

## **SMITHS GROUP 2018 INTERIM RESULTS**

### **PRESENTATION**

**Andy Reynolds Smith** - Chief Executive

Good morning, everyone. Thanks very much for turning out on a Friday. Delighted to welcome, everyone, today. This is a really important year for Smiths Group. I'm delighted to welcome, also, our Chairman, Sir George Buckley; and Bill Seeger, who, some of you, will, no doubt, remember. This is an inflection point for the group. We've been building hard on the foundations in operations, in innovation and in people to drive sustainable growth above our markets. The outlook for growth in 2018 is reaffirmed. Our confidence is supported by the improving trends that we see throughout the divisions during the period, and importantly, in the start of the second half.

As you can see, John Crane is back to growth driven by the positive trends in oil and gas and further progress accelerating on non-oil and gas activities. We've got a strong order book in both OE and aftermarket.

In Medical, I'm very pleased that results of our investment in new products and in sales effectiveness are starting to bear fruit with revenue now back to flat on prior year. After the second half of 2017 that was down 4%, we said that we expected material progress back towards flat for the first half. And I'm pleased that we've done even better, as we drive the division back into growth in the second half and for the year as a whole.

As expected, Detection revenue was down on the prior year. However, we saw continued strong growth of 8% in air transportation, despite the mid-teens first half comparator last year. This growth was offset by programme phasing in other markets, but I remain very positive about this business. The Morpho integration is gathering pace, and it was really good to see margin at 16%, despite revenue being down in the first half. We saw evidence of our market-leading combined product range supporting new business wins, such as the recent GBP 50 million order from airports of India.

Smiths Interconnect made continued progress in its refocusing and restructuring. We've sold 40% of the business and we're now targeting six high-tech seeking, high-growth markets. Revenues in these markets grew by 3%, but they were offset by further tail cutting of products and customers we plan to exit as we complete the restructuring of the business, positioning it for growth in the second half and the future.

Flex-Tek had a gangbusters half, with growth of 10% driven by strong U.S. construction markets, improvement in aerospace and mid-teens growth in heating solutions. Flex-Tek is well-positioned for continued strong growth.

Moving to the group highlights.

First half revenue was within GBP 10 million of last year, so broadly flat. On an underlying basis, operating profit was down 2%, when it was adjusted for restructuring in the pension admin costs as headline items that we communicated last year. This underlying movement primarily reflects the volume effect of revenue phasing in Detection, as well as higher R&D costs in Smiths Medical related to the wave of new product launches that are supporting the division's return to growth.

We continue our intense focus on cash and working capital improvement. Progress on working capital and inventory turns was slower in the half, as we prepared for growth, but the pace of improvement will accelerate again in the second half and ongoing, as we drive towards our medium-term targets of six stock turns and working capital at 20% of sales freeing up cash for investment in the business. This is all underpinned by permanent structural and systemic changes in the business.

We also continue to make progress on our portfolio high grading with the low growth, low-margin bearings business from John Crane being sold. And I'm pleased to announce this morning, the acquisition of Seebach. Seebach is a GBP 20 million high technology filters business, which is very complementary to our John Crane business with strong growth in margin and is accretive to the group and accretive to both the margin and growth of John Crane.

In China, we also announced a JV between Huafeng and Interconnect to move us more rapidly into the country's fast-growing aerospace and rail industries, supplying world-class advanced connectors.

We expect to continue this portfolio high grading, alongside our focus on organic development and investment for future growth.

I'm pleased to announce that the Board has declared an interim dividend of 13.8p, up 1.8%, reflecting the continued confidence in the growth and prospects for the group.

I'll be back to talk to you a little bit more on the strategy and the continued pace of our transformation, but now I'd now like to hand it over to John to take us through the numbers in a bit more detail. Thanks, John.

### **John Shipsey – CFO**

Thanks, Andy. Good morning, everyone. It's a pleasure to present these results. My first as CFO of Smiths. And as Andy mentioned, the trends are improving and the group is on track to deliver growth for the year. Reported revenue for the group of GBP 1.549 billion was down 4%. On an underlying basis, excluding the impact of FX and of acquisitions and disposals, revenue was down 1%. Operating profit of GBP 247 million was down 11% or 2% on an underlying basis. After adjusting for

restructuring and pension admin costs, which, as previously promised, are now treated as headline items.

On the same basis, the group operating margin was down 20 basis points at 16%. Reported EPS decreased by 11%. On an underlying basis, it was down 2%. Free cash flow was down, but nonetheless strong with cash conversion of 98% for the first half.

Return on capital employed was 15.2%, reflecting investment in growth, with the most notable impact, as expected, coming from the inclusion of Morpho. And finally, as mentioned by Andy, the dividend per share is up 1.8%. So let's now review the results in more detail.

Starting with revenue. Underlying revenue was broadly flat year-on-year. Translational FX reduced revenue by GBP 49 million, whilst the Morpho acquisition and four divestitures last year had a net impact of minus GBP 8 million. Total underlying revenue was down GBP 10 million driven primarily by Detection. Elsewhere, John Crane and Flex-Tek grew 3% and 10%, respectively. Medical was flat and Interconnect declined 3%.

Let's have a look in more detail at the revenue performance by division. The revenue trend improved from minus 2% in the first quarter to flat in the second quarter.

John Crane saw a return to growth and finished the half up 3%. Aftermarket grew by 5%, accelerating the pace from last year. It now represents 66% of John Crane's revenue, up 200 basis points from last year. And importantly, original equipment sales improved and were flat. Looking at end markets, John Crane's revenues from oil and gas and nonoil and gas were both up 4% and 3%, respectively. The latter driven by pharma, chemical and pulp and paper.

