

## **Business update transcript**

Tuesday 13 April 2021

### **David Lockwood**

Chief Executive Officer

Good morning everyone. Thank you for taking time to join today's call. I am going to give you a brief overview of this morning's announcement and then David will give you an outline of the numbers before we go to Q&A.

So back in January we announced that we were looking at many areas of the business starting with our strategic priorities, a new operating model to deliver those priorities and a contract profitability and balance sheet review to set the right financial baseline.

Today we're giving an early update on these areas plus a first look at our full year results. These are being shared to give early transparency in all these key areas. So what's the headline? At its core, Babcock is a good business and we have a route to restore the Group to strength without the need for an equity issue.

This route includes self-help measures through the simplification of the business taking out layers of complexity and generating proceeds through the rationalisation of our portfolio in line with the strategy. I think it's important to say that this is a rationalisation in line with the strategy. We're not selling just to raise funds.

Looking forward we will focus on being an international aerospace defence and security company. We have a leading naval basis and we offer value-add services in many areas from land and air defence to civil, nuclear, and through support in emergency services. We will focus on five countries - the UK, France, Canada, Australia and South Africa.

We see many opportunities across these markets in the medium term. Our new operating model and people strategy will help us maximise this potential while creating a better place to work for our employees.

With that, I will pass over to David who will take you through the headline financials.

### **David Mellors**

CFO

Thanks David. One point of stress up front which it says in the announcement, these are our early view of the numbers. We've literally just shut the year end books. We are going through the year end process and audit now. Obviously there are a lot of adjustments here. We will give you more details when we do our preliminary results.

We've also said that given the constraints of going through the year end process and audit under COVID-19 restrictions and the volume of work we are flagging that there could be a delay in our preliminary results. We will update you on a date as soon as we can.

So it's just running you through the headline numbers. Underlying revenue is £4.7 billion including our share of joint ventures, down 2% on last year excluding FX and disposals. Underlying operating profit was £307 million. This also includes our share of joint ventures but is before the impact of the contract profitability and balance sheet review numbers which we will come on to.

Closing net debt was £750 million. That benefited from three things that we've called out - the VAT deferral of £56 million - that's a timing difference - some corporation tax repayments of £67 million - that's a one-off that we received in the second half of the year - and some foreign exchange translation benefit of about £20 million. So that's where we closed the net debt position.

We've also said as we've done the last couple of times, we've given you the average net debt on a month basis which was around £1.2 billion. So we still have period-end cash management within the business. That will unwind over time as we make it a more linear and predictable business. Then the net debt to EBITDA our gearing ratio is 2.5x on a covenant basis at the year end.

So now if I just go on to the headlines of the contract profitability and balance sheet review that we've set out the numbers in the release today. The total of the impairments and charges all together is about £1.7 billion. Most of this is one-off and non-cash and includes about £1 billion of goodwill and acquired intangible impairments.

The ongoing impact of profitability is around £30 million for future periods. That number is about £20 million in FY21, about £30 million going forward. We will run you through obviously all the details when we do our preliminary results. But we put the five key balance sheet captions in the statement today with the approximate numbers for each and the items that have caused it.

Finally, although we're not giving an outlook today because it is just an early view, we are stressing that with all the changes that we've outlined, FY22 will be a transition year for obvious reasons. Therefore we are cautious about the progress that we can make on the reported numbers in FY22.

So with that I will now hand back to David for Q&A.

### **David Lockwood**

CEO

Thank you David.

## Q&A Session

### Kean Marden - (Jefferies)

Morning gents. I have a few if I could, mainly focused on free cash flow and balance sheet just initially.

### David Lockwood

Can we do them one at a time though because it's easier that way?

### Kean Marden - (Jefferies)

Yes. They're quite short anyway so don't worry. I'm not going to ramble for ages. So just on the March 2021 balance sheet. You called out some tailwinds for the net debt number but they don't fully explain the gap between consensus and the £750 million you reported. So I'm just wondering if you've made any progress on the working capital line or anything else that you'd like to call out there.

As an adjunct to that, just initially on that balance sheet question, why has the gap between period-end and average net debt expanded a bit during the year? So it looks like its sort of £400 million to £450 million. You were guiding to £350 million. That's the first topic of discussion please.

