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SAUNDERS INTERNATIONAL LIMITED (SND)

Wilson HTM INVESTMENT GROUP | *A Leading Wealth Manager and Adviser to Emerging Companies*

BUY HOLD SELL

ACTION & RECOMMENDATION

We initiate coverage of specialist bulk liquid storage tank construction and maintenance company Saunders International with a BUY rating. We believe that Saunders is a well-managed business with a long track record of achieving very high returns on capital. We see Australia's continuing transition into a net petrochemical importer, the mining industry moving to production phase and the increasing focus of state water boards on water security as providing a range of opportunities for Saunders to prosper into the future.

12m Target Price (AUD)	**$1.00**
Share Price @ 09-Sep-13 (AUD)	$0.86
Fcst 12m Capital Return	16.8%
Fcst 12m Dividend Yield	6.4%
12m Total S'holder Return	**23.2%**

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Building a future around liquid assets

Initiating Coverage

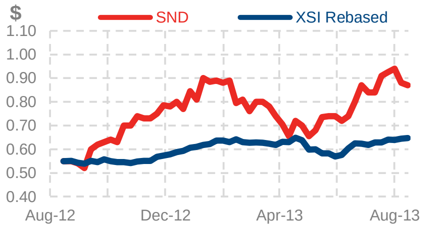
What's Changed

- **Business overview.** Saunders provides tank design and construction services for the oil and gas industry, fuel terminal sector, mining and mineral processing industry, and water and waste water infrastructure sector. It also provides facilities maintenance services to petroleum refineries and distributors as well as oil and gas producers.
- **Growth options.** We see Australia's continuing transition into a net petrochemical importer (hastened by announced refinery closures), the mining industry moving to production phase (with requirements for large volumes of chemicals) and the increasing focus of state water boards on water security as providing a range of opportunities for Saunders to prosper into the future.
- **Forecasts.** We forecast FY14e EBIT growth of 9.1% to $7.8m. This indicates an NPAT of $5.9m and EPS of $0.074.
- **Valuation.** We initiate coverage with a BUY rating. Our 12-month target of $1.00 per share is set as a blend of our peer-reviewed EV/EBIT capitalisation valuation and discounted cash flow valuation.

Risks & Catalysts

- **Risk:** Changes to the oil industry that reduce/remove need for additional storage capacity; cancellation of mine development leading to mid-term production cancellation/slowdown.
- **Catalysts:** Level of petrochemical imports – driven by national demand; demand for maintenance services on existing tank infrastructure.

12m Share Price Performance

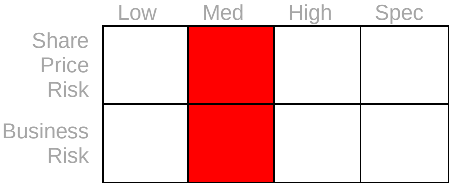


	1m	6m	12m
Abs. Return (%)	1.1	10.4	67.3
Rel. Return (%)	-3.3	9.3	49.6

WHTM Return Re-investment Matrix

Return	Low Re-Investment	High Re-Investment
High	**Cash Generator**	Champion
Low	Challenged	Potential

WHTM Risk Assessment



Year-end June (AUD)	FY12A	FY13A	FY14E	FY15E	FY16E
NPAT Rep ($m)	4.9	5.4	5.9	6.4	6.8
NPAT Norm ($m)	5.0	5.4	5.9	6.4	6.8
Consensus NPAT ($m)					
EPS Norm (cps)	6.4	6.9	7.4	8.1	8.5
EPS Growth (%)	11	7	9	8	6
P/E Norm (x)	13.4	12.5	11.5	10.6	10.0
EV / EBITDA (x)	7.7	7.0	6.5	5.9	5.6
FCF Yield (%)	5.7	5.5	9.2	9.2	9.8
DPS (cps)	9.0	5.0	5.5	5.5	5.5
Dividend Yield (%)	10.5	5.8	6.4	6.4	6.4
Franking (%)	100	100	100	100	100

Mkt Cap: $69m **Enterprise Value:** $54m **Shares:** 79m **Sold Short:** %

Key Changes		Before	After	Var %
NPAT:	**FY14**		5.9	
Norm	**FY15**		6.4	
($m)	**FY16**		6.8	
EPS:	**FY14**		7.4	
Norm	**FY15**		8.1	
(cps)	**FY16**		8.5	
DPS:	**FY14**		5.5	
(cps)	**FY15**		5.5	
	FY16		5.5	
Price Target:			**1.00**	
Rec:			**BUY**	

ASX 300 wgt: n/a **Median T'over/Day:** $0.0m

PRICE TARGET

	Valuation	Price Target
Cost of equity (%)	12.0	
Equity component (%)	100.0	
Cost of debt (%)	8.0	
Debt tax advantage (%)	30.0	
Debt component (%)	0.0	
DCF enterprise	**69.33**	
Option exercise	0.0	
less Net debt	12.9	
Equity Value	82.3	
Diluted shares on issue	79.0	
TOTAL ($ / Share)	**1.04**	**1.00**

INTERIMS ($m)

Half Yr (AUD)	Dec 12	Jun 13	Dec 13	Jun 14
	1H A	2H A	1H E	2H E
Sales	28.2	31.7	29.9	33.6
EBITDA	3.7	4.0	4.0	4.4
EBIT	3.6	3.6	3.7	4.1
Net Profit	**2.7**	**2.7**	**2.8**	**3.1**
Norm. EPS	**3.4**	**3.5**	**3.5**	**3.9**
EBIT/Sales	12.6	11.4	12.4	12.3
Dividend (c)	2.0	3.0	2.5	3.0
Franking (%)	100.0	100.0	100.0	100.0

FINANCIAL STABILITY

Year-end June (AUD)	FY13A	FY14E	FY15E
Net Debt	-12.9	-14.9	-16.9
Net Debt / Equity (%)	<0	<0	<0
Net Debt / EV (%)	**<0**	**<0**	**<0**
Current Ratio (x)	2.6	3.1	3.2
Interest Cover (x)	<0	<0	<0
Adj. Cash Int. Cover (x)	**<0**	**<0**	**<0**
Debt / CashFlow (x)	0.0	0.0	0.0
Net Debt (cash) / share	<0	<0	<0
NTA / share ($)	0.2	0.2	0.3
Book Value / share ($)	0.2	0.2	0.3
Payout Ratio (%)	73	74	68
Adj. Payout Ratio (%)	210	69	69

EPS RECONCILIATION ($m)

	FY13A		FY14E	
	Rep.	Norm.	Rep.	Norm.
Sales Revenue	60	60	63	63
EBIT	7.2	7.2	7.8	7.8
Net Profit	**5.4**	**5.4**	**5.9**	**5.9**
Notional Earn.	0.0	0.0	0.0	0.0
Pref./Conv. Div.	0.0	0.0	0.0	0.0
Profit for EPS	**5.4**	**5.4**	**5.9**	**5.9**
Diluted Shrs(m)	79	79	79	79
Diluted EPS (c)	**6.9**	**6.9**	**7.4**	**7.4**

