Financial Review

After joining Devro as Group Finance Director in 2016, Rutger Helbing was appointed Chief Executive on 28 February 2018. In this Financial Review, written just before his new appointment, he reflects on 2017.

As in 2016, the financial results in 2017 comprised a number of significant moving parts including, for the first time, the full operational costs of our new manufacturing plants in the US and China. The adverse impact of the additional costs was offset by benefits delivered through the Devro 100 programme, both in terms of revenue growth and manufacturing cost reductions. As a consequence, underlying operating profit for the year was unchanged, but underlying EBITDA increased by 9.0% after adding back the increased depreciation, primarily related to the new plants.

Exceptional items for the year were significantly lower in 2017, resulting in an increase of operating profit of £17.6 million.

In 2017, considerable progress was made in improving the covenant net debt to underlying EBITDA ratio, which reduced from 2.7 times at 31 December 2016 to 2.1 times by the end of 2017. The business continues to deliver strong underlying cash generation, supported by increasing underlying EBITDA in 2017. A significant reduction in capital and exceptional item spend also contributed to the reduction in net debt in the year, together with exchange rate movements, partly offset by higher cash tax payments.

With the completion of the capital investment programme in 2016, the business is now focused on bringing the covenant net debt to underlying EBITDA ratio down nearer to historic levels.

Revenue

	2017 £'m	2016 £'m	Change	Change at constant currency
Revenue	**256.9**	241.1	+6.6%	+2.2%

Revenue for the year was ahead of 2016, with increased volumes and the benefits of exchange rate movements, partially offset by price/mix. Year-on-year revenue growth can be analysed as follows:

	2017 vs 2016	2016 vs 2015
Volume	**+6.5%**	-6.6%
Price/mix	**-4.3%**	-0.3%
Foreign exchange	**+4.4%**	+11.6%
Total	**+6.6%**	+4.7%

The increase in sales volumes represents a return to growth in 2017 across almost all sales areas, with particularly strong growth in China, South East Asia and Russia, together with strong growth in Continental Europe in the second half. The growth in China follows the successful start-up of Devro's new plant in Nantong in 2016, with this ramp up in volumes supported by increased sales activity once the capacity became available. The increase in volumes in South East Asia also reflects capacity becoming available for this region together with successfully matching products with customers' requirements. In Russia, the volume grew through a combination of a recovery in market share and an increase in local sausage production following disruptions in recent years related to import restrictions and currency devaluation.

Approximately half of the price/mix impact was due to country mix, primarily related to the increased volumes in China where market prices are lower than the global average. In addition there was some investment in pricing to secure long term relationships with key customers and also some tactical pricing related to specific market opportunities.

Operating profit

Operating profit for the year can be analysed as follows:

	2017 £'m	2016 £'m	Change
Underlying EBITDA	**64.1**	58.8	+9.0%
Underlying depreciation and amortisation	**(26.0)**	(20.7)	-25.6%
Underlying operating profit	**38.1**	38.1	–
Exceptional items	**(5.1)**	(22.7)	
Operating profit	**33.0**	15.4	

Underlying operating profit was in line with 2016, but there were a number of significant moving parts which are summarised below:

	£'m
Underlying operating profit 2016	38.1
Sales volumes	+6.3
Price/mix	-7.8
Recovery of conversion costs	+7.1
Volume	+5.6
Savings from replacement of old US plant & 2016 pre-operating costs of new plants	+1.4
Start-up of new plants in 2016	-14.8
Impact of new plants	-13.4
Devro 100 cost savings	+7.0
Foreign exchange (translation)	+4.2
Other movements	-3.4
Underlying operating profit 2017	**38.1**

The increased sales volumes and adverse impact of price/mix are explained above. The volumes also contributed to the higher recovery of conversion costs due to the related increase in production volumes.

The construction of new plants in the US and China was completed in early 2016, after which a six month start-up period was required for each plant to bring the plants on-line and build up production. Given that capacity from the new plants was only available for a restricted period during the start-up period, and not available prior to the commencement of operations, the related costs were not reflected in underlying operating profit in 2016. The additional costs in 2017 reflect the fact that both plants were fully operational by the end of 2016, and therefore all related costs were included in underlying operating profit in 2017.

The old US plant was closed at the end of H1 2016, with the related savings benefiting H2 2016 and H1 2017.

The Devro 100 programme realised savings of £7.0 million in 2017, which were ahead of plan. The savings related to areas such as sourcing of raw materials, optimising operational structures at the plants and standardising processes through sharing best practice across our global operations.

