

Matrix C & E Ltd (MCE)

The rise and rise of Matrix

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Heath Andrews
handrews@austock.com
+613 8601 2644

Three Key Points

- Post several high priced acquisitions in the oil & gas sector at high multiples, MCE's share price has increased 30% in less than a month. We expect the rerating of MCE to slow.
- MCE has potential for earnings to surprise to the upside due to increased production capacity about to be commissioned. The order book would need to increase to give certainty of this occurring in our opinion.
- Our forecasts previously had margin decline and sales decline in FY'15. We have removed the sales decline (margin decline retained) and this is the key reason for the large increase in our DCF valuation to \$7.45/share.

Share price appreciation has been remarkable

MCE's share price has appreciated 30% in less than a month with no announcements. As we highlighted in our last note, where else could you buy an Oil & Gas leveraged stock in the Australian market at <10x's FY'12 EPS. This is no longer the case.

The four recent takeovers in the sector have been on average FY'11 multiples of:

- 19.5x's EPS
- 9.9x's EV/EBITDA

MCE is trading at 9.4x's FY'11F EV/EBITDA. In our opinion, this caps the upside from here.

The X-factor for MCE is growth. Production capacity growth is greater than forecast growth. In order for MCE to grow at production capacity growth, it would need to secure more orders. This is possible, but not prudent to factor in.

In our opinion, the current share price implies modest growth and for the FX to mostly offset reduced costs of production. It looks about right in our opinion.

At the AGM, the 1Q'11 update indicates that MCE profitability has risk to the upside, but not materially so in our opinion.

MCE is still to demonstrate that it has broken into the Production Buoyancy market. We don't expect this to occur until after Henderson is running and could be a catalyst that see MCE further re-rated.

Investment View

Our DCF valuation and price target of \$7.45/share is 8.5% above the current share price. With the market re-rating oil & gas service companies, we believe that MCE has the potential for further share price increases, but not likely at the level of increase we have seen recently.

We are moving to a Hold (from Buy), mainly due to the 30% share price appreciation in the last month alone and the 8.5% return that our target price offers is below our 20% hurdle rate required for a Buy.

Recommendation

Hold

Previous Recommendation	Buy
Risk Rating	High
Current Share Price	\$6.81
12 Month Price Target	\$7.45 (from \$5.80)
Price Target Methodology	DCF
Total Return (Capital + Yield)	11.6%
DCF Valuation	\$7.45 (from \$5.80)
Market capitalization	\$490m
Liquidity – Daily Value	\$1.1m

EPS Changes & Austock vs. Consensus

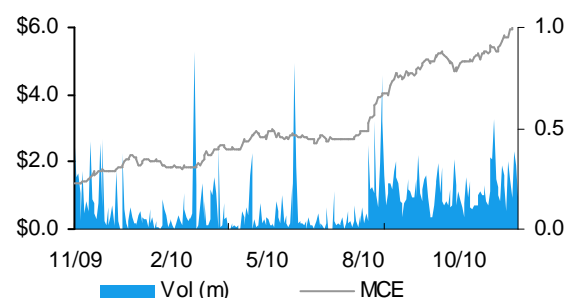
Y/e Jun (\$m)	2011F	2012F	2013F
Previous EPS (cps)	45.6	62.5	70.3
Change in EPS (%)	0%	0%	0%
Consensus EPS (cps)	43.5	58.5	64.8
Austock vs. Consensus (%)	5%	7%	8%

Financial Forecasts & Valuation Metrics

Y/e Jun (\$m)	2010A	2011F	2012F	2013F
Revenue	103	205	247	282
NPAT	18.4	32.6	45.6	51.3
EPS (cps)	29.4	45.6	62.5	70.3
EPS Growth	365%	55%	37%	12%
DPS (c)	0.0	15.0	20.6	23.2
EV / EBITDA (x)	17.3	9.4	6.8	6.3
PER (x)	23.2	14.9	10.9	9.7
Dividend Yield	0.0%	2.2%	3.0%	3.4%
Gearing - D/E	-9%	-2%	-10%	-8%
Interest Cover (x)	98	125	nm	Nm

Source: Austock Securities estimates

MCE Share Price / Volume



Source: Austock Securities estimates

Sector hot for takeovers

In our opinion, the spate of takeovers in the oil & gas sector in recent times is why MCE has been re-rated. The businesses taken over are different to MCE, though Wellstream is a potential customer and competitor in the production buoyancy market. Below is information on the 4 main transactions that have occurred in the past month (several also have mining services components).