RETURNS

	FY13A	FY14E	FY15E	FY16E
ROE (%)	31.0	34.1	33.5	31.8
ROIC (%)	200.9	162.9	188.3	196.9
Incremental ROE	-107.8	-199.3	27.9	17.0
Incremental ROIC	37.6	52.7	-259.3	1,719.6

KEY ASSUMPTIONS

Year-end June (AUD)	FY09A	FY10A	FY11A	FY12A	FY13A	FY14E	FY15E	FY16E
Revenue Growth (%)		-20.7	18.7	-12.8	31.9	5.9	8.0	5.0
EBIT Growth (%)		18.8	8.5	15.3	11.2	9.1	9.1	5.1
NPAT Growth (%)		20.0	12.7	11.4	7.3	8.5	8.4	5.9
EPS Growth (%)		**20.0**	**12.7**	**11.4**	**7.3**	**8.5**	**8.4**	**5.9**
EBIT / Sales (%)		11.8	10.7	14.2	12.0	12.3	12.4	12.5
Tax Rate (%)		30.0	28.0	28.0	30.0	30.0	30.0	30.0
ROA (%)		**19.3**	**22.0**	**24.8**	**27.1**	**29.7**	**30.6**	**29.3**
ROE (%)		**23.1**	**25.8**	**28.7**	**32.2**	**34.0**	**33.5**	**31.7**
Design and construction EBIT ($m)					4.6	5.0	5.5	5.8
Maintenance EBIT ($m)					3.5	3.8	4.0	4.2

PROFIT & LOSS ($m)

Year-end June (AUD)	FY09A	FY10A	FY11A	FY12A	FY13A	FY14E	FY15E	FY16E
Sales Revenue	55.3	43.9	52.1	45.4	59.9	63.5	68.6	72.0
EBITDA	5.2	6.0	6.2	7.0	7.7	8.3	9.1	9.6
Depn & Amort	0.9	0.8	0.6	0.5	0.5	0.5	0.6	0.6
EBIT	**4.3**	**5.2**	**5.6**	**6.5**	**7.2**	**7.8**	**8.5**	**9.0**
Net Interest Expense	-0.4	-0.6	-0.7	-0.6	-0.6	-0.6	-0.6	-0.7
Tax	1.4	1.7	1.8	2.0	2.3	2.5	2.7	2.9
Minorities / pref divs	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Equity accounted NPAT	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net Profit pre Sig. Items	**3.4**	**4.0**	**4.5**	**5.0**	**5.4**	**5.9**	**6.4**	**6.8**
Abn's / Ext's / Signif.	0.0	0.0	0.0	-0.1	0.0	0.0	0.0	0.0
Reported Net Profit	**3.4**	**4.0**	**4.5**	**4.9**	**5.4**	**5.9**	**6.4**	**6.8**

CASHFLOW ($m)

Year-end June (AUD)	FY09A	FY10A	FY11A	FY12A	FY13A	FY14E	FY15E	FY16E
EBITDA	5.2	6.0	6.2	7.0	7.7	8.3	9.1	9.6
Interest & Tax	0.4	0.6	0.7	0.6	0.6	0.6	0.6	0.7
Working Cap / Other	-1.4	1.8	-7.4	-3.4	-3.1	-2.1	-2.8	-2.9
Operating Cash Flow	**4.2**	**8.4**	**-0.5**	**4.1**	**5.1**	**6.8**	**6.9**	**7.3**
Maintenance Capex	-0.3	-0.4	-0.1	-0.2	-1.4	-0.5	-0.5	-0.6
Free Cash Flow	**4.0**	**8.0**	**-0.6**	**3.9**	**3.8**	**6.3**	**6.3**	**6.7**
Dividends Paid	-2.4	-2.4	-3.1	-3.2	-7.9	-4.3	-4.3	-4.3
Growth Capex	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Invest. / Disposals	0.1	0.3	0.0	0.0	0.0	0.0	0.0	0.0
Other Inv. Flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Cash Flow Pre Financing	**1.8**	**5.9**	**-3.8**	**0.8**	**-4.1**	**1.9**	**2.0**	**2.4**
Funded by Equity	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Funded by Debt	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Funded by Cash	-1.8	-5.9	3.8	-0.8	4.1	-1.9	-2.0	-2.4

BALANCE SHEET SUMMARY ($m)

Year-end June (AUD)	FY09A	FY10A	FY11A	FY12A	FY13A	FY14E	FY15E	FY16E
Cash	14.2	20.1	16.3	17.1	12.9	14.9	16.9	19.3
Current Receivables	7.3	4.2	5.9	8.0	9.8	8.1	8.7	9.1
Current Inventories	1.1	0.7	0.3	0.4	1.6	1.0	1.1	1.1
Net PPE	2.4	1.8	1.3	0.9	1.8	1.8	1.8	1.8
Investments	0.3	0.0	0.1	0.0	0.0	0.0	0.0	0.0
Intangibles / Capitalised	0.9	0.9	1.0	0.9	1.0	1.0	1.0	1.0
Other	0.0	0.1	0.0	0.2	0.1	0.1	0.1	0.1
Total Assets	**26.2**	**27.7**	**24.9**	**27.5**	**27.2**	**26.8**	**29.6**	**32.4**
Current Payables	7.4	6.3	5.3	5.4	6.2	5.3	5.7	5.9
Total Debt	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other Liabilities	2.0	3.0	2.4	3.6	4.5	3.6	3.8	4.0
Total Liabilities	**9.4**	**9.2**	**7.7**	**9.0**	**10.7**	**8.8**	**9.5**	**10.0**
Minorities / Convertibles	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Shareholder Equity	**16.8**	**18.4**	**17.2**	**18.5**	**16.5**	**18.0**	**20.1**	**22.5**
Total Funds Employed	**16.8**	**18.4**	**17.2**	**18.5**	**16.5**	**18.0**	**20.1**	**22.5**

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Investment overview

COMPANY

Saunders International is an Australia-based company engaged in engineering and construction. Saunders focuses on the design, construction and maintenance of steel bulk liquid storage tanks and the project management of ancillary facilities.

RECOMMENDATION AND 12-MONTH PRICE TARGET

We initiate coverage of Saunders International with a BUY rating and a 12-month price target of $1.00 a share.

KEY DRIVERS OF INVESTMENT VIEW

The move towards greater petrochemical import reliance. Australia is becoming increasingly reliant on imported oil as our domestic production ages and declines. This should see continuing growth in demand for port access and the requisite storage capability and volume that this will entail.

