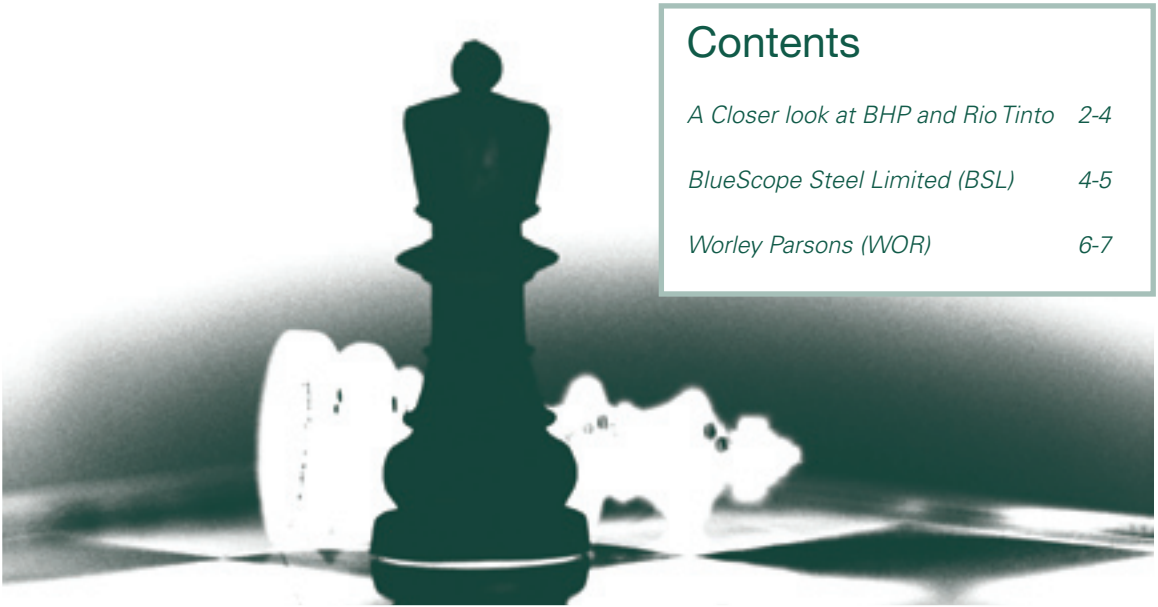


Leyland Lines is our monthly newsletter providing investors with our insights on the overall market, individual companies and other relevant issues. All the information contained in this newsletter is for general reading only and should not be taken as a personal recommendation. We encourage you to call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



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## Welcome to the July 2009 edition of Leyland Lines

It is extraordinary to see that the same publications which were forecasting doom and gloom when the market was at 3000 have now changed their tune entirely.

We believe that it is impossible to predict short term market movements, but investors should always be trying to identify companies which are for sale at a price which represents good value. A lower index, by definition, equates to generally lower prices. Even at current levels we believe there are still many opportunities for the sensible investor.

Company earnings have generally held up extremely well, and far better than the falling share prices had anticipated. In many cases, share prices have retreated to levels last seen 5 to 10 years ago. These are the type of opportunities which investors should relish.

Fear and investor temperament prevents this sensible attitude from prevailing in many cases and investors often feel more comfortable buying

“when things look clearer”, unfortunately the premium paid “when things look clearer” is the difference between a good investment and an average investment. One is always anchored by the price they pay. At Leyland we manage many accounts on a discretionary basis as clients realise they suffer the same problem of being afraid to buy at exactly the wrong time (often as a result of the aforementioned media). People should spend more time doing things that are important to them instead of watching or reading excitable newsreaders and columnists.

In this edition of Leyland Lines we look at the resource behemoths RIO and BHP and establish if recent market movements have altered the relative attractiveness of these businesses, we also examine Worley Parsons and look at BlueScope steel in light of the share price falling from \$14 to \$2.

