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Babcock International Group plc Trading Update Call

Wednesday 19 September 2018

Archie Bethel, Chief Executive

Good morning, and first of all, thank you for joining the call this morning, following the issue of the updated trading statement. I'm joined this morning by Franco Martinelli, our Group Financial Director, and after I make a few opening remarks we'll be happy to take your questions.

It's only two months since our last update, so it shouldn't be a surprise that in some way we are confirming that we are trading in line with our expectations, and we are confirming our outlook for the year.

All of our sectors continue to make good progress in the period, including our international businesses. Our order book and pipeline remain strong, with a combined value of £32 billion, and we have around 80% [correction: 87%] of our revenue for this year in place, and 50% [correction: 57%] for next year.

As I mentioned in July, as part of our focus on our three core markets of defence, emergency services and nuclear, we are exiting a number of non-strategic, small, low margin businesses, and we have agreed the sale of our media services business. And we have exited our North American mining and construction business, and this follows on from the exit of our renewables and civil infrastructure business in the UK last year.

This process will continue in the second half of the year when we expect to exit our powerlines business in South Africa and to reshape our oil and gas crew change business while ensuring we still meet our customers' needs in that sector. And of course we will provide a full update on these activities with the announcement of our half year results in November.

So in summary, we continue to perform well, our pipeline and order book remains strong, and we look forward to updating you again at our half year results on November 21st. So at that I'm going to hand over to questions which Franco and I will answer. Thank you.

Question and Answer Session

Question 1

Joe Brent, Liberum Capital

Three questions if I may. Firstly, on the disposal programme could you give us an indication of what the impact on revenues and profits would be? And secondly, in respect of the portfolio rationalisation could you give some indication of what the exceptional costs may be? And finally, on modernisation defence programme could you give us a sense of the progress there and whether orders are starting to flow in the land business?

Archie Bethel

Okay, on your first question, again as we stressed in July these businesses that we're exiting are all really small in terms of the Group. You know, when we emphasise the three core sectors of defence, emergency services and civil nuclear, which in our accounts are around 76% of our business, and the other 24%, we've clearly been looking at, at the future shape of these businesses, there are three large businesses within there that make up about 22%, 23% of that 24%.

So the businesses that we are talking about here are pretty small, so in total probably in the region of between £100m up to maybe £140m in total of our turnover, and the main reason we're exiting them is because they make very, very low, if any, margin. So by exiting these businesses we are improving the performance of the business.

But again, I'd stress they are very small, each of them in their own right, probably not worth really mentioning, but we are doing this as part of this type of focus around our three core markets.

In terms of NDP - I think before the kind of holiday period that the statement that was made on the progress that had been made on it, and everyone will probably have seen that - it's still a work in progress, it's been a fairly positive experience for us and this engagement has been quite deep and constant. And we are moving out of the process now and looking forward how the relationship between industry and defence can be developed in a way that suits both of us, i.e. we deliver more efficiencies and more capability to the armed forces, one, for less money but two, in a more efficient way. And again NDP, I think later on this year you'll hear more about that process but it's now an ongoing process.

Franco Martinelli

Joe, just on the middle question, the second one on the portfolio rationalisation, I mean overall the exit costs will be offset by the disposal profits and stuff, so overall it won't be material in significance and not significance to change our press guidance.

<u>Question 2</u>

Edward Stanley, Morgan Stanley

Hi there. Just a sort of high level question. Can you give us an idea of why your net debt isn't going down, given that H2 implied like-for-like is somewhere between 4% and 5%? And given your visibility, are you comfortable that run rate can continue into next year?

Franco Martinelli

Okay, the consensus net debt is going down and we're expecting our net debt to EBITDA to go down to about 1.4 times around for this year end, and that's progressing from this year into next year, so we steadily have de-geared over time and we can expect to continue to do that.

The like-for-like revenue growth, our guidance is low single digit in terms of organic, so the four to five is once you add back the exit of QEC which are one-off type items, so we do get to that sort of number, but we are continuing to pay down debt and we are continuing to de-gear and that is part of our investment story and has always been.

<u>Question 3</u>

Allen Wells, Exane

Morning Archie, morning Franco. A couple from me. Maybe firstly just sort of following up on some of the comments on LGE and DSG when you were talking, and obviously Marine and Land were flagged as part of the reasons for the sort of slightly weaker growth expected when you flagged in July. Is it right to sort of think the comments you're thinking there on ecoSMRT and some of the revenues coming in on DSG, at least, are suggesting that those delays aren't getting any worse?

That's my first question, and then secondly, on the crew change Air MCS business and the restructuring there, how should we think about the potential for any sort of write downs or sort of changes in that part of the business?

And then finally just a quick third one on FOMEDEC. I know obviously there was a little bit of uncertainty on the timing of the cashback from the leases on that one; a bit further along now, any update? Will we expect to see all that coming back in by the half year or still not sure? Thank you.

Archie Bethel

I'll take probably the first two and I'll let Franco think about FOMEDEC, while I'm doing that.

