The Boatman Capital Research

Babcock International: Underperformance and Overcomplexity

Ticker: BAB.LN
Date: May 2019
Price: 519p
Market Capitalisation: £2.6bn

In our opinion, Babcock International needs to write down the value of its Defence Support Group (DSG) subsidiary, which was acquired for £148 million. According to our calculations, Babcock DSG has overvalued its main contract by £50 million, based on an average assessment of underlying operating profits. An impairment on this scale would be equivalent to 12.8% of Babcock's pre-tax profits. Based on a pessimistic assessment of DSG's performance, the impairment would be £75 million – equivalent to 19.2% of pre-tax profits.

We also believe that Babcock's corporate structure and its array of inter-company transactions creates a system that is opaque, needlessly complex, needlessly expensive and prone to errors.

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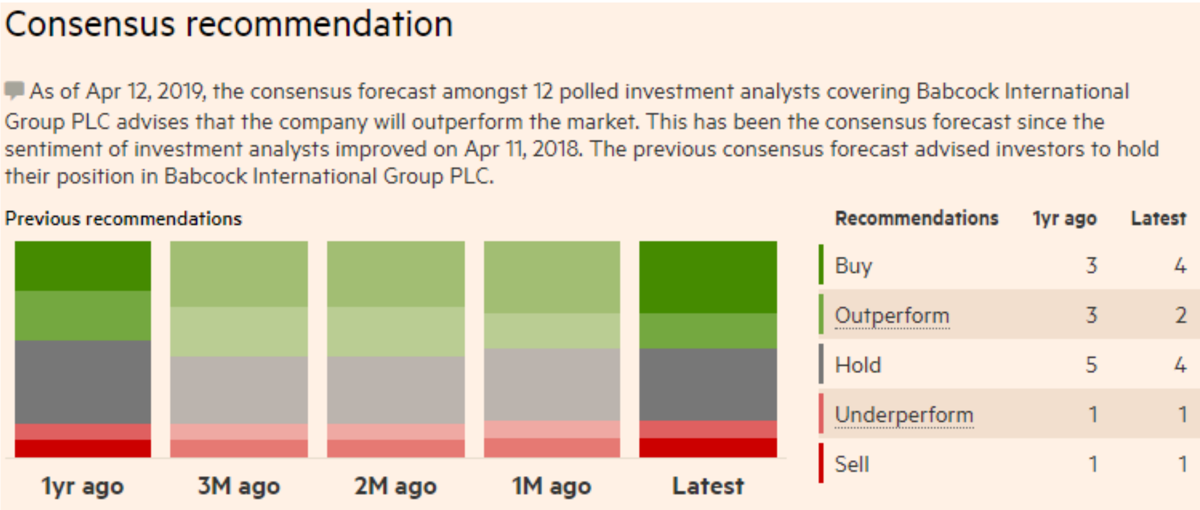
Introduction

In October 2018, the Boatman Capital Research published a report on Babcock International. We are returning to this subject ahead of the company's full-year results, which will be released on 22 May 2019.

According to data from the Financial Times, analyst consensus on Babcock International is bullish. Only two of 12 rate the company as underperform or sell, despite a 24% fall in the share price since the start of 2018. The shares are down 42% since the start of 2017.



Recommendations	1yr ago	Latest
Buy	3	4
Outperform	3	2
Hold	5	4
Underperform	1	1
Sell	1	1

Source: Financial Times

The financial community has been consistently wrong about Babcock and consensus share price targets have massively over-estimated the company's performance. It is clear that the pricing models are not capturing the full story.

Source: Marketscreener

In our first report we argued that Babcock had consistently sought to paint a positive picture of its business while burying bad news and we gave several examples of this. We believe our thesis has been borne out by the downgrades, write-offs and announcements made by the company since last October. And although Babcock is trying to win back support (the appointment of a new chairwoman is welcome news), some investors continue to view the company with suspicion. We share their concerns.

[Report updated to remove called up capital section.]

Executive Summary

- **Babcock International has written off £120 million from the value of the Avincis helicopter deal but we think the company needs to go further and write down the value of another acquisition, the Defence Support Group (DSG). According to our calculations, we believe DSG is overvalued by approximately £50 million based on our average scenario – or £75 million based on our pessimistic scenario. An impairment on this scale would represent a write down equivalent to 12.8% of the PLC's pre-tax profits based on last year's figure of £391.1 million. Our pessimistic valuation would incur a write down equivalent to 19.2% of pre-tax profits.**

Babcock International has tried to improve its weak underlying revenue growth over the past decade through acquisitions. Unfortunately, a combination of poor strategy and poor operational management means that many of these acquisitions are underperforming. In our last report, we highlighted the problems at Appledore Shipbuilders, which was subsequently closed by Babcock. In this report, we look in-depth at another struggling acquisition: the Defence Support Group (DSG). Babcock DSG provides repair and maintenance facilities for the British Army's vehicles. It was privatised by the UK Ministry of Defence (MoD) in late 2014 and acquired by Babcock for £148 million. As part of the privatisation, DSG was awarded a 10-year contract for vehicle maintenance.

Babcock hoped to use DSG as a springboard to win more outsourcing work from the Army, as it had done expanding its naval business. However, the strategic failure of this acquisition is demonstrated by a sales prospectus for DSG that was prepared by Lazard in 2014. The document identified four new business opportunities for DSG but our research indicates that two have already been lost and the remaining two are in doubt. Lazard also said there was an opportunity for DSG to move up the value chain by becoming a Strategic Support Supplier (SSS), providing end-to-end services from training to deployment in the field. Lazard said DSG would be able to target 16 SSS arrangements but our research shows DSG has won just one.

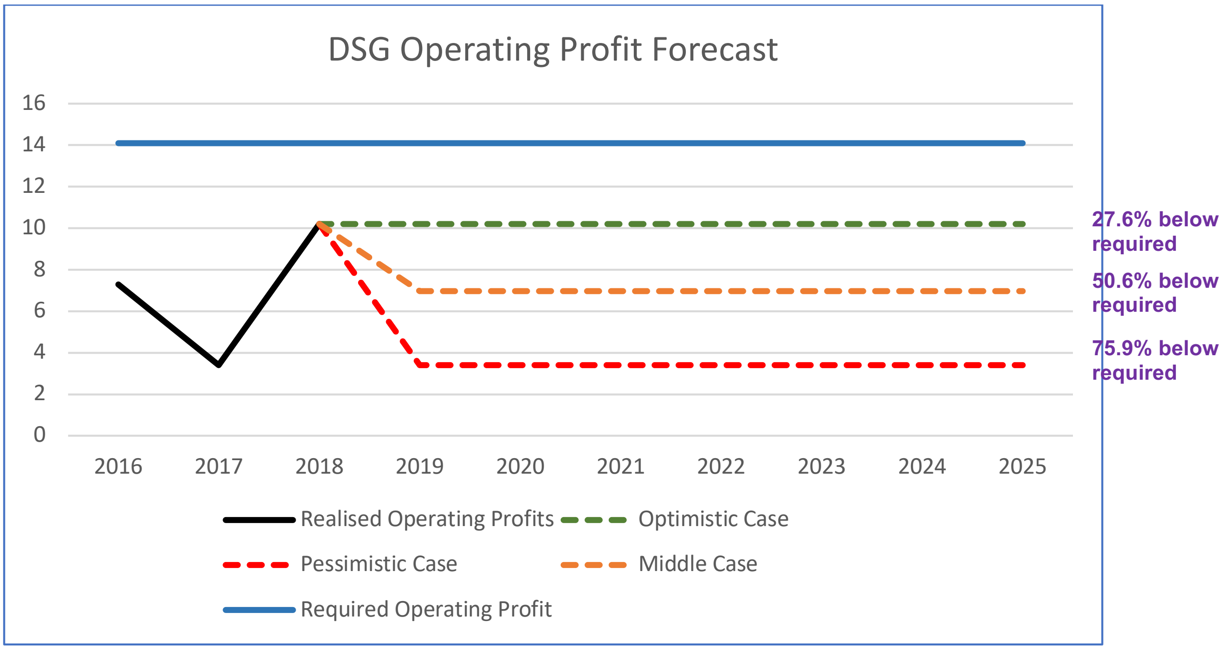
To get a picture of Babcock DSG's underlying performance we have stripped out a number of items that are included in its accounts, specifically amortisation of the acquisition cost and exceptional items. Doing so demonstrates how poorly Babcock DSG has done against the Lazard forecasts:

£m	2016	2017	2018
Lazard Forecast Operating Profit	12	12.1	11.6
Actual Operating Profit/(loss)*	7.3	3.4	10.2

*Excluding exceptional items and amortisation.

