mark to talk about IAE. In terms of confidence, I think what Mark has outlined, I think, in more detail in his presentation, we would historically have given – we are trying to help as much as we can, we've heard very clearly the comments that have been made about providing more information, and it clearly revolves around two things. Which is the OE order cover, which as Mark has said is strong in both Marine and Industrial Power, and in those businesses where the waiting is in terms of services cover. And we've got varying levels of services cover. So stronger in naval, less so in Rolls-Royce Power Systems.

If you were to look at the weighting, for example, between last year and first half and second half for Rolls-Royce Power Systems, you would see a not dissimilar pattern; so this isn't something that is exceptional or particularly unusual. I think that what I would say is – is that we have really gone around again on the Marine services side because we were too optimistic in the first half on Marine services and have reassessed that position completely and we've actually got some additional people working in that area; we're addressing a number of aspects of that business to make sure that we can deliver on the services side.

So as we sit here today, we're pretty confident about that step up in the second half. In terms of the reduction in Marine, as Mark said, whilst it isn't very precisely clear to you, it's improvements across the other businesses that compensate for that within the guidance ranges that we've already issued. As it is across all of those businesses.

In terms of IAE – Mark this is a recurring question, I know, and I know that you are keen to answer this one.

Mark Morris: Yeah, look the short answer, Ben, is – look, we stopped giving the relative move from what I'd call old world to new world, just because it gets difficult; but the absolute contribution is not too dissimilar to H1; and just, trying to be clear, there is no sudden drop off of the V2500 business and as we look forward over our ten-year forecast it will continue to contribute to part of the portfolio for many years to come. So I think that's probably all I'll say on that at the moment.

John Rishton: Do you want to talk about the three sources of income that we've got there, Mark, and how they –?

Mark Morris: Yeah; yeah. I mean – I mean, Ben I think you probably know this already. I mean, there's sort of three sources of income that come from the V2500; there's the fact that we manufacture parts and assemble engines; we do overhauls and obviously sell spare parts; and then finally we continue to collect a number of dollars-per-engine flying hour that will go into – which will carry on every engine in service that will go for many more years to come.

Ben Fidler: Okay, thank you. And actually, did you expect any upside over your original expectations in the scale of that earn-out? It's just looking at some of your competitors who report numbers on the V2500 the aftermarket growth there has been probably stronger than we were expecting. Does that generate upside for you or is there a cap or limit as part of the agreement of the scale of that earn out with Pratts?

Mark Morris: No I think it's fair to say, and as we reflected actually over the last couple of years, we have seen better trading from V2500 and of course it's got a big installed base so we'll continue to see that coming.

Ben Fidler: Thank you.

Operator: The next question is from the line of Celine Fornaro of Bank of America Merrill Lynch. Please go ahead with your question. Your line is open.

Celine Fenaro: Yes, hi. Good morning everyone. I have two questions if I may. The first one would be just to clarify on the division of guidance which you now provide and the trends there on the revenues and profit. Does that include the FX, or are those guidances based on the current spot rates really for the year?

And my second question would be, if you can comment your progress on the cash. You seem to be fairly pleased with that although it's still down compared to last year, you know by £100million, and if you could comment on your inventory turns especially on the aerospace business but also the industrial businesses. And if we – and how do we think about that into H2 as you're going to start to ramp up again for next year – so how do we think about the inventory turns then? Thank you.

John Rishton: Okay, why don't I get Mark just to comment on the FX and the guidance first of all and we'll talk – I'll talk a little bit about cash?

Mark Morris: Okay, so Celine, just to be clear, the guidance that we are giving and have given is what we refer to as being a constant FX so it's at the same level as 2013 FX; and in the press release and as I've also provided in the presentation, the impact of the current effect of average rates for the year if they were to stay exactly the same – of course we've no idea whether they will or not – it will impact revenue adversely by £500 million and profits by about £70 million, which obviously has sort of gone up a little bit from where we were at Q1. And that's purely the movements in average exchange rates on the translation FX as we call it.

John Rishton: In terms of cash and, specifically, inventory turns, what we've seen in the first half is an improvement in terms – turns compared to the same period last year, from 2.8 turns to – sorry from – yes from 2.8 turns to 3.2 turns. So that's a good improvement. Now it's slightly more complicated and I'll just explain a couple of things. First of all that is down from year end when it was 3.4 turns; as Mark has explained, that's been one of the reasons for the – some of the cash outflow talked about the increase in working capital. But it's an improvement compared to the same period last year.

