UNDER THE SOUTHERN CROSS Print | + Font | - Font

Thursday September 9, 2010

By the Southern Cross Equities team as edited by Charlie Aitken

In this edition:

Charlie's morning thoughts; Leighton Holdings (LEI); a finger or two in every GROWTH pie, buy $38.00 target

Good morning,

"***Wise men don't need advice, fools won't take it***" - Benjamin Franklin.

Good to see the Australian dollar punching higher in ALL CURRENCIES again last night as investment capital flows back into our high structural growth, high interest rate, high dividend yield economy. The AUD is at 91.90usc, 72.21eur and 59.39p this morning, and I want to remind you that **our medium term price targets on AUD are 1.05usc, 80eur and 70p**. Our number 1 bet remains Australian resource stocks (particularly mid caps) in AUD, followed by Australian resource service companies in AUD. Today we again look at the biggest and most liquid play in resource services, **Leighton Holdings** (LEI).

As I have written previously, the historic lows for bond yields is providing a silver lining for corporates. The unprecedented demand by fixed interest investors has flowed through to corporate bond yields. This new dynamic has significantly lowered borrowing costs and opened corporate debt and capital markets which were previously closed following the global financial crisis. The result has been an explosion of M&A activity (note another $1b + bid this morning in **Avoca Resources** AVO). In addition, **I believe a combination of lower corporate funding costs, and the record company cash levels, will result in a significant increase in future cap-ex investment, particularly as management gets more convinced the worst is over.**

Last week the release of the June quarter ABS new private cap-ex figures revealed a fall of 0.8%. While the total cap-ex figure fell below consensus expectations, the recent trend has been soft for two major reasons. Firstly, cap-ex commitments are still suffering the residual effects of the dramatic fall in business confidence following the GFC, the effective closure of capital markets, and the fall-out from the global recession. Secondly, Australia has been additionally affected due to a confluence of negative issues: the Federal election uncertainty, the end of the business depreciation allowance, and the proposed RSPT. In the meantime however, I believe lower and more easily accessible corporate funding costs, a less penal MRRT, and the election resolution will alleviate the previous uncertainties. As a result, I expect this will ultimately support a return to the business investment boom conditions prior to the global financial meltdown.

The clear proof of my expectation of a surge in domestic cap-ex investment was highlighted by the second part of the new cap-ex figures, which is the ABS survey of future business intentions. **The survey revealed Estimate 3 for 2010-11 cap-ex commitments is currently at a record $123.3b, which is +24.3% higher than Estimate 3 for last year**. More importantly, the current Estimate 3 figure of $123.3b for 2010/11 represents a 17.5% upgrade on the Estimate 2 figure released just 3 months previously. In addition, it is important to note the timing of Estimate 3, which was calculated following the rejection of the RSPT and introduction of the revised MRRT. Obviously, this has lifted a cloud of uncertainty. As a result, I expect future cap-ex releases will be subsequently revised higher again.

It is worth noting, that despite a fall in the June quarter total cap-ex figure, a breakdown of the industry figures revealed that mining cap-ex actually rose 2.2% quarter on quarter (qoq) and 2.3% year on year (yoy). On our estimates, **the current 2010/11 private cap-ex intentions implies that nominal mining investment is expected to rise by over 50% in the upcoming year**. Incredibly, **mining investment currently comprises nearly 50% of private cap-ex investment intentions**. A prime example is BHP Billiton's recent decision to allocate a record $US15b for growth projects this year.

Consequently, once infrastructure spending accelerates, I would not be surprised if business investment over the next 2 years surges back to the 15%+ p.a growth levels pre the Lehman Bros meltdown. **I also believe that the mining services sector remains on the cusp of a major earnings upgrade cycle**. As a result, I continue to recommend the mining services sector as the bar linking resources and selected financials at either ends of our barbell strategy for domestic equities. Our preferred big cap leverage to an expected surge in mining cap-ex and business investment is **Leighton** (LEI) **which is both the world's largest contract miner and Australia's biggest builder of infrastructure/construction projects**.

The recent FY10 result revealed a record profit up 39% to $612m. In the context of the severe global economic slowdown, this represented a very impressive achievement. The result was even more impressive given the losses from Leighton Properties and the Middle East. The key to the strong result was once again the performance of the core divisions- infrastructure and mining-which recorded underlying growth of 21%. In addition, I believe the strength of FY10 result clearly demonstrates LEI's geographic and operational earnings diversity, which is the strength of the LEI business model.

