Transcript of the half year results for the six months ended 30 September 2023

Tuesday 14 November 2023

David Lockwood
Chief Executive Officer

Well, welcome, everyone, to the half-year results for the six months to 30 September. I'm just going to do a quick what we hope you take away from this. I think for the first time in three years, David has a relatively straightforward set of numbers to take you through, and then I'll finish with a bit of colour, not that David isn't colourful. And then we'll do Q&A.

When we get to Q&A, although this is a small room, it's being webcast. So, if you could wait for a mic, so people can hear your inspiring questions and my and David's inspiring answers, that would be tremendous.

So, what are the key messages that we want you to take away from today? So firstly, it's been a strong start to the year, not just in the headline numbers, but the underlying operational performance. That has led to the generation of free cash flow. We've always said we would only pay dividends from free cash, not from borrowings, so we can now reinstate the dividend with confidence.

And as we go into the pack, that there is a growing opportunity set, particularly outside the UK as well as in the UK, which gives us confidence in our medium-term targets, all of which leaves our FY24 expectations unchanged but with growing confidence.

So, with that, David will now do the numbers.

David Mellors
Chief Financial Officer

Thank you, David. Good morning, everyone. So, these are the four main messages from me this morning: We've had a strong H1, albeit with some favourable timing effects, and we're on track for FY24 expectations. Cash conversion is improved on prior periods. The balance sheet is stronger again, and we've reinstated the dividend.

The headline financials for H1 are set out here. The key points are: Organic revenue growth was 18%, with growth in three of the four sectors, but of particular note is the infrastructure revenue growth in Nuclear. Underlying operating profit was up to £154 million, particularly due to the three licenses sold on the Polish frigate programme, which also boosted margins and EPS for the half year.

Cash flow was better than last year, which was when we completed the unwind of the historic balance sheet window dressing. So operating cash conversion is 82%. And the higher profits and better cash conversion delivered an improved free cash flow of £67 million, which helped us to reduce debt to £288 million and gearing to 1.1x. And all of this gave us the confidence to reinstate the dividend at the half year, and the declared dividend is 1.7p.

So, to Group revenue before we go into the sectors. You can see here the effects of disposals and foreign exchange translation on the reported revenues and the resulting organic revenue growth for the Group of 18%. As we'll come to later, over £100 million or one third of that organic growth is due to the ramp-up of infrastructure revenue in Nuclear.

On the Group profit summary, again, we've separated out the effects of disposals and foreign exchange translation. And whilst all four sectors contributed to the £38 million organic profit increase, Marine and Nuclear were the main drivers. And the largest individual item boosting profits and margin was the sale of the three Arrowhead licenses in Poland in the period.

Now looking at the sectors, with Marine first. The key points are on revenue: Strong organic growth of 15% was largely due to the license sales, the increases in Type 31 revenues and the completion of QEC support work. Conversely, the Liquid Gas business did go backwards from a revenue point of view despite strong order flow as a result of project start-up timing.

In the period, there was approximately £140 million of low or zero margin programme revenue, of which Type 31 is the largest part. And on the profit side, the above factors and most particularly the one-off license sales boosted margins to 8.4% in the half.

The main points to note on Nuclear are that the 27% organic revenue growth is driven mainly by the doubling of infrastructure project revenue in Devonport in the period. We delivered £218 million of infrastructure revenue, and the second half could have a similar amount.

So, the resulting FY24 infrastructure revenue could be £400 million to £450 million. Whilst it's too early to be precise, we're currently expecting FY25 infrastructure revenues to be lower than FY24, maybe by 20% as certain work packages complete.

Other revenue also grew in Nuclear in the half in both submarine support work and in civil nuclear. And these revenue increases helped the profit growth over last year, which was also low due to a provision of £6 million on a programme which has now been completed. All of these factors helped the margin to take a step forward to 6.4%, despite prudent future inflation assumptions on some programmes .

Moving to Land. The main factors driving both revenues and profits higher are as follows: in South Africa, we had another strong period of growth in vehicle sales to the mining industry and in aftermarket sales as well; in Australia, we've now commenced the defence high frequency comms contract; and in the UK, there were higher volumes in rail and vehicle engineering. And these obviously fell through to profit. The resulting sector margin was 6.9%, lower than last year, which benefited from a one-off accounting credit, but well up on where we were two years ago. So going in the right direction.

