

Principal risks and uncertainties

The Board is responsible for the Group's risk management and the review of financial risk has been delegated to the Audit Committee. The Group's risk framework was last reviewed by the Board in 2015 when it was updated to ensure it continues to meet UK Corporate Governance requirements. Under the leadership of the Group Head of Risk, Bodycote's risk management framework is used to identify, report and manage its business critical risks. The Group Head of Risk is supported by the Risk and SHE Committee, attended by senior managers from each of the operating divisions, which met three times during 2016. The Risk and SHE Committee assists the Group Head of Risk in identifying critical risks, embedding risk management and facilitating the implementation of risk management measures throughout the Group.

A variety of approaches is used to identify and report risks, which are aggregated first at a divisional level and then at Group level. For each business critical risk, assurance activities have been documented in risk assurance maps and these are used to direct assurance activity.

The Group Head of Risk provides an update to the Audit Committee on the Group's risk activities at every meeting and a comprehensive review of the Group's business critical risks is presented to the Board in December. The Board concluded that a robust assessment of the Group's principal risks had been undertaken.

The table below highlights the major risks that may affect Bodycote's ability to deliver the strategy, as laid out on page 7. These risks have been reviewed throughout the year and they have not materially changed since 2015. Details of the Group's financial risks (funding, foreign exchange, interest rate and counterparty risks), which are managed by the Group's treasury function, are provided in note 19 to the financial statements. The mitigating activities described below will help to reduce the impact or likelihood of the major risk occurring, although the Board recognises that it will not be possible to eliminate these risks entirely. The Board recognises that there could be risks that may be unknown or that may be judged to be insignificant at present but may later prove to be significant. For this reason business continuity plans have been prepared for all plants to provide for situations where specific risks have the potential to severely impact the business.

In determining the principal risks, the Board has considered the result of the referendum on the future of the UK's membership in the European Union. While this result increases the level of market uncertainty, it is not expected to have a material impact on Bodycote as customers are served locally and cross-border trading is minimal. This risk is therefore included as an element of the existing market risk.

In September 2016, a fire occurred at the Huntington Park facility in California. Bodycote personnel responded safely and quickly to ensure continuity of service for customers. The Group's business continuity framework, utilising the local plant network, provided an interim back-up capability and this significantly mitigated the impact of this event and prevented a major disruption. The facility was operational again one month after the event.

| Risk description | Impact | Mitigation and control | Relevance to strategy |
|--|---|---|---|
| Market and customer risks | | | |
| <p>Markets</p> <p>Bodycote operates in 23 countries and a substantial amount of sales are closely linked to the economic cycle and the general macro-economic environment. The result of the referendum on the future of the UK's membership in the European Union is not expected to have a material transactional impact as customers are typically served locally and cross-border trading is minimal.</p> | <p>The high proportion of short-term fixed costs in the business means that a drop in sales will have a significant impact on profitability. Sales in the markets served by the AGI businesses (66% of the total Group) tend to develop in line with or ahead of the economic cycle, whereas aerospace and defence sales (25%) tend to track behind the economic cycle. Sales to the energy sectors (9%) are closely linked to energy prices, which in turn can be affected by general economic activity.</p> | <ul style="list-style-type: none"> Bodycote's presence in 23 countries across a wide variety of end-markets acts as a natural hedge to neutralise localised economic volatility. There is some short-term flexibility in the cost base e.g. by ensuring that a proportion of the workforce is employed on temporary contracts. Changes in customer demand on a local or a Group-wide level are responded to quickly. |    |
| <p>Loss of key customers</p> <p>Bodycote benefits from many long-term relationships with key customers and the damage to, or loss of, any of these relationships would be detrimental to the Group.</p> | <p>The loss of a key customer could adversely affect the Group's financial results and the viability of one or more of Bodycote's facilities.</p> | <ul style="list-style-type: none"> There is no significant customer dependency, with the Group's top ten customers accounting for less than 16% of sales and the balance made up by many thousands of customers. There is a continued focus on customer service and quality processes to maintain excellent relationships with major customers. Key account management is in place and customer satisfaction is monitored. |  |

| Risk description | Impact | Mitigation and control | Relevance to strategy |
|---|--|--|---|
| Market and customer risks (continued) | | | |
| <p>Competitor action</p> <p>The entry of competitors into one or more of the Group's Specialist Technologies.</p> | <p>The erosion of market share resulting in loss of revenue and profit.</p> | <ul style="list-style-type: none"> ■ The close control of proprietary knowledge. ■ Rapid increase in the scale of the Group's offerings to maintain the position as supplier of choice. |  |
| Corporate and community risks | | | |
| <p>Safety and health</p> <p>The nature of Bodycote's activities presents safety and health risks.</p> | <p>Bodycote is committed to providing a safe work environment for its employees but Bodycote's operations, if not properly managed, could have a significant impact on individual employees. Furthermore, poor safety and health practices could lead to disruption of business, financial penalties and loss of reputation.</p> | <ul style="list-style-type: none"> ■ Group-wide health and safety policies set by the Group Chief Executive. ■ OHSAS 18001 and ISO 14001 compliant SHE management systems being used by Group Head of Safety, Health and Environment with support of divisional safety, health and environmental teams. ■ Programme in place to focus on reduction of incidents which could have a high impact. ■ Safety compliance audits at all plants at least every two years. ■ Oversight of safety and health framework provided by the Group Risk and SHE Committee. |  |
| Operational risks | | | |
| <p>Service quality</p> <p>The Bodycote brand is reliant on the repeatable delivery of parts to agreed specification to an agreed time.</p> | <p>Deterioration in quality or service levels can cause serious long-term damage to Bodycote's reputation with financial consequences such as the loss of a customer and the cost of damages or litigation. Work that is released into use which is not in compliance with specification could arise as a result of system or human failure.</p> | <ul style="list-style-type: none"> ■ Bodycote has stringent quality systems in place managed by qualified staff. ■ Quality systems and processes operated at plant level with oversight by divisional quality teams. ■ Where necessary, plants maintain industry relevant accreditations, such as ISO 9001, Nadcap and TS 16949. ■ All plants subjected to internal and external quality audits and inspections at least once a year. |  |

