Research Insight

CommSec

Issue 159 06 May 2010 (4.30pm)

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:

- **Wesfarmers Limited**
- **Orica Limited**

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

Wesfarmers Limited

Last traded: $27.99	Sector: Staples	Market cap: $28,134m
Buy		Price target: $34.15

Summary of previous report dated 04/05/10

Resources tax no reason to panic

The Federal Government has proposed a Resource Super Profits Tax (RSPT). We have performed sensitivity analysis based on our current coal price forecasts to determine potential earnings and valuation implications for WES.

Based on our initial estimates, the RSPT would be a material negative on FY13–15 EPS forecasts (2.1–5.8%). However, when we revert to long-run coal price forecasts (FY16-20), the EPS impact is less than 1% pa. The EPS changes would be less in FY13-15 and greater in outer years if WES chooses an accelerated depreciation method. Combined with the new company tax rate, the DCF valuation impact is negligible and we have not made any changes to our earnings forecasts. Our price target remains $34.15 per share.

Maintain Buy

Coles is demonstrating the early signs of a credible turnaround and driving momentum in a tougher competitive environment; Bunnings continues to operate in a sector that is large ($32.6b) and highly fragmented; and WES will generate significant free cashflow from its Resources division over the next three years. We maintain our Buy recommendation on WES.

Market Wrap

The Reserve Bank Board meeting has come and gone for another month. Of course while some will be happy about the fact, many others will be nonplussed – to a large extent it depends whether you have a mortgage or not. And on this score it is always worth reminding ourselves that Australians are quite different. In fact a third of people own their homes outright, a third rent and the remaining third have a mortgage.

It's interesting that interest rate increases are generally portrayed in a negative light when in fact many people – basically those with savings – are quite happy when rates rise.

Still, we always have to remember the broader ramifications. If home-buyers trim spending then this has negative effects for a raft of consumer-dependent businesses. These businesses also may have borrowings, and the higher repayments affect cash flow, profits and perhaps employment. It would be nice if there was another tool to control the economy, that is, other than the blunt tool of monetary policy. But the Reserve Bank certainly hasn't indicated that a change is in the wings.

Stephen Karpin
Managing Director

Feature Article

Orica Limited

Last traded: $26.98 Sector: Materials Market cap: $9,742m

Buy Price target: $30.50

Summary of previous report dated 03/05/10

1H10: Productivity and capital efficiency deliver

Orica reported a 1H10 NPAT of $293m ($264m pcp). This was ahead of our expectations of around $282m (at the upper end of market forecasts). Significant items of $238.1m largely reflected impacts of the Pharmaceuticals tax case $191.8m combined with environment and integration expenses.

Divisionally, we have increased AN and EBS revenues in the US and Europe Mining Services businesses, in Minova we have included the full roll out of the steel impacts from 1H09, reflected improved Chemicals volumes and in the DuluxGroup included demerger-related costs and market share gains. We have also incorporated CBA's revised currency forecasts and reduced our dividend expectations in light of ORI's progressive dividend policy.

Maintain our positive view

Our positive view is supported by: ORI's demonstrated earnings resilience through the GFC; ORI's market-leading position in the attractive global explosives market (consolidated industry structure, limited raw material cost risk, resource volume leverage); the improving outlook for the Australian resource sector as highlighted by recent improvements in export coal demand, Queensland in particular; balance sheet strength and potential for significant growth initiatives; and valuation appeal with potential for further P/E re-rating as the proportion of Mining Services earnings increases subsequent to the DuluxGroup demerger.

Stocks at a glance

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

Stocks by sector

Financials

WBC
06/05/10

Summary of report dated 05/05/10

Westpac Banking Corporation

Last Traded: $25.10 Market Cap: $74,722m Sector: Financials
Hold Price target: $27.52

Managing for the long-term comes at a cost

WBC reported a 1H10 result ~2.5% above consensus with cash profit of $2,983m (CBA: $2,907m) and an interim dividend of 65cps (CBA: 67cps).

We have subsequently revised FY10 and FY11 EPS by -1.7% and -3.0% respectively driven by lower margins, heightened cost pressure and normalising markets/treasury income. Downgrade to Hold with a price target of $27.52 per share.

Overall we like the quality of the WBC franchise and acknowledge management's cautious stance on key risks such as funding and liquidity. Nonetheless, we find core earnings momentum lacking with PPOP growth hard to see until conditions change more meaningfully – more likely from FY11 onwards. With WBC's valuation broadly in line with historical multiples we see limited upside for the stock until the path to core earnings momentum is restored.

With WBC's valuation broadly in line with historical multiples we see limited upside for the stock until the path to core earnings momentum is restored.

Staples

WOW
06/05/10

Summary of report dated 30/04/10

Woolworths Limited

Last Traded: $27.16 Market Cap: $33,678m Sector: Staples
Hold Price target: $30.10

Expect no change

WOW released 3Q sales below CBA and consensus expectations and downgraded sales growth guidance from high single digits to 3–6% (ex petrol, CBAf: 4.9%). However, WOW was confident it has taken share in Australian Food & Liquor and reaffirmed NPAT growth guidance of 8–11% for FY10.

We have made marginal downward revisions to our forecasts based on lower sales and the slower-than-planned share buyback. Our DCF values WOW at $29.59, $27.05 on sum of the parts and our blended valuation is now $28.32 per share (down 0.3%). We have marginally reduced our price target to $30.10 (down 0.3%).

WOW is trading on an FY11 PE of 15.2x and offers three-year forecast EPS CAGR of 10% pa. This compares to the ASX All Industrials trading at an FY11 PE of 12.9x, and three-year forecast EPS CAGR 12.8% pa.

WOW reaffirmed NPAT growth guidance of 8–11% for FY10.

Utilities

SPN 06/05/10	SP AusNet

Summary of report dated 05/05/10

Last Traded: $0.88 | Market Cap: $2,366m | Sector: Utilities

Hold | Price target: $0.93

Review of the electricity distribution regulatory reset and the Victorian bushfires

In regards to regulatory resets and transmission incentives We expect the AER Draft Decision to pull back materially on SPN's submission. Note that SPN also has the ability to benefit (up to +3% NPAT) through early adoption of the AER's transmission incentives scheme but to date has chosen not to apply.

In terms of the Victorian bushfires, The Victorian Government's response may include asset placement or undergrounding of assets in fire-prone areas. Any capex required will be funded through the RAB or require special arrangements. This is expected to be a contentious political issue and the eventual outcome will most likely be decided in the Victorian election in November.

Subsequent to our review, Distributable cashflow forecasts are only moderately lower on higher interest/capex. Distribution growth of 2.5% pa is retained given they remain comfortably funded. Consequently our valuation and price target have been lowered 3%.

We have downgraded our recommendation to Hold.

SPN remains the most defensive regulated utility with the strongest balance sheet and lowest gearing. However, we see greater capital upside in SKI, DUE and HDF.

SPN remains the most defensive regulated utility with the strongest balance sheet and lowest gearing. However, we see greater capital upside in SKI, DUE and HDF.

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.

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

CommSec

Disclosure and Disclaimer

End of Report