Leyland Lines

July 2008

MARKET UPDATE

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 July 2008 edition of Leyland Lines

Market update

The last month has continued the trend of disappointment on the market with the All Ordinaries Index reaching a two year low and the recently reliable resource sector taking a dive.

A number of industrial stocks have felt the hit more than most, highlighted by their share prices plummeting to 10-year lows following a tumultuous 12 months.

The financials have continued to struggle, although they bounced in the few days prior to the publication of this newsletter.

With so much concern regarding company earnings there will be plenty of interest in the upcoming company reports, where details for the year ending June 30 will be released and comments by the management regarding their respective outlooks will be announced.

In this edition of Leyland Lines we take a look at CSR Limited and the array of businesses the company is involved in.

We explore a number of companies that have been among the most severely hit in recent times and the opportunities that may have arisen as a result.

Following the recent merger with Zinifex we discuss Oxiana, now OZ Minerals, and cover several retail stocks that are showing promise on a medium to long term basis.

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MARKET UPDATE

CSR Limited (CSR)

Price $2.04 Market Cap $1,981m

CSR is the high profile conglomerate with operations in building products, aluminium, property and sugar. The success of CSR relies predominantly on a competitive cost structure, strong management and strong market position.

Divisional Breakdown

Sugar

The sugar division of CSR saw substantial setbacks where earnings were substantially reduced from an EBIT of $130.1m in FY07 to $71.1m in FY08. This was due to a major price drop of $54 per tonne for raw sugar and substantial rain, which consequently delayed harvesting the sugar cane and reduced crop yield. Improved results are expected looking forward based on upgrades which have been made to sugar mills and average expected weather conditions.

Property

The property division of CSR also returned a lower EBIT of $45.4m, down from $69.7m. Performance for this division in FY09 is expected to reduce further to between $35m to $40m.

Aluminium

Higher input costs and reduced sales volume saw earnings of the aluminium division reduce by 4% from FY07 to $136.7m. The outlook for this sector is expected to benefit through higher metal prices, although future earnings are expected to reduce as a consequence of increased carbon costs. Current FY09 EBIT is $122m.

Building Products

Building products was the standout division for CSR in FY08 with an earnings increase of 75% to $147.6m. This result was achieved through commercial market sales rather than residential and bolstered through the strategic acquisition of Viridian. CSR plans to implement upgrades within this division of the business, resulting in expected FY09 EBIT of up to $157m.

Divisional Breakdown

Performance

The most recent report for CSR for the year ending March 31, 2008 saw EPS drop to 20.9 cents from 27.0 cents the previous year.

Dividends for FY09 are expected to remain at 15cps, which still represents a yield in excess of 7.3% fully franked. Based on projected earnings, CSR is currently trading on 8.5 times earnings.

FY09 provides a substantial test for CSR with significant capital expenditure of approximately $400m planned for upgrades and plant commissions. This is going to impact heavily on the company's balance sheet as it is already highly leveraged, as a result of the debt financing used for the Viridian acquisition.

Interest coverage is currently at three times FY09 projected earnings. Expected negative free cash flow is likely to limit dividend growth in the near term. As a result CSR intends to focus heavily on debt reduction in FY10.

Management is conservatively optimistic for future prospects of CSR with EBIT growth forecasts of 5-10%. This growth is likely to come predominantly from the building products and sugar divisions.

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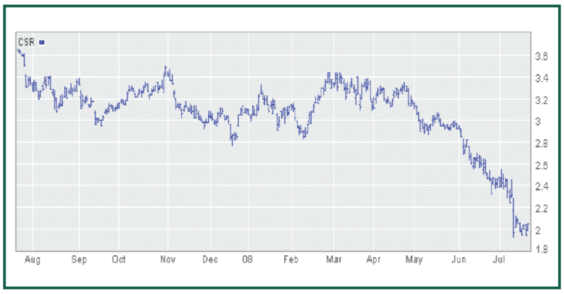
CSR Limited (CSR) cont'd

Potential upside gains remain for CSR in the long term with the possible upswing in property markets and rezoning of land, which is expected to provide opportunities for the property division. CSR management expects to grow through organic growth and acquisition to support future earnings.