In Medical, as anticipated, the trends are improving and the rates of new product introductions has accelerated. Eleven products have been launched since the start of the year compared with three in the first half of last year. Overall, revenue was flat. Infusion Systems saw a growth in disposables, offset by declines in hardware. In Vascular Access, PIVC was down, but sharps safety grew by the launch of a new safety lancet. And Vital Care was flat with a decline in respiratory care, offsetting growth from all other segments.

In Detection, revenues declined 11%. Air transportation, which now accounts for 66% of Smiths Detection, continued its strong growth, up 8% on an underlying basis, despite a very strong comparator. Growth was driven by the ECAP regulations in Europe as well as important contract wins in India, Canada and the Middle East. Morpho contributed GBP 91 million in the period. Total revenues from air transportation grew to GBP 241 million in the first half -- sorry, GBP 241million versus GBP 140 million in the first half of 2017, before the acquisition of Morpho. However, as expected cyclical effects in non-aviation segments held performance back. Military revenue was down 75%, as some major programmes came to an end. Ports and borders and urban security were also down 26% and 4%, respectively, due to the timing of contract completions. In part, thanks to Morpho, aftermarket

revenues for Detection grew to a cyclical peak of 48% of revenues, which we would expect to moderate in second half.

At Smiths Interconnect, to complete the restructuring process, we are exiting certain products and customers. The declining sales associated with these exits offset a 3% revenue increase in its six key market segments. As a result, underlying revenue was down 3%.

Flex-Tek revenue was up 10% with growth across-the-board, including construction up 4% and both Fluid Management and Heat Solutions up 14%.

Moving now to operating profit. Underlying operating profit was down 2%. Let me walk you through the operating profit bridge. As you will remember, we announced last year that henceforward we would report restructuring charges and pension admin costs as part of headline profit. These charges impacted last year by GBP 19 million and in the appendix, you will find a detailed breakdown by division.

Translational FX reduced operating profit by GBP 10 million, whilst acquisitions and disposals increased profit by GBP 4 million. As a result, on an underlying basis, operating profit reduced by GBP 4 million or 2%.

On an underlying basis, the first half margin last year was 16.2%. Growth in both John Crane and Flex-Tek and a broadly flat performance in Interconnect were more than offset by Medical, Detection and the increased investment in innovation in i3.

Let's now review the profit and margin by division in more detail. All variances are shown on an underlying basis, including the reclassification of restructuring and pension admin costs recorded as non-headline in 2017.

John Crane operating profit was up 5% at GBP 91 million and the margin expanded by 30 basis points to 21.3%. This was driven by the recovery in volumes and a favorable mix from strong aftermarket growth.

In Smiths Medical, operating profit was down 5% and margin decreased by 90 basis points to 18.1%. The margin was impacted by higher R&D in relation to newly launched products. It's also worth reminding you here that in the second half of 2017, Smiths Medical benefited from a GBP 6 million one-off device tax refund in the U.S.

In Smiths Detection, operating profit was down 13% and margin decreased by 40 basis points to 16.2% as a result of the lower volumes in non-air transportation. This was partially offset by higher mix of aftermarket and also Morpho synergies. In that regard, I am happy to confirm that we are on track to deliver the target of \$30 million annualized cost savings by year three.

In Smiths Interconnect, operating profit was down 1% with margin up 20 basis points to 10.3%, following the disposal of lower-margin businesses in 2017. Gross margin improved as the business focused on high value end markets. But lower volumes and some further restructuring costs nonetheless, held net margins back.

Flex-Tek operating profit was up 15%. The good growth plus procurement and efficiency savings drove margins up by 80 basis points to 18.6%. Overall, operating profit was down 2% to GBP 247 million and margin was down 20 basis points on an underlying basis.

Moving then on to tax. U.S. tax reform has a favourable impact on our effective tax rate. We announced in January a preliminary assessment of the likely impact and that the one-off revaluation of deferred tax assets would be reported as part of headline profit. However, in order to align ourselves with market practice and because the charge is nonrecurring, we have decided to report this as a non-headline charge. As a result, the headline tax rate for 2018 is now estimated to be in the range of 25.5% to 26.5%. And for 2019, we are estimating a headline tax rate of 22% to 24%, down from the 23% to 25% previously communicated.

Moving on to the important subject of cash. Cash is our lifeblood. We manage it actively and spend it wisely. Free cash flow of GBP 113 million was down against prior year, but represented continued good cash conversion at 98%.

CapEx at GBP 46 million was broadly in line with depreciation, reflecting our asset-light operating model. Working capital showed an outflow of GBP 18 million. Working capital is a critical component of our cash generation. Typically, in the first half, it's higher than H2. And this trend was exacerbated by the strong order book, which required higher working capital at the end of the first half.

What is important is that we continue to see improvement. We have stated our ambition to reduce working capital to 20% of revenues versus 29% today. We have put in place incentives to ensure that this ambition is shared throughout the business. And we are adding content, so that the right motivation is backed by the right capabilities in every division for every line of working capital, whether that be inventory, accounts receivable or accounts payable, customers and suppliers as well as nontrade items like tax payments.

Our good cash generation continues to support a strong balance sheet and we ended the period with a net debt-to-EBITDA ratio of 1.5x. Our cash flow performance in the first half was good, but there is more to come. Cash is not a battle, it's a war and we still have plenty of territory to capture.

I'd like now to briefly update you on the pension situation. And here, I should certainly pay tribute to the outstanding work of the team, who've placed our main schemes 1 in the U.S. and 2 here in the U.K. on such a strong financial footing. On an accounting basis, the overall surplus was up to GBP 237 million at the end of January. In October, the SIPS scheme completed a GBP 207 million buy-in of liabilities. And in December, the U.S. scheme paid \$36 million to members, who opted to take lump sums in lieu of annuities.