Principal risks and uncertainties continued

| Risk description | Impact | Mitigation and control | Relevance to strategy |
|---|---|--|---|
| Operational risks continued | | | |
| <p>Major disruption at a facility</p> <p>Bodycote's business processes are inherently risky and there is a possibility that a major fire such as that suffered in 2016 at the Huntington Park facility (USA) or utility outage could lead to closure of a facility's operation. In addition, a number of sites are exposed to natural hazards, such as earthquakes, flooding and storms.</p> | <p>Any significant incident at a site could result in the service to Bodycote's customers from the affected site being disrupted.</p> | <ul style="list-style-type: none"> ■ As demonstrated with the fire at Huntington Park, disruption was substantially mitigated by Bodycote's global network of 189 facilities. These facilities create a framework to provide back-up capability for affected facilities. ■ Business continuity plans are in place for all plants. These are updated and tested annually. ■ Independent insurer inspections to assess hazard and business interruption risks. ■ Insurance cover, including business interruption cover. ■ Scheduled equipment maintenance and inspections. |  |
| <p>Information technology projects</p> <p>The efficient operation of the Group relies on the proper development and operation of its IT systems. Bodycote is currently undergoing a Group-wide implementation of a new ERP system.</p> | <p>Failure to manage the implementation of the ERP programme successfully could result in cost overruns and, potentially, disruption to the business.</p> | <ul style="list-style-type: none"> ■ Project approval and progress subject to regular Executive Committee and Board review. ■ Project teams made up of skilled subject matter experts supplemented with third party advisers. ■ Best practice project management processes in place with assurance provided by third parties. ■ Defined disaster recovery planning and data backup procedures. |  |
| Regulatory risks | | | |
| <p>Regulatory and legislative compliance</p> <p>The global nature of Bodycote's operations means that the Group has to comply with a wide range of local and international legislative requirements, including anti-bribery and anti-competition legislation, taxation legislation, employment law and import and export controls.</p> | <p>Failure to comply with legislation could lead to substantial financial penalties, disruption to business, diversion of management time, personal and corporate liability and loss of reputation.</p> | <ul style="list-style-type: none"> ■ Business processes are supported by HR policies and the Group Code of Conduct alongside training and awareness programmes. ■ The "Open Door Line" whistleblower facility which is managed by a third party. ■ Engagement of local specialists to support Bodycote at local, divisional and Group level. ■ Regular audit of the effectiveness of implemented procedures. |  |

Viability statement

In preparing this statement of viability, the directors have considered the prospects of the Group over the three-year period immediately following the 2016 financial year. This longer-term assessment process supports the Board's statements on both viability, as set out below, and going concern (on page 23). A three-year period was determined as the most appropriate as it is the period covered by the Group's annual strategic planning process, which sets the long-term direction of the Group and is reviewed at least annually by the directors. The Board concluded that a period of longer than three years would not be meaningful for the purpose of concluding on longer-term viability, given the limited forward visibility of the Group.

The strategic plan considers metrics which enable assessment of the Group's key performance indicators (including return on capital employed, headline earnings per share and headline operating cash flow) in addition to net debt, liquidity and financing requirements.

In conducting the review of the Group's prospects the directors assessed the three-year plan alongside the Group's current position, the Group's strategy and the principal risks facing the Group (all of which are detailed in the Strategic report on pages 6 to 26). This assessment considered the impact of the principal risks on the business model and on future performance, liquidity and solvency and was mindful of the limited forward visibility that the Group has as it carries a minimal order backlog. The directors' viability assessment included a review of the sensitivity analysis performed on the three-year plan, whereby the principal risks, and particularly those related to markets and customers (see page 24), were applied to the plan in a number of diverging scenarios. The developed scenarios were designed to be plausible, yet severe.

In making this viability statement the directors considered the mitigating actions that would be taken by the Group in the event that the principal risks of the Company become realised. The directors also took into consideration the Group's financial position at 31 December 2016, with net cash of £1.1m, available committed facility headroom of £225.0m and a history of strong cash generation.

The directors have assessed the viability of the Group and, based on the procedures outlined above in addition to activities undertaken by the Board in its normal course of business, confirm that they have a reasonable expectation that the Group will be able to continue in operation and meet its liabilities as they fall due over the period to 31 December 2019.