REAL ESTATE: HOW TO NEGOTIATE LIKE A PROFESSIONAL

Money

OCTOBER 2010 $6.95 ISSUE 128
www.money.ninemsn.com.au

FREE TICKETS TO HOME BUYER & INVESTING EXPOS

MONEY SOLUTIONS

EXPERTS ANSWER YOUR QUESTIONS

BONUS BOOKLET INSIDE

1. PROPERTY
How to live off real estate

2. SHARES
ETFs: Low cost, high growth

3. INVESTING
Mortgage free - what next?

4. KIDS' MONEY
Where to invest $2000

5. PAY LESS TAX
Setting up family trusts

PRINT POST APPROVED PP255003/04450
acp magazines

SUPER STRATEGY: CUT SUPER, BOOST CASH

Picks & shovels

It all started with the gold rush, says Roger Montgomery

IN 1851, THE PEACE AND TRANQUILITY enjoyed by shepherds in Buninyong was shattered when gold was discovered. The gold rush saw rapid growth in the new town of Ballarat and soon nearly 1000 miners were digging for gold. By 1853 there were more than 20,000 miners and within the decade the population of Victoria had grown from 80,000 to half a million.

A large part of the civil service and police of Melbourne were said to have abandoned their posts for the gold diggings. Businesses lost workers, fathers left their families, schools emptied and ships' crews deserted. Ten million grams of gold were transported to the Melbourne Treasury in 1851 and more than 77.7 million grams over the next four years.

Not every miner was lucky. Of those that struck it rich some weren't miners. They were the people supplying every single miner with the tools and services they needed: accommodation, food, and their picks, shovels, pans and rock cradles that had to be repaired and replaced.

Supplying miners with the equipment they need and the skill to repair it is now big business. The Australian Bureau of Statistics reveals miners expect to invest $54.8 billion in 2011, up nearly 30% from 2010. While the technology may have changed, the economics have not.

The latest results of three companies in this space have reinforced their appeal.

Forge Group (FGE), Decmil (DCG) and Matrix Composite & Engineering (MCE) are engineering companies that supply and maintain or replace the equipment or accommodation miners require. All three have recently received or confirmed their "A1" MQRs (Montgomery Quality Ratings) but all are more than subtly different.

Decmil provides services to tier 1 resource companies. Its clients include BHP Billiton, Woodside Petroleum, Fortescue Metals, Rio Tinto and Chevron. The Decmil business is the remaining one of many acquisitions that have otherwise been wound up – written off or divested – by the renamed company. Using a combination of fixed-price and cost-plus contracts, the company integrates itself horizontally in its clients' life cycle, providing a range of services from accommodation to non-process infrastructure (think workshops), through the various phases of site and mine establishment, growth and maturity.

Perhaps surprisingly, the company does not have a large capital expenditure burden, so operating leverage concerns usually ascribed to the sector may be misplaced.

Founded in 1979, Decmil's combination of established reputation, contract win ratio of about 25% (never being the lowest price) and revenue streams from diverse clients should ensure the forecast capital expenditure plans of the resource sector will benefit the owners of Decmil.

Decmil's shares are trading at a small discount now to my estimate of their $2.27 intrinsic value, which should remain stable provided the company's board does not submit to pressure to pay dividends (one director is from Monadelphous – a company that pays 80% of earnings as a dividend) while simultaneously raising capital and borrowing money to fund any overpriced acquisitions.

Forge also provides engineering services to the resource sector but that is where the similarities end. Forge caters to tier 2 players in the resources sector and its contracts tend more towards fixed-price types. The result is that the company's margins are higher than Decmil's but with fixed prices comes the perils of inflation or cost blowouts. Forge tends to vertically integrate itself into a single project of its customers and because, in the resource sector, those customers may be junior participants, there may be little repeat business. However the company has also completed construction projects for WorleyParsons, Alumina, Alcoa Australia, BHP and Woodside as well as civil contracting.

Unlike Decmil and Forge, Matrix's primary focus is offshore and the manufacture of buoyancy devices for deep sea oil and gas explorers, exporting to over 30 countries. With only a handful of global competitors, it has built a reputation for quality that has resulted in many of the world's largest oil companies becoming clients.

All three companies have strong order books that will underwrite at least the next 12 months' revenues. Importantly, each company demonstrates strong rates of return on equity, has little or no debt and has been trading at discounts to my estimates of their intrinsic value.

Notwithstanding a significant macroeconomic shock such as the collapse of a property bubble in China and the deferral of capital expenditure plans by explorers and miners, the combination of prospects, solid balance sheets and high rates of return on equity for these three companies should ensure supplying picks and shovels will remain as sensible as it always has.

PICK AND SHOVEL STARS

SHARE	ASX CODE	QUALITY SCORE	INTRINSIC VALUE	PRICE
Decmil Group	DCG	A2	$2.27	$2.19
Forge Group	FGE	A1	$4.45	$3.91
Matrix C&E	MCE	A1	$6.02	$4.60

Roger Montgomery owns all three stocks

VALUE STOCK TO WATCH

Matrix (MCE)

ROGER MONTGOMERY

Roger Montgomery is a value investor and fund manager. His book, *Value.able*, is available at www.rogermontgomery.com

CLOSING SHARE PRICES AS AT 17-SEP-10

GETTY IMAGES