

## **SMITHS DETECTION INVESTOR DAY**

### **29 MAY 2012**

#### **CORPORATE PARTICIPANTS**

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#### **PRESENTATION**

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**Peter Durman - *Smiths Group plc – Investor Relations***

Good morning and welcome. For those of you who don't know me I'm Peter Durman. I'm in charge of investor relations at Smiths Group. There are just a few items I want to cover before we get underway this morning.

## **SLIDE – STATEMENT**

First I want to draw your attention to the statement on this slide, a copy of which is in your packs. And second, please can I ask you to switch off your phones and batteries to avoid interruptions.

## **SLIDE – TODAY'S PROGRAMME**

And then third I will just take you through the expected running order this morning. I'll hand over in a moment to Philip Bowman for a brief introduction. Mal Maginnis and some of his team members will take you through their presentation. We'll then take a short break for tea and coffee and then after that we will resume for a question-and-answer session with Philip and the detection team.

Following the Q&A the detection team will stage a mock incident to demonstrate how their equipment is used in attacking security events every day around the world. I think it will be an interesting spectacle for you. They try to make it as realistic as possible and I hope that it will help to bring some of their technology to life.

We'll then split into groups and take you around the product displays that you can see as you came in, and including the truck at the back, those were outside. And this is a great opportunity to see some of the equipment firsthand and ask any further questions that you might have.

You're then invited to join us for a light buffet lunch which will then complete the proceedings. So I hope you enjoy what we have planned for your today. I will now hand over to Philip. Thanks.

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**Philip Bowman - *Smiths Group plc* - CEO**

## **SLIDE – PHILIP BOWMAN**

Peter, thank you very much indeed. Ladies and gentlemen, good morning and welcome to the impressive home of the Honourable Artillery Company, today's presentation by the Smiths Detection team.

I'd like to thank you for coming along for what I hope will be an interesting and informative session. To start I'd like to make a few introductory remarks and then I'll hand over to Mal Maginnis for the main presentation.

## **SLIDE –SMITHS DETECTION – BACKGROUND**

Smiths Detection is a relatively young business within Smiths Group... it started with the acquisition of Graseby in 1997, and grew rapidly through a series of acquisitions, most notably Heimann in 2002. These acquisitions – leaders in their respective fields of chem/bio and x-ray detection – established an unrivalled platform of leading edge technologies. Smiths Detection also benefited from being in the right place at the right time as the security incidents over the past decade or so helped drive

significant organic growth. As a result it became the market leader in the sector, serving a broad range of end markets and customers.

At an investor day in New York last June, I commented that our customers have become increasingly sophisticated and demanding in the past few years. Their procurement processes have evolved and the drivers of their decision-making have changed. As I said then, the disciplined processes, data flow, and management competences in Smiths Detection failed to keep pace with these developments. Hence, the changes that took place last year

One major failing was that while we had continued to invest in new technology and products, we had not aligned them closely enough to customer needs.

The fixed cost base of the business was too high given the increasingly variable nature of order flow and we had not made the progress in operational improvement and enhancing margins as seen in, say, John Crane or Smiths Medical.

## **SLIDE - OBJECTIVES**

Today's presentation will focus on the steps we have taken over the past year to address these challenges by rebuilding the growth profile and reducing the cost base. Mal will take you through the detail of these initiatives which I will now highlight:

First, strengthening management – we have changed a significant portion of the executive team with further changes still ongoing at other levels.

Second, we are revitalising the sales force. In addition to managing out underperformers, we have also introduced more rigorous processes, disciplines and incentives. We can now prioritise our resources more effectively and avoid entering into unattractive low margin contracts. We are also building a strong order book for 2013.

Third, our cost reduction programme is already cutting our fixed costs. There are several different aspects to this programme that we will review today, including value engineering, site rationalisation and realigning our manufacturing footprint,

Fourth, at the same time we have focused on reducing the volatility in the business by seeking to expand the run-rate elements – such as in critical infrastructure. We are also improving the way we capture the annuity-style aftermarket sales. Over time, our intention is to cover our reduced fixed costs by these run-rate style sales which will result in a better drop-through on the larger programmes – the root cause of the historic variation of sales and margins.

Fifth, we are also leveraging the data from our information systems, a key element in underpinning a number of these initiatives – such as improving our understanding of the sales pipeline and order flow. We are only now beginning to make progress in this area, and if Medical is anything to go by, there are further attractive opportunities.

Last, we have refined our new product development processes to align them far more closely with our customers' needs. You will hear more today about our rich pipeline of innovative launches.

## SLIDE – SMITHS DETECTION – OPPORTUNITIES

Having spent a significant time in the business over the past year, I now feel more optimistic than ever before about the opportunities for Detection – particularly as many are within our own control.

- The business operates in markets with good long-term growth trends. These are driven by “incidents”, regulatory policy, government spending and a medium-term replacement cycle.
- It has strong positions across a wide range of technologies as a result of its sustained investment and strength in product engineering. In essence, this is the ability to take complex scientific analytical procedures and package them in equipment which has a very simple user interface. This enables relatively unskilled operators to obtain consistent, reliable results - time after time. Furthermore, our engineers are experts at making this equipment rugged so that these sophisticated laboratory tests can be applied reliably in the harshest of environments such as war zones. Detection currently has one of the strongest product pipelines in its history. One element is the new checked baggage screener we have developed with Analogic. You will hear more about this product and its market opportunities later. There will also be the opportunity to see many of our products as part of today’s tour.
- Smiths Detection has been able to leverage its technology across a broad range of end markets and applications – broader than any of its competitors.
- It is also one of our most geographically diverse businesses with a strong global presence – particularly in emerging markets.
- There are clear opportunities to cut costs and we are making good progress against this year’s target. The lowering of fixed costs will help us to manage the variability in the order and sales profile. I am confident the operating profit margins will continue to improve and over the next couple of years should return to within the target ranges previously set at 17-20%.

Overall, I am excited by the opportunities for this business and I hope that we will demonstrate why today. It is also an opportunity for you to meet some of the management team who will comment in more detail on the business and our initiatives.

I will return later to moderate a question and answer session.

So with that brief introduction I'll pass over to Mal for the body of the presentation, Mal, over to you.

**SLIDE – REBUILDING PROFITABLE GROWTH IN SMITHS DETECTION**

Thank you, Philip. Good morning, ladies and gentlemen, and welcome to Smiths Detection. Thank you for giving me your time today. I look forward to explaining to you the changes that have happened in this business and our path to the future growth and returning profitability at the level of that is expected.

**SLIDE – SMITHS DETECTION – AN ATTRACTIVE INVESTMENT CASE**

Why are we an attractive business case? Well it's fairly straightforward. We exist as a business within a market that has growth. And that's basically centred around the aspects of the market, transportation, port of orders, movement of goods, services and people and, of course, the threat that continues.

On top of that we have an outstanding technology portfolio and an excellent product engineering history. That gives us an ability to address those emerging threats and meet the market growth requirements.

And the third point that makes us attractive is the business has been completely re-energised and focused on delivering profitable growth. We are building an order book which is the basis for reducing volatility and we have been aggressively cutting costs in the last ten months and we'll continue to do that into the future.

So that's it on building the investment case. Let us look at the focus and priorities that I've set for the business in the past ten months.

**SLIDE – TODAY'S KEY THEMES**

Philip very kindly introduced the history and so I can avoid doing that. And I can focus for you on the actions we've already taken in the last ten months and our plans for the future to maintain that return to growth.

Firstly, we have re-engaged and focused on our customers. All of you are well aware of the challenges that large governments face at the moment in the current environment. It is imperative for us to focus on what the customer needs and ensuring that that actually delivers their needs. That's important because we've seen a period of significant investment in the security area.

That investment will gradually move over the next decade into a replacement, a sustainment and a support environment. The second key focus and priority is our technology and our products. Smiths Detection is a product company. We use advanced technologies to build products that solve problems in the market space.

We have an outstanding technology base and we haven't always leveraged it as well as we could. We are going to focus on our core strengths: our technology leadership, our superbly engineered

quality products and a truly global reach. One of the most overused words around is 'people are global'. Detection is truly a global company and I'll show you that shortly.

This is coupled with our focus on reducing costs and improving margins. Growth is critical, but we also need to reduce our costs which were not as well managed in our past.

And we have to build on the advantages of an outstanding and extensive installed base. This gives us the opportunity to expand our aftermarket position and our ability to produce additional products to meet the market.

## **SLIDE – CHANGING THE BUSINESS MODEL**

I want to talk to you about the change in the business model. Many of you have heard about this being a lumpy business, about it being a volatile business. And it is that because fundamentally we are a large prime contracting business.

Over 50% of our business is prime contracting and clearly you can understand that if a GBP30 million opportunity or programme moves by three months that significantly moves the performance of the business. So the business model that we have designed looks to adjust that volatility and do everything we can to dampen it.

I cannot remove the volatility, but I can remove the violence of the swings within the business. So let me explain how we're going to do that.

Firstly, programmes these are complex and major projects with large government customers are a core part of the business. In the past above 50% has been quite common. Going forward we intend to concentrate on fewer on these large complex programmes and particularly concentrate on the value and the return from doing those large programmes.

We also intend to focus on our process of enhancing delivery and ensuring that we actually can meet the need that the customer has asked for. The second part of the new model we look at aftermarket. In the past the focus has been on large capital programmes and we haven't focused on the aftermarket to the degree we should.

Our intention is over the next three years to raise the aftermarket profile to between 25% and 30% of the business. This means a significant penetration in the business and looking with our customers to how we'll actually achieve that. Terry Gibson later on will actually take you through in detail the complete plan for the aftermarket business development.

Now there are two extra advantages in this. One, we will improve our customer service and relationships. And secondly we will improve the recurring revenue stream within the business.

And a third part of it requires business plan is the run rate business. In the past we haven't focused on the interesting market areas that do provide opportunity for our excellent products. Duncan Emery will speak later on about the strategy and the market sectors where there are tremendous opportunities to grow our run rate business.

Again this has the advantage that it increases our regular business, increases our steady cash flow and improves the stability of the revenue strength. These are the three core elements of the business model going forward, but of course they will have no impact unless we focus on the fourth one, which is reducing our cost base.

We have been absolutely aggressive about the approach to this and later in the presentation I'll take you through the major activities we've already enacted and the ones are yet to come. And the cost of sales are being addressed primarily through major initiatives in the process and programme deployment and in value engineering of both the products and their processes.

And we've looking seriously at the structural footprint of the business and how we can reduce and balance that. And I'll speak about that in more detail. So in summary the key issue on the new business model is to focus on our recurring revenues, expand our position with the customers and dampen the volatility of the business going forward.

## **SLIDE – BUSINESS PROFILE**

I want to explain to you the mission of the business. This seems a simple a thing, but a business without clear mission will struggle. Our mission is absolutely clear and has been developed and released through the business this year. We are going to be and will remain the world's leading provider of advanced technologies. I stress that word. It is advanced technologies that we are providing. And we are doing that to solve constantly evolving threats.

The threat base is not static and therefore we have to actually address the constantly evolving threat. And we do that in the market space, chemical, biological, radiological, nuclear and explosive.

