

**INTERIM RESULTS 2009/2010**

**FULL TRANSCRIPT**

**SLIDE – INTERIM RESULTS 2009/10**

**SLIDE – CAUTIONARY STATEMENT**

**SLIDE – PHILIP BOWMAN**

Ladies and Gentlemen, good morning and welcome to the interim results presentation for Smiths Group. I am joined by John Langston, our Finance Director. Most of you will have seen today's announcement that John is retiring after ten years with the Company. His successor will be Peter Turner, who joins us on 19 April as Finance Director designate. John will formally pass on the mantle at the end of May which allows appropriate time for an orderly transition. I would like to take this opportunity to thank John for his valuable contribution to Smiths Group. His counsel and knowledge of our multi-industry business has been particularly helpful to me over the last two years since I joined.

The divisional general managers and some of the corporate functional heads, who will join John and me in answering your questions at the end of the presentation, are seated in the front row. Ralph Phillips reminded me that he has made the trip three times from California for results presentations – without being asked a single question. I am sure I can count on at least one of you to remedy this for him today.

To avoid interference with the sound system, can I ask you to check that your mobile phones and blackberries are turned off?

I'd like to start by giving a brief overview of the results and some of the key achievements before asking John to present the detailed financials. Later I will review progress in each of the divisions over the past six months and set out priorities for the remainder of the fiscal year.

So turning to today's results.

## **SLIDE – BUSINESS HIGHLIGHTS**

These numbers illustrate just how effective our focus on operational improvement and restructuring has been despite very tough economic conditions.

Profit margins improved across all five businesses, and at 16.2%, reached a 10 year high - a notable achievement in the current environment. It reflects our continued focus on executing a range of cost-saving initiatives and a continued drive to raise operational efficiency.

This margin improvement has been achieved despite reported sales falling 1%; or 5% on an underlying basis. Headline operating profit increased by 12%.

Another strong cash performance pushed free cash-flow up 28% to £133m, as our sharper focus on working capital management continued to reap benefits.

In line with the policy we set out two years ago to rebuild dividend cover, the interim dividend remains unchanged at 10.5 pence per share.

## **SLIDE – RESULTS BENEFITED FROM KEY OPERATIONAL ACHIEVEMENTS**

We continue to make good progress against the priorities first set out some 18 months ago.

- Restructuring initiatives have delivered a further £10m in savings, taking the annualised total to £27m to date and these programmes, when complete, should produce annualised savings of some £50m by the end of next year.
- Portfolio profitability reviews have generated substantial improvements in pricing and margins, particularly in Smiths Medical and in John Crane
- Improved data systems are supporting our global procurement project which generated savings of £6m in the period, or cumulative savings of £15m to date and we are on track to deliver our targeted annualised savings of £20m by the end of the year.
- Better working capital management, particularly of inventories and debtors, and lower capital expenditure, have helped raise free cash flow to £133m. Headline operating cash rose sharply to £230m, representing 111% of profit. This improved cash flow is funding our investment in future growth.

- We have extended our portfolio and presence with two acquisitions – both in Interconnect, and I will cover those later.
- Future growth will be driven by our investment in technology and the launch of new products which can command higher margins and generate superior returns. To help drive this company funded investment in R&D rose 6% in the half year to £43m.

## **SLIDE – SAFETY IS DELIVERING CONTINUED IMPROVEMENTS**

Last September, I commented that providing a safe working environment should be a priority within any well managed company. Smiths Group has made good progress in recent years but there remain opportunities to do better. We have raised the topic of the management agenda with the Group Board and Divisional Boards reviewing our safety record at every meeting and in parallel, a process of continuous improvement allows us to explore how we can deliver further improvements. There are also financial benefits flowing from a safer working environment and we've seen a significant fall in workers' compensation costs over the past three years.

Now with that brief introduction I would like to hand over to John who will take you through the detailed financials. John...

JOHN LANGSTON:

Thank you Philip and good morning to you all.

## **SLIDE – INTERIM RESULTS 2010**

I'll start by reviewing some of the key financial numbers of the Group for the first half. Sales at nearly £1.28bn were down 1% on the prior year. The decrease came from a fall in underlying sales of £66m, which was partly offset by currency gains of £35m and the incremental benefit from acquisitions of £19m. On an underlying basis, sales were down 5%.

Headline operating profit at £207m was 12% up on 2009, benefiting from £5m of currency translation and £3m from the incremental impact of acquisitions. The underlying headline operating profit was 7% up, driven by a better performance in Detection and the benefit of the cost saving initiatives in all other divisions.

Headline pre tax profit of £178m was higher than last year on both an underlying and a reported basis, despite increased interest costs associated with the debt refinancing last year.

The headline tax rate was 24%, with headline earnings per share up 7%, to 34.7p. For the full year, we anticipate holding an effective tax rate of 24%, however, as I have said before, there is upward pressure on the tax rate which is likely to have an impact from 2011 onwards.

Also disclosed on the slide are the statutory numbers which take account of the items we exclude from headline measures. I will deal with these separately in a few moments.

The strong free cash flow is the result of a focus on working capital by all divisions.

#### **SLIDE – PROFIT PROGRESSION 2009 to 2010**

Looking at the profit progression, this slide really sums up the significant progress we have made on the various self-help programmes that Philip has outlined on a number of occasions. Looking at the profit progression between the two periods, you can see that volume declines in a number of divisions reduced profit by £34m. That was driven primarily by John Crane, however, the most striking point on this slide is the extent to which we have successfully addressed these declines through the swift and effective action to cut costs. Manufacturing efficiencies, such as value engineering and a move to low-cost countries, accounted for £15m of savings. We have successfully lowered our material costs by £9m, largely as a result of the Group-wide focus on leveraging our scale in procurements. Our restructuring programme and the transformational cost initiatives helped lower overheads and other costs to save another £15m. Even with a very challenging economy, we've been able to achieve some price improvements, mainly in John Crane and Medical which added £5m to the pre tax profit.

At the pre-tax level, foreign exchange provided a £10m boost to the reported profits before the increased financing costs, resulting in a pre-tax profit of £178m.

