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.

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Feature Article

Our feature articles this week are:

Developers & Contractors – Commodities super cycle to shift pricing power

CSR Limited – Sugar pricing weakness mitigated by improved volumes

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

Developers & Contractors

DOW[1] Last traded: $7.15	Market cap: $2,427M	DOW: Hold	Price target: $7.77
LEI[2] Last traded: $38.81	Market cap: $5,664M	LEI: Hold	Price target: $41.95
TSE Last traded: $3.99	Market cap: $1,438M	TSE: Buy	Price target: $4.62
UGL Last traded: $14.60	Market cap: $2,407M	UGL: Buy	Price target: $16.78

Summary of previous report dated 24/03/10

Commodities super cycle to shift pricing power back to contractors

We forecast significant medium and long-term order book growth and margin expansion across the sector. As the Australian economy shifts gear post the pause in construction and mining during the GFC, CBA expects:

- revenue growth via a five year commodity boom, and
- margin growth, driven by demand outstripping supply, and labour and equipment shortages, shifting the balance of power back to contractors.

Economic tail winds are gale force for all stocks

Our view on D&C stocks in order of preference is outlined below.

- *UGL* – Huge leverage to coal and iron ore production ramp-up, LNG and social infrastructure projects in transport, power and water. Strong cash flow and balance sheet will allow strong flexibility.
- *TSE* – New management team lead by 30-year oil and gas veteran, Dr Peter Goode. Massive LNG opportunity, strong balance sheet with a good base of defensive and recurring revenue. TSE's existing relationships with US oil companies is a key competitive advantage in domestic LNG projects.

Market Wrap

Looking across global markets there is an interesting conundrum. In Australia the key sharemarket gauges have barely moved in the March quarter, up around 0.5%. But in the US and the UK there have been gains of 4-5%, while even the Japanese Nikkei has risen by 2%.

The conundrum is the fact that the Australian economy grew through 2009, earnings are rising and the outlook is positive. In contrast all other major economies went into recession in 2009 and the outlook is decidedly cloudy.

So what gives? In part there is the bounce back effect – the perception that economies that fell sharply have the potential to rebound sharply. Then there is currency. The general view is that the US dollar will lift later in 2010 when rates start rising. And in Australia investors are spoilt for choice with term deposits, property and shares all providing good returns.

It all goes to show that there are a range of issues for investors to consider when thinking about where to put their money.

Stephen Karpin
Managing Director

- *LEI* – Best positioned company which will continue to win most major infrastructure projects in Australia. There are some question marks over LEI's ability to transpose its business model in the growth areas of Middle East and Asia.
- *DOW* – Whilst DOW has a large exposure to resources and infrastructure spend, we shall wait for further clarity on Reliance Rail, the SPV set up to deliver the Waratah trains PPP before buying this stock.

Feature Article

CSR Limited

Last traded: $1.665	Sector: Industrials	Market cap: $2,570M
Hold		Price target: $1.65

Summary of previous report dated 19/03/10

Sugar pricing weakness mitigated by improved volumes

CBA has made some negative revisions to its sugar forecasts. While CBA was expecting some sugar price weakness on the back of the start of the Brazilian sugar harvest in March and again on the back of the start to the Indian sugar harvest in October, recent sugar price movements have been more violent than was previously anticipated.

Operationally we have made a number of changes. Sugar earnings have been increased in FY10 to reflect improved volumes, CCS, and spot pricing through 4Q10 while FY11 earnings have been lowered to reflect CBA's revised sugar pricing expectations albeit mitigated by improved cane volumes. Building Products earnings have been modestly lowered reflecting the discontinued Home Insulation Program. Aluminium and alumina prices have also been marked to market leading to modest negative earnings revisions in FY10. Despite the earnings changes our $1.65 price target remains unchanged.

Despite CBA's positive views on residential housing we are reluctant to hold a more positive view given emerging pressure on sugar prices currently trading at USD0.19/lb (down from peaks of USD0.299/lb) and significant separation uncertainty. CBA is forecasting sugar prices to decline to USD0.163/lb at the end of CY10 and USD0.13/lb at the end of CY11.

