Schaffer Corporation Limited

CHAIRMAN'S ADDRESS TO THE 2016 ANNUAL GENERAL MEETING

Good Morning, Ladies and Gentlemen

My Directors and I have great pleasure in welcoming you to Schaffer Corporation's 2016 and 62nd Annual General Meeting. This same group of Directors has had that pleasure since 2005, when the 'new boy' Michael Perrott joined the Board.

The long-term involvement of our Directors is complemented by their broad and varied experience. They have detailed knowledge of our businesses and of the world in which those businesses operate. I firmly believe that combination is critical to Schaffer Corporation's adaptability and long-term success.

Our businesses exist in an ever-changing industry landscape. They also operate in different industries and geographical markets. Such diversification provides distinct advantages. It also means that the challenges each of the businesses faces are unique.

Our Board and management continually assesses the businesses and their markets. Where required, we transform ourselves to grasp new opportunities and defend against significant threats.

Schaffer Corporation has certainly made 2016 a transformative year.

At last year's meeting, I highlighted the completion of our new leather processing facilities in Slovakia. In the intervening year, we managed both a significant growth in production volumes and the transition from Australia to Slovakia of hide processing for European-based customers.

We implemented this change to maximise our competitive position in a global market. We improved our production flexibility, local presence and our cost effectiveness. This necessarily carries cost – both financial and social – but these difficult decisions are what protect and enhance the long-term value of the company.

For the year, Schaffer Corporation recorded increased profit. At the Group level, the results were:

- A 36% increase in revenue to $213.6 million
- A 60% increase in earnings before interest and tax (EBIT*) to $8.7 million
- A 61% increase in net profit after tax (NPAT*) to $5.7 million
- An increase in earnings per share from $0.25 to $0.41 per share
- An annual dividend of $0.25 per share, which was the same as the prior year.

Our Total Shareholder Return (TSR*) is a measure of the combined returns to shareholders from share price movements, dividends and dividend imputation credits. For the past year, we achieved a TSR of 21% and have averaged 20% returns for the past five years.

I will now review each division in greater detail.

Automotive Leather

Schaffer Corporation owns 83% of Howe Automotive Limited (Howe or Automotive Leather), which supplies high quality leather to the global automotive industry.

In recent years, automotive manufacturers in Asia and Europe awarded Howe 16 new programs. Those programs have been rolled out over the latter part of the 2015 financial year and the 2016 financial years. Many of these programs are now reaching steady state production. The impact is reflected in the 53% (that is, $54 million) increase in revenue for the division in the 2016 financial year.

In anticipation of that increased volume, Howe embarked on a strategy to expand its capacity and presence in Europe. Howe established a new 15,000 square metre facility in Slovakia. That facility accommodates increased leather cutting for Europe. More significantly, it established Howe's first leather finishing facility outside Australia. Howe completed the facility successfully and on schedule. The facility produced its first hides just prior to last year's annual general meeting.

We have now hired, trained and integrated approximately 500 new employees in Slovakia. We have achieved compliance approval from all our customers. We are bedding down the new programs to maximise efficiencies. We are also managing the complexities of transferring hide processing for the European leather business from Australia to Slovakia.

Settling in new programs and reaching steady-state volumes takes both time and money. Whilst production at the facility is scaled up to higher capacity, fixed costs are greater per unit of production. As staff are trained and gain experience, production efficiency is lower and wastage is higher than targeted for steady-state operation. This contributed to a reduction in Howe's EBIT* for the 2016 financial year to $4.8 million.

Previously, Howe shipped hides from South America to Australia for finishing and then on to Europe. Hides now ship directly to Slovakia. That will result in a material reduction in inventory levels, order lead times and working capital invested in the business. Howe will apply in part the funds released to finance the increased hide volumes required to supply the new sales levels. Howe will also benefit from ongoing reductions in freight costs and manufacturing expenses.

The next element in Howe's strategic plan is for all finishing of European customer leather to be undertaken in Slovakia by early calendar year 2017. In support of that goal, late in the financial year, Howe commissioned a second finishing line in Slovakia.

