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Clare Scherrer

Hello, I'm Clare Scherrer, Chief Financial Officer. I joined Smiths six months ago and during this time I have met with many investors and stakeholders. Today, I want to address the topics that I know are top of mind for many of you.

The question I'm most often asked is why did you decide to join Smiths, and what are your first impressions? I worked for many years as a financial advisor to Smiths, so I know our businesses well, and appreciate our market-leading positions and our strong financial framework. Following Paul being appointed as Chief Executive, I felt that the CFO role at Smiths presented a unique opportunity to help intrinsically strong businesses reach their full potential. So I signed on to be part of the team.

We're a focused industrial technology company with clear priorities, and growth and execution roadmaps that are already delivering results. I have worked in financial services with global industrial companies for over 25 years, so I bring both an informed perspective on our business and the opportunities ahead of us, as well as a strong work ethic, a team orientation, and a drive to deliver against our commitments. I'm squarely focused on delivering against the opportunity ahead of us and helping Smiths achieve its full potential.

The potential for value creation at Smiths is significant. As you can see on this chart, today we trade in line with the median of our US engineering peers, but at a 2.5 multiple discount to the UK engineering median, and there is a three to six multiple discount to the top quartile of those peers. We appreciate that the key to closing this valuation gap is for us to progress our strategy to consistently deliver on our commitments and to achieve our medium-term targets of four to six per cent organic revenue growth, with 18 per cent to 20 per cent operating margins, and cash conversion of 100 per cent plus. On this chart, you'll see that when we deliver that, our financial performance will compare favourably to our global peers.

This leads to the question, how is Smiths progressing so far on this journey? As a reminder, in FY22 we delivered strong organic revenue growth of 3.8 per cent. Yesterday we announced our FY23 First Quarter trading update. For Q1 we delivered 13 per cent organic revenue growth, our sixth consecutive quarter of growth. We anticipated this very strong start to the year, as we knew we would benefit from the healthy order book we had built up coming into FY23, as well as continued momentum across our end markets.

In the first quarter, John Crane delivered good revenue and strong order growth. The ongoing supply shortages we discussed at year end continued to limit the pace of our order to revenue conversion.

Smiths Detection had a very strong start, as some of our large deliveries for the year were concentrated in the first quarter. We know, based on our order delivery calendar, that Detection's second quarter will not be as strong. But the anticipated combined Q1 and Q2 First Half trend gives us confidence on our full-year expectation that Detection will return to growth this fiscal year.

Flex-Tek continued its strong performance, and Interconnect also delivered good growth against a strong Q1 comparator.

Our balance sheet also remained strong and gives us strategic flexibility. During Q1, we purchased a further £107 million of our shares, putting us 83 per cent of way to our £742 million surplus capital return at quarter end. Adjusting for our Year End FY22 leverage of 0.3 times for completion of the share buyback programme, as well as the repayment of our €600 million bond that matures in April, our pro forma leverage is below one times.

While our stated leverage policy is to maintain a solid investment grade rating and operate under two times leverage, in the current macroenvironment we consider around the one times level to be appropriate. We also own a 10 per cent stake in ICU Medical, which gives us additional flexibility, and is currently valued at approximately $370 million.

Given the current uncertain macro and geopolitical environment, you may also be wondering how confident we are in the guidance we provided for FY23. The short answer is that we remain confident, but I want to elaborate on some of the tailwinds and headwinds that we're experiencing.

Firstly, John Crane. As we said at the FY22 Results, and again yesterday, John Crane is benefiting from strong demand and has a record order book. We initiated targeted actions to simplify our end-to-end value chain for customers, which will also improve our operating leverage as we move to the latter part of the year. Over the medium term, we're going to be a critical and trusted and partner to our customers, as they develop and execute their energy transition plans.

However, a small number of critical components are still delayed and difficult to source. We do anticipate that these supply-chain constraints, while moderating, will continue throughout the fiscal year. John Crane also faces a headwind from our stopping sales to Russia in March, which will be a 90-basis point headwind to divisional growth in H1.

Next, Smiths Detection, where our order book going into FY23 was also strong, and three of the four business segments, Other Security Systems, Original Equipment, Aftermarket, and Aviation Aftermarket continue to perform well. The targeted actions we're taking to reduce overhead costs should also have a positive impact in the coming quarters. However, critical electronic component shortages do continue to limit our order conversion and profit growth. While we see increased tender activity, which will benefit future years, near-term Aviation OE deliveries are already set. Finally, Smiths Detection will also see a 40-basis-point headwind in H1 revenue growth from having topped sales to Russia in March.

Flex-Tek continues to see good demand, driven by its core end markets of construction, industry and aerospace. We're also benefiting from new product introductions, namely our Python Line Set and geographic expansion in the South. Of course we're alert to the US residential market headwinds, and we too anticipate slowing will come in this end market, but we're not yet seeing that in our sales.

Interconnect also continues to see strong demand, in particular for space and semi-conductor test socket offering. While we expect to see slowdown in our sales to the semi-end market, we expect to see full-year growth. Consistent across all divisions we continue to focus on pricing to offset the ongoing high levels of inflation across raw materials, wage, and freight. As a reminder, we did offset inflation with these pricing actions in FY22, and we continue to be proactive in managing inflation.

Taking all these tailwinds and headwinds across the Group in the round, recognising the strong start to FY23, but knowing we face tougher comparators through the rest of the year, and taking into account continued inflation and macro uncertainties, we re-confirm our full-year guidance of four to four-and-a-half per cent organic revenue growth, with moderate margin improvement.

