Why Ultra?
We enjoy solving tough problems, beating our competitors and making a difference for our customers, people and shareholders.

Ultra Electronics Holdings plc
Interim results presentation and script for the six months ended 30 June 2017

Rakesh Sharma, Chief Executive
Amitabh Sharma, Group Finance Director
7 August 2017
The **Ultra Electronics** Group manages a **wide range of specialist capabilities**, generating **highly-differentiated solutions** and products in the **Defence & Aerospace, Security & Cyber, Transport** and **Energy** markets.

We meet **customer needs** by applying **electronic and software technologies** in **demanding environments** and **critical requirements**.
Rakesh Sharma, Ultra’s Chief Executive provided an overview of the Interim results.

Good morning everyone it’s good to see you all and welcome to Ultra’s presentation of the Interim results for 2017.

Ami will, as usual, cover the first half performance of the Group and I will then cover the geopolitical landscape, US Defense Outlays, the second half and long term opportunities. To allow more time for questions we have retired updates of some previous slides to the appendix.

The presentation and script will be available later this afternoon on our website. Please remember that this session is being audio recorded and is being transmitted on a web cast. A transcript of the Q&A session will be available later this week.

Onto the overview.
I am pleased to say that the results for H1 2017 are in-line with expectations, if not a little ahead of management expectations, as shown on this slide. The analysis and guidance that we presented at Ultra’s 2016 Prelims, in March of this year, have been realised and we are on a trajectory to deliver the year end. There is no change to our guidance based on the same £/US$ assumption made in March.

The cash conversion of 53% reflects the higher capital expenditure this year and follows the usual cycle owing to dividend and tax payments both occurring in the first half. We remain on track to achieve the guided full year performance of around 80% cash conversion.

With the continuation of the good cash conversion achieved in 2016 the balance sheet remains strong and the debt levels are within a comfortable range.

I am pleased with the operating margin of 15.7%, which is in-line with the prior period, despite the increased mix of engineering compared to production programmes.

The order book of £808m is up from the start of 2017 and has increased by 2.8% from H1 2016. This represents a pleasing book-to-bill ratio of 1.07.

Ami will provide the customary detail but suffice to say that I am very satisfied with the progress of our S3 initiative and that it remains on track to deliver at least £20m of enduring savings by the end of 2018.

As you are all aware, we have entered into a conditional merger agreement to acquire Sparton and completed the placement of 9.9% of equity, in July, since the period end. I am happy to take further questions on this acquisition but may I remind you that since this is a class one transaction my answers are limited to public domain information.

Let me now handover to Ami to take you through the detail of the first half performance.
Amitabh Sharma, Group Finance Director, presented the details of Ultra’s first half financial performance.

Thank you Rakesh and good morning to everyone.

I am pleased to present our interim results for the period ended 30 June 2017.

You will have seen the numbers for this slide earlier this morning so I intend only to cover a few points.

The Group has closed with a good order book, improved order intake and strong balance sheet. A lower tax rate has helped increase earnings per share.

FX movements during 2017 clearly had a positive impact on most of our key indicators. For reference, sterling weakened 12% against the US dollar, with the average rate moving to 1.26 in the first half of 2017 from 1.43 in the comparable period last year.

The order book was £808m compared to £786m at the end of June 2016 and £799m at the end of December 2016. Looking at the order book increase compared to June 2016, the overall increase of 2.8% included 1.8% of organic growth and a foreign exchange benefit of 1.0%. Compared to the order book at the end of December 2016, overall growth of 1.1% included organic growth of 3.9% offset by a foreign exchange reduction of 2.8%.

Order intake increased 7.4% to £390.3m which takes order cover for 2017 at this stage to 82% compared to 84% last year. Foreign exchange accounted for 8.7% of the increase; disposals reduced growth by 2.8% and underlying order intake increased by 1.5%. Order intake was strong in May and June following the end of the Continuing Resolution.

Revenues and operating profits were broadly flat at £366m and £57.6m respectively, leaving margins at 15.7%

Earnings per share improved by 0.3% as the tax rate reduced slightly to 21.5% compared to 2016.

The dividend has increased by 2.8% to 14.6p.

Operating cash flow of £30.5m represents 53% cash conversion.
Moving to the revenue bridge.
The weakening of sterling against the US dollar increased revenues by £34.4m or 9.3%.
The ID business, Ultra’s first divestment, was sold in August 2016 and diluted revenue growth by £10m or 2.7%.
This left an underlying organic decline of £24.6m or 6.7%. This decline was due to the FY 2017 Continuing Resolution ending in early May which delayed order intake and hence revenues compared to last year when the FY 2016 Continuing Resolution ended in January 2016.
Furthermore, there were a higher proportion of engineering contracts in our Communications and Security division compared to last year. I will talk about this later on.
The profit section is shown at the bottom of the slide which highlights the main drivers within the movement of operating profit.
Currency increased profits by £4.6m or 8%.
The ID disposal diluted profit to the tune of £1.6m or 2.8%.
The effect of lower revenues led to an organic decline of £3.1m. This included a transactional foreign exchange loss of £1.0m as the period end US$ rate moved from 1.23 at the end of 2016 to 1.30 at the end of June.

