

Melrose

Capital Markets Day Q&A
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Melrose

Chris Dyett, Investor Relations

Peter Dilnot, COO, Melrose

David Paja, CEO GKN Aerospace

Matthew Gregory, CFO GKN Aerospace

Geoffrey Martin, CFO Melrose

Simon Peckham, CEO Melrose

Questions From

Mark Davies Jones, Stifel Nicolaus Europe

Rory Smith, UBS

Martin Wilkie, Citi

Jonathan Mounsey, Exane BNP Paribas

Andrew Hollingworth, Holland Advisors

Matt Pickering, Select Equity

Andrew Wilson, JP Morgan

Questions and Answers

Chris Dyett, Investor Relations

Hi everyone. So welcome to the Q&A part of the proceedings, I'll just wait for the guys to get seated. We have got plenty of time for Q&A, about 33 minutes' worth to be fair and then straight away afterwards we have drinks.

A little bit of housekeeping, if you could state your name and where you work that would be great – for the record.

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Mark Davies Jones, Stifel Nicolaus Europe

Thanks, David mentioned this briefly, I know it's a long way away, but can we talk a little bit more about how you're positioned for the next generation of engines? And particularly, if that technology roadmap as you see it today has scope for more GKN content, or indeed less GKN content in those new generations of engines?

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David Paja, CEO GKN Aerospace

Yeah, that's a great question. I mean I've covered the two main narrowbody next generation engine developments in the presentation, the next generation GTF from Pratt and Whitney and the Rise engine for CFM. We are actually the only partner on the demonstrator phase today and that is a very, very good leading indicator to our position relative to what will happen in the future.

Those are two engines that aim for step changes, or step improvements in fuel economy and emissions reduction, 20%. So substantial technology leaps. And we are really honoured to be considered as the partner for both.

We cannot disclose exactly the content that we have on those programmes, but we can say that we are at the heart of innovative designs that build on our capabilities that I've explained today, such as the fabrication that's one, but not the only one. And we have a track record with those customers in terms of decades of successful partnerships. So we believe that we're very well positioned with the combination of our longstanding relationship and the technology precision on those demonstrators.

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Chris Dyett, Investor Relations

Thanks, David. Mark a follow up?

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Mark Davies Jones, Stifel Nicolaus Europe

Can I ask one slightly different one, you've mentioned capex, but are there any spikes within that longer term trend. I mean clearly, you're seeing very strong growth on the engine side and you're taking out quite a lot of manufacturing plants. Are there other areas where you're going to have to reinvest more in the near term than that long term trend?

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Chris Dyett, Investor Relations

Matthew, one for you, I think.

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Matthew Gregory, CFO GKN Aerospace

Yeah, sure. Look I mean from our perspective we don't see a significant need for capex over and above what we have laid out in our forecast of 1 to 1.2 times capex to depreciation. I think it's fair to say that we will be investing in those programmes that are ramping up, so particularly around the narrowbody, but around widebody, you know we're clearly below the pre COVID levels, so we've got that Defence, relatively low growth and the business jets is already at the prior level. So I think we've got the capacity and we've built in the capex to get that growth.

In terms of the sites, yes, we have restructured the sites, but you know that doesn't mean we've lost the capacity, it's only when we've exited programmes. And in fact we have, as David said earlier, we have been investing in capital to improve technology and throughput as well.

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Chris Dyett, Investor Relations

Thanks, Matthew.

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Mark Davies Jones, Stifel Nicolaus Europe

Thank you.

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Chris Dyett, Investor Relations

This might be easier Mark if you pass the microphone one forward to Rory who caught my eye.

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Rory Smith, UBS

I have three questions if I may. The first question, if I think about the old margin targets, 14%+ on recovered revenues and the targets that you've given today, 17 to 18% for Aerospace, clearly you always used to say that you never gave targets that you weren't comfortable in beating, I

think this is a fairly considerable amount of beat. But thinking about the new targets just how conservative are you being there?

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Chris Dyett, Investor Relations

Peter, I think possibly one for yourself and then Geoff to add in too.

