



## SMITHS ANNUAL RESULTS 2018

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

Thanks, Jemma. And morning, everyone, and thanks very much for being here.

We're joined by John, the CFO; a number of Smiths executives in the audience here today; and also Sir George and Bill down at the front. So thanks for being here.

I wanted to talk to you today about what we've achieved in 2018: the improving quality of the business, our momentum and particularly our confidence in the future. I also wanted to update you on our strategic plan, including the implications of the recently announced halt in talks with ICU Medical.

2018 marked a very important milestone in our journey towards sustainable outperformance versus the markets that we serve. We said that we were going to return to growth in 2018, and we have. The group delivered underlying growth for the first time in 5 years, with revenue up 2% for the full year and profit up 3%, with a much stronger second half up 5% on revenue. The fact that we've been able to deliver this despite the previously announced disappointment in Smiths Medical speaks for me to the strength of the group overall and the improving position.

In 2016, I set out the new strategy and vision for the group. Over the last 3 years, we've been putting in place the building blocks that will support sustainable growth above the markets that we serve. As you know, I firmly believe that the capabilities for execution, innovation and people must be strong; and we've made good progress in 2018. Firstly, we've successfully implemented the Smiths Excellence System. That's our group wide operating model to drive speed and efficiency and particularly importantly ensure robust execution. Secondly, we're investing more in R&D and targeting that investment more intelligently. Importantly, we're paying for that increased investment, as we said we would, through our efficiency improvements. And third, our group wide people plan is in full swing, ensuring that we're investing in and developing the very best people around the world. All of this, of course, is coupled with a targeted group capital allocation process that drives highly disciplined organic and nonorganic investment decisions. Through this investment process, we're optimizing the portfolio to become increasingly focused on businesses with the characteristics and market positions that we want.

We've achieved a lot in 2018, but there's much more to do. We're confident that we can deliver the significant potential that we have in the business. Before I take you through the strategic process -- progress, I'd like to hand it over to John to give you a view of the numbers and the outlook.

Thanks, John.

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

Thanks, Andy. Good morning, everyone, and thank you for coming today.

It's been an important year, challenging in some respects, but I'm very pleased that we've delivered on the group's return to growth.

So let's take a look at our progress in FY '18. The group returned to growth in terms of underlying revenue and profit. For clarity, underlying numbers have been adjusted to eliminate the impact of 3 factors: foreign exchange; acquisitions and disposals; and this year, the reclassification of restructuring and pension admin costs previously reported as non-headline. Contrary to what you might think, we haven't added this last adjustment to make year-on-year comparison harder. We've reclassified non headline costs to headline in order to improve the quality of our earnings. Fundamentally, we think this is the right thing to do. A regrettable by-product is some additional complexity this year, but it's only this year, and this allows us to move to a much better place going forward.

Reported revenue was down, but underlying revenue rose 2%. Operating profit was up 3% on an underlying basis, and margins improved 10 basis points. Underlying EPS growth of 4% reflects an improved contribution from both the interest and the tax lines. And our asset-light operating model translated into 99% cash conversion and yielded GBP 302 million of free cash flow. Return on capital employed rose by 30 basis points on an underlying basis. The reported decline is caused by inclusion of Morpho as well as the reclassification of costs to headline profit.

Finally, the proposed dividend increase of 3% is consistent with our underlying growth rate in operating profit. It's enabled by strong cash generation, and it signals our continuing confidence in the trajectory of the business.

So let's review the results in more detail, starting with revenue. Translational FX reduced revenue by GBP 126 million, with the biggest impact coming from the U.S. dollar. Acquisitions and disposals had a net impact of only GBP 1 million. Within that, the main movements were the positive contribution of Morpho offset by multiple disposals, not least power and telecoms, by Smiths Interconnect in FY '17. After adjusting for both of the above, group underlying revenue rose by GBP 58 million or 2% for the full year, with second half growth accelerating to 5%, in large part due to the phasing of deliveries in Detection and in spite of a strong July comparative.

And you can clearly see here the good performances in John Crane, Smiths Detection and Flex-Tek; an improving performance in Smiths Interconnect; and the disappointing outturn from Smiths Medical.

So let's take a look, a closer look at the performance by division, beginning with John Crane, where revenue growth accelerated to 7% in the second half, closing the year up 5%. We saw recovery in oil and gas, up 7% for the full year compared with 4% in the first half; and continued growth of 3% in nonoil and gas. OE grew for the first time since 2014, whilst aftermarket climbed 8%. It now accounts for 67% of John Crane revenue.

Smiths Medical's performance was not what we had originally expected. Impacted by the change of notified body in Europe and the loss of 2 contracts in America, revenue finished the year down 2%. On the positive side, NPD has started to have an impact, relatively

immaterial to date but nonetheless growing.

In Smiths Detection, Air Transportation delivered a very strong result, up 20% for the year and 28% for the second half. That growth does reflect the uneven phasing of deliveries, which as you know is a feature of this business, but it also evidences the strength of the combined business following the acquisition of Morpho. Smiths Detection is truly a global leader in air transportation. Revenues in this segment grew by GBP 194 million, more than 50% year-on-year, and it now accounts for 68% of divisional revenue. In contrast, both Defence and Ports & Borders went backwards in FY '18. As previously communicated, Defence has been impacted by the sunset phase of key programs. We are developing products for the next generation, but they will not translate to meaningful revenue before 2022. Ports & Borders is also affected by program completions, but we have also underperformed and are now focused on revitalizing momentum both tactically and strategically.

Smiths Interconnect returned to revenue growth in the second half, albeit not quite for the full year. And Flex-Tek continued to deliver double-digit growth, with sustained performance from all its segments.

So turning to operating profit. Last year's operating profit was GBP 589 million at a margin of 18%, excluding restructuring and pension admin costs. As previously communicated, from FY '18, we've reclassified these costs as headline. After restating for this as well as foreign exchange and the impact of acquisitions and disposals, FY '17 profit would have been GBP 531 million at a margin of 16.8%. FY '18 operating profit of GBP 544 million represents 3% underlying growth and an improvement in underlying margin of 10 basis points to 16.9%. The chart shows clearly the positive contribution from John Crane, Smiths Detection and Flex-Tek in contrast to the decline at Smiths Medical.

