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.

Issue 135 **22 October 2009 (4.30pm)**

Feature Article

Our feature articles this week are:

- **BHP Billiton & Rio Tinto: Next cycle likely to eclipse 2008 peak earnings**
- **AXA Asia Pacific Holdings Limited: Growth in Asia offset by AUD strength**

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

BHP Billiton & Rio Tinto: Next cycle likely to eclipse 2008 peak earnings

Last traded: $39.66	Sector:	Materials	Market cap:$134B
Last traded: $66.80	Sector:	Materials	Market cap:$28,991M
BHP: ACCUMULATE /OUTPERFORM			Valuation: $43.93
RIO: ACCUMULATE / OUT PERFORM			Valuation: $72.35

Summary of previous report dated 21/10/09

Initiation of coverage

Both BHP and RIO are likely to experience massive earnings growth to 2013 from global financial crisis (GFC) lows. Investors should look for entry points that may result from a short term base metal price correction.

- **BHP Billiton**: We initiate with an ACCUMULATE / OUTPERFORM recommendation and a AUD44 price target.
- **RIO Tinto**: We initiate with a ACCUMULATE / OUTPERFORM recommendation and AUD70 price target.

Market Wrap

Judging by the Reserve Bank's recent commentaries, it looks like inflation is back on the worry list. When the Reserve Bank was cutting rates late last year, inflation was the least of its concerns. But now that the economy is getting back to normal, the Reserve Bank is fretting that if it doesn't get a hurry along in lifting rates, then the inflation rate could start rising again.
So the new figures on inflation in the coming week will largely decide whether the next rate hike will be 25 basis points (quarter of a percent) or 50 basis points. If the figures are higher than the market expects, interest-rate sensitive companies like retailers will face increased scrutiny.

And then there are the currency effects. Australia is lifting rates whereas other countries haven't started. A 50 basis point rate hike could give the Aussie dollar another boost. Overall it's clear that a lot is riding on these new inflation figures – *watch this space…*

Matt Comyn
General Manager

In the long term, the continued economic development of China coupled with a broader global economic recovery from the GFC will see strong demand growth for commodities. BHP and RIO will both be major beneficiaries of this demand growth. Indeed, we forecast BHP's NPAT will peak in 2013 at a level 50% above the previous peak in 2008.

In the short term however there is a significant chance of a correction in over exuberant commodity markets that have been driven by restocking activity in China. A correction in base metal prices is likely to flow through to equities.

Four key issues examined in this initiation report

- *Quality of the asset base*. BHP has a higher quality portfolio thanks to its diversification and exposure to fundamentally stronger commodities. RIO relies on just four tier 1 assets to generate over 80% of its earnings.
- *Cost performance*. A 'produce at all costs' environment in 2007/08 has resulted in a significant cost blowout.
- *Growth outlook*. Both companies have a very strong growth profile to 2013 and a good pipeline of organic growth options.
- *The Iron Ore JV*. We estimate the JV creates USD12.3b in value of which BHP captures USD6.7b and RIO USD5.6b.

BHP over RIO

BHP has the better quality asset base, more attractive commodity exposure and perhaps better growth options due to its stronger balance sheet. However, and somewhat perversely, the lower margin RIO businesses provide the company with excellent leverage to upside in prices. RIO also has restructuring potential as it 'fixes' the portfolio following the ill-timed Alcan acquisition. We believe both companies will outperform the market to 2013 but if we had to own just one it would be BHP.

Feature Article

AXA Asia Pacific Holdings Limited: Growth in Asia offset by AUD strength

Last traded: $4.55	Sector: Financials	Market cap: $4,513M
ACCUMULATE / OUT PERFORM		Valuation $5.75

Summary of previous report dated 21/10/09

Event

- On Wednesday 21 October, AXA released its new business and fund flows for the nine months ended 30 September 2009.

Implication

- The Asia business has performed slightly above our expectations; however, the Australian business is likely to continue its underperformance.
- Wealth management outflows, high lapse rates and an unfavourable business mix are still posing issues for the Australian business unit.
- In Hong Kong, FUM were up 14% in the quarter as asset values increased in line with market conditions. In addition to this, financial protection sales again experienced the strong third quarter lift, with the business mix slightly favouring the high-margin traditional life business, up 3% on pcp.
- After some unstable periods of sales, growth has continued for the ex-Hong Kong business, with all regions up on last quarter (Thailand slightly down). China sales were up on last quarter but they are still down on the strong sales that flowed through in late 2008 and early 2009.

