BELL POTTER

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E&C December Newsletter

Inflation brings opportunities & threats

Bell Potter E&C Coverage

Stock	Rec.	Target
GNG	Buy	$1.35
MND	Hold	$14.25
SSM	Hold	$1.85
LYL	Buy	$6.00

Bell Potter Index

Engineering & Construction

BP Engineering & Construction Index

Company	Market Cap ($m)*
BSA (BSA)	143.0
CIMIC (CIM)	8000.3
Civmec (CVL)	238.0
Decmil (DCG)	73.4
Downer (DOW)	3773.0
GR Engineering (GNG)	**181.5**
Lycopodium (LYL)	**232.1**
MACA (MLD)	475.0
Monadelphous (MND)	**1359.6**
NRW (NWH)	1267.4
Primero (PGX)	97.9
Saunders (SND)	60.2
SRG Global (SRG)	218.4
Service Steam (SSM)	**739.6**
Sthn Cross Electrical (SXE)	147.6
Tempo (TPP)	26.1
Verbrec (VBC)	48.0
Worley (WOR)	6338.0
WestStar (WSI)	19.5

*As at 25 January 2020

BP E&C Index ($100 at 1 Jan 2020)*

Total Market Cap	**$22.4bn**
Index Price	**$76.64**
1-month price change	**-3.5%**
Change since inception	**-23.4%**

*As at 31 December 2020

SOURCE: IRESS, BELL POTTER ESTIMATES

December sees big end to the year—over $1bn in awards

December saw another big month of contract awards in the BP E&C Index, with over $1bn of awards estimated to have been reached for the 3rd time in the last 5 months. This continues a trend of higher contract activity, which has rebounded sharply from the COVID lockdown induced low of $56m in April 2020.

Currency debasement, stimulus to fuel a current of activity

With a recently heightened investor focus on a possible return of inflation as a result of currency debasement and stimulus measures, the impact on the E&C sector is likely to be a strong current of project activity. Currency debasement and stimulus measures are both likely to buoy commodity prices, which have generally seen strong increases in recent months. Infrastructure investment, which was already slated to be substantial in Australia, is now likely to receive even greater emphasis in an attempt to stimulate economies.

