Babcock International Group plc Trading Update Call

Tuesday, 26th February 2019

Archie Bethel, Chief Executive

Good morning and welcome all on the call. As usual I'm supported this morning by our Financial Director, Franco Martinelli, who will help me answer your questions.

We did issue a trading update this morning, and before going to the questions I would like to highlight a few key performance updates.

Firstly, trading performance this year. Generally across our key markets of defence, aviation and nuclear we have performed in line with our half-year guidance, and I'm happy to confirm that in terms of the fundamental important areas of underlying profit margins and earnings, net debt reduction, new order intake and order book evolution the Group is trading in line with or ahead of our guidance at the half year.

However we're not perfect. Revenue in a couple of areas has been a little bit softer than we had forecast and we now expect underlying revenue for the year to be around £5.2bn with additional exits and disposals in the second half of the year coupled with lower revenues in our Rail and South African businesses making up the majority of the difference.

We've also added two different exceptional costs since the half year. The first relates to GMP equalisation between men and women in our pension schemes. And every company with a defined pension scheme is likely to have such an additional charge this year. We assess the charge at £30m to be paid over the next six years.

We've also incurred an additional one-off tax charge of £10m relating to the costs associated with the restructuring of our European aviation businesses to ensure we remain compliant with the aviation regulations post-Brexit even in a no-deal scenario.

Secondly, looking forward to next year. We are confirming basically what we said at the half-year position, and I'm only going to add one new item of guidance.

We highlighted that in mid-2019 and 2020 it will be a transition year as we come to the end of two of our biggest long-term contracts, the building of the two aircraft carriers and the early handback of our Magnox nuclear decommissioning contract, as we have discussed on several occasions now. The step-down in revenue from these two contracts, coupled with the revenue previously coming from the exits and disposals of this year, creates a step-down in revenue of around £400m next year.

The profit contributions from these, plus the normalisation of the Holdfast JV profits, again previously highlighted, steps-down the baseline profit by around £40m. And all of this has been previously signalled.

We are also now highlighting an additional ongoing cost of £10m per annum related to the UK leaving the EU. The cost relates to the operation of the new structure, mentioned previously, that has been put in place to meet regulatory requirements in our European aerial emergency services businesses across Europe.

We're still in the detailed planning process for next year, and we're currently assessing the level of growth we might expect to drive in our key markets from our strong order book and pipeline of opportunities, and we will, of course, provide further details on this at our results presentation in May.

And thirdly in operational highlights, I don't intend to go through the RNS note, but we are really busy in terms of delivering contracts and winning new orders, and I would like to highlight the performance across our contracts remains strong. And we are really pleased at the continuing growth of our International business, as shown in our list of new contract wins. In particular I would point at the important new business wins in Australia, Canada and France.

Overall new order intake has been strong, and our order book and near-term pipeline of opportunities remains at around £32bn level, and we have added £1bn of new opportunities for the pipeline since the end of last year, in addition to replacing the year contract wins.

And finally, we are looking forward to holding a Capital Markets Day in June, shortly after we announce our full-year results. And on the day it is our intention to lay out in detail our strategy and performance targets for the next few years.

So, let's move on to questions.

Q&A session

Question 1

Joe Brent, Liberum

Good morning, if I can have three questions please. First question, you've told us in 2020 what some of the drags are; could you give us some indication of what some of the positive drivers might be, just the big numbers, to help us get a bridge?

Secondly, on the Brexit related costs in aerial emergency, could you give us some indication of when those became apparent and if they have become particularly necessary given the fact there is a possibility now of a hard Brexit?

And thirdly and finally, could you give us some indication of the profit trajectory in Holdfast, particularly the move between 2019 and 2020?

Archie Bethel

I'll take the first two and I'll ask Franco to take the third.

On the first one, yes looking forward to next year the order pipeline is pretty strong across the Group. In fact probably the pipeline is as strong as we have seen in it recent times.

In the UK in the defence side I think the main projects have all been pretty much trailed. We'll be looking to renew our MSDF contract later this year. We are involved in the bidding for the Type 31e frigates. We are involved in the bidding on the FSS joint support vehicles. We're currently bidding on the ASDOT Air contract. And we have been involved in a number of other potential related bids, and this is on an ongoing basis, so that remains strong.

In the aviation side again across Europe we're working on a number of large opportunities in terms of both emergency aerial services and military, building on the back of our successes in France. We continue to win further orders in France, and we're working on other European contracts.

And then of course in our kind of co-home markets of Canada and Australia we've picked up significant contracts this year that will then play into next year for starting of delivery. Particularly in Canada in with the Manitoba contract for emergency air services, and again we're sitting on a number of other bids in Canada. And I think the significance of Canada is that this first contract provides us with an air operator certificate for Canada, which actually we should also be able to use in time to have a look at some of the United States market for emergency firefighting.

So, again that's a significant move forward, and next year that contract comes alive.

And in Australia the winning of the 15-year support contract for their two largest ships, so it's their Queen Elizabeth class equivalents, the two Canberra-class LHDs, again I think a good new win of business that wasn't there previously, which again kicks in in the next couple of months.