Devro has operations around the world in multiple currencies. Movements in exchange rates had a favourable impact on underlying operating profit of £4.2 million, reflecting the weakening of sterling against most other key trading currencies of the group towards the end of H1 2016. Whilst sterling was weaker for the year as a whole in 2017, it did strengthen over the course of the year and if exchange rates remain at current levels this will result in a headwind for operating profit in 2018.

Other movements in underlying operating profit compared with 2016 included wage inflation and bonus payments.

Underlying operating profit for 2017 included an increased depreciation charge of £5.3 million, primarily related to the impact of the new plants but also including foreign exchange movements (£1.3 million). So, whilst underlying operating profit for 2017 was in line with 2016, EBITDA increased by 9.0%.

Reported operating profit for the period was £33.0 million, which was significantly higher than 2016 primarily due to lower exceptional items.

Exceptional items

	2017 £'m	2016 £'m
Devro 100 programme	**5.1**	2.0
Capital investment projects	**–**	20.7
Total exceptional items	**5.1**	22.7

During 2017, exceptional costs incurred related to the Devro 100 and restructuring programmes. An analysis of the nature of these costs is set out in Note 4 to the financial statements. In addition, there was £2.3 million of capital expenditure related to Devro 100.

For the Devro 100 programme, as previously guided, total exceptional items are expected of between £10-12 million over 2017 and 2018, plus capital investments of between £7-8 million, with expected benefits of between £13-16 million by 2019. These expectations of total investments and savings remain unchanged but the phasing is now expected to be different given the accelerated delivery of savings in 2017 and lower level of exceptional items and capital investments in 2017 than originally expected.

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Operating margin

	2017	2016
Underlying operating margin	**14.8%**	15.8%

The underlying operating margin for the year declined by 1.0 percentage point, reflecting the full costs of the new plants in China and the US, whilst they operated below full capacity in their first full year of production in 2017.

The reported operating margin increased to 12.8% from 6.4%, supported by significantly lower exceptional items in 2017, compared with 2016.

Capital investment

	2017 £'m	2016 £'m
Capital investment	**10.4**	22.2

With the start-up of the new plants in 2016, capital investment in 2017 was significantly lower than in 2016, and was at the lower end of the range of historical maintenance levels.

Working capital

	2017		2016	
	£'m	Number of days	£'m	Number of days
Inventories*	**32**	**50**	34	60
Trade and other receivables	**35**	**38**	35	39
Trade and other payables	**(35)**	**35**	(38)	40
	32		31	

* Inventories days are calculated by dividing the value of finished goods and goods for resale at the end of the reporting period by the value of cost of goods sold in the period multiplied by the number of days in the period.

Working capital increased by £1 million during the year with the benefits of lower inventories offset by lower payables. The lower payables largely reflect the decrease in capital accruals noted above.

The movements in inventories reflected improved working capital management and, combined with the higher revenues, resulted in a reduced number of inventory days compared with 2016. With unchanged trade and other receivables, combined with increased revenue, receivable days also improved.

Cash flow and net debt

Devro continues to be a highly cash generative business. In order to fund the significant investments made as part of the transformation of the manufacturing footprint, new long-term facilities were put in place in 2014 to supplement the shorter-term bank facilities.

With the start up on the new plants in China and the US completed in 2016, and resultant reduction in capital expenditure and exceptional items, significant progress was made in 2017 in reducing net debt, which ended the year at £134.9 million, compared with £153.6 million at the start of the year. This reduction included the effect of the strengthening of sterling during 2017 (given that a part of the group's debt is denominated in US dollars), which reduced the reported net debt figure at 31 December 2017 by £7.4 million. Including the effect on derivative liabilities, covenant net debt ended the year lower at £135.3 million (2016: £156.2 million).

Key financial measures are as follows:

	2017	2016
Net debt	**£134.9m**	£153.6m
Covenant net debt/underlying EBITDA ratio	**2.1 times**	2.7 times
Underlying operating cash flow	**£66.9m**	£64.4m
Return on capital employed (ROCE)	**11.1%**	11.5%

At 31 December 2017 the covenant net debt to underlying EBITDA ratio was 2.1 times. This represented a further reduction from the 2.4 times reported at 30 June 2017. The underlying EBITDA to net interest payable ratio was 7.7 times at 31 December 2017, meaning that both ratios were within their limits.

With the capital investment projects now complete, cash generated from the business will enable net debt levels to reduce further, which will ultimately result in the covenant net debt to underlying EBITDA ratio returning nearer to historic levels.