Gives all comers a chance to flourish, M&A to continue

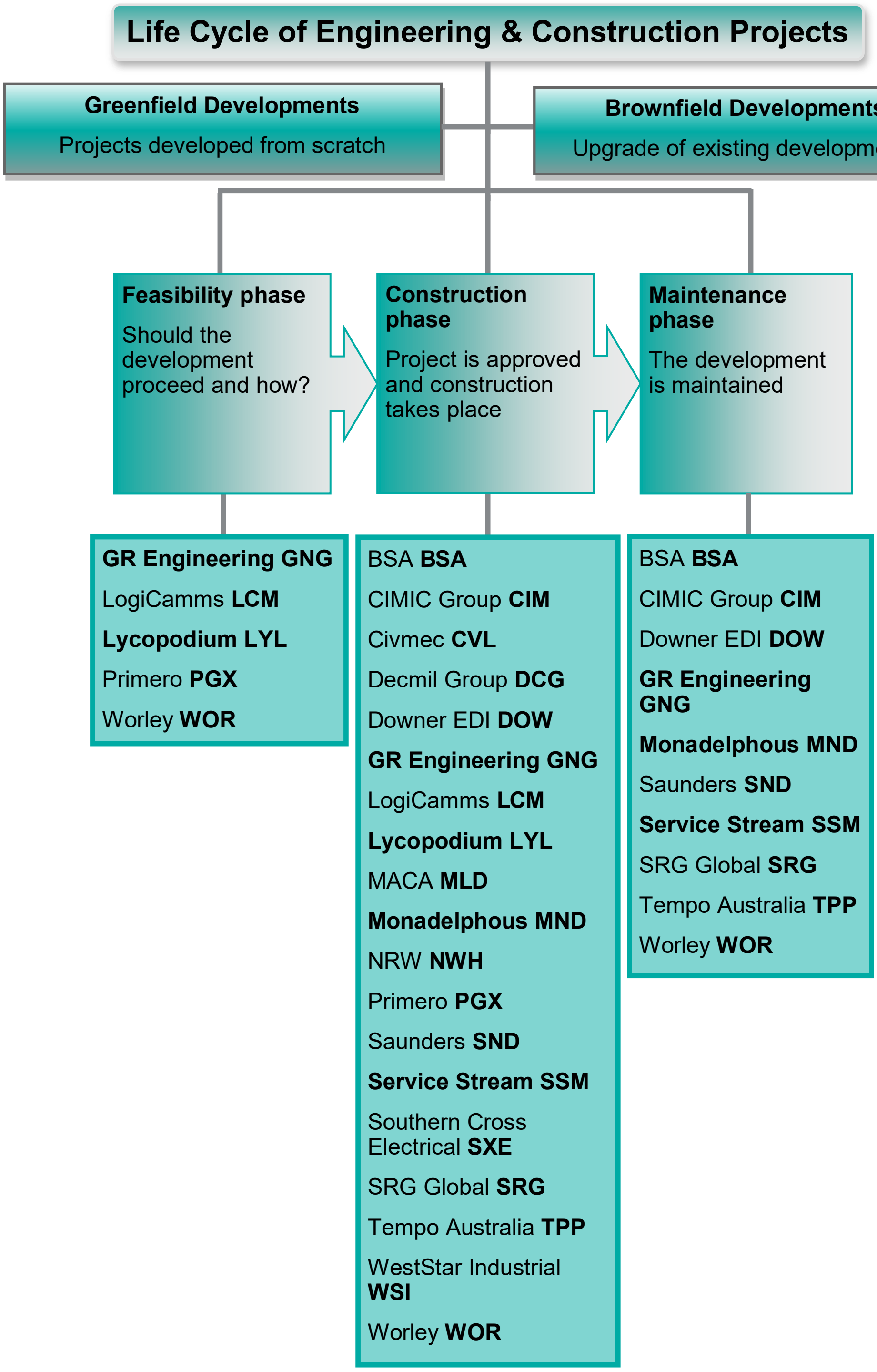
The heightened level of activity that is likely to result from higher commodity prices and high levels of infrastructure activity, likely means that E&C contractors will experience an opportunity to significantly grow their order books in current and upcoming halves. This will give all contractors, including those who have recently struggled, including the likes of DCG, the chance to re-establish a strong base level of revenue. SRG is another such example, with the company recently increasing its FY21 profit guidance. The positive industry demand tailwinds, and relatively easy access to capital, are likely to ensure that M&A activity remains a recurring theme in 2021. December saw continued M&A activity with DOW divesting its Open Cut Mining West business to MLD, whilst CIM completed its 50% sale of Thiess.

Beware of the flipside, particularly given strong competition

Unfortunately currency debasement and stimulus activity also has consequences, with project costs likely to also be driven higher. Whether it be wages, construction inputs such as steel, or capital equipment, cost pressures are likely to increase. This is likely to place pressure on contractors with long-term agreements, and those undertaking fixed price construction projects. These pressures remain a risk to our Buy thesis for contractors such as GR Engineering, who despite having a strong revenue outlook, may see some margin pressures.

These risks are particularly elevated given that the tendering environment appears to remain competitive. This has resulted in margins contracting across the sector in recent halves. A microcosm of a further sign of potential market competitiveness is MND's 1H21 contract awards, which were estimated to be the weakest since 2H18, despite plenty of activity in its core markets. On the flipside, contractors such as SRG, CVL and PGX have seen significant contract awards over the past ~6-12 months. With MND seen as having a strong risk management framework and tendering discipline, it may be losing out to competitors who continue to more aggressively tender, as they seek to significantly grow their revenue.

