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Trading Update

Wednesday 25 September 2019

Archie Bethel

Chief Executive Officer

Good morning and thank you for joining us for this call. We issued a short trading statement this morning. Before Franco and I take your questions, I would like to highlight just a few things.

It is only a few months since our Capital Markets Day when we laid out our plans for the next few years. So I guess, unsurprisingly the trading for the group is in line with our expectations. Overall, on Defence we are slightly ahead. In Nuclear we are bang in line and in Aerial Emergency Services we are slightly behind, but overall we are in line and we are maintaining our guidance for the year.

In Marine, our warship support team has had a very busy start to the year with the Type 23 frigate life extension programme progressing well, including the launch of a connected support platform, which some of you may have seen demonstrated at DSEI earlier this month. After more than 12 years the design and build phase of the QEC programme is nearing successful completion and HMS Prince of Wales left the Rosyth site a few days ago to begin sea trials. In our technology and international areas of Marine we have also had a strong start to the year. Land sector teams have made great progress so far this year too, working closely with the customer across DSG and successfully starting on the new CP6 contract in Rail. I'm also pleased to see a marked improvement in the trading conditions of our South African business.

Our teams across both the Naval and Nuclear sectors have also been busy delivering to our customers and in the period, we handed back all of the Magnox site to the NDA as scheduled. In Aviation we have made a really good start on our new contracts in both Canada and Norway, as we continue to build a wider international presence. In Aerial Emergency Services we have had a high level of bidding activity, although we have seen some contract award slippage being experienced.

Last month we successfully completed our refinancing. We issued new bonds and refreshed our credit facilities. Our credit rating remains at BBB, triple B, with the two rating agencies. This allows us to maintain our flexibility as we develop the business over the medium term.

Finally, the highlight of the period was our selection as preferred bidder for the Royal Navy's Type 31 general-purpose frigate programme. We are absolutely delighted to have been chosen and we are very excited about this great opportunity for our company. I'm extremely proud of our naval engineering team who developed the Arrowhead 140 concept design and I'm confident that this flexible and innovative naval platform will also be attractive to other navies around the world.

Looking ahead, we will present our half year results on 20 November and we look forward to talking in more detail at that point.

So, now Franco and I will take any questions that you have.

Q&A Session

Rob Plant, Panmure Gordon

Morning, Archie and Franco. At the time of the full year you mentioned that the short cycle market was quite weak, how has that progressed please? Thank you.

Franco Martinelli

Hi, good morning Rob, Franco here. Yeah, look, because the short cycle is across different types of businesses. As Archie said, South Africa is doing well, Rail has now gone into CP6, and so that is coming through there, and procurement is pretty much in line but is variable. So, yeah, it's as expected really.

Rob Plant, Panmure Gordon

Okay. Thanks.

Kean Marden, Jefferies

Morning all. Could I start with a few questions on Nuclear, please. So, first of all, I can see that you've picked up contracts in Japan and Canada recently. If you can just give us some insight into what you're doing there. Presumably they are probably quite "small in revenue terms", but that would be helpful.

Back in the UK we've seen some activity, some packages come into market with Sellafield. I'm just wondering whether you bid on those and missed out, or whether your opportunities are still to come? And then your latest thoughts on Magnox, where, obviously, I think the chairman is parting company with the NDA later on this year, so quite what you think is the most appropriate timeline for a new business to come through.

Then the second area just covers off the EC225 helicopters. I don't think you've managed to sell all of the surplus helicopters in the first half, I'm just wondering what the environment is like at the moment and the likelihood for any of those to be divested in H2?

Archie Bethel

Okay, there's a few things there so I'm going to quickly go through them.

Japan and Canada, yeah, these are both Nuclear markets who, we think, long term will provide us with good opportunities. I'm very pleased that we're winning our first engineering consultancy contract in Canada, and in Japan, we continue to build on the work that we have been slowly building up there. They are still relatively small scale for us, but certainly over the next 10 years we will see Babcock continue to participate in greater degrees in both these markets.

At Sellafield, you mentioned, there's quite a lot of things going on up there. We are concentrating on the design support alliance which we are a core member of and we have a couple of major decommissioning contracts that are in full swing, and we are pursuing opportunities as they come up.

In Magnox the position hasn't really changed. We've focused really, really tightly on handing back the contract which we did on time, successfully, to exactly the programme that was required, with a very clean, commercial settlement. So Magnox, that phase of it, is pretty much behind us and looking forward we are keen to see how the new team at Magnox starts to develop the supply chain solutions for taking Magnox forward. So I would expect, over the next couple of years to start to build up a pipeline of opportunities back in Magnox.

I think another one was EC225.

Franco Martinelli

I'll take that Archie. EC225, we committed it to be used in firefighting and they are working really well. They have been well utilised over the summer. We have four left. We're still looking to sell the two in the second half and that's our current plan. We'll decide whether the final two are converted to firefighting or sold over the next 12 months, but we haven't sold any in the first half, you are correct.

Kean Marden, Jefferies

Great. Thanks, Franco.

