The Boatman Capital Research

Babcock International: Burying the Bad News

Ticker: BAB.LN
Date: October 2018
Price: 672p
Market Capitalisation: £3.39bn

Our investigative team has been researching Babcock International, a London-listed defence and outsourcing company, for the past six months. We have reviewed hundreds of pages of company accounts, government documents and have interviewed numerous sources in the defence sector.

In our opinion, Babcock has systematically misled investors by burying bad news about its performance. We believe that Babcock's senior leadership team – specifically the chairman and chief executive - are not up to the job and their failings will damage the company's future prospects.

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Our Thesis:

Since the outsourcing sector's problems were exposed so brutally last year, Babcock International (BAB.LN) has been strenuously telling the market that it is not another Carillion or Capita. We agree, it is a much better company than that with some impressive capabilities.
But…
Based on an intensive six-month investigation into Babcock, we believe that the company has buried a lot of bad news and it faces potentially massive exceptional costs, revenue pressure and declining margins in its core business.

1. Babcock's largest customer is the UK's Ministry of Defence, which accounted for 38% of revenue last year (about £1.8 billion). Despite the importance of the UK Government as a customer, relations between Babcock and the MoD are terrible.
We understand that Archie Bethel, the chief executive of Babcock, was recently kicked out of a meeting with the Secretary of Defence Gavin Williamson. On another occasion, Bethel and his chairman, Mike Turner, were summoned to the MoD for what one source described as a "bollocking" over their company's poor performance. The executives were told to come up with remedial measures or face the consequences.
We also understand that a senior Royal Navy Admiral told a conference of officers last year that he was determined to give Babcock a 30% haircut on its naval contracts, which are the company's largest and most lucrative.

- **The breakdown in Babcock's relationship with the MoD is a fundamental threat to the company's future. Billions of pounds of revenue are at risk if Babcock fails to win back trust.**

2. The issue that has most annoyed the Ministry of Defence about Babcock's performance is a delay to construction of a submarine dry dock at the Devonport naval base, which is managed by the company. The MoD blames Babcock for the delay and related cost overruns. We understand that discussions have taken place between Babcock and the MoD in relation to the company shouldering some, or all, of the cost increase. We think Babcock will have little choice but to accept some sort of penalty as the new drydock will unlock more than a decade's worth of future submarine business for the company.

- **Based on the limited public disclosures so far, we estimate the cost overrun at £200 million and rising. If Babcock is forced to eat half that, it would be the equivalent of a 25% reduction in pre-tax profits. Investors have been told nothing about this problem.**

3. Another issue that has infuriated the MoD is Babcock's performance in upgrading the Warrior light tank. Babcock is part of a consortium with Lockheed Martin on the £1 billion project. The delays and cost overruns to the Warrior CSP project have led to it being classed as "unachievable" by a UK Government watchdog and there has been speculation in the defence press that it will be cancelled.

- **Lockheed Martin took a $65 million impairment charge on the Warrior CSP project in its Q2 results. But Babcock hasn't even mentioned this problem to its investors.**

4. The organic growth in Babcock's core business has been poor for at least a decade. To compensate, the company has bought a series of new businesses - often overpaying for assets that subsequently underperformed. Management's failure to substantially increase revenue in its core business has now created a crisis at Babcock's Appledore shipyard, which employs 226 people. Appledore has been building ships on the coast of North Devon since 1855 but it has now run out of work. The subsidiary accounts for Appledore Shipbuilders (2004) Ltd show that at the end of March 2018 the yard had orders of just £5.55 million.

Babcock is now bussing workers to its other facility at Devonport, a four-hour daily commute. The GMB trade union has launched a campaign to save the yard after claiming that Babcock recently lost a contract to build an offshore patrol vessel for Malta. We understand that Babcock has tried to strong-arm the UK Ministry of Defence into putting more work into Appledore with a threat to close the yard. It seems unlikely that this tactic will work given the toxic relationship between the MoD and Babcock's senior executives.

Babcock's recent actions certainly suggest it may be preparing to shut the business down, drawing dividends from the subsidiary of £6 million and £5 million in the last two years. This has cut the subsidiary company's retained earnings from £11.7 million to £2.9 million. Just as a crisis looms for Appledore, Babcock has raided the piggy bank and left it with almost nothing.