During the period, the average rate for the US dollar was almost unchanged while the Euro strengthened 6%. Let me remind you that a 1 cent move on the US dollar has an effect on profits of just over £1.5m; the Euro has an impact of just under £1m for every cent movement.

I'd now like to look at the financial performance in each Division. Philip will provide more colour on the market sector details as part of his operational review.

## **SLIDE – SMITHS DETECTION: STRONG GROWTH IMPROVING MARGINS**

Starting with Smiths Detection. You can see it delivered strong results following a tough year last year. Reported sales grew 14% to £266m and, at £39m, headline operating profit was 62% up on last year. Operating margin improved 430 basis points to 14.5%, which reflects the increased volumes and the associated improvement in recovery of factory overheads.

The £15m improvement in headline operating profits was largely a result of higher volumes which added £10m. We achieved some savings from manufacturing efficiencies which offset a slightly lower mix. We increased R&D investment by £1m and there was a £6m gain from a combination of transaction and translation effects of foreign currency.

## **SLIDE – JOHN CRANE: DELIVERING IMPROVED MARGINS**

Moving on to John Crane. Margins improved by 110 basis points in spite of the decline in sales. In line with our guidance, reported sales were down 9%, having benefited by £23m from currency and acquisitions. On an underlying basis, sales fell 15% reflecting a strong comparative period and lower capital investment by customers in a number of markets. Underlying headline operating profit declined 8% to £64m. The lower volumes reduced profit by £28m, however, this was almost made up for by operational efficiencies from John Crane's major restructuring programme and other initiatives which contributed £20m. We also achieved £3m of price benefit. Acquisitions added £1m of profit and currency gains another £2m.

## **SLIDE – SMITHS MEDICAL: SHOWING STRONG MARGIN IMPROVEMENT**

Smiths Medical saw reported sales 3% higher at £414m and headline operating profit 12% higher at £86m. The operating margin was 20.9%, some 180 basis points up on the prior period.

Underlying sales slipped 1% because of the exit from diabetes. Excluding diabetes, underlying sales rose 2%.

Headline operating profit increased by £9m. The reduction in volumes, which reflects the diabetes exit, reduced profit by £4m. Pricing initiatives, including actions taken as part of the portfolio profitability review, added £1m. A range of operational efficiency measures have contributed £9m of profit. Acquisitions brought an additional £1m of profit while foreign currency translation gains contributed £2m.

## **SLIDE – SMITHS INTERCONNECT: RESTRUCTURING DELIVERING MARGIN IMPROVEMENTS**

Moving on to Smiths Interconnect, where margins improved by 30 basis points to 16.0% as it benefited from the restructuring initiatives which began last year. Reported sales at £146m are 4% lower than 2009 and the headline operating profit at £23m is 2% lower. We have seen some delay to contracts on the Military side of the business, and continued weakness in both the wireless and industrial sectors, which has caused a volume impact of £6m.

Restructuring and other initiatives such as procurement savings have delivered £4m of additional profit, whilst foreign exchange contributed £1m.

## **SLIDE – FLEX-TEK: DRIVING COST EFFICIENCIES TO PRESERVE MARGINS**

Finally, Flex-Tek. Flex-Tek faced another six months of very challenging markets with declines in both sales and profit. However, increasing its margin by 10 basis points is, in my view, a very good result.

Headline operating profit fell £2m on the back of a 14% decline in underlying sales. The decline led to a volume impact of £6m, however, the procurement savings generated £2m of additional profit and their relentless focus on other operational efficiencies, including site rationalisation, supported another £2m of profit.

## **SLIDE – RECONCILIATION: HEADLINE OPERATING PROFIT/ STATUTORY PROFIT**

Let me now move to the reconciliation of headline operating profit to the statutory numbers.

The key differences between headline operating profit and statutory are exceptionals and amortisation.

Starting with the exceptionals. Further to the action we took last year to reduce the pension liabilities, we closed the UK-defined benefit pension schemes to any future accrual, and this led to £4m of exceptional gains.

A further £4m gain relates to proceeds from the sale of John Crane Automotive in 2007.

The £5m restructuring charge is the continuation of the programme announced in 2008. I will say more about this in a moment.

The remaining £5m relates to the John Crane asbestos litigation and comprises some £1m in respect of the litigation with the insurers, and the remaining £4m relates to an increase in the provision – in line with our normal experience. As you know, the adverse judgment provision takes a rolling 10 year view and the charge reflects the addition of a further six months.

The amortisation of acquired intangible assets of £19m is higher than last year, reflecting recent acquisition activity.

### **SLIDE – EXCEPTIONAL ITEMS: RESTRUCTURING PROGRAMME**

Moving on to the restructuring programme that we announced last year. We have incurred costs to date of £33m.

You will see that the current year has benefited from £10m of savings bringing the annualised savings to date to £27m out of the target of £50m.

We expect a further £7m of benefits to be delivered in the second half of this year and the remainder of the benefits will be delivered in 2011 in line with our original plans.

### **SLIDE – IMPROVED OPERATING CASH**

Turning to cash generation, which has continued to be strong. Operating cash flow was £230m. That represented a substantial increase on the £154m achieved last year with a conversion rate of 111% of headline operating profit. The improvement is a combination of both working capital management and reduced net capital expenditure. The lower capital expenditure mainly relates to the end of our investment in ERP systems, which have also driven a higher depreciation charge.

We achieved a working capital inflow principally as a result of the inventory reduction and improvements in trade receivables. Obviously, the volume reduction has had some impact but, notwithstanding this, I am pleased at the efforts that have been made across the divisions and which will continue in the second half.

## **SLIDE – NET DEBT INCREASED BY £30M**

You can see that the net debt increased by £30m to £915m over the six month period. This can be explained by the exchange rate movements. Free cash flow at £133m more than covered the final dividend payment of £92m, our acquisitions and financing costs. The financing costs of £20m includes a cash outflow of £25m on rolling over net investment hedges offset by £5m of cash from share options.

This is a particularly strong cash performance for the first half of Smiths' year.

Looking at the second half, we have recently sold the old head office building on Finchley Road, raising proceeds of £10.5m. This, coupled with continued strong free cash flow, will enable us to fund our investment in future growth such as the acquisition of Interconnect Devices or IDI, announced on Monday. We are also supported by a strong balance sheet, good credit facilities and a long-term debt maturity profile.

