



INVESTMENT PERFORMANCE											Since	Since
Period ending	30 June 2010	Month	Qtr	Year	2 Yrs <sup>1</sup>	3 Yrs <sup>1</sup>	5 Yrs <sup>1</sup>	7 Yrs <sup>1</sup>	9 Yrs <sup>1</sup>	10 Yrs <sup>1</sup>	Inception <sup>1</sup>	Inception <sup>2</sup>
<b>Lonsec Core Model Total Return<sup>3</sup> (%)</b>		-3.8	-11.6	9.2	3.4	-0.5	9.8	15.0	13.7	14.0	15.5	336.5
S&P/ASX TOP 100 Accumulation Index (%)		-2.5	-11.2	13.5	-4.2	-7.2	4.8	9.9	7.3	7.1	8.3	125.7
Out/Under Performance (%)		-1.2	-0.4	-4.3	7.6	6.7	5.0	5.1	6.4	6.8	7.2	210.8
<b>Standard Deviation</b> (volatility of quarterly returns)												
Lonsec Core (%)				27.0	22.5	19.9	16.9	15.1	14.2	13.5	14.1	
ASX TOP 100 Acc. Index (%)				27.2	25.4	22.3	19.0	16.6	15.6	14.9	15.2	
<b>Tracking error</b> (volatility of excess returns) (%)				1.6	7.9	7.2	6.0	5.7	7.2	7.0	7.0	

<sup>1</sup> % per annum <sup>2</sup> Total return since inception date 17 April 2000

<sup>3</sup> Investment Performance is calculated before fees, charges, brokerage and taxes. Dividends are reinvested at the end of each month.

The portfolio is reset at the end of each month back to the model portfolio weightings. This prevents portfolio weightings from skewing over time and ensures performance figures remain relevant. The Lonsec Core Model portfolio is a fully-invested notional portfolio with no cash weighting. Physical portfolio results will differ depending on cash levels, start date, fees, brokerage, taxes and compliance with model weights. Past performance is not a reliable indicator of future performance.

## Comments

***“The Lonsec Core Model Portfolio aims to deliver strong absolute returns over the medium to long-term.”***

The Core portfolio gained 9.2% over FY10, underperforming the S&P/ASX Top 100 Accumulation Index by 4.3%. However, portfolio performance remains substantially above benchmark over longer timeframes. The portfolio has had a few stocks underperform since January 2010, notably PRY, TOL, AMP and WBC, which has dragged performance down a touch but Lonsec is confident these stocks, and the portfolio, will recover over the short to medium term. Lonsec will continue to monitor these companies closely as we move through the profit reporting season.

Lonsec expects that HSP shareholders will soon receive a recommended cash takeover offer of around \$6/share, which would be a good outcome when one considers the average HSP cost base should be under \$4.50/share, including rights issues and placements. Lonsec will use the probable exit of HSP as an opportunity to carefully review portfolio weights and composition. Lonsec’s key top-down industry themes are: **Australian Banking & Wealth Management, Energy, Mining and Private Healthcare.**

Note: Recommendations made within the Lonsec Model Portfolios may differ from other stock research published by Lonsec/Aspect Huntley.

### Comments on stocks with corporate actions:

**HSP (-5.5%)** Healthscope has received takeover offers from two separate private equity consortiums. Both involve major US-based private equity groups that have the capital and financial connections to conclude a \$1.8bn acquisition. The HSP Board has engaged with the suitors in the due diligence process and bids are currently being finalised. The highest offer currently stands at \$5.80/share. Media reports suggest that there is a strong likelihood that HSP will receive at least one firm takeover offer at around \$5.80/share.

The HSP share price has traded between \$5.20 and \$5.50 reflecting a small discount for the time the deal will take to reach conclusion (1-2 months to pass Board, shareholder and court approval) and the small chance both bids could be withdrawn or rejected by the Board.

