
CHIEF EXECUTIVE'S REVIEW



Rolls-Royce is in business to deliver better power for a changing world. The integrated power systems that we develop, build and maintain, address the increasing global demand for transport and energy.



We continually seek to reduce cost to remain competitive and to generate the funds we need to invest in future growth.”

JOHN RISHTON
Chief Executive

As society becomes more integrated, population expands and the world becomes more affluent, the requirement for the type of advanced engineering solutions we provide will grow. These are long-term trends that require long-term investment and present us with the opportunity for long-term profitable growth.

The path to growth will not always be smooth. For Rolls-Royce, 2014 has proved a challenging year for reasons that I will explain in some detail. During 2014, Group underlying revenue was 6% lower than in 2013 and underlying profit before tax declined by 8%. However, the Group order book grew to a new record of £73.7 billion, demonstrating the confidence our customers continue to place in our technology and the growth that lies ahead. It is encouraging that the Defence aerospace order book increased for the first time since 2010, with continued growth in the order books of Civil aerospace and Power Systems.

In this review I will explain why we believe our business model is robust, I will describe the transformation we are driving through the Group and the reasons for our confidence in the future. I will also outline the challenges we face and the decisive action we are taking to accelerate a return to our long-term trend of profitable growth.

So let me start with our business model. We invest in technology in order to meet our customers' current and future needs. Through constant innovation we create the opportunity to grow sales and expand our market share. We earn revenue both from the sale of original equipment and from servicing the power systems we produce. We continually seek to reduce cost to remain competitive and to generate the funds we need to invest in future growth.

We have evolved and simplified our strategy to focus on the core areas of: **customer, innovation and profitable growth.**



Customer: we put customers at the heart of the organisation. We understand their needs and then focus relentlessly on delivery.



Innovation: is at the core of Rolls-Royce and drives a culture of continuous improvement. Delivering relevant innovation is critical to meeting our customers' current and future needs.



Profitable growth: by focusing on our customers and presenting them with a competitive portfolio of innovative products and services, we create the opportunity for long-term profitable growth.

This sharper focus enables us to drive our business model harder and will, over time, deliver improving financial returns.

From its earliest days Rolls-Royce has addressed a range of markets where demand exists for advanced engineering solutions. Our 1906 articles of association describe the business as producing technology for use in the air, on land and at sea. More than a century later this approach remains relevant and we run our business through the two Divisions of Aerospace and Land & Sea that you will see described in the pages of this Annual Report.

There is an industrial, commercial and strategic logic that ties these two Divisions together and generates value for the Group.

Industrially, our knowledge of advanced engineering applies across both our Divisions. World-class technology is required by all of our customers and as the power systems we produce become more sophisticated, a deep understanding of materials science, electronics, data management and aftermarket services are increasingly important in every part of the Group.



BETTER POWER

Our Land & Sea Division is well positioned to meet the requirements for cleaner power that will be driven by future growth in world trade.

£74bn Our order book increased in 2014 to a record level



Commercially, we and our competitors recognise the requirement of a broad portfolio and exposure to differing business and investment cycles. It is not a coincidence that there is no pure aerospace power system company in the world.

The scale represented by our two Divisions is important in maintaining a strong balance sheet and protecting our investment grade rating. Scale has also enabled us to maintain a global R&D network comprising 31 University Technology Centres and seven Advanced Manufacturing Research Centres. These facilities envisage, develop and test emerging technologies that have applications across our portfolio. Our breadth increases market access and generates opportunity. For example, our Nuclear business is relatively small but extends our influence and gives us access to the highest levels of government internationally.

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INNOVATION

We invest in technology in order to meet our customers' current and future needs. Through constant innovation we create the opportunity to grow sales and expand our market share.

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 We continue to make good progress improving quality, delivery, reliability and responsiveness.”

Strategically, our two Divisions address markets where long-term growth is assured and where increasingly sophisticated engineering solutions will be required. We believe both aerospace and land & sea markets offer attractive returns and play to our strengths.

The future growth of air travel is widely understood and reflected in our £63 billion Civil aerospace order book. To give this some perspective, in the past decade we have delivered 1,600 Trent engines. In the decade ahead we expect to deliver 4,000. All of the engines in this expanding fleet will produce service revenues that will extend for decades to come. Our Land & Sea Division is well positioned to meet the requirements for cleaner power that will be driven by future growth in world trade (90% of which is carried by sea), urbanisation, population growth and tighter environmental regulations.

