



Resource Services

2 June 2010

The Fear Factor

A convergence of bad news has hurt the market, and very sharp share price falls have been evident in the highly cyclical resource services sector. The timing of the RSPT could not have been worse and the subsequent posturing has added to the uncertainty.

Balanced view – we believe it important to keep a balanced view:

- × Capital is already committed for some very significant projects
- × While it may be hard to undo the damage done to Australia’s reputation, we believe the RSPT itself will be significantly amended over time
- × Investment decisions will still be made based on long term secular trends

Volatile sector – however we have to accept that risks have increased and that in such times, share prices within the sector can fall dramatically (whether warranted or not). During the GFC we saw many shares in the resource services sector lose in excess of 80% of their value (see charts on page 3).

Our concerns – with confession season now well underway, we need to be alert to:

- × Companies joining the 2H10 downgrade club (see summary at left and detail on page 4) in the short term – if unexpected, shares will be dealt with harshly
- × The chance that project delays result in a dent in earnings down the track

Investment strategy – our concerns suggest it would be wise playing it safe. There will be a time to invest in a rebound in the sector, but with downside risks still evident it isn’t now. In the near term we recommend focusing on companies:

- × With strong balance sheets / cash flow and exposure to offshore oil & gas, WA LNG, gold and overseas projects
- × That exhibit relative outperformance during market weakness

Target prices & recommendations – the increased chance of a dip in earnings in FY11 / FY12 and the heightened level of risk aversion has been captured in our updated target prices (see detail on page 7). Adjustments take into account volatility in earnings and prices as exhibited in recent years. We have made a couple of recommendation changes as a result (see detail on page 8).

Defensive picks – our picks meet the guidelines above and offer defensive qualities:

- × **Mermaid Marine (MRM)** - offshore oil & gas; vessels and boats will remain busy during Gorgon construction
- × **Tox Free (TOX)** - waste happens regardless of cycle; FY11 growth; exposed to industrial as well as resources waste
- × **Fleetwood (FWD)** - good Searipple cash flow supports dividend; strong balance sheet; conservative management
- × **Ausdrill (ASL)** - diversified; exposure to gold and Africa; strong balance sheet post capital raising

It could be argued that **Austin Engineering (ANG)** has some defensive qualities with an active acquirer (BKN) on its register.

During both the GFC crash and the recent correction TOX, FWD and MRM were all amongst the best relative sector performers (top quartile), joining the likes of UGL, CLO and MND. ASL fell into the second quartile performers, joining the likes of LEI, WOR, ANG and LYL.

2H10 Outlook

Company	Original Outlook	Earnings Updates
AAX	positive	negative
ANG	positive	
AJL	positive	negative
ASL	positive	
BKN	positive	positive
BLY	positive	positive
CLO	negative	
COF	flat	negative
DCG	flat	same
DOW	positive	negative
FWD	positive	
GCS	positive	
IMD	positive	
LEI	positive	same
LYL	flat	positive
MAH	positive	
MCE	positive	
MIN	positive	
MND	flat	
MRM	positive	
MSL	positive	
NMS	positive	
NOD	positive	negative
NWH	positive	
PEA	positive	
RCR	positive	
SKE	flat	same
SWK	positive	negative
SXE	positive	
TOX	positive	negative
VMG	positive	
WDS	positive	negative
WOR	positive	same

Please refer to important disclosures on page 10

Analyst:
Ian Christie, CFA



Recent falls warranted?

The negatives

There's been a spate of bad news recently

There's been a convergence of bad news that's hit the market. These issues have been well covered, so we just note the headlines.

Globally	Debt – investors are recognising that a number of western economies have solvency problems and not simply liquidity issues
	Growth – apart from defaulting on debts and printing money, there's no easy fix and growth is threatened
	China – with bubble worries and major customers (Europe and the US) weak, there is mounting concern that China will be unable to take up the consumption slack in the short term
Domestically	Resource Super Profits Tax (RSPT) – the timing could not have been worse

Both global and domestic issues could result in project delays and/or cancellations, with the latter having the potential to chase capital offshore.

The positives

..... but it's important to keep a balanced view

Markets are panicking but the world hasn't stopped. It's important to keep a balanced view.

