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ANNUAL RESULTS 2015/2016

FULL TRANSCRIPT

SLIDE – ANNUAL RESULTS 2015/2016

SLIDE – DISCLAIMER

Andrew Lappin ***- Smiths Group plc - Director, Corporate Affairs***

Good morning, ladies and gentlemen, and welcome to the annual presentation for Smiths Group. My name is Andrew Lappin. I'm the Head of Corporate Affairs here.
(Conference Instructions).
A quick look at our disclaimer slide, and I'm pleased to introduce our Chief Executive, Andy Reynolds Smith.

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

SLIDE – AGENDA

Morning, everyone, and great to see everyone. A very warm welcome to our annual results. My first year in the job finishes today and continues today.

I can tell you it's been quite a year for me, including numerous jokes, endless jokes from my children about Mr. Smith at Smiths, which I've got to say is getting a little bit thin now.

But I'm delighted to be here. I'm joined by Chris O'Shea, our Finance Director, and I'm also pleased to say that we have two of our non-executive directors, Bill Seeger and Anne Quinn sitting at the side there.

I'll start this morning by taking you through the business performance highlights for the year, and then I'm going to hand it over to Chris for the financial review. Then, I'd like to come back and talk to you about our strategy, laying the foundations for future value creation through stronger growth, improved competitiveness, more consistent execution, and a better-focused portfolio.

SLIDE – BUSINESS REVIEW

SLIDE – FULL YEAR HIGHLIGHTS

Let's start with the business review.

Smiths delivered a very robust performance this year. Reported revenue and headline operating profit grew in four out of five divisions.

On an underlying basis Group revenue of GBP2.9 billion declined 2%; and headline operating profit of GBP510 million declined 4%, with positive performance in most of our divisions more than offset by John Crane.

We delivered good margin growth in our medical, detection and interconnect divisions, and a stable margin in Flex-Tek. Against a backdrop of some of the toughest global energy markets in many years, John Crane's margin declined, but to a still very resilient 21.9%.

Despite the tough headwinds John Crane remains our highest margin division, and I'm pleased that the quality of this business continues to show through in this year's results.

Overall, the Group headline operating profit margin was 17.3%, down 40 basis points.

I've spoken before of the importance that I attach to free cash flow and improving it on a systemic basis throughout the Group. We saw some of the early results of our actions with cash conversion of 102%.

For me, another highlight of the year was being able to announce the proposed acquisition of Morpho Detection, a super business and a great strategic fit with Smiths detection. The deal, as you know, is subject to the usual regulatory clearances, which are progressing as expected, and we continue to anticipate completion in the first half of 2017.

Now let me take you through the performance of each division during the year.

SLIDE – JOHN CRANE

John Crane's underlying revenue declined 10% primarily driven by challenging conditions in global energy markets. Oil and gas represents nearly 60% of John Crane's revenue, with 40% coming from other sectors like pharma, chemical and paper. This gives us a broader range of exposures, and increasing this focus in other sectors and verticals is a key focus for the business in the future.

John Crane's other source of resilience is that 60% of the sales that come from aftermarket products and services. Aftermarket revenue for the year declined 4% on an underlying basis. That rate of decline moderated slightly in the second half when aftermarket revenue was down only 2%, but this was against a weaker comparator period.

John Crane continued to invest in the aftermarket business and signed multiple agreements with customers around the world, including Valero, Shell, BP and BASF.

First-fit revenue declined 16%, primarily driven by reduced volumes across most geographies. We also continued to invest through the cycle in strategic first-fit projects in order to expand the installed base to develop John Crane's position in the future.

Key wins in first-fit included Mitsubishi, Siemens, and Weir, and after a large project order last year, John Crane delivered 600 seals and systems for the massive clean fuels project in Kuwait. However, we do continue to see delays in first-fit oil and gas projects globally.

Overall across first-fit and aftermarket, pricing was broadly neutral, but we do have a very cost-conscious customer base, so we've acted decisively throughout the year to increase our manufacturing and service efficiency, and to cut the fixed cost base of the business. Headcount was reduced by more 400 in 2016.

Our object has been to strengthen John Crane during these challenging times so that we're better positioned to take advantage of the market recovery as it occurs.
We've continued with our progress on prognostics and condition monitoring technologies too, with a further nerve centre installation planned in a major oil refinery in the next few months.

You'll also have seen that on Friday, we announced the disposal of our artificial lift business. This provides sucker rods for onshore upstream oil and gas. It's a good little business, but suffering from tough market conditions. It has little synergy with the John Crane business overall, and limited potential to differentiate from a technology perspective and achieve market leadership.

I'm convinced this business will progress in its new home, just as I expect there will be other examples of this approach across the portfolio as we actively manage and focus ourselves to position better for long-term growth and market leadership.

Now let's take a look at Smiths Medical.

SLIDE – SMITHS MEDICAL

Underlying revenue grew 1%, with a strong performance from Vital Care in trach tubes and bronchial hygiene products. Infusion systems revenue was flat against a very strong prior year for sales of portable infusion pumps, although we did see increased sales of disposables from our installed base of pumps. As a reminder, every pump we sell typically leads to five to seven years of annual recurring revenues, including software updates and consumables.

As expected, vascular access revenue was broadly flat, but we're making good progress with our significant investment programme to refresh and reinvigorate this segment as we seek to enhance our overall pump to patient offering.

Headline operating profit grew 7% year on year, with margins increasing 160 basis points to 21.4%. This reflected the benefits of improved productivity, restructuring activities and strong cost control.

Our focus on increasing sales in Asia also continued to bear fruit, with growth in China and India of 22% and 21% respectively. The growth in China was supported by the launch of a brand new pump product in the Graseby franchise. It was actually developed at our technology centre in Shanghai in close cooperation with our global R&D staff. This is precisely the sort of joint working that will help us improve the speed of new product introduction in this important part of the world.

We also opened medical's new global headquarters in Minneapolis. It's a fantastic facility. And right at the heart of the building is our world-class R&D labs that we're going to need to support our global expansion plans.

R&D investment in medical increased to 6% of sales, along with a better, more focused product development process, and this increased investment will result in a strong new product pipeline.

Now let's turn to Detection.

SLIDE – SMITHS DETECTION

Smiths Detection had a very strong year; underlying revenue growth of 9%, operating profit growth of 20%, and an improved margin of 13%, up by 110 basis points.

As we all know the security threats the world faces keep evolving, and detection has an important role to play in anticipating and addressing these global challenges.

Revenue in transportation fell 6% as airport build and refresh activities went through their expected cycle, but sales were strong in Europe and the Middle East.

As well as deliveries for major customers like Heathrow and Abu Dhabi Airport, we won new business in Saudi Arabia and Egypt. And today, I'm delighted to announce the first sales of eight of our XCT systems and 30 image stations to Berlin's brand new Brandenburg Airport. It really is cutting-edge technology that uses high resolution x-ray and computer tomography and advanced detection algorithms to deliver exceptional levels of security to the latest regulatory standards.

Revenue in ports and borders grew 75% on an underlying basis thanks to a revised product offering and big programs in Indonesia, Nicaragua, Kuwait, and for the US Customs and Border Protection agency.

Military revenue was up 9% as we continued to have success with our chemical and rad-nuke detection equipment.

Critical infrastructure revenue growth of 13% was driven by new business wins like the recently announced $65 million five-year contract with the US Federal Protective Service providing x-ray systems for government buildings across the country. We've also captured more aftermarket sales for this piece of the business.

For the division as a whole, aftermarket sales now account for 37% of revenue. That's more than double where it was just a few years ago, and this continues to be an important focus for us, ensuring that we're building customer attach rates with service contracts, and updates for image libraries, and advanced detection algorithms as new threats emerge.

Good progress was also made on robust program execution and lean manufacturing initiatives right across the business. This is one area with material opportunity for us across the Group, and I'll talk more about this later.

