FINANCIAL REVIEW

HD Orica pure play could be blast of fresh air

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Explosives and chemicals **group** Orica is familiar with big changes.

The **company**, which started out selling explosives to the Victorian goldfields in the 19th century, would have been unrecognisable in 2005 when it bought the Dyno Nobel explosives **business**.

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Explosives made up 40 per cent of Orica's revenue back then compared with 83 per cent last year.

Orica is on the cusp of its latest transformational deal as it prepares to find a new home for its chemicals division and focus on what it does best: providing explosives to the world's miners.

The move towards being a pure-play explosives manufacturer is the latest step in a restructure initiated by chief executive Ian Smith since he took the top job just over two years ago.

It has not been an easy journey though and Orica is under enormous pressure to get the chemicals deal right.

Orica stock has wavered in and out of favour under Smith's reign as it struggled with high costs in its Minova ground support **business**, a downturn in global **mining** that hit demand for explosives and a chemicals leak at an ammonium nitrate plant north of Sydney that tarnished its environmental record.

Smith, whose no-nonsense style does not always go down well with the investment community and some of his own managers, has made inroads though.

The stock has recovered since a damaging profit downgrade last July.

Analysts and investors who followed Smith's presentation at an investment conference in **Hong Kong** last week praised Orica's pro-active **energy** strategy and investment in the Burrup ammonium nitrate plant in Western Australia.

"He has been fairly maligned but if you look at his report card at Orica we think it stacks up fairly well," one analyst says.

The future of the chemicals division is the biggest question mark hanging over the **company**'s future. Orica is under pressure from investors to spin off the **business**.

This is no surprise as corporate splits are flavour of the month. Amcor, Brambles and News Corp went down the same path last year. Orica also has a track record of spin-offs and separated its DuluxGroup paints **business** in 2010.

CIMB analyst Andrew Scott sees 9 per cent to 18 per cent upside on Orica's market valuation because a separation would force the market to reassess the value of two stand-alone businesses. The value of a stand-alone chemicals **business** is estimated at between $900 **million** to $1 **billion**.Breaking up is hard to do

While Orica has already folded some of its chemicals operations into mining services, the remainder focuses on caustic soda, water care and chemical distribution.

But break-ups are not always easy to do, even with favourable equity markets, and management does not always like succeeding a large chunk of the business.

Goldman Sachs-advised Orica has been talking to private equity firms and potential trade buyers about an outright sale. All options remain on the table.

A third scenario that Orica flirted with is selling off bits and pieces of the chemicals business, such as its Bronson & Jacobs division, which is strong in dairy and food.

There has been chatter about a tie-up with Perth-based Wesfarmers, which has its own chemicals operations and has had its eye on Orica for years.

One look at Orica's board offers a clue as to the personalities who may drive a tie-up with Wesfarmers. Former BHP Billiton senior executive Alberto Calderon joined the Orica board last year. Calderon is not the type of director who would shy away from a more radical deal.

Former Wesfarmers finance director Gene Tilbrook was appointed to the Orica board in August last year. Tilbrook worked at Wesfarmers for more than 20 years and was a key player in the conglomerate's $19 billion acquisition of Coles. Russell Caplan became chairman in January, replacing Peter Duncan.

Orica announced a review into chemicals in January but a sale or spin-off of chemicals has been on the cards since Andrew Larke was appointed to run that business last year.

Larke is Orica's deal maker and has been instrumental in the company's strategy since he was brought in under former chief Malcolm Broomhead.

Still, many in the industry say they cannot see an obvious buyer who could bring the synergies needed to justify a deal. A likely scenario is that chemicals will be run as a stand-alone listed entity. Orica hopes that will result in a re-rating for the entire group. A decision is expected by the end of the year.

Smith points out that 80 per cent of the division's business is traded chemicals, which effectively makes it a trading business which should be attractive to a number of buyers. It products are used in watercare, the dairy industry, building and construction, cosmetics, food and beverage and pulp and paper. Orica is the biggest importer of carob into Australia.

Smith told investors in Hong Kong last week the impact of first-half earnings on the chemicals business include lower acid volumes due to a temporary customer shutdown, rationalisiation in the Latin America business and lower average global caustic soda prices.

The sale of chemicals would leave Orica with a pure-play mining consumables business. While Orica is valued at 7.8 times enterprise value to earnings before interest, tax, depreciation and amortisation, CIMB says the stand-alone mining services business could be worth as much as eight to 8.5 times EV/EBITDA or $10.8 billion to $11.5 billion.

Smith warned explosives volumes will be lower in the first half of the year than the same period a year ago but says full-year forecast is unchanged. There are signs that margins in explosives are improving.

North American coal markets have been challenging for Orica's explosives business as stockpiling and the changing balance of coal seam gas has impacted. Australian coal exports are at record levels but miners have been lowering their stripping ratios, which affects the amount of waste rock required.

But Smith, a fourth generation Broken Hill mining engineer, says this cannot continue forever.

Last week, Orica also struck a second deal to buy natural gas from junior explorer Strike Energy, which is expected to lock in its Australian east coast energy needs for the next two decades. This is conditional on Strike finding gas, but many analysts expect Orica to be in the luxurious position of having more gas than it needs. Orica is also waiting on approval to expand its manufacturing facility near Newcastle.Constant change

The chemicals separation will be the latest in a string of changes since Orica was spun out of the former British parent ICI in the late 1990s. Orica acquired Dyno Nobel in 2005, demerged its Incitec

Pivotbusiness in 2007, spent $870 million on a business called Minova in 2006, which provides specialist chemicals and resins to the mining industry to stabilise underground mines.

In 2007, it paid $775 million for Excel Mining, the world's biggest maker of roof bolts and metal plates used as supports in underground mines, to expand the Minova business. It bought both those businesses from private equity. In 2010, it spun-off DuluxGroup.

The Minova deal continues to haunt Orica which in 2012 wrote down $367 million on the value of the business.

Unable to find a buyer for Minova, Smith restructured the business and integrated it with the group's mining services operation. Credit Suisse analysts say they struggle to see Orica's Ground Support business breaking even in 2014 as hoped.

Orica shares closed at $21.56 on Friday.

The stock has had a wild ride after dropping to a low of $17.61 after July's profit downgrade but touched a high of $24.78 in January.

The stock topped $34.86 on April 18, 2007 after an approach from a private equity consortium including Bain Capital, Morgan Stanley and Blackstone Group, which valued the company at $32 a share. The offer was rejected by former chairman Don Mercer and the board.

While growth in the mining sector remains subdued, Orica's business relies more on volumes than the price of commodities and investors are hopeful they can realise some value from a pure play mining services business.

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