- **If Appledore does close, we estimate that Babcock will have to buy out the remaining six-year lease on the facility at a cost of £708,000 a year. In addition, Babcock is likely to face significant penalties for dumping its lease as well as redundancy payments and pension contributions for the workforce. We estimate that closing Appledore could cost Babcock up to £20 million, equivalent to about 5% of profits.**
- **Closing Appledore would also sink Babcock's ambition to win some future naval construction work including the Type 31e frigate. And it would further sour relations with the Government. It is worth noting that the Member of Parliament for Appledore is Geoffrey Cox, the UK's Attorney General.**

5. The UK Government set up a body called the Single Source Regulations Office (SSRO) four years ago to determine acceptable profit margins on non-competitive defence contracts. According to the MoD, about 50% of Babcock's contracts are non-competitive. The average profit margin permitted by the SSRO last year was 8.47%. Babcock's margin in its Marine division, which is heavily weighted towards MoD naval contracts, was 13.1% last year.

- **Based on a very rough estimate, we calculate that if the SSRO was to impose an average margin of 8.47% on Babcock's Marine division, it would wipe £52.9 million from company profits. That is the equivalent of 13.5% of group profits.**

Babcock insists that the SSRO will not impact its business and says it cannot work out why people think this could be an "Armageddon" issue. It seems to us that the entire purpose of the SSRO is to reduce margins so we don't understand Babcock's confidence that it, of all companies, will be spared any impact.

- **When Babcock announced its full-year results for 2017/18 on May 23rd, the company put a slide in its presentation deck that showed a margin forecast of 11.85% for SSRO contracts. Shortly after publishing the results, Archie Bethel, the CEO, held a conference call with analysts during which he admitted that Babcock never got a margin of 11.85% from the SSRO. The slide was nonsense and an apparent attempt to mislead investors into thinking that the SSRO would have little impact on profit margins.**

Single Source Regulations Office

Contract profit rate steps	2018/19 Rates	Babcock Commentary
Baseline profit rate (BPR)	6.81%	
Cost risk adjustment: +/-25% x BPR	+/- 1.7%	No cost reimbursable contracts Expect close to +25% x BPR
SSRO funding adjustment	-0.024%	
Incentive adjustment	Up to 2.0%	Typically at the top end
Capital servicing adjustment	Average 1.36%	
Maximum CPR	**11.85%**	**Before shared cost savings**

Source: www.gov.uk SSRO 2018 contract profit rate

The slide also showed Babcock expected to be awarded incentive payments, which would increase its permitted profit margin by 2%. Bethel confirmed this number during the May 23rd conference call. What the company neglected to mention was that the incentive payment is "exceptional". Last year, just 16% of contracts got an incentive award and the average bonus was 0.29%.

- **We note that the SSRO incentive award is discretionary and is awarded by the Secretary of Defence – a man so infuriated by Babcock's recent performance that he reportedly kicked the CEO out of a meeting. Good luck getting that 2%.**

6. We believe that Babcock's problems stem from poor leadership. **Mike Turner has been the chairman for 10 years and can no longer be considered independent under the UK's Corporate Governance Code.**

Turner was previously the CEO of BAE Systems and is remembered for strategic disasters such as selling the company's 20% stake in Airbus for €2.75 billion (now worth more than €20 billion). He used the Airbus money to buy Armor Holdings, which was written down three years later by nearly £600 million. Turner also had a toxic relationship with the MoD and the situation got so bad that BAE's chairman eventually ousted his CEO to prevent more damage being done.

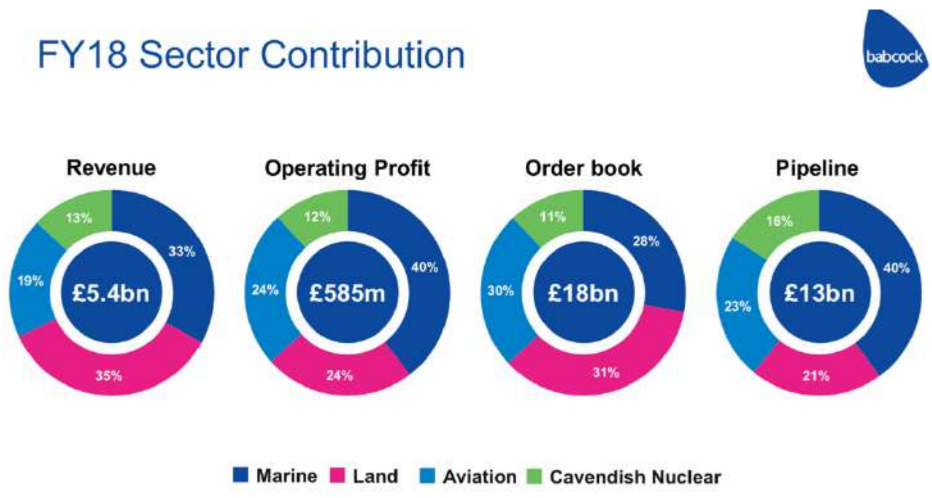
- **Turner's legacy at BAE was bad deals and a bad relationship with the MoD. He has done exactly the same thing at Babcock. Change is needed.**

Background

Babcock International was founded in 1891 and for more than a century it built a reputation as one of the UK's leading engineering companies. Babcock has retained that heritage and the core of the business continues to be built around complex engineering. For example, Babcock is responsible for refuelling the Royal Navy's nuclear submarines, is involved in maintenance of the UK's aircraft carriers and it is decommissioning nuclear reactors.

