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Emeco Holdings Limited
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Emeco Holdings Limited's net profit after tax of \$30.5 million for the first half of FY08 was 12% lower than the proforma NPAT of \$34.8 million for the prior corresponding period and was in line with revised guidance. EBITA was down 10% to \$55.4 million on revenue growth of 15% resulting in a decline in EBITA margin to 19% from 24%. What were the major factors that caused the decline in profitability?

MD Laurie Freedman

A mix of factors impacted this result, including industry issues, such as revenue mix, infrastructure blockages and lower levels of production from some major mines.

A large proportion of the increase in revenue was attributable to the acquisition of Euro Machinery on 1 January 2007, which has increased the proportion of revenue generated from our Sales division and decreased margins.

Margins in our overseas businesses were impacted by some factors that relate specifically to the roll out of our global growth strategy. For instance, we are building our business in the US from the ground up and we've incurred some start-up losses. In some markets softer demand leading to lower equipment utilisation rates has coincided with increasing capacity as we invest for the medium term.

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On a regional basis where have you underperformed?

MD Laurie Freedman

Our EBITA from offshore operations was \$7.8 million (\$9.4 million excluding Europe) lower than in the first half of FY07 as demand for equipment hire fell below expectations due to a range of factors that are proving to be short term.

Our Australian EBITA growth of 4% was constrained by shipping delays which created elevated inventory levels and growth constraints due to the cutbacks in coal production in NSW and Queensland.

We took a \$4.4 million EBITA hit in Indonesia on the loss of a substantial contract and changed market conditions. In FY07 a number of mine owners reviewed their operating arrangements in favour of local contractors which resulted in the off hire of our equipment in some cases. However, demand for expatriate contractors over the last six months has improved which is beginning to have a flow on effect on the demand for our plant.

The on-going start up in the United States saw EBITA losses increase by \$3.0 million. While we incurred establishment costs as we built our US presence, our US utilisation rate was minimal. We are introducing our 'dry hire' business model to the US market. Whilst it is a new concept in this market we remain confident it will be well accepted, although results to date have fallen short of our initial expectations.

Our Canadian operation's EBITA was down \$2.0 million on last year as we had ramped up equipment and personnel in anticipation of strong market activity in the oil sands and traditional oil and gas industries. Revenue fell short of expectations, principally because cost pressures caused the major oil sand producers to contract capital works, whilst at the same time the Alberta Provincial Government imposed a royalty on oil and gas production in the province that caused a short term disruption in exploration and development works.

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Plant utilisation is a key metric for your business. What was the trend in the first half result and what are your expectations going forward?

MD Laurie Freedman

Rail and port infrastructure bottlenecks in NSW and Queensland saw our Australian utilisation rate decline slightly.

In Indonesia, the weakness in demand temporarily pushed the rate to 40%, however as demand recovered we gradually redeployed the fleet and utilisation averaged about 70% in the second quarter. With a change towards Australian-based mining contractors, we're confident that the flow on to our business will push our utilisation rates back up towards 80%.

Canada is always affected by the thaw and freeze seasons and as a result of our strategy to gear up the Canadian fleet December quarter rates were as low as 40% while we averaged around 60% for the period. Coming into spring we expect utilisation rates to get back to 65% to 70% as increased activity in oil sands mining is expected. Our strategy is to smooth the seasonal cycle by targeting demand for bigger mining equipment that we can maintain on mine sites for the full year.

In the US we've worked vigorously to take the fleet deployment from 5% up to 53% at the end of December and we're currently at about 62%. Increased US coal exports as a result of higher prices and tightening credit markets are increasing demand for our fleet. We're confident that we will get utilisation rates in the US up to 70% through the second half of this year as our 'dry hire' offer to US customers gains traction.

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You've provided FY08 NPAT guidance of \$65 to \$72 million. This implies a stronger second half performance. What are the primary profit drivers that will contribute to a stronger second half?

MD Laurie Freedman

Improving demand across all our regions is driving higher fleet utilisation and creating growth opportunities.

Our organisation's improving management capability is another factor that enhances our outlook. We're continuously upgrading skills as the business matures. With the recruitment of experienced operating, marketing and commercial personnel we are increasingly better placed to maximise opportunities to grow revenue, manage costs and utilise the funds employed within our existing asset base, particularly offshore.

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You have underperformed previous guidance. Has the forecasting process been more rigorous this time? What are the key risks to your FY08 guidance?

MD Laurie Freedman

We regularly test the variables and drivers of our forecasts. Our guidance is based on the forecasts of our operating managers and is reviewed monthly. I accept our previous expectations for profit from the US have proven to be optimistic, but shareholders should appreciate we are building a business for the medium and longer term. I don't expect losses to continue in the US for much longer, so that variable will diminish.

We expect infrastructure constraints and labour conditions to remain tight around the world and to show no sign of major relief until 2010. Our profit guidance reflects these conditions. The risks to our growth expectations would be based around unexpected interruptions due to extreme weather, acute infrastructure problems or major constraints on labour availability.

Our guidance also reflects our current assessment of the effects of the flooding in the Bowen Basin in northern Queensland. We continue to monitor the impact of the flooding on our customers and our current and future rentals. At this stage, our Mackay facility has not suffered any significant damage.

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Operating cash flow in the latest 6 months was \$29 million versus \$39 million in the previous correspond period. What caused the decline and can you comment on your intentions to reduce working capital across the business?

