HD The McAleese Compulsion

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- Broker initiations - Transport and logistics solutions in the right sectors - Compelling valuation

By Greg Peel

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McAleese Ltd ((MCS)) provides specialised transport and logistics solutions to the infrastructure and resource sectors.

An investor looking to find upside opportunity at the smaller end of the market capitalisation scale, given a call from many an analyst that large caps are looking well-priced, would be forgiven for feeling any exposure to Australian infrastructure and resources is a one-way ticket on the train heading out of town. The Australian economy is transitioning, we were told at length in 2013, away from "**mining**" and back towards those non-**mining** sectors which have either been quiet since the GFC or heavily impacted in recent years by the strong currency. It is easy to fall into the trap, nevertheless, of misconstruing what throwaway lines like "the end of the **mining** boom" actually mean.

Notwithstanding an LNG export industry still very much in the ramp-up phase, Australia's **China**-driven **mining** "boom" has not actually "ended". It has simply shifted from its ramp-up phase into its production phase. During ramp-up, **mining** companies spent **billions** increasing their production and processing capacity in order to exploit demand from **China** and other emerging economies anticipated to remain in at least a gradual uptrend over subsequent decades. With a few exceptions, such as the two big **iron ore** miners' ongoing Pilbara expansion plans, Australia is now "ramped up". This means less engineering and construction requirement in the sector ? a fact already evident given the recent routing among listed engineering and construction contractors. The projects are complete. Let the production begin.

So once produced, how do Australia's **mining** products then make their way into the hands of buyers? They are transported in most cases by sea from Australia's ports. Getting to those ports requires a good deal of transport and logistical solutions.

McAleese' key activities include specialised transport and lifting, bulk haulage and metropolitan liquid fuels distribution. The McAleese strategy is to make accretive acquisitions and build a diversified Australian transport and logistics **company**. As an example of its activities, a month ago McAleese won an additional contract with **iron ore** miner Atlas **Iron** ((AGO)). Brokers agree that Atlas' ambitious production growth plans provide the potential for the **company** to become a significant player in the sector, assuming stable **iron ore** prices, but that the **company**'s biggest issue is a lack of transport infrastructure. The new contract signs up McAleese to 3mtpa of **iron ore** loading and haulage over four years, which Deutsche bank notes is worth some $60-70m for MCS.

"In our view," say the Macquarie analysts, "one of McAleese' key strategies is to grow with existing customers such as Atlas **Iron**. From a standing start in FY09, Atlas is targeting a 15mtpa run-rate by FY15. McAleese has an umbrella contract with Atlas".

"Despite concerns around the outlook for **mining** and infrastructure capital expenditure in Australia," the Macquarie analysts go on to suggest, "we are reasonably confident in the longer term revenue outlook for the specialised transport and heavy business given its specialist skills and integrated service offering". The **company**'s existing contracted revenue base sourced from its **oil** & gas business provides a "stable backbone" given the mature nature of the industry. And the group's strategy is to continue to build a leading diversified transport and logistics **company** by expanding into new segments, geographies and product capabilities.

Macquarie initiated coverage on McAleese just before Christmas, with an Outperform rating. Credit Suisse initiated coverage this morning, also with an Outperform rating. Deutsche Bank retains a Buy rating, bringing to three the number of FNArena database brokers now covering the stock.

Credit Suisse is not oblivious to the risks perceived for a contractor in today's Australian resource sector. To account for such risks, the analysts have built expectations of a decline in the **mining**/**energy** capex outlook into their valuation model, amounting to a 41% reduction in sector earnings before interest and tax for MCS over FY13-16. They have also conservatively factored in the assumption of a potential loss of existing fuel distribution contracts with BP and Shell, to the tune of 50%.

Credit Suisse still finds MCS offers a "compelling" valuation.

According to the analysts' numbers, MCS is trading on an FY14 price/earnings multiple of 10x which represents a 30% discount to transport peers and a 36% discount to the Small Industrials. MCS generates a greater return of **equity** than its peer group (14.1% to 11.2% average) and exhibits lower gearing. Credit Suisse forecasts a 10% compound annual growth rate in earnings per share over the next two years and believes the stock's price/earnings multiple will re-rate over the next 12 months as management executes on its **acquisition**/contract win strategy and de-risking is achieved through existing contract renewals.

Macquarie has lined up the usual suspects among the listed transport & logistics sectors to offer a benchmark comparison for MCS ? Toll Holdings, Asciano, K&S Corp and Boom Logistics. The analysts have further widened their benchmarking by looking at mid-cap **mining** service companies as a comparison. Based on earnings multiples among comparables, Macquarie has arrived at a valuation for MCS which forecasts a 15.9% return on **equity** and a target price of $1.88 (last trade $1.54).

Credit Suisse has set its target at $1.80 and Deutsche Bank $1.75 to provide an FNArena consensus target of $1.81. Consensus shows a dividend forecast of 4.2cps in FY14, rising to 7.0cps in FY15 and beyond.

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