Research Insight

CommSec

News from CommSec research

Welcome to this week's edition of the CommSec Research Insight. Each week we share the unique insights of the CommSec Equities Research team based on the research we prepare for institutional clients (ie fund managers). We provide you with a quick wrap on the state of our share market, a few feature articles on the most interesting recent research reports we've issued and snippets on stocks and sectors that have been making the news.

Issue 136 **29 October 2009 (4.30pm)**

Feature Article

Our feature articles this week are:

- **PrimeAg Australia Limited: Cotton price downgrade. Time for a buyback**
- **NIB Holdings Limited: Policyholders happy to wear premium increases**

The comments in the article below are an abbreviated restatement of our analysts' reports.

A glossary of frequently used investment terms can be found at the end of this report

Feature Article

PrimeAg Australia Limited: Cotton price downgrade. Time for a buyback

Last traded: $1.03	Sector: Financials	Market cap: $155m
BUY / MARKET PERFORM		Valuation: $1.86

Summary of previous report dated 27/10/09

Event

- Following downward revisions to our medium term cotton price forecasts, we have subsequently downgraded our forecasts for PAG's earnings.
- We now believe that the time has come for PAG to initiate a share buyback.

Implication

- *Strong currency hurts local cotton prices*. Global cotton prices have displayed strength throughout 2009, with US cotton futures reaching CBA's USc70/lb price target for mid-2010. However, we have had to reduce our local cotton price forecasts and PAG's FY10–11 earnings forecasts.
- *PAG's winter crop yield assumptions now look overly optimistic*. We believe that it is unlikely that PAG will achieve its targeted winter crop yields for FY10. We have therefore cut our FY10 winter crop yields but left our summer cropping yield assumptions unchanged.

Market Wrap

The sharemarket bulls may not agree, but the past week has represented a healthy period of consolidation for the market. In an eight-day period through to mid October, the Australian market lifted by over 6%. Such an increase over such a short space of time is rarely sustainable and this appears to ring true in this event. At the time of writing the market had given back over 3% of its gains.

Apart from the fact that the market had put on significant gains in a short period, it has also been traditional valuation measures that have been flashing warning signals. The forward price-earnings ratio, a measure that compares share prices with earnings forecasts, pushed ~10% above long-term averages.

With better news on the economy in recent months, investors have become more optimistic. But that optimism constantly has to be validated – not just in actual earnings results but also company statements.

Matt Comyn
General Manager

- *Doesn't change embedded portfolio value*. PAG's business will always be subject to high volatility in both output prices and production yields. This does not change the long-term value in PAG's rural land and water assets.

Earnings and valuation revisions

- The cotton price and FY10 winter crop yield downgrades have reduced our forecast earnings but our adjusted NAV-based valuation and price target remains unchanged at $1.86 and $1.80 per share respectively.

	FY10			FY12			FY12		
	New	Old	Change %	New	Old	Change %	New	Old	Change %
NPAT ($m)	9.2	13.4	-31.3%	14.6	14.9	-2.0%	19.9	20.3	-2.0%
EPS (cps)	6.1	8.9	-31.5%	9.7	10.0	-3.0%	13.3	13.6	-2.2%

Investment view

- *It is now time for a buyback*. PAG's diversified rural land and water portfolio is highly undervalued. We now see it as an opportune time for PAG to undertake a share buyback with excess funds. The current share price implies that PAG's rural land is worth around 25% of what PAG paid for it, which is unjustified in our view. We therefore retain our BUY / MARKET PERFORM recommendation on PAG.

Feature Article

NIB Holdings Limited: Policyholders happy to wear premium increases

Last traded: $1.28 Sector: Financials Market cap: $637m

ACCUMULATE / MARKET PERFORM Valuation $1.37

Summary of previous report dated 28/10/09

Event

- NHF held its annual general meeting (AGM) on Wednesday 28 October and updated the market on some key earnings drivers for the quarter ending 30 September 2009.

Implication

- Net policyholder growth for the first three months of FY10 was 1.8%, the same rate of growth experienced in the pcp.

- We previously assumed that NHF would lose policyholders in 1H10 due to the flow-on impact of Medicare Levy Surcharge (MLS) changes and the potential 30%+ premium increases that some policyholders would receive.

- In addition to policyholder numbers, NHF commented that actual investment return for first three months of FY10 was 5.3%, or $23m for the period.

- Surplus capital as at 30 September 2009 of approximately $150m was up on the $132m at 30 June 2009.

- **Earnings and valuation revisions**

- We have increased our investment earnings in FY10 to allow for the mark to-market impact of the September quarter. No changes to future period investment earnings.

- We have adjusted our policyholder growth assumption to the upper end of the 4–6% management guidance.

