STRATEGIC REVIEW

"Halma has made good progress this year, continuing to create value for shareholders through organic growth, successful acquisitions and increasing dividends."

Andrew Williams
Chief Executive

Growth in all three sectors and all major regions

Revenue growth was achieved in all three sectors and in all major geographic regions and increased by 12% to £580m (2011: £518m). Adjusted[1] profit grew to £120.5m, an increase of 15% (2011: £104.6m). Organic revenue growth and organic profit growth were both 5%, increasing to 6% for continuing operations excluding the figures for Volumatic which we sold just before the year end.

Revenue grew in both developed and developing regions, demonstrating the resilience of the underlying growth drivers in our chosen markets of safety, health and environmental technology. UK was up by 18% to £126m (2011: £106m), whilst US increased 8% to £162m (2011: £150m). Revenue from Mainland Europe contributed £154m (2011: £138m), an increase of 12%. Revenue from outside these territories was up by 11%, representing 24% of the Group total (2011: 24%). This included 15% growth from Far East and Australasia. China revenue improved by 25% and represents slightly over 5% of Group revenue.

Health and Analysis performed well, increasing revenue by 16% to £254m (2011: £218m), contributing 44% of the Group (2011: 42%). Profit[2] grew substantially by 25% to £57.8m (2011: £46.1m), 46% of Group operating profit[2] (2011: 42%). Return on Sales grew strongly to 22.8% (2011: 21.1%). All four sub-sectors, Water, Photonics, Health Optics and Fluid Technology increased revenue with organic growth boosted significantly by acquisitions made in 2010/11. Following a tough first half year, Fluid Technology had a much steadier performance in the second half with revenue slightly ahead of the first six months. Water had a very good year gaining significant market share for water network monitoring instruments in the UK.

Infrastructure Sensors had a solid year increasing revenue by 4% to £204m (2011: £197m), 35% of the total (2011: 38%). Profit[2] was marginally ahead of last year at £39.1m (2011: £39.0m), which is 31% of Group operating profit[2] (2011: 36%). Return on Sales was 19.1% (2011: 19.8%). Fire Detection, Automatic Door Sensors and Security Sensors all increased revenue whilst Elevator Safety revenue was flat. A significant management reorganisation within Elevator Safety started in November 2011 and will be complete by mid-2012. This will reduce profitability in Elevator Safety by around £1m during the first half of 2012/13 but is expected to have delivered significant benefits to more than cover this charge by the end of the full year.

Industrial Safety performed strongly with revenue increasing by 19% to £122m (2011: £103m), which is 21% of the Group (2011: 20%). Profit[2] increased by 20% to £29.2m (2011: £24.4m), which is 23% of Group operating profit[2] (2011: 22%). The four sub-sectors of Gas Detection, Safety Interlocks, Bursting Disks and Asset Monitoring all increased revenue with demand underpinned by Health and Safety regulations and positive end-markets including Oil and Gas. Return on Sales in Industrial Safety remained the highest in the Group at 23.9% (2011: 23.7%).

Our three major measures of returns improved

Return on Sales improved to a new record of 20.8% (2011: 20.2%) with acquisitions improving margins in Health and Analysis and organic growth edging up Industrial Safety's performance. Infrastructure Sensors was a little lower than the prior year, albeit well within our 18% to 22% target range.

A high Return on Capital Employed is a key metric for Halma companies and is a characteristic we look for when considering acquisition prospects. This year it improved to 74.7% from an already very high level of 71.9% last year.

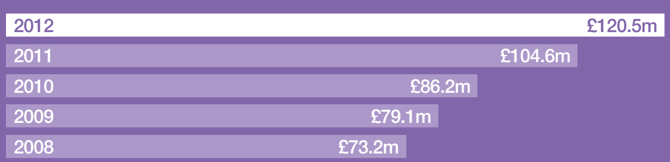
Return on Total Invested Capital is the post-tax return Halma has generated on all our assets including all historical goodwill. It is, therefore, an important long-term measure of how efficiently we deploy capital to grow our business both organically and through acquisition thereby creating value for shareholders. This year it increased to 16.8% (2011: 15.5%), well above our weighted average cost of capital, estimated to be around 8%.

Profit

£120.5m

Profit growth

+15%



Good cash generation and a strong balance sheet

Clearly, high returns are an indicator of a business' ability to generate cash. We aim to grow organically and through acquisition without becoming a highly geared business. This year cash generated was 104% of adjusted[1] profit (2011: 108%) and we ended the year in a strong position with net debt of £19m (2011: £37m).

In October 2011, we decided to renew and increase our bank credit facilities which were due to terminate in February 2013. We have put in place a £260m five-year revolving credit facility which gives us greater certainty over our medium-term funding and a greater freedom to complete acquisitions when suitable opportunities arise.

