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:

- **APA Group: Avoiding an 'Epic' scenario**
- **Leighton Holdings Limited: Honkers revival - small but positive**

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

APA Group: Avoiding an 'Epic' scenario

Last traded: $2.78	Sector: Utilities	Market cap: $1,182M
REDUCE / UNDER PERFORM		Valuation $3.45

Summary of previous report dated 20/07/09

Event

- Following a comprehensive review of APA Group (APA), we believe APA should undertake a significant equity raising to buttress its balance sheet and avoid a HDF (Epic Energy) type scenario where access to capital constrained growth upside.

Implication

- APA has the highest gearing in the regulated utilities sector. D/D+E is 68% and ICRs are 1.9x.
- APA has the most significant refinance task in the sector. APA's debt tenure is short; it must refinance ~60% of its total debt over the next three years. APA must refinance $900m in bank debt by June 2010 of which ~76% is with foreign banks.
- APA relies on both a DRP and SPP to raise equity to fund capex.

Market Wrap

In recent weeks, central banks around the globe have started providing more upbeat commentary on the economic landscape. And the much more optimistic rhetoric was clearly highlighted by Federal Reserve Chairman Ben Bernanke in his semi-annual testimony in front of Congress. He cited "tentative signs of stabilisation" in demand, the prospect of an improvement in export demand and early signs that businesses are starting to rebuild inventory level - all of which suggests a slower rate of contraction (and possible expansion) in the US economy over coming quarters.

Domestically, the latest minutes from the Reserve Bank's last meeting suggested that the downside risks to the economy are waning. Stronger retail sales, buoyant housing activity, the pick-up in confidence levels and a more resilient Chinese economy should help support growth.

It seems the big question likely to weigh on central banks, is when to start raising rates. In the US it is more likely that interest rates will remain low for an extended period of time. However domestically the possibility of rate hikes in a year's time cannot be ruled out, especially considering the Reserve Bank's historical stance on being ahead of the inflation game.

Matt Comyn
General Manager

- APA is entering a period of higher growth with the expected lift in gas demand opening up opportunities for APA.

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- A more flexible balance sheet would enable APA to pursue growth opportunities with vigour and without concerns over access to capital.

- Certainty on NSW privatisation – either affirmative or otherwise – is likely to be a trigger for the acceleration of gas-fired power developments in NSW.

- APA will need to be ready to invest to protect the competitive position of the MSP in supplying gas to NSW.

Investment view

Our DCF has been cut to $3.45 per security (down 73cps). This revision can be attributed to lower NOCF forecasts due to higher interest expense assumptions.

APA trades at a significant premium to its peers despite its challenges. We have set our target price at $2.42 per security which equates to a 30% discount to DCF and an EV/EBITDA of 9.6x to account for APA's stretched balance sheet, sizeable refinance task in FY10 and the likelihood of a large equity raising.

We have moved to a REDUCE / UNDER PERFORM recommendation.

Feature Article

Leighton Holdings Limited: Honkers revival - small but positive

Last traded: $26.77	Sector: Industrials	Market cap: $3,612M
ACCUMULATE / MARKET PERFORM		Valuation $26.07

Summary of previous report dated 21/07/09

Event

- Leighton Holdings (LEI) has announced a $410m contract (LEI share $330m) for a major sewerage tunnelling project in Hong Kong in a joint venture with Leonhard Nilsen & Sonner AS (LNS). This is very positive, as it is the first evidence of a Honkers revival in D&C work for LEI.

Implication

- Hong Kong is a good source of growth — LEI had flagged Hong Kong construction as a potential source of growth; this win opens the gates of Honkers. LEI is bidding on further work in the areas of road, rail and sewerage. LEI has a history of undertaking rail and road work in Hong Kong, with a reputation for delivery.

- Acquisitions of strategic stakes are creating contract win opportunities — This is the first sign of cross leverage of its MAH JV, that is, MAH's shaft expertise complementing LEI's tunnelling expertise.

- Timing of revenues welcome — The timing of the project starts (still small) to cover the 2H10/1H11 hole in project revenues previously expressed.