Group costs went up on a reported basis because of restructuring and pension admin costs. On an underlying basis, they were down year-on-year and half-on-half, evidencing our commitment to a center-light operating model.

So looking at the operating profit more closely by division, starting with John Crane again. Operating profit rose 6% at a margin of 22.9%, up 10 basis points. This was underpinned by volume growth and the greater mix of aftermarket. On the other hand, there were continued headwinds from geographic mix and the cost of switching capacity back on to meet demand.

Smiths Medical's operating profit was down 14% at a margin of 17.6%, down 250 basis points. As previously communicated, performance was impacted by the change of notified body in Europe and the loss of 2 contracts in the U.S. As forewarned, margin was also impacted by higher R&D expense associated with the wave of new product launches, but margins should only improve from here.

Smiths Detection had a very strong performance, with operating profit up 16% and margin up 240 basis points to 16.9%. There were 3 main drivers of the margin improvement: a high proportion of aftermarket, some one-off releases from long-term programs and Morpho synergies. We now expect these to be delivered in full by FY '19, a year ahead of schedule. Because they've been front-end loaded, incremental FY '19 benefits will be lower than FY '18.

Smiths Interconnect operating profit was down 2%, and margin was down 10 basis points to

14.1%. That reflects higher investment in sales and marketing and R&D to drive future growth. It also marks a significant improvement in margin from first half to second half.

Finally, Flex-Tek continued to perform strongly, with operating profit up 10% and margin held at 18.9%. It's an impressive track record of consistent delivery over many years, epitomized by their return on capital employed of 35%. They've grown through operational excellence and value-added acquisitions, most recently with the successful acquisition and integration of Osram's heating solutions business, but they're not complacent. And our aim is to exploit their proven operating model both inorganically and organically.

Moving next to cash flow. Cash generation was again strong in FY '18. When comparing against prior year, remember that reported profit is handicapped by FX and the inclusion of previously non headline costs. The small excess of CapEx over depreciation and amortization reflects Smiths' asset-light business model. Consistent with that, we also reduced working capital as a percentage of net sales from 27% to 26%. Cash conversion was 99%. And lower pension and tax payments supported free cash flow of GBP 302 million.

I'll speak to pensions in a moment. On tax, the effective rate reduced to 25.8%. U.S. reform delivered a positive benefit, offsetting the expiry of some tax-efficient legacy planning. The effective rate for FY '19 is expected to be around 25%. Whilst lower than FY '18, this is higher than the range we previously forecast. This is due to a mix of forecast profits towards higher-tax jurisdictions and also an expected increase in non-deductible items. We will continue to manage the cost of taxation in a responsible manner whilst protecting our competitive position.

Strong cash generation is a consistent feature of all Smiths divisions. It underpins our strategy and our operating model. We don't just have targets and incentives. We have developed content internally to help every business structurally improve their working capital metrics, stock turns and debtor and creditor days. And for that reason, I'm confident that, even as we return to growth, we can keep driving down working capital as a percentage of net sales to our medium-term ambition of 20%.

Cash generation underpins our ability to drive organic growth, especially through investment in commercially focused R&D. In FY '18, our cash investment in R&D was maintained at 4.6% of sales. And in the income statement, underlying R&D expense increased by 8%.

Cash generation also underpins our ability to fund the growing dividend. Our aim is to increase dividends in line with long-term underlying growth in earnings whilst maintaining minimum dividend cover of around 2x. Consistent with that, the board is recommending a final dividend of 30.75p. That's a 3% increase for the full year in line with underlying growth in operating profit.

And cash generation also underpins a strong balance sheet. It allows us to invest in organic growth first and to enhance that with disciplined acquisitions as and when the opportunities arise. We ended the year with net debt of GBP 893 million, equivalent to 1.4x EBITDA. Following the redemption of a \$250 million bond earlier this month, there are now no further debt maturities until 2022.

Moving on to pensions. The positive direction of travel continues. Cash contributions reduced from GBP 105 million to GBP 49 million in FY '18 and are not expected to exceed GBP 45 million in the coming year. The accounting surplus for all schemes has grown from

GBP 224 million to GBP 381 million principally as a result of higher discount rates and therefore lower liabilities. And we continue to work with the trustees to de-risk schemes through, for example, buy-ins and lump-sum offerings. And we're on track to achieve our common goal for Smiths to have no further liability to all the main defined benefit schemes within the next 10 years.

Before I move to the outlook, a brief word on exchange rates. With around 95% of our revenue coming from outside the U.K., FX has an important influence on our reported results. Our 2 main translational exposures are to the U.S. dollar and the euro. I've already spoken about the actual impact of FX on FY '18, a GBP 26 million reduction in profit principally because the U.S. dollar weakened versus prior year. Broadly, a 0.10 movement in the dollar has a GBP 25 million impact on profit, and a 0.10 move in the euro a GBP 10 million impact. At yesterday's FX rates of \$1.32 for the dollar and EUR 1.13 for the euro, FY '18 profit would have been GBP 5 million higher. This will enable you to adjust your forecast models appropriately.

And so finally to the outlook.

We expect the group to at least sustain its underlying revenue growth in FY '19, with performance again weighted towards the second half.

John Crane is expected to continue to grow at a similar rate to FY '18. For Smiths Medical, regulatory and contract challenges will progressively abate, and we anticipate revenues returning to growth in the second half. At Smiths Detection, we anticipate growth driven by Air Transportation, with program phasing further weighted to the second half. Smiths Interconnect is expected to return to growth. And Flex-Tek will continue to grow, albeit against a stronger prior year comparator. And as I just mentioned, if current exchange rates prevail, they will provide a small tailwind to both revenue and operating profit in all divisions.

Finally and importantly, Smiths will maintain its strong track record of cash conversion.

In summary then, a good performance with return to growth for the first time since 2013, an important milestone, but our journey doesn't stop here. We aim to at least sustain that growth rate in the coming year and then further progress towards consistent outperformance, which is a good point for me to hand back to Andy, who's going to talk more about our strategic journey.