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Peter Dilnot, COO, Melrose

Yeah, you're right I mean it is a material upgrade and also of course from where we are today, we're talking about doubling profits a couple of times. But the targets we put out there are comprehensive and specific, and we are not going to do that as you suggest unless we're really confident about hitting them.

I think beyond that I'd make a couple of points. I think the first is, just to reiterate actually what Geoff said, which is if you break it down, and we have in quite a lot of detail today, but stepping all the way back, about 70% of the profit improvement between '23 and '25 is actually from the market growth. And so if you believe in you know what's happening in terms of OME build rates, there are a lot of strong backlogs there, but also engine flying hours, that will come through. And I don't want to belittle actually what the team has to do to deliver that ramp up, but the reality is that market growth will come through to us automatically, given our platform positions.

And then the other 30% is on business improvement projects, initiatives that are well under way, we have got positive momentum that hopefully has come across today, and also frankly got a very good track record of delivering such improvements. So I think that takes care of sort of the 2025 piece.

To your point about – I think you're hinting about what comes beyond that, I think it's really worth reinforcing that although we are hinting to the fact – of which you've Engines, After Market coming through more strongly and the Structures going up to double digits, just to be really clear our focus is on those 2025 numbers. And we have said we can get this business to £1bn of EBITDA in due course, that's nearer than perhaps some thought, but right now we're not going to be talked up, or we don't want to be giving any more targets before 2025. They are comprehensive, clear, and we've got confidence in hitting them, and that is our focus.

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Chris Dyett, Investor Relations

Thanks, Peter.

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Geoffrey Martin, CFO Melrose

In terms of relating back to our previous targets, I mean we put in the trading statements last week that we would achieve our 14% target next year, so we would achieve that as a run rate. So it was time to update that.

I would think of it less as a blended margin target now, the 17%-18% and I would think of it more now as the margin target for Engines and Structures, because you can see they are very different here. And I think the reason that it's gone from 14% to 17%-18% is less about a sort of four-point uplift, like for like, it's much more about the mix effect. And you have clearly seen here that the Engine business is coming through fastest with the CAGR, but also it is still only on the foothills of that After Market, which comes through at the richest margin.

So I would point you much more to modelling it based on the two individual margins than a blended margin from here, because that's what makes it richer.

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Rory Smith, UBS

Great, thank you. And my second question is on supply chain health, to what extent do you, or are you able to monitor the financial strength of individual suppliers, I think it was 100 plus on that slide, and to what extent is supply chain finance a lever that you can pull to enable that healthy supply chain behind you, feeding into yourselves and then into the OEMs?

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David Paja, CEO GKN Aerospace

Maybe I'll start with a comment on the supply chain situation overall and maybe Matthew if you want to add on supplier finance. Well in general, well the first thing is we're not facing any problems with customer deliveries, so we're supporting the ramp up of all the different customers and platforms providing the parts in advance. So we are in a pretty healthy position vis a vis our customers and helping the ramp up, so that's a great place to be.

But it doesn't mean it goes without challenges, everybody knows that supply chains are still quite challenging these days. And things have improved in some commodities, but we still see troubled areas. I would probably point out castings and forgings continue to be a problematic area in terms of supporting the ramps and things around electrical distribution systems, connectors have been also a little bit troublesome, so those are probably the two areas. But we are managing that obviously very, very carefully and proactively and that is why we are supporting the ramp ups of all our customers without problems.

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Chris Dyett, Investor Relations

Thanks David, Matthew, anything to add?

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Matthew Gregory, CFO GKN Aerospace

Sure, and on the supply chain finance side, yeah, we have comprehensive programmes that we speak to our suppliers about regularly, so that is something we are very used to using and continue to want to push that forward as well.

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Rory Smith, UBS

Great thank you. And just one quick final one from me. Is any of your After Market business and I know this won't apply to RRSPs, but is any of it exposed to generics, PMAs, used serviceable materials, anything like that? Substitution from generic parts in the After Market?

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David Paja, CEO GKN Aerospace

Well the parts that we make, as we have explained they are – I mean they last the full life of the engine, right. So they are not parts that need to be replaced in scheduled maintenance, right, so to that extent I would say no.