The diverse array of businesses in which CSR are involved provide a smoothing of cash flows given their cyclical nature. In the current market, investors appear to have overreacted to short term issues, providing a genuine entrance for patient investors seeking strong yield and long term growth.

CSR	2007a	2008a	2009f	2010f
EPS (cps)	27.0	20.9	18.8	22.9
P/E (x)	7.6	9.8	10.9	8.9
DPS (cps)	15.0	15.0	15.0	16.0
Yield (%)	7.4	7.4	7.4	7.8
Franking	100.0	100.0	100.0	100.0



Oxiana (OXR)

Price $2.05 Market Cap $6,243m

Following the successful merger with Zinifex, Oxiana will be renamed OZ minerals. We are comfortable purchasing the stock at current levels. The resource sector has continued to suffer with the rest of the market as the flight to cash has seen almost every stock sold heavily inspite of sound fundamental valuations.

The stock has become a much more diversified resource company since the merger and the quarterly production report highlighted the stages of development of the many projects. Copper production from the Sepon fire cost around 2000 tonnes of copper production, but they have continued to get good exploration results there. Copper now represents 50% of revenue and places the company in the top 20 producers in the world. Sepon gold is only a small part, coming in around 90,000 ounces.

The gas crisis has slightly affected production at Golden Grove in WA, but zinc output has been good.

Prominent Hill in South Australia is going well with construction 72% complete and costs being on target. Exploration success continues and there appears to be the potential for a significant new deposit adjacent to the current mine.

The Martarbe gold project in Indonesia made a deal with the Indonesian partner recently, which is a positive. Construction of the mine has now commenced.

Century Zinc had record production for the full year.

The acquisition of Allegiance mining has now been completed with the first nickel concentrates produced in July and first sales in August.

The zinc price has come back substantially and this has been one of the main reasons for the falling share price and management have indicated that substantial improvement may take around 12 months.

The query for all resource stocks is the resilience of the Chinese economy. We still believe that growth will continue for many years and the supply constraints are actually increasing as a result of the world credit crisis as funding for major projects becomes even more difficult.

Costs have increased in most mining operations, with diesel and sulphuric acid the main culprits. The market will be focusing on how the $1 billion cash and equivalent debt finance will be used.

We believe that a lot of the negative news is now factored into the share price, and at the current price represents extremely good medium term value for those who do not have exposure.

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MARKET UPDATE

Higher rewards should reward the higher risk

In markets such as the one we are currently experiencing all stocks suffer. Smaller companies have suffered at a higher rate than the top 50 and anything related to finance, property or discretionary spending has been absolutely thrown out.

With the world deleveraging and consumers coming under pressure from interest rates, combined with fuel earnings of companies in these sectors, normal valuation metrics have been ignored.

In an environment of fear many companies have overshot the mark on the downside.

When rationality returns their shares will bounce significantly as fundamental valuations return.

In this article we focus on some of the companies that have been hit the hardest.

Each still face risks to their business, but we would argue that the risk is more than factored into the discounted price.

Allco Finance (AFG)

Share Price $0.54 Market Cap $200m

The next stock that has recently dramatically improved its risk return characteristics is Allco Finance.

Whilst we recognise it is still in the high risk category, it is priced on one times 2010 earnings.

After successfully selling a number of non core assets, Allco's syndicate of banks has agreed to a >$600m facility for a further 12 months. During this time Allco will further reduce the debts and retain its core shipping and aviation leasing business.

These are tough times for companies such as Allco, however, we note that with the banks agreeing to the 12 months rollover, the risk of it going under have been dramatically reduced. Yet the share price remains in the absolute doldrums.

Aumina (AWC)

Share Price $4.41 Market Cap $5084m

Alumina has tumbled to five year lows. It is now trading at below the replacement cost of its operations.

It wasn't long ago that it was considered a takeover target at almost twice these levels.

