CHAIRMAN'S STATEMENT

SIR GEORGE W. BUCKLEY
Chairman

Dear shareholders,

This is the final Chairman's shareholder letter I'll write to you since I retire at the upcoming shareholders' meeting. You'll have a new Chair, Steve Williams, at the close of voting.

You will likely know I write these letters myself, not our corporate staff. I've always thought a personal letter from the Chairman is important, and I generally use these letters as teaching pieces. This letter will reflect on past achievements and postulate a few things for the future.

Over the last 20 years, Smiths Group plc experienced only very moderate organic growth. My mission as Board leader was to try to change that pattern. But, as the Chairman, you are constrained by good governance because directors are generally required to be 'nose in, finger out'. While the Board constantly monitors performance, intervention only comes when the Board senses a significant deviation from performance and investor expectations. Until then, we are mostly advisers, guides, and inspirers, but sometimes cajolers and even pleaders. I've seen the Chair as a position where we can help develop the senior management team to learn new skills and approaches to persistent historical problems. All great leaders are great teachers.

During my tenure with Smiths, we have seen the disposal of the medical business, the COVID-19 pandemic, tremendous supply chain shortages, rampant inflation, the Russia-Ukraine war, tensions in both the Middle and Far East, and a growing trade war between the United States and China.

There are always challenges and worries in any period of history, but this one has had several spectacular problems. We haven't seen a global pandemic since the so-called 'Spanish flu' (Influenza type A, subtype H1N1) between 1918 and 1919. But we got one in COVID-19. I have written much previous commentary on supply chain dynamics, forecasting the end of COVID-19 and anticipating President Xi's change of heart regarding COVID-19. I recently spoke to the UK Parliament about rebuilding Britain's manufacturing and technological capabilities. We cannot solve poverty and social deprivation in Middlesbrough or South Wales simply by having more bankers in London.

Two primary causative agents were at work in producing this larger set of challenges. During the pandemic, it created temporary peaks in demand for certain types of services, local logistics and delivery services, plus huge demand for electronics and things related to safe environments where, except for factory workers, we all largely worked from home. Other things suffered: airline travel, transportation, restaurants and conventional retail shopping.

After the end of the pandemic, supply chain shortages were generated by a simultaneous start-up of all the world's economies. The illusory overshoot in companies' sales demand curves also led to panic buying, component shortages and huge price inflation. The outcome of panic buying was excess and sometimes high-priced inventory, high-priced shipping containers, and energy and food shortages because of the Russia-Ukraine war. The illusory overshoot in demand was the thing that could've been avoided most easily, including its contribution to inflation.

Regarding inflation, I have often used the phrase that the solution to high prices is high prices. Manufacturers re-engineer their products, substitute new materials, find ways to reduce waste, and find new suppliers. A significant piece of the inflation in the UK was due to energy. To illustrate this point, I pay nine cents per kilowatt hour in my home in Florida for my electrical energy. I pay 59 pence per kilowatt hour of energy in the UK, about eight times as much as in the United States. Therefore, any energy-intensive process manufacturing was crushed and cannot compete long term in the UK. We understand the obvious smelting and steelmaking processes, but a surprising component of this problem is manufacturing cars, where the paint process is hugely energy intensive. One way around this might be using body films instead of paint.

"

Adaptability and proactive measures the Company took ensured minimal disruptions to our global operations during COVID-19. Over the last two years, the Company has also returned to encouraging levels of organic growth.

PERFORMANCE HIGHLIGHTS

Adaptability and proactive measures the Company took ensured minimal disruptions to our global operations during COVID-19. Over the last two years, the Company has also returned to encouraging levels of organic growth. Some comparisons benefit from easier year-over-year comparisons, but the results reported in the last two years still significantly bettered expectations.

Smiths businesses cover many industries, but among the largest are energy, construction and transportation – primarily aviation and airport-related businesses. But we also have a business in defence and vast opportunities to move into other areas of urban safety and food safety, for example. We have technologies currently applied to detecting military chemical warfare contaminants that can be applied in commercial property applications and the home. And sealing technologies developed by John Crane will have a significant role to play in the decarbonisation of existing industries, including oil & gas, and the growth of new low- and zero-carbon energy infrastructure like hydrogen, supported by carbon capture.

One of the most exciting developments is in Smiths Detection, where X-ray diffraction can help identify specific materials based on their molecular spacing, not just material density, which is what traditional X-ray methods use. This will make Smiths the world's most advanced hold baggage and carry-on baggage screening company.

Investors naturally worry about our end markets under pressure. Two of our end markets experienced significant contractions during the year. The first is electronics, particularly those related to semiconductor testing. The second is construction.

