KILLIK & Co

12 January 2012

Large Cap

.COMPANY:	EPIC:	MARKET CAP:	RECOMMENDATION:	RISK RATING:	PRICE:
Rolls-Royce	RR..L	£14.4bn	Buy Initiating Coverage	6 CATEGORY: UNRESTRICTED (see bottom of note for risk categories)	767p

Rolls-Royce is a global leader in the provision of power solutions, with global operations serving four sectors: Civil Aerospace, Defence Aerospace, Marine and Energy.

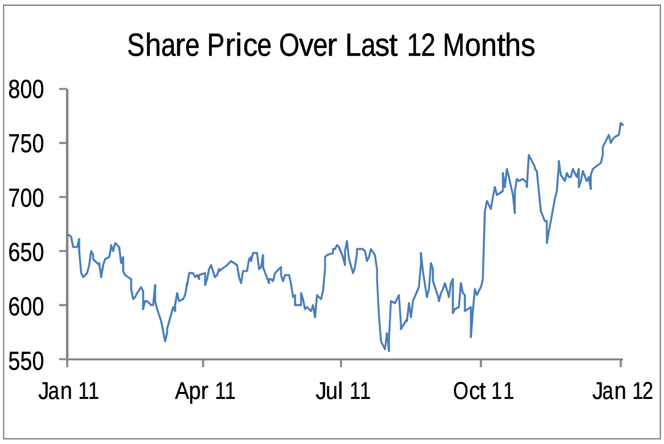
Investment Case

- The group has built up a strong industry position with high barriers to entry following long-term investment in research and development, production facilities and service capability.
- The group is aiming to double its revenues over the coming decade through organic growth alone (i.e. 7% growth p.a.). Growth is expected to be driven by increased global air travel, continued concerns over the environment, expansion of deepwater oil production and increased demand for power.
- An order book in excess of £60bn – driven by record backlogs for Boeing and Airbus – provides excellent visibility over future revenues, a valuable asset in today's uncertain times.
- A huge installed equipment base of 54,000 engines provides a source of resilient, higher margin aftermarket sales which account for 53% of group revenues.
- A strong balance sheet, with a net cash position, provides the flexibility to fund organic growth and make accretive acquisitions. The group generates attractive returns on invested capital.

The shares trades on 12.7x consensus 2013 earnings and offer a 2.5% dividend yield that is well covered by earnings.

52 Week High	779p
52 Week Low	525p
Price to Book Value	3.6x
Dividend Yield	2.3%
Free Cash Flow Yield	8.4%
Dividend Cover	2.4x
Net Cash	£1.45bn
Interest Cover	12.3x
Emerging markets sales	32%
Next announcement	9 February 2012

Source: Company Data and Bloomberg Consensus



Year End	Sales (£m)	PBT (£m)	EPS (p)	PE (x)	DPS (p)	Yield (%)
Dec 2010	11,085	702	29.20	26.3	16.0	2.1
Dec 2011	11,415	1,126	45.20	17.0	17.3	2.3
Dec 2012	12,800	1,369	53.80	14.2	19.1	2.5
Dec 2013	14,261	1,587	60.20	12.7	21.1	2.8

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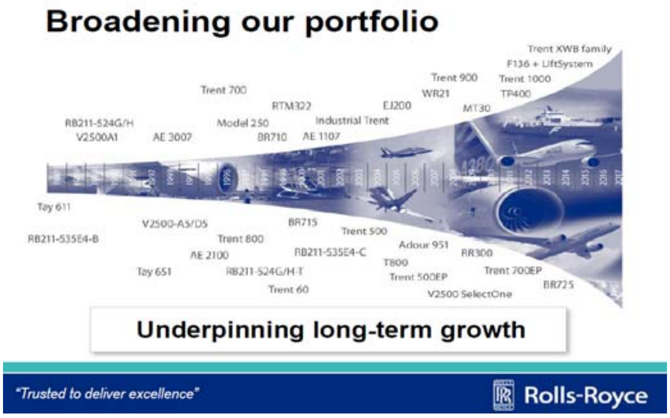
Unmistakably KILLIK & Co

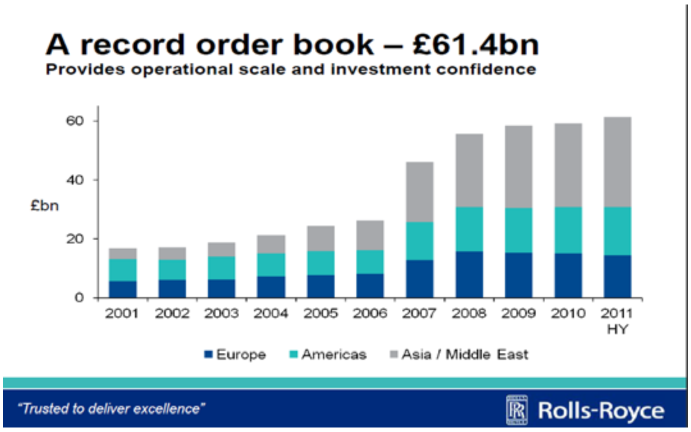
Rolls-Royce (RR) is a UK-listed engineering company with global operations serving four sectors: Civil Aerospace, Defence Aerospace, Marine and Energy. In 2011, the group is expected to have generated revenue of more than £11bn and PBT of c. £1.1bn. The group's four global markets offer a total opportunity worth in excess of $2 trillion over the next 20 years. The group also seeks to transfer products and technology across each business to generate additional revenues.

