Title of Meeting: Fiscal 2017 Quarter 2 Results Call

Hosted By: Kenneth Gregor

K. Gregor

Thank you, and good morning, good afternoon, good evening to everybody who's taking the time to join us today for the Jaguar Land Rover Q2 FY17 Financial Results Call.

Starting as usual on slide 4, I'll just talk through the highlights of the quarter. Retail sales were up 29%, at 142.5k units, compared to the same quarter a year ago, and that drove revenue higher up to £6 billion.

Profit before tax was £280 million, up from the loss that we had a year ago, primarily reflecting favourable volume and mix offset by higher manufacturing costs and some one-time costs. Unrealized FX and commodity hedge revaluation, which is primarily a non-recurrence of losses in Q2 FY16, and also, of course the non-recurrence of the £245 million provision that we made in the same quarter a year ago relating to the explosion at Tianjin.

Free cash flow is positive £70 million, which was after £784 million of investment spending, and that left us with continuing solid liquidity and balance sheet strength with cash and deposits of £3.8 billion and an undrawn revolving credit facility of almost £2 billion. We were pleased that Moody's also really did follow through on the upgrade, which we were hopeful of in the last call from Ba2 up to Ba1 during September following the upgrade that we got from S&P back in August.

And the point to note was that our China joint venture was profitable in the quarter, declared its first dividend, which will mostly be reinvested back into the joint venture. It's positive there in terms of development of that business.

On slide 5, I called out most of the key metrics on that slide already. So, it's really just the partner slide for the words I described.

On the sales graphs on slide 6, all regions were up in the quarter, US 39%, China up 49% year-on-year, with the UK and Europe up around 30% between them. Overseas was a tougher place to do business in the quarter with Russia, the Middle East, and Brazil all being tough markets for us, so, flatter growth there in the overseas markets.

And when you look at slide 7, it helps to provide some explanation for what's driving the sales growth, which was the strong growth we had in the all-new F-PACE we launched earlier this year, of which we had a full quarter of sales that was not there in the same quarter a year ago.

Also, the Jaguar XE was launched in the US this year, and so, you have volume growth in XE.

That wasn't all about Jaguar of what you can see there, we also have growth on the Land Rover side of the business in particular on the Evoque and the Discovery Sport, with the Discovery Sport reflecting the launch of the local product in China earlier at the back end of last year. So, year-on-year giving us good growth there on both sides of the business with product led growth really being the driver.

A little bit more texture on slide 8, I've already mentioned that the revenue is higher up from £4.8 billion. That's driven by two factors, one is the higher wholesale volume, which is up about 12%. The other is favourable foreign exchange, which is a significant driver in the revenue line also, because of the weakening of sterling that has happened following the Brexit vote in the UK.

The EBITDA was up to £615 million in the quarter, reflecting favourable volume and mix, favourable operating exchange offset by realized hedges, and unfavourable FX revaluation of current assets and liabilities, that's around about £58 million in the quarter, worth about 1 point of EBITDA margin.

We also have a one-time provision for new customer quality programs. That's also worth a point of EBITDA margin. And those effects together with the accounting affects if we were to adjust revenue for realized FX hedging losses included in EBITDA means that the reported EBITDA, which was 10.3%, would have been more like 12.9% on an underlying basis in the quarter.

Which then talks to the PBT, again up to £280 million from a loss a year ago reflecting that higher EBITDA, with the ins and outs I just described with year-on-year favourable unrealized FX and commodity hedge revaluation, mainly, the non-recurrence of negative adjustments in the same quarter a year ago.

I mentioned the China JV profits, which were £33 million. That's up £34 million. So, continued profitability within the China joint venture, which has been good to see. And all of that partially offset by higher depreciation and amortization, which is a feature we should expect to continue to see given the growing level of investments in the business and the non-recurrence of the Tianjin charge in Q2 last year.

Slide 9 talks to the cash flow that we saw in the quarter. Pleased with the cash flow performance of the business in the quarter with positive operating cash flow (after investment) of £70 million and a fair bit stronger than the same quarter a year ago. So, that was good to see in the first half, also, a lot stronger than the same first half a year ago. So, a solid performance on the cash flow front with the investment funded by the EBITDA, and the movement in working capital and non-cash accruals.

