

Transcript of ShawCor's First Quarter 2006 Results Conference Call

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OPERATOR: Good morning, ladies and gentlemen. Thank you for standing by. Welcome to the ShawCor first quarter financial results conference call. At this time, all participants are in a listen-only mode. Following the presentation, we will conduct a question-and-answer session. Instructions will be provided at that time for you to queue up for questions. If anyone has any difficulties during the conference, please press \* 0 for operator assistance at any time.

Your speakers today will be Bill Buckley, President and Chief Executive Officer; Alan Thomas, Vice-President, Finance, and Chief Financial Officer; Jim McTurnan, Vice-President, Legal.

I will now turn the conference over to Jim McTurnan. Please go ahead.

JIM McTURNAN (Vice-President, Legal, ShawCor Ltd.): Thank you, Yvonne.

Today's conference call includes forward-looking statements that involve estimates, judgments, risks and uncertainties that could cause actual results to differ materially from those projected. The uncertainties include, among others, economic conditions, levels of drilling and pipeline activity, environmental and regulatory risks, liability claims, exchange rate fluctuations, political risk and raw material prices.

Further information on risks that could affect the company can be found in ShawCor's 2005 annual report and annual information form, copies of which are

available on Sedar at [www.sedar.com](http://www.sedar.com) and may also be found on the ShawCor website at [www.shawcor.com](http://www.shawcor.com).

We would like to remind participants in today's call that the company's trading symbols will change effective this Friday, May 12th, in line with the TSX's discontinuance of its symbol extension program.

The company's Class A subordinate voting shares will in the future drop the SV designation, and the Class B multiple voting shares will drop the MV designation. The new symbols will be SCL.A for the Class A shares and SCL.B for the Class B shares.

I would now like to turn the call over to Bill Buckley.

WILLIAM BUCKLEY (President and Chief Executive Officer, ShawCor Ltd.): Thank you, Jim. And good morning, everyone. Thank you for joining us this morning.

As most of you know, we held our annual general meeting yesterday and it was a pleasure to be able to meet with many of you face to face. In addition, it was nice to be able to announce good first quarter results and also to announce that the directors had approved a doubling of the dividend \$0.045 payable semi-annually to \$0.045 payable quarterly on the Class A shares effective with the May dividend. Payment of a sustainable and growing dividend is a fundamental financial policy, and one that we wish to maintain as we pursue our growth programs going forward.

We are pleased with our first quarter results. They do represent a record quarter in terms of ongoing operating income. They also reflect the strength in management and business processes that we've put in place over the last year.

Before I provide you with an update on our major programs, I'd ask Alan to take us through the details of the first quarter.

ALAN THOMAS (Vice-President, Finance, and Chief Financial Officer, ShawCor Ltd.): Thanks, Bill. If anyone doesn't have our first quarter press release in front of them, it is available on our website at [www.shawcor.com](http://www.shawcor.com).

Revenues for the first quarter totalled \$258 million, a 6-per-cent increase over the first quarter of last year but 12 per cent lower than the record fourth quarter of 2005, a result of the completion of the coating on the Ormen-Lange project in Norway and the Balgzand and Bacton undersea pipeline from Holland to the U.K. in the first quarter. Load-out of the pipe on those contracts will continue in the second and third quarters.

Compared to the first quarter of last year, pipeline and pipe services revenues were 5 per cent higher, led by very active coating markets in North America and the Far East. Small-diameter coating activity in North America was very strong, with volumes running 25 per cent ahead of first quarter 2005, more than offsetting the 20-per-cent drop in North Sea revenues I referred to.

Guardian and CANUSA-CPS remained steady, despite the strengthening Canadian dollar, and Shaw Pipeline Services, our inspection business, was running almost 25 per cent ahead of last year in local currency. In total, the

stronger Canadian dollar relative to not only the U.S. dollar but also the euro, the pound and the Norwegian krone reduced our first quarter revenues on translation by some \$16 million, or 7 per cent in comparison to the first quarter of 2005.

Compared to the previous quarter, Bredero-Shaw's revenues were down 18 per cent, with all the decrease coming from the North Sea-West Africa sector, where the large volume projects that were going full blast in the fourth quarter were completed in the quarter. Only \$3 million of the change in revenue can be attributed to currency fluctuations compared to the fourth quarter.

