Presentation

Operator
Ladies and gentlemen, thank you for standing by. Good morning and welcome to the Smiths Group announcement. Throughout the call all participants will be in a listen-only mode, and afterwards there will be a question and answer session. Just to remind you, this conference call is being recorded. Today I am pleased to present Andrew Lappin, Group Director of Corporate Affairs. Please begin your meeting, sir.

Andrew Lappin
Good morning everyone, and thank you for joining this call at short notice. I'm Andrew Lappin, Group Director of Corporate Affairs here at Smiths Group. Joining me on the call today are Andy Reynolds Smith, our Chief Executive, and Chris O'Shea our Chief Financial Officer. Today we're announcing the acquisition of Morpho Detection from Safran. Andy and Chris will give you a brief overview of the transaction, and then we'll open the call for questions. I would encourage you to study the customary disclaimer slide on slide 2, and then we can turn to slide 3 and I will pass you over to Andy.

Andrew Reynolds Smith
Good morning everyone, and thanks very much indeed for joining, as Andrew says, at quite short notice. It's a really exciting and important day for Smiths today. We've agreed to acquire Morpho Detection from Safran for an enterprise value of $710m or around £493m. A little bit more on Morpho Detection: it manufactures and supplies detection systems and services to improve mission-critical security at airports, borders and other high-risk critical infrastructure sites, including nuclear power plants, military installations and government buildings. The acquisition has a strong strategic and financial rationale, and is consistent with our approach to increasingly focus our investments in attractive technology-led areas.

The global addressable market for detection is expected to grow at mid-single digits each year to more than £4.5bn by 2021. Morpho Detection is a really high-quality business, and it's well-managed. It has strong operating margins and derives more than half of its revenue from after-market services. I'm convinced that the combination of Morpho Detection and Smiths Detection is going to enhance our product, technology and services leadership.

Morpho Detection has particular strength in air transportation and has a product portfolio that complements Smiths Detection well. The acquisition will bring together sector-leading muscle in research and development, which is a really critical feature in anticipating and countering the ever-evolving threats that we face. With excellent routes to market in the key segments and geographies, the combined business will be well-positioned for the future. On closing, Morpho Detection will be merged with Smiths Detection.

Now, if I could I'd like to turn to slide 4. I'd like to take a moment to highlight the attractiveness of the global detection industry and the compelling strategic sense that this acquisition makes for Smiths. We estimate the global addressable detection opportunity to be around £3.3bn today, with growth driven by a number of important factors. These include evolving security threats, as geopolitical unrest and terrorism incidents continue to increase. Coupled with rising numbers of airline passengers and greater international trade flows, there's an ongoing demand for detection technologies to constantly innovate to provide enhanced security. Customers, ranging from government agencies and airports to critical infrastructure and ports and borders authorities, will continue to make purchasing decisions that are driven by regulatory compliance, technological capability and service delivery, as well as the total cost of lifetime ownership. To meet customer demands, there is enhanced value in being able to deliver cutting edge technologies and cost-efficient solutions. Future revenues are not only driven by replacement cycle and regulations, but also by recurring after-market services and digital solutions, such as enhanced networking, software and diagnostics.

Now turning to slide 5. Morpho Detection provides detection solutions principally for air transportation and critical infrastructure worldwide. Around 80% of Morpho Detection's revenues come from North America and Europe, with 20% from the rest of the world. Its core technology offering is Computed Tomography Explosive Detection Systems, or EDS for short, and Explosive Trace Detection equipment. Those are industry terms, and just to put a little bit more colour on that: the EDS systems are broadly those that you and I see every day when we're moving through the airports, passing our bags through the checkpoint, and also very large equivalents of those machines that sit underground pushing through the transported baggage once you've checked it in. On the Trace side, it's a wide range of trace capability, from the sort of trace that the random selection of your bags when it gets pulled to one side at the checkpoint and they run a swab over your bag, right the way through to more advanced technologies such as the Smiths RadSeeker which sniffs out the equivalent of dirty bomb materials and nuclear materials. The business has a well-established track record in developing these technologies, as well as anticipating some of the advanced software and networking capabilities that are set to grow in the future.

