Financial Review

Delivering strong growth while investing to fully capture market opportunities

John Heasley
Chief Financial Officer

Overview

Having delivered strong revenue and profit growth in 2017, the positive outlook for our Minerals and Oil & Gas markets, together with our disciplined investment in strategic priorities and improving leverage ratios, mean that we look forward with confidence.

Revenue growth
28%
as reported

PBT growth
47%
as reported (excluding exceptionals and amortisation)

You can read more in the Financial Statements section on page 126.

2017 has been a year of significant turnaround driven by our Oil & Gas division which, against an improving market backdrop, demonstrated great execution to deliver a 67% increase in revenues and a £101m increase in operating profit without faltering on customer commitments. With Minerals markets at the beginning of a positive upcycle, after a tough few years, we took the opportunity to invest in people and facilities to ensure that our Minerals division is optimally placed to build upon its market leading position and maximise the opportunities for growth through the upcoming market cycle.

Financial highlights

Order input and revenue (on a constant currency basis) increased by 20% and 19% respectively, primarily as a result of the significant upturn in North American oil and gas markets together with a strong Minerals performance. Aftermarket input growth was 22% and original equipment orders grew by 16%. On a reported basis, revenues grew by 28%, supported by a £127m foreign exchange translation benefit.

Profit before tax, amortisation and exceptional items of £250m was up by 47%, primarily driven by our Oil & Gas division. Operating exceptional charges of £13m were incurred, mainly in right-sizing operations in later cycle markets. The reported profit before tax from continuing operations of £181m compares to £43m in 2016. A £119m investment in working capital to support current and future year growth resulted in a free cash outflow of £24m, leaving net debt £8m higher than 2016 at £843m with net debt to EBITDA improving to 2.5 times.

Excellent Oil & Gas performance

Oil & Gas showed great operational execution to respond to the improving market conditions in North America by delivering a 67% increase in constant currency revenues and a 36% flow through to profits, which resulted in operating margins of 13% compared to a small loss in 2016. This was achieved by leveraging a significantly reduced overhead base compared to the previous cycle which, along with other industry players, is contributing to the establishment of shale as a highly cost-competitive source of oil and gas for global markets.

Results summary

Continuing operations[1] £m	2017	2016	As reported	Constant currency[2]
Orders[2]	**2,395**	1,989	n/a	20%
Revenue	**2,356**	1,845	28%	19%
Operating profit[3]	**292**	214	36%	25%
Operating margin[3]	**12.4%**	11.6%	+80bps	+60bps
Net finance costs[3]	**(42)**	(44)	5%	2%
Profit before tax[3]	**250**	170	47%	32%
Reported profit after tax	**162**	43	274%	n/a
Cash from operations[4]	**221**	293	-25%	n/a
Net debt	**843**	835	-£8m	n/a
Net debt / EBITDA[5]	**2.5**	2.8	11%	n/a
Effective tax rate	**23.9%**	22.5%	+140bps	n/a
Earnings per share[3]	**86.7p**	61.2p	42%	n/a
Dividend per share	**44.0p**	44.0p	–	n/a
ROCE[6]	**10.4%**	7.5%	+290bps	n/a

The Financial Review includes a mixture of GAAP measures and those which have been derived from our reported results in order to provide a useful basis for measuring our operational performance. Operating results are for continuing operations before exceptional items and intangibles amortisation as provided in the Consolidated Income Statement. Details of other non-GAAP measures are provided in note 2 of the financial statements.

1. Continuing operations excludes American Hydro Corporation and Ynfiniti Engineering Services, which were disposed of during H1 2016 and are reported as discontinued operations.
2. 2016 restated at 2017 average exchange rates.
3. Adjusted to exclude exceptional items and intangibles amortisation. Reported operating profit and profit before tax from continuing operations were £223m (2016: £90m) and £181m (2016: £43m) respectively. Reported earnings per share from total operations were 73.5p (2016: 17.8p).
4. Cash from operations includes both continuing and discontinued operations.
5. Calculation is at covenant basis with net debt at average rates.
6. Continuing operations EBIT before exceptional items (excluding KOP EBIT) divided by average net assets (excluding KOP net assets) excluding net debt and pension deficit (net of deferred tax asset).

