Rolls-Royce Holdings plc

2018 Half-Year Results

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Introductions

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Introduction

Thank you for joining us here at the London Stock Exchange and for those of you who have joined us online. My name is Jennifer Ramsey and I lead the Investor Relations team at Rolls-Royce. Welcome to our 2018 half-year results presentation. In terms of the agenda today, Warren East, our Chief Executive, will be sharing his perspectives on the progress of the first half of the year. That will be followed by Stephen Daintith, our CFO. He's going to talk you through the financial results in more detail and then Warren will then round up with his outlook.

In terms of format, the presentation should take around 45 minutes and we'll have time for Q&A at the end and we'll be able to take questions online. Please access the webcast services via the web page to ask your questions on-line. We'll endeavour to take those questions that haven't already been asked in the room. We're not expecting a fire alarm test today so if the alarm does go off, please leave in an orderly fashion by the doors and can I kindly remind you to switch off your mobile phones?

And with that, I'll hand over to Warren.

Highlights

Warren East

Chief Executive Officer, Rolls-Royce

2018 Half Year Overview

Great. Thank you very much for clearing. Thank you everybody and for coming along this morning. So, as Jennifer says, I'll start with a quick overview and I'm well aware of my reputation for not being able to keep the time and I'm going to do my best this morning so that we have plenty of time for questions and answers.

So, a quick summary. You know, this is a good slide. It shows good half year progress for 2018 and that's really what is underpinning our confidence in the full year which is why we've made the comments we've made this morning about full-year free cash flow and profit at the upper half of or guidance range. Basically, all of these metrics are moving in the right direction and it's a strong performance across all parts of the business and I'm particularly encouraged by good control of some of our costs, particularly, our discretionary costs as well in the first half. So, we're feeling pretty good about it from an overall point of view.

I'll talk about that in a little bit more detail and run around the businesses, and then some comments on the restructuring. So, our civil aerospace business, you know, good metrics here are, obviously, overshadowed by the issues we're seeing on Trent 1000 and I'm going to talk about Trent 1000 in just a moment. But large engine production is up about 24%. Encouraging to see the run rate there. We're well positioned on run rate for the second half of the year. We do have a change in product mix going into the second half of the year that we can probably talk about a bit later and that's going to bring its own challenges but it's a very good first half position to start with.

And that's all, basically, led to growth in the installed fleet so we're now up to about 4,600 large engines in the installed fleet which is great and you're seeing that the size of the fleet driving growth in engine flying hours as encouraging and seeing that come through to the business. We also made good progress in the OE losses and I think both Stephen and I can talk in a little bit detail in a few moments about that.

Very good seeing new engines launched, as well. We, obviously, couldn't talk with you in March about our new Pearl engine that's launched in business aviation but it's also encouraging to see some of the other new engine activity as well. So, all in all, a good half for civil aerospace and I'll talk about Trent 1000 in a moment.

Power systems, again, a standout performance from power systems. Overall growth of about 13% driven by volumes and strong growth in the target markets, particularly, in marine and industrial sectors. Defence was a solid performance, very good on cash and a good development of their pipeline. The opportunity pipeline which we believe can turn into orders in the second half of the year.

At our Capital Markets Day a few weeks ago – six weeks ago now – we talked in more detail about the restructuring programme that we announced and I'm pleased to say that that's going very well inside the business and we're making good progress on that. Taken altogether, that gives us a good platform from a financial results point of view at this halfway stage in year, growing in confidence for the full year.

Trent 1000

And now I'm going to go into a bit more detail, and I'll start with the Trent 1000 since this is really a sort of contextual backdrop that has been a big issue for us in the first half of the year. It's been an even bigger issue for our customers and I have to say that, you know, of course, we apologise and do regret all the disruption caused to our customers. If you're a customer who has a large fleet of Rolls-Royce-powered 787s, then, you know, there has been an unacceptable level of disruption. However, we are working very constructively with each and every one of those customers on a customer-by-customer, almost engine-by-engine basis so that we have the situation with each customer's engines plotted out over the next 12 to 18 months. And that is a dynamic situation but we are working very closely with them on that. And I have to say that in spite of all the disruption caused, our customers, generally, are being incredibly supportive, and by working together, we are achieving minimal disruption for those customers.

Structure to Enable Change

So, from an operational point of view, at our Capital Markets Day, we had just passed what we believed to be the peak of the aircraft on the ground, and I'm very pleased with the team performance that has managed that situation. We've seen a lot of creativity, we've seen a lot of commitment and some very good results. The actions and the pace of response has been very good. We are now sitting well below that peak of just under 50 aircraft on the ground and increased MRO capacity is absolutely keeping pace with just slightly, slightly ahead, because we are on a slight downward trend, of the inspections and the fallouts from the inspections.

More importantly, we're also making great progress on the long-term fixes here and, obviously, six weeks since our Capital Markets Day and the update I gave then, I'm six weeks more confident in the final fixes to the situation around the Trent 1000's. So, from an operational point of view, that's good.

When we stood here in March, we talked about the cash impact on 2018 and 2019 and, obviously, the additional inspections that have come to light since then and the full, sort of, extent of what it takes to deal with all those inspections, we were able to quantify the 2018 impact at our Capital Markets Day in June and say that that's actually increased from the expected £350 million to £450 million in 2018 and over the last several weeks, we've been busy quantifying the cash impact in 2019 and 2020 and that's what we're talking about today. The cash impact in 2019 we now expect to be the same as 2018, £450 million. We do expect that to reduce in 2020 by 100 million and for a very significantly after that and Stephen will talk, I'm sure, in a little bit more detail around the exact timing of that.

And moving on to the expected P&L treatment of that where we've taken an exception charge this morning. So, we'll cover anything else about Trent 1000 in the Q&A session.

Restructuring Progress

Another key topic at our Capital Markets Day was our rewire programme, the restructuring and addressing significant change to Rolls-Royce across structure, across process, people and culture and I'm pleased with the progress that we've made over last six weeks since the Capital Markets Day but, of course, what I'm really pleased with is the progress that we've made internally since February when we kicked off this programme in earnest. The restructuring that we announced to three business unit has taken place. We are making good progress with tightening down on what is going to be our smaller, very lean head office and we have launched group business services, organisation and generally marching forward on that restructuring.

Our executive team has been in action around the business, consulting with thousands of our employees. So, here's a summary of what's happened. The group business services organisation is bringing together about 2,000 people from functions like finance and HR and legal to support our empowered businesses. We have established another central grouping, bringing together things like strategy and our technology group really focused around beyond the investment horizon of our businesses creation of genuine competitive advantage and intellectual property and that's quite a small team of a few hundred.

As I said, the executive team's been around the business. We have face-to-face met with thousands of our employees around the business since the middle of June and that's been an effort from all of our execs who've been out hunting in pairs. It's been a very rewarding exercise. A lot of two-way communication, and we've actually been able to use the input from our employees to help set priorities; it's actually initiated some short-term, immediate actions which have been quite useful, and helping us with our zero-based budgeting approach to making significant changes with our processes.

