Melrose

Full Year Results Webcast
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Melrose

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Introduction & Key Highlights

Peter Dilnot, Chief Executive Officer
Thank you and hello everyone. Welcome to the Melrose Results for the first half of 2024. It's great to see so many of you here with us in London, particularly on what I know is a very busy day for results in our sector. I know we've also got lots of other people joining on the webcast so good morning, good afternoon wherever you are in the world and thanks for joining us.

Now these are actually our second set of results as an Aerospace focused Melrose, and it's been certainly a busy period. We've delivered a strong first half performance which we'll go through in a few moments but in addition to that today we're announcing a new growth strategy and an associated capital allocation framework for the future.

So, look, let's get straight into the highlights. As I've said it was a strong first half performance and indeed ahead of expectations with a north of 60% improvement in operating profit and margin expansion of 450 basis points versus the prior year. So clearly a strong performance and it's been powered by the Engines outperformance in the first half with very strong margins at 29% powered by in particular the aftermarket there.

We've also made good progress in Structures objectively in terms of margin expansion but also with the many business improvement projects we have underway there to improve the quality of earnings.

Now this performance in the first half gives us real confidence about the full year guidance for 2024 and we're confident in reaffirming that today but also clearly, it's de-risked our targets for 2025 as well. So really positive momentum in the business.

The other key message really is about demand and there's lots of talk isn't there in the market at the moment about supply chain issues but what we mustn't lose sight of the fact is that demand is strong, it's there and it's underpinned by long order backlogs on the OEM side and clearly reading through also in terms of strong demand for the aftermarket as older Engines fly longer. And clearly Melrose is exposed to both of those things.

Beyond the civil side we've also got defence with a strong demand fuelled by the unfortunate challenges geopolitically, but it does read through in terms of a positive defence demand for us and our platforms going forwards from here.

Now that long-term demand really is the first underpinning of a clear growth strategy and the growth strategy, we're talking about here today just to be clear goes well beyond the 2025 time frame that we've talked about up until now.

Now the first focus for us as a business is to profitably capture the market opportunity that we have in front of us on our established positions with that broad exposure across all the major aircraft that are out there and as OE ramps up and the aftermarket is strong, we capture that and deliver profitable growth and cash from that and that is the primary focus.

But beyond that we have some fantastic opportunities to expand Melrose's business both in terms of its technology but also in terms of the platforms that we sit on and we're going after that selectively particularly in Engines where returns are good.

And furthermore, in terms of growth, we of course need to talk about cash and that cash mountain is coming ever closer with the RRSPs contributing £5.7bn in NPV terms in the decades to come.

Now talking of cash we'll go through in a bit of detail our new capital allocation approach but it's fairly straightforward. The primary use of our cash is to make sure that we can deliver against the growth opportunities that we have both in terms of our established platforms with the capacity ramp up but also in terms of selective investment in those growth opportunities.

Beyond that we have a commitment, and we have confidence in the balance sheet, to continue to generate cash and return that cash to shareholders in the form of both a growing annual dividend but also ongoing share buybacks while keeping our leverage between one and a half and two times.

Now since the demerger, we've actually given back in various forms £750m of cash to our shareholders and we're announcing today a further £250m buyback programme that takes us out to March 2026.

Now the final piece here, as I close this opening piece if you like is around our EPS growth. Now our EPS growth is clearly strong you know we're up 65% in the first half and it's going to be very strong next year. But looking beyond that for many, many years to come we can step forward with confidence and say that we see a path towards double digit EPS growth and there are few companies that can do that on an ongoing basis. And the other point about that EPS growth is it's coming from all parts of our business and that seems like a good point to hand over to Matthew to talk about specifically our first half performance.

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Financial Update

Matthew Gregory, Chief Financial Officer
Great thanks Peter and good afternoon everyone. Great to see you all here today and we're hoping that we've saved the very best until last on what's been a very busy day for you.

So, I'm going to take you through the key highlights for the first six months of the year. As you can see on slide six the business has delivered a very strong performance in the first half and this is ahead of our expectations. The Group has generated 12% revenue growth after excluding sales from disposed businesses with the Engines division driving this strong performance.

Group operating profit is up by around 60% to £247m as a result of this revenue growth and also the benefit of our business improvement programmes reading through.

At an Aerospace level margins have increased by 420 basis points reaching 14.9% for the half with both divisions contributing to the margin improvement. PLC costs are slightly better than guidance too. Now logically EPS improves up 65% to 11.9p.

So overall a strong set of results continuing our relentless progress towards our 2025 targets and beyond.

So turning to slide seven now, I have got a slide for each division coming up, but at a headline level you can see that both divisions delivered revenue growth. The overall growth rate of 12% is driven by the strong aftermarket performance of the Engines business and both divisions also delivered substantial margin growth with Engines reaching 29.4% up 490 basis points and Structures almost doubling margins to 4.7% up 220 basis points. And these improvements demonstrate the continued positive effect of operational and commercial improvement and restructuring activity.

So, let's dig a little deeper into the drivers behind each division turning to Engines on slide eight. Revenue growth was strong in the first half despite the continued operational challenges from the supply chain and aftermarket sales were very strong in the first half ahead of our expectations at 31% growth.