After the successful completion of IDI and assuming a US\$ rate of 1.50, I anticipate that the year end debt will be around £970m.

## **SLIDE – PENSION DEFICIT HAS REDUCED FURTHER**

Finally pensions. You will note that the pension deficit has reduced further from the £339m at the year end to £294m at the end of January.

As you can see from the slide, asset performance since July has been relatively good. It has more than offset the change in liabilities, which reflects lower discount and higher inflation rates. Finally, there was the £4m benefit in respect of the closure of the UK-defined benefit schemes.

Just to remind you, the finance income credit this year is expected be of the order of £1m.

At the year end, I commented that we had begun the triennial review with the Trustees of the UK Pension Plans. There has been a constructive dialogue which is still ongoing. We will let you know the level of future cash payments in due course once we have reached an agreement.

## **SLIDE – FINANCIALS: CONCLUSION**

Summing up, there are three key messages to highlight from the results.

1. They demonstrate the significant progress made with the “self help” restructuring programme which has helped to deliver enhanced margins.
2. We have continued to deliver excellent cash performance.
3. We have a strong balance sheet in place to fund future growth through investment in R&D and acquisitions.

So, all in all, a healthy platform for future growth and driving returns.

Now I will hand you back to Philip for his operational review of the Divisional performance.

PHILIP BOWMAN:

#### **SLIDE – PHILIP BOWMAN**

#### **SLIDE – OPPORTUNITIES TO CREATE VALUE**

Last September, I set out these priorities for the coming year. Our priorities in the second half of the year remain to push through the restructuring initiatives and operational improvements that are driving margin expansion and cash generation. We will continue upgrading our data systems and leveraging the Group’s scale in procurement. A sharp focus on better working capital management and cash generation is helping to fund our investment in future growth engines through a greater investment in new product development and in targeted acquisitions. Our recent acquisitions are expanding both our technologies and geographic reach, particularly in faster growing markets like China.

#### **SLIDE – OPERATIONAL IMPROVEMENT IS DELIVERING RESULTS**

The progress against these objectives is evident by these three metrics... margins; cash-flow and investment in R&D.

As I already mentioned, operating margin for the first half reached a ten year high. This chart shows margin progress over the past six years and highlights the improvement following the disposal of Aerospace in 2007 and the marked increase in the current period.

Cash conversion has also improved over recent periods and we continue to build on our recent strong free cash flow.

We have increased our investment in new product development to drive future sales growth and support the launch of new products that command high margins and superior returns.

I still believe there are considerable opportunities to drive operational improvements in Smiths Group and we remain committed to delivering these to improve returns for shareholders. However our attention over the next eighteen months will progressively turn to delivering sustainable growth in the top line.

After that summary, I would like to review the operational developments in each of the divisions starting with Smiths Detection...

#### **SLIDE – SMITHS DETECTION: SALES GROWTH AND MARGIN IMPROVEMENT**

Smiths Detection's performance showed a marked improvement over what was a relatively weak comparator period.

Underlying sales grew by 11%, driven by Ports and Borders and Military and only marginally offset by a slight decline in Transportation and other segments. Margins rose 430 basis points to 14.5% helped by higher volumes.

Sales in Ports and Borders grew by 92% as orders that had been delayed by constrained government budgets and the economic downturn came to fruition. The largest markets included Russia and Saudi Arabia where we sold 13 high-energy scanners for cargo inspection.

Military, with revenues up 30%, continued to be driven mainly by the roll-out of the long-term JCAD programme for advanced chemical point detectors.

Underlying sales in the transportation segment slipped by 5% mainly because of delays in orders to the second half of the year. However, there have been some good contract wins in the US, Canada and Australia. The repercussions of the Christmas Day bomb attempt over Detroit

are still being felt with demand for explosive trace detection systems beginning to increase as operating practices at airports evolve. We have also seen the deployment of body scanners in airports as the authorities have begun equipment trials. Our 'echo' device, which uses millimetre waves and shows real-time moving images, has now been deployed at Heathrow and is due to be installed in a number of other airports in the coming weeks. Our leading-edge technology in this field leaves Smiths Detection well placed to address the far-reaching changes to aviation security that are now taking shape.

## **SLIDE – SMITHS DETECTION: CONTINUING TO INVEST FOR THE FUTURE THROUGH R&D**

Strong investment in R&D over the years has helped Smiths Detection maintain its industry leadership. Company funded investment increased by 4% to £16m or 5.9% of sales. Customer funded projects brought total spend in the first half to £20m or 7.4% of sales.

Advances in X-Ray detection for a range of applications continues to be our main focus. In December we signed an agreement with Analogic to develop the next generation of high-speed systems for screening checked airport baggage for explosives. In simple terms, the device will harness the specialist strengths of both companies to produce a hybrid multi-energy X-Ray and three-dimensional Computed Tomography system. It is designed to combine unrivalled detection imagery with fast throughput. Development costs will be met through an increase in Smiths Detection's ongoing R&D investment over the next two to three years.

We have already received positive feedback on the detection capabilities, the small footprint and the ease of use of echo during its trial at Heathrow. We are now looking at further ways of addressing privacy concerns by developing "auto-detect" software that would effectively eliminate the need for most visual checks.

Diagnostics is another focus of our R&D efforts and we have just announced a collaboration and licence agreement with Novartis to develop unique, diagnostic tests for a range of serious clinical infections.

The agreement will leverage Smiths Detection's expertise in point-of-care DNA analysis and identification with the clinical trials capacity, regulatory experience and global market reach of Novartis Diagnostics.

## **SLIDE – SMITHS DETECTION: OPERATIONAL PRIORITIES**

Looking ahead, the operational priorities for Smiths Detection are:

- to continue implementing the cost reduction initiatives and introduce more flexibility into the cost base;
- to accelerate the trials and development of eqo in particular to meet the latest demands for aviation checkpoint security;
- to continue our investment in developing innovative new products; and
- to build on our recent contract wins in the high-energy cargo screening market.