Across the Group, we invest in technology that is continually setting new standards in power efficiency and environmental performance. The complexity of what we do creates barriers to entry and generates new market opportunities. Put simply, there will be significant long-term growth in demand for the complex integrated power systems we deliver, and there are not many companies with the ability to do what we can do.

Despite these fundamental strengths, in 2014 our short-term performance has been negatively affected by a number of factors. In Aerospace our Defence revenues fell by 20%, reflecting reduced government defence spending in our main markets of North America and Europe. In Land & Sea, slowing growth in a number of our major markets including Continental Europe, South America and China has caused some customers to delay or cancel orders. At the same time, sharp declines in the price of oil and other commodities have led customers to reduce or defer expenditure, especially in the oil & gas, mining and construction industries.

In response to these adverse conditions, we have accelerated progress on the **4Cs** of **Customer, Concentration, Cost** and **Cash** – with a particular emphasis on cost. This decisive action is driving a transformation of the business that will, in time, make us a stronger Group and hasten our return to profitable growth.

On Customer: we continue to make good progress improving quality, delivery, reliability and responsiveness; the characteristics our customers tell us they value most. The results can be seen across a wide range of programmes. At Group level there has been a further improvement in delivery times – particularly for spare parts. In Aerospace, the Trent 1000 that powers the Boeing 787 Dreamliner has achieved an industry-leading 99.9% engine dispatch reliability after completing over 500,000 flying hours in service. Since launch, we have doubled the time on wing for both our Trent 700 and Trent 800 fleets. In our Civil Small and Medium Engines business, we achieved a 57 percentage points improvement in restoring operational availability for business jets in the past year.

Recognising the progress we have made, Airbus has presented us with its Supply Chain and Quality Improvement Award. The US Government's Defense Logistics Agency recognised Rolls-Royce as a 'first tier supplier' from among 153 companies and we were awarded joint first place by Aviation International News for the quality of our business aircraft support.

In Land & Sea, our delivery on time to Marine customers has improved by 33 percentage points since 2012. Marine also signed its first commercial long-term service agreement. As the power systems we deliver in Land & Sea become more complex, we see further opportunities to expand our aftermarket activities, building on the data and service capabilities we have developed in Aerospace. In Power Systems, we opened an additional logistics centre in Singapore, enabling a 5% improvement in the availability of spare parts and setting a new standard for customer service.

Improving performance in this way strengthens the relationship we have with

our customers, and generates opportunities for us to secure additional business.

Concentration: means deciding where we want to invest and where not to.

In August, we were pleased to acquire Daimler's 50% shareholding in Rolls-Royce Power Systems for £1.94 billion. Power Systems adds scale and capability to our reciprocating engines portfolio. It has outstanding technology, operates in long-term growth markets and has proved a valuable addition to our Land & Sea Division.

We also divested a significant business in December, completing the sale of our Energy gas turbines and compressor business to Siemens. This is a business that has excellent technology and a talented workforce, but it lacks the scale required to prosper as part of Rolls-Royce. Siemens has a far bigger power generation business and is a more suitable owner. The sale generated proceeds of around £1 billion. We are returning this to shareholders by way of a share buyback that started in December 2014.

Turning to Cost: we have taken action to improve cost performance in every part of the business and in every cost category. We have made good progress in some areas and as a result, Group gross margins improved by 1.7 percentage points in 2014. In Defence, we have improved margins despite declining revenue. In Land & Sea, we closed five plants and are rationalising other parts of the business. For example, we are consolidating production of steering gear in Norway and waterjets into Finland. We are driving down cost by improving quality, simplifying logistics, reducing waste, and adopting processes that allow us to make things better and faster.

In November, we announced a restructuring programme in our Aerospace Division and central functions, which is expected to reduce headcount by 2,600. By the end of 2014, 545 people had left the business, with the majority of the reductions expected in 2015. This programme is expected to result in restructuring charges of around £120 million, of which £56 million was recognised in our 2014 results.