Cash contributions for this year are expected to be around GBP 50 million, down from a GBP 105 million in 2017. We continue to work with the trustees of the U.K. schemes in a positive and open way, and are currently discussing options with them regarding the next triannual valuation. We expect to provide an update on this before the year-end. Our aim and that of the trustees is to continue funding the three

schemes, such that all liabilities can be externalized within the next ten years. Based on current projections, we are certainly on track to achieve that.

Finally, just a point of housekeeping. Given recent volatility in foreign exchange, I would like to remind you of our FX sensitivity on a translational basis. In the half, adverse translation of foreign exchange reduced revenue by 3% and operating profit by 4%. Every 0.10 move on the dollar impacts operating profit by around GBP 30 million on an annualized basis. And every 0.10 move on the euro impacts our operating profit by around GBP 8 million on an annualized basis. And if current rates prevail for the rest of the year, foreign exchange is expected to reduce operating profit by about 6% or GBP 35 million.

This set of results demonstrates clear progress against our objective of returning the group to organic growth. Our outlook for the second half is strong, and we are confident that 2018 will mark a year of growth for the group.

And now, I'll hand you back to Andy, who will cover this in more detail. Thank you.

**Andy Reynolds Smith - Chief Executive**

Thanks, John. I really like the passion and quality of thought that you're bringing to the group, particularly on cash, capital allocation and innovation.

Smiths is really clear about what we want to be. We're building a world-leading technology company that's diversified and high-performing. We're successfully repositioning ourselves and building the capability to execute consistently, develop innovative new products and all driven by our investment in people and leadership.

The organic development of the business is our priority, as I've said many times before, number one, two and three. But the parallel path of non-organic development is also supporting and accelerating our repositioning geographically in technology and with customers and markets.

At the same time as improving each of our businesses, we continue to carefully consider and review capital allocation across the group to ensure that we're able to prioritize the scale and focus of our investments to create maximum value from our assets.

We're committed to businesses in markets with good, long-term growth prospects that match the characteristics that we like. Cutting-edge technology, including digitalization, asset-light with high aftermarket and recurring revenues and all of them giving us flexibility, strong returns and growth. But the most powerful source of sustainable growth, returns and competitive advantage, we want Smiths to be known for outstanding execution for doing it better than the rest.

Our medium-term metrics that we laid out at the Capital Markets Day are clear. They indicate both the financial shape of the business in the future and the important things that we focus on to drive our business. Through operating model, these objectives are used to guide decision-making and drive performance. They're all

linked to our management incentives and our ways of working. We're making good progress and we'll provide an update against these at the full year results.

I'd like to talk now in a bit more detail about some of the stuff that underpins our confidence in the second half.

Let's start with John Crane. We're seeing good momentum in the business. Overall, we're back to growth and margins remain strong with further potential in the coming years. The first half grew 3%, driven by improving oil and gas markets and our strong push into non-oil and gas with particular strength and wins in chemical and pharmaceutical. The momentum will continue, expanding our installed base and supported by both strong OE order book and further good aftermarket demand. As I mentioned before, we're focused on building scalable leading positions in our markets and this is what drove our exit from the bearings business and the acquisition of Seebach that I talked about earlier.

We've also, in John Crane, increased our investment in innovative new products, which operate at higher temperatures and pressures, helping our customers achieve greater efficiency. As the rate of investment in the market begins to pick up, our customers are increasingly focused on getting more output from every dollar of investment in their refineries and their processing plants. This dynamic is one of the driving factors behind the development of our sense condition monitoring system, which significantly increases our customer intimacy. It allows us to understand how to bring more value to customers through the use of sophisticated analytics. The number of installations globally continues to increase. Our improving markets and the work that we're doing to develop our leadership position supports our confidence in continued growth momentum in the second half and beyond.

Moving to Smiths Medical. We're clearly seeing the results of our increased investment in both new products and sales effectiveness. We're confident that the business will grow for the year as a whole and with further growth momentum into 2019.

You'll be very familiar with our significant programme of 23 new product launches that will refresh more than half of the division's total revenue. Eleven of these products were launched in the first half of the year and the remaining twelve are on track to be launched over the next 6 months. You can see two of them here.

One, our market-leading CADD-Solis Pump, is our first wireless ambulatory pump and increases our position in the rapidly expanding hospital and home care digital environment. The pump helps hospitals increase efficiency, reduce costs, and importantly, allows better patient outcomes.

The really neat Neoheel more accurately and painlessly allows blood testing from baby's feet. The innovative design reduces the number of punctures and the time taken to complete the test and the babies cry a little bit less as well, which is normally a good thing.

Sales from our new products are gradually ramping up and supporting our confidence in the continued improving trend in Medical.

Smiths Detection performed as expected, with revenue more heavily weighted to the second half with further strong growth in the half in airports. This good growth of 8%

in air transportation is expected to continue, supported by the now, fully integrated Morpho business.

As an example, 60% of the European programme to upgrade checked baggage to CT is still to come. And so far, we're doing at least as well as we planned in winning our share. Confidence is underpinned by strong order books in the second half and beyond.

As we've reported before, we are in the sunset phase of a key programme in our military segment, which will continue until the next generation in around 2020.

Roland Carter, who is sitting right back there in the audience today is now in place and driving hard on execution, technology leadership and importantly, accelerating our activities in markets beyond their transportation to take full advantage of the strong growth drivers in the threat Detection environment everywhere, as it develops at an increasingly high pace.

Interconnect continued with its restructuring, which is now completing. And it will support an improvement in return to growth in the second half. New business wins were strong in our focused growth market segments, particularly in space and medical, including the Lockheed Martin-Orion data network and the Jupiter 3 satellite programme.

Flex-Tek had a super half and is really well-positioned for continued strong growth for the year as a whole. Key markets are supportive and we're especially pleased by the progress in Heat Solutions, where the integration of the newly acquired Osram business is on track and already opening new market opportunities, including Chinese aircraft production. In this case, our products are contributing to large improvements in plant efficiency and reliability.