If we could just take a look at these two product offerings from Morpho Detection in a little bit more detail. So turning to slide 6, EDS systems are used to detect larger quantities of threat material in hold baggage being checked onto an aeroplane. They're typically based on both X-ray or CT technology. As you will know, EDS is a highly regulated market. Products are certified by government agencies prior to being marketed. The US, Canada and Japan all require that CT EDS is used for checked baggage in their airports. With regards to the European Union, regulations require that all installed EDS machines that check baggage will move to CT by 2022. Morpho Detection's advanced service model focuses on integrating remote monitoring, predictive maintenance and diagnostics and, as a reminder, more than 50% of the revenue is derived from the after-market.

Now turning to slide 7 and the other core product offerings of Morpho Detection: Explosive Trace Detectors. These are used to analyse samples of invisible particles for the presence of explosives and narcotics. These are typically based on Ion Mobility Spectrometry, or IMS. Next-generation technologies under development include a combination of IMS and Mass Spectrometry. Morpho Detection produces desktop and handheld trace units which are sold to air transportation, critical infrastructure and military customers. The regulatory framework is similar to EDS, and certification is required by regulators for use in civil aviation.

Now turning to slide 8. At the start I talked about the growth drivers for this industry, and what it takes to succeed in the future. This acquisition better positions Smiths Detection to develop and compete in attractive global threat detection segments. The combination creates a broad offering of leading products and services, and it will lead to an extensive international presence with strong routes to market in key areas. It will also give us best-in-class technology capabilities and we'll be better placed to meet our customer requirements. The strong after-market presence will position us to develop long-term recurring services revenues, including digital solutions. This is an area I believe we will continue to grow strongly. Increased software engineering capabilities will enhance the opportunity for network solutions and the trends we see towards the integration of remote monitoring and diagnostics.

In terms of the next steps, the closing of the acquisition is conditional upon regulatory clearances, and completion is expected in early 2017. I'd now like to pass over to Chris O'Shea, the CFO, to take us through the financial highlights of the transaction. Over to you, Chris.

Chris O'Shea
Thanks, Andy. Good morning everyone. As you've seen, we've agreed to acquire Morpho Detection for an enterprise value of $710m on a cash-free, debt-free basis. The consideration will be paid in cash at completion of the transaction, which is expected in early 2017 upon receipt of all

necessary regulatory approvals. Morpho is a strongly cash-generative business with a cash conversion rate over 90% in 2015. In terms of value creation, we estimate run rate pre-tax annual cost synergies of around $30m, which we expect to deliver by the third full year following closing. We expect one-off integration costs of about $30m to achieve those synergies. In addition, the acquisition generates a cash tax step-up benefit for Smiths Group. The transaction will be treated for US tax purposes as an asset purchase, and as such we will be able to deduct the full purchase consideration from our US taxable profits on a 15-year amortisation schedule. The net present value of this additional benefit is around $110m. We also expect to benefit from additional revenue growth opportunities, and for the avoidance of doubt any revenue synergies will be in addition to the cost synergies of $30m.

In terms of valuation multiples, the acquisition price is 10.1 times Morpho Detection's 2015 EBITDA. When you factor in the cost synergies, the EBITDA multiple falls to 7.1 times, and when you adjust the benefit of the tax step-up the multiple falls to six times the 2015 EBITDA. The acquisition will be financed from our existing cash resources and our available committed bank facilities. We expect the acquisition to be mid-single digit earnings accretive in the first full year of ownership, and for the return on invested capital to exceed our cost capital by the third full year of ownership. Excluding synergies, the proforma net debt to EBITDA ratio at the previous year end would have been two. We remain committed to a strong investment-grade credit rating and will continue to take a disciplined approach to our balance sheet management.

