

# Company Review

Ord Minnett Research

Tuesday, 28 June 2011

## Delta SBD

### 2H11 update

We have retained a Buy and decreased our price target to \$0.99ps following a review of our assumptions. In short, we believe Delta SBD remains well placed within a growing sector and offers a reasonable valuation buffer.

- Delta SBD recently announced (i) higher-than-expected capex plans for FY12/FY13, and (ii) a new contract and a FY12 contract revision. We have increased our revenue forecasts to reflect these new developments:
  - With the new continuous miner yet to be assigned to a designated contract, we view last week's capex announcement as a positive sign of future demand – the remaining equipment has been allocated.
  - From our perspective, it was interesting to note that this week's contract win and contract volume upgrade pertain to existing clients. This highlights the importance of offering a broad array of services.
- While our favourable medium-term view of Delta SBD remains unchanged, we have moderated our key forecast assumptions following contact with Mastermyne's (MYE.ASX, not covered). Key takeaways are:
  - Management noted that operating margins within Mastermyne's core business remain under pressure in 2H11. While margins are expected to improve in FY12, labour constraints are the key issue.
  - Management indicated that the company's long-term EBITDA margin target is 11%. While viewed as a sustainable 'through the cycle' target, we note that this is below our expectations for Delta SBD.
- While revenue upgrades more than offset our margin cuts at the EBITDA line, our price target has nonetheless declined by 13% to \$0.99ps given market PE changes. However, we retain a Buy given our 12-month TSR of 29.5%.

#### Key Financials

Year ending 30 June	FY09A	FY10A	FY11E	FY12E	FY13E
Revenue (A\$m)	75.6	75.9	83.3	101.7	116.4
EBITDA (A\$m)	7.2	8.0	9.6	12.8	15.0
Reported NPAT (A\$m)	3.2	4.6	4.4	5.2	6.1
Reported diluted EPS (¢)	n/a	11.6	9.1	10.5	12.1
Reported P/E (x)	n/a	6.9	8.8	7.6	6.6
EV/EBITDA	n/a	5.9	5.4	4.1	3.6
Dividend (¢)	n/a	0.0	3.0	3.5	3.5
Net Yield (%)	n/a	0.0%	3.8%	4.4%	4.4%
Franking (%)	n/a	100%	100%	100%	100%
Normalised NPAT (A\$m)	3.5	4.9	5.0	5.5	6.3
Normalised diluted EPS (¢)	n/a	12.3	10.3	11.1	12.4
EPS Growth (%)	n/a	n/a	-16.1%	7.1%	11.6%
Normalised P/E (x)	n/a	6.5	7.7	7.2	6.5
Normalised ROE (%)	9.5%	12.9%	10.4%	10.7%	11.5%

Source: Iress, Company Data, Ord Minnett Est. Share price: \$ 0.8 Jun 27, 2011

DSB A\$0.80

Recommendation  
Buy

Risk Assessment  
High

#### Capital Goods

James Lennon

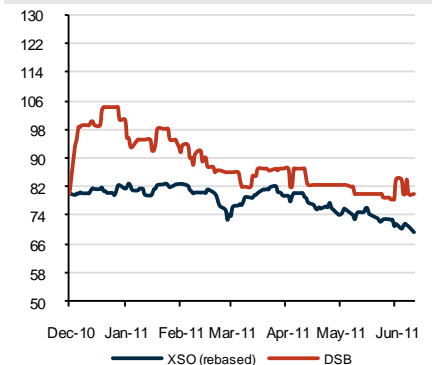
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#### Delta SBD

ASX Code	DSB
52 week range	A\$0.79 - A\$1.06
Market Cap (A\$m)	40.0
Fully Diluted Shares (m)	50.0
Avg Daily Shares	7,616
ASX Small Ordinaries	2,472
ASX Small Industrials	1,943
NTA (¢ per share)	42.0
Net Debt/(Cash) (A\$m)	9.1

#### Relative price performance



Source: Iress

#### OM & consensus forecasts

June Y/E	FY11E	FY12E
NPAT (C)	n/a	n/a
NPAT (OM)	5.0	5.5
EPS (C)	n/a	n/a
EPS (OM)	10.3	11.1

Source: Iress, OM forecasts

## 2H11 update

Following two minor announcements in two weeks, we have updated our thoughts on Delta SBD. While our favourable medium-term view of Delta SBD remains unchanged, we have moderated our key forecast assumptions following contact with industry peers.

