Earnings fall in a hole

Roger Montgomery gives an example of why he is avoiding mining services

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OUR WARNINGS about mining services businesses are becoming increasingly pertinent to investors looking for value.

For some time The Montgomery [Private] Fund has eschewed all exposure to the mining services sector. The reason is simple. We believe a plethora of operators will be bidding for less and less work as mining companies scale back their project and capital expenditure plans. This means contractors that win tenders will earn less and those that don't win any could go out of business. And as each day passes, the evidence of challenges mounts.

Calibre Group (ASX: CGH) is an engineering services business that was floated in August 2012 at $1.63 a share by leading investment banks. The company's activities were split 47% rail, 43% mining services and 10% infrastructure and the company benefited from significant customers: Rio Tinto, BHP Billiton and Fortescue Metals Group accounted for over 70% of its $561 million in revenue.

In early October 2012, Calibre announced the acquisition of G&S Engineering Services, a provider of operations maintenance and asset management services to coal companies based in Queensland and NSW. Additional clients included the BHP Mitsubishi Alliance, Xstrata, Wesfarmers Coal, the Dalrymple Bay coal terminal and Peabody.

After reporting revenues of $279 million in the year to June 2012, at acquisition G&S was expected to contribute $160m in revenue and $10m in EBITDA (earnings before interest, tax, depreciation and amortisation) to Calibre's statutory results for the year to June 2013. Given Calibre's prospectus forecasts were for revenue of $715m and EBITDA of $93m, it might be reasonable for investors to assume that the company was now targeting revenue of $875m and EBITDA of $103m.

Things were looking good six weeks later and, at the annual general meeting in late November, Calibre announced a total order book of $1.5 billion and a full-year 2013 order book of $610m. The asset management component of revenue was expected to jump from 10% in FY12 to 34% in FY13. The acquisition of G&S meant iron ore, as a proportion of total revenue, would fall from 73% in FY12 to 53% in FY13. There were additional contracts with Rio, the Australian Rail Track Association and Adam Mining; there was a slide articulating "a global presence"; and an interim dividend of 55% to 65% of the normalised net profit for the six months to December 31 was expected to be paid in April 2013.

Releasing results for the six months to December on February 19, things generally seemed on track, despite a minor decline in the revenue and earnings forecast for the year to June 2013. EBITDA margins at 13% were broadly in line with budget. After dropping to below $1 with the severe iron ore sell-off in September-October 2012, Calibre had recovered to its $1.63 float price.

Management was true to its word and announced an interim dividend of 5.8¢ a share on fully diluted normalised earnings of 9¢ a share. Despite the G&S acquisition being partially cash funded, net debt, including deferred acquisition consideration, grew by only $11m to $62m in the six months to December. The forward order book was $1.3bn, the strengthened "pipeline" was valued at $12bn and there were "new overseas market opportunities".

Just over seven weeks later, Calibre went into a trading halt and on April 12, 2013, it dropped a bombshell by severely cutting its earning guidance for the year to June 2013. Including the small reductions announced at the half-year report, the revenue forecast had been cut by nearly $200m to $680-$695m, EBITDA expectations halved from $103m (including G&S) to $50m-$55m, the normalised net profit after tax halved to $30m-$35m and the forecast return on shareholders' funds (at December, $226m) halved to 14%.

The share price sank to about 37¢, a 50% discount to shareholders' funds per share of 73¢. With the new forecast normalised EPS of around 10.5¢, the company is now selling on a prospective PE of 3.5 times. On the surface, these fundamentals make Calibre look cheap, but readers should be aware of an old adage: "earnings downgrades are like cockroaches, there's never just one in the kitchen."

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