A strong aftermarket is reflective of recent sector performance and the Engines business has outperformed the industry as a result of strong growth in our new Engines repair business as well as strong growth in defence aftermarket which is specific to our business.

Operating profit increased by nearly half and margins increased to 29.4% up 490 basis points and this improvement was driven by the mix effect of the more lucrative aftermarket business as well as the impact of a business improvement in this division which is now largely complete.

Margins have also benefited from increased volumes working through our factories and better productivity on this throughput. So a strong performance for Engines which is expected to continue into the second half.

Turning to Structures on slide nine. So the revenue numbers are slightly more complicated this half. You'll recall that we were expecting sales to be flat in Structures as a result of exiting certain business and also de-stocking at a major customer.

Now we've experienced that but also disposed of three Structures businesses during the half which is great news and I'll come back to this later.

At a headline level growth was 1%. After excluding the revenue from disposed businesses revenue growth was 6% largely in line with our expectations for the half and this is despite supply chain issues that have persisted during the period.

And the growth has been driven by stronger performance from business jets up 15% as well as the recovery of widebody up 9%.

Defence continues to progress with repricing its contracts and we are very much on track to deliver our target of 85% of contracts being sustainably priced by the end of 2025. And operating profits grew by 90% in the period and margins grew by 220 basis points to 4.7%. And as such you can see the impact of pricing improvements and business improvement initiatives dropping through and this is a good performance. And as we discussed at the year end since the Structures business is second half weighted this will increase again to the end of the year. So positive progress in Structures with revenue profit and margins all growing in the half.

So having talked about the divisions let's talk about the numbers below operating profit on slide 10. As ever we put the details of our adjustments to operating profit in the appendix.

Net interest costs were £43m which primarily represents interest on our bank loans at 5.6% and this is better than our plan. And I'm pleased to say that we've been supported by our banks to extend all of our facilities that were due to mature in April 2026 and these were amended to include two one-year extension options at the company's option. In addition the US portion of these facilities was increased by $400m to provide further headroom.

The adjusted ETR for the half was 21.6% and we maintain our ETR guidance for the year at around 21%.

Diluted EPS grew by 65% to 11.9 pence per share and finally an interim dividend of 2 pence per share has been declared representing a 33% increase versus last year's interim dividend.

Having covered off the financial results for the period I wanted to spend a couple of minutes on slide 11 showing you some key highlights across the Group in the half. And we pulled out a small selection of the numerous commercial successes that the business has won during the half with an example from each part of the business.

In Engines we're celebrating a number of milestones in our repair solutions business. We've added 30 new customers in the first six months. We've added leap fan blade repair capability to our portfolio and have also delivered our 10,000th part from our Malaysian facility.

In civil we've signed a long-term contract with Airbus to deliver the full A220 wiring package within our industry leading electrical wiring business. And then in defence we're extremely pleased to be asked to build a new state-of-the-art production line at our facility in Garden Grove to double the capacity for F35 canopies. Now this will be funded by our customer and is scheduled for completion in 2027.

From an operational perspective we continue to focus on safety and quality with zero lost time accidents in the half which is an exceptional achievement that we aspire to continue and have reduced quality issues that reach the customer by one third. Also our reinvigorated and simplified lean approach called Brilliant Basics has helped improve productivity by two percentage points.

Finally, our restructuring and business improvement process continues to progress with the sale of three non-core businesses in H1 and the reduction of the manufacturing footprint from 35 sites to 31 sites.

On this final point I wanted to cover the impact of these three disposals. The overall net impact of the disposals is a loss of £16m. The fuel systems and Orangeburg sales generated a total profit of £49m and these businesses are non-core and relatively small.

The sale of the St Louis business generated a loss of £65m and this reflects handing over the business as a going concern for a token price as well as a total of £39m still to be paid to the acquirer over the next two years.

In addition to this the sale of the St Louis business resulted in the need to bring an existing US multi-employer pension liability onto the balance sheet valued at £21m. Now there's no additional cash impact arising from this recognition, but it does add to our balance sheet liabilities, and you'll find some more details on this in the appendices.

Now while we're talking about operational improvement it's worth recapping on slide 12 how we're progressing towards our 2025 margin targets. Looking at Engines first we said that we'd improve margins from 22% to 28% and 4% of that increase is coming from the RRSPs and 1% coming from both growth initiatives and business improvements.

We discussed at the full year results and again today that the aftermarket is very strong, and this has been driving margins forward. As such we're delivering ahead of plan. Our parts repair growth initiative is driving forward with the new facilities coming online and an increase in the breadth of our offering and this area is very much on track.

And finally for Engines business improvement is largely complete and we're seeing productivity and cost improvements reading through ahead of plan and this gives us a great deal of confidence in this division breaking through the 28% margin level.

From a Structure's perspective margins were targeted to increase from 3% in 2023 to 9% in 2025 and half of the 6% improvement was expected to be driven by the civil ramp up with 2% coming from defence repricing and 1% from business improvements. Overall, we're on track with all of our initiatives in this division.