In the petrochemical and industrial segment, ShawFlex led the 12-per-cent increase in revenues over the first quarter of last year and the 25-per-cent increase over the previous quarter as its specialty cable products, particularly in the Western Canada mega-projects, continued to have success. DSG-CANUSA recovered from a weak fourth quarter, matching its first quarter levels.

A better story in terms of operating income, \$37.5 million, up 8 million, or 26 per cent over the first quarter of last year and almost 6 million over the fourth quarter levels, the combination of some of Bill Buckley's operational management changes he's talked about, as well as improved product mix in the pipe coating businesses.

Overall Bredero-Shaw's operating margins improved by 2 percentage points over the first quarter of last year and by almost a percentage point increase over the fourth quarter. The pipeline and pipe services segment operating margin as a percentage of sales increased from 14.2 per cent last year

to 16.7 per cent in this quarter, with improvements at both SPS and CANUSA-CPS contributing to the margin improvement.

In the petrochemical segment, both ShawFlex and DSG-CANUSA reported substantial increases over fourth quarter levels. While their fourth quarter had some seasonal softness, the pick-up was more than just the seasonal bounce. The increase in earnings over the first quarter in this segment was due to the higher level of activity in the wire and cable business. Indeed, we're accelerating some 2007 capital spending plans into this year in ShawFlex to try and meet the increased demand.

Depreciation was down slightly from fourth quarter levels, and \$1 million below the first quarter of last year, really mostly just the difference in exchange rates. Depreciation going forward should remain about the same level as the first quarter, with reduced charges from the Farsund plant offset by the amortization charges associated with the new coating plants in Indonesia, Brazil, and in Portland, Oregon.

EBITDA for the quarter was 47.6 million, \$0.64 a share, 16 per cent ahead of last year and a 12-per-cent improvement on the previous quarter. This represents, on a consolidated basis, 18.5 per cent of sales, our best performance in some time. EBITDA margins in the pipeline and pipe services segment exceeded 20 per cent for the quarter.

Net interest expense is positive, with our cash balances more than offsetting the interest payments on our long-term debt. The after-tax credit is

greater than what you see here on a pre-tax basis, as much of the cash is sitting in our U.S. companies where we still have unused tax losses to shelter the interest income.

Our Saudi Arabia joint venture produced a very good first quarter. Our share of their earnings almost tripled to 1.3 million in the quarter. Their plant is going full out and there's lots of potential new work in this region.

Our tax rate for the quarter is 34 per cent, about what we expect it to be for the year, although it can move around a little bit depending on where we earn our profits.

The non-controlling interest on our statements of \$19,000 is our 25-per-cent partner share of earnings in the Indonesian operation, where the new plant has had a successful start-up and has now returned to profitable operations.

Overall earnings of 2.8 million or \$0.33 a share, compared to \$0.25 in the first quarter of last year from continuing operations, and \$0.30 in the fourth quarter. In this current quarter we had a few ongoing expenses related to Mobile, but hopefully most of those costs are now behind us.

Looking forward, the current strength of the Canadian dollar against the U.S. dollar is an obvious concern. While the greater impact is on our top line, where more than 50 per cent of our consolidated revenues are U.S.-dollar based, there's also an impact on the bottom line. Based on our current outlook, every \$0.01 change in the U.S. dollar versus the Canadian, for example from \$0.89 to

\$0.90, would impact revenues by \$6 million and net earnings on an annual basis by approximately \$750,000, assuming no other counter measures.

Turning to cash flows, very strong cash flows from operations, \$49 million for the quarter including 16 million from reduced working capital needs. Capital expenditures of 6.5 million included completion of the Kabil plant in Indonesia, continuing work on our new coating plant in Belo Horizonte, Brazil, and some smaller capacity and efficiency expansion projects in the other divisions. While capex was only 50 per cent of depreciation in the quarter, we expect capex on an annual basis to significantly surpass depreciation for the year with a number of capacity expansion projects planned or under way in all of the business projects.

Overall cash increased \$43 million in the quarter to 244 million at the end of March. While some of this cash is committed to higher-dividends, new capital expenditures and the Garneau acquisition, we still have capacity to fund additional growth opportunities.

