NGE Capital Limited

Investment and NTA update | As at 30 September 2018

NGE CAPITAL LIMITED SUMMARY

ASX ticker	NGE
Share price (30-Sep-18)	$0.650
Shares outstanding	37,268,552
Market cap	$24.2m
NTA per share after tax	$0.815
NTA	$30.4m

OVERVIEW

NGE Capital Limited is an internally managed Listed Investment Company which allows investors to gain exposure to a concentrated, high conviction, actively managed portfolio of financial assets. NGE primarily focuses on listed ASX and international equities, with the aim of generating strong risk-adjusted returns over the medium to long term.

INVESTMENT STRATEGY

NGE has a flexible investment mandate and invests according to a defined set of investment principles, summarised as follows:

- Only invest in a compelling opportunity, otherwise hold cash;
- Invest based on fundamental analysis;
- Target investments that can generate strong returns with an adequate margin of safety; and
- Aim to hold a concentrated portfolio of high conviction investments.

BOARD & MANAGEMENT

David Lamm	Executive Chairman & Chief Investment Officer
Adam Saunders	Executive Director & Portfolio Manager
Ilan Rimer	Non-Executive Director
Les Smith	Company Secretary & Chief Financial Officer

CONTACT DETAILS

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NET TANGIBLE ASSETS (NTA) PER SHARE

	30 Sep 2018	31 Aug 2018
NTA per share before tax	$0.815	$0.795
Expected tax liability on realised and unrealised income and gains	($0.051)	($0.046)
Previously unrecognised tax losses now brought to account to reduce tax expense	$0.051	$0.046
NTA per share after tax	$0.815	$0.795

NTA PER SHARE PERFORMANCE SUMMARY

			Since inception (1)	
1 month	Year-to-date	Last 12 months	(p.a.)	(cum.)
2.6%	29.4%	29.6%	29.2%	59.9%

Note: Returns are net of all operating expenses and expected taxes. As an internally managed LIC NGE does not incur external management and performance fees.

(1) From 30 November 2016, the date on which NGE became a LIC.

TOP HOLDINGS (% OF NTA)

Company	Ticker	%
Powerwrap	Unlisted	19.6%
United Company RUSAL	0486.HKE	12.9%
Eureka Group	ASX:EGH	8.6%
Not disclosed	Listed	7.3%
Horizon Oil	ASX:HZN	6.8%
Base Resources	ASX:BSE	6.4%
Millennium Services	ASX:MIL	5.1%

PORTFOLIO COMPOSITION

	30 Sep 2018
Listed equities	50%
Unlisted equities	20%
Convertible notes	3%
Cash less other net assets	27%
Total	**100%**

UNRECOGNISED TAX LOSSES

After providing for the expected tax liability on year-to-date realised and unrealised income and gains NGE has approximately $21m of realised tax losses that are not currently carried on the Company's balance sheet as a deferred tax asset. In addition, NGE also has approximately $21m of capital losses available as at 31 August 2018.

The Company has received tax advice that these losses should be available to be offset against future tax liabilities, which in the aggregate equates to a potential future tax benefit of approximately $12m or $0.32 per share, so long as NGE continues to satisfy the continuity of ownership test as set out in Divisions 165 and 166 of the *Income Tax Assessment Act 1997* (Cth).

MONTHLY COMMENTARY

NGE's portfolio produced a return of 2.6% for the month of September. On a rolling 12-month basis, the portfolio is up 29.6%.

This month we disclose one of our new investments, **Horizon Oil Limited (ASX:HZN).** Horizon is an oil and gas producer. The company holds a 26.95% interest in producing assets in the Beibu Gulf, offshore China, a 26% interest in the producing Maari/Manaia fields in offshore New Zealand, and a strategic interest in a PNG LNG development project.

The company's all-in free cash flow break-even point is ~US$38/bbl, which accounts for direct production costs, capex, overheads, financing costs and tax. We forecast that the company will produce ~1.7 mmbbls (~1.1mmbbls from China; ~600 kbbls from NZ) in FY19E. The company gets a slight price discount on its heavier Chinese oil, and a slight premium on its light, sweet NZ crude. At an assumed all-in blended price received of US$70/bbl, Horizon should make roughly US$55m (A$75m) of free cash flow. If the oil price holds at current levels of US$85/bbl, Horizon should achieve a price of US$83/bbl and free cash flow on a run-rate basis of US$75m (A$100m).

CHEAP ON SUM-OF-THE-PARTS VALUATION

We value Horizon's producing assets in the Chinese Beibu Gulf and New Zealand's Taranaki Basin at ~20c per share (~26c less net debt of ~6c) based on a LT Brent oil price of US$70/bbl. The kicker to valuation is Horizon's stake in a midscale LNG project in Papua New Guinea, which could potentially be worth an additional ~10-20c. At the current share price level of 15c, we are getting the PNG LNG stake for free. Our average entry price was ~12.5c.

CHEAP ON A FREE CASH FLOW MULTIPLE VALUATION

At a share price of 15c, Horizon has a fully diluted market cap of A$260m. The Company's leverage has been a problem in the past, though the company is steadily paying down its debt with free cash flow. At 30 June, Horizon had net debt of US$75m (A$102m), including A$18.3m that should be received at some point from IMC's ITM options. Horizon's net debt also includes US$40m of expensive sub debt which is the near-term focus for paydown or refinance. The company is trading on a cash P/E of ~2.6x based on the Brent oil spot price of US$85/bbl, which is on the cheap side.