With the development of the Slovakian operations and the rationalisation of supply chains, Howe assessed the scale of operations in Australia, particularly the Thomastown leather finishing facility and Rosedale tannery. Late in the financial year, Howe undertook redundancies at Thomastown and ceased operations at Rosedale. Pre-tax non-recurring costs included $1.1 million in redundancies and a $0.3 million non-cash write-down of decommissioned assets.

The strategic planning, process design and documentation, and subsequent implementation that goes into a transformative project such as this is remarkable. The Board commends the team who have managed this highly complex, multifaceted project and looks forward to the culmination of what has been a successful process to date. I often step back and remind myself that we have only been finishing leather in Slovakia since the start of the 2016 calendar year. The Slovakian team has come a long way since. We have ongoing improvements in efficiency and profitability to achieve.

For the 2017 financial year, Howe expects further increase in volumes and revenue. The current programs continue to scale up and several new programs commence in the second half. First half volumes should be in line with those achieved in the second half of the 2016 year. Profitability should increase (at current exchange rates) with improved efficiency of the new programs and facilities.

Building Materials

Building Materials comprises Delta Corporation and Building Products, both of which are 100% owned by Schaffer Corporation.

For the 2016 financial year, Building Materials' EBIT* more than doubled while revenue increased by 6% to $51.8 million.

The division's leading business unit was Building Products. This unit supplies paving and walling products to the residential and commercial building sectors. It comprises UrbanStone, Urbanstone Central retail outlets, Archistone (including Archistone Masonry products), Limestone Resources and Imported Stone products.

Residential spend has reduced over recent years. Building Products' focus has been on increasing commercial paving and natural stone opportunities and rationalising retail operations.

The past year saw comparatively better economic conditions on the East Coast, including local government spending. This contributed to an improved result for the commercial business. Building Products' exclusive Australian-sourced natural stone has good penetration with key commercial projects in key locations. Margins have also improved with ongoing cost reductions and production efficiency programs.

The order bank at the end of the financial year was at record levels. Building Products is conscious that the economic climate and national weather conditions in recent months have slowed down the timing of numerous orders.

The business has implemented considerable cost savings in recent years without impacting revenue. In the financial year, the business identified and implemented additional cost savings and increased efficiency. We are confident that there is further opportunity to reduce costs and increase efficiency in future to maintain competitiveness in a difficult environment.

Delta Corporation produces pre-cast and pre-stressed concrete products. Delta is in its 50th year of operations and has been part of Schaffer Corporation for the last 36 years.

For the 2016 financial year, Delta achieved an improved revenue result on the previous period but profit was slightly down. The Western Australian construction industry is experiencing suppressed conditions both directly and indirectly from the decline in resources sector activity. Additionally, a number of new competitors were established during the resources construction boom, which has led to increased pressure on margins for the work available.

There are signs of growth in the infrastructure industry with an increase in tendering activity. However, the oversupply of competitors continues to pressure margins. Delta does not believe the competitive environment can sustain all its competitors indefinitely. Should rationalisation occur, the market would move towards a balancing of supply and demand and more sustainable conditions. Delta continues to implement cost reductions and efficiencies to maximise its competitive position now and into the future.

Conditions, especially for Delta, make forecasting particularly difficult. Accordingly, Building Materials' forecasts are conservative despite the order book for Building Products being strong. We expect revenue and profits to be lower for the first half of the 2017 financial year compared to the prior corresponding period.

Investment Property

The Investment Property division comprises Schaffer Corporation's interests in syndicated property investments.

In December 2015, we sold our 20% share in the 616 St Kilda Road syndicate. We had acquired the interest in 616 St Kilda Road for $1 million in the late 1990s. Since that time, the company has received excellent annual rental income. That income far exceeded the purchase price. The sale realised additional EBIT* of $5.7 million ($4.0 million after tax). We have applied the proceeds to reduce corporate debt.

The 616 St Kilda Road interest reflects our approach to property and our operating businesses more broadly. All divisions are managed to maximise shareholder value over time. On an ongoing basis, Schaffer Corporation maximises rental returns from the portfolio. It also looks to identify opportunities to realise capital gains, where appropriate.

