

Transcript of ShawCor's First Quarter 2007 Results Conference Call

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OPERATOR: Good morning ladies and gentlemen. Thank you for standing by. Welcome to the ShawCor First Quarter 2007 Financial Results conference call. At this time, all participants are in 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 hearing the conference, please press star followed by zero for Operator assistance at any time.

I'll now turn the conference over to Mr. Jim McTurnan, Vice President, Legal. Please go ahead, sir.

JIM MCTURNAN (Vice President, Legal, ShawCor Ltd.): Thank you Melissa. Today's conference call includes forward-looking statements that involve estimates, judgments, 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 risk that could affect the company can be found in ShawCor's 2006 Annual Report and Annual Information Form, as well as the Quarterly Report for the first quarter of 2007.

Copies of these reports are available on SEDAR at www.sedar.com. They may also be found on the company's website at www.shawcor.com.

I would now like to turn the meeting over to Bill Buckley, President and CEO of ShawCor.

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

As expected, revenue in the first quarter was down on a sequential and year-over-year basis. However, our overall net income and earnings per share remain strong. Gary will describe in a moment the tax adjustments that favourably impacted net income but first I'd like to take a few minutes to describe the three main factors that contributed to the first quarter revenue decline.

First, in comparing revenue to the first quarter of 2006, it should be noted that in Q1 '06, approximately \$30 million in revenue was booked from the Langed and B2B Projects in the North Sea. In addition, we have significant revenue from large diameter pipe coating projects in Malaysia and Indonesia.

By comparison, in the first quarter of 2007, both our Europe-Africa region and our Far East region experienced low utilization with the Far East region impacted by projects that have been delayed to the second quarter by our clients.

The second major factor impacting revenue is that Western Canada, particularly in the fourth quarter of 2006, saw unprecedented production volumes as a result of very strong small diameter pipe demand. This was coupled with full production at our large diameter facilities in Canada.

In the first quarter of 2007, our Canadian large diameter plants continued to operate at full production, however, the small diameter market was directly impacted by the decline in drilling combined with excess coated pipe inventories in the channel.

The third major factor was the impact of the completion by the end of 2006, of the PDEG Project in Brazil and the KOC Project in the Middle East. These two areas were relatively quiet in the first quarter.

Now, despite the lower revenue, we're pleased with the operational performances of our businesses as the operating margin in our pipeline segment did not contract to the extent that would be expected given the revenue decline. This fact gives us grounds for optimism as we should see margins move higher as revenue levels recover over the next three quarters.

The other strong area of performance for ShawCor in the first quarter was in our petrochemical and industrial segment where revenue, operating margins and operating income all reached record levels.

I'll have more to say about our outlook in a few moments but first I will ask our CFO, Gary Love, to comment on some of the particular accounting and finance developments in the quarter. Gary.

GARY LOVE (Vice President of Finance and Chief Financial Officer, ShawCor Ltd.): Thanks Bill. As Bill described, revenue in the first quarter declined by 20 percent compared with the fourth quarter 2006 and also declined by 16 percent compared with the first quarter of '06. In both cases, as Bill

described, the reductions were tied to fluctuations in major projects in our various regions.

While our pipe coating activity did soften in the quarter, our other business units showed considerable strength with each of our other divisions reporting year-over-year revenue growth and, as Bill mentioned, our petrochemical and industrial segment businesses had a record revenue level of \$40 million in the quarter, up 13 percent from the prior year.

With the decline in consolidated revenue, we would expect operating margins to be impacted. This, of course, stems from the fact that particularly in our pipe coating operations, fixed cost and depreciation are a significant element of the cost structure.

By holding fixed costs and depreciation at prior year levels and with the year-over-year increase in contribution margins that exceeded 2.5 percentage points, the pipeline segment operating margin at 13.4 percent was only down three points from the prior year. And this is despite a 25 percent decline in revenue in that segment. As revenue levels improve in future quarters, we expect the contribution margin gains to drive operating margins higher.

In the petrochemical and industrial segment, operating margins reached a new high level of 17.7 percent with the result that operating income in that segment reached a record of \$7 million.

The depreciation expense in the first quarter, at \$10 million, was in line with the first quarter of last year but was notably lower than both the third and

fourth quarters of 2006. You'll recall that in those two quarters, we had recorded equipment write-offs related to asset redundancies.

Compared with the prior year, depreciation has increased as a result of our new facility in Indonesia and the capital expansions that we've undertaken in Portland, Camrose, Brazil and Saudi Arabia. These increases have been offset by the reduction in depreciation at our facilities in Europe.

