Finance Review

Record profit delivered

"After a return to growth in the first half of the year, growth accelerated in the second half."

Jez Maiden
Group Finance Director

Sales value
£1,373.1m
2016: £1,243.6m

Adjusted profit before tax
+11.1%
2016: +13.2%

Free cash flow
£98.5m
2016: £155.5m

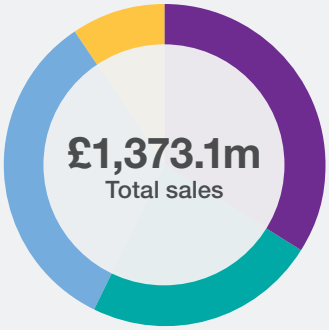
Currency

Currency translation had a beneficial impact on both sales and profit in the first half of 2017, due to the continued weakness of Sterling. However, Sterling strengthened somewhat during the second half year, reducing this benefit. Across the year as a whole, Sterling averaged US$1.290 (2016: US$1.354) and €1.141 (2016: €1.224). Currency translation increased sales compared to 2016 by £71.9m and adjusted profit before tax by £13.2m.

Sales

Sales grew by 10.4% to £1,373.1m (2016: £1,243.6m) (Figure 1). At constant currency, sales rose by 4.6%. There was no material impact from acquisitions. In the Core Business, constant currency sales increased by 5.6%, with sales volume 3.0% higher and sales price/mix benefitting from the impact of innovation and an improved product mix, together with raw material price recovery in Performance Technologies. After a return to steady growth in the first half of the year, with Core Business constant currency sales rising by 4.4%, growth accelerated in the second half of the year, up 5.7% in the third quarter and 7.9% in the fourth quarter. This reflected a progressive improvement in Personal Care and Life Sciences (Figure 2).

Sales by sector (£m)



Personal Care	£466.6m
Life Sciences	£322.6m
Performance Technologies	£456.9m
Industrial Chemicals	£127.0m

Financial data

Figure 1

Sales (£m)

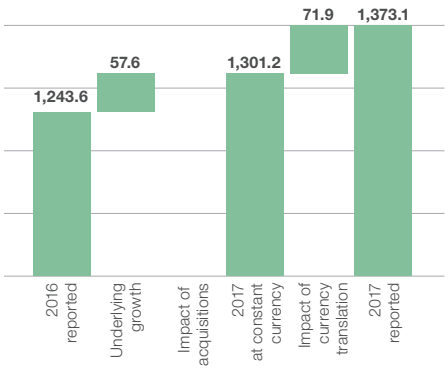
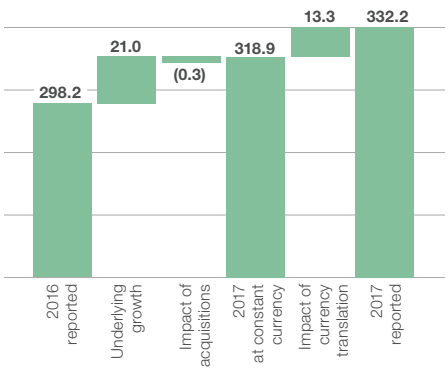


Figure 2

Sales at constant currency	First half %	Second half %	Full year %
Personal Care	2.3	8.2	5.3
Life Sciences	0.8	8.2	4.6
Performance Technologies	9.1	4.3	6.6
Core Business	4.4	6.8	5.6
Industrial Chemicals	(1.1)	(6.8)	(4.0)
Group	3.8	5.4	4.6

Figure 3

Adjusted operating profit (£m)



Adjusted profit

Adjusted operating profit rose by 11.4% to £332.2m (2016: £298.2m) (Figure 3). On a constant currency basis, adjusted operating profit increased by 6.9%.

The constant currency improvement in adjusted operating profit was driven by the organic growth across the Core Business, with all sectors seeing profit increase (Figure 4). Return on sales increased by 20 basis points to 24.2% (2016: 24.0%). To reflect changes to product portfolios, 2016 sector revenue and adjusted operating profit have been restated by £3.1m and £0.4m respectively for a net reclassification of business from Industrial Chemicals to Performance Technologies.

The net interest charge increased to £11.9m (2016: £9.9m), with higher debt from acquisitions and the special dividend in the prior year partly offset by capitalised interest on the construction of the North American bio-surfactant plant. Adjusted profit before tax increased by £32.0m to £320.3m (2016: £288.3m) (Figure 5).

The effective tax rate on this profit reduced to 26.8% (2016: 28.0%), reflecting the geographic mix of profit and the lower UK statutory rate of 19.25% (2016: 20.0%). There were no other significant adjustments between the Group's expected and reported tax charge based on its accounting profit.