The civil ramp up from 2023 to date has met expectations overall. However, it's clear from recent announcements that the industry is facing operational and supply chain challenges, and the ramp up is under scrutiny. And I'll talk about our guidance in this respect in a couple of slides.

Defence repricing is on track as noted previously and business improvements are progressing well. US restructuring is largely complete, and the final major project is the integration of three businesses into one site in The Netherlands which we expect to be completed by the end of the year. So overall positive progress in Structures and our half year margin and guidance reflects this.

Moving on to cash flow on slide 13, the Group generated £54m of operating cash flow before capex, 70% ahead of last year and this included working capital being impacted by revenue growth, supply chain effect on inventory as well as the GTF powder metallurgy costs starting to

come through. As expected and guided capex is now starting to increase as we start to prepare for the ramp up and invest in growth initiatives.

Also as expected restructuring costs have increased to £85m reflecting payments for activities that were accrued last year as guided.

As an aside and on this point at March's result I guided to around £125m of restructuring cash costs and this cash cost is expected to be around £15m higher than this due to some additional restructuring costs in our Netherlands site consolidation as well as the resolution of certain legacy issues.

Now coming back to cash this leaves a free cash outflow of £145m slightly above last year but in line with our expectations since our cash flow is seasonally weighted to the second half.

The share buyback programme is progressing well with £246m spent this year alongside ordinary dividends taking us up to a total of £339m spent in total and we remain committed to completing our £500m share buyback programme by the end of September.

Net debt at £976m is better than expectations. Leverage has increased from 1.1 times to 1.7 times net debt to EBITDA as a result of our share buyback and it's important to say that around £200m of tax and national insurance impact of net settling the 2020 LTIP has been paid in July and our guidance for the full year leverage remains at less than 2 times net debt to EBITDA. So let's turn then to guidance on slide 14.

As discussed, the half-year performance was strong and gives us confidence that we're on track to achieve our 2024 guidance. Engines continue to perform strongly with the aftermarket more than offsetting the challenges to the OE business.

In Structures we continue to grow whilst continuing to work through customer destocking. Now clearly changes to customer production rates could give some challenges in the second half but we remain comfortable that the business will contain the effect of this as well as the impact of disposals within the range of our current guidance.

Looking forward to 2025, given the challenges in both divisions with respect to OE Engine sales and the civil volume ramp-up plus disposals, this means we've tempered our revenue guidance by around £100m in each division this changes our revenue guidance to £3.8bn.

However we remain fully committed and confident in each division's ability to hit its operating profit target of £500m for Engines and £200m for Structures. And as a result we're pleased to confirm that the Group margin will be greater than 18% in 2025.

To close from my side, we've had a strong first half we're maintaining our guidance for 2024 despite the operational challenges and we're increasing our margin target for 2025 to greater than 18%. So with that let me hand back to Peter.

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Business Update

Peter Dilnot, Chief Executive Officer
Thanks Matthew and now let's turn to growth and longer-term growth with our strategy to deliver in many years to come profitable growth and cash generation.

Now this all starts clearly with the market which we know is strong with record order backlogs and also a very strong aftermarket and that demand is structural. We are sat relative to that with great positions in terms of our technology embedded onto the world's leading aircraft and with opportunities to extend that.

And as we think about the growth there's really three waves to it. The first is what is front and centre and what you're hearing from us which is around capturing the opportunity profitably from the established positions as the production ramps up and as the aftermarket reads through.

That's the first priority, and it's really embedded in terms of much of the guidance that we've given, and we'll continue to give. And it's not only just meeting that ramp up but it's doing so in a way that is productive, driving operational improvements and making sure we're focused in the right areas.

The most powerful lever here is the RRSPs and I'm going to talk a little bit more about that but in addition to that we clearly have our growing repair business. Matthew's given you some highlights from that and of course the ongoing ramp ups as they come through and let's be clear they are coming through.

Beyond those established positions, we've got the opportunity to expand our business in some really exciting opportunities, particularly I have to say in Engines where returns are very strong and most notably in additive fabrication and again, we'll spend a few moments on that in a second.

But beyond that we are expanding our business in China for the indigenous market there with our joint venture with COMAC. And also our capabilities, these design capabilities are hugely in demand in the eVTOL market and also with the developing drone and unmanned air vehicle market in defence and there's lots of opportunities out there.

Typically, we're playing these in a capital light way but specifically in Engines we are deploying capital because we've got some exciting opportunities to grow and unique opportunities to grow there.

Now beyond those we also will continue to position this business for the longer term and to favourably position for the next generation of aircraft. And that includes of course the next generation of single aisle Engines, but also the airframes when those read through, the 6th gen fighters where we have positions there, and of course longer term hydrogen flight where we have a number of programmes, all funded in part by the government and in partnership also with other industry players.

So three waves of growth, I've talked about hydrogen as part of the longer-term piece on sustainability but underpinning all of this is actually running the business in a way that minimises its impact on the environment indeed as being reinforced by our recent SBTI targets.

So, growth all starts with the market of course and as I think we're all aware demand is strong. On the civil side we've got flight hours increasing, production which is gated at the moment or paced should I say by supply chain issues but record order backlogs and a strong aftermarket. The civil story I think is pretty clear and on the defence side geopolitically we're seeing the drivers on governments having to increase spending as a proportion of GDP particularly in NATO and in Europe where we're very well placed.

