

## Alto Capital Newsletter (from the desk of the Wombat)

13<sup>th</sup> April 2010

### Economic / Market Commentary

A very positive couple of months for global equities, with most indices gaining over 10% during the period and trading at their highest levels for 18 months (back to levels before Lehman Bros went bust).

The Australian market (measured by the ASX200) is up almost 500 points (10.5%) since early February as global concern over European debt markets resides, and the risk trade increases in popularity. As mentioned previously the local market is being driven by external factors, particularly the belief that Australia provides a proxy for the fast growing Asian economies.

The resource sector is helping drive our market higher, with the new iron ore quarterly pricing mechanism combined with the expected 100% increase in the iron ore contract price pushing companies in the iron ore sector to 52 week highs.

Corporate action in the gold and coal sectors is also providing support for the resources sector with the ongoing bidding war for MacArthur Coal and Newcrest's attempt to take over Lihir Gold helping drive up share prices.

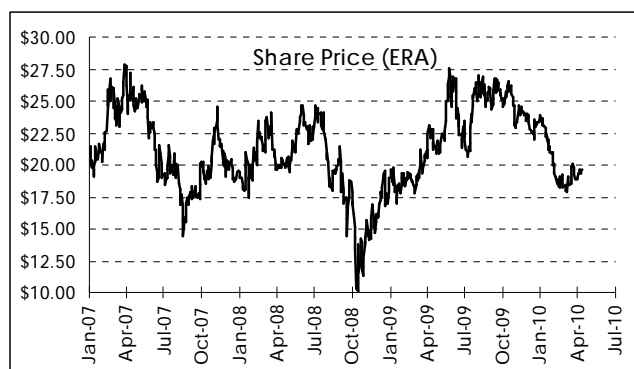
The announcement over the weekend that the EU has finally agreed to terms of a Greek bailout has significantly reduced the risk of a sovereign debt default (for the time being) to the global financial system; however speculators are likely to now shift their attention to Spain, Portugal and other large indebted counties.

Most eyes in Australia will be on China this week, with a number of significant economic reports to be released including 1<sup>st</sup> quarter GDP, inflation data, and a breakdown of exports and imports for the month of March (China reported its first trade deficit in four years in March).

Major economic events this week include the CPI, PPI and retail sales in the US, UK, and the EU, trade balances for the UK, EU, and the US, and the start of the 1<sup>st</sup> quarter earnings season for companies listed in the US.

We believe all the loose money currently flowing around the world is obscuring some fairly major economic issues, and continue to take a conservative approach to investing. While it is impossible to time markets, we believe a number of underlying global economic issues have the potential to result in an equity market correction within the next 8 months.

### Energy Resources (ERA) (\$19.69)



	2007(a)	2008(a)	2009(a)	2010(e)	2011(e)
NPAT (\$m)	76.1	119.0	272.6	245.0	300.0
EPS (¢)	39.9	62.4	142.9	128.4	157.3
DPS (¢)	20.0	28.0	39.0	48.0	55.0
Franking	100%	100%	100%	100%	100%

Energy Resources of Australia (ERA) is the world's fourth largest uranium producer via its Ranger mine in the NT. Operating since 1980, Ranger produces 12Mlb of U<sub>3</sub>O<sub>8</sub> a year. Mining was originally to cease in 2009 with stockpile processing until at least 2020. Successful exploration extensions of Ranger 3 and Ranger Deeps suggest a minimum four extra years mining. Longer term growth relies on further exploration success at Ranger and/or development of nearby Jabiluka, requiring traditional owner consent. Rio Tinto has a 68.4% interest in ERA.

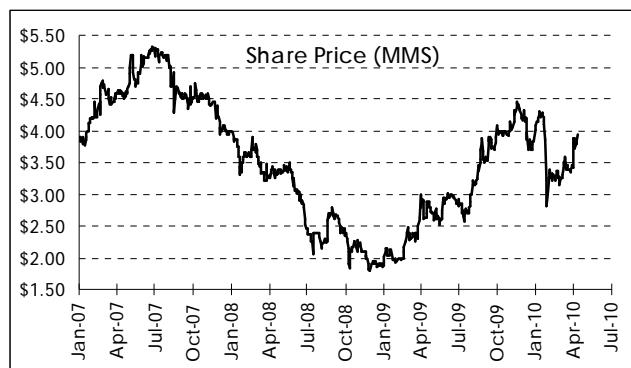
The Ranger mine is located in the Northern Territory about 250km east of Darwin. The ore is sourced from stockpiles and the Ranger No.3 mine and processed through the

Ranger mill to produce approximately 5,200-5,400t U<sub>3</sub>O<sub>8</sub> per annum. Reserves at Ranger including stockpiles as of December 2009 were 27.7mt @ 1,400ppm U<sub>3</sub>O<sub>8</sub> for 37,400t U<sub>3</sub>O<sub>8</sub>, with a total resources base of 155mt @ 940ppm U<sub>3</sub>O<sub>8</sub> for 145,500t U<sub>3</sub>O<sub>8</sub>.