Lonsec's portfolio manager believes HSP could generate EPS of around 40cps in FY11 and should be valued on this number. On that basis, the bid represents a FY11 PER of 14.5x which is reasonable but not really compelling for full ownership of the business. Lonsec recommends investors HOLD their HSP shares and await further direction from the Board. We anticipate the Board will soon recommend an offer for HSP in the \$5.80 to \$6.20/share range.

**ORI (-1.8%)** Orica recently demerged Dulux (DLX) as a newly listed company. Lonsec's comments follow:

#### Key Points:

- Orica demerged Dulux Group (on a 1 share for every ORI share basis) on 12 July 2010
- Dulux Group is a premium brand (Dulux, Selleys, Cabot's, Yates) coatings, home improvement and garden care business focused on the Australia/NZ retail market
- Dulux contributed about 12% of ORI's Group EBIT and is valued at approximately \$2.50/share\*
- Dulux was demerged to allow it to focus on the Australian/NZ retail consumer product market whereas ORI's remaining businesses (Mining Services, Minova and Chemicals) are all wholesale businesses focused on the global mining market
- The ORI Board and Independent Expert both believe the demerger is in the best interests of ORI shareholders
- Lonsec's portfolio manager recommends that Dulux holdings be divested over the short term

\*Lonsec portfolio manager's valuation (see below)

#### Comments:

Dulux is a medium sized business that represented about 12% of Orica's EBIT. It has been demerged because it is a retail premium brand business focused on the relatively mature Australian and NZ coatings, home improvement and garden care market. In contrast, Orica's explosives, chemicals and mining products businesses are all wholesale businesses focused predominantly on the global mining industry.

Dulux is the leading provider of premium branded coatings, home improvement and garden care products in Australia and NZ with about 40% market share. In FY09, it had revenue of \$940m and EBIT of \$122m. Dulux is quite profitable with an EBIT margin of 13% and has been growing at a reasonable rate - over 2002 to 2009, Dulux grew revenue at a CAGR of 5.6% while EBIT grew at a CAGR of 7.9%. Dulux has been growing above industry growth rates (1-2% pa) by increasing market share and improving operational efficiency. However, Lonsec questions how much further Dulux can go in Australia given market volumes are flat and competition seems to be increasing with Nippon paints being distributed by Bunnings and US-based Valspar looking to acquire Watty.

Lonsec also notes that the demerger will saddle Dulux with an extra \$13m pa in costs which will, initially, drop EBIT margins to 12%. Dulux's balance sheet will have pro-forma total assets of \$516m, net debt of \$245m and net assets of \$41m. The existing Dulux management team is transferring to the newly listed company.

### Lonsec's portfolio manager valuation of Dulux

<b>Dulux Group</b>				
	Y/e Sept	FY09	FY10F	Assumptions
Sales (\$m)		947.2	977.4	1H11 result annualised
EBITDA		145.9	143.8	1H11 result annualised
EBIT		123.9	117.0	1H11 result adj+ annualised
Interest			13.6	8% interest on \$245m debt
Tax			23.2	30% company tax
NPAT			63.2	
Shares on issue (m)			361	
EPS (c)			0.19	
Net Debt (\$m)			245	
Net Assets (\$m)			41	
<b>Equity Valuation</b>		<b>Market cap</b>	<b>Share price</b>	
EV/EBITDA (x)	8	945	2.62	
EV/EBIT (x)	10	925	2.56	
PER (x)	12	818	2.27	
	13	886	2.46	
	14	955	2.64	

Source: Lonsec estimates, Scheme Booklet, Independent Expert Report

Lonsec's portfolio manager has valued the equity of Dulux at between \$818-955m or \$2.27-2.64/share. This valuation is based on applying median Australian and International listed consumer product earnings multiples to Dulux forecast FY10 earnings. With a market capitalisation around \$900m it is likely that Dulux will reside just outside the ASX Top 100, which cuts off at \$1bn.

