MD & CFO on FY13 Outlook

Incitec Pivot Limited

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

Incitec Pivot Limited
Level 8, 28 Freshwater Place
Southbank VIC 3006

In this Open Briefing®, James and Frank discuss:

- Drivers of H1 results, impact of Moranbah plant start-up
- Early benefits, lower than expected cost of BEx program
- Sustainable dividend payout at around 50 pct

Record of interview:

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Incitec Pivot Limited (ASX: IPL) today reported net profit after tax (NPAT) of A$110.2 million for the first half ended 31 March 2013, down 23 percent from the previous corresponding period (pcp). Excluding the Moranbah unfavourable contract liability write-back in the pcp, underlying NPAT was down 10 percent. Underlying EBIT was A$172.5 million, down 1 percent, with Explosives EBIT up 7 percent to A$146.8 million, and Fertilisers EBIT down 19 percent to A$49.6 million. How indicative is the first half of the expected performance of the business over the remainder of the current year ending 30 September 2013?

MD James Fazzino
The result reflects the inherent differences in the businesses in IPL's portfolio. Our Dyno Nobel explosives business delivered positive earnings growth at a time when global hard commodity prices were falling and US coal production declined by over 9 percent. The continued positive performance of Dyno Nobel reinforces our strategic direction to build the explosives side of the business while maintaining our commitment to fertilisers. Earnings from the fertiliser businesses were down, reflecting that businesses' exposure to foreign exchange and commodity price volatility.

We don't provide profit forecasts due to the potentially material impacts of movements in commodity prices and foreign exchange markets on the Group result. However, it's important to remember that due to the seasonality of our businesses, our earnings are biased towards the second half in both explosives and fertilisers. Further, when considering the first half result versus the second half for 2013, key differences to keep in mind are firstly, full production at Phosphate Hill, where 510,000 tonnes are expected to be produced at a significantly lower cost than the first half, and secondly, production at Moranbah, which will continue to improve.

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In explosives, Dyno Nobel Asia Pacific (DNAP) booked an EBIT of A$67.5 million, up 22 percent from the underlying result in the pcp. The Moranbah plant was the main contributor to growth, providing A$16 million in incremental EBIT. Nevertheless, Moranbah's first half production of 85,000 tonnes and incremental EBIT contribution of A$23 million appears to be running below your targets for FY2013 of 250,000 tonnes and A$75 million respectively. What have been the key factors in the lower than targeted production and earnings, and are these indicative of longer term problems at the plant?

MD James Fazzino
After a promising start-up where production hit early milestones, we experienced issues in recent months as we ran Moranbah as an integrated chemical complex – including external supplier issues related to gas which have been outside our direct control. We understand the residual issues impacting production and have a path to safe, reliable production that delivers the investment case.

The prill and emulsion plants are fully operational and are producing high quality product for foundation customers in accordance with the DNAP sales forecast. We've demonstrated that the nitric acid and ammonium nitrate (AN) plants can run at nameplate capacity but production at both plants was constrained by the ammonia plant.

We experienced supplier issues related to gas supply, where there were failures in the compressors at both ends of the gas line.

While the ammonia plant has operated at over 80 percent of nameplate, we've experienced production interruptions related to integration, gas supply and recently damage to the ammonia plant subsequent to gas supply outages. We have three issues to fix: damage to the ammonia plant, steam balance, and the integration of equipment controllers with the site's overall control system (DCS).

Moving forward I've approved a schedule of work to address these issues. Today we start an estimated one month ammonia plant shutdown to repair the damage. Gas compressor issues will be addressed during this outage. Our gas supplier is expected to put additional nodes in place creating redundancy in the gas supply chain by end of the third quarter of this calendar year.

A team has been in place from late December addressing logic issues in the DCS. This work will be complete by the end of our financial year. We're optimising steam usage from existing boilers and will add an additional boiler which will be in place by April 2014. Importantly, there are immediate gains as components of these works are completed, meaning that every month the complex becomes more reliable.

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EBIT from the DNAP base business was down 8 percent in the first half, with the loss of a Hunter Valley coal customer and weather impacts on the east coast of Australia offset by growth in Western Australia and in demand from the hard rock and underground segments. With Australian mining coming under price pressure, and AN supply having recently increased, can you comment on the demand for explosives, your contractual positions and how you're being affected by customers' drive to reduce costs.

