

Transcript of ShawCor's Third Quarter 2006 Results Conference Call

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OPERATOR: Good morning, ladies and gentlemen and welcome to the ShawCor third quarter financial results conference call. At this time, all participants are in a listen-only mode. Following today's presentation, instructions will be given for the question-and-answer session. If anyone needs assistance at any time during the conference, please press the \* followed by the 0.

I would now like to turn the conference over to Jim McTurnan, Vice-President, Legal. Please go ahead, sir.

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

Today's conference call includes forward-looking statements that involve estimates, judgements, risks and uncertainties that may 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, as well as quarterly reports for the first three quarters of 2006. Copies of these reports 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).

I'd now like to turn the meeting over to our President and CEO, 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.

I can report that we are quite pleased with our third quarter results. As we had indicated earlier, we expected weaker performance in the quarter. However, revenues were better than expected due to stronger than anticipated pipe-coating activity in the Americas region, as well as the positive impact to the major KOC project in the Middle East.

In fact, revenue in the quarter constituted a record for a third quarter and operating income continued to show year-over-year growth. Earnings per share in the quarter were \$0.22, and this is after charges for facility and overhead rationalization in Leith and in Nigeria which will improve the operating cost structure at these facilities in the future.

In the quarter, we also wrote off the capitalized transaction costs upon the termination of the Garneau arrangement agreement. With the Garneau deal terminated, we subsequently announced on October 10th a \$30 million investment in a new pipe-coating facility in Camrose, Alberta, and work has begun on this project.

Earlier in the quarter, we announced the acquisition of the 50-per-cent equity interest in Eupec, Brazil, which expands our activity in this important geographic region. I'll provide some additional information on our performance and the outlook for our business. But first, I will ask our CFO, Gary Love, to provide some additional detail on our third quarter results.

GARY LOVE (Vice-President, Finance, Chief Financial Officer, ShawCor Ltd.): Well, thanks, Bill, and good morning.

First, I'd just like to make a quick reminder to call participants that our third quarter press release, if you haven't already obtained it, can be obtained on our website at [www.shawcor.com](http://www.shawcor.com).

To begin with, third quarter results continue the trend of year-over-year improvement that was so evident in the first half of this year. Revenue for the third quarter of \$245 million was up 3 per cent over the third quarter of 2005.

On a segmented basis, revenue in our pipeline and pipe services segment at \$211 million was up marginally from the prior year while the petrochemical and industrial segment reported revenue of \$35 million for an increase of 21 per cent over the prior year. Year-to-date consolidated revenue of \$766 million has increased by 8 per cent over the prior year.

In the pipeline segment, we were able to generate sufficient revenue growth through increased activity in North America and the Middle East to offset the \$42 million year-over-year decline in Europe. That decline resulted from the fact that the third quarter of 2005 had seen very significant sales from the Langede project in the North Sea.

Year-to-date pipeline segment revenue has increased 7 per cent over 2005 with significant gains in North America and the Far East region more than offsetting the \$100 million decline in Europe and Africa activity.

Looking at the third quarter compared to the second quarter of this year, revenue in the pipeline and pipe services segment was lower by 7 per cent.

Generally pipeline segment activity levels in the third quarter are impacted by seasonal trends in western Canada with third quarter activity being typically the weakest quarter of any year.

In the third quarter of this year, this seasonal factor was somewhat mitigated by the start-up of large diameter project work. In addition, we saw a significant decline in revenue from the second quarter in the Far East region where several major projects in both Malaysia and Indonesia were completed in the second quarter.

In the petrochemical and industrial segment, revenue increased by 17 per cent year over year on strong demand in both the ShawFlex and DSG-Canusa units. Compared to the second quarter of 2006, segment sales declined 4 per cent and this was primarily due to shutdowns at DSG-Canusa's industrial and automotive customers and these would be the summer shutdowns.

On a year-to-date basis, the petrochemical and industrial segment has reported an increase in revenue of 14 per cent with both ShawFlex and DSG-Canusa contributing to the revenue growth.