## Earnings revisions

We have made downward revisions to our forecasts for Delta SBD, as outlined in the table below. Our EBITDA revisions reflect our expectation for reduced GP and EBITDA margins given labour cost pressures, while our net profit revisions are also impacted by lower interest income given reduced cash flows.

**Table 1. Delta SBD – earnings revisions**

Year Ending 30 June	2011F			2012F			2013F		
	Old	New	Chg	Old	New	Chg	Old	New	Chg
EBITDA (A\$m)	9.9	9.6	-3.1%	12.1	12.8	5.6%	13.3	15.0	12.1%
NPAT (A\$m)	4.7	4.4	-5.5%	5.6	5.2	-6.2%	6.4	6.1	-4.1%
Normalised NPAT (A\$m)	5.3	5.0	-4.9%	5.9	5.5	-5.9%	6.5	6.3	-4.0%
EPS ¢	11.1	10.5	-5.5%	12.8	12.0	-6.3%	14.4	13.8	-4.3%
Normalised EPS ¢	12.5	11.9	-4.9%	13.5	12.7	-6.0%	14.8	14.1	-4.2%
DPS ¢	3.5	3.0	-14.3%	3.5	3.5	0.0%	4.0	3.5	-12.5%
Free cash flow (A\$m)	2.1	1.7	-20.8%	2.7	-5.0	-286.1%	4.5	4.8	5.8%

Source: OM forecasts

## Updating our thoughts

Delta SBD has released two notable updates to the ASX over the past two weeks. These comprise (i) a list of some of the company's capex items that are scheduled for delivery over the next 12 months, and (ii) one new contract and one contract upgrade.

### Capex

Delta SBD announced last week that it has placed orders for new equipment to position the company for future growth in its underground contracting and plant hire activities. While limited details have been provided, we nonetheless view the announced capex as a positive indicator of future earnings. In particular, we note:

- Delta SBD has placed orders to purchase (i) one continuous miner that will be delivered by July 2012, (ii) three loaders, two chock transporters and one shearer carrier – these will all be delivered in the 1H of FY12.
- While quantum of the announced capex was not disclosed, we understand that Delta SBD will utilise its existing lease finance facility to fund the new equipment purchases.
- Management expect the new continuous miner (i) will be deployed on one of the contracts the company is currently bidding for, and (ii) enhance the company's ability to service the growing trend towards bigger long-walls.
- The remainder of the new equipment currently on order has been assigned to contracts in the western coalfields of New South Wales. As such, these new loaders/transporters will make part-contributions to 1H12.
- Management is considering the purchase of additional continuous miners – in our view this reflects positively on the medium-term outlook for underground coal production volumes and demand for service providers.

## Comment

We have not adjusted our earnings forecasts for Delta SBD to reflect these new equipment purchases given that our estimates already assume an (i) increase in capex, and (ii) increased ROA profile on the basis that the current long lead-times for new equipment orders and increased production levels will underpin demand.

## **Contracts**

Delta SBD announced today that it has (i) secured a new contract to provide drill and blast dyke extraction services to Anglo Coal's Grasstree Mine, where the company has an established track record with this type of work, and (ii) secured a 25% FY12 production uplift for its whole of mine operation at Berrima.

## Comment

While we expect new contract wins to become more frequent over the next 12-18 months, it is worth noting that today's announcement pertains to existing clients. This reminds us (i) that it is unusual to lose existing contracts to competitors, and (ii) of the importance of promoting a broad array of capabilities to existing customers.

