Chief Executive's statement

We have delivered strong sales and profit growth driven by good performances from John Crane, Smiths Detection and Smiths Interconnect. A performance improvement programme is underway to address the operational issues that have held back Smiths Medical over the past two years.

The portfolio has been strengthened this year through one divestment and seven acquisitions which bring new technologies and extend Smiths geographic footprint – particularly in developing markets.

Our focus is on top-line growth and margin enhancement while there are significant opportunities to improve performance and generate value across the Group. We have begun a substantial restructuring programme that will deliver operating efficiencies and improve customer service. The scale of the opportunities is demonstrated by the new divisional targets set out here for the first time.

The sustained upheaval in the world economy is creating uncertainty in many markets and may disrupt government spending patterns – particularly in the US and India where there are forthcoming elections. However, Smiths Group is well placed among global businesses to meet these challenges.

Looking at this year's results, sales rose by 7% and the headline pre-tax profit increased by 10%; after adjusting for currency translation and acquisitions and disposals the underlying improvement was 6% and 8% respectively. The headline numbers exclude various exceptional items which are detailed in the Business Review; one of these is a charge of £40m in respect of John Crane, Inc. litigation, a full explanation of which is on page 29.

Since joining Smiths some nine months ago, I have undertaken a thorough review of operations. It is a Group with a strong set of technology-based businesses applying some of the world's most advanced industrial sciences – from airport X-ray scanning machines to mechanical seals for the oil industry. In addition, the businesses operate in markets sustained by long-term secular growth: Smiths Medical's market is growing as populations age and increase in prosperity, John Crane by energy consumption, and Interconnect by the need for increased bandwidth and upgraded wireless infrastructure. Smiths Detection is driven by demand for increased security and protection. Although Flex-Tek is exposed to more cyclical markets such as US housing, it has a portfolio of high-performance products that supply the aerospace market.

My review of operations identified significant opportunities to improve performance progressively over a two-year period and maximise value for shareholders. To deliver these benefits, the Board has already taken some key decisions:

- manage the Group as five divisions from 1 August 2008 and restructure each to improve customer service and deliver efficiencies;
- restructure and reduce the corporate centre to cut cost and focus it on delivering returns from the business;
- improve business systems and data-flow which, over time, will support data-driven decision-making and enable the Group to be more responsive to changing market conditions and opportunities;
- build the business through acquisitions which will add complementary technologies, expand the geographic footprint or leverage existing scale;
- increase investment in research and development and focus it more intensely on higher growth areas that will deliver greater returns; and
- introduce an incentive scheme for senior management that reinforces our new culture of performance improvement and delivery against recently established divisional targets.

In June, we announced that the Specialty Engineering division would be disbanded so that its three constituent businesses – John Crane, Interconnect and Flex-Tek – report directly to me. This reduces cost and gives greater accountability to each of the businesses. In addition, all Smiths divisions will now be managed from divisional headquarters that are closer to their operations, key markets and customers.

We also aim to realise value by restructuring the divisions themselves. For example, John Crane which had historically been managed as two separate operations from the UK and US, is now combined under the leadership of Paul Cox and headquartered at Morton Grove, near Chicago. In Medical, the management structure in the US will be simplified and we will introduce a global approach to R&D. There are also further opportunities to re-organise Flex-Tek's portfolio of businesses to drive efficiencies and improve operational effectiveness.

At the same time, we have defined more clearly the roles of the divisions and their interface with the corporate centre. These changes will reduce substantially the size of the corporate office and improve the way we work by introducing better defined governance and decision-making. The small head office will concentrate on three areas: setting the Group's strategic direction and capital allocation; leveraging the Group's scale where appropriate; and ensuring compliance as a UK-listed company. In future, we will report the corporate centre costs separately which will give greater clarity to the underlying margins of the divisions and provide a clear incentive to minimise corporate costs.

Taken together, these restructuring programmes are expected to deliver annual cost savings of £47m once they are complete in three years time. The cost of delivering these programmes will be £48m which will be treated as an exceptional item. Further details are given in the divisional reviews.

