Babcock International Group plc

Half Year Results for the six months ended 30th September 2018

Wednesday 21st November 2018

Archie Bethel, Chief Executive

Good morning. Thank you for joining us. I think it's fair to say it's been a challenging six months. The political environment and the economic environment has been pretty volatile and, at times, unpredictable. But we've kept our focus on delivering for our customers and on strengthening our business.

The half year results we're reporting today clearly demonstrate that our focus is paying off, but I'm frustrated that we're not achieving the shareholder returns that our underlying financial results would normally deliver. So we are taking very specific actions to strengthen the business and to make us more attractive to a wider pool of investors.

Overall, we've had a steady first half to the year. We've delivered underlying results right in line with the forecast we gave in May. But we do face a couple of headwinds, and I'd like to tackle them right up front.

As I said a minute ago, we've had a difficult few months. We were attacked by an anonymous short researcher who issued a report attacking Babcock by making false accusations and claims. The motive behind the attacks was clearly to short our stock, and sadly, it worked.

The most damaging false accusation was that our relationship with the UK Government and MoD is bad, and that is simply not true.

Babcock has been a key supplier to Her Majesty's Government and the MoD for over forty years; in fact we've been supplying products and services to the MoD for over 100 years, and there are not too many companies who can claim that. Today, we are currently delivering 128 contracts with a combined value of over £25bn across government. Talking just of Defence, we've been the MoD's second biggest supplier for the last ten years, and we are their largest provider of engineering support services.

This is highly complex and challenging work, and the MoD quite rightly demands the highest levels of performance, and we always strive to meet their expectations, and most of the time we achieve just that.

And sometimes issues arise, as has been the case over these many years, and in these instances we work together harder than ever to resolve the issues, because none of us has the full answer on our own.

That's why we participate in both the Cabinet Office's Strategic Partner Programme, and the MoD's Strategic Partner Programme. And earlier this week all three parties confirmed their cooperation in signing up to a Joint Way of Working Charter that will progressively develop our relationship to the next level. And we're the first of the defence companies to progress through that programme.

So I would characterise the relationship as being much as it has always been: professional, robust, demanding, supportive, frank, open, honest and enduring. Does that describe and constitute a good and strong business relationship? Well I think it does.

The second area I want to address right up front is the exceptional charge we are taking against our Oil & Gas Helicopter business. In 2016, following a fatal crash in Norway involving one of our competitors and an Airbus EC225 helicopter, as a result, Airbus EC225 helicopters were grounded worldwide whilst the cause of the crash was investigated. In July 2017 the Norwegian and UK Air safety authorities lifted the ban, but in both the UK and Norway oil companies decided that they would no longer accept the use of EC225's.

As we have reported in the past, Babcock has 13 Airbus EC225 in our offshore fleet of 50 heavy lift helicopters. These grounded assets are obviously a significant drag on our offshore business. In the last two years grounding these aircraft has pulled operating margins in this area of our business down to low single digit.

So we have taken the decision to re-value these assets to a level where we will be able to either sell them in the used aircraft market or re-purpose them for alternative uses. In fact, the picture here shows the first EC225 that we have successfully re-engineered for firefighting duty in Spain.

Today, the oil price has recovered significantly from the $30 per barrel low point of a few years ago, but there is still volatility in that price, and market activity, especially in the up-stream sector, remains subdued, although over the summer we did experience our first modest growth in revenues.

Our Aberdeen based business has consistently performed well throughout this difficult period. They've kept firmly focused on safety and on delivering for our customers. Their determination and commitment has paid off, and unlike our main competitors, we have avoided moving into a loss making situation.

The impact of the impairment and provisions will be to improve the profitability of this part of the business and put us in a strong position to benefit from increasing activity as the market recovers.

The third area I'd like to update you on is our Magnox Decommissioning contract. We have updated you on this a number of times as we work towards the hand back point on 31st August 2019.

In March 2017 the Government announced its intention to terminate the Cavendish Fluor Partnership contract from August 2019. At the time, the Government emphasised that this was not a negative reflection on our performance, and we were awarded a contract to run the project to an agreed end state by August 2019, and we are committed to achieving a smooth transition back to the NDA.

There's still an extensive scope of work to be completed on the Magnox estate after the contract end date next year, and the NDA has confirmed that it intends to take the contract back in-house. They will then re-contract for the work on a package by package basis.

We are still really confident that Babcock Cavendish will be successful in winning future Magnox work. But, based on our current knowledge of where the NDA are in terms of the overall process, we believe there is now likely to be a time gap between the end of the August termination date and when the NDA will be ready to come back to the market with the packages of work.

For planning purposes, our assumption is that when work ends in August 2019 there will be no follow up work on Magnox for a two year period. Now that might not be a correct assumption, but based on our best judgement we think that this is the prudent position to take, and from the beginning of next year we will start to see new opportunities develop in a pipeline for Magnox down later.

The stepdown in revenue in 2019/20 is now expected to be around £250m. Our previous guidance was £100m, with a stepdown in operating profit of around £20m, against a previous guidance of £7m.

So let me now move on to some operating highlights for the first half of the year. Across all four sectors, we've had a very busy first half to the year. In Marine, we've had a full surface warship and submarine programme in the UK, and we also made good progress in our international markets.

In Canada we were awarded a 384m Canadian dollar three year extension to our submarine support contract, and in Australia our frigate support contract continued to grow and perform well.

We delivered our first batch of submarine missile launch tube assemblies to the United States as part of the Dreadnought/Columbia common missile compartment. And the Babcock, Bernard Schulte joint venture completed its first LNG Gas Supply Vessel, which will be deployed in the Baltic Sea by the end of the year.

In our Land Sector we prepared 490 vehicles for the British Army as they deployed to Oman for one of the biggest training exercises in recent years. And we were also awarded a £50m two year extension to our Metropolitan Police vehicle support contract. We mobilised a major training contract at Hinckley Point C for EDF as well.

