Matrix Composites and Engineering Ltd
(MCE $2.60) Initiation of Coverage, Buy

EUROZ
SECURITIES LIMITED
AUSTRALIAN RESEARCH

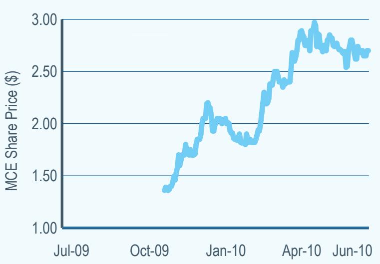
28 July 2010

Sector: Manufacturing (offshore oil & gas)
MCE.ASX

Key Metrics

12M price target	$3.80
+/- up/downside	46%
Methodology	PER & DCF
Market Cap	$189.7m
Shares on issue	70m
Free float (est.)	50%
12M avg daily volume	$0.5m
12M high/low	$2.97 - $1.30

Share Price Performance



MCE is a Western Australian based manufacturer and supplier of specialised products, with a focus on buoyancy modules manufactured for deep sea drilling rigs. The company is in a growth phase with $210m in current orders and we are forecasting revenues to double in 2011 and growth to continue steadily thereafter. Overall we like the sector MCE is engaged in, we see strong growth as possible over the medium term and initiate with a Buy recommendation and a 12 month price target of $3.80.

Investment Highlights

- We are forecasting revenues to double in 2011 and growth to continue steadily after that.
- The 2011 forecast growth is fully supported by a current $210m order book.
- The key driver is deep sea exploration drilling in which there is currently strong demand.
- Manufacturing capacity is being expanded to meet the demand, with a new facility in Henderson, WA at the Australian Marine Complex. The facility will significantly increase current production capacity and is due for completion in October 2010.
- There are high barriers to entry, with few competitors and MCE has strong pricing power providing a product critical to its customers.
- Growth in 2011 is above average for the sector.
- Risks include a future sustained low oil price, poor ramp up of the new Henderson facility, possible impact from the Gulf oil spill, and the possibility that the current significant increase in demand for riser buoyancy (the primary MCE product) proves unsustainable.
- MCE trades on a PER of 11.7 x 2010 earnings and 6.9 x 2011, compared to possible peer companies (those exposed to oil & gas or mineral exploration and construction themes) generally trading around 13 x 2010 and 9 x 2011, very reasonable in comparison.
- **We commence coverage with a Buy recommendation and 12 month price target of $3.80.**

Key Financial Metrics	2008A	2009A	2010F	2011F	2012F
NPAT Normalised (A$m)	0.8	2.4	16.3	27.7	31.3
Fully Diluted Normalized EPS (A$)	0.01	0.04	0.22	0.38	0.43
PER (x)	205.6	72.5	11.7	6.9	6.1
EPS growth (%)	na	na	521%	70%	13%
EV/EBITDA (x)	81.8	34.3	6.8	4.5	3.4
Cashflow per share (A$)	0.03	0.07	0.29	0.49	0.58
P/CFPS (x)	96.0	38.3	8.9	5.3	4.5
Dividend (A$)	0.00	0.00	0.05	0.08	0.10
Dividend Yield (%)	0.0%	0.0%	1.9%	3.1%	3.8%
NBV per share (A$)	0.24	0.32	0.87	1.18	1.53
P/NBV (x)	10.6	8.1	3.0	2.2	1.7
Net Debt/Equity	14%	20%	net cash	21%	net cash

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Matrix Composites and Engineering Ltd

EUROZ SECURITIES LIMITED
AUSTRALIAN RESEARCH

Sector: Manufacturing (offshore oil & gas) **Price ($A):** 2.60 **Market Cap ($A):** 189.7m
Recommendation: Buy **Target Price ($A):** 3.80 **Enterprise Value ($A):** 181.2m

