spectris

2019 Half Year Results

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Business Overview

Andrew Heath

Chief Executive, Spectris

Introduction

Good morning. Thank you everyone for coming along. Welcome to all of you in the room but also to those on the webcast to Spectris' first half results for 2019. I'm Andrew Heath, Chief Executive, and I'm joined today by Derek Harding, our CFO. I think you have all seen and heard from us fairly recently at our Capital Markets Day back in June, so today we're going to focus the presentation primarily on the first half results but also talk to you about the outlook for the rest of the year. I'll go through the headlines then pass over to Derek to run through the numbers and how we currently see the second half. I'll then come back to talk to you about some of the operational developments in the business before opening a session to Q&A.

H1 2019 Headlines

Headlines

So let's get into it. In terms of the headlines, you'll have already seen the details of our first half results. I'm pleased to say that overall they were in line with expectations. Sales at £759 million reflect a 1.2% like for like increase year over year, a moderation in growth, admittedly, from 2018 but very much as we anticipated.

As a consequence of our focus on profitable growth, our adjusted operating margin was up 30 basis points on a like for like basis and we also saw strong operating cash flow conversion of 89%. Adjusted EPS was up 4% and we've increased the dividend ahead of this by 7%. The strategic review, as you know, is now complete and we're firmly focused on executing our strategy for profitable growth and that's very much where our management attention is now moving.

Profit improvement programme

We've been very busy implementing initiatives also under the profit improvement programme and as you'll have seen in this morning's announcement, we now expect the benefits from the programme to be at the upper end of the £15-20 million range that we'd previously guided and we are reconfirming the exit run rate coming out of this year of £30 million.

Strategic review

As part of the strategic review and our focus on profit improvement, as you know we've been critically appraising all aspects of the business and inevitably this has consequences. And as such we've taken a number of decisions on restructuring, which has led to a charge of £35 million relating to an impairment of good will and £45.8 million relating to other intangibles, and I'll speak further about those in a moment.

Focus on small units

But before I do, I'd just like to reiterate a few of the key messages from our recent capital markets day. Spectris represents an exciting opportunity to make a good company even stronger. We're moving away from a number of disparate businesses to a small number of highly attractive focus platforms, investing to maintain and build their leadership positions and also their differentiation into the future. Simply put, we're going to be a more focused and less complex business. We've confirmed the selection of Malvern Panalytical, HBK and Omega as platforms, we're clear on the direction for each of the industrial solutions businesses and our capital allocation approach has been redefined and communicated.

As I've just said, going through the strategic review alongside the focus on the profit improvement programme, has led us to critically assess all of our assets and businesses. As well as identifying the future growth drivers for Spectris, we've also had to appraise any businesses which are underachieving in our eyes, and as a result we've concluded it necessary to cease a business line within the Test and Measurement segment and we are proposing a restructuring at Concept Life Sciences.

Concept Life Sciences

Just in terms of Concept Life Sciences, I think it's absolutely fair to say we've been disappointed with the performance. It fell significantly below expectations again in the first half of this year, posting an underlying loss of £4.9 million. Despite all the remedial action that's been put in place to improve operational effectiveness in the environmental analysis side of the business, it continues to be loss making. The integrated drug discovery and development services business also lost its major customer and we were unable to backfill that work in the first half. Consequently we replaced the senior management at CLS in the second quarter and asked the new team to undertake a detailed review of both businesses. And in result of that it's proposed that subject to consultation and the usual legal requirements, the environmental analytical laboratories will be closed. Significant investment would be required in our view in order to recapture share and build that business back, and we don't see that investment as being viable. As a result, a non-cash impairment of goodwill and other intangible assets has been charged to the income statement as previously mentioned.

So to be clear, we still see the markets for pharmaceuticals, life sciences and food analysis as being attractive for CLS. There, we see customers continuing to outsource more analytical services and also pharmaceutical development work. From the start of July, CLS is now part of the Malvern Panalytical platform and in combination, the two businesses will provide the opportunity to develop both differentiated instruments but also differentiated CRO offerings for customers. And the work the two businesses have been doing since CLS joined Spectris back in February of last year is already to demonstrate that point.

So I'll now pass you over to Derek, who will take you through the numbers and also how we see the second half. Derek?

Results and Second Half Outlook

Derek Harding

Chief Financial Officer, Spectris

Summary of key metrics

Thanks, Andrew. Good morning everyone. It's nice to see some familiar faces and also to meet those of you I've not met before. I'm Derek Harding, I'm the CFO here at Spectris since March of this year.

So my first slide is a summary of the key metrics. Andrew's been through these but I'll take you through them again, just in a little more detail. You can see that sales have increased by 4% to £759.1 million. And of that, 1% came from acquisitions, net of disposals, and 2% came from favourable foreign exchange, leaving a like for like sales increase of £8.3 million or 1%. And I'll take you through each of the component movements of that shortly.

Adjusted operating profit increased by 8% to £83.5 million. Again, 1% of this came from acquisitions, 3% came from favourable foreign exchange, leaving a like for like increase of £3.3 million or 4%.

I'm pleased to report an improved adjusted operating margin at 11% for the first half. This is 40 basis points higher than the same period in the prior year, and the difference between the adjusted operating profit you see on this slide of £83.5 and profit before tax of £77.2 is interest and our share of post-tax results from the EMS joint venture, and you can see that that number also grew by 4% year on year.