However, the real driver of earnings growth is work in hand (WIH). In this regard, **WIH surged to a record $41.5b (up +18% on the previous corresponding period [pcp])**. Importantly this reversed 5 previous flat quarters. A breakdown of WIH growth revealed the strong pipeline of work from the overseas mining operations, with Indonesia up 132%, India up 90% and Mongolia up 26% respectively. The WIH split is now domestic/offshore 65%-35% compared to 75%-25% 2 years ago. Consequently, I believe offshore mining represents a new and genuine, long term, structural growth driver. I think **the record level of WIH adds a real <u>transparency</u> to the revenue outlook and represents a genuine inflection point for earnings**.

More importantly, LEI **has secured another $2.5b of work since June 30. Management confirmed the company was the preferred, or sole bidder on a further $9b of contracts, as well as targeting another $20b of work. At the Nov AGM, the company expects WIH to be $42.5b to $43b. I believe this could prove conservative**.

The ability of management to deliver a slight increase in the group EBIT margin to 5.5% was impressive given the soft global economy and the losses from Leighton Properties and the Middle East. In the meantime, LEI continues to have an enviably strong financial position. The FY10 operational cash flow doubled to $1.74b which enabled a repayment of over $250m in debt. Importantly, this was achieved in an environment where many other companies were desperate to raise capital. Consequently, the balance sheet is strong, with net debt to equity falling from 48% to 38% (including operating leases) over the last 12 months. This provides great financial flexibility for acquisitions or increased dividends.

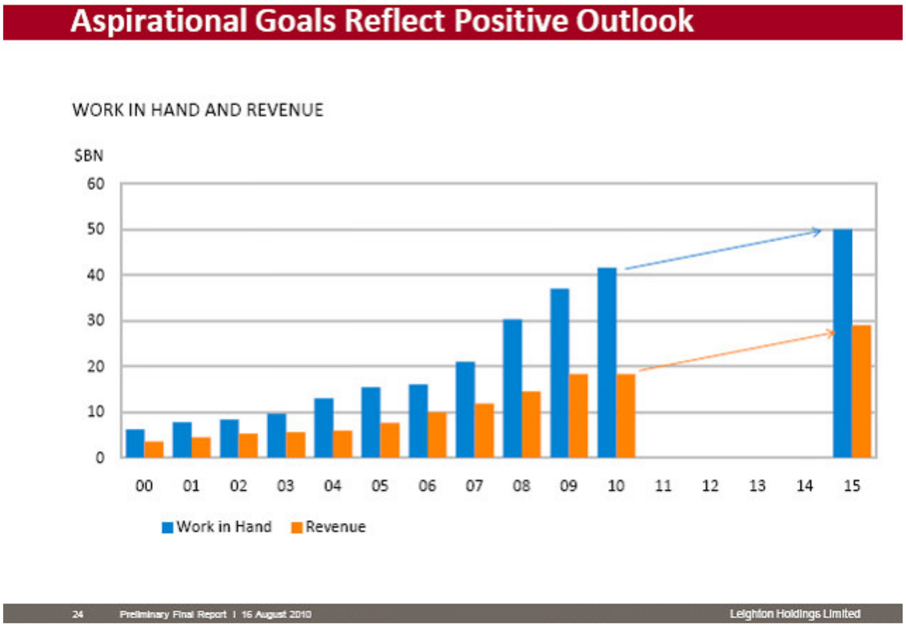
Yet once again, the market appeared disappointed with the lack of formal earnings guidance. However, **I believe a final dividend of 85c (55c pcp), which represented a payout ratio of 72% (56% pcp), clearly confirms management's positive outlook**. Management appears comfortable with consensus FY11 earnings of approx $675m, which implies 11-12% NPAT growth. As a result, I believe LEI is being deliberately conservative and appears intent on under-promising and over-delivering. The prime example was achieving the aggressive June 30 WIH target despite widespread scepticism. My strong view is that a record WIH figure, and a massive pipeline of domestic and offshore opportunities, have given LEI a real visibility and genuine earnings momentum which I believe will support further profit upgrades. In this context, I believe it is worth highlighting just some of the future project opportunities which LEI highlighted in the results presentation.

Currently, **Infrastructure Partnerships Australia estimates the backlog of infrastructure projects to be a massive $770b**. In the June report, IA also highlighted an updated priority list of road, rail, transport energy, freight and port projects of $80b. It is also worth remembering that the Gillard government has promised to allocate a significant part of the MRRT to crucial infrastructure projects. Importantly, **LEI is well placed to participate in the current long-term pipeline of State projects including: NSW's $62b in infrastructure projects over the next 4 years, the Victorian government's 10-year $38b transport plan, and the Qld government's $107b 20-year infrastructure plan**. LEI has also highlighted the huge power opportunities with electricity generation forecast to grow at 23% annually from 2011.

