

Leyland Lines is our monthly newsletter providing investors with our insights on the overall market, individual companies and other relevant issues. All the information contained in this newsletter is for general reading only and should not be taken as a personal recommendation. We encourage you to call Leyland Private Asset Management for specific advice in relation to your portfolio.



## Welcome to the February 2008 edition of Leyland Lines

In this edition we provide a market update in light of an extraordinary month in January.

We also identify some of the bargains (of which there are many) available to value investors. Included amongst our notes this month are Virgin Blue, Emeco Holdings, Saferoads, Incitec Pivot and issues surrounding the fall in value of the retail sector including JB Hi Fi, David Jones, Harvey Norman and Woolworths.

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## Market Update

January was one of the worst months on the stock market in 40 years, finishing the month 10.4% down.

Much of the damage was accentuated by the high level of gearing that had built up over the last few years particularly with private investors using margin lending. With 12 down days in a row it was difficult for anyone with a margin loan to avoid a margin call.

Tuesday, January 22 was one of the more dramatic days on the stock market since 1987; with the snowball affect of margin lending selling cascading into a record number of trades on the ASX. Internet broker Commsec was inundated with orders and had a malfunction with their computer system, further exacerbating the panic. Accentuating the problems was broker Tricom, which received the inauspicious accolade of becoming the first broker to fail settlement since the ASX became a single exchange. The previous settlement failure was in the 1970's.

Although corrections in the market have become speedier and more violent in recent years, it is still daunting to experienced operatives to see the extent of the indiscriminate selling. On days like this there are very limited places to hide.

The subsequent bounces are still fickle and a return to confidence is likely to take some months as the dearth of buyers lead to even greater falls in stocks, many of which have excellent medium term growth prospects.

In spite of the falls over January, the most intriguing aspect is that most commodity prices have actually improved over the month. We still believe that the sectors to be overweight remain the precious metals, base metals and soft commodities, with scope for the health sector also to outperform.

Significant value now exists in most of these sectors and although we do not discount the likelihood of further bad news and negative sentiment flowing through to the market, those with cash can find some excellent medium term buying at this point in time.

The proposed takeover of Rio Tinto by BHP is indicative of the positive view both companies have of the continued strength of economies such as China, India, Brazil and the Middle East.

A scheme of arrangement for a merger would make more sense for both RIO and BHP to circumvent much of the regulatory paperwork; however the boards of both companies have some serious disagreements as to the best commodities to concentrate on in any merged group. RIO argues the Alcan takeover is still very much undervalued and they do not believe oil should be part of a metal company. BHP sees oil as a highly valuable asset for the long term and is less enthused by aluminum.

These prevarications between the two boards have forced BHP to go to the RIO shareholders to entice them separately and encourage them to put pressure on RIO's board of directors to enter into discussions with BHP.

The regulatory process will take between nine and 12 months, which is a huge amount of time bearing in mind the current economic environment. The merits of both combatant's arguments will change many times over this time period prior to the final outcome.

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## Retail Sector

The recent interest rate rises has resulted in many analysts becoming concerned about the ability of the consumers to maintain their discretionary spending. The rise in mortgage rates towards 9 percent and the jump in credit card rates towards 20 percent, together with the sustained oil price are undoubtedly having an affect on discretionary spending.

The question is whether the earnings peak has been reached in the December quarter for companies exposed to discretionary spending. Already we have seen some heavy falls in stocks such as Harvey Norman and JB Hi-Fi. Have these falls been an overreaction or are they an indication of a significant earnings falls for the retail sector?

We briefly look at some of the stocks in this sector:

### *Harvey Norman*

**Current Price \$4.79**

The stock has suffered dramatically over the last month, falling from a peak of \$7.25 on November 30 down to its current price of \$4.70.

Harvey Norman does have an excellent land bank, which will put a floor under the share price.

The one area of sales that is likely to continue is in plasma and LCD televisions as HD digital transmissions increase and prices continue to fall.

At current levels the stock is factoring in a substantial slowdown in consumer spending.

### *JB Hi-Fi*

**Current Price \$11.24**

The company came out with an excellent result but was marked down by the market, more than likely because of a re-rating of the whole sector rather than its individual performance. The price earnings ratio is still high, pre-empting significant earnings growth. The store expansion continues at pace with more debt now on the balance sheet.

JB Hi-Fi is therefore more vulnerable to a greater slowdown than expected in consumer spending than other retailers because of their store expansion. It continues however to do very well in the LCD/Plasma television space.

### *David Jones*

**Current Price \$4.05**

David Jones has got its act together over the last few years and the results have followed accordingly. Nevertheless, when consumer spending slows they do suffer as their product range is so broad.

The company's share price has fallen from a peak of \$5.66 in July to \$4.05, which is factoring in quite a slow down in spending.