Thank you.

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

Thanks, John, very clear.

Strategy. Our strategic framework is founded on the characteristics of the sort of businesses that we want to own and operate, those with the characteristics of the Smiths business. That's really our DNA. Smiths is very good at running businesses with these characteristics. An example of that is customer intimate service networks that take care of the aftermarket and service for our customers. That's something that's really easy to say but very hard to do; and we've been doing it well for many, many years.

Exciting things are happening in all of our businesses. John Crane is making great progress in nonoil and gas, and now also has more than 60 condition monitoring pilots running around the world in refineries. Detection is building on its leading position in airports based on a product range and software capability which we believe is unmatched. It's investing more and at the same time has improved margins. Flex-Tek continues to sparkle. It's a real standout performer growing strongly, having successfully integrated last year's acquisition in the Heat Solutions area, and is winning on all of its product lines. Interconnect has completed its market refocus and restructuring that took place over the last 2 years was back in growth in the second half; and is bringing some really clever, new products to the world of high-speed, secure connectivity in very demanding applications, like space. Medical is launching new products at its highest rate ever, some of which are game changing. At the same time, we're making progress on its operational capabilities despite the setbacks that we suffered recently.

We've spoken often about strategic repositioning of our portfolio to create higher-quality businesses in growing markets. Work has been continuing at a pace both organically and non-organically. Risk-assessed financial discipline guides all of our capital allocation decisions. In 2016, we set out to improve the position of the group's portfolio and since then have moved from 60% to around 80% of the portfolio that is well positioned in growth-attractive markets. Businesses that are not well positioned fall into 2 categories: fix or sell. Fix means we can get it done in 3 years, or we'll allocate our resources elsewhere. In the last 2 years, we've bought 4 businesses, including Morpho; and sold 9. Total proceeds from these divestitures to date are around GBP 530 million. And acquisition costs of around GBP 620 million represent very positive recycling of capital as we reposition our overall portfolio. Expect more of this active portfolio management to continue. We'll continue to buy well and sell well in every case. We're disciplined as we think about fair value, time value of money, risks and alternatives. We're rational and not emotional in our approach, and if we can't be satisfied, we'll walk away.

I'm pleased to report that the integration of our largest acquisition to date, Morpho, is going very well. We talked about GBP 30 million of annualized cost synergies, and we now expect to deliver these a year ahead of schedule. Importantly for me, the combination of Morpho and Smiths Detection is yielding clear technology and commercial advantage in the market and for our customers. I'm also pleased to announce today the agreement to sell one of Smiths Medical's specialty businesses, a sterile water bottling business, for around \$40 million, which is 4x revenues, further focusing Smiths Medical on its core category leadership positions.

This leads me to Smiths Medical more broadly. It has obviously been the subject of a lot of focus this year both internal and external. Smiths Medical is a high-quality business but had been underinvested for many years in a number of areas. Over the last 3 years, we have significantly increased investment in R&D, which has been up 40%. We launched over 20 new products in 2018, and we've made progress on operational execution and sales effectiveness. Smiths Medical enjoys many well-positioned brands and franchises, particularly in Infusion Systems and Vascular Access, and the majority of our investments in new products have been focused on developing category leadership in these segments.

Our performance in the second half was disappointing, as operational execution felt -- fell short, together with issues related to regulatory certification. These disruptions offset an underlying positive trend in the division. We have a clear understanding of the issues in each area of operations and sales effectiveness and are systematically taking the necessary

actions to resolve them. And I'm very confident in the fundamentals of the business in the future.

As you know, we announced last week the cessation of talks with ICU, having been unable to reach agreement on terms. There's been a lot of speculation around the potential transaction, much of it inaccurate. I want to talk to you a bit about how we look at it. The industrial logic of the combination in this rapidly changing market was strong, and the potential to accelerate category leadership and scale in infusion therapy, with synergies and also the ability to maintain exposure to the upside of the investment we've made in Smiths Medical, but the terms and recognition of value and risk sharing have to be right. We know the value and potential of our businesses. All of these decisions must be and are driven by a clear understanding of the risk of execution and the disciplined focus on fair value creation in the context of the group overall. We were unable to satisfy ourselves in this respect as part of our determination to deliver and maximize shareholder value. We will continue to drive the development of our Medical business and realize the fruits of our investments, but in parallel we'll continue to explore opportunities to accelerate and optimize shareholder value on the right terms.

As the ICU discussion showed, we're approaching this across the group with imagination and a flexibility, as we do in all the businesses.

Now I'd like to move on to the group operating model. I talked earlier about the progress we're making in the 3 building blocks of execution, innovation and people. And I'd like to take you through each of those in a little bit of detail.

The Smiths Excellence System is our group operating model. It's the thing that will enable us to drive performance, execute consistently and continuously improve across the group and extract value from our organic and inorganic investments. It will also be a primary differentiator for us in the market. It's now fully deployed and helping us to apply best practice across the group to drive speed and efficiency. Our capabilities are building well, but like any continuous improvement journey, it never ends. The key for me is speed of implementation, and that is our focus.

It's a centre-light philosophy founded on the best benchmarks. The centre focuses on the framework, leveraging group strengths and developing the necessary skills and capabilities in the divisions. The divisions are fully accountable for execution and also encouraged to be entrepreneurial. A comprehensive program of training is in place from lean leadership to highly technical black belt programs, with several hundred more employees being trained this year. This approach is driving some real operational improvements, and there are some fantastic examples across the business. John Crane has developed a global inventory system. This has reduced slow-moving inventory, enhanced planning and improved stock turns by 28% in the last 2 years. Smiths Interconnect led a supplier development program, working with a key supplier, to simplify product design. It generated 14% savings on the spend with that supplier and importantly with no margin erosion for that supplier. This program is being deployed across the group; and is crucially important, as half of everything we sell is bought from our suppliers. So they're not just the source of commercial advantage but also a source of innovation for us if the partnerships are long term and strategic.

All of our operational improvement activities are targeted and aligned with delivering on our medium-term performance targets; and are measured and driven day in, day out.