Our feedback from industry was that Babcock has traditionally been viewed as a dull but reliable partner – exactly the qualities needed for an engineering company involved in nuclear and military activities. However, in recent decades Babcock has expanded into support services such as vehicle fleet management for airports and emergency services as well as facilities management. Babcock, a FTSE 250 company, is now listed in the "support services" sector. As a result, Babcock has been subject to scrutiny following the collapse of Carillion and the difficulties of other sector peers such as Capita and Serco.

Babcock recently reorganised its business into four divisions: Marine, Land, Aviation and Nuclear. Of these, Marine is the most important contributing 33% of revenue and 40% of profits. Land contributes 35% of revenue and 24% of profits. Babcock operates in 25 countries but the UK accounts for 72% of group revenue.



Source: Babcock International Annual Results Presentation May 2018

Babcock: A Failure of Leadership, Poor Customer Relationships

It is our view that Babcock International is badly led and this has resulted in poor relations with the company's primary customer; poor governance and poor growth. This lack of leadership is driven from the top, specifically chairman Mike Turner and chief executive Archie Bethel.

The Chairman

Mike Turner joined Babcock from BAE Systems, where he had been chief executive for six years. Turner spent much of his tenure as BAE's CEO dealing with allegations of corruption against the company and he was even detained[1] by the US Department of Justice during its investigation. BAE eventually settled the corruption allegations after Turner had gone and the company paid $450 million in penalties[2].

Turner's time at BAE was also marked by some poor strategic decisions, such as selling the company's 20% stake in Airbus for €2.75 billion. That stake would be worth over €20 billion now. Turner used the Airbus cash to fund the $4.1 billion purchase of Armor Holdings in 2007. This turned out to be another bad decision and three years later, BAE was forced to write down £592 million from Armor Holdings' value[3].

But Turner is best remembered at BAE for the terrible relations that the company had with its primary customer: the UK Ministry of Defence. BAE had long been nicknamed "Big And Expensive" by the MoD but under Turner relations soured. The situation got so serious that BAE's chairman, Dick Olver, refused to give Turner a new employment contract and Turner was forced out of the company[4].

After BAE, Turner joined Babcock as a non-executive director in June 2008 and he became chairman in November 2008[5]. That means Turner has been chairman of Babcock for 10 years despite the UK

[1] https://www.theguardian.com/world/2008/may/18/bae.armstrade
[2] https://www.ft.com/content/8134d35a-126a-11df-8d73-00144feab49a
[3] https://www.theguardian.com/business/marketforceslive/2010/feb/18/baesystems-loss
[4] https://www.theguardian.com/business/2007/oct/21/observerbusiness.businessandmedia1
[5] https://www.babcockinternational.com/Who-We-Are/Leadership-and-Governance/The-Board/Mike-Turner

Corporate Governance Code stating that a chairman should hold the role for no more than nine years. **Turner can no longer be considered an "independent" chairman.**

> 19. The chair should not remain in post beyond nine years from the date of their first appointment to the board. To facilitate effective succession planning and the development of a diverse board, this period can be extended for a limited time, particularly in those cases where the chair was an existing non-executive director on appointment. A clear explanation should be provided.

Source: UK Corporate Governance Code 2018

Turner's legacy at BAE was a series of bad deals and a bad relationship with the MoD. It is hardly surprising that a similar story has played out at Babcock.

The Chief Executive

Archie Bethel became the boss of Babcock in 2016[6] following the retirement of Peter Rogers, who had run the company for 13 years. It was Rogers who was the architect of Babcock's acquisition-led growth strategy and many of the company's current problems stem from this ambitious period. Bethel has shown little evidence that he is getting to grips with the problems left by his predecessor and his relationship with the MoD is terrible (see below). Defence sources we consulted believe that Bethel is simply not up to the job.

Babcock and the Ministry of Defence.

For years, the Ministry of Defence loathed one company above all others: BAE Systems. But it appears that Babcock has seized this unwanted accolade and the company's terrible reputation in Whitehall is now widely discussed in the defence sector.