HIGHLY LEVERAGED TO THE OIL PRICE

Our DCF applies a LT Brent oil price of US$70/bbl and a WACC of 10%. Applying the spot price of US$85/bbl increases the production assets DCF to ~29c – i.e. a 21% increase in oil price leads to a 42% increase in valuation. Of course, this works the other way if the oil price declines. We show a sensitivity analysis to our production assets DCF valuation in the table below, along with the potential upside from the PNG LNG project:

		Brent oil price (US$/bbl)					
				Base case		Spot	
		$50	$60	$70	$80	$85	$90
Value of	$0.00	$0.092	$0.148	$0.205	$0.262	$0.291	$0.320
PNG LNG	$0.10	$0.192	$0.248	$0.305	$0.362	$0.391	$0.420
interest	$0.20	$0.292	$0.348	$0.405	$0.462	$0.491	$0.520

PNG LNG PROJECT THE POTENTIAL VALUE KICKER

Horizon is planning for an "uncomplicated, low-risk" 1.5 mtpa LNG development, which is at a relatively advanced stage. The project plan is to draw gas across a number of fields, though foundation gas for the project is concentrated in two fields. The fields have appraised resources of 2.0-2.5 tcf gas and 60-70 million barrels of condensate. Horizon and Repsol have a combined interest of 70% of the total resource and operate all the fields.

In June 2018 Repsol announced it had signed an agreement with a Chinese party, Changcheng Group, to sell its stake in the PNG LNG project. The PNG Government is stalling the deal for reasons that have not been made public. Details around the transaction have also not been released to the market, but if the deal eventually gets the green light it is likely to be positive on a look-through basis for Horizon's stake. We believe Horizon, which holds 30% of the key fields, could sell down part of its stake (perhaps to 10-15%) to Changcheng as part of a co-ordinated transaction. It is feasible that Horizon could sell its part-stake for A$100m (~6c per share).

If a Final Investment Decision (FID) is made on the LNG project, Horizon is entitled to a US$50m cash payment (perhaps 3cps on a present value basis) and US$80m of free carry on development costs from Osaka Gas, which acquired its stake in the project from Horizon several years ago. Upon FID, Horizon will hold a valuable minority stake in the project (together with the free carry, perhaps worth ~10c on a PV basis).

Recent developments on the PNG LNG Project have thrown a spanner in the works to the upside story. During the June 2018 quarter the company announced that the PNG Petroleum Minister had given the joint venture partners a notice of intention to cancel Petroleum Development License (PDL) 10, one of the key gas fields. The Minister is frustrated that PDL 10, and Pipeline License 10, are not further progressed or developed, having first granted the PDL in May 2014. We understand the reason for delaying was initially down to the ridiculously high capex costs at the time of the grant as oil was trading above US$100/bbl and in-demand oil services companies had carte blanche when it came to charging clients. This was then followed by a period in which all oil and gas companies struggled due to super low oil prices that went sub US$30/bbl in January 2016. The joint venture partners have put these arguments, along with some legal ones, to the Minister. As this is PNG, the process for these sorts of matters is not always straightforward, so time will tell what happens but it seems to be counterintuitive to cancel a license which underpins a significant capital investment program that is on the cusp of starting.

In summary, we like Horizon because although the investment bears commodity price risk we believe there is a sufficient margin of safety, with strong upside potential and limited downside.

During the month several developments worked in favour of our investment thesis for **United Company RUSAL Plc (0486.HKE)**. Firstly, the Office of Foreign Assets Control (OFAC) put out a FAQ that further explains what the word "maintenance" means in the context of RUSAL's general licenses. The general licenses authorise companies and people to conduct certain transactions with RUSAL and deal in the company's equity and debt up until a specified expiry date.

General License 14 authorises certain activities that are "ordinarily incident and necessary to the ***maintenance*** or wind down of operations, contracts and other agreements…involving RUSAL" up until the expiry of the license [emphasis added].

The updated definition of maintenance allows for the continuation of certain dealings with RUSAL if the parties were already conducting business prior to 6 April, when the sanctions were initially introduced, even if no contract existed. OFAC is also authorising the ability to sign new contracts with RUSAL, including contingent contracts that extend beyond the current expiry date that are contingent on the sanctions being lifted. A caveat is that the level of activity cannot exceed the activity level between the parties prior to 6 April. The updated definition allows RUSAL to continue to supply alumina and aluminium to existing customers, as well as continue to receive goods and services from its suppliers. We consider OFAC's clarification to be highly unusual and a promising concession.

Secondly, OFAC provided another extension to the expiry date for RUSAL's general licenses to 12 November from 23 October, which is conveniently just after the US midterm elections to be held on 6 November.

Finally, we acquired a further significant parcel of **Millennium Services Group Limited (MIL)** shares at 55c after the price dropped significantly following its poorly received FY18 results. At 55c per share, the company was valued on a FY19E EV/EBITDA multiple of ~3.0x (assuming EBITDA comes in at the middle of the guidance range) and an adjusted P/E (adjusted for acquisition-related amortisation) of ~3.5-4.0x – surely far too cheap for a profitable business experiencing reasonable growth, with a high percentage of recurring revenue.

Millennium is likely to be on the radar of small private equity firms – cleaning and facilities management firms have been happy hunting grounds for PE in the past – as the company has high a blue-chip client base, a large contracted earnings book, high renewal rates of existing contracts, and growth potential in the Security division. The business should also generate decent cash flows in the future, though cash flows were hampered in FY18 following significant investment in personnel to grow the Security division, investment in IT systems, an unusually high tax bill, and higher capex spend following several large contract wins.

At the time of writing, we note that the major shareholders (original vendors) have exerted their influence to effect substantial board change; we will monitor the situation.