We're a technology company and innovation is at our heart. We're investing 20% more than we were 3 years ago. You can see behind me some great examples of new products that we've launched this year, including a new CT scanner from Detection. This has been designed to meet the latest European level 3 approvals. This will allow liquids and computers to be left in hand baggage and works by far higher levels of molecular density analysis and processing speed. It's very important when lithium-ion batteries have a similar density to certain explosives, for example. We've just won an important tender for this in Asia as part of an integrated checkpoint solution. And this business is now rapidly becoming a software-led solutions business.

Software and hardware integration are key themes across the group, as you know. And our digital forge, which is a global centre of excellence, is up and running in the Silicon Valley area. It focuses on artificial intelligence, augmented reality and digital security, working very closely with the divisions on both current programs and next-gen capability. Examples include our augmented reality partnership with Microsoft to help refinery maintenance support technicians visualize the right solutions for the pump and the seal that they're looking at on the ground in real time. The forge team are also developing our network of academic and technology start-up partnerships for the future in both software and advanced machining and processing capability.

Some may argue, but I passionately believe that the single most important sustainable differentiator is people and leadership. We've made some great progress on our people and leadership and our cultural transformation program. 3 years ago, when I got here, this company was a fragmented group of businesses culturally, many of which were waiting to be sold. This year, we recognized how far we've come with our group culture with our first Smiths day, celebrating the Smiths Way and our values. And over 15,000 employees took part. We're building a learning organization that supports our people through very specific initiatives, including the Smiths Excellence System academy and a globally coordinated graduate and apprentice program and increased all employee communication. We've also prioritized our focus on diversity and inclusion at all levels. This is a key priority for me. I'm inspired by the ideas and perspectives that my colleagues bring to work each day. And I believe that creating a more inclusive environment is the foundation of innovative thinking as we seek to attract, retain, develop, engage and inspire the very best people.

All of the organic and inorganic investment we're making is targeted at achieving our medium-term ambitions that you saw laid out at the Capital Markets Day and building our company for the future. These measures form the basis of our management plans, our performance drive; and also are tightly aligned to our incentivisation. You've heard me articulate this before. And I'm often asked, what do I want Smiths to look like in the coming years? Well, it can really be summed up by looking at these elements: a well-positioned portfolio; innovation at the heart of what we do, bringing commercial and differentiation success, growing faster than the markets we serve; a through-life customer value proposition; and strong financial returns with a high cash yield. If all of these measures were in range, which they will be, you can see why I believe so strongly in the upside potential that we're on track to deliver.

2018 marked a really important milestone in our progress towards outperformance, but there's still a lot to do. We're aiming to make further progress in 2019 as we move towards sustainably outperforming our markets in the medium term. The potential is huge, and we're confident and committed to continue delivery.



Thanks for listening. And I'd be delighted, along with John, to take any questions that you've got. Thank you.

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## QUESTIONS AND ANSWERS

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

Mark Davies Jones of Stifel. Sorry to be inevitable, but can we start on Medical? Clearly, the things that went wrong this year, some of it might be attributed to bad luck, but the regulatory changes in Europe should have been seen coming. And perhaps [you can give a] little background on those contracts that were lost. I guess, looking forward, are you confident that you've got the operational management you need there? Obviously, the challenge to bring a lot of product to market is one thing. Was the eye slightly off the ball in terms of the European business? And are there further contracts that are at risk in that?

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### **Andy Reynolds Smith *Smiths Group plc***

There were really 3 pieces of the story. The first was the change in notified body that we did not expect. So that covered a number of products in Europe, that many of which had been sold for the last 20 or 30 years and entailed effectively a recertification. So you have to rebuild the support files that meet the requirements of the new notified body. So that one was hard to see coming. You don't get notified in advance of that change -- or very much in advance. The second piece is operational execution, and we're coming on a journey with Medical right now. I mean we deliver very good-quality products to the market, but that quality is not built into the process that I would like. So customer gets great quality, but there's a cost which is too high associated with delivering that. And also, as we went through the phase of new product launch, inevitably, there was a lot higher activity than we'd seen before. 20 new products versus an average of two a year for the previous three years puts a strain through the organisation. And we've also been very focused on selling effectiveness, which is absolutely key in the Medical market. A lot of efforts gone in there through incentivisation particularly to ensure that we've got a really a strong sales force properly incentivised and properly focused. So that was about 1/3 of the drag that we saw.

We've got plans in place in each of those areas to improve it. The MDR piece, the longer-term European regulation, is something that is well known and well understood and comprised about 1/3 of the issue that we saw in 2018. And we've also said that, for the next couple of years, there probably will be continued costs, which I know you've all considered because we confirmed and announced them, of about GBP 10 million or GBP 15 million related to that. As far as the two contracts -- and this is a long answer, but it's important because this is a really good business and a really important business that we need to get where it needs to be. The two lost contracts, one of them was an end-of-life product that was sold in the prior year. We knew that it wasn't going to recur. We had a number of contingency plans in place for alternative sales, which we didn't deliver. And the second piece of that was a disappointment with one of our major distributors with whom we had big sales the year before and they went very close to zero. We terminated that arrangement, and as we move into 2019, we're moving to direct sales of those products. It's the COPD thing. The thing you blow in and helps your lungs circulate a bit better, Acapella. So those are really the pieces of the puzzle. There is the continued improvement of the operational

side, which we're on a journey we're working hard on. And we've got a clear plan that will improve as we move through and into '19. And the other two pieces are well understood.

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**Michael Blogg *Investec Bank plc***

Michael Blogg from Investec. Just for clarity, could you say what you think your underlying market growth was in the last year and what your assumption is in coming to your guidance for 2019?

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**Andy Reynolds Smith *Smiths Group plc***

As we said at the Capital Markets Day that, through cycle, our aggregate market growth is 3% to 4%. I don't have the precise number for '18, but it would have been a little bit lower than that in some areas, but overall we see it as 3% to 4% aggregate going forward. And we want to grow more than that.

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**Andre Kukhnin *Crédit Suisse***

It's Andre from Crédit Suisse, over here. Can I ask on Detection? That move in Ports & Borders is quite striking, and you said there's some share loss, so maybe could you walk us through what exactly you're doing to counter that? And then linked to it, that launch of the new CT checkpoint scanner machine, has that happened already? Is that making impact, or is that yet to come?