Earnings and valuation revisions

- We updated our numbers in a mark-to-market report on 6 October and there have been minimal operational changes based on the flows data with the net impact being a 1.2% increase in operational earnings.

- However, our AUD assumptions have altered since that report and as a result our FY09 NPAT is down 1.4% and FY10 is down 6%.

Investment view

- The short-term pressure from the AUD has minimal impact on our $5.75 valuation; however, our price target at $4.49 remains a 20% discount to our valuation. We previously commented that continued sales growth in SE Asia would lead to an unwind of our blue-sky growth discount; however the downside from the risk of further AUD appreciation offsets this currently.

- The majority of AXA's profit growth comes from outside Australia and hence the AUD strength will have a significant impact on near-term earnings.

- With the share price trading at $4.66 on the day of this announcement, we maintain our ACCUMULATE / OUT PERFORM recommendation.

Stocks at a glance

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

Stocks by sector

API[1,] 22/10/09

Summary of report dated 21/10/09

Australian Pharmaceutical Industries Ltd: FY09 result: Getting back in the game

Last Traded: $1.055 Market Cap: $178M Sector: Healthcare
ACCUMULATE / MARKET PERFORM Valuation: $1.30

Event

- API announced a capital raising and its FY09 result. The result was slightly below our high expectations, with $18.6m in NPAT versus CBA's forecast of $19.2m (consensus estimate of $14.7m). API also announced a $150m equity raising with the net proceeds to be used to reduce its debt and enable it to invest in the Priceline brand and other future opportunities.

Implication

- *API follows SIP with an equity raising:* API announced a 2-for-3 entitlement offer (raising $112m) and an institutional placement (raising $38m). In contrast to SIP, the 0.65c offer price is a significant 39% discount to yesterday's closing price. Post the capital raising, API's balance sheet will be consistent with its conservative healthcare peers (~18% gearing).

- *Respectable operational result:* The Pharmacy division captured market share with margins up slightly (100bp) due to work from GlaxoSmithKline without a corresponding CSO payment and 'CSO creep'. Priceline sales were resilient amidst challenging market conditions with the division reporting an 11.3% increase in underlying margins (excluding store sales and the brand investment).

- *Focus on the supply chain and scale*: The Revitalise program is on budget and on time with cost savings of $10m and $18m+ confirmed for FY11 and FY12 respectively. API is also on track to reach its 400-store target in 2010 (versus 321 stores today) with a pipeline of ~40–50 potential franchisees.

Post the capital raising, API's balance sheet will be consistent with its conservative healthcare peers (~18% gearing).

Earnings and valuation revisions

- We have decreased our FY10 EPS by 30.6% and FY11 EPS by 34.8% due to dilution from the capital raising and the withdrawal of premature Revitalise cost savings in FY10.

- In contrast to our major EPS changes, our price target is down only slightly to 66c because we use have adopted a weighted PE multiple valuation using underlying current and forward earnings to factor in the cost savings associated with Revitalise (which offsets the impact of the equity raising).

	2009			2010			2011		
	New	Old	%diff	New	Old	%diff	New	Old	%diff
NPAT	18.6	19.2	-3.3%	29.4	24.6	19.8%	39.0	31.9	22.1%
EPS	7.2	7.5	-3.3%	6.6	9.5	-30.6%	8.1	12.4	-34.8%

Investment view

- Our price target is set at 66c using an even weighting between FY10, FY11 and FY12 underlying earnings and a PE multiple of 9.5x. We have maintained our ACCUMULATE / MARKET PERFORM recommendation on valuation grounds tempered by regulatory risk surrounding the next Pharmacy agreement and execution risk surrounding its Revitalise and store conversion programs.

RMD
22/10/09

Summary of report dated 19/10/09

ResMed Inc: Keeping up with the Joneses at Medtrade

Last Traded: $5.35	Market Cap: $798M	Sector: Healthcare
BUY / OUT PERFORM		Valuation: $5.20

Despite currency headwinds, we retain our strong call on RMD based on product extensions and new platforms set to be released throughout FY10 as well as highly attractive industry fundamentals.