So at year end we said we'd improved by 0.4 turns to 3.4 turns, which was good improvement. The improvement of 0.4 turns versus the same period last year is true for the half year but it's now down at 3.2. So we're making good progress against the same time period as last year which reflects the same kinds of movements in the working capital flows so we're expecting improvements again in the full year in terms of inventory turns.

Now, the only other point that I would make, and this is one that I do want to make sure that we're clear on, is that those turns exclude at the moment Rolls-Royce Power Systems, but we will include those when I next talk to you, and I'll tell you what those numbers are. In detail, the Power Systems numbers turns are lower because of the nature of the business and the way that they carry particularly service parts and they're in the low twos. They have been fairly flat year on year but we'll bring those to your attention at the end of this year – I'll make sure I'll bring those. But in terms of the numbers that we've talked about in the past, we've seen, you know, a good improvement in turns in the course of the year.

Celine Fornaro: But, John – thanks for the answer, but just to follow up on this – is it that the H1 you actually were expecting to make a little bit maybe of progress, you know, compare to the year end? Or it was half planned, you know, all in line? And also if you could give just a little bit more colour on the inventory turns; what was the division that maybe, you know, continued to do better or improved or, you know, disappointed and, you know, how is aerospace tracking in that? Or Marine? Thank you.

John Rishton: Okay, yes sure. It was – actually the turn rate was better than we – sorry, better than we expected, we made more progress than we expected and again this is where it gets slightly – I could make it more complicated, but we'll make it simple. The answer is, it's better than we expected. The primary improvements that we've seen have been in Civil, particularly Civil Large Engines, so we've seen good improvements – good improvements across the board but particularly in Civil and Civil Large. And one of the ways that we've been doing that, of course, is we've been rebalancing the total inventory position, and one of the drags that I've currently got is that increased some of the burden allocation costs and my fixed costs as I reduce production to take out inventory to drive turns, which is something I talked about a little bit about at the investor day.

Operator: Okay. Our next question is – sorry. Our next question is from the line of Harry Breach at Westhouse Securities. Please go ahead. Your line is open.

Harry Breach: Morning John, Mark and everybody. I've got four fairly brief questions. I'll start with the simple, more numeric ones if I can. Firstly, just in the first half, could you give us the percentage of Civil Aerospace aftermarket revenues from TCAs? I think it's probably somewhere in the low 70s. Second one: in the past you've commented on the movement in a period on the achieved rate.

Perhaps there wasn't any movement in the first half of 2013, but could you just give us some indication of that, both for the first half and what you expect for the full year this year? Third question: the dividend increase looks like the lowest since 2009 but hopefully the outlook's a bit brighter since then. Can you just help us to understand how you're thinking about the, sort of, pacing of dividend growth? And the last question is about Marine. Can you give us – two things really – firstly: a little bit more colour about the quality issue? Historically, thinking back to times with Mermaid and I believe other issues, these things have occurred and they weren't just entirely one offs. It would be great if you could give us some reassurance and confidence about what happened and the fix. And the other thing is about services; can you give us some sense about why things have fallen down? When I look at day rates for offshore vessels I can't see collapsing numbers there. Can you give us a feeling about why the services part of Marine has come so short this year and how you're feeling about it going forward? Thank you.

John Rishton: Yes, sure. Mark, why don't you take the first – the numbers questions, the first three, maybe, and I'll talk a little bit about Marine?

Mark Morris: Certainly, John. Okay. Morning, Harry. Right, Civil Aerospace TotalCare revenues first half of total aftermarket revenues was 72%. That's a nice, easy one to get out.

Harry Breach: Thank you.

Mark Morris: Achieved rates – so this is transactional exposure – very little movement and for the full year, again, pretty – very negligible movement on achieved rate from 2013 to 2014.

Harry Breach: Thank you.

