EDISON

QinetiQ Group

FY18 results

Unique position

Aerospace & defence

QinetiQ holds a unique position in the global defence market, providing capability generation and assurance in challenging times. The company is working tirelessly with the UK MOD to provide world-class Test and Evaluation (T&E) facilities in the face of a tight budget environment. In addition, it is building its global footprint, leveraging both its technological expertise and global defence budget dynamics.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
03/17	783.1	116.1	18.1	6.0	14.8	2.2
03/18	833.0	122.1	19.3	6.3	13.9	2.4
03/19e	842.6	107.7	16.5	6.7	16.2	2.5
03/20e	851.1	110.9	16.9	7.1	15.8	2.7

Note: *PBT and EPS are normalised, excluding amortisation of acquired intangibles, exceptional items and share-based payments.

FY18: Second successive year of growth

FY18 group orders were £687.4m, up from £276.3m at H118. FY19 revenue under contract at the start of FY19 stood at 75% for EMEA Services and 51% in Global Products. The latter reflects the shorter-term nature of contracts in this division. FY18 revenue at £833.0m (FY17: £783.1m) was up 3% on an organic basis, with EMEA Services up 4% and Global Products down 4% on the same basis. Acquisitions and currency drove revenue growth to 6%. Underlying operating profit was £122.5m (FY17: £116.3m), with a higher contribution from non-recurring items. Excluding these non-recurring trading items, currency and acquisitions, underlying operating profit fell by £3.4m (H118: £3.6m) in EMEA Services, primarily due to a lower baseline profit margin on single-source contracts (c 75% of the division). Underlying basic earnings per share of 19.3p (FY17: 18.1p) increased by 6.6% and the dividend increased 5% to 6.3p (FY17: 6.0p).

Transformational times

QinetiQ has delivered its second year of organic growth under its new strategy. It is actively embracing the UK defence environment to help the UK MOD achieve the cost savings that it needs. Renegotiating the Long Term Partnering Agreement (LTPA) has enabled QinetiQ to make the required investment to provide world-class T&E services to both domestic and international customers. EMEA Services remains underpinned by long-term contracts and the company anticipates that by FY19 just c £100m, less than 12% of group revenue, will be exposed to potential annual Single Source Regulations Office (SSRO) pressures. The Global Products division is at the forefront of R&D while the group's total funded order book of £2.0bn demonstrates the breadth of opportunity. A strong balance sheet supports future M&A and a focus on successful conversion of order down-selects is key.

Valuation: upside

We adjust FY19 estimates and introduce FY20 estimates. Our new forecasts see QinetiQ trading on 16.2x FY19e P/E. On a calculated WACC of 8.0%, our DCF model currently delivers a value of 275p, up from our previous value of 241p.

13 June 2018

Price	**267.6p**
Market cap	**£1,513m**
	$1.32/£1
Net cash (£m) at 31 March 2018	266.8
Shares in issue	565.4m
Free float	96%
Code	QQ.
Primary exchange	LSE
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	13.0	25.2	(9.3)
Rel (local)	12.8	17.6	(12.4)
52-week high/low		294.9p	195.5p

Business description

QinetiQ provides technical support services to customers in the global defence and security markets. The group operates through two divisions: EMEA Services (78% of FY18 sales) and Global Products (22% of FY18 sales).

Next events

Interim results	November2018

Analysts

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Edison profile page

QinetiQ Group is a research client of Edison Investment Research Limited

Investment summary

Company description: World leader

QinetiQ is a world leader in providing scientific and technological advice, services and solutions to the global defence and security markets. The UK remains the only advanced nation to permit, on this scale, its national defence laboratories to be transformed into a separate entity. While QinetiQ considers the UK, US and Australia “home countries”, it has customers in over 40 countries around the globe. It is in a unique position in the global defence market, providing valuable capability generation and assurance in challenging times. The company is working tirelessly with the UK MOD to provide world class Test and Evaluation (T&E) facilities, ensuring that the investment made both repatriates spending and attracts international customers. A key element of QinetiQ’s strategy is internationalisation, growing from 21% to 27% of group revenues over the last two years. QinetiQ’s unique products and services should be able to drive top-line growth and operating margins.

Valuation: Upside through strategy

We use a cash-based capped DCF valuation, which is, in our view, a conservative basis for estimating cash flow values as it does not assume any growth in the terminal value. While we normalise working capital to zero and capex to equal depreciation, it still eliminates some element of the potential terminal value. With our improved model and higher future year performance, the DCF on a calculated WACC of 8.0% currently delivers a value of 275p, up from our previous value of 241p. Our new forecasts see QinetiQ currently trading on 16.2x FY19e P/E, which still represents a 12% discount to the UK aerospace and defence sector. As the company grows market share and leverages international opportunities, the improved profitability should support a higher valuation multiple.

Financials: Further SSRO impact in FY19

We have updated our forecasts following the FY18 report and introduced our FY20 estimates. The better than expected consensus FY18 results provide momentum into FY19e and this is reflected in our higher estimates. The company did not guide any change to expectations in the FY18 statement, excluding non-recurring trading items. A £6m profit headwind from SSRO revenue is incorporated into our estimates. We are looking for modest revenue growth from both divisions, with some FX impact. From FY20e we see a reduced headwind in EMEA Services profitability and further growth in Global Products. We have not included the E.I.S. acquisition as it has not yet completed. However, we would estimate our net cash forecast might reduce by c £60m on completion of the deal and would expect it to add c £2m at the EBIT level, enhancing FY19 EPS by 2-3% and more than 4% in FY20. QinetiQ expects to complete the acquisition in H119.

Sensitivities: Domestic budget pressures dominate

The pressures on the UK defence budget are the most important factor in the QinetiQ investment case. This keeps the company focused on working closely with the UK MOD to deliver best-in-class services in a tighter budgetary environment. SSRO margin pressure continues to create a headwind for EMEA Services, although an increasing proportion of QinetiQ’s revenue is contracted on a long-term basis, which provides some protection from rates falling further in the future. Renegotiating the next LTPA amendment is a complex procedure, given the number of sites and personnel involved. Meanwhile, the company is committed to significant investment under the LTPA amendment and there is some risk to this investment in terms of timing and execution. International markets bring both new competition and new customer dynamics. We view “value-enhancing acquisitions" as a core element of the company strategy and hence the ability of management to identify and integrate acquisitions purchases is important.

FY18 results

The following table outlines the FY18 results.

Exhibit 1: QinetiQ income statement, FY17 and FY18 (underlying basis)

£m	2017			2018			% change		
	H117	H217	FY17	H118	H218	FY18	H1	H2e	FYe
Revenues	361.8	421.3	783.1	392.5	440.5	833.0	8.5%	4.6%	6.4%
EMEA Services	*293.3*	*320.2*	*613.5*	*311.6*	*339.8*	*651.4*	*6.2%*	*6.1%*	*6.2%*
Global Products	*68.5*	*101.1*	*169.6*	*80.9*	*100.7*	*181.6*	*18.1%*	*(0.4)%*	*7.1%*
EBITDA (underlying)	65.1	80.2	145.3	71.0	80.8	151.8	9.1%	0.7%	4.5%
Depreciation	(12.0)	(14.4)	(26.4)	(11.7)	(13.9)	(25.6)			
EBITA (underlying)	53.1	65.8	118.9	59.3	66.9	126.2	11.7%	1.7%	6.1%
Amortisation	(1.2)	(1.4)	(2.6)	(1.8)	(1.9)	(3.7)			
EBIT (underlying)	51.9	64.4	116.3	57.5	65	122.5	10.8%	0.9%	5.3%
EMEA Services	*43.0*	*49.7*	*92.7*	*47.3*	*47*	*94.3*	*10.0%*	*(5.4)%*	*1.7%*
Global Products	*8.9*	*14.7*	*23.6*	*10.2*	*18*	*28.2*	*14.6%*	*22.4%*	*19.5%*
Financial Items	0.1	(0.7)	(0.2)	(0.3)	(0.1)	(0.4)			
Pre-tax profit (underlying)	52	63.7	116.1	57.2	64.9	122.1	10.0%	1.9%	5.2%
Taxation	(6.5)	(1.7)	(12.3)	(6.1)	(7.0)	(13.1)			
Net Income (underlying)	45.5	62	103.8	51.1	57.9	109.0			
EPS (p) (underlying)	7.9	10.2	18.1	9	10.3	19.3	13.9%	1.0%	6.6%
DPS (p)	2	4	6	2.1	4.2	6.3	5.0%	5.0%	5.0%

Source: Company reports

We give an outline of the FY18 performance as follows:

- Total orders were £687.4m, up from £276.3m at H118 and comparable to FY17: £1,676.7m. Excluding LTPA amendments, the FY18 order total was £587.2m, down from £675.3m in FY17, which included £109m from the Naval Combat Systems Integration Support Services (NCSISS) contract and £55m Strategic Enterprise contracts. At this time, FY19 revenue under contract stands at 75% for EMEA Services and 51% in Global Products, reflecting the shorter-term nature of contracts in this division.
- Revenue at £833.0m (FY17: £783.1m) was up 3% on an organic basis and ahead of our £823.9m estimate. Within that, EMEA Services revenue grew by 4% on an organic basis, while Global Products revenue declined 4% on the same basis. Acquisitions and currency drove revenue growth to 6%.
- Underlying operating profit was £122.5m (FY17: £116.3m) versus our £112.1m estimate. The majority of the difference was due to non-recurring items included, which rose to £8.7m from £7.4m in FY17. This included a £5.3m credit relating to the release of engine servicing obligations and a £4.7m credit related to settlement of a contractual dispute. There was a £2.7m charge relating to property liabilities and a number of other contract-related releases.
- Excluding these non-recurring trading items, currency and acquisitions, underlying operating profit fell by £3.4m (H118: £3.6m) in EMEA Services, primarily due to lower baseline profit margin on single source contracts (c 75% of the division). Meanwhile, growth in operating profit at Global Products was driven by improved profitability at OptaSense and high Q4 QinetiQ Target Systems (QTS) margins.
- Underlying basic earnings per share of 19.3p (FY17: 18.1p) increased by 6.6%, with a higher profit before tax contribution and a reduced number of shares due to the share buyback programme (completed in H217). The underlying effective tax rate actually increased marginally to 10.7% (FY17: 10.6%).

