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Company Insight
the intelligent market update

Swick Mining Services Limited

Date of Lodgement: 24/10/12

Title: "Company Insight – 1Q 2013 Update"

Highlights of Interview

- **Strong conditions remain in Swick's main markets in 2013 after strong FY2012**
- **Swick's predominant underground diamond drilling business is not exposed to the same negative influences affecting companies such as Boart Longyear**
- **Swick provides services at the heart of operating mines – not exploration drilling**
- **Good contract coverage and customer and commodity spreads underlie 2013 prospects that are running at guidance**
- **Discusses rig utilisation levels and explains why the new Swick rig build should receive excellent market acceptance**
- **Discusses trial of the Swick underground drilling technology at the Neves-Corvo mine in Portugal**
- **Outlines reasons for the Company's buyback and explains the strategic thinking behind the Company's continued growth**

Record of interview:

With Kent Swick, Managing Director of Swick Mining Services Limited (ASX: SWK, market capitalisation A$65 million).

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Following the Company's FY 2012 full-year result, and your first quarter operating update for 2013, what are conditions like in Swick's markets?

Managing Director, Kent Swick
The operating conditions for Swick in the current market are strong because we are in the brownfields operating area of the resources sector. Unlike the exploration area, demand for our services is reasonably consistent and we've got a strong contract base with operating miners. I know the wider sector is under pressure with tight equity markets and constrained capital and construction budgets in certain areas, but the work we do in the operating sector is consistent and strong.

In 2012, the underlying Australian business improved as we focused on contract renewals, pricing of new tenders and the mix of the Australian business. We could therefore compensate for some of the temporary dips in our North American business in the second half. The Company's only exposure to greenfield projects was in North America, and all three of those projects were suspended – for conditions outside our control – causing the suspension of around fifty percent of our North American fleet around December and January. But the improvements in our Australian business compensated for this – so overall we had a better position in terms of rig count and new contracts. In the end, our focus on efficiency and productivity allowed us to maintain our financial performance and meet our growth targets.

We've now reached the point, in our sector of the market, where the outlook for Swick is reasonably predictable. Of the three sectors in the resources market – exploration, construction and operations – we are firmly entrenched in the operations sector. The critical point is that our mineral drilling services primarily allow the *mining operations of existing mines to run as efficiently as possible*. The Company's drilling provides information for mine design, ground support, grade control, metallurgical understanding of the ore and reserve replacement. Importantly, our services inform the high level and ongoing decisions about capital investment, and allow operating costs to be properly controlled. Operating mines must also have a reasonable forward position on mine-life and the significant amounts of product our clients produce each year have to be replaced on the balance sheet.

In other words, our work is done at the heart of operating mines– it is not exploration drilling. That means that mines with sunk investments and an ongoing production imperative continue to need the kind of drilling services we supply.

In financial terms, we had an excellent FY2012 in both halves, and we continued to meet guidance as we went along.

To date in FY 2013, and despite a lot of talk about the resources sector, you can see the impact of the points I've made. We are tracking well against guidance at increased revenues of $145–155 million (up from $136.4 million in 2012) and higher EBITDA of $30.5-34.5 million (up from $28.6 million in 2012).

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How is Swick's net debt position performing?

Kent Swick
Net debt is similar to the end of FY2012 at around $6 million. We've just paid a dividend, have a buyback program in place, and have plenty of headroom for growth. Debt reduction has reached a satisfactory level for the moment and because we continue to have excellent growth in the underground diamond drilling business, we will expand our capital expenditure program and build ten rigs this year. Our net debt position is going to remain relatively constant whilst we are undertaking the accelerated capex program and undertaking the buyback simultaneously. Our priority is to use our excess cash in the generation of solid and balanced growth where possible. We are fortunate to have, and should take advantage of, ongoing growth opportunities in what is a 'defensive' part of the drilling market.

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Why is Swick's business outlook for 2013 and the future so different from that announced recently by Boart Longyear?

Kent Swick
Swick has a different mix of business to companies such as Boart Longyear as our primary exposure is to underground diamond core drilling which generates around 80% of our revenue.

The majority of other drilling contractors have a higher exposure to surface drilling and a reasonable mix of junior, mid cap and major clients, so when equity markets can't fund exploration drilling for junior companies, they – like other surface drilling contractors - will be affected to varying degrees.