The aluminium price has been hit hard recently, but with the Chinese indicating they are about to reduce production due to the energy requirements we could see a turnaround fairly quickly.

FlexiGroup (FXL)

Share Price $0.44 Market Cap $99m

FlexiGroup Limited scores the trifecta of market concerns as it is relatively small and provides finance to consumers whom shop at places such as Harvey Norman.

The market has reacted by selling the stock down from almost $3 to $0.44. Essentially the market is pricing the company such that they believe it is going broke.

Simplistically, FlexiGroup arranges finance for people buying computers, plasmas etc.

When a finance deal is taken up, the loan goes on the books of three financiers - Esanda, Suncorp and CBA. The deal to the end customer is written at 25%, with the underlying financiers charging 10%.

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The difference, less a bad debt provision, is retained by FlexiGroup.

FlexiGroup's exposure is limited to the bad debt provision, which is 10%. Currently bad debts are traveling at less than 4%.

The risks within the FlexiGroup business are that people stop borrowing to buy such items. The next risk is that bad debts rise.

This will inevitably happen, however, there is a cap of 10%, after which FlexiGroup does not carry any exposure.

The financiers could refuse to continue to support the model and therefore FlexiGroup ceases to be able to provide new facilities.

However, when you look deeper into the business the following can be argued:

- History overseas has shown that as consumers feel the pinch they are more likely to finance such items.
- The financiers have just extended (12 month rolling) and increased the underlying facilities to cater for increased business following FlexiGroup's takeover of a company called Certegy. This is a ringing endorsement for the business in what are probably the worst banking times for decades.

FlexiGroup Limited is currently trading on just three times earnings and a dividend yield of 18%.

On these numbers and given the recent increased funding the risk /return equation looks to add up. The sector may remain out of favour but as time goes by rational pricing always returns.

Lend Lease (LLC)

Share Price $8.85 Market Cap $3,771m

The property slide has been well publicised. In many cases companies were highly geared and therefore weakening valuations have had a dramatic and sometimes fatal consequence.

However, amongst the property companies Lend Lease has an exceptionally strong balance sheet and a geographically diverse income stream. Yet it too is trading at five year lows.

The market has been concerned over Lend Lease's UK exposure. Even if this was written off entirely the company is arguably worth more than the $8.85 it is currently trading on.

Futuris, which owns 40% of AA Co (the largest beef property company in Australia) and one of the largest and most respected rural businesses in Elders, is now trading at 10 year lows.

After making some appalling decisions management has now been fired and we wait to see what the board does now. Should the board not restore the share price then it will inevitably be broken up.

There are many others which are also trading on dramatic discounts to rational valuations, but the above mentioned are some of the highlights. We appreciate that for normal valuation metrics to apply, sentiment needs to come back into balance and timing is impossible to predict. Within each company there are still risks with the business, however, the risk is priced into the discount.

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Retail Food Group (RFG)

Share Price $1.35 **Market Cap $133m**

During the month Retail Food Group (RFG) announced that, based on management accounts, the company's net profit after tax (NPAT) for FY2008 will exceed the previous financial year by at least 116%. This will translate into a minimum increase in earnings per share (EPS) of 75% and is well above the guidance given by management in February, which was for 50% EPS growth.

The result for the financial year was driven primarily by the acquisition of the Brumby's and Michele's Patisserie franchise systems and was also helped by steady growth in new store openings as well as same-store sales.

Although many people are talking about a significant downturn in consumer spending, we continue to be attracted to RFG due to the defensive nature of the business and its earnings. The company earns an ongoing royalty which is 6% p.a. of franchisee revenues, providing a relatively stable annuity-style income stream.

In tough times consumers are more likely to cut back their spending on big ticket items, such as a new plasma TV or laptop computer, but are less likely to defer spending on smaller daily treats such as coffees and donuts. RFG considers the positioning of their stores and products in terms of price points, with most transactions ranging in value of between $1 and $5. Historically, demand in this price point has proven to be relatively insulated from fluctuations in overall economic conditions and consumer sentiment.