- The FY18 dividend increased 5% to 6.3p (FY17: 6.0p), in line with consensus.
- Capital expenditure of £80.4m in FY18 (FY17: £32.9m) falls between the expected £70-90m as investment is made, as per the LTPA contract amendment announced in December 2016. This has a net cash impact of £54.5m and a further £5.9m capex creditor to be settled in H119.
- The FY18 working capital unwind of £14.2m was close to the anticipated £15-25m. FY19 is expected to see a working capital outflow of between £15-25m.
- As at 31 March 2018 QinetiQ had net cash of £266.8m (30 September 2017: £194.7m; 31 March 2017: £221.9m) and the company reported net cash conversion of 103% before capex.
- International business accounts for 27% of group revenues, up from 26% at H118 and 21% two years ago.
- From a pension standpoint, the net asset position was £316.2m at the year end, equating to £257.6m after tax. The company ceased to make cash deficit recovery payments of £10.5m from March 2018.

EMEA Services

QinetiQ is actively embracing the UK defence environment to help the MOD achieve the cost savings that it needs. The Air Strategic Enterprise and the first part of the LTPA amendment demonstrate a win-win for both parties, and training is another area where further efficiencies can be delivered. For example, under the LTPA amendment, the investment in air ranges facilitates more complex trials and rehearsals for both the UK and international customers. In addition, one of five significant down-selects in FY18 was the invitation by the UK MOD to negotiate the Engineering Delivery Partner (EDP) programme on a sole-source basis.

As evidenced already in the H118 report last November, EMEA Services is facing margin headwinds from the 75% of divisional revenues derived from single-source contracts. The baseline profit rate is set by the UK SSRO and is applied to all MOD contracts that are uncompeted. We provide more detail on this later in the report. However, for new and renewed single-source contracts signed in FY19 the baseline profit rate will fall by 65bp from 7.46% in FY18 to 6.81%. It is important to note, though, that this is a smaller year-on-year fall versus last year and the rate is just the starting point. Companies can earn higher returns through adjustments for risk, capital requirements and good execution of contracts. In addition, an increasing proportion of QinetiQ's revenue is contracted on a long-term basis, which provides some protection from falling rates. For example, the £1bn 11-year contract amendment to the LTPA was agreed at the FY17 rate. Going forward, there is an additional c £100m of non-tasking revenues to be negotiated under the LTPA and the company is aiming to achieve conclusion in FY19. With these actions fully underway, by FY19 only c £100m of revenue pa will be subject to annual repricing, hence protecting QinetiQ from feeling the full impact of the SSRO's declining single-source baseline margin. Thus FY19e is viewed as the peak SSRO impact with a c £6m operating profit reduction.

QinetiQ continues to bolster its presence in international markets. FY18 has seen record order success in Australia, which QinetiQ actually considers a home market, facilitated in part by the RubiKon acquisition. We give more detail on international growth prospects later in the report.

Global Products

The order picture has continued to be encouraging here, with orders of £231.3m (FY17: £154.4m) boosted by a €24.2m order from the European Space Agency (ESA) for a spacecraft docking mechanism and more than $50m of orders for maritime systems in the US. The QinetiQ Target Systems (QTS) acquisition has been exceeding expectations, adding to the order backlog and underpinning reported 7% top-line growth. However, on an organic basis revenue fell by 4% on lower robot sales. QTS supported improved profitability in the division, with strong Q4 margin performance, as did an improved performance by OptaSense.

While the shorter order cycle at Global Products can leave the division's results looking inherently lumpy compared to the stability of the EMEA Services division, the business is progressing in many areas. QinetiQ North America (QNA) addresses a market that the company believes is growing and the US DOD accounts for 8% of group revenues today. In addition to the business recorded in the maritime system market, QinetiQ was successful in being selected as one of two suppliers for the Engineering and Manufacturing Development (EMD) phase of Common Robotic System (Individual) program of record. The company believes that this phase will last c 10 months. The total budget for the programme is c $400m in the form of an indefinite-delivery/indefinite-quantity contract over seven years. QinetiQ acknowledges that this is a very competitive area, but remains confident of future order success here.

Staying with the international theme, the company has established a joint venture with the UAE to manufacture aerial targets. This is very much building on the QTS acquisition. It also gives a foothold in the region and the chance to move further up the value chain into greater advice and T&E work. The Middle East is an attractive market for QinetiQ and it is working on a number of opportunities to provide pre-procurement advice, capability assurance and support for defence transformation.

OptaSense is QinetiQ's fibre sensing solutions business and it has seen an improvement in performance as confidence returns to the oil field market with increasing activity in North America. The business has undergone a change to both align itself to the customer and improve its commercial proposition. There is also a security angle to this business, with power facilities and rail lines.

QinetiQ's Space Products business develops satellites, payload instruments, subsystems and ground station systems. Returning to the ESA contract, this is a three-year deal whereby QinetiQ will qualify and produce a first flight model of its International Berthing and Docking Mechanism. While the system is lighter and more versatile than the competition, it also operates with both larger and small spacecraft. In addition, work on this project establishes a new product line for the business going forward.

Accounting non-recurring items

QinetiQ has been very detailed around the number of non-recurring items in FY18. To explain in more detail, the £5.3m credit noted at the H118 report related to the release of engine servicing obligations with the investment in new aircraft for test aircrew training in EMEA Services. As we understand it, this is part of the strategy to invest in new aircraft and sell the old fleet. As the old fleet aged, it was becoming more expensive to maintain, hence the original provision was taken. With the new fleet acquired and the old fleet disposed of, the servicing costs have become much lower and thus the provision has been released. The investment in the new fleet is aligned with management's strategy to invest in core UK T&E capabilities. This delivers enhanced services and, particularly in this case, lower operational costs. So the non-recurring item here is essentially the manifestation of this strategy taking effect. In addition, the investment allowed the company to secure contracts with the Swiss defence procurement agency and the Royal Netherlands Air Force.

Outlook

We give more detail on QinetiQ's strategy later in the report and update our forecasts. However, for FY19e the company will continue with its investment and campaign approach focusing on major customer opportunities. The impact of SSRO is expected to intensify in FY19, but the company is taking key steps to mitigate this. QinetiQ enters the year with a strong order pipeline and expects overall organic growth, with an adverse currency impact likely. Cash flow impacts have been well flagged in relation to capex in the region of £80-100m, including some deferred cash spend from FY18, and a working capital outflow of £15-25m.

QinetiQ will continue to work with the UK MOD, to address new threats within the constraints of a limited budget, while also developing business opportunities overseas. Exhibit 2 details five key recent down-selects that the company hopes to convert in the near future.

Exhibit 2: Down-selects based on major government-funded programmes and strategic partnering

Programme	Customer	Budget	FY	Duration
Engineering Delivery Partner (EDP)	UK	£1bn+	19	10 years
Defence Core Systems & Services (DCS&S)	UK	£75-120m	19	5 years
Battlefield & Tactical Communications & Information Systems (BATCIS)	UK	£50-95m	19	5 years
Common Robotics System Individual (CRS-I)	US	$429m	20	7 years
Air Support Defence Operational Training (ASDOT)	UK	£1-1.25bn	21	10 years

Source: Company reports

Company description: From self-help to growth

QinetiQ is a world leader in providing scientific and technological advice, services and solutions to the global defence and security markets. While QinetiQ considers the UK, US and Australia “home countries”, it has customers in over 40 countries around the globe. With an average number of employees of 6,114 in FY17, QinetiQ operates from 50 sites.