In Babcock DSG's 2016 accounts, the 10-year MoD contract was assigned a value of £141 million and the company has amortised the acquisition on a straight-line basis at a rate of £14.1 million per annum. In Babcock DSG's 2018 accounts, the company states that the current value of its MoD contract is £99 million, after amortizing for three years. We believe this contract is overvalued and we do not think that Babcock will make its money back.

In our calculations for the value of this contract, we assumed a discount factor for future cash flows of one, which is consistent with the low-risk nature of the contract and DSG's own straight-line amortisation approach. This means that the value of the contract is simply expected operating profits multiplied by the number of years remaining in the contract. Our optimistic valuation assumed that operating profits would remain at the 2018 level (excluding exceptional items), which gives an implied value for the contract of £71.4 million – 27.6% less than Babcock's valuation. We think this is optimistic because of the unusually low administrative expenses reported in 2018, which are unlikely to be repeated. Our pessimistic case used operating profits from 2017, which produced a valuation of £23.8 million or 76% below the company's measure. We also used an average of operating profit under Babcock's ownership, which gave a contract value of £48.7 million – or 50.6% below the company's valuation.



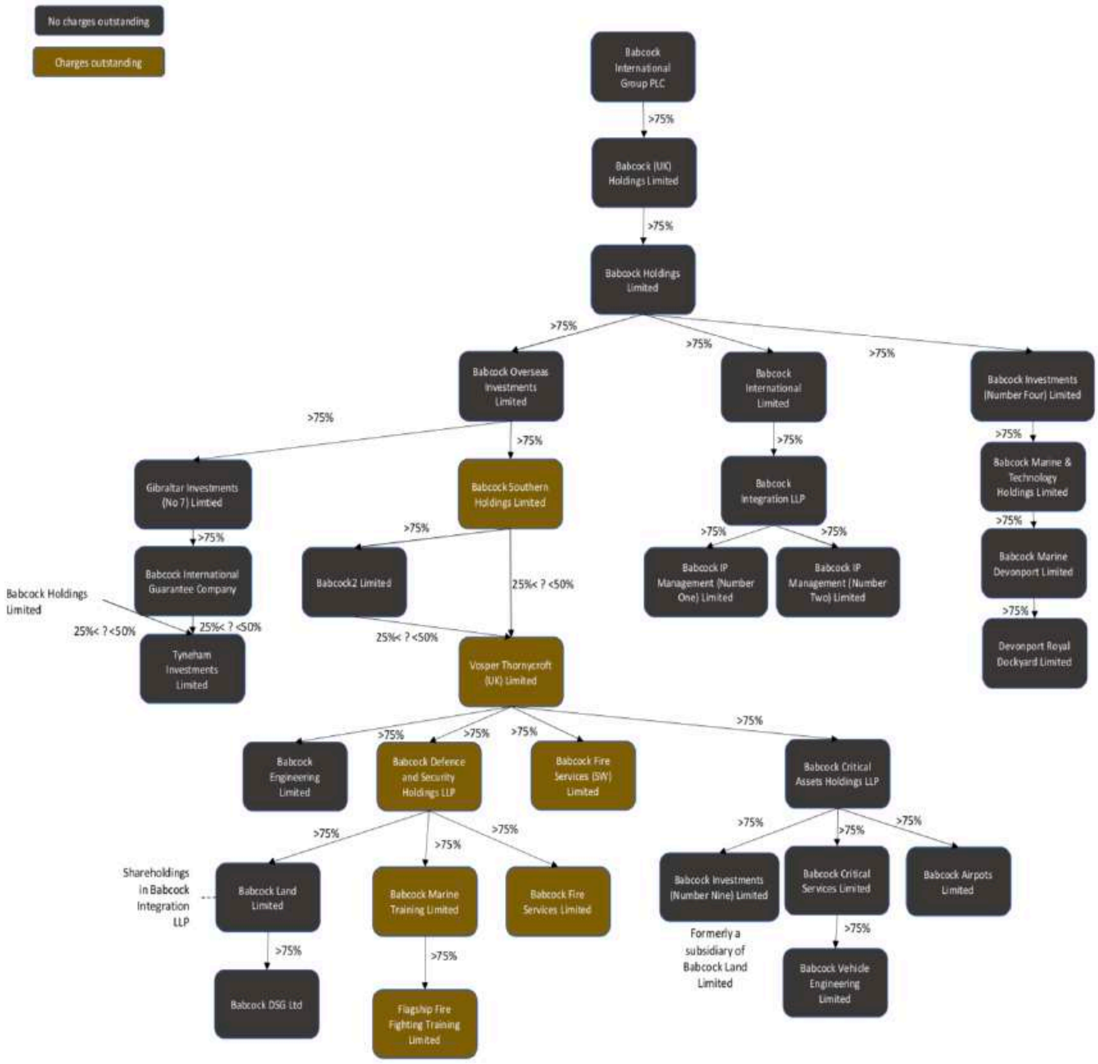
In 2018, Babcock DSG reported an exceptional administrative credit – or "royalty accrual" of £9.05 million. This significantly improved DSG's profits in 2018 but the only explanation for this credit was that *"there has been a release of the accrued intercompany royalty provision as the liability has been waived by the billing group company"*. What was the royalty for? We cannot see why a repair and maintenance facility with no brand and few assets would be paying royalties to another Babcock entity. Babcock DSG gives no cash flow statement but we believe that the royalty provision is an accounting measure and not a cash transfer, so we have excluded it from our calculations of operating profit.

It is not clear where this royalty was owed but we did identify a company called Babcock Integration LLP, which has two subsidiaries that reported a combined decline in revenues of £8 million last year – possibly due to waiving the DSG royalty payment. Babcock Integration was set up in 2010 to hold "proprietary know-how" associated with the purchase of VT Group. This know-how could not be capitalised but has provided distributions to members every year. Given that the VT assets bought by Babcock were primarily support services contracts, it is not clear what intellectual property, patents or exceptional knowledge would have existed that required housing within Babcock Integration. We are concerned by the level of inter-company transactions with Babcock Integration and the lack of detail about what this entity does, or what it is for (see below).

- **Babcock's structural complexity and array of inter-company transactions creates a system that is opaque and limits understanding of the company's underlying performance. We cannot see how this lack of clarity benefits investors or financial analysts. We, therefore, ask the rhetorical question: who does it benefit?**

The DSG exceptional item described above is illustrative of a broader problem with Babcock's structure. The company is made up of about 350 subsidiaries - the chart below represents less than 10% of that structure. The structural complexity is compounded by the large number of entities within Babcock that have payables owed to other subsidiaries. These inter-company transactions appear to be little more than accounting measures that store assets and liabilities in different places. In effect, dozens of Babcock subsidiaries are passing IOU notes between each other for reasons that are not adequately explained.

Structure Chart: Less than 10% of Babcock's subsidiaries are represented here.



The scale and complexity of this system also makes catching errors or misstatements harder. We have identified what appear to be a number of errors in the accounts of Babcock subsidiaries. It is a legal requirement to file accurate accounts. While some of these apparent errors are small, they undermine our confidence in the company and paint a picture of weak internal controls. Examples are given later in this report. The bloated structure also imposes costs on the company, which pays £1.8 million a year to audit these subsidiaries – many of which have no purpose other than to hold ownership of other subsidiaries. On a pro rata basis, if Babcock reduced its number of subsidiaries to about 60 it could save roughly £1.5 million a year. Given that some analysts are forecasting flat profits this year, a £1.5 million gain to the bottom line should not be dismissed.

- **We remain concerned about Babcock's performance at the Devonport Royal Dockyards and its relationship with the Ministry of Defence (MoD).**

Media reporting since our first publication has highlighted additional problems at Devonport and our industry sources continue to warn that the MoD may demand Babcock contributes financially to some of the cost overruns. Babcock denies that it faces any such liability.

Babcock's relationship with the MoD has also come under scrutiny following our first report, in which we said that the chairman and CEO had been given a dressing down by the Secretary of Defence for various contract failures. A review of ministerial meetings shows that Babcock's CEO did meet the Secretary in January and, that after January, there were no further meetings with MoD ministers for more than six months. In the same period, BAE Systems had six meetings with ministers and Airbus had five. Babcock is the MoD's second-largest supplier, after BAE and ahead of Airbus. Media reporting has also confirmed relationship difficulties, with the Financial Times quoting an official saying: "They really need to pull their finger out. There is real concern."