Order input

Order input at £2,395m increased 20% on a constant currency basis. Original equipment orders were £722m. Aftermarket orders were £1,673m.

Minerals order input increased by 11% to £1,347m (2016: £1,215m). Improved commodity prices continued to support the industry's drive to increase production and improve efficiency of current mining operations. Original equipment orders were up 14% year-on-year reflecting increased brownfield wins driven by our strong service and engineering network in close proximity to mine sites as well as a small number of initial greenfield and major expansion projects. Aftermarket orders, at 70% of total input (2016: 71%), increased by 9%. The division showed positive book to bill of 1.05 for the full year.

Oil & Gas input at £732m (2016: £438m) was 67% higher (64% on a like for like basis) reflecting the recovery in North American upstream activity as oil prices and technological advances supported increased activity. These factors resulted in an improving oil price throughout the year and saw a 74% increase in North American rig count, principally through the first part of the year before stabilising. International markets were more subdued although showed some initial signs of increased quotation activity towards the end of the year, especially in the Middle East. A positive book-to-bill ratio for the division of 1.04 for the full year demonstrates the momentum that we carry into 2018.

Flow Control order input decreased by 6% to £316m (2016: £336m), principally driven by continued weakness in mid and downstream oil and gas markets, with input across the Power sector broadly stable and Industrial markets showing initial growth. Original equipment orders were down 16% driven by lower project activity while aftermarket input improved by 6% due to increased focus and the end of destocking activities by a number of customers.

Group revenue

Revenue of £2,356m showed growth of 19% on a constant currency basis mainly reflecting the improvement in orders in the Oil & Gas division and continued strong input performance in Minerals. Aftermarket accounted for 69% of revenues, remaining consistent with prior year. Reported revenues increased 28%, supported by a foreign exchange translation benefit of £127m.

Minerals revenue was 7% higher on a constant currency basis at £1,287m (2016: £1,201m). Both original equipment and aftermarket revenues were 7% higher with strong growth across South America, Africa and Asia Pacific. Reported revenues increased by 16% (2016: £1,112m), supported by a foreign exchange translation benefit of £89m.

Oil & Gas revenue increased by 67% to £704m on a constant currency basis (2016: £421m) and 64% on a like-for-like basis, reflecting order input trends. Reported revenues increased by 75%, after a £20m foreign exchange translation benefit. North American revenues increased sequentially throughout the year, reflecting input trends while International revenues stabilised during the second half of the year.

Flow Control revenue increased by 4% on a constant currency basis to £365m (2016: £350m), with aftermarket revenues unchanged from the prior year and original equipment revenues up 7% driven by delivery of a large part of the legacy order book for downstream oil

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and gas projects. Reported revenues rose by 10% reflecting an £18m foreign exchange translation benefit.

Operating profit

Operating profit from continuing operations (before exceptional items and intangibles amortisation) increased by £78m (36%) to £292m on a reported basis. Excluding an £18m foreign currency translation benefit, the constant currency increase was £60m.

Oil & Gas delivered an excellent operating performance, increasing operating profits by £101m through successfully leveraging workforce and supply chain requirements to meet increased North American demand. The Minerals constant currency operating profit reduction of £7m reflects strong underlying growth offset by a £25m investment in growth initiatives including one-off costs of £10m associated with reconfiguring operational capacity as volumes increase. Flow Control saw a £35m year-on-year constant currency reduction primarily due to £13m of one-off costs related to legacy contracts in downstream oil and gas and associated under-recoveries in that business. Second half operating margins in Flow Control returned to mid-single digits following the one-off charges incurred in the first half of the year.

Unallocated costs were unchanged from the prior year at £24m.

Operating profit (including exceptional items and intangibles amortisation) for the year of £223m was £133m higher than the prior year due to the £78m increase in underlying operating profit and a £55m reduction in exceptional items and intangibles amortisation.