As noted during previous conference calls, the strengthening of the Canadian dollar has somewhat obscured the growth occurring in our foreign currency entities that are translated to Canadian dollars for reporting purposes. When we factor out the impact of the higher Canadian dollar, our underlying business growth in revenues on a year-over-year basis was 12 per cent compared with the reported growth of 8 per cent.

Now, if we turn to operating income from continuing operations, we again reported year-over-year growth despite incurring some significant charges for rationalization activities in our Europe and Africa region and also an increase in corporate costs associated with the termination of the Garneau acquisition.

On a consolidated basis, operating income at \$23.6 million was 8 per cent ahead of the third quarter of 2005 and on a year-to-date basis, operating income has improved by 52 per cent over the prior year.

In our pipeline and pipe services segment, operating income increased by 6 per cent to \$24 million. This reported result includes \$5.4 million in charges related to facility rationalization in Nigeria and the mothballing of production facilities in Leith, Scotland. Excluding the rationalization charges, the growth in pipeline segment operating income on a year-over-year basis was 30 per cent with margins improving from 10.8 per cent of sales to 13.9 per cent.

Now, compared to the first half of this year, operating margins had been impacted by increasing fixed costs associated with the build-up of infrastructure in advance of new facility launches, first in Portland, Oregon, as well as increases in Western Canada that will support future pipe-coating activity growth.

On a year-to-date basis, pipeline segment operating income has grown by 49 per cent with the operating margin at 14.8 per cent compared with 10.5 per cent in 2005. In the Petrochemical and Industrial segment, operating earnings reached a record level for the segment at \$5 million, a result that represented a 67-per-cent improvement over the prior year.

Operating income margin at 14.3 per cent in the third quarter was up close to 4 percentage points over the prior year. Both DSG-Canusa and ShawFlex contributed to the strong results and as expected, ShawFlex received a boost from higher selling prices that provided full recovery of copper price increases that had been experienced in the first half of this year.

As with our revenue, the impact of the stronger Canadian dollar on the translation of foreign entities has been a negative factor and has obscured underlying operational profit improvement. On a year-over-year basis, the stronger Canadian dollar reporting currency has reduced reported operating income by \$6 million.

Corporate administrative costs increased by \$1.7 million over the prior year. Over \$1 million of the increase is attributable of the write-off of legal and other closing costs that had been capitalized in the first half in anticipation of the closing of the Garneau acquisition. With the termination of the Garneau transaction, these costs were written off.

Depreciation in the third quarter at \$13.3 million increased over both the prior year and the second quarter of this year. The reported depreciation includes \$2.8 million in fixed asset write-offs that forms part of the \$5.4 million facility rationalization charges in Europe and Africa. Excluding this amount, the depreciation for the third quarter is actually down about \$700,000 from the prior year. That year-over-year reduction of course attributable to the lower amortization in Norway following the completion of the Langeled project.

Now, this reduction in depreciation is being partially mitigated by increasing depreciation following the commencement production at our new facility in Indonesia, our new insulation facility in Brazil that started production in the third quarter, and in the fourth quarter, we will launch and commence depreciating our new plant in Portland, Oregon.

With operating income up and depreciation significantly higher, EBITDA came in at \$36.9 million, or \$0.50 per share, an improvement of 12 per cent from the prior year. The EBITDA margin of 15 per cent was down from the 16.8 per cent margin of the second quarter but again improved over the prior year. On a year-to-date basis, EBITDA has increased by 32 per cent to \$129 million, or \$1.74 per share.

The income tax expense of \$8 million in the third quarter represents an effective tax rate of just over 32 per cent. This of course is below our expected tax rate of 34 per cent.

As noted previously, we are currently benefiting from the utilization of tax losses in the U.S. so that the accounting benefit of which has not been previously recognized. This benefit has again been partially offset by losses from operations, principally Nigeria, where we are not reporting any tax benefit.