Mark Morris: Sorry, and then sorry – third question here we are. Dividend – yeah, look – I mean, you were aware, and as I said at the investor day, that our dividend policy is really a progressive policy that moves broadly in line with earnings growth. I mean, mechanically from that you could infer that we should have no increase on the grounds that we've guided no growth for this year, but again, like we said, this is temporary. We expect to resume growth next year and that really reflects our confidence. And, clearly, we're confident about H2, and, obviously, when we get to the end year we can see, as the next staging post, what we'll do on dividends, really, so –

Harry Breach: Thank you.

John Rishton: Okay. I'll talk a little bit about Marine. I'm not going to get into the details of the specific product quality issue, but what I would say is a couple of things. First of all, this goes back quite a way and it's something that we've been investigating and trying to unravel for some time. Quality in Marine is something – as we do across the entire business – something that we measure and are focused on as part of our customer focus. So if you think about the – what we call the customer DNA, the very first item there is quality and delivery responsiveness and reliability, and I'm pleased to say that the way that we measure quality has improved across the business and across all parts of the business including Marine. So this is something that – it has – is historical and is something that we are working to fix and we will fix.

In terms of services, I think a couple of things. First of all, as with many parts of our business, it really depends on exactly what businesses you're in, what you've actually seen going on in any particular period. So you can talk about the Marine business as a broad business. You need to then go down into exactly what parts of the Marine business you're in and what's – and what's going on in them. So whilst, as you say, you haven't seen significant change in some of the vessel rates, we've seen reductions in utilisation of a number of vessels and we've continued to see that, and in some of our parts of business we've seen some reduction in rates as well. So, within the Naval business, for example, we've seen good services; that's been fine, that's been as predicted, but in Offshore we saw it coming down. Now, I would say that I think we were overly optimistic in our forecast, and that's part of it, when we started off the year, and part of it is what's going on in the market. And that's what we've been reassessing, and we've been reassessing that from what's happened, what we think's happened. We've also been getting some more expertise in this particular area, which I think will help us in – in the future.

Harry Breach: And, John, can I just take that a tiny stage further, what you're saying: do you think that for that offshore business, the services demand is something where rationally we might think about it coming back or rebounding next year or beyond? Are we kind of rebasing to a lower level of Offshore activity?

John Rishton: No, we're not rebasing to a lower level of offshore activity. As Mark said in his presentation, we've seen, actually, a higher order of intake for offshore in the first half which gives us more confidence about the second half, and we've actually – we actually believe, as Mark has said, that we're going to have more OE sales in the second half, which will eventually flow through into more services. So I think there will be some services uptake, and it's an area that we are spending more time on, as I say, getting more expertise on. I think I mentioned at one of the calls or maybe the investor day that we'd signed our first long-term service care agreement in the offshore market earlier this year with one of our main customers. That's a very – a very important step, a very big step, but a very small part of the business. So I think, as I look to the future, our increasing focus on services, both in terms of getting the service centres into the geographies that they need to be, in terms of building the organization behind that, and the structures and processes behind that, we've got more work to do but it is the right direction of travel, because the services business is and will be very important to us in the Marine business in the future; particularly, I think, in Offshore, because that's where our strength is.

Harry Breach: Thank you very much indeed, John and Mark.

Mark Morris: Thank you.

Operator: Our next question is from the line of Rami Myerson at Investec. Please go ahead. Your line is opening.

Rami Myerson: Hi, good morning, gentlemen. Two questions: a short one and a longer one. On – could you provide similar colour on the Rolls-Royce Power Systems on the trends in end markets and why you expect a pick-up in services, and in which markets in H2? And, just to clarify, because there has been some ambiguity in the past, in the statement you talk about growth in 2015; does that imply revenue and profit? Thank you.

John Rishton: Okay, so 2015, again, revenue and profit. We expect growth in the – in that year in both of those – both those areas. In terms of Rolls-Royce Power Systems, a couple of things: again, I think that their services has tended to be more in the second half than the first half, but again, it depends explicitly on the markets that we get into. So, they serve a wide variety of markets with different – different requirements in terms of servicing. What we saw is a weakness in oil and gas and mining in the first half which we think we'll strengthen in the second half for a variety of reasons. So we believe that the services will improve in that – in that business in the second half, 1) on the basis that that's what they've done in the past, and 2) because of the mix of the business that we see strengthening in the second half.

Rami Myerson: So you expect oil and gas and mining to pick up in H2?

