Stockpicker News March 2016 – SinterCast CEO-interview
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SinterCast is one of Stockpicker´s Top Picks. In our last analysis after the final accounts, the target rate increased to SEK 110 (SEK 106). Once again we described the company as a success story with a very strong long-term outlook. That is why we this time chose to have an interview with the CEO of the successful and exciting company – Dr Steve Dawson.

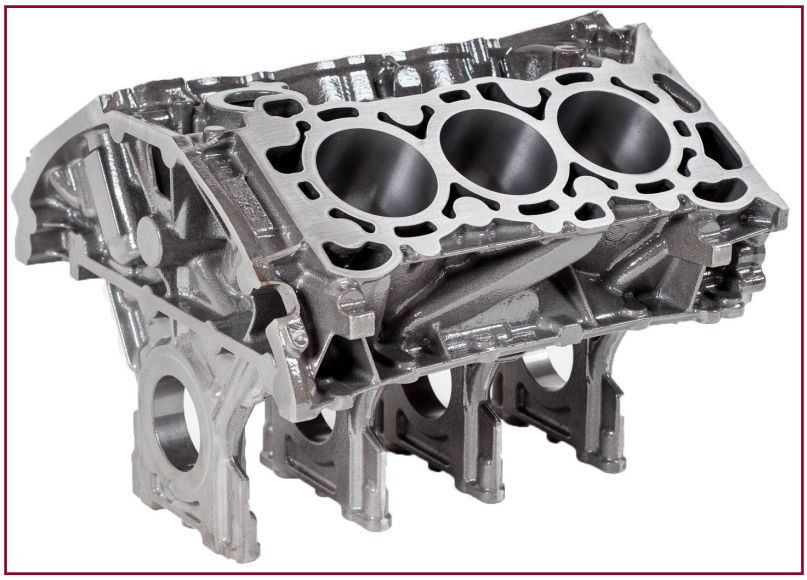
SinterCast's main market is engine blocks, exhaust components and cylinder heads for cars and light- and heavy duty vehicles, in which you have established a strong and growing position. The company is now also growing steadily in industrial engine components for marine, locomotive, off-road and stationary engine applications. The share of the cast iron market addressed by the company to date is still very small, and there should be potential for an expansion that could lead to SinterCast's market growing very strongly in the long term. What new areas do you think are closest at hand to establish your CGI technology?

Our current production is approximately 55% passenger vehicle, 35% commercial vehicle and 10% 'other' components. The other components include automotive castings other than cylinder blocks and heads (mainly exhaust components and bedplates) and industrial power components. So actually, industrial power is about 5% of our total. Industrial power did grow by about 40% in 2015, but still, it is a relatively small part of the business.

In 2002, before the first high volume production had even begun, we introduced the Five Waves to share our vision of the potential market development. These waves identified sequential steps in the main ramp-up of CGI, including: V-diesel cylinder blocks for passenger vehicles in Europe; commercial vehicle cylinder blocks and heads worldwide; in-line diesel engine cylinder blocks for passenger vehicles in Europe; V-diesel cylinder blocks for passenger vehicles beyond Europe; and, petrol engine cylinder blocks.

In addition to these Fives Waves, we also presented two other growth opportunities: automotive components other than cylinder blocks and heads (again, exhaust components and bedplates); and, industrial power. Today, we have delivered high volume series production in four of the five waves and both of the 'other' categories – that's six out of seven 'hits'. We're very proud of our track record of identifying and achieving our target market.

The Five Waves continue to provide the main growth opportunity for CGI and for SinterCast. The simple reality is that, once you get outside of cars, trucks and industrial power, most engine markets are small. There is a great growth opportunity ahead in the Five Waves –these core applications have a need for CGI and our technology is proven and respected. We don't need to try to develop new niche activities; we need to do more of the same.



If we look 10 years ahead, do you think that the automotive industry is still your main market and power industry number two?

Absolutely. Let's begin by explaining the background of CGI. Cast iron is a combination of iron with microscopic graphite particles in it. The shape of the graphite particles determines the properties of the iron.

Historically, there were two types of cast iron: grey iron with sharp and elongated graphite flakes; and ductile iron with the graphite in the form of individual spheres. Grey iron is good at transferring heat and damping vibrations. Ductile iron is strong and stiff, but it is difficult to cast in complex shapes and it is not efficient at heat transfer of vibration damping. The graphite shape in Compacted Graphite Iron is between grey iron and ductile iron – the elongated graphite helps with vibration damping and heat transfer, while the rounded edges of the graphite provide strength and stiffness. The net result is that CGI is ideal when there is a need for both heat transfer and strength. The obvious example is internal combustion engines. If the application only needs strength, like a suspension part, the engineer will choose ductile iron. If the casting is only used in heat applications, like a furnace or a cooking pot, the engineer will choose grey iron.

So we need to present CGI for the applications where it can provide the best technical and economical solution. We can't lose time, money and credibility by promoting CGI in applications that aren't appropriate. The bottom line is that engines are ideally suited to CGI and the global engine market is huge. And we have all seen the progress in engine performance – there is a continuous demand for higher performance from smaller engines, and this will continue. As the demand continues to grow, the opportunity for CGI will continue to increase.

