



## Emerson Stewart SPECULATIVE BUY

8 July 2008

Current Price: **\$0.20**

Ticker: **ESW.ASX**  
Sector: **Engineering**

Shares on Issue (m): **123.6**  
Market Cap (\$m): **24.7**  
Debt (\$m): **0.0**  
Cash (\$m): **10.0**  
Enterprise Value (\$m): **14.7**

### Key Metrics

EV/EBITDA (x) 09F 3.08  
P/E (x) 6.75

### Financials:

	07A	08F*	1H09F*
Revenue (\$m)	4.4	9.7	11.3
EBITDA (\$m)	0.2	2.0	2.4
NPAT (\$m) **	0.2	1.4	1.8

### Notes:

\* ESW Forecasts

\*\* FY2008F NPAT is pre non-recurring costs

### Directors

Steven Cole	Non-exec Chairman
Dario Amara	MD/CEO
Angelo Dabala	Exec Director
James Cullen	NED
David Richardson	NED

### Major Shareholders

	# (m)	%
Dario Amara	34.4	27.8
Angelo Dabala	31.3	25.3
Entrust Pvt Wealth	22.3	18.0
Argonaut	2.6	2.0

Analysts:  
Jason Moore  
Ian Christie

## Engineering Growth

Emerson Stewart (ESW) is an emerging WA based consulting engineering firm recently listed on the ASX. The business is divided into 3 divisions servicing the Resource, Infrastructure and Energy sectors.

ESW was founded by 2 seasoned WA engineers, who have quickly built an impressive team around them by hand picking respected skills in the industry. Each divisional head is able to boast of a CEO role at engineering firm prior to joining ESW.

The diverse backgrounds of the senior personnel brings with it extensive contacts and relationships with blue chip clients that have been established over many years. This provides a solid platform for the business.

ESW's business model is differentiated from other consulting firms through:

- × A pricing structure that allows for performance fees based on demonstrable savings for the client
- × An early involvement in the project and integration of ESW staff within the owner's team, allowing ESW to control the outcome of the assignment

ESW aims to occupy a niche at the upper end of the consulting engineering universe, offering premium skills and steering away from the "bulk", volume driven market. An awareness of risk within the group means every project is thoroughly assessed prior to being taken on. Project work has been turned down in the past.

Growth prospects are good. ESW is:

- × A young company coming off a low base
- × Servicing sectors which are growing rapidly
- × A provider of an undersupplied resource

Coupled with the high potential for organic growth, the expansion path should see at least 2 strategic acquisitions over the next 18 months. As a result there is likely to be considerable positive news-flow in the near term.

There are risks. The skills shortage in WA is a potential impediment to longer term growth, although this can be overcome by financial incentives and geographical diversification. More immediate risks are associated with ESW's lack of track record and the difficulties in forecasting beyond the short term.

Argonaut has computed forward multiples based on inferred FY2009 profit numbers extrapolated from ESW's forecast for 1H2009. These indicative numbers do not fully account for organic growth, nor is there any regard for any acquisitions which may occur.

However, as a rough guideline they compare favourably to ESW's peers, and on an indicative forward P/E ratio of 6.8x, Argonaut believes the case for inclusion of the stock in small-cap growth portfolios is compelling.

## SPECULATIVE BUY

### Important Disclosures

Please refer to important disclosures on page 9.





## Business Lines

**Focused on 3 strongly growing sectors**

ESW has identified 3 key growth sectors that fall within its scope of expertise, and has established 3 business lines to exploit opportunities in these sectors.

Table 2: Business Lines

Resources	Infrastructure	Energy
All Commodities	Urban Development Buildings Water & Waste Water Roads & Highways Telecommunications	Power Generation Power Distribution

Source: ESW

ESW was founded around the Resources division and Argonaut sees it as being central to the company’s future success. The unit has focused on mid-sized WA based companies, where strong relationships exist. Work is currently ongoing for several clients including Straits Resources and Windimurra Vanadium.

The Infrastructure division is targeting the considerable public and private sector spend required to address the widespread infrastructural shortfalls common around Australia.

The third division, Energy, is seen as a viable stand alone business line that will also operate as a natural extension to the other divisions, providing supporting services to the group. The focus will be on gas and renewable energy, with a predilection towards “island” (off the grid) power stations.

