2019 Interim results transcript

Andy Reynolds Smith ***Smiths Group plc - Chief Executive***

Morning, everyone. It's a really important day for us today and it's a really major milestone in the history of Smiths. Our first half results are evidence of the continued progress we're making against the strategic plan. Back in 2016, we set out our vision to transform Smiths. And since then, the company has been through a programme of extensive change and development. We've been putting in place the building blocks that will really support sustainable growth above our markets in the future.

Last year, we returned the group to growth for the first time in 5 years. This year, the group has delivered 2% growth in the first half, and in the second half, we're in line with our expectations to meet the full year.

Building on the progress we've made and our confidence in the future, we've also announced our plans to separate Smiths Medical. We will pursue a demerger and separately list Smiths Medical in the U.K. Both companies will be premium, London listed constituents of the FTSE Index. The separation will create 2 stronger companies, both industry-leading companies, which have distinct strategies, focus and are better positioned to take advantage of the opportunities for growth and importantly for value in their individual markets.

The demerger will also enable Smiths to concentrate on growing as a leading industrial technology group. It will enable Smiths Medical to focus on delivering its full potential as a standalone medical devices company. We expect the demerger to complete during the first half of calendar year 2020, and I'd like to take you through a bit more detail around that later.

But right now, I'll hand over to John to take us through the first half results.

John Shipsey ***Smiths Group plc - CFO***

Thank you, Andy, and good morning, everyone. I'd like to take you through the results for the first half. They demonstrate good progress against our expectations for both the full year and the medium term.

So let's go straight in. Sustained -- sustainable growth was our stated ambition for this year, and the H1 results demonstrate that we're on track to achieve that, with both reported and underlying revenue up 2%. Operating profit was down 1% on a reported basis and 2% on an underlying basis, with margins of 15.6% driven by Smiths Medical. Reported EPS was down 1% or 2% on an underlying basis, including a one-off increase in the tax charge to mitigate the impact of tariff changes.

Free cash flow was GBP 71 million, and cash conversion was 74% due to specific timing factors at the half year that I'll cover later. Cash conversion is expected to be much stronger for the year overall, consistent with our track record. Return on capital employed was 14.5%. And finally, the interim dividend increase of 2.2% signals our continuing confidence in the trajectory of the business.

So let's review the results in more detail, starting with revenue. As I flagged at the last full year results, we have restated 2018 for the impact of IFRS 15, resulting in a GBP 7 million reduction to reported 2018 revenue. Translational FX increased revenue by GBP 21 million, with the biggest impact coming from a stronger U.S. dollar. The average rate was 1.29 for the first half compared with 1.33 in the first half of FY '18.

Acquisitions and disposals had a net impact of GBP 15 million, including the disposal of bearings and the acquisition of Seebach by John Crane, alongside the disposal of 2 noncore businesses by Smiths Medical. After adjusting for the above, group underlying revenue for the first half was up by GBP 25 million or 2%. Growth in Asia strengthened and revenue was up 8%. It's good to see our strategic focus on the region rewarded with China up 18% and India up 44%.

So let's now take a closer look at revenue by division. We delivered performance in line with our expectations in all divisions. John Crane continued to deliver strong revenue growth, up 7% for the half. Within that, oil and gas was up 9% and non-oil and gas, 4%. Original equipment growth accelerated 7%, whilst aftermarket remained strong, climbing 8% and accounting for 68% of John Crane revenue.

As anticipated, Smiths Detection's performance in the half was impacted by the phasing of deliveries. Overall Detection revenues were down 3%. Air Transportation, the largest segment, was down 7% against a strong comparator in FY '18. Non-air transportation segments were up 3%. The expected return to growth in Ports & Borders, up 32% or GBP 10 million, came directly as a result of the active revitalization of this segment, and there's more to come in H2 in compensation for the phasing of key programmes in defence and urban security.

Flex-Tek continued to deliver good growth, up 6% with sustained performance, notably in heat solutions and construction. Smiths Interconnect continued its return to growth and was up 7%, in this case against a softer comparator. Growth came, in particular, from the semiconductor test and Defence segments. And finally, Smiths Medical was down 3%. As anticipated, legacy regulatory issues and pricing pressures continue to provide headwinds, but in our favour with the recovery of acapella distribution midway through the half and continued growth in sales of new products. And as we move through H2, the sales impact of last year's regulatory issues will switch to become a positive.

So let's now turn to operating profit. Last year's operating profit was GBP 248 million with a margin of 16.1% after the previously mentioned IFRS 15 restatement. FX represented a GBP 4 million tailwind year-on-year. H1 operating profit of GBP 246 million represents a 2% underlying decline and the reduction in margin of 50 basis points to 15.6%. The positive developments in John Crane, Flex-Tek and Interconnect and lower central costs were outweighed by declines in Detection and Medical.

So let's now take a look at each of those in more detail, starting with John Crane. Operating profit rose 5% with a margin of 21.7%, up 40 basis points. This was underpinned by volume growth and the greater mix of aftermarket. Profit conversion benefited from the disposal of bearings, but was still held back to some extent by investment in capacity to meet stronger demand.

Smiths Detection operating profit was down 9%, with margin down 100 basis points to 15.2%. The higher proportion of aftermarket up at 50% of revenue in the half and incremental Morpho synergies were offset by lower volumes, the mix between Air Transportation and non-air transportation and pricing on airport OE contracts.

Flex-Tek continued to perform strongly with operating profit up 3%. Margins were strong at 18% despite inclusion of a one-off noncash charge relating to an Asian facility.

Smiths Interconnect delivered a strong performance with operating profit up 19% and margin up 130 basis points to 11.9%. The drivers of the improved margin were higher volumes as well as successful completion of the restructuring programme that has been executed over the last 2 years.

Finally, Smiths Medical's offering profit was down 12% at the margin of 16.5%. Performance was impacted by the lower volumes and pricing pressure, that I mentioned earlier, but also by the previously communicated costs of regulatory approvals and some operating inefficiencies. As is usual for Smiths, all divisions are expected to show improved margins in the second half.

