Hammond Power Solutions Inc.

# 2009 Q2

Six months ended June 27, 2009

## We've got a good thing going on.

A good thing is a company that can consistently deliver to shareholders in a challenging global environment.

A good thing is a company that can stand the test of time and deliver quality products and innovation for over 90 years.

## A good thing is a great leader.

HPS is the largest manufacturer of dry-type transformers in North America. We engineer and manufacture a wide range of custom transformers that are exported globally in electrical equipment and systems. As the global environment changes, we change with it. Transformers are a necessary part of industry whether it be mining, manufacturing, oil and gas, steel, waste and water treatment or wind power.

A good thing is being solid and poised for the future.

## A good thing is Hammond Power Solutions.



# DEAR FELLOW INVESTOR,

After many quarters of industry-beating performance, Hammond Power Solutions Inc. ("HPS") has experienced a drop in financial results. An unexpected and significant increase in the Canadian dollar during our second quarter negatively impacted our earnings by approximately 18 cents a share.

Like all other companies in the electrical industry, we have been coping with the most challenging economic times in recent memory, and doing so relatively well, however this extreme fluctuation in exchange rates in such a short period was unpredictable. Although largely out of our control, we are implementing further hedging strategies which will assist in reducing the impact of large currency swings going forward.

The second quarter was also slower than expected as both the U.S. and Canadian economies continued to decelerate. A number of projects booked for the quarter were pushed out due to the tight availability of credit and financing. We also saw a slowdown in spending in the oil and gas sector, given the drop in both commodity prices and demand as compared to earlier in the year, all of which contributed to the year-over-year drop in bookings.

Even though we have seen a fall in sales rates, we are gaining market share in many market segments in this recession. In fact, HPS is increasing its market share of the U.S. and Canadian distributor channel, however this advantage will not really be seen until the general economy improves and distributors begin reordering for inventory and those projects currently on hold are finally released.

Through all of this we have been carefully managing and reducing our costs and expenses, although these savings were not enough to compensate for the unexpected negative impact of the higher Canadian dollar. In response, we will continue to aggressively pursue further ways of reducing our costs in these challenging times in the event there are more unexpected bumps in the road ahead.

Going forward, it is fair to say that the global economy is performing worse than even our most pessimistic forecasts of six months ago. We are not absolutely certain when robust growth will resume again; however, we remain firm that HPS is well positioned in its markets as well as its channels and is financially sound with a strong Balance Sheet, all of which will help us weather this recession and prosper as commodity prices recover, credit becomes more available, and government funding finally stimulates the economy. •

William G. Hammond
Chairman and Chief Executive Officer

# MANAGEMENT'S DISCUSSION & ANALYSIS SECOND QUARTER 2009

## Overview

Hammond Power Solutions Inc. ("HPS" or the "Company"), is a North American leader for the design and manufacture of custom electrical engineered magnetics, as well as a leading manufacturer of standard electrical dry-type transformers. Advanced engineering capabilities, high quality products and fast responsive service to customers' needs have established the Company as a technical and innovative leader in the electrical and electronic industries. The Company has manufacturing plants in Canada, the United States and Mexico.

The following is Management's Discussion and Analysis of the Company's consolidated operating results for the quarter ended June 27, 2009, and should be read in conjunction with the notes to the Consolidated Financial Statements of the Company, contained in our 2008 Annual Report, which have been prepared in accordance with Canadian generally accepted accounting principles ("GAAP"). All amounts in this report are expressed in Canadian dollars unless otherwise noted. Additional information relating to the Company may be found on SEDAR's website at www.sedar.com.

## Sales

Sales for the quarter ended June 27, 2009, were $48,203,000 down $6,733,000 or 12.3% from the comparative quarter last year, and were $6,642,000 or 12.1% lower than Quarter 1, 2009 and were slightly lower by $244,000 or 0.2% year-to-date, finishing at $103,048,000 compared to $103,292,000 last year.

Sales in the U.S. were $28,969,000 a decrease of $4,644,000 or 13.8% from Quarter 2, 2008 and were down $8,229,000 or 22.1% from Quarter 1, 2009. Year-to-date sales in the United States were $66,167,000, an increase of $2,502,000 or 3.9%, when compared to $63,665,000 last year-to-date. U.S. sales, stated in U.S. dollars were lower by $8,628,000 or 25.9% from Quarter 2, 2008 and decreased by $5,219,000 or 17.5% from Quarter 1, 2009 and are lower by $8,672,000 or 13.7% year-to-date finishing at $54,523,000 as compared to $63,195,000 in 2008.

Canadian sales for the quarter were $19,234,000, lower by $2,087,000 or 9.8% over Quarter 2, 2008 and 9.0% higher or $1,588,000 from Quarter 1, 2009. Year-to-date Canadian sales were $36,884,000 a decrease of $2,743,000 or 6.9% as compared to sales of $39,627,000 last year.

Geographically stated, U.S. based sales were 60% of our total sales, while 40% of the sales in the quarter were derived in Canada.



During Quarter 2, 2009, HPS saw a significant decline in the U.S. and Canadian electrical markets. This was evidenced by our lower booking rates, reduced sales, lower backlog levels, and reduced financial performance. The Company experienced a significant drop in several of its markets, namely, oil and gas pumping, capital project, the National Association of Electrical Distributor (NAED) and specialty transformer markets in both Canada and the U.S. However, the mining, motor control, switchgear and panel builder markets all show sales growth in the quarter.

HPS' market diversification hedging strategies provide a business hedge as the Company is not single market dependent. As a result, the Company's reduction rate in sales is less than half of the industry average.

The Company has strong resolve to expand its market share penetration through channel growth initiatives in strategic market segments in the United States and Canada. HPS' focus on custom and competitive product design, product breadth and uncompromised quality will continue to support market share despite the deflated electrical market activity. We also expect that this combined organic and new customer sales, flexible manufacturing capacity, and our multi-national operations capabilities will support future sales and market growth opportunities.