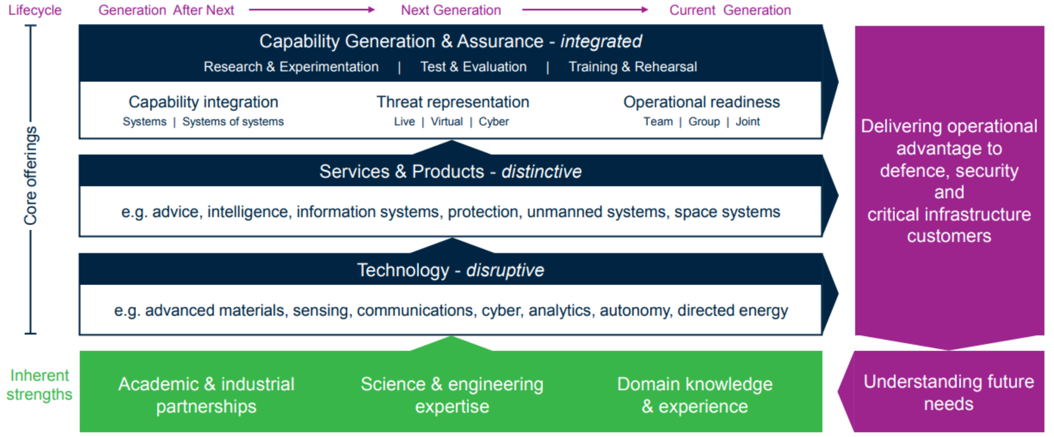
QinetiQ benefits from over 65 years of experience in providing defence research to the UK Government. In 1993, the UK government transferred its non-nuclear defence research establishments to a separate trading fund, originally as the Defence Research Agency (DRA) and subsequently as the enlarged Defence Evaluation and Research Agency (DERA). In 2001, DERA was split up with the majority forming QinetiQ and a smaller portion rebranded as Defence Science & Technology Laboratory (DSTL). In 2002, the UK MOD agreed to sell a 33.8% share in QinetiQ to Washington DC-based Carlyle Group. On 10 February 2006, QinetiQ was listed on the London Stock Exchange, raising £617.5m and the UK MOD retained a 23.7% share.

In 2013, the company began a further transformation with a full strategic review of its US services business, as it was not fulfilling the required strategic growth role. This resulted in this business being acquired by the SI Organization Inc for an initial sum of $165m and a further potential earnout of up to $50m based on gross profits.

Today, the UK remains the only advanced nation to permit, on this scale, its national defence laboratories to be transformed into a separate entity as an arm’s-length commercial enterprise and to operate as a private sector entity. This is not to say that other countries could not benefit from the same approach.

Exhibit 3 demonstrates how QinetiQ creates value. Research and development is at the heart of QinetiQ. However, it is important to stress how the company is central to the UK MOD today through defence capability generation and assurance. The company is responsible for the UK MOD’s core T&E capabilities under the 25-year LTPA, which was first signed in 2003 and is currently in a process of upgrading the facilities provided. World-class delivery here not only attracts international customers to use UK-based T&E services, but also demonstrates QinetiQ’s credentials to win contracts overseas.

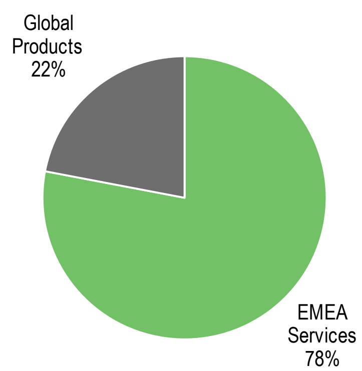
Exhibit 3: How QinetiQ creates value



Source: Company reports

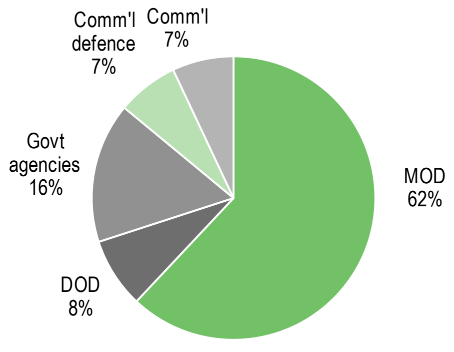
QinetiQ reports under two divisions with slightly different operating dynamics: EMEA Services and Global Products.

Exhibit 4: FY18 revenue by division



Source: Company reports

Exhibit 5: FY18 revenue by customer



Source: Company reports

EMEA Services (78% of sales)

At its core, this division is typically focused on providing facilities, research, testing and evaluation capabilities and services, and has built out through acquisition. The nature of the services provided means that this division typically operates under major long-term contracts. QinetiQ is responsible for the UK MOD's core T&E capabilities under the LTPA.

To give an outline of what is involved in T&E, QinetiQ provides services for operational and tactical training exercises that can combine simulated and real-world events with high-integrity performance measurement and replay systems. This allows for both day-to-day training plus a realistic rehearsal space ahead of full operations tailored to the following arenas:

- **Air ranges:** includes provision of targets, data analysis, and mobile instrumentation.
- **Land ranges:** includes environmental testing and static or dynamic firing of general and complex weapon systems and subsystems.
- **Sea ranges:** includes torpedo and weapons tests, acoustic and electromagnetic signatures, compass calibration and radar cross-section measurements.
- **Target services:** includes aerial targets, maritime dynamic targets, instrumented barges and land targets.

Exhibit 6 provides more detail of some of the key long-term contracts, as well as the latest E.I.S. acquisition.

Exhibit 6: EMEA Services operations

Business	FY18 sales % of division	Operation	Sites
Maritime, land & weapons	c £293m 45%	Delivers operational advantage to customers by providing independent research, evaluation and training services.	Farnborough, Boscombe Down, Shoeburyness, Fort Halstead, Hebrides, Aberporth, Pendine, West Freugh, Portsdown Technology Park and Haslar, UK.
Air & space	c £189m 29%	De-risks complex aerospace programmes by testing systems and equipment, evaluating the risks and assuring safety.	Farnborough and Boscombe Down, UK.
Cyber, information & training	c £98m 15%	Helps government and commercial customers respond to evolving threats based on the company's expertise in training, secure communication networks and devices, intelligence gathering and surveillance sensors, and cyber security.	Farnborough, Malvern and Crewe, UK.
International	c £72m 11%	Delivers our products and services in international markets. The newly acquired RubiKon Group, based in Australia, is reported in the international business.	Australia, Sweden, Canada and Dubai, UAE.

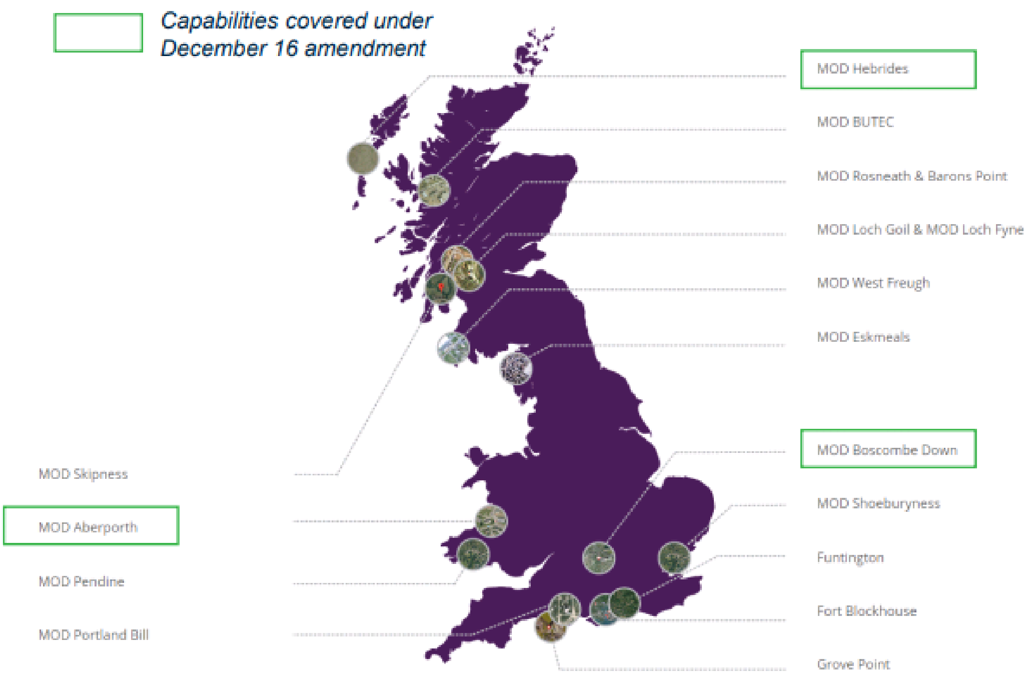
Source: Company reports

Long Term Partnering Agreement (LTPA)

The LTPA between the MOD and QinetiQ was signed in February 2003 and is the company's largest contract. The contract covers the delivery of T&E and training support services to the UK Armed Services over 17 sites. There are two revenue streams in the contract:

- Non-tasking (c £200m revenue): the fixed costs of maintaining and operating the facilities (including associated infrastructure).
- Tasking (c £100m revenue): revenue payable by the customers covering the direct cost of conducting each trial or test.

Exhibit 7: LTPA facilities around UK



Source: Company reports

Although the contract is scheduled to run over 25 years, it has five-year review points on pricing. In December 2016, QinetiQ successfully renegotiated the non-tasking element of the air ranges and test aircrew training facilities, equivalent to c £100m revenue pa, with pricing agreed until 2028. At the time of writing, QinetiQ is in repricing discussions with the MOD regarding the operation and management of 12 LTPA sites and facilities not covered by the amendment signed in December 2016. An interim pricing arrangement covers the 12 months from 1 April 2018 and the group is confident of successfully concluding the repricing discussions within this timeframe. As we discuss later in the report, the anticipated repricing of this remaining LTPA contract will be the largest driver of SSRO headwind in FY19.

At its core, QinetiQ is actively embracing the UK defence environment to help the MOD achieve the cost savings that it needs while providing best-in-class facilities, equipment and services. In addition, the improved test facilities should preclude customers seeking alternatives within the UK or overseas. The company estimates that approximately half the UK's test and evaluation money is currently spent overseas because the UK is not deemed to have the correct facilities. It is important to note that this is a progressive amendment, creating a cost-plus model that allows QinetiQ to invest its own capital and have greater control over the returns it can generate from the assets.

