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HGL Limited
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HGL Limited today reported a net loss of \$7.5 million for the year ended September 2008, compared with net profit of \$15.7 million in the previous year. Core profit was \$8.4 million, down from \$9.3 million reflecting a lower contribution from the fund management businesses and higher interest costs, which were only partly offset by an increased contribution from the import and distribution businesses. HGL's portfolio resembles that of a passive investment fund. What is HGL's business model and how do you add value for your shareholders?

CEO Kevin Eley

We invest in and develop the potential of small and medium sized businesses. Historically we acquired businesses through listed company takeovers and private company acquisitions. This has led us to focus on importers and distributors of branded goods and fund management companies.

We've recently acquired more attractive companies at fair values in the private market. This is a large market with a capitalisation well in excess of the ASX. Typically we make acquisitions in this market when a business owner seeks to retire or reduce their involvement.

We have a philosophy of entering into partnerships with the people who run the businesses we acquire. This provides the people running each business a substantial incentive to ensure the business prospers. We find that

management with equity or quasi-equity enhances returns and builds value over the medium to long term through properly managing opportunities and risks.

We build businesses for the long-term benefit of our shareholders and don't acquire a business with the intent to sell.

When we acquire a business its earnings are incorporated in our core earnings. Our aim is to grow our core earnings and dividends and over the past five years we've grown core EPS by 27 percent compound and dividends per share by 10 percent compound.

We're not a passive investment fund, the only passive investment we have is a non-core portfolio of listed investments valued at \$10 million at 30 September 2008.

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You anticipate 2009 will be a difficult year and that core profits could fall. Which sectors of the business are most exposed to the slowing economy and what ability do you have to mitigate the impact through internal initiatives?

CEO Kevin Eley

We have a diverse range of businesses that primarily import branded products and distribute them into niche markets. These businesses turned over in excess of \$169 million and earned \$17.7 million before interest and tax for the year to 30 September 2008. At that date they employed 468 people.

All our businesses are exposed in varying degrees to the recent sharp decline in the Australian dollar and weakening demand by consumers as a result of the credit crisis.

It's too early to estimate the likely impact these factors will have on the profitability of our businesses this financial year however over the long term we're confident of growing earnings.

In the meantime we've adopted, and continue to adopt, numerous internal initiatives to mitigate the impact of these factors on HGL and its businesses. These include increasing prices, increasing our market share through gaining business, minimising both overheads and product costs, and reducing working capital in each business and head office.

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HGL announced a final fully franked dividend of 5.1 cents per share for 2008, down from 8.2 cents in the previous year, bringing the full-year dividend to 12.1 cents, down from 14.4 cents paid last year. The payout ratio was 70 percent of core profit, down from 73.4 percent, and at the current share price of \$1.10, the pre tax yield is 11 percent. In light of the difficult conditions expected in 2009, how sustainable is the dividend at the 2008 level?

CEO Kevin Eley

Our board has a policy of paying dividends equivalent to 70 to 80 percent of core profit in any given year. The decision to declare dividends at the bottom

end of the range for the 2008 year has not been taken lightly. We're disappointed not to maintain last year's level but given the uncertain economic conditions we believe it's a prudent decision.

In regard to 2009, it's too early to estimate how the weak Australian dollar, slowing economy and our internal initiatives to counteract these factors will impact our core earnings. Our board will review all these factors and the outlook for our businesses at the time of declaring our interim and final dividends.

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The core profit was offset by a "non-core" \$15.9 million loss relating to impairment losses on HGL's minority stakes in listed shares. Do you remain committed to holding these minority stakes? Given your investment model for your majority owned import and distribution businesses is based around partnership and management involvement, what's the rationale for maintaining these more passive investments?

CEO Kevin Eley

The majority of the non-core loss was attributable to the decline in the value of our investment in MMC Contrarian which is involved in funds management. We sold MMC Contrarian in November 2008 and since the original investment in 2003, our total cash and accounting gains were approximately \$6 million after interest and before tax.

At 30 September 2008 our investment in Hunter Hall was valued at \$10.7 million and our investments in non-core listed companies at approximately \$10 million. It's our strategy to realise these non-core listed investments over the medium term as and when the stock market recovers. These funds will then be used to repay debt or fund further acquisitions where we can acquire a majority stake and enter into partnerships with people who run the businesses.

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One of your stated strategy goals is to develop your funds management interests yet after the sale of your 14 percent shareholding in MMC Contrarian in November, your only remaining funds management interest is the 6 percent stake in Hunter Hall. What is your rationale for remaining in this area and what is your intention with regard to the Hunter Hall stake?

CEO Kevin Eley

We invested in MMC Contrarian when its strategy was to invest in equities and fund managers. As a result of MMC Contrarian broadening its presence in the wealth industry, we decided to sell our investment for \$21.3 million cash which will result in a \$3.8 million profit before tax to be recognised in the March 2009 half-year result.

Hunter Hall was established in 1993 by HGL and Peter Hall and listed on the ASX in 2001. We recognise that Hunter Hall's profitability may be affected in the short term but remain confident that over the long term it's a sound investment.

