

21 January 2010

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Neptune Marine Services

Earnings sink

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\$0.46 (from A\$0.59)

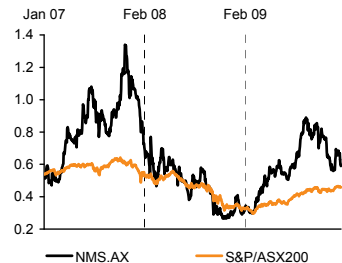
Price
A\$0.51

Short term (0-60 days)
n/a

NMS100121

Price performance

	(1M)	(3M)	(12M)
Price (A\$)	0.56	0.85	0.30
Absolute (%)	-8.9	-40.0	70.0
Rel market (%)	-13.0	-40.3	21.4
Rel sector (%)	-12.6	-38.8	18.1



Market capitalisation

A\$207.69m (US\$189.64m)

Average (12M) daily turnover
A\$1.10m (US\$0.93m)

RIC: NMS.AX, NMS AU
Priced A\$0.51 at close 21 Jan 2010.
Source: Bloomberg

Analysts

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Poor market conditions in the US and delays in contract awards dip vessel contributions into the red. Management expects a strong recovery in the 2H10. With earnings visibility out only three months we consider the stock fully priced trading at PE 10x recovery earnings in FY11.

Key forecasts

	FY08A	FY09A	FY10F	FY11F	FY12F
EBITDA (A\$m)	14.20	43.10	30.20 &	47.00 &	50.50 &
Reported net profit (A\$m)	7.41	21.00	9.20 &	23.10 &	26.20 &
Normalised net profit (A\$m) ¹	10.90	25.10	11.50 &	23.10 &	26.20 &
Normalised EPS (c) ¹	4.33	8.21	2.66 &	5.14 &	5.79 &
Normalised EPS growth (%)	n/a	89.80	-67.6	93.40	12.70
Dividend per share (c)	0.00	0.00	0.00	1.00	2.00
Dividend yield (%)	0.00	0.00	0.00	1.96	3.92
Normalised PE (x)	11.80	6.21	19.20	9.92	8.80
EV/EBITDA (x)	13.70	5.12	7.40	4.45	3.79
Price/net oper. CF (x)	8.91	3.99	12.70 &	7.31 &	6.27
ROIC (%)	18.80	20.40	6.69	9.67	10.20

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

year to Jun, fully diluted

1. Pre non-recurring items and post preference dividends

Accounting standard: IFRS

Source: Company data, RBS Morgans forecasts

Downgrades 1H10 guidance to breakeven to A\$1m loss

NMS has downgraded guidance from a "weak 1H" to a net loss after tax of A\$1m. This compares to an A\$15.6m NPAT in the pcq and well below the A\$7m we were expecting. Management still maintains that there will be a strong turnaround in profit and earnings for 2HFY10 and into FY11. It appears that a decline in drilling activity in the US, cancellation of exploration budgets, deferral of a number of Inspection, Repair & Maintenance projects, negatively impacting vessel/ROV utilisation rates, and lower margins due to strong competition has all impacted the bottom line.

We continue to wait for an appropriate ROI and EPS growth profile

Concerns we have had about integration risk and management stretch look to be emerging. NMS has invested some A\$250m in 11 acquisitions, ROVs and vessels since December 2006. Assuming a 15-20% target ROI hurdle rate, NMS should be delivering NPAT (excluding NEPSYS) of A\$37m-50m. A loss in 1HFY10 is extremely disappointing and tarnishes confidence in management. Excluding NEPSYS, our FY11 NPAT forecast is now A\$23m.

Cautious stance on the turnaround in the short term – Hold

Our DCF valuation falls to A\$0.44 from A\$0.59. Looking through a poor FY10 into a US-led recovery in FY11, we set our target price at an FY11F PE of 10x or A\$0.46. We maintain our Hold rating taking a 12-month view but in the short term we believe the stock will struggle to re-rate until management reignites investor confidence by delivering EPS growth. Upside risks are contracts. Downside risk is loss of key personnel, execution risk, vessel utilisation and decline in market conditions.

Significant earnings downgrade

NMS has announced that it is now forecasting 1HFY10 NPAT/NLAT in the range of breakeven to a loss of A\$1m. We were expecting a significantly weak 1H but this is well below our expectations. Management had previously flagged a soft 1H10 but promised a strong 2H based on good growth prospects. Management still maintains that there will be a strong turnaround in profit and earnings for 2HFY10 and into FY11.