Based on the unaudited results for the financial year RFG is trading on a historical PE ratio of 7.6x, which is far from demanding. The stock is also offering a fully franked dividend yield of 7.1%. We believe the market will, over time, begin to appreciate the strength and stability of the company's earnings and re-rate the stock. RFG remains a compelling medium to longer term investment opportunity.

	2007A	2008F	2009F
NPAT $million	7.5	16.3	21
EPS cents	10.5	18.4	21
DPS cents	6.3	10	13
PE ratio	13.3x	7.6	6.7x
Dividend Yield	4.5%	7.1%	9.3%

Source: Consensus estimates

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One of the biggest challenges for those people with Self-Managed Super Funds (SMSF) is finding the time to manage investments wisely to gain the best possible return on those investments. So, many of our clients choose Leyland Private Asset Management to manage the equities portion of their personal super fund. Most investors want to maintain overall control, but recognise that their time and market knowledge sometimes limits their investment returns.

Please contact Leyland Private asset Management if you would like to talk further about us managing you super fund equity investments.

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MARKET UPDATE

Retail stocks

The retail sector has taken a big hit over the past 12 months as loan faults, rising interest rates and inflation have taken their toll on consumer spending.

This has also resulted in a lack of confidence by investors towards the retail sector, which has contributed to a fierce decline in the share price.

Billabong (BBG)

Price $11.02 Market Cap $2,286m

Surfwear manufacturer and distributor Billabong has struggled over the past 12 months, falling from a high of $18.30 in June 2007 to below $10 recently.

As a brand Billabong is going from strength to strength. With brand awareness on the increase and recent positive acquisitions, profit margins continue to be strong despite the downturn in consumer spending.

While sales have slowed in many areas, some positives came out of BBG's June results including an increase in sales from US surfwear brand PacSun.

These positives could be attributed to several factors including increased promotional activity, benefits of the tax rebate cheque being paid and favourable weather in the USA.

Earlier this month BBG acquired well respected US longboard skate brand Sector 9. This is predicted to add $30 million to FY09e group sales.

This followed last months acquisition of Quiet Flight, a 13 store US retail chain.

BBG is also trading at a depressed PE ratio, which has a strong correlation with 12 month outlook for sales growth.

On the downside, a slowing US economy and high AUD/US are likely to continue into FY09, which will impact on the companies reported NPAT.

The US market is vital to the success of the Billabong brand and this is where the majority of risk lies for investors.

Despite the challenging economic conditions BBG appears cheap at its current price.

The brand has a history of success and continues to grow, not only via acquisitions but also through organic growth and global recognition.

On a medium to long-term outlook BBG does look attractive, though the share price is likely to remain volatile in the short-term.

BBG	2007	2008	2009	2010
EPS (cps)	80.7	84.4	93.7	108.2
P/E (x)	13.7	13.1	11.8	10.2
DPS (cps)	50.5	56.1	59.7	68.5
Yield (%)	4.6	5.1	5.4	6.2
Franking (%)	100	100	100	100

Harvey Norman (HVN)

Price $3.22 Market Cap $3,421m

Harvey Norman operates primarily as a franchiser, selling electrical products, homewares and computers.

After reaching a high of $7.25 last November the share price experienced a dramatic decline, reaching a recent low of less than $3 per share.

One thing that has worked in HVN's favour through the bad times has been the fact one-fifth of the companies earnings are accounted for by property assets.

This reduces earnings volatility and provides cheaper access to debt, which HVN has little of.

Competition from recent market entrant JB Hi-fi (JBH) has made HVN's quality management team, led by the highly respected Gerry Harvey, more aggressive in its approach. This is likely to have some impact on the company's margins.

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HVN has spread to other corners of the globe, including New Zealand where it is now the strongest retail business in the nation, and expansion is likely to continue from new formats.

Importantly, HVN is trading at a PE discount to its peers and may prove to be a great buying opportunity once the market climate turns around. HVN has a less risky earnings profile than many of its peers, which are more specialised retailers.