At the end of the third quarter, we continued to have approximately \$25 million of unrecognized tax losses in the U.S. that are available to shelter taxable income in upcoming periods.

Net income from continuing operations of \$16.5 million, or \$0.22 per share was down from reported earnings per share of \$0.46 in the third quarter of 2005.

It should be remembered however that the third quarter 2005 income from continuing operations included a significant one-time tax recovery benefit that arose on the sale of our Omsco division. Excluding this tax recovery of \$18.4 million, or \$0.25 per share, provides a more meaningful comparison to this year's results.

Turning to the cash flow statement, you will note the very strong cash flow generation in the third quarter with cash provided by continuing operations for the third quarter before working capital changes at \$27.5 million, or \$0.37 per share. This provided an improvement of 37 per cent from the \$0.27 per share in the prior year if we exclude the aforementioned \$0.25 per share tax recovery benefit.

Net working capital declined by \$34 million in the third quarter, a decrease that was proportionately much greater than the 6 per cent quarter-over-quarter sales decrease. This result was accomplished to a 10-per-cent reduction in raw material inventories and a three-day reduction in our average receivables day sales outstanding. Year-to-date, the change in working capital has provided a source of cash flow of \$47 million.

The company's growth initiatives are leading to increases in our capital spending. Capital expenditures on plant and equipment in the third quarter totalled \$21.5 million with the major projects being the new Portland, Oregon pipe-coating facility, land development and facility preparation at our new site in Camrose, Alberta, significant expansion investments at our Thermotite plant in Norway, and that will include or does include a major R&D initiative to install a

pilot line for new insulation coating developments. And finally, plant upgrades related to the KOC project at our pipe-coating plant in the United Arab Emirates.

The other major capital expenditure in the quarter was the acquisition of a 50-per-cent interest in Eupec, Brazil, which operates a pipe-coating plant adjacent to the Vallourec & Mannesmann pipe mill in Belo Horizonte. Eupec, Brazil will be operated as a joint venture under common management and with the same partners with whom we have established our Thermotite, Brazil operation. This joint venture will enable ShawCor to offer complete range of anti-corrosion coatings along with high performance insulation coatings to serve both the on-shore and off-shore Brazilian pipeline markets.

Net cost of acquiring the 50-per-cent interest in Eupec, Brazil, was \$8.6 million and the acquisition is expected to be immediately accretive.

Despite increasing capital expenditures, the strong cash flow from operations translated into continued strong free cash flow which in the quarter exceeded \$31 million and year to date exceeds \$90 million. Free cash flow was partially deployed through the common share dividends of \$3.3 million in the third quarter and through continued share buybacks under our normal course issuer bid.

During the quarter, we purchased 197,000 Class A shares at an average price of \$18.37 for a total cost of \$3.6 million. Year to date, we have bought back 433,000 shares at an average price of \$18.01 per share and a total cost of \$7.8 million.

Finally, the balance of our free cash flow has translated into a \$70 million growth in cash resources with a total cash balance of \$270 million at the end of the third quarter. This compares with total debt outstanding of \$84 million.

On that note, I'll turn it back to you, Bill.

WILLIAM BUCKLEY: Thank you, Gary.

I'd like to offer some brief comments on the key highlights from the third quarter and then provide you with my perspective on ShawCor's outlook for growth over the next three years.

In recent months, several important initiatives have been undertaken to position the company for profit growth in 2007 and beyond. In Europe and Africa, we have taken steps to rationalize facilities and reduce overhead to respond to market uncertainties in Nigeria and the reduction in business activity in the North Sea in 2007. These actions include writing off redundant assets and reducing administrative costs in Nigeria, as well as demobilizing our Farsund facility in Norway and the two coating plants in Leith, Scotland.

The North Sea demobilizations are expected to last through 2007 but commencing in 2008, most of our available capacity is expected to be required to manage a number of major large-diameter pipe-coating projects that are currently under development.