Air Strategic Enterprise

In November 2015, QinetiQ was awarded a five-year £153m contract by the MOD to deliver technical services to fast jets (including Typhoon and Tornado) and the A400M heavy-lift transport aircraft fleets. Essentially, this contract introduces a framework and standardises delivery of services for multiple projects. At the time of signing, Air Marshal Simon Bollom, chief of materiel for air services at DE&S, said: "This new approach transforms the provision of QinetiQ provided technical services for our aircraft. The Strategic Enterprise will deliver considerable savings and improve long-term planning through further improving our joint working. It will also support the retention of the UK skills base that will be required to deliver future programmes."

The "output-based" contract is a key example of how integrated QinetiQ is with the UK MOD in terms of providing world class services, reducing costs and building visibility for all parties.

Naval Combat System Integration Support Services (NCSISS) contract

QinetiQ was awarded the NCSISS contract by the UK MOD in 2012. This was then renewed for £109m in September 2016 for a further 11 years. At its core, QinetiQ works with the Royal Navy to develop and de-risk mission systems and infrastructure. This is centred at Portsdown Technology Park in Portsmouth, UK and work is undertaken with the Department Equipment & Support (DE&S) agency and BAE Systems. QinetiQ is investing £23m in a new naval testing facility together with Solent Local Enterprise Partnership.

As with the LTPA, the NCSISS contract demonstrates QinetiQ's unique relationship with the UK MOD. QinetiQ can generate capability and provide assurance on delivery. In addition, the long-term nature of the contract builds visibility.

E.I.S. Aircraft Operations ('Aircraft Operations')

QinetiQ announced in April 2018 that it was in agreement to acquire E.I.S. Aircraft Operations from the E.I.S. Aircraft Group for €70m. The operation is a leading provider of airborne training services based in Germany. As we discussed above, providing T&E services is core to QinetiQ's business and the deal would establish a capability in Germany with the market penetration opportunities that presents. In FY17 (YE December), Airport Operations generated €20.1m in revenues and €5.4m in EBITDA. As yet, we have not included the deal in our forecasts; however, we would expect the deal to enhance FY19 EPS by 2-3% and more than 4% in FY20. QinetiQ expects to complete the acquisition in H119 and it will be reported within the International division.

Global Products (22% of sales)

While the shorter order cycle at Global Products can leave the division's results looking inherently lumpy compared to the stability of the EMEA Services division, the business is progressing in many areas while serving a broad customer base.

Exhibit 8: Global Products operations

Business	FY18 sales % of division	Operation	Key sites
QinetiQ North America	c £73m 40%	Develops and manufactures innovative defence products specialising in unmanned systems, survivability and maritime systems, along with products in related commercial markets	Waltham, Massachusetts; Pittsburgh, Pennsylvania; and Virginia, US
EMEA Products	c £64m 35%	Provides research services and bespoke technological solutions developed from intellectual property spun out from EMEA Services. QinetiQ Target Systems is reported in EMEA Products	Farnborough, Malvern, Haslar and Ashford, UK and Medicine Hat, Canada
OptaSense	c £25m %14	OptaSense provides innovative fibre sensing solutions to deliver decision-ready data in multiple vertical markets	Farnborough, Winfrith, Portishead, UK; Houston, US; Calgary, Canada and Dubai, UAE
Space Products	c £20m 11%	Provides small satellites, payload instruments, subsystems and ground station services	Farnborough, UK and Antwerp, Belgium

Source: Company reports

QinetiQ North America

QinetiQ North America has over 40 years of experience in the design, development and operation of tactical robots. The business has a broad innovative offering primarily in the defence field, but also operates in commercial markets. FY18 brought success with a selection for Phase I of the US Department of Defense's (DOD) Engineering and Manufacturing Development (EMD) phase of the Common Robotic System (Individual) program of record. The EMD phase will last approximately 10 months, during which time the DoD will test and evaluate robots from the two suppliers. The company believes that this phase will last c 10 months and future success here equates to potential sales of c $400m over seven years. The company acknowledges that this is a very competitive area, but it remains confident of future order success. In FY18, the business won in excess of $20m Talon robot orders and more than $20m of orders for its Q-Nets and Armor products. Also in FY18, the business won more than $50m in orders for maritime systems in the US, including for aircraft launch and recovery equipment for the new class of aircraft carriers.

EMEA Products

EMEA Products' role is to provide research services and bespoke technological solutions developed from intellectual property spun out from EMEA Services, which means it has a broad remit. In FY18, the business supported the Canadian government with trials of QinetiQ's counter-UAV system, Obsidian, for detecting and tracking drones. The business is also launching its new secure Iridium-based satcom phone for the military and emergency services using a ruggedised design and encrypted data links.

On 21 December 2016 QinetiQ announced that it had acquired Meggitt Target Systems for £57.5m on a cash free, debt free basis. Now called QinetiQ Target Systems (QTS), we believe that the deal was both financially and strategically astute, filling a gap in QinetiQ's existing T&E offering. The business makes cost-effective unmanned aerial, naval and land-based target systems. Customers using any of QinetiQ's ranges need targets to test against so the company is now able to offer an end-to-end solution. QTS also generates 90% of its revenues from outside the UK so complements QinetiQ's desire to become a more international company. QTS won business from the UAE very quickly after acquisition and in FY18 it won new customers in the Republic of Korea Air Force and the Japanese Self Defence Force. In FY18 it also reached production milestones with its Hammerhead and Banshee targets, making them the most proliferated surface maritime and aerial target anywhere in the world.

OptaSense

OptaSense uses distributed acoustic sensing (DAS) technology across over 40 countries to a variety of different end markets. The business has seen considerable growth, increasing its employee base from three to over 140 in four years. OptaSense uses fibre optic sensing to protect oil and gas pipelines, and it was encouraging to see oilfield investment return in H118. OptaSense is involved with the 1,800km Trans Anatolian Natural Gas Pipeline Project (TANAP), which represents a longstanding focus from the business to work on an international pipeline project. Further improvement in the oil price backdrop supports an improvement in the capex environment, including the Middle East. This region could provide an opportunity in the water transport assurance space. The business is pursuing studies in adjacent markets, including transport where traffic flow management and incident detection have been of interest. There are also opportunities in the security field for asset protection for power stations and rails lines. The business is benefiting from the decision to be more aligned with its customers while working closely with corporate and university-based partners. Overall, the increase in work and the new strategy is improving profitability.

Space Products

Space Products is in an exciting phase. In FY18, the business was awarded a €25m contract from the European Space Agency for an innovative International Berthing and Docking Mechanism. The design was considered lighter and more versatile than competing designs and can accommodate large or small spacecraft. In addition, in FY18 the business secured a €3m contract with the ESA for the preliminary design activities on the Altius earth observation satellite. The Space Products business is a relatively small part of the overall group, providing a range of services from product innovation to system integrator. It has longstanding roles on key programmes, including Galileo, and is confident it will have a role on any future projects in this area given the recent conversations prompted by Brexit and the UK's role in the programme. In addition, QinetiQ has very recently entered a strategic collaboration with ÅAC Microtec. This cooperation will allow QinetiQ to market the satellite platforms, subsystems and space services to broaden the addressable market of both businesses.

Management

CEO Steve Wadey joined QinetiQ in Q116 from MBDA UK where he held the role of managing director. He believes defence companies have two options in the changing defence environment: either sit back and try to defend the status quo of the past, or adapt and be part of shaping the future. He is choosing to meet the "challenges and opportunities head on." He appointed the first managing director responsible for international business in August 2016 and has developed a campaign style approach to winning new business. This is similar to his experience at MBDA where he had to manage the complex relationship between a prime contractor and the MOD. CFO David Smith joined QinetiQ in fiscal Q417 bringing a wealth of sector experience from his time at Rolls-Royce, latterly serving as group CFO.

Strategy

FY18 results comment, "Our strategy was developed in anticipation of the market conditions we see today and is designed to reinforce our leading position in the UK T&E market, increase our international exposure and draw upon our ability to innovate. The three components of the strategy, while presented distinctly, are interlinked and mutually reinforcing. Delivery of the strategy will enable us to better support customers and deliver long-term, sustainable growth and returns to our shareholders. As the trusted partner to UK defence, our UK credentials enable us to establish relationships with international customers. Investing in modernising our UK T&E reinforces QinetiQ's credentials and is a competitive advantage when bidding for international work."

