QinetiQ
Trading update call

17th March 2025

Transcript

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Steve Wadey: Okay, good morning everybody and thank you for joining us at short notice. As you would have seen in this morning's trading update, we have highlighted two specific factors that have impacted our year-end performance. Firstly, we updated you at the end of the third quarter that we had experienced slower order intake due to a difficult trading environment. Those conditions have persisted. Secondly, within the context of the US market environment and following the appointment in January of Tom Vecchiolla to lead our US sector, we have reviewed our US operations and are embarking on a restructuring to support future growth. Notwithstanding these two short-term factors, we do remain well-placed for long-term growth due to the underlying strength of the group and relevance of our mission-critical capabilities.

Addressing the first factor, the tough near-term trading conditions have affected short-cycle work in our UK intelligence and US sectors, resulting in further delays to a number of contract awards. In addition, the recent geopolitical uncertainty has impacted our usual fourth quarter weighting to higher margin product sales from the US. As a result, today we're announcing that we expect organic revenue growth for FY25 to be approximately 2% at an underlying margin of approximately 10%, including one-off in-year charges of approximately £25-30 million. Order intake we expect to be good with a book-to-bill ratio of more than one and cash conversion to be good with net debt in line with last year.

Reflecting the slower order intake, we are also providing preliminary guidance for FY26 revenue growth to be approximately 3-5% and within the margin range of 11 to 12%, consistent with our existing financial framework. Addressing the second factor, the review of the US, the market backdrop, and operational performance combined with a higher discount rate has resulted in a number of updated judgments leading to a number of one-off exceptional largely non-cash charges of approximately £35-40 million, predominantly related to inventory and cost recovery in our legacy US operations, not Avantus, and a goodwill impairment charge of approximately £140 million at year-end.

In response to these two short-term factors, we have taken proactive action including re-sizing some of our capabilities in our

UK intelligence sector, which we noted in our third quarter trading update and we are embarking on a restructuring of our US sector to support future growth, building on our core capabilities and leveraging incumbent positions across the group. We are a highly cash-generated business and both short and medium-term cash conversion remains strong. Consistent with our capital allocation policy, We're also announcing today an extension to our share buyback program of up to £200 million over the next two years. In essence, we are continuing our buyback program at the same rate once the current £50 million tranche completes at the end of May. Longer term, the underlying strength of our group, coupled with the relevance of our mission-critical capabilities, the national security needs of our customers positions us well for long-term future growth. Martin and I would be now happy to take any of your questions. Thank you.

Moderator: Thank you. Ladies and gentlemen, as a reminder, if you would like to ask a question, please press star one on your telephone keypad. Thank you. We will now take our first question from Sam Burgess of Citi. Your line is open. Please go ahead.

Sam Burgess: Morning, all. Thanks for the update and thanks for taking the questions. I've got a couple if that's okay. If we can just start on UK intelligence, I understand MoD is probably looking to ring-fence funds for larger strategic programs ahead of SDR, but with rising defence budgets, I mean what do you think happens going forward here? What's the visibility? Do those funds get turned back on? That's the first question. I think the second question is just on the US business. I think when we think about US market conditions, there were clearly some headwinds pre-Trump, but with DOGE I think investors might worry things get worse before they get better. How prudent have you been in the assumptions you are making around US business going forward? And then the third question would be can you just talk us through the margin recovery you are expecting in FY26? How much visibility do you have on that? Thank you.

Steve Wadey: Okay, thanks, Sam. We'll take each one in turn and I think I'll start first and then you build, Martin, we'll work through each of the three. So on UK intelligence, Sam, and we discussed this after the Q3 trading update, we've obviously undertaken some re-sizing, as we flagged in our Q3 trading update, we had seen impact on short cycle work with effectively awards slipping to the right and we have maintained market share with that slippage. So I think we are addressing well the short-term environment that we are facing. In terms of looking forward, I think it's worth reinforcing the strength of our UK business. If we look at our UK business, nearly 75% of the group, we have very significant major long-term contracts and frameworks such as the long-term partner agreement and engineering delivery partner contract, which provides activity for our UK intelligence sector.

And I think that we have taken a very prudent view in the preliminary guidance that we have given. We'll come back with more information and more detail on that clearly when we report in May. And we do expect next year to be a year of growth and we will see that come through both the UK defence and the UK intelligence sector. I mean, I think you are right that we expect the market backdrop to improve towards the latter part of next year. So I think we've got the visibility and we've been prudent in the assumptions that we've guided. On the UK intelligence, Martin, book builds.