I would like to take this opportunity to discuss IFRS 15, which is the new accounting standard on revenue recognition. This will be effective for the calendar year 2018 so we have undertaken a project to identify the changes it would make to our 2016 results. This project is nearing completion and has identified that even after applying the new standard the majority of the Group’s long-term contracts will not produce different numbers. The changes we have identified arise from separating contract performance obligations and some transactions which will no longer be accounted for using long term contract accounting.

A substantial majority of transactions where revenues are recognised as control of goods pass to customers will not change either. Remember that the new standard will not change cash flows. Our auditors will be reviewing the project findings, including the changes that have been identified, and we will report further after this is complete.
Turning to the next slide which shows our investment to support future growth.

You will see on the right hand side that the acquisition spend in the period was £6.8m, reflecting retention payments relating to our 3 Phoenix business which were scheduled at the time of acquisition.

On the left hand side you can see the R&D spend for the period which, in absolute terms, was £76.6m in 2017, compared to £68.6m in 2016 reflecting the increased customer funded engineering. This represents 20.9% of revenues compared to 18.7% of revenues in 2016. Ultra funded R&D was £16.6m in the period.
Operating cash flow

<table>
<thead>
<tr>
<th>£m</th>
<th>2017 H1</th>
<th>2016 H1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating profit*</td>
<td>57.6</td>
<td>57.7</td>
</tr>
<tr>
<td>Depreciation &amp; disposals*</td>
<td>6.6</td>
<td>7.0</td>
</tr>
<tr>
<td>Capital expenditure*</td>
<td>-4.8</td>
<td>-2.2</td>
</tr>
<tr>
<td>Working capital increase</td>
<td>-27.5†</td>
<td>-19.8</td>
</tr>
<tr>
<td>Other</td>
<td>-1.4</td>
<td>-4.2</td>
</tr>
<tr>
<td>Operating cash flow</td>
<td>30.5</td>
<td>18.5</td>
</tr>
<tr>
<td>Cash conversion</td>
<td>53%</td>
<td>67%</td>
</tr>
</tbody>
</table>

Full year expectations of around 80% unchanged

* Software is considered part of Ultra’s capital expenditure, consequently these lines reflect expenditure, amortisation and disposals of software. The 2016 comparative has been restated to present software on the same basis.
† Working capital as defined in note 11 includes cash, equity in associates, prepayments, receivables, inventories, trade payables and other working capital items.

Operating cash flow of £30.5m represented cash conversion of 53%, compared with 67% last year.

Capital expenditure increased, as expected, to £4.8m as our ERP implementations began. There are two in progress at the moment, one at our PCS business and the other at our CSS business. Both projects are on track and one is scheduled to go live in the last quarter of 2017 and the other in the first quarter of 2018. A further three have been authorised and will commence in the second half.

Working capital increased by £28m over the first half of the year in advance of anticipated deliveries over the rest of the year. A breakdown is included in the box on the right hand side of the slide.

Inventories represented £6m of the build up in working capital, with a number of businesses increasing stock levels. The Communications & Security division has a greater proportion of engineering programmes under way in the first half and this contributed towards the increase in the debtor balance. Creditors decreased as we paid £3m in previously accrued Oman legal fees in the period as well as bonus payments and released some risk reserves on international sonar programmes that are coming to an end.
Moving on to net debt.

I am pleased to report that closing net debt was similar to the year-end close position, remaining almost unchanged at 1.78x, compared to 1.76x at the end of December, and was substantially below the 2.3x position at the end of June 2016.

Looking at the various non-operating cash flow items:

Interest, tax and dividends were higher at £36.0m which was caused by cash tax paid being higher than the unusually low level of payments in the prior year.

The US Dollar has weakened against sterling over the half year resulting in US$ debt decreasing in value by £10m. This foreign exchange difference represents most of the other balance.

During the period there were no changes to our banking facilities. Headroom on committed facilities was £194m at the end of the period.
We have received in some investor meetings questions around the growth in 2016 amounts receivable from contract customers. I would like to take this opportunity to explain the movements in this line.

Firstly, Herley, as a new company to the Group in 2015, included, in error, their £7m amounts receivable from contract customers in the prepayments and accrued income line of the balance sheet. Had this been included in the right line, there would have been no significant increase other than FX.

