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## CEO on H1 10 Result

Open Briefing interview with CEO Kevin Eley



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### In this Open Briefing<sup>®</sup>, CEO Kevin Eley talks to us about:

- Rebound in underlying earnings; focus on supplying branded products into niche markets
- Low debt provides strong base to grow branded products business
- Strong cash generation allows sustainable dividend payout of 70-80 percent

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### Record of interview:

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HGL Limited today reported underlying net profit of \$4.1 million from its branded products business for the first half ended March 2010, up from \$2.2 million in the previous corresponding period. Group net profit, including profit on the sale of listed securities, was \$7.8 million, up from \$3.7 million. To what extent did the underlying profit improvement reflect stronger demand and to what extent did it reflect management initiatives?

#### CEO Kevin Eley

Underlying profit is management's prime point of focus as it drives shareholder value. Approximately 18 months ago we faced a volatile currency, potentially weakening demand and a financial crisis. Management responded quickly with numerous initiatives, including cost containment, margin improvement and sales management. We also repaid debt and focused on our business of supplying brands into niche markets. These initiatives have strengthened HGL immensely and we're now reaping the rewards.

In the first quarter we more than likely benefited from the government's stimulus package, so it's pleasing that sales in the second quarter grew 5 percent on the previous corresponding period, with sales for the six months up 3 percent. It therefore appears that underlying demand in the niche markets we operate in generally remained robust in a tough economic environment.

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The focus of your business has changed over the last 12 months, shifting to the branded product import and distribution businesses following the sale of your interests in funds management and the ongoing sale of your listed security holdings. What is HGL's business model?

### CEO Kevin Eley

Selling the funds management business and our listed equities and focusing on our core business has made us a much simpler company. We're now focussed on supplying branded products into niche markets. We supply over 40 brands through 10 separate business units, each focused on their own brands and markets.

We don't run a centralised business model and the CEO of each business has responsibility for developing their brand, growing their business, managing their EBIT and funds employed, and developing strategy.

We usually source our products from overseas brand owners who manufacture the goods and provide varying levels of marketing support. We focus on niche markets where we can sustain some pricing power. Our brands tend to be among the top four in these niche markets: almost by definition these markets tend to be quite small and our customers tend to be independent retailers and businesses.

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What is your strategy to grow HGL?

### CEO Kevin Eley

Our strategy is to grow organically by sensibly managing our sales force, taking on additional brands within our existing markets, diversifying into adjacent niche markets and acquiring other businesses distributing well recognised brands in niche markets.

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During the first half, HGL received \$7.2 million cash from the sale of listed securities and as at 31 March 2010 net debt stood at \$4.9 million, down from \$13.4 million six months earlier. Net debt to equity was 6 percent, down from 16 percent. You've indicated your intention of retaining funds to invest in additional businesses and agencies. What capacity do you have for acquisitions and where do you see the opportunities?

### CEO Kevin Eley

At the end of this financial year we should be debt free. We could comfortably fund an acquisition or a number of acquisitions to the value of about \$30 million through debt. Any larger acquisition would require an equity raising, which we'd be reluctant to do at our current share price.

Most of the opportunities we identify, and many of the companies we've acquired in the past, have been from families wishing to exit their businesses. We're usually able to tailor an attractive exit solution for them and enhance the consideration they receive. There are also opportunities to acquire smaller divisions of public companies or businesses from private equity owners if these organisations wish to deploy funds elsewhere.

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HGL announced a fully franked interim dividend of 6.0 cents per share, up 100 percent from 3.0 cents last year. At the current share price of \$1.10, the interim dividend provides an annualised yield of 10.9 percent. The interim payout ratio was 74 percent of underlying profit, compared with a full-year payout of 80 percent in 2009. Will you maintain the full-year payout at last year's level? How sustainable is the dividend at these levels?

### CEO Kevin Eley

As we're a wholesaler of branded products, we don't have much capital expenditure and as a result generate a high amount of cash. We therefore have a policy of paying between 70 and 80 percent of our underlying profit by way of dividend. We've consistently paid dividends at the upper end of this range and it's only once in the last four years, when our underlying earnings were reduced as a result of the economic environment, that our board decided to pay dividends at the bottom of the range.

