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Full Year 2012 Results

Incitec Pivot Limited

Open Briefing interview with MD & CEO James Fazzino and CFO Frank Micallef

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In this Open Briefing®, James and Frank discuss:

- Positive indicators for return to growth
- Portfolio benefits of explosives and fertilisers exposure
- Balance sheet strength provides for growth investment, shareholder returns

Record of interview:

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Incitec Pivot Limited today reported net profit of A$510.7 million for the year ended September 2012, up 10 percent from the previous year. Excluding individually material items (IMIs), underlying NPAT was A$404.7 million, down 24 percent. What is your expectation for the 2013 financial year?

CEO James Fazzino
We don't provide profit forecasts given the significant impact that US-dollar denominated fertiliser prices can have on our results. However we provide earnings sensitivities to those items, which allows investors to form their own view. Excluding those factors, there are a lot of reasons to be positive about the outlook for 2013, including improved execution in the second half of the 2012 year laying foundations for the future.

In Explosives, 2013 will be the first full year of production from our Moranbah plant which is forecast to generate A$75 million in incremental earnings. We'll also have the benefit of a part year of earnings from the Pilbara emulsion plant. In the North America business, we'd see moderate earnings growth as the coal industry recovers after the slow-down in 2012 and also from business restructuring initiated by Dan McAtee, who is the new president of Dyno Nobel North America and Canada.

In Fertilisers, we'll see the benefits from the consolidation of the business in 2012 and expect distribution earnings to return to normal after a disappointing 2012. Quantum will return to profit after losses sustained in 2012 when fertiliser prices declined during the European economic crisis. Fertiliser production performance will improve, albeit modestly given the current outage at the Mt Isa acid plant.

Both businesses will benefit from the initial productivity improvements from BEx. As an initial milestone, we're targeting BEx to break even in 2013 with expenditure of A$25 million being matched by benefits of A$25 million.

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Explosives EBIT was A$399.9 million, up 8 percent, while Fertilisers EBIT was A$270.9 million, down 40 percent. Explosives accounted for 60 percent of Group EBIT, up from 45 percent in the previous year. How do you expect the relative contributions of the businesses to trend going forward? Given its volatility and falling significance to earnings, are you considering exiting Fertilisers?

CEO James Fazzino
Both Explosives and Fertilisers are great businesses but play different roles in delivering the IPL strategy.

In Explosives we have a long-term contracted volume leverage to hard commodities. This is important as the next phase of the hard commodity cycle, particularly in Australia, will be volume driven and not price led. The long-term contracted nature of the business results in predictable and stable cash flows and this is why Explosives is the growth platform for IPL and will be where we will make the majority of our investments.

The Fertiliser business is linked to global fertiliser prices and Australian agriculture. While we concur with suggestions that Australia could become the food bowl of Asia, cash flows are less predictable in this business than in Explosives and therefore the role of Fertilisers is to generate cash – and I'd note that cash flow is less volatile than earnings due to the countervailing impact of working capital. This means that we will re-invest in our Fertiliser business to maintain our plants and drive productivity.

Invariably this means that the bias in earnings towards explosives will grow from the current 60 percent, with the most obvious catalysts being Moranbah and the recovery in North America volumes and prices as the US economy improves.

There are obvious upstream synergies in manufacturing between explosives and fertilisers as nitrogen chemistry is common to both. Being able to draw on specialists from our Queensland fertiliser plants played a key role in the successful start-up of the Moranbah plant. What's also common is our business model where we execute through a common business system to drive productivity – and that's BEx.

Fertilisers is a quality business and is a core part of the group. It has great market positions, quality assets and while there's year-to-year volatility, when you look through the cycle, it generates strong cash flow. To put the 2012 result in perspective, in a challenging year, the business still generated over A$270 million in EBIT at a 31 percent return on net assets.

Finally, the cash flow from Fertilisers is a vital input into growing the Explosives business. Arguably Fertiliser cash flow "paid" for Moranbah, where we've been able to invest around A$1 billion without raising equity and with only a small increase in Group debt.