We are quite different. 90% of Swick's revenue is from underground and 10% from surface - while the vast majority of our competitors have no or little underground exposure relative to the rest of their business. Since underground operations tend to be continuing mines, 90% of Swick's business has this 'continuity feature'. So - within the stable 'operations' component of resources services - we're in one of the most resilient parts.

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What are the specific reasons behind the Company's positive outlook for 2013 and beyond?

Kent Swick
We have pretty good visibility. Our contract lengths are between 1 and 3 years, and we've got a good understanding of where we sit with expiry dates and contract renewals. We have an excellent track record of retaining our clients, and a very good track record of negotiating extensions without even going to tender.

The 2013 year is not so much about replacing what we might lose, but more about the pipeline for growth. There is considerable opportunity in the tender pipeline, and our strong business development focus is targeting regional objectives and clients we want to work with. We will be tendering on multiple drilling rigs across multiple operations between now and the end of the financial year, and we'll have a reasonable chance of winning a lot more work. Swick is now regarded as the world's largest underground diamond drilling contractor, and we provide an excellent value proposition.

In considering our outlook for 2013, most of our revenue is gained in operating mines delivering what we believe to be the most resilient non-ferrous commodities - being gold and copper. In fact our gold customers comprise about 60% of our revenue, and copper and copper/gold porphyry customers deliver another 25%, meaning 85% of our customers operate in markets producing the two strongest commodities.

So - we believe we have developed the business into a position of resilience and we have good reasons for a positive outlook. At the end of Q1, our run rate is on track to meet our guidance.

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The Company recently launched (very successfully) the latest version of its underground diamond drilling rig. What reasons support your view that the rig will be well-received in the marketplace?

Kent Swick
When I say that the Company tries to deliver the best possible value to our clients, this means we focus not only on safety and quality but also on our productivity and costs. Our internal target of doubling metres-per-man-hour over 5 years is a real efficiency target, and a key metric for our operations. Labour is about 60% of the cost base of our services, and so we focus on improving output per manhour. Achieving progress in this area represents additional value to our clients, and our clients should reward us - and have done so in the past. This business focus can generate strong financial outcomes for the Company - because our competitive advantage will continue to grow in the marketplace.

The new Swick rig build has a lot of innovations to improve metres per manhour. High-flow, high-pressure water pumps, to reduce the time taken to pull core from our drill strings, reduces non-drilling time and allows more time for drilling. These changes will improve productivity. Our rigs are also automation-ready, with the hardware able to take automation input, and we'll begin upgrading our rigs with automation in the near term with field testing to start in November this year. This should allow us to reduce manning levels in the future on minesites, which will greatly benefit our cost base and financial returns, and enhance our ongoing attractiveness to customers. There are also a lot of incremental safety improvements in the new rig design. A step change is introducing a rod-handling system that is a world-first – which will allow our drill crews to operate with a lot less hazard in the underground environment. Like our clients, we are very focussed on providing as safe a workplace as possible and so this will improve our market attractiveness. We offer much more than rig mobility - continually moving our technology well ahead of our competitors. Our investment in improvements is money well spent.

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You recently announced a trial of the Swick underground drilling technology at the Neves-Corvo mine in Portugal. What does the trial entail, and what are the prospects for the Company from this initiative?

Kent Swick
We proposed the trial to the mine - which wanted a fairly quick solution to their drilling on site. They are world-class operation with over 20 years of profitable mining, and they've got a lot of reserves and resources. They try to produce as much copper as possible - as opposed to zinc – and this is increasing their drilling requirements. The general manger had a favourable experience when the Company drilled for him at Citadel Resources, and he would like to bring some of our performance features into the mine. We believe it is best for us to trial the technology and show its value and the higher quality service. At the same time, we can also understand the cost base and productivity expectations of the mine - so neither party will take too big a risk. Their overall drilling requirement totals around 10 to 15 million Euros per annum.

A long-term tender proposal is contemplated within about 6 months of the trial which, if successful, will give us a cornerstone contract in Europe on a long-term basis. In the immediate vicinity, the Iberian pyrite belt has been well-known source of copper over time, and we expect the economic circumstances of Portugal and Spain will generate strong investment in mining in the near future.

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What is the current and projected strength of the Company's rig fleet, and its projected utilisation?

