

Company Review

Ord Minnett Research

Tuesday, 23 August 2011

Delta SBD

FY11 result

We have retained a Buy and increased our price target marginally to \$1.00ps following today's result. In short, we believe Delta SBD remains well placed within a growing sector and offers significant valuation upside.

- Delta SBD reported a normalised net profit of \$5.3m, up 8.9% on pcp and marginally ahead of our \$5.0m forecast. A final fully franked dividend of 3.6cps was declared, ahead of our 3.5cps forecast.
- The key positive from the result was the improved operating performance of the business, with both revenues and the EBITDA margin having benefited from increased levels of activity in 2H11. Operating cash flow was also strong.
- The key negative from the result was the lack of explicit earnings guidance for FY12. Nevertheless, the outlook appears positive with (i) recent contract wins set to provide a full 12 months, and (ii) current high levels of tendering activity.
- We have made minor upward revisions to our earnings forecasts following today's result, increasing EBITDA by 1.2%, 0.5%, and 0.9% in FY12, FY13, and FY14, respectively.
- In our view, Delta SBD's exposure to a growing sector and ability to participate in consolidating what is a fragmented industry underpin our expectation for a three-year net profit CAGR of 12.4%.
- Our revised price target of \$1.00ps implies a PE rel of 0.81. While noting that Delta SBD is hamstrung by its limited track record as a listed entity and small free float, we are confident that these issues will be addressed in FY12.
- We retain a Buy rating on Delta SBD given the prospect of reasonable earnings growth and valuation upside, the combination of which imply a 12-month TSR of 38.7%.

Key Financials

Year ending 30 June	FY10A	FY11A	FY12E	FY13E	FY14E
Revenue (A\$m)	75.9	83.8	102.3	117.1	126.1
EBITDA (A\$m)	8.0	9.4	12.9	15.0	15.9
Reported NPAT (A\$m)	4.6	4.8	5.3	6.1	6.8
Reported diluted EPS (¢)	14.1	10.2	10.6	11.9	13.3
Reported P/E (x)	5.3	7.4	7.1	6.3	5.6
EV/EBITDA	5.0	5.1	3.8	3.6	3.3
Dividend (¢)	0.0	3.6	4.0	4.0	4.5
Net Yield (%)	0.0%	4.8%	5.3%	5.3%	6.0%
Franking (%)	100%	100%	100%	100%	100%
Normalised NPAT (A\$m)	4.9	5.3	5.6	6.2	6.8
Normalised diluted EPS (¢)	15.0	11.4	11.2	12.2	13.3
EPS Growth (%)	n/a	-24.1%	-1.7%	8.9%	9.3%
Normalised P/E (x)	5.0	6.6	6.7	6.2	5.6
Normalised ROE (%)	12.9%	11.1%	10.7%	11.3%	11.4%

Source: Iress, Company Data, Ord Minnett Est. Share price: \$ 0.75 Aug 23, 2011

DSB A\$0.75

Recommendation

Buy

Risk Assessment

High

Capital Goods

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Delta SBD

ASX Code	DSB
52 week range	A\$0.55 - A\$1.06
Market Cap (A\$m)	38.3
Fully Diluted Shares (m)	51.1
Avg Daily Shares	8,226
ASX Small Ordinaries	2,351
ASX Small Industrials	1,781
NTA (¢ per share)	43.5
Net Debt/(Cash) (A\$m)	6.2

Relative price performance



Source: Iress

OM & consensus forecasts

June Y/E	FY12E	FY13E
NPAT (C)	n/a	n/a
NPAT (OM)	5.6	6.2
EPS (C)	n/a	n/a
EPS (OM)	11.2	12.2

Source: Iress, OM forecasts

FY11 result

Delta SBD reported a normalised net profit of \$5.3m, up 8.9% on pcp and marginally ahead of our \$5.0m forecast – on a reported basis, net profit increased by 3.7% to \$4.8m (OM \$4.4m). A final fully franked dividend of 3.6cps was declared, ahead of our 3.5cps forecast.

