John Crane Deep Dive Q&A

Thursday, 30th November 2023

Q&A

Paul Keel, CEO, Smiths Group: All right, we are tracking well schedule-wise. So I think we have about 40 minutes for Q&A before we have to go on the tour. Raise your hand and fire away. I will start with an easy one, Christian.

Christian Hinderaker, Goldman Sachs: Hi everyone. Thanks for taking the questions. Christian Hinderaker from Goldman Sachs. I wanted to come back to, Bernard had a slide on the OE and aftermarket portfolio. You talked to the mix within aftermarket across retrofit, servicing, spares. Can you just give an indication of how that mix is split across the 71%? And curious here in particular to gauge how much is really repeat business versus maybe the quasi-discretionary retrofit.

Paul Keel, CEO, Smiths Group: You are trying to get at the breakdown of aftermarket by product type. Is that what you are looking for?

Christian Hinderaker, Goldman Sachs: More by how much of it is repeat year in, year out business versus that which might be delayed due to macro conditions or other factors, interest rates, etc.

Bernard Cicut, President, John Crane: I will provide a few comments, and then I will ask Sook Won to add to my comments. So to the point about the cycle, aftermarket, as I think Sook Won has illustrated, is really important to us because it is something which is going on for years, 25 years or plus. And your point about how recurring it is, that is really the duration of the market, so it is about recurring revenues. And part of that is definitively coming from the spare parts. But the added value services that are coming on top of it to ensure the reliability of the equipment and the seal is a critical part of the equipment, are the great opportunities for us to add to those recurring spare parts revenues.

I will let Sook Won comment on a few examples on how we are, with the customer, really bringing that value up and the rate of renewal that we have on this contract.

Sook Won Moon, VP Sales and Aftermarket, John Crane: Thanks very much. So I think I did mention that I think we are sticky at 90% of whatever we actually deliver on the first fit, we come back for the refurbishments or new seals. It does not mean that it is only refurbishments, but also aftermarket; depending on the customers, we do also sell new seals to the customers. If we think about the rate, 71% is the aftermarket, and among that, about 40% is the service. So that service can be traditional service for the retrofits or refurbishments. It is also including the extended services, which we have more potential to grow. So I think that is about the range if we talk about the actual service range.

Reoccurring, I think we can say it is about 90%, but where we want to be bringing that value up is additional services, as you see in the Sense or condition monitorings. Because we build into customers with the traditional services, we may start with that, but we want to be bringing that up to the other services that we can provide the value to them, as well as it helps us to increase our revenue and margin. So does that cover it?

Christian Hinderaker, Goldman Sachs: I think so. Maybe just to follow up, you mentioned the 25-year product lifecycle. We talked earlier perhaps as well about the importance of the service capability in your footprint, and I think the 3,000 or so engineers. Can you talk about labour availability and specifically the experience and skill within the labour mix? Is that a challenge for your business? Is that a challenge for your customers? Just interested in the landscape there.

Bernard Cicut, President, John Crane: No, thanks for all the questions, and I will start by the customers. What we have seen – and it has started some years ago, but it is accelerating – is that customers are losing skilled employees, which means that they rely on a company like us to provide the skills and/or services that they are not providing internally anymore, which is adding to the opportunity we are talking about.

Now, to your question about our own workforce, like any other company in the recent terms, we have seen some more difficulties to get to the labour market and hire and retain the people we need. But it has not been extremely challenging at the end of the day. So we have gone through that. Our attrition rate is similar to what we see in the market. The ability to retain people and to support their expectations through the development we provide, through the career opportunities we provide, through the inclusion and diversity we promote, is helping us to achieve those goals. So we are very solid coverage and fantastic engagement from the workforce.

Paul Keel, CEO, Smiths Group: Andy, big Andy.