MATRIX COMPOSITES AND ENGINEERING (MCE) YEAR END 30 JUNE

Income Statement	**08A**	**09A**	**10F**	**11F**	**12F**
Sales	22.0	54.3	104.4	190.9	234.0
Other	1.0	0.4	0.3	0.0	0.0
Revenue	**22.9**	**54.7**	**104.7**	**190.9**	**234.0**
Operating costs	-20.6	-49.1	-78.0	-144.7	-180.2
EBITDA	**2.3**	**5.7**	**26.7**	**46.2**	**53.8**
Depreciation	-0.9	-1.7	-3.5	-6.8	-9.2
Other non cash	0.0	0.0	0.0	0.0	0.0
EBIT	**1.5**	**3.9**	**23.2**	**39.4**	**44.7**
Net Interest income/(expense)	-0.3	-0.5	0.0	-0.2	-0.2
Associates	0.0	0.0	0.0	0.0	0.0
Other income/(expense)	0.0	0.0	0.0	0.0	0.0
Abnormal items (pretax)	0.0	0.0	-1.5	0.0	0.0
EBT	**1.2**	**3.4**	**21.7**	**39.2**	**44.4**
Tax expense	-0.5	-0.4	-6.1	-11.9	-13.4
Discontinued operations	0.0	0.0	0.0	0.0	0.0
Minority interest	0.0	0.0	0.0	0.0	0.0
Reported Earnings	**0.7**	**3.1**	**15.6**	**27.4**	**31.0**
Dividends	0.0	0.0	-3.5	-5.6	-7.0
Adjustments (one off)	0.0	0.0	0.0	0.0	0.0
Retained earnings	0.7	3.1	12.1	21.8	24.0
Normalized Net Profit	**0.8**	**2.4**	**16.3**	**27.7**	**31.3**

Cash Flow (A$m)	**08A**	**09A**	**10F**	**11F**	**12F**
Pretax Profit	**1.2**	**3.4**	**21.7**	**39.5**	**44.7**
+ Depreciation	0.9	1.7	3.5	6.8	9.2
- Tax Paid	-0.4	-1.0	-6.1	-11.9	-13.4
+ inc (- dec) in provisions	0.0	0.2	0.1	0.0	0.0
- Profit/+ loss on disposal	0.0	0.0	0.0	0.0	0.0
+/- Other	0.0	0.0	0.0	0.0	0.0
Gross Cashflow	**1.7**	**4.3**	**19.3**	**34.4**	**40.4**
- Capital expenditure	-3.9	-10.3	-28.0	-45.0	-8.0
+/- Changes in working capital	-1.7	1.3	-3.2	-10.0	-3.1
Operating Free Cashflow	**-3.8**	**-4.7**	**-11.9**	**-20.6**	**29.3**
+/- Investments	0.0	-0.8	0.0	0.0	0.0
- Dividends	-1.0	0.0	-3.5	-5.6	-7.0
+ Proceeds from equity raised	2.2	0.0	26.9	0.0	0.0
+ Acquisition	0.0	0.0	0.0	0.0	0.0
+/- Minority interests	0.0	0.0	0.0	0.0	0.0
+/- Other	0.4	3.5	0.0	0.0	0.0
Net cashflow	-2.2	-1.9	11.5	-26.2	22.3
Cash at beginning of period	0.0	-2.2	-4.1	7.4	-18.8
Cash at end of period	-2.2	-4.1	7.4	-18.8	3.5

Balance Sheet ($m)	**08A**	**09A**	**10F**	**11F**	**12F**
Cash	1.4	1.5	13.0	2.8	9.1
Receivables	16.5	9.4	18.8	34.4	42.1
Inventories	-9.5	-3.6	-4.0	-4.0	-4.0
Other	2.0	6.1	6.1	6.1	6.1
Current Assets	**10.3**	**13.4**	**33.9**	**39.3**	**53.4**
Receivables	0.0	0.0	0.0	0.0	0.0
Investments	0.0	0.0	0.0	0.0	0.0
Property/Plant/Equipment	11.1	19.2	43.8	82.0	80.8
Intangibles	7.6	7.6	7.6	7.6	7.6
Other	0.0	1.8	0.1	0.1	0.1
Deferred tax assets	0.6	0.7	0.7	0.7	0.7
Non Current Assets	**19.3**	**29.4**	**52.1**	**90.4**	**89.2**
Total Assets	**29.6**	**42.8**	**86.1**	**129.7**	**142.6**
Payables	-8.1	-13.1	-17.2	-22.7	-27.4
Interest bearing liabilities	-0.9	-1.6	-1.6	-1.6	-1.6
Current tax liabilties	-0.2	-0.1	-0.1	-0.1	-0.1
Provisions	-0.6	-0.8	-1.0	-1.0	-1.0
Current Liabilities	**-9.7**	**-15.6**	**-19.8**	**-25.4**	**-30.0**
Payables	0.0	0.0	0.0	0.0	0.0
Deferred Tax	-1.4	-2.5	-2.5	-2.5	-2.5
Interest bearing liabilities	-2.7	-4.0	-4.0	-20.0	-4.0
Provisions	-0.2	-0.1	-0.1	-0.1	-0.1
Non Current Liabilities	**-4.3**	**-6.6**	**-6.6**	**-22.6**	**-6.6**
Total Liabilities	**-14.0**	**-22.2**	**-26.4**	**-48.0**	**-36.6**
Net Assets	**15.6**	**20.6**	**59.7**	**81.7**	**106.0**
Contributed equity	13.1	13.1	40.1	40.1	40.1
Reserves	1.9	4.8	4.8	4.8	4.8
Retained profits	0.6	2.7	14.8	36.9	61.2
Minority Interests	-	-	-	-	-
Total equity	**15.5**	**20.5**	**59.6**	**81.6**	**105.9**