NMS says it has been negatively impacted by a sharper-than-expected decline across both the US and South-East Asian markets during the first half of this year, specifically the:

- sudden and significant decline in drilling and exploration activity in the US due to very low natural gas pricing in the domestic market;
- cancellation/postponement of exploration budgets throughout most operating regions;
- deferral of a large number of Inspection, Repair & Maintenance projects in SE Asia that negatively impacted on vessel and ROV utilisation rates;
- strength of the Australian dollar; and
- lower margins due to deep discounting in some sectors.

Changes to forecasts

We have downgraded our FY10, FY11 and FY12 NPAT forecasts by 52%, 24% and 23%, respectively, to reflect guidance and the competitive market conditions. The changes to our forecasts are summarised in the table below.

Table 1 : Changes to forecasts

	FY10 prev	FY10F rev	% chg	FY11F prev	FY11F rev	% chg	FY12F prev	FY12F rev	% chg
Revenue	200.7	170.9	-14.8%	238.8	220.8	-7.5%	258.7	240.2	-7.2%
EBITDA	47.1	30.2	-35.9%	56.4	47.0	-16.7%	60.4	50.5	-16.4%
EBIT	36.4	19.5	-46.4%	45.5	36.0	-20.7%	49.5	39.6	-20.0%
Reported net profit	21.6	9.2	-57.4%	30.6	23.1	-24.4%	33.9	26.2	-22.8%
Normalised net profit	23.9	11.5	-51.9%	30.6	23.1	-24.4%	33.9	26.2	-22.8%
Operating cash flow	24.0	15.0	-37.4%	40.3	31.3	-22.3%	44.5	36.8	-17.2%
Reported EPS (c)	5.0	2.1	-57.4%	6.8	5.1	-24.3%	7.5	5.8	-22.7%
Normalised EPS (c)	5.5	2.7	-51.9%	6.8	5.1	-24.3%	7.5	5.8	-22.7%
Dividend per share (c)	0.0	0.0	0.0%	1.0	1.0	0.0%	2.0	2.0	0.0%

Source: RBS Morgans forecasts

Acquisition history

Table 2 : Acquisition history (A\$m)

Date	Acquisition	Upfront	Deferred	Total consideration	Annualised profit on acquisition	Profit multiple
04-Dec-06	Allied Diving Services, Perth WA	2.7	0.0	2.7	0.72	3.8
04-Dec-06	Territory Diving Services, Darwin NT	3.3	1.8	5.1	0.67	7.5
02-Mar-07	Subsea Developments, Perth WA	7.3	4.3	11.6	1.95	6.0
28-Mar-07	Link Weld Engineering, Perth WA	7.1	2.6	9.7	3.11	3.1
06-Jun-07	US Underwater Services, Texas USA	22.5	0.0	22.5	4.88	4.6
01-Aug-07	Tri-Surv Geomatics, Perth WA	18.0	14.5	32.5	8.9	3.7
01-Apr-08	Sea-Struct, Fremantle WA	17.3	4.4	21.8	4.0	5.5
29-Jan-08	Ross Deeptech Initiatives, Aberdeen UK	28.7	0.0	28.7	4.6	6.3
01-Jul-08	Access Management, Perth WA	4.6	5.3	9.9	1.3	7.7
12-Jan-09	Subsea Engineering Services, Aberdeen UK	13.7	4.3	18.1	2.0	9.2
Jul-08	Neptune ROV Supporter A\$6.7m + 3 ROVs for A\$9m	9.0	9.0	22.7	0.0	!
Oct-08	Trident A\$31.3m	0.0	0.0	31.3	4.7	6.7
Nov-09	Submersible Technology services, Aberdeen	29.1	5.9	35.0		
Total		163.5	52.2	251.7	36.7	

Source: RBS Morgans

Valuation and 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 recently 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) that was performing well.

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. Today's downgrade comes following recent guidance in December 2009 when we downgraded FY10 NPAT forecasts 20%. We have downgraded the FY10 forecast a further 52% today to meet revised guidance a couple of months later. This highlights 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 risks to our target price include underperforming acquisitions, poor integration, vessel underutilisation, dilutionary and cash flow impact of earnouts and key man risk.

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For listed property trusts (LPTs) the recommendation is based upon the target price plus the dividend yield, ie total return. A Buy implies a total return of 10% or more; a Hold 5-10%, and a Sell less than 5%.

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