Company Review

Ord Minnett Research Tuesday, 1 February 2011

Delta SBD

Pure play on underground coal

Delta SBD (DSB) provides mining services to the domestic underground coal industry in New South Wales and Queensland. The business was formed in October 2007 following the merger of Delta Mining and SBD Services.

We initiate coverage on DSB with a Buy recommendation and $1.16 per share price target. We believe the company is well placed to benefit from the positive outlook for coal exports and the likely consolidation within its industry.

The underground coal mining services industry is characterised by a reasonably high level of customer concentration – there are 31 mines in Australia – and a high level of fragmentation among its participants.

The industry's proposition is premised on being able to deliver superior outcomes to the mine owners/operators. This is generally achieved through productivity gains, increased focus on core activities and reduced capex.

Australia is the world's largest exporter of metallurgical coal and second-largest exporter of thermal coal. In FY10, underground coal accounted for 15% and 35% of Queensland and New South Wales' saleable black coal.

ABARES forecasts FY10–15 Australian coal exports to increase at a CAGR of 4.9% and, factoring in market share and cost efficiency gains, we expect revenue and EBIT CAGR of 8.6% and 10.0%, respectively.

Our fair value estimate and price target for Delta SBD is $1.16 per share. Based on our forecasts this implies an FY11 PER of 11.1x and a PE rel to the Small Industrials of 0.72x.

We are forecasting a 12-month TSR of 25.3%. This is based on the combination of our $1.16 price target and dividend yield of 3.2% (30% payout ratio). This underpins our **Buy** rating despite liquidity constraints.

Key Financials Year Ending 30 June	2009A	2010A	2011F	2012F	2013F
Revenue (A$m)	75.6	75.9	83.2	95.4	102.7
EBITDA (A$m)	7.2	8.0	10.4	12.4	13.3
Reported NPAT (A$m)	3.2	4.6	5.1	5.5	6.1
Reported diluted EPS (¢)	n/a	11.6	10.5	11.0	12.2
Reported P/E (x)	n/a	8.2	9.1	8.6	7.8
EV/EBITDA	n/a	6.6	5.9	4.9	4.4
Dividend (¢)	n/a	0.0	3.0	3.5	3.5
Net Yield (%)	n/a	0.0%	3.2%	3.7%	3.7%
Franking (%)	n/a	100%	100%	100%	100%
Normalised NPAT (A$m)	3.2	4.6	5.2	5.5	6.1
Normalised diluted EPS	n/a	11.6	10.7	11.0	12.2
EPS Growth (%)	n/a	n/a	-7.9%	3.4%	10.7%
Normalised P/E (x)	n/a	8.2	8.9	8.6	7.8
Normalised ROE (%)	9.5%	12.9%	13.1%	12.6%	12.9%

Source: Iress, Company Data, Ord Minnett Est. Share price: $ 0.95 Jan 31, 2011

DSB A$0.95

Recommendation
Buy

Risk Assessment
High

Capital Goods

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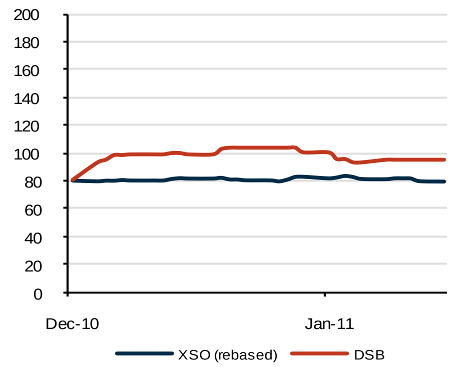
Delta SBD

ASX Code	DSB
52 week range	A$0.91 - A$1.06
Market Cap (A$m)	46.9
Diluted Shares (m)	49.4
Avg Daily Shares	4,088
ASX All Ordinaries	4,850
ASX200 Industrials	3,743
NTA - FY11 (¢ per share)	20.3
Net Debt - FY11 (A$m)	14.9

Relative price performance



Source: Iress

Consensus earnings

	FY11	FY12
NPAT (C)	n/a	n/a
NPAT (OM)	5.1	5.5
EPS (C)	n/a	n/a
EPS (OM)	10.5	11.0

Source: Iress, OM forecasts

Investment view

Attractive thematic

Delta SBD provides investors with an alternate means of gaining pure exposure to Australian black coal, Australia's largest export, and the world's largest source of seaborne trade. We are favourable on the outlook for Delta SBD given a combination of three factors:

- Industry forecasts for strong export demand for Australian coal over the medium-term
- Our expectation that the outsourcing of non-core mining activities will accelerate as labour and capital constraints increase
- Our expectation that there will be consolidation among the industry's third-party underground mining services providers.

Australian black coal production

Delta SBD, by virtue of its service offering to underground coal mine operators, provides investors with pure exposure to black coal production in Australia. According to ABARES, Australia is forecast to expand its black coal exports by a CAGR of 4.9% between FY10–15.

Outsourcing

We expect demand for the outsourcing of underground mining activities to third parties to increase over the medium term. This view is based on trends observed in related sectors; demand for specialist services and equipment, which is a product of growing production volumes; and the potential for productivity gains.

Industry consolidation

Our research indicates that, in contrast to the underground mining industry itself, Australia's underground mining services industry is highly fragmented. We expect industry consolidation to be driven by the growing preference among clients to minimise contractor numbers and to improve returns on invested capital.

Valuation

Using ABARES' black coal production forecasts as our base and factoring in revenue and margin upside from gains in market share and operating efficiency gains, we forecast FY10–15 revenue and EBIT CAGR of 8.6% and 10.0%, respectively. These forecasts underpin our blended valuation of $1.16 per share.

Investment rating

With reference to the table below, we forecast a total shareholder return of 25.3%. This is based on our price target of $1.16 per share, which equates to our blended valuation; and a fully franked FY11 dividend of 3.0cps based on a payout ratio of 30%, 100% to 2H.

Table 1: Delta SBD – forecast total shareholder return

Year ending 30 June	FY11
Valuation/Price Target	1.16
Implied TSR	**25.3%**
Nominal Dividend Yield	3.2%
Capital Return	22.1%

Source: OM forecasts

Based on our projected TSR of 25.3% and OM's investment rating classification system, we initiate coverage of Delta SBD with a Buy recommendation. While acknowledging the current lack of liquidity in the stock, we do expect this constraint to ease as the company expands through both organic growth and acquisitions.

Company overview

Delta SBD operates in an industry with a reasonably high concentration of customers and a large number of small competitors. We expect Delta SBD's earnings to benefit from increased coal production, increased use of outsourcing and industry consolidation.

Delta SBD provides mining services to the domestic underground coal industry in New South Wales and Queensland. Having originally built the business on an expertise in conveyor installations (Delta Mining) and roadway developments (DSB Services), the merged entity now offers a growing range of services, including:

- Whole of mine operations
- Long-wall relocations and support
- Roadway developments
- Conveyor installations and maintenance
- Mine services:
  - Secondary support installations
  - Excavation
  - Ventilation device installation
  - Services/utility installation/recovery
- Plant hire and maintenance
- Supplementary labour.