The Group's adjusted profit for the year was £234.4m (2016: £207.6m). Adjusted basic earnings per share (EPS) increased by 14.9% to 179.0p (2016: 155.8p).

IFRS profit

Adjusted profit is stated before exceptional items (including discontinued business costs), acquisition costs and amortisation of intangible assets arising on acquisition, and tax thereon. The Board believes that the adjusted presentation (and the columnar format adopted for the Group income statement on page 88) assists shareholders in better understanding the performance of the business and is adopted on a consistent basis for each half year and full year results.

The charge before tax for exceptional items, acquisition costs and amortisation of intangible assets arising on acquisition was £6.2m (2016: £12.6m). Acquisition costs were £0.8m (2016: £1.1m), the charge for amortisation of intangible assets was £3.7m (2016: £3.1m) and exceptional items were £1.7m (2016: £8.4m), being an increase in environmental provisions on discontinued business. The US Tax Cuts and Jobs Act led to a revaluation of the Group's net deferred tax liability, resulting in a £7.7m exceptional tax credit. The net credit after tax for exceptional items, acquisition costs and amortisation of intangible assets arising on acquisition was £2.3m (2016: £10.0m charge).

The profit after tax for the year on an IFRS basis was £236.7m (2016: £197.6m) (Figure 6) and basic EPS were 180.8p (2016: 148.2p).

2018 potential impacts

A preliminary assessment of the impact of the new US tax law on the Group's effective tax rate suggests an expected fall of approximately 2.5 percentage points in 2018, which will benefit EPS. Currency translation could have an adverse impact on 2018 reported currency profit, compared to the beneficial impact in 2017, if Sterling maintains its recent strength.

Figure 4

Adjusted operating profit	2017 Reported £m	2017 Constant currency £m	2016 Restated £m
Personal Care	**155.5**	**147.8**	143.1
Life Sciences	**97.0**	**93.5**	82.0
Performance Technologies	**75.4**	**73.7**	66.6
Core Business	**327.9**	**315.0**	291.7
Industrial Chemicals	**4.3**	**3.9**	6.5
Group	**332.2**	**318.9**	298.2

Figure 5

Summary income statement	2017 £m	2016 £m
Sales	**1,373.1**	1,243.6
Operating costs	**(1,040.9)**	(945.4)
Adjusted operating profit	**332.2**	298.2
Net interest charge	**(11.9)**	(9.9)
Adjusted profit before tax	**320.3**	288.3

Cash management

Delivering good cash generation is core to Croda's strategy. This cash is used to invest in Research and Development, faster growth technologies, both organically and by acquisition, to expand production capacity and to pay increased dividends. EBITDA increased to £381.8m (2016: £344.3m), which funded net capital expenditure of £157.2m (2016: £104.5m), as our capital programme peaked with the completion of installation of our bio-surfactant plant. Working capital increased by £33.3m, reflecting stronger trading and higher inventories at the end of the year to support sales orders. As a result, free cash flow was £98.5m (2016: £155.5m) (Figure 7).

After currency translation, net debt increased by £17.4m to £381.5m (2016: £364.1m). The leverage ratio (the ratio of net debt to EBITDA) reduced to 1.0x (2016: 1.1x) and remains substantially below the maximum covenant level under the Group's lending facilities of three times.

There were no material changes to committed debt facilities during the year. These facilities provide ample liquidity to meet the Group's immediate plans at a relatively low interest cost. At 31 December 2017 the Group had £433.7m (2016: £461.6m) of cash and undrawn committed credit facilities available.

Dividend and capital allocation

Croda seeks to deliver high quality profits, measured through a superior ROIC, earnings growth and strong cash returns. The Group's capital allocation policy is to:

1. **Reinvest for growth** – we reinvest in capital projects to grow sales, increase product innovation and expand in attractive geographic markets, delivering a superior ROIC of 19.2% in 2017 (2016: 19.3%). During 2017 capital investment was over three times depreciation, funding asset replacement, new investment in key technologies and construction of the bio-surfactant plant, all of which should support future ROIC. We expect the level of capital expenditure to return to around 1.5x depreciation from 2018, depending on organic growth opportunities;
2. **Provide regular returns to shareholders** – we pay a regular dividend to shareholders, representing 40% to 50% of adjusted earnings over the business cycle. The Board has proposed an increase of 9.5% in the full year dividend to 81.0p (2016: 74.0p), a payout of 45% of adjusted EPS;
3. **Acquire promising technologies** – we have identified a number of exciting technologies to supplement organic growth in existing and adjacent markets. Some of these will be acquired, either as nascent opportunities for future scale-up or as larger 'bolt ons'. During 2017 we completed the acquisitions of Enza Biotech and IonPhasE, together with an investment in Cutitronics; and
4. **Maintain an appropriate balance sheet and return excess capital** – we maintain an appropriate balance sheet to meet future investment and trading requirements. We target leverage of 1 to 1.5x (excluding deficits on retirement benefit schemes), although we are prepared to move above this range if circumstances warrant and will consider further returns to shareholders in the event that leverage falls below the target range.