## **Contact with industry peers**

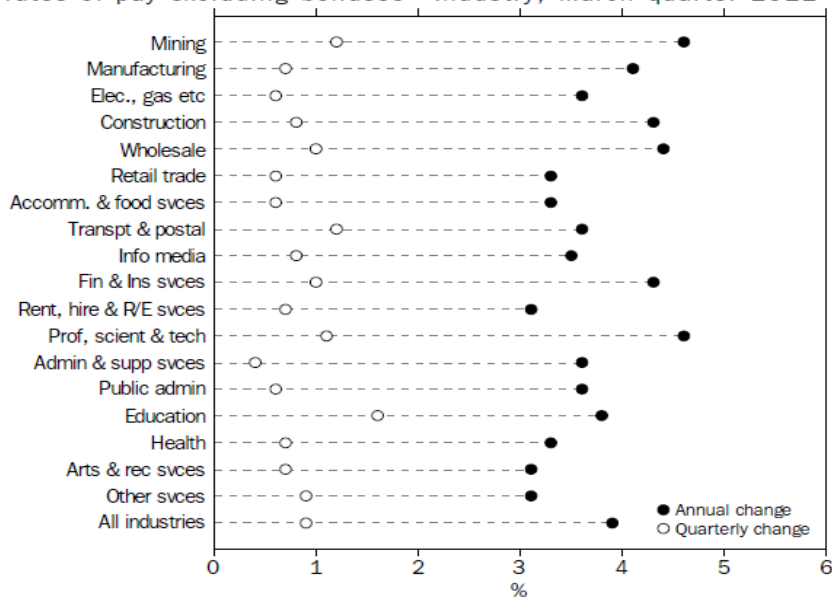
We met with Mastermyne (MYE.ASX, not covered), which for all intents and purposes is a larger version of Delta SBD. While we were impressed by management and the story in general, there were two key takeaways from the meeting that have assisted in updating our view on Delta SBD. These are:

- First, OM believes that operating margins within Mastermyne's core business remain under pressure in 2H11. While margins are expected to improve in FY12 as trainees become more productive and reduce the need for subcontractors, labour constraints remain an issue.
- Second, Mastermyne management have indicated that the company's long-term EBITDA margin target is 11%. While viewed as a sustainable 'through the cycle' target, we note that this is below our expectations for Delta SBD.

While wages pressure is by no means a new obstacle for mining services providers, the wage price index chart below does highlight the extent to which labour constraints are likely to be placing upward pressures on costs. In our view, margins are likely to be under pressure given an inability to pass on all the cost increase.

**Chart 1. Wages price index – March quarter 2011**

WPI—ANNUAL AND QUARTERLY CHANGES: ORIGINAL, Total hourly rates of pay excluding bonuses—Industry, March quarter 2011

