



GR Engineering HOLD

Current Price: **\$1.67**
Target Price: **\$1.70**

Ticker: **GNG.ASX**
Sector: **Construction & Eng**

Shares on Issue (m): **150.0**
Market Cap (\$m): **250.5**
Net Debt (Cash) (\$m): **-51.3**
Enterprise Value (\$m): **199.2**

52 wk High/Low: **\$2.30 \$1.67**
12m Av Daily Vol (m): **0.10**

Key Metrics

	12F	13F
EV/EBITDA (x)	9.3	5.7
P/E (x)	16.1	10.0

Ratios

	11A	12F	13F
ND / Equity	-86%	-105%	-92%
EBIT Mgn	19.6%	12.5%	16.1%
RoA	83.4%	55.7%	70.0%
RoE	51.7%	34.7%	45.0%

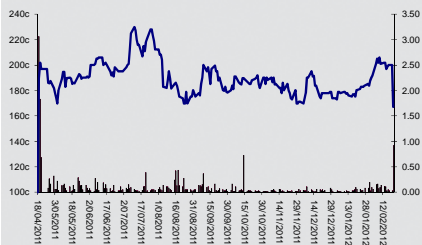
Financials:

	11A	12F	13F
Revenue (\$m)	142.5	165.0	210.0
EBITDA (\$m)	28.9	214	34.7
NPAT (\$m)	211	15.6	25.2
Net Assets (\$m)	40.8	45.1	56.0
Op CF (\$m)	15.6	25.2	20.4

Per Share Data:

	11A	12F	13F
EPS (cps)	16.8	10.4	16.7
DPS (cps)	4.0	8.0	10.0
Div Yield	2.4%	4.8%	6.0%
NTAPS (cps)	27.2	30.0	37.1
CFPS (cps)	12.4	16.8	13.5

Share Price Graph



Please refer to important disclosures on page 5

Analyst:
Ian Christie, CFA

22 February 2012

Margin squeeze

1H12 Results:

While revenue was close to our forecast, GNG has reported 1H12 profit numbers well below expectations on the back of lower margins:

- × Revenue was up 12% on pcp to \$79.3m (Argonaut \$82.5m)
- × EBITDA was down 43% on pcp to \$9.9m (Argonaut \$15.9m), with margins falling from 24.5% to 12.5% (Argonaut expectation was for a 19.3% margin)
- × NPAT was down 37% on pcp to \$6.7m (Argonaut \$11.5m)

The balance sheet remains in excellent shape. Operating cash flow of \$22.4m was similar to pcp, and GNG had cash of \$51.9m at period end with very little debt (\$0.6m).

The pipeline is significant, with construction project opportunities of ~\$880m through FY15 based on current / completed studies and traditional study conversion rates.

For the full year GNG will be focusing on margin improvement and expects revenue to at least match that obtained in the first half.

Impact:

Negative

As shown in the past margins can be volatile, with lumpy profit recognition dependent on accounting treatment and timing of project completion. Prior to this result, half yearly EBITDA margins in FY10 and FY11 had ranged between 14.7% and 24.0%.

However, in the last half we had under-estimated the combined impact of an increase in overheads with delays in contract awards. On review, our forecasts see significantly lower profit in FY12 (see further analysis on following pages):

	FY11	FY12F			FY13F		
	Actual	Old	New	Change	Old	New	Change
Revenue (\$m)	143	180	165	-8.3%	225	210	-6.7%
EBITDA margin	20.0%	19.3%	13.0%	-32.7%	19.1%	16.5%	-13.6%
Norm. NPAT (\$m)	21.1	25.1	15.6	-37.7%	31.2	25.2	-19.2%

Our View:

Positive

However, in our view the medium term outlook remains positive:

- × The increase in overheads (staff numbers are up ~35% over the last year) has given GNG the ability to take on a significantly higher volume / value of work
- × The balance sheet is in excellent shape to take advantage of opportunities
- × The pipeline is large and, with a number of projects in final stage study, we would expect to see considerable conversion to EPC and EPCM work during CY12

Our Recommendation:

Hold

Our target price has fallen from \$2.15 to \$1.70 based on a blend of DCF and PE-based valuations (see detail overleaf). This revised target price represents 10x FY13 earnings forecasts, which in our view are more reflective of GNG's earnings potential.

