Driving profit and cash flow

"A key strength of the Croda model is its cash generation. In 2019, free cash flow increased by 30%."

Jez Maiden
Group Finance Director

Sales value

£1,377.7m

2018: £1,386.9m

Adjusted profit before tax

£322.1m

2018: £331.5m

Free cash flow

£201.7m

2018: £154.9m

Currency

Currency translation benefitted reported sales and profit in the first half year as Sterling weakened against the dollar, before recovering later in the year. Sterling averaged US$1.278 (2018: US$1.334) and €1.141 (2018: €1.130).

Sales

Sales in reported currency reduced by 0.7% to £1,377.7m (2018: £1,386.9m). Constant currency sales fell by 2.6%, including a £11.0m benefit from acquisitions.

Sales	£m	%
2018 reported	1,386.9	
Underlying growth	(47.4)	(3.4)
Impact of acquisitions	11.0	0.8
2019 constant currency	1,350.5	(2.6)
Impact of currency translation	27.2	1.9
2019 reported	**1,377.7**	**(0.7)**

In the Core Business, constant currency sales reduced by 2.3%. Sales volume was 5% lower, partly offset by price/mix adding 3%, driven by innovation and an improved product portfolio. Sales in Life Sciences grew by nearly 6%, whilst Personal Care sales were 3% lower and Performance Technologies declined over 7% due to weakness across industrial markets.

Sales at constant currency	First Half %	Second Half %	Full Year %
Personal Care	(3.6)	(2.3)	(3.0)
Life Sciences	13.0	(0.9)	5.9
Performance Technologies	(6.0)	(8.6)	(7.3)
Core Business	(0.4)	(4.2)	(2.3)
Industrial Chemicals	(7.4)	(5.7)	(6.6)
Group	**(1.0)**	**(4.3)**	**(2.6)**

Adjusted profit

Adjusted operating profit decreased by 0.8% in reported currency to £339.7m (2018: £342.5m). Operating costs reduced, with the benefit of actions to reduce costs and no annual bonus charge due to profit being slightly below the previous year. No depreciation charge was incurred in 2019 on the North American biosurfactant plant, as this did not come into operation until early in 2020. The impact of its increased capital cost and delayed commissioning has been reviewed but it was not considered to be at risk of impairment, with the plant forming part of the profitable North American business.

Income statement	2019 £m	2018 £m
Revenue	**1,377.7**	1,386.9
Cost of sales	**(865.5)**	(864.6)
Gross profit	**512.2**	522.3
Adjusted operating costs	**(172.5)**	(179.8)
Adjusted operating profit	**339.7**	342.5
Net interest charge	**(17.6)**	(11.0)
Adjusted profit before tax	**322.1**	331.5

Adjusted operating profit declined by 1.8% in constant currency due to lower sales and the impact of acquisitions. Reflecting the strong business model, return on sales remained unchanged at 24.7% (2018: 24.7%) in reported currency.

Adjusted operating profit	£m	%
2018 reported	342.5	
Underlying growth	(5.3)	(1.6)
Impact of acquisitions	(0.7)	(0.2)
2019 constant currency	336.5	(1.8)
Impact of currency translation	3.2	1.0
2019 reported	**339.7**	**(0.8)**

The margin improvement saw adjusted operating profit increase modestly in Personal Care in reported currency, broadly flat in constant currency. Life Sciences grew profit strongly, whilst profit in Performance Technologies was sharply lower, as reduced volume impacted fixed cost recovery in this more volume sensitive business.

Adjusted operating profit	2019 Reported £m	2019 Constant currency £m	2018 Reported £m
Personal Care	**162.1**	159.9	160.3
Life Sciences	**107.1**	106.9	95.8
Performance Technologies	**69.4**	68.9	85.2
Core Business	**338.6**	335.7	341.3
Industrial Chemicals	**1.1**	0.8	1.2
Group	**339.7**	336.5	342.5

The net interest charge increased to £17.6m (2018: £11.0m) in reported currency and £17.1m in constant currency. 2019 saw higher debt from the payment of a special dividend and the acquisition of Biosector at the end of 2018. In addition, the prior year benefitted from capitalisation of interest on the North American biosurfactant plant, construction of which was materially completed in 2018 when capitalisation of interest to the project therefore stopped. However, as noted above, delays in commissioning the plant, together with a small leak after first start up, prevented the plant becoming operational until early in 2020. Adjusted profit before tax reduced to £322.1m (2018: £331.5m).