### David Mellors

Okay. I'll pick that one up. The gap between average and closing, if you take the three things that we've called out in the statement, so VAT timing, the corporation tax which is a permanent one-off cash inflow that we received, and the FX translation, then the gap between closing and average is about the same as it was at the half year, slightly less and slightly less than it has been before.

So as I said there is still a period-end focus to the way the business has driven cash which we will change over time. But those three things will get you to about the same level of gap as you've seen before. It's actually slightly less.

### Kean Marden - (Jefferies)

Okay. That's fine. Thank you. Then secondly, I think initially during meetings with analysts last September you expressed the view that you could return the business to £250 million of free cash flow generation. Do you still stand by those comments now?

### David Mellors

I wasn't here in September. I only joined at the end of November.

### Kean Marden - (Jefferies)

I agree. But the question is not just to you, sorry. Apologies, it should have been clearer.

### David Lockwood

Okay. So my recollection of what Franco said was that if the Company had made £250 million of free cash flow in a 12 month period, but that that definition of free cash flow included disposal of businesses and the VAT deferral which accounted for the vast majority of it. I'm looking at Simon McGough. That's what I recall he said. Is that correct?

### Simon McGough

Exceptionals.

### David Lockwood

Yes, and exceptionals - and exceptional cash - so before exceptional cash. It was made up of those three components. Though I don't think Franco said that there was a return to £250 million because he had a different definition of free cash. But we could talk about free cash more generally David.

### David Mellors

Well I think the way - once we do our preliminary results and we're able to give you more detail, the way I would think about it going forward is, we said in the statement we are going to simplify the results by taking out the joint ventures from profits and equity accounting as per the standards. So what we will be looking at going forward is an operating profit number which is due to our own subsidiaries in the business we run.

We would expect to be able to deliver a cash conversion number from that operating profit. That's what we would hold ourselves and the businesses to account for, is the level of cash conversion.

Below that of course you've got interest, tax and the pension deficit payments. We can talk about those in more detail at the preliminary results. But it should be simpler to see what a good cash conversion would be on the operating profit when we've stripped out the joint ventures. Then as I say its interest, tax and pension deficit below that that gets you to a free cash [inaudible] next time.

### Kean Marden - (Jefferies)

I'll leave it there. Thank you very much.

### Anvesh Agrawal - (Morgan Stanley)

Hi, good morning. I've just got a couple of questions. Maybe if you can - firstly you're obviously expecting a £20 million, £30 million negative impact which is ongoing. Can you just let us know how long you expect this sort of impact to continue? What are your initial long term margin assumptions for the business? Then maybe just more clarity on the planned disposals, where do you expect them and how do you expect it to pan out over the next 12 months or so?

### David Lockwood

Okay, well I'll do disposals while David thinks about the best way to answer margin. We've said a minimum of £400 million in 12 months. Clearly this is strategically driven, not need. So when we lay out the strategy in the prelims we'll be able to talk about this more thoroughly. We have got identified businesses that we think would be more appropriately owned by somebody else.

We have got identified processes for those which enable it to happen within 12 months. So as I say by the time we get to the prelims I hope we'll be able to be more - well we will be more specific because in laying out the strategy in more detail it will become clear.

### David Mellors

So on the point about margins, I mean obviously we're not giving guidance today. We're just doing the early view of the numbers. But when we simplify the accounting so that we don't put joint ventures in operating profit, what you will see is the actual trading margin that we're at with the businesses. We've obviously given you a steer as to what the impact of things like the operating model would be.

So I would start with where are we today and within the numbers - obviously because we've used the same format as before - we've included the joint ventures. But you can work out from the half year statement that joint venture revenues that are included in this £4.7 billion would be of the order of £300 million and that the joint venture profit that's included within the £307 million would be of the order of £60 million.

So the way we will report going forward, we would strip those out. That gives you a picture of where we are currently operating. Obviously we're not giving forward guidance at this point but at least you've got a start point there.

### Anvesh Agrawal - (Morgan Stanley)

But then at least given your statement around the impact from that start point at least we expect the margins to go down at least for FY22 before any underlying improvement we can forecast. That's at least a fair way to model the business right now?

