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RR.L - Full Year 2014 Rolls-Royce Holdings PLC Earnings Presentation

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PRESENTATION

Jilinda Crowley *- **Rolls-Royce Holdings Plc - Assistant Director IR***

Good morning, everyone. Thank you very much for joining us today.

Before we begin, it falls to me for the housekeeping job, so I'd like to draw your attention to our Safe Harbor statement which you can see on the screen in front of you, and it's also in your packs. Can you please a moment to read the statement and remember that forward-looking statements carry risks and can change. (Conference Instructions).

Just one final thing that I'd like to mention before we get started. For those of you that are joining via webcast, you can also submit question to the management team via the webcast functions, and we'll read those out loud, so please participate if you're able to remotely.

With that, I'm very delighted to introduce, this morning, our Chief Executive, John Rishton.

John Rishton *- **Rolls-Royce Holdings Plc - CEO***

Good morning; thanks for coming. Let me start by introducing the members of the senior team on the stage. On your right and the far left, Lawrie Haynes, who's President of our Land and Sea Division; next to him Tony Wood, who is President of our Aerospace Division; and then Colin Smith, who's Director of Engineering and Technology.

We're also joined by one colleague who is appearing on this stage for the last time, and one who's making his first appearance. This morning, we announced that Jim Guyette will be retiring as President of Rolls-Royce North America. Jim has been with the Company 17 years and has made a tremendous contribution, particularly on customer focus. Jim, we're going to miss you.

The new joiner, of course, is David Smith who was appointed Chief Financial Officer in November, and who you will hear from in a minute or two. For those of you who have not met him, David has an outstanding record in finance, including as CFO at Jaguar Land Rover, where he also served as CEO during the transition of ownership from Ford to Tata. He joined Rolls Royce around a year ago as CFO in Aerospace.

As well as driving our performance on cost and cash, and strengthening management information, David shares my commitment to improving investor communications. He has spoken to a number of already, and I'm sure you'll get to know him much better during the course of 2015. In the audience we're joined by our Chairman, Ian Davis.

In a minute, David is going to take you through the numbers, then I will talk about the future direction of the business and the progress we are making.

But let's start with the main themes from last year. Clearly, 2014 was a challenging year in which we had to contend with reduced government defense spending in our most important markets, an economic slowdown in China, Brazil and eurozone, and sharply falling commodity prices that have impacted many of our customers in the oil and gas, mining and construction sectors.

This has been reflected in the share price, and we've been left in no doubt about the frustration that this has caused. I've said before that our communications with the investment community have not been good enough. David and I, and the rest of the team, are listening and we are working to address your concerns. I hope you have seen some improvements, and I'm sure you will let us know how we're doing.

It's easy for the challenges we face to obscure the indicators that tell a different story; most importantly that we've continued to win business and grow our installed base. The order book reached a new record of GBP73.7 billion, and this includes the first increase in the defense order book since 2010.

In civil aerospace, of 454 widebody aircraft contested in 2014 Rolls-Royce won 284. That's 62%, yes, 62%.

As you know, we've been reshaping the Company, and during the course of the year we completed the sale of our energy gas turbine and compressor business to Siemens. This was an issue that needed to be addressed and we've dealt with it. We also completed the acquisition of Power Systems.

So all the challenges have been substantial. The decisive actions we have taken are strengthening the business and creating a momentum that I'm going to talk about more after David has taken you through the numbers.

David Smith - ***Rolls-Royce Holdings Plc - CFO***

Thank you, John. It's really a great pleasure to be here this morning. I've met a couple of you already, and as John said, I know I'm going to meeting a lot more of you in the next couple of weeks, so I'm looking forward to that.

Although I've only been in this role now for a couple of months in Rolls-Royce, some things are already very clear to me. This is a great Company with amazing technology, and I'm saying that having been in the car industry for most of my career and in the semiconductor industry recently, which also have pretty amazing technologies.

But three things I've seen in the last couple of months really bring that out to me. The dynamic positioning on our Azimuth thrusters which allows to keep a anchor handling winch machines on our ships to keep those oil rigs at a point of precision that allows those oil rigs to drill thousands of meters under the surface of the sea; that's a pretty amazing piece of technology.

Equally, the Lift System on the F-35, the swivels that allow the thrust of those jets, supersonic jets, to power at vertical thrust in a way that only Rolls-Royce can do. Only Rolls-Royce has that system; we're the only people capable of doing that.

Look also at the parts in our gas turbine engines that are operating -- small instruments that are operating at temperatures that exceed the melting point of the metals of which they're made and have to be cooled with microscopic air systems. And that cooling air is still at 700 degrees; it's just amazing technology.

I'm giving those as examples because it just shows the great opportunities that are ahead of us and the great opportunities we have. However, there's also a lot to be done to deliver that opportunity.

One thing that's really struck me is, if I take a program like the XWB, we are just at the first few years of creating a 30-year business there; a business that will generate a lot of cash flow in the future and value. The investments that we're making now are, therefore, absolutely critical to creating that installed base.

Let me put that another way. We're really undergoing a multiyear transformation; I call it a generational transformation. We're in a heavy investment phase of that, and that is clearly impacting margins and free cash flow. But I don't see that at all as a bad thing; it's absolutely a necessary thing, to build value for the long term.

However, at the same time I'm still acutely aware that we've entered a period now, a more uncertain external environment and, therefore, we need to redouble our efforts and really focus down on the near-term things that improve costs and cash while we pass through this phase.

I've had a lot of experience of that in past businesses, and John and I are absolutely clear that we've got to do that, while, at the same time, making sure efforts to cut costs are not going to undermine the investment in our future.

From the meetings I've had already, I'm also very clear that we've got to do more to improve our communications, and particularly information flows with you. That's part of my agenda today and will remain so.

Let me now start with the numbers, which I'm sure you're keen for me to start with.

2014 was not an easy year for Rolls-Royce, and we know it wasn't an easy year for our investors either. Conditions deteriorated in several of our major customer markets; nonetheless, we met our guidance given in October.

Our order book grew 5%, excluding energy, showing continued customer confidence and underpinning our strong medium-term growth prospects. We actually took in GBP19 billion of new orders last year.

We've also increased our payment to shareholders by another 5%, and that reflects the continued confidence of the Board in the future growth of this Company.

This slide shows the main drivers of our revenue, compared to last year. Revenue, excluding adverse FX effects and the divestment of the energy business, fell by 3%. That was slightly smaller than the decline we guided you to in October.

The main factors of the year-on-year movement within aerospace were a sharp decline in defense aerospace, as we've talked about. OE revenue was down due to lower volumes, as government spending in many countries was scaled back.

This was, however, partially offset by continuing growth in civil aerospace deliveries, as the Trent 1000 engines in particular ramped up last year. We also saw an improvement in our defense aerospace service revenue.

In land and sea, both marine OE and services revenue fell, due to weaker end markets.

Now the same slide for profit, so turning to pretax profit. The underlying result was in line with the guidance we gave of flat that we told you about in October. We did see a negative impact from the lower volumes I've just talked about and that was especially so in defense and marine, as I've just described.

We also had increased civil R&D investment. It was actually our peak investment that we ever made, so the investment in technology was at its highest level ever last year. And we had higher restructuring charges, particularly in the aero side of the business.

These factors were offset by improved trading margin, which included a significant improvement in TotalCare within civil aerospace, as we had lower costs and improved mix in defense.

We also saw lower commercial and admin costs, including the lower bonus cost. Overall, costs were down more than revenue, and if I look at that on a gross margin basis, it contributed to the 1.7 point gross margin improvement that you'll see in our numbers.

Coming back to the restructuring for a second, the program that we announced in November is an important part of the cost saving initiatives. It's expected, as we've told you, to generate savings of GBP50 million this year and GBP80 million on an ongoing basis. I'm going to talk to you about some of these factors in a bit more detail when we go through the individual segment results in a moment.

This next slide shows a fairly traditional view of cash flow, tracking from profits through to free cash flow, with GBP254 million for the total business or GBP447 million for the retained business, excluding energy.

You can see the significant net working capital change, which was primarily driven by that increase in TotalCare receivables, as we increased our linked installed base.