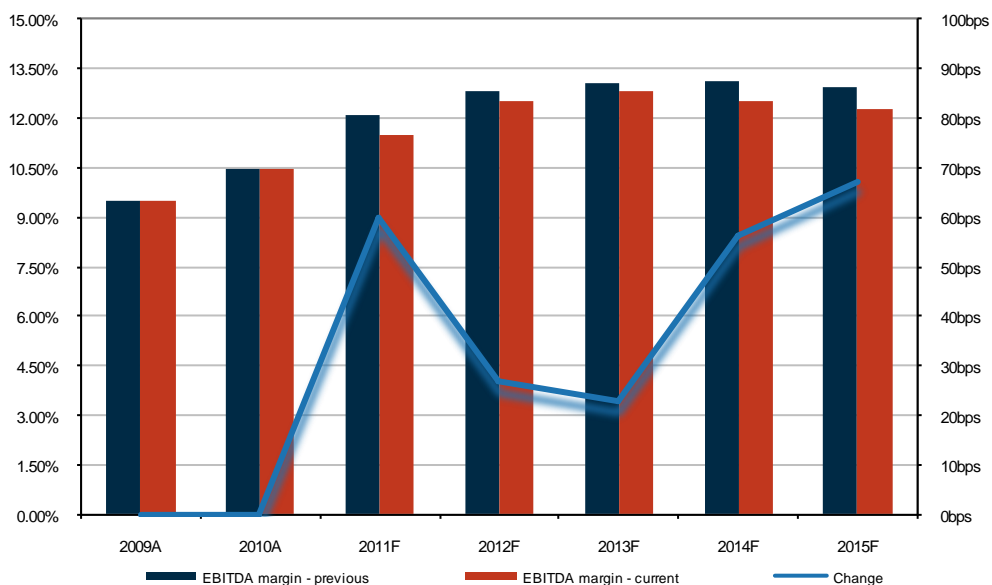


Source: ABS

Comment

As outlined in the chart below, we have moderated our EBITDA margin assumption for Delta SBD. While noting that there are arguably valid reasons for expecting Delta SBD’s margin to remain above that of Mastermyne, we have taken a more cautious approach given the limited amount of historical data from which to assess.

**Chart 1. Delta SBD’s historic and forecast EBITDA margin**



Source: Company data, OM estimates

As per above, we still expect Delta SBD’s EBITDA margin to exceed Mastermyne’s internal target of 11%. This is based on our view that (i) Delta SBD has a lower percentage of contractors on its books – we estimate c10%, and (ii) Delta SBD’s business model is more focussed on earnings quality than revenue growth.

## Price target

We have reduced our price target from \$1.14ps to \$0.99ps based on the average of the three valuation metrics outlined in the table below. The key drivers behind the change to our price target are the (i) earnings revisions tabled in this research note, and (ii) changes in market multiples since the 1H11 result in late February.

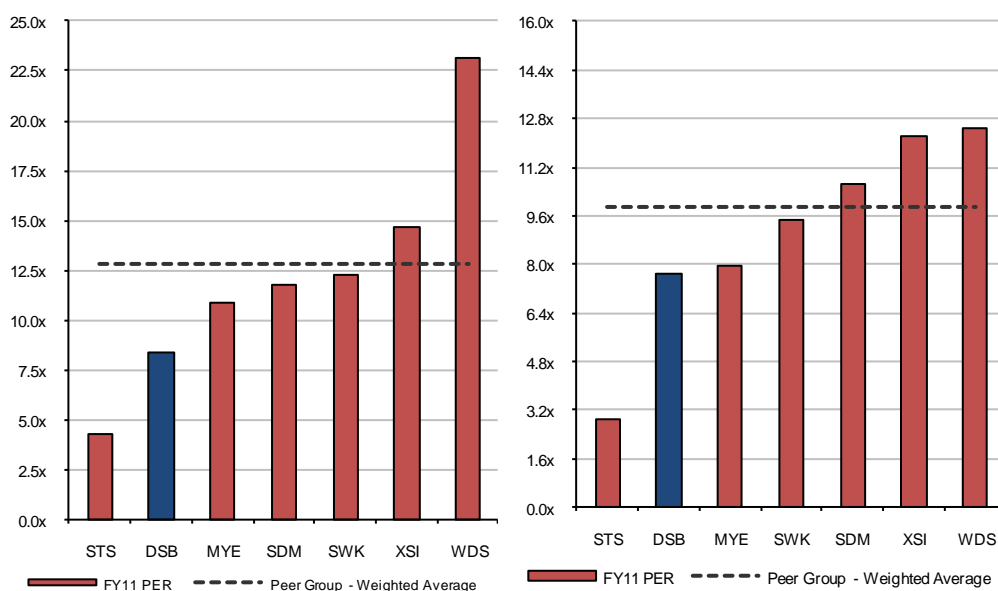
**Table 2. Delta SBD – valuation summary**

Delta SBD - Valuation Summary	FY12
DCF: WACC 12.3%, I-t growth 2.0%, liquidity discount 20%	\$1.10
PER: 20% discount to Small Industrials	\$1.08
PER: 10% discount to Mastermyne (MYE) multiple	\$0.79
<b>Blended Valuation (Average)</b>	<b>\$0.99</b>

Source: OM forecasts

Our revised price target implies a FY12 PER of 9.0x and a PER rel of 0.74. As outlined in the table below, we note that (i) Delta SBD's PER discount to Mastermyne has narrowed since the release of their 1H11 results, and (ii) our price target implies a PE rel to our compco of 0.90, which we view as realistic/attainable.

