

Chief Executive's statement

Sales

£3,523m

Headline pre-tax profit

+22%

£492m

Statutory pre-tax profit

£132m



Keith Butler-Wheelhouse
Chief Executive

For the second year running, Smiths has achieved double digit growth rates, with sales increasing 17% and headline operating profit up 25%. In each of the last two years operating profit rose faster than sales. The headline operating margin on sales improved by a full percentage point to 14.8%.

It is important that this growth was achieved right across Smiths. In 2006 each division grew sales by 10% or more, and taking the last two years together, each grew sales by 20% or more. Our growth is equally divided between acquisitive and organic growth, and it is gratifying that organic growth is accelerating from 8% in 2005 to 9% in 2006.

Recognising continued deterioration in the automotive component market, particularly in the US, an impairment review of the preference share investment in TI Automotive has been undertaken. As a result, Smiths has decided to write down the carrying value of the investment in the TI Automotive preference shares from £325m to nil value in the accounts. There is no cash impact from this decision.

I am pleased that this year we have converted some 81% of headline operating profit into cash despite making significant investment in the business.

One vital aspect of my job is visiting Smiths facilities around the world. What unifies all our 250 plus locations, whether new or long established, is the quality of the people who work there. I would like to thank each and every Smiths person for their dedication and achievements over the past year.

Driving for Full Potential

Last year I outlined Smiths six fundamental strengths. Our strengths help us shape the Company, defining our markets, creating opportunities and growing from our core businesses. They are the basis of our 'Full Potential' programme, introduced three years ago to grow sales and enhance profitability.

'Full Potential' is not an abstract concept at Smiths. People in every part of our business are taking action to achieve the best possible long-term performance for shareholders, with targets based on first-class execution of our plans against realistic expectations for their markets. Here, in the context of our six strengths, I will provide a snapshot of some past and present examples of actions we have taken to deliver continuing high levels of growth.

1. Operating in sectors of high growth: Smiths applies technology in the key growth markets in which we compete. Our investment in creating a ports and borders business for

<p>Smiths Full Potential programme</p> <p>A set of actions undertaken by Smiths people to achieve the best possible long-term performance.</p> <p>Targets based on a realistic expectation of market performance and first class execution.</p>	<p>Actions based on Smiths six strengths</p> <p>The actions necessary to develop the business towards its Full Potential are planned, and our people then vigorously pursue those actions.</p> <p>1. Operate in sectors of high growth Creating positions in sectors with above average long-term growth; Seeking faster growth than the overall markets in which we compete.</p> <p>2. Reach deep into global markets Scale and infrastructure to operate globally; manufacturing, customer support, sales and technology development increasingly located to achieve growth objectives.</p> <p>3. Develop technology to help customers succeed Investing in R&D to access the technologies needed to secure greater market shares.</p> <p>4. Deliver constant improvement Continuous productivity improvement sustains our competitive positions.</p> <p>5. Improve the business mix Evaluate what a business is worth to Smiths – essentially the value of the future profit and consequent cash-flows expected from successful Full Potential actions – and seek to sell businesses where others can create more future value than Smiths. Acquire businesses that are worth more under Smiths ownership. Concentrating investment in product areas and markets expected to generate superior returns also improves business mix.</p> <p>6. Do business the right way The 'Smiths Code of Corporate Responsibility and Business Ethics' sets out a clear framework for all employees.</p>	<p>Metrics</p> <p>1. Top and bottom-line growth</p> <p>2. Cash generation Generation of above average free-cash-flow contributes to additional growth by enhancing reinvestment opportunities. Aim to generate at least 75% of profit in cash.</p> <p>3. Return on capital Pursue investment opportunities to generate after-tax returns of at least 12%. Exact threshold depends on degree of risk in the project. Aim to generate risk-adjusted returns comfortably exceeding cost of capital. Acquisitions should generate after-tax returns of 12% by the 3rd full year of ownership.</p> <p>4. Shareholder value A combination of above-average free cash-flow plus business growth enables double-digit total shareholder returns to be targeted.</p>
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Smiths Detection is already fuelling growth, as is our drive to expand our position as a Tier 1 supplier in aerospace, particularly in the civil market. Looking forward, we are seeking to broaden our product offering in other high-growth markets such as petrochemicals and telecommunications.

2. Reaching deep into global markets: As global leaders we apply technology across the world to serve our customers better and to build brand loyalty. The success of many of our businesses is rooted in their matching the geographic footprint of their customers. Smiths Medical continues to develop its global distribution network, both by acquiring distributors and

by establishing new offices to develop the relationships we need around the world. Looking forward, new global infrastructure creates new opportunities to build profitable positions in high-growth sectors worldwide. In Bangalore, India, a new centre of excellence opened by John Crane offers better access and support for the significant Indian and Asian markets. Similarly, our new Smiths Detection facility in St Petersburg, Russia will serve the fast-growing Russian security market. And to co-ordinate and support our increasing China activities, we have opened a corporate office in Shanghai.

3. Developing technology to help our customers succeed:

Our customers are continually seeking competitive advantage. All our divisions have a long tradition of using technical leadership to develop and apply the products and services that our customers need to achieve this. Smiths Medical has helped customers meet increasing safety requirements; Smiths Aerospace is developing a core computing system to improve aircraft efficiency and flexibility; and Smiths Detection applies increasing levels of sophistication to help counter threats to security. R&D is often an important measure of how successful we have been in winning contracts, giving us an opportunity to improve long-term market share and returns.