Retirement benefits

The post-tax deficit on retirement benefit plans, measured on an accounting valuation basis under IAS 19, decreased to £21.1m (2016: £112.7m), reflecting strong asset returns. Cash funding of the various plans within the Group is driven by the schemes' ongoing actuarial valuation reviews. No deficit funding payments are currently required to the Group's largest pension scheme, the UK Croda Pension Scheme, and this is not expected to change with the latest valuation of the scheme, as at 30 September 2017, which is currently ongoing.

Financial data

Figure 6

IFRS profit	2017 £m	2016 £m
Adjusted profit before tax	**320.3**	288.3
Exceptional items, acquisition costs and amortisation of intangibles	**(6.2)**	(12.6)
Profit before tax	**314.1**	275.7
Tax	**(77.4)**	(78.1)
Profit after tax	**236.7**	197.6

Figure 7

Cash flow	2017 £m	2016 £m
Adjusted operating profit	**332.2**	298.2
Depreciation and amortisation	**49.6**	46.1
EBITDA	**381.8**	344.3
Working capital	**(33.3)**	7.2
Net capital expenditure	**(157.2)**	(104.5)
Non-cash pension expense	**3.4**	(10.9)
Interest & tax	**(96.2)**	(80.6)
Free cash flow	**98.5**	155.5
Dividends	**(100.0)**	(230.2)
Acquisitions	**(30.4)**	(1.4)
Other cash movements	**5.6**	3.6
Net cash flow	**(26.3)**	(72.5)

Alternative performance measures

We use a number of alternative performance measures to assist in presenting information in this statement in an easily analysable and comprehensible form. We use such measures consistently at the half year and full year and reconcile them as appropriate. The measures used in this statement include:

- *Constant currency sales and profit*: these reflect current year results for existing business translated at the prior year's average exchange rates, and include the impact of acquisitions. They are reconciled to reported results in Figure 1 and Figure 3. Sales in Latin America are primarily based on US dollars, which is used as the functional currency for constant currency sales translation;
- *Underlying sales:* these reflect constant currency values adjusted to exclude the impact of acquisitions. They are reconciled to reported sales in Figure 1;
- *Adjusted profit*: this is profit before exceptional items, acquisition costs and amortisation of intangible assets arising on acquisition. It is reconciled in Figure 6;
- *Adjusted EPS*: this is earnings per share using the adjusted profit after tax and is reconciled in note 7 of the accounts;
- *Return on sales*: this is adjusted operating profit divided by sales;
- *Return on Invested Capital (ROIC)*: this is adjusted operating profit after tax divided by the average invested capital for the year for the Group. Invested capital represents the net assets of the Group, adjusted for earlier goodwill written off to reserves, net debt, retirement benefit liabilities, provisions and deferred taxes;
- *Net debt*: comprises cash and cash equivalents (including bank overdrafts), current and non-current borrowings and obligations under finance leases; and
- *Leverage*: this is the ratio of net debt to Earnings Before Interest, Tax, Depreciation and Amortisation (EBITDA). EBITDA is adjusted operating profit plus depreciation.

The Core Business comprises the core sectors of Personal Care, Life Sciences and Performance Technologies.

Case study

Incotec adding value to crop growth

Seed enhancement leads to sustainable crop growth

With the world's growing population and declining availability of arable land, our innovative seed enhancement business, Incotec, is hugely important due to the extrinsic sustainability benefits of its products, which are offered to its customers.

Seed treatments can be integrated within our film coatings, allowing for a targeted application, stimulating root and plant growth and leading to enhanced nutrient uptake. During the early weeks of plant growth, seed coating leads to an 80-90% reduction in the amount of plant protection product required.

Improving the livelihood of farmers in Ethiopia

Teff is the most valuable seed crop in Ethiopia, and a traditional staple due to its nutritional value. The small size of Teff seeds causes problems during sowing, making it difficult to control distribution, thus impacting crop yield. Incotec has developed a pellet which doubles the seed size, enabling more accurate planting. In recent field trials, this saw an increase in seed yield by 80%, helping to transform the livelihood of local Teff farmers.