Existing Projects	Capital is committed for a number of significant projects, which we would expect to continue. Their combined value dwarfs prior period resource project capex, and in most cases the projects still have years to run. See nearby examples.	BHP – RGP5 / RGP6
		FMG – Christmas Creek
		Gindalbie – Karara
		CP Mining – Cape Preston
		Chevron – Gorgon
		WPL - Pluto
RSPT	We find it hard to believe that the mining sector in Australia, given its importance, will be allowed to be irreparably harmed. While a new resource tax may be implemented in time, we believe its form will ultimately be very different to the current RSPT proposals. While it's too late to reverse the harm to our international reputation, this view suggests that the RSPT's damage to the resources sector will be limited to its negative impact on project timelines.	BHP – Macedon
Project assumptions	Large project decisions are made based on long term assumptions. The secular trend for China and India, and therefore demand for energy and commodities, is unchanged. Thus, the chances that Chevron for example moves onto Wheatstone post Gorgon are still reasonable.	

On balance the risks in investing in the sector have increased. Some falls in share prices are therefore warranted from a valuation perspective.

Still, risks have increased and it's no surprise stocks have fallen

However, the charts on the following page show that when fear and greed set in, the sector often overreacts in the extreme. We therefore could see market sentiment driving unwarranted falls in prices to well below their fundamental value.



Highly cyclical

Resource service stocks can be highly volatile,

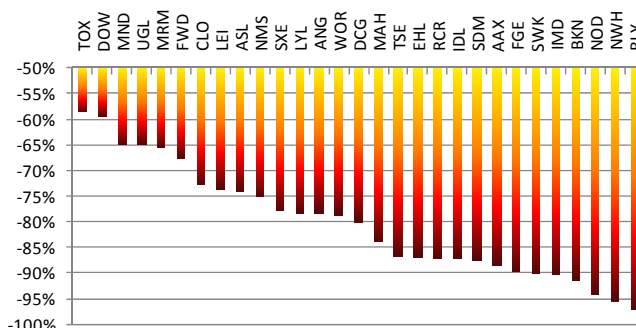
The resource services sector is highly cyclical and share price movements magnify overall market moves. From the 2008 peak to trough the ASX All Ordinaries lost 52%, while a broad selection of resource service stocks lost on average 80%.

It's been a similar story so far in 2010. The All Ords low has dropped to 15% below the high, but the lows for resource services are on average 39% below recent highs.

Conversely the gains can be spectacular during an upswing. While the All Ords bounced 62% off its lows post the GFC, every stock shown on the charts below more than doubled. The better performers climbed more than five-fold, and some more than ten-fold.

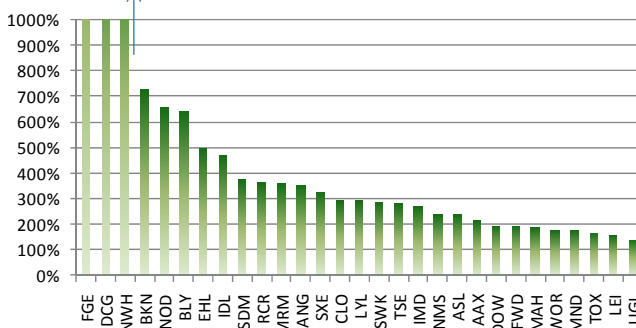
Figure 1: Selected resource service stocks – changes in share price

2008 Peak to Trough



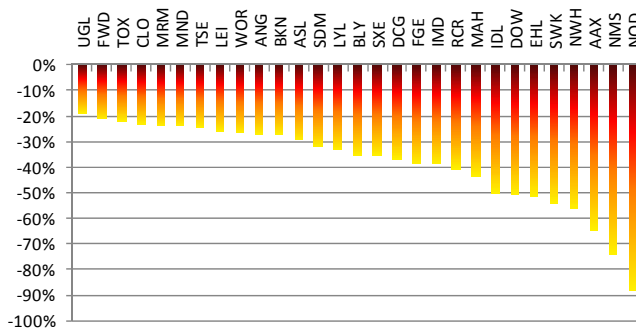
..... with big losses in market downturns

Post GFC Bounce



..... offset by dramatic gains during recovery

Fall from Recent Highs



In recent market corrections, the best and worst performers have been similar

The worst performers during downturns have tended to be the same stocks. Nomad (NOD), Swick (SWK) and NRW (NWH) have been in the bottom quartile in both downturns, whereas United (UGL), Fleetwood (FWD), Tox Free (TOX), Clough (CLO), Monadelphous (MND) and Mermaid Marine (MRM) have been those least negatively affected.