Intangibles also went up, really around certification and participation costs, our development costs, and the contractual aftermarket rights which were associated with unlinked sales. However, personally, I actually think the next slide is a little more helpful to understand this pattern.

Here, I'm comparing our free cash flow in 2013 compared to 2014, and this is all for the retained business, excluding energy. As you can see, there was a higher cash flow from operations and lower CapEx spend in 2014 compared to the prior year. But this was more than offset by an increase in our net working capital.

That reflects a couple of factors. The net utilization of customer deposits in 2014, compared to an increase with order intake the prior year, and a higher increase than last year in TotalCare receivables. These are important points.

To build our installed base, we have to invest in higher levels of working capital. We're also trying to manage the customer deposits, where possible, to mitigate that. Of course, that doesn't mean that we're not focused intently on improving operating cash flow. We absolutely are, as we did in 2014 when, for instance, we delivered over GBP140 million of inventory reduction, net of FX.

I'm going to talk to you about the outlook for free cash flow and the steps that we're taking to improve it in a moment.

Let me turn just for a second to our overall balance sheet picture. Our balance sheet and credit rating remain strong. Why is this important? Well, not only for financial reasons; it gives us the ability to withstand shocks and turbulence, which sometimes occur in our industry. But it also provides important confidence to our customers who, remember, are buying products that will remain in service for decades and require decades of aftermarket support. They look very closely to our credit rating.

It also gives us the flexibility, for example, to return the proceeds of the divestment of our energy business to shareholders through the share buyback, and that's currently underway.

Having covered the Group picture, I want now to turn to the 2014 performance for each of the business segments.

Starting with civil aerospace; civil aerospace is the principal engine of our future growth, and the order book increased a further 5% in 2014. That included our first Trent 7000 orders at Farnborough and GBP7 billion in new orders for other products as well. That represented a market share of over 60% in the widebody market.

Our OE revenue grew strongly, more than offsetting a small decline in services and adverse FX effects.

The service decline reflects the fact that we saw lower utilization and so lower times and materials for older installed engines, primarily the RB-211, which was down 24%. This is now less than around 10% of our revenue base. And it was largely offset by growth in our Trent fleet, which was up 6%, which is more than half of our revenue base.

Higher Trent 1000 volumes and the first XWB deliveries were partly offset on the OE side also by lower Trent 900 sales. The Trent 700 was roughly steady to the prior year.

The ramp up in Trent XWB production is really only just beginning. We delivered 13 engines and we had over 1,500 orders in the pipeline last year. In December, we saw the XWB enter service with Qatar Airways. We were also selected by Gulfstream earlier in the year to power the new extended range version of the G650 jet.

Talking about profit, profit improved by 12%. Some of that was due to the higher volumes and trading margins. We also had a GBP150 million retrospective benefit from better profitability in our TotalCare contracts, and that reflected a combination of factors like cost improvements, changing operating patterns, which, by the way, are driven also by the same factors. So our enhanced engine health monitoring processes and systems feed back into better operating patterns for our customers and also reduced contract risk.

These positive factors were partially offset by restructuring charges, and we also had some adverse mix effects. The significantly higher R&D costs that I've mentioned as we invest in the next generation of products and new technologies were at their peak last year.

Turning to defense aerospace, we have a very good example here, I think, of how our focus on costs and restructuring programs are flowing through to the bottom line.

The order book grew in defense for the first time in 2010, but clearly we saw, as we said, our OE revenues coming down significantly. They were down 41%, and that reflected lower volumes, particularly the EJ200 and reductions in Adour sales as well. That was partially offset by growth in aftermarket services.

Profit, though, declined at a much smaller rate of 16%, so the impact of lower volumes was, therefore, offset both by the cost reductions that we've been making in the defense business, and also the favorable mix shift that we saw towards the aftermarket with OE volume coming down. In defense, aftermarket is now 61% of defense revenue; that's up from 46% in the previous year.

I think our success in costs in defense reinforces our confidence that the focus on this issue is bearing fruit, albeit that it was masked by other headwinds across the business.

Let's turn now to power systems. As you know in August, we acquired from Daimler the 50% of Rolls-Royce Power Systems, previously known as Tognum, that we did not already own, and are in the process of integrating that business with the rest of our Land and Sea business and developing our common strategy.

The order book grew modestly, although underlying revenue fell 4%, and that was mainly due to FX effects, particularly the Euro. Strong naval sales and power generation were largely offset by a non-repeat of regulatory driven sales that we'd seen in 2013 in Europe.

Our underlying profit declined 14% overall; however, the acquired Rolls-Royce Power Systems/Tognum business actually improved but we had a very difficult year in our Bergen business. We've taken steps to improve future performance there already.

FX effects were negative in the business. Talking about product, we launched at Bergen the 33:45, which is a new range of medium speed diesels which gives significantly enhanced performance.

I want to turn now to our marine business, and this is probably the area where we had the most difficult year with revenue down 16%. We also saw a decline in orders, although, at constant FX, the orders grew by 6%, so that was mainly a currency effect.

Once again, foreign exchange and the oil price have played the biggest role in revenue decline. But there's also been pressure on prices in this market, and also pressure on discretionary aftermarket spend in many of our major markets, particularly the offshore and merchant businesses.

Profit was done 41%, therefore, and that reflected the revenue drop as well as some of these adverse shifts in pricing and margins, plus the GBP30 million marine charge that we talked about last year.

Unfortunately, these negative factors more than offset some good progress that was made in the business on cost, both on product cost and indirect cost; we lost about 300 people last year.

Clearly, since the start of, or since September/October, oil prices have halved. That will create additional further pressure in many of our markets, and I'll come back to that issue a little bit later.

Turning finally to the nuclear and energy business, which, for the final time, is reflected in our numbers. That was sold to Siemens on December 1. As you can see, I've actually excluded that business from the analysis to give you a better understanding of the drivers in the retained business.

Revenue overall improved 3%. The retained business actually showed a sharp increase in profitability, up to GBP48 million, although that was from a low base. And the improvement reflected a combination of volumes and cost efficiency improvements, as well as a non-recurrence of GBP10 million that was a drag in 2013 in the comparator year. While currently small, our capability in civil nuclear is also an important part of optionality for the future.

So that concludes my run through of 2014 performance. It was a mixture, but one I think in which you can see there are encouraging underlying signs, especially on the four Cs, even if other factors, including the tougher external environment, masked or offset some of that progress for the Group as a whole.

I'd now like to turn to the outlook and our expectations for future performance. I won't labor this point, but it is against a more uncertain backdrop. And that frames really the way that I'm giving the guidance for Rolls-Royce's future performance.

You can see on this slide our guidance for revenue, profit and a number of other factors. In response to feedback from you, and actually my own personal views, in the interests of simplicity, you can see that we're now going to provide guidance in absolute numerical ranges instead of the complexity of percentage changes, and I hope you're going to find that change helpful.

We're guiding revenue to GBP13.4 billion to GBP14.4 billion and profit to GBP1.4 billion to GBP1.55 billion. I'm going to talk about the factors driving this expectation on the next slide.

On cash flow, we expect continued headwinds as we scale up our Trent volumes and continue to utilize customer deposits. This will be partially offset by the benefits of the actions we're taking on costs and cash, such as the continued focus that we've got in detail on inventory.

And although profits are down, you will also note that our earnings per share will benefit from the reduction in the equity base from the share buyback.

As previously indicated, we expect both CapEx and net R&D in absolute terms, and over time, to reduce as a percentage of revenue. Our guidance is based on 2014 FX rates and, therefore, assumes no currency effect either adverse or favorable. Obviously, as we normally do, we'll update you during the year on that.

Turning to restructuring, we expect underlying restructuring charges to be in the GBP90 million to GBP100 million range in 2015; that's about GBP60 million lower than it was in 2014.

As in 2014, we expect performance delivery to be weighted towards the second half of the year. On earnings, there will be a weighting of the R&D charge towards the first half of the year, and civil deliveries are also more biased than they were last year towards the second half.

We expect a second half bias on profit, but also on cash as well, and that's, incrementally on cash, the impact of our restructuring spend, which although it was partially charged at the end of last year, the cash charges will come through at the beginning of this year. We also expect free cash flow to be more biased towards the second half than it was last year as well.

