

WATERCO

Water, the liquid of life



Half year report

for the six months ended 31st December 2006

www.waterco.com

REVIEW OF OPERATIONS

For the six months ended 31 December 2006 Waterco Limited reported a Net Loss After Tax of \$0.96 million. The reported net loss was after allowing for unrealized foreign exchange losses totaling \$1.17 million.

The result is consistent with Waterco's announcement to the ASX on 18 January 2007, that the half year result represented a break even after tax (before Foreign Exchange adjustments). The actual after tax profit (before Foreign Exchange adjustments) was \$0.234 million.

The result compares with a reported after tax profit of \$3.08 million (after Foreign Exchange gains of \$869,741) for the previous corresponding period being the six months ending December 2005.

Earnings Before Interest & Tax (excluding FX adjustments) for the period were \$1.11 million (Half Year Dec 05 \$4.68 million), after consolidation adjustments.

Total Revenue was \$43.2 million (Half Year Dec 05 \$49.6 million).

Detailed below is a breakdown of the Total Revenue contribution for the Dec 06 Half compared to previous Dec 05 Half Year:

Waterco Limited - Half Year\ Divisional Revenue	Dec 06 Actual	Dec 05 Actual	% Change
Australia	\$ 31,492,890	\$ 32,847,919	-4.1%
S E Asia	\$ 1,889,015	\$ 1,784,371	5.9%
North America	\$ 3,413,708	\$ 8,384,902	-59.3%
New Zealand	\$ 3,106,248	\$ 3,221,515	-3.6%
Other	\$ 2,708,006	\$ 2,817,947	-3.9%
Unallocated Revenue	\$ 578,119	\$ 518,039	11.6%
Total	\$ 43,187,986	\$ 49,574,693	-12.9%

The table above highlights the 12.9% (\$6.39 million) revenue decline was principally attributable to the USA and Canada which represented 78% (\$4.97 million) of the total revenue decline against the previous year.

Our sales of product in the Northern Hemisphere, reflecting the back end of the summer season, were below expectations. In the USA sales were impacted by the loss of the Waterpik (USA) business and timing delays in the re-order by existing customers. As a result we were unable to replace this lost

business prior to year end December 2006. However forward orders currently on hand are higher than this time last year.

In the European markets our sales results were impacted by a delay in the volume of early purchase orders by distributors in Europe and key customers in Canada and USA. Distributors, six months earlier in the Northern Hemisphere summer, had experienced an unseasonally cool summer and had been left with surplus stock, leaving our first half year revenue results below expectation.

Waterco Canada sales were down on last year caused by lower production volumes as a result of product quality issues. This issue is being addressed with the restructuring of production of heat pumps with part of the production line in Canada relocated to Waterco Far East in the second half.

Sales in Australia declined approx. 4.1% over the previous period due to an unseasonally cool summer and a reduction in sales of our chemical business. Delays in the delivery of heat pumps from our Canadian operation which was budgeted to boost sales in Australia, also impacted negatively on sales revenue.

In terms of our 58 store Swimart franchise group in Australia, we were pleased to note that first half revenues were ahead of the previous 6 month corresponding period by approx. 3%. In the first half, Waterco product sales in Australia were represented by 24% to Swimart stores with the balance represented by major retail and trade sales.

DIVISIONAL PERFORMANCE

Detailed below is a division breakdown of divisional EBIT contributions (before forex) for the half year ending Dec 2006:

Divisional EBIT (before Forex) Half Year – 6 months ending	Dec 06 Actual	Dec 05 Actual	% Change
Australia	\$ 3,539,179	\$ 4,943,767	-30%
S E Asia	\$ 199,521	\$ 790,030	-75%
North America	-\$ 2,663,186	-\$ 1,312,183	-103%
New Zealand	\$ 107,307	\$ 191,810	-44%
Other	-\$ 4,943	\$ 136,421	-104%
Reported EBIT (before Forex)	\$ 1,177,878	\$ 4,749,845	-75%
Consolidation adjustments	-\$ 66,450	-\$ 66,450	
Unrealised Forex Gains / (Losses)	-\$ 1,169,751	\$ 869,741	
Reported EBIT	-\$ 58,323	\$ 5,553,136	

The half year EBIT result (before foreign exchange adjustments) of \$1.17 million reflected the impact of USA and Canada which recorded EBIT losses of \$2.66 million as against the previous period's losses of \$1.3 million. Compounding this position was a \$1.4 million deterioration (before foreign exchange adjustments) in the Australian EBIT result.

In general terms the poor EBIT performance was caused by a combination of lower than anticipated sales revenue and lower gross margins. The group's relatively fixed cost structure (both in terms of manufacturing and sales & admin overheads) meant that declines in revenue and gross margin flowed through directly to EBIT.