And in terms of the headcount reduction that we announced in the middle of June, then, you know, we're on target for our goals there. We're conscious of the fact that, you know, this is about real people. It's 4,600 people leaving the business by the end of 2019 with approximately one third of that happening during 2018. We are on target for that.

Progress in Civil

So, that's restructuring. Now I'll just do a quick canter round the three businesses. And looking at civil, it's not all been about the Trent 1000 in civil in the first half of the year, and that's really what's quite encouraging. You know, Trent 1000 is – I said I've been very pleased with the excellent response from our business but we've been able to do that at the same time as a lot of other good things happening. So, it's good to see growth in usage of the fleet and you see a significant half year on half year in invoice flying hours, partly, of course, driven by the increase in the size of the fleet so it's encouraging to see the ramp up in volumes. You know, we've been on this journey of 300, 400, 500 and, hopefully, this year about 600 engines being – large engines being produced. We are on track for that and encouraging as well to see progress on the OE losses driven by XWB but as Stephen will share a bit later, you know, some of the other engines contributing there to reduction in cash loses.

In terms of, you know, fuelling that in the future, encouraging to see the new engines coming through so Trent 7000 achieved certification and those of you who visited Farnborough a week or two ago, will have seen the Trent 7000 on the new A330.

And again, on new engines, you know, very good to see the launch of Pearl. Obviously, it's been in development for some time. We haven't been able to talk about it. It's a very well-kept secret but good to see a resurgence there and at a time when we see a little bit of an uptake in the business jet market as well.

And it isn't all about the current activity. You know, we are also seeing good progress on new technology looking further ahead and our ultra-fan core demonstrator. We've had some very good result in terms of testing there.

Progress in Power Systems

On Power Systems, they are saying another stand out performance really, very encouraging momentum at power systems. The pipeline for the second half and for 2019 also looking good, driven by strong markets, particularly, marine industrial and that's been that extra volume has been helping our margins. Looking ahead to cleaner technologies and demand there for gas power and in terms of what we've been doing inside the business then a continuation of the simplification I've talked about several times standing at this very spot, you know, we're continuing with the reduction in the number of product variance we've now reduced about 30% of the product variance, obviously, progress is a bit slower at that because you get the low-hanging fruit first but, you know, we're continuing on that journey.

I also talked before about Power Systems and service, and the massive installed base we have out there and how we aim to do a much better job on service in our Power Systems business, pushing digital, pushing connectivity. Obviously, we're prioritising the relevant applications there but we've also – you know, we have actually seen the first really digitally driven applications in people's hands to help with the service there and a replication of the service centre model that's in our Civil Aerospace business up and running in Power Systems. It's good.

And looking ahead, Power Systems, we also, you know, again driven by underlying fundamentals, cleaner fewer emissions, more efficient engines and also system solutions that we're working on in Power Systems. So all in all, a good first half year there.

Progress in Defence

Defence saw what we can describe as solid progress. I mean, actually, we haven't any huge announcements to make about what's been going on in events in the first half of the year. Clearly there was some work upfront on the structure, putting together different pieces of our business, all related to Defence under one umbrella. That's been encouraging. We've seen, actually, some early signs of first customer contact where that's actually becoming quite useful to join up. Good to see the F-35s appear in the UK, from a UK perspective. Good to see the MT30 getting outside of the UK and the US traditional navies, so in Korea and in Japan. I mentioned before the pipeline in Defence looking good for the second half of the year and again, those of you who were at Farnborough saw us on the platform alongside BA and others with the UK's new combat programme that was announced there.

Portfolio Restructure

Just one tiny bit to finish on, the overall shape of the portfolio. So we've talked about cleaning up the portfolio and we talked about the elements of that before. So as of the half year, pleased to be able to talk about the bottom half of the slide there where the sale of Commercial Marine has been announced. We rearranged a few of the pieces in the – in our formally marine business before we embarked on this process, which meant that we had essentially just a Commercial Marine operation to sell. Very pleased that we found an excellent buyer in KONSBERG for that business and a good result financially.

And with that, I'll hand over to Stephen. Thank you.

Financial Review

Stephen Daintith

Chief Financial Officer, Rolls-Royce

Agenda

Great. Thank you, Warren and morning everybody. So Warren's kept us on time and I'll do my best to stick with that. So thanks for joining us for the half year results and as Warren said, I think an encouraging start to the year, certainly ahead of our own internal expectations. We don't issue half year a consensus – sorry, guidance numbers for consensus but it's certainly ahead of our own internal expectations. Just running through the numbers. There's the agenda. Half year results, a quick account through the business units, accounting policy updates and then guidance for the balance of – well, for the full year 2018.

Half Year Results

Core & non-core business reporting format

So the half year results. First of all, we'd like to introduce a new format that we're going to be using on a go-forward basis to how we're going to present the Rolls-Royce numbers, highlighting what we consider now the core business. So we've announced the sale of Commercial Marine. We've completed the sale of L'Orange. So those are coming out of our core numbers. Late December last year, we completed the transaction for ITP, so that comes into our core numbers and that's how we've arrived at our core business. So this is – when you see the expression core business throughout the presentation and in the R&S, that's what this is all about. And in fact, we've shown updated our guidance to show this new format as well, which is consistent with the treatment we adopted for the group in March earlier this year with the full-year results.

Group underlying numbers

So the group underlying numbers. First of all, revenue growth. 26% growth in revenue across the group and we'll see that's a very strong contribution from civil, Power Systems and ITP as well. Sorry, that was 26% for Civil Aerospace there. It's 14% across the group. Civil Aerospace growing at 26%. That's growing in OE. Long term service agreement revenue but also in time a material revenue as well. So good growth across all three revenue streams. Power Systems growing at 13%. ITP growing at a very nice 19% and that's largely driven by its share on the Rolls-Royce engine programmes. Core business there growing at 16% and the group underlying results at 14%. So good revenue growth and as we'll see in a couple of slide, across our three core revenue streams of OE, LTSA and time and material revenue.

And then looking at the profit on a business by business section. The underlying operating profit or loss in Civil was £112 million but that's a £149 million improvement on the equivalent period of last year. Defence was pretty much flat. Power system, nice profit growth in Power Systems of £56 million on an organic basis to £80 million and that's good flow through of profit from revenue growth into profit. ITP growing by £32 million to underlying operating profit of 40 and you get to the group perspective there, core businesses growing by £183 million. And there's a strapline there just as a reminder that on free cash flows, as we'll see in a little while, £211 million growth in organic free cash flow to -£72 million but a significant improvement to the first half last year and group free cash flow at £267 million improvement there as well. So good progress across the group.

Core business underlying results

Looking at the core business underlying results when you add all that can take into account R&D and C&A and bring us some details in there. So there's a 16% revenue growth. Gross profit grown by 12%, R&D costs are down slightly by £100 million or so, 28% organic change, but just to make the point, and I'll show a slide a little later that really demonstrates this clearly, our cash spend on R&D is actually up on last year. So we are spending more than last year but the hit to the P&L account is lower, largely driven by the increase in capitalisation in line with our new policy, and I'll show you that detail in a second. C&A costs are up by 4% to £479 million. This is the indirect expenditure across the group. Most of our businesses, in fact, are flat, if not down on C&A and it is in Power Systems that's really driving this increase at a group level and that's largely a phasing difference which we expect to correct itself to an extent in the second half of the year. So core underlying profit growing by £183 million and core free cash flow at the bottom there, which we'll explain in a second growing by £214 million.