Although it seems to be bottoming at current levels we think that the negative sentiment will restrict the upside moves and feel there are other companies/sectors that offer more upside potential.

### *Woolworths*

**Current Price \$28.87**

Although strictly not a discretionary spending stock, the price earnings ratio is at a large premium to its local and international peers. This PE premium has in the past been justified by the supposed defensive nature of the company, its good management and continued excellent growth.

Nevertheless, as money becomes tighter competitors such as Aldi and Coles, under the new management of Wesfarmers, are likely to make inroads into Woolworths market share. We therefore caution against buying Woolworths as a defensive stock and for investors with a shorter term focus there is a strong argument to take some profits at current levels.

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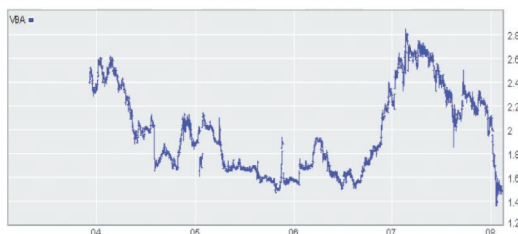
## Virgin Blue (VBA)

Current Price \$1.45

As most readers would be aware, Virgin Blue is the highly successful airline which came to Australia in 2000 and revolutionised the domestic airline industry.

Whilst Virgin Blue started out as a discount airline it has now positioned itself as a full service value airline, charging a reasonable price for a reasonable service. Initiatives such as lounges, rewards and premium economy seating are allowing Virgin Blue to compete more aggressively for the (higher margin) corporate dollar.

Virgin Blue floated in late 2003 and after a brief post-listing run drifted to \$1.50 and stayed around that price for twelve months. When the market started to realise the value in owning a duopoly business in a growing market the shares moved up to \$2.80. Virgin Blue has fallen back to the \$1.50 mark in the recent market sell down; a price at which we believe the investment hypothesis is compelling.



In 2004 Virgin Blue reported earnings of 16.8 cents-per-share. In the year ended 30/6/07 Virgin Blue reported earnings of 20.5 cps. In the meantime Virgin Blue's share price has retreated (see graph). Sometimes short term share price movements bear little relation to the underlying fundamentals of the business.

We believe that Virgin Blue's core domestic business is reason enough to purchase shares. In addition to the local operations Virgin Blue is both increasing its reach and leveraging off its existing customer base with initiatives such as:

- Increasing fleet size to 81 planes
- New Premium Economy targeted at business travellers
- High demand for lounge access

- Live TV
- Plans to fly to the USA by end 2008
- Increased routes to Pacific Islands and domestic New Zealand

### Fuel

One reason proffered for Virgin Blue's disappointing performance has been the high cost of aviation fuel. Most global airlines have been implementing a fuel surcharge for over two years now, with no obvious impact on demand. Virgin now has a hedging policy in place and over 50 percent of their fuel is now hedged. The market seems to be ignoring this fact.

### Ownership

TOL inherited 62.7 percent of Virgin Blue when they purchased Patrick Corporation. This has been perceived as an overhang and the market has been concerned about ownership. Ownership is almost irrelevant when analyzing the long term potential of Virgin Blue; management should be concentrating on the operations and leaving the share price and owners to their own volition.

### Management

Virgin Blue is run by Brett Godfrey who has been at the helm since inception. Despite his detractors he has done an extremely good job at growing the airline whilst maintaining their young and fresh image. Virgin Blue is in good hands.

Virgin Blue is an efficient business operating in a high growth sector of the market. With a combination of good management, very cheap multiples, reasonable gearing and an attractive growth profile we believe that the risk/reward scenario for Virgin Blue is compelling.

	2008	2009	2010
EPS	22.5	22	26
DPS	4.0	5.0	5.0
PE Ratio	6.44	6.59	5.58
Dividend Yield %	2.76	3.45	3.45
Franking %	100.00	100.00	100.00

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## Emeco Holdings Limited (EHL)

Current price: \$0.79



As the above graph shows, Emeco's share price has dropped by 66 percent in less than 12 months.

The recent rapid falls are a result of a series of profit downgrades, which although disappointing we believe are far from terminal.

In the latest interim profit announcement for the six months to December Emeco have provided guidance to a full year profit of \$65-72 million. This places them on a current PE of less than nine and an EV/EBITDA multiple of less than 4.4 times, both of which are significant discounts to the market valuation multiples.

Emeco's gearing is reasonable and the net assets are valued at approximately \$0.75. This asset backing will place a floor under the share price, with upside coming from improved management performance or the inevitable corporate activity in a sector that continues to consolidate.

Emeco is Australia's biggest supplier of large earthmoving equipment, predominantly supplying the mining and civil works industries. The majority of its business is dry hiring (i.e. without the associated drivers) as well as supplying on a full maintenance basis and selling equipment to customers.