## Group Structure

Table 3: Group Structure

Managing Director / Chief Executive		
Dario Amara		
Resources	Infrastructure	Energy
John Morhall	Marino Evangelisti	Angelo Dabala

Source: ESW

## Board and Management

**An experienced team provides expertise and extensive relationships**

The performance of the Company will relate to the quality of senior management and it is a positive that ESW boasts a team with more than 120 years experience, earned both within Australia and internationally.

### Executive Directors

Dario Amara (Managing Director / Chief Executive) is an engineer with 29 years’ experience in Australia and internationally across the resources and infrastructure sectors. Prior to co-founding ESW he was CEO of GRD Minproc and is a former CEO of John Holland Asia.

Angelo Dabala (Executive Director / Director Energy) has 26 years’ global experience in the energy and resources sectors, including onshore and offshore oil & gas, power generation, alumina, mineral sands, gold, brewing, food and manufacturing. Prior to co-founding ESW he was the Managing Director of engineering consultancy group PCT Engineers.



**Non-executive Directors**

Steven Cole (Chairman) has 35 years’ professional, corporate and business experience through senior legal consultancy, as well as via a range of executive management and non-executive appointments. He held senior executive management roles with law firms Parker & Parker and Allens Arthur Robinson before retiring from legal practice in 2007.

James Cullen is a qualified Chartered Accountant with extensive commercial experience in several industries and countries. From 1994 to 2007 he was the Managing Director of ASX-listed PCH, which provided a range of industrial services to numerous industry sectors including mining and processing, oil and gas, petrochemicals and infrastructure.

David Richardson is a mechanical engineer with 24 years’ experience in the resources industry. He has commercial experience in the conception and execution of resource and infrastructure projects, and has strong technical and contractual understanding of the resources and renewable energy sectors. He co-founded Toussaint and Richardson and is a former executive director of WorleyParsons.

**Senior Management**

Marino Evangelisti (Director Infrastructure) is a qualified civil engineer with 25 years’ experience in the consulting industry in Australia and overseas. He has held senior executive roles in engineering design and management and the construction of civil infrastructure associated with urban development, transportation and mining projects.

John Morhall (Director Resources) is an engineer with over 40 years experience in both the Australian and international markets in the resource sector. He has worked in both mining and in oil and gas. Prior to joining ESW John was the CEO of Hancock and before that was CEO of the Western Australian Departments of State Development and Resources Development.

Rod Smith (Chief Financial Officer) is a qualified CPA with 17 years commercial experience in the resources industry. Prior to joining Emerson Stewart, Rod worked with GRD Minproc from 2004 to 2007 supporting BHPBilliton’s US\$ 2.2billion Ravensthorpe Nickel project in the role of Shared Services Manager. Rod also brings to the group, experience gained in various financial and commercial roles with Worley Parsons and Rio Tinto.

**The Listing**

**Funds raised at listing will fund growth opportunities .....**

The funds raised at listing will be used primarily to fund growth opportunities and / or acquisitions (see further commentary below), as well as to fund increased working capital requirements.

Table 4: Use of Funds

	\$m
Growth Opportunities / Acquisitions	5.3
Additional Working Capital	2.0
Fees and Expenses of the Offer	0.7
<b>Total</b>	<b>8.0</b>

Source: ESW

Executives and other existing shareholders have retained their shares at listing, but have been diluted as the new IPO shareholders take a 32.4% stake in the business. A share option scheme has also been designed and implemented to incentivise other key staff members.



Table 5: Shareholder Details

	Pre Issue (%)	Post Issue (%)	Post Issue (m)
Executives	78.5	53.1	65.7
Other Existing Shareholders	18.3	12.4	15.3
Argonaut	3.1	2.1	2.6
New Shareholders		32.4	40.0
<b>Total</b>	<b>100.0</b>	<b>100.0</b>	<b>123.6</b>

Source: ESW

Of those held by executives, 62.50m shares will be subject to voluntary escrow until 31 January 2010 (31.25m each for Dario Amara and Angelo Dabala).