Company history

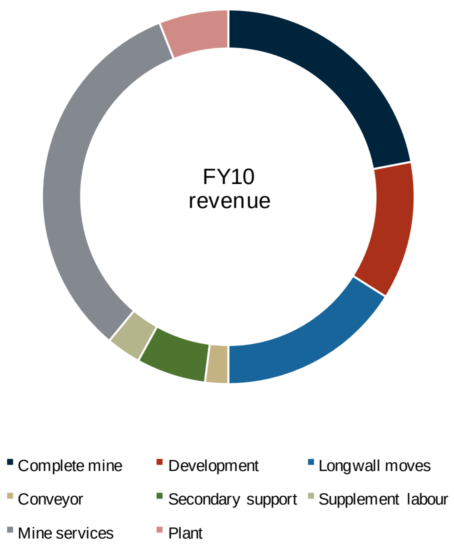
Delta SBD was established in October 2007 following the merger of two underground coal mining companies – Delta Mining and SBD Services. The merger effectively brought together two complementary businesses that had been operating independently for more than 10 years:

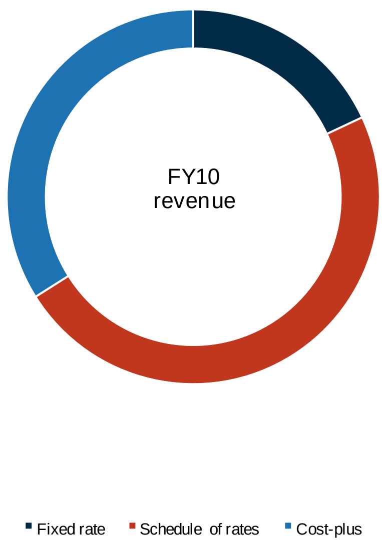
- Delta Mining's core markets are located in southern New South Wales
- SBD Services' core markets are located in Queensland and northern New South Wales.

Business model

Delta SBD generates its revenues by charging clients for services through varying pricing regimes. The company's FY10 revenues were spread across a wide range of services, the majority of which are charged on either a schedule of rates or cost-plus basis, as the charts below show.

Charts 1 & 2: Delta SBD – range of services and pricing structure by revenue





Source: Company data, as per prospectus

Comment

In our view, the success or failure of Delta SBD's business model boils down to its ability to retain existing contracts and expand either the number of services it provides to existing customers or the number of clients it provides services to. To this end, a good operating track record and diverse service offering are vital.

We expect that, as the underground mining services industry matures, industry consolidation will accelerate. Furthermore, we believe that Delta SBD will play an active role in consolidating the industry as a means to diversifying its client base, service offering and regional exposures.

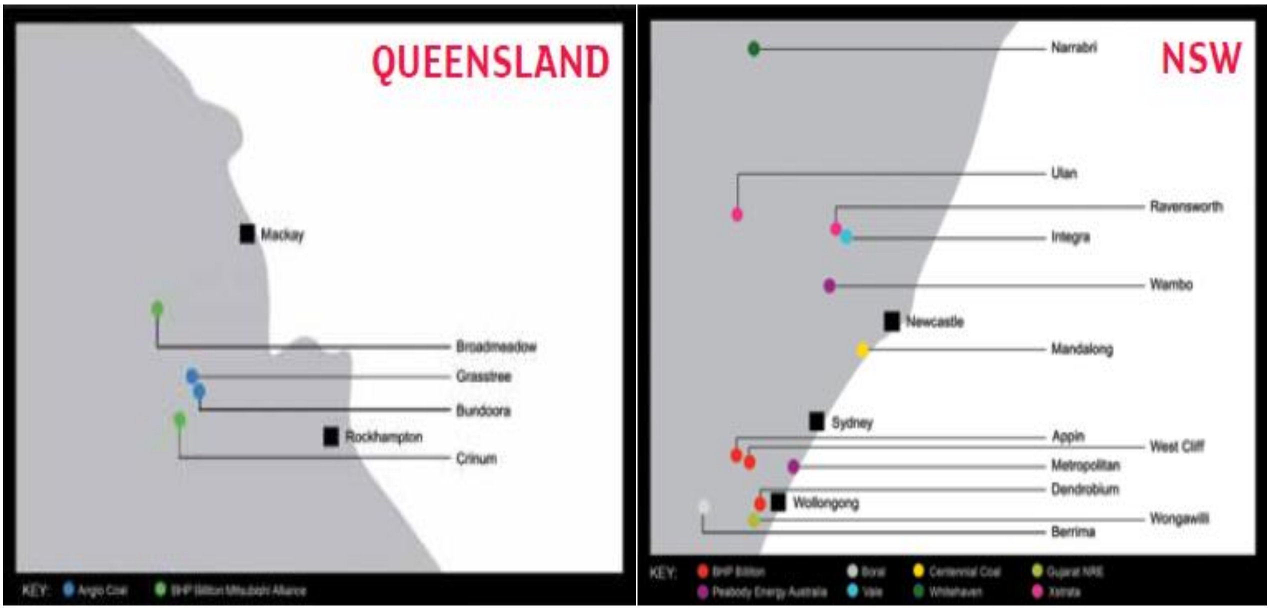
With regards to pricing structure, we note that the key driver of revenues is production volumes. While variability in commodity prices may have an indirect impact on mine volumes and thus revenues, we expect any volatility to be minimal over the medium term due to:

- **Demand**: The general view that strong forward demand for seaborne coal from China and India will drive new coal mine developments.
- **Services**: Delta SBD's broad range of services, which in our view make the company more resilient to periods of lower mine output.

Operations

Given that the entirety of Delta SBD's business is the provision of coal mining services to underground mines, the company intends to report its future financial accounts as one business segment. The company's regional operating exposures are outlined in the following illustrations.

Maps 1 & 2: Delta SBD's regional operating exposure



Source: Company data, as per prospectus

Fleet of equipment

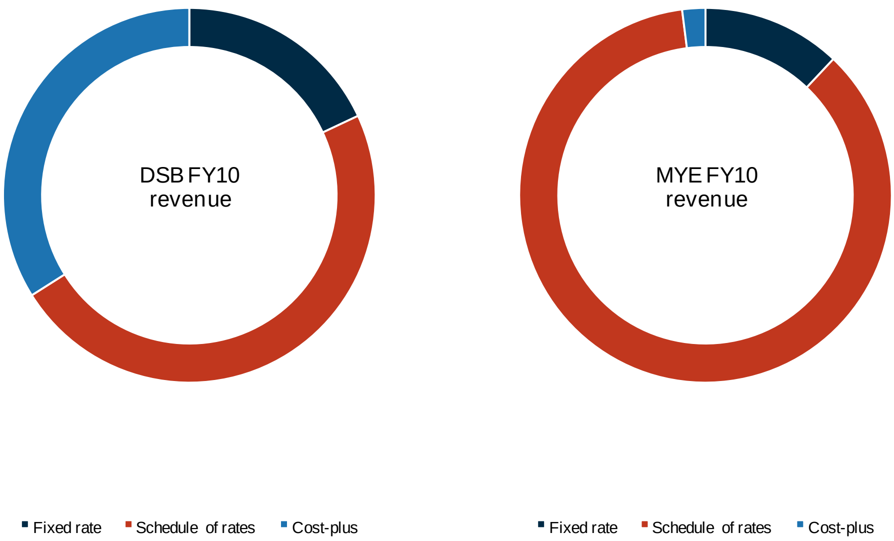
Given the abrasive nature of working underground and the safety requirements therein, Delta SBD's businesses are capital intensive. According to Delta SBD's prospectus, the average age of the company's fleet is less than five years, and company has $17.3m worth of plant and equipment.

Contract composition

While not quantified, Delta SBD's prospectus does indicate that a large proportion of the company's revenues are derived from a small number of clients. In particular, BHP's Appin mine accounts for four and Peabody Energy accounts for two of the company's eight "key contracts".

With regards to pricing structure, we have compared the composition of Delta SBD's contract pricing structure to Mastermyne Underground, which is the most relevant peer. As the charts below show, there are some notable differences, particularly with respect to the proportion of performance-based contracts.