On to Aviation. The prior period has been adjusted for the disposal of the European AES business, which completed in H2 last year. After stripping that out, the organic revenues go backwards by £38 million, as you can see on the slide. This is primarily due to the phasing of two French defence programmes , which are transitioning from aircraft acquisition and delivery into the long-term support phase.

There are other programmes of this type in the pipeline, which we hope to win. And as a result, revenues may be a little lumpy, but program margins should be consistent. On the profits. The lack of significant bid costs in the half, coupled with a one-off inflation catch-up, has helped to deliver a 5% margin for the sector.

Moving to the cash flow. This is a busy slide, and I won't go through every number on the table, just focusing on operating cash flow in the middle of the table and free cash flow at the bottom.

The operating cash conversion of 82% is up on the prior period for two reasons: One, the prior period had the final unwind of the historic balance sheet window dressing through working capital; and two, the net capex is higher this half, largely due to lower sales proceeds on aircraft following the AES business disposal. But as you know, on capex, we are investing in both facilities and systems, which will have capex above depreciation for some time.

Moving to free cash flow at the bottom, the reduced pension payments and interest and tax payments were as expected, leading to a positive free cash flow in H1 for the first time. So, the resulting free cash flow was there a £67 million inflow. And I've put some guidance on the slide as well for FY24.

On the balance sheet, again, this slide is busy, and I've put it up before at results presentations to show the progress on repairing the balance sheet. These are the four areas in these boxes that I look at when judging the balance sheet.

Three points to make on the progress to date: As the top box shows, net debt is now down over £1 billion over this period and the gearing ratio reduced to 1.1x. As the second box shows, we've completed the unwind of the historic window dressing practice at period ends, and this has cleaned up the balance sheet by over £400 million.

And if we add the pension deficit in the third box, the technical provisions to the debt in the window dressing, the aggregate of these debt and debt-like items has substantially improved from some £2.8 billion three years ago to less than £800 million now. Just on the pension deficit, you can see the technical provisions deficit came down a little in the half. That was due to rising gilt yields and our contribution payments.

We are engaged with the trustees of the three main schemes in their managing of the liabilities. And whilst the three schemes are all in different funding positions, I'm hopeful that one of them will get self-sufficiency within the next year or so, unless markets surprise us.

The fourth box on this slide shows the improvement in aggregate working capital of the Group. This improvement is largely as a result of having focused on cash flow performance rather than period-end balance sheet management.

You'll remember at the full year last year, we said we'd overperformed by some £70 million on working capital. Whilst we continue to focus on being as lean as possible from a working capital point of view, I think further improvements are going to be quite hard with the current contract portfolio, and there continues to be some risk of reversal over time. So, to summarise this busy slide, we're in a much better place from a balance sheet point of view than we were.

This is the capital allocation framework we published last year. And just to touch on the top three priorities as an update. Firstly, investment. We continue to invest in the business, both through capex and opex, to support delivery, improve control and enhance growth. We're spending £50 million a year on capex on Submarine infrastructure, for example, as well as investing in upgraded systems and facilities, amongst other things.

The second priority, financial strength. We've already touched on the balance sheet in the previous slide. And the third priority, the ordinary dividend. We've reinstated the dividend at a prudent start point, given the investment priority, and the free cash flow still needed to trade out the onerous contracts and get the pension schemes to a better place. We intend the dividend to be progressive over time. And the interim dividend will be approximately one third of the full year dividend.

So, to finish, we are on track for the full year. We've had a good start, and we have over 90% of the expected full year revenue under contract at the half year stage. So still some work to do, but we are in a good place.

And with that, I'll now hand back to David.

David Lockwood
Chief Executive Officer

Thank you, David I thought I'd start with the road map to the sustainable medium-term guidance. This is excluding one-offs. It's just how do we get a really solid run rate.

So mid-single-digit growth. Clearly, there is a supportive geopolitical environment for defence companies. For us, in particular, that is manifest itself in a strong backlog and framework coverage, i.e., we have a frame, but we haven't yet booked the orders. We book them as we physically get the contracts. And the opportunity set, which I'm going to come to, is growing, and the visibility of that is growing as well.