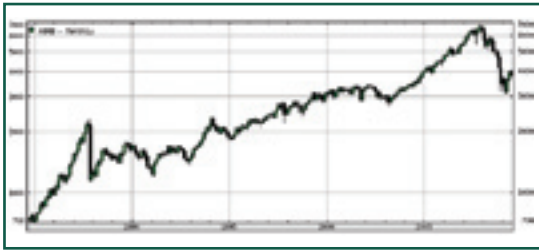
Please feel free to contact our Sydney or Melbourne office if you have any questions.

# Leyland Lines

## A Closer look at BHP and Rio Tinto

Over the past 25 years, any investor who put their money into an index fund would have seen approximately 8% p.a. growth – even after the crash in 1987 and 2007/8.

*S&P ASX 200*



More recently those returns have been dwarfed, with companies like BHP generating a return of 80% pa between 2005 and 2007 - flattened out by the recent correction, BHP has still returned an average of 20%pa from 2005 through to today.

*BHP Chart*



With 2008 well and truly behind us, it becomes incumbent on all investors to revisit their portfolio and reassess the businesses in which they are invested.

### Benefiting from a turnaround

Many analysts suggest that the resource sector has always provided the greatest leverage to an economic cycle. As consumption goes up resource company shares – by their very nature - often rise by several factors (and visa-versa). It is the nature of these companies that any marginal increase (or decrease) in the price of their underlying assets will result in a magnified change in their profitability. By way of example, RIO's share price reached a high of \$157 during the boom and, more recently fell as low as \$30

With the resource sector contributing to some 30% of the wider All Ordinaries Index, two of the key players in the index are BHP (20% of S&P20) and RIO (4% of S&P20).

For some time there has been an argument over which provided the most sensible investment. It is an argument that has led to a take over attempt (of RIO) by BHP and a partial takeover attempt by Chinalco.

But for all the volatility in both the BHP and RIO share price, the essential question, as always, is: Where to from here?

### BHP Billiton

BHP is the world's largest diversified resources group with a global portfolio of high quality assets. Core activities include the production and distribution of minerals, mineral products and petroleum.

In a recent move, BHP has signed a non binding joint venture agreement to combine their WA Iron Ore assets with RIO's. This move will ensure BHP has greater capacity to lift production, and shore up greater port access. For RIO the BHP offer comes at a time of capital desperation. As such, BHP have ended up with a 50:50 partnership in the venture, rather than the 45:55 deal they would have settled on had their original take over offer been accepted. However, the BHP offer coupled with a massive rights issue is a significantly better result for RIO shareholders than the Chinalco alternative...

Consensus on the deal is positive, with estimates of EPS growth increasing to the tune of 3-4% in 2010/2011. Synergies too will save both organisations many millions of dollars, with starting estimates suggesting an immediate saving of \$8 billion, with significant further upside conceivable as cost saving measures are incorporated.

There remains quite some time before a deal will be signed and binding, but given a positive outlook across the major metals and petroleum, the outlook for BHP continues to look bright.

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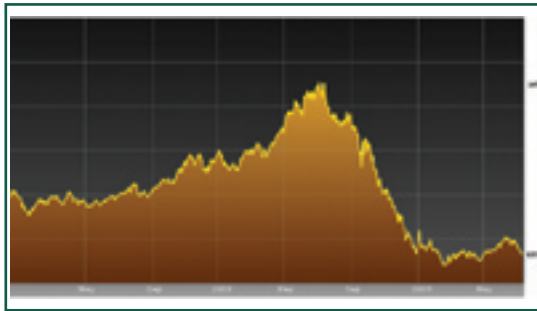
## A Closer look at BHP and Rio Tinto cont'd

Metal	Price change
Year to date	
LME Aluminium	2.9%
LME Copper	59.4%
LME Nickel	27.4%
LME Tin	16.4%
LME Zinc	26.6%
LME Steel	17.9%

Rio Tinto Daily Chart



### Oil Nymex Futures



Source Bloomberg

### Rio Tinto

Much like BHP, RIO is one of the worlds leading diversified miners. Focussing on tier one projects, they explore and produce a broad range of minerals and mineral products. The key difference between the focus of the two companies has been RIO's large exposure to Aluminium and BHP's to petroleum.