As I said at the start, I'm convinced the agreement to buy Morpho Detection once approved will mean that we can all serve our customers better with additional technology and innovation resources. Morpho really is a well-run business with a great team.

When it comes to merging the talents and skills of both businesses, I'm sure there will be many learnings in both directions, but one example of that opportunity is that Morpho's aftermarket revenue currently represents more than 50% of their sales.

Now turning to Smiths Interconnect.

SLIDE – SMITHS INTERCONNECT

Underlying revenue was marginally down year on year. This reflected 3% growth in power driven by data centre expansion in North America, a 5% fall in microwave, and flat revenue for connectors.

The 150 basis point margin improvement of 13.1% shows the progress the team has made improving productivity through lean and automation initiatives and delivering savings from restructuring and procurement.

Margins improved right across the board in power, microwave and connectors, and I'm confident the actions now will continue to deliver benefits in the future.

We've also implemented a reorganisation of the business with a focus on target markets and key customers in a much sharper and smarter way, and the positive results of this are already being seen.

We're also taking action to strengthen our business and our levels of content with customers higher up the value chain. A bit more on that later.

Total R&D expenditure in Interconnect was in line with the prior year, and we're focusing investment on higher-growth market segments, like new millimeter wave products with advanced radar systems.

And finally, moving to Flex-Tek.

SLIDE – FLEX-TEK

It delivered a solid performance over the year. Underlying revenue was flat, with fluid management revenue down 1% due to a softening of aerospace orders. Heat solutions revenue was down 5%.

In contrast, 3% revenue growth in construction showed the benefit of our exposure to the US housing market. 1% growth in flexible solutions was driven by increased demand in medical.

Operating profit fell 3% on an underlying basis, largely due to a transition to a range of new gas tubing products. However, we saw margins improve in heat and flexible solutions.

We continued to see good sales growth in China, and we focused our R&D spend on specialty heating elements, gas tubing and aerospace products, to meet the requirements of the next generation of more fuel-efficient aircraft.

I'm now going to hand you over to Chris for the financial review of the year.

Chris O'Shea ***- Smiths Group plc - Finance Director***

SLIDE – FINANCIAL REVIEW

Thanks, Andy. Good morning, everyone. I'll now take some time to cover the financial results for the year ended 31 July 2016.

SLIDE – ROBUST FINANCIAL PERFORMANCE

Turning to the key financials, revenue for the year was GBP2.95 billion, an increase of 2% on 2015. Underlying revenue, excluding the positive impact of foreign exchange translation, declined by 2%, principally due to softness in John Crane's end markets.

Headline operating profit fell GBP1 million to GBP510 million, which resulted in the margin decreasing by 30 basis points to 17.3%. Underlying headline operating profit declined 4%.

Headline free cash flow performance was strong, increasing 18% to GBP400 million. And our return on capital employed decreased 70 basis points to 15.3% with the effect of softness in our John Crane end markets being partially offset elsewhere, most notably in detection.

Headline earnings per share were 85.2p, a decrease of 0.9p on 2015, reflecting as expected a higher interest charge partially offset by 0.5 percentage point tax rate reduction to 25%.

The Board has proposed a final dividend of 28.75p per share, which when added to the interim dividend of 13.25p, will take the full-year dividend for 2016 to 42p, an increase of 2.4% on last year.

Now I'll take you through the results in some more detail.

SLIDE – GROUP REVENUE FELL 2% PRIMARILY DUE TO TOUGH END MARKET CONDITIONS AT JOHN CRANE…

The impact of currency translation increased revenue by GBP97 million. The net impact of the 2016 acquisition of XPD8 and the 2015 disposal of Specac was negligible. Both transactions were in the John Crane division.

Revenue performance was heavily impacted by the continuing challenges in some of the markets served by John Crane where revenue fell GBP87 million, or 10% on an underlying basis. Growth in Medical, and particularly in Detection, more than offset modest falls in Interconnect and Flex-Tek.

Aftermarket revenue continued to grow ahead of our original equipment sales taking the overall proportion of revenue from aftermarket to more than 53% of total revenue. All in all, reported revenue increased by GBP52 million to GBP2.95 billion.

Moving now to headline operating profit.

SLIDE - …DRIVING A 4% DECLINE IN PROFIT

Excluding the impact of currency translation, profits fell by GBP20 million, with improvements in Detection, Medical and Interconnect more than offset by the decrease in John Crane. We continued to see downward pricing pressure in Medical and Detection, but this was more than offset by increased volumes and a favourable product mix.

Pricing in the other three divisions was flat to marginally positive.

We see the benefits of cost-saving measures, with around GBP20 million feeding through to the bottom line when compared to 2015, most notably in John Crane and Interconnect. This includes the impact of reducing the workforce by almost 800 people during the year, including reductions of more than 400 in John Crane and almost 300 in Interconnect.

Overall, reported headline operating profit of GBP510 million was down GBP1 million from the prior year.

All in all, the Group's operating margin was down 30 basis points to 17.3%, with the increase in profitability at Detection, Medical and Interconnect more than offset by the decline in the John Crane margin.

It's a sign of the quality of the John Crane business that its operating margin remained well above 20% despite softness in our main end market.

SLIDE – HEADLINE FREE CASH FLOW INCREASED 18%...

When I spoke to you in March, I emphasised the importance of cash as a primary measure of performance. Ultimately, we need cash to invest to grow the business. Here you see some of the early results of our focus, and I'm very pleased to say that we converted 102% of our headline operating profit into cash, which was an increase compared with the 95% we managed last year.

Our capital investment of GBP108 million was ahead of depreciation and amortisation, reflecting our investment in the business to lay the foundations for future growth. Indeed, we increased cash CapEx by 14% in 2016.

We saw a GBP9 million inflow of cash from working capital improvements, with inventory slightly down, partially offset by an increase in trade receivables reflecting a strong end to the year. Whilst this is decent progress over a short period of time, we still have a huge opportunity for further improvement. As you can see, the improvement year on year is almost GBP50 million, with an outflow of GBP38 million in 2015, to an inflow of GBP9 million in 2016.

Overall, our headline operating cash flow was GBP520 million, GBP10 million higher than headline operating profit, and GBP36 million higher than we delivered last year. Headline cash outflow and interest in the year was GBP58 million, slightly up in 2015, due to the full-year impact of our April 2015 GBP600 million eurobond issue, and we made cash tax payments of GBP62 million, down GBP29 million on last year. As a result, the headline free cash flow was GBP400 million for the year, an increase of GBP61 million or 18%.

Turning now to slide 16, I'd like to take some time to walk you through the movement in our net debt.

SLIDE …WHICH DROVE A £23M UNDERLYING REDUCTION IN NET DEBT

We hold the majority of our debt in Euros and US dollars. The retranslation of our opening net debt in sterling terms to closing FX rates together with related fair-value and FX hedge movements, gave rise to an increase in net debt of GBP183 million. Accordingly, our opening net debt adjusted for FX movements in 2016 would have been slightly over GBP1 billion.

I'm pleased to report that our headline free cash flow more than covered a record year for cash contributions to our legacy pension schemes, ongoing cash payments for other historic liabilities, and our dividend payment, which resulted in an underlying reduction in net debt of GBP23 million.

Our net debt to EBITDA ratio for the year was 1.6 based on the number as reported. Using the same FX rates for the net debt and the EBITDA results in the gearing ratio falling to 1.5.

SLIDE – NON-HEADLINE ITEMS IN OPERATING PROFIT

As you see in many companies, we disclose certain items separately to allow a clear and consistent view of our underlying performance. These items principally relate to legacy liabilities, and amortization and cost of acquisitions and disposals; i.e., the things we believe are not trading related. In the past, we've also included restructuring costs here, most recently the fuel for growth programme.