Strategic growth priorities

We have a clear strategy to generate sustained organic growth, actively manage our portfolio and deliver growing dividends. The medium-term rate of organic growth determines the rate at which we can acquire businesses and increase dividends. Our management reward structures are clearly aligned with our objectives of delivering sustained growth and high returns. We actively manage our business portfolio through acquiring in (or adjacent to) our existing markets, merging as market needs change and selling businesses where we do not see the medium-term prospects for sustaining high returns or growth.

We drive organic growth through a focus on investing in the three areas of: Innovation, People Development and International Expansion.

Innovation

Our businesses build market leadership, gain market share or create new market opportunities through innovation in products and processes. Within Halma, companies have great opportunities to collaborate and share know-how with their sister companies. We are creating a culture and environment to encourage this behaviour in a variety of ways including ensuring a diverse mix of representation at Halma training programmes and holding a biennial Halma Innovation and Technology Exposition. Network groups and forums focused on specific functional areas such as manufacturing and IT have also been established to foster regular benchmarking and continuous improvement.

Innovation by individual employees is formally recognised in Halma through a monthly Eureka award (top prize £1,000) and the Halma Annual Innovation Awards (top prize £20,000).

In 2012, the Halma Innovation Award was won by a team from Oseco in Oklahoma, USA, who designed a new Bursting Disk product which improves safety in Oil and Gas exploration. The runners-up were a team from HWM-Water in Cwmbran, UK, who developed a software platform which gives customers a 'data-gateway' to easily integrate their control systems with HWM's water monitoring technology. In third place was a team from Ocean Thin Films in Colorado, USA, who created a spectral imaging camera which enables scientists to analyse target objects in real-time video through a range of discrete specialist optical filters simultaneously (see page 28).

R&D expenditure increased by 7% to £27.4m (2011: £25.7m) representing 4.7% of Group revenue (2011: 5.0%), well above our 4% KPI target. Underlying growth in R&D spend was in line with revenue growth so the slight decline in spend as a percentage of revenue was due to the lower rate of R&D investment of companies recently acquired. One of the ways we aim to add value to newly acquired businesses is by increasing their rate of innovation through investment in new products.

People development

Halma's decentralised operating structure relies upon having capable local managers empowered to make timely decisions in the best interests of their business. R&D, manufacturing, sales and administrative resources are controlled by local subsidiary boards who have an intimate knowledge of market dynamics and customer needs. Strategic objectives, annual performance goals and management incentives are aligned with a strong commitment to attract and develop high quality talent at all levels.

Halma offers a range of training programmes for employees including the Halma Executive Development Programmes (HEDP and HEDP+), Halma Management Development Programmes (HMDP and HMDP+) and Halma Certificate in Applied Technology (HCAT) programmes. During 2011/12, 166 employees attended these Halma-run programmes and many more benefited from training provided by their subsidiary company. The value of this investment is shown both in our excellent financial performance and succession planning. In April 2012, Philippe Felten the CEO of BEA, our Automatic Door Safety business, was promoted to the Halma Executive Board and took on the additional responsibility of our Security Sensors sub-sector.

In 2012, we launched the Halma Graduate Development Programme (HGDP) with the first group of UK and US graduates due to start in early Autumn 2012. Through HGDP, we aim to increase the depth of talent coming through our management ranks and also expect it to increase management diversity in the longer term. Graduates will work at Group companies in different global regions and attend residential training modules. Halma is an attractive employer for new graduates offering the chance to work in diverse markets, gaining international experience and providing a genuine opportunity for significant early career progression.

International expansion

We have made great strides in recent years growing our business in developing markets. In the process, we have learned a lot about these markets and have improved our understanding of the growth opportunities, both organic and through acquisitions. In the future, we expect to find a greater number of acquisition opportunities in developing markets and we are building the resources to support this objective.

Our strategic objective is for at least 30% of revenue to come from outside the UK, USA and Mainland Europe by 2015 and we maintained that metric at 24% this year even with the acquisition of two US-focused businesses in the year (2011: 24%). By 2015 China is targeted to be 10% of the Group total.

This year, good momentum was maintained in China with revenue increasing by 25% to £29.5m (2011: £23.6m) which is slightly over 5% of total revenue. This compares with £6.6m in 2006 when we set up our first hubs in Shanghai and Beijing. In 2012, the number of employees based in China represents 10% of the total Halma workforce.

A number of Halma businesses are investing in building stronger channels to market in South America either directly or by developing trading relationships with local businesses. Revenue from South America increased by 23% to £11.2m (2011: £9.1m).