This should be a matter of serious concern for Babcock's shareholders because the MoD accounts for 38% of the company's revenues, equivalent to about £1.8 billion last year. Babcock's work for the

[6] https://www.babcockinternational.com/Who-We-Are/Leadership-and-Governance/The-Board/Archie-Bethel

Royal Navy is particularly lucrative and the 13.1% margin achieved by the company's Marine division last year was driven largely by MoD contracts. The Marine division's profits underpin the performance of the whole business.

But the relationship between Babcock and the MoD is in a terrible state. Defence sources told us that Archie Bethel, Babcock's chief executive, was recently kicked out of a meeting with the Secretary of State for Defence, Gavin Williamson.

Both Bethel and Mike Turner, the chairman, have been summoned to the MoD in recent months for what one of our sources described as a "bollocking" over the company's multiple failures. They have been told to come up with remedial measures or face the consequences.

A breakdown in relations between the MoD and Babcock has been confirmed by multiple sources. One industry executive said: *"It's got to the point where MoD is going to get ugly with them."* Another said: *"The company is seen as lazy and lacks innovation. They seem not to be satisfied with a near-guaranteed pipeline of work but are always asking for more profit."*

We heard from another source that a senior Royal Navy Admiral told a gathering of officers at a leadership conference last year that he was determined to drive a better bargain from Babcock. The Admiral is reported to have said that he wanted Babcock to take a 30% haircut on its naval business. [We think this might be a reference to the impact of profit margin guidelines introduced by the Government for certain suppliers. Our estimate suggests that these guidelines could cut Babcock's Marine margins by about one-third, which would be in line with the Admiral's threat. See SSRO section later.]

Based on our research, we understand that there are two issues in particular that have infuriated the MoD about Babcock's performance: Devonport and the Warrior programme.

Devonport

Babcock operates the Devonport Naval base on behalf of the Royal Navy – it is one of the company's most important contracts. Babcock is also responsible for the repair and maintenance of the UK's fleet of nuclear submarines, which is also largely done at Devonport.

The Royal Navy's new Astute-class nuclear subs are too large to be fixed in Devonport's existing dry docks so new facilities are needed. Similarly, the planned Dreadnought class of submarines, which will carry the UK's nuclear deterrent, will also need new drydock facilities at Devonport.

According to a National Audit Office[7] estimate published last year, the cost of these new facilities at Devonport will be £884 million. But things appear to be going wrong. The first hint that all was not well at Devonport came in a report by the Sunday Times[8] last year, which claimed that the timeframe for completing the new Astute dock had slipped by at least a year already.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Navy faces subs repair crisis

John Collingridge

March 26 2017, 12:01am, The Sunday Times

Construction of the dock is estimated to cost £1bn but is at least a year overdue, insiders say

ANDY BUCHANAN/AFP/GETTY IMAGES

Further problems came to light in July this year when Julian Kelly, who is responsible for the Nuclear Estate, gave evidence to the UK Parliament's Public Accounts Committee. Kelly said: *"The issue has been nailing down the plan for a nuclear-licensed dock to do the Astute mid-life refit… We are now fast narrowing down what the options are and are clear it will require additional investment."*

Kelly quoted a bill of £1.1 billion for the new infrastructure, £200 million more than the NAO report just a few months before.

According to our sources, the MoD blames Babcock for most of the drydock delays and cost overrun. We were told that discussions between Government and Babcock have taken place over who will pay for the delays. The MoD wants Babcock to shoulder the overrun cost, Babcock disagrees.

The problem for Babcock is that the company is heavily reliant on the MoD for work and the new drydock is needed for the company to win future submarine maintenance work. We therefore think it is inevitable that Babcock will shoulder some of the overrun cost – the long-term opportunity cost is simply too great for it not to pay up.

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7 https://www.nao.org.uk/report/the-defence-nuclear-enterprise-a-landscape-review/

8 https://www.thetimes.co.uk/article/navy-faces-subs-repair-crisis-fx75sl776

Based on the small amount of information that has been revealed so far, a 50:50 share of the current overrun would cost Babcock about £100 million – equivalent to 25% of pre-tax profits last year.

Babcock has made no provision for this outcome and has not even mentioned the problem to investors.

Warrior CSP

The Warrior Capability Sustainment Programme (CSP) is a project to upgrade the British Army's fleet of Warrior light tanks. The upgrade contract was awarded to a consortium led by Lockheed Martin in 2011 and is worth about £1 billion.

Babcock, via its DSG subsidiary, is responsible for the vehicle's hull but the project is not going well. The UK Infrastructure and Projects Authority, a government watchdog, downgraded the Warrior CSP project to "unachievable" in its latest report, prompting speculation that the programme could be axed[9]. The project is years behind schedule and is overbudget.