Since their arguably ill conceived take over defence – a top of the market takeover of Alumina - RIO have struggled with an uncomfortably high level of debt and a falling market for their commodities. After receiving a take over from BHP, RIO reached a high \$157. Subsequently the commodities market weakened and BHP pulled their bid, sending Rio to a low of \$30.

However, since their recent 1:1 rights issue and BHP Joint Venture, Rio has been able to bring their leverage from an uncomfortably high 170% (Net debt/equity) down to a more acceptable 20-40%.

### A Comparison

Both BHP and RIO will benefit from a recovery in the global market and with RIO's debt issues now passed, and debt/equity similar to BHP's, we would expect both firms to command very similar valuations.

When comparing Rio Tinto and BHP Billiton, one of the key indicators to stand out is the operating leverage advantage of Rio Tinto. In 2009 RIO's EBIT margins are at 19% compared to BHP at 31%. However, an improvement in the aluminum and iron ore markets would see RIO's EPS rise 40% (by 2011) and its margins increase to 27% - translating into significantly improved profitability. A comparative look at the company PE's also shows a disparity between BHP's and RIO's multiples, with UBS estimates showing BHP on 16.5x (CY2010) compared to RIO on 12x.

Similarly, BHP now trades at twice the price/book ration of RIO, without generating the same doubling for sustainable return on equity.

# Leyland Lines

## A Closer look at BHP and Rio Tinto cont'd

Based on RIO \$49.00, BHP \$32.50	RIO 2009	BHP 2009	RIO 2010	BHP 2010	RIO 2011	BHP 2011
Price Book	1.7x	3.7	1.6x	3.5	1.4x	3.2
Price Earnings (PE)	15.6x	15.8x	16.8x	20.6x	12.0x	14.0x
Earnings Growth		-40.40%	-6.80%	-23.30%	44%	47.20%
Net Debt to Equity	44.10%	11.3	26.20%	16	10	16.3
Dividend	1.10%	3.20%	2.40%	3.20%	2.50%	3.50%

Based on Credit Suisse numbers

### Recommendation

As is clear from the table above, in valuation terms, RIO offers the superior investment based current valuation measures. While BHP has been our preferred large cap miner for quite some time, recent events and the quick deterioration in the RIO share price has forced us to reconsider our preferences. Currently RIO seems to offer more short term upside to earnings (and its share price) than BHP, it is more geared to an improvement in global commodity prices, and all

things being equal, presents a relatively better value investment than BHP at present.

That being said, BHP's oil exposure could see it outperform RIO's growth profile in a bullish medium to long term oil environment. A popular method by which investors can obtain an oil exposure while holding RIO is to couple the RIO investment with one in Woodside petroleum.

At this stage we prefer RIO as our core large cap mining company.

## BlueScope Steel Limited (BSL)

BlueScope Steel is Australia's largest steel company. The company focuses on steel products including slab, hot rolled coil, and plate, as well as specialty steels such as metallic coated, and painted steel solutions.

BlueScope's main facility is its Port Kembla Steelworks in New South Wales, which has a capacity of 5.3Mtpa of raw steel and is the largest steel production facility in Australia. The company also owns and operates primary steelmaking facilities in North America and New Zealand, and has downstream operations in Asia.

BlueScope offers strong leverage to a global and domestic recovery which has recently been driving an increase in steel prices and an increase in volumes.

With a relatively high fixed cost base, the key to BlueScope's profitability is its margins. BlueScope's margins are primarily predicated on the price of steel, and input costs - in particular iron ore.

Over the past 18 months BlueScope's share price has fallen from highs of over \$12.50 to recent lows of \$2.00, and is currently trading at \$2.80 per share.

### BSL 24 month chart



The fall in share price is what makes this company so attractive over the medium term. The recent weakness as a result of the past twelve months is the result of short sightedness - and only takes into account the recent economic problems - it does not consider the long earnings history or rejuvenated balance sheet of the business. Earnings will always be volatile for a company like BlueScope (in the past 6 years eps

MARKET UPDATE

# Leyland Lines

## BlueScope Steel Limited (BSL) cont'd

has varied between 20cps and \$1.00 per share – average 60cps). Investors should be purchasing when the market is focused on short term problems (such as now), and selling when the market is experiencing short term boom times.

