BAE Systems plc LSE:BA.

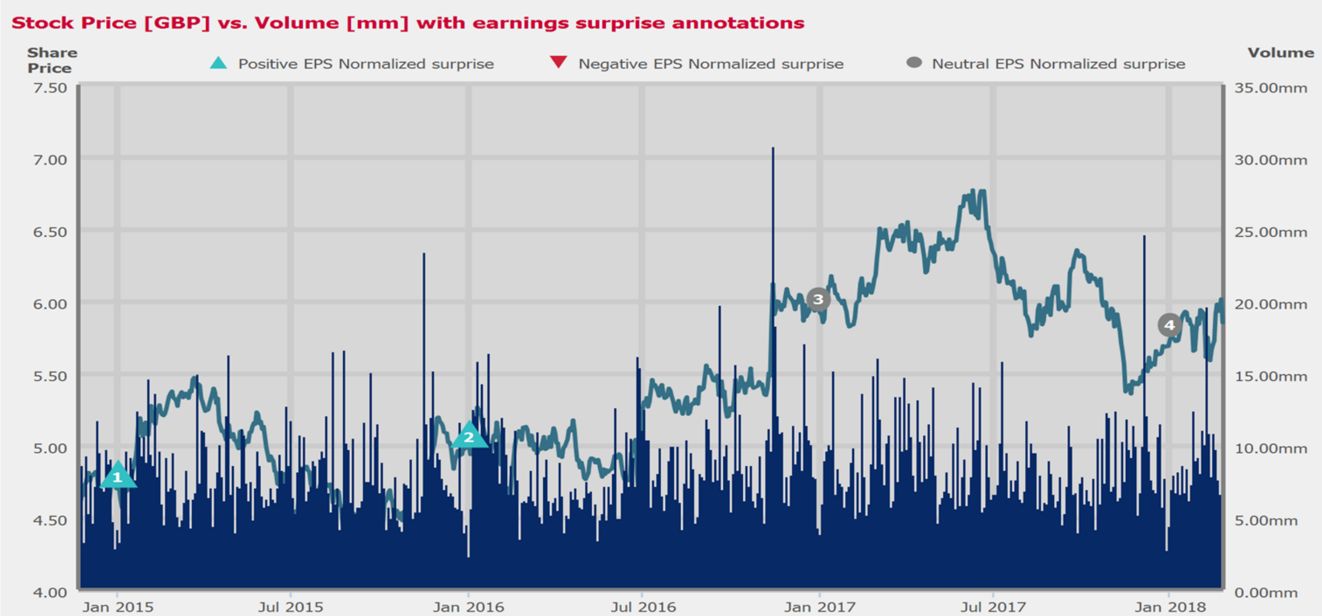
FY 2017 Earnings Call Transcripts

Thursday, February 22, 2018 9:00 AM GMT

S&P Global Market Intelligence Estimates

	-FY 2017-			-FY 2018-	
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	GUIDANCE
EPS Normalized	0.43	0.43	0.00	0.44	0.42
Revenue (mm)	19691.31	19626.00	(0.33 %)	19523.56	-

Currency: GBP
Consensus as of Feb-22-2018 8:53 AM GMT



	- EPS NORMALIZED -		
	CONSENSUS	ACTUAL	SURPRISE
FY 2016	0.40	0.40	1 0.00 %
FY 2017	0.43	0.43	2 0.00 %

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Call Participants

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Executive Director

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Presentation

Roger M. Carr
Chairman

Well, good morning, everybody, and welcome to our 2017 preliminary results meeting. There's absolutely no doubt that 2017 was a successful year. And I think, most importantly, a year in which the leadership baton was smoothly and efficiently passed over to Charles as Chief Executive of the group.

Now following Charles' appointment, management changes were also made to ensure our structure was simplified and aligned with the demands of business today. These changes acknowledge the increasing requirement for in-country production by our customers, the need to continuously hone our competitive edge in all markets and the emphasis that must be placed on efficient execution of a very strong order book. And I'm confident that these changes will bear fruit in the areas of improved cost control, swifter decision-making and greater innovation.

As we enter 2018, a substantial order book will, however, not shield the company from a year when the rhythm of customer delivery schedules make our ambitions for sales and profit performance a little more challenging than usual. But I am very pleased to say, nonetheless, that management has committed to address these short-term headwinds and deliver an earnings performance in 2018 that is in keeping with 2017, whilst also maintaining a strong focus on cash performance. This will be an important building block in the return to improve growth in profits and cash, as the natural flow of orders and production and delivery is restored in 2019 and beyond.

For my part as Chairman, I've been really pleased to witness the company's ability to manage a structural and leadership change in a period of general world turbulence. It has been made clear to me by customers, shareholders and employees that all have valued the preservation of seasoned executive experience with the introduction of fresh thinking and renewed energy in the management team at this time of geopolitical turbulence. Now this has also been true in the nonexecutive area with the appointment of Revathi Advaithi to our boardroom, a woman with strong international -- very strong international pedigree, relevant engineering and digital skills, first-class credentials and really good senior operational experience at both Honeywell and Eden Corporation. She's been a great addition to the boardroom. And we've just spent 2 days together, and already, great added value. So, so far, so good, but the defense market is becoming more competitive, and customers continue to be demanding, both at home and abroad. Relationships are, as always, very key, as is reputation. And in this context, it is pleasing that a very close [liaison] in the U.K. and the U.S.A., plus regular visits to both the Gulf and Australia by Charles and I continue to ensure we are well-received at the highest levels of government right across the globe.

Now this will be particularly important in 2018 in the pursuit of major business opportunities in land, sea and air that are currently under negotiations.

The year ahead, therefore, remains demanding, both in delivering the order book we have and building an even stronger order backlog for the long-term future of the business. The management is clear on their mission, and under Charles' leadership, remain enthusiastic and focused on achieving their objectives.

I now hand over to Charles and to Peter to look more closely at our performance in 2017 and examine, in a little more detail, the prospects for the year ahead. Charles?

Charles Woodburn
CEO & Executive Director

Thank you, Sir Roger, and good morning to everyone here in the room and those joining us via webcast. Today, we've announced a good set of results consistent with our earnings expectations for the year and a particularly strong cash performance, in part flatted by some GBP 400 million of timing benefit.

Looking back over the past 8 months, I'm pleased to say that we've made strong progress in delivering for our customers, securing new business and advancing our strategy. Overall, operational performance was strong. We achieved significant milestones in delivering all 8 Hawk aircraft and 8 of 12 Typhoons to the Sultanate of Oman, ramped F-35 production up to 80 sets, in line with targets to reach full rate production, and commenced production on the Type 26 program.

However, in Applied Intelligence, performance was disappointing. We have changed management, restructured the business and taken a goodwill write-down, reflecting lower growth assumptions.

On the balance sheet, reaching clarity and a largely unchanged pension funding position in November was a significant milestone and derisked future cash flows. Order intake of just over GBP 20 billion meant our large order backlog was sustained, and that's before booking the Qatar order, ensuring good visibility of future sales.

Before Pete takes you through the detailed financial results and guidance for 2018, I wanted to start with a brief recap of our strategy and priorities for the year ahead and the actions taken since we last met in August.

After a brief overview of the markets, I'll give a medium-term outlook for our key programs and franchises. As usual, we'll take your questions at the end of the presentation.

As outlined at the half-year results, our strategy remains largely unchanged and is underpinned by a disciplined capital allocation policy. Within this strategy, I set out, in August, 3 priority areas to grow and win new business in a fast-moving and increasingly competitive market environment. They are as follows: operational excellence, improving our competitive edge, and advancing our technology base.

Over the past 8 months, we have taken decisive action to improve performance in each of these 3 key focus areas

Firstly, operational excellence. Our highly skilled workforce is delivering some of the world's most challenging and complex engineering programs. In 2017, we saw a higher tempo of activity across many of our businesses. Manufacturing got underway on the Type 26 and Dreadnought submarine program, and the U.S. business continued its ramp to rate in combat vehicles and a number of Electronic Systems products.

In Saudi Arabia, we achieved the key milestone of commencing Hawk aircraft final assembly, In-Kingdom, as part of our ongoing industrialization strategy. As we move into 2018, we need to maintain the drumbeat on U.K. maritime programs, continue the production ramp in Electronic Systems in U.S. combat vehicles and drive improved performance from our Applied Intelligence business. Where required, management changes have been made to strengthen and underpin our performance. Maintaining focus on delivering to our customers is the best way to highlight our skills and capabilities and, therefore, to win new business.

Secondly, competitiveness. This is crucial if we are to secure new opportunities and address customer affordability challenges. In 2017, we commenced restructuring actions in military air, maritime services and Applied Intelligence. These difficult but necessary actions will maintain critical capabilities and enhance our competitive position in securing anticipated new orders.

