Rolls Royce Cleared for Take Off

When large engine manufacturer **Rolls Royce Holdings plc** (LSE:RR) announced its first half result a few weeks ago it was above expectations. Which is to say, it was somewhat less bad than we expected.

But the current result is not the main game here. Rolls has a blockbuster wide-body aeroplane engine on its hands—the Trent XWB, the monopoly engine option on the very popular new Airbus A-350 that first went into service early 2015.

Over the next decade, merely by fulfilling orders already placed, the company will grow production significantly. And more orders will follow. All those engines will generate juicy service revenues for decades to come. Future revenue growth is both attractive and unusually predictable at this company.

The main opportunities, and risks, for Rolls' shareholders revolve around expense management. If it can manage costs well, we will be happy shareholders.

There were a couple of interesting pieces of information in the recent profit release. One relates directly to what counts and another to how it's counted.

What counts

One of the main bull arguments for Rolls is that, in conjunction with the current ramp up in production, there's a lot of fat to cut.

That argument is one of the reasons we first bought the stock soon after the appointment of Warren East as CEO. East's former starring role at **ARM Holdings** (LSE:ARM) suggested he might be a great pick for the task at hand. In the year since, East seems to have grown increasingly confident in his role and the company's direction. One snippet from the results conference call might be indicative.

Rolls opened a new engine production facility in Singapore in 2012 to produce Trent 900 engines for the Airbus A380. They also moved production of the Trent 1000 engine for the Boeing 787 from Derby to Singapore, apparently to free up room for the Trent XWB production in the UK.

Recently, a team in Singapore has been focused on improving the efficiency of production of the Trent 1000 engine. That team has improved the lead time—total time of production of an engine—by 24%. It has also identified a further 17% of improvements to come. When all's done, the company will be able to produce these engines roughly 40% faster than before. That's a monumental leap.

While hard to quantify, improved lead times of that magnitude should result in an impressive fall in the unit cost of production—it means less labour per unit, less overhead per unit and more efficient use of resources overall.

Where this gets particularly intriguing is when East revealed that they think these lessons can be transferred to XWB production. He alluded to a targeted 50% fall in XWB production lead times. Such a dramatic improvement on such an important engine program would be profoundly good for the intrinsic value of the shares. Expected revenues won't change, expected costs will fall significantly. Paraphrasing East:

'If we can do this on the XWB, and it's already proven on the 1000, we're effectively doubling our capacity with no incremental operational costs, it's just materials. I've been hugely encouraged by this over the past 6 months'

Encouraged indeed.

How it's counted

The other piece of news revolves around the accounting, specifically the implementation of IFRS 15.

Earlier this year we described [Rolls Royce's accounting as a mixture of raisins and turds].

Rolls operates a version of the Gillette-model. Gillette is happy to sell razor systems for no profit because it makes so much profit on the blades it will subsequently sell you.

In the expectation that its long-term maintenance contracts will be highly profitable, Rolls sells its engines at an upfront economic loss. Through tricks of accounting, though, it doesn't report that loss at the time of sale. Instead, the upfront loss is spread over the life of the maintenance contract, meaning that there is a lot of accounting discretion involved in calculating any one year's profit and there are huge gaps between profit and cash flow.

That is going to change with the implementation of IFRS 15 from 1 January 2018.

Gone will be linked accounting that allows the company to report a profit on the upfront sale of older engine models despite actually losing money on the sale. It also appears to me that unlinked accounting as it's currently practiced—which allows them to report a zero profit on a loss-making engine sale—is gone too. Both the revenue and full cost of production should be recognised at the time of sale (meaning reporting a loss, if that's the economic reality). The changes also reduce the smoothing effect on long-term maintenance contracts, a topic for another time perhaps.

In short, from 2018 onwards, reported profit will much more closely track economic profit and cash flow.

This is potentially important for three reasons. First, it will make my life easier. Second, the 'accounting fog' is almost certainly part of the reason why the stock has been cheap over the past year or more. Better, less convoluted reporting might bring new interest to the company. And, third, improved accounting might create improved focus. When accounting rules allow a company to avoid reporting losses on the production of an engine, at least in the short run, is it a stretch to suggest that those losses might not receive their full attention? I think East is very cost-focused, but this might remove any remaining hurdle to a very sharp focus on efficiency.

It’s been a tough period for Rolls Royce on many fronts. But if management gets the big things right over the next few years, the ascent from here could be impressive.