Smiths Group PLC Half Year Results FY2024

Tuesday, 26th March, 2024

Opening Remarks

Paul Keel

Chief Executive Officer, Smiths Group

Good morning, everyone, and thanks for joining us. As we typically do, I will provide a short recap of our first-half results and then turn it over to Clare, to walk us through the numbers. I will come back and update you on our progress with respect to strategy and operations, and then we will open up for your questions.

Before we get to results though, let me say a few words about today's announcement regarding our CEO transition. As you will have seen, I am leaving Smiths to take a new role in the US, and our board has appointed Roland Carter as my successor. The last three years have been a period of strong progress for Smiths. We completed a transformative portfolio action in FY22. We delivered record performance in FY23 and we have now posted 11 consecutive quarters of growth with, as we will cover in just a moment, significant momentum for the second half of FY24 and beyond. Roland is the right leader to build on all this momentum.

Clare and I will cover results in Q&A today, but I did want to take this opportunity to introduce and personally congratulate Roland. Roland, over to you.

Roland Carter: Thank you very much. Hello, I am Roland Carter. I am delighted to have been appointed as CEO of Smiths Group. I am a chartered engineer, and I have been at Smiths for over three decades. In this time, I have had the opportunity and the privilege to lead many parts of this company. This has enabled me to develop an in-depth operational and strategic understanding of Smiths and its fundamental growth drivers. For the past six years, I have been president of Smiths Detection. Prior to that, I was president of Smith Interconnect and Asia Pacific. I have worked for Smiths in the UK, China, France, Germany, and several other places, and I am responsible for some of the acquisitions that form part of Smiths and also for some of the divestments that have reshaped us. Smiths is a fantastic business with great people and a wonderful culture. It has a hugely exciting growth potential.

I would like to thank Paul for all he has done for Smiths. We are making great strategic progress and our operational and financial performance has improved, with Smiths well-positioned to deliver on its significant potential. Thank you.

Paul Keel: Thank you, Roland. And again, congratulations. Okay. Having covered the CEO transition, let us now turn to our first-half results. I will open with a short recap of our first-half performance before turning it over to Clare to walk us through the numbers. I will then come back and update you on our progress with respect to strategy and operations, and as always, we will have plenty of time at the end for Q&A.

HY2024 – Solid growth, building on a record year

Growth

We delivered 3.9% organic revenue growth in the first half, building on a record year in FY23. We have now posted our 11th consecutive quarter of growth, extending our track record of consistent performance. Driven by strong underlying demand in energy security and aerospace, our orders grew 16.5% in H1, providing good momentum for the second half and beyond.

Execution

Our execution focus and Smiths' Excellence System are delivering further tangible benefits. Organic operating profit increased over 5%, resulting in a 20 basis point increase in operating margin and a 50 basis point improvement in ROCE. Our balance sheet remains strong, and cash flow is much improved. Operating cash conversion increased 26% points to 89% and free cash flow more than doubled. As such, we increased our dividend by 5% and have announced a new £100 million share buyback programme.

People

With respect to people, we continue to actively develop our global talent. For example, we more than doubled our investment in leadership development, and our wave one cohort of Black Belts and Master Black Belts are now completing their assignments and re-entering into high-impact leadership roles across our company, backfilled by an even larger cohort of wave 2 talent.

We are also continuing to make good progress on advancing our sustainability strategy as the Science Based Targets initiative, SBTi, validated our Net Zero targets and plans last December. In support of our communities, I mentioned the launch of our new Smiths Foundation on our FY23 call in September. I am now excited to share that we are making our first wave of grants in support of charitable causes that link to our purpose of improving our world through smarter engineering.

In summary, we are off to a successful start in fiscal 2024 and carry strong momentum into the second half, and as such, we are reaffirming our full-year guidance of 4-6% Organic revenue growth, with continued margin expansion.

Smiths Value Engine

You are familiar with our Smiths Value Engine, which connects the three components of our success: our purpose, our strengths, and our priorities. For today's presentation, we have also added our financial commitments to the slide to illustrate how our strategy is purposefully shaped to deliver the financial commitments we make to all of you. Let us turn to those now.

Sustained progress against our medium-term targets

Clare will provide details on each of these in just a moment, so I will just hit the high points. It was yet another period of strong, well-balanced performance for Smiths, 4% organic top-line growth and 6% with M&A, good operational execution, turning this into 4.5% EPS growth, or 11% on a constant currency basis, and improved capital efficiency, resulting in a significant increase in operating cash conversion and more than doubling free cash flow. As all of you know, when this business grows, as it has now for 11 straight quarters, it generates a lot of profit and cash.

And with that as an overview, I will hand it over to Clare.