Smiths Detection has enjoyed a positive start to the year. The order book is ahead of last year and should support continued growth into the second half - although there is always some uncertainty as to the timing of delivery and site acceptance testing (and therefore billing) for some of the major projects. Military sales, while strong, are likely to flatten in the second half due to the phasing of orders. Overall, a recovery in volumes will support further margin improvement.

Turning then to John Crane...

## **SLIDE – JOHN CRANE: MARGINS BENEFITING FROM RESTRUCTURING PROGRAMME**

The business delivered a 110 basis point increase in margins to almost 18% despite a 15% decline in underlying sales. This improvement stemmed primarily from savings generated by the global restructuring programme and better procurement.

The lower underlying revenues reflect both the late cycle nature of the business and the particularly strong comparator period the previous year. Sales of mechanical seals, seal support systems and couplings for OEM equipment declined 16% as customers' capital budgets continued to be heavily constrained. However, the aftermarket in oil, gas & petrochemical – the largest market – again proved more resilient with only a 2% decline in sales. Aftermarket business in other areas fell by approximately 12%.

Our position in the new product lines of bearings and filters has benefited from the acquisition of Orion which, with an increased presence in the US, has established John Crane as one of the leading manufacturers in the hydrodynamic bearings sector. In line with our strategy, these

products are now being leveraged through our existing global portfolio of sales and service centres and we are well placed to build aftermarket revenues.

John Crane Production Solutions, the upstream energy services business, won a major follow-on contract for pump repair services with Petrom for Romania's oil wells. This new contract began in December and is expected to generate annual revenues of some £14m. John Crane has worked with Petrom since 2007, delivering significant benefits in terms of increased output, increased reliability and lower costs.

### **SLIDE – JOHN CRANE: DRIVING EFFICIENCIES AND INVESTING IN FUTURE GROWTH**

The restructuring programme launched in 2008 to create one global John Crane is on track and is delivering sizeable gains. It generated £6m of savings in the first half, lifting the cumulative total to £12m. When complete in 2011, the project should deliver £25m in annualised savings.

Sales and service functions are now as close as possible to our customers and some manufacturing has been moved to low-cost centres in Eastern Europe, Asia and Mexico. Overall, customer service is faster and better.

Building on the eight new service centres we opened last year, a new service centre will open in New Zealand to support a new refinery contract. We have also significantly expanded and upgraded two existing service centres: one in Manchester, UK and the other in Houston, Texas.

We maintain our industry leadership through investment in product development – although much of this is customer funded. Our recent expansion of our bearing and coupling test capabilities will help speed the launch of new products, including the next generation of high-speed composite couplings. Other new products during the period included advanced seals for the enhanced oil recovery and carbon capture markets; energy-efficient bearings; and a sophisticated filtration valve capable of withstanding ultra-low temperatures.

### **SLIDE – JOHN CRANE: OPERATIONAL PRIORITIES**

Priorities for the remainder of the current year are:

- to push through the global restructuring and margin improvement programme;
- to continue expanding the footprint of our network of service centres, particularly in higher growth regions;

- to complete the SAP implementation outside the Americas by the end of July 2010; and
- to strengthen the business through further acquisitions that suitably complement our geographic footprint or portfolio of technologies.

In line with our previous guidance, John Crane has continued to grow its overall order book which signals a return to sales growth in the second half. However, second-half growth is unlikely to offset fully the first half weakness. Despite this pressure on sales, our cost reduction initiatives will continue to support margin expansion at the full year.

Turning to Smiths Medical...

### **SLIDE – SMITHS MEDICAL: DELIVERING POSITIVE SALES MOMENTUM AND MARGIN GROWTH**

The positive sales momentum achieved in the second half of fiscal 2009 has continued. Excluding the discontinued diabetes franchise, underlying sales grew by 2%. Margins expanded by 180 basis points, mainly reflecting cost-saving initiatives and the portfolio profitability review. By the end of October, we had successfully eliminated some 3,000 low margin, low volume SKUs. In parallel we have transitioned customers to alternative products, improving pricing and removing complexity from the business.

In Medication Delivery, revenues rose 6%. Sales of our next-generation ambulatory smart pump, CADD®-Solis, continued to grow strongly in North America and is gaining considerable traction in new markets.

Vital Care sales grew 1% mainly through a sustained turnaround in our temperature management franchise. We also benefited from increased sales in our respiratory products partly due to the preparations for the H1N1 flu virus. The tracheotomy business also performed well.

Our safety needle product lines gained from the vaccination programme for H1N1. However, overall revenues in Safety Devices were flat as catheter sales came under pricing pressure in some European markets and some distributors destocked.

## **SLIDE – SMITHS MEDICAL – 24-MONTH IMPROVEMENT PROGRAMME DELIVERING RESULTS**

Smiths Medical is in much better shape than when we began the improvement programme some two years ago. At that time, the supply chain was broken – we were losing customers because we could not deliver product on time. We also had to halt the ERP implementation and we had just experienced three major product recalls.

A lot of people have worked very hard to address these issues. A combination of the improved financial results and the fact that we are winning back customers shows that Srin's team have made very real progress. There are still many opportunities for further improvements but the business is off the critical list.

Customer back orders have fallen significantly from the peak in mid 2007 and on-time delivery is much improved.

Inventory turns have increased from 2.4 in 2007 to 3.4 – a statistic that compares favourably with our competitors. Steady improvement in this metric is targeted, with a goal of reaching 4 turns by the end of the 2011 fiscal year. This would place Smiths Medical firmly in the top decile amongst competitors.

The ERP implementation has been completed with nearly 100% of our sales going through the new systems. This is driving data-based decision making and highlighting additional opportunities for operational improvements and efficiency gains. The achievements we have made in rationalising SKUs, and the further steps in this programme that we are now working on would simply not have been possible without the data from the Oracle ERP system.

A further significant focus of our business improvement program has been value engineering and accelerated investment in new product development. A streamlined product development process has increased our success rate in generating sales from new product launches. The percentage of sales from products launched in the last three years has increased 53% since 2007.

## **SLIDE - SMITHS MEDICAL: INVESTING IN GROWTH OPPORTUNITIES**

We have made strong progress against this metric in the last six months, with a 21% increase in sales from new products. The more focused approach to R&D has clearly helped achieved this result.