Charts 3 & 4: Contract pricing composition – Delta SBD and Mastermyne



Source: Company data, as per prospectus

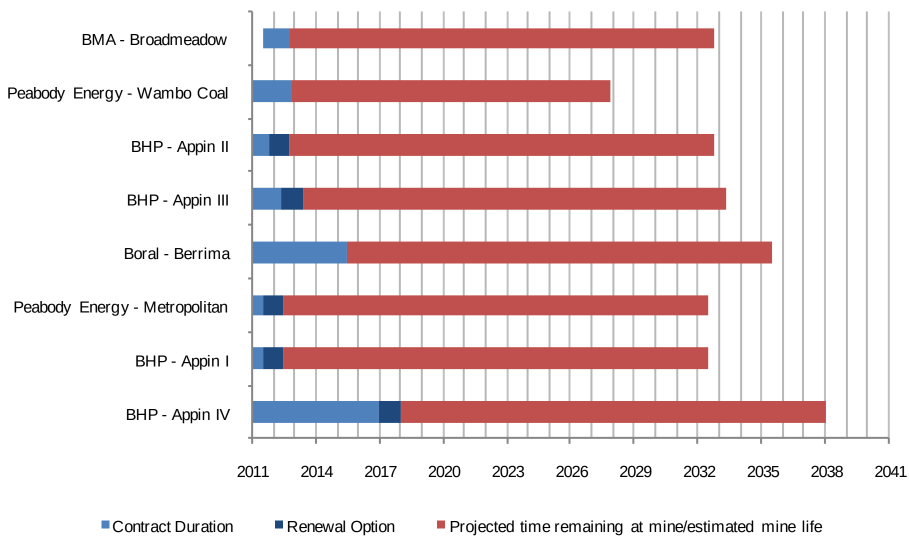
Comment

We prefer Delta SBD's more balanced pricing structure over Mastermyne's significant weighting to schedules of rates. This is based on our belief that, while more variable, Delta SBD has the potential to generate higher returns, and Delta SBD's higher risk profile is backed by its operating track record to date.

Clients

As illustrated below, Delta SBD has a reasonably concentrated client base. While not ideal from an investment and operating risk perspective, this also reflects the concentrated nature of the underground coal mining industry, with only 31 underground coal mines in Australia, and the recent formation of Delta SBD.

Chart 5: Delta SBD's contract profile



Source: Company data, as per prospectus

Competitors

According to Mastermyne's prospectus, the underground mining services industry is both competitive and highly fragmented – there are a large number of small, independent operators within the industry. Furthermore, there is also the prospect of new entrants emerging from related market segments, particularly larger firms.

Delta SBD notes that new contracts are typically contested on a combination of price, service quality, and operating and safety track records. While the fragmented nature of the industry indicates limited barriers to entry, capital constraints and a good track record are more important factors on larger contracts/mine sites.

WDS (WDS.ASX, $0.615 per share, Lighten)
WDS is an Australian-based company that provides services to the energy, mining and infrastructure sectors via three business segments – Infrastructure & Services, Mining, and Oil & Gas. The company's Mining business provides "fully integrated underground coal mining services" to underground mine operators.

Mastermyne (MYE.ASX, $1.54 per share, not covered)
Mastermyne is an Australian-based company that provides services to the Australian coal mining industry via three business segments – Underground, Engineering and Services. The company's core Underground business provides identical services to Delta SBD, albeit on a larger scale.

UGM Australia (Not listed)
UGM Australia provides contract services to Australia's mining industry, both underground and surface. Having started in 1997 by providing conveyor support services to underground coal mines in New South Wales, the company's service offering has been expanding and now includes mining, labour hire and engineering.

BIS Industries (Not listed)
Formerly a division of Brambles and now owned by private equity firm KKR, BIS provides services to a range of industries across Australia. One area of focus for BIS is its coal mining business, which was recently expanded through the acquisition of Allied Plant Services' underground coal equipment business.

Industry overview

Delta SBD's business is based on ongoing strong demand for black coal in global seaborne markets, and sustained outsourcing of underground mining-related activities to third parties. With regards to the latter, we believe industry consolidation will become increasingly attractive.

Types of coal

There are two main types of coal: brown coal, which has a higher moisture and lower energy content, and thus lower economic value; and black coal, which having had more exposure to heat and pressure has a lower moisture and higher energy content, and thus a higher economic value.

For the purpose of this report, we focus on black coal given brown coal's lower economic value precludes it from being mined underground. Notwithstanding this, there are large variations in black coal prices that reflect the extent of the product's thermal or coking qualities. Market dynamics for both are discussed below.

Supply

Australia is the world's largest exporter of metallurgical coal and second largest exporter of thermal coal. In FY10, 97% of Australia's saleable black coal was sourced from Queensland and New South Wales, with underground coal accounting for 15% and 35% of their respective totals.

Metallurgical coal

According to the World Coal Association, almost 70% of steel produced today uses metallurgical (coking) coal – in 2009, around 761Mt of coking coal was used to produce 1.2 billion tonnes of crude steel. Given growing demand for steel globally, it follows that the supply of its inputs (iron ore and coking coal) is also increasing.

Outlook for metallurgical coal

ABARES is forecasting strong growth in global demand for metallurgical coal through 2011. The key driver of this growth is increased private consumption of steel, which is expected to more than offset the post-GFC declines in government stimulus worldwide.

As per the table below, Australia is world's largest exporter of metallurgical coal, while Japan is the largest importer of metallurgical coal. While global demand for imported metallurgical coal is expected to remain strong through 2011, ABARES expects the lack of new coal developments to limit Australia's export growth to 2%.

Table 2: Outlook for world metallurgical trade

Region	Unit	2008A	2009A	2010F	2011F
Metallurgical coal imports					
European Union 27	Mt	57.0	41.0	46.0	48.0
Japan	Mt	57.0	46.0	53.0	57.0
China	Mt	7.0	34.0	44.0	45.0
Korea, Rep. of	Mt	24.0	15.0	22.0	25.0
Chinese Taipei	Mt	5.0	4.0	7.0	7.0
India	Mt	29.0	23.0	25.0	27.0
Brazil	Mt	11.0	9.0	12.0	13.0
Other	Mt	46.0	39.0	37.0	37.0
World imports	**Mt**	**236.0**	**211.0**	**246.0**	**259.0**
Metallurgical coal exports					
Australia	Mt	135.0	135.0	159.0	162.0
Canada	Mt	22.0	22.0	25.0	27.0
United States	Mt	34.0	34.0	34.0	34.0
Russia	Mt	13.0	13.0	18.0	21.0
Other	Mt	32.0	7.0	10.0	15.0
World exports	**Mt**	**236.0**	**211.0**	**246.0**	**259.0**

Source: ABARES

Thermal coal

According to the International Energy Agency (IEA), approximately 26% of the world's energy needs and about 40% of the world's electricity is derived from coal. While such a reliance on coal is not expected to subside over the medium term, an increased focus on energy efficiency and renewable energy is likely to reduce demand for lower quality coals.

Recent surveys from BP and the IEA estimate that the world's recoverable coal deposit is 2 trillion tonnes. This equates to approximately 300 years of supply based on current rates of consumption. Based on consensus data, the US, Russia, China and Australia have the largest reserves of both brown and black coal.

Total world production of both brown and black coal in 2009 was estimated at 7 billion tonnes. Approximately 1 billion tonnes of this output was exported, virtually all of which was seaborne trade. The composition of the export volume was 70% thermal and 30% metallurgical.

Comment

While ongoing investment in rail and port infrastructure is expected to remove a number of bottlenecks and thus increase supply, in our view, this could, to some extent, be offset by policy changes, both proposed and enacted, in key regions such as North America, China and India. These policies are outlined below:

- **US**. The American Clean Energy and Security Act of 2009 (ACES), which is similar to the European Union Emission Trading Scheme, is designed to place a cap on greenhouse gas emissions between 2012 and 2050. The bill was approved by the House of Representatives in 2009 and is awaiting consideration by the Senate;

- **China**. Currently reforming its coal industry as a means to improving both mine safety and energy efficiency levels. This is being done by closing down marginal coal mines in China and replacing domestic production with higher-grade imports. The country's recently released five-year plan has reiterated its current policy direction.