## Growth Opportunities

..... organically and via acquisition

ESW is committed to increasing the scale and scope of its operations, with the listing enhancing the capability to do so:

- × Organic growth is anticipated as a result of expansion of resources and capabilities, as well as through targeting a wider geographic footprint (Queensland, SE Asia, and potentially southern Africa).
- × Acquisitive growth will also be both functionally and geographically driven. ESW has already identified and engaged in initial discussions with targets. It is expected that there will be at least two strategic acquisitions within 12-18 months of listing.

ESW is adamant that future acquisitions will not be made to simply grow the head count, and the following key criteria have been established. Potential targets must:

- × Complement existing business lines and service offerings
- × Enhance scale and geographic footprint
- × Provide access to lower cost labour environments

The company respects the risks associated with international expansion. Whilst extension into Asia has already commenced, ESW favours a "client led" approach to expanding into the region. ESW is overall project manager for the expansion of a coal project in Indonesia on behalf of an existing Australian client, and it has signed a MoU with Malaysian Engineering firm Konsultant Proses.

The group's business lines are complementary, providing opportunities for organic growth through sub-contracting and sales across the divisions. For example, resource projects typically require both energy and infrastructure components.

ESW also flags the potential for the development and management of energy assets on a proprietary basis in the future based on the Build, Own, Operate (BOO) concept. This provides a further unique differentiating feature to the group, but more detail will be needed to determine the financial impact of this non-traditional model.

That there is currently a significant pipeline of resource and infrastructure related projects, particularly in WA and QLD, is without question. ABARE has recently reported that strong resource project growth is expected to continue in the medium term, providing ESW with a solid, medium-term platform for growth.



## Investment Rationale

**A positive macro picture, strong management and a differentiated service are attractive qualities**

A positive macro picture:

- × ESW is servicing 3 sectors that are experiencing robust growth. The company's position is further strengthened by the fact that their area of expertise is widely accepted as an undersupplied resource.

Strong management team:

- × Management have impressive résumés, boasting 120+ years of combined experience. Coupled with this are invaluable personal relationships with customers that have been built over many years.
- × The listing of the company will allow the Group to attract and retain qualified staff through incentives such as share options. Clearly, in a growing service based business, skills and quality personnel are key ingredients for success.

Unique service offering:

- × ESW differentiates itself from traditional firms through the "Owner's Team" concept, limiting its exposure to risks and structuring remuneration to include performance incentives.
- × The company places great emphasis on assessing risk versus potential reward before taking on a new project, and see their niche in the premium end of the market. As a result of this certain contracting styles and projects, such as lump sum contracting, construction and tendering are generally avoided. ESW will turn down business if the risks are too great, or rewards are not sufficient.

## Key Risks

**Risks primarily relate to the lack of track record, small size and difficulties in finding skills in a tight market**

Specific risks:

- × The company's success is dependent on the skills and reputation of a relatively small number of key people. In Argonaut's view this is the primary risk, and investment in ESW necessarily requires faith in management and their ability to deliver.
- × ESW has only been operating since 2005. Furthermore, 2 of its 3 divisions are less than 12 months old. There is thus a limited earnings record to go by, which increases the probability of errors in financial forecasting.
- × At this point ESW still has a limited client base. This raises the risk of revenue expectations not being met and increases the potential for company failure in the event of a downturn in general market conditions or intensifying competition.
- × Acquisitions are an important part of ESW's growth strategy and will be subject to a number of risks. Rapid organic and acquisitive growth needs to be carefully managed.

General risks (apply to the industry):

- × Australia's skilled labour constraints could impede growth.
- × Contractual disputes and litigation that are not covered by insurance could result in direct financial loss.
- × Non-performance of subcontractors.
- × Work tendered for outside of Australia could be negatively impacted by the strength of the A\$.



## Financials

**A limited track record and forecasts only 6 months ahead**  
.....

The pro forma historical Income Statement for the year ended 30 June 2007, and the pro forma forecast Income Statements for the year ending 30 June 2008 and for the half year ending 31 December 2008 are show below.