Lockheed Martin said in its Q2 2018 financial results[10] that it would be taking a $65 million impairment charge due to problems with Warrior CSP. Babcock has made no impairment provision.

increases were partially offset by a decrease of $50 million for tactical missile programs primarily due to a charge recorded in the second quarter of 2018 of approximately $65 million for performance matters on the Warrior Capability Sustainment Program, which relates to designing, developing and installing an upgraded turret. Adjustments not

Source: Lockheed Martin 2018 Q2 Results

The Times, The Telegraph and Janes, the defence journal, have all written stories about serious problems with the Warrior project but Babcock has told its investors almost nothing. It its latest Annual Report, Babcock made only passing reference to Warrior: "We continued our work building the Warrior Capability Sustainment Programme demonstration vehicles for Lockheed Martin."

[9] https://www.janes.com/article/81687/warrior-capability-sustainment-programme-at-risk
[10] https://www.prnewswire.com/news-releases/lockheed-martin-reports-second-quarter-2018-results-300685151.html

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Land Platforms

Warrior Capability Sustainment Programme at risk

Samuel Cranny-Evans, London - IHS Jane's Defence Weekly

11 July 2018

As usual it seems, Babcock has preferred to bury the bad news.

Babcock: Poor Growth

For the past 10 years, Babcock has pursued a strategy of buying growth. The company's underlying organic growth has been minimal, as demonstrated by the low-single digit forecast for this year. The poor organic growth has been masked by acquisitions, although as previously noted many of these assets have performed badly under Babcock's subsequent management.

The failure of Babcock's senior leadership team to win new business means that some of its assets face an uncertain future. We will look here at Appledore and other non-performing parts of the business will be looked at in future research.

The Appledore Shipyard

The Appledore yard in North Devon has been building ships, boats and yachts since 1855 but the future of the facility is in doubt because Babcock, the current operator, has failed to win new business for it.

The workers at Appledore recently finished construction of an offshore patrol vessel for the Irish Navy but since then there has been almost no work at the facility.

According to company accounts for Appledore Shipbuilders (2004) Ltd., a Babcock subsidiary, by the end of March 2018 the yard had orders worth just £5.55 million – only a few months of work.

Order Book	**£5.55m**	£29.0m	Includes total value of signed contracts and prudent estimate of value of framework contracts. Decrease in order book reflects completion of work in relation to the fourth OPV in 2018. The Company should be well placed to benefit from future opportunities in the UK and international defence markets in relation to this sector.

Source: Appledore Shipyards (2004) Ltd. Company Accounts.

The collapse in orders at Appledore has prompted considerable concern in the local press and among trades unions representing the 226-strong workforce. Given the headlines below, investors may be surprised that their company's management has not been more open about these issues.

North Devon Gazette

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Union claims future of Appledore Shipyard is 'on a cliff edge'

Sarah Howells sarah.howells@archant.co.uk Read more from Sarah Howells

July 27, 2018 Updated: Monday, July 30, 2018 (11:59)

News ▸ Devon News ▸ Employment

Union says closure of Devon shipyard would be 'devastating' and urges Government to 'stop playing with people's jobs'

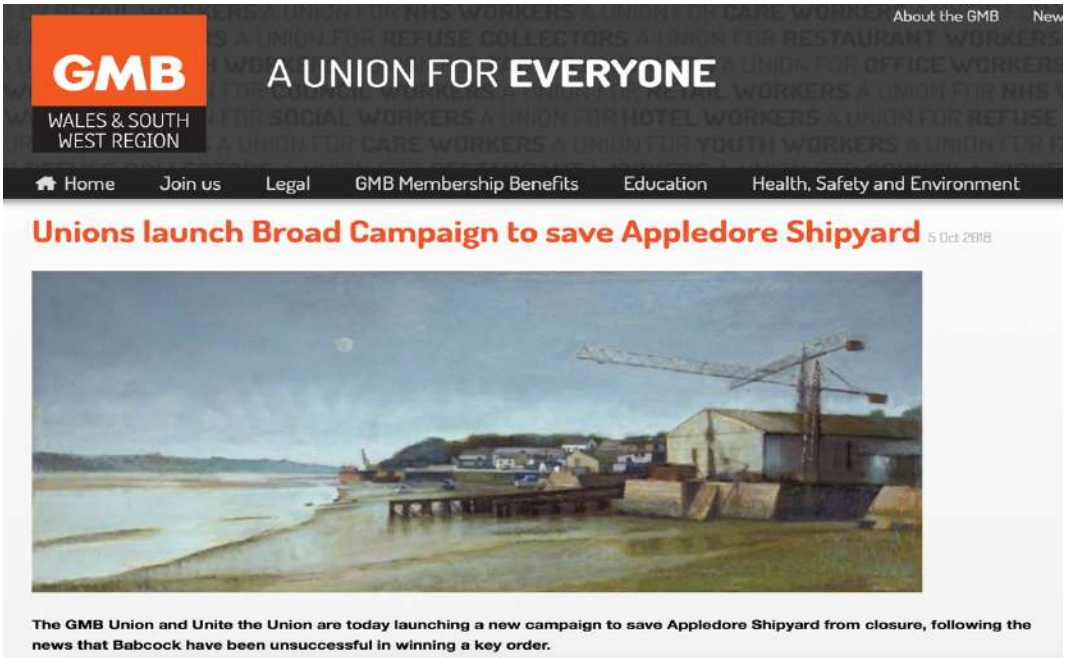
"The government needs to stop playing with people's jobs"