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Rory Smith, UBS

Brilliant, thank you.

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Peter Dilnot, COO, Melrose

Perhaps can I just add to that very specifically in terms of what David on our parts, on the additional parts around parts repair we are building up a capability to repair other peoples' parts. And on that in particular it takes quite a long time to actually get the certifications for that. And as David said, we have got those certifications for now the three main geographies that we need to be in, but there is a huge you know shortage of really good supply here. So we are building our capability into that, but that is more on the third-party side.

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Chris Dyett, Investor Relations

Thanks Peter and thanks Rory. Let's go to Martin here and then we'll got to Jonathan behind afterwards.

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Martin Wilkie, Citi

Just a question coming back to your opening comment that you would have to consider if you got a bid for the whole of the Aerospace business. I think last year you said that you either wouldn't or couldn't separate the two divisions if there were to be a sort of portfolio choice amongst the two of them, is that still the case? And if they can't be separated is that pension, tax, shared services, you know what would stop you from looking at the two separately.

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Simon Peckham, CEO Melrose

The answer to your question is we could separate them if we wanted to. So there is no tax or particular pensions issue that would stop us separating them. But just because you could doesn't mean you should. So the answer to your question is no, we have no intention of separating them. So if there was to be an interest in buying Melrose in the next few months, whatever happens, you know that's fine, we're happy to sell at the right price, we always have been. but we have no intention of breaking them into bits.

There is an industrial logic in keeping them both together, I think size actually is relevant in Aerospace, by the way, but also from a technology point of view, I think what you have been hearing is the technology goes across both businesses and actually there is no distinction desire to separate them.

What you couldn't do is separate the Structures, Civil and Defence, which may be what you are talking about. So within the Structures we couldn't split Civil and Defence, there are two many shared sites. But Structures and Engines, absolutely we could split if we wanted to, but we just don't.

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Martin Wilkie, Citi

Thank you. Can I have an unrelated follow up just on cash. On one of the slides there was a comment about 13% working capital to sales, but if we think about the progression of the Engines business and if all these parts don't need to be replaced because they are put on the engine at the beginning, then presumably the working capital in the Engines business is going to come down as a percentage of sales over time. I just wanted to see – or am I reading too much into this, that the intensity of the Structures business is going up, I just want to make sure I sort of understand those dynamics?

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Chris Dyett, Investor Relations

Geoff, one for you to start with and then Matthew.

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Matthew Gregory, CFO GKN Aerospace

There isn't sort of a mix dynamic within that sort of 13%, I think you're probably just going a bit too far out actually in terms of the numbers.

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Geoffrey Martin, CFO Melrose

Yeah, the targets we go for are all for sort of 2025. Engines just gets better and better on cash, we haven't hidden away from that, you can model it yourself. So ratios get better, yes.

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Martin Wilkie, Citi

Thank you.

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Chris Dyett, Investor Relations

Thanks, Martin, if you could reach over your left shoulder and pass to Mr Jonathan Mounsey.

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Jonathan Mounsey, Exane BNP Paribas

Thank you. Just a follow up on capital allocation. Obviously traditionally Melrose is buy, improve, sell, it looks like obviously we're treating it far more now as an Aerospace and going concern business, although if someone wants to offer a good price, we are willing to sell. What about acquisitions? Traditionally it has been buy, improve, sell, now would the rationale for an acquisition be different within this vehicle to what it was traditionally?

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Simon Peckham, CEO Melrose

Look, I think what we said quite clearly here is we are not going to do an unrelated activity. So what Melrose has done in the past is go looking for underperforming engineering business and we have bought two simultaneously and dealt with them, we are not going to do that. So that part of the previous behaviour is over and permanently over. So we are not going back to here we think for a number of reasons, shareholder value point of view, you know a pure play Aerospace business is where you want to be, and we don't want to dilute that.

In the immediate future, we don't see any material Aerospace acquisitions either. The job for the next 12 months is to sort this business out, get the cash flows working and coming back to shareholders. Now whether if you look forwards in two to three years' time there will be very – certainly there will be some differences in the people talking to you in two to three years' time.