Wellstream, a potential customer of MCE and the closest peer in terms of takeover action

i) Wellstream is under takeover offer by GE for US\$1.2bn.

Wellstream has two manufacturing facilities, UK and Brazil and two key areas of operation:

- Risers & flowlines – Wellstream manufactures unbonded dynamic flexible risers, static flowlines and quasi-static jumpers, these are key integrating technologies connecting subsea structures with surface production units.
- Well services - Wellstream produces a suite of high pressure/high temperature products ideally suited to well servicing applications.

PSN, several parties were believed to be interested

ii) John Wood has acquired PSN for US\$950m.

PSN's primary business is to provide long-term brown-field support for customers who operate existing oil and gas facilities – whether that be platforms, pipelines or terminals.

They provide engineering, commissioning, project management, maintenance and construction services. PSN's customer base includes major independent integrated oil companies, national oil companies, utilities companies and refineries. PSN has a global network of offices

Easternwell, fully priced for a company with cyclical elements

iii) Easternwell has been acquired by Transfield Services for \$575m.

Easternwell is primarily a drilling company, with 65 rigs. Approximately two thirds of the business is drilling new CSM wells and well maintenance drilling services to the CSM industry in Qld.

The remaining third of the business is involved in dewatering of iron ore mines in WA and RC drilling.

MSL, a stable earnings base, but capital hungry

iv) The MAC Services is under offer for \$651m by Oil States International.

The MAC Services designs, constructs, installs and operates accommodation villages for the mining industry, predominantly for the coal industry in the Bowen Basin of central Qld (potential exists to be involved in the growing CSM/LNG industry) – it has over 3,500 units under management.

It adds other profitable services to the villages such as maintenance, catering, pub operation and linen services. Customers include leading global mining companies.

Takeovers have been acquired on high multiples

The key takeaway from the acquisitions in recent times is that they are on full multiples.

MCE is potentially a target, but it would need to be friendly

MCE has blocking stakes that make a takeover difficult, unless it is on very generous terms. We believe that MCE is an attractive target, but with low likelihood of a takeover occurring.

Take over multiples vs. Matrix

Company	FY'10 EV/EBITDA	FY'11 EV/EBITDA	FY'12 EV/EBITDA	FY'10 PE (x's)	FY'11 PE (x's)	FY'12 PE (x's)	Year End
Wellstream	19.0	12.4	9.8	41.0	23.8	16.6	Dec
PSN	9.6	na	na	na	na	Na	Dec
Easternwell *	11.5	7.6	5.4	24.5	14.7	9.9	Jun
MAC Services	11.4	9.7	7.8	23.6	20.0	16.3	Jun
Average	12.9	9.9	7.7	29.7	19.5	14.3	
Matrix	17.3	9.4	6.7	22.9	14.7	10.8	Jun

Source: Austock Securities estimates. Easternwell PE multiples are Austock estimates

High Growth Potential

The likely growth potential that exists within MCE could see the current re-rating continue, but relies on MCE delivering ahead of expectations. The new Henderson factory is set to open around Mar'11 and is unlikely to be fully ramped up until FY'12.

Potential exists for higher growth than forecasts

Key points on potential growth:

- The Malaga factory has a maximum capacity of 40 units a day. The new Henderson factory is described by the company as having a capacity of 62 units/day;
- We believe that the Henderson factory will have a design capacity greater than 62 units per day. The 62 units/day probably takes into account down time and repairs. We estimate the potential capacity is closer to 70 units/day, with the design of the plant allowing for bolt on growth;
- Once Malaga is closed, some of the equipment can be installed at Henderson, further increasing Henderson production capacity.
- It is possible to envisage up to 100% production capacity over current production levels in FY'13; and
- The reduced costs of producing modules (lower labour and logistic costs), should see the bottom line grow faster than the top line.

It is easy to get excited by the potential of MCE. The risk to growth is demand, not production capacity. We are bullish the oil & gas sector and expect that MCE will grow at a rate higher than most industrial companies.

We are forecasting 20% revenue growth in FY'12, significantly below the growth in production capacity that we believe will come on stream in FY'12. While MCE has to win work and potentially break into the production buoyancy market, risk appears to the upside in terms of our forecasts.

Margin decline still factored into our forecasts

In relation to margins, we forecast that EBITDA margins peak in FY'12 (due to cost out from the new factory) at 28.7%. We have this declining to 26.2% by FY'15. Risk exists that margins could fall further, but this will hinge on the supply/demand equation which is difficult to forecast.

