

25 February 2010

Produced by: RBS Morgans Limited

## Hold

**Important:** The above recommendation has been made on a 12 month view and may not suit your investment needs or timeframe. The basis it is prepared on is summarised on the last page of this report. **PLEASE CONTACT YOUR ADVISER TO DISCUSS THIS GENERAL RECOMMENDATION BEFORE ACTING ON IT.**

### High Volatility

#### Target price

A\$0.42 (from A\$0.46)

#### Price

A\$0.415

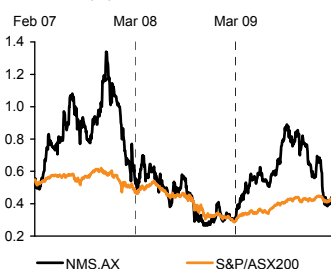
#### Short term (0-60 days)

n/a

NMS100225

#### Price performance

	(1M)	(3M)	(12M)
Price (A\$)	0.47	0.73	0.31
Absolute (%)	-11.7	-42.8	36.1
Rel market (%)	-9.8	-42.3	-2.5
Rel sector (%)	-9.0	-39.8	-6.3



#### Market capitalisation

A\$169.00m (US\$150.74m)

#### Average (12M) daily turnover

A\$1.18m (US\$1.01m)

Sector: BBG AP Eng & Mach  
 Part of: ASX/S&P 300  
 RIC: NMS.AX, NMS AU  
 Priced A\$0.44 at close 24 Feb 2010.  
 Source: Bloomberg

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# Neptune Marine Services

## Underwater but can see blue sky

**A breakeven result was disappointing. However, management is confident of a strong recovery. Until earnings visibility improves and there are signs of a better EPS growth profile, we continue to remain cautious on this stock. Hold.**

#### Key forecasts

	FY08A	FY09A	FY10F	FY11F	FY12F
EBITDA (A\$m)	14.2	43.1	26.2 ▼	42.5 ▼	45 ▼
Reported net profit (A\$m)	7.41	21	6.16 ▼	19.7 ▼	22 ▼
Normalised net profit (A\$m) <sup>1</sup>	10.9	25.1	8.46 ▼	19.7 ▼	22 ▼
Normalised EPS (c) <sup>1</sup>	4.33	8.21	1.96 ▼	4.38 ▼	4.87 ▼
Normalised EPS growth (%)	n/a	89.8	-76.2	124.1	11.2
Dividend per share (c)	0	0	0	1	2
Dividend yield (%)	0	0	0	2.41	4.82
Normalised PE (x)	9.59	5.06	21.2	9.47	8.52
EV/EBITDA (x)	11	4.22	7.13	4.13	3.61
Price/net oper. CF (x)	7.25	3.25	11.6 ▲	6.79 ▲	5.7 ▲
ROIC (%)	18.8	20.4	5.3	8.51	8.78

Use of ▲ ▼ indicates that the line item has changed by at least 5%.

1. Pre non-recurring items and post preference dividends

Accounting standard: IFRS

Source: Company data, RBS Morgans forecasts

year to Jun, fully diluted

#### Result in line with guidance issued late January

NMS reported a normalised NPAT (pre IFRS adj) of A\$1.3m, down from A\$15.6m in the pcp. EBITDA margins contracted from 20.7% to 4.2%, impacted by sharp declines in activity in the USA and South East Asia, deep discounting, a strong AUD and low utilisation rates on NMS's two vessels. Gearing (ND/E) was 8% as of 31 Dec 2009 and EBIT interest cover was 5.6x. Cash flow was -A\$0.6m and overheads appeared high, increasing 30% to A\$8m.

#### Improving market conditions signal a turnaround, but visibility is just three months

NMS reiterated a "strong recovery in profit for the 2H10 and return to growth from FY11" driven by improved vessel utilisation, IRM work shelved during 2009, opportunities in Qatar and improving conditions in the US. Whilst the company continues to apply an integrated model to target larger, longer-term contracts earnings visibility of remains about three months.

#### We remain cautious on the turnaround in the short term

We believe a return to FY09 profitability will be more gradual than previously expected and continue to have concerns about integration risk and management systems. Our FY11 forecast implies an 8% ROI well below the 20% return on acquisitions the company targets.

