Chairman's statement

Dramatically transformed

Overview I am delighted to report on a year of excellent progress both for the Group and its two trading divisions. Group operating profit from continuing businesses has again grown strongly, as have the Group's net cash resources. The benefits from the successful restructuring of the Group's portfolio were already apparent at this time last year but we are now also beginning to see the benefits from the strategic and performance improvement initiatives being pursued by the divisions. The Group has been dramatically transformed and is capable of generating further improvements in performance. It has significant resources to invest for growth both organically and by acquisition.

Financial summary In summary, the turnover from continuing operations was £495 million (1998: £533 million) and the corresponding trading profit was £22.2 million (1998: £17.9 million).

The turnover from all operations was £496.3 million (1998: £568.3 million) and the corresponding trading profit was £22.8 million (1998: £14 million).

Net interest receivable in the year was £2.5 million (1998: £0.2 million).

Group profit before tax and exceptional items was £25.3 million (1998: £14.2 million).

The earnings per share before exceptional items were 11.44p (1998: 5.93p) and after exceptional items were 15.07p (1998: loss per share 5.12p).

After accounting for exceptional items relating to the disposal of the Group's water engineering businesses amounting to £6.1 million, the profit before tax was £31.4 million (1998 loss: £4.5 million).

It has been a year of exceptionally strong cash generation which has resulted in a year end net cash balance of £82.1 million (1998: £21.1 million).

Dividend The Board is recommending a final dividend of 1.40p, making a total of 2.20p for the year (1998: 1.80p), an increase of 22%.

Order book The Group's year end order book for its continuing operations was £353 million (1998: £334 million).

Divisional changes and strategies
The Facilities Management Division has been re-named Babcock Engineering Services ('BES') to reflect better both the nature of its current trading activities and future development plans. In addition to the provision of engineering and technology support services to the defence, marine, rail and "secure facilities" sectors, BES's activities include materials management, logistics support and nuclear engineering services.

In order to reflect the technology shift that has taken place within the Materials Handling Division and to reflect its future development, the Division will be referred to in future by its established trading name BMH. From this year the trading results of the Group's South African activity are reported within BMH.

Our strategy for growth both organically and via acquisition remains focused upon the achievement of leadership in our main business activities and the development of new opportunities in related fields. We will continue to leverage off the core strengths of our businesses, including our global network and knowledge of international markets.

BES – engineering and technology support services to the defence, rail, marine and "secure facilities" sectors
BES achieved good progress in the year, improving its operating margins and increasing its operating profit by 28% to £13.3 million.

During the year the Division continued to improve efficiency and performance and extended its customer base and markets. Leveraging off its facilities and skills, BES is gaining access to new opportunities and alternative business streams. The Division now has a growing list of substantial expansion opportunities in the defence, rail, marine and "secure facilities" markets. In certain cases it is pursuing these opportunities as part of teaming or joint venture arrangements. Many of these opportunities, including the development, manufacture and support contract for a new towed array sonar and the management contract for the Aldermaston nuclear weapons establishment, have already been bid to the MoD. The outcome of both these bids should be known by the end of the new financial year. Other projects, such as the Mega 3 rail freight wagon, that would assist in diverting freight from our roads onto rail, should begin to generate revenue in the new year now that the final phase of pre-registration testing is within sight.

Meanwhile the Division's mainstream naval ship and nuclear submarine refitting activities in both the UK and New Zealand made excellent progress in the year. This trading performance reflected the Division's initiatives to increase efficiency and competitiveness. In addition to the refit during the year of vessels under the programme of work agreed on the privatisation of the Rosyth Dockyard, the Division undertook the refit of two competitively won vessels, HMS Argyll, a Type 23 frigate, and the 31,500 tonnes RFA Fort Victoria, the largest vessel in the fleet.

Over the next two years the naval refitting activities of the Division will be dominated by two substantial contracts totalling around £200 million to refit HMS Spartan, a nuclear powered submarine, and the aircraft carrier, HMS Ark Royal. Both of these contracts were awarded within the past four months.