We anticipate annualised cost benefits of around £80 million from 2016 onwards, with £50 million in benefits expected in 2015. Our total Aerospace 2014 restructuring activities cost £164 million (of which £139 million was underlying).

However, in a complex and highly-regulated business, we recognise that it will take some time for the full benefit of our cost programmes to feed through. There are also a number of headwinds in our Civil aerospace business associated with our future growth. For example, we have invested in the capacity required to deliver our record order book, but delay in a number of our customers' major programmes has meant some of this new capacity has come on stream before it is needed, leaving us with under-utilised production facilities. We have also constructed a number of new world-class facilities to replace older, less productive plants. For a period of transition we are carrying the cost of both the old and new facilities.

Group restructuring costs in 2014 were £188 million, of which £149 million was underlying. Over the past two years, the Group has reduced indirect headcount by 18%. We expect Group underlying restructuring costs to be between £90 and £100 million in 2015.

Cost performance will continue to be a major focus, and as we rationalise and transform the Group, we have targeted a 20% reduction in our footprint and a doubling of our lower-cost country sourcing by 2020. We are now accelerating progress towards these targets.

Cash: we continue to focus on improving our free cash flow, particularly in the face of near-term headwinds. Our programmes to reduce product and aftermarket costs, lower our headcount and to reduce our footprint all require upfront investment but will deliver cost and cash benefits in the medium term. As revenue increases, we expect to reduce our capital expenditure and R&D as a percentage of sales. The customer progress highlighted earlier is improving our operational performance.

OUR FIVE PRIORITIES FOR THE GROUP

DURING 2014 WE OUTLINED THE PRIORITIES FOR THE BUSINESS GOING FORWARD.

FIX THE BASICS (THE 4Cs)

This is about improving the bedrock of the organisation: focusing on our customers and their needs; concentrating on what we are good at; attacking cost across the Group and managing our cash position effectively.

CULTURE

We want a business-orientated, innovative and cost-conscious culture, one that understands our customers and delivers on their behalf. We must have a culture where ethical behaviour is fully embedded, so that we don't just win but win right.

CIVIL WIDEBODY

We are building on success. In the last decade we delivered 1,600 Trents and in the next we will deliver 4,000. We power over 50% of new widebody aircraft. Our next generation engines, Advance and UltraFan™, will help maintain our leading market position.

CIVIL NARROWBODY

Narrowbodies represent 70% of the civil aircraft market by volume and 50% by value. We have the requisite skills and technology to return to this market and are determined to do so when the opportunity arises. This is important in the longer term, not just because of the scale this market segment offers but also because of the chance it presents to develop greater customer intimacy.

MEDIUM-SPEED RECIPROCATING ENGINES

Medium-speed reciprocating engines power the vast majority of the marine vessels that we design and equip. We have world-class technology, but it is characteristic of this industry that the engine supplier is particularly well placed to pull through other technologies, so our lack of scale in medium-speed engines confers a disadvantage we need to address.

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TECHNOLOGY

We have continued to invest in our Land & Sea Division, bringing new technology to market across the portfolio. In September, we unveiled the first of a new family of medium-speed reciprocating engines for power on land and at sea. The new Bergen B33:45 offers a 20% increase in power per cylinder, while reducing fuel consumption, emissions and operating costs.

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Combined with increasing volumes, this will enable us to reduce our inventory buffers.

While a great deal of attention has been focused, quite rightly, on the financial performance of the Group, it is important to recognise significant achievements in 2014 that will support the Group's future profitable growth.

1,500 Trent XWB engines are on order. The first engines were delivered to Qatar Airways in 2014



We marked a major milestone in the development of carbon titanium (CTi) fan blades with the launch of a test flight programme on board a Boeing 747 flying test bed. CTi technology delivers lighter fan blades that will be incorporated into future aero engines. Combined with a composite fan casing, it forms a system that can reduce weight by up to 1,500lb per aircraft, the equivalent of seven passengers.

In Land & Sea we have also continued to strengthen our portfolio, bringing new technology to market across the Division. In September, we unveiled the first of a new family of medium-speed reciprocating engines for use on land and at sea. The new Bergen B33:45 offers a 20% increase in power per cylinder, while reducing fuel consumption, emissions and operating costs. It is our first new product to combine the engineering strengths of our traditional Bergen engines operation and our new Power Systems business. Because of its greater power range, the new engine increases our addressable market in medium-speed engines by 20%.

