HY2023 Financial Results

Friday, 24th March 2023

Opening Remarks

Paul Keel

Chief Executive Officer, Smiths Group

Good morning everyone, and thanks for joining us. With me in London today is our CFO, Clare Scherrer. In terms of our agenda, I will make a few opening comments before turning it over to Clare to walk us through the numbers. I will come back and provide an update on our strategic and operational progress and then we'll open it up to all of you for Q&A.

HY2023 – Material Progress Resulting in Higher Performance

By way of overview, we saw a continued improvement in the first half, resulting in meaningfully higher performance. We posted record organic revenue growth of 13.5%, which translated to nearly 26% on a reported basis. We have now delivered seven consecutive quarters of accelerating growth as we capitalise on strong underlying demand in most of our end markets. Our earnings conversion was stronger still as we also delivered record EPS growth of 52%. And given this strong momentum, we have once again raised our full year guidance, now to at least 8% organic revenue growth.

Operating margins grew 20 basis points, reflecting strong volume as well as continued investment in future growth. ROCE expanded by a point, while Smiths Excellence System is the centrepiece of our stronger execution and the impact of SES is now visible in our financial statements as we are on track to deliver over £25 million of annualised operating profit from SES.

Our people make this progress possible and we have a number of initiatives underway across our company to advance our inclusive and high-performing culture. Our ESG plan is also progressing at pace, as detailed in our inaugural sustainability report, which is available on our website. In summary, we delivered another period of higher performance, enabled by our strategy of accelerating growth, improving execution, and investing in our people, the focal point of our Smiths Value Engine, which I will recap on the next slide.

Smiths Value Engine

Our value engine connects the three components of our success: our purpose, our strengths, and our priorities. We are grounded in our purpose of improving the world through smarter engineering. This has been the North Star for Smiths for over 172 years and continues to guide and inspire us today. Our strengths are unique and compelling: world-class engineering, leading positions in critical markets, global capabilities, and a robust financial framework. You'll see evidence in the coming slides of how each of these is contributing to an ever stronger Smiths.

Our purpose and our strengths are then directed towards advancing the three priorities I mentioned on the previous slide: accelerating growth, improving execution, and doing even more to inspire and empower our wonderful people.

Significant progress against 4 of our 5 medium term financial commitments

We first shared this slide with you in November 2021, my first Capital Markets event with Smiths, when we laid out five medium-term financial commitments by which to measure our progress.

This chart provides a summary of how we are tracking. We are making good progress on organic growth and for the first half, we are well ahead of our 4-6% committed range. About half our growth is coming from volume and the remainder from price, which we expect will subside at some point as the world eventually returns to more normalised inflation levels.

As mentioned, we are also having good success converting revenue to EPS. We commit to 7-10% earnings per share growth over time and are tracking above the range here as well.

Higher profitability naturally supports higher ROCE, and you can see this in our 120 basis point gain, which brings us into our 15-17% range.

Operating margins were up 20 basis points in the half on top of the 150 basis points expansion in the same period last year. We see further upside available to us in this category as we will continue to progress into the 18-20% range moving forward.

The only area where we did not post year-over-year improvement was operating cash conversion. We continue to see record demand across several of our end markets and we are naturally supporting this growth with investment. Cash generation has long been a calling card of Smiths with 100% cash conversion over the past five years. We expect to return to these levels as growth and supply chains normalise.

With that as an overview, I will turn it over to Clare to walk us through our first half results in greater detail.

HY 2023 Financial Results

Clare Scherrer

Chief Financial Officer, Smiths Group

Thank you, Paul. Good morning everyone, and thank you for dialling in. I am pleased to share the half year results; a half which provides more evidence of the progress we are making.

HY2023 – A Strong Start

On revenue, as Paul said, we delivered record organic growth of 13.5% with FX increasing reported growth to 25.6%. We generated £241 million of operating profit, which equates to organic growth of 12.7% and a margin of 16.1%, up 20 bps over the same period last year. EPS growth of 52.1% was a record for Smiths. Cash conversion was impacted by investment in working capital, and I will talk later about the actions we are taking to drive improvement. ROCE expanded by 120 bps, reflecting our increased profitability. And as planned, we are rebuilding our dividend cover post the sale of Smiths Medical and are recommending an interim dividend of 12.9p, an increase of 5%. In the first half, we returned £241 million to shareholders, including both our share buyback and the FY22 final dividend.

Record organic revenue growth

Now looking at the results in more detail and starting with our record organic revenue growth. We have posted seven consecutive quarters of organic revenue growth and both Q1 and Q2 delivered growth in excess of 13%. First-half growth was driven equally by price and volume, and we delivered growth across all divisions, geographic areas, and major customer end markets. Revenue for the half also surpassed our pre-COVID revenue, up 12% compared to the first half of FY20.

Moderate operating margin improvement

As per our guidance, this revenue growth translated into moderate operating margin improvement of 20 bps to 16.1%. We delivered 60 bps of margin expansion from increased volume and 50 bps of margin improvement from the targeted savings projects, which we announced at the full year, primarily in John Crane and Smiths Detection. These programmes remain on track, with expected benefits for the full year of approximately £15 million and annualised benefits in line with our previous guidance of between £25 million and 30 million.