#### We consider the stock fully priced for its risk profile, Hold

Trading at 10x FY11F recovery earnings is considered fully priced given the risk profile. We maintain our Hold rating and set our target price at our A\$0.42 DCF valuation. In the short term, we believe the stock may struggle to re-rate until management reignites investor confidence by delivering EPS growth. Upside risks are contracts and improved profit performance.

## 1H result summary

- **Reported result:** loss of A\$0.3m, down from A\$12.9m reported in the pcp.
- **Normalised NPAT:** on a normalised basis, NPAT came in at A\$1.3m after adding back inferred interest on deferred payments (A\$1.1m), cost of options (A\$0.4m), interest swap adjustments (-A\$0.3m), and STS acquisition costs (A\$0.4m). The result was in line with guidance issued a month ago, but is well down from A\$15.6m reported in the pcp.
- **EBITDA margins:** revenue was A\$84.3m, down just 12% on the pcp. The main impact on first half profitability was the sharp decline in activity in the USA and South East Asia, deep discounting, strong AUD and low utilisation rates on NMS's two vessels. Consequently, EBITDA margins contracted to 4.2%, down from 20.7% in the pcp.
- **Cashflow:** net operating cashflow was negative, down 110% to -A\$0.6m, impacted by FY09 tax expense. Cash flow is forecast to improve in 2H10.
- **Gearing:** NMS balance sheet is well placed after A\$40m capital raising with gearing (net debt/equity) at 8% as of 31 December 2009. EBIT interest cover is acceptable at 5.6x so long as profitability improves as well as management expects.
- **Overheads:** we were surprised to see corporate and administration expenses increase 31% from A\$6.0m to A\$7.9m for the half. This corporate overhead equates to 9.4% sales, a level we consider high for size of the company. To cover an overhead of this size may make it difficult for acquisitions to price competitively on work they did prior to being acquired. So the NMS businesses need to secure larger scale projects which may come with higher risk.
- **Guidance:** NMS is focused on "returning to profitability" in the remainder of the financial year, which we find ambiguous. We feel the presentation tempered expectations to a 'gradual' return to profitability rather than a 'rebound' to FY09 levels. NMS is working to stabilise the earnings profile to significantly reduce the impact of one-off issues and grow revenue in both Australia and internationally.
- **Outlook:** NMS remains confident of improving trading conditions and prospects in all operating regions, and believes this bodes well for 2HFY10. The company believes market conditions in the US and Asia are showing positive signs of recovery and improvements. NMS anticipates that it is well placed to secure new projects across a range of markets, which offers diversity of earnings. NMS's workforce has increased by 10% indicating management's confidence in the current market. NMS is starting to see cross selling of services accelerate as customers recognise the broader capabilities of the NMS group.
- **Divisionals**
  - **Offshore:** revenue was down 45% to A\$39m and EBIT fell 72% to A\$6.2m. Margins halved from 31% to 16% . The division was impacted a severe decline in drilling and exploration activity in the US, deferral of a large number of Inspection, Repair & Maintenance projects in SE Asia, cancellation/postponement of exploration budgets, strong A\$ and lower margins experienced due to deep discounting in some sectors.
  - **Engineering:** While revenue was up 68% on the pcp to A\$45.3m, EBIT was down 40%. Margins contracted sharply from 12.3% to 4.4%. The Engineering division was impacted by the above mentioned factors. However, it should be noted that margins were heavily eroded through significant discounting in some markets as well as currency fluctuations (depreciation of the UK Pound Sterling had significant impact on profitability). The company is now only bidding on projects that have acceptable terms and this should help improve margins in the full year.

