Chief Financial Officer's report

Financial overview

	2016 £m	2015 £m
Revenue	**600.6**	567.2
Headline operating profit	**99.6**	102.1
Amortisation of acquired intangible fixed assets	**(4.5)**	(4.2)
Operating profit prior to exceptional items	**95.1**	97.9
Acquisition costs	**(0.6)**	–
Reorganisation costs	**–**	(20.0)
Operating profit	**94.5**	77.9
Net finance charge	**(2.6)**	(2.9)
Profit before taxation	**91.9**	75.0
Taxation	**(24.9)**	(18.8)
Profit for the year	**67.0**	56.2

Group revenue was £600.6m, an increase of 5.9%, with revenues at constant exchange rates down 4.7% and foreign exchange rate movements having a positive impact of 10.6%.

Headline operating profit for the year decreased by 2.4% from £102.1m to £99.6m, and headline operating margin was 16.6% (2015: 18.0%). Headline operating profit at constant exchange rates decreased by £13.7m, whilst favourable foreign exchange rate movements increased headline operating profit by £11.2m. The drop in headline operating profit as a proportion of the drop in revenue, both at constant exchange rates, was 51%. Given that most of the Group's costs are fixed in the very short term, this creditable result is testament to the Group's dedication to act quickly to adjust the cost base when weaker demand is experienced.

The amortisation of acquired intangible assets arises from acquisitions in the current and prior years. The charge has increased to £4.5m (2015: £4.2m).

Operating profit was £94.5m (2015: £77.9m) after charging £4.5m (2015: £4.2m) in respect of the amortisation of acquired intangible assets, £0.6m (2015: £nil) of acquisition costs and reorganisation costs of £nil (2015: £20.0m).

Headline operating cash flow[1] for the Group was £91.4m (2015: £81.6m). This was 92% of headline operating profit (2015: 80%), reflecting improved working capital flows compared with last year. Net working capital in the year benefited from higher than average inventory levels present at the end of 2015 decreasing to more normal levels. The increase in receivables was driven by increased activity in the final quarter of 2016. Net capital expenditure was 1.1 times depreciation (2015: 1.2 times). It is worth noting that only half of this capital expenditure was expended to maintain the Group's existing business. The other half was expended to help grow the business in the future, most notably in greenfield facilities and in expanding capacity in our high-margin Specialist Technologies businesses.

After deducting interest and tax, the Group recorded positive free cash flow[1] of £60.5m (2015: £47.4m).

Exceptional costs

Total exceptional costs charged to the income statement amounted to £0.6m (2015: £20.0m) and related to acquisition costs. In 2015 reorganisation costs amounting to £23.8m were incurred, offset by a profit on disposal of the Group's Brazilian and Indian operations of £3.8m.

Restructuring provisions outstanding at 31 December 2016 totalled £13.3m (2015: £14.7m), of which £9.7m is expected to be spent in 2017. All expenditure anticipated after the end of 2017 relates to ongoing environmental remediation, primarily in the USA.

1. Headline operating cash flow and free cash flow are reconciled on page 15.

Profit before taxation

Headline profit before taxation was £97.0m (2015: £99.2m). Profit before taxation was £91.9m (2015: £75.0m). These amounts are reconciled as follows:

	2016 £m	2015 £m
Headline operating profit	**99.6**	102.1
Net finance charge	**(2.6)**	(2.9)
Headline profit before taxation	**97.0**	99.2
Amortisation of acquired intangible fixed assets	**(4.5)**	(4.2)
Profit before taxation prior to exceptional items	**92.5**	95.0
Acquisition costs	**(0.6)**	–
Reorganisation costs	**–**	(20.0)
Profit before taxation	**91.9**	75.0

Finance charge

The net finance charge was £2.6m compared to £2.9m in 2015. The net finance charge is lower as a result of lower interest rates and financing costs.

	2016 £m	2015 £m
Net interest payable	**0.2**	0.3
Financing costs	**1.3**	1.5
Bank and other charges	**0.8**	0.8
Pension finance charge	**0.3**	0.3
Net finance charge	**2.6**	2.9

Taxation

The taxation charge was £24.9m for the year (2015: £18.8m).

The headline taxation rate for 2016 was 27.5% (2015: 24.4%), being stated before accounting for exceptional items and amortisation of goodwill and acquired intangible fixed assets. The rate in 2015 benefited from the recognition of some brought forward tax losses. A number of the Group's key markets have rates of corporation tax above the Group average. Future profitability growth in these markets, therefore, is likely to place some upward pressure on the Group's blended corporation tax rate.

Earnings per share

Basic headline earnings per share (as defined in note 10) decreased to 37.0p from 39.5p. Basic earnings per share for the year increased to 35.2p from 29.6p, with the prior year significantly impacted by reorganisation costs.

Dividend and dividend policy

The Group aims to pay ordinary dividends so that dividend cover will be at or above 2.0 times earnings (see note 10). 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.

The Board has recommended a final ordinary dividend of 10.8p per share (2015:10.3p) bringing the total ordinary dividend to 15.8p per share (2015: 15.1p). If approved by shareholders, the final ordinary dividend of 10.8p per share will be paid on 2 June 2017 to all shareholders on the register at the close of business on 21 April 2017.