Turning now to the detailed guidance for performance at the business segment level. You can see that we expect continued strong grow in our civil aerospace business, and this is primarily is the Trent 1000 and XWB deliveries increase and the aftermarket begins to grow. This will be partially offset by lower Trent 700 and 900 sales next year, or this year, sorry.

However, our civil profit is expected to be lower in 2014, and that largely reflects the increased proportion of sales that are going to be accounted for on an unlinked basis on the XWB. But also, I don't expect the scale of the retrospective TotalCare lifecycle improvements to be as high as they were in 2014. This will be partially offset by lower restructuring charges, as I've just mentioned already, in 2015.

In defense, we expect further progress on costs and margins. In land and sea however, this is where I'm really more cautious as I think we can expect continued further pressure from the external environment. And there is more uncertainty here, both around the duration of the oil price impacts, but also pricing and adverse mix pressures.

Of course, that doesn't mean that we're not going to be really focused on improving operating performance to try and offset some of those external factors, but they're there.

So that completes my review of the key numbers. I'd actually like to stand back a little bit from the detail for a second and talk more broadly about how I see the business and the journey we're now on. John will expand on this in his own remarks in a moment, but I want to underline that this is a growth business, that's very, very clear when you look at our order book.

The size of our order book really shows the scale of our opportunity. I'm excited about that potential and it's why I joined this Company. We are as I said, undergoing a generational change in our product portfolio and, at the same time, a transformation of our industrial base. And this has, and will, require major investment.

The issue I know you are all very focused on, as are we, is when the timing of that growth is going to be reflected in our profits and free cash flow. And particularly, what additional steps we can take to mitigate some of those headwinds during a period of unprecedented expansion in production in our civil business.

John, of course, recognized all of that in 2011 when he launched a program of focus on the four Cs, Customer, Concentration, Cost, and Cash, and significant actions have already been taken. We now have real traction here, but the environment we face has become more difficult and the scale, therefore, of the required transformation is, I think, bigger than could have been imagined back then.

This multiyear transformation is now my principal focus. The next two to three years, in my view, are critical. You saw the steps we announced in the restructuring of the aerospace business last year and the progress we've already made in defense. We have been taking a similar action already in Land and Sea, and that process is going to accelerate now.

In fact, I was in Friedrichshaven a couple of weeks ago, going around the Rolls-Royce Power Systems facilities there, and I was very, very impressed with the work they're doing on lean manufacturing. It's as good as anything I've ever seen in the automotive industry. We must, and will, do more however, in all of our businesses, but in doing that, we must also be realistic. This will take some time.

Much of what lies ahead is very familiar to any industrial company, and it's ground that my experience in the automotive, and more latterly in the semiconductor industries, has prepared me for. And it starts with a thorough understanding of our cost base and the levers that we can pull within that.

Firstly, the focus on our product and manufacturing costs, and our supply chain. As I said, that is now really gaining some good traction. Last year, our design and supplier programs delivered good progress, but unfortunately, that was offset largely by the growing pains John's talked about in the past, of having underutilized capacity in the short term. But we delivered underlying improvements.

Second is the focus we have on lifecycle costs. This is hugely important as product life costs can be three, four times the OE cost of an engine. Our focus here is really delivering and there are recurring and non-recurring benefits. You can see that within the GBP150 million, but actually the benefits that we're delivering are greater than that. They will come through in future years as well and so the progress, I would say, is ahead of our expectations.

The third thing that we're getting more focused on, I think, is deployment of lean processes right across the business. Actually, we made, as I've said already, real progress in some areas, particularly I'd say in the manufacturing area, but the concept of Kaizen and continual improvement that I'm very familiar with, again, from the automotive industry, are things that we are now deploying right through the business.

One of the things I've really enjoyed in my new role is spending time on the shop floor. I always get a thrill at seeing these actions. I was up in Sunderland a few months ago and had the pleasure to see the new facility there. And the first thing that happened to me as I walked through the door was a young lady, one of our high-potential graduates, talked me through not only what they were doing on cost, but what they were doing to change culture in that business.

Later that day, I went to our older plant, which is a few miles down the road, and I expected to see a huge difference there. Actually I didn't, because that infectious enthusiasm that's come from that new investment has actually spread into the older facility as well, and they're really excited about what they're doing on lean manufacturing.

Of course, this continued focus is absolutely critical for our business. We're also looking now much more closely at indirect costs and overhead, and trying to improve efficiency there. We've reduced the size of our head office and we're moving to new ways of working. Overall in the Company, we've cut our indirect headcount now by about 18% in two years, but there's more to do.

That, I would say, is the operating side of the business. Perhaps the greatest potential in my view lies in what I would describe as the transformation of our industrial base. During the last few years, we've been investing in a major expansion in our manufacturing capacity, but that capacity build phase is now over.

What we're really focused now is making those investments deliver. And the next investments that we'll be making in the next couple of years are much more around capability and the technology that's required, both to fulfill our order book, but also provide the next generation of engines as well.

Our task is now to build efficiently through these new facilities and reap the benefits of the improvements in the capacity utilization, while progressively either exiting or resizing our older facilities. All the time, we have to maintain service and support to our customers, so we have to do this methodically and make sure that we can continue to produce products at the right quality in our old facilities. We also need to continue to improve our focus on low cost country sourcing where that is an opportunity.

As I said, this isn't a simply or a rapid process, but the prize is very significant. The GBP80 million savings we told you about on the implementation of the aero restructuring last November are a part of that, but only a part, and it's an indication of the potential. I'm now really focused on what can be done also in Land and Sea, building on the work that they've already started.

In my view, further benefits will come as we see our volume growth drop through, and that's an effect that many of us call operating leverage. But the key is making sure our fixed costs don't grow as fast as our revenue line. Cost efficiency and operational leverage will, ultimately, be what drives that margin improvement in the future as our portfolio matures, that we've talked about.

I've talked a lot about costs in those couple of slides, but also, this equally applies to cash. What does the process of transformation look in cash terms? The question is, what levers also can we pull and what milestones can we identify to ensure that we're on the right trajectory?

In the near term we are incurring heavy investment, both in the restructuring and some of the headwinds that I've described on net working capital. And that's clearly a very necessary part of building that growth in our installed base, which will deliver cash flow for decades to come and much more efficient operations.

At the same time as we launch the new Trent engines, as I said, we're investing in that net working capital, specifically the development certification costs, the Contractual Aftermarket Rights, as we call them on the launch of the OE sales. And that's alongside the build of the TotalCare net debtor unlinked accounting.

I know this sounds complex, and I'm very happy to cover it again in more depth if you have questions, but what's really more obvious, I think, is that over time, what we will see is a combination of factors that will drive improved cash conversion. Firstly, OE margins will improve as we exit the launch phase, which is higher cost and lower pricing.

We'll also begin to generate growing amounts of cash from our aftermarket revenues as the OE curve begins to flatten out and the aftermarket becomes a bigger part of our business through increased engine flying hours. As we do that, we must maintain a rigorous focus on capital allocation and investment efficiency, and that includes inventory and net working capital.

As I said, these cash actions are what are going to improve the cash conversion in the medium term. But don't believe for a second that means we're not intensively focused on improving cash this year.

For example, we've got multiple work streams now looking at investment efficiency in many different areas; inventory, logistics, improving our trade cycle management, our capital efficiency, all of those things. I'm really focused on that stuff.

So to conclude it, I'm confident and excited about the growth that we can deliver as a Company. However, we must manage the transformation that we're going through in this critical phase that's required to deliver the installed base for the future, and very carefully redouble our efforts on cash and costs to help counter some of the increased uncertainty that's around us.

This won't be easy, but I've done this before in other companies. It takes time, but we now have the whole team focused on it.

Thank you for your attention. I'm now going to pass back to John, but I really look forward to your questions later.

John Rishton - ***Rolls-Royce Holdings Plc - CEO***

Thanks, David. David has talked in some detail about last year and 2015, and I want to take a longer-term view and give some context.

Above all, I want to make three points clear.

First, the fundamentals of the business are strong and we're committed to investing in future growth.

Second, we are clear how to address the growing pains that are holding us back.

And third, we are taking decisive action that will make us a stronger Company and return us to profitable growth.