Net finance costs

Total net finance costs, including exceptional items, were £43m (2016: £48m). There were four components of this net charge, the most significant being the interest cost of £38m (2016: £41m) on the Group's borrowings (including amounts in relation to derivative financial instruments). The other elements were a charge of £4m (2016: £3m) in relation to the Group's defined benefit pension plans and an exceptional cost of £1m (2016: £4m) being the unwind of the discount on contingent consideration liabilities. The overall decrease of £3m compared to 2016 was principally due to the favourable impact of foreign exchange on US$-denominated interest payments.

Net finance costs (excluding retirement benefit related amounts and exceptional items) were covered 7.7 times (2016: 5.3 times) by operating profit from continuing operations, before exceptional items and intangibles amortisation.

Profit before tax

Profit before tax from continuing operations (before exceptional items and intangibles amortisation) increased by 47% to £250m (2016: £170m). The reported profit before tax from continuing operations of £181m compares to £43m in 2016.

Exceptional items and intangibles amortisation

Exceptional items resulted in a reduced charge of £13m (2016: £74m) with intangibles amortisation at £55m (2016: £50m).

Restructuring and rationalisation charges of £13m in the current year predominantly represent the continuation of programmes to right-size operations and realign certain activities, including the later cycle international markets in Oil & Gas and the downstream oil and gas pump business in Flow Control.

The remaining elements of the exceptional charge in the year are £2m of costs associated with the finalisation of historical legal claims, a £10m gain on sale of our 49% share in the Energy Products LLC joint venture and a fair value adjustment of £9m to contingent consideration, reflecting the final settlement for the acquisition of the remaining 40% of Weir International, our Korean valves business.

The exceptional tax credit of £41m includes £17m of tax on the exceptional operating items and amortisation described above. In addition it includes a one-off £24m credit in respect of the impact of US tax reform following the signing into law on 22 December 2017 of the Tax Cuts and Jobs Act. The one-off credit arises from revaluing US deferred tax assets and liabilities at the reduced US federal corporate income tax rate of 21% (previously 35%) and from the release of previously held tax provisions for US tax on unremitted overseas earnings which will no longer be required.

Taxation

The tax charge for the year of £60m (2016: £38m) on profit before tax from continuing operations (before exceptional items and intangibles amortisation) of £250m (2016: £170m) represents an underlying effective tax rate (ETR) of 23.9% (2016: 22.5%). Our ETR is principally driven by the geographical mix of profits arising in our business and, to a lesser extent, by the impact of Group financing and transfer pricing arrangements.

Operating profit to EBITDA

	2017 £m	2016 £m
Continuing operations		
Operating profit	**223.1**	90.3
Adjusted for:		
Exceptional items (Note 5)	**13.3**	73.5
Earnings before interest and tax (EBIT)	**236.4**	**163.8**
Intangibles amortisation (Note 5)	**55.4**	50.2
Depreciation of property, plant & equipment (Note 4)	**58.2**	55.9
EBITDA	**350.0**	**269.9**

The Group has a robust framework to mitigate tax risks, together with a prudent and consistent approach to tax provisioning. This is discussed further in note 2.

In terms of cash tax, the Group paid income tax of £61m in 2017 across all of its jurisdictions compared to £16m in 2016, the increase principally driven by the non-repeat of cash tax refunds received in the prior period in respect of tax losses in the US.

Capital expenditure

We were able to increase investment in our strategic priorities with net capital expenditure increasing from £62m to £81m, reflecting a return to previous expenditure levels.

Cashflow and net debt

Free cash flow from continuing operations was an outflow of £24m (2016: inflow £130m), before cash exceptional items of £29m. Cash from operating activities reduced by £72m from £293m in 2016 to £221m in the current year which mainly reflected the upturn in Oil & Gas operating profit, offset by a £119m investment in working capital in the year mainly across Oil & Gas and Minerals to support increased activity levels in current and future years.