Our concerns – the FY10 downgrade club

Members are beginning to join the 2H10 downgrade club

In the short term we need to be aware of companies that may join the FY10 downgrade club. Since the interims we've noted the following earnings updates:

Table 1: Outlook and updates to June 2010

2H10 Outlook			
Selected Resource Service Stocks			
Company	Prior Guidance / Outlook	Original Outlook	Earnings Updates
AAX	Growth expected from 2Q10 for FY10 (Dec y/e); record level of project & tender opportunities (US\$24.8b)	positive	negative
ANG	Stronger 2H10; increased revenue and profit to lead to a record result	positive	
AJL	Encouraging signs, with positive macro for coal and CSG industries	positive	negative
ASL	Expects improved full year result (excluding merger costs and any further A\$ appreciation)	positive	
BKN	EBITDA slightly down on FY09, expect improving trading conditions in 2H10	positive	positive
BLY	Optimistic but cautious; FY10 guidance - revenue US\$1,125m (upside to this), EBITDA US\$170m	positive	positive
CLO	2H10 earnings expected to be lower than 1H10 - FY10 EBIT expected to be consistent with FY09 (\$56m)	negative	
COF	Limited outlook commentary; cautious / mixed outlook	flat	negative
DCG	2H10 revenues and earnings similar to 1H10	flat	same
DOW	FY10 guidance of NPAT growth of ~5%	positive	negative
FWD	Improving demand in RV division, increased tendering in MA division	positive	
GCS	Conditions in some markets remain soft, but an improvement is expected in 4Q10	positive	
IMD	2H10 started well; revenue and EBITA are expected to be higher than 1H10	positive	
LEI	Revenue ~\$19b, NPAT >\$600m; longer term outlook "solid"	positive	same
LYL	Revenue of \$110m and NPAT of \$8m	flat	positive
MAH	FY10 increased from \$34m to \$36-40m; lots of potential to grow order book (which is light FY11+)	positive	
MCE	No specific FY10 guidance, but positive commentary	positive	
MIN	No specific FY10 guidance - company well positioned financially to execute an expansive strategy	positive	
MND	2H10 sales and earnings similar to 1H10	flat	
MRM	Expect continued growth in 2H PBT, higher tax rate in 2H ~17-18%	positive	
MSL	Company expects a solid 2H10, will install ~1,000 rooms over next 18 months	positive	
NMS	Boat utilisation expected to improve, expected recovery in US	positive	
NOD	FY10 revenue of \$250m, NPAT -\$2m; indications that tender activity is strong	positive	negative
NWH	20% revenue growth, NPAT \$33-38m; tendering pipeline \$2b, record \$720m order book	positive	
PEA	Number of opportunities under negotiation; push into eastern states expected CY2010	positive	
RCR	Spare capacity; 80% of 2H10 revenues locked in; expect improved 2H10	positive	
SKE	Some recovery, improving margins, variability across divisions, predictions tough	flat	same
SWK	Stronger second half performance; revenue ~\$105m; EBITDA ~\$28m	positive	negative
SXE	2H10 revenue ~\$11m higher than 1H10 at similar gross margins; acquisition costs expensed 2H10	positive	
TOX	40:60 1H:2H earnings split indicates EBITDA ~\$30m; current guidance remains \$26-28m	positive	negative
VMG	Anticipating revenue for FY10 approaching \$500m, tender pipeline strong	positive	
WDS	FY10 guidance for EBITDA \$31m and NPAT of ~\$7m; subsequently talked down at interims	positive	negative
WOR	FY10 NPAT \$280-320m; increasing activity, expect significant earnings weighting to 2H10	positive	same

Source: Argonaut, companies

Risks of downgrades are greater for companies with a big 2H turnaround story – the likes of NMS, IMD and NWH

We believe that some of the biggest risks are for those companies with an expected strong rebound in 2H10 when compared to 1H10. Of those we cover, we've already seen SWK, TOX and NOD pare back guidance. Based on the table below we are particularly nervous about NMS, and will be watching IMD and NWH.

