

# GRANT'S

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## The big 'however'

"To be properly bearish on China," said *Grant's* on June 3, "one must be similarly bearish on the things connected with the vast Chinese enterprise." To be true to that doctrine, one must, in fact, be comprehensively bearish. The People's Republic not only consumes vast amounts of the world's resources, but it also writes long chapters of the world's growth narrative.

This publication is ambivalent. Of course, China will eventually go the way of all state-directed abusers of bank credit and over-builders of real estate (risk off!). However, in counterpoint, there's nothing like a cheap stock (risk on!).

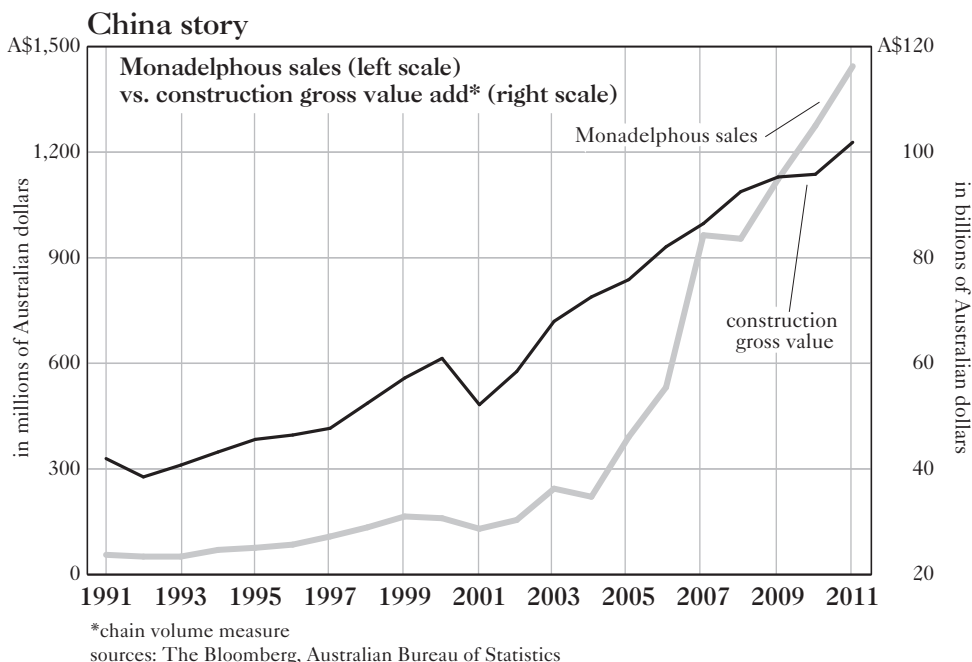
To clarify, we take up the investment merits and demerits of a pair of representative commodity-sensitive equities, Belgian and Australian, respectively. The latter, Monadelphous Group (MND on the Australian Stock Exchange), is a China story, plain and simple. The former, Sipef NV (SIP on the NYSE Euronext Exchange in Brussels), is a China and India story at one remove. Monadelphous is an undisputed corporate jewel and is so priced. Sipef is an out-of-the-way value stock, small and illiquid, and is so priced. To anticipate, we are bearish on Monadelphous and bullish on Sipef.

Concerning Monadelphous, we are exceedingly timid bears, inclined not to sell it, but, rather, to wait to buy it until after China has had its come-uppance. What has driven Australian growth in the past decade is not so much the exporting of commodities

as it is the building of the mines and ports and refineries with which to export commodities. Thus, between the fiscal years 2001 to 2011, Australia's real GDP chugged along at a 3.1% annual rate. However, while the mining portion of the national output increased at a 2.3% rate, construction zoomed at a 6.9% rate.

"No company," observes colleague Evan Lorenz, "has capitalized better on the commodities-related construction boom than Monadelphous. It was founded in 1972 in Kalgoorlie, Western Australia, to sell mechanical construction services to the mining industry. For the non-botanically inclined, 'monadelphous' is a term describing

the stamens of plants and flowers whose filaments have united to form a single bundle, sort of an *e pluribus unum* of the plant world. Unlike Fluor, for instance, Monadelphous does not design projects but rather builds them. Structural-mechanical, piping and electrical work are its stock in trade. Notable by their absence at Monadelphous are the lists of problem contracts that plague larger peers like Leighton Holdings and Downer EDI. Between its engineering division and its maintenance and industrial services division, resource- and energy-related clientele contributed all but 11% of revenues in the fiscal year ended June; a new infrastructure



segment accounted for the balance.”