Diesel use in mining regions to continue to grow. Oil refiner and distributor Caltex expects that demand for diesel in Australia's mining regions will continue to grow as mines under development move into the production stage of their life cycles.

Move from mine construction to production processing. Saunders can build tanks for the containment of highly toxic chemicals used in various ore leaching processes to produce refined metals such as gold, copper and nickel as projects under construction come into production in the next 3-4 years.

Facilities management. Saunders has maintenance contracts in place with six of Australia's seven remaining oil refineries. These relationships should continue even after refineries cease production and are converted to a storage terminal focus.

Focus on water security. A long-standing association with state water boards. Awareness of the value of and need for water security by states and regional councils should mean Saunders is able to continue to bid for a consistent flow of regional water infrastructure projects.

Experienced management team with very sound balance sheet. Three of Saunders' board members each have more than 30 years' relevant industry experience. Prior to becoming Saunders' MD in 2003, Mr John Power had gained 25 years of experience in the sector's leading player, Chicago Bridge & Iron. The Saunders balance sheet is very clean with no debt and cash of $12.9m at 30 June 2013, equivalent to 78% of net assets.

Potential for partnerships with larger synergistic firms. There are arguments both for and against Saunders becoming part of a larger construction group. In a merged entity, a streamlined tendering process could help it win additional work. However, currently Saunders may be able to bid for work on a given project that a potential merger-partner may not be invited to tender for.

VALUATION

Our 12-month target of $1.00 per share is set as a blend of our peer-reviewed EV/EBIT capitalisation valuation and discounted cash flow valuation.

Our EV/EBIT capitalisation valuation draws on a review of Netherlands-based, global leader, Chicago Bridge & Iron (NYSE: CBI) and its FY14 consensus trading multiples (8.7x). We apply an EV/EBIT of 8.0x to our FY14 EBIT estimate, providing a valuation of $0.96/sh. We view EV/EBIT as the appropriate metric, given a P/E-based valuation would not take account of Saunders' substantial net cash position that is worth around 20% of its market capitalisation.

While some discount for Saunders' relative size may be seen as appropriate we see its strong net cash position, exposure to maintenance services and lack of exposure to high risk activities, such as nuclear power plant construction, as providing it a relatively lower risk profile than its larger peer.

TABLE 1: PEER REVIEW – EARNINGS CAPITALISATION

Peer comparison (consensus)			EV/ EBITDA		EV/ EBIT		P/E	
Yr to Dec			FY14e	FY15e	FY14e	FY15e	FY14e	FY15e
Chicago Bridge & Iron	NYSE:CBI	x	7.4	7.1	8.7	8.1	11.8	10.9
Saunders International	SND	x	6.6	5.8	7.0	6.2	11.7	10.8
Discount		%	-11%	-17%	-19%	-24%	-1%	0%

Source: WHTM, Bloomberg (Consensus as at 16 August)

We also derived a three-stage DCF valuation that comprises specific forecasts through to FY16, followed by 3.5% annual growth to FY20 and a terminal growth rate of 2.5%. We have a cost of equity of 12% and no debt (weighted average cost of capital 12%). This provides a valuation of $1.04/sh.

TABLE 2: DISCOUNTED CASH FLOW VALUATION

DCF Valuation		Value
Cost of equity	%	12.0
Equity component	%	100.0
Cost of debt	%	8.0
Debt tax advantage	%	30.0
Debt component	%	0.0
WACC	**%**	**12.0**
DCF enterprise valuation	$m	69.3
Option exercise	$m	0.0
less avg net debt	$m	12.9
Equity Value	**$m**	**82.3**
Diluted shares on issue	m	79.0
WHTM valuation	**$/sh**	**1.04**
NTA 30 Jun 13	$/sh	0.209

Source: WHTM, SND

FINANCIALS SUMMARY

A summary of our key financials is included below. Refer to page 13 for our detailed financials review.

TABLE 3: KEY FINANCIALS

Key Financials							
Yr to Jun		FY11	FY12	FY13	FY14e	FY15e	FY16e
EBIT (normalised)	**$m**	**5.6**	**6.5**	**7.2**	**7.8**	**8.5**	**9.0**
- growth	*%*	*8%*	*15%*	*n/a*	9%	9%	5%
NPAT (normalised)	**$m**	**4.5**	**5.0**	**5.4**	**5.9**	**6.4**	**6.8**
- growth	*%*	*13%*	*11%*	7%	9%	8%	6%
EPS (normalised)	**cents**	**5.7**	**6.4**	**6.9**	**7.4**	**8.1**	**8.5**
- growth	*%*	*13%*	*11%*	7%	9%	8%	6%
FCF	**$m**	**-0.6**	**3.9**	**3.8**	**6.3**	**6.3**	**6.8**
- growth	*%*	*n/a*	*n/a*	*-4%*	67%	1%	7%
Net debt (cash)	**$m**	**-16.3**	**-17.1**	**-12.9**	**-14.9**	**-17.1**	**-19.2**

Source: WHTM, SND, Iress

INVESTMENT RISKS

Risks include but are not limited to:

- **Reliance on key clients and contracts.** Saunders reported 13 customers in FY13 (10 of which were repeats). The loss of only a small number of clients would have a material impact on Saunders' revenues and profitability. Similarly, a delay in a previously contracted project could place a strain on Saunders' operating metrics.
- **Fixed price contracts.** A significant portion of the company's revenue is derived from fixed price contracts. Negative impacts on a contract could include: unforeseen technical/design problems; failure to perform of subcontractors; and unexpected delays.
- **Operational risks.** Saunders is ultimately responsible for the final design and delivery of its storage tanks and so is exposed to the risk of failure from both poor design and faulty construction. There is OH&S risk involved in many of Saunders' projects and an accident may have substantial financial (short term) and reputational (long term) impact on the company.
- **Skilled labour constraints.** The ability to retain and hire appropriately skilled labour is critical to business success. The mining sector has been competing strongly for the past several years but this has reduced in recent times.
- **Cyclicality of business.** Saunders has a large exposure to clients in the hydrocarbon, mineral processing and water storage industries. Demand for Saunders' services will be affected by pricing and demand of products removed from Saunders' specific business.
- **Reliance on suppliers.** Securing materials and services in a timely manner and at agreed prices is particularly important given the largely fixed-price nature of contracts. In some materials, there are few or only one supplier of that product.

Company overview

Saunders provides tank design and construction services for the fuel terminal sector, oil and gas industry, water and waste water infrastructure sector, and mining and mineral processing industry; we estimate Saunders has a 33%-40% market share in the bulk tank industry. Saunders also provides facilities and maintenance to petroleum refineries and distributors and oil and gas producers. Management believes it is the largest player in this space.