Secondly, the growth in H1 2017 is due to the increased number of engineering programmes. As we have discussed previously, revenue and margins on those programmes are taken in accordance with long term contract accounting. As you know, we are prudent by taking lower margins on these early contracts.
For completeness we are including the geographic and segment analysis.

UK revenues reduced from 24% in 2016 to 22% for the first half of this year, with the decline attributable to the disposal of ID and a number of UK programmes ending last year. This reflects our previous comment that the UK market remains a difficult one.

The Rest of the World revenues grew by 2% due to international sonobuoy sales and increased international sales from our Forensic Technology business.

As normal we present the revenues by segment on the right for your information.

The most significant movement was a lower C2ISR segment as a proportion of revenues, as the segment moved from 22% in 2016 to 19% for this first half. This was principally due to the disposal of ID. Maritime improved by 200 basis points to 8% due to increased spend on radar programmes in the US.
It is worth reminding everyone that each of our divisions go through margin cycles as they move through different phases and this slide seeks to illustrate graphically where each division is at the moment. Further, depending on the type of engineering contracts awarded, some require Ultra to fund the engineering phase while others attract customer funding.

Research and development expenditure is typically highest in the Aerospace and Infrastructure division as commercial aerospace programmes are company funded. However, our aerospace activities are transitioning into production and therefore R&D expenditure will be reducing as a percentage of sales in the second half of the year. In the Communications and Security division, where the production of the crypto contract (ECU RP) completed in 2016, there are a number of engineering contracts that are customer funded. The Maritime and Land division has a number of large production contracts with limited R&D programmes.

The consequences of this cycle is that total R&D will increase in the year, however, internal R&D as a percentage of revenue will decrease by the end of 2017.
Moving on to how the three divisions performed, we start with Aerospace and Infrastructure.

Both revenues and profits increased, with margins improving due to the continued weakening of sterling against the US dollar.

Whilst the Communications and Security division saw an overall decline, when the ID business, which was sold in August 2016 is excluded revenues in this division were flat. The operating profit decline, when excluding ID, was 8.5% with £13m compared to £14.2m in H1 2016. This was due to the greater level of development programmes in the period when compared to 2016 and the Continuing Resolution which has moved revenues out of the first half of 2017. Encouragingly, strong order intake, notably at our CIS business, resulted in a 7.2% improvement in the order book.

Looking at the Maritime and Land division, increased demand for both US domestic and international sonobouys continued. The CR has an impact on this division as well, but margins improved due to the release of risk reserves as an international sonar programme comes to an end.
The aim of our S3 programme is to reduce complexities within our group so that management can focus on growing their businesses rather than managing the back office processes.

The programme remains on track as we reach the mid-point and the table summarises the financial elements of the S3 initiative:

From left to right, column 1 shows the programme has cost £3.0m for the first half and column 2 shows that cumulatively we have spent £14.4m.

The costs to date comprise project costs, together with onerous lease provisions, consolidation costs and the costs of some headcount reductions owing to property closures.

Column 4 shows that S3 has generated savings of £5.6m in the first half of 2017, which on an annualised basis, as shown in column 5, represents £11.2m per annum. This was in line with our expectations for the mid-point of the programme. The project continues with the estimated cost savings of £20m per annum by 2019 unchanged.

<table>
<thead>
<tr>
<th>Workstream</th>
<th>Total spend year to date (£m)</th>
<th>Total spend to date (£m)</th>
<th>2017 savings achieved to date (£m)</th>
<th>Annualised savings achieved to date (£m)</th>
<th>Total enduring savings from 2019 (£m)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property/facility management</td>
<td>1.3</td>
<td>8.7</td>
<td>3.8</td>
<td>7.6</td>
<td>7.6</td>
</tr>
<tr>
<td>Consolidation</td>
<td>0.5</td>
<td>1.6</td>
<td>0.8</td>
<td>1.6</td>
<td>3.5</td>
</tr>
<tr>
<td>Sourcing</td>
<td>0.7</td>
<td>2.3</td>
<td>0.9</td>
<td>1.8</td>
<td>6.6</td>
</tr>
<tr>
<td>HR</td>
<td>0.2</td>
<td>0.4</td>
<td>0.1</td>
<td>0.2</td>
<td>0.9</td>
</tr>
<tr>
<td>ERP related</td>
<td>0.3</td>
<td>1.4</td>
<td>-</td>
<td>-</td>
<td>1.4</td>
</tr>
<tr>
<td>Total</td>
<td>3.0</td>
<td>14.4</td>
<td>5.6</td>
<td>11.2</td>
<td>20.0</td>
</tr>
</tbody>
</table>
Finally some thoughts on outlook.
As we have indicated since the preliminary announcement in March, our performance is more heavily weighted to the second half than usual. Our full year guidance is unchanged for organic growth to be in the zero to 1% range. The India defence systems contract, which was won last month, will not alter this as it is not scheduled to enter production until the end of 2018.
We expect cash conversion to be around 80% in 2017 and to return towards our through-cycle target of 85% in the medium term.
We expect organic growth to continue in 2018 and beyond. The speed and timing of this will be dependent on the annual US Federal Budget process.
I provided the detail earlier on the current investment cycle. Moving forwards internal R&D is likely to be lower while customer funded R&D will increase and therefore total R&D spend is a better guide to our investment plans.
Our recent equity raise has reduced our debt levels until the acquisition of Sparton is complete. Our net debt to EBITDA ratio at the end of the year will therefore reflect this.