In the private sector however, **the pipeline of resource projects is massive, with $17b of iron-ore projects currently committed, with another $26b in the planning stage. An additional $5b of coal projects are committed, with another $25b in the pipeline. More importantly, there is $68b in LNG projects committed, or under construction, with another $111b in the planning stage**. As Australia's largest contract miner, LEI is perfectly positioned. However, the overseas infrastructure opportunities are bigger, with the Indian government earmarking $20b of infrastructure projects for just next year. Meanwhile, the pipeline of HK government funded infrastructure projects over the next 5 years is up 50% to $45b. In the Middle East, LEI reports that $1.9trillion in projects are expected to be awarded to the Gulf co-operative from 2010-14, with 85% located in Saudi Arabia, the UAE and Kuwait with 75% representing infrastructure. Clearly the infrastructure and mining opportunities for LEI are both massive, global, and long-term.

In the current "glass half empty" environment, it would be very easy to gloss over the recent FY 10 result given all the financial metrics either met, or slightly exceeded, both the company guidance and consensus forecasts. However, I believe that would be a major, major mistake. **<u>It is worth noting that after a near systemic meltdown of the global financial system, and the worst world recession in over 80 years, LEI achieved a record profit up 39%, a record WIH figure up 18%, and a 2H dividend up by over 50%</u>**.That is an amazing achievement for company leveraged to economic growth. Once again, I believe this demonstrates the diversity and the strength of the LEI model which is the very reason why LEI should attract a significant P/E premium.

I believe this achievement not only provides the highest endorsement of senior management, but also highlights the leading global and domestic positions in both contract mining and infrastructure. Importantly, this feat was achieved despite falling US non-farm payrolls, weakening ISM supply figures and the soft Philly-Fed survey data! Clearly, LEI is leveraged to the strong, structural economic growth of the developing economies through a multi-decade industrialisation cycle. **LEI provides the ultimate exposure to the strong growth of the new world economies with virtually none of the earnings drag from the stagnant OECD bloc. Yet at the most attractive point in the cycle, LEI is trading a 10% P/E discount to the 5 year average**.

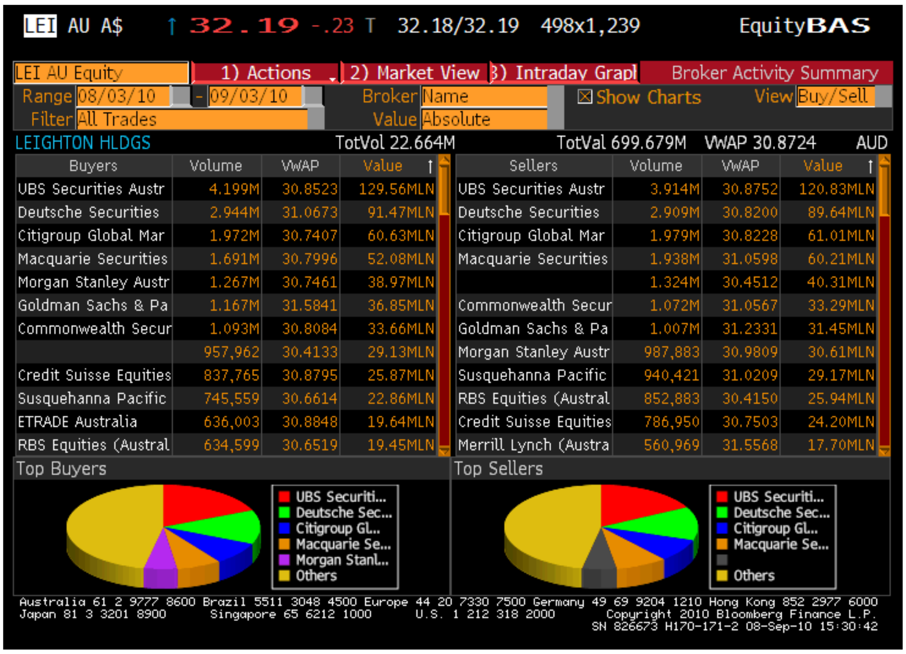


The chart above represents management's aspirational 5-year sales revenue, WIH and earnings targets of $29b, $50b, and $900m respectively. This implies an impressive 8% CAGR over the next 5 years. I have included this chart in previous reports, only to receive comments like "Wal's dreaming." Yet at the recent result, management revealed that it believes these targets can be achieved just through organic growth. This is a major new positive. However, given the strong track-record of earnings growth, the record WIH pipeline, and the domestic and global opportunities in both mining and infrastructure, I believe the targets could be conservative. As a result, **I believe a 10% CAGR over the next 5 years is more likely**, making LEI **a genuine structural GROWTH stock**.