When we arrived last year, we reviewed the programme and decided to deliver the initiatives originally intended. So we worked with our businesses to ensure that they were planned appropriately and executed optimally. As a result, the timeline for some of the projects was pushed to the right, and we therefore expect a charge on 2017 at a similar level to that seen in 2016.

This programme is now closed and no new projects will be added. Looking to the future, we will include restructuring costs and headline results, and we'll only consider separately identifying costs if they relate to a major and material single programme executed relatively quickly.

SLIDE – THE GROUP HAS A GOOD RANGE OF DEBT MATURITIES

We have a consistent financing strategy with a well-diversified debt portfolio consisting principally of US dollar and Eurobonds with a range of maturities out to 2023, and a $800 million revolving credit facility on which we successfully exercise our option to extend by one year during 2016. This committed facility, which is currently undrawn, will now mature in 2021.

In June, we repaid a GBP150 million 7.25% sterling bond from cash resources. And at the end of the year, our debt facilities had a weighted average life of 4.5 years, with an overall interest rate of 3.7%.

SLIDE – SUBSTANTIAL PROGRESS MADE ON PENSIONS

This year, we've seen a step change in pensions. During the year, we announced the conclusion of our triennial valuations with the trustees of both of our UK pension schemes such that total cash contributions to legacy defined benefit schemes will fall from GBP129 million in 2016 to around GBP50 million in 2017.

In August last year, we completed the purchase of a bulk annuity for retirees in the US. This resulted in a GBP351 million reduction of gross liabilities in our US schemes. This was a buyout transaction such that the liabilities have been transferred to the insurance company, and are therefore no longer shown in our accounts.

We are, of course, a responsible employer, and we're happy to be able to reduce contributions whilst continuing to meet and secure commitments to our pensioners, both current and deferred. In order to do this, we have continued to substantially de-risk the schemes in the UK. And in the US, our main schemes use liability-driven investment strategies with the assets matching the liabilities.

Overall, we've got pension assets of GBP4.3 billion at the end of the year, backing total pension liabilities of GBP4.2 billion. You can see in the charts in the bottom of this page that we've reduced the proportion of assets invested in equities from almost one-third at the end of 2015 to less than 15% at the end of 2016. At the same time, we've increased the proportion of the schemes' assets invested in bonds from a bit less than one-half at the end of 2015 to almost three-quarters at the end of 2016. And when you add in liability matching insurance policies, we have a little over 90% of the GBP4.3 billion pension assets invested in liability matching schemes.

This strategy ensures that the impact of interest rates on the scheme liabilities is largely matched by compensating movements in the asset values.

We've introduced some leverage into the SIPS scheme in order to increase the exposure to matching assets, and thus the hedge. This has reduced substantially the value at risk at our pension schemes.

SLIDE – NET PENSION POSITION IMPROVED FROM A £108M DEFICIT TO A SURPLUS OF £80M

So what does all this mean for our pension exposure? I'm pleased to confirm that our pension position on an accounting basis switched from a deficit of GBP108 million at the end of 2015 to a surplus of GBP80 million at the end of 2016. A substantial proportion of this improvement came from the contribution of GBP152 million of UK government bonds previously held in escrow to the UK SIPS scheme.

You can see in the box in the middle quite clearly the impact of our hedging position, and the substantial increase in asset values which more or less offset the increase in liabilities which were driven in large part by interest rate reductions. And we will continue to de-risk the Group's pension position wherever we can do so economically.

This next slide gives a little more detail on FX.

SLIDE – CURRENT FOREIGN EXCHANGE RATES COULD PROVIDE A SIGNIFICANT TAILWIND IN REPORTED PROFITS

As you know, around 95% of our revenue and profits are delivered outside the UK. I'm not able to accurately predict where FX rates will end the year, but I thought it might be useful for you to understand the potential impact of current rates remaining in force for the full year.

To illustrate this, we've retranslated our 2016 results at the closing year end rates which are quite close to the rates today. As you can see, had these rates prevailed for the full year in 2016 they should have provided an additional tailwind of around 10% to revenue and operating profits.

I'd now like to take a few minutes to highlight the financial strategy that will support the delivery of the corporate strategy that Andy will outline shortly.

SLIDE – OUR FINANCIAL STRATEGY IS STRAIGHTFORWARD AND…

We talk about squaring the circle. Our margins were strong at 17.3%, our return on capital employed is a very healthy 15.3%, and cash conversion of over 100% is very pleasing. But as we've said, we need to start growing, and revenue declining at 2% on an underlying basis is simply not good enough. Andy will talk to you soon to lay out how we will return the Group to growth over the long term.

At the core of our strategy is a simple financial framework. We will maintain a strong investment grade credit rating. We will invest in opportunities that create value. We will maintain discipline in our balance sheet management, ensuring that we have the capacity to fund opportunities.

We will actively strengthen and focus the portfolio with a disciplined approach to M&A. We will deliver a competitive tax rate. And we'll do all of this with a robust approach to enterprise risk management.

Let's look at what the strategy means in terms of ongoing actions together with an assessment of progress in 2016.

SLIDE - …IS EASILY TRANSLATED INTO DAY-TO-DAY ACTIONS…

We'll continue to extract efficiencies across our businesses through intelligent cost control. This year, we've taken out almost GBP20 million of costs and a large number of people. However, in Detection, we've added almost 100 positions and we've increased our costs accordingly. It's about having the right cost base; not about cutting costs for the sake of it.

We'll ensure we get the best return from our invested capital by deploying our assets more efficiently. This year, we reversed the trend of prior years and delivered a net cash inflow from working capital movements.

As I mentioned previously, we'll keep a relentless focus on cash. This year, we converted more than 100% of our profits to cash, the first time we've done this since 2010.

And finally, we will deploy capital to support initiatives to stimulate growth and returns. This year, we committed $710 million to the acquisition Morpho, and last week, we announced the sale of our upstream-focused artificial lift business. In addition, we increased our organic reinvestment rate by a couple of percentage points.

SLIDE - …AND IS DRIVING FURTHER PROGRESS IN FOCUSING THE PORTFOLIO

Let's take a minute to look at what last week's disposal means for the John Crane results.

In 2016, our artificial lift business lost $10 million on $60 million of revenue. These numbers were included in the John Crane results, and contributed to John Crane's margins of 21.9%.

Stripping these numbers out shows that John Crane's underlying margin was just below 24% in the toughest market conditions for almost two decades. This shows the quality of John Crane.

In addition, the rate of decline in John Crane revenues is around 2% points lower when the results of the artificial lift business are removed. The same applies for first-fit revenues. And excluding the results of the disposal, aftermarket revenues in John Crane in 2016 amounted to 62% of total revenue.

SLIDE – OUTLOOK FOR 2017

So what do we expect in 2017? We anticipate a broad continuation of the current trends, with the world remaining in a low-growth environment. As is typically the case, our performance will be weighted towards the second half. We're beginning to see the benefits of a focus on working capital, and in particular inventory, and we expect the rate of improvement to pick up in 2017.

As it appears the sterling's decline may be with us for a while, we should see a boost to reported earnings from FX translation. And we also expect to close the acquisition of Morpho in the first half of 2017.

SLIDE – MEDIUM TERM GUIDANCE

So how do we see the portfolio, quality of assets and the growth potential?

We have five strong businesses with good profitability. Over the long term, we see John Crane and Medical as 20% plus margin businesses. Detection, Interconnect and Flex-Tek are mid-teen businesses, with a skew to the higher end of this range.

For revenue growth, we have one simple target. We aim to grow faster than our chosen markets in all of our chosen markets.

Now I'll hand you back to Andy so he can tell you just how we're going to achieve our aim of returning the Group to growth, strong consistent revenue growth.

Thank you.

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

Thanks, Chris.

SLIDE – STRATEGY REVIEW

Hello again. Okay. Now for the stuff that's been consuming a lot of our time and thought for the last few months.