MD James Fazzino
In the explosives business we're exposed to mining volumes, not hard commodity prices. Looking back to prior years in which hard commodity prices declined, customers typically cut back on new projects and focused on existing deposits. This invariably means that mines get deeper, with an increase in overburden and strip ratios. In terms of mine cost competitiveness, the most important lever of cost per tonne is volume and accordingly there's a compelling case for many of our customers to increase output from existing assets to improve cost competitiveness. Both factors drive an increase in explosives use and it's important to remember that we blast both overburden and minerals.

In the DNAP business our key sector exposures are to metallurgical coal and iron ore. In both markets we've made large capital investments to provide long-term security of explosives supply to our customers and in return they've signed long-term take-or-pay contracts for both price and volume to underpin the return on these investments. In terms of the total DNAP business, around 75 percent of sales are made under long-term contracts for both price and volume, with 100 percent of Moranbah volume contracted on this basis.

Of course, explosives are the cheapest form of energy on a mine site and hence explosives use is a key driver of mine productivity and therefore cost competiveness. Accordingly, most of our large contracts contain a "value in use" (VIU) component where we partner with our customers to apply our blasting expertise and specialised products (such as Differential Energy®, Digishot® electronic detonators and Titan® customised emulsions) to increase the efficiency and profitability of mines. We also formally educate our customers in the concepts of VIU though programs such as our North American Quarry Academy®. Importantly our VIU program drives our research and technology program, ensuring it's customer-led and delivers practical innovation. Globally, we have over 160 people focused on VIU across DynoConsult, Research and Technology, product management and engineering solutions.

The current key areas of VIU focus are: reducing ore dilution, reducing coal loss, optimisation of fragmentation size which improves digging and processing, optimisation of broken rock bulk density, improved underground development advance rates, reducing fines generation in quarry applications, and finally moving to larger and more efficient shot sizes without vibration impacts.

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EBIT in the Dyno Nobel Americas (DNA) business was US$82.9 million, down 2 percent, primarily due a 14 percent fall in AN volumes sold into the coal sector, partly offset by savings realised via the BEx business productivity program. In light of the fall in coal sector volumes accelerating in the first half, and US coal inventories remaining above the long-term average, can you comment on the outlook for underlying demand from the sector and the prospects for DNA growth?

MD James Fazzino
DNA delivered a great result given the decline in coal production which is the largest end market for explosives in North America. We've worked hard in this business since acquisition to get the cost base right to enable us to deliver good results in tough markets and outstanding results when market conditions are more favourable, and the first half result reflects this. BEx builds on this work as it's focused on driving enduring bottom-up productivity improvements which flow through to earnings.

Turning to coal, in 2012 the decline in explosives sales to US coal producers occurred mainly in the second half, so the prior year comparative reflects a relatively positive coal market. The reason for this skew to the second half in 2012 was that the coal industry was slow to curtail production in the face of the 2011/12 unseasonably mild winter and this, together with take-or-pay obligations at utilities, resulted in a significant build of coal inventories. This position was compounded by coal-to-gas switching driven by record low gas prices which bottomed at around US$2 MMBtu in August 2012. The first half 2013 volume decline was driven by an unwinding of these factors.

In terms of outlook, the recovery is more likely to be "u" shaped than "v" shaped. The US had a "normal" winter in 2012/13, spot gas prices have recently adjusted upwards and coal stocks have fallen from a peak of 202 million short tons in May 2012 to 177 million in March 2013. In fact, US coal consumption was up year on year in the first quarter of the 2013 calendar year – so the issue is de-stocking. Stocks are still around 10 percent above long-term averages so this will temper the pace and timing of any recovery in production in the second half.

Our long-term view of US coal remains unchanged: we expect production to be slightly down long term, with reduced local consumption due to power plant retirements partially offset by exports. What's clear is that new power plants will be gas fired which means coal's share of power generation will continue to decline – which is not new. These factors, combined with higher strip ratios, mean explosives demand is likely to be flat to slightly negative.

Importantly there will be a continued shift in coal production from east to west, due to the cost competiveness of Powder River Basin (PRB) and Illinois Basin coal, environmental

constraints on Appalachian coal and plant retirements primarily impacting older south-eastern plants. DNA is particularly well positioned to benefit from this shift as our Cheyenne, Wyoming plant sits right on the doorstep of the PRB.

It's also why having "more than one arrow in our quiver" is so important and why I'm pleased by the growth in our North American industrial chemicals business in the first half, where we saw an increase in profit of 6 percent.

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Last month, you announced plans to build a US$850 million, 800,000 tpa ammonia plant on a brownfield site in Louisiana in the US. Production is expected to start in the September quarter 2016. How is the plant expected to impact margins and returns in the DNA business?