Table 2: Argonaut forecasts – 1H:2H splits

	Revenue			Normalised NPAT		
	1H10A	2H10F	Δ on pcp	1H10A	2H10F	Δ on pcp
ASL	259,336	338,870	31%	23,484	22,476	-4%
ANG	67,223	84,951	26%	8,169	9,298	14%
FWD	130,068	152,860	18%	16,800	18,049	7%
IMD	58,394	66,610	14%	5,942	8,900	50%
MAH	656,300	653,536	0%	21,460	18,198	-15%
MCE	43,545	55,255	27%	6,939	8,374	21%
MRM	87,258	96,020	10%	20,010	18,848	-6%
NMS	84,301	109,460	30%	949	8,648	811%
NOD	94,464	135,536	43%	-5,208	-766	n/a
NWH	268,284	340,509	27%	15,301	21,596	41%
SWK	46,111	50,873	10%	1,460	3,214	120%
TOX	46,703	51,037	9%	4,623	4,967	7%



Our concerns – a medium term earnings dip

There is also an increased risk of a medium term earnings dip – thanks to delays caused by the RSPT

Regardless of the state of the global economy, we believe that the RSPT has ensured that some projects will get deferred. Given lengthy timelines for new projects, we expect that:

- × Work in hand should keep resource service stocks generally busy in the near term (a number of companies would have a reasonable portion of FY11 anticipated revenue locked into their order books)
- × Project delays would be more likely to cause a dent in earnings from 2H11, and potentially more seriously in FY12
- × Given that engineering firms are involved from the beginning of the project lifecycle they are likely to be the first impacted by project delays, followed later by those involved in the construction phase

While we have not changed our medium term forecasts yet

There is a high level of uncertainty at present, and at this point we have not changed our earnings forecasts for FY11 and FY12. However, comparing 1H10 to 1H09 we note that the GFC induced downturn had the following financial impact on the stocks that we cover:

..... we note the impact of the last downturn on 1H10 revenues

Figure 2: 1H10 revenue (Δ on pcp)

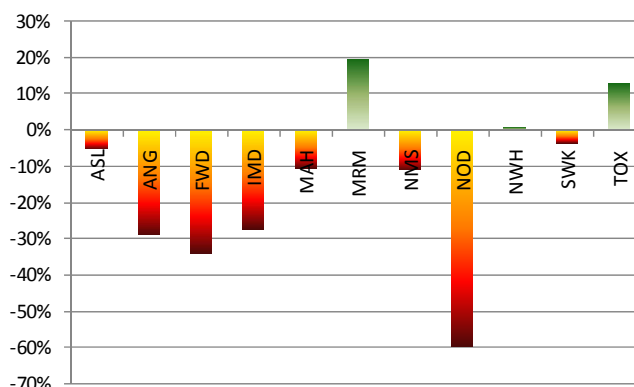
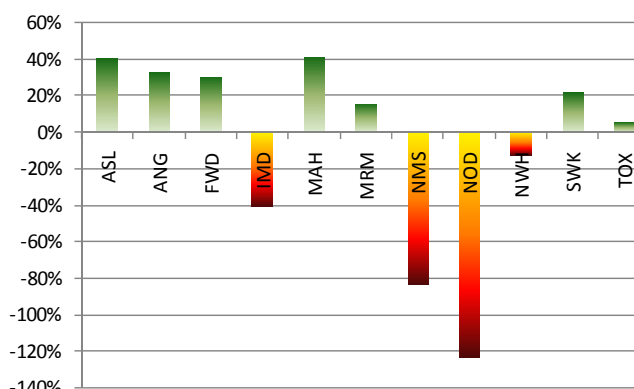


Figure 3: 1H10 normalised EBITDA margin (Δ on pcp)



For a number of companies cost-cutting in 1H10 had a positive impact on margins, offsetting the revenue decline. However, cost cutting is largely a one-off event and we believe that any reduction in revenue in coming periods will tend to be reflected on the bottom line.



Investment Strategy

We suggest cautious investing in the sector for now

..... and it's not yet time to look for the bounce

Given the present uncertainties we suggest:

- × Playing it safe in the short term.
- × That in time there will be a strong rebound in the sector, and many of those hardest hit now will climb the most. There will be a time to invest in the bounce, but with downside risks still evident that time is not now.