Engineering & Construction Food Chain



<u>BELL POTTER COVERAGE</u>

GR Engineering **GNG**
Monadelphous **MND**
Lycopodium **LYL**
Service Stream **SSM**

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December contract awards

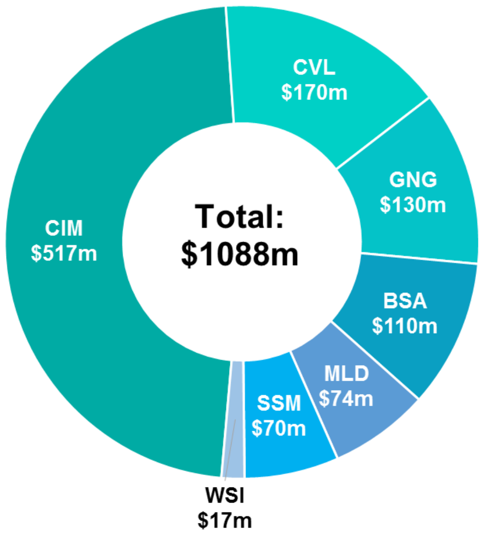
~$1.1bn of contracts awarded in December

E&C contract awards in our BP E&C Index ended the year with a bang, with ~$1.1bn of new contracts awarded during the month of December.

CIM secured the most E&C awards at $517m. CVL, GNG and BSA were all able to secure at least $100m in additional work during December.

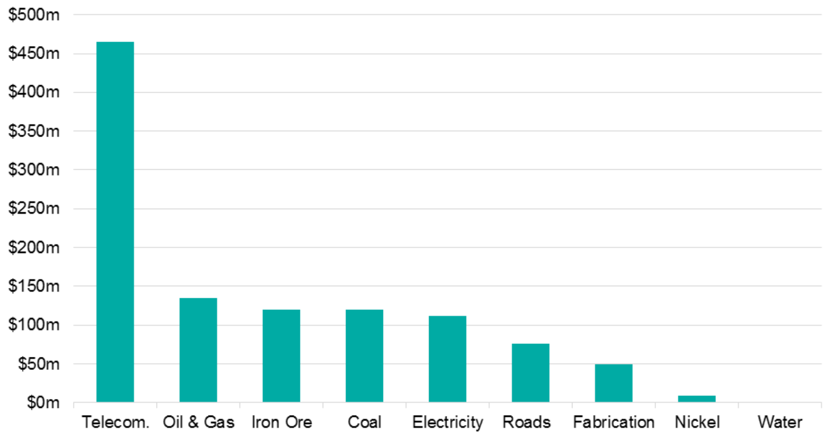
With NBN Co and Telstra awarding work during the month, the Telecommunications sector saw the largest share of awards, at $465m. Over $100m of awards were also estimated to have been awarded in the Oil & Gas, Iron Ore, Coal and Electricity sectors. December's Electricity awards may be a sign of further things to come as a result of the changing nature of Australia's electricity grid, which requires investment in order to cope with additional renewable power.

Figure 1: December awards by company



SOURCE: COMPANY DATA, BELL POTTER ESTIMATES

Figure 2: December contract awards by sector

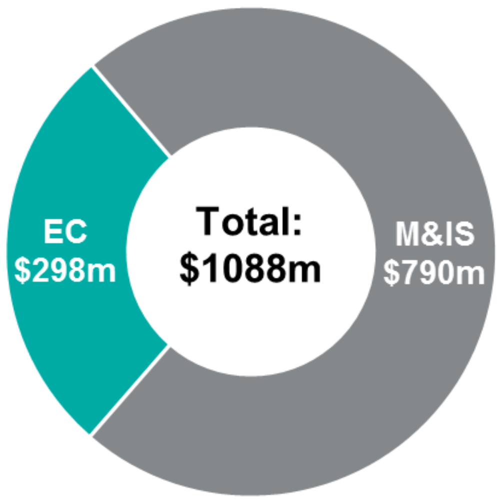


SOURCE: COMPANY DATA, BELL POTTER ESTIAMTES

M&IS contracts dominate December's monthly awards

December's monthly contract awards were dominated by Maintenance & Industrial Services (M&IS) type awards. This was driven by Telecommunications and Oil & Gas contracts.