Additionally, the streamlined organizational structure, in place since January 1, has been designed to drive focus and performance in each of the 3 key priority areas. Importantly, we are also starting to see the benefits of increasing collaboration across the group, pursuing new business such as the LAND 400 and SEA 5000 programs in Australia, and sharing best practice and in developing and exploiting in innovative new technologies.

The procurement transformation being led by Chief Procurement Officer, Paul Smith, is a great example of collaboration in action whilst also improving our competitiveness.

For 2018, we need to drive efficiencies across a number of supply chain categories and implement a more strategic approach to managing our suppliers and our design, engineering and manufacturing processes.

Embedding the new organizational structure and work now underway in the CTO organization to enhance collaboration are all important steps in 2018 to making us more competitive.

Thirdly, technological innovation. Technology is a key driver of competitive advantage and, increasingly, a critical determinant for our customers in awarding new business.

In 2017, we increased self-funded R&D by 15%, expanded our partnerships with academia and appointed Nigel Whitehead into the position of Chief Technology Officer. Nigel and his team will create -- will target value creation through greater focus, collaboration and innovation in technology across the entire enterprise. There will be more external collaboration opportunities, and we will refine technology plans to underpin our business and product strategies whilst also continuing to appropriately self-fund R&D in support of our core franchises.

So the strategy and strategic actions are in place and being rolled out across the business. We have a firm foundation, and whilst there is much to do, we are well-placed.

Moving on to our new organization structure and outlook in key markets. The new structure is an important step in achieving the strategic objectives as we look to become a stronger company, match fit for the opportunities and challenges ahead. The new Air sector, led by Chris Boardman, brings together our combined expertise in military aviation across the U.K., Saudi Arabia, Australia and other international programs to harness our capabilities more effectively for both existing and potential customers around the world.

The maritime sector contains our long-term U.K. contracted programs in submarine and shipbuilding. These are critical programs for the U.K., and this sector now reports directly to me, with an absolute focus on program execution. The U.S. sectors continue unchanged after Jerry and the [Inc] team streamlined and reorganized a few years back.

So a brief take on market outlook. The U.S. business has become skilled at managing through periods of continuing resolution with minimal impact. The bipartisan budget agreement passed in early February would increase the 2018 U.S. Defense budget by approximately 10% over current levels. The agreement increases the budget caps for 2 years whilst extending the Continuing Resolution into March to allow time for an omnibus appropriations bill to be passed. Our U.S.-based businesses continue to plan conservatively and remain well-aligned with customer priorities and growth areas, and we see continued support for increases in defense spending, as demonstrated by the President's recently released 2019 budget request.

In the U.K., defense and security remains a priority for the government. We expect this to be reaffirmed in the ongoing capability reviews. Our U.K. business, of course, is centered around our long-term contracted positions in air and maritime. We continue to execute on these while working with our customers to address their affordability challenges.

In our international markets, defense and security remains high on national agendas, with a number of countries responding to an increasingly uncertain security environment.

Whilst Pete will outline 2018 guidance in a few minutes, given the market conditions I've just outlined, I wanted to give you more color on the strength and medium-term outlook for our key franchises and contracted programs.

Electronic Systems has a very broad, well-placed technology driven portfolio. Growth will be generated across the portfolio from F-35 ramp-up and F-15 upgrade programs, as well as from increased activity in the classified domain. Our APKWS product is also seeing significant demands. Our Investor Day in May will focus on the strength and breadth of our Electronic System's franchises.

U.S. Platforms & Services is set to deliver growth from all 3 of its businesses. Combat vehicles production is set to double in the next 3 years, underpinned by our secured positions on the M109, the Armoured Multi-Purpose Vehicle and the Bradley vehicle franchise. The business is also pursuing a number of export opportunities, and an award decision on the U.S. Amphibious Combat Vehicle is expected later in the year.

Ship repair had a good year of order intake and is expected to benefit from demand requirements and the U.S. Naval budget outlook. Through the additional capacity added by the new dry dock facility in San Diego and our positions across our U.S. shipyards, we are well-placed to compete for future work.

Our weapon systems business is executing on a number of key orders in our naval guns franchise. Indian M777 production is ramping up, and there's a good drumbeat of work through our Holston and Radford munition facilities.

The air sector comprises a number of different program dynamics, as this -- as is shown on this slide. The main points to note: As previously flagged, Typhoon and Hawk production will reduce in 2018. Typhoon is then expected to stabilize based on the current order book and anticipated finalization of the Qatar order.

We continue to pursue further export opportunities, which, if secured, would drive growth back into this highly capable platform as we move into the next decade. Typhoon support, already generating more revenue than production, is expected to grow as further aircraft are delivered into service.

On the F-35, we are seeing a continued ramp in production over the next 3 years, and securing a global support position remains a key priority. Having won initial work packages in the U.K. and Australia, we continue to work on long-term support positions with our industrial partners and customers.

The final point I would draw out is that our MBDA joint venture has again grown its order book to stand at nearly EUR 17 billion. This supports good sales growth in the medium term.

The maritime sector is underpinned by our long-term positions on Astute and Dreadnought and on the Type 26 frigate program. Whilst the U.K. maritime budgets are under pressure, this contracted programs give us stability and visibility.

In the U.K., we have teamed with Camell Laird for their bid on the U.K.'s -- U.K. MoD's proposed Type 31e General Purpose Frigate program. Beyond these U.K. programs, we've submitted our tender response to the 9-ship Australian SEA 5000 Future Frigate Program, and we are teamed with Lockheed Martin Canada to provide the Type 26 design into their bid for the Canadian surface combatant.

Now turning to Cyber. The U.S. Intelligence & Security business is well-run with a high tempo of bid activity. The business is a mix of shorter cycle contracts in what is a highly competitive market. Reflecting the poor operational performance and goodwill impairment, our U.K.-based Applied Intelligence business has been reorganized to focus on a targeted portfolio of products, services and markets that will accelerate improvements in about competitiveness and profitability while still targeting top line growth.

So to conclude. We have reaffirmed our strategy and highlighted 3 priorities in order to maximize performance in the near and medium term and secure further opportunities.

The balance sheet remains strong, following the pension funding agreement, which derisked future cash flows. And our capital allocation remains clear, consistent and disciplined.

2018 is a transition year for earnings underpinned by continuing cash generation. The business is well-placed from his contracted programs and long-standing franchise positions to deliver growth in the medium term.

I will now hand over to Pete to run through the year's financials and guidance for 2018. Over to you, Pete.

Peter J. Lynas
Group Finance Director & Executive Director

Good morning, everybody. Thanks, Charles. So today's results are technically more challenging than -- to present than usual, given the impacts we've got from exchange movements, U.S. Tax reform, our new sets of reporting structure and changes from the new IFRS accounting standards. So before I step through the detail, I'd like to draw out some key points.

And firstly, in terms of 2017, underlying earnings per share was up 8%, and that's towards the higher end of our guidance range. And the EMEA loss, as Charles referred to, at Applied Intelligence was matched by good performance across the rest of the group.

Cash performance has been strong, and that's even stripping out the GBP 400 million of timing benefit that we had in the year. Our strong order backlog was maintained on a like-for-like basis, and that's without yet having booked the Qatar Typhoon contract.

The dividend was growing for the 14th consecutive year with earnings cover sustained. And as previously announced, we've materially derisked future free cash flow through a sensible outcome on the U.K. triannual pension valuations.

And looking into 2018. Despite the significant headwind from the lower Typhoon and Hawk production activity, and after the IFRS 15 restatement, earnings are expected to be line with the 2017 performance. And at the earnings level, the headwind from U.S. dollar translation is broadly matched by a lower effective tax rate, benefiting from the U.S. tax reform measures.

And other than our U.S. services businesses, growth is projected to be strong. We do see the Applied Intelligence business moving back to breakeven as the rationalization programs that we announced in 2017 delivered to the bottom line.

And finally, in terms of free cash flow generation, we see around GBP 2 billion being delivered across 2017 in aggregate, and that's ahead of consensus.

So those are the key messages, and I'm now going to move on to the detailed results for 2017, and then the guidance for '18. That guidance is in our new sector structure and is prepared under the new IFRS 15 accounting standard. There's been some volatility in exchange rates in the year. And for reference, the dollar rate averaged at $1.29 in 2017 and was $1.35 in 2016.

So the headline numbers, and compared to 2016. Sales increased by GBP 0.6 billion to GBP 19.6 billion, and the majority of that has been due to currency translation.

Underlying earnings before interest tax and amortization increased by GBP 129 million to GBP 2,034,000,000.