On pricing, we more than offset cost inflation thanks to the positive pricing actions that we took throughout last year and going into this year. FX translation had a positive impact on margin of 30 bps. SES projects in this period primarily focused on pricing, customer service and productivity, and generated £5 million of incremental profit.

Offsetting these gains were three headwinds. Supply chain disruption in some key parts of the business, resulting in 10 bps of impact, although overall we did see supply chains trending positively. We continued to invest in growth to support increasing demand, which had a 90 bps impact. The largest impact on margin was mix, reflecting rapid growth in original equipment in Smiths Detection. This will support future growth from the associate aftermarket services. And the final impact, in Flex-Tek, was from product mix.

Record EPS growth in the first half

This strong profit performance drove record EPS growth, up more than 52%. The largest contributor to this was organic profit growth, which drove roughly a third of the increase or 5.1p. Our share buyback, which was 88% complete at the half, had a 4.6p benefit on EPS, about a quarter of the total. Weaker sterling through the first half had a positive FX translation impact of 4.3p. Our effective tax rate reduced 200 bps to 26%, resulting in a 1.4p benefit on EPS. We also had reduced interest expense as a result of repaying our £300 million bond in February 2022. All of these drivers resulted in basic EPS of 46.6p for the first half.

Cash generation

Smiths has a strong track record of delivering over 100% operating cash conversion over time. Our operating cash conversion during this half reflects the impact of both strong customer demand and our continuing investment to secure supply. Two of our fastest growing businesses in the half were Smiths Detection and John Crane, which accounted for over 85% of our £106 million working capital outflow and 60% of our £36 million of CAPEX investment. These investments not only ensure that we meet customer demand, but also underpin the large order books that both businesses have going into the second half. Working capital also reflects where we have secured supply to overcome specific supply chain challenges for critical electronic components in Smiths Detection and for elastomers and ceramics used in some John Crane products.

That being said, while we continue to prioritise customer delivery, at the same time, we are taking targeted reduction actions where we can. These targeted plans and SES projects include improving demand planning, optimising our global network, and continuing to reduce sole source supplier positions. We know that we have a hard road ahead on inventory reduction, but we remain committed to our medium-term target of 100% operating cash conversion and we are confident that the actions we are taking now will put us back on this path.

Business Update

Let us now look at our divisional performance in more detail.

John Crane – delivered accelerating growth and strong operating leverage

Starting with our largest business, John Crane, which delivered accelerating growth and strong operating leverage. Organic revenue grew 14.6%, driven by strong demand across all parts of the business. OE and aftermarket grew in both the energy and industrial segments. We have improved order to revenue conversion as the actions we have taken to manage the supply chain have had a positive effect. Operating profit grew even faster than revenue, up 24.6%, to deliver margin expansion of 200 bps. This was achieved as higher volumes drove good operational gearing and our pricing actions more than offset inflation.

Looking ahead to the second half, John Crane's order book remains very strong with order intake in the first half of 14.2%, and we are excited by the critical role that our products play in supporting energy transition, particularly in methane emission reduction, carbon capture and hydrogen applications. We are well positioned in these areas with over 40 years' experience in providing stealing solutions for hydrogen and with an installed base today of over 5,000 units. Key wins in the half include multiple orders supplying the largest hydrogen project in Canada and dry gas seal upgrades in Oman. As we go through the second half, we will continue to deliver against a strong order book and our margins will benefit from SES and productivity programmes.

Smiths Detection – growth across all segments

Next to Smiths Detection, which has solidly returned to growth, up 14% and with revenue growth in all segments. Aviation was up 10.3% and other security systems up 22.9%. It is especially good to see the return to growth in OE. Although this has a near-term impact on margin, it puts Detection in a strong position in the medium term, given that aftermarket revenue directly results from growing our installed base. Operating profit increased 4.5% with margins of 10.5%, reflecting the fact that lower margin OE was up 20.7% while higher margin aftermarket was up 8.4%. Again, this OE investment will be margin accretive in the aftermarket going forward.

Order book conversion is also improving in Smiths Detection, although supply chain constraints continue, especially with some electronic components. And we also took action in the first half to simplify our organisation, which will improve efficiency and reduce cycle times going forward.

And looking to the second half, our order book includes a number of airport CT checkpoint upgrades. At airports which install CT at their checkpoints, passengers will no longer need to remove laptops and liquids from their carryon luggage. An example of this is in New Zealand where we won the contract for its five major international airports. We also won a contract with DHL in Australia for centralised air cargo screening. Increased security needs is a mega-trend, driving not only strong demand in aviation, but also in other security systems, with 39.2% OE revenue growth in the first half and good wins across all segments, including ports screening in Japan and the provision of x-ray screening for the G20 summit in Indonesia.