The Jabiluka deposit is located 22 km north of the Ranger facilities, and began development in 1998. Following the completion of stage I development in 1999, the project was placed on care and maintenance to allow ERA to complete negotiations with the traditional land owners and the Northern Land Council (NLC). Reserves at Jabiluka as of December 2009 are 13.8mt @ 4,900ppm U<sub>3</sub>O<sub>8</sub> for 67,700t U<sub>3</sub>O<sub>8</sub>, with a total resources base of 29.2mt @ 4,800ppm U<sub>3</sub>O<sub>8</sub> for 140,000t U<sub>3</sub>O<sub>8</sub>.

The uranium oxide spot price has decreased significantly since mid 2007, falling from its peak of over US\$145/lb to current levels around US\$42/lb. However we believe the market for uranium oxide is likely to shift to a significant deficit in 2013 and prices are likely to return to +US\$80/lb within the next three years. The swing to a deficit in 2013 will be driven by a significant increase in the number of nuclear power plants coming online world wide from 2012 onwards and the end of the "Megatons to Megawatts" program in 2013, which currently supplying over 15% of global demand.

We believe ERA provides the safest, most financially secure (\$250m cash no debt) exposure to the growing uranium sector, having operated successfully for 30 years. While it may not appear cheap, trading on an earnings multiple of 15x, we believe earnings are likely to increase significantly over the next 5 years as uranium oxide prices increase to match demand.

**McMillan Shakespeare (MMS) (\$3.95)**

	2007(a)	2008(a)	2009(a)	2010(e)	2011(e)
NPAT (\$m)	13.2	17.4	20.6	25.7	33.5
EPS (¢)	19.7	25.7	30.4	38.0	49.5
DPS (¢)	12.5	16.5	19.0	21.5	25.0
Franking	100%	100%	100%	100%	100%

McMillan Shakespeare Limited (MMS) is Australia's largest provider of independent salary packaging services. The core business lies in the administration of salary packaging services and fleet management and other services such as performance management system design, remuneration and reward system design and a financial advisory referral service. The group operates two wholly owned subsidiaries: Maxxia Pty Ltd (fleet services), and RemServ Pty Limited (remuneration services).

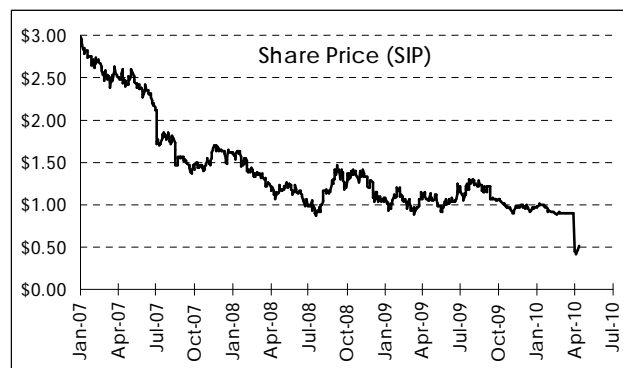
Since our initial recommendation last month MMS has made a company transforming \$208m acquisition (Interleasing (Australia) Limited) which has dramatically changed the earnings profile and financial position of the company.

Interleasing Group provides car leasing services for the SME, mid-corporate and large corporate sectors in Australia. It manages an Australia-wide car fleet comprising a multi-brand fleet provided through Interleasing and the Holden fleet provided through Holden Leasing.

The \$208m purchase price for Interleasing was at an 11.3% discount to net assets, so there will be no goodwill component added to McMillan's balance sheet. MMS also reported that that the acquisition would have been 45% earnings per share accretive on a pro forma basis for the 2009 calendar year.

We believe the acquisition will prove to be a large positive for the group, and have increased our forecast earnings per share for 2010 and 2011 by 12.8% and 31.0% respectively. However it must be noted the company has now gone into a net debt position to fund the purchase which does increase the financial risk profile.

With the share price around the \$3.90 level the group is trading on a PE ratio of under 8.0x 2011 eps, and a fully franked dividend yield of 6.4%, which we believe significantly undervalues this growing business.

**Sigma Pharmaceuticals (SIP) (\$0.52)**

	2008(a)	2009(a)	2010(a)	2011(e)	2012(e)
NPAT (\$m)	87.5	83.6	66.6	77.5	82.5
EPS (¢)	9.6	9.6	6.5	6.6	7.0
DPS (¢)	7.0	7.0	3.0	3.0	3.5
Franking	100%	100%	100%	100%	100%

Sigma Pharmaceuticals Limited (SIP) is a leading Australian manufacturer and marketer of prescription, over-the-counter and generic pharmaceutical products. SIP is also a leading full-line wholesaler and distributor to over 3,500 pharmacies throughout Australia under the brands Amcal and Guardian.