And now, I'd like to turn it back to Bill.

WILLIAM BUCKLEY: Thank you, Alan.

As you have seen, we've reported a good quarter. The Bredero-Shaw profit improvement program is beginning to show good results. In addition, the market is strengthening. While the small-diameter market for gathering lines has been strong – this market follows drilling activity – the large-diameter market has been spotty. However, based on our quotation activity, we expect that this is

going to change and we anticipate large-diameter coating to increase moderately in 2007 and to be up sharply in 2008.

Now turning to some of the key events of the quarter, we completed coating of the Ormen-Lange pipeline, the longest underwater pipeline in the world. This project for Statoil and Norsk Hydro was completed ahead of schedule. Ninety-six thousand pipes were coated over a 22-month period and 20,000 remain to be loaded out to the lay barges this summer. By all measures, this project was an execution success for us and for our clients.

We have two small projects to complete in Farsund over the next 12 months and don't expect the Farsund plant to return to full production until late 2007 or early 2008.

We also completed coating the B to B, or Balgzand to Bacton project. This underwater pipeline runs from Holland to the U.K. At this time all of the pipes have been moved to Holland for staging, and it will be loaded out later this summer.

We completed on schedule and on budget the West Africa gas pipeline, using two of our portable concrete plants in Tema, Ghana. One of these portable concrete plants is now being moved to Port Elizabeth, South Africa, to coat the South Coast gas project.

The relocation of our Indonesian coating facilities to Kabil is complete and we have another world-class facility in the Far East. Our new Brazilian operation

in Belo Horizonte will be providing Thermotite insulation coating for the PDEG project by the end of this quarter.

And in the quarter we secured two major international projects. First, we were awarded the Kuwait crude oil export project with a value to us of over \$40 million U.S. We will commence coating operations in June at our plant in Ras Al Khaimah in the Emirates. And we secured the 476-kilometre South Sumatra to West Java project with a value in excess of \$30 million U.S. Coating has begun on this project.

We've also been awarded the coating for the 390-kilometre Wabasu pipeline from Fort McMurray to Edmonton. This project will use our proprietary HPCC high-performance composite coating, which will provide additional protection and durability for our client's pipeline.

We announced an agreement with Oregon Steel to establish a coating facility at their site in Portland, Oregon. This facility is now under construction and is using coating assets from Mobile, Alabama, and is expected to be in production before year-end.

As well, in the quarter we announced that we've entered into a definitive agreement to acquire all of the shares of Garneau Inc. The transaction will be affected by a court-approved plan of arrangement. The independent committee of Garneau has unanimously recommended the arrangement transaction to the shareholders of Garneau. An annual and special meeting of the shareholders of Garneau has been scheduled for May 30th.

After closing, we plan to invest 4 to 5 million in new capital in the Garneau Camrose plant over the next year. This will be used to add capacity, to improve productivity, quality and HSE performance. Production efficiencies will result by integrating this plant into our existing Western Canadian pipe coating network, and this will result in improved service for our customers in this active market.

Last week we closed on the purchase of 130 acres of land adjacent to our plant and to the Garneau plant in Camrose, Alberta. Forty acres of this land is currently being prepared for a double jointing operation to meet the needs of our clients who are accessing Japanese pipe to complete their projects in Western Canada. The remaining area on this site will be used for lay down of client pipe during the active period expected over the next several years. And it also gives us the option of having a site for future plant expansion, if required.

In the other divisions, ShawFlex completed a record quarter for both revenue and operating income. To keep pace with their strong order book, they will be installing a new cabler and a new extrusion line in the third quarter. Shaw Pipeline Services has successfully introduced the next generation of ultrasonic weld inspection technology. CANUSA-CPS had their second best quarterly revenue in their history and continues to expand their markets worldwide. Guardian's web-based inventory control system continues to gain customers and DSG-CANUSA's automotive markets in both Europe and North America showed some improvement.

Backlog ended the quarter at 333 million, as expected, down from year-end with the completion of the two major projects in the North Sea. We do expect a decline in revenue in 2006 compared to 2005, but earnings on a continuing operations basis should be up slightly.

Revenues will soften in the last half of this year due to project timing, but revenue will increase in 2007 over 2006 and we expect revenue will be up sharply in 2008 as we feel the full impact of the ramp-up in large-diameter coating activity.