We welcome the appointment of Ruth Cairnie as chairwoman. We encourage her to rebuild Babcock's relationship with the MoD, refresh her Board of Directors and bring in new senior executives. We also urge her to simplify Babcock's unnecessarily complex structure and ditch the accounting tricks and obfuscations, which contribute to distrust in the company's finances.

Babcock Underperformance

Babcock International's underlying revenue growth has been poor over the past decade and it continues to disappoint – revenues for 2018/19 are forecast[1] to be down about 3% to £5.2 billion when the company announces results on May 22nd. Babcock has sought to address this stagnation by buying growth via a series of expensive acquisitions that started with Appledore Shipbuilders in 2007 and has included VT Group, Avincis helicopters, the Defence Support Group and MacNeillie & Son.

Unfortunately, a combination of poor strategy and poor operational management means that many of these acquisitions are underperforming. In our last report, we highlighted the problems at Appledore, which had run out of work and was on the verge of closing. Babcock eventually confirmed that it was shutting down the 163-year old shipyard in November[2].

Our report also argued that other acquisitions including Avincis, bought for £1.6 billion, should be written down. The company had previously denied such action was necessary but agreed to take a £120 million hit on the Avincis acquisition in its half-year results released in November[3].

The thesis we put forward in our first report was that Babcock had consistently avoided giving investors bad news. The company's decision to come clean about the problems at Appledore and Avincis only after our research was published bears out this argument.

Another theme of our research has been poor operational performance, which we attribute to weak management. We continue to uncover alarming examples of Babcock's underperformance, particularly in the assets it has acquired. In this report, we will look in depth at the Defence Support Group.

Babcock DSG Limited

The Defence Support Group (DSG) provides repair and maintenance facilities for the British Army's vehicles. It was bought by Babcock from the UK Government in late 2014 for £148 million, which was about £100 million higher than the next bidder, according to our research. As part of the privatisation, DSG was awarded a 10-year contract that guaranteed the company would be the primary repair and maintenance provider for most of the Army's armoured vehicles.

DSG Strategy

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[1] https://www.babcockinternational.com/-/media/Document-Library/Investors/Results-and-Presentations/Updates/Babcock-February-Trading-Update-260219.ashx

[2] https://www.bbc.co.uk/news/uk-england-devon-46057616

[3] https://www.proactiveinvestors.co.uk/companies/news/209657/babcock-plunges-as-it-takes-120mln-hit-from-oil-and-gas-business-and-slashes-nuclear-outlook-209657.html

We have obtained a copy of the sales prospectus produced by Lazard for potential DSG bidders in 2014. The 129-slide deck contains strategic and commercial information, including financial projections and the business opportunities presented by the privatisation.

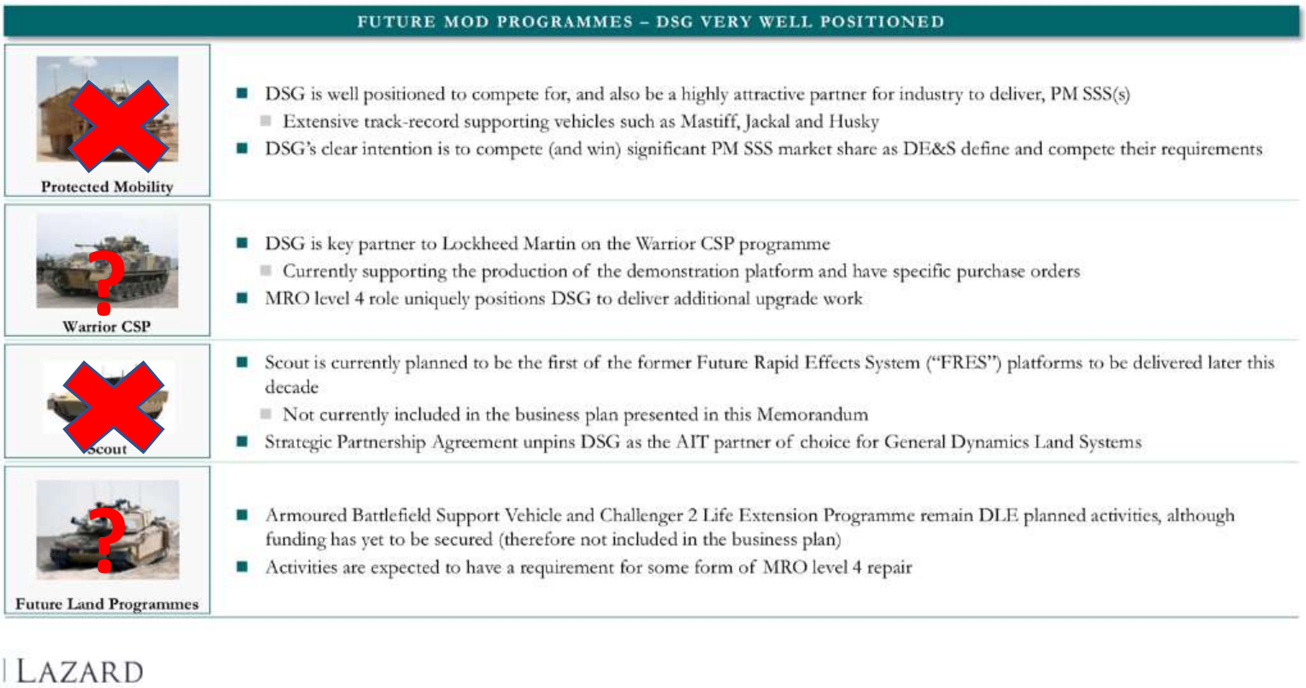
DSG was supposed to be a springboard for the acquirer to win additional work from the British Army. Babcock would have hoped to use DSG as a platform to expand its Land business by winning more outsourcing work from the Army, in the same way that the company had expanded its naval business over the years.

According to Lazard, there were a number of opportunities beyond the 10-year maintenance contract. However, four-years into Babcock's ownership of DSG and it is already clear that many of these opportunities have been missed.

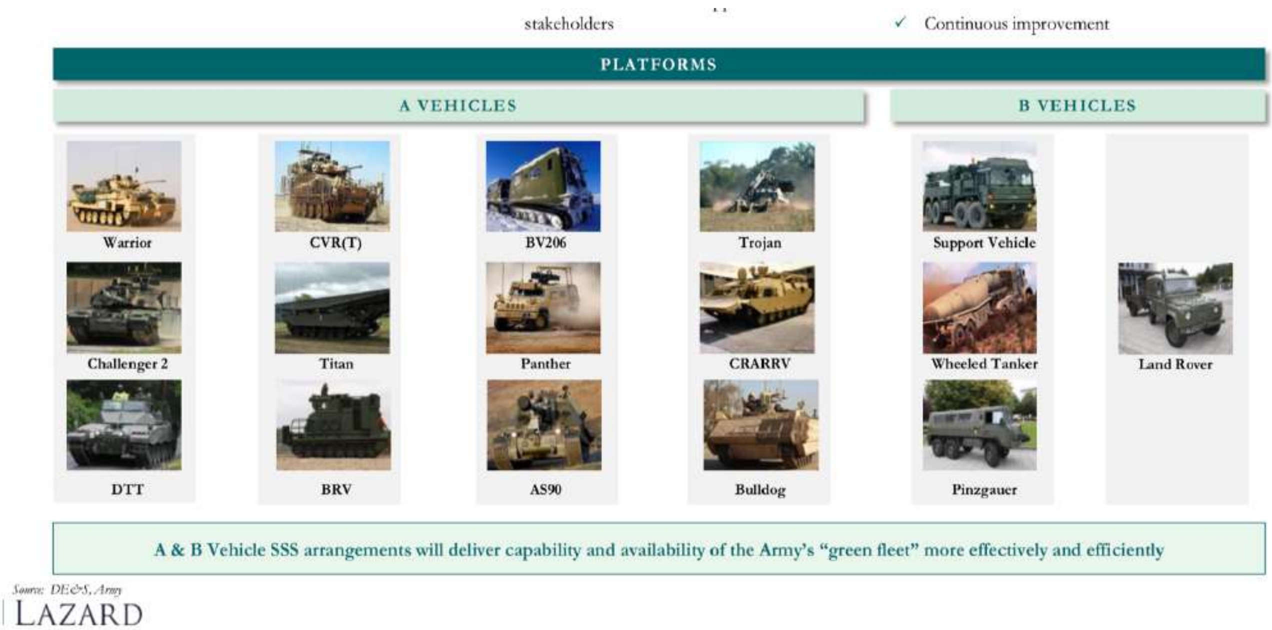
Opportunity	Activity	Outcome
Protected Mobility	Delivering support for the Army's fleet of armoured troop transports including the Mastiff, Jackal and Husky.	Cancelled or awarded to other companies.
Warrior CSP	DSG is a partner to Lockheed Martin in the Warrior upgrade project. Currently in demonstration phase.	The project is 3 years late and £227 million over budget[4]. A government watchdog has downgraded the project to "unachievable" and there is persistent speculation that it will be cancelled.
Scout	New armoured vehicle now called Ajax being built by General Dynamics. Opportunity for "strategic partnership".	DSG has no involvement.
Future Land Programmes	Armoured battlefield support vehicle and Challenger 2 upgrade.	Delayed. About 1/3 of the Challenger 2 tanks are to be scrapped.