In the Aviation Sector we achieved full mobilisation on our Hades Project. That project covers 17 Air bases. And we also mobilised on three new air ambulance contracts in Sweden, Norway and Finland.

In Spain, we were awarded a five year contract from the Region of Valencia for firefighting, emergency coordination and medical services. And in France our FOMEDEC pilot training contract is progressing to plan. Seventeen aircraft have been manufactured, and all the simulators are now up and running.

In Cavendish Nuclear, we made good steady progress at Dounreay, where we continue to implement the Government's site restoration strategy. And across the Magnox Fleet we continue to make good progress, and are committed to achieving a smooth transition of this contract back to NDA in August 2019.

And just last month we opened a new office in Japan to support our ongoing work at both Tokai and Fukishima, and because we're convinced that opportunities there will continue to develop.

During the first half of the year we continued to sharpen our focus around our three key Strategic Markets: Defence, Emergency Services and Civil Nuclear. I'm particularly pleased to report that our International business continues to grow. It is now becoming an increasingly important element in our overall business strategy, with around 30% of our revenue now coming from outside of our UK markets.

In the last few weeks we have made further important breakthroughs in our International Strategy. We are now very close to award on new Marine and Aviation opportunities worth around £200m. And in both cases it's a combination of domain knowledge and expertise provided from our Sector teams, combined with our established in-country operations that provide us with the platforms to win this new business.

It's also essential that we remain competitive. So we are innovative, we continually improve our productivity, and we improve the quality of our services to our customers. And it's also vital that at the same time we continue to improve our safety performance across the Group.

It's also crucial for us to focus on our core business where we see future growth and investment opportunities. At the same time, we've got to address small areas of the business that are not part of our core activities.

During the first half of the year we completed exits from our Offshore Renewable business at Rosyth, our small North American construction support business, and our Powerlines business in South Africa, and we sold our Media Services business.

We've also reduced our production capacity, mainly in the Marine area. There we will exit the Appledore facility in North Devon, and at Rosyth we have been right sizing the workforce and facilities as the Aircraft Carrier project enters its final stages with HMS Prince of Wales nearing completion.

We've taken these actions I'm talking about to retain our competitive position, and to protect and improve our overall financial performance.

The Order book remains strong at £18bn. In the first half of the year we added £2.6bn of new orders. The bidding pipeline increased by £1bn to £14bn during the period, with £3.7bn of new opportunities being added. And as you can see from this slide, 93% of our order book and 87% of our pipeline opportunities are in our key three markets.

Our UK Government and MoD work also increased, and we now have, as I mentioned before, 128 contracts running across the Government. The majority of those contracts are with the MoD, and during the period we added another £650m to our order book.

So I hope that gives you an idea of where we are at the moment, and a reasonable picture of what we are doing to continue building on the solid performance we've delivered during the first half of the year.

So I'd now like to hand over to Franco who will take you through some of the detail behind the financial results.

Franco Martinelli, Group Financial Director

Good morning. This morning I'd like to focus on my priorities in driving shareholder value in four ways. First, sustaining margins. Second, generating cash. Third, de-gearing. And finally, fourth, improving returns.

I'll also take a minute to explain why joint ventures are really important and why they will be a source of future cash.

I'm going to begin with a summary of the key figures for the first half of the year.

Our underlying organic revenue was down by 1% at constant exchange rates. Underlying profit has grown by 2.4% at constant exchange rates.

As a result of the actions we're taking to further strengthen the Group we have recognised £120m of exceptional charges of which £80m is oil and gas. That's £100m after tax. The total net cash cost is expected to be around £10m over the next few years. I will come back to these numbers in more detail shortly.

As you know, cash generation is an important part of our model; and I'm pleased to say that we generated free cash flow of £140m. We also achieved our target of delivering pre-capital expenditure cash conversion of over 100% and cash conversion works out at over 80% post capital expenditure.

And we continue to reduce our gearing as planned with net debt around £160m lower than it was at this time last year.

Finally our earnings per share is up 3.1% and we're increasing our interim dividend by 3.6%. That dividend increase shows our continuing confidence in the future.

As you can see, underlying revenues fell slightly while underlying profits increased. I'll take you through those movements on the next two slides. Our underlying results excludes £120m of exceptional charges I mentioned earlier.

The exits from our lower margin businesses has led to a year-on-year improvement in underlying margins to 10.9%. Reduced interest charges and a stable tax rate have resulted in earnings per share growth of 3.1%.

So I'd like to be clear about our revenue movements. As you can see from the revenue bridge. There is a £17m FX impact, and a £15m effect of disposals. Once rebased this gives underlying organic revenue growth down 1.1%.

Then we had £42m reduction relating to exits from low margin businesses. So taking that into account our continuing business was up 0.5%.

You can see from this next bridge the effect of FX and disposals. The increase in operating profit was driven by a strong performance in Land and a good performance in both Aviation and Nuclear offset by Marine. I will go into more details when I come to look at each sector.

Again, for clarity, we have provided a reconciliation between underlying results and statutory results. The main difference between the two are of course the exceptional costs of £120m which results from those actions we've taken to sharpen our strategic focus and our increased share of joint venture profits.

So looking at the exceptional items in more detail. We've broken them down into 3 areas: Oil & Gas, Capacity Reduction & Restructuring, and Exits & Disposals.

Firstly in reshaping our Oil & Gas business we have taken an asset impairment charge of £38m. That charge reduces our oil and gas assets, mostly the EC225 helicopters, to their market value. We have also recognised an onerous lease provision of £42m against our leased helicopters. That additional £42m reflects the cost of these commitments versus current market rates.

