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101 GOLD-WINNING PRODUCTS: SAVE ON HOME LOANS, CREDIT CARDS, BANK ACCOUNTS, PHONE & NET PLANS

SPECULATOR SOARS: PORTFOLIO UP 82%

10 WINNING MANAGED FUNDS & ETFS

11 WINNING SUPER & PENSION FUNDS

EXPERT VIEW: PROPERTY, SHARES, $A

TOP TIPS: PAUL CLITHEROE, ALAN KOHLER, ROSS GREENWOOD

PRINT POST APPROVED PP255003/04450

12

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Price gap appeals

Roger Montgomery steps out of his comfort zone

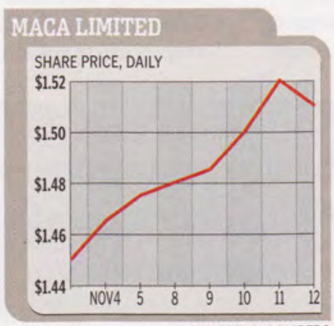
VALUE STOCK TO WATCH
Mining & Civil Australia (MLD)

WITH ALL THE NOISE ABOUT the QR National float – you may recall my previous view that QR National is not a great business and appears to be expensive – you may have missed another float that had all the hallmarks QR National doesn't. An ideal company you will remember is one that has little or no debt, generates a high rate of return on equity and has a sustainable competitive advantage to drive that return. Given that we should be thinking of the stock exchange as a supermarket for stocks, we also want them to be "on sale".

A company that appears to have met those criteria is one that recently listed called Mining & Civil Australia, or MACA Limited (ASX: MLD). The company is a relatively straightforward mining services business founded in 2002. Using both its own employees and contract labour, it loads, hauls, drills and blasts, crushes and screens rocks and dirt for mostly smaller or mid-sized resource companies. It lists its clients as Atlas Iron, Regis Resources, Western Areas NL, Crescent Gold, Sinosteel Midwest, Barrick Gold Corp, Magellan Metals and Crosslands Resources.

Like all business, MACA has its risks and the most obvious is exposure to the resource sector. However, the ongoing debasement of the US dollar should ensure investors will swap their depreciating cash for hard commodities which in turn should spur further capital expenditure and investment in the sector. Well, that's the conventional thinking anyway.

The biggest risk is that many of MACA's largest contracts (for which it contracts labour) expire in 2011 and more than half of all contracts expire before the end of 2012. In 2010 the item in the profit and loss statement called "subcontracting expense" exceeded employee costs and I deduced the important clients by revenue are Atlas, Crosslands and Western Areas. These contracts all expire between December 2011 and February 2012.



SOURCE: BLOOMBERG

Interestingly, a very large number of shares held in escrow by the founders will become available to be sold just before the expiry of these contracts.

I have written about my current affinity for pick and shovel suppliers, but they have few competitive advantages and even fewer barriers to imitation. The only thing stopping you and me from starting up in competition is a few million dollars (which a lot of people are willing to supply and is therefore easy to obtain) and the more difficult to obtain relationships and reputation. But even this hurdle can be surmounted by someone willing to charge less and lose a few dollars while they win clients and get going. That there is no dearth of companies in this sector is testament to how low the barriers to entry are.

While commodity prices and demand remain strong, the services MACA provides will also be in demand. But not all these businesses can be fed when the music stops – and we know that eventually the music does stop for commodities.

When that happens, high fixed costs and spare capacity will produce unpleasant substantial losses for many players.

Those risks suggest that this opportunity may be a shorter-term one than those I am normally fond of and perhaps even recognised for. Appropriately, an allocation of capital to MACA should reflect the its outlook's more speculative nature.

Revenue grew 88% to $155 million in 2010 and, while this appears impressive, it's partly due to contract delays that lowered the previous year's revenue.

In 2011, the company is forecasting revenue of $242 million, earnings before interest, tax, depreciation and amortisation (EBITDA) of $53.2 million (up 41%), and a net profit after tax of $23.1 million, and some comfort comes from the fact that MACA's existing contracted work accounts for 98% of 2011 forecast revenue.

Based on the equity, return on equity and expected level of dividends to be paid, I reckon MACA's shares are worth more than the current price and while it's rare for me to even suggest such a strategy, a large gap between price and current intrinsic value is even rarer.

ROGER MONTGOMERY

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

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