HISTORY

Saunders International was founded as VG Saunders Pty Ltd in 1951 but did not list on the ASX until late 2007. The company has always specialised in the design and construction of bulk storage solutions for liquids in the form of tanks and reservoirs. Saunders has developed a symbiotic expertise in facilities management.

BUSINESS MODEL

The products and services provided by Saunders incorporate a wide range of specialist skills which include engineering analysis and design, procurement, fabrication, construction and project management. Saunders also provides ongoing specialist services around tank inspection and evaluation and maintenance.

In design & construction (D&C), Saunders tenders for projects. Work on a successful project usually commences within 3-6 months of the announcement and can generally takes a period of 6-12 months after that time to complete a new development. In the maintenance arm, contracts are generally awarded for multi-year periods (1-5 years).

In both maintenance and D&C, Saunders employs a majority full-time staff. Key D&C staff are shifted around the country as work demands. On some D&C projects Saunders will use local tradesman to assist its permanent staff – these tradesman often become repeat temporary staff should Saunders win further contracts in a particular region.

STRATEGY

Saunders aims to leverage its six decades of experience through providing clients specialist knowledge and experience in steel bulk storage tank design, construction and maintenance. Management sees its complete tankage design, construction and maintenance solution as a key competitive advantage. In addition, Saunders has developed specialist techniques for working in a variety of geographies and climatic regions.

OPERATIONS

Design and construction. Saunders is one of a limited number of engineering firms in Australia with a national focus and capability in the design and construction of industrial-scale steel storage tanks and facilities.

Oil refiners and distributors contribute more than 50% of revenue. Distributors are increasingly appearing outside of the traditional “oil majors” as port operators take advantage of Australia’s continuing shift to reliance on hydrocarbon imports. Resource and oil and gas production provides the next leg of revenue, which we estimate to be approximately 30%, with the water authorities feeling the effects of budget tightening (and likely to contribute around 10% of revenue in the next few years). The balance comes in the form of smaller, ad-hoc projects in other industries.

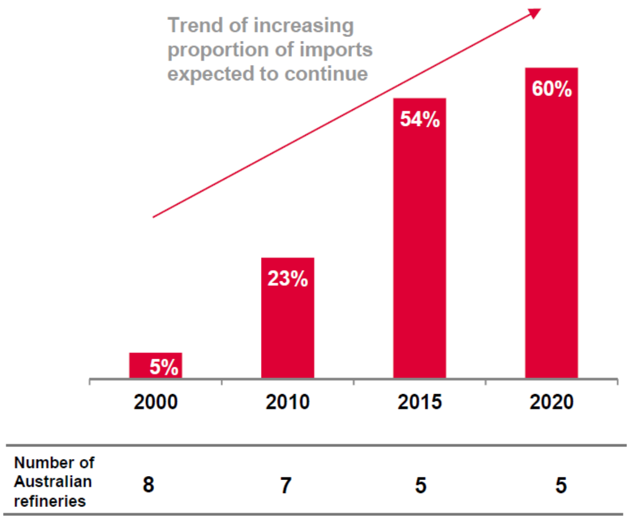
Facilities maintenance. Saunders management believes that it is the largest provider of proactive maintenance and repair services for steel storage tanks to the petroleum refining and distribution sector. Saunders is the principal supplier of such services to five of Australia’s six major operating petroleum refineries.

GROWTH OPPORTUNITIES

Move towards greater oil import reliance. Australia is becoming increasingly reliant on imported oil as our domestic production ages and declines.

This should see continuing growth in demand for port access and the requisite storage capability and volume that this will entail.

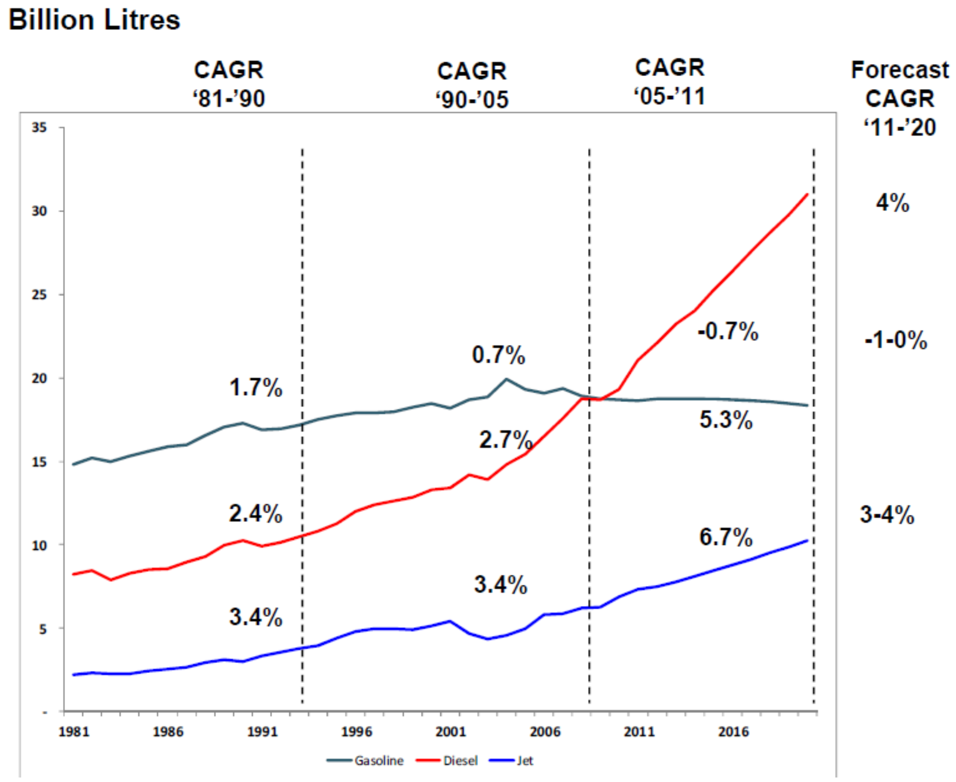
CHART 1: AUSTRALIAN IMPORTS OF TRANSPORT FUELS (% OF TOTAL)



Source: Caltex presentation (with ABARES)

With cessation of oil refining having already occurred at Shell Clyde and the announced end for Caltex’s Sydney operations, we see the potential for new work in converting or replacing existing refinery and terminal storage capacity to meet the new needs of an import-focused petrochemical market.

CHART 2: CALTEX-AUSTRALIA FUEL USE FORECAST BY PRODUCT



Source: Caltex presentation (with ABARES, DRET, Caltex)

Diesel use in mining regions to continue to grow. Caltex expects that demand for diesel in Australia's mining regions will continue to grow as mines under development move into the production stage of their life cycles.

