Finance Review

Strong free cash flow funds acquisitions

17.2%
Adjusted operating margin

£59.0m
Free cash flow

21.1%
ROATCE

Results in 2016

Diploma delivered a strong performance this year, with revenues increasing by 15% to £382.6m and adjusted operating profit increasing by 9% to £65.7m. The Group's financial results were characterised by two factors: a strong contribution from businesses acquired during the past three years and the substantial weakening in UK sterling in the last quarter of the financial year, following the UK's Brexit vote on Europe.

The contribution from acquisitions completed both this year and last year was £26.6m to revenue and £4.2m to adjusted operating profit. With ca.75% of the Group's businesses based overseas, the impact on headline results from currency translation has led to an increase in revenues and adjusted operating profits of £13.8m and £2.7m respectively, when translated at last year's exchange rates.

Underlying organic growth in all of the Group's markets remained challenging throughout the year, which led to underlying revenues increasing by 3% this year. However, in this lower growth environment the Group focused on maximising free cash flow, which was again very strong at £59.0m. This will provide the resources to continue to pursue acquisition opportunities which should provide a good base for further earnings growth in future years.

Underlying revenues are after adjusting for the contribution from businesses acquired during the year (and from the incremental impact from those acquired last year) and for the impact on the translation of the results of the overseas businesses from the significant weakening in the UK sterling exchange rate in the last quarter of the year.

Adjusted operating margin

The Group's adjusted operating margin remained broadly in line with the first half of the year at 17.2% (compared with 18.1% last year), continuing to be impacted by weaker gross margins in the Healthcare businesses.

Diploma's Healthcare businesses represent ca.25% of Group revenues and their gross margins have again been impacted this year on a transactional basis by the substantial depreciation of the Canadian and Australian dollars, against the US dollar in particular, which is the currency in which most of their products are purchased. The depreciation of these two currencies began in late 2013 and has continued through the past two years, reaching a low point in mid-January 2016.

In this financial year, currency depreciation led to a 390bps reduction in the gross margins of the Canadian and Australian Healthcare businesses compared with last year. This reduction was partly mitigated by a combination of forward currency hedges, supplier cost reductions and tight control over operating costs. However, the ability of the Healthcare businesses to continue to mitigate this transactional impact on gross margins is now quite limited.

The Canadian and Australian exchange rates have remained relatively stable since the early part of this year at more favourable levels and this provided the businesses with an opportunity to resume forward currency hedging during the second half of the year. These hedging contracts should provide some respite to the currency pressure on gross margins in the new financial year, although both currencies have begun to weaken again in November 2016.

Transactional currency exposures in the rest of the Group's businesses were not significant during the year, despite the impact on the UK businesses in the last quarter of the year from the substantial weakening in UK sterling.

"The businesses acquired during the past three years contributed 20% of Group revenues in 2016."

The Group's adjusted operating margin was also impacted by acquired businesses which ordinarily join the Group with initial operating margins which are lower than the Group's adjusted operating margin. With the increased acquisition spend over the last three years, this has impacted the adjusted operating margin negatively by 30bps this year.

However, investment by the Group in these acquisitions to grow revenues, combined with synergy benefits, will generally improve margins in the 2-3 years post-acquisition and move them towards the Group's average.

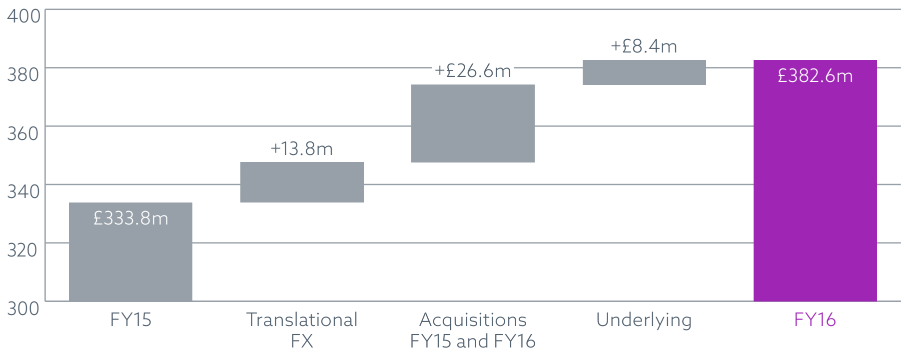
The Group's adjusted operating margin this year was also impacted positively by the mix of Group revenues and by the absence of one-off costs from last year's reorganisation in the Seals businesses. These together accounted for a 40bps improvement in the Group's adjusted operating margin.