Table 3: Resource services investment strategy

Timing	Strategy & focus		Examples
Short term	Ideally, look for companies with exposure to:	Offshore oil & gas (subject to PRRT or exempt)	ASL, CLO, FWD, LEI, LYL, MND, MRM, TOX, UGL
		WA LNG (believe CSG LNG economics less attractive)	
		Gold (prices have climbed in US\$ and A\$)	
		Offshore & non-resource sectors (less RSPT exposure)	
	Strong balance sheets / cash flow		
	Companies that exhibit relative outperformance during downturns (see charts on page 2)		
Later (based on unfolding events)	Invest in the rebound – riskier stocks and those that were hardest hit during downturn		AAX, BLY, DCG, EHL, FGE, IDL, NOD, NWH, RCR, SWK



Adjustments to target prices

We have adjusted our target prices

Based on the above, we have decided to capture the increased likelihood of a dip in earnings in FY11 / FY12 and the heightened level of risk aversion by:

Table 4: Basis for adjusting target prices

	Limited Risk Stocks*	Lower Risk Stocks*	Higher Risk Stocks*
Lowering the multiple to set earnings capitalisation values by:	Unch.	10%	20%
Increasing the discount rate to obtain a DCF value by:	Unch.	10%	20%

* As evidenced by share price reaction & revenue performance in the prior downturn

..... based on our perceived level of risks

We have categorised stocks based on our views of the potential earnings impact of a downturn as well as the level of risk as reflected by downward share price moves in the prior downturn.

Table 5: Stock categorisation w.r.t. adjusting target prices

Limited Risk Stocks	Lower Risk Stocks	Higher Risk Stocks
ANG*, FWD, MCE, MRM, PEA, TOX	ASL	IMD, MAH, NMS, NOD, NWH, SWK

* ANG would typically be classified as a lower risk stock, however we believe it is underpinned by corporate appeal (BKN has been acquiring shares recently at up to \$3.40)

As a result of the above, our adjusted valuations and target prices are shown in the table below.

Revised valuations and target prices

Table 6: Revised valuations and target prices

Stock	Previous Valuations			Adjusted Valuations		
	Multiple-based	DCF-based	Target Price	Multiple-based	DCF-based	Target Price
Ausdrill	2.62	3.11	2.80	2.34	2.70	2.50
Austin	3.26	3.35	3.30	3.26	3.35	3.30
Fleetwood	9.00	8.78	9.00	9.00	8.78	9.00
Imdex	0.76	0.89	0.80	0.61	0.69	0.65
Macmahon	0.73	0.75	0.73	0.58	0.61	0.58
Matrix	3.01	3.44	3.00	3.01	3.44	3.00
Mermaid Marine	3.19	3.29	3.20	3.19	3.29	3.20
Neptune Marine	0.47	0.46	0.45	0.37	0.36	0.35
Nomad*	0.12	0.42	0.12	0.12	0.42	0.12
NRW	1.74	1.64	1.65	1.39	1.27	1.25
Pacific Energy	0.47	0.57	0.50	0.47	0.57	0.50
Swick	0.55	0.61	0.55	0.40	0.38	0.40
Tox Free	n/a	2.74	2.75	n/a	2.74	2.75

* Recently updated – already risk adjusted



Changes to recommendations

Recommendations restated

We have reviewed our recommendations in the light of the above adjustments.

Table 7: Revised recommendations

	Current Price	Target Price	Current Rec.	Prior Rec. if changed
Ausdrill	\$1.80	\$2.50	Buy	
Austin	\$3.09	\$3.30	Hold	
Fleetwood	\$8.66	\$9.00	Buy	
Imdex	\$0.72	\$0.65	Hold	Spec Buy
Macmahon	\$0.54	\$0.58	Hold	
Matrix	\$2.81	\$3.00	Buy	
Mermaid Marine	\$2.43	\$3.20	Buy	
Neptune Marine	\$0.23	\$0.35	Hold	
Nomad	\$0.13	\$0.12	Sell	
NRW	\$0.92	\$1.25	Buy	
Pacific Energy	\$0.25	\$0.50	Buy	
Swick	\$0.36	\$0.40	Hold	Buy
Tox Free	\$2.16	\$2.75	Buy	

Note that NMS is retained as a Hold despite the current share price falling well below our target price due to heightened concerns over second half earnings.