Martin Cooper: Yeah, I mean I just think as we said, this is a good core, strong underlying business delivering good margins. We continue to see that and good cash flow. Clearly we do need some fund flows to be turned back on, but as Steve says, we've taken a prudent view of the timing of that going into FY26.

Steve Wadey: So if I move on to the second question, Sam, about the US. So as we've updated, we appointed Tom Vecchiolla in January. Tom comes with very seasoned experience of the US defence and intelligence market as well as international markets. We've also strengthened the board. We're very pleased to have Roger Krone joining the board with very big experience in all of our markets actually around the world and in particular in the service-related businesses that we operate. And together with Martin and I, we've been undertaking a review. And in some ways, you are right, Sam, that there are similarities of market conditions impacting our shorter cycle contract work in the US. And we've seen that impact predominantly, and this is an important point, on our US legacy operations where market conditions have led to some different judgements through that review. And we expect the output of that review really, to ensure that we are focusing on capabilities that are highly relevant to our customer. We have a number of very significant long-term programs, particularly that we acquired through the Avantus acquisition with the Strategic Capabilities Office of the US DoD, the Space Development Agency, and the Tethered Aerostat Radar System, which is providing a mission-essential or mission-critical capability along the southern border of the United States. And all of those capabilities, which are mission-essential, have delivered very good on-contract growth during the course of this year.

So when we look at the headwinds, what our review is really doing is making sure that we are focusing our business on the core capabilities and investing in those core capabilities, including where we can, leveraging those across the group. And as a result of that, again, within the guidance that we've given, we believe even with the context that you are referring to, we built sufficient prudency through this update today into our guidance for next year. Martin?

Martin Cooper: Yeah, I think the only other piece I'd add is in the US where we're probably alongside the short-cycle product sales where we're seing the downturn also in some of our federal IT and government services work. The last month or so, we have seen a stability in that in the headcount and the bookings and things going through there. So hopefully that is a floor that we've reached looking forward.

Steve Wadey: And Sam, your third one was about margin recovery and the primary driver clearly will bring more volume. We expect to be delivering what I would call modest growth at 3% to 5% next year, as I've said, and returning to our normal range. But maybe Martin, you could just talk through the recovery steps on...

Martin Cooper: ...Yeah, I don't Want to sugar coat what is obviously a disappointing announcement today, but if you take the trading impact on profit then of around £20 million pounds in year, then that still gets you to a margin level of high tens for this year on an underlying basis. And so looking forward into next year, then the growth we expect to be led predominantly out of our UK defence business, which is good profitable growth. As we alluded also, we will continue to drive cost efficiency through the business and have an ongoing supply chain efficiency program as well. So we're confident that we can get back into the 11% to 12% range that we have been delivering in the last few years.

Steve Wadey: Sam, I hope that answers your three questions.

Sam Burgess: Yep. Very clear. Thank you.

Moderator: Thank you. We'll now take our next question from David Farrell of Jefferies, please. Go ahead.

David Farrell: Hi. Morning. Thanks for taking my questions. I've got two, please. Firstly, given what's going on in the US and your reappraisal of some of those markets, can you confirm that the long-term or medium-term growth rate for QinetiQ of high single digits is still a valid one? And then secondly, as a follow-up to that, given what is going on in the US and how difficult that continues to be, is there any sense that QinetiQ might over the coming years try and pivot a bit more towards Europe? Thanks.

Steve Wadey: Okay. So take the first question. What we've done over this last weekend, David, is really thought, well, as we've come forward with this update, it was critical that we gave you preliminary guidance for '26, and we wanted to get that news out today to assure the market that this is a short-term issue. We understand the issues, we're in control, we're dealing with them, and we will return to growth. And we've guided at a modest level for '26, and we'll come back with more detail of that in May.

In terms of the long-term growth rates, we fundamentally still believe that we are aligned structurally to really good defence and security markets, both domestically in our three core countries and associated with the very various allies of NATO, and the financial framework that we have that refers to long-term growth rates of 7% to 9%, we ultimately do see that as a continuing financial framework. And when you look at the strong backlog that we have and the pipeline that we have of over 11 billion pounds of future opportunities, whilst this is clearly, as Martin said, a disappointing short-term impact, we ultimately see that we will return to that financial framework and we'll give more details of the timing of when we expect to return to that longer-term revenue and margin guidance in May. In terms of your...