These opportunities were presented in a Lazard slide, which we have now updated:

[4] https://www.thetimes.co.uk/article/army-plan-to-improve-warriors-is-3-years-late-v38vc5tdh



Another opportunity identified for DSG was for the company to evolve into fleet management. It would no longer be just a repair shop but manage the various vehicle platforms "end-to-end". These so-called "Strategic Support Supplier" (SSS) contracts were envisaged for nearly all of the Army's vehicles and would include services such as training through to ensuring operational readiness in-theatre. The number of platforms identified as potential SSS opportunities were presented in a Lazard slide:



Of the 16 opportunities given in this slide, our research indicates that Babcock DSG has won only one of them – for supporting the Land Rover fleet. The other B Vehicle support contracts went to rival suppliers while the armoured fleet has seen no SSS arrangements.
A particularly worrying trend for Babcock is that two recent contracts for new vehicles – Ajax (General Dynamics) and Boxer (Rheinmetall) – have awarded the long-term maintenance contracts to the manufacturer, effectively cutting DSG out of future work.

Archie Bethel, Babcock's CEO, told analysts during the company's interim update in February that he saw opportunities in UK Land Systems, pointing to the likelihood of DSG becoming a subcontractor on the Challenger 2 upgrade project. This project was also an opportunity four years ago but it keeps getting delayed and smaller in size, the latest announcement being the mothballing of 1/3 of the tank fleet[5]. Babcock's role might be further limited by competition from the new BAE Systems-Rheinmetall joint venture, which we understand is eyeing the lion's share of work.

British Army outgunned by Cambodia after tank cuts

Cost constraints mean that only 148 of 227 Challenger 2 tanks will be upgraded

Source: The Times, 19 April 2019

In our first report on Babcock, we highlighted problems with the Warrior CSP tank programme, which DSG is working on. The demonstration phase (to prove the upgrade can be done) is now 3 years late and £227 million overbudget[6] and Lockheed Martin, the prime contractor, took a $65 million impairment on the contract last year. In response to our report, Babcock said that it was only a subcontractor on the Warrior project and its work accounted for about 10% of the contract value, therefore its exposure was small. We are not so sanguine. The defence media has repeatedly warned that the Warrior project could be cancelled, which would deprive Babcock DSG of tens of millions of pounds in future revenues. And the ongoing

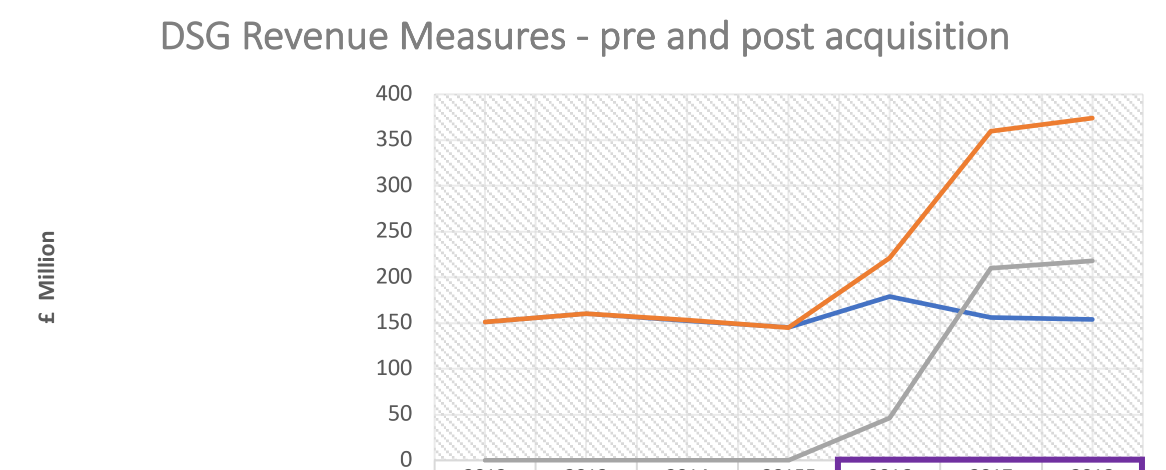
[5] https://www.thetimes.co.uk/article/british-army-outgunned-by-cambodia-after-tank-cuts-qczvrqz0n
[6] https://www.thetimes.co.uk/article/army-plan-to-improve-warriors-is-3-years-late-v38vc5tdh

problems with Warrior damage Babcock's reputation as a supplier of complex engineering projects.

Babcock can blame DSG's failure to win new business on decisions made by the MoD, as the company did when Appledore started to struggle. But if Babcock wants to grow its business and expand into new areas, it cannot keep blaming the MoD. It has to demonstrate it can operate these businesses efficiently and develop a relationship with its customer that leads to more work. Disasters like the Warrior programme hardly instil confidence in Babcock's ability to deliver for the British Army.

Revenues

On the surface, Babcock has more than doubled DSG's revenues since acquiring the business in 2015. Before the acquisition, DSG turned over roughly £150 million a year while the latest 2018 company accounts show a total revenue figure of £365 million. This is technically accurate but the growth in revenues is almost entirely attributable to business activities that do not generate any profit.



	2012	2013	2014	2015E	2016	2017	2018
Revenue (from Long Term Contracts)	151	160	153	145	179	156	154
Revenue (from Sale of Goods)	0	0	0	0	46	210	218
Revenue (inc Sale of Goods)	151.0	160.0	153.0	145.0	221.0	360.0	374.0

As can be seen from Babcock DSG's accounts, its revenues are inflated by the inclusion of "the purchase of materials and spares on behalf of customers". This is described in the accounts as "Sale of Goods" and is accompanied by a "Cost of Sales" item that is exactly equivalent, which means that Babcock DSG makes a margin of 0% on this business. Therefore, in evaluating the company's profitable turnover we should discard Sale of Goods, which we do from hereon when discussing DSG's *actual revenues*.

4 **Revenue**

Revenue is wholly attributable to the principal activities of the Company and is of United Kingdom origin and destination.

Revenue includes £217,698,000 (2017: £209,680,000) relating to the purchase of materials and spares on behalf of the customers. Revenues related to these items have been period costed.

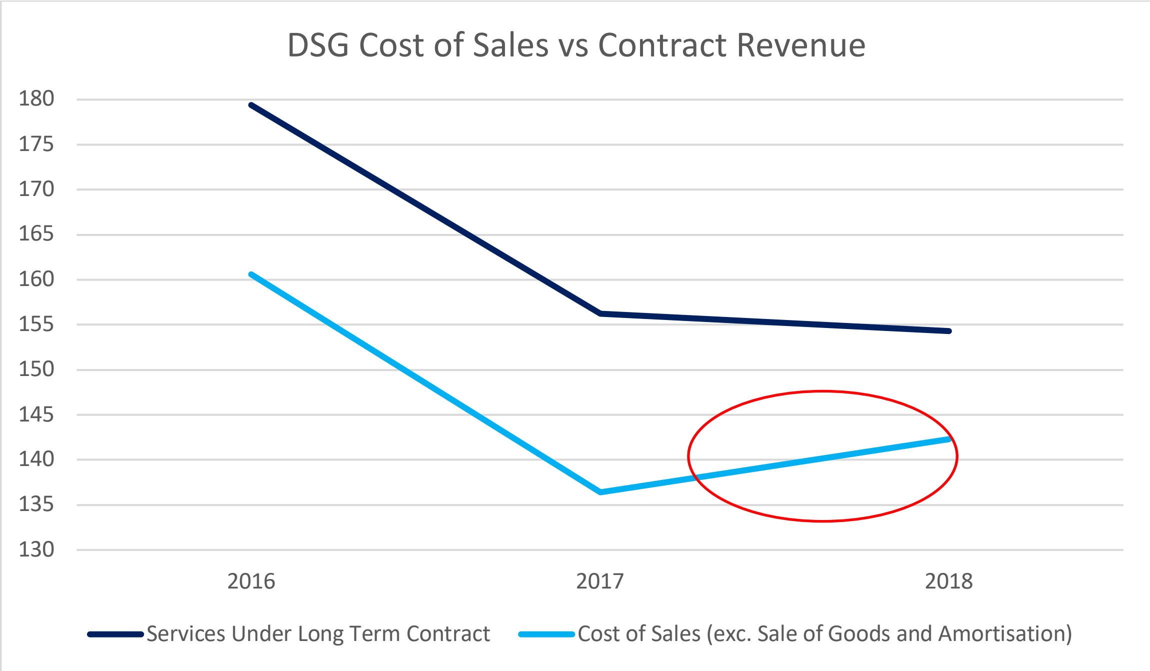
Note 4, page 22, Babcock DSG Limited 2018 Annual Report

