FIRST LINE OF DEFENCE

QINETIQ'S TREASURY TEAM HAS WON ACCOLADES FOR HELPING TO RESTORE THE TECHNOLOGY COMPANY TO STRENGTH. GROUP TREASURER STEPHEN WEBSTER EXPLAINS HOW

In May 2010, defence and security company QinetiQ embarked on a journey to get its business back on track following two profit warnings in the preceding six months and the appointment of Leo Quinn as CEO.

Quinn, who had previously led banknote printer De La Rue, launched a 24-month 'self-help programme', a widespread cultural change initiative that aimed to improve competitiveness and transform the group from a public-sector offshoot to a more commercially focused business that was equipped to meet the challenges of the 21st century. It had been squeezed by government cutbacks on defence spending, and weighed down by its bureaucratic structure and civil service practices, an overhang from its days as an agency of the Ministry of Defence. QinetiQ recorded a £66.1m loss for the financial year ending 31 March 2010 (although underlying operating profit was £120.3m).

Like many companies, QinetiQ had enjoyed the good times of the previous decade, benefiting from an ever-growing defence spend, while not taking the necessary measures to establish the company as a commercial enterprise following its launch in 2001 and subsequent flotation in 2006. So when the recession – and government cuts in defence spending – followed, the pain it felt was acute. It had more UK employees than it could realistically support and they were still employed on civil service terms, meaning the cost of restructuring was significant. Some long-term employees, for example, had redundancy terms that would entitle them to a pay-out of up to three years' salary.

As the company couldn't afford to reduce the size of its UK workforce within the existing terms of employment, it had to convince its employees to change their terms of employment and accept new conditions. This meant convincing employees of the benefits of the self-help plan and ultimately around 75% of trade union members voted in favour of halving redundancy benefits. This, then, paved the way for restructuring and a £50m reduction in the UK cost base.

> Against a backdrop of restructuring, QinetiQ's treasury was charged with securing refinancing for the group's credit facilities

Against this backdrop, QinetiQ's treasury was charged with securing refinancing for the group's credit facilities. In 2010, QinetiQ had one large syndicated bank credit facility dating back to pre-flotation that was due to expire in 2012. But we were concerned that the facility was fairly restrictive and we wanted to replace it with a facility based on more normal

IT LESSON

Technology has played an important part in transforming QinetiQ's treasury over the past three years. Back in 2009, there was no connectivity between the different treasury platforms and other systems. Our main focus was on foreign exchange management and creating a straight-through process. We changed to 360T, an online trading platform, to process FX and have a bespoke interface that can upload data without the need to rekey. We have an interface with a Misys platform for matching trades between the business and its banks, delivering straight-through processing for all deals. We also make better use of SAP enterprise resource planning software to improve our treasury management, enabling us to move away from storing data in Excel files. The upshot of this is we have vastly improved visibility and control.

My advice for other treasurers is to be determined when developing new IT systems. You do encounter roadblocks and there are always complications. You have to be prepared to make brave decisions and bring in new systems that are more compatible with your processes. We consulted with our banks to see which systems they preferred and which they thought would work best.

Loan Market Association terms and conditions, while also extending the maturity. But the two profit warnings had caused market sentiment towards QinetiQ to turn and this was exacerbated by the fact that the company was highly leveraged. Its net debt was 2.5 times EBITDA, something that put it towards the cusp of the sub-investment-grade credits, limiting its attractiveness to lenders.

Together with David Mellors, our CFO, the treasury team took the strategic decision that it was better to refinance when the banks had capacity to support us. So in late 2010, we put out a request for proposal (RFP), inviting our existing lenders to bid for replacing QinetiQ's credit facility. We soon found that the principal banks that we used for our cash management were unable to help us, so we invited new banks to back the refinancing. These banks needed to have the capability to support QinetiQ in its principal locations: the UK, the US and Australia. For example, we approached Bank of America Merrill Lynch, where we had a long-established relationship, about refinancing the credit facility and we helped to arrange for the bank to have an opportunity to tender for the group's cash management business in the US. >

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QINETIQ IN NUMBERS

10,000+ is the number of QinetiQ's worldwide workforce

£122.2m was QinetiQ's net debt as at 31 March 2012, a reduction from £537.9m in 2009

£31.5m was the deficit in QinetiQ's pension scheme at 31 March 2012, down from £124.6m a year earlier

1,000+ is the number of defence contracts QinetiQ is working on at any one time

£1.5bn was QinetiQ's revenue in 2012

The refinancing was a great success: we secured a new £275m, multi-currency, five-year revolving credit facility. And because we had the support of an improved banking group, the terms and conditions of our credit facility were those of an investment-grade company and more in line with market practice than the terms of our previous credit facility. Ancillary business has been gradually realigned to the new banking group in recognition of those banks' participation in the new credit facility.