Our tax rate came in at 21.5%, which is in line with the guidance given at the year end, and that increase resulted from the unwind of our previous finance company structure. Adjusted earnings per share have increased by 4% to 52.4 pence, reflecting the net impact of the 4% increase in adjusted profit before tax, the increase in the effective tax offset by the increase in the effective tax rate and the decrease in the average weighted number of shares, which went from 119 to 115.7 at the first half following the share buyback last year.

We've increased the interim dividend by 7% to 21.9 pence and this is in line with our stated policy of progressive dividend based on affordability and sustainability. The cover remains good 2.4 times and is consistent with our long term average, which has been around 2.5 times.

Adjusted operating cash flow generation of £73.9 million during the period resulted in a cash conversion of 89%, compared with 69% in the first half last year. And I'll talk about cash a little more later as well.

During the period, net debt increased by £15.5 million to £312.6 and our net debt to EBITDA covenant for covenant purposes was 1.1 times compared to an upper limit of 3.5 for our RCF and 3 times for our EIB loans. And our interest cover at the half year was well in excess of our minimum requirement of 3.75 times.

And finally on this slide you can see our new measurement of return on gross capital employed. You can see that it fell from 14.2 last year to 13.4 at the half year, and that's mainly due to the full year impact of the CLS acquisition. And I'll talk you through that measure as well slightly later.

First half at a glance

Key drivers of sales increase

So the next slide just looks at the first half at a glance. Starting on the top left, I've bridged the key drivers of the 4% increase in our sales. So to arrive at a comparable basis, we've reduced last year's reported sales by £8.8 million, which reflects the five months of sales from EMS, which we sold to the joint venture to Macquarie on 31st May 2018.

We then have incremental revenue from acquisitions of £15.9 million. That was six months of VI-grade, three months of Revolutionary Engineering and one month of CLS in the comparable.

Translation foreign exchange has increased our reported sales by £15.7 million, the majority of that came from weakness of sterling against the dollar, and that leaves a like for like sales growth of £8.3 million or 1.2%. The majority of this like for like increase has come from improved pricing, resulting from the additional focus on the factors in the business that we can control.

Reconciliation of adjusted operating profit

The chart at the bottom left of the slide reconciles the adjusted operating profit, which as I said, went up by 8% to £83.5 million. Disposals net of acquisitions contributed £0.5 million in the period and this primarily related to the disposal of EMS, which was loss making last year, plus a small net contribution from the other acquisitions mentioned above.

Currency movements gave a benefit of £2.5 million, again due to weakness of sterling against the dollar, and a change in the mix of product, meaning increased material and labour overhead, has offset our improved pricing and that resulted in a small decline in our gross profit despite the increase in sales. That resulted in a 70 basis point reduction in the gross margin to 55.2%.

Despite the reduction in gross margin, we still delivered a 40 basis point margin expansion, from 10.6 to 11, and that is as a result of our continued focus on the cost base, which more than offset inflation and incremental depreciation.

Improvement in overheads

If you look more closely at that overhead's improvement of £3.8 million, there are a number of moving parts worth noting. Overall, our employee costs have remained broadly flat in the period compared to the prior year, with the actions of our profit improvement programme offsetting those inflationary increases. Additional depreciation and net transactional foreign exchange charges were broadly offset by slightly lower R&D charge due to the capitalisation of £3.5 million of R&D following the policy implementation in the second half, and then savings in marketing spend, travel expenses, consulting and external services, have all contributed to the net profit contribution and the overhead control that we've seen.

Notwithstanding the progress we've made in the first half, we do still see opportunity to improve further in the second half and beyond.

Cash generation and uses

This is a waterfall showing how we generated cash and then what we did with it. It's another way of looking at sources and uses, as I talked about at the Capital Markets Day as a key focus of the group. So starting by adding back the depreciation and amortisation - this is all on an adjusted basis, as well, by the way – there's £28 million of depreciation and that brings you up to £111.5 million EBITDA generated in the first six months.

Working capital was broadly stable with a decrease in receivables being offset by higher inventory and lower payables. I'll come back to that later when I look at the balance sheet. And CAPEX net of grants at £39.3 million was broadly in line with the same period last year and includes investment in Millbrook of £18.4 million. As you think about your modelling for the full year, we're anticipating total CAPEX in 2019 of around £90 million, of which £40 million will relate to Millbrook.

And that then gives us the adjusted operating cash and operating activities of £73.9 million, which we divide into our operating profit to give our cash conversion. At 89% we're very happy with the first half of the year and we anticipate the full year conversion will be in the range of 80-90%.

Interest and tax had a combined cash effect of £20.7 million and the full year dividend is due to utilise £46.9 million of the cash generated in the first half.

Transaction costs

We completed one acquisition during the period, which had a total cost of £3.8 million, and then there was £1.9 million payed in respect of prior-year acquisitions, making that outflow £5.7 million and furthermore we spent £1.7 million on transaction related costs, which gives a total transaction outflow of £7.4 million in the period.

We spent £13 million on restructuring and within the other items of £1.4 million, there is a lease payment of £9.9 million, which was offset by cash from the sale of the property at Omega. And overall that then leaves you the £15.5 million increase in our debt position during the period.

Reconciliation of adjusted operating profit with statutory profit

Now, there are a number of moving parts in the announcement this morning and I thought it would be helpful to give you a reconciliation between our adjusted operating profit and the statutory profit measures that you can see in the accounts. So I'll take each one in turn.

We have incurred restructuring costs of £29.1 million, of which £8.1 million relates to non-cash items. The largest of those restructuring costs, the £29.1 million, relate to redundancy payments across the group.