During the last 18 months, Emeco has either acquired or commenced operations in Indonesia, Europe, USA and Canada. One reason for the recent underperformance of Emeco shares is that its overseas businesses have disappointed, but

we believe these businesses need to be viewed in perspective of their relative size and the fact that they are start-up operations.

Over 80 percent of Emeco equipment and revenue is in Australia. Locally it is the dominant supplier to the base metal mining companies, which are desperately trying to ramp up operations across the country, putting Emeco in a great position. In its last reporting half year (to December 2007) Emeco's results were affected by the floods in the coal mines in Queensland and port congestion in Newcastle in NSW. Notwithstanding these short term problems, Emeco still exceeded its previous year's earnings in Australia.

Emeco's second largest operation is supplying large earth movers to the Canadian Oil sand companies. These companies dig up huge amounts of sand which they then truck to a plant which separates the oil. As this process costs around US\$40 per barrel and oil is over US\$90 per barrel, these operations are ramping up at an extraordinary rate. In the last six months Emeco had some issues with some mine disruptions which drastically reduced the overall utilisation of the equipment. Again this would appear to be a short term issue.

The US operation is essentially a start-up. For this reason management knew it would lose money for a period of time; however it was hoped that it would be breakeven by now. Emeco now expects its US operation to breakeven next quarter and to be profitable the following quarter.

Emeco's European operations continue to be on track and are profitable although not that material to the overall results. Its Indonesian operation is relatively small, and was somewhat reliant on one major customer. When this customer slowed operations it took some time to redeploy the vehicles. Management has stated that they have redeployed the machinery to other customers.

To add to recent problems Emeco's interim results were further hampered by the delay in the supply

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## Emeco Holdings Limited cont'd

of some machines which were scheduled to be sold at a profit of \$2m. These sales will now occur in the next quarter.

Emeco's management has disappointed in a market that is very unforgiving. There is no doubt that management have made the cardinal mistake of over-promising and under-achieving, which has led to many research houses being quite negative about the stock. The net result is the dramatic drop in share price.

From an investor's perspective, we believe this to be the bottom for Emeco's share price for the following reasons:

1. At its current share price it is trading in line with the net asset value, which is essentially the heavy trucks which have a ready market. There is no value placed on the contracts, brand etc., so these are all upside.
2. From a financial perspective, Emeco is trading on a very cheap EV/ EBITDA ratio of 4.4 times. By way of reference National Hire took over Coates Hire at a price of over 7.5 times EV/EBITDA.
3. Emeco has a reasonably sound balance sheet with net debt to capitalisation of 37 percent and interest cover of 4.7 times. Their debt is locked in at reasonable rates and does not need to be rolled over for another 18 months. It also has an unused banking facility of \$150m, which is supplemented from the cash generation from existing operations.
4. The attraction for National Hire or others is that Emeco's existing fleet is substantial and it has solid supply agreements to expand its fleet if necessary. New competitors could not emulate the equipment due to the global shortage.
5. Emeco's base metal mining and road building customers all have significant expansion plans over the next five years.

There is the possibility of Emeco being the subject of a takeover. An acquirer of Emeco could sell its overseas businesses or equipment, reducing Emeco's debt which would leave a very profitable and dominant Australian operation. This may well be attractive to the private equity industry and/or large construction firms such as Leightons. Not coincidentally, National Hire moved on Coates after it disappointed analysts with a slip in its performance. National Hire is backed by private equity and Kerry Stokes, giving it the financial muscle to takeover a company the size of Emeco.

The risk of investing in Emeco is if base metals fall so much that the large mining companies stop their expansion projects, then the demand and hence value of the large earth moving equipment will fall. With base metals remaining in demand and larger mining companies stating they want to increase the size of their production this risk seems reasonably low.

In particular, the iron ore industry through BHP, Rio Tinto and Fortescue is set for huge expansion over the next five years in Western Australia. The logistics of iron ore mining requires an enormous amount of Emeco-style equipment. Coal prices are extremely high with the only issue holding back expansion being the ports and the wet weather. It is a fair assumption that if utilisation rates are not acceptable in the coal industry then the equipment can be moved to other mines such as iron ore. Finally, Emeco's equipment is also used for the major infrastructure projects such as road building and all Australian states have many projects slated for development in the next five years.

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## Agriculture and Incitec Pivot

As the market comes to terms with what has become an unprecedented mining boom, investors begin to look for the next big movers. As such, the spotlight has turned towards the agricultural industry. For those who closely follow the market, this should come as no surprise. Over the last few months we have witnessed the agricultural sector weather the general market correction better than most. In fact most of the soft commodities have shown double digit percentage gains since January, and significantly more over the last year.

