



Market Trading Newsletter

Issue 1 – Week ended 5
November 2010

Welcome to the inaugural edition of the CIPL Market Trading Newsletter.

The newsletter will cover the major recent economic & company news as well as any pertinent company recommendations. We will also include a hypothetical portfolio which will take its decisions directly from the newsletter.

The goal of the newsletter is to be a valuable source of information used for making investment decisions and with the help of the hypothetical portfolio to give a good starting point when constructing portfolios.

We hope you enjoy the newsletter and that you benefit greatly from it!

Regards

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Market Wrap

Australian Market

- The RBA unexpectedly raised the **cash rate 25 basis points to 4.75%** on Melbourne Cup Day. The rationale behind the decision was the abatement of concerns arising from a slowdown in China, the downturn in inflation was probably ending and that Australia was being hit in a “terms of trade shock” associated with the latest upturn in the mining sector.
- **CPI Numbers** released on October 6 further highlighted the underlying strength in the Australian economy. The number came in much better than expected with the average of the two measures rising by 0.5% in the quarter and 2.4% year on year.
- The 3rd quarter **PPI** came in much higher than expected. Final Commodities prices increased by 1.3% due to the strength of the continuing China boom.

Company News

- The most significant company news in recent weeks has been the announced proposed merger between the **ASX Ltd (ASX)** and **Singapore Exchange Ltd (SGX)**. The proposed tie up has met opposition here in Australia and a possible blocked path in the Senate. From the initial findings, it appears significant cost savings should stem from the creation of the fifth largest worldwide exchange.
- **Macquarie Group (MQG)** announced positive results on Friday the 29th of October, comprehensively beating market expectations as well as its own guidance. The 1H2011 net profit came in at \$403m, down 16% on the preceding period. MQG benefited from acquisitions as well as improving market conditions. We will take a more in depth look at MQG in the next newsletter.



- The finance theme dominated the week, with **ANZ Group Ltd (ANZ)** also reporting earnings. Similarly to MQG the FY2010 numbers came in ahead of market expectations at \$4.50b representing a 53% gain from the preceding period. CEO Mike Smith signalled his intentions for the bank to aggressively target the Asian markets with the desire within five years to generate at least one third of the banks revenues from that region.
- It has not been smooth sailing for engineering contractor **Macmahon Holdings (MAH)**. On the 19th of this month, the company issued a profit downgrade sending its share price over 20% lower on the news. The market appears to have lost faith in the company's management being the second profit downgrade in the space of six months. MAH is featured in more depth on pages 5-7.



Chart Outlook:

Our market is still nudging up against overhead resistance which has repelled price action on four separate occasions now. This is interesting as it also corresponds with the 61.8% retracement from the mid-April high to mid-May low. We favour a bust through, however cannot see the market taking off for its next major move higher until at least later in November.





Chart Outlook:

The Australian Dollar (AUD) has spent the last two weeks consolidating between the 96.5c – \$1.00 range. This is positive and the longer the currency stays within this range the stronger it looks. Any retracement should be corrective in nature and will most likely be contained by the down trending support line, shown above.

Company Recommendations

BUY: Cabcharge Australia Limited (CAB)



'Back to Business'

- (CAB) is enjoying concentrating on the operation of its business once again after settling its proceedings with the ACCC for alleged breaches of the *Trade Practices Act 1974*. It was claimed CAB (i) refused to allow 3rd party supplied EFTPOS terminals to process CAB's proprietary *Charge Cards* (ii) supplied taxi meters for free or below cost to taxi vendors and (iii) entered into an agreement with Townsville Taxis resulting in a substantial reduction in competition in the processing of non cash taxi fares.
- The settlement totalled **\$15m inclusive of costs**. This came in slightly above the better case scenario however importantly a far cry from the worst case scenario. The latter involved opening up the CAB *Charge Card* to 3rd parties which was estimated to cost the business 6% in its bottom line.
- We feel the negative sentiment surrounding CAB since the issue was first announced on the 26th of June last year is overdone and the result of the case is not representative of a 10% decline in the share price.



- Evidence of this was seen when the result of the proceedings with the ACCC was announced. CAB jumped over 10% on the news.