Growth on a constant-currency basis was at 4%.

Underlying finance costs in the year decreased marginally to GBP 245 million, underlying earnings per share were at 43.5p, and that's up 8% over 2016.

There was an operating cash inflow of GBP 1.8 billion. And net debt at the end of the year closed ahead of our guidance at GBP 0.8 billion.

Order backlog at the end of the year was at GBP 41.2 billion, and that is unchanged against the previous year on a constant-currency basis.

And as I mentioned, the dividend for the year has been increased to 21.8p per share. That's up 2% on 2016. And at that level, the dividend is covered twice by underlying earnings per share.

In addition to the impacts from exchange translation on the balance sheet, where the U.S. dollar closed at $1.35 compared to the opening $1.24, there were a number of items that impacted the closing balance sheet. We have taken an impairment charge of GBP 384 million against the goodwill carrying value on the Applied Intelligence business, prudently reflecting the future level and timing of expected returns from that business.

As planned, capital investment was made in support of the production ramp-up in our U.S. Electronic Systems and combat vehicles businesses.

Within working capital, there are some items of note. Firstly, as anticipated, the remainder of the advances received in 2012 on the Omani Typhoon and Hawk order as well as European Typhoon production are almost all now consumed.

On the Saudi support contract renewals, some GBP 300 million of cash was received in 2017, representing advanced funding to be utilized in '18 and '19. Costs have been incurred against provisions created in previous years, as the U.S. commercial shipbuilding programs are closed out. And the final working capital point is at around GBP 100 million of VAT payments rolled from December into 2018.

In aggregate, working capital is decreased by some GBP 200 million. The group share of the IAS 19 accounting pension deficit has fallen over the year to GBP 3.9 billion. And that lower pension deficit also drives the reduced deferred tax assets. And whilst the reduction in U.S. corporation tax has had no impact on the 2017 underlying earnings, it has also reduced the deferred tax asset by GBP 67 million.

So I'm now going to move on to the pension deficit position and the clarity achieved through last November's funding agreement.

So firstly, a look at the accounting deficit. I think we're running ahead on the slides. You want to move back one. Thank you. There are a number of moving parts here, which I'll touch on, but the combined impact of them all is a GBP 2.2 billion increase -- sorry, decrease in the group share of the pretax deficit. The value of the scheme assets has increased over the year to GBP 27 billion, and that's after pension payments paid out of some GBP 1.3 billion and an adverse exchange translation impact of GBP 0.4 million. The return on assets in the year was at 9%.

At the end of the year, reported liabilities had fallen by GBP 1.3 billion to GBP 31.2 billion. Real discount rates in the U.K. were unchanged over the year and a 50 basis points adverse movement in the U.S. gave a GBP 0.3 billion increase in reported liabilities.

A significant liability reduction of almost GBP 1 billion has come from the increased mortality assumptions as we adopt both the latest actuarial tables and scheme-specific changes based on membership experience.

Reported liabilities have also fallen by GBP 0.5 billion due to exchange translation. So overall, a net GBP 2.2 billion reduction in the accounting deficit.

As we've always stated, it is the funding deficit which really counts and is of economic importance to the company. So we thought it would be useful to illustrate the key differences between the reported accounting number and the agreed U.K. funding position. This chart highlights how the reported U.K. accounting deficit represents a very material overstatement when compared to our agreed funding obligations.

This is a complicated chart, so let me step you through it. To the left of the chart, in the first column, is the accounting deficit. And of that, GBP 3.7 billion relates to U.K. schemes. To the right of the chart, in the last column, is the GBP 2.1 billion U.K. funding deficit.

So in terms of the 2 columns in the middle, column 2 adds back the benefit of the latest actuarial mortality tables. And those tables -- that benefit was included in the accounting number, but was not recognized in the more prudently assessed funding deficit.

Column 3 simply aligns the asset values between the year-end accounting date and the April 2017 funding valuation date.

As you can then see, there is a GBP 3 billion difference, and that arises from the use of different discount rates applied to the scheme liabilities. Whilst the accounting, usually AA corporate bond rate, the funding now uses a blended rate of the prudent asset returns that we assume. That blended asset return rate is 3.3%, which is just 70 basis points higher than the accounting discount rate.

Moving on to cash. This slide sets out the movement from our net debt position of GBP 1,542,000,000 at the beginning of the year. The operating business cash flow of GBP 1,752,000,000 was clearly ahead of guidance. Receipts of some GBP 300 million were received in the year, representing advanced funding on the Saudi support contract. And there was also GBP 106 million of VAT payments that rolled from '17 into '18.

Interest and tax payments were GBP 408 million. Payment of 2016's final and 2017's interim dividend totaled GBP 684 million. Exchange translation and all other movements were GBP 130 million.

So we closed the year with gross debt of GBP 4 billion, cash of GBP 3.2 billion and net debt of GBP 0.8 billion. And we do have a $1 billion bond maturing in mid-2019, and that will be repaid from cash held.

The cash flow performance of the 5 sectors is shown here, and I'll return to this when I cover the results of each of the sectors. But just to note, the total cash outflow for pension deficit funding made in 2017 was GBP 271 million. And the head office number shown on the chart contains GBP 133 million of that.

Okay. I'll move now onto the sectors. I'll cover the in-year performance here and the outlook for 2018 a little later. And the first of those sectors is Electronic Systems, and the numbers here are in U.S. dollars. Sales compared to 2016 were up 5% at $4,685,000,000. The growth came in the electronic warfare business from the F-35 and DEWS programs as well as an increasing volume of classified activity. Sales on -- of the APKWS product almost doubled over the year and now represent one of the top 5 sales lines in this sector. Return on sales achieved at 15.5% exceeded our guidance range, largely from continued strong program execution and risk retirement.

As expected, cash conversion of EBITDA for the full year was at 85%, excluding pension deficit funding. Order backlog was at a record high of $7.3 billion, following further awards for F-35 systems, classified EW activity and APKWS product.

The Cyber & Intelligence sector comprises the U.S. Intelligence & Security Business, together with BA Systems Applied Intelligence, and the numbers here again in dollars. In aggregate and slightly below guidance, sales were marginally lower at $2,346,000,000. The U.S. business saw a 4% decrease, largely in a highly competitive area of IT support services to the Intel community.

Growth in the Applied Intelligence business was at 6%, benefiting from increases in the U.K. government and international government service divisions. The aggregate margin for the sector was just 2.9%. Margins in the U.S. business were similar to last year at 8.8%. However, in Applied Intelligence, the total loss for the year was GBP 61 million. And that includes a GBP 24 million restructuring charge.

The first half loss of GBP 27 million was reduced to a second half operating loss of GBP 10 million as the cost reduction actions under that restructuring program start to deliver bottom line benefit. Cash conversion of EBITDA for the year was in excess of 100%, and order backlog reduced marginally in the U.S. to $2.9 billion.

Moving to the U.S. Platforms & Services sector, and the numbers again in dollars. Sales in the year were slightly behind guidance, down by 3% to $3.8 billion, as deliveries of land vehicles to Brazil and Japan slipped into the first half of 2018. However, in line with guidance, the business has delivered an improved margin of 8.3%. Charges taken in the year on a commercial shipbuilding programs amounted to $16 million or 40 basis points, with just one contract now remaining for completion.

As expected, cash conversion of EBITDA was significantly improved, despite the impact from the use of provisions on those commercial [shipbuild]programs.

Order backlog was increased to $6.3 billion, supportive of future growth expectations. Key awards in the year include the $0.5 billion engine order for M777 ultra-lightweight howitzers, around $400 million for Paladin production and a total of $1.3 billion in the ship repair business.

In the U.K. Platforms & Services sector, the year sales of GBP 7.7 billion were only marginally lower than 2016, slightly ahead of our guidance. Activity levels on the submarine programs were ahead of plan. In line with that guidance, return on sales was at 10.3%.

Cash performance was better-than-expected with an inflow of GBP 427 million. However, that does include the temporary GBP 106 million benefit relating to VAT.

As I mentioned earlier, consumption of customer advances on the Omani, Saudi and European Typhoon contracts has now largely completed. As expected, order backlog reduced to GBP 16.8 billion, the GBP 5 billion order received from Qatar in December for 24 Typhoon aircraft in support has not yet been taken into the backlog pending completion of the financing package, which we expect in the coming months.

Sales in the international sector of GBP 4.1 billion were 5% up over 2016. With all 72 Salam Typhoon aircraft now in service, we have seen high levels of support. And in addition, we've seen expected ramp-up coming from MBDA's strong order backlog.