Our business is all about creating fantastic new cars and SUVs, which our customers love, and slide 10 talks to some of the exciting new developments that are happening at the moment. First off being that the all-new XF Long wheel base that has been launched in the China market. Production has started and we look forward to ramping up over the next couple of quarters. We saw a small number of sales in September, but I think that's one to look forward to over the next couple of quarters.

We announced at the Paris Auto Show in October the launch of the all-new Discovery, replacing the prior model with a new lightweight aluminium construction almost 500 kilos lighter than the prior vehicle with significant reduced CO2 emissions, but still with the flexible interior providing seven full-sized adult seats. At the present time, we expect wholesales to start in Q4 of FY17.

And also, without stealing my PR team's thunder, I'm very much looking forward to a major product reveal in advance of the LA motor show, today.

So, looking forward, as I said, our strategy is very clear, and continue to invest in new cars, technology, manufacturing capacity to enable us to grow profitably. We do think in FY17, our investment spending might be slightly lower than the prior indication of £3.75 billion, but we continue to move ahead with our investment plans.

And in that vein, we're going to continue to build on the success of our recent product launches, with the continued sales ramp up of the Jaguar F-PACE, the XF Longwheel base in China, the Evoque convertible, as well as the new models that I've just described, and others to be announced.

I'm confident that increasing sales of these new products, and the plan to start the new Discovery wholesales in the fourth quarter should drive profitable growth and support a solid second half to the year. We continue to have a balanced sales profile, which I think helps us as we navigate the external environment and the market conditions that vary in a number of our regions around the world.

So, with that, a quick tour through the presentation, I'm happy to answer a few questions on Jaguar Land Rover results for the quarter.

Coordinator	Thank you very much. We will now begin the question-and-answer session. [Operator instructions]. Please stand by for your first question. Your first question comes from the line of Richard Smith of Citi. Please go ahead.
R. Smith	Hi there. Good afternoon. Just a very quick one on—I'm trying to get my head around the kind of main drivers behind the relatively weaker margin and particularly given that if anything, the gross margin has actually improved slightly versus last years' comp. In terms of this, we're seeing increasing amounts in the other expense line, which now represents circa 25%+ of revenues, and you gave some indication that some of that would have been the provision on the quality programs, and also some FX. But can you be any granular with what makes up that number?
K. Gregor	Thanks for the question, Richard. The other expense line, and there are a number of elements running through that line, includes a couple of foreign exchange effects, one being the revaluation of current assets and liabilities that I described, which is £58 million in the quarter. But a bigger number is realized FX hedges in the quarter, which is negative £274 million in the quarter. So, the effect of our hedges, runs through that line. In fact, there's a backup slide, number 24, in the investor presentation that details out how much the foreign exchange effects are in the quarter. What I would say about that, just as a thought though, is remember that the foreign exchange hedging program is there to hedge our revenue exposures, and that £274 million is basically offset by more positive net revenue that we had in the quarter. And if you were looking at slide 24, you'd see that I called out the change year-on-year and operational exchange as being plus £251 million, and the change on realized FX hedges is about minus £258 million. So, the two items are offsetting, but you get the hedge loss in the other expense, and the revenue gain in the net revenue line. But that's part of the reason for why the other expense is such a big number in the quarter.
R. Smith	Okay, and can you give any more detail around the new customer quality programs? What do they involve, and to what extent? Are there likely to be further adjustments to this provision going forward? Or is it really kind of a one-off that needs to be taken now?
K. Gregor	It's a one-off to be taken now, because its a number of actions we're taking to address the quality of a number of our vehicles and to improve the experience our customers have. So, it's a one-off provision, but actually I wasn't going to talk anymore about the details in this call.

R. Smith Okay. Thank you.

Coordinator And your next question comes from the line of Kapil Singh of Nomura. Please go ahead.

K. Singh Firstly, on China, do you feel that profitability has come down from the levels we've seen for the last two quarters, if you could help us understand that? Secondly, how are cost from a foreign exchange perspective, affect our vulnerability in sales given that pound has seen further depreciation from an average of around $1.30 to somewhere around $1.20 kind of levels. If other things remain constant, how does it affect our margins and drop in sales as well? Thanks.