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**Andy Reynolds Smith *Smiths Group plc***

Okay, really clear view of this one. The airports business did great, as you know, and is well positioned, 20% growth in '18. We grew in Urban Security, which is the crowded places business, so sports stadiums and government buildings, those sorts of things. Military, we knew what was happening because we've got two products with the Department of Defence. And when they're not buying them, you don't have any sales. So we're in great position to win those businesses going forwards. Ports & Borders was disappointing. And you've seen in the numbers we were down more than 40%, and that's because we were losing share. For me, there is a major focus now going forwards on developing our Ports & Borders business because there's a real rising tide in terms of technology going on there. Historically, it was largely unregulated, certainly nowhere near the levels of regulation that you see, or technical demands. It tended to be a lot more rudimentary product. At the Capital Markets Day, you might remember the CORSYS product, the digital product which is targeted at Ports & Borders. So we've got more to do. We think there is huge read-across synergy between our airports business and the Ports & Borders business, and our aim is to have the best product and the best capability out there quickly and to not -- to really take advantage of what will be this rising tide of regulatory demand and commercial demand in Ports & Borders. But we can't get away from the fact that we have been losing out to competition. And we do expect Ports & Borders to go back into growth in '19, though...

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**Andre Kukhnin *Crédit Suisse***

The CT checkpoint scanner.

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**Andy Reynolds Smith *Smiths Group plc***

Things are moving very quickly there. The reference that we made on the level 3 approval is about keeping the liquids and computers in the bag. That is in process of being developed and deployed now. There are limited sales, so far. And we expect that it will become very widespread very quickly, but the plans for that implementation from a regulatory point of view are not yet fully formed. So as I mentioned, we have won a business that we can't talk about exactly which country it is, Roland, can we, but in Asia that takes advantage of that. And the Americans are now starting to swing into action on the checkpoint versus the checked baggage, where there are already CT, to improve quite an aged fleet of checkpoint in the U.S. So there's a lot of positive trends going on there, not material in terms of sales, but it's going to be a bit like electric vehicle. It's very small now, but it's going to be profound going forwards.

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**Andre Kukhnin *Crédit Suisse***

And if I could just switch to John Crane and the margin outlook there. This business peaked out at close to 25%. We're now at 23%. And it sounds like the message is, given how the demand mix is turning out, that margin is more likely to be flat than kind of climbing. We're in the recovery. Do you think there is a chance to hit the previous highs, or not?

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**John Shipsey *Smiths Group plc***

So our guidance is that margins will be flat. There are definite positives in terms of demand. Demand is pent up, and it's good for John Crane. And aftermarket is strong, but the headwinds are really, from the market point of view, the geographic mix. So in growing markets, we are -- they are more competitive. They are tighter margin. And also, we do intend to invest more in R&D going forward. That's we'll pay for that. We won't allow margins to go backwards, but that will be a headwind.

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**Alex Virgo *BofA Merrill Lynch***

I'll grab the mic while I can. Alex Virgo, Bank of America. I guess, under your own definition of fix, it's been three years with Medical. I appreciate that there are explanations for the performance, but it isn't fixed. So what is it that you didn't get from ICU that you -- that forced you to walk away? What is it that you think you should be getting? And perhaps as a way of trying to frame the returns that you want to get on that business: I guess you've probably spent, what, GBP 100 million in R&D over the last 3 years in aggregate.

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**Andy Reynolds Smith *Smiths Group plc***

Yes, probably in that order, yes.

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**Alex Virgo BofA Merrill Lynch**

What return are you expecting to get on that? Because we're not really seeing it. And I appreciate that you've launched products in the last year which should deliver that, but when are we actually going to see it come through?

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**Andy Reynolds Smith Smiths Group plc**

We talked earlier about the nine businesses sold. The four bought was part of the recycling and high-grading of the portfolio. And for me, the three-year fix is targeted at those sorts of businesses which are part of the business today. Medical sits in a very different category for me. I mean it's fundamentally a great business in a great position that, if you can execute well, incrementally introduce lots of new technology and sell well, there's an environment there which is extremely attractive. And I think that gets reflected in the way that the world looks at the value of some of those assets. I continue to believe that this is a business with great fundamentals. It was further away from where we wanted it to be than some of the others, I think, by virtue of the or negative virtue of the historical underinvestment and uncertainty that we created around that business. So my message here is really one of this is a good business we continue to invest in, but I think the evidence of considering options to accelerate shareholder value creation here in a risk-assessed way, versus what we think the potential value of the business is now and for the future, is really what drove us to say now is the time to stop these discussions. And as I've clearly said, across the business, in all areas, we continue to look at options that exists to deliver more shareholder value more quickly. Thanks, Alex. Glen?

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**Glen Liddy JP Morgan Chase & Co**

It's Glen Liddy from JPMorgan. In terms of the portfolio, I mean you have highlighted your 9 disposals and recycled the cash. And Morpho certainly seems to deliver growth, and the businesses you've sold don't. How much more of your portfolio is there an opportunity to divest and recycle into value-adding businesses? Or...

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**Andy Reynolds Smith Smiths Group plc**

Well, I can't give you precision, but if you look at 80% of it well positioned, 20% of it fix or sell, it's approximately half and half.

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**Glen Liddy JP Morgan Chase & Co**

And in terms of recycling. It is a tough market for buying, and multiples are high. And are there smaller businesses where you would be having an edge because of savings? Or is it going to be just a tough battle to find things to bolt on?

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**Andy Reynolds Smith Smiths Group plc**

Yes, it is difficult because, on the whole, good assets are highly valued at the moment. I mean our focus is on the things that we think we can really bring something to that's going to

take us forward in terms of customer position, technology position particularly, and with a strong focus on growth potential. We have got a really good-quality pipeline in place now across the business, in all areas, both small, medium and large, that we're constantly working. All of them sit in different places, of course, but we've got a really clear view of how we assess them. We've got a good-quality pipeline, and we continue to actively work that Glen.

