Rolls-Royce

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RR.L - Full Year 2016 Rolls-Royce Holdings PLC Earnings Presentation

EVENT DATE/TIME: FEBRUARY 14, 2017 / 09:00AM GMT

CORPORATE PARTICIPANTS

John Dawson *Rolls-Royce Holdings plc - Director, IR*

Warren East *Rolls-Royce Holdings plc - Chief Executive*

David Smith *Rolls-Royce Holdings plc - CFO*

Q&A PARTICIPANTS

Nick Cunningham *Agency Partners - Analyst*

Christian Laughlin *Bernstein - Analyst*

Ben Fidler *Deutsche Bank - Analyst*

Tristan Sanson *Exane BNP Paribas - Analyst*

Gordon Hunting *Fiske - Analyst*

Zafar Khan *Societe Generale - Analyst*

Celine Fornaro *UBS Securities - Analyst*

David Perry *JPMorgan - Analyst*

Rami Myerson *Investec - Analyst*

PRESENTATION

John Dawson ***- Rolls-Royce Holdings plc - Director, IR***

Okay, I think we're ready to kick off. So, thank you very much. And good morning, ladies and gentlemen, and welcome to the London Stock Exchange.

My name is John Dawson; I'm the Head of Investor Relations at Rolls-Royce, and it's my pleasure to welcome you to our 2016 full-year results presentation, both to those of you joining us here, but also joining us online.

The agenda for today's presentation is as follows: Warren will kick off and give you some highlights of 2016, and then David will take you through the financial results in a little bit more detail, and then Warren will come back with some closing remarks, looking to the future.

The presentation should last around 45 minutes. But we've got plenty of time at the end for questions, so we expect to finish at about 10.15 AM.

We will take questions online as well. So if you are joining us through the Web and you wish to submit a question, please do and a member of the investor relations team will read it out, if it hasn't already been asked already.

Finally, before we kick off, (Conference Instructions).

Thank you. And I'll now hand you over to Warren.

Warren East ***- Rolls-Royce Holdings plc - Chief Executive***

Thank you, John. Good morning, everybody. And I won't bother doing an introduction, as John's just done one, so let's kick off.

Now, recent news flow around Rolls-Royce has been dominated by the announcements that we made in conjunction with the Serious Fraud Office a couple of weeks ago and so we wanted to get this out and address this upfront in the discussion.

I think the best way of describing it, is summarised in these two quotes. Quote from me, talking about the business, what we think of what's happened. And there's another quote from me elsewhere about how Rolls-Royce is a completely different business. But it's all very well for me to say that, and I think it's much better to refer

to the quote from the Judge who actually said that.

> *[Quote on slide: Behaviour uncovered…is completely unacceptable and we apologise unreservedly… unworthy of everything which Rolls-Royce stands for': Warren East]*

> *[Quote on slide: Rolls-Royce is no longer the company that once it was; its new Board and executive team has embraced the need to make essential change and has deliberately sought to clear out all the disreputable practices that have gone before, creating new policies, practices and cultures. Sir Brian Leveson. 17 January 2017]*

With that, I'm not going to talk any more in this presentation, about those events which have dominated the news flow over the last few weeks. But I want you all to be under no doubt whatsoever that it is front and centre in our minds as a management team, and making sure that such things don't happen again is very much a priority.

So, now, a quick snapshot of the results; and David's going to talk about these in a lot more detail. But, basically, revenues are approximately in line with what we and everybody else expected.

People across the business have worked very hard during 2016, so the net outcome is that cash and profit is a lot better than expected.

Yes, indeed, there are some one-offs behind some of those numbers; but, by the way, there are one-offs in both directions. We encountered quite a lot of operational challenges, some of which you read about in the newspapers, during the year. And the fact is that underlying all that there is some sustained improvement, which means that when those one-offs go in both directions then we still come in better than expected. And David will go into a bit more depth on that.

Now, a reminder of what I said 12 months ago, when standing here, in terms of setting some goals for 2016. Three goals: one about focusing on engineering and operational excellence and making sure that we allow our business model to really work, leveraging the installed base. Two, make sure we got off to a really good start with our transform programme. And three, understanding that we have a job in hand to re-build trust and confidence in this business.

So, that was the goals that we set out. And now, I'm going to step through a few scorecards to illustrate how we've got on in 2016 addressing those objectives.

Referring to the first goal, about focusing on engineering excellence, operational excellence, and aftermarket; in terms of R&D: record expenditure in R&D in 2016. Even though times are tough, we recognize this is an engineering- and technology-led business. And it's very important that we spend that money, because that money is going into new products that we are bringing to market.

We are readying, during this year, now three large engines for our civil business for entry into service very, very soon. And so, it's very important that we bring those products to market for our future.

But it's also important, if we're spending all that money on engineering, that we spend it wisely and we keep getting better at how we spend it. And some examples, on the right-hand side of the slide there, about the impact of some of those efficiency improvements that we're making.

And yes, as far as that digital product definition example is concerned. It will take a few years for the full benefit of this to show through in the results, but the underlying improvements have been initiated and, actually, a lot of work has taken place.

Switching to operational excellence, because it's all very well to engineer some great products but we need to make some money out of delivering them, that also doesn't come for free. So, about one-third of our CapEx in was 2016 spent on new capital equipment to make sure that we can make these things as effectively and competitively as possible.

The payback, however, for that capital investment, on the left-hand side of this slide, is that we will achieve increased volume in a reduced footprint, and we will be able to do more with less.

During the year, we've communicated a bit, and we've highlighted some of the improvements, and there are some improvements on the right-hand side of this slide. And I'd like to stress, it's not just about how we spend the money; it's about how we actually do the work that leads to significant improvements in things like assembly lead times.

And it's also important to say that this isn't just a civil aerospace activity. Yes, we're making some fantastic improvements in how we build our large engines for airplanes, but we're also addressing some other really significant opportunities to make a big difference in other parts of our business.

The third part of the focus is about leveraging the business model and making the aftermarket work for us. And the important thing is that this is a big chunk of our revenues, and as we look forward it's a very significant driver of profit and cash. And it's very important that we keep that asset base working out in the field.

As we look at our fleet of large engines then we do have a young fleet. The flip side of being a young fleet is it's getting older; and as it gets older then the transitions, which are natural between the first owner and the second owner of these things, becomes much more normal.

And because we want to keep those assets operational as much as possible then it's important that we're able to minimize that transition time, so we have introduced a dedicated transition team. That dedicated transition team has managed twice as many transitions in 2016 as in 2015 as we seek to minimize the transition time. Also, numerous other examples of what we're doing to leverage our installed base.

Our second goal was to get off to a really good start on the transformation programme. I am pleased that we are announcing this morning that the in-year savings for 2016 were GBP60 million, against our original estimate of GBP30 million to GBP50 million. So, that's a very good start.

But more importantly, some of the activities and changes that we undertook during 2016 feed into 2017, which is why we're confident that we can deliver an annualized run rate at the very top end of those GBP150 million to GBP200 million expectations for run rate at the end of 2017.

As we go into 2018, there'll be a little bit of continued momentum in those activities that we have already done so far.

Now, I'm quickly going to step through what's been going on around the business, using some scorecards here.

In civil aerospace, which is 50% of our business, there or thereabouts, we overcame some pretty clear headwinds; and these were the headwinds that were identified as early as 18 months ago, when I joined the business. They did, indeed, come to pass. And we overcame some other challenges, as well.

So, in terms of numbers, and David will go through the numbers shortly, then results slightly ahead of expectations, but pretty much where we expected them to be.

A lot of that is caused by the transition from older engines into newer engines. You can see the effect of that is happening both at the OE stage, but also at the aftermarket end as well, where we have new engines growing, but the aftermarket revenue from those new engines not really coming through and completely dominating but being held back a little by the older engines with higher-margin spares type activity falling off.