I am dubious personally, but you shouldn't rule it out – so what you've got is actually – in a way we'd have the same problem I suspect MTU currently has, which is a very high performing Engines business and why would you want to dilute that by looking elsewhere in the Aerospace market. But that will be a problem for someone else.

So categorically no unrelated acquisitions, ever, you know ever is a big word, but you know what I mean. And secondly no material Aerospace acquisitions in the foreseeable future.

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Jonathan Mounsey, Exane BNP Paribas

Maybe an unrelated follow up. Very impressive on the Engine side, the margins, the margin potential, the target, on the Structures side and this is from memory, so I may be wrong, but it feels like ten years ago, the Structures business, probably around the time that Engines was bought by the previous managements, margins weren't so very different to what the target for 2025 is, you know Melrose – the improve bit, you know why is it proving difficult? Are you actually sitting on more margin upside than you're communicating today when it comes to Structures, has something changed in that industry? Clearly Defence was on the charts there, it's a problem, why isn't the margin potential of this business under your control, I mean Structures here, better?

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David Paja, CEO GKN Aerospace

I'll take that one, yeah. So the first one to say is that on Structures we were talking about the 2025 margin target, which is 9%, so we've hinted at obviously going higher beyond that. The reason, there are a couple of reasons why Structures got a bigger impact through COVID. One is, remember we are still way below pre pandemic levels, in terms of build rates and we already have a little bit of a capacity – and over capacity issue going into the pandemic. So as long as the widebody volumes don't recovery, etc, etc, we have to deal with the over capacity and excessive footprint, in particular too many roof tops. And that is what we are doing. So that will be completed in the next 12 months.

And the second piece is inflation, in particular in Defence with contracts that are fixed price contracts. That takes a little bit of time waiting for the repricing window to compensate for that. But I personally have no doubt that this is a high-class, high-quality Structures business that will have you know the best margins in that space.

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Jonathan Mounsey, Exane BNP Paribas

Maybe one last one on Structures. You had the chart – well actually there was some pictures, it showed I think Western Approach, well as I remember it with the autoclaves and the construction of the wings, that's the A350 if I remember rightly?

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David Paja, CEO GKN Aerospace

Yeah.

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Jonathan Mounsey, BNP Paribas Exane

And then you were showing what it would have to look like to do this at higher volume, A320, my remembering of Western Approach was it was a very expensive capex project. If we are going to move to do this at high volume on say A320, I imagine it could be even more expensive. You know how does that investment that would be needed to be involved in that transition, because

you're obviously going to lose aluminium wing structures through that transition. How is that factored into this cash story?

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David Paja, CEO GKN Aerospace

Yeah, so you're talking about a case where there is a new wing development for the A320 in the future, so that will require capex. That is clear. We don't see that happening, certainly not in the 2025 timeframe. For new aircraft it's going to be maybe later in the decade or into the next decade. But that will require capex.

The new process approach is much more modular, remember we are removing all the autoclaves which are substantial you know high capex intensity types of equipment. We are going to a scalable manufacturing cell, more kind of automotive style type of assembly that is more modular and more cost effective. And so when we go to those rates without having to use autoclaves, I think we're in a much more capex efficient situation. But no doubt every time you have a big wing programme or new aircraft programme there is capex to be put in it.

And look with regards to Western Approach the capital that we have put in, I mean there are going to still be years and years of A350 volumes. So I think we'll get that back.

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Chris Dyett, Investor Relations

Thanks, Jon for your questions.

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Jonathan Mounsey, Exane BNP Paribas

Thanks,

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Chris Dyett, Investor Relations

Next questions? I can't see anybody with their hand up, wave harder if you have got your hand up. Oh drinks are coming sooner than I thought. In the centre there, the lights in my eyes are making it a little hard.

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Andrew Hollingworth, Holland Advisors

Hi, just one quick question. Can I just ask a quick question, you specifically talked about share buybacks, in the past obviously the company has done special dividends and share buybacks, could you maybe just talk about - I mean obviously the share price has gone up a good amount since the split, it will likely go up more as the market digests what you have explained to them. Do you definitively want to cancel shares and therefore buy your shares back, or are you the

same as you were in terms of looking at share price to consider share buybacks or special dividends?