Revenue growth of 10% was more than matched by 15% growth in profitability with good future prospects as we build on our global markets and market positions.

So I'm sure you know, I'm a passionate technologist. There's no doubt in my mind that the strongest driver of sustainable growth is innovation and cutting-edge technology. I said, I wanted to invest more in R&D, but to do it more intelligently and get it to market and convert it into new sales more quickly. Our focus on R&D continued in the first half and stands at 4.6% of sales.

You can see behind me some of the market-leading innovative stuff that we have been doing. Our focus on developing new digital products and solutions is high. The first of our digital forges is now up and running in San Francisco, and our Chief Digital Officer is driving our activities across the group and in the divisions. Artificial intelligence and augmented reality features strongly across the group, alongside 3D printing, advanced materials and nanotechnology. Much more to come here as we drive and track our innovation vitality in products, processes, materials and services globally.

Now to operational excellence and our group operating system. The focus is intense and unrelenting to improve speed, efficiency, cost and execution in all aspects of our business. The Smiths Excellence System is now deployed across the group and is being used to improve processes, production, share best practice and build the capability of our people to continually improve towards our objective of world-class operations.

This, of course, has multiple benefits, including happier customers, who get what they want when they want it, systemically stronger cash generation, profit improvement to pay for the investment in growth and new products coming to market quicker.

It's self-help that brings with it the added critical dimension of better and consistent execution. You've seen from our medium-term objectives the working capital and inventory reduction that there's a large potential. Inventory turns improved to 3.6x in the first half. As a reminder, one turn is worth close to GBP 100 million of cash.

The example behind me is one of the contributors to this programme. The Smiths Detection site in Hemel Hempstead that I visited recently has reduced inventory by 35%, product assembly time by 70% and has better safety on its main product through the introduction of a flowline concept. It's a fascinating location in many ways, as it's also our global technology centre of excellence for our chemical and biological Detection equipment, which includes nerve agents.

Finally, to the outlook for the year. We said 2018 would be a year of growth and it will be. We expected continued growth in John Crane, a return to growth in Medical, a strong second half in Detection, improved performance in Interconnect, continued strong growth in John Crane and Flex-Tek; and as John said, we do expect a continued translational FX headwind in the second half.

Our relentless focus on operational excellence, self-help and cash generation will continue to be central to what we do. We'll also be continuing with our portfolio high grading, both organically and non-organically with capital allocation discipline across every investment decision in the divisions and the group portfolio. The plan for the year and the strategic plan are on track.

Thanks very much for listening. And be delighted to take any questions along with John.

## **QUESTIONS & ANSWERS**

**Andre Kukhnin** - Crédit Suisse

Three questions, please. Firstly, on Medical profitability. Obviously, quite high R&D intensity at the moment. You've got another twelve products to launch in the second half, but you expect growth to come back. Could you just help us to weigh it up in terms of how the margins are likely to evolve in the second half, given that you are going to launch? And then what is the, sort of, real potential of that business once that 50% of sales are revamped and all those products are launched? Do you see evidence of what you've launched coming in with high profitability, for example? If you give us those examples, that would be great. Secondly, on -- or do you want to go one at a time?

**Andy Reynolds Smith** - Chief Executive

Yes. Let me cover that one because it's a really important one, I think. Yes. You're right, I mean, this is the largest ever wave of new product introduction that we've ever seen. Renewing half the revenue of the entire division in the next two, three years. The first half, we did have our higher R&D expense and the amortization

starts to come in as the new products are launched, whilst they're in the gradual ramp-up phase. So the 90 basis points that we sold down in the first half is really associated with that. My confidence in the margin for Medical overall, as we have said is, it's a 20%-plus business. The hit in the first half will be offset as we move into growth in the second half as it stands.

**Andre Kukhnin** - Crédit Suisse

And on John Crane deal, could you talk about what you've acquired and whether that could be beginning of an acquisition cycle for that business?

**Andy Reynolds Smith** - Chief Executive

Okay. Well, John Crane is a very strong business, as you know. I mean, it's a really high-quality business. Really, the focus of that business is on mission-critical components that help refineries and processing plants run more efficiently. The business that we bought is a high-performance polymer filter business. When I told my kids about it, they had in their minds that this was like the oil filter that sits on your car. It's nothing like that. This is a really high-performance big unit of this sort of size. They sell, on average, for about EUR 5,000. So it's really a high-technology piece of kit. It's highly complementary overall to -- and combines very well with our seals business. In fact, we already have a filters business, which this will be a really good complement to, and really put us in a leading position. Although it's relatively small, it's a really neat little business with good growth, good margins. And as I said, it's accretive to both growth and margin for Crane.

**Andre Kukhnin** - Crédit Suisse

Are there further deals like this to do?

**Andy Reynolds Smith** - Chief Executive

Well, we've got a lot to do organically in Crane. I think as we've started to push into the other markets outside the traditional oil and gas markets, we're seeing a lot of opportunity and we're seeing a lot of opportunity geographically as well. That being said, I would very much like to continue to add and grow that business more quickly, where we can find the sorts of things that make sense that have similar characteristics to the seals. So you put them in the refinery at the beginning, and then you replace them very frequently throughout the life of the refinery or a plant. So continue to look at it. Organic is a priority, but we are continuing to actively look at further options to develop Crane, yes.

**Andre Kukhnin** - Crédit Suisse

And last one, just a quick one on -- you've made some changes to how you treat various items to essentially improve the quality of earnings like the restructuring cost and the pension administration costs. Obviously, it's the right thing to do, but the question is, as you look at what you report, is there more of this to be done? Is there anything else that we should be aware of?

**John Shipsey** - CFO

No. I think, as you know, we promised that we would move persistent restructuring charges and pension admin up into headline and that's what we've done. At this time, I don't see any need to make any further changes to that.