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**Glen Liddy *JP Morgan Chase & Co***

And on cash conversion. I mean organic growth picked up. You have reduced your inventories. Can you continue to hover around the 100% if you're successful in accelerating the growth a bit further over the next couple of years?

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**John Shipsey *Smiths Group plc***

That's absolutely what we intend to do. And as I said, we dropped from 27% to 26% of sales -- working capital of sales. And I'm very confident we've still got a lot to do and both on inventory, but also we're just rolling out some really good technology content on accounts receivable across the divisions. And for me, I mean, cash is fundamental. It's something that transcends every business, every division. And I still -- it's a war. It's not a battle. It's something that we fight day in, day out, month in, month out, but I still see absolutely 100% for me. I hesitate to call it the pass mark because we hit 99% this year, but 100% is absolutely our target year-on-year.

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**Andy Reynolds *Smiths Group plc***

For me, Glen, cash is absolutely a focus here. The cash yield of the business is one of the very attractive characteristics that we will maintain. We grew 5% in the second half. So there was a lot of working capital that gets absorbed into that growth, particularly when you haven't grown for some time and you're switching back on suppliers that have been switched off. So I was pleased to see some small improvement in working capital as a percentage of sales despite that return to growth. So we've got a very high level of confidence that really for me is underpinned by how much the opportunity there is. I mean we're sitting working capital percentage of sales at 26% now. 1% movement is over GBP 30 million. And our target is to be at 20%, and we absolutely see the way there. There's a lot of scope on cash generation.

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**Glen Liddy *JP Morgan Chase & Co***

And finally, on John Crane, growth has been very strong in the aftermarket recently. As that moderates and OE growth picks up, what's the counterbalancing item that keeps your margins stable? Because typically you've got much higher margins in the aftermarket.

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**John Shipsey *Smiths Group plc***

It will be volume, so it will be operating leverage countered by that geographic mix and that higher R&D, but we're confident we can maintain margins in Crane. And yes, it is a magnificent -- it is a great business. And it does have pretty enviable margins, but we're

confident we can hold them.

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**Jonathan Hurn *Deutsche Bank AG***

It's Jonathan Hurn with Deutsche Bank. Just two questions, please. Firstly, just coming back to John Crane. Obviously, there were costs of bringing capacity back online in 2018. Can you just give us a feel for how much more capacity needs to be brought in line -- or back online in '19 and what the costs of that will be, please? That was the first one.

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**Andy Reynolds Smith *Smiths Group plc***

Certainly there is capacity that needs to be brought back online. And a lot of it had lain quite fallow for some time since the downturn started in 2013. And one of the challenges is, for me, changing the supply structure, the supply chain because historically a lot of it tended to orientate around much smaller machining and finishing operations. And the team are working through now a supply chain structure and a supply base that's fit for the future. So we're able to operate well at the moment, but we've got lots of potential to optimize. I don't see a particular cost drag there. I mean this is an efficiently run business today. I see upside opportunity. And I see that really, for me, enabling us to pay for some of the technology that needs to come through in Crane now to maintain our leadership position. So I don't see a drag there, Jonathan.

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**Jonathan Hurn *Deutsche Bank AG***

Second question was just on Medical. Can you just talk a little bit about the new product introductions that have come through in '18 and how the market has received them? And I think maybe I've got this wrong, but I thought you were supposed to launch 12 products in the second half. And it looks like you've actually only launched nine. Is that correct?

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**Andy Reynolds Smith *Smiths Group plc***

Yes, we said we were looking for north of 20 this year. I mean, as I look at that, there were two factors. There's stuff that we've got to do to launch them, so development, industrialisation, testing and so on. And then there's the getting it through the approval process, particularly the FDA approval process. So we're on track within the orders of error on timing that we expected at the moment. We were just about to launch another one next week actually. And I was really pleased that -- as part of the large-volume pump programme, which is really in nature a game changer for us because it's a market-leading, smart, connected pump. We submitted the software package to the FDA a couple of days ago, we call it PharmGuard server, which put more simply is the drug libraries and the ability to manage and run the drug libraries and link them to the records, so which is a big, big step in getting that product to market also.

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**Jack O'Brien *Goldman Sachs Group***

It's Jack O'Brien from Goldman Sachs. Just thinking about some risks as we look into the next 6, 12 months from a group wide perspective. We've seen one or two engineers recently talk about tightness of some components. And as an assembler, is that something you're



seeing within any of the divisions? That will be the first.

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**John Shipsey Smiths Group plc**

I think the area that we're probably watching most carefully is tariffs and making sure that we're protected or we're mitigating any risks there. That's something that is making us look carefully. Smiths does benefit from quite good geographic diversity in terms of where we produce, so we tend to produce locally for local sales. That's not always the case. And I would say that Medical, Interconnect and Flex-Tek are exposed to tariffs. And in the short term, it's not a material amount, but it's probably GBP 5 million to GBP 10 million. And obviously, it's a moving feast. The volume of tariffs could go up or down. That's a short-term impact. Clearly, in the longer term, we can make changes to accommodate those, but that's probably what's exercising us most in the short term.

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**Jack O'Brien Goldman Sachs Group**

Just following on from that. Obviously, well geographically balanced, but is there a risk, being a U.K.-listed business, from the ongoing sort of Brexit negotiations? How are you thinking about those trade agreements? Has anything been flagged? Clearly, you're a huge business. Is that something you're monitoring carefully?

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**John Shipsey Smiths Group plc**

We're certainly monitoring it. We are U.K. listed but our operations - actually in terms of what's counts - less than 5%, I think, of our operations are in the U.K. So we'll monitor it. And we're keen to understand how it's going to operate, but I would say probably the wider tariff map is more important.

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**Andrew Caldwell Barclays Bank**

It's Andrew at Barclays. Just two. Coming back to Medical, on growth for '19. The guidance, obviously you expect to be growing in the second half. Is that going to be enough to offset the decline in the first half? Should this be a positive growth or flat growth here in '19 for Medical? And secondly, in Detection, on the sort of 2 large contracts [around, say, the] \$70 million and \$50 million. Are those for delivery in '19, '20? Or what's the time line there? And is there an aftermarket component in those order numbers?