### David Mellors

The number we've given you is for future periods because the contract and balance sheet review is about £30 million whereas in FY21 it's about £20 million.

### Suhasini Varanasi - (Goldman Sachs)

Thank you. Hi, good morning. A couple of questions from me please. I'll just go through them one by one. On the first page of your press release you mentioned that you will be revising your forecast for profitability for future periods as you continue to assess the business. I just want to check if this is just caution or if we should expect further reductions on profitability in the future years as you revisit contracts?

### David Mellors

We are revisiting our internal budgets and forecasts now. We will be able to report out more in - when we do our preliminary results. The impact we expect from the contract profitability and balance sheet review for future periods will be about the £30 million. Of course that might change when we finalise the numbers but we're not expecting it to change materially. It's the underlying forecast that we'll be looking at over the next two months if that helps.

### Suhasini Varanasi - (Goldman Sachs)

Got it. The second one is on the disposal proceeds please. Can you maybe give us some colour on the scale of revenues and profits in total that's up for sale and whether you are already in discussions with potential buyers at this point in time?

### David Lockwood

Certainly. I think the aim is to cover that fully at the prelims. I think any half answer to this actually makes the problem harder, not easier. So we'll answer that at the prelims.

### Suhasini Varanasi - (Goldman Sachs)

Great. Thank you very much.

### Joe Brent - (Liberum)

Good morning gentlemen, a couple from me as well if that's okay.

I know you're reluctant to give guidance but if we look at the old basis of accounting and rebase FY21 to around £300 million, is there any reason that number wouldn't grow given that FY21 already had quite a big COVID effect and you would hope that COVID effect gets less in FY22?

### David Lockwood

Well, I'll do the COVID effect first. The single most important COVID effect for us is social distance working and not the efficient part of home working because there are parts of home working which are good, but the inefficient parts of home working. If I take our largest site at Devonport we still have nearly 50% of people permanently home working. We still have social distance working on the frigates and in the submarines.

So I think this idea that we're through it is just not valid. We really need that - that's the restriction we need to change so we can move to effective - what we're calling agile working - which is the best of the old and the best of the new. So we've got a target - when we talk about operating model that includes how people work. So we need to be able to move to that.

Then for people who actually do the physical work we need to work in a non-socially distanced way to get back to where we were. I don't see that fully happening in H1 at all. So that's very difficult to predict the benefit year on year.

Do you want to answer the second part?

### David Mellors

Also of course COVID apart, it's a year of huge change. We've said that in the statement. It's a year of transition. So we're changing the operating model of the whole Group. That is quite a big thing to do. We've already said we've started three disposal proceeds. There are many other changes going on.

So that is a big transformation going on internally. Whilst all that is happening at the same time I think we would be cautious as to what you can actually deliver in that year of change. It obviously sets the Company up very well for future periods. But in that year of change I think we should take a cautious view.

### Joe Brent - (Liberum)

Thank you. Lots of other ones but I'm only going to ask one because you're busy. But on an average for FY22 if we assume you don't - assuming you do make the £400 million of disposals what sort of an average do you think that might leave you with at the year end? A band would be good. I think you said you can get to your target leverage in maybe 36 months, something like that. What is an acceptable leverage for you in the business going forward?

### David Lockwood

I will do the second one because the first one sounds like maths, so that's David. Leverage is a function of where you get to in your business model and your risk appetite as we look at how the opportunities develop and we look at the certainty we can drive into the business. I mean historically we've said 1x for 1.5x. I don't think that's an unreasonable start place. Then would you go beyond 1.5x if you can de-risk the business? I think that's part of the Board's ongoing strategic assessment in the next 12 months.

### Joe Brent - (Liberum)

Thank you.

### David Mellors

If you're looking at the shorter term, you will remember that the Company has agreed to put extra pension deficit repair payments into the Rosyth scheme, about £50 million extra this April, and £50 million extra next April. So that's obviously a short term headwind. Then there's the reversal of the timing differences around this period-end's net debt position. So we called out the VAT in detail here.