Sam Bland, J P Morgan

Morning. Two from me please. The first one is can you just talk about the expected H1/H2 split this year and whether there is anything different from normal? I'm thinking particularly on cash flow where I think there may well be quite a large H1/H2 split. And then the second one is on the refinancing. Obviously, the statement notes some higher short term refinancing costs. I don't think they were included in the May 2019 guide. Can you just talk about when that refinancing programme was initiated and when you realised what the implications of it would be? Thanks.

Franco Martinelli

Okay, on the cash flow, it's pretty much, in terms of operating cash flow, in line with previous years if you exclude the Fomedec effect which is obviously the words that we try and not talk about in terms of cash flow. But excluding that it's pretty 30/70 as it was previously and so we expect that to be still the same. So that's where we thought.

In terms of refinancing, we had the option to refinance quite a bit later than we did. Late on in the summer we decided that the markets were open and that there is a bunch of uncertainty, particularly in the UK, which seems not to end. Because the markets were open, we decided to remove any refinancing risk from the group. So we did that post May. We looked at the markets at the beginning of September and said, yes, it's open let's go and, as I say, we could have done that later but we decided that it was important to restructure.

What it does for us, with the RCF actually going to 2024/25 and the bonds now to 2027, we're pretty well set in terms of financing. So we just took that risk off the table in an uncertain world. So we thought that was worth doing. Just to clarify, we have identified the extra interest charge for this year and the year after but then it all reverses out, plus the 2 million gain in the following year. So in all, it doesn't work out from the present value any significant difference really and gives us certainty for our position. So we felt that it was a good thing to do and still do. So that's that. I think that answers your question.

Sam Bland, J P Morgan

Sure. Yep. Thanks.

Joe Brent, Liberum

Morning, gentlemen.

Franco Martinelli

Morning.

Archie Bethel

Morning.

Joe Brent, Liberum

Two questions if I may. Firstly, could you just talk us through the pipeline in Aviation and why there may have been some slippage on contract awards? Secondly, on fleet solid support ship, I think there has been some positive noises from government, I would be interested in your perspective on whether that's a prospect or not and what the time might be.

Archie Bethel

Okay, Joe. On the pipeline first. There's no big deal. The pipeline in Aviation is really strong. We've had a lot of bidding activity but we have two or three contracts which we expected in the first half decisions to be made on, that have slipped into the second half. They are in Spain and Italy. I don't think there is any significant indication of a change in conditions, but that's just set the nature of our business. So the overall pipeline is actually growing in Aviation and again, at the half year, we'll provide more details on that.

FSS, well we are in a competition there so I don't want to say too much about it. That continues. Team UK, which is led by Babcock and includes VA Systems, is still the only UK bid for FSS and we are progressing that bid.

Joe Brent, Liberum

Thank you.

Suhasini Varanasi, Goldman Sachs

Hi, good morning. Thank you for taking my question. Just two please. On free cash flow you mentioned that the studies have a split H1/H2, excluding Fomedec. Can you give us some colour on what that split is, including Fomedec please? The second one is can you give us some colour on how the MSDF negotiations are going?   Do you still expect no change to revenue margin expectations going in to FY21/22? Thank you.

Franco Martinelli

Sorry Suhasini, what I meant was Fomedec was last year, there is no effect this year. So the 30/70 split is as is and it's an operating cash flow which is what where talking about. So that's as we have previously guided.

In terms of MSDF, Archie do you want to pick that up?

Archie Bethel

Yeah, MSDF it's a single source negotiation, it's well underway. There will be, I think, a phased new contract being put into place from next April, but it's pretty much in line with what we've previously talked about. So we continue on that. As I say, it's a single source negotiation that we expect to conclude probably around the end of the year.

Suhasini Varanasi, Goldman Sachs

Thank you. Just one follow up please. So operating cash flow that you have given, is the free cash flow still going to be different from 30/70 because you've sold less helicopters, I'm guessing?

Franco Martinelli

It's not really. I mean 30/70 is really what it's going to be.

Suhasini Varanasi, Goldman Sachs

On free cash flow?

Franco Martinelli

The helicopters, on the sale, there's only the exceptional ones which we haven't sold, but there is no real issue on net CapEx, no.

Suhasini Varanasi, Goldman Sachs

Okay. Thank you.

Allen Wells, Exane BNP

Good morning guys. A couple from me. Just firstly following up from Kean's question earlier on on Sellafield. I think there was at least one pretty chunky contract won by Wood Group for £700 million back in May. Again, is this something that you wouldn't have been bidding on? And separate to the work you're doing now, did you bid on this and didn't get it to try and understand the competitive dynamics around Sellafield. That's the first question.

Second question just on Type 31. Obviously, it's been in the pipeline for a while, it's sorted of expected, but how important are the potential for international orders for this contract for you guys? If you could maybe make some comments there. Thank you.

Archie Bethel

Okay. Sellafield, I think it was back before May, these were framework agreements. I think they were called PPP, where there were four different frameworks where contractors were selected. We bid on one of them. It was the same one that went to Wood Group. In that case we didn't win it. But these are frameworks for specific developments at Sellafield. Our main interest is in actually the decommissioning work at Sellafield so we are still pretty much focused on that pipeline and still competing and winning work on that. We don't win everything we bid. We win 40 per cent. I'd love to win everything that we compete for, but we don't.