Adjusted profit before tax, earnings per share and dividends

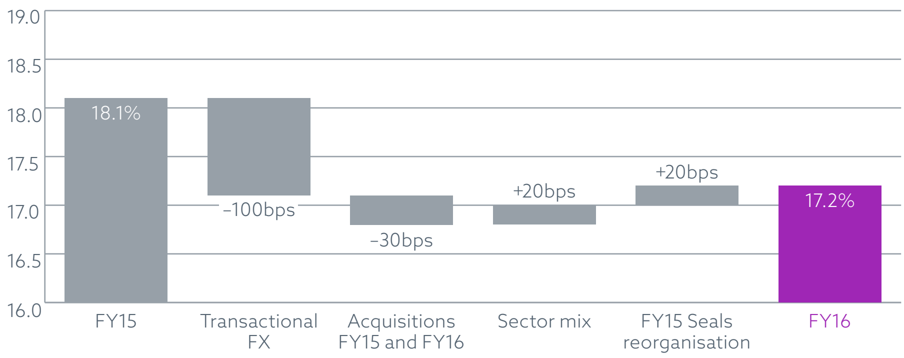
Adjusted profit before tax, which excludes the gain on sale of assets, increased by 9% to £64.9m (2015: £59.6m). The finance expense this year was £0.8m (2015: £0.7m) which included £0.4m (2015: £0.3m) of interest costs on borrowings drawn down during the year to help finance acquisitions. The notional interest expense on the Group's defined pension liabilities remained unchanged at £0.2m (2015: £0.2m) and £0.2m was paid as facility commitment fees.

Statutory profit before tax was £54.0m (2015: £51.8m), after acquisition related charges of £10.3m (2015: £7.4m), fair value remeasurements of £1.3m (2015: £0.4m) and a gain of £0.7m (2015: £Nil) on disposal of assets. The acquisition related charges largely comprise the amortisation of acquisition intangible assets and the fair value remeasurements relate to the put options held over minority interests. The increase in the charge for remeasurements reflects the increase in the liability to acquire these minority interests, all of which are overseas interests, as a result of the significant depreciation in UK sterling.

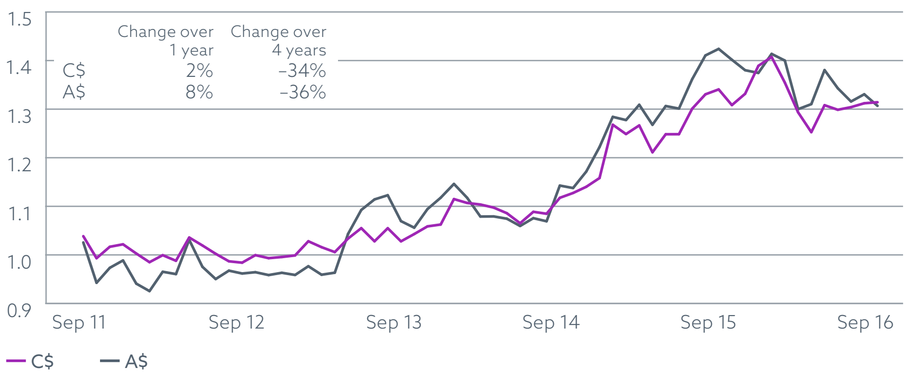
Underlying revenue bridge – FY2016 (£m)



Adjusted operating margin bridge – FY2016 (%)



Transactional impact base currency (US$)



The Group's effective tax charge on adjusted profit in 2016 was 60bps below the previous year at 25.7% of adjusted profit before tax. The charge this year benefited from a further reduction in the UK corporation tax rate to 20% (2015: 20.5%) and from lower tax rates applied to the businesses acquired during the past two years; however the effective tax rate in the US increased to 38% (2015: 36%) because of much lower manufacturing tax credits this year.

