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Transcript: FY24 results update and Type 31 contract update conference call

Wednesday 17 July 2024

Lockwood
Chief Executive Officer

Good morning. Hello and thank you for joining the call this morning. As you will have seen today, we issued an update on our results and on the Type 31 contract. And yesterday, the Board finished its final review of the results and all the final programme estimates. And we wanted to take the opportunity to give you as much early transparency as we could before we get to the full prelims next week.

So, we are obviously still in closed period. So, we will tell you as much as we can, recognise that we're in closed period and not actually doing the full prelims. So, what do I think you should take how do I think we're doing? If you go back to the Capital Markets Day, we talked about the platform we were building, the strong growth opportunities, the opportunities to expand margin, the naturally cash-generative nature of the business, and if you look at the underlying results, all of those have come through building strongly on last year's performance. I think that's a really positive.

I think the other really big positive for me is when David and I started nearly four years ago, we talked about the, if you like, the real balance sheet, not just what's in the accounting balance sheet, but all the things off balance sheet: window dressing, then the finance -- the last one left really is pensions, sitting off the balance sheet, and David will talk about it more. And it's right that he does because he's led the charge on this.

But we have made really good progress with the pensions, both in reducing the off-balance sheet liability, but also reducing the annual charge. And I think a bit like we've done with our customers, changing the relationship we have with trustees so that we now have a shared vision of what good looks like for our pensioners and the schemes themselves. So, I think that's best, really good news in terms of future cash flows, and if you like, the holistic balance sheet.

In terms of the actual balance sheet, the strong cash flow has taken debt down, so that we're now at 0.8x on a calculation basis, the use for net debt. So that's also really strong.

So, when I was a growing chap, probably the most important boss in my career once said to me, never look at a business through your weakest programme or you'll misunderstand that, but never ignore your weakest programme. So, we can't look at the whole business without looking at Type 31. So, I'll remind you, we've said for four years, our destiny, we set 50% in the contract. We set 30% in how we mobilise and 20% then in how we either reap the benefits or have to manage the problems.

The truth of Type 31, as we've said repeatedly, is the terms are not terms that we would not take, but where we've taken onboard risks, we can't easily manage or in some cases, manage at all. We then tried to mobilise during COVID and latency in that are a number of issues which are only surfacing as we go into the deep production phases. So now we're in the 20% of actually really trying to make the best of what we've got on.

So, in the year, operation -- and again, I'll let David do the numbers as is tradition -- in the year, we've effectively with some external, some large external help, deconstruct programme under every line of every cost item, and then rebuilt it, re-understood the learning curve, made sure that that the gaps which have been occurring, we understand the programme fully. So, we've got into a really, I think, much greater understanding of what it takes. The downside of that is that we've identified -- cost driven by engineering overrun.

And also last year, we talked about the inflationary cost on labour. Our contract protects us to CPI, but labour costs, particularly in Rosyth area are significantly above CPI, and that was not anticipated last year. So, two big things there. The upside is, when we look at the programme now and we look at the -- say, the latter ships, the ones which drive the affordability of the product for export markets, whether we build or someone else builds are actually our core estimate of what those ships cost hasn't really moved that much. What's moved just the cost of getting there.

So, the price hasn't really changed that much. But the cost of getting to the price has undoubtedly gone up. There obviously still remains risk. We have an integrated combat system. So, we're not saying we're completely out of the word, but the range of outcomes has definitely narrowed.

So -- and the other thing is, I don't know you'll know this, but to the extent we have improvement plans, you only bank improvements as they occur, when you can see a cost, you bank the entire cost. The day you see it from a P&L point of view, even though you pay it out over the next five years, the programme. So, accounting in that sense is quite asymmetric between risk and reward.

So, we haven't given up on and have found quite a few things that could take the programme forward in us in a better way, that are yet to be mature enough to bank. So, with all of that as an -- actually, the only other thing I'd say is, just to -- again for Type 31 in context, it's about 5% or 6% of our revenue and about 5% or 6% of our workforce. So those really important. And while it's causing us pain, it's really important. Yeah, we shouldn't judge the company by that programme.