MD Laurie Freedman

Inventory levels, particularly in our Australian Sales business, increased by \$68 million over the December half year. Most of that inventory is ear-marked for sale, but delivery has been delayed due to shipping constraints. Inventory levels will come down by about \$50 million in the second half.

The increased inventory was triggered by a commercial opportunity to purchase gear at attractive margins. In this instance, we'd expect our ROFE hurdle rates to be exceeded. We need to manage the business for the medium term and not be frightened to take investment decisions that will generate strong returns. That said; we are seeking ways to improve our global inventory management. We are confident that will drive improvements in working capital.

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In 2008 we are seeing global growth slowing and tightening credit with rising interest rates in Australia. What is the potential impact on your business?

MD Laurie Freedman

We are a capital intensive business: always have been and always will be. That may be of concern to some in the near term, but it also provides us with opportunities.

We are well funded and have tremendous fleet capacity. We believe in our model and consider ourselves somewhat insulated from any slowdown as we're embedded in the core production processes at a lot of major and small mines. We're not expecting our clients to cutback production, and continue to work with them to help increase production, as required.

Another issue to consider is that capital intensity is a barrier to entry. In these times of tightening credit availability, companies will seek alternative ways to outsource equipment supply and conserve their capital. Tighter credit conditions can lead to stronger demand and better utilisation rates.

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Australian operations lifted revenue by 6% to \$211 million and EBITA rose 4% to \$46.8 million. Can you define the impact of flooding in New South Wales and Queensland floods on these results and on future earnings?

MD Laurie Freedman

There was only a modest negative from flooding in New South Wales coal fields early in the half year. The Queensland floods hit in January.

Queensland is a big component of our Australian results and business. We can't be certain as to when the floods are going to recede and our hire revenues resume normal levels, but we believe we have made appropriate allowance in our forecasts. Our NPAT guidance range of \$65 to \$72 million factors is a reasonable outcome.

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The Australian resource industry is experiencing cost pressures from materials and labour. To what extent is this trend a threat to earnings?

MD Laurie Freedman

Our business is capital intensive and labour costs are not as great a concern as they are for more labour intensive businesses. Some longer term contracts are structured to insulate us from cost increases.

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Has your international expansion plan been too ambitious?

MD Laurie Freedman

We see a huge advantage in getting into these markets first and building a global network. First mover advantage is behind our thinking on a daily basis. We believe the opportunity is significant as offshore markets are far less mature than the Australian market. We can use our expertise and Australian experience to offer international customers new solutions.

The international scene is like Australia was ten years ago before we rolled out our dry rental model for large mining equipment. We're confident our 'dry hire' business model is as valid offshore as has been proven in Australia.

I don't believe we've been too ambitious, but we may have been too enthusiastic. With hindsight, I should have talked about a medium term program and highlighted the investment and costs up front. Perhaps we underestimated the costs of establishing in the US market, but we now have a facility and sales force that is working overtime to establish the 'dry hire' concept, especially in the US Appalachian coal fields.

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What is the outlook for maintenance and growth capex?

MD Laurie Freedman

We have always maintained that our maintenance capex will approximate depreciation in the long run. That's happening as we've now reached a "steady state" in our fleet in terms of aging and turnover.

For the full 12 months to June 2008 we expect net rental maintenance capex of \$70 million and growth capex of \$100 million. For the half year, net rental maintenance capex was \$35 million and growth capex was \$40 million. There is no substantial change in the second half.

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Net debt at 31 December 2007 of \$395 million was 34% higher than at 30 June 2007 and the ratio of net debt to equity rose to 58% from 44%. What leverage is appropriate for your company?

MD Laurie Freedman

We have done a lot of modeling on a 65% debt to equity ratio. We are comfortable at that level. Interest cover based on EBITDA is another benchmark and for the latest six months that was 8.6 times and we expect a further increase in interest cover for the full year. Our current gearing gives us a fair bit of head room.

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Emeco listed on ASX in July 2006 at an IPO price of \$1.90 per share. The closing price yesterday was \$0.755 per share. Do you consider the company vulnerable to a take over offer? Have there been any significant changes within your share register?

MD Laurie Freedman

With an NTA \$0.73 per share and a recent share price near \$0.755 there is some vulnerability. However, given our supportive register which includes management, Archer, Pacific Equity Partners and a number of new deep value institutional investors, the prospect of success for an opportunistic and undervalued offer appears remote.

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You've announced an interim dividend of 2.0 cents per share. This is a payout ratio of 41% given interim EPS of 4.8 cents per share. Given the fall in your share price since IPO will the Board consider additional capital management actions that may boost shareholder returns?

MD Laurie Freedman

Our dividend policy of paying out 35% to 45% of earnings remains unchanged. Beyond dividends, the Board monitors a range of options to ensure the best capital structure.

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In addition to annual profit, what returns do you target?

MD Laurie Freedman

As a capital intensive business we are very focused on discounted cash flows and the value of money. ROFE is a major benchmark at all business levels. After corporate allocations we seek 18% EBITA ROFE.

For the latest period we're at 15% and that reflects the cost of starting up our new international businesses and temporary elevated inventory levels.

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Thank you Laurie.

For more information about Emeco, please visit www.emecoequipment.com or contact Michael Kirkpatrick, General Counsel and Company Secretary, Emeco Group, telephone + 61 8 9420 0222.

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