Adjusted earnings per share ("EPS") increased by 10% to 41.9p, compared with 38.2p last year and the statutory basic EPS increased to 33.9p (2015: 32.5p).

The Board's policy is to increase dividends to shareholders each year, while targeting towards two times dividend cover (defined as the ratio of adjusted EPS to total dividends paid and proposed for the year). A combination of a robust Group balance sheet and particularly strong free cash flow provides the Directors with confidence to recommend an increase in the final dividend of 11% to 13.8p per share (2015: 12.4p). This gives a total dividend per share for the year of 20.0p per share which represents a 10% increase on the prior year dividend of 18.2p. The dividend remains 2.1 times covered by adjusted EPS, unchanged from last year.

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Finance Review continued

Disposal of assets
The Group made a gain of £0.7m after tax on the sale of assets during the year and this is disclosed separately on the face of the Consolidated Income Statement. The Vantage Healthcare business in Canada disposed of the Medivators product line for consideration of £2.2m, after both expenses of sale and providing for the costs of integrating the retained Vantage business with its affiliate business, AMT based in Kitchener. A gain after tax of £0.3m was realised on this disposal. The Medivators product line accounted for ca.8% of DHG's total revenues in 2016, but only ca.3% of adjusted operating profit as a substantial part of the business's infrastructure, including a large proportion of Vantage's operational employees, were transferred to the purchaser as part of the transaction. During the year, the Group also sold three small legacy properties for aggregate proceeds of £2.3m which realised a gain of £0.4m after tax.

Free cash flow
The Group generated very strong free cash flow in 2016 which increased by £18.7m to £59.0m (2015: £40.3m). A reduction in working capital contributed £6.3m to cash resources (2015: outflow of £1.9m) and the proceeds from the sale of assets added a further £4.6m to free cash flow. Free cash flow represents cash available to invest in acquisitions or return to shareholders and this year represented a cash conversion of adjusted earnings of 124% (2015: 93%).

The Group's businesses continued to work hard during the second half of the year to further reduce working capital, particularly in a low growth economic environment. These efforts to reduce working capital were again largely focused on improving inventory procurement processes designed to constrain the growth in inventories across the Group's businesses.

The Group's KPI performance metric of working capital as a proportion of revenue reduced to 16.6% at 30 September 2016, compared with 17.0% last year; this metric reduces to 15.3% on a constant currency basis.

Group tax payments increased by £2.2m to £17.6m (2015: £15.4m) and included £1.5m on pre-acquisition tax liabilities relating to Cablecraft and WCIS. On an underlying basis and before the currency effects of translation, cash tax payments represented ca.23% of adjusted profit before tax which was unchanged from last year.

The Group's capital expenditure this year was more modest at £3.7m, compared with £4.3m last year. Within this total expenditure, an initial £0.5m was invested by J Royal, a Seals business based in the US, on the construction of a new expanded facility, close by their existing facility in North Carolina. The total construction cost of this facility is expected to be ca.£2.5m on completion in April 2017 when it will be sold and leased back to the business. Operationally, a further £0.9m was invested by the Seals businesses during the year, including £0.5m on acquiring two new seal cutting machines, a new crane and other tooling equipment. A scheduled upgrade of the US Seals ERP system cost £0.2m and £0.2m was spent on general infrastructure improvements across the Sector.

In Life Sciences, Vantage saw its expenditure on funding equipment contracts on a cost per procedure ("CPP") basis reduce to £0.3m (2015: £1.0m). The investment in field equipment acquired in support of customer contracts with hospitals also reduced to £0.6m from £0.9m last year as the Canadian hospitals cut back their expenditure. The completion of the refurbishment of TPD's new leasehold facility in Ireland cost £0.6m and a further £0.4m was invested on general infrastructure improvements across the Sector, including IT upgrades.

"The Group generated very strong free cash flow in 2016 which increased to £59.0m."

Capital expenditure in the Controls businesses remained very modest at £0.4m and included £0.2m on establishing a separate stand-alone warehouse and offices for Clarendon's developing specialty fasteners business in the existing IS-Group facility in Swindon. The remaining £0.2m was invested in new tooling and on upgrading IT infrastructure across the Sector.