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EBIT in the DNA business grew by 10 percent to A$190.6 million, driven by higher urea prices and earnings growth in Canada following the Velocity restructure. However, earnings growth flattened in the second half, reflecting weaker prices as well as softer volumes into coal mining, which accounted for 58 percent of total DNA AN volumes. What is the outlook for demand from the coal sector?

CEO James Fazzino
In the US coal market in 2012 we saw a significant downturn, with volumes off 8 percent overall: 5 percent in the first half and around 10 percent in the second half. There were two key drivers of the decline.

Firstly, an unseasonably mild North American winter reduced electricity demand for heating. The impact of the mild winter on electricity generation mix was magnified as the mild conditions impacted US states where coal has large share of power generation.

Secondly, gas prices were at recent historical lows during 2012 which drove coal to gas switching for electricity generation.

I'd note that the coal industry was slow to adjust to these changes, with significant inventory build in the first half and destocking in the second half and accordingly, while the numbers show a worsening trend as the year progressed, this largely reflects the stocking cycle.

We look to our customers and industry forecasters to form a view on future demand from the coal segment. Leading industry indicators point towards a moderate recovery in coal demand in 2013 – with increasing gas prices, and predictions of a normal winter and hot summer in North America providing an indication that the soft conditions of 2012 will moderate. Some of our key customers as well as the US Energy Information Administration (EIA) also support this cautiously optimistic outlook for the US coal industry in 2013, provided current gas prices and weather trends continue.

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Dyno Nobel Asia Pacific (DNAP) booked EBIT of A$211.3 million, up 8 percent. Excluding the Moranbah unfavourable contract liability release, underlying earnings were A$130.2 million, up 17 percent. Earnings growth fell to 3 percent year on year in the second half, with the loss of a significant contract and a less favourable AN/emulsion product mix. To what extent did the lower second half growth reflect increased competition? What is the outlook for prices given the increased AN capacity in the market?

CEO James Fazzino
The explosives industry in Australia has always been highly competitive and that didn't change in 2012. Over the past 24 months, we've lost two contracts, one in the Pilbara, which impacted the 2012 result and one in the Hunter Valley, which will impact the 2013 result.

In both instances, we were involved in a competitive tender process and were not successful. Explosives contracts involve long-term binding supply commitments with significant capital investment and so we have a disciplined approach and bid at prices that meet our financial hurdles. This means we won't be successful in all tenders.

Looking into 2013 and beyond, in Australia, the DNAP business has the vast majority of its major customers in the Bowen Basin and in Western Australia signed up to long-term contracts. Therefore, the exposure to changes in local spot AN prices is minimal.

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The 330,000 tpa Moranbah plant began producing AN in July, and you've indicated it is on track to produce 250,000 tonnes of AN and generate an incremental A$75 million of EBIT in 2013. Now the plant is operating, what are the key risks to your forecast it will generate EBIT of A$165 million in 2015?

CEO James Fazzino
Pleasingly the plant produced 17,000 tonnes of AN in the month of October, which is in line with the plan to produce 250,000 tonnes in the 2013 financial year. This is the next significant milestone for the plant. Given that 100 percent of the nameplate production of the plant (330,000 tonnes) is sold out via long-term customer contracts, and that we have long-term fixed priced inputs, the key deliverable to achieve A$165 million EBIT is to run the plant to its nameplate production level.

The front end plants have been tested at or above nameplate and the ammonia plant will be ramped up to design rates over the next few months. We'd expect some issues to arise from time to time over the next quarter as the plant is run as a fully integrated complex. All indications to date are that the plants are on track to ramp up production in accordance with the guidance we've provided previously.

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Incitec Pivot's individually material items of A$106.0 million after tax included the A$183.1 million write-back of the Moranbah unfavourable contract liability, reflecting the fact you no

longer need to import AN to service the Moranbah foundation customer contracts following the commissioning of the plant. Will there be any further impact from the liability on future earnings?