	% since January
Soy Oil	14.0%
ASX	-11.5%
Corn	10.1%
Dow	-6.7%
Cattle	8.0%
NASDAQ	-12.5%
Wheat	13.8%
FTSE	-8.5%

### Incitec Pivot (IPL)

#### Current Price \$132.20

One of the greatest beneficiaries and most exciting stories of 2008 has undoubtedly been the success of Incitec Pivot (IPL) - up 14 percent since January.

After exploiting merger synergies from the 2003 merger between Incitec Fertilisers and Pivot, IPL commenced a restructure process in June 2005, reducing annual costs by \$25m through improved management practices and optimising asset utilisation. However, still an unfashionable industry, IPL didn't truly make its move on the investment scene until after Orica sold its 70 percent stake in the business in mid-2006. Since then IPL have grown their business both organically and through a number of savvy acquisitions.

From January 2006 to January 2008 Incitec's share price has risen eight-fold, from \$16 to \$130. But what sets IPL aside from many other

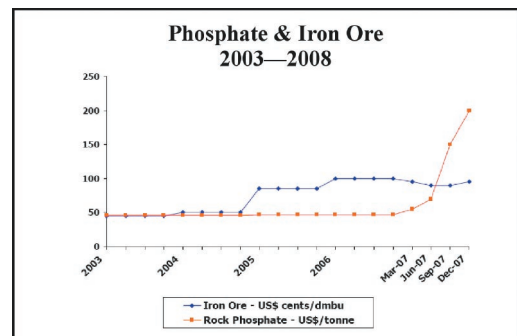
high achievers of recent time, is that unlike many companies that have experienced a run up on positive market sentiment IPL has achieved their share price growth through its improved outlook and profitability.

### The Story:

It began in 2006 with the expectations for a break in drought conditions. At the time Incitec was seen as a perfect entry point for institutions looking for agricultural exposure without the volatility of a single commodity business. Still, even renewed institutional interest does not account for the 700 percent rise in market cap.

During our recent (June 2007) visit to the company we had the opportunity to speak with Simon Atkinson (Chief Financial Officer). At the time, Mr Atkinson outlined Incitec's unhedged exposure to DAP and explained the supply/demand scenario for the foreseeable future which was extremely tight, with very little new capacity available.

As it turns out, Mr Atkinson's estimates were conservative - to say the least. Subsequent to our meeting DAP prices have soared, touching recent spot price of US\$755. Comparing the recent run of rock phosphate (the unprocessed base element for DAP) with the current market favourite Iron Ore; it's not difficult to see where Incitec Pivots revenues have been coming from.



The obvious question becomes what has led to this run up, and is it sustainable?

Fertiliser is a fundamental ingredient for the agricultural sector. As soft commodities continue to outperform, more and more farmers will be looking to cash in on the opportunity

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## Agriculture and Incitec Pivot cont'd

(well deserved after many years of hardship). To increase crop output greater amounts of land must be cleared, treated and farmed, but to achieve genuine results mass quantities of fertiliser is needed.

The good news for the agricultural investor is that:

- demand for food is steadily growing (to the extent that reports in India suggest that internal demand will soon outweigh the existing production capacity).
- the price of oil is blowing out the costs of synthetic fabric substitutes (expect to see more cotton in store over the near term).
- the growing trend towards preference for ethanol as a substitute for crude.

We expect to see continued growth in the agriculture sector and its supporting industries.

For Incitec Pivot this translates to continued growth in demand for DAP (the companies key driver). As a market leader it makes Incitec a price setter. Until such time that a major competitor enters the local market (WES import their raw materials and will continue to struggle when competing with IPL in the wider fertiliser industry) we expect to see continued growth and increased profit margins.

All this coupled with a top notch management team bodes very well for the continued success of a company which has become an Australian favourite.



## Saferoads (SRH)

### Current Price \$2.90

Saferoads (SRH) has announced a pleasing half year result. The company reported a net profit after tax (NPAT) of \$2.95 million, which represents a 33 percent increase over the corresponding period last year. First half sales of \$28.1 million represent a 64 percent increase over last year's result.

Much of the increase in sales can be attributed to a nationwide rollout of sales offices and strong organic growth in all product divisions. Of particular note, the company's T Loc concrete temporary barrier, Ironman steel temporary barrier and traffic control equipment all performed ahead of expectations.

Demand for Saferoads' products is expected to remain strong in the foreseeable future as local and state governments increase spending on road safety and road infrastructure upgrades. The company has low gearing and a net cash position, so is well-placed to pursue acquisitions of complimentary businesses.

Saferoads' aim is to be a \$100 million revenue company by 2010, while maintaining the current net profit margin of 10 percent. If the company can continue the current rate of organic growth this goal is achievable. We remain positive on Saferoads and believe there is considerable medium term upside from current share price levels.

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