News Release

Rolls-Royce

Trusted to deliver excellence

12 November 2015

ROLLS-ROYCE HOLDINGS PLC
UPDATE ON OPERATING REVIEW
AND INTERIM MANAGEMENT STATEMENT

Rolls-Royce is today announcing the initial findings of Chief Executive Warren East's review of operations, an update on the outlook for 2015 and implications for 2016. Highlights include:

- **Fundamentally strong portfolio of products and services providing highly differentiated power systems**
  - Opportunity to develop high market shares, strong cash flows and higher returns on capital employed
  - Sustainable barriers to entry through embedding engineering excellence in long-life world-class products

- **Further market headwinds increase uncertainty for 2016**
  - 2015 guidance unchanged but profit expected to be at lower end of range
  - Negative outlook reflects sharply weaker demand in 2016, including in wide-bodied aftermarket, corporate and regional aerospace markets and offshore marine

- **2016 profit headwinds increase to around £650m; cash flow largely unchanged**
  - Impact of TotalCare product mix changes outlined in July unchanged at £250m
  - Further modest revenue reductions on a high fixed cost base highlight increased sensitivity to market-led revenue changes
  - Cash flow expected to be more consistent year-on-year principally because cash flow is not impacted by TotalCare accounting adjustments in 2015 and 2016
  - Shareholder payments policy will be reviewed by the Board and changes, if any, will be announced in due course

- **New wide-ranging restructuring programme to be implemented from 2016**
  - Major programme to simplify the organisation model, streamline senior management, reduce fixed costs and add greater pace and accountability to decision making
  - Work will enhance plans underway to improve our management information, forecasting and business systems
  - Incremental gross cost savings of £150-200m per annum, with benefits accruing from 2017 onwards
  - More details to be provided on 24 November 2015

- **Financial liquidity is strong, supported by a healthy balance sheet**

Warren East said: *"While 2015 remains broadly as expected, the outlook for 2016 is very challenging. The speed and magnitude of change in some of our markets, which have historically performed well, has been significant and shows how sensitive parts of our business are to market conditions in the short-term.*

"At the same time I remain very confident about the opportunities before us and convinced that our long-term outlook is positive. Our industrial transformation is proceeding well and our core large engine business remains on track to gain significant market share and build a strong, cash generative platform for the future.

"The next few years are going to be important in laying the foundations for our long-term profitable growth. Therefore it is important to ensure we are financially stronger, more resilient to short-term shocks and more flexible to take advantage of growth opportunities. My operating review has already highlighted a number of areas where I believe Rolls-Royce can make fundamental changes to its structure and ways of working that can generate material improvements to the business. Rolls-Royce is already undergoing significant change, but I am convinced these new actions are vital if we are to invest sensibly and grow, well into the next decade and beyond."

<u>Further market headwinds increase uncertainty for 2016</u>

2015 Guidance unchanged but profit expected to be at lower end of range

Trading during the third quarter was satisfactory, despite a mixed operating performance in several markets. Overall performance expectations for 2015 remain unchanged, although there have been developments in aerospace and marine markets that have created additional headwinds. For 2015, these should be largely mitigated by a number of positive developments, including cost saving measures; however the headwinds are likely to impact 2016 more than previously expected. A more detailed report on the third quarter and 2015 guidance is included in Appendix A.

Negative outlook reflects sharply weaker demand in 2016

Compared to the expected outturn in 2015, the key areas of demand weakness are affecting selected aerospace and offshore marine markets. In aerospace, these mainly relate to the themes emerging in the third quarter, including sharply lower volumes of corporate jets powered by Rolls-Royce engines, further weakness in demand for corporate jet aftermarket services, further significant declines in aftermarket service demand for our engines on 50-70 seat regional jets and more conservative assumptions on demand reductions for some legacy programmes. Together, these impacts on our corporate and regional business account for roughly £100m of our incremental profit headwind.