EBITDA of GBP 472 million and return on sales of 11.4% was slightly ahead of expectations, reflecting improving performance from our KSA partner companies and stronger performance from MBDA. Operating cash flow was at GBP 671 million, although GBP 300 million of that was for the advance payment on the Saudi support program.

Order backlog was marginally higher at GBP 13.3 billion as further order intake was booked under the renewal of the 5-year support contract in Saudi Arabia, and Qatar naval orders became effective within MBDA.

And for reference, there is a chart running a summary of the trading performance of all 5 sectors, along with the headquarters' numbers appended to your presentation packs.

Okay, let's move to guidance. And this next chart seeks to give guidance as to how we see the performance of each sector developing from 2017 through to 2018. But just before I go through that, I'd just like to say that the 2017 performance on this chart has been recut to our new sector structure. And in addition, the numbers have been restated under the new IFRS 15 accounting standard.

As we said in November's WebEx, IFRS will impact the way that we account for revenue. On the majority of our longer-term contracts, revenue is recognized earlier as we incur costs rather than on performance milestones or deliveries. And as you can see from the chart, that has had a material impact on the reported sales numbers for 2017. But on those long-term contracts, profit will continue to be recognized progressively based on risk mitigation and retirement.

On the shorter-term contracts, mainly in our U.S. businesses, there will be some acceleration of both revenue and profit recognition. So as expected, whilst reported 2017 sales under IFRS have reduced by around GBP 1 billion, the impact on our earnings per share is just 1.4p. And I'd stress now that the IFRS 15 will not change the way in which we manage our contracts nor does it change the lifetime contract profitability nor our cash flows. And we have included full reconciliations on both the new sectors and the IFRS 15 restatement in your packs. And for reference, before we get into the guidance, our exchange rate planning assumption for the U.S. dollar now is at $1.40, and a sensitivity to $0.10 movement in the U.S. dollar is now approximately 1.5p of earnings per share.

So looking at the individual sectors, and firstly, Electronic Systems. Overall, we expect 2018 sales in dollar terms to show high single-digit growth driven by a number of electronic warfare contracts. And in aggregate of 2018's projected sales, some 70% are in the 2017 closing order backlog, and that's similar to last year's starting point. And on margins, we've changed our guidance to an improved 14% to 16% range.

Next, Cyber & Intelligence. And in aggregate, we expect the sales to be marginally higher in '18. The U.S. business, which was 70% of this sector last year, is expected to be largely unchanged. In the Applied Intelligence business, we expect to see some top line growth, again coming from the U.K. and international government services divisions.

The margin in '18 is expected to improve to around 5%. The U.S. business is, again, expected to contribute around the 8% mark. And whilst Applied Intelligence should move to a breakeven position for the full year benefiting from the changes made to rationalize the business, this will be second-half-biased.

Moving to Platforms & Services in the U.S. And here, we expect sales growth to be double-digit with increasing volumes from the U.S. combat vehicles and weapons system businesses, as well as higher ship repair activity. Of this sales guidance, almost 75% is already within backlog. And at the margin level, we expect another year of improvement, moving up into a 9% to 10% range.

Moving on to Air. And as we've previously flagged, sales are expected to be some 5% lower as production activity on Typhoon for the European, Saudi and Oman contracts is largely complete. Around 80% of that guidance is within closing backlog. And margins in the sector are expected to be within an 11% to 13% range.

And the last of the sectors Maritime. Here, we expect sales to be stable as activity levels on carrier reduce but are largely offset by increases on the submarine programs. Around 90% of this guidance is already covered by backlog. And of note, only some 5% of the sector sales come from short-term service and support contracts. Margin levels are expected to be similar to those in '17 within an 8% to 9% range.

And to complete your models, headquarter costs will be similar to those in '17. Underlying finance costs are expected to be around 15% lower, benefiting from the weaker dollar, in which most of the group's interest cost is borne, reduce charges within our equity-accounted investments and lower net present value charges.

The effective tax rate is expected to reduce from 21% to around 18%, benefiting from the U.S. Tax Reform changes. And the final number there is, of course, dependent upon the geographic mix of profits.

And so with the assumption of a dollar rate at $1.40, we expect the group's 2018 underlying earnings per share to be in line with our 2017 performance, as restated under IFRS 15.

This final chart highlights our cash utilization. In the left-hand column are the numbers for 2017, and to the right are those for 2018 that we expect.

In respect of operating cash flow, firstly, we expect capital expenditure to be marginally above depreciation levels, reflecting continued investment for expanded production facilities in Electronic Systems and the U.S. combat vehicles business. There will also be some spend against provisions created in previous years.

As previously indicated, we expect that our historic working capital volatility will be greatly reduced as export customer advances have now been largely utilized. However, in 2018, the GBP 300 million of accelerated receipts will be utilized and a temporary VAT benefit will reverse. And these flow through both advances and other working capital movements lines on this chart.

The final operating cash flow item is this year's pension deficit funding, which we know will be around GBP 300 million. The nonoperating cash flow items are predictable. Outflows for interest and tax are again expected to total around GBP 400 million, and dividends to shareholders, around GBP 700 million. So in aggregate, 2018 is expected to see net debt broadly unchanged.

Looking across 2017 and 2018, the group, therefore, expects to have generated circa GBP 2 billion of free cash flow, of which around GBP 1.4 billion would flow to shareholders and dividend. And with that, I'll pass it back to Charles.

Charles Woodburn
CEO & Executive Director

Thanks, Pete. In summary, a good year for the company, delivering sales and earnings growth and strong cash generation while implementing steps to build a firm foundation to deliver medium-term growth and a stronger, smarter and sharper business. Looking ahead, we remain focused on delivering our order book, driving our 3 -- and driving our 3 key strategic priorities. This will enable us to generate long-term growth and shareholder value.
Pete and I will now take your questions. Thank you.

Question and Answer

Christian A. Laughlin
Sanford C. Bernstein & Co., LLC., Research Division

Christian Laughlin from Bernstein. A couple of questions for me. Basically, centered on aircraft sales campaigns and ground vehicle opportunities, particularly in export markets. So starting with aircraft, as we start to see potentially some order inflow from -- for additional Typhoons, what are some of the markers we need to see or this sort -- or the milestones with respect to timing that would impact production rates. That is to say -- I mean, obviously, with roughly like a 2-year lead time where you could see some orders come in over the next 12 or 18 months but they don't really change the pace of production, conversely, I guess, you can see a flood of orders come in, and then you decide to take rates up in about 2 years or so. So if you could just kind of sort of outline how that works, that'd be great. And then secondly, with respect to ground vehicles, particularly in Middle Eastern export markets, you've discussed before ongoing sales campaigns, particularly in Saudi Arabia for M109s and some Bradley work. Ostensibly, those activities were somewhat reduced while the U.S. Congress had a ban on equipment sales into that market. But that ban was recently lifted. So could you talk a little about how that has changed or not changed the pace of discussions around those campaigns?

Peter J. Lynas
Group Finance Director & Executive Director

Just before -- I'll let Charles talk about opportunity on export programs. But just to be clear on Typhoon, we are now at a level, in terms of our 2018 guidance, where Typhoon production is less than GBP 0.5 billion. So I know we've had -- we clearly stated back in -- 6 months ago, where we sat here, that we were expecting to see a sort of GBP 800 million, GBP 900 million headwind from Typhoon. That's where we are. But it is now less than 3% of the group sales. Support revenues on Typhoon are 3x that volume. So we are moving through. In terms of -- the question is, when would we start trading? One of the issues of IFRS 15 is you don't have to make deliveries before you start trading sales now. It is about when you incur costs on those programs. So as you get those programs in, you'll see some top line coming through, albeit it will be at a very, very low margin because we're still holding on to the fact that we only trade profit and margin on contracts as when we retire risk. So you'll see some sales go up. You might see a dilution in terms of margin percentage, but that's just the way IFRS 15 takes you.

Christian A. Laughlin
Sanford C. Bernstein & Co., LLC., Research Division

Okay. That part I understand, but my question is mainly more on the physical, industrial process of thinking about Typhoon production capacity under various order scenarios, but that was helpful.

Peter J. Lynas
Group Finance Director & Executive Director

Okay. I mean, in terms of capacity, if you remember the original Typhoon production line was set to take 60, 60 a year. And we're clearly nowhere near that. I don't think we ever got to 60. I think the most we ever got to was in the 40s. But the capacity is there.

Charles Woodburn
CEO & Executive Director

I think it is fair to say that, I think you've already concluded that in terms of the opportunity pipeline in terms of campaigns in Europe and in the Middle East, I think the opportunity pipeline is as good as we've seen it. And I think, certainly, encourages us that we'll see growth coming into the next decade in Typhoon production. And you've got to reflect the fact that the platform now with this -- since you had an upgrade so then going into the RAF, it is at its -- it's the most capable that it's ever been. And I think we'll continue to see further export success.