Flex-Tek – another period of strong growth

Flex-Tek built on its consistent track record with another period of strong growth. Revenue was up 17% with double-digit growth in both industrials and aerospace. Operating profit was up 9% to £77 million, a record, driven by increased volume and price offsetting inflation. Operating margin remained high at 19.5% and included new product launch costs and the ramp of a new ducting facility in Houston. Mix impacted margins here as well, as we saw especially strong volumes in our industrial tubing product. And a few weeks into the second half, we are beginning to see slowing in our US construction business as we expected. However, Flex-Tek's diversified end-market exposure and new product launches are supporting resilience and continued growth in this segment. Aerospace was up 14.8% in the first half, driven by increasing aircraft builds and our expanded product offering, and we will continue to benefit from aerospace growth in the second half. New product launches are also ramping well. We received our first Midrex / H2 Green Steel purchase order and our Python flexible refrigerant line platform is growing quickly.

Smiths Interconnect – growth moderating, as expected

Onto Smiths Interconnect, which as expected, saw more modest growth of 3.3% in the first half, following a record year in FY22. Operating profit of £32 million reflects pricing actions to offset inflation and an increase in R&D to support new product development. At Interconnect, we have a good pipeline of next generation products which will support future growth, as will the strategic acquisition of Plastronics, which closed in January. Plastronics is a leading supplier of test sockets which complement our existing product range, and it is a great example of an accretive and strategic bolt-on acquisition. We are beginning to see the expected slowdown in the semiconductor end market, although this accounts for less than 3% of Smiths Group revenues.

Capital allocation

Underpinning our accelerated growth is a strong and flexible balance sheet. Net debt to EBITDA was 0.8 times at the end of January. This is after the return of £241 million to shareholders in the first half, which consisted of our share buyback and our final FY22 dividend payment. We also expect a reduction in gross debt in the second half, with the repayment of our €600 million bond.

Our capital allocation policy is unchanged. First, we look to maximise organic opportunities through investment in R&D, sales and marketing, and capacity expansion. And in the first half, we invested £77 million in R&D and CAPEX projects. Second, we want to implement this organic strategy with complementary and disciplined M&A, such as the acquisition of Plastronics. And third, we look to return capital that is surplus to our reinvestment needs. We have a progressive dividend policy and have recommended a 5% dividend increase. Through the first half, we continued to repurchase shares under the £742 million share buyback programme, which is now 90% complete. By staying true to these three pillars of our capital allocation policy, we are confident we can deliver our medium-term financial targets.

FY2023 Outlook

And in conclusion, as a result of the strong first half and recent trading, we are once again raising our guidance for the full year. We now expect organic revenue growth of at least 8% with moderate margin improvement. This is supported by a number of tailwinds, such as the strong order books, particularly in John Crane and Smiths Detection, coupled with a good pipeline of new products. SES projects will continue to deliver growth and strength in execution, and targeted cost actions will improve our speed and operating leverage. Moderating this, we have stronger top line comparators in the second half, and OE growth will continue to have a mix impact as our installed base grows. Geopolitical and macro uncertainty remains high, and we are actively managing supply chain challenges that persist. And while a couple of our smaller end markets are showing signs of softness, momentum in the rest of the business remains strong. So balancing these various headwinds and tailwinds, we remain confident of delivering a second half of further progress.

And with that, I will hand back over to Paul.

CEO Review

Paul Keel

Chief Executive Officer, Smiths Group

Thank you, Clare. I will now provide a strategic and operational update organised within the framework of growth, execution and people, and we will begin with growth.

Growth – driven by new product development

New products are clearly playing a role in our accelerating growth. Our new product vitality index, which measures the proportion of revenues from products launched in the last five years, was just under 30% for the half, up 90 basis points year-over-year. The vast majority of our new products are developed to support specific customer needs, and as such, they are well aligned with key global mega-trends, like energy transition, ever-rising security needs or the world's insatiable demand for data. On this slide, you can see examples of new platforms launched already this year in support of these trends. Collectively, new launches delivered £32 million of revenue in the half, or just over two points of growth on a gross basis. To continue fuelling our strong new product pipeline, we increased R&D investment by almost 14% in the period.

Growth – progress building out priority adjacencies

In addition to strong new product performance, we are making good headway building out priority adjacencies, like those you see here. Energy transition describes the $100 trillion, multi-decade transformation of the world's energy supply from fossil-based to zero carbon sources. John Crane is ideally positioned to help our customers along this journey, with our leading installed base and our global service network. We are currently engaged in over 40 active hydrogen and carbon capture projects around the world and have seen our opportunity funnel more than double over the past 12 months.

For example, in the first half, we won 100% of the gas seals, couplings and filters tendered to date for a $1.6 billion blue hydrogen facility being built in Edmonton, making it the largest ever in Canada, producing enough liquid hydrogen to power every public transit agency across the province of Alberta. The surging demand is propelled by a number of market and regulatory forces, such as the Inflation Reduction Act in the US and similar programmes in other parts of the world.

For Smiths Detection, in addition to double-digit growth in aviation, we expanded our presence in other high-security markets, like ports and borders, defence and urban security. Our business in these adjacencies grew 23% in the first half, behind major customer wins in markets like the US, Japan and Indonesia.

Flex-Tek is helping customers meet their sustainability goals in a number of ways. In October, we announced a strategic partnership with Midrex Technologies and H2 Green Steel to build the world's first zero-emission steel plant in northern Sweden. Midrex provides the hydrogen reduction process that powers the facility, and Flex-Tek provides the high temperature electric elements that superheat the hydrogen.

