Chief Executive's review

"The Group delivered a resilient performance in 2015. The speed and effectiveness of management's actions, in addition to the continued focus on improved mix, enabled headline operating margins to be sustained."

S.C. Harris | Group Chief Executive

Overview

The Group benefits from serving a broad spread of industrial sectors and geographies. In 2015 the macro-economics were favourable for our aerospace and automotive sectors, but the rapid decline in oil prices weighed heavily on our customers in the energy sector. The weakness in the energy sector bled over into the general industrial markets and was further compounded by the slowing growth in China, weakening global demand for many commodities and the embargo on global trade with Russia.

The net result for Bodycote was a 7% decline in revenue to £567.2m (2014: £609.1m). However, headline operating profit only reduced by 8% to £102.1m (2014: £111.1m), including negative foreign currency translation of £2.3m.

The potential impact the weakening global demand conditions would have on the Group started to become clear early in the year. As a consequence, management decided to undertake a series of actions to mitigate the situation, some giving immediate benefit, while others are aimed at accelerating future growth.

A restructuring programme was announced at the half year, with an associated charge of £20m (of which £9m related to non-cash impairments) and which focused on our facilities serving the oil services and general industrial sectors. By year end we had successfully exited the businesses in Brazil and India. Elsewhere we have closed five facilities and consolidated poorly performing activities within a further six facilities. Closure of an additional five facilities will be completed in the first half of 2016. Equipment is being relocated within the Group, and in many cases business is being transferred to neighbouring facilities.

The speed and effectiveness of management's actions, in conjunction with the ongoing drive for mix and efficiency improvements, have been such that the headline margin[1] has been sustained at 18%.

Improving the flexibility of the Group's cost base has been a high priority for several years. A noteworthy element of this has been greater use of temporary labour which can be flexed at little or no cost to suit the prevailing workload. Temporary employees were reduced by 11% during the year, however at year end, temporary and contract labour still represented 12.7% of total employees.

Basic headline earnings per share was 39.5p, a decline of 9.8% which reflects the absence of the one-off tax credit the Group enjoyed in 2014. Bodycote is reporting another year of strong cash generation, with 80% of headline operating profit turned into cash[2] (2014: 90%). As a result, the Group continues to be in a strong financial position and had net cash of £12.3m at 31 December 2015. Return on capital employed remained excellent at 19.0% for the year (2014: 20.7%).

Strategic progress

To enhance our future growth we have accelerated investment in high growth potential areas, mindful of the Group's 20% hurdle rate for return on capital employed. The increase in capital expenditure was driven by the number of greenfield facilities under construction along with specific capacity expansion in Specialist Technologies and civil aerospace. Nine greenfield sites were under construction in 2015, of which four are for Specialist Technologies and three are in the targeted expanding markets of Eastern Europe, Mexico and China. Additionally, capacity has been expanded at specific existing Specialist Technologies and civil aerospace facilities.

Overall capital investment increased by 14% to £61m, corresponding to 1.2 times depreciation.

The strategy of preferential investment in Specialist Technologies continues to benefit the Group. While two of these technologies, Surface Technology and HIP Product Fabrication, were hard hit by the decline in activity in the oil sector, the remaining four showed good growth. Average margins continue to exceed 30% in Specialist Technologies.

During the year we launched a new specialist technology in the field of ion implantation. We believe it to be the only form of ion implantation that is capable of processing bulk material. Applications include hardening of materials without temperature distortion and the reduction of surface friction in polymers, eliminating the need for lubrication. Sales are currently at the pilot stage.

The pursuit of operational excellence in the Group is a major priority. Part of this effort is a goal to improve the margins in the AGI Classical Heat Treatment business to the level we have been able to achieve in ADE Classical Heat Treatment. This is particularly the case in AGI in Europe where margins have been lower for some years. One of the tools used for this is the Bodycote Margin Model which employs a job costing methodology and strategic pricing process to help facilities drive the mix of work towards higher added value. Lean techniques are also being deployed at an increasing rate, which help to improve production flows and efficiencies. This work, in conjunction with the restructuring actions taken, drove the margins in the AGI business up by 90 bps, notwithstanding the decline in revenues.

During 2015 we continued to pursue potential acquisitions, although none were completed during the year. The acquisition priorities are divided into two broad areas. The first is to acquire bolt-on activities in Classical Heat Treatment that will enhance our network of operations. These will typically be small businesses in Western Europe and North America as there are few, if any, suitable targets outside of these territories and very few of any scale. The second area we look to acquire in is Specialist Technologies. There are few potential targets given the rarity of competitors, but some of the targets are of a larger scale. We also actively pursue ideas in areas adjacent to our existing technologies. The environment in 2016 looks more conducive to making acquisitions and the Group is well placed should sufficiently attractive targets become available.

Summary and outlook

The Group delivered a resilient performance in 2015. Automotive and aerospace revenues moved ahead. However, the decline in oil price combined with downward pressures on our general industrial business led to Group revenues falling by 4% at constant exchange rates. The speed and effectiveness of management's actions, in addition to the continued focus on improved mix, enabled headline operating margins to be sustained. Recognising the Group's net cash position, the Board is recommending a further special dividend.

The Group will continue to follow its strategy of investing in areas of robust revenue opportunity, notably in Specialist Technologies and in higher growth territories, as well as further enriching the mix towards higher added value services. The Board is confident that management's continued focus on business improvements will generate good returns throughout the cycle.

S.C. Harris
Group Chief Executive
25 February 2016

1. Return on sales is defined as headline operating profit as a percentage of revenue.
2. Cash conversion is defined as headline operating cash as a percentage of headline operating profit.