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**Andy Reynolds Smith Smiths Group plc**

I'll take the first piece. You take the second piece, John. And Medical back in growth in the second half. We are very confident of that. And so moving from 2% for the year and '18 down and which was 3% or 4% in the second half. So positive progress back towards flat in the first half, so I expect at least flat for the year as a whole.

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**John Shipsey Smiths Group plc**

I'm sorry. Your second question, I'm not sure what you were referring to.

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**Andrew Caldwell *Barclays Bank***

The two Detection contracts. There was a \$70 million TSA contract, and there was a \$50 million India contract. I think it was in the release.

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**John Shipsey *Smiths Group plc***

Okay, yes. So India, I think, is largely delivered. And the TSA is an ongoing contract.

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**Andrew Caldwell *Barclays Bank***

Is there an aftermarket component within the order numbers?

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**John Shipsey *Smiths Group plc***

Absolutely -- sorry. There's aftermarket for both, yes.

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**Andrew Caldwell *Barclays Bank***

Roughly how much of the \$70 million is OE versus aftermarket?

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**John Shipsey *Smiths Group plc***

So I couldn't comment on the specifics. For Detection as a whole, the aftermarket is more than 40%.

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**Robert Davies *Morgan Stanley***

It's Robert from Morgan Stanley and just a couple of questions. First one was around the Detection business. I think the growth versus consensus is sort of a little below expectations. I was just wondering if you could kind of talk about the order book there; and how much is, I guess, kind of expected to come through. Were there any contracts that got cancelled or pushed out? How many framework agreements. Do you have framework agreements in the order book, or is it just firm borders? And then the second one: You mentioned the valuations generally in the sector have been quite expensive. Are there any bits of your portfolio that you would maybe see as noncore that you would potentially sell at this point in the cycle?

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**Andy Reynolds *Smiths Group plc***

In Detection?

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**Robert Davies *Morgan Stanley***



No, just across the group in general.

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**Andy Reynolds Smith *Smiths Group plc***

I'll take the second piece first. I've said that we continue to look at businesses which we either can't improve quickly enough or we think are noncore. And we are definitely continuing with that process, so you can expect more. As I look at Detection overall, I'm really pleased with what's going on in the airports business. I mean we've got a true leadership position. They're up 20%. However, that underlying market in airport isn't a 20% market. And that's really a function of the fact that we've got really good visibility of what will happen, but the precision on the timing is really the challenge. It's not quite where we wanted it to be in terms of divisional growth overall. It's really about the Ports & Borders business that did worse than we thought. So critical infrastructure or Urban Security we made progress. And as expected, the military business was a lot down but exactly as expected. Airports, there's always some movement on timing, which is why you need to look at it through a longer period of time. So this is about getting Ports & Borders, well, back to growth, which it will be in '19, but particularly developing the capability in terms of technology and product -- customer offering that meets the demands for the future. It's the unfortunate fact that almost everything in terms of contraband and weapons or explosives does go through ports and borders. You don't smuggle stuff on planes. And there's a big rising tide in the demands in that space, so big focus. We didn't get what we wanted last year.

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**Robert Davies *Morgan Stanley***

And on just the framework agreement part of that business...

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**John Shipsey *Smiths Group plc***

So we do have framework agreements in that. Framework agreements in aftermarket give us very good visibility however, what isn't predictable is the timing of tenders and our win rate. And within that, for me, it's more about the timing of tenders and when they're executed rather than our win rates. So we are performing very, very well. And we have created this champion, this leader in air transportation, but it depends on the timing of tenders and when they are executed. And yes, just to emphasize: 20%, let alone the 28% in the second half, those are not underlying rates. They reflect also contract phasing.

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**Sandeep Gandhi *Exane BNP Paribas***

This is Sandeep Gandhi from Exane BNP Paribas. So just a quick question on John Crane. So OE was only up 2% in H2 in terms of revenues. I guess, given what other peers are exposed to [and similarly what the] markets are saying, I would have thought this might have been a little bit higher. So you've talked about extra costs going to the business to increase capacity. To what extent does that have an impact on the top line in H2? And therefore, would you expect a sharp pickup in '19?

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**Andy Reynolds Smith *Smiths Group plc***

First of all, on the market growth piece. So the OE did return to small growth. It was the first time in four or five years that piece had grown. The aftermarket is very strong. I think the important piece to understand about it, versus what some people might call peers, is we are all downstream exposed. So we're in refineries. We have almost zero exposure in the upstream extraction. So a lot of the growth we talk about the Permian basin well completions, for example, has no effect on our business. Our business is really all about the refineries, the amount of oil that they're refining and the replacement and renewal rate of refinery capacity. So ROE means oil and refineries essentially rather than extraction. Not sure if that's helpful. The second piece of it is we are improving our supply chain. I don't see that as a drag. And I mean, for me, the margin potential in the medium term of Crane is positive, on the way up, but in the meantime, as with many of our businesses, we're investing more in R&D. As I look at all of the businesses, I've said clearly that, as we return to growth, we'll continue to improve efficiency, invest more in R&D because that's what will give us the sustainable growth for the future. And then as we move through that short-term period, we'll start to look at margin improvement potential. Thank you.

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**Sandy Morris Jefferies**

This is going to get a bit agricultural, so forgive me. Last time, John Crane's aftermarket went up 8%, and OE was flat. The margin had a big bump. Okay, it's a long, long time since it went up 8%. I mean that is a stonking result.

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**Andy Reynolds Smith Smiths Group plc**

Yes.

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**Sandy Morris Jefferies LLC**

What happened to the margin?

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**John Shipsey Smiths Group plc**

In '18, there are two factors that went against margins. So it is geographic mix. So we are our higher-growth markets are higher competitiveness and therefore lower margin. And secondly, I don't have all the history that you have, Sandy, so I'll tread carefully, but this was switching from down to up. And the cost of switching that capacity both within our own supply chain, so within our own production, but also with our third-party subcontractors, that has cost us.

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**Sandy Morris Jefferies LLC**

Right, but you see where I'm trying to come from on this is plus 8% in the aftermarket isn't from new markets. That's from your well-established, traditional base. Therefore, there shouldn't really be, all right? Do you see where I'm coming from now?