As Clare mentioned, we completed the bolt-on acquisition of Plastronics in January, leveraging cross-sell and new product synergies with Smiths Interconnect, and extending our leadership into attractive adjacencies in connectors and testing.

Execution – SES benefits visible and scaling quickly

Now, having shared some updates on growth, let me say a few words about our progress on the execution front. The Smiths Excellence System is the framework through which we are building a more aligned, consistent and higher-performing culture here at Smiths. SES improves results delivery and accelerates talent development. We relaunched SES around this time last year, initially putting in place five full-time master black belts to lead the programme and 20 black belts to lead the projects. The first wave of projects have now been completed, contributing roughly £5 million to the bottom line.

The impact of SES is scaling quickly. Our initial target was to generate £20 million in annualised benefit, and based on the good start in first half, we are now tracking to just over £25 million. And encouraged by our progress, we have added an additional master black belt and five more black belts in key commercial and operational areas around our company.

Execution – SES in action

SES is fast becoming the way we work here at Smiths. To give you a feel for how this plays out on a day-to-day basis, we thought we would share a typical project. I will quickly frame the effort and then turn it over to the project team to walk you through the details. I mentioned on a previous slide that demand for electric heating solutions is growing quickly, driven by the same mega-trends we just touched on. Flex-Tek supports customers in this area in a number of ways. The Green Steel programme I mentioned is one example. Another is our electric heat kits used in residential HVAC units. Around this time last year, high demand, coupled with supplier constraints, resulted in surging back orders in this part of our business. We pointed SES at the problem and over the span of roughly six months, increased our capacity by a quarter, cut lead times in half and fully eliminated the customer backlog.

Now let's hear from Dane, Justin and Kevin who led the project.

[VIDEO]

Dane Owen: *Hey, I am Dane Owen. I'm the VP and GM for the Heat Solutions Group with Flex-Tek, and we are located in Cookeville, Tennessee.*

Justin Robertson: *I am Justin Robertson. I work in the TUTCO division of the Heating Solution group of Flex-Tek. I am the planning and inventory manager, and I will be the process owner of the black belt process that came out of this project.*

Kevin Modrall: *I am Kevin Modrall. I am the black belt for the Heat Solutions Group under Flex-Tek.*

Justin Robertson: *So basically if you have a heating unit outside of your house in the US, there is a heating element that goes in there. The heating elements heat up and they blow air across it. Anything with electric heat that air blows across with elements that heat up, Tutco can pretty much find that solution for you.*

Dane Owen: *The problem we were facing, due to COVID, we had serious component issues and our late list, which is historically $0.5 million to $1 million, grew to an astonishing $13 million. To me, the way I look at black belts is, what is my greatest pain point, and there was not a greater pain point than having a $13 million backlog.*

Kevin Modrall: *Supply chain was an issue. China was shut down. The Ukraine and the Russian War had actually started. So there was all these outside influences that were influencing the supply chain. One of the solutions that we came up with was the dashboards. Then we went to Dane and we went to the team and said, 'Look, this is what the data's showing.' Within a week, we had another line set up. We did not have to add cost to that line, but we added another line to set up and we started producing more heat kits, so we increased heat capability 23%.*

Dane Owen: *That really allowed us, within about six months, to take this $13 million backlog and reduce it down aggressively to about $1 million. And so you can imagine the excitement from the Group, from Mexico all the way to Cookeville, our location, seeing the results and seeing how quickly we all connected. And also seeing the solutions that came out of that, not just in getting us down to a minimal backlog.*

Justin Robertson: *The other big thing was on lead times. Our lead times when we started the project was around four to six weeks. We are now back down to two weeks, which is fantastic.*

Dane Owen: *To not only hitting head on the problem, but also digging deep down and finding, oh my goodness, there are so many other things now that made us better because of this.*

Paul Keel: Thank you Dane and team. A terrific project.

People – inspiring and empowering our people

As growth accelerates across Smiths, we see variants of this opportunity in a number of areas and are quickly replicating the project, learning and building with each successive result. Our people priorities are focused in four areas: safety, leadership development, diversity and inclusion, and engagement. Recognising that a picture is worth 1,000 words, we thought we would share a few photos from some of the many powerful initiatives we have underway across our company. And if we get 1,000:1 leverage with photos, hopefully the following video will further bring to life the wonderful culture that we are advancing here at Smiths.

[VIDEO]

Speaker: *Safety's the measurement of the heart. Safety is about people.*

Speaker: *Our aim, zero harm. Zero harm to people, zero harm to environment, as well as our communities.*

Speaker: *I am so pleased to welcome Pam Cheng!*

Pam Cheng: *We push the boundaries of technology at Smiths. You think about Detection, we are keeping the world safe. How do you improve the world? By technology and innovation.*

Speaker: *So I found the Accelerate training really interesting and really valuable because it really underpinned the meaning of what it takes to be a leader.*

Speaker: *In as much as I am developing myself, I want to carry people along because you can only go as far as the people around you.*

Speaker: *I am truly honoured to be here today to introduce our first ever celebration of Black History Month as a Group.*

Speaker: *I am delighted to introduce you all to – title only once – Professor Dame Ann Dowling.*