## Order bookings and backlog

The quarter was harshly impacted by the depressed electrical industry market conditions which resulted in a decline in booking rates in Quarter 2, 2009. This was evidenced by a 24.2% decrease in bookings over the same quarter last year and down 11.5% on a year-to-date basis. Many of our customers have seen devastating booking level drops in their business as a result of the recession and restricted project financing availability and are further reducing their inventory investment. As a result we continue to see a reduction in their new order bookings. By channel, booking rates decreased 26.6% on a direct basis, and also decreased 2.0% through our distributor channel as compared to Quarter 2, 2008. Due to this decline in booking rates, our backlog was down 34.2% from Quarter 2, 2008 and 11.8% lower than Quarter 1, 2009.

## Gross margins

Gross margin rates for the quarter finished at 26.0%, versus 28.0% in Quarter 2, 2008, a decrease of 2.0%.

On a year-to-date basis, gross margin rates were 27.6% compared to 28.0% in 2008, down 0.4%.

In Quarter 2, 2009 gross margin dollars decreased as a result of lower sales levels, caused by the deteriorating economic conditions. Margin rates in the quarter were negatively impacted by a lower U.S. dollar to Canadian dollar exchange rate, and a significant reduction in capacity utilization.

As a result of the lower electrical industry business activity, there is

additional downward pressure on selling prices from many of our competitors. Manufacturing lead-times continue to reduce and our available excess manufacturing capacity has increased. Due to the unfavorable impact that lower manufacturing throughput has on our factory cost structures, the Company has implemented labour reduction programs at all of its facilities through layoff, reduced shifts and work sharing. This will better match manufacturing capacity requirements to booking rates. The Company is focused on combating these negative gross margin rate deterrents through its engineering and material procurement cost reduction initiatives, product development, responsive custom design capabilities, and by maximizing margin rates through servicing short lead time order opportunities. The Company is focused on productivity improvement and cost reduction throughout the organization. These actions will help improve margin rates.

Achieving and stabilizing gross margin rates is a key success area for our Company.

## Selling general & administrative expense

Total selling, general and administrative ("SG&A") expenses amounted to $8,554,000 in Quarter 2, 2009, versus $9,194,000 in Quarter 2, 2008, a decrease of $640,000 or 7.0% and were $18,413,000 year-to-date versus $17,860,000 in 2008, an increase of $553,000 or 3.1%.

Expenses were positively impacted by the reduction in allowance for doubtful accounts as the Company was successful in collecting previously reserved accounts receivable. Spending was directed in the area of information services and strategic headcount additions.

Although SG&A costs have risen less than inflationary rates, the Company is very mindful of managing selling and administration cost structures during this volatile time.

Management is committed to strong SG&A expense management and its cost containment initiatives.

## Earnings from operations

Earnings from operations for the quarter were hammered by the significant impact of U.S. dollar translation exchange losses, lower sales and the drop in gross margin rates. Quarter 2, 2009 results were down $4,197,000 or 70.1% from the same quarter last year, finishing at $1,786,000 in the quarter, as compared to $5,983,000 in Quarter 2, 2008. Earnings from operations on a year-to-date basis were lower by $2,932,000 or 25.9% finishing at $8,398,000 compared to $11,330,000 for the same period last year.

Excluding foreign exchange losses which are mainly U.S. Balance Sheet translation losses, earnings from operations were $3,966,000 or down 33.7% as compared to Quarter 2, 2008.



Higher raw material costs and the detrimental effects of a higher Canadian dollar on our resale margins in the U.S. negatively impacted our earnings from operations. The Company is focused on market expansion strategies in Canada and the U.S., gross margin rates, and cost reduction initiatives, all of which help combat these negative influences.

## Interest expense

The interest expense for the quarter ended June 27, 2009, amounted to $10,000 compared to $116,000 in Quarter 2, 2008 a decrease of $106,000 or 91.4% and was $72,000 year-to-date versus $179,000 last year, down 59.8% or $107,000.

The decrease of interest expense for the quarter was as a result of solid working capital cash generation which was the main cause of a decrease in total bank indebtedness as compared to Quarter 2, 2008, of $8,640,000. Interest expense as a percent of sales in Quarter 2, 2009 was a negligible 0.02% of sales compared to 0.21% in Quarter 2, 2008, a decrease of 0.19% and dropped 0.1% year-to-date, finishing at 0.1% compared to 0.2% in 2008.

## Gain/loss on foreign exchange

The foreign exchange loss in Quarter 2, 2009 was $2,180,000 compared to a foreign exchange loss of $178,000 in Quarter 2, 2008 and there was a year-to-date foreign exchange loss of $1,640,000 compared to a gain of $254,000 in 2008. The majority of the foreign exchange gains and losses are as a result of realized and unrealized gains and losses from U.S. Balance Sheet translation and the Company's settled U.S. dollar hedge contracts.

## Co-tenancy expense

The property at 2 Glen Road, Georgetown, Ontario, is owned equally as a co-tenancy agreement with Hammond Manufacturing Company Limited ("HMCL") and expenses in respect to the property are shared equally. Our expenses relating to the co-tenancy were $33,000 covering ongoing legal and consulting costs, for Quarter 2, 2009, compared to $32,000 in Quarter 2, 2008 and were $66,000 year-to-date compared to $65,000 in 2008.

The Company has a Balance Sheet provision of $383,000 for future costs of environmental remediation at this site.

## Sale of equity investment in Moloney Electric Inc./ 1159714 Ontario Inc. properties

As disclosed, in Quarter 1, 2008, the Company sold its 45% equity interest in the operations of Moloney Electric Inc. ("MEI") to Universal Power Transformer Private Limited. The Company also sold the Sackville, New Brunswick and Spruce Grove, Alberta plants, which had been jointly owned with HMCL in 1159714 Ontario Inc., which were associated with the Moloney Electric Inc. operations. The Sterling Road, Toronto, Ontario plant continues to be held by 1159714 Ontario Inc. and is currently listed for sale with a local real estate broker.