David Mellors

Chief Financial Officer

Okay. Thanks very much, David, and good morning, everyone. So, these are the results that we will be announcing next week at the prelims. The audit is largely complete, and we don't expect any changes from the figures we have here.

I'll start with the cash flow and balance sheet numbers as these are not impacted by the Type 31 charge, and then we'll come on to the P&L in a moment.

So, I'll start with free cash flow. Free cash flow was £160 million. That's significantly ahead of expectations with good working capital performance being enhanced by some early customer receipts. And within that £160 million free cash flow, is an accelerated £35 million of pension contributions, which I'll come back to in a moment. So, significantly stronger cash flow. This has helped us reduce net debt to £435 million or £211 million excluding leases.

And the gearing ratio, as David mentioned earlier, is down to 0.8x. So significant balance sheet strengthening in the year.

On the pensions point I mentioned, we have made significant progress in the year in reducing the overall deficit and de-risking the outcome. So as many of you know, we have three large UK defined benefit schemes in the tail of smaller ones, and we've reached agreements with the trustees of two of the three large schemes in the last few months on long-term funding arrangements.

And these plans give better visibility and predictability of the scheme for both pensioners, trustees, and obviously, the Company. And there are many details in all of this. But fundamentally, the material points are, as a result of the £35 million accelerated contribution that I mentioned before, one of these three schemes has now reach self-sufficiency. And therefore, we don't expect to make any further contributions to that scheme. And we expect it will be able to manage its own way to buy in or buy out in years to come.

The second scheme arrangement covers amongst other things, the closure to future accrual of the scheme, which is our last big scheme that was open as well as a long-term funding arrangement.

So, what does all of that mean? That means on an actuarial basis, the total aggregate deficit comes down from an estimated £400 million last year to an estimated £200 million at the year-end FY24. And the annual cash contributions dropped from all what we've said previously at £65 million down to £40 million. So, immaterial reduction.

So on to the income statement then. So, revenue grew 11% organically, with particularly strong growth in Nuclear and Land sectors, a continuation of what you saw at the half year. So very strong in both of those sectors.

Underlying operating profit was £238 million. But as this statement shows, this included two things: a £90 million charge on Type 31, which I'll come back to, and also profit on the sale of a property of £17 million, all of which completed in the year. So, cash in the bank, et cetera, but it's -- still, it's a one-off.

So, if we look at the result excluding those two items on the go-forward basis, the underlying operating profit would be £311 million or a margin of 7%, and that comparator for FY23, as we presented last year, would be £265 million or 6.6% margin. So, progress on revenue, profit, and margin underlying.

And the profit growth was driven by three of the sectors, actually: Nuclear, Land, and Aviation sectors. We'll give you more detail on those at the preliminary results, but good progress in all three of those.

And so on to the Type 31 charge taken at the year end. So, we've rebuilt the forecast cost of the programme, working with external consultants as well as with the new group functions of engineering, supply chain, and project management, which we've told you about before and you met at the Capital Markets Day. This has been a detailed bottom-up rebuild of the forecast costs to go. And the £90 million is the total impact over the life of the programme, all of which we've recognised in FY24, although the cash impact of that £90 million will be incurred over the life of the contract.

And the two main impacts or changes in the forecast going forward that generate that £90 million are the maturing of the design and the labour rates, as David said. We are also planning some future productivity improvements and potentially continuation of the contract, but they are not included in the accounting in FY24, although we expect to generate some benefit over the life of the contract that will be recognised as it comes rather than upfront. So that's the Type 31 charge and the recognition during the year.

And just to round off the results, having reintroduced the dividend at the interims, we will be proposing a final dividend of 3.3p, giving a full year dividend of 5p. in line with our capital allocation policy.

So that's the summary of the results for the year.

David Lockwood
Chief Executive Officer

So as a wrap up, I think David and I have broadly said the same thing. So, intuition of tell them what you're going to say tell them and then tell them what you told them, I think we don't take Type 31 lightly. It's very important that -- we get -- we, having narrowed the band about something we absolutely know the programme. So, we're not taking it lightly. But if you look at the results, actually, we've made significant progress, generated significant free cash despite Type 31. So, we also need to keep it in context.