Professor Dame Ann Dowling: *Equity. So yes, being fair and just, and it means we have moved on, beyond just being – trying to treat everybody equal, but we are recognising that everyone is an individual.*

Tony Tielen: *I am Tony Tielen, Group SES Director, and I am so excited to be hosting the first Excellence Awards sponsored by the SES team.*

John Ostergren: *It is a true honour to be part of the awards this year and have the chance to recognise some of the biggest impacts we are making to improve the world.*

Progress advancing our sustainability strategy

Sustainability. It plays an important role in our growth, execution and people priorities. On the growth front, in addition to energy transition programmes that I mentioned earlier, we have multiple green new product platforms in development. With respect to execution, we are accelerating emission reductions at the same time that we are growing our business. We are tracking ahead of plan on our three-year targets for water, waste, renewable electricity and greenhouse gases. In terms of people, this is the first year where delivery of concrete ESG commitments are part of both our short and longer-term incentive comp at Smiths. You can find a good summary of our sustainability strategy from John Ostergren, our CSO, if you visit the Capital Markets site on our webpage, and you can find even more detail in the sustainability report, which is also available for download in the same location. Sustainability is an area of both strength and competitive advantage for Smiths, so please do have a look.

Building a consistent record of continuous improvement

Just a few comments by way of summary and then we will open it up to all of you for your questions. After a record start in the first half, we are well on track for a strong fiscal 2023. Our growth is good, 13.5% in organic terms and over 25% reported. Order books and current trading remain strong and as such, we have once again raised our full-year organic revenue guidance, now to at least 8%.

Our execution is continually improving, allowing us to deliver year-over-year gains in four of our five medium-term financial commitments, including EPS, which was up 52%. SES is playing an important role on this dimension and encouraged by our progress, we are scaling the programme accordingly.

And our people enable all this progress and I want to thank and recognise my 15,000 colleagues around the world for doing what we do best: improving our world through smarter engineering. By aligning behind our people priorities of safety development, D&I and engagement, we are advancing the wonderfully inclusive and high-performing culture of Smiths. As a 172-year-old company, we think as much in quarter centuries as we do in fiscal quarters. We are encouraged by the progress we've made over the past six months and carry strong momentum into the second half and beyond.

Thank you for your attention and support. And with that, we will turn it back to the operator to open the Q&A.

Q&A

Christian Hinderaker (Goldman Sachs): Good morning and thanks for the opportunity to ask the questions. Very strong set of results, so forgive me for starting on one of the rare negatives in the prints. Can we talk a little bit about inventories? Up from 22% of sales at year end to 24%. Not unusual in terms of the industrial end markets we are seeing at the minute, and obviously you have got good reason for that to support the substantial growth. But you have talked about targeted plans including SES projects to reduce that inventory.

Just be grateful for a little bit more clarity around that as well as how we should think about inventories, either in days or percent of sales, developing through this year and into the following. And then I will come back to the other two.

Paul Keel: Yeah, thanks for the question, Christian. As Clare mentioned in her comments, about 85% of that inventory increase went into John Crane and Detection. And what you would like to see if you broke that down was the components of inventory lining up with the growth. So we look at inventory by the three big categories, raw materials, work in process and then finished goods. In John Crane, the largest percentage increase came in work in process. These are orders that came in, materials that are moving through the factory, and those will now progress on to customer sites. We are further along on the Detection side, where the largest percentage increase was in finished goods. So these are large Detection systems that now are fully assembled and we are just waiting for the customer to receive them. So that will work through naturally here as the business progresses forward.

For us, we think of it as an investment. In the same way that we are willing to trade near-term margin on OE for the higher margin recurring aftermarket, we are willing and, in fact, excited to use our strong balance sheet for competitive advantage to support this kind of growth. I do not know, Clare, if you had anything you wanted to add to that?

Clare Scherrer: I think that is a terrific explanation of where our cash conversion in the half reflects our investment in inventory and it reflects our belief that that will, in turn, support medium-term growth. Nothing has structurally changed about our ability to generate cash conversion consistent with what we have done in the past.

Christian Hinderaker: Thank you both. And secondly, I wanted to ask about Flex-Tek. We are seeing a bit of a softening in the housing data, both in terms of starts and now year-on-year in terms of pricing. Can you talk about the positioning of the Flex-Tek business within the US housing market and what you are seeing in terms of demand conditions today on the ground? I note that 67% of division sales are now HVAC related. That may provide a buffer perhaps in terms of spending towards energy efficiency over general DIY investment. Grateful for your thoughts.

Paul Keel: So, Flex-Tek is a fabulous business. Over time, it grows regardless of what is happening with its underlying markets. It has double-digit 5, 10, 15-year top-line CAGR and even better earnings CAGRs over that same period. We have been anticipating the well-understood slowdown in the US housing market would have impacted Flex-Tek sooner. Flex-Tek came in stronger than many people expected. Now we do see, as you pointed to, those macro indicators on the US housing starts. While it did not impact us in the first half, in the first six weeks here now of the second half, we are starting to see evidence of that. So, Flex-Tek will continue to grow as it always has, just not at those same record levels we saw in fiscal 2022 and then here in the half.