Table 1. Delta SBD – full-year result summary

Year Ending 30 June	1H10A	2H10A	2010A	1H11A	2H11A	2011A	2H11/2H10	2H11/1H11	2011/2010
Profit & Loss									
Sales Revenue	38.9	37.0	75.9	39.7	44.2	83.8	19.2%	11.4%	10.4%
COGS	5.7	5.6	11.3	7.7	7.8	15.5	40.2%	1.1%	37.1%
Gross Profit	33.2	31.5	64.7	32.0	36.4	68.3	15.5%	13.8%	5.7%
Non-sales Revenue	0.0	0.0	0.0	0.0	0.0	0.0	0.0%	0.0%	0.0%
Operating Costs	29.0	27.7	56.7	27.7	31.2	59.0	12.8%	12.6%	4.0%
EBITDA	4.2	3.8	8.0	4.2	5.2	9.4	36.3%	22.7%	17.7%
Depreciation	0.8	0.7	1.5	1.4	1.0	2.4	44.8%	-30.8%	65.4%
EBITA	3.4	3.1	6.5	2.8	4.2	7.0	35.0%	50.1%	7.4%
Amortisation	0.0	0.0	0.0	0.0	0.0	0.0	-92.0%	0.0%	-93.0%
EBIT	3.4	3.1	6.5	2.8	4.2	7.0	35.0%	50.1%	7.4%
Net Interest Expense	0.7	0.7	1.4	0.8	0.6	1.4	-23.0%	-30.6%	-5.4%
Pre Tax Profit	2.7	2.4	5.0	2.0	3.6	5.6	52.8%	83.2%	11.1%
Tax Expense	0.8	-0.3	0.4	0.3	0.6	0.8	-262.8%	110.9%	88.2%
Reported NPAT	1.9	2.7	4.6	1.7	3.1	4.8	12.5%	78.9%	3.7%
Non Recurring Items	0.2	0.1	0.3	0.5	0.1	0.6	43.0%	-77.4%	88.5%
Normalised NPAT	2.1	2.8	4.9	2.2	3.2	5.3	13.3%	45.6%	8.9%
Other Information									
EPS (reported)	6.4	8.5	15.0	5.0	7.2	12.1	-16.3%	43.1%	-19.5%
EPS (underlying)	5.8	8.3	14.1	3.9	6.9	10.8	-16.8%	75.8%	-23.4%
DPS (¢)	0.0	0.0	0.0	0.0	3.6	3.6	n/a	n/a	n/a
Shares - Closing Balance (m)	32.6	32.6	32.6	43.3	44.1	44.1	35.3%	1.7%	35.3%
Margin/Ratio Analysis									
Gross Margin	85.3%	85.0%	85.1%	80.6%	82.4%	81.5%	-263bps	179bps	-361bps
EBITDA Margin	10.7%	10.2%	10.5%	10.6%	11.7%	11.2%	147bps	108bps	70bps
EBIT Margin	8.7%	8.4%	8.5%	7.0%	9.5%	8.3%	110bps	244bps	-23bps
Effective tax rate	29.6%	-14.6%	8.8%	13.5%	15.6%	14.9%	3021bps	204bps	608bps
GOCF/EBITDA	70.5%	217.1%	140.2%	95.1%	124.7%	111.4%	-9242bps	2955bps	-2882bps
Interest Cover (EBIT)	4.7	4.2	4.5	3.4	7.4	5.1	n/a	n/a	n/a

Source: Company data, OM

Earnings revisions

We have made minor upward revisions to our earnings forecasts following today's result, increasing EBITDA by 1.2%, 0.5%, and 0.9% in FY12, FY13, and FY14, respectively. These revisions are essentially the result of the re-basing of our revenue expectation, with FY11 marginally ahead of our forecast.