Charles Woodburn

CEO & Executive Director

On the combat vehicles, I think, Jerry, would you mind -- do you want to just say a couple of words on that, since you're here? So Jerry runs our Inc. business. I've just to introduce him. And he's...

Gerard J. DeMuro
Executive Director

With respect to Middle Eastern campaign, you mentioned the M109, the self-propelled howitzer and the Bradley. We do have 2 pending opportunities in Kingdom of Saudi Arabia. The congressional hold that was put on sales to Saudi Arabia by Senator Corker, if you'll recall, was just lifted recently. So we're just now beginning to reengage with the Congress and State Department on clearance of that. I would expect that we will probably have to renew discussions with the Saudis about in-country content mix and how we're going to deliver that. So that'll -- that is just initiating, but the dialogue has begun. So it'll take a little while to sort through that, but still very valid requirements.

Robert Alan Stallard
Vertical Research Partners, LLC

Rob Stallard from Vertical. Maybe a follow-up for Jerry as well. The FY '19 budget request that came out the other day, I was wondering if you could highlight how BAE has fed -- I know it's just a request, but how it looks at this preliminary stage in terms of your various programs there, and what the revenue growth implications could be for the company down the line? And then, secondly, maybe one for Pete. On Qatar, you said that you'd close it at some point in the next 6 months or so. Have you included any potential impact for cash flow from this closing in your guidance?

Charles Woodburn
CEO & Executive Director

Rob, I'll answer the second one quickly. The answer is no, we haven't. Jerry, hopefully you've got more extended answer than I have on the first question.

Gerard J. DeMuro
Executive Director

In both the FY '18 and FY '19 budgets that have been approved by the authorizers in Congress, we see strong growth potential in, really, 3 or 4 areas. The first one is combat vehicles, plus up at [cross] the army brigade combat team, an opportunity to increase production on those vehicles. Think about the M88, the Paladin, the self-propelled howitzer, the AMPV and the Bradley. They're -- all of those will increase by about 50%. So right now, in our plan, we're looking at roughly over the next 2 to 3 years, roughly, depending on when this money finally gets obligated and put on contract, doubling the production volume to our U.S. combat vehicle business. You could see roughly another 50% increase from those budgets. So that's one area. Ship repair, you could see maybe about a 10% increase. We're anticipating that, with greater stability in the budget, the Navy will be able to extend its repair modernization times on each of the ship. We're also seeing strength in electronic warfare, as both Charles and Pete had alluded to, and an acceleration of some programs. F-35 even gets plussed up a little bit, or at least the production is extended a little bit further out in the U.S. But one area that we mentioned, Charles talked about the APKWS. It's really across a number of our precision weapon systems and initiatives that we have there at APKWS. We have a couple of other Class 5 programs where we're providing guidance, things like the seeker on the THAAD. So a host of artillery programs, where we're now putting guidance into artillery and the Hypervelocity Projectile is being accelerated. So in the precision weapons area, ship repair, combat vehicles, we see an opportunity for plus side. As to when that would flow into revenues and earnings, you're probably -- 18 months after a contract order, you'll really see something noticeable, if that makes sense. Okay?

Charles Woodburn
CEO & Executive Director

Maybe on this side here. Halfway down.

Jeremy David Bragg
Redburn (Europe) Limited, Research Division

Jeremy Bragg from Redburn. I've got 2 questions, please. Firstly on cash conversion. You've been very clear as to why cash conversion was strong in '18 and why it will soften a bit in -- sorry, strong in '17 and soften a bit in '18 as some of those things reverse. But what's the right number in terms of free cash flow-to-net income conversion? I mean, simplistically, CapEx is a bit higher than depreciation, your tax is a bit lower than the P&L charge and you pay GBP 300 million into the pension, give or take. So if you're doing $1.4 billion of net income, you should be doing GBP 1.2 billion roughly of free cash flow. Just...

Peter J. Lynas
Group Finance Director & Executive Director

Before dividend, yes, absolutely.

Jeremy David Bragg
Redburn (Europe) Limited, Research Division

Before dividend. Yes, absolutely. So that kind of implies, this is my man math, so that's like 85% conversion ratio. But if I sum the 2 years, '17 and '18, it looks like you're guiding for about 75%, i.e., GBP 2 billion of cash on GBP 2.8 billion net income. So my question is -- sorry, it's very long-winded, when do we get to this 85%? And is that the right number? Or is it higher, please?

Peter J. Lynas
Group Finance Director & Executive Director

I mean, the piece you're missing is what we said in the guidance this time last year, when we said that '17, we would see the end of the utilization of advance payments on those European and Saudi and Omani Typhoon production programs. We're through that. So what you're actually seeing is probably outperformance compared to what we expected. And when we look to -- if you look at 2018 and what we're guiding today of net debt unchanged, that's giving a total, over the 2 years, of debt reduction of about GBP 600 million. So yes, we're not over the 85%, and your math is pretty good as you would expect, but we're getting through that and '17 was the last year of using up those advances. So as we move into '18, '19, and beyond, your model absolutely holds.

Jeremy David Bragg
Redburn (Europe) Limited, Research Division

Okay. And then on organic growth, it looks like it's slightly negative this year. I haven't done the detailed math. It's obviously because of Typhoon and Hawk, but can you give a comment on '19 and '20, please? Clearly, you don't want to give guidance on '19, but just some sort of commitment that you're happy with organic revenue growth in '19 and '20, please.

Peter J. Lynas
Group Finance Director & Executive Director

Yes. I think in -- what we're saying in -- what you've seen in '17 is fairly flat. Again, Typhoon production was a big step-down. And as we go into '18, we've got another step-down from that GBP 1.3 billion Typhoon production, down to that GBP 500 million that I talked about earlier on. So that's where you're getting the headwind from. If you look at the guidance we've put up on that chart, clearly, we're guiding for growth elsewhere in the business. And then if you look at the chart that Charles put out there, when we look at those long-term programs and franchises, there are not many arrows going downwards. They're nearly all pointed upwards. So we're pretty confident.

Charles Woodburn
CEO & Executive Director

Yes, medium-term growth. Maybe the guy with the injury.

Peter J. Lynas
Group Finance Director & Executive Director

It's the sympathy vote.

Unknown Analyst

Just on the U.S. businesses, you've taken margin guidance up on each of Electronic Systems and the U.S. Platforms businesses. I appreciate that there's a mix of stuff going on there, but to the extent you're able to characterize it, is that broadly driven by mix? Is it the current budget situation giving you maybe better visibility and better ability to plan? Or is it the feeling that you can go after a bit more of the shorter-cycle stuff that's coming through which maybe gives you a bit more short-term margin upside?

Peter J. Lynas
Group Finance Director & Executive Director

It's a bit of all of those. But I mean, if I take the 2 divisions separately. I mean, Electronic Systems, if you look back over the last 3 years, we've delivered an -- 15% return on sales in each of the last 3 years. They have performed well, they continue to perform well. Program execution is strong, they are getting the benefits of volume coming through. 5% growth last year, another 5% with sort of -- sorry, high single digit we're projecting for '18. So it's volume and it is program execution in Electronic Systems.

Charles Woodburn
CEO & Executive Director

And some operational leverage of growing the top line quicker than the cost base.

Peter J. Lynas
Group Finance Director & Executive Director

And in Platforms & Services in the U.S., we've -- we're almost through those commercial shipbuild programs. So I talked about there's a 40 basis point hit in 2017, for the $16 million charge. We're not anticipating any more charges in the -- on those programs. And again, with the scale coming through, that gives us confidence to move that margin rate up from a 9% to 10%. And sometimes we get questions, "Well, why is it down at the 9% to 10%?" You do need to remember, there is about GBP 1.2 billion, GBP 1.3 billion of ship repair business going through there, and that is not double-digit business and nor will it ever be.

Charles Woodburn
CEO & Executive Director

That's a very competitive market. Maybe the -- halfway down, on the right.

Peter J. Lynas
Group Finance Director & Executive Director

[indiscernible] question.

Rami Yehuda Myerson
Investec Bank plc, Research Division

Rami Myerson from Investec. So first question would be on strategic review. Charles, so you've now completed your first year CEO. And usually, early in the tenure provides a good opportunity to do a review of the portfolio to decide which businesses belong in the portfolio, which businesses could be managed better outside of the portfolio, potentially, and where you think you need to strengthen. So it doesn't feel like -- you may be doing that, but if you could just talk a little bit about where you are there. Things like vertical integration of your supply chain and digitization. And the second question is around the U.K. medium term, which you've alluded to. But how do you reconcile a supportive 10-year equipment plan, which is supposed to grow over the next 10 years, combined with that pretty supportive political backing on the one hand; on the other hand, U.K. revenues for your business don't appear to be growing over the next few years? And when do you expect the growth to recover? And maybe just a small, technical question for Pete. Are the margins that you've provided for Air and Maritime representative of the margins that you think that business can do over the medium term?