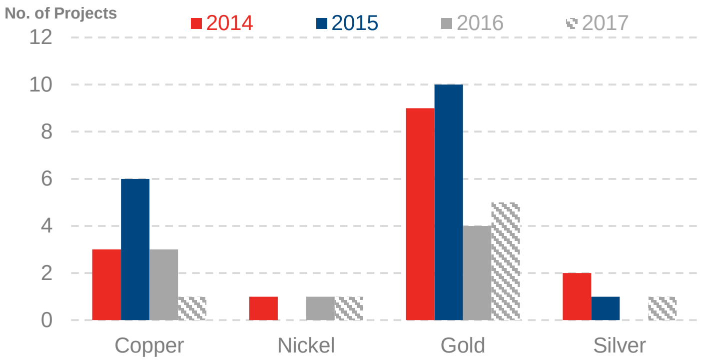
Saunders' FY13 presentation highlights that Western Australia has provided the largest share of work in recent times, with the company noting that work is focused on WA's Pilbara mining region.

We see this being a continuing trend as remote mining regions seek to have a local large-scale storage system to reduce reliance on major city/coastal-focused storage and distribution networks. Works around Newcastle Port are said to be expanding at the moment.

Move from mine construction to production processing. Saunders can build tanks for the containment of highly toxic chemicals used in various ore leaching processes to produce refined metals such as gold, copper and nickel.

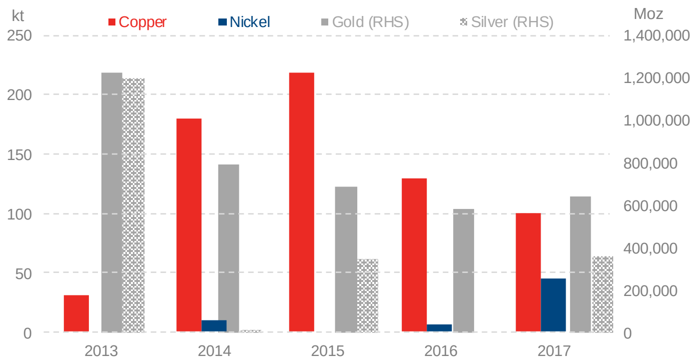
There are a large number of metals mining projects under construction or committed that are due to come into production in the next 3-4 years. These projects will need specialist storage capability prior to commencement of production. We see Saunders as well placed to win a portion of this work.

CHART 3: FORECAST NEW PROJECTS ENTERING PRODUCTION



Source: Bureau of Resources and Energy Economics (June 2013)

CHART 4: FORECAST NEW METALS PRODUCITON (AUST.)



Source: Bureau of Resources and Energy Economics (June 2013)

Facilities management. Saunders has maintenance contracts in place with five of Australia's six remaining oil refineries. It also provides maintenance services for a range of private and public tank infrastructure sites. Management sees a continuing if not varied role in maintaining oil refiners' facilities even after they cease production as the sites will be used for storage long after production has ceased.

Facilities management has been a very valuable component of Saunders' business, contributing 45% of revenue in 1H13. An increase in the national installed tankage capacity should continue to provide new opportunities for Saunders Maintenance.

Water boards. Saunders has a long-standing association with state water boards. It can supply very large-scale water storage tanks as well as "wine-glass" tanks (tanks that sit on top of a column to create water pressure).

Awareness of the value of and need for water security by states and regional councils should mean Saunders is able to continue to bid for a consistent flow of regional water infrastructure projects.

Partnering with a large industrial construction company. Saunders' major competitor – Chicago Bridge & Iron – is a fully integrated construction company that can offer a full turn-key solution of which tanks are but one core component.

We see there being potential synergies for Saunders in entering into a strategic partnership with a national infrastructure construction company so that both parties can work to provide one unified bid for relevant projects, making their offering more on par with CBI as well as providing potential clients with a single, domestic, construction partner.

Industry overview

MARKET

Saunders operates in the Australia-Pacific steel bulk liquid tank design, construction and maintenance industry. The demand for large-scale steel storage tanks will be affected by general economic conditions and changes in local import/export mix of petrochemicals; growth of oil and gas exploration; and growth in the need for specialist chemical storage in mineral processing and regional water storage and delivery needs.

Storage tanks are generally constructed above ground and can be up to 80 metres in diameter and 30 metres high (150 million litres). Tanks are generally constructed on-site from pre-fabricated components. A common alternative is a wine-glass shape utilised by water boards to assist with water pressure creation. Water authorities sometimes require certain grades of concrete be used in place of steel.

COMPETITORS

Market share: Saunders management estimates that the bulk liquid storage tank design and construction industry in Australia generates annual revenues of $80-100m. This implies Saunders has a design and construction market share of approximately 33% to 40%. Saunders' major competitors are either too large to provide estimates to that level of detail or too local region-specific to focus on national markets.

In the maintenance market Saunders believes it is the largest player in proactive inspection and maintenance.

Major competitors include:

- Chicago Bridge & Iron: Netherlands-based Chicago Bridge & Iron Company N.V. (NYSE: CBI) provides design, engineering, construction, fabrication, maintenance and environmental services. CBI builds and repairs refineries, nuclear power stations, LNG terminals, steel storage tanks, process vessels, and low temperature and cryogenic storage facilities. CBI offers its services worldwide to the oil and gas, infrastructure, wastewater and power industries.
  - CBI had Australian sales of US$667m across a range of construction projects beyond purely tanks and global sales of US$5.5bn in FY12. Global FY12 EBIT was $437m (7.9% margin).
  - CBI has a market capitalisation of US$6.5bn.
  - Has a major contract (worth $3.4bn) to construct three trains for the Browse LNG project in WA.
- Brockman: A subsidiary of ASX-listed EVZ Ltd (ASX: EVZ). Brockman, which is based in Corio (Geelong), designs, manufactures and installs large steel tanks, silos, cooling towers, pipe spooling and pressure vessels, and fabricates structural steel.
  - The engineering segment (largely Brockman) reported FY12 revenue of $36.5m and EBIT of $1.5m (a 4.1% margin).
  - The engineering segment reported FY13 revenue of $26.6m and EBIT of $1.9m, a steep fall in revenue over the pcp but a material improvement in margins (7.2% margin).