Contraction in our Smiths Interconnect business partially relates to silicon wafer volume and certain types of chipsets passing through semiconductor manufacturing. During the pandemic, those industries saw huge increases in demand for electronic products. Those electronic end markets contracted a few percentage points as the pandemic eased. However, demand in the upstream supply chain saw temporary contractions year-over-year of around 40% in many cases. That, in turn, reflects in the demand seen by businesses like Smiths Interconnect. These contractions are perfectly normal in electronics and tend to be relatively short-lived.

In any environment experiencing demand contraction, management has two primary responsibilities. The first estimates how deep the contraction will go, and the second is to estimate how long it will last. In any make-to-stock business, demand in the channel, both in expansion and contraction, is always many multiples of what happens in the end market. Typically, the higher the demand overshoot/undershoot, the shorter it lasts, as companies in the supply chain work to clear the excess inventory quickly. Regular readers will remember my forecasts of high energy costs and the consequence of panic buying during the illusory demand increase as the global economy restarted post-COVID-19. This is exactly what we're seeing.

Part of our Flex-Tek business participates in the important US construction industry. It's a make-to-stock business and supplies products through large retailers and distributors in the United States. A similar phenomenon of channel demand contractions to those in the electronics industry happens in construction. End market conditions change, and the channel adjusts quickly to new circumstances. It does this in both directions: increasing or decreasing demand. So, there's reason to expect that, as the calendar year 2024 unfolds, we will see improving demand conditions in the construction segment of Flex-Tek. The aviation segment of Flex-Tek remains robust as the demand for new airplanes increases rapidly.

At the end of the Smiths financial year, the US inflation rate was 3.2% compared to 6.8% in the UK. July's inflation rate was down to 0.2%, so it is clearly headed in the right direction. The demand for goods and services is up 0.3% and 0.5%, respectively. This data can all be found at www.bls.gov. The US Federal Reserve Bank has an inflation target of 2% and is still cautious, but perhaps unnecessarily. US housing starts have begun to increase again. It's reasonable to expect that the upward trend in housing starts will continue and will accelerate once the Federal Reserve either pauses or ultimately reduces interest rates. In conclusion, the pressure on our construction-oriented business will ease.

One of the most important data sets investors can examine is the US Bureau of Economic Analysis on its site, www.bea.gov. The Bureau publishes overall GDP numbers in a sequence of three estimates, but one of the most important Table 2 entries is the heading "Change in private inventories". In the first quarter of calendar year 2023, the change in private inventories was a full negative 214 basis points of GDP, indicating that the economy was, as expected, reducing inventories on a large-scale basis. The contribution to US GDP of change in private inventories in the second quarter is a positive 14 basis points, suggesting an easing in the inventory bleed-off. The US economy overall is running a little over 2% growth. While that may not be spectacular, it's stable in the economic context we find ourselves in.

The only real negative I see is that, in my view, the Federal Funds Rate is still too high and likely to produce an overshoot in cooling demand unless the Federal Reserve Bank eases monetary policy soon.

INNOVATION AND R&D

We remain committed to the belief that the best tool for new value creation is higher than market organic growth. The best unlock code to achieve this objective is innovation. As I have said in previous letters, the core of every company is dying, so the contribution to growth for innovation has to exceed the core attrition rate caused by cannibalisation, end-of-life technology, competitive attack, and changing customer preferences.

As we embark on a new year, we focus on innovation, growth, and increasing value to our shareholders. We identified key strategic priorities guiding our efforts in 2022 and beyond. We will continue to invest in research and development, driving innovation across our product lines and positioning Smiths as a leader in cutting-edge technologies.

In an early Chairman's letter, I said I believed the great crystal ball of the future for engineering companies is mathematics, electronics and materials science. The mathematics here covers every piece of engineering calculation and forecasting, including artificial intelligence, deep cognitive learning, and mathematical taxonomy. Electronics here include sensors, controllers, software, and the like. Materials science includes aspects of physics and chemistry, including X-ray diffraction, special surface coatings, nanomaterials, 3D printing, and graphene.

CONCLUSION

I sincerely thank our dedicated employees, esteemed shareholders, and valued customers. Smiths journey has been marked by resilience, innovation and a shared vision of a better future. As we navigate the path ahead, I am confident that our collective efforts will continue to drive success and create lasting value.

It has been both an honour and a privilege to serve as Chairman of this great business and, on behalf of the Board, I would like to thank you for your continued trust and partnership.

Sincerely,

SIR GEORGE W. BUCKLEY
Chairman of the Board, Smiths Group plc

> **We remain committed to the belief that the best tool for new value creation is higher than market organic growth. The best unlock code to achieve this objective is innovation.**

REVIEW OF THE YEAR
Read more about our performance.

→ PG 18