It's important that we recognise that we've got a big step-up to do in 2017, and I'll come on to that in a moment.

But our new product introductions are going quite well. And it's important that we keep looking at that engineering pipeline and making sure it's in good shape.

Two examples. And it's worth dwelling a little bit on our civil business, because that is half of the total. So the two key drivers of cash over the next 10 years are probably the XWB and the Trent 700. These are at very different stages in their life cycles, so we'll look at XWB first, and then at Trent 700.

On XWB, deliveries in 2016 more or less doubled. At the bottom of the slide there, on the bottom left, you'll see, however, we've still got this big step up to do in 2017. So it's absolutely essential that in 2016 we achieved the essential improvements in things like lead time to make that volume step up in 2017 possible.

We clearly have some more work to do on cost, and we will in time benefit from better pricing as we move away from the launch pricing in this engine.

Switching to the installed base, obviously, from a standing start, more or less, massive change in the size of the installed base for XWB in 2016.

I think the important things to note are the 6X increase in installed base by the time we get to 2020. And if we look at the backlog of future orders, we've got 8 times the current installed base out there in the backlog. So this is clearly going to be a very important product for us.

Trent 700 is the other big generator. Now, this engine was launched into service 20 years ago and so clearly we are approaching the end as far as getting these engines installed new on to airplanes is concerned. Interesting to note, however, that we are still working on improving things like the lead time and how long it takes us to build one of these things.

In 2017, we will actually enjoy a little bit more volume as we move into installing, effectively, the tail end of the Trent 700 programme.

But the big focus looking forward is about how this engine works in the aftermarket, actually in use. And after 20 years, of course, the installed base is still growing.

And the other point to note is that even though this has been a 20-year programme, it's been a much slower rate of installations than XWB and so this is still a relatively young fleet with a very, very long way to go.

Defence aerospace, generally, a solid year. I think we'll talk a bit more about the factors driving profit. But fundamentally, we saw a product mix putting downward pressure on profit, and we saw a reduction in part sales.

But importantly, what we concentrate our effort on in defence is really getting close to our customers and strengthening the service support. Because it's very important with, essentially, a large installed base that we work that as hard as possible.

Our power systems business, this outperformed our competitors. I remember being sat here a year ago listening to, or receiving, lots of questions about how we were going to perform in this business during a year when our competitors were forecasting massive drops.

Well, it was broadly flat for the year. The answer is, broadly, what we gave one year ago: revenues flat because volumes in some of the growth areas that we're exposed to are higher than the volume downward pressure in some of those areas, particularly in oil, gas, and commodities, that our competitors are exposed to.

And, yes, because of that then there is a product mix effect; and because volume came down a little, and the mix changed then, and our profit's down a little. But we still outperformed the peer group.

I'm very pleased with the excellent start that our new leader in that part of the business has made. He's really started injecting some pace and energy into the business in the six-to-eight weeks that he has been with us, and I look forward to much more from that business as we go forward.

Now, marine, the offshore market, we know, is very, very weak. There are laid-up vessels everywhere and that has a knock-on effect into the merchant space as well.

There is really very, very little demand, and lots of the overhauls are being deferred, and so it's affecting our service business as well. We have been, however, addressing the operation, and gross margin has actually improved in percentage terms. In absolute terms, it's down because the size of the business is down. But we have seen improvements in gross margin because our cost-reduction activities are bearing some fruit.

And what we're seeking to do, if you look at the graph on the right-hand side, is say this is a cyclical business. It's always been a cyclical business. And we have, over recent years, become a little bit over-exposed to offshore and we have become a little bit larger in terms of fixed cost base than we should ideally be.

And so we are resizing the business and positioning it for the trough of the cycle, and we are tilting our activity towards new technologies and new adjacent applications. So we will benefit from the cycle improving. And we will continue to win business, as, indeed, we are winning business today in adjacent applications, and particularly around new technologies, such as all-electric ships.

And just a measure of the right-sizing is there on the bottom, where, essentially, we will have reduced the headcount by about one-third and rationalized facilities.

In our nuclear business, it's been a story of a little bit of increased revenue because more submarine work. But submarines are actually a lower-margin activity and we have seen the need to invest in operational improvements.

Some of you may remember some pretty nasty headlines from about 12 to 14 months ago around that programme. I think we've addressed a lot of those issues. But addressing those issues hasn't come free and we've had to invest a little to fix things.

And we're continuing to invest in new designs for new opportunities, and things like the small modular reactors represent those opportunities.

So, overall, I'd say it's a year of stabilizing. We've made significant progress in simplifying the structure. We are investing for the future. We have to have an eye on the future in terms of the technologies and the applications. We also have to keep addressing the operational issues.

I think as we look to 2017 then it's challenging, but we're on track. We're delivering at volume run rates that allow us to achieve the required volumes in 2017. And our new big programmes, we're focused on those new engines for entry into service over the next year or so.

Longer term, we're talking about transformation towards a better-performing, simpler, and a more resilient business and so we absolutely need to continue working on that.

So, briefly summarising at this point, I think we've done a good job addressing the goals set for 2016, both the key goals in terms of strengthening our focus and getting

our transformation programme off to a good start.

I hope as well, alongside that, we're doing a reasonable job at rebuilding confidence and trust in the outside world, but that's for you folks to judge, not us.

And with that, I'll hand over to David to take us through the numbers in a bit more detail.

David Smith - ***Rolls-Royce Holdings plc - CFO***

Thank you, Warren. I'm going to take you now through a review of each business, the Group cash flow and balance sheet, and provide our outlook for 2017. Before I do that, let me just summarize the key elements of Group performance. And remember, our percentage change comparisons will be on a constant currency basis, unless stated otherwise.

Starting with Group revenue and profit, underlying Group revenue of GBP13.8 billion was 2% lower in 2016, reflecting declines in both original equipment revenue and services.

By business, Civil and Defence aerospace and power systems revenues were steady, while marine decreased 24%; and nuclear actually increased by 11%.

Our underlying profit before financing, at GBP915 million, was 45% lower, largely driven by a reduction in civil aerospace profit of GBP367 million, broadly reflecting the headwinds we've previously communicated.

And profit in defence aerospace, at GBP384 million, was 8% lower, and that was mainly due to TP400-related programme support costs.

Power systems was down 14% year on year at GBP191 million, largely as a result of adverse product mix.

The marine loss of GBP27 million was driven by continuing weakness in offshore markets, but was actually better than we originally expected, due to additional cost actions.

Nuclear profit was down 37% to GBP45 million, due to margin mix in submarines, but also a pretty significant non-repeat of the R&D credit we had last year.

So turning now to look at the businesses individually, and first starting with civil, if we start with revenue, overall, our underlying original equipment revenue for civil aerospace was flat on a constant currency basis.

Revenue from linked and other engine was actually up 2% with increased volumes of Trent 900 and a higher number of spare Trent XWB engines sold. Of this, sales of spare engines to joint ventures generated a revenue of about GBP277 million. This was partly offset by lower Trent 700 volume, and also the price reductions on those engines, ahead of the introduction of the Trent 7000 on the A330neo.

Unlinked revenues increased by 47%; and that was largely, obviously, led by the higher volumes of Trent XWBs.

Business aviation engine sales were 25% down, reflecting both general market weakness and the transition to newer non-Rolls-Royce powered platforms from our BR710 engines.

Volumes of our newer BR725 engine, which powers the Gulfstream 650s, were pretty stable.

Finally, the V2500 module revenues did decline by about 10% as production slowed, obviously, again, as Airbus transitions to the A320neo.

Then, turning to aftermarket, in the aftermarket the overall result was down 1%. Service revenue from large engines would have actually been up by about 2%, but was down 4% after we adjusted for contract accounting effects, which were, however, significantly lower than the prior year.

