



WILSONS

Fortress WA - Six Beneficiaries of the Border Reopening

Our weekly view on Australian equities.

09 December 2021

The Island State of WA

For West Australian (WA) exposed companies, COVID continues to have an oversized impact on profitability. While closed borders have contributed to good health outcomes in WA, the restrictions on people mobility have been a significant issue for companies with WA exposure.

A smaller pool of skilled labour has resulted in higher costs, constrained production capacity and extended approval processes for growth projects.

Our basket of six WA exposed companies (S&P/ASX 200) has underperformed the market by >20% YTD, while valuations relative to the market are 30% below long-term levels, suggesting an opportunity is emerging.

All companies have made mention of the WA borders impacting their business over 2020/21 and into 2022.

The two most exposed companies in our basket - Monadelphous (MND) and NRW Holdings (NRH) - have seen profit margins fall to a record low, pushing share prices to multi-year lows.

With the prospect of the WA border reopening in 1Q22, headwinds around labour issues could begin to reverse. This sets up an opportunity for a potential re-rate in the share prices in our basket of six WA exposed companies. In many cases, the capex cycle and expectations of buoyant global growth imply growing order books of work, particularly if oil and gas sector activity accelerate post-COVID.

We explore the prospects of fortress WA reopening and assess the likelihood of whether earnings expectations in our basket of WA exposed companies have bottomed ahead of the February results season.

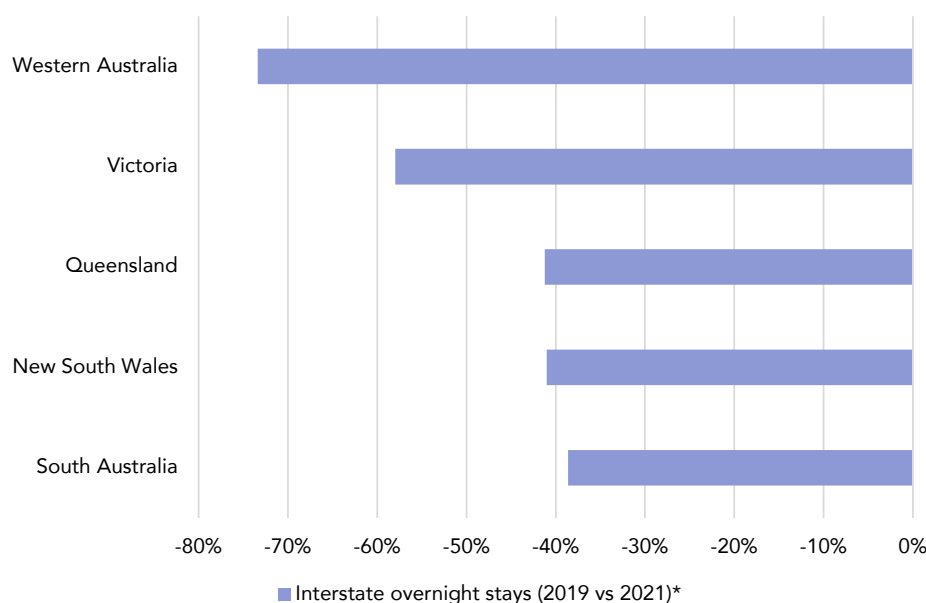
Fortress WA - Borders Closed Since 2019

Unlike the east coast states, WA relies more heavily on the flow of skilled labour for improvements to its capital base. The capital base is a critical input into the WA economy, supporting the extraction and distribution of key Australian export commodities like iron ore and other base metals.

The oil and gas industry is also heavily reliant on continued upgrades to the capital base, drawing on domestic and international labour pools. After a flood of oil and gas projects were completed in 2018/19, activity in this sector continues to remain depressed despite the higher oil price.

WA border restrictions have effectively left WA an island state in terms of its labour pool. This has resulted in labour scarcity, pushing up labour rates for WA based employees. The issue for company earnings has been masked somewhat by buoyant commodity prices for the miners. Without the direct benefit of higher commodity prices, mining service companies have seen significant margin pressure.