But you've also seen the difference between average and closing net debt. That will reverse over time, not necessarily all in one year, but we will reverse that out so that we have a more linear business. So in the short term there are some headwinds. But we do think the combination of the operating improvements and potential divestments get us to where we need to be in that time frame.

### Joe Brent - (Liberum)

Thank you very much.

### Sash Tusa - (Agency Partners)

Thank you very much indeed. I've got three questions. I'll try to keep them brief. First of all, just in terms of where the write-offs are, the fact that you have de-emphasised Italy and Spain suggests that a very substantial proportion of the write-offs and impairments relate to Avincis. I just wondered if you could confirm that and if there's any other major single focus for the write-offs in terms of previous acquisitions.

### David Lockwood

So that we'll have to give you more at the preliminary results. So we're not going below Group level today. As I say this is just an early view of where we are at a total level. So we'll do the detail next time.

### Sash Tusa - (Agency Partners)

Okay, thank you. Then the other question that I will ask at Group level - I can understand that you feel that the reporting treatment of joint ventures has rather contaminated the view of operating profitability and the gap between that and cash flow. But on a broader level, does this mean that you are anti joint ventures in this business because they do that? Hence, does that mean that you would eschew projects that require some sort of joint venture structure simply because you would rather be smaller and cleaner rather than larger and muddled?

### David Lockwood

No. So if I think about our pipeline, there are several bids ongoing where we operate in some form of joint venture arrangement. Some of them are effectively special purpose vehicles to combine talents of organisations. Some are legal entities. What we're saying is that we should - when we enter into a structure we should account for it in accordance with the rules that apply to that structure and not as though it was something it isn't. So they can still be a very good way of delivering our capability to market in the right circumstance. We just want to account for them more simply.

### David Mellors

Yes, I would emphasise that. I mean you used the word contaminated. I certainly didn't. I think this is just about [inaudible] so that we can see what the results, the margins and the cash that our owned businesses deliver and we can see what our share of the results and share of the dividends are that our joint ventures deliver. So it's just a simplification.

### Sash Tusa - (Agency Partners)

Thank you very much.

### Thierry Anid - (Citigroup)

Hello, thank you for the question. I'm just trying to think about what we should think about three things going forward, currently, mid-BBB and outlook negative. How do you intend to manage the business? Obviously it's going to be dependent on your view on the capital structure. But would you be comfortable with one or two notches lower than your current rating? That's my first question.

Then you were talking about discussion with banks in order to secure protection. Can you give a bit of colour on that? Is it extending your liquidity for RCF and easing the governance as well? Thank you.

#### **David Mellors**

Okay, so I'll answer both of those generally rather than specifically. Obviously we do look at our credit rating as something of great importance. We obviously don't control it. But we are determined to get ourselves back to a strong balance sheet obviously under our own steam. That should play well into the medium and long term in terms of rating.

In terms of banks, we've said that we are commencing discussions with them to protect the downside risks. There are certain things obviously that are not entirely within our control from the timing and quantum point of view like disposals. Obviously our plans and the route we have, we should be fine as we say. But we do need to make sure that we've got all angles covered. So we will be talking to them to make sure that if things don't go quite to plan for the things we don't control that we've got those plans covered too.

#### **Thierry Anid - (Citigroup)**

Okay. Just a follow-up. In terms of rating, do you have sort of margins, hedging, that would increase if the rating were to be lower or this shouldn't be an issue?

#### **David Mellors**

Look, there will obviously be several impacts, none of which I'll go into specifically now. So we've factored in what we think might be certain risks. There's nothing material that I would call out for you now.

#### **Thierry Anid - (Citigroup)**

Okay, thank you.

#### **Allen Wells - (Exane BNP Paribas)**

Good morning gentlemen, just a couple from me. I'll take them one at a time then if you prefer. You alluded to this earlier, but can I just ask just for some clarification on those cash commitments over the next 12 to 18 months? Obviously you talked about £140 million of combined tax deferral impacts. You've alluded I think to the pension payments which I think you said was £50 million this year, £50 million next year.

Where are we with things like the Avincis fine? Is there any additional CapEx catch-up requirements with things like ship building in there? Just to get a bit of an understanding of what the slightly unusual cash headwinds might be and if there's an update there for FY22 and FY23.