The Sparton acquisition process continues with the shareholder and regulatory approvals in progress. We will update in due course. The estimated completion date is 1 January 2018.
Thank you. I will now hand over to Rakesh to discuss future prospects.
Rakesh Sharma, Ultra’s Chief Executive, continued by discussing full year and future performance as well as market dynamics against Ultra’s market segments.

Thank you Ami.

My presentation today is going to have four distinct sections;

• Geopolitical landscape
• US Defense Outlays
• Second half 2017 revenue and
• An update to the long-term opportunities

So first, onto the geopolitical landscape.
The geopolitical landscape is generally as presented at the Prelim presentation earlier this year. Therefore, I intend to focus on the minor changes and nuances.

First, North America. You will have read that defence spending is on the increase, in both Canada and the US. Canada has declared its intent to near double defence spending by 2020. The majority of this increased investment is to build ships to patrol and defend the opening of the arctic circle passage, between the Atlantic and the Pacific. As I have mentioned before, a defence friendly White House, House and Senate is supportive of an increased investment budget as is being demonstrated in the FY18 requests and the positioning for FY19. However, it is by no means straight forward. The Democrats still want an increase in non-discretionary spending before they will agree to vote for an increased defence budget. With the recent weakening of the GOP, the Democrats are feeling stronger and emboldened. Additionally, the recent announcement of the potential absence of John McCain through illness, is a worrying setback. John is a vocal supporter of the military and the need to keep it properly equipped as well as being able to cross the aisle to garner support from both parties. His anticipated absence will be keenly felt.

Second, the UK. We continue to have concerns about the UK market. At best, defence currently comes sixth in the Governments pecking order after; healthcare, social care, police, education and building safety. I do not anticipate any new money until 2020.

Third, mainland Europe. Merkel has indicated that ‘Europe must be in control of its own destiny’. Consequently we have seen indications of rising defence spending, although France has recently announced a cut to bring their economy back into EU guidelines as an example to other countries. Any increased funding will favour national champions over Ultra as defence is not an open market.

Finally, the Middle East and Asia-Pacific. Both regions have a need to increase defence spending but contrastingly for different reasons. The former for terrorism and the latter for Chinese ambitions and North Korean volatility. The Middle East is still pre-occupied by regional tensions with Yemen, Qatar and Iran. This in turn slows spending on improving defence capability in favour of war materiel. This is further exacerbated by the oil price refusing to budge from less than $50 per barrel of oil. The oil price is also causing a cash crisis in this region with many companies suffering significant negative cash flows on their contracts.

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The Asia-Pacific is experiencing a mini arms race reminiscent of the Cold War. Many opportunities exist, not only for new platforms and systems, but also for the upgrade and refresh of legacy systems. Anti-Submarine Warfare is a growing requirement with many nations becoming submarine hunters for the first time. This is helped by the export of the Boeing P-8 Poseidon and the Lockheed SH-60 Romeo ASW platforms.

Onto the next slide.
We have done more analysis of Ultra’s performance relative to the US market. I thought that the result may be of interest as it forms the backdrop to the investment case in Ultra.

This graph takes the publicly available US Defense Outlays, over the indicated years, as a percentage of growth in spend in calendar year and plots it alongside the organic revenue growth percentage generated by Ultra. Within the Ultra numbers we have omitted the one-off effect of the cancellation of the Oman contract and the impairment of the ProLogic business. However, the correlation is still evident with those effects in or out.

The result is as you can clearly see that there is a strong correlation between the two with a lag of 18 months to two years.

You will also remember that I have previously said, on many occasions, that I do not watch or concern myself with the level of the US Defense Budget. I watch more closely the US Defense Outlays as it is a clearer picture of whether the US DoD is actually spending the money. The US Defence Outlays for Calendar Year 16 of the investment budget was up 1.3%, the first time in five years, and for the Calendar Year to end of June 2017 it was up 4%. I am heartened by this as a leading indicator of organic revenue growth for Ultra. The Group can grow in the US at a faster rate than the growth in Defense Outlays because we are in two of the three sweet spots experiencing increased spending being;

• Underwater Warfare and especially Anti-Submarine Warfare and
• Electronic Warfare

The third being Ballistic Missile Defense where Ultra has a small supplier position.