So the demand is there, now the pace of the ramp-up clearly can be debated but I think it is clear to see that demand is there and will underpin this business and Melrose for many years to come.

Our position relative to that is we're focused where we can both deliver but also where we can capture most value through our proprietary design. Our business model is about embedding our technology into our customers at the OEMs aircraft.

We do that on today's aircraft and we're also doing it on tomorrow's aircraft and so we're positioning ourselves as a designed to spec, and designed to build business. What that does is it gives you a life of programme position largely but also of course increases the quality of earnings. And this has been the shift that we've been on for the last few years and again we've talked about our disposals that don't fit within this framework.

Our ability to do this is underpinned by our position in the value chain which is unique both on the Engine side and on the Structure side. With Engines we're one of really only a small handful of global partners who have the technology and the longevity to be RRSP partners. And then on the Structure side of the business relative to a very concentrated OEM customer base we're one of the few super tier one companies that can lean in with design to support against the backdrop of a very fragmented supply chain.

So overall we like to think like a peer, we act as a partner and deliver as a trusted supplier. We are deeply embedded with our customers with our technology, to make sure that the quality of earnings is there, and the growth will read through.

So I'm now going to deep dive on a couple of areas around Engines starting with one of the first wave of things which is the RRSPs. Now RRSPs we have a unique portfolio of these life of program contracts - 19 Engines in total and they are coming into the aftermarket sweet spot if you will, and the aftermarket is particularly favourable at the moment due to scope, price and volume.

Specifically and uniquely, what GKN does here is it makes structural components for these Engines. So, what it means is as an Engine gets shipped the majority of our work is done and so then the entitlement for the aftermarket profit reads through very nicely in terms of profitability for us and leads to decades-long cash which I will come back to.

So to focus just a moment on this portfolio because it is unique and it's incredibly important to the quality of our business and its earnings.

RRSPs are life of program contracts that last for 60 years, and we have 19 RRSPs currently and if I start on the right-hand side of this chart with those that are deeply in the aftermarket phase generating profit and cash. And we have a unique position here in that on the legacy narrowbody Engines which is the CFM56 and the V2500 we are the only RRSP partner on both of those Engines.

Similarly on the widebody side we have RRSP partnerships on the Gen X and the Rolls-Royce Trent XWB. So collectively those mature Engines power in total actually around 70% of the world's flights, and we have an RRSP exposure to this.

We should touch on the Engines in the middle, the two Engines that are not currently cash positive, the GTF Engines and to be clear these Engines were always projected not to be cash positive until 2028 and that's still on track.

Clearly, the well publicised issues around powder metallurgy and manufacturing issues mean that the cash drag is more than was originally expected. But we're confident that the fleet management plan is on track and fully in line with what we've said previously. But perhaps more importantly than that, the GTF is fundamentally a good Engine with architecture which is advantaged particularly around fuel consumption which bodes well for the long backlog of A320s that are linked to long-range flights such as the 321XLR.

So the GTF is on track and fundamentally a good Engine, and then if you go further to the left here you can see two Engines which are the two next generation single aisle Engines - not full RRSPs yet let's be clear they're development programmes, but GKN is the only player that has a position on both of these Engines the CFM Rise, the open fan rotor and the next generation of GTF.

So overall the portfolio is broad in terms of how it sits relative to the market but also includes deep relationships with all of the Engine OEMs.

So let's turn now to talk about how the cash reads through. Now you've seen this cash mountain of many of you before and indeed it stays consistent with a net present value worth around £5.7 billion discounted to today. And what's important here is that in some of these RRSP contracts, the cash does trail the profit. And the reason for that is, as I've described, the majority of our work is done as an Engine gets shipped and therefore the accounting requires us to recognise some of the revenue and profit from the aftermarket when we ship that Engine. We're extremely conservative about that in terms of our assumptions there, but it does mean that cash lags profit.

What is clear is that cash is coming through and it's starting to come through now and that cash forecast is based on a range of inputs which are objective and based frankly on customer and industry forecasts. There's four of them at the highest level.

The first is around the fleet size, the number of Engines and clearly that's increasing as OEM production grows and retirements are held back. Flight hours, with travel demand going up especially in developed markets in the years ahead. Shop visits are also increasing as older Engines are flying longer and expanding MRO frequency. And this aftermarket profitability which is the most powerful thing for our economics overall, is particularly favourable because of the increased scope of what's happening in the aftermarket but also because of a favourable pricing dynamic both on shop visits and also on spares.

So all the trends here are positive and feed into that cash mountain. And just to be clear that the absolute value of cash coming from this current portfolio of RRSPs is expected to increase in absolute terms every year out to the mid-2050s.

So overall RRSPs are a great foundation for our business growth and for cash generation and, as I've described already, we're also investing in new opportunities and I'm going to just dive deep on one which is unsurprisingly around Engines and it's around our additive fabrication and where the majority of our capital is going.