Moving next to cash flow. Strong cash generation is a distinguishing feature of Smiths' performance. The small excess of CapEx over depreciation and amortization reflects Smiths' asset-light business model. But working capital was adversely affected by 2 factors specific to the first half of FY '19, primarily inventory build, especially in Detection, to support the strong second half order book; and secondly, the U.S. government's shut down, which had a negative year-on-year impact of GBP 11 million on collections and disguised otherwise good progress that has been made on receivables and payables. As a result, cash conversion was 74%. Given the specific drivers of this election, I would like to reiterate that cash conversion is expected to be much stronger for the year overall, consistent with our track record.

Interest and taxation combined for an outflow of GBP 77 million versus GBP 69 million in the prior year with the increase coming from timing differences on tax payments. In taking action to mitigate the impact of tariff changes, we did incur an incremental one-off cost which will increase the effective tax rate this year by 1 percentage point. All other things being equal, the effective tax rate will thereafter refer -- revert back to 25%.

Pension contributions were GBP 15 million, lower than last year which included a top up for the U.S. scheme. The full year cash contribution is estimated to be around GBP 40 million. Both our U.K. schemes continue to be very well funded, with agreed annual contributions of GBP 12 million each. We are on track to externalize them by 2028, if not before.

Cash generation underwrites a strong balance sheet. We ended the half with net debt of GBP 938 million, equivalent to 1.5x EBITDA. We redeemed $250 million of 7% notes in August, leaving an average debt coupon of 3.3% and no further maturities until 2022.

Cash generations and a strong balance sheet are both trademarks of Smiths, but they are not ends in themselves. They go hand-in-hand with disciplined capital allocation applied to all the investment opportunities that we face. Reinvestment in organic growth remains our priority 1, 2 and 3, as you will have heard Andy say before. The clearest example of this is R&D spend, which grew to 5.1% of sales in the first half, an increase of GBP 10 million year-on-year. But it's not sufficient just to spend more. Higher R&D needs to translate into higher sales. Hence, our increasing focus on vitality as a measure of organic reinvestment. We complement organic growth with disciplined M&A to create additional value. The most recent example is the acquisition of United Flexible, which strengthens Flex-Tek's position in aerospace and industrial end markets globally.

And finally, we use our cash generation to deliver a secure and progressive dividend to our shareholders. The interim dividend increase of 2.2% evidences our confidence for the second half and beyond.

And so finally to the full year outlook, which is unchanged from what we said back in September. The group will at least sustain its underlying revenue growth in FY '19. We expect both Medical and Detection to deliver growth in the second half and the other divisions to perform well, albeit in the face of tougher H2 comparators. Finally, and importantly, Smiths will maintain its track record of strong cash conversion.

In summary then, positive delivery against our expectations for both the full year and the medium term.

Let me now hand back to Andy. Thank you.

Andy Reynolds Smith ***Smiths Group plc - Chief Executive***

Thanks, John. This is all about positioning and creating two stronger companies. I did want to remind you, though, of the three fundamental beliefs that are really driving the separation of Medical. First, it is about creating those two stronger companies, which are industry leading with distinct management, clearer strategies and real focus of time, effort and money, both of them better positioned for growth and value creation in their markets. Second, it will enable Smiths to concentrate on growing as a leading industrial technology group that's united by our shared business characteristics and our common operating model. And third, it allows Smiths Medical to focus on delivering on its full potential that means capitalizing on its leading positions, its large programme of new product launches and the value-creating opportunities in its rapidly changing market.

Our plan will provide immediate clarity through a clean separation of the two businesses. Our overriding objective has been and remains maximizing value for all our stakeholders on a time- and risk-adjusted basis. We expect to complete the demerger during the first half of calendar year 2020. We're timing the separation to build on Smiths Medical's improving trajectory. Over the last three years, we've undertaken sustained operational improvement. And we've invested in Smiths Medical to make sure that it's properly positioned and strongly positioned to capitalize on its leadership per market positions and new products.

Over the last three years, we've increased our investment in new products by 40%. Medical's first half results were in line with our expectations, and we're now very much focused on delivering growth and revenue in the second half and you should see a strengthening trend in margin. Over the last few months, we've been working on the key demerger work streams. And today, we're satisfied that there are no potential roadblocks that would stop us from executing the plan.

To help us progress on all fronts, we've appointed legal accounting tax and financial advisers. On the pension, both companies' schemes are in a strong funding position. That's really the result of a very close alignment and active dialogue with the trustees. They're fully invested in the future success of the company. And in that context, I'm confident that we'll be able to execute the separation in a way that safeguards our pensioners' interests and also creates value for our shareholders.

We also don't see any roadblocks on tax. It's still relatively early days, of course, and significant work does continue, including all the necessary approvals.

On capital structure, we'll make sure that both businesses have a strong financial framework and the right capital structures to invest in their future growth and success.

On the dividend, we plan on that -- that on separation, the dividends of the two companies will in sum be the same. Smiths will maintain our progressive dividend policy. That means increasing our dividends in line with our long-term underlying growth in earnings and cash flow and maintaining dividend cover of roughly 2x.

There are some key milestones in the business over the coming months. Firstly, the appointment of a new CEO to the Smiths Medical business, and we're making really good progress on that. I've been really impressed by the calibre of the candidates we've interviewed. It was a really important and exciting opportunity, and we're focused on getting the right person in place as soon as we can. They will, of course, be supported by breadths and depths of talent throughout Medical, who to their great credit have stepped up to this really significant development for the business with real drive and ambition to realize the vision and the potential value in the business. Second, the business is expected to return to growth in the second half, and we're confident of delivering.

And finally, as you know, the ongoing launch of new products is critical to our plans. The most significant of those will be the submission of our new large-volume pump to the FDA for their approval this financial year. The launch of that new pump is being supported by the group's digital forge. It's been a long-term project and represents a significant opportunity for the Medical business. Global sales of large-volume pumps and dedicated consumables are worth about GBP 2.5 billion a year, and we currently have none. We, of course, do have very strong positions in all other parts of the Infusion Systems market. So this key adjacency for us is an area where we think we can do well and it expands our total addressable market by more than 30%. As we further develop the strategy for a better positioned stand-alone Smiths Medical, all of these milestones are going to be important.

The strength of the Medical business is really founded on three key fundamentals. It has many well-respected brands, which are leaders in the attractive markets that they serve. It's well invested for the future, operationally and in technology. And importantly, Smiths Medical has great financial characteristics. I'd like, if you don't mind, to talk about each of these in a bit more detail.