I'll now pass you back to Andy to round up.

Andrew Reynolds Smith
Thanks very much, Chris. So in summary, Smiths Detection and Morpho Detection will be a compelling combination in a strong industry segment with attractive long-term growth drivers. As you can see, we expect the global industry to increase to more than £4.5bn by 2021. The combined business will deliver global leadership and be a best-in-class technology provider. A substantial installed base and growing after-market revenues, combined with rapid growth in digital solutions, will ensure that we're well-positioned for future growth.

And with that, thanks very much for your attention and I'd be happy to answer along with Chris any questions that you've got. Thanks very much.

Q&A

Michael Blogg - Invectec
Morning. My question's going to expose my lack of knowledge about the Safran business, but I wonder if you could comment about its record on project-based work? In other words, not the after-market that you've been talking about but the new business acquisition; how does that compare with Smiths?

Andrew Reynolds Smith
Okay. Difficult for me to comment on Safran's performance, but I guess what you're referring to is the robustness of programme management and contract management, which is really important in this business.

Michael Blogg - Investec
Yes.

Andrew Reynolds Smith
I think, you know, there's some history in the past that we were not strong enough in this area. In recent years there's been a significant change in management around Smiths Detection, and a

really strong focus on programme and contract management which we're starting to see some real benefits from. Because I believe that's absolutely key. You go in with the right agreement, you deliver on that agreement in a robust and rigorous way and you get the returns and the long-term benefit that you expected at the beginning. So that's really high on the agenda. It's a big piece of the significant improvements that we've seen, based on the results of Detection over the last couple of years, and it's an area that we'll continue to focus on strongly. As we've gone through the due diligence around this business, it's an area that I think demonstrably based on their financial results they're doing really well. It's a high quality business, Morpho Detection.

Chris O'Shea
I mean, I would add to that, Michael, to say that based on the financials that we've reviewed as part of the acquisition, their profile over the previous years has been less lumpy than we've seen in Smiths.

Andrew Reynolds Smith
Yes.

Michael Blogg – Investec
And that's even on the OE side of the business?

Chris O'Shea
Yes.

Andrew Reynolds Smith
Yes.

Michael Blogg - Investec
Okay. Thanks very much.

Andrew Carter - RBC
Morning, gents, I had a couple of questions, please. I guess the first one was looking at the in price that you've paid to buy the asset, it does look like it's a pretty attractive price, so congratulations on that. But, I mean, I wondered if you could talk a little bit about, you know, perhaps who you were competing against in the process? And is there anything that we should be aware of that would kind of explain why you've managed to sort of buy a business at a multiple that looks pretty attractive compared to your own trading multiple?

Chris O'Shea
Yeah. I mean, I think that, Andrew, in terms of that we would love to have known who we were competing against, but unfortunately we couldn't get that from the other side. And the negotiations were long and tough. I think that this is a good deal for both sides. It is a quite a small part of Safran's business, and I think they've decided that this wasn't core to their business. It's probably less than 3% of their revenue. But I was heavily involved in the discussions, and I can tell you that it wasn't very easy, so they drove a hard bargain. But we're quite comfortable. We obviously had an advantage over any non-strategic buyers in terms of the synergies that we could see both on cost and revenue. I would expect that there are some other large players in this space, and I think along with us they would have been crazy not to have had a look at this. So we're very happy to have won out in what was a competitive process.

Andrew Reynolds Smith
I was very pleased to have a Scotsman as a CFO on my team through this process!

Andrew Carter - RBC
Could I just ask a sort of a follow-on in terms of sort of the competition situation? I mean, I noticed in the presentation you haven't really talked about market share in any of the businesses. And I

guess it would be interesting to know, on the trace detection side, whether you've got a feel for what either of the individual businesses have got as regards market shares?

And also, on a sort of similar thing, I guess we haven't in recent calls touched on the competitive environment in detection very much, and one of the things that we have been talking about or seeing, I guess, is some of the Asian players becoming a bit bigger. Is there anything that you can sort of say about that? I mean, are the Asian players involved in either of these two areas that Morpho's involved in?