Contract details

- Value: $410m contract and LEI's share is $330m

- Project type: To construct the sewerage conveyance system from Aberdeen to Sain Ying Pun on Hong Kong Island. Includes design and construction of 7.5km of deep sewerage tunnels.

- Project to commence: August 2009

- Project finish: October 2013

- Other: LEI will draw on technical expertise from MAH for shaft construction.

Investment view

- CBA estimates almost two-thirds of LEI's total revenues and around three quarters of its Australian revenues are leveraged to construction. While construction activity is slowing, CBA Economics does not expect engineering construction to 'fall off a cliff' so to speak. CBA Economics anticipate growth in FY11 when construction on government-funded projects begins.

- LEI remains well positioned to win its fair share of engineering construction work, including mining construction and construction work in Hong Kong. CBA's DCF valuation is $26.07 and we retain our ACCUMULATE / OUT PERFORM recommendation.

Sector wraps

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

Reg. Utilities — Fund level debt problematic

22/07/09

APA: Last Traded: $2.78	Market Cap: $1,182M	Sector: Utilities
DUE: Last Traded: $1.53	Market Cap: $1,057M	Sector: Utilities
ENV: Last Traded: $0.50	Market Cap: $321M	Sector: Utilities
HDF: Last Traded: $0.90	Market Cap: $424M	Sector: Utilities
SKI: Last Traded: $1.11	Market Cap: $1,049M	Sector: Utilities
SPN: Last Traded: $0.75	Market Cap: $947M	Sector: Utilities

Summary of report dated 20/07/09

APA: REDUCE/ UNDER PERFORM	Valuation: $3.45
DUE: BUY / OUT PERFORM	Valuation: $2.53
ENV: REDUCE/ UNDER PERFORM	Valuation: $0.50
HDF: BUY / MARKET PERFORM	Valuation: $1.60
SKI: ACCUMULATE / MARKET PERFORM	Valuation: $1.75
SPN: BUY / OUT PERFORM	Valuation: $1.07

Event

- We have reviewed corporate or fund level debt across the utilities sector in light of the experiences of AIX and more recently HDF. These experiences indicated that lenders appear to have a new found aversion to fund level or corporate debt.
- Overall gearing does not appear to be the driver of lenders' apparent new found aversion. Rather it is a change in the risk tolerance of lenders to provide debt at a hold co level which is unsecured and subordinated to senior debt.

Implication

- After reviewing the sector, SKI and DUE are at risk. SKI has $425m and DUE has $585m of fund level debt respectively.
- The SKI fund level debt is more akin to HDF and AIX. The debt sits above the assets at the hold co level and is unsecured and dependent on cash flows pushed up from the assets. While SKI should have greater chance than HDF and AIX to refinance, the relatively strong credit metrics of SK's underlying assets may not be enough.
- DUE's structure is more favourable for lenders. Formal arrangements exist between DUE and its assets. Lenders have security over DUE's equity interests in the assets in the event of default.

Investment view

- Our DUE recommendation remains BUY / OUT PERFORM and our price target is $2.02 (down 25cps).
- After reviewing DUE's structure in detail, we are confident that DUE will enjoy ongoing lender support for its corporate debt. However a gradual degree of de-leveraging is expected given the gearing at the asset level, reducing our DCF to $2.53 (down 19cps).
- We have downgraded SKI to ACCUMULATE / MARKET PERFORM with a price target of $1.23 (down 17cps). Risks on the corporate debt are considered the key to the stock over the coming 12 months.
- Our rankings in the sector are: DUE, SPN, HDF, SKI, ENV and then APA. SKI falls behind HDF. The recent run of the ENV share price has also triggered a downgrade to REDUCE / UNDER PERFORM.

Stocks at a glance

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

Stocks by sector

Consumer discretionary

FXJ[3]
22/07/09

Summary of report dated 20/07/09

Fairfax Limited: Google in their Domain

Last Traded: $1.37 Market Cap: $2,764M Sector: Consumer discretionary
REDUCE/ UNDER PERFORM Valuation: $1.35

Event

- Google has entered the online real estate market with a strategy we believe will be successful.