We are well positioned with our strong balance sheet to meet this growing demand through expansion, productivity upgrades to our current facilities, and we are prepared to establish new greenfield sites as opportunities arise. And as we stated before, we see opportunities to grow our businesses through geographic expansion, new product introduction, share gains supported by productivity improvements, and through joint ventures and acquisitions.

And I'd now like to open the phones to questions.

OPERATOR: Thank you. One moment, please. Ladies and gentlemen, we will now conduct the question-and-answer session. If you have a question, please press the \* followed by the 1 on your touchtone phone. You will hear a tone acknowledging your request. Your questions will be polled in the order they are received. Please ensure you lift the handset if you are using a speakerphone before pressing any keys. One moment, please, for your first question.

Your first question comes from Neil Jacobs, of Beaudry Capital Management. Please go ahead.

NEIL JACOBS: Good morning. Congrats on a great quarter. Couple of things. Vis-à-vis the currency, could you just remind me, how do you price your services? Do you price it in U.S. dollars throughout the world, or how exactly does that work?

WILLIAM BUCKLEY: Neil, it's a mix, but the majority of the contracts that we price are in U.S. dollars. Approximately 60 to 70 per cent of the projects that we price are in U.S. dollars.

NEIL JACOBS: I see. And then you seem to be, to have a fair amount of conviction, at least on the large-diameter business in '08. How do you have that much visibility, I guess to put it bluntly?

WILLIAM BUCKLEY: Yes. Good question. We're working on the sort of pre-engineering phase of a number of projects now, so we're putting in budgetary estimates, price estimates on several projects. Not all of them will go ahead, but you know, at this point we're seeing a very high percentage sanctioned and they will go ahead. We're also seeing for the first time some projects being brought forward.

We have our investor presentation up on our website, and in that presentation we show not all of the projects that we're working on, but we show sort of a selection of projects in each of the major regions globally. And in there

you can get an idea of some of the projects that, you know, we're factoring in as we look at upcoming work.

But we know that, you know, there's several projects that will begin coating in, later this year and into '07, and then there's some very, very large ones – the Papua-New Guinea project I had mentioned, the NEG North European Gas project – which the coating timeframe on those is going to be in that 2008 period.

NEIL JACOBS: And typically for those type of contracts, I know in a lot of those instances they're securing the pipe already. When do they actually commit to using you or whoever else on the coating side?

WILLIAM BUCKLEY: Yes. Generally they do secure the pipe first and we'll get the coating contract afterwards. And often, you know, they could have secured the pipe a year and a half in advance of us getting the coating contract. We might know that we're logistically positioned to get the coating contract, but the actual purchase order might come to us as much as a year and a half after they've placed the order for the pipe.

NEIL JACOBS: Got you. Okay. Thanks a lot.

WILLIAM BUCKLEY: Okay.

OPERATOR: Ladies and gentlemen, if there are any additional questions at this time, please press the \* followed by the 1. As a reminder, if you are using a speakerphone, please lift the handset before pressing any keys. Your next question comes from Dana Benner, of Westwind Partners. Please go ahead.

DANA BENNER: Thanks. Good morning, gentlemen.

WILLIAM BUCKLEY: Good morning, Dana.

DANA BENNER: Bill and company, I wonder if you could provide perhaps just a little bit more colour on your margin performance in pipeline and pipe services. I know it's been a goal of yours for quite some time to continue to move those margins up and it looks like you're really starting to take hold, to gain success there, and perhaps just provide a bit more colour.

And I wonder if you feel optimistic that you can continue to move those higher. I mean, you've done that on a lower top line, so presumably with the visibility that you have up to '07, I wonder if you have optimism that you can move it higher on even... move your margins higher on higher top line.

WILLIAM BUCKLEY: The margins did improve this quarter, as you stated, Dana. And it is a number that we're watching very closely, the operating income to revenue number. It's coming back. It's not at the target that we set internally here for our operating managers in Bredero-Shaw.

The improvements that we've had so far do reflect the operational efficiencies that we put in place, and I think there's more than can be done there. They do reflect as well a favourable mix. We're beginning to see some lower-margin projects get completed, and they're being replaced by higher-margin projects.