The key issue is to we equip our customers with high integrity solutions. These are solutions that actually work. We have soldiers, emergency responders, security operators whose lives and the lives of their customers depend on their work. And we do that to protect life and support for the free flow of trade. And that is a very clear and straightforward mission. And it has provided the business with a much better focus.

We of course link that mission to our market leadership position. We have an enormous array of deployed equipment and Terry Gibson will talk to you later about how that leads to the enhanced after market position.

## **SLIDE – CORE TECHNOLOGY STREAMS**

I want to talk to you about the core technology strengths. Philip mentioned at the start about us reengaging with the customer and applying our technologies more ruthlessly in the pursuit of our market. I'm going to specifically talk to you about those technology strengths and also mention the normal opposition we see in those streams.

The first one is our cargo inspection business which focuses on the major ports and borders market and screening large containers and goods, high energy x-ray, complex, very, very major investment required in the technology. It is the most competitive of the markets and the most aggressive with the

opposition. And you see three of the examples that we face every day, Nuctech from China; AS&E from the United States; and Rapiscan from the United States.

The second key market technology stream is the chemical and biological sensors focused on taking analytical instruments from the laboratory into the security market space. Now interesting in our major competition in that space are all analytical companies, Bruker from Germany, Flir and Thermo from the United States. Smiths Detection is the only one in that group that focuses entirely its technology application on the security market.

Then conventional x-ray, a standard x-ray offering, a very large part of the business and a steady growth part of the business, we are the market leader in that sector. The major competitors you see are L3 from the United States and Rapiscan from the United States, although there are a plethora of smaller companies regionally based who also work in this space.

We then come to explosive detection systems (EDS). These are the systems focused on automatic, high-speed scanning of baggage going on to aircraft. It's a critical market sector and we have been a major player in it for over ten years. The normal competitors you see in this space include Reveal from the United States; Morph Detection previously from the United States, now owned in France; and L3 Communications from the United States.

One of the newest technology streams is the millimetre-wave systems for passive people screening, a non-ionising technology which is being deployed in both transport and critical infrastructure. And I believe going forward we will also move into the military and emergency response sectors. A major competitor here is L3 Communications from the United States. In our sixth technology stream; trace radiation and nuclear detection products primarily based on spectroscopy and focused mainly on the civil emergency response and military markets, our major competitor there is Morpho Detection, again from France.

And finally an unusual technology stream for us, the integrated systems. These are large truck-based systems primarily focused on meteorology. We have one system which is used to do meteorology in support of artillery predicted fire, appropriate being today in the Honourable Artillery Company and another system for meteorology actually for expeditionary forces in providing complete weather systems, and the third system a large truck-based protective system for chemical and biological shelters and hospitals.

All of those are major programmes and we design them specifically to the programme. And the typical competitors we see are DRS in the United States, are RAE and ENSCO, also from there.

## **SLIDE – SERVING A BROAD RANGE OF MARKETS, GLOBALLY**

So let me talk now from the technology streams and take you through into the markets and the global stretch of the business. Now in market sectors we see a very large market in air transport, nearly 40% plus of the business. This is a critical factor within our business and one that we focus on.

It is well supported by three key pillar markets including ports and borders, military and critical infrastructure all around the 15% of the business. Those numbers of course vary year-by-year depending on developments in the market and the various governments.

We have a smaller market sector in emergency response, but it's a highly valuable sector and one that we continue to spend a lot of time on. And finally we also use some of our technology in non-security adjacencies.

The next part I would like to stress is the global destination and reach of this business. This is a truly global business. You can see by those numbers almost 40% of the business in the United States, 25% in Europe and 36% in the rest of the world. Now clearly I don't need to tell you that the adjustments in those markets occurring will see movements in the rest of the world and a gradual decline in the United States and likely Europe.

For Detection we are fortunate that we are actually deployed across all three of the major market sectors. However, I will discuss with you later about the fact that we have not been as well placed globally in our operational footprint or our support footprint, but I do stress to you that we are one of the truly global companies.

## **SLIDE – NEW SENIOR MANAGEMENT TEAM**

I now want to talk and address the senior management team. Most of you know this has been a period of significant change within detection. In the last ten months we have seen a lot of movements of people in and out of the business as we restructure the organisation.

I want to tell you that we have successfully promoted some people from within the business, concentrating on our talent that we already have developed, but I have also consciously brought talent from outside the business to change and enhance the capabilities within the business. Within this, we have recruited more than six directors in the past two years and in fact I'm pleased to advise you here today that three critical directors have been appointed within the last two months.

It includes Mr. Ian May, the head of sales, Mr. Dave Anning, the head of global operations, Mr. Shaun Doherty, the head of finance. These have been major moves to improve the business and to change its approach and its focus on the way we operate.

In addition, I have appointed the chief scientist, Dr. Brian Boso, to the board. We are a technology company. It's quite appropriate that we have someone at his level sitting on the board.

I've also brought three key functions into the management area to ensure that we have the focus on the customer and the delivery of the growth profile. And this includes Terry Gibson who you will hear from later in aftermarket service; Rod Wilson, the head of products; and Sal Cipres, the head of programmes.

So in summary this has been a major series of changes over ten months within the business. These are not plans that we are discussing. They are plans that we have executed and put in place. There is, of course, a lot more to do, but the fact is that we have made a lot of our tough decisions already.

What I would like to do now is to hand you over to Duncan Emery, who is going to take you from my introduction on building the business and rebuilding the business to how we address that within the market sectors going forward. Thank you, Duncan.

**SLIDE – REBUILDING SALES GROWTH – MARKET STRATEGY**

Right. Thank you, Mal. As we have updated and deployed the divisional strategy we have maintained a strong focus on identifying the most attractive niches within our core markets where we have demonstrable competitive advantage.

**SLIDE – REBUILDING SALES GROWTH – MARKET SIZE AND CHARACTERISTICS**

We believe that our core markets of air transportation, ports and borders, critical infrastructure and defence and emergency responders will continue to exhibit substantial demand, and driven by the geopolitical situation will grow above global GDP. Total demand in 2011 in the primarily civilian-based markets was estimated to be approximately GBP1.6 billion and will grow to GBP2.2 billion by 2016. That's a compounded annual growth rate of approximately 7%.

For the military and emergency responder markets total demand in 2011 was estimated to be GBP2.5 billion, growing to just under GBP3 billion by 2016, 3% compounded growth. By leveraging the division's core capabilities and product portfolio across this range in markets we aim to minimise our exposure to any one market in particular, and hence the inherent market risk, while maximising overall economies of scale and cross fertilisation of technologies and products.

I would now like to take you through each of these markets in more depth and highlight the strategic approach that we are adopting in each.

**SLIDE – KEY SECTORS: AIR TRANSPORT**

The provision of security detection equipment to customers in the air transport sector remains the foundation of our business, as Mal has mentioned. We serve a wide range of customers including large integrated government agencies such as the TSA, airport and airline operators and air cargo operators. All of these customers work under increasingly more stringent regulatory frameworks from a range of different accreditation agencies.

To meet these requirements they must deploy a range of different technologies including x-ray scanners, explosive trace detection systems and whole body scanners. Global demand for new equipment and sales in 2011 was estimated at GBP530 million and is expected to grow at 5% over the next five years. This is driven by growing volumes of air passenger and cargo traffic with a concomitant increase in infrastructure and the increasing regulatory regimes which are frequently amended to take account of events such as the one reported on the 8th of May.

At the same time many of these items of equipment installed shortly after the 9/11 attacks are now coming to the end of their working lives, or will require replacement. The new equipment will need to meet the new stringent regulatory standards.

## **SLIDE – AIR TRANSPORT: TECHNOLOGY DEVELOPMENT FOR EMERGING THREATS**

Our strategy in air transportation is to maintain our leading position by utilising our technology base to bring to market new products and to meet the new regulatory criteria and satisfy our customers' core operational requirements. Our aTIX range of x-ray scanners have been certified for both hold and carry-on luggage screening and can provide automatic liquids detection.

These units comply with the forthcoming carry-on liquid regulations in Europe. We have recently launched a new dual-view x-ray scanner for palletised air cargo and in response to recent events and new regulations in both Europe and the US.

Our millimetre-wave body scanner is about to undergo accreditation testing including its automatic threat recognition software, which has been designed to address previous privacy concerns. Hermann will talk to you shortly about our new computed tomography hold baggage scanner, which will be critical in enabling us to meet the future regulatory requirements across the globe.

Our handheld and desktop trace detection systems continue to have strong demand and we will continue to develop these products to meet future customer requirements. Overall, we remain confident in our ability to maintain our position at the forefront of the transportation sector.

## **SLIDE – KEY SECTORS: CRITICAL INFRASTRUCTURE**

From one of our most mature sectors I would now like to move to one of our most rapidly developing and highest potential. Critical infrastructure is an amalgam of sub sectors with the common need to protect individual facilities or events from terrorists or criminal activities. Potential customers in this market include high profile public and private sector buildings and offices, prisons, large process plants and power stations and major events.

At present we estimate global demand from new equipment across these sub segments to be GBP450 million per annum and forecast it to grow at almost 8% per annum. There are a few regulations that cover this market and customer requirements continue to evolve and mature as a result.

However, this also results in procurement cycles being less prone to volatility caused by changes in government procurement practices. However, we do need to meet shorter lead times in order to satisfy our customer requirements in this market.

Growth will be driven by heightened perception of risk and customers seeking to protect their assets and staff. As requirements mature we expect to see a move towards more sophisticated equipment which at the same time will need to be easier to operate to meet the customer requirements in this market.

## **SLIDE – CRITICAL INFRASTRUCTURE: BUILDING A RUN-RATE BUSINESS**

Our strategy in critical infrastructure is to build market share, which we will accomplish by strengthening our sales force particularly in the US, which is leading the way in this market, by targeting applications where our technology can provide a significant advantage. For instance we

have developed a transmission X-ray-based whole body scanner which is rapidly gaining acceptance in prisons worldwide to prevent the smuggling of weapons and contraband.

Our baggage scanners and millimetre-wave body scanners have found a very wide variety of uses including helping shops, factories and distribution centres prevent theft by customers and staff. Our trace detection equipment is deployed in many facilities to detect explosives and narcotics.

Where we identify new applications and as customer requirements evolve we will continue to bring forward new products specifically designed to address these opportunities in this fast moving market. This variety of applications across a broad customer base will enable us to establish a more stable and repeatable run-rate business, which will help to establish a base load in our production facilities.

## **SLIDE – KEY SECTORS: PORTS & BORDERS**

Smiths Detection has a longstanding position in the ports and borders market sector providing screening equipment to customs, and border agencies and port operators. We estimate total global demand for detection equipment to these customer groups to be approximately GBP600 million per annum, which we forecast to grow by approximately 7%.

This will be driven by globalisation of trade, and increasing freight volumes and government's desire to minimise the trafficking of contraband and bomb-making materials. This includes the detection of nuclear materials required for dirty bombs, a significant area of focus across the globe at the moment.

To mitigate the impact of potential threats there is increasing regulation of the scanning requirements for international traffic, most notably for freight inbound to the United States, but also under international agreements as laid out by the world customs organisation and the international maritime organisation. In order to meet the necessary regulations our customers require increasing throughput from the scanning systems and are seeking less costly units so they can deploy more of them to provide overall greater capability.