Continued underlying growth in core OE & LTSA revenue

Looking at the three revenue streams that I mentioned a little while ago. So whilst we're reporting core underlying revenue growth of 16%, it is not as though it's just one of our revenue streams that's sort of driving that 16% growth. It's pretty much it's good growth across our three core revenue streams. OE revenue, 19% organic growth, largely driven by the Civil Aerospace ramp up, which we'll talk about in detail, and the growth in Power Systems . LTSA service revenue, again, the flying hour growth is a big driver of that but also the shop visits growth as well in LTSA service revenues and again, largely civil aerospace. And then other service revenue, time and material revenue, we see this growth in Power Systems but also in Civil Aerospace where, as you'll see in a little while, the growth there in the – on legacy engines, the old-fashioned time and material parts and so on, high-margin business growing very nicely. So it's encouraging to see a balance of growth across the group and not just in one particular area.

Key point here, we actually have visibility of revenues as well. We have a very clear order book around Civil Aerospace, and as we'll see in a little while, Power Systems, as well, has good visibility around its order book and indeed a strong order book as well, and we'll go into that. And you can see the mix there of the types of revenue streams. OE, 49% growing at 19, LTSA 25% and other service revenue 26%. So a good balance of revenue streams, as well.

Core business R&D

Here's the chart on R&D. So R&D actually increased by £43 million on a cash basis to £663 million. Third-party contributions represents government funding and so on to contribute towards our R&D programmes. So our net cash spend is up by 14% at 518. We're capitalising £239 million of that spend and if you recall when we highlighted our new accounting policy, we're capitalising a little earlier and stopping capitalising a little later than previously and the comparative for the first half 17 did not have that new accounting policy in place. So that's why you've got a bit of a disconnect in those two numbers. So there core R&D P&L charge for the first half was £296 million. What else is there to say on this slide? I think where there is increased investments in Civil Aerospace largely the advanced development programmes, the Ultrafan progress continues, as Warren talked about, and we've got the new business aviation family, the Pearl 15, which we announced earlier this year. There's an increase spend in Defence as well, which we'll see shortly, explains the Defence profit before tax coming – operating profit coming down slightly and that's on future programme investments to support those new orders that Warren talked about that we're expecting at the second half of the year.

Restructuring: good start

So restructuring. Warren's talked quite a bit about this already but let me just put the sort of financials on this. The exceptional P&L charge that we're reporting for today for the first half of the year is £132 million and the test for this – this is largely headcount cost-related, the test for this is that our employees have a reasonable expectation of being impacted by this programme and it's the trigger for putting the provision in place for that headcount reduction. And as Warren mentioned, I think every ELT member, executive team member has probably done 40 to 50 town hall sessions around the Rolls-Royce group over the last four weeks, not just UK but across the UK but also Singapore, Germany, the US around all parts of the global Rolls-Royce. And explained in detail the restructuring programme, the implications of it but also what we're looking to try to achieve out of it from a culture and a process change across the business. So it's been a good start on delivering plan.

The next five months are – is a critical time when we then start implementing on those headcount reductions. Just as a reminder, we have highlighted that we're expecting around a third of the headcount reduction to be in 2018 and the balance in 2019. The benefits of this, reaffirming the benefits, £400 million of net saving run rate by the end of 2020, around fixed costs and headcount. Going back to my point about process, a much simpler, more responsive business structure, improved efficiency and effectiveness. And what's been encouraging, just to reinforce Warren's words is the degree of enthusiasm across the work force to get involved in this restructuring, so we've been delighted at that reaction. Total costs are £500 million, so the £132 million is a proportion of that £500 million. I think we guided to around 25% in 2018, so we're kind of broadly on track with that, maybe a little bit ahead of it. In its own way, that's good news because it demonstrates the progress that we're making on the restructuring.

Just as a reminder as well, the underlying profit and free cash flow excludes the one off restructuring items. So this £500 million cash cost is excluded from our underlying cash flow and profit numbers.

Trent 1000/900 cost update

The Trent 1000 and 900, and I've combined the two engines on this chart, but the numbers, particularly as we're getting sort of 18 through to 20 and beyond, are – a very large majority of those are in respect to the Trent 1000. So the 7th March guidance that we gave was £350 million cash cost for the Trent 1000 and 900. Since the Pack C and Pack B worthiness directives, that cost has increased to around £450 million. As Warren mentioned in his presentation, we're now expecting 2019 to be broadly flat with 2018 at around 450 million. 2020 falls by £100 million to about £350 and then we have a material reduction into 21 and 22 beyond that. The updated impact, what does this extra cost reflect? It reflects the cost of the compressor rotor blades and the significant ongoing customer disruption over a period of time as these worthiness directives remain in place. We'll talk about that in a second. I should say, as well, that all the cash costs for the Trent 1000 and 900 are included in our underlying free cash flow guidance and targets that we've given for the years ahead. Just to make that point. So whilst the accounting treatment, which we'll get to in a second, is around the accounting of it in cash, this 1000 and 900 in service cash costs are included.

Trent 1000 exceptional charge

So the triggers for the exceptional treatment – and over the last few weeks, we've exercised a lot of brain cells on this treatment with our auditors, with our audit committee, with our brokers – and we have all landed on this accounting treatment that we're highlighting today for the Trent 1000. A £554 million provision that we're setting up for the exceptional costs of the Trent 1000 total costs over the next five years. That's 2018, '19, '20, '21 and '22.

So what are those triggers? Well first of all – and we've put these words down very – prepared these words very carefully, because these are the sort of triggers that we'll use going forward, should we ever be in the position again, we're certainly not expecting that – and what we have is a pretty unique event with the Trent 1000 and this is just to clarify exactly what has triggered this treatment. So first of all, a series of abnormal events giving rise to a significant level of cost of a nature not normally expected. And most importantly, it's not reflected in the contract price. Not included in the original long-term contracts.

The abnormal events, I think there's the material technical issues arising from the regulatory Airworthiness Directives. And the Airworthiness Directives fleet-wide is an important trigger as well. It's a wide-ranging impact across the fleet of an entire product type, the Trent 1000, and it's causing significant disruption to our customers. In these cases, then, the costs of disruption, wasted material, labour, etc., in respect of the abnormal events, will be treated as exceptional in the P&L. And when we do all our sums, that item comes out at £554 million and that represents around 40% of the total cash costs of resolving the Trent 1000 issues for period over 1st January 2018 through to 2022. So it's a multi-year provision, 40%.

The balance of around 60% therefore will be recognised over time in the P&L through our normal contract accounting margins over the next 15-20 years. That balance of around £800 million also.

Final bullet point is just reinforcing my earlier comment. The cash costs will continue to be fully reflected in underlying free cash flow, as they are being for 2018.

Drivers of cash flow

The drivers of the growth in free cash flow. We're reporting a £267 million improvement on the prior year and a number of drivers that get us to that number. First of all, increased cash inflows from civil, aftermarket and engine flying hours. Flying hours growing at 20% on an underlying basis, so good strong growth there and good cash generation from that.