Lonsec has identified the following positive and negative catalysts for Dulux:

#### Positive catalysts

- De-merger leads to improved business focus and performance
- De-merger facilitates a growth strategy to expand into new products and markets, e.g. Asia
- Australian housing maintenance, improvement and construction activity rises
- Dulux market cap expands and the company enters the ASX Top 100
- Major international firms (in particular Dutch-based Akzo Nobel NV which distributes Dulux in Europe) look to acquire Dulux

#### Negative catalysts

- Dulux growth rate slows to industry growth rates (1-2% pa) due to increased competition from international players including US-based PPG Industries, Japan-based Nippon and US-based Valspar
- Major home improvement retailers (Bunnings, Mitre 10 and Woolworths/Lowe's) squeeze Dulux margins
- Australian housing maintenance, improvement and construction activity falls
- Dulux earnings multiple declines due to ex-ASX Top 100 status
- Dulux smaller revenue and reduced business diversification (relative to Orica) leads to an increase in its cost of capital

## Conclusion

Lonsec is not as attracted to the coatings industry as it is to the global explosives, chemicals and mining supplies industry. Orica is currently valued at \$9bn and is included in the ASX Top 50 while Dulux has a market capitalisation around \$916m. Orica will remain in the ASX Top 50 while Dulux will be just outside the ASX Top 100.

Orica currently trades on a FY10 PER of 14.2x but Lonsec is not confident Dulux will be able to maintain such a rating. While Dulux has been a strong performer over the past decade, it does look as if large international players (PPG Industries, Nippon and Valspar) are now entering the Australian market. In addition, the likely dominance of Bunnings, Mitre 10 and Woolworths/Lowe's in home improvement distribution could drive Dulux profit margins down over time. On the positive side, Dulux is a premium player with dominant market share and there may be international interest in Dulux itself. Although, one wonders why a potential acquirer didn't purchase Dulux from Orica as a trade sale in the first place? Perhaps they think it could be acquired cheaper on-market?

Accordingly, Lonsec views Dulux as a non-core holding and recommends shareholders divest their holdings in the short term.

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## Comments on major outperformers:

**WOW (+1.4%)** Woolworth's held up well in a weak market due to the defensive qualities of its food and liquor divisions. Lonsec recently commented on Woolworths 3Q10 sales results:

### Key Points:

- 3<sup>rd</sup> quarter sales of \$12.9bn, up 4.7% (3.8% excluding petrol sales)
- Sales growth slowing due to zero food and liquor inflation, cycling down of 2009 fiscal stimulus and higher interest rates
- YTD sales growth is 5.3%
- FY10 sales guidance lowered to 3-6% from upper single digit
- FY10 NPAT guidance maintained at 8-11%

### Comments:

WOW sales results were solid given that the retail environment has obviously cooled this year. Factors that have caused the slowdown include: zero food inflation; roll off of Government stimulus; higher interest rates and petrol prices. Nearly all the retail stocks are off this year with discretionary retailers suffering the most pain.

This was also the case for WOW with BIG W, general merchandise and consumer electronics experiencing a 3.3-3.7% drop in sales over the quarter. However, 90% of WOW sales are derived from the relatively defensive food, liquor, hotels and petrol divisions where sales were up 4.6%, in aggregate. Moving forward, there is no reason why sales growth cannot recover if food inflation returns and the economy gains momentum but increased competition from Coles and Aldi means that WOW will need to watch its margins.

While sales are slowing this year, WOW has maintained its NPAT guidance of 8-11%. The market (broker consensus) expects WOW to generate FY10 profit of \$2.0bn equivalent to EPS of \$1.63 and DPS of \$1.13. On that basis, WOW trades on a FY10 PER of 16.5x and yield of 4.2% ff. In FY11, EPS is expected to lift to \$1.80 which implies a FY11 PER of 14.9x. In comparison, WES trades on a FY10 PER of 19.8x and FY11 PER of 14.8x. In the short term, WES looks considerably more expensive than WOW because the market expects a much higher growth rate over FY11 (37%).