K. Gregor There are a number of moving pieces. I already talked at length about the hedges and the revenue side, but it's also the case that we source about half of our material costs for our cars in mainland Europe. So, the weaker pound does mean that the cost of the material cost of our cars have increased. Also, that's another effect that has happened in the quarter due to foreign exchange.

Although the number that I called out previously of the operational exchange, the quarter-on-quarter effect that I already called out to £251 million is a net number of the net positive on revenue, net of the higher material cost, giving us positive £251 million, compared to the same quarter a year ago, offset by the hedging losses.

And on the China joint venture, I think overall, actually, I'm feeling positive about the general direction of the China joint venture in 2016. It is the case that there's an ebb and flow of results quarter-to-quarter, but overall actually, we're quite pleased with the development of the profitability in the full year 2016 of the JV, and we have the XF Longwheel base to look forward to later this year and into next year. So, overall solid result from the JV.

K. Singh A small follow up, on the material cost side, did we see any significant cost inflation in the material cost?

K. Gregor I think, perhaps, not that's worth talking about. I mean, in my mind, I'm thinking about there are some commodity price movements that ebb and flow quarter-to-quarter, but not significant enough to justify calling out this quarter.

K. Singh Okay. Thanks.

Coordinator The next question comes from the line of James Maxwell of Henderson. Please go ahead.

J. Maxwell — Good afternoon. A few questions, the first one on the adjusted EBITDA margin guidance. I'll say EBITDA margin, you said, you would have had in the quarter, you talked 12.9%, which would infer an EBITDA around just short of £770 million versus the £615 million. You called out the customer quality program as an FX, which you spoken to like £50 odd million each. Where's the rest of it?

K. Gregor — Should I do your first question first? My memory's not that good. It's slightly technical effects in here. One of the effects of foreign exchange is to drive the revenue significantly higher. And that's being offset with FX losses, and so, one of the factors you have with the EBITDA margin is the denominator in the calculation of calculating the EBITDA margin is getting bigger, year-on-year.

If one would take the hedge losses that I already described, and applied them against the revenue, which is sort of matching the stronger revenue with the hedge losses, because one is driving the other if you like, then the reduced size of the denominator relative to the same EBITDA would be worth about half a point higher.

And the other two factors are the ones that you already described on the quality program worth about a point of EBITDA. One being the FX readout of foreign currency liabilities also being about a point of EBITDA, and so, the three things together would have given us an EBITDA that's around about 12.9%.

J. Maxwell — Okay. Thank you. It was a strong quarter in terms of volumes, and clearly revenues, I take it part of that is FX. Margins even on your adjusted figure, and now I guess a little bit on the disappointing side, I'm wondering whether you think we're transitioning to a new lower margin, whether it be the EBITDA or EBIT level going forward. What's your sense of what the business should be aiming for?

K. Gregor — I'll probably say two or three different things. One is quarter-to-quarter; I think one always expects to see some fluctuation in margins. And traditionally, the first couple of quarters of our financial year, if you look at last year, we're weaker than the second two quarters of our second financial year, because there are some seasonal factors and other things that tend to favour the second half of the year.

It's a case that our margins historically, outside of a couple of very strong years, have ranged between 14% and 16%. And we always did expect the margins to come down from the higher exceptional levels into that sort of range. Last year, in FY16 the full year margin was 14.2% or 14.9% if I adjusted for one-time factors and there is some seasonal quarterly variation in the margins.

So whilst we've never given formal guidance on margins, we continue to plan our business based on the historical range, and move forward with our new product launches, some of which I've talked about, and some of which I'll talk about in future calls. I'm confident that those new products, in the fullness of time, will enable us to have sustainable profitable growth, and that's what I look forward to.

J. Maxwell — Okay. So, do you think that a seemingly better second half would be reasonable? Is that your sort of expectation this year as well?

K. Gregor — Yes. I'm cautious not to give specific margin guidance, but in general, the second half is seasonally stronger than the first half in our business. So, all other things being equal, that's what I'm looking forward to.

