Finance Director's review

Paul Heiden, Finance Director

We are focused on improving cash flow returns on invested capital. We expect returns to grow as a result of the management of margins and enhanced utilisation of assets.

Improving returns
Rolls-Royce achieved underlying double-digit earnings growth, while increasing investment in new product development. Order book, turnover and underlying profit were, again, at record levels. While a combination of factors is expected to result in unchanged underlying earnings in 2001, the company is confident that growth will resume in 2002.

Results for the year
Underlying profit before tax was £436 million, up 18 per cent over 1999. Underlying earnings per share grew by 10.8 per cent, to 21.63p.

Group turnover increased by 27 per cent to £5,864 million (1999 £4,634 million), largely as a result of the inclusion of a full year's turnover in respect of the businesses acquired towards the end of 1999.

Civil aerospace sales grew by 24 per cent. This included growth in aftermarket sales of 27 per cent.

Defence sales increased by 23 per cent as a result of the inclusion of a full year of Vickers Defence Systems.

Marine sales grew by 95 per cent, reflecting the enlarged business following the acquisition of Vickers.

Energy sales were unchanged, reflecting delays in sales of the industrial Trent and the depressed oil and gas markets, offset by the contribution from acquisitions.

Financial services sales increased by 8 per cent, reflecting the increasing maturity of these businesses.

The company maintained its position as a leading UK exporter, with 82 per cent of sales delivered to overseas customers.

Underlying trading margins, before restructuring and non-trading items, and after the net impact of risk and revenue sharing partners, reduced from 16.7 per cent to 15.4 per cent, as a result of the increased loss in the energy business and the lower defence profits.

The interest charge increased from £53 million to £123 million. This reflected the higher level of average debt which resulted from the acquisitions made in 1999 and the growth in the financial services businesses, the gross assets of which are primarily funded by debt.

Group interest was covered 5.7 times, based upon underlying profit before interest, excluding joint ventures.

An exceptional provision of £120 million was made to cover the costs associated with the introduction of new combustion technology on the industrial Trent. Of this, £55 million was utilised during the year. The balance is expected to be utilised in 2001.

The Group made an underlying profit before tax of £436 million (1999 £368 million). After including exceptional and non-trading items, profit before tax was £166 million (1999 £360 million).

A final dividend of 5.00p per share is proposed, making 8.00p per share for the year, an increase of 10.3 per cent over 1999. The dividend is covered 2.7 times by underlying earnings and 0.7 times after exceptional and non-trading items.

The number of Group employees reduced by 5,900 during the year.

The firm order book was £13.1 billion (1999 £11.5 billion). In addition a further £1.4 billion had been announced but not yet included in the order book (1999 £1.7 billion). Total care packages for aftermarket services represented almost ten per cent of the order book. These are long-term contracts where only the first seven years' revenue is included in the order book.

Investments

The company has continued to invest to create future value.

Gross research and development investment amounted to £604 million (1999 £626 million). In previous years, net research and development was stated after crediting certain receipts from risk and revenue sharing partnerships. All such receipts are now reported as other operating income. On the revised basis, net research and development was £371 million, an increase of £34 million, which was largely attributable to acquisitions.

Investment in training amounted to £27 million.

Capital expenditure, excluding investments in financial services businesses was £186 million, including £35 million invested by the newly acquired businesses.

Investment in financial services businesses amounted to £67 million. These sums represent investments in businesses which are expected to produce increasing returns.

Underlying pre-tax return on average capital employed	%
1996	11.9
1997	14.2
1998	15.8
1999	17.0
2000	**17.8**

Capital investment	£m
1996	143
1997	229
1998	368
1999	412
2000	**253**

Capital expenditure Project and sales finance

Net research and development (restated)	£m
1996	217
1997	268
1998	310
1999	337
2000	**371**

The company invested £74 million in restructuring and rationalisation programmes. Ongoing restructuring, of £49 million was charged against cost of sales and included within the calculation of underlying earnings. Excluded from underlying earnings was £16 million spent on restructuring acquired businesses crystalising the benefits of acquisition synergies, and £9 million of rationalisation costs, which represents the first charges against the £150 million the company has indicated it will spend as part of a fundamental reassessment of the business structure. The company is identifying opportunities to accelerate this programme, bringing forward returns. It is likely that half of these rationalisation costs will be incurred by the end of 2001.

The company invests only in projects which create value and expects the cash flow return on investment to improve. This will result from growing margins, as the business mix improves and cost reductions are secured; improved working capital efficiency, through the implementation of new enterprise resource planning systems; and stable expenditure on fixed assets, as output levels stabilise following a period of rapid growth.

Cash

The Group cash flow statement is shown on pages 40 and 41 of the financial statements.