It's been a really interesting year; and it's been quite a year for me, one I've really enjoyed. I've done a lot of due diligence before deciding to come here, and I've thought long and hard about what Smiths was today, what Smiths has been in the past, but more importantly, what Smiths can be in the future.

I think from the start I could see that the quality of this Group was there. It's well governed, good financials, some great market positions, and some really neat technology as well. It's a solid platform, and it provides us with a great opportunity to develop, focus and grow.

I've seen a lot of this business over the last year in all parts of the world, and it's become clear that the potential to do more is both material and larger than we first thought. We can grow this company. We can run it better and more efficiently.

SLIDE – OUR VISION AND STRATEGIC PRIORITIES

I mentioned at the start this morning the key components of value creation for me, and it really comes down to two strategic priorities: outperforming our chosen markets, and working to achieve world-class competitiveness. All of this, of course, is underpinned by strong financial discipline, intelligent capital allocation, and excellent governance and control.

The vision is very clear. We're going to focus on these objectives, and we can chart the course to a bigger, better, more focused Smiths that can count itself as one of the world's leading technology companies.

A lot has been said about the lack of growth at Smiths over the years, so we really set out to try and demystify the growth question through a better understanding of the way our businesses are positioned, and through a hard look at our own competitiveness that covered all aspects from technology to operations and the way we look after our customers.

We conducted a strategy review across the Group to identify the drivers for growth and value creation, and we're going to hold a Capital Markets day in the first half next year, but I wanted to share some thinking with you now.

The fundamental objective of the strategy review was to understand our market positioning and our own competitiveness at a very granular, market, sub-segment level.

There was also a third dimension to the thinking around the review to assess the 'doability'. What I mean by this is: How far are we from where we want to be? What are the risks involved in getting there. What are the resources and the time required?

Through this detailed assessment of the business we now have a good understanding of the market positions that we occupy and their long-term growth potential. We better understand our own competitive positioning and the areas we need to improve, including at a Group level the things we need to do more consistently across the business, irrespective of what the end market is or the end customer.

Looking at Smiths and its businesses has really allowed us to define the core characteristics of a Smiths business of the future. We've also aligned our findings with a robust Group-wide capital allocation process to determine investment in organic and inorganic growth opportunities.

SLIDE – THE MAJORITY OF OUR BUSINESSES ARE WELL POSITIONED

We looked at market attractiveness by a combination of factors, including market size, long-term growth rate, segment profitability, and competitor concentration. We looked at our own competitiveness in a similar way, but this time based on our market share, relative profitability, and relative growth versus competition. And here's what we found.

Around two-thirds of Smiths' businesses are both positioned in attractive long-term markets, and are competitive. The others are on the whole of good quality, but either require improved positioning or increased competitiveness over time.

The ‘doability’ I mentioned earlier also comes into play here as we think about how far these businesses are from where they need to be if we're to achieve market leadership. We know from experience that we can improve any business, and we have a lot of opportunity to do so, but I want to ensure that our efforts and our investments, both organic and inorganic, are increasingly focused with long-term sustainable market leadership in mind. When I say market leadership, I mean top three in the markets we choose to serve.

In some cases, as we saw earlier, we do have smaller businesses which are good, high-quality franchises, but for reasons of scale and synergy, with our overall objective of achieving market leadership, they may well sit better in a different home. The artificial lift business is a good example of this.

On the flipside, when it comes to acquisitions, it was very clear early in our thinking that there's significant long-term growth potential and differentiation potential in the detection business, and that's where the Morpho deal came from.

SLIDE – STRATEGY IN ACTION

I'd now like to return to our two strategic focus areas; firstly, growing faster than the markets we choose to serve, and achieving market leadership.

SLIDE – THE GROWTH FRAMEWORK

To deliver market leadership and sustainable growth, there are a number of key things that we need to address.

First, we need to be in the right market segments, we need to be exposed to the right geographies, and serving the right customers. We also need to have the potential for increased aftermarket and recurring revenue opportunity, and to have more value of content with customers overall. You've also got to be able to differentiate on a sustainable basis from a technology and innovation perspective.

We're calling this way of looking at the businesses our growth framework. Delivering against these criteria will position us for top three leadership and growth above the markets we choose to serve. All of these factors also build a picture of the characteristics which define a Smiths business.

I'd like to just take you through an example of how we applied this thinking to parts of Smiths Medical. Hopefully, it will give you a flavour of how we can materially expand our potential markets and grow prospects by being clearer about market segmentation and the breadth of product and service capabilities that we could bring.

SLIDE – SMITHS MEDICAL – MARKET SEGMENTATION

I'd like to use the example that we mentioned earlier, the pump-to-patient strategy in Medical. Medical's vascular access and infusion systems businesses are each just under GBP300 million in annual revenue. Together, they're about two-thirds of the business in total.

The bars on the left here show the size of the market segments that we currently address with these products, valued at just over GBP4 billion, and expected to grow at 2.4% over the next five years.

Within vascular access, however, some market categories are growing at double-digit, and some are in decline. So knowing the sub-segment growth rates and knowing where to invest has an absolutely critical impact on growth.

We currently have eight vascular access product lines. Only four of these are growing, and those are the ones where we're least exposed. That's one of the main reasons why our vascular access revenues were flat year on year.

We've got a similar picture with our infusion systems products, with some very good positioning in some segments, but with potential for product category expansion and to access higher long-term growth rates. As the bars on the right show, we can significantly increase our growth rate by investing smartly in the right segments, both organically and non-organically.

The addressable market potential doubles to GBP8 billion and continues growing at a rate of 4.3% over the next five years. It's really clear that by reinvigorating our new product innovation, and by accelerating our moves into adjacencies, and by expanding our reach in attractive geographies such as China and India, we can tap into higher-growing market segments.

China and India, along with the whole of Asia are, of course, a key Group-wide priority as well.

SLIDE – STRATEGY IN ACTION

Now let me take you through some thoughts on our second strategic priority, achieving world-class competitiveness through the Smiths excellence system.

SLIDE – SMITHS DRIVEN BY EXCELLENCE SYSTEM

We launched the excellence system earlier this year. It's about doing the things that the customer will pay for and that create value in our business consistently well across the Group in a highly prioritized way. It's about the structures, the processes, the tools and the skills, which make a good business irrespective of whether it's a medical device or an oil refinery.

All customers want the best quality on time, when they want it. They want to be quoted quickly. They want leading innovations first, and they want market competitive costs and service.

There are six elements of the system.

Customer excellence; which is driving greater customer intimacy and alignment with their future needs.

People excellence; attracting, retaining, developing, engaging and inspiring the very best people.

Technology excellence; creating a true culture of innovation across the Group.

Production excellence; continuous improvement and lean enterprise.

Programme excellence; really applies to consistent and flawless execution of our product launches and programme launches.

And Supply chain excellence; improving the speed of flow through the business.

We're now organising and resourcing the system and driving it centrally and throughout the divisions. It's all about speed and efficiency in the business. And by driving those priorities in each of those areas, I strongly believe we'll achieve world-class competitiveness over time.

Now let me take you through some examples from our business which demonstrate excellence in action, starting with our customers.

SLIDE – CUSTOMER EXCELLENCE - CONNECTORS

Smiths Interconnect, and we have some management from Smiths Interconnect here today, has been an enigma for many years. It contains some of the most incredible technology, yet it's been considered a conglomerate within a conglomerate. And that's not surprising because that's basically the way we managed it. But no more.

Through a clear focus on market and the customers we want to serve, we've now reorganised the business by main customer category servicing six main markets, and enabling a much simpler and more focused management process. And the results are beginning to show.

The picture shows how our connectors business has been segmented into its customer base from four categories, from low tech up to technology seeker and technology partners at the top who really want sophistication and capability, and are prepared to pay for it. It's enabling us to gain content and extend our access to higher-growth segments as a result.

