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CEO on FY10 Outlook

Open Briefing interview with CEO Kevin Eley

HGL Limited
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SYDNEY,NSW, 2000

In this Open Briefing®, HGL CEO Kevin Eley talks to us about the outlook for 2010

- Simplified business model focused on import & distribution of branded products into niche markets
- Stronger balance sheet to support continued growth in the core businesses
- Recent strength of Australian dollar supporting improved profit outlook for 2010

Record of interview:

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HGL Limited today reported net profit of $8.0 million for the year ended September 2009, compared with a net loss of $7.5 million in the previous year. Core profit was $5.0 million, down from $8.4 million, reflecting reduced earnings from niche branded product import and distribution, and a lower contribution from your funds management investments, offset partially by reductions in central costs, interest and tax. You've said HGL is well placed to "create an improved performance" in the current year ending September 2010. What are the expected drivers of an improved performance this year?

CEO Kevin Eley

The biggest contributor will be an increase in our gross margin dollars from distributing branded products into niche markets. We'll continue to reduce overheads where possible, and we're also aiming to continue reducing our interest costs through selling our remaining listed securities and using the funds to further pay down our borrowings. Over the 12 months to 30 September 2009, proceeds from the sale of our listed investments reduced our net debt to $13.4 million from $34.1 million.

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HGL has decided to simplify its business model by focusing on its core import and distribution businesses, and during 2009, you raised $25.7 million from the sale of shares. What was the rationale for this strategic shift and what are your intentions regarding your remaining $13.8 million of listed shares?

CEO Kevin Eley

We believe focusing on our import and distribution businesses will provide a number of benefits to our shareholders. These include growth in recurring earnings, making the company more easily understood by the investment community, and releasing capital for more productive use.

Previously, we focused on selling niche branded products, funds management and investing in listed shares. We've sold our investment in the MMC Contrarian funds management business and continue to sell the balance of our listed shares. We now have the capital to fund the growth of our core niche branded products businesses which are proving to be resilient in the current economic environment. We're confident we can now support the growth of these businesses organically and/or through acquisition.

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How do you define "niche branded products" and what is your basis for selecting the particular niches HGL is involved in?

CEO Kevin Eley
These are products that have brand recognition in their respective markets; a full list of our brands is set out in our latest annual report. We see the markets for these products as niche because typically they're not dominated by very large retailers. This allows us to distribute, invest in, and support our brands, customers and suppliers, and still earn respectable margins.

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HGL announced a final fully franked dividend of 5.0 cents per share for 2009, down from 5.1 cents in the previous year, bringing the full-year dividend to 8.0 cents, down from 12.1 cents. The payout ratio was 80 percent of core profit, up from 70 percent and at the top of your payout policy range. How sustainable is this level of payout?

CEO Kevin Eley
Our distribution businesses aren't capital intensive and therefore generate substantial cash flows. This allows us to reinvest in the businesses and maintain a policy of paying between 70 and 80 percent of core profits by way of dividends. Before deciding the level of payout, the board assesses a number of factors, including the economic outlook, our level of gearing, potential acquisitions and the specific outlook for our businesses. Therefore, paying a dividend at the top end of the band may not always be prudent.

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HGL's import and distribution businesses booked EBIT of $11.1 million, down 27 percent from the previous year, on sales of $164.7 million, down 3 percent. The EBIT fall partly reflected a $6.9 million reduction in gross profit and one of your goals in the current year is to increase gross profit. To what extent will this depend on price rises and how effective can price rises be if the Australian dollar remains strong?

CEO Kevin Eley
We purchase most of the products we sell in our distribution businesses in US dollars. In the September 2009 year, the average exchange rate for the Australian dollar was 74 US cents, whereas now the rate is 91 US cents. If the Australian dollar remains at these levels through the year, there will be no need to seek substantial price rises from our customers.

We can manage moves in the exchange rate when they occur over a longer time frame. Where we experience difficulty is when there is a sudden fall in the currency, which is what happened last year between July and October when the Australian dollar weakened significantly.