The only other revenue item in Note 4 of DSG's financial statement is for "Services from Long Term Contracts", which primarily represents the income from the 10-year contract awarded when Babcock bought DSG. While revenues from the contract rose in the first year, they have since fallen to be in-line with pre-acquisition levels. The stagnant revenues are a result of DSG's failure to win any significant new business in the four years under Babcock's management, despite this being the primary rationale behind purchasing the company.

Costs

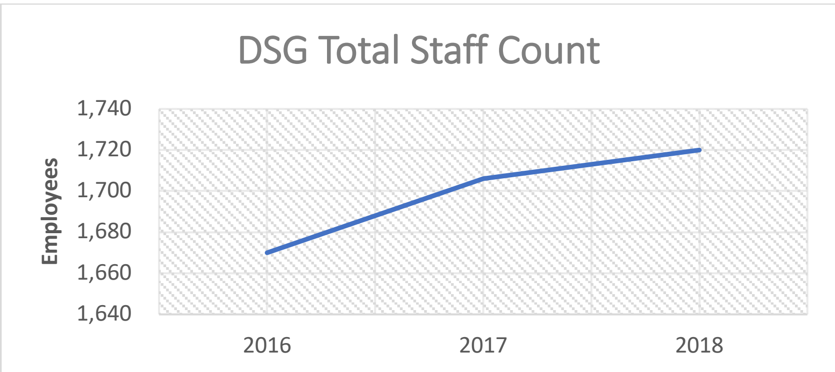
With revenues flat, a small rise in costs can lead to a significant fall in profitability. In the case of DSG, we can see a worrying trend emerging with costs rising while revenues are flat or falling.

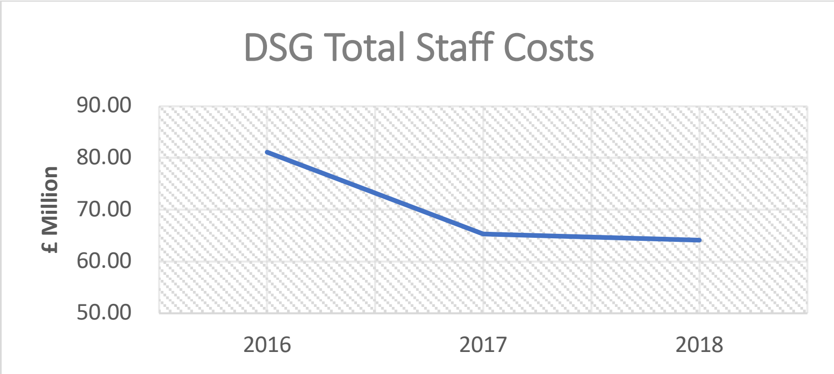
As with revenues, the underlying cost of sales are confused by the addition of "Sale of Goods" (i.e. spares bought for the Army). We have therefore excluded Sale of Goods and Amortisation of Contract Intangible (a constant straight-line amortisation of the purchase price of the DSG contract) to infer the actual costs incurred providing the contracted services. We compare this directly to revenue generated from Services under Long Term Contracts.



What this shows is that between 2016 and 2017, cost of sales fell in line with revenues, as would be expected from a cost-plus contract arrangement where the supplier (DSG) receives profits at a fixed percentage above project costs. What is more concerning is that between 2017 and 2018, costs have increased as revenues have continued to fall. If this upward trend in costs continues, it does not bode well for the future profitability of the division.

Labour Costs





Babcock DSG spent a combined total of £7.6 million on redundancy charges in 2017 and 2018, according to the company's accounts. Over this time period, total staff numbers rose by 3% while wage costs fell by 4%. This suggests that Babcock DSG has been involved in labour arbitrage: the process of dumping more experienced staff and replacing them with younger, cheaper employees. This policy seems destined to stoke disputes with labour unions and could also have an impact on productivity in an engineering-focused field.

15 Provisions *(continued)*

Redundancy provisions

Following the acquisition of the Company by Babcock Land Limited, a review was carried out to identify the synergies and savings across the enlarged Group. During the year, £5,341,000 was utilised. A further provision was made of £4,496,000 for the next stage of the programme. The remainder of this provision is expected to be utilised during the next year.

Source: Note 15, Babcock DSG Annual Accounts 2018

The accounts show a further provision of £4.5 million has been made for more redundancies. The provision mirrors the redundancy costs for 2018, which implies that Babcock DSG expects a similar number of people to leave the business in 2018/19. We question whether Babcock's "added value" to DSG is simply to replace experts with apprentices, which has a serious risk of hampering the quality of its work.

Profits

Babcock DSG arrives at its operating profit/loss by taking gross profits (revenue minus costs and amortisation) and subtracting administrative expenses. We have excluded amortisation from our operating profits/loss calculations because it gives an inaccurate view of the underlying performance of the business. (If you do include amortisation, DSG has made an operating loss each year under Babcock's ownership, excluding exceptional items.)

£m	2016	2017	2018
Revenue	226.2	365.9	372
Costs (Cost of Sales plus Sale of Goods)	(207.4)	(346.1)	(360.3)
Gross Profit	18.8	19.8	11.7
Administrative expenses	(11.5)	(16.4)	(1.5)
Exceptional administrative credit	0	0	9
Operating profit exc. amortisation	7.3	3.4	19.2
Operating profit exc. Exceptional credit and amortisation	7.3	3.4	10.2

As this table shows, the big variable in the profitability of Babcock DSG are administrative expenses. Unfortunately, DSG's accounts offer no visibility on what these administrative expenses are but they fluctuate considerably from year to year. We don't offer a judgment on the validity of these administrative costs but we are concerned about the inclusion of an exceptional administrative credit in 2018. This credit – or "royalty accrual" – was worth £9.05 million in 2018 and without it, DSG's operating profit was £10.2 million. We think it is likely that this royalty is an accounting measure and not a cash item and, as such, we will exclude it from our evaluation of DSG's performance. (We dig deeper into this debateable exceptional item in the next chapter.)

Forecasts

Stripping out amortisation from operating profits also allows us to compare DSG's performance under Babcock's ownership to the forecasts made by Lazard in the privatisation brochure. The document outlined year-on-year expectations for revenues and operating profits.