The group is aiming to double its revenues over the coming decade through organic growth alone (i.e. 7% growth p.a.). This strategy has five key elements: address four global markets; invest in technology, infrastructure and capability; develop a competitive portfolio of products and services; grow market share and the installed product base; and add value through product-related services.

Core strengths

Rolls-Royce has a broad customer base comprising more than 500 airlines, 4,000 corporate and utility aircraft and helicopter operators, 160 armed forces, more than 4,000 marine customers, including 70 navies, and energy customers in nearly 120 countries. In many of its markets, the group is one of a small number of companies that operate in a global oligopoly. Barriers to entry into the business are high as a result of long-term investment in high-technology products and aftermarket services. In Defence, for example, the group's R&D programmes will typically feed a procurement cycle of new products lasting 30-50 years, with support services continuing for many years after that.





A strong order book (£61.4bn as at 30 June 2011) provides excellent visibility over future revenues. Although the order book includes both firm and announced orders, there are three reasons why it understates the potential value of future business. In Civil Aerospace, where Boeing and Airbus are enjoying record backlogs, it doesn't include options for future orders. In Defence Aerospace, long-term programmes are often ordered for only one year at a time, with only the contracted business included in the order book, even though the customer may not have an alternative engine choice. Finally, only the first seven years' revenue of long-term aftermarket contracts is included in the order book.

Many of the group's products have operational lives which run into decades, and the installed base of 54,000 engines creates significant opportunities for aftermarket services. The group has a comprehensive network of service delivery centres, which generate revenue from spare parts, overhaul services and long-term service arrangements. Service revenues have achieved CAGR of 10% over the last decade. The aftermarket further enhances the industry's barriers to entry – as an original equipment manufacturer with a close relationship to the customer and an understanding of the technology, the group can offer a service package far beyond that of an independent provider. RR has increasingly shifted to long-term service agreements (TotalCare, CorporateCare and Mission Care) which generate a stable annuity stream, reduce cyclicality and enhance operating margins.

As a result of the group's diverse product and geographic spread, the business has proved to be fairly resilient to the downturn. Between 2007 and 2010, RR achieved growth in order book (+30%, 9% CAGR), revenue (+40%, 12% CAGR), profit (+20%, 6% CAGR), average net cash (from £350m to £960m) and dividends (7% CAGR), all during a period of challenging economic conditions. The recent IEA deal (see below) led to a 10%+ upgrade in earnings for 2013, and highlighted the value locked up in the business. The group has a strong balance sheet, providing the flexibility to invest organically (through R&D and capex) and via acquisition. The group generates attractive returns on invested capital.

RR is a well-managed business. In March 2011, John Rose stepped down as CEO after 15 years in the role. The new appointment, John Rishton, is seen as a strong replacement with broad industrial experience. He has served as a non-executive director on the RR board for four years, been CEO of Ahold, been CFO of British Airways and held a number of senior positions at Ford. Given the long-term nature of the group's business model, we do not expect any dramatic change of strategy. However, given the background of the new CEO, we sense an increased focus on operational efficiency and cash generation.

Rolls-Royce is exposed to a Number of Attractive Themes

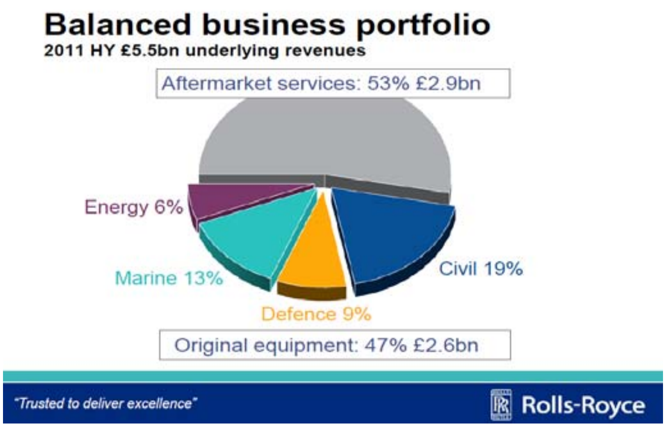
Increased Air Travel – In emerging markets, such as China, India and Brazil, passenger volumes are being driven by rising incomes and spending power, while the retirement of the baby-boomer generation in the West is leading to an increased propensity to travel. Even in Europe, the industry is expected to benefit from a weak currency which should attract tourists and trade exports. At the same time, increased access to the Internet has opened up the world of air travel to a far wider number of people, while the emergence of more low-cost airlines has made travel more affordable. According to the International Civil Aviation Organisation (ICAO), between now and 2030, global air traffic (as measured by revenue passenger kilometres) is expected to increase from five trillion to 13.5 trillion (i.e. 5% p.a.). We believe this demand can only be met through increased aircraft build rates and the major manufacturers are increasing production in response. At present, the two largest players – Boeing and Airbus – have record backlogs of more than six years, with more than half coming from emerging markets.