Exhibit 1: WA has been isolated from the rest of Australia since 2019 with a 75% fall in overnight visitor stays



*Jan-Sep period

Source: Tourism Research Australia, Wilsons.

WA borders Should Open in February 2022

Under WA's COVID roadmap, its border with the rest of the country should open in mid-February 2022, as the state slowly grinds its vaccination levels higher. Border reopening should begin to alleviate some of the cost and labour pressures that have built up since 2019. It is also likely to improve sentiment towards WA exposed companies amongst investors.

Border Closure Impacts

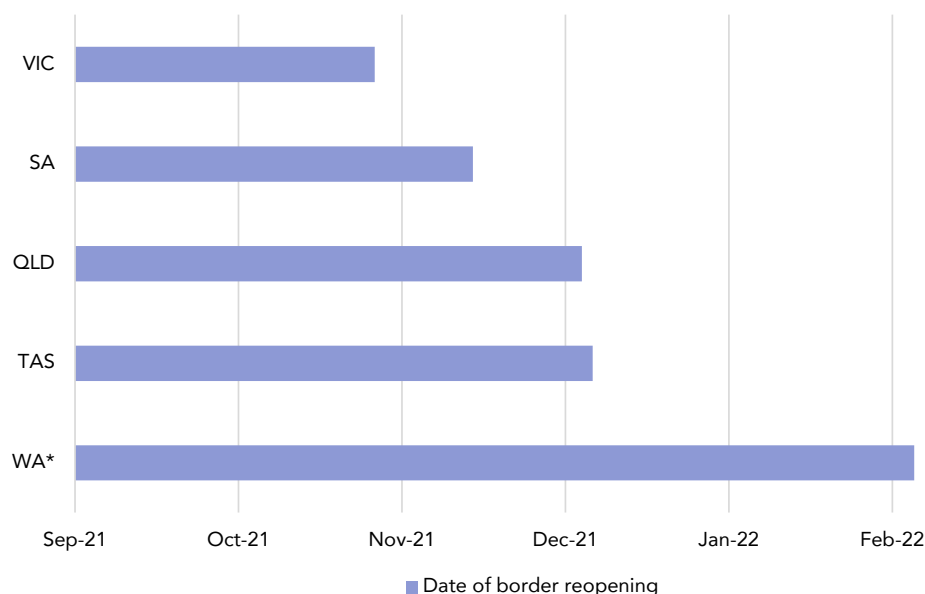
Share prices of companies exposed to WA have been materially impacted. Our basket of WA exposed companies has underperformed the market by 20% YTD.

The basket includes mining service providers, miners with operating assets and miners with non-producing develop assets in WA. Most significantly exposed have been MND and NRW, with the underperformance of close to 40% YTD.

The prospect of improved news flow and increased availability of skilled labour beginning in 1Q22 has the potential to significantly change the narrative for investors.

The WA miners are suggesting it is likely to take around two quarters post-reopening for things to return to a new post-COVID normal. By reporting season in February 2022 companies are likely to be able to talk about their reopening plans. We expect share prices will begin to anticipate this recovery during 1Q22 as a belief about WA border reopening increases.