Charles Woodburn
CEO & Executive Director

In terms of strategic review, I mean, I've outlined the 3 areas. I think there's a lot of legs left to run on the 3 areas that I've focused on, in as much as we've made some structural changes, but just embedding them in the way that we run the business. So for example, on the Chief Technology Officer organization, I mean that's an organization that's really designed to look at technology at the enterprise level, and there's a lot to be done there. Technology bolt-ons, the way we run it, increases in self-funded R&D. I think these are all things that I think we have the opportunity to do more and do better at this. And I think there is a lot that we can do down that front. So I'd that whilst it is early days, I mean, those 3 themes, I think, you will see a lot more to be done on each of those 3 themes as we go forward. On the second, I -- can you just repeat the second one?

Peter J. Lynas
Group Finance Director & Executive Director

Well, supply chain, I think was the other one...

Rami Yehuda Myerson
Investec Bank plc, Research Division

Just around the portfolio [indiscernible]

Charles Woodburn
CEO & Executive Director

Yes, I mean, we take a good, hard look at the portfolio through the board reviews and the strategic reviews that we do. And that's really one of those things you would not be surprised to see that we have a good, hard look. I do -- in the short term, I do believe that we'd mentioned already in terms of technology bolt-ons that there are a number of opportunities that we could and should be looking at there to strengthen our technology portfolio. The supply chain...

Peter J. Lynas
Group Finance Director & Executive Director

The supply chain -- I mean, in terms of supply chain, we spend around GBP 8.5 billion a year across the group. And I think, as you know, and Charles mentioned, we hired Paul Smith as Chief Procurement Officer, and we've also hired a new Head of Procurement in the U.K., 3 global category managers. And really, they will all be the chief officers of supply chain management going forward. In terms of global categories, we're looking at IT, raw materials, machining fabs, electronics. We're targeting now deflationary pricing. We're upgrading IT tools around spend analytics, and we're looking to consolidate the vendor base. All of that is good, makes us more affordable, more competitive.

Charles Woodburn
CEO & Executive Director

More likely [indiscernible] export opportunities, all of these things. I think it's fair to say that what we see is more opportunities at the enterprise level that we've had. A number of -- we're a portfolio of relatively discrete, well-run businesses. And there's more we can get out of the enterprise level, be it through either supply chain, the technology piece of it, the way that we run and manage the business and get more out of this enterprise level. And so far, we've identified, through supply chain and others, a rich seam of opportunities there that we'll continue to exploit for a number of years.

Peter J. Lynas
Group Finance Director & Executive Director

And there was one other question on the margins in terms of the guidance for Air and Maritime. I mean, yes, we would see those as stable margins going forward.

Rami Yehuda Myerson
Investec Bank plc, Research Division

Just on the U.K. growth, when do you expect to [indiscernible]?

Peter J. Lynas
Group Finance Director & Executive Director

I mean, our planning assumption is U.K. business is stable. We're not expecting -- it's not like the U.S., which it will be the growth engine and international opportunities. U.K. is stable.

Charles Woodburn
CEO & Executive Director

I mean, U.K. is committed to 2% GDP. Take a view on the economy and where it is, but I think it's probably a relatively prudent set of assumptions to assume a stable outlook for the U.K. in the near term here.

Peter J. Lynas
Group Finance Director & Executive Director

Nick.

Charles Woodburn
CEO & Executive Director

Nick. Yes.

Nick Cunningham
Agency Partners LLP

Nick Cunningham, Agency Partners. Coming back to the portfolio question and looking at Cyber & Intel, where it seems to have been a bit of a struggle to try and commercialize that business in the U.K. Is there something wrong there? It's not going to work, or is it just it's a technology startup that burns cash for a long time? And is there a cultural problem with having that inside a big corporate like BAE? Could you spin it out? Is the technology separable from BAE that it could go into a spinout, so on?

Charles Woodburn
CEO & Executive Director

I think so just to contain, in a sense, the challenge somewhat. I mean, the business is about 3% of our total revenue. So not insignificant, but it's not massive. But within that 3%, I think most people in the room recognize that there are 3 parts to that business. And the bit that has been causing us some challenges is the commercial piece, which is about 1/3 of that total business. Meantime, the work that we do for national security, both here and abroad, has been performing actually pretty well within that business. We certainly see an opportunity in the commercial space to grow that business and to take some of our capabilities and make sure that, as that business sort of -- there is an opportunity for a flight to quality, where customers are looking for not just sort of a minimally compliant solution, but who is really the best at doing that. I think that, that transition, and I spoke about that a little bit at the half year, but I think that transition will happen as some of the cyber breaches and the challenges associated with them become more and more costly for customers and challenges become more obvious. We want to be there when that space opens up. You are right. This is kind of a growth mentality that you're competing with a lot of startups who are going for growth and so on and so forth, and that does provide some challenges in the space. I think it's fair to say that in our, in a sense, push for top line growth, we in some cases got ahead of ourselves in terms of pushing for opportunities, sales opportunities in various countries. So we've pulled back from that a little bit to basically put this on a sustainable footing, to basically get it onto a better-than-breakeven position for 2018. And I'm confident that we can do that and demonstrate that we will be there with a quality product when our customers need it.

Nick Cunningham
Agency Partners LLP

Sorry, just to follow up on that. Part of the thrust of the question was that value realization from that, is that best if it's retained in BAE and it becomes profitable and cash-generative, or is the scope to spin it, perhaps float it or sell it to somebody else or whatever, who would pay for what that future represented?

Charles Woodburn
CEO & Executive Director

I mean, our priority now is to get the business on sound footing, being able to, in a sense, wash its face with its own financials and make sure that it generates a reasonable return for the business. And we will exchange some top line ambition for a -- in order to do that and put it on a sustainable footing. And that is our priority at this point. Jaime.

Peter J. Lynas
Group Finance Director & Executive Director

Jaime.

Jaime Bann Rowbotham
Deutsche Bank AG, Research Division

Jaime Rowbotham from Deutsche. Three from me. The first kind of follows on from Jeremy's question about the outlook for free cash. So when we're thinking about the outlook beyond the run rate of whatever it is, GBP 1 billion, GBP 1.1 billion per annum in '17, '18. Clearly, we don't know what FX is going to be, putting that to one side and without a Typhoon headwind, the outlook for growth potential and profit seems good, driven by the U.S. businesses. If we thought about other things that could boost the profit growth, it looked like the debt refinancing in 2019 might provide a boost in the income. I don't know if you can give us some numbers around that. And then, as we then think about cash conversion, I hear what you're saying on the pure-play advances. I just wondered if there was anything else on the bridge that might boost the cash conversion. CapEx, for example, where I hear you're spending still a fair bit in Electronic Systems and P&S U.S. Is the scope for that to come down to the benefit of cash conversion a bit further out? Second one's a slightly dull one, for which I apologize, on IFRS 15. But the GBP 1.1 billion lower revs in '17, I think it is mainly in the new Air division. I think that's due more to more performance obligations than milestones met in previous years, but perhaps you could just clarify that and explain which the main contracts are that are sort of causing that. And then, finally, Charles, you mentioned good visibility on future sales, and Pete, I just wondered, when you look at 2018 having delivered the sort of GBP 41 billion order book and 2017, is it possible to give a steer on how much of this year's revs are already contracted or in the bag if you like?

Charles Woodburn
CEO & Executive Director

I mean, the last one is in excess of 70%, so I think I mentioned that already in my presentation.

Peter J. Lynas
Group Finance Director & Executive Director

Yes, it's -- in fact, it's just shy of 75%. It's just shy of 80% in terms of order cover for 2018 sales. Okay, first question was the bond. Yes, we have a $1 billion U.S. bond, which matures in mid-'19. I think the coupon on that is north of 6%. So we will be repaying that out of existing cash holdings. And clearly, we're getting nothing like that in terms of return on cash. So that, you can work that one out. That's worth $0.01 of earnings in sort of -- for the full year for 2020 and half of that in 2019. You asked about CapEx. I mean, the CapEx we're spending at the moment, in excess of depreciation, is largely in the U.S. in support of ramp up for combat vehicles and Electronic Systems. Yes, we will burn through that. We'll get through that largely in '18. There'll be some in '18 (sic) ['19], but largely in '18. And then the IFRS 15 question, if I take you back to the WebEx we had in November, we did say that the cumulative impact of IFRS 15 was going to be to drag back GBP 3.7 billion of sales, which is effectively the amount of work in progress that we had in the balance sheet. And that drag back occurs in a number of years. And probably, the best way to illustrate that is on the Typhoon Oman contract. So we got that contract at the end of 2012. We've been building up work through 2013, '14, '15, '16, and we delivered aircraft in 2017.

