

Q&A – Interview between Ian Smale and Cameron Young, BRR Media.

Welcome

Ian Smale, CEO of Hydrodec Group

Q1. Following on from your insurance settlement for the Canton fire, you have now announced a US\$10m loan facility for the US business; can you explain why?

- A. There are many benefits to the financing, not the least of which is a strong signal of confidence from a third party, an independent bank, in the future of the Hydrodec business at Canton. The finance will bring competitive debt onto the balance sheet of the operating company, a more efficient capital structure for long dated assets; it will also fund additional working capital for the expanded business and create flexibility for Hydrodec as a group to invest further in strengthening the value chain or in other opportunities.

Once drawn down, the facility will return Hydrodec Group's cash position to levels similar to that following the fundraising in November 2013, and before the incident; with the rebuild and expansion fully funded.

The capacity of the new plant at Canton will be ***more than 50% greater than before the incident, safer and easier to maintain, with significant unit efficiencies and only marginal increase in headcount.***

Although we expect production to ramp up over the second quarter while we prove the quality and re-establish the market position – once fully operational, the new plant is expected to produce the highest quality transformer oil available domestically in the US; of course, it will be the only oil with the benefit of being a registered carbon offset.

Q2. That sounds like a positive note to end what has otherwise been a difficult year for Hydrodec?

- A. It has, not least because we had developed some real momentum in 2013. I made a commitment publically following the incident that we would recover, learn and ***“re-emerge stronger” – as a business in the US, and as a Company generally.*** There have been a number of significant milestones through this year that, I am confident, will restore the momentum from a **stronger base with lower risk.**

I have already mentioned Canton – but it is worth mentioning that we have a robust and constructive relationship with our ***partners, G&S Technologies,*** now tested in adversity. We have worked really well together through a major dislocation of the business and continued to cooperate and trade oil together that is very encouraging. They have also been active including the addition of new break-bulk storage in New Jersey and Alabama, linked to rail, which should have a positive impact on our logistics for waste oil collection from next year forward.

As I said at the time, the ***insurance settlement*** was extremely pleasing at the end of a long and arduous process. It has allowed us to rebuild at Canton with confidence, fully-funded, to set us up to re-capture the growth and momentum in this business interrupted by the incident. A flow of partial payments meant we were able to proceed with the rebuild and expansion; it has also held us financially whole through this year, with the business interruption payment covering the first quarter of next year while we finish and commission the project.

We made progress this year in ***protecting our IP*** with two provisional patents, both of which are progressing as expected. The first extends our cover for the core transformer oil business for a further 20 years reinforcing our unique capability in the market; the second extends similar principles into lubricant oil re-refining, patenting a process that will (once deployed) increase yield and quality of the base oil we will produce.

Q3. So that is the catalyst for the UK re-refining project?

- A. It is a strong motivation, but on its own insufficient. The technology we are patenting and other aspects of the lubricant oil re-refining process constitute a package of upgrades to a well-known process. When we reviewed this earlier this year, I was struck by the time, and many steps we would have required, as well as the technology risk we would have incurred, to develop this to full scale. The approach to CEP followed a detailed review of available technology, where we assessed them as one of two best in class processes. I describe this as having the technology package to deliver a “*top-of-line*” AMG in due course, but I needed the Mercedes car to upgrade in the first instance! Above all, we will not now spend time reinventing the wheel in hydrogenation.

The agreement with CEP is an evergreen, exclusive licence for the technology in the UK, as well as the opportunity to collaborate on the development of the technology going forward. CEP is the most commercial and distributed of the re-refining technologies, with current projects and installed capacity there will be approaching a billion litres per annum of capacity globally.

The key impact for Hydrodec is a ***significantly de-risked project***, capable of meeting our original timetable of a new re-refinery by end-2016, with substantial opportunity to upgrade as we mature our own technology.

Q4. Talking about the UK, you are one year on from the acquisition of OSS, has it gone as you expected?

- A. Cameron, I think I learnt the hard way with Hydrodec that nothing is ever as you first expect once you get a real insight into the business. That said OSS has some excellent people, has a very strong brand and remains the UK market leader in the used oil and associated waste management business. Emerging from administration created a number of challenges, all essentially behind us now. On top of that, current lower oil prices are of course having an impact, but one which in time I

expect to ***reset business margins, stress weaker competition and potentially create opportunities for growth and consolidation.***

Following a review with the management team we are in the process of delivering a number of changes in the business: targeting more than £0.5m of operating synergies; we have re-financed the vehicle fleet through a sale and leaseback arrangement which has released funds to cover a significant re-organisation of the business which we are ***re-aligning to the customer.***

Above all we are looking to leverage Hydrodec UK's ***"integrated, compliant, convenient"*** business offer through a clear market segment strategy, recruiting where necessary to add to our bench strength in the business. We have discontinued use of an outsourced call centre, and scaled back our own call centre activity to focus more on customer service and sales. We have also stopped the sub-economic collection of oil, as well as the cross-subsidising of services. The OSS business is capable of delivering a genuinely differentiated, integrated oil and waste management service which can be profitable in its own right and essential to secure the investment in our UK re-refinery.