### Recent Events

In the past few months BlueScope has undertaken two significant decisions:

#### 1. Capital Raising

In June BlueScope raised just over \$1.4bn to strengthen their balance sheet. This places BlueScope in a strong position in these times of tight credit, and also removes perceptions of debt related issues. BlueScope have also managed to roll over a significant portion of their remaining debt.

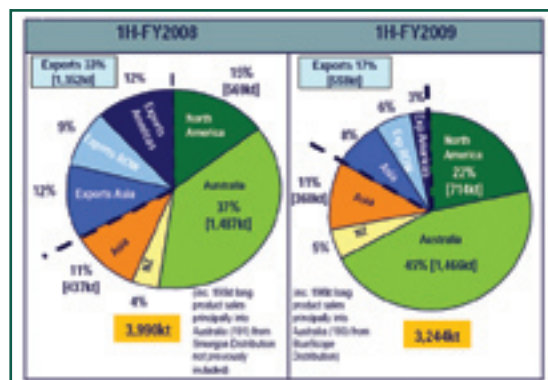
#### 2. Restart of Number 5 Blast Furnace

During the recent downturn BlueScope took the opportunity to refurbish their number 5 blast furnace, this significantly reduced output from the Port Kembla operations. BlueScope has now restarted this furnace in what is widely seen as an indication that steel prices are improving along with equity and commodity markets.

### Outlook

There is no doubt a risk that steel makers around the world may concurrently increase production and force steel prices down, but the same argument could be made for most commodities; the key mitigant of this risk is the relatively cheap share price at which Blue Scope steel is trading.

BlueScope's export profile has altered significantly in the past twelve months, highlighting growth in the USA and sustained local demand. Historically BlueScope has had a constantly shifting customer base, and this is likely to continue as different nations grow at different rates.



### Cost Cutting

A more detailed overview from BlueScope's half yearly report indicates significant cost cutting, which places them in a strong position for a pick up in prices and/or volumes. It is possible that they receive benefits from both with capacity now back online.

Given the historic earnings history (which is known to be volatile), potential upside, recent capital raising and extremely oversold share price, BlueScope looks attractive for growth investors with a medium term time frame.

### Consensus Estimates

BSL (\$2.90)	2007 A	2008 A	2009 F	2010 F	2011 F
EPS (c)	78.38	94.33	10.75	7.66	24.88
P/E (x)	3.72	3.12	37.63	56.29	12.44
DPS (c)	47.00	49.00	5.80	8.08	13.52
Yield	16.21%	16.90%	2.00%	2.79%	4.66%
Franking	100.00	100.00	100.00	100.00	100.00

# Leyland Lines

## Worley Parsons (WOR)

### Company Profile

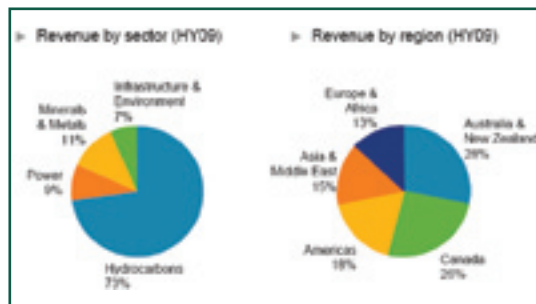
Worley Parsons Limited (WOR) provides professional services to the energy, resource and infrastructure industries. The company offers a range of services including feasibility studies, design, project services, upgrade services and maintenance services.

They are involved in the main services spanning an assets lifecycle, including identifying and designing project sites, construction management and maintenance. This allows for potentially strong earnings to be derived from winning low margin start-up contracts. For example, WOR should be in a strong position to gain construction and maintenance contracts on a project where it has been involved in the project design phase.

1. IDENTIFY >> 2. EVALUATE >> 3. DEFINE >> 4. EXECUTE >> 5. OPERATE

WOR also has a geographically diverse revenue stream revenue coming from Australia (28%), Canada (26%), the US (18%) and UK/Europe (11%).

Hydrocarbons (oil and gas) account for 73% of earnings, resulting in a high correlation between the price of oil and the WOR share price. The remaining divisions include Minerals & Metals, Power, Infrastructure & Environment.