Net debt for the year reduced by £4 million, following a significant cash inflow in the second half of the year, as net working capital reduced. Year end net debt was £690 million (1999 £694 million). The company attaches greater significance to the average net debt level, which reduced, as expected, on a comparable basis from £390 million to £335 million. After taking into account the impact of acquisitions, average net debt was £1,323 million (1999 £573 million).

The level of average net debt is expected to continue to reduce in the future.

Net cash flow from operating activities was £479 million (1999 £359 million). Major uses of funds were capital expenditure and investments in financial services businesses.

Provisions for liabilities and charges increased by £98 million, largely as a result of the £120 million industrial Trent provision.

Taxation

The overall tax charge on the profits before tax was £83 million (1999 £74 million), a rate of 50 per cent (1999 21 per cent). This relatively high overall Group tax rate is mainly due to the impact of goodwill charged against profits for which no tax relief is available. The rate is also affected by losses in certain overseas businesses for which tax relief will only be available against future profits in the same jurisdiction. No relief has been taken for such losses in the accounts.

The tax charge on underlying profits at 22.8 per cent reflects the benefit of timing differences where full deferred tax has not been provided, and the writeback of Advance Corporation Tax (ACT) of £18 million, written off in previous years. The remainder of the Group's previously unrecognised surplus ACT has been offset against UK corporation tax payable in the balance sheet.

Acquisitions and disposals

The fair value adjustments relating to newly acquired businesses, which were reported provisionally in the 1999 accounts, have been finalised. This has resulted in an overall increase to fair value adjustments of £33 million, with a corresponding increase in goodwill.

The company disposed of several businesses during 2000 to further enhance the focus on its core activities.

During the year the company sold or announced the closure of its materials handling businesses. This resulted in a loss of £73 million, including a charge of £40 million for goodwill previously written off against reserves.

The bulk of Vickers Turbine Components was sold in December for £77 million, representing net assets of £56 million, costs of £4 million and £17 million goodwill. Cash relating to this disposal was received in 2001.

Other disposals included: Cochran Boilers, which resulted in a loss of £1 million; and a £3 million final adjustment in respect of the sale of transmission and distribution businesses. The company reduced its effective holding in NEI Africa from 35 per cent to 24 per cent.

Accounting policies

FRS 15 tangible fixed assets was implemented in 2000.

The Accounting Standards Board has issued three new standards. FRS 17 retirement benefits has a phased implementation, beginning in 2001 for disclosure, with full implementation in 2002. FRS 18 accounting policies will be implemented in the 2001 financial statements. FRS 19 deferred tax becomes mandatory for 2002 financial statements.

The implementation of UITF 24, Accounting for Start-up Costs, has resulted in a change of accounting presentation for aero-engine certification costs. These were previously included in prepayments and are now treated as intangible fixed assets.

Risk and revenue sharing partners (RRSPs) are a standard form of cooperation within the civil aerospace industry. Partners share in the investment in new programmes and share the risks associated with such programmes in return for a reward based on future programme revenues.

The company has simplified its accounting presentation in respect of RRSPs. All receipts from RRSPs will be recorded as other operating income. In the past, receipts from partners have been treated as either credits to research and development or to turnover depending on the nature of the participation agreement. Payments to risk and revenue sharing partners continue to be recorded within cost of sales.

Aftermarket services

The company has responded to the market demand for a comprehensive range of aftermarket services. Increasingly, the company is selling Total Care packages, covering long-term support for customers' engines. This is leading to an increase in long-term contracts where the engine maintenance agreement may be linked to, and entered into at the same time as, the original equipment sale. In such cases, the original equipment sale and support activities, including the sale of spare parts, will form part of the same long-term contract. The pricing of such contracts differs from conventional engine sales and reflects the long-term nature of the contract. Profit will be taken progressively on a prudent basis and any amounts recoverable on these contracts are included in debtors.

Risk management

The Board has established a risk management committee with accountability for the system of risk management and reporting the key risks and associated mitigating actions. A Director of Risk Management, reporting to the Finance Director, has been appointed.

The risk management process complies with the Turnbull committee guidance on internal control, issued in September 1999. This brings together the various risk management and audit activities throughout the company, including Business Assurance, which carries out internal audit duties.

Treasury management

The Group uses various financial instruments in order to manage the exposures that arise in its business operations as a result of movements in financial markets. The Group does not trade in financial instruments for profit generation. All treasury activities are focused on the management of risk. There have been no significant changes in the Group's policies in the last year. The main risks continue to be movements in foreign currency exchange rates, interest rates and commodity prices. The Board regularly reviews the Group's exposures and risk management and a specialist committee also considers these in detail. All such exposures are managed by the Group Treasury function, which reports to the Finance Director and which operates within written policies approved by the Board and within the internal control framework described in the report of directors.