Key Risks

The high FX rate will impact MCE, though current hedging provides FY'11 earnings protection

MCE sell its products in US\$. The increased exchange rate is a negative. MCE has sufficient hedging in place to protect MCE in FY'11 and a natural hedge applies from raw materials purchased in US\$ of ~50% of revenue.

We incorporate FX changes in our model (negative in FY'11, but positive in FY'12 due to expectations of falling A\$ in that year to 0.91 FX rate (from 0.96).

Epoxy resin pricing can be volatile

Epoxy resin is the key raw material. In the past, factory shutdowns by suppliers have caused supply shortfalls and price spikes have resulted. This is a left of field event that has occurred on an adhoc basis in the past that could impact MCE.

Sales of new products may not meet expectations

Production buoyancy products rely on selling to a new customer base (i.e. EPCM contractors). Track record is important in developing relationships and securing orders. MCE may find it difficult to break into this market.

High reliance on riser buoyancy sales

Riser buoyancy is leveraged to new rig build which has been strong in recent years. Orders for new rigs are coming through for FY'13 now, but risk exists that orders could be lower than prior years.

Henderson delays

Post a recent visit to the new Henderson facility, we believe that MCE will not be producing from this site until Feb'11, behind the current official start date.

Forecast Changes

Long term sales decline removed from forecasts

Previously we had sales declining in FY'15 by 14%. We now assume sales remain flat in FY'15. We are forecasting 70 units/day in FY'15 (currently around 40). Near term profit assumptions remain unchanged.

Lower risk weighting post visiting the Henderson factory

We have lowered our Beta in our DCF valuation from 1.3x's to 1.2x's. This results in a WACC of 11.5%. Post visiting the new Henderson factory and MCE's track record to date, a lower risk weighting is justified we feel.

In essence, we have removed much of the conservatism built into our model and replaced it with more realistic assumptions. As a result of the above changes, our DCF has increased to \$7.45/share (from \$5.80).

Investment Thesis

MCE could re-rate further, but not a lot in our opinion

At 15.1x's FY'11F EPS and 11.0x's FY'12F EPS, MCE potentially has more re-rating upside when likely growth is factored in. However, more certainty on FY'12 via an increase in the order book should be a precursor for a further re-rating from here, in our opinion.

30% share price appreciation in 1 month

MCE's share price has risen 30% in the past month due the spate of high priced takeovers globally in the sector we believe.

In Australia, not many oil & gas service companies exist. WOR is the main way to gain exposure, and it has appreciated by 20% in the past 6 weeks. MCE is a stand out oil & gas pure play, that post the construction of the new factory, should generate strong cashflow and require low capex.

It would appear that MCE has become a market darling for retail investors. We believe that institutional investors that got in early would be at the least starting to trim their position in MCE. This offers downside risk if the Retail buying appetite dries up.

\$7.45/share target offers 8.5% upside from current price

Our DCF valuation and price target of \$7.45/share is 8.5% above the current share price. With the market re-rating oil & gas service companies, we believe that MCE has the potential for further share price increases, but we would prefer to see an expansion in the order book to give more certainty on MCE's ability to deliver growth. As a result, we are moving to a Hold (from Buy), mainly due to the 30% share price appreciation in the last month alone.

COMPANY SUMMARY

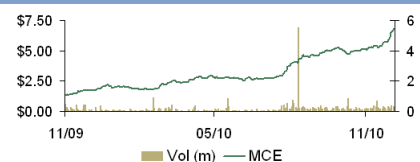
Matrix C & E Ltd

MCE.AX

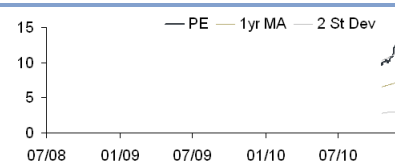
Price Information

Price (\$/share)	6.81
Mkt Cap (\$m)	490
Enterprise Value (\$)	489

Share Price & Volume Chart



12 Month Fwd PER Chart



Business Background

MCE has two divisions,. 1. The Composites division supplies buoyancy products to the offshore oil & gas industry. The main market is riser buoyancy, though MCE has a range of products to supply to the production buoyancy market. 2. The Engineering division represents ~5% of revenue. It supplies equipment to the Resources industry and supports Composites above.

Key Drivers

Drivers of the Composites division are: A new facility in Henderson will double existing production capability and reduce costs; The Malaga plant has seen large production increases over prior years Oil & gas demand is expected to be robust, particularly in Brazil.....

