

Cyclical Industrials

Key Points:

Risks to earnings and market valuations have increased on the back of global macro concerns

In our view the withdrawal of global liquidity & tightening credit is a key issue

This may impact growth options for cyclical stocks (in our coverage contracting & engineering firms)

Risk is greater for companies exposed to new, uncommitted, & unfinanced projects

Risk is lower for companies exposed to production, east coast infrastructure, and WA iron ore

Valuations fall in a “risk off” world even if earnings are unchanged

We have reviewed covered stocks to ensure we have considered and factored in the risks

Having done so, in our view share price falls provide some attractive opportunities

Best risk / reward combinations are ASL, PEA and SXE

We also see considerable upside for micro-caps SWK and VMX

Please refer to important disclosures at end of the report (from page 3)

Wednesday, 2 January 2019

Into 2019

Factoring in the risks

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Quick Read

Leading into the interim reporting period we have reviewed our cyclical industrial stocks under coverage. We address risks to forecasts in a potentially slower, credit-constrained world, and revisit our valuation calculations to reflect this uncertainty. Barring a debt default induced crisis (not out of the question, but very hard to predict), we find value at acceptable risk in a number of stocks following unreasonable share price falls, notably **ASL** (BUY, valuation \$2.00), **PEA** (BUY, valuation \$0.73), and **SXE** (BUY, valuation \$0.85).

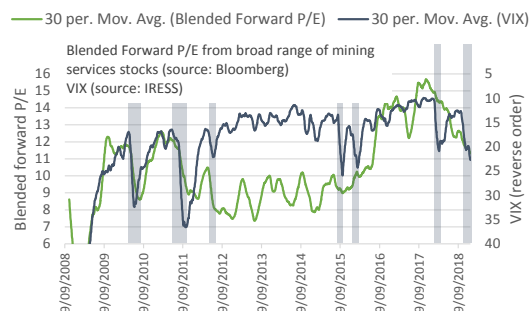
Uncertainty into 2019

Cloudy macro picture: Many of the global concerns in late 2018 were not new. The US-China trade spat, a messy Brexit and EU friction, unsustainable credit growth, and a reversal of central bank expansionary policy (amongst other things) were all in evidence through the year. In our view it was the steady removal of liquidity and resultant tightening of credit markets in the last quarter which caused the angst.

Considerations: As we enter 2019 we need to address two key issues for covered cyclical industrial stocks (which are largely contracting and engineering firms). Firstly, by how much will a slowing economy here and abroad impact growth opportunities? Secondly, what will happen to market valuations in a “risk-off” environment?

Growth opportunities: In our view, contractors exposed to production, east coast infrastructure, and WA iron ore spend face less risk to growth than those exposed to green-field mining projects. A number of committed projects will deliver opportunities, but from a timing perspective financing risks in a credit-constrained environment could become an issue for new, uncommitted projects. We have assessed our bottom-up forecasts for individual cyclical industrial companies accordingly.

Equities and risks: Stocks dislike uncertainty and it gets reflected in market valuations; see changes to broad cyclical industrials’ trading multiples when the VIX spikes (axis order reversed on chart at right). With this in mind we have also reviewed valuation metrics.



Impact

We find the best combination of risk and reward in **ASL** (BUY, valuation \$2.00), **PEA** (BUY, valuation \$0.73), and **SXE** (BUY, valuation \$0.85). Micro-caps with higher risk upside include **SWK** (BUY, valuation \$0.40) and **VMX** (BUY, valuation \$0.42). For further details and links to latest Company-specific notes, please refer overleaf.

Comparison of prior to current valuations, recommendations and forecasts

Company	Code	Current Price (\$)	Valuation (\$)		Price Upside to Valuation (%)	Recommendation		Latest Adjustments to EBITDA (%)		EV/EBITDA Multiple*		P/E Multiple*	
			Prior	Current		Prior	Current	FY19	FY20	FY19	FY20	FY19	FY20
Austin Engineering	ANG	0.195	0.270	0.240	23%	BUY	BUY	-6%	-10%	5.7	5.2	10.9	9.2
Ausdrill	ASL	1.130	2.250	2.000	77%	BUY	BUY	0%	-7%	4.1	3.3	7.3	6.9
Decmil	DCG	0.695	1.200	1.100	58%	BUY	BUY	-9%	-16%	4.1	3.2	9.2	7.8
GR Engineering	GNG	1.090	1.550	1.300	19%	BUY	HOLD	-2%	-17%	7.8	6.1	14.1	10.9
Matrix E&C**	MCE	0.350		0.470	34%		SPEC BUY			n/a	5.6	n/a	n/a
Pacific Energy	PEA	0.570	0.750	0.730	28%	BUY	BUY	0%	0%	6.1	6.1	11.3	11.2
SCEE	SXE	0.550	0.850	0.850	55%	BUY	BUY	0%	0%	3.0	2.7	9.3	8.3
SRG Global	SRG	0.500	0.750	0.700	40%	BUY	BUY	0%	-5%	4.1	3.6	10.3	8.8
Swick***	SWK	0.230	0.380	0.400	74%	BUY	BUY	8%	3%	2.7	2.5	10.3	7.6
Valmec	VMX	0.230	0.420	0.420	83%	BUY	BUY	0%	0%	3.3	2.7	5.8	4.5

* Based on Argonaut earnings forecasts

** No changes to prior report released on 19 December 2019; "n/a" multiples as a result of negative earnings

*** Adjustments to EBITDA and multiple calculations based on Drilling business only (excludes Orexplora)

Links to latest reports (which include 1H:2H splits)

Austin Engineering (ANG), "[Waiting on crane sale](#)", 02/01/19
 Ausdrill (ASL), "[Price falls overdone](#)", 02/01/19
 Decmil (DCG), "[Market needing reassurance](#)", 02/01/19
 GR Engineering (GNG), "[Timing risks](#)", 02/01/19
 Matrix C&E (MCE), "[Larger order improves outlook](#)", 19/12/18
 Pacific Energy (PEA), "[Standout consistency](#)", 02/01/19
 SCEE (SXE), "[Diversification benefits](#)", 02/01/19
 SRG Global (SRG), "[Broader opportunities](#)", 02/01/19
 Swick (SWK), "[Positive trends](#)", 02/01/19
 Valmec (VMX), "[Cheap given tailwinds](#)", 02/01/19

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Matrix (MCE): Argonaut acted as Lead Manager to the Placement that raised \$3M in December 2018 and received fees commensurate with this service.

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