So let me be clear about this. This is a unique opportunity that GKN has with huge customer demand from all the Engine OEMs. What is it? Well what we do at GKN is we make structural components at the heart of all the world's leading Engines and additive fabrication is a new way of making those parts through additive technology and we do it in two ways.

The first thing is we can do is actually print the whole structural component so using laser wire deposition, which is a mouthful,l but what it essentially does is it prints relatively swiftly in additive terms near final form structural components. The other thing we can do is we can build those structural components from smaller components and effectively weld them together so that you end up with a much broader way in which you can build these things without being reliant on particularly large forgings and castings.

Why is it valuable? Well that's the first thing. It's an alternative supply where there are constraints at the moment. The second is it's lower cost, higher quality, you can design in new features and critically it's also more sustainable because you have less machining and less waste to create these products.

The best example of why this is great technology is because it was the additive fabrication capabilities that we have with the heart of the GE deal, the $5bn deal that we announced recently because GE want to get this technology onto their Engines starting with the Gen X.

And we do have leadership here. We've been at it for a while. This is not a startup opportunity. We've been at it for about 20 years and where we are through the research phase and applying this firstly into production applications, but then into the customer applications we're now into a certification phase. So we're spending money on building factories to produce parts that are already certified and more will come through the pipe.

But again, what is our capability here and why are the OEM is looking to us? The first is that structural components are what we do. We've been doing it for eight years. The second thing is we've been after additive fabrication and advanced welding for the last 20 years. The third is

that we have system insight here. This is not easy to do, and you can imagine the amount of data, thousands of parameters over thousands of applications here. And perhaps again most importantly we have parts that are flying on Engines today that are made through additive fabrication and we're the only company in the world that are doing that currently.

So that's where we are. It's that unique capability if you like that is the unique combination of those factors that is the secret sauce here.

Now we are investing in this area as we've said with good returns and perhaps that's a good time to hand back to Matthew to talk about both sources and uses of cash.

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Capital Allocation

Matthew Gregory, Chief Financial Officer
Great thanks Peter. So, I am going to talk about our capital allocation policy, but before doing that I think it is worth looking at as you say the source of future cash that we'll be looking to allocate.

As we conclude our major business improvement programmes, we expect our Structures business and the non-RRSP business in Engines to move towards a more normal 80 to 85% cash conversion. As we continue to grow, working capital will still be required, but we expect to contain this in line with revenue growth.

Clearly there may be the opportunity to optimise inventory as the supply chain issues ease but at this stage it's difficult to predict when that will happen, but we will have ongoing free cash flow growth.

On top of that we know that we have the cash mountain coming into view and as Peter said previously, we have a unique portfolio of RRSP contracts which give us contractual entitlement to the most lucrative aftermarket cash flows. 17 of our 19 RRSPs are cash generative with the GTF being the exception which will improve over the coming years.

Now we know that the cost of rectifying the powder metal issues is assumed to be around £200m over the next three years, the programme is still in the final phase of development and will become cash positive in 2028.

Also the cash from our RRSP portfolio will increase each year going forward until the 2050s. Now this cash mountain is valued at £5.7bn net present value which alongside the ongoing operational cash flow will provide a substantial source of cash for decades.

So with that as context we now set out our capital allocation policy for the business in line with the business strategy.

As we've said the company is an organic growth story with a significant ramp up in volume required to meet customer demand and orders. We'll invest 1 to 1.2 times capex to depreciation

to maintain the business and position it to deliver the ramp up and this is what we told you at the Capital Markets Day last year.

The new news however is we will target expansion opportunities to leverage our exciting proprietary technology. To this end over and above the 1 to 1.2 times of capex we've guided to, we expect to spend around £300m in additional investment over the next five years and the vast majority of this will be in additive fabrication.

Now this is a long-term programme and will yield IRR greater than 20% so it's a very good use of shareholder capital. And I'd reiterate that this is to deliver organic growth and we're not planning any significant M&A in the short term. There is no change to what we've said there.

So then looking at our balance sheet we intend to take a disciplined approach to leverage. We intend to maintain leverage between 1.5 to 2 times net debt to EBITDA and this level is in line with the sector and we also believe that it's right to target investment grade metrics over time. The range in our leverage policy allows us to have flexibility to exploit additional opportunities that may arise.

Now using this framework we'll then look to return value to shareholders via an ordinary dividend and we're committed to growing the dividend. And as you've seen we've announced a dividend of two pence per share which is up 33% on last year and finally we will deliver ongoing buybacks that are aligned with our free cash flow and our leverage targets.

This year we will complete the £500m buyback in September and today we're announcing a further £250m buyback continuing through to March 2026 which aligns us to our annual results date. And from that point we'll announce future buybacks with the annual results as appropriate.

So to conclude we believe that the business will generate growing cash from 2025 onwards and we'll look to use this cash in a disciplined way.

We're excited by the substantial organic investment opportunities ahead of us particularly in additive fabrication and we'll target investment in this area to drive growth and returns. We'll maintain discipline over our leverage, targeting investment grade metrics over time and we will reward shareholders with ordinary dividends and annual share buybacks that align with our framework sustaining long-term success and maximising shareholder returns and with that I'll hand back to Peter.