Based on the operating income and steady depreciation, EBITDA for the first quarter declined from the record levels of the fourth quarter to \$38.4 million or \$0.52 per share. The EBITDA margin, at 17.3 percent, was unchanged from the level achieved in all of 2006.

Despite the reduction in operating income from the first quarter of '06, our reported net income at \$23.3 million and our EPS at \$0.31 per share were not materially lower than the prior year. This is a result of the fact that in the first quarter of 2007, our effective tax rate came in at a very low level of 22.8 percent. Now this rate compares with the 33 percent rate that we experienced for all of 2006.

Now, several factors account for the tax rate reduction. First, certain of our business units generate income in jurisdictions with tax rates below Canadian rates. This effect reduced our overall rate by close to three percentage points.

Second, we continue to realize the benefit of previously unrecognized tax losses in the US with a favourable impact on our tax rate of three percentage points.

Lastly, the reduction in future tax rates at the federal and Alberta provincial level has caused us to revalue future taxes on our balance sheet with a favourable impact on our tax rate of five percentage points in the quarter.

Now of these factors that I've just mentioned, this revaluation of future taxes should be considered a non-recurring benefit.

Cash provided by continuing operations for the first quarter of 2007, before working capital changes, at \$33 million or \$0.45 per share was basically in line with the prior year. The major change from the first quarter of '06 was in the working capital movement where we saw a \$10 million increase investment in working capital compared with a \$13.6 million reduction in the prior year.

Our receivables and payables were both lower in this quarter and that was in line with the reduction in revenue. What really changed and caused the working capital build was a \$15 million reduction in taxes payable as a result of large tax installment payments that we made in the quarter.

Cash flow from operations continue to more than cover our capital expenditures on plant and equipment in the first quarter. This, despite the fact that capital expenditures, more than doubled from the prior year to \$15.5 million.

Major projects accounting for the spending include our large diameter capacity expansions at our Pearland, Texas facility; continued spending on the new Portland, Oregon facility; an acceleration of spending at our new facility in Camrose, Alberta that's currently under construction; and the commencement of

a major upgrade and capacity expansion at our Ras Al Khaimah facility in the United Arab Emirates.

During the first quarter, we continued to utilize strong free cash flow with our quarterly dividend increasing by 28 percent over the 2006 level. In addition, we spent approximately \$10 million to repurchase 385,000 shares under our normal course issuer bid.

Even with these actions, our cash balances remained very strong at \$302 million and it's worth noting that's significantly higher than the \$243 million a year ago.

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

WILLIAM BUCKLEY: Okay. Thank you, Gary. I'd like to offer some brief comments on our outlook and on our growth initiatives.

To begin with, you should note that our backlog has increased to \$403 million at the end of March and that's up from \$368 million at the start of the quarter. We include in our backlog, only the value of work that we will undertake over the next 12 months and only if the revenue is supported by a firm contract.

In understanding our business outlook, we need to consider the underlying fundamentals in each of our major regions.

First, in our Americas region we are expecting that the high level of large diameter project activity that we have seen in Canada over the past two quarters should remain strong through 2009.

In the US, our large diameter facility in Texas and the new facility in Portland should see increasing volumes as we pick up projects delayed from the first quarter and as the OSM spiral mill in Portland ramps up its production.

In Brazil, the recently awarded BC-10 and hybrid deep water projects should see both our anti-corrosion and our insulation facilities operating at high utilization commencing in the second half of 2007 and continuing through 2008.

The key uncertainty that we face in the Americas is really centered on the Western Canadian drilling cycle and whether we will see a pickup in small diameter demand in the second half of 2007. Without a pickup in drilling activity, our small diameter volumes could stay depressed until 2008.

Now, partially offsetting the small diameter situation will be the commencement of a major insulation project for one of the new oil sands developments. And this project will commence in the second half of 2007 and will be produced at our new facility in Camrose, Alberta.

A second key element in our outlook is the growing prospect of a very strong cycle for large diameter pipeline activity in Northern Europe. It is now quite likely that several large projects will be undertaken to provide gas transmission capacity from both Norway and Russia to Western Europe. And while we won't see the revenues from these potential projects until 2008 and beyond, we will be heavily involved in bid tendering and project engineering throughout 2007 and these activities have begun.