The journey we have embarked on will involve the transformation of our business. Let me tell you a story that illustrates the scale of change.

Three years ago, I went to Montreal where we repair and maintain engines for business jets. The facility was amongst our worst performing anywhere in the world, and it was a depressing place to visit. The atmosphere was terrible, the workforce was demoralized, and customer metrics were dreadful. But Montreal has turned itself around. In the space of three years, it has become one of the best performing facilities in Rolls-Royce.

On-time delivery to customers has risen from 61% to 100%. Inventory turns have increased from 7.1% to 12.6%. And last September, I was delighted to present our annual Trusted to Deliver excellence award to the Montreal team.

This was achieved without any change in its physical location, without any real investment, but simply by the entire team putting the customer at the heart of their business; for example, by bringing customers in to meet their Rolls-Royce team, and running red carpet events to celebrate outstanding delivery. It's now a joy to visit.

It's a powerful demonstration in just one plant of the transformation that is taking hold across the rest of the Group. And it's a good way to introduce the first and most important of the four Cs, Customer.

As you know, this has been one of my top priorities. When I arrived at the Company, the conversations I had with customers left me in no doubt about the urgent need to improve. One immediate issue was inadequate and inconsistent data. We've put that right. We now record customer metrics in a consistent way across the Group, measuring quality, delivery, reliability, and responsiveness, the characteristics our customers value most.

In 2012, I discovered that our civil large engine business on-time delivery to our own internal plan was zero. In defense, the number was 7%. Shocking figures; more shocking by the fact that no-one seemed to think this was an issue. In 2014, we improved civil to 59%, and defense to 72%; still not where we need to be, but a big step in the right direction.

In terms of delivery on time to our customers, we've also made good progress across the business, with 100% on-time delivery by yearend in civil large engines, 91% for the whole year, and a substantial improvement in customer deliveries in marine, from 55% to 88%.

Recognizing the progress that we have made, Airbus has presented us with their Supply Chain and Quality Improvement Award; both the US Air Force and the US Government Defense Logistics Agency have recognized Rolls-Royce as a first tier supplier; and we were awarded joint first place by Aviation International News for the quality of our business aircraft support.

If you talk to the team, they will tell you how all this has transformed our conversations with our customers. So now, instead of sorting out their problems, we're talking about what business we can do together in the future.

To avoid any doubt, delivery of the four Cs depends critically on getting the customer right. Only by getting the customer right can we focus on strong financial performance. Fix quality, fix delivery, and the cost will follow.

In terms of concentration, as I hope we've made clear in the past, we are reshaping the Group to optimize our performance and returns. Key to this has been the transactions over the last four years, some of which are shown on this chart. We've sold businesses where we couldn't make a proper return, and bought businesses that strengthened our market position or added to our capability.

For example, SmartMotor is a world leader in permanent magnet technology that we apply to our marine thrusters. HyperTherm has increased our knowledge of ceramic matrix materials that are critical in improving gas turbine efficiency. Individually, not all these transactions are especially significant, but taken together, they represent a focusing of the Group on technologies and markets where we're confident of long-term profitable growth.

On cost and cash, I know there is some skepticism about our progress on cost. But I don't want any of you to be in any doubt about the management focus that has been applied to this critical area. We are addressing costs in every part of the business and in every cost category. We're improving quality of delivery, reducing headcount, and driving productivity. We're transforming our supplier base, and we'll reduce footprint over time.

We have compelling examples of progress in all of these areas and show a number on this chart. But I recognize there's much more we can, and will, do. This is going to take time with progress being impeded by the growing pains. For example, in our civil business we have underutilized capacity and are impacted by launch pricing and launch costs. But these are headwinds that will be overcome as the business grows and matures.

Across the organization, we have grasped the importance of reducing costs. And if you look at the progress that we're making in our defense business, you can see how seriously we're taking this. The journey we're on, and the actions I've described, emphasize the most important thing that any investor, commentator, or customer needs to understand about Rolls-Royce.

It's a critical point that Ralph Robbins made, John Rose repeated, and you'll have heard me say many times before, this is a long-term business. We invest for the long term, as we have done consistently for decades. Our products are mission critical and take years to develop. As the manufacturers of original equipment, we are well placed to provide aftermarket services that make up 48% of our Group revenue.

As the equipment we provide becomes more complex, the opportunity for aftermarket sales grows. Our power systems have long lives and service, and generate aftermarket revenue that can last for decades. In marine, for example, we've just celebrated the 40th anniversary of the UT-Design that continues to set industry standards for offshore support vessels. There are now 800 UT-Design ships operating around the world, including the very first vessel that is still working off the coast of Nigeria.

The longevity and nature of our products means that our installed base grows year by year, and this is where the majority of the value of the business lies. This was demonstrated, I think quite clearly, when we sold our stake in IAE when I know many of you were surprised by the value we realized for what was just one small component of the civil aerospace business.

This is a Company with a track record of delivering significant long-term growth. In the past decade, our revenue has more than doubled, the order book has more than trebled, and profits have more than quadrupled. Looking forward to the next decade, our prospects for long-term growth remain strong.

As you know, the area of business where we have most visibility is civil aerospace. This chart shows the size and shape of our fleet today. We have around 4,300 engines in service, predominantly operating in North America and Europe. Turn the clock forward 10 years, and you can see that our fleet is predicted to grow to 7,500 engines, with much of that growth coming in the Middle East, Asia, and South America.

This chart shows our installed thrust. As you know, thrust is a reasonable proxy for revenue. As you can see, thrust through the next decade doubles, and continues to grow after that. Over the lifetime of an engine, service revenue is around four times higher than OE revenue. And by the latter half of this chart, the ratio between OE and services shifts in favor of the higher margin aftermarket business.

Rolls-Royce has always been a long-term business with a steadily growing installed base. It is also a business that, from its earliest days, has made power systems for land and sea, as well as aerospace. These are markets that are characterized by growth over many decades, and that we continue to address through our aerospace and land and sea divisions.

There is an industrial, commercial, and strategic logic tying these two divisions together to generate long-term value for the Group. Industrially, our advanced engineering capability benefits the whole Group. And as power systems we produce become more sophisticated, deep technical knowledge will become increasingly important.

Just a few areas in which we have world-leading expertise, are fluid dynamics, that is a broad application for the development of fan blades and water jets, to understanding coolant flow in nuclear reactors. 3D printing and hot isostatic processing manufacturing techniques that improve design, reduce costs and shorten delivery time.

Safety critical engineering processes developed in our nuclear and aerospace businesses that are being applied across the Group to meet our customers' increasing requirement for safety and reliability. Our common core of engineering capability allows us to integrate systems and to take technology from one part of the business and apply it to others, multiplying its benefits.

To give just two examples; knowledge of material science from our aerospace division has enabled us to develop new seals for marine. Automated manufacturing technology developed for marine propeller surface finishing is now being applied to aerospace fan blades.

Commercially, we and our competitors recognize the requirement for both scale and breadth of portfolio. Scale is crucial to maintaining a strong balance sheet and protecting our investment grade rating, which, as David has said, is essential comfort for customers who sign long-term service agreements with us. Scale also enables us to maintain a global R&D network that now comprises 31 University Technology Centers and seven Advanced Manufacturing Research Centers.

Maintaining and building this network is critical to our future, because this is where the next generation of products and services are envisaged, then taken off the drawing board, developed, and tested for commercial application.

Breadth is important because it provides a balance of differing business and investment cycles. It's worth remembering that, between 2008 and 2010, Group performance was powered by an 89% increase in marine profit, which more than offset the 22% decline in civil profit.

Strategically, our two divisions address markets where long-term growth is underpinned by expanding population, increased affluence and environmental regulations. Both aerospace and land and sea markets offer attractive returns and play to our strengths.

I've spoken about the four Cs; explained our long-term approach. Before closing, I want to talk about our long-term strategy that we now describe in terms of three themes; customer, innovation and profitable growth.

This strategy has been in place for many years and proved itself through good times and bad. For example, it has driven growth in civil large engines where, in the 1980s, we had a market share of less than 10%, we now have more than 50% of the wide-body engines on order. It has guided the expansion of our marine business that has more than doubled in the past decade.

Customer is the first element of our strategy; recognizing the customer is at the heart of our business is central to everything we do. I have talked already about the progress we're making.