Expected demand for new wide-bodied engines remains unchanged from that set out in the summer. Rolls-Royce continues to gain market share in installed thrust and as a result, we should benefit from increased demand in the year for our aftermarket services. However, we have begun to see reduced utilisation by some specific operators of older wide-bodied engines. This management of short-term excess capacity, as the market takes delivery of newer, more fuel efficient airplanes, is already starting to impact aftermarket revenue and profit. Together with other changes, the incremental profit headwinds for our wide-bodied engine business are expected to be roughly £100-150m.

In addition, offshore marine markets have continued to deteriorate throughout the year and, as a result, 2016 forecasts have weakened further. As a result, we are setting expectations to reflect a further 15-20% decline in offshore marine market demand, weakening marine profit by a further £75-100m.

Changes in product mix and pricing weakness will weigh on Aerospace margins

As indicated in our 30 July 2015 half year results announcement, the reduction in Trent 700 engine deliveries in 2016 and 2017 is expected to have a marked effect on profit performance as a result of reduced volumes and pricing. As principally a linked engine programme, the profit impact is exacerbated by the relatively high initial profit recognition on original equipment deliveries for what has been a long-standing successful engine programme. This effect is further exacerbated by a change in mix to unlinked engines as we ramp up production of the new Trent XWB for the Airbus A350. As a result, overall we expect the percentage of unlinked large engines, on which no upfront profit is recognised, to grow in the year from around 33% to 40%. The impact on cash, which is unaffected by linked accounting, will be significantly less.

Profit headwinds in 2016 increased to £650m; cash flow largely unchanged

Our preliminary view on 2016 is materially impacted by these new headwinds, together with the changes in demand outlined in our 6 July 2015 update and repeated in our half year results on 30 July 2015. These included around £250m of profit headwinds related to lowered volume and pricing expectations for our Trent 700 programme, which are unchanged, combined with a further £50m related to our corporate jet and regional aftermarket businesses, both of which have since weakened further.

As a result, expectations are that profit headwinds may be around £650m compared to 2015. Many of the headwinds impact higher than average margin segments of the business, or businesses where fixed costs are relatively high. As a result, the profit fall through is significant.

Commenting on this, Warren East added: *"One of the fundamental findings of my operating review is that, as a business, we carry too much fixed cost and are inflexible in managing this in response to changes in market conditions. This is unacceptable in a world-class business that, as I've said before, needs to be more resilient and sustainable."*

Despite the year-on-year profit impact, cash flow is expected to be more consistent year-on-year principally because cash flow is not impacted by the TotalCare accounting adjustments in 2015 and 2016 and the benefit of further working capital improvements, particularly within inventory management.

Existing performance improvement programmes on track for further savings in 2016

Our announced performance improvement programmes remain on track for delivering £115m of year on year cost savings for Aerospace and Marine in 2016, led by significant headcount reductions and plant rationalisation. In Aerospace, the supply chain transformation and roll-out of best-in-class manufacturing facilities will deliver further capacity in 2016. However costs related to the double-running of facilities while this transformation takes place will continue to remain a headwind until the multi-year investment programme has been completed.

At this stage, the decision has been taken not to provide comprehensive guidance for 2016 or to reiterate or replace medium term guidance as set out by previous management.

Shareholder payments

As a result of the developments set out above the Board of Rolls-Royce will consider changes, if any, to Rolls-Royce's policy related to its payment to shareholders. A further update will be made at the appropriate time.

New wide-ranging restructuring programme to be implemented from 2016

The review of operations undertaken since July has resulted in a programme of proposed changes to improve long-term performance and help enhance management information and processes.

Proposals for major structural changes are being finalised for implementation during 2016. These will simplify the organisation model, streamline senior management, reduce fixed costs and add greater pace and accountability to decision making. This wide-ranging cost reduction programme will target incremental savings of around £150-200m per annum, with the benefits accruing from 2017 onwards, while maintaining key investments in capital equipment and R&D.

While the broad scope of the programme has been developed, more work needs to be done to finalise the implementation timetable and overall cost. Further updates will be included in the update on our operating review on 24 November (see below) and at our Full Year Results in February.