Within this, we saw double-digit growth in revenue from our in-production engines, but that was more than offset by a reduction from the older engines. This included the expected lower utilization of Trent 500 and Trent 800.

Time and materials revenue also reduced, with fewer engine overhauls across the out-of-production fleet.

The business aviation aftermarket was slightly down. And regional jets were down 14% as a result of reduced utilization, primarily by North American operators.

However, V2500 service revenues were actually 21% higher. And that reflected a combination of price escalation built into contracts on flying hour payments, together with some increased overhaul activity.

Turning now to gross margins, overall, gross margins for civil aerospace were GBP1.1 billion, or about 16.8% of revenue, which was down GBP397 million from 2015. Within that, trading margin was down GBP248 million, with the main revenue and margin headwinds, as I've just highlighted, being as we forecast at the start of the year.

We also saw some additional programme charges of around GBP30 million incurred for engines still in development.

The lower margin was partially offset by releases of accruals related to the termination in prior years of intermediary services, which totalled about GBP53 million.

And remember, 2015 also benefited from a couple of things: a one-off GBP65 million release of Trent 1000 CARs impairment write-back and provision release.

As you can see from the slide, the in-year net benefit, when we look at all of the long-term contract accounting adjustments, totalled GBP90 million; that was down from GBP222 million in 2015, a reduction of GBP132 million. But remember that last year we had that GBP189 million benefit from the risk methodology adjustment.

Technical costs for large engines were GBP74 million higher at an absolute of GBP98 million. And that included Trent 900 costs and upgrades to the Trent 700 engine management system.

This was offset by a GBP77 million higher contribution from the lifecycle cost improvements; an absolute of GBP217 million for the year, compared to GBP140 million in 2015.

And as we discussed at the half-year, we also recognized a GBP35 million benefit from a change to our long-term US dollar planning rate.

Turning to the rest of the profit waterfall, costs below gross margin were GBP89 million higher than the previous year.

Underlying C&A costs were GBP43 million higher, and that was primarily due to higher employee incentive costs.

Net R&D charges were GBP34 million higher, reflecting higher spend on key programmes, particularly the Trent 7000.

And also, development cost contributions are also lower, but those are partly offset by some increased R&D capitalization on the Trent 1000-TEN.

As a result, overall, profit before financing and tax was GBP326 million, and GBP367 million after positive FX.

Turning now to civil's trading cash flow, civil trading cash flow, at GBP43 million positive, actually compares to break-even in 2015. Within that trading cash flow, and before working capital movements, the main change year on year was obviously the GBP445 million reduction in underlying profit.

We saw CARs additions at GBP208 million, which was up GBP47 million from the prior year. In addition, there was an incremental GBP237 million spend on PPE and intangibles, primarily certification costs on the XWB-97K; and also, as I've mentioned, the R&D capitalization on the Trent 1000.

Net long-term contract debtor additions were GBP160 million lower than in the previous year. And that reflected, in part, the lower profits on Trent 700, and the lower net long-term accounting adjustments.

So, overall, trading cash flow also benefited from better-than-expected working capital improvements of GBP345 million. And that was really principally around customer collections and deposits. And I'd say that, that was really the outperformance that you saw both in civil and at Group level, that outperformance on working capital.

Turning now, just a little bit, into the detail of TCA and CARs, TotalCare net assets actually increased by GBP230 million to GBP2.44 billion. And this reflects both linked profits and cash losses on the new engine sales, plus the catch-up adjustments, offset, in part, by the cumulative amortization charge.

And to pre-empt any questions, that's slightly different from the GBP246 million in the trading cash flow; and that's simply an FX difference within the TotalCare balance.

New linked engines of GBP432 million and contract accounting adjustments of GBP90 million were offset by cash inflows and other net adjustments of GBP292

million. So we ended up, as I said, at GBP2.44 billion at the end of the year. And we still expect this to peak at our previously-guided range of between GBP2.5 billion and GBP2.7 billion.

The CARs balance increased by GBP169 million, reflecting higher sales of unlinked Trent XWBs.

Turning now to defence, so starting again with revenue, underlying revenue of GBP2.2 billion was slightly up on the prior year on a constant currency basis.

OE revenues were helped by higher volumes of both the TP400, and also increased Adour engine deliveries.

Service revenues were stable with lower demand for spare parts offset by some increased revenues from Typhoon and C130J contracts.

In terms of the gross margin, the gross margin actually declined by GBP49 million to GBP530 million. And that reflected a combination of some of those volume effects and adverse product mix, together with the GBP26 million of additional costs we booked for the TP400.

Long-term contract releases, at GBP82 million, were down GBP5 million from the previous year, but actually higher than we had expected earlier in the year. That was principally due to the benefit of locking in some significant cost savings on the UK Typhoon contract, which is now in its last couple of years, including a cost-saving incentive award.

Outside of gross margin for defence profit, R&D and restructuring costs were lower than the prior year. And that was mainly due, on restructuring, due to the lower severance costs around the Indianapolis programme.

Overall, profit before financing of GBP384 million was 8% lower than 2015, driven primarily by the lower gross margin I've discussed.

So, moving on now to Power Systems, underlying revenue of GBP2.7 billion was slightly down excluding FX. And I think that was a pretty good result, given the market conditions.

OE revenue declined by only 1%. And we saw growth in power generation and industrial sales, which partially offset the weaker commodity-related markets, and some reduced activity in our naval business.

Service revenue was 2% lower. And that largely reflected, again, some of the fleet utilization issues we're seeing in the marine medium-speed market.

Power systems gross margin reduced by 28% in absolute terms to GBP628 million, primarily, mix effects there, adverse mix. But it did include some good progression on cost reduction, which offset some of the volume and mix effects.

On overall profit, underlying profit declined GBP27 million, that's 14%, and that was led by the reduction in gross margin. But, I have to say, power systems are starting to get some benefits from product streamlining as well.

Turning now to marine, we've just got a single slide here, underlying revenue of GBP1.1 billion was 24% lower with some continued weakness in offshore also seen in a declining order book.

Gross margin was, therefore, GBP44 million lower, as a result; but, actually, 170 basis points higher in percentage terms, partly through our cost-reduction activities, and also some lower warranty and contract charges.

The resulting net loss was GBP27 million.

The December announcement of further organisational changes and headcount reduction led to an additional GBP5 million restructuring charge with the remainder due to be taken in 2017.

And we also took a GBP200 million impairment charge against goodwill, reflecting the ongoing tough conditions and reshaping of the business.

Finally, to nuclear, our underlying revenue for nuclear increased by 11%, largely within the submarine programmes. Volume on key civil programmes in both France and Finland were also strong. But our gross margin was lower by 80 basis points, and that really reflected a greater weighting in the overall mix towards the lower-margin submarine programmes.

Below gross margin, we took some additional cost to support the higher volumes and to improve delivery performance of submarines. And we're also investing modestly on the initial design phase for small modular reactors.

We have, in the year, a GBP7 million R&D credit, but no repeat of the 2015 catch up that we saw; and we expect the GBP7 million credit to decline to near zero in 2017. As a result, underlying profit before financing was GBP45 million, or GBP38 million if you exclude the R&D credit.

Turning back now to the Group as a whole, again, net finance charges in our underlying result were GBP102 million. And tax was GBP261 million, reflecting an underlying tax charge of 32%. As a result, underlying earnings were GBP552 million, or 30.1p per share.

The underlying tax rate rise was higher, and was due to a combination of a decision to derecognize deferred tax assets on our losses in Norway; and a greater proportion of our profits coming from higher corporate tax countries.

Turning to look at the reconciliation to our reported result, there are clearly a number of very key differences I'd like to highlight this year.

Firstly, as I've already mentioned, we had impaired goodwill associated with a number of the acquisitions, but principally that GBP200 million within marine. In addition, we recognized the GBP671 million charge related to the agreements reached recently on the legacy investigations.