Innovation is the second theme. This is the lifeblood of Rolls-Royce and we need to make sure our innovation pipeline is strong and relevant to customer needs. In 2014, we filed 600 patents and invested GBP1.2 billion in research and development. We're pressing ahead with new technologies, delivering today, investing for the future.

As you're all aware, we're progressing our next generation of aero engines, Advance and UltraFan. We have flown a test engine with carbon/titanium fan blades and we're building a new test facility for power gearboxes in Dahlewitz. In our reciprocating engine portfolio, we are investing in technology to further improve fuel efficiency and emissions.

These are all necessary investments in the future, which brings us to the third element of our strategy, profitable growth.

Our prospects for long-term profitable growth are driven by the fundamental strength of the markets that we address. But it's helpful to look at independent dates to understand the scale of opportunity.

These charts give a 40-year view of growth in population, GDP and energy. They demonstrate, very clearly, how growth is driven by the developing world, and they make the case for the fundamental strength of our business.

This chart from Airbus shows the growth anticipated in the wide-body fleet in the next 20 years, a 250% increase, with the vast majority of the fleet in 2033 made up of aircraft yet to be delivered.

So the fundamentals that underpin our business and provide opportunity for long-term profitable growth are strong. Of course, in the short term, the pace of economic growth in individual markets will fluctuate. The price of commodities may be volatile. The most obvious example at the moment is the oil price, which has halved in the space of months.

This should, of course, help growth across the world, but has pluses and minuses for Rolls-Royce. In civil, there is limited short-term impact, although it helps airline profitability which, in the medium and longer term, could translate into more orders.

In land and sea, reduced CapEx from the oil majors has a more immediate impact on our revenue, forcing us to focus even more on cost, so in the long term, we will be leaner and more efficient.

But none of these near-term factors alter the market fundamentals. In the last decade, nearly 1 billion people have been lifted out of poverty. The middle classes are growing by more than 100 million every year.

As people become wealthier, they join the markets for goods and services that require power to be manufactured and transported. The megatrends are on our side, and that gives me a great deal of confidence for the long-term future of Rolls-Royce.

We have built strong positions in growth markets, we have world-class technology and customer relationships across aerospace, land and sea, and we see significant opportunities for long-term profitable growth across our portfolio.

To take advantage of the opportunities that lie ahead, we must continue to improve performance right now by being better integrated, focusing on delivering consistently for our customers, and driving performance on costs and cash. We understand this and it has our full attention.

So let me conclude with the same three messages I opened with. The fundamentals of the business are strong and we're committed to investing in future growth. We are clear how to address the growing pains that are holding us back, and we're taking decisive action that will make us a strong Company and return us to profitable growth.

Thank you. Now, we're delighted to take your questions.

QUESTION AND ANSWER

John Rishton *- Rolls-Royce Holdings Plc - CEO*

I will go round the room and take questions off the WebEx as they come in. If you could state your name and affiliation before you start, that would be great. We will provide you with a microphone so that all listeners to the call can hear your questions.

Christian Laughlin *- Bernstein - Analyst*

Christian Laughlin, Bernstein. Just one question from me.Taking a step back at a high level, the steep decline in oil price, obviously, was clearly a big surprise to everyone in 2014 and knock-on effects are still working their way through the system and various adjacent businesses.

John, has this changed the way you view the attractiveness of this end market versus last year at this time, or when you took over as CEO? And might it change or influence decisions to further invest in the short-cycle businesses that are heavily geared towards energy, exploration and production, either organic or inorganic investments over the, say, medium term?

John Rishton *- Rolls-Royce Holdings Plc - CEO*

Thanks for the question. I tried to address that I think in my set piece in the sense that we see the longer-term growth in these markets being substantial. The longer-term growth driven by population, driven by urbanization, driven by the increasing demands for power.

I'm certainly not well-placed to forecast oil prices and I'm not even going to try. There are other people who are better placed to do that. But we believe that the megatrends, as I've described them, of population, urbanization, that will drive demand for power are really strong in the long run, and that's what I'm looking at.

In the shorter term, the issue is addressing the impacts that we see particularly in our marine business that is impacted most directly by cutbacks in CapEx from the oil majors, and that means focusing intently on costs.

Now, what I would say on the plus side about that is that, in my experience, where there is a clear and present need, it is usually easier to get everyone's attention and take more action more quickly; that's my experience. So I think that we're well placed to do that.

Lawrie and his team have taken a lot of significant action over the last year; I think over the last two years, Lawrie, about 1,100 people have left the business? We've announced the closure of about five plants already. We need to do more; we will do more. But I think, in the long run, these are still very good businesses, supported by growth.

Christian Laughlin *- Bernstein - Analyst*

Okay. So it's fair to say then that your result year on year, are you still resolute in terms of your overall view and how you view the attractiveness of it?

John Rishton *- Rolls-Royce Holdings Plc - CEO*

Yes.

Christian Laughlin *- Bernstein - Analyst*

Okay, so [nothing virtual]?

John Rishton - ***Rolls-Royce Holdings Plc - CEO***

No.

Gordon Hunting - ***Fiske - Analyst***

Gordon Hunting, Fiske. Singapore, are you finding it much more difficult to start production there than you were anticipating, particularly as the temperature is about 80 degrees Fahrenheit and the humidity, about a similar figure of 80? Is this going to be a problem and did you anticipate that when you started moving XWB production across to Singapore?

John Rishton - ***Rolls-Royce Holdings Plc - CEO***

Okay. The short answer, and I'll give a short answer, is, we were fully aware of the temperatures in Singapore. Production has ramped up very successfully, particularly on the fan blade side. The issue that we have in Singapore is unrelated to temperature. It's the speed with which we fill the facility, which is geared to build Trent 1000s and Trent 900s. We're ramping that up slowly, over time.

Ben Fidler - ***Deutsche Bank Research - Analyst***

Ben, Deutsche. The first one, just to clarify, on marine, what have we done on restructuring charges? Are there restructuring charges you have taken embedded in these numbers? Is the expectation there will be restructuring charges? Have I missed something? Just if you could give some clarity on that, please.

The second question is, just that free cash flow guidance of GBP200 million, just a housekeeping question. That, presumably, includes the cash receipt from the IAE earnout. Do I add that in at that level, or does that come below the GBP200 million?

And the third question; just to come back to, I guess, your chart and your comment, John, on slide 27, where you talk about 170 basis point gross margin improvement and also, picking up on slide 10 on that bridge chart on civil aerospace profits, the trading profit improvement of GBP263 million.

It looks to me like, I know there's a lot other things going on in the business, but year over year, you had about a GBP260 million swing in the cum-catchup going from GBP110 million negative to GBP150 million positive, doesn't that explain all of the gross margin improvement and that trading profit improvement? So where's the evidence that I should see, or am I missing something on the underlying cost progress you're making? That's it. Thank you.

John Rishton - ***Rolls-Royce Holdings Plc - CEO***

I'm going to ask David if he'll make comments on that; I think on all three of those. Clearly, in terms of restructuring in marine, as I said to a previous question, we've already taken, over the last two years, about 1,100 people have left the business. We have announced the closures of, I think it's five plants, Lawrie, if I remember correctly?

Lawrie Haynes - ***Rolls-Royce Holdings Plc - President, Nuclear & Marine***

That's in 2014; previously another four plants. So over the year, we've closed nine plants, or consolidated them. That's 30,000 square meters of property that has actually been disposed of. And just over 1,000 people, both indirect and direct, have left those facilities.

John Rishton - ***Rolls-Royce Holdings Plc - CEO***

So we clearly have been taking actions there. But why don't I ask David to make some comments on the three questions that you asked?

David Smith - ***Rolls-Royce Holdings Plc - CFO***

Yes, sure. So just on the specific, there's about the same restructuring charge for Land and Sea, in both 2014 and 2015, so I think it's about GBP25 million to GBP30 million in both years.

The free cash flow guidance, yes, that would include the total business, so there's nothing excluded from that. And then on the gross margin point, so within the GBP150 million of one-time effects, and you're right, there's a bigger swing than that on a year-over-year basis, there's a significant amount of costs within that. I tried to describe this, and this is quite complicated, because as everything, it gets into the way that we have to do the contract accounting.

