# CHAIRMAN'S ADDRESS TO THE 2011 ANNUAL GENERAL MEETING

Good morning, ladies and gentlemen

It is my pleasure and that of my fellow Directors to welcome you all to Schaffer Corporation's 2011 and 57th Annual General Meeting. I thank you all for your attendance.

The financial year that we are here to review was, in a word, challenging. It is fair to say that 'challenging' is also an appropriate description for the conditions in which Schaffer Corporation's divisions have operated for a number of years now. Whilst we would like to report to you every year that trading conditions are the best we have seen and your Company is effortlessly producing record results, we all know that is not the world in which we live.

Our businesses operate in naturally competitive markets and are impacted by broader economic, currency, financial and political forces of which we have no control. What we can control is how Schaffer Corporation's divisions are set up and prepared to respond to difficult conditions and changing circumstances. So whilst the last years have been challenging, your Board has been diligent in ensuring that our businesses have appropriate strategy and 'settings' and the Company's management has worked tirelessly in implementing the strategy set forth by the Board.

It is correct to say that, in its 57-year history, your Company has never been better prepared to respond and adapt to the business conditions in which it finds itself operating. This has been the work of years, has involved great effort and no shortage of very tough decisions. And whilst we cannot deliver record results every year, we are confident that the Company is positioned to deliver the best possible results in the circumstances.

As is typical for these meetings, I will first review Schaffer Corporation's performance in the last financial year and then focus on how the Company is addressing the continuing challenges presented by global and local economic conditions.

**A diversified group**

As you are aware, Schaffer Corporation operates across three divisions, being Automotive Leather, Building Materials and Property. To the extent that these divisions operate in geographically diverse and distinct markets, they provide the Company with natural diversification of risk and opportunity.

One of the reasons for diversification is that it increases the probability that difficult conditions in one market can be offset by stronger performance in another. That was certainly the case last year when Automotive Leather and Property had improved results over the previous year whilst Building Materials, operating in tough trading conditions, had a reduced profit result.

Automotive Leather was a keen example of the type of strategic planning and decision making that the Company pursues. Global economic conditions were poor for the year and the market for automotive leather is global. Nonetheless, the division results were positively impacted by the strategic decisions to withdraw from the low margin whole-hide sales market in Asia and to close and sell loss-making leather cutting operations in Mexico. Those decisions enabled Automotive Leather to concentrate on better yielding products and markets.

Conditions in Building Materials' markets led to increased competitive behaviour, which impacted on margins and profitability. Those conditions included tight bank credit, low consumer spending, low levels of private residential and commercial construction, the slower-than-anticipated start up of major mining projects and currency movements increasing Australian dollar purchasing power, which in turn makes imported products more attractive.

The Property division benefitted from the sale of investment property interests, principally Schaffer Corporation's share of the syndicated joint venture property at 89 St Georges Terrace, Perth. Contrastingly, net rental income declined as a consequence of previous property sales and there was a slight increase in vacancy rates across the portfolio.

At the Group level, the final results were:

- A one percent increase in revenue to $138.0 million
- A 19% increase in earnings before interest and tax (EBIT) to $12.2 million
- A seven percent increase in net profit after tax (NPAT) to $4.8 million, and
- An increase in earnings per share from $0.32 per share to $0.34 per share.

In assessing Group performance, a key internal measure we use is Return on Average Capital Employed (ROCE), which assesses the efficiency of the use to which the Company applies capital in generating profit. ROCE increased from 8% to 11%. As indicated earlier, we believe that the result is the best that the Company could achieve in the circumstances, but is still below our long-term internal benchmark for ROCE of 15%.

The Board's dividend policy remains to pay out a majority of earnings as dividends whenever prudent. In making the decision on dividends for the 2011 financial year the Board was conscious of the uncertainty of prevailing economic conditions. Accordingly, the Board declared and paid conservative dividends of $0.20, representing a payout ratio of 59%.

I will now discuss each division in some more detail.