The margin improvement, there are two things: One is the fade of the low and zero margin, which particularly comes through in 2025, and I've got another slide on this, I won't do it all now, but also improving the way we deliver the order book we've got today. And then it's booking better orders.

And finally, cash conversion, you clearly get paid when you execute the contracts well, so contract execution equals milestones, equals cash and the controls that go with that. But secondly, and David's touched on this in most of these sessions, is it's an obsession with both of us. You set your destiny in the contracts you book. And if you can book contracts with more frequent smaller milestones with cash in the right place that you can control, you can drive your cash efficiency in a much more controlled fashion, and you make the business as lumpy.

And it's clear from the bids we see coming through now, that has really landed in the business. That's not something we going to talk about it, it just comes through naturally. So, you're just having better structure in the backlog that's building.

So, from financial year 2025, you'll remember from the slide we put up at the year-end, we have significant fade of that low and zero margin, which will necessarily push margin up.

Operational improvement. I focused here on digital capabilities. We've talked about the investment in capex through things like SAP. We have procurement software going in. We have data analytics software going in.

As we transition Babcock essentially from an analogue business into a digital business, that will drive operational efficiency, give us the data to run the business and give us new services to offer our customer. So, it's a very important part of the next phase of Babcock.

I talked about a year or so ago, the -- I think this time last year, about how we improve delivery. DSG is a good example. We have, in Babcock, really good people who want to do a really good job. And to do a really good job, it means when they turn up, they need tools that are calibrated, they need to be fully kitted. They need everything in order to do their job.

If you can combine that with digital infrastructure, with the SAP rollout in DSG, you can get to a position where the amount of what we call productive utilisation, i.e., if you pay someone for 8 hours, how many hours do they actually work; you can drive productive utilization of DSG. Over the last three years is a great example how a combination of management discipline and digital infrastructure drives improvement in delivery. All of that means that you can deliver competitive long-term margins.

And then contract discipline. We've talked about how our job is to take on the risk we can manage and manage that risk well to deliver premium margins. That's what good contractor does because it's our responsibility to take from the customer risk we manage better than them. It's also our job is to make sure that they manage the risk that they manage better than us.

And so, getting that discipline right about developing our risk management ability so that we can take on risk, improve our margin, improve the experience for our customer, whilst making sure that they understand that they should retain the risk that they are better placed to manage, inflation being a good example; really matters. And we're seeing that discipline come through along with the cash discipline in the way we bid.

So, in my mind, of the 50% of your destiny, is set in the contract you get. The two most important things for Babcock are the risk discipline and the cash discipline. You get that right and you book good orders, and that really will drive the sustainable and predictable margin that we're looking for.

So future growth, I pulled a few things out. We've seen the benefits of exports of Arrowhead last year with Indonesia, this year with Poland. There is -- obviously, we don't talk about them much until they happen, but there are a number of opportunities for Arrowhead in additional export markets. So that's very positive.

We have the cooperation we announced with Saab for the advanced corvette, which is also looking very encouraging. We have a range of collaboration opportunities with HII in the States in both Naval and Civil Nuclear.

And we've announced some first steps of that in Australia, including skills work with Australia and universities and looking at infrastructure together. So, I think that's a very promising step forward. HII, very similar to us in kind of outlook and market position and very complementary skill sets. Obviously, for AUKUS, we have both the Virginia work with HII, and we have already got our first order on supportability of the SSN AUKUS boat that BAE Systems is leading the design on. So that will continue to grow.

I touched on most of these presentations about how particularly in Civil Nuclear, our biggest constraint is the supply of people. And in Civil

Nuclear, we do build, with EDF for example, at Hinkley, we operate, and we decommission. So, it's a broad range of skills we need from post docs through to highly skilled pipe vendors and welders.

And so, the Babcock Skills Academy is designed to effectively be self-help in the skills agenda. So, we're aiming to get 2,000 people through it in the next three years and working in conjunction with the Nuclear Skills Taskforce the Government has set up, which Collette is leading our efforts on. We aim to drive that number higher because I suspect that the more we get, the more we'll need, because each growth in capability will drive more opportunities. So that's a critical contribution to the UK, but also a critical contribution to growth.