Lonsec's portfolio manager views WOW as a defensive holding along with our holdings in ORG, PRY, HSP and CWN. They should all outperform when market sentiment is negative but they all still offer good growth prospects over the medium to long term. WOW is good value at these levels. Lonsec recommends a BUY under \$28/share.

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### Comments on major under-performers:

**TOL (-11.9%)** Toll's share price has been weak since it downgraded earnings guidance in April. Lonsec suspects that the broader economy is generally weaker than the GDP data suggests because growth is focused in the mining and public sectors. Toll is our preferred transport sector exposure and is best viewed as a cyclical stock. It should recover as freight volumes rise over the medium to long term. That said, Lonsec continues to monitor the transport sector and Toll closely.

Toll Holdings recently released a trading update:

#### Key Points:

- TOL expects 2H10 profit to be up 5-10% on the pcp (below market expectations)
- Trading conditions have softened in Australia and NZ but Toll Global is improving
- Market forecasts for FY10 EBIT have been downgraded ~5% to \$400-410m from \$422m

#### Comments:

Toll has consistently been unable to meet market expectations over the past year or so. It is hard to determine whether this can be solely attributed to cyclical factors or whether there are also structural issues within the company. At this stage, Lonsec is willing to give management the benefit of the doubt given there does seem to be broad weakness across the transport sector (BXB, AIO, QAN, VBA, KSC) and the retail sector (WOW, MTS, MYR, DJS, HVN, PBG).

Offsetting the cyclical slowdown in revenues, somewhat, will be TOL's acquisition program which continues at a steady pace. TOL still has room for a number of bolt-on acquisitions as its debt levels are modest with net debt of around \$900m and gearing (ND/ND+E) of 25%. This compares favourably with AIO which carries \$2.8bn in net debt and has gearing (ND/ND+E) of 48%.

The market (broker consensus) has revised down forecast FY10 NPAT to \$286m equivalent to EPS of 41cps and DPS of 24cps. However, the market still expects a 20% rebound in earnings in FY11 to \$335m equivalent to EPS of 48cps.

On that basis, TOL trades on a FY10 PER of 14.6x falling to 12.5x in FY11. TOL is a cyclical stock so there is plenty of operational leverage to economic activity. If activity picks up as forecast by the RBA and economists, then TOL looks reasonably cheap at these levels. It's also comforting to know the balance sheet is strong. Lonsec retains the holding and a BUY under \$6.00.

**WBC (-7.5%)** Westpac has been weak over the past two months in line with general weakness in bank stocks globally and domestically. European sovereign debt issues are sparking concerns about another wave of bad debts for European banks. While Australian banks hold little European sovereign debt as assets, they do fund a considerable portion of their wholesale debt in European debt markets. If credit spreads start to rise in Europe the cost of capital will go up for Australian banks meaning they will have to increase loan rates and/or absorb some of the cost through lower interest margins.

At this stage, Lonsec does not expect a repeat of the GFC, where the Australian Government had to lend its AAA credit rating to the banks, so they could continue to access foreign debt markets on reasonable terms.

At the same time, credit growth is stalling in Australia and recent equity market weakness will crimp investment income. The outlook does look less rosy than a couple of months ago but the major banks are now in a strong position to cope with any economic or market weakness.

In the case of WBC, it has increased interest margins to 2.28% and ROE to 16.6% and it has a strong capital position with a tier 1 capital ratio of 8.6% and an additional collective provision of 1.5%. It retains a AA credit rating (one of the top 10 rated banks in the world) and has a market capitalisation of \$67bn, making it Australia's 2<sup>nd</sup> largest bank after CBA.

Asset impairment charges have been falling since the GFC from \$1.6bn per half to around \$880m in the most recent interim result. A decline in asset impairment charges goes straight to the bottom line, so WBC still has plenty of room to grow cash earnings if this charge continues to come down.