**Table 1 : Half on Half performance**

	1HFY09	1HFY10	% Change
Revenue (A\$m)	95	84	-12%
EBITDA (A\$m)	24.1	3.6	-85%
EBITDA Margin (%)	25.4%	4.3%	-83%
EBIT	18.22	-1.381	-108%
Reported NPAT (A\$m)	12.9	-0.3	-102%
Normalised NPAT (A\$m)	15.6	1.3	-92%
EPS (c)	4.33	0.3	-93%
DPS (c)	0	0	n/a
Net op cash flow (A\$m)	6.4	-0.6	-109%
Net Debt/Equity	17.2%	8.0%	-53%
Divisions			
OFFSHORE			
Revenue	71.431	39	-45%
EBIT (A\$m)	22.537	6.3	-72%
EBIT Margin (%)	31.6%	16.2%	-49%
ENGINEERING			
Revenue	26.942	45.3	68%
EBIT (A\$m)	3.308	2.0	-40%
EBIT Margin (%)	12.3%	4.4%	-64%
Unallocated expenses before interest and tax	7.63	9.68	27%

Source: RBS Morgans

## Acquisition history

**Table 2 : Acquisition history**

Date	Acquisition	Upfront	Deferred	Total Consideration (AUD)	Turnover (\$m)	EBIT (\$m) est on acquisition	Est. EBIT multiple
04-Dec-06	Allied Diving Services, Perth WA - now called Neptune Diving Services	2.7	0.0	2.7	3	0.8	3.6
04-Dec-06	Territory Diving Services, Darwin NT - now called Neptune Diving Services	3.3	1.8	5.1	5	1.0	5.1
02-Mar-07	Subsea Developments, Perth WA	7.3	4.3	11.6	10	1.5	7.8
28-Mar-07	Link Weld Engineering, Perth WA	7.1	2.6	9.7	12	2.0	4.9
06-Jun-07	US Underwater Services, Texas USA	22.5	0.0	22.5	11	4.2	5.3
01-Aug-07	Tri-Surv Geomatics, Perth WA	18.0	14.5	32.5	10	4.6	7.1
01-Apr-08	Sea-Struct, Fremantle WA	17.3	4.4	21.8	9	4.0	5.4
29-Jan-08	Ross Deeptech Initiatives, Aberdeen UK	28.7	0.0	28.7	22	4.7	6.1
01-Jul-08	Access Management, Perth WA	4.6	5.3	9.9	4	1.0	9.9
12-Jan-09	Subsea Engineering Services, Aberdeen UK	13.7	4.3	18.1	9	2.3	7.9
Jul-08	Neptune ROV Supporter \$6.7m + 3 ROVs for \$9m	9.0	9.0	22.7	23	4.5	5.0
Oct-08	Trident \$31.3m	0.0	0.0	31.3	18	6.3	5.0
Nov-09	Submersible Technology services, Aberdeen	29.1	5.9	35.0	20	6.4	5.5

Source: RBS Morgans

## Changes to forecasts

We have become more cautious on sustainable margins going forward, updated our forecasts to reflect higher-than-expected overheads and reduced earnings expectation from NEPSYS. The changes to our forecasts are summarised in the table below.

**Table 3 : Change to forecasts**

	FY10 prev	FY10F rev	% chg	FY11F prev	FY11F rev	% chg	FY12F prev	FY12F rev	% chg
Revenue	170.9	175.9	2.9%	220.8	207.0	-6.3%	240.2	225.5	-6.1%
EBITDA	30.2	26.2	-13.4%	47.0	42.3	-9.9%	50.5	44.8	-11.3%
EBIT	19.5	15.5	-20.7%	36.0	31.4	-12.9%	39.6	33.9	-14.4%
Reported Net Profit	9.2	6.2	-33.1%	23.1	19.6	-15.3%	26.2	21.9	-16.4%
Normalised Net Profit	11.5	8.5	-26.4%	23.1	19.6	-15.3%	26.2	21.9	-16.4%
Operating cash flow	15.0	13.2	-12.1%	31.3	27.3	-12.8%	36.8	32.8	-11.0%
Reported EPS (¢)	2.1	1.4	-33.1%	5.1	4.4	-15.3%	5.8	4.8	-16.4%
Normalised EPS (¢)	2.7	2.0	-26.4%	5.1	4.4	-15.3%	5.8	4.8	-16.4%
Dividend Per Share (¢)	0.0	0.0	n/a	1.0	1.0	0.0%	2.0	2.0	0.0%

Source: RBS Morgans

## Valuation

We value NMS using a DCF valuation methodology. The calculation is based on the parameters in table 4. Following changes to our forecasts, our DCF valuation has decreased to A\$0.42 from A\$0.46 per share.

