Financial Review

"Operating profit for European Pharmaceuticals grew by 29.6% at constant currency with the operational leverage effect of higher pharmaceutical revenue being clearly demonstrated"

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Group Performance

Financial Highlights

	Underlying Results			Reported Results		
	2012	2011	Change	**2012**	2011	Change
	£'000	£'000	%	**£'000**	£'000	%
Revenue	**426,041**	389,237	9.5	**426,041**	389,237	9.5
Gross profit	**99,259**	88,361	12.3	**99,259**	88,361	12.3
% of revenue	**23.3%**	22.7%		**23.3%**	22.7%	
Distribution costs	**(17,979)**	(17,659)	(1.8)	**(17,979)**	(17,659)	(1.8)
Selling, general and administrative expenses	**(38,944)**	(33,658)	(15.7)	**(54,655)**	(43,763)	(24.9)
Research and development expenses	**(5,735)**	(5,221)	(9.8)	**(5,735)**	(5,221)	(9.8)
Operating profit	**36,601**	31,823	15.0	**20,890**	21,718	(3.8)
% of revenue	**8.6%**	8.2%		**4.9%**	5.6%	
Profit before taxation	**32,966**	30,069	9.6	**16,820**	18,514	(9.1)
Taxation	**(8,664)**	(7,321)		**(5,071)**	(4,380)	
Profit after tax	**24,302**	22,748		**11,749**	14,134	
Earnings per share	**32.37p***	31.53p*	2.7	**15.65p***	19.59p*	(20.1)*
Operating cash flow before interest and tax payments	**29,128**	25,374	14.8	**29,128**	25,374	14.8
Cash conversion rate	**91.7%**	82.8%		**91.7%**	82.8%	
Free cash flow	**7,905**	9,294	(14.9)	**7,905**	9,294	(14.9)
Tax rate	**26.3%**	24.3%		**30.1%**	23.7%	
Total dividend per share	**12.27p***	11.12p*	10.3	**12.27p***	11.12p*	10.3
Net borrowings	**86,717**	34,091		**86,717**	34,091	

* Restated to reflect the impact of the bonus element of the Rights Issue.

Revenue, Underlying Operating Profit and Underlying Profit Before Tax at Constant Currency

	2012	2011	Change
	£'000	£'000	%
Revenue	**426,991**	389,237	9.7
Underlying operating profit	**36,845**	31,823	15.8
Underlying profit before taxation	**34,108**	29,070	17.3

Analysis of Revenue and Underlying Operating Profit Growth

	Revenue		Underlying Operating Profit	
	£'000	%	£'000	%
Year ended 30 June 2011	389,237		31,823	
Organic growth at constant currency	30,627	7.9	4,170	13.1
Impact of acquisitions	7,127	1.8	852	2.7
Impact of foreign currency movements	(950)	(0.2)	(244)	(0.8)
Year ended 30 June 2012	**426,041**	**9.5**	**36,601**	**15.0**

Revenue

	2012 £'000	2011 £'000	Change %
At Constant Currency			
European Pharmaceuticals			
Own branded pharmaceuticals	**64,322**	48,614	32.3
Diets	**28,143**	27,621	1.9
Third party contract manufacturing	**11,431**	10,772	6.1
Instruments, consumables and equipment	**1,894**	2,280	(16.9)
Total European Pharmaceuticals	**105,790**	89,287	18.5
US Pharmaceuticals	**20,287**	16,107	26.0
Services			
Veterinary wholesaling	**310,184**	291,180	6.5
Laboratories	**5,488**	5,078	8.1
Total Services	**315,672**	296,258	6.6
Inter-segment	**(14,758)**	(12,415)	
Total revenue at constant currency	**426,991**	389,237	9.7
Currency impact	**(950)**	—	
Reported revenue	**426,041**	389,237	9.5

Overall Group revenue increased by 9.5% compared to the 2011 financial year. Of this increase, 7.9% was organic growth, the *Eurovet* acquisition contributed 1.8% and currency movements had a negative impact of 0.2%.