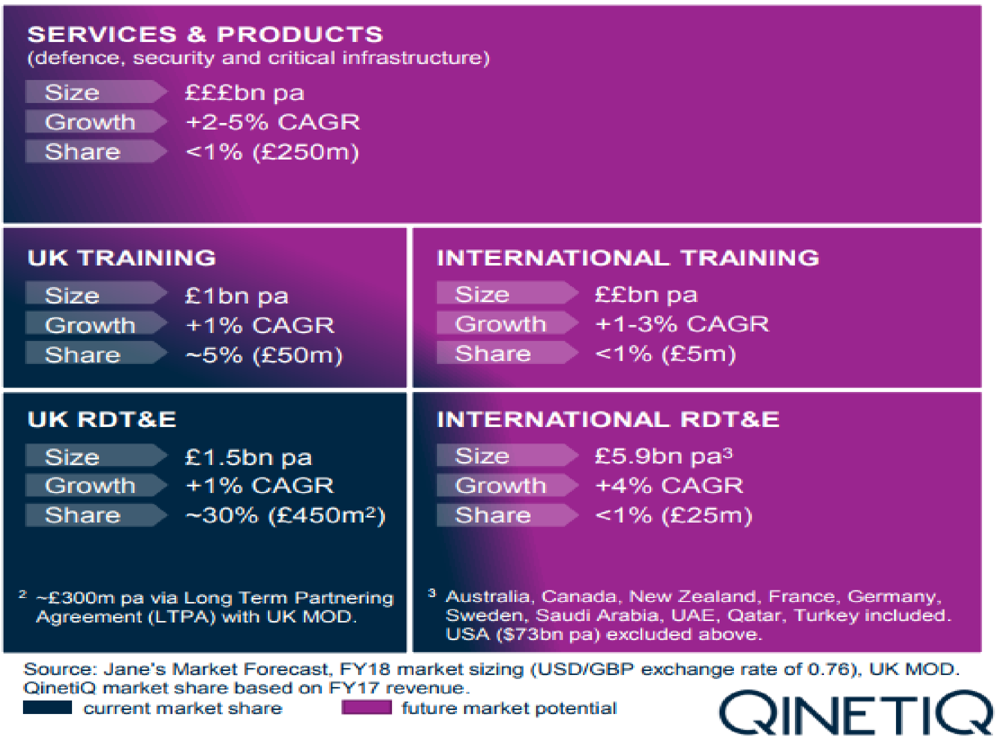
The vision and strategy of QinetiQ is to be "the chosen partner around the world for mission-critical solutions, innovating for our customers' advantage."

QinetiQ has always been seen as technologically innovative, but management identifies a crucial nuance in that not only is it applying its innovative expertise to the technology, but also to creating original and experimental customer-focused solutions and delivery. In QinetiQ's own words, "Turning creativity and innovation into tangible value for our customers increasingly requires innovative thinking across the broader range of activities." CEO Steve Wadey has set in place a campaign strategy that will take between three and five years to have a meaningful impact on revenues. The company is in a period of investment to deliver against future growth and has taken steps to outline its addressable markets with three core areas:

- UK: "Lead and modernise the UK Defence Test & Evaluation enterprise, by working in partnership with government and prime contractors".
- International: "Build an international company that delivers additional value to its customers by developing our home markets, creating new home markets and exporting".
- Innovation: "Invest in and apply our core competence for customer advantage in defence and commercial markets".

Exhibit 9 outlines the addressable markets, including a strategy of growing market share and leveraging strengths into adjacent markets. It is clear that the addressable markets include widening the company's geographic reach. QinetiQ has already started to invest in its business so that it can meet future growth. However, strategic M&A will play its part. QinetiQ currently considers the UK, US and Australia as its home markets, but adding new home markets could prove lucrative. Overall, the international business could grow to be worth 50% of the group from 27% currently and should support operating margins, as overseas business tends to generate higher performance using this metric.

Exhibit 9: QinetiQ market opportunities



Source: Company reports

SSRO and EMEA Services

Operating margin pressure at EMEA Services has been in focus following the Defence Reform Act 2014, which addresses all MOD contracts that are uncompeted. The SSRO is required annually to review the figures used to determine the contract profit rate for pricing qualifying defence contracts. (Full details on the methodology behind the SSRO can be found here.)

Exhibit 10 indicates how the three-year rolling average baseline profit rate (BPR) has declined. Essentially, for new and renewed single-source contracts signed in FY18/19 the BPR will fall by a further 69bp to 6.81% from 7.46% in FY17/18. The SSRO states that "It is important to note that the baseline profit rate (BPR) is the first of six steps that contribute to the calculation of the contract profit rate (CPR)...For each individual contract, adjustments can be made to take account of factors such as risk, performance incentives and capital servicing rates." Hence the rate is only the starting point and companies can earn higher returns through adjustments for risk, capital requirements and good execution of contracts.

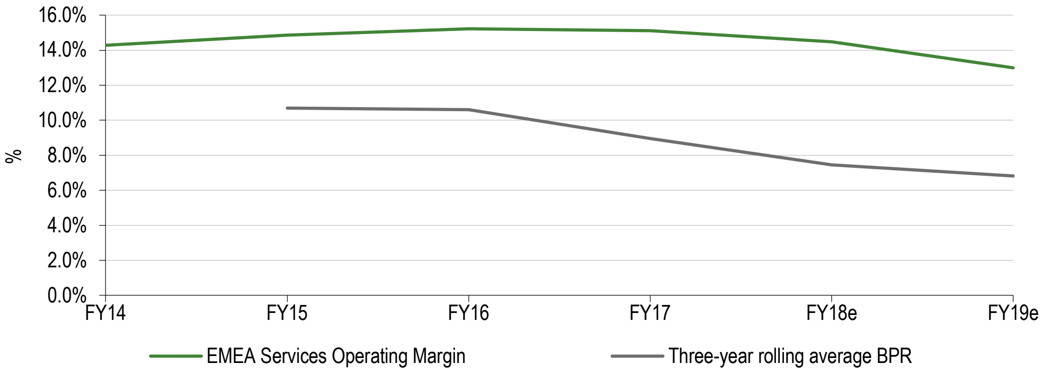
Exhibit 10: Profit on cost of production

Year to April	2014/15	2015/16	2016/17	2017/18	2018/19
Underlying rate (unadjusted for capital servicing)			7.52%	8.39%	9.22%
Capital servicing adjustment			-1.46%	-1.95%	-1.29%
Underlying rate	10.92%	9.88%	6.06%	6.44%	7.94%
Three-year rolling average	10.70%	10.60%	8.95%	7.46%	6.81%

Source: SSRO. Note: The capital servicing (CS) adjustment accounts for different levels of capital employed across the companies in the index.

Around 75% of EMEA Services revenue is derived from single-source contracts, which equates to 88% of QinetiQ's revenue from the MOD. The anticipated repricing of the remaining LTPA contract will be the largest driver of SSRO headwind in FY19, of c £6m from operating profit.

Exhibit 11: EMEA Services operating margin progression (FY14-19e)



Source: SSRO, Company reports, Edison Investment Research

Although we have factored in a further EMEA Services margin decline, we believe that significant further downside is limited for the following reasons:

- Exhibit 11 shows that since the SSRO BPR has been introduced, EMEA Services margins have exceeded the BPR level. As mentioned above, the BPR is only the first of six steps to determine the contract profit rate and QinetiQ is clearly able to deliver margins in excess of the guidelines set.
- An increasing proportion of QinetiQ's revenue is contracted on a long-term basis, which provides some protection from rates falling further in the future. For example, the £1bn 11-year contract amendment to the LTPA was contracted at the FY17 rate. With regard to the LTPA as discussed earlier, subject to a successful negotatiation, by FY19 only c £100m of revenue per year will be subject to annual repricing, hence protecting QinetiQ from feeling the full impact of further BPR declines.
- A key element of QinetiQ's strategy is internationalisation. Export contracts typically provide the opportunity to recognise a higher operating margin than domestic contracts.
- Overall, the rate of decline in the BPR has slowed, suggesting the potential for a longer-term stabilisation in the rate used. Fundamentally, "The SSRO's approach to the BPR is intended to support value for money for the taxpayer and fair and reasonable prices for contractors." While there is a balance to negotiate here, defence procurement benefits from the financial security of its suppliers and their ability to invest for future development.

Market backdrop

QinetiQ has three "home" markets: the UK, US and Australia. We consider defence market dynamics in each of these areas, together with the opportunities globally.

UK (73% of FY18 group revenues)

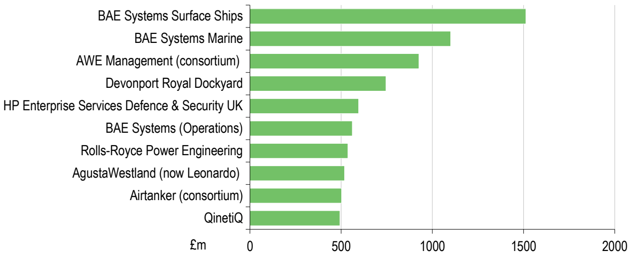
In our update note on the H118 results, we noted that the UK defence market had been under considerable scrutiny. Although it is the fifth largest defence budget globally, ongoing budgetary pressures, a change in defence secretary and a new review launched in January have all kept the spotlight on the sector.

Defence secretary Gavin Williamson intends for the current the Modernising Defence Programme (MDP) to be completed by the summer and is unlikely to be "fiscally neutral." However, the Public Accounts Committee has already made it clear that the current Defence Equipment Plan falls short of requirements. It states that "The Equipment Plan for 2017 to 2027 is not realistic and the Department lacks cost control. A significant affordability gap has again opened up; with forecast costs at least £4.9 billion, and potentially as much as £20.8 billion, more than the £179.7 billion budget...The Department has put its faith in the Modernising Defence Programme to solve its affordability issues and to prepare for the continued challenges of a fast-changing defence landscape, including the UK's capabilities for cyber, chemical, biological, radiological, nuclear and electromagnetic attacks. We are highly sceptical that the Modernising Defence Programme will be able to return the Department to a balanced position."

QinetiQ believes that the outcome of the MDP will "present opportunities and challenges" and it is important to note how closely the company works with the UK MOD today to provide cost-effective and long-term solutions in the current market. With c 62% exposure to the UK MOD, it is understandable that investors want to understand developments here. Exhibit 12 demonstrates QinetiQ's top 10 position as a UK MOD supplier. Exhibit 13 shows the current direction of UK defence spending although, given recent commentary, we expect this to alter. We continue to monitor the situation.