**Charts 2 & 3. FY12 compco as at 1H11 result (left) and today (right)**



Source: Iress, OM

## Investment view

Notwithstanding the earnings revisions and related valuation reductions tabled in this note, we continue to promote Delta SBD as an attractive medium-term investment opportunity. While noting the company's currently limited free float, our favourable view is based on two components. These are:

- First, the **thematic**. In our view, while the outlook for coal is positive, we are particularly upbeat about the prospects for underground coal mining given ongoing technological advancements that are making underground coal mining a more viable option.
- Second, the **valuation**. Based on our estimates, Delta SBD looks reasonably cheap, trading at a 19.2% discount to our blended valuation. While acknowledging liquidity constraints associated with such a small free float, we have chosen to look through this near-term issue.

We have retained a Buy rating on Delta SBD given our (i) positive view on the company's medium-term earnings, and (ii) estimated 12-month TSR of 29.5%, the key components of which are outlined below. In our view, there is sufficient buffer at the current price to compensate for the company's limited track record.

**Table 3. Delta SBD's estimated TSR**

12-month Price Target	FY12
Valuation/Price Target	0.99
<b>Implied TSR</b>	<b>29.5%</b>
Nominal Dividend Yield	5.7%
<b>Capital Return</b>	<b>23.8%</b>

Source: OM forecasts

## Risks

In our view, Delta SBD represents a high-risk investment. This is based on the company's limited track record as a listed entity, small market capitalisation and free float, and exposure to a cyclical industry with numerous operating hazards and low barriers to entry. Key risks include:

- **Variability in export demand.** Delta SBD's business model is premised on continuing offshore demand for Australia's coal exports. In our view, a prolonged decline in demand from current levels could prompt mine operators to re-assess their outsourcing arrangements with third parties.
- **Contract risk.** It is worth noting that most of Delta SBD's contracts can be terminated by the customer at short notice and with minimal financial compensation. Furthermore, Delta SBD has a high proportion of contracts that are either subject to fixed prices or performance hurdles.
- **Competition.** Delta SBD operates in a highly fragmented industry with limited barriers to entry. While we expect industry consolidation to gather pace over the medium term, any weakness in export demand could lead to intense competition and thus threaten current levels of profitability.
- **Labour shortages and associated costs.** We view labour shortages as a mixed blessing. While positive to the extent that they may encourage mine operators to outsource non-core mine functions, they also pose a potential threat to Delta SBD for similar reasons.
- **Constraints on plant and equipment.** Not unlike labour shortages, limited availability and subsequent increases in plant and equipment costs can pose both a threat to Delta SBD, by restraining growth, and an opportunity, through increased demand for outsourcing.
- **Operating issues.** Delta SBD's revenues are to varying degrees, directly and indirectly, linked to the quantity and quality of the mined coal. While there are a number of risks within the company's control, there are an equally large number of factors (i.e. fires, floods) outside of the company's control.
- **OH&S.** Delta SBD operates in a hazardous industry. If not managed well, the company may be adversely impacted by frequent OH&S claims, which can be expensive; the loss of existing contracts; and an inability to secure new contracts.