Within European Pharmaceuticals, own branded pharmaceuticals grew strongly with a constant currency increase of 32.3% compared to the prior year (17.7% excluding *Eurovet*). This was the first full year that the marketing of *Vetoryl* came back in-house from our previous marketing partners. Our range of specialist pet diets grew by 1.9%.

Third party contract manufacturing grew by 6.1% compared to the 2011 financial year, returning to growth after a small reduction in revenue last year.

Revenue from US Pharmaceuticals grew by 26.0% compared to the prior year with *Vetoryl, Felimazole* and the *DermaPet* range all performing strongly. As with prior reporting periods, continued manufacturing issues with our ophthalmic and otic range had a negative impact of US$1.1 million on revenue.

Within the Services segment, our UK veterinary wholesaler, *NVS*, recorded growth of 6.5% in the financial year. This was slightly lower than overall market growth in the period due to *NVS* being underweight in internet pharmacies. Revenue from our Laboratories business showed an increase of 8.1%, reflecting a bounce back from the reduction in revenue seen in the 2011 financial year.

Gross Profit

Gross margin for the Group increased from 22.7% to 23.3%. This was driven by increased revenue from higher margin pharmaceuticals which was partially offset by a reduction in the *NVS* gross margin caused by increased discounting and an adverse sales mix.

Underlying Distribution Costs

Distribution costs increased by 1.8% compared to 2011, if *Eurovet* is excluded, the increase was only 1.0%. This below inflation increase was as a result of increased efficiency, particularly in our DVP EU and *NVS* businesses.

Underlying Selling, General and Administrative ("SG&A") Expenses

SG&A expenses increased by 15.7% (8.1% excluding *Eurovet)*. This increase reflects, in particular, the continued build of sales and marketing infrastructure within our US business and the additional costs of marketing *Vetoryl* in-house within our DVP EU operation.

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Research and Development Expenses

Research and development expenditure increased by 9.8% from £5.2 million to £5.7 million. This increase supports our product development programme which has been enlarged following the acquisition of *Eurovet*. Further details are given on pages 17 to 19.

Underlying Operating Profit

	2012 £'000	2011 £'000	Change %
At Constant Currency			
European Pharmaceuticals	**29,166**	22,506	29.6
US Pharmaceuticals	**5,845**	4,838	20.8
Services	**11,056**	13,087	(15.5)
Research and development	**(5,735)**	(5,221)	(9.8)
Central costs	**(3,487)**	(3,387)	(3.0)
Underlying operating profit at constant currency	**36,845**	31,823	15.8
Currency impact	**(244)**	—	
Reported underlying operating profit	**36,601**	31,823	15.0

Operating profit for European Pharmaceuticals grew by 29.6% at constant currency (24.3% excluding *Eurovet*) with the operational leverage effect of higher pharmaceutical revenue being clearly demonstrated.

US Pharmaceuticals achieved a strong increase of 20.8% in operating profit despite the build-up of sales and marketing infrastructure noted earlier.

The Services segment showed a reduction in operating profit compared to 2011 with the reduction in gross margin noted above only partially mitigated by efficiency savings. Although operating margin for the year fell from 4.4% to 3.5%, the operating margin in the second half of the financial year showed an improvement to 3.6% compared to the 3.4% achieved in the first half.

Underlying Net Finance Expense

The underlying net finance expense in the 2012 financial year was £3.6 million compared to £1.8 million in 2011. However, the 2011 figure was flattered by a £1.0 million gain on foreign exchange whilst there was a loss of £0.9 million in 2012. Excluding foreign exchange gains and losses, the charge for 2012 is broadly equivalent to that for 2011.

Underlying Profit Before Taxation

Underlying profit before taxation increased by 9.6% from £30.1 million to £33.0 million. At constant currency, the increase was 17.3%.

