ASX ANNOUNCEMENT: 29 August 2011

CEO & CFO on FY Results & Outlook

Open Briefing interview with CEO Terry Stinson and CFO Keith Halliwell

Orbital Corporation Ltd
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Orbital Corporation Limited (ASX OEC) provides engineering innovation, support, design, product development and operational improvement services to producers, suppliers, regulators and users of engines and engine management systems for application in motorcycles, marine and recreational vehicles, automobiles and trucks.

Current Market Cap $17 million

In this Open Briefing® Terry and Keith discuss:

- Continued profitability with improved margins and Synerject growth
- Additional revenue in FY12 with the launch of Ford EcoLPi
- Outlook for growth markets and opportunities in China

Record of interview:

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Orbital Corporation Limited (ASX: OEC) reported underlying NPAT of $0.16 million for the year ended June 2011, compared with an underlying loss of $2.30 million in the previous year. Profit in the second half was $0.13 million and Orbital has now booked underlying profit for three consecutive halves. Do you see further recovery in the current year ending June 2012? What will be the earnings drivers?

CEO Terry Stinson:
Orbital booked an underlying profit for the year and is on track for further improvement. The investments we've made in the Ford Falcon EcoLPi system, as well as our other businesses are expected to begin to bear fruit this year. The earnings drivers will be the launch of EcoLPi which will generate additional revenue for the Orbital Autogas Systems (OAGS) business, and we expect further growth in other areas of the business. The coming year is not without its challenges. The continuing strength of the Australian dollar makes it more difficult to trade with international customers, and this will also impact the translation of our Synerject dividends and our US dollar-based royalty revenues.

Synerject has been a real earnings performer for Orbital over the past few years and has done especially well over the past 12 months. This is projected to continue into the coming year. Synerject is the highest performer in the Orbital stable and the results from this segment are often overlooked by investors. The contribution from Synerject provided underlying financial support over the past two years and facilitated Orbital's ability to make investments in new business streams such as alternative fuels and Unmanned Aerial System (UAS) engines. As noted in the past, our strategic plan is to use the Synerject model to grow organically and also through acquisition. We have a five year plan for growth and I am excited by our prospects for the future. Synerject continues to be a primary driver of earnings for Orbital in this plan.

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In February, Orbital undertook the sale and lease-back of its head office property for $8.65 million, booking a $4.24 million gain. This contributed to an increase in cash and equivalents, which stood at $6.87 million as at the end of June, up from $3.61 million a year earlier. Can you comment on the adequacy of this cash buffer for the nearer term needs of the business?

CFO Keith Halliwell
We anticipate growth this financial year with a significant part of that driven by Sprint Gas Australia (SGA), which will make a full year contribution. We'll require working capital funding for the ramp-up of the Ford EcoLPi but that can be supplied via our cash buffer. We'll target further acquisitions as opportunities arise, but at this stage we have adequate cash for our known requirements.

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You acquired 55 percent of Sprint Gas in May. Sprint Gas is an importer, assembler and distributor of automotive LPG conversion kits in the aftermarket. You've flagged an interest in further acquisitions. What are your acquisition criteria and to what extent will you be looking for acquisitions like Sprint Gas that are a "step out" from your core activities?

CFO Keith Halliwell
We see Sprint Gas as part of our core activities. Our core business is engineering innovation but we're also looking at businesses offering different channels to sell our innovation. For example, our Liquid product is sold in the LPG aftermarket and the Sprint Gas acquisition added a broader channel to sell this product. Our underlying acquisition criteria are return on investment, growth potential and synergies with our existing businesses. Sprint Gas ticked all those boxes.

We're also interested however in adjacent businesses that still meet our investment criteria. We have key criteria like growth potential, management, quality brands and relevant industries, but are willing to take a "step out" from core activities for an appropriate acquisition.

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Orbital booked net operating cash outflow of $1.79 million in 2011, versus outflow of $5.05 million in the previous year. What were the key drivers and can the cash flow improvement trajectory be sustained?

CFO Keith Halliwell
Our reduced cash outflow was driven by improved day to day operations. We reduced overhead costs across a range of expenses like travel, communication, insurance and patents. We also spent less on Liquid kit development as we completed a range of kits for the LPG aftermarket. Gross margins generated by OAGS improved with the strengthening Australian dollar and our product mix. We also reduced working capital, in particular by reducing inventory and increasing payables.