## Investment view

NMS remains confident of improving trading conditions and prospects in all operating regions, and believes this bodes well for 2HFY10. The company believes market conditions in the US and Asia are showing positive signs of recovery and improvements. NMS anticipates that it is well placed to secure new projects across a range of markets, which offers diversity of earnings. The company has secured about A\$50m worth of new contracts since November 2009. It believes that its 2HFY10 earnings should be further enhanced by the contribution of Submersible Technology Systems (STS) acquired in November 2009 and performing well.

The result was in line with guidance issued a month ago. The concerns we have had for some time about integration risk, cash flow and management stretch have not gone away. NMS has invested some A\$250m in 11 acquisitions, ROVs and vessels over the last three years. Assuming a 15-20% target ROI hurdle rate, NMS should be delivering NPAT (excluding NEPSYS) of A\$37m-50m. A breakeven result in 1H10 has been disappointing.

We remain cautious in our growth projections as the company digests such a rapid number of acquisitions and the businesses take on larger projects.

We maintain a Hold recommendation on NMS for the following reasons:

- Earnings visibility is only three months. Guidance downgrades in December and January highlight the limited visibility management has on earnings. If conditions remain soft or competition intensifies, there is a risk of further downgrades.
- EPS growth profile is negligible and diluted by capital raisings, earnouts and underperforming businesses.
- Concerns we have on integration of acquisitions across country borders and management stretch.
- Execution risk associated with acquisitions taking on larger-scale contracts, of a size they have not done before.
- Trading at 10x FY11F recovery earnings is considered fully priced given the risk profile of the company.

Key downside risks to our target price include underperforming acquisitions, poor integration, vessel underutilisation, dilutionary and cash flow impact of earnouts and key man risk.

Upside risks include faster-than-expected turnaround in profitability and new contracts.