## Financial Statements

### Delta SBD

Profit & Loss (A\$m)	2009A	2010A	2011F	2012F	2013F
Sales revenue	75.6	75.9	83.3	101.7	116.4
COGS	-12.9	-11.3	-14.2	-18.3	-23.3
Gross Profit	62.7	64.7	69.2	83.4	93.2
Non-sales Revenues	0.0	0.0	0.0	0.0	0.0
Operating Costs	-55.5	-56.7	-59.6	-70.6	-78.2
<b>EBITDA</b>	<b>7.2</b>	<b>8.0</b>	<b>9.6</b>	<b>12.8</b>	<b>15.0</b>
Depreciation & Amortisation	-1.3	-1.5	-2.9	-4.0	-4.8
EBIT	5.9	6.5	6.7	8.8	10.2
Net interest expense	-1.5	-1.4	-1.4	-2.1	-2.0
Pre-tax profit	4.4	5.0	5.3	6.7	8.1
Tax expense	-1.3	-0.4	-0.9	-1.4	-2.0
<b>Reported NPAT</b>	<b>3.2</b>	<b>4.6</b>	<b>4.4</b>	<b>5.2</b>	<b>6.1</b>
Net Abnormals/NRIs	0.3	0.3	0.6	0.3	0.2
<b>Normalised NPAT</b>	<b>3.5</b>	<b>4.9</b>	<b>5.0</b>	<b>5.5</b>	<b>6.3</b>
Effective Tax Rate	28.6%	8.8%	17.0%	21.5%	25.0%
Reported diluted EPS	n/a	11.6	9.1	10.5	12.1
Normalised diluted EPS	n/a	12.3	10.3	11.1	12.4
DPS (cps)	n/a	0.0	3.0	3.5	3.5
Dividend Yield	n/a	0.0%	3.8%	4.4%	4.4%
Payout Ratio	n/a	0.0%	29.0%	31.6%	28.3%
Franking	n/a	100%	100%	100%	100%

Cash Flow (A\$m)	2009A	2010A	2011F	2012F	2013F
EBITDA	7.2	8.0	9.6	12.8	15.0
Change in working capital	0.0	2.6	-0.8	-1.7	-1.4
Net Interest	-1.5	-1.4	-1.4	-2.1	-2.0
Tax	0.3	1.3	-0.5	-1.0	-1.5
Other Operating Items	-0.2	-2.0	0.0	0.0	0.0
<b>Operating cash flow</b>	<b>5.8</b>	<b>8.4</b>	<b>6.9</b>	<b>8.0</b>	<b>10.0</b>
Capex	-0.9	-2.1	-5.2	-12.9	-5.2
Net Investments	-0.2	-0.1	0.0	0.0	0.0
Other Investing Items	0.0	0.0	0.0	0.0	0.0
<b>Investing Cash Flow</b>	<b>-1.1</b>	<b>-2.2</b>	<b>-5.2</b>	<b>-12.9</b>	<b>-5.2</b>
<b>Free cash flow</b>	<b>4.9</b>	<b>6.3</b>	<b>1.7</b>	<b>-5.0</b>	<b>4.8</b>
Dividends	-0.4	-0.7	-1.4	-1.5	-1.1
Equity	0.0	0.0	5.5	0.0	0.0
Debt	-1.5	-0.8	-5.0	11.9	-1.6
Other Financing Items	-3.8	-0.9	0.0	0.0	0.0
<b>Financing Cash Flows</b>	<b>-5.8</b>	<b>-2.4</b>	<b>-0.9</b>	<b>10.4</b>	<b>-2.7</b>
<b>Change in cash</b>	<b>-1.1</b>	<b>3.8</b>	<b>0.8</b>	<b>5.4</b>	<b>2.1</b>

Balance Sheet (A\$m)	2009A	2010A	2011F	2012F	2013F
Cash	2.5	6.3	7.1	12.5	14.6
Receivables	13.7	12.0	18.0	21.4	24.1
Inventory	0.1	0.2	0.2	0.4	0.6
Property, plant and equip	10.8	17.3	19.6	28.6	29.0
Goodwill	29.2	29.2	29.2	29.2	29.2
Other assets	1.7	2.1	2.1	2.1	2.1
<b>Total Assets</b>	<b>58.0</b>	<b>67.0</b>	<b>76.3</b>	<b>94.2</b>	<b>99.6</b>
Payables	3.4	4.1	8.3	10.2	11.6
Borrowings	17.0	21.2	16.1	28.0	26.4
Provisions	3.4	4.3	4.3	5.1	5.7
Other liabilities	0.9	0.0	0.0	0.0	0.4
<b>Total Liabilities</b>	<b>24.6</b>	<b>29.6</b>	<b>28.8</b>	<b>43.3</b>	<b>44.1</b>
Retained Profits	4.0	7.9	11.0	14.7	19.3
Issued Capital	29.2	29.2	36.1	36.1	36.1
Other Equity	0.2	0.4	0.4	0.1	0.1
<b>Shareholders equity</b>	<b>33.4</b>	<b>37.4</b>	<b>47.5</b>	<b>50.9</b>	<b>55.4</b>