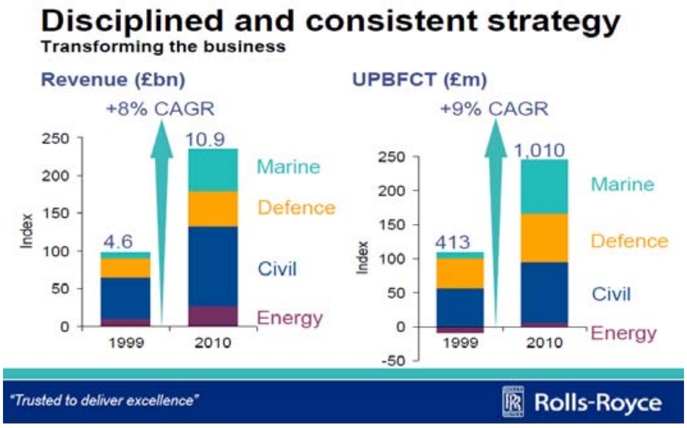
Continued Environmental Concerns – The need to improve energy efficiency (especially in a high oil price environment) and lower emissions will remain central to global industrial development. Improved efficiency lies at the heart of the group's R&D programmes. Not only will new products help to meet stricter legal requirements, they will also deliver cost savings for the customer base. The replacement of the existing fleet with aircraft with better engines and satellite-based air traffic control systems will improve safety, reduce fuel use, cut emissions and reduce noise levels. RR has a relatively young commercial aircraft installed base and so it should be impacted less by retirements. Meanwhile, it will supply engines for new aircraft to replace the ageing fleet, especially in the US and Europe where the average age of the wide-body fleet is 14 years and 12 years, respectively.

Increased Power Generation – The US Energy Information Administration (EIA) estimates that energy consumption will increase significantly to 2035, driven by 50% growth in emerging markets demand. RR has exposure to traditional sources of energy, and is also developing products for low carbon energy sources, such as nuclear and tidal.

Increased Oil & Gas Production – The International Energy Agency (IEA) has forecast that, over the next 20 years, worldwide demand for oil and gas will grow by more than 18% and 44% respectively. Growing demand, combined with the depletion of existing fields, will require increased expenditure on new production. We believe the high oil price – a trend we expect to continue – will support this investment, especially in deepwater acreage. RR has a strong position in this market, which has been enhanced by the acquisition of Tognum.

Defence – Spending in the West is likely to remain subdued as governments look to cut costs. However, in the key US market, this is a reduction in the rate of growth over the next 10 years, rather an outright cut in spending. We believe the ongoing instability in the Middle East, combined with an increase in the perceived threat in the Asia Pacific region, mean that defence is likely to remain high on the agenda. As part of last week's plans unveiled by President Obama, the US will place greater emphasis on naval and air power – a positive for RR given the focus of its defence business. Overall, the defence lobbyists appear to have succeeded in their argument that large cuts will damage the industrial base and employment prospects of the US. Outside of the subdued Western markets, there are also growth opportunities in emerging economies in Asia, the Middle East and South America.





Four Global Divisions

Civil Aerospace (47% of H1 2011 revenue, of which 40% is OE and 60% is services)

RR is the world's second largest engine maker, with a market share of around 30%, and powers over 30 types of commercial aircraft. In the wide-body market (62% of revenue), the group is the global leader (c. 50% market share), with its Trent and RB211 products. Every one of the group's Trent engines was either chosen to be the first engine on a commercial aircraft programme or subsequently became the market leader. Current versions in use include: the Trent 900 (for the Airbus A380) and the Trent 800 (for the Boeing 777). The older RB211 engine is used for the Boeing 747. Demand is being driven by route liberalisation, as well as the capabilities of the new aircraft, which allow new routes to be opened up more profitably.

In the narrow-body market (13% of revenues), the V2500 is installed on 4,500 aircraft, including the Boeing 737 and the Airbus A320. Demand is being driven by low cost carriers and emerging market growth, especially in Asia. In October 2011, RR announced the sale to Pratt & Whitney of its 32.5% share in International Aero Engines (IAE), the producer of the V2500 engine. RR will receive $1.5bn and an agreed payment for each hour flown by the current installed fleet of V2500-powered aircraft for 15 years. In addition, RR will continue to be responsible for the manufacture of high pressure compressors, fan blades and discs, as well as for engineering support. The transaction, which is expected to complete later this year, will improve the profitability of the division by £140m in the first full year (due mainly to the fact that the group is no longer incurring losses on the sale of new engines), with a slowly diminishing contribution in successive years.

