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PearlStreet



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Date of lodgement: 20-Jul-2007

Title: Open Briefing® . PearlStreet. Implications of Metlabs and ITS Purchases

Record of interview:

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PearlStreet Limited (ASX Code: PST) has recently announced the signing of a Memorandum of Understanding (MOU) to purchase the Metlabs and ITS businesses from Leighton Holdings. How significant are these acquisitions?

MD Anthony Wooles

These are very significant acquisitions for us. They are a near perfect fit with our current services, and are also of significant scale. If we'd completed them prior to the recent closures of our Australian NDT (ANDT) and Accura Laboratories purchases, they would have doubled our revenues. Even after these purchases, on an annualised basis, they'll add around 70 percent to our top line. If Metlabs and ITS were to make a full 12 month contribution to FY 2008 we'd be expecting group revenues of around A\$80 million, which is a quantum leap when compared with our FY 2007 IPO prospectus forecast of A\$37 million.

Metlabs has been our primary acquisition target for well over 18 months. It's a well considered move on our part. We're still in the black-box due diligence phase of discussions, but we think it's a tremendous opportunity for us.

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What services do Metlabs and ITS offer? What are the strategic rationales of the purchases? How do they complement the recent purchases of ANDT and Accura?

MD Anthony Wooles

Metlabs is a business with a very rich history in the non-destructive testing and asset integrity industries. It was established in 1955, and was bought by Leighton in 2005. It has a full range of services from condition monitoring, heat treatment, and NDT testing, to metallurgical and engineering analysis. Its geographical strength is in Western Australia, particularly in the Kwinana strip, and it has revenue of a similar size to our PETRS activities. The ITS business adds new services to our portfolio in vibration analysis, condition monitoring, oil analysis and lubrication services. ITS operates primarily in Queensland.

These purchases, along with ANDT and Accura, are strategically important on several levels. Firstly, they broaden our technical offerings. The asset integrity sector services the need to ensure the safety and soundness of the metallurgy of large energy, resource and engineering assets. To be effective across this broad sector you need to be able to offer varied and flexible services. All our purchases are an absolutely consistent fit of complimentary service lines which expand our capability to service clients.

Secondly, the geographic fit is compelling. Metlabs is very strong in Western Australia, and has a significant presence in South Australia, whereas PETRS is strong across Victoria, New South Wales and Queensland. The two businesses dovetail very neatly. This will give us an unrivalled national coverage, with an unrivalled national response capability.

Thirdly, given the unique offering and geographic footprint we'll have after these purchases, it gives us the opportunity to re-engineer our own processes. Traditionally this has been a very technical, engineering-led industry. With our new found national scale we believe there is an opportunity to put in place more contemporary business processes and customer partnership models.

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What synergies do you see flowing from the acquisitions?

MD Anthony Wooles

We're not looking at these purchases on the basis of significant cost rationalisation opportunities, rather we see them as delivering growth synergies and the opportunity to redesign the way we take our services to market.

Our industry is no longer just a case of supplying labour. It's increasingly defined by the application of advanced technology and qualified, experienced human resources. Our enlarged group will be in a great position to provide enhanced career development and training opportunities internally, which in turn will enable us to offer a more highly skilled workforce to our customers. We all know that good technical skills are currently in critically short supply throughout the national economy. Advancing our skills base will be a great advantage for us.

We'll also be able to provide geographical flexibility in a way that we haven't before. This will be a career opportunity for our employees, as well as increasing our flexibility to service customers. For example, we are already deploying

technicians from the Latrobe Valley in Victoria to Queensland for the shutdown season. Another powerful growth opportunity is that we can now seek to strike national contracts with national resource and energy players.

These are capable standalone businesses. They don't require wholesale redesign, but rather the introduction of rigorous commercial disciplines. We're not looking to go into the integration phase and turn them upside down. We're paying fair value for very good businesses in a high demand environment which will enhance our group service offer enormously.

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Following the closure of all of these purchases, what will be your approximate divisional revenue split between Asset Management and Asset Integrity? What EBITDA margin do you expect the enlarged group to generate?

MD Anthony Wooles

Our business was founded in the Asset Management area, whereas our most recent acquisitions have been broadly defined within Asset Integrity. After integrating these businesses we're looking at a split of about A\$10 million revenue in the Asset Management division and about A\$70 million in Asset Integrity.

Within Asset Integrity, we defined the Engineering Services line in our prospectus. Metlabs is going to boost this line by the order of A\$10 to A\$20 million, a figure that's subject to final due diligence. Strategically this is important to us because it carries a number of tertiary and higher qualified technicians. From that base we can offer the most technically advanced services to our customers. It also offers us the ability to develop our future management from this tertiary qualified base.