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In India, there was slower progress, with revenue increasing by 8% to £7.0m (2011: £6.4m). We are adding both sales and technical resource in Mumbai and during the year moved to larger premises. However, it is clear that India is not currently offering us the same rate of revenue growth as China, South-East Asia and South America.

Acquisitions and disposals

During the year, we completed two acquisitions and one disposal. Following the year end, we acquired a further three businesses. For these five acquisitions we paid £80m, including £3m of debt acquired, (plus potential for £14m of earn-outs) and received an initial payment of £4.4m for the disposal. All transactions, except the Kirk Key acquisition, were within our Health and Analysis sector.

In May 2011, we acquired Kirk Key Interlocks, based in Ohio, USA for US$14.5m (£8.8m), including US$1.9m of debt. Kirk Key was our most significant competitor for Safety Interlocks in the US market and is a strong addition to our group of market leading interlock businesses within the Industrial Safety sector.

In July 2011, we bought Avo Photonics, based in Pennsylvania, USA for US$9.1m (£5.7m) plus a one-year earn-out of up to US$11.0m dependent on profit growth. Avo adds significant new technology and manufacturing know-how to our Photonics businesses. Their expertise in miniature electro-optic design and manufacturing has potential applications across many other Halma sub-sectors.

In March 2012, we sold Volumatic, based in Coventry, UK to a private equity fund, for £4.4m plus performance based earn-outs of up to £3.9m. The end-markets for their cash counting products are retail and banking which do not have the long-term growth drivers we seek. This disposal is a further example of our ability to divest businesses for sensible prices where the longer-term returns and growth prospects do not meet our objectives. Volumatic was the only Halma business whose products and activities were not related to any of our 12 sub-sectors.

In April 2012, we paid US$37.5m (£23.4m) to acquire Sensorex, a manufacturer of water quality test sensors based in California, USA. Sensorex is very complementary to our existing water test business, Palintest, and joins the Water sub-sector.

In April 2012, we acquired Accutome for US$20m (£12.6m), including US$2.3m of debt, plus an earn-out of up to US$5m based on future profit growth. Accutome adds new products and greater sales and distribution strength in the USA for our Health Optics businesses. Based in Pennsylvania, USA, it already trades with our ophthalmic instrument businesses Keeler and Volk.

In May 2012, we acquired SunTech for US$46m (£29.6m) plus US$5m for cash retained in the business with a potential earn-out of US$6m. Their blood pressure monitoring technology is a perfect complement to Riester's own clinical grade blood pressure monitoring devices.

Our current acquisition prospect pipeline is strong. We are looking for successful businesses in, or closely related to, our existing sub-sectors. Although most of our transactions in recent years have been in the Health and Analysis sector, we continue to look for opportunities in our safety-related sectors too. This combination gives Halma a great balance between sustainable growth and strong returns.

Macro-economic, regulatory and competitive environment

With our focus on the supply of safety, health and environmental related products, Halma businesses are positioned in relatively non-cyclical markets that have clear, long-term growth prospects. Most of our markets are underpinned by regulatory drivers where customer spending is often non-discretionary. Our businesses benefit from strong market positions providing upgrade and replacement sales opportunities. These factors combine to create genuine resilience in tough economic conditions and enable us to achieve organic growth above prevailing market growth rates.

With demand for our products increasingly stimulated by regulation, we can invest for the longer term with confidence. Our competitive environment is heavily influenced by global, regional and national product approvals or technical validations. Compliance with product regulations is a steadily increasing overhead and a technical challenge but our focus on this area enables us to build competitive advantage. We are exposed to a very diverse range of niche markets, each with its own unique competitive environment. Our strategy is to empower local management to respond to changing market conditions by controlling their own competitive strategy. More details are given in the sector reviews on pages 30 to 53.

In the current macro-economic environment each of our businesses is experiencing very different challenges and opportunities according to their particular market and geographic exposure. In 2012/13, we expect the macro-economic and political circumstances in Europe and the Middle East to remain challenging with the USA maintaining a relatively low rate of growth. We believe that the broader socio-economic development of developing regions like Asia and South America will continue to increase demand for a safer environment and for greater access to healthcare and energy/water resources. This should benefit Halma businesses.

Our primary market growth drivers

Halma's strategy is to develop market positions with a horizon of ten years or more. Growth strategies within our individual operating businesses tend to have three to five-year horizons.

The markets we select must have robust growth drivers with potential for organic growth well above the underlying market or GDP growth.

All of our businesses are positioned in markets that are underpinned by at least one of the following growth drivers:

"Our focus on Safety, Health and Environmental Technology is continuing to provide opportunities for growth in both developed and developing regions."

Increasing demand for healthcare

Three key demographic trends support increasing worldwide demand for healthcare: global population ageing, global population growth and rising incomes in the developing world. Demand for healthcare services and health-related products drives growth in our Health and Analysis markets.