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The reduction in gross profit was partly offset by a $2.8 million decrease in expenses to $58.5 million. How sustainable are expenses at this level if sales increase?

CEO Kevin Eley
Throughout last year we adopted rigorous expense controls and curtailed all discretionary expenses. Unfortunately, we also had to reduce our employee numbers by 7 percent, but we retained our experienced and skilled workforce by using annual and long service leave to help manage costs. With the improvement in consumer confidence, we're aiming for increased sales this year and are unlikely therefore to maintain expenses at last year's level.

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You've indicated that your only distribution businesses to suffer a decline in sales of more than 10 percent in 2009 were Mountcastle, which had a large one-off Australian Defence Force headwear order in 2008, and Biante, which saw a fall in demand for its more highly priced model cars. Can you comment on the current trend in sales across the businesses?

CEO Kevin Eley
Across the businesses monthly sales in the current year have been at very similar levels to the corresponding months last year. However, with the Australian dollar at around 91 US cents, we're able to achieve better gross margin dollars and therefore increased profitability.

Our weakest months in the 2009 financial year were January to May so we'd hope to see recovery coming through in those months in 2010. This time last year, although the Aussie dollar had fallen substantially, a huge drop in consumer confidence wasn't evident. That only started towards the end of the 2008 calendar year, carrying over to the middle of 2009.

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The import and distribution businesses had EBIT return on net assets of 15.4 percent in 2009, down from 21.4 percent in the previous year, and below your target of 20 percent. What scope is there to improve returns in the absence of a recovery in sales and what is the outlook for returns?

CEO Kevin Eley
Last year the working capital in the businesses remained similar to the previous year, but the big factor was our profitability. Our gross margins fell to 42.3 percent from 45.0 percent in 2008, which was primarily responsible for the reduced return on investment. This year, with the strong Australian dollar, we're aiming to achieve a gross margin rate similar to 2008 and thereby reach our 20 percent hurdle rate.

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HGL booked non-core profit of $3.0 million in 2009, compared with a loss of $15.9 million in the previous year, with a $4.2 million profit on the sale of listed shares partly offset by a $1.2 million impairment charge on listed shareholdings. What is the outlook for non-core profit in the current year? When do you expect to report earnings that predominantly reflect the core business?

CEO Kevin Eley

At 30 September we had a revaluation reserve of $7 million in relation to our equity investments. If we sell these investments during the current year at their market value at 30 September 2009, there will be non-core profit of around $7 million after tax. We'll continue to sell our listed equity portfolio and use the proceeds to reduce debt, and we'd hope to have exited these holdings by the end of the financial year if the current economic environment prevails. Therefore, in 2011 our reported earnings should reflect the underlying earnings of our core distribution businesses.

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The reduction in net debt to $13.4 million as at 30 September 2009 from $34.1 million a year earlier resulted in net debt to net debt plus equity falling to 14 percent from 30 percent. What is your target gearing range and what balance sheet capacity do you have for acquisitions given weaker credit markets and significantly higher bank interest margins?

CEO Kevin Eley

We currently have bank facilities of $24 million. Given we continue to sell our equity portfolio, net debt is likely to reduce to less than $5 million before the end of the financial year. This means we have ample capacity for acquisitions.

We're comfortable with a target gearing of around 25 percent, especially given our focus on distributing branded products into niche markets.

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How will the longer term earnings and dividend profile of HGL change as a result of your simplification of the business model?

CEO Kevin Eley

Our medium term aim is to increase our sales from branded products into niche markets over the $164.7 million sales in 2009. This should bring our underlying core earnings closer to the core earnings achieved in 2008. Our aim is to achieve these earnings levels by focussing on distributing branded products into niche markets. Dividends should increase in line with our stated dividend policy of paying between 70 and 80 percent of core profit.

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Thank you Kevin.

For more information on HGL, visit www.hgl.com.au or call Kevin Eley on (+61 2) 9221 7155

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