Secondly, we have made significant changes to capacity across the Group, including the exit from Appledore shipyard, rightsizing capacity in our other Marine facilities, reducing capacity in Rail ahead of our bid for the new CP6 contracts, and the restructuring of our business relating to Magnox. All together these reductions in excessive capacity have resulted in a charge of £40m.

And lastly, we have exited a number of low margin businesses. They include: Renewables, North American mining and construction support and Powerlines in South Africa. These costs of these exits have been offset by the proceeds from the sale of our media services business.

So, net of tax the exceptional charge is £100m. But our total expected net cash cost is only around £10m. This has been reduced through expected sales of helicopters of around £40m.

Revenue in Marine was lower in the first half. That reflects the exit of our renewables business last year and the step down in QEC work of £47m. But excluding these factors the continuing business grew by 2%.

Margins remained stable. A minor change in business mix offset the loss of low margin revenue in both QEC and renewables.

We expect revenue for FY19 to be broadly stable year-on-year and that we will maintain a stable margin.

In FY20 we expect a stepdown of £75m in Marine in relation to the carrier programme. That stepdown will have a minimal impact on operating profit.

Revenue in Land was down 14.6% with a £33m impact from business exits and disposals. And they had a £10m impact from FX movements.

As we talked about earlier in the year there was reduced procurement activity in defence and less rail electrification work.

The Land Division’s operating profit increased significantly. That improvement came from South Africa in its equipment business, improved contract performance, cost reduction and from better than expected savings in our Holdfast (RSME) JV. We expect Holdfast (RSME) JV profits will normalise next year. The increased profits in South Africa came from our buoyant equipment business

For FY19, exits and disposals this year will contribute to a year-on-year revenue 10% lower, but with a strengthening margin.

The strong revenue growth in Aviation was largely driven by the delivery of aircraft and simulators on our French FOMEDEC contract. We expect Emergency Services and UK Military Air growth to be second half weighted.

Operating profit increased in Aviation but margin declined due to new contracts being at an early stage. As many of you will recall, we typically take lower margins during the initial phase of our contracts.

We expect strong year-on-year revenue growth for FY19 albeit with the pace of growth slowing somewhat in the second half and with a softening margin year-on-year.

Our Nuclear business delivered good revenue and operating profit growth in the first half. That solid performance was driven by our Nuclear Services business and increased activity on our Magnox JV.

Our outlook for FY19 is for year-on-year flat revenue with a stable margin.

As you heard from Archie earlier our Magnox contract is scheduled to end in August 2019. However, we now think that the NDA procurement strategy will be insufficiently advanced by then for us to assume any further revenue in the short term. So we have changed our modelling assumptions.

Therefore, the FY20 Magnox step-down is estimated to have roughly a £250m impact to revenue and about a £20m impact to operating profit, compared to previous guidance of £100m of revenue and £7m of operating profit.

In FY21, we expect a Magnox step-down in revenue of £100m and a corresponding £7m impact to operating profit. In the medium term we still see Magnox as a significant opportunity.

FOMADEC had a £50m working capital outflow in FY18 which fully unwinds in FY19. Slightly larger benefit in the first half offsetting the guided phasing of working capital. The FOMADEC contract is now cash positive. Full year cash flows are on track as previously guided.

Aircraft payments drive capex in the first half. But, these aircraft payments will reverse in the second half as we convert them to operating leases.

And, as I said before, we achieved our target of delivering pre-cash conversion of over 100% and post-cash conversion over 80% and we are right on track for the full year.

Free cash flow before pensions was £140m. That £140m was driven mainly by improved working capital performance and growing JV dividends.

Pension payments in excess of income statement have increased by £9m which is partly phasing, and I will talk about pensions later.

The net cash cost of exceptionals was £5m in the first half.

Over the last 12 months we have reduced net debt by £160m. That cuts our net debt to EBITDA ratio by 0.3 times.

We continue to expect net debt to reduce to around 1.4 times to EBITDA by the end of the financial year, and 1.1 times for FY20 excluding the impact of IFRS 16.

Our net debt of £1.1bn includes £160m of finance lease debtors related to FOMEDEC. All of that £160m will convert into cash in the second half. As of today we have already received nearly £100m of cash.

As always, net debt excludes non-recourse JV debt, which is currently £345m, mainly held in the AirTanker and Ascent JVs.

We have assessed the impact of IFRS 16 which will impact FY20, and it will be a 0.4 increase to the net debt to EBITDA ratio. This additional debt is unchanged from previous guidance.

You'll recognise this slide, it sets out our capital allocation policies which haven't changed.

Firstly, we will invest in the business to drive growth. We are highly disciplined in applying our investment criteria to support return on invested capital. Any investment we make has got to meet these hurdles or it won't happen.

Secondly, we will de-gear the balance sheet. That gives us the flexibility to make sure we are well-positioned whatever the environment. And we think de-gearing the balance sheet is particularly important during this period of economic and political uncertainty. It also safeguards our credit rating, and provides additional funding for our pension schemes.

Thirdly, we want to return capital to shareholders. We'll do that primarily through a sustainable dividend. Our ordinary dividend is growing, and our free cash flow gives us more than adequate cover for the dividends we're paying. As we continue to reduce debt we will have scope for additional returns.

Our IAS 19 position is now a surplus of £26m, compared with last half year's deficit of £116m. This improvement has largely been driven by discount rates, asset performance and our deficit contribution. Whilst it's good news, remember this is an accounting valuation, not a funding valuation.

To remind you, we have three main schemes. In the first half the Devonport scheme valuation was signed off, with no effect on the deficit but an increase in the cash service cost. Our Rosyth scheme is currently under discussion and is more challenging.

The increase in the cash service cost on top of the IAS 19 service cost, will be a cash drag of £5m, but our cash service cost will in the future be partly offset by increased employee contributions and restructuring.

Finally, we expect to pay a contribution in excess of income statement of around £55m for FY19.