Table 6: ESW Income Statements

	Pro forma FY2007A (\$m)	Pro forma FY2008F (\$m)	1H2009F (\$m)
<b>Revenue</b>	<b>4,407</b>	<b>9,700</b>	<b>11,349</b>
Operating Expenses	4,173	7,651	8,959
<b>EBITDA</b>	<b>234</b>	<b>2,049</b>	<b>2,390</b>
D&A	15	26	75
<b>EBIT</b>	<b>219</b>	<b>2,023</b>	<b>2,315</b>
Net Interest	59	174	301
<b>PBT</b>	<b>278</b>	<b>2,197</b>	<b>2,616</b>
Tax	100	755	785
<b>NPAT</b>	<b>179</b>	<b>1,442</b>	<b>1,831</b>
Costs of Acquisition*		1,227	
<b>NPAT after Acquisition Costs</b>		<b>215</b>	

\* Non-recurring costs associated with acquisition of operating entity

Source: ESW

Argonaut highlights the following:

- × The forecasts for FY2008F and 1H2009F are provided by ESW
- × FY2008F has been arrived at after accounting for the actual figures achieved over the 9 months ended 31 March 2008
- × The 1H2009F numbers are based on the company's expectations and budgets. Cognisance has been given to work in progress and there is an assumption of some organic growth. However, nothing has been factored in for any acquisition that may occur during the period.

**..... makes modeling difficult**

Argonaut has not yet developed an extended financial model for ESW as the short track record and limited financial detail would make forecasting beyond the 6 month forecast period provided by the Company highly speculative.



## Recommendation

### Based on inferred numbers for FY2009 .....

In order to compare ESW to other listed consulting engineering firms, Argonaut has calculated an inferred a 12 month profit figure by doubling ESW's 1H2009 forecast. It must be noted that the actual profit outcome for FY2009 could be significantly different as this gives no regard to:

- × Acquisitions (which are a fundamental part of ESW's growth strategy)
- × The rapid organic growth that is often experienced by companies at similar stages of their lifecycles

Table 7: FY2009F Consulting Engineering Peer Group Multiples

		Mkt Cap (\$m)	EV/EBITDA	EV/EBIT	P/E
Ausenco	AAX	1,347	10.7	11.9	16.6
Clough	CLO	503	6.5	8.9	12.7
Sedgman	SDM	464	9.1	10.9	15.0
VDM Group	VMG	181	3.5	4.3	5.1
Lycopodium	LYL	166	8.2	8.8	12.9
GRD	GRD	155	7.8	10.3	18.0
<b>Average</b>		<b>469</b>	<b>7.6</b>	<b>9.2</b>	<b>13.4</b>
<b>ESW</b>		<b>25</b>	<b>3.1</b>	<b>3.2</b>	<b>6.8</b>

Source: Argonaut, Broker Consensus

### ESW's multiples are undemanding when compared to peers

ESW's market capitalisation dictates that it should trade at a significant discount to its much larger listed peers. Conversely, the stronger growth potential coming off a very low base should be reflected positively in the multiples. Much will depend on management's ability to deliver against the Company's growth potential in the coming months.

Argonaut has drawn attention to the risks associated with ESW's small size and short history, but contends that this is offset by compelling positive attributes:

- × Impressive management with an incentive to succeed
- × Established relationships within the market place
- × Potential for rapid growth off a low base
- × Servicing 3 robust industries
- × Can provide "in demand" skills in an undersupplied market
- × A unique, results driven approach to the business
- × A focus on, and proactive management of, risks

### Growth potential is underpinned by .....

Argonaut believes the potential for ESW to develop into a strong and sustainable business is high. The greatest hindrance to its development is likely to be the ability to attract skills, rather than gaining market acceptance.

### ..... a strong team, a differentiated model, and a positive environment

ESW provides investors with an opportunity to achieve exposure to an emerging company exhibiting solid growth potential at a time of strong demand for engineering services from the resources and infrastructure sectors.

### SPECULATIVE BUY

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**Important Disclosures**

Argonaut has acted as corporate advisor to ESW and as manager and broker to the IPO in June 2008. Argonaut has received fees commensurate with these services.

Argonaut holds and/or controls 2,626,000 shares in ESW.

Argonaut Securities may receive brokerage income from clients who wish to buy and sell ESW shares subject to this report.

This report was produced by Ian Christie and Jason Moore. Jason has an interest in ESW shares.

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