Argonaut key picks

Key defensive picks reaffirmed

We believe that the following companies under our coverage tick all or most of the the short-term boxes:

Table 8: Argonaut preferred defensive stocks in short term

Mermaid Marine (MRM)	offshore oil & gas; vessels and boats will remain busy during Gorgon construction
Tox Free Solutions (TOX)	waste happens regardless of cycle; exposed to industrial as well as resources waste
Fleetwood (FWD)	good cash flow supports dividend; strong balance sheet; conservative management
Ausdrill (ASL)	diversified; exposure to gold and Africa; strong balance sheet post capital raising

We believe that **Austin Engineerings (ANG)** also provides some defensive qualities due to the potential for corporate activity (Bradken has acquired stock recently at up to \$3.40)

During both the GFC crash and the recent correction TOX, FWD and MRM were all amongst the best relative performers (top quartile), joining the likes of UGL, CLO and MND. ASL fell in the second quartile performers, joining the likes of LEI, WOR, ANG and LYL.



Argonaut Summary Forecasts & Comparatives

Company	Code	Market Cap.	Enterprise Value	Share Price	Valuation/Tgt Price	Rec	Revenue			EBITDA			NPAT					
							2008A	2009A	2010E	2011E	2008A	2009A	2010E	2011E	2008A	2009A	2010E	2011E
Ausdrill	ASL	463	565	1.80	2.50	BUY	387	505	598	743	83.8	110.5	142.3	167.1	35.3	31.6	46.0	58.0
Austin	ANG	214	222	3.09	3.30	HOLD	106	179	152	194	18.9	23.8	27.4	34.9	11.5	14.8	17.5	22.3
Fleetwood	FWD	440	433	8.66	9.00	BUY	344	355	283	330	61.6	63.9	61.5	65.9	34.2	35.6	34.8	38.2
Index	IMD	138	162	0.72	0.65	HOLD	142	135	125	141	41.7	27.8	22.7	31.5	21.1	11.3	8.3	15.1
Macmahon	MAH	389	361	0.54	0.58	HOLD	1,201	1,358	1,010	1,069	114.9	73.6	108.1	117.6	48.8	17.2	39.7	44.8
Matrix	MCE	188	167	2.81	3.00	BUY	22	54	99	182	2.3	5.3	25.7	39.4	0.7	3.1	15.8	22.0
Mermaid Marine	MRM	456	590	2.43	3.20	BUY	149	164	200	245	38.3	49.3	65.9	79.3	17.9	26.5	38.9	41.1
Neptune Marine	NMS	102	118	0.23	0.35	HOLD	87	189	194	216	10.6	39.3	20.2	38.8	10.9	25.1	9.6	19.7
Nomad	NOD	20	43	0.13	0.12	SELL	336	415	230	240	44.5	41.3	2.3	14.4	24.6	20.1	-6.0	3.6
NRW Holdings	NWH	231	296	0.92	1.25	BUY	471	510	609	624	71.3	81.2	85.2	87.4	40.4	37.1	36.9	39.7
Pacific Energy	PEA	51	103	0.25	0.50	BUY	1	19	26	33	-1.8	13.1	17.6	22.6	-1.5	6.2	11.1	15.2
Swick	SWK	85	117	0.36	0.40	HOLD	83	84	97	128	23.3	20.1	25.7	33.9	10.3	2.1	4.7	10.2
Tox Free Solutions	TOX	219	227	2.16	2.75	BUY	34	88	98	126	14.0	22.2	25.0	34.6	6.7	8.0	9.8	16.3

