Chief Financial Officer's report

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Chief Financial Officer

Financial overview

	2018 £m	2017 £m
Revenue	**728.6**	690.2
Headline operating profit	**138.3**	123.9
Amortisation of acquired intangible fixed assets	**(3.7)**	(4.5)
Acquisition costs	**(0.5)**	-
Operating profit	**134.1**	119.4
Net finance charge	**(1.9)**	(2.4)
Profit before taxation	**132.2**	117.0
Taxation	**(28.6)**	(19.7)
Profit for the year	**103.6**	97.3

Group revenue was £728.6m, an increase of 5.6% at actual exchange rates, and 6.7% at constant currency. New facilities contributed 1.6% to revenue growth.

Headline operating profit for the year increased by 12% to £138.3m (2017: £123.9m), and return on sales increased to 19.0% (2017: 18.0%). Price increases once again more than covered the increase in input costs. Statutory operating profit grew 12% to £134.1m (2017: £119.4m).

Finance charge

The net finance charge was £1.9m compared to £2.4m in 2017, analysed as follows:

	2018 £m	2017 £m
Interest received on bank overdrafts and loans	**0.2**	0.1
Net interest payable[1]	**0.1**	0.1
Financing and bank charges	**1.8**	2.0
Pension finance charge	**0.2**	0.4
Total finance charge	**2.1**	2.5
Net finance charge	**1.9**	2.4

1. Amounts arising on financial liabilities measured at amortised cost.

As at 31 December 2018, the Group's £230m Revolving Credit Facility is totally undrawn and has a remaining life of 3.3 years.

Profit before Taxation

	2018 £m	2017 £m
Headline profit before taxation	**136.4**	121.5
Amortisation of intangibles	**(3.7)**	(4.5)
Acquisition costs	**(0.5)**	-
Profit before taxation	**132.2**	117.0

Statutory profit before tax increased to £132.2m (2017: £117.0m), while headline profit before tax increased 12% to £136.4m (2017: £121.5m).

Tax

The headline tax rate for the Group fell to 21.7% (2017:22.9%) as a result of the reduction in the US Federal corporate income tax rate.

However, the statutory tax rate of 21.6% increased from that of 16.8% in 2017, since the 2017 tax charge benefited from a one-off tax gain of £6.4m as a result of a revaluation of the Group's deferred tax liabilities, following the passing of the Tax Cuts and Jobs Act in the US in December 2017.

Some clarifications on implementation of the US Tax Cuts and Jobs Act were issued in December 2018. While these only apply from 2019, the impact will likely be a reduction in benefit to Bodycote from the financing activities into the US, as the ability to take tax deductions for interest is restricted. This is a trend common across tax legislation developments everywhere, including other jurisdictions where Bodycote operates.

The Group's statutory tax rate is impacted by a certain level of taxation risk related to the jurisdictions in which the Group operates. Provisions of £16.1m are carried in respect of potential future additional tax assessments related to 'open' historic tax years. Reference is made to note 6 of the financial statements for more information.

Earnings per Share

The improved Group business performance drove basic headline earnings per share up to 55.9p (2017: 49.2p) while basic earnings per share for the year increased to 54.2p (2017: 51.0p).

	2018 £m	2017 £m
Profit before taxation	**132.2**	117.0
Taxation	**(28.6)**	(19.7)
Profit for the year	**103.6**	97.3
Basic headline EPS	**55.9p**	49.2p
Basic EPS	**54.2p**	51.0p

Return on Capital Employed (ROCE)

The return on capital employed rose in the current year to 20.5% from 19.3% in 2017. This improvement was driven by the increase in the Group's operating profit. Moreover, since 2014, the Group has invested over £215m on acquisitions and expansionary investment projects, many of which are not yet fully mature and are not contributing as fully to Group returns as they will once they have all reached financial maturity. The Group continues to exert strong financial discipline in the area of capital expenditure, applying stringent financial returns hurdles to all of its projects.

Cash Flow

	2018 £m	2017 £m
Headline operating profit	**138.3**	123.9
Add back non-cash items:		
Depreciation and amortisation	**62.0**	59.8
Impairment of fixed assets	**1.8**	0.4
Share-based payments	**3.8**	7.8
Profit on disposal of property, plant and equipment	**(1.7)**	(0.7)
Loss on disposal of businesses	**0.6**	-
Headline EBITDA[1]	**204.8**	191.2
Net capital expenditure	**(74.0)**	(74.8)
Net working capital movement	**(2.1)**	(4.7)
Headline operating cash flow	**128.7**	111.7
Cash cost of restructuring	**(4.4)**	(3.7)
Acquisition costs	**(0.5)**	-
Operating cash flow	**123.8**	108.0
Interest paid	**(1.9)**	(2.1)
Taxation	**(24.5)**	(22.9)
Free cash flow	**97.4**	83.0
Acquisition spend	**(8.3)**	(14.2)
Disposals	**0.7**	-
Ordinary dividend	**(34.2)**	(30.6)
Special dividend	**(47.6)**	-
Own shares purchased	**(10.6)**	-
Other	**(0.1)**	0.3
(Decrease)/increase in net cash	**(2.7)**	38.5
Opening net cash	**39.6**	1.1
Loans acquired with subsidiaries	**(0.7)**	-
(Decrease)/increase in net cash	**(2.7)**	38.5
Closing net cash	**36.2**	39.6

1. Earnings before interest, tax, depreciation, amortisation, share-based payments, impairment of fixed assets, profit or loss on disposal of property and plant and equipment.