Non-underlying Items

Non-underlying items in the year comprised amortisation of intangibles acquired as a result of acquisitions together with one off costs relating to acquisitions and subsequent reorganisations, principally *Eurovet*. Full details are shown in notes 4 and 5 to the financial statements. The Directors believe that highlighting these items separately gives a better understanding of the performance of the Group.

Taxation

The effective tax rate on underlying earnings was 26.3% compared to 24.3% in 2011. In 2012 there were certain foreign exchange losses for which there was no tax credit. In 2011 the tax rate benefited from non taxable foreign exchange gains.

Earnings Per Share and Dividend

Underlying earnings per share was 32.37 pence compared to 31.53 pence in 2011, up 2.7%. Both of these figures have been adjusted to reflect the bonus element of the Rights Issue. The relatively small increase reflects the additional number of shares issued in respect of the *Eurovet* acquisition against the small profit contribution from *Eurovet* recognised in the period from acquisition to the year end. *Eurovet* is expected to be earnings enhancing in the year ending 30 June 2013.

The Board is proposing a final dividend of 8.50 pence per share which, when added to the interim dividend of 3.77 pence (adjusted for the bonus element of the Rights Issue), gives a total dividend of 12.27 pence. This compares to the Rights Issue adjusted 11.12 pence in 2011. The cash dividend is up by 25.9% from £8.0 million to £10.1 million.

The total dividend is covered 2.4 times by underlying profit after tax (2011: 2.8 times).

Cash Flow

	2012 £'000	2011 £'000
EBITDA	**35,238**	33,616
Share-based payments charge	**1,001**	830
Changes in working capital	**(7,111)**	(9,072)
Cash generated from operations	**29,128**	25,374
Net interest	**(2,426)**	(2,629)
Taxes paid	**(7,241)**	(5,034)
Capital expenditure	**(3,278)**	(4,090)
Proceeds of asset sales	**50**	2
Repayment of borrowings	**(8,328)**	(4,329)
Free cash flow	**7,905**	9,294
Acquisitions	**(117,335)**	(33,047)
Net new borrowings	**61,400**	29,556
Issue of share capital	**59,288**	541
Dividends	**(8,325)**	(7,221)
Foreign currency effects	**(994)**	(129)
Net cash flow	**1,939**	(1,006)

The cash conversion rate in 2012 was 91.7% compared to 82.8% in 2011. A strong cash inflow in the second half resulted in an improvement of 14.8% compared to last year.

Free cash flow was slightly below the 2011 level due to higher debt repayments in the year.

Financial Position at the Year End

	2012 £'000	2011 £'000
Non-current assets		
Intangible assets	**225,872**	125,098
Property, plant and equipment	**16,720**	7,721
	242,592	132,819
Working capital	**49,531**	32,494
Deferred and contingent consideration	**(13,863)**	(14,055)
Current tax liability	**(8,155)**	(5,391)
Deferred tax liability	**(29,343)**	(13,443)
Employee benefit obligations	**(363)**	—
Net borrowings	**(86,717)**	(34,091)
Net assets	**153,682**	98,333

The balance sheet at 30 June 2012 is enlarged due to the acquisition of *Eurovet* on 23 May 2012 together with the consequent Rights Issue.

Net borrowings at the year end represented 1.8 times underlying pro-forma EBITDA compared to 2.3 times at the time of the *Eurovet* Prospectus. Of the increase in working capital, £11.0 million was as a result of *Eurovet* with the remainder reflecting increased trading activity.

Bank Facilities

The Group's bank facilities were re-financed and increased during the year in order to partially fund the acquisition of *Eurovet*. The new facilities have been provided by a syndicate of four banks and comprise:

- a £55 million term loan repayable in instalments through to October 2016. The first repayment of £5 million is due on 31 March 2013
- a £65 million revolving credit facility commenced until October 2016

The main covenants are:

- cash flow cover no less than 1.25:1
- interest cover no less than 4:1
- the ratio of net borrowings to annualised EBITDA no higher than 2.75:1 up until 30 June 2013 and 2.50:1 thereafter
- consolidated net worth no less than £120 million

There was substantial headroom on all covenants during the year.