SLIDE – TECHNOLOGY EXCELLENCE – DIGITAL TRANSFORMATION

I'd like to take a look now at a real passion area of mine, technology.

We're in the midst of the fourth industrial revolution. The first used water and steam to mechanise production; second, electric power to create mass production; and the third, electronics and IT to automate production. We're now facing and in the middle of the digital revolution, blurring the lines between physical, digital and biological. Smiths is focused on accelerating our ability to provide digital services and solutions.

We already have 250 software engineers at work developing solutions in our divisions, and we now plan to extend our Group-wide capabilities to ensure we build on our strengths, such as prognostics in John Crane, security algorithms in Detection, and software libraries and interoperability in Medical.

We want to be moving faster towards leadership in digital solutions, from networking and reporting, to controllable devices and condition-based monitoring through expertise in analytics.

We've set up, and I'm also currently leading, a new innovation forum across the Group. It's a team of executives from across the Group focused on creating a culture of innovation and identifying technology trends and disruptors which we need to address to build our position.

We need to do more also in areas such as 3D printing and nanotechnology. This activity is not going to be defensive for Smiths. We're determined to lead.

We've also created a new central innovation fund in addition to our existing R&D spend to pursue Group-wide innovation opportunities and ensure Group-wide leverage of capability.

SLIDE – PRODUCTION EXCELLENCE

Next, I'd like to call out an example of production excellence that really struck me on one of my first visits at Smiths, Wiesbaden in Germany.

Lean enterprise and continuous improvement throughout our operations is going to be central to how we improve efficiency and deliver competitive advantage for our customers.

By applying lean principles to how we assemble generators and x-ray scanners, in fact the products that I mentioned earlier, the new business win in Berlin, the team has redesigned assembly processes and production-line layout and moved from fixed material supply to just-in-time delivery and flow-line manufacturing. They've cut the operational footprint by 40%, cut manufacturing lead times by 50%, and improved productivity by 13%. It's a great example of best practice we can apply across the Group.

SLIDE – SUPPLY CHAIN EXCELLENCE

Another area we're driving hard is our supply chain, specifically our sales and operations planning. I've spoken about this often in the context of cash. It's become clear to us very quickly that there is material opportunity right across the Group to improve the way we manage flow through our business.

With better sales and operations planning, there's much we can do to reduce the dead time in the process when we're not actually adding value. Shortening intervals between the customer placing new order and us finally delivering to the customer and getting paid, the order-to-cash cycle, is a really important part of the story.

It's fundamental stuff. There's far too much time between value-added activities that we perform. And this is an example for an Interconnect test cable. You can see overall a lead time from order to cash and shipment of 14 weeks, and we're only adding value for less than a week during this time.

Cutting down this dead time is a key focus to deliver faster, more efficient business, freeing up capacity, stronger cash generation, faster responses, and of course, happier customers because they get what they want when they want it. Ask us how we're doing next year.

SLIDE – STRATEGY IN ACTION

I've taken you through some concrete examples of how we're taking practical action to meet our strategic priorities of outperformance in our chosen markets and world-class competitiveness. Over time, we'll improve positioning and competitiveness in our business. And by investing intelligently in growth opportunities, focusing the portfolio and accelerating moves into adjacent markets, we will concentrate on building businesses with the essential characteristics of a Smiths business.

SLIDE – CHARACTERISTICS OF A SMITHS BUSINESS

I mentioned them earlier: good competitive positioning by market segment, with strong growth characteristics, a top three player; potential to increase recurring aftermarket revenues and gain more overall content with customers; good technology differentiation and increasing digital capabilities; tech heavy, competitive and asset light.

If a business doesn't have these characteristics, or the potential to get there and achieve market leadership, we're unlikely to be building our capital resource there.

SLIDE – CREATING ONE OF THE WORLD'S LEADING TECHNOLOGY COMPANIES

As we think about our plan to become one of the world's leading technology companies, we start to see the shape that it will take. We've carried out our initial review, and we're now working through improving our competitiveness and achieving a sharper focus on attractive market segments. As we've shown, active portfolio management is going to be important.

From the improvements we generate, we'll continue to invest in strengthening our capabilities and focusing our R&D spend to feed that new product pipeline. The potential we see to improve tells me we have the resources today to deliver the company we want tomorrow, redeploying our capital and cost base away from business as usual into the engines of growth.

Probably a good time for me to stop. Thanks very much for listening, and I'll join Chris now if you've got any questions.

Thank you.

SLIDE - QUESTIONS AND ANSWERS

Mark Davies Jones ***- Stifel Nicolaus & Company, Inc. - Analyst***

Mark Davies Jones, Stifel.

Firstly, just on 17, there are lots of moving parts within the margin. Obviously, getting out of artificial lift helps, but there's GBP20 million of additional R&D. Within your plan, would you expect overall profitability to be trending up in full-year 2017?

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

We made the outlook statement update just before the results a few weeks back, and I think Chris has just gone through where we are today.

So we're seeing a continuation of the broad trends. Broadly, we're seeing improvements in the business offsetting some of the additional costs and building capability. So no update to the outlook as it stands.

Chris O'Shea ***- Smiths Group plc - Finance Director***

You've got to bear in mind when the results for 2017 come in, there is -- we expect the profitability in the four divisions that will grow to improve moderately, subject to R&D spend, but there is a negative mix because John Crane is our most profitable division. I'd like them to grow, but probably broadly flat I would say is what we think just now.

Mark Davies Jones ***- Stifel Nicolaus & Company, Inc. - Analyst***

Thank you. And then the balance between fixing and exiting businesses, obviously the artificial lift piece is a nice deal to deliver, but it's a relatively small piece of the cake.

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

It is, yes.

Mark Davies Jones ***- Stifel Nicolaus & Company, Inc. - Analyst***

Is that where you're guiding us to? The majority of this you want to fix of the 40% that's not where you want it today, or could be there be more material disposals?

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

Well, I think it's just back to the high chart, which is obviously a very high-level chart because it captures the whole portfolio. And we've got about two-thirds of the business which is well positioned competitively and in the right market sub-segments. And the rest are a combination of both.

So there's going to be a very strong focus on improving the competitiveness and driving that piece up, and it's really going to be quite a surgical approach to the sub-segments within the divisions. So whilst the John Crane move is relatively small, you can see the relatively significant impact that it has on the John Crane business. So it's really important for us to get our minds around those targeted surgical actions in the first instance and get moving with this competitive improvement.

Mark Davies Jones ***- Stifel Nicolaus & Company, Inc. - Analyst***

Thank you.

Mark Fielding ***- UBS - Analyst***

Mark Fielding, UBS.

Actually, following on from that, you mentioned at this point a high-level chart. If we were to take that circa two-thirds and overlay that analysis onto the divisions, is there significant variation across the different divisions, or is it a pretty steady picture?

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

No, it's a super question. If I look across all of the businesses, it's probably not a dissimilar picture. And I couldn't put it as identical, but not dissimilar, which probably isn't an unreasonable normal distribution, actually; the sort of thing that you'd expect of a business that's built up over a period of time. So I think broadly similar.

Chris O'Shea ***- Smiths Group plc - Finance Director***

There isn't one or two divisions that occupy the 40%. There's things across all the divisions.

Mark Fielding ***- UBS - Analyst***

Can I also ask just one other question? In terms of Interconnect, can I be clear? I think the press release talked about low to mid-teen margins and you talked about 15%, or mid-teen plus in the slides. Just in terms of clarification of what you're thinking for Interconnect, and if it is mid-teen plus, what's the drivers to get there?

Chris O'Shea ***- Smiths Group plc - Finance Director***

Well, as Andy said, we've got some of the team here, so we've got Roland the CEO, and Alan the CFO, and some other people. So I would say, actually, we want 20% plus margins from interconnect for them to note that!