The cost actions that we take, and these are the things that we're doing to improve time on wing, the cost of intervention, when we actually take engines off wing and into service, the cost of the spare parts that we fit, all of those things, we assess within each model's contract packs, and we will assess each year the things that we're actually confident that we've now implemented. There may be a list of other things that we're going to do, but what we've actually implemented.

And we will flow that into the contract packs, with a degree of conservatism. So what actually gets released in profits, is typically the catchup effect, and anything that affects that period. It will not include what will be happening in the future, because that will come through in future years.

So you're right, a large part of that gross margin improvement can be explained by those effects. But cost is a significant part of that gross margin improvement.

John Rishton - ***Rolls-Royce Holdings Plc - CEO***

Thank you.

Jaime Rowbotham - ***Morgan Stanley - Analyst***

Jaime Rowbotham, Morgan Stanley. Two questions please. The first one for David, on cash, and then a question on defense.

Obviously, it's unfortunate that, in addition to the investments for growth in civil, you've got this additional issue of working capital outflows, due to utilization without replacement of deposits in the short cycle land and sea businesses, which are shrinking at the moment.

It looks, from the cash flow guidance, as though you've allowed for very much the same again, in 2015, on that point. Is that fair? And is the work you're doing around working capital management, and you mentioned inventory turns, can that push you towards the upper end of the guidance range?

And the second question, if we look at today's divisional guidance for 2015, compare it to the 2015 consensus that you put on the website a week or two ago, I think unsurprisingly, in some respects, the range is on marine and power systems are probably a bit lower than where people stand. But the one division where you're higher is defense.

So I just wondered what needs to happen, what are the key things that need to happen, and on which programs in defense, to allow that revised 2015 defense guidance to be hit? Thanks.

David Smith - ***Rolls-Royce Holdings Plc - CFO***

Okay. Let me take the cash working capital one first. You're absolutely right, I think this is one of the dynamics of the market that has a negative effect on the short term at the moment. I think there's both a greater reluctance to give deposits as part of the order take process, and we have seen some run off of contracts that were longer that have actually been completed.

So there is a degree of caution that we've put into the guidance for that. That doesn't mean that we're not going to work on that issue, but I'm trying to be realistic about that as well. I would say, and this I guess will be a mea culpa, although it's not a mea culpa personally, but I think we were overoptimistic on that. In the early part of last year, on cash flow, I think that was one of the areas that I think we were overoptimistic on, and resulted in some of the underperformance on cash flow last year.

On the second question around consensus, I think you rightly picked up that in setting the consensus, I still have the kitchen sink with me by the way, I haven't thrown it out quite yet, but I am more cautious in certain areas. I think particularly Marine is a clear one. Power Systems is not so much just about the oil price; it's actually more about my caution around general economic factors at the moment.

So it's what's happening in slowdown in China; what's happening in the Eurozone. I'm hoping I'm wrong on some of these things, but I think it's right in a more uncertain environment, to set guidance in a way that's cautios. And I have a great belief that I've built up over 30 years, that is the right way to run an industrial business as well. To run it on a series of plans that allow you to make the upside if it comes through, so you have the flexibility, but make sure that we're planning cautiously in the short term.

On defense, there was an improvement that I don't think any of us necessarily picked up completely around the fact that OE volumes comes down, and, therefore, service mix improves; that, as I'm sure you can guess, is a higher margin part of the business.

I think actually the defense numbers are very solid. They've done a great deal of work and they continue to do a great deal of work in that team. I don't think there's any thinking there that I would be concerned about, in terms of projects not happening, or the question that you asked.

John Rishton - ***Rolls-Royce Holdings Plc - CEO***

Tony, do you want to make a couple of comments on defense? I think we've pretty strong order cover there.

Tony Wood - ***Rolls-Royce Holdings Plc - President, Aerospace***

Yes, three quick points. Obviously very strong book to bill, in 2014, GBP2.5 billion of orders secured. That's really given us better confidence on order cover in 2015. We have largely launched the cost reduction and consolidation program to resize the defense business for what we see the future years being. And the mix benefit that David mentioned, those are the three things that largely sit behind the defense guidance we're giving today.

Zafar Khan - ***Societe Generale - Analyst***

Zafar Khan, Soc Gen. If I could please ask four questions? The first one is on this retrospective TCA profit, David, that you released the GBP150 million. And as Ben pointed out, that's a GBP260 million swing year on year. Could we just focus on 2014 for a minute; could you please help us in understanding the mechanics of this, because I think it was given as a Trent 700 profit release?

So I'd like to understand how you get at these numbers, and how volatile are they, on a longer timescale. So you had a positive GBP150 million in 2014, negative GBP113 million in 2013, what happened in 2012 and 2011, for instance? So how do we think about this? That's the first one.

The second one is on the capacity utilization in the three new plants that you've built, and I'm thinking of Sunderland, Seletar and Crosspointe, and when you might get to a decent level of utilization so you get a good drop through on that.

The third one is one for Colin, if I may? It's just to ask about the R&D, it's a pretty big increase year on year and I was thinking that a lot of the big stuff happened. So I'd like to understand where you're spending the money; what it is, is it people, prototypes, GBP150 million is quite a big number?

And then one for David on just the margin targets, David, that were given in October. Is there another case of mea culpa for the Group, or are you happy with the longer-term margin targets that were given? Would you underwrite those? So I think that's about it for the time being. Thank you.

John Rishton - ***Rolls-Royce Holdings Plc - CEO***

Yes, thank you very much for the four questions. I'm going to suggest that maybe I talk a little bit about capacity, and then ask David to comment on the three. I will ask Colin to come in about R&D spending, but maybe David can make some comments on that one as well.

In terms of capacity utilization, it's different across the different facilities. So we've got some new facilities that quickly get up to full capacity. So the Sunderland plant, we'll quickly get up there and we take it out of the old facility. The issue there is we've still got the old facility which has now only got old parts in it.

In Crosspointe, we've got a slightly different issue, which is we've got a building, we're fully utilizing the machinery that we've put into that building, but we've got space for more machinery that we can put in. And Sunderland, we've got a full site there which does fan blades, which is quite high capacity utilization, and the assembly which has got a low capacity utilization.

So as I've said to you many times, Singapore has got a 250/300 capability in terms of engine assembly. Last year I think, Tony, we did about 40 or something like that which reflects the mix of engines that we can build there.

And as we've said a couple of times, clearly the delay in the programs, for example the 787, impacts when that will be used. So that will ramp up over time, but with those very large fixed capital investments, making sure that we have the capacity is very important. But with the delays that we've experienced from some of the programs means that we've got them a little bit too soon. Volume will solve that, but it's a different story, I think, in each of them.

David, maybe you want to make comments about the other ones?

David Smith - ***Rolls-Royce Holdings Plc - CFO***

So let me just tackle a couple of different aspects of the first question which was around the TCA profit movements. The swing that we saw last year and the year before are probably at the high end of the range over typical ranges. I'm just trying to recall the chart exactly, but I think the average over the last five or six years is probably more in the 50 to 75 sort of range.

And there's a particular reason, I think, why last year was higher, which is what I'm going to come to. But actually Tony and I, probably about a year ago now, initiated a very thorough process within aerospace of essentially looking what every team was doing on this whole area.

So all of the work that was being done on looking at the cost of the spare parts, the costs particularly of the intervention, the shop visits, and then all the good work on time and wing, and I think we showed you all the charts and things like that we look at there.

We're also getting incremental benefits now from the engine health monitoring systems, so we have a process of converting that information now back to give us a much more accurate view on what the lifetime usage of parts is going to be and the replacement requirements.

So that GBP150 million has been boosted by that program where we went through, very rigorously, every single program and made sure that we were using all of the tools effectively right through the business. And I think that that, and I'll give Tony a lot of credit for that, that really supercharged that process last year. And it has over-delivered from what we might have expected last year.

So I think that's why I'm saying I don't think we'll see GBP150 million of benefits in 2015, part of the reason that civil profit's are going to be down year over year.

That was the first. Shall I do the fourth?

Zafar Khan - ***Societe Generale - Analyst***

In terms of the timing on that, as to when you recognize it, is it arbitrary or is there some -- ?