SHARE 1 COMMENT By Joel Cooper Chief Reporter 11:55, 27 JUL 2018 UPDATED 09:24, 30 JUL 2018 NEWS

With no work at Appledore, Babcock has been bussing employees down to its other facility at Devonport. This has kept the staff occupied but has imposed a four-hour daily commute on them.

Babcock has said that these desperate measures are being taken while it seeks additional work for Appledore. However, we doubt that Babcock will be able to get new work into Appledore in the foreseeable future.

Babcock had been competing to win export orders for offshore patrol vessels from Malta and Ghana but the GMB trade union has reported that the company lost the Maltese contract to an Italian shipyard. The Ghana project also seems unlikely to happen, according to our sources. This crisis has prompted the GMB to launch a campaign to try to save the yard[11] and the jobs of the 226 people working there.



With minimal export opportunities, Babcock is reliant on the MoD but there appear to be only two pieces of government work that the company could win - and both are years away.

The Royal Navy's MARS Fleet Tanker support vessels are to be built in South Korea and Appledore is slated to do the fit-out work, although this will not be until about 2022 at the earliest. Appledore is also part of Babcock's consortium for the Type 31e frigate competition but there is no guarantee the company will win this work – or even that the project will happen. Babcock is up against BAE Systems for the Type 31e and it is unlikely there will be any construction work for whoever wins until the early 2020s.

It is clear that Appledore has had a problem for some time, although Babcock has kept its shareholders in the dark about this. In its most recent Annual Report, Babcock merely stated that

[11] http://www.gmbwalesandsouthwest.org.uk/news/article/unions-launch-broad-campaign-to-save-appledore-shipyard

the Irish vessel had been completed and was due for commissioning. There was no reference to the lack of future work in the yard or the potential impact this might have on the balance sheet or the workforce.

However, Appledore's problems can plainly be seen in the subsidiary company accounts. Revenue at Appledore has fallen nearly 30% in two years to £13.9 million and the workforce has also been declining. Despite this, Babcock paid itself a dividend of £6 million in 2017 and £5 million in 2018 cutting its retained earnings from £11.7 million two years ago to just £2.9 million.

With a crisis looming, Babcock's response has been to loot Appledore's piggy bank leaving it with almost no retained income. The worrying conclusion is that Babcock knows that Appledore is doomed and has pulled its money out of the operating company ahead of closure.

Babcock has admitted that it may need to cut capacity at Appledore but we believe the situation is considerably worse than the company is admitting. Not for the first time, Babcock is burying bad news.

Defence and trades union sources said that Babcock had tried to pressure the Ministry of Defence (MoD) into putting additional work into Appledore or speeding up future work (presumably the MARS project or Type 31e). The threat has been clear: give us work or we close the shipyard. Unfortunately, Babcock's stock is not high in the MoD and the cash-strapped ministry sees no reason to bail out the company given its failure to attract orders from overseas or commercial customers. Separately, we believe that Babcock and/or another party have engaged consultants to find a new owner for Appledore but with no success so far.

Babcock is in a difficult position because if its shuts Appledore it will struggle to win future Naval construction work, particularly the Type 31e frigate. This would significantly derail the company's ambition of becoming a diversified defence contractor rather than simply a maintenance and repair shop for the MoD.

Shutting Appledore would also have financial consequences (see below) but we believe the most damaging aspect to this situation is that it will further tarnish Babcock's already terrible reputation within the MoD and UK Government. **It should be noted that the member for parliament for the constituency that includes Appledore is Geoffrey Cox, the UK's Attorney General.**

Babcock took over Appledore in 2007 from KBR, a Haliburton subsidiary. KBR became involved in 2003/4 when the Appledore yard went into receivership due to a lack of business.

