Interim management report

Overview

The macro-economic environment for Bodycote in the first half of 2016 showed little change from 2015. Notwithstanding this weak macro-economic backdrop, the quality of the Bodycote business continued to improve. The Group's headline operating margin[1] reduced only 110 basis points to 16.9%, even though revenues declined 8.1% (at constant exchange rates). Group revenue was £291.0m with currency translation reducing the year-on-year revenue decline to 2.9%. Headline operating profit for the Group was £49.3m in the first half of the year.

The weakness in industrial production and in particular in industrial machinery continued the slow downward trend that has been evident for some time. These sectors are the main drivers for the Group's general industrial business which suffered accordingly. Oil & gas, which has reduced each quarter since the end of 2014, declined further, with subdued activity onshore and with large sub-sea projects once again postponed. There are, however, signs that the sequential quarterly decline in oil & gas may be abating.

Outside the oil & gas and general industrial sectors much of the rest of the business grew. Civil aerospace in Europe was strong, as expected, while in North America growth was restrained by a fall in business jet revenues. Business jets make up a small but concentrated piece of the Group's business in North America and the decline resulted from a change in structural design that reduces the amount of processing work required. In automotive, car and light trucks continued to grow strongly and this sector was the main driver for the like-for-like growth of 14.4%[2] in the emerging markets.

Aerospace, Defence and Energy (ADE) business unit headline margins[1], excluding oil & gas, remained stable with Automotive and General Industrial (AGI) business unit headline margins[1] growing 40 basis points to 16.5%. Improving AGI margins, particularly in Europe, has been a priority for some time and it is pleasing to see this continue, particularly in the face of declining revenues. Margin expansion is achieved in the business by a continual focus on improving the mix using tools such as the Bodycote Margin Model. The exit of the loss-making business in Brazil also helped global AGI margins.

The Specialist Technologies of HIP Product Fabrication (HIP PF) and Surface Technology have large portions of their business exposed to the oil & gas sector and so it was unsurprising that these revenues were impacted in the period. The other Specialist Technologies performed well, such that the percentage of Group profits contributed by the Specialist Technologies in total increased to 41% (2015: 39%).

The Group increased net capital expenditure in the first half by 6.2% to £31.0m, which equates to 1.2 times depreciation (2015: 1.1 times). This increased capital expenditure is being deployed in keeping with the Group's strategy of investing where we can achieve above average profit growth, with some 50% being invested in capacity expansion. The particular focus areas for investment are in Specialist Technologies, aerospace and the developing economies in Eastern Europe, Mexico and China. Net debt at the half year was £5.5m (2015: £7.0m) with the Group generating £20.9m of free cash in the first half (2015: £20.6m).

The Group's strategy remains unaltered. The drive for operational efficiency in the more mature parts of the business, expansion of the Group's footprint in rapid growth countries and the focus on growth in the higher value-added businesses, particularly the Specialist Technologies, are all designed to increase the quality of the Group's earnings and create significant value.

1 Headline operating profit as a percentage of revenue.
2 Excluding closed sites and the business in Brazil, which was sold in the second half of 2015.