J. Maxwell — Okay. And just moving away from margins, given the various noise that's been around for the last few weeks, with regards to capitalization of R&D, have you ever reviewed your policies there? Are you comfortable with the level of capitalization? Is there risk of any write-downs or of any intangibles on the balance sheet?

K. Gregor — The policies on the capitalizations are reviewed by the audit committee and the board, and we have full disclosure on our reporting accounts of how those work. So, I'm happy with them, and I really don't have anything to add beyond that.

J. Maxwell — Great. Thanks very much.

Coordinator — Thank you, and your next question comes from the line Amyn Pirani of Deutsche Bank. Please go ahead.

A. Pirani — Hi. Thanks for the opportunity. My question on the margins have been answered by you. But I was wondering that in the second half, what are the drivers for an improvement as Land Rover sales have been on the lower side in the first half?

K. Gregor — What I'm quite excited about is we have the launch of the all-new Discovery, with wholesales probably really starting to take effect in Q4, but I think that will help our second half. So, that's something to look forward to. And I'd just say, in the fullness of time over the next 18 months, just watch this space, because we have lots more exciting new cars and SUVs that we're going to be talking about over the coming quarters and years.

A. Pirani — And any big drivers regarding the mid-cycle refresh for the Range Rover and Range Rover Sport? What could be the timing for that?

K. Gregor — My PR guys really would give me a telling off if I start talking about items like that. So, I'd just like to say do watch this space. You can rest assured that we're very busily working on lots of exciting projects here at Jaguar Land Rover.

A. Pirani Thanks for the answers.

Coordinator Your next question comes from line of Sonal Gupta of UBS Securities. Please go ahead.

S. Gupta Hi. Good evening. Thanks for taking my question. Just in terms of Castle Bromwich, could you just talk about how you are seeing the response continuing for the F-PACE, and also, in terms of the capacity, ramp-up plans? I mean, how do we see the capacity ramp up? I understand the XE has been moved to Castle Bromwich. Could you just guide in terms of where your capacity is with these changeovers and how do you see that ramping up as well?

K. Gregor Yes. Couple of good questions there. I'm not sure I have all the details at my finger tips on the capacity, and this particular call might be a matter for a future discussion. But in general terms, I'm pleased with the development.

In terms of the F-PACE, the level of consumer interest and demand has been really positive this year. So, we look forward to building on that in the coming quarters. Yes, we have commenced moving production of the XE from Solihull to Castle Bromwich, where it will be built alongside the XF model, and that frees up some capacity at Solihull to enable more vehicles such as the F-PACE, which is built at Solihull. So, in terms of the overall development, I think it's pretty positive, and we can perhaps talk a bit more about the specific numbers in a future call.

S. Gupta I just have two more follow-ups to that one. So, one was on the F-PACE, you indicated that you have about three to four months global waiting for an average. Do you still have a global average waiting period?

And secondly, just a separate question on the XE, XF, and F-PACE sharing the same platform, are we seeing already the benefits of the platform consolidation, or do you feel that there's more to come over a period of time as these models ramp up?

K. Gregor Yes. In terms of the order bank for the F-PACE, it's still strong. So, I'm still pleased with it and in terms of the architecture planning of the way we engineer our vehicles, it is of course the case that we do work hard to drive a common approach to the vehicle architectures. So despite the fact that the vehicles can be very different for consumers there's some commonality of approach in platforms and significant components, such as the engines, the drive train, entertainment, which enables some efficiencies from the engineering and the development side to be achieved, as you rightly point out.

So, that's been a key part of our strategy going forward recognizing that we have less scale than perhaps some of our competition do. So, that is something that we will continue to move forward with. Yes.

S. Gupta — Okay. Thank you so much.

Coordinator — Thank you. Ladies and gentlemen, due to time constraints, no further questions can be taken. I now hand the floor back to Mr. Ken Gregor for closing comments.

K. Gregor — Okay. Thank you. Sorry, we started a bit late, but I was keen that we didn't finish too late. So, I really appreciate your interest and support for the Jaguar Land Rover business. Thank you.

Coordinator — Thank you. On behalf of Jaguar Land Rover, that concludes this conference. Thank you for joining us and you may now disconnect your lines.

[END OF CALL]