So we have some great leading brands in attractive markets, a lot of them are the go-to brands in the categories. In ambulatory infusion, we have a strong position and our CADD pumps are well known for their reliable performance, accuracy and ease of use. In Vascular Access, we have our blood control catheters, such as ViaValve, that reduce risk of exposure, blood exposure and contamination. And in new Vital Care, we have leading products, such as our newly introduced next-generation convective warmer. Importantly, the markets we currently serve, which total about GBP 6 billion, have attractive long-term growth drivers. They're highly regulated and have -- we have strong defensible intellectual property rights and know-how.

We're well invested for the future. Our R&D has increased significantly and it's clinically targeted and developed in close consultation with our customers. That's how we make sure we're delivering the right solutions that they actually need. That investment is funding a strong pipeline of new products. We've launched 29 new products in the last 18 months, and we expect to launch a further 10 products in the second half of this year. All that compares to zero launched in 2015 and only a handful in the years before that, and there's more to come.

Also as part of our overall group portfolio management and refinement, we're recycling our capital intelligently in Medical. We have divested three medical businesses in the last few years, two of those have been completed in the first half of this financial year.

As I said a minute ago, Smiths Medical has strong financial characteristics. About 80% of Medical's revenue is recurring consumables and disposables. We've got attractive gross margins across all of our segments with an average of over 50%. That gross margin strength, our focus on operational improvement and our newer, more innovative product portfolio with stronger pricing power is what supports our confidence that this is a 20%-plus margin business going forwards.

What I really like is, it's highly cash generative with a low working capital as a percentage of revenue. And I think, together, these attributes that I've been talking about, make for an attractive future as a stand-alone business.

Following the separation of Medical, Smiths will be a focused market-leading industrial technology company. I'd like to take you through how our reshaped group will generate value and the ambition to count ourselves amongst the world's elite industrial technology companies. The story starts with the characteristics that define our businesses. We actively manage our capital allocation and our portfolio, both organically and inorganically. We aim to make sure that our businesses are targeted in growing markets where we can achieve top three leadership positions or strong niches. We drive speed, efficiency and continuous improvement by having a culture of innovation at the heart of everything we do, and it's all driven by the best people and leaders around the world. Consistent and robust execution is central to what I'm talking about. And of course, it's all underpinned by our strong financial framework that allows us to generate growth and superior returns.

At the heart of our framework are the characteristics of the sort of businesses that we want to own and operate. To be a Smiths business, you've got to be growing and well positioned in attractive markets and importantly, highly competitively differentiated. Smiths is very good at running businesses with these core characteristics, technology differentiation, increasing digitization, operationally excellent, asset light and having a high proportion of aftermarket and services. We actively manage our investment decisions with these business characteristics defining where we spend more and when -- where we spend less.

Since 2016, we've been strategically repositioning our group portfolio and having moved from around 60% to 80% of the business that is now well positioned. We've carved out a parallel path of organic investment and a disciplined approach to acquisitions and disposals. Since 2016, we've completed 17 transactions. Total proceeds from divestitures to date are around GBP 530 million. We've spent around GBP 880 million on acquisitions. That represents very positive reinvestment of capital in higher growth, higher margin businesses as we continue to buy well and sell well.

In the coming years, I expect the percentage of Smiths' businesses that are well positioned will continue to improve, but it's not a race to 100%. Portfolio review and maintaining capital -- disciplined capital allocation is, as you know, a constant and dynamic process.

Honing the portfolio to make sure that we've got leading business in attractive markets is clearly very important. But the key ingredient for me is a combination of excellence and execution. You've heard me talk a lot about the Smiths excellence system, our group-wide operating model. That's based on a centre-light philosophy. Tangible outputs that we point to include the reduction in working capital from 28% to 26% of sales over the last 2 years. That reduction represents over GBP 60 million out of the group's working capital and our medium-term target that we communicated at the Capital Markets Day of 20% of sales would yield a further GBP 200 million.

Improving productivity and reducing costs are also critical elements of the excellence system. Last year, we reduced the cost of non-quality by GBP 15 million, which is good for Smiths and gives happier customers.

i3 is our group-wide innovation framework. We are a technology company. Innovation, therefore, is at our heart. Our i3 framework helps us identify and translate market trends into real revenue opportunities quickly. We've increased group-wide R&D by 25% in the last three years. We're now tracking the effectiveness of our innovation through our vitality index, which measures revenue from products launched in the last 3 years as a percentage of total revenue. The measure currently stands at 13%, and our aim is to get back to 20%. I passionately believe that our single-most sustainable differentiator is people and leadership. We're building a learning organization, and we've prioritized our focus on diversity and inclusion at all levels. We aim to attract, retain, develop, engage and inspire the very best people around the world. A super example of this is that we now have more than 200 Six Sigma Green and Black belts fully trained, that's up from 1/10 of that number two years ago. And more than 6,000 of our employees have now completed Lean basics training. Something that's important for me is our graduate and apprentice programmes have also been stepped up significantly. Together, these three building blocks are the foundation of our sustainable growth: Excellence, innovation and people.

You've heard me say it before, our ambition is to outperform the markets that we serve. We believe that in aggregate, they will grow 3% to 4% a year. As you can see from the chart on the top left of the slide, our industrial technology businesses are already growing in line with those markets and they have a strong trajectory of improving growth. Coupled with this growth is enhanced margins. Today, the margins of the group's industrial technology divisions are up 260 basis points since 2016. We believe that the group can consistently deliver overall margins of between 18% and 20%, and we can see a clear path how we'll get there. John Crane and FlexTek are already there, and Detection and Interconnect are making solid progress.

Our inherent business characteristics create an asset-like model and that supports our cash generation and business flexibility. We've generated strong free cash flow every year, and cash conversion has been above 100% for the last three years, in line with our medium-term targets. Underpinning this are strong returns on investment. Our ROCE has increased by 160 basis points and that's despite the dilutive impact of Morpho goodwill, which is an investment that will generate superior returns and growth over the longer term. Financial discipline is a key factor in all of our decision-making processes and everything we do. We generate strong cash flow and are really disciplined in how we use it to make sure we're driving long-term sustainable value.