PERFORMANCE RATIOS	**08A**	**09A**	**10F**	**11F**	**12F**
Growth and Margins					
Revenue Growth	n/a	147%	92%	83%	23%
EBITDA Growth	n/a	141%	373%	73%	17%
EBIT Growth	n/a	168%	494%	70%	13%
Normalized Net Profit Growth	n/a	n/a	576.8%	70.1%	13.1%
EBITDA margin	10.2%	10.3%	25.5%	24.2%	23.0%
EBIT margin	6.4%	7.2%	22.2%	20.7%	19.1%
Normalized net profit margin	3.7%	4.4%	15.5%	14.5%	13.4%
Effective tax rate	38%	11%	28%	30%	30%
Liquidity					
Capex/depreciation (x)	4.3	5.9	8.0	6.6	0.9
Current ratio (x)	1.1	0.9	1.7	1.5	1.8
Quick ratio (x)	2.2	0.8	1.8	1.6	1.9
Receivable days	n/a	87	49	51	60
Payable days	n/a	79	71	50	51
Risk Measures					
Payout ratio (%)	0%	0%	22%	20%	23%
Net interest cover (x)	5.8	8.1	1426.6	230.4	195.1
Net debt/equity (%)	14%	20%	net cash	21%	net cash
Returns					
Return on avg capital employed (%)	na	18%	53%	48%	55%
WACC (%)			12%		
Return on assets (%)	na	11%	36%	37%	33%
Return on average equity (%)	na	17%	39%	39%	33%
Company cost of equity (%)			14%		

SHARE DATA/VALUATION	**08A**	**09A**	**10F**	**11F**	**12F**
Share Data					
Issued shares (m)	64.0	64.0	70.0	70.0	70.0
Weighted ave shares (m)	64.0	64.0	70.0	70.0	70.0
Fully diluted shares (m)	67.0	67.0	73.0	73.0	73.0
Basic EPS (A$)	0.01	0.05	0.22	0.39	0.44
YoY change (%)	na	na	367%	75%	13%
Fully diluted EPS (A$)	0.01	0.04	0.22	0.38	0.43
YoY change (%)	na	na	521%	70%	13%
Fully diluted normalised EPS (A$)	0.01	0.04	0.22	0.38	0.43
YoY change (%)	na	na	521%	70%	13%
Dividend/share (A$)	0.00	0.00	0.05	0.08	0.10
Franking (%)	100%	100%	100%	100%	100%
Gross cashflow/share (A$)	0.03	0.07	0.28	0.49	0.58
NBV/share (A$)	0.24	0.32	0.85	1.17	1.52
NTA/Share (A$)	0.13	0.20	0.74	1.06	1.52
Valuation					
PER (Basic) (x)	222.3	54.3	11.6	6.6	5.9
PER (Fully diluted) (x)	205.6	72.5	11.7	6.9	6.1
PER (Fully diluted, normalized) (x)	205.6	72.5	11.7	6.9	6.1
P/CFPS (x)	96.0	38.3	9.4	5.3	4.5
Price/NBV (x)	10.6	8.1	3.0	2.2	1.7
Price/NTA (x)	20.7	12.8	3.5	2.5	1.7
Dividend Yield (%)	0.0%	0.0%	1.9%	3.1%	3.8%
Fully dil. normalized 3 yr EPS Cagr (%)	na	na	127%	na	na
PEG ratio (x)	na	na	0.1	na	na
EV	191.9	193.8	182.3	208.5	184.1
EV/EBITDA (x)	81.8	34.3	6.8	4.5	3.4
EV/EBIT (x)	131.4	49.5	7.8	4.6	4.1
EV/Revenue (x)	8.4	3.5	1.7	1.1	0.8
NPV/SOP (A$)			4.03		

OTHER INFORMATION	
Estimated free float	70%
12-mth High/Low (A$/sh)	2.97/1.30
Average daily volume (A$m)	0.5
ASX Code	MCE
Next result	Aug 10 (FY10 results)

COMPANY DESCRIPTION

Matrix is a manufacturer of deep sea oil exploration riser buoyancy and insulation systems and other associated buoyancy products. Matrix also operates a heavy engineering facility.