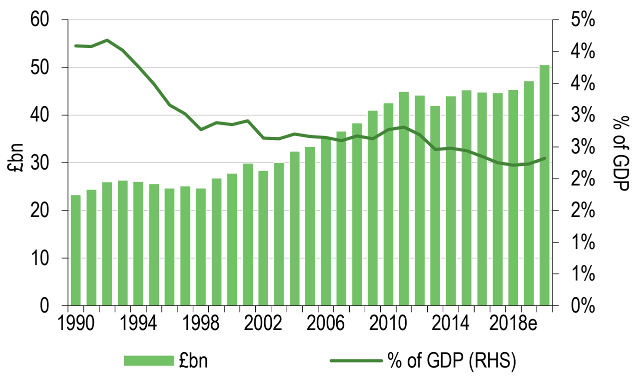
We believe that QinetiQ is continuing to manage things within its control and adapting swiftly to the change in UK MOD procurement that we described earlier. Key to this is longer-term contracts and delivering savings to the UK MOD while reducing margin headwinds. In addition, building the international portfolio from 27% of the group today to closer to half in the medium term will help QinetiQ to reduce its dependence on the UK MOD while leveraging the growth that overseas markets represent. There is also a potential to drive operating margins, as we will discuss later, as international business typically delivers a higher margin.

Exhibit 12: Top 10 recipients of MoD expenditure on defence equipment and support, 2015-16



Source: UK MOD

Exhibit 13: UK government defence spending (in £bn and % of GDP), 1990-20e (before MDP outcome)

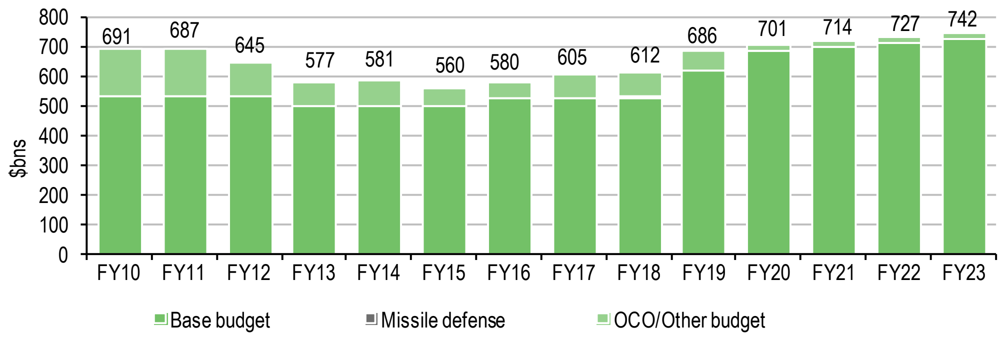


Source: UK MOD

US (10% of FY18 group revenues)

Commentary around the US defence budget is much more positive than for its transatlantic neighbours. The direction of travel of the world's largest defence budget has reversed the declines seen earlier in the decade with reduced overseas operations. Exhibit 14 demonstrates the uplift in FY18 and further into FY19. The FY19 Department of Defense (DO) budget is very much focused on addressing future threats from a position of strength. Hence the required uplift in defence spending is increasingly visible.

Exhibit 14: US DoD funding FY10-23e (Discretionary Budget Authority)



Source: US Department of Defense FY19 PBR documentation

The FY19 budget overview states that "For decades the United States has been uncontested or dominant in every operating domain...Today, all domains are contested—air, land, sea, space, and cyberspace...and therefore requires more lethal, resilient, adaptable, and innovative capabilities in every domain of warfare." The document also asserts that the budget needs a timely appropriation to be fully effective.

We believe that QinetiQ has a great opportunity to leverage the modernisation trend in a growth budget environment. The technological advancements required by the DOD budget include advanced computing, "big data" analytics, artificial intelligence, autonomy, robotics, directed energy, hypersonics, and biotechnology. As we mentioned earlier, QinetiQ was down-selected for the first phase of a robotics contract and we believe the company is well placed to capitalise on future opportunities from the US military and other government agencies.

Modernising T&E capability also has a strong role to play in the US defence budget investment drive, which plays to the heart of QinetiQ's strengths. During FY18 the US Navy ran a complex ballistic missile trial at the Hebrides range. This is another good example of how modernising UK-based facilities makes the service more attractive to international customers.

Australia (7% of FY18 group revenues)

QinetiQ considers Australia a home market and its presence in this market has been enhanced by the acquisition of integrated logistics supporter RubiKon Group in February 2017, now reported within EMEA Services.

The 2016 Defence White Paper set the scene for the current uplift in defence procurement, stating: "We can expect greater uncertainty in Australia's strategic environment over the next two decades as a consequence of: the changes in the distribution of power in the Indo-Pacific and globally; the continuing threat of terrorism from groups like Daesh and from foreign terrorist fighters; the modernisation of regional military capabilities; the introduction of new military technologies such as cyber systems; and the proliferation of weapons of mass destruction and ballistic missile technology."

The budget builds on this white paper and is looking for AUS$36.4bn of spending in FY18. This keeps the government on track for the 2% of GDP target by FY21, which is ahead of the 2013 election pledge. This represents a real increase of 1.3% on last year's budget. The budget works in with the Defence Integrated Investment Plan, National Shipbuilding Plan, Defence Export Strategy and Defence Industrial Capability Plan. This shows that in addition to the increased perceived threat, the Australian Department of Defence is seeking to deliver capability with future defence procurement underpinned by a strategic contracting approach through collaborative relationships with industry.

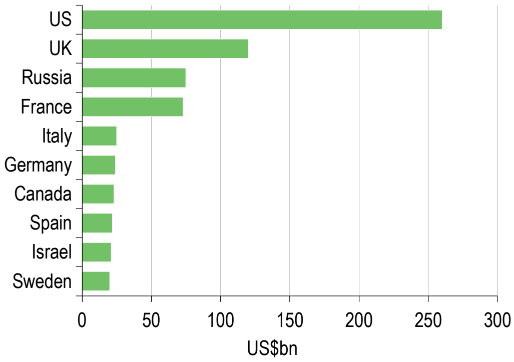
QinetiQ is well-positioned in the Australian market, supported by its RubiKon acquisition, which provides specialised integrated logistics support. The company has won its second T&E facilities contract, providing mine warfare engineering facilities and support at HMAS Waterhen.

Rest of World (10% of FY18 group revenues)

As we mentioned before, international business accounts for 27% of QinetiQ's business today, up from 21% just two years ago. QinetiQ's growth strategy includes taking the products, skills and expertise developed in its home countries into attractive international markets. Thus QinetiQ views its role as a "customer friend" to international customers, providing best advice and support on how to develop indigenous defence and security capabilities. The company is focused on high-growth markets and sees an opportunity to drive operating margin as international business typically delivers a higher margin.

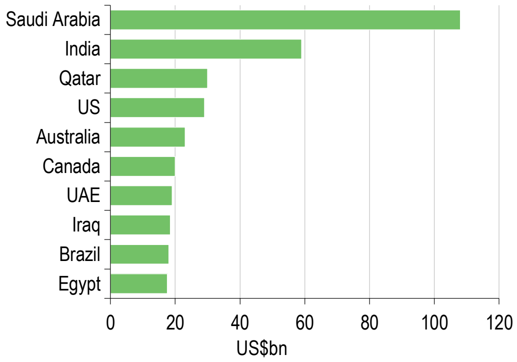
As a backdrop, Exhibit 15 illustrates the UK's strong position in defence exports since 2007, ranking only behind the US, while Exhibit 16 lists the key defence importers in that time frame.

Exhibit 15: Top defence exporters 2007-16



Source: UK Defence and Security Export Statistics 2016

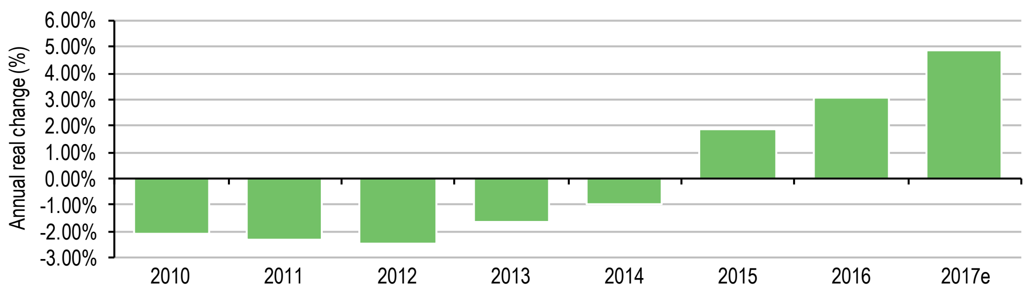
Exhibit 16: Top defence importers 2007-16



Source: Department for International Trade, Defence and Security Organisation

With 25 NATO countries planning to increase defence spending in real terms, the number of countries moving towards the 2% of GDP guideline is increasing. Exhibit 17 reflects NATO's belief that non-US NATO members will continue to see a real increase in their defence spending. With the 2018 NATO summit set for Brussels in July, the message from the secretary general is: "In response to evolving threats, NATO has implemented the biggest reinforcement of our collective defence in a generation... We are also stepping up our efforts against cyber-attacks and hybrid threats."

Exhibit 17: Changes in NATO Europe and Canada defence expenditure



Source: NATO. Note: Annual real change, based on 2010 price and exchange rates.