We completed the global launch of a new, full range of convective warming blankets which has been well received in all of our key markets. Our new launches continue to meet or exceed expectations and we have extended the reach of a number of our products into new markets. These included the CADD-Solis pump and the UniPerc tracheotomy tube - among other products listed on this slide.

### **SLIDE – SMITHS MEDICAL: OPERATIONAL PRIORITIES**

For the remainder of this year, the key focus for Smiths Medical is:

- to exploit further gains from the SKU and customer profitability reviews;
- to continue to cut business complexity and reduce costs;
- a further increase in the investment in new product development in the second half and the launch of new products specifically targeted at growth markets; and
- Greater investment in sales and marketing to generate long-term revenue growth.

We anticipate the positive sales momentum will continue into the second half, although the exit from the diabetes franchise will constrain underlying performance to a similar level to last year. Margins will benefit from the price increases and cost reduction initiatives which will be partly offset by increased investment in new product development and sales and marketing.

Turning to Smiths Interconnect...

### **SLIDE – SMITHS INTERCONNECT: MARGIN IMPROVEMENT FROM RESTRUCTURING**

Despite lower sales, operating profit margins rose slightly to 16% as benefits from restructuring and procurement initiatives were delivered. Sales to military and aerospace customers declined by 3% due to a slowdown in the commercial aerospace sector and some slippage in military programmes for the second half of the fiscal year.

Ongoing military production projects remain strong to support a range of programmes such as electromagnetic pulse protection, secure communications systems and antennas for Unmanned Aerial Vehicles. In-flight connectivity has long been one of our key technologies and of

particular note is our new Ku-Stream broadband satellite antenna system which has been selected by Row44 and Southwest Airlines to provide in-flight applications such as live TV, internet, email and other services. Deliveries and installation will commence from April this year.

Underlying sales in wireless fell 16% as demand for new infrastructure projects remained weak given the current economic environment. However, sales of test equipment designed to improve network performance gained traction as operators invested in their existing networks and we were able to leverage our global marketing strengths and scale.

The rail, medical and automation sector continues to prove challenging and sales fell 9% although there are more recent signs of stabilisation. For example, fresh investment in rail networks has prompted increased demand for components for signalling and communications systems. We have also benefited from the launch of a new component used in implantable medical devices like pacemakers and circulation pumps.

#### **SLIDE – INTERCONNECT: STRENGTHENING THE BUSINESS THROUGH ACQUISITION**

Smiths Interconnect operates in a fragmented market with many opportunities for consolidation. Our acquisition strategy has three objectives: to add complementary technologies and products; to extend our geographic reach, particularly in faster growing developing markets; and to leverage our existing sales and marketing infrastructure. The acquisition of Interconnect Devices, Inc. or IDI, achieves all three objectives.

IDI brings a completely new range of spring-probe connectors which complement Interconnect's existing portfolio of specialist components. These are critical to our customers' products and operations - and, importantly, command high margins. This acquisition will allow Interconnect to offer a much wider range of connector technologies to key customers.

IDI also has a strong presence in China and helps build our scale in this important market. We are excited by the opportunity to leverage our existing international sales resource, particularly in Europe where IDI currently has limited market penetration.

This will be our fifth acquisition in Interconnect over the past two years; four of which have included a strong presence in China. These transactions have already added to the microwave and protection technologies and the IDI acquisition will extend this to the connector group. It is expected to be immediately earnings accretive.

Last October, we completed the acquisition of Channel Microwave, a purchase that complements our microwave components business focused on the defence and homeland security markets. It is a relatively small company but its components add to the product range that our Lorch and TRAK businesses can offer to customers.

### **SLIDE – INTERCONNECT: OPERATIONAL PRIORITIES**

For the rest of the year, Interconnect's operational priorities will be:

- Maintaining focus on managing the cost base;
- Integrating the recent acquisitions of IDI and Channel Microwave; and
- Delivering the key commitments to our customers to ensure we are well positioned to gain follow-on contracts in major programmes.

We foresee a return to growth in sales to military and aerospace customers based on the strong order book, supported by sustained investment in military communications and the launch of the Ku-Stream broadband antenna.

Wireless infrastructure spending still looks constrained although we have detected some early signs of improvement which should drive demand for our network enhancing products.

Finally margins should continue to benefit from the cost-savings initiatives and increased volumes.

Turning last to Flex-Tek...

### **SLIDE – FLEX-TEK: FACING CHALLENGING MARKETS; IMPROVES MARGINS**

Flex-Tek continues to perform well against extremely challenging trading conditions. It increased margins slightly to 9.8% despite a 14% fall in underlying sales. Again, the improvement is mainly due to the savings delivered by an aggressive restructuring programme. This has cushioned the impact of the downturn in the US residential construction and US appliance markets.

In aerospace, sales of components and services have weakened, particularly in the market for regional aircraft and business jets.

Revenue from Heat Solutions, though now showing some signs of stabilising, fell 14% because of lower sales of gas piping and air-conditioning units, and sales of hose assembly from Flexible Solutions fell 16% because of continued weak demand in the US floor-care and general industrial markets.

### **SLIDE – FLEX-TEK: IMPROVING TREND IN HEAT SOLUTIONS AND FLEXIBLE SOLUTIONS**

However, both Heat Solutions and Flexible Solutions are showing some improvements in recent months with an increase in sales in January and February.

This chart illustrates the monthly sales trend where growth is compared against the prior year month. You can see the trend turned positive in January and continued in February.

This is the first positive trend in volumes that we have seen since the business peaked in 2006. It is encouraging, but recovery is fragile. The US residential construction market has benefited over recent months from the Homebuyer Tax Credit program which has stimulated builders to increase housing inventories to support demand ahead of the tax credit expiring at the end of April.

### **SLIDE – FLEX-TEK: OPERATIONAL PRIORITIES**

Flex-Tek continues to rationalise its manufacturing portfolio and to deliver efficiency improvements. It is looking at ways of expanding its non-construction sectors such as aerospace and medical, and will also work to expand sales into higher growth markets in Asia.

The restructuring programme will remain a key focus and we recently announced the rationalisation of a manufacturing plant at Springfield, Massachusetts.