Investment case

Relative peers

MCE trades at a discount to peers (described as small capitalisation companies exposed to exploration and construction themes in the oil, gas and mineral resources sectors).

MCE trades on a normalised 2010 PER of 11.7x and 2011 PER of 6.9x.

On a EV/EBIT basis, MCE trades at 7.8x 2010 and 4.6x 2011.

These metrics are fair based on 2010 and offer good value on 2011 numbers compared to small capitalization companies who are also exposed to exploration and construction themes in the oil and gas and mineral resources sectors.

TICKER	NAME	Price (A$/sh)	M Cap (A$m)	P/E 10	P/E 11	EV/ EBIT '10	EV/ EBIT '11	'11 EPS growth	Div Yld '10	Div Yld '11
LEI	Leighton Holdings	31.03	9330	15.2x	13.7x	10.3x	9.5x	11%	4%	5%
WOR	Worley Parsons	21.37	5119	17.0x	13.9x	12.6x	10.8x	22%	4%	4%
UGL	United Group	14.18	2353	16.0x	14.2x	11.5x	10.0x	13%	5%	5%
DOW	Downer EDI	4.15	1397	7.3x	6.8x	6.0x	5.5x	8%	7%	7%
TSE	Transfield Services	3.37	1396	12.3x	11.0x	12.0x	10.7x	12%	4%	4%
BLY	Boart Longyear	2.98	1374	15.9x	10.3x	11.1x	7.2x	54%	0%	2%
MIN	Mineral Resources	8.28	1338	23.3x	13.5x	16.9x	8.7x	72%	2%	4%
MND	Monadelphous*	13.83	1260	15.5x	14.3x	10.1x	9.1x	9%	6%	6%
BKN	Bradken	7.81	1084	14.5x	11.6x	11.1x	8.8x	25%	4%	5%
CLO	Clough*	0.80	575	11.8x	10.3x	9.2x	8.8x	15%	4%	5%
MRM	Mermaid Marine*	2.67	521	15.6x	12.8x	12.4x	10.2x	21%	3%	3%
FWD	Fleetwood Corp*	9.51	505	15.2x	12.9x	9.8x	8.4x	17%	7%	7%
MAH	Macmahon Holdings*	0.59	429	11.7x	10.0x	6.7x	6.2x	17%	5%	5%
	Larger capitalisation			**14.7x**	**11.9x**	**10.7x**	**8.8x**	**23%**	**4%**	**5%**
ASL	Ausdrill*	1.64	343	6.8x	6.5x	5.0x	4.3x	4%	7%	7%
CDD	Cardino	3.74	327	9.6x	8.9x	7.2x	6.4x	8%	7%	8%
SDM	Sedgman	1.50	309	22.5x	7.4x	8.5x	3.9x	203%	4%	6%
PRG	Programmed	2.58	272	8.2x	6.8x	6.9x	6.1x	20%	6%	7%
NWH	NRW Holdings*	1.04	260	7.3x	6.6x	5.3x	5.1x	11%	6%	7%
AAX	Ausenco	2.11	258	13.4x	6.9x	9.4x	5.1x	96%	3%	7%
FGE	Forge Group*	2.91	229	7.7x	9.4x	4.4x	4.9x	na	1%	2%
MCE	**Matrix Composites & Eng,***	**2.60**	**197**	**11.7x**	**6.9x**	**7.8x**	**4.6x**	**70%**	**2%**	**3%**
DCG	Decmil Group*	1.54	194	10.8x	8.3x	6.2x	5.0x	30%	0%	4%
IMD	Imdex*	0.80	161	16.1x	8.7x	13.6x	7.5x	85%	0%	4%
COF	Coffey	1.13	146	7.8x	6.3x	7.0x	6.0x	23%	10%	11%
SXE	Southern Cross Electrical*	1.12	137	11.1x	10.7x	7.4x	6.9x	4%	5%	6%
RCR	RCR Tomlinson*	0.85	119	15.7x	8.1x	10.6x	6.8x	93%	3%	4%
NMS	Neptune Marine Services*	0.26	111	45.2x	9.4x	23.6x	6.8x	381%	0%	0%
SWK	Swick Mining*	0.36	84	27.4x	7.6x	15.1x	6.1x	262%	0%	0%
VMG	VDM Group*	0.40	69	5.9x	5.5x	3.7x	3.7x	7%	0%	0%
BYL	Brierty*	0.26	28	5.9x	3.7x	4.8x	3.2x	59%	5%	7%
NOD	Nomad*	0.14	19	na	3.6x	na	5.9x	na	0%	0%
	Smaller capitalisation			**13.7x**	**7.3x**	**8.6x**	**5.5x**	**85%**	**3%**	**5%**
	Average			**14.1x**	**9.2x**	**9.5x**	**6.8x**	**57%**	**4%**	**5%**