- **India**. Surging domestic demand for coal as an energy source and the government's restrictive resource allocation policy has resulted in increased demand for coal imports, and investment in foreign entities in order to secure supply. The Indian government has also allowed foreign investment locally to the extent that coal use is for domestic consumption.

In our view, policy initiatives in the US and China are likely to curb demand for low-grade coal and provide increased incentives for the development of clean-coal and renewable energy technologies. Furthermore, we believe this trend will accelerate as technological developments make these environmental initiatives more viable.

Outlook for thermal coal

According to ABARES' December 2010 Australian commodities report, the thermal coal spot price for seaborne trade is expected to remain around US$100 per tonne through 2011. This is based on ABARES' expectation for a strong supply response to increased demand from China and India.

Australia, along with Russia and Indonesia, are forecast to be the major contributors to increased seaborne trade. While import demand from Japan and the Republic of Korea is expected to remain high, it is China and India that are expected to drive increased demand for seaborne thermal coal.

As shown in the table below, ABARES is forecasting a 16.6% increase in FY11 thermal coal tonnes produced. The increase in production is being supported by the recent commissioning of a number of new coal mines, and increased port capacity, which has encouraged existing mines to increase their capacity utilisation.

Table 3: Thermal coal forecasts

Region	Unit	CY09A	CY10F	CY11F	CY11/CY10
World Trade	**Mt**	**720.8**	**757.9**	**792.2**	**4.5%**
Imports					
Asia	Mt	444.2	511.2	539.3	5.5%
- China	Mt	92.1	119.8	125.0	4.3%
- Chinese Taipei	Mt	59.4	55.0	57.0	3.6%
- India	Mt	48.6	60.0	77.0	28.3%
- Japan	Mt	112.5	128.0	128.0	0.0%
- Korea, Rep. of	Mt	82.4	99.0	100.0	1.0%
- Malaysia	Mt	16.1	16.4	16.8	2.4%
- Other, Asia	Mt	33.1	33.0	35.5	7.6%
Europe	Mt	203.1	175.2	184.2	5.1%
- European Union	Mt	166.5	136.8	145.8	6.6%
- Other Europe	Mt	36.6	38.4	38.4	0.0%
Other	Mt	73.5	71.5	68.6	-4.1%
Exports					
Australia	**Mt**	**139.1**	**143.5**	**161.9**	**12.8%**
China	Mt	21.5	19.0	19.5	2.6%
Columbia	Mt	63.4	71.2	72.0	1.1%
Indonesia	Mt	233.5	260.0	270.0	3.8%
Russia	Mt	83.5	87.4	93.0	6.4%
South Africa	Mt	66.9	65.7	70.0	6.5%
United States	Mt	19.6	21.3	22.0	3.3%
Other	Mt	93.3	89.8	83.8	-6.7%
Australia		FY09	FY10	FY11	FY11/FY10
Production	Mt	203.6	195.5	227.9	16.6%
Exports	Mt	136.4	135.0	158.8	17.6%

Source: ABARES

Coal production in Australia

As the table below shows, Queensland and New South Wales produce in excess of 95% of Australia's black coal. While the majority of each state's black coal is sourced from open-cut mines, New South Wales extracts a higher proportion of its coal from underground (35% versus 15%).

Table 4: Australian coal production profile

Region and type	Unit	1Q FY10	2Q FY10	3Q FY10	4Q FY10	1Q FY11	FY09	FY10	FY10/FY09	1Q11/1Q10
Black coal, raw										
Underground	Mt	28.29	28.74	26.49	28.82	29.80	103.28	112.34	8.8%	5.3%
Open-cut	Mt	90.48	92.48	77.67	89.42	90.00	337.53	350.04	3.7%	-0.5%
New South Wales	Mt	51.61	47.45	44.94	46.66	50.34	182.18	190.66	4.7%	-2.5%
Queensland	Mt	63.94	70.55	56.00	68.36	66.25	244.52	258.85	5.9%	3.6%
Western Australia	Mt	2.10	2.10	2.10	2.10	2.10	8.75	8.39	-4.1%	0.0%
South Australia	Mt	0.96	0.96	0.96	0.96	0.96	4.73	3.84	-18.8%	0.0%
Tasmania	Mt	0.16	0.16	0.16	0.16	0.16	0.64	0.64	0.0%	0.0%
Australia	**Mt**	118.77	121.22	104.16	118.24	119.81	440.82	462.38	4.9%	0.9%
Black coal, saleable										
Underground	Mt	21.52	21.39	18.50	21.34	22.50	81.65	82.76	1.4%	4.6%
Open-cut	Mt	71.94	71.68	63.94	68.32	70.31	252.12	275.89	9.4%	-2.3%
New South Wales	Mt	39.72	36.98	34.37	36.28	38.67	135.94	147.36	8.4%	-2.6%
Queensland	Mt	50.95	53.30	45.28	50.59	51.36	186.43	200.12	7.3%	0.8%
Western Australia	Mt	1.68	1.68	1.68	1.68	1.68	7.00	6.71	-4.1%	0.0%
South Australia	Mt	0.96	0.96	0.96	0.96	0.96	3.79	3.84	1.3%	0.0%
Tasmania	Mt	0.15	0.15	0.15	0.15	0.15	0.62	0.62	0.0%	0.0%
Australia	**Mt**	93.46	93.07	82.44	89.66	92.82	333.78	358.65	7.5%	-0.7%
Brown coal										
Victoria	Mt	n/a	n/a	n/a	n/a	n/a	68.25	68.70	0.7%	n/a

Source: ABARES

While there are economic advantages (i.e. lower production costs and risk profile) associated with open-cut mines, some coal reserves can only be accessed by operating underground. For this reason, underground mines are expected to remain a feature, if not increase in prevalence as more accessible reserves are exhausted.

New mine developments

According to Wood Mackenzie, investment in Australian coal production is being driven by the expected surge in seaborne coal demand, particularly from China and India; and increased private and public investment in infrastructure, which is removing export bottlenecks. Key underground mine developments are outlined below.

Table 5: Australian underground coal mine development pipeline

Name	Operator	Location	Project type	Coal type	Mine type	Timeframe
Queensland						
Belvedere	Vale	Bowen Basin	Greenfield	Metallurgical	Longwall	5-10 yrs
Eagle Downs	Aquila	Bowen Basin	Greenfield	Thermal	Longwall	<5yrs
Ellensfield	Vale	Bowen Basin	Greenfield	Thermal	Longwall	<5yrs
Grosvenor	Anglo Coal	Bowen Basin	Greenfield	Metallurgical	Longwall	<5yrs
Kestrel	Rio Tinto	Bowen Basin	Brownfield	Metallurgical	Longwall	<2yrs
Minyango	Caledon	Bowen Basin	Greenfield	Metallurgical	Board & Pillar	5-10 yrs
Sarum	Xstrata	Bowen Basin	Greenfield	Metallurgical	Longwall	5-10 yrs
New South Wales						
Caroona Moolarben	BHP Billiton	Gunnedah Basin	Greenfield	Thermal	Longwall	5-10 yrs
UG	Felix Resources	Sydney Basin	Greenfield	Thermal	Longwall	<2yrs
Ulan West	Xstrata	Sydney Basin	Brownfield	Thermal	Longwall	<2yrs
Watermark	Shenhua	Gunnedah Basin	Greenfield	Thermal	Longwall	5-10 yrs