As we move forward we think that we're going to begin to see, you know, some real pricing power that we haven't seen in the large-diameter segment for many years as capacity tightens for us and globally, and we expect that, you

know, through the latter part of '06 and into '07, we'll see margins improving because of the price-cost relationship.

We also think that we're going to see further gains in terms of our operational programs. As you know, we established a new Operations Department within the company and we're bringing some of the, you know, standard techniques that are used in the automotive and electronics industry, and we're bringing those to bear on the pipe coating industry. That program's under way. But you know, for it to show its full effect is probably a 24-month timeframe and we're about seven or eight months into that program.

DANA BENNER: Great. And to your petrochemical segment, you put up some pretty good growth numbers there. I wonder, would it be reasonable to use the 35 million in top line in the first quarter as a sort of run rate for this year, or what's your feeling?

WILLIAM BUCKLEY: There's a little bit of seasonality to that business, but you know, I expect that their revenues are going to stay strong through the balance of the year, with one exception: the summer shutdown quarter. Business is always a little softer for both DSG-CANUSA and ShawFlex at that time.

Revenues in ShawFlex have been quite strong due to demand. They are also pushing through the copper price increase as well. So, Dana, just one little cautionary note there: If copper was to decline significantly, that would impact the revenue line.

DANA BENNER: Right. Could you just give us just some guidance on R&D for the year?

WILLIAM BUCKLEY: R&D spending will probably be up this year, with some of the new additions that we've made, about 25 per cent over last year's level. And we're going to begin, we have begun to measure internally sort of RD&E, research, development and engineering. And when we've got some good and reliable numbers, you know, on our RD&E expenditures, we'll probably be publishing those numbers.

DANA BENNER: Right. And in what areas would you be spending the bulk of those monies this year? Where are you focusing?

WILLIAM BUCKLEY: Major focus is in Bredero Shaw on new pipe coating technologies, products like the high-performance composite coating, also insulation coatings for offshore and deepwater, and in particular, insulation coatings for high-temperature lines coming down from the oil sands that are carrying hot bitumen.

DANA BENNER: Great. Two more questions. You've amended your normal course issuer bid. Can you provide us any more colour on that?

WILLIAM BUCKLEY: We intend to use it this year. We want to make sure that we buy back at least enough shares to eliminate any dilution due to our options program, at the minimum. We also will be buying back shares on weakness, as we did this past year. And you know, if there is weakness in the

stock price, we'll move into the market and acquire some more shares at that time.

DANA BENNER: Great. Finally, could you address Shaw? Have there been any changes in the competitive dynamic, the landscape, in any of your segments that either is affecting you currently or may start to affect you in the quarters to come?

WILLIAM BUCKLEY: No, I think there's no significant changes there. We continue to acknowledge that we have the strongest balance sheet in the industry. We think we're going to be able to use that to good effect as our client base demands us to respond with expanded facilities or new facilities. We think that we'll have an advantage over our competitors during that phase. And we're also looking for opportunities where we can consolidate this industry as well.

DANA BENNER: Presumably on the pipeline side.

WILLIAM BUCKLEY: Yes.

DANA BENNER: Yeah. Great. That's all I've got. Thanks a lot.

WILLIAM BUCKLEY: Okay. Thanks, Dana.

OPERATOR: Your next question comes from David Sacks, of Hawke(phon) Capital. Please go ahead.

DAVID SACKS: A couple of questions. One, if you could refresh us on what your margin goals are by segment. Secondly, if you could discuss the margin or operating margin leverage on increased sales. And third, the capacity utilization today for ShawCor and then maybe if you have a sense for the industry

in large-diameter pipe coating. And capacity utilization today, and then, as you're saying, through... as you look at '08 being a very strong period, does utilization go from a depressed level to fully utilized in your expectations in '08? Thanks.

WILLIAM BUCKLEY: Maybe I'll answer your last question and let Alan respond, you know, on your questions relating to margin.

In terms of capacity, our small-diameter capacity is operating, you know, near max capacity right at the moment. Drilling activity's been strong. Where the open capacity is, is in our large-diameter plants, and we expect that we're probably running today at about 30 per cent of maximum capacity if we put on maximum shifting and utilized all of our facilities.