Andrew Douglas, Jefferies: Getting bigger. Three questions from me, Andrew Douglas from Jefferies. Can you talk about your competitive position in a bit more detail? We know that you are one of a few players. You operate in the top end of the pyramid. We know you are a world-class company. Can you explain how you think that is going to evolve, both in new energy and old energy, if you will? Do you just take your nice market share from a growing market, or are you expecting to win? And more specifically in new energy, part of your M&A strategy is to buy businesses, maybe to give you access to new technologes. What are the new competitors doing? How are they different to the old competitors? Exactly what is going on there, that would be helpful.

Second question is regarding digital solutions. You have given us a 40%; that is helpful. What percentage of sales come from digital solutions? And again, for someone who is really ignorant and sits in the office in London, pontificating all day, what exactly is your offering compared to your peer group? Because I have no idea.

And then the third thing is on the cash conversion. You talked about cash conversion opportunities to improve. You are doing well at 95%. You are not at the 100% target, or do you think you can do better than that? You said in your opening remarks, Bernard, that you thought there is upside for cash flow. So if you can just talk us through that, please.

Paul Keel, CEO, Smiths Group: All right, you covered the landscape. Well done. Let me set the table on the competitive landscape in M&A. And then I will ask Sook Won, who does battle with these people every day, to give you more detail. On digital solutions, that is going to be Sook Won. She can tell you what our offerings are there. And then cash conversion, we will give it back to Bernard.

So you guys know the competitive set. There is basically three players who can do this. There is us, there is a publicly traded US company called Flowserve, and there is a privately held company owned by Freudenberg called EagleBurgmann. Similar sorts of companies, these high-end gas or new energy tenders, those are the typically the only three companies that show up.

Right now, to your question about new energy and a different competitive set, it is the same products used in a hydrogen solution as is used in a natural gas solution. The trick is compressing a gas at those very high RPM pressures and low temperatures that Sook Won described in her presentation. Hard to do, and that is why the competitive set is so small.

At some time in the future, the world will think of new ways of making hydrogen. One that gets batted around is, can you do it through membranes? Can you pass water through a series of membranes to break the oxygen and hydrogen bond? That does not require a seal to do. You still have to liquefy the hydrogen and transport it. That is traditional business for John Crane. But yeah, at some point in the future there will be new models, and that is why we invest so much in R&D, to try to stay in front of that.

Sook Won, you want to say more about the competitive set?

Sook Won Moon, VP Sales and Aftermarket, John Crane: I think you have covered everything.

Andrew Douglas, Jefferies: Is there any reason why you should not maintain your market share, or can you increase it and double it in the new world because of what you guys have compared to what your competitors have?

Sook Won Moon, VP Sales and Aftermarket, John Crane: As Paul said, actually it is quite the same products right now. And just adding more to that right now – especially because those new energy projects are in the OE stage. It is not yet on the aftermarket stage. And actually, even if there are new end users who may invest for those new markets, it is actually same OE customers. So it is same customers, same products. So we are in the same competitive landscape, the same as the other traditional markets. So it is not much different. But we do try to really identify where we want to be winning more and where we want to target. And that is how we actually go and try to secure our share. So that is more on the competitive side.

Digital products, we do have several digital products. And then what you see here is this Sense Turbo. And that is the product that is unique in the market. We do not really have a competitor right now on that product itself. So without going into details of the value, of amounts of it, that is how it is different. And that is where we do see exciting differentiation, really, in how it goes into the market, and how we will be evolving more in the future.

We do also have products like the Sense product to check the equipment, monitor the equipment, and that is where it is more in the market, where it is similar – we are competing with those products there. That is what is already in the market for a while, and that is where it is competitive, but it helps. We are not just selling for that, but it actually helps us to extend our service. So, it is not just about selling that individual service or product but about adding to our overall service contracts for the reliability.

Paul Keel, CEO, Smiths Group: All right, Bernard, you get me asking you about cash conversion every month, so now you get it from him.