FORECAST PROFIT & LOSS

(March Year End, £m)	NCA YR 2 2015E	SPC YR 1 2016E	SPC YR 2 2017E	SPC YR 3 2018E	SPC YR 4 2019E	SPC YR 5 2020E	SPC YR 6 2021E	SPC YR 7 2022E	SPC YR 8 2023E	SPC YR 9 2024E	SPC YR 10 2025E	16E – 20E CAGR	21E - 25E CAGR
SPC Nominated Revenue	n.a	145.6	149.9	141.0	142.9	143.4	145.0	147.6	135.1	135.8	138.1	*(0.4%)*	*(1.2%)*
Additional Opportunities	n.a	14.7	12.6	13.5	9.3	25.3	25.7	26.1	43.3	26.6	27.1	*14.5%*	*1.3%*
Turnover	**157.1**	**160.3**	**162.5**	**154.5**	**152.2**	**168.7**	**170.7**	**173.7**	**178.4**	**162.4**	**165.2**	*1.3%*	*(0.8%)*
% growth	*2.7%*	*2.0%*	*1.4%*	*(4.9%)*	*(1.5%)*	*10.8%*	*1.2%*	*1.8%*	*2.7%*	*(9.0%)*	*1.7%*		
Gross Variable Costs	(38.8)	(40.2)	(41.8)	(39.4)	(38.6)	(45.2)	(45.4)	(46.0)	(47.5)	(39.3)	(39.9)	*3.0%*	*(3.2%)*
% margin	*24.7%*	*25.1%*	*25.7%*	*25.5%*	*25.4%*	*26.8%*	*26.6%*	*26.5%*	*26.6%*	*24.2%*	*24.2%*		
Gross Profit	**118.3**	**120.1**	**120.7**	**115.1**	**113.6**	**123.5**	**125.3**	**127.7**	**130.9**	**123.1**	**125.3**	*0.7%*	*0.0%*
% margin	*75.3%*	*74.9%*	*74.3%*	*74.5%*	*74.6%*	*73.2%*	*73.4%*	*73.5%*	*73.4%*	*75.8%*	*75.8%*		
Total Fixed Costs	(107.0)	(107.7)	(107.9)	(102.9)	(102.4)	(111.2)	(112.9)	(115.0)	(117.8)	(111.2)	(113.2)	*0.8%*	*0.1%*
% margin	*68.1%*	*67.2%*	*66.4%*	*66.6%*	*67.3%*	*65.9%*	*66.1%*	*66.2%*	*66.0%*	*68.5%*	*68.5%*		
EBITDA	**11.3**	**12.5**	**12.7**	**12.2**	**11.2**	**12.3**	**12.4**	**12.6**	**13.1**	**12.0**	**12.2**	*(0.4%)*	*(0.4%)*
% margin	*7.2%*	*7.8%*	*7.8%*	*7.9%*	*7.4%*	*7.3%*	*7.3%*	*7.3%*	*7.3%*	*7.4%*	*7.4%*		
Depreciation	(0.4)	(0.5)	(0.6)	(0.6)	(0.6)	(0.6)	(0.6)	(0.6)	(0.7)	(0.7)	(0.7)	*4.7%*	*3.9%*
% sales	*0.3%*	*0.3%*	*0.4%*	*0.4%*	*0.4%*	*0.4%*	*0.4%*	*0.3%*	*0.4%*	*0.4%*	*0.4%*		
Operating Profit	**10.9**	**12.0**	**12.1**	**11.6**	**10.6**	**11.7**	**11.8**	**12.0**	**12.4**	**11.3**	**11.5**	*(0.6%)*	*(0.6%)*
% margin	*6.9%*	*7.5%*	*7.4%*	*7.5%*	*7.0%*	*6.9%*	*6.9%*	*6.9%*	*7.0%*	*7.0%*	*7.0%*		

The table below compares the Lazard forecast to DSG's actual numbers. As can be seen, revenue has been similar to the Lazard forecast but the company has missed its operating profit target by a wide margin.

£m	2016	2017	2018
Lazard Forecast Total Revenue	160.3	162.5	154.5
Actual Revenue*	179.4	156.2	154.3
Lazard Forecast Operating Profit	12	12.1	11.6
Actual Operating Profit/(loss)*	7.3	3.4	10.2

*Excluding exceptional items, sale of goods and amortisation.

The Lazard forecast anticipates a jump in revenues from 2020 onwards based on opportunities to expand the Land business by winning new contracts. As we have noted previously, Babcock DSG has so far failed to pick up any significant new business implying that revenue will underperform versus the forecast for the foreseeable future.

DSG Valuation

From Note 18 of DSG's 2016 financial statement, we know that Babcock assigned a value of £141 million to the ten-year bundle of contracts with the MoD that came with the purchase of the company. This suggests Babcock was expecting the contract to generate at least £14.1 million in profits per year and it has duly amortised the acquisition on a straight-line basis at a rate of £14.1m per annum.

Net assets and liabilities from the acquistion are as follows

Acquired contract intangible	140,951
Property plant and equipment	549
Deferred tax	(28,190)
Stock	25,540
Current assets	23,418
Current and non current liabilities	(13,494)
Provisions	(1,155)
Net assets acquired	**147,619**

In a previous section, we demonstrated that operating profits have been significantly lower than the £14.1 million profit rate anticipated by amortisation. In other words, Babcock massively overpaid for DSG. Worryingly, even the Lazard forecast for operating profits would not have matched the required levels for this acquisition to break even. This suggests that Babcock took a gamble on using DSG as a vehicle to generate more MoD business, which has been unsuccessful.

In Note 10 of DSG's 2018 financial statement, the company states that the current value assigned to its MoD contract in March 2018 was £99m, after amortizing it on a straight-line basis for three years. We establish three forecasts – one optimistic, one pessimistic and one average – to describe what we believe the actual value of the contract was in March 2018.

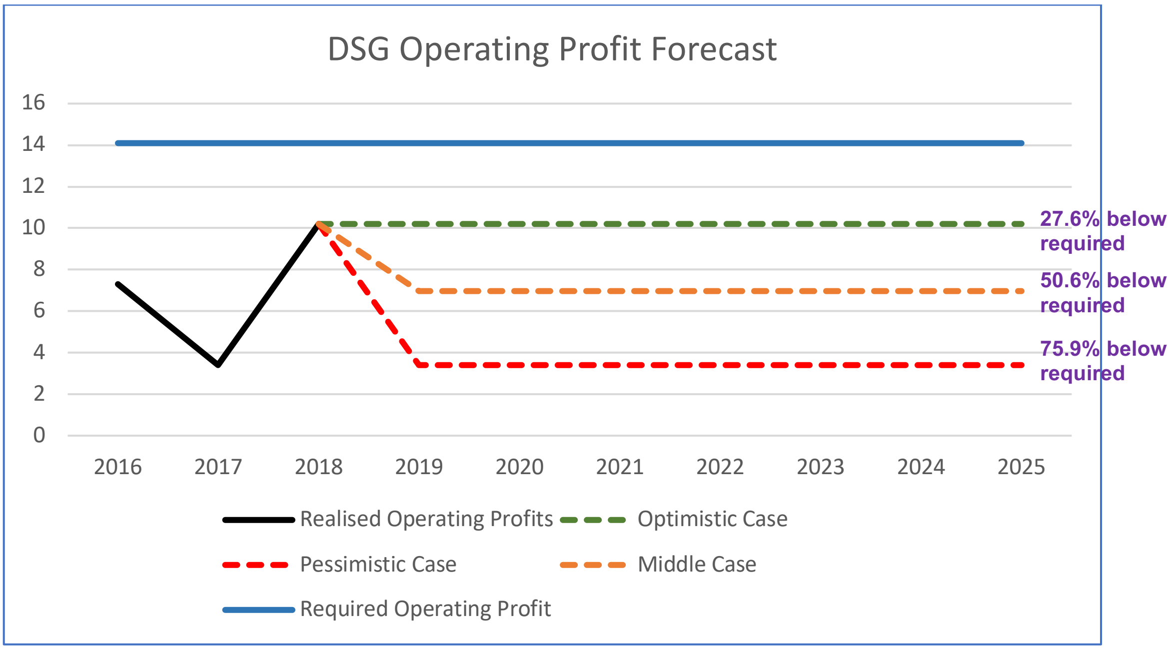
Our optimistic case assumes that the operating profit of FY 2018 continues until the end of the contract in 2025. We argue this is optimistic because costs are rising, margins are falling and 2018 benefitted from a strangely low level of administrative costs which we don't expect to be maintained. We have excluded the exceptional royalty payment, which, as stated earlier, we think is dubious. This gives us an operating profit of £10.2 million per year.

Our pessimistic case assumes that operating profits continue at the same level as FY 2017 for the rest of the contract. The third forecast is based on averaging the profit levels of the past three years.

As government procurement contracts are considered low-risk sources of revenue, we assume a discount factor for future cash-flows to be equal to one. This has the effect of inflating the value slightly, but the calculations are significantly simpler and this is consistent with DSG's straight-line amortisation approach. (We don't account for depreciation as the depreciable assets were treated separately when DSG was privatised.) This means that the value of the contract is simply expected operating profits multiplied by the number years remaining in the contract.