We believe the deal makes sense, and brings forward cash flow from the programme. It also reduces the group's exposure to the Airbus A320 which is due to be replaced by the Airbus A320neo, a programme on which RR is not supplying engines. The group has also allayed concerns that it will miss out on a part of the market, that accounts for the majority of deliveries each year, by entering into a new joint venture with Pratt & Whitney to develop engines for the next generation of narrow-body aircraft. This is a fast-growing segment in which worldwide demand for around new 20,000 aircraft (or nearly 45,000 engines) is predicted over the next 20 years.

In the smaller corporate and regional aircraft market (25% of revenues), the group is the global market leader, and supplies engines for Cessna, Embraer and Gulfstream. The group also supplies engines for helicopters. The corporate market is still suffering from the impact of the downturn, with deliveries almost half the level of the peak in 2008. A recovery in the near term is not expected, and will depend on an improvement in the economic and political backdrop. However, a pick-up in important indicators, such as corporate profits, second-hand prices and utilisation rates, provide some encouragement. The long-term outlook for regional jets is positive driven by both the overall growth in air travel and the increased penetration of such aircraft in emerging markets.

Over the next 20 years, RR predicts that 137,000 engines, worth over $800bn, will be required for more than 63,000 commercial aircraft and business jets. Faster growth rates are expected for long-haul markets and those markets to, from and within Asia. Factors driving demand will include GDP growth, aircraft productivity, operating costs, environmental issues and the number of aircraft retirements. At present, the two largest players – Boeing and Airbus – have record backlogs of more than six years, with more than half coming from emerging markets. In addition, with the average age of the wide-body fleet in the US and Europe currently 14 years and 12 years, respectively, there is a clear need for vast investment to achieve a fleet closer to that of some of the emerging market operators (e.g. 6.7 years at Emirates). High oil prices and increased concerns over safety encourage airlines to retire older aircraft. The RR powered fleet is relatively young and, as a result, more fuel-efficient.

RR has recently undergone period of heavy investment, with the development of engines for three wide-body aircraft (the Airbus A350 and A380, and the Boeing 787). As a result, the group has been taking market share and now has strong positions on new programmes. During 2011, the group entered into an exclusive agreement to power the Airbus A350-1000 with the Trent XWB, an engine which has become the group's fastest-selling Trent engine, with 1,200 firm orders from 36 customers. In addition, the group is launching a variant of the Trent XWB to support the Airbus A350-1000, which will involve a more significant investment, with the aircraft now expected to enter service in 2017 rather than 2015. Elsewhere, the Trent 1000 is powering the Boeing 787 Dreamliner that has recently entered commercial service. The engine will generate revenues for decades to come and has set new standards in efficiency, fuel burn and noise, winning seven out of the last eight Boeing 787 engine competitions.

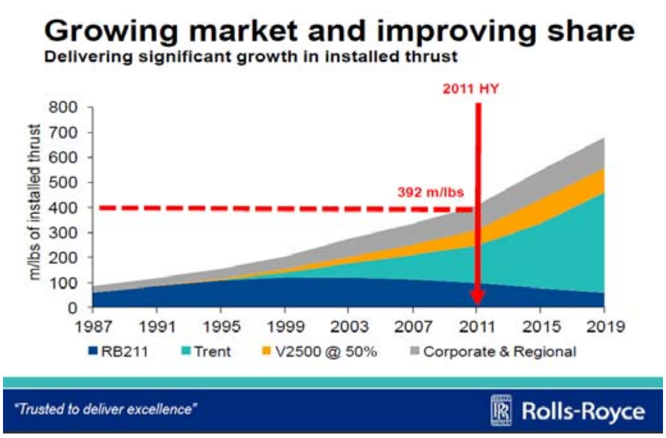
As at 30 June 2011, the RR order book stood at £51.3bn and contained almost 5,000 engines that will add, over time, around 250m lbs (or 65%) of installed thrust to the current installed base. Although, in light of the outlook for the economy, there is some risk of aircraft deferrals or cancellations, this will require the group to more than double its output of Trent engines.

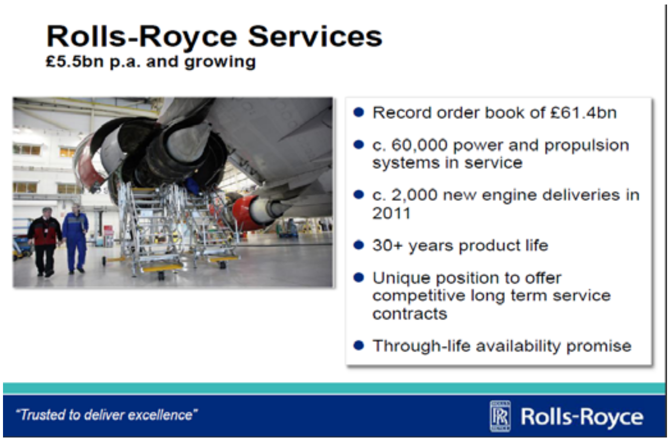
Having developed a portfolio of new products and lined up a huge order book, the focus of the group is now on the execution of those orders involving the increased production of existing products (in particular, the Trent 700 for the Airbus A330 and the Trent 900 for the A380), the roll-out of new products (including the Trent XWB and 1000) and the ongoing servicing of the installed base. The group is commissioning a new aerospace plant in Singapore and a new components facility in the US, following which deliveries of the Trent engine are expected to rise from 185 in 2010 to more than 500 in 2015. Although the group has a good track record on bringing new products to market on time and within budget, the scale of the ramp-up over the next few years, and the fact that engines will be manufactured outside the UK, means that execution is clearly a risk. We would also remind investors that, in 2010, the group experienced a high-profile product failure due to an uncontained disc release on a Trent 900 engine on a Qantas Airbus 380. However, such failures only happen about once a year on the world's large civil aircraft fleet, and this was the first occurrence on a RR engine since 1994.