4. Delivering constant improvement: World-class performance requires constant improvement. A good example is our relentless drive to improve manufacturing efficiency, which requires constant attention to detail. We have changed the scale and location of manufacturing to deliver the best value while maintaining or enhancing quality. Over the last year with sales growing by 17% and headcount increasing by only 4%, productivity improved sharply – sales per employee increasing by 6%. Expansion of existing manufacturing capacity in both China and Mexico is evidence of a continuing programme to locate our manufacturing where we can deliver the best possible quality and economics.

5. Improving our business mix: We routinely look at our business mix to ensure we build and maintain definitive positions in high-growth sectors worldwide. We do this through acquisitions and organic growth, and also the disposal of businesses no longer appropriate for Smiths ownership. Over the past five years we have acquired businesses valued at £1,157m and disposed of businesses valued at £935m.

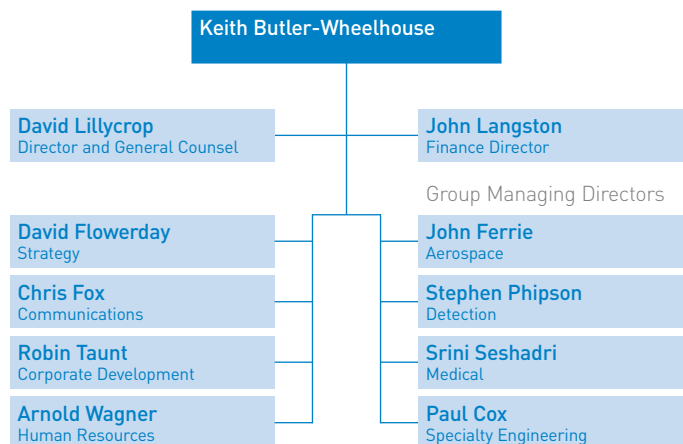
Smiths Medical is now 50% bigger than in 2004, with much of this growth coming from the Medex acquisition. The past year has seen a number of relatively small but important bolt-on acquisitions. Additionally, we are investing internally to develop existing capability in growth markets, for example in the Smiths Aerospace components business. With production capacity in both China and Poland growing substantially, we also invested US\$44m in a new turbine engine components facility in North Carolina, US, to create further opportunities for this fast-growing business.

6. Doing business the right way: Our customers rely on Smiths people to be rigorous and ethical in everything we do. Our 'Code of Corporate Responsibility and Business Ethics' sets out a clear framework to help our people make the right decisions whatever the circumstances. To explain more clearly what this means, this year, for the first time, we are producing a Corporate responsibility report, available on our website, www.smiths.com. Environment, health and safety performance is included in this report. After a year of very significant progress in 2005, EHS has advanced more modestly this year. Going forward, we are re-energising our efforts to ensure continuous improvement across the board.

2006: a year of growth and transition

Applying the six elements of the Smiths Full Potential programme helped ensure 2006 was a year of growth. There have also been some important transitions: we have made changes to the executive team and are seeing a revolution in Smiths Medical.

The diagram (below) shows important changes to the key management of Smiths. Alan Thomson retired as Group Finance Director in September, and I would like to thank

Smiths executive committee

him for the enjoyable, as well as enduring, partnership we had over the past ten years. Alan has agreed to continue to assist Smiths on special projects.

John Langston took over from Alan as Group Finance Director, while Paul Cox succeeded John as Group Managing Director, Smiths Specialty Engineering. John's operational knowledge (he also previously ran Smiths Detection) and financial acumen will be very beneficial to the team. Paul joined Smiths in January 2005 as President, Smiths Interconnect from Andrew Corporation in Chicago, Illinois, where he had led both its Satellite Communications and Antenna Products divisions.

On 1 March 2006 we welcomed Srini Seshadri as Group Managing Director of Smiths Medical. Srini joined us from GE Healthcare Technologies where he was Chief Marketing Officer. Smiths Medical has undergone a major change in scale over the past two years. This, together with the change in leadership, is catalysing a transformation within this business in three ways: bringing together manufacturing; simplifying business processes; and focusing our product brands.

Moving manufacturing to fewer, larger units has been under way for some time, but the pace of change has picked up in the past year. This has led to some hard decisions, including ceasing manufacturing at some major locations. Such decisions are never easy, but I know that these are very necessary for the future prospects of the business.

Across the business we are bringing together our internal processes, simplifying and standardising how we do things. We are already seeing benefits from this and expect to see more in the next financial year.

Smiths Medical has created a small family of strong product brands that command excellent customer recognition and loyalty. In sum we have created a business that leverages the benefits of being Smiths Medical while maintaining the trusted relationships that our customers have with our product brands.

The Smiths Story

Smiths is a world leader in the practical application of advanced technologies. Throughout Smiths, we deliver products and services that make the world safer, healthier and more productive. This is obvious when considering

Smiths Detection's equipment that delivers increased security in a variety of arenas; Smiths Aerospace's strong record in helping advance aviation safety; and Smiths Medical's specialist devices which help medical practitioners make people healthier and save lives. Smiths also makes a contribution in improving productivity, not least in delivering energy efficiently, thanks to John Crane, or providing reliable telecommunications, through Smiths Interconnect. Our products are integral to the productivity of many aspects of everyday life.

Our future growth is underpinned by a number of key factors. Smiths Aerospace is moving from a period of high investment to one where the rewards of that investment will be reaped. Smiths Detection offers a portfolio of technologies that address a world of increasing insecurity. In Smiths Medical, as I have discussed above, we have a business that is in shape to benefit from the relentless rise in global healthcare spend. And in Smiths Specialty Engineering we are well positioned to exploit strong markets.

Thanks to our people, our technology and our access to customers in some of the most exciting markets, Smiths brings technology to life. We are already working hard to communicate this positive message, and that effort is being redoubled through a new focus on our branding, which will flow through all our communications channels. Smiths has a great story and we are determined to ensure people hear about us.



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