Bernard Cicut, President, John Crane: So yeah, I am used to it. No, you saw, and you know that cash conversion for John Crane is very close to the goal set for the group. And the key elements for improving cash conversion for us is to continue to improve while we improve our flexibility and agility on supply chain, here, is to continue to improve our inventory. And basically what it means, you know as well as me, is to reduce the value of inventory and to increase the terms. That is where SES is definitively playing a role. That is where the standard work that Rob was describing is also playing a role. And we are on that journey to improve our service to customers, reduce our lead time, continue to leverage the relationship with the suppliers to get even better service from them and improve our internal processes to increase our inventory too. That is one of the key levers to enable us to continue to grow even beyond what we have already achieved in term of cash conversion.

Paul Keel, CEO, Smiths Group: Andy, as you know, at the group level, we do about £0.5 billion of operating income. So one point of operating cash conversion is £5 million. We were at 86% operating cash conversion last year, so it is £70 million that we tied up in network and capital. We increased inventory in our company over the last two years by almost £200 million. A third of that was safety stocks coming out of COVID, so that we did not have supply interruptions. A third of it was just to support our rapid growth. And a third of it, I think we can do a better job on optimising our supply chains. So of the £200 million we added, we need to get about a third out and that will get us back to 100%.

Andrew Douglas, Jefferies: Super. Thank you.

Jonathan Hurn, Barclays: Hi, it is Jonathan Hurn from Barclays. I just have two questions, please. Firstly, I think in one of your comments, you said that more innovation is needed to tackle the energy transition, but if I look at your R&D, it is actually going down. It actually went down last year versus the year before. So the question is really, do we need to see a step-up in the R&D going forward from you guys? And if we do, what kind of impact do you think that could have on the margin progression potentially?

Paul Keel, CEO, Smiths Group: Jonathan, your question, is it specific to Crane or…?

Jonathan Hurn, Barclays: Specific to Crane.

Paul Keel, CEO, Smiths Group: Good, Bernard.

Bernard Cicut, President, John Crane: Just to put the context of R&D, what we see in the financial statement is the direct investment we are making on research and development. What we do not see directly in the financial statement is all the engineering support, which is provided to 1,000 engineers, which is provided on the engineering to order process. And innovation is also happening each day when we receive a bespoke requirement from customers, and we have to customise. So that is part of our capability to innovate, and that is what customers really recognise. I think you heard that, and you know that from the customer pulse survey and recognition.

Now, specifically on the research and development part, the investments are also made in the context of a 15% revenue growth. So our spend in R&D continue to increase. And you will see today during the tour, hopefully, beside the human investment, the type of capital investments which have been made, and continue to be made, to support the development of new solutions, to support capabilities, to test to higher level and complete different levels of requirement, which are even not yet reality in the market.

And therefore, I can confirm to you that we are absolutely in agreement that those investments, both in engineering and in R&D, are what will continue to drive the differentiation of John Crane.

Jonathan Hurn, Barclays: And the second question is just on the geographical breakdown. If I look at that and I look at APAC, it is essentially half of what Americas is in terms of sales. Why is APAC so small relative to Europe and the Americas? Is it a potential market-share type issue there, or is it an area where you need to gain more investment or put more investment into to grow that?

Bernard Cicut, President, John Crane: I think historically, you know well that John Crane has been very strong, historically, over 100 years. Started in Europe and in the US. Latin America is also very strong for John Crane. Now, to your point about APAC, that is definitively really an opportunity for growth acceleration. Just looking at a country like India, we have opportunities to gain share in India. We need the full potential of John Crane to grow over segments of the markets where we do not have a presence today. And we have the portfolio to succeed in doing that. There are countries in Southeast Asia where we have excellent penetration. There are others where we need to continue to invest. So it is about leveraging those both economic and also geographic opportunities.

Paul Keel, CEO, Smiths Group: Next question.

Edward Maravanyika, Liberum: Thanks everyone. I have got two questions, I think. It is very helpful talking about the new energy dynamics and some of the growth in there. I guess probably quite a difficult question to answer, but when we think about the next ten, 15, 20 years – and clearly the short-term trends in energy are very strong and in the long-term, you have got the new energy stuff kicking in. But in terms of the phasing, is there a potential risk in the middle, there is a drop-off before it gets better? Or is some of the decarbonisation things you are talking about, helpful in bridging the gap and keeping growth strong?