Key Risks

Deep sea oil & gas is high on the cost curve, should the price of oil fall, we expect demand for deep sea products will fall. Raw material pricing can be cyclical and MCE has little purchasing power. Production expansion is occurring at peers and the current backlog of orders may reduce, applying margin pressure.

VALUATION SUMMARY

DCF Valuation

Risk Free Rate (%)	6.0%
Equity Risk Premium (%)	6.0%
Equity Beta (x)	1.2
Tax Rate (%)	29%
WACC (%)	11.5%
PV of Cash Flows	543
less Net Debt	0
PV of Equity	543
SOI (m)	73
PV of Equity per Share	\$ 7.45

FINANCIAL SUMMARY

Year End - Jun

	FY08A	FY09A	FY10A	FY11F	FY12F	FY13F
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KEY METRICS

EPS Growth (%)	-99	122	365	55	37	12
PER (x)	239.2	107.8	23.2	14.9	10.9	9.7
PEG (x)	-2.4	0.9	0.1	0.3	0.3	0.8
P/Free CFPS (x)	530	57	16	12	12	9
Dividend Yield (%)	0.0	0.0	0.0	2.2	3.0	3.4
EV/EBITDA (x)	219.9	89.5	17.3	9.4	6.8	6.3
EV/EBIT (x)	363.8	130.6	19.4	10.6	7.5	6.9
ROE (%)	8.2	17.1	45.6	46.0	47.0	39.6
ROA (%)	8.3	8.3	27.2	31.2	34.1	34.3
ROIC (%)	4.2	12.4	33.3	40.1	47.8	53.4

PROFIT & LOSS (AUD \$m)

Revenue	23	54	103	205	247	282
EBITDA	2	6	28	52	71	76
Depreciation & Amortisation	1	2	3	6	7	7
EBIT	1	4	25	46	64	70
Net Interest Expense	0	0	0	0	0	3
Income Tax Expense	0	0	-6	-13	-19	-21
NPAT Reported	1	3	18	33	46	51
Sign. Items & Other	0	0	0	0	0	0
NPAT Adjusted	1	3	18	33	46	51

PER SHARE DATA (cps)

Shares on Issue (m)	25	49	62	71	73	73
EPS Reported	3	6	29	46	63	70
EPS Adjusted	3	6	29	46	63	70
DPS	0	0	0	15	21	23
Free CFPS	1	12	42	57	58	74

BALANCE SHEET (AUD \$m)

Cash	1	1	14	14	14	14
Debtors & Inventory	7	27	51	75	91	99
PP&E	11	19	57	88	96	93
Intangibles	8	8	9	9	9	9
Other Assets	2	8	4	4	4	4
Total Assets	30	64	134	189	213	219
Borrowings	4	6	8	12	2	2
Creditors	8	13	23	51	61	70
Other Liabilities	2	25	44	44	37	0
Total Liabilities	14	44	74	108	101	72
Net Assets	16	21	60	82	112	147

BALANCE SHEETS RATIOS

Gearing - Debt/Equity (%)	14	20	-9	-2	-10	-8
Interest Cover (x)	7	12	98	125	nm-	Nm
					279	
Leverage (x)	1.0	0.7	-0.2	0.0	-0.2	-0.1
NTA per Share (cps)	29.7	25.1	82.1	102.3	142.2	189.2

CASH FLOW (AUD \$m)

EBITDA	2	6	28	52	71	76
Interest & Tax	0	-1	-1	-14	-18	-18
Working Capital Change	2	6	1	5	-6	0
Operating Cash Flow	4	9	26	44	46	58
Maintenance Capex	-4	-3	0	-3	-4	-5
Free Cash Flow	0	6	26	41	42	54
Expansion Capex	0	-7	-41	-34	-10	0
Dividends	-1	0	-2	-11	-15	-17
Equity Issues / (Buy Backs)	2	0	27	0	0	0
Proceeds from Borrowings	0	2	3	0	0	0
Other	0	0	0	0	0	0
Net Cash Flow	1	0	12	-4	17	37

DIVISIONAL EBITDA ANALYSIS

Advanced Materials	36.5	91.8	193.5	235.0	270.4	288.8
Heavy Engineering	21.4	10.3	10.5	10.7	10.9	11.1
Operating Revenue	57.9	102.1	204.0	245.7	281.3	299.9
Advanced Materials	2.2	4.5	25.7	51.4	70.0	75.7
Heavy Engineering	0.0	1.0	2.3	0.6	0.6	0.7
Total EBITDA	2.2	5.5	28.0	52.1	70.6	76.4