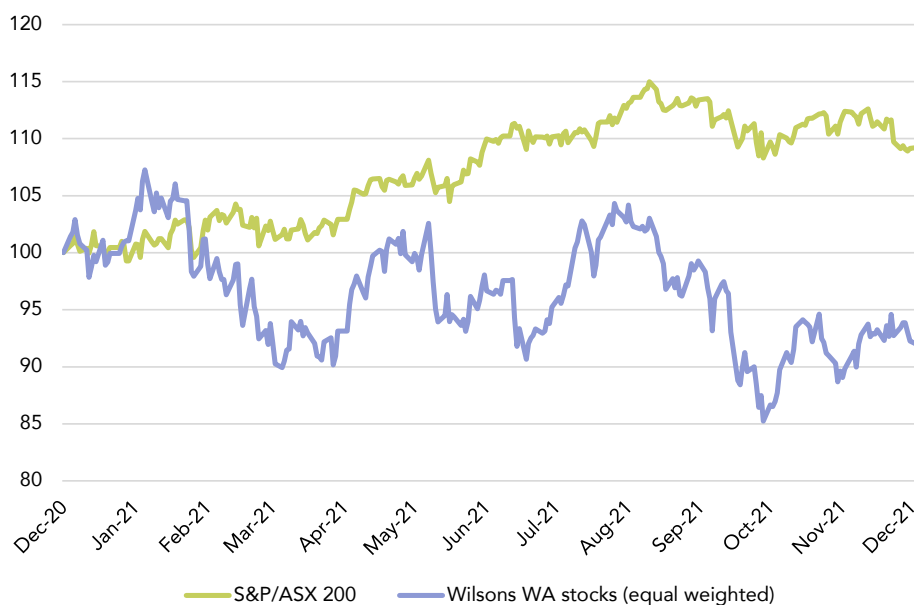
Exhibit 2: WA is expected to reopen in 1Q22, around the time of results season



*WA is expected date based on 90% double vaccination rate

Source: Various state governments, Wilsons estimates.

Exhibit 3: WA exposed companies have underperformed the market during 2021



*Rebased to 100

Source: Refinitiv, Wilsons estimates. Includes: Mineral Resources, Monadelphous, Northern Star, NRW, Oz Minerals, Seven Group.

Wilsons WA Exposed Basket

Company	Ticker	Market Cap
Mineral Resources	MIN	8.4
Monadelphous Group	MND	0.9
Northern Star Resources	NST	10.7
NRW Holdings	NHW	0.7
OZ Minerals	OZL	8.8
Seven Group Holdings	SVW	7.8

Source: Refinitiv, Wilsons.

Valuations imply a 30% discount on MND, NWH, SVW

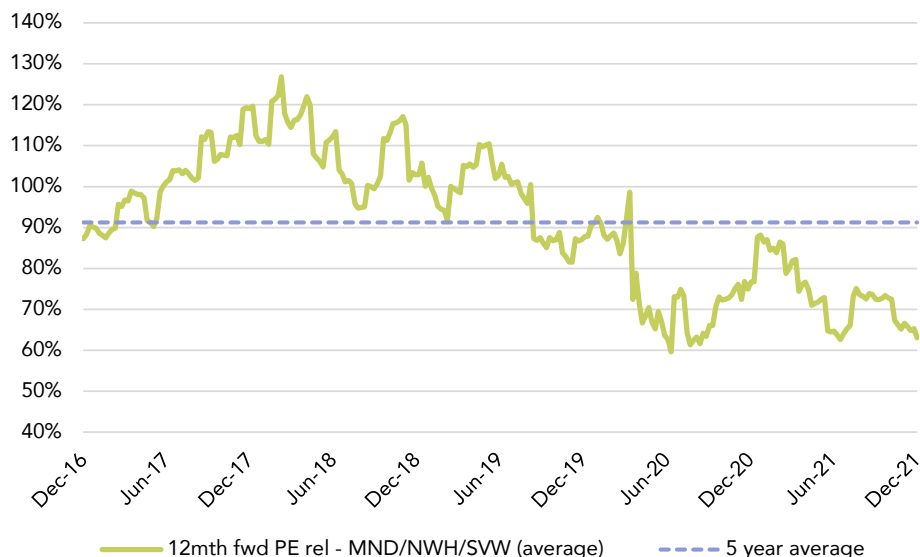
The most WA-centric business of MND, NWH, and Seven group Holdings (SVW) have seen their PE relative valuations collapse by >30% since 2019. This suggests to us that a level of investor fatigue has set in. We also think there is very little recovery being built into the share prices of these three companies (compared to travel stocks, at least on this measure).