In Land, we are an integrator of vehicles, so the Jackal and the General Logistics Vehicle, where we already take Toyota Land Cruisers and convert them for various customers into more special vehicles. The Land business is very skilled at that, and there are a number of quite significant opportunities, going forward.

Obviously, asset support is one of our core activities, and we've talked about recently in announcements that the additional asset support we're doing, for example, in the Land domain in France.

And finally, we do have a very, very high skilled, highly capable training capability, training the UK Army, training the London Fire Brigade, training the Met Police, training in France with the Ascent joint venture. So, we're doing a lot of high-end, high-value training that few people can compete in. So, if you look across all of that, it's some very significant growth drivers for us, both in slightly new areas and in our core business.

I said earlier that people are a big deal for us. We are a people-centric business. Compared with many companies, we're not an IP-centric business. We're a people-centric business. So last year, we launched our first people survey. This year, we did the second version.

I'm pleased to say all of the key measures move forward. The highest scores were quite important to delivery, 'I know what I need to do to be successful in my job'. It's quite good that 80% plus of people say that because otherwise, you're probably in trouble in a people business; 'I have a clear understanding of my role and responsibilities', and 'we're committed to health and safety'. Those are big core enablers to a people business.

Interestingly, still one of our more negative scores, although it has improved, is 'I believe management will do something with the survey'. In my experience, people often say that. Participation actually went up from 79% to 80%, so you kind of don't have a second go unless you think someone's going to do something.

And over that, over 80% provided comments. There are always comment boxes on these. And we had, in total, over 100,000 comments. So, we're actually having to get some data analytics tools because we've got so many comments. We don't know how to sort them. Well, we do know how to sort, but it's a big deal to sort them.

So, I've talked about the Skills Academy and working in Australia on skills. We're also featured in The Engineer's Top 10 Employers in 2023, which is the first time we've got onto that list. So, I think as a people business, which is one of our lead indicators, lots of good progress.

So summary, I said it at beginning, David said it in the middle, so I'll say it at the end, strong start to the year, I think that's difficult to argue with.

For me, the dividend is really important because if you've got three core capital allocation goals to invest in the business, then to maintain the balance sheet, then to pay a dividend, once you can do all three, you're starting to say we can generate the cash flow to support our core deliverables to all of our stakeholders, and we can do that with confidence. So, I think it's really important psychologically, and the growth on top.

And finally, we're going to hold a Capital Markets Day on the 7th of February, hold that date. We're going to do it in Devonport because it's where so much stuff is going on. I think it's important to people they have the chance to see it. We will be streaming some of it. But really, you'll get the most out of it if you come down to Devonport in February, which is not always the best place to be in February but come onboard in February and see us in action.

And with that, we'll do questions. If you could wait for the mic, as I said at the beginning, so that those who are not in the room can hear you, that would be tremendous. So, any questions?

Q&A Session

Sash Tusa *Agency Partners*
Sash Tusa from Agency Partners. You made a comment about how you set your destiny and the contracts you book, and you want more, I think, frequent smaller milestones. What pushback do you get from customers? Or do you get any pushback from customers for that? Because that seems to be quite different from some of your larger manufacturing prime contractors.

David Lockwood
Yes. So, in general, we don't get pushed back because it gives customers more milestones to monitor us if neither of us want to lurch into either a big success or a big problem. And therefore, if you're measuring progress more frequently, you get less shocks, positive or negative, to the system. So, in general, customers see it as positive.

Sash Tusa *Agency Partners*
Just one other follow-up on the border infrastructure work that you're doing. What's the relationship of the £750 million contract that you announced last week, about that, to your views of the current profile of the contract, is it actually a backward-looking contract that it just formalised stuff? Or is that additional work to what you expected two to three years ago?

David Lockwood
So, it's what we expected. It's confirmation of what we expected for 10 Dock. But there's probably more infrastructure work going on now than we thought there would be three years ago. But certainly, from a year ago, it's just confirmation of the work on 10 Dock.

Sam Burgess Citi –
If I could just follow up a bit more on the Devonport infrastructure programme. Just in terms of the absolute profit number, obviously, that's positive news. But given its lower-margin work in terms of the mix and the effect that will have on margin, is there any particular change there? Or what sort of shape of the margin should we expect to see over the next couple of years?