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HGL's import and distribution businesses booked pre-tax earnings of \$17.7 million, up from \$15.6 million in the previous year. Excluding the \$2.3 million contribution from the Biante business, which made a five-month contribution of \$0.7 million in the previous year, earnings were up 4 percent. To what extent did the underlying growth reflect external factors such as demand conditions and to what extent internal factors?

CEO Kevin Eley

In 2008 the revenue from our businesses increased by \$25 million from \$145 million to \$170 million. Approximately \$9 million of the increase related to Biante and the remaining increase of \$16 million was due to a combination of numerous internal and external factors.

We had strong growth in profitability from JSB which distributes specialist light equipment, SPOS which is Australia's leading point-of-purchase provider, and BOC Instruments, a supplier of ophthalmic equipment.

However, the earnings of J Leutenegger, a fabrics and haberdashery business, fell by \$1.3 million due to reduced sales, an aggressive stock reduction programme and as a result of the costs incurred when relocating into a new warehouse and head office, while Aarque Graphics, New Zealand's leading distributor of specialist printing equipment and associated consumables, suffered from the very weak New Zealand economy in the second half.

In aggregate the profitability of our other businesses was at the same level as last year. These businesses are: Anitech, a supplier of wide format printing equipment, consumables and maintenance; Mountcastle, a manufacturer of hats and bags; Thalgo, the Australian distributor of Thalgo and Essie beauty and skin care products; XLN, a supplier of quality home sewing fabrics; and Safilo, a supplier of spectacle frames and sunglasses.

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The import and distribution businesses had return on capital employed of 25.0 percent in 2008, up from 22.6 percent in the previous year. What scope is there to maintain or improve returns in a slower economy?

CEO Kevin Eley

We recognise that we're now operating in a changed environment. In addition to focussing on increasing selling prices, increasing our market share through gaining business and reducing overheads and costs, we're placing greater emphasis on reducing working capital. This involves carefully monitoring the extent of credit provided to customers, reducing stock by identifying and selling slow moving items, and improving our logistics through liaising with our suppliers. It's still too early to ascertain whether these measures will be sufficient to maintain let alone improve returns in a slower economy, however the current environment may provide a great opportunity to improve returns over the long term.

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You've indicated that the cost of most products you import has increased by an average of 35 percent as a result of the recent depreciation of the Australian

dollar to around US\$0.65 from an average of US\$0.90 during 2008, and that you are unlikely to be able to fully pass this cost rise onto customers. To what extent was there an earnings benefit from the exchange rate in 2008 and what will be your main considerations in setting prices in the year ahead?

CEO Kevin Eley

When the Australian dollar is strong we generally pass this benefit onto our customers as they expect us to do so.

In setting prices for the year ahead we'll have to take into account the ability of our suppliers to reduce the cost of our goods and the ability of our customers to accept an increase in our selling price.

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In 2008 cash flow from operations was \$6.6 million, down from \$9.9 million while capex rose slightly to \$2.5 million from \$2.2 million. Why was cash flow down and what are the ongoing capex requirements of the core business?

CEO Kevin Eley

Import and distribution businesses generate high amounts of cash as they're not capital intensive. That's one of the reasons we concentrate on this industry. If you add back the net interest and income tax charge and deduct dividend income for the 2008 year you'll note that the businesses generated just over \$11.9 million of cash from operating activities. This compares with \$13.3 million of cash generated last year.

Ongoing capex relates primarily to the purchase of vehicles for the sales force and is unlikely to exceed a level of around \$2.0 million per annum. Last year J Leutenegger incurred an additional amount of capex of about \$0.4 million in relation to its move to a new head office and warehouse.

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HGL's net debt stood at \$34.2 million at the end of September 2008, up from \$27.5 million a year earlier, and gearing was 30.1 percent, up from 20.6 percent. Following the sale of your stake in MMC Contrarian, gearing is now about 18 percent and you've said you're well placed for acquisition opportunities. What opportunities do you see in the current environment?

CEO Kevin Eley

Management is currently focussed on mitigating the effects of the weakness in the Australian dollar and the potential slowdown in the economy on our operating businesses. Our intention is also to realise any non-core listed investments when opportunities arise and to reduce gearing further from the current level.

With our financial strength we're well placed to acquire agencies from competitors not so fortunate and in the medium term will aim to make acquisitions at compelling prices.

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HGL has an ongoing share buy-back program, under which it bought back 0.7 million shares during 2008. You also offer a dividend reinvestment plan

(DRP). What is the rationale for maintaining the DRP when the company has relatively low gearing levels?

CEO Kevin Eley

We have a concentrated share register as the top 20 shareholders control more than 60 percent of the company's capital and there's relatively low liquidity in our shares.

For some time we've provided shareholders with the opportunity through the DRP to acquire additional shares at market value without paying brokerage. We also take the opportunity of any share price weakness to acquire back shares at prices lower than the price at which shares were issued under the DRP, thereby trying to maintain a constant level of shares on issue.

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Can you comment on the longer term earnings and dividend outlook for the HGL portfolio?

CEO Kevin Eley

I'm cautiously confident of our ability to continue with our growth pattern over the long term.

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Thank you Kevin.

For more information about HGL, visit www.hgl.com.au or call Kevin Eley on (+61 2) 9221 7155

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