Earnings Outlook

- CAB has delivered an enviable record since the company was floated back in 1999. In fact the only year of negative EPS growth was 2010 with a 6% decline in earnings.
- This fall was attributed to the tough conditions during the Global Financial Crisis where demand for taxi services declined. This was the result of lower plane travel impacting the CAB bottom line most markedly in the corporate sector.
- The diversification strategy into the broader land passenger transport sector represents 22.2% of FY2010 company profits compared with 18.1% last year. Essentially this underlines that risk is now being shared amongst different components of the business.
- One troubling aspect of CAB's underlying earnings is the UK associate business, CityFleet UK. Particularly hard hit, its profit contribution plummeted 45% from \$3.3m to \$1.8m. The Icelandic volcano incident also affected the bottom line.
- The improving UK economy (economic growth of 1.1% in the 2nd qtr of calendar year 2010) and lead up to the 2012 Olympics should see a positive impact on the CAB bottom line.
- ComfortDelGro Cabcharge Pty Ltd (CDC) increased its profit contribution by 40% from \$7.8m to \$10.9m after the acquisition of Kefford buses in Melbourne in March last year. This is expected to continue to grow as a result of the additional buses under the NSW Government Bus Growth Program.
- Due to the strengthening local and global economy, CAB must be considered a candidate for future potential earnings upgrades.

Valuation

Earnings and Dividends Forecast (cents per share)				
	2010	2011	2012	2013
EPS	47.8	51.4	55.2	50.8
DPS	34.0	36.0	38.0	37.0

Source: Thomson Consensus Estimates

- At a current price of \$5.74 CAB trades at an undemanding **2011 PE of 11.16**. This is a 7% discount to the industrials sector and a significant 26% discount to the overall market. This is taking into account the legal costs attributed to the ACCC proceedings which will be brought to account in the FY2011 result.
- The **2011 EV/EBITDA multiple** is also undemanding at **9.4x**.
- CAB is trading with an estimated **2011 dividend yield** at an enticing **6.2% fully franked yield**.

Chart Outlook:

The price action on the ACCC result is shown below. The huge spike higher was a clear indication of the markets support for the result. The positive aspect since the news is the underlying strength exhibited by the stock. Notice the share price has consolidated around the midpoint of the large move up. Furthermore the volume has tapered off noticeably with the recent accumulation. These factors bode very well for higher prices in the future.





SELL: Macmahon Holdings (MAH)



'Second downgrade in six months'

- On the 19th of October, MAH released another profit downgrade to the market. The new outlook is for a breakeven result in the first half and second half profit of more than \$20m.
- **Construction business struggling:** The major reason for the downgrade lay in the reduction in profitability in the Construction business.
 - A Western Australian rail contract has been poorly executed.
 - A Lack of recent project wins.
 - Revenue of \$550m locked in for FY11. This is below the \$788m achieved in FY2010.
 - An independent analysis of the Construction business will be conducted by the end of the year.
- **Mining business performing strongly:** This segment of the business is performing strongly as expected. The underground operations have shown particular strength following full production at Roxby.
- Management however has once again failed to deliver on guidance and considering the variability in earnings in recent years, we feel it is prudent to sell MAH and look elsewhere in the sector (such as ANG, BKN, EHL, IDL, LEI, MND, SDM and UGL).

Earnings Outlook

- The forecast is for a **break even result for the six months to December 2010**. A **\$20m profit** is then forecast **for the second half of 2011**.
- This is a **42% decline in projected EPS** over the FY2010.
- The dividend payout will subsequently decline in line with the decline in earnings to 1.5c compared with 3c in FY10.

Valuation

- Despite trading on a reasonable **2011 EV/EBITDA of 5.4x** MAH will see a significant decline in EPS in FY11. The company is trading at a **17.5x PE ratio in FY11** and **8.6x FY12**.
- The **dividend yield** is forecast at **3.6% in FY11**.

Earnings and Dividends Forecast (cents per share)				
	2010	2011	2012	2013
EPS	4.9	2.8	5.7	7.0
DPS	3.0	1.5	3.1	4.0

Source: Thomson Consensus Estimates



Chart Outlook:

*Since declining over 84% in the GFC, MAH has been range bound between \$0.30 and \$0.89. Although this type of price activity is deemed as long term positive (as long as the price can stay within this range to build a base and **not** break below) there is no knowing how long this range will take to complete. This may be several years or less however when you also include the risk of a break to the downside the prudent strategy would be to move out of MAH.*

BUY: Retail Food Group (RFG)



'Bakers Delight'