As I mentioned earlier, our share of JV net debt is £345m, with the majority in AirTanker and Ascent. This debt is all non-recourse. As you can see, our JVs have significant cash balances due to JV performance ahead of schedule, and that cash is held for scheduled debt repayments and dividends, which you will see on the next slide.

JVs are an important part of our underlying business. They represent 12% of our underlying revenue, and 21% of our underlying profit. They hold distributable reserves of about £140m, and as the non-recourse debt in the JVs is paid down, they increasingly have more cash to pay out in dividends.

Higher profits in our JVs have resulted in an increase in dividends. We expect cash dividends of around £50m for FY19, and £45m for FY20. The cash gap between net profits and dividends, which particularly affects the asset JVs, has marginally improved year-on-year, but we expect a significant improvement in the coming years.

There is no overall change to Group guidance for FY19. We continue to expect low single digit organic revenue growth for the Group with margins stronger year-on-year. But, we have refreshed our expectations to reflect some of the changes to specific sectors.

These are some modelling considerations for FY20. Firstly, on exits and disposals, we have to have a revenue impact of £40m with a small profit impact. And on step downs, we expect the stepdown on QEC as we continue the programme to have a revenue impact of £75m, but at low margin.

We expect the stepdown on Magnox to have a revenue impact of £250m, and an operating profit impact of £20m as we continue to the end of the contract. This is more than our previous assumption of an impact of £100m of revenue and £7m of profit. This is to reflect an immature NDA procurement strategy solution by the end of August 2019.

Finally, I'd like to be absolutely clear about our priorities. The team's focus is on creating value for our shareholders and our customers, and so we have four priorities.

Firstly, to sustain margins. We are on track for this year. In fact, we think that margins will be a little stronger. But we've got to maintain our sharp focus on costs for future years, and continue our disciplined bidding control and our success in avoiding loss making contracts.

Secondly, cash generation. Overall, our cash performance in the first half is in line, and we are on track to meet full year expectations. But we continue to pay close attention to cash. Our zero based budgeting model for working capital is beginning to realise benefits.

Thirdly, de-gearing. We are on track to reduce our net debt to 1.4 times EBITDA by March 19. That reduction supports a growing dividend and gives us the flexibility we need.

Last but not least, to improve returns for our shareholders and to benefit for our customers.

I am determined to make absolutely sure that we will tell the Babcock story to the market in a clear and transparent way. I hope we're doing that today, and now I'll pass you back to Archie.

Archie Bethel

Thank you very much for the numbers. There was a lot of numbers there, so I hope you were all listening very intently. I would like to spend the few minutes of the presentation just looking forward to the rest of this year and to the medium-term.

As well as strengthening and consolidating our strong positions in the UK, as I've said before growing and developing our International business remains a very key priority. Our aim is to establish operations in our chosen territories for more than just one Babcock sector.

In Australia and New Zealand we are already operating across Marine, Land and Aviation sectors with the scale, capability and the management strength to operate locally with agility and flexibility.

Canada is on a similar path, and in the very near future we will be operating across two of our four sectors there. And in France, Spain and Italy, we also see the potential for multi-sector operations over the next few years.

In the first half of the year we opened offices in South Korea and Japan. The office in Busan is focused on both naval equipment support, particularly round about the submarine programme there, and provision of Liquid Gas marine transportation systems. And in Japan our initial focus will be on nuclear decommissioning where we will be building on our growing work at Tokai and Fukishima.

Our business model is built around a small number of key business drivers. All four of our sector teams operate in highly complex and regulated environments and markets, and we have the deep expertise and skills that you've got to have to deliver these complex projects, and to deliver them at the highest possible standards.

Our customers are government departments, regional governments, government agencies and large scale private sector companies. And our relationships with those sophisticated customers are deep and by their nature long-term.

We own and operate large and unique marine support facilities, manufacturing and assembly plants, a fleet of over 500 fixed and rotary wing aircraft, large aviation maintenance, repair and overhaul support facilities, as well as complex facilities to build and support critical military vehicles.

We own and operate extensive training facilities to support our customers' operational training requirements. Often that means incorporating cutting edge capabilities in the areas of simulation and artificial intelligence. And a large percentage of our contracts are long-term in nature, and that gives us a clear view of our forward revenues. These unique capabilities and assets give us real competitive advantage, and they create high barriers to entry for any potential new competitors.

The defence markets in the countries where we choose to operate are growing steadily. Both in Canada and Australia they continue to increase their spend on defence, and both countries are in the process of replacing and upgrading large parts of their naval fleets.

Normal budget pressures mean that initiatives that reduce through-life cost of support are effective and attractive way of maximizing the funds available for new products, systems and platforms, and this is as true in Italy, France and Spain, as it is in the UK, Canada and Australia. In the UK, the government recently re-confirmed its commitment to spend 2% of GDP on defence, and they confirmed that the strategic programmes identified in the 2018 Equipment Plan would continue to be fully supported.

Today emergency services are increasingly being delivered in a more joined up way by making greater use of technology for communications, monitoring, surveillance, and for improving response and reaction times.

Babcock is one of the world’s leading providers of Aerial Emergency Services. And as I said a minute ago, we own and operate a large fleet of fixed wing and rotary wing aircraft operating across a dozen or so countries.

Air ambulance medical services, aerial fire-fighting, coastal search and rescue, mountain rescue and civil order and surveillance are all critical activities, where helicopters and specialist fixed wing aircraft play a crucial role.

The market for these services is growing steadily. Today, more and more countries are improving their emergency response by investing in aerial capabilities.

For instance in Europe we are seeing a greater pooling of effort. During the summer we deployed a number of our aircraft from our Italian fire-fighting operation to Sweden and we also deployed aircraft to Greece to support fire-fighting there.

The UK has a large legacy of nuclear facilities that are being de-commissioned progressively on long-term programmes. Sellafield, Dounreay and the Magnox Fleet are the largest programmes currently running. And in just a few years' time the ageing fleet of AGR power stations will start coming offline. And they will be replaced by new build capacity.