So by positioning the portfolio in attractive growth markets, our ambition is to outperform those markets, driving increased revenue growth. By running our businesses more effectively and striving to achieve world-class competitiveness, we'll be able to deliver margins between 18% and 20%. Our strong financial framework allows us to convert that profit into cash with strong conversion. We then use that cash to generate a strong dividend and to invest back into the business to deliver future growth. Our approach is effective and comprehensive, creating a growing, value-driven and customer-focused Smiths.

So what next? We will remain focused on driving all of our divisions forwards. We've committed to delivering sustainable growth, and we will. In parallel, with our continued operational and financial progress, we'll be pushing ahead with the separation of Medical. We aim to effect that separation with pace, whilst making sure that we've done everything necessary to best position our businesses for future success. Our overriding objective is maximizing value in the interest of all of our stakeholders.

Thanks very much and delighted to take any questions that you might have now.

QUESTIONS AND ANSWERS

Andre Kukhnin *Crédit Suisse*

It's Andre from Crédit Suisse. A few questions, please. Firstly, on Medical. Could you walk us through kind of decision-making process on the logic of listing it in U.K.? Who would you think would be the right peers for this business once it is a stand-alone entity? I will go one at a time.

Andy Reynolds Smith Smiths Group plc - Chief Executive

Thanks, Andre. This has been about better positioning both businesses and creating the strategic clarity around the Smiths industrial technology businesses and the Medical business and ensuring that they are best positioned to accelerate and execute on value realization through the investments that have been made in the businesses and are best positioned to take advantage of their markets -- the opportunities that are occurring in the markets. As we thought about this, it was really important for me that we were able to do that with clarity and certainty of outcome, which was one of the key drivers of the decision process. We clearly have reviewed all options in order to achieve that in the most efficient certain way. And we think we clearly have the right answer to better position and create two stronger companies. As we go forwards, we've got a great plan, which we think will create shareholder value and success for both companies. And we continue, however, to review and evaluate opportunities that we see that might occur to accelerate that value creation over that great base plan.

John Shipsey ***Smiths Group plc - CFO***

Just to add on, I think in viewing the location and the peers, we think that -- actually, it's agnostic to location of listing and the peers are global. So it's not just a U.K. peer base, it's European, American and global.

Andy Reynolds Smith ***Smiths Group plc - Chief Executive***

I would add that the operational headquarters of the Medical business remain in the U.S. It is a largely U.S. business right now.

Andre Kukhnin ***Crédit Suisse***

And if I can just switch to Detection. You mentioned pricing pressure in OE. If you could talk about that a little bit more if that's kind of any change in trend? And secondly, in terms of your market share development on the new market segment in Europe on Checkpoint CT technology screening. How is that developing? Are you getting your fair share? Are you outperforming the market in that segment?

Andy Reynolds Smith Smiths Group plc - Chief Executive

A couple of comments there. First of all, Detection is quite similar to Crane and as much as the installed base is crucial because that's how you get the tail, the long-term tail of service and aftermarket business, which is at about half software right now. So that continues to evolve. You probably saw that we're in the range of 40% to 50% is aftermarket and service in the Detection business right now. What that means is, the battle for installed base in both Crane and Detection is tough, really tough. I'm not seeing any change in that trend, but it was already tough, frankly. It continues that way. We continue to see the strength of margin position in the aftermarket and service business. As far as the activities around European Checkpoint for the new regulations, that's probably about 2/3 to 3/4 awarded now. We've won at least our fair share. Forgive me for not being more specific about precise shares. And we continue to work through the final phases of that. What's also happening is that the U.S. is now moving towards a Checkpoint CT upgrade. They got there a lot quicker than Europe on the checked baggage. But with the Checkpoint now coming online as well, phase by phase, there's a building layered trend of moves towards technology to meet higher regulations.

Mark Davies Jones ***Stifel, Nicolaus & Company***

Yes. Mark Davies Jones from Stifel. Lots going on, so a few questions, please. What lies behind the decision to change management at Medical as you prepare it for IPO? Was there any (inaudible) advanced strategy? Or does it just require a different person to lead the independent company?

Andy Reynolds Smith ***Smiths Group plc - Chief Executive***

The previous CEO had been in the company for 3 years, and we've done a great, great job on bringing operational discipline to the company. He felt that as we announced our separation process, we should have a change to take it forward for the long term because this is really about taking it not just through the process, but into separation and then building the success for the future. So it was the right time for a change. He put a lot of great stuff in place. We're doing a lot on that recruitment. I mean one important point for me is, this isn't just about the CEO. This is about the strength of the team, and there's a great team in place there. We're making good progress on the recruitment of the CEO into what really is a kind of exciting opportunity to lead a separately listed company. And we'll be updating as soon as we've got more on that, but progress is good.

Mark Davies Jones ***Stifel, Nicolaus & Company***

And on the large-volume pump, is there any change to that timetable? You say it hasn't been submitted to the FDA yet. When do you think that product might be in a position to generate revenue?

Andy Reynolds Smith ***Smiths Group plc - Chief Executive***

It's a different answer for both Europe and for the U.S. The FDA submission is expected soon. And I said in my speech, during the remainder of our financial year, we're pushing to get that done as quickly as possible. It will then go through both with Europe and with the U.S. an approval cycle. Those are a little bit unpredictable. They're out of our control, but there have been a number of pre-submissions that have taken place to make sure that we're in good shape with that submission. So we hope to get that done and then expect to see revenues starting to come to fruition as we move through the next financial year. I don't want to put a timing on it because the certainty of how quickly they approve it is beyond our control.

Mark Davies Jones ***Stifel, Nicolaus & Company***

Understood. And one for John, if I may. You don't see pensions being an obstacle to the split of the business. It's current thinking that you'd split the pension across the two entities or would you retain it within the industrial company?

John Shipsey ***Smiths Group plc - CFO***

So, Mark, we don't see pensions as an obstacle. We have a very good dialogue with the trustees. The principal U.K. schemes are very well funded. It's important to recognize that the employer is actually Smiths Group Plc. So the pension schemes will stay with the industrial technology group, they won't move across with Medical.

Jonathan Hurn ***Deutsche Bank***

It's Jonathan Hurn, Deutsche Bank. Just 2 questions, please. Firstly, can you just talk a little bit about urban security? First half, it was down 8%. How do we think of that business going into the second half and into the next fiscal year, please?