We have consistently adjusted for transaction-related costs, depreciation, fair value adjustments, relating to acquisitions. As you can see they're broadly similar year on year. And then we've also put in £5.2 million of profit on disposal, which is a property sold as part of our facility footprint rationalisation across the group.

Andrew's already discussed the situation at Concept Life Sciences, and here you can see the £35.1 million impairment of goodwill relating to that asset and there is also £32.4 million impairment relating to customer relationships and technology within the CLS decision today. And that balance is part of the £63.9 million that you can see there shown on the slide, the remainder of that balance being made up of the normal annual amortisation, which you can see was £18 million last year, and then there's £13.4 million relating to other restructuring activities that we undertook as part of the profit improvement programme. Again, the impairment of customer-related intangibles.

So if you then look at the statutory loss for the first half of 2019 and compare it to the profit in the prior year, the comparison's further complicated on that bottom line by £57 million of profit that we made in the prior year.

So as you can see, there are a few moving parts to consider but hopefully the slide helps you see the wood from the trees and get a sense of underlying performance in the first half.

Balance sheet

Always good to have a look at the balance sheet. I'm not going to go through every line on here but I'll just pull out a couple of the key metrics. First of all, you can see the effect of the goodwill in the intangible impairment at the top of the table. Just a reminder, although this impairment does have the impact of reducing the group's net assets, in the way in which we're calculating our return on gross capital employed, we will actually add that impairment back.

PPE appears to have significantly increased in the half and that's mainly due to the accounting impact of IFRS 16. Actually, on this balance sheet as presented here, you can see the other side of that accounting, with a lease liability balance there of £70.2 million at the year end. We do not include that balance in our definition of net debt. So if you're looking at your models and I talk about net debt, it does not include that £70.2 million and the reason for that is because our banking covenants don't include it either, so we report our net debt in line with our banking covenants.

Joint ventures

And there's a balance, three down, for net investment in joint ventures. Now, this is an interesting balance actually. It was generated as part of the disposal of EMS to the joint venture with Macquarie last year, and as you recall, at the time we recognised a profit on disposal of £57 million. So the recoverable amount is based on the future value which is expected to be achieved from an ultimate sale of that joint venture, and the estimate's derived from the operating cash flow, future growth rates and multiples achieved from sale of similar entities in the same sector. It's worth noting that the joint venture is in the early days of delivering a nascent business plan and as such any future events could change the assumptions used to determine that recoverable amount. If there are changes in the future to that balance, they will be non-cash and accounted for below operating profit in the same way as the profit that we recognised last year that effectively generated the balance in the first place.

Working capital

So moving on to working capital, as you can see the overall balance has not moved materially since the year end, with increases in inventories being offset elsewhere, but average trade working capital expressed as a percentage of sales did increase by 1.2 points to 12.6%, which is well inside the range of 11 to 15 which I outlined at the Capital Markets Day. Notwithstanding that, I do think there are pockets around the group where we can do better, particularly around stocking the right inventory and swifter collection of receivables, and this will remain a focus for the finance teams around the group over the coming six months.

And finally on this page, you can see our pension liabilities. They increased slightly since the year end due to actuarial assumptions but as you can see in the context of the group, our net liability is not material. So, unlike many companies, pensions are not a particularly major area of concern for us.

Return on gross capital employed

So, return on gross capital employed. So this is the slide that bridges the primary movements in that calculation. And as I said at the Capital Markets Day, our return on gross capital employed is defined as the ratio of adjusted operating profit to the average year-end shareholders' equity, net debt, accumulated amortisation, impairment of goodwill and acquired intangible assets. So we've chosen the measure because it's easy to calculate from looking at the accounts and it is also easy to compare to our group WAC, which we determine to be around 10%.

At the half year, though, it's not quite so easy to determine from the accounts, because we're using a trailing 12-month set of numbers. So when you look at the operating profit, it's effectively the adjusted operating profit number you see there of £254.6 is the sum of £171.1, which was H2 last year, plus the £83.5 that we're announcing today. So it's effectively the trailing 12 months. And then the average working capital is the average of the two averages from last June and this June. So that's why, when you look at that number, at 13.4%, it's slightly lower than the number I gave at the capital markets, because that was a year-end position. And then once we get into the rhythm of this, you'll see how it flows.

The main driver of the difference year on year is the full year impact of having CLS come through the whole 12 months of this year versus not being in all of last year's starting point.

Guidance on Second Half 2019

So before I hand back to Andrew, I thought it would be helpful to share, some guidance on how we see the second half, although I'll let you be the judge of how helpful when I get to the end. At the end of the day, when you're managing a business in a dynamic environment, there are headwinds and tailwinds that we face.

So starting with the headwinds, we remain cautious about the impact of the current political and economic environment in which we operate. Like many of our peers, we have experienced a slowdown in the second quarter compared to the first quarter, and we do not have enough visibility at this stage to determine if this is a slight blip or the beginning of a concerning trend. Our lack of visibility does extend to the fourth quarter as well, which has traditionally been our strongest performing period. The uncertainty is highlighted best perhaps when looking at the North American industrial market and the automotive sector. Over recent weeks, we've seen external commentators give both positive and negative views on each of these sectors, so it's fair to say that we are operating on less than perfect information.

In this environment, we intend to focus on the areas that we can control and make plans on the assumptions that the market will not help us. So to this end, we do have some reasonable tailwinds. We're confident that our profit improvement activities can continue to offset inflationary pressures in our cost space and a number of challenges that we faced in the first half, such as the launch of the Omega website, the restructuring of HBK sales and marketing teams, are now behind us. And furthermore, the recent CAPEX invested at Millbrook is now coming online and we anticipate an improved performance here in the second half.

