

## 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

Analyst | Ian Christie, CFA

#### 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).

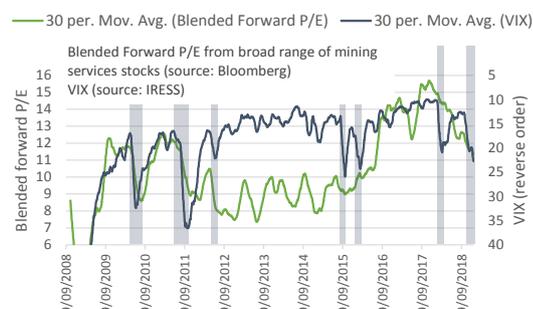
#### Uncertainty into 2019

**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	<b>0.240</b>	23%	BUY	<b>BUY</b>	-6%	-10%	5.7	5.2	10.9	9.2
Ausdrill	ASL	1.130	2.250	<b>2.000</b>	77%	BUY	<b>BUY</b>	0%	-7%	4.1	3.3	7.3	6.9
Decmil	DCG	0.695	1.200	<b>1.100</b>	58%	BUY	<b>BUY</b>	-9%	-16%	4.1	3.2	9.2	7.8
GR Engineering	GNG	1.090	1.550	<b>1.300</b>	19%	BUY	<b>HOLD</b>	-2%	-17%	7.8	6.1	14.1	10.9
Matrix E&C**	MCE	0.350		<b>0.470</b>	34%		<b>SPEC BUY</b>			n/a	5.6	n/a	n/a
Pacific Energy	PEA	0.570	0.750	<b>0.730</b>	28%	BUY	<b>BUY</b>	0%	0%	6.1	6.1	11.3	11.2
SCEE	SXE	0.550	0.850	<b>0.850</b>	55%	BUY	<b>BUY</b>	0%	0%	3.0	2.7	9.3	8.3
SRG Global	SRG	0.500	0.750	<b>0.700</b>	40%	BUY	<b>BUY</b>	0%	-5%	4.1	3.6	10.3	8.8
Swick***	SWK	0.230	0.380	<b>0.400</b>	74%	BUY	<b>BUY</b>	8%	3%	2.7	2.5	10.3	7.6
Valmec	VMX	0.230	0.420	<b>0.420</b>	83%	BUY	<b>BUY</b>	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

**RESEARCH:**

**Ian Christie** | Head of Research  
+61 8 9224 6872 ichtistie@argonaut.com

**Matthew Keane** | Director, Metals & Mining Research  
+61 8 9224 6869 mkeane@argonaut.com

**James Wilson** | Analyst, Metals & Mining Research  
+61 8 9224 6835 jwilson@argonaut.com

**Helen Lau** | Analyst, Metals & Mining Research  
+852 3557 4804 hlau@argonaut.com

**Michael Eidne** | Director, Research  
+61 8 9224 6831 meidne@argonaut.com

**INSTITUTIONAL SALES - PERTH:**

**Chris Wippl** | Executive Director, Head of Sales  
+61 8 9224 6875 cwippl@argonaut.com

**Damian Rooney** | Director Institutional Sales  
+61 8 9224 6862 drooney@argonaut.com

**John Santul** | Consultant, Sales & Research  
+61 8 9224 6859 jsantul@argonaut.com

**Ben Willoughby** | Institutional Dealer  
+61 8 9224 6876 bwilloughby@argonaut.com

**Josh Welch** | Institutional Dealer  
+61 8 9224 6868 jwelch@argonaut.com

**George Ogilvie** | Institutional Dealer  
+61 8 9224 6871 gogilvie@argonaut.com

**INSTITUTIONAL SALES – HONG KONG:**

**Damian Rooney** | Director Institutional Sales  
+61 8 9224 6862 drooney@argonaut.com

**CORPORATE AND PRIVATE CLIENT SALES:**

**Glen Colgan** | Managing Director, Desk Manager  
+61 8 9224 6874 gcolgan@argonaut.com

**Kevin Johnson** | Executive Director, Corporate Stockbroking  
+61 8 9224 6880 kjohnson@argonaut.com

**James McGlew** | Executive Director, Corporate Stockbroking  
+61 8 9224 6866 jmclew@argonaut.com

**Geoff Barnesby-Johnson** | Senior Dealer, Corporate Stockbroking  
+61 8 9224 6854 bj@argonaut.com

**Rob Healy** | Dealer, Private Clients  
+61 8 9224 6873, rhealy@argonaut.com

**Cameron Prunster** | Dealer, Private Clients  
+61 8 9224 6853 cprunster@argonaut.com

**James Massey** | Dealer, Private Clients  
+61 8 9224 6849 jmassey@argonaut.com

**Chris Hill** | Dealer, Private Clients  
+61 8 9224 6830, chill@argonaut.com

**Important Disclosures**

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

**Global Construction (GCS) [now merged with SRG and renamed SRG Global (SRG)]:** Argonaut has acted as Financial Adviser to GCS in the previous 12 months and received fees commensurate with this service.

**Information Disclosure**

Each research analyst of this material certifies that the views expressed in this research material accurately reflect the analyst's personal views about the subject securities and listed corporations. None of the listed corporations reviewed or any third party has provided or agreed to provide any compensation or other benefits in connection with this material to any of the analyst(s).

