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The resource service sector headwinds

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Recently the Bureau of Resources and Energy Economics (BREE) released their biannual Resources and Energy Major Projects report, and it is not good reading if you are a shareholder in a business servicing the Australian resource service sector.

According to BREE the amount of committed project work dedicated to the resources and energy sector has declined by $40 billion, or 15%, to around $230 billion over the past year. I now think this decline is likely to be the tip of the iceberg.

There are some enormous projects, particularly in the energy sector, that are shifting in status from construction to production over the next few years, from which Australia will benefit enormously, with export value of LNG expected to grow fivefold over the next five years to $65 billion.

For example, five projects moving into production over the foreseeable future with a combined volume of 50 million metric tonnes per annum of LNG, include Curtis Island CSG to LNG, Gorgon LNG project, Gladstone CSG to LNG, Australia Pacific CSG to LNG and Wheatstone LNG.

The headwinds

I have recently attended a Wood Mackenzie presentation entitled "Changing of the guard in energy markets" kindly hosted by Deutsche Bank, and I am convinced the "second phase" of Australian LNG capacity expansion is off the agenda until further notice due to global competition from North America and East Africa as well as a lack of cost competitiveness.

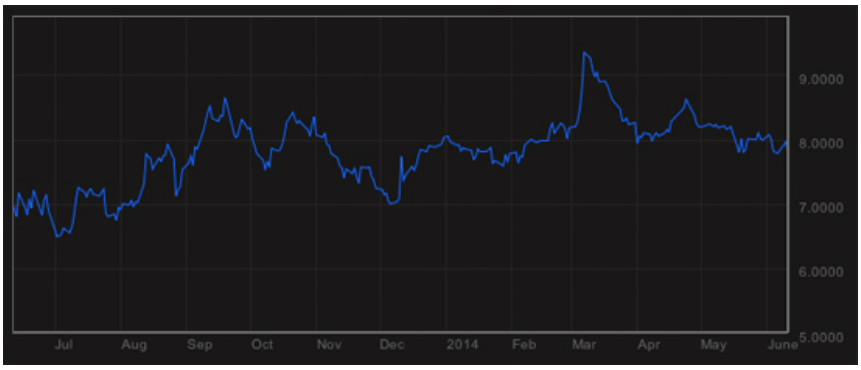
Now back to those worrisome forecasts. The Australian Bureau of Resources and Energy Economics estimates the combined value of "committed and likely" resource projects will decline by 75% from the current $228 billion, to an estimated $55 billion in the four years to 2018. The crucial point from the resource service company sector viewpoint is that the production phase relative to the construction phase of these enormous energy projects requires relatively few people and very little servicing.

So for those companies whose prime focus is servicing the Australian resource sector – whether that is via civil works, construction, accommodation or processing – they should expect to face a very stiff headwind over the next few years.

WesTrac and Seven

While there are over two-dozen ASX listed companies and some hundreds of unlisted companies in this category, I thought I would touch on WesTrac Australia, a wholly owned subsidiary of Seven Group Holdings Limited (ASX: SVW), the industrial services, media and Investments conglomerate. At the current $8.00 share price, its market capitalization is $2.44 billion, and with $608 million of net debt at 31 December 2013, its enterprise value is $3.05 billion. Kerry Stokes controls 68% of the issued capital.

Seven Group Holdings



WesTrac Australia operates as the sole Caterpillar dealership in Western Australia, NSW and the ACT, and supplies new and used machinery to the construction, mining, forestry and quarrying industries. The last three six-month periods have seen a severe decline in revenue – from the $2.38 billion peak in the December 2012 half-year to $1.73 billion in the June 2013 half-year to $1.26 billion in the December 2013 half-year. Earnings before interest and tax (EBIT) has fallen even faster – from $275.4 million to $209.1 million to $88.7 million, respectively. EBIT to sales margins have come down from 12% to 7%, and it looks to me like there is worse to come.

Recently released data from Caterpillar Inc., a company with 2013 revenue of US$55.7 billion, does not auger well for the June 2014 half-year. For example, the months of February, March and April 2014 have seen Caterpillar Inc's Asia/Pacific machine sales record a year-on-year decline of 17%, 20% and 25%, respectively. Furthermore, Caterpillar Inc's sales to the Asia/Pacific Resource Sector for February, March and April 2014 declined by 55%, 65% and 70%, respectively!

While the business has done an excellent job in growing the product support component of their revenue, we believe the hit to sales in the Asia/ Pacific region by Caterpillar Inc and the headwind from the Australian Resource Sector is likely to see WesTrac Australia's revenue and earnings line deteriorate somewhat further.

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