In addition, the magnitude of the potential projects is such that we are undertaking capital expansions at our Farsund, Norway plant with the further need for additional new plant mobilizations currently under evaluation.

Also of great interest to us, is the success that we're having in securing new business in the Mediterranean. In recent weeks, we have secured three major contracts that we will execute in 2007, including the MedGas Project that will be coated in our Malaysian facility as well as two concrete coating projects for major offshore pipelines. The latter will use our portable plant technology to execute these projects in the Mediterranean region.

In the Middle East, we've now shut down our Emirates facility having completed the KOC Project and we will, over the next six months, undertake a substantial upgrading and expansion of this plant to enable this facility to participate in several projects that are scheduled for 2008.

Having seen relatively low volumes in the first quarter, our Far East plants are now ramping up production on several major projects including the aforementioned MedGas Project for the Mediterranean.

Given the planned oil and gas reserve developments that are underway, and in particular, the multitude of LNG projects, both the Middle East and Far East regions offer good potential for consistent growth in 2008 and beyond.

And with that, I'd now like to turn the floor over to the Operator for questions. Melissa?

OPERATOR: Thank you. Ladies and gentlemen, we will now conduct a question and answer session. If you have a question, please press the star followed by the one 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 speaker phone before pressing any keys.

Your first question comes from Dana Benner from Westwind Partners. Please go ahead.

DANA BENNER: Good morning gentlemen.

WILLIAM BUCKLEY: Good morning.

GARY LOVE: Good morning.

DANA BENNER: Well, first thanks for the thorough overview. It's just a bit more specifics if you could.

I'm just trying to get a sense for; you've announced in of the Brazil contract, I guess it was earlier this week or late last week. Can you give us a sense for how much of your business as you look out to '08/'09 of your pipe coating business would be deep water related? Give us a sense as to how your job mix may be changing or how well that market may be coming along for you.

WILLIAM BUCKLEY: Sure, Dana. In the Brazilian market, we've got a very dominant position established now through the acquisition that we made last year and the establishment of our thermal insulation line.

If you look at the BC-10 project and the hybrid project that we had there and you combine that with all of the project work that's coming out of our Thermotite facility in Orkanger, and you look at the expansions that we're making in foam insulation technology in the Far East, and there is the potential that there will be another cycle of deep water projects in the Gulf of Mexico and we're evaluating those.

I think that what we're going to see is an increasing of percentage of our revenues coming from offshore deep water projects.

To give you a metric though, in 2007 we'll probably see somewhere in the neighborhood of 10 to 25 percent of our revenues coming from offshore deep water.

What is still dominant in our business, is the offshore transmission line projects that involve our heavy coat concrete weight coating. And that kind of dominates the revenue number in the offshore area, at the moment.

DANA BENNER: Right. Could you give us a bit more of a window into, you know, I think you've given us some pretty good insight on how '07 may be shaping up, but as we look out to 2008, maybe I guess, first talk about work that you know will be going forward, and I guess a little bit of that will be in the backlog given it's a 12 month out number. But - so, what do we know you have and then what are the major projects that you think could hit in '08, overall?

GARY LOVE: Sure. I guess taking it by region, in the Americas region we're quite strong and we're saying we're going to remain strong.

Some of the projects we've announced, some projects perhaps we don't have firm purchase orders for and those we haven't announced. But, you know, at the moment we are working on the Corridor and TMX Projects, the Rockies Express Project. We do have the insulation project coming at us, the Wapasu Project and the Southern Lights Project. We do anticipate that we will be getting other additional projects in the Americas, but as I say, those are not announced at the moment and we do expect that the Americas region will stay strong through the remainder of 2007 and all of 2008 and into 2009.

The real uptick in revenue is going to come from the projects that we mentioned in the North Sea and Baltic and those projects we don't have purchase orders on them yet and they are, you know, progressing through the engineering and sanctioning stage at the moment. They're not certain and we said that, but they're likely, would be our estimation.

And as some of those projects are related to work that Statoil is doing and that's bringing Norwegian gas to Europe and one of those projects is related to Gazprom Project and bringing Gazprom gas from Russia down to Europe. And that one has been reported on in the press quite widely and that's the Nordstream Project.

And Dana, that's where the uptick's going to come in the European region. And then, you know, we've mentioned that in the Far East, it's beginning to get more active again and we see continued growth there really driven by the

expansion in the local economies there, and also the expansion in LNG gas that's coming to Europe and coming to North America increasingly.

DANA BENNER: Right. What about, how would China figure into your three year plan?

