Q&A with Richard Cotton

Richard Cotton Chief Financial Officer

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> Chief Financial Officer

Q What were the key drivers behind the EBIT margin percentage improvement?

A Gross margin at 54.5% was slightly lower than prior year (2016: 55.9%). The dilution in Group gross margin came as expected from the acquisitions, in particular from Putney, where margins are lower due to long term contract manufacturing partnerships.

Sales, General and Administrative costs (SG&A) were greater than in 2016, though lower as a percentage of sales at 27.7% (2016: 30.4%), as additional volume leveraged the cost base.

Underlying EBIT margin increased by 140bps to 22.6%, as revenue growth generated operating leverage across the Group as a whole, outweighing the margin dilution from the acquired products.

Q How did the Board decide on the level of dividend, and what is it likely to do in the future?

A The Board reviews the dividend twice a year, and in particular considers EPS growth, dividend cover, and the Group's balance sheet and cash flow forecasts in setting the dividend.

Underlying diluted EPS, including acquisitions, has grown strongly by 35.1% in the year, and during the year the Group has generated significant cash flow, reducing the leverage of the Group to 1.4 times EBITDA.

Reflecting the strong performance of both the existing and acquisition businesses and the improved net debt leverage, the Board has proposed an increase to the final dividend of 18.7%, which when added to the interim dividend of 6.11p, gives a total dividend for the year of 21.44p, a 16.11% increase on the prior year (2016: 18.46p). Dividend cover based on underlying diluted EPS is 3 times (2016: 2.3 times). The Board continues to operate a progressive dividend policy recognising investment opportunities as they arise.

Q Net debt now represents only 1.4 times underlying EBITDA compared to 2.0 times a year ago. What has caused this improvement and does the Board have a target?

A Cash conversion, measured as net cash generated from operations after non-underlying items as a percentage of underlying operating profit is an important KPI and core discipline for the Group. In 2017 it was 115.9% consistent with the prior year (2016: 106.8%).

The strength of the cash conversion is behind the strength of the Statement of Financial Position. In a year of increased capital expenditure, the acquisition of Apex, the investment in Medical Ethics, and adverse foreign exchange effects, Dechra's net debt grew by only £3.4 million to £120.0 million. With the benefit of the greater underlying EBITDA from both the existing and acquisition businesses of £88.2 million (2016: £58.0 million), the net debt leverage of the Group has reduced to 1.4 times the enlarged underlying EBITDA (2016: 2.0 times).

Since the end of the financial year the Group has refinanced its Revolving Credit Facility to provide longer dated, larger and more flexible borrowing facilities to finance its working capital, investment and future acquisition needs.

The Board takes a prudent view of balance sheet leverage. It would typically target maximum Net Debt: underlying EBITDA of 2.0 times, though in the right circumstances may go to a level above this.

Q Third party contract manufacturing sales have declined again, and you link this to your manufacturing strategy. Can you describe your manufacturing strategy?

A As Dechra has grown organically and through acquisition, the number of manufacturing sites and complexity of its contract manufacturing network has grown significantly. During the year the Group has evaluated this in detail, considering its current and future needs, and has developed a Manufacturing remodelling strategy.

- The strategy anticipates the remodelling of certain parts of the network to focus on the manufacture of specific dosage forms, and matching our product margins in line with our input cost base.
- As a result of this, we will transfer some products around the Dechra network over the next five years, at the end of which period we expect to have terminated most third party contract manufacturing sales.
- Over the five years we expect to invest an additional c.£18.0 million between capex and non-underlying costs which will pay back in two to three years in manufacturing cost efficiencies.

Watch the full interview with Richard Cotton at **dechra.annualreport2017.com**