On Type 31, and the potential for international. What I would say is that as part of that bid process we did have to identify our view on what the potential international business was and we were part of that evaluation. We think there are some very strong interests from a number of countries. I think once we have finished the contract negotiations, we will be sitting down with the Department of International Trade and we will be working to identify which of these countries that have shown interest so far.

So none of these are built into a plan. So anything in that would be upside going forward and I don't think it's something that is going to happen in the next 6 months. I think most people will watch how we develop the Type 31 and how it goes here, but I think we've got a ship here that's in a price bracket that will be attractive to many of the world's smaller navies.

Allen Wells, Exane BNP

Maybe one quick follow up clarification just to be clear. The 30 per cent 70 per cent guide on free cash flow. So first half free cash flow bearing in mind the full year guidance is over £250 million. We should be seeing positive £75 plus million free cash flow in the first half based on the 30/70 split, is that correct?

Franco Martinelli

We're clear that the 30/70 is operating cash flow and below that there will be items like interest, et cetera, and the interest is obviously split 50/50. Then there will be pension which is more 50/50 than it has been in the past. So I think 30/70 is operating cash flow which is the guidance that we gave.

Allen Wells, Exane BNP

Okay. So free cash flow will be less than 30 per cent in the first half?

Franco Martinelli

That's what the maths says, yes, that's right.

Allen Wells, Exane BNP

Okay.

Sash Tusa, Agency Partners

Thank you. Good morning. I've got two questions. One is about the contract delays in Aviation. I wonder whether those delays have yet got to a stage where that might affect your view about the next financial year, financial year 2021, or is it just well within the margin of error for these sorts of things? The second question is about Type 31. Do you expect to be able to contribute as a programme to overhead recovery at the site in the current financial year, or will that really only start once you have the facilities up and running?

Archie Bethel

Okay. On the first one, Aviation, these delays I would say are just within the normal business. In Italy and Spain, particularly in Southern Europe, it sometimes can take quite a long period of time before they finish their evaluations and decide who has won contracts and stuff like that and that's just part of that kind of business. It's not anything unusual. So I don't see it as being anything that changes our view.

On Type 31, I think as we have said, in the current financial year there will be some contribution mainly in the design side, but it will be pretty small. So you're basically getting to next year when we really start the physical build up and the procurement of long lead items, et cetera, and everything for the programme. So, this year, very light, very little, and then start to build up next year.

Sash Tusa, Agency Partners

Thanks very much.

Christopher Banbury, Peel Hunt

Good morning. A couple of questions if I may. I was wondering what the size of the order book and pipeline currently were and the visibility that you have on revenues for this year and next year? Secondly, given the movements in FX, what is your current assessment of the impact on net debt?

Archie Bethel

What I would say about the order book and pipeline, we will give full details of this at the half year. I'd say just off the top of my head, the pipeline is definitely up from the beginning of the year, the order book is up from the beginning of the year. By the time we get to the half year, we will provide a full breakdown of that. The second one?

Christopher Banbury, Peel Hunt

FX on debt.

Franco Martinelli

Sorry Chris. Good morning Chris. Franco here.

Christopher Banbury, Peel Hunt

Morning.

Franco Martinelli

For that 25 odd million at this point in time, we have got a bunch of Euro debt and that's roughly what it is at the half year but, of course, it moves daily as the exchange rate moves.

Christopher Banbury, Peel Hunt

Okay. Sorry, just a follow up on the order book. I mean is visibility at this stage of the year kind of similar to last year and prior years in terms of revenues for this year and next year?

Archie Bethel

Yep, absolutely. It's pretty much just the same as we've had in the last couple of years actually, but it's just exactly where we predicted it would be.

Christopher Banbury, Peel Hunt

Thank you very much.

Robin Speakman, Shore Capital Markets

Morning chaps. Nice to see the shares up 5 per cent this morning. I just thought you might be able to provide a little bit more colour on the improvement in South Africa. Can I ask what the strategic options for South Africa are? What are your views?

Archie Bethel

The business, not surprisingly, I think as we reported last year, we saw the lowest level of engineering work for Eskom at the lowest we'd seen it. Coming into this year, the new government down there has found money for Eskom because the energy situation was getting pretty dire. So we started the year very strongly, with two major outages now fully underway. So I think the short term problems of last year at least have been alleviated for a while.

Strategically the business is a reasonably performing business. It's been part of our group for a long time. It's not a market where we are looking to invest further in it, but it's definitely a business that we believe makes a good contribution to the group and on that basis, it's one of our adjacent businesses and that we will continue to develop.

Robin Speakman, Shore Capital Markets

Okay, thanks.

Archie Bethel

Okay, well, can I just say, again thank you for joining the call this morning. Thank you for your questions. We did present a 5 year plan at the Capital Markets Day in June and we have made, I think, a very good start to delivering on that. Our intention is to regularly update you on that progress and I look forward to updating you more fully on the progress at our half yearly results presentation on 20 November.

Ends