HY2024 Financial Results

Clare Scherrer

Chief Financial Officer

HY2024 – Growth across all key metrics

Thank you, Paul. As previously mentioned, organic revenue growth for the half was 3.9%. Acquisitions added 2.2%, and there was a negative 5.4% FX impact, bringing reported growth to 0.7%. We grew our operating profit to £246 million, up 5.3% organically, and we improved margin by 20 basis points while at the same time investing for growth. This operating profit growth, combined with the net impact of the previous share buyback programme and FX, contributed to EPS growth of 4.5%. We increased cash conversion by 26 percentage points to 89%, with improvements in working capital. ROCE was up 50 basis points to 15.7%, reflecting increased profitability. In line with our progressive dividend policy, we are announcing a 5% interim dividend increase. And I am also pleased to announce a new share buyback programme of £100 million. We launched the initial tranche of up to £50 million to be completed by the end of September.

Building a track record of consistent growth

We continue to extend our track record of delivering growth, now having grown revenue on an organic basis for 11 consecutive quarters, with growth in the first half against strong comparators last year. Notably, eight of those quarters were in or above our medium-term target range. H1 performance reflected growth in our two largest divisions, John Crane and Detection, and was delivered despite softness in certain end markets at Flex-Tek and Interconnect. Our portfolio helps provide resilience when end-market performance is variable, underpinning a more consistent growth performance for Smiths.

Moderate operating margin expansion

We converted revenue growth into 5.3% organic operating profit growth. On the positive side, acquisitions added 10 basis points and pricing more than offset inflation, leading to a further 20 basis point expansion. Benefits from the Smiths Excellence System, together with the 2023 savings projects, added 130 basis points. Volume in John Crane, Detection and Flex-Tek together contributed 100 basis points. The market-driven sharp volume contraction at Interconnect compressed margin by 80 basis points. To support the elevated activity at Smiths Detection, we invested in additional field service engineers, increasing the number of engineers by 11%, and this impacted margin by 30 basis points. We also invested 120 basis points to support future growth, primarily in John Crane, reflecting additional hiring and operations, together with increased spending on marketing and systems.

In summary, we delivered a 16.3% operating profit margin, a 20 basis point expansion and in line with our full-year guidance for continued margin improvement.

Delivering EPS growth

For the half, the primary drivers of EPS growth were growth in operating profit and the benefit from our previous share buyback programme. FX netted EPS growth down to 4.5%. However, on a constant currency basis, we delivered 11.3% EPS growth.

Improving cash conversion

Cash conversion in the first half was 89%, a 26 percentage point increase from last year, driven by working capital improvement. Our medium-term target is 100% cash conversion, and we looked to make further improvements in the second half toward this level. We increased CAPEX 5.6% to £38 million, representing 1.5 times depreciation. This included capacity expansion and investment in automation at John Crane. Finally, operating cash performance translated to £112 million of free cash flow, more than doubling year-on-year.

Business Update

John Crane – strong organic revenue and operating profit growth

Now, turning to each of the divisions. John Crane delivered organic revenue growth of 12.7%, with a particularly strong performance in the first quarter, and this was against a strong comparator last year. Growth was broad-based by end market and in both original equipment and aftermarket sales. This revenue growth translated into strong operating profit growth and 110 basis points of organic margin expansion. Pricing discipline offset the impact of cost inflation, and SES also drove performance. And we delivered this margin progression while also continuing to invest in growth to service the strong demand we see now and in the future. This encompasses additional hiring and operations to support the strong growth, together with increased spending on marketing and systems. Order intake grew 10.9% in the half, and the sustained high order book supports our positive outlook and expectation for continued growth through the second half of the year. John Crane is playing an increasingly important role in helping our customers improve efficiency and reduce emissions from their operations and is now present in more than 100 hydrogen and carbon capture projects. We will talk later about some of these recent contract wins.

Smiths Detection – significant growth in order book

Smiths Detection delivered strong organic revenue growth of 8.9%, with growth in both aviation and other security systems. In aviation, we continue to have strong demand for our CT airport checkpoint scanners, and we continue to secure new contracts, with multiple wins across the globe during the first half. We estimate that the industry is only about 40% of the way through the checkpoint upgrade. Importantly, these OE sales secure an attractive aftermarket for us that we expect to continue to contribute to margin expansion over the medium term. In other security systems, aftermarket revenue growth was particularly strong at 34%. We expect growth overall to remain strong in the second half.

Operating profit growth was 10.3%. Margin expanded by 20 basis points, reflecting the positive benefits of SES and cost actions and the investment we made in increasing our field service engineering team by 11% to support our record activity. Orders were up more than 38%. Order intake in defence was particularly strong, driven by a multi-year contract for an initial £88 million award from the UK Ministry of Defence for the next generation of chemical detection equipment. This followed an earlier award from the US Department of Defense to supply chemical agent detectors. Orders in Detection are for multi-year deliveries, with around a third of the order book expected to contribute to revenue this year.

In summary, Smiths Detection is delivering on its growth potential, and we believe SES benefits, increasing aftermarket revenue, and the impact of new contracts will support margin expansion in the coming years.