Table 2. Delta SBD – earnings revisions

Year Ending 30 June	2012F			2013F			2014F		
	Old	New	Chg	Old	New	Chg	Old	New	Chg
EBITDA (A\$m)	12.8	12.9	1.2%	15.0	15.0	0.5%	15.7	15.9	0.9%
NPAT (A\$m)	5.2	5.3	2.1%	6.1	6.1	-0.2%	6.9	6.8	-1.9%
Normalised NPAT (A\$m)	5.5	5.6	2.0%	6.3	6.2	-0.2%	6.9	6.8	-1.9%
EPS ¢	12.0	12.0	0.2%	13.8	13.5	-2.4%	14.9	14.3	-4.3%
Normalised EPS ¢	12.7	12.7	0.1%	14.1	13.8	-2.4%	14.9	14.3	-4.3%
DPS ¢	3.5	4.0	14.3%	3.5	4.0	14.3%	4.0	4.5	12.5%
Free cash flow (A\$m)	-5.0	-5.2	4.6%	4.8	4.4	-7.4%	6.0	5.9	-1.9%

Source: OM forecasts

Key positives

Delta SBD has delivered a result that is marginally ahead of our expectations at the net profit line, due largely to slightly higher revenues and lower depreciation and tax expenses. The other key positive was the operating cash flow, which comfortably exceeded our forecast due to better-than-expected gross cash flows.

Key negatives

The key negative from the result was the lack of explicit earnings guidance for FY12. Nevertheless, the outlook appears positive with (i) all existing contracts expected to be retained, (ii) recent contract wins set to provide a full 12 months, and (iii) high levels of tendering activity and capex upgrade indicative of future prospects.

Result quality

Result quality was mixed, although in fairness this is to some extent due to the transition from a private company to a listed entity – the IPO was in December 2010. In terms of operating performance, the result featured revenue growth, an increased EBITDA margin but lower EBIT margin, higher tax rate, and good cash flows.

Key takeaways

In our view, the key takeaways from today's result include the following.

Delta SBD – off to a reasonable start

In our view, Delta SBD has got off to a reasonable start as a listed entity, having secured several contract extensions/wins, placed orders for \$14m of new equipment, and secured a new COO. While revenue growth of 10.4% is expected to be lower than Mastermyne's FY11 run rate, we note the following points:

- **Improving margin performance.** While a major 2H11 contract win would have been the difference between a good result and a great result, it is pleasing to note that Delta SBD's FY11 margin performance did improve on pcp, albeit still below Mastermyne's conversion rate.
- **FY12 capex upgrade a positive sign.** Delta SBD announced in June 2011 that it had committed to investing \$14m on new equipment. In our view, this provides a positive lead indicator on additional contract announcements through FY12.

Good thematic

Our expectation for improved revenue growth and increased margins over the medium-term is premised on Delta SBD benefiting from (i) increased throughput within its existing contract base, (ii) securing contracts at new mine developments, and (iii) being an active participant in consolidating the fragmented industry.

Notwithstanding current volatility in global markets, we expect demand for coal, particularly with respect to Asian demand for thermal coal, to remain relatively resilient. Furthermore, we expect underground coal mining to become more prominent given:

- **Technology.** We understand that technological advancements have, in some instances, made underground mining more cost effective than open-cut mining.
- **Finite resource.** The ongoing extraction of Australia's open-cut resources, while far from exhausted, is resulting in an increased prevalence of underground mines.

Capex

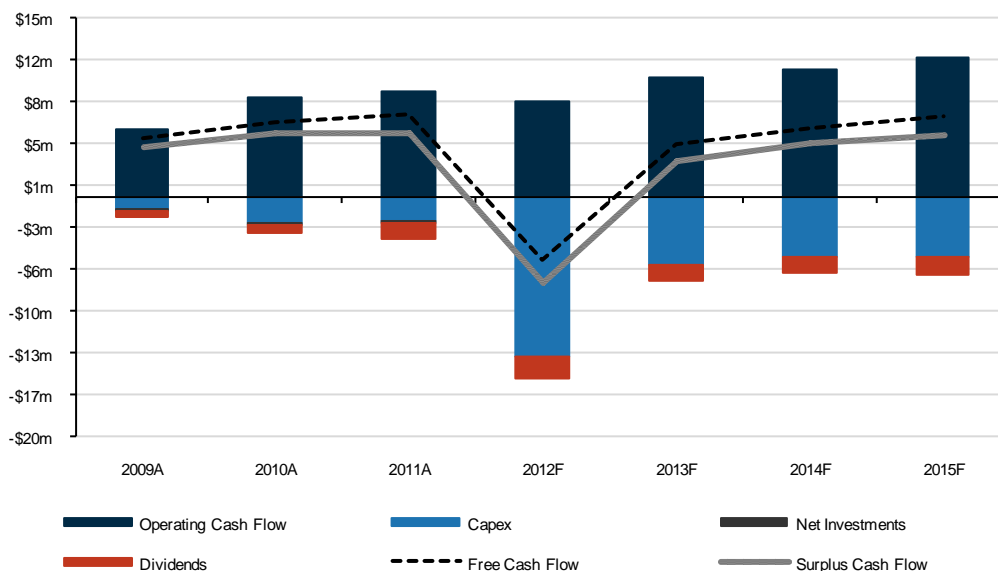
Delta SBD announced in June 2011 that it has placed orders to purchase \$14m of new equipment. The investment is expected to position Delta SBD for future growth in its underground contracting and plant hire activities. While limited details have been forthcoming, we note the following:

- The capex will comprise (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.
- Management expect (i) the new continuous miner will be deployed on one of the contracts the company is currently bidding for, and (ii) the expanded fleet to enhance the company's competitive position on larger projects.
- 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.

Cash flows

Delta SBD's FY11 gross cash conversion rate, while below the pcp, was impressive at 111.4% (120.3% after adjusting for changes in working capital). However, in FY12, with increased working capital and capex more than accounting for free cash flow, we expect borrowings to increase. Positive free cash flows return from FY13.

Chart 1. Delta SBD cash flow summary



Source: Company data, OM

Balance sheet

With debt having been reduced in FY11 by \$5.1m, \$2.6m of which related to shareholder loans, we expect borrowing to increase in FY12. While this increase in debt pertains entirely to capex, we are not concerned by the increase in financial leverage given:

- **Increased return on investment.** Notwithstanding the increase in invested capital, we expect the Group's financial returns to increase in FY12 on the basis that the new equipment will be deployed upon delivery.
- **Debt serviceability/gearing.** Based on our FY12 estimates, key metrics remain comfortable. While net debt to equity increases from 12.8% to 30.7%, EBIT interest cover remains in excess of 4.0x.

Outlook

While management has not provided any explicit earnings guidance for FY12, the general tone remains positive. In particular, we note that management expect (i) to retain all of their existing contracts, with recent contracts adding a full 12 months, and (ii) new business opportunities to arise, as per the recent capex upgrade.

Price target

We have increased our price target marginally from \$0.99ps to \$1.00ps 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 note, and (ii) changes to market multiples since our last publication.

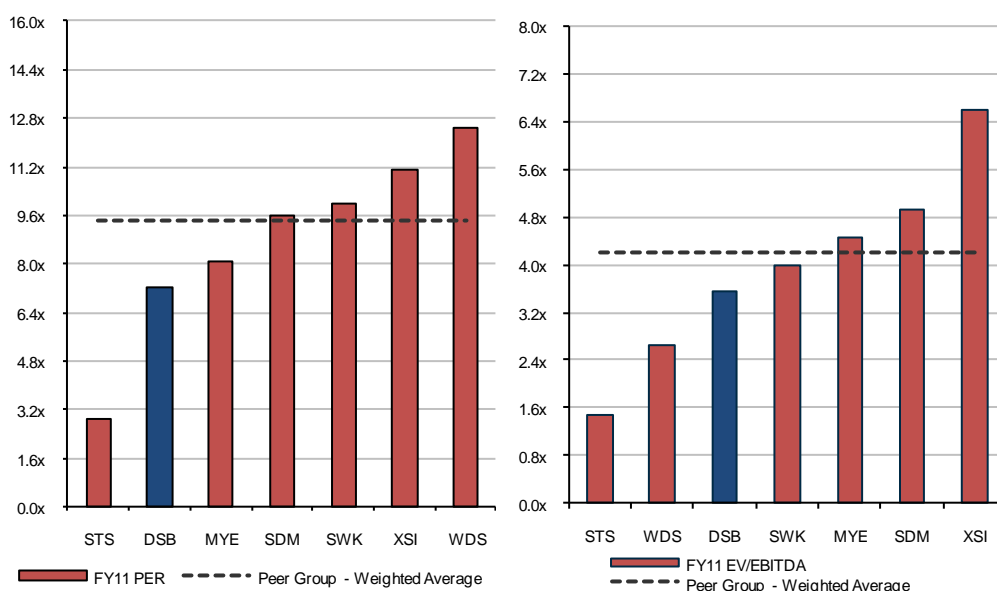
Table 3. Delta SBD – valuation summary

Valuation Summary	FY12
DCF: WACC 12.3%, I-t growth 2.0%, liquidity discount 20%	\$1.30
PER: 20% discount to Small Industrials	\$0.99
PER: 10% discount to Mastermyne (MYE) multiple	\$0.72
Blended Valuation (Average)	\$1.00