*Note to table: Stocks marked with an * are covered by Euroz, all other data is consensus*

MCE is, in our view, growing strongly in 2011 and this should be sufficient to see a solid re-rate of 2011 numbers, to circa 10 x earnings, assuming expectations (12 months from now) for 2012 and beyond are steady.

DCF Valuation

DCF valuation of $4.34

Our DCF based valuation is coming out at $4.34, assuming:

- WACC of 11.8%
- Strong growth in 2011 as modeled, 20% growth in 2012 and 5% until 2016.
- Terminal growth is assumed at 0%

Catalysts

- Strong 2010 result and associated positive commentary concerning 2011
- Henderson commissioned and ramped up as budgeted
- Contract wins from approximately $230m in tendered opportunity

Risks

- The largest short term risk in our view is a significant drop in Riser Buoyancy Module demand in say 2012 or 2013 caused by a drop in the construction requirements of new deep sea vessels.

  This is possible if:

  - Current construction plans reflect the pent up demand of a previous drilling cycle, which proves unsustainable.
  - Rigs deployed out of the Gulf, due to the drilling moratorium, see rig day rates drop and construction plans shelved for the short term.

- This risk is mitigated by the probability of long term high oil prices and the common view that new oil discoveries will be deep offshore.
- Ramp up at Henderson takes longer than anticipated, inhibiting growth.
- Longer term, MCE is unsuccessful in pushing into other product markets; ultimately this will be required in order to diversify MCE exposure away from Riser Buoyancy Modules, currently the primary product manufactured.

12 Month Price Target

12 Month Price Target $3.80

In our view, provided MCE hit our current 2011 forecasts, and the market forms the view during the course of 2011 that 2012 earnings will not fall off a cliff, MCE should trade at 10 x 2011 forecast EPS of $0.38 at least.

This translates to a 12 month price target of $3.80.

Business Overview

Matrix has two business divisions, Advanced Materials and Heavy Engineering.

The Heavy Engineering division designs, manufactures, and supplies products and services to the offshore oil and gas, mining and mineral processing industries.

The Advanced Materials division designs, manufactures and supplies products primarily for the oil and gas industries. A speciality is the design and manufacture of products that assist in the provision of buoyancy for offshore oil and gas exploration and production.

In our view Heavy Materials does approx $15m to $20m in revenues per annum. The balance, and therefore clearly the most important part of the MCE business, is the Advanced Materials division.

Advanced Materials Division

Riser Buoyancy Modules

Riser Buoyancy Modules are used to provide buoyancy to the riser (a series of pipes) that connects the offshore, exploration drilling vessel to the seabed.

While the Advanced Materials Division manufactures many products, the primary product is the manufacture and distribution of Riser Buoyancy modules (around 90% of revenues).

Riser Buoyancy Modules are used to provide buoyancy to the riser (a series of pipes) that connects the offshore, exploration drilling vessel to the seabed.

With the push into deeper water, the exploration drilling vessels are requiring more buoyancy and on a “typical” ultra deep water rig (approx 3,000 meters), approx $15m of buoyancy modules are required.

MCE currently has an orderbook for $210m, most of which is to supply Riser Buoyancy Modules to 5 key customers (explored below).

The demand for this product supports our view that revenues for MCE will approximately double in the next 12 months.

Other products

In addition to Riser Buoyancy Modules, the Advanced Materials Division provides a range of other products including:

- Subsea production buoyancy systems which, provide buoyancy to flexible subsea flow lines.
- ROV buoyancy systems which neutralize the underwater weight of remotely operated vehicles.
- Bend Restrictors which provide protection around flexible risers, used in production.
- Hydrostatic testing; MCE has one of the largest testing facilities in the world.

Going forward, MCE will need to diversify into these products to de risk exposure to the currently very successful Riser Buoyancy Modules.

Heavy Engineering

The heavy engineering division manufactures connectors, conductors and casing used in offshore exploration and production drilling. In addition it provides repair for marine risers and material handling systems under Original Equipment Manufacturer arrangements.