The Group also has a £10 million overdraft facility which is currently unutilised.

Risks and Uncertainties

As we have stated in previous reports, the Group, like every business, faces risks and uncertainties in both its day-to-day operations and through events relating to the achievement of its long term strategic objectives. The Board has ultimate responsibility for risk management within the Group and there is an ongoing and embedded process of assessing, monitoring, managing and reporting on significant risks faced by the separate business units and by the Group as a whole. More detail in relation to this process can be found within the Corporate Governance section on pages 44 to 54.

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The table below highlights the main potential risks to the Group strategy, as identified by the Board, and the controls put in place in order to mitigate the risks:

Strategy	Risk
To develop a high growth, cash generative specialist veterinary products business	Competitor product launched against one of our leading brands
	Revenue from recently launched new products failing to meet expectations
	Failure of clinical trials
	Prescribing pressure on veterinarians to reduce antibiotic use
	Failure to meet regulatory requirements under which we operate
To sustain growth and innovate in our Services business	Loss of key personnel*
	The failure of a major customer or supplier*
	Fuel shortage/logistics failure

* These risks apply across all trading segments.

How we mitigate the risk
• Product improvement plans and marketing strategies are reviewed on a regular basis • Where competitor products are launched a response strategy is established and followed by our marketing team to highlight any unique selling points or competitive advantages or to position our products defensively to minimise competitor impact • Market research is conducted in order to allow the marketing team to better understand customer needs and ensure that our products fulfil the identified requirements • Any product patents are monitored and consideration given to the formulation of a defensive strategy towards the end of the life of the patent
• In respect of all new product launches a detailed marketing plan is established. Progress against the plan is constantly monitored • The Group ensures that it has detailed market knowledge and retains close contact with customers through its sales team • Alongside the marketing plan the sales team receives training on the product, its benefits and all available technical information
• Before major costly efficacy studies are initiated, smaller proof of concept studies are conducted to study the effects of the drug on target species and for the target indication
• Regular contact is made with all relevant veterinary authorities to ensure that we have a comprehensive understanding of anticipated regulatory changes • Programme of development of new products that minimise antimicrobial resistance concerns
• The Group always strives to exceed regulatory requirements and ensures that its employees have detailed experience and knowledge of the regulations • All businesses have clearly established quality systems and procedures in place • Regular contact is maintained with all relevant regulatory bodies in order to build/strengthen relationships and ensure good communication lines • The regulatory and legal teams remain constantly updated in respect of proposed/actual changes in order to ensure that the business is equipped to deal with and adhere to such changes • Where any changes are identified which could affect our ability to continue to market and sell any of our products a response team is created in order to mitigate such risk and to retain effective communication with the relevant regulators • External consultants are utilised to audit our manufacturing systems prior to any major inspection
• Succession planning is given consideration by the Board and, where deemed necessary, Key Man Insurance is in place • In 2009 the Group HR Director developed and implemented a leadership development programme for the senior management team in order to further strengthen the retention of the individuals. This programme is ongoing and includes the involvement of personal coaches • As stated in earlier in this report a Performance and Development Review process is in the early stages of implementation
• The business units monitor the financial status of both key customers and suppliers and maintain regular contact with them (including face to face meetings) • All contacts with customers are reviewed from both a commercial and legal perspective to ensure that assignment of the contract is allowed should there be a change of control of either of the contracting parties
• Standard operating procedures have been drafted in respect of fuel emergences to provide a daily service. Such standard operating procedures are regularly reviewed in order to ensure they remain effective • Delivery routes are constantly monitored by the operations department in order to ensure that they remain effective, economic and efficient • Routine ongoing maintenance of the automated picking circuit at *NVS* and ensuring that all critical components are held on site