Implication

- Google will cause a permanent change to industry structure. Pricing, strong rewards for scale at incumbents, and the advantages of a sales network are all reduced if Google proves effective.
- Margins will fall and FXJ market share will be at risk. Faced with increased choice and lower listing costs, agents will put pressure on existing fees.
- Google will change the search context and behaviour of buyers permanently. The new website will change the way people search for real estate introducing a spatial search engine for a spatial product - perfect!
- Whilst not threatening viability – growth will be lost.

Earnings and valuation revisions

- Valuation $1.35 (-4%); Price target unchanged $1.03.
- Revenue: FY09: $2633m; FY10 $2584m; FY11 $2731m.
- EBITDA: FY09: $539m; FY10 $595m; FY11 $641m.
- NPAT: FY09: $211m; FY10 $234m; FY11 $269m.
- EPS: FY09: 12.0cps; FY10: 9.9cps; FY11: 11.4cps
- DPS: FY09: 2.6cps; FY10: 2.0cps; FY11 2.3cps

Investment view

- Limited protection from structural decline and limited earnings rebound. FXJ owns a mix of newspaper and online assets, with the vast majority of earnings still reliant on the printed newspaper copy. As more revenue moves online FXJ will only capture value if its online brands are successful.
- Paying for a capital light FXJ before it can be delivered should be avoided. We suggest earnings growth out of the advertising recession may disappoint. This leaves cost-out as a driver of earnings growth. Whilst a 'capital light', cost-out model may be possible, the structural risks are far too high.

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Financials

SUN[2]
22/07/09

Summary of report dated 16/07/09

Suncorp-Metway Limited: High risk play at these levels

Last Traded: $6.90	Market Cap: $8,739M	Sector: Financials
REDUCE/ MARKET PERFORM		Valuation: $8.36

What's new?

We have increased our FY09 NPAT (pre significant items) by 15% to $535m. The increase is entirely due to mark-to-market movements and does not change our underlying business assumptions.

The increase in our FY09 NPAT forecast is entirely due to mark-to-market movements rather than a change to our underlying business assumptions.

The general insurance business gets a $163m increase due to the movement in credit spreads in 2Q09 (after a loss in 1Q09), while the life insurance business receives a $65m loss as a result of the increase in discount rate over the half.

Business pressures

The issues with SUN's banking business have been the main headlines of late; however, we note increasing pressure across the rest of the SUN group.

At this point in the general insurance cycle SUN appears to be losing market share in the attractive personal lines space and gaining share in the very risky commercial lines area. In addition to this the Promina synergies will be all but undone due to significant increases in reinsurance costs.

On the wealth management side, despite the obvious impact of falling FUM, SUN's life insurance business continues to lose market share and its skew to income protection business presents potential issues in the current environment.

We see downside risk to both the general insurance and wealth management earnings in the next few years.

Valuation and recommendation

While we have made a significant increase to our FY09 earnings, this is a 'one-off' mark-to-market increase and has not impacted our 12-month price target of $5.97.

We accept that on a break-up basis there is increased value in SUN and while ANZ has excess of $4b on its balance sheet this will assist the SUN share price. Speculation on a sale of the bank is likely to continue until ANZ spends its money elsewhere, at which time we expect the SUN share price to suffer.

We note that the SUN share price is up 13% in the last week since ANZ announced the completion of its SPP. We believe that relying on a breakup of the company is a high-risk strategy at these share price levels. We maintain our REDUCE recommendation and with the share price currently around $7.00 this provides a good opportunity to exit the stock.

Industrials

QAN[1]/VBA[1]
22/07/09

Summary of report dated 20/07/09

Qantas and Virgin Blue: MAp June pax stats and the negative implications

QAN Last Traded: $2.10	Market Cap: $4,706M	Sector: Industrials
VBA Last Traded: $0.30	Market Cap: $239M	Sector: Industrials
ACCUMULATE / MARKET PERFORM		Valuation: $3.22
ACCUMULATE / MARKET PERFORM		Valuation: $0.73

What's new?