Finally, while an increasingly small piece of the overall MCE pie, Heavy Engineering manufactures the module casts used by Advance Materials to make the Riser Buoyancy Modules, an important contribution.

We forecast this business to be steady at around $15 to $20m per annum.

Earnings breakdown

Growth is driven by the Advanced Materials Division, generating strong GP off a solid orderbook.

We provide below our forecast breakdown of earnings for each division:

	2009	1H 2010 Actual	2H 2010 Forecast	2010	2011	2012
Revenue						
Advanced materials	34.3	38.5	51.0	89.5	170.1	212.7
Heavy Engineering	20.0	5.6	9.0	14.6	20.5	21.1
Other	-	0.3	-	0.3	0.3	0.3
	54.3	**44.4**	**60.0**	**104.4**	**190.9**	**234.0**
Cost of sales	-33.3	-20.7	-30.0	-50.7	-95.4	-121.7
Gross Profit	**21.0**	**23.8**	**30.0**	**53.8**	**95.4**	**112.3**
Other income	0.4					
Manufacturing expenses	-11.6	-8.8	-12.0	-20.8	-38.2	-46.8
Admin expenses	-3.9	-2.2	-3.0	-5.2	-9.2	-9.4
Marketing expenses	-0.5	-0.6	-0.6	-1.2	-1.9	-2.3
Other	0.2	-0.1	-	-0.1	-	-
Operating costs	**-15.4**	**-11.7**	**-15.6**	**-27.3**	**-49.2**	**-58.5**
EBITDA	**5.7**	**12.1**	**14.4**	**26.5**	**46.2**	**53.8**
Depreciation & amortisation	-1.7	-1.6	-1.9	-3.5	-6.8	-9.2
Other - Equity based payments	-					
EBIT	**3.9**	**10.5**	**12.5**	**23.0**	**39.4**	**44.7**
% of revenue						
COGS	-61%	-46%	-50%	-49%	-50%	-52%
Manufacturing	-21%	-20%	-20%	-20%	-20%	-20%
Admin	-7%	-5%	-5%	-5%	-5%	-4%
Marketing	-1%	-1%	-1%	-1%	-1%	-1%

Henderson facility

Henderson facility scheduled for completion in October 2010.

MCE has secured a long term lease for 8.4 hectares of land at the Australian Marine Complex in Henderson, Western Australia.

MCE is in the middle of a $60m construction and fit out of new facilities which will consolidate the 7 existing MCE operational sites, and increase production capacity substantially.

In particular, manufacturing capacity on the Riser Buoyancy Modules will increase by circa 75% and the ability of MCE to manufacture other products will increase considerably, as currently the majority of capacity is used up to make the Riser Buoyancy Modules.

The facility is due for completion by October 2010 and production will ramp up slowly after that. In the interim, existing facilities will continue to operate to ensure continuation of production.

The $60m has been partially funded by approximately $30m in equity raised over the last 9 months and the balance will be funded by debt.

Barriers to Entry

Strong Barriers to Entry.

Barriers to entry include high capital expenditure, long term customer relationships and a knowledge around a physical process that is difficult to replicate.

While the supply inputs are readily available worldwide, the physical process, combined with the testing capabilities, (one in every twenty are tested to full depth) presents high barriers to entry.

Macro Drivers

Riser Buoyancy Modules

While MCE has a suite of products on offer, by far the largest driver of revenues is the manufacture of Riser Buoyancy Modules.

As described above, industry wide, Riser Buoyancy Modules are used in the construction of new deep sea drilling rigs and in repair of existing deep sea drilling rigs to provide buoyancy to the risers (a series of pipes connecting the drilling rigs to the seabed).

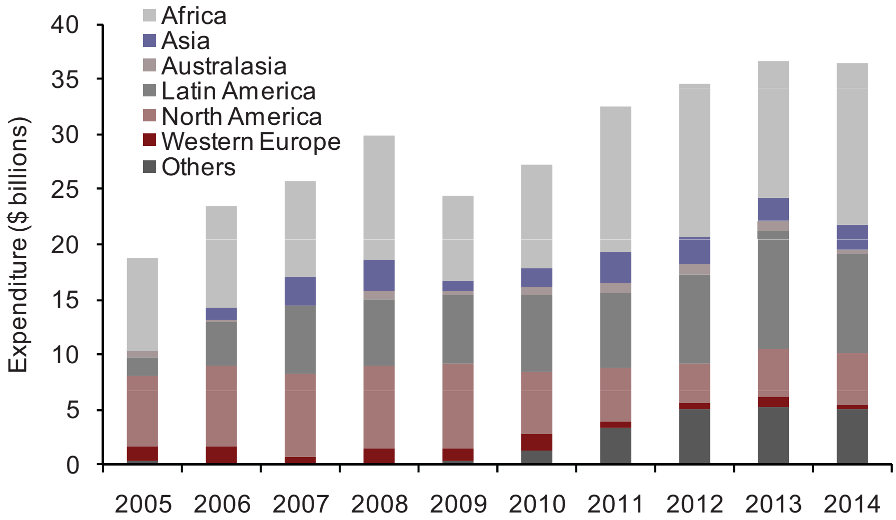
In the case of MCE, customers are primarily involved in new deep sea rigs. (Customers are explored below).

