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 article this week is:

- **Spark Infrastructure Group: Tastier than CHEDHA**

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

Spark Infrastructure Group

Last traded: $1.30	Sector: Utilities	Market cap: $1,341m
Buy		Price target: $1.60

Summary of previous report dated 12/04/10

Tastier than chedha

We have analysed SKI's funding requirements for CHEDHA and ETSA and have also explored the potential outcomes of SKI's strategic review. Consequently we have adjusted our forecasts – capex and interest expense have been lifted, reducing our FCFE forecasts. Our distribution forecasts are also lowered to 12cps (from 13.56cps). We have also lifted our price target to $1.60 per share (up 20cps).

Upgraded to Buy

We have upgraded our recommendation for SKI to Buy given:

- Our view that the most likely outcome of the strategic review will be a full asset sale/wind up of SKI which will yield prices well in excess of the current share price.
- Attractive valuation metrics with SKI trading on a forecast EV/EBITDA of 7.9x and FCF yield of 11.6%.
- We note upcoming catalysts: AER final decision for ETSA due at the end of April; update on strategic review is expected before SKI's 1H10 result in August.

Market Wrap

There's an interesting 'disconnect' affecting the economy at present. Aussie businesses and consumers are relatively upbeat with latest surveys showing that confidence remains near historic highs. But despite these healthy confidence levels, businesses are seemingly not borrowing and consumers are reluctant to spend.

At face value all this is understandable. Last year's US financial crisis is still fresh in peoples' minds, so they are taking a far more conservative approach to their finances and spending.

But spare a thought for retailers in this environment. Shoppers are staying away from the stores, thus prompting retailers to launch major 'mid-season' sales to get the cash registers ringing. Larger retailers are better able to engage in this form of competition than smaller retailers, but there are limits to how long it can continue.

The good news is that Reserve Bank is aware of this 'disconnect' and is taking it into account in its interest rate deliberations.

Stephen Karpin
Managing Director

Sector wraps

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

Cons. staples	Clash of the Titans		
15/04/10	WES: Last Traded: $32.75	Market Cap: $37,888m	Sector: Staples
	WOW: Last Traded: $27.38	Market Cap: $33,951m	Sector: Staples
	MTS: Last Traded: $4.16	Market Cap: $3,185m	Sector: Staples
Summary of report dated 14/04/10	WES: Buy		Price target: $35.70
	WOW: Hold		Price target: $30.20
	MTS: Hold		Price target: $4.40

WES: Firing on all cylinders

We initiate coverage of WES with a Buy recommendation, valuation of $33.43 and price target of $35.70. Coles is demonstrating early signs of a credible turnaround and driving momentum in a tougher competitive environment. The Resources division will see earnings growth from both medium term price and volume increases, and the Home Improvement operations will sustain further stable growth.

WOW: It's not about the bike…

We initiate coverage of WOW with a Hold recommendation, valuation of $28.40 and price target of $30.20. The supermarket industry is facing a resurgent Coles and the re-establishment of hard discounters with significantly lower cost models than the full service incumbents. WOW is the undisputed leader of the sector, but will find it hard to grow ahead of market under this scenario.

MTS: Feeling the blow torch of competition

We initiate coverage of MTS with a Hold recommendation, valuation of $4.25 and price target of $4.40. We believe MTS is the most exposed to both increased competitive pressure and the structural bifurcation in the Australian supermarket sector. Fresh expansion will provide some supporting growth and Mitre 10 will offer some minor earnings diversification.

Insurance	Insurance sector		
15/04/10	AMP[2]: Last Traded: $6.48	Market Cap: $13,275m	Sector: Financials
	AXA: Last Traded: $6.35	Market Cap: $13,126m	Sector: Financials
	IAG[1]: Last Traded: $3.91	Market Cap: $8,128m	Sector: Financials
	QBE: Last Traded: $22.20	Market Cap: $22,798m	Sector: Financials
	SUN[2]: Last Traded: $9.15	Market Cap: $11,724m	Sector: Financials
Summary of report dated 14/04/10	AMP[2]: Hold		Price target: $6.82
	AXA: Hold		Price target: $6.75
	IAG[1]: Hold		Price target: $4.09
	QBE: Buy		Price target: $23.77
	SUN[2]: Hold		Price target: $8.97

March mark to market – Back in the red

We have updated our insurance forecasts based on investment market movements beyond our normalised assumptions in the March quarter.

- **QBE:** QBE is our preferred pick in the sector with a Buy recommendation. The macro factors will obviously have an influence on short-term volatility in QBE's earnings; however we see continued strength in underwriting earnings as a positive for the stock.
- **SUN:** The rest of the sector does not look very exciting based on current share prices. We can appreciate upside to SUN's earnings should the second attempt at integration in the general insurance business succeed, however with minimal detail and considerable downside risk in the short term we remain cautious.
- **IAG:** While we expect further improvements in IAG's underlying business in 2H10, further growth in FY11 will be a challenge as competition continues to flood our market, both personal lines and commercial lines.
- **AMP:** AMP is still under the regulation cloud and six months of flat equity markets will put further pressure on earnings in FY10. The falling revenue is at a time of increasing expenses as AMP move to a fee based model. The potential corporate action will however limit the downside risk in its share price in the near term.
- **AXA:** Despite a slight downgrade to earnings there is no change to our price target of $6.75 which is based on corporate activity. Following NAB's bid for AXA on 17 December for $6.43 (the cash offer option), this effectively put a floor on AXA's share price.

