Schaffer Corporation Limited

CHAIRMAN'S ADDRESS TO THE 2014 ANNUAL GENERAL MEETING

Good Morning, Ladies and Gentlemen

My fellow Directors and I have great pleasure in welcoming you to Schaffer Corporation's 2014 and 60th Annual General Meeting.

One word you will hear a lot from me today is 'diversity'.

Diversity is a key element of Schaffer Corporation.

We have diversity across our group's businesses and within each division.

The effect of that diversity is reflected in each of the 2014 financial year, the current and future financial years.

In the 2014 financial year, diversity saw a strong result from Automotive Leather to compensate for a decline in the other divisions.

Automotive Leather operates in a globally competitive industry. However, over recent years, the business has evolved to become our single largest profit contributor. We have achieved this by diversifying Automotive Leather's business to take advantage of lower cost operating environments that are close to key markets in Europe and Asia. We have diversified away from shrinking and higher cost environments in Australia and North America.

In 2014, Automotive Leather drove increased volumes and also benefited from the significant devaluation of the Australian dollar just prior to the start of the financial year. As a result, the division's profit increased substantially.

Automotive Leather is positioning for further significant growth. In the current year, we are further investing in and gearing up the division to accommodate increased volumes from a new supply agreement with Mercedes Benz. That agreement commences during the 2015/16 financial year, with pre-production having already commenced.

At the Group level, the statutory results were:

- An 18% increase in revenue to $163.6 million
- A 31% increase in earnings before interest and tax (EBIT*) to $19.3 million
- An 18% decrease in net profit after tax (NPAT*) to $6.2 million
- A decrease in earnings per share from $0.54 to $0.44 per share
- An annual dividend of $0.25 per share.

The strong improvement in EBIT reflected the strong performance of Automotive Leather. The decrease in NPAT resulted from the Board's decision to impair the carrying value of goodwill in the Building Products business, part of the Building Materials division.

Building Materials is a diverse business. It includes the Delta pre-cast and prestressed concrete products, and the Building Products business unit, which supplies paving and walling materials.

Delta was benefiting from private and government sector development projects. Currently, Delta has joined Building Products in facing a challenging Australian domestic market. The market conditions have led to intensified competition and margin pressure, which once again presented subdued results.

Given the sustained period in which Building Products has faced these operating conditions, the Board believed it was prudent to impair the business's carrying value of goodwill by $3.7 million. I note that the goodwill impairment is a non-cash item – Building Products still earns revenue in the same manner as always. This is an accounting adjustment that impacts on reported profit or NPAT in the 2014 financial year but does not affect the operation of the business or the cash flow it generates.

That said, as always, we continually monitor our cost structures and reduce them where possible to best align our businesses with the prevailing market conditions.

The Board's dividend policy remains to pay out a majority of earnings as dividends whenever prudent. In setting dividends for the year, the Board noted the ongoing uncertainty of prevailing economic conditions. The Board also took into consideration the capital investment required to achieve the forecast growth in Automotive Leather. Accordingly, the Board declared and paid dividends of $0.25, which represents a conservative payout ratio of 57%.

I will now review each of our divisions 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.

This is a global business and supply chain.

Howe primarily purchases its raw materials – semi-processed hides – from South America. Those hides are finished at our facilities in Victoria and then cut for supply at our component cutting plants in China and Slovakia. Howe supplies a strong and regionally diverse customer base in Asia and Europe, including major motor vehicle manufacturers Audi, Land Rover, Nissan, Toyota and Ford.

Because Howe exports the vast majority of its product to Asia and Europe, currency fluctuations are important to us. Most of Howe's revenue is generated in Euro. The majority of expenses (hides and chemicals) are purchased in USD. Therefore, a weakening Euro and a strengthening US dollar against the Australian dollar are negatives for our business and vice versa.

For the 2014 financial year, Howe's EBIT more than trebled to $15.2 million from $5.0 million. The increase was due to a 16% growth in volumes, including 31% growth for Europe following new programs from existing customers. Automotive Leather also benefited from an abnormal stock profit that accrued from the weakening of the Australian dollar against foreign currencies just prior to the start of the financial year.

That depreciation immediately increased export sales revenue. However, Howe was shielded for about 6 months from increased input costs whilst the division utilised stock in hand purchased prior to the depreciation. Getting away from the currency jargon, Howe benefited because its hide costs were effectively lower whilst revenue from the sale of those hides increased.

We have worked very hard to position Howe as a low cost producer. We invested in sites that allow us to be competitive globally whilst also having local presence in key automotive markets. That diversity – there's that word again – gives Howe an ability to respond more efficiently to customer needs. It was those attributes that assisted Howe in securing new supply programs from automotive manufacturers in Asia and Europe, particularly Mercedes Benz.

The new supply programs will increase volumes significantly from the 2015/16 financial year. This increased volume will underpin a strategic initiative to further increase Automotive Leather's operational presence in Europe. Planning is well underway for production capacity increases for both leather finishing and cutting in Kosicé, Slovakia. These facilities are due to go live towards the end of 2015, which aligns with the timing of forecast program volume increases.

Howe's medium term volume outlook is buoyant and positions the business to be a growth engine and the largest profit earner in the Group. However, in the first half of the 2015 year, Howe's result will be significantly lower than the previous corresponding period. The decrease is largely due to sale of cheaper stock in hand and restocking with more expensive hides, following the currency depreciation. In addition, whilst volumes were greater in the first half last year, we expect volumes to be tilted towards the second half this year. Finally, the strengthening USD and weakening Euro have had a negative impact in the first half.