The effective tax rate increased to 25.6% (2018: 24.6%), reflecting reduced profit in lower tax jurisdictions. There were no significant adjustments between the Group's expected and reported tax charge based on its accounting profit. Adjusted profit after tax in reported currency was £239.7m (2018: £249.9m). Adjusted basic earnings per share (EPS) decreased to 185.0p (2018: 190.2p).

IFRS profit

IFRS profit is measured after exceptional items, acquisition costs and amortisation of intangible assets arising on acquisition. The charge for these before tax was £19.8m (2018: £13.7m). Exceptional items in the current year were £10.7m related to delivery of cost saving actions (the exceptional cost in the prior year was £4.9m, relating to a past service cost on the UK defined benefit pension scheme). Acquisition costs were £0.3m (2018: £2.7m) and the charge for amortisation of intangible assets was £8.8m (2018: £6.1m). Profit before tax on an IFRS basis was £302.3m (2018: £317.8m), the profit after tax was £223.8m (2018: £238.3m) and basic EPS were 172.8p (2018: 181.4p).

Income statement	2019 £m	2018 £m
Adjusted profit before tax	**322.1**	331.5
Exceptional items, acquisition costs & intangibles	**(19.8)**	(13.7)
Profit before tax (IFRS)	**302.3**	317.8
Tax	**(78.5)**	(79.5)
Profit after tax (IFRS)	**223.8**	238.3

Cash management

A key strength of the Croda model is its cash generation. In 2019, free cash flow increased by 30.2% to £201.7m (2018: £154.9m) in reported currency, after funding net capital expenditure of over £100m, which will see new capacity become available during 2020. Working capital management improved during the year after a disappointing 2018. The strong cash flow helped support almost £267m in dividends to shareholders, including a special dividend of 115 pence per share paid in May 2019. There were no material acquisitions in the year.

Cash flow	2019 £m	2018 £m
Adjusted operating profit	**339.7**	342.5
Depreciation and amortisation	**57.6**	50.1
EBITDA	**397.3**	392.6
Working capital	**1.6**	(69.3)
Net capital expenditure	**(106.8)**	(103.1)
Payment of lease liabilities	**(8.8)**	(0.5)
Non-cash pension expense	**2.8**	3.8
Interest & tax	**(84.4)**	(68.6)
Free cash flow	**201.7**	154.9
Dividends	**(266.9)**	(110.5)
Acquisitions	**(5.0)**	(82.5)
Other cash movements	**(17.9)**	4.4
Net cash flow	**(88.1)**	(33.7)
Net movement in borrowings	**115.4**	15.2
Net movement in cash and cash equivalents	**27.3**	(18.5)

After currency translation, and including leases under the newly adopted accounting standard IFRS16 (which brought £46.0m of additional lease debt onto the balance sheet on transition), net debt increased to £547.7m (2018: £425.5m), a leverage ratio of 1.4 times (31 December 2018: 1.1x). During the year, the Group refinanced its principal bank debt and issued US private placement bonds at attractive pricing, and at 31 December 2019 had £1,058.6m of committed debt facilities available with principal maturities between 2023 and 2029, providing undrawn committed facility headroom of £463.8m (2018: £358.4m).

Case study:

'Green' banking

Reflecting our new Purpose, Smart Science to Improve Lives™, Croda worked with a core group of nine banks to promote delivery of our sustainability objectives within the Group's principal committed bank facilities. Aligned with Croda's commitment to be Climate Positive by 2030, the new funding agreement requires Croda to reduce its carbon use every year by a specified amount. Provided Croda achieves this challenging target, the banking group will reduce the interest margin which Croda pays, and Croda will reinvest this saving in sustainability projects. If Croda does not achieve the target in any year, Croda will pay a higher interest margin and our banking group will reinvest this in sustainability projects. As a result, our 'green' banking facility achieves alignment between Croda and its core banking partners in delivering sustainability for our fragile world.

Capital allocation

Croda seeks to deliver high quality profits, measured through a superior return on invested capital (ROIC), earnings growth and strong cash returns. Following a recent programme of increased capital expenditure, including the construction of our North America biosurfactant plant, our organic investment is now returning to our normal, more 'capital light' model. In addition, we have seen increased technology acquisition spend in recent years, whereby new exciting technologies are acquired but where it is likely to take several years to reach commercialisation. As a result, capital employed has nearly doubled since 2014. Consequently, ROIC has reduced to 17.0% (2018: (restated definition): 19.2%). This is expected to improve as the profit benefits of recent investments develop over the coming years, although we will continue to seek new opportunities to invest capital as set out below.