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Simon Peckham, CEO Melrose

Look, I think how technically you do it is a fair debate. I mean actually what Melrose did in the past is not actually special dividends, we actually effectively consolidated the capital and took it away. Partly that was down to George Osborne who said shareholders couldn't any longer choose which route they wanted to go down, so blame the Tories for that one.

But from our point of view if you look forwards, so I mean what we're trying to tell you is - look this is a billion EBITDA business, we're not giving a precise timetable of that, but we know we're at £870m, we expect in 2025. What valuation do you want to put on that? I mean in a way we're trying to put a rough idea for you.

But in Aerospace terms, I mean 10, 12 times EBITDA, I mean you can argue for higher than that. I'm talking to Aerospace experts, so you can come to your own views, but that is a £10bn to £12bn market cap business. That's a substantial share price improvement from where we are today, I don't think we'd be embarrassed to buyback 5 to 10% of the capital, £500m ish at those kinds of pricing.

So I think share buybacks would be a perfectly good tool. And I think for that kind of size of return it would be right. If you did a substantial re-leveraging, would you look at maybe a more broad view, maybe you could, but basically, I think from our point of view we were actually quite pleased with how the share buyback process went, when we just did it recently, which is the first time we've ever done it I admit. But I think a long going, ongoing programme I think is probably more appealing and I suspect will be where we go down in the future.

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Geoffrey Martin, CFO Melrose

That was the main message that I was given in my section was you know if you own Melrose today this is a business that doesn't need all this cash, this is shareholders' cash, and we will find the right mechanism to get that back to shareholders consistently and for a long period of time. And therefore as a shareholder if you have got this kind of profit increase coming through, particularly in the Engine's After Market, the most valuable bit, the share base is being made smaller each year that is really good cumulative returns, or alternatively you have a very good return to all shareholders. So it's very rewarding. You know this business, as we've said, even if we're on the two new engine developments that are out there, 90% of the cash mountain is shareholders money.

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Simon Peckham, CEO Melrose

And that doesn't happen until 2030. I also wouldn't forget that we are also substantial shareholders in Melrose. So our interests are very aligned.

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Andrew Hollingworth, Holland Advisors

Very clear, thank you.

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Chris Dyett, Investor Relations

Thanks, Andrew. Apologies this light is right in my eyes, so I can't see people that well, but if there are further questions. A question over here, Matt, over to you.

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Matt Pickering, Select Equity

Slide 52 was highly informative, it was the variant on the RRSP net cash flow and Peter, I know you want to commit to 2025. But from 2025 the green line goes vertical for a number of more years at a huge quantum of increase. And I just want to appreciate perhaps which programmes that you've relied on, the OE build rates that drive that, because the presumption is that a lot of that is incremental cash and margin post the targets that you are presented today? Thank you.

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Chris Dyett, Investor Relations

Matthew?

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Peter Dilnot, COO, Melrose

I think the first thing to say is that vast majority of the cash that's certainly coming in the short period of time comes on actually the more mature engines. So that's in particular the CFM 56 and the V2500 which is this 100% coverage of the narrowbody. And as we have talked those are relatively mature engines, but a good chunk of those haven't even gone through their first engine visit. So the cash that is closest in is predominantly those engines and the more mature engines.

The GTF actually doesn't kick in until further out beyond that. And I think the chart that you're referring to which Matthew can talk about basically splits that out in terms of the engines that are actually flying out there. But in the short term, as I say most of it is on the mature engines.

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Chris Dyett, Investor Relations

Matthew, would you like to add to that?

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Matthew Gregory, CFO GKN Aerospace

Just to repeat the point that we said, at the moment 17 of our 19 RRSPs are cash positive and within five years all of them will be. So you can see that's why it sort of slips.

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Chris Dyett, Investor Relations

Thanks, Matt. Andy Wilson.