**Andy Reynolds Smith** - Chief Executive

I think from my side, the management philosophy of treating those costs above the line is the right thing to do. In my mind, it gives a very strong correlation between the cost and the benefit as stuff gets done. And -- but we'll continue to do the right thing in terms of repositioning and restructuring the business. So we will continue to have some spend going forward. And focus the business. Okay. I think Mark.

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

A few bits and pieces, firstly, on the sort of mix effects at Detection and Interconnect drags on the sort of course of those businesses. Are those bottoming out now in terms of the non-airport business Detection and the other bits?

**Andy Reynolds Smith** - Chief Executive

Yes. I'll separate Detection and Interconnect there. The mix effect with Detection in the first half was lower OE. You'll note in some of the notes that the aftermarket revenue was at 48% in the first half with Detection versus 35% for the whole year, last year. That was partly driven by -- one was down and the other one was up, but also an increasing trend of more aftermarket and service coming through, which is essential because you've got more sophisticated kit coming through the story. Military is the biggest down as you can see. And as we have said before, that's related to the sunset phase on a combination of products, the RadSeeker and the JCAD; one in chemical, one in nuclear detection. That's where we expect it to be. It will continue that way, but we are also looking at pushing some of those technologies and applying them -- look at those core competencies and applying them more broadly. For example, some of the things that are happening in the world at the moment are very applicable to the way we think about stuff.

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

Your only sort of step down, has that -- is that sort of in the run rate now?

**Andy Reynolds Smith** - Chief Executive

There will be some movement in it. I mean, just to scale, military is about 3% to 4% of total revenue. So there might be some movement in it. The big headline of 75% in this half, it's running at a lower level, but there will be some movement in that, but it's relatively small in materiality to the whole story. Moving to Interconnect, what's happening there is the focus around the six key markets that we've talked about several times and effective tail cutting on lower margin, lower growth markets and products that we're seeing elsewhere. We're expecting that restructuring to complete by the end of this financial year. We're expecting to see Interconnect move back into growth in the second half as that balance changes because we're growing in the 6 we want to be in, and exiting quite quickly and heavily in the others and then that gives us the platform for moving into next year.

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

Can I just come back on the Medical margins, because obviously a key one? There are lots of moving parts there, but do you think you will be achieving higher gross margins on the newer businesses to allow you to get to the same sort of margin level even with structurally higher R&D?

**Andy Reynolds Smith** - Chief Executive

Right now, we're -- it's too early, because they're too early in the launch phase. As I've said before, inherently, those should be better margin and support our bottom line margin going forward. And also give us the ability to withstand pricing better, because there's undoubted pressure more in the commoditized end of the industry. So the more new and innovative stuff that we have, the better. Alex.

**Alex Virgo** - BofA Merrill Lynch

So could you perhaps start by just elaborating a little bit on the EBIT bridge year-on-year, John? The GBP 19 million and restructuring and pension costs, I guess, what, GBP 3 million of that is pension or so, or is it a bit more? How much of it is restructuring, I guess, the first question? What does that mean for the second half?

**John Shipsey** - CFO

Its split GBP 15 million and GBP 4 million. GBP 15 million restructuring and GBP 4 million for the prior year for pension admin.

**Alex Virgo** - BofA Merrill Lynch

And does that mean you're tracking a little bit ahead of where you'd expected to be on restructuring in terms of spend, and therefore what do we think for the second half?

**John Shipsey** - CFO

Yes. So we did have a larger spend last year in restructuring. So I think it was GBP 33 million last year, and -- so it will reduce. We've guided to the fact that it will be GBP 15 million on an ongoing basis.

**Alex Virgo** - BofA Merrill Lynch

For the full year?

**John Shipsey** - CFO

For the full year.

**Alex Virgo** - BofA Merrill Lynch

Okay. Would you mind just doing a little bit of the same for the Medical business specifically because obviously, we have gone from GBP 99 million to GBP 82 million? I guess, GBP 6 million of it's the device tax, GBP 6 million of it's restructuring, some of it must be FX. But if I look at the -- if I just apply your percentage of R&D to the sales number, then actually you have got lower R&D expensed -- sorry, this year, in the first half. So how do we think about that in the context of what you said by way of explanation for that profitability?

**John Shipsey** - CFO

Just clarify that the device tax is a second half effect.

**Andy Reynolds Smith** - Chief Executive

Second half. Yes.

**Alex Virgo** - BofA Merrill Lynch

Which makes the question even more relevant, I suppose.

**Andy Reynolds Smith** - Chief Executive

Yes. So it's really the costs in the first half associated with introducing the new products, scaling them, getting them up to speed. Overall, we've moved, as you know, over the last couple of years, from about 4% to 6% R&D, which will start to flow through in the amortization. But our aim in Medical and overall is, as I've said a number of times, that we're going to invest more, but we're going to offset it and pay for it with improvements elsewhere in the business and that stands absolutely for Medical.

**John Shipsey** - CFO

To be specific on your question, the GBP 4 million decline. The majority of that is driven by R&D in Medical. Higher expense.

**Alex Virgo** - BofA Merrill Lynch

Okay. Last one just on cash. What term would you expect that to be, I suppose, at the end of the year if we've gone to 3.6 over the half?

**Andy Reynolds Smith** - Chief Executive

Well, over the medium term, we want to get to 6. I expect that to be a fairly smooth curve of improvement over the next two to three years. You can deduce back from that. That means in the order of half a turn to one turn a year from where we are now. And you'll see some more meaningful progress in the second half on that inventory turn, in line with that glide path upwards.

**Alex Virgo** - BofA Merrill Lynch

Okay. And then I suppose just to finish on a more positive note, could you talk a bit about the quarterly progression you've seen, particularly in John Crane and Medical and how we can think about that for the second half, because, obviously, the prognosis on growth is a lot more positive than perhaps the development of profitability so far this year?