Exceptional restructuring totalled GBP129 million for the year, up around GBP80 million; and this included the costs for that programme, which delivered the in-year benefits of GBP60 million that Warren has already mentioned.

Also, as we've previously announced, in November, Legal & General acquired the assets and liabilities of the Vickers Pension Scheme, the largest deal of its kind in 2016. The significant pension risk transfer also resulted in use reducing by GBP300 million our book surplus on pensions as that, effectively, transferred to L&G.

And, of course, we had the GBP4.4 billion accumulative mark-to-market adjustments during the year of our hedge book.

As you've heard from me many times before, we've never believed that, that mark-to-market valuation adjustment is particularly relevant for the ongoing business, given that those underlying hedge cash flows will provide corresponding benefits in the future.

Turning then to the profit to cash flow walk, our free cash flow of GBP100 million was GBP79 million lower than the prior year, but well ahead of our original guided expectations for GBP100 million to minus GBP300 million. And that overall change reflected the stronger working capital performance in civil than in 2015, which helped offset the lower profit and higher expenditure on PPE and intangibles.

This is our usual bridge slide, from profit to cash flow. On an absolute basis, we saw a GBP55 million outflow from net working capital, including GBP230 million higher TotalCare net assets and higher inventories related to the production ramp, but these were offset by higher payables and deposits.

We had GBP570 million of CapEx, that included some payments against 2015 invoices; and GBP631 million of intangibles, including the GBP208 million that came from CARs. And the rest of that would have been the higher R&D capitalization, mainly on the Trent 1000, plus higher certification costs on the XWB-97K.

In 2017, despite the increased investment in installed engines as we increase our large engine production to around 500 units, we should be able to keep some of this working capital performance we saw in 2017. As a result, we're now expecting to be able to deliver another year of slightly better than break-even free cash flow, similar to 2016. So that is an improvement from what we've been saying over the last year.

As you know, we value a very robust balance sheet with a healthy investment-grade rating. We believe this is commercially important when offering products and support contracts that will be in operation for decades.

After the SFO announcement, you'll be aware that Standard & Poor's did update their rating to BBB+ stable, from A minus negative outlook, although Moody's have maintained their rating at A3 stable, as have Fitch.

We will continue a very close dialog with the agencies so that they can best see the progress we're making, particularly in terms of transformation, and our path to long-term cash generation.

During 2016, the Group's net debt position did increase to GBP225 million. But leverage remains at a comfortable level, although, clearly, we do have some additional cash calls during this year with the DPA.

We have no significant refinancing, however, until 2019. And remember that last April we increased our revolving credit facility by GBP500 million to provide additional liquidity.

Turning now to payments to shareholders, our stated objective in the long term is to progressively rebuild our payments to shareholders to an appropriate level, subject, obviously, to short-term cash needs. And this reflects the Board's longstanding confidence in the strong future cash generation of Rolls-Royce.

At this stage however, the investment needs of the business remain high, reflected in the low level of free cash flow in 2016, and again in 2017. In addition, the Board sees the need to retain a degree of balance-sheet flexibility.

As a result, we have decided to keep the final payment to shareholders at the same level as last year; in other words, 7.1p per share. This means that the cash cost of the payments to shareholders during 2017 will be about GBP215 million, including what we've already paid.

Turning now to hedging, as I explained in November, our hedge book has a fairly simple purpose: we're trying to match our future customer and supplier commitments which are very long lasting, thereby, mitigating risk to our reported margins over time.

In any year, we will take advantage of attractive rates in the market if they're available, but this isn't the primary consideration. More importantly, is to be sufficiently flexible to keep the rate relatively stable over time, even if our dollar revenue or cost profile changes.

The 2016 movement in the average achieved rate was worth about 2.5 $cents; and net of some translation effects, that gave us a Group benefit of about GBP20 million.

Clearly, market conditions have enabled us to reduce the rate really quite rapidly whilst expanding the size of the book, from $29 billion up to $38 billion at the year end, with an average rate on that book of 1.55.

We have delivered, therefore, on the core purpose of this programme, smoothing the effective rate, and I believe the rate will remain relatively stable over coming couple of years.

So after a big increase in 2016 in the size of the book, we're unlikely to be growing the book much further and will look to utilize the hedges in a way which keeps the achieved rate relatively steady.

Even actually at current rates, replacement hedges won't achieve rapid reduction in the average rate of the hedge book, unless the spot rate sustains at this level for quite a long time.

Turning now to outlook, business by business, our outlook is mixed.

For civil aerospace, on a constant currency basis, we should see some modest growth in revenue and profit in 2017. Within this, our large engine business will continue our OE production ramp, which will consume cash, although this will be partially offset by growth in engine flying hours on the new Trents. We'll also capitalize more R&D, and continue to take out costs.

Business aviation OE demand is expected to weaken further, as will demand in the regional aircraft aftermarket.

And, as I said, we need to continue to work both on cost, and also on inventory, with further improvements.

Overall, we'd expect cash flow to be marginally ahead as well, despite a strong performance at the close of 2016.

Our updated five-year revenue outlook for civil, actually, has only changed in one respect in the near term; we now see a bit more positive business aviation aftermarket for 2017. So the arrow there is now flat, rather than down, previously.

Switching now to cash flow, turning to the outlook, nothing has changed, again, directionally, and we expect 2017 to be broadly the same as 2016. We've also just added a column for 2021, now that we've finished 2016.

Looking out further, clearly, the important thing is the roll out of the new engines, with an exclusive position on the A330neo for the Trent 7000, and on the A350 for the XWB; and that will significantly grow our installed base. And as we've previously said, the resulting installed base is the thing that will deliver strong aftermarket revenues and cash flows for decades to come.

Moving now to defence outlook, while revenues should remain relatively steady, we are still expecting margins to come under some pressure. We saw about a 2 point decline last year. And we are continuing to make investments, particularly in Indianapolis, as well as for lower contract-performance incentives that are available to us on key programmes this year. As a result, margins and profits are expected to soften a bit further from recent levels.

The outlook for power systems remains steady, that's a positive, as we continue the transformation of that business. The business finished last year with a strong order book for several of its key markets. And although some commodity-related markets remain difficult, we expect the business to deliver some modest growth in revenue and profit in 2017.

For marine overall, the outlook has to remain very cautious with revenue down further in 2017, and losses at a similar sort of level.

We expect that the market will continue to feel the impact of low oil prices for some time, and the general overcapacity in several segments will take time to reach equilibrium. So we're continuing to sustain our cost reduction programmes, focused on manufacturing, supply chain, and overhead costs, in order to deliver a more competitive business.

Finally, for nuclear, the long-term outlook remains positive, supported by the confirmation from the UK Government of its ongoing investment in the Dreadnought class submarines.

With renewed activities in the civil market, particularly in the UK and China, there are also some encouraging growth opportunities.

However, shorter term, our results will be impacted by a couple of factors: the absence of R&D credits, and also some lower margins on our submarine business, and further increases in our investment in SMR technology and other initiatives. So, as a result, we believe our profit is likely to be around half that achieved in 2016, reflecting these investments.

Turning now to Group technical guidance as a whole, I'll just focus on a couple of points here. Firstly, changes to the FX environment over the last 12 months clearly have continued to have a benefit to our reported underlying results in 2017.

Should rates remain unchanged from where they were at year-end, it would provide us some further translation-related improvement, obviously, as we translate foreign profits and revenues, of about GBP400 million on revenue, and about GBP50 million on profit before tax, comparing to GBP725 million and GBP80 million last year.

Secondly, net R&D spend is expected to be at a similar level in 2016, although the charge to profits will come down because we'll have some higher capitalization by about GBP60 million to GBP100 million, close to GBP800 million in total. As I said, that really reflects high R&D capitalizations for the new engine programmes.