This data should allow you to see the case for organic growth in Ultra in the future.

Turning now to how I see the second half of 2017 developing.

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The required second half performance is typical for Ultra but I’d like to provide a little more detail to demonstrate why we have confidence in delivering our guidance for the year.

On this slide you can see that our order cover at the end of June is 82% of the full year revenue. This is broadly in-line with 2016 at 84% and 2015 at 83% remembering that we had a CR this year till early May. That means that we have to ‘book’ 18% in the second half and ‘ship’ it by the end of December. Currently the total value of bids outstanding and opportunities yet to be bid, that will provide revenue this year, is 413% of the ‘book and ship’ needed.

Let me also provide you with the flash results for July. Please bear in mind that because this data is gleaned from our flash process it may not be wholly accurate but is indicative of the month’s results.

In July we had an order intake of about £70m and revenues of approximately £44m. Consequently, our order cover for full year revenue is now 86% which is exactly the same, at this point, as 2016. This leaves 14% as the ‘book and ship’. Major orders booked in July include;

- Indian Navy Defence Systems – Value not to be disclosed at customer’s request
- South Korea Sonobuoys – $5m
- P8 Sonobuoy Receiver refresh – $4m
- US Navy cyber security – $3m

Moving onto the next slide.
This slide is an update to the one presented earlier this year. I have removed the programmes that were won at the time of the Prelims and added four more items being:

- **US Virginia Class** – follow on
- **UK encryption and key management**
- **UK RAF secure radio upgrade** and
- **Nuclear sensors build and support**

First, the US Virginia Class. Our business in Long Island, NY has been on the Virginia Class submarine since the start of the programme. This opportunity is for the next flight of submarines and therefore has a high probability of proceeding and that we will get the award. I cannot go into the details of what the system is as even the nature of it is classified.

Second, UK encryption and key management. Ultra has been selected to support the UK Government’s sovereign encryption and key management requirements. Orders will be placed, for a combination of engineering contracts, towards the end of 2017. These will be followed by a significant production programme in the future.

Third, the RAF secure radio upgrade. Ultra is providing encryption and secure communication upgrades to the UK’s Typhoon aircraft. An engineering contract of approximately £4m is to be placed in the last quarter of 2017 followed by production orders in 2018. Through Life support will be additional to this.

Finally, the nuclear sensors. Ultra is involved in multiple live programmes as it continues to replace and upgrade aging US nuclear power plants with both existing products and newly qualified sensors extending the product range. Moving on to the summary.
Summary

- First half performance in line with expectations
- Order book of £807.8m, up from £799.3m at start of 2017
- Business model is sufficiently strong and resourced to deliver operational performance and M&A objectives
- Market remains as previously highlighted
  - Uncertainty in UK
  - Strong growth in US and Asia Pacific
  - Growth expected in mainland Europe which will benefit national champions
  - Middle East volatility
- Guidance for full year-end maintained

Executing strategy for growth

As you have seen and heard, the first half of 2017 has been busy. Despite the CR lasting until early May our order intake has held up very well. A trend that we have seen continue into July, with the award of the contract from the Indian MoD. As the banner says at the bottom of this slide, we have been executing the strategy and the goals that we communicated last year, in an efficient and timely manner. This bodes well for the end of this year as well as beyond.

Whilst delivering the operational performance we have also agreed a conditional merger with Sparton. This illustrates that we have the management depth and breadth, as well as the organisational resilience, to deliver the organic revenue growth as well as any acquisition growth.

Even though we have seen an improvement in the US and Asia-Pacific markets we are not complacent, The World continues to be a volatile place and geopolitics could alter defence budgets for the better or the worse. We have been prudent in our forecasts by excluding certain export opportunities where the timing is unpredictable.

Finally, our guidance for the full year and 2018 is maintained. It could be a little bit higher if yet more export contracts are secured: it could be a little bit lower if a CR were to extend into 2018. A situation very similar to last year but now with a few more data points from which to base the forecast.

Thank you, that is the end of our presentation. We will now take your questions.
Ultra 2017 Interim Q&A transcript

Q:
I have some big-picture questions about the medium-term growth rates and achievable margins within the industry. On the growth rate front, it feels like the US budget's been waiting to rise for, really, a couple of years at least now, and it still – it just doesn't happen. Your colleagues at Northrup Grumman were saying it's really going to be FY19, because there aren't even enough people in position in the DoD to actually execute a new policy, carry out an increase in spending and so on. I'd be interested in your views on that.