**Andy Reynolds Smith** - Chief Executive

Yes. Absolutely. Well, the group as a whole for the first half was down 2% on revenue in the first quarter and flat in the second quarter. There's a fairly similar trend of improvement across the businesses, Medical now back to flat having been a minus 4 in the second half of last year. The business will grow for the year as a whole, so you can expect to see growth now moving into positive growth throughout the second half. So this isn't particularly spiky in any of the businesses now in the second half. Right. Okay. We've got Glen.

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

On the Medical business, you've gone from almost no product launches or one in 2015 to 23 now. Looking forward beyond this year, are we looking at a similar sort of burden in terms of launch costs for the foreseeable future? Or is this a bit of a hump and it moderates gradually over the next year or two?

**Andy Reynolds Smith - Chief Executive**

Well, I think, first of all, for the division, we expect around the 6% of sales to be the run rate. There will be some ups and downs on that as we go through coming years. We will expect a continued much higher pace of new product launches, in fact indeed across the group as we move into this phase of better vitality than we have had. I think for me, the division came from a place of not launching anything to a place of launching a lot. And the improvement in product launch, in programme management, in industrializing new products has been really high. It's still holding us down a little bit related to that, but the aim is to be not just launching lots of products, but launching them well and quickly. So, no, I don't expect that to be a recurrent every time we launch products, it holds us back. This is about, as it is across the group, building the capability to do it well.

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

And secondly, on Detection, you seem more confident now about 5% growth for the year as a whole. Firstly, what is giving you the, sort of, confidence that you can deliver that? And secondly, John mentioned quite clearly, 48% of revenue in the aftermarket in H1 will moderate. Against that backdrop, is there enough leverage and shift in the quality of the OE sales to keep the margins where they are or even higher as we go through the second half of the year?

**Andy Reynolds Smith - Chief Executive**

Well, just as a reminder, I see that business as a mid-teens plus business. I mean, you'll recall from a year and a half or so ago, that we said we've got 20%-plus expectation through cycle in Crane and Medical and mid-teens plus in the other businesses. I think the Detection business in the second half, we were really strong in growth in airports, which is about 2/3 of the total now. It was held back particularly by contract phasing in -- this is aside the military business, contract phasing in ports and borders and some of the open security stuff, but particularly ports and borders. We got very good visibility of the order book in the second half in those areas. So aside military, we are expecting air transportation to keep going well above market as it is. And we are expecting that phasing of the ports and borders and open security stuff based on the order book we can see to drive us where we want to be for the year. I think on margin overall, if we were growing above-market, sort of, the notional 4% or 5% that people view that market to be, and we have margins consistently growing, and we have margin in the mid- to high-teens, I'd be a happy man. And I can see the potential for that. I think the point that John made around moderating the aftermarket percentage in the second half wasn't so much a negative. It's just a function of one was down and the other was up, but also more underlying strength. When we bought Morpho, we said that it was a 55% aftermarket business, and we were sitting at 30-ish at the time. And we said, we expected that to progress over time into the 40s, which is an important part of the value that we think is there in the business, but just not to expect it to be 48% again in the second half was the point there.

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

There is leverage in the volumes that are going up to counterbalance the shrinkage in the proportion of highest margin business.

**Andy Reynolds Smith** - Chief Executive

Yes. The aftermarket business, it won't surprise you to hear because a lot of it is software-related, is better margin. So -- and -- but it's also more protectable, because, as we've said before, you can't supply the software for my machine. A competitor can't supply the software for my machine anymore or the image libraries for my machine anymore and that used to be the case to a greater extent. So this is a good margin business. My focus there really is ensuring it's a strong growth business, so we're really taking advantage of what's going on in the world.

**Jonathan Hurn** - Deutsche Bank

Just two questions, please. Firstly, just coming back to John Crane, I think in some of your comments, you've talked about the OE order book, it's seeing strong growth in that business in the first half. Can you talk through a little bit about the margin of that order book? I think, historically, you've said, you've been selling a lot of OE orders close to cost. Has that, sort of, pattern changed through the first half of this year?

**Andy Reynolds Smith** - Chief Executive

Not a great deal. There are several different aspects to that. The OE business is lower margin than the aftermarket and will continue to be. One of the things that we've said quite early on is, in some cases, the economics of taking a piece of OE business that then drives a 30- or 40-year high margin annuity is really good. So we've been very focused on ensuring that we focus on ensuring that we can fund and take those lower margin OE installations to buy the annuity effectively. We're not seeing too much movement in margin in either at the moment. In fact, the opposite in aftermarket, which is up slightly. But we're not really seeing -- I mean, there are some programme-by-programme cases in different parts of the world, where it's -- there is more competitive pressure or less, but in general, OE is about flat margin-wise and aftermarket's a little bit better.

**Jonathan Hurn** - Deutsche Bank

And the second question is, just coming back to your chart, where you showed that essentially 25% of Smiths is non-core, and you may be looking to get out of there. I think probably within that 25%, you could argue that a fair proportion is Flex-Tek. Obviously, you've seen strong growth in Flex-Tek coming through. In terms of exiting that 25%, has it been pushed farther out on the back of Flex-Tek performance?

**Andy Reynolds Smith** - Chief Executive

Well, we've sold the bearings business in Crane, as you know. For me, this isn't about getting it to 100% either. This is just about continued repositioning of the business organically and non-organically. I think there's probably -- there's actually nothing in Flex-Tek that I think would come out right now. I think as we think about some other parts of the business, we have some businesses in a similar position to the bearings business in Crane that are lower, lower growth or further from the top three leadership position that we want. So I won't pick any one division there, but I certainly wouldn't gravitate to it being in Flex-Tek.

**Roshni Rajan** - J O Hambro Capital Management

Have you considered the impact of, sort of, potential trade tariffs on the business and perhaps on your end markets?