For now, we do not believe that competition from the Chinese is a real threat. Although they are clearly committed to manufacturing their own aircraft, at present they are lacking in terms of reliability, technological capability and safety. Additionally, we would note that the initial focus of the Chinese manufacturers is the narrow-body market, where RR has less exposure.

Given the general backdrop for lending at present, one risk is the reduced availability of financing for aircraft. However, as recently as November, EADS (the owner of Airbus) highlighted that it had not experienced any difficulty in obtaining aircraft finance. At the same time, RR's contingent liability relating to financing support provided to customers remains modest (gross $959m, net $181m, as at 30 June 2011).

In addition to the demand for new engines, the group forecasts a market opportunity worth $600bn for the provision of higher margin aftermarket services. The value of the aftermarket over the life of the engine can be 3x-4x the revenue generated by the original equipment sale. The group's weighting towards larger engines is a further positive as they generate higher service revenues than smaller engines. The group currently has over 13,000 engines in service and its installed thrust – an indicator of the amount of product in use and, therefore, a guide to the outlook for the aftermarket business – has risen from 320m lbs in 2006 to 382m lbs in 2010. The installed thrust is expected to double in the next five years and triple in the next 10 years. Over, the long term, the aftermarket should grow in line with the long-term rate of passenger growth (i.e 5%). In the short term, the business may also benefit from the need of airlines to undertake discretionary maintenance work that may have been deferred during the downturn.





Service revenues account for 60% of divisional sales. More than 60% of the installed fleet (and 90% of Trent engines) operates under TotalCare contracts. These long-term agreements operate on a pay-as-you-go basis over the lifetime of the engine. Charges are based on flying hours, providing an incentive for RR to get the planes up in the air as quickly as possible. In the business market, the 60% of the fleet is maintained under CorporateCare contracts.

During the first half of 2011, the group gained new orders of £6.5bn and grew underlying revenues by 14%, to £2.6bn. OE grew 22%, to £1.0bn, driven by significantly higher deliveries of wide-body and corporate & regional engines. Strong growth is also expected to have been achieved in the full year. Service revenues increased 8%, to £1.6bn, and are expected to have grown by mid-single digits in the full year. Underlying profit before tax increased 19%, to £250m, and is expected to have grown by 20%-25% in the full year.

Margins of 8% in 2010 were well below the 13% achieved in 2006, and even further behind the peer group (Merrill Lynch estimates Pratt & Whitney and GE generate 18% and 24% respectively). By 2014, margins are forecast to move above 13%. Although the launch of new engines provides a headwind, this is expected to be offset by the increase in TotalCare services as the fleet matures, the decline in R&D on new engine programmes following a lumpy period of spend, and increased cost efficiencies. Although this closes some of the gap relative to the peer group, a differential is still warranted by virtue of RR's smaller installed base and volume of new deliveries.

Defence Aerospace (20% of H1 2011 revenue, of which 46% is OE and development and 54% is services)

RR is the world's second largest provider of defence aero-engine products and services, with 18,000 engines in service (25% of the world total) for 160 customers in 103 countries. The group's engines power aircraft in all sectors: transport (52% of revenue), combat (41%) and UAV/training (7%). This broad range of products and customers helps to provide protection against programme cuts.

In the combat market, the group supplies engines for the Eurofighter Typhoon and Tornado, and engine components for the F35 Joint Strike Fighter (JSF). In the transporter market, the group supplies engines for the Lockheed C-130 Hercules and the Airbus A400M. In the helicopter market, the group supplies the Sikorsky X2, the fastest helicopter ever. Emerging technologies include Advent, which is being co-funded with the US Air Force and focuses on reduced fuel burn. Another is Invent, which is involved with power management on aircraft.

Over the next 20 years, the group predicts that demand for military engines will be worth over $160bn, with the largest market expected to remain the US, followed by Europe and the Far East. Growth rates will depend on the scale of defence budgets (where expectations in Europe and the US have been reined in) and geopolitical developments around the world. The group will also benefit from engine upgrades on old platforms.

In the US, the DoD has halted the F136 second engine programme for the JSF, which RR was developing with GE, with development around 80% complete. In addition, the Short Take-Off and Vertical Landing variant of the JSF, which uses the RR LiftSystem for vertical thrust, is on probation. However, as part of last week's plans unveiled by President Obama, the US will place greater emphasis on naval and air power – a positive for RR given the focus of its defence business. In the UK, although the Strategic Defence and Security Review has impacted a number of long-term programmes, including Nimrod and Harrier, the group's exposure to the market is fairly limited. Meanwhile, there are growth opportunities in emerging economies in Asia, the Middle East and South America. In addition, the exposure to transport aircraft provides further protection given there is always a need to move personnel, goods, fuel and food around the world for military uses and humanitarian needs.