Martin Cooper: Perhaps Steve, just build on that. As we've flagged in the statement, David, then we do expect a book to bill of over one still for this year, despite the difficult backdrop, which obviously gives us that confidence. And for all your models and things, we would expect order backlog still to be broadly in line with where we were at half year at around £2.8 billion to £2.9 billion. So we do have that visibility and the opportunity set over and above that that we've flagged at the half year.

Steve Wadey: And to your second question, David, I think our strategy is a multi-domestic strategy. So we're very focused on each of our domestic customer needs. And in fact, the US review that we've just been talking about is really about making sure that our US business is very aligned to the mission-critical, mission-essential priorities of the US government. But in terms of your question about pivot towards Europe, I think you'll have seen that in the last year or so, we've been increasingly talking about Europe and NATO and NATO allies, our long-term positions, incumbent positions on programs like the Long-Term Partner Agreement are not just serving UK customer needs, but increasingly supporting a whole range of NATO allies. And we gave major many examples of that with German Air Force, Italian Air Force, Spanish Air Force coming and utilizing our capabilities in the long-term partnering agreement.

And I think beyond that, if I look at value that we create across the entire group and we refer to leveraging positions across the group, our strength in aerostat persistent surveillance systems in the US where we have seen significant on-contract growth, there is plenty of articles around at the moment talking about the growing need for that type of persistent surveillance system, particularly if there is a ceasefire in Ukraine to protect borders along the NATO boundary. And those are areas where we will both be focused on, yes, on domestic needs, but also on the wider European and NATO ally needs.

Martin Cooper: I think David, it's perhaps worth just also building that obviously there's going to be a big step-up and is currently a big step-up in European defence spending and fielding equipment. And a lot of our European allies haven't fielded that amount of equipment in recent years and we are one of the few countries, and obviously companies, who have the ability and capability to be able to help these countries get this equipment into service in the coming years. So I know it's coming down the line, but we do feel that we have significant opportunity there to help our allies.

David Farrell: Thank you very much for the colour.

Moderator: Thank you. Our next question comes from David Perry of J.P. Morgan. Your line is open, please go ahead.

Steve Wadey: Hi, David.

David Perry: Good morning. Few different questions. But first, I think it'd be quite helpful, I know it's not a results call this, but it'd be quite helpful if we could just have the actual growth splits for the two divisions for FY25 and FY26. Secondly, could you just say a few words on Avantus, you talk about a lot of the impairments being in legacy U.S. operations, which doesn't suggest Avantus, so I'd just like some colour on how that has actually performed, specifically. And then just a technical one for you, Martin, which you may not have the answer to hand, but the share price obviously been very volatile, actually very strong the last month. What has been the average price you've been paying for the share buybacks in the year just about to end? Thank you very much,

Steve Wadey: Martin, should I tell the second one about Avantus?

Martin Cooper: Yeah, and I'll take the other two.

Steve Wadey: I can answer your technical question, David. Yeah, so I think, that's a good second question. Sorry. They're all good, David, but it's a good second question. And I think as I was referring to earlier, you're right that in the U.S., market conditions really have led us to more impact in our U.S. legacy operations and we referred to a number of judgments in the trading update around inventory and cost recovery where we've had to take different view as a result of the review that Tom has been leading with Martin.

But if I moved to Avantus, and I think it's very important that whilst we have reported an impairment, if I look at the core Avantus business, the core Avantus business has moved in the last year or two onto a series of long-term contracts. They're the ones I referred to David earlier in this call. These are five-year long-term contracts with the strategic capability office, set, space development agency, and the Aerostat radar system, and all of those contracts we're performing exceptionally well. They've all delivered very good on-contract growth and they are good examples of, as we focus the U.S. business on core mission essential programs, that business ultimately will support our ongoing growth.

We don't have specific numbers today on overall Avantus performance, but the review will identify where we're going to really invest, where we're taken different judgments and then come out even stronger as a platform to meet future US and International needs. Martin, do you want to pick up the other two? Yeah, I will do.

Martin Cooper: Thanks, Steve. David, for your models, obviously we still have a few weeks to go to close out the year-end, but from the numbers we've given today, then you'd expect in a mere services that revenue growth would be around 2% and margin for that division at around 11% for global solutions, you'd probably see around a 2% decline and margin will be at about 5% representing obviously the trading dynamics, but also obviously, the one-off charges as to, as we've highlighted.

