
CHAIRMAN'S REVIEW

After a decade of strong performance and growth, 2014 was a year of mixed fortunes for our Company.

 We are totally focused on returning the Company to its long-term trajectory of profitable growth and of superior shareholder returns.”

IAN DAVIS
Chairman

There have been some real pluses and achievements alongside a number of challenges that held back the Company's financial performance.

During the course of the year, our order book reached its highest ever level. We also celebrated the delivery of the first Airbus A350 XWB to our launch customer Qatar Airways, powered by Rolls-Royce Trent XWB engines. Our record of customer service continues to improve, in Civil aerospace for example, we have maintained a record of 100% on-time delivery to Airbus for the past two years. In the same period our Marine business improved original equipment on-time delivery by 11%, while spares delivery improved across the Group. We still have more to do here and we are totally committed to enhancing customer satisfaction with our products and services. However, progress is encouraging and bodes well for the future. Happy customers are a precondition for a successful, long-term business.

Set against these achievements, 2014 was the first year in a decade in which revenue and underlying profits, on a like-for-like basis, did not grow. The Defence business was hit hard by constraints in government expenditure. In our Land & Sea Division, we faced tough market conditions, characterised by pricing pressure and deferred or cancelled orders by customers, particularly in the oil & gas, construction and mining industries.

In addition to some difficult trading conditions, we did not make as much progress as planned on improving our cost and cash performance. We fully recognise this is a priority if we are to provide attractive returns to shareholders as well as to fund the investment requirements that will underpin long-term growth. Ours is a business that requires significant up-front cash investment to generate long-term cash flow.

SHAREHOLDER DISTRIBUTIONS

Despite the short-term challenges, the fundamentals of the business remain strong. Rolls-Royce is a growth company, well positioned in long-term growth markets that offer the prospect of attractive returns.

We know that shareholders do not invest in growth alone, they invest for growth that's profitable. Our payment to shareholders of 23.1p reflects the confidence the Board has in the Company's profitability and cash generation prospects. At the same time we are committed to retaining a strong balance sheet. Civil aerospace in particular, although an attractive long-term business, can still be prone to external market shocks. Our customers, who depend on our service support for periods of up to 25 years, both expect and demand a financially resilient supplier.

STRATEGY

Rolls-Royce is intrinsically a long-term business and has to be directed and managed as such. In Civil aerospace for example, products take many years to develop, test and bring to market, and are quite rightly subject to strict regulatory process. Revenue from the sale of original equipment and subsequent aftermarket services generate cash flows for decades.

The Board reviewed the Group's product portfolio and corporate structure in light of these financial and investment characteristics. This review led to the decision to divest our Energy business and we completed its sale to Siemens in December. At the same time we strengthened our position in the core division of Land & Sea by completing the acquisition of the shares held by Daimler in Power Systems. We are focused on the twin pillars of Aerospace and Land & Sea because of their technology and service model synergies and their combined ability to create shared competitive advantage.

Our strong belief is that shareholders, as well as customers and employees, will be best served if the Company continues to focus on expanding its position in the highly attractive global markets for power and propulsion. We have long-established and

FINANCIAL HIGHLIGHTS

PAYMENT TO SHAREHOLDERS

23.1p (2013: 22.0p)

UNDERLYING EPS

65.3p (2013: 65.6p)

ORDER BOOK

£74bn (2013: £72bn)

RETURN ON SALES

11.5% (2013: 11.8%)

 MORE FINANCIAL INFORMATION ON PAGES 26 TO 31

 The fundamentals of the business remain strong."

CHAIRMAN'S REVIEW

CONTINUED

PEOPLE AND TALENT

We are exploring ways of accelerating and broadening career paths for our highest potential talent across the world and for further increasing diversity as an important element of changing and strengthening our culture.

→ MORE INFORMATION
ON PAGES 42 TO 43



 We are committed to being a leader in environmental and social responsibility and to being regarded as a good corporate citizen.”

competitive technology platforms, as well as customer relationships, in gas turbines, reciprocating engines, nuclear services and controls. We see substantial long-term value creation and growth potential from these products, not least from aftermarket services where Rolls-Royce has been a pioneer. There will be cyclical and volatility – external and internal risks are not insignificant – however, our long-term aspiration is to build on our position as a leading global provider of complex integrated power systems for use in the air, on land and at sea.

INNOVATION

Innovation has been, and is, critical to the long-term success of Rolls-Royce. We cannot depend on size and scale alone for competitive advantage. We invest more than £1 billion a year in research and development (R&D) to ensure that we conceive, design and deliver world-class technology that meets our customers' current and future requirements.

Innovation is not just about R&D numbers and not just about product technology. An increasing focus, for example, is on data analytics and on control systems to reflect our customers' increasing requirements for integrated solutions. Rolls-Royce has long been an innovator in services and we will be looking to build on this. I am especially proud of our collaborative approach to innovation, particularly our work with leading universities across the world on designated topics and technologies. We are quite clear that we must improve our capital efficiency, our cost competitiveness and our cash generation. However this will not be at the expense of our strategic commitment to innovation and development. These will be the drivers of long-term profitable growth and value creation.

