Chief Executive's review

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S.C. Harris | Group Chief Executive

Overview

Bodycote moved strongly ahead in 2013 despite mixed market conditions. Reported revenue grew by £31.8m (5.4%) to £619.6m, albeit helped by a positive contribution of £14.2m (2.4%) from foreign exchange translation effects. This corresponds to a 3% growth at constant exchange rates. The acquisitions made in 2012 contributed £32.4m, or 5.5%, with organic revenues declining by £14.8m (2.5%). Nearly all of Bodycote's markets were weak in the first part of the year but, encouragingly, many strengthened as the year progressed.

Margins increased once again with progress in both the Aerospace, Defence & Energy (ADE) and Automotive & General Industrial (AGI) businesses. Group margins rose to 17.3% from 16.6% in the prior year. ADE now has a margin of 27.0% (2012: 26.8%) and AGI has improved to 14.7% (2012: 13.4%). These margin improvements are largely down to the continuing drive towards a better mix of business, notably from increased revenues generated in S^{3}P and HIP Product Fabrication, and strong cost management. This can be seen very clearly when looking at the organic performance of the Group on a constant currency basis. Overall organic profit fell only £0.4m on £14.8m of organic sales decline. Both ADE and AGI saw organic sales declines, the former primarily driven by falling oil & gas demand and the latter driven by weak general industrial demand. The mix improvement and cost management efforts held organic headline operating profit decline in ADE to £0.9m on organic sales down £4.5m, while in AGI headline operating profit increased by £0.8m notwithstanding a £10.3m drop in organic revenues. Acquisitions added £6.7m of headline operating profit.

A key element of the Group's success in these weak economic conditions was its ability to maintain price increases at or above cost inflation. In 2013, the business demonstrated its pricing power once again with price increases some £1.6m greater than cost increases.

In 2013 headline EPS grew by 10% to 41.2p while return on capital employed grew to 19.9% (2012: 17.9%). The high quality of the Group's earnings was underscored by the cash performance with a headline operating cash flow of £108.9m (2012: £110.8m), corresponding to a headline operating cash conversation rate of 101%. This was despite a 20% increase in capital spending. One of the consequences of Bodycote's focus on high returns on investment and a constant focus on cash generation resulted in the Group finishing the year with net cash of £15.0m. This compares to £34.2m of net debt at the end of 2012.

The Group's priority for the use of cash is firstly to fund organic expansion followed by enhancement of the core dividend. Acquisitions form the third priority after these first two items. Supplemental distributions will only be made if cash generation exceeds the immediate needs of the business and such a distribution can be undertaken without compromising the Group's acquisition strategy or sacrificing its strong financial position.

Strategic progress

The Group's expansion in China continued with one new plant coming on stream in 2013. There is strong demand for Bodycote's service offering in China, which is geared towards non-Chinese companies targeting the domestic Chinese market. Further facilities are currently in the planning stage for the emerging markets.

The market in Brazil remained challenging in 2013 and even though 20 basis points of the Group's margin improvement was derived from a better operating performance in Brazil, the business has yet to reach breakeven. Further progress is expected in 2014 with the focus now firmly shifted to sales expansion following the restructuring activities of previous years. Any improvement in the Brazilian economy in this region should have a significant positive impact, as operational gearing is likely to be very high on extra sales generated.

The new technologies of S^3P and HIP Product Fabrication are starting to be meaningful contributors to the Group performance. Investment in these exciting technologies has been a focus for some five years now and they have moved from a virtual standing start to adding 40 basis points to the Group's margins in 2013 compared to 2012. Significant capacity expansion took place in S^3P during 2012 and 2013 and more expansion will occur in the coming year. Meanwhile, extra Giga HIP capacity was brought online at the end of 2013 which will further assist the growth in the HIP business in 2014.

A significant focus in 2013 was the post-acquisition integration of the three businesses acquired in 2012. The integration has been virtually seamless and the new businesses together generated a 13% return on investment in their first full year of Bodycote ownership. No new acquisitions were made during the year. The Group continues to be on the lookout for value enhancing acquisitions.

Summary and outlook

In 2013 improvements in business mix, plus the full year effect of the 2012 acquisitions, enabled Bodycote to achieve good growth and strong returns, despite weak markets in the early part of the year.

At this early stage in the year and on a constant currency basis, the Board expects Bodycote's growth initiatives to deliver further progress in 2014.

S.C. Harris
Group Chief Executive
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