Chief Executive's Review

In 2013 we have strengthened the platform from which to pursue our growth strategy

François Wanecq
Chief Executive

In our first complete year as an independent company, we have successfully initiated the recovery of margins across the Group despite the unfavourable economic environment. Market conditions remained challenging in 2013 continuing from the reduced levels of activity seen in the second half of 2012, and sterling strengthened substantially in the second half of 2013, impacting our reported growth numbers. Against this backdrop we have taken a disciplined approach to implementing our stated strategy. We streamlined our business portfolio and activities, exiting non-core low-margin businesses, further improved the quality of our products and services and implemented self-help measures to increase the productivity of our own businesses. The result is improved profitability, strong cash flow and a more focused Group. This gives us a strong platform from which to pursue our growth strategy.

Group Trading Performance

Group revenue from our continuing operations was £1,511million, a reduction of 2.4% compared to 2012. Underlying revenue, excluding impact of exchange rate movements, acquisitions and disposals, declined by 0.8%. Trading profit for the year was £140.0 million, up 6.6% from £131.3 million in 2012, up 10.9% on an underlying basis, reflecting the success of management's focus on self-help initiatives in light of continuing weak market conditions.

Market Trends and Business Performance

Our business comprises two divisions, Steel and Foundry, with the Steel division operated as two principal product lines, Steel Flow Control and Advanced Refractories. Divisional reports are set out on pages 24 to 31 of this Strategic Report.

Steel Division

After steep downturns in the steel industry in mid-2012, activity stabilised at those lower levels through the second half of 2013. Whilst world steel production grew by 4.8% driven primarily by growth in China, volumes outside China were flat, with year-on-year production reductions of 2.3% and 1.9% in the EU and the USA, respectively. To date, the Chinese steel market has been predominantly focused on 'long' products for use in infrastructure and construction, the production of which requires fewer Vesuvius products. In the coming years, with the evolution towards a more consumer-driven economy, a significant restructuring of the Chinese steel industry is anticipated, leading to a greater focus on quality and performance rather than volume. This will require more 'flat' steel production, and with our advanced process-enhancing solutions, we are in a very good position to participate in this development.

Revenue performance in the Steel division remained broadly flat versus 2012, with the effect of disposals offsetting underlying growth of 1.9%. The division reported a 6.7% improvement in trading profit, and a 9.9% increase in underlying profits. This also demonstrates that the self-help initiatives and streamlining of the portfolio, implemented from mid-2012 and throughout the year, has improved the strength of the underlying business.

Steel Flow Control

Steel Flow Control products supplied by Vesuvius include: the Viso™ product range, which are isostatically pressed alumina graphite refractories; slide-gate refractories; temperature measurement and slag level detection; fluxes; and control devices to monitor and regulate steel flow. The majority of these products are consumed during the process of making steel. Consequently, demand for Vesuvius' products is primarily linked to steel production volumes, with global steel representing almost 100% of the end-market for Vesuvius' Steel Flow Control products.

In the face of overall subdued market conditions outside China we delivered top line growth and performed ahead of the underlying steel production trend. We were able to do so because of our ability to innovate and to help customers improve process productivity and therefore extract more value from their products. This capability is particularly valued by customers in periods when their focus is on quality and cost rather than on volume.

Underlying Steel Flow Control revenue in the Americas and EMEA was broadly in line with the underlying steel production trend. Steel production in the Americas was 2.1% lower than in 2012, with US and Brazilian steel output lower by 1.9% and 1.5%, respectively. In EMEA, steel production was 0.1% lower than in 2012, with a 2.4% reduction in Europe and C.I.S, more than ofsetting a 20.7% increase in the Middle East and Africa. Revenue in EMEA grew 5.4% despite a lack of underlying market growth, owing predominantly to increased sales in the Middle East and in the UK and strong sales of fluxes through Metallurgica, a recent acquisition which was integrated successfully in 2013.

Trading in Asia-Pacific, however, showed stronger progression versus 2012. Growth in the Indian steel market (volumes up 5.9% versus 2012), following the start-up of new capacity which uses our higher value technology solutions, and increased penetration of our products in South Korea contributed to revenue growth in Asia-Pacific of 6.5%.

During the year we successfully commissioned our first robotic handling operation for Hyundai in Korea. This system brings reliability and speed to the steel production process whilst improving quality through a more precise and repeatable sequence of operations. It also enhances safety at our customers' facilities by allowing them to isolate employees from a dangerous work environment.