The Company paid the PAYE income tax liability of £0.3m (2015: £1.0m) on the exercise of LTIP share awards, in exchange for reduced share awards to participants. No further shares in the Company were acquired by the Employee Benefit Trust this year, following last year's £0.7m expenditure on the acquisition of 100,000 shares.

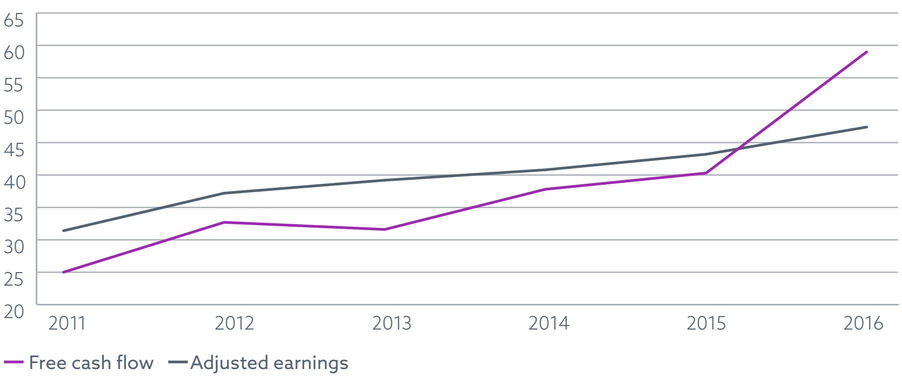
The Group spent £32.7m of the free cash flow on acquisitions, as described below and £21.4m (2015: £19.9m) on paying dividends to both Company and minority shareholders.

Acquisitions completed during the year
The Group invested a further £32.7m in acquiring new businesses this year (2015: £37.8m), including £1.9m on acquiring outstanding minority interests and £0.7m of deferred consideration.

The largest investment this year of £21.3m was made in March 2016 to acquire Cablecraft, a leading supplier of cable accessory products, managed from its principal facility near Dunstable in the UK. A further £8.4m was invested in October 2015 to acquire the WCIS businesses in Australia and New Caledonia which supply gaskets, seals and associated products mainly to the Mining industry. In February 2016, a small connector business based in France was acquired for £0.4m by Filcon, to broaden its access to the European connector markets.

These acquisitions added £18.4m to the Group's acquired intangible assets, which represents the valuation of customer and supplier relationships which will be amortised over periods

Cash conversion (£m)



ranging from five to ten years. At 30 September 2016, the carrying value of the Group's acquired intangible assets was £54.6m. Goodwill increased by £25.9m to £115.2m at 30 September 2016; £11.8m related to businesses acquired during the year (including fair value adjustments to the assets acquired) and £14.1m reflected the impact on overseas goodwill from the depreciation in the UK sterling exchange rate.

Goodwill is not amortised but is assessed each year at a Sector level to determine whether there has been any impairment in the carrying value of goodwill acquired. The exercise to assess whether goodwill has been impaired is described in note 10 to the consolidated financial statements and concluded that there was significant headroom on the valuation of this goodwill, compared with the carrying value of goodwill at the year end.

Liabilities to minority shareholders

The Group's liability to purchase outstanding minority shareholdings at 30 September 2016 decreased to £5.1m (2015: £5.7m), following the £1.9m purchase in July of an outstanding 10% minority shareholding in TPD. However, the liability at the year end was impacted by the substantial weakening in the UK sterling exchange rate which increased the UK sterling liability payable to these minorities which are all based overseas.

At 30 September 2016, there remain put options over the outstanding minority interests held in M Seals, Kentek and TPD which were valued at £5.1m, based on the Directors' latest estimate of the Earnings before Interest and Tax of these businesses when these options crystallise. None of these options are exercisable within the next year.

In addition to the liability to minority shareholders, the Group also has a liability at 30 September 2016 for deferred consideration of up to £1.7m (2015: £0.9m) which comprises the amount likely to be paid to the vendors of businesses purchased during the year, based on the Group's best estimate of the performance of these businesses next year. During the year, £0.7m was paid as deferred consideration relating to acquisitions completed in earlier years and £0.2m was released and was included as a deduction from acquisition related charges.