Property	Property – Office sector		
15/04/10	IOF[1]: Last Traded: $0.60	Market Cap: $1,651m	Sector: Financials
	CQO: Last Traded: $0.29	Market Cap: $1,437m	Sector: Financials
Summary of report dated 13/04/10	IOF[1]: Hold		Price target: $0.65
	CQO: Hold		Price target: $0.31

CQO: Looks aren't always what they seem

We initiate coverage on CQO with a Hold recommendation. Price target $0.31. While CQO continues to trade at a meaningful discount to NTA (~34%) we believe this is unlikely to close materially given the earnings profile does not justify a unit price at NTA.

With an absence of near-term catalysts, CQO is likely to be supported on valuation grounds given: (1) a 7.2% yield, 120bp above the sector average; and (2) a 9.5x forward P/E which is below its historical average and a discount to the sector.

IOF: Value needs a catalyst

We initiate coverage on IOF with a Hold recommendation. Price target $0.65. The key driver to IOF in our view will be leasing existing vacancies (specifically 20 Bond St, Waltham Woods and Park Tower) to materially improve occupancy. We estimate a 200bp increase in occupancy could improve FY11 EPS by ~3%.

At current levels IOF enjoys valuation support highlighted by: (1) 6.5% yield, the second highest in the sector (after CQO at 7.2%); (2) 11.6x forward P/E, in line with its historical discount (16%) to the sector P/E (currently 13.8x); and (3) a reasonable earnings growth profile (three-year EPS CAGR 3.9%).

Stocks at a glance

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

Stocks by sector

Healthcare

CSL
15/04/10

Summary of report dated 14/04/10

CSL Limited

Last Traded: $36.66 Market Cap: $21,252m Sector: Healthcare
Hold Price target: $37.36

Time will tell with Alzheimer's opportunity

Baxter (BAX) released encouraging data overnight from its Phase II study of Gammagard Liquid and Gammagard S/D for mild to moderate Alzheimer's.

No changes to earnings

While we have made not changes to our earnings forecasts or price target off label usage of IVIG could present ~1-4% upside to our FY11 EPS forecast - this is not however sufficient to warrant an upgrade to a Buy recommendation. Until payers reimburse the therapy, the take up rate will be limited by its prohibitive cost (and this could be some time away).

The next catalyst for CSL will be BAX's 1Q10 result on 22 April. Specifically, we will be looking for an improvement in US IVIG sales after modest 4Q09 sales growth of 4% (on pcp).

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Industrials

LEI[2,]
15/04/10

Summary of report dated 13/04/10

Leighton Holdings Limited

Last Traded: $37.65 Market Cap: $11,320m Sector: Industrials
Hold Price target: $41.95

Positive signs of life, but caution around Mongolia remains

Leighton Asia was awarded a AUD940m contract adjustment by Energy Resources LLC, to increase capacity at the Ukhaa Khudag (UHG) coal mine in southern Mongolia to 10Mtpa by June 2011.

While we had not factored a significant ramp-up in Mongolia in our earnings, given the insignificance of this particular contract to LEI's group earnings we remain comfortable with our forecasts.

At this stage, we continue to treat LEI's aspirations in Mongolia with caution.

Further expansion into higher risk markets should limit LEI's premium

Although historically the market has been willing to value LEI's WIH at big multiples, any significant growth going forward will be from higher risk markets such as Mongolia, Hong Kong and the Middle East, which we feel should not offer the same levels of premium.

Hold recommendation retained. Despite our overall favourable view of the company's domestic and more mature operations, which accounts for the bulk of its earnings and order book, we feel these expectations are sufficiently priced into the stock at current levels.

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Materials

SGM' 15/04/10	Sims Metal Management Limited

Summary of report dated 12/04/10

Last Traded: $22.48 | Market Cap: $4,582m | Sector: Materials
Hold | Price target: $22.70

Earnings and margin constraints remain

Ferrous scrap prices have increased around 20% in the past month. This has prompted a review of current scrap markets and implications for SGM. As a result we have made some modest revisions to our earnings expectations. We have also made small adjustments across the Trading and Recycling Solutions businesses, and lowered corporate expenditure. While we have modestly increased our forecasts we continue to believe SGM is likely to report a soft 3Q result.

Our new price target is $22.70 (previously $22.50)

Our Hold recommendation is a function of the following factors: strong medium-term earnings growth underpinned by improving economic conditions (though visibility around key earnings drivers is limited), solid balance sheet and a plethora of bolt-on opportunities.

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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 IOF and IAG.

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

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