However, KBR only acquired a 20-year lease to operate the shipyard rather than buying it outright. Similarly, Babcock does not actually own Appledore, it merely rents the facility.

According to the UK Land Registry, the owner of the Appledore yard is Appledore Land Ltd., which is a subsidiary of Langham Industries – the owner of the yard before it went into receivership in 2003.

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Registered Owner(s)          : APPLEDORE LAND LIMITED (Co. Regn. No. 1098114) of
                               Bingham's Melcombe, Dorchester DT2 7PZ.
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As a result, Babcock only carries a nominal amount of assets in the Appledore operating company – just £85,000 in 2018. The company pays a lease of £708,000 a year, presumably to rent the facility and it had staffing costs of £7.7 million last year.

We believe there are three options facing Babcock and Langham Industries:

Option 1: Babcock shuts down Appledore

We estimate that if Babcock were to close Appledore it would need to pay out the remaining six years on the lease (£4.25 million) plus likely penalties for ending the contract. These penalties are unknown but are likely to be substantial given the nature of asset and the difficulty of finding new operators.

The cost of redundancy payments and pension contributions we estimate at about £10 million, although this could be reduced if Babcock can persuade workers to relocate to Devonport.

Therefore, we believe that walking away from Appledore could cost Babcock between £15 million and £20 million. This would represent approximately 5% of profits.

Option 2: Babcock puts Appledore into long-term care and maintenance

Babcock could mothball Appledore, which would enable the company to retain the facility if it wins the Type 31e frigate contract. Babcock would still need to pay the £708,000 a year lease and it would likely face significant redundancy payments for workers who refuse to continue their 4-hour daily commute to Devonport. Babcock would also face substantial costs when it tried to restart production at Appledore as the labour market in North Devon is not large.

Option 3: New Operator

It is possible, although unlikely, that Langham Industries and/or Babcock will find someone else to take over the Appledore lease. We understand that this is being considered but is not imminent.

Babcock: Burying Bad News

In our opinion, Babcock deals with its problems by burying the bad news. We think this is typical of a management team that are out of their depth and trying to paper over the cracks in their business. We do not think Babcock is another Carillion but we do think there are good reasons for shareholders to be concerned. Here are some of our concerns:

SSRO

The Single Source Regulations Office (SSRO) was set up by the Government to ensure that departments were getting value for money when they award non-competitive contracts. According to the National Audit Office[12], the SSRO has already contributed savings of £313 million for the Ministry of Defence and the political intention is for the agency's remit to keep expanding.
According to MoD data, half of Babcock's defence contracts are non-competitive and will therefore fall under the SSRO's remit once they are rebid. That means Babcock can expect to see downward pressure on margins for half of the roughly £1.8 billion in revenue it does with the MoD[13].
The average contract profit rate (CPR) permitted by the SSRO last year was 8.47%, compared to Babcock's 13.1% margin in its Marine division – which is likely to be hardest hit by the imposition of margin limits.
We note that the difference between 8.47% and 13.1% is roughly one-third. This is exactly what the Royal Navy Admiral quoted earlier said would happen to Babcock.
It is difficult to know exactly how Babcock will be impacted by the margin limits as they are determined on a per contract basis and some of the company's divisions will have more MoD work than others. But we can make an educated guess:
If we assume that 50% of the contracts in Babcock's Marine division are awarded on a non-competitive basis, that would mean the division's profits of £231 million last year could be cut by more than £50 million assuming the SSRO average margin. This would be equivalent to a 13.5% reduction in Babcock's total group profits.

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[12] NAO - *Improving value for money in non-competitive procurement of defence equipment.* Published October 2017

[13] MOD: *Finance and Economics Annual Bulletin.* Published Sept 2017

Here's the calculation:

50% of £231m = £155.5

Difference between 13.1% and 8.47% = 34%

34% of £155.5 = £52.9m

£52.9 as a % of group profits last year = 13.5%

This is obviously just a rough calculation but given the potential impact, Babcock's shareholders might have expected to hear a lot about it from their management. Unfortunately, not.