Then, on the margin front, you've been traditionally a 16.5%, 17% business. Your colleagues at Cobham are saying – they are, if you like, to some degree newly-arrived in the sector, are saying we think the natural margins for a high added-value defence company, such as themselves, is 13% to 14%, because, in the end, your selling to government at-end market. Obviously, we've had lots of noise both in the UK and the US about pricing and allowable margins, so is your historical margin performance sustainable in the medium term? Thank you.

A:
Rakesh Sharma, Ultra

Let me cover the US budget first of all. If you remember, when we did our “This is How Washington Works” Capital Day, we said that today's budget is first worked on three years in the past. It takes three years to bring all the baseline bottom-up requests up to the top level and get it through the DoD, and then through the White House, and onto Congress and through the Senate. So from that point of view, 2019 is the first budget that the Trump administration will have been able to directly influence. It has a small influence on 2018, and a negligible influence on 2017.

There's a lot of numbers that have been thrown around about the US defence budget. I've heard numbers of 10%, 8%, 9%. There's an interesting statistic, the US defence budget has only grown sustainably between 3% and 5% for a period of six years in one point in history, that was during the Second World War. Ever since then, it has not managed to achieve a sustained 5%, so I discount the growth rate and we have been prudent in our forecast assumptions. All of our guidance at the moment assumes only what's in the FYDP budget, which is 2% compound growth. Until I see the piece of paper in my hand as to what has been agreed by the White House, I'm not going to work it into the numbers.

Now, as you saw, because we're in two of the sweet spots, we believe that we can grow faster than that 2% sustainably. The '18 budget is going through at the moment currently ‘18 is a 4% or 5% increase. If that comes through, then that's good news. I've got some upside, but I've limited the downside in my forecast, so we're being very prudent.

On the defence margins it's for Cobham to speak to how they see their business. I can't speak for the industry, because the industry is so varied. I think it's like comparing apples with oranges; they're both fruit, but they're completely different. I can only comment about Ultra. We have shown sustainable margins even during the difficult period that we've had. We've had organic decline over the last four years but our margins have actually increased. Some of it is self-help, some of it is the pricing power that we have in the market.

When you do the types of things that we do, there's very few people, if any on some technologies that can compete against us. We are regarded by our prime customers as being part of their team, because they can't go anywhere else.

We believe that not only can we sustain the 16.5%, but, as a result of the S3 programme, the higher margins from Herley, and also bringing Sparton into the Group, which has a higher than the Group average blended margin, all of those things put together, we can actually sustain 17.5% beyond 2019. I've also said to you previously I won't allow the margins to go up much higher than that, because I've got a lot of lustful customers who look at my report and accounts every year and say, I wish we were making the margins that Ultra make. So, we will top slice at that point, and any profit on top we will put back into R&D to generate more organic growth.
Q:
Just a brief follow-up on that. You’ve mentioned Boeing, and they’ve been a particular case in point, but they appear to be adopting a much harder line towards their supply chain. Collins are an example of that, which I suppose is probably a level above you in terms of the tiers. From what you’re saying, you’re not feeling any of that at all from Boeing?

A:
Rakesh Sharma, Ultra
No. The two examples that I’ve got are; the engine ice protection for the JSF. Lockheed is coming under a lot of pressure from the DoD to reduce prices. In fact, the last flight, they got a price £30 million below what they offered per aircraft. And the wing ice protection for Boeing; there is nobody else on this planet that has the same wing ice protection technology. What is Boeing going to do? Decide not to build aircraft if I don’t supply? It’s a case of knowing when you have to be tough and when you have to bend. You can’t be tough all the time, but you have to know when you have that pricing power, and we do.

On the Lockheed Martin, the F-35, where we do the engine ice protection, again, similar position. Nobody else has the technology that we have, but not only that, we actually have a life-of-platform agreement with Lockheed Martin, where they asked us, hit this price target. The quid pro quo was, if we hit the price target, they would give us a life-of-platform agreement. I have a legally-binding agreement that says, as long as they are producing F-35s, that we will supply the engine ice protection and the fan ice protection for that aircraft.

Also, when you look at the pecking order, I’m $300,000 per aircraft. They could beat me up till the cows come home; it’s not going to save them that £30 million. There are a lot bigger guys out there with a bigger portion, bigger share of the aircraft, that they could make significant inroads into their price structure before they even contemplate coming to me.

Q:
I’ve got three questions: The first one, Maritime and Land, where – very impressive margins in the first half. I notice you talk about some risk releases on some international contracts. I know you had some risk releases last year, I think, on US sonobuoy. Was this US stuff, or is this truly international? And have we seen all the risk releases now or is there more to come?

A:
Amitabh Sharma, Ultra
No, it is truly international. It’s not US.