QinetiQ acknowledges that defence budgets in the Middle East have remained resilient and believes it is well placed in this area through partnerships with local companies and governments. Further east, QinetiQ notes that Singapore, Malaysia and South Korea are all looking to modernise and enhance overall capabilities.

Sensitivities

- UK defence budget: UK defence secretary Gavin Williamson said "In order to secure competitive advantage over our potential adversaries we need to ensure we can move quickly to further strengthen our capabilities." In addition, he said that the outcome would not be "fiscally neutral." The pressures on the UK defence budget are probably the most important factor in the QinetiQ investment case. This keeps the company focused on working closely with the UK MOD to deliver best-in-class services in a tighter budgetary environment.
- Brexit: As defence policy has always remained sovereign under the EU, Brexit is not expected to dramatically alter QinetiQ's position. However, there have been discussions around Galileo and Copernicus satellite systems. Current discussions may drive an increased focus on UK space spending, especially when national security is in focus, which could play to QinetiQ's strengths. For now, QinetQ CEO Steve Wadey has a prefence to stay with the current programmes. Meanwhile, Airbus CEO Tom Enders believes Britain should remain part of observation satellite programmes to "ensure security and defence ties are strengthened for the benefit of Europe as a whole, during a period of increasing threats to our security and geopolitical instability."
- SSRO margin pressure: For new and renewed single-source contracts signed in FY18/19 the BPR will fall by a further 69bp to 6.81% from 7.46% in FY17/18. However, it is very important to note that the rate is the starting point but companies can earn higher returns through adjustments for risk, capital requirements and good execution of contracts. Furthermore, an increasing proportion of QinetiQ's revenue is contracted on a long-term basis, which provides some protection from rates falling further in the future.
- LTPA: Renegotiation is a complex procedure, given the number of sites and personnel involved. Clearly, negotiating the first amendment was a breakthrough for upgrading facilities and should drive increased interest from overseas customers. QinetiQ estimates that over half the UK's T&E budget is currently spent overseas because the UK is not deemed to have the correct facilities.
- Cash conversion: While FY18 cash conversion before capex was 103% (FY17: 96%), this drops to 59% after capex. The company is committed to significant investment under the LTPA amendment. There is some risk in this investment in terms of timing and execution.
- Overseas risk: QinetiQ is dominant in many areas of its domestic footprint, although international markets bring both new competition and new customer dynamics. We believe that QinetiQ has been able to deliver significant growth from this area over the last two years and needs to continue to deliver profitable growth.
- Acquisition integration: Recent portfolio activity has included the acquisition of E.I.S. Aircraft Operations in Germany. We view "value-enhancing acquisitions" as a core element of the company strategy and hence the ability of management to identify and integrate acquisitions purchases is important.

Forecast changes

We have updated our FY19 forecasts following the FY18 report and introduce FY20 estimates (see Exhibit 18). FY18 beat our top-line estimates by 1.2%, providing improved momentum into FY19 and this is reflected in our marginally higher estimates. The company did not provide any change to expectations in the FY18 statement, excluding non-recurring trading items. A £6m profit headwind from SSRO revenue is incorporated in our estimates and we expect FY19 to be the peak impact. Given current order cover levels and end-market dynamics, we are looking for modest revenue growth from both divisions, with some FX impact. From FY20e we see a reduced headwind in EMEA Services profitability as we move past the peak SSRO impact, and further growth in Global Products as the company continues to deliver on its strategy. However, our growth assumptions are modest, and as QinetiQ converts down-selects and delivers against longer-term contracts, this should add predictability to the group. As we discussed earlier, a higher contribution from International should support operating margin uplift.

We have not included the E.I.S. acquisition as it has not yet completed. However, we see a negative cash impact of c £60m for the deal given the price agreed (c €70m). In FY17 (year-end December), Aircraft Operations generated €20.1m revenues and €5.4m EBITDA. We would expect the deal to enhance FY19 EPS by 2-3% and more than 4% in FY20. QinetiQ expects to complete the acquisition in H119 and it will be reported in the International division within EMEA Services.

We have increased our FY19 capex estimate to the top end of the £85-100m guidance and increased our working capital outflow. Our depreciation charge moves up in accordance with this capex uplift. We have reflected the impact of the pension surplus and the fact that cash deficit payments have ceased.

Exhibit 18: Revisions table (FY18-20e)

Year to March (£m)	2018e			2019e			2020e
	Prior	Actual	% change	Prior	New	% change	New
EMEA Services	629.6	651.4	3.5%	642.2	659.2	2.6%	665.8
Global Products	194.2	181.6	(6.5)%	196.2	183.4	(6.5)%	185.3
Sales	**823.9**	**833.0**	**1.1%**	**838.4**	**842.6**	**0.5%**	**851.1**
EBITDA	**143.6**	**151.8**	**5.7%**	**140.7**	**145.8**	**3.6%**	**153.5**
EMEA Services	86.9	94.3	8.5%	83.5	80.6	(3.5)%	83.2
Global Products	25.2	28.2	11.7%	25.9	27.5	6.2%	28.2
Underlying EBITA	**112.1**	**122.5**	**9.2%**	**109.4**	**108.1**	**(1.2)%**	**111.4**
Profit before tax (norm)	**111.9**	**122.1**	**9.1%**	**110.2**	**107.7**	**(2.2)%**	**110.9**
EPS - underlying continuing (p)	**17.1**	**19.3**	**12.5%**	**16.9**	**16.5**	**(2.2)%**	**16.9**
DPS (p)	6.4	6.3	(1.6)%	6.8	6.7	(1.6)%	7.1
Net debt/(cash)	(197.2)	(266.8)	35.3%	(195.8)	(235.9)	20.5%	(268.5)

Source: Company reports, Edison Investment Research

Valuation

We use a cash-based capped DCF valuation, which is, in our view, a conservative basis for estimating cash flow values as it does not assume any growth in the terminal value. While we normalise working capital to zero and capex to equal depreciation, it still eliminates some element of the potential terminal value. On a calculated WACC of 8.0%, the DCF currently delivers a value of 275p, up from our previous value of 241p. This reflects moving the model on by one year, but also an improvement in divisional performance in future years. We have increased our depreciation charge to reflect the capex uplift and removed the pension from the DCF calculation as it is now an asset.

Our new forecasts see QinetiQ currently trading on 16.2x FY19e P/E, ahead of Bloomberg consensus estimates trading on 15.3x. This still represents a discount to the UK aerospace and defence sector and global peers. While our value of 275p represents a 16.7x FY19e P/E multiple, a focus on shorter-term multiples does not fully reflect the strategy change and future growth opportunities, and we see upside for the stock price. As the company grows market share and leverages international opportunities, the improved profitability should support a higher valuation multiple. The benefit of delivering against longer-term contracts should build visibility, while international growth should support operating margin growth. In addition, successful negotiation of the next part of the LTPA amendment should reduce the amount of revenue exposed to annual SSRO impact.

Exhibit 19: Aerospace & defence sector peer multiples

Company	Reporting Currency	Share price	Market cap	EV/Sales (x)		EV/EBITDA (x)		P/E (x)		Div yield (%)	
		(local)	(local m)	Current	Next	Current	Next	Current	Next	Last yr	This yr
QinetiQ Group	GBP	267.6	1,518	1.5	1.4	8.5	8.0	15.6	15.3	2.4	2.7
Avon Rubber	GBP	1450.0	450	2.6	2.5	11.8	11.3	20.1	19.8	0.8	1.1
BAE Systems	GBP	647.4	20,672	1.2	1.1	9.7	9.2	14.9	13.8	3.4	3.5
Cobham	GBP	125.0	2,989	1.8	1.8	12.0	11.0	26.6	19.2	0.0	1.1
Cohort	GBP	350.0	143	1.1	1.1	7.0	6.8	12.0	11.4	2.1	2.3
Chemring Group	GBP	218.0	610	1.3	1.3	9.5	9.1	16.9	15.4	1.4	1.5
Meggitt	GBP	500.0	3,882	2.5	2.4	10.7x	10.2	15.5	14.5	3.2	3.3
Rolls-Royce Holdings	GBP	841.4	15,649	1.1	1.1	10.	9.0	39.9	27.6		1.4
Ultra Electronics Hldgs	GBP	1629.0	1,214	1.7	1.6	10.5	9.7	14.3	13.1	3.0	3.1
UK average				**1.7**	**1.6**	**10.2**	**9.5**	**20.0**	**16.8**	**2.0**	**2.2**
Airbus	EUR	100.5	77,960	1.0	0.9	8.5	7.2	22.5	18.0	N/M	1.7
MTU Aero Engines	EUR	162.3	8,440	2.3	2.0	12.4	11.6	20.0	18.6	N/M	1.6
Safran	EUR	102.4	42,704	2.0	1.9	11.4	9.9	22.8	19.0	1.6	1.7
Thales	EUR	109.6	23,331	1.3	1.1	9.6	8.6	20.6	17.5	N/M	1.8
Rheinmetall	EUR	110.4	4,809	0.7	0.7	6.4	5.8	17.0	14.8	N/M	1.8
FACC	EUR	16.6	759	1.2	1.1	9.5	8.4	18.3	15.4	N/M	1.0
Saab	SEK	375.1	40,227	1.2	1.1	11.2	9.5	21.9	17.6	N/M	1.7
Leonardo	EUR	9.0	5,215	0.7	0.6	5.2	4.9	11.9	9.3	N/M	1.6
Euro average				**1.3**	**1.2**	**9.3**	**8.2**	**19.4**	**16.3**	**1.6**	**1.6**
Boeing Co/The	USD	370.0	215,567	2.2	2.1	15.3	14.3	25.1	21.6	1.6	1.9
General Dynamics Corp	USD	199.7	59,309	1.7	1.5	11.7	10.6	17.9	15.8	1.7	1.8
General Electric Co	USD	14.1	122,333	1.5	1.5	11.0	10.0	15.0	13.4	5.1	3.6
Harris Corp	USD	152.7	18,125	3.5	3.3	15.5	13.7	23.5	19.5	1.5	1.5
L3 Technologies	USD	201.6	15,823	1.9	1.8	13.7	12.5	20.7	18.3	1.5	1.6
CAE	CAD	27.7	7,413	2.6	2.5	11.4	10.7	22.4	20.2	1.3	1.4
Lockheed Martin Corp	USD	316.0	90,224	2.0	1.9	12.5	11.5	19.7	17.4	2.4	2.6
Bombardier	USD	4.9	10,337	1.0	0.8	13.3	9.5	51.9	19.1	0.0	0.0
Northrop Grumman Corp	USD	329.8	57,507	2.1	1.9	14.7	13.1	20.2	17.7	1.2	1.4
Heroux-Devtek	CAD	16.2	586	1.2	1.0	8.3	6.8	18.8	15.2	0.0	N/M
Raytheon Co	USD	206.8	59,410	2.3	2.2	12.5	11.6	21.0	18.2	1.6	1.6
United Technologies	USD	128.3	102,644	1.9	1.8	11.0	10.0	18.0	16.3	2.2	2.3
Rockwell Collins	USD	138.8	22,798	3.3	3.2	14.2	13.5	19.5	18.5	1.0	1.1
Honeywell International	USD	151.9	113,481	2.8	2.7	12.8	12.1	18.9	17.4	1.9	2.0
US average				**2.1**	**2.0**	**12.7**	**11.4**	**22.3**	**17.8**	**1.6**	**1.7**