David Lockwood
In the spirit of survivability, I don't answer margin questions and let David answer them.

David Mellors
Okay. So, I'll start with Nuclear sector as a whole. We've always said that Nuclear, as with Marine and Land, should be able to get to the 8%+ margin levels over time, and nothing's changed there. You've seen the step forward they've made in the period, which is good.

We don't give individual project margins, all sorts of reasons and won't. So, whilst the infrastructure is at a slightly lower margin than the rest of it, it is a bubble. The rest of the work is still going forward. We just saw there's growth in Civil Nuclear as well as other underlying submarine support work as well.

So, the margins step forward, going in the right direction. And I don't think it changes anything, actually. It's just a kind of bubble, if you like, a multiyear bubble of work that won't distort either the targets or the progress.

Joe Brent *Liberum*
Joe Brent, Liberum. Can I ask three questions and maybe one at a time? Firstly, I think you indicated, David, that the macro environment is quite positive. But I don't know if you saw the kind of Labour conference speech, I'm sure you did.

But they were talking about defence spend of around 2%, whereas the Government policy is 2.5% to 3%, in the long term, of GDP. And they also talk a lot about in-sourcing, which I think is really more relevant to other sectors than your own. But interested in your view of the Labour defence plans -- defence spend plans, but also their in-sourcing agenda?

David Lockwood
So, I don't think in-sourcing, as you say, is particularly relevant to us. We talk to Labour a lot as we talk to the Conservatives a lot. My view is that if you don't grow the budget, you have to get more out of what you've already got. What we deliver is more out of what you've already got. And therefore, I still think if what you're driving for is availability and capability, the top-level need is still conducive to what we do.

So, I don't think that changes things. And although the current Government, I'm not sure they do say 3% anymore. But they've indicated a higher number; they haven't delivered it. So, I don't think against the backdrop of what we're looking at is that different.

Joe Brent *Liberum*
And second question, on one of your sorts of pipeline of growth prospects, something that's absent there, in my mind, is HFC. Is that because there's such a long list that could be there? Or has something changed?

David Lockwood
No, it's not, we do a high-frequency comms in the UK, Australia and New Zealand already. So that's kind of not, those will grow in scope but with the incumbent in those three places already. So, if you think of it as a Five Eyes issue, and with the link between Canada and the US, so the question really is, is there a market entry strategy to the US, which is what we're thinking about.

Joe Brent *Liberum*
And then finally, one for this, David. On the working capital, in my mind, quite a lot of things going on there. Firstly, you've got your organic growth. Secondly, you've got the project financed £35 million. Thirdly, you've got an unwind from, I think, quite a favourable position the year before. And I don't think there's much impact from the stretch, which I think was resolved last year. Could you just help us talk through the various components of working capital in the first half?

David Mellors
Yes. So, if you look at the working capital at the top level, it hasn't changed since the year-end. I mean, very small. So, what we said was an overachievement of the full year. At the top level, we've managed to hold on to, although I did say again today, there is always that risk of some reversal there.

We're now, as you saw on the slide, we've got very negative working capital, which is good. But there's only so far you can go with the current portfolio. Unless we sign up new contracts with cash positive profiles, then there's always a risk for some reversal on that. And this is largely a degree to what we said about cash flow management. If you look at the individual components, it's not about inventory is relatively flat. This is about your contract assets and your contract liabilities, and that goes back to what David said about setting up contracts with the right milestones and then delivering the milestones so that you get the cash flow in.

David Perry *JPMorgan*
It's David Perry at JPMorgan. I've got a few as well. So, David L, your slide on all the strategic initiatives to drive future growth, there's a lot there, Saab, HII, Poland, etc. What's the sort of lead time on those projects when we see them coming through to sales? That's the first question. The second one, I don't think you've said anything this morning...

David Lockwood
Can we do one at a time?

David Perry *JPMorgan*
Yes. Sure, sure.

David Lockwood
Because you'll remember questions more than I will. So lead times vary a lot. I mean if you look at the lead time for AUKUS support, for the SSN AUKUS boat rather than the planning for it, we're talking decades, if you look at some equipment support in France, for example, the lead time from bid to order win to commencing work is less than 18 months. So, I think there's a big spectrum amongst them. I mean, typically, incremental work is 12 to 24 months and strategic work is in the years, I think, is big handfuls.