Figure 3: December EC vs M&IS contract split



SOURCE: COMPANY DATA, BELL POTTER ESTIMATES

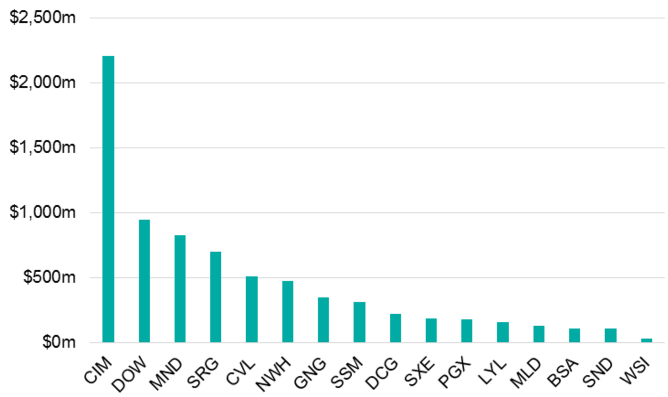
CY20 contract award totals

$7.4bn of contracts awarded in CY20

Estimated CY20 E&C contract awards totaled $7.4bn, with CIM, DOW, MND and SRG all securing over $700m of additional work in CY20.

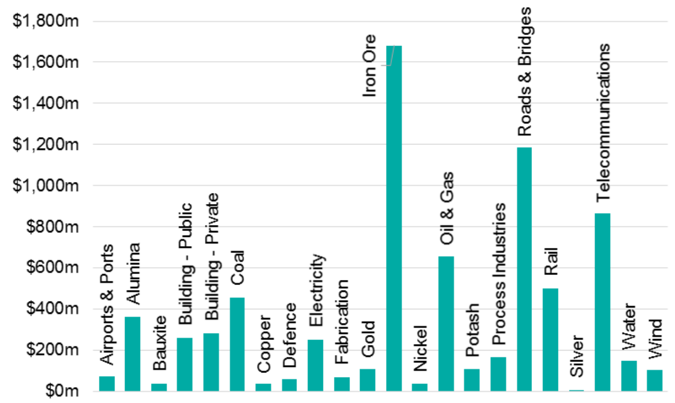
Iron Ore and Roads & Bridges both saw estimated awards of over $1bn, highlighting the activity across both the minerals and infrastructure sectors.

Figure 4: CY20 contract awards by company



SOURCE: COMPANY DATA, BELL POTTER ESTIMATES

Figure 5: CY20 contract awards by sector

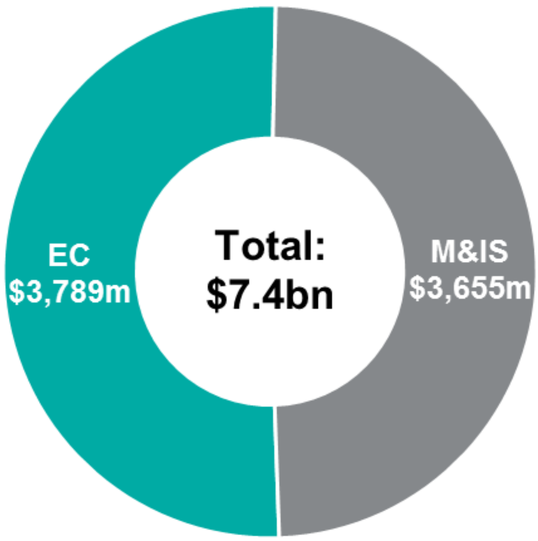


SOURCE: COMPANY DATA, BELL POTTER ESTIMATES

EC and M&IS contract awards evenly split in CY20

Across CY20, there was a relatively even split between Engineering Construction (EC) and M&IS awards. This followed the large value of M&IS contracted awarded in December.