WILLIAM BUCKLEY: We, you know, some of our business operate in China now. There are some significant projects coming up in China that we're doing work on at the moment in preparation for them; sort of two areas. One is offshore work.

It looks like, you know, China is going to be an increasing market for offshore deep water products and they're, we suspect that the technology that we have, they're going to need. They don't have that technology in-country at the moment.

And then the other large project that's upcoming is the West to East 2 Pipeline. This is a second major pipeline that brings gas over to the Shanghai area and then is going to proceed on south. And there again, we're hoping that we'll be participating in that and we're working to do that.

Timing on those is really getting out to the edges of our three year horizon but we are doing work on those projects now.

DANA BENNER: Right. I guess just finally, interesting, you know, comments on the oil sands and I just wonder if you can maybe give us a bit more colour as to, you know, how you're penetrating that border market and what you

think the upside might be over the next few years for ShawCor in and around the oil sands.

WILLIAM BUCKLEY: Well, sure. You know, there's take-away capacity right at the moment of about a million barrels a day; that's going to go up to three million barrels a day. There are pipelines proposed that have been reported in the press for that take-away capacity. And, you know, we're working on doing the coating on those projects.

Typically, you know, pipelines that have been proposed have take-away capacity of anywhere from 300,000 barrels a day to 600,000 barrels a day. So, you know, you look at that and you look at the incremental two million barrels a day that has be taken away and that probably means that there's going to be somewhere in the neighborhood of three to six very significant pipelines over the next three to four years.

So, you know, we're working on some of those. We have nothing that we can announce right at the moment, but we expect that we will be in a position to make some announcements, you know, as we go forward through this year.

DANA BENNER: Right. If I could just ask one more question. Turning to the northern pipelines, Mackenzie Valley and, I guess, perhaps the Alaskan pipeline. I just wonder if you have anymore colour, given all the efforts that you've made over the years to stay close to those projects.

WILLIAM BUCKLEY: No. We continue to, you know, work on the engineering phases of those projects and work on, you know, demonstration

lines that are proving out the northern technology. We think that's going to be good for those lines in Canada. We also think they'll be good for some other opportunities around the globe, so we continue to advance our technology aggressively on those programs and be dedicated to them.

In terms of timing, at the moment we see, we're counting on those projects being outside of our current three year horizon. If they come in, that would be great, but that's our sense at the moment.

DANA BENNER: Okay. That's terrific, guys. Thanks.

WILLIAM BUCKLEY: Thank you.

OPERATOR: Your next question comes from David Sachs from Hocky Capital. Please go ahead.

DAVID SACHS: Good morning. Could you address the cost of materials environment for ShawCor and the pricing environment in terms of your ability to pass those costs along to customers and potentially, the goals for margin over the next two to three years in your timeline?

WILLIAM BUCKLEY: Sure David, we've had, you know, high raw material escalation on, particularly on materials that we use such as iron ore, steel that we use in reinforcing mesh in our offshore concrete heavyweight coated products, the certain grades of polyethylene and polypropylene that we use in our offshore deep water insulation products. And also in our downstream businesses, we've had very high escalation in copper prices as well.

I would say that in today's market, it's never easy but we are able to pass through our material cost increases and we would not expect those to have a negative impact on our margins. And, you know, as you've been seeing, our margins have been progressing well and I think that's really because of, in our new product innovations and mix that we have. And then also, as we've mentioned in the past, in some cases you're starting to get tightness in supply and some, you know, competition for access to capacity.

DAVID SACHS: So what is that doing for pricing? So, you've got the ability to pass through raw materials so you're getting that in pricing, and are there any opportunities to enhance pricing just as a demand phenomenon?

WILLIAM BUCKLEY: I think probably the answer to that question is yes, a little. You know, it still is a compatible market out there and we still try to bring value to our clients. But within that environment, I think the answer to the question is yes.

DAVID SACHS: Okay. Thank you.

WILLIAM BUCKLEY: Thank you.

OPERATOR: Ladies and gentlemen, if there are any additional questions at this time please press the star followed by the one. As a reminder, if you are using speaker phone, please lift the handset before pressing the keys.

Gentlemen, there are no further questions at this time, please continue.

WILLIAM BUCKLEY: Okay, I'd like to thank everyone for calling in today and thank you for your questions and we'll talk to you again next quarter. Thank you.

OPERATOR: Ladies and gentlemen, this concludes the conference call for today. Thanks for participating. You may now disconnect your lines.