Financials

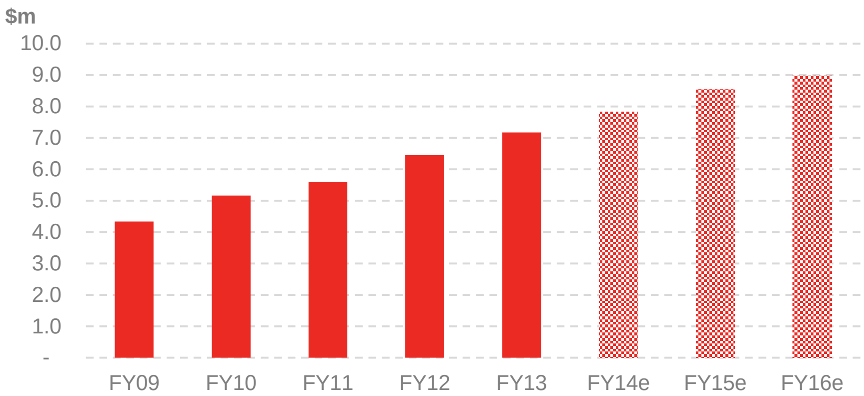
TABLE 4: DIVISIONAL EARNINGS SUMMARY

Divisional earnings summary									
Yr to Jun		FY11	FY12	1H13	2H13	FY13	FY14e	FY15e	FY16e
Design and construction	$m	28.8	25.0	14.1	15.8	29.9	31.7	34.9	36.7
Maintenance	$m	23.4	20.4	14.1	15.8	29.9	31.7	33.7	35.3
Total operating revenue	**$m**	**52.3**	**45.4**	**28.2**	**31.7**	**59.9**	**63.5**	**68.6**	**72.0**
- growth	*%*	*18.9%*	*-13.0%*	*22.4%*	*41.5%*	*31.8%*	*6.0%*	*8.0%*	*5.0%*
Design and construction	$m	3.7	4.3	2.2	2.4	4.6	5.0	5.5	5.8
Maintenance	$m	2.8	3.2	1.7	1.8	3.5	3.8	4.0	4.2
Corporate	$m	-0.9	-1.0	-0.4	-0.5	-0.9	-0.9	-1.0	-1.0
Operating EBIT	**$m**	**5.6**	**6.5**	**3.6**	**3.6**	**7.2**	**7.8**	**8.5**	**9.0**
- growth	*%*	*8.5%*	*15.3%*	*2.9%*	*20.8%*	*11.2%*	*9.1%*	*9.1%*	*5.1%*
- margin	*%*	*10.7%*	*14.2%*	*12.6%*	*11.4%*	*12.0%*	*12.3%*	*12.4%*	*12.5%*
Segment margin									
Design and construction	%	*12.8%*	*17.0%*	*15.7%*	*15.1%*	*15.4%*	*15.8%*	*15.8%*	*15.8%*
Maintenance	%	*11.8%*	*15.6%*	*12.1%*	*11.6%*	*11.8%*	*11.8%*	*11.8%*	*11.8%*

Source: WHTM estimates, SND

Timing of individual projects is a key driver of periodic earnings but scarcely relevant in the longer term. Revenue and earnings are recognised on a percentage of completion method. Some weighting is given to recognition after reaching 50% of completion as management can gain clarity around the forecast final earnings of the project. In addition, the timing of award of a project and the time to commencement (and therefore completion) of a project can have a large impact on a single period's apparent earnings performance although in the longer term the impact is negated.

TABLE 5: UNDERLYING EBIT HISTORICAL AND FORECAST



Source: WHTM estimates; SND

Revenue evenly split but margins better in construction. Saunders does not disclose divisional earnings between D&C and maintenance work. Management does provide informal annual guidance as to the revenue split of work completed in the year. This generally ranges between a 45%-55% weighting to D&C and was said to be approximately 50% in FY13. Maintenance work does provide a consistent flow of work and allows Saunders insights into potential D&C activity that may be undertaken. We believe that successfully completed D&C work would provide a higher EBIT margin than contracted maintenance services. This is supported by peer review of construction and maintenance service providers.

HISTORICAL EARNINGS

Underlying EBIT compound growth of 13.5% since FY09. Saunders has managed to grow its underlying EBIT by a compound annual growth rate of 13.5% since a GFC-induced downturn in FY09, returning to near record-level underlying EBIT in FY13 of $7.2m. Our underlying historical EBIT estimates can differ materially from that reported by the company as Saunders was forced to defend (ultimately successfully in early FY13) a legal claim against it by a customer in relation to work completed; legal costs ran to the millions and Saunders was not able to fully reclaim these costs from the plaintiff.

FY11. Revenue grew 19% in FY11 and was split evenly between design/ construction and maintenance services. On our estimate, underlying EBIT growth did not keep pace with revenue growth in FY11 as the prior year (FY10) had seen a larger weighting to D&C work.

FY12. A fall in revenue of 13% was more than offset through better-than-expected profitability on key projects that management reported were particularly well executed. The revenue fall was attributed to general market weakness but management did note that an improvement in activity levels had been seen towards the financial year's end. Revenue was weighted approximately 55% to D&C work.

EBIT margin rebounded strongly on the back of the weighting towards D&C. We estimate EBIT rose from 10.7% in FY11 to 14.2% in FY12.

FY13. Strong revenue growth, at 32%, led to sound EBIT growth. The reported 50/50 revenue split between D&C and maintenance indicates relatively stronger growth in revenue was seen in that division relative to FY12. We estimate underlying EBIT growth of 11.2%.

The margin fall is attributable to the increased share of revenue attributable to maintenance work.

Management notes a large number of projects continuing into 1H14. This indicates that FY14 should be assisted by a larger-than-average contribution from the final recognition of project revenue and earnings.

We estimate the group EBIT margin at 12.0%.

FORECAST EARNINGS

FY14e. Early indications for FY14 indicate that D&C work should continue at the level seen in FY13 at the least. There is also some indication that potential customers are beginning to release projects that they were previously able to hold-off on.

- We forecast revenue continuing to be split 50/50 and for group revenue growth to be 6%, or $63.5m.
- We forecast EBIT growth of 11.2% to $7.8m and a group EBIT margin of 12.3%. The relatively larger increase in EBIT over revenue is due to an expectation of final recognition of some key FY13 contracts falling into FY14.
- This indicates a group NPAT of $5.9m and EPS of 7.4 cents. We forecast a total dividend of 5.5 cps (split 2.0/3.5).
- Work is expected to be weighted more towards the east coast in FY14e. Non-oil-refiners with port access are keen to grab some of the expected increase in oil and refined product imports over the next few years, increasing the demand for relevant port-side storage.
- Some early work in relation to conversion of oil refineries to storage and distribution terminals should commence but management believes that the core work in relation to those conversions (Shell and Caltex refineries in particular) will likely fall into the FY15 financial year.
- In the interim those sites continue to need Saunders' maintenance services and management notes that it is picking up maintenance work further along those sites' pipelines than just the tanks.

FY15e. We forecast FY15e group revenue growth of 8%, with construction-related revenue forecast to grow 10%. We believe there is potential for this number to increase, dependent on Saunders' success in claiming a share of the estimated $80m of worth of tankage work required as part of the Shell and Caltex refinery conversions.

- We forecast EBIT of $8.5m (9% growth). This indicates EPS of 8.1 cps.

FY16e and beyond. We forecast revenue growth of 5% in FY16, falling to 3.5% thereafter. We maintain a consistent 50/50 revenue split from FY17 and a group EBIT margin of 12.5% throughout the forecast period.