Hinkley Point C is well into its construction phase now and the Horizon Project at Wylfa continues to progress through its detailed planning phase.

Support for nuclear facilities and projects creates a strong ongoing demand for nuclear engineering and associated skills and will continue to provide good growth opportunities for us here in the UK.

And there are also opportunities emerging internationally. I have spoken previously about our office in Japan and we are investigating opportunities in Spain and Italy where nuclear stations are nearing the end of their design life.

So, what are our immediate priorities? Well we will be continuing to focus the business around our key three markets of defence, aerial emergency services and nuclear.

We will continue to focus on margin quality by exiting low-margin businesses and strengthening margins through improving our contract performance.

The UK remains our largest market and the UK Government our largest customer. We will focus and invest on developing our key strategic partner relationship.

As I have highlighted many times, international expansion is key to our future growth and as the results show we are making good steady progress.

But my own personal focus is firmly on providing better performance to our key customers and better returns to our shareholders and in my mind there is no conflict here. The better we perform for our customers, the more business we will win and the better opportunities we will have to provide growing returns to our shareholders.

So let me conclude before handing over to you for questions.

We've had a solid first half with our underlying results in line with expectations and with our full year guidance confirmed.

We have tackled the issues of the EC225's and business restructuring head on and we'll see the operational and financial benefits flow through next year and beyond.

We have re-set our expectations on Magnox taking a prudent view but being ready to respond to further opportunities as they emerge. And we have continued to develop our long-term relationship with the UK Government and the MoD as one of their key strategic partners and suppliers.

Fundamentally we are a strong company, as strong as we have ever been in our 128 year history, with a solid balance sheet supporting delivery of a large order book and long-term opportunity pipeline.

And our 36,000 strong workforce are one of the most qualified, skilled and experienced workforces anywhere in the world, and they are dedicated to providing the highest quality products and services to our customers.

We have delivered improved financial performance year-on-year for 15 years now and the Board and management of this company are confident that we can continue this run of success.

We will continue to improve our performance and I am confident that the quality of our long-term performance will be recognised, and we will create improved shareholder value.

So, let's hand over to you for your questions. I'm going to ask my executive team to join us up at the front here and we'll take your questions.

Q&A session

Question 1

Joe Brent, Liberum

Three questions if I may. Firstly, there have been a lot of negative press comments around HMS Vanguard. Can you comment on how that contract is progressing?

Secondly, on Carrier you talk about a step-down in revenues but no step-down in profits. Is that because it's not making much money or because you get a catch-up payment and profits on the tail of that contract?

And thirdly, you've given very explicit guidance around Magnox and the change to expectations to 2020. You've given the absolute number for 2021. Could you give us an indication of the change to guidance for 2021?

Archie Bethel

Let me start. On Vanguard really I'm not going to say that word again. I mean, we never talk about individual contracts. But believe me CASD, Continuous at Sea Deterrents, it's covered by the Official Secrets Act. I think it's been ridiculous what's been written about it in the papers. All I'm going to comment is that our submarine programme is a long-term programme; it runs continuously and it is carried out in great, if not secrecy, almost secrecy.

We have maintained it as part of the team that has maintained Continuous at Sea Deterrents for 30 years, and I'm confident we'll continue to do that for the next 30 years. And really that's all I want to say about that programme.

And as I said earlier, the inference that there is something different in the relationship between Babcock and the MoD is just simply not true.

On the Carrier project we're coming to the end of the Carrier project. We are in a phase. This contract since we renegotiated it in 2013 the margins aren't great. And as we come near the end of it there is a kind of tendency in big long naval programmes to run a bit at the end. So, again taking a prudent view and we're not planning for too much more profit out of that contract – simple as that.

And I think in Magnox, I can't remember the numbers Franco, and beyond 20…

Franco Martinelli

The answer to that question is obviously for 2020 the step-down was 100 and now it's 250. And the following year it was 100 and now it's still 100 in step-down, but actually in absolute terms that's 150 down in 2021 because we've re-baselined it downwards, that's what we've done.

So, we've assumed a prudent position of not getting any revenue from Magnox for either 2020 or 2021 other than the contract that we have. We would hope to do better than that, and that's what we're going to task Simon to do. And I'm sure he can talk about Magnox in more detail if you want to speak to him.

Joe Brent

So, crudely speaking the impact on guidance for 2021 is similar to 2020 i.e. about 12 or 13 -

Franco Martinelli

Yes, we've baselined it downwards, correct.

Joe Brent

Got it, that's clear, thanks.

<u>Question 2</u>

Sash Tusa, Agency Partners

Two questions. Firstly, I appreciate that you don't want to say a great deal more about Vanguard, but perhaps if you could just say – and this is clearly an unplanned refuelling, it was never planned to be refuelled at this stage – is there anything in the refuelling or in the scope of work that was unexpected by either you or the customer when you actually signed the contract?

Archie Bethel

Pass. That is an official secret.

Sash Tusa

But it is also material to you, isn't it?

Archie Bethel

I'm just quoting you back a figure. I've got a customer who would not expect me to publicly break the law, and I'm not going to do it.

Sash Tusa

Okay. Change the subject then to helicopters.

Archie Bethel

Okay there.

Sash Tusa

The write-downs on helicopters does that just cover the H225s, because if so it seems to be a very substantial proportion of the value of those helicopters? Or have you actually done a complete scrub of all of your aviation assets in terms of their value compared to current market value?

Archie Bethel

No, the EC225s are expensive aircraft. Their initial purchase cost was probably about £17m or £18m times 13. We're writing them down to values considerably less than that, and the number is made up of about half of it is write-downs of owned assets and the other half is provisioning against leases. So, five of the 13 current helicopters are leased and eight are owned.