Andy Reynolds Smith ***Smiths Group plc - Chief Executive***

You probably heard from John that I'm really pleased with how Ports & Borders is progressing now. I was disappointed last year as we lost some ground. There's been a huge re-focus both strategically and in terms of technology in Ports & Borders and that's coming to fruition now. So up 30% in the first half on Ports & Borders and even more in the second half. I do know your question was urban security, which is by nature a much more fragmented market and competition is much more fragmented. So this is everything from government buildings to schools to sports stadia. However, there is a common theme and that is technology is the solution. So we're now working very hard on how we strengthen our position in urban security and in military, bleeding across technologies and cross fertilizing technologies to create the right solutions. I think there's a lot of opportunity in Urban Security. Right now, it's too small as a proportion of the Detection business. And we got airports at 2/3 and the other 3 urban ports and military at the balance, more or less equally split. So they're too small, but the opportunity is very high there. So more progress and the same attention is being paid to it as it was paid to Ports & Borders.

John Shipsey *Smiths Group plc - CFO*

Could I just clarify one thing, if I may, and then I'll answer that. Again, with Detection, particularly with defence, but even in Urban Security, there are programme phasings and big cycles of programmes. In the Urban Security, in particular, there was a programme with the Department of Homeland Security, RadSeeker, that finished in the prior year. So that's been an underlying reason for that decline.

Jonathan Hurn Deutsche Bank

Okay. And in just in terms of the second half, will that return to growth? Or would it be down year-on-year in H2?

John Shipsey *Smiths Group plc - CFO*

I think we guide by sub segment, but we do foresee a return to growth for Detection in the second half.

Jonathan Hurn *Deutsche Bank AG*

Okay. And the second question was just on John Crane. Just looking forward into the back end of calendar 2019. LNG is obviously going to come back. Is that an opportunity for John Crane?

Andy Reynolds Smith *Smiths Group plc - Chief Executive*

Yes. Great question, actually. In fact, we've been having a number of strategic reviews recently. And we have a very good position in oil and gas, as you know. We focus very hard on the nonoil and gas piece and how we can take advantage of similar, critical, high-stress situations in pharmaceutical and chemical and in power. So I mean for me, the traditional focus on energy had really been around nuclear power stations. That will broaden now. I mean there are a lots of trends in the world as you know. We need more power, but the methods of generation and the competitiveness of those methods is changing quickly. And we're very much focused on how we bring Crane's capabilities to power is one of our key non-oil and gas focuses, much more than nuclear power only.

Alex Virgo ***BofA Merrill Lynch***

It's Alex Virgo, Bank of America. Forgive me if you addressed this John before I go ahead. But the cash conversion in the first half obviously a little bit lighter than you'd expect. Clearly, I understand that some of that's inventory build and guessing around the Detection business, in particular. Couple of years back when Andy first got here, you talked about increasing the working capital. You talked about increasing the speed of the business and the working capital release was a big part of that. Can you perhaps talk a little bit about that in the context of the split and the ongoing cash generation ability of the core business? And if you can give us any more colour around what you'd expect that cash generation to be for the full year this year would be very helpful?

John Shipsey ***Smiths Group plc - CFO***

Thanks, Alex. So a couple of answers, yes. In the first half, there were very specific circumstances. One part was U.S. government shut down, but the major part we had a GBP 50 million increase in inventories and the bulk of that, 80% of that, was in Detection for H2 programme delivery. Probably the majority of the remainder in John Crane also for delivery in H2. So we do see and I want to really stress, this is a very cash-generative business across all divisions. That is unchanged. Our calling card is cash generation, and it will continue to be so. It's interesting, your question regarding the separation. I would make two responses. One is Medical is a very cash-generative business, as Andy highlighted. It's in really good shape. And two, in terms of our working capital targets, we have and we retain a medium-term goal to get our businesses from starting closer to a 30% of sales of working capital down to 20%. We've made progress. We've actually moved from 28% to 26%, and Medical is at the forefront of that and is already the best positioned. So Medical has very strong cash generation. Interestingly, for the industrial technology group, it is the group with actually the greatest improvement. And the improvement that we have shown -- we have delivered more than 100% cash conversion every year for the past three years. And if you just split Medical out of that, actually, it's an even greater improvement in working capital in industrial technology. And so I still see that going forward. I see Medical is already in a good place and continuing to generate cash. And we still have opportunity, and we still maintain our goal of getting to 20% working capital as a percentage of sales for the industrial technology group.

Andy Reynolds Smith ***Smiths Group plc - Chief Executive***

I mean this is a really important point for me. The Smiths industrial technology business, as we showed in the slides, has been generating greater than 100%. Medical is a very good cash generator, but so is Smiths industrial technology and will continue to be so. So how I see the quality of the business and the financial quality of the business and the ratios that we can maintain is very much there.

Sandeep Gandhi ***Exane BNP Paribas***

This is Sandeep Gandhi from Exane BNP Paribas. So just a couple of questions on the Medical division. And so firstly, could you give an idea of how big the pricing pressure was in H1 '19? And how you expect this to evolve in H2? And then secondly, can you just talk about the operational efficiencies you are seeing in that division? What exactly does this relate to? And when could we expect to see improvement?

Andy Reynolds Smith ***Smiths Group plc - Chief Executive***

Firstly, on price. The average pricing pressure, we're not seeing any significant difference to previous periods. It has, as you know, been running at about 1% or 1.5% down a year. I think the important point for me is, it does very much split between the older, more mature products where there is more pressure and the new products where there is much less pressure. So where you got proprietary difficult to match products, you clearly have strength. So I think this pipeline of new product coming through does give us better price resistance, let's call it price opportunity. Operationally, it's something that I've been very focused on in the Medical business. And as I look at it overall, the opportunity for improving operational performance particularly through supply chain management because you buy a lot of what you sell typically and assemble it. And improving what were some quite complicated historical supply chains and getting ourselves better aligned there is really the key focus around both where opportunity lies because it means that we're going to be making stuff on time when the customer wants it and getting it to them when they want it in a much more effective way which is financially good for us but also better for our customers. We've also been very focused on fundamental cost structure to get ourselves in a position that we can really enjoy the benefits that come from being a 50%

plus gross margin business. So really how we make things fit for the future and continuously improve to achieve that.