If you look back at your Capital Markets Day presentations, then I think the really positive thing is this, other than Type 31 is very in line with everything we told you, which is, consistency is a pretty important thing in our world. So that's really good. And to be honest, David and I are looking forward to seeing you next Friday when we can fill you in with all the colour that we can't tell you now.

So, with that, we will open the floor to questions, bearing in mind, as I said at the beginning, we are in closed period and therefore, we can't answer the questions that we will be able to answer next Friday, which is not a way of discouraging questions. This is just managing your expectations. Next Friday, being July 26, just to be clear?

Q&A Session

Samuel Burgess - Citigroup

Morning, guys. Thanks for taking the question. And so, I'll start with the obvious question, in that, what's your level of confidence here that this is the last charge you'll be taking on Type 31. And it's my understanding that the programme will be significantly derisked after delivery of the first ship. Do you have any update on the likely timing of first float for Type 31? Thanks.

David Lockwood

Yeah. So, one of the interesting things, and we'll talk about it more on the 26th -- one of the interesting things about having deconstruct the programme and really, really got to understand it is that one of the things we understand much better is the relative cost and risk of things like out of sequence work, but also the relative efficiency of doing work in the shared or work afloat.

And what it really proves, in a nutshell is, we want to do as much work as possible in the shed. So really, you don't want to move Boat 1 out until you need to get Boat 3 in -- Ship 3 in. So, part of the reprogramming is to is to deemphasise getting a float because actually it's much more efficient to be in the shed. And as you can imagine, in the shed, you've got -- you're surrounded by scaffolding with floors. If you came, you would see -- if you've been or seen in the pictures, but all of your access points, the moment you're afloat, your access points reduce. It's not about stability, it's very stable, but your access points reduce. Therefore, you're about to get stuff on and off the ship reduces. So, one of the things we have done in the reprogramming is to deemphasise floats off and emphasising sequence working.

Samuel Burgess - Citigroup

Got it. Thanks.

Chloe Lemarie - Jefferies

Yes, good morning. Thank you for taking my question. I'd actually have a -- one on free cash flow performance. If you could help us understand the breakout between what was timing versus in your underlying beat, please?

David Mellors

Yeah, sure. So, this is all about working capital. You will remember that we've said previously, the working capital, we've made huge progress on in recent years and there's some risk of reversal. And we telegraphed that that could be over the next couple of years, a few tens of millions. And but that didn't happen during the year. So, the risk is still there, but didn't happen. So, we manage that. So that was a few tens.

And about -- I would say the other half of the increased performance was due to the early payment of customer debtors, which obviously takes it out of one period and into the other outflow rather have cash early, but you only get it once. So that is straight timing.

Everything else, CapEx, tax interest, all the other line items were pretty much as we expected them to be. And the only other moving part, obviously, is that the £160 million included the £35 million accelerated pension payment, as I said earlier.

Chloe Lemarie - Jefferies

And fair to assume that the early payment of debt is obviously mainly towards forward from fiscal '25, right?

David Mellors

Yeah. Exactly. So that that by itself would just come out of FY25. The other two moving parts for FY25. Obviously, the cash impact of the £90 million charge is recognised over the remaining life. So, you need to think about that. But also on the plus side, the pension payments going forward at £25 million lower every year. So that would be a positive for FY25. I've seen you take all those three things into account. So, would FY25 be more H2-weighted likely? Does that mean FY25 isn't achievable?

No, it doesn't. So, we should be -- we should still be okay for FY25 cash.

Chloe Lemarie - Jefferies

Very clear. Thank you.

James Beard - Deutsche Bank

Thanks. Morning, guys. Just one question going back to Type 31. Are you able to give us some colour around what has -- what if anything has changed in that labour market in Rosyth over the last 12 months rather when you were last devising cost assumptions that Type 31?

David Lockwood

I guess there were a couple of things I'll pick out. David, maybe a couple of others. Three things. Firstly, demand front, we expected demand from competing -- people who compete for that resource to plateau, and it hasn't, number one. Number two is the inflation profile that we have when we set this provision isn't the one that played out. And therefore, wage settlements generically were higher than CPI.