The group remained within its funding facilities throughout the year, which include the US$100 million US private placement that took place in the first half of 2014, and the £110 million revolving credit facility which was negotiated in December 2014 and will be in place until December 2019.

Underlying operating cash flow (before pension deficit funding) increased during the year to £66.9 million (2016: £64.4 million), with the improvement in EBITDA being partially offset by lower improvements in working capital.

Cash outflow from exceptional items was £5.7 million (2016: £22.9 million), contributing to improved operating cash flow of £58.2 million (2016: £39.0 million).

The reduction in ROCE reflects the lower average capital employed balance in 2016, related to the build up of investments during 2016 as the new plants in the US and China were completed.

Finance costs

	2017 £'m	2016 £'m
Net finance cost	**8.6**	6.9
Net finance cost on pensions	**2.8**	2.3
Total net finance cost	**11.4**	9.2

The net finance cost for the year was higher than 2016 due to higher rates of interest on borrowings drawn down in Chinese renminbi to support our investment in China, and the ceasing of capitalisation of interest during 2016 following completion of the new plants (2016: £0.5 million interest capitalised).

The increase in net finance cost on pensions over 2016 reflects the higher discount rates assumed at the start of 2017 compared with the year before.

Pension schemes

Devro operates a number of defined benefit schemes around the group, although all of these are now closed to new entrants. The net pension liabilities of these schemes can be analysed as follows:

	2017 £'m	2016 £'m
Fair value of scheme assets	**247.6**	254.8
Present value of scheme liabilities	**(329.6)**	(350.8)
Net pension liabilities	**(82.0)**	(96.0)

The decrease in net pension liabilities during the year largely reflects revised assumptions for the UK scheme, following a review of all components of the pension scheme in conjunction with the pension trustees as part of the triennial valuation. This was partially offset by a decrease in discount rate assumptions across the schemes. Further analysis of the movement in net pension liabilities is set out in Note 26 to the financial statements.

Tax

	2017 £'m	2016 £'m
Tax charge on underlying profit before tax	**5.8**	6.7
Tax charge/(credit) on exceptional items & exceptional tax charge	**0.2**	(2.7)
Tax charge in income statement	**6.0**	4.0

The group operates around the world and earns profits which are subject to tax at differing rates in different tax jurisdictions. Tax reforms were enacted in the US on 22 December 2017, and although effective from 1 January 2018 the reforms did have an impact on the tax charge in 2017 due to the revaluation of deferred tax assets and liabilities to reflect the change in federal tax rate. The impact on 2017 was an additional tax charge of £4.2m which was reported as an exceptional item.

The underlying tax charge includes the effect of additional deferred tax assets on previously unrecognised losses. These additional deferred tax assets have been recognised in the year as a result of an increase in the projected taxable profits in the relevant jurisdictions, reflecting the benefit of a review of internal funding structures. To the extent that the additional deferred tax assets related to losses previously charged to exceptional items, the associated tax credit has also been reported as an exceptional item.

Earnings per share

	2017	2016
Underlying basic earnings per share	**12.5p**	13.3p
Basic earnings per share	**9.3p**	1.3p

We have again presented an adjusted earnings per share (EPS) measure, which excludes exceptional items, to provide a better indication of the underlying performance of the group. Underlying basic EPS reduced by 0.8p with the unchanged underlying operating profit and lower effective tax rate (+0.2p), being more than offset by the effects of increased interest (-1.0p).

The increase in basic EPS reflects lower exceptional costs in 2017, more than offsetting the factors resulting in lower underlying basic EPS.

Dividend

	2017	2016
Interim per share	**2.7p**	2.7p
Final per share	**6.1p**	6.1p
Total	**8.8p**	8.8p

The Board is recommending an unchanged dividend in 2017.

Alternative performance measures

In addition to statutory financial measures, management uses certain alternative performance measures (which are not defined by IFRS) to assess the operating performance and financial position of the group. The alternative performance measures that Devro uses are 'constant exchanges rates', 'underlying', 'earnings before interest, tax, depreciation and amortisation (EBITDA)', 'net debt', 'covenant net debt' and 'return on capital employed (ROCE)'.

Constant exchange rates

The group has operations across the world in multiple currencies, and is exposed to translation risk on fluctuations in foreign exchange rates. As a result the group's reported revenue will be impacted by movements in actual exchange rates. The group presents revenue growth on a constant currency basis in order to eliminate the translation effect of foreign exchange rate movements, enabling investors to better understand the operational performance of the group.