Capital structure

The Group's balance sheet at 31 December 2016 is summarised below:

	Assets £m	Liabilities £m	Net assets £m
Property, plant and equipment	509.0	–	509.0
Goodwill and intangible fixed assets	206.7	–	206.7
Current assets and liabilities	163.8	(181.7)	(17.9)
Other non-current assets and liabilities	0.4	(13.2)	(12.8)
Retirement benefit obligations	–	(21.5)	(21.5)
Deferred tax	32.5	(68.8)	(36.3)
Total before net cash	912.4	(285.2)	627.2
Net cash	12.0	(10.9)	1.1
Net assets as at 31 December 2016	**924.4**	**(296.1)**	**628.3**
Net assets as at 31 December 2015	805.5	(255.9)	549.6

Net assets increased by £78.7m (14.3%) to £628.3m (2015: £549.6m), mainly as a result of the positive translation impact following the significant depreciation in the value of sterling after the UK's EU referendum. At constant exchange rates, net assets decreased by £22.5m (4.1%).

Net cash

Group net cash at 31 December 2016 was £1.1m (2015: £12.3m). The Group continues to have access to committed facilities at competitive rates and therefore currently deems this to be the most effective means of funding.

Chief Financial Officer's report continued

Cash flow

The net decrease in cash and cash equivalents was £6.5m (2015: £23.6m), made up of net cash from operating activities of £125.9m (2015: £111.3m), less investing activities of £84.6m (2015: £59.9m) and less cash used in financing activities of £47.8m (2015: £75.0m).

The increase in net cash flow from operating activities from £111.3m to £125.9m was driven primarily by the increase in EBITDA[1] from £134.9m to £155.2m.

Net cash outflows from investing activities increased from £59.9m to £84.6m, primarily as a result of the acquisition of various businesses in the year. The level of net capital expenditure in 2016 was £63.1m (2015: £61.3m), consistent with plans to increase the Group's capacity in its Specialist Technologies and high-growth markets.

Net cash outflows used in financing activities decreased from £75.0m to £47.8m, primarily due to the decrease in dividend payments from £66.0m in 2015 to £48.1m in 2016.

Receivable days at 31 December 2016 increased by one day to 63 days (2015: 62 days).

Net interest payments for the year were £2.3m (2015: £2.6m). Tax payments were £20.4m (2015: £23.2m).

Capital expenditure

Net capital expenditure (capital expenditure less proceeds from asset disposals) for the year was £63.1m (2015: £61.3m). The multiple of net capital expenditure to depreciation was 1.1 times (2015: 1.2 times). The Group continues to invest in maintaining its assets to a high quality, as well as investing in the implementation of a new ERP system. Crucially, almost half of the Group's capital expenditure was expended to help grow the business in the future, most notably in greenfield facilities and in expanding capacity in our high-margin Specialist Technologies businesses. As a consequence of the timing of these key projects, the value of assets under construction has increased by £16.9m, from £51.6m in 2015 to £68.5m in 2016.

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 2016 was £225.0m (2015: £230.0m). At 31 December 2016, the Group had the following drawings and headroom under the committed facility:

Facility	Expiry date	Facility £m	Facility utilisation £m	**Facility headroom £m**
£230m Revolving Credit	3 July 2019	230.0	5.0	**225.0**

1. EBITDA is defined as earnings before interest, tax, depreciation, amortisation, impairment of fixed assets and other assets, profit or loss on disposal of property, plant and equipment, profit on sale of businesses and share-based payments.

Capital management

The Group manages its capital to ensure that entities in the Group will be able to continue as going concerns, while maximising the return to shareholders. The capital structure of the Group consists of debt, which includes borrowings, cash and cash equivalents, and equity attributable to equity holders of the parent, comprising capital, reserves and retained earnings.

The capital structure is reviewed regularly by the Board. The Group's policy is to maintain gearing, determined as the proportion of net debt to total capital, within defined parameters, allowing movement in the capital structure appropriate to the business cycle and corporate activity. Due to the net cash position at 31 December 2016 the gearing ratio is 0% (2015: 0%).

Defined benefit pension arrangements

The Group has defined benefit pension obligations in the UK, Germany, Switzerland, Liechtenstein and the USA and cash lump sum obligations in France, Italy and Turkey, the liabilities for which are reflected in the Group balance sheet.

The net deficits in these arrangements are as follows:

	2016 £m	2015 £m
Funded:		
UK	**3.6**	2.7
Other Western Europe	**1.9**	2.0
North America	**0.4**	0.5
	5.9	5.2
Unfunded:		
Western Europe	**15.5**	12.6
Emerging markets	**0.1**	0.1
	15.6	12.7
Total deficit	**21.5**	17.9

The UK plan is closed to new entrants but the 45 active members continue to accrue benefits. The arrangements in France, Italy and Turkey are open to new members. All other arrangements are closed to new entrants.

UK scheme liabilities have increased by £26.7m to £126.6m (2015: £99.9m). This is largely due to a change in the actuarial assumptions used to assess the present value of the liabilities. Most notably, the discount rate assumption has decreased from 3.5% in 2015 to 2.3% in 2016, which has resulted in an increase in the liabilities. UK scheme assets increased in the year by £21.6m to £123.0m (2015: £101.4m).

The deficit for the other European schemes increased by £2.8m, mainly due to a decrease in the discount rate assumptions.

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 exchange rates, to allow the 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.

Going concern

In determining the basis of preparation for the Annual Report and the Group's viability statement made on page 27, 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 2016 were as follows:

- £230m Revolving Credit Facility maturing 3 July 2019

The December 2016 weighted average life of the committed facilities was 2.5 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 foreseeable future. For this reason the directors continue to adopt the going concern basis in preparing the financial statements.

D. Yates
Chief Financial Officer
28 February 2017