It is therefore important to understand drivers of demand for new drilling rigs industry wide.

Global Deepwater Exploration Expenditure

Global future deepwater capital expenditure is a key macro driver.

A key driver to deep sea drilling rig demand is forecast global deepwater capital expenditure. Douglas- Westwood forecasts expenditure to occur as follows:



Source: "The World Deepwater Report 2010 – 2014" – Douglas Westwood.

Key takeaways:

- A significant increase in expenditure is expected in the next five years versus the preceding five years.
- Exploration looks set to continue offshore of Africa and in the Gulf (provided the recent spill can be dealt with), with large increases forecast in Latin America, particularly Brazil.

Overall, the general outlook for expenditure on global deepwater capital expenditure is positive for MCE.

We estimate approximately 64 rigs currently under construction.

Rigs available and under construction

It is some what difficult to fully articulate exactly what is the construction outlook for new rigs.

MCE estimate there are 230 floating vessels currently in operation world wide.

According to company reports, a broad spread of the rigs owned and under construction are indicatively presented below as follows:

	Deep Sea Rigs	Deep sea rigs Construction plans	Buoyancy Value ($15m per rig)*
Transocean	71	3	$45
Diamond Offshore	33	-	$-
Pride	18	3	$45
Noble	19	3	$45
Seadrill	14	4	$60
Ensco	4	4	$60
Brazil region	-	28	$420
Other	71	19	$285
Total	**230**	**64**	**$960**

Source: Company reports, management presentations and Bloomberg
**Rigs under construction are for a range of depth - we have assumed 10,000 ft average for which an average of $15m in buoyancy is required.*

The above suggests that there is perhaps $960m in buoyancy required over the next few years to support current construction plans.

In addition, according to Energy research company Douglas – Westwood, there are an additional circa 30 rigs, not yet under construction however in advanced levels of contemplation destined for Brazil.

Overall, the macro environment for MCE over the medium term is positive, with plenty of pent up demand on existing construction plans.

A key question will be longer term demand, particularly if the Gulf of Mexico experiences a significant moratorium on drilling, freeing up existing drill rigs and decreasing rates. There is already evidence of this; the question becomes, does this impact construction plans longer term?

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The Gulf Oil Spill

As discussed above, beside the clear environmental consequences, this disaster has potential repercussions for MCE.

In the short to medium term a six month moratorium on drilling in the Gulf of Mexico may mean drilling rigs in the Gulf are deployed into Latin America or Africa, potentially reducing the urgency of further build programs. This may see a "lull" in construction plans over the 2012 to 2013 period. MCE will be keen to fill any gap with production based, rather than exploration based, products. Refer below.

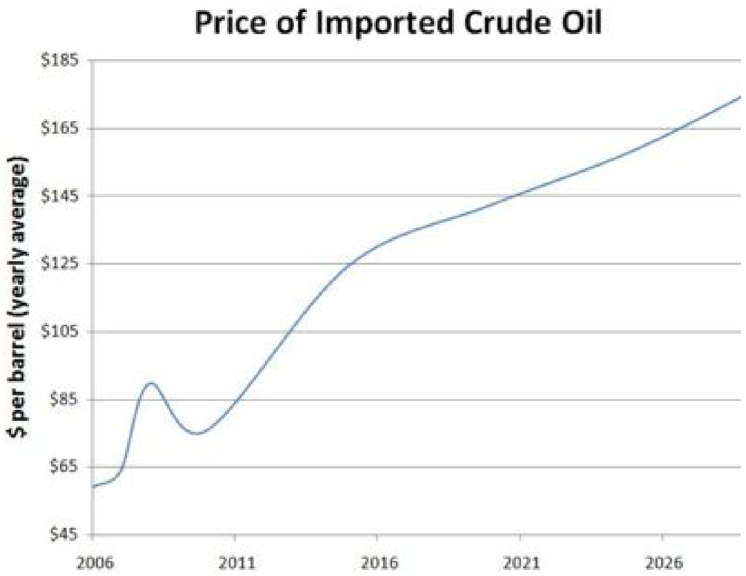
On the other hand, it is possible regulatory change in relation to the rigs may require rigs to be over hauled or replaced, including replacing buoyancy, which may improve orders.