If you look into FY26, I think at the moment, again, as Steve says, we'll cover this at more length in May, but as a preliminary guide, I don't think you'll be far off if you have both divisions at around the growth rate of the three to 5%. We're obviously expecting good growth in EMEA and UK defence, but we've taken a prudent view on the UK intelligence growth levels as Steve's articulated, margins in EMEA Services, as I had said, should be, again, in the strong 11 to 12% range. In Global Solutions, I think again, we see growth in targets and on contract growth that Steve said. So I think a growth rate for around 3 to 5% is prudent but sensible and I would caution margins in more than 9 to 10% range for FY26 as we sit here and work through the US restructuring.

And then on the share buyback, David, for the technical, the first a hundred million that we completed averaged at about, well, it was 416p, so £4.16. I think if you blend in what we've done since then, you're probably an average of about £4.30. So it's been a highly accretive program to the group to date and we continue to see it as a very good use of shareholder funds.

David Perry: That's all super helpful. Can I just ask a follow-up because UK intelligence, quite a big bit of the group, what exactly is it that, this is a very open-ended question, but what exactly is it that's led to this weakness, which is clearly quite dramatic relative to what you expected? Can you just give some concrete examples, please?

Steve Wadey: Yeah, I think really, David, it goes right back to the first question that Sam had, which is just a number of a shorter cycle contracts slipping to the right. We haven't lost anything materially, it's just a general slowdown that has moved that work to the right, and as a result of that impact, that's why we had to launch and embark upon the resizing of the UK intelligence sector and we brought that into account in the guidance that Martin has just talked through. I think as we reflect on that, as we came into the air, if you go back into even our full year results, we built in a level of prudency to deal with the environment that we could see occurring this year. And ultimately, it's transpired to be worse than we assumed. And I think what's important now is that reflecting and learning upon that is the level of prudency that we built in, as Martin said, into next year's guidance, and we do see the second, there'll be a slightly greater weighting to the second half.

But ultimately, the company in the UK has some very good long-term positions on significant contracts and frameworks and we expect the value that we deliver to our customers to be well regarded and we will see us rebuild to the more modest growth that we've guided for next year. But it's short cycle work slipping to the right, nothing major loss and we'll see it progressively return next year, David.

David Perry: Okay, thank you.

Moderator: Thank you. Once again, as a reminder, if you would like to ask a question, please press star one on your telephone keypad. Thank you. We will now move on to our next question from George McWhirter of Berenberg. Please go ahead.

George McWhirte...: Good morning. Thank you very much for the questions.

Martin Cooper: Hi, George.

George McWhirte...: Morning. Firstly, just firstly on the UK intelligence business, just in terms of any quantitative detail on audit intake, for instance, maybe the book to bill that you've seen in the second half of FY25, and the second one is just on the US, in terms of, you mentioned delays to higher margin product bills. Can you just give a bit more context on that please? Thank you.

Steve Wadey: Yeah, if I do the second one, maybe you can do the first one, Martin. I think, George, you're absolutely right that we mentioned in the trading update and the update that generally, our U.S. business has a natural weighting to product sales in the fourth quarter. That's our normal business pattern. And that's particularly higher margin product sales related to robots and other products that we sell from the US. And what we've seen in quite a dramatic timeline, actually, is that over recent weeks many of those orders that are very short cycle, what we call book and burn, in-year, have slid, and slid to the right.

Again, similar to the answer that I've just given to David, nothing has fundamentally been lost but, given the general geopolitical uncertainty in the market, that has slowed down customer decisions in a variety of countries around the world, and that's meant that that higher margin revenue associated with those product sales has moved into next year. That's the answer to your second question. The first one, UK intelligence? Martin?

Martin Cooper: Yeah. If we pick up on orders, George, we then split out our orders by each of the divisions. I'd perhaps point to you, obviously, at Q3 trading update. We flagged about £1.3 billion of orders for the group to date. Clearly today we're flagging that we expect order intake to be greater than one. So you can allude that obviously order intake has picked up in Q4 as to where we are. Some of that is in UKI. But it's not picked up at the rate, certainly in UK intelligence that we hoped it would do, in reference to Steve's comments earlier around... and that is reflected, obviously, in our preliminary review of guidance going forward. But just said in answer to David's question, then, we've taken a prudent view on the outlook for growth in UK intelligence. Most of the growth in EMEA services will come from the incumbent positions on UK and defence.

David: Thank you.

Moderator: Thank you. And our last question comes from Joel Spungin of Investec. Your line is open. Please go ahead.

Joel Spungin: Hey. Good morning, guys. Can you hear me?

Steve Wadey: Yes we can, Joel. Morning.

Martin Cooper: Hello.