## **SLIDE – PORTS & BORDERS: BUILDING A STRONG ORDER PIPELINE**

Consequently our strategy is to get closer to our customers through enhanced business development processes and a stronger sales force combined with adaptation of our product portfolio to meet these changing requirements. New product introductions which are already planned include the HCVM a range of lighter and lower priced mobile high energy scanning systems which you will have seen outside on your way into the building today.

This product was designed to meet specific client requirements and in response to customer feedback. Enhanced material discrimination technology is being designed to help the operators identify potential threats whilst increasing throughput. And the recent launched RadSeeker handheld rad/nuc detector provides spectroscopic identification of potential threats.

Recent tendering activity in the ports and border sector has confirmed the strongly improvement in market demand. And recent big wins provide us with confidence, but our strategy is aligning us well with the markets' requirements.

## **SLIDE – KEY SECTORS: MILITARY & ER**

The sale of detection equipment to defence agencies and emergency responders globally is a very large and attractive market for Smiths Detection. We estimate the global demand to be in excess of GBP2.5 billion pounds per annum and to grow at approximately 3%. I should note that this market value includes elements of collective and personal protection and the large integrated systems that Mal mentioned earlier which lie on the periphery of our current capability.

In common with other parts of the defence market, we expect government spending to be more in line with pre-conflict levels, although we do not anticipate that these areas will be significantly cut onto sequestration or other budget cuts. The reason for this is there remains an ongoing demand to protect troops and staff from ongoing threats both when deployed abroad in theatre, but also when based domestically.

## **SLIDE – MILITARY & ER: LEVERAGING THE TECHNOLOGY PORTFOLIO**

The key requirements from both sets of customers for detectors are that they need to be smaller, faster, lighter, ruggedised and easy to use. In turn many customers are also seeking networking capability and additional software support in order to help with their decision making. This is a challenging set of requirements which will require continuing technology and product development to fulfil, a challenge that customers are increasingly asking suppliers like us to fulfil as they seek to purchase commercial-off-the-shelf equipment.

Consequently we will continue to develop products designed to meet the customers' critical requirements utilising the full breadth of our technology portfolio. In many cases we will seek to combine in complementary and orthogonal technologies into a single solution to improve threat recognition and reduce false alarm rates.

Increasingly we ask to integrate these sensors into fully integrated vehicle born systems. At the same time we aim to cross fertilise products within the military and emergency responder markets and where appropriate utilising technologies developed in other sectors.

Recently launched products which highlight this approach well include the GUARDION portable mass spectrometer-based chemical threat detection system. This provides a step change in detection speed and accuracy for this type of unit.

The Sensa-LINX wireless communication system enabled interconnectivity for our equipment whilst the SABRE 5000 handheld detector for explosives narcotic and chemical warfare agents is a further evolution of our well established Sabre platform. We will deploy the RadSeeker rad/nuc detector to military and emergency responder customers.

## **SLIDE – MARKET STRATEGY - SUMMARY**

So I hope that provides you with an update on our market strategies in our core markets. We are confident that the markets in which we participate remain strong and will continue to grow driven by geopolitical events, the increased regulation we have described, ongoing replacement cycles for equipment and the growth in international trade and associated traffic.

The evolving and broadening range of threats will require an upgrade of technology over time which we believe that we are well positioned to address. We will continue to focus our resources on these applications within the markets where we can establish and maintain demonstrable competitive advantage and consequently continue to strengthen our overall performance, including a reduction in overall earnings volatility.

Thank you for your attention. I would now like to hand you back to Mal, who will provide further information on how we intend to grow our sales and strengthen our overall order book.

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**Mal Maginnis - *Smiths Group plc* - President**

## **SLIDE – REBUILDING SALES GROWTH**

Thank you, Duncan. So in the first part of the presentation I talked about our path to bring us back to profitable growth and giving you the outline of the business model. Duncan has now addressed how we focus that by using data from the market to address the actual strategy going forward.

## **SLIDE – IMPROVING SALES EFFECTIVENESS**

What I want to talk about now is some of the actual data of the plans and procedures within what we are building as a Company and we will focus on three key areas: sales force effectiveness, managing the order book and investing in the product development. So let's first look at sales.

I mentioned before that I have appointed a new head of sales, Ian May. In addition I have appointed a new head of sales in the United States and also in Asia-Pacific. And we have replaced approximately 40% of the senior management in the sales force.

This is a conscious decision to improve the effectiveness of the force and ensure that we could address the markets and the accounts that are appropriate to the business. We deployed the sales force now across all the markets and technologies.

That might sound slightly strange, but the fact was that we were not well deployed across all the market sectors. Not every salesman can sell every technology in every market. And we specifically needed to target the appropriate sales force to the right market sector.

In addition, we have put the entire sales force back to a series of training academies on product and activity so they learn the product, they learn the market and learn how best to actually sell the opportunity. In addition, we have linked our business to the key account management, linking it to the same approach as the customers.

There is no point in us having a structure of an organisation that doesn't reflect the way the customer actually works and thinks. On top of that Ian has introduced an analysis of the key processes within sales focusing on the opportunity pipeline and building long-term sustainable, audible development.

As well as looking at our own sales force we have very carefully reviewed all of our agents and distributors across the globe. It is the same with them that they cannot be expected to address every market and every technology in their countries. And, as a result, we have appointed new agents and distributors in various markets where we see the opportunity for growth.

I mentioned also more discipline and processes within the sales force. We have a large budget cycle, a long budget cycle within the business. That means you have to be very, very carefully aligned to the way those budgets are developed.

As a result of that we need rigorous process in development of the pipeline. We need a sound bid/no-bid process to ensure that we are not taking business that has no profitable value. That's a key factor within the business. We should do business and win bids that are profitable for the business.

We now analyze all of the sales force based on their forecast, their pipeline, and their ability to live with the results. And we have matched that to the environments and incentives schemes. All of this has given us a much greater visibility within the business and an ability to predict better, although never perfectly, the actual forecast and opportunity pipeline.

This has all been driven by the businesses' intent to increase the order book position and make it a more predictable event. So therefore in summary we have refreshed the sales force. A significant number of people have been changed and we have added sales structure in the United States, Asia, Brazil and Russia, key markets where we saw short falls in our force.

We have increased the focus on sales training in both products and access in accounts. And we have improved the interaction between programmes and sales. As I said earlier on within the model, programmes are a critical part of our business. It is important that programmes are involved from the very start of the sales process to make sure they can deliver complex activities effectively.

## **SLIDE – MAINTAINING ORDER BOOK STRENGTH**

I now want to go on to maintaining the order book strength and I am going to take you through this slide because there is a little bit of detail here that I am sure you want to be clear on. The first and important issue is that given our focus in the last ten months in building the order book we can see that our order book profile today is significantly ahead of the same time compared to last year.

That is a good thing, but it is not the major part of the story. The critical issue is the profile of that order book, which needs to be spread over a longer period to give me more confidence and better cost efficiency management within the business.

If you look at the previous profile over 47% of the order book was deliverable in the immediate year, and 53% in the alpha years. The profile today has moved to 38% within the current year and 62% in the outer year, but I stress this is coupled with a significant increase in the base order book. Therefore, we have built sustainability in the business out into the outer years.

This gives the capability for operations to manufacture efficiently, for the business to manage its after sales and installation force properly, and to remove, although as I said before, not replace entirely the volatility in the business. On top of that we have had many significant wins this year.

And you have seen a lot of them announced, but just in from memory over a EUR100 million with the new Doha International Airport in Qatar spread over a series of years, wins with Indian customs, Brazil customs, Azerbaijan customs, Malaysian airports and continuing success in the United States JCAD programme.

There are also a lot of other ones that I haven't been able to name on that sheet, but it has been a global improvement in the order book, a marked improvement across every sector. And it's fundamentally a result of a better sales force more driven and focused in the market place and being closer to our customers. We are at the start of this change, but it is an encouraging movement within the business.

## **SLIDE – INVESTING FOR THE FUTURE TO ENHANCE CAPABILITY**

I want to now move on to what complements the building of the order book, which is the investing for the future, enhancing our capability. I mentioned at the start that we are a technology and product business.

And even during the difficulties we've faced as a business we have maintained approximately 7% of sales in our R&D investment. But that is only part of the story. Because of the rigorous approach to the road map development and the strategy outlined by Duncan we have changed the investment profile to align more closely to the markets and the customers.

Hence, our core markets in checked baggage systems, conventional x-ray, container systems and chemical detection have received significant enhancements in investment. And this you will see in the product profile I am about to show you.

We will continue to take customer funding and use that to enhance our programmes. but we will focus on what is of value to this business and the customer and not just chase customer funding for the sake of it. Financial year 2012 sees a major product launch programme, as Philip mentioned the largest programme we have had in the business.

And this has been building over the last 18 months. I am pleased to say that when I took over the organisation for product and technology two years ago our focus was to do two things: build the opportunity product pipeline and reduce the time from development to market. And I will speak about that in a moment.

We have identified a very clear product and technology roadmap linked to our strategy, and I realise some of you might find that surprising that we did not have that in the past, but it was a critical change to the business. It takes normally between two to three years to develop a new product on a platform base or a new technology, five to eight years.

That requires a sound strategy to manage the investment. And we have continued to invest aligned to the strategy that Duncan has briefed you on. So the key issue there we continue to invest and we refocus the investment on the appropriate technologies to the market.

I also should note that our vitality index is a core measure by which we look at the results of our product development. And I am pleased that it will stay around the 23%. I aim to grow that to around 25% to 28%, but that clearly takes a little bit of time to build that momentum, but it shows that we are getting results from our investment in the products going forward.

## **SLIDE – RECORD PRODUCT LAUNCH PROGRAMME**

Let me look at the product launch programme to emphasise the results of the last 18 months of work. These are colour coded to make it simple for all of us, but particularly for me. If you look on the left-hand side of the screen you can see the markets colour coded and the right-hand side the products with the colour coding indicating where the products are most appropriate. This has been another significant change in the business to ensure that products can meet more than one market. We can't have a single platform having a one shot. It's too expensive and too much effort to get to that.

So I'm not going to go through all of these products, although quite a few of them you will see later on during the demonstration, but I wanted to highlight three in particular that I'm going to talk about, which is the second one on your list, the 145180 dual-view container, sorry, air cargo system x-ray.

I am going to look at the HCVM e, the light-weight compact x-ray cargo scanner for large containers, and GUARDION, our chemical threat identifier. But as you can see we have launched the largest programme in our history and we are having a tremendous response from the customer base on these launches.

## **SLIDE – THREE HIGH IMPACT LAUNCHES**

Let me look at those three that I highlighted. You will see the HCVM e outside. This product was specifically driven by customer requirements. The customer needed to see a product that was lighter so that they didn't have to have special licenses and health and safety requirements, obviously cheaper and one with a smaller footprint. The technology and product group developed and launched this product in a 14-month cycle. It's a tremendous improvement from our standard three-year cycle in previous lives.