What is clear, is that post this spill, MCE will need to stay nimble to react to any applicable product changes required as a consequence of the spill.

The oil price

Long term oil price forecasts are positive.

The oil price is the ultimate driver of exploration drilling programs. Oil prices above $70 per barrel long term are required to justify the expensive drilling programs. Following are oil price forecasts according to the Energy Information Administration:



Source: http://www.wikinvest.com/image/Oilforecast2009

In general, in our view, prospects for the long term oil price bode well for MCE

Customers

There are two primary buyers of buoyancy riser systems i) oil service companies that provide rigs on day rate to the E&P companies and ii) the construction companies that build the rigs for both E&P companies and the Oil Service companies.

Specific to MCE, current customers include:

Oil Services:

- Diamond Drilling
- Pride

Construction Companies:

- National Oil well Varco
- GE Vetco
- Aker Solution

These five customers currently support the near entirety of the current $210m order book, which supports our 2011 forecasts.

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Clearly, while the order book is strong, Matrix will be keen to access other potential clients to diversify opportunity and risk.

Other Oil Service companies not currently clients include:

- Transocean
- Noble
- Seadrill
- Ensco

Competitors

We estimate MCE has 20 – 25% of the overall market for Riser Buoyancy Modules for deep sea exploration drilling.

Competitors include:

- Trelleborg AB – operations UK and USA – 35% of the market
- Cuming Corp – operations US – 20% market share and under takeover negotiations
- Balmoral Offshore – operations UK – 20% market share.

At present, demand for buoyancy is sufficiently strong that margins are healthy.

The Board

The board consists of Nigel Johnson (Chairman), Aaron Begley (Managing Director), Paul Wright (Executive Director), Max Begley (non executive director) and Craig Duncan (non executive director).

Max Begley founded Matrix as a heavy engineering business in 1982 and has substantial experience servicing the oil and gas and resources sectors.

His son Aaron Begley, now the managing director of the group has been involved with the company since 1996. Aaron is the driving force of the Advanced Material Division, the growth engine of the business.

Paul Wright is the chief financial officer, having been involved in Matrix since 1996.

The chairman, Nigel Johnson has a financial background and was previously CFO of Straits Resources.

The remaining non executive director is Craig Duncan, who has 30 years experience in offshore oil and gas.

Paul Wright will be retiring as CFO in the short term to take a non executive position on the board and a new CFO will be appointed at that time.

Summary

MCE looks set for a terrific 2011, well supported by a strong orderbook. This should be sufficient to approach a 12 month price target of $3.80. After that MCE will need to diversify client base and products and evolve into much more than a Riser Buoyancy Modules manufacturer. In general, the macro enviroment supports this prospect. We initiate with a Buy.

Top 20 Shareholders

Matrix Composites & Engineering Ltd **as at 12 November 2009**

No.	Shareholder	Shares (m)	(%)
1	Milto Pty Ltd	20.73	32.41
2	Milto Pty Ltd	7.08	11.07
3	Mr Aaron Paul Begley	3.32	5.19
4	National Nominees Ltd	2.37	3.70
5	Mr Todd Justin Begley	2.07	3.24
6	Wasos Pty Ltd	1.29	2.01
7	HSBC Custody Nominees (Aus) Ltd	1.27	1.98
8	Mr Paul Richard Wright & Ms Karen Bronwyn Wright	1.16	1.81
9	Mr Bruce Ronald Smapey	1.08	1.69
10	Mr Bruce Ronald Smapey & Ms Linda June Sampey	0.90	1.41
11	JP Morgan Nominees Australia Ltd	0.87	1.35
12	Vector Nominees Pty Ltd	0.82	1.29
13	Glorie Holdings Pty Ltd	0.76	1.19
14	Mr Peter Lindsay Wright	0.74	1.16
15	UBS Nominees Pty Ltd	0.72	1.13
16	Cogent Nominees Pty Limited	0.72	1.12
17	Pengana Emerging Companies Fund	0.70	1.09
18	Sinedie Pty Ltd	0.64	1.01
19	Vector Nominees Pty Ltd	0.63	0.98
20	Mr Maxwell Graham Begley	0.61	0.95
	TOTAL	**48.48**	**75.78**

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