The reduction in free cash flow is further explained by a £45m increase in cash tax as noted above and a £28m increase in cash dividends paid as a result of lower uptake for the scrip dividend compared to the prior year.

Our working capital efficiency was demonstrated by working capital as a percentage of sales reducing from 27.1% to 25.7% and inventory turns improving from 2.2 to 2.7.

Exceptional cash items include a restructuring and rationalisation cash outflow of £29m (2016: £58m outflow offset by £36m proceeds relating to the 2016 asset disposal programme). Cash proceeds of £32m from the disposal of our 49% share in Energy Products LLC, our non-core North American Oil & Gas distribution joint venture, were offset by our £37m purchase of the remaining 40% of Weir International, our Korean valves business. Our acquisition of KOP Surface Products was financed via the issue of share capital totalling £90m during the year.

The above movements resulted in closing net debt of £843m (2016: £835m), which includes a favourable foreign exchange movement of £49m. On a lender covenant basis, the ratio of net debt to EBITDA was 2.5 times (2016: 2.8 times) compared to a covenant level of 3.5 times.

Pension

The Group has four defined benefit pension plans, the largest of which are the two UK plans. During the course of the year, the Trustees of the UK Executive Scheme entered into a full buy-in transaction with Scottish Widows, with all of the benefit payments due from that scheme now covered by an insurance policy. As a result, insurance policy assets held now cover 43% (2016: 40%) of the Group's total funding obligation across all schemes, reducing the Group's exposure to actuarial movements.

The net deficit in the plans of £138m represents a minor increase from £137m in 2016. The increase in deficit is mainly due to actuarial losses of £35m (following a reduction in the UK discount rate to 2.4% from 2.6%), offset by actuarial gains of £17m due to updated life expectancy assumptions, gains of £15m on pension scheme assets and £4m of Group contributions. The remaining balance of £2m comes primarily from experience adjustments on liabilities.

Asbestos provision

Certain of the Group's US-based subsidiaries are co-defendants in lawsuits pending in the United States in which plaintiffs are claiming damages arising from alleged exposure to products previously manufactured which contained asbestos. At the end of 2017, there were 1,657 asbestos-related claims outstanding in the US (2016: 1,477).

During the year, and with the assistance of external advisers, we completed our triennial review of estimated future indemnity and defence costs. As a result of this review a US asbestos provision of £53m (2016: £48m) has been recognised. The Group has comprehensive insurance cover for these cases and as a result recognises a corresponding insurance asset.

In the UK, there are 16 (2016: 18) outstanding asbestos-related claims which are not the subject of insurance cover. The expected settlement costs of these and anticipated future claims in the UK are fully provided for.

Full details of the US and UK provisions, plus related insurance receivable, are provided in note 22.

The key accounting and policy judgements are contained within note 2 to the Group financial statements on page 131.

Earnings per share

Earnings per share from continuing operations (before exceptional items and intangibles amortisation) increased by 42% to 86.7p (2016: 61.2p). Reported earnings per share including exceptional items, intangibles amortisation and profit from discontinued operations was 73.5p (2016: 17.8p). The weighted average number of shares in issue increased to 219.9m (2016: 215.6m) following the issue of 6.2m shares during the year in respect of the KOP acquisition and scrip dividends.

Dividend

The Board is recommending a final dividend of 29.0p resulting in a total dividend of 44.0p for the year, in line with 2016. Dividend cover (being the ratio of earnings per share from continuing operations before exceptional items and intangibles amortisation, to dividend per share) is 2 times. If approved at the Annual General Meeting, on 26 April 2018, the final dividend will be paid on 4 June 2018 to shareholders on the register as at 27 April 2018 with a scrip dividend alternative continuing to be offered.

John Heasley
Chief Financial Officer
28 February 2018

The Strategic Report, covering pages 1 to 67 of the Annual Report and Financial Statements 2017, has been approved by the Board of Directors in accordance with The Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013.

On behalf of the Board of Directors

Christopher Morgan
Company Secretary and General Counsel
28 February 2018