HD **Seven Group's Nexus A Long Term Punt**

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- Opportunistic acquisition - Strategic diversification into oil & gas - Long term potential value - Costly upfront exposure

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Seven Group Holdings ((SVW)) is a disparate conglomerate the major assets of which are WesTrac, a 33% shareholding in Seven West Media ((SWM)), owner of media assets such as the Seven Network and the West Australian News, and a lot of cash. WesTrac is the authorised Caterpillar dealer in Western Australia and NSW/ACT and more recently in northern China.

Analysts regard WesTrac is a quality franchise but the fact remains the heyday of mining construction, in which Caterpillar equipment was highly sought after, is now passed. Energy sector construction is also soon to reach a peak but will exhibit a long tail decline as further LNG projects ramp up over the decade. LNG is now Australia's biggest growth industry, and LNG is set to match or knock off iron ore eventually as Australia's biggest export.

Seven Group's CEO was previously the CEO of LNG major Woodside Petroleum for around ten years which suggests he has a fair bit of experience in the oil & gas space. And he was formerly the chairman of Nexus Energy ((NXS)). It is thus perhaps of little surprise Seven Group has announced an offer to acquire Nexus.

Such an acquisition, or merger as is the suggestion in this case, potentially offers SVW a sensible level of diversification to offset the decline in WesTrac earnings. It is also highly opportunistic.

Nexus owns the Longtom Gas Project in the Gippsland Basin, the Echuca Shoal gas exploration concession in the Browse Basin, and 15% of the Crux development licence in the Browse Basin (Shell 82%, Osaka Gas 3%). On the other side of the balance sheet Nexus is heavily geared. The company has struggled financially and did not benefit from two production outages at Longtom in the past 18 months. In late 2012 Nexus initiated a strategic review to explore funding options which by May 2013 included the possible divestment of Longtom and by late 2013 the possible divestment of the entire company.

Nexus did receive non-binding offers on Crux and Longtom but these were unlikely to convert to binding proposals before the company hit the wall. Tomorrow Nexus was due to make a decision on refinancing or retiring the remaining $44m Longtom senior debt facility. Yesterday Seven Group made its announcement.

SVW announced a merger implementation agreement with Nexus in which it will acquire all the outstanding equity, the senior debt and majority of subordinated debt for $215m, with a further $235m to be provided for future capex requirements over the next 3-5 years. The agreement amounts to SVW offering 2cps for all of NXS' shares, which were previously trading at 16c.

The Nexus board has unanimously recommended the offer to shareholders. With the strategic review failing to deliver any alternatives and liabilities growing, there remains little alternative, Macquarie suggests, other than to accept. Macquarie has thus lowered its rating on Nexus to Underperform (implying Sell) from Outperform and cut its price target to the offer level of 2c from a previous 20c.

The question, then, for brokers is as to whether the deal is steal or a mistake from Seven Group's point of view.

BA-Merrill Lynch points out that for SVW to generate cost of capital returns from its $450m outlay it would require earnings (EBIT) of around $55mpa from Nexus over the medium term. In the six months to end-December, Nexus lost 3.3m. But this is not your average **acquisition**. Says Merrills:

"It should be noted, however, that the **acquisition** is not a near term EPS [earnings] accretion story, in our view, but rather a medium to long term entry into **oil** & gas with significant prospective value."

The last point of valuation for Crux was available from a transaction in late 2012 and if one were to use that valuation as a guide, SVW has picked up a bargain. But Merrills warns it would be foolish to assume this simple comparison given Crux is unlikely to begin production until after 2020 and even then the project is dependent on the ramp-up of Shell's Prelude floating LNG facility and will require ongoing capital expenditure. But at least one might say the asset is highly prospective.

Certainly the **acquisition** would not stretch SVW's balance sheet by any means. Merrills believes the strategy underpinning the **acquisition** appears sound and the **company** was looking for opportunities in adjacent sectors where it sees a sustainable competitive advantage. And while Seven Group as a **company** has no former experience in **oil** & gas production, CEO Don Voelte certainly has.

Merrills will not readdress its earnings forecasts until after the Nexus shareholder vote and retains a Buy recommendation and $9.80 target, for now, on SVW.

In JP Morgan's view, SVW is using its strong balance sheet to diversify into **oil** & gas at a fair price. The analysts' quick calculations suggest SVW is buying Nexus' gas reserves for US61c per **million** cubic feet compared to a peer average value of US69c/mcf. But SVW must commit to spending to meet near term maintenance and fulfill requirements under development leases and exploration licences as well as stump up for the as yet undefined cost of remediating Longtom-3 after its production outage issues. Then there will be no doubt material costs involved in further exploration and development of Nexus' other assets.

Growth in WesTrac **China** and some improvement in SVW's media businesses may help offset the decline in WesTrac earnings domestically, and Nexus offers diversification, but JP Morgan is concerned as to just how much value SVW can extract from Nexus. And how will capital be allocated in future? SVW's share price currently implies an 18% discount for WesTrac to the value of Caterpillar dealer peers but the broker suggests this is now reasonable given the uncertainty the Nexus merger would imply.

Hence JP Morgan has downgraded its rating on SVW to Neutral from Overweight and cut its target to $8.64 from $9.89.

Macquarie acknowledges that the Nexus assets may prove to be valuable for Seven Group in the medium term but notes their short term earnings contribution will be limited. The biggest problem Macquarie has, nevertheless, is the additional complexity a Nexus **acquisition** brings, making valuation of SVW by the market more difficult. In short, the analysts believe the **acquisition** has the potential to dilute the value of the quality WesTrac franchise.

To that end Macquarie has downgraded its rating on Seven Group to Underperform from Neutral and cut its target to $8.02 from $8.36.

On broker updates to date the consensus price target for SVW in the FNArena database has fallen to $8.55 from $8.86 and the stock attracts two Buy or equivalent ratings, two Hold and a Sell.

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