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A reporting season special

Monadelphous's Missing Mojo

Former market darling in value territory — but its earnings risk is elevated.

Successful value investors have a clear focus: buy exceptional companies at bargain prices. Mining services provider Monadelphous Group has performed exceptionally for the best part of a decade, and after slumping 40 per cent this year on fears of a fading resources boom it looks like a bargain.

The market, however, doesn't see it that way. Broking firms have fallen over themselves this year to issue sell recommendations on Monadelphous and short sellers and even some prominent offshore investment newsletters have gone cold on the former market darling.

Seasoned value investors know the best time to buy is when everyone is selling and excessive market noise is driving stocks well below their intrinsic value. Such scenarios can create tremendous value opportunities for investors who go against the tide.

Could there even be parallels between higher-quality retail stocks and the best mining services stocks after recent price falls? Retail stocks were thumped last year amid market fears over a slowing economy and the threat of online retail sales. Six months later, the best retailers, such as JB Hi-Fi, had soared off their lows.

Nothing had changed fundamentally for retail – if anything, the outlook has deteriorated in recent months as consumer and business confidence has waned and retail sales growth slowed. The market simply over-reacted and oversold retailers, creating opportunities for value investors.

True believers could argue the same situation is unfolding for Monadelphous. Like JB Hi-Fi, Monadelphous is its sector's highest-quality company, firmly in the sights of short-sellers and bearish broking analysts, and battling a perfect storm for its industry.

Signs that Monadelphous is weathering the resources storm would provide much-needed relief and possibly a share-price bounce when full-year profits are reported (due on August 20). That Monadelphous did not issue a downgrade in the lead-up is a good sign in itself.

The mining services sector has been a sea of profit downgrades and smashed share prices this year. Mining activity has slowed sharply because falling commodity prices have forced billions of dollars of projects to be cancelled, deferred or cut back. More cancellations seem inevitable.

In turn, competition among mining service firms has intensified and led to greater price discounting and lower profit margins. At the same time, big mining companies have renewed focus on cost cutting to help counter falling revenue, meaning further pressure on service providers.

The result is poor earnings visibility for most mining services stocks. Service providers, of course, point to their pipeline of work to reassure the market. But the pipeline can dry up quickly for companies at the mercy of projects being deferred or cut back.

This is no market for companies with even a sniff of earnings uncertainty. Fund managers have shown they will pay higher multiples for large and even small-cap companies with "annuity style" recurring earnings, and dependable growth, such as telcos, utilities and banks – and punish the rest.

The big problem is nobody knows where the resource sector malaise will end. Trying to second-guess China's economic strength and short-term commodity price movements is a mug's game. The best guide is history: the commodity price cycle has a habit of doing better than the market expects on the way up, and worse on the way down – and taking longer to play out than investors expect.

Another certainty is the resource sector being a big ship to turn. Key headwinds for the sector, notably high wages and input costs, are starting to ease as lower demand pushes down prices. The resolution of the federal election on September 7 will help if the Coalition is elected and reduces green tape and other regulatory uncertainty for miners. And the lower Australian dollar is helping offset falls in US-dollar-priced commodities for local miners and ease some pain.

But these trends will take time to help resource projects. Perhaps in a few years the smart money might recognise the seeds have been planted for the next boom in resource stocks. For now, a slow, painful transition is ahead as the resource sector deals with its "new normal".

The other problem is the nature of many mining services providers: high capital investment, high fixed costs, and rapidly depreciating equipment that can idle for months. This is a great industry when demand is strong and a terrible one when projects quickly stop and service providers have low flexibility.

Overall, the macro outlook for Monadelphous and other service provides suggests more profit downgrades and disappointments, a pick-up in mergers, and even a few companies going into in administration in FY14. It is a brave bet to believe mining services stocks cannot possibly fall any further, after savage declines this year.

Value investors must consider whether Monadelphous can navigate through these conditions and come out stronger as it uses its balance sheet strength to diversify operations, and mop up weakened competitors. If it can, today's valuation will look like a huge opportunity to enter the stock.

Monadelphous's record gives hope. The market, of course, always looks forwards, but in times of great earning uncertainty it can pay to look backwards as well. Monadelphous's return on equity (ROE), above 50 per cent for the past seven reporting periods, is exceptional.