David Smith - ***Rolls-Royce Holdings Plc - CFO***

No, we have a very, very detailed and complex process that we go through -- I say complex -- a rigorous process that we go through.

Zafar Khan - ***Societe Generale - Analyst***

The reason I ask this is that GBP150 million coming from this year would have been a very big help to the 2015 numbers. If you had a look at this 2014, could you have deferred it?

David Smith - ***Rolls-Royce Holdings Plc - CFO***

No.

John Rishton - ***Rolls-Royce Holdings Plc - CEO***

We recognize it consistent with the accounting policies that we follow which are audited and that we're absolutely clear on.

David Smith - ***Rolls-Royce Holdings Plc - CFO***

Yes. Shall I just tackle the last question which was around margin targets? Yes, I'm absolutely fully behind those. And remember, the way that we described those is very, very important here. We were not making a forecast of margins in 2018, and I think there's some confusion about that. What we did was said, this is where the business should be able to get to on a medium-term basis, once we've met certain criteria or events.

And these events are very, very important, I mentioned them earlier, around when we see the OE volumes flattening off; when we've got the initial launch losses on the XWB and Trent 1000 in particular, we're through that launch period, and the aftermarket service business begins to grow.

Those are the things, plus the cost leverage, the operating leverage that you referred to, that are going to generate those margins. I think we're absolutely behind those; I'm personally absolutely behind those margins as part of that process. So that's the answer to that question.

John Rishton - ***Rolls-Royce Holdings Plc - CEO***

R&D?

Colin Smith - ***Rolls-Royce Holdings Plc - Director, Engineering & Technology***

R&D, it's a mixture. First of all, there's the mixture between capitalized and expense which can make the numbers move around a bit more than is normally visible. But last year, we ended up investing a lot more money in the latest variance of the XWB and the -TEN.

And with a baseline which entered service in the end in December, the engineering on that was coming off in the year as the productionization was ramping up. So a lot more expense on the latest variants, a lot of which was hardware and resource. You'll see it coming off this year as we come over that peak; we've got a lot of engine testing to do but it's less manpower. So balance moves the number around a bit.

And also on the technology side, the difference in funding ratios that we get when we get grants in from our customers, or our supporting partners, such as governments, does vary. So those movements give quite a big change in the IFRS reported number.

Zafar Khan - ***Societe Generale - Analyst***

Thank you.

Nick Cunningham - ***Agency Partners - Analyst***

Nick Cunningham, Agency Partners. I wanted to ask about net cash flow, because you've given a free cash flow guidance of GBP200 million; I think the dividend's about GBP400 million. Do we assume that all of the buyback takes place during 2015? In which case, does that give us a net about of about minus GBP100 or am I missing something?

And then, looking at the average net debt figure that you give, it's a complicated year in 2014, but it looks like it was about GBP1.2 billion worse or lower, if you like, than the arithmetical average. Is that a sort of good rule of thumb to apply to 2015?

Obviously, there was a bit of a subtext to those questions which is, given the deterioration and uncertainty that you have in some of your end markets, does it still feel like a good idea to be pushing through with that buyback process? Thank you.

David Smith - ***Rolls-Royce Holdings Plc - CFO***

Our expectation is that we will complete the buyback during this year, yes. We've done -- I didn't get the latest figures, I was staring at Jilinda because I was going get an update on that, but I think about GBP200 million up to the beginning of February. And our expectation is, providing nothing really happens in the market, that we'll continue on that rate.

You're right, on top of the dividend that will mean that we have net cash after financing, if you like, that's negative. We do have, in addition to the drawn debt that we have, we do have additional facilities and we're actually in the process of consolidating and increasing those a little bit at the moment. So from a liquidity point of view, to manage the midyear dip that we get, then we have sufficient liquidity to manage that, if that was your concern.

John Rishton - ***Rolls-Royce Holdings Plc - CEO***

And then on the average debt, is that -- ?

David Smith - ***Rolls-Royce Holdings Plc - CFO***

Well, I think that's the point, that there's a low point during the year.

John Rishton - ***Rolls-Royce Holdings Plc - CEO***

Okay. Let's go to the WebEx and

Rolls-Royce employee

I've got a question from Rob Stallard, RBC. On inventory levels, particularly in civil aerospace, how much further do you think you have go in terms of optimal inventory terms and how long do you think it will take to get there?bAnd also, what sort of assumptions have you built into your 2015 to 2017 plan regarding build rates on Trent 700 engine production for the A330 CO?

John Rishton - ***Rolls-Royce Holdings Plc - CEO***

Let me take the second one first. In terms of Trent 700, as I've said many times to this audience over the last eight/nine months, clearly there's going to be a level of change in that, in the number of Trent 700 engines that would be needed for the A330, clearly depending on Airbus's sales of the A330 aircraft.

As you would expect, our 2015 numbers are completely aligned with where with Airbus are. As they look out into the future between 2016 and 2017, we'll make sure we are aligned with them. But really, it's a question I think for Airbus, in terms of what do we think we can sell, or what do they think they can sell of those aircraft. We'll make sure that we have the engines for the aircraft they sell, and clearly we will help them in that sales process. But in terms of forecasting what that's going to be, I think that sits more with Airbus.

In terms of inventory levels, I think the question was how much more and what do we think inventory turns could be in the civil business? I'm not going to get into what I think we can get to, but I think we would all agree, and I'm going to look at Tony in particular as the civil business, that we can make quite some improvements in terms of turn rate.

I think we made some improvements in the absolute amount during the course of last year, but were impacted a little bit by some of the volumes. Tony, do you want to make any comments on that?

Tony Wood *- Rolls-Royce Holdings Plc - President, Aerospace*

We're looking at inventory in a very detailed way across the whole of the aerospace business. We have made some progress in the year, aerospace turns running at about 3.5 times at the moment. Still some opportunities to step that up.

A number of areas that are driving it. David mentioned in his pitch what we're doing on lean. So a standardized approach to how we look at lead time, the planning of lead time and the performance in the factories. A standard approach, in terms of how we run every one of those factories worldwide is the big drive that we're going for and started 12 months ago.

We've been doing Kaizen, we've been doing lean, we've been doing value stream mapping for quite some time, but doing that in a very consistent way across all of our facilities. Clearly, we have confidence that that will improve inventory turns as we go forwards.

We do, however, have a number of programs at different stages in their life. We've had some build rate moves with some of our major airframe partners that have caused some inventory to still be sitting on the book at the end of 2014. We do expect, though, progressive inventory improvement over the course of the next two to three years.

Celine Fornaro *- BofA Merrill Lynch - Analyst*

Three questions, if I may? Last year, you actually commented on what was the order cover for the business at this point in the year for 2015. So it would be great if you could share that with us and probably also the divisional level, marine being the most interesting one, depending on defense and the commercial end markets.

My second question would be on FX, what we should think about FX, any tailwind in 2015 to profits based on the hedge book rates you may have.

And my final question would be just back on this lifecycle cost recognition when you've got this GBP150 million catchup. Just to be clear, there is no cash impact on this? So even if you keep doing this, it will improve your margin, but there is actually no cash incremental recognition coming from it. Is this correct?

John Rishton *- Rolls-Royce Holdings Plc - CEO*

Let's take those in the order that you gave them. In terms of order cover, for original equipment across the Group it's around 80% in terms of the order cover. As you would expect, a higher level on civil and defense.

Marine is relatively high and you saw the marine order book, at constant exchange rates actually went up. I think that what I would say in terms of marine, though, is we have a level of caution, certainly David and I have a level of caution, I think Lawrie you would share this, which is, despite the fact that the order cover appears high, we are concerned clearly about customer deferrals in that book. And we've reflected that caution in the guidance that we've given you.

In terms of service order cover, again, quite a significant variation. And again, no particular surprise, defense would be the highest order cover we'd have in service. And the land and sea would be pretty low, because it is very short cycle in terms of the service.

But if I look at the total book across the Group, there is nothing exceptional, either good or bad, about where we sit in terms of order cover, either in terms of OE or in terms of services at this stage of the year, but for the caution I've expressed on the land and sea side.

David, maybe you could talk about the other?