Chris O'Shea
Okay. So I mean, I think firstly in terms of the competition and market share, clearly we have a regulatory process to go through. That will take some time, which is why we expect closing to occur in 2017. And we believe that this is good for the customer, but don't want to get drawn on who's got what. Morpho is a strong competitor of ours and will remain a strong competitor during this process.

Andrew Reynolds Smith
I would add to that as well. I think people have heard me say on a number of occasions that I think Smiths is too small in Asia. This does complement our position in Asia, particularly in China from a detection perspective, so it's moving us in the right direction. But more work to be done to develop the Asian market opportunity.

Mark Davies Jones - Stifel
Thank you very much. Andy, can I just ask about how the two businesses fit together in a bit more detail, in terms of where there might be some overlap? I get the point about the CT and X-ray complementary nature of the product lines, but obviously you've been each assessing parts of each other's marketplace. So are there product lines that need to be discontinued? Is that part of the synergies that you think you can achieve? Or are they truly complementary in terms of their focus?

Andrew Reynolds Smith
Well, we're clearly planning to continue to support the combined product lines going forward. I won't go into the details of shares and splits; As you know, we're going to be running through a regulatory process. I think just to reinforce here, you know, we believe that this is going to be good for customers, and we believe it's also going to give us a really strong R&D and technology platform to stay ahead in the future and build the business. So if you'll forgive me for not going into details as a result of that.

Mark Davies Jones - Stifel
Understood. And then just more broadly, the 18% operating margins that they've been achieving: is there any structural reason why the Smiths business shouldn't be capable of that kind of level of return? Is that to do with the share of after-market in the mix? Is that the major difference?

Andrew Reynolds Smith
Yeah. I mean, firstly, there is no reason why the Smiths business should not be capable of that structurally. I mean, the structural potential of this has been very much top of my list as I've been thinking about this as an investment proposition. It is fair to say that Morpho Detection has a higher percentage of after-market revenue than the Smiths Detection business does today. And we'll be looking to move that up as part of our plan now.

Mark Davies Jones - Stifel
Thank you very much.

Glen Liddy – JP Morgan Cazenove
Good morning. On the R&D spending, has Morpho invested at an appropriate level of R&D, and have they got new products coming to the market imminently?

Andrew Reynolds Smith
Yeah, that's a great, great question; thanks, Glen. First thing is, is, as you know, this is very much a technology-led environment, so I've been very keen to look at where the money's getting spent. You know, in broad terms, they've been spending as much, if not more, than Smiths Detection have. Just looking at this, I think one of the issues I've had in Smiths Detection's historical spend has been just the focus and efficiency of that spend, as I've said for the Group overall. So, you know, there's certainly no reason to feel that – they've been investing at the right level here on R&D, and one of the key things for me is, can we look at this as a positive combination of R&D muscle together? Can we spend more efficiently and better in the future? That's certainly our objective as we bring, you know, the two pieces of the puzzle together.

Glen Liddy – JP Morgan Cazenove
The other thing is on organic growth. If you just look back over the last five years or longer, and just strip out the volatility in the Smiths business, has the organic growth at Morpho been in line, better, worse than Smiths has delivered, excluding the sort of lumps and bumps because of projects?

Chris O'Shea
I would say, firstly, with a business such as this was over the past five years, in terms of the Smiths business, it's hard to strip out the lumps because it was essentially quite a lumpy business. The Morpho Detection business has had a slightly higher growth rate than the Smiths Detection business over the past five years.

Glen Liddy – JP Morgan Cazenove
And in terms of the after-market, I mean, Smiths has grown their after-market over the last few years. Is there anything structurally different in your product mix that would make that 50% that Morpho achieved today as not achievable?

