

Research Insight

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:

- Blackmores Limited
- PaperlinX 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

Blackmores Limited

Last traded: \$27.30

Sector: Healthcare

Market cap: \$460m

Buy

Price target: \$28.61

Summary of previous report dated 21/10/10

Healthy result patience reward

BKL released its 1Q11 earnings results posting an impressive first quarter Australian sales growth of 11% despite cycling a low interest rate environment and the effects of the fading fiscal stimulus. The key contributor was strong growth in its grocery channel (~30% of domestic sales), driven by high levels of promotional activity in the health and beauty category. Key drivers of growth in Asia were increased sales into markets such as Hong Kong (up ~300%) and Taiwan, on the back of recent retail partnership formed post the expiry of Watsons exclusivity. Margin expansion was strong with the positive impact from the AUD and cost of goods sold (COGS) savings from direct purchasing, more than offsetting the dilutive impact from increased sales to the lower margin grocery channel.

Medium term upside risk remains

We have updated our forecasts to reflect better than expected sales and margins in the domestic business and incorporate the acquisition of Pure Animal Wellbeing Ltd (PAW) into our sales and earnings forecasts. We see upside risks to margins in the medium term from greater fixed cost leverage (via higher Asia volumes) and COGS savings as it rolls out its direct purchasing program.



Issue 183 28 October 2010 (4.30pm)

Market Wrap

Next week is shaping up to be pivotal for investors. Not only does the Reserve Bank Board meet, but the Bank also releases its new growth and inflation forecasts on Friday. Then in the US the midterm elections are held and the Federal Reserve decides on more stimulus for the economy.

Here in Australia, economists have now grown cold on the idea of a rate hike next Tuesday given the low result on inflation. But some haven't abandoned the concept entirely, saying that it is all about future inflation, and the Reserve Bank may want to take out some insurance. But if there is no rate hike, the focus will shift to the updated inflation forecasts. If the forecasts are cut, rule out a rate hike this year.

In the US, the midterm elections will probably see the Democrats lose control of Congress. Analysts believe that this could actually be positive for the stockmarket – meaning fewer decisions are made and thus less uncertainty.

And the Federal Reserve meeting will be important for currencies. If stimulus is only modest, the greenback will receive support and the Aussie dollar could push further away from parity.

Clearly a lot of balls are in the air – the crucial point is to work out where they settle.

Stephen Karpin
Managing Director

Feature Article

PaperlinX Limited¹

Last traded: \$0.46

Sector: Materials

Market cap: \$275m

Buy (from Hold)

Price target: \$0.60

Summary of previous report dated 22/10/10

Upgrade to Buy

PPX provided a 1Q11 trading update in conjunction with its AGM commenting that operating earnings and earnings after tax were both meaningfully ahead of pcp as a result of cost reductions and modestly improved pricing, and that these were the first signs of a turnaround in the European business. Given the AUD/EUR and AUD/USD have moved unfavourably by 20% and 7% respectively versus the pcp this is impressive. To an extent this is a function of the law of small numbers vis a vis the significant reduction in corporate costs (\$10m on an annualised basis), the reduction in headcount by 1,000 and recent consolidation of prices at higher levels that would have made a meaningful difference.

PPX commented that that no meaningful recovery in volumes has been seen as yet which recent industry data supports. While European volumes are up 12.3% yoy August 2010, the rate of recovery from cyclical lows in the middle of 2009 has stalled a little in recent months. From PPX's perspective, weakness in coated paper demand versus the uncoated paper demand (-1.7 vs 2.7% rolling 12 mth) is not encouraging. In the US, the recovery remains more established with total volumes up 5.6% yoy.

Pleasingly however, pricing improvements are gaining traction and there appears to have been some consolidation of higher paper prices across Europe with UK coated paper prices up 11.1% yoy and European up 6.6% yoy. As well, uncoated paper prices are up 17.9% yoy in the UK and up 11.5% yoy in Europe. By contrast the story in the US is not as encouraging, with coated paper prices flat yoy and uncoated paper prices up by high single digits. This is surprising given the better demand outlook,

We take a positive view despite longer-term paper industry concerns

Whilst our long-term concerns around the structure of the paper industry remain we have taken an upbeat stance on the back of positive AGM commentary; improving paper pricing momentum; improving volume trends; good progress on cost reduction initiatives; significant balance sheet repair; and new management. Consequently, we have upgraded PPX to a Buy from a Hold and for now retained our conservative pricing assumptions and not made any earnings changes at this stage.