There was no reference to the SSRO in the company's most recent Annual Report and only one slide in the full year results presentation. The slide showed Babcock getting a maximum margin of 11.85%:

Single Source Regulations Office

Contract profit rate steps	2018/19 Rates	Babcock Commentary
Baseline profit rate (BPR)	6.81%	
Cost risk adjustment: +/-25% x BPR	+/- 1.7%	No cost reimbursable contracts Expect close to +25% x BPR
SSRO funding adjustment	-0.024%	
Incentive adjustment	Up to 2.0%	Typically at the top end
Capital servicing adjustment	Average 1.36%	
Maximum CPR	**11.85%**	**Before shared cost savings**

Source: www.gov.uk SSRO 2018 contract profit rate

In a conference call with analysts on 23 May 2018, Archie Bethel, the chief executive, insisted that the SSRO would not impact the company. He said that contracts worth about £100 million a year were coming under SSRO oversight and that from 2020 a further £500-600 million would be added because of the renegotiation of MSDF – the contract that covers Babcock's management of Devonport and Clydeport.

At least Bethel finally admitted that MSDF would be governed by the SSRO rules. We understand that Babcock had been telling analysts previously that MSDF would be excluded based on their own questionable interpretation of the rules.

Bethel made another strange confession on the conference call: *"So, I'll put there, a max of 11.85%, we do not on SSRO contracts make 11.85%"*.

So, Babcock published a slide on the morning of May 23rd showing what appears to be a margin forecast of 11.85% but then a few hours later Bethel admitted it was made up. What was the slide for if not to mislead investors?

"We never make the full amount, but we do make more than 10% and I don't expect that to change at all," Bethel added.

It certainly seems fair that Babcock should earn good margins on the complex engineering work it does, like refuelling a nuclear submarine. But what about facilities management contracts? That is not usually work that generates margins of 10%, at least in the civilian sector.

Bethel's confidence that Babcock will continue to get big fat margins from its defence contracts seems to run contrary to the entire purpose of the SSRO.

Babcock's shareholders might also be interested to know that the 2% incentive payment detailed on the slide above is discretionary. It is awarded by the Secretary of Defence in "exceptional" circumstances and the SSRO's own data[14] shows that average incentive payment last year was just 0.29% paid to just 16% of contracts.

Babcock's CEO is therefore banking on receiving a bonus that is awarded by a man who kicked him out of his office recently

"I don't know why it still has this prominence as Armageddon," Bethel said of the impact of the SSRO.

We are not saying it will be Armageddon. But this company has a habit of burying bad news and it would be helpful to shareholders to know exactly how the SSRO process will affect future profitability rather than relying on management's wishful thinking and misleading data.

Acquisitions

Babcock overpaid for its last three acquisitions: Avincis (helicopters), Defence Support Group and MacNeillie. Each of these businesses has performed below expectations since they were acquired and at least one - DSG - is loss making.

We think Babcock should have written down the value of these assets already because there is no way the company will recoup its investments. Instead, Babcock has bundled these companies into bigger divisions and then shuffled everything around. As a result, the company claims it does not need to take an impairment. Hiding problems will not make them go away.

Debt

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[14] SSRO - *Annual Qualifying Defence Contract Statistics 2017/18*. Published 12th June 2018

Babcock's management made a big deal out of reducing net debt by 5% to £1.11 billion in its annual results presentation in May. The message was clear: we are not drowning in debt like those other outsourcing companies. Unfortunately, the small print revealed that the company had actually raised £33.5 million more in loans than it had repaid last year.

Another accounting fudge was Babcock's inclusion of profits from joint venture enterprises in its earnings. But the company did not include an estimated £740 million debt that these joint ventures carry.

We note with concern the work done by other analysts that shows if Babcock were to include the JV debt and various other non-reported liabilities, the company's financial liabilities increase to about £3.3 billion versus a market capitalisation of £3.5 billion.

Disclosure

When Babcock released its full year results for FY17/18 in May, management were in full optimism mode. The Board was "confident" of achieving low to mid-single digit revenue growth and stable margins in the year ahead.

About six weeks later, Babcock came back to the market to revise that outlook. It now expects only low single digit revenue growth. The company blamed the revision on the introduction of the Government's new Submarine Delivery Agency, which is reviewing spending commitments (including presumably the Devonport drydock mess).

Given that Government moves at glacial speed we think it is very unlikely that Babcock could not have foreseen issues with submarine spending when it made its full-year presentation in May. Perhaps the company thought the impact would be minimal or perhaps management were hoping to dazzle investors while it had their attention and then slip out a downgrade in mid-summer when everyone was on holiday.

Something similar happened in February when Babcock issued another downgrade wedged between positive results presentations.

We would normally give a company the benefit of doubt over forecast changes because the world isn't a predictable place. But Babcock does appear to have a habit of telling investors as little as possible and then revealing bad news when it is too late.

Conclusion

Time and again during our research, we uncovered information that should have been in the hands of Babcock's investors. But management appears to prefer to bury the bad news.

None of the company's problems are insurmountable but Babcock needs to come clean and bring in new leadership capable of rebuilding the business.