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 186 18 November 2010 (4.30pm)

Feature Article

Our feature articles this week are:

- **Alumina Limited**
- **Incitec Pivot 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

Alumina Limited

Last traded: $2.06	Sector: Mining	Market cap: $5,027m
Buy (from Hold)		Price target: $3.06

Summary of previous report dated 17/11/10

Structural change to pricing unlocks upside

We have updated our AWC forecast in a structural shift of alumina pricing toward a spot/index and away from aluminium price-linkage contracts. Alumina markets have responded to the evolution of a robust spot market fuelled by increasing demand from a chiefly non-integrated Chinese sector. Our forecast is now based on a composite of contract-linked and spot prices reflecting the progressive rollover of AWC's historical contracts to 2015. Under our new forecast, prices rise by an average of 11% over our previous base case. Our recent industry visit to China confirmed that new price linkage contracts are being set at or near 16% of the aluminium price and Alcoa's recent investor briefing reaffirmed that AWAC is now setting all new contracts on an index basis aligned to alumina industry fundamentals. Pricing will now shift away from aluminium linked pricing toward spot driven prices reflecting alumina specific cost of production. Although some uncertainty still exists around the exact structure of index-based contracts, we believe our composite price line is not overly optimistic

AWC is highly leveraged to movements in alumina pricing

Our new pricing brings substantial upgrade to earnings as the shift to index pricing is set to unlock AWC's low-cost alumina leveraged production base. We expect the market to reflect this as the structural transition gathers momentum. AWC is currently undervalued by 53% against our new price target of $3.06 per share and we have upgraded our Hold call to a Buy recommendation.

Market Wrap

Many investors have been disappointed at the performance of the share market this year. While the US Dow Jones has lifted by over 7%, the ASX 200 has dropped 3.5% while the All Ordinaries is down 2%.

However to get a better sense of how the Australian market has fared, it is worth taking a different perspective. The capitalisation of the sharemarket is probably a better measure in the current environment, reflecting moves by companies to shift from debt capital to equity. And in fact the capitalisation of the All Ords has lifted 6% in 2010, not far off the gain made by the Dow Jones.

And then there are the currency differences. When measured in US dollar terms, as many fund managers and hedge funds do, the Dow Jones has lifted by 11% over 2010, slightly above the 10.2% lift in the All Ords. And a measure of the "world" sharemarket has lifted by 10.7%.

No doubt many investors had been hoping to replicate the gains made last year, but overall the Aussie sharemarket hasn't fared too badly – it's just that the performance has been masked by special factors.

Stephen Karpin
Managing Director

Feature Article

Incitec Pivot Limited[1,2]

Last traded: $3.69 Sector: Materials Market cap: $6,010m

Hold (from Sell) Price target: $3.70

Summary of previous report dated 15/11/10

FY10 result – a favourable blend

IPL reported FY10 NPAT of $443m ($348m pcp), which was well ahead of ours and market expectations ($402m and $399m, respectively). The final dividend of $0.06 (unfranked) was declared. Individually material items of $32.3m were announced and related to Velocity (-$16.8m), manufacturing and distribution restructuring (-$18.2m), environmental remediation (-$16.3m), and Nitromak profit ($19.0m). Operationally, we were impressed by the performance of Southern Cross and Dyno Nobel Asia Pacific (DNAP), both of which were ahead of our expectations. While Dyno Nobel Americas (DNA) was broadly in line with our expectations, we were underwhelmed by the strength of the result when compared to ORI's recent strong performance from its North American business. That said, given continued good progress on Velocity, it would appear the business remains on track to meet original targets, assuming a reasonable US economic recovery at some stage. While Incitec Pivot Fertilisers (IPF) was below our expectations, the fact that the business appears to have retained the full benefit of Project Tardis some two years after the programme has finished is encouraging. Despite the result being well ahead of market expectations and the likelihood of market upgrades, we were somewhat surprised by the weak share price reaction. In our view, this serves as a strong reminder that while IPL represents an interesting long-term value proposition, it will be a wild ride and with DAP towards the top end of its historic trading range, we continue to see potential for downside risk, albeit diminishing.

Upgrade to Hold on better than expected performance

A stronger-than-expected result and associated earnings and valuation upgrades have all but eliminated the downside to our price target. Consequently, we have upgraded our recommendation to Hold, despite our continuing concerns regarding DAP prices in the medium term, currency risks, and the shape of the recovery in US explosives.