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**John Shipsey Smiths Group plc**

It is from [newer] markets. It's aftermarket. By mix, it is in lower-margin markets.

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**Sandy Morris Jefferies LLC**

Right. So as long as you are promising me that this drive into non-oil and gas OE isn't doing what it did the last time, which is to trash our margins -- I mean, as long as you're promising me that, I'll give up. And we can...

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**Andy Reynolds Smith Smiths Group plc**

I've got a very clear view of that one, Sandy. And our market share in non-oil and gas is less than 1/3 of our market share in oil and gas. In historically, our focus had been largely oil and gas even though the revenues of the business were 50-50 between oil and gas and non-oil and gas, as you know. I've been laser focused on exactly the point you make, that -- and I don't want to switch to a growth profile in non-oil and gas that dilutes margins. So we could be growing faster in non-oil and gas right now, but we've been very selective about the projects that we're taking that are on the more aggressive end of the technical demand scale or are new projects. So we are not out trying to win business and grab share. We are out when there are new, more high-performing pharmaceutical plants being built or chemical plants being built where our products work and we can maintain margins. So one of my key measures has been what the margin is on one and the other. And we don't disclose that, as you know, but it's very much front of mind. This isn't an attempt to grab growth. This is an attempt to diversify into similarly attractive applications that we enjoy in oil and gas, which is why it's only 3%. I say "only." I'm very pleased with 3% in non-oil and gas. It could be more if we were doing what you said.

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**Sandy Morris Jefferies LLC**

All right, cool. So it's just really important to establish that because Crane is just... I mean plus 8% on the aftermarket, that's just an achievement.

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**Andy Reynolds Smith Smiths Group plc**

Yes, it is.

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**Sandy Morris Jefferies LLC**

And then we get back to Medical, which to be tedious, I understand that you're saying it's got lot more value than we were able to get, but it's the gory detail that I'm afraid always eludes me. Because if I look at infusion, despite some contract termination, it grew 4%, it had a stonking second half, yes.

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**Andy Reynolds Smith Smiths Group plc**

Yes.

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**Sandy Morris Jefferies LLC**

And then the one that really bugs me, not that I really ever want to go near one of these things, is in PIVC, which has now been declining and we don't seem to have arrested it. Or are we going to bring...

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**Andy Reynolds Smith Smiths Group plc**

There is a very precise answer to both of those: the growth in infusion is primarily down to the CADD-Solis ambulatory pump, which is without doubt a world leader. It's the best pump on the market. It's the one others would covet and do covet. So despite some hits -- and the contract loss, the largest part of that was in the COPD products and not infusion at all. On PIVC, what you're seeing at the moment is a switch in PIVC between non-blood control and blood control. So what that basically means, and apologies, is when you plug it in and plug it out, the blood doesn't squirt out. So a really important product. The high growth in PIVC is in the blood control products. We have a big chunk of our NPD focused on blood control PIVC right now, it's in the process of launching as we speak. So that's why you see something that looks slightly out of kilter at the moment in PIVC. Because PIVC overall is growing strongly, but all the growth is in blood control, not in non-blood control, products.

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**Sandy Morris Jefferies LLC**

Okay. I mean it's just that that used to be the body and soul of Medical...

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**Andy Reynolds Smith Smiths Group plc**

And PIVC is a great product line, but this is where the devil in the detail occurred when we first started to look at the growth problem, when we segmented the market in more detail and said this is much more detail than just PIVC holistically. This is about the categories within PIVC and which are growing and which aren't. So that's been part of the repositioning. So your observation is absolutely correct, but we understand it and the programmes are well advanced. In fact, John and I were there a couple of weeks ago, on the plans going forward in all areas, to get them locked down so that we can manage it well.

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**Sandy Morris Jefferies LLC**

Right. I mean I'm going quickly with it. Then we get into the last one, if I can remember the name, Vital Care or Specialty. And we're minus 6%. It's now age since we've see a minus 6%. So these contract terminations can't have been quite as trivial as perhaps...

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**Andy Reynolds Smith Smiths Group plc**

It was the Vyair contract, which is the COPD contract that fits in specialty and Vital Care. It was GBP 28 million year-on-year. It's a big number.

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**Sandy Morris Jefferies LLC**

Right then. So now you say that, I imagine, if I add that back, I'm going to discover there was actually good underlying growth ex this contract...

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**Andy Reynolds Smith *Smiths Group plc***

There's a number of very attractive areas in the Specialty and Vital Care. Sometimes it gets put to one side because we talk about Infusion Systems combining Vascular Access. So for example, the business we sold or announced we sold this morning is one of those that's not growing. We weren't a good home for it. The IVF business was in that area. It wasn't growing and we weren't a good home for it. It deserved to be somewhere who was focused on that more generally. And we continue to look at other areas within that business. Some of them are growing really strongly. I mean temperature management, for example, absolutely great, and we've got a really clear view of that within specialty. And that's what's driving the stuff that we look at keeping or selling.

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**Sandy Morris *Jefferies LLC***

Yes. I mean I get the Medical regulatory stuff is an elephant in the room, but I mean we can't -- we didn't do so badly, honestly, in other places.

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**Andy Reynolds Smith *Smiths Group plc***

I agree completely, Sandy. It was a frustrating period of time for me, I can tell you, as I'm sure it was for you.

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**Sandy Morris *Jefferies LLC***

[I did get] quite emotional.

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**Andrew Reynolds Smith *Smiths Group plc***

Me too. That's because we care, Sandy!

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**Edward Maravanyika *Citigroup***

It's Ed Maravanyika from Citi. A less-emotional question from me. Just for CapEx in '19 and '20, what sort of numbers should we be putting in? Sorry.

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**John Shipsey *Smiths Group plc***

So I think we will continue our asset-light model. So at the moment, we're at 1.1x amortization and depreciation, and we see that continuing going forward.

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**Andy Reynolds Smith *Smiths Group plc***

Well, thank you very much indeed for attending on a Friday morning. We look forward to seeing everyone out and about quite soon.

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Thank you very much. Have a great weekend. Thanks.