In conjunction with this improved penetration of new products and solutions, the Steel Flow Control product line commissioned an extension of its successful Viso™ operation at Trinec in the Czech Republic, and an integrated raw material mixing facility in Brazil. The latter will allow us to take advantage of local raw materials in local currency and to reduce our carbon footprint through more efficient logistics.

Advanced Refractories

The Vesuvius Advanced Refractories product line offers a full range of specialist refractory materials for lining steelmaking vessels such as blast furnaces, ladles and tundishes, and for applications in other high temperature process industries.

As previously outlined, a change in focus has been adopted for the Advanced Refractories product line to concentrate on more differentiated, higher-margin products and solutions. In line with this strategy, non-core low-margin businesses in Germany and Canada were disposed of in February and July 2013, respectively.

Revenue in the Americas and EMEA were each 1.8% lower than 2012, owing primarily to the initiative to withdraw from non-core low-margin business which more than offset the effect of increased penetration of our more specialised solutions.

In Asia-Pacific, revenue was down by 8.9%, reflecting the impact of the disposal in 2012 of the Andreco-Hurll construction business in Australia, which more than offset underlying growth.

A positive development was the increased penetration achieved by our ELBY™ ladle bottom, a product which allows steel makers to maximise the quantity of clean steel they can tap from a ladle before slag pollution occurs. Having already been well received in the North American market, this concept is now gaining traction in Europe and Asia-Pacific.

In addition, two new plants were commissioned in Port Kembla (Australia) and in Ras al Khaima (United Arab Emirates). These are now ramping up production and sales in line with expectations.

Combined, these developments clearly demonstrate our innovative approach, our focused investment, and our ability to deliver more engineering services to our customers in addition to the sale of our technologically advanced consumables.

Foundry Division

The Foundry division of Vesuvius, trading under the Foseco brand, is a world leader in the supply of consumable products and services to the global foundry industry, which produces castings used in a wide variety of engineered components. Some 40% of castings are produced for the vehicle sector, comprising approximately 25% for cars and light trucks ("light vehicle") and 15% for heavy trucks. Other end-markets include machinery for the construction, agriculture and mining industries, power generation equipment, railroad and general engineering.

The foundry market was significantly impacted in 2013 by the difficulties in the mining industry and, in particular, the reduction of investment spending in the extraction of hard rock metallic ores. This impacted sales in the USA, Brazil and Australia in particular. Furthermore, the truck and railroad markets remained stagnant, and the overall market in India and ASEAN was disappointing. However, Vesuvius' Foundry division made good progress in China where our solutions started to gain wider adoption.

Revenue in the Foundry division was down 7.0% year-on-year, reflecting the reduced end-market activity and the restructuring of the Fused Silica product line.

Profitability, meanwhile, has improved during the period, with trading profit up 6.4% (12.6% on an underlying basis) and return on sales margin improving from 9.1% to 10.4%, demonstrating that self-help initiatives to improve flexibility, including stemming the losses from the Solar Crucibles business, have increased the division's resilience to end-market cycles.

Revenues in all three regions were lower than in 2012, owing to the challenging end-market conditions seen globally across the foundry casting industry.

In the Americas, despite growth in the Brazilian truck industry, revenue was down 8.2% reflecting a 3% reduction in truck production in NAFTA and the lower volumes experienced by the US railroad and mining industries.

Revenue in EMEA was 3.5% lower than in 2012, reflecting a 3% reduction in German light vehicle production and European truck production volumes being lower by 4% year-on-year.

In Asia-Pacific, 11% growth in Chinese light vehicle output was offset by a 4% and 14% reduction in Japanese and Indian car production, respectively. Additionally, the foundry sector in Australia was affected by the reduced investment in the mining industry.

We continue to mitigate the effects of these challenging end-market conditions through manufacturing efficiency programmes and by maintaining the strength of the division's differentiated offering.

Chief Executive's Review continued

Construction of a new manufacturing plant for foundry products in ChangShu, China commenced during the year, with completion of Phase One expected in mid-2014.

In the Fused Silica product line, our glass roller business made good progress, benefiting from investments related to vehicle manufacturing in China and the USA.

