

INDUSTRIALS

Table with columns: Last Sale, Move, Buy, Sell, 12 month High, Low, Sales 100, Div Yield, P/E. Lists various industrial stocks like 21stCnFx, AACL, AALC, etc.

THE SHORTCUT



with Roger Montgomery

WARREN Buffett famously said, "A rising tide lifts all boats. It's not until the tide goes out that you realise who's swimming naked."

As value investors, we at Montgomery Investment Management frequently reference the Sage of Omaha's wisdom.

I can think of no saying that would be more fitting to describe how the slowdown in the resources sector has exposed the true quality of mining services companies.

As many of you may know, the mining sector has been riding high in recent years on a wave of capital flowing into Australia.

Miners accelerated production to capitalise on strong commodity prices, and mining services companies rushed to secure contracts with little attention paid to their cost base.

Many of these mining servicers were capital intensive and burdened by debt, but as long as China demanded commodities, there was sufficient work for these operators to remain profitable.

However, as commodity prices sharply fell during the year, miners were forced to shelve projects and cut costs by directing work to the most efficient contractors.

The vast majority of servicers were left high and dry by the exodus of capital, and many were forced to flag downgrades to full year earnings in recent months.

Now that reporting season for the 2013 financial year has drawn to a close, the quality of their financial health has been fully revealed, with many results being starkly different to the year before.

Emeco Holdings was one company whose results were representative of the sector's poor performance.

Emeco is the world's largest independent mining equipment rental business, with operations in Australia, Indonesia, Canada and Chile.

Like many capital-intensive contractors, Emeco is highly leveraged to the deployment of its assets, which means that any change in utilisation rates will have a disproportionate impact on earnings.

So as Emeco's utilisation rates fell from 86 per cent in 2012 to 67 per cent in 2013,

its operating profits halved. The outlook for Emeco is grim, with utilisation rates at the end of 2013 at just 42 per cent.

Emeco management is pursuing immediate downsizing of its cost base, but there is a very real risk that the company will trade at a loss in 2014, and potentially be forced to make significant write-downs if conditions do not improve.

Boart Longyear is one capital-intensive mining servicer that is already at this stage. The company has the world's largest fleet of drilling equipment, but it has only managed to deploy half of its assets in this weak climate.

In the six months to June, the company generated a loss of \$60 million, and was forced to write off a quarter of its asset base.

Boart Longyear took on a lot of debt to expand capacity during the boom, and now it is in imminent danger of breaching its debt covenants.

The company is not alone in this regard, and it is likely that many servicers will be forced to go to shareholders with caps in hand to service their debts.

In Boart Longyear's case, an equity raising would be a bitter pill for shareholders to swallow, having already watched the share price fall by over 75 per cent in the calendar year to date.

Investors will be even less convinced to loosen their purse strings after management ominously warned that second half results were likely to be lower than the first half due to further price erosion.

At Montgomery, we only invest in high quality companies that have sustainable competitive advantages and bright long-term prospects.

We do not own companies that will only be profitable on a rising tide. In doing so, we have avoided disappointing results this reporting season, and have in fact been delighted by the performance of the companies in our funds.

While companies like Emeco and Boart Longyear may recover when capital returns to the mining sector, we certainly won't be doing any skinny dipping.

Roger Montgomery is founder of Montgomery Investment Management

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