

# Cautious Upswing

## investment insight

### Hood Sweeney Securities Investment Committee

“

With the reporting season for the first half of the 2010/11 Financial Year now over, we thought it would be an ideal time to highlight the results and provide our views on a selection of our Core Domestic Equities portfolio.

#### Reporting season

Our views from 6 months ago have been validated in the recent results and we continue to have similar outlooks on our shares and key areas of the economy.

With the reporting season now complete, results have been subdued but in aggregate do not appear worse than the market was pricing. That is, despite the subdued tone to profit releases, share price reactions have on average been relatively neutral.

However, we believe that share markets remain fragile because profit momentum will need to accelerate and broaden from here to see sustained gains in the market.

#### Our approach

Each week Hood Sweeney Securities Investment Committee conducts an in-depth and rigorous analysis of investments within the Core Domestic Equities portfolio and of any other investments to be considered for future inclusion.

We base our shares selection on a value approach and focus on the long-term outlook and fundamental valuation of a company based on 10 desirable criteria:

- > management should own a material number of shares in the company
- > the company should not be capital intensive

- > the company should be producing an attractive level of 'free cash flow'
- > companies that are out of favour or subject to negative reporting
- > companies with an identifiable growth profile
- > management who have a track record of performance and integrity
- > companies which show empathy towards shareholders returns
- > generation of attractive returns on capital employed
- > low price earning ratios and free cash flow multiples that reflect undervaluation
- > an appraisal value standing at a significant premium to the current share price

#### Company analysis

Our analysis has been conducted on the following shares:

- > Amalgamated Holdings Limited (AHD)
- > BHP Billiton Limited (BHP)
- > Banking Sector Shares
- > CSL Limited (CSL)
- > Origin Energy Limited (ORG)
- > QBE Insurance Group Limited (QBE)
- > QR National Limited (QRN)
- > Telstra Corporation Limited (TLS)
- > Woolworths Limited (WOW)
- > Woodside Petroleum Limited (WPL)

#### ADELAIDE

11-16 South Terrace Adelaide SA 5000  
PO Box 10516 Adelaide BC, SA 5000  
t 1300 764 200 i +61 (08) 8203 8400  
www.hoodsweeney.com.au

#### WHYALLA

Suite 13, Level 1 City Plaza Building  
15-15a Darling Tce Whyalla SA 5600  
t 1300 764 200 i +61 (08) 8203 8400  
info@hoodsweeney.com.au

#### KADINA

6a Graves Street Kadina SA 5554  
Office hours are determined by  
pre arranged appointment  
t 1300 764 200 f (08) 8232 1968

## Amalgamated Holdings Limited (AHD)

We were not surprised at the company's recent result. However, the company did announce a profit downgrade slightly larger than what we expected.

The quality of films over the Christmas period and previous 3 months have not been as well received by the public as 12 months ago.

The previous period did incorporate Avatar which made a substantial impact. Their German cinema operations have also underperformed with December being their worst month on record. Profits have also been impacted by the floods and natural disasters that have affected Queensland.

Through this, the share price has remained resilient with a number of positives:

- > Their hotel business remains strong and activities from Thredbo Ski Resort should make more of an impact in the 2nd half due to the snow season.
- > AHD should maintain a 70% payout ratio with two dividend payments equating to \$0.37 over the next 12 months which equates to a yield of approximately 6% - 7% fully franked based on current prices.
- > The company continues to be run very conservatively with very low levels of debt and strong cash flows.

## BHP Billiton Limited (BHP)

The half year 2011 results for BHP were very strong and reflected in the share price which has increased 21.63% over the past six months to the end of February 2011.

They have achieved strong operating performance across their portfolio with attributable profit up 88% compared with the previous corresponding period.

We remain with our stance that BHP is a long-term stock for portfolios but we believe that such a significant and rapid increase in price has caused the stock to become overvalued with the following points to keep in mind:

- > Iron Ore prices are now approximately \$200 per tonne due to the huge increase in the supply of Iron Ore over the last 1 - 3 years. With the long-term average having been between \$55 and \$100 per tonne, this has meant that revenue has doubled.
- > We believe these prices as well as other commodity prices may come down significantly over the next 3 or so years as supply potentially exceeds demand.

- > Labour costs and other areas linked to the mining industry are at all time highs which we believe has caused many resource stocks to become overvalued.

## Banking Sector Stocks

Banks have been regarded as stand out blue chip stocks by investors for a long time. This has been a result of a number of factors:

- > Banks have benefited from the credit growth over the past 10 years.
- > Surreal excess returns over the last 15 years with large increases in bank fees.

We still believe it will be a tough environment for the banking sector in the short to medium term due to the continuation of the following risks and themes:

- > Provisioning for bad debts has been minimal for a long period of time which inflates profits over the years. This is not sustainable in the long-term.
- > House prices may not grow at previous high rates in the future which will hurt the profitability of major banks.
- > Banks have experienced low mortgage defaults and low non performing loans due to lower interest rates. This is not sustainable in the long-term as rates increase.

We believe that banking stocks continue to be a valuable part of a long term investment portfolio. However, these must be purchased at the right prices with a number of the major banks currently overvalued.

## CSL Limited (CSL)

The profit announcement by CSL contained no surprises with currency still a major headwind as overseas earnings are exposed to increases in the Australian Dollar.

Even with this headwind which represented a foreign exchange impact of \$47 million, sales were up 7% on the previous corresponding period and reported net profit after tax was \$500 million.

We continue to believe in the longevity of CSL as a standout company:

- > CSL is a very well managed company and is a good long-term stock for portfolios.
- > The cycle is turning and CSL is debt free with growth potential.

- > As the Australian Dollar settles at lower levels the earnings will eventually increase over the medium to long-term.