David Larkam ***Numis Securities***

David Larkam, Numis. Couple of questions. Just first on Medical. I wonder if you've had any sort of trade buyer interest, whether you're still running a dual process on this or whether you know you are 100% going down the demerger route? And then secondly, Interconnect. You talk about semiconductor test being strong. A lot of people in that area have seen quite a bit of weakness of late. So what's driving the strength you're seeing?

Andy Reynolds Smith ***Smiths Group plc - Chief Executive***

David, you're right. We've got a great plan here. This will be two stronger companies that can accelerate their progress and create value. My responsibility and our responsibility is to continue to keep our eyes open to opportunities to do even better, and we continue with that. You'll forgive me, but you wouldn't expect me to comment on particular details around that. But I think the emphasis for me is this is a very, very strong plan that we have in place. The second one - yes, it's an interesting one. The nice thing about Interconnect after it's been restructured now because as you know, we've effectively sold a large portion of it, 40% and refocused the remainder where we think we can compete. Now we focus with what we call tech-seeking customers, which sounds a bit management gobbledygook. But basically, it's where they want leading advanced technology and are prepared to pay for it because it makes a difference rather than the commoditized end of the market. So a great example of that would be a company like NVIDIA. So really advanced graphics processing demands very high capability and your semiconductor test capability. So we're not broad-brush in semi. I quite often get asked, I see semi up, I see semi down, why aren't you reacting the same? And it's because we're very targeted in those particular high-performance areas.

Andy Wilson ***JP Morgan***

It's Andy Wilson from JP Morgan. Couple of questions, maybe just following-up on Jonathan's to starting with. On the John Crane, on the oil and gas side, clearly that's been very strong and it feels like there's a benefit there in terms of a period where it's obviously weaker and some catch up. Can you give us an idea of kind of what you sort of feel like sustainable over the next sort of 12 to 18 months using that sort of growth would look like?

Andy Reynolds Smith ***Smiths Group plc - Chief Executive*** For

Crane?

Andy Wilson ***JP Morgan***

For oil and gas in Crane. Yes, just try to kind of split out underlying momentum and then the, obviously, recovery.

Andy Reynolds Smith ***Smiths Group plc - Chief Executive***

There's couple of things for me, really. I mean first of all, our business is almost 100% downstream, so in the refining of the oil. So the future very much depends on demand for barrels of oil a day essentially rather than the oil price, which does have an impact on the sentiment of investment clearly. The demand for oil is increasing steadily going forwards. We currently are in, let me call it, some level of catch up, where major refurbishments have been deferred. So we have pretty good visibility going forwards through the second half, which gives us our confidence around our second half guidance. But importantly for me, the OE piece of the business is at very strong levels at the moment. So that's starting to come through. I won't put it one or two years on this, but I think the key thing for me really is, our exposure is to oil demand and refining demand and making that more efficient, rather than in the extraction piece. John, if you wanted to add anything there?

John Shipsey ***Smiths Group plc - CFO***

No, I think, I agree, yes.

Andy Wilson ***JP Morgan***

And just secondly, it's kind of a broad question on, I guess, M&A and the portfolio. Does this separation process kind of put on hold actions elsewhere in the group kind of when those opportunities either come along or are identified? Or is this still -- you're still looking and basically continue to take action on the portfolio more broadly?

Andy Reynolds Smith ***Smiths Group plc - Chief Executive***

It doesn't put it on hold at all. Organic, organic, organic is always my focus. Let's get both businesses, Medical, keep it delivering and the industrial tech business delivering. As I said earlier on, we've been doing a lot actually. 17 transactions have taken place buying and selling in the last couple of years. We remain very focused on organic, but we remain very wide-eyed on opportunities to do more in terms of technology, market position, customer position, but with a very strong financial discipline. And that's key for me, really. We've got to get more out of this than we pay for it. So the ability to extract those synergies, whether they're cost or revenue or technology is really important for us. So, as I said, we have carved a parallel path of organic primarily, but complemented accelerate through nonorganic.

Jack O'Brien *Goldman Sachs*

It's Jack O'Brien from Goldman Sachs. Just one question on the Detection business. Obviously, you've talked about returning to growth in the second half predicated on your order backlog. Can you just give us a bit of detail as to which sort of geographies or customers you are serving there? And I guess there's always a risk with infrastructure projects that things get pushed a few months. So without wanting to sort of pull water on that, is that a risk? And who are you sort of serving in that?

Andy Reynolds Smith *Smiths Group plc - Chief Executive*

First of all, the order coverage through the second half is very high. But as you rightly say, this comes down to our own ability to fulfil, so to make it and ship it and install it. But primarily it depends on how well customers manage those installations because we are never the central point of airport expansions. We fit in with civil works, civil engineering. So there's always some variability that takes place there. But our order book is really strong through the second half. And the percentage is high, that's not my worry at all. Fulfilment internally isn't my worry. We just need to keep really close to the days that these things actually get commissioned, which depends on some other customer factors.

Jack O'Brien *Goldman Sachs*

And in terms of the long-term growth rate for that Air Transportation division, you're still sort of thinking mid- to high single-digit growth CAGR on that?

Andy Reynolds Smith *Smiths Group plc - Chief Executive*

Yes, we've said in the mid-single digit range. As I look at the way that things are layering, as I mentioned earlier, you've got the European Checkpoint CT, you've got U.S. Checkpoint CT, you've got other upgrade cycles taking place. We just did a very important deal on nextregeneration technology in the Middle East that, Roland, I can't say what it is, can I? But a really important deal in the Middle East, which was important for me because it isn't just about current generation technology, it's about NexGen. And then of course, you have the rest of the world, which is moving at different rates and different paces, but it all layers together to give us good confidence in that market growth position.

Michael Blogg ***Investec Bank***

Michael Blogg from Investec. A couple of questions on Medical, please. In the commentary on profit performance, there was a -- perhaps a little bit of a throwaway and it was operational inefficiencies. Is that a separate issue from the lower volumes and the other things that we know about?

John Shipsey ***Smiths Group plc - CFO***

Well, I think, Andy commented on it earlier that we have still got room to improve on Medical. Clearly, the disruption that we had in the second half of last year doesn't help operational efficiencies. But they're not systemic, they're the ones that we can eliminate.

Michael Blogg ***Investec Bank***

So that was really a spin-out of the other things that were going on in Medical? Or was it something else that's...

John Shipsey ***Smiths Group plc - CFO***

Not 100%, but they were up in explanation of where we ended up on the margin, we still had room to eliminate operational inefficiencies for sure.

