# Research Insight

CommSec

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## 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.**

## Feature Article

**Our feature articles this week are:**

- **BHP Billiton: March production softer than expected**
- **UGL Limited: Rail division getting back on track**
- **QBE Insurance Group Limited: Dark clouds hovering over the crop**

**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

### BHP Billiton

| | | |
|---|---|---|
| Last traded: $42.21 | Sector: Materials | Market cap: $143B |
| Buy | | Price target: $52.00 |

Summary of previous report dated 21/04/10

**March production softer than expected**

BHP's March 2010 quarterly production was softer than expected across most commodities. The March quarter is always seasonally weak but weather disruptions were more significant than usual and copper production was weaker than expected.

Subsequently we have reduced our FY10 EPS forecast by 3.4%. The changes are primarily driven by lower than expected copper production and weaker iron ore and met. coal shipments. We expect consensus FY10 numbers will be trimmed around 3% on the back of this production report, however the changes are likely to be overwhelmed by ongoing commodity price upgrades.

**Maintain Buy recommendation**

We retain our Buy recommendation with an AUD52 price target. BHP is experiencing massive earnings growth from GFC lows. From PE multiples >20x 12 months ago, BHP is now back to 11x FY11 earnings.

## Market Wrap

It's never easy trying to analyse market reaction to corporate news. For instance this week Harvey Norman reported flat sales for the most recent quarter and its share price fell by over 5%. But the following day its share price rebounded by over 2%.

Did investors initially over-react, causing 'bargain hunters' to move in the following day? Did analysts need more time to assess the results, resulting in a more favourable market mood the following day? Were expectations for the sales results too optimistic?

The simple answer is that we never know the true reasons why markets react as they do. At the end of the day the reaction may have nothing to do with the actual corporate announcement. And while price volatility is good news for traders, when major news is breaking, longer-term investors may wish to stay on the sidelines until the dust settles.

**Stephen Karpin**
**Managing Director**

# Feature Article

## UGL Limited

| | | |
|---|---|---|
| Last traded: $14.90 | Sector: Industrials | Market cap: $2,454M |
| Buy | | Price target: $16.78 |

Summary of previous report dated 16/04/10

### Rail division getting back on track

Despite QR awarding UGL a $100m rolling stock and wagon order, we have made no change to our earnings forecasts as we have assumed a constant win rate in the division.

We estimate a ~7% EBIT margin for the division, so $100m translates into ~$7m or 2.5% of EBIT over FY10 (~$5m) and FY11 (~$2m). We have ~7.5% revenue growth factored in for the rail division already in FY11, but smoothing out in FY12 and we do see some upside risks to revenue growth in this division contingent on port and rail capacity.

### Strong outlook for resources and infrastructure driving our positive view

The tailwinds likely to be experienced across the sector will hit all of UGL's businesses and unlike other stocks in the sector, its capex is low and has little major construction or project risk. With $2.7b of work already sold for FY11, we feel risks are to the upside for consensus earnings forecasts and believe the share price will re-rate accordingly.

# Feature Article

## QBE Insurance Group Limited

| | | |
|---|---|---|
| Last traded: $21.80 | Sector: Financials | Market cap: $22,528M |
| Buy | | Price target: $23.52 |

Summary of previous report dated 16/04/10

### Dark clouds hovering over the crop

We have made minor changes to our QBE price target and valuation following revisions to our FX forecasts and QBE's acquisition of NAU Country Insurance Company (NAU) and its holding companies.

We have decreased our valuation by 0.8% to $26.20 and our price target by $1.1% to $23.52. Our price target and valuation revisions aren't more significant because the changes to our currency forecasts have effectively cancelled out the NAU acquisition. The net effect in FY10 is 0% change to NPAT, while in FY11 it is negative 1.4% impact.

### Investment view

Given the run in QBE's share price since we upgraded it to a Buy following the FY09 result, the share price is now only 6% below our price target. Despite this we maintain our Buy recommendation and highlight potential upside to our forecasts.

While we are not convinced on this acquisition we note that a key driver in our currency changes was further strength in the US economy. This US strength is a positive for QBE that should assist in generating further premium growth and hence drive underlying business earnings.