The Group has also introduced a measure of Economic Value Added (EVA) as an underpin to its Remuneration Policy (p72). This reinforces the importance of delivering superior returns on invested capital.

The Group's capital allocation policy is to:

1. **Reinvest for growth** – Croda seeks to invest in organic capital expenditure to drive shareholder value creation through new capacity, product innovation and expansion in attractive geographic markets to drive sales and profit growth;
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 3.4% in the full year dividend to 90.0 pence (2018: 87.0p), representing 49% of adjusted EPS;
3. **Acquire disruptive 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 complementary acquisitions. During 2019, we increased our associate investment in the personal care device company, Cutitronics, and acquired Rewitec in Performance Technologies; 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 1.0 to 1.5x (excluding retirement benefit schemes), although we are prepared to move above this range if circumstances warrant. We consider returning excess capital to shareholders when leverage falls below our target range and sufficient capital is available to meet our investment opportunities. In 2019, we paid a special dividend of 115p per share (£151.5m).

Brexit update

In 2019 we undertook contingency planning for the UK leaving the European Union (EU) without a transition arrangement. In the event, this was not required. We are now planning for the UK leaving the EU at the end of 2020 ('Brexit'). With 96% of sales and 84% of production outside the UK, the overall impact is expected to be limited. Our focus remains on ensuring our ability to offer continuity of service and supply to our customers, through our Brexit-ready trading model, customer service and supply chains, and in compliance with regulatory frameworks under a number of different Brexit scenarios.

Retirement benefits

The post-tax deficit on retirement benefit plans, measured on an accounting valuation basis under IAS19, increased to £60.1m (2018: £12.4m), largely due to lower corporate bond yields. This is expected to result in an increase in the Income Statement charge in 2020 of around £3m. Cash funding of the various plans is driven by the schemes' ongoing actuarial valuations. No deficit funding payments are currently required to the largest pension plan, the UK Croda Pension Scheme, with the next valuation due at 30 September 2020.

Jez Maiden
Group Finance Director

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 results:* these reflect current year performance for existing business translated at the prior year's average exchange rates and include the impact of acquisitions. For constant currency profit, translation is performed using the entity reporting currency. For constant currency sales, local currency sales are translated into the most relevant functional currency of the destination country of sale (for example, sales in Latin America are primarily made in US dollars, which is therefore used as the functional currency). Sales in functional currency are then translated into Sterling using the prior year's average rates for the corresponding period. Constant currency results are reconciled to reported results in this Finance Review;
- *Adjusted results:* these are stated before exceptional items, 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) assists shareholders by providing a meaningful basis upon which to analyse underlying business performance and make year-on-year comparisons. The same measures are used by management for planning, budgeting and reporting purposes and for the internal assessment of operating performance across the Group. The adjusted presentation is adopted on a consistent basis for each half year and full year results;
- *Return on sales:* this is adjusted operating profit divided by sales, at reported currency;
- *Return on Invested Capital (ROIC):* this is adjusted operating profit after tax divided by the average adjusted invested capital for the year. Adjusted invested capital represents net assets adjusted for net debt, earlier goodwill written off to reserves and accumulated amortisation of acquired intangible assets. This definition has been amended in 2019 to more closely align with common market practice (no longer adjusting invested capital for pensions, deferred tax or provisions). The amended definition has been applied consistently to all comparatives in the 2019 Annual Report and Accounts;
- *Net debt:* comprises cash and cash equivalents (including bank overdrafts), current and non-current borrowings and lease liabilities;
- *Leverage ratio:* this is the ratio of net debt to Earnings Before Interest, Tax, Depreciation and Amortisation (EBITDA). EBITDA is adjusted operating profit plus depreciation and amortisation; and
- *Free cash flow:* comprises EBITDA less movements in working capital, net capital expenditure, payment of lease liabilities, non-cash pension expense, and interest and tax payments.
- *Economic Value Added (EVA):* this is adjusted operating profit after tax less the charge for invested capital ('CIC') in that year. CIC is the average adjusted invested capital for the year for the Group multiplied by the Group's post-tax cost of capital.