We revise our recommendation from buy to hold.



GR Engineering

Equities Research
Ian Christie, CFA

Recommendation	HOLD
Current Price (\$)	1.67
All Ords (XAO)	4,368.2

Sector	Construction & Eng
Market Cap (\$m)	250.5
Date	22 February 2012

Profit and Loss (\$m)	2011A	1H12A	2H12F	2012F	2013F
Revenue	142.5	79.3	85.7	165.0	210.0
Norm. EBITDA	28.9	9.9	11.5	21.4	34.7
Depreciation	-0.5	-0.3	-0.4	-0.7	-0.9
Norm. EBIT	28.3	9.6	11.1	20.7	33.8
Net Interest	0.9	1.0	0.6	1.7	2.2
Norm. PBT	29.2	10.6	11.7	22.4	36.0
Norm. NPAT	21.1	6.7	8.9	15.6	25.2
Rep. NPAT	21.1	6.7	8.9	15.6	25.2

Cash Flow (\$m)	2011A	1H12A	2H12F	2012F	2013F
Receipts	132.6	96.7	68.1	164.9	200.3
Payments	-112.5	-71.5	-67.5	-139.0	-171.4
Other	-4.6	-2.8	2.2	-0.6	-8.6
Cash from Operations	15.6	22.4	2.9	25.2	20.4
Property, Plant & Equip	-1.1	-0.2	-1.4	-1.5	-1.7
Payment for Subsidiary	0.0	0.0	0.0	0.0	0.0
Other	0.0	0.0	0.0	0.0	0.0
Cash From Investing	-1.1	-0.2	-1.4	-1.5	-1.7
Issue of Shares	27.9	0.0	0.6	0.6	0.8
Net Borrowing	0.3	-0.3	-0.2	-0.6	-0.2
Dividends	-19.0	-6.0	-6.0	-12.0	-15.1
Cash From Financing	9.1	-6.3	-5.6	-12.0	-14.5
Net Cash Flow	23.6	15.9	-4.1	11.7	4.2
Ending Cash	36.0	51.9	47.7	47.7	51.9
Total Capex (incl HP)	1.1			1.5	1.7

Balance Sheet (\$m)	2011A	1H12A	2012F	2013F
Cash	36.0	51.9	47.7	51.9
Receivables	24.7	18.9	24.9	34.5
Inventory	1.7	1.7	2.0	2.4
Other	1.2	2.5	1.2	1.2
Current Assets	63.6	74.9	75.8	90.1
Property, Plant & Equip	2.0	1.8	2.8	3.6
Intangibles	0.0	0.0	0.0	0.0
Other Non-current Assets	3.2	1.9	3.2	3.2
Non-Current Assets	5.2	3.8	6.1	6.8
Total Assets	68.8	78.7	81.8	96.9
Payables	14.8	14.6	19.7	24.0
Borrowings	0.9	0.6	0.3	0.2
Provisions	6.7	4.2	6.7	6.7
Unearned Inc. / Other	5.6	17.6	10.0	10.0
Total Liabilities	28.0	37.0	36.7	40.9
Net Assets	40.8	41.7	45.1	56.0
Ordinary Equity	28.5	28.5	29.1	29.9
Reserves	0.1	0.2	0.1	0.1
Retained Earnings	12.3	13.0	15.9	26.1
Total Equity	40.8	41.7	45.1	56.0

Summary

Target Price (A\$ per share)	1.70
Forecast 2012 Yield (%)	4.8%
Forecast 2012 P/E (x)	16.1
Forecast 2013 P/E (x)	10.0