## Origin Energy Limited (ORG)

The half year results were consistent with our views with profit figures 14% lower than the first half 2010. This lower profit has resulted from the company going through a period of substantial capital investment to expand their production and capacity capabilities.

We believe that Origin Energy (ORG) is a great long-term company with reserves of gas and infrastructure which are almost impossible to replicate, meaning the value of these resources is significant.

The company has many new upcoming projects which will require capital expenditure but should provide long term sustainability and good returns on this invested capital.

Origin continues to be a core holding in portfolios due to its strong balance sheet with high levels of cash and sound management.

## QBE Insurance Group Limited (QBE)

QBE is a leading provider of general insurance and reinsurance services around the world and is one of the best managed and profitable companies in this industry.

Not much has changed over the past 6 months as the earnings for QBE are sourced overseas. The Australian Dollar has remained high over this period which has affected QBE's results significantly as expected.

The additional Quantitative Easing (the process of increasing money supply) in the United States is causing lower interest rates which leads to QBE receiving lower yields on their fixed interest investments. This also affects the companies profit and is part of the reason for the downgrade in the results released.

We remain cautious on QBE and will watch the company closely, although we remain upbeat in regards to their business operations due to the following positives:

- > QBE continues to be well run, with continued growth in the underlying business activity and conservative management.
- > QBE employs a conservative investment strategy, holding low risk fixed interest and cash investments.
- > QBE has a strong positive cash flow.

## QR National Limited (QRN)

Since listing in November 2010 the share price has increased 31.02% as at the end of February 2011.

The results released were extremely good but were only for a 3 month period. How the company performs over the next 3 - 5 years is important to driving share price growth.

Many of the scenarios and outcomes that we anticipated before the company listed have come to or are beginning to come to fruition:

- > New contracts are being signed which increases the customer base and reduces the company's relative cost base. This increases profit at the bottom line as the high cost of fixed infrastructure is already in place.
- > These new contracts are being written at commercial rates with Internal Rates of Return at 14% - 16%. These are replacing the same contracts which were producing 7% Internal Rates of Return in the initial prospectus.
- > QR National Limited plan to offer 1/3 of their workforce (approximately 3,500 employees) voluntary redundancies which should result in significant cost savings. However, there would be some upfront costs in year 1 for redundancy packages.

Overall, this is still a cyclical business and there will be some decreases in share price over time but we believe the first 3 months is a good indication of the future and maintain our view for it as a long-term core holding.

## Telstra Corporation Limited (TLS)

The half yearly results made by Telstra were in line with our expectations and confirm our views from 6 months earlier.

We expected that there would not be any surprises and worst case scenarios had been factored into the share price.

A summary of the results are as follows:

- > Fixed line revenue is still decreasing but this should already be reflected in the share price.
- > The company's intention to increase market share in the mobile phone market has come with increased costs for writing new business with the initial costs of customer attraction being expensive through new handsets. These initial expenses have been higher than expected due to the success of the strategy. This is a positive as it is only a short-term factor with long-term benefits, such as high customer retention.

- > Free cash flow is covering dividends which provides confidence in a reliable dividend income to investors

There are still many other positives which remain with Telstra including:

- > The NBN deal to buy Telstra's copper network for \$11 billion after tax is closer to finalisation and will remove a great deal of uncertainty from the share price.
- > \$0.28 annual fully franked dividend should continue over the next 2 years.

There has been a great deal of negative press and news surrounding the company over the last couple of years. However, these results appear to be the start of a positive era for the company.

## Woolworths Limited (WOW)

Woolworths continues to show signs of a maturing company and this was evident in their results as well as their recent purchase of Cellarmasters.

- > We believe the purchase of Cellarmasters was very expensive and displays their struggle to grow their current markets.
- > Competition in the grocery industry is increasing from Coles and Metcash.
- > Retail sales are decreasing and affecting K-Mart and Big W with lower consumer spending, higher internet sales and lower margins.

However, Woolworths is still a strong business which:

- > Has a very conservative balance sheet with just over \$2 billion in net debt
- > Has low gearing and strong cash flow.
- > There may be some synergies with Dan Murphy's and BWS businesses in the future as a result of the Cellarmasters purchase.
- > Retail sales have been impacted across many industries not just those that Woolworths operate in.

## Woodside Petroleum Limited (WPL)

Woodside Petroleum Limited (WPL) has operations encompassing the production of liquefied natural gas, domestic gas, condensate, crude oil and liquefied petroleum gas.

The half year results for the 2011 year reported that Woodside's profit was up 7% compared to the same period last year and operating cash flow increased by 42%.

The main reason for these increases were due to stronger commodity prices.

We still believe Woodside is suitable as a long-term core portfolio stock to gain oil and gas exposure and is a stand-out company for long term growth.

Woodside continues to be:

- > well managed with a strong balance sheet
- > owns large resources that other companies such as BHP would wish to own
- > it remains a takeover target as it would be very hard for a new company to access Woodside's resources.

**Hood Sweeney Securities Pty Ltd**  
**AFSL 220897**  
**t. 1300 764 200**  
**www.hoodsweeney.com.au**

### DISCLAIMER:

Information contained in this article is of a general nature only. It does not constitute financial or taxation advice. The information does not take into account your personal. We recommend that you obtain investment and taxation advice specific to your objectives, financial situation and specific needs before making any investment decisions or acting on any of the information contained in this article. The information in this document has been derived from sources we believed to be reliable and accurate. Subject to law, neither Hood Sweeney Securities ABN 40081 455 165, AFS License No. 220897, nor their directors, employees, agents or representatives gives any representation or warranty as to the reliability, accuracy or completeness of the information; or accepts any responsibility for any person acting, or refraining from acting, on the basis of the information contained in this article.