These measures, while impacting profit in 2006, will enable the Europe-Africa region to continue to develop key new projects at a cost that can be absorbed by a much reduced volume of revenue. In the Americas region,

revenues continued to grow and several strategic initiatives have been implemented that will provide significant growth potential in 2007 and beyond.

First, we have now firmly established a strong presence in the South American market through our twin joint ventures in Brazil. During the quarter, we completed the acquisition of 50 per cent Eupec, Brazil, and commenced production on the PDEG, deep water insulation coating project at our new Thermotite, Brazil facility.

The South American region has been the sole domain of our largest pipe-coating competitor and having now acquired Eupec, Brazil, we are well positioned to gain market share and expand our scope into high-potential South American markets.

In the months ahead, we expect our investment in Brazil to enhance both our operating income and our strategic and competitive position. In North America, we have seen that the strong market in Western Canada has continued and been joined by increasing activity in the U.S. In this month of November, we will be ready to commence coating activity at our new facility in Portland, Oregon. And by mid-2007, our new state-of-the-art facility in Camrose, Alberta, will begin full production and augment our ability to service high-temperature insulation coating requirements associated with several tar sands projects.

These investments are necessary and prudent in light of our record backlog in North America and will drive growth in the future. It should be recognized, however, that such investments necessitate increases in fixed expenses that have impacted third quarter results.

In the Middle East, we commenced production at our United Arab Emirates facility on the 56-inch Kuwait crude oil export pipeline project including both anti-corrosion and concrete weight coating. We are currently undertaking detailed engineering analysis to support a plant expansion in capacity at our Ras al Kaimah facility in the Emirates. A large number of projects presently being developed in the Persian Gulf provide us with the confidence to evaluate this capacity expansion and we expect to be finalizing plans in the fourth quarter.

In addition, our Saudi Arabian joint venture has a record backlog at the end of the third quarter and has now commenced coating on the \$60 million Khurais project for Saudi Aramco.

At our other divisions, we continue with expansion activities that were initiated earlier in the year. At Canusa-CPS, we successfully commissioned a new extrusion line and expect further capacity additions in 2007. ShawFlex will significantly add to its capacity with a start-up in the fourth quarter of a new cabler and a new jacketing line.

At Guardian, we launched production late in the third quarter of a new facility that is co-located with a major customer to offer integrated drill pipe inspection and refurbishment. The launch has gone very well and the facility is expected to reach full production by the end of this year.

Now, looking ahead to the fourth quarter of this year, as suggested in previous conference calls, we do expect the fourth quarter revenue will weaken slightly from the third quarter, which with costs associated with the new facility construction in Oregon and Camrose will impact operating income. This outlook

reflects continuous strength in the Americas, offset by market softness in Europe-Africa and the Far East.

In 2007, we expect the Americas region to remain strong with an active large-diameter market. While we don't anticipate any large increase in year-over-year revenue in 2007, we do expect profits to increase due to the profit improvement initiatives that we have been implementing over the last several months.

In 2008, we expect large-diameter coating activity to increase in the Europe-Africa region while the Americas market continues strong. This will have the effect of increasing both ShawCor's revenue and profit performance in 2008 versus 2007.

Projects such as the G&E project in the North Sea, and it was formerly called the Troll project, and the North Stream project in the Baltic sea have the potential to equal or exceed the largest projects that the company has ever undertaken.

Finally, in the Far East and Middle East, project activity is expected to increase in 2008 and 2009. Our world-class facilities in Indonesia and Malaysia will enable us to participate in projects planned throughout Asia. The Papua, New Guinea to Australia gas project is currently being re-evaluated by the partners. If it is sanctioned, it alone could absorb much of the industry's capacity in the Far East.

With this activity and other expansion activities that we are evaluating, we anticipate that ShawCor's revenue and profits will continue to grow strongly in 2009.

And with that, I'll turn the call back to the operator for questions. Marcia?

OPERATOR: Thank you, sir. Ladies and gentlemen, at this time, we will begin the question-and-answer session. If you have a question, please press the \* followed by the 1 on your pushbutton phone. If you would like to decline from the polling process, press the \* followed by the 2. You will hear a three-tone prompt acknowledging your selection and if you are using speaker equipment, you will need to lift the handset before pressing the numbers. One moment, please, for the first question.