Flex-Tek – soft construction market impacting growth

Now let us look at Flex-Tek where revenue declined 4.1% organically. Flex-Tek's industrial segment declined 7.6% in the first half, as expected, mainly in HVAC and due to soft US residential construction. Offsetting this, aerospace sales grew more than 12%, linked to new aircraft builds. Despite the overall lower sales, organic operating profit increased 2.6%, and we expanded margins by 140 basis points. The margin expansion resulted from tight cost control plus positive mix impacts reflecting new industrial contracts. This was supplemented by the contribution of HCP, the acquisition we made in Q1, where integration is ahead of plan.

Looking forward, we expect our HVAC sales to improve as the US construction market recovers. Combined with continued strong aerospace sales, we anticipate that Flex-Tek will return to growth in the second half of the year.

Smiths Interconnect – quarter-on-quarter momentum, with orders returning to growth in Q2

Turning now to Smiths Interconnect, organic revenue contracted 13.7% in the first half as a result of challenging semiconductor and connector end markets, although importantly the market backdrop improved through the half. In Q1, Smiths Interconnect had double-digit organic revenue decline, and in Q2 this improved to flat. Order activity has also improved. We had order growth in the second quarter, and we now have a positive book-to-bill ratio. Reflecting lower sales, organic operating profit declined by a third, resulting in an operating margin contraction of 370 basis points. Despite the challenging first half, we maintained R&D investment to support our new product pipeline, with recent product launches in medical, space and defence markets. Our orders have returned to growth, and the market backdrop is showing signs of gradual improvement, underpinning our expectation for an improved second half and underscoring our confidence and our medium-term outlook.

Capital allocation

Organic investment

Now to our capital allocation framework. Our first priority is to support organic growth, and we invested £83 million in R&D and CAPEX in the first half.

Portfolio changes

We supplement organic growth with strategic acquisitions, and we have spent £90 million on three bolt-on acquisitions since the start of 2023, most recently Flex-Tek's acquisition of HCP, which we announced in the first half. We will maintain a disciplined approach as we actively look for further additions to complement our portfolio. At the end of the first half, we sold around a third of our stake in ICU Medical, raising almost £70 million, and have flexibility on future monetisations.

Returns to shareholders

Our third priority is returning capital to our shareholders, and we are increasing our interim dividend by 5%. And given the strength of our balance sheet, we are also announcing a new £100 million buyback programme with an initial tranche of up to £50 million to be completed by the end of September.

Our leverage at the end of the half was 0.9 times net debt to EBITDA, so we have the strength and financial flexibility to execute our growth strategy and to continue to deliver against our medium-term financial targets.

H2 outlook reaffirms our FY guidance

Finally, with respect to our guidance, we are well-positioned for the remainder of the year. With record order books at John Crane and Smiths Detection and expected gradual market recovery in semicon and US construction and our new product pipeline, we expect growth to improve in the second half, and we reiterate our 4-6% organic growth guidance. We also expect to see continued margin expansion.

With that, I will hand back to Paul.

Operational Update

Paul Keel

Chief Executive Officer, Smiths Group

Thank you, Clare. I will now give an update on some of our strategic and operational progress, beginning with growth.

Growth – market update

Building on what Clare said earlier, underlying demand remains strong in three of our largest end markets, energy, security, and aerospace, while two other markets, construction and semiconductors, contracted in H1.

John Crane

In the interest of time, I will touch on current dynamics in just one end market for each business, beginning in the top left, with energy, for John Crane. Energy was our fastest-growing market in the first half where we grew 17%. Energy volume is a key metric for John Crane as it determines capacity needs for our customers, which in turn drives demand for both OE and aftermarket services for our products. As you can see from the chart, energy output continues to climb steadily, a trend we expect to continue throughout the second half and beyond.

Flex-Tek

Moving counter clockwise to Flex-Tek, in the lower left, our construction sales in H1, around 15% of total Smiths were down 10%, consistent with the housing start data that you see here. We track a number of indicators in this part of our business: housing starts permit applications, mortgage rates, builder confidence, etc. And some of these factors, for instance, housing permits and builder confidence, are trending positively. Others, however, like US mortgage rates, still have further to go before a sustained construction uptick can confidently be expected.

Now, as Clare mentioned, in total, we expect Flex-Tek to return to growth in H2, behind continued momentum in aerospace and industrial electrification, alongside gradually improving conditions in HVAC.

Smiths Interconnect

Moving to the lower right, you see semiconductor market growth over time. Semi-test represents just under 3% of group sales, and after bottoming out in the spring of last year, this market is now showing signs of recovery. As such, we expect semi-tests specifically, and Interconnect more broadly, to also return to growth in the second half.

Smiths Detection

Finally, for Detection in the top right. Revenue passenger kilometres, one important metric for our business, were up almost 30% in the half. Regulatory mandates are another important driver, such as required checkpoint CT upgrades, which are underway across the globe and of which I will say more in just a moment. The strength of these and other dynamics underpin good ongoing growth for Smiths Detection.

