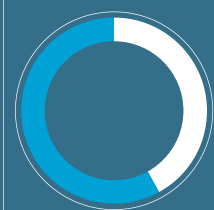
Summary

Marine is a leading provider of complex and integrated propulsion and handling systems to the maritime offshore, merchant and naval markets. The product offering ranges from individual items of equipment to integrated systems and flexible mission-critical solutions, including complete vessel designs. The business has more than 4,000 customers. Seventy naval forces and over 30,000 commercial vessels use our equipment.

Key highlights

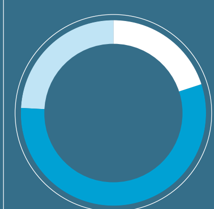
- Underlying revenue down 16%; weak offshore markets impacting both OE and aftermarket revenues.
- Underlying profit before financing down 94%; significant reduction in gross margin, led by lower volumes, and higher restructuring costs only partially offset by reduced commercial and administration costs.
- Challenging outlook for 2016; led by reduced demand in offshore oil & gas markets.
- Launched two restructuring programmes in 2015 focused on manufacturing footprint and back-office functions; expected benefits to start to accrue from 2016 onwards.

Underlying revenue mix



OE revenue	58%
Services revenue	42%

Underlying revenue by sector



Merchant	24%
Offshore	56%
Naval	20%

Latest bridge designs
Our Unified Bridge is ergonomically designed to be intuitive for crews.

MARINE

OPERATIONAL REVIEW

Underlying revenue of £1,324m was 16% lower on a constant currency basis (down 23% at actual rates). Within this, original equipment revenues were 19% down at £773m. Service revenues were more robust, although still declined 10%. This reflected weaknesses in offshore and merchant, as ship owners deferred overhaul and maintenance on the back of reduced utilisation of their vessels.

As a result of the revenue weaknesses, price pressure and cost under-recovery, gross margins declined 500 basis points to 19.6% and overall gross margin was £260m, £139m lower than in 2014. As a result, with only modest reductions to date being achieved in corporate, administration and other costs, underlying profit was £15m, 94% down on a constant currency basis.

Around £15m of restructuring charges were incurred in 2015 and excluding these, underlying profit declined 83%. In the first half we took a non-underlying charge of £69m for the impairment of goodwill on two of our businesses owing to a less favourable business outlook, partly driven by the impact of market deteriorations on our offshore businesses.

Investment and business development

The focus in 2015 has been on repositioning the Marine business to reflect the very challenging market environment and outlook. During the year, we also announced a number of restructuring programmes that will in total lead to the loss of around 1,000 employees in operations and back-office functions as we shrink our Northern European footprint, reduce indirect headcount, and consolidate manufacturing activity. This will deliver projected cost savings of £65m per annum from 2017 onwards and create a business better able to compete in an increasingly cost-conscious market place which is geographically shifting towards Asia.

Overall, the Marine order book declined 26% during the year, mainly reflecting a very weak offshore market, particularly in Northern Europe. Orders for new vessels, projects and services were all sharply lower than 2014 and as a result order intake was only £997m, 45% down on the previous year.

The offshore market was extremely weak reflecting a low oil price and reduced capital expenditure within the upstream oil exploration and related services sectors. Targeted investment in R&D and improving our Asian position saw progress later in the year with two major orders from China. These comprised an equipment contract for nine tug supply vessels and a package of advanced ship equipment for a dive support vessel. We also saw demand from non-oil related sectors such as wind farm support and fishing trawlers.

Activity within our target merchant sectors was subdued, but we made progress in our strategy of developing markets for offshore derived technologies within specialist areas such as azimuth propulsion systems for double-ended ferries. We also delivered Asia's first LNG-powered tug and the first of two all-gas powered cargo vessels for a Norwegian transport company.

The naval business was focused on further development work and deliveries against contracts in both the UK and US. These included the first DDG 1000 multi-mission destroyer class for the US Navy and the world's largest, gas turbine engines, the MT30 for the UK's two new aircraft carriers. We also signed a contract to supply MT30s for operation on the first three of the Royal Navy's new Type 26 Global Combat Ship.

Product development work within the business included expanding the range of permanent magnet-based propulsion systems, as well as spearheading research into our pioneering ship intelligence technology focused on data-driven value-added services.