Our first question is from Neil Jacobs, with Beaudry Capital. Please go ahead.

NEIL JACOBS: Good morning. Congrats on a good quarter and interesting perspective on the outlook. I'd be curious, you know, regardless of the timeline, based on your existing footprint what sort of capacity you think you have on the top-line and then you know, I don't know if you have assessed costs of adding incremental capacity.

WILLIAM BUCKLEY: Neil, I guess to answer your question in terms of capacity, where we have open capacity at the moment is in our large-diameter plants and as I mentioned in my comments, we have kind of a mixed situation around the world. We are running at about 80 per cent capacity in the Americas region in our large-diameter plants but globally our total capacity take-up is in the

range of 50 to 60 per cent. So without getting into specific numbers, there is an opportunity on the capacity side to fill that capacity and we expect that that will happen over the next 24 months.

In addition to that, as I also mentioned, we are adding capacity. We are adding capacity in the Americas, we are looking at adding capacity in the Mideast and those will be incremental to our plans going forward as well. So in a qualitative way, I think that kind of sums up the potential going forward.

NEIL JACOBS: Got you, and would you characterize... how would you characterize the capacity utilization, if you would, in the rest of your business?

WILLIAM BUCKLEY: Fairly highly utilized in all of our other businesses and in the small-diameter plants within our pipe-coating businesses. And as we commented, we are adding incrementally capacity in our other businesses. We did so at Canusa-CPS. We're doing so at ShawFlex. One phase just completed, another phase under way of capacity additions there and we had an addition in Guardian with a new facility that we have opened up in conjunction with one of our clients in Western Canada.

So incrementally, we continue to add capacity to those businesses and we'll continue to do so.

NEIL JACOBS: Got you. And one more question, if I could. Given the opportunities of deploying capital the way you are seems to be, you know, a very good decision, what, if you totalled all your projects that you have already "sanctioned", what is the total yet to be spent, if you would? And it relates to... my related question is you have such a strong balance sheet and such a strong

outlook, presumably you'll be generating a significant amount of cash over the next few years. How do you envision utilizing that cash?

WILLIAM BUCKLEY: Neil, our capex requirements are rising significantly as we follow the various opportunities that we see in front of us. You know, capex this year will be in the range of \$60 to \$70 million. Next year, it will be higher as we pursue these opportunities. We think there's going to be other opportunities for acquisitions and without getting specific, you know, we want to have the capability to pursue those opportunities as well. And we also, in the interim period, think that there is an opportunity to return cash to our shareholders through share buy-backs and we'll be pursuing that as well.

The market is relatively buoyant now, as you know. Acquisition prices in certain cases are high, but it is a cyclical market and geographically, it's cyclical so opportunities will emerge as we go forward and we're willing to wait until the opportunities meet our hurdle rates and requirements.

NEIL JACOBS: Got you. Would you do a dilutive deal?

WILLIAM BUCKLEY: Potentially, but you know, short term, potentially.

NEIL JACOBS: Okay, great. Thanks a lot and congrats.

WILLIAM BUCKLEY: Thank you.

OPERATOR: Thank you. Our next question is from Levon Von Redden, with Hockey Capital. Please go ahead.

LEVON VON REDDEN: Good morning. Congratulations on the numbers. A couple of questions. You kind of I guess indicated that for 07, we have some puts and takes, strong North America or Americas and kind of offset by some

weakening in Europe, taking that it's going to be almost flattish revenue wise, but you also thought that you have the ability to have some margin expansion. Could you kind of run through or kind of talk about either big buckets from either some of the restructuring actions or whatever to kind of give me some sense as to how I should look at the margins in 07 and how that will expand in 07 versus 06?