Railcare, which dominates the Division's rail activities and is involved in the provision of heavy maintenance and refurbishment services, had another successful year. The outlook for that business remains positive, with opportunities such as the London Underground public private partnership offering good potential for the future.

BES, given its stable platform of refit work for the MoD and its exciting opportunities for growth, has a strong base from which to make good progress.

BMH – materials processing technologies and engineered systems BMH, with its portfolio of materials processing technologies and engineered systems businesses, made strong progress during the year, improving its operating margins and increasing operating profit by 17% to £8.4 million.

Over the past few years the Division has successfully pursued a strategy that has transformed it from a business with a strong dependence upon material handling in the cement, pulp and paper and energy sectors to a broader portfolio of technologies and businesses where there are clear opportunities for organic growth. Similarly it has taken steps to reduce its dependence on in-house manufacturing other than that of low volume, high value-added items to protect core technologies. At the same time it has accelerated its investment in new product development and technology acquisitions as well as on-going product maintenance. BMH is now a multinational engineering house for materials processing technologies and engineered systems, with leading positions in growth markets and a global presence.

During the year BMH faced challenging trading conditions in certain geographic markets. However, its flexible and global operating structure allowed it to refocus its marketing and sales resources to address opportunities in other parts of the world. In this way BMH was able to take advantage of opportunities in Europe and North America and grow operating profits in spite of a decline in the Asian market.

The trading performance in the year again involved a high commitment to product development and new technology. Expansion in this area included the latest pneumatic grain unloading technology, which is strengthening BMH's position as a major supplier of equipment and systems to leading international marine grain terminal operators. Similarly, the Division, through the acquisition of AKI Dryer Manufacturers Inc, secured drying technology for the gypsum wallboard segment of its engineered building materials business, thereby confirming BMH as a leading supplier of gypsum wallboard process systems. The strong emphasis on engineered building materials will remain a key part of the future growth strategy of BMH, together with a continuing commitment to product development.

The Group's South African activities, which are now included within BMH, made further progress during the past year. Operating margins were ahead of those achieved in the previous year on a turnover of £33.4 million. The South African operation has been extending the range of engineering services offered to its customers and is establishing long-term partnership arrangements for the supply of repair and maintenance services.

The Division has entered the new year with a healthy order book, its business trading satisfactorily and a clear strategy for earnings growth.

Corporate development During the second half of the year the Group disposed of its 50% interest in Babcock Water Engineering Limited and its wholly owned subsidiary, Babcock Water Engineering LP (USA) to Earth Tech Inc companies for a total consideration of £13.25 million. These disposals followed the disposal of the Group's other Process interests a year earlier.

During the first half of the year the Group strengthened its market position in the wallboard and fibreboard market by acquiring the technology for grinding and calcining by-product gypsum from Delta Steel Co (USA) and for drying systems for wallboard, fibreboard and veneer through the acquisition of AKI Dryer Manufacturers Inc, in Oregon, USA, for a maximum consideration of $8 million.

Directors and officers Ian Hartigan, who has served as a non-executive Director since 1994, will be retiring at the forthcoming AGM. I would like to thank him for his support and valuable contribution to our Group Board. Meanwhile I am delighted to welcome Dipesh Shah of BP Amoco who joined the Board as a non-executive Director on 15 June 1999. Dipesh's current responsibilities for BP Amoco cover the Forties pipeline system and the Grangemouth complex. He was previously CEO of BP Solar International. We are confident that his extensive international business experience will be of considerable value to the Group.

During the year, John Allen, who had served the Group for nearly ten years, retired as Company Secretary and we thank him for his efforts on behalf of the Group. Helen Mahy has been appointed as Company Secretary and General Counsel.

Outlook The Group has an exciting year ahead and I am pleased to report that it has started well. Having moved away from large scale, heavy contracting and manufacturing risk it has been dramatically transformed and is a very different Group from that of a few years ago. It possesses a clear strategy, a competent management team and an exceptionally strong financial platform from which to develop both organically and by acquisition.

T. John Parker

Dr T John Parker Chairman
15 June 1999