John Rishton: Yeah. I think we'll see some strengthening in that, certainly in terms of the OE and also in terms of the servicing – the servicing part of those businesses.

Mark Morris: I mean, it's also worth saying that, generally, where we're dealing with governments and public sector bodies, we do see buying patterns growing in the last – last quarter as they look to spend their budgets so they reset at the same level, and that's generally – we see, always, a much higher uptick in Q4. As I said in the presentation, obviously we tend to get higher – we've got quite high order cover, actually, on Power Systems when we look at our naval and defence parts of the business as well. So that's why we have the confidence.

Rami Myerson: All right. Thank you.

Operator: Next question. Sorry, before we go onto our next question, if anyone has any questions at this stage, could you please press 0 and then 1 on your phone keypad now in order to enter the queue, and if you wish to retract that question, just press 0 and 2. And we now go to the line of Ben Fidler at Deutsche Bank. Please go ahead. Your line is open. Ben, your line may be on mute. If you want to unmute your line –

Ben Fidler: Yes, sorry. That always helps. Sorry to come back with another question. Just a quick follow-up, having read a little bit more in the statement now I've had some time. Still struggling, I suppose, to understand and drill down into some of the margin performance in Defence and also Civil Aerospace in the first half. And I know in the – you refer on both commercial Civil Aerospace and Defence to reduce maintenance costs on the Trent 700 and to improvement in some of your long-term service agreements in Defence. That – presumably, this led to some sort of cumulative catch-up type of profit effect, and I just wondered how significant that was, both within the Defence business and in the commercial business in the first half. Do you see those cumulative catch-up effects continuing in the second half?

Mark Morris: Ben, I'm – I was quite impressed when you said the 'cumulative catch-up'. Obviously the investor day has done its bit on highlighting. But, yes, there is an element, and, again, if you remember when I was talking about the fact that you would make an estimate about cost and as the reliability improves – and we've seen that happen in a number of our Defence and Civil engines – obviously we will release effectively margin as part of – and then obviously adjust the revenue as well. So the short answer is these things only ever arise when we come and do – two times a year when we do these full up reviews. Whilst we can forecast what we might think happen, only once we've gone through that process – because there's quite a few moving parts – so it's difficult to say. What we have done, though, is in our view in looking at where we're seeing our progress on cost and reliability, we do bake that in, and that's reflected in our overall guidance for the year for civil and defence. But, like I said, on defence there are a number of moving parts, which is why I said don't sort of – whilst we would love you to get used to 19% margins on defence, you know, we think longer term there's probably more like the mid-teens for defence.

Ben Fidler: Okay, thank you. And presumably those effects must have been – I don't know, how significant were those effects in the first half? Of significance or not materially?

Mark Morris: Of significance but not materially.

Ben Fidler: Okay. Thank you.

Operator: Our final question is from the line of Sandy Morris at Jefferies, and if you could please go ahead, your line is open.

Sandy Morris: Morning, everyone. Well, believe it or not, I have read the statement, and I have actually tried to listen to the answers to the question, and I'm still going to come back to Civil Aerospace, which is what I think Ben was asking about. I mean, it's funny, isn't it? When we get a good result, it worries us. Bluntly, the decline is due to restructuring in higher R&D. Then we have adverse mix, in theory, because we've got fewer corporate engines and more Trents, although Trents are linked, I guess. And, you know, I understand that there's a lot of variables washing through here, but my impression is that something must be going right in the business in the sense that the new facilities must be coming on-stream smoothly or something. And so, without wishing to go through, 'Did that go up or down a bit?' how are we feeling about the ramp-up, albeit we're still at a relatively early stage?

John Rishton: Thanks, Sandy. Yeah, your description is a good one. I think we're feeling very good about it, actually, Sandy. The new facilities that we're opening are opening – and I'm touching wood now – very smoothly. We're getting very good performance out of – out of all of them. So I think at the investor day I used the example of our new facility in Washington, where we've improved productivity by 50%, we're seeing 'right first time' pretty much all the time compared to the old facility where we weren't because of the nature of the facility and processes.