WILLIAM BUCKLEY: Sure. We just came off a period in the North Sea of pretty heavy activity. Our Farsund plant was running flat out on the Longeled project and our Leith plant was also running its large-diameter plant in support of that project, which as we have mentioned before, was generating round numbers about \$100 million U.S. a year in revenues. Rather than continue to hold those plants in a condition that they could still operate with a skeleton staff, we have basically shuttered them and that is, you know, represents some costs that we had in the third quarter. But it will mean that as we go forward over the next three quarters or so, before they ramp up again, that our cost structure will be lower in that period.

It also means when the North Sea activity comes back, and we do have some fairly good visibility and are working on projects now and doing bidding on projects that will be coming up and will be working on in late 07, early 08. We know that we're going to get a good response in terms of the margins that we're going to generate on those plants now that we have not only shuttered them but also adjusted their footprints slightly. And that particularly applies in Nigeria where we have adjusted our footprint there.

So some of those things that we have done to basically size our operations appropriately for the coming business will pay off. I think when I talk about the profit improvement programs that we have accomplished over the last several months, a lot of those go to reorganizations that we have done within the Bredero-Shaw organization and the moving in of talent from our other businesses and also hiring talent from the outside and we're beginning to see the positive impacts of that. And that's going to continue on and contribute even more as the revenue line goes up.

So without getting into the specifics of all of those programs that we have undertaken on the profit improvement side, I think those speak to the major elements.

LEVON VON REDDEN: Is there a number in terms of a dollar sign cost improvement that you might be able to share with us in terms of 07 versus 06?

No, we couldn't give you that specific number. What we could maybe advise you to do is to take a look at the last say six quarters and look at the margin improvement that's been accomplished there. And you know, we did say in the most recent quarter we do have some one-time charges and I think we have detailed those out.

So I think if you look at that trend, it'll give you some indication as to what the outlook might be going forward.

LEVON VON REDDEN: Okay, and when the North Sea comes back on in 08, are those expected to come on at margins that are similar to what you're

getting in 07 or is there going to be some leverage in the business as that ramps in the North Sea?

WILLIAM BUCKLEY: That's a good question. Certainly what we have been seeing in the areas that are active is that we are generating better margins than we have in the past, partly because of the positive impacts of the higher rates of utilizations. We'll see that in the North Sea as well. But also generally in the active markets, although they remain competitive, we are seeing that the price-cost relationship is moving up and we anticipate that we'll see some of that in the North Sea as it becomes busier as well.

LEVON VON REDDEN: Okay, thank you.

OPERATOR: Ladies and gentlemen, if there are any additional questions, please press the \* followed by the 1 at this time. As a reminder, if you are using speaker equipment, you will need to lift the handset before pressing the numbers. One moment, please, for the next question.

And our next question is from David Fondrie, with Heartland Funds. Please go ahead.

DAVID FONDRIE: Yes, good morning, and also congratulations on a nice quarter. Would you be so kind as to review the charges, the one-time charges that you incurred in the quarter, some of it delineated here and also tell us where they are reflected in the financial statements?

GARY LOVE: Yes, let me take a stab at that. We spoke of the facility rationalization charges in the Europe-Africa region totalled \$5.4 million in the quarter; \$2.8 million represented asset write-offs, essentially impairment charges

on fixed assets. And that amount is captured in our amortization line item on the income statement.

The balance of the \$5.4 million is captured in operating expenses line item on the income statement relates to provisions for costs that will be incurred to rationalize facilities.

The other item that we made note of was the approximately \$1 million, just over \$1 million in capitalized costs on the Garneau transaction that were written off in the quarter and that write-off amount is contained within the operating expenses line item and on our segmented reporting is captured as part of our corporate cost segment.

DAVID FONDRIE: Great, thank you very much.

OPERATOR: Thank you. And, Management, there are no further questions at this time. Please continue with any closing remarks you may have.

WILLIAM BUCKLEY: Okay, thank you. I'd just like to take this opportunity to thank everyone for listening in today. Thank you.

OPERATOR: Thank you. Ladies and gentlemen, this concludes today's conference call. You may now disconnect.

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