One final item to note on this chart is the clear benefit that comes from a balanced portfolio. H1 softness in Flex-Tek and Interconnect was more than offset by strength in John Crane and Detection. You will remember that the exact opposite took place in FY22 when Flex-Tek and Interconnect both grew double digits while Crane and detection were still recovering from COVID. With a well-balanced portfolio – balanced by market, balanced by geography, and balanced between OE and service – we are now demonstrating that we can deliver profitable growth as well as stability.

Growth – H1 progress against long-term megatrends

Let me now say a few words about our near-term progress, accessing longer-term megatrends.

Energy transition

Energy transition describes the world's multi-year, multi-trillion dollar commitment to moving from fossil-based to low-carbon fuels. As we covered in some detail at our H1 capital markets event, John Crane is uniquely positioned to support our customers along this journey. We continue to see strong growth in this part of our business with a number of new contract winds in H1, two of which you see here. On the top left, a contract to supply dry gas seals for critical compressors in a large-scale blue hydrogen project in Texas; and in the lower left, a significant contract to supply wet seals for an electric battery facility in Tennessee. The scope and diversity of these wins further demonstrates the breadth and depth of John Crane's capabilities in energy transition.

Insatiable data demand

With respect to supporting the world's insatiable demand for data and connectivity, Smiths Interconnect is similarly well-positioned. Our orders in satellite communications grew double digits in H1. Further bolstering momentum here, we received a £2 million grant from the UK Space Agency to expand our space qualification lab in Dundee, Scotland, a major satellite manufacturing hub for Europe.

Ever-rising security needs

On the right side of the chart, Smiths Detection plays a central role in protecting our world from ever-rising security threats. During H1, we secured two awards to develop and supply next-generation chemical detector systems, one from the US Department of Defense and the other from the UK Ministry of Defence. These multi-year awards will contribute accretive growth in H2 and beyond.

As mentioned on the previous slide, mandated upgrades of airport security checkpoints are now well underway. 40% of the roughly 6,000 checkpoints around the world have thus far ordered new machines. Smiths Detection has won more than half of all awards, and we were particularly active in H1. These are just a few of the many growth programmes underway across our company.

Growth – organic investment and acquisitions support geographical build-out at Flex-Tek

At our Capital Markets event in 2022, we discussed our strategy of building Pan-North American coverage for our highly successful HVAC business headquartered in South Carolina. This is a great business for us, one where geographic proximity to customers is especially important due to freight costs, cycle times, and regional product differences. The first step in our expansion several years back was opening greenfield locations in Florida and Arizona, two of the fastest-growing states in America. In 2021, we acquired Royal Metal Products in Georgia, another fast-growth state, further bolstering our position in the southeast. In 2022, we opened our third greenfield site in Texas, strengthening our coverage in yet another top-10 housing market. Earlier this fiscal, we acquired heating and cooling products in Ohio, a market leader in important Midwest and Northeast states.

While we are now able to competitively serve customers across North America, we will continue to look for additional organic and inorganic opportunities to deepen our penetration in markets where our customers need us most.

Execution – SES in action

Having covered a few of the many growth initiatives underway, let us now turn to execution, where our Smiths Excellence System is at the core of our strategy. As we did on the full-year call, today, I will share another example of SES in action, this time in Smiths Interconnect. Let me quickly set the stage.

In partnership with a major global healthcare customer, we designed a custom medical connector, leading to a £10 million contract. As the size of the programme necessitated more than a tenfold increase in line capacity, we charted a Black Belt project to map the value stream, optimise line layouts, and implement visual management systems, enabling our team to respond in real-time. The results of the project have been encouraging for both our customer and for Smiths. This project delivered a five-point improvement in gross margins and a follow-on order, for an additional £4million, with line of sight to still more opportunity down the road.

Let us now hear from Allyssa Skidmore, one of our senior engineering managers.

[VIDEO STARTS]

Case study video: Medical connector scale-up at Smiths Interconnect

Allyssa Skidmore (Senior Engineering Manager): *Smiths Interconnect supplies advanced electronic components and subsystems and optical and radio frequency products for customers requiring reliable high-speed and secure connectivity across many end markets. One end market our connectivity solutions supplies is medical devices, where our products are used in applications ranging from MRI systems to defibrillators*

Lee Keller (Principal Engineer): *As the principal engineer for medical connectors and cables, I was the lead on this important project where we partnered with a leading medical device manufacturer to develop an extension cable for next-generation heart mapping catheters used to map the electrical activity of the heart. Each cable consists of dozens of micro coax cables, each finer than a human hair. Our cross-functional team designed and are in the process of patenting a method that connects each tiny wire in a way that achieves reliable electrical and mechanical performance.*