- As a result of these changes, FY10 EPS is up 26% and FY11 is up 1.5%.

Investment view

- We have increased our valuation by 3% to $1.37, in line with our earnings adjustment.
- In regards to our price target, we have previously commented that FY10 was the unknown year for us and hence we were cautious leading in to 1H10. As a result we applied a discount to our price target.
- This has not played out with customer stickiness proving far stronger than anticipated. As a result, we remove our discount and our price target is up 30% to $1.30.
- Following the increase in our price target, we remove our negative call on the stock and upgrade to a neutral stance based on the current share price of $1.30. Our recommendation is ACCUMULATE / MARKET PERFORM.

Stocks at a glance

Following is a summary of a selection of recent reports distributed by CommSec research.

Stocks by sector

Financials

AMP[1,]
29/10/09

Summary of report dated 22/10/09

AMP Limited: The slow road to recovery

Last Traded: $5.89 | Market Cap: $12,067m | Sector: Financials

ACCUMULATE / OUT PERFORM | Valuation: $6.44

Event

- On Thursday 22 October, AMP released its quarterly cashflows for the period ending 30 September 2009.

Implication

- There was nothing of concern in the flows data; however, they were not spectacular either. They highlight the long delay in improving investor sentiment following the market downturn, despite the recent equity market rally.
- The wealth management numbers came in slightly better than our previous mark-to-market adjustments, with retail disappointing and corporate super above expectations.
- We did think that there was upside risk to our numbers but this did not play out with discretionary contributions weak.
- The capital investors AUM came in below our estimate, only up 8% in the quarter versus an equity market rise of 20% in the quarter.
- The excess capital position has improved from $1.1b at 30 June to $1.4b at 30 September. This was better than we expected and it appears to be explained by the pull back in hedges over the period.

Earnings and valuation revisions

- We updated our numbers in a mark-to-market report on 6 October and while the flow numbers did disappoint, they have led to less than 1% EPS downgrades for FY09 and FY10.
- With minimal changes to our earnings, our price target ($6.30) has not moved. We have, however, increased the valuation by 2.5% to $6.44 given the stronger-than-expected capital position.

Investment view

- In our recent note on AXA we indicated that we may switch back to AMP as our preferred pick. Based on valuation and closing share prices, we see little need to actively jump into either stock at these levels. However given this flow data, we maintain our preference for AXA over AMP.
- While the downside to AXA in the near term is AUD related, the equity leverage for AMP earnings may be pushed out further than we anticipated and hence represents downside risk to earnings. In addition to this the regulation cloud hangs over AMP and the two risks combined more than offset the AUD impact for AXA. AXA's diversification and multiple growth opportunities could again benefit them in the near term.

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Healthcare

HSP
29/10/09

Summary of report dated 28/10/09

Healthscope Limited: Insights from site tour provide some colour

Last Traded: $4.77	Market Cap: $1,499m	Sector: Healthcare
ACCUMULATE / MARKET PERFORM		Valuation: $5.80

Event

- We attended a site tour of The Melbourne Clinic, Victoria Rehabilitation Centre, Knox Private Hospital and HSP's pathology laboratory in Clayton.

Implication

- *Brownfields rationale very clear:* The three hospitals are operating at full capacity (95–103%), have latent demand and the support of favourable demographics. These factors combined with competitive offerings (e.g. single 'hotel-style' rooms at The Melbourne Clinic) have increased our confidence that the additional beds/theatres are close to being fully utilised and that HSP will meet its high return targets. In addition, the three projects are on track and on budget (potentially under budget with lower building tenders).

- *Evidence of leverage across businesses*: As well as improving its product mix, HSP remains focused on leveraging its hospital referrals. It revealed that Victoria Rehab Centre receives ~30% of its referrals from HSP hospitals (with 75% from Knox Private Hospital). This focus on leverage was further highlighted by the fact that ~85% of Knox's pathology work is being sent to the Gribbles collection centre around 300m down the road – even though there is a competing centre on site.

- *Pathology business at a juncture*: HSP's key strategy is to capture share in the Qld and NSW markets in 2010 through price competition, where SHL and PRY are pushing private billing. It is 'tracking well' to date and expects to recoup the 'majority' of the ~$10m impact from the budget funding cuts. It is also 'ready to go' in terms of trying to capitalise on collection centre deregulation in 2010 and generic referrals in 2011.

Earnings and valuation revisions

- With limited new information revealed on the site tour, we have not made any material changes to our forecasts or price target.

Investment view

- As per guidance, its hospitals are well positioned to win market share and improve margins with good leverage and partial contributions from new projects in FY10. In the short term, however, we remain cautious about HSP recouping the full extent of the pathology fee cuts with market share gains and believe its 'lower risk' growth projects (weighted towards FY11) are unlikely to grab investors favouring higher beta stocks. We retain our ACCUMULATE / MARKET PERFORM recommendation at this stage.