Source: OM forecasts

Our revised price target implies a FY12 PER of 9.0x and a PER rel of 0.81. As outlined in the table below, we note that (i) while Delta SBD trades at a c10% discount to Mastermyne, their PER discount to the market is much more pronounced, and (ii) our price target implies a PE rel to our compco of 0.95.

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



Source: Iress, OM

Investment view

While today's result was good without being exceptional, we remain of the view that Delta SBD represents an attractive medium-term investment opportunity.

Notwithstanding 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 33.3% 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 38.7%, 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 4. Delta SBD's estimated TSR

12-month Price Target	FY12
Valuation/Price Target	1.00
Implied TSR	38.7%
Nominal Dividend Yield	5.3%
Capital Return	33.3%

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)	2010A	2011A	2012F	2013F	2014F
Sales revenue	75.9	83.8	102.3	117.1	126.1
COGS	-11.3	-15.5	-19.4	-22.8	-25.2
Gross Profit	64.7	68.3	82.9	94.3	100.9
Non-sales Revenues	0.0	0.0	0.0	0.0	0.0
Operating Costs	-56.7	-59.0	-69.9	-79.3	-85.0
EBITDA	8.0	9.4	12.9	15.0	15.9
Depreciation & Amortisation	-1.5	-2.4	-4.1	-4.9	-5.0
EBIT	6.5	7.0	8.8	10.1	10.9
Net interest expense	-1.4	-1.4	-2.0	-2.0	-1.9
Pre-tax profit	5.0	5.6	6.8	8.1	9.0
Tax expense	-0.4	-0.8	-1.5	-2.0	-2.3
Reported NPAT	4.6	4.8	5.3	6.1	6.8
Net Abnormals/NRIs	0.3	0.6	0.3	0.2	0.0
Normalised NPAT	4.9	5.3	5.6	6.2	6.8
Effective Tax Rate	8.8%	14.9%	21.5%	25.0%	25.0%
Reported diluted EPS	14.1	10.2	10.6	11.9	13.3
Normalised diluted EPS	15.0	11.4	11.2	12.2	13.3
DPS (cps)	0.0	3.6	4.0	4.0	4.5
Dividend Yield	0.0%	4.8%	5.3%	5.3%	6.0%
Payout Ratio	0.0%	31.6%	35.8%	32.9%	33.8%
Franking	100%	100%	100%	100%	100%

Cash Flow (A\$m)	2010A	2011A	2012F	2013F	2014F
EBITDA	8.0	9.4	12.9	15.0	15.9
Change in working capital	2.6	-0.7	-1.9	-1.4	-1.1
Net Interest	-1.4	-1.4	-2.0	-2.0	-1.9
Tax	1.3	-0.1	-0.9	-1.5	-2.1
Other Operating Items	-2.0	1.8	0.0	0.0	0.0
Operating cash flow	8.4	9.0	8.1	10.1	10.8
Capex	-2.1	-2.0	-13.3	-5.6	-5.0
Net Investments	-0.1	0.0	0.0	0.0	0.0
Other Investing Items	0.0	0.0	0.0	0.0	0.0
Investing Cash Flow	-2.2	-2.1	-13.3	-5.6	-5.0
Free cash flow	6.3	6.9	-5.2	4.4	5.9
Dividends	-0.7	-1.4	-1.9	-1.3	-1.3
Equity	0.0	5.8	0.0	0.0	2.0
Debt	-0.8	-5.0	11.9	-1.6	0.0
Other Financing Items	-0.9	-2.7	-2.7	-2.7	-2.7
Financing Cash Flows	-2.4	-3.3	7.4	-5.5	-2.0
Change in cash	3.8	3.6	2.2	-1.1	3.8