I think the big thing, and you see a lot of work done in the segmenting of customers, and I think previously, so we've got five separate business units within there and it wasn't impossible for five separate sales people to turn up at one customer and sell bits. And what I think the team have done really well is to implement key account management.

And it sounds very simple, but to have one person turn up, and sometimes Roland has been doing this himself, turn up and say, here's everything that I sell. And I think, as Andy mentioned at the first-half results, we saw quite a substantial improvement in our business space systems a lot of because of that and the kit that we've got on satellite.

So I think there's a lot we can do there in trying to focus on the detect seekers, the detect partners, and not being essentially busy fools trying to just sell for the sake of it but selling to customers that want our high technology and are willing to pay for it. And I think you'll see good margin improvement there.

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

There's also a piece that relates to a business that's built up over a period of time. We've got distribution channels that need some work, potentially leading you to serve customers that you may not choose to, and certainly those that are not willing to pay for the sort of sophistication and capability that we're able to bring.

And just as a reminder on this product, it's not the millions of connectors typically; it's a small number of connectors that go into the Joint Strike Fighter, $20,000 a piece, that sort of thing. So it's quite a wide range of things.

I do think across the portfolio as a whole that as we go through the sub-segmentation work, there are going to be businesses that we look at and they're too far away from where we want to be in achieving our top three market leadership objectives. And those will start to stand out to us as we go through the process now.

Alasdair Leslie ***- Societe Generale - Analyst***

Alasdair Leslie, Soc Gen.

I was wondering if you could talk a little bit about the pricing environment as we head into next year. It's interesting looking at your EBIT bridge there's actually several positives, I think; particularly, saw John Crane, saw positive pricing. It doesn't seem to be down to mix because you've put that in the volume mix bucket. So maybe you can talk about the dynamics there.

Also, Medical, it seems to be there at just over 1% of sales. We've typically seen price downs close to maybe 2% in Medical.

And also Interconnect, you were just talking about that division there, but again, we're used to seeing price downs in that division; now positive this year as well. Just whether that's sustainable.

Thanks.

Chris O'Shea ***- Smiths Group plc - Finance Director***

Yes. I think that you'll be finding in John Crane, as Andy mentioned, we have had the great fortune to service a very cost-conscious energy customer, customer base, over the last 30 years. So it's like not many companies that are focused on the upstream business or on mining where costs don't matter until you have a huge downturn, then costs are all that matters.

So for the downstream business, costs have mattered since the late 70s, early 80s, and so that means that we've had pricing pressure for many years. And we continue to innovate and bring service and we can price for that service. So that's why you don't see this huge impact on pricing in there.

With regards to Medical, again, the team, they set a budget and they aim to beat that. And we're quite happy with the performance. They would prefer it to be positive pricing, but to get positive pricing in Medical you have to bring new products in. And we are hopeful we've got some product launches coming out towards the end of 2017.

But if you don't innovate, you lose price, and so the team are having to run really hard just now to compensate for price reductions by volume growth or by cost management. And we hope that as we get into FY18 and beyond that we'll bring pricing power because of our products.

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

And just a couple of observations.

I think in John Crane in the area of first-fit, it's been a really pressured year; a lower number of projects, more mouths to feed, so to speak. So that wouldn't surprise you at all.

However, on the oil refining side, which is largely the aftermarket side, demand remains at 92m barrels a day and they need to keep the refineries running, so you tend to see less immediate pressure.

I think Medical, we're starting to see some price resilience because of some of the new innovations that are coming through. I think it was tougher in the areas where we needed to reinvigorate some of our innovation, for sure.

Thinking around Detection, one of the things I'm really pleased about is this growing aftermarket and recurring revenue piece, because that tends to be people getting trained on the lines, that tends to be software updates in machines. And that's quite a different pricing dynamic than fitting out an entire airport from Day 1. So it's a really important part of that pricing resilience.

And generally for me, pricing, ability to withstand pricing and increased pricing is just directly tied to your ability to differentiate really. And hence to push on, we've got to differentiate ourselves.

Thank you.

Alasdair Leslie ***- Societe Generale - Analyst***

Thanks. And, sorry. If I could just quickly follow with a question on the innovation investments, digital areas, lots of different areas that you could potentially look at.

Of the divisions, where do you feel you're already pretty well placed and where do you need to maybe play a bit of catch-up relative to some of your peers?

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

That's a great question. If I look at Medical and Detection, I think they're pretty well placed. Both of them have increasing content from a digital perspective and increasing significantly in the future.

With Medical, the big advent of events at the moment is interoperability and linking infusion pumps, particularly as there's a big push towards home care. They want you in your bed in the hospital for as little time as possible -- or they want you to be cared for at home, which is driving lots of thinking around how you connect, how you get that data, control that data, make sure that people are being treated properly. So I think good progress there but a lot still to happen.

John Crane, we're as good as anyone else, but it's right at the beginning of the journey. So the moves into full condition monitoring and the way you might think about it in the world of jet engines, for example, isn't there yet, so a big push, I think around that area.

And, of course, Interconnect does provide a little bit of a spine when it comes to some of this digitalization and electronics through the Group because some of the smart stuff that it's doing around guidance systems and so on.

And I think the main area for me is that doing it in different pieces, we had to pull some of these areas of analytics, data security, clouding data, together, and push them harder in a more critical mass way than we've been able to do in the past if we're going to lead and not just be defensive about this. And that's the aim.

Andrew Carter ***- RBC Capital Markets - Analyst***

Andrew, Royal Bank of Canada. Three questions, please.

First of all, just in terms of the targets that you've given, the margin targets today, have they been set with an eye on what you're thinking in terms of some exits and some bolt-ons? Or do you think as we hear what you're doing in terms of the portfolio, we'll hear some changes in terms of those margin targets?

The second one was just in terms of Detection. I'm just thinking about next year. You've obviously just had very, very strong organic sales growth in the year. I was wondering if you could just give us an idea as to what the backlog looks like, the deliverability of it. And I guess the important market for us to think about really is North America, and is there any sign of any pickup in investment there?

And then the third one is actually pension related, for which I apologize, but because of yields, the movements that we've seen even since the financial year end, there's been -- there's a lot of interest in that area. And I noticed again that the asset sensitivity that you've got looks a bit weird in the report. Can you just give us a bit of an idea as to why that number looks so low?

So the sensitivity to the discount rate for the asset number in the report, and perhaps if you have looked at it, would you be able to have a stab at where the surplus or deficit might be today based on the latest iBoxx?

Chris O'Shea ***- Smiths Group plc - Finance Director***

I'll take the pension one first, if you want.

Since the end of the year, the iBoxx rate has gone down by 20 bps. So we used 2.3% at the end of July, and at the close of business yesterday, it was 2.1%. Gilts have gone down by 17 bps from 1.5% to 1.33%.

So although Governor Carney reduced the rates on, I think, 3rd August, it was pretty much priced into the curve. There's no material change to the pension position now from the end of the year. As you see with the hedging that we've got, we have a match there. So as the liabilities go up, the asset values.

Now that works the other way. If the liabilities go down hugely because of big growth in discount rates, the assets will go down as well. So it's not a one way bet, but really what we're trying to do is to reduce volatility and trying to make -- clearly, the pensions is no longer a huge issue for us; it's something that we manage rather than something that manages us.

Actually, the question on the sensitivities, maybe we'll take that at the end, we can have a look at the exact numbers, but we've got quite a team that goes through that. But overall, we're quite comfortable. The hedging means that there's a question how low, we've been saying for years interest rates can't go any lower, but my God, they continue to test the depths, and that's why we're more than 90% hedged.

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

And around the targets, the intent was to convey the underlying confidence in some of the things that we think we can do with the business. We do have to invest in the business and we do have to build the capability of the business.

I think as far as the impact of portfolio changes, for me, they would clearly be targeted at helping. The example that Chris showed around JCPS; and if you just do some back of a cigarette packet high-level numbers, Morpho is a higher-margin business than our own Detection business today.