The expense reductions are sustainable and we'll see a full year benefit this year. We anticipate growth this year and are closely monitoring our working capital requirements.

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What needs to happen for the Changan project to move in to commercial production? What would be the estimated timeline and how would Orbital be involved with the various aspects of the project?

CEO Terry Stinson
Changan has many advanced projects moving forward in parallel. Some of these are targeted at improving fuel economy and emissions. This project proved technical capability; the FlexDI technology integrated into Changan's ICCS engine delivered 20 percent reduction in fuel consumption. Changan will now determine the commercial feasibility of FlexDI and compare this to other alternatives that it has developed. If FlexDI is determined to be commercially feasible, Changan will then pick a platform and begin to select potential suppliers. From my experience, the evaluation process can take 12 to 18 months, perhaps longer.

A new engine project like the ICCS with FlexDI would take three to five years and require further significant investment by Changan to get to commercial production. The engine to vehicle part of the project can happen almost in parallel if Changan decides to use an existing platform. The integration of FlexDI requires base engine changes as well as the incorporation of advanced fuel and engine management systems. The new base engine components, like the cylinder head, require new tooling and equipment which have long lead times. The new tooling and capital required drive the front end timing for the project; the vehicle integration reliability and durability testing and certification drive the back end.

In my view, this commercial feasibility gateway is the point where Orbital's automotive projects have stalled in the past. Orbital is limited by not being a mainstream automotive systems supplier like Bosch or Delphi, as we don't have the financial strength to fund a major automotive program and this raises the risk level for the customer. Suppliers like Bosch and Delphi have their own competing Direct Injection systems and are very reluctant to consider adopting and supporting a new technology. The barrier to entry has been much lower for the non-automotive market, allowing the same Orbital FlexDI technology to sell into over 650,000 engines in this market. Based on history, I'm cautiously optimistic that Changan will take Orbital's FlexDI into production.

Our primary thrust moving forward with Changan will be on the engineering side. If the ICCS program moves forward, the program support from Orbital could exceed the proof of concept phase. From this success we expect that there will be other programs with Changan.

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Alternative Fuels generated an underlying loss of $0.76 million (excluding the write-off of capitalised development costs and provision for slow moving inventory) in 2011, compared with a loss of $1.73 million in 2010. Revenue declined by 6 percent to $5.85 million. To what degree was this earnings improvement due to structural cost savings versus the impact of exchange rate movements, including upon the cost of materials?

CEO Terry Stinson

The improvement was mainly due to overhead management. Ford stopped production of their previous generation LPG Falcon in September 2010 and OAGS had to adjust costs at all levels to compensate for the loss of sales. The OAGS team delivered the required savings and I'm pleased with its performance. In parallel, the team focused on growing our after-market sales which helped soften the drop in Ford business. The lower level of trading due to Ford ceasing production minimised the effect of the exchange rate.

CFO Keith Halliwell

Gross margins also improved due to the sales mix. A significant part of our aftermarket revenue is made up of spare part sales, which provide better margins than supply to OEMs. Lastly, margins also improved because we bought Sprint Gas towards the end of the year – Sprint Gas has better margins than OAGS.

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In 2012, what is the expected contribution to Alternative Fuels from the Liquid LPG system (Liquid LPi), which is fitted to the recently launched "EcoLPi" Ford Falcon, and what is the outlook for the LPG aftermarket? How are your expectations of demand in these markets reflected in your level of investment?

CEO Terry Stinson

We expect a major contribution from the sale of Ford EcoLPi components this year. Last year, OAGS had no Ford production from September through the end of the year. Over the next few months we'll be ramping up to full production with Ford. The value of the content we sell to Ford on EcoLPi will be higher than that on the previous model.

We have a sales plan, however the market will ultimately decide on the level of sales for the full year. Feedback from the motoring press on the Ford EcoLPi vehicle has been very good. I've driven a number of the test vehicles and they really deliver on performance.

The aftermarket picked up late last year however it's still significantly down year on year. The downturn created an unexpected advantage for Orbital. OAGS picked up sales when one of our key competitors failed. This was one of the biggest players in the market. The best time to make a strategic acquisition is often in a declining market. We feel that the Sprint Gas acquisition fits in this category. Orbital has the best system on the market and now has a mature distribution channel. Sprint Gas also carries a full line of LPG products.