TALENT AND CAPABILITIES

I would like to touch on some of the key enablers that will be required to deliver our strategy and our operational plans. In particular, we need to attract, develop and retain outstanding talent everywhere we operate, commercial and functional talent as much as engineering talent. In the past year we recruited 354 graduates from 112 universities in 11 countries and we recruited

357 apprentices across the world. I am pleased that 26% of our graduate recruits and 10% of our UK apprentices are female – not good enough but progress. Our community programmes remain directed towards encouraging young people, particularly females, to choose science, technology, engineering and maths (STEM) subjects. We are in the process of reviewing our training and leadership development programmes, particularly for middle managers. We are also exploring ways of accelerating and broadening career paths for our highest potential talent across the world and for further increasing diversity as an important element of changing and strengthening our culture.

CORPORATE GOVERNANCE

The Board recognises that strong governance is a hallmark of excellent companies. We remain committed to being a leader in ethical behaviour and in environmental and social responsibility. We are updating and upgrading our governance structures and controls, with a particular focus on risk and compliance procedures. The concerns about bribery and corruption involving intermediaries in overseas markets, and the subsequent SFO enquiry, together with wider speculation, have been a body blow to the Company and we have responded accordingly. We have expanded significantly our compliance team, invested heavily in training and awareness building across the Group and strengthened our internal controls. Our staff have received a new Global Code of Conduct, together with mandatory training. We have established or expanded our own offices in many international markets and reduced dramatically the number of external intermediaries. Further details are contained in the Safety and Ethics Committee Report on page 66. We are grateful to Lord Gold who continues to advise us on compliance and ethics best practice.

BOARD APPOINTMENTS AND CHANGES

Ruth Cairnie, formerly an executive vice president with Royal Dutch Shell, joined the Board in September. In addition, Pamela Coles, previously at Centrica, has joined Rolls-Royce as Company Secretary. We are lucky to have both of them.

I was also very pleased to welcome David Smith to the Board. David was appointed Chief Financial Officer (CFO) in November, replacing Mark Morris who left the Company. David joined Rolls-Royce at the beginning of 2014 as the CFO of the Aerospace Division. Prior to that, he had extensive international experience in engineering and technology companies. A particular focus for David will be to strengthen further our financial controls and management information systems as well as improving our communications with the investment community.

I would like to thank Mark Morris for his years of service and contributions to the Company and to the Board. I would also like to thank Iain Conn who stood down from the Board after nine years of dedicated and exemplary service. He was succeeded as Senior Independent Director by Lewis Booth.

After a successful career spanning 17 years with Rolls-Royce, James Guyette will step down from the Board at the conclusion of the 2015 Annual General Meeting (AGM) and retire from his role as President and Chief Executive Officer of Rolls-Royce North America on 31 May 2015. James has made a tremendous contribution to the Company over many years. He has helped guide the business through a period of significant expansion, especially in the North American market. His energy, good humour and commitment to our customers will be missed by us all.

John Neill has also indicated that he will step down from the Board after just over six years as a Non-Executive Director and will not therefore put himself forward for re-election at the 2015 AGM. I would like to thank John for his tremendous contribution to the Board and his exemplary commitment to Rolls-Royce over the last six years. He will be missed and we wish him well for the future.

I am pleased to announce that Irene Dorner will be joining the Board as a Non-Executive Director with effect from 27 July 2015. She will also become a member of the Nominations and Governance Committee

and the Safety and Ethics Committee from the date of her appointment. She brings a wealth of experience from international banking along with a passion for driving culture change in large organisations.

Irene was CEO and president of HSBC USA until December 2014 where she was responsible for all of HSBC's operations in the US and played a key role in strengthening their risk processes. During her 29-year career at HSBC, she held a number of international roles. She was the first woman to lead HSBC in Malaysia and launched its Islamic banking unit. She is a passionate advocate of diversity and inclusion.

There have been some adjustments to the committee structure of the Board, explained in more detail in my introduction to the Directors' Report on page 56. Safety and Ethics have been combined into one committee under the chairmanship of Sir Frank Chapman, formerly CEO of BG Group. I have also established a Science and Technology Committee, under the chairmanship of Warren East, formerly CEO of ARM Holdings. Science and technology are critical to the Company's success and warrant the attention of a focused committee, in addition to general board oversight.

We have benefited again from the insight and experience of our International Advisory Board (IAB) the composition of which is described on page 57. The role of the IAB is to provide contextual understanding of international economic and political developments, and to help management and the Board better understand long-term geographical opportunities and risks. Members of the IAB are also available to our senior management on specific issues and areas of expertise. We are fortunate to have such a wealth of experience and knowledge at our disposal. I am very grateful to them and in particular to Lord Powell for his exemplary chairmanship of the IAB.

I would like to thank my fellow board members for their diligence and outstanding commitment to Rolls-Royce.

I would also like to thank John Rishton, his management team and all our employees for their hard work and exceptional dedication in a demanding year.

I hope this review demonstrates our understanding of the concerns about Rolls-Royce's financial performance in 2014 and the 2015 outlook. We are totally focused on returning the Company to its long-term trajectory of profitable growth and of superior shareholder returns. We will continue to focus on the 4Cs of Customer, Concentration, Cost and Cash to improve performance, and we will strengthen our financial controls and communications. We will sustain our commitment to innovation and development.

The fundamentals of the business remain strong. They are underpinned by our record order book and our expanding installed equipment base that will generate value for years ahead. This is a sound business with continued growth potential.

IAN DAVIS
Chairman
12 February 2015