Oscar Romero (Black Belt): *At the start of the project, we were producing 50 cables per week with an average first-pass yield of 85 per station. Our Black Belt project began by improving the measurement system so we could first understand the baseline state of our production line with high level of position and accuracy. We now achieved this by having implemented an hour-by-hour tracker for each workstation to measure and track output and quality performance. Our team analysed the data and performed a value stream map and process mapping to quantify our current state. And as is value flow, we used a statistical process control to identify the main bottlenecks in our process. Using lean tools including 5S, standard work and kaizens, an optimised line layout has now been established. We have introduced standardised documentation to support our efforts, which the teams audit at the start of each shift. In addition, the cross-functional team participates in daily meetings to build ownership and identify opportunities to continuously improve the process.*

Lee Keller (Principal Engineer): *We now deliver a fully validated and technically superior product within the aggressive 18-month timeline that our customer required. We recognise that the SES toolbox contains great methodologies and tools to support this required expansion, so we initiated a Black Belt project to rapidly scale assembly line output and position us to realise this £10 million annual sales opportunity.*

Allyssa Skidmore (Senior Engineering Manager): *We are currently building at a rate that exceeds 20,000 cables per year, with an average first-pass yield per station greater than 98%. Our customer is delighted and what is more, the capabilities we developed for this programme have positioned Smiths Interconnect to deliver tremendous value to our customers and end-users across the medical field. It is a great testimonial to how SES makes profound difference for us and for our customers every day.*

[VIDEO ENDS]

Paul Keel: Thank you, Alyssa and team. Another 50 or so projects like this are currently underway across the company, and we are on track for £20 million in SES contribution for the full year.

Execution/People – Smiths Excellence Awards: Advancing our high-performing and inclusive culture

Consistent with this, our Smiths Excellence Awards, which we celebrated last fall, recognised distinctive contributions in support of the highest priorities you see here. They are organised around our strategies for growth, execution and people. The Excellence Awards are one of a broad array of initiatives that can continually reinforce and advance our high-performing and inclusive culture. You have seen a marked uptick in Smiths performance over the past three years. The many actions we have taken across this time, for example, strengthening our leadership team, revitalising our new product engine, improving our portfolio, and embedding SES and the Smiths leadership behaviours, are all interconnected building blocks of a much broader, stronger, and more stable foundation for Smiths. It is our culture of continuous improvement that underpins our sustained performance, and it is this foundation that will provide continued success as we move forward.

People - Smiths Group Foundation awarding first grants

I will close my comments on H1 with a quick update on people and culture before wrapping things up, with a look forward to H2. With an eye to supporting all stakeholders, we launched the Smiths Group Foundation last summer. Across the first half of this fiscal, employees from around the world nominated close to 100 different causes for funding consideration, and after a rigorous selection process, the first wave of grants are now being made. We have asked Hannah Constantine, Group Director of Legal Operations and Chair of the Smiths Group Foundation, to say a few words about how we are advancing our purpose and supporting stakeholder success.

[VIDEO STARTS]

Hannah Constantine (Group Director): *I am Hannah Constantine, Chair of the Smiths Group Foundation. We launched the foundation in August, 2023 with an initial commitment of £10 million from Smiths Group. The foundation supports our goal of contributing positively to our communities by providing grants to charitable organisations that align with our purpose to improve our world through smarter engineering. Each year, we aim to donate between £0.5 million and £1 million, with individual grants ranging in size from £10,000 to £200,000. The charities all support causes with activities in three key areas. One, expanding access to STEM education and skills for underrepresented groups. Two, improving safety and connectedness within our communities. And three, improving the environmental sustainability of our communities. Importantly, Smiths employees nominate the organisations that will benefit from these grants, choosing courses that are close to their hearts and within their own communities.*

Now, having reviewed and vetted this first round of nominees with the help of the Charities Aid Foundation, I am excited to announce that we are making our first grants worth around £1m in total. Let me share with you just a few of the organisations that we will be supporting and the impact the grants will have: Inspire, GEANCO Foundation, Palace for Life, and STEMAZINGKids will provide greater access for STEM learning, mentoring, and career support for underrepresented groups in a number of communities. Meanwhile, Just a Drop and Flint Global will support activities to safeguard safety and environmental sustainability.

I look forward to seeing the outcomes and impacts of these first grants and to the many awards we will make in the future. Thank you.

[VIDEO ENDS]

Paul Keel: Thank you, Hannah. Exciting to think about the positive impact that these grants will support.

Double-digit order growth and gradually improving market conditions – reaffirming full-year guidance

Now, just a few comments by way of summary, and then we will open it up for your questions. Double-digit order growth in H1, coupled with gradually improving market conditions, has us well on track to deliver our full-year organic growth guidance of 4-6%. The operating leverage that comes with this, alongside additional benefits from SES and other productivity initiatives, has us reaffirming our guidance of continued margin expansion. And on the back of our strong balance sheet and much-improved cash flow, we are announcing a 5% dividend increase and a new £100 million share buyback. In short, a good start in H1 with even more to come in H2.

Our wonderful people make all this progress possible. I want to recognise my colleagues around the world for doing what we do best, improving our world through smarter engineering. In the same way, we are grateful for the strong support that we enjoy from customers and shareholders.