Higher spare engine volumes. We have a much better mix of spare engine volumes first-half second-half compared to last year, which was very much second-half weighted. So there is a growth there in the first-half this year compared to what was a relatively low number in the first half of last year, as the spare engine volumes were very much second-half-weighted. So there is a benefit in what is, at the moment, a very buoyant spare-engine market. Not just because of the Trent 1000 issues, because there are so many new engines going to a number of operators who'd like to build up an inventory of spare engines for their new fleet.

Defence and other business working-capital improvements. You might recall from the capital markets, today we're encouraging all of our businesses to work harder at working capital in inventory, in debtors, in creditors. We still have a large balance of old debts to be collected. We still have some suppliers that we tend to pay a little earlier than the terms, than we ought to. So there are old-fashioned opportunities for working-capital improvement.

Inventory remains at too high a level, as well, which I talked about. There's good opportunities there.

And then mitigation actions are contributing as well to the Trent 1000. As Warren alluded in his presentation, managing discretionary spend very tightly, particularly on travel costs, which have come down quite significantly over the last few months, and in capital expenditure as well.

On the other side of the coin, the outflows. Trent 900-1000 engine in-service costs, we've guided to that number around £450 million in 2018 for the full year. Power Systems is modestly lower, due to the order-book composition. But also, if you recall, Power Systems last year had a particularly good cash flow performance and particularly in the first half of the year, which of course you can't tend to repeat that year after year. And then we've talked about the high future programme R&D investment across Civil and Defence. That gets us to the numbers in the middle of the page there. Slightly higher tax, slightly lower pension costs, reflecting the surplus that we have on our pension scheme, and there's the out-turn below, of Group free cash flow but also highlighting the core free cash flow.

And all of these items give us confidence therefore around the full-year 2018 cash flow, hence the updating to guidance today to be in the upper half of our guidance range for cash and indeed profit as well.

Group net working capital change

Looking at working in a bit of detail. We tend to get quite a bit of questions on working capital, so we put this slide in just to help that analysis. Inventories have grown by £427 million. One shouldn't be surprised at inventory growth with Civil aerospace and Power Systems and the volume growth that we're seeing in those businesses. Of course, there's an argument to be had around the efficiency of our inventory balances, but that's another story.

The increase in trades and other receivables, again largely volume driven. And then increase in trades and other payables. There's been a material increase in the Civil long-term service agreement creditor balances, which has been driven by that engine flying-hour growth in advance of revenues recognised. And within that number is also the £154 million prior-year contract catch-up adjustment, which is a debit cost to our P&L account in the first half of the year, which I'll talk about in a second.

We've got phasing ahead of the H2 ramp-up of Power Systems, again you'd expect that given the order book and growth expected in the second half of the year. And you've got underlying volume growth in civil aerospace as well. So an equal and opposite match for that inventory growth that we're see up above at the top of that chart.

Group balance sheet

The Group balance sheet, just reinforcing our ambition to return to a single A-rating category. Single A ratings, I should say. Just a couple of things. During the first half, we completed the disposal of L'Orange, we announced the sale of Commercial Marine, and at the same time we successfully issued a €1.1 billion bond at attractive rates to pre-fund the existing debt maturities until the end of 2018. So our view that 2018 is probably going to be a better year than 2019 for debt maturities and so we pre-funded that.

Just on this point on the balance sheet, on these disposals, as well. What I like about these two transactions is that we end up with broadly £1 billion extra cash on the balance sheet but zero loss to profit or cash in our numbers, which is a nice piece of portfolio management from a financial perspective.

Shareholder payments

Shareholder payments. We're holding those flat for the interim payment at 4.6 pence per share. The cost of that is about £86 million. We are committed – we mentioned this at the capital markets date – to restoring shareholder payments to an appropriate level over time, and 2.5 times free cash flow dividend cover through the cycle is a sort of rough guide that you should be using to think about how we're approaching dividends. We view dividends in the context of our overall capital allocation – going back to the capital markets day – and the sorts of cash return on investor capital that we're looking for across Rolls-Royce.

Business Unit Review

So the business unit review. Much of this I've touched on already, so I'll try and run through these slides.

Civil aerospace overview

Underlying revenue growth in Civil, 26%, right in the middle of the chart there. And you can see the growth in OE revenue. There's a benefit there in that number related to those spare engine volumes in the first half of the year, which sell at list price of course, rather than at the post-concession price that we see in the deliveries to the airframers and then subsequently on to the airlines. Long-term service agreement, driven by the growth in flying hours and shop-visit growth, and then services time and material around often legacy engines and sales of spare parts.

So revenue growth of 26%, good profit flow-through, improvement in profit by £149 million.

Within these numbers, the operating loss, there's a net capitalisation increase of £174 million but at the same time, in that middle bullet point, there's a £154 million negative contract catch-up in our numbers, which are broadly awash, those two things. And you'll recall that in roughly May and November of every year are when we have our material contract pact reviews to look at things like what are the operational assumptions for our fleet, what are our assumptions around retirement, what are we seeing about – what visibility are we getting on the cost of shop visits and how much they're aligned with the plans that we have for those long-term contracts, and we adjust our contract margins for any changes in all of those things. This year we have had times when this has been a positive number, for the first half of this year it's a negative number to the tune of £154 million.

Engine deliveries

Engine deliveries grew by 24% to 259 wide-body engines in the first half of the year. And again, reinforcing Warren's comments there, looking at a number that is in the high 500s if not getting towards 600 on a full-year basis therefore.

Looking at the mix of the revenues there, 45% Trent-XWB, you can see a few more Trent 700s and 900s, and around a quarter or so, 28%, Trent 1000s. The order book profile's on the left-hand side. And again just reiterating the increased spare engine deliveries.

Seven business – a growth of seven business aviation engines. So there's an improving market for business aviation. Pearl 15 we believe is arriving at the right time.

Civil aerospace: key cash drivers

The OE loss on our engines. There's a 15% improvement. A bit of this is mix improvement. XWB 84 continues to make good progress towards its break-even target by 2020, which we're reaffirming today. There's both cost and price reductions, improvements I should say. The Trent 900 has a temporary pricing impact, so please don't read too much into the 15% for first-half, I think that's going to be completely replicated in the second-half. The mix will change significantly in the second half. We have a large ramp up in the Trent 7000 production in the second half, and traditionally our newer engines have a higher OE deficit than our older engines.

Engine flying-hour growth grew at 20% over the period. One of the stand-out numbers in today's results, I think. We have a growing fleet but we also have a growing flying-hour growth as well. Invoiced flying-hour representing good passenger traffic but also the use – our fleet is getting younger. And as our fleet gets younger, the utilisation of our fleet gets better, and that's also driving flying-hour growth as well. And there's the fleet now just short of 4,600 wide-body engines.

Shop visits. On the left-hand side are the regular overhauls that take place, the major shop visits. They've grown by 46 from 91 to 137. And on the right-hand side are the check and repair type visits, the unanticipated shop visits for various items. And as you might imagine, the key driver of that significant growth in the first half was around the accelerated maintenance activity on the Trent 1000 that Warren has talked about.