Source: Wood Mackenzie

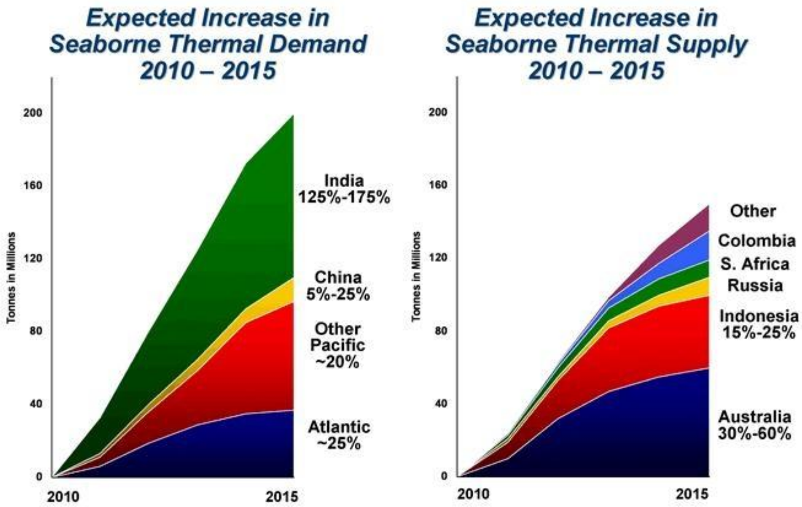
Demand

Usage of thermal and metallurgical coal is broadly linked to economic growth, with the global seaborne thermal coal market having increased at a compound rate of 10% over the past 30 years – seaborne coking coal trade has increased by around 2% per year. These growth rates are expected to continue given the view that:

- Economic activity will accelerate given the combination of a modest recovery in a number of the developed economies and strong growth in emerging economies such as China, India, Korea, Taiwan and SE Asia.
- Asia will continue to industrialise its various regions and thus continue to bring one-third of the world's population out of poverty. This will have a significant impact on energy consumption and steel demands.

Notwithstanding growing demand for renewable energy, coal is expected to remain the world's main energy source over the coming decades. This reflects the long lead times associated with developing clean energy technologies that address changes in world energy requirements.

Charts 6 & 7: Thermal coal forecast supply and demand



Source: Peabody Energy

The largest end-market for coal globally is Asia, which according to the World Coal Institute, accounts for 56% of global coal consumption. While we expect Asia's influence on the global coal market to increase with the ongoing industrialisation in the region and subdued growth in developed nations, we note the following drivers:

- The World Coal Institute is forecasting coal use to increase by in excess of 60% by 2030, with developing countries expected to account for 97% of this new demand, primarily for the purpose of generating electricity.
- There is growing awareness of the need to reduce the environmental impacts associated with industrialisation, with China's five-year plan to 2015 having broadly reiterated its intent to establish a more "modern energy" industry.

Comment

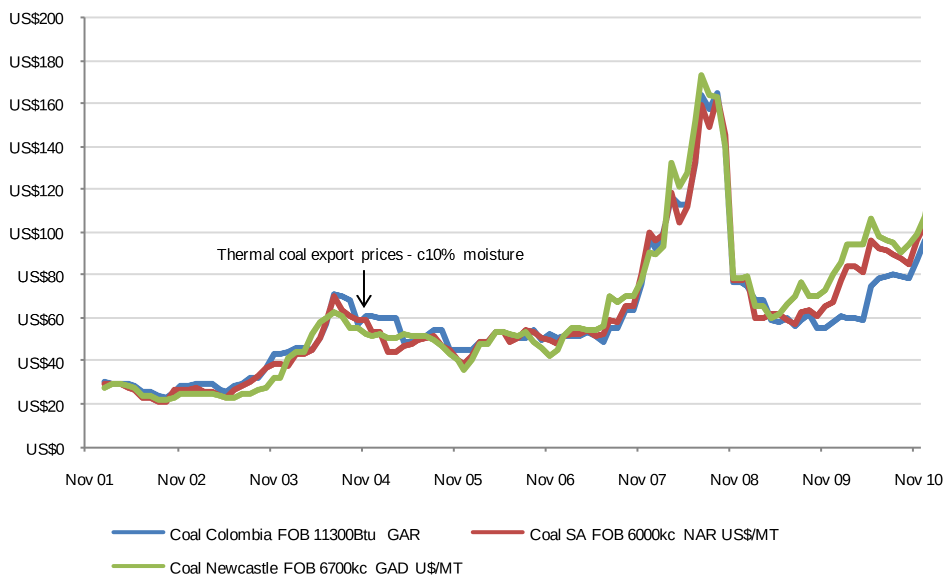
Recent press coverage on China's twelfth five-year plan suggests that the country's Central Committee may target a slightly lower economic growth rate as a means to mitigating the environmental costs of industrialisation. In our view, this is likely to have ramifications for the coal industry due to:

- China's current dependence on thermal coal for a large proportion of its current and projected electricity requirements
- China's current reliance on low-quality Mongolian, Chinese and Indonesian coal for its electricity generation needs
- The likelihood that China, by becoming more reliant on renewable or alternative energy, will seek to import more high-rank coal over the near term.

Coal prices

A key feature of the global coal market is the abundance of lower-rank brown coals and the relative scarcity of higher-rank black coals. While both brown and black coal prices have been rising strongly, their relative price movements suggest that strong demand for black coal imports has been the key driver of price differentials.

Chart 8: Coal price



Source: Datastream

Outsourcing

In our view, there are two key themes that have emerged across outsourcing services markets globally. First, the growing preference among clients to reduce the number of contractors they have direct dealings with. And second, the preference among clients to increase the number of services they outsource.

We expect demand for the outsourcing of underground mining functions/activities to third parties to increase over the medium term. While our view is based primarily on trends observed in other, more mature outsourcing services markets, there are also industry-specific catalysts that support this view. These are discussed below.

- **Expected increase in underground mine production volumes**. As per ABARES' most recent commodity forecasts, ongoing urbanisation of emerging economies such as China and India is expected to result in sustained high levels of demand for seaborne coal.
- **Expansion of existing mines and development of new mines**. Mining companies are responding to the expectation that there will be sustained high levels of demand for seaborne coal by developing new coal mines, both open-cut and underground.
- **Demand for specialist services and specialist equipment**. Within the context of rising labour and equipment shortages, outsourcing a range of underground mining functions to third parties that are equipped to provide such services and have a track record of doing so makes sense.
- **Mine operators' preference for outsourcing**. In our view, the popularity of outsourcing will increase as mine operators become more aware of the benefits that can be derived from doing so. Such benefits include the following:
    - Enabling mine operators to focus on the core aspects of their operation
    - Ability to access skilled specialists that are otherwise in short supply, while also potentially improving operating efficiencies
    - Ability to better manage the cost base in response to variations in production volumes
    - Ability to more efficiently allocate capital, particularly at mines that are more marginal or non-core.