That doesn't mean I'm entirely excluding however businesses that we think can get there, but on the whole we're looking at the portfolio activities as intended to high grade over time as we take the thing forward.

Chris O'Shea *- Smiths Group plc - Finance Director*

The aim is always to buy a business that has low margins, that you can see a clear path, buy something that's 10%, take it to 20%. But these margin numbers that we gave, obviously, we've got an idea of the M&A that we'd like to do so they're not entirely inconsistent with that.

But we look at every opportunity on its own merits and make a judgment based on not just the margins but the things that Andy laid out. Has the technology differentiated? Is it top three, or can we make it top three? Is it asset light? So we don't want to change the capital intensity.

Your last question on Detection, we've got Richard Ingram, some of his team here that runs that business. It's got a good backlog; not as good as we would like, but the book to bill was in excess of 1.

As a frequent traveler to the United States, I hope that they decide to upgrade their infrastructure. But any of these agencies there's bureaucracy, so if you travel there you see that the infrastructure is probably less modern than you see in some of the more modern European airports. I think the TSA know that, and we expect that -- we don't know when, but we expect in the not too distant future they'll upgrade a lot of these things, try and improve the customer experience and the security as well.

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

There are a number of changes going on. It tends to be driven partly by regulation, or strongly by regulation, and then also by different threats emerging. And one of the orders that we announced last year was 3,000 of these RadSeekers which are essentially the things that you would deploy to see whether you have dirty bomb material in essence, and they were being deployed right across the US.

Other areas of regulation are a bit hard to fathom. They're very clear, but for example, what you would say is a more sophisticated version of computer tomography scanning is already in place for checked baggage in the US and not in Europe, but legislated to be in place by 2022. And you've almost got the flipside on the checkpoint baggage.

So we're tracking very closely the evolution of the regulations, but also the threats are evolving so quickly, which is one of the reasons we think it's so important to invest heavily in the R&D and the innovation and detection to be able to shape what's possible as we go through this regulatory and threat evolution situation.

Sandy Morris – *Jefferies - Analyst*

It's only Sandy. Just a few things just to keep me happy.

Did we price down on John Crane OE to try and keep market share with a view to the long-term aftermarket or not? Sorry. Within that GBP1 million price positive?

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

In some cases, because there have been fewer programmess on the table, the margins that those have been won at have been lower.

Sandy Morris – *Jefferies - Analyst*

So what was our OE, down 16 or something, was the market down at least that in your opinion?

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

I don't have the market number in my head.

Chris O'Shea *- Smiths Group plc - Finance Director*

Yes. We don't believe that we lost market share. We did take price hits to establish, or to maintain or even grow our share. And we look at these what we call strategic first-fit projects, we look at them as we look at any capital investment.

So we look at the IRR, and we prefer to get the money up front for the equipment, but as long as it's got the right tail of aftermarket revenue then we'll take the upfront hit. And we did take more in 2016 than we had in 2015, so that's in the pricing.

Sandy Morris – *Jefferies - Analyst*

Cool. And jumping around, sorry, into Medical, was there a headwind from the Japanese yen, and does it get bigger next year?

Chris O'Shea ***- Smiths Group plc - Finance Director***

Does it get bigger next year? That depends on where the rates hit. I think that we had -- I need to look. I think we had a slight reversal. We've had headwinds in the yen up to 2015. I think we had a slight tailwind from that. I think there was a slight reversal on the yen/dollar rate through 2016.

So I think either the headwind moderated or we had a slight tailwind. But who knows how it will go during the year, but the yen certainly strengthened a bit against sterling so we obviously saw some benefit there.

Sandy Morris – ***Jefferies - Analyst***

Do we hedge the transaction exposure into Japan?

Chris O'Shea ***- Smiths Group plc - Finance Director***

Yes.

Sandy Morris – ***Jefferies - Analyst***

We do?

Chris O'Shea ***- Smiths Group plc - Finance Director***

We do, but we hedge about 85% of our transactional exposure, or hedge that on a divisional basis. But what that does is it just kicks the can down the road. So one of the big things, Medical has the majority of its manufacturing costs in the States; so the majority of its revenue, but has more costs than it does have revenue in dollars. So one of the things I'll be looking at with the team this year is, do we have the right footprint in the right place for the markets that we serve just now.

So hedging is all well and good, but it just gives you one year breathing space, and we have to look at this properly.

Sandy Morris – ***Jefferies - Analyst***

Yes. We've been staring at this for a few years but not really able to do much about it. And we totally control the distribution now in Japan, don't we?

Chris O'Shea *- Smiths Group plc - Finance Director*

I believe so. Andy and I will be there next month to have a bit more a look at this business, but I believe we do.

Sandy Morris – ***Jefferies - Analyst***

And then I don't want to pre-empt what you're going to discuss next year, but in amongst all this high-level stuff, I was intrigued by this eight segments in Vascular Access. And just a little bit of fleshing out just so we understand what's going on with medical device tax going away, but also Safety is in there.

So a little bit of color about what Safety is doing, whether that's volume price trade-off, what the medical device tax impact is, and whether it will come. And then just a little bit of color about -- Jeff used to go on about his vitality index, and I think we were targeting 15 or something products introduced in the last three years. And I'd just like to know roughly where we are, please.

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

Okay. Well, I'll make a couple of comments about the Vascular Access segment, and perhaps you could have a chat.

I'm not familiar with that vitality index, Sandy. I apologize. But I'll come back to that.

On the Vascular Access piece, I think there's a number of things that are moving now. Probably one of the largest is around different coatings, anti-microbial coatings, for example, becoming more popular. People are prepared to pay because there's quite a significant cost factor between the two, but if they have something stuck in their body they want it to behave and work in the right way.

There's also what's called a closed-loop system and needleless access that is growing and developing. There's still a very strong market around the other products, but some of the high-growth segments are 10%+ growth; others are flat to even slightly down. And as I mentioned in my little talk, many of the areas that are extremely high growth we have lowest exposure to today. So we're going to be doing a lot around trying to focus our R&D, and potentially some of our non-organic activity around that as well.

Chris O'Shea ***- Smiths Group plc - Finance Director***

The vitality index, we still track that as between 15% and 20% for Medical, but we do expect that to go up towards the end of this year and into 2018, with the primary thing being the launch of a large volume pump, the Intellifuse pump.

Sandy Morris – ***Jefferies - Analyst***

Is there a new pump coming?

Chris O'Shea ***- Smiths Group plc - Finance Director***

Yes. That's around the end of 2017. So we don't bank on any revenues from 2017 for that but we hope that we get approval. We're at the mercy of the regulators a little bit but we're very hopeful of that and it's part of the drive into operability and having a standard pump platform.

We believe you need a large volume pump to remain competitive in the infusion pump business. So that's why we've increased the R&D spend in Medical. That's a lot of the stuff that's on the balance sheet in R&D for Medical. So the team are quite enthusiastic. As a Board we were there in July; we had a look at it. I don't know much about pumps, but it looks quite good.

David Larkam – ***Numis Securities - Analyst***

Two questions. Titeflex; could you just talk about the liabilities there? They seem to have gone up quite substantially over the year. So just flesh out what that is firstly.

Secondly, have you got any other loss-makers in the Group around that you’ve seen or just disposed of?

And finally, Chris, can you talk about the financial structure? Obviously, you've got the headroom for the acquisition, but you've got some bonds which are coming up, quite expensive bonds that can be replaced. So what are your thoughts on the next 12 months for that?

Chris O'Shea ***- Smiths Group plc - Finance Director***

Sure. So Titeflex is rather confusingly related to the Gastite business. So we have a business in Flex-Tek called Titeflex which sells aerospace mainly. But the company that owns Gastite is called Titeflex Corporation. We've got some historic liabilities provision there. When we can accurately predict what will happen in the future, we will sometimes truncate the period over which a provision is made.