**Andy Reynolds Smith - Chief Executive**

Yes. I mean, we look at the whole political, economic, socioeconomic environment pretty carefully all the time. And I think overall, Smiths is in, by virtue of historical decisions, a really good position as far as spread across regions, geographies. But I think more importantly, for me, our transactional exposure to that is lower because on the whole, we make stuff where it's consumed. We do have some incoming supply chain, but on the whole, we balance our costs pretty well with where we are doing business and where we generate our revenue. So it's something that we constantly looking at doing better progressively as we evolve footprint and evolve the business. But it's not an area where we're expecting substantial major impact.

**Robert Davies - Morgan Stanley**

Just a few questions. First one is just, you mentioned in the release, I think, there's sort of 3% to 4% annual growth target in the medium term. I guess, you could sort of flesh out how you're thinking about that, sort of, division-by-division, because you've obviously mentioned Detection is kind of running above that level at the moment. Crane is obviously coming off a fairly depressed couple of years. Just if you could give us a little more colour, I guess, what is the scope to potentially go higher than that? Or are you still thinking 3% to 4% is a, sort of, sensible through cycle range?

**Andy Reynolds Smith - Chief Executive**

Well, the 3% to 4% is what we think our markets overall are growing through cycle. Our aim is to grow better than that. With Detection, we're doing that right now. With Flex-Tek, we're doing that right now. With Interconnect and Medical, we're not right now. So our aim clearly is through being more competitive and more innovative and doing stuff better to grow better than the markets that we serve. So the base is really is 3% to 4% for the market, and us doing better than that. So we continue to push in that direction.

**Robert Davies - Morgan Stanley**

And then just maybe a little bit more colour on the trends you're seeing in Crane. You mentioned some of the refining and those sub segments. Maybe can you kind of flesh us a little bit more into -- you mentioned some of these kind of new markets and new areas that Smiths is going into that they've not been into before. Could you give us a little more colour there, what are you particularly targeting, certain regions, customers, new products?

**Andy Reynolds Smith - Chief Executive**

Yes. About half of the business is oil and gas and about half isn't. Our market share typically in nonoil and gas versus oil and gas is about half or a 1/3. Now it does differ in different countries and different places. Chemical plants, we're pushing very hard on now, because it's not dissimilar to an oil refinery in the way it works and the demands that it creates. Pharmaceutical is really interesting for us at the moment because the focus on increasing efficiency, getting more out of every dollar of investment in those processing plants is really high at the moment. One interesting area that we're pushing hard on now is in mining as well, which traditionally have been relatively small for us, or a much lower focus. And the guys were out in Australia recently, and we're already starting to make some progress there. The key thing for me is, there are parts of nonoil and gas that aren't as attractive because

typically the demands are lower. The temperatures are lower, the pressures are lower, the aggressiveness of the materials that you're processing is different. So we're really only focused on the things where the demand is high and therefore, it fits the stuff we do and the returns we want to make.

**Robert Davies - Morgan Stanley**

Great. And then just a final one was around, I guess, digital. Particularly with the thought -- you really sort of mentioned, I think, Interconnect being a division historically that people have said maybe it was not as core to Smiths as perhaps some of the other divisions. You mentioned sort of big push and that was kind of core of your digital platform. How do you think about digital now you've got a Chief Digital Officer and kind of that rollout? And I guess, broader question is, do you see the kind of current structure of Smiths as the right structure? We haven't got questions of how do you align these 5 different divisions all on different growth cycles at different times to kind of deliver 3% to 4%. How do you, from a top-down view, view the structure of the group?

**Andy Reynolds Smith - Chief Executive**

Okay. Well, first of all, there are a lot of companies talking about digital transformations now. I think the difference with Smiths is that we -- our model is moving quickly and if I just pick a couple of examples of that. We are not trying to create something. There's no pull forward. So in Detection, we are in a situation, probably 5% of our revenue, 4 or 5 years ago was generated from software. Over the next few years, that will become 30-plus percent. But the sophistication of that software is increasing substantially. The use of artificial intelligence in that software and image recognition is increasing substantially. And it's not surprising because if you think about the good old days when you had someone just staring at a screen hoping to spot something that looked like a gun going past or a knife going past, you now have a thousand and one different examples of things that have to be spotted. It's much more difficult to spot them because you have people taking component parts of explosives and taking different bottles and different bags. So this is really now down to spotting molecular density in different places and correlating it with six different bags that might have gone through half an hour apart, but to the same destination. So the AI bit, it's just simply verging on impossible now for people to do it. Similarly in Medical, the digital environment links to electronic medical records. The real-time changing of delivery based on your vitals at any particular time and what it should be is changing so quickly. And with it, of course, the data security implications, I mean, I wouldn't have to explain the data security implications in airports and hospitals, of course. We have got about 400 software engineers across the group, but the concern was that they were in pockets, so we have people working on AI. We have people working on data security, split across divisions. So the aim of creating the centre of excellence approach through the forges is to bring that together. Really create critical mass in some of that thinking to drive us forward overall. As regard to Interconnect, I mean, Interconnect is really about high-speed secure connectivity in really demanding environments. Now when you apply that to aerospace, space, medical, that's the stuff that we really wanted to be focused on, not competing in your run-of-the-mill type connectivity and electronics. And that was what the refocusing of the whole Interconnect business was really about. As far as the portfolio overall, we are driving to get five growing, five competitively differentiated through operational execution and innovation with the best people. But

at the same time, we continue to very carefully consider the pieces of the business that are of a higher risk of execution, are further from a top-3 leadership position, which is our objective. So that we can prioritize the way we invest and the way we think about realizing the value of the assets. So I won't go to the overall shape, but you can take from that, that we're thinking about things carefully.

**Sandy Morris** - Jefferies

A real dumb question, what was actually the R&D charge in the first half?

**John Shipsey** - CFO

So the total R&D is disclosed. It's around GBP 70 million.