Macquarie Airports (MAp) has announced its June traffic data. The Sydney data in particular has implications for QAN and VBA. June passenger statistics have not been released by QAN or VBA.

- Sydney domestic traffic decreased by 3.8%. By rough comparison, QAN and VBA reported domestic growth of -3.1% and 0.4% respectively in May.
- Sydney international traffic decreased 4.0%. By rough comparison, QAN reported international growth of -1.7% in May.

In terms of Sydney, Management commented this morning "Despite the difficult external environment, it is pleasing that our airline marketing efforts are continuing to result in our airports winning new routes and services. Tiger Airways and Delta Airlines commenced operations from Sydney in early July and Tiger have already announced a significant expansion in their Sydney presence when they receive their next aircraft in October."

From 4 October Tiger will fly up to nine times daily between Sydney and Melbourne with two daily flights between Sydney and Adelaide.

The start up of Tiger services out of Sydney is likely to affect Jetstar more than VBA. This is because Jetstar's target customers are the same as Tiger's. Tiger flies to Tullamarine rather than Avalon, which will be attractive to anyone travelling to Melbourne CBD, North, South or East.

We expect QAN and VBA to release June passenger statistics when they report their FY09 results in August - QAN on 19th August and VBA on 27th August.

The start up of Tiger services out of Sydney is likely to affect Jetstar more than VBA. This is because Jetstar's target customers are the same as Tiger's

TOL[1]
22/07/09

Summary of report dated 17/07/09

Toll Holdings Limited: Peer results suggest further margin pressure

Last Traded: $6.41	Market Cap: $4,060M	Sector: Industrials
ACCUMULATE / MARKET PERFORM		Valuation: $7.79

What's new?

Given the forthcoming results season, we have taken the opportunity to review TOL's competitors' performance, the outlook for household consumption and gross domestic product (GDP), and likely performance implications for TOL. Overall we expect TOL's earnings to soften in FY10 before recording stronger growth in FY11.

- Competitor experience suggests a soft 2H09. Across key listed international peers (DHL, K&N, Fedex and Conway) revenue and earnings growth has been challenging and margins mostly low single digit or negative.
- However, TOL's competitive position in Australia is generally stronger than its peers. CBA Economics is of the view that household consumption has bottomed, and with the exception of the September quarter, expects modest increases in household consumption. For TOL, this implies a challenging 1H10.
- GDP outlook does not foreshadow a recession, rather slightly positive growth. CBA Economics expects 2009 GDP growth of 0.3% in year average terms (-0.4% previously). Stronger growth of 1.9% is expected in CY10 but growth at this pace would remain well below longer-run trends. For TOL, this implies low single digit volume growth.

TOL's key leverage remains to its Australian business. While its international peers provide some insight into segment performance, TOL's premier position in some of its Australian operations (notably Express Freight) places it in a relatively stronger position.

- Acquisitive as ever, TOL has continued to supplement its revenues with growth from small bolt-on acquisitions; we estimate at least $150m in revenues from the acquisitions. TOL has the capacity to undertake up to $1b in further acquisitions.

Earnings revisions

Forecast EPS has been revised down 4.7% in FY09, 6.0% in FY10 and 3.7% in FY11. The revisions account for: a slightly improved GDP growth forecast in Australia for FY10 (0.8%, up from 0.1%) and FY11 (3.3%, up from 2.7%), and weaker margins across most businesses but in particular Australia and Asia.

Investment view

TOL's key leverage remains to its Australian business. While its international peers provide some insight into segment performance, TOL's premier position in some of its Australian operations (notably Express Freight) places it in a relatively stronger position. That said, volumes are not going to grow strongly, but what volume there is will still be transported and TOL is well placed to do it. The DCF valuation is $7.79 (down 28c) and our recommendation remains ACCUMULATE / MARKET PERFORM.

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 hold: between 5 and 10% of Qantas Airways.

[2] Members of the Commonwealth Group have received fees within the previous 2 years from Suncorp Metway Limited.

[3] Members of the Commonwealth Group hold more than 10% of Fairfax Media Limited.

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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Disclosure and Disclaimer

End of Report