US residential construction has shown some tentative signs of improvement although aerospace is likely to remain challenging. However, the cost reduction initiatives have made Flex-Tek a leaner, stronger business, leveraged to a recovery in the US housing and US appliance markets.

## **SLIDE – SMITHS GROUP – OPPORTUNITIES TO CREATE VALUE**

In conclusion, trading conditions remain tough and any recovery is unlikely to be swift or smooth. While Smiths Group can do little to influence these macro factors, today's results show just how much we have done that is within our control to optimise business performance across the whole portfolio.

We will continue to drive margin expansion through operational improvement and cost-saving initiatives. The gains from our investment in new business systems are helping us access far better data to drive decision-making and leverage the Group's scale in procurement.

A continued and relentless focus on cash generation will be maintained through better working capital management, and this in turn helps fund the investment that we need to develop the new products vital for the Group's future growth and long-term prosperity. At the same time, we will continue to seek out bolt-on acquisitions to strengthen our product portfolio or build our presence in high-growth, developing markets.

In conclusion, Smiths Group is much better positioned to benefit from economic recovery when this finally arrives on a sustainable basis. Improved operational efficiency is not only allowing us to deliver improved margins, profits and cash flow – but importantly it is allowing us to invest more in sales, marketing and new product development to support future growth.

I remain far from sanguine about the outlook for many of the world economies over the next year and beyond – in particular that for the UK. The future will bring the challenges of increased interest rates, increased taxes, reduced consumer and government spending and ultimately inflation. However our first-half results, together with increased investment in new product development and our ongoing program of performance improvement initiatives, provide a solid foundation for the full year.

## **SLIDE – SMITHS SLIDE**

## **BUILD – QUESTIONS AND ANSWERS**

That, ladies and gentlemen, brings us to an end of the formal presentation and John and I, along with other members of the management team, will be happy to take your questions. In terms of housekeeping, can I please just remind you to wait for the microphone, this

presentation is being webcast, and to preface your questions with your name and the company that you represent?

ALEX TOMS: Thank you, it is Alex Toms from Bank of America, Merrill Lynch. Can I ask three questions please. The first one, can you talk about confidence levels in your margin targets you gave a while back, given you've integrated your ERP systems and the first half margin performance. The second question, can you talk about the financial implications of the US healthcare bits and pieces that were going on over the weekend and the third question, can you talk about operational leverage within Flex-tek and Interconnect please.

PHILIP BOWMAN: Okay. The one on US healthcare, I think it's very early days to give a very clear answer to, but I will pass that to Srinu in just a minute. In terms of operational leverage in Flex-Tek and Interconnect I can think of no better people than Tedd and Ralph to answer those. In terms of confidence in the margin targets I would simply go back to the presentation that we made in September when we presented the full-year numbers and at that time I said very clearly that we did not resile from the margin targets that we had set approximately a year before that and that we still believe that the revenue growth targets when economic conditions return to normal, the range was still possible. I think the message I give you today is very straightforward. We have delivered on what we said about margin targets, we have moved up the margins of each of the divisions under a still very difficult trading environment, revenue growth still remains challenging and I believe will remain challenging. I'd be delighted to be proved wrong in my outlook for the

economy, but I think we are going to have a slow and pretty painful recovery in most places around the world. That won't be made any easier by what we are seeing in some of the countries, whether it is China or India where a combination of changes to banking requirements or interest rates are being used to start to damp down growth in the economy and that will spread out of those economies as well.

In terms of US healthcare if someone will give Srini a microphone, please? You have got one?

SRINI SESHADRI: I'm not normally in the business of handing out recommended reading lists, but this morning's USA Today has in one page a very, very good summary of what potentially could be happening. So I just recommend that, it is worth reading. Having said that, we have some experience of what happened in Massachusetts when a similar move happened there and so what we are in the process of doing right now is to learn from that. Although Massachusetts is only one small part of the US there are some projections we can make. We are in the process of modelling. Probably flat to modestly positive volume effect over the long run. Many of the people who are now covered by this healthcare proposal were already being taken care of in terms of acute care facilities and emergency room settings anyway, but certainly improved care is improved care and 36 million more people is 36 million more people. Having said that, there are tax implications starting in 2013. How material those are we are in the process of figuring out. I hope that's helpful.

PHILIP BOWMAN: I think the other comment I would make on that would simply be, come 2013 will the tax increases that are actually proposed be enacted? And I

think 2013 is a long way off and three years in politics is a very long time, so I think it will be interesting to see whether that actually transpires the way it's written today.

So moving to operational leverage and, that most operationally leveraged of businesses, Flex-Tek.

TEDD SMITH: Yes, I think the response to the question about leverage is that we are really very highly leveraged at this point in terms of having completed site rationalisations and shortly organisational rationalisations and as long as people pay attention to where their net variable margins are and don't allow there to be creep with commodity inflation at a price we should be in good shape in the future with any kind of sales rebound.

PHILIP BOWMAN: Thank you, Tedd. Ralph?

RALPH PHILLIPS: I think Interconnect is in a similar position to Flex-Tek, maybe not quite as leveraged but we have done site rationalisations across several of our technologies and sites and I think we're very well leveraged and with a little pick-up of volume which we've already seen a little bit this year in some areas that it goes to the bottom line in a hurry.

PHILIP BOWMAN: Ralph, thank you for that. Next question please.

MARTIN WILKIE: Good morning, it's Martin Wilkie from Deutsche Bank. The first question is on M&A. Obviously you've made some acquisitions now in Interconnect. If you could just let us know how you are seeing the M&A landscape. Do you have a set amount of cash deployment in mind over the next year or so in terms of how much you could be spending and

where those focal areas would be? And of course the flip side to that is are you then thinking of disposals and just generally what the environment is like for selling assets? Thank you.

PHILIP BOWMAN: I think in terms of M&A I still believe it is a better time to be a buyer than it is to be a seller and I suspect that will continue for some time. My enthusiasm for paying large equity control premiums for businesses is very, very limited indeed so hence the emphasis primarily on bolt-on acquisitions. Clearly we do see consolidation opportunities within Interconnect. That is an area we continue to focus on. I did talk in my presentation about John Crane, the acquisitions into the bearings and the filtration sectors were targeted to widen our addressable market. They were also targeted to leverage our great asset of global sales and customer support centres.