## Income taxes

Quarter 2, 2009 income tax expense was $1,271,000 as compared to $2,212,000 in Quarter 2, 2008, a decrease of $941,000 or 42.5% and was $3,546,000 year-to-date, versus $4,438,000 last year a decrease of $892,000 or 20.1%. The quarter income tax rate of 72.9% is inflated by the foreign exchange loss from Balance Sheet translation of $2,045,000 as this is not an expense that affects the tax provision. Adjusted for this, the tax rate for the quarter is more normalized at 33.6%. The current future tax assets and liabilities consist mainly of reserves and allowances, and are related to current assets and liabilities, which are not deductible against current year earnings. The long-term future tax assets and liabilities relate to temporary differences resulting from losses carried forward, capital leases (the lease payments are expensed for tax purposes), foreign exchange losses (recognized for tax purposes only on the actual debt repayments), and the difference between net book value and undepreciated capital cost of capital assets.

## Net earnings

Net earnings for the quarter were seriously impaired by our U.S. Balance Sheet translation loss of $2,045,000 and the impact of the recession.

As a result of decreased sales, lower margin dollars, and foreign exchange losses net earnings for Quarter 2, 2009 were lower by $3,151,000 or 87% concluding at $472,000 compared to $3,623,000 in Quarter 2, 2008 and was down $4,029,000 or 46.1% year-to-date, finishing at $4,714,000 year-to-date versus $8,743,000 last year. It is important to note that the net earnings for the year-to-date ended June 28, 2008, were favourably impacted by gains from the sale of its' equity investment in MEI and related properties.

Excluding foreign exchange losses which are mainly U.S. Balance Sheet translation losses, adjusted net earnings were $2,515,000 or down 30.6% as compared to Quarter 2, 2008.

Earnings before interest, taxes, depreciation and amortization ("EBITDA") for Quarter 2, 2009, were $2,900,000 versus $6,954,000 in Quarter 2, 2008, a decrease of $4,054,000 or 58.3% and year-to-date was $10,677,000 versus $15,292,000 a decrease of $4,615,000 or 30.2% from last year-to-date. Although there is not a standard definition of this term, the Company uses EBITDA as a non-GAAP financial measure as one of its indicators of operational profitability.

EBITDA is calculated as outlined in the following table:

| | **Quarter 2 2009** | Quarter 2 2008 | **YTD 2009** | YTD 2008 |
|---|---|---|---|---|
| Net earnings | **$ 472,000** | $ 3,623,000 | **$ 4,174,000** | $ 8,743,000 |
| Add: | | | | |
| Interest expense | **$ 10,000** | $ 116,000 | **$ 72,000** | $ 179,000 |
| Income tax expense | **$ 1,271,000** | $ 2,212,000 | **$ 3,546,000** | $ 4,438,000 |
| Depreciation and amortization | **$ 1,147,000** | $ 1,003,000 | **$ 2,345,000** | $ 1,932,000 |
| EBITDA | **$ 2,900,000** | $ 6,954,000 | **$ 10,677,000** | $ 15,292,000 |
| Less: | | | | |
| Extraordinary earnings related to MEI sale | **$ 0** | $ 0 | **$ 0** | $ (2,086,000) |
| Normalized EBITDA | **$ 2,900,000** | $ 6,954,000 | **$ 10,677,000** | $ 13,206,000 |

## Capital resources and liquidity

Cash provided by operations for Quarter 2, 2009 was $8,006,000 versus cash used of $2,179,000, in Quarter 2, 2008, an increase in cash provided by operations of $10,185,000. Cash provided by operations year-to-date was $10,018,000 versus cash used of $5,003,000 in 2008, an increase in cash provided by operations of $15,021,000.

Net working capital further decreased due to lower sales that resulted in lower accounts receivable (-$6,718,000) and inventory (-$3,019,000) as well as a decrease in accounts payable and accruals ($304,000) from Quarter 1, 2009. The Company remains focused on its customer accounts receivable collections, inventory turnover velocity, and prudent management of accounts payable.

Capital expenditures were higher by $2,432,000 finishing at $4,210,000 this quarter compared to $1,778,000 for Quarter 2, 2008 and increased $3,905,000 year-to-date, finishing at $6,324,000 compared to $2,419,000 in 2008. Our committed manufacturing capacity expansion and product mandate projects at our Monterrey and Granby facilities, productivity improvement initiatives and information technology infrastructure continue to be key areas of expenditure.

There have been no long-term debt repayments in 2009, compared to $411,000, for the same quarter last year and $570,000 year-to-date 2008.

Bank operating lines increased by $3,194,000 in Quarter 2, 2009, as compared to an increase of $3,755,000 in Quarter 2, 2008, due primarily to increased purchases of capital assets.

Net overall bank operating lines of credit and long-term debt, net of cash balances decreased to $970,000 as at June 27, 2009, a decrease of $8,640,000 as compared to a balance of $9,610,000 as at June 28, 2008.

All scheduled payments of principal and interest have been made by the Company on the applicable due dates and the Company is well within all bank covenants as at June 27, 2009.

## Contingent liabilities

The Company has two properties for which there are contingent liabilities.

**Moloney Properties (1159714 Ontario Inc.):**

The Company and HMCL each own 50% of the shares of 1159714 Ontario Inc., which in turn owns the property at 213 Sterling Road, Toronto, Ontario and was vacated by MEI at December 31, 2008. The property has mineral oil contamination as well as some PCB contamination although the source of such contamination (except for a spill in 1993 reported by MEI) has not been determined. The contamination is not a result of the normal operations of the Company and it appears to pre-date the Company's ownership. The source or sources may include adjoining properties. As indirect owner and occupier, the Company and HMCL may, without admitting any liability, have some responsibility to participate in the remediation of the property and adjacent properties. In this regard, the Company received a complaint in 1994 from Toronto Hydro, as an adjoining owner, to the effect that mineral oil and possibly PCB contaminants may have migrated to its property, which is an inactive substation. The Company continues to review further remediation activities. 1159714 Ontario Inc. will fund current recovery, monitoring, professional fees and reporting at this site through its rental income. The Sterling property is currently listed for sale or lease. No determination as to the specifics of full remediation has been made, but the recovery period is expected to take several years.