Sigma has turned out to be our worst invest call over the last 12 months, down 47% since our recommendation in October 2009, which is doubly disappointing as it is in our Income Portfolio, which is supposed to be lowest risk of our three portfolios.

For the full year ending Jan 2010 Sigma reported a net loss of \$389m, due to a \$424m goodwill impairment charge and \$32.7m in other one off charges. Underlying earnings came in at \$66.6m or 6.5¢ per share compared to \$83.6m or 9.6¢ per share last year.

The write downs resulted in the group breaching its banking covenants however the group's banks waived the covenant breaches and debt facilities remain in place until January 2011. As a result of the covenant breaches and write downs the group did not declare a final dividend.

Sigma management has lost a lot of credibility in the financial community, particularly considering it raised \$297m at \$1.02 per share back in September 2009. Management have a lot of work to do in order to regain the trust and confidence of the financial community.

We believe the current share price around 50¢ has factored in the potential downside and is worth holding or buying some more. However due to the increased business risk, and the significant decrease in forecast future dividends we have moved SIP to the Aggressive Portfolio and moved Challenger Infrastructure Fund (CIF) to the Income Portfolio.

**Changes to Portfolios****Iluka Resources (ILU)**

Removed from the aggressive portfolio due to significant share price appreciation since selection (+55%) reducing the attractiveness of this mineral sands producer.

**Energy Resources (ERA)**

Added to the aggressive portfolio to replace Iluka Resources, see previous page for summary.

Current PortfoliosIncome Portfolio

Company	Code	Dividend	Franking	Yield	Gross Yield	Industry	Index	Entry Date
Austereo Group	AEO	\$0.093	100%	5.2%	7.4%	Radio	ASX300	Aug 09
APA Group	APA	\$0.315	nil	8.7%	8.7%	Gas Pipelines	ASX200	Aug 09
Challenger Infra Fund	CIF	\$0.140	nil	9.3%	9.3%	Utility	ASX300	Sep 09
McMillan Shakespeare	MMS	\$0.215	100%	5.4%	7.8%	Commercial Services	All Ords	Mar 10
OBE Insurance	OBE	\$1.30	20%	6.0%	6.5%	Insurance	ASX20	Mar 09
TABCORP Holdings	TAH	\$0.60	100%	8.5%	12.2%	Casino & Gaming	ASX50	Mar 09
Telstra Corp	TLS	\$0.28	100%	9.0%	12.9%	Telecommunications	ASX20	Mar 09
Westfield Group	WDC	\$0.94	nil	7.7%	7.7%	Property Trusts	ASX20	Mar 09

Dividends are forward 12 month Alto Capital estimates

Growth Portfolio

Company	Code	2010		2011		Industry	Index	Entry Date
		EPS	PE Ratio	EPS	PE Ratio			
AGL Energy	AGK	\$0.95	16.0x	\$1.02	14.9x	Utility	ASX50	Sep 09
BHP Billiton	BHP	\$2.15	20.7x	\$2.80	15.9x	Diversified Resources	ASX20	Mar 09
Beach Petroleum	BPT	\$0.041	19.1x	\$0.06	12.8x	Oil & Gas	ASX200	Oct 09
Brambles Limited	BXB	\$0.432	16.8x	\$0.45	16.1x	Industrials	ASX20	Jul 09
Foster's Group	FGL	\$0.354	15.3x	\$0.39	13.9x	Brewer	ASX20	Jul 09
Healthscope Limited	HSP	\$0.337	13.4x	\$0.356	12.7x	Healthcare	ASX200	Apr 09
Metcash Limited	MTS	\$0.317	13.2x	\$0.343	12.2x	Retail	ASX100	Jul 09
Toll Holdings	TOL	\$0.344	21.7x	\$0.465	16.1x	Freight & Logistics	ASX50	Mar 09

EPS are a mixture of consensus forecasts and Alto Capital estimates

Aggressive Portfolio

Company	Code	2010		Debt / Mkt Cap	Price Decline	Industry	Index	Entry Date
		EPS	PE Ratio					
Aristocrat Leisure	ALL	\$0.215	21.4x	3%	-74.0%	Casino/Gaming	ASX100	Mar 09
Bluescope Steel	BSL	\$0.113	26.1x	14%	-76.7%	Steel	ASX50	Mar 09
ConnectEast Group	CEU	-\$0.027	-17.0x	58%	-75.8%	Toll Roads	ASX100	Jun 09
Centennial Coal	CEY	\$0.179	25.7x	14%	-28.1%	Resources (Coal)	ASX100	Jun 09
Elders Group	ELD	\$0.124	11.1x	6%	-50.4%	Rural Services	ASX200	Dec 09
Energy Resources	ERA	\$1.284	15.3x	-7%	-31.1%	Resources (Uranium)	ASX100	Apr 10
Resolute Mining	RSG	\$0.069	16.6x	21%	-54.2%	Resources (Gold)	ASX300	May 09
Sigma Pharmaceuticals	SIP	\$0.066	7.9x	50%	-82.1%	Healthcare	ASX200	Oct 09