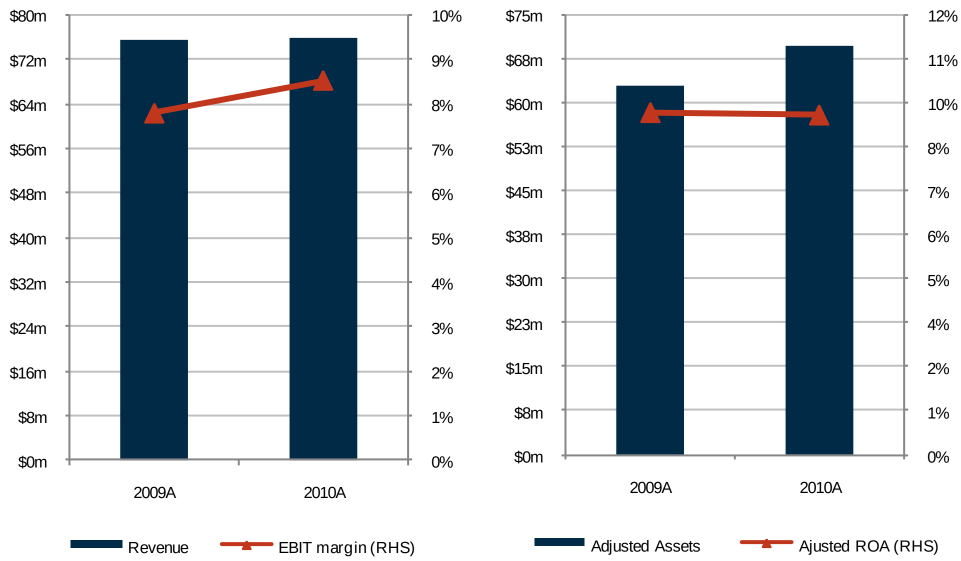
Financials

We expect the company to increase revenue by a CAGR of 8.6% between FY10-FY15. Our forecasts are premised on industry forecasts for coal exports and production volumes, and some contract price rises. What our forecasts do not factor in is any upside from acquisitions.

Historical performance

Analysis of Delta SBD's historical financial performance is limited to two years of data – FY09 and FY10. As outlined in the chart below, the company's performance over these two years has been characterised by a flat revenue performance, modest margin uplift, and slight decline in ROA due to a higher asset base.

Charts 9 & 10: Delta SBD historical financial performance



Source: Company data

Other key points to note about Delta SBD's financial performance include: i) its strong free cashflow generation – 16.8% yield in FY10 based on current share price; ii) a modest decline in net debt, with debt to equity sitting at 40% as at 30 June 2010; and iii) a payout ratio in FY10 of 30%.

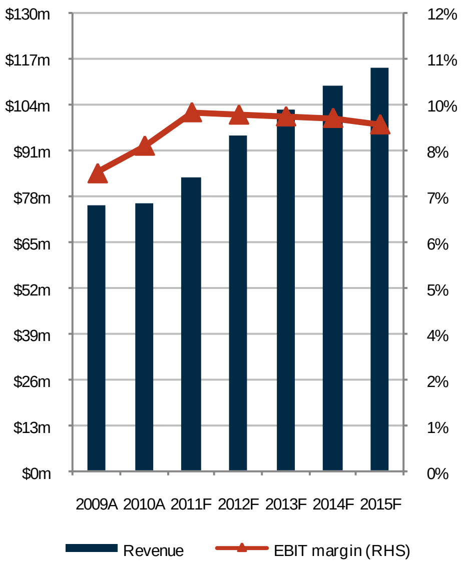
Dividends and dividend policy

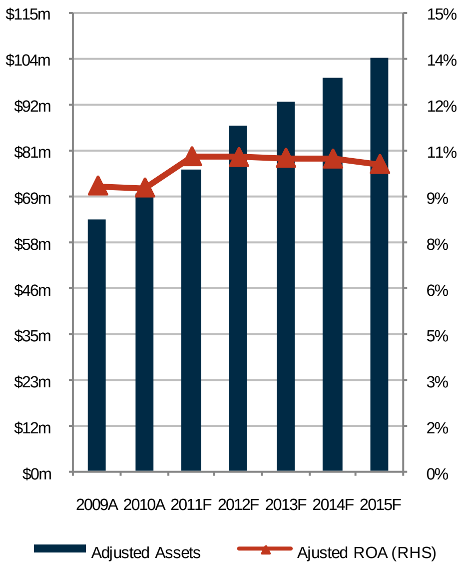
According to Delta SBD's Prospectus, the company distributed 30% of its FY10 net profit as fully franked dividends. In contrast to future years when Delta SBD's directors intend to pay interim and final dividends, the company will only distribute a final dividend in FY11.

Earnings forecasts

We are forecasting a revenue CAGR of 8.6% and an EBIT CAGR of 10.0% over our explicit forecasting period (FY11 – FY15). While we expect EBITDA margins to expand over this period, the benefit is partially lost at the EBIT line due to higher depreciation rates, which we increase from 10% in FY10 to 15.25% by FY13.

Chart 11 & 12: Delta SBD forecast financial performance

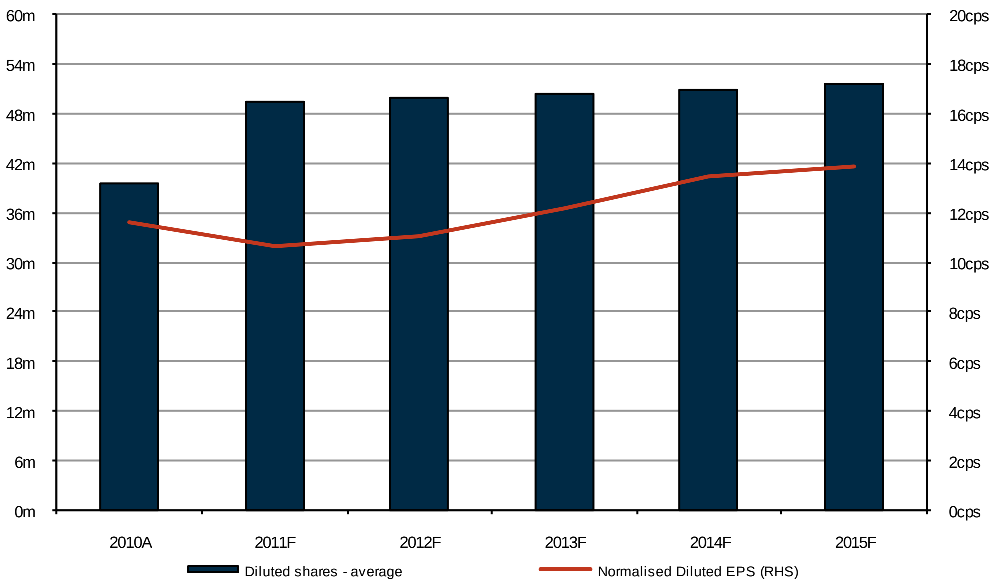




Source: Company data, OM forecasts

With regards to EPS, we are forecasting underlying diluted EPS of 10.7 cents in FY11, versus 11.6 cents in FY10. While we expect FY11 net profit to increase by 12.7% on pcp, our per share forecasts are impacted by the new shares and options issued as part of the IPO. We expect modest dilution to FY15 (options, LTIP, DRP).

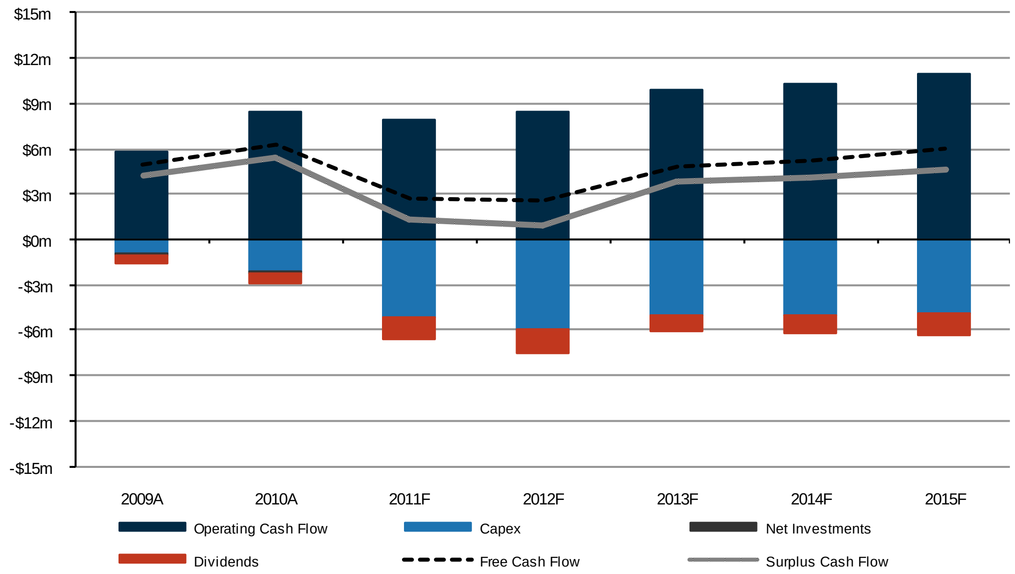
Chart 13: Delta SBD - forecast EPS



Source: Company data, OM forecasts

As the chart below shows, we expect reduced free cashflows in FY11 and FY12 before returning to 10%-plus yields from FY13. The key driver of our lower free cashflow forecasts over the near-term is our higher capex/depreciation rates – cash conversion from EBITDA ranges between 90–100%.