FINANCIAL STATEMENTS

TABLE 6: SUMMARY FINANCIAL STATEMENTS

Profit & Loss							
Yr to Jun		FY11	FY12	FY13	FY14e	FY15e	FY16e
Sales revenue	$m	52.1	45.4	59.9	63.5	68.6	72.0
EBITDA	$m	6.2	7.0	7.7	8.3	9.1	9.6
Dep'n & Amort'n	$m	(0.6)	(0.5)	(0.5)	(0.5)	(0.6)	(0.6)
EBIT	**$m**	**5.6**	**6.5**	**7.2**	**7.8**	**8.5**	**9.0**
Net interest expense	$m	0.7	0.6	0.6	0.6	0.6	0.7
Tax expense	$m	(1.8)	(2.0)	(2.3)	(2.5)	(2.7)	(2.9)
Minorities	$m	-	-	-	-	-	-
NPAT (normalised)	**$m**	**4.5**	**5.0**	**5.4**	**5.9**	**6.4**	**6.8**
Abnormals	$m	(2.7)	(0.6)	0.4	-	-	-
NPAT (reported)	$m	1.9	4.5	5.8	5.9	6.4	6.8
EPS (normalised)	**$**	**0.057**	**0.064**	**0.069**	**0.074**	**0.081**	**0.085**
DPS	$	0.040	0.090	0.050	0.055	0.055	0.055
Sales growth	%	71%	-13%	32%	6%	8%	5%
EBIT growth	**%**	**184%**	**15%**	**11%**	**9%**	**9%**	**5%**
EPS (norm) growth	**%**	**11%**	**11%**	**7%**	**9%**	**8%**	**6%**
EBIT margin	%	11%	14%	12%	12%	12%	12%
ROCE	**%**	632%	452%	201%	248%	268%	281%
ROE	%	26%	27%	33%	33%	32%	30%

Key metrics							
Yr to Jun		FY11	FY12	FY13	FY14e	FY15e	FY16e
Weighted avg shares	m	79.0	79.0	79.0	79.0	79.0	79.0
Enterprise Value	$m	52.0	52.6	53.9	54.4	52.5	50.3
EV / EBITDA	x	8.4x	7.5x	7.0x	6.5x	5.8x	5.3x
EV / EBIT	x	9.3x	8.2x	7.5x	7.0x	6.2x	5.6x
PER	x	15.2x	13.6x	12.7x	11.7x	10.8x	10.2x
Yield	%	4.6	10.3	5.7	6.3	6.3	6.3

Balance Sheet							
Yr to Jun		FY11	FY12	FY13	FY14e	FY15e	FY16e
Working Capital	$m	0.9	3.0	5.1	3.8	4.1	4.3
PPE	$m	1.3	0.9	1.8	1.8	1.8	1.8
Other Assets / (Liabilities)	$m	(1.3)	(2.5)	(3.3)	(2.4)	(2.7)	(2.9)
Total capital employed	**$m**	**0.9**	**1.4**	**3.6**	**3.2**	**3.2**	**3.2**
Net debt	$m	(16.3)	(17.1)	(12.9)	(14.9)	(16.9)	(19.3)
Total equity	$m	17.2	18.5	16.5	18.0	20.1	22.5
Avg net debt	**$m**	**(16.8)**	**(16.2)**	**(14.9)**	**(14.3)**	**(16.2)**	**(18.4)**
Avg ND / Avg ND + E	**%**	**n/a**	**n/a**	**n/a**	**n/a**	**n/a**	**n/a**
Avg ND / EBITDA	x	(2.7x)	(2.3x)	(1.9x)	(1.7x)	(1.8x)	(1.9x)
EBIT / Net interest expense	**x**	**n/a**	**n/a**	**12.7x**	**13.6x**	**14.9x**	**13.3x**
NTA/sh	**$**	**0.22**	**0.23**	**0.21**	**0.23**	**0.25**	**0.27**

Cash Flow							
Yr to Jun		FY11	FY12	FY13	FY14e	FY15e	FY16e
EBITDA	$m	6.2	7.0	7.7	8.3	9.1	9.6
Less net interest expense	$m	0.7	0.6	0.6	0.6	0.6	0.7
Less tax expense	$m	(1.8)	(2.0)	(2.3)	(2.5)	(2.7)	(2.9)
Change in working capital	$m	(0.9)	(2.0)	(2.1)	1.3	(0.3)	(0.2)
Other	$m	(4.7)	0.6	1.3	(0.9)	0.3	0.2
Operating cash flow	**$m**	**(0.5)**	**4.1**	**5.1**	**6.8**	**6.9**	**7.3**
Capex	$m	(0.1)	(0.2)	(1.4)	(0.5)	(0.5)	(0.6)
Acquisition / divestment	$m	0.0	-	-	-	-	-
Investing cash flow	**$m**	**(0.1)**	**(0.2)**	**(1.4)**	**(0.5)**	**(0.5)**	**(0.6)**
Equity raised	$m	-	-	-	-	-	-
Change in debt	$m	-	-				
Dividends paid	$m	(3.1)	(3.2)	(7.9)	(4.3)	(4.3)	(4.3)
Other	$m	-	-	-	-	-	-
Financing cash flow	**$m**	**(3.1)**	**(3.2)**	**(7.9)**	**(4.3)**	**(4.3)**	**(4.3)**
Net cash flow	$m	(3.8)	0.8	(4.1)	1.9	2.0	2.4

Source: WHTM, SND **Inc 5 cps special div*

Depreciation and amortisation. Saunders leases its primary workshops. Its primary depreciable assets relate to equipment used in pre-fabricating components of projects to be trucked to site for construction.

Interest expense. At 30 June 2013, Saunders held a net cash position of $12.9m, equivalent to 78% of group net assets.

Tax expense. Saunders pays tax at the 30% corporate tax rate with occasional claims for R&D tax credits being achievable dependent on projects and designs undertaken in a given period.

Dividends and franking. Saunders has a payout ratio of around 65%. A $0.05/sh special dividend was also paid in FY12. Given Saunders' large cash balance further specials are possible, but the company has now used a large portion of its franking balance (franking balance $1.6m at 30 June 13).

Cash flow. FY11 negative operating cash flow was something of an aberration due to legal fees incurred as part of Saunders' successful contract dispute defence. As noted in Table 7, we forecast operating cash flows to equate to approximately 100% of adjusted group EBITDA on average going forwards.

