

## UKSA Meetings with Pittards and Surface Transforms

*Serious investors know the value in meeting with Company Directors  
and fellow members of UKSA.*

*Maybe a company does not at first glance suit your personal portfolio, but a day spent talking with the directors of a company always sharpens your generic investment skills and knowledge, whilst opening up new avenues of thought. So it was no surprise to find the three key Directors of an AIM market company, Surface Transforms, willing to travel 150 miles each way to meet UKSA members, and the Finance Director of Pittards, John Buckley, willingly giving a day to explain why things went wrong for his firm after July 2000.*

*Likewise many of those members present travelled over 250 miles and confirmed afterwards that the Didmarton seminar on June 14th 2005 was, like its predecessors, very good value for money.*

AIM Mkt PLC(1)	Est.	Mkt Cap	Turnover	Share Pr	Share Pr	NAV
		16.5.05 £m	2004 £m	1.1.03	16.5.05	5.05
<b>PITTARDS</b>	<b>1814</b>	<b>4.5</b>	<b>73.2</b>	<b>52.5p</b>	<b>23p</b>	<b>69p</b>
<b>SURFACE TRANSFORMS</b>	<b>1992</b>	<b>4.5</b>	<b>0.5</b>	<b>68p</b>	<b>34p</b>	<b>25p</b>

Both companies have seen their shares halve in the past 30 months. Both are making losses but in every other respect they are different. The essential difference is that Pittards has established products and in the past was profitable but is now failing to make a profit and has cancelled dividends. Surface Transforms has never paid a dividend or made a profit but believes it has a product for which it has yet to establish regular sales. Recently their share price movements seems to reflect a lack of confidence in each achieving its objectives. What are the facts and what are the possibilities?

### Pittards

Leather is a commodity with annual sales of \$19b, twice that of sugar or coffee, and expanding. Interesting there is no futures market. Pittards' target the top end of this market. This company is about chemical technology applied to a natural product. Pittards produce some of the best leather in the world with enhanced qualities for coping with sweat, abrasion, flame, water, and chemicals as well as fine leather for gloves and Louis Vitton products. Leading brands for their top of range products add the Pittard name to define value but at the same time are telling Pittards that their leather is too expensive. The problem is the collapse of the dollar in 2003 when it weakened from \$1.6 to \$1.95 to the £, leaving Pittard with losses on translation to sterling and from a dollar priced contract lower revenue. In 2004 Pittards was forced to lift prices and within 6 months some customers had resourced leading to lower sales. In response Pittards has withdrawn from processing hides in the UK releasing land in Kinghorn, Fife for sale for housing and the headcount is down 200 from 778, but no chemist has been made redundant. The Chairman and Chief Executive have both stepped down and have been replaced. Although to day some of that pressure has been eased with the dollar at c\$1.85, the value end of the leather market has not recovered. Meantime Pittards has stepped up its joint marketing with brand leaders and is about to make a very significant move in entering into manufacture in Ethiopia from where its finest sheep skins have always been sourced. In return for an exclusive marketing agreement and input of its technology it will acquired joint ownership of Government tanneries. 780 people in the UK used to cost £21m plus pension costs. In Ethiopia 800 employees cost \$1m howbeit productivity is perhaps a third of that of Yeovil.

Last year the loss was £5.5m of which £2.7m was non-recurring exceptional. So with UK payroll savings already down by £4m, and the prospects of £3m from the sale of Kinghorn Pittards could be moving into profitability and the prospect of £3m plus from the Kinghorn should help cash flow.

Yet the share price is not responding. Why? The three reasons are that the company has broken its banking arrangements and the Bank has taken a charge on the proceeds from Kinghorn, the company has yet to see in a "lack lustre market" prospects of an upturn in sales, and a pension fund deficit, which required giving the Trustees a charge over the Yeovil site. 1<sup>st</sup> quarter 2005 losses were not covered by 2<sup>nd</sup> quarter profits, but at least profits are now being made. The other good news is that property is in the books at 1990 values and the factory site in Leeds, on which there are no charges, is perhaps worth £7m. The real problem is the third factor. The pension fund, with liabilities of £56.3m and assets nearer £36.6, now supported by a charge of the Yeovil site, has required a commitment to double the employer's contribution to £2.4 m p.a. It may need more if the Stock market investments fail to recover. Pittards have to get themselves back within their banking terms, and they have to generate a cash flow strong enough to support the pension fund.

The actions taken so far have gone a good way towards achieving this but the market is awaiting an upturn in sales. News of this and a stronger dollar would help. As already mentioned last time exceptionals were £2.7m of a £5.5m loss. If the staff cut backs have saved £4m then the operating loss of last time plus the extra Pension Fund contribution of £1.2m is covered and when Kinghorn is finally sold this will cut interest charges. So a modest uplift in sales, helped by lower quality leather costs out of Ethiopia should see a return to profit. The brokers expect £300k loss this year covered by £0.5m profit next.