CFO Frank Micallef

The Moranbah unfavourable contract liability was created on the acquisition of Dyno Nobel, to cover the anticipated losses arising from supplying AN to the Moranbah foundation customers, noting that at the time of the acquisition the project was not proceeding. The commencement of production at the plant in the last quarter of the 2012 financial year has resulted in the DNAP business no longer being required to import AN to service the foundation customers. As a result, the basis for carrying the liability no longer exists, and the remaining balance of the liability relating to the 2013 to 2019 years has been released to the income statement in the 2012 financial year as an individually material item.

Considering that the business imported AN during the 2012 financial year, the liability release relating to the 2012 year has been recorded in the DNAP business EBIT, in the same way it was in the 2008 to 2011 financial years. The following table represents the impact the liability release had on the 2012 result.

	2012 Act	Mnb Liab release	2012 Rebased
Fertilisers	*270.9*	*0.0*	*270.9*
Southern Cross International	175.3		175.3
Incitec Pivot Fertilisers	92.3		92.3
Elimination SCI to IPF	3.3		3.3
Explosives	*399.9*	*(81.1)*	*318.8*
Dyno Nobel Americas	190.6		190.6
Dyno Nobel Asia Pacific	211.3	(81.1)	130.2
Elimination DNA to DNAP	(2.0)		(2.0)
Corporate	*(71.7)*	*0.0*	*(71.7)*
Earnings Before Interest and Tax (EBIT)	*599.1*	*(81.1)*	*518.0*
Interest	(55.5)	21.1	(34.4)
Tax	(141.6)	18.0	(123.6)
Net Profit After Tax (NPAT) excluding IMIs	**402.0**	**(42.0)**	**360.0**
Minority Interests	**2.7**		**2.7**
NPAT attributable to Shareholders excluding IMIs	**404.7**	**(42.0)**	**362.7**

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Incitec Pivot recently announced the suspension of its feasibility study on an AN plant at its Kooragang Island site in New South Wales due to an anticipated reduction in AN demand and the high cost of construction in Australia. You've previously forecast long-term AN demand growth of around 8 percent. To what extent has the demand outlook changed in recent months? In the absence of a new plant, what will be the drivers of future growth in DNAP after the ramp-up of Moranbah?

CEO James Fazzino

The key take-away for investors from the decision not to proceed with the Newcastle AN project at this time is that projects in IPL must not only meet strategic objectives, but just as importantly, financial ones. Our key financial hurdle remains unchanged: all projects must deliver a 15 percent IRR. Given the magnitude of the potential capital investment in Newcastle, we'd also targeted to sell out a significant percentage of the plant's production on long-term contracts in the plant's footprint.

Increasing capital costs and uncertainty in the near-term outlook for coal in the Hunter Valley, the project was not going to achieve our investment hurdles at this point in time. As such, we decided to defer consideration of the project for at least two years.

In regards to future growth, in the 2012 financial year, the DNAP business reported an underlying EBIT of A$130.2 million (excluding the impact of the release of the Moranbah unfavourable contract liability but including A$16 million from Moranbah initiating systems and services). The Moranbah AN plant will deliver an incremental A$149 million to the 2012 result by the 2015 financial year, which will more than double the earnings of the DNAP business.

In addition to the Moranbah AN plant ramp up, we'd also expect growth in our Western Australian business, which will be underpinned by the investment we've just made in an emulsion plant in the Pilbara. Also, there remains an opportunity to de-bottleneck the Moranbah AN plant to achieve up to 20 percent more production from the plant.

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Incitec Pivot Fertilisers (IPF) booked EBIT of A$92.3 million in 2012, down 28 percent, largely reflecting the negative impact on distribution margins of selling product into a falling market, versus a rising market in the previous year. Earnings also suffered in the first half due to the mistiming of inventory purchases, which you've addressed by implementing a value at risk (VAR) methodology to limit the size of long inventory open positions. How will this affect IPF's ability to respond to customer needs given the inherent volatility of demand and prices?