So what's been happening through this IFRS 15 restatement, all the sales that we took on deliveries on those aircraft in 2017, all get pushed back to prior years when we were spending that -- incurring the cost and spending the cash. So pulling sales into prior years. The margin, however, which is why you see 13.3% margin, I think, it was for the sector as restated, doesn't change the margin performance on that program. So you get a lot of profit coming through, when we made the deliveries, because the risk have been retired, but almost no sales, because all sales have been taken earlier. This is IFRS 15. I'm not a fan, as you can tell. I think that was -- was that all your questions? Okay.

Celine Fornaro
UBS Investment Bank, Research Division

Celine Fornaro from UBS. I've got 2 questions, if I may. The first one would be for Charles. So you mentioned the word competitiveness, and you said that competitiveness comes from R&D, I guess, and efficient costs. But you haven't really said what you're looking in terms of order and the potential order intake, particularly in the U.S. divisions, or when you see those efforts paying out? My second question would be for Pete. If I look at the Air division, now I appreciate the IFRS 15 dynamics, but fundamentally, it's becoming more and more a support or international business. So why are we not getting more towards the high end of that range of that division? And when could you have a higher margin range?

Charles Woodburn
CEO & Executive Director

I think competitiveness is more of a general comment, that there are opportunities that we can exploit at the enterprise level, be it through procurement, technology, so on and so forth, to do more and offer more a competitive product to our customers, which has to help us in export markets and here in the U.K. and in the U.S. I mean, there's no question that defense budgets, whilst they might be growing, customers want to do more with less. And we need to be shown to be able to respond to that. And I think that there are, as we've already seen in the last 12 months, some substantial opportunities for us to do that. And I think we're all taxpayers here in the room and want to make sure that our budgets are being used in the most efficient way possible. And we are finding some -- a number of opportunities. So these businesses, I've said already, they're well-run businesses, but there is a layer at the enterprise that we've not exploited before that we will continue to push hard. And I think that will then offer better value to our customers and position us better in competitive situations, where cost is always a factor in a lot of our bid situations.

Peter J. Lynas
Group Finance Director & Executive Director

On the Air question, I think, if -- when you look at the margins between production and support, they're not that different in any of our businesses. And if you look within the Air sector, for example, now it's Saudi support business, the Saudi customer -- as you know, the Saudi contracts are government-to-government contracts. We execute those contracts on behalf of the U.K. government. The pricing that the Saudis get is very similar to the U.K. pricing, the U.K. pricing is driven by sales and procurement regulations. So there is no big differential between production and support margins. It's very consistent. You will not see big swings in mix between whether in production or whether in support phases. It doesn't work like that.

Charles Woodburn
CEO & Executive Director

Halfway down, on the right for me or the left for you.

David Howard Perry
JP Morgan Chase & Co, Research Division

It's David Perry at JPMorgan. I've got 3. I think one is probably for Pete and 2 for Charles. Pete, just on the Eurofighter production comment, the comment that it's stable post '18. As I understand it, Oman drops to 0 in '19, U.K. and Europe deliveries fall a lot under their low value as a little bit of Kuwait comes in, but net-net, it's a big drop. And even notwithstanding percentage of completion accounting, I don't see how it's stable unless you have in your business planning a new order. So if you could comment on that, or if I just got it wrong, which I may have. And the 2 for the CEO, please. The U.K., I mean, you said it looks like a stable outlook, but from what I read in the newspapers, frankly, it could be anything. It strikes me there may be downside risk potentially. So I just wonder if you could talk about this flexibility in your system, in the workforce, your planning for certain eventualities that may come out of this defense review. And then the second one please, Charles. Interesting times in the global defense sector, because it strikes me, we're seeing more M&A, and quite substantial M&A than we've seen for about 20 years. GD's doing a big deal, Northrup's doing a big deal. Taranis is doing a big deal. BAE doesn't look to have a lot of flexibility. We've talked about the cash flow in previous questions. There isn't a lot left after the dividend. I just wonder how you feel about the risk of BAE perhaps being a little bit left behind in this latest round of consolidation.

Charles Woodburn
CEO & Executive Director

You want to do the first one first?

Peter J. Lynas
Group Finance Director & Executive Director

Yes. In terms of Typhoon production, as I said, we're down at sub-GBP 500 million in terms of volume. But under IFRS 15, it is no longer linked to milestone performance or deliveries. So in our plan, obviously, we've still got Kuwait going through, we've got some European final acceptance activity still going through. We do [indiscernible] Qatar in the plan. We have a contract, as I said earlier on. We're waiting for the finance package to be agreed and then we have that contract. And because from the day you start the contract and start incurring cost, we will be recognizing revenue. We don't wait under IFRS 15 now on the revenue for milestones or production deliveries. So it is a change to the model, David.

David Howard Perry
JP Morgan Chase & Co, Research Division

And [indiscernible] on record, but I mean, Qatar is 2022...

Peter J. Lynas
Group Finance Director & Executive Director

No, it's not. It's not. That's when deliveries, David. That's what I'm trying to say. You need to get off deliveries and think about when are we actually doing activity under a contract. We can take you through it, but you've got to get off that trading on deliveries. That model doesn't work anymore.

David Howard Perry
JP Morgan Chase & Co, Research Division

Okay, we'll do that one offline.

Charles Woodburn
CEO & Executive Director

In terms of U.K., I mean, as you know, there's defense and security reviews split into 2, security and the defense modernization program. We'll await the outcome of that, but I think the U.K.'s still very much committed to the 2% number. You are aware that, in the U.K., most of the impact -- 95% of our revenues are on these long-term programs, which does give us good visibility, mindful of the affordability challenges. And we've got to make every effort to make sure that we are offering better value to our customer here, because that's exactly what they expect of us. So I think our planning assumptions based around that still stand. I think, for M&A, I think we've made clear before that we do see opportunities for bolt-ons, small technology additions to the portfolio, and those are the kind of things for the [CK] organization that we're going to be pursuing.

Peter J. Lynas
Group Finance Director & Executive Director

Sandy or Harry.

Charles Woodburn
CEO & Executive Director

Sandy.

Sandy Morris
Jefferies LLC, Research Division

Yes, 23 questions, if I may. Just swiftly, what did you say about provisions in the second half? I thought I heard the word mentioned, that they went up quite a bit in the second half, just on the balance sheet, Pete.

Peter J. Lynas
Group Finance Director & Executive Director

Provisions in the second half?

Sandy Morris
Jefferies LLC, Research Division

Yes.

Peter J. Lynas
Group Finance Director & Executive Director

Yes, I mean, there's 2 things. One is we took the restructuring charge in AI. I mentioned we took another $16 million on the U.S. ship repair programs. And obviously, we took some provisioning in respect of the announcements we made on reorganization back in November. So no one big item; it's a collection.

Sandy Morris
Jefferies LLC, Research Division

Okay. And then -- so where do they go through under...

Peter J. Lynas
Group Finance Director & Executive Director

They go through the P&L and then the -- [on the line], absolutely, we don't keep those out separate, and then -- but you'll see -- and what I said on the cash guidance, you'll see the cash then go out through 2018.

Sandy Morris
Jefferies LLC, Research Division

[indiscernible] something did well in the second half, didn't it?

Peter J. Lynas
Group Finance Director & Executive Director

Yes.

Sandy Morris
Jefferies LLC, Research Division

And then a slightly tedious question because I can't see anything in the cash flow. When Riyadh Wings buys into our operation in Saudi, should I expect to see any payment in cash flow?

Peter J. Lynas
Group Finance Director & Executive Director

If and when we do that, Sandy, then the answer is yes.

Sandy Morris
Jefferies LLC, Research Division

I thought they bought a wee bit.

Peter J. Lynas
Group Finance Director & Executive Director

They bought 4%.

Sandy Morris
Jefferies LLC, Research Division

And that's so small that, that doesn't even show up?

Peter J. Lynas
Group Finance Director & Executive Director

It's lost in the roundings when you get to the 0.1s of billions, yes.

Sandy Morris
Jefferies LLC, Research Division

Okay. Okey dokey. That's not what I expected. And the last thing, and this is just back to ship repair. Real bump up in orders in the second half. And actually, 2018 is not meeting its level either. And there is this -- I heard what Jerry said about 10% more, but there's this argument that the public shipyards -- this is around, not me, the public shipyards now get flocked with work, so much more work comes available to third-party yards like yourself. That is the theory, that actually ship repair could step up quite a bit. And the pace of contracts already this year has been pretty quick. So that's me done.