Most importantly this product is targeted for both the United States and the European and rest of world market with specific chassis and other developments that match the market requirements. For example, in the United States we had to have the product under 12 tons to allow a standard civilian licence to drive it. That has a tremendous impact on the training needed for a customer and is a key focus. In addition, the customer wanted to keep a 4MeV structure to ensure he can actually see the threats. An excellent product and please feel free afterwards to have a good look at it outside.

The second product, the 145180 dual-view was specifically targeted to enhance air cargo detection. Air cargo has now come under a lot of regulation and requires an enhanced offering. We took our single view platform and with very, very clever engineering in our Wiesbaden site we were able to introduce an under-the-belt second generator which provides an outstanding detection response for the customer. And it meets the TSA regulatory requirements.

The third product is GUARDION. This is the longer term and most technically challenging product that we've launched for some time. It has taken us nearly six years to bring it from idea to market and

actually shows you that when you are going to a risky technology area there is a longer cycle, but this is going to transform this market space.

It's a lightweight, fast, gas chromatography mass spectrometer which can identify chemical threats. It's already very effective in the deployment with the expeditionary forces to military and emergency responders and has received an excellent response. I believe that this technology will progressively move over the next ten years into other markets as it continues to become more militarised and faster in its deployment.

## **SLIDE – RECORD PRODUCT LAUNCH PROGRAMME**

I then wanted to talk quickly about the planned product launches. Overall as you can see there are 17 launches that we have been working on, and we already have launched eight, and have another nine to go.

All of these again are focused on the different parts of the market and are specifically designed to solve key customer problems and address a growth profile for the Company. Again I'm not going to go through all of them for you, but I would like to come down to the bottom one and highlight this as it's been a major investment for us.

The XCT explosive detection system is a large new and innovative product specifically designed to match the high-speed, large tunnel, automatic baggage screening market. Let's have a look at that market and let me explain why we have made this large investment.

## **SLIDE – MAJOR DEVELOPMENT: HI-SCAN 10080 XCT – MARKET OPPORTUNITIES**

Many of you would know that we have always been a world leader in line scan x-ray systems. Similar to our conventional x-ray and our advanced systems we have a very successful inline baggage group deployed in Europe and the rest of the world. However, one market specifically would only use computed tomography.

The United States market did not use x-ray line scanning technology. Therefore we were blocked from that market space.

We saw two years ago a convergence between the United States, the European and the rest of the world regulators that while they will never be identical, as no governments will ever be, but there is a convergence in the approach to baggage regulation. So if we look at the market opportunity today we have a zero position in the United States. And there are over today 2,100 inline or front of house baggage systems deployed in the United States.

As they go through the replacement cycle close to ten years from 9/11 those models will be progressively replaced or new baggage systems utilised to improve efficiencies at those airports, which will move the market towards the high-speed approach. In Europe and the rest of the world that market is already at high speed. It already operates at 0.5 metres per second. It already operates at tunnel size of one meter by 0.8 meter.

There was no way we were going to design a new product to be smaller or slower than the already established market position, hence we went through a major design review to be able to achieve both for the United States with computed tomography and Europe and the rest of the world on high-speed large tunnel size. This means that over the progressive replacement cycle and new airport cycle we can address the European Union requirements and in the rest of the world continue to use a mixture of US and European Union we can offer all of that.

The key issue is that XCT will give you a machine for the next ten years that meets all the requirements in the European Union, the rest of the world and the United States. So the answer to the market position, this development gives us the access to a new market. It maintains our strong incumbency in the European and in the rest of the world markets.

Now what I would like to do now is show you a video of the insides of the machine and how it operates to give you a concept. I will attempt to describe that as best I can with my limited technical experience. And then I will bring up Hermann Ries, our chief technology officer, imaging systems, who will actually do the product justice with a proper technical description for you.

(VIDEO PLAYING)

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**Mal Maginnis - *Smiths Group plc* - *President***

You can see that the machine is a standard looking Heimann-style machine from our high scan product line. Most interestingly it doesn't look like a bulbous CT with a big bulging circular rotating gantry. It is there you see the gantry neatly inside the machine. It is a single core unit that is delivered and installed into the machine. The tunnel size is one meter by 0.8 meters.

It rotates at 200 revolutions per minute with a belt speed of 0.5 meter per second, and as a result meets all the requirements. And at the front you can see our line scanning x-ray that provides the standard material discrimination images that the market expects.

There's a very exciting development and as Hermann is going to explain to you we have done that from concept to regulation testing in under two and a half years, so overall XCT is an exciting product for the future. It reinforces our position in the line scanning market, builds on our current incumbency and meets all the requirements of the new and emerging regulators.

And I can think you can see from watching this it is a highly complex machine with a very careful design to be able to service it in the field. And I think looking at design you can see the way we built it a modular pattern, and we have concentrated on both Analogic's and our core technology strengths in the past.

I would now like to ask Hermann Ries to come up and give you a somewhat more effective technical description of the product. Hermann?

**SLIDE – APPLYING ADVANCED TECHNOLOGIES**

Thank you, Mal. As Mal has indicated this new XCT has a few innovative capabilities which at the same time presented the major challenges for the development.

**SLIDE – MAJOR DEVELOPMENT STEPS**

These were first to include an XCT part and the line scanner part into one system, second, to keep the high speed, the high through-put as we did in the past with non CT machines and which of course includes some challenges for the high speed, for the high revolution speed for CT, and third to provide the large tunnel size which matches to the baggage handling systems in Europe and other parts of the world. End of 2009 we signed a development contract for the CT part with Analogic.

Analogic is a very experienced CT supplier and also an OEM supplier for parts. And is located in Boston in Massachusetts. After one year of development we already could integrate the CT part and the line scanner part into the mainframe.

And in the same month we got the first image from the system. In March 2011 we had four prototypes built and the decision was taken immediately to start with a lower rate initial production series. And so far six of those have been built and two are pending.

In August 2011, the operation of the device looked stable enough and we brought it to the American Transportation Security Agency in New Jersey to the labs for image recording, which is the first part of the certification process already. Two months later we installed the first units into the more difficult airport environments in Munich and at Baltimore airports.

Again the purpose is image recording, in this case real passenger luggage as it is today. Since April all available units are on the test. Particularly one unit is integrated into a test loop which prominently feeds it infinitely more or less with the bags. And this is done to stress the machine over 24 hours a day, seven days a week to make sure that there are no problems with operation.

All in all, up to 63 engineers and scientists have worked on this development in parallel on both sides, on Smiths and on Analogic side. And to summarise it has been a fast and efficient development due to an excellent cooperation with our partner, and also due to the investment done for this project's product development.

**SLIDE – HI-SCAN 10080 XCT UNIT STATUS**

Before application in the airports, explosive detection systems must undergo a certification for an approval. In Europe the appropriate Standard 3 approval is obligatory at the moment for installations from 2014 on. We have done pre-tests in a French lab and these pre-tests were pretty promising.

At this time this week we are installing a unit again in this lab in France to undergo the approval testing for Standard 3. Once we have passed the Standard 3 approval, we will launch this product.

In the United States the EDS systems need a certification. A certification is issued by TSA and it is a longer procedure. It comprises more steps and it is scheduled by the authority. The first steps have been done and the most relevant part, the detection test is expected to happen in this calendar year.

In parallel, we have completed the lower rate initial production, nearly completely, in two production sites, one in Edgewood in Maryland, USA, and also in Wiesbaden in Germany. Smiths Detection is also talking to baggage handling system suppliers. That's an important partner and we want to integrate the XCT already know into their test loops. This gives us two advantages; first we can do the necessary adaptations to the various suppliers already now. And second, we can make the suppliers feel comfortable about our product which has, in the past, shown is another advantage in promoting these systems.

### **SLIDE – HI-SCAN 10080 XCT HIGH SPEED EDS**

The large tunnel size is an advantage as it conforms with the requirements for baggage handling systems outside US. And even more it will reduce the number of bags being considered as out of gauge and thus reduces the number of extra treatments and ultimately provides an additional operational advantage to our customers.

The belt speed for the throughput is important again to match the baggage handling system, but especially also to enhance the throughput of the system. So far these capabilities have been achieved only by noncertified machines.

The high resolution material classifying line scanner images besides the 3D CT images is the operators' reviews at higher level in check workstations. These new capabilities provide significant advantages to our customers.

The high throughput allows the customers to integrate fewer units. Two XCTs at the moment can check as many bags as three of the previous CTs have done in the past. But more important it also reduces the more significant costs due to having fewer feeding systems for the EDS systems, and also it reduces space consumption, which is also an issue at airports.

Accordingly, less maintenance and lower electricity consumption leads to lower operational costs. Finally, this results in lower costs per checked the bag, which is exactly what our customers are looking for these days.

The combination of line scanner and CT parts finally will allow us not only to detect threat materials which are requested today, but also those which have already been identified as threats in the near future. So we are bringing technology to life not only for today, but also for tomorrow.

And next is service and aftermarket, and I would like to introduce Terry Gibson, the Vice President of Service.

**SLIDE – SERVICE AND AFTERMARKET DEVELOPMENT**

Thank you, Hermann. As we began the process of looking at our aftermarket business we tried to move our business from a repair response to a value-add offering for our customers.

I'm going to take you through the process of some of the things we have done in aftermarket to grow our business, improve our profitability and focus on improvements to our customer as were talked about earlier. One of the most important things when we look at our aftermarket business is the fact that Mal discussed there are approximately 300,000 pieces of equipment in the field.

That equipment is in more than 160 countries around the world protecting our men and women in uniform, our emergency responders and our Homeland Security providers. Our responsibility in aftermarket is to ensure that equipment maintains its operational performance and capabilities.

**SLIDE – FOCUS ON SERVICE**

Let's look at our aftermarket business in more detail. As we said, we have a considerably large installed base of equipment, approximately 300,000 pieces of equipment. By focusing on a value-add approach to our customers, of contracts, we've been able to increase our aftermarket sales in the first half of this year.

Consistently, we've been able to increase our percentage of aftermarket revenue as a total trend upward. Our main focus has been looking at the regulatory markets where we can support our customers' needs to ensure equipment is properly maintained and exceeds the operational requirements.

If we look at our aftermarket business, our revenue streams are in consumables; maintenance contracts is an area of growth for us because it allows us to plan the service and support for our customers; spare parts sales and replacing and repairing where necessary; and specialised training for our customers to ensure that the equipment operates as required and they have the documentation necessary.

We will continue to provide repair response or time and material repairs for our customers, but as we expand our business into special service programmes that provide logistics support and other operational needs that our customers are asking them to provide them. We'll look at more detail at those revenue streams shortly.

**SLIDE – AFTERMARKET GOALS**

We're taking a holistic approach to our customers' needs. One of the key strategies that Mal outlined earlier was a closer relationship with our customer. From a service perspective, having that long-term relationship with our customer allows us to maintain that.

Our focus is to grow our aftermarket share of the overall revenue base as we continue to grow the business. But in addition to that, we will do that by focusing on taking our customers to value-added contracts from a repair response approach to our business. Those value-added contracts will help us in the fact that we'll be able to plan preventative maintenance; it will allow us to reduce our costs because we'll be able to plan trips to our customers, plan service outages, and utilisation of our resources in a more effective manner.