Read [Does Omicron Quarantine the Recovery in Travel Stocks?](#)

To be sure, other factors are likely weighing on share prices of our basket – the cost of goods inflation, capex cycle, lower A\$, and in SVW's case, the PE relative may now be structurally lower following the 70% acquisition of Boral (BLD). Regardless, the WA border closure in the eyes of investors is seen as a headwind for our basket of WA exposed companies.

Below we outline the investment debates on our three most exposed WA companies in our basket; MND, NWH, and SVW.

Exhibit 4: PE valuations relative to the market have collapsed by >30%



Source: Company Data, Refinitiv, Wilsons estimates.

Exhibit 5: Wilsons Basket of WA exposures

■ Focus List Company

Company	Ticker	WA Exposure	Key Issue	Estimated Impact	Wilsons Comment
Mineral Resources	MIN	>95%	Skilled worker shortage.	Not quantified. Strong Fe/Li pricing masked higher costs. Margins lifted to 52%.	AGM comments continued to highlight both COGS and labour supply issues across WA. Consensus has margins returning to 32% in FY22E (FY17-19 average).
Northern Star Resources	NST	>85%	Skilled worker shortage.	NST has flagged higher labour costs. Vast majority of mine workers are local or WA based, minimising impact.	Once borders reopen labour issues should fade away with ~2 quarter lag.
NRW Holdings	NHW	>80%	Skilled worker shortage. Typically 30% of labour force ex WA.	FY21 EBIT margins fell to 5.4%. Margins have historically held at 7-8% pre-COVID.	FY22 guidance implies an EBIT margin of ~6% for FY22 (consistent with consensus). Could be potential for a downgrade (below 6% margin) if borders remain closed.
Monadelphous Group	MND	>60%	Skilled worker shortage. Typically 40-50% of labour force ex-WA.	EBITDA margins fell to record low at 5.1% 2H21, vs 6-7% typical. Market expects margins in 1H22 to be the bottom, before normalising.	Improving merging trajectory, new project wins in iron ore, oil and gas sector contact wins are key to share price re-rate. Market is assuming margins return to 6.5% in FY23E & FY24E.
Seven Group Holdings	SVW	>50%	Supply chain issues (port access, shipping delays)	Not quantified. SVW has flagged supply chain issues with the WesTrac business.	Easing of global supply chain issues and the reopening of WA's border, we expect market sentiment for SVW to improve. We believe actual impact is currently relatively low vs other mining services peers.
OZ Minerals	OZL	0%	Access to WA	Producing assets are in SA and Canada, so minimal impact.	New Ni mine West Musgrave (WA), FID expected in 2022. FID work has been more challenging, with border closure.

Source: Company Data, Refinitiv, Wilsons estimates.

Monadelphous (MND)

Perth-based engineering group MND has seen margins fall from 6-7% to 5.1% in 2H21 – the lowest in the company's history. Pre-COVID up to half its FIFO workforce in the Pilbara would be based interstate. The Pilbara region accounts for the majority of MND earnings. This represents a significant headwind to earnings near-term.

From a market's perspective, MND is unlikely to show revenue growth until 2023, following the completion of several large contracts in 2019/20. The pipeline of available work for MND continues to look robust, and the companies win rate of major projects has accelerated through 2021. Oil and gas new project work remains subdued but could pick up a

post-COVID interruption of the past two years. Historically, this sector contributed more than half of MND's earnings 3-4 years ago. Relative to NWH, MND is typically bought on projects later in the construction phase.

The key question is, when does earnings momentum return to the stock? Whilst we cannot be categorically sure MND margins have bottomed in the last half, the share price at \$9.00 has little in the way of recovery priced in. MND trades at 7x EV/EBITDA (on depressed margins) vs a long-term average of 8x. In prior cycles the market put MND on >15x. In the short-term, MND outlook commentary in February will be closely watched for signs of acceleration in activity.