Valuation Method Calculations Results

DCF Valuation	Calculations	Results
	Discount Rate / WACC (%)	12.1%
	PV Free Cash Flow (\$m)	235.2
	Less Net Debt / Plus Cash (\$m)	51.3
	Unpaid Capital (\$m)	1.3
	Equity Value (\$m)	287.8
	Equity Value (A\$ps)	1.91

On FY13 Earnings	Multiple	EV	Equity Val	per Share
P/E (x)	9.0		226,832	1.51
Multiple Valuation (A\$ps)				1.51

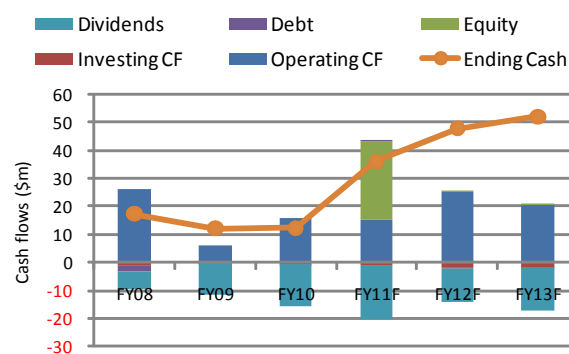
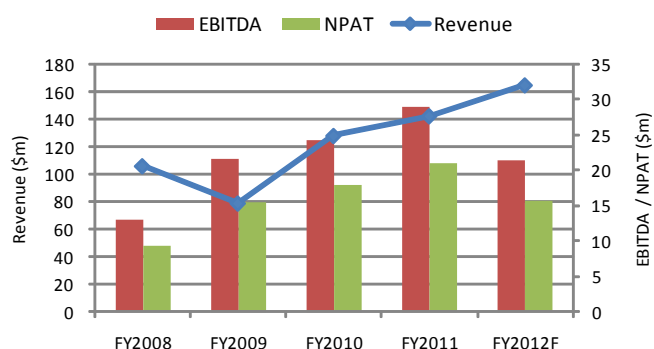
Target Price

Financial Ratios

	2010A	2011A	2012F	2013F
Balance Sheet Ratios				
Net Debt / Equity (%)	-115.3%	-85.9%	-105.1%	-92.4%
Current Ratio (x)	1.2	2.3	2.1	2.2
Net Interest Cover (x)	-33.9	-31.1	-12.4	-15.0
Profitability Ratios				
EBITDA Margin (%)	18.7%	20.0%	13.0%	16.5%
Net Profit Margin (%)	13.9%	14.8%	9.5%	12.0%
Return on Assets (%)	63.0%	83.4%	55.7%	70.0%
Return on Equity (%)	175.1%	51.7%	34.7%	45.0%
Cash Flow Ratios				
Free Cash Flow Yield		5.0%	9.4%	7.4%

Per Share Data

	2010A	2011A	2012F	2013F
Reported EPS (cps)		16.8	10.4	16.7
Basic Norm. EPS (cps)		16.8	10.4	16.7
Diluted Norm. EPS (cps)		16.8	10.4	16.7
Diluted Norm. P/E (x)		10.0	16.1	10.0
Dividends per share (cps)		4.0	8.0	10.0
Dividend Yield (%)		2.4%	4.8%	6.0%
NTA per share (cps)		27.2	30.0	37.1
Cash Flow per share (cps)		12.4	16.8	13.5





Growth in o/head not matched by revenue

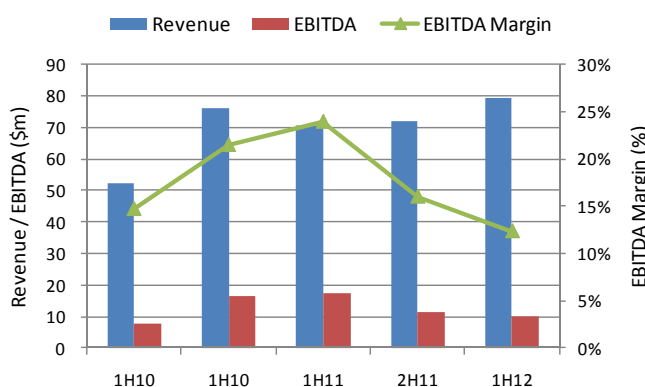
A reasonable revenue line was marred by a significant drop in margin in 1H12