David Perry *JPMorgan*
Just specifically on Saab and Poland.

David Lockwood
So, Poland, so we've done the licenses. In fact, the Poles announced that the intention was to have a collaborative arrangement in Poland to deliver their ships. The partner is a state-owned shipyard, part of the PGZ Group. And therefore, clearly, the change of government means we will need different political approval.

We've heard nothing to suggest they don't want to proceed, and neither was the UK Government, but we still got to finish that. I would guess that's early, that's before the end of this financial year, but it's a bit of a guess because its politics thrown in. And exactly how we recognise that will depend on what structure we come up with, which is what David is working on.

And in terms of Saab, I think the design work was, again, at a lowish level, will start in this financial year, but not enough to move the dial. And build work will be end-user dependent, which again, is a political decision.

David Perry *JPMorgan*
But you do expect there is a ship behind this, is there? Or is it speculative?

David Lockwood
The Saab work is not speculative. No.

David Perry *JPMorgan*
So, what Swedish government is going to buy a ship, is that...

David Lockwood
I didn't said it was a Swedish government. I said it wasn't speculative.

David Perry *JPMorgan*
Okay. I don't think you said much about the new submarine terms of trade with the UK government for the FMSP. Can you just update us? I want to talk to...

David Lockwood
David?

David Mellors
We talking about the DMP for the next boat that's come in?

David Perry *JPMorgan*
No, the long-term.

David Lockwood
The long-term strategic thing, so that is still under discussion. As you can imagine, for something of that scale by long term, clearly, we mean longer than FMSP. FMSP to more than a couple of years to negotiate. So, the long term it's going to take a while. So, we won't be able to discuss it until we're further through.

David Perry *JPMorgan*

Okay. And then just the last one. Do you have a target for a medium-term dividend pay-out ratio?

David Mellors
We've not published one. So, we've said progressive. It is the third priority. We've got plenty of investment opportunity. We've still got, as I said, cash flow to sort out the onerous contracts and the pensions. We still want to keep a strong balance sheet. Obviously, in the medium term, those things would have been sorted one way or the other. And then, we will have a more normal ratio.

We've started off looking at it from a free cash flow point of view, rather than earnings because things like pensions and capex, obviously, are cash issues, not earnings issues, primarily. So that's where I've started thinking about it. But rather than just put a cash flow ratio out there, we'll wait for a little while until we've got those things behind us. But clearly, we will revert to some normal ratios over time.

Sash Tusa *Agency Partners*
Sorry, a couple of follow-ups on lessons learned or possibly not lessons learned. I think you started to talk about DMP for HMS Victorious, but I wondered whether you're seeing any lessons from HMS Vanguard materialise at this stage?

David Lockwood
So, obviously, there are two lessons: One is, operationally, because it was the first (of Class), second time around deep maintenance that was done, so lots of operational things we learn. And then the second is contracting. I take you back to my -- we should embrace the risk we can manage, and we should persuade the customer why they should own risk we can't manage. So, I think there's also contract learning. And I think the programme has learned both of those things.

Sash Tusa *Agency Partners*
Is that even adjusting for the fact that clearly, you're not doing a refuelling this time, so the massive risk that probably nobody could manage is inherently isn't in this one?

David Lockwood
So, we've learned the lessons on everything, I think, is the way to think. I mean we jointly put a lot of effort into understanding how you get from one to the other.

Sash Tusa *Agency Partners*
Okay. And then on Aviation, are there any better lessons to learn from the failure of the Canadian contract other than never competing against a Canadian incumbent on a Canadian contract?

David Lockwood
I think the biggest single thing other than taking on an incumbent is hard, is really deeply understanding how the technical evaluations go on in different countries. So, our team is a combination of Brits, French and Canadians. And it was obviously being scored technically by Canadians. And I think there were a couple of areas where we probably undersold ourselves.

So, I think it reconfirmed the need for market intimacy. And I think if we'd started again, and it started, obviously, three years before I joined; we would have probably invested more upfront on people that really understood the Canadian aviation market.

David Mellors
Is there anyone on the web? There are no questions on the web. Well, in that case, thank you very much for your questions, and we'll see you on the 7th of Feb in windy wet Devonport.

ENDS