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Peter Dilnot, Chief Executive Officer
Thanks Matthew and putting this all together we believe there's a clear and compelling equity case very much built on what we've been talking about together for the last 18 months or so. And it's based fundamentally on an attractive growing market, our unique position on all the world's platforms but particularly leading platforms, but in particular our exposure to the Engines aftermarket and we can see our path to continued and sustained profit growth well on

track as we just described with ongoing returns for our shareholders and so with that we'll open up to questions.

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Questions and Answers

Analyst, Ben Heelan - BofA
Morning. So the Engine margins were very strong in the first half, well above what you thought they were going to be – and you haven't raised it. It implies quite a strong deterioration in the second half of the year so obviously there's a lot of stuff going on in terms of supply chain. But could you help us understand what's going on there?

The second one, you talked about de-stocking at the beginning of the year particularly in Structures we've seen issues at other Structure suppliers as well in the last couple of weeks, so is de-stocking something that's going to continue to be a theme in the second half of the year?

And then this £300m investment, what sort of milestones can we look for over the next five years and what's the level of conviction that you have in this 20% IRR, like how can we go away from this meeting with conviction in that?

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Matthew Gregory, Chief Financial Officer
Sure, shall I take the first two?

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Peter Dilnot, Chief Executive Officer
Yeah sure.

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Matthew Gregory, Chief Financial Officer
Okay so on the Engine margins that's a fair question. I think we've had a very strong first half and it's been driven by both the aviation repair business and also defence aftermarket being better than we expected.

I think as we look to the second half there are still some challenges around the supply chain. We are adding to our capacity on aviation repair. So, I think the first half was very much a real sweet spot as we got high utilisation from our existing facility and our Malaysian facility was ramping up so there's a bit of cost and capacity coming in in the second half and we are just looking at the supply chain and seeing how that's working through.

So, I think that we probably are being a little bit cautious there, but given recent announcements I think it's sensible to be cautious around that business. But fundamentally, as I said before, we are expecting this business to drive its margins forward.

On the de-stocking point, we have very regular conversation with our customers and that's why we were able to talk about this point at the beginning of the year. We've had further announcements come out in the past three or four weeks around the build-up and we've said that we can maintain our guidance despite some of those issues.

Look I think that the challenge here is that, as Peter alluded to earlier, the industry has to ramp up from a production level of 50 to 75 a month, which is a 50% increase in the production rates that are required. What we can't have is our factory bouncing up and down in terms of its capabilities and in terms of its production. So, we'll be working with our customers to make sure that we plan, and we work with them to deliver the ramp up that they want as they go forward.

So, there may be a few bumps coming along, but we're maintaining our guidance despite the announcements that were made a few weeks ago, but we do think fundamentally we all need to ramp up and we're committed to doing that.

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Peter Dilnot, Chief Executive Officer
Can I just build on what Matthew said around the destocking because I think we actually stood up and talked about this quite a while ago when we were looking forward and looking at production rates and we've adjusted obviously the revenue guidance for next year reflecting the production rate. So, we'd like to think that where we are in terms of our guidance is ahead and we're not expecting anything further to deteriorate from here. We think there's been a reset there. And as you know Ben we're much more exposed to Airbus than we are to Boeing, where I think there's probably more uncertainty frankly given the nature of the issues there, being quality rather than supply chain.

So just to be clear, we are confident on where we are on the revenue guidance on civil with today's announcement.

On the investment, look, what we've talked about here is it's a great opportunity, very confident about it, very confident that it'll generate above 20% IRR. What we haven't talked about is very specifically the returns from that and our pathway beyond 2025 numbers and we will come back and obviously talk to you in the market about that in due course. And part of that will be describing what we're doing on these growth initiatives.

But are we confident that it's a great use of shareholder money? Absolutely, 100%. I don't think genuinely there's a position where you've had technology which meets a market need as much as this and it's a unique opportunity.

So we'll come back and talk more about the milestones in due course but also let's be clear, we're getting on with it. If you go out to Sweden right now, we've got a new factory, we've got robots going in, we're hiring people. This is not a wish list, this is industrialisation.

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Jonathan Hurn, Barclays
So I just have two questions please. Just coming back to this £300m of expansionary capex, can you just talk us through the phasing of that capex? Is it sort of quite front end loaded or are we going to start to see the majority of that spend coming at the back end of that five-year period?

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Matthew Gregory, Chief Financial Officer
Largely it's evenly phased as we go through the next five years. There'll be ups and downs but broadly it'll be evenly phased.

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Jonathan Hurn, Barclays
And the second question was just about that comment you made about double digit EPS growth over the long term. In terms of what's sort of behind that, is that assuming a buyback that comes through every year of around about the £200m, £250m mark? Or is that sort of incremental to that or would it be incremental to that growth?

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Matthew Gregory, Chief Financial Officer
We're not assuming a certain level of buyback to get to those numbers. I mean obviously there's a compounding effect if you do the buyback which depends slightly on what our market cap does. But fundamentally this is an organic growth story based on earnings coming from the business rather than buybacks. So that's the major underpin here.