So we're seeing really good progress, but it's not just the new facilities that are really starting to improve; we're seeing the benefits starting to flow through from the focus that we're putting on and the team have put on manufacturing processing capabilities. So as an example, this morning, this is sort of an embarrassing example in many ways, at Barnoldswick, which is one of our oldest facilities, we have for the first time in one of the areas of production eliminated all of the arrears. So arrears are things that, you know, we're supposed to have produced and we haven't, and we're behind time, and that's one of the things that affects our production rate. So for the first time in the history of the plant we have no arrears on structures, which is 1) extraordinary in the sense it's the first time ever, but 2) it's brilliant because we've managed to get there which will help improve our performance to plan, which will then help improve our performance to customer, which will then help us reduce our cost and our inventory in cash. So we are seeing good progress from the new facilities that are coming on-stream smoothly, and much better performance from many of our older facilities as we drive standardisation, lean production, new production methodology into those plants.

Sandy Morris: Yes. I mean, my sort of impression is that what you've just described is just as important as any of the other ups and downs and IE or whatever. Am I right in sort of thinking that?

John Rishton: Yeah, you're exactly right, Sandy. It's – the things that I was trying to emphasise at the – at the investor day, and it's what I talk about as growing pains, which is, there's a cost associated with getting this in, but once it's in, up and running, then we're in good shape. So it's getting through that – that hurdle. So it's getting the new facilities in, getting the production processes operating smoothly and efficiently and effectively, getting the capacity utilisation up which is going to come as we grow the business and the growth is – is there, you know. Exactly how it falls, we'll see that over time, but we know it's there, and then we've got to restructure, which means reducing some of our facilities, and we said – I said at the investor day, reduce the floor footprint by 20% by 2020 to make sure that we have the lean, efficient machine that we need, with the right capacity and the right processes, that delivers production according to plan and to the customers on time at the right quality, at the right cost, at the right time. So it is exceptionally important that we get that right, and that is – that is a large part of the transformation that's going on at Rolls-Royce as we go from a low-volume engine manufacturer – a bespoke tailor, as I said to many of you – to a high-volume producer where we absolutely have to have the production disciplines in place, and that is a tough journey, but we're making really good progress.

Sandy Morris: Okay. Right. Great. I mean, frankly I think that's just incredibly important, but then what I think doesn't matter very much. Tedious question just on Marine services: I mean, I suppose, if there is an air of disappointment, it's only because services did so well for us, you know, for a good few years, but then we were opening the service centres. Now I'm just, sort of – idle curiosity whether there's any particular weakness in any region, if you see what I'm driving at, whether it's Gulf of Mexico or Brazil or whatever, or whether actually, for some reason, it's just slow everywhere.

John Rishton: I think it's reasonably slow, as far as we've seen, everywhere. We've seen lower sales of upgrades, lower sales of spare parts, and, you know, again, in the specific areas that we've been servicing we've seen vehicle use, vessel utilisation and rates below historic averages, and people being more cautious about services and spares. And, as I said, I think we were overly optimistic at the start of the year on the – on the services side. It is an important area for us. It is an important area in terms of revenue and in terms of margin, and it's an area that we'll continue to invest in because there is growth in the future.

Sandy Morris: Yes. I mean, forgive me, because this is more an observation than a question, but the vessel utilisation in offshore seems to be going up, if anything, so this all seems just a slightly sort of odd trend in services. But maybe it's because they're out there working that the services have gone down.

John Rishton: Yeah, well, there is an element of truth in that, Sandy, which is very true, but if you look at historic rates of where we are now and some of the areas that we've been in, the rates are lower, but certainly if they're on job, the last thing that they want to do is to pull them off job to do spare parts, so they'll just – you know, if you're earning reasonable rates and you've got them working, keep them out working.

Sandy Morris: Yes. Well, I think I'll get back to working. Thanks ever so much.

John Rishton: You're welcome.

Thanks very much indeed for joining us this morning. It was good to talk to you again. If you have any views or comments or feedback about the way that we've managed the presentations today and the information, please do let us know as we are working hard to reflect the comments that you make, and we look forward to seeing you, of course, at our investor day in October.

I think before we finish, though, if I stand back and look beyond the half one results, beyond 2014 and out into the future, if I conclude with what I really said at the investor day in June: we have a very strong position in markets that are growing. We are really concentrating on doing what we know and doing that better than we've ever done it in the past, and there are significant opportunities to improve our business internally and significant opportunities for growth externally everywhere we look.

Thanks for joining us today. Look forward to speaking to you soon.

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