In terms of revenue, that would mean – and it depends on pricing of course – but it would mean that we could add somewhere, you know, in excess of 200 million of revenue with our existing plant that we have in place at the moment.

We do expect, though, that as we run up through 2008, that we'll have to be adding capacity within our existing plants through productivity improvements, and that we'll also have to establish some new greenfield facilities to logistically serve the market as it starts to emerge.

DAVID SACKS: And that number doesn't include Garneau, because you mentioned that they have some large-diameter capacity as well.

WILLIAM BUCKLEY: It does not include Garneau, no.

DAVID SACKS: How much does that help you by, in large-diameter?

WILLIAM BUCKLEY: Well, we estimate that, you know, by acquiring their plant and also being able to realign our manufacturing network that we have in Western Canada – and we'll get some efficiencies by being able to have, you know, more focused factories out there, theirs included – but we believe that through both the Garneau facility and the realignment of manufacturing, that we could probably get another 50 to 60 million of large-diameter capacity in place. And we need to add that capacity and, you know, our first choice is to do it through the acquisition of Garneau and by investing capital into Garneau.

DAVID SACKS: No, I applaud that move. And then in terms of the leverage on that incremental 200 to 260 million in sales that you're suggesting could happen before you add capacity, what's the fixed and variable relationship there? And as that revenue comes on, is it disproportionately profitable?

WILLIAM BUCKLEY: Those large-diameter plants have relatively low fixed cost as a percentage, but you do get some absorption throughputs. We also did get some advantages in terms of our raw material contracts, which have, you know, often have rebate thresholds built into them, so as volume increases you get larger rebates. And that has a fairly dramatic effect because we are material sensitive. And you know, additionally what we're going to get is the pricing power effect as capacity for us and for the industry starts to tighten up.

DAVID SACKS: And is 30 per cent your sense of sort of where you think the industry is, and given where large-diameter pipe orders are now through, I believe Oregon Steel's sold out through the third quarter of '08 and said on their

last conference call that they see the cycle running into 2011, as one example. Is the rest of the industry running at this 30-ish per cent level?

WILLIAM BUCKLEY: Well, I think there's a competitor that we have, Wasion(phon), that really only has one large-diameter facility and it's in Kuantan, Malaysia. It's actually located almost across the street from our facility in Malaysia. And both of our facilities are running quite actively there right now. So I'd say their utilization, you know, I'd estimate it at being higher than 30 per cent. I would think 30 per cent is a good average for the industry in total.

DAVID SACKS: Yeah, but that plant won't help Canadian demand.

WILLIAM BUCKLEY: No. No.

DAVID FECKS: Okay. Alan, I had a few questions as well that were asked earlier.

ALAN THOMAS: Okay. Oh, on the margin, one way we try and answer that is by, if you look back, 1998 was the previously best year we've had and in that year when you looked at operating margins, we were in total above the 15-16 per cent as a percentage of sales. But in the pipe coating we were 19 per cent, and that's on an annual basis as opposed to just a quarterly basis. So we see that still as a target that, you know, we would expect in the pipe and pipe services sector 19, 19.5 per cent operating margins, EBITDA margins 21, 22 per cent is where we would put in the pin as targets.

DAVID SACKS: And would '98 have been a year where large-diameter pipe coating was...

ALAN THOMAS: Yes.

DAVID SACKS: ... 100 per cent absorbed?

WILLIAM BUCKLEY: It was pretty close to being 100 per cent absorbed. We had the Alliance pipeline project running in North America, which was basically eating up all capacity for us and others in North America. And then in the North Sea we also had our Farsund operation running flat out.

DAVID SACKS: Thanks.

OPERATOR: Your next question comes from Neil Jacobs, of Beaudry Capital Management. Please go ahead.

NEIL JACOBS: The previous caller just asked my questions, very good questions. Thanks, guys.

WILLIAM BUCKLEY: Okay, thanks.

OPERATOR: There are no further questions at this time. Please continue.

WILLIAM BUCKLEY: Okay, thank you, Operator. I'd like to take this opportunity to thank everyone for calling in today, and I look forward to talking with you at the end of the second quarter. Thank you.

OPERATOR: Ladies and gentlemen, this concludes the conference call for today. Thank you for participating. Please disconnect your lines.

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