#### **David Mellors**

Yes, sure. Well you've picked out the big ones already. So just the two specifics that you mentioned that we hadn't answered earlier. There is no update on the Italian situation. As and when there is one, we'll let you know. So no update there. On CapEx, yes we do expect a few tens of millions to finish off the spend in Rosyth. So that will be largely during the first half of this year.

#### **Allen Wells - (Exane BNP Paribas)**

Okay. Then the second question, just on the leverage. Obviously you've provided the net debt numbers ex-leases. Could you just let us know to what extent you can the year end lease balance and maybe just how much of that is Avincis or the old Avincis business, part of which is obviously in the process of being sold and the rest of it you kind of allude to being under review.

#### **David Mellors**

I'll give you the net debt including leases which is about £1.4 billion. At this stage I won't split that down into where it comes from, from the different businesses although you've got last year's annual report. So £1.4 billion including leases.

#### **Allen Wells - (Exane BNP Paribas)**

Okay. Then very final question just to try and ask Sash's question slightly differently. When you talk about the £30 million lower profitability moving forward how much of this is potentially non - if you want to call core business - non-Avincis. I'm just thinking about if that business is sold does some of that reduced profitability just drop away with the sale or is this more around core impacts in that reduction? Thank you.

#### **David Mellors**

Okay, look we haven't split out the impacts, either the one-offs or the recurring by sector or business at this point. Nor would we expect to because it is just an early view. So we haven't split that out. But the impact does cover a number of the businesses. We're not commenting on what is going to be disposed of at this point. So to the extent that anything would impact that £30 million going forward if we decided to divest, we would obviously update you if it was material.

#### **Allen Wells - (Exane BNP Paribas)**

Okay, thank you.

#### **James Beard - (Numis Securities)**

Thanks, morning all. I've got one question around net debt. You obviously flagged the difference between average net debt and period-end net debt in here. What is your ideal view of what that difference should be once you've made the portfolio changes that you're planning to make and how you get there?

#### **David Mellors**

So simplistically I don't think there should be a big difference but it will take a little bit of time to get there. I think it's as much a cultural point as an operational point. So we will be focusing on cash flow as a priority measure 52 weeks a year. The period-end therefore in a sense gets de-emphasised. Now you don't do that overnight. So it takes some time to get there.

Contracts that have been set up or bids that have been set up in a particular way need to run their course. So over the period of time that we've talked about here, 24 to 36 months, we would expect that to normalise. There's always a little bit of a spike around a period-end in any business. But it shouldn't be that great.

**James Beard - (Numis Securities)**

Thanks.

**Kean Marden - (Jefferies)**

Thanks. It's actually I think mainly from a few investors who have been ID-ing me. It's just on that balance sheet point again. So would it be right in thinking that the 1x to 1.5x reasonable net debt to EBITDA range that you referenced earlier, along the way there that would assume that the average net debt to period-end reduces quite substantially. The invoice discounts aim sort of circa £100 million. That utilisation of that completely disappears. The £450 million actuarial pension deficits, what assumptions have you made regarding dealing with that in that 1.0 to 1.5 times ratio please?

**David Mellors**

Okay, so firstly we haven't actually updated a target capital structure so David referenced what the Group had previously said. I'm not in any sense saying that that isn't reasonable. I'm just saying we haven't given a target band today. However we definitely want a strong balance sheet and 2.5x is not as strong as we would like. So we obviously will be on that journey.

Over that period of time as I've already said, I would expect the gap between average and closing to narrow. I think over that period of time, you can see from the announcement today, we have slowed significantly and will stop the use of supply chain financing. Over a period of time we will obviously stop the use of factoring too.

In terms of pensions, we don't actually have all the year-end numbers yet on pensions. So I can't necessarily help you on that. Obviously pensions is a longer term point rather than the shorter term working capital points that we've just listed out. We'll obviously meet all our pension obligations as they fall due. But they are slightly longer term than the other points you raised.

**Kean Marden - (Jefferies)**

That's very helpful. Thank you very much.

**David Lockwood**

Okay, well thank you everyone. I hope you found the statement and this session helpful. We look forward to coming back to you with the prelims and the answers to the questions that you will have then. So thank you very much.

**ENDS**