And the second question is on decarbonisation as well. That 30% of revenue that is from decarbonisation, how quickly has that grown relative to the other 70% over the last five years, or what percentage of sales was it five years ago? Just to get an idea of the different dynamics. Thank You.

Paul Keel, CEO, Smiths Group: Why dont I take the first one? Frank, you want to take the second one about how fast is the 30% growing, and what are the categories that are driving that growth?

The first one, Frank showed a chart of the breakdown of total energy in the world from traditional and new sources and how that changes over time. The big opportunity for John Crane is today, most of the world's energy comes from a fossil fuel. We have the largest installed base and 70% of our revenue is servicing that huge installed base at 1.75x the gross margin of OE. So it is a very good spot to be in. And for the next 30 years, that infrastructure will need to be serviced. Good spot for John Crane. At the same time, the 30% new energy is going to grow to 70% in the future. So that is a big OE opportunity. That is the exciting dual benefit that John Crane faces.

The risk that you ask about, and it is a good question, is that we do not navigate that transition in the same way that we have done the previous 100 years. So a perfect analogue is with natural gas. The world used to have coal and oil. 40 years ago, 50 years ago, the world started using natural gas. John Crane figured out how to seal natural gas. That is the centrepiece of this site, a dry gas seal. You will see it on the tour. And that really amplified the market position for John Crane. They were the first company to figure out how to do that.

We hope we will be the one to figure out these new energy solutions in business models as they emerge. But if we do not, of course this is a super attractive market and that will be a bad day for John Crane if they do not innovate. Everybody get that?

Frank, you want to talk about the 30% and how that is growing?

Frank Ma, VP New Energy Solutions, John Crane: Sure. So I think historically, those portfolios have grown roughly in line with our overall growth. If you think about where a lot of those products are actually installed, they are installed in existing oil and gas and industrial applications already. And if we take a more future-looking view, if you think about the addressable market growth, we anticipate growing in those areas. Plus as we win additional new energy projects, and we talk about the OE and aftermarket dynamic, as these sites become operational towards 2030 and beyond, a lot of these customers will be needing aftermarket services, spares. And that will further accelerate the growth in new energies for us.

George Featherstone, Bank of America: Thanks very much. George Featherstone, Bank of America. A couple of questions on margins if possible. I just wonder where you see the operating margin potential for John Crane in the coming years. You have got pricing ahead of inflation, good things on SES are happening too. Got strong demand order book and operating leverage in the business. So where do you see that going? That would be the first question.

Paul Keel, CEO, Smiths Group: Statistically, John Crane's margin cycles from a low of about 20% to a high of about 25%. Right now, with the strong demand and the economies of scale in this business, as it continues to grow, you should expect margins to continue to expand. Can it get above 25%? Never say never, but my inclination would be I would encourage them to invest more rather than drive for more margin. They have 30 years of very attractive growth ahead of them. So that would be my guidance.

Bernard Cicut, President, John Crane: And we appreciate the guidance because investing in growth is, as Paul just said, leveraging margin too.

George Featherstone, Bank of America: Thank you very much. And then just one on the OE for the new energy segments versus the traditional. Is there any margin difference there? Because I know you have talked about the products being broadly similar, but it strikes me, speaking to some of the experts we have from the team here, that they are probably the most highly engineered products that you have. So I thought that would put them in the upper echelon of the pricing bracket and that may be better margins. Can you just talk about that, let us know what the OE margin differential would be?

Paul Keel, CEO, Smiths Group: Bernard, you want to take that one?

Bernard Cicut, President, John Crane: Yeah, I will take on and probably ask my colleague to add comments. So I would say the first answer would be too early to say. OE in new energy customers on the new energy investment, those investments are just starting. So we are not yet generating any aftermarket revenue. So early to say what exactly it will be.