And finally, the framework we thought we'd have for non-UK workers has taken longer to enact than we thought. So that first cut in the end, it's a supply and demand thing, and it's taking us longer to get supply to where we need. And the demand in the region is higher.

But David, will pick up. Anything to add?

David Mellors

No, I think that's it.

James Beard - Deutsche Bank

All right. Thanks.

Joe Brent - Liberum

Good morning, gentlemen. Three questions, if I may.

David Lockwood

Yeah. But one at a time, Joe. Remember, we're old.

Joe Brent - Liberum

Me too. But, okay. One at a time it is. Firstly, on the -- you talked about profit on disposal. Could you tell us what the cash on disposal is and tell us that's not in the free cash flow guidance.

David Mellors

Yeah. So £20 million with a profit of £17 million, all received in year. So is in the cash flow number.

Joe Brent - Liberum

It's in the free cash flow direction number?

David Mellors

Yeah.

Joe Brent - Liberum

Okay. Secondly, my sense is, numbers are probably going up a little bit today, which, to your perspective, where numbers could be a bit higher?

David Lockwood

I think that's a conversation for next Friday. That's not something we can comment on in close.

Joe Brent - Liberum

Okay. And finally, for now on the pension, I think we originally expected £65 million, and additional £35 million, that's £100 million in, which accounts presumably for half the reduction from £400 million to £200 million. Is that math, right? And what's the other £100 million?

David Lockwood

So, there's a number of things in the rest of the reduction. We've done a number of de-risking things and obviously there's investment performance as well. All of the detail we'll give you next week. But things like closure to future accruals obviously reduces overall deficits. So that's probably one of the big ones. We've mentioned before that we do several liability management measures, that's probably the most material, there's investment performance, there's contributions. So, they're probably the big three.

David Mellors

Okay. But the ones that are so high, I would like to start -- sorry, can I just reiterate the ones outside contributions, which are just in our guest, how those play out are driven by the relationship between the Company and the trustees, and targeting what -- I have an agreed view of what's in the interest of the members of the scheme and being able to do those other things is a function of completely changing our relationship with the trustees. That didn't -- that wasn't magic, that was three or four years of hard work.

David Mellors

Good morning. Thank you for taking the question. Two, please. Just firstly, on the labour cost issue, are you seeing any similar cost pressures outside of side and are they specific to the area? That's the first one.

David Lockwood

Okay. So, thank you for separating them as well. The answer is there are two issues. One is, is there a cost pressure. And the second is who pays the big issue on Type 31 is under the contract we pay for everything above CPI. So, it's not just with the cost pressures, the pace for the cost structures. That is a big area. It's probably one of the higher areas of cost pressure, but also, is one where we pay. That's the combination of the two.

Joe Brent - Liberum

Okay. Thank you. And the second one is on the Nuclear growth. Is this being driven by nuclear infrastructure spending? And if so, how do you expect this to trend in the future, in particularly FY25?

David Mellors

Yeah, sure. So, we'll give you the numbers next Friday. But yes, that's one of the three things we -- if you remember at the half year, we said there are three things in the Nuclear sector, all going forward. So, there was infrastructure revenue, and it did increase. So that is a big one. The submarine support work was also increasing at the half year. And that continued all the way through the second half. And also, the civil Nuclear business grew again as we expected. So, all three areas went forward, which obviously drove the extremely strong revenue performance in Nuclear.

And the profitability on the infrastructure, we'll give you more detail next week. It will be a sisable number next year. I'll give you more of a steer next week. It will largely be down to timing as to roughly how much it will be. But it will be a similar order of magnitude. Might be a bit lower, but a similar order of magnitude.

David Lockwood

Great. Thank you.

Operator

There are no further questions on the conference line. Now I'll hand back to David Lockwood for closing remarks.

David Lockwood

Yes. Well, thank you, all, for taking the time. I recognise that this kind of call is quite frustrating, because you can't ask and we can answer them easy questions, but I'm looking forward to having given you 10 days to prepare those meaty questions the next Friday. So, we can have a really enjoyable session when we meet up then. So, we look forward to seeing you then. And with that, enjoy the rest of your day.

ENDS