QinetiQ has never actually needed to draw on the credit facility since the company has

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been extremely successful since the self-help programme was launched. After its loss the year before, the group reported a pre-tax profit of £26.6m for the year ending 31 March 2011, followed by a £331.6m pre-tax profit for 2012 with the underlying operating profits more stable.

As part of its self-help programme, QinetiQ had focused on improving the general health of its balance sheet. At the end of 2009, its net debt was £500m, but by March 2012, this had fallen to just over £100m. A number of initiatives contributed to this, including the suspension of the dividend for 12 months. But the debt reduction has largely been driven by working capital improvements and a pan-QinetiQ focus on cash generation.

Once QinetiQ had generated more cash, we decided to use it to buy back approximately $300m in US private placement debt over a 15-month period from the start of 2011. We wanted to reduce the financial risk of the organisation when we had the cash available to us to do it and we hoped to position the company for the future with lower interest costs.

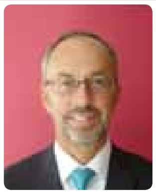
We invest cash almost exclusively in AAA-rated money market funds that produce low returns. We follow a cautious and prudent investment approach. This is not something that is likely to change in the forseeable future. Meanwhile, the mass downgrading of the major banks by the rating agencies has meant we have had to revise our rating policies and drop the rating thresholds of our counterparties. 'A' is the new 'AA' long-term rating, it seems. Nevertheless, rating remains our primary means of counterparty evaluation.

QinetiQ's drive to strengthen its balance sheet has not just focused on debt pay-down and cash management, but also on broader financial risks, including pensions and insurance. QinetiQ's treasury team plays a vital role in managing QinetiQ's financial risk profile. This includes its defined benefit pension scheme, which currently is marginally bigger in terms of liabilities than its market capitalisation.

TOP TIPS FOR WORKING WITH BANKS

- **Never take your banking relationships for granted. Take time to enhance those relationships and build trust with your banks. Remember that from the bank's point of view, you are the link to your company's organisation, risks and culture. A good relationship with a corporate treasurer gives comfort to a bank that is looking to provide credit.**
- **When approaching banks for credit, make sure that you're prepared well in advance and have a good strategy and pitch document.**
- **Don't be afraid to draw on your previous experience and contacts to create a new, strong banking group.**
- **Be open and transparent. Banks will be more likely to lend money to you if they have a genuine understanding of your company and objectives.**
- **Remember that the 'fit' has to be right in terms of capability and ancillary business, and the relationship goes two ways. Reach an understanding with your bank about the benefits of the relationship and set realistic expectations.**

Since the launch of the self-help programme, there has been a noticeable cultural transformation at QinetiQ. It has developed more of a commercial and competitive ethos. But it's a long journey and the intensity and pace of change has not slackened at all. The focus has now shifted to growing our sustainable earnings through an Organic-Plus programme, but the disciplines that we established during the self-help phase – including balance sheet strength and high cash conversion – will remain.



Stephen Webster is group treasurer at QinetiQ

In association with Bank of America Merrill Lynch

Bank of America Merrill Lynch

ABOUT QINETIQ

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QinetiQ uses its domain knowledge to provide technical support and know-how to customers in the global aerospace, defence and security markets. QinetiQ's unique position enables it to be a trusted partner to government organisations, predominantly in the UK and the US, including defence departments, intelligence services and security agencies. Among its customers are the US Department of Defense, the UK Ministry of Defence, the Australian Department of Defence, NASA and the US Department of Homeland Security.

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QinetiQ's origins lie within the national Defence Research Agency (DRA), an executive agency of the UK Ministry of Defence, which was formed through the union of several government research organisations in 1991. Four years later, it changed its name to the Defence Evaluation and Research Agency (DERA).

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In July 2001, the UK government divided DERA, then the UK's largest science and technology body, into two separate organisations. Around three-quarters of the employees and most of the facilities of DERA were transferred to QinetiQ, a newly-founded commercial entity, while the remainder went to the Defence Science and Technology Laboratory, a trading fund of the Ministry of Defence, to carry out work best done within government.

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Initially a wholly-owned government company, QinetiQ became a public-private partnership in February 2003 with US-based Carlyle Group being the equity investor. In February 2006, QinetiQ was floated on the London stock market.

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QinetiQ acquired 16 businesses in the US from 2003 onwards and in January 2008, it bought three defence companies in Australia.

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In 2008, the Ministry of Defence sold its remaining shareholding in QinetiQ for £257.3m. In total, the privatisation of QinetiQ generated £1bn of value for the UK taxpayer.

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In its mission statement, QinetiQ says: "Customers around the world rely on the ideas, innovations and drive of our people to help them meet their goals – often in environments where their mission has no second chance for success."