Then in Norway we spent the last year mobilising the large air ambulance contract there; again that contract now starts to kick in operationally. So, I think looking forward into next year we're in a pretty strong position.

In terms of Brexit costs we've had to, like most other companies, look at impacts on us in terms of Brexit as the process has developed, and that's not been easy or straightforward in any way.

The big issue that affected us is the fact that all our 400 aircraft that are operating every day across Europe are covered by an air operating certificates which are at the moment governed by a European agency called EASA, and of course on 1st April that relationship changes.

In terms of Brexit costs, well we've had to, like most other companies, look at impacts on us in terms of Brexit as the process has developed, and that has not been easy or straightforward in any way. The big issue that affected us is the fact that all our 400 aircraft that are operating every day across Europe are covered by air operating certificates which are at the moment governed by a European agency called EASA, and of course on 1st April that relationship changes and we've had to put in place a fairly complicated structure that allows us in the event of any outcome.

And initially we were pretty sure like most people that that would be a fairly soft structure, which we managed to put in place fairly quickly, but over the last year, so as the uncertainty has proceeded we have been forced, both in terms of our own kind of views on this, plus our government customers in Europe to give them the certainty that they needed, we've had to move to a much stronger, harder structure. So we're basically had to make a complete restructuring of the European businesses that allow us to comply with the regulations under EASA.

There was a tax charge there this year of £10m, and we're assessing the costs of operating this complex structure going forward, again at around £10m. But again, by the time we get to the May results and we have some more clarity on Brexit by that stage, we'll be able to say more about what we actually think that figure will definitely be. But we think it will be around the £10m.

Do you want to say anything, Franco?

Franco Martinelli, Group Financial Director

Yes, good morning, Joe, it's Franco here. Yes, the whole step down we provided a half year was about £15m, we're not changing that number, this is not new news, it's just that's what we expect the number to step down. Just to remind you, it's a long term contract for 30 years and it came to a benchmarking at the end of ten. We were able to reassess the costs and we've done that and it should step down to a normal profitability, which as I say is a £15m step down for next year.

<u>Question 2</u>

Allen Wells, Exane BNP Paribas

Hi, good morning guys, three for me as well please. Firstly just on the revenue guidance of £5.2bn, I mean it seems like you stepped away from giving an organic growth number there. I just want to see what the 5.2 implies from an organic number versus the previous guidance, if anything has changed there.

Secondly, sorry if I missed this but just to understand, the ongoing cost in relation to the emergency services business of £10m, exactly what is the additional cost? Why is there an additional £10m per year? Is this people? Is this something else? I'm not exactly sure what that is.

And maybe just as a follow up there, and to what extent you can comment obviously. What did it actually then do the MCS profitability which obviously had already fallen quite a way since the time of the Avincis acquisition?

And then maybe one very final one. Obviously, there's been a bit of noise since November on the nuclear new build in the UK. Maybe if you could just make a couple of comments on the position of your nuclear business and what's going on there with those new build delays. Thank you.

Archie Bethel

Okay. I'll let Franco think about the ongoing costs. So on that first one the revenue, I mean this close to it we just thought it would be sensible to tell you what we think that we would come out with, nothing more so. We're into March next week, the last month of the year, so we're kind of pretty well signalling that it's round about the £5.2bn figure, down from the £5.36bn of last year, top line.

If you take out the one-off kind of disposals and the exits and they're roughly pretty flat, very slightly negative but very flat in terms of that growth. You've got to carry that step down and Magnox step down in there. So that's where we are on that.

I'll take the nuclear new build. Yes, the nuclear new build projects, I mean to be honest in the ones, you know, the Wylfa and Moorside contracts we've got nothing in our pipeline of order books. Even if these had progressed on the timescale they were still some years away from Babcock being involved in these. So there's no immediate impact on us. We continue to grow our business at Hinckley Point where the construction of that contract is well under way and we are year-on-year picking up more business. We are one of the four contractor alliance that's involved in that project.

I think in terms of the future new build, well again a lot of that will depend on government strategy for the overall energy mix. If they remain with the strategic aim of providing 20% of energy from nuclear power then they will have to find a way of making some of these contracts, some of these new projects, kind of work. But we have to wait and see what kind of happens there. Franco, do you want to say something about the ongoing costs?

Franco Martinelli

Yes. Just re-emphasising what Archie said earlier; the soft structure we had in place was a top level structure. What we've had to put in place as we've engaged with the local authorities in each country, we have an ASE in each country in Europe, is to produce a sort of a two company structure per country which has added significant costs and some interface costs in terms of VAT between the two. So those are the two principle areas of where the £10m comes from. So that's what we've had. As I said, we've had to go to two companies per country.

In terms of MCS profitability, the emergency services business is doing really well. We'll get into Norway next year, we'll get into Manitoba next year, so this is all driving an improved position. The actual profitability of what is… MCS doesn't exist anymore because we've merged it into the other countries so I can't give you that number. I think that's the four questions. Thank you.

