

Finance review



“Increased profit was driven by organic growth and improved mix.”

Jez Maiden
Group Finance Director

Sales value

£1,386.9m

2017: £1,373.1m

Adjusted profit before tax

£331.5m

2017: £320.3m

Free cash flow

£155.4m

2017: £98.5m

Currency

Sterling averaged US\$1.334 (2017: US\$1.290) and €1.130 (2017: €1.141). Currency translation reduced sales compared to 2017 by £26.2m (1.9%) and adjusted profit before tax by £8.7m (2.7%).

Sales

Sales (figure 1) in reported currency grew by 1.0% to £1,386.9m (2017: £1,373.1m). In constant currency, sales rose by 2.9%. Acquisitions, including IonPhasE and Plant Impact, added 0.6% to sales growth.

In the Core Business, constant currency sales increased by 3.8% (figure 2). Sales volume was around 3% lower and sales price/mix 7% higher, reflecting improved mix in Performance Technologies, with a move to value over volume, together with the benefit of greater product innovation across the Group and some limited raw material price increases which were fully recovered.

Sales in the first half of the year were particularly strong, with Core Business constant currency sales up 4.7%. Growth in the second half was slightly softer, up 2.8%, with stronger prior year comparators. Personal Care continued its return to sales growth, Life Sciences delivered good sales growth, partly offset by the exit of the North American API contract at the end of 2017. Performance Technologies continued to shed low margin business and grow higher value applications, improving return on sales.

Adjusted profit

Adjusted results are stated before exceptional items, acquisition costs and amortisation of intangible assets arising on acquisition and tax thereon.

Adjusted operating profit rose by 3.1% (figure 3) to £342.5m (2017: £332.2m). On a constant currency basis, adjusted operating profit increased by 5.8%, and by 7.5% before the impact of losses incurred on recent technology acquisitions.

The growth in adjusted operating profit (figure 4) in constant currency was driven by organic growth and improved product mix across the Core Business, with all sectors seeing profit increase. Performance Technologies increased profit by 15.0%, the third consecutive year of double digit percentage profit growth. Group return on sales increased by 50 basis points to 24.7% (2017: 24.2%).

The net interest charge (figure 5, p36) was broadly flat at £11.0m (2017: £11.9m) at reported rates, with a lower charge on pensions liabilities. £3.3m of interest was capitalised on the construction of the North American bio-surfactants plant until the half year, reflecting completion of the principal project expenditure. Thereafter, the interest on this additional debt has been charged to the income statement. Adjusted profit before tax at reported rates increased by £11.2m to £331.5m (2017: £320.3m).

The effective tax rate on this profit reduced to 24.6% (2017: 26.8%), reflecting a lower US Federal tax rate. 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 at reported rates was £249.9m (2017: £234.4m). Adjusted basic earnings per share (EPS) increased by 6.3% in reported currency to 190.2p (2017: 179.0p).

IFRS profit

IFRS profit (figure 6, p36) is measured after exceptional items, acquisition costs and amortisation of intangible assets arising on acquisition. The charge for these before tax was £13.7m (2017: £6.2m). Acquisition costs were £2.7m (2017: £0.8m), the charge for amortisation of intangible assets was £6.1m (2017: £3.7m) and exceptional items were £4.9m (2017: £1.7m). The latter related to a past service cost charged in 2018 to equalise benefits for the effects of unequal Guaranteed Minimum Pensions (GMPs). The profit before tax on an IFRS basis was £317.8m (2017: £314.1m). The profit after tax for the year on an IFRS basis was £238.3m (2017: £236.7m) and basic EPS were 181.4p (2017: 180.8p).

Cash management

Delivering good cash generation is core to Croda's strategy (figure 7, p37). This cash is used to invest in R&D, faster growth technologies, both organically and by acquisition, to expand production capacity and to pay increased dividends. 2018 saw an increase of £56.9m in free cash flow to £155.4m (2017: £98.5m).

This reflected an increase in EBITDA to £392.6m (2017: £381.8m) and reduced net

capital expenditure of £103.1m (2017: £157.2m), following completion of the construction of the North American bio-surfactants plant. Working capital rose by £69.3m, reflecting a reduction in capital creditors, as the recent investment programme was completed, and an increase in inventories above planned levels; action has been taken to reduce the excess. Tax payments were reduced by fiscal rule changes and allowances on recent investment in North America.