As to whether there is a specific quantum of money, the answer to that is no. I think we will evaluate opportunities. There are a variety of ways we can finance opportunities if we believe them to be compelling but as we go ahead the forward radar is clearly scanning and we are looking at further opportunities.

VIDYA ADALA: Thank you. This is Vidya Adala from Morgan Stanley. I have two questions, one on John Crane. It was very impressive that you were able to put through price increases in arguably the toughest half you will ever see in the cycle. Now is this a function of executing out of backlog and what are you seeing in your current backlog given that it's book to bill is higher than one? Will this price increase go through in the second half or will you see some pressure there?

The second question is on your Interconnect acquisition. My understanding is that the technology is complementary to what you currently have. What kind of addressable market are you thinking of and what are the specific areas that it helps you expand into?

PHILIP BOWMAN: Thank you for those two questions and I am going to I think pass the first one to Paul to answer in terms of John Crane, and Ralph, you get your second question so we have paid for half your air ticket. Paul?

PAUL COX: Good morning. The pricing, I think the key metric you have to remember about our business is two-thirds in the aftermarket, our largest customer is 2% of our sales. So we've been putting the price up primarily in the aftermarket. Our projects business, the OEM business, we don't get a lot of price there, but in the aftermarket part we do. Indeed actually to answer your question about the second half, we put some more prices up actually on some of our, if you will, the tail. Approximately 10% starting in February so we do continue to have opportunities to get price in the aftermarket where we can exploit it.

PHILIP BOWMAN: Paul, thank you for that. Ralph?

RALPH PHILLIPS: Can you repeat the question just really quickly on IDI?

VIDYA ADALA: Can you help us understand how this complements your portfolio, not just in terms of technology but in terms of which additional markets are you targeting, in terms of end markets, whether that's medical or otherwise?

RALPH PHILLIPS: Okay. IDI complements Interconnect very, very well. About two-thirds of its sales are in semi-conductor and board test markets that we have a very small position in. On a geographic perspective we have a very complementary geographic overlay where we are much stronger in Europe than they are. They have very, very limited sales resources and in the Interconnect business about a quarter of all connectors are sold into the European economy, so that is another complement. Geographically we are also less strong than they are in China, they have a strong facility. Almost half of their employees are in China, and that's a real good resource as well as there's a strong engineering resource in China, that's also very complementary and in the US for the most part their manufacturing is done in Kansas and there are opportunities to move that into some of our low-cost manufacturing facilities in Mexico. Another area where we complemented the market is what they call OEM or medical, military, industrial applications. Interconnect is much stronger than they are in those markets and we plan on bringing their complementary technologies into our markets there.

PHILIP BOWMAN: Ralph, thank you.

SANDY MORRIS: Yes, good morning, everyone. It's Sandy Morris from RBS. I intend to watch USA Today as my research tomorrow, so it's very easy. A little bit of nitty gritty for which I apologise. Ever since we launched the ERP improvement stuff I have been kind of watching the working capital assets that are given in note 2 and to be honest they haven't actually really changed very much. I know FX is moving that around and I don't want to pick on Detection, but I am intrigued by the fact that detection shows working capital assets of over £300 million, which is roughly half

its sales. I am just curious if that is telling me anything about the outlook for detection or the way it works. The second bit, and I apologise, I am turning into Ben Fidler, is Paul has done incredibly well which I acknowledge, so he wins whatever bet we had, but when I look at the drop-through the underlying decrease in sales in Crane was probably £60 million or £65 million and the drop-through is incredibly large given that the decline all came in OE and I'm just slightly curious about that, if you can help me out there.

In terms of airfares, this IDI thing is interesting, but I've always wondered how sort of determined we were to really go into these commercial markets. I mean having had our fingers burnt a couple of times in wireless here we are going off into semi-conductors, which is just one great cyclical disaster normally. That is a question for which I apologise but it's a curious sort of thing.

PHILIP BOWMAN: I wasn't quite sure, Sandy, whether it was a question or a statement, but nevertheless, John, do you wish to comment at all on the working capital numbers and note 2?

JOHN LANGSTON: Yes, well, Sandy there is a big movement on foreign exchange, you're right, which accounts for quite a big movement. The other factors that really affect Detection are firstly a very pleasing movement which is that the level of inventory on the ports and borders has dropped dramatically and we've seen a build-up on the JCAD programme and we know that we have the contract and the sales there, so there is a mix coming through.

I think also we've got some issues in terms of a slight delay in one or two of the payments in the division in terms of recovery but nothing

significant, just where they've slipped actually. But overall I think they've made good progress. It is something that you have to monitor on an ongoing basis and it's the one area that we've always flagged up will and potentially could have at any point in time a working capital increase because of the nature of the business. It's not like a book to bill business so you will see I think movement in the working capital in detection.

I think two years ago I flagged up we could see up to, at any one point in time at the half or full year, a £40 million swing in working capital. As payment terms have changed I think we're beginning to come out to the end of that roll-out period and getting to a more stable working capital as we move forward now in the business.

I'm trying to think of your other questions.

PHILIP BOWMAN: Paul, do you want to take back on the one about John Crane?

PAUL COX: Yes, I find it a slight bit odd being defensive about saving that much money. I recognise you're seeing the volume declines and we had the benefit, frankly, of being ahead of the curve with the cost restructuring so we were ahead with regard to the SG&A reductions we made, we were ahead in terms of the kind of price we went after from leveraging our overall scale within John Crane and indeed within Smiths from a materials pricing standpoint and we've made a lot of moves in terms of where we manufacture product today is not where we manufactured product 18 months ago. So there's been a good bit of cost come out of the business.

SANDY MORRIS: It is not meant to be a criticism at all. I was trying to be cheerful and nice for once.

PAUL COX: You told me ahead of time that wasn't you, so I kind of assumed it wasn't.

SANDY MORRIS: I mean it sure as hell isn't me, so I don't know what's happening. But the underlying decline in your sales was £55 million or £60 million. The volume effect on your profit was £28 million, so I'm actually sort of paying you a backhanded compliment because that's a much bigger gearing effect than I expected, given that the decline was mainly in your OE business and not in aftermarket.