<u>Question 3</u>

Karl Green, Credit Suisse

I've got three questions if I can. Firstly, just in terms of the change in the description of the margin guidance from broadly stable to stronger; how much of that reflects costs which were previously budgeted for QEC and also for CP6 and Rail coming out of your definition of underlying costs and going into that exceptional bucket?

Following on from that in terms of the £40m of capacity adaptations, can you break that down between QEC, Appledore, Rail and Magnox please?

And then my third question is just around looking into – well actually there are two parts really – for working capital. Firstly, can you just indicate what the delta and factoring has been in the first half of this year? And then looking forwards into next year, given the clear guidance you've given around revenue development, what kind of working capital impact would you expect that to have please?

Archie Bethel

I'm going to hand that to you. But just an interest, there's a lot of detailed stuff there that I guess we would be happy to go into at the end or with Simon, but do you want to take the headline of that?

Franco Martinelli

The answer to your question is we've removed capacity in relation to CP6 in Rail. It wasn't in our previous forecast; we've just restructured it depending on how the contract has developed. So, as we get more visibility as to what the contract was going to be we have to put our cost base in line with what the contracts are looking like. So, that's what's actually the answer to that.

In terms of the breakdown, I think we're not going to break it down into detail. We are going to tell you it's Appledore, it's Rosyth, it's Devonport, it's Rail and Magnox. So, it's spread across those businesses is what it is.

The easiest answer to give is the delta in the factoring is none; the factoring is at the same level as it was previously. It's southern Europe and it's at the same level it's always been at.

Final question was on working capital guidance given the growth. Well, the answer to that question is that the growing areas are aviation and that's where the working capital is tied up, so it's actually the one where you do need working capital to grow. So, we're not actually changing our guidance at this point in time on working capital.

Joe Brent

Okay. thank you.

<u>Question 4</u>

Allen Wells, Exane

Three from me if it's okay. First of all just on FOMEDEC, I'm not sure if I missed this, but could you give us the absolute impact on working capital from FOMEDEC in the first half versus the £50m outflow that we saw at the end of last year?

Secondly, just on the cash exceptionals, if I net off in the notes there the £26m disposal proceeds it suggests about £52m cash exceptionals. Could I just check what the £21m cash provision relates to and then the remaining £31m what that would be?

And then finally just on the JV dividends which you've given us guidance obviously for FY20. Could you confirm, I'm not sure if my memory serves me correct, but is there a hold-fast catch-up dividend that's due in FY20? If so what's the delta move between 2019 and 2020 that's helping that out? Thank you.

Franco Martinelli

The FOMEDEC debtors last year was £109m, the creditors were £59m, giving a net £50m. That will unwind over the year. What we have said is it's slightly ahead of that in the first half in the creditor line. We haven't given specifics because our customer, now that the contract is now cash positive, our customer does not want us to keep on talking about working capital, which was a significant negotiation between us and them. So, I've given you pretty good guidance but not specific.

In terms of the exceptionals and cash cost yes you're right, there is £26m of income in the period in relation to the media sales. So, if you took that out you'd get to £31m, as you say £5m plus £26m equals £31m. Overall it is a net cash cost position of £10m that we're forecasting. The sales of the helicopters which we say would be around £40m we're expecting in the following year, so none of it this year.

The advantages in this second half of this year will be the tax effect, we'll have a cash effect and we're expecting to dispose of our Powerlines business in the not too distant future, for somewhere between £5m and £10m. So, if you work back from the £10m net cash you can work out all the numbers to get you back to gross. Those are the key numbers.

Finally financial year 2020, sorry Allen can you remind me?

Allen Wells

The impact of hold-fast?

Franco Martinelli

The JV dividends, no I think it's starting now. It's not a catch-up and I think it will be solid going forward the JV dividend.

Allen Wells

Thank you.

Question 5

Ed Steele, Citigroup

Three please as well. First is a numbers one, Franco. The £38m asset right-down, is that core within the depreciation number of PPE which was 74 from 45 last year? Is that all in there, please?

Franco Martinelli

In the statutory numbers it will all be in the impairment which will be in the depreciation. It's overwhelming that's what it is, yes.

Ed Steele

Okay. It looks like the underlying depreciation has gone down quite a lot year-on-year then. Is that the benefit from the write off?

Franco Martinelli

No. The depreciation has not gone down. I'll talk to you in detail later to reconcile that for you. Depreciation and amortisation has actually gone up year-on-year, and there's an EBITDA reconciliation within the document which will show you the depreciation so you can see what the number is, you can see it there.

Ed Steele

Okay, thanks. Secondly, in the preliminary results 2018 you guided for a £5-10m Holdfast profit reduction in FY19. Your land JV profits seem to be up year-on-year in the first half, and you're simply saying that the normalisation will happen next year, not this year now. So are we looking actually at a rise in Holdfast profits this year, and therefore what's the stepdown next year, please?

Franco Martinelli

Over the year I don't expect a rise in Holdfast profits, and I expect the stepdown, which I think I guided to £15m previously not £5-10m, I think it was £15m, but anyway, will be next year.

Ed Steele

So a £15m stepdown in 2020?

Franco Martinelli

In the Holdfast RSME and JV number in isolation. In isolation, Ed. There are lots of moving parts obviously in contract starts, but that's one number in isolation, one contract.

Ed Steele

Okay. That's not in your modelling considerations for FY20 page, is it?

Franco Martinelli

No, we said it would normalise. That's what we've given. We haven't finalised the Land numbers, we have not finalised our guidance, we're just giving you some key numbers that we're updating for today.

Ed Steele

Okay. And just to be clear, why is that not normalised this year? I know you mentioned some cost savings, but if it's going to normalise next year it's going to normalise still. So what's the pushout, what drove that please?