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Sam Burgess, Citi
Thanks very much. Two questions if I can guys. Firstly just on the cash conversion target you mentioned, the 80 to 85% operating cash conversion. I might have missed it but was there, is that a sort of midterm guide for you guys? And what's the kind of time frame you're looking at with that?

And then I guess the second question would just be around the restructuring costs. £85m in H1, four-year guidance £140m. Just any colour on why those are coming down, why we should be confident they will come down and any kind of colour around working capital movements in H2 would be helpful.

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Matthew Gregory, Chief Financial Officer
So on the cash conversion, what I said was that our Structures business and our non-RRSP business in Engines will be 80 to 85% cash conversion, kind of a more normal industrial cash conversion level. And that will come as the restructuring drops off, which will drop off in 2025 to 2026. So there will be a relatively short-term improvement there.

On the restructuring costs, they will drop off. So we set out a programme three years ago with major restructuring in the US and in Europe. The Engines restructuring is largely finished. There's just a small amount we're doing in California. The Structures business, the restructuring element of that is just left to The Netherlands site.

Here, we've done the physical move. So that just kind of happened right at the back end of last year in December. We've brought all this, these two businesses into our Papendrecht site. And now it's the integration and getting the machines up and running and getting the people skilled, recruiting and getting all the right people to make it work. So we're saying through 2024, that will be largely completed.

There will be an element of restructuring that goes into 2025, relocation of people and those kinds of things. But it will be a dramatic reduction from that £140m in 2025. Because, you know, as we put on the chart there, the actual projects that we're undertaking, we're very, very close to completing.

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Peter Dilnot, Chief Executive Officer
Great, thank you.

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Mark Davies Jones, Stifel
Thank you. Two, please. Firstly, on that additive fabrication build out, how much of that capacity is underpinned by existing contracts with customers, particularly GE? And how much is that you just building it and expecting the demand to follow?

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Peter Dilnot, Chief Executive Officer
My concern is the other way around, actually, which is the demand outstripping what we're doing. The key thing at the moment is actually to build up the industrialisation capability and to get more parts certified.

But certainly, all the capacity we have and we're building at the moment, will be used up by agreements that we've got.

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Mark Davies Jones, Stifel
The revised guidance implies certainly if you're at the higher end of the ‘24 outcome, very little in the way of revenue growth in ‘25. Understand all the OE and Structures, caution around the supply chain. But have you changed any thinking around the growth in the aftermarket end of Engines? Is there anything we should be aware of in the phasing of RRSPs or anything through that period?

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Matthew Gregory, Chief Financial Officer
Not really. I mean, the guidance that we set out the capital markets, did anticipate the disposal and exiting of certain businesses. And we set that out at the time. So that's what you're seeing. There's going to be a little bit of impact coming from the fact we disposed businesses and one of them is quite a big business. So that makes it a little bit difficult to compare.

In terms of the aftermarket versus OE split, in our view, this business is very well positioned. It has a strong aftermarket business. If the OE is softer, then we make it up in the aftermarket, which is why although we're being realistic about the revenue side, we're able to maintain the profit numbers. So that kind of tells you that one will compensate the other. Naturally, that improves the margin.

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Peter Dilnot, Chief Executive Officer
And very, very specifically, the revenue adjustments are purely to do with the OE side. And actually, that's completely consistent with our OEM customers. If you look at what GE is doing or Safran, the build rates are coming down. So the revenue adjustment is, just to be crystal clear, is all OE linked.

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Harry Philips, Peel Hunt
Just a couple of questions, please. I was just thinking in this sort of increasingly crazy geopolitical environment. So it's a question about China, just how you run a relationship into China in this sort of new world where we're entering into and the sort of sensitivities around it, and how you might sort of remit cash profits over time and stuff like that. So just some detail around that, if you could.

The second is, again, sort of, and you've touched upon it in capital market days and stuff, but there's sort of, when is your planning around having to up exposure towards sort of next generation, both engines, airframes, etc. Thinking around buyback potential and stuff like that.

And then lastly, a very simple one, sort of interest for the year, is it just sort of double the second half or is that too old fashioned?

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Matthew Gregory, Chief Financial Officer
So, the interest is going to increase because the debt's going up, we're going to put more buyback through. So, it's not just a straight doubling, it will be more than that.

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Peter Dilnot, Chief Executive Officer
Okay, so China. China is an important market, obviously, for global aviation. And if you play forward, certainly to 2040, it's going to represent on the civil side, between 30 and 40% of the market. So as a global player, you want to be part of that.

We have a unique position in the sense we have a JV with COMAC, who as we know, they're the domestic or the Chinese civil airframer. And it's based around Structures and we're building, with actually support from the Chinese government and COMAC, a number of factories. We bring our design capability and manufacturing expertise in, but it is purely for the domestic market and for development for COMAC'S C919 and actually the 929 going forwards.

We should also be clear, actually, that Airbus, for example, have a final assembly line in China. And we actually make parts for that assembly line in China, and that will continue. We're very careful going back to the COMAC side about what we do in terms of development and making sure it's ring fenced, but Airbus are very aware of what we're doing and are comfortable with it.