The market (broker consensus) currently forecasts FY10 NPAT of \$5.9bn equivalent to EPS of \$1.95 and DPS of \$1.35. On that basis, WBC trades on a FY10 PER of 11.6x and dividend yield of 6.0% ff. The stock looks good value at these levels and Lonsec recommends a BUY under \$23/share.

**AMP (-6.8%)** AMP has retreated from \$6.50 to \$5.40 from April to June. The shares have retreated on a few areas of market concern which include:

1. Equity market weakness since April which will reduce investment income;
2. Cooper review of the Australian Superannuation Industry with two key recommendations: *MySuper* (a simple and cheap well-designed super product intended to be suitable for the majority of 'disengaged' members) and *SuperStream* (clean-up of back office processes); and
3. AMP bid for AXA Australia which is still alive if the ACCC continues to reject AXA's preferred NAB bid.

Lonsec is fully aware of these issues but notes there is still great uncertainty around Government adoption of the Cooper recommendations and AMP proceeding with any bid for AXA Australia. Yet the market seems to have priced in a fair amount of downside given AMP trades on a FY10 PER of 13.5x and yield of 6.1% (based on broker consensus forecasts).

On the Cooper review, Lonsec notes the Government will consult with industry for two months before the Government forms its own view (and there is no certainty the Government will retain office in the short term). Lonsec acknowledges that *MySuper* will bring industry margin squeeze for AMP (and indeed all Super providers) but there are some offsetting positives which include:

1. The SGC is proposed to increase from 9% to 12% by 2020 and Australia's superannuation pool is projected to increase from \$1.3 trillion to over \$6.1 trillion by 2035<sup>1</sup>;
2. AMP has already developed a *MySuper* product and is keen to break into award default funds which the industry funds have a monopoly over (Note: for Labor to adopt *MySuper* they will be under pressure to allow Retail Funds to compete with Industry Funds for award default funds thus undermining their own union powerbase.)

<sup>1</sup> Cooper Review of Superannuation

3. *SuperStream* efficiency gains in the processing of Superannuation may help offset margin squeeze from *MySuper*; and
4. The timing and implementation of *MySuper* is very uncertain and is unlikely to be 'big bang' and is more likely to impact gradually on industry structure and margins.

On the AMP takeover for AXA, Lonsec notes that NAB is modifying its bid for AXA Australia, to meet ACCC concerns, and still seems to be the front runner. AXA's share price has retreated from \$6.30 to \$5.30 since April, reflecting increased uncertainty and lower market multiples. If the NAB bid continues to be blocked by the ACCC, it is likely that AMP will become the frontrunner by default and it will most probably be more reserved in its offer price. In other words, AMP is only likely to bid for AXA if the NAB bid is blocked and then only if it can extract decent value out of the acquisition. Lonsec notes that there are probably more synergies between AXA/AMP than AXA/NAB.

Overall, Lonsec remains positive on the top-down outlook for Australian Superannuation and AMP remains our key exposure, at this stage. We also have indirect exposure via CBA and WBC. Investors should note that the banks, AMP and AXA dominate the Retail superannuation segment with about 80% market share. It is impossible to invest in the Industry Funds and very difficult to get 'blue-chip' exposure to the growing SMSF segment, so the Retail superannuation segment remains the best listed exposure. However, Lonsec is aware that the Retail superannuation industry has been losing market share to Industry Funds and SMSFs, and if this trend continues, we will need to review our exposure to AMP.

Lonsec recommends AMP as a BUY under \$6/share.

For further information on the top-down outlook, tactical asset allocation, model portfolios and bottom up stock research, please review Lonsec's *Investment Insight* quarterly report and direct equity research on the web: [www.lonsec.com.au](http://www.lonsec.com.au) and/or contact Lonsec Stockbroking via email [broking@lonsec.com.au](mailto:broking@lonsec.com.au) or call the Melbourne Desk **1800 648 518** or Sydney Desk **1800 155 514**.

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