**Sandy Morris** - Jefferies

Yes. And then you capitalize less and presumably amortize more. So half-on-half, I'm pretty damn convinced that your R&D charge went up.

**John Shipsey** - CFO

Sorry. Our R&D expense actually dropped in -- slightly in absolute terms. It's disclosed in there.

**Sandy Morris** - Jefferies

I know somewhere it is, but I couldn't find it.

**John Shipsey** - CFO

It's in the -- it's actually in the press release, so under financial review. So the group invested GBP 70 million in R&D. Off of Page 11.

**Sandy Morris** - Jefferies

That's the expense as well because you then capital...

**John Shipsey** - CFO

That's the invest -- sorry. That's the investment.

**Sandy Morris** - Jefferies

Yes. Because you then capitalize a chunk, but you capitalize a lot less this time plus the amortization must have gone up.

**Andy Reynolds Smith** - Chief Executive

Plus customer funded.

**Sandy Morris** - Jefferies

Yes. I'm trying to sort of flutter around with that, but my impression is that the R&D expense has actually gone up for the group in the first half, not down. I get the spend is down. I just can't actually find the R&D charge number somewhere.

**John Shipsey** - CFO

I don't think we disclose that. So...

**Sandy Morris** - Jefferies

Cool. That's why I always read the financial review very carefully. And this restructuring thing is slightly sort of not upsetting me, it's just I can't quite get it straight because a big chunk of that was Fuel for Growth and that was GBP 33 million last year. I'm assuming the GBP 19 million that you've now decided is underlying is all really Fuel for Growth.

**John Shipsey** - CFO

No. That includes GBP 4 million of pension admin costs.

**Sandy Morris** - Jefferies

Yes. But the GBP 15 million that's restructuring is all Fuel for Growth?

**John Shipsey** - CFO

Correct. For the first half of '17, that's correct.

**Sandy Morris** - Jefferies

And you still think you're going to have GBP 15 million of restructuring cost?

**John Shipsey** - CFO

For the full year, not for the half.

**Sandy Morris** - Jefferies

For the full year. Right. So it begins to wash through basically, and stops distorting things.

**Andy Reynolds Smith** - Chief Executive

But I would add, Sandy, that when changing the treatment, we want to continue and are doing the right things in the business to position it, restructure it as necessary. What we didn't want to do is continue with a large chunk that was taken below the line. So, for example, in Interconnect, in the first half, as part of completing current restructuring, we continue to do things that weren't categorized in the fuel for growth, although there is still some tail of that.

**Sandy Morris** - Jefferies

Yes. I mean, there is just a slight risk that you hide your light under a bushel a bit, but that's all, I think, by being a bit too straight.

**Andy Reynolds Smith** - Chief Executive

I don't want to do that, Sandy.

**Sandy Morris** - Jefferies

And then, sort of, silly things. I mean, if military revenues and Detection went down GBP 34 million. I mean, that's all of the underlying decline more or less, give or take GBP 1 million.

**Andy Reynolds Smith** - Chief Executive

We were up 8% in 2/3 of the business. Ports and borders was also down due to contract phasing on some of the big port projects. But it's a big piece of it. Absolutely.

**John Shipsey - CFO**

Yes. [Just downsize] if you strip out Detection, the rest of the business was up, I think, 2%.

**Sandy Morris - Jefferies LLC**

Yes. Just kind of different way of pitching it, if you wanted to be. And then another, sort of, slightly odd question. When you're managing Medical and I go through last year's products, ups and downs and then this first half's products ups and downs, and they're still going all over the shape. I mean -- so hardware pumps is still -- was down, down.

**Andy Reynolds Smith – Chief Executive**

Yes.

**Sandy Morris - Jefferies**

And other things like PIVC catheters were up and are now down. And it's difficult to, sort of, look at the new products that are coming and saying, yes, there is the impact apart from in sharps, which turned around.

**Andy Reynolds Smith - Chief Executive**

Yes. Sharps slightly was up.

**Sandy Morris - Jefferies**

So, how the hell do you manage it month-to-month, if you're trying see how these launches are working?

**Andy Reynolds Smith - Chief Executive**

Well, we've got a very granular view of that as you would imagine. But I think you'd need to take it a step further, the 23 products that we're launching are actually product families as well. And I think, you might recall from the Capital Markets Day that this curve of something moving up and another one building on it, we had some disconnect. So what you're seeing at the moment is a new product or an old product running down, a new one coming in sometimes with a little bit of disconnect. So it's not just replacing it on day one from where it should have been. So it does need a lot of attention to manage, but we are extremely confident with what we are seeing in that trending that we're back in growth in the second half, and we'll be for the year, and then that momentum goes into next year. But it's a lot of launch to manage, but it's not an unusually large amount versus where we should be, to be the innovation leader in that business.

**Sandy Morris – Jefferies**

I don't mean to (inaudible) just as a layman, at a granular level, it's a bit difficult.

**Andy Reynolds Smith - Chief Executive**

Yes. And I think if you look at -- we were very strong in infusion, consumables and disposables, which is always the great measure on infusion because it correlates directly with your installed base. Part of it is dedicated sets that go with a pump, for example. Part of it is stuff that just gets used and thrown away for every patient or every treatment. So that's an important litmus test always of infusion because the

infusion hardware does tend to be a big hospital buying a 1,000 pumps and those things can be a little bit more lumpy. So I suggest the thing to look out always is, how we are doing on consumables -- consumables and disposables. Thanks, Sandy.

Well, beaten everyone to death. Well, I really appreciate you taking the time and listening. I hope you can hear from the way we've been expressing ourselves, we're feeling really confident that the second half is in growth. The year as a whole is in growth, and that you can see the trends within each of the divisions that support that. But more importantly, position us for continued momentum in 2019. So thank you very much. Have a great weekend, everyone. Much appreciated.