Trent XWB

Looking at the XWB, we talk a lot around the Trent 1000 and quite rightly, given its financial impact and customer disruption. But as a reminder just on the XWB 84 now entering its fourth year, over 2 million flying hours now. 99.9% dispatch reliability and the one or two engines that we have brought in for routine inspection or to carry something out are performing very well at this stage. So it's a case of touch wood four years in but at this stage the XWB 84 is performing extremely well. And this is important given its significance to the order book and what the fleet will look like in five years' time. So it's an important indicator for us.

Power Systems overview

Power Systems, moving on to that business. Again, using Warren's words, a stand-out performance for Power Systems. Very much showing the conviction that Andreas demonstrated during the capital markets day, and these numbers reinforcing those statements around the strength of that business. 13% growth and good profit flow-through. £26 million operating profit growing to £80 million. And this growth is across pretty much all end markets. The one market which is down slightly is power generation market, which is largely due to a very good first-half with the sale of engines into China to support the growing data centre market in China. And good operating margin improvement as well, of 330 basis points.

On Power Systems, again, growth across both of its core revenue streams of OE and services. I've pretty much talked to those words. Just on the order book as well, there's good visibility of the order book but also very good order coverage. It's over 80% coverage of the order book right now, and that's well ahead of where it was this time last year. So it gives us confidence therefore around the Power Systems revenue performance in 2018.

Defence overview

And then finally – sorry, not quite finally, penultimately – Defence. A solid performance in Defence. Underlying revenue flat on an organic basis, operating profit down slightly but largely due to higher R&D spend, that's partly offset by reduced C&A costs.

And looking at Defence, and again reinforcing Warren's comments, we do have a good pipeline of orders that we're expecting to flow through in the second half of the year. The orders are very much weighted in that direction and we remain confident on the outlook that we've given for 2018 for our Defence business.

ITP Aero overview

Quick word on ITP. We completed the transaction at the end of December. ITP is a very important part to Rolls-Royce. It has shares on all our key engine programmes, particularly the newer engine programmes, and it has for example shares of around 10% or so on the XWB. The underlying revenue growth is driven by the growth in Rolls-Royce civil aerospace programme. The margin shows good improvement, higher after-market volumes and improved OE mix and some good growth in operating profit as well, growing from £8 million to £40 million, organic change of £32 million, and there's the 19% revenue growth.

Accounting Policy Update

A quick accounting policy update. IFRS 9 is effective 1st January 2018, small adjustments to reserves on that date, no recent comparatives, and it has no material effect on our first-half numbers – and this is just accounting for financial instruments. IFRS 16 will come into play on 1st January '19. We'll update you later in the year and the impact on Rolls-Royce, but all of our leases including operating leases will come onto the balance sheet. So, for example, leases for our car fleet, for example, will come onto the balance sheet. We'll update you more on that. We're making good progress on the policies, the impact assessment, working with a very good software tool to capture all the data, so we'll be in a position later this year to report to you what that looks like for Rolls-Royce. The property and aircraft engines are the most material item. Interestingly enough, the car fleet causes us the most complication with all the detail that's attached to that – but that's a different story.

Guidance

2018 cash outlook

So, the guidance for 2018 that we're updating today. This is just a reminder of where we were. Free cash flow, we guided £450 million, that excluded ITP at that stage, on the 7th March. Updated free cash flow guidance on a like-for-like basis – so the red bar there shows you where we think we're going to be on a like-for-like basis in comparison to where we were on 7th March. So we now think we're going to be somewhere in that top half, the upper half of the range.

The core business, if we then add ITP in, and take out Commercial Marine & L'Orange, free cash flow there is at £400 million. Because as we highlighted at our full-year results on the 7th March, we expected ITP to have £50 million cash outflow in 2018.

2018 profit outlook

Profit outlook. The guidance we gave was £400 million plus or minus £100 million for profit, again that excludes ITP. On a like-for-like basis again, similar to the free cash flow guidance, we're highlighting now we expect to be in the top half of the range. And then if we look at our core business, so we throw in ITP, take out Commercial Marine & L'Orange, we're now expecting to be £450 million, because we guided that ITP would deliver around £50 million of profit in 2018. So just hopefully you can get your heads around that maths; it's a little complicated, but I hope you can see now how we're looking at Rolls-Royce.

And that's it from me. And I'll hand over to Warren for some concluding comments.

Business Outlook

Warren East

Chief Executive Officer, Rolls-Royce

Develop: Our Long-Term Vision and Strategy

Thank you, Stephen. Right, I've got three slides here, and I'm going to cheat a bit, so we can get along to Q&A. And I'm going to flick through and go slightly in reverse order. So, first half results, obviously the emphasis is around 2018. And we put this slide in, because we wanted to say that, yes, we are concentrating a lot on what we're doing this year. We've got a lot of things on our plates in terms of restructuring, in terms of Trent 1000, and so on. But the future doesn't just happen, we have to make it happen. And you saw this slide at our full-year results, but you saw it with different pictures. And so, we're putting it up here, same slide, to show that our approach to the future is very consistent, hasn't changed, and we're executing according to plan. But in spite of everything that is happening and that we're doing in 2018, we have our eye on the future. So, yes, it's about the balanced portfolio, and we just talked about restructuring the portfolio.

But, starting on the left-hand side of this slide, clearly the inescapable theme towards more electrification. Okay, we're actually doing things about it. Those of you who visited us at Farnborough would have seen us investing in pure electrical, seen us investing in small-scale hybrid, and seen an update on the larger-scale hybrid activity that we're doing in conjunction with Airbus. And so, the picture changes a little bit there.

Reinventing with digital. Yes, we've been dealing with this Trent 1000 issue this year. Actually, we've been deploying our R2 Data Labs team to work on that programme. And the Trent 1000 team have been benefiting from the data analytics that we've been deploying through R2 Data Labs. So, the reinventing with digital is starting to be real. And transforming our business in terms of production, a couple of weeks ago, those of your who look at these things very closely will have spotted us announcing a little robot developed in conjunction with Nottingham University, been doing that for a little while. But now we're actually bringing that into use so that we can automate some of these inspections that are costing us a lot of time, and effort, and people. And if we can automate that a little more it can be both cheaper, faster and more reliable.

And down at the bottom, the picture here is a picture of our composite fan which will be used on UltraFan in the future. As these fans get larger and larger you just can't make them out of the titanium anymore because they get too heavy, and clearly we need to be working – this is one of the ingredient technologies for the future. So, just wanted to put that in.

Restructuring

Coming back to 2018. At our Capital Markets Day we talked about restructuring. This is a fundamental, big thing, that we really need to get done over 2018 and 2019. And the must-dos that we put on the slide in June, this is a reminder. We're working on all of these must-dos now, and you heard from both Stephen and I how pleased we are with the start of that progress.