**Glen Ewing Properties:**

The property at 2 Glen Road, Georgetown, Ontario is owned equally as a co-tenant with HMCL and any expenses or liabilities in respect of the property have been agreed to be shared equally. In January 2002 the two owners were served with a statement of claim by an adjoining industrial property owner, in which the plaintiff has claimed damages in the amount of $8,000,000 for negligence, breach of warranty and other matters relating to alleged environmental contamination of the property. The Company intends to vigorously defend the action if it proceeds. In 2004, the Company and HMCL served a counter-claim against the plaintiff in the amount of $8,000,000. Both claims, by agreement between the parties, are in abeyance. The contamination does not result from the normal operations of the Company. The parties, under the direction of the Ontario Ministry of the Environment, are in the process of undertaking a coordinated and shared investigation of the condition of the property and remediation options. In 2008 the exact approach for active remediation was not finalized, but there was a determination of remediation alternatives and estimates of related costs to the Company. During the year the Company undertook a detailed selection process for the engagement of environmental remediation consultants and finalizing a remediation plan and is now just entering the first phase of the plan. The Company is satisfied that the best estimate available for the Company's portion of the environmental remediation costs for this site remains at $383,000 (December 31, 2008 - $383,000). Excluding the provision, HPS will share the ongoing operational legal and consulting costs pertaining to the Glen Road site with HMCL.

Management is not aware of any other contingent liabilities.

## Special dividend declared

On May 25, 2009, the Board of Directors declared a special cash dividend of $0.10 per Class A Subordinate Voting Share and $0.10 per Class B Common Share payable on July 15, 2009, to shareholders of record at the close of business on June 22, 2009. The ex-dividend date is June 18, 2009. The special dividend was declared in recognition of the Company's record financial performance in 2008 and demonstrates confidence in HPS' business strategies going forward.

## International Financial Reporting Standards

Accounting standards in Canada are to converge with International Financial Reporting Standards ("IFRS"). HPS is required to begin reporting under IFRS by the first quarter of 2011 with comparative data also reported under IFRS. While IFRS has similarities to Canadian GAAP, there are significant differences with respect to recognition, measurement and disclosures. The Company is assessing the impact on accounting policies, data systems, internal controls over financial reporting and business activities, such as financing and compensation arrangements during the period to the transition date.

## Controls and procedures

During 2008, there were no material changes identified in HPS' internal controls over financial reporting that had materially affected, or was reasonably likely to materially affect, HPS' internal control over

financial reporting. HPS carries out ongoing improvements to its internal controls over financial reporting but nothing considered at a material level.

Canadian Securities Administrators require that companies with year-ends after December 15, 2008 be required to certify the effectiveness of internal controls over financial reporting. It also requires a company to use a control framework such as the Internal Control – Integrated Framework (COSO Framework) to design internal controls over financial reporting. As well, the threshold for reporting a weakness of internal controls over financial reporting should be of a "material weakness" rather than "reportable deficiency." HPS has designed its internal controls in accordance with the COSO Framework and has carried out testing during 2008, which was completed in the fourth quarter, and confirms the effectiveness of these controls.

HPS will be auditing the operations and conducting testing at Delta Transformers Inc. ("DTI") to assess the effectiveness of the controls at that entity in the third quarter of 2009.

## Risk factors

As with most businesses Hammond Power Solutions Inc., is subject to a number of marketplace, industry, and economic related business risks, which could have some material impact on our operating results.

These risks include:

- The cyclical effects, unpredictability and volatility of market costs and supply pressures for commodities such as copper, insulation, and electrical grain oriented steel;
- A significant, unexpected change in the global demand for resources;
- The extreme variability of the Canadian dollar versus the U.S. dollar;
- Global economic recession;
- Interest rates;
- Competition;
- Credit risk; and
- Global political unrest.

The Company continuously works to minimize the negative impact of these risks and strengthen its position through diversification of its core business, market channel expansion, geographic diversity of its operations and business hedging strategies.

## Strategic outlook

HPS has a solid record of delivering consistent and solid profit performance. As evidenced in Quarter 2, 2009 the Company is not immune to the ravaging effects of the recession and extreme currency fluctuations.

We are battling an extremely negative and unpredictable global recession, particularly in Canada and the United States and irregular U.S./Canadian dollar foreign exchange fluctuations. We are unsure as to the exact timing of when the global economy will bottom as many pundits are unable to predict the period of recovery. The Canadian and U.S. resource-based markets have reduced their capital spending on equipment as resource prices have softened and financing has become restricted. We do however still expect sales growth in some of our market segments but will see decline in others. A portion of our sales will come from major customer projects for which the exact timing is hard to predict, thus influencing quarterly sales fluctuations.

HPS continues to face an uncertain and unpredictable economic environment particularly unpredictable demand, volatile raw material commodity costs, and an extremely variable Canadian dollar. We remain cautious yet determined that we will deliver industry leading financial results through market expansion, cost reductions, margin maintenance initiatives, productivity gains, and product development.

The Company has fortified its Balance Sheet, is well capitalized, and has little debt and a long-term committed credit facility.

Management is committed to counter the challenges created by this economic uncertainty and remains steadfast in the execution of its short-term and long-term strategies.

## Forward-looking information

Certain information in this MD&A is forward-looking and is subject to risks and uncertainties. The results or events predicted in this information may differ from actual results or events. Forward-looking statements are often, but not always, identified by the use of words such as "anticipate", "plan", "estimate", "expect", "may", "project", "predict", "potential", "could", "might", "should" and other similar expressions. The Company believes the expectations reflected in forward-looking statements are reasonable but no assurance can be given that these expectations will prove to be correct. These forward-looking statements speak only to the date of this MD&A. The Company disclaims any intention or obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, except as required pursuant to applicable securities laws.

# SELECTED ANNUAL AND QUARTERLY FINANCIAL INFORMATION

The information contained in the following table presents the historic audited annual financial information as at December 31 and the un-audited financial information for the previous eight quarters up to, and including the second quarter of 2009.

The quarterly information has been extracted from our un-audited consolidated financial statements, which, in the opinion of management, are prepared in accordance with Canadian generally accepted accounting principles.