**For U.S. persons only**

This research report is a product of Argonaut Securities Pty Limited, which is the employer of the research analyst(s) who has prepared the research report. The research analyst(s) preparing the research report is/are resident outside the United States (U.S.) and are not associated persons of any U.S. regulated broker-dealer and therefore the analyst(s) is/are not subject to supervision by a U.S. broker-dealer, and is/are not required to satisfy the regulatory licensing requirements of FINRA or required to otherwise comply with U.S. rules or regulations regarding, among other things, communications with a subject company, public appearances and trading securities held by a research analyst account.

This report is intended for distribution by Argonaut Securities Pty Limited only to "Major Institutional Investors" as defined by Rule 15a-6(b)(4) of the U.S. Securities and Exchange Act, 1934 (the Exchange Act) and interpretations thereof by U.S. Securities and Exchange Commission (SEC) in reliance on Rule 15a 6(a)(2). If the recipient of this report is not a Major Institutional Investor as specified above, then it should not act upon this report and return the same to the sender. Further, this report may not be copied, duplicated and/or transmitted onward to any U.S. person, which is not the Major Institutional Investor.

In reliance on the exemption from registration provided by Rule 15a-6 of the Exchange Act and interpretations thereof by the SEC in order to conduct certain business with Major Institutional Investors, Argonaut Securities Pty Limited has entered into an agreement with a U.S. registered broker-dealer, Marco Polo Securities Inc. ("Marco Polo"). Transactions in securities discussed in this research report should be effected through Marco Polo or another U.S. registered broker dealer.

**Hong Kong Distribution Disclosure**

This material is being distributed in Hong Kong by Argonaut Securities (Asia) Limited which is licensed (AXO 052) and regulated by the Hong Kong Securities and Futures Commission. Further information on any of the securities mentioned in this material may be obtained on request, and for this purpose, persons in the Hong Kong office should be contacted at Argonaut Securities (Asia) Limited of Unit 701, 7/F, Henley Building, 5 Queen's Road Central, Hong Kong, telephone (852) 3557 48000.

**General Disclosure and Disclaimer**

This research has been prepared by Argonaut Securities Pty Limited (ABN 72 108 330 650) ("ASPL") or by Argonaut Securities (Asia) Limited ("ASAL") for the use of the clients of ASPL, ASAL and other related bodies corporate (the "Argonaut Group") and must not be copied, either in whole or in part, or distributed to any other person. If you are not the intended recipient you must not use or disclose the information in this report in any way. ASPL is a holder of an Australian Financial Services License No. 274099 and is a Market Participant of the Australian Stock Exchange Limited. ASAL has a licence (AXO 052) to Deal and Advise in Securities and Advise on Corporate Finance in Hong Kong with its activities regulated by the Securities and Futures Ordinance ("SFO") administered by the Securities and Futures Commission ("SFC") of Hong Kong.

Nothing in this report should be construed as personal financial product advice for the purposes of Section 766B of the Corporations Act 2001 (Cth). This report does not consider any of your objectives, financial situation or needs. The report may contain general financial product advice and you should therefore consider the appropriateness of the advice having regard to your situation. We recommend you obtain financial, legal and taxation advice before making any financial investment decision.

This research is based on information obtained from sources believed to be reliable and ASPL and ASAL have made every effort to ensure the information in this report is accurate, but we do not make any representation or warranty that it is accurate, reliable, complete or up to date. The Argonaut Group accepts no obligation to correct or update the information or the opinions in it. Opinions expressed are subject to change without notice and accurately reflect the analyst(s)' personal views at the time of writing. No member of the Argonaut Group or its respective employees, agents or consultants accepts any liability whatsoever for any direct, indirect, consequential or other loss arising from any use of this research and/or further communication in relation to this research.

Nothing in this research shall be construed as a solicitation to buy or sell any financial product, or to engage in or refrain from engaging in any transaction. The Argonaut Group and/or its associates, including ASPL, ASAL, officers or employees may have interests in the financial products or a relationship with the issuer of the financial products referred to in this report by acting in various roles including as investment banker, underwriter or dealer, holder of principal positions, broker, director or adviser. Further, they may buy or sell those securities as principal or agent, and as such may effect transactions which are not consistent with the recommendations (if any) in this research. The Argonaut Group and/or its associates, including ASPL and ASAL, may receive fees, brokerage or commissions for acting in those capacities and the reader should assume that this is the case.

There are risks involved in securities trading. The price of securities can and does fluctuate, and an individual security may even become valueless. International investors are reminded of the additional risks inherent in international investments, such as currency fluctuations and international stock market or economic conditions, which may adversely affect the value of the investment.

The analyst(s) principally responsible for the preparation of this research may receive compensation based on ASPL's and / or ASAL's overall revenues.

**Copyright**

© 2019. All rights reserved. No part of this document may be reproduced or distributed in any manner without the written permission of Argonaut Securities Pty Limited and / or Argonaut Securities (Asia) Limited. Argonaut Securities Pty Limited and Argonaut Securities (Asia) Limited specifically prohibits the re-distribution of this document, via the internet or otherwise, and accepts no liability whatsoever for the actions of third parties in this respect.