Research Report

Report Date

14th February 2017

Analyst

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Collins Sarri Statham Investments Ltd

Share Price	708p
Yr/Hi/Low	831p/599p
Shares o/s	1.839m
Market Cap	£13.02bn
Avg Daily Vol	11.5m
Dividend Yield	1.58%

Website: www.rolls-royce.com

Key Risks

i) Margin pressures in core markets

ii) Weak cash generation due to high investment needs

iii) GE is a major competitor

Please note the risk warnings and disclaimers on the last page of this

Rolls Royce FY2016

*The headline results reflect exceptional items; i) £4.4bn revaluation of Rolls' derivatives exposure and ii) £671m charge relating to the bribery settlements in the UK, USA and Brazil iii) £200m goodwill impairment in respect of the 1999 Vickers acquisition. The first and last items are non-cash but the second is a cash charge. The headline loss is £4.636bn and loss per share of 220.1p.

*Stripping out exceptional items, Rolls revenues were £13.78bn (-2%) with pre-tax profits of £813m (-49%) and EPS of 30.1p (-54%). Using underlying numbers, operating margins dropped from 11.2% to 6.6%.

*Rolls-Royce deferred prosecution agreements (DPAs) with the Serious Fraud Office and US Department of Justice will be financed from internally generated cashflow but future payments approximate Rolls' entire annual free cash flow (£100m) in 2016. The DPAs envisage payments of £293m in 2017, £100m in 2019, £130m in 2020 and £148m in 2021. The DPA costs will impact Rolls cash flow and dividends in the next five years – a long time for investors.

*One notable positive, the first flight of the new A350-XWB powered by the low noise, fuel efficient Trent XWB-97 engine marks a milestone for Rolls' widebody ambitions, at least amongst EU manufacturers.

*Rolls' marine operations performed poorly, revenues fell 24% to £1.11bn with losses of £27m. The board's December 2016 restructuring of marine operations will extract £110m from costs by mid 2017 potentially enabling the division to turn a profit in 2017. However the outlook is heavily dependent on an oil services recovery/ higher crude oil prices which appear elusive.

*Rolls' power systems had a flat year, with underlying profit of £191m but lower operating margins of 7.2% (-1.1%). Demand fell in markets sensitive to low oil prices.

Conclusion

Rolls Royce has challenges keeping up in its core commercial aerospace market. Some of its product range is a bit dated, with newer products, the Trents 7000, 1000 and 900 and XWB engines all in the cash consuming stage in the engine life cycle. Rolls needs to do better in the high growth widebody aircraft relative to its major competitors (Pratt & Whitney/ Safran). Rolls is targeting 50%+ market share in installed widebody "over the next decade". This is a good target but Rolls has catching up to do.

There are plenty of moving parts in Rolls, but the 2016 results are to some extent a "kitchen sink" exercise, with plenty of bad news in the

document.

knowledge that investors post the bribery scandal are expecting bad news. Still the group free cash flow generation of just £100m is very low (2015 £179m) with virtually all cash generated from operations (£1.41bn) spent in investments (£1.36bn). Underlying EPS fell 49% to 30.13p. This decline could take 2-3 years to recoup.

Rolls Royce is a UK engineer specializing in commercial aerospace aircraft engines including Trent 1000, military engines, power systems, marine, nuclear equipment.

The board hedged with an outlook statement that affirmed a strong long term outlook but a flat short term outlook. There is no improvement in free cash generation (still £100m for FY17) which is low given £14bn annual revenues. The losses today are due to the realization that profit growth is post 2017.

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Rolls Royce **Relevant disclosures: <2>**

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2. Collins Sarri Statham Investments Ltd has clients who hold either shares or CFD positions in this security.

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