- It was of little surprise when Retail Food Group (RFG) once again delivered another excellent profit report in August. The company has now achieved a five year NPAT and EPS cumulative average growth rates (CAGR) of **50.2% and 38.9%** respectively.
- Furthermore, the result was achieved in the face of a difficult retail environment. ABS Retail Sales data for the *Department Stores* segment saw a decline of -0.4% yoy (August 2010). To highlight the relative success of RFG, the company was able to deliver a 1.6% increase in weighted average weekly sales (AWS) amongst its franchise outlets.
- RFG has focused on continued store rollout and provided guidance to the market for a net opening of 15 stores in FY2011. This was worked out by the cumulative difference of 40-45 new openings and 30 closures. Although this remains below the normal rollout scenario of around 70 openings and 30 closures, the changed conditions in the availability of bank finance has affected the number of franchisees.
- Michel's Patisserie has now been predominately converted into the franchise royalty-based model, with the vast majority of stores expected to be converted by the end of FY11. This will be one of the contributing factors to the growth in the bottom line next year.
- One of the highlights of the FY10 result was the marked increase in **operating cash flow of \$29.2m, an increase of 25.9% over FY09**. Consequently the payout ratio also increased from 39% to 48%, and there is guidance for further increases in FY11. The low capital expenditure requirements for the firm mean that cash flow may be used for further acquisitions down the track or alternatively employing a payout ratio of +75%.
- Furthermore, the increased cash flow has given the company the opportunity to target a decrease in the gearing ratio from 45.7% to 34.4%.
- We recommend buying RFG as it is undervalued despite a buoyant outlook.

Earnings Outlook

- One factor which will have to be absorbed or passed onto consumers is the rising cost of raw materials such as milk and flour. The case is for RFG to push these increases through to the consumer.
- Currently, organic growth remains modest due to the current weak retail sales conditions. Although as mentioned, RFG must be commended on its AWS figures given such an environment.
- As RFG is leveraged to cyclical factors, (subdued new shopping centre development, shortage of financing for new franchisees and weaker retail sales figures) once the cycle does turn, RFG is very well placed to capitalise. Hence RFG must be considered as a candidate for future earnings revisions.
- Another area for growth is through acquisitions. RFG has a successful track record of integrating companies, such as with *Brumby's*, *Big Dad's Pies* and *DCM Coffee & Donuts*.



Valuation

- Consensus **EPS for FY11 is 27.7c** placing RFG on a very attractive **forward PE Ratio** of just **9x**. RFG is trading at a 51% discount to the overall market and a 29% discount to its sector.
- The **FY11 dividend yield** is also an enticing **5.6%**.
- RFG trades at a forward **EV/EBITDA** of just **6.1x**.

Earnings and Dividends Forecast (cents per share)				
	2010	2011	2012	2013
EPS	25.5	27.7	31.2	36.5
DPS	11.0	14.2	16.4	19.0

Source: Thomson Consensus Estimates



Chart Outlook:

The RFG chart (shown above) is exhibiting underlying strength from September last year to today. Notice the very shallow retracement (38.2% at its most severe) coupled with the long time taken trending sideways in a range between \$2.30 and \$3.00. This clearly illustrates holders are reluctant to sell out and are willing to wait out this period of consolidation. Once complete, I expect RFG to continue strongly to the upside.

CIPL Trading Newsletter Model Portfolio

In this edition of the CIPL Newsletter, we will initiate the *CIPL Newsletter Model Portfolio*. This hypothetical portfolio will be aligned with the recommendations in the newsletter when possible. We will start with a balance of \$20,000 and begin by risking 0.5% on each trade. Each new trade will be accompanied with a set *stop loss* which will indicate the signal to exit any given stock. This is enforced to reduce the risk involved, a crucial element when trading the markets.

We began the portfolio on the 1st of November, taking the closing price of the stocks involved on that day to take our entry price. We have initiated the portfolio with two new entries, **CAB** and **RFG** which are covered in more detail above.

<i>CIPL Newsletter Portfolio</i>			
<u>Stock</u>	<u>Entry</u>	<u>Quantity</u>	<u>Current Stop Loss</u>
CAB	\$5.77	270	\$5.40
RFG	\$2.50	384	\$2.24
Cash:	<u>\$17,482</u>		
			Starting Balance \$20,000
			Risk 0.5%

The content of the newsletter constitutes general advice and does not take into account your particular needs. Please seek appropriate advice before acting on anything contained herein.