After acquisition spend of £82.5m (2017: £30.4m), dividends and currency translation, net debt increased by £44.0m to £425.5m (2017: £381.5m). The leverage ratio (the ratio of net debt to EBITDA) increased to 1.1x (2017: 1.0x) and remains substantially below the maximum covenant level under the Group's lending facilities of 3 times.

There were no material changes to committed debt facilities during the year. At 31 December 2018 the Group had £380.7m (2017: £433.7m) 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 (figure 8, p37). The Group's capital allocation policy is to:

1. Reinvest for growth – we invest in organic capital expenditure, product innovation and expansion in attractive geographic markets to drive sales and

Investing in biotechnology

During 2018 we opened our Centre of Innovation for Marine Biotechnology at our Nautilus site in Canada. This investment, which includes automated, high-throughput analytical testing, will accelerate their research and product development programme, thereby increasing our ability to discover sustainable, natural sources of functional ingredients for a broad range of personal, health and crop care ingredients.

This investment in biotechnology demonstrates our commitment to new, truly sustainable ingredients to meet consumer demands.

profit growth. This in turn delivers a superior ROIC. Over the last three years, ROIC has declined modestly to 18.2% (2017: 19.2%) as increased capital investment and technology acquisitions have reduced the return by close to three percentage points. As these investments start to generate profitable sales, we expect the ROIC to improve (subject to the impact of any further acquisitions);

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 7.4% in the full year dividend to 87.0p (2017: 81.0p), a pay out of 46% of adjusted EPS;

Financial data

Figure 1
Sales (£m)

	£m	%
2017 reported	1,373.1	
Underlying growth	31.2	2.3
Impact of acquisitions	8.8	0.6
2018 at constant currency	1,413.1	2.9
Impact of currency translation	(26.2)	(1.9)
2018 reported	1,386.9	1.0

Figure 2
Sales at constant currency

	First half %	Second half %	Full year %
Personal Care	9.3	4.1	6.8
Life Sciences	2.3	3.3	2.8
Performance Technologies	1.7	1.1	1.4
Core Business	4.7	2.8	3.8
Industrial Chemicals	(7.0)	(3.6)	(5.4)
Group	3.6	2.2	2.9

Figure 3
Adjusted operating profit

	£m	%
2017 reported	332.2	
Underlying growth	24.8	7.5
Impact of acquisitions	(5.6)	(1.7)
2018 at constant currency	351.4	5.8
Impact of currency translation	(8.9)	(2.7)
2018 reported	342.5	3.1

Figure 4
Adjusted operating profit by sector

	2018 Reported £m	2018 Constant currency £m	2017 Reported £m
Personal Care	160.3	163.1	155.5
Life Sciences	95.8	100.0	97.0
Performance Technologies	85.2	86.7	75.4
Core Business	341.3	349.8	327.9
Industrial Chemicals	1.2	1.6	4.3
Group	342.5	351.4	332.2

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 2018, we completed the complementary acquisition of Biosector, technology acquisitions of Nautilus and Plant Impact, invested in a minority interest in novel drug technology company SiSaf and increased our associate 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 1.0 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. With leverage at the end of 2018 close to 1x and our confidence in future cash generation, the Board is proposing to return 115p per share (£150m) to shareholders by way of a special dividend with associated share consolidation. The effect of this return of capital, had it been made in 2018, would have been to increase the 2018 year end leverage towards the upper end of the Board's target range.

Brexit update
With 96% of sales and 80% of production outside the UK, the overall impact of the UK leaving the European Union (EU) is expected to be limited for Croda. This includes potential impacts from WTO tariffs, restrictions on labour mobility and any impact on the UK economy. Croda has 30 manufacturing sites, of which four are located in the UK, and over 4,500 employees, with 1,000 based in the UK. Protecting our ability to manufacture product in the UK and to ship to customers, particularly in the EU, have been important elements of our contingency planning.