They have two businesses balancing the construction impact that we just described. You noted one of them, aerospace. Order growth in aerospace was in the double digits in the first half and that business will continue to grow here moving forward. And then the second is the electric heating business that we touched on in the call. The demand for electric heating elements – as all businesses like ours have made net zero commitments, a place you look early is on your process heating. And so we are getting a strong inflow of questions how we can help our customers convert from fossil based heating to electric heat. So, we feel pretty good about where we are at with Flex-Tek.

Christian Hinderaker: Thank you, Paul. And then linked to my second question and, in fact, your comments on the net zero ambition, I wanted to ask if you are seeing any signs of incremental demand from some of the policy announcements we have seen, for example, the CHIPS Act, which might help Interconnect, and you flagged the US IRA earlier on in the call. Just wanted to think about how we should calibrate the impact of those policies on demand for your businesses.

Paul Keel: Energy transition is one of these giant global mega-trends. $100 trillion the world will invest over the next 20, 30, 40 years, as we get to net zero. Whether that is in 2040, 2050, we will have to see. And this is now playing out in our business in a number of ways. We gave the example of the blue hydrogen facility in Canada as a very clear example of that; the H2 Green Steel partnership in northern Sweden, another clear example of that. And so legislation like the Inflation Reduction Act and parallels of it in most major economies all help accelerate that tidal wave of transition that is coming. So, we find that supportive, absolutely.

Christian Hinderaker: Thank you, Paul.

Paul Keel: Thanks Christian.

Andrew Wilson (JP Morgan): Hi, good morning. Thanks for taking my questions. On John Crane, I am interested in terms of what indications you are getting from customers with regards to demand. The orders in the first half, I think you said, were up 14% year-on-year, so clearly very strong there. I am interested in terms of how much of that is a catch-up, maybe pent-up demand. Supply chains obviously have been challenged, etc., and how much of it is real genuine underlying… We are obviously expecting energy markets probably to be pretty strong for maybe the next year or two at least. But I guess interested in terms of what the customers are actually telling you and interested from both what we would describe as traditional markets, but also the newer markets as well, in terms of into second half and maybe into FY24.

Paul Keel: Yeah, thanks, Andy. It is a good question. So Crane is seeing strong demand, both on the order front and on the revenue conversion side across all of its end markets, and it is seeing it both on the OE and the aftermarket side. And there is three pockets of customer demand. Yes, the traditional energy business right now is seeing very strong demand. Part of that is post-COVID. Part of that is the increased demand for supply out of non-Russian sources.

The second piece, remember John Crane also participates in a number of non-energy segments: water treatment, pharmaceuticals, chemical. All of those businesses, demand is strong.

The third piece of it is this energy transition wave again, which we had been thinking about as the future. But that future is very much here right now. 40 active hydrogen and carbon capture projects underway right now, our opportunity funnel more than doubling, and then some very big projects, like the Canada project, and then last year we had the very large NEOM project. So it is a good time in John Crane. And incrementally exciting for us is there is good reason to believe for Crane, the near-term demand will extend into the medium term for all of the reasons I just described. And then this long-term tailwind from energy transition. Provided that we can respond to the demand, both in terms of operations but also in terms of new product and service offerings, we should be well positioned here for some time to come.

Andrew Wilson: Thank you. And my second question is actually something similar on the Detection side. There is a couple of aspects to it. Obviously, the first half was very encouraging in terms of that order conversion coming through and I think you have been fairly clear in terms of what we should expect for the second half on a slower growth rate. But in terms of the visibility that you are getting with customers and the visibility that that is providing you with in terms of profitability, I am interested if you have been able to make any progress with regards to better understanding the profile of the business going forward. Because historically we have seen it being quite volatile and it has been quite challenging, I think, at times, in terms of trying to understand what we should be expecting. And clearly, within the context of the group targets, Detection has to contribute to that. So it is a very broad question, I appreciate, but just in terms of your confidence and visibility around what we should be expecting in Detection, again, probably in the next 12 to 18 months.

Paul Keel: Yes, well, we think of Detection in a two-by-two grid. You have aviation security, you have other security systems, you have the OE part of the business, and then you have aftermarket. On the OE side of the business, you tend to have good visibility. The order book in Detection tends to be multi-year, so you can see forward across many quarters of what the OE side should look like.

Attached to every OE order is typically a committed service period. And that service piece has both scheduled maintenance as well as break fix, so you can see the scheduled maintenance and model that out. What you cannot see as well is how fast these adjacencies grow. So we have a pretty good feel on the aviation side, but the adjacencies we are moving into, other security systems had very rapid growth in particular on the OE side in the first half. That is a little bit more difficult to predict. And then again, the other security systems side of that business also has the defence piece. Those tend to be very large orders. And so when those come in or those roll off in a comparable period, that tends to introduce a little bit of volatility.

Clare Scherrer: Paul, I might add, we enter the second half with our largest order book ever in Smiths Detection, which is up double-digit versus a year ago and up high single-digit percent growth in order book versus the start of the year. And so I think that positions us well. As you mentioned, Andy, it is a programmatic business, so quarter to quarter, things don't always advance in a smooth fashion because we do need to wait for customers to be ready to receive delivery. But overall, the order book that we enter the second half with, positions us well for sustained growth in that division.