As another subset of Asset Integrity, through Accura, we have formally entered the Scientific Services sector. This includes water, oil, and coal laboratory testing and analysis. We think this on or off-site analytical laboratory capability has a very big future with major energy and resource players. In revenue this is probably only about A\$5 million, so it's small, but we believe this is another growth business.

As for group profitability post the purchases, and again subject to final due diligence, we expect the combined businesses will generate around 12 percent EBITDA margins and 10 percent at the EBIT level.

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What proportion of the enlarged group revenues will be made under contract? What proportion of revenues do your largest 5 customers generate, and do you face any major near term contract expirations?

MD Anthony Wooles

Currently, prior to Metlabs and ITS, 50 to 60 percent of our revenue is made under contract. Whilst Metlabs has one significant contract, it is a broad base business with approximately 35 to 40 percent of revenue made under contract. This is a proportion that we'll seek to increase. Our estimate at this point in time is that the enlarged group will derive around 30 percent of revenues from our top five customers. This is a good balance to have since we'll not be overly reliant on any

single customer or contract, but it does provide a deep enough contact to really get to know our customer's needs.

We're not facing any major short-term contract expirations other than the current Exxon Mobil contract which we discussed in the IPO prospectus. The renewal of this contract is quite procedural, and is in its very final stages. The next contract renegotiation of note is Verve Energy, but that process won't occur until 2009.

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What price have you agreed with Leighton Holdings? What multiple of earnings does this price represent? When do you expect the deal will close? What short term earnings impact do you expect?

MD Anthony Wooles

We are buying these businesses, with net tangible assets of A\$5.0 million, for A\$32.0 million. This represents an EV/EBITDA multiple of around 8.0 times, which is a higher multiple than we paid for our recent private company acquisitions. However, it is broadly consistent with our stock rating prior to the purchase. We expect the deal to close in late August, but they will have an effective date of 1 August. We also expect to have operational control from 1 August. This means we expect to consolidate Metlabs and ITS earnings for 11 months of FY 2008, and we expect it will be immediately EPS accretive.

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How will you finance the acquisitions? What balance sheet gearing will you have following closure of the deals? What balance sheet flexibility will the purchases leave you for further acquisitions that may present themselves?

MD Anthony Wooles

We will finance the purchases with debt. We have always intended to use an optimal gearing, and this is something our bankers have been aware of for some time. This is not an unplanned debt request that will surprise our banking partners.

We estimate that our gearing, in terms of debt to debt plus market value of equity, will be about 56 percent after closure of the purchases. However, in the way we manage our capital, it's important to note that coverage ratios are more significant than simple balance sheet metrics. One key measure is debt to EBITDA. We would be uncomfortable running above four times cover even for the short term. We also carefully monitor interest and debt service cover ratios.

We have a very good and longstanding relationship with our bankers. We have shown them that we can run this type of business. Their confidence in us is demonstrated by the fact that even after this gearing uplift we will still be within our covenant terms. We are not in a bridging debt situation, and we are not required to undertake an immediate equity placement.

As far as further acquisitions are concerned, it probably is the case that we are approaching optimal gearing. We would hope to be able to grow to A\$100 million revenue without issuing equity, but this desire is somewhat affected by the timing

of any potential further moves. Any further acquisitions of meaningful size in the short term probably would involve a limited amount of equity issuance.

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At this stage you have signed an MOU. What conditions need to be satisfied before the MOU becomes binding?

MD Anthony Wooles

The primary conditions relate to completing final due-diligence on the legal, financial and operating terms of the businesses, as you would expect in any major transaction. There are no unusual conditions, and we've not found anything at this point that would suggest the deal won't proceed. Nevertheless, our board needs to be satisfied that we know precisely what we're purchasing. From a practical point of view we're buying businesses that are driven by know-how and intellectual capital. We need to bring 250 skilled employees across to PearlStreet with conditions of employment that are equivalent to those they are currently on. We don't anticipate any issues with this, but we won't leave ourselves open to a situation where, for example, a fifth of the workforce decided not to join us.

Another procedural point is that we have yet to formally complete the business sale agreement. We have, however, already defined the primary terms of the transaction through the MOU process.

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How has trading developed since you updated the market on 28 May? Do you still expect FY 2007 EBITDA to be down 15-20 percent from prospectus forecasts?

MD Anthony Wooles

Trading has run in line with our expectations. Subject to audit, and as previously announced, we expect our FY 2007 EBITDA to be comfortably within the range of 15 to 20 percent below that forecast in our IPO prospectus. As we announced with that guidance, we were affected by the delays on several customer projects that were beyond our control. This type of delay is simply a fact of life when servicing large infrastructure and energy assets, and it's something we're used to dealing with. Perhaps a flip side to those delays is that we're facing an extremely busy first quarter in FY 2008.

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Thank you Anthony.

For more information about PearlStreet, visit www.pearlstreet.com.au or call MD Anthony Wooles on +61 8 9327 7536

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