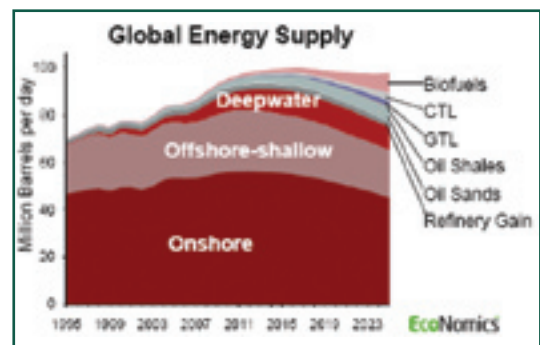
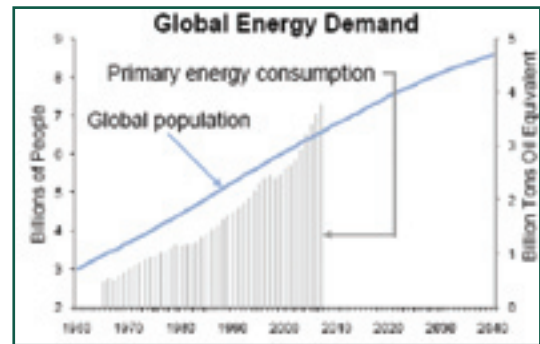


### Energy Trends

Energy projects are expected to be resilient given a 43% increase in the price of oil to above USD60/barrel.

The project value of the entire oil and gas market is valued at USD 450bn, with a similar amount required over the next 10 years for ongoing construction, upgrading and maintenance.

Whilst global demand for energy has reduced, the long term fundamentals are unchanged, with a shortage of supply. Most of the easily accessible oil fields have been discovered, resulting in companies having to access more difficult areas. WOR has specialised expertise and technology to access such areas.



### Guidance

Worley has forecast 15% growth in NPAT to \$A394m for FY09. Growth is expected to continue into 2010 and beyond, given recently awarded contracts, some of which are amongst the largest in Worley has undertaken.

# Leyland Lines

## Worley Parsons (WOR) cont'd

With gearing at approximately 40%, and with 80% of the drawn facility having duration of over 4 years, it is not anticipated that the balance sheet will hinder business growth.

### Contracts

WOR is involved with 3 key LNG projects (Exxon's PNG project, Woodside's Pluto development and Chevron's Wheatstone project) and is well positioned to pick up as much as A\$700m revenue from ongoing contracts from these projects.

Management has constantly won contracts of considerable size in pipelines, refining, ports/ infrastructure, minerals, offshore and onshore oil.

In 2009, WOR had a number of contracts cancelled. However, WOR have indicated "customers are beginning to talk about reinitiating some larger projects." There will be a lag before new projects come through, but sentiment around this is more positive now than 3-6 months ago.

To maintain revenues, Worley is required to be awarded about 30% of new contracts per year.

Recent contracts include;

**Nuclear:** WOR has won two in Egypt (USD 160m) and Armenia (USD 0.6m) adding roughly 5% to sales. Although not a significant impact on current revenues, potential revenues could be >US\$430m. This highlights the company's global opportunities and that it is still winning work.

**Iron Ore:** WOR has been appointed to do the feasibility study for the proposed Oakajee port and rail project in Midwest WA. Modest revenues are expected, but places WOR in a position to benefit from any improvement in the capital expenditure in the WA iron ore market.

### Margins

WOR notes that "strong pressure on margins is continuing so far." In the past year the AUD has appreciated 16% against the USD and 10% against the CAD and GBP. The impact of this will be a \$40m reduction in AUD earnings.

During the commodity price upswing, Worley were adept at identifying highly accretive acquisition targets, and subsequently adding headcount and capacity. The challenge now is to manage these resources to ensure costs are kept to a minimum to limit the effect of margin compression.

### Risks

- Prolonged weakness in oil prices
- Ongoing margin pressure
- Order book cancellation or deferral
- Timing delays on new projects
- Availability of credit for large scale project financing

There is no doubt that these risks are real, however, the potential upside from prevailing prices is also significant.

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