Priorities for 2018 Remain Unchanged

And continuing in reverse order on this slide, our priorities for 2018, completely unchanged in terms of categories of priorities. Good start to the year in the first half. In the second half of the year, we absolutely need to continue to think about our customers. We need to make sure that our production ramp-up continues to happen, we're well positioned at the half year for it to happen going forward. There is a change in engine mix, we do have some challenges producing significant quantities of new engines – 7000s and 97Ks – in the second half of the year. We think we're well positioned to do that. With that growth in the fleet now, 4,600 large engines out there, as Stephen mentioned, we have been expanding the service network. Again, the eagle eye would have spotted a few press releases about joint ventures and licensing out there so that we can build the MRO capacity in line with the demand. And we continue to deal with the Trent 1000 issue, both the operational management of the inspections and the customer issues, and the long-term fix or fixes we're working on for the Trent 1000 engine. So, very much a priority there.

Not forgetting the future, the technology pieces I spoke about; not forgetting resilience, the future of the business, built very much around the transformation programme, the restructuring that we're doing – pleased with the progress there. Put all that together, that's why we're confident in tone this morning with the financial outlook for 2018. But this is only half time, and we've got a lot of work to do in the second half.

So with that, I'll let you to ask us some questions. So, I'm not sure who went first.

Q&A

Andrew Humphrey (Morgan Stanley) : Hello, hi. Three, if I may. One is on the 20% flying hour growth, which I think was a standout number this period. Can you tell us how much visibility you had on that in June, particularly in relation to guiding around mid-term targets?

The second one is on working capital. Clearly, there's been a substantial benefit in the half-year. Yeah, a lot of that came from organic flying hours growth, but there are clearly other moving parts around that. There's been limited discussion around the concessions which we thought would unwind after a pretty favourable position in December. So, perhaps give us a little colour around that and how that evolves in the second half.

And then, finally on the Trent 1000, you've taken a charge representing around 40% of the overall costs. Can you tell us to what extent that sort of de-risks programme margin on the rest of the Trent 1000s as we look ahead and as we try and model it on a P&L basis over the mid-term?

Warren East: Yes, of course we have some visibility of flying hours, we're in daily communication with our customers – and we haven't got thousands of customers, there are several hundred. In terms of being precise about this, then we can't always model accurately. And when we talk about invoiced flying hours then we can see significant growth over the next several years. I think Stephen's comments about the age of our fleet are particularly pertinent. And so, if you consider airline customers who have a mixed fleet but want to retire some aeroplanes, they're going to retire the older aeroplanes first. So, the Rolls-Royce share of the underlying growth in the market will tend to increase because of our younger fleet. And of course we are growing our fleet compared with our competitor who are actually shipping more large engines and, and so you've got the underlying growth in our fleet as well. So, those three things.

Stephen Daintith: Okay. And on the working capital guidance, I think first of all on the concessions item. Well, in the first half of the year we actually again had some Trent 700s and 900s that we delivered that again have the concession that gets paid in subsequent periods. So, we were able to offset that potential headwind, and we still expect it to flow through ultimately as the Trent 700s in particular wind down. And that may very well be in the second half of the year. As it stands, working capital as a contribution to free cash flow, for a variety of reasons, I still expect it to be a modest generator of cash flow for us going forward each year. Inventory levels, we have around £4 billion of growth inventory on our books, there's opportunities there, less than three turns of inventory. So, I think there's a really good opportunity to improve that one. Debt, as I've talked about, and indeed payables as well. So, I think there are working capital opportunities. So, we shouldn't expect there to not be a contribution going forward. But certainly, that headwind on the concession item, I'm expecting it to be second half of this year, but it may move into the first half of 2019. Very much dependent, though, on the profile of the 700 and the 900 deliveries.

And, sorry, your third question was?

Andrew Humphrey: Was just on the Trent 1000 charge and the extent to which taking that charge upfront now basically de-risks programme margin for the rest –

Stephen Daintith: Yeah, to an extent it does. And clearly, if we're taking £554 million of cost now through the income statement that would otherwise flow through the contract margin. And if I try and put this in financial terms what it means, in 2018, for example, it would have been about £32 million hit to profit through in the contract margin in 2018 had we not accounted for that £554 million, to try and put it in financial terms for you.

Jaime Rowbotham (Deutsche Bank): Thanks, Jaime Rowbotham from Deutsche Bank. Three questions, very similar topics, I'm afraid. So, Stephen, on the working cap, in the first half, if we exclude the benefit from the increase in the contract creditor, there was an underlying working capital outflow, I think, not perhaps as big as we might have seen in previous years despite the seasonality of the business. Did that benefit from some of the work you've been doing around bad debtors or debt factoring or sale and leaseback type stuff, or is that all still to come?

Secondly, I was grateful for slide 24 on the Trent 1000. The comments you made, so you'll spend an extra £200 million, roughly, than what you previously thought over the course of 2019 and 2020. And that does not affect your confidence in the ability of the Group to deliver around £1.2 billion of free cash by 2020, from what I understood, but perhaps you can clarify.

And lastly, cash costs of restructuring. Were there any in the first half that were excluded from the £72 million free cash outflow? Apologies if I've missed it, what was the cash cost on Trent 1000 in the first half? And presumably, having now identified some of Trent 1000 as exceptional you're not about to start Xing that out of the underlying free cash flow.

Stephen Daintith: Okay. So, the short answer to the first questions is, yes, they pretty much flowed through. There might be some impact, but it's not material on those first few items that you mentioned, the washout in terms of working capital.

On the Trent 1000, yeah, we are reaffirming our confidence in 2020 free cash flow getting to our £1 billion number. I mean, clearly, as we're indicating today, 2019 and 2020 are each £200 million more than we had anticipated on 7th March, but our visibility and confidence around the rest of the group, across Civil, Defence and Power Systems, means that we still feel confidence around that £1 billion, around £1 billion by around 2020, that we've highlighted earlier. Clearly, it means, of course, that number might be a little lower than it might have been a few – a couple of months ago, but it's still a nice – we're still nicely confident around the overall conviction around that number. And, indeed, the £1 of cash flow per share by – in the mid-term.

The cash costs of restructuring in the first half of the year, no, there were no, at all, in fact, cash costs in the first half of the year on restructuring.

Jaime Rowbotham: And Trent 1000 cash costs, first half?

Stephen Daintith: Trent 1000 cash – we don't actually disclose that number and we're choosing not to. We'll give you an update on the full year cash costs at the end of 2018.

Jaime Rowbotham: Thanks.

Christian Laughlin (Bernstein): Thank you. Christian Laughlin from Bernstein, good morning, gentlemen. Just two questions from me. Firstly, starting with the XWB-84. Just, broadly speaking, how do you think about the drivers of the unit cost improvement year over year with respect to pricing getter better and getting through launch customer pricing, if that's applicable, or how much that is applicable, and – versus, say, reduction of unit costs from learning curve improvements and benefits from any other initiatives?

And the second question is around the, say, for lack of better descriptor, the legacy portion of your aftermarket portfolio: Trent 800s, older 700s that are, maybe, on their second – or contract or on time and materials, and then RB211s. How has performance of that group over the last half changed your outlook going forwards for the rest of this year and beyond, just at least in general trends: positive, same, negative?

Warren East: Do you want to do the first and I'll do the second?