David Smith *- Rolls-Royce Holdings Plc - CFO*

On FX, we have a hedge book that is roughly four to five years' cover. It's about GBP25 billion roughly, with an average rate of about $/$ 1.61. And therefore, we'll get relatively small movements on transactional exposure within a year.

Clearly, there are bigger movements around translational exposures, but those are not something that we would ever hedge. And those are just conversion of balance sheet items, so foreign currency items at yearend. We will, as we always do, I think, update during the year, as we give progressive information, any currency effects that we're seeing. But essentially within the guidance there are no effects.

On the lifecycle cost, I think it depends really about whether you're talking about period or the lifecycle itself. Within the period, you're right there's no cash effect. But clearly, anything that we end up putting on the TotalCare debt, it will come through as cash at some stage.

In other words, if you never sold another engine or never delivered another engine, it didn't grow, that cash has to come back into the business over time. So it's really a timing effect and, in fact, the whole TotalCare debtor is really a timing effect between profit recognition and cash flow.

David Perry *- JPMorgan - Analyst*

I've got three questions, it's all chronological. Just first of all, for 2015, just to repeat Celine's question, because I think she was asking about, if today's rates prevailed, could you just talk us through the translation impact on EBITA in each division? That would be very helpful, please.

The second question then is moving on to 2016. You may not want to comment, but any sort of tentative view on free cash flow, even directionally, would be helpful.

And then my third one; it was good, David, to hear you endorse the medium-term guidance. I just wanted to clarify one thing, because I think most of us assume the medium-term guidance is 2018. Your slide now has 2018 to 2020, so should we think, as you said, they're targets, it's not guidance as such, but is it a 2018, or is it more a 2018 to 2020 potential target?

John Rishton *- Rolls-Royce Holdings Plc - CEO*

Thanks, David. I'll take the last question and David may want to add a few comments to that. What we clearly said in the release that the medium-term guidance was exactly what David said. And then we said, as we sit here, 2018 is what we think that those events will come together. So that was where the 2018 came from.

In David's chart, which shows the period, I think it says in the chart, that's where we should be realizing the benefits from the investment which starts in 2018. So that was a period shown for when we realize the benefits, rather than anything relating specifically to the medium-term guidance.

But the key point that David makes, and we tried to make at that time was, it's the combination of factors driving the OE, aftermarket, the launch pricing, launch costs, the cost progression that we make that drive the margin performance, which you all know. And, based on the discussion that we had back in June last year, we viewed that as being 2018. So that hasn't really changed, but the chart David put up had a time period, so that's where we benefit from the investments.

David, do you want to talk about FX again?

David Smith *- Rolls-Royce Holdings Plc - CFO*

I think I'm going to give the same answer, that as we see it -- we've given the guidance, obviously, at 2014 FX. From where we are at the moment, at a Group level, there's only a very marginal effect. We will update you during the year if that changes. And there's not a significant effect on a segmental basis either. So I'm going to take a pass on that, because I'm not going to go through detailed review of that. We will update that during the year.

On 2016 free cash flow, I'm also not going to give any guidance for 2016. What we've done today, essentially, is given you a lot more information, obviously, around 2015. As we previously committed, we'll come back at the end of the year and update the medium-term guidance.

The reason that I took you through, hopefully, to try and clarify some of the key things that impact on cash flow, is I think it's very important that you and we, to be quite honest, work through these fairly methodically and think through them.

So the effects that are coming in, both from the investment phasing, from the growth in TotalCare net debtors that there has obviously an effect in cash flow because of the recognition issue that we've talked about between profit and cash, on the unlinked contracts the contractual aftermarket rights also that have a negative effect on cash as well.

It is very important that we think through this because my observation is that, when I look at the way that people are thinking about that, they've taken quite a linear approach, but it clearly isn't linear. And I think we have to think about those in a bit more detail, which is why I've given you both the update on 2015, and as you can see, the cash flow is actually lower than 2014.

That's impacted by a couple of things; the additional restructuring spend, as I explained earlier, that mainly comes through in 2015, but also because we start seeing a bigger ramp up on XWB which is unlinked as well.

And think through that in terms of the following years. I'm not going to give guidance, but I hope I've given you a lot more help in understanding some of the levers and mechanics that are going through those years to enable you to think about the modeling of that.

Rami Myerson - ***Investec - Analyst***

One question in three parts, on pricing, general heading pricing, but in aerospace can you talk a little bit about pricing pressures? So how much of those benefits from longer time on wing are you sharing with your customers for new TotalCare contracts, and, of course, the catchup that you've had?

And also on the old aircraft under time and materials, are you providing incentives for airlines to keep them on wing?

In defense, in the past, if I remember correctly, you used to talk about a mid-teens margins for that business; guidance implies closer to 20%. How should we think about that, going forward; is this now a 20% or high teen margin business?

And lastly, of course, on the land and sea businesses, can you talk a little bit about the pricing pressure? We have heard some of the customers talking about requiring price decreases from their suppliers.

John Rishton - ***Rolls-Royce Holdings Plc - CEO***

Okay, Tony, do you want to talk a little bit about air, and time on wing?

Tony Wood - ***Rolls-Royce Holdings Plc - President, Aerospace***

Yes, certainly we price competitively in terms of how we position our TotalCare offering. We are obviously confident about the process that we've put in place. David spoke, I think, in some detail about how we do that and how we leverage the tools, engine health monitoring, the detailed way in which we link our engineers to driving reliability in the components to get time on wing, less overhauls, less spare parts being consumed.

So we do share some of that with our customers, that is very much the competitive marketplace, but we price competitively and we're winning in the market. The engines that we secured orders for last year and the market share, I think, speaks to a combination of being competitive on pricing and having very good products.

John Rishton - ***Rolls-Royce Holdings Plc - CEO***

Thanks, Tony. David, would you like to talk a little bit about margins on defense?

David Smith - ***Rolls-Royce Holdings Plc - CFO***

Yes, the observations are obviously correct that defense margins are above mid-teens at the moment. That doesn't mean that I want to change my medium-term view. I think that we have had the benefit, as I mentioned earlier, of the fact that, with OE volume coming down, the proportion between OE and services increase. I don't think that's necessarily a natural position and I would hope, and we all hope, that we will do better, or sorry not that we will do better, that we will have some OE opportunities over the next few years.

So I think that's why I think the midterm is still the right guidance, because we'll see a bit of reversion, I think, from where we are over time. Is that fair, Jim?

Jim Guyette *- Rolls-Royce Holdings Plc - President & CEO Rolls-Royce North America*

Yes, absolutely.

John Rishton *- Rolls-Royce Holdings Plc - CEO*

Lawrie, Land and Sea pricing.

Lawrie Haynes *- Rolls-Royce Holdings Plc - President, Nuclear & Marine*

On the defense side, the naval side, yes, the various budgets at MOD/DOD are under pressure, so we're having significant pushback from our customers to say they were looking for price reductions.

On the marine original equipment, about 60% of our supply is into the oil and gas industry, the offshore industry, so yes, what we're seeing at the kind of top level, the top tier, is rippling into us. We're having considerable discussions with a number of our customers on the OE side. And on the services side, a number of our customers are destocking; they're actually using their existing stock which, of course, is putting pricing pressure onto the marine side.

We're also seeing, on the land side, a number of our customers are taking advantage from the lower oil price, but at the same time, they're using that oil price to pressurize all suppliers on price. So I'm afraid it's a uniform view across the market.

John Rishton *- Rolls-Royce Holdings Plc - CEO*

Thanks very much. Sorry we have run out of time. Thank you very much indeed for coming. A couple of just closing comments from me, other than to say thank you, as I said, for coming.

We are working, I hope as we have demonstrated, extremely hard to address the shorter-term financial pressures that many businesses including ours are facing. We are working very hard to address our cost and cash issues.

In the longer term, as you're well aware, the fundamentals for this business are very sound. The fact that we delivered the XWB engine on time and to spec is very, very important for the future of this Company. It is a great credit to the people that work at Rolls-Royce; an extraordinary achievement, in my view.

The future growth potential is significant. We understand the growing pains that as I have described them, and what we need to do about them, and they have our intense focus. The good news about that is it will make the business in the long run leaner and fitter than it would have done maybe if we hadn't have had those pressures today.

So thank you very much again for coming. I look forward to seeing you again soon.

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