Building Materials

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

Delta Corporation produces and supplies pre-cast and pre-stressed concrete products. During the year, there was a steep decline in resources sector construction and related Government infrastructure in Western Australia. That decline directly impacted volumes and margins. Delta captured work in the Perth metropolitan area infrastructure and commercial sectors, albeit at lower margins resulting from intense competition. This trend has continued through the first half of this year. Delta remains a market leader for highly specialised, higher margin work and is well positioned to capitalise on improved conditions.

The Building Products business unit supplies paving and walling products, and comprises UrbanStone, Urbanstone Central retail outlets, Archistone (including Archistone Masonry products), Limestone Resources and Imported Stone products. Competition remains intense and the market subdued, particularly within the residential sales sector. The business unit's Masonry Block penetration strategy is progressing well with increasing supply of value-added architectural products.

For the 2014 financial year, Building Materials had a decrease in EBIT to $1.8 million, while revenue decreased by 11% to $52.0 million.

Continual business improvement and cost reduction is fundamental in our management process. Building Products continues to address opportunities to reduce costs across production and retail operations whilst maintaining high standards of service and quality.

We expect the first half result for Building Materials to be lower than the prior year. However, profitability should improve modestly in the second half, based on improvement in sales volumes and adjustments to cost structures.

Investment Property

The Investment Property division comprises the Group's interests in syndicated property investments. Revenue increased by 18% to $7.7 million and EBIT increased by 7% to $3.1 million. The result included $0.5 million profit from the final sales of land and marina assets by the Mindarie Keys Syndicate.

Excluding the profit from property sales, revenue reduced by 7% to $6.1 million and EBIT reduced by 10% to $2.6 million. That result reflects the weaker commercial office market, which caused occupancy of net lettable area to decrease to 91% at 30 June 2014.

For the first half of the 2015 financial year, we expect a slight reduction in Investment Property's result due to lower occupancy and leasing incentives that we anticipate will be required to retain and increase occupancy rates.

Gosh Capital

At last year's AGM, I announced the establishment of a new investment business, Gosh Capital. Gosh Capital, which is owned 83% by Schaffer Corporation, seeks to maximise the value of the land asset on which the former Gosh Leather business operated at 10 Bennett Avenue, North Coogee, Western Australia.

The Cockburn Coast area is presently undergoing conversion to a high-density residential precinct. The process has enhanced the future development potential of the site. Gosh Capital will also reinvest profits earned to grow its available capital for investment.

Gosh Capital reinvested insurance proceeds from the loss of the factory building by fire at Bennett Avenue. These proceeds were combined with debt to purchase a bulky goods retail centre located at 39 Dixon Road, Rockingham, Western Australia, for $7.75 million (at an 8.75% yield). The purchase was funded 60% by debt, with recourse against the property. Gosh Capital has invested a further $1.8 million to expand the property, which it has leased for an initial term of 7 years.

Gosh Capital has made other smaller investments of $2.5m in three property unit trusts, yielding 11%. It has made a fourth investment of $0.5m in a regional 50.9 hectare commercial subdivision that will be developed over time.

For the first half of the current year, Gosh Capital's profit will increase from a low base.

Asset Backing

Schaffer Corporation maintains its conservative accounting policy of historical cost less accumulated depreciation in valuing the property portfolio. Our estimate – backed by qualified independent valuations – is that there are approximately $34.3 million of post tax unrealised gains on property above those book values. At 30 June 2014, the addition of those unrealised gains increases Group Net Tangible Assets to $7.14 per share compared to the book value of $4.69 per share.

Group net debt will increase over the current financial year to increase Automotive Leather's hide stocks levels to meet forecast sales volumes in the 2016 financial year and fund the capacity expansion of the leather cutting and finishing operations.

Outlook

We anticipate the consolidated Group will record a significant decrease in revenue and underlying profit for the first half of the 2015 financial year due to:

- A significant decrease in the result for Automotive Leather
- A decrease in the result for Building Materials
- A slight decrease in the result for Investment Property with no expected property sales
- An increase in the results for Gosh Capital, but off a low base.

In the second half, we anticipate:

- Automotive Leather increasing sales volumes over the first half
- Building Materials to improve with increased sales volumes and cost saving measures.
- On a Group basis, assuming prevailing foreign exchange rates continue, an overall improvement in profitability compared to the first half.

As always, your Board and management will closely monitor those factors within our control in order to provide the best possible result for our shareholders in the prevailing conditions.

The most significant factor that will 'move the needle' for the Group is the newly awarded supply for Automotive Leather by Mercedes Benz. During the current year, we will invest in Automotive Leather, to ultimately service that program as well as our entire European business. As that program comes on stream in the 2016 year, we will derive the benefit not just of increased volumes but the significant improvements in the efficiency of our global supply chain from that investment. It will reduce both our working capital requirements and our time to market.

Dividends

The Board is pleased to advise that we intend to continue with an interim dividend of $0.12, the same as last year. The interim dividend will be finally reviewed and ratified when the Group releases its half year results in February 2015.

Conclusion

The balance of the current year will be challenging and also a period for consolidation. With the investment we are making in Automotive Leather, we will realise significant growth of the Automotive Leather division next year and beyond.

We will continue to analyse the strategic positioning of the other businesses within our diversified Group to enable Schaffer Corporation to continue to maximise profits within the current set of economic circumstances.

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

On behalf of the Board, I would like thank our management and employees. They have approached positively the challenges of the past financial year but will do the same for those challenges ahead of us.

It is our people collectively that will enable Schaffer Corporation to maximise the future benefit for our shareholders.

Finally, I would like to thank you, our Shareholders. We have had a very long history with many of you and we appreciate your loyalty and support as we address the many challenges and opportunities that are presented to us.

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

John Schaffer
Chairman

19 November 2014

* *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 2014 Annual Report for the definitions of non-IFRS measures.*