In FY22 we intentionally invested in working capital to navigate supply chain constraints and enable growth. So naturally, how and when we can release some of this working capital investment is another topic I know is top of mind. Our FY22 cash conversion, of 80 per cent, was impacted by [£109 million] working capital investment, of which [£154 million] related to inventory, as we invested to secure supply and enable growth.

Good receivables and payables management helped to offset some of this inventory build. Our average cash conversion over the last five years was 100 per cent, and we're confident we will return to that level going forward through more proactive inventory management when supply chains normalise further, and because our asset-light model, which requires CapEx of less than three per cent of sales.

Now let's look more closely at our current inventory setup. In John Crane and Detection, we've increased investment in both raw materials and finished goods. The former, because we needed, and continue to need, to source especially scarce materials and components when we can. The latter, because we've nearly finished goods that are awaiting receipt of one, or a small number of components, to enable us to complete and ship.

For Flex-Tek and Interconnect, our inventory build is primarily raw materials to support very strong revenue growth. While we did have some supply issues to manage in FY22, for these divisions, supply is well on its way to normalising. Across the Group, we have 15 SES projects focused on inventory. We're also onboarding new suppliers to reduce our sole-supplier relationships. John Crane, for example, reduced its sole-supplier relationships by roughly 80 per cent since the beginning of FY22.

So, in summary, we're managing our inventory in a differentiated way by division, taking real-time decisions as markets evolve, investing when we need to in order to underpin growth, but at the same time also taking targeted reduction action when we can. In addition to operating cashflow, of course we manage free cashflow as well. Over the past five years, our free cash flow conversion has averaged 46 per cent of operating profit. Both are included in our incentive plans, with operating cash conversion included in our annual incentive plan, and free cashflow conversion in our LTIP.

This chart shows the line items between operating and free cashflow, and I want to highlight three. First, our interest expense is coming down. We repaid our $400 million US Bond in February of '22, and we will repay our €600 million Euro Bond when it matures in April 2023. Second, we expect cash costs related to our pension obligations to be £12 million in FY23. This is a significant reduction from the roughly £30 million of pension-related cash outflows we were averaging just two years ago and reflects progress we've made in de-risking these liabilities for both our pensioners and our shareholders.

This year we will also have a £35 million to £40 million cash charge associated with the targeted cost actions Paul described earlier. We'll take this charge below the line as it's one off, but of course it will impact our free cashflow.

Now let's turn to our capital allocation priorities. Our first priority is organic investment which includes R&D and CapEx, as well as sales and marketing. Our second is strategic and disciplined M&A, and we prioritise returning capital to shareholders through our progressive dividend, and more recently we returned the majority of our medical sale proceeds through share buyback. In fact, in FY22, we returned a total of £661 million to shareholders, our highest return in 15 years.

As a global industrial technology company, R&D is critical. We aim to invest four to five per cent of sales in R&D. While this dipped in FY21, partly due to COVID, in FY22 we returned to this range and consistently investing at this rate puts us in the top quartile of our peers. Our approach to R&D under Paul's leadership is now much more focused. We're all focused on commercialising a prioritised list of high-return and high-impact products. This year we've even added new product commercialisation to our incentive plan.

Although CapEx is less than three per cent of sales, it's a critical component of investing in our operations to enable growth and stronger execution. For example, in both John Crane and Smiths Detection, we've invested in our technology capabilities, and in Flex-Tek and Interconnect we're investing in expanding capacity and increasing automation.

Moving to our second priority, targeted acquisitions. We aim to accelerate organic growth, primarily through bolt-on acquisitions that strengthen our market positions and enhance our technological capabilities, as well as helping us access priority adjacencies. Over the past five years, we've reviewed many potential opportunities and acquired three businesses which enhanced our core, and four which have helped us penetrate adjacencies.

The process by which we review acquisition opportunities starts with the divisions. Our business leaders know their markets and customers intimately, and so our division leaders are best placed to generate the best ideas. Our experienced Group M&A team supports the divisions in evaluating and prioritising opportunities based on strategic fit and synergy potential and supporting on due diligence and valuation.

Our goal is to see all the ideas that could advance our strategic positioning, and at the same time to have an efficient screening process that we very quickly focus our energy on understanding and advancing the targets which are most interesting. Over the past five years, we've closed one to two acquisitions per year. In FY22 we looked at several potential opportunities but kept our focus and value discipline and chose not to close any. We continue to look expansively but vet ideas rigorously and aim to ensure that every acquisition we do creates real shareholder value.

Now turning to capital returns. We have a progressive dividend, and our policy is to increase our dividend in line with long-term earnings growth while maintaining at least 2 times cover. We've paid a dividend for over 70 years, and our dividend yield is in the top quartile among our peers. In addition, following the successful sale of Smiths Medical, and after consulting with our shareholders, we designed a buyback program to return 55 per cent of the proceeds. As I mentioned earlier, we're currently 83 per cent of the way through the programme and expect it will complete in early calendar '23.

In conclusion, we're well positioned to capitalise on both near- and medium-term opportunities and remain committed to achieving our medium-term financial targets. For organic revenue growth, we're on track to move into our target range in FY23. We expect to see moderate margin improvement in FY23. The operating leverage that will come from top-line growth coupled with our SES initiatives will result in further improvement in the medium term. Our cash conversion: our near-term priority remains to deliver for our customers, but as supply chains normalise, we remain confident on returning 200 per cent over time. Growth in expanding margins will contribute to EPS growth, and along with capital discipline, ROCE expansion.

So we're pleased with the progress we've made so far, and we're excited for the opportunities ahead of us. Thank you so much for the time you've spent with us today.

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