And with that, I will ask the operator to please open it up for Q&A. Thank you.

Q&A

Lushanthan Mahendrajah (JP Morgan Casenove): Morning, all. Thanks for taking my questions. I have got two, I think. The first is just on margins, and going back to that operating bridge you showed us in terms of both the 80 basis points headwind I think from Interconnect volumes and then the 30 basis points from Detection and field service engineers. How do we think about both those moving parts going forward? Presumably Interconnect, that reversed in the second half, perhaps not fully. And in Detection, how much further you have to go in terms of the field service engineers? Is that going to be an incremental headwind going forward as well or are you done there?

Paul Keel: Morning Lush, thanks for the question. With respect to margins, you asked about Interconnect and Detection, let me take the two in sequence. For Interconnect, yes, your hypothesis is correct. As that business gradually returns to growth here in the second half, margins will gradually return as well. You remember that was an 18% margin business in FY22, and as it gets back to the same volume levels, that same ballpark is about right for what you should expect.

With respect to Detection, we are clearly prioritising growth over margin in that business right now, and that is for two reasons. First, we are as interested in operating profit growth as we are in operating margin for Detection. It has had double-digit operating profit growth, both in 2023 and in the first half, just that the top line is growing so quickly that the margin percentage probably is not as pronounced as you would typically think with that much top-line growth.

The second important thing is the market share piece for Detection. The world is going through an upgrade of all checkpoint systems from 2D to 3D scanners. Those machines will be in service for 10 years, and the gross margin on the service is better than two times what it is on the OE. So, we are pleased with our market share performance there. As I mentioned in my earlier comments, the world is maybe 40% through the total upgrade, and we have won better than half of all tenders. So the NPV of those awards will generate a lot of value moving forward.

Lushanthan Mahendrajah: Okay. Very helpful, thank you very much. And the second one is just on the orders which are very strong in the first half. And for some of these divisions, it is a bit more obvious than the others, but it would be helpful just to get a reminder in terms of the timing of orders and for each division in terms of when that leads to sales. And also particularly for Interconnect and Flex-Tek, what percentage of revenue do you have visibility on an orders. I am just trying to get an idea of H2 and then the underpinning there of that order growth we have seen in H1.

Paul Keel: Yeah, let us see. A couple questions in there. Let me see if I can remember them. The first is orders. We are up 17% in the first half, and we expect roughly half of that to convert to revenue in fiscal 2024. A little bit different business by business. The largest percent of order book conversion, or the shortest cycle time, is in John Crane. Almost all of their double-digit order growth will convert here in fiscal 2024. Probably the lowest number would be Detection. Those are typically multi-year contracts. In particular, the two large defence contracts, those are eight to ten-year contracts. So maybe a third of Detection's record order book will convert in this fiscal. And then it is about half for Flex-Tek and for Interconnect. Let us see. You asked how much of Flex and Interconnect is covered by orders. Roughly a third of Flex-Tek is order driven, and roughly two-thirds of Interconnect.

Lushanthan Mahendrajah: Brilliant. Thanks very much.

Mark Davies Jones (Stifel): Thank you very much. Morning, Paul. Morning, Clare. Can I ask a bigger-picture one to start? Paul, as you plan to depart, firstly, sorry to see you go, but can you tell us any more hints about where you are heading to? Can you give us a little reflection on where you think Smiths is relative to that US industrial peer group operationally? I know you did some benchmarking when you turned up. Where are we now, do you think, because obviously, there is still quite a big valuation gap?

Paul Keel: Thanks for the question, Mark. As I mentioned in my introductory comments, I am going back to the US to lead a US-listed company and doing so principally for personal reasons. I come from a big and close-knit family, and our kids, our siblings, our parents are all in the States, and this is just a great opportunity to be closer to them.

With respect to US versus UK industrials, I took this job, and you and I talked a lot about that when I did because I saw an opportunity for a fundamentally good company to perform at a higher level, in line with Smiths' vast potential. And as I reflect back on the last three years, that proved to be even more true than I imagined at the time.

And my second reflection would build on that. For all Smiths has accomplished over the last three years, I have not a shred of doubt that our brightest days are still ahead. I do not see any meaningful performance difference between the high-performing UK industrials and our peers in the US. I think you are accurate though that there is a valuation difference in aggregate, but there is not in specific. The highest valued UK engineering companies trade at multiples, as good or better than what they would trade in the US.

Mark Davies Jones (Stifel): Thank you. Can I ask one slightly more specific one around Flex-Tek? Very impressive margins there in the period. You talked about mix within industrial. What is driving that?

Paul Keel: Our industrial business is 80% of total Flex-Tek. Of the 80%, two-thirds of that, or 60%, is HVAC, and 20%, or one-third, of it is other industrial. And a big part of that is our process electrification business. So the mix comment we made there would be specific to process electrification. In particular, we talk about the H2 green steel project, that very high margin. The last 20% then of Flex-Tek is aerospace, and of course that is margin accretive as well.