Andrew Reynolds Smith
The answer to that is no. Smiths has an opportunity – as you know, we've moved it up from in the teens as a percentage of revenue to in the 30%-plus, now. Morpho Detection's at 50%-plus, so this is really the result – this is not a technology or product-line-based or a service capability story; it's simply an approach-to-market, an approach-to-customer story.

Glen Liddy – JP Morgan Cazenove
Okay then, thank you very much.

Andrew Reynolds Smith
Thanks, Glen.

Sanjay Jha – Panmure Gordon
Good morning, gentlemen. Just a couple of questions, if I may. My understanding was that Safran wanted to sort of exit this market because they didn't want to invest in sort of the digital transformation that's going on in the security market. So what I want to know is, how much in-house skills do you have to deal with this transformation, and do you need to hire people in that space?

Andrew Reynolds Smith
Yeah, thank you, that's a good question. I can't comment on Safran's rationale, here. I can make an observation that at less than 3% of total Group revenues for them, this was clearly a less important part of their picture than it is for Smiths. I mean, as we go forward, yes, there is an increasing trend of technology-driven and regulation-driven demand. You know, very simply,

people want to be able to detect more, more accurately, more broadly, in more places. That is going to require investment, and that goes back to my comments earlier about, we – you know, this gives us a really strong, you know, leading position of R&D muscle and critical mass, but we have to spend it well and in a really focused way. And as part of our thinking through this transaction and the potential for growth in the future, we've really thought through what that means, what it takes, to create that leadership position. So it's been foremost in our minds.

Sanjay Jha – Panmure Gordon
Can I ask a question – this is for Chris, I suspect: Chris, you've talked about the tax benefit from the sale. I'm just trying to get my head around it. So the tax benefit comes, what, $710m divided by 15 and then discounted back? Is that…?

Chris O'Shea
No, it's slightly more nuanced than that. Essentially, any asset will have a tax base, so this asset comes with a tax base of a couple of hundred million dollars. That's just regular depreciation that you can have. The $110m NPV is over and above that, and essentially it's – you can have a tax deduction on the goodwill, more or less. So the $110m is the step-up over and above the normal tax base that comes with the asset, and it's discounted over 15 years. The vast majority is depreciated over 15 years; there is a smaller proportion, which is a step-up in property values, which is depreciated over seven years. But about 90% of the step-up is over 15 years. The undiscounted value is a couple of hundred million dollars.

Sanjay Jha – Panmure Gordon
So if I was – presuming the acquisition completes, in the first full year what am I think in terms of tax rate? I mean, is it still 26%, or am I taking off the…?

Chris O'Shea
So the booked tax rate will – so the cash tax rate is beneficially affected by this. The booked tax rate is not, because as you – I'll get a bit techy, but as you depreciate your tax bases but not your booked bases, you build up a deferred tax liability, so the cash tax rate will be lower, but that will be partially offset by the creation of a deferred tax liability.

Sanjay Jha – Panmure Gordon
Okay, right. So the tax rate doesn't – the P&L tax rate doesn't change from this deal? The tax impact is on cash?

Chris O'Shea
That's true. I mean, if anything, this acquisition in and of itself would slightly adversely impact our reported tax rate, because it's – about 60–70% of this business is based in the United States, where, as you know, it currently attracts a tax rate of 38%. So other things remaining equal, our tax rate would be slightly pushed up by this, but not materially.

Sanjay Jha – Panmure Gordon
Okay.

Chris O'Shea
That's just a mix issue.

Sanjay Jha – Panmure Gordon
Alright. Okay, thank you, gentlemen.

Jonathan Ackerley – Exane BNP Paribas
Yeah, morning, gents. I just had a bit more of a general question for you around – well, this looks like a good-sized deal. You said it takes you to around two times net debt to EBITDA proforma. Looking forward in terms of deal appetite from here, how should we think about it? Would you be

prepared to issue equity if the right deal came along, or are you going to focus on getting this one completed and getting the assets consolidated?