HVN	2007	2008	2009	2010
EPS (cps)	24.6	33.1	31.7	34.2
P/E (x)	13.1	9.7	10.2	9.4
DPS (cps)	11	14	14.5	16
Yield (%)	3.4	4.3	4.5	5
Franking (%)	100	100	100	100

David Jones (DJS)

Price $3.36 Market Cap $1,624m

The share price of Australia's leading upmarket retail store David Jones' has suffered through a difficult period over the past 12 months, recently plummeting to two year lows.

In the companies favour DJS target demographic is in the upper end of income earners, selling exclusive brands of clothing, accessories and homewares.

Generally speaking this demographic has felt less on an impact by the issues that have plagued the economy in the past year, though many of these people may have felt the effects of a downturn in the sharemarket and other investments.

DJS commands considerable purchasing power with it being the most important channel in Australia for the suppliers of some women's clothing brands and cosmetics, as well as other categories such as household appliances.

This also means that in some cases DJS can require suppliers to partially absorb cost increases, including landlords who view DJS as a valuable generator of pedestrian-traffic.

The reduction in costs will put DJS in a strong position to capitalise on any rebound in consumer spending.

A planned in store credit card could generate significant earnings growth after 2009, while the company is also broadening the customer base to 20 and 30 something's with its emphasis on private labels.

Competitor Myer has vacated DJS's market segments under the direction of new management.

Important factors for investors to consider in regards to DJS is that it offers a blend of moderate growth and an above average dividend yield of >7%.

The risk will probably continue in the short-term as the above mentioned issues are likely to contribute in these testing times, as inflation impacts consumer's earnings and therefore a decrease in demand.

DJS	2007	2008	2009	2010
EPS (cps)	22.7	27.7	28.5	31.4
P/E (x)	14.8	12.1	11.8	10.7
DPS (cps)	22	24.8	25.9	28
Yield (%)	6.5	7.4	7.7	8.3
Franking (%)	100	100	100	100

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Building wealth with focus

By buying a diverse position an investor can de-risk their portfolio. Specifically, if any given share represents only a fraction of the investors overall portfolio, then any company-specific negative information will not have a material affect on the overall position.

But is diversification for everyone and does it work to an investors benefit all the time?

"Diversification protects wealth, but concentration builds wealth."

Warren Buffet

While diversification negates the negative effects of a poor stock choice, it also limits the gains achieved on a well researched and carefully chosen business.

In response to the question of diversification Warren Buffet often asks "how many people do you know who got rich off their 7th best idea?"

Not many.

So what does it take to become the kind of investor who can create genuine wealth through stock picking, rather than the type that will get hurt chasing dreams?

The starting point is a realisation that it takes an extreme amount of commitment, both in terms of time and effort, to realise the potential opportunities available in the stock market. And, while people do not have the ability to know everything about everything all of the time, given the chance, investors can work hard enough to find just a few miss-priced opportunities and then take advantage of them.

It's really quite a simple concept - work hard, do the research, act with patience, and invest with conviction.

And still, for the vast majority of the investment world, people tend to believe that rather than waiting for a near cinch and loading up, they are better served by owning a highly diversified portfolio and trying to learn everything about everything all of the time. If this wasn't so impossible it would be a fantastic aspiration.

For your average self managed retail investor the answer is in fact diversification (or hiring someone to spend the necessary time finding those opportunities and following them up). But even for them, the dynamics of the current market has changed significantly enough over the last 12 months to warrant a re-think.

Managed funds aim to meet benchmark index returns, and so, own an extremely diversified position. That's fantastic for limiting your losses in a struggling market (and acceptable when the benchmark returns have been as high as 20% over the last five years) but now that most analysts agree that we are nearer the bottom of this correction than we have ever been, surely there is an opportunity to focus your portfolio to achieve the highest possible unhedged returns.

Now more than ever, as we approach the bottom of this bear market, investors should be rethinking their superannuation and investment portfolios. They should be concentrating on building their wealth rather than preserving it.

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