Q:
And that’s now done, or is there more to carry on the second half?

A:
Amitabh Sharma, Ultra
No, that’s done, that particular programme.

Q:
The £10.4 million of charge that you took below the, on acquisitions and other items, which seems to be some of the earn-out payment on historical acquisitions and also the costs of the Sparton due diligence. Are you able to break those out, for us to understand what those are?

A:
Amitabh Sharma, Ultra
Yes. About £7 million for the 3 Phoenix and most of the rest is Sparton around £3 million.
Q:
The final question that I had was just, the organic growth that you’ll have in the second half and that you need to deliver in the second half, to hit the 0% to 1%, what are the major contracts that we should be looking for to come through in the second half, or that you think are most likely to come through, to help you drive that and achieve that on your target list Rakesh?

A:  
Rakesh Sharma, Ultra
The major contracts; The first will be some of the aerospace contracts. If you remember, we’ve been talking about the internal R&D funded engineering work that we’ve been doing on all the commercial aerospace positions that we’ve won. They now start to ramp up in production. If you remember, I said it breaks even on cash in 2019. There’s been no revenue in the first half of 2017 on these new programmes. That’s one of the reasons why you see the inventory build-up, because we’ve got the inventory in order to execute that production programme. That’s in the Aerospace and Infrastructure.

There’s another largish contract for us on the nuclear deterrent, the Dreadnought Class, where we are part of the Submarine Enterprise Programme, and we’re waiting for that contract to be awarded. BAE Systems have been funding us on a limit of liability basis and the programme will get up and running in full-steam in the second half. That’s Maritime and Land.

In the Communications and Security division, there are more engineering programmes than anything else. It’s not production. There’s a lot more engineering going on in Comms and Security and that’s all customer funded. Those are the three areas, I would say.

Q:
A slightly technical question to do with used sonobuoys. Do they self-destruct, are they used again, or do they fall into the hands of enemy and explode?

A:  
Rakesh Sharma, Ultra
Well, they definitely don’t explode. With a sonobuoy, you pre-programme its life. Different scenarios live different hours. At the end of that period, the sonobuoy burns a hole in the float bag that keeps it above the surface, and the whole thing just sinks to the bottom.

Q:
Just about the UK and under water, is Sea Sentor, or whatever it’s called nowadays, UK or US technology, or both?

A:  
Rakesh Sharma, Ultra
It’s UK. Sea Sentor is a UK device and a UK technology. But we also have US technology which is supplied to the US Navy, called the Torpedo Weapon System.

Q:
Therefore, for the UK stuff we don’t need US clearance?

A:  
Rakesh Sharma, Ultra
Correct. It goes through UK export licensing. The MoD and the Royal Navy have been very helpful in some of the export contracts, because we’ve been able to demonstrate a system being used operationally on a ship. The Royal Navy has very much helped our export drive by welcoming foreign visitors onto the ships to see the system working.
Q:
On Type 26, are we just robbing equipment from Type 23?

A:
Rakesh Sharma, Ultra
If you remember, we’re supplying Sonar 2150, which is a new sonar for the Type 23. It’s an upgrade of the 2050. One of the reasons why we won that competition, against the incumbent, is that we proposed brand new technology that could then be taken from the 23 and put onto the 26. Depending on how many ships there are in the class, either they’ll have enough from the Type 23, or they’ll need to buy more. That hasn’t been determined yet.

Q:
Then a slightly – just so that I get this clear. I get the idea that we’re funding a lot of engineering development work, which is customer funded.

A:
Rakesh Sharma, Ultra
Yes.

Q:
The increase in contract receivables is then what, broadly speaking? I’m not looking for specific contract terms. I just wanted to know which division it’s in.

A:
Amitabh Sharma, Ultra
Yes, for the Comms and Security division, so they tend to be longer for development contracts, and so the cash flow profile isn’t quite the same as the production contracts, which are shorter. The cash flow profile is different to development programmes. That’s why the amounts recoverable on long-term contracts is growing.

Rakesh Sharma, Ultra
There are three leading indicators in Ultra for organic growth. The first is the defence outlays, as we’ve discussed. The second is commercial Aerospace, where production is yet to ramp up. – We’ve had nothing but cash going out and no revenue. Eventually, when that production happens, it’s pent-up revenue that comes through. The third leading indicator is the makeup of the total R&D spend between internal company-funded R&D and customer-funded R&D.

We are a make-to-order business, most of our contracts will have an element of engineering before they get into production. When you start to see customer-funded engineering rising, it means we’re employing engineers to do funded work-generating revenue, which then eventually generates more revenue and more margin when it goes into production, as we take margin at a very low level during engineering.