Closing order book

26%

Marine outlook

Overall the outlook for Marine remains cautious. We expect that the market will continue to be hit by low oil prices which will impact on demand for our products and services. As a result we will sustain our cost reduction programmes, focusing on manufacturing facilities, supply chain and overhead costs, in order to drive a more competitive business while also adapting to volume risks.

As set out in November 2015, we expect the net impact of weak trading conditions and cost saving initiatives to result in 2016 profits being between £75m and £100m lower than those achieved in 2015. As a result, the business is expected to be significantly loss making in 2016.

MARINE / KEY FINANCIAL DATA

£m	2014	Underlying change	Acquisitions & disposals	Foreign exchange	2015
Order book	**1,567**	(403)	–	–	**1,164**
Underlying revenue	**1,709**	(269)	–	(116)	**1,324**
Change		*-16%*	–	*-7%*	*-23%*
Underlying OE revenue	1,070	(204)	–	(93)	773
Change		*-19%*	–	*-9%*	*-28%*
Underlying services revenue	639	(65)	–	(23)	551
Change		*-10%*	–	*-4%*	*-14%*
Underlying gross margin	**425**	(139)	–	(26)	**260**
Gross margin %	*24.9%*	*-500bps*	–	–	*19.6%*
Commercial and administrative costs	(254)	27	–	26	(201)
Restructuring costs	(4)	(16)	–	4	(16)
Research and development costs	(29)	(2)	–	3	(28)
Underlying profit before financing	**138**	(130)	–	7	**15**
Change		*-94%*	–	–	*-89%*
Underlying operating margin	**8.1%**	-750bps	–	–	**1.1%**

MARKET REVIEW

In Marine, where we offer integrated ship solutions (including design, propulsion, deck machinery, automation and control, and power electrics), we forecast the market opportunity across the offshore, merchant and naval market segments to be £250bn.

Market dynamics

- Increasing environmental legislation and system efficiency requirements.
- Population growth is leading to an increasing energy and resources demand for cargo and passenger transportation in the long term.
- Increasing global and regional trade and transport of goods with effects on short-sea shipping.
- Strong shift from traditional markets towards Asia, both in shipbuilding and operation.
- Geopolitics and an increasing multipolar world results in increasing defence expenditures especially in emerging markets which stimulates demand for naval vessels.
- Increased technology requirements for harsher environments, eg. deepwater.
- Currently significant challenges in offshore markets due to low oil prices and weak investment signals.

Competition

- Major competitors fall into two groups – focus on strengthening systems capability or focus on product and technology.
- Industry consolidation within recent years has resulted in the establishment of large market players.
- Increasing competition from Asia, especially China.
- Increasing competition from industrial and electric companies driven by more focus on efficiency and electrification.

Business risks

- Markets: significant reduction in oil price creates pressure in the offshore market with all customer groups seeking to reduce costs and capital commitments.
- Order delays and cancellations impact our revenue, cash and profit but also put our supply chain under financial stress.
- Competition: competitors react to a depressed market by cutting costs, pricing aggressively and partnering with other players.
- Business continuity: the main risk is our key suppliers remaining solvent. We monitor and manage this to ensure no supplier has critical mass and maintain business continuity plans for these risks and other operational risks such as IT.
- Technology: failure to invest in the right technologies to meet customer demand in the future.
- Risk of product failure in the field resulting in the need for intervention to rectify the issue with financial consequences.

Opportunities

- Capture value on more advanced vessels in offshore.
- Grow in tugs, ferries and workboats and short-sea shipping in merchant segments.
- Continue to leverage the joint value proposition in naval markets together with MTU.
- Continue to develop clean propulsion solutions which are emission compliant to new regulations, including alternative fuels (eg. gas/dual-fuel).
- Grow in integrated propulsion and electric systems.
- Establish a leading position in ship intelligence.
- Leverage local partnerships to generate regional growth in Asia, especially China.

Key Rolls-Royce differentiators

- Unique domain knowledge; unique system portfolio including vessel design; joint value proposition within naval together with MTU; continuous innovation and technology leadership; and leadership in ship intelligence.

Potential for OE and services over the next 20 years

Marine – all sectors

£250bn

Waterjets for fast cats

These Watercat M18 multi-purpose vessels use Rolls-Royce Steel Series Kamewa waterjets to propel them at speeds of over 40 knots. These lightweight, agile boats from Marine Alutech of Finland are ideal for fast patrol and troop transportation roles.

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