Figure 6: CY20 EC vs M&IS contract award split



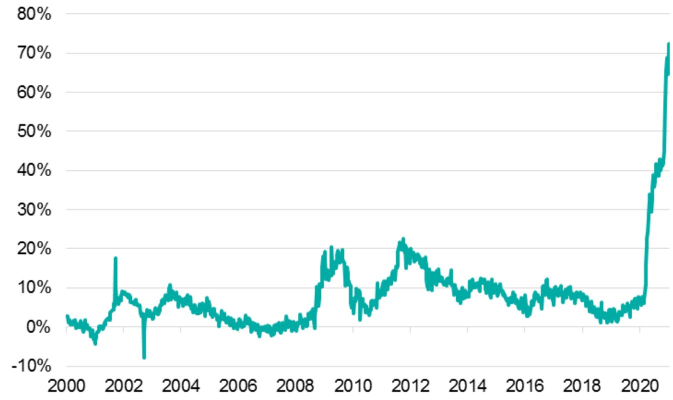
SOURCE: COMPANY DATA, BELL POTTER ESTIMATES

Expect momentum to continue in 2021

Currency debasement to support commodity prices

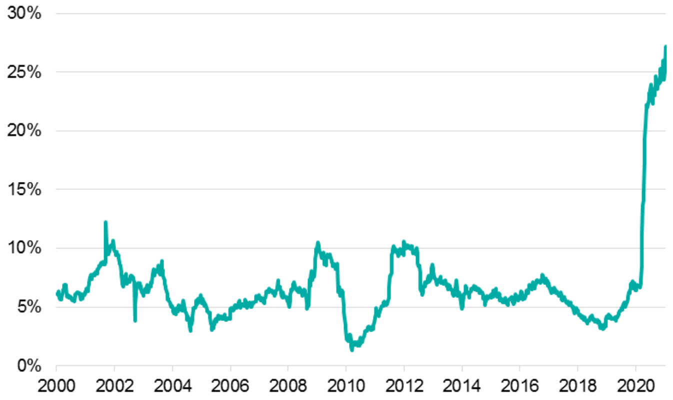
With contract awards increasing significantly in the back half of 2021 versus COVID induced lows, continued currency debasement is likely to provide continued support for commodity prices. Given the extreme USD monetary supply growth in 2021, and calls from the new Biden administration for further extraordinary stimulus, we may only be at the very beginning of a USD weakening and rise in bond yields.

Figure 7: YOY USA M1 Money Supply growth



SOURCE: BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, BELL POTTER

Figure 8: YOY USA M2 Money Supply growth



SOURCE: BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, BELL POTTER

Given that the US already had a significant structural budget deficit, further aggressive spending plans will only place further pressure on the US FED to continue with its quantitative easing programs, in order to finance the large deficits and keep bond yields artificially low, so as to prevent cumbersome interest burdens. In turn, this will likely further erode confidence in the USD and weaken its value.

There is thus clear fundamental economic reasoning behind the recent rise in commodity prices, and weakening USD. The trend towards hard assets, and impact on the value of fiat currencies, is likely to only further grow as economic theories such as the Modern Monetary Theory (MMT) appear to gain increased credence.

Stimulus to drive infrastructure, commodity demand

In addition to commodity prices, and thus mining investment, being supported by currency debasement, specific areas that stimulus is being targeted towards is creating demand for commodities, and increasing the number of infrastructure projects on offer.

With countries worldwide looking towards infrastructure investment as a means to stimulate economies, the prices of commodities which underpin such investment are seeing increased prices. General stimulus measures designed to prop up economies and increase demand, will also likely flow on to increased factory and manufacturing output, further bolstering commodity prices.

In regards to infrastructure investment in Australia, with a pipeline that was already significant, investment has received a further impetus, with governments looking to use it as a lever to promote economic growth.

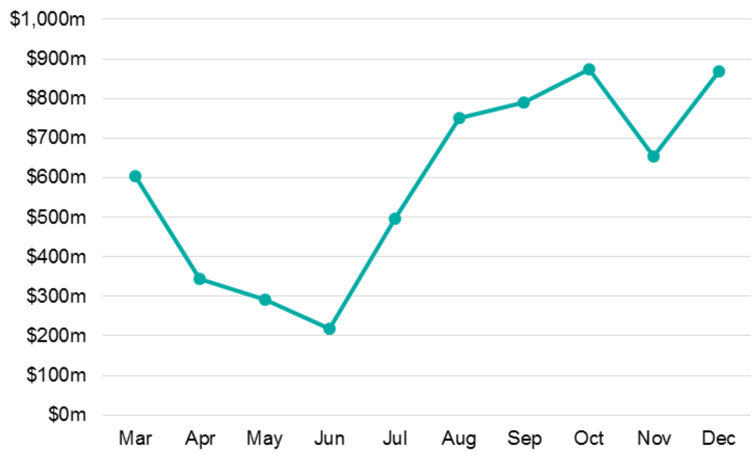
E&C providers in Australia are thus likely to benefit from dueling tailwinds of increased commodity prices boosting mining investment, and increased project opportunities in infrastructure.