At 30 June, the market value of syndicate investment property was $37.1 million or $18.0 million net of debt.

Due to the St Kilda Road asset divestment, we expect lower revenue and EBIT* for the 2017 financial year.

Gosh Capital

Schaffer Corporation owns 83% of Gosh Capital, which is an investment company. It continues to reinvest profits in a range of diversified investments.

The Cockburn Coast area, encompassing North Coogee, is undergoing conversion to a high-density residential precinct. Landcorp, the Government-owned majority land owner, has completed significant work during the year on the properties and public spaces surrounding Gosh Capital's 2.1 hectare site, enhancing its future development potential. The site's zoning allows for the building of approximately 175 units.

Gosh Capital made a range of investments during the year. The market value of Gosh Capital's portfolio at 30 June was $28.5 million gross or $22.3 million net of debt.

Excluding the profit on the sale of the Space 207 office building during the 2016 financial year, SFC forecasts an increase in Gosh Capital's profit for the first half of the 2017 financial year (from a low base).

Other Property

Schaffer Corporation owns several other properties in Perth that are primarily occupied by various functions of the Building Materials division. The Directors believe several of these properties have significant future redevelopment potential. The long-term strategy is to ultimately redevelop these properties and maximise returns to shareholders.

Schaffer Corporation owns 57 hectares of combined property in Jandakot. This property is strategically placed between two freeways, just 15 minutes south of the Perth CBD. Just over 13 hectares currently has special-use zoning, including 6.4 hectares where our Urbanstone factory is located. Thirteen hectares is designated as "Bush Forever". The remainder of the site has the potential for zoning to be amended to include light industry and commercial uses, as an extension of the Jandakot Specialised Activity Centre. The City of Cockburn is conducting roadworks that enhance this potential. Those works include the establishment of a new road along the north-western boundary of our site to connect the Kwinana Freeway with Jandakot Airport.

Outlook

Following a transformative year, we expect Automotive Leather to deliver increased efficiency and profitability.

We are conscious of prevailing risks, such as foreign currency movements and intensifying competition. For the first half, excluding property sales and restructuring costs, we expect a similar underlying result, to the prior corresponding period including:

- Improved profit for Automotive Leather.
- A decrease in profit for Building Materials, mainly Delta.
- A decrease in profit for Investment Property.
- An increase in profit for Gosh Capital.

The Board will provide an update on the full year outlook in February, when Schaffer Corporation releases its first half results.

Dividends

The Board is pleased to advise that we intend to maintain an interim dividend of $0.12 per share fully franked – matching last year. The Directors will confirm and ratify the interim dividend when the Group releases its half year results in February 2017.

Conclusion

Your company has achieved much over the past year. I am very proud of the progress to date. Our team continues to work diligently to bed down our current strategies to maximise efficiency, profitability and shareholder value.

The other Directors and I would like to thank our management and employees. We can do no more than set a strategy. To achieve it requires hard work, inspiration, sacrifice and dedication from our team. Managing change is difficult regardless of whether a business unit is growing or rationalising its operations. I commend our managers in each area of the Group for the way they have approached and dealt with their unique set of challenges.

Finally, I would again like to thank you, our shareholders. We are a company focussed on long-term value. We appreciate your patience and support whilst we grow a sustainable diversified group. The future always contains unknown challenges. We remain confident in our abilities to make the right decisions and adapt the businesses appropriately. Providing future value for our shareholders is and will always remain our top priority.

I trust that I will see you all again at next year's Annual General Meeting.

John Schaffer
Chairman

16 November 2016

* *Schaffer Corporation results are reported under Australian Accounting Standards and International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board. The Company discloses certain non-IFRS financial measures. The non-IFRS measures should only be considered in addition to, and not as a substitute for, other measures of financial performance prepared in accordance with IFRS. Please refer to page 5 of the 2016 Annual Report for the definitions of non-IFRS measures and page 54 for our definition of Total Shareholder Returns.*