Michael Blogg ***Investec Bank***

Okay. And do you have any feel at this stage, obviously, it's a little way off, what the additional cost of running two publicly listed companies will be?

John Shipsey ***Smiths Group plc - CFO***

So we've taken an early look at that, and we think that the two combined and really the extra incremental cost of standing up a separate public company for Medical will be low- to mid-single digit millions per year.

Andy Reynolds Smith ***Smiths Group plc - Chief Executive***

And this has been a really important point for me because aside the clarity and uncertainty -- strategic clarity and uncertainty, the cost efficiency of it has very important. We run a very centre-light structure anyway, but there are clearly some public company stand-up costs.

John Shipsey ***Smiths Group plc - CFO***

But you're right, centre-light will continue for both to be the watchword.

Michael Blogg ***Investec Bank***

Okay. Just one out of curiosity in Medical, is there any pushback at all against the use of polymer-based single use products?

Andy Reynolds Smith ***Smiths Group plc - Chief Executive***

So a really interesting question because we have an internal cross-divisional focus on a lot of the requirements from a materials perspective that are evolving and which are good to use, which are not good to use. We're all over that. They are different by country. And then the way the Europeans look at it, the U.S. looks at it, China looks at it. There are changes taking place, polymers using DHPs, for example, are moving out of favour. But I think this is just normal course of events to manage and ensure that your products use the right products that work from both a regulatory and or legislative and a customer perspective. So it's not something I'm worried about, but it's something you have to constantly watch and work on.

Alex Virgo ***BofA Merrill Lynch***

Alex, again. Just another curious question. Have you seen any impacts in John Crane oil and gas business from changing customer behaviour ahead of IMO 2020?

Andy Reynolds Smith ***Smiths Group plc - Chief Executive***

Everyone's very aware of it. The questions are constantly being asked. I haven't seen anything more than the focus on how do we get it right. And what are the implications of it. So it's on everyone's agenda right now, but I can't point to materiality at the moment.

Sandy Morris ***Jefferies***

Yes, it's me from Jefferies. At the risk of being -- well, I'm not the sharpest tool in the box. But when you do your slide of the group ex Medical and you show the free cash flow, it looks like you've left all the tax paid and all the interest paid in industrial group.

John Shipsey ***Smiths Group plc - CFO***

We did for simplicity. So I totally agree with -- you're right in the analysis. I don't agree with your previous comment that you're not the sharpest tool, so you clearly are. You're right, it's just for simplicity, we took out Medical for those purposes.

Sandy Morris ***Jefferies***

Right. Because you see it's one of these things where at worst Medical, the way you've described it, almost looks like a corporate bond, GBP 180 million, GBP 200 million of EBIT, same of cash.

Andy Reynolds Smith ***Smiths Group plc - Chief Executive***

Yes. I mean I think the way I'm looking at this, is what it will look like precisely at the time of separation. Our job is to put in place the right capital structures for both businesses as we go forward. The way it's modelled at the moment just shows that both businesses are strong. And as we work through the process and make further announcements around what it will look like on the day that will become a lot clearer.

John Shipsey ***Smiths Group plc - CFO***

So, we hadn't made judgments about capital structure in that. I do agree with you, Medical is a very high-quality cash-generative business. Maybe the bond underplays it a bet because our investment in R&D and in NPD is about delivering growth in the future as well. So that's the only addition I would make.

Sandy Morris ***Jefferies***

Right. I'm not about to prove you wrong and saying I'm a bit thick. Clearly, leaving pensions in the industrial group is absolutely fine and hunky-dory. Are there any significant tax implications that differ between simply demerging to shareholders and a proper IPO? Or does that choice also dictate the ease of which we could include debt in Medical or not?

John Shipsey ***Smiths Group plc - CFO***

No. The tax factors attribute to the way group has been structured by people before me but Medical is set up so that any form of separation is tax efficient. And the introduction of debt into Medical is -- all of that can be achieved without tax consequences. The only thing we're looking just in terms of tax is we have some non-cash deferred tax assets based in the U.K., would those be affected by the mix of profits in the future, but that's the only thing on the tax side.

Sandy Morris ***Jefferies***

That's quite handy. And now going from, by my standards, the sublime to the ridiculous. I know this is a stupid nasty area, but obviously for the industrial group becomes a bit more important. So John Crane actually getting some money back from insurers. Is that something that we should be encouraged by in terms of further limiting any potential impact from asbestos on John Crane?

John Shipsey ***Smiths Group plc - CFO***

Yes. So it's true we did -- you'll have seen in the results, we did recover monies from insurers. I don't think going forward, it's not a material amount relative to the total provision. But it is important that we hold our insurers to account for the coverage that they provided.

Sandy Morris ***Jefferies***

Right. So we have not lost anymore, we're not paid anymore, but we've eventually got some money in. John, just trying to bracket this as to whether...

John Shipsey ***Smiths Group plc - CFO***

Well, it is still our best provision, is still our best estimate of the asbestos exposure.

Andy Reynolds Smith ***Smiths Group plc - Chief Executive***

Yes. And perhaps just to add to that. We just completed about six months ago, a review with the FRC on carrying value and period around provisions based on all the trends in the market. And we're in the right place at the moment. Can you see trends that the position will improve over time? Probably, yes. But we aren't changing our position right now. But we do continue to look at all opportunities to improve the situation.

Robert Davies *Morgan Stanley*

It's Robert from Morgan Stanley. Just a couple of questions One was just around, you've, obviously, done quite a lot on portfolio change in the last couple years. Maybe you could just give us a bit more colour of what you are thinking in terms of the direction of the group. Is there a particular division or sub segment or what area or technology you're looking at to kind of add or take out of the group? And then the second one was just on the Medical division. You mentioned vitality index and that was a focus. You'd increased R&D and spent quite a lot of money kind of bringing that up to speed. How much of that is being basically a catch up from a period of underinvestment? And how much is -- where we are if you were kind of drawing a line of being able to really accelerate future growth in that business? And I guess giving some color particularly around the focus, you mentioned it was sort of very heavy consumable focused. Is that particularly an area that you're spending money on? Are you just piling up all the money into the OE side?