Stocks at a glance

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

Stocks by sector

Materials

CSR[2]
17/11/10

Summary of report dated 12/11/10

CSR Limited

Last Traded: $1.69	Market Cap: $2,565m	Sector: Materials
Buy		Price target: $2.00

Tomago powers on

Tomago Aluminium (TAC) signed an additional 11-year base-load power supply contract for the period from November 2017 to 2028 with Macquarie Generation, effective upon the lapse of the current agreements. TAC has previously commented that electricity is around 28% of its total costs. CSR effectively owns 25.2% of Tomago (70% stake in GAF, which owns 36.05% of Tomago). This agreement is particularly important to Tomago's operations, as it provides supply certainty, in the uncertain NSW electricity market connected to the privatisation of NSW's electricity assets. While details of the agreement were limited, it would be reasonable to assume an increase from current rates will occur, given the current contracts were established in 1983 and 2005. Having said that, securing future supply today avoids potentially costly surprises that may result from the proposed deregulation of electricity pricing and should the market move into short supply. Increased electricity supply certainty, the strong outlook for aluminium and CSR's strong net cash position (post Sucrogen) suggests the possibility of further capital expenditure at Tomago should not be dismissed. Tomago capacity was last upgraded by around 15% over a three-year plan completed in 2005.

Marginal valuation impact

We have made no earnings changes following this announcement and estimate marginal impact from increased electricity costs. We have been somewhat surprised by CSR's share price weakness subsequent to receiving FIRB approval. That said, we remain attracted to its significant balance sheet capacity subsequent to the announced sale of Sucrogen to Wilmar International; CBA's continued positive view on Australian housing commencements through FY11; and CSR's limited exposure to the shaky US housing market. CSR is currently the cheapest stock in our coverage universe.

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Media

SEK[1]
17/11/10

Summary of report dated 12/11/10

Seek Limited

Last Traded: $6.57	Market Cap: $2,211m	Sector: Media
Buy		Price target: $8.05

Trading update disappointing

Seek has provided a trading update signalling a combination of top-line pressure and higher re-investment which will see earnings from its learning divisions move down in FY11. Seek Learning, THINK (with campuses in NSW, VIC and QLD plus online) and its international student recruiter IDP are all now expected to have lower earnings than we previously forecast. Whilst we are clearly disappointed by the lacklustre performance of Seek's learning businesses, we remain positive on the cyclical recovery playing out for Seek's classifieds business, which make up 85% of earnings in FY11f and 70%+ of our valuation.

Reiterate Buy with $8.05 price target (was $8.80/sh).

Seek is a well-run company with an attractive business model and a substantial first-mover advantage in online employment classifieds in Australia. We expect the classifieds business will continue to benefit from the structural shift from print to online, and maintain the large lead it enjoys in unique users/revenues over the No.1 and 2 players.

Whilst we are clearly disappointed by the lacklustre performance of Seek's learning businesses, we remain positive on the cyclical recovery playing out...

Consumer Discretionary

MYR[2,] 17/11/10

Summary of report dated 12/11/10

Myer Holdings Limited

Last Traded: $3.79	Market Cap: $2,204m	Sector: Consumer Discretionary
Buy		Price target: $4.55

Myer, the 'premium' department store

MYR reported weaker than expected.comparable 1Q11 sales of -1.31% (excl Bourke Street), at its AGM. Conditions remain tight leading up into Christmas, with consumers remaining cautious. Sales have been weaker than anticipated across the retail space, primarily due to deflation as volumes remain in reasonable shape. The key focus however is on improvements fuelling growth. Importantly, MYR's investment in distribution, merchandising, POS and stores will enable greater growth independent of the macro environment. Furthermore, independent earnings drivers continue to support switching to MYR from DJS. The internal improvements at MYR, a mix shift towards exclusive brands and AUD benefits coming through from a variety of sources are all medium-term differentiators of earnings performance between the two business models. Management reiterated 5% to 10% NPAT guidance. We are forecasting FY11 NPAT of $184m, implying 8.8% NPAT growth.

Valuation remains compelling and independent earnings drivers a plus

We continue to favour MYR in the discretionary retail sector. The stock offers a three-year EPS CAGR of 10.6%, is trading at 12.3x FY11 PE and offers a 6.4% fully franked dividend yield. While the macro environment is tougher than we expected, internal improvements within MYR provide a degree of earnings certainty beyond many of its peers. We maintain our Buy recommendation.

Importantly, MYR's investment in distribution, merchandising, POS and stores will enable greater growth independent of the macro environment.

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 IPL

[2] Members of the Commonwealth Group have received fees within the previous 2 years from MYR; IPL; CSR

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