Finally, free cash flow for 2017, at Group level, is expected to be at a similar level. And clearly, any view is vulnerable to relatively small movements on what are extremely large balances at year-end.

So, in conclusion, we have had a good year, end to the year, and delivered on expectations. But there's clearly plenty of work to do, with a significant operational execution challenge. The outlook is biased to positive across the five businesses. And we'll still be very focused on our transformation programme, delivering cost efficiencies and improving cash flow.

Finally, as this is my last results announcement for Rolls-Royce, I did want to thank you for all your patience and support.

When I started as the CFO, in November 2014, we faced a pretty challenging and difficult situation; and, clearly, we also had to significantly recalibrate expectations about the performance of the business during 2015 and take some difficult decisions around the balance sheet and shareholder payments.

But after delivering a good set of results this year, and also, actually, last year we outperformed expectations as well, I hope that we're also developing some track record and consistency. And it's good to have such a track record, and obviously Warren and the team's commitment is to see further performance improvements in 2017.

So I'm hoping that's going to give you continued confidence in your view about Rolls-Royce's long-term future.

Thank you. And I'd like to hand back to Warren.

Warren East - ***Rolls-Royce Holdings plc - Chief Executive***

Thanks, David. Thank you. Right, briefly, I'm going to conclude the presentation section with a little bit of a look forward.

Just over one year ago, I talked about building a new leadership team, and I talked about, roughly, one-third of new people coming on to the team from inside the business with knowledge of the business; one-third continuity candidates; and we would get in some people from outside to give some fresh, external perspective.

Last November, I said we were a little bit behind in terms of how I had hoped to get that done, and the time I hoped to get it done. But now, the team is pretty much there and in place and starting to deliver. As I said before David came up, so now we can do a little bit of focusing on looking forward.

In November, I put this slide up saying, looking forward, we need to take into account four areas of analysis, long-term outlook; how we are positioned competitively; and how we can go to continue to improve our operational performance; and, importantly, what are our resources available, and how do we allocate capital?

Now the new team is in place we are doing that; alongside, as David just said, we've got a lot of work to do on delivering in the meantime, and improving the operational performance.

So, I haven't got a big reveal for you this morning. We will talk about how we take the business forward as we go later into the year.

But just by way of emerging framework, how we're starting to think about this, it's fundamentally an engineering- and technology-led business. And we have some great leadership technologies, so that's where we start at the top the slide.

Then, we need to go about engineering and think, perhaps, a little more broadly about the ecosystem in which we operate, hence, the term dynamic engineering, where we think about acquiring technology; we think about developing technology; we think about manufacturing.

Actually, securing the best value way of doing that from our ecosystem, including our own supply chain and the activities in that outside world, so leveraging our university relationships would be one example, but continuing to take very careful account for how we manage our intellectual property, and how we map our intellectual property, looking forward.

Then, with that great technology and optimal engineering, of course, we need to continue to work very closely with our customers and our partners to make sure that we translate that into really compelling offerings that provide solutions for our customers, and that's the bottom grey box.

The crucial piece is how we link that to financial performance in the business. That's what we're calling the value bridge: converting these compelling customer offerings, based on leadership technology and sound engineering, into money.

That's what our transformation programme is all about, driving competitive levels of performance so that we can get sensible returns; so that we can generate cash; so that we can make the business sustainable; we can invest in building competitive barriers around our business; and so that we can continue to invest and acquire new technology. That's the emerging framework that we're using.

If I translate that into the priorities for the leadership team in 2017, and I'm afraid it's a little bit boring, the left-hand side of the slide is pretty similar to what you saw in 2016.

We have to really focus on getting our engineering and operational performance right so we can leverage the amazingly powerful business model that we have. We must keep doing that to develop a simpler and more resilient business.

But, at the same time, on the right-hand side of the slide, we do need to start to tilt a little bit to the future, look ahead to think about new disruptive technologies and ways in which we can improve the competitiveness of our business, from a strategic point of view, to disrupt and to win.

So, that's a little glimpse of the future.

My summary: 2016, year of stabilization, meeting expectations.

I look at 2017 and it's very clear to me what we have to do in 2017 in terms of operational focus and ramp up, and that translates into some very clear priorities for me and for the team.

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But we do that in an environment where, actually, we're pretty well positioned with growing market share, in growing markets. And, providing we can concentrate on growing the profitability and the competitiveness of the business then that's a pretty good outlook for the future.

With that, I'll hand over and we'll take your questions.

QUESTION AND ANSWER

Nick Cunningham - ***Agency Partners - Analyst***

Nick Cunningham, Agency Partners. I hope it's not inappropriate to say thank you to David, actually, for having helped the analysts so much in what, actually, for us, has been a rather complicated time, and then perhaps go on to ask him for some more help.

The particular point -- the question I wanted to raise was around, naturally, I'm afraid, IFRS 15, and a rough idea, perhaps, of what the delta might have been in 2016, and, maybe 2017, relative to your guidance, and how that tapers, if you like, as we go forward over the next, say, five years, or so. Thank you.

David Smith - ***Rolls-Royce Holdings plc - CFO***

Nick, it's a fair question. We really want to be more precise, though, for 2016 because it will be a comparative year, and we did take the time over 2015. So, Stephen's going to do that a little bit later in the year.

If you remember, I had a chart with some sort of cartoony lines up in November and I think you can take from that that we don't see the 2016 number being significantly less than the GBP900 million that we ended up in 2015. I think it might be a bit lower, but I would rather that we did that work and just go through that. But it's going to be in that kind of ballpark, I think, and then we'll progressively improve. But don't expect it to be significantly different from the GBP900 million.

Nick Cunningham - ***Agency Partners - Analyst***

And in terms of, perhaps, some vague indication, if you like, of how the difference diminishes as we go forward.

David Smith - ***Rolls-Royce Holdings plc - CFO***

Well, I think that line [sorry, I don't have the chart in front of me] clearly, there's a different timing on aftermarket and OE effects, and we try to lay it out on that line. The cross-over point is somewhere between 2020 and 2025 on that line. I think that's still our best estimate.

But we are doing a lot of further work on this. It may not sound like a difficult problem, but it is an intensely hard amount of accounting work that's going on around this at the moment. And it's not worth giving you numbers that we're going to change later; we'd rather get the numbers right. Stephen, I know, is committed to come back as soon as we can, really, to give you an update on that.

Nick Cunningham - ***Agency Partners - Analyst***

Thank you very much.

Christian Laughlin - ***Bernstein - Analyst***

Christian Laughlin, Bernstein. Just a few questions on civil aerospace, if I may, Warren. Basically, starting from the back end of 2016, and looking into how things are trending and setting up for 2017, how are unit costs progressing for the XWB-84?

And, as a corollary to that, how do you feel about schedule? In terms of meeting the schedule requirements from Airbus, still under a lot of pressure, or better than it was, say, H1 last year, etc.? Some sort of qualitative characterization would be helpful.

Then, secondly, just kind of thinking about your development portfolio, if you could just update where we are on your expectations for meeting the schedule for the Trent 1000-TEN, the XWB-97, and the Trent 7000, in terms of performance and cost expectations; and then, of course, schedule.

Warren East *- Rolls-Royce Holdings plc - Chief Executive*

Yes, okay, so how I feel about costs on XWB, I think we're in reasonable shape. It is going to take a few years to achieve where we want to get to on costs, but we are absolutely on track with that.

In terms of the cash loss per engine, I'd also draw your attention to the fact that particularly as we come to the back half of 2017 and into 2018 then we lose the deliveries that are attached to launch pricing and so we go up a couple of notches in terms of achieved pricing.

So we're actually attacking the cash loss from both ends, from the cost reduction, which is 7% in 2016, and there'll be more to come in 2017, we're on track; but also, we get that little bit of assistance from improved pricing.