All players likely have a chance for growth

Demand tailwinds create sector wide growth opportunities

The major demand tailwinds for the E&C sector are set to provide significant opportunities for E&C providers to significantly grow their order books and revenue in the coming halves. The beginnings of this process were seen in 2H CY20, with 3 of the last 5 months of CY20 seeing contract awards of $1bn or more.

Figure 9: Rolling 3-month average BP E&C index contract awards



SOURCE: COMPANY DATA, BELL POTTER ESTIMATES

SRG gets the ball rolling, others to see similar benefits

SRG announced improved guidance in December, increasing its FY21 EBITDA guidance range from $38m-$42m to $42-$45m, with the guidance weighted towards 2H21.

SRG notes $550m in contract wins since 1 July 2020 and record WIH of $1bn, while also promoting further near-term contract wins are expected amongst what it considers to be a massive $6bn opportunity pipeline.

With SRG struggling to deliver consistent profitability in recent times, the tailwinds that are now present in its operating markets are providing it with ample opportunities to materially grow its revenue and improve its underlying performance.

These tailwinds should be providing support to other companies in the industry, with recent laggards and inconsistent performers such as DCG and CIM now facing an opportune time to grow their order books without tendering as aggressively for a more limited pool of opportunities.

GNG & LYL tipped to see strong demand tailwinds

Two company's under our coverage who we anticipate to significantly benefit from these demand tailwinds, specifically in relation to rising commodity prices, are GNG and LYL.

We forecast GNG to deliver a record revenue performance in FY21, and for revenues to remain elevated over the medium-term, with the company set to benefit from its focus on providing minerals processing engineering & construction services for junior to mid-tier miners. We estimate its near-term opportunity pipeline is worth ~$690m, of which GNG is the preferred contractor on ~$520m of projects.

LYL is highly leveraged to mining project activity in gold, and particularly projects in Africa. We expect gold to be a particular beneficiary of continued monetary debasement, and LYL's pipeline of secured work to improve as COVID restrictions ease in the African region.

M&A activity continues

DOW progresses its divestment strategy, MLD buys up

After noting in our November newsletter the likelihood of increased M&A activity in the sector on the back of relatively easy access to capital and strong demand tailwinds in the operating environment, some additional transactions were made during December.

DOW divested its Open Cut Mining West business, with MLD acquiring the business for $175m. MLD is to fund the acquisition via a $130m debt facility and a $75m capital raising. MLD's strategic rationale for the acquisition includes additional scale for its existing mining business and contract diversification. MLD also considers the acquisition financially compelling at 2.5x EV/EBITDA (FY20 adjusted).

The sale of DOW's Open Cut Mining West business comes after an agreement was made to sell its Blasting Services business for an enterprise value of $62m in November, whilst DOW also reached agreement to sell 70% of its laundries business in early December.

VBC acquires Energy Infrastructure Management

VBC (formerly LogiCamms (LCM)), acquired Energy Infrastructure Management (EIM), a Queensland based infrastructure services company for $10.1m. The acquisition is intended to progress its "refocused growth strategy", adding scale and capability to its existing pipelines business, as well as adding longer-term maintenance revenues.

CIM completes 50% sale of Thiess

CIM completed the sale of 50% of Thiess in December, with CIM receiving approximately $2.2bn in cash proceeds. The sale will allow CIM to significantly reduce its debt position, as well as reduce its outstanding factoring and lease liability positions. The sale should materially improve CIM's balance sheet metrics, with greater focus now able to be turned towards the strong pipeline of opportunities in its construction business. With construction now a greater proportional contributor to CIM, the importance of this division generating solid and consistent margins and cash flow has grown.

Beware cost pressures likely to emerge

Inflation pressures would also impact costs

While we have noted the increase in commodity prices which is in part being stemmed by currency debasement, it is important to realise that these same factors will eventually lead to a rise in costs for contractors. The high level of construction activity taking place in Australia is already creating wage price pressure. The higher prices of commodities will place pressure on other construction input costs like steelwork, while the prices of capital equipment will also likely rise on account of higher demand, and increased manufacturing costs.