Until China goes the way of all credit abusers, Monadelphous may prove a most resistant short-sale candidate. Over the past decade, its sales have compounded at a 27% annual rate, earnings per share at a 37% annual rate. And while sales growth flagged in two of these years—2004, down by 9%, and 2008, off by 1%—earnings never failed to gain.

“Really, it is a China story,” the chief financial officer, Zoran Bubic, tells Lorenz. “We take our guidance from our customers, and our customers are watching what’s happening in China. Whilst we have created an infrastructure division not too long ago, our core business is in resources and energy, and that is all driven by demand out of China. A lot of our work comes from bulk commodities. In resources it is iron ore—predominantly iron ore—coal [and] alumina to a lesser extent. . . . The reality is that bulk commodity prices are strong but some of the other base metals prices are struggling.”

It enhances the bear story not one whit that Monadelphous has missed its target for annual revenue growth. Though management strives for 15%, it has actually achieved 17.4% since going public in 1991. The balance sheet shows A\$129.5 million, or A\$1.46 a share, in net cash. Top management, which owns 5.7% of the outstanding shares, pays out 80% or more of the earnings in dividends (the indicated yield is 6.6%). Maybe the front office should hold back more. In February 2008, with shares of Norfolk Group, an electrical, communications and HVAC engineering concern, trading for A\$0.24 apiece, Monadelphous bought a 12.4% stake for A\$3.9 million. Today’s price: A\$1.08 a share. “What they say they are going to do happens, and they are very cautious, very conservative, and they are very good at what they do,” attests one Aussie sell-side analyst. “They don’t take on work they can’t do, and they don’t take on work outside their area of expertise.”

However, China is the rub, and to judge by the surprise narrowing of the Australian trade surplus for November and a slowdown in Australia’s service industries, now in month three, it may already be rubbing Australia the wrong way. An Oct. 11 note by J.P. Morgan reported a rising incidence of cancella-

tions and project delays in Australia’s construction industry, including hold-backs originating in resource companies. At 18.9 times earnings and 9.3 times book value, Monadelphous isn’t priced for delay—or comeuppance.

Société Internationale de Plantations et de Finance, a.k.a. Sipef, is a China- and India-dependent company of a different stripe. It grows things—palm oil and rubber—instead of building them, and it operates its company-managed plantations in Indonesia and Papua New Guinea. Palm oil delivers three-quarters of the earnings, rubber the rest.

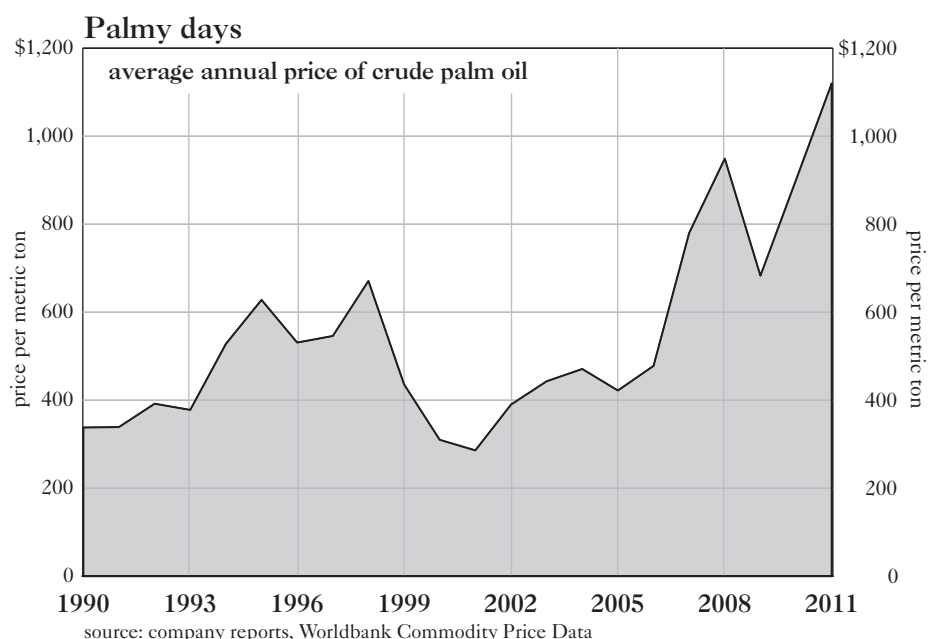
You could build a pretty fair bear case for Sipef with the materials at hand. Thus, tire makers are cheering the biggest rubber crop since 2004, with softening prices to match. Palm oil prices, too, are well off their peaks of a year ago, and the handful of analysts who follow Sipef forecast \$7 per share of earnings this year, down from \$9 in 2011. Then, too, as much as 16% of world palm oil production and 40% of world rubber production winds up in the country on which *Grant’s* isn’t bullish. As for Indonesia, host to Sipef’s palm trees, Bloomberg reported on Jan. 3 that the national pension fund is bearish on Indonesian commodity stocks, palm-oil producers included. The fund, PT Jaminan Sosial Tenaga Kerja, is worried about global growth, Bloomberg said. Then, again, who isn’t?