MD James Fazzino
The Louisiana ammonia plant will more than double the earnings of the DNA business. It will drive a step-change in EBIT margins and returns in DNA as ammonia is the most attractive part of the AN value chain – in explosives most of the value is created upstream in manufacturing.

The project is strategically attractive as it backward integrates the US AN business to low-cost US gas, enables us to leverage IPL's core manufacturing competency, leverages existing market positions and delivers a world class plant at the bottom of the global cost curve.

This is consistent with our strategy of pursuing growth close to the core which is relatively lower risk as compared with major step-outs, for example. The execution model is also lower risk, with capital and schedule benefits from a brownfield site, the plant sold out from day one, a reference plant approach to plant engineering using the world's best ammonia technology and limiting technical and scale-up risk, and construction being undertaken under a lump sum turnkey engineering procurement and construction contract by North America's leading contractor.

Most importantly, the project meets IPL's strict financial hurdles, with an expected 15 percent IRR and simple payback of less than five years. In terms of contribution to the overall IPL group it "moves the dial" and provides the platform for our medium-term growth.

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You've chosen not to lock in long-term gas supply for the Louisiana plant, whereas you entered a 15-year take-or-pay gas supply contract for the Moranbah plant in Australia. What were the key drivers of these decisions and to what extent does the viability of the two plants depend on gas prices?

MD James Fazzino
Moranbah and Louisiana are driven by two different investment thematics.

The Moranbah plant was constructed to provide our Bowen Basin coal customers with long-term security of explosives supply and certainty of explosives cost. Accordingly, we signed long-term take-or-pay contracts with our customers at defined volumes and prices. Gas makes up the majority of the cost of producing ammonia, so we back-to-backed the customer contracts with a long-term gas agreement that covered both volume and price.

In contrast the Louisiana investment leverages the differential between long-term US gas prices and European gas prices, where Europe is the marginal producer of ammonia. Our view is that this differential will persist. That doesn't mean that we won't manage this exposure in a way that doesn't negatively impact project returns. In our explosives business, gas prices are passed on to customers via rise and fall provisions in the contract. Further,

it's likely that some merchant ammonia from the plant will be priced on a cost plus basis and we'll opportunistically look to hedge the gas prices via participating cover.

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Incitec Pivot Fertilisers (IPF) booked EBIT of A$25.5 million, up from A$2.2 million, with distribution margins recovering due to improved risk management processes. What success have you had in introducing firm contracts with your customers and what percentage of IPF business is contracted? How sustainable are IPF earnings at the first-half level?

MD James Fazzino
We undertook a number of actions to improve the margins and ensure these are sustainable into the future. Firstly we restructured the fertiliser business by combining domestic and international operations to get a single view across the entire fertiliser value chain – from the dynamics of the global fertiliser market to forecasting domestic demand through to delivery at the farm gate.

We've also introduced contracts to provide surety of supply to our customers, locking in both price and volume. This provides increased certainty to us and our customers. Finally for volumes not committed via contract, we apply value at risk methodology, 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 risk tolerance levels.

It's important to note that we'll never eliminate the volatility entirely due to weather, exchange rates and/or commodity prices. The aim was to mute this impact, and the first half results demonstrate that we've been successful.

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EBIT from the Phosphate Hill DAP plant fell to A$5.2 million from A$49.8 million in the first half. Can Phosphate Hill remain viable at current Australian dollar levels of US$1.05 and what progress have you made on sulphuric acid supply?

MD James Fazzino
Absolutely, Phosphate Hill is profitable at US$1.05. Looking at the first half performance, the decline in earnings from Phosphate Hill was firstly driven by an outage at the Mt Isa sulphuric acid plant which took the plant off-line for approximately a month, secondly by lower commodity prices and thirdly the higher Australian dollar. Both commodity prices and foreign exchange are out of our control; however, plant efficiency and output are within our control. Through BEx we're making significant improvements to Phosphate Hill's plant efficiency and the expectation for the second half is that production at the plant will be 510,000 tonnes. Production at this level will place the cost per tonne of production at Phosphate Hill around the middle of the global cost curve – a significant achievement for any Australian manufacturer.

We've been evaluating numerous options for long-term sulphuric acid supply to Phosphate Hill post the closure of Xstrata's Mt Isa copper smelter from 2017. Our initial options were to either build another sulphuric acid plant at Phosphate Hill or modify our existing Mt Isa sulphuric acid plant to increase sulphur burn. The initial cost estimates for these options were up to A$300 million. I'm delighted to say that the team applied BEx thinking to the problem and have come up with an innovative capital light solution costing A$50 million involving a combination of sulphuric acid imports and decant.