As per guidance, HSP's hospitals are well positioned to win market share and improve margins with good leverage and partial contributions from new projects in FY10. In the short term, however, we remain cautious about HSP recouping the full extent of the pathology fee cuts

SHL[1,]
29/10/09

Summary of report dated 28/10/09

Sonic Healthcare Limited: Read throughs from Quest and Labcorp's 3Q results

Last Traded: $14.25 | Market Cap: $5,535m | Sector: Healthcare
BUY/OUTPERFORM | Valuation: $16.18

Event

- The two largest US laboratory companies, Quest and Labcorp announced their 3Q results during the week.

Implication

- Volumes are up despite macro weakness: Volume growth ranged from ~0.5% to 1% and revenue/test increased by ~4.3% due to test mix shift and price increases from Medicare last January. A 1.9% fee cut is expected next January due to CPI indexation.
  - SHL has traditionally grown volumes faster than the market growth of both Quest and Labcorp. Despite an expected Medicare fee cut of 1.9% next year, Medicare work only represents ~30% of SHL's US revenue.
- Acquisitions are on the horizon: Comments by both CEOs indicated that increased acquisition opportunities are expected as regional labs (previously bought by private equity) need to rollover upcoming debt. Additionally, there has been an increasing trend of hospitals monetizing their outreach lab businesses'.
  - This trend is a positive for SHL's business model, particularly comments about hospitals looking to sell their outreach labs as these represent ~55% of the US lab market. We have already seen the first signs of hospital lab divestitures (SHL's acquisition of Piedmont Medical and Quest's acquisition of Caritas in August).
- All major managed care contracts are locked in for FY10. This is a small negative for SHL as it means the opportunity to pick up additional work from contract churn throughout FY10 is minimal.

Earnings and valuation revisions

- We have made no revisions to our earnings estimates or recommendation.

Investment view

- We take some comfort from comments about acquisition opportunities in the US, however we note that our BUY/OUTPERFORM recommendation is predicated on SHL delivering in the near term.

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Happy investing!

Recommendation Definitions

SHORT TERM (over the next 6 months we expect the share price to):

BUY	Appreciate by >10%
ACCUMULATE	Increase between 2% and 10%
REDUCE	Increase by less than 2% or fall by up to 5%
SELL	Fall by >5%
REV	Company is under review - no recommendation available

LONG TERM (over the next 24 months we expect the total return to):

Outperform (O / P)	Exceed market return by >5%
Market Perform (M / P)	Be in line with market return, +/-5%
Under Perform (U / P)	Be less than market return by >5%
REV	Company is under review - no recommendation available

[1] Members of the Commonwealth Group have received fees within the previous 2 years from AMP and SHL

Glossary of frequently used investment terms

2P	proved plus probable	FUM	funds under management
3P	proved, probable and possible	GEP	gross earned premiums
ABARE	Australian Bureau of Agricultural and Resource Economics	GJ	gigajoule
ACCC	Australian Competition and Consumer Commission	GWP	gross written premiums
AGM	annual general meeting	JV	joint venture
APRA	Australian Prudential Regulation Authority	LNG	liquefied natural gas
ARTC	Australian Rail Track Corporation Ltd	L-R	long run
ATO	Australian Taxation Office	MAT	moving annual total
bbl	billions of barrels	Mboe	thousands of barrels of oil equivalent
bbls	barrels	mom	month on month
bp	basis points	MOU	Memorandum of understanding
CAGR	compounded annual growth rate	MRET	mandatory renewable energy target
CCGT	combined-cycle gas turbine	NAV	net asset value
CEO	chief executive officer	NPAT	net profit after tax
COGS	cost of goods sold	NPV	net present value
cps	cents per share	NTA	net asset backing per share
cpu	cost per unit	OCGT	open-cycle gas turbine
CSG	coal seam gas	OIP	oil in place
CSM	coal seam methane	OTC	over the counter
DCF	discounted cash flow	P/E	price-earnings ratio
D&A	depreciation and amortisation	pcp	prior comparable period
DRP	dividend reinvestment plan	ppt	percentage point
EBIT	earnings before interest and tax	PSI	offering into pipelines
EBITDA	earnings before interest, tax, depreciations, amortisation	SOTP	sum of the parts
EPCM	Engineer Procure Construct Manage	TEUs	twenty equivalent units
EPS	earnings per share	VWAP	volume-weighted average price
ETS	emissions trading scheme	WACC	weighted average cost of capital
EV	enterprise value	WIH	work in hand
FTA	free to air	y-o-y	year on year

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End of Report