Andrew Wilson: That is really helpful. Thank you very much guys.

Paul Keel: Thanks Andy.

Operator: Thank you. Now we are going to take our next question. And the next question comes from line of Mark Davies Jones from Stifel. Your line is open. Please ask your question.

Mark Davies Jones (Stifel): Thank you very much and morning both. If I can start with a broad one and then a couple more specifics. The broad one is obviously now you have roughly doubled your expectation of organic growth for the full year. If you were isolating particular parts of the business that have driven that, is it more about stronger demand and in which case, what part of the business? Or is it more about better availability as you deal with some of the supply chain issues? Can we take that one first?

Paul Keel: So, for, well, call it 18 months now, demand has exceeded supply and right now, both on John Crane and Detection, they have such strong order books that demand is still above our ability to supply it. We have been scaling supply in both Crane and Detection, both in terms of CAPEX, adding capacity, but also SES is – as you saw a good example there with the Flex-Tek project, we are getting more supply out of existing capacity. So on both fronts there, that is supportive.

Mark Davies Jones: Okay, thank you. And then this wave of OE we are seeing in Detection, what typically is the lag between one of those OE waves and the aftermarket coming through? Because I know there is a period of time when the aftermarket stuff is effectively included in the sale process. So how long is that lag?

Paul Keel: Yeah, for Detection it can be anywhere from six to 18 months for an order to convert to revenue, on the OE side. It's shorter, more typically three to six months, for an aftermarket order in Detection to convert to revenue.

Mark Davies Jones: Okay. And perhaps one quickly for Clare. Obviously, a lot going on on the balance sheet. In terms of the benefit of seeing a lower finance cost coming through, can you give us some indication of timing and scale of that?

Clare Scherrer: Yes. Thank you for the question. So, we are planning to repay our €600 million bond when it comes due in April. So we will have interest reduction from that repayment. When you think about the other bond which we will have, which will remain outstanding, which doesn't mature until 2027, half of that is swapped to floating. And so you should think about, right now, the effective interest rate that we pay on that remaining bond of around 4.2%.

Mark Davies Jones: Thank you very much.

Andrew Connery (Credit Suisse): Hi, good morning. Thank you very much for taking my questions. I will go one at a time as well. Can I start with the Smiths Excellence System that is clearly delivering results, and you have outlined very clearly what to expect for the second half, and then the increased annualised benefit of £25 million. But beyond that, should we think about SES as something that is a continuous process and think about that similar level of annual savings that you could generate, obviously, in 2024 with a full annualisation and beyond that? Or is this something that you are still ramping up very actively and is something that has got potential to actually deliver substantially more than the current run rate?

Paul Keel: So SES, as you see in other businesses that have deployed continuous improvement methodologies across the enterprise, it brings you two primary things. It improves your execution, your project management, the predictability with which you can solve problems. And then the second thing it does for you is it accelerates development of talent. Certainly, the black belts and master black belts who are in full-time roles in the programme, but all of the project participants learn that same problem-solving methodology. And then over time, you improve your culture, you get used to better execution and it becomes the norm.

Now, you can point that capability at a lot of different things. Across the first half, we principally pointed it at customer service, because of Mark's question regarding demand and supply. With demand exceeding supply, we have our SES teams focused on customer service. Also helps, of course, on productivity front. So, while we more than cover input inflation with our own price, there's still more margin to be captured. So moving forward, we are using a few more resources on the productivity side. As we get through that piece, I think you are going to see more emphasis, as Clare mentioned, on the working capital side. We start to bring our cash conversion numbers back up into that 100% range that you guys are used to from us.

So SES does a lot of things for the company and you can point it at a lot of different problems.

Andrew Connery: Great. Thank you. And maybe to extend that a little bit, I know it is multifaceted, but we have some companies that talk about a minimum level of productivity to be delivered every year. Some talk about 3%, 4%, 5% at the highest. Is that maybe a way for us to think about Smiths going forward with SES being the tool and being flexibly applied to different kind of trigger points?

Paul Keel: Yeah, of course you would like to see productivity both on your COGS line, in your factories, and then you like to see SG&A productivity. We look at both. We had good SG&A productivity in the first half. I think if you look at SG&A as a percent of sales, it was down 70 basis points or something like that. And then if you look at our margin walk, you can see examples of that factory productivity coming in. So yes, productivity on both sides is absolutely something we are focused on.

Andrew Connery: Thank you. And if I may, just a couple of quick ones on John Crane. One, very excited to see some numbers on the new energy. Is there any chance you could give us an order of magnitude of potential value of those, say, 40 projects? I know you would not give it for an individual contract award, but just for us to have an idea what these 40 projects could mean in terms of potential revenue, even a rough ball park.

Paul Keel: At this stage, no, we could not give you an accurate answer. Because it is growing so quickly, it is tough to know what that growth rate will look like moving forward. If the current rate continues over several years, it will be a big part of our business.

Andrew Connery: Right, right. Maybe I will follow up. And the final one was just on the margin for John Crane. Clearly, strong performance in H1, and you normally have quite healthy seasonality in the second half. Can that happen in this year? Or should we not get too overexcited on that kind of sequential potential improvement in margin further from already healthy level in H1?