The solution capitalises on the BEx Decant project. Gypsum and site waste water containing low concentrations of phosphoric acid are produced as by-products during the manufacture of ammonium phosphates. These by-products are disposed of in cells adjacent to the plant through a wet stacking process. Gypsum is combined with waste water producing liquor that is continuously recirculated through the cells, increasing concentration. The liquor contains 4 to 5 percent phosphoric acid, which is then placed in evaporation ponds to increase its concentration up to 20 percent. The concentrated phosphoric acid is then pumped back to

the plant for the manufacture of ammonium phosphates. The process of recovering phosphoric acid in this manner is referred to as "decant". In a nutshell, the BEx solution is to use our gypsum cells as a solar phosphoric acid plant.

As you are aware, we have to construct new gypsum cells approximately every six years, so we've modified the cell currently under construction to increase its surface area to speed up the Decant.

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Costs relating to the BEx program were A$7 million in the first half and you've lowered the forecast cost of the program in the current year to A$15 million from A$25 million. First half BEx benefits were A$13 million, generated primarily at Phosphate Hill and in DNA, and you continue to expect benefits of at least A$25 million in the current year. Why have costs been less than expected, and in which parts of the business do you expect the current year benefits?

MD James Fazzino
BEx is all about driving productivity improvement from the bottom up – the shop floor, the mine bench or in our fertiliser sheds – by transforming the way work is performed by all of the 5,500 employees in the IPL Group. The A$15 million is an investment in our people – giving them the right support through training, processes and workplace culture – and building a business system that supports them and ensures gains are sustainable.

We've learned that we simply don't need the type of head office support for BEx that you need with traditional top-down business improvement, so the spend has been less than originally planned. The 2013 benefits will be primarily in manufacturing and our supply chain and we remain confident of delivering the A$25 million target.

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Incitec Pivot booked net operating cash outflow of A$64.6 million in the first half, versus outflow of A$127.3 million in the pcp. This chiefly reflected lower tax paid and lower outflow on non-trade working capital, with some improvement in trade working capital. To what extent has the reorganisation of IPF lowered your seasonal working capital volatility? Are further working capital efficiencies achievable across your businesses?

CFO Frank Micallef
The changes in the domestic fertiliser business have had some marginal positive impacts on the seasonal volatility of trade working capital by enabling us to more accurately forecast demand, which results from better contractual positions with our domestic customers. Also, we've been successful in obtaining better terms on our imported fertilisers which more closely match the order-to-cash cycle profile. Work is ongoing in this area, and there may be some more improvement we can make on fertiliser working capital in this respect.

In respect of working capital in the explosives businesses, the net working capital required to run the Moranbah business will have a small but ongoing impact on net working capital requirements going forward, but there's more we can do here on supplier terms and receivables collections using BEx methodology to make our processes more efficient, so I expect over time some more improvement here. What's important for us is to ensure that the improvement is sustainable and hard-wired into our business processes, and I think our record in this area over the last few years has been very good.

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Net debt was A$1,634 million as at 31 March, up from 30 September, but flat compared with a year earlier. Net debt to EBITDA was 2.3 times, up from 1.9 times, and close to your targeted gearing "ceiling" of 2.5 times. What is the expected trend in net debt and gearing as Moranbah ramps up and you start investing in the Louisiana ammonia plant?

CFO Frank Micallef
Net debt is always seasonally higher at the half year mark, therefore the movement from 1.9 times to 2.3 times was not unusual. It's normal for us to have a significant reduction in net debt in our second half, all other things being equal. As Moranbah ramps up, this will have a significantly positive impact on our net debt to EBITDA levels – at the moment we're carrying the net debt incurred from the plant build however the earnings generated from the project have only started to build to expected levels.

We expect that free cash flows from our operations, including the increased earnings from Moranbah, will enable us to fund construction of the Louisiana ammonia plant while still maintaining our credit metrics within target levels.

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You've announced a 75 percent franked interim dividend of 3.4 cents per share, up from last year's 3.3 cents (50 percent franked). What is the outlook for dividends and franking for the current year? Will you be able to maintain a payout in your higher range of 30 to 60 percent as you ramp up investment in the Louisiana plant?

CFO Frank Micallef
We expect to be able to maintain the dividend payout at around 50 percent, notwithstanding the requirement to fund the build of the Louisiana plant. In terms of franking, we'll return franking credits to shareholders as they become available. While the level of franking credits available for distribution can vary due to a number of circumstances, we don't expect the level at which we're able to frank dividends to reduce in the short to medium term.

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Thank you James and Frank.

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

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