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Revenue growth at constant currency is calculated by translating both the current and prior year local currency amounts using the prior period average exchange rates.

Underlying

Underlying figures are stated before exceptional items. Devro is undergoing a major transformation including the construction and start-up of two new plants in China and the US which completed in 2016, a restructuring of operations in Scotland and Australia initiated in 2014 and the Devro 100 programme with full benefits expected by 2019. The incremental costs associated with this transformation are significant, and as a result have been classified as exceptional items.

A reconciliation from the underlying figures to the equivalent reported figures is presented below:

	2017			2016		
	Underlying	**Exceptional items**	**Reported**	Underlying	Exceptional items	Reported
Operating profit (£'m)	**38.1**	**(5.1)**	**33.0**	38.1	(22.7)	15.4
Operating margin	**14.8%**	**(2.0%)**	**12.8%**	15.8%	(9.4%)	6.4%
Profit before tax (£'m)	**26.7**	**(5.1)**	**21.6**	28.9	(22.7)	6.2
Basic earnings per share	**12.5p**	**(3.2p)**	**9.3p**	13.3p	(12.0p)	1.3p

Earnings before interest, tax, depreciation and amortisation (EBITDA)

EBITDA is defined as operating profit excluding depreciation and amortisation. This measure is used by management to assess operational efficiency and, given that it excludes non-cash depreciation and amortisation, it is a useful approximation for cash generation from operations. This measure is in common use elsewhere and a reconciliation from reported figures is shown below:

	2017			2016		
	Underlying	**Exceptional items**	**Reported**	Underlying	Exceptional items	Reported
Operating profit (£'m)	**38.1**	**(5.1)**	**33.0**	38.1	(22.7)	15.1
Depreciation and amortisation (£'m)	**26.0**	**–**	**26.0**	20.7	2.3	23.0
EBITDA (£'m)	**64.1**	**(5.1)**	**59.0**	58.8	(20.4)	38.4
EBITDA margin	**25.0%**		**23.0%**	24.4%		15.9%

Net debt

Net debt is defined as the excess of total borrowings over cash and cash equivalents. It is a measure that provides additional information on the group's financial position and is a measure in common use elsewhere. A reconciliation from reported figures is presented below:

	2017 £'m	2016 £'m
Current borrowings	**(1.5)**	(1.9)
Non-current borrowings	**(144.2)**	(161.6)
Total borrowings	**(145.7)**	(163.5)
Cash and cash equivalents	**10.8**	9.9
Net debt	**(134.9)**	(153.6)

Furthermore, the definition of net debt used to calculate one of the group's banking covenant ratios also includes derivative financial liabilities, as shown below:

	2017 £'m	2016 £'m
Net debt	**(134.9)**	(153.6)
Derivative financial liabilities	**(0.4)**	(2.6)
Covenant net debt	**(135.3)**	(156.2)

Return on capital employed

Return on capital employed (ROCE) is used as a measure of how well the group is utilising its available capital, and is a measure in common use elsewhere. ROCE is calculated by presenting underlying operating profit as a proportion of average capital employed.

Capital employed for this purpose is defined as net assets excluding interest-bearing assets and liabilities, derivative financial instruments, current and deferred tax balances, pension obligations and provisions for liabilities and other charges.

A reconciliation from reported figures is presented below:

	2017 £'m	2016 £'m	2015 £'m
Intangible assets	**10.4**	10.4	9.2
Property, plant and equipment	**291.1**	308.6	270.1
Inventories	**32.3**	33.8	28.5
Trade and other receivables	**35.1**	35.2	38.4
Trade and other payables	**(34.5)**	(37.8)	(33.7)
Total capital employed	**334.4**	350.2	312.5
Average capital employed*	**342.3**	331.4	
Underlying operating profit	**38.1**	38.1	
Return on capital employed	**11.1%**	11.5%	

* Average capital employed is calculated as the average between the balances as at the start of the year and as at the end of the year.

Going concern

At 31 December 2017 the group was operating within the banking covenants related to its revolving credit facility and US private placement facilities. The group's detailed financial forecasts indicate that there is sufficient headroom in the facilities for the 12 months from the date of approval of this statement and that they can be repaid in line with the expected terms.

After making enquiries, the directors have a reasonable expectation that the group has adequate resources to continue in operation for the 12 months from the date of approval of this statement. For this reason, they continue to adopt the going concern basis in preparing the financial statements.

Rutger Helbing
Chief Executive