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Given the current strength of the balance sheet, why have you maintained the dividend reinvestment plan (DRP) and have you considered a capital return to shareholders?

### CEO Kevin Eley

Besides the DRP, we also have a share buyback. We have a strong, supportive base of shareholders with the top 36 shareholders controlling over 60 percent of the company. We believe that operating the DRP and share buyback in tandem has helped improve the liquidity of our shares and that over the long term it will improve EPS for our remaining shareholders.

As we're now focused on supplying branded goods into niche markets and are looking to grow through acquisition, it's premature to consider any capital return. Shortly we'll have realised over \$41 million of capital by selling our funds management interests and our listed shares, and I'd like to see a substantial part of this employed in expanding our current business, acquiring further brands, or acquiring new businesses with strong brands. This will increase our underlying earnings and dividends and thereby create more value for our shareholders.

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Branded products generated EBIT of \$8.8 million, up from \$4.9 million in the previous corresponding period, on sales of \$84.8 million, up 3 percent. The increase in EBIT partly reflected a \$3.8 million rise in gross profit to \$38.2 million. What was the trend in volumes and prices during the half and to what extent did the increase in gross profit reflect the stronger Australian dollar?

### CEO Kevin Eley

We're now focused on sales, gross margin and expenses. In the first half, sales were up 3 percent and gross margin dollars up 11 percent, while expenses dropped as a percentage of sales. In terms of gross margin dollars, it's worth noting we benefit in a strong Australian dollar environment as we're able to manage pricing better. The converse applies in a weaker Australian dollar environment.

During the six months to 31 March, the Australian dollar averaged US\$0.91 cents compared with US\$0.67 in the same period last year. That's a 36 percent increase in the value of the Australian dollar, but our gross margin percentage rose by just 3 percentage points. That was because we adjusted down our selling prices and the concessions given by our suppliers when the Australian dollar was weak were removed. The converse applied last year when

we were faced with a weak Australian dollar. This shows the strength of our business model and the relationships we've developed with our suppliers and customers.

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Expenses rose to \$29.9 million in the first half, up 2 percent from the previous corresponding period. Can you continue to contain the growth in expenses in an environment of more robust sales growth? How do you see expenses trending over the remainder of the year?

**CEO Kevin Eley**

We're very conscious of our expense line. As well as comparing expenses with the previous period, we also consistently monitor expenses as a percentage of sales. During the first half, that percentage fell to 34.5 percent from 35.7 percent, which is a good outcome. We'd aim to reduce this expenditure rate further as we grow sales in the periods ahead.

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In the first half, branded products had annualised EBIT return on capital employed of 23 percent, up from 13.0 percent, and ahead of your hurdle return of 20 percent. What are your investment hurdles in relation to acquisitions and without the buffer of listed security sales, how is the business positioned to maintain returns during future downturns in the economy?

**CEO Kevin Eley**

When we acquire a business, we usually expect to achieve a minimum return on our investment of 20 percent within the first year of operation. However, in some instances we need to increase costs to strengthen the business and enable it to stand alone under our model. This can affect our initial return, but strengthens the business over the long term.

We believe that achieving a return of 13 percent in an economic downturn as severe as the one 18 months ago was a creditable outcome. It proves our business model. We have a diverse range of customers, suppliers and products and we operate in niche markets, all of which positions us well to handle any future economic downturns.

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In 2009, underlying EPS was 4.4 cents in the first half, and 5.6 cents in the second half, so the 2010 first half underlying EPS of 8.1 cents marks a steep recovery. Do you expect the momentum to continue? What is the outlook for earnings over the remainder of the current year ending September 2010?

**CEO Kevin Eley**

Once again there's a lot of volatility in the financial markets and there appears to be weakening retail demand. These factors could have some effect on our earnings and also on the confidence of our customers. However, if the Australian economy can maintain the momentum experienced over the previous six months, we'd expect to surpass last year's underlying earnings.

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Our focus on supplying branded products into niche markets gives us a stronger business model, and looking at the longer term, which is the way we run HGL, our initial goal is to achieve underlying earnings in excess of where they peaked in 2007, just before the commencement of the financial crisis.

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Thank you Kevin.

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For more information on HGL Limited, visit [hgl.com.au](http://hgl.com.au) or call Kevin Eley on (+61 2) 9221 7155

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