# Sector wraps

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

| Healthcare | Healthcare sector report |
|---|---|
| 22/04/10 | CSL: Last Traded: $36.60 Market Cap: $21,653M Sector: Healthcare<br>COH[1]: Last Traded: $75.15 Market Cap: $4,289M Sector: Healthcare<br>RMD: Last Traded: $63.34* Market Cap: $4760M* Sector: Healthcare<br>SHL[2]: Last Traded: $14.02 Market Cap: $5,586M Sector: Healthcare |
| Summary of report dated 16/04/10 | CSL: Hold Price target: $35.86<br>COH[1]: Hold Price target: $71.41<br>RMD: Buy Price target: $61.80 *<br>SHL[2]: Buy Price target: $14.92 |

**Revised FX forecasts hit healthcare stocks**

Following revisions to our FX forecasts we have updated our view on RMD, CSL, SHL and COH. We also updated our assumptions for our Cochlear implant upgrade profile following discussions with COH management.

**RMD**: We remain positive on RMD operationally but expect FX headwinds to intensify. Our forecast of a higher AUD will put pressure on translated COGS, while a firmer USD/EUR will provide a revenue headwind given ~36% of group revenues are derived in Europe.

**CSL:** With more than 80% of revenues from offshore (mainly US and Europe), our stronger AUD/USD and AUD/EUR results in translational headwinds, leading to EPS downgrades of 7% and 6.4% in FY11 and FY12.

**SHL**: With a large portion of its operating costs and debt denominated in foreign currency, the impact on earnings forecasts from changes to our FX assumptions is lower than the other healthcare companies.

**COH:** The impact on our COH EPS is twofold:

- We have revised our EPS downwards due to higher AUD assumptions partially offset by gains on its hedge book.
- We have also updated our FY11–13 estimates to reflect a larger upgrade pool (from ~55k to 70k) and stronger upgrade profile to the BP810 sound processor following discussions with management.

*We retain our Buy on RMD and SHL. We retain our Hold recommendation on COH and CSL but we note both have outperformed recently.*

*Price target, Last traded price and Market cap are in USD.

| Financials | ACCC knocks back NAB's bid | | |
|---|---|---|---|
| 22/04/10 | AXA: Last Traded: $6.22 | Market Cap: $6,024M | Sector: Financials |
| | AMP[2]: Last Traded: $6.34 | Market Cap: $13,322M | Sector: Financials |
| | NAB: Last Traded: $28.34 | Market Cap: $60,321M | Sector: Financials |
| Summary of report dated 20/04/10 | AXA: Hold | | Price target: $6.75 |
| | AMP[2]: Hold | | Price target: $6.82 |
| | NAB: Hold | | Price target: $28.00 |

**Samuel the saviour**

The ACCC announced its decision on the merger proposals put forward by AMP and NAB for AXA. The NAB bid was knocked back with the ACCC commenting that a NAB/AXA deal would significantly lessen the competition in the market for retail investment platforms for investors with complex investment needs. AMP's proposal was approved with the ACCC noting that AMP does not own its own wrap platform.

**Investment view**

In the short term we expect AMP's share price to react negatively due to the NAB announcement with the expectation of an increased offer for AXA and the need to raise cash to support the bid. Post a potential merger of AMP and AXA, a beefed up AMP becomes 'takeover-proof' and hence the current takeover premium in AMP's share price would be stripped out.

BUT, the situation is far from clear with NAB and hence there is still likelihood that the floor in AMP's share price remains for the time being. We therefore expect the fall in AMP's share price to be restricted to around 5% initially.

We expect NAB's share price to initially react positively given the removal of transaction uncertainty, uninspiring near-term acquisition metrics and the integration risk associated with AXA. However, uncertainty as to NAB's final aspirations in domestic wealth, a lack of clarity in the UK, a slow turnaround in retail banking and ongoing challenges in seeking to improve ROE in line with the sector is likely to temper potential upside. Maintain Hold recommendation.

# Stocks at a glance

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

## Stocks by sector

### Consumer discretionary

**WTF**
**22/04/10**

**Summary of report dated 20/04/10**

**Wotif.com. Holdings Limited**

| | | |
|---|---|---|
| Last Traded: $6.64 | Market Cap: $766M | Sector: Cons. discretionary |
| Hold | | Price target: $7.05 |

**Cycling the booking window extension**

Following Wotif.com's (WTF) update on its FY10 NPAT expectations we have revised downward our short and medium term earnings forecasts. WTF provided and indicative range of $52–56m, we previously forecast FY10 NPAT to come in at $57m.