Mark Davies Jones (Stifel): Thanks very much.

Christian Hinderaker (Goldman Sachs): Yes. Morning, Clare, Roland, Paul. Can I just ask firstly, on the Interconnect business in terms of the mix, 19% semi-test, 26% other industrial for the safety, security, and the rest aerospace? I think the semi-test and sat com dynamics may be a bit better understood. Can you just remind us of the technology applications and growth dynamics for the other parts, and then also maybe add some colour on which of those areas drove that sharp inflection in orders in the second quarter?

Paul Keel: You set the table well. Roughly half of all Interconnect is connectors. I will come back to that. Maybe a quarter is sat com, and then a quarter is semi-test. You are also right that the dynamics are well understood. Sat com market, strong double-digit growth and no signs of softening. I spoke about semi semi-test earlier, gradually recovering. We expect it to return to growth in the second half.

Now for the connectors' part, there is a couple different pieces to that. We have an industrial connectors business. A typical application would be rail. Our connectors are good in high-vibration environments. So the connectors between two rail cars is a typical example. That market is still in recovery, up and down. We have a medical connector business that we gave an example of the SES project for. That is going well because of these big contracts that we are winning. And then we have a small defence electronics piece of that as well, connectors that go into those applications, and as you would expect, that market is growing, but they are typically forward-dated contracts.

Christian Hinderaker: Well, I have got two now on the capital allocation, the buyback £100 million, and how we should think about that in the context of the £70 million proceeds from the ICU estate[?] sale. Should we assume that one spurred the other, and how do we think about the remaining equity stake in ICU?

Paul Keel: Clare, do you want to take that?

Clare Scherrer: Yes. So thanks Christian. The decision to initiate a new buyback programme reflects our improved cash conversion and also our commitment to return excess capital to shareholders. So we took that decision looking holistically at our anticipated sources and uses of cash. We took into account firstly our first priority for capital allocation, which is organic investment. [Inaudible] we looked at our anticipated acquisition [inaudible] –

[BREAK IN AUDIO 44.39 – 45.12]

Christian Hinderaker: Thanks, Clare. Maybe just if you could add to that, what are the views here in terms of comfort levels on leverage, I think 0.9 times net debt to EBITDA today? And then in terms of the M&A piece, are there particular priorities across the portfolio that we should be thinking of?

Clare Scherrer: At 0.9 times net debt to EBITDA, we are sitting very comfortably. We feel that that is a balance sheet that allows us to pursue all of the organic and inorganic opportunities that we have in our sight. It is a very comfortable place for us to be. In terms of our M&A pipeline, I would describe that as active and growing. And you have seen the successful acquisitions we have made recently since the start of FY 2023. We deployed £90 million for acquisitions, the largest of which was HCP and Flex-Tek, which is performing ahead of plan. And we are really happy with that integration. We would love to do more acquisitions like that.

Christian Hinderaker: Very clear. Thank you.

Jonathan Hurn (Barclays): Hey guys. Good morning. Just three questions from me. Firstly, I just wonder if we can just come back to the margin bridge for 2024, but take it up to a group level. Maybe Clare, could you just give us a little bit of colour about how would you think on a full-year basis, the impact from mix, from[?] investment growth, and also, what tailwinds on a full-year basis we could see from price, cost and SES?

Clare Scherrer: So when you think about the full year, we reiterate our guidance for continued margin expansion. We will continue to save where we can in order to spend where we want. And that is what you see when you look at the group-level margin bridge. We will continue to achieve more in price than in input inflation. We intend to continue to deliver SES benefits. We have almost 50 Black Belt projects in flight. You saw one of those described here today. That will continue to deliver benefit. We also have the full-year benefit of the savings programmes that we put in place last year.

Then on the other side, we will of course have the benefit of the order books coming through in Crane and Detection and gradual recovery in Flex-Tek and Interconnect, which will improve volume and operating leverage. And as Paul mentioned though, we are going to continue to lean into growth, and that is where you saw the investment in field service engineers for Detection. You also saw the investment primarily in John Crane, in commercial aftermarket support and systems and marketing, because we have momentum, and we want to continue to build that momentum.

Jonathan Hurn: Okay. But just on a basis points' impact, is there going to be any significant difference full-year relative to what we saw in the half-year bridge?

Clare Scherrer: It will not be significantly different.

Jonathan Hurn: Okay. That is very clear. Thank you. The second question was just on, obviously, the defence contracts that you won. I think you alluded to them being mixed beneficial. Can you just talk a little bit about the margins of those defence contracts, please?

Clare Scherrer: Well, we certainly do not talk about margin by contract, but that segment, the defence segment within Detection, is margin accretive.

Jonathan Hurn: Okay. And is that significantly above where the current margin for Detection is in terms of relative for those defence contracts?

Paul Keel: Jonathan, these are chemical detector contracts to develop the next generation of lightweight mobile chemical detector to be used in defence and civil applications. Again, one is with the US DoD, one is with the UK MoD. So the first piece of it is development revenue that tends to be high margin, and then it turns into production units. Those units are also margin accretive to Detection.