Chart 14: Delta SBD forecast cashflow performance



Source: Company data, OM forecasts

In terms of dividends, we are assuming: i) a dividend payout ratio of 30% of net profits; ii) 100% franking despite a lower tax rate over the near-term; and iii) a interim/final split of 45%:55% from FY12. Based on our earnings forecasts and the current share price, Delta SBD is generating a fully franked yield of 3–4%.

Revenue – key drivers

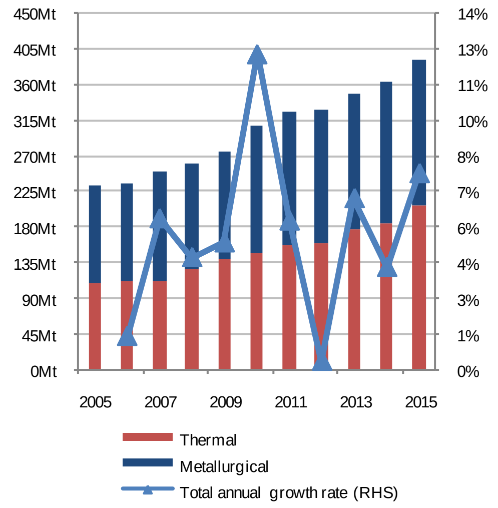
In our view, there are three key drivers of Delta SBD's revenues. These are:

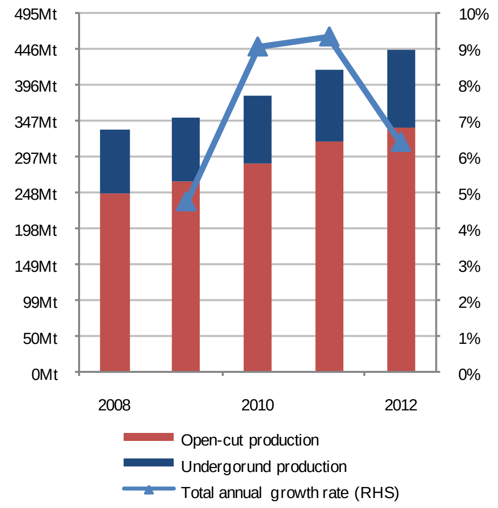
- underground coal production volumes, the key indicators of which are the relevant coal price and mine development pipeline
- contract pricing
- market share gains/losses, which can occur organically or through acquisitions.

Comment

While market share gains/losses are difficult to assess, in our view there is no doubt that industry consolidation will occur over the medium term. With regards to production volumes, ABARES' forecasts for coal export volumes suggest a 2010 – 2015 CAGR of 4.9%, as the chart below shows.

Charts 15 & 16: Australian coal exports by coal type and mine type





Source: ABARES, Wood MacKenzie

We view our forecast revenue CAGR of 8.6% between FY11 and FY15 as appropriate given: i) ABARES' forecasts; ii) the outlook for underground mine production volumes; and iii) the outlook for coal prices and labour rates, both of which suggest mining services providers will be able to negotiate rate increases.

Operating margins – key drivers

In our view, there are three key drivers of operating earnings. These are:

- operating performance, with around 35% of Delta SBD's contracts linked to operating performance
- operating scale, particularly where additional services contracts can be secured from existing clients
- the level of competition/pricing.

Comment

While not directly impacted by recent flooding in Queensland, it is worth noting that Delta SBD's revenues and margins are exposed to factors outside the company's control. These include transport and infrastructure bottlenecks, and mine accidents or disruptions caused by other parties.

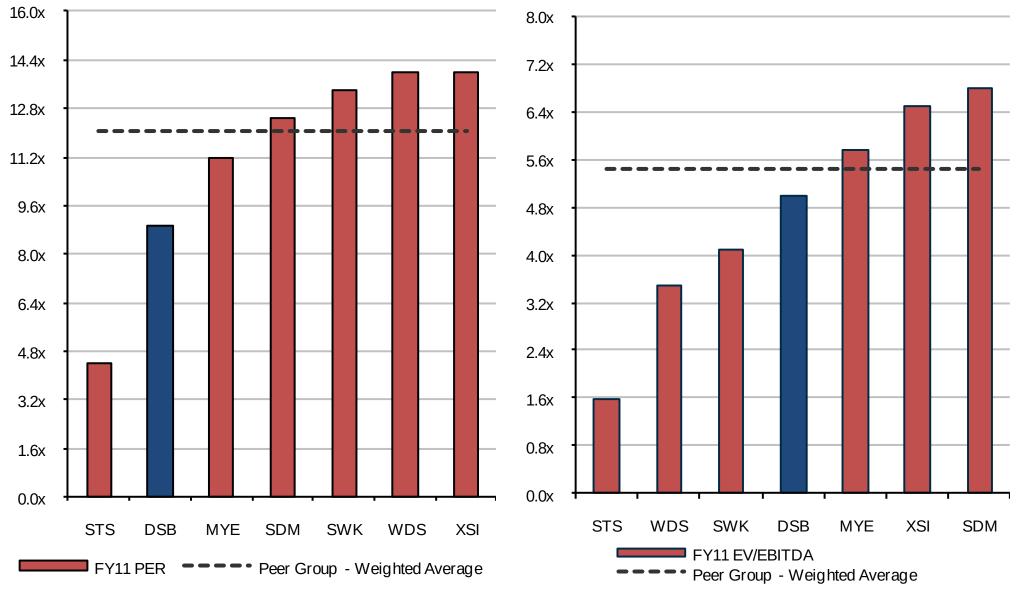
Valuation

We have used a combination of PER and DCF valuations to arrive at our fair value estimate of $1.16 per share. Based on our current FY11 forecasts, this price target implies a PER of 11.1x and a PE rel of 0.72x, both of which we view as realistic given Delta SBD's limited track record as a public entity.

Listed peers

In arriving at our valuation, we have compared Delta SBD to a number of other listed companies that, to varying degrees, operate in similar or related markets. As shown in the charts below, Delta SBD trades at a marked discount to our selected peer group on a PER basis, but closer to parity on an EV/EBITDA basis.

Charts 17 & 18: PER and EV/EBITDA peer comparison



Source: IRESS, OM forecasts

Valuation

Our fair value estimate for Delta SBD is $1.16 per share – this is based on our diluted shares estimate and represents the average of our DCF, PER – Small Industrials, and PER – Peers valuations. Note that our DCF valuation does include a terminal value given that we have no idea when coal production will reach terminal decline.

Table 6: Delta SBD – valuation summary

Valuation methodology	FY11
DCF: WACC 12.3%, l-t growth 2.0%, liquidity discount 20%	$0.94
PER: 20% discount to Small Industrials	$1.29
PER: assigned Mastermyne (MYE) multiple	$1.27
Blended Valuation (Average)	**$1.16**

Source: OM forecasts

Price target

We have set our price target at our blended valuation of $1.16 per share, which based on our forecasts implies an FY11 PER of 11.1x and a PE rel to the Small Industrials of 0.72x. We believe our price target is realistic given Delta SBD's limited track record as a public entity, and the cyclical and competitive nature of the industry.

