INTERIM MANAGEMENT REPORT

OVERVIEW

Bodycote delivered a strong first half performance. Revenues increased by 5% in the first six months of 2012 (7% at constant currencies). Headline operating profit grew by 10% to £47.5m, operating profit grew by 7% to £45.6m, and Group headline margins[1] increased to 15.8% from 15.0%.

These results continue the Group's track record of improving performance, despite currency headwind and clearly weakened demand in the Eurozone economies. The Group's performance has been driven primarily by continued growth in the North American automotive and general industrial businesses and aerospace and energy in all geographies. This performance has been moderated to some extent by softer demand in the European automotive and general industrial segments.

Bodycote completed the acquisition of the heat treatment business of Curtiss-Wright Corporation at the end of the first quarter for a consideration of £32.6m. This brought nine additional facilities into the Group, one of which was closed as planned and the assets redistributed to other Bodycote sites. The remaining sites offer high margin services across the spectrum of market sectors in the USA, but with a notable presence in aerospace and energy. The fit into the existing Bodycote network is excellent, bringing us into the key aerospace manufacturing hub in Wichita, Kansas. The acquired sites also help to fill in gaps in our capability to service automotive and general industrial customers from Indiana to New Jersey. The business has performed somewhat ahead of our expectations in its first three months of ownership.

All parts of the Group continue to focus on operational efficiency and cost control. Excluding employees who joined the Group with the acquisition, average headcount was unchanged from 2011, notwithstanding the continued increase in sales. Headline operating cash flow conversion was 110%[2], yielding an operating cash flow of £49.1m. Net capital expenditure remains closely controlled, but did increase to £26.6m (from £20.6m in the first half of 2011), a capital expenditure to depreciation ratio of 1.1 (2011: 0.8), in line with our stated intent to invest in capacity to service specific areas of long term demand growth. The investment is primarily in our selected focus technologies, notably in Hot Isostatic Pressing (HIP) and Speciality Stainless Steel Processes (S^3P), together with expanded capacity to service the aerospace market. We expect to achieve accelerating growth from these activities as capacity constraints are eased.

Our facilities in Empalme (Mexico) and London (Ohio) are being expanded and a new site is being built in Toulouse (France) as part of the increase in aerospace-orientated capacity. In emerging markets we continue to prioritise China and a new facility is under construction in Jinan. All of these significant investments are backed by long term contracts, including those announced earlier this year with Precision Castparts Corp, Rolls-Royce and ZF Lenksysteme.

The key elements of the Group's strategy are: a focus on services that are highly valued by our customers; targeted customer engagement; increasing our emerging market footprint; growth in selected proprietary technologies; and the drive for operational excellence. The successful execution of our strategy is being reflected in the Group's performance and promises further improvements in returns in the medium and longer term.

BUSINESS REVIEW

Markets

In the first half of 2012, the civil aerospace market was buoyant, as expected, and saw a continuation of the increase in aircraft build rates. Demand for aircraft spares was stable. The Boeing supply chain has seen particularly strong demand, both in North America and France, driven by 737 and to a lesser degree by 787 output. The defence market for Bodycote's processes, which is not dependent on major new programmes, has been flat. Bodycote's sales in the aerospace and defence market rose 19.2%[3] compared to the first half of 2011.

Oil and gas demand has been strong in both North America and Europe, with first half 2012 sales 32.0%[3] ahead of the prior year. While requirements for gas fracking were subdued in Q2, total rig count remained at a high level, so there was little impact on Bodycote. The industrial gas turbine market has continued to grow at a reasonable pace, with Group sales up 4.7%[3] compared to H1 2011. The growth rate was similar in both North America and Europe.

Market performance in car and light truck has been markedly different between North America, which has continued to see increases in output, and Europe where production has fallen. Bodycote sales in this sector are weighted to Europe and Group sales were down 1.8%[3] compared to the same period last year. The geographic pattern is similar for heavy trucks but Group sales overall were higher than the first half of 2011 by 1.2%[3], as growth in North American demand was particularly strong.

Sales to the general industrial sector grew by 21.4%[3] in North America compared to H1 2011, with much of this coming from mining and agricultural equipment. European demand from the early-cycle segments has weakened and this has been exacerbated by lower growth from exports to Asia. European general industrial sales were 1.9%[3] lower than the first half of 2011.

Demand in emerging markets in the first half has been somewhat weaker than we had expected at the beginning of the year.

[1] Headline operating profit as a percentage of sales.

[2] Headline operating cash flow divided by headline operating profit.

[3] Stated at constant exchange rates.

Aerospace, Defence & Energy

Revenues for the Aerospace, Defence and Energy business (ADE) were £130.3m (2011: £115.9m), an increase of 12.4%, of which 9.5% was organic. Expressed at constant currency rates the increase was 12.6% with organic growth at 9.7%.

Headline operating profit was £31.3m (2011: £25.2m), an increase of 24.2%, and operating profit was £30.1m (2011: £25.1m), an increase of 19.9%. The headline operating profit margin improved from 21.7% to 24.0%. Net capital expenditure was £15.6m (2011: £7.2m), representing a spend rate of 1.7 times depreciation (2011: 0.8 times depreciation). Average capital employed for the period was £228.6m (2011: £220.9m).

Capital investment has continued in both the USA and Europe to increase capacity in HIP, including for HIP Product Fabrication capability, to support sales development in aerospace, industrial gas turbine and oil and gas markets.

Automotive & General Industrial

Revenues for the Automotive and General Industrial business (AGI) were £171.0m (2011: £172.3m), a decrease of 0.8% which was in part due to the weakening of the Euro. Revenues are lower by 2.6% on an organic basis. Expressed at constant currency, revenues were £178.5m, an increase of 3.6% and organic growth was 1.9%.

Headline operating profit was £22.8m (2011: £22.9m), a decrease of 0.4%, and operating profit was £22.1m (2011: £22.5m), a decrease of 1.8%. The headline operating profit margin was maintained at 13.3% (2011: 13.3%). Net capital expenditure was £9.5m (2011: £12.3m), representing a spend rate of 0.6 times depreciation (2011: 0.8 times depreciation). Average capital employed for the period was £262.1m (2011: £288.5m).

FINANCIAL OVERVIEW

Revenue and headline operating profit

	Half year to 30 June					
	Revenue		Headline operating profit		Headline operating margin	
	2012 £m	2011 £m	**2012 £m**	2011 £m	**2012 %**	2011 %
ADE	**130.3**	115.9	**31.3**	25.2	**24.0**	21.7
AGI	**171.0**	172.3	**22.8**	22.9	**13.3**	13.3
	301.3	288.2	**54.1**	48.1	**18.0**	16.7
Head office costs	**–**	–	**(6.6)**	(4.9)	**–**	–
Total	**301.3**	288.2	**47.5**	43.2	**15.8**	15.0

Revenue for the half year was £301.3m (2011: £288.2m), an increase of 4.5% compared to the same period last year. In constant currencies the increase was 7.2% (£20.8m), of which £6.5m (2.3%) was the contribution of the Heat Treatment business of Curtiss-Wright Corporation, acquired on 31 March 2012.

Headline operating profit increased to £47.5m (2011: £43.2m) and headline operating margin again improved to 15.8% (2011: 15.0%). The contribution to headline operating profit from the acquisition was £1.6m. Operating profit increased to £45.6m (2011: £42.7m) and operating margin was 15.1% (2011: 14.8%).

Headline operating margins for the first six months improved in ADE and were maintained at prior year levels in AGI. ADE reported a headline operating margin of 24.0% (2011: 21.7%) and AGI reported a headline operating margin of 13.3% (2011: 13.3%).