That will also improve the customer's product life cycle. It will give us an avenue of information to our customers' needs for the future. It allows us to become a strong partner for our customers in the chemical, biological, radiological, nuclear and explosive applications. We will align our service packages to meet the customers' needs.

It will allow us to take our information systems, giving better performance data on the operations, the uptime, and the support of these products to our customers. Premium level service agreements enhance customer loyalty, improves our business margins.

### **SLIDE – DEVELOPING THE AFTERMARKET – CHANGING THE REVENUE MIX**

Let's look at each of those revenue streams and what we've already started to see in our business. The growth areas in service programmes and the areas of contracts, or maintenance contracts, are two key areas of a change in our strategy. That allows us, again, to plan service and support for our customers, focus on these value-added contracts of supplying what our customers are looking for. We're starting to see a step change in our service revenue and our profitability based on planning and process of supporting our customers.

### **SLIDE – AFTERMARKET – CUSTOMER REQUIREMENTS ARE CHANGING**

If we look at our market, Duncan talked earlier about the life cycle. That long life cycle of support of our customers allows us to look at where our customers are spending their money and align our service programmes to meet those needs.

Each of the market areas has unique requirements. Our job is to address them with special contracts, special service programmes, so that we can ensure that we maintain the customer connection through the entire life cycle, that we give the operational and maintenance funding and use it effectively. Even in times when they may not be buying additional equipment, they're buying support costs. And it allows us to develop a path of shifting funding from a repair response to a long-term maintenance contract.

### **SLIDE – BENEFITS OF THE NEW VALUE-ADDING APPROACH**

The benefits of a new value-added approach to our customers should be obvious. It helps them to develop a preventative, if not even pre-emptive strategy for their systems and their investment in capital equipment. By doing this in an effective manner with the customer, we're able to replace parts before they break. We also are able to ensure that consumables are available for our customers when they need to replace them, getting better utilisation of those consumables.

It provides them effective and efficient information on the equipment's performance and reliability, increasing its availability for the customer. It also allows them to use better resource planning for the equipment that they have at checkpoints or ID locations so that we can swap the equipment as needed so that they have continuing operations. And it provides our customer the ability to meet their regulatory requirements for inspections of equipment in accordance with government rules.

It's also good for Smiths. It generates annual service revenue contracts for our business. It provides us a reliable, consistent revenue stream. In many cases, those contracts can be multiple years signed up-front, helping us with our order book. And also, those customers pay for those contracts up-front, generating cash, allowing us to better support our customers.

The planning of our resources allows us to ensure that we get the optimal utilisation of our manpower for installations as well as service contracts. It reduces our service costs because we plan the interventions at a time when it's good for our customers and the availability of our resources. It also creates a very strong partnership and planning process with our customers for the future of their business. We're using a global set of standards for our service, but service will always be delivered locally in those 160 countries around the world.

#### **SLIDE – SERVICE & AFTERMARKET SUMMARY**

In summary, aftermarket approach allows us to respond to our customer requirements in a very holistic approach by achieving our goals through a closer partnership approach with our customer. It allows us to move from a break/fix, or, as I said earlier, repair response, to a contracted support for our customers. It reduces our risk with up-front, long-term contract relationships with our customers and of receiving our cash up-front. As you can see, we've established some goals for over the next three to four years of increasing maintenance contracts with our installed base and increasing our total revenue of aftermarket.

Mal, I'm going to hand it back to you now.

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**Mal Maginnis - *Smiths Group plc - President***

#### **SLIDE – ENHANCING MARGINS**

Thank you, Hermann and Terry. I hope they've been able to give you a good flavour of the focus within the business on technology and product, followed by a core part of the change in the business model of looking at the aftermarket and, as Terry said, moving from a repair and break/fix-type concept into a contract of support as a partner with the customers.

Well, I spoke at the start that we're going to go through our improvements in sales growth and profitability, but we now need to get to the hard bit, which is reducing our costs and improving and enhancing our margins. So let me take you through the key activities already done and those that are planned over the next three years.

## **SLIDE – PERFORMANCE IMPROVEMENT INITIATIVES**

We announced in September to you that we were going to start a major cost reduction exercise within the business. And the plan, as already announced, is to achieve GBP40 million of annualised savings by 2014. This plan is already well in place and is working hard towards achieving those targets, with the first one being GBP15 million in this financial year.

That GBP15 million has been made up of some GBP7 million of investment within the business to gain in the initial year GBP8 million of return. And the focus has been on reducing the fixed costs, commencing a value engineering and value process effort within the business, significant site and headcount reduction, and I'll explain that to you shortly, and rationalisation out of our non-core areas. I briefed you on our mission. I described the core technologies. We are focused clearly on those core areas and won't invest outside those.

And manufacturing and supply chain rationalisation. We're a business that grew up as a series of acquisitions. We have to move forward to being a single business focused and driven by a single global approach, and all of that is led by data, not opinion or anecdote, and that's the business is moving towards achieving these savings.

At the moment, I am pleased to tell you that these major activities are on track and we are going to deliver the results in this financial year as already announced -- that is, the cost reduction targets that are already announced.

## **SLIDE – COST REDUCTION**

Let's have a look at what we've done in financial year '12 to actually meet those requirements. Fundamentally, we have to reduce our fixed costs. And this was due to a major day-to-day cost management exercise in reducing costs in all sorts of areas within the business, our various non-core activities, travel, consultants, assistants, expenditure in other areas, and property costs that have been all over the business in the last several years.

This strong approach since last May and June has already given us significant benefits. It has not been an easy process to manage and we've had to do it at the same time as refocusing the business onto its customers and the delivery of the results promised to Group.

I'd like to talk specifically about one of the activities before I move on to look at the footprint of the business, which is value engineering. As I've mentioned, this is a large programme business and also a significant product business. There are a lot of opportunities for us to improve the way we manufacture the products and particularly when thinking about how they're deployed in programmes and, for Terry's group, in aftermarket effort. We can make significant savings within the business by better value engineering of the products right at the front and throughout their lengthy life cycle.

We've been challenging established practices. The common comment of, "We've always done it this way, so it should be this way," have been ruthlessly challenged within the business, looking for proof and evidence that that statement is actually true. Not surprisingly, it often is not.

And we have at the moment over 200 projects in play looking at value engineering improvements. But as well, we also have a series of major enhancements in the process and aftermarket management of our products to provide further value. The targeted savings for this year alone in the value engineering is GBP3 million, and I want to give you a simple example of one of the products that we've already implemented changes.

Our MMTD is a threat detection machine manufactured in Toronto and deployed in the critical infrastructure transport and port environments. It has also recently started to be deployed into the military environment. We had a very complex and lengthy process in manufacturing and one that required some very serious overhaul.

As a result of the all of the work within the group from both engineering, from process, calibration and design, we've been able to reduce the cost of the unit by GBP700.00, which is a significant effort within a product that's already been launched. It's those types of efforts in value engineering that will product long-term effort and improvement in our margins.

## **SLIDE – RESTRUCTURED US BUSINESS – LOCATIONS ALIGNED TO CUSTOMERS**

One of the biggest issues in the business has been reducing our footprint. Our United States business was one of our major issues of concern. The business had grown up by acquisition and very little effort had been made to bring that into a single operating model. Over this year already, we have done the following activities.

We have closed our Boston R&D office. We have closed our Newport, Rhode Island office that managed our video systems. We've divested our optical components business in Connecticut and New York, Spectral Systems. We have closed, at the end of this month, our major sales and service office in Morristown, New Jersey, which was a very significant activity that has been done in under 10 months. And, of course, previously we divested the food inspection business that was located in our Alcoa, Tennessee business.

All of that is five major sites within the business in the United States that we have closed, divested, or removed from the business in the period of one year.

In the continuing operations, we have focused the business in Edgewood, Maryland as our core United States manufacturing, technology, service and programme centre. We will continue to do container system work and support our customers at Alcoa, Tennessee due to the skill set that is in that facility and we'll continue to do the spectroscopy work in Danbury, Connecticut.

So, as you can see, that's a major change in footprint in our United States business in 12 months. The annualised savings from the Morristown closure alone will be GBP12 million. And we've taken out already more than 50 heads and across the complete business over 190 heads, reflecting a 9% reduction in the total workforce. These have been major activities within the current year while also delivering the enhancements to our order book and our sales process.

## **SLIDE – STRUCTURE & PROCESS ENHANCEMENT**

Let me take you now to the complementary part of this, which is the process and supply chain rationalisation. This is, of course, a much more complex task and one that has to be managed with some care to ensure that we do not affect deliveries of our orders and the customer processes; however, we have already restructured the procurement group into a single globalised group.

In the past, all procurement was done within each of the sites and factories in each of the local markets. That clearly was not efficient and didn't give us efficiencies of scale. We've also strengthened a new team in Asia-Pacific to allow us to more effectively source components from that rapidly growing market. Overall, we've also linked the procurement and supply chain group into the product and technology development areas to ensure that we take the advantages of the best suppliers and materials we can get. And overall, introduce competitive bidding within our procurement and supply chain.

Coupled with the manufacturing and supply chain changes, we've brought in place a series of data-led efficiencies fully utilising our SAP ERP implementation, which we did four years ago. We now can see business transparently across the entire business. That may surprise you, but in the past we fundamentally managed each site on its own and were not entirely clear on what the impacts between each site was across a contract over many countries.

We've centralised the order to cash system within the business, again to provide a better service to our customers and a better control over how we manage orders right through to the cash process and we've enhanced the business intelligence aids that are available out of the ERP system. I think you can hear from that there would have been -- and there is -- a lot of change within the business over the past year and particularly changed a lot of cultures and habits.

## **SLIDE – GLOBAL MANUFACTURING FOR CORE X-RAY TECHNOLOGY**

I'd like to now address specifically a major approach to changing the way we manufacture X-rays. I mentioned at the start that we are a truly global Company. Our markets and sales are across the world. The piece that was missing was that we manufactured in a single place in Wiesbaden in Germany. X-rays are neither small nor light; they require a lot of distribution and logistics effort to get the seven tonne-type machines from Germany into Asia. That makes us less agile, we're slow to the customer requirements, and we were certainly not able to respond as effectively as we should.

As a result of that, we've initiated a major programme and already implemented part of it. We are now manufacturing x-rays in Edgewood facility. Hermann specifically mentioned to you that the new XCT product is going to be built for the American market in the Edgewood, Maryland facility. It makes no sense to ship components to Germany and back to the United States, particularly at the size and weight of which they are.

I'm pleased to say that the Edgewood facility is already moving to serial production and will be in full production of the North American Free Trade area supplied by the end of July. Coupled with that, we've commenced a programme to establish a facility in Johor Bahru, Malaysia linked closely to our already very successful business in Singapore.

That particular business should be fully established -- sorry, should be established by July and we will then commence ramping up production over the next six months. I anticipate by the end of the first half of the next financial year that Johor Bahru will be in serial production.

All of this has major advantages in the marketplace. It places us closer to the market and our emerging markets. If you look at the growth pattern in Asia, having our factory in Johor Bahru, directly next to the region, will give us much greater speed to market and greater flexibility in being able to meet the programme requirements. This is also a strategy in removing some of the volatility that has been caused by distribution and logistics from a single centre.