Now we believe that with the expertise that we have, not just about the seal, but also about the equipment and the process, we will be able to add value to those customers that will be recognised through the pricing and through the margin.

Now the second element I will add to your point about evolution of the margin, that is also why we are looking at additional services and expanded services in order to continue to increase not just our presence in the market, but also increase the value that we are providing. And by doing that, hopefully increasing or maintaining the level of margin that we enjoy today.

George Featherstone, Bank of America: Okay, thanks. Do you mind if I just follow up slightly though, because I think I understand what you mean in terms of the lifetime value, the margin we are not too sure about yet. But in terms of an OE for a seal today, green hydrogen project versus LNG, is it very different?

Bernard Cicut, President, John Crane: Frank.

Frank Ma, VP New Energy Solutions, John Crane: So I think my view on that, it is very application specific. So we should not think about hydrogen or CCUS as a monolithic thing. And what we typically do is we do not target every single project that is being announced. As Sook Won mentioned, we are very strategic around which projects we target. And we target projects where we believe we have a chance to win, we could provide technology benefits and differentiation. And so in those areas that we target, we believe we could bring significant value to the customer, from an OE perspective. And that is important because as we build the installed base and these sites become operational, we strongly believe we will get the benefit of the aftermarket over the longer-term. And that is where the higher margins are going to come in.

George Featherstone, Bank of America: Okay, thank you.

Paul Keel, CEO, Smiths Group: Yeah, Mark.

Mark Davies Jones, Stifel: Thank you. Mark Davies Jones at Stifel. We have focused a lot, unsurprisingly, on energy, but could you talk a little bit more about the non-energy markets? And particularly whether the longevity of the product, the scale of the aftermarket, the wear and tear on products is any different in some of those markets to it is in the core energy business and what that means in terms of relative profitability and returns.

Paul Keel, CEO, Smiths Group: Sook Won, you are best positioned to talk about non-energy markets.

Sook Won Moon, VP Sales and Aftermarket, John Crane: So as you have seen, it is actually 40% of our whole revenue is non-energy, so industrial market. And it is the margin or even the aftermarket repeatable – that is not really different with the energy. It is quite similar on our margin perspective and how aftermarket goes. It is of course different, a little bit more on the applications that are more critical. We may have more aftermarket, which has to be repeating more. But in general, overall it is quite similar.

What is different, I think what we have a little bit more, is that we do have specific applications where we do on the general industrial – I think Frank also did introduce about upstream pumping sales or diamond faces. Those are what we can use more in the general industrial, and that is where we also have more margin and revenue growth. So that is how I think we are balanced, which is similar in the end.

Mark Davies Jones, Stifel: Thank you. And are there any other newer industrial verticals that you think you have got opportunities in? It is fairly specific, the sectors you are in. Are there more sectors that you could make an offer to?

Sook Won Moon, VP Sales and Aftermarket, John Crane: We are in the mining and mineral. But how that evolves – and it is not exact, it is similar, but it moves into the battery supply where we are looking into those opportunities as well. If you want to add anything Frank.

Frank Ma, VP New Energy Solutions, John Crane: No, just to follow up on what Sook Won said, critical minerals support the energy transition when it comes to lithium, cobalt, nickel, copper. It is expected to grow significantly over the next 20, 30 years. We are starting to see some of that demand increase come in. And this is an area whereby we will also see the benefits indirectly through the growth in renewables, like solar PV and wind turbines, because a lot of that minerals will be needed for those applications. And there we have already existing products and solutions that is able to serve those markets. So that is an exciting area that we are also seeing growth in.

Mark Davies Jones, Stifel: All right. And can I ask how important margin is for you in the OE business itself? Because if you compare this industry to the elevator and escalator industry, you have seen OE margins compress. If you compare it to engine manufacturers, you have seen OE margins compress over time because of the NPV in the aftermarket and the attraction in the aftermarket. So do you think this is a different industry compared to those, and if so, why? And how critical is the OE margin for the division?