Joel Spungin: Good morning. Sorry. Just a couple of quick clarifications, if I can. Sorry. Just following on from David's question earlier. Of the £140 million impairment, how much of that impairment, if any, relates specifically to Avantus?

Martin Cooper: Yeah, I'll take that. Yeah. Of the £140 million in sterling, then I'd say, to break it down, probably about £30 million is related to assumptions on the discount rate. That is an externally provided discount rate that we always use. So that's a deterioration of about £30 million. I'd say probably around 25% to 30% would be related to Avantus, and the rest is very much around the legacy businesses of FMI and MTEC. So the majority is predominantly the legacy operations. And that is also what the one-off and in-year charges, predominantly rates, are around cost recovery and inventory valuations.

Joel Spungin: Okay, that's helpful. Thank you. And actually that was my second question. Obviously if we think that the bulk of the hit to this is profit guidance is from this 25% to 30%, yeah, if you could give us some tangible examples of what those costs are, it would be quite helpful just to understand how you arrived at that number and also why it can't be treated as a one-off.

Martin Cooper: Yeah. Some of it is treated as one-off and will go through the exceptionals line. That's largely towards recovery of historical costs and things. Because of the market dynamics that we've seen and then the recoverability of that, then a lot of this is around a prudent but a sensible view on the valuation of inventory and the costs associated with that for some of the programs that we've got forward. Steve mentioned some of the slippages and timings of that. We don't know when some of those will come in, so we're taking a prudent assessment of that.

There's also the revenue in the US business in certain areas, as you've seen, has also slipped, so you have a lower revenue basis to spread your costs over, and therefore your cost recoveries, which is a bit of a technical rates point, means that you had some of the recoverability through the rates of some of our costs. I've had to take a judgment of it this year due to the downsizing of the US business in revenue terms this year. So these are judgments that are taken, and obviously all subject to year-end audit, but I'd say they're pretty good ranges for you as we sit here today, given the outlook.

Joel Spungin: Okay, thank you. That's helpful.

Steve Wadey: Thanks, Joel.

Moderator: Thank you. There's one. It's just came in. And we'll take our next question from Philipp Schweneke of DWS. Your line is open. Please go ahead.

Philipp Schwene...: Good morning. Thanks for taking my question. On the US business, please. It sounded that this lack of product sales you recently experienced was for exports from the US. Is that the right understanding? So that other countries are not ordering or getting the volumes from the US. Is that like a export restriction? Is it tariffs-related? Are those decisions made by those countries, firstly? And secondly, also on the US, you said you had made some wind-down decisions on products no longer being sold. Is that the explanation why FY26 will have lower growth than previously expected? So how much headwind from winding down those products will you still experience year-over-year for the next fiscal year? Thank you.

Steve Wadey: I'll take the first one. Martin will take the second one for that. Yes, the higher margin product sales that I was referring to are predominantly related to exports from the US, but I wouldn't attribute that at all to tariffs. I would just attribute it to the general geopolitical uncertainty. Second question, Martin?

Martin Cooper: Yeah. Just on the products level again, to take a prudent view with... and some of the judgements that we've taken. Then obviously we don't know, given the geopolitical backdrop and market conditions, as to when some of these products and things will be sold. So we're obviously taking a prudent view in our outlook as to the growth. Basically, we're assuming that the products business in the US is fairly stable year-on-year. Clearly, if we can prosecute some of these in the coming months, then that will be upside to where we are. But it's far too early to say, given the backdrop.

David Perry: Okay. Thank you.

Moderator: Thank you. That was our last question. I will now hand it back to Steve Wadey for closing remarks. Thank you.

Steve Wadey: Well, thank you, everybody, for joining. We appreciate you joining this call at short notice. Just to summarize a number of key points: clearly disappointing news, where we've seen the trading environment that we flagged in the Q3 trading update persisting. Has clearly had a significant volume effect on our short-term trading and has led us to a number of different judgements, as Martin and I have been talking about, predominantly relating to our US legacy business.

I do want to assure everybody that we understand the issues. We've taken action, and other actions are underway. And we do see this as a short-term effect on the business. We're positioned for growth, modest growth into FY26, returning to our normal guidance. And fundamentally, the company has got strong capabilities and is well-positioned to meet the needs of our customers in our domestic markets and associated NATO allies. And we'll be poised for significant long-term growth in the years to come. Thank you for joining the call. And if anybody has any further questions, please contact Stephen Lamacraft, our head of IR. We're pleased to provide any further clarifications or answers to your questions during the course of the day. Thank you all. Thank you.

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