So overall at the moment, the impacts are significant. We will be adding about 170 staff and 100,000 square foot facility in Johor Bahru. We've already added 20 staff and another 100,000 square foot facility in Edgewood, concentrating a United States manufacturing in that facility.

And we will be taking staff and scale out of our Wiesbaden factory over the next period; however, Wiesbaden will remain the centre of excellence for engineering and technology as already proven in its great products that it delivers and, of course, it will be delivering to the EU customers' area and other specific customers who are linked to the EU. This has been a major development within the business and one that will transform its approach over the next year.

#### **SLIDE – ALIGNING X-RAY MANUFACTURING OPERATIONS WITH CUSTOMERS & MARKETS**

I just want to emphasise some of those points within this slide. As I said, 100,000 square foot improvements in the manufacturing facility in Maryland and in Malaysia. And the graphs on the bottom show the fundamental reason why. The markets in Asia over the next series of three to four years will most likely grow by between 30% and 50%. It's absolutely critical that we are closer to that market base with the x-ray product line.

#### **SLIDE – MEETING OUR GROWTH OBJECTIVES**

So, ladies and gentlemen, I want to bring you to the end of the formal part of the presentation. I started at the beginning talking about how we would plan and intend to give you an increase and a return to profitable growth. Let me go through the key pieces that we've done to date.

We have strengthened the management team. Over 60% of that has been changed and revitalised over this year. We've completely rebuilt the sales force, and both that and the efforts within the business and the product lines has led to a 50% growth in the order book profile. We delivered the cost reduction programmes. There's a lot more work to be done over the next three years, but we are delivering the programmes as predicted and on time.

We are planning to reduce the volatility in the business by focusing on a new business model. That's already in place and the improvements in the order book will assist that; however, I need to stress to you that this will not be solved in a single year. It will take us hard work over the next three years to get the full benefit from the run rate, the aftermarket, and the changes in the programme structures.

We also have made enormous effort in leveraging the data that's available within the business. We now can actually see the business, understand it, and plan where it goes. Of course, some of that data we see today is challenging our assumptions and that will continue over the next few years.

And the final point is aligning our products and technology to the customers. I do believe we had lost some of that alignment in the previous years. We are very focused on that at the moment and you'll see some of the examples of that in the rest of today.

Ladies and gentlemen, that concludes the formal part of the presentation today. Although it's been a fairly lengthy morning with a lot of data and information, I'd like to invite you to take a break, go and have some coffee. Could I ask you to be back in by about 25 minutes past 10, if possible? We are a detection and security Company, so we should attempt to be on time, of course. If you could get back in by that time and then we'll take the question-and-answer session, which Philip has kindly offered to chair for me. Thank you very much.

## QUESTION AND ANSWER

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**Philip Bowman - *Smiths Group plc* - CEO**

### SLIDE – QUESTIONS AND ANSWERS

Well, ladies and gentlemen, as Mal said before we broke for coffee, the next item on the agenda is a question-and-answer session. And what I'd like to do is invite any of you who do have questions for Mal and his team or, indeed, myself or Peter Turner, who is in the front row over there, please to ask the questions. There are a couple of roving microphones; if you could wait, please, until you do have a microphone in front of you so everyone can hear the question. And also, identify yourself by name and the organisation you represent.

So, who wants to start off with the first question? There we are, on the right-hand side, second row.

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**Andrew Carter - *Royal Bank of Canada* - Analyst**

Good morning. It's Andrew Carter from Royal Bank of Canada. A couple of questions, please. I guess just in terms of some of the different regulations and things at the interim results, I think there was some suggestion that it wasn't entirely clear what was going on in terms of I think hand luggage regulations in Europe and also hold baggage and freight. I wonder if you could just provide a little bit of an update on the sort of details and the timing of when that legislation comes into force and how that will impact the business.

And then I guess just in terms of the strong order book and the 50% growth that you talked about there, could you just help us to understand in particular which sort of segments that's been driven by? And also, in terms of your experience of the business over recent years, how do you think about the

convertibility of that increased order book? Is it sort of plus or minus 50%, or is it a lower number in terms of conversion into sales in financial year 2013?

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**Philip Bowman - *Smiths Group plc* - CEO**

Okay, thank you for those three questions. Firstly, Mal, do you want to talk a little bit about legislation, both hand baggage and also a number of other changes that are going in the EU?

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**Mal Maginnis - *Smiths Group plc* - President**

If you look at the EU regulation changes, there are three key areas. You have the inline baggage system changes, which is moving from EU Standard 2 to EU Standard 3, which we specifically mentioned XCT is designed for. That regulation will come in the period around mid '14. I'm careful with those dates because they have tended to move as the regulators have seen the readiness of the airport industry and ourselves, as the suppliers, to meet all of the requirements. But I am comfortable around mid '14 for the EU Standard 3 change.

But remember, we will still be selling our EU Standard 2 machines in '14, '15', and '16 to certain airports and they will remain in service until '18. So, for example, Terry's aftermarket group will both be looking after the previous generation for at least another six years to seven years, and we will be transitioning from the Standard 2 machines to Standard 3, which is one of the reasons why I'm confident about that approach of inline baggage.

With check-in hand baggage, a slightly less clear model is in place. By April next year, the EU intends to lift the liquid explosive restrictions at the moment. I can't tell you where that sits at the moment. We work closely with the regulators, and that remains their intention.

But I would just remind you that the liquid explosives is only one aspect of the hand baggage regulation development because, of course, they also are looking for threats, guns, knives, etc. and classical explosive threats. So those regulations are still in development and we've specifically targeted the aTiX machine, you'll see at the back, as a platform that can meet both small inline baggage requirements, it can meet liquid explosives, which it's already certified for, and also future growth paths for check-in hand baggage.

And the third one was on the passenger screening side. The regulations have not yet been finalised within Europe, but they will move down a path of people screening in a form or another.

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**Philip Bowman - *Smiths Group plc* - CEO**

Mal, do you want to say anything about harmonisation of regulation between the EU and the US, which has been sort of Holy Grail for a number of years, but very elusive?

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**Mal Maginnis - *Smiths Group plc* - *President***

Yes. I don't think we're ever going to see an identical regulatory standard between security agencies across the world. We can't achieve that in just about any industry in the world, so I don't see why security would be different. But what we do see is a convergence.

So, the US TSA is closely working with the EU on the liquid lifting. The US check-in hand baggage machine development is more advanced than the Europe. That's where we sold a lot of aTiX. And that -- they are working with Europe on the cross-convergence of those machines into Europe, and across the rest of the world they look closely to both regulators. It's not a simple picture of regulation occurs... which then translates into sales, but the change in regulation and the change in products leads to a steady growth within the market.

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**Philip Bowman - *Smiths Group plc* - *CEO***

Mal, the other question was about the order book and I think an attempt to get a little bit more information as to where the wins have been, and in which sectors, and also a little bit more in terms of when those will convert actually into billable revenue.

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**Mal Maginnis - *Smiths Group plc* - *President***

Okay. As the slide showed you in the presentation, the convertible in the first year is 38%. But, of course, given the significant increase in the order book, that's actually a larger number. In general terms, if you run the business in a seven-month cycle, you can work out yourself a seven-month, I'm looking for an order book of somewhere between 50% and 60% to allow me to deliver the results. I'm within those brackets at the moment, and that's the target I've set for the business going forward.

So it is deliverable within the next financial year. And also, as the slide shows, deliverable also in the outer years, and that's the intention.

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**Philip Bowman - *Smiths Group plc* - *CEO***

Okay. Move on to the next question, please. Yes, on my left, on the extreme left in the second row.

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**Rami Myerson - *UBS* - *Analyst***

Hi, good morning. Rami Myerson from UBS. Just trying to understand the underlying revenue and revenue growth of the business. In the strategy presentation, you discussed the different growth attributes of the different markets, and trying to aggregate that gets to somewhere around mid single digit. Is that sustainable revenue, the long-term revenue trend growth of the business?

And a second question on the aftermarket growth. Trying to do the maths, it would appear that you are targeting doubling aftermarket revenues over the next three or four years. Is that achievable? Is that more a target?

And just the third one on the sequestration. You mentioned that you did not really think there would be a big risk from sequestration in the US. Why is that and what could the implications of sequestration be -- or have on the business?

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**Philip Bowman - *Smiths Group plc* - CEO**

I think if we take those questions in order, perhaps, Duncan, you'd like to talk a little bit about the first question in terms of the macro outlook in terms of growth?

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**Duncan Emery - *Smiths Group plc* - Director - Strategy**

Okay, yes. In terms of the revenue growth, although the market demand, we do estimate, is going to grow on average by about 6%. In terms of our own revenue growth, we believe that we can exceed that, partly because of your second point regarding aftermarket increases. We expect to further increase our penetration there, but at the same time we expect to extend our reach into other markets and, indeed, improve our market share.

So we do believe that we can continue to grow quicker than the market itself.

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**Philip Bowman - *Smiths Group plc* - CEO**

I think one of the comments I would make is it's clear that we did lose market share over the last several years, and part of the plan that Mal and I have worked on, and indeed are working towards, is to rebuild that share. So not only do we have the opportunity of a growing market and various sectors that are growing, but also I believe we do have the opportunity to take back share in some areas where we have not competed as effectively as we had historically.

In terms of service revenue, Terry, do you want to make a brief comment?

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**Terry Gibson - *Smiths Group plc* - VP - Service**

From the sense of the current aftermarket, when you look at the maintenance contracts that we have, the growth in maintenance contracts will help us achieve that market sense. That's where our growth opportunity exists.

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**Philip Bowman - *Smiths Group plc* - CEO**

Okay. Thank you for that. And the final question was on the sequestration. Mal, if you'd like to pick that one up?

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**Mal Maginnis - Smiths Group plc - President**

Always, the American market and the American budget process is one that we watch very carefully. We have a good team in Washington who runs carefully through the whole budget process. And this is actually one of the questions linked to all of the issues I talked about in the change to the business model. In America, we're actually dominated by the large programmes in the past. And by changing the size of the sales force and its skill set, we start to move away from that dominance in the large programmes and lets us move into the other markets which are not as affected if there is that type of budget problem within the US.

So it's one we watch very carefully, but I personally think, given our market sectors, it's not as serious for us as it would be for some of the bigger defence players.

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**Philip Bowman - Smiths Group plc - CEO**

I think having said that, I don't think anybody knows how sequestration is actually going to play out in the US. As one four-star general described to me, it's a bit like playing Russian Roulette with a bullet in each chamber, and I think that probably is not a bad way of describing it. I think it's a bit more like the doomsday device in Dr. Strangelove, but we'll see what happens.

It has the potential, I think, for the defence industry to be very serious. The question is what will actually happen politically, and I don't think we can second-guess that at this stage. I think the best we can do is position ourselves to be as agile as we possibly can.

Next question, on the right, please? Third row.

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**Glen Liddy - JPMorgan - Analyst**

Good morning. It's Glen Liddy from JPMorgan Cazenove. In terms of the aftermarket, are there big regional variations? Do people in Asia take up an aftermarket contract when it's offered or is something for the West? And if you're pushing the growth in that area, are you going to have to add significant resources to get that growth coming through or is it just better and more efficient use of what you've got?