In the case of CLS, we do anticipate losses in the second half, but they will be around £1.5 to £2 million, which is broadly the same as the second half of last year. So if you're doing a second half to second half comparison, it doesn't make a big difference.

Perhaps a little easier to model is our tax rate, which we expect – and our CAPEX spend – which we expect to be around 21.5% and £90 million. As I said earlier, £40 million relating to Millbrook.

And finally, looking at foreign exchange, the sensitivities haven't moved materially since prior guidance. The table on there shows the impact of 1 cent within euros and dollars both in terms of the profit line and the sales line, so you can see that 1 cent moved in dollars is a £4 million move in sales and £600,000 in profit.

Overall, we do expect to deliver a modest improvement in our second half profit compared to the prior year. And with that, I'll hand back to Andrew.

Operational Developments

Andrew Heath

Chief Executive, Spectris

Sales summary

Thank you Derek. So let me take you through the operational performance, which is how we see the businesses performing today, and I'll start by looking at sales and give you a high-level summary of the sales by region and by segment, and then I'll go through each of the segments in turn in more detail.

By region

So by region, like for like sales were lower in both North America and in Europe, with sales in Germany down. I think these generally reflect what we're seeing in terms of PMI trends across these geographies. We have seen softening industrial production in the US with Europe, particularly Germany and the UK, also down.

Asia continues to deliver good growth broadly spread across the region, although in China we have seen like for like sales marginally lower. I think that just reflects a tougher comparator and the impact of US-China trade tensions.

Across the end markets, we see growth in semicon, electronics, advanced materials, academic research and with pulp and paper, energy and utilities well up on last year.

By segment

By segment we saw particularly good growth in materials analysis and inline instrumentation. Weakening US production and a declining automotive environment, however, has negatively impacted test and measurement and industrial controls in particular. And of course I think this is the last time we will be reporting in this way by segment, as we committed to do at the Capital Markets Day, we'll be reporting by platform and the industrial solutions segment in the future.

So moving on to materials analysis. There we saw good sales growth, up 6% on a like for like basis, particularly in advanced materials, semicon and academic research. Adjusted operating profit increased 3%, however the like for like decline in operating margin reflects the dilutive effects of CLS.

Pharma was flat year over year, reflecting a tough comparator, particularly for North America. But we saw good growth in Asia in the first half, especially in China where efforts to develop the healthcare system to support a rising middle class supports the demand for retail pharmaceuticals. Our pharma pipeline and order book are good, with Malvern Panalyticals order intake notably ahead of last year.

There's also been some softening in metals and mining but offsetting that we are seeing good orders in building and also advanced materials. They remain robust.

Malvern Panalytical

Sales into academic research institutes have also been particularly strong in the first half. Both Malvern Panalytical and PMS achieved good sales growth, delivering strong financial performance and operating margin expansion. Malvern Panalytical also benefitted from improving pricing and lower overheads as a consequence of its focus on its merger but also on implementing the profit improvement programme.

Malvern Panalytical has also continued to deliver new products with its latest generation of x-ray fluorescent spectrometers and a new laser particle size analyser adding to the steady number of products that we've launched since 2018. They are also looking to extend their offering with more predictive and prescriptive solutions and are partnering with the University of Bristol here in the UK to open a new data science facility using artificial intelligence to develop these new software offerings.

PMS

PMS delivered a strong first half performance especially in Asia, again reflecting a strong year end order book for PMS. While the semiconductor market has been weaker this year, with sales of manufacturing equipment predicted to be down almost 20%, PMS' strong order book coming into 2019 enabled sales to grow year over year. And in 2020 all the signs are that the equipment market is expected to recover on the strength of memory spending, a new product in China starting in the second half of this year, so we fully anticipate a return to strong order intake towards the back end of this year moving into next year.

Pharma and life sciences has also been strong for PMS. They've launched a new clean-room monitoring software product. The software is used with its FacilityPro processors, which connect directly to environmental, temperature and humidity sensors. These monitoring solutions are key to helping customers meet regulatory requirements, which are becoming ever more stringent.

Test and Measurement

In Test and Measurement, like for like sales declined 3%, which reflects a tough comparator in automotive, especially in Asia and Europe. Adjusted operating margins were flat. The impact of the lower sales volumes and higher depreciation at Millbrook was mostly contained by lower overheads for the segment and ESG also moving into profitability. However, we do remain positive on the near-term opportunities with test and measurement. I'll take you through those in a moment.

Technology and developments in automotive, such as the wider proliferation of platforms across conventional, electric and connected vehicles, is supporting significant R&D spend and demand for our products. In particular, vehicle electrification is accelerating and 2019 is set to become the year when model activity in the battery-electric vehicle sector appears to be finally taking off. We're positioning ourselves to take advantage of these trends. For instance, HBK is seeing good demand for its new eDrive system, we showed that at the Capital Markets Day. That's used for testing electrical inverters and motors, utilising our data acquisition systems, dedicated application software, torque and other sensors. And that's in addition to the battery durability testing solutions which cover voltage, temperature, vibration measurement and also lifecycle testing. And there's increased interest in our sound measurement tools to simulate the exterior sound of hybrid and electric vehicles and also evaluating exterior pass-by noise.