NRW Holdings (NWH)

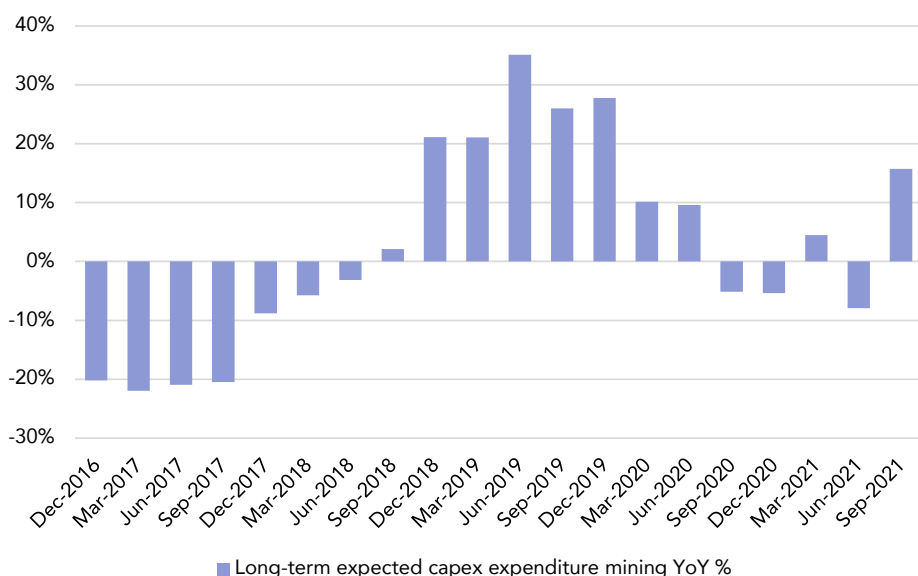
Due to labour cost pressures, NRW (NWH) has been severely impacted by the closure of the WA border. Prior to COVID, 30% of NRW's WA workforce was sourced from the east coast and/or overseas.

NRW's EBIT margin fell to 5.4% in FY21. Margins have historically held at 7-8% pre-COVID. NRW's FY22 revenue guidance was retained at the most recent AGM at \$2.4-2.5bn and earnings (EBIT) at \$145-155m; this implies a margin of ~6% for FY22 (consistent with consensus). We believe margins could improve further with a full reopening of the WA border by the start of FY23E.

NRW should continue to benefit from iron ore capex in the medium-term. NRW's tender pipeline grew to A\$19.3bn (+33%) in November 2021 vs June (A\$14.5bn). The majority of this increase was due to civil resources (+\$1.9bn) and mining capex (+\$2.7bn), indicating a healthy level of sustaining/replacement capex for NRW in the medium-term, underpinned by mining giants BHP and RIO.

NRW trades at a significant discount to peers (FY22 PE is ~7x), but we expect that if these issues are resolved over the next 12 months, NRW's multiple should re-rate as earnings rebound.

Exhibit 6: Mining sector capital expenditure intentions rose in the quarter



Source: ABS, Wilsons

Focus List

Seven Group Holdings (SVW)

WesTrac is an authorised Caterpillar dealer operating in Western Australia. SVW has historically generated 50% of group earnings (EBIT) from the WesTrac segment. At the recent AGM, SVW reiterated that the WesTrac business is continuing to benefit from strong mining and construction demand but conceded that there have been some supply chain issues.

The Coates segment (25% of group EBIT) seems to be largely unaffected by supply

chain issues; activity has rebounded since the easing of lockdown restrictions in NSW and VIC.

The most recent ABS capex intentions survey indicated a surge in capex growth for CY22 (mining +16%, non-mining +17%). Higher levels of capex, coupled with the easing of global supply chain issues and the reopening of WA's border, should lead to an improvement in market sentiment for SVW. SVW is a member of the Wilsons Australian Equity Focus List.

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Recommendation structure and other definitions

Definitions at www.wilsonsadvisory.com.au/disclosures.

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