Service revenue accounts for more than half of the divisional total, and has helped to further protect the business from pressure on defence spending in the West. The group forecasts a market opportunity worth $270bn for the provision of aftermarket services over the next 20 years. This is being driven by customers' budget constraints and their need to increase the value they derive from their assets. Only around 20% of the fleet operates under long-term MissionCare contracts, which generate 40% of service revenues.

As at 30 June 2011, the order book stood at £6.2bn, down 5% year-on-year, reflecting budgetary pressures in Europe and North America. During the first half, underlying revenue grew 7%, to £1.1bn, and is expected to have grown by mid-single digits in the full year. OE fell 1%, to £504m, driven by phasing of engine deliveries, while service revenues increased 15%, to £584m. Underlying profit before tax increased 19%, to £250m, due mainly to one-off settlements from the MoD. In the full year, modest underlying profit growth is expected. Margins were 14.6% in 2010, and are expected to have moved towards 17% in 2011 (due to the one-off). Going forward, margins are expected to remain between 13% and 14%.

Marine (22% of H1 2011 revenue, of which 59% is OE and 41% is services)

RR is involved in the design, supply and support of power and propulsion systems for offshore oil and gas (49%), merchant (21%) and naval (30%) vessels. The group has more than 2,500 customers and has equipment installed on 30,000 vessels (30% of the world's fleet). The ships are specialised and increasingly sophisticated, with high levels of technology to help them reduce fuel consumption. They have to be continually renewed and supported to remain operationally efficient. The Tognum acquisition (see below) will add complementary products and scale to the group's portfolio.

The group forecasts demand for marine power and propulsion systems of $215bn over the next 20 years. OE accounts for a higher proportion of revenues, making the division more cyclical than aerospace.

In the merchant business, the group supplies specialist vessels such as fast coastal ferries, tugs and short sea cargo boats. Demand is driven by shipping of raw materials, finished goods and passengers, all of which are linked to global GDP. In oil & gas, a high oil price – a trend we expect to continue – will drive investment. The group is exposed to growing markets such as seismic surveying and subsea deepwater installation. In naval, growth rates will depend on the scale of defence budgets and geopolitical developments around the world.

The OE business has been weak over the last couple of years, although new orders rebounded in the second half of 2011. The hope is that 2011 represented the trough for new orders and, given lead times of 12-18 months, deliveries should start to flow through in 2013, although there is clearly a risk to the downside. However, volatility in the division is reduced by the fact that merchant and offshore markets are rarely at the same stage in the business cycle.

Service revenue accounts for around 40% of the divisional total. Over the next 20 years, the marine aftermarket is expected to be worth more than $125bn. We believe the market remains relatively undeveloped due, in part, to the fragmented nature of the customer base. In response, the group has sought to expand its offering through the opening of new service centres around the world. The economics of the new centres (there are now 36) are attractive – each centre costs £5m and generates a payback within 2-3 years. The group is also looking to take advantage of the trend towards more-complex vessels to increase the penetration of long-term service agreements (which still account for less than 5% of the fleet). As a result, service revenues will continue to grow, enhancing divisional margins and reducing the cyclicality of the business.

As at 30 June 2011, the order book stood at £2.9bn, well below the peak of £5.2bn in 2008. In the first half, there was a further 3% reduction due to the phasing of orders. Significant new orders included MT30 gas turbines and water jets for the US Navy. In the first half of 2011, revenue fell 14%, to £1.2bn, due to a 25% fall in OE revenues, mainly in merchant and offshore sectors. Service revenues increased 11%. Full-year revenue is expected to have been similar to 2010, with a strong second-half improvement in OE and double-digit growth in services. PBT increased 3% due to a better revenue mix and unit cost improvements, and is expected to be broadly flat in the full year. Margins were 12.8% in 2010 and are expected to remain at a similar level going forward, pre the impact of the Tognum deal.

Energy (11% of H1 2011 revenue, of which 57% is OE and 43% is services)

RR is a world leader in the supply of power solutions for onshore and offshore oil and gas applications (55%), power generation (36%) and civil nuclear power (9%). The Tognum acquisition (see below) will add complementary products and scale to the group's portfolio.

To satisfy the growing demand for energy there will be an increased requirement for aero-derivative gas turbines. RR believes that sales of these products to the oil & gas and power generation sectors will exceed $70bn over the next 20 years. Service revenue accounts for almost half of the divisional total. The group expects demand for energy aftermarket services over the next 20 years to be around $50bn.