Current Contract Value	£ 98,666,000

	Annual Operating Profit	Implied Value	Implied Discount
Optimistic Forecast	£ 10,200,000	£ 71,400,000	27.63%
Pessimistic Forecast	£ 3,400,000	£ 23,800,000	75.87%
Average Forecast	£ 6,966,000	£ 48,762,000	50.57%
Required by Contract	£ 14,095,143		

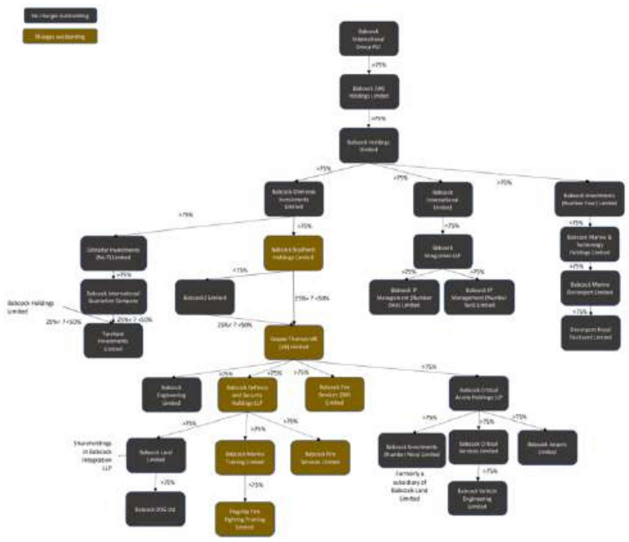


We do not think that DSG will make its money back and Babcock therefore needs to write off approximately £50 million based on our average valuation forecast – or £75 million based on our pessimistic valuation. An impairment on this scale would represent a 12.8% hit to the PLC's pre-tax profits based on last year's figure of £391.1 million. Our pessimistic valuation would cause a 19.2% hit to the PLC's pre-tax profits.

Babcock has already written off £120 million from the value of the Avincis deal but we think it needs to go further and also write down the value of DSG. Write downs on this scale demonstrate that Babcock’s strategy of buying growth has failed and been value destructive for investors.

Babcock's Accounting

During our research into Babcock International, we were surprised by the arcane nature of its accounting structures. Babcock has about 350 subsidiary companies, which bear little resemblance to the PLC's reporting divisions as far as we can tell.



The structure chart (left, and at the start of this report) shows 30 companies and it is already a muddle. **This chart represents less than 10% of Babcock's structure.**

The complexity is compounded by multiple entities within Babcock having payables that are owed to other subsidiaries. In effect, dozens of Babcock subsidiaries are passing IOU notes between each other for reasons that are not adequately explained.

These inter-company transactions appear to be accounting measures that store assets and liabilities in different places. In theory, the inter-company transactions should have no net impact on the overall financials but it creates a system that is opaque and limits understanding of Babcock's underlying performance. We cannot see how this lack of clarity benefits investors or financial analysts. We, therefore, ask the rhetorical question: who does it benefit?

Babcock DSG: Exceptional Release of Royalty Accrual

As we mentioned in the previous chapter, Babcock DSG reported an exceptional administrative credit – or "royalty accrual" - of £9.05 million in 2018. Without this, DSG would have recorded an operating profit of £10.2 million excluding amortisation, or a loss of £4.1 million if amortisation is included. Either way, the inclusion of the exceptional item significantly improved DSG's numbers for 2018.

The exceptional credit is explained in Note 5 of Babcock DSG Limited's 2018 annual statement:

During the year there has been a release of the accrued intercompany royalty provision as the liability has been waived by the billing group company.

No further explanation is given. Babcock DSG gives no cash flow statement but we believe that the royalty provision is an accounting measure and not a cash transfer. But what is the royalty for? We cannot see why a repair and maintenance facility with no brand and few assets (the workshops remain government-owned) would be paying royalties to another Babcock entity.

Babcock has hundreds of subsidiaries and many have significant intercompany loans between them. It is therefore impossible to conclusively determine where the DSG credit has originated from. However, there may be a clue in the accounts of DSG's parent company, Babcock Land Ltd.

According to Note 12 of Babcock Land's annual accounts, the company owns a share in another entity called Babcock Integration LLP. This share was awarded in return for the transfer of "proprietary know-how" to Babcock Integration originating from the 2010 purchase of VT Group.

On 15 September 2010, proprietary know-how, not capitalised in the financial statements of the Company was transferred to Babcock Integration LLP in exchange for an interest in that partnership. This was in order to facilitate the integration of the Babcock and VT Groups. The partnership interest has been recognised at a cost of £nil given that the know-how transferred was not recognised in the financial statements of the Company prior to the transfer. A royalty is payable at the rate of 1.5% of non-passthrough revenue. The charge for the year is £2,293,000 (2017: £3,888,000).

During the year the Company received dividends of £1,238,000 (2017: £nil) from Babcock Integration LLP, a company incorporated in England and Wales, registered office, 33 Wigmore Street, London, W1U 1QX.

Source: Note 12, Babcock Land annual accounts 2018

The "know-how" transferred into Babcock Integration apparently could not be capitalised but has generated profit distributions every year. Given that the VT assets bought by Babcock were primarily support services contracts, it is not obvious what intellectual property, patents or exceptional knowledge would have existed that required a special home within Babcock Integration.

Babcock Integration itself has a split the company's various IPs into two separate entities: Babcock IP Management (Number One) Limited, and Babcock IP Management (Number Two) Limited.

Babcock IP Management (Number One) Limited

5 Revenue

	2018 **£000**	2017 £000
Group royalty revenue	**9,688**	15,423

Revenue for both years originated in the United Kingdom.

Babcock IP Management (Number Two) Limited

5 Revenue

	2018 **£000**	2017 £000
Group royalty revenue	**30,982**	33,168

Revenue for both years originated in the United Kingdom.

Combined, these two companies show a fall in revenue of roughly £8 million in 2018, which could tally with the theory that they waived royalty payments from DSG in 2018. If this is the case, it raises the question as to why DSG is paying for Babcock "industry knowhow" obtained five years before it was acquired. Is there any real value associated to this know-how? And why would DSG's expertise be any different now than before it was privatised?

It is possible that the royalty payments were paid to another Babcock subsidiary, in which case we would like to know where the money went and what the rationale was. Wherever the counterparty lies, we suspect that no cash has left the DSG business and these royalties are simply an accounting measure to accumulate intercompany debts.

Other Accounting Issues

We have identified what appear to be a number of errors in the accounts of Babcock subsidiaries. It is a legal requirement to file accurate accounts. While some of these apparent errors are small, they undermine our confidence in the company and paint a picture of weak internal controls.

Babcock DSG:

On page 14 of DSG's 2018 accounts, it gives details of a statement of changes in equity. The equity in 2017 is given as £138,356 ('000) and the addition of profits for the financial year of £7,283 give an equity balance for 2018. The total is given as £145,601. This is wrong: 138,356 + 7,283 = £145,639.

At 1 April 2017	**147,619**	**(9,263)**	**138,356**
Profit for the financial year	-	7,245	7,283
Other comprehensive (expense) / income: (net of tax)	-	-	-
Balance as at 31 March 2018	**147,619**	**(2,018)**	**145,601**

Babcock International Limited:

On p9 of Babcock International Limited's 2018 accounts, the company gives an administrative expense as a positive – i.e. a profit, not an expense. This could be a mistake or it could be a profit booked in the wrong place or a provision reversal. But we do not see how it could be an expense and we would normally expect an explanation of what this represents.

For the year ended 31 March 2018	Note	2018 £'000	2017 £'000
Administrative expenses		903	(2,359)
Operating profit / (loss)	4	903	(2,359)

Babcock Holdings:

On page 13 of the 2018 accounts for Babcock Holdings Limited, foreign exchange gain/(loss) is included within operating profits. It should be classified as non-operating profits or other income.

4 Operating profit/ (loss)

Operating profit/ (loss) is stated after charging / (crediting):

	2018 £000	2017 £000
Auditors' remuneration		
- audit fees	**2**	2
Operating lease rentals		
- land and buildings	**1,404**	1,296
Staff costs (note 6)	**17,131**	17,994
Foreign exchange loss/(gain)	**56,395**	(67,559)
Management fees	**33,121**	30,624

Accounting Costs

Babcock has to pay to prepare the accounts of each of its subsidiaries. According to the company's annual report, this cost was £1.8 million last year. This is not a huge amount of money given Babcock's revenues but we think that a simplified structure would save money and help investors understand the company better.