## NMS – financial summary

Year to 30 Jun (A\$m)	AIFRS 2008A	AIFRS 2009A	AIFRS 2010F	AIFRS 2011F	AIFRS 2012F	Closing price (A\$)	0.41	Price target (A\$)	0.42	
<b>Income statement</b>						<b>Valuation metrics</b>				
Divisional sales	88.7	189.0	175.9	208.7	227.4	Preferred methodology	DCF	Val'n (A\$)	\$ 0.42	
Total revenue	89.4	190.9	175.9	208.7	227.4	<b>DCF valuation inputs</b>				
EBITDA	14.2	43.1	26.2	42.5	45.0	Rf	5.25%	10-year rate	5.25%	
Associate income	0.0	0.0	0.0	0.0	0.0	Rm-Rf	6.00%	Margin	2.0%	
Depreciation	-1.5	-7.3	-10.7	-10.9	-10.9	Beta	1.70	Kd	7.25%	
EBITA	12.7	35.9	15.5	31.6	34.1	CAPM (Rf+Beta(Rm-Rf))	15.5%	Ke	15.5%	
Amortisation/impairment	0.0	0.0	0.0	0.0	0.0	E/EV*Ke+D/EV*Kd(1-t)		NPV cash flow (A\$m)	199.6	
EBIT	12.7	35.9	15.5	31.6	34.1	Equity (E/EV)	80.0%	Minority interest (A\$m)	0.0	
EBIT(incl associate profit)	12.7	35.9	15.5	31.6	34.1	Debt (D/EV)	20.0%	Net debt (A\$m)	17.5	
Net interest expense	0.7	-2.2	-3.4	-3.5	-2.6	Interest rate	7.25%	Investments (A\$m)	0.0	
Pre-tax profit	13.2	34.1	12.1	28.1	31.5	Tax rate (t)	30.0%	Equity market value (A\$m)	182.1	
Income tax expense	-2.4	-8.9	-3.6	-8.4	-9.4	<b>WACC</b>	13.4%	Diluted no. of shares (m)	432.5	
After-tax profit	7.4	21.0	6.2	19.7	22.0			<b>DCF valuation (A\$)</b>	<b>0.42</b>	
Minority interests	0.0	0.0	0.0	0.0	0.0					
NPAT	10.9	25.1	8.5	19.7	22.0	<b>Multiples</b>	<b>2009A</b>	<b>2010F</b>	<b>2011F</b>	<b>2012F</b>
Significant items	-3.5	-4.2	-2.3	0.0	0.0	Enterprise value (A\$m)	181.9	186.5	175.7	162.2
NPAT post abnormals	7.4	21.0	6.2	19.7	22.0	EV/Sales (x)	1.0	1.1	0.8	0.7
						EV/EBITDA (x)	4.2	7.1	4.1	3.6
						EV/EBIT (x)	5.1	12.0	5.6	4.8
						PE (pre-goodwill) (x)	5.1	21.2	9.5	8.5
						PEG (pre-goodwill) (x)	3.4	14.1	6.3	5.7
						<b>At target price</b>	<b>2009A</b>	<b>2010F</b>	<b>2011F</b>	<b>2012F</b>
						EV/EBITDA (x)	4.3	7.2	4.2	3.7
						PE (pre-goodwill) (x)	5.1	21.5	9.6	8.6
						<b>Comparable company data (x)</b>	<b>2010F</b>	<b>2011F</b>	<b>2012F</b>	
<b>Cash flow statement</b>	<b>2008A</b>	<b>2009A</b>	<b>2010F</b>	<b>2011F</b>	<b>2012F</b>	Mermaid Marine Aust	EV/EBITDA	10.0	8.8	8.0
EBITDA	14.2	43.1	26.2	42.5	45.0	Year to 30 Jun	EV/EBIT	12.3	10.8	9.8
Change in working capital	2.6	3.6	-3.6	-3.2	0.0		PE	14.1	13.9	13.1
Net interest (pd)/rec	0.6	-1.8	-3.4	-3.5	-2.6		PEG	7.1	6.9	6.6
Taxes paid	-3.0	-5.8	-3.6	-8.4	-9.4	Clough	EV/EBITDA	8.1	7.4	6.7
Other oper cash items						Year to 30 Jun	EV/EBIT	9.2	8.4	7.5
Cash flow from ops (1)	14.4	39.1	15.5	27.4	32.9		PE	13.9	12.6	13.1
Capex (2)	-18.0	-48.9	-14.0	-10.7	-10.9		PEG			
Disposals/(acquisitions)	-48.6	-21.5	-49.5	-9.0	-6.1	<b>Per share data</b>	<b>2009A</b>	<b>2010F</b>	<b>2011F</b>	<b>2012F</b>
Other investing cash flow	-0.6	0.5	0.0	0.0	0.0	No. shares	358.2	447.4	451.0	453.1
Cash flow from invest (3)	-67.2	-70.0	-63.5	-19.7	-17.0	EPS (cps)	6.8	1.4	4.4	4.9
Incr/(decr) in equity	61.1	11.3	44.7	3.2	1.9	EPS (normalised) (c)	8.2	2.0	4.4	4.9
Incr/(decr) in debt	-2.2	30.5	19.0	-11.0	-8.9	Dividend per share (c)	0.0	0.0	1.0	2.0
Ordinary dividend paid	0.0	0.0	0.0	0.0	-4.3	Dividend payout ratio (%)	0.0	0.0	21.6	38.9