I expect the aftermarket to continue to be depressed until fuel prices rise and the world economic situation improves. There is, however, an underlying trade-user market that has been less affected than the consumer market and that will support the continuing profitability of our LPG aftermarket business, even in a depressed market. The Australian LPG aftermarket has experienced many highs and lows over the years, primarily driven by the price of petrol. Ford and Holden have invested heavily in new advanced LPG vehicle platforms with the expectation that the market will be sustained and hopefully grow. We'll have the right product alternative for Australian car buyers when the price of petrol rises and squeezes the pocket books of fleets and average drivers.

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Orbital Consulting Services (OCS) booked pre-tax profit of $0.16 million in 2011, down from $1.03 million in 2010, on revenue which was down marginally to $9.49 million. Pre-tax profit in the second half was $0.13 million, up from $0.04 million in the first half, on revenue of $5.29 million, up $1.09 million. Is the momentum of the second half sustainable in a high Australian dollar environment?

CEO Terry Stinson
The momentum is sustainable for both our domestic and overall business. Our domestic alternative fuel initiatives will be less affected by the exchange rate. International projects like our UAS engine systems initiatives rely on FlexDI, Orbital's proprietary technology. FlexDI is only available from Orbital so we have a unique selling proposition that partially insulates us from the strong Australian dollar.

However, the high Australian dollar is of course still impacting our OCS business. International customers seeking general power train and vehicle engineering and testing have options. OCS costs have effectively increased for international customers over the past 18 months due to the big swing in exchange rate.

Our goal is to offset the potential downside due to the exchange rate through higher domestic revenues and profits from our new business activities. We need to continue to win consulting services contracts to protect our core engineering infrastructure. This core supports the birth and growth of new businesses like Synerject, OAGS and Sprint Gas.

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Orbital's Royalty and Licence pre-tax profit was $0.61 million in 2011, down 17 percent on 2010, with revenue of $1.08 million, down 10 percent. What was the impact of the high Australian dollar on earnings and are there any indications of improvement in the US marine and recreational markets?

CFO Keith Halliwell
The business is profitable, cash flow positive and currently requires minimum investment but we're taking a conservative view on future investment until we see the market improve.

The high Australia dollar eroded earnings by $125,000 compared with the previous year. If the exchange rate had remained constant, profit would have been about $735,000. Our markets were essentially flat, although royalty earning units in the marine market increased slightly. While the market has improved since the onset of the global financial crisis, recent economic uncertainty in Europe and North America does not give us confidence that discretionary spending will pick up in the near future.

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Having completed your program with Changan in China during 2011, what are Orbital's key opportunities in China and in other growth markets in the short to medium term?

CEO Terry Stinson
We expect our China initiatives will continue to grow in the short to medium term but we'll have to offset the significant impact of the exchange rate. The successful completion of Changan leaves us with a hole in our China order book that we're working hard to fill. Our key opportunities are in our traditional markets of engine development and engine management systems. For example, we have just won a smaller engineering project in China based on our success with Changan that could build into another Changan type opportunity.

We're working on offsetting the high Australian dollar by offering unique selling propositions and expect FlexDI will contribute to this. Other potential growth markets this year are India, Taiwan, and the US. As for China, the Changan project was a significant technical success. The fuel consumption reduction achieved on the engine was benchmark. Changan invested a significant amount of R&D and we achieved the targets. Hopefully the project will advance to the next phase of commercial development. If it goes forward, Orbital will be involved in that work. Orbital is also exploring the potential for other advanced R&D projects with Changan.

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Synerject, Orbital's 42 percent owned associate, made a contribution to earnings of $3.23 million in 2011, up from $1.87 million in 2010. The associate's US dollar NPAT was up 37 percent to US$6.50 million, with cash flow increasing to US$8.52 million, up 43 percent. To what extent was the growth driven by demand in emerging markets? What is the outlook for Synerject's earnings and cash flow, given the planned launch of new products over 2012?

CFO Keith Halliwell

Synerject sales grew in a number of areas, including emerging markets. There's demand for Synerject products across a wide range of markets. In 2011 Synerject saw growth in the marine sector, snow mobiles, high end motorcycles in North America and low end motorcycles in Asia.

Synerject's outlook for earnings and cash flow is positive. While growth may not be as dramatic as last year, Synerject will grow again this year. Despite an unfavourable exchange rate, the dividend we received from Synerject increased nearly 80 percent to A$1.2 million in 2011 and we anticipate a further increase in 2012. Synerject has a great management team and we're very pleased with the way the company is developing.

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Thank you Terry and Keith.

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