Peter J. Lynas
Group Finance Director & Executive Director

Yes. You're right, Sandy. And when you looked at the guidance for '18, you were talking about 10% to 15% growth rate for that P&S U.S. business, and that's where the ship repair business is. We had GBP 1.3 billion of orders in that division last year, and that compared to GBP 1 billion of sales in the division. So absolutely, the order backlog is building nicely.

Charles Woodburn
CEO & Executive Director

On the services part of the portfolio, as you're aware, is one of the things that sees the benefit of any increased spending quicker than anywhere else because you can deploy the additional spending quickly.

Peter J. Lynas
Group Finance Director & Executive Director

One there and one for Harry.

Olivier Brochet
Crédit Suisse AG, Research Division

Yes, Olivier Brochet with Crédit Suisse. I would have 2 questions, please. First one on F-35 and the shift from [indiscernible] to full-rate production. Should we expect a change in the margin profile for the group on this program due to that shift? And the second question is, you mentioned MBDA quite a number of times in your prepared remarks. Can you give us a bit more granularity about what it represents today in terms of contribution to cash on earnings and what it could be in 2020, for instance?

Charles Woodburn
CEO & Executive Director

On [indiscernible] we're not expecting a significant change in margin as a result of the step-up.

Peter J. Lynas
Group Finance Director & Executive Director

The margins remain double-digit, and we're not expecting any significant movement from moving to full-rate production.

Charles Woodburn
CEO & Executive Director

MBDA?

Peter J. Lynas
Group Finance Director & Executive Director

And on MBDA, it is seeing significant growth. It's not that long ago, it was about a EUR 2.8 billion business. It's looking to move to a EUR 4 billion over a 4- to 5-year window, and it's seeing good margin growth. It's a double-digit margin business and performing very well. And sales growth will grow in line with increasing backlog. And you saw the orders that have booked during the year, we're very proud owners of that business.

Olivier Brochet
Crédit Suisse AG, Research Division

And the cash? [indiscernible]

Peter J. Lynas
Group Finance Director & Executive Director

Yes, and the cash comes with the orders and in deliveries. So it's a nice business to own. Harry.

Harry William Freeman Breach
Raymond James Euro Equities

Harry Breach, Raymond James. I promise, no questions about IFRS 15, Pete. Sorry to disappoint. But one, I want to pick up from one of Dave's questions and another one slightly differently. But the pick-up from Dave's question is, thinking about the U.K. and the MoD sort of behavior at the moment, are we seeing contract awards happen on a pace you'd expect? Or at least no further behind schedule than normal? So, our contract issuance, is it happening on the pace you'd expect or are we starting to see lags and delays as -- due to the uncertainty connected with the review? And then completely differently, much more a program level, it's absolutely not lost on me, Charlie, that you have Dreadnought reporting to you directly. Clearly, build design complexity on SSBNs is high. They haven't been manufactured for some decades. Astute was challenging. Can you help us to think about sort of milestone achievement on that? And particularly, when are we over the highest risk phases with Dreadnought? [indiscernible]

Charles Woodburn
CEO & Executive Director

I think we -- I mean, it's fair to say that we got on contract with a number of big programs over the last few months, and we are not seeing any real change in contracting rhythm from the U.K. MoD, would be fair to say, I think.

Peter J. Lynas
Group Finance Director & Executive Director

Yes. I mean, you're right. I mean, we booked on 26, so we have the first 3 ships manufacturing. We've got Astute. We did have to just do the final pricing on both [indiscernible], but the work has been running for us for some time. And Dreadnought we're funded. It will require further funding later in the year, but there's no delays.

Charles Woodburn
CEO & Executive Director

I mean, these are big programs with big invest marching armies behind them. And we've seen a steady drumbeat of contracting activities, as you'd expect with them.

Harry William Freeman Breach
Raymond James Euro Equities

[indiscernible] for the lag?

Charles Woodburn
CEO & Executive Director

No.

Harry William Freeman Breach
Raymond James Euro Equities

And then on Dreadnought, the sort of key -- when do we get key risk retired on that and when?

Charles Woodburn
CEO & Executive Director

I mean, as you're aware, it's a very big program, a very complicated program. And we're still at quite early days of transition to build. We did cut steel last year on this, and I think with -- I mean, it's -- first in class, as you're well aware, is always the toughest build of any shipbuild or boatbuild. And we're at early days on that, but I think it's also fair to say it's getting, as you would expect, a very high level of attention, both from me and the rest of the exec team to make sure that we deliver well and effectively on this program.

Peter J. Lynas
Group Finance Director & Executive Director

And Harry, from a risk perspective, financial risk perspective, This is an ascertained cost contract. So this is not a firm fixed price. We're not running those sorts of risks, if that was behind the question.

Harry William Freeman Breach
Raymond James Euro Equities

[indiscernible]

Peter J. Lynas
Group Finance Director & Executive Director

So it's ascertained cost. So it's cost reimbursement plus fee.

Charles J Armitage
Citigroup Inc, Research Division

Charles Armitage, Citi. Political question. You've got a new Minister of Defense who may want to become PM. You've got a Chancellor -- [indiscernible] who may want to become PM. Can you -- you mentioned the 2% of GDP. When Hammond was in defense, he put on, what was it, 0.5% real increase in the modernization budget. Can you just sort of talk through the different dynamics of whether the MoD wants to increase spending outside of modernization, and hence modernization gets pushed, how do you see that -- is that 0.5% [invalid] or not?

Charles Woodburn
CEO & Executive Director

Frankly, I think it would be premature to try and speculate, and it would be speculation, given the ongoing reviews that we await with interest the outcomes of. And until we hear something different, we continue to work on the prior planning assumptions, noting that I think the defense secretary has said on a number of occasions that he would like to see something that is not spending neutral, is better than that. And frankly, over and above that would be pure speculation. Okay. No further questions? Question on the line, you may have...

Peter J. Lynas
Group Finance Director & Executive Director

Oh, question on the line. Okay. Please, whoever, fire it in.

Operator

Tristan Sanson of Exane, please go ahead.

Tristan Sanson
Exane BNP Paribas, Research Division

Yes, so it's Tristan Sanson from Exane. Had 2 questions. The first one, I wanted to follow up on the answer you made to David about the fact that you need to sync in -- about the declaration of revenue recognition versus deliveries on some large contracts. So if we're a bit optimistic and we assume that this year you may win LAND 400, SEA 5000, the CSC in Canada and the ACV in the U.S., if you get these 4 key contracts, could we see revenue recognition fast enough to get to mid-single-digit organic growth as soon as 2020 if ever? Am I looking at it the wrong way? And the second question is I wanted to know if you could give us an outlook for the evolution of self-funded R&D going forward.

Charles Woodburn
CEO & Executive Director

I think it's fair to say that we never plan on winning everything. That would be a great problem to deal with, but we don't plan on winning everything. I don't know if you want to comment any more on that. So more than that would be real speculation, I think.

Peter J. Lynas
Group Finance Director & Executive Director

Yes. It would be, yes. I would just stress again, and I'm starting to sound like a broken record, even if we got more revenue, that's not going to change earnings. Because we will only take risk -- we will only take profit when we retire risk on a program. So even if we get some top line, and so it looks like organic growth, you need to be focused on the earnings now more than you used to -- you can discount sales more than you used to. Sales is vanity, profit is sanity and cash is king. So focus on the earnings and the cash.

Charles Woodburn
CEO & Executive Director

What was the second point?

Peter J. Lynas
Group Finance Director & Executive Director

The second point was around the outlook for R&D.

Charles Woodburn
CEO & Executive Director

I think, as you're aware, a large piece of our R&D is indeed customer funded. And that just depends on where we are with programs, what part of the program that is -- are developmental items within a program. So that, frankly, will have its ups and downs. But in terms of self-funded part of the R&D, the ambition that we have for the technology organization that we're creating is that we then create a framework to allow us to efficiently or more efficiently deploy self-funded R&D programs within the group, and to, over time, increase R&D funding. I'm not prepared to sort of give numbers around that. And I think a fair bit of it depends on the opportunities that Nigel and the team are able to put together in the context of bolt-ons as well and bring to the board. But I'm certainly in a sense committed to present these opportunities to the board. And I think, done convincingly and with the right organization behind it, we can make a good case -- a good investment case to increase self-funded R&D.

Peter J. Lynas
Group Finance Director & Executive Director

Any more questions on the line? Okay. No more questions? Thank you very much.

Charles Woodburn
CEO & Executive Director
Thank you very much.