Commodity producers stand to benefit handsomely at first, given the prices for their products are generally actively traded and amongst the first to see prices adjust due to stimulus measures and currency debasement. As noted earlier, this is likely to stimulate project demand. It is not until the increased money supply flows throughout the economy that other costs are likely to rise.

The lag in some cost increases is particularly important for contractors who have long-term contracts, or large construction projects expected to take some time to complete. It is of vital importance for fixed price work, where it will be extremely difficult to obtain any adjustment for cost pressures. This may result in some contractors seeing their margins materially impacted.

Competition appears to still be strong: not the best sign

This is of particular interest given that tendering competition still appears to be significant. This could become dangerous amongst a backdrop of rising input costs, with projects aggressively tendered for at present, potentially becoming marginal or onerous should significant cost inflation pressures eventuate over the next 6-12 months.

In addition to continued lackluster margins across the E&C space in recent halves, we note a further hallmark of this competition through seeing historically smaller players like SRG, CVL and PGX win significant amounts of work over the past 6-12 months, in contrast to the historically very disciplined MND, who is estimated to have recorded the lowest level of contract awards in 1H21, since 2H18. This comes despite MND’s core markets seeing a high level of activity, and suggests that some may be persisting with tenders at lower margins in order to significantly swell order books while opportunities are present.

Share price performance

E&C sector ends the year slightly down

While delivering another solid performance in December, the BP E&C Index ended 2020 2.4% below where it began in simple average terms. A strong end to the year saw this decline tempered greatly, with simple average gains of 14.4% and 5.4% recorded in November and December respectively. The strong finish comes as confidence of a rebound in cyclical activity rises, with commodity prices and economic activity benefitting from huge amounts of stimulus and currency debasement.

Figure 10: Share price changes to 31 December 2020

	1-month price change	12-month price change
BSA (BSA)	23.7%	-7.6%
CIMIC (CIM)	-4.7%	-22.8%
Civmec (CVL)	-2.3%	-3.4%
Decmil (DCG)	-8.1%	-65.1%
Downer (DOW)	2.5%	-35.2%
GR Engineering (GNG)	**8.9%**	**40.0%**
LogiCamms (LCM)	45.9%	0.0%
Lycopodium (LYL)	**-1.7%**	**-14.9%**
MACA (MLD)	25.0%	-6.2%
Monadelphous (MND)	**5.3%**	**-23.3%**
NRW (NWH)	10.2%	-18.0%
Primero (PGX)	2.8%	55.7%
Sanuders (SND)	-2.5%	85.9%
SRG Global (SRG)	18.6%	-12.5%
Service Stream (SSM)	**-20.1%**	**-15.0%**
Southern Cross Electrical (SXE)	7.5%	-9.4%
Tempo (TPP)	10.9%	12.2%
Worley (WOR)	-10.9%	-15.7%
WestStar (WSI)	-8.3%	9.1%
Simple average	**5.4%**	**-2.4%**

SOURCE: IRESS, COMPANY DATA, BELL POTTER ESTIMATES

BSA & SSM highlight varying impact of NBN Co

SSM and BSA saw two large share price deviations during the month following news from NBN Co of a shift in its operations and maintenance contracting framework, with its long-standing Operations and Maintenance Master Agreement (OMMA) replaced by a long-term Unified Field Operations (Services) (Unify Services) agreement. SSM saw its ~$330m FY20 OMMA contract replaced with a ~$70m Unify Services agreement, whilst BSA secured the key regions of NSW and VIC, with its contract expected to generate ~$85m in revenue in its first year.

BSA's market share gain, and SSM's loss, are reflected in the 23.7% and -20.1% respective share price performances during the month of December.

Recommendation structure

Buy: Expect >15% total return on a 12 month view. For stocks regarded as 'Speculative' a return of >30% is expected.

Hold: Expect total return between -5% and 15% on a 12 month view

Sell: Expect <-5% total return on a 12 month view

Speculative Investments are either start-up enterprises with nil or only prospective operations or recently commenced operations with only forecast cash flows, or companies that have commenced operations or have been in operation for some time but have only forecast cash flows and/or a stressed balance sheet.

Such investments may carry an exceptionally high level of capital risk and volatility of returns.

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Steven Anastasiou, authoring analyst, holds a long position in MND.

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