Franco Martinelli

The Holdfast RSME JV – it's a long story – at the 10 year anniversary of the contract it was benchmarked again, and we were able to do internally a review of what the future cost base was going to be required for that RSME JV, and we did that internally. We then went out and asked for an external review, and the review has come back and it allowed us to see that the savings would be more significant than we originally thought.

Ed Steele

Okay, thanks very much. My last question. I don't want to go into ins and outs of the SSRO, but I just wondered have you got anymore clarification on the timing of the pricing decision with the MoD SSRO, please?

Archie Bethel

Timing of what?

Ed Steele

Of the outcome of your current negotiations with the SSRO and MoD, please.

Archie Bethel

Anyone know?

Franco Martinelli

I'm not sure we have any discussions. We don't have a negotiation with the SSRO. There are a bunch of contracts which come through. The SSRO is a guidance to say how you would price, and Archie spent a lot of time discussing that last year and how we were comfortable with the range of profit outcomes that will come from an SSRO. There are contracts with us. The next big one that will come on is the MSDF, which we have to discuss with the customer exactly how we price that, and that will happen March 20. We are pretty comfortable with any process around that and actually have no worries about it at all.

Question 6

Matija Gergolet, Goldman Sachs

Two questions for me. You were mentioning some business exits, some disposals. With these announcements do you think you still have more to do, there are more businesses within the Group or more segments that need to be addressed where you're not happy with the profitability and therefore there might be further announcements of further disposals or business exits?

My second question is, on one hand you say exiting some of these smaller businesses basically simplifies the whole Group. On the other hand you are adding a little bit of complexity by going in to new countries, you mentioned Japan, Korea, looking for work in Spain, in Italy in the decommissioning. Can you just a little bit elaborate strategically, say a three/five year view, basically where do you see the direction, will we see you going more and more international? Then also on that point, what kind of revenues can we expect from these international expansion from the incremental ones say five years from now? If you give us a bit of colour on the strategies.

Archie Bethel

So we're clear, direction of travel is to continue to invest and grow in the three major markets of Defence, Aerial, Emergency Services and Civil Nuclear Engineering. And that's about 75/76% of the Babcock business. The other 24%, we've got a couple of sizeable businesses in there. There's the Rail business and there's the South African business, which although are not [inaudible], they are well performing, good, significant businesses.

It is true, other small businesses, and that's what we've mainly been addressing this year, that make up the balance, we are looking at ways of exiting or selling these businesses, and that will happen as we review the businesses and make decisions on that. But the strategic direction of travel is to continue to invest in these three key sectors, both in the UK, but increasingly internationally.

For instance, the area of emergency services is predominantly an international business. The Marine sector, the Defence business is predominantly UK but with growing involvement internationally. And the Nuclear business again predominantly UK, but has taken the first steps to internationalise that. So it's a strategy that's built round about these three sectors, growing them both in the UK and increasingly internationally. So international growth will be in one of these three sort of markets, and that's what exactly has been happening.

We've come from five years ago less than 10% international, to 30% this year. I expect that to continue to grow faster than the rate of growth of the UK business, so I'm not going to put a target on it this time, but I'm thinking about it. But I would expect in five years' time it will be significantly higher than 30%.

Question 7

Kean Marden, Jefferies

Just back to MSDF. So if contract ends in 2020 normally you enter into negotiations sometime considerably in advance with that. So can we just go on whether those discussions have started, and then if you're able to comment any initial observations there? Also, just on that MoD relationship, what in practice does the Joint Ways of Working Charter mean, and does it place any sort of obligations on either Cabinet Office or the MoD or yourselves, or any developments there?

Then two other sort of quick areas to touch on. International, you frequently give us the proportion of Group revenues. It's grown really rapidly. Do you have a feeling for how much in constant currency International grew in the first half, because it's getting bigger and it's the fastest growing part of your business? So some insight into that would be quite helpful.

And then finally, one for Franco. If the Magnox EBIT comes down over the next few years, is there a joint venture dividend impact as well, or is that profit not taken in the associate line, it's taken elsewhere?

Archie Bethel

I'll take the Joint Ways of Working. The importance of that is it's a commitment by all parties to go forward in a manner that allows the government to continually get better value for money, and gives more certainty to the key suppliers so that we can make decisions round about investment, investment in facilities, investment in people etc, so that there is a clear line of... There is an expectation through this process that as we do that we will be able to, both the government side and the suppliers, be able to have more clarity, but also through that investment generate more savings and more efficiencies. It's a big programme, it'll take some time to start to work through. We've already started on it in one or two projects, but it's pretty key. I think it's the biggest thing that's probably happened to us since we signed the ToBA in 2010.

Kean Marden

Sorry to interrupt. Why do you think you were the first to sign up? Is that just because of your willingness, or did they want to engage with you?

Archie Bethel

We've been in the Cabinet Office system for seven or eight years, so we've been in the Cabinet Office Strategic Supplier Programme since 2010. It's part of the MDP process. As part of that Defence have signed up to the same programme. So defence companies, and we are probably the only defence company who was part of the Cabinet office system, so we were kind of an obvious to start with. The other ones who are named in Defence are BA Systems, Rolls Royce and Lockheed Martin.

Right MSDF.

John Davies, Chief Executive Land

So as I said the MSDF contract gets replaced in March 20 by something called The Future Maritime Support Programme, FMSP for short. Actually we're quite excited about it. As a contract this one is much more of an enterprise, a naval support enterprise view of how to drive transformation. It'll be delivered under our ToBA so it's part of that ToBA framework which is why we expect it in financial terms to look a lot like the contract we have just now. But in the way it's delivered it will be one of the standard bearers under the joint ways of working

Charter as a sort of collaborative programme to deliver transformation for the navies. I think it's quite an exciting development for us.

Franco Martinelli

Absolutely. Thank you, John. So in terms of international growth it's around 10% this year so it's a key driver, there are some key opportunities coming up. As Archie alluded to earlier we're hoping to hear some good news in the not too distant future from two of our key countries. But in the first half 10%.