Your big launch programmes this year, 17 launch programmes, is that giving you a significant sort of headwind in terms of the costs to launch all of these products in a short space of time and does it drop out quite quickly? And the final thing is in terms of progress towards your margin targets, which is the bigger driver, your cost cutting or the change in the mix? Thank you.

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**Philip Bowman - Smiths Group plc - CEO**

Three good questions there. I think the first one, in terms of service, we pass to Terry, please?

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**Terry Gibson - Smiths Group plc - VP - Service**

There are two parts of the question. You talk about first, regionalisation are different. When we look at our marketplace, we are, of course, in 160 countries around the world. But because we're in a regulated market and we're servicing government agencies, we find those requirements to be fairly consistent around the world. As we talk about the harmonisation of those requirements, it's also harmonisation of what they expect. Are the pricing models exactly the same through the world? No, they're not. That is going to be unique, and how we manage that will have to be delivered on a local basis.

The second part of your question, of adding resources. By moving our customers to a value-added, a maintenance contract approach, we actually will be able to utilise our resources more effectively versus the repair response of having to scramble someone immediately to do a service. So we have a good stable of resources and capabilities in order to support these global programmes.

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**Philip Bowman - Smiths Group plc - CEO**

I think in terms of your question about margin structure, I think it's quite useful to look at the experience certainly within Smiths Medical, where clearly value engineering has played a major part in expanding margins within that business, and I am convinced that there are significant opportunities within Detection to do something very similar indeed.

I think the other part of that question in terms of product mix is important and I would simply highlight what Mal said in the presentation -- having better data enables you to make a lot better decisions. And one of the things that hit us in the first half and we announced in March with the interims was that we had signed up for a number of cargo inspection contracts primarily in the Middle East some three or four years ago, and those proved to be pretty painful because they got delayed and we were not adequately protected in those contacts for cost inflation.

So, I think better data is clearly going to help us make better decisions. I think the final comment is don't forget this is still a business, even after what we're doing on the fixed cost space, that has significant operational gearing. If we get another GBP100 million worth of revenue through this business, that has a big effect in terms of operational gearing. So I think you've got all three of those there.

And when I went into the business last May, I was sceptical, I have to say, that we were going to get to the sort of margin targets in the range that we had set out three-and-a-half years ago. I came out of that process and working with Mal over the last few months, not that we're going to get there next year, but over the course of the next two to three years we should be able to get there if we run the business properly. So, I think there's a lot of opportunity in that area.

Mal, do you want to pick up the question about launch costs?

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**Mal Maginnis - *Smiths Group plc* - *President***

Yes. The launch costs, I think, they are generally manageable within the business. The biggest impact for the launches has been the impact on the sales force to take those on-board. And also, for Terry's group and Hermann's group, a lot of launches has an enormous impact on the technology group and the service group, one of the reasons we've been changing resources within the technology group due to those changes in divestment and closure and focusing a lot more resources on these launch programmes.

And in terms of the physical costs for the launch, we have a very targeted customer group and we use a fairly normal process on those launches and exhibitions. But the real cost for us will be carefully managing Terry and Hermann's group to support the launches effectively.

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**Philip Bowman - *Smiths Group plc* - *CEO***

Okay. Next question, please? On the left, second row back, please?

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**Nick Cunningham - *Agency Partners* - *Analyst***

Yes. Nick Cunningham from Agency Partners. Mal's slide of the incremental orders was very much focused in emerging markets, but your big installed base is in the US and the EU and one sees a lot of old pieces of both Smiths and Rapiscan equipment in use. So my question is even if you don't have imminent regulatory drivers forcing people to replace equipment, when does it wear out? And is there is a sort of delayed lump of business out there that's got to flow through at some point in the relatively near-term?

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**Philip Bowman - *Smiths Group plc* - *CEO***

The simple answer to that is a lot of the equipment, as you rightly say, is now very old. It would be equally true to say that the TSA is having an increasing difficulty in keeping a lot of this equipment serviceable. I think there are two issues if you look at the US as a specific example. The first is that the GAO got its claws into the TSA, it wrote a very critical report. A Congressional committee then savaged the TSA, so the TSA is in some degree of disarray at the moment.

And then you come back, of course, to the issue which affects pretty well developed governments, and that is funding pressure. And Mal was talking a little bit earlier in terms of new equipment in the EU and there's no doubt there was pretty vociferous lobbying from airport operators and others -- some government funded, some not government funded -- saying, "We don't want to spend the money. We haven't got the money to spend at this stage."

My view is very clear. Not only does a lot of the equipment in service simply not detect the threats that are prevalent today, but a lot of the equipment is simply going to be difficult to keep in operation. I don't know, Mal, if you want to add anything to that?

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**Mal Maginnis - *Smiths Group plc* - President**

Just a couple of points. The replacement cycle is pretty clear within the industry. If you have a look at the slide Terry showed you on the actual replacement cycle, that's a pretty accurate reflection. The interesting point at the moment is quite a lot of the customers, because of the budget pressures, are looking to sustain and enhance rather than replace, which is again one of the reasons its focus is to go down this aftermarket contracting approach.

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**Philip Bowman - *Smiths Group plc* - CEO**

Okay. Next question. Third row on the right, please?

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**Alex Toms - *Bank of America/Merrill Lynch* - Analyst**

Hi. Alex Toms from Bank of America Merrill Lynch. A couple of questions from me. First of all, just on the aftermarket dynamics, can you just flush out how kind of warranty periods work, who you think you'll be taking market share of going forward, and perhaps maybe a comment on kind of the margin differential between the OE side of the business and the aftermarket, maybe an obvious one?

And then the second question, obviously the TSA, I think, have been talking about maybe outsourcing some of their employees to private services companies. Could you see a change in structure of that business which impacts you in terms of who's buying the equipment or how they buy it? Thanks very much.

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**Philip Bowman - *Smiths Group plc* - CEO**

Okay. Thank you for the questions. The first one, in terms of the -- how warranties work, Terry, would you like to answer that one, please?

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**Terry Gibson - *Smiths Group Plc* - VP - Service**

We generally have two approaches to the warranty. And for TSA specifically, they have a stated contract period of warranty that they expect. We, for other customers, have an agreed to warranty that we state as a standard practice, so we try to be compliant with our customers. And some of our emerging markets customers are asking for longer warranties, and we tend to put that in our contracts where appropriate.

It's appropriate to add up the longest warranty period possible that makes business sense for the customer and us, that gets them into the O&M funding, operations and maintenance funding, for that

warranty. Generally, the product warranty is one year. Some governments require other years. There are also governmental regulations in certain countries that state two or three years with the purchase.

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**Philip Bowman - *Smiths Group plc* - CEO**

Okay. And, Mal, do you want to comment on the potential outsourcing of some of the inspection by the TSA?

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**Mal Maginnis - *Smiths Group plc* - President**

There was a couple of comments I just want to make very quickly on that. There is potentially across the world outsourcing opportunities within service to other organisations. Obviously, we want to be one of those potential outsourcers and should have a natural advantage as the OEM supplier.

One of the biggest changes we see at the moment occurring is where governments in other -- in particularly emerging markets are no longer prepared to support their large engineering incumbent bases. So, as has happened in the more advanced markets, progressively those markets tend to move towards an outsourced-type environment, but it is a gradual process that you see across the business.

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**Philip Bowman - *Smiths Group plc* - CEO**

Okay. Next question. Towards the back on the right-hand side, right over at the wall over there.

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**Sandy Morris - *Jefferies & Co.* - Analyst**

Thank you. Good morning, everyone. It's only Sandy from Jefferies. Just a couple of things that I don't quite get. Just on this combining x-ray and computed tomography, the US could just go down the route of sticking with CT. And if three CT machines are cheaper than two of your things, where are we going to be? So perhaps you might just sort of contemplate how you're going to go to market with that product?

The second bit is just critical infrastructure seems to have turned into what you're now calling a run-rate business, which is new since a year ago in New York. I can see that your critical infrastructure business grew nicely last year, FY11; I suspect it's doing okay again this year. But presumably, this isn't the big Middle East lumpy stuff; this is meant to be small, relatively high volume stuff and there's that stuff that grew last year.

And can I just say on the service side, if you forgive us for grubbing around, but the transcript from last year is actually quite tricky because we had 40% of our machines under a service contract, they were typically one-year rolling service contracts, and now we're down to 30%. So you can understand

why we've been waiting ever since the GE deal, if you remember that, for aftermarket to grow and why we're all probably getting a bit scratchy about it, if you'll forgive me for saying so.

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**Philip Bowman - *Smiths Group plc* - CEO**

Sandy, thank you for that. We'll forgive your scratchiness. I have to say I've been a bit scratchy about this before, not because it's been taking a long time, but because we couldn't get the data to actually substantiate the figures. And last May when I ended up running the business and asked for what percentage of our revenue came from service, I couldn't actually get a single answer.

So I'm afraid you're going to have to accept my apologies and say that we have better, more reliable data than we had. But I think what I would also say is for the first time we have got a very clearly-defined strategy and focus on growing the annuity-style service business. And I'm sure Mal will say a couple more things about that.

Your other question, in terms of the cost of the XCT versus conventional CT, I think Mal is also going to address.

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**Mal Maginnis - *Smiths Group plc* - President**

Yes. Thank you, Sandy. The XCT combination of a line scanner and the computed tomography approach is specifically about targeting and identification of the emerging threats. There is a series of new programmes at the TSA where we do not believe that a single technology will actually meet the requirements easily, and whether it meets it at all will be part of the testing regime. But we know from our background that the line scanning technology has specific advantages as does computed tomography, and we bring those into the one-detection approach.

In addition, we have a very large installed base of people who are very, very happy with the image resolution part of the line scanning image and we don't want to lose that contact with our customer base. We want to enhance it with the 3D image plus an improved line scan image, which is what we've done.

So it was a conscious strategy to improve our detection capability and ensure we can meet all of the markets and all of the emerging threats, and you have to do that up-front in the design. Hopefully that answers your question.

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**Philip Bowman - *Smiths Group plc* - CEO**

I think, Mal, the question probably that Sandy is focused on, does that give us an insuperable cost disadvantage?

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**Mal Maginnis - *Smiths Group plc* - President**

No, it doesn't. That was a core part of the design. One, it is our actual skill set. We used something we'd already built as a platform to put it into this machine and although enhanced it. And secondly, the fact is we concentrated that design with the tunnel size and the belt speed. All of those go towards the value proposition. It's not just 'did you pass the test'? You have to pass the test, get the bags through, detected correctly, ensure you detect the rejected bags by image management, and the speed of it, all of that leads to the cost.

And as Hermann said, we can achieve two machines replacing three and I believe we can do even better in some of the environments, depending on the airport design.

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**Philip Bowman - *Smiths Group plc* - CEO**

And, Mal, the other question from Sandy concerned critical infrastructure and the suspicion that perhaps we have changed the definition a little compared with where we were in the meeting in New York last June.