Financial position remains strong with enhanced liquidity

There have been no material changes to the balance sheet position of the company since the last update. In the last three months we raised a further £1bn in debt to replace maturing facilities and enhance liquidity for general financing purposes over the next few years. As a result, Rolls-Royce's balance sheet remains strong.

Capital Markets Presentation planned for 24 November 2015

As previously communicated Warren East, Chief Executive of Rolls-Royce and David Smith, Chief Financial Officer, will be hosting a presentation on the afternoon of 24 November to outline the initial findings of their ongoing operating review of Rolls-Royce's businesses, setting out key findings and priorities for the business.

The event will be held in the UK at etc.venues, 200 Aldersgate, near St Pauls, London, EC1A 4HD, and full webcasting facilities and web-based question and answer capabilities will be used for those who are not able to attend in person. Please contact Jacinta Francis (jacinta.francis@rolls-royce.com) in the IR team at Rolls-Royce if you are interested in attending. Numbers will be limited.

Full Year Results for 2015

We will report the Group's 2015 Full Year Results on 12 February 2016.

<u>Conference calls for 12 November 2015</u>

<u>08:30 (UK) 12 November</u>

Warren East, CEO, and David Smith, CFO, will host a conference call and Q&A from 08:30 to 09:30am UK. Please find details of our conference call below:

Participant dial in details:

UK Standard:	**+44 (0)20 3364 5937**
UK Toll free:	0808 2389714
US standard:	163 163 852 56
US Toll free:	1866 793 4273
Participant PIN:	**944432#**

Please access the WebEx via the following link using the event password: 375282
https://arkadin-event.webex.com/arkadin-event/onstage/g.php?d=707525838&t=a

<u>16:00 (UK) 12 November</u>

Warren East, CEO, and David Smith, CFO, will host a conference call and Q&A from 16:00 to 17:00 UK. Please find details of our conference call below:

Participant dial in details:

UK Standard:	**+44 (0)20 3364 5937**
UK Toll free:	0808 2389714
US standard:	163 163 852 56
US Toll free:	**1866 793 4273**
Participant PIN:	**401547#**

Please access the WebEx via the following link using the event password: 375291
https://arkadin-event.webex.com/arkadin-event/onstage/g.php?d=707015337&t=a

For further information, please contact:
<u>Investors:</u>

John Dawson, Director / Head of Investor Relations
Helen Harman, Assistant Director, Investor Relations
Ross Hawley, Assistant Director, Investor Relations

Tel: +44 (0)207 227 9237
investor.relations@rolls-royce.com

<u>Media:</u>

Richard Wray, Director of External Communications

Tel: +44 (0)20 7227 9163
Richard.Wray@Rolls-Royce.com

Appendix A – Third Quarter Update and 2015 Guidance

Trading during the third quarter was satisfactory, despite a mixed operating performance in several markets. Overall performance expectations for 2015 remain unchanged, although there have been developments in aerospace and marine markets that have created additional headwinds. For 2015, these should be largely mitigated by a number of positive developments, including cost saving measures, however the headwinds are likely to impact 2016 more than previously expected.

Overall, **Aerospace** delivered a steady quarter with growth in the order book, improved engine delivery performance and progress on supply chain transformation.

Order intake has remained robust. During the third quarter, we announced around $3.5bn of new orders, including new business with Saudia, IAG and Vietnam Airlines. We also introduced TotalCare® Flex with Cathay Pacific as its first customer. This innovative service will provide enhanced end-of-life engine management to maximise the performance of our installed engine fleet.

We continued the transformation of our industrial base in the quarter with a £60m investment programme at Inchinnan, Scotland, and plans to establish production facilities in Poland to support our accessory gearbox joint venture with Hispano-Suiza (Safran). Since the end of the quarter, we have announced a major modernisation programme at our aerospace manufacturing facility in Indianapolis, US. This will generate significant cost savings while providing a world-class manufacturing platform to support our North American business.