How do I feel about that from a delivery point of view compared with, say, 12 months ago, and meeting the Airbus schedules? Well, 12 months ago we weren't in as good a position as we are today. We are in good shape today, but most of the volume ramp in XWB was delivered from us in the second half of the year. That was fortunate because, as far as we're concerned, the Airbus had some other issues.

And so, at no stage had we actually been the pacing item in terms of delivery of the airplane, and we don't intend to be a pacing item as we look forward. We've already delivered in the first six weeks of this year, and we're absolutely on track with Airbus and their plans. And they'll talk about their volumes, I'm sure, when they do their results, next week.

As for the new three large new ones, then the Trent 1000-TEN is flying. We have a 787 flying with two Trent TEN engines, and so they're going through extended flight testing, ahead of certification, now. And we are on schedule for that to go into service in the second half of the year.

Similarly, similar position on the A350 1000, with the 97K engine, where they have three airplanes now on extended flight testing. And that's scheduled for its entry in the second half of the year.

And on the new A330 with the 7000 engine, that is about six months behind, but it's on a similar trajectory. And that airplane will fly with its new engines, for the first time, over the coming months.

Christian Laughlin *- Bernstein - Analyst*

Okay, great. Thank you.

Ben Fidler *- Deutsche Bank - Analyst*

Ben Fidler, Deutsche. I have three questions, please. First one, just on FX, just to make sure I've understood the messaging on your slide 42, which you showed to us, David.

Am I right, it now seems that the currency sensitivity, because of the balance sheet movements within civil aerospace, is - kind of my mistake - that it sounds like it's one-half to one-third of what I previously had assumed is your FX sensitivity, once you take into account the balance sheet effects? Is that right?

David Smith *- Rolls-Royce Holdings plc - CFO*

I think the transactional side of it is exactly as you'd expect, because we did also get some movements on the revaluation of foreign currencies, supplier payables, receivables, whatever. That diluted that a little bit. That's really going --

Ben Fidler - ***Deutsche Bank - Analyst***

[Is that an ongoing effect?]

David Smith - ***Rolls-Royce Holdings plc - CFO***

Well, it is. But it could be the other way, depending on exactly balance sheet-to-balance sheet rate changes. So it happened to be a slightly diluted effect this time, yes. And the transactional calculation is still going to be about right.

Ben Fidler - ***Deutsche Bank - Analyst***

And then, related to that is also, that slide, your comment, again, to check I haven't misinterpreted it, you're saying you don't expect any average effective rate change in 2017, you also mentioned in 2018, for the next couple of years? So, is that the message?

David Smith - ***Rolls-Royce Holdings plc - CFO***

The message is I don't think we're going to be net increasing that GBP38 billion. So it's more likely that we'll stay at a similar level. So we will replace some hedges, as they roll off, clearly, with new ones. But that's over the whole of the hedge book.

What we will continue to try and do is try and keep the average rate year by year fairly flat. So I don't - we may get some, but I wouldn't bet on a lot of additional benefit in the near-term from just that rollout. The reason that we've got the bigger benefit over the last year is that, actually, because we've increased the size of the hedge book as well, so it's diluted the average by more. Does that make sense?

Ben Fidler - ***Deutsche Bank - Analyst***

Yes, that does. Thank you. My next question was just on the IAE earn out, whether you're able to just let us know, and give us an indication, of what the IAE earn out was that you received in calendar 2016 embedded in these numbers?

David Smith - ***Rolls-Royce Holdings plc - CFO***

As you know, there's the three areas that we get. The module revenue has obviously come down a little and is disappearing. But actually, the license income is about the same. And we saw a bit of an increase in aftermarket revenue, both from pricing and from volumes.

So, overall, I think we probably saw about the same level of total IAE, which I think is about 250, something like that. So it's about the same number. I don't think it's changed radically, year to year.

Ben Fidler - ***Deutsche Bank - Analyst***

Thank you. And the third question is just, as I'm trying to understand more about modelling your civil aerospace cash flows, how many shop visits did you do in 2016, and the direction of how that compared with 2015?

David Smith - ***Rolls-Royce Holdings plc - CFO***

Yes, and it is, unfortunately, something that you have to go a little bit deeper because there are clearly different levels of shop visit, from a major overhaul to a smaller intervention.

I think in absolute numbers, actually, the numbers weren't that different in 2016 and 2015. And I don't think we expect it to be that different in 2017; maybe a modest increase in 2017. But we're clearly seeing less activity on some of the legacy programmes. So that's really why some of the legacy aftermarket, particularly the time and

materials, has come down a bit.

So in absolute terms, the numbers haven't changed very much. But what we're really seeing is this mix change continuing to go on between aftermarket, legacy programmes on both engine flying hours and T&M, and then a pickup and a stronger double-digit pickup on the engine flying hours on the new stuff.

Ben Fidler - ***Deutsche Bank - Analyst***

Thanks very much.

Tristan Sanson - ***Exane BNP Paribas - Analyst***

Tristan Sanson, Exane BNP Paribas. I have two questions. The first one is on large engine aftermarket in 2016. So organic, the large engine aftermarket was down 4%. Can you give us a bit of colour on what was the trend between the erosion of time and material on RB211?

What is the evolution on the normal Trent engines, your TotalCare agreement? And what is the impact of the engine transition that you may have felt impacting, I know, the number of Trents in service? And, as a consequence, reflected in that 4%, not in precise number, but to understand the various movements, and how these three factors are expected to develop in 2017. That's the first question.

And the second one, I'm a bit confused by the fact that in civil aerospace you're releasing profit based on the revaluation of lifecycle costs on your engine under long-term maintenance agreements; and, at the same time, in 2016 you have GBP98 million of technical cost that you say are related to a need for increased shop visits, in short term, for Trent 900 and the upgrade of engine management system for Trent 700.

So it's more philosophical question about how predictable do you think are the costs of your engine under long-term maintenance agreements, and so how do you bake this into your assumptions?

Warren East - ***Rolls-Royce Holdings plc - Chief Executive***

This is a very detailed question, and I'm going to take the whole of the morning on this, I have to say.

The aftermarket trends, the trends are pretty clear. Our older engines, time and materials, these RB211 engines are being retired and that's what's contributing the downward pressure: those time and materials contracts are high margin. That's being offset by newer engines. And newer engines tend to be long-term service agreements and that exerts upward pressure. And the net is the net.

We can look at the numbers. You asked how the trend is set over the next year or so, and we're going to see a continuation of that.

With some of our mid-age transitions, then we are seeing a little bit of demand. Maybe, there'll be a little bit of turning some things which have been under a long-term service agreement into one of the new models of TotalCare flex, and those types of model, which will have slightly different implications.

But listening to your question, and Ben's question earlier, I think we could probably do with a slide that summarizes it without going into every single detail, but a little bit more than the big plus and minus.

Do you want to add more on the last bit?

David Smith - ***Rolls-Royce Holdings plc - CFO***

Yes. The last bit is actually just a factor of the way that we do the accounting. So, eventually, those costs will end up in the contract margin, but we book them, in the first instance, through this technical provision. As we then update the contract packs later on, we'll probably move that money from that provision into the contract packs. It's a bit of a holding place.

But you're right that overall, in terms of the absolute level of lifecycle cost improvement on civil, which I said was GBP217 million, that was better than last year of GBP148 million. But the GBP98 million of absolute booking into technical things will eventually get into long-term contract margin as well. So, there's a plus and a

minus there.

Warren East *- Rolls-Royce Holdings plc - Chief Executive*

Yes, and there always will be pluses and minuses because we have, on an ongoing basis, an effort to reduce the cost of servicing these things in the long term and then we take individual issues as they come. So you're always going to see some effect like that.