PAUL COX: Well, we pointed out the OE business was down in the order of 15% or 16%. The non-oil and gas aftermarket business was down at least 12% I think is the number we've got and there is a considerable amount of profit in that aftermarket business. So probably on balance that's where the number is coming out the way it is. But it just does say that when our volumes come back that we should be able to leverage pretty strongly and that's how we're going to meet our objectives that Philip has reiterated today with regard to our margin performance. We're still headed there, Sandy.

PHILIP BOWMAN: Ralph, I warned you that somebody might ask you about semi-conductors so I hope you did your homework?

RALPH PHILLIPS: Yes, I think that the part of the market that Interconnect Devices plays in is less cyclical, they're providing the test sockets that are really driven by

the changes that are associated with technology in that that market tends to turn over on a nine-month basis as opposed to the volume. So there's a piece of the semi-conductor market that is tied to capital equipment when they buy the big test equipment and the fixtures that go with that. Certainly this company plays in that part of the market as well, but mostly where they play in is the mission critical devices that actually test the semi-conductors and that is really driven by the change in technology as opposed to buying the large capital equipment that is the most cyclical. So we actually like this company extremely well, it is very complementary and there are some really good synergies on what they provide and what Interconnect can provide.

PHILIP BOWMAN: Thank you, Ralph, for that. Given the headline in the Sun today does anyone want to ask Stephen Phipson a question? He's had a very quiet time. Over there, please.

AVI HODDES: Hi, it's Avi Hoddes at UBS. Just one question on Detection and then one on John Crane. The second half, just kind of reading your statement in the release and what you said this morning, should we consider that the growth rate of second half can be comparable to what we have seen in the first half, better or worse? I appreciate that contracts are lumpy and so probably could go either way but on the balance of probability what do you think is going to happen? Then in John Crane talk about the book to bill being greater than one so are you expecting sales growth in the second half? If you think about aftermarket in OE across the different segments can we get some more colour on how the book to bill across those segments is coming through?

PHILIP BOWMAN: Okay. Thank you for those two questions. Stephen, do you want to talk about the second half please?

STEPHEN PHIPSON: Okay. In terms of the business if we look at where we are at the moment and divide it up into its major sectors, the military business we've got very good visibility on. We're in full rate production on our joint chemical agent detector programme with the DoD, with the Pentagon. So we've got a full order book there, so we've got very good visibility. So that sustains itself through the second half. There's not a great deal of contract fluctuation there. Our cargo business you've seen recovered enormously in the first half and had 90% growth year-on-year and of course we've booked contracts for the second half as well so that continues through the second half. So we're feeling confident about that sector of our business.

Transportation is the one area that's variable. I'm not quite sure what the government is going to do yet. They're changing the regulatory environments on an almost weekly basis as they're trying to think about how to improve security at airports, so on the checkpoint side we're still open to a few surprises up and down, we think, which is a relatively small part of our business. If we look at other initiatives we have to remember that we've got the air cargo regulations coming in for 1 August and we're seeing in the second half quite a bit of growth coming from air cargo transportation businesses buying detection equipment to fulfil their regulatory responsibilities for explosive detection. So we've got a good second half ahead of us, a good second half in progress and I think we are on track to achieve good growth in the second half as well.

So exactly what that is will be subject to those variations that we see in those transportation sectors primarily I think.

PHILIP BOWMAN: Stephen, thank you for that. Paul?

PAUL COX: With regard to the backlog, that's predominantly in the OE sector. If you think about the lead times associated with our products, the bigger lead times we get are actually in the OE sector of the business and that's where most of the backlog has been inbuilt. The first phase of that is when our OE customers kind of finish their destocking programmes. There was a period of time where they were most certainly running through the stocks they had and their stores are at a critical level or below critical level, so now we're seeing the full demand where before we were seeing a bit of a lightness in demand because they were running through their stocks. So what we've seen in the last few months and continue to see is a return to some of that ordering coming through the OEMs. We're seeing a good bit of quoting activity on international projects and we anticipate that we'll see some orders come through there although that won't impact the second half sales as much. We do also have in terms of second half, H1 and H2, the Romania contract which was awarded and started in December and we're progressively ramping up on that. So that's an element that actually we currently do a book and bill on that, there's not a big element of our backlog in there but it is -- a contractor will be executing the second half that will show some growth relative to the first. Overall what I keep saying to Philip and to John is this is very much a slope of the line question. We are seeing some signs of recovery but it is by no means a V-shaped recovery so we're gratified that we're seeing

the orders returned. At what growth rate, as I think Philip said, it's kind of a tenuous situation to make a forecast but we are happy that we're seeing book to bill rates above one which is a sign that we're coming out of it.

PHILIP BOWMAN: Paul, thank you very much. Any other questions? Yes, Sandy?

SANDY MORRIS: Yes, I just can't let it pass. Safety devices which last year was the one bit that actually grew 2% has now sort of decided to conk out, so some sort of context, just in terms of procedures or the number of procedures or something might be helpful so that we can actually work out whether its volume in terms of operations or whether this price thing is serious or not?

SRINI SESHADRI: It is skewed heavily by distributor behaviour as well, so some of what you've seen is from period to period comparisons of how distributors either stock up or stock down. The second thing is to do with this whole preparation for H1N1 and that certainly drove some volume and then we've seen quite a bit of that tail away as that scare never materialised. So those are the two factors I would offer to you. The underlying demand does not change. It is procedure driven and it will continue to grow. Then as you see in the rest of the world, non-US markets, the requirement for safety becomes a part of law that long-term trend is going to make it a healthy business for sure.

PHILIP BOWMAN: Srini, thank you. Any more questions? If there are no more questions a quick commercial before we go. Tampa on 22 June, Ralph is hosting an investor day on Interconnect for everything you always wanted to know

about Interconnect but were afraid to ask and then from there the show moves on to St Paul on 23 June where Srinu will be talking a little bit about Smiths Medical. Thank you all for coming here this morning, thank you for your questions and I guess for now we're all going to go back and see what atrocities are done to us in the budget this afternoon. Thanks very much.