Allen Wells

And maybe just a quick follow up, just to make sure I'm completely clear. Your previous guidance was low single digit organic growth. Archie's comments said flat to slightly negative, and the difference there is basically the comments you made around the outages in South Africa and slightly weaker activity in Rail. Is that correct?

Archie Bethel

Yes, that's the main thing.

Allen Wells

That's the Delta, okay.

Archie Bethel

Plus the additional exits in the second half of the year.

Question 3

Karl Green, Credit Suisse

Yes, thank you. I've just got a couple of questions just on the Brexit impact for the EMS business. Can I just clarify there's going to be no legal requirements for different structures as regards the military activities? That's the first part of that question.

And then secondly, just to check that those incremental £10m costs are going to be tax deductible.

The second question is just back to the issue of the rail and the Eskom delays. Have you got any kind of line of sight around the likely recovery or the trajectory of that recovery for those businesses please?

Archie Bethel

Okay right thanks for that. The first one's easy, the military side in Brexit isn't impacted at all so there's no impacts on our military business in Europe. I'll let Franco answer in terms of the second aspect of the £10m.

Franco Martinelli

Yeah clearly tax deductible/ They're just normal operating costs, so tax deductible and probably will be at higher than the 18% across Europe.

Archie Bethel

Okay in terms of the rail and Eskom they're different; I mean the rail one is related to basing of the timing of the ending, we're ending contract period five now and as we announced not so long ago we've been successful in securing the Scottish region for the next ten years as part of CP6 and CP7.

It was always going to be difficult to exactly know how this transition would take place but we've found that the step-down from CP5 was bigger in the second half of the year than we had originally thought it would be. That probably means that next year the build-up on 6 and 7 will be quicker so when we come and look at next year's numbers we'll be looking to see if there's any kind of gain, upside, in that there.

And in Eskom, well Eskom has been difficult all year, if anyone follows that in the news, they are the world's most chaotic customer. We generally in South Africa would be expecting to be doing three major power station outages a year, if we do two we're doing fine, we do really well. If we do one it's not a bad year. This year we haven't had one major outage which has been really, really disappointing.

As a result again, you'll be able to read in the newspapers, there's brown-out outages all over Johannesburg at the moment and I think that situation has to change at some point. So again although it's always the area that we always say about South Africa is it's always difficult to predict. I would expect that next year there's likely to be some sort of catch-up to get the power stations back on to the performance level that's needed to permit these outages. But that's South Africa.

Question 4

Robert Plant, Panmure Gordon

Morning. Given that you're flagging the underlying earnings are unchanged but revenue has stepped down, probably the margin expectation has gone up since H1, you talk about the cost reductions and the higher JV contribution, what exactly has changed since H1? Thanks.

Franco Martinelli

Good morning, Rob. I think the truth of the matter is the revenue step down is at very low margin so the actual effect on profits is low. So what we're talking about is marginal increases partly to do with mix.

The cost-cutting, we're always doing cost-cutting improvement programmes and we're doing it every year, and we're doing it this year as well.

In terms of what's changed, I think we're seeing the benefits of that cost-cutting coming through against a minor reduction in profit from those low margin revenues.

Question 5

Sash Tusa, Agency Partners

Thanks very much, good morning. This may be a question that you'd like to talk about more at the Capital Markets Day but there seemed to be some quite significant changes going on in the UK land systems market with the joint venture announce of Rheinmetall and BAE Systems and I just wondered how you see that affecting the DSG business and in particular your ability to access some of the major upgrades, Challenger 2, and possibly ultimately the Warrior upgrades if there's a much stronger prime contractor there than there was before?

Archie Bethel

I think in terms of what we've got planned in terms of DSG, I'm not that sure that that joint venture is likely to have any significance. In fact we probably look at it as probably an opportunity for us to have another customer because we've got facilities that support some of these vehicles already. I think the joint venture's initially going to be primarily focuses on the standard new vehicle Boxer and then we'll look and see.

I mean we were always going to be a sub-contractor in terms of the Challenger 2 upgrade if it happens and I think that still would probably be the case with the new joint venture being the prime. I'm thinking I'm looking at it more as maybe an opportunity than a threat.

Concluding comments: Archie Bethel

Okay well thank you for joining us this morning. I'd like to just end by again emphasising again that this year in all of the key main important areas we are pretty much on track for delivering the results that we had indicated and I think importantly to us maintenance in growth of margin and strong cash flow are the main areas we have been focused on.

And I think looking forward to next year nothing really new there and again the one thing we have had to add is Brexit, EU costs and I think like most companies we have really struggled to push buttons and make strategies. I mean the reality is that if all of a sudden next week or the week after there was a deal done then it would look like we've spent this money for nothing; but we really have had no choice but to do that. We've got customers that we have to satisfy and we can't take any risk on that. So this lateness in the day of things emerging has meant that we've had to put in place a structure that works all the way down to a no deal and although that's unfortunate it's something that we've had to do.

I think it doesn't change the underlying strength of that business, the European emergency services businesses have been growing steadily for the last five years. Their margins are amongst the highest that we have in the Group and it's a business that we've got big hopes for in the future. But thank you again for joining us this morning and if there are any other further questions later on please feel free to contact us. Thank you.