Event

- The Medtrade expo and conference for home medical equipment suppliers was held in Atlanta in the US this week. For sleep therapy suppliers, the expo is an opportunity to showcase their latest products to DMEs and customers.
- As expected, Philips Respironics (RES) released its long awaited 'Philips Respironics Sleep Therapy System' as well as two full face masks – the FullLife and the FitLife. Meanwhile, RMD launched the Mirage SoftGel mask and promoted its recently released Swift FX nasal pillows.

Implication

- *RES's new platform responds to industry feedback*: Features include a patient friendly design, improved pressure relief and advanced humidity control, making it more tolerable for users. Sleep technicians will also be interested in the device's ability to identify symptoms beyond Obstructive Sleep Apnea (OSA) and its strengthened data management capabilities.
- *Better than M Series or S8 II Series?* RES new system addresses flaws in its previous M Series such as 'rain out' (with the Dry Box technology). However, several new features appear to be incorporated already in RMD's S8 II Series reducing its competitive threat. The one exception is the system's ability to identify non-OSA symptoms.
- *RMD comparatively quiet at Medtrade*: While RMD's two new masks are strong offerings, there was not the same 'fan fair' about RMD as there appeared to be about RES at the Medtrade expo. Following descriptions of a 'stellar product pipeline', we now eagerly await the launch of RMD's new platform (as well as more masks) over the next six to nine months.

Earnings and valuation revisions

- We have not made any changes following the Medtrade show.

Investment view

- Despite currency headwinds, we retain our strong call on RMD based on product extensions and new platforms set to be released throughout FY10 as well as highly attractive industry fundamentals. Furthermore the new platform launched by RMD's strongest competitor RES at Medtrade does not appear to contain ground breaking new features that will pose a major threat to RMD's existing S8 II Series let alone its (hopefully soon to be released) new platform.
- In addition industry sources claim that there was strong interest in sleep therapy once again at the Medtrade expo suggesting ongoing improvement in OSA awareness.

CommSec

CSL
22/10/09

Summary of report dated 16/10/09

CSL Limited: Baxter 3Q09 result read through US plasma market growth robust but challenges ahead

Last Traded: $32.25 Market Cap: $19,274M Sector: Healthcare
ACCUMULATE / MARKET PERFORM Valuation: $35.82

Plasma industry fundamentals remain attractive but risks are emerging with respect to industry supply and pricing. Combined with currency headwinds, it is difficult to see CSL outperforming in the near term.

Event

- Baxter International (NYSE: BAX), the largest global supplier of plasma-derived products, reported 3Q09 results overnight.
- US IVIG sales growth remains robust at 10%, with volume growth in the "mid to high single digits" expected moving forward. This is consistent with our expectations of around 6–8% volume growth in FY10.
- US sales growth in the plasma products division (including albumin and plasma-derived Factor VIII) remains strong at 17% while operating costs fell as collection centres reduced opening hours and lowered donor fees.
- Baxter reiterated that it believes the current H1N1 orders are potentially a multi-year opportunity and not just a one-off and yields are improving.

Implication

- Growth in key plasma-derived and IVIG segments were robust; however, the timing on product orders influenced 3Q09 and 4Q09 comparables. We remain comfortable with our ~7% volume growth assumption for CSL.
- Management was coy when questioned about IVIG pricing. Baxter is currently renegotiating a number of GPO contracts. We look to these as the next data point as an indicator of industry supply/demand balance. We currently assume flat IVIG price growth in 2010.
- The market is currently factoring H1N1 orders as a one-off for CSL; however, upside opportunity exists beyond the 2009 flu season which is not priced in.

Earnings and valuation revisions

- We have made no earnings revisions or recommendation changes to CSL.

Investment view

- Plasma industry fundamentals remain attractive but risks are emerging with respect to industry supply and pricing. Combined with currency headwinds, it is difficult to see CSL outperforming in the near term. We retain our ACCUMULATE / MARKET PERFORM recommendation. The next catalyst for CSL will be the Advisory Committee on Immunisation Practices decision on 21 October on Gardasil for young males funding.

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

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