The Foreign Exchange adjustment at the half year totaled \$1.17 million after tax loss. The Foreign Exchange loss has no impact on cash flow. The unrealized losses relate to inter-company loans of A\$29.47 million from the parent entity to overseas subsidiaries in order to fund growth and working capital. The loans are denominated and repayable in various foreign currencies in the controlled entities' accounts and are translated to an Australian Dollar equivalent at each reporting date. The changes in the valuation are reported as unrealized foreign exchange losses or gains. In the last six months the A\$ appreciated to US\$0.79 as of 31 December 2006, causing the unrealized loss. In the event the A\$ were to return to US\$0.74 then the losses would be reversed.

AUSTRALIAN OPERATIONS

The decline in our revenue of approx 4% or \$1.4 million for the half was caused by lower sales of product to our Swimart outlets and in particular chemicals. Revenues from product sales to trade and retail remained flat. The lower revenues from Swimart related product sales was caused by some franchisees taking advantage of select product discounts available from other suppliers in the market. This issue is being addressed.

The decline in reported EBIT of approx. \$1.4 million as against the previous corresponding period reflected a combination of the revenue decline and gross margin decline of approx. 3% as compared to the previous period.

The unseasonal weather and its impact on lower than forecast revenue had the effect of causing suppliers to discount margins on our key product categories. As a result we were forced to

meet the market in terms of pricing, reflected in our lower gross margins.

During the six months 2 new Swimart stores were opened.

WATERCO FAR EAST

Waterco Far East is now the group's principal manufacturing facility for pumps and filters (commercial and residential). Waterco Far East supplies all major overseas divisions, including Australia.

Over the last 2 years Waterco has invested in expanding the manufacturing capacity of Waterco Far East in anticipation of increased order volumes from USA, Canada and Europe.

In the last six months the lower than anticipated sales volumes from USA, Canada and Europe adversely affected Waterco Far East with manufacturing output lower than budgeted. Whilst the reported Sales Revenue actually showed a slight increase over the Half, this excluded inter-company sales. If the inter-company sales volumes are taken into account the decline (as against the Dec 05 half year) was much more substantial and accounted for the drop in reported EBIT of approx. \$0.5m.

WATERCO NORTH AMERICA

Waterco North America represents the group's operations in USA and Canada. Waterco North America reported an EBIT loss for the six months of \$2.66 million which was a variance from the previous corresponding period of \$1.35 million.

For Waterco USA, the negative EBIT result was caused by a decline in sales revenue of nearly \$3 million caused by the loss of a major customer – Waterpik – and the shifting purchasing pattern of our customers caused by weather conditions. The customers we now have are dealers, (unlike Waterpik which was a manufacturer) who delayed their orders as a result of holding higher than expected inventories. Higher operating expenses - predominantly rent and fixed overheads also impacted on profitability.

The US market is the largest in the world and Waterco has made a substantial investment through its acquisition of Baker Hydro in March 2005. Our operations in Augusta, Georgia

manufacture larger filters and assemble commercial pumps. All indications are that our core products are competitively priced for the US market and will, in time, reach acceptable sales levels sufficient to cover our operating costs. Obviously we are addressing the cost structure of our US operations to ensure this occurs as soon as possible.

The previously foreshadowed turnaround plan for Waterco Canada failed to materialize as expected. As a result, Waterco Canada reported an EBIT loss of \$1.769 million for the six months.

Material items that contributed to the Waterco Canada operating loss included a \$2 million decline in revenue (compared to the previous corresponding period); prior warranty commitments of \$177,871 (excluding labour services) and write downs of stock totaling \$208,557. Labour and overhead recoveries were low, resulting in a loss of \$240,024. The decline in sales revenue was caused by a combination of lower orders and an inability to supply due to poor manufacturing capability from the previous summer.

We had previously expected that the manufacture of the smaller heat pumps would be relocated from Waterco Canada to Waterco Far East. This did not occur in the last six months and as a result the required reduction in overheads did not materialize and production volumes were less than anticipated. It is however currently being addressed as a priority.

The global demand for heat pumps that will be manufactured by our Far East and Canadian operations is growing and despite the production problems and quality issues, the product remains accepted by wholesalers in Europe, USA and Australia. Confidence of our customers has returned, demonstrated by a larger 'early buy' which will be delivered in the second half.

WATERCO EUROPE

Revenue from our European division was negatively impacted by the same Northern Hemisphere unseasonal weather 6 months ago that affected the purchasing pattern of our distributors.