CEO James Fazzino
A trend in commodity markets, especially post the Global Financial Crisis, is for ongoing volatility. This increases the price risk in any distribution business, particularly one with a long supply chain, as is the case with our domestic fertiliser business. In addition, the business has the added complexity of weather which can move seasonal purchases by up to three months.

The implication of this volatility is that fertiliser distributors globally, including IPF, have recorded significant losses in recent years, particularly in 2008, during the GFC, and 2012, during the European financial crisis. There are two major actions we've taken in the past six months to reduce the business risk from volatility.

First, in order to guarantee supply to our customers, we're putting in place firm contracts that lock in both price and volume rather than conducting business on a spot basis. We'll then commit to honouring that contract. This gives increased certainty to us and customers.

Secondly, for volumes that are not committed via contract, we'll apply a VAR approach, which means that at certain times, we may not be able to meet uncommitted market demand if we deem the price risk to be outside our pre-determined thresholds.

These changes will have the impact of reducing the range in which distribution margins can vary and therefore provide a more stable earnings stream through the fertiliser commodity cycle.

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Within the Fertiliser business, Southern Cross International (SCI) booked EBIT of A$175.3 million, down 46 percent, primarily reflecting the A$77 million impact on the Phosphate Hill plant of adverse moves in DAP prices and exchange rates and A$22 million in one-off costs associated with the planned plant turnaround. You expect the Phosphate Hill DAP plant to run at around 900,000 tonnes this year, lower than capacity due to the current sulphuric acid plant outage. In the absence of full capacity utilisation, what scope is there to increase efficiencies in SCI given its dependence on commodity prices and exchange rates?

CEO James Fazzino
In 2013, we expect that through BEx we'll start to make some significant in-roads into our manufacturing cost base and increase the scope for efficiencies at Phosphate Hill. BEx will help the Phosphate Hill team further optimise the efficiency in each of the plants, which will have the benefit of less waste of key inputs such as gas, met-gas, sulphuric acid and phosphate rock. It will also allow for a greater alignment of the procurement function with the plant, drive efficiency of plant maintenance and sustenance capital spend and encourage our plant operators to generate ideas that will improve the production process.

A great example of BEx at work at Phosphate Hill is the Decant project. In the mineral acid plant we react 2.2 tonnes of phosphate rock with around 1.4 tonnes of sulphuric acid to make 1 tonne of phosphoric acid and 2.6 tonnes of gypsum. The waste gypsum still contains available phosphate which, in addition to process water, is stored in gypsum stacks on site. The Decant uses the gypsum stack as a filter and the water evaporation ponds to concentrate the lost phosphate to a 20 percent specification. This is then returned to the plant as free phosphoric acid and added during granulation. The Decant will deliver A$5 million of benefits in 2013.

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Corporate costs totalled A$71.8 million in 2012, up from A$45.7 million, including A$17 million spending on the BEx business excellence program, up from A$10 million. You expect a benefit of A$25 million from BEx in 2013, versus expected spending of A$25 million. What will be the ongoing cost of BEx and when do you expect it to begin to make a positive return on investment?

CEO James Fazzino
BEx is an ongoing initiative in the business. We expect that from 2013 BEx will self-fund. In the 2014 financial year we expect BEx will generate a return on investment. From 2014 the ongoing cost of BEx will be paid for by the businesses and no longer reported in the corporate cost centre.

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Incitec Pivot booked net operating cash flow of A$620.8 million in 2012, down from A$719.1 million in the previous year. This reflected the fall in EBITDA as well as significant increases in interest and tax paid, offset by a A$119 million reduction in trade working capital. How sustainable is the improvement in working capital, particularly in a growth scenario?