Q5. You have previously said that you are developing the business case for the UK re-refining project – how is that coming on?

We are making good progress and all is on track for an independent development of a re-refinery in the UK. We have a basic engineering design from CEP, and should be appointing a contractor early in the New Year to develop the front end engineering design (FEED). We have secured a very suitable location and are fully engaged in the pre-planning and permitting process which I would hope will lead to a full planning application in February, next year, with full project sanction before the end of the first half next year. The wider business case remains robust, and there is a real opportunity to meet a significant gap in the market, as well as move the UK forward with respect to the development and regulation of the used oil market.

Q6. You have mentioned the oil price which is much in the news – does that affect your plans? You have said in the past that over time oil price is not significant – surely this amount of volatility must be having an impact?

It will have a short term impact, but less of an impact on our business than the E&P or supply and service sectors of the oil and gas industry. Oil is always a margin game – it always was at BP; it is at Hydrodec. It is essentially the difference between two large numbers – what you pay for your feedstock, and what you are able to achieve for your products. Both are significantly influenced by factors well beyond our control, but which have a habit of realigning through an efficient global traded marketplace.

The issue at Hydrodec has always been one of temporary dislocation, where one price moves faster than the other can respond. The issue is slightly exacerbated in the UK collections and PFO business as margins are significantly smaller, making the impact of change greater, but not necessarily any longer lived.

Along with the changes already discussed in the UK business, we have initiated a bi-weekly pricing meeting and have worked hard to explain the changes to customers and respond effectively. Of course in the US we are not currently producing, which is – for once – good news!

Q7. So your strategy remains intact? No change?

- A. We have held to our very clear strategy based on driving growth and returns through our cash generating US and Australian transformer oil businesses, while we develop a unique general lubricant opportunity in the UK.

There are clear actions ahead which will deliver cash generative growth, through project delivery and business performance, supported by

responsible balance sheet management and a relentless focus on EBITDA.

We put a lot of emphasis on reducing business risk – through IP protection, technology, partnerships and collaboration. This includes in **Australia** where we are outsourcing operations by relocating our business to Southern Oil in Wagga Wagga which will occur during 1Q next year. It also includes **reinforcing the Board** where Dame Mary Archer, as a leading chemist, will I am sure provide a robust challenge to, and an opportunity for, our technology programme, as well our governance generally as we grow with her extensive experience of organisational governance and good practice. Dame Mary will chair a recently former Health, Safety, Environment, Quality and Technology Committee (**HSEQT**) for the Board.

So the **current business strategy and focus is clear**: three independent businesses and a significant technology-led step-up. We continue to identify and review other opportunities across the value chain and continue to believe that there remain opportunities for consolidation in each of our businesses. Overall, by the end of 1Q next year we should be absolutely back on plan and trajectory despite the Canton incident.

Q8. So, we have seen announcements today, and follow on comment from your broker and Edison, but still no research – how long will this be “under review” and when can shareholders expect more clarity on your prospects for the future?

A. I would expect we will see re-initiated coverage on Hydrodec with our trading update which will publish before the middle of January. Coverage from Peel Hunt and Edison was suspended pending a resolution of the insurance claim in December of last year. It hasn't helped the Company or investors, but with that lack of clarity it was always going to be difficult.

I absolutely intend to follow on from what I think was a clear pattern established over the incident itself, one of transparency and timely

communication to all our stakeholders. Re-initiating coverage will be a good start, but the Board has separately committed to a schedule of meetings and briefings, not just to our institutional and large shareholders, but also to the retail sector. This will include a retail business lunch during 1Q as well as a strategy roadshow for investors. I hope this will establish a growing sense of understanding about what we have done, and what we intend to do with the Company.

The key issue for me is that during 2014 we have continued to focus on the long term goal for the business while devoting the necessary time to an appropriate resolution of the Canton situation. By the end of 1Q 2015 we will have rebuilt Canton, and expanded the capacity, we will have relocated the Australian business, and driven change through the UK collection business. We have a strong balance sheet and a clear sense of direction with three core business streams and a strong expectation of growing cash generation. The insurance settlement removes any residual uncertainty from the business, while our actions on technology protection and access as well as business preparation have done what we can to reduce overall business risk. ***I believe we are emerging stronger, and I am looking forward to 2015.***

Thank you. That was Ian Smale, CEO of Hydrodec Group...