The Group's headline operating cash flow increased 15% to £128.7m, mainly reflecting the improvement in the headline operating profit. Headline operating cash conversion was 93% as the Group continued to demonstrate an impressive record of converting profit into cash. Consequently, free cash flow increased 17% to £97.4m. Net cash from operating activities increased 8% from £159.9 to £173.3m. The Group ended 2018 with £36.2m of net cash, only slightly lower than 2017 (£39.6m) despite paying ordinary and special dividends totalling £81.8m, and investing £44.1m in expansionary capital expenditure projects during the year.

Capital expenditure

Net capital expenditure (capital expenditure less proceeds from asset disposals) for the year was £74.0m (2017: £74.8m). The multiple of net capital expenditure to depreciation was 1.2 times (2017: 1.3 times).

As noted above, £44.1m of capital expenditure was invested in expansionary projects, in line with our strategy to invest for profitable growth, particularly in new facilities and incremental capacity for Specialist Technologies, in several new facilities in Emerging Markets and to support the long-term structural growth opportunity in the civil aviation market. Alongside this, the Group continues to invest in maintaining its assets to a high quality, with repairs and maintenance costs also being expended directly in the Group's profit and loss account.

Acquisitions and Disposals

We acquired a small facility in the US towards the end of the year, which fits well with our existing business in the South East, enhancing growth opportunities and helping with operating efficiency. In addition, we disposed of two small non-core businesses in France and Germany. Net consideration totalled £8m.

New standards

A new IFRS standard on the accounting of leases (IFRS 16) will impact Bodycote's accounts in 2019. While it does not change the underlying nature of our business at all, from an accounting perspective, it recognises leased assets as 'right of use' assets held on the balance sheet and classifies future lease liabilities as a financial liability. This will have the impact of adding c£80m to the Group's financial liabilities (based on leases we held at the end of 2018). In the P&L, it will add c£2m to Headline Operating Profit, with a similar increase in finance charges, leaving Profit before Tax and Earnings per Share measures unchanged.

During 2018, IFRS 9 (Financial instruments) and IFRS 15 (Revenue from contracts with customers) were adopted, with an immaterial impact on the Group's accounts.

Dividend and Dividend Policy

The Group aims to pay ordinary dividends so that dividend cover will be at or above 2.0 times earnings. The Board may also recommend payment of a supplemental distribution to shareholders. The amount of any supplemental distribution will be assessed in light of the cash position of the Group, along with funding requirements for both organic growth and acquisitions.

In line with this policy, the Board has recommended a final ordinary dividend of 13.3p (2017: 12.1p), bringing the total ordinary dividend to 19.0p (2017: 17.4p). In addition, in light of the Group's strong balance sheet and year end net cash position, the Board has recommended a special dividend of 20.0p (2017: 25.0p). If approved by shareholders, both the final ordinary dividend and the special dividend will be paid on 7 June 2019 to shareholders on the register at the close of business on 23 April 2019.

Borrowing Facilities

The Group is financed by a mix of cash flows from operations, short-term borrowings, long-term loans, and finance leases. The Group's funding policy aims to ensure continuity of finance at reasonable cost, based on committed and uncommitted facilities and loans from several sources over a spread of maturities. The Group continues to have access to committed facilities at competitive rates and therefore currently deems this to be the most effective means of long-term funding.

The total undrawn committed facility funding available to the Group at 31 December 2018 was £230.0m (2017: £230.0m). At 31 December 2018, the facility was undrawn.

Facility	Expiry date	Facility £m	Facility utilisation £m	Facility headroom £m
£230m Revolving Credit	3 April 2022	230.0	-	230.0

Post balance sheet events

There are no post balance sheet events that require disclosure in the financial statements.

Alternative performance measures

Bodycote uses alternative performance measures such as headline operating profit, headline earnings per share, headline profit before taxation, headline operating cash flow and free cash flow, together with current measures restated at constant currency. These assist users of the financial statements to gain a clearer understanding of the underlying performance of the business, allowing the impact of restructuring and reorganisation activities and acquisition costs to be identified separately. These alternative performance measures can be found in Note 1 to the accounts.

Going concern

In determining the basis of preparation for the Annual Report and the Group's viability statement, the directors have considered the Group's business activities, together with the factors likely to affect its future development, performance and position. This includes an overview of the Group's financial position, cash flows, liquidity position and borrowing facilities.

The Group meets its working capital requirements through a combination of cash resources, committed and uncommitted facilities, and overdrafts. The overdrafts and uncommitted facilities are repayable on demand but the committed facilities are due for renewal as set out below. There is sufficient headroom in the committed facility covenants to assume that these facilities can be operated as contracted for the foreseeable future.

The committed facilities as at 31 December 2018 were as follows:

- £230m Revolving Credit Facility maturing 3 April 2022

The December 2018 weighted average life of the committed facilities was 3.3 years.

The Group's forecasts and projections, taking account of reasonable potential changes in trading performance, show that the Group should be able to operate within the level of its current committed facilities.

The directors have reviewed forecasts and projections for the Group's markets and services, assessing the committed facility and financial covenant headroom, central liquidity and the Group's ability to access further funding. The directors also reviewed downside sensitivity analysis over the forecast period, thereby taking into account the uncertainties arising from the current economic environment. Following this review, the directors have formed a judgement, at the time of approving the financial statements, that there is a reasonable expectation that the Group has adequate resources to continue in operational existence for the forseeable future. For this reason, the directors continue to adopt the going concern basis in preparing the financial statements.

D. Yates
Chief Financial Officer
8 March 2019