Offshore power generation requires high levels of power densities (i.e. a small piece of equipment that generates a lot of power at high levels of reliability). A high oil price is positive for new equipment sales into the oil & gas market, with the deepwater sector expected to experience strong growth in particular. The group recently announced a facility in Brazil to assemble and test RB211 gas turbine packages for the domestic oil & gas market. Demand in the power generation market is driven by GDP growth, and so has been subdued in the West as a result of sluggish demand for electricity. However, this is being offset to some extent by sales to countries with significant power shortfalls, where permanent energy infrastructure is lacking and distributed power is needed. Future demand in power generation is likely to be driven by the need for affordable, efficient, distributed multi-fuel systems. The group is currently testing a 500KW tidal power turbine.

As at 30 June 2011, the order book stood at £1.0bn. In the first half of 2011, revenue grew 2%, to £600m, with OE down 1% and Services up 5%. For the full year, revenues are expected to have been broadly similar to 2010. However, profit guidance was downgraded and is expected to be broadly similar to 2010. With margins of only 2%, the improvement of profitability in the division is a key priority for management. Looking forward, the growth in OE sales seen during the last five years should now flow through to growth in service revenues. Given the diverse spread of activities within the division, some rationalisation is possible.

Financial Considerations

The bulk of the c. $1bn of development spend for a civil aircraft engine will occur over five years, following which the engine will enter production. Sales are then made (at breakeven or for a cash loss). For flight hour agreement (FHA) contracts – which are most common on long-haul aircraft – the engine starts to generate revenue when it enters service. At first, the small size of the installed fleet means that revenues generated will fail to cover the losses on new engines sold. Eventually, a programme will become cash positive as the revenue generated from the installed base outweighs the losses on new engines. Once production ends, there will be a sharp jump in cash profits, and then a gradual decline as the engines are retired from service. Under the other type of agreement (Time & Materials), which is most common on narrow-body aircraft, the manufacturer sells the engine for a loss and receives nothing until the first service, maybe 5-10 years later.

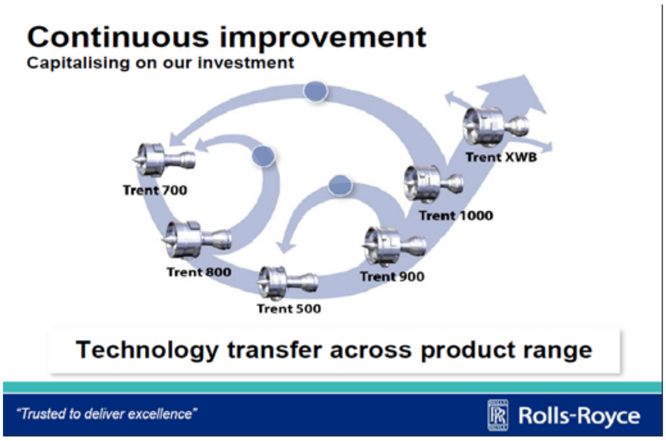
During the first half of 2011, the group gained new orders of £8.7bn, and since then has seen an encouraging level of order flow. Underlying revenues grew 4%, to £5.5bn. OE fell 2%, to £2.6bn, as strong growth in Civil Aerospace (+22%) was offset by the anticipated reduction in Marine (-25%). Services increased 10%, to £2.9bn, driven by the increased size of the installed base and the expansion of the network. Underlying profit before tax increased 28%, to £595m, driven by the increased size of the installed base, better revenue mix, improved productivity, currency and a number of one-off items. At the time of the results, the group confirmed its full-year 2011 guidance for revenue (modest growth) and profit (good growth), and did so again at the time of the trading update on 11 November. The group is due to release its 2011 full-year results on 9 February.

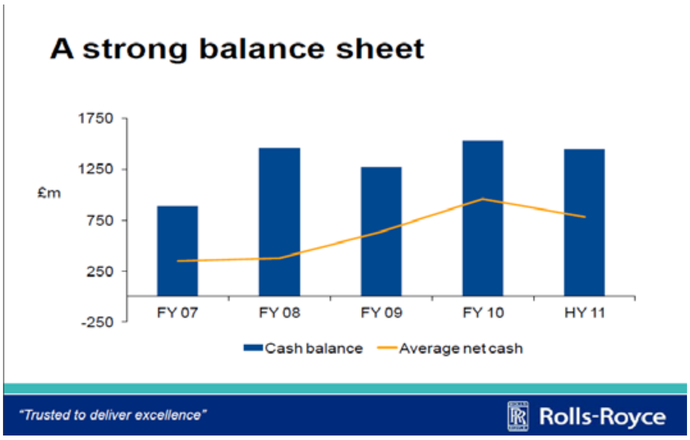
Looking forward, RR is aiming to double its revenues over the coming decade through organic growth alone (i.e. 7% growth p.a.). Although the group hasn't set margin targets, management have suggested the potential for expansion over the medium term, driven by reduced R&D and launch costs on new aircraft, cost efficiencies, improved profitability in the Energy business and the continued expansion of aftermarket activities. The financial background of the new CEO – he was formerly the British Airways Finance Director – has driven an increased focus on the cost base, especially supply chain management, where the competition have a stronger record. Earnings are forecast to grow by double digits for the next three years.