At Millbrook we have new capacity coming online. Eight of the new battery test chambers are now in operation with a further four to follow in the second half. We also have a new test facility for ADAS and connected autonomous vehicles at the Millbrook facility, supported by the recently installed 5G network. In the US, Millbrook has doubled its capacity at Millbrook RE with a new test facilities in both Detroit but also in California for the testing of electric vehicle development, and VI-grade is partnering with Multimatic for a simulation centre near Detroit to serve the US OEMs.

In aerospace, sales were slightly lower in the first half but again we see good opportunities in research and development for the electrification of aircraft plus business jet programmes focussed on component testing and various space programmes as well.

In telecoms and electronics, our acoustic testing products are also in demand for the increased audio quality requirements for new products, both in terms of voice activation and also noise abatement.

However, I guess the one dark spot is really in oil and gas at the moment. The outlook is uncertain for our ESG business in microseismic, the US onshore looking more challenging after a more encouraging end to 2018.

But just in terms of HBK as one of our platform businesses, they are merging HBM and Bruel & Kjaer Sound and Vibration, as you know. The extended leadership team is being formed and is almost fully complete. They have integrated their sales team and developed a new go-to-market model, and while we saw some interruption from the merger activity in the first half, encouragingly orders picked up quite significantly in May and June, which gives us more comfort going into the second half. And I think it’s fair to say we see 2019 very much as a transition year for HBK but with good opportunities for margin expansion as we bring the businesses together.

In-line Instrumentation

On In-line instrumentation, there was good like for like sales growth of 7%, though to be candid, this is against an easy comparator from last year. Growth was broadly spread across most of our key end markets, being particularly strong in North America and Asia. The segmental operating margin improved 360 basis points on a like for like basis, with all companies contributing to the improvement, predominately reflecting the higher sales and gross margin at BTG and Servomex but also the profit improvement programme benefits coming in across all of the operating companies.

BTG is performing very well. We’re seeing good like for like sales growth there, particularly in tissue in Europe and Asia, with graphic paper doing well despite the decline in the coated paper market and a slowdown in China. We expect the overall market conditions to continue for BTG into the second half.

Servomex saw good sales growth, particularly into energy and utility customers in Asia and North America, with hydrocarbon orders in particular doing well. We’ve seen the demand for gas analysis increasing as emissions regulations become more stringent.

Industrial Controls

On Industrial Controls, like for like sales, disappointed. They declined 7% in the first half and this is also reflected in the profit decline and the lower margin achieved over that period. Both Omega and Red Lion saw lower sales as a consequence of slowing US industrial production, the US-China tensions and high one-off sales not repeating in Omega from last year. But frankly, the sales performance also reflected temporary disruption to activity at Omega, both from some teething issues following a supplier change but also some teething issues following the implementation of the new ecommerce platform and getting the traffic flows back up to the previous levels. But equally candidly, going into the second half, the traffic on the Omega website is now back to prelaunch levels, delivering enhanced customer experience and we're seeing our conversion rate, order volume and order value all improving.

Both Red Lion and Omega are actively working on refreshing their product lines. Red Lion has launched its new Halo integrated communication product to replace multiple older versions and that's being trialled with its first customer as we speak, and Omega has launched more than 30 new product lines to date including handheld thermal imaging and ultrasonic liquid level sensors. They have many more such product introductions to make through the rest of the year.

We expect the combination of the new digital platform Omega and this product refresh on both businesses to drive sales into the second half and beyond. I think it's fair to say, given the 70% exposure that both Red Lion and Omega have to the US in this segment, their performance will be contingent on the US industrial markets, which have been softer for us in the first half and we do expect that to continue. Demand is clearly also being impacted by the US-China tariff situation, particularly at Omega, where its products are incurring duties as they are exported into China and then frequently the sensors get incorporated into products which are then re-exported back to the US, so effectively they're getting a double hit on a number of the tariffs.

Profit improvement programme

So that's the segments. Moving on to the profit improvement programme. While there are some uncertainties in our end markets, we continue to focus on what we can control. I think we've said that consistently since I've arrived. In the first half all our operating companies have been implementing their initiatives under the profit improvement programme. We have made really good progress, as you saw with the numbers Derek took you through. The benefits fall into the four categories that we described before, I'll just quickly run through each in turn.

People

Firstly, on people. Organisational restructuring is predominantly the main driver here, reducing headcount, and a number of our operating companies, including Servomex, Omega, Millbrook and ESG have all completed their restructuring. Other businesses are still continuing with that activity into the second half, which will bring further benefits into the second half.

Property

On property, we have closed a number of facilities and offices around the world. Malvern Panalytical has closed its Longmont facility, NDCT has closed its property in Colorado, ESG are closing their Denver office, Red Lion has sold its St Louis facility and a number of other sites are being closed as well. Again, all helping to reduce ongoing operating expense.

Products

On the product side, lower margin products are being phased out. We've declared the cessation of a business line within test and measurement and taken a charge in the results but for instance we've also reduced our metals product line at NDCT as well as a cable-testing product there. So as we're going round the businesses, we're continuing to challenge and look at the profitability of the product portfolios within each of the businesses and make sure that we've got high quality products on sale now and developing new products into the future.

Processes

And with regards to process, we're actively deploying the Spectris business system and implementing lean and using things like value analysis/value engineering tools to make our processes more efficient and our products more competitive.

Overall benefits

So overall this is enabling us to control costs and reverse the inflation overheads that we've seen in the past two years, in 2017 and 2018. Like for like overheads in the first half were down 1.2% while sales were up 1.2%. And we can see, as Derek said, more benefits coming in the second half. We've delivered £8 million of savings so far this year at a cost of £29 million and fully expect the benefits, as I said earlier, at the upper end of the range versus our previous guidance and as such we are confident in achieving the £30 million exit run rate coming out of the back end of this year. And while the costs to achieve the programme have increased to £45 million, the rise reflects the impact of further restructuring, the largest item being within CLS.