Return on adjusted trading capital employed and capital management

A key performance metric that the Group uses to measure the overall profitability of the Group and its success in creating value for shareholders is the Return on Adjusted Trading Capital Employed ("ROATCE"). At a Group level, this is a pre-tax measure which is applied against the fixed and working capital of the Group, together with all gross intangible assets and goodwill. At 30 September 2016, the Group ROATCE had reduced to 21.1% (2015: 23.9%) which largely reflected the mismatch of a stronger average UK sterling exchange rate used to translate the operating profit of overseas businesses and the much weaker exchange rate used to translate the Adjusted TCE of these overseas businesses at the year end. Adjusted TCE is defined in note 2 to the consolidated financial statements.

The Group continues to maintain a strong balance sheet with net cash funds of £10.6m (2015: £3.0m) at 30 September 2016, comprising cash funds of £20.6m, offset by £10.0m of bank borrowings. Surplus cash funds are generally repatriated to the UK, unless they are required locally to meet certain commitments, including acquisitions.

On 7 March 2016, the Group exercised the final part of the accordion option within its existing revolving multi-currency credit facilities and increased its committed bank facility by £10.0m to the maximum available of £50.0m. These additional funds were provided at a cost of 30bps and were used to assist in financing the acquisition of Cablecraft. These bank facilities are committed until June 2017 and are used to meet any shortfall in cash to fund acquisitions. These facilities will be reviewed and extended or renewed at a similar amount during the first half of the next financial year.

Employee pension obligations

Pension benefits to existing employees, both in the UK and overseas, are provided through defined contribution schemes at an aggregate cost in 2016 of £2.5m (2015: £2.3m).

The Group maintains a legacy small closed defined benefit pension scheme in the UK which at 30 September 2013 had a funding deficit of £2.7m. The next funding actuarial valuation is being carried out as at 30 September 2016 and the results of this exercise will be reported in next year's Annual Report. In Switzerland, local law requires Kubo to provide a contribution based pension for all employees, which are funded by employer and employee contributions. This pension plan is managed for Kubo through a separate multi-employer plan of non-associated Swiss companies which pools the funding risk between participating companies.

The Group continues to make regular cash contributions to the UK scheme at an annual rate of £0.3m, as agreed with the scheme actuary, with the objective of closing the funding deficit over the next six years. However, given the substantial reduction in bond yields at 30 September 2016, compared with those used to value the pension liabilities at the last valuation in 2013, it is very likely that these cash contributions will have to be increased in future years to eliminate the funding deficit. In Switzerland, Kubo's annual cash contribution to the pension scheme is £0.3m (2015: £0.2m).

Both the UK defined benefit scheme and the Kubo contribution scheme are accounted for in accordance with IAS 19 (Revised). At 30 September, the aggregate accounting pension deficit in these two schemes increased by £7.4m to £17.2m because of a further significant reduction of bond yields compared to last year. The gross aggregate pension liability in respect of these two schemes at 30 September 2016 increased by £11.6m to £56.1m which is funded by £38.9m of assets.

Potential impact of Brexit

The outcome of the UK's Brexit vote to leave the European Union is unlikely to materially impact the Group's businesses at an operational level as only ca.25% of the Group's overall revenues are generated in the UK. In addition, these businesses, as well as those based in Continental Europe, are substantially "in country" industrial suppliers of goods with very little sales activity being carried out across country borders.

At a macroeconomic level however, the Group's financial results have already been, and are likely to continue to be, impacted by the rapid and substantial depreciation in UK sterling that followed the Brexit vote. This has resulted in gains to the Group's reported revenues, operating profits and net assets from translating the results of the Group's overseas businesses into UK sterling.

In addition, it is also likely that the Group's UK based businesses may be impacted to a lesser degree from substantially weaker UK sterling; this may have an adverse effect on their operating margins because of an increase in the cost of their goods purchased from overseas for sale in the UK.

The Group's UK businesses remain alert to these economic risks and are already taking action to mitigate the impact on their operating margins through a combination of seeking supplier cost reductions, price increases to customers and tight control over operating costs.

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