Balance Sheet (A\$m)	2010A	2011A	2012F	2013F	2014F
Cash	6.3	9.8	12.0	10.9	14.8
Receivables	12.0	18.4	25.0	31.0	35.2
Inventory	0.2	0.2	0.4	0.6	0.6
Property, plant and equip	17.3	20.2	29.4	30.1	30.1
Goodwill	29.2	29.2	29.2	29.2	29.2
Other assets	2.1	1.5	1.4	1.4	1.4
Total Assets	67.0	79.3	97.5	103.3	111.3
Payables	4.1	9.2	11.3	13.2	14.2
Borrowings	21.2	16.0	27.9	26.3	26.3
Provisions	4.3	5.5	6.6	7.6	8.1
Other liabilities	0.0	0.0	0.2	0.3	0.3
Total Liabilities	29.6	30.7	46.0	47.5	49.0
Retained Profits	7.9	11.3	14.8	19.1	23.7
Issued Capital	29.2	36.6	36.6	36.6	38.6
Other Equity	0.4	0.7	0.1	0.1	0.1
Shareholders equity	37.4	48.6	51.5	55.8	62.4

Revenue Split (A\$m)	2010A	2011A	2012F	2013F	2014F

Operating Metrics	2010A	2011A	2012F	2013F	2014F
Growth					
Revenue growth	0.5%	10.4%	22.0%	14.5%	7.7%
EBITDA growth	10.9%	17.7%	37.7%	16.3%	5.6%
Normalised EPS growth	n/a	-24.1%	-1.7%	8.9%	9.3%
Margin					
Gross margin	85.1%	81.5%	81.0%	80.5%	80.0%
EBITDA margin	10.5%	11.2%	12.6%	12.8%	12.6%
EBIT Margin	8.5%	8.3%	8.6%	8.6%	8.6%
Returns					
ROIC (post-tax)	8.8%	8.9%	9.8%	10.0%	10.3%
ROE (post-tax)	12.9%	11.1%	10.7%	11.3%	11.4%
ROA (pre-tax)	10.4%	9.5%	9.9%	10.0%	10.1%

Financing Metrics	2010A	2011A	2012F	2013F	2014F
Closing Net Debt/(Cash)	14.9	6.2	15.9	15.4	11.6
Net Debt / Equity	39.9%	12.8%	30.9%	27.7%	18.6%
Net Debt / Total Assets	22.3%	7.8%	16.3%	14.9%	10.4%
EBITDA Interest Cover (x)	5.5	6.8	6.5	7.7	8.6
EBIT Interest Cover (x)	4.5	5.1	4.4	5.1	5.9

Valuation Ratios	2010A	2011A	2012F	2013F	2014F
Reported PER	5.3	7.4	7.1	6.3	5.6
Normalised PER	5.0	6.6	6.7	6.2	5.6
EV/EBIT	6.1	6.9	5.6	5.4	4.9
EV/EBITDA	5.0	5.1	3.8	3.6	3.3
Free Cash Flow Yield	25.9%	18.5%	-13.6%	11.4%	14.8%
NTA backing (cps)	24.6	43.5	49.4	58.0	67.2

DCF Assumptions	
WACC	12.4%
Diluted Shares (m)	50.9
Cost of Equity	14.6%
Target Gearing (Debt/EV)	25.0%
Risk Free Rate	5.5%

DCF Valuation	A\$m	A\$
Explicit Cash Flows	18.8	0.37
Terminal Cash Flow	59.4	1.17
Enterprise Value	78.1	1.53
Net Debt	6.2	0.12
Dividends Paid	0.0	0.00
Minorities	0.0	0.00
Net Imputation	11.0	0.22
Unrisked Equity Value	82.9	1.63
Premium/(Discount) to Share Price		117.1%

Price Target	
12-month Price Target (A\$)	1.00
Premium/(Discount) to Share Price	33.3%
Implied PER (x)	9.0
Implied PE rel XSI (x)	0.81

Please contact your Ord Minnett Adviser for further information on our document.

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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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Ord Minnett acted as a broker to the IPO for Delta SBD.

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