The Spectris business system

But before I finish, I just want to emphasise the importance of implementing the Spectris business system across all our operating companies. As we execute our strategy it's absolutely essential we engage our people in the process of making Spectris a better and stronger business. At the heart of the business system are a set of tried and tested tools that help us reduce waste, drive growth, improve profitability. Kaizen on the shop floor as I said at the Capital Markets Day, you know, whether it's the shop floor at the offices or in the field, it has to become a way of life for Spectris. This is a fundamental part of our ongoing profitability and profit improvement activities.

Consequently, we've been placing greater emphasis on accelerating deployment of the business system this year. We've been running numerous kaizen events across our businesses, primarily focussing on improving on-time delivery but also, not just in terms of the shop floor but also in the offices. And there we've been focussing on what we call commercial-oriented kaizens focussing on the flow from lead-generation opportunities through to order conversion and supporting the sales and marketing teams to become more efficient as well as more effective in translating orders to sales.

As I said, the objective of these events is to engage our people. They know the processes best, give them the right tools, the right facilitation, we can drive significant continuous improvement across Spectris, reducing lead times, reducing waste, improving quality and also driving up customer satisfaction, which in turn delivers incremental yet more sustainable profitable growth.

We're making good progress. I think as I said previously, there's considerably more to do. We're relatively new on the lean journey but that does mean there's much more opportunity ahead of us.

Summary and outlook

So finally in terms of summary and outlook, despite the more challenging macro-economics and geopolitical backdrop, our results have been in line with overall expectations and I'm pleased with the operating margin expansion and cash flow that we've delivered. Our full year expectations remain unchanged though clearly the current environment does make that more challenging, hence our focus on the factors we can control. There are lots of positives in the business helping to drive our performance in the second half of the year. We have a number of attractive markets still performing well, we have a number of product launches happening in the second half. The new digital platform at Omega is up and running and performing well now. Further benefits from the profit improvement programme will continue and flow through into the second half and we remain absolutely focussed on controlling our costs in this more uncertain environment. And with the strategic review now complete, our focus is firmly on the execution of the strategy to deliver enhanced shareholder value.

And with that, Derek and I will be more than happy to take your questions.

Q&A

William Turner (Goldman Sachs): I've got a couple of questions. The first one is, clearly you grew about 3% in the first four months of the year and then 1% for the whole half. Can you talk about which of the businesses deteriorated the most in the last two months for that slowdown?

Andrew Heath: I'll give you a broad answer, William. I think certainly we were pretty pleased with the first quarter but we have seen a slowing, and a progressive slowing, in the second quarter, particularly towards the end of the quarter. The businesses that we have seen the impact the most have been within test and measurement and the industrial controls, as we've said. The general automotive environment has been less positive for us this year than certainly last year. It was a tough comparator for sure in automotive last year. We're still seeing a large number of R&D programmes, a proliferation of new platforms within the OEMs, but there has clearly been a tightening of belts in certain of our end customers. But generally speaking we still see plenty of opportunities there. To some extent it's unfortunate, the combination of HBM and Bruel & Kjaer within HBK has come at a time just where the market took a bit of a turndown, so that's not helped by the fact we've been changing the sales force, refocussing it around end-markets as we've combined the businesses.

And I think the other part of this is the softening of industrial production in the US. That's certainly impacted both Omega and Red Lion.

William Turner: And then on that last point, when we look at some of the PMI indexes, some manufacturing distributors into the US, they're still having some growth and it's often more European-related industrial production which seems to be the weakest spot. So between those three factors that drove the industrial controls slowdown, which were the most dominant?

Andrew Heath: Well, 70% of the turnover of industrial controls is North America so it's predominantly what we've seen in the slowing down in predominantly the US on IP that's impacted those businesses the most. China, Asia's been a good growth, certainly for Omega, in recent years. The tariffs have certainly impacted that.

William Turner: Okay, thanks.

Andrew Douglas (Jefferies): Good morning. Three questions, please. The profit improvement plan, clearly you're reasonably happy with the numbers you've put out there and upper end is good. Are you happy with how that's been driven by the business? No issues with wastage of customers from the actions you've taken? Just a bigger view on how the business has approached that.

Again, similar question for HBK in terms of the progress made. We've taken the playbook from Malvern Panalytical, which I think is roughly what we're doing, it's broadly similar for HBK. Again, as chief executive, almost a year in, are you happy with how HBK is doing? I appreciate there's a few hiccups in the first half but that's always the way, but a view there.

And Derek, can you just remind us, CLS loss was £4.9 million in the first half. What was that in the prior year?

Andrew Heath: We'll try and take them in turn, if I can remember then all, Andrew. So the first one, profit improvement rate. I'm delighted with the progress, I think the way the business and the business leadership has responded to the programme right from the get-go has been hugely encouraging. There's been real strong ownership and that is really what has driven the £8 million of benefits we've been able to cash in the first half of the year. That gives us confidence going into the second half. The messages around profitable growth, getting focus, looking at making sure we've got the product portfolios in each of those business right and set up for the future, getting the footprint more rationalised, look at the efficiency and deploying the Spectris business system into all of that, are being really well embraced. And I think that's one of the powers of the Spectris operating model. We've had an operating model whereby each of the operating companies have been quite devolved and we've strengthened that and provided the greater accountability and responsibility and they've responded really well to it.