Within **Land & Sea**, Power Systems had a steady quarter, helped by a strong opening order book position. Nuclear also maintained steady progress. Our Marine performance continued to be impacted by weakening offshore markets and continued deferment or cancelation of orders. Overall, Land & Sea progress was in line with full year expectations, although weakness in the off-shore market continues to adversely impact the business. As a result, while expectations for the full year remain unchanged, the risk of further deterioration remains high in 2016.

Although many Land & Sea businesses had good order intake in the quarter, the offshore business intake was very weak. New contracts included MT30 gas turbines for the Royal Navy's Type 26 Global Combat Ship, MTU diesel engines for the refit of the Royal Navy's fleet of Type 23 Frigates and a new agreement for the supply of engines for a range of Sunseeker luxury yachts.

Since the end of the quarter we have announced a further restructuring programme within our Marine business. This will focus on reducing corporate and administrative costs, including a 400 reduction in headcount – in addition to the 600 announced in June – with most of the early savings being reinvested in increased R&D to strengthen the competitive position of the business.

Full Year guidance for 2015 is unchanged

Group guidance for 2015 is unchanged from 30 July, albeit profit performance is now expected to be towards the low end of the range. Excluding adverse foreign exchange translation effects (estimated at £500m on revenue and £10m on profit) we expect to be as follows:

Full Year 2015 Guidance *Group, at constant 2014 FX*	**2014 Actuals** ***(excluding Energy)***	**2015** **Guidance**
Revenue	£13.9bn	£13.4bn - £14.4bn
Profit before tax	£1,620m	£1,325m - £1,475m
Free cash flow	£447m	£(150)m - £150m
Earnings per share	65.4p	55 – 62p
Capital expenditure*	£649m 4.7% of revenue	~ £600m
Net R&D spend	£819m 5.9% of revenue	> £750m
Tax rate	24%	23%

* Defined as capital additions to property, plant and equipment

At a **business** level guidance is also unchanged from 30 July:

Full Year 2015 Guidance *Businesses, at constant 2014 FX*	**Revenue**	**Profit before finance charges and tax**
Aerospace		
Civil Aerospace	£7,000m - £7,300m	£800m - £900m
Defence Aerospace	£1,900m - £2,100m	£360m - £410m
Land & Sea		
Power Systems	£2,500m - £2,750m	£200m - £250m
Marine	£1,450m - £1,650m	£0m - £40m
Nuclear	£670m - £730m	£40m - £50m

About Rolls-Royce Holdings plc

1. Rolls-Royce's vision is to create better power for a changing world via two main business segments, Aerospace and Land & Sea. These business segments address markets with two strong technology platforms, gas turbines and reciprocating engines. Aerospace comprises Civil Aerospace and Defence Aerospace. Land & Sea comprises Marine, Nuclear and Power Systems.

2. Rolls-Royce has customers in more than 120 countries, comprising more than 380 airlines and leasing customers, 160 armed forces, 4,000 marine customers, including 70 navies, and more than 5,000 power and nuclear customers.

3. Our business is focused on the 4Cs:

    - Customer – placing the customer at the heart of our business
    - Concentration – deciding where to grow and where not to
    - Cost – continually looking to increase efficiency
    - Cash – improving financial performance.

4. Annual underlying revenue was £14.6 billion in 2014, around half of which came from the provision of aftermarket services. The firm and announced order book stood at £76.5 billion at 30 June 2015.

5. In 2014, Rolls-Royce invested £1.2 billion on research and development. We also support a global network of 31 University Technology Centres, which position Rolls-Royce engineers at the forefront of scientific research.

6. Rolls-Royce employs over 54,000 people in 50 countries. Over 15,500 of these are engineers.

7. The Group has a strong commitment to apprentice and graduate recruitment and to further developing employee skills. In 2014 we employed 354 graduates and 357 apprentices through our worldwide training programmes. Globally we have over 1,000 Rolls-Royce STEM ambassadors who are actively involved in education programmes and activities; we have set ourselves a target to reach 6 million people through our STEM outreach activities by 2020.