The LGE and DSG, we highlighted these for a couple of reasons. One, at the end of last year, actually in the final quarter last year, we did flag up that we had some big delays in our LGE liquid gas business and that some contracts hadn't come through. I think we're now emphasising or just pointing out that actually all of the contracts that we had anticipated have now come through. So, again I'll just confirm that that had in fact been the timing issue that we thought it was going to be. So, that has come through and that business is performing well this year.

On the DSG, actually, nothing has really changed in that. The kind of flow through equipment still remains as we guided it would be. But I think what we're pointing out there is that we have been awarded in the last six weeks £120m worth of new contracts that expand the DSG contract, so this is new scope, new work and at decent normal defence margins and it's a positive sign that as we kind of open that DSG contract that over time it will continue to grow.

Second one was crew change business. I think it's quite early days. We clearly signalled at the year-end when we put the focus, when we clearly sat and put our focus in defence, emergency services and nuclear that the crew change, the offshore oil and gas business was not seen by us as a kind of key core part of the business. So, again that has kicked off an exercise that says what happens with that business, how do we run it, how do we operate it. It's a reasonable size business, it's still profitable, and I think all we're signalling here is we're going to look at what we can do with it in terms of making it the best we possibly can, whilst of course still maintaining total priority in safety and in meeting our customers' needs.

But we do feel the oil and gas business overall in that sector has stabilised a little. It's still not great, but I think the business will be there. The question is what we do with it in the long term. Again, the exercises that we're doing at the moment might lead us towards some kind of conclusions there. But in the first instance it's all about us taking actions round about making sure that we're making the best out of that business that we possibly can at the moment.

Franco Martinelli

Really no change to guidance. We set out pretty clearly what we intend to reverse and it's on track to reverse, and we would expect it to reverse in the first half.

Allen Wells

Great, thanks guys.

<u>Question 4</u>

Sam Bland, JP Morgan

I've got two really, both of them on the H1/H2 split that might be expected. If we start with organic revenue growth, I think obviously we're expecting low single digits for the full year. Is there any commentary around what that might look like in the first half, possibly slightly weaker than that just because of some of the phasing that's in the business with different contracts and then a little bit stronger in the second half?

And then the second one is on the cash flow, what kind of phasing H1/H2 might be expected? I think you said at the full year last year the operating cash flow was a 30/70 split and you were expecting similar for this year; is that still the case? And if so what causes that 30/70 split in the operating cash flow?

Archie Bethel

I'm going to let Franco give some detail on that. But again I'll just emphasise that this is the normal pattern for this business. If you went back there has typically been a bigger second half of the year to first half of the year. And that's due to a number of factors within our trading cycles that Franco I'll let go into some of the detail on that bit. We've signalled all that. Last year we felt a bit clearly the markets hadn't noticed that and we probably hadn't signalled enough. This year we're being very clear that this year, like many years before, will be pretty much the same with H2 being bigger than H1.

Franco Martinelli

Yeah, I think you put the revenue split pretty well. Overall, it is single digit growth for the full year. And as we signposted in July we started off a little bit slower than we'd hoped because some of the throughput; although those orders are now all coming through. You're absolutely right, I think you put it pretty well, slightly lower in the first half than that and better in the second half.

In terms of cash flow, yes, we're not changing our guidance at all on the cash flow. And the reason why it happens is twofold: a large proportion of our customer base is government and they settle their cash positions towards the year end. And it's not about invoice payments, just settling of transactions. And the additional one is the firefighting season which in Southern Europe is based over the summer. So, those two factors tend to keep cash in the second half.

And of course, obviously, as you know, net debt generation the dividend is first-half weighted.

So, those three things are the things to bear in mind when we're looking at our net debt and our operating cash flow.

Sam Bland

That's very good, thanks very much.

Question 5

Ed Steele, Citigroup

I have a question about 2020. Obviously, this is a trading update related to the first half of 2019, but looking at consensus for 2020 it seems to be for a few percent organic growth. You've obviously got three big step-downs in contract revenue, FOMEDEC, QE Carrier and Magnox now. At what stage do you think you'll be turning your attention to some guidance for 2020 please?

Archie Bethel

We've given mid-term guidance. We think that our business is a single-digit type growth business, we've given that guidance. We did identify those things that you've said. And on the opposite side of that we have got the Norway contract starting which is significant in next year. And as we said we do expect to get a significant part of the Magnox stuff back.

Yes, we're happy with where the market is at the moment but we need to go through our proper reviews and of course we'll update in November. So, I think that's where we are. We're not uncomfortable where it is but we'll update in November.

Ed Steele

Thank you very much.

Operator

That concludes the question and answer session. I would now like to turn the conference back over to Archie Bethel for any closing remarks.

Archie Bethel

Thank you again for joining the call this morning. As I said at the beginning, it's only two months since the last trading statement so not surprisingly there are not huge amounts. But I think overall we feel that we are pretty much on track from where we thought we were, particularly in terms of new order flow.

So, again thank you for joining us and we will speak to you at the next call.