An orderly transition of the UK out of the EU is expected to be manageable for Croda. However, given uncertainty over the method and timing of the UK's exit from the EU, we have progressed contingency plans for a 'hard Brexit'. The objective has been to ensure that we can offer continuity of service and supply to our customers, wherever they are, and regardless of the type of exit. Following our risk assessment, we have focused on those areas that could have the most impact on our ability to service customers, in the event that the UK was to leave the EU abruptly, without a transition period:

- Having a Brexit-ready trading model. We have made minor changes to our trading model within Europe to ensure that our ability to move UK manufactured

product onto the continent and vice-versa is not at risk. These amendments have included reviewing which ports are best placed to protect service levels, as well as ensuring that we have full EU recognition for imports and exports;

- Maintaining effective customer service and supply chains. We are working to mitigate supply issues if there are delays at borders. We have secured additional warehousing capacity and are building finished goods inventory in our distribution network in continental Europe. To ensure continued effective operation of our UK manufacturing sites, we have also developed a plan to protect critical raw materials; and
- Ensuring compliance with regulatory frameworks, most notably the EU's REACH programme. UK-held REACH registrations may no longer be valid for sale of products in the EU, although the UK government has confirmed that EU-held REACH registrations will continue to be valid in the short term for products coming to the UK. This risk is mitigated through greater inventory of UK manufactured goods on the continent and through re-registration of UK products sold in the EU.

In addition, with the vast majority of the Group's sales outside the UK, reported profits are impacted by movements in Sterling, with reported profit benefiting from any weakening in Sterling. Overall, we have stress tested a range of potential

financial outcomes and do not believe these would alter our view of viability of the Group.

Retirement benefits

The post-tax deficit on retirement benefit plans, measured on an accounting valuation basis under IAS19, decreased to £12.4m (2017: £21.1m), largely reflecting net actuarial gains. 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.

Future trading updates

The Board has decided to cease issuing quarterly trading updates from 2019 onwards, given developing market practice. Routine updates will occur as part of the half year and full year results, normally in July and February each year.

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 the Finance Review;
- **Adjusted results:** these are 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) 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 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, deferred taxes and acquisitions as appropriate. Acquisitions made at year end without a profit contribution in the period are excluded;
- **Net debt:** comprises cash and cash equivalents (including bank overdrafts), current and non-current borrowings and obligations under finance leases;
- **Leverage:** 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;
- **Free cash flow:** comprises EBITDA less movements in working capital, net capital expenditure, non-cash pension expense, and interest and tax payments.



Jez Maiden
Group Finance Director

Financial data

Figure 5
Summary income statement

	2018 £m	2017 £m
Sales	1,386.9	1,373.1
Operating costs	(1,044.4)	(1,040.9)
Adjusted operating profit	342.5	332.2
Net interest charge	(11.0)	(11.9)
Adjusted profit before tax	331.5	320.3

Figure 6
Income statement

	2018 £m	2017 £m
Adjusted profit before tax	331.5	320.3
Exceptional items, acquisition costs & intangibles	(13.7)	(6.2)
Profit before tax (IFRS)	317.8	314.1
Tax	(79.5)	(77.4)
Profit after tax (IFRS)	238.3	236.7

Figure 7
Cash flow

	2018 £m	2017 £m
Adjusted operating profit	342.5	332.2
Depreciation and amortisation	50.1	49.6
EBITDA	392.6	381.8
Working capital	(69.3)	(33.3)
Net capital expenditure	(103.1)	(157.2)
Non-cash pension expense	3.8	3.4
Interest & tax	(68.6)	(96.2)
Free cash flow	155.4	98.5
Dividends	(110.5)	(100.0)
Acquisitions	(82.5)	(30.4)
Other cash movements	4.4	5.6
Net cash flow	(33.2)	(26.3)

Figure 8
Return on invested capital (ROIC)

	2018 £m	2017 £m
Adjusted operating profit	342.5	332.2
Adjusted tax at effective rate	(84.3)	(89.0)
Adjusted operating profit net of tax	258.2	243.2
Net assets	998.0	829.9
Adjustments for:		
Net debt	425.5	381.5
Net retirement benefit liability	18.5	30.5
Net deferred tax liability	68.5	30.3
Provisions	11.1	12.6
Goodwill previously written off to reserves	50.2	50.2
Acquisitions*	(71.1)	–
Invested capital	1,500.7	1,335.0
Average invested capital	1,417.9	1,266.0
Return on invested capital %	18.2%	19.2%

* The Group acquired Biosector on 28 December 2018. Given the proximity of the acquisition to the balance sheet date, the Group's measure of invested capital has been adjusted to exclude this.