CFO Frank Micallef
The trade working capital result was very good, and mainly reflected lower fertiliser inventories and lower trade receivables. The lower fertiliser inventories resulted partially from our revised risk methodology in the fertiliser distribution business and the fact that urea stocks were low compared with the previous year. So it's difficult to see the fertiliser working capital position getting too much better.

The lower trade receivables result came mainly from the Explosives businesses and I think there is still some scope for incremental improvements here by focusing on invoicing and collection processes using BEx methodology.

Importantly, our reduction in trade working capital over the last few years has been generated by real improvements across the year, rather than temporary year-end solutions, and our trade working capital as a percentage of average 12 months sales continues to trend favourably and assist us in keeping interest costs to a minimum.

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Net debt was A$1,287 million as at the end of September, up from A$1,189 million a year earlier, reflecting investment of A$449.8 million in growth projects, including the completion of Moranbah. Net debt to EBITDA was 1.7 times, up from 1.3 times. You're continuing to

look at building an ammonia plant in the US. With debt expected to peak this year, how would you fund such a project and what impact would it have on your capacity to spend on smaller growth projects such as the Pilbara emulsion plant, due for completion this quarter, and the third phosphoric acid filter train at Phosphate Hill, which is in final commissioning?

CFO Frank Micallef

Our balance sheet ended the 2012 financial year in a very strong position, with net debt to EBITDA being 1.7 times and well within our target range of 2.5 times or less. Our cash flows in the future will also be augmented by the cash earnings from Moranbah. So projects like the potential U.S ammonia plant can be self-funded by the business within our target credit metrics.

We've just finished funding the Moranbah project of just less than A$1 billion of cash costs using the debt capacity and reinvesting the cash flows from the businesses. From here on, the earnings from Moranbah will enhance our ability to provide returns to shareholders and, where appropriate, fund capital expenditure that meets our investment criteria. The Pilbara emulsion plant and the Phosphate Hill third filter project are, for the large part, already paid for and incorporated into the 2012 year-end debt figures.

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You've announced a 75 percent franked final dividend of 9.1 cents per share, up from last year's 8.2 cents (unfranked). This brought the total 2012 dividend to 12.4 cents, up 8 percent. The payout ratio was 50 percent, up from 35 percent (of NPAT excluding IMIs), and the company has changed its target payout range to 30 to 60 percent, up from 20 to 40 percent. Does the higher payout range mean you see more limited growth opportunities? What factors would push dividends to the upper or lower levels of the range and what is the outlook for dividends and franking for the current year?

CFO Frank Micallef

The revised payout range recognises that the completion of Moranbah, and the cash and earnings that will come from Moranbah in the coming years, changes the capacity of IPL to pay dividends in the future, all other things being equal. It makes no comment on the growth opportunities that may be available to us, but provides the flexibility to either re-invest some cash in the business where appropriate, or return more cash to shareholders.

Given the lower NPAT pre IMIs in 2012 versus 2011, this higher payout has enabled us to pay a full year dividend of 12.4 cents per share, which is up from 2011's 11.4 cents per share, reflecting the confidence we have in the year ahead and the improved cash flow and earnings profile that Moranbah will bring.

The dividend in 2013 will continue to be set by the board with reference to the revised payout range, taking into account free cash flows, the capital needs of the business, our franking position and any other relevant factors. We're also aware that the market has, over the last couple of years, raised expectations in relation to the dividend yield it generally expects from industrial companies.

The franking outlook is subject to tax paid which, of course, can be difficult to forecast and is subject to a number of variables. We intend to pay out franking credits as they become available. All other things being equal, we anticipate that as we start to pay tax on Moranbah earnings, we should be able to maintain a franking level of greater than 50 percent. However, given the approach of immediately paying the franking credits that are available, rather than smoothing the franking level, franking levels in the future may vary.

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Thank you James and Frank.

For more information about Incitec Pivot, visit www.incitecpivot.com.au or call Nick Stratford, General Manager Group Finance and Investor Relations on (+61 3) 8695 4569.

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