Source: Bloomberg. Note: Prices as at 12 June 2018.

Exhibit 20: Financial summary

£m	2016	2017	2018	2019e	2020e
Year end 31 March	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS					
Revenue	755.7	783.1	833.0	842.6	851.1
Cost of Sales	0.0	0.0	0.0	0.0	0.0
Gross Profit	755.7	783.1	833.0	842.6	851.1
EBITDA	134.7	145.3	151.8	145.8	153.5
Operating Profit (before amort. and except.)	111.3	118.9	126.2	114.3	118.2
Intangible Amortisation	(2.5)	(2.6)	(3.7)	(6.2)	(6.8)
Exceptionals	(18.4)	15.4	22.7	0.4	0.9
Other	0.0	0.0	0.0	0.0	0.0
Operating Profit	90.4	131.7	145.2	108.5	112.3
Net Interest	(0.2)	(0.2)	(0.4)	(0.4)	(0.4)
Profit Before Tax (norm)	108.6	116.1	122.1	107.7	110.9
Profit Before Tax (FRS 3)	90.2	131.5	144.8	108.1	111.9
Tax	8.4	(8.2)	(6.7)	(14.6)	(15.7)
Profit After Tax (norm)	95.8	103.8	109.0	93.1	95.4
Profit After Tax (FRS 3)	98.6	123.3	138.1	93.5	96.2
Average Number of Shares Outstanding (m)	587.0	573.9	565.2	564.9	564.9
EPS - normalised (p)	16.3	18.1	19.3	16.5	16.9
EPS - normalised and fully diluted (p)	16.2	17.9	19.2	16.4	16.8
EPS - (IFRS) (p)	16.8	21.5	24.4	16.5	17.0
Dividend per share (p)	5.7	6.0	6.3	6.7	7.1
Gross Margin (%)	100.0	100.0	100.0	100.0	100.0
EBITDA Margin (%)	17.8	18.6	18.2	17.3	18.0
Operating Margin (before GW and except.) (%)	14.7	15.2	15.2	13.6	13.9
BALANCE SHEET					
Fixed Assets	317.4	384.1	414.5	480.9	503.6
Intangible Assets	81.4	142.5	142.6	141.1	139.6
Tangible Assets	233.4	238.8	269.0	336.9	361.2
Investments	2.6	2.8	2.9	2.9	2.9
Current Assets	453.8	587.8	779.0	757.3	793.6
Stocks	19.0	28.9	38.1	42.1	39.3
Debtors	129.9	143.5	117.4	116.3	119.9
Cash	274.5	221.9	266.8	235.9	268.5
Other	30.4	193.5	356.7	363.0	365.9
Current Liabilities	(383.9)	(372.0)	(349.8)	(339.1)	(342.2)
Creditors	(383.9)	(372.0)	(349.8)	(339.1)	(342.2)
Short term borrowings	0.0	0.0	0.0	0.0	0.0
Long Term Liabilities	(62.5)	(67.3)	(99.4)	(99.1)	(98.7)
Long term borrowings	0.0	0.0	0.0	(0.0)	(0.0)
Other long term liabilities	(62.5)	(67.3)	(99.4)	(99.0)	(98.7)
Net Assets	324.8	532.6	744.3	800.1	856.3
CASH FLOW					
Operating Cash Flow	182.4	113.6	117.2	128.3	155.4
Net Interest	(3.5)	(0.2)	(0.2)	(0.4)	(0.4)
Tax	(17.3)	(4.1)	(0.3)	(14.6)	(15.8)
Capex	(30.2)	(32.9)	(54.5)	(107.9)	(68.1)
Acquisitions/disposals	27.4	(65.7)	(1.6)	0.0	0.0
Financing	(48.6)	(48.1)	(0.7)	0.0	0.0
Dividends	(32.3)	(33.4)	(34.5)	(36.3)	(38.5)
Other	1.1	18.2	19.5	0.0	0.0
Net Cash Flow	79.0	(52.6)	44.9	(30.9)	32.6
Opening net debt/(cash)	(195.5)	(274.5)	(221.9)	(266.8)	(235.9)
HP finance leases initiated	0.0	0.0	0.0	0.0	0.0
Other	(0.0)	0.0	(0.0)	0.0	0.0
Closing net debt/(cash)	(274.5)	(221.9)	(266.8)	(235.9)	(268.5)

Source: Company reports, Edison Investment Research

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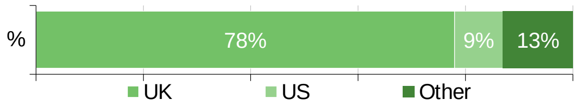
Revenue by geography (FY18)



Management team

Non-executive Chairman: Mark Elliott

Appointed non-executive chairman in March 2010, Mark was a non-executive director from June 2009. Previously, he was a non-executive director of G4S, where he was the senior independent director and chairman of the Remuneration Committee, from September 2006 until May 2016. He was a non-executive director of Reed Elsevier Group (and chairman of its Remuneration Committee) and Reed Elsevier NV from April 2003 until April 2013. Mark worked for IBM for over 30 years where he occupied a number of senior management positions, including general manager of IBM Europe, Middle East and Africa, and was a member of IBM's worldwide Management Council. He is also chairman of Kodak Alaris Holdings.

Chief executive officer: Steve Wadey

Appointed CEO in April 2015, Steve is a fellow of the Institution of Engineering and Technology, a fellow of the Royal Aeronautical Society and a fellow of the Royal Academy of Engineering. He was previously co-chair of the UK Defence Growth Partnership, a member of the Prime Minister's Business Advisory Group, co-chair of the National Defence Industries Council Research & Development Group, and a non-executive director of the UK MOD Research and Development Board. Steve held various roles with MBDA from 2001 to 2014, most recently as MD, MBDA UK and technical director for the MBDA Group. Before that, he held various roles in engineering with Matra BAe Dynamics from 1996 to 2001, and various roles with British Aerospace between 1989 and 1996. Steve is chair of the Defence Industry Liaison Board of the UK Department for International Trade, Defence & Security Organisation.

Chief financial officer: David Smith

Appointed CFO in March 2017, David was CFO and a director of Rolls-Royce Holdings from November 2014, having joined the company in January 2014 as CFO of the Aerospace division. Prior to Rolls-Royce, David was CFO and a board member of Edwards Group from 2010 to 2013 and CEO of Jaguar Land Rover from 2008 to 2010, having been CFO and interim CEO in 2008 and, from 1983 to 2008, held a variety of roles with Ford Motor Company. During the year under review, David ceased to be an Advisory Board member for the Warwick Business School. He is a non-executive director of Motability Operations Group.

Principal shareholders	(%)
Silchester International Investors	5.08%
Schroder Investment Management	4.23%
The Vanguard Group	4.21%
Newton Investment Management	4.10%
Pendal Group	3.49%
Norges Bank	3.44%
BlackRock	3.30%

Companies named in this report

Avon Rubber, BAE Systems, Cobham, Cohort, Chemring Group, Meggitt, Rolls-Royce, Ultra Electronics, Airbus, MTU Aero Engines, Safran, Thales, Rheinmetall, FACC, Saab, Leonardo, Boeing, General Dynamics Corp, General Electric Company, Harris Corp, L3 Technologies, CAE, Lockheed Martin, Bombardier, Northrop Grumman, Heroux-Devtek, Raytheon, United Technologies, Rockwell Collins, Honeywell International

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