**Growth still solid**

Despite a downgrade to our forecasts, our revised FY10 forecasts still represent a solid 25% growth in earnings. In line with the change in our earnings forecasts, we have downgraded our price target from $7.96 to $7.05. While medium-term earnings growth remains sound, this is factored into the share price in the short term and as such we retain our Hold recommendation.

Despite a downgrade to our forecasts, our revised FY10 forecasts still represent a solid 25% growth in earnings

### Consumer staples

**GNC[2,]**
**22/04/10**

**Summary of report dated 21/04/10**

**GrainCorp Limited**

| | | |
|---|---|---|
| Last Traded: $5.97 | Market Cap: $975M | Sector: Staples |
| Buy | | Price target: $7.15 |

**Big non-cash impact to forecasts**

GNC has updated the market on the likely accounting treatment of its malt business, grain receivals YTD and the search for a new CEO. FY10 EBITDA guidance for the group and malt business was reaffirmed.

We have downgraded our earnings forecasts but the majority of the downgrade is a result of the non-cash adjustment to D&A.

**Earnings and valuation revisions**

We have cut our earnings forecasts across all periods but only FY10f has changed beyond the assumed accounting adjustments (increased D&A of $16–17m pa). We have assumed less grain receivals and exports for FY10.

Given the non-cash adjustment to D&A and positive forecast impact on tax paid, our DCF valuation is only down 3.9% to $8.40 per share. We have applied a 25% discount to FY11 EV / EBITDA XJI multiple of 8.7x to derive our price target of $7.15 per share (down 3.4%).

**Risks are more than adequately priced in**

FY11 crop planting conditions on the east coast are very good. Longer term, GNC will continue to increase malt capacity and further penetrate the export wheat market in Australia. The current share price more than adequately prices in the risk surrounding GNC's acquisition of UMH, and malt EBITDA guidance was again reaffirmed. If the FY11 crop continues its solid start, there is the chance of a swift re-rating and we retain our Buy recommendation.

FY11 crop planting conditions on the east coast are very good. Longer term, GNC will continue to increase malt capacity and further penetrate the export wheat market in Australia.

**TGR'**
**22/04/10**

**Summary of report dated 22/04/10**

## Tassal Group Limited

Last Traded: $1.70 | Market Cap: $165M | Sector: Staples
Hold | Price target: $1.70

**Cut to Hold**

Data for sea temperatures in February show a significant spike and our industry contacts indicate that the raised sea temperatures have continued throughout March and into April. We expect average fish size to be reduced as a result of the warmer sea temperatures.

Consequently we have reduced our forecast fish volumes but kept total costs constant, which has a significant impact on EBITDA per kg. We have also changed our price target methodology from our DCF valuation to a 30% discount to the market PE, which reduces our price target to $1.70 per share (down 34.6%).

**Negative sentiment unlikely to turn materially in the short-term**

We are still positive on TGR's long-term ability to drive fixed cost leverage. The company will also benefit from supplying Superior Gold in FY11, and will have larger smolt from the new hatchery in FY12. However, we cannot take a more positive 12-month view on the stock given the increased risks around FY11 fish size. We therefore cut our recommendation on TGR to Hold.

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***Happy investing!***

### Recommendation definitions

CBA Institutional Equities Investment recommendations are determined by the covering analyst and reflect the analyst's assessment of a stock's expected total shareholder return (TSR). TSR is calculated as the difference between the analyst's 12-month price target and the current share price plus the forecast dividend yield.

Buy: Stocks with a Buy recommendation represent the most attractive stocks under the analyst's coverage. They are forecast to generate significantly positive expected total shareholder returns.

Hold: Stocks with a Hold recommendation are less attractive than Buy rated stocks. They are forecast to generate flat to slightly positive expected total shareholder returns.

Sell: Stocks with a Sell recommendation are the least attractive stocks. They are forecast to generate flat or negative expected total shareholder returns.

[1] Members of the Commonwealth Group hold between 5 and 10% of COH.

[2] Members of the Commonwealth Group have received fees within the previous 2 years from SHL, ANZ, GNC and AMP.

### 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