We are focussed on CGI and engines, but we also have good diversification. Our series production castings range from 2 kg per piece to 9,000 kg and we are in production in 11 different countries. Our objective is to be the best in the world at what we do and to be the market leader. The best way to do that, and to earn the recognition and respect of the industry, is to focus.

How well protected are you against copycats? What opportunities do you have in the future to secure or even strengthen patent protections?

We have 12 patents that are granted or pending in a total of 69 national applications. The newest patents address our current technology and these have 18-year lifespan, so we have a strong patent strategy and safeguards for the future. In a perfect world, we could describe and patent everything that we do to secure more patents. But in the real world, that approach would simply publish the recipes for others to copy. So strategically, we keep the majority of the core technology as internal know-how. But patents are something for the back pocket – like insurance, you have to have it but you hope that you don't need to use it. Our primary protection is the accuracy of our technology, the robustness of our equipment and the efficiency of our technical service. We need to provide technology and service that gives our customers confidence and allows them to focus on other tasks in the foundry. We have a good team, with a nice mix of experience and new energy. Our technology is successful and our customers like us. Since 2008, our average customer feedback rating is over 95%. We really work hard to support our customers and earn their loyalty, respect and friendship. We have the comfort of the patents in our back pocket, but our operational performance is at the forefront of our daily activities.

What do you see as your main future competitors?

Our core market opportunity is diesel and petrol engines. We all read a lot about electric powertrains in the media and that attention might make a lot of people think that the horizon for combustion engines is limited. But that isn't the reality. Electrification will increase, but it is forecast to remain less than 10% until 2025, and the majority of this will be as electric-assist of internal combustion engines – not as pure electric vehicles. Throughout the industry, it is widely agreed that the internal combustion engine will remain dominant power plant until at least 2050. We don't know exactly how the market will develop, but even if SinterCast has an initial planning horizon of ten years, we can be confident that there aren't going to be any significant changes that will affect our development in that period. We all know of a lot of examples where the hype is different from the reality.

To the contrary, the main engine trends are in our favour. The ongoing demand for more power from smaller engines helps SinterCast. The only way to get more performance from a smaller engine is to increase the pressure and the temperature, and this needs stronger materials like CGI. The pick-up truck market in the US is an excellent example. Today, in the full size light duty pick-up sector, there are five trucks with 12 different engine options. The top two engines for fuel economy – the Ram 1500 3.0 litre EcoDiesel and the Ford F-150 2.7 litre V6 petrol engine – are both produced with SinterCast-CGI cylinder blocks. Providing more than 20% improved fuel economy in America's highest selling vehicles is an environmental contribution that we can all be proud of.

So the competition can be regarded as electrification; as grey iron and aluminium for car engines; and, grey iron for truck engines. In this sphere, CGI is a strong and confident competitor. Together with the millions of successful SinterCast-CGI references on the road, we need to keep telling our story and keep supporting our foundry customers to help them grow their CGI business.

In the book closing report, it was stated that the company " ... constantly examines new concepts and develop new technologies. SinterCast is currently developing the use of its expertise in thermal analysis to control the production of ductile iron, including measuring device for customised thermal analysis of ductile iron, as well as optimisation of the metallurgical correlation. SinterCast is also developing other technologies, in the field of thermal analysis, and beyond that, to improve quality and production efficiency in the iron foundry industry. " . If we look quite far into the future, do you consider that your know-how could be used in thermal analysis also in other metals? If, which metals and uses do you think, in the first place could be considered?

When we consider the development of new technologies, our ambition is to develop unique technologies that improve efficiency in the foundry and reinforce the image of SinterCast as a technology leader. We have clever engineers with a lot of ideas, so we investigate a variety of different concepts. One of these concepts has been the extension of our thermal analysis technology to ductile iron and that development is ongoing. But over time, we have frequently found that the growth in the core CGI business demands all of our resources, so we prioritise the CGI. We are also investigating some other concepts, as the report says – within and beyond the scope of thermal analysis – but we aren't ready to disclose details about the development at this stage.

The other thing that we need to consider when we evaluate new technologies is the best investment of our resources. We are still at the early stages of the core CGI market development and the most important thing we can do is to support and foster the CGI development, both in technical functionality and market awareness. As Stockpicker correctly points out, the CGI business has strong gross margins and it won't be easy to replicate those margins in our area of thermal analysis and process control expertise. New products will be contributors to our business rather than competitors to our core CGI attentions and revenues. We will keep working in the background, but the best thing we can do is to be the best at CGI.

SinterCast benefitted from a long period with a combination of strong dollar and a weak krona. If the outlook would change in the future to a significantly weaker dollar against the Swedish krona, could the company then consider applying hedging and to what extent?