## Annual Information

(in thousands of dollars except earnings per share)

| | 2004 | 2005 | 2006 | 2007 | 2008 |
|---|---|---|---|---|---|
| Sales | $ 81,349 | 98,896 | 131,978 | 160,606 | 226,358 |
| Earnings from operations | 4,627 | 7,231 | 14,067 | 19,575 | 29,732 |
| EBITDA | 6,361 | 9,789 | 16,190 | 22,704 | 34,742 |
| Net earnings (loss) for the year | 1,449 | 3,857 | 8,674 | 12,403 | 22,829 |
| Total assets | 40,760 | 45,260 | 57,688 | 70,264 | 110,891 |
| Total liabilities | 21,907 | 22,242 | 25,907 | 25,784 | 41,107 |
| Total cash (debt) | (10,387) | (5,463) | (180) | 4,395 | (4,100) |
| Cash provided from operations | 5,042 | 4,280 | 7,661 | 7,611 | 6,254 |
| Basic earnings (loss) per share | $ 0.13 | 0.34 | 0.76 | 1.08 | 1.95 |
| Diluted earnings (loss) per share | $ 0.13 | 0.34 | 0.75 | 1.06 | 1.93 |

## Quarterly Information

(in thousands of dollars except earnings per share)

| | 2007 | | 2008 | | | | 2009 | |
|---|---|---|---|---|---|---|---|---|
| | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | Q1 | **Q2** |
| Sales | 40,995 | 38,207 | 48,356 | 54,936 | 57,940 | 65,126 | 54,845 | **48,203** |
| Earnings from operations | 4,108 | 5,104 | 5,347 | 5,983 | 6,567 | 11,835 | 6,612 | **1,786** |
| EBITDA | 5,096 | 5,730 | 8,338 | 6,954 | 7,379 | 12,071 | 7,777 | **2,900** |
| Net earnings | 2,983 | 2,715 | 5,120 | 3,623 | 4,335 | 9,751 | 4,242 | **472** |
| Total assets | 65,255 | 70,264 | 86,688 | 93,467 | 99,669 | 110,891 | 107,200 | **107,446** |
| Total liabilities | 23,508 | 25,784 | 34,688 | 37,811 | 39,645 | 41,107 | 33,087 | **33,981** |
| Total cash (debt) | (1,045) | 4,395 | (5,481) | (9,610) | (9,884) | (4,100) | (4,527) | **970** |
| Cash provided (used) by operations | 2,219 | 7,185 | (2,824) | (2,179) | 3,735 | 7,522 | 2,012 | **8,006** |
| Basic earnings per share | $ 0.26 | 0.24 | 0.44 | 0.31 | 0.37 | 0.83 | 0.36 | **0.04** |
| Diluted earnings per share | $ 0.26 | 0.23 | 0.43 | 0.30 | 0.37 | 0.82 | 0.36 | **0.04** |

## CONSOLIDATED BALANCE SHEET

| (unaudited) (thousands of dollars) | As at **June 27 2009** | As at December 31 2008 |
|---|---|---|
| **Assets** | | |
| Current assets: | | |
| Cash and cash equivalents | **$ 8,465** | $ 2,373 |
| Accounts receivable | **30,915** | 41,069 |
| Inventories | **30,386** | 33,903 |
| Prepaid expenses | **557** | 395 |
| Income taxes recoverable | **962** | 919 |
| Future income taxes | **999** | 1,046 |
| | **72,284** | 79,705 |
| Property, plant, and equipment | **25,814** | 21,655 |
| Investment in properties | **1,044** | 1,044 |
| Long-term investments | **1,302** | 1,302 |
| Future income taxes | **64** | 66 |
| Intangible assets - customer relationships | **4,758** | 4,939 |
| Goodwill | **2,180** | 2,180 |
| | **$ 107,446** | $ 110,891 |
| **Liabilities & Shareholders' Equity** | | |
| Current liabilities: | | |
| Bank operating lines of credit | **$ 9,435** | $ 6,473 |
| Accounts payable and accrued liabilities | **23,000** | 30,451 |
| Income taxes payable | **(2,012)** | 1,181 |
| Dividends Payable | **1,173** | – |
| Notes payable | **1,233** | 1,833 |
| | **32,829** | 39,938 |
| Accrued pension benefit obligation | **27** | 29 |
| Future income taxes | **901** | 916 |
| Environmental reserve, net of current portion | **224** | 224 |
| Shareholders' equity: | | |
| Share capital | **13,117** | 13,061 |
| Contributed surplus | **596** | 512 |
| Retained earnings | **59,752** | 56,211 |
| | **73,465** | 69,784 |
| | **$ 107,446** | $ 110,891 |

## CONSOLIDATED STATEMENTS OF EARNINGS AND COMPREHENSIVE EARNINGS

(unaudited) (thousands of dollars, except per share amounts)

| | Quarter Ending | | 6 Months Ending | |
|---|---|---|---|---|
| | **June 27** | June 28 | **June 27** | June 28 |
| | **2009** | 2008 | **2009** | 2008 |
| Sales | **$ 48,203** | $ 54,936 | **$ 103,048** | $ 103,292 |
| Cost of Sales | **35,683** | 39,581 | **74,597** | 74,356 |
| Gross Margin | **12,520** | 15,355 | **28,451** | 28,936 |
| | **26.0%** | 28.0% | **27.6%** | 28.0% |
| Selling, general and administrative | **8,554** | 9,194 | **18,413** | 17,860 |
| Earnings from operations | **3,966** | 6,161 | **10,038** | 11,076 |
| Other (income) and expense: | | | | |
| Interest expense | **10** | 116 | **72** | 179 |
| Foreign exchange loss (gain) | **2,180** | 178 | **1,640** | (254) |
| Gain on sale of investment | **–** | – | **–** | (1,033) |
| Co-tenancy expense | **33** | 32 | **66** | 65 |
| Equity earnings - (refer to MD&A Sale of MEI) | **–** | – | **–** | (1,062) |
| Income before income taxes | **1,743** | 5,835 | **8,260** | 13,181 |
| Income tax expense | **1,271** | 2,212 | **3,546** | 4,438 |
| Net earnings and comprehensive earnings | **$ 472** | $ 3,623 | **$ 4,714** | $ 8,743 |
| Earnings per share for the period | | | | |
| Basic | **$ 0.04** | $ 0.31 | **$ 0.40** | $ 0.75 |
| Diluted | **$ 0.04** | $ 0.30 | **$ 0.40** | $ 0.73 |
| EBITDA | **$ 2,900** | $ 6,954 | **$ 10,677** | $ 15,292 |

### Disclosure

In the opinion of management, these unaudited financial statements are prepared in accordance with Canadian GAAP and use the same accounting policies used in the preparation of the Company's annual financial statements. These interim statements and notes have not been independently reviewed by the external auditors and should be read in conjunction with the December 31, 2008, Notes to the Consolidated Financial Statements.