Services provided by the Group's auditor and network firms

During the year the Group (including its overseas subsidiaries) obtained the following services from the Group's auditor as detailed below:

	2018 £m	2017 £m
Audit fees:		
Fees payable to the parent auditor and its associates for the audit of the parent company's individual and consolidated financial statements	0.4	0.4
Fees for other services:		
Fees payable to the parent auditor and its associates in respect of the audit of the Company's subsidiaries	1.8	1.7
Audit related services	0.2	–
Taxation advisory services	–	0.1
Other non-audit services	0.1	–
Total fees paid to the Group's auditor and network firms	2.5	2.2

Babcock currently has about 350 subsidiaries and a significant number of these have no purpose other than to hold ownership of other subsidiaries. On a pro rata basis, if Babcock was to reduce the number of its subsidiaries to about 60 (still a lot) it could save roughly £1.5 million on its accounting bill. Given that some analysts are predicting that profits this year will be flat, a £1.5 million gain to the bottom line should not be dismissed.

Babcock Defence and Security Holdings:

This subsidiary describes itself as an intermediate holding entity for other group companies and its activities also include "provision of management services across the aviation sector of Babcock International". It has a management committee of seven people, four of whom are paid by Babcock Defence and Security Holdings. Three are paid by other Babcock companies.

Management Committee

R Hardy
S Landrey
C McMullen
N Misell
C Redmayne
I Urquhart
K Hayzen-Smith

Except for four committee members (2017: four), the committee members of the LLP are remunerated by other Babcock Group Companies. It is not possible to make an accurate apportionment of these committee members' emoluments relating to services provided to the LLP and as such no disclosure of emoluments received by these committee members has been made in these financial statements.

The management committee's remuneration was £889,000 in 2018, up from £542,000 the year before. The highest paid member of the committee received £306,000. We think it odd that only two of the seven committee members describe their work as "defence and security" on their LinkedIn profiles or in company documents (see below). All the other members appear to work for an assortment of divisions, none of which looks like Babcock Defence and Security Holdings.

This illustrates the disconnect between how the PLC (and staff) describe its activities versus the complex corporate structure put in place to own the operating assets. Paying people from different payrolls also makes it difficult to evaluate performance by division and makes it difficult to scrutinise how management is rewarding itself.

- Roger Hardy: Chief Executive of Aviation, Babcock board member
- Steve Landrey: Managing Director, Defence and Security Division
- Collette McMullen: Projects Director at Babcock International Group; Business Support Director at Cavendish Nuclear
- Neal Misell: Managing Director at UK Military Air
- Iain Urquhart: director of 116 Babcock entities. Appears to be an accountant with Babcock Corporate Services.
- Karen Hayzen-Smith: Finance Director, Defence and Security Division
- Catherine Redmayne: HR Director and formerly organisation and development director, Aviation.

Source: LinkedIn and UK Companies House.

Devonport

Babcock International manages the Devonport Royal Dockyard facility on behalf of the Ministry of Defence (MoD). The facility is part of the Devonport naval base where the UK's nuclear submarines are based, serviced and repaired. In our first report on Babcock, we said that the company's operations at Devonport were one source of rancour with the MoD. Specifically, we pointed to major delays and budget overruns for a drydock upgrade needed for the Astute class submarines.

Industry sources told us that the Government wanted Babcock to share some of the cost overrun, which we estimated could be as much as £200 million based on the very limited details available. If Babcock were forced to take on a share of the overrun it would have a significant impact on profits.

Babcock denied that it faced any liability because the MoD is responsible for "strategic" capex at Devonport and the company only pays for "maintenance" capex. The upgrade work has reportedly paused while the Government works out what to do with its nuclear infrastructure and how it will afford the Devonport upgrades.

While the MoD is responsible for the drydock costs, our understanding remains that the Government does not want to pick up the full bill. The issue appears to have dropped in priority while the MoD reviews the nuclear estate but we do not think it has gone away. In the meantime, more information has come to light about what else has been going wrong at Devonport.

UK defence industry + Add to myFT

Babcock under MoD watch over submarine contract

Move raises fresh questions over performance of UK's second-biggest defence supplier

Babcock has been asked to deliver regular updates on its maintenance of the UK's Vanguard-class submarines, such as the HMS Vengeance © FT montage

The Financial Times reported in November that the MoD had placed Babcock under scrutiny over the performance of some of its Devonport contracts[7]. The newspaper said: “While the exact reasons for the MoD’s concerns are not clear, one of the four submarines, HMS Vanguard, has been in dock at Devonport for the past three years for unplanned refuelling at a cost of at least £200m.”

According to our research, the FT was correct in its assessment that it was the £200 million Vanguard project that was causing trouble. However, we believe the situation was even worse than reported. Babcock’s performance on the Vanguard project was so poor that the company was required to provide weekly and then monthly reports on its remedial actions.

In addition, we understand that MoD experts from the Submarine Delivery Agency were sent in to monitor activities at Devonport and ensure Babcock upped its performance. According to our sources, the project continues to face problems and, like the drydock, we question how long the MoD will put up with cost overruns and delays before demanding financial contributions from Babcock.

Babcock and the MoD

The problems at Devonport and with the much-delayed Warrior tank project help to explain why the MoD has grown frustrated with Babcock. This is openly discussed by executives in the defence industry, despite Babcock’s insistence that all is well with its largest customer.

In our first report we raised concerns that the break down in relations between Babcock and the MoD could be a threat to the long-term revenues of the company. According to our sources, Mike Turner, Babcock’s chairman, and Archie Bethel, the chief executive, were summoned to the office of former Secretary of Defence Gavin Williamson for a dressing down last year. We were told that Bethel was kicked out of a subsequent meeting with the Secretary of Defence.

Babcock denied there were relationship problems but recent media reporting has picked up the same concerns. The Financial Times[8] wrote that MoD relations with the company were “strained” as a result of the Devonport problems. The FT quoted an official saying: “They really need to pull their finger out. There is real concern.”

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[7] https://www.ft.com/content/692abde4-e680-11e8-8a85-04b8afea6ea3
[8] https://www.ft.com/content/692abde4-e680-11e8-8a85-04b8afea6ea3

A look at the official government records[9] for ministerial meetings also tells an interesting story. The data confirms that meetings took place between Bethel and Williamson at the start of last year, although obviously the content of the discussions is not revealed.

Minister	**Date**	**Name of organisation or individual**	**Purpose of meeting**
Gavin Williamson	2018-01-08	Babcock Executives	Routine industry engagement
Gavin Williamson	2018-02-28	Meeting with CEO Babcock - Archie Bethel	Routine industry engagement

Source: MoD ministerial meetings Q1 2018

In the two quarters following the Secretary of Defence's reprimand, Babcock appears to have been cold-shouldered by officials. Defence ministers did not have a single meeting with Babcock in over six months, despite the company being the second-largest supplier to the MoD. In the same period, ministers had six meetings with BAE Systems and five with Airbus. It was only in October 2018 (after our report was published) that Babcock met Stuart Andrew, minister for defence procurement.

We accept that ministerial meetings are not the sum of Babcock's relationship with the MoD but we believe this illustrates, along with media coverage, that something went badly wrong with Babcock's relationship with its largest customer. We hope that the scrutiny following our first report has encouraged Babcock to focus on its relationship with the MoD.

Babcock's Leadership

In our first report we pointed out that Mike Turner, Babcock's chairman, could no longer be considered independent under the UK's Corporate Governance Code as he had been in the role for more than 10 years. We also questioned Turner's management style and his habitual conflicts with the MoD. It appears shareholders agreed that it was time for Turner to go and he is to be replaced by Ruth Cairnie, who will become chairwoman in July. We welcome this move and believe that Ms Cairnie will be in a position to rebuild bridges with the MoD.

[9] https://www.gov.uk/government/publications/mod-ministerial-gifts-hospitality-travel-and-meetings-january-to-december-2018

Conclusion

When Ms Cairnie's appointment was announced, analysts at Stifel wrote in a research report: "We view Mrs Cairnie's appointment as a necessary but small step in Babcock's journey to becoming trusted again by the City… We believe shareholder value can be created but without change, the stock is going nowhere, or even further down, and this situation is not sustainable."

We agree.

Ms Cairnie needs to overhaul her executive team and find a new CEO and CFO. She needs to refresh her Board, starting with Sir David Omand – the senior independent director who is also no longer independent under the UK Corporate Governance Code (he has been a board member for 10 years). We encourage Ms Cairnie to simplify Babcock's unnecessarily complex structure and ditch the accounting tricks and obfuscations, which contribute to distrust of the company's finances.