## **Surface Transforms**

Formed by Professor David Clark and Julio Faria a colleague, then working for ICI, when the company decided not to pursue a new discovery, for a decade this was essentially a research company. By 2003 the team, which has access to all the relevant major university research groups, felt it had a commercial product. Aware that success depends upon turning the new product into a commercial success managers were appointed to complement a research-orientated leadership. In the past year this has been further strengthened. The company came to the AIM market in November 2003 at 90p. The market welcomed the new company with enthusiasm, but this was followed by a rapid descent over 4 months to 14p from where within 8 months it recovered into a range 60-80p. The recovery was supported by news of major research and product testing contracts and partnerships sufficient to allow it, in April 2004, to raise new capital from VCTs and EISs, at 70p a share, to cover the next three years needs. Since the beginning of 2005, with the development contacts not yet producing mainstream contracts, the price has slid to around 33p.

The product is carbon fibre reinforced ceramic composite (CFRC) and the application is Brakes and Clutches. CFRC can reduce the weight of automotive steel brakes by 70 percent and in areas of high performance deliver improved braking and longer life compared with steel brakes. The main areas of application are (i) aircraft brakes where the improved wear rates and weight saving offer a worthwhile improvement in load capacity/fuel saving, less maintenance and especially on aircraft carriers safer landing and (ii) high performance cars (from F1 down to a £40,000 plus car) where CFRC can deliver high weight savings, improved braking withstand high temperatures without brake fade. It is also applicable to rocket nozzles (£1.5m p.a. potential) where it can withstand very high temperatures because it has a high heat capacity and thermal shock resistance.

Surface Transforms claims that it has technological leadership over others experimenting with CRFCs and it has the process equipment capable of producing volume at a consistent standard. Compared with its competitors, the technology chemically transforms carbon carbon to a solid piece of CRFC (ceramic), which can be machined to size giving the ability to be applied in the special applications, where small runs are the norm. By contrast competitor equivalents have to be moulded which means the high costs of precision moulds make them unsuitable for the low volume high performance car market and moulding uses chopped reinforcement fibre, which gives less strength than continuous woven fabric used in solid CRFC piece production.

The market for aviation carbon-carbon discs is estimated at £625m (2002) and currently a prospective £72m plus p.a. for ceramic high performance car brakes, where the O.E. potential is 72,000 cars and if 25% of use ceramic brake sets at £4000 per set. Furthermore, there is the potential for the refit and replacement after market.

So why are current sales less than £1/2m p.a.? The US Air Force has tested CFRC; there is a Dunlop (Meggitt PLC) Development and Licence agreement; a US Airbrake manufacturer has signed a development agreement; nozzles have been tested on rockets and the defence conglomerate Roxel has commenced tests; the MOD has commissioned ceramic armour plate testing; METEK, a European brake supplier, has signed a two year co-partnership agreement to sell the automotive CFRC brake disc in the German after market, and more test orders are in the pipeline. Unfortunately R & D contracts do not yield profits.

Does the low price suggest the market lacks confidence in the ability of the present team to convert R & D contracts, each worth very little (the MOD paid £40k) into mainstream sale? The Board have 25% of the shares and Institutions some 70%. Many institutions are there for the medium term (VCT/EISs) so with 85% of the shares held tight there is a very small market. This means if there is little private investor interest the price will slide away. It only needs good news, as in the case of the 2003 Dunlop contract, to cause the price to soar but this time good news will need to be about actual product sales as opposed to R and D, or maybe approval to incorporate into an aircraft undercarriage. Aviation contracts do not come quickly. Products have to be cleared for use on each model of existing aircraft. New aircraft take many years in planning and the component bidders specify the product. Surface Transforms has to be inside a successful bidding consorting. Automotive may be faster as the private luxury car owner looks for an upgrade to give his car "the edge". A few, well publicised, sales here may force the O.E. carmakers to offer CRFC as an option. To form a view as to the prospects and timing of success it may be worthwhile reading the performance car magazines

Do not expect the emergence of profits to lead to a dividend. The Board recognises that on the aviation brakes side of their business there are only 5 major players and that if they get a toe hold in the market then one or other will want to buy them. On the automotive side there are more brake suppliers and there are competitive products but Kevin D'Silva, chairman, is confident that once the product is in production there will a trade buyer. His time frame is 3 years, and the price...it will be good if his targets are achieved, so the share purchase and sales activities of the Directors may well be significant market pointers.

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*(1) Factual figures as reported by Company Refs.*

*(2) This summary is based upon a presentation made by John Buckley, Group Finance Director to the United Kingdom Shareholders Association on June 14<sup>th</sup> 2004*

*(3) This summary is based upon a presentation made by Kevin D'Silva, Chairman, Julia Faria, MD and Kevin Johnson, Ops.D. to the United Kingdom Shareholders Association on June 14<sup>th</sup> 2004*