Revenue Split (A\$m)	2009A	2010A	2011F	2012F	2013F

Operating Metrics	2009A	2010A	2011F	2012F	2013F
<b>Growth</b>					
Revenue growth	n/a	0.5%	9.7%	22.0%	14.5%
EBITDA growth	n/a	10.9%	20.4%	33.1%	17.2%
Normalised EPS growth	n/a	n/a	-16.1%	7.1%	11.6%
<b>Margin</b>					
Gross margin	82.9%	85.1%	83.0%	82.0%	80.0%
EBITDA margin	9.5%	10.5%	11.5%	12.5%	12.8%
EBIT Margin	7.8%	8.5%	8.1%	8.6%	8.7%
<b>Returns</b>					
ROIC (post-tax)	8.4%	8.8%	8.5%	9.8%	10.5%
ROE (post-tax)	9.5%	12.9%	10.4%	10.7%	11.5%
ROA (pre-tax)	10.2%	10.4%	9.4%	10.3%	10.5%

Financing Metrics	2009A	2010A	2011F	2012F	2013F
Closing Net Debt/(Cash)	15.4	14.9	9.1	15.6	11.9
Net Debt / Equity	46.1%	39.9%	19.1%	30.6%	21.4%
Net Debt / Total Assets	26.5%	22.3%	11.9%	16.5%	11.9%
EBITDA Interest Cover (x)	4.9	5.5	6.9	6.1	7.3
EBIT Interest Cover (x)	4.0	4.5	4.9	4.2	5.0

Valuation Ratios	2009A	2010A	2011F	2012F	2013F
Reported PER	n/a	6.9	8.8	7.6	6.6
Normalised PER	n/a	6.5	7.7	7.2	6.5
EV/EBIT	n/a	7.2	7.7	6.0	5.3
EV/EBITDA	n/a	5.9	5.4	4.1	3.6
Free Cash Flow Yield	n/a	20.0%	4.2%	-12.3%	11.7%
NTA backing (cps)	n/a	20.3	41.8	49.0	58.6

DCF Assumptions	
WACC	12.4%
Diluted Shares (m)	50.3
Cost of Equity	14.6%
Target Gearing (Debt/EV)	25.0%
Risk Free Rate	5.5%

DCF Valuation	A\$m	A\$
Explicit Cash Flows	20.8	0.41
Terminal Cash Flow	48.2	0.96
Enterprise Value	69.0	1.37
Net Debt	9.1	0.18
Dividends Paid	0.0	0.00
Minorities	0.0	0.00
Net Imputation	9.0	0.18
<b>Unrisked Equity Value</b>	<b>69.0</b>	<b>1.37</b>
Premium/(Discount) to Share Price		71.5%

Price Target	
12-month Price Target (A\$)	0.99
Premium/(Discount) to Share Price	23.8%
Implied PER (x)	9.0
Implied PE rel XSI (x)	0.74

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## Guide to Ord Minnett Recommendations

BUY	The stock's total return (nominal dividend yield plus capital appreciation) is expected to exceed 15% over 12 months.
ACCUMULATE	The stock's total return is expected to be between 5% and 15%. Investors may add to existing holdings, or initiate holdings on share price weakness.
HOLD	The stock is fairly priced, and its total return is expected to be between 0% and 5%.
LIGHTEN	The stock's total return is expected to be less than 0% and possibly down 15%. Investors should consider selling into share price strength.
SELL	The stock's total return is expected to lose 15% or more.
RISK ASSESSMENT	Classified as High, Medium or Low, denotes the relative assessment of an individual stock's risk based on an appraisal of its disclosed financial information, volatility, nature of its operations and other relevant quantitative and qualitative criteria.

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