In terms of Magnox EBIT yeah that's part of the reason why you'll have noticed that the JV dividend came down a bit and that's part of the Magnox profit coming down a bit, in the future years, not this year, next year and that's allowed for that.

We might do better than that and it will come through on the EBIT line if we do get any of the Magnox contracts that we're hoping to get at some point. They won't be on the JV line in future. So we've assumed zero, sorry.

Kean Marden

I suppose the question in my mind was so the JV dividend drops from memory from…

Franco Martinelli

50 to 45.

Kean Marden

…50 to 45 from [inaudible] but you flagged that the EBIT drops by £20m so I'm just trying to rationalise or is there a lagged impact on the JV dividend from that?

Franco Martinelli

You are correct there is a lagged impact because some of the cash in the Magnox JV will come out next year, part of it, that's true.

<u>Question 8</u>

Unidentified analyst

The rating of your shares is probably at an all-time low is there a chance of moving to maybe a more flexible dividend policy? If you were to cut your pay-out ratio to 10% you could start that £250m buy-back right now which would probably, on a shareholder return basis be much more attractive to shareholders than the 3.5% rise in the dividend because the market's telling you today it's not interested?

Archie Bethel

In an ongoing process we continue to review our shareholder return policy. I mean we recognise, the same as everyone else how all the shares are being valued. It's difficult for us to really understand why that is the case because we have pretty much grew the business, spent in the business year-on-year for the last 15 years. We've seen all the arguments about sentiment round about outsourcers and all that type of stuff, it hasn't impacted the results.

And I think until we really understand what is happening there I think that's when we'll make the decision about what the capital return policy could be. It could be enhanced dividends, it could be share buy-backs. I'm sure we'll get to a point as we keep de-levering.

At the moment our priority is to continue with the current priorities of strengthening the business, getting it into the right shape that we want it in and de-gearing. But as we do that and we get closer to the de-gearing levels that we're comfortable with I'm pretty sure we will be seriously reviewing our shareholder return policy.

Question 9

Nicholas Thompson, Santander

I'm just wondering you appear to be including the earnings of JVs in your leverage calculation but excluding the debt, am I correct in understanding that?

Franco Martinelli

The answer is this that we are allowed per our covenants to include the dividends. So if you take the dividends and the JVs into the calculation then the calculation is marginal, it's 0.1 different. So yes, the answer to your question is yes. Because we've got the earnings, the debt is non-recourse and the difference between that and the covenanted ratio is 0.1 once we allow for the JV dividends.

Nicholas Thompson

But the difference against statutory net debt is 0.6 is it not?

Franco Martinelli

No. Sorry if you're putting the whole of the JV debt in you're saying, the non-recourse debt. If you exclude JV profits, sorry if you take our operating profit as statutory EBITDA and you add the JV dividends and you compare that to our net debt the different is 0.1. And that's our covenanted ratios so that's why we've put it that way.

Question 10

Sabrina Han, BNP

My question is regarding working capital. We have seen an increase in unbilled income over the past three years, how is the change of that item during this term and can you provide some details about that such as from what kind of long-term contracts were the sectors? Thank you.

Franco Martinelli

Okay it's true that the unbilled income, the amounts recoverable on contracts and earned income as a total balance has gone up. The total amount of unearned, sorry accrued and amount recovered on contracts plus trade receivables is still less than 60 days. So it's one month work and one month to get paid, which is a reasonable number.

We think we can do better than that and we're targeting to do better than that. And as I referred to earlier, you'll remember from my presentation we talked about our zero based budgeting model and in that zero based budgeting model for each business unit we've identified what their ideal working capital balance should be. And each of those, for two of the four sectors we're there already. For the other two we need to work on it and where that will show itself is a reduction in that number, which I think overall is not too bad at 60 days between the two. So that's our target and that's what we're going for.

Overall you must be very careful because the trade receivable balance has generally gone down and it is part of the same equation because how you negotiate with your customer, they'll pay you earlier for your debtors and maybe not invoice quite so quickly. And you've got to look at it in the round and that's why the model is what counts, the total balance. Because we can't take one number in isolation.

Question 11

Ed Steele, Citigroup

Just a very quick clarification, a follow up, on the Holdfast stepdown now I just checked your annual report and your guidance was for £5m - £10m stepdown, are you saying it's £15m now?

Franco Martinelli

I'm saying it's £10m - £15m.

Ed Steele

So it's gone up a bit?

Franco Martinelli

I think that's probably right, £10m - £15m.

Question 12

Sam Bland, JP Morgan

I have two please. On the JV dividends obviously you said earlier about how Magnox is causing a little bit of a stepdown in FY20; just thinking beyond that what the path to full convergence is between the JV dividends and the JV net income, obviously as the net debt falls down there, is that a five year path, three years or any sort of help with that would be helpful?

And then on the pension, obviously in the context of this de-gearing group the deficit in the pension scheme is coming down, at least on an accounting basis and actually the cash into the pension is going up. Might there be an opportunity to do something a little bit more strategic there as the Group continues to de-gear to maybe improve the cash conversion post pension? Thanks.

Franco Martinelli

I'll take the second question first if I may, Rob. Yeah I think that's something we need to look at and we need to look at that in the context of where we are in the next 18 months as to what, Sam sorry. Yeah that's something we need to look at absolutely and we need to look at that.

In terms of JV dividends net gap it's going to reduce. It won't go away it will reduce as we get the dividends in as we have done for this year for AirTanker and Ascent but the gap will narrow significantly next year and thereafter there will still be a gap of £15-odd million is where it'll be, driven by AirTanker which is a long-term play.

Concluding comments: Archie Bethel

If there are no more questions can I just say thank you again for coming. I hope you got something out of the presentations and please be kind to us. Thank you.