Stephen Daintith: Yeah, sure. So the XWB-84, I think we mentioned previously the improvement in the deficit. Still the majority is price-driven rather than cost-driven, but cost increasingly playing a – you know, playing a contribution. So, you know, I would kind of think about, sort of, 70/30 in that mix, in terms of – as percentage contribution to the deficit, so that improvement, but moving much more in the cost direction as the volumes pick up in particular. So that's where we are today. And then, Warren, second question.

Warren East: Yeah. So on the second question, the – basically, the older engines and the service revenue that we derive from the older engines, there's not been a material change that I want to highlight in the first half of the year. I think, you know, the confidence that we are portraying about the full year is not really driven off… I was asked a question earlier this morning, you know, what's the one thing? And there isn't a 'one thing,' it's across the piece, and the fact that there is, effectively, no material change in those legacy engines does nothing to our confidence in the second half.

Christian Laughlin: Thank you.

Celine Fornaro (UBS): Thank you for not showing the videos about the snake robots and the bugs robots, I appreciated that. So two questions, if I may? The first one would be on the 787-10, if you could talk about that one a little bit? And I guess you may have done some checks on that engine too: how is it flying; how is it behaving; and if there is, you know, any charges there or any risks there on a – from a technology perspective, or what you've have on the other 787s?

And the second question is related to the business jets. If you could just give us a little bit of a view on how we should think about the deliveries of the BizJets and also commercial interest on the Pearl engine, and, you know, maybe getting another OE backing, what's the timeframe on that?

Warren East: Okay, righto. So, on the TEN, you know, it is a different engine but it is clearly – it's a Trent 1000 and there are common components, and so a couple of things. When the TEN was originally certified, there were some life limitations on some of the components built into the certification. Those life limitations have not all been alleviated yet, and so, you know, there will be some overhauls as a result of those life limitations as we get into the fourth quarter of this year and the first half of next year.

As a precautionary measure, then, we are changing the design; we're taking the lessons out of the Pack Bs and the Pack Cs around the compressor that we're dealing with at the moment. And rather than wait for, potentially, those issues to arise on the TEN, we're redesigning the corresponding blades on the TEN as well. And part of the costs that we've talked about and fully scoped out this morning include both the expected additional overhauls from the life limitation on the TEN that we have at the moment, and on the precautionary redesigns. The Pack Bs and the Pack Cs also have some issues that we're dealing with in the turbine section of the engine as well, and we're not anticipating those issues to occur on the TEN because they're already a different design of turbine blade and they already have different coating. But, you know, the turbine blade lifeing is something that we attend to, in terms of putting engineering effort into taking cost out of the whole engine maintenance programme, and if we can extend the life of the turbine blades generally then we will, and we're doing that on the TENs as we speak, but it's rather separate from the question that you asked, I think.

On the business jets, then, yes, we're seeing a little bit of an uptick in the market at the moment, which is good. And as Stephen mentioned, you know, from a, sort of, sentiment point of view it's a good time to be launching a new family of engines. On the Pearl 15 on the Bombardier planes, Bombardier are really hoping, I think, to have those planes entering into service around the end of next year. And so, in terms of sentiment and how they're being taken up, that's really a question for them right now. But we're seeing positive signs from all our business jet airframers in terms of demand signals as we look into 2019.

So then I think we had a couple in the middle.

Jeremy Bragg (Redburn): Good morning. Jeremy Bragg from Redburn. I've really only got one question, please, and it's on Trent 1000 again, sorry for that. You've described the situation as dynamic, and without meaning to be, sort of, abrasive about it, the cost estimate has increased a couple of times. And at what point – well, what needs to happen for it to stop being dynamic, i.e., at what point do you think, 'Okay, we can draw a line under this, it's not going to increase anymore.' Or is there a risk that, as we get through 2018 or 2019, you say, 'Well, actually, 2020's a bit worse'?

Warren East: So, first of all, let me caveat the whole thing, you know. On all of these engines, until you actually get a sustained period of operation between regular maintenances with, you know, no issues then you can't guarantee that there won't be some other issue. And so I'll say that everything I'm now going to say about the Trent 1000 is about the identified issues. The identified issues, you know, came to light the back end of 2016 through 2017, and it was described as a 'dynamic situation' because we were learning about what those issues are. And that culminated in a discussion with the airworthiness authorities just before Easter this year, when we agreed with them airworthiness directives around the compressor. The turbine section was pretty much understood by that stage, but we had issues with the compressor which, frankly, weren't really well understood until we got to around about the first quarter of this year and realised that, you know, we had to, basically, redesign these blades. I am, as I said, six weeks more confident in the final solution than I was at the capital markets day, and in terms of the diagnosis of the problem and, you know, the manifestation of the problem, that has now not really evolved since around the end of last year, so it's pretty stable. So you can never say never. But as far as these issues are concerned that we're dealing with at the moment, we think we have them fully scoped. We have a maintenance programme agreed, as I said, with the airworthiness authorities and we have an operational programme agreed on a customer-by-customer basis with each of our customers.

And so, as far as this setup issues is concerned, then I think we have a very good handle on it. And that's why it's sort of ceasing to be a dynamic situation.

Nick Cunningham (Agency Partners): Good morning. Nick Cunningham from Agency Partners. Couple of questions. A nerdy working capital one, and then a more general question. On the working capital, short-term trade payables went up a lot and long-term trade payables fell. And I was just struggling a bit to understand that because you would have thought if the payables reflecting the increase and LTSA receipts that you've received ahead of overhauls, that would be a long-term issue. So I wondered if one could get inside that a bit.

And should I go on to – and the second question is a much wider one and slightly odd. But CFM and IATA announced a deal to liberalise the aftermarket for CFM56s and LEAPs early this week, sort of nicely timed for the francophone world to be at the beach, I think. But one suspects that was to fend off the European Commission Enforcement Action and that would seem to be quite a monumental event, which might undermine the business model at least for them but maybe for the industry. I mean, do you see other OEMs, including you, having to do similar deals, is one question.

And then the second question is, would you go after CFM aftermarket if it effectively opens up to you? Thank you.

Stephen Daintith: Okay. So working capital, yes, you're right. It is a nerdy question, and I anticipated that and I've got a pretty nerdy answer as well, actually. So I'm happy to talk on the telephone with you later, if you like, to go through it. But right now, and I'll just go through the key drivers of each and then without specific numbers and we can – if you want to follow up, we can do that. So on the increase of £1.4 billion in the current liabilities, we move Commercial Marine to assets held for sales. That's a big chunk of the adjustments.

And the Civil – and also includes the Civil LTSA revenue on shop visits that are greater than the cash received. So that's two of the big drivers in there. And then the £1.7 billion increase on the delta on the other side on the current liabilities, it represents Civil and Defence deposits, the AE 1107 in particular. Then the Civil LTSA cash received is being greater than shop visit revenue for certain items there. That's in advance of the shop visits.

We've also included in that movement, is the Civil LTSA catch-ups of around £150 million that I highlighted earlier. There is also some risk and revenue sharing partner deferred income money that's in there. And finally there's quite a significant movement on the regional business jet LTSA moment as well. So there are a lot of things going on in this classification. Again if you'd like to have a follow-up, then I'm very happy to do that. But that's the best answer I can give you at the moment.