Andy Reynolds Smith *Smiths Group plc - Chief Executive*

From a group portfolio perspective, we look really carefully at how well we're positioned in each of the market sub segments. And that's really what all the work around moving from 60% to 80% and then upwards has been about. Can we enjoy either top leadership positions in the market or strong niches. That applies right across the industrial technology business. And you will have seen actions across all, so an acquisition in Detection, acquisitions and divestitures in Crane, similarly in Interconnect, Flex-Tek most recently with the acquisition of United Flexibles that gives us a leading position in aerospace or commercial aerospace jet engines on high-pressure hosing, which I'm really pleased with, we had lots of opportunity there. So this is really across the piece. And then, John, perhaps you could talk to the second point?

John Shipsey *Smiths Group plc - CFO*

So in terms of R&D investment in OE versus consumables, was that the question?

Robert Davies *Morgan Stanley*

Yes. Where you are in the investment cycle?

John Shipsey *Smiths Group plc - CFO*

So R&D investment is a long-term thing. We have launched a lot of products, and they are going up the S-curve, right now. So we still have a long way to go in terms of getting full value even for the products that we've launched, and we have more products to come. They do span -- yes, OE, as a hardware, is really, really important, but they span consumables as well. So it's across the portfolio that we still have -- clearly, Medical still has mileage to go in terms of raising that vitality.

Robert Davies *Morgan Stanley*

Is that part of the reasons margins were lower in the first half?

John Shipsey *Smiths Group plc - CFO*

NPD is a positive to margins. You heard Andy speak about the kind of 1% to 1.5% price impact and that's acute and commoditized. And we don't want to be there. We want to be with -- NPD is part of our margin recovery. As that grows, clearly, it will become even more beneficial.

Andy Reynolds Smith *Smiths Group plc - Chief Executive*

And as I think about Medical R&D overall, you're right, there clearly has been some catch up necessary from underinvestment in the past. We've spent more than 40% up over the last three years, which has meant that we've been peaking at 6% to 7% of sales in some periods. As we move through the catch up and into ongoing or steady state, I don't see that you see a substantial reduction in R&D because it's really important -- I think it will be a little bit lower on average. But again, it does go through cycles but it's really important that we remain and retain our leadership position in terms of technology. So quite hard to split it by half because obviously there's, for example, a lot going on in LVP, the large-volume pump at the moment, quite intensive spend has taking place in the last 12 months or so.

Andre Kukhnin *Crédit Suisse*

It's Andre again. Can I just follow-up on Medical margin for the second half? What should we expect? I mean, I think that's one piece that came in a bit below, and I don't think you have kind of given an outlook.

Andy Reynolds Smith *Smiths Group plc - Chief Executive*

Some strengthening.

Andre Kukhnin *Crédit Suisse* Sequentially

or year-on-year.

Andy Reynolds Smith ***Smiths Group plc - Chief Executive***

From the current position.

John Shipsey ***Smiths Group plc - CFO***

Yes. Better in the second half than the first half.

Andre Kukhnin ***Crédit Suisse***

So it could be still kind of flat year-on-year? Or should it be better year-on-year?

John Shipsey ***Smiths Group plc - CFO***

So I think it's just same better in second half than the first half.

Andre Kukhnin ***Crédit Suisse***

Okay, great. And the tax rate, I think is guided for being higher this year, and we expect it to come down. What do you expect for 2020 at this stage?

John Shipsey ***Smiths Group plc - CFO***

So we haven't guide on that. But yes, I do see that the extra 1% this year is a very specific and effective investment to mitigate impacts of the tariff changes. And we do see that reverting back to 25% going forward. So yes, I guess, that is guidance.

Andre Kukhnin ***Crédit Suisse***

Was there an expectation for the tax to come down in 2020 versus 2019? Because I think when there was original guidance of 25% for this year, I think the expectation was for that to then be lower in 2020.

John Shipsey ***Smiths Group plc - CFO***

I don't recall that. But in any event, we certainly do want to make sure - I can assure you, it is a line that we focus on.

Andre Kukhnin ***Crédit Suisse***

Yes, got it. And just not to end and maybe a more boring question. Can I just ask about your digital efforts and something that you flagged to clear of investment, something you can cross pollinate the whole Smiths Group with? Are there any kind of KPIs we can have a look at from that perspective, like number of connected devices or percentage of sales from digitally enabled products or something like this?

Andy Reynolds Smith ***Smiths Group plc - Chief Executive***

Yes. And it's not a boring question at all. It's one that, as you know, I get incredibly excited about because the digitizing of our business is not a parallel path, it's becoming a digital solutions business over time. We stood up the digital forge in San Francisco with three key objectives. And the first of those was how we better support projects that exist within the divisions. The second was to pull together the core digital capabilities that we had in machine learning and artificial intelligence across the group, which it's very successfully doing. I mean it's a very impressive location now we've got some amazing people there. But importantly, for me the third layer of it is stuff that just doesn't exist within the 5-year strategic plans of the divisions. What do we need to be thinking about in terms of core digital competencies for the future? They have conducted a complete inventory of all of our digital activities right across the group. And as we go forwards now, we'll be starting to put some measures effectively around that. But one of the key projects we're working on at the moment is in John Crane. I mean we've mentioned before, Sense, essentially that's a smart seal. If we think that we've got 3 million seals in existence in installed base around the world, progressively those are becoming connected and connected to the operating system of the -- either the refinery or the chemical plant. So I won't put targets on it at the moment, forgive me. But this is very much an increasing trend across the business.

Andre Kukhnin ***Crédit Suisse***

Maybe the starting point rather than the target? Like what does that mean for the year?

Andy Reynolds Smith ***Smiths Group plc - Chief Executive***

There is an awful lot of commonality and capability, but we want leveraging critical mass of activities. So an example being, you had a handful of software engineers working on Sense in one location and yet in Roland's organisation and around the rest of the organisation, lots and lots of people have been working on the same things, whether it's blockchain, secure end-to-end ledger systems or machine learning in general. It's also enabled us to identify the stuff that we need to be good at and the staff where we need help from either academic institutions or the outside world. Because we're not seeking to become Google. We are seeking to bring digital solutions using our own core competencies and owning the stuff we need to own and bringing in the other pieces of the puzzle externally as necessary.

Thank you. Well, really appreciate everyone coming out this morning. Thanks for all the questions and the continued support. We really appreciate it, and have a great weekend everyone. Thank you.