Paul Keel: Well, all of our businesses have scale economies. So you put more volume through the factories, you get longer runs, you get fewer changeovers, and all of that shows up in the gross margin line. You saw that in John Crane. And then secondly, of course, is the SG&A efficiencies. You put more revenue over the same cost base, you get margin expansion from that. John Crane's high watermark is still north of where we currently are. So if we continue to execute as we have been, yes, we believe there is additional upside to Crane moving forward.

Andrew Connery: Great. Thank you very much.

Bruno Gjani (Exane BNP Paribas): Hi, thanks for taking the question. My question relates to orders and the order outlook. I recall back at the Capital Markets event a couple of months ago, you indicated that 5-7% organic order growth was possible in FY23. I was hoping you could share what organic order growth was in H1 and was wondering whether you still expect to deliver 5-7% organic order growth this year, or whether your expectations have evolved since then?

Paul Keel: Yeah, thanks for the question, Bruno. So we shared the number for John Crane, the 14% order growth. That business remains strong and we expect similar kinds of levels moving forward. In Flex-Tek, the order growth is most relevant in the aerospace part of that business. We are seeing low double-digit order growth for Flex-Tek. Detection, Clare mentioned it is a programmatic business, so looking at order intake growth probably is not as helpful as looking at total order book growth year-over-year. And as Clare mentioned, that was double digits here heading into the second half. The one business where we had negative order growth was Interconnect, and that relates to the slowing in semiconductor tests that we knew was coming, as well as a little bit in our FOCOM business. Some of our customers have delayed projects. We think they will come but in the first half they were delayed.

Bruno Gjani: Okay, that is helpful. And I have another question just on investments and growth and the impact that has on the bridge. Could you help us think about how we should be thinking about the development year-over-year in H2 in terms of the dilution to margin? Because am I right in thinking that the year-on-year headwind in H2 2022 was more pronounced, and so therefore this year, when we are looking at that year-over-year impact, it should be less pronounced as you started to ramp up investments more meaningfully towards the back end of last year, or the last fiscal year? Just the shape would be useful.

And just on the mix element as well, was there anything exceptional that was delivered in H1 that weighed down on that margin particularly, that might not repeat in H2, or would you expect mix within revenue for H2 2023 to be largely similar to that of H1? So a similar mix headwind?

Paul Keel: For the full year, we expect to continue seeing moderate margin improvement. It will be the same trade-off that we talked about for the first half. We could goose margins more. We could back off on our R&D investment. We could be more discerning in terms of our OE tenders. But our current posture is that we'll continue to prioritise growth. So tenders that play to our strength, that value technical differentiation, that value strong service using our global service networks, we are going to continue to invest in the OE piece, knowing that it's a near-term margin impact, because we have decades of evidence that it leads to higher margin recurring revenues. So I think it is going to be, Bruno, the same sort of dynamic here in the second half as we talked about for the first.

Bruno Gjani: Sure, sure. And on Detection, we are seeing more airports install or rather order CT technology on the cabin baggage side in Europe. Could you perhaps talk about the upgrade opportunity that exists in Europe? You touched on it in terms of New Zealand but what that opportunity might look like for you over the next two to three years.

Paul Keel: Yeah. There is two sides of that business of course, the checkpoint and the hold baggage. Hold baggage conversion to CT in Europe is largely complete. It is the check baggage that's now going country by country and it is different in each part of the world. The UK has mandated CT for the checkpoint here, I believe by the end of 2024. The US is just starting. There is only one purchaser in the US, that is the TSA, and for all intents and purposes, their major tenders right now are all for CT. So country by country has a different pace. The furthest ahead is the Netherlands, for instance. They are nearly complete on both hold baggage and check baggage.

Bruno Gjani: Sure. And just finally on Flex-Tek, so you noticed that you are seeing the slowdown. Does that relate to just volumes or is pricing starting to roll off as well? In your construction markets, that is.

Paul Keel: I would say you should expect a slowing on both sides. We did not see price come off in the first half. We had good volume and price for Flex-Tek. But in particular, on the construction side, our customers are asking more questions around price than they did previously. And that goes with demand. When demand is strong, they ask you, 'When can you deliver?'; they do not ask you at what price. Now, as that demand on the construction side is normalising, price comes into play.

Bruno Gjani: Sure. Got it. Well, that has been very, very useful. Thank you very much.

Paul Keel: Thank you.

Okay. Well, thanks everybody for tuning in. As I think you heard on the call and you saw in the release, the very strong momentum in the business right now, that seven consecutive quarters of accelerating growth punctuated with record organic revenue growth, record reported revenue growth, and record EPS growth. Also unique in that all four businesses, all parts of the world and all customer end-markets were in growth in the first half. So we feel good about the momentum we currently have. We would balance that with an observation of macro uncertainty, which remains at a very high level. So the things that we can control, we expect to continue progressing in, in the second half, but uncertainty is pretty high. So you put those two together and you get the increased guidance for the full year of at least 8% organic revenue growth, which is our second raise now in two months.

Thanks again for your interest and we will be talking to all you guys here in the coming days and weeks. Bye for now.

[END OF TRANSCRIPT]