Preferred dividends (4)	0.0	0.0	0.0	0.0	0.0	Dividend yield (%)	0.0	0.0	2.4	4.8
Other financing cash flow	0.0	-1.0	0.0	0.0	0.0	<b>Growth ratios</b>	<b>2009A</b>	<b>2010F</b>	<b>2011F</b>	<b>2012F</b>
Cash flow from fin (5)	58.9	40.8	63.7	-7.8	-11.2	Sales growth	113.0%	-6.9%	18.6%	8.9%
Forex and disc ops (6)	-0.6	0.0	0.0	0.0	0.0	Operating cost growth	95.8%	2.7%	11.0%	9.7%
Incr/(decr) cash (1+3+5+6)	5.6	9.9	15.7	0.0	4.6	EBITDA growth			62.5%	5.9%
Equity FCF (1+2+4)	-3.6	-9.8	1.5	16.8	22.0	EBITA growth			104.1%	8.0%
<b>Balance sheet</b>	<b>2008A</b>	<b>2009A</b>	<b>2010F</b>	<b>2011F</b>	<b>2012F</b>	<b>Operating performance</b>	<b>2009A</b>	<b>2010F</b>	<b>2011F</b>	<b>2012F</b>
Cash & deposits	18.2	24.3	37.7	37.7	42.3	Asset turnover (%)	20.0	13.7	14.5	15.1
Trade debtors	19.9	39.4	35.7	42.3	46.1	EBITDA margin (%)	22.8	14.9	20.4	19.8
Inventory	3.3	4.6	4.2	5.0	5.5	EBIT margin (%)	19.0	8.8	15.1	15.0
Investments	0.0	0.0	0.0	0.0	0.0	Net profit margin (%)	13.3	4.8	9.4	9.7
Goodwill	113.3	142.7	192.3	201.3	207.4	Return on net assets (%)	19.7	6.6	12.4	12.4
Other intangible assets	1.4	3.1	3.1	3.1	3.1	Net debt (A\$m)	12.9	17.5	6.7	-6.8
Fixed assets	23.1	69.3	72.6	72.4	72.4	Net debt/equity (%)	7.1	7.5	2.6	-2.5
Other assets	2.5	6.9	5.9	6.1	6.2	Net interest/EBIT cover (x)	16.4	4.6	9.1	12.9
Total assets	181.7	290.3	351.4	367.8	382.9	ROIC (%)	20.4	5.3	8.5	8.8
Short-term borrowings	2.1	12.8	11.0	8.9	7.1	<b>Internal liquidity</b>	<b>2009A</b>	<b>2010F</b>	<b>2011F</b>	<b>2012F</b>
Trade payables	21.5	46.7	39.0	43.3	47.5	Current ratio (x)	1.1	1.5	1.6	1.7
Long-term borrowings	3.5	24.3	44.1	35.5	28.4	Receivables turnover (x)	6.4	4.7	5.4	5.1
Provisions	1.7	9.4	9.4	9.4	9.4	Payables turnover (x)	4.3	3.5	4.0	4.0
Other liabilities	18.9	14.8	14.8	14.8	14.8					
Total liabilities	47.7	108.0	118.3	111.8	107.2					
Share capital	139.8	157.7	202.4	205.7	207.6					
Retained earnings	-3.8	17.2	23.4	43.1	60.8					
Other equity	-2.1	7.0	7.0	7.0	7.0					
Total equity	134.0	181.9	232.8	255.7	275.4					
Minority interest	0.0	0.0	0.0	0.0	0.0					
Total shareholders' equity	134.0	181.9	232.8	255.7	275.4					
Total liabilities & SE	181.7	290.0	351.1	367.5	382.6					

Source: Company data, RBS Morgans forecasts

## RESEARCH TEAM

ROGER LEANING	-	Executive Director - Research	BELINDA MOORE	-	Director - Research
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GOLD COAST	(07) 5592 5777	SCONE	(02) 6544 3144
IPSWICH	(07) 3202 3995	WOLLONGONG	(02) 4227 3022
MACKAY	(07) 4957 3033	<b>MELBOURNE</b>	(03) 9947 41 11
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NOOSA	(07) 5449 9511	BRIGHTON	(03) 9519 3555
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SPRINGWOOD	(07) 3808 7588	TRARALGON	(03) 5176 6055
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SUNSHINE COAST	(07) 5479 2757	<b>CANBERRA</b>	(02) 6232 4999
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TOWNSVILLE	(07) 4771 4577	NORWOOD	(08) 8461 2800
YEPPON	(07) 4939 3021	<b>PERTH</b>	(08) 9261 0888
<b>SYDNEY</b>	(02) 8215 5000	BUNBURY	(08) 9791 9188
ARMIDALE	(02) 6770 3300	<b>DARWIN</b>	(08) 8981 9555
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