Well, I don't think that the exchange rates have been helping us for that long – maybe only for the last one and a half or two years. Before that, the krona was rather strong. We do have an active hedge programme that started in 2009 and the Board reviews the hedge strategy at each of the four main Board meetings. We also solicit advice from our banks and our hedge providers. Our hedge strategy is defined in our internal Finance Policy and there is an operational range within which we can alter the hedge in response to market conditions. Of course, we try to secure favorable price levels and secure the Dollar and Euro contracts at favourable rates.

In Stockpickers recent analysis of SinterCast, we argued that the company's financial position is rock solid, with high gross margins, and limited investment needs and relatively fixed costs, which we judged ensures steadily growing cash flow and dividends. SinterCast has a generous dividend policy, but how do you see the opportunities for and the appropriateness of the possible introduction of a share buyback program?

We did canvass our major shareholders a few years ago to ask for their preference regarding dividend vs. buy-back and the preference was almost unanimously in favour of dividend. And indeed, this was the original ethos of SinterCast; that the excess capital would be primarily 'funnelled' to the shareholders. I think that the Board has been very proactive in promoting the dividend path and the shareholder feedback that we have received regarding the dividend development has been very positive. But we would be open to asking the shareholders again, in case the preference has changed. In the meantime, the Board does seek and receive the authorisation of the shareholders every year at the AGM to be able to acquire and dispose of shares, so the authorisation is in place is there is a change in the preference.

Despite a good spread of ownership the liquidity of the SinterCast share is usually thin. Do you have any plans of action to try to improve liquidity?

We have always tried to promote the liquidity. We have a good relationship with Remium and they serve as our liquidity provider. We also conduct quarterly internet CEO interviews after each interim report on Remium's introduce.se portal. In parallel with the Remium activities, we commissioned Erik Penser Fondkomission to publish analyst reports a couple of years ago, but ultimately we felt that this was too much redundancy in the home market. We therefore decided to focus on Remium in Sweden and to increase our meetings with international fund managers, where we have presented our story to approximately 20 fund managers in the UK and the US over the last two years. We also meet directly with fund managers in Sweden and we participate in aktiespararnas meetings and conferences from time-to-time. Our next conference presentation will be at the Remium kapitalmarknadsdag in Stockholm on 22 March.

The Board regularly monitors our press release activity compared to our peer group on the Nasdaq OMX stock market. We typically issue 6-10 operational press releases per year and our frequency is clearly more active than our peer group. I think that we have a good story and we tell it often. We just need to keep making progress in the market, keep offering an increasing dividend, and keep telling the good story.

According to the Financial Supervisory Authority's insider register, you own 30,700 shares in SinterCast. The size of the holding has not changed in the last five years, apart from a purchase of 950 shares last year. Are you satisfied with the number of shares, or do you wish you had the opportunity to buy more?

Actually, I have 34,700 shares, but I loan 4,000 of them to Remium to support the liquidity guarantor service. Therefore, Finansinspektionen only sees 30,700. I re-register my shares in my own name in advance of each AGM, so I vote with 34,700. My SinterCast holding is my largest individual shareholding.

I joined SinterCast in 1991 as a 29 year old engineer and I have committed my career to SinterCast. I always tell the employees that they have committed their families and their careers to SinterCast. The priority is that they put forward their best efforts to make SinterCast a better company, but they shouldn't simultaneously feel a pressure to put their financial investments in the same basket. With the exception of one employee in China who is unable to purchase SinterCast shares, I believe that all of the employees, and of course, all of the Board members, are shareholders. I think it is great that the employees can participate as shareholders, but the amount of their investment should be a personal decision that is free from external pressure or expectation. And I'm confident that the vast majority of the shareholders share that opinion.

Have there been interests in acquisition of SinterCast? If, why did it failed?

We have received enquiries from time-to-time, but in our industry, that type of acquisition isn't so common. All enquiries are welcome, but our focus is on growing – not on selling.

If you could wish/dream, which dream scenario do you see in front of you for the next five years?

Well, if I'm allowed to wish, I would have many wishes. My first wish would be for the current global market uncertainty to be replaced with stability. America and Europe are performing nicely, but many other markets are shaky and managers tend to make fewer decisions when markets are shaky. Stability would help the CGI development, particularly in the developing BRIC countries. I would also wish for governments to change from simplistic tailpipe emissions standards to embrace well-to-wheels energy policies. And I would wish that the 'sticker' on every new car would state the total energy contained in the vehicle. It is a short-sighted frustration that car manufacturers are forced to reduce weight in order to reduce tailpipe CO_2 emissions, when the low density lightweight materials like aluminium consume much more energy than iron during the manufacturing process, resulting in a net CO_2 penalty to society. I would wish for Governments and the industry to adopt life-cycle energy approaches so more holistic decisions can be made for society. And finally, I would wish for a level playing field for all technologies – it is right that legislators should put forward CO_2 and fuel economy targets, but they should leave it to the manufacturing industry and consumers to identify the best solutions. Credit systems and subsidies for technologies like biofuels and electric vehicles rarely work. If 95 g/km CO_2 in Europe and 54.5 mpg in the US isn't enough, then set the bar higher and let the best technology win - we have a good story; we welcome that opportunity.