Paul Keel, CEO, Smiths Group: For us, we have dual responsibilities. We are a publicly listed company, so we have near-term responsibility to deliver results. At the same time, we are a 172-year-old company. So we are as likely to think of a quarter century as we are a fiscal quarter. In the near-term, margins, of course, are important. You saw it in vivid detail last year in our detection business. So our detection business had record growth, record OE growth, and that has a margin impact. And I got a lot of questions about margins in Detection. Now those are all NPV positive projects, so in the long run, they create shareholder value. But yeah, we do sometimes need to trade near-term margin for longer-term capital or shareholder value creation. And same in Bernard's business.

Bernard Cicut, President, John Crane: You already heard, I think, Sook Won and Frank talking about the way we evaluate OE opportunities. So definitively, we are fully aligned to what Paul just explained. We look at the return we will have, or we think we will have on those OE opportunities for the investment we will make on OE and the ability to generate the longer-term revenue through aftermarket. And when the demand is high in the market, we of course select based on those capabilities and opportunities. So it is not about trading short-term for long-term, it is really combining short-term capabilities, short-term opportunities, and long-term return.

Mark Davies Jones: All right, thank you. You have obviously got fantastic retention in aftermarket with that 90% of John Crane seals being serviced by John Crane. But just focusing on that remaining 10%, just interesting to hear why people do not go with John Crane and just how that 90% number has trended over John Crane's history.

Paul Keel, CEO, Smiths Group: Sook Won, you are in the hot seat again. Why are you letting 10% of that business get away?

Sook Won Moon, VP Sales and Aftermarket, John Crane: I think we always have some customers who try to see if they can get either a better price or looking for something different. But I think we also have experienced, and we have seen this especially on the gas sales, we have seen a few customers going to our competitors for refurbishment. But we have also seen a lot of time that after several years, they come back to us because of the reliability of the product. But also not just about the product, but also about these service they can get. So we have seen that a lot, but we still have that percentage of the customers who may still try to seek outside. And I cannot tell how much percentage is coming back, but we have seen that a lot too. So I think that is what it is. It is nature of the business.

Bernard Cicut, President, John Crane: And you would maybe disagree with me, but it is always good to not win 100%.

Paul Keel, CEO, Smiths Group: I would disagree with you. Next question.

Sook Won Moon, VP Sales and Aftermarket, John Crane: I am sorry, but it helps actually helps them to realise how we are doing better sometimes.

Paul Keel, CEO, Smiths Group: All right. I think we have time for one more question. Somebody end with an easy one. Yeah. Oh, you are not, Christian never has an easy one.

Christian Hinderaker, Goldman Sachs: Thank you for the follow-up. And apologies because it is less about John Crane. But you had the slide on the growth outlook for each of the end markets at the beginning of your presentation, Paul. 4-5% was the outlook for aerospace in terms of end market growth. That stacks higher than the other end markets, but it has the lowest exposure in terms of your mix, at 7%. Just interested in – I guess, two parts of the question. Number one, should that therefore be a focus for M&A relative to other businesses like John Crane? And number two, how do we think about that exposure in terms of the Interconnect business and Flex-Tek opportunities?

Paul Keel, CEO, Smiths Group: Yeah, so our aerospace, the way we defined aerospace for that chart is the products we sell into aerospace companies. So Interconnect and Flex-Tek serve it. Detection, although that feels like an aerospace business, we have put that in the safety and security category. We would like to make that part of our business bigger, in particular right now. The 20% of Flex-Tek that is aerospace, that also has record order book right now and has book to bill over 100%. That business can see 90% of this year's revenue already in the order book. So we would be fools not to want more of that.

We are looking at M&A opportunities in Flex-Tek, in particular our tubing business. We make highly engineered tubing systems either for a fuselage of an airplane – move around hydraulics or exhaust gases – or in the jet engine. So yeah, we like that business quite a bit. We would like to make it a bigger part of our portfolio.

Okay. With that, were going to bring Neil back up and he is going to tell us about the tour.

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