Stocks at a glance

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

Stocks by sector

Healthcare

CSL' 22/03/10

Summary of report dated 22/03/10

CSL Limited

Last Traded: $36.08 | Market Cap: $20,750M | Sector: Healthcare
Hold | Price target: $37.36

International plasma conference rundown

We attended the International Plasma Protein Congress in Berlin, Germany. The conference was well attended by key industry participants including suppliers and regulators as well as patient and industry associations.

Investment view

The stock is trading in line with highs reached in early CY09 amidst the excitement of the Talecris deal, IVIG pricing growth and a solid contribution from Gardasil. CSL remains a high-quality business but these EPS growth drivers of the past are simply not there anymore.

On a separate issue, CSL's strong cash balance raises the possibly of another buyback (it has completed ~95% of its current program). Even with another buyback program and the potential EPS upside however, the stock appears close to full value and we maintain our Hold recommendation at this stage.

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Industrials

TCL' 25/03/10

Summary of report dated 24/03/10

Transurban Group

Last Traded: $5.05 | Market Cap: $6,515M | Sector: Industrials
Buy | Price target: $6.00

Future Fund out, Canadians still in

The Future Fund advised that it had terminated discussions with the Canadian Pension Plan (CPP) and Ontario Teachers' Pension Plan (OTPP) for a joint bid. TCL, however, confirmed discussions with the Canadians had taken place.

We retain our Buy recommendation given:

- Our view that a revised bid of ~$6.00 per share remains likely.
- The drivers behind the initial bid of $5.25 per share, if anything, have strengthened.
- In the event a deal were not to proceed, downside is minimal given the strong 1H10 result from TCL and improvements demonstrated in credit markets for highly rated utility and infrastructure assets.

Our DCF ex takeover premium is $5.75 per share

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Materials

ORI
25/03/10

Summary of report dated 24/03/10

Orica Limited

Last Traded: $26.67 Market Cap: $9,415M Sector: Materials
Buy Price target: $29.50

Housekeeping continues

ORI announced a number of non-operational provisions which will be taken below the line as part of its 1H10 result in May. These include:

- a $45m ($31.5m after tax) environmental provision relating to the groundwater plume at the Botany site
- an $18m ($12.6m after tax) environmental provision relating to the HCB at the Botany site
- a $192m after-tax provision relating to the recent Federal Court decision on the sale of the pharmaceuticals business to Zeneca in 1998.

This is not overly positive as it continues the recent trend of below the line non-recurring items but is relatively minor in the scheme of things.

We have included the above-mentioned provisions in our forecasts as significant items. Earnings changes have been minimal (-0.3% in FY11, -2.5% in FY12). Our price target, which is the average of our DCF and sum-of-the parts valuation, has been lowered to $29.50 from $30.00.

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OST[1],
25/03/10

Summary of report dated 22/03/10

OneSteel Limited

Last Traded: $3.84 Market Cap: $5,184M Sector: Materials
Buy Price target: $4.00

Strategically securing steel scrap supply

OST announced it has signed an agreement to purchase Metals Trading, an Australian metals recycling business. The details are as follows:

- Metals Trading operates as a scrap dealer in NSW and Victoria.
- Metals Trading collects around 120kt of ferrous scrap and 30kt of nonferrous scrap.
- OST is currently a major ferrous customer of Metals Trading, buying around 80% of its volumes. OST does not currently purchase any nonferrous scrap from Metals Trading.
- The transaction remains subject to regulatory approval.

Investment view

While our $4.00 price target offers diminishing upside, our Buy rating remains. Despite our view that benefits from improving iron ore fundamentals are largely factored into the share price, we still see positive catalysts in the short term given continued tight iron ore fundamentals, updates around extension work under Project Magnet phase II and earnings and valuation upside.

Although our preferred stock in the steel sector remains BSL given its significant leverage to improving steel markets, we believe OST offers lower-risk exposure to improving fundamentals across the steel industry particularly while steel margins for non-integrated producers remain under pressure.

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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 DOW and OST.

[2] Members of the Commonwealth Group have received fees within the previous 2 years from CSR and LEI.

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

Disclosure and Disclaimer

End of Report