Chris O'Shea
I mean, I think that on this, we have a disciplined approach to the balance sheet, and that extends to the capital structure. I wouldn't want to be drawn on whether or not we would issue equity, but if we saw a fantastic opportunity that we thought we could add value for shareholders, then we would look at that. These things ideally come along when you would like them to, but in reality they come along when the other party wants to dispose of an asset. So it could come sooner or later than we would prefer. And if that was the case, then as you would expect, we would retain a discipline. We may consider disposing of assets or we may consider asking shareholders for equity, so I think anything's on the table. There's nothing that's off the table, but we will continue to look at good-quality, attractive acquisitions that will enhance the business like this does.

Jonathan Ackerley – Exane BNP Paribas
Understood. Thanks very much, Chris.

David Larkam – Numis Securities
A couple of questions. Firstly, just on technology: given that it's grown faster than the Smiths business, is there anything they're bringing with you that you really need?

And secondly, just in terms of where the overlap is, air transportation looks like it's going to be around 45% market share. Is that right, and is that the main area that you've got to get the clearances?

Andrew Reynolds Smith
Hi, David. It's been a long time since we bumped into each other, so hope you're doing well. I think picking up on the technology, you know, one of the areas here is the computed tomography for checked baggage, particularly around the US market, which is very complementary to the Smiths business; that's again on the checked baggage side. And as we go forward, there's a lot of opportunity with complementary technology. And a lot of that through, you know, combining next-generation capabilities on after-market services and the digital solutions, so I'm really excited about what can be done there with the networking and diagnostics and software image libraries and so on.

As far as the market share: again, I must ask your forgiveness, as we're about to commence the regulatory review process, so I hope you understand.

David Larkam – Numis Securities
Okay. And just on the $30 million of synergy costs: that presumably is all cash, Chris, over what sort of time period?

Chris O'Shea
Yeah, so that is all cash, and I would expect that that would be in year one and two, because we will have the $30 million cost benefits in year three. Probably slightly more in year one than year two, maybe a 60:40 split, but those will be cash costs.

David Larkam – Numis Securities
Okay. And is year one your 2017 or your 2018?

Chris O'Shea
It's a good question. We expect this to complete in early calendar 2017. So that would, if it was very early calendar 2017, that would give us six months in our FY2017, because our year-end is 31st July. But obviously, as soon as we can start the integration, we will.

David Larkam – Numis Securities
Okay, thanks.

Jonathan Hurn – Credit Suisse
Hi guys, just one question from me. Obviously, you've talked about a cost synergies number, but I wonder if you could just sort of talk a little bit about what you think is the potential for the sales synergies? Maybe just in terms of the amount, and also how fast you can actually extract some sales synergies from this deal? Thanks.

Andrew Reynolds Smith
Yeah, hi, Jonathan. You know, for me, as you can see in the transaction financial summaries, we've taken a more conservative approach around including the cost synergies, which are usually things that you have directly action-planned from an execution perspective. Revenue synergies: I'm really excited about the opportunity. I won't put a number on it here now, but clearly in terms of being able to bring the most competitive technical and cost-efficient solutions to the market, there's going to be opportunity as we work on this globally. So you know, for me, a very interesting one. Neither Chris nor I wanted it to be part of the summary here, but it's a key piece of the work that we're doing across the piece.

Jonathan Hurn – Credit Suisse
Great, thanks.

Andrew Reynolds Smith
Well, thanks again very much everyone for joining us. I really appreciate the engagement and the questions. I mean, it's a day that we're all feeling very excited on this side of the table. We think it's, you know, a really positive step for Smiths Group. The deal is good. Strategically, it makes a lot of sense, and it's very focused around how we create the momentum and the capabilities for growth for Smiths Group in the future. It's the first deal of this size for pretty close to a decade, and we very much appreciate your support and look forward to keeping an open dialogue as the story unfolds. So thanks very much indeed everyone for joining, and I'm sure we'll be bumping into each other over the coming weeks and months. Thanks very much indeed. Have a good day there.