“But what if the world economy

doesn’t fall apart? colleague David Peligal reasonably inquires. “It might not be the worst thing to own a company in the first section of the supply chain, where margins are usually the widest. For example, in the first half of 2011, Sipef generated \$59.2 million of operating profit on \$177.1 million of revenue. Sure, the company is probably over-earning in this cycle of high commodity prices, but tropical agriculture isn’t going away—Sipef was incorporated in 1919. And there’s lots of room for error when palm oil sells for \$1,000 a ton but costs \$350 a ton to produce, and when rubber sells for \$3.50 a kilogram but costs \$1.70/kg to produce. Furthermore, it might not be the worst thing to own a company whose management is eager to expand but not to overborrow. It means to use cash from operations.”

A citizen of the world, Sipef makes its headquarters in Schoten, in the province of Antwerp, but conducts its operations in Indonesia (source of two-thirds of gross profit) and Papua New Guinea (source of the remainder). It keeps its accounts in dollars, quotes its stock in euros and books its costs, or most of them, in Indonesian rupiah and Papuan New Guinea kina. The weaker the local plantation currencies against the dollar, therefore, the better it is for the corporate bottom line.

Having been around the global block once or twice, Sipef says it chooses to sell directly neither to China nor India.



"We have experienced in the past—not us, but others—that with the volatility of commodity prices, those countries do not seem to have the same standards applied to signed contracts and agreed prices. . . ." François Van Hoydonck, managing director at Sipef, tells Peligal. "Thus, we sell to Cargill, Wilmar International, Sime Darby and Archer Daniels Midland. These customers, after refining our palm oil, or even after buying our crude palm oil, might export that oil to China."

"Based on supply and demand fundamentals alone, the vegetable oils market looks set to move back up from current lows," said management in the nine-month interim report dated Oct. 27 (full-year results are slated for release on Feb. 23). "Slower growth in palm oil next year, lack of moisture in South America's soybean crop areas and growing demand for biodiesel should give support to prices. Today, however, the markets are totally overshadowed by the woes of the financial crisis and a lack of credible solutions.

So fear that the world may slip back into a second recession dominates the markets and outweighs the bullish fundamental factors. This is the case for palm oil and rubber."

The Sipef 10-year plan anticipates a doubling of the corporate plantation leasehold (in Indonesia, a foreign investor may lease but not buy) from 45,000 hectares, or 111,150 acres, at present. Management is budgeting \$505 million for the project—let's call it an average acquisition price of \$10,150 a hectare for 50,000 additional hectares. "Clearly," notes Peligal, "the scope of this expansion will largely depend on commodity prices. As things are—a €536 million market cap, a \$1.28/euro exchange rate and a leasehold of 45,000 hectares—Sipef is quoted in the public markets at \$15,246 a hectare, well above the \$10,150 per hectare that management estimates the expansion will cost. As cash was accumulating on the balance sheet last fall, management announced a €10 million share buyback.

If commodity prices stay elevated, the company and its shareholders would be well served by the projected greenfield expansion."

Altogether, Sipef is a special case. The shares are cheap—11 times this year's estimate, 8.6 times trailing net income—in part because of the company's tiny, €536 million market cap, 1/26th the size of Malaysian-listed Sime Darby, and in part because of the structure of ownership. Some 37.5% of the stock is controlled by a pair of European entities, the family Bracht and a publicly traded holding company, Ackermans & van Haaren (Bloomberg ticker ACKB BB). "While Sipef has received some informal expressions of interest from potential acquirers," relates Peligal, "management says it has never received a serious and definite proposal. But it would not be surprising if a larger company, faced with a build-or-buy decision, presented such a bid to the controlling shareholders. It just might be their exit strategy."

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