In Aerospace in December, we were delighted to celebrate the first delivery of the Trent XWB, powering the new Airbus A350 XWB for launch customer Qatar Airways. The Trent XWB is the most fuel efficient large aero engine operating in the world today. I would like to congratulate everyone at Rolls-Royce who has worked so hard over many years to support the successful delivery of this exceptional aircraft, for which Rolls-Royce is the sole engine provider.

At the Farnborough International Airshow in July, we announced the seventh member of the Trent engine family, the Trent 7000, that will power the new Airbus A330neo. This new engine will incorporate technology from our most recent Trents and will deliver a 10% improvement in specific fuel consumption and halve the noise energy output compared to the current engine on the A330. Rolls-Royce will be the exclusive engine supplier on the A330neo, due to enter service in 2017.

We have continued to bring new world-class facilities on stream in 2014. These include the opening of our new advanced disc manufacturing facility at Washington in the UK and the first production aerofoil from our new Advanced Aerofoil Manufacturing Facility at Crosspointe, Virginia in the US. 2014 saw the inauguration of our new large engine test bed in Dahlewitz, Germany and the opening of a new marine customer training centre outside Rio de Janeiro in Brazil.

In the naval market two important new ships powered by our MT30 gas turbines were officially named: the multi-mission destroyer USS Zumwalt and the Royal Navy aircraft carrier Queen Elizabeth.

In the rail sector, Power Systems has developed an MTU hybrid PowerPack that generates additional power through the braking control system. This technology offers a fuel saving of up to 25% with a proportional reduction in emissions.

For off-highway vehicles, MTU's latest Series 4000 engine has improved fuel consumption by 5%. For a typical application this can represent a saving of up to 100,000 litres of fuel and reduction of 350 tonnes of CO₂ emissions each year.



MTU's latest Series 4000 engine has improved fuel consumption by

5%



In our Nuclear business, we were encouraged that, in October, the European Commission approved the construction of the first new commercial nuclear power station to be built for a generation in the UK, at Hinkley Point in Somerset. The Commission concluded that new nuclear power is vital for Britain's energy security and will be key to reducing carbon emissions from the UK's electricity industry. Hinkley Point C is the first of at least 11 new reactors planned for the UK, for which Rolls-Royce is well positioned to supply components, systems and engineering services.

31 University Technology Centres. This research network extends relationships we have with world-leading universities



As the Chairman said, we continued to strengthen the governance of the Group. We expect the highest standards of behaviour from our employees and we have been explicit that we will not tolerate business misconduct of any sort. The Serious Fraud Office investigation into concerns about bribery and corruption involving intermediaries in overseas markets continues and we are cooperating fully with the investigating authorities. Lord Gold is heading a review of our process and procedures regarding compliance and business ethics.

This year our Global Code of Conduct has been ranked by the Red Flag Group as third among those within the FTSE 100 companies that were assessed. Following the roll-out of our Global Code, dilemma-based ethics training has been deployed to all our employees to ensure continuing attention on this important topic. Training in ethics and compliance will continue in 2015. All employees will be required to certify annually that they have completed their training. We will be setting similar standards for our supply chain through the publication of our Supplier Code of Conduct.

Responding to the difficult circumstances of 2014 has required fortitude and resilience from the talented men and women who work for Rolls-Royce. I would like to thank them for their hard work and for the enthusiasm I encounter wherever in the Company I travel. I am grateful to our suppliers and partners who make such an important contribution to Rolls-Royce and share our commitment to continuous improvement. I would like to thank our customers who continue to place their faith in our technology. Meeting their current and future needs is our highest priority.

This year we held our inaugural Trusted to Deliver Excellence Awards to recognise Rolls-Royce teams who have achieved outstanding results for their customers. The imagination, passion and ability to execute demonstrated by all the finalists is inspiring. You can read more about these awards on pages 42 to 43.

Returning our Group to profitable growth will demand firm resolve and commitment and will take some time. However, as I have described in this review, the business fundamentals of Rolls-Royce remain sound, we have the right strategy and we are clear about the action that is required. Everything I know about this great Company makes me confident that the team will rise to the challenge.

JOHN RISHTON
Chief Executive
12 February 2015

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