The group is financially robust, and intends to maintain a strong balance sheet and a single-A credit rating. This is essential if RR are to enter into long-term manufacturing and service agreements with its customers. During the first half of 2011, average net cash was £780m, and the group ended the half with net cash of £1.45bn. Since then, the group has spent c. £1.4bn on acquisitions and will receive $1.5bn following the completion of the IAE transaction later this year. The company capitalises losses on new engines, and so over the next few years (as new production comes onstream), cash conversion is expected to lower.

The strong balance sheet provides the capacity to invest organically (through R&D and capex) and via acquisition. The focus of organic investment is on increased performance, safety and fuel efficiency. The new Trent XWB is 16% more fuel-efficient than the first Trent aero engine to enter service 15 years ago. The group is also exploring other low carbon energy sources, such as nuclear and tidal. R&D is both self-funded (46%) and customer funded (54%). In 2011, internally funded R&D is expected to have been modestly higher than in 2010. The level of spend as a percentage of sales is likely to fall (from 5%) given that the group is coming to the end of a large development programme.

In addition to organic growth, the group has sought to broaden its portfolio through acquisitions. Most notably, in 2011, the group acquired (through a JV with Daimler), Tognum, the German diesel engine group. RR contributed its Bergen engine business to the JV, leaving a net cash investment of £1.3bn. The deal will combine the strengths of the three companies to create a leader in integrated solutions for industrial engines, systems and services. The business will target a global market, worth €30bn, that is seeing significant growth. The business is very skilled in low emissions capability, and will add scale to the group's Marine and Energy divisions. It will make RR the world leader in the design and equipping of specialist vessels for the deepwater oil & gas industry. Although there is a lot of overlap in terms of addressable end markets, there is little crossover in terms of products, providing plenty of opportunities for cross-selling and product bundling.





The group pays a well-covered dividend (2.4x in 2010) that has grown every year since 2004. At the 2011 interim stage, the payout was increased by 8%. Unlike other listed companies, RR makes payments to its shareholders in the form of C shares, which are redeemable preference shares. Shareholders can opt for one of the following: redeem all C shares for cash; redeem the shares for cash and reinvest the proceeds in additional ordinary shares; keep the C shares. The issue of C shares should not give rise to a charge to UK Income Tax or Capital Gains Tax. The redemption of C shares for cash may, depending on your circumstances, give rise to a Capital Gains Tax charge.

Currency remains a key variable for the company, with the vast majority of its manufacturing base in the UK selling into a dollar-based market. The group needs to cover annual exposure of $3.5bn-$4.0bn, and so its current long-term hedging programme (c. $21.2bn as at 30 June 2011), in place at a rate of $/£ 1.60, should provide cover of more than five years. Going forward, the expansion of overseas production will increase the group's natural hedge.

In 2007, RR made a £500m payment into its UK pension scheme. As a result, and in contrast to many of its UK industrial peers, the group doesn't have a large legacy pension issue. As at 30 June 2011, the group's net pension liabilities stood at £681m. The group does not expect any significant change to the ongoing funding levels on the UK pension schemes in 2012.

The shares are currently trading on 12.7x consensus 2013 earnings. The table below highlights the comparable ratings of the group's main engine competitors and customers. However, we would note that many of these comparisons are unhelpful. Both competitors – Pratt & Whitney and the engine business of GE – are part of large conglomerates.

	PE			Dividend Yield			EV/EBITDA		
	2011	2012	2013	2011	2012	2013	2011	2012	2013
Rolls-Royce	17.0x	14.2x	12.7x	2.3%	2.5%	2.8%	8.6x	7.3x	6.4x
Boeing	16.6x	15.2x	12.8x	2.3%	2.4%	2.4%	8.2x	7.6x	6.7x
United Technologies	13.8x	13.2x	11.3x	2.5%	2.7%	3.0%	7.7x	7.2x	6.3x
EADS	26.3x	14.3x	10.9x	1.1%	1.7%	2.2%	5.2x	3.8x	3.2x
Dassault	17.0x	14.9x	13.2x	1.7%	1.9%	2.2%	9.8x	8.8x	8.8x
Safran	14.0x	11.5x	10.1x	2.7%	3.2%	3.4%	6.7x	5.8x	5.2x
Lockheed Martin	10.6x	10.4x	9.6x	4.1%	4.9%	5.3%	6.1x	6.0x	5.9x

Risks with this recommendation

- A slowdown in global GDP growth will have an impact on the group's business.
- An increased threat of terrorism will have an impact on air travel.
- A sharp increase in the oil price will impact air travel.
- The programmes which the group supplies to may be delayed or cancelled, or the group may fail to execute its order book.

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Investment ideas in the FTSE 100 which we believe will generate returns ahead of the All-Share index.	*Investment ideas in the FTSE 250 which we believe will generate returns ahead of the All-Share index.*	*Global investment ideas which we believe will generate returns ahead of the FTSE World (ex UK) index over the long term.*	*Funds that aim to generate an absolute return over the medium to long term, i.e. a positive return irrespective of equity or bond market direction.*	*Income producing funds, which are attractive in the context of the yield available from cash, gilts and UK equities.*	*Funds which we believe have the potential to generate a high level of capital growth over the long term.*

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