Gordon Hunting *- Fiske - Analyst*

Gordon Hunting, Fiske. Two quick conceptual questions. The troubles that Toshiba and Westinghouse are having, is this a benefit or a negative?

Secondly, have you got to make a big provision for the Type 45 destroyers conking out regularly?

Warren East *- Rolls-Royce Holdings plc - Chief Executive*

Yes, the conceptual question about the nuclear reactors, clearly, Toshiba is a potential partner, a potential customer, for our civil business in nuclear. If they're not active, they're pulling out of that, then we'll have to see if that project goes ahead, perhaps with somebody else. The opportunity will still be there.

I think if you back off it a little bit and say, actually, the really big nuclear projects are quite challenging. And they're quite challenging to finance, and this is one of the reasons why we are keen to promote the small modular alternative.

Yes, there's the technology piece, which is a little bit different, and but the consequence of that from a commercial point of view, because we can make these things, by definition, in the factory, instead of on site, is that they eventually become more cost effective; and, in particular, more bite-sized chunks, so you don't get this big volatility around the big decisions.

And so, conceptually, it's an opportunity for us, because we can play a larger role there than we can with just our instrumentation and control and waste management systems around the big reactors.

As for the Type 45, I'm afraid, that's a specific contract, specific issues, and we can't really comment on it, other than to say that we're supporting the Navy with their efforts, and we'll continue to support the Navy to make sure that the thing is reliable.

Zafar Khan *- Societe Generale - Analyst*

Zafar Khan, SocGen. I've got a couple of questions, please: one's on cash flow, and one is on costs. If I can take the costs one first, and I'm looking at slide 13 in the supplementary slides that you've kindly provided, you've been talking about transformation, how you're taking out the costs and making good progress on that.

But if I look at slide 13, I note that the commercial and admin costs in 2016 have gone up from GBP1,004 million to GBP1,163 million, so it's a major reversal there. Is there some one-off cost in that line? Or what has actually happened there? Could you help me understand that, please?

David Smith *- Rolls-Royce Holdings plc - CFO*

One of the biggest things is that we're paying a bonus this year. There was no bonus in the 2015 numbers, so that will come through C&A, so that's one of the biggest charges. But there are other FX --

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Zafar Khan *- Societe Generale - Analyst*

David, it's GBP163 million increase.

David Smith - ***Rolls-Royce Holdings plc - CFO***

I know, it is on an adjusted basis, after you take out currency effects.

Zafar Khan - ***Societe Generale - Analyst***

So I should be thinking it's FX and not Warren's bonus (laughter)?

David Smith - ***Rolls-Royce Holdings plc - CFO***

No, there's an element of bonuses. Some of the Group bonus goes through C&A, obviously, some will go through gross margin, and a little bit through engineering.

David Smith - ***Rolls-Royce Holdings plc - CFO***

We'll give you a bit more help with that, but that's the biggest performance-related issue; the rest will be around economics.

Zafar Khan - ***Societe Generale - Analyst***

Okay. And then, if I just go to the earlier slide, just one before, slide 12, you've kindly given quite a good historical data there. I remember, and this reinforces this, that the free cash flow, the record, I think, the Group has ever achieved is that GBP781 million, and you see it in 2013.

Now, we've got problems on the earnings front. Because IFRS comes in it's going to be pretty difficult to understand what happens there, so I guess many of us are looking at the promise of cash flow, Warren. And I wonder if in your idle time you kind of blue-sky these things, and when do you think we might get to that GBP781 million again? Is it going to be in my working life, do you think?

Warren East - ***Rolls-Royce Holdings plc - Chief Executive***

Yes, well, I certainly hope it's early in my tenure, so let's put it like that.

Actually, no change from what we said in November, when we talked about IFRS and we talked about the cash as well, because it was important to do so. This year, obviously, we had a slightly better-than-expected outcome last year and so, rather than talking about an improvement this year, we're talking about roughly flat performance.

You have to understand the law of relatively small numbers. Cash at the year-end is a little bit volatile and so we are quoting a range. But notwithstanding the better performance in 2016, 2017 is exactly what we thought it was going to be.

And we talked about getting towards GBP1 billion-plus towards the end of the decade, and it's a reasonably linear journey from here to there. It's a little bit more back-end loaded than linear, but if you sketch that then I think you can expect it in the next few years. And that's no change to what we've said before.

Zafar Khan - ***Societe Generale - Analyst***

Is GBP1 billion the aspiration or --?

Warren East - ***Rolls-Royce Holdings plc - Chief Executive***

No, goodness me. Of course, we can go beyond that, based on the size of the opportunity we have. But let's just think about the journey to translate the current business that we have into that cash-generating world, and it's in that time line.

Zafar Khan *- Societe Generale - Analyst*

Thank you. And just a supplementary on the A380. Airbus put out a statement suggesting that some of the deliveries on the A380 to Emirates were going to be deferred, and it was to do with your agreement with them on the engine. Can you just tell us what's actually happened there, what's going on? Does this mean that there's an issue in terms of overhead recovery?

Warren East *- Rolls-Royce Holdings plc - Chief Executive*

I think there's been enough negotiating in the media around this issue, and I don't want to perpetuate that negotiation in the outside world.

Suffice to say that we did reach an agreement with Emirates at the end of last year, and that is around the service life of the high-pressure turbine blades in our Trent 900 engine. We're pleased with that agreement; they're pleased with that agreement; Airbus is pleased with that agreement. We have a way of working forward.

Separately, Emirates have their own issues around how many planes they want to buy and when they want to receive them from Airbus. And that's a matter for Emirates and Airbus, between them, and so, I'm afraid, you'll have to take that one either to Emirates, or to Airbus.

Celine Fornaro *- UBS Securities - Analyst*

Celine Fornaro, UBS. My first question would be on the Group cash and how, when I think about your long-term incentive plan for 2016, 2017 and 2018, which was about GBP350 million cash cumulatively, does it look like after the better cash flow in 2016 and the guidance that you've given in 2017, because, basically, this implies a very small improvement for 2018, as well? So, how should we think about that?

And my two other questions would be on the civil divisions. The first one is if you could give us a little bit of colour of the in-service behaviour of the Trent XWB and the fleet that is out there after two years, and how the engines are performing. How are the shop visits, or any changes that you have to make to those engines, if any?

Secondly, if I think about the lead time transfer improvement that you've made on the Trent 1000, which is really good, shall I think, for the Trent XWB, that this only happens when production flattens, or, actually, this is something that you can also start doing earlier?

And on the Trent 1000, does the lead times change when we start introducing the Trent 1000-TEN, or we actually keep them? Thank you.

Warren East *- Rolls-Royce Holdings plc - Chief Executive*

As for the cash and the cash in the long-term incentive programme, I just draw your attention to what I said a moment ago on the general trajectory, and that's exactly the same. But during that period, don't forget, we have the law of relatively small numbers and year-end volatility.

So it's by no means, in terms of the absolute numbers, in the absolute years -- there is this variability that we see of plus or minus GBP100 million to GBP150 million, or so, and so that's going to be there. When we get into the realm of GBP781 million and GBP1 billion then that volatility becomes much less significant and so would affect a long-term incentive plan like that a lot less.

XWB in-service behaviour, well, it is early in the life of XWB as a complete fleet. Obviously, the fleet's grown a lot in the last 12 months in relative terms. But, however, the first engine has been in service for over two years now and the early signs from XWB are very good.

Yes, we have had a few maintenance issues that are perfectly normal, but we haven't had any serious issues. And we have been pulling these engines in for inspection as a sort of early -- because it's early in its lifecycle we've been pulling them in a little bit more regularly than we will be doing when they're in normal service. And so, if there was anything untoward, I'm sure we would be spotting it.

Lead time improvements on Trent 1000, when we switch over to TEN I'm sure, in practice, there will be some degradation in lead time for a short period of time, but we don't anticipate a big material change.