Spending on healthcare continues to grow rapidly throughout the developed world, particularly in the USA where it is projected to rise by over a third between 2011 and 2016. Population growth and rising incomes in the developing world are other strong drivers of healthcare demand. China's healthcare expenditure, for example, grew at a compound annual growth rate of over 18% during 2006-2010, and is forecast to continue at this rate during the 12th Five Year Plan (2011-2015).

Population ageing creates rising healthcare needs and, as incomes rise, health services become available to an increasing number of people in the developing world. Continuous advances in medical technology create new medical procedures, which also stimulate demand for new instruments and equipment. The number of people aged 60 and over is increasing dramatically. In 2010 there were 759 million people in the world aged 60 and over; this is projected to rise to two billion by 2050. Although the older population is growing in all parts of the world, the increase is most marked in the developing world. The proportion of the world's older population living in less developed regions is forecast to rise from 65% in 2010 to about 80% by 2050.

Increasing demand for energy and water

Rising energy consumption and water usage, the inevitable consequences of social and economic development, are driven by three key trends: population growth; rising living standards; and changing patterns of food consumption and agriculture. Energy and water supply are interdependent in many economies. Consumption of water for energy production in the USA is forecast to rise by 50% from 2005 to 2030, accounting for 85% of the total US increase in water demand.

Global energy consumption is projected to increase by over 50% from 2008 to 2035 with the highest growth in non-OECD economies. While water demand rises relentlessly, the quality and availability of clean water continues to decline. Eighty per cent of the world's population lives in areas with high levels of threat to water security.

Several of our Health and Analysis businesses are positioned to benefit from the global trend of rising demand for water. In both developed and developing regions we see increasing competition for water resources between economic groups and between national governments. The increasing value placed on water resources drives demand for our water conservation, treatment, monitoring and testing products.

Continued investment in Oil and Gas exploration and extraction drives demand for our Industrial Safety products.

Increasing urbanisation

The world's population is currently growing faster than at any time in history. Despite a decline in the annual population growth rate to 1.2% per year, world population grows by about 83 million annually.

Future population increase will be a largely urban phenomenon. Falling birth rates in most developed economies mean that population growth will occur in the less developed regions, mainly among the poorest urban populations. The world's urban population is expected to rise by over 70% between 2011 and 2050. In China, for example, over two-thirds of the population is forecast to live in cities by 2030, a 300 million increase over 2012.

Urbanisation drives investment in non-residential buildings like shops, offices, and schools and in transportation, key markets for our Infrastructure Sensors businesses, while it also requires investment in healthcare facilities and utilities such as water, which are target markets in Health and Analysis.

Increasing Health & Safety regulation

The International Labour Organisation estimates that about 2.3 million men and women die from work-related accidents and diseases every year. This includes close to 360,000 fatal accidents and an estimated 1.95 million fatal work-related diseases. Every day nearly 1 million workers will suffer a workplace accident, and around 6,300 workers will die due to an accident or disease from their work. However, significant advances are being made in occupational safety and health (OSH) and the number of fatal accidents has fallen over the last ten years.

In economic terms it is estimated that roughly 4% of the annual global GDP (US$1.25 trillion), is lost by the direct and indirect costs of occupational accidents and diseases such as lost working time, compensation, production downtime and medical expenses.

Throughout the world, governments are requiring employers to comply with increasingly strict laws and regulations to protect workers from workplace hazards. In parallel with government regulations, many multinational employers based in the developed world are extending health and safety protocols to developing regions.

This combination of increasing safety regulation and globalisation drives demand for our Industrial Safety and Infrastructure Sensors products.

Delivering Corporate Responsibility and sustainability

Our primary market growth drivers mean that Halma companies operate in markets in which their products contribute positively to the wider community. These market characteristics and our commitment to health and safety, the environment and people development are reflected in the values held by our employees and our operating culture. We review our responsibility and sustainability reporting in accordance with best practice. Recent legislative changes, particularly concerning the environment and bribery and corruption, have provided an opportunity to review and ensure that our procedures in these important areas are accessible, compliant and firmly embedded within our business.

A detailed report on Corporate Responsibility is on pages 64 to 67.

Outlook

Our focus on safety, health and environmental technology is continuing to provide opportunities for growth in both developed and developing regions. The combination of strong local operational management and active portfolio management ensures that we are able to deliver short-term financial performance and invest for growth in the longer term. These qualities are reflected in this year's performance and in Halma's track record of growth and high returns over a long period. We expect to continue to make progress in the year ahead.

Andrew Williams
Chief Executive

[1] See Group highlights.
[2] See note 1 to the Accounts.