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**Mal Maginnis - *Smiths Group plc* - President**

Yes, I think that's a good question, Sandy. Critical infrastructure is normally a run-rate style business. You do not see a large number of regulated programmes within critical infrastructure. Now, the reason for the change is being one, identify the market, and we hadn't done that well in the past. Secondly, enhancing the sales force, selling into a less regulated or unregulated, smaller footprint-type market means we're going to need a lot more salesmen on the ground and they need to be better skilled in that area.

We would generally in the past take a big programme seller and tell you go to off and try to sell into a hotel or a nuclear power station. It doesn't work as well as you would expect. So it's a change in your approach within the business, and a focus on the critical infrastructure is an emerging part. And across the rest of the world, the critical infrastructure is a core market that we did not address in the past.

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**Philip Bowman - *Smiths Group plc* - CEO**

Sandy, any comeback?

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**Sandy Morris - *Jefferies & Co.* - Analyst**

Only in the sense that if you're going to stop me shoplifting, then this is going to be sort of quite small, tens of thousands type of business. And if you do get it rolling and that provides a base workload through certain facilities, I can understand how you're building out robustness into it.

But I'm just feeling -- I'm sort of slightly trying to grasp the stick and not quite getting there as to what this achieves for you. Because it's not going to load a lot of your factories, if you see what I mean, if

that's where it goes -- small, cheap and cheerful, kind of call it. And I'm just struggling a little bit -- sorry, being a bit dim as usual.

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**Philip Bowman - *Smiths Group plc* - CEO**

Mal, do you want to respond?

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**Mal Maginnis - *Smiths Group plc* - President**

Well, apart from the fact that we would be able to stop you shoplifting, Sandy, and if you did do that, but it's more than just that type of retail environment, but that has grown as the environment. It's -- for example, we're doing contracts with hotel chains to look at their global approach, but we don't consider that to be a style of programme. Because although you may negotiate as an account, it's entirely delivered and managed locally.

It's the same across a lot of the markets. They are small in the numbers, but a very wide market group that actually looks at the different technologies. In the past, they didn't even know we existed. But now, through distributors and better access with our sales force, they actually know that the market leader is in that market space. It's primarily, Sandy, an issue of focus. If you don't have anyone out there and you have no distributors selling, no one will know you're in the market.

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**Philip Bowman - *Smiths Group plc* - CEO**

Okay, I'm going to move on. On the left-hand side, about four rows back, please?

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**Colin Campbell - *Soc Gen* - Analyst**

Good morning. Colin Campbell at Soc Gen. Can you just talk a little bit more about product pricing? I think you said you'd lost a bit of share and you certainly said that Nucotech and Rapiscan had been quite aggressive. So, what's the pricing like?

And then secondly, if you're able to give us some more of the dynamics on margin between the aftermarket and OE equipment, because typically some of the sort of long-term service contracts may be pretty low margin?

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**Philip Bowman - *Smiths Group plc* - CEO**

I think in terms of the differentiation between OE sales and aftermarket, that's not data that we have put into the market and I don't think today is the appropriate time to do that. I'm not saying that we will never do that, but I think certainly it's not something we've elaborated on anymore than we've given any specifics, for example, in John Crane.

In terms of the price competition, Mal, do you want to pick that up?

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**Mal Maginnis - *Smiths Group plc* - *President***

Yes. Clearly, we're in a government tendering environment, so price is an important issue. But also, the critical issue is to get the specifications of the equipment right to actually meet the threats, and that's where we need to focus first.

At the moment, the most competitive environment is the container systems with some pretty aggressive pricing from several of the suppliers. Our focus is now as you've seen with the machine outside, is by using our technology base and our engineering advantage, get the product costed correctly into the market and design specifically what the customer is after in the market. And I think if we do that better, as I outlined, I think the pricing pressure we can control.

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**Philip Bowman - *Smiths Group plc* - *CEO***

Okay. Sorry, just wait for the microphone, please.

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**Colin Campbell – *Soc Gen* - *analyst***

Just on the introduction of new products and their pricing... typically at the launch of a new product, is that the best time for pricing and then it degrades over a number of years or – is there anything you can do with that?

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**Mal Maginnis - *Smiths Group plc* - *President***

No, we have a fairly unusual profile because you can have a product survive for seven to 10 years and the part of that product line, if well managed, and we manage the sales effort well, we actually can see rises in the product price over the time because of the demand. So, it's not a simple answer of as a product matures it gets cheaper and cheaper and cheaper and then we replace it. There are some products that are in that profile.

But we also have others that have maintained their product position all the way through their life, which is why Philip talks so strongly about value engineering. If we have good, long-term sales value and the price is consistent, then the best way for me to improve margin is to improve the engineering and the costs going into it.

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**Philip Bowman - *Smiths Group plc* - *CEO***

Okay. Next question? Yes, towards the very back on the right-hand side.

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**Graham Philips - M&G - Analyst**

Graham Philips from M&G. Just putting aside the military business and thinking about the civilian airports and borders activities, if we look across Europe we're hearing stories of airports being closed in Spain. And then you look at China; in their five-year plan they are calling for a large number of new airports, at least 10 a year over the next five years, and refurbishing and moving probably more than double that.

Is this a market that you just completely have to keep away from? I mean, is it a closed box, or is it something that you can deliver? Are you worried about the technology being stolen, the IP?

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**Philip Bowman - Smiths Group plc - CEO**

I think there are two issues implicit in your question. The first one is clearly concern over IP. The second one is actually whether China is an open market into which we can sell because not only do you have the Chinese government sponsoring Nuctech, you also have the Chinese government that argues that security is a matter of national security. So there are challenges.

Mal is well positioned to answer that as he used to run the office in Singapore. Mal?

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**Mal Maginnis - Smiths Group plc - President**

Yes, I think it's -- I would love to be a stronger position in China. But if I can't, then I'll focus on the other emerging markets -- Russia, India, Brazil -- and we also see the general movement of air transportation continuing to grow. So even though there are some restrictions in parts of Europe where they're having financial problems, some of our best growth this year has been in major airport developments in Europe, particularly in Austria, the Scandinavian countries, and Germany, and also in France.

So, the market is a very large one. The large number of airports that are in big countries have a replacement and a growth cycle, and we're well positioned to take advantage of that growth.

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**Philip Bowman - Smiths Group plc - CEO**

Okay. Yes, in the second row on the left, please?

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**Nick Cunningham - Agency Partners - Analyst**

Thanks. It's Nick Cunningham again. Looking at the CT products, I thought the original idea of aTiX was that you wouldn't need to have CT; you could get a CT-type performance without the large amounts of rapidly rotating machinery. So have you adopted CT simply because the US market won't accept anything else?

And secondly, is your CT machine actually superior in performance to aTiX or can you still hope to achieve a CT performance?

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**Philip Bowman - *Smiths Group plc* - CEO**

I think it goes back in part to a comment that Mal made in terms of almost physical limitations of different technologies to detect different types of threat. If I was a physicist, which I most certainly am not, I could explain I suspect rather more eloquently that there are certain threats that CT has extreme difficulty in detecting. And equally, there are other threats that conventional, multi-view x-rays struggle to detect.

So I think there is one element there, but, Mal, do you want to give a bit more flavour on that?

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**Mal Maginnis - *Smiths Group plc* - President**

I'll give you a little bit, and then I might ask Hermann to just give you a little bit of flavour on the combination of CT or the difference between CT and high speed multi-view. Remember there, that the aTiX machine is specifically for hand baggage design and so a CT is simply too expensive for that environment, in our opinion. And the performance that we can get out of the smaller tunnel with the multi-view handles most of the threats. But as Hermann will probably explain better than me -- much better than me -- the difference between CT and line scan, each has an advantage.

The second part, though, is the emerging threat to manage. We didn't see the value in CT, but we needed a couple of key changes. It had to be able to manage 0.5 meters per second because our customers wouldn't accept a slower belt speed. That means we had to increase the rotational speed. We had to remove a lot of the contactless -- contact issues in the bearings. So we needed to see optical data and power links as opposed to carbon links. So there were a couple of very clear, very tough design criteria that we put to get to the CT solution.

Hermann, would you mind making a few comments about the difference between CT and line scan?

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**Hermann Ries - *Smiths Group plc* - Chief Technology Officer**

Sure. There are -- explosives or threat materials are very difficult to identify. They have one common property, and if this happens it's too late. So you have to ask the question, "How can I get an explosive in earlier times?" And it turns out there are two major physical parameters you could look at. One is the density, which is a little bit of a specialised area, and the other is, let me call it, the atomic number.

The CTs are excellent in detecting densities. The line scanners, where there's dual energy capability, you see that when you see these coloured images, are very good in identifying the atomic number. And so far, the US market was served by CTs because all of those explosives which were tested and which are very quiet or threat materials in general could be detected easily by density.

Now, the emerging future threat requirements, which are already known to some extent by the experts, show that we definitely need the atomic number as well as density. That's why we have this combination and that's why we believe we are on the safe side for the future.

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**Mal Maginnis - *Smiths Group plc* - *President***

Thanks, Hermann.

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**Nick Cunningham - *Agency Partners* - *Analyst***

Could I just follow with a related question? How does the commercial relationship with your partner, Analogic, work? Is it a revenue -- a risk and revenue sharing deal or are you paying them as suppliers, effectively?

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**Philip Bowman - *Smiths Group plc* - *CEO***

I think the simple answer to that is we paid them a fixed fee for the development work that was involved working with us and essentially thereafter they are a sub-contract manufacturer. And, like any such arrangement, the price at which we buy is linked to the volume that we take from them going forward. But Analogic's business model is essentially that of an OEM manufacturer, so it is effectively a sub-contract manufacturing arrangement.

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**Philip Bowman - *Smiths Group plc* - *CEO***

Okay. Any other questions? It seems to have exhausted the flow -- no, one more, on the right-hand side, halfway back.

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**Serena Zuidema – *Deutsche Bank***

Thank you. This is Serena Zuidema from Deutsche Bank. You've talked a lot about your new product introductions, of course. And I was wondering, could you maybe give an idea of how the margins are for these new products and how they compare with the existing product portfolio? And when do you think most of the benefits from these new products will kick in? Is this mainly this year or next year?

And then I have a second question on the fixed costs. Could you maybe give an indication of what fixed costs versus the variable costs will be when the cost savings programme is completed? Thank you.

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**Philip Bowman - *Smiths Group plc* - *CEO***

Okay. I think, Mal, a question about new products, in very general terms, margin structure.

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**Mal Maginnis - *Smiths Group plc* - *President***

As we talked about before, clearly we do better with a new product as it comes out because we've specifically targeted the design and the price for the market. But as I stressed, some of our products have enormous longevity and we're able to improve the margin position in that.

I would caution you; remember, once we launch a product, because we're a government and a particularly regulated supplier, it takes time for that product both to get into specification and then to be tendered and then to be built, supplied, etc. So there is a cycle that takes time for the new products to build up. You will see the impact, obviously, of new products in the next financial year, but the substantial impact tends to come in the year two outwards.

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**Philip Bowman - *Smiths Group plc* - *CEO***

Okay. And in terms of the question about fixed and variable costs, I think I will fall back on simply saying that this is not an area where we have given any guidance to the market so far. And that's not the purpose of today, so I'm afraid that one will have to wait for a future presentation. Okay. If there are no further questions, thank you for your participation in the session.

ENDS