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Andrew Wilson, JP Morgan

Thank you. I've got two actually. Can I just ask on R&D in terms of likely spending over the next few years versus history? And then I guess it's probably a question on visibility as you talk about some of these next generation programmes potentially whether you anticipate there being a big step up there, or whether that's I guess embedded in the way that you're thinking about it already?

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Chris Dyett, Investor Relations

Matthew, I think for you?

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Matthew Gregory, CFO GKN Aerospace

Yeah, I can comment on R&D, or if David wants to?

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David Paja, CEO GKN Aerospace

Yeah, maybe I'll say a couple of words and then Matthew can complement. So in terms of R&D we have always said we are always targeting around 3% of sales into R&D and that is a gross number. We often get – probably a little bit under half of that funded through different types of funding schemes. So our net is probably more in the – you know one and a half or slightly higher than that. And that is kind of a run rate.

What you need to think about is obviously when there are big programmes that come – we were talking before, if there is like a big new development programme, obviously that generates a different type of spike and with its own accounting treatment, right. So I don't know Matthew do you want to add to that?

Now what we have booked in obviously up to 2025 we know very well what has to be done and everything that we have presented in terms of our initiatives that require engineers are fully funded. So that is all in, so it is not incremental to that. And beyond 2025 obviously it all depends on customer programmes fundamentally.

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Matthew Gregory, CFO GKN Aerospace

I think that answers it.

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Geoffrey Martin, CFO Melrose

And the investment into the two new engines we scaled that roughly, I mean this – you know this is projecting quite some way out, so you need to allow us a bit of estimation here, but roughly about 10% of the net present value of the cash mountain. So that was the line that I used, I think Matthew used that 90% of the cash mountain is surplus to requirements, even after investing in new engines that are coming if we get on both of them. I think we're the only supplier that's pilot project on both. So this is the surplus capital point that we are making under a number of the answers here. You know new investment won't eat into those cash flows materially.

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Chris Dyett, Investor Relations

A follow up Andy?

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Andrew Wilson, JP Morgan

In terms of the – you've obviously provided a tonne of information in terms of – particularly the Engine's business and I guess – this feels like a statement, but I guess it's a question, or I'd like you to confirm it, but it feels as if the openness that you've kind of given us, which obviously is very helpful, your competitors potentially, your partners are going to look at this as well. I mean I presume that sort of the confidence and the technology speaks to your preparedness to give us these numbers, because obviously at some point you're going to be renegotiating, whether it be next generation, etc. It's just the thought process in terms of being quite so transparent about it.

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Simon Peckham, CEO Melrose

Andy, we haven't given you anything that we think will be a problem for us, or we wouldn't have given it to you.

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Andrew Wilson, JP Morgan

It was a statement then.

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Geoffrey Martin, CFO Melrose

I think the important point there is – and it was the point again that it was mentioned. If you take the 50-year life of an engine programme it's not super rewarding, you know it's normally rewarding and will be for this business if you trace it back to the day one. What you have got here though is the lucrative second half. But it is only coming because a lot of money was spent, Volvo Aero which is the derivation of this Engine business spent huge amounts of money on these engines' contracts.

So in terms of the conversation with an OEM, by the way we're in the same contract they are, so it's not that we're taking money off them, all they have done is share the risk and the reward, we're not negotiating with them if you see what I mean. Over the 50-year life it's a normal return, just life is about timing is the point that we made a few times.

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Peter Dilnot, COO, Melrose

And the fact that it is a life of programme contract, so it goes on literally from the word go right to the time that the engine is retired.

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Chris Dyett, Investor Relations

Thanks, Andy.

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Andrew Wilson, JP Morgan

Thank you.

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Chris Dyett, Investor Relations

We've probably got time for one more question and then we'll head for some drinks outside and a chance to speak to some of the people who are sitting in the balconies. Any other questions? Can anybody see any questions.

No question, on that basis thank you everybody for coming. Simon, would you like to say any final words?

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Simon Peckham, CEO Melrose

No, I think you said it. Thank you very much for coming, I hope people have enjoyed it and hopefully you'll join us for a drink outside. Thank you very much.

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Chris Dyett, Investor Relations

Thanks everybody, we appreciate you coming.

Applause

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