The lower level of production of commercial filters translated into poor overhead and labour recoveries which affected UK profitability resulting in a negative EBIT result for the six months. The result was particularly disappointing given the turnaround in profitability that had been achieved in the previous 12 months.

Arrangements are in place to relocate manufacturing of commercial filters to Waterco Far East. Waterco Europe, despite reporting a negative EBIT contribution at the half year, remains profitable and is expected to improve on the previous year full year result of \$0.4 million, before restructuring costs. Our cost reduction measures would further enhance this entity's profitability for the next financial year. Key distribution relationships remain in place and trends are that product acceptance and ranging with wholesalers are growing. We are also focused on reducing fixed overheads to ensure profitability at lower sales volumes in the future.

WATERCO NEW ZEALAND

Waterco NZ reported a positive EBIT of \$107,307 for the six months. Waterco NZ was similarly affected (like Australia) with unseasonal weather. The lower than forecast sales subsequently translated into a lower gross profit contribution which accounted for the entire decline in profitability of \$90,000 relative to the previous corresponding period.

Waterco NZ owns 4 Swimart outlets outright as corporate stores. The performance of these stores in the first half was less than satisfactory with both revenue and profitability below comparable franchised outlets. Each company owned store reported losses of average \$62,000 due to excessive overtime and low accountability of their time sheets. Waterco expects that most of the corporate stores will be franchised by June 2007, with one of the stores already franchised on 1 Feb 2007.

WORKING CAPITAL & GEARING

WORKING CAPITAL	DEC 05 ACTUAL	DEC 06 ACTUAL
TOTAL	\$ 36,070,179	\$ 33,861,465
INVENTORY	\$ 31,635,873	\$ 31,456,979
DEBTORS	\$ 20,286,799	\$ 17,767,406
CREDITORS	-\$ 15,852,493	-\$ 15,362,920

The group's working capital position as at December 2006 has shown a slight decrease over the previous corresponding period. However the majority of the improvement was not reflected in inventories, which remained unchanged.

The level of inventory at 30 June 2006 (\$30.98 million) was considered high, mainly due to a poor Northern Hemisphere summer six months ago when Waterco USA, Waterco

Canada and Waterco Europe stocked up in anticipation of a normal season. The Northern summer starts in April 2007 and management will work towards achieving an inventory reduction.

At the half year end December 2006 Waterco reported a total (net) debt position of \$32 million which reflected a gearing ratio of approx. 87.5%. During the period and subsequently, Waterco has received funding support from a major shareholder GSS Holdings Pty Limited and other parties in the form of unsecured bridging loans of \$4.5 million at commercial rates to finance working capital, while plans are made to increase the company's share capital.

PRODUCT DEVELOPMENT & WATER TREATMENT

In the six months ending December 2006 Waterco spent approx. \$600,000 on research & development which was fully expensed. This level of expenditure is consistent with previous years and underpins the strong company culture we have towards delivering our customers innovative, durable and energy efficient products.

New product initiatives include an improved version of our commercial composite pumps, launching a range of stainless steel pumps and re-introducing our electro-coagulation machine for recycling of grey water after completion of an extensive user manual.

PLANNED COST AND PRODUCTION RESTRUCTURING

A restructure of our organization – in particular Canada and USA has commenced, with part of the restructure taking effect in March 2007. The restructuring program is expected to be completed by July 2007.

Detailed below is a summary of the key cost and restructuring initiatives planned by Waterco:

Cost and Restructuring Initiatives	Date	Expected Savings Annualised
Relocation of manufacturing facilities in UK, Canada, and USA to Waterco Far East	March - June 07	\$ 600,000
Reduce manufacturing overheads in Australia	Feb - Sept 07	\$ 250,000
Reduction in Waterco Canada overheads	July 2007	\$ 400,000
Reduce overhead costs USA	July 2007	\$ 400,000
Reduction in group wages & on costs	July 2007	\$ 400,000
Total Savings (per annum)		\$ 2,050,000

Most of our manufacturing facilities in Australia, UK, USA and Canada will be consolidated into our Malaysian manufacturing plant, Waterco Far East. This will have the effect of reducing our group overhead cost by approx. A\$2.0 million on an annualised basis (refer table above).

In addition, Waterco will accelerate its program of franchising out its 5 company owned stores, whose turnover has been increasing in the last 2 years. Conversion of the stores to franchises is expected to recoup in excess of \$300,000 in goodwill expenses.

Waterco proposes to implement centralized stock control and new order management processes aimed at ensuring an alignment between forward orders and production volume. This should reduce working capital (inventories). Overhead costs in Europe and USA / Canada will be substantially reduced and better aligned to existing sales revenue.