In terms of China, I would say more broadly though, and I've been there fairly recently, is that there is a regionalisation of supply chains. That is life. And therefore, some of the work that we used to do, for example, in wiring that used to be done in China is now being moved to Mexico or back into Europe. So that is taking place, and it does mean that we're starting up new regional facilities which tend to be in low-cost parts of regions to serve our customers well.

But there is an important market in China, and we will play it. We do it, as I say, in a very capital light way, and we're very much in demand, but I'm clearly very thoughtful about how it's been set up with JV and IP etc.

So the next question, which is around next gen. My own view on this is that the challenges that the industry is facing at the moment, in terms of supply chain and production ramp up, is likely to push that out to the right.

But we've already guided to any significant investment in next gen Engines, that's the Rise, or the next gen GTF, being likely ttowards the back end of the decade to 2030 timeframes, and there's no real change to that guidance. So, we've got a good run for the next seven years, really, without heavy development costs. When it comes to it, we'll be very thoughtful about what we play in.

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Matthew Gregory, Chief Financial Officer
No more questions? Anything on the webcast?

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Chris Dyett, Investor Relations
So just as a reminder, if you're online and you'd like to ask a question, please do so through the portal. At the current time, we one person asking a question with two elements. So let me start with the slightly easier one.

Why is 1.5 to 2 times EBITDA the right leverage for Melrose when other Engine makers seem more prudent on leverage and talk about the importance of resilience and balance sheet strength?

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Matthew Gregory, Chief Financial Officer
Yes, it's a good question. I'll take that one. I think when we look at the Engine manufacturers, the OEMs are obviously dealing with a huge amount of capital investment in terms of their development and have to take a much longer-term view than potentially we do.

I think we have taken a balanced view by having a sensible and efficient balance sheet, at 1.5 to 2 times, rather than pulling back towards the 1 or 0.5 times EBITDA. I think we've looked at it across a number of different metrics and we feel that we pitched it about right. And I think that's very much in line with UK PLCs, that it's a sensible level of leverage, but without overextending ourselves.

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Chris Dyett, Investor Relations
The second part of the question relates to GTF and cash flows. So cash conversion in Engines will be weak due to GTF recall until 2026. You said GTF cash flow will remain negative after that. Can you explain the reasons for the delay and the gap between the strong RRSP margins and the cash generation and explain when you expect profits and free cash flow to match?

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Matthew Gregory, Chief Financial Officer
Sure.

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Peter Dilnot, Chief Executive Officer
I'll do the GTF piece around the programme. The first thing to say is that these are long-term programmes, 60 years, and they have a phase, and we're actually benefiting from that, of course, as a majority of our Engines are in the aftermarket phase generating cash. The GTF was always expected to be cash negative – it's in the early stages of its life cycle. I know it doesn't feel like the early stages, but in Engine terms it is. It was always expected to be cash negative until 2028. So there's no change to that guidance.

What the change is, is that it is more cash negative over that period, because beyond the development costs and getting the Engine up and running, which the programme bears, we've also got this unfortunate incident with the powder metallurgy issue which is being dealt with. So I just want to be really clear that the timeline of the GTF becoming cash positive actually hasn't changed relative to our assumptions, but the shape of it has because of the powder metallurgy issue. In terms of profit and cash recognition, do you want to go on?

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Matthew Gregory, Chief Financial Officer
Yeah, no, I'll cover that one off, that's fine. So we've said consistently that we have an exceptional portfolio of RRSP contracts, which give us a contractual entitlement to the aftermarket. The accounting standards require us to recognise some of the profits from that aftermarket, because we have a contractual entitlement to it and because our work is done. So we have no significant cost arising from delivering that aftermarket.

So what we do is at the point of shipping our OE part that goes on the Engine, we will recognise in a very, very prudent way an element of that aftermarket profit ahead of receiving the cash. So we have this unbilled work done. So that will continue whilst we're still shipping OE parts going on to Engines.

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Chris Dyett, Investor Relations
Thanks Matthew. There's one follow up question from a shareholder. Consensus is assuming much higher than simplly double digit EPS growth, e.g. 35% in 2025, 20% in 2026. Is consensus a reasonable baseline?

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Peter Dilnot, Chief Executive Officer
Well, consensus clearly is for a relatively short period of time. And on the EPS guidance, just to be really clear, I hope I was reasonably precise in this in that we're seeing very strong EPS. I mean, we're at 65% growth in the first half. The guidance we put out will also, if you just read that through for next year, mean EPS growth is going to be very strong, and it will continue to be strong.

The key piece though, is that we see over a longer period of time, way out to the end of the decade, that this is a story which isn't just about a big recovery, you know, with all of our improvement actions reading through.

This is about sustained long term EPS growth to a double-digit level going out for the medium term. So absolutely. I'm not going to comment very specifically on consensus year by year. But clearly, that's as far as our guidance goes.

The new news is the length of our commitment to EPS growth over time.

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Chris Dyett, Investor Relations
There are no further questions.

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Peter Dilnot, Chief Executive Officer
Well, with that, let me wrap up. Thank you very much for all of you here in London, for coming in from the sunshine on a busy day, and also for everyone joining on the webcast. Thanks very much. Goodbye.

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