Self-Help Initiatives

Within an uncertain environment, we have retained our focus on self-help actions to improve our performance. We have initiated a focus on quality in all business segments across the Group. Significant improvement was recorded in our Chinese steel operations and new business was successfully initiated in Korea.

As a result of our significant restructuring work the Fused Silica product line recovered from the substantial challenges experienced in 2012 in the Solar Crucibles product line.

Across the Group, specific effort was also dedicated to inventory reduction. Significant improvements were experienced across the business, most notably in Foundry. We look forward to continuing this progress in 2014. Together, these actions generate savings in the cost of handling, warehousing and rejects, and improve our overall productivity.

This emphasis on self-help has been rewarded by productivity gains in both divisions, with margins progressing markedly despite the weak market conditions and significant headwinds from foreign exchange rate fluctuation towards the end of the year. Overall margins progressed from 8.5% in 2012 to 9.3% in 2013; underlying margins increased by 1.0%.

Our successful efforts in inventory reduction together with good control of receivables allowed us to generate a substantial level of cash flow, with a cash conversion rate of 107%.

Details of our programme of excellence, encapsulating our Lean Programme, and focus on quality and safety are set out later in this Strategic Report.

Portfolio Management and Capital Allocation

Our strategy, and the focus of our management team, is to grow those activities where we can develop and exploit synergies from existing technological and market expertise. We are also committed to maintaining a robust balance sheet, and to delivering long-term dividend growth for our shareholders.

Following the demerger, we resolved to refocus Vesuvius on the businesses where we can offer a unique value proposition and differentiation from the competition. In May, we completed the disposal of the Precious Metals Processing division which had no fit with our core business of molten metal flow engineering, and which carried significant metal financing requirements. The majority of the proceeds of the transaction were returned to shareholders through a £30 million share buy-back as a sign that we are committed to delivering attractive returns to our shareholders.

We sold our German brick production business, VGT-Dyko, in February 2013 and our Canadian construction business in July 2013, thereby increasing the focus of our Advanced Refractories product line on higher margin segments.

Capital expenditure of £48 million represented 3.2% of revenue, with the focus being on expanding our capacity in emerging economies and extending our research centres.

Health and Safety

The Board places great emphasis on the importance of health and safety in the workplace and in the communities in which we operate. We measure the Lost Time Incidents Frequency Rate as a key indicator of our performance. Safety is of paramount importance as our employees often operate in harsh environments. Whilst we are constantly evolving and improving our safety programmes, we did not achieve our targets in the reduction of accidents in 2013. Very regrettably, one of our colleagues lost his life in April 2013, in a work-related incident at our Chicago Heights, Illinois, facility. It is important that, at the most senior level, we formally acknowledge and reaffirm our objective of zero accidents in the workplace. Further details of our safety programme are set out on pages 32 and 33 of this Strategic Report.

A Renewed Senior Management Team

The overall progress made in our first year owes much to the good understanding that has been developed between our new, focused Board of Directors and our widely renewed management team. Of the ten-strong Group Executive Committee, three are in their first year of tenure and three others have served less than three years in their present roles.

This executive team is engaged in re-examining all our past practices and in ensuring quality, consistency and technology are embedded at the heart of everything we do. This will be central to our success in reinforcing and growing our share of our targeted market segments. In June 2013, we launched our Group-wide plan to deliver a step change in our Quality performance. Significant progress has already been made, most notably in our Advanced Refractories product line, and within our operations in China.

The Group's overall strategy, reconfirmed by the Board in June, places particular emphasis on technology. A new worldwide research centre for Foundry is being established in Enschede, in the Netherlands, to be commissioned in mid-2014 and, in October, George Coulston (PhD, MBA) joined the Group as Chief Technology Officer to drive forward this increased focus on technology development. We continue to focus on annual R&D spend as a KPI.

Outlook

We expect the underlying trading environment during 2014 to be broadly similar to that experienced in 2013.

We are progressing with our plan to improve operational efficiency across the Group. These actions should continue to drive improvement in our trading margins and working capital performance in 2014. If the recent strength of sterling continues it will have a negative impact on our reported growth in 2014.

Our primary objectives for the medium term are to improve margins further, increase investment in research and development, sustain our global leadership in core businesses, grow further our presence in China, retain a strong balance sheet in order to give us financial flexibility, and progress our overall strategy of providing superior technical products and services for the steel and foundry industries.

François Wanecq
Chief Executive
4 March 2014