We are also investing more to improve data-flow and speed up decision-making through the implementation of better information systems. For example, ERP systems are currently being deployed in Detection, John Crane and Medical. At a Group level, a new information platform is being introduced which will help capture operational data from the divisions. This creates opportunities to leverage the scale of the Group for the first time by group-wide procurement of travel, IT, and other services. We have already launched a programme to consolidate IT service delivery across the Group, improving service quality and cutting costs. We have also signed a deal with AT&T to supply a range of communication services such as mobile telephones, remote access, etc. which will deliver annual savings of at least $5m.

Our management team has also been strengthened. Reflecting the importance of the IT investment, Brian Jones has joined us as Chief Information Officer. He brings many years' experience in implementing ERP systems and improving information flow within large organisations. Michael Herlihy has been appointed General Counsel and is also a member of the Executive Committee and Peter Durman has joined to lead an invigorated investor relations programme. The mix of talent at Smiths will continue to be refreshed and reinforced with external appointments bringing different competencies and innovative ideas to the Group.

There are valuable opportunities to build Smiths through bolt-on acquisitions – particularly in John Crane, Interconnect and Detection. Such acquisitions bring complementary technologies, support geographic expansion or leverage existing infrastructure. John Crane acquired Indufil, a specialist in filtration systems, and Sartorius Bearing Technology, a leading provider of high performance rotating equipment for the oil and gas industry; both have added valuable new technologies that can be leveraged through John Crane's global network of more than 220 sales and service centres. John Crane also acquired Fiberod which further extends our upstream energy services capability and complements the CDI acquisition made last year. In addition, John Crane expanded its presence in Japan, the world's second largest market for OEM pump manufacturers, by increasing its ownership share of John Crane Japan from 49% to 70%. In Interconnect, the acquisitions of Shanghai-based Allrizon Tongguang and Brisbane-based Triasx Pty Ltd have strengthened its position in the growing Asian market. Flex-Tek's acquisition of Fast Heat has extended its range of specialty heating solutions.

We are also driving higher levels of revenue growth organically through an increase in research and development (R&D) investment focused more tightly on growth areas that can deliver the most attractive returns. R&D investment for the Group increased by 8%, or £7m, to £86m. In Detection, our spend has been focused on X-ray detection systems for both airports and cargo screening, while we have extended our portfolio of chemical and trace detectors. We are at the cutting edge of a number of technologies – X-ray screening, millimetre wave imaging and biological detection. In Medical, we have launched a number of new products during the year as we begin to benefit from the introduction of a streamlined product development process. It has resulted in a 50% increase in the number of product launches this year.

To reinforce our new culture of performance improvement, we have established targets for sales growth and margins for each of the divisions. These are the ranges we anticipate the divisions will operate within over the next three years, based on organic growth at constant currency and assume a financial and macro-economic environment consistent with that of recent years. Alongside this, we have introduced a new incentive plan for senior management and divisional leadership. It more closely links remuneration with performance and, ultimately, value creation and places much greater accountability on the divisional leadership for the performance of their businesses. The new incentive plan means that each division will have its own targets to meet, reward will be bound together by one common currency, the Smiths share price. In that way we will reflect the value-creating performance of each division.

Sales

	2008* £m	2008 growth#	Target growth range#
Detection	**509**	12%	10-12%
John Crane	**626**	8%	6-8%
Medical	**703**	0%	3-5%
Interconnect	**261**	13%	6-10%
Flex-Tek	**206**	(4%)	0-7%
Total	**2,305**		

Headline operating profit

	2008* £m	2008 margin	Target margin range
Detection	**93**	18%	17-20%
John Crane	**104**	17%	17-22%
Medical	**140**	20%	20-24%
Interconnect	**54**	21%	21-23%
Flex-Tek	**24**	12%	11-16%
Corporate centre	**(35)**		
Total	**380**		

*The above analysis reflects the revised operating structure for 2008/09, see page 72, and excludes three months of trading for Marine Systems which was sold in November 2007.

#Organic growth at constant currency

Delivering these returns will be a team effort and I would like to thank our 22,000 employees around the world for their hard work and support during a time of very real change both within Smiths Group and the wider economy.

In summary, I believe that most divisions have the opportunity to improve margins significantly. The greater responsibility, accountability and incentivisation of the divisional management teams, combined with the availability of better data to underpin management decisions, should progressively unlock value for the benefit of shareholders.

Philip Bowman
Chief Executive