### Segment Sales

Consistent with the prior year, HPS reflects its results under a single reportable operating segment

## CONSOLIDATED STATEMENT OF CASH FLOWS

(unaudited) (thousands of dollars)

| | Quarter Ending | | 6 Months Ending | |
|---|---|---|---|---|
| | **June 27 2009** | June 28 2008 | **June 27 2009** | June 28 2008 |
| Cash provided by (used in): | | | | |
| Operations: | | | | |
| Net earnings | **$ 472** | $ 3,623 | **$ 4,714** | $ 8,743 |
| Add (deduct) items not involving cash: | | | | |
| Amortization of property, plant, and equipment | **1,058** | 828 | **2,165** | 1,757 |
| Amortization of intangible assets | **89** | 175 | **180** | 175 |
| Equity income on long-term investments | **–** | – | **–** | (1,062) |
| Gain on sale of investment | **–** | – | **–** | (1,033) |
| Accrued pension benefit obligation | **(2)** | – | **(2)** | 1 |
| Future income taxes | **37** | (4) | **34** | (14) |
| Stock option compensation costs | **17** | 10 | **104** | 297 |
| | **$ 1,671** | 4,632 | **7,195** | 8,864 |
| Change in non-cash operating working capital | **6,335** | (6,811) | **2,823** | (13,867) |
| Cash provided by (used in) operations | **$ 8,006** | $ (2,179) | **10,018** | (5,003) |
| Financing: | | | | |
| Finance Costs | **–** | – | **–** | – |
| Advances from bank operating lines | **3,194** | 3,755 | **2,962** | 5,859 |
| Issue of common shares | **36** | 23 | **36** | 93 |
| Proceeds from notes payable | **–** | – | **–** | 1,208 |
| Principal repayment of notes payable | **(275)** | – | **(600)** | – |
| Principal repayment of long-term debt | **–** | (411) | **–** | (570) |
| Cash (used in) provided by financing activities | **2,955** | 3,367 | **2,398** | 6,590 |
| Investments: | | | | |
| Other assets | **–** | (100) | **–** | (100) |
| Repayment of notes receivable | **–** | – | **–** | 1,949 |
| Proceeds on disposal of investment | **–** | – | **–** | 4,134 |
| Acquisition of subsidiary company | **–** | (95) | **–** | (12,867) |
| Purchase of property, plant and equipment | **(4,210)** | (1,778) | **(6,324)** | (2,419) |
| Cash used in investment activities | **(4,210)** | (1,973) | **(6,324)** | (9,303) |
| Increase (decrease) in cash | **$ 6,751** | $ (785) | **6,092** | (7,716) |
| Cash and cash equivalents, beginning of period | **1,714** | 1,463 | **2,373** | 8,394 |
| Cash and cash equivalents, end of period | **$ 8,465** | $ 678 | **$ 8,465** | $ 678 |

## CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

(unaudited) (thousands of dollars)

Three month periods ended June 27, 2009 and June 28, 2008

| | Share Capital | Contributed Surplus | Retained Earnings | Total Shareholders' Equity |
|---|---|---|---|---|
| Balance as at December 31, 2008 | $ 13,061 | $ 512 | $ 56,211 | $ 69,784 |
| Cash consideraton on exercise of stock options | 36 | – | – | 36 |
| Ascribed value credited to share capital from exercise of stock options | 20 | (20) | – | – |
| Stock option compensation costs | – | 104 | – | 104 |
| Issue of shares | – | – | – | – |
| Net earnings | – | – | 4,714 | 4,714 |
| Dividends | – | – | (1,173) | (1,173) |
| Balance as at June 27, 2009 | $ 13,117 | 596 | 59,752 | 73,465 |

(unaudited) (dollars in thousands)

| | Share Capital | Contributed Surplus | Retained Earnings | Total Shareholders' Equity |
|---|---|---|---|---|
| Balance as at December 31, 2007 | 10,850 | 248 | 33,382 | 44,480 |
| Cash consideraton on exercise of stock options | 93 | – | – | 93 |
| Ascribed value credited to share capital from exercise of stock options | 42 | (42) | – | – |
| Stock option compensation costs | – | 297 | – | 297 |
| Issue of shares | 2,043 | – | – | 2,043 |
| Net earnings | – | – | 8,743 | 8,743 |
| Balance as at June 28, 2008 | $ 13,028 | 503 | 42,125 | 55,656 |

## CONDENSED NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

Hammond Power Solutions Inc. ("HPS" or the "Company") is a public company, traded on the Toronto Stock Exchange ("HPS.A") and is incorporated under the Ontario Business Corporations Act.

The following notes should be read in conjunction with our 2008 Notes to the Consolidated Financial Statements contained in the 2008 Annual Report for the Company.

### 1. Summary of significant accounting policies:

The consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles ("GAAP") and reflect the following policies:

**(a) Principles of consolidation:**

The consolidated financial statements include the accounts of Hammond Power Solutions Inc. and its wholly owned subsidiaries, Hammond Power Solutions, Inc., Hammond Power Solutions, S.A. de C.V., and Delta Transformers Inc. All significant intercompany transactions and balances have been eliminated.