Directory

Equities Research Team

Melbourne

Craig Stranger	613 8601 2010	Head, Emerging Companies
Paul Jenz	613 8601 2068	Agribusiness & Energy
Heath Andrews	613 8601 2644	Engineers & Contractors
John Burgess	613 8601 2018	Consumer Services
Andrew Chambers	613 8601 2605	Infrastructure
Andrew Cleeland	613 8601 2065	Quantitative
Maribel Quiza	613 8601 2085	Emerging Companies
Andrew Shearer	613 8601 2624	Resources

Sydney

Lawrence Grech	612 9233 9635	Resources
Stefan Hansen	612 9233 9612	Energy
Anna Kassianos	612 9233 9603	Resources
Rohan Sundram	612 9233 9638	Gaming / Small Property
David Barilla	612 9233 9652	Resources

Private Clients

Melbourne

Merrick Abraham	613 8601 2077	Client Adviser
John Axsentieff	613 8601 2042	Senior Client Adviser
Ryan Batros	613 8601 2614	Client Adviser
Damien Brown	613 8601 2636	Client Adviser
Thomas Ha	613 8601 2658	Client Adviser
Kate Hanrahan	613 8601 2058	Client Adviser
Melanie Hawgood	613 8601 2055	Client Adviser
Michael Heffernan	613 8601 2053	Senior Client Adviser
Xiaoming Huang	613 8601 2088	Client Adviser
Daniel McFarlane	613 8601 2639	Client Adviser
Luke Pavone	613 8601 2071	Client Adviser
Stephen Sun	613 8601 2001	Client Adviser
Patrick Trindade	613 8601 2669	Client Adviser

Sydney

Owen Beattie	612 9233 9621	Client Adviser
David Dwyer	612 9233 9643	Client Adviser - Options
Josh Graham	612 9233 9645	Client Adviser - Options
Jason Norval	612 9233 9625	Client Adviser
Mark Schwarz	612 9233 9642	Client Adviser - Options
Peter Semaan	612 9233 9649	Client Adviser
Edward Tao	612 9233 9609	Client Adviser

Institutional Sales

Melbourne

Tony Smith	613 8601 2041	Co-Head of Institutional Sales
Stuart Low	613 8601 2022	Research Sales
Chris Walker	613 8601 2038	Research Sales
Matthew White	613 8601 2641	Sales Trading
Robert Wood	613 8601 2031	Head of Sales Trading

Sydney

Bruce Rolin	612 9233 9651	Co-Head of Institutional Sales
Leo Borovilas	612 9233 9606	Sales Trading
Mark Pashley	612 9233 9641	Sales Trading
Doc Cromme	612 9233 9608	Research/Sales Trading
Gavin Todd	612 9233 9639	Research Sales
James Wilson	612 9233 9607	Research Sales
Chris Chia	612 9233 9605	Asia Research Sales

Corporate Finance

Melbourne

Dale Moroney	613 8601 2035	Managing Director
Harry Kingsley	613 8601 2089	Director
Stephen Nossal	613 8601 2017	Director
Jonathan Tooth	613 8601 2006	Director
Terence Wong	613 8601 2651	Associate
John So	613 8601 2033	Associate
Yehuda Gottlieb	613 8601 2618	Analyst

Sydney

James Green	612 9233 9613	Head of Sydney
Andrew Champion	612 9233 9647	Director
Paul Levitt	612 9233 9626	Analyst
Grant Wong	612 9233 9656	Analyst

Equity Capital Markets

Robert Thomson	613 8601 2078	Head of ECM
Enzo Salvatore	613 8601 2081	ECM
Brooke Picken	613 8601 2025	ECM

OFFICE LOCATIONS AND DISCLOSURE**Melbourne**

Level 1, 350 Collins Street
 Melbourne VIC 3000
 Phone: 613 8601 2000
 Fax: 613 9600 1138

Sydney

Level 9, 56 Pitt Street
 Sydney NSW 2000
 Phone: 612 9233 9600
 Fax: 612 9251 9368

Recommendation Criteria**Investment View**

Austock Securities Investment View is based on an absolute 1-year total return equal to capital appreciation plus yield.

Buy	Hold	Sell
>20%	20% – 5%	<5%

A Speculative recommendation is when a company has limited experience from which to derive a fundamental investment view.

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