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.

Comment

It is worth noting that there are a number of related party transactions within Delta SBD. These include: i) interest-bearing loans made by several of the company's directors to Delta SBD; ii) one non-interest bearing loan to Delta SBD's COO, Tony De Santis; and iii) the New Holland Capital Advisor Agreement.

With regards to the latter related party, which is owned by Delta SBD's Chairman, Gordon Galt, the company will be paid: i) a retainer of $10,000 per month until 20 December 2012; ii) a success fee equal to between 1.5% and 2.5% of the value of any M&A until 20 December 2013; and iii) a debt raising fee of 1% if procured.

Financial statements

Delta SBD

Profit & Loss (A$m)	2009A	2010A	2011F	2012F	2013F
Sales revenue	75.6	75.9	83.2	95.4	102.7
COGS	-12.9	-11.3	-12.5	-14.3	-15.4
Gross Profit	62.7	64.7	70.7	81.1	87.3
Non-sales Revenues	0.0	0.0	0.0	0.0	0.0
Operating Costs	-55.5	-56.7	-60.3	-68.7	-73.9
EBITDA	**7.2**	**8.0**	**10.4**	**12.4**	**13.3**
Depreciation & Amortisation	-1.3	-1.5	-2.6	-3.5	-3.8
EBIT	5.9	6.5	7.8	8.9	9.5
Net interest expense	-1.5	-1.4	-1.6	-1.6	-1.4
Pre-tax profit	4.4	5.0	6.2	7.3	8.2
Tax expense	-1.3	-0.4	-1.1	-1.8	-2.0
NPAT (pre NRIs)	**3.2**	**4.6**	**5.2**	**5.5**	**6.1**
Net Abnormals/NRIs	0.0	0.0	-0.1	0.0	0.0
Reported Profit	**3.2**	**4.6**	**5.1**	**5.5**	**6.1**
Effective Tax Rate	28.6%	8.8%	17.0%	25.0%	25.0%
Reported diluted EPS	n/a	11.6	10.5	11.0	12.2
Normalised diluted EPS	n/a	11.6	10.7	11.0	12.2
DPS (cps)	n/a	0.0	3.0	3.5	3.5
Dividend Yield	n/a	0.0%	3.2%	3.7%	3.7%
Payout Ratio	n/a	0.0%	28.1%	31.8%	28.7%
Franking	n/a	100%	100%	100%	100%

Cash Flow (A$m)	2009A	2010A	2011F	2012F	2013F
EBITDA	7.2	8.0	10.4	12.4	13.3
Change in w orking capital	0.0	2.6	-0.4	-1.1	-0.2
Net Interest	-1.5	-1.4	-1.6	-1.6	-1.4
Tax	0.3	1.3	-0.5	-1.2	-1.9
Other Operating Items	-0.2	-2.0	0.0	0.0	0.0
Operating cash flow	**5.8**	**8.4**	**7.9**	**8.5**	**9.9**
Capex	-0.9	-2.1	-5.2	-5.9	-5.1
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
Investing Cash Flow	**-1.1**	**-2.2**	**-5.2**	**-5.9**	**-5.1**
Free cash flow	**4.9**	**6.3**	**2.7**	**2.6**	**4.9**
Dividends	-0.4	-0.7	-1.4	-1.5	-1.1
Equity	0.0	0.0	0.0	0.0	0.0
Debt	-1.5	-0.8	0.0	0.0	0.0
Other Financing Items	-3.8	-0.9	0.0	0.0	0.0
Financing Cash Flows	**-5.8**	**-2.4**	**-1.4**	**-1.5**	**-1.1**
Change in cash	**-1.1**	**3.8**	**1.3**	**1.0**	**3.8**

Balance Sheet (A$m)	2009A	2010A	2011F	2012F	2013F
Cash	2.5	6.3	7.6	8.6	12.4
Receivables	13.7	12.0	13.4	15.6	17.2
Inventory	0.1	0.2	0.2	0.4	0.5
Property, plant and equip	10.8	17.3	19.9	22.3	23.6
Goodw ill	29.2	29.2	29.2	29.2	29.2
Other assets	1.7	2.1	2.0	2.0	2.0
Total Assets	**58.0**	**67.0**	**72.4**	**78.2**	**85.0**
Payables	3.4	4.1	5.0	6.2	7.7
Borrow ings	17.0	21.2	21.2	21.2	21.2
Provisions	3.4	4.3	4.9	5.5	5.8
Other liabilities	0.9	0.0	0.0	0.1	0.5
Total Liabilities	**24.6**	**29.6**	**31.1**	**33.0**	**35.2**
Retained Profits	4.0	7.9	11.8	15.7	20.3
Issued Capital	29.2	29.2	29.2	29.2	29.2
Other Equity	0.2	0.4	0.4	0.4	0.4
Shareholders equity	**33.4**	**37.4**	**41.3**	**45.2**	**49.8**

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

Operating Metrics	2009A	2010A	2011F	2012F	2013F
Grow th					
Revenue grow th	n/a	0.5%	9.5%	14.7%	7.6%
EBITDA grow th	n/a	10.9%	30.9%	19.0%	7.5%
Normalised EPS grow th	n/a	n/a	-7.9%	3.4%	10.7%
Margin					
Gross margin	82.9%	85.1%	85.0%	85.0%	85.0%
EBITDA margin	9.5%	10.5%	12.5%	13.0%	13.0%
EBIT Margin	7.8%	8.5%	9.4%	9.3%	9.3%
Returns					
ROIC (post-tax)	8.4%	8.8%	10.0%	10.8%	11.2%
ROE (post-tax)	9.5%	12.9%	13.1%	12.6%	12.9%
ROA (pre-tax)	10.2%	10.4%	11.2%	11.8%	11.7%

Financing Metrics	2009A	2010A	2011F	2012F	2013F
Closing Net Debt/(Cash)	15.4	14.9	13.6	12.5	8.7
Net Debt / Equity	46.1%	39.9%	32.9%	27.7%	17.6%
Net Debt / Total Assets	26.5%	22.3%	18.7%	16.0%	10.3%
EBITDA Interest Cover (x)	4.9	5.5	6.6	7.7	9.7
EBIT Interest Cover (x)	4.0	4.5	4.9	5.5	6.9

Valuation Ratios	2009A	2010A	2011F	2012F	2013F
Reported PER	n/a	8.2	9.1	8.6	7.8
Normalised PER	n/a	8.2	8.9	8.6	7.8
EV/EBIT	n/a	8.2	7.8	6.8	6.1
EV/EBITDA	n/a	6.6	5.9	4.9	4.4
Free Cash Flow Yield	n/a	16.8%	5.8%	5.4%	10.1%
NTA backing (cps)	n/a	20.3	27.5	36.2	46.2

DCF Assumptions	
WACC	12.4%
Diluted Shares (m)	49.4
Cost of Equity	14.6%
Target Gearing (Debt/EV)	25.0%
Risk Free Rate	5.5%

DCF Valuation	A$m	A$
Explicit Cash Flow s	19.8	0.40
Terminal Cash Flow	43.5	0.88
Enterprise Value	63.3	1.28
Net Debt	13.6	0.27
Dividends Paid	0.0	0.00
Minorities	0.0	0.00
Net Imputation	8.2	0.17
Unrisked Equity Value	**57.9**	**1.17**
Premium/(Discount) to Share Price		23.4%

Price Target	
12-month Price Target (A$)	1.16
Premium/(Discount) to Share Price	22.1%
Implied PER (x)	11.1
Implied PE rel XSI (x)	0.72

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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.