**(b) Translation of foreign currencies:**

The Company's subsidiary operations, located in the United States and Mexico, are deemed to be integrated foreign operations and, therefore, their financial statements are translated using the temporal method. Under this method all asset, liability, revenue and expense items are translated at the exchange rate in effect at the transaction date. At the balance sheet dates, monetary assets and liabilities are adjusted to reflect the year-end exchange rate. The gain or loss resulting from translation is included in the determination of income for the current period.

**(c) Revenue recognition:**

The Company recognizes revenue when products are shipped and the customer takes ownership and assumes risk of loss, collection of the relevant receivable is probable, persuasive evidence of an arrangement exists and the sales price is fixed or determinable.

A provision for potential warranty claims is provided for at the same time of sale, based on warranty terms and prior claims experience.

**(d) Cash and cash equivalents:**

Cash and cash equivalents consist of cash and short-term deposits with original maturities of three months or less.

**(e) Inventories:**

Inventories are valued at the lower of cost, determined on a first-in, first-out basis, and net realizable value. When circumstances which previously caused inventories to be written down no longer exist, the previous impairment is reversed.

**(f) Long-term investments:**

The investments in the co-tenancy of Glen Ewing Properties (50%) and in 1159714 Ontario Inc. (50%), the rental property investment, are accounted for using the proportionate consolidation method whereby the Company's proportionate share of the assets, liabilities and the related revenues and expenses of the co-tenancy and rental property is included in the consolidated financial statements.

**(g) Property, plant and equipment:**

Property, plant and equipment are stated at cost less accumulated amortization. Property, plant and equipment under capital leases are initially recorded at the present value of the minimum lease payments at the inception of the lease.

**(h) Financial instruments:**

The Company is party to derivative financial instruments in the form of forward foreign exchange contracts used to manage foreign currency exposures on export sales. The Company records all of its forward foreign exchange contracts at fair value, with changes in fair value recognized through earnings as foreign exchange gains or losses. The carrying amount of foreign exchange contracts is included in accounts receivable in the case of contracts in a gain position and in accounts payable and accrued liabilities in the case of contracts in a loss position.

The Company capitalizes transaction costs related to financial instruments classified as other than held-for-trading.

The Company uses trade date accounting for regular-way purchases and sales of financial assets.

**(i) Goodwill:**

Goodwill is the residual amount that results when the purchase price of an acquired business exceeds the sum of the amounts allocated to the assets acquired, less liabilities assumed, based on their fair values. Goodwill is allocated as of the date of the business combination to the Company's reporting units that are expected to benefit from the synergies of the business combination. The amount recognized as goodwill would include acquired intangible assets that do not qualify for recognition as separate assets in accordance with generally accepted accounting principles.

**(j) Income taxes:**

The Company provides for income taxes under the asset and liability method. Under the asset and liability method, future tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying value of existing assets and liabilities and their respective tax bases. Future tax assets and liabilities are measured using enacted or substantively enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on future tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the date of enactment or substantive enactment.

**(k) Stock-based compensation:**

The Company has a stock-based compensation plan, which is described in Note 15(c). The Company accounts for all stock-based payments using the fair value based method, in accordance with Canadian Institute of Chartered Accountants ("CICA") Handbook Section 3870 - Stock based compensation and other stock based payments.

Under the fair value based method, compensation cost for stock options and direct awards of stock is measured at fair value at the grant date. Compensation cost is

recognized in earnings on a straight-line basis over the relevant vesting period. The counterpart is recognized in contributed surplus. Upon exercise of a stock option, share capital is recorded at the sum of the proceeds received and the related amount of contributed surplus.

(l) Earnings per share:

Basic earnings per share are computed by dividing net earnings by the weighted average shares outstanding during the reporting period. Diluted earnings per share are computed similar to basic earnings per share except that the weighted average shares outstanding are increased to include additional shares from the assumed exercise of warrants or stock options, if dilutive.

(m) Impairment of long-lived assets:

Long-lived assets, including property, plant and equipment, other intangible assets and certain other long-lived assets are amortized over their useful lives. The Company periodically reviews the useful lives and the carrying values of its long-lived assets for continued appropriateness.

(n) Use of estimates:

The preparation of the consolidated financial statements in conformity with Canadian GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities. Management is also required to disclose contingent assets and liabilities at the dates of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting periods. Significant estimates and assumptions are used when accounting for items such as the determination of estimated useful lives of other intangible assets and property, plant and equipment; valuation of receivables, inventories, future income taxes, long-term investments, investment in properties, derivative financial instruments, obligations related to accrued pension benefit, environmental liabilities, stock-based compensation costs, and reporting units and related goodwill. Actual results could differ from those estimates.

(o) Share capital:

a) Authorized:

Unlimited number of special shares, discretionary dividends, non-voting, redeemable and retractable

Unlimited number of Class A subordinate voting shares

Unlimited number of Class B common shares with four votes per share, convertible into Class A subordinate voting shares on a one-for-one basis. Annual dividends on the Class B common shares may not exceed the annual dividends on the Class A subordinate voting shares.

| | (dollars in thousands) | |
|---|---|---|
| b) Issued: | 2008 | 2007 |
| 8,942,000 Class A shares (2007 - 8,726,000) | $ 13,054 | $ 10,843 |
| 2,778,300 Class B common shares (2007 - 2,778,300) | 7 | 7 |
| 11,720,300 total Class A and B shares | $ 13,061 | $ 10,850 |



## 2. Changes In accounting policies:

Effective January 1, 2008, the Company adopted the following new CICA standards:

### Capital Disclosures

CICA Handbook Section 1535 - Capital Disclosures, establishes standards for disclosure of information regarding the Company's capital and how it is managed, including information about the Company's objectives, policies and processes for managing capital. The Section also requires disclosure of the existence of any capital requirements to which the Company is subject and whether it is in compliance with such requirements and the consequences of non-compliance. These new disclosures are included in Note 26.

### Financial Instruments – Disclosure and Presentation

CICA Handbook Section 3862 - Financial Instruments - Disclosures, outlines disclosure requirements for financial instruments and places increased emphasis on disclosure of the risks associated with recognized and unrecognized financial instruments and how these risks are managed. Handbook Section 3863 - Financial Instruments - Presentation, carries forward the presentation requirements from Section 3861 - Financial Instruments - Disclosure and Presentation. The expanded disclosures are included in Notes 21 and 27 through 32.