Warren East: Okay. And on the general question, I'll try to be brief because we could go on about that. It's an interesting topic. So the EU inquiry that came to light that was launched a couple of years ago that this appears to be related to. Yes, we did respond as requested to the inquiries. We've eventually heard nothing about this since. At the time, we said we think it's rather more to do with the narrow-body section of the market than the wide-body section of the market, and indeed that looks like that's the case.

To your sort of then broader question about what happens to the service market. Well, there is a profit pool there and the relevant interested parties are the airlines themselves, independent repair and overhaul operators, airframers and engine manufacturers. And our hook to maintain a claim on that profit pool is that the knowledge that we have of our engines and the intellectual property that's embodied therein.

And I see that profit pool and the different players as a sort of normal market evolution. You take a snapshot today and this is how it works. Clearly there is scope there for evolution as different players jostle for different shares of that over the future and all the engine manufacturers have the same hooks as we do in terms of knowledge and intellectual property in their engines. And so I can't predict exactly how that will play out over multiple years.

What I could say short term about our intention to go and service a load of CFM engines and vice versa, is that we all are playing battles with the boundaries of the laws of physics. We've all got, what you might call, issues with our engines and our customers in terms of durability of components and reliability, and so on. And I don't think – I think all of us are pretty occupied with dealing with our own issues for now.

Nick Cunningham: Thank you.

Harry Breach (Raymond James): It's Harry Breach from Raymond James. Just two. Firstly, I was really struck by the strength of T&M revenue growth of Civil in the first half. Can you give us a feeling about the particular engine programmes driving that? On the margin impact of the T&M revenue growth being so far in excess of the LTSA growth, and how you're thinking about T&M in the back office here? Is it sustainable? Was there some big lump in overhaul scheduling, given how you're seeing the lives of those T&M engines?

And then just turning on to a maybe much simpler thing. The R&D capitalisation resulting from the policy changes clearly very significant in the context of operating profit overall. As we look to the sort of second half, should we be thinking about roughly double that number in the second half and can you give us some feeling for how that net capitalisation number is going to be evolving given it's sort of looking like about £350 million on an annualised run rate?

Stephen Daintith: Okey-doke. So on the time of materials, the two key engines that are generating revenue there are RB211 and the 700, and these are the more mature engines that are not necessarily on long-term service agreements. The margins, there is good margin on this business and it's a revenue stream that we don't probably talk about as much as we should do. It's nicely profitable, and clearly over time it will become smaller over a long period of time as we move to very much sort of a total care agreement type basis. But it can be with us for quite a bit time to come and at a very healthy margin.

And I think I've answered the sustainable question there, as well. R&D capitalisation, you should be thinking around £400 million or so on a full-year basis, the capitalisation. And then that will be a pretty good sort of steady-state amount for the next few years, particularly as we go through relatively new engines, finally getting certified, finally getting on wing and then we'll start to tail down as we get into sort of, I would say, the 2021, '22 type time period and you would naturally given as the engines become more mature that the capitalisation will cease and we move into a steady state.

Harry Breach: Thank you.

Warren East: Over here. And then we must remember we've got a couple coming through online. So let's go just there first and then down to the online ones.

Rami Myerson (Investec): Thank you. Rami from Investec. Three questions. On the free cash flow guidance, in the AGM statement you talked about a similar cash outflow to H1 '17 and you've obviously done a lot better than that commentary provided at the trading statement in Q1. But guidance is still – the change is smaller than we would have anticipated. Is there something we need to be concerned about in H2 – are you concerned about in H2 which limits the upgrade to guidance?

Second on Trent 1000. We understand that part of the compensation some of the engine manufacturers have provided to airlines has been through credits on future engines sales and on maintenance events. Does the £1.4 billion include the credits that you may provide to some of the airlines for future engine sales and maintenance?

And the last one. Just on the French German, the FCAS programme. Would you be able to bid for that via your German facility in the future? Thanks.

Stephen Daintith: Okay, so free cash flow on a full-year basis. I think Trend 1000 cash costs in particular will be more second-half-weighted than first-half-weighted. So that's another reason. And then I don't want to raise – I'll come back again to this sort of working capital subject. But I think it's just – it's difficult to be precise around working capital given the very nature of the sort of items that take place. You've got concessions. You've got customer deposits. You've got repayments of customer deposits. You've got collection or payment of risk and revenue sharing partner fees. So, we naturally, you know, build in a degree of estimation around working capital therefore. So, as it stands we're comfortable to give the guidance that – the updated guidance that we've given in the top half of the range and nothing more beyond that.

And then the second question, the short answer is no.

Warren East: And the third question, the short answer is yes.

Stephen Daintith: I think, Jennifer, we have to come to someone online, just to be fair.

Jennifer Ramsey: Yes, there's a question from Chloe Lemarie at Exane. How should we think about the margin profile of the Trent 1000 aftermarket? Arguably at this stage you've put quite a lot of costs on a small margin, so going forward, does that mean that margin could improve slightly with time as risks are retired or will the margin remain depressed through the life of the engines which are affected by the current issues?

Stephen Daintith: I think, well, the Trent 1000 margin has a lower aftermarket margin than, for example, the Trent 700 which has a good aftermarket margin, and XWB and so on. But we do, as the questioner has asked, we do expect that to improve as we retire the risk and costs that are attached to the remediation of the current issue around 2021-22, we will start seeing improvement then.

Jennifer Ramsey: Another question. In terms of the restructuring, Warren, how do you plan to keep the restructuring in line with your current long-term strategy post-2020. I guess, this is with regard to increase in development cost of new products post-2020, and keeping a cap on our indirect costs.

Warren East: So, what we're doing with the restructuring at the moment is basically a bit of long-term maintenance on the organisation. We are modernising a lot of behaviours and processes and simplifying, removing activities that perhaps were appropriate at one stage in the past that are no longer appropriate going forward, and behaving a bit more like a sort of modern competitive company. I think, you know, that is a – that is a one-off change and we hope to get through most of that change during 2018 and 2019. Of course, then, you know, companies such as ourselves that depend on technology as sort of the lifeblood of our future products and business, of course, we have to spend money on that. And that's the very reason why we're doing all this effort on transformation. We have to generate a sensible, competitive amount of cash so that we can reliably continue to invest in R&D at the sort of levels that we need to invest in. I don't anticipate any great kick-ups in investment in R&D after 2020. It's business as usual and you will see us investing a sensible, competitive proportion of our annual turnover in R&D generally going forwards.

Right, we don't have any more from online?

Jennifer Ramsey: We have one more. We have a few from David Perry (JP Morgan) but some of them have been answered already, so this is his third question. And he's just suggesting that he wondered, Stephen, whether you answered Jaime's question around if any of the Trent 1000 cash costs would be treated as exceptional items in free cash flow.

Stephen Daintith: No. Sorry, just to absolutely clarify, our underlying free cash flow will include all the cash cost outflows in relation to the Trent 1000.

Warren East: Thanks for that clarification question. Any others in the room before we wrap up? No. Great. Well, in that case, thank you very much everybody for your support and we'll be back with some full-year results early next year.

[END OF TRANSCRIPT]