START OF TRANSCRIPT

Speaker 1 – John Shipsey

Hello everyone. I'm John Shipsey, and I'm the CFO of Smiths Group. In this section, I'm going to explain the financial framework that underpins our strategy, how we see a very clear path to creating value and attractive returns, and why we're confident that this will flow directly and tangibly from our three-pronged focus on growth, execution, and people.

You heard Paul talk earlier about the intrinsic business strengths that add up to make Smiths a leading industrial technology group. These business strengths translate to financial strengths, and they're the reason why we command good margins and why we consistently generate exceptionally strong cash conversion. Our key financial priority is accelerating organic top-line growth, because we know that revenue growth fuelled by high margins and low capital intensity will convert into exceptional cash generation. We also know that we can enhance organic growth further through M&A that's complementary and disciplined.

The potential returns from all this are very attractive indeed, and we will reinvest to keep accelerating this virtuous circle of growth, but we will also use our excellent cash flow to reward shareholders with a stronger and more progressive flow of dividends and with share buybacks where capital is surplus to our reinvestment needs. Let me explain our simple and highly effective financial framework in more detail. You've just heard from Paul how the Smiths Value Engine is powered by four strengths: world-class engineering; leading positions in critical markets; some really great global capabilities; and of course, a robust financial framework.

And you'll hear shortly direct from the divisional presidents about how we're developing differentiated technology for products and services used in demanding applications where performance really matters. Also, you'll hear about proprietary technologies that are founded on decades of R&D investment and how we've built leadership positions in attractive growing markets, where 50 per cent of revenues come from high quality recurring aftermarket services.

Importantly, these key business strengths translate into financial strengths. Firstly, let's take a look at our margins. Pre-COVID, we were growing operating margins steadily, to 17 per cent. Revenue growth improved fixed cost absorption and translated at higher incremental margins to profit, so delivering positive operating leverage. During COVID, our margins proved resilient, despite revenue loss and unprecedented disruptions. That's because we moved quickly and took decisive action to protect margins and get our cost structure into better shape, and we delivered promised savings ahead of schedule.

Looking forward, we're confident in our ability to deliver operating margins within the target range of 18 to 20 per cent. On the back of a return to top-line growth as well as the full restructuring benefits, all while still growing organic investment in R&D to five per cent of sales. Indeed, all this was evidenced by the 18 per cent margin that we actually delivered in the second half of last year. A key point to see here is our ability to convert revenue growth into profit, not just consistently, but faster, while still allowing for reinvestment. It's good operating leverage and a big reason why our financial framework is so effective, so business strengths translating into financial strength.

As well as good operating leverage, another financial strength of Smiths' is cash generation. Operating cash conversion of almost 130 per cent, and free cash flow of over £300 million in FY '21 was a remarkable, but not an isolated achievement. Over the past five years more than 100 per cent of operating profit has been converted to operating cash, by the group as a whole, but also by each and every one of the businesses. That's because each and every business has similar characteristics: IP-owning assemblers, with low capital intensity that apply group-wide best practices to manage working capital.

Although proud of our track record on cash conversion, we're not complacent. We still have plenty of opportunities to improve, with the consistency of execution that Paul mentioned earlier, we're confident that we can continue to deliver a 100 per cent plus operating cash conversion over the medium term.

If we then look at returns on capital, you can see how they validate the financial strengths that I've just highlighted. Firstly, return on tangible assets, excluding goodwill. At more than 30 per cent, it clearly proves the high value that can be created from organic growth, but also return on capital employed including goodwill. It's a critical measure in capturing the return on all investment, and we continue to use it as a discipline on M&A activity.

Pre-COVID return on capital employed, or ROCE, averaged over 15 per cent, well ahead of our cost of capital, and underscoring the financial strength of the business. ROCE did unsurprisingly dip in FY '20 and '21, as profit was affected by COVID. For the reasons I spoke about earlier, ROCE should return to our target range of 15 to 17 per cent in the medium term, so again you can see business strengths translating tangibly to financial strengths.

Our financial framework is very deliberately constructed around these strengths. Margins on incremental revenue mean that we have positive operating leverage. Revenue growth converts through the income statement to a higher rate of growth in profit, and low capital intensity means that profit gets efficiently converted into cash. With the result being strong, sustainable free cash flow.

Before COVID, we were delivering modest top-line growth of three per cent, which accelerated to five per cent growth in profit, and we converted more than a 100 per cent of that profit into cash. As Paul highlighted in his presentation, a central part of our go-forward plan is to accelerate the pace of top-line growth, because we know that we can take top-line growth and convert it even faster into profit and cash.