### Inventories

CICA Handbook Section 3031 - Inventories, provides additional guidance in the measurement of inventories, including the requirements to measure inventories at the lower of cost and net realizable value, allocate overhead based on normal capacity and reverse previous write downs to net realizable value when there is a subsequent increase in the value of inventories. The Company adopted this standard retrospectively without restatement and there was no impact on opening returned earnings as at January 1, 2008 as a result of the adoption of this standard.

The standard also expanded disclosures associated with inventories, including the requirements to disclose the amount of inventory recognized as an expense and writedowns and reversals of writedowns recognized. These new disclosures are included in Note 4.

## 3. Future accounting changes:

### Goodwill and intangible assets

In February 2008, the CICA issued Handbook Section 3064 - Goodwill and Intangible Assets, which will be effective on January 1, 2009, for the Company. The standard provides new guidelines for recognition, measurement, presentation and disclosure of goodwill and intangible assets and eliminates the practice of recognizing as an asset startup, pre-production and similar costs that do not meet the definition and recognition criteria of an asset. The Company is currently evaluating the impact of the adoption of this standard.

### International Financial Reporting Standards

Accounting standards in Canada are to converge with International Financial Reporting Standards ("IFRS"). HPS is required to begin reporting under IFRS by the first quarter of 2011 with comparative data also reported under IFRS. While IFRS has similarities to Canadian GAAP, there are significant differences with respect to recognition, measurement and disclosures. The Company is assessing the impact on accounting policies, data systems, internal controls over financial reporting, and business activities, such as financing and

compensation arrangements during the period to the transition date.

### Capital risk management

The Company's objective is to maintain a strong capital base so as to maintain investor, creditor and market confidence and to sustain future business development. The Company includes cash and cash equivalents, debt and equity, compromising of issued common shares, contributed surplus and retained earnings in the definition of capital. The Company is not subject to externally imposed capital requirements and there has been no change with respect to the overall capital risk management strategy during the year ended December 31, 2008.

### Financial risk management

The Company is exposed to a variety of financial risks by virtue of its activities: market risk (including currency risk, credit risk and interest rate risk) and liquidity risk. The overall risk management program focuses on the unpredictability of financial markets and seeks to minimize potential adverse effects on financial performance.

Risk management is carried out by the finance department under guidance by the Board of Directors. This department identifies and evaluates financial risks in close cooperation with management. The finance department is charged with the responsibility of establishing controls and procedures to ensure that financial risks are mitigated.

### Currency risk

The Company operates internationally and is exposed to foreign exchange risk from various currencies, primarily U.S. dollars. Foreign exchange risk arises from purchase and Canada/U.S. cross border sales transactions as well as recognized financial assets and liabilities denominated in foreign currencies. The Company manages its foreign exchange risk by having geographically diverse manufacturing facilities, purchasing U.S. dollar raw materials in Canada and foreign exchange contracts. The Company also monitors forecasted cash flows in foreign currencies and attempts to mitigate the risk by entering into foreign exchange contracts. Foreign exchange contracts are only entered into for the purposes of managing foreign exchange risk and not for speculative purposes.

Fluctuations in the U.S. dollar exchange rate could have a potentially significant impact on the Company's results from operations. However, they would not impair or enhance the ability of the Company to pay its foreign currency-denominated expenses, as such items would be similarly affected.

### Sensitivity analysis

The Balance Sheet impact of a one cent decline in the Canadian dollar against the U.S. dollar as at June 27, 2009, would have increased equity by $69,000 and increased net earnings by $73,000 for the quarter. This analysis assumes that all other variables, in particular interest rates, remain constant. Inversely, a one cent increase in of the Canadian dollar against the U.S. dollar as at June 27, 2009 would have had an equal but opposite effect.

### Interest rate risk

Interest rate risk is the risk that the future cash flows of a financial instrument will fluctuate because of changes in market interest rates. Financial assets and financial liabilities with variable interest rates expose the Company to cash flow interest rate risk. The Company's cash and cash equivalents include highly liquid investments that earn interest at market rates. The Company manages its interest rate risk by maximizing the interest income earned on excess funds while maintaining the liquidity necessary to conduct operations on a day-to-day basis. Fluctuations in market rates of interest do not have a significant impact on the Company's results of operations due to the low level of bank indebtedness. A 1% increase or decrease in interest rates as at December 31, 2008 would increase or decrease net earnings by approximately 45,000 respectively.

### Credit risk

A decrease in the allowance for doubtful trade accounts receivables of $516,000 (2008 - increase of $741,000) was recognized in selling, general and administrative expenses. The aging of trade receivables at the reporting date was as follows:

| | **2009** | | 2008 | |
|---|---|---|---|---|
| (In thousands of Canadian dollars) | **Gross** | **Allowance** | Gross | Allowance |
| Not past due | **17,658** | **–** | 20,503 | – |
| Past due 0-30 days | **9,254** | **–** | 13,903 | – |
| Past due 31-120 days | **2,686** | **989** | 6,793 | 1,091 |
| More than one year | **9** | **27** | 45 | 45 |
| **Total** | **29,607** | **998** | 41,247 | 1,136 |

### Liquidity risk

Liquidity risk is the risk that the Company will not be able to meet its obligations as they fall due.

The Company manages its liquidity risk by forecasting cash flows from operations and anticipated investing and financing activities. Senior Management is also actively involved in the review and approval of planned expenditures.

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## Corporate Information

### DIRECTORS
William G. Hammond, Chairman and Chief Executive Officer *
Chris R. Huether, Corporate Secretary and Chief Financial Officer
Donald H. MacAdam, Director * +
Zoltan D. Simo, Director * +
Douglas V. Baldwin, Director * +
Grant C. Robinson, Director * +

* Corporate Governance Committee

+ Audit and Compensation Committee

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### STOCK EXCHANGE LISTING
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### AUDITORS
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