Company	Code	Market Cap.	Enterprise Value	Share Price	Valuation/Tgt Price	Rec	EV/Revenue (x)			EV/EBITDA (x)			P/E					
							2008A	2009A	2010E	2011E	2008A	2009A	2010E	2011E	2008A	2009A	2010E	2011E
Ausdrill	ASL	463	565	1.80	2.50	BUY	1.5	1.1	0.9	0.8	6.7	5.1	4.0	3.4	11.2	5.0	8.2	8.0
Austin	ANG	214	222	3.09	3.30	HOLD	2.1	1.2	1.5	1.1	11.8	9.3	8.1	6.4	7.1	5.2	12.3	10.0
Fleetwood	FWD	440	433	8.66	9.00	BUY	1.3	1.2	1.5	1.3	7.0	6.8	7.0	6.6	13.7	8.6	12.8	11.7
Index	IMD	138	162	0.72	0.65	HOLD	1.1	1.2	1.3	1.1	3.9	5.8	7.1	5.1	11.9	7.0	9.4	6.5
Macmahon	MAH	389	361	0.54	0.58	HOLD	0.3	0.3	0.4	0.3	3.1	4.9	3.3	3.1	18.4	11.1	9.9	8.7
Matrix	MCE	188	167	2.81	3.00	BUY	7.6	3.1	1.7	0.9	71.5	31.5	6.5	4.2		11.0	8.9	
Mermaid Marine	MRM	456	590	2.43	3.20	BUY	4.0	3.6	2.9	2.4	15.4	12.0	9.0	7.4	13.3	12.7	11.9	11.3
Neptune Marine	NMS	102	118	0.23	0.35	HOLD	1.4	0.6	0.6	0.5	11.1	3.0	5.9	3.1	11.3	6.6	10.5	5.3
Nomad	NOD	20	43	0.13	0.12	SELL	0.1	0.1	0.2	0.2	1.0	1.0	18.7	3.0	9.0	3.2	-3.4	5.6
NRW Holdings	NWH	231	296	0.92	1.25	BUY	0.6	0.6	0.5	0.5	4.2	3.6	3.5	3.4	11.9	6.4	6.3	5.8
Pacific Energy	PEA	51	103	0.25	0.50	BUY	137.0	5.4	4.0	3.1	n/a	7.9	5.9	4.6	-9.1	17.1	7.7	5.6
Swick	SWK	85	117	0.36	0.40	HOLD	1.4	1.4	1.2	0.9	5.0	5.8	4.5	3.4	18.2	30.1	15.7	8.3
Tox Free Solutions	TOX	219	227	2.16	2.75	BUY	6.7	2.6	2.3	1.8	16.3	10.2	9.1	6.6	15.7	17.4	21.3	13.5

**Contact Details****Research:**

Ian Christie
Director Research
+61 8 9224 6872

Troy Irvin
Associate Director
+61 8 9224 6871

Tim Serjeant
Analyst
+61 8 9224 6806

Institutional Sales:

Paul Carter
Executive Director
+61 8 9224 6864

Chris Wippel
Senior Institutional Dealer
+61 8 9224 6875

John Santul
Consultant, Sales & Research
+61 8 9224 6859

Damian Rooney
Senior Institutional Dealer
+61 8 9224 6862

Ben Willoughby
Institutional Dealer
+61 8 9224 6876

Corporate and Retail Sales:

Kevin Johnson
Executive Director
+61 8 9224 6880

Glen Colgan
Executive Director
+61 8 9224 6874

Geoff Barnesby-Johnson
Senior Dealer
+61 8 9224 6854

James McGlew
Senior Dealer
+61 8 9224 6866

Andrew Venn
Dealer
+61 8 9224 6865

Rob Hamilton
Dealer
+61 8 9224 6830

Melaney Brans
Dealer
+61 8 9224 6873

Important Disclosures

Ausdrill (ASL) – Argonaut acted as joint lead manager to the Capital Raising and joint underwriter to the Entitlement Issue in March/April 2010. Argonaut was advisor to Ausdrill in relation to the merger by Scheme of Arrangement with Brandrill in December 2009. Argonaut has and will receive fees commensurate with these services. Argonaut has an interest in 297,731 ASL shares.

Austin Engineering (ANG) – Argonaut acted as co-manager to the ANG placement in June 2009 and received fees commensurate with this service.

Matrix Composites & Engineering (MCE) – Argonaut acted as corporate advisor and broker to the Initial Public Offer in November 2009 and manager to the Placement in April 2010. Argonaut received fees commensurate with these services. Argonaut holds and/or controls 337,000 shares in Matrix.

Pacific Energy (PEA) – Argonaut acted as the corporate advisor to PEA in relation to the KPS acquisition and arranged the financing of the acquisition of the KPS business. Argonaut has an interest in and/or controls 2.6m PEA shares and 5.0m PEA options exercisable @ \$0.275 and expiring 30 June 2011.

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