While revenue was close to our forecast, GNG's 1H12 profit numbers were well below expectations on the back of lower margins, which were impacted by:

- × Profit recognition accounting treatment
- × Delays in contracts being awarded
- × Increasing overheads associated with positioning the Company for growth

The first point was understood. As shown in the past, margins can be volatile, with lumpy profit recognition dependent on accounting treatment and timing of project completion. Prior to this result, half yearly EBITDA margins in FY10 and FY11 had ranged between 14.7% and 24.0%.

Figure 1: Previous volatility



While margins have in the past been volatile due to accounting treatment on projects

Source: GNG, Argonaut

..... increased overheads without a corresponding increase in revenue resulted in further margin squeeze

However, in the last half we had significantly under-estimated the combined impact of an increase in overheads with delays in contract awards.

Forecasts

Revenue

FY12:

- × Commentary with the results indicate 2H12 revenue is expected to be consistent with 1H12, with potential for upside
- × Accordingly we have reduced our full year forecast from \$180m to \$165m, on the assumption that GNG can deliver \$85m revenue in 2H12

Our FY12 revenue forecasts have been reduced by 8%

FY13:

- × We expect delays to projects may continue, particularly in base metals
- × Our FY13 revenue forecast of \$210m is down 7% on our prior \$225m forecast
- × We believe this remains achievable based on the strong identified pipeline of opportunities



Margins

..... but the biggest impact on forecast profit is as a result of significantly lower margin assumptions

The biggest impact on our forecasts is as a result of adjustments to our margin assumptions.

FY12:

- × The EBITDA margin in 1H12 was 12.4%
- × Despite a stated focus on margin improvement in 2H12, with little growth in revenue we do not expect margins to climb significantly in the short term
- × We have forecast a margin of 13.5% for 2H12, which implies a full year margin of 13.0%
- × This would deliver a 1H:2H net earnings split of 43%:57%
- × There could be upside to 2H12 margins depending on timing of project completions

..... in FY12

FY13 and beyond:

- × We had previously assumed a flat 19% EBITDA margin for FY13 and beyond
- × We now expect longer term margins to be lower as a result of:
 - GNG entering into larger contracts, which are likely to be lower margin
 - The additional costs incurred (at least initially) of winning work outside of Australia (for example in west Africa and south-east Asia)
- × Our long-term EBITDA margin forecasts are now set at 16.5%

..... and FY13

Impact on profits

These adjustments to our assumptions have resulted in significant changes to our numbers, particularly in FY12.

Table 1: Changes to Argonaut forecasts

	FY11	FY12F			FY13F		
	Actual	Old	New	Change	Old	New	Change
Revenue (\$m)	143	180	165	-8.3%	225	210	-6.7%
EBITDA (\$m)	28.9	34.7	21.4	-38.4%	43.0	34.7	-19.4%
EBITDA margin	20.0%	19.3%	13.0%	-32.7%	19.1%	16.5%	-13.6%
EBIT (\$m)	28.3	34.1	20.7	-39.3%	42.1	33.8	-19.8%
EBIT Margin	19.6%	19.0%	12.5%	-33.8%	18.7%	16.1%	-13.9%
Norm. NPAT (\$m)	21.1	25.1	15.6	-37.7%	31.2	25.2	-19.2%

FY12 NPAT is 38% lower and FY13 NPAT 19% lower than our previous numbers

Source: Argonaut

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- × In December 2011 Argonaut managed the founding shareholders' sale of 18 million shares at \$1.80
- × Argonaut holds and/or controls 200,000 shares in GR Engineering.

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