TABLE 7: EBITDA TO CASH CONVERSION

EBITDA conversion							
Yr to Jun		**FY10**	**FY11**	**FY12**	**FY13**	**FY14e**	**FY15e**
EBITDA	$m	6.0	6.2	7.0	7.7	8.3	9.1
- Cash interest expense	$m	-	0.7	0.6	0.6	0.6	0.6
- Cash tax expense	$m	(1.7)	(0.8)	(1.8)	(2.5)	(2.5)	(2.7)
Adjusted EBITDA	**$m**	**4.3**	**6.1**	**5.7**	**5.8**	**6.4**	**6.9**
Operating cash flow	**$m**	**8.4**	**- 0.5**	**4.1**	**5.1**	**6.8**	**6.9**
Conversion of EBTIDA to cash	**%**	**196%**	**-8%**	**71%**	**89%**	**106%**	**99%**

Source: WHTM, SND

Working capital. Saunders does not need to hold large amounts of inventory as required inputs will be job-specific and need only be ordered once a project schedule is established. Working capital relates primarily to the mix of receivables and payables. On average working capital needs only be funded for around 22 days. However, we expect project-specific working capital requirements would stretch to months.

TABLE 8: WORKING CAPITAL AND CASH CONVERSION

Working capital							
Yr to Jun		**FY11**	**FY12**	**1H13**	**FY13**	**FY14e**	**FY15e**
Receivables	$m	5.9	8.0	6.4	9.8	8.1	8.7
Inventory	$m	0.3	0.4	0.8	1.6	1.0	1.1
Payables	$m	5.3	5.4	4.8	6.2	5.3	5.7
Total	**$m**	**0.9**	**3.0**	**2.3**	**5.1**	**3.8**	**4.1**
- growth	*%*	*35%*	*222%*	*n/a*	*72%*	*-26%*	*8%*
- % of sales	*%*	*1.8%*	*6.5%*	*n/a*	*8.5%*	*6.0%*	*6.0%*
Receivables days (based on sales)	days	41.1	64.5	38.8	59.4	46.3	46.3
Inventory days (based on sales)	days	2.2	3.0	4.8	9.6	5.6	5.6
Payables days (based on sales)	days	36.9	43.7	29.5	37.9	30.2	30.2
Cash conversion cycle	**days**	**6.4**	**23.8**	**14.1**	**31.1**	**21.8**	**21.8**

Source: WHTM, SND

Corporate

BOARD & MANAGEMENT

Board of directors

- **Timothy Burnett – Chairman:** Mr Burnett has 35 years of management experience in engineering and construction including 15 years as MD of Saunders. Harvard MBA.
- **John Power – Managing Director:** Mr Power has 33 years of experience in construction and engineering. He joined Saunders in 2003, and was previously with Chicago Bridge & Iron for 25 years.
- **David Smart – Director (Non-Executive):** Mr Smart has 30 years of professional services experience in finance, company secretarial and board positions in listed companies with a focus on specialist industrial manufacturers.
- **Malcolm McComas – Director (Non-Executive):** Mr McComas has experience in equity capital markets, mergers and acquisitions. Manager of IB at County NatWest for 10 years and at Grant Samuel for 11 years.

Annual General Meeting: 19 November 2013.

Management

- John Power – Managing Director
- Steven Dadich – Company Secretary

TABLE 6: CAPITAL STRUCTURE

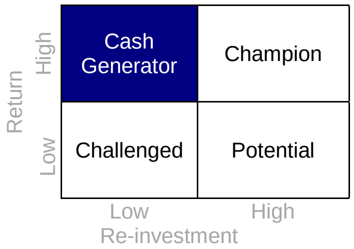
Significant Shareholders	
Holder	**% Holding**
Desmond Bryant	30.1%
Timothy Burnett	20.1%
John Power	5.1%
Total	*55.3%*

Source: SND/WHTMe as at August 2013

Approximate shareholder composition	
Type of Holder	**No. of Holders**
1 - 1,000	27
1,001 - 5,000	103
5,001 - 10,000	117
10,001 - 100,000	25
100,001 - and over	50

Source: SND as at 31 July 2012

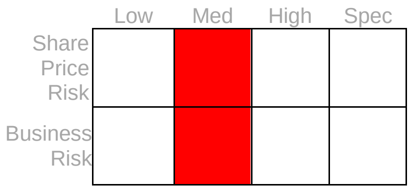
RETURN RE-INVESTMENT MATRIX



Saunders achieves a return of equity of ~30%. We estimate a conversion of adjusted EBITDA to cash nearing 100%.

With a large net cash position it has a high dividend payout ratio (~65%).

RISK MEASURES



Share price: A small and relatively illiquid company poses some risk for a shareholder should they require a quick liquidation of position.

Business: A long history of consistent workflow supported by a very conservative balance sheet.

BUSINESS DESCRIPTION

Saunders International provides tank design and construction services for the oil and gas industry, water and waste water infrastructure sector, fuel terminal sector, and mining and mineral processing industry. It also provides facilities and maintenance to petroleum refineries and distributors and oil and gas producers.

INVESTMENT THESIS

The products and services provided by Saunders incorporate a wide range of skills which include engineering analysis and design, procurement, fabrication, construction and project management. Saunders also provides ongoing services around tank inspection and evaluation and maintenance.

Saunders aims to leverage its six decades of experience through providing clients specialist knowledge and experience in steel bulk storage tank design, construction and maintenance. Management sees its complete tankage solution as a key competitive advantage. In addition, Saunders has developed specialist techniques for working in a variety of geographies and climatic regions.

REVENUE DRIVERS

- Demand for new tanks
- Demand for maintenance services on existing tank infrastructure

MARGIN DRIVERS

- Demand levels and margins being achieved by customers on their own operations
- Required returns of large peers potentially being below that desired by Saunders forcing Saunders to reduce margins to remain competitive

KEY ISSUES / CATALYSTS

- Level of oil imports – driven by national oil demand.
- Demand for maintenance services on existing tank infrastructure

RISK TO VIEW

- Cancellation of early-stage mine development leading to mid-term production cancellation/slowdown
- Changes to oil industry that reduce/remove need for additional storage capacity
- New entrants with balance sheet to make a national footprint

BALANCE SHEET

- $12.9m net cash at 30 June 2013
- NTA of 21 cps at 30 June 2013

BOARD

- Timothy Burnett – Chairman: 35 years' management experience in engineering and construction including 15 years as MD of Saunders. Harvard MBA
- John Power – Managing Director: 33 years' experience in construction and engineering. Joined Saunders 2003, previously with Chicago Bridge & Iron for 25 years
- David Smart – Director (non-exec): 30 years' professional services experience in finance, company secretarial and board positions in listed companies with a focus on specialist industrial manufacturers
- Malcolm McComas – Director (non-exec): Experience in equity capital markets, mergers and acquisitions. Manager of IB at County NatWest for 10 years and at Grant Samuel for 11 year

MANAGEMENT

- John Power – Managing Director
- Steven Dadich – Company Secretary

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Regulatory Disclosures

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Return Reinvestment Matrix and Risk Measures

Definitions at http://www.wilsonhtm.com.au/Disclosures

Recommendation Structure and Other Definitions

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