Foreign exchange

The Group is exposed to movements in exchange rates for both foreign currency transactions and the translation of net assets and profit and loss accounts of foreign subsidiaries.

The Group does not hedge the translation effect of exchange rate movements on the profit and loss account or balance sheet as it regards its interest in overseas subsidiary companies as long-term investments.

The Group is exposed to a number of foreign currencies. The most significant transactional currency exposure is the US dollar followed by the Euro. US dollar income, net of expenditure, represents 37 per cent of the UK turnover.

The Group seeks to hedge its transactional exposure using a variety of financial instruments with the objective of minimising the impact of fluctuations in exchange rates on future transactions and cash flows.

The permitted range of the amount of cover taken is determined by the written policies set by the Board, based on known and forecast income levels. The forward cover is managed within the parameters of these policies in order to achieve the Group's objectives, having regard to the Group's view of long-term exchange rates.

US dollar cover extends for periods up to eight years, while Euro cover extends for periods up to four years. The majority of cover is in the form of standard foreign exchange contracts, although some cover, primarily of longer duration, includes instruments on which the exchange rates achieved may be dependent on future interest rates. The Group also writes currency options against a portion of the unhedged dollar income at a rate which is consistent with the Group's long-term target rate. The premium received from the sale of the options is included in the Group's achieved rate. Total US dollar cover approximated to four years' net US dollar income at December 31, 2000 (1999 two and a half years).

The result of this policy has been to maintain a relatively stable long-term foreign exchange rate.

Credit risk management

The Group's policy is to monitor and manage its exposure to counterparties. Credit limits are set to cover all financial instruments for each counterparty. The Group policy is that it is exposed only to those counterparties that have a long-term credit rating of A3/A- or better.

Interest rate risk

The Group has historically managed its exposure to interest rates by using interest rate swaps to change fixed rate borrowings into floating rate borrowings in order to match rates achieved on short-term deposits and cash at bank. The Group has a net debt position as a result of acquisitions undertaken during late 1999. The acquisitions were originally financed by a £1 billion syndicated loan facility on a floating rate basis. In order to secure the longer-term financing of the Group, two fixed rate bonds of £200 million and €500 million were issued with maturities of 16 and seven years respectively. The balance of the Group's exposure to interest rates is managed via a combination of fixed rate borrowings, interest rate swaps and interest rate caps.

Commodity risk

The Group has an ongoing exposure to the price of jet fuel arising from business operations. The Group's objective is to minimise the impact of price fluctuations. The exposure is hedged in accordance with parameters contained in a written policy set by the Board. Hedging is conducted using commodity swaps that extend for periods up to four years.

Asset value guarantees

In civil aerospace markets, manufacturers will, from time to time, guarantee a portion of the future value of aircraft. This assists customers in financing the purchase of products. Rolls-Royce has a strong track record in managing the risks associated with asset value guarantees and has experienced no material losses from such obligations. As part of the management of these risks, the Group has taken the prudent step of insuring the gross exposure to asset value guarantees associated with a portfolio of Trent-powered Boeing and Airbus aircraft. Rolls-Royce has been able to develop this innovative arrangement as a result of recent developments in financial markets.

Contingent liabilities

Note 27 to the accounts describes the Group's contingent liabilities under sales financing arrangements. These have increased to £184 million (1999 £118 million), reflecting the growth of the Group's civil aerospace business and the mix of products sold. The directors regard the possibility that there will be any significant loss arising from these contingencies as remote.

Shareholder value

The Group continues to subject all investments to rigorous examination of risks and future cash flows to ensure that they create shareholder value. All major investments require Board approval.

The Group has a portfolio of projects at different stages of their lifecycles. Discounted cash flow analysis of the remaining life of projects is performed on a regular basis to compute the value which underlies the Group's market capitalisation.

During the year Rolls-Royce shares fell by 7.4 per cent from 214p to 198.25p per share, compared to a 5.4 per cent fall for the aerospace and defence sector and a ten per cent fall for the FTSE 100.

The company's shares ranged in price from 161p in September to 261p in May. In September the company fell out of the FTSE 100 index but regained its place in December.

The number of shares in issue at the end of the year was 1,569 million, an increase of 24 million of which 6.6 million related to share options and 17.6 million related to scrip dividends.

The average number of shares in issue was 1,558 million (1999 1,506 million). Underlying earnings per share were 21.63p, an increase of 10.8 per cent over 1999. The proposed final dividend per share will result in a total payment of 8.00p per share, an increase of 10.3 per cent over 1999.