This is the key point, put very simply: turning the handle of revenue growth faster, converting that at the higher rate to profit, and turning that profit into cash. With the output of all this being high and growing free cash flow. We're also very clear how to deploy this. Our goal is growth. Reinvesting to turn that handle faster, so we will use our strong free cash flow first and foremost to reinvest in accelerating organic growth, but also to enhance that growth with complementary and disciplined M&A. At the same time, we can provide consistently good returns to shareholders. Our key priority in the plan is to increase organic revenue growth, accelerating past the pre-COVID level of three per cent, and targeting four to six per cent through cycle, confident that this will convert at high rates to profit and cash.

You've heard from Paul, and you'll soon hear from the divisional presidents about the exciting tangible ways in which we're going to deliver that higher pace of organic growth. From market growth, from new product development, and from building out adjacencies. All of that is why we believe we can successfully turn that revenue handle faster. Much of that growth will come from new products and services that our customers value for their differentiated performance in demanding applications.

We’ve grown our R&D investment considerably since 2017. Going forward, we expect to reinvest five per cent of sales in order to strengthen and sustain our business for the longer term. It’s primarily an organic strategy, but which we will also enhance through M&A. We will continue to add profitable top-line growth each year through complementary, disciplined M&A. By complementary, we mean acquisitions that strengthen our leadership positions, and deliver access to new adjacencies, geographies, and technologies. By disciplined, we mean acquisitions that create real value, typically through low-risk synergies that are uniquely available to Smiths, and so confidently deliver above-threshold returns.

This playbook has been working well for us. As you can see from this list of all our acquisitions over the last five years. I’ll just pick out two examples to illustrate the point. First, the largest acquisition on the list, Morpho. This reinforced Smiths Detection’s leading position in the US aviation market. It extended our CT product portfolio, and importantly, brought x-ray diffraction technology, meaning we’re years ahead of the competition on next-generation detection capabilities. Then Royal Metal Products, the last on the list, acquired just back in February. It significantly strengthened Flex-Tek’s product range in the construction sub-segment. You’ll have already seen in our annual report that against an acquisition cost of £78 million, it delivered £33 million of revenue, and £10 million of operating profit, in less than six months of our ownership. That’s certainly M&A that is disciplined and complementary to organic growth.

We will dedicate ourselves wholeheartedly to reinvesting behind organic growth, and complementary, disciplined M&A. But our strong cash generation means we also have a third use for cash, which is returning to shareholders what is surplus to our reinvestment needs. We’ve done that via dividends every year for the last seventy years, and we will continue to grow the dividend in line with earnings, whilst maintaining minimum cover of around two times. The growth strategy underpins our plans to maintain a progressive dividend going forward, and one that’s even stronger and more reliable.

But as well as an attractive dividend policy, right now we also have a one-off opportunity to return surplus capital to shareholders, as a result of the sale of Smiths Medical. The sale of Smiths Medical is a major strategic milestone, creating a higher performing Smiths Group that is clear to focus on its priorities of growth, execution, and people. Back in September, we said that the deal would complete by the end of the first half of calendar ’22. However, we’ve since satisfied the US antitrust condition, so along with Smiths shareholder approval, we’ve now cleared the two major conditions precedent, and we’re now confident that the deal will complete significantly earlier than previously expected in the new year.

Initial cash proceeds are $1.85 billion. Additionally, Smiths will receive 2.5 million shares in ICU medical. This is a liquid financial investment, structured to allow Smiths to participate in the significant synergies that the deal creates. We will seek to maximise the value of this investment, taking into account the tax advantages of holding for more than 12 months, and the $100 million earnout which is triggered if the ICU share price hits $300 within four years of completion. The current value of the deal is $2.75 billion, but with the potential for that to increase to over $3 billion, if the earnout is triggered. Given that completion of the sale will now take place much earlier than expected, the board has decided to start the return of $1 billion of proceeds to shareholders immediately.

We will effect this through a program of share buybacks over the next 18 to 24 months, and we will continue to supplement a progressive dividend with ongoing share buybacks, as we generate capital that is surplus to our reinvestment needs. We have a simple but effective financial framework that matches the financial strengths of Smiths, with top-line growth accelerating down through the income statement to profit, and then into cash. That's reflected in the quantified medium-term targets that Paul shared earlier. First, delivering organic revenue growth of four to six per cent, with complementary, disciplined M&A on top. Then, strong margins of 18 to 20 per cent that convert revenue into earnings growth of seven to 10 per cent.

ROCE, including acquired goodwill, will continue to act as a discipline on both organic and inorganic reinvestment, with a blended target return of 15 to 17 per cent. Of course, we will continue to set the bar for operating cash conversion at over 100 per cent. It's a robust financial framework, with Smiths' business strengths translating to the financial strengths that make these targets achievable. Our key priority is accelerating the pace of top-line growth as we execute the plan, and we know for sure that revenue growth fuelled by high margins and low capital intensity will convert into exceptional cash generation, which in turn can either be reinvested in further accelerating growth or returned to shareholders if surplus to our reinvestment needs.

It's a virtuous circle that we're confident will deliver our ambitious medium-term financial targets.

Thank you.

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