At the end of 2015, the Titeflex provision for the Gastite product was made looking forward 10 years. We saw some movement in the legal framework in the US, our understanding of it and some more history. And that gave us more confidence that we made this essentially a whole-life provision. So we had to remain longer truncated 10 years. That's the increase in the provision.

So there's been no change really in the underlying environment other than we have more confidence that we think we can see beyond 10 years.

The other loss-making businesses, nothing major.

Structure of the bonds, so we have a EUR300 million Eurobond that comes up in May. We've got GBP400 million to GBP500 million in cash at the moment so we can pay for that. We've got some proceeds coming in from John Crane. We will go to the market to issue a bond on the completion or before the completion of Morpho. No need to do that at the moment because we don't want to be presumptive. We want to wait for approval from the regulator. But we will lock in lower rates than the bonds that are maturing. So it's a good time to be raising money.

But you have to make sure that you have an efficient balance sheet. There's no point in going out and raising money; 1.25% in Euros or 3% and a bit in dollars and then sticking it in the bank and making 20 basis points. It's not efficient.

Robert Davies – ***Morgan Stanley - Analyst***

Robert, Morgan Stanley. I just wanted to flesh out a little bit more around the guidance on John Crane for 2017, and what you're expecting.

The margin guidance, the midterm margin at 20%, that's almost 400 basis points below the pro-forma level at the moment; that's up 20 plus exactly versus what you see this year which is 290 basis points compression. Is that basically indicative that you're expecting FY17 to be tougher than FY16? And just what you're thinking there.

And then just on the headcount reduction that you've already done in Crane, how much more scope is there and how are you thinking about your cost base? I guess how far have you cut in that business already?

Chris O'Shea ***- Smiths Group plc - Finance Director***

So on the margins, we're saying we do expect some more softness in 2017, 20% plus. We're not saying we expect 20% in 2017, to be clear. The reason that we, we had quite some discussion about where we should put it. I don't like specific very narrow margin targets, revenue targets, which we had in the past.

So how do we see Crane? We see Crane as 20% plus, and the plus is very important. We see Medical the same. So there's no more sophistication than that. It's not where we expect the margins to be in this coming year.

In terms of the cuts, we wanted to take our time because a lot of the profitability margin quality of John Crane comes from the people, comes from the service, and so we didn't want to do what other companies may have done which is you see a downturn, you react very quickly, you get rid of a lot of people, because they will go and find other jobs and you can't always get them back. So we spend many, many, years training people. And they're very loyal. When you visit John Crane places, they love John Crane.

So we take our time and we went through and had an exercise and made sure that we understood the consequences of cutting people. We've cut some more this month. And there's always more you can do. But it's not a business in which you cut to the bone. We're happy to take a bit more of a drop-through in the downside to retain what we think is our unique market proposition, maintain the service network and have people there to service the Company.

This Company has been going for 85 years and it will go for another 85 years as long as you manage it sensibly.

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

I've been very impressed by the quality of the John Crane business, just coming to your point a little.

I was out at the Slough facility, which is the second largest of the global facilities a couple of weeks ago, and six out of the top eight managers joined either as apprentices or graduates; and they'd all been there -- they were only 40 years old but had done 20 years' service, or 25 years' service at Crane, which was fantastic.

I think to reinforce the point, we've tried to think about what we've done in Crane intelligently, because it is a very, very, capable network of service and technology. We do need to expand into other verticals more quickly.

Just to give you a feeling of it, the 60% that's in oil and gas and the 40% in other verticals, the pharma, the chemical, if you asked me to assess today how the management focus was, I'd probably say it was nearer to 80%/20% or 90%/10%. So it has been very oriented towards the oil and gas, and we're using this opportunity to redeploy people as well into the other verticals in a much more formal way.

So there's a lot of thought going into intelligently redesigning the network, so to speak. That being said, we felt we needed to cut as hard as we needed to cut to ensure that we came out of this well. And you can see that in some of the margin resilience that we've just been able to report.

Glen Liddy ***- JPMorgan Cazenove - Analyst***

Glen Liddy, JPMorgan Cazenove.

For John Crane, looking at the longer-term growth, what's going to be the bigger growth driver? Changing the verticals or product diversification? So selling not just seals to the oil and gas industry but more filters and such like?

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

I think it will be a combination of both. The fastest will be the moves into other verticals. And then as we think about a broader range of product, because one of the processes we're going through at the moment is thinking about the other high technology products which have similar characteristics to a seal; i.e., they're high technology and differentiated when you fit it and they wear out and get replaced lots of times.

The moves into the other verticals, I think, will start to feed through more quickly than any diversification or investment in organic technology. But over time they'll both be important.

Glen Liddy ***- JPMorgan Cazenove - Analyst***

And you flagged up then the skew of revenue and profits to the second half of this year. Is it any more pronounced than it's been in the past?

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

Not really.

Glen Liddy ***- JPMorgan Cazenove - Analyst***

Or is it driven by different business units to normal?

Chris O'Shea ***- Smiths Group plc - Finance Director***

No. It's no more pronounced. It's as much as you would expect. And also, just bear in mind that the different FX rates that you have in play for the first half and the second half can -- so that's led to bigger skew in 2016 than if you'd used a constant FX rate. So we had a 47%/53% skew in 2016 because we saw more tailwinds in the second half than in the first half. I think the previous year we saw more of 49%/51%. So we're talking about it in that range.

Glen Liddy ***- JPMorgan Cazenove - Analyst***

And finally on R&D, GBP20 million of extra spending is pretty chunky relative to what you've spent already. Is it going to be skewed to any particular area? And presumably, these aren't instant paybacks, so what sort of time horizon before you start to deliver better growth?

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

Well, roughly the split of that number is half embedded in the divisional plans around areas like the large volume pump that Chris mentioned earlier, for example, in Medical. So we're trying to do more in the embedded divisional plans, and then centrally the other half.

There's some work going on already, we've just signed off a 3D printing machine, a new one to complement some of the other activities going on already. But by far the largest focus for that money will be around building the skills for digitization. So we're going to be looking particularly in areas of clouded data analytics and building critical mass of capability and resource around that.

So that will be the majority of the number if you ask me to peg it today. I don't have the full picture, but that's the way it will look.

Glen Liddy ***- JPMorgan Cazenove - Analyst***

Okay. Thank you.

Jonathan Hurn – ***Deutsche Bank - Analyst***

Jonathan, Deutsche Bank. Just two quick questions, please.

Firstly, just coming back to R&D at Medical, can you just give us a feeling of the pipeline of introductions in that business? Obviously, 2017 is probably going to be a step-up on 2016. Will we see an incremental growth at 2018 on 2017?

That was the first question.

The second one was just on the aftermarket at John Crane. Can you just give us a feel for the book to bill in that business in the second half, please?

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

Okay. Well, I'll go for Medical. Do you want to speak about Crane, Chris? I know you've been looking at it recently.

I think the two biggest areas of work going on in Medical at the moment are around the Vascular Access piece and the infusion pump piece. Both of those will have lower bite in 2017 and really start to come in towards the end of 2017 and into 2018.

And as Chris said, a lot of it does depend -- there is a regulatory process here as well, which is why I'm being a bit circumspect, to get through, which isn't entirely predictable particularly around the pump side. But that would be the approximate phasing of it.

Chris O'Shea ***- Smiths Group plc - Finance Director***

And on the John Crane book to bill, I'd prefer not to get too granular on that, but we're comfortable with what we see in the aftermarket at the moment and we see no real concern in order intake or in the execution of the program. I was talking to the CFO of that business last night to get an update and it's progressing as we expect.

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

Okay. Well, thank you very much, everyone, for coming along. Really looking forward to sharing a little bit more as we go through the first-half results and into the Capital Markets Day. And thanks ever so much for coming this morning; lots of great questions. And look forward to seeing you all again soon.

Thank you very much indeed.