A product review has commenced to ensure achievability of budgeted gross margins and product costings.

In Australia, Waterco intends to increase product sales to Swimart franchisees through improved store merchandising and ensuring that external sourcing of product by franchisees is minimized. This should lead to improved sales volumes and margins in FY08. Waterco is also reducing the overhead cost

structure in Australia by relocating production and assembly to Malaysia.

The planned restructuring of the business will involve the relocation of assembly activities from various centers. It should have no adverse effects on trading. Retrenchment costs will be approximately \$250,000 incurred in the second half.

SECOND HALF REVIEW / FULL YEAR FORECAST

As a result of the various factors outlined in our ASX announcement, the downturn in our first half results is expected to have a direct impact on the full year forecast result.

With the lower than anticipated sales revenue and gross margins reported at the half year, Waterco has instituted a full review of sales and operating budgets for Australia and offshore entities for the remainder of the FY07 period.

The year end June 2007 forecast, at this stage, is expected to reflect a \$0.75 million profit before tax and Foreign Exchange adjustment. This compares with the initial year end estimates of \$3 million after tax. The major variations to the forecast year end position (including retrenchment / restructuring costs) are as follows:

- Waterco Canada – downgraded second half profitability by \$1.3 million as a result of lower trading margins caused by higher than expected overheads and lower than expected labour recovery rates. Our revenue estimates for the second half remain unchanged at this stage.
- Waterco Far East – downgraded second half profitability as a result of lower inter-company sales (Europe and USA) forecasts. Both Europe and USA had high inventory levels from the previous year, hence the more conservative revenue estimates and lower production volumes for Waterco Far East.
- Waterco China – we have lowered the second half profitability by \$0.3 million due to the requirement to write-off pre-operating costs related to the opening of the new building in 2006, instead of capitalizing the expenditure.

- Waterco Europe – we have revised the profitability for the second half downward by \$0.95 million due to lower sales forecasts and under-recoveries of labour and overhead costs. The entity will be profitable by year end June 2007, after absorbing one-off costs of restructuring in relocating manufacturing activities to Waterco Far East.

The positive impact of the restructuring initiatives is not expected to be felt until FY08.

DIVIDEND

Your directors have decided to not declare a final dividend in view of the disappointing half year result. This position will be reviewed again at the time of release of the full year results.

OUTLOOK

The board of Waterco recognizes that the revised forecast for year end June 2007 is extremely disappointing. However steps have been taken to reduce overhead costs, consolidate manufacturing operations and improve manufacturing margins. Subject to these initiatives being executed within established timeframes and sales revenue holding at current levels – an improvement in profitability is expected in the FY08 period.

PERFORMANCE SUMMARY

- Profit/(Loss) attributable to shareholders before income tax of (\$1,150,294) was down by 124.3%.
- Earnings per share of (4.3) cents, was down by 124.6%.
- No interim dividend has been declared.

CONDENSED CONSOLIDATED INCOME STATEMENT

(extracted from the Financial Report for the Half Year)

For the Half Year ended 31 December 2006	2006 \$M	2005 \$M
Profit/(loss) before income tax	(1.121)	4.726
Income tax expense	(0.185)	0.780
Net profit/(loss) after income tax	(0.936)	3.946
Outside equity interest	0.029	(0.006)
Net profit/(loss) attributable to members of the parent entity	(0.965)	3.952
Basic earnings per share (cents)	(4.3)	17.5
Diluted earnings per share (cents)	(4.3)	17.5

CONDENSED CONSOLIDATED BALANCE SHEET

(extracted from the Financial Report for the Half Year)

At 31 December 2006	2006 \$M	2005 \$M
Current assets	51.534	56.006
Non-current assets	37.206	32.441
Total Assets	88.740	88.447
Current liabilities	21.954	20.592
Non-current liabilities	30.105	27.175
Total liabilities	52.059	47.767
Net assets	36.681	40.680
Contributed equity	24.500	23.448
Reserves	3.004	3.49
Retained profits	8.874	13.439
Parent entity interest	36.378	40.377
Outside equity interest	0.303	0.303
Total equity	36.681	40.680

REGISTERED OFFICE

Waterco Limited
A.B.N. 62 002 070 733
36 South Street, Rydalmere, NSW 2116
PO Box 230, Rydalmere BC NSW 1701
Website: www.waterco.com
Tel: (02) 9898 8600
Fax: (02) 9898 1877

SHARE REGISTRY

Computershare Investor Services Pty Ltd
Level 3, 60 Carrington Street
Sydney, NSW 2000
Website: www.computershare.com
Tel: 1300 85 05 05
Fax: (02) 8234 5050