## Automotive Leather

The Howe Automotive Group (Howe), of which Schaffer Corporation owns 83%, is a global business that exports virtually all of its whole finished hides to China and Europe. Howe operates leather cutting plants in those markets and previously also did so in North America.

As I noted last year, the 'whole hide' market in China has undergone a material and unacceptable deterioration in trading terms. As a result, Howe took the difficult but correct decision to exit that market segment in the second half of the 2010 financial year. Exiting that market improved profitability and is reflected in an improved 2011 financial year result.

A similar difficult decision was taken to close the Juarez, Mexico cutting plant. The plant and its employees were subject to increasing local violence against a background of declining volumes and pricing in the North American market. The closure and sale of the Mexican subsidiary occurred in March 2011 and Howe incurred once-off closure costs during the financial year of $1.3 million after tax. The overall loss after tax incurred for the year from the discontinued operation was $3.1 million.

Being a global business that earns almost all of its revenues in foreign currencies, Howe's results are affected by global economic conditions, particularly foreign currency exchange rates. The revenues are partially naturally hedged by associated foreign currency raw material costs, mostly in US dollars. Nonetheless, the approximate 27% increase in the US dollar and 10% increase in the Euro against the Australian dollar had a net negative effect on Howe's profitability.

Overall, Howe's profitability performance improved substantially from the previous financial year. The Board expects further improvement to achieve satisfactory profits and ROCE levels, allowing for the uncertain and unpredictable effects of any future foreign currency fluctuations.

## Building Materials

The Building Materials division comprises Delta Corporation and Building Products. Whilst the division achieved a 10% increase in revenue, its margin decreased in an increasingly competitive market, the causes of which I mentioned earlier.

Delta Corporation, the pre-stressed and pre-cast concrete manufacturing business, achieved improved revenue due to the improving buoyancy of the resource and mining sector. However, that increased activity came late in the year and margin was compressed for most of the period. As a result, EBIT was lower when compared to the prior year. The increase in revenue was also associated with a decision to re-enter the architectural precast market. That re-entry provided a wider range of opportunities including the Fiona Stanley Hospital Project, which was a major contributor for the financial year.

Building Products, comprising UrbanStone, Urbanstone Central, Archistone (including the new Archistone Masonry products), Limestone Resources, Imported Stone products and Lumeah, recorded a slight decrease in revenue but a substantial decrease in margins. The margin pressure resulted from declining commercial and residential building activity and increased competition. The sales and distribution strategies of the Building Products segment enabled the business to maintain sales volumes, albeit with some margin erosion.

## Property

Property increased its EBIT by 51% for the year. The result was increased by the sale of Schaffer Corporation's interest in the syndicated joint venture property at 89 St Georges Terrace, Perth and a property at 1500 Albany Highway, Cannington.

Underlying rental income from investment properties decreased by 19% following previous property sales and a slight increase in vacancy.

Schaffer Corporation completed the sale and leaseback of three Urbanstone Central retail outlets during the year. The process generated cash of $11.4 million that was used to decrease net debt.

## Asset Backing

Schaffer Corporation continues to adopt a conservative accounting policy of historical cost less accumulated depreciation for valuing its property portfolio. The Company currently estimates, with the support of qualified independent valuations, that there are approximately $32.5 million of post tax unrealised gains on property that are not reflected in those book values. At 30 June 2011, the addition of those unrealised gains increases Group Net Tangible Assets to $5.81 per share compared to the book value of $3.50 per share.

## Cash and Net Debt

I am pleased to report a 16% or $9.6 million reduction in net debt for the Group and, in particular, a $10.9 million reduction in debt with recourse to assets that are 100% owned by Schaffer Corporation. That is, with recourse to the Building Materials and Corporate segments. I note that debt associated with our joint venture property and with Automotive Leather is primarily non-recourse to other assets of the Group.

Schaffer Corporation retired $17.4 million of debt during the year, including $12.1 million for Building Materials and Corporate, $3.4 million for syndicated joint venture property, and $1.9 million for Automotive Leather. Incorporating reliable estimates of market value, the Group's Loan to Valuation Ratio (LVR) is a conservative 33%.