As for whether we have to wait on XWB for those lead time improvements to happen, no, we don't. And they are happening. When we first started on XWB and supplied a few in 2015 then the assembly lead time was quite long, of the order of 40 days. And we are targeting getting the thing down to closer to 20 days, and the

production engineering team are very highly motivated to get there.

I think that's it. Can we go to the online now, and then we'll come back? So, online questions.

John Dawson - ***Rolls-Royce Holdings plc - Director, IR***

Thank you, Warren. One of them has just been answered, actually, on FX, so I'm not going to pick that one up. But Robert Stallard asks should we expect CapEx and R&D spending to ease in 2018? And if so, by what sort of amount?

So, building on the guidance for 2017, what's the trend into 2018, and beyond? And what will be the expected delta?

Warren East - ***Rolls-Royce Holdings plc - Chief Executive***

The short answer on that is that we need to continue to invest in R&D. We're going through a little bit of a peak at the moment, but, I think, you will see in the 2017/2018 period a significant investment in the Advance and UltraFan engines. And, don't forget, I said civil is essentially the lion's share of R&D expenditure, so that's going to be the key driver there.

As for CapEx, then it's going to be flattish over that period. We are investing quite a lot at the moment in modernizing facilities. A lot of those modernization activities will have taken place and so there will be some downward pressure in that those factories won't need to be updated in the short term. But then, we will be into the next wave, so I'm sure it will be flattish.

We'll actually manage it, by the way, in terms of we don't just operate with an open checkbook. We'll be managing that capital expenditure and phasing it in the normal project-approval process.

John Dawson - ***Rolls-Royce Holdings plc - Director, IR***

One additional question from the online guests, do you intend to pay for ITP in shares? If so, have you discussed with the vendor what they intend to do with that stock?

Warren East - ***Rolls-Royce Holdings plc - Chief Executive***

Well, as everybody knows, we have an agreement with the vendor that we can pay any one or more of the eight quarterly instalments after the transaction closes in shares, rather than cash. And as far as the vendor is concerned, that is the option that we have, and that is up to us and is our decision. As to what the vendor does with those shares, we don't have an influence over what the vendor does.

But we will take those decisions as they come, on a quarter-by-quarter basis. We have no intent at the moment to drive specifically down the share route, or specifically down the cash route.

We'll be managing the cash as we go through that period, and we'll be always keeping an eye to other requirements for cash: what's going on with the share price and long-term shareholder value. It's a decision that will be taken in the round, and the Board will be involved every quarter.

David Perry - ***JPMorgan - Analyst***

David Perry, JPMorgan. One high-level question in two parts, I think. The strategic review, I'm sure you want to keep some of your powder dry, but maybe it's taking a bit longer than we thought. Just, can I ask, is it going to be more biased to the operational, or more biased to portfolio?

And then, the second part is related to it. Does the possibility of a border tax adjustment impact the strategic review and your thinking? At this stage, have you got any thoughts of the positives and negatives that might have on Rolls-Royce?

Warren East - ***Rolls-Royce Holdings plc - Chief Executive***

To answer the high-level piece first, in terms of where we are today, as I said when I was presenting, I would have liked to have been a bit further ahead. But it isn't that this is a difficult problem that's taking us longer; it's more a question of getting started.

And what actually took a little bit longer was to assemble the team. But I think we had to make some difficult calls and it would not have been right for me to have been concentrating on long-term vision while the short-term performance of the business was not improving.

And even as we go through 2017, we've got a lot of work to do, as a team, to make sure that we continue to improve the operational performance of the business.

Will it be more operational, or will it be more portfolio-oriented, the answer is that you can't ignore the operational piece. That's got to happen anyway. And so I think when we talk about strategic review it will be more what does the shape of our business look like out into the future, and what do we need to do in 2017, 2018, 2019, 2020 to get there. And it's a given that in that time period we need to keep improving the operational performance.

David Smith - ***Rolls-Royce Holdings plc - CFO***

I assume, on border tax, you're referring to the US proposals?

David Perry - ***JPMorgan - Analyst***

Yes.

David Smith - ***Rolls-Royce Holdings plc - CFO***

Clearly, maybe you've got more detail than I have. I haven't seen a lot of detail around those proposals yet, and I assume that they're going to take a lot of filling out. And we already have enough Brexit duty and custom things to think about as well. But I think the key for us, like any company that needs to trade over borders, is to retain flexibility.

We have a site in Indianapolis that we are reinvesting in, which is very capable of producing engines or other parts that we have around component facilities. So we'll just have to see, David, where all of that comes out. But, as an international company that trades across borders, we will have to retain flexibility if we see changes and due to your border tax regimes to make sure that we can keep that as efficient as possible.

Warren East - ***Rolls-Royce Holdings plc - Chief Executive***

We already do a little bit of civil work in that facility and so work can move around the organization, as required.

Okay, so I think we need to move to the penultimate question.

Rami Myerson - ***Investec - Analyst***

Rami Myerson, Investec. Three. F-35B, how many modules did you deliver in 2016? And how many do you plan to deliver in 2017? And is that a headwind to profitability, or is that already profitable?

Warren East - ***Rolls-Royce Holdings plc - Chief Executive***

I don't have the answer off the top of my head, I'm afraid, to the number of F-35B modules.

David Smith - ***Rolls-Royce Holdings plc - CFO***

Why don't you ask your second question?

Rami Myerson - ***Investec - Analyst***

Second one is on SSRO. What is the percentage of revenues of the Group that could be subject to SSRO regulation and I understand that the Astute boat 5 is going to…are you going to liaise with the SSRO on that boat?

And you talked about accelerating UltraFan R&D, is that for a middle-of-the-market aircraft?

Warren East - ***Rolls-Royce Holdings plc - Chief Executive***

On the SSRO, it's roughly 10% of our business that is potentially exposed. But this is an ongoing dialog at the moment, and the SSRO is consulting with companies such as Rolls-Royce around how they move forward.

Middle-of-the-market aircraft, it's a paper airplane at the moment. There is potentially an opportunity for about 5% of the traffic, maybe, to be taken by that sort of airplane, but we're a long way away from any decision there.

If it makes business sense, and if that airplane goes ahead, then we would be very keen to power it. And Boeing, I'm sure, will make a decision based on sound business principals; and they understand that if we're going to put an engine on that plane it has to make business sense for us as well.

David Smith - ***Rolls-Royce Holdings plc - CFO***

It looks like it was actually pretty flat in 2015/2016, and will be again in 2017, at about 12, something like that.

Radaslaw Becker – Sumitomo Bank

If you could just tell us what is your relationship with the UK Export Finance Agency, just regarding the press releases saying that they may request some funding, or may not support your contracts in the future.

And the second question, just on the FX hedges, do you expect any cash impact in the medium term as some of the hedges matures, or just continue to rollover the hedge book at the same rate, as you said?

David Smith - ***Rolls-Royce Holdings plc - CFO***

Quickly, we actually work really close with the UK from a number of projects each year. I think we have an excellent relationship, and I think they'd say that as well.

Clearly, there were a couple of the contracts that were mentioned in the DPA that had financing originally, that was quite a long time ago, so they are doing some additional diligence around that. But the ongoing relationship is actually really strong and they're very supportive of the business.

On FX, Cash impact, there's absolutely no cash collateralization requirement, if that was your question.

In terms of as those mature, clearly, they will either be positive or negative; but then, the underlying transaction that they're hedging will be positive or negative the other way around. So it's basically those hedges give us an effective rate of 1.55 at the moment, and that's the end result of those transactions.

Warren East - ***Rolls-Royce Holdings plc - Chief Executive***

Okay, so that concludes the question and answers.

And before we break, this is David's swansong, so I'd like to thank him, as well, for being a great support.

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