Kent Swick
Utilisation of our rig fleet continues at the mid-to-low 80% levels, which is where we want it to be. That's because we need spare capacity in a drilling fleet to maintain an opportunistic position to assist existing and potential clients at short notice. We need this for upside.

We also need to be able to pull rigs out of operation for scheduled overhauls and rebuilds, and update them for technological improvements. All rigs come back around every 4 years, for 4-6 weeks, to be stripped and rebuilt. We also have to cater for this factor as our rig fleet grows.

Maintaining this level of utilisation also allows us to trial technology in the field, for example, the prototype Swick rig just launched was trialled in the field to understand it properly in an operational setting.

We target a certain number of rig rebuilds using a probability matrix taking into account opportunities to expand our business, the number of rigs at each site and our expected potential success rate. The rig build figure is a product of this calculation. It is a pretty detailed assessment and something we update as new information comes to light. That is why we increased our earlier six rig build plan assessment for 2013 to a ten rig build plan. Our probability assessment was that we may need another 11 or 12 rigs before July 2013 to meet demand.

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What is the Company's thinking behind instituting the share buyback? Why did you decide on a share buyback rather than increasing dividends?

Kent Swick
The buyback makes a lot of sense when we're trading at well below our net tangible asset backing. Our NTA is around 44 cents a share compared with a share price in the mid-to-higher 20 cents range. So, while shareholders could probably enjoy a special dividend in the favourable circumstances we're experiencing, the better long-term solution is to reverse some of the dilution we have undertaken in the past through capital raisings. If we've raised capital at 38 cents, we can now buy it back at mid-20's and that makes a lot of sense. It also allows us to reward those shareholders who are long-term holders. As our multiple normalises – it is far too low at the moment – the share price will move further than if the buyback hadn't been instituted.

So I think we're doing the right thing as a Company. We're not constraining growth by any means, we're still maintaining a dividend, and free-cash is being applied to the buyback. On balance we're doing a bit of everything, meeting the various claims on our excess cash, and importantly, we're not restricting natural growth.

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As the Company's business model settles and demonstrates it is working, what is the Company's strategic thinking in terms of growth?

Kent Swick
The more I understand the global marketplace in our specialty area of underground diamond drilling, the more I understand how fragmented the global market really is. There is a great opportunity for Swick to apply its technology to be a world class and best in practice leader in the market.

We can now consolidate some of these markets in our speciality. For example, with our entry into Europe, I now understand that we have a competitive advantage in that region, so we can consolidate some of these fragmented markets over time using our solid value proposition.

We believe this is sound strategy because we are sticking to our knitting. The Company is running the business to have controlled and profitable growth, which is strategically planned and assessed, and where we appreciate the risks involved.

Our capital expense per rig and the capital expense per revenue dollar is low compared with our peers. A $1 capital expenditure in our underground diamond drilling division inside Swick can generate $3 of annualised revenue, which in turn gives a pretty good return on investment. We can fund the growth internally, it is just a question of strategically planning the opportunities in the right regions.

The capital costs are manageable, but we have to be careful with the operating cost aspect of growth – dilution of our talent and management pool. This point is addressed because - with Swick targeting revenue of $145–155 million this year – targeting about an additional $30 million in business – this is not a stretch. We are not attempting to double revenue – we want to maintain our reputation, competitive advantage, value proposition to clients, and a sensible growth trajectory in a marketplace that presents good opportunity.

Our payback on capital costs is very attractive and that means the financing of the capital costs for expansion does not put too much pressure on the business. Ten rig builds a year can be accommodated quite comfortably within operating cashflows without unduly affecting our net debt. This is the beauty of the underground diamond drilling business. It gives a very good 'bang for your buck'. The issue for us is really how to strategically approach the opportunities in the market.

I admit that the Company's return on capital expenditure, and return on equity, wasn't good historically, but that was because of the Company's large exposure to surface drilling in the past – where the capital costs were around 4 times higher per operating rig than our underground diamond drilling division. Therefore, as our underground drilling division grows with returns becoming more consistent, we expect our return on equity to increase.

I don't think the market truly understands the differences between the Company as it was in 2008, and the Company it is currently today. The risks are very much reduced from what they were before the GFC. The Company has a much better commodity and revenue mix, a very much stronger balance sheet, and the business is far more efficient than it ever has been. This means investors can look forward to better returns and solid growth - at the same time as holding an exposure that has superior defensive qualities to our competitors.

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Thank you, Kent.