Jonathan Hurn: Okay. That is clear. And just finally, maybe on John Crane, obviously, you talked about the order book and most of that being delivered, if not all about being delivered in the second half. If we look to John Crane to next year FY25, obviously, you are coming up against tougher comps. How do we think about that growth of that business? Do you think it starts to slow down towards mid-single digits growth, or do you think next year could be another year of high to maybe double-digit growth for John Crane? Thanks.

Paul Keel: I might say two things. First is we do not see any evidence in the market data that we get, or in our order book, or in our customer behaviour of near-term slowing in that market. Both the traditional energy side and certainly the new energy side are buoyant right now.

With respect to the second half, as I mentioned, half of our total order book for Smiths will convert in FY24, but almost all of the John Crane order book. So we have good visibility to the second half. Rolling into FY25, it is a little early to provide guidance on that. We expect the market to remain strong. We expect John Crane to be accretive to group growth. So if the group is going to be at 4-6%, we expect John Crane to be at the north end of that or a little bit higher.

Jonathan Hurn: Okay. That is clear. Thank very much guys. Thank you.

Andrew Douglas (Jefferies): Morning, guys. Three questions for me please. Can you talk about the broader investments in the group? You have got 30 basis points and then a 120 basis points headwinds this year. We have got Flex-Tek recovering clearly, and we have got John Crane. Hopefully[?] what you are saying is wrong[?]. Is this business under invested? What the rationale behind putting 150 basis points of cost into this business? Or is it [inaudible] and last year?

On the cash flow, can you just talk about the building blocks for getting towards 100%? You doubled your cash flow, which is a good improvement in the first half against a low base. But can you just talk about how we get to that 100%?

And then lastly, on the M&A buyback debate, the buybacks are less than 2% of your market cap, you have probably got over £1 billion of firepower, yet you appear, Clare, to be talking about more bolt-ons in terms of future M&A. Is that right? Or is there any, maybe not transformational, but large-scale M&A that could be happening? Otherwise, I do not quite understand the £100 million. Thanks.

Paul Keel: All right, Andy. Let me take the first one, group growth. I will let Clare to handle cash flow, and then you called it a debate between M&A and buyback. I am not sure there is a debate. I think our allocation strategy is clear, but I will let Clare answer that one. Investments in growth, the answer to your question is embedded in the question itself. Market demand is so strong in 70% of the company right now, in John Crane and in Detection and in the aerospace part of Flex-Tek, that I think we would be silly not to be in investing in that growth. All of these businesses have a combination of an original equipment and a higher margin aftermarket component to it. And capturing share now from an NPV perspective is the easiest maths you will run. So taking advantage of that opportunity, to us, seems like a value accretive decision. That is why we are doing it.

Andrew Douglas: Does that continue into 2025, Paul?

Paul Keel: Will that continue into 2025?

Andrew Douglas: Yeah.

Paul Keel: If the market dynamics continue to give opportunity, we will continue to prioritise growth. And along with that comes not just top-line growth, Andy, but the operating profit growth. Over the last three years, the company has a compounded annual growth rate of operating profit of 14% alongside the 7% CAGR on organic growth. So we are getting strong top-line growth and converting it to even stronger profit growth. We are very pleased with that dynamic.

Andrew Douglas: Okay.

Clare Scherrer: And then Andy, in terms of your other questions, as we look to the second half, we do have the opportunity to continue to improve working capital. We also specifically have the opportunity to improve inventory and our inventory turns. That is why I said that we do believe as we go to the second half, we will continue to improve upon the 89% operating cash conversion.

From an M&A perspective, primarily what we look at are what you would describe as bolt-ons, consistent with what we have done in the past, most recently HCP and Plastronics. Of course, we look at opportunities for all of the divisions across all geographies. We are always looking to see if there are new technologies that enhance our core or strengthen us in adjacencies. We do, of course, look at larger opportunities when they come along, but our primary focus continues to be on bolt-on opportunities.

And then finally, in terms of your question around the balance sheet, prior to the sale of Medical, we ran the balance sheet at around 1.5 times leverage. We are now at 0.9 times, so we have ample headroom if we were to find an interesting and larger acquisition. However, right now, it is a very comfortable place for us to be. It allows us to execute on what we have consistently communicated as the priority ranking, organic first, M&A second, and then returning excess capital to shareholders.

Andrew Douglas: Okay. Thanks very much, and good luck, Paul, with your next venture.

Paul Keel: Thanks, Andy. Okay, well, thanks everyone, for tuning in today. As we mentioned, we are pleased with the start to FY24, good top-line growth, again, converting to even higher EPS growth on a constant currency basis. And the very strong order growth in the first half leaves us confident of continued margin expansion and acceleration in the second half, causing us to reaffirm guidance of 4-6% for the year.

So with that, well, thank you for your kind attention and we will leave it at that.

[END OF TRANSCRIPT]