Stocks at a glance

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

Stocks by sector

Energy

OSH¹
28/10/10

Summary of
report dated
26/10/10

Oil Search Limited

Last Traded: \$6.43
Hold

Market Cap: \$8,389m

Sector: Energy
Price target: \$6.20

3Q10: FY10 production to beat guidance

OSH has reported on production, exploration and development for 3Q10. Production was down 5% on 2Q10, largely from lower gas production from Hides with reduced offtake at the Porgera mine site due to water shortages. With offtake levels returning to normal, we expect Oil Search to beat FY10 production guidance. Revenue for 3Q10 of USD142.2m was in line with 2Q10 as marginally higher average realised oil prices offset declines to production.

PNG LNG is still in early stages of development with startup in 2014 while PNG LNG JV discussions indicate the most likely source of gas for expansion remains the Hides gas field. Oil Search continues to focus on options to accelerate appraisal of the field ahead of development drilling, which is not expected until 2012. Near term material exploration is limited to Mananda Atti and scheduled to commence in November 2010 with drilling of key gas targets, Huria and Barikewa at least 12 months away. Outcomes of the strategic review are now set to be released to market by year-end.

We retain our Hold recommendation and \$6.20 price target.

We view Oil Search's long-term outlook as remaining strong, however the company has few short-term catalysts other than oil price movements to drive the share price further. The next major event will be the results of the strategic review and news on expansion options for the PNG LNG project – probably linked to further drilling on the Hides gas field. Valuation upside from PNG LNG train 3 is therefore at least 18 months away.

We view Oil Search's long-term outlook as remaining strong, however the company has few short-term catalysts other than oil price movements to drive the share price further.

Stocks by sector

Financials

BEN²
28/10/10Summary of
report dated
26/10/10**Bendigo and Adelaide Bank**

Last Traded: \$9.12

Market Cap: \$3,218m

Sector: Banks

Hold

Price target: \$9.13

Rural Bank – a tactical top-up

BEN has agreed to purchase Elders' 40% stake in Rural Bank for \$176m, comprising a sale price of \$165m and an \$11m special dividend to give BEN 100% ownership. Notwithstanding the cyclical nature of a specialist agricultural lender such as Rural Bank, the total purchase price compares favourably with historical domestic bank transactions and our expectation of Rural Bank's through-the-cycle ROE of ~15% and ROA of ~1.15%. EPS and ROE accretion are an incremental positive with the deal fully funded by subordinated debt rather than equity, assisting EPS and ROE accretion.

There are minimal synergies, but the deal is driven by other considerations. Rural Bank already has a very low cost-to-income ratio of ~26% given a small fixed cost base and leverage of BEN's infrastructure. Instead, the deal has been driven by a combination of factors including capital treatment of minority interests under Basel III, management's desire for greater use of tier 2 capital, a distressed seller flexible on pricing as well as retaining distribution via Elders while obtaining full control of the bank.

Capital reduced with more buffer desirable. The deal will reduce pro-forma core tier 1 at BEN to ~6.85% (majors >7%) bringing forward the impact of harsher capital deductions for minority interests under Basel III. While regional banks are clearly not systemically important given BEN's lack of earnings diversification and potential capital charges from revisions to APS210 (securitisation), we believe it is prudent for BEN to maintain core capital above 7% until the new standards are finalised.

1Q11 trading update. BEN reiterated ongoing margin pressure driven by lower growth in higher margin business, liquidity build-up as well as no increase in cash rate and no out-of-cycle rate changes. Volume growth remains relatively subdued with mortgages growing in line with system, margin lending in decline partly offset by growth in small business. Asset quality remains reasonably stable with improving consumer arrears while business arrears continue to rise, albeit modestly.

Hold maintained

While the deal is a modest positive from an ROE accretion and earnings perspective, the stock appears fairly valued at this time with implied ROE from the current stock price already at ~10.4% versus through the-cycle ROE of ~11.3%. Further, downside appears limited given an attractive dividend yield of ~6.9% and commitment to a stable payout ratio of ~60%-70% given its retail shareholder bias.

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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 PPX; OSH;

² Members of the Commonwealth Group have received fees within the previous 2 years from BEN

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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More information on our research methodology, organisation structure, summary documenting frequency and recommendations can be obtained at research.commsec.com.au

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End of Report