## OUTLOOK

As I said before, these are challenging times. We see some positive signs within volatile and uncertain global economic conditions. That makes forecasting difficult.

Global demand for automotive leather is increasing with developing nations (particularly China) and the rise of their middle classes driving that growth.

The Western Australian resource industry and civil infrastructure projects continue to show strength. Those sectors should underpin the earnings of Building Materials.

Conversely, the reduction in residential and commercial building activity appears to be ongoing within the foreseeable future.

As we are now well into the first half of the 2012 financial year, I will outline how your Board currently expects the first half to unfold.

## Automotive Leather

The first half for 2011 included a loss before tax of $2.1 million relating to the Mexican cutting operation, which will obviously be absent from this year's first half results.

Excluding the discontinued Mexican operation, we anticipate the remainder of the Automotive Leather division to improve profitability through increased first half sales volumes in Europe and China resulting from the commencement of new supply programmes. This should also result in increased operational efficiency flowing from higher volumes.

In September 2011, the Federal Government has entered into a new 10-year loan agreement with Howe to the value of $25 million. This loan will be able to be drawn down on the repayment of $30.7 million principal plus annual interest owing on the current loan agreement, which is due on 1 February 2012. This net reduction of Federal Government debt is expected to be funded from the accumulating working capital of the Automotive Leather division.

## Building Materials

Within the Building Materials division, Delta continues to build a healthy order book with resource industry and civil infrastructure projects within Western Australia gaining momentum. First half production levels and margins at Delta are forecast to improve compared to the prior year.

However, Building Products' first half revenue and margin is expected to be similar to the first half of last year as a result of the continuing suppression of activity in the residential and commercial building sectors. We had previously anticipated an improvement in those markets.

Given the diversity of its operations, the Building Materials division expects overall profit improvement should the anticipated resource and civil infrastructure momentum offset the continued slowdown in commercial and residential building activity.

Whilst margins have been impacted as Building Products seeks to maintain sales volumes, the business is well positioned to take advantage of any upturn in the market given its complimentary product range development, which now includes our new masonry block range, and the national distribution network of Urbanstone Central concept stores.

## Property

We anticipate net rental income from the Property division for the first half to be lower than in the previous corresponding period, as a natural result of the further property sales last year and in the current period.

During September 2011, the syndicated joint venture property at Vulcan Road, Canningvale was sold. Schaffer Corporation's proceeds will generate $0.4 million profit before tax. As a result, the Company expects overall EBIT for Property to improve on the prior year. In the leasing market, additional incentives may be required to fill remaining rental vacancies.

## Share Buy-Back

As part of the Company's capital management, we have recently announced an on-market share buy-back for a maximum of 700,000 shares (approximately 5%) over the 12 months from 2 November 2011.

## Dividends

In line with policy, in January 2012, the Board will consider the interim dividend after reviewing the preliminary half-year results and the anticipated conditions for the second half of the 2012 financial year. At present, the Board expects to declare and pay a fully franked dividend of at least $0.10 per share.

## Summary

To summarise, your Board expects the current year to be – again – challenging due to the combination of global and local economic conditions. Nonetheless, given the strategic positioning of our businesses, the diversified nature of the Group and some growing momentum in particular markets, there are positive signs.

Whilst we anticipate improved earnings for the first half over the prior year, volatility makes it imprudent to make a forecast at present for the full year. The Board will provide an update on the full year outlook in February, when Schaffer Corporation releases its first half results.

During these volatile and uncertain times, as in the good times that we have shared and will share again, your Board appreciates your support of the Company as shareholders.

We also value, as we know you do too, the dedication of our employees in a period when we must work ever harder to address the challenges we face.

The executive management team remains strongly focused on creating long-term shareholder value and positioning our various businesses to achieve the best long-term result for shareholders.

I look forward to seeing you all again next year.

John Schaffer
Chairman

16 November 2011