Its management team is among the best regarded in the mining services sector, debt is low for a company of its size, and it has a history of under-promising and over-delivering. It has all the marks of a high-performing business.

The $1.5 billion service provider, involved in large engineering construction projects, maintenance and industrial services, and infrastructure, earns a big chunk of its revenue from blue-chip clients such as BHP Billiton and Rio Tinto. In this market, look for mining services companies that are leveraged to production rather than exploration projects, and to lowest-cost miners that will survive if commodity prices fall further.

Monadelphous's interim result in February was strong: sales revenue up 47 per cent to $1.28 billion and net profit up 38 per cent to $79.1 million for first-half FY13, thanks to a surge in construction activity. Such growth cannot be repeated in coming years as the resources investment boom tapers, so all eyes are on Monadelphous's upcoming full-year result and importantly, its guidance for FY14.

Monadelphous has said FY14 would be a year of "consolidation" with challenging revenue growth and a "slowdown in near-term major project approvals likely to reduce the pipeline of opportunities in the medium-term". Judging by its share price falls, investors expect weaker outlook commentary again.

As the market obsesses about next year's earnings, it is worth examining Monadelphous's strategy during this transition period for the resources sector. With revenue slowing, it wants to recruit more of the best talent, improve efficiencies, cut costs and diversify the business into other sectors.

Newspaper reports in August suggested Monadelphous might invest in the troubled telecommunications contractor, Service Stream, but Monadelphous did not respond to the rumour. It clearly has the balance sheet firepower to buy weakened competitors and move into other sectors.

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Returns to 31 July 2013

Code		Change	Outperfomance
MPF	The Montgomery [Private] Fund	34.95%	-
XNAJI	ASX 200 Industrials Accumulation Index	6.20%	28.75%
XTOAI	ASX 100 Accumulation Index	20.59%	14.36%
XJOAI	ASX 200 Accumulation Index	18.02%	16.93%
XAOAI	All Ordinaries Accumulation Index	14.95%	20.00%
XKOAI	ASX 300 Accumulation Index	16.60%	18.35%
XTLAI	ASX 20 Accumulation Index	25.46%	9.49%
XMDAI	ASX Midcap 50 Accumulation Index	-0.51%	35.46%
XSOAI	ASX Small Ordinaries Accumulation Index	-19.56%	54.51%

Benchmarked returns are since inception (23 Dec, 2010) of the Montgomery [Private] Fund and assumes distributions are reinvested.
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Essentially, Monadelphous is de-risking the business and positioning it to cope with continuing profit-margin pressure and client demands for more service efficiency. It is a smart strategy, although critics could argue the transition should have happened earlier and that it adds to investment risks.

From a sentiment point of view, strategic shifts that create efficiencies and diversify earnings are not nearly as sexy as big contract wins and can quickly bore an impatient market. But they can also lay the groundwork for the next growth spurt, and reward long-term investors who can withstand short-term share price pain and volatility.

The critical question, of course, is whether Monadelphous's valuation fairly reflects these opportunities and threats. Montgomery's assessment of intrinsic value for Monadelphous is around $22.00, compared to the current price of $19.03.

That suggests that Monadelphous is trading at a modest discount to intrinsic value. However, mining services stocks must normally offer a substantial margin of safety to attract value investors – such is the earnings uncertainty.

Monadelphous has falling return on equity in the next two years according to consensus forecasts, although still hovering in the 40 per cent area, and falling intrinsic value. Investors should always look for companies heading the other way, with big future increases in ROE and intrinsic value.

This scenario suggests two things. First, that Monadelphous should have a pole position on watchlists for investors who are comfortable with higher-risk sectors, such as mining services. It is on the borderline of value, assuming a high margin of safety is required, and further falls could be a catalyst for more aggressive investors to enter the stock, provided they can withstand any short-term pain.

Secondly, it suggests that there is time for more conservative value investors to assess the situation. The resource sector's transition will take a few years to play out, and Monadelphous itself could have a year or two of consolidation before stronger growth resumes.

Better to let the fog clear a little more and perhaps sacrifice the earliest part of a potential share price recovery, knowing Monadelphous has a long way to recover when the worst for the resource sector is finally over and the sector starts to turn.

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