EPS and Dividends are a mixture of consensus forecasts and Alto Capital estimates

**Income Portfolio:** This portfolio contains companies that generally have strong stable free cashflows which we forecast will enable the companies to maintain dividends even during periods of economic uncertainty. Companies selected are expected to provide an above market income stream over a three to five year period.

**Growth Portfolio:** This portfolio contains companies that are highly leveraged to the economic cycle, i.e. produce strong growth during good economic periods, and tend to suffer earnings declines during periods of economic contraction. Companies selected are expected to out perform the market over a three to five year period once economic growth resumes.

**Aggressive Portfolio:** This portfolio contains companies that have been heavily sold down due to either 1) company specific concerns, or 2) overall sector concerns. Market concerns may relate to large debt level compared to market capitalisation, debt refinancing concerns, deteriorating operating environment etc. Companies selected for the portfolio are expected to survive their current issues, and provide strong capital gains over a three to five year period.

The author of this report currently owns shares (personally or by related parties) in ALG, ATQ, CEU, DMG, NQM, PMX, QBE, TAH, TLS, and TBR.

Carey P. Smith  
Research Analyst

Phone: 08 9223 9838  
Mobile: 0400 216 502  
E-mail: [carey@altocapital.com.au](mailto:carey@altocapital.com.au)

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## Investment Managers

Stockley Davis  
Corporate Manager  
Phone: +618 9223 9835  
[stockley@altocapital.com.au](mailto:stockley@altocapital.com.au)

Adam Belton  
Director  
Phone: +618 9223 9818  
[adam@altocapital.com.au](mailto:adam@altocapital.com.au)

Craig Brown  
Director  
Phone: +618 9223 9828  
[craig@altocapital.com.au](mailto:craig@altocapital.com.au)

Shane Wee  
Director  
Phone: +618 9223 9868  
[shane@altocapital.com.au](mailto:shane@altocapital.com.au)

Brendan Fogarty  
Investment Manager  
Phone: +618 9223 9810  
[brendan@altocapital.com.au](mailto:brendan@altocapital.com.au)

Peter Hayes  
Investment Manager  
Phone: +618 9223 9836  
[peterh@altocapital.com.au](mailto:peterh@altocapital.com.au)

Alan Lawson  
Investment Manager  
Phone: +618 9223 9878  
[alan@altocapital.com.au](mailto:alan@altocapital.com.au)

Maciej Rosiewicz  
Investment Manager  
Phone: +618 9223 9830  
[maciej@altocapital.com.au](mailto:maciej@altocapital.com.au)

Brett Schreuders  
Investment Manager  
Phone: +618 9223 9825  
[brett@altocapital.com.au](mailto:brett@altocapital.com.au)

Cameron Bolton  
Investment Manager  
Phone: +618 9223 9832  
[cameron@altocapital.com.au](mailto:cameron@altocapital.com.au)

Chris McGrath  
Investment Manager  
Phone: +618 9223 9822  
[chris@altocapital.com.au](mailto:chris@altocapital.com.au)

Ian Leete  
Authorised Representative  
Phone: 0415 707 065  
[ian@altocapital.com.au](mailto:ian@altocapital.com.au)

Mathew Walker  
Director  
Phone: +618 6460 4960  
[mathew@cicerocorporate.com.au](mailto:mathew@cicerocorporate.com.au)

Russell Lynton-Brown  
Authorised Representative  
Phone: +618 6460 4960  
[ruslb@westnet.com.au](mailto:ruslb@westnet.com.au)

Nathan Barbarich  
Authorised Representative  
Phone: +618 9223 9848  
[nathan@altocapital.com.au](mailto:nathan@altocapital.com.au)

Paul Poli  
Authorised Representative  
Phone: +618 9223 9888  
[Paul.poli@matsa.com.au](mailto:Paul.poli@matsa.com.au)

James Robinson  
Authorised Representative  
Phone: +618 6460 4960  
[james@cicerocorporate.com.au](mailto:james@cicerocorporate.com.au)

Carey Smith  
Research Analyst  
Phone: +618 9223 9838  
[carey@altocapital.com.au](mailto:carey@altocapital.com.au)

Carrie Burns  
Office Manager  
Phone: +618 9223 9888  
[carrie@altocapital.com.au](mailto:carrie@altocapital.com.au)

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