Q:
Yes, that’s cool. I’m just slightly perplexed. Unless the customer isn’t funding the R&D regularly, and that’s explaining part of the increase in long-term contract receivables, I’m also trying to probe where the receivable is building, because I can’t think of an obvious major…

A:
Amitabh Sharma, Ultra
It’s long-term contract accounting, remember, you incur costs as you go through and you recognise revenue on costs, so it’s long-term contract accounting that causes that build up.
Q:
Then just an idle curiosity question. This litigation in Oman, which is clearly quite costly; the aim of doing that- It’s worthwhile? We are convinced?

A:
Rakesh Sharma, Ultra
If we didn’t fund that litigation, and the employer wanted to litigate, they would win a case in absentia, which would then mean, potentially, a further case that we would be forced to fund. The whole idea of funding litigation at the moment is to come to an amicable settlement. That’s what we want. If we don’t do anything they’re not going to want to settle. They’ll want to follow through and go after the subsidiary, Ithra, and then try to argue a case against plc.

For us to encourage them to come to the table, we have to fund a level of litigation to show them that we are serious. Now that they are going to have to ramp up their spending, we expect that it starts to hurt them in their pocket. They will want to have coffee with us around a table and come to a deal.

Q:
Messy, wasn’t it, really, all that?

A:
Rakesh Sharma, Ultra
Yes. That’s why we want to draw a line under it. It happened. We feel, unjustly, that it happened, but I learned a long time ago, justice and the law are two different things. As far as the Board is concerned, we just want to draw a line under it and move on.
Q:
Maybe just a quick follow-up, if I could, on the theme of the Sparton acquisition and, particularly, around some of the funding of that. Just if you could help share with us your thinking as to the scale of the modest equity placement, but the scale of that in the context of, once you get on with MDS disposal, assuming you get half decent proceeds for it, and your confidence about the ongoing cash conversion rate of the business, which 85% last year very good. Unless my modelling is wrong, after that acquisition, and the disposal, and the capital raising, the [net equity to] EBITDA goes down over that which it has been previously, and you’re going to be generating all this cash. Why do the maximum 9.99% equity placement?

A:
Amitabh Sharma, Ultra
Yes, it’s a prudent level of funding, though. That’s the way we looked at it in terms of the equity to debt. The net debt to EBITDA, the target is 1.5 times by the end of 2018, is what we’ve said publicly.

Rakesh Sharma, Ultra
In terms of, why go for the whole 9.9%, it sounds like a glib answer, but it isn’t. We may as well have a good balance between equity placement and debt so that it does give us headroom. We will look at acquisitions in the future. I’m not saying I’m going to go out tomorrow and buy something else, but, certainly, what we’ve said is the cycle now is buy a large acquisition, integrate it, pay the debt down, and then a year to two years later do another largish acquisition. When you take a look at that sort of cycle, it made sense to do the full 9.9%, rather than 6% or 7%. It would be bad management practice otherwise.

Amitabh Sharma, Ultra
Can I add to that? Our guidance for this current year was 1.5 times by the end of the year, in the absence of any M&A. By the end of 2018 it will be at 1.5 times in the absence of M&A.

Q:
I get the fact that the Continuing Resolution for FY17 has pushed things out. Arguably, that’s all going to get superseded by FY18 if Congress can get some legislation through. I’ve only done a superficial analysis of it, but from what I can see in terms of upgrade and modernisation it’s hello time from your perspective. Because I can’t believe that these US warships don’t need a substantial amount of modernisation, and God knows what, let alone whatever they do with P3 and God knows. It just looks like FY17 becomes irrelevant if FY18 goes through on time.

A:
Rakesh Sharma, Ultra
Let me talk about FY18 and the process there. Our early indications – and I went to Washington a couple of weeks ago, is that the budget will not be signed at the end of September and there will be a CR. We think that with all of the issues that the administration has at the moment, and the Republicans have with it, in terms of the political drama that’s being played out in Washington, the Democrats will hold out. They will not agree a budget by the end of September. Now, we think that that CR will last until December. The reason being is that now that the Republicans are in charge of the White House and the Senate, for it to extend into 2018 will be seen as a failure on part of the Republican Party. I think they will agree to compromise with the democrats as we have mid-term elections in 2018. In terms of the 2018 budget itself, it’s looking good for companies that are doing more with the Navy than with the Army and the Air Force. When you take a look at our split in defence spending, something like 58% is with the navies of the world. We are heavily dominated by the maritime influence.

But I’m not going to start popping corks and having parties until I see the piece of paper in my hand. There are a lot of things that can change. There are a lot of political games that can be played. Until we see some of the sentiment coming through into law and programmes of record, we’re going to continue to be prudent with the guidance that we’ve provided. I hope to do better, but I expect not to do worse.

Anything else? If there are no other questions, thank you very much for coming along today. Good to see you all.