So that's going very well. In HBK we've changed the leadership. You saw Joe Vorih, the new president, at the Capital Markets Day. Joe's an impressive individual, ex-Danaher, worked in private equity. He knows how to do this. He's absolutely focussed on the right things and driving things hard. We've had to make a few more changes in terms of getting the overall leadership team to come together, that's taken a bit of time, disrupting the sales force. Any merger process always has some impact. As I said earlier to William's question, it's just unfortunate it's coincided with a bit of a dip in the market. But in terms of our views of test and measurement, our views of HBK, remain unchanged. Their view of the world, and I agree with this, is that they have plenty of opportunities to go after for them to get themselves organised and focus on that.

Derek Harding: CLS was breakeven in the first half last year. So if you recall that we only bought it at the beginning of the first half of last year and then lost around £1.5 million in the second half, and I guess when we came out at the year end, we'd guided that there would be a flip to plus 6 at that business.

Mark Davies Jones (Stifel): Not had much mention of Millbrook so far. There is a lot of CAPEX obviously that continues to go in there, with the weakening of demand in auto, do you still have visibility on the future loading of those investments that you've put in over the last couple of years?

Andrew Heath: Yes, so we absolutely track the CAPEX investment at Millbrook. We have spent, as you know, quite a lot of money there and we're continually revaluating the effectiveness of that CAPEX in terms of sales. We've clearly seen a slowing down of test services in the UK in the first half, which has impacted them, but a lot of the investment has gone into areas like electric vehicle drive testing, battery testing, durability testing, and those areas in those investments we are getting good loading and good capacity utilisation of the assets we've put in place. That's both at the Bedford facility but also in the US, the acquisition of Millbrook RE, Revolutionary Engineering. We've had to expand the capacity both in Detroit but also put in new capacity on the ground in California to take advantage of the growing electric vehicle cluster that's developing around the Valley.

Mark Davies Jones (Stifel): So we're comfortable that those investments are not going to be sitting there looking excessive over the next year or two?

Andrew Heath: No. We were clear when the investments were made where the target opportunities were. Whether we're going to fully deliver on the business plans in the current environment is obviously questionable and we'll continue to monitor it but in terms of the absolute demand is still strong for the assets that we've put in place. Going forward clearly we're being quite thoughtful and critical around any further investments we put on the ground in Millbrook. Most of the CAPEX that Derek took you through – I think he quoted the Millbrook number – that was committed CAPEX predominantly from last year. So we have slowed up the rate at which we're spending CAPEX in Millbrook.

Speaker: One unrelated one. On Omega and those tariff issues in and out of China, is there anything you can do about that or is that just where you sit in the supply chain?

Andrew Heath: It's mainly where we sit in the supply chain. We manufacture in the US and therefore shipping to China, unless we move the manufacturing base, which we have clearly given thought to but at the moment we have decided not to do that.

Richard Paige (Numis): Just a quick question. The academic research like for like 26% is a standout figure in terms of the end markets, to what extent is that specific project activity? I'm trying to understand ultimately the repeatability of the growth there.

Andrew Heath: Yes, so it is a standout spot, for sure. The numbers show it. I think it's the comparison in the first half of last year makes it a bit easier but even with that taken into account, we've seen strong growth there. In part some of that is in Malvern Panalytical the merger activity around the sales force that took place in 2017/18 did have a bit of an impact there and now that we're 12 months on from those changes, that has meant that the renewed focus has brought in more orders and sales as a consequence of that. But we've also seen strong demand in terms of China, Asia, in terms of research, but North America I believe is also up. So there's money going into a number of their target markets. We spoke around the Capital Markets Day around automotive, semicon, electronics, pharma, life sciences, tech-led industrials – the technology side of that, advanced materials, fine chemicals. There's quite a lot of research around the world going into those areas which we're well focussed on.

Andrew Wilson (JP Morgan): Hi, I just wanted to ask around how you're thinking about some of the lower-margin product lines. You've obviously mentioned a few and you've exited a few and I think with the strategic review completed, but I presume there's an ongoing review of where these product lines sit, where the different businesses sit, and is it just a case of where it doesn't make sense at the moment, you need to fix it or you need to exit it, and should we expect this to be a theme of the next couple of years or are you pretty happy with how things are sat?

Andrew Heath: So looking at products and customer profitability, doing that analysis on a regular basis is a good housekeeping discipline. I think I said at a previous event, typically it hasn't been done in Spectris on a routine basis and we're bringing that discipline to bear. It's a health index within the business, because inevitably some products will get older, get obsolete or it just costs you more money to continue to support older products and the profitability declines. Now, some of them you may want to keep because in the basket of goods to customers they're important, you accept that. But others it's just something in the salesman's toolbag which we don't really need anymore and we need to deal with it. So that will be an ongoing process and should be an ongoing process which is just a refresh and continual keeping the housekeeping going, I don't think you should really worry about that. That's for us to launch new products in target markets and continue to develop products as well as retire older ones. That should be a natural process. I think in terms of customer intangibles around product lines and things, we have had a close look at all of that and over the last six months, part of the strategic review, and as things stand today we're comfortable with what we've done and where we've got to.

Derek Harding: Yes, I wouldn't expect to see the types of impairment we've talked about this morning in customer intangibles as a result of just ongoing product management.

Andrew Wilson (JP Morgan): Sorry, just as a follow up to one of your comments there, Andrew, it doesn't sound like that kind of granular review of the different product lines was ever really a feature possibly before. Does that provide you with some opportunities from a pricing perspective as well?

Andrew Heath: Inevitably as you look at the product portfolio, you retire some, you knock a bit of sales off but from a profitability perspective it will improve, absolutely, yes. And that's the whole focus of it.

Derek Harding: I think it also links into, we talked at the Capital Markets Day around looking into R&D spend and getting that as efficient and effective as possible, so making sure that we are spending that money on the right future products and not on sustaining older products, for example. It's another area that that focus will come in on. It will take a while but that's the other part of that focus.

Michael Blogg (Investec): Has the underlying rate of sales growth been affected in a measurable way in the first half by retiring less profitable products?

Andrew Heath: Michael, I would say that's not really a factor. I mean, if anything, we've lost a little in some areas but equally some products that we've looked to retire, we've had quite a lot of end-of-life demand from customers. So some of the sales have actually been boosted by that albeit the profitability of some of those may be not what we'd want, but as we manage that process out, there is a natural churn that goes on.

Michael Blogg (Investec): Thanks, and the impairment charge in test and measurement, what product line is that?

Andrew Heath: For commercial reasons, we're not going to disclose what it is. It's just one of the product lines that we've had for a while that, as time's gone on, it's become less and less effective and therefore we've elected, given it's not profitable now, to take a decision to cease trading there.

Michael Blogg (Investec): It is quite a significant write off.

Andrew Heath: Yes. I agree with you.

Michael Blogg (Investec): Thank you.

Derek Harding: Just so you have the numbers, it's £13m of that £63m.

Robert Davies (Morgan Stanley): A couple of questions. Thinking about all the changes you're making in the businesses and you're clearly doing a lot on the ground but how should we think about the impact on the second half in terms of drop through from sales to profitability and how do you think that varies depending on the potential outcomes whether you end up in a low single-digit or even if you end up in a high single-digit growth rate? How much flexibility versus your current assumptions of what you're planning to do, do you have?

And then the second one was around China. If you could give us a little more colour by end market of what you're seeing and what customers are saying to you on the ground, that would be helpful. Thanks.

Andrew Heath: So I think the first point in terms of the second half, we're not going to predict what the macro environment is going to be like in the second half. I think it is quite uncertain. Our stance therefore is one of end market uncertainty and we are driving the business to improve profitability in a lower growth environment and so it comes back to what we said, we are focussing on what we can control, controlling costs, being very clear about where we're spending money and where we should not be spending money and making sure we drive the profit improvement programme as hard as we can across the businesses.

That being said, there are still some strong growth opportunities for us. Order intake in pharma is up at the end of the first half. Life science is good, advanced materials, fine chemicals are doing well. Semicon is relatively small for us but we expect to see a pickup in the second half. Installation of our devices into electronic FAB manufacturers is strong. So there are a number of end markets: academia as well, emissions in the energy-utility space, that are still very positive and we've got good opportunities. And even within automotive, as I said, there are plenty of opportunities out there, we've got to make sure we get through the merger of HBK and Bruel & Kjaer and VI as fast as we can and get the salesforce focussed on driving, going getting those.

So our stance is one of still very much let's push for growth, let's look at revenue, look at the order opportunities, but at the same time being very careful about the costs.

Robert Davies (Morgan Stanley): Thanks. And maybe just one follow up on your sales force and the way the change in your business structure will affect the type of people you have on the ground. Do you have everyone you need, is there any additional headcount you need or is it simply a case of retraining some of those people, changing some of those people? How do you think? Because obviously your cost base has been a big focus for the last couple of years.

Andrew Heath: It's a big question, that is. Where are we at the end of the first half? Like for like overheads are down 1.2% despite the sales growth. We said when we launched the profit improvement programme, the reason that we called it a profit improvement programme was that we were looking at growth initiatives and also pricing as well as cost reduction opportunities, so it's not just purely a cost reduction programme. So as we've restructured in some areas and reduced headcount, we have also increased headcount in targeted areas where we are looking to grow. So each of the businesses in turn have been making those decisions. They bring that forward to Derek and me at our regular reviews, so we're clear, do we agree that's something we should be going after? If yes, then they get on and do it. If no, then we won't. So it comes back to being very targeted around growth.

We have a large sales and marketing team within the business so generally we have more than enough people to do that, we just need to make sure we utilise them in the best places.

Robert Davies (Morgan Stanley): Thanks.

Andrew Heath: Any other questions? No? Alright, well, with that, let's close. Derek and I will be staying around for a bit longer afterwards, if you want to come and talk to us, we'll be very happy to do so. I think if you look at our results, yes there are quite a number of moving parts within it but I think we've tried to lay out the entire story in both the press release and the presentation today in terms of what are those moving parts and how they impact the business. But I think overall we are very pleased with the focus that we have inside Spectris and our operating companies in driving profitability and driving improvement programmes, but also going after those growth initiatives that we talked about.

Net-net where am I? Well, I'm positive. I'm still optimistic. We have reiterated our guidance for the full year, it remains unchanged. Yes, the end markets are more challenging. The questions are clearly focussed around that. We're not alone in that respect either. But as I've said a number of our end markets are going well. We've got product launches happening in the second half and overall we're still targeting growth where we can see it, but at the same time we're focussing on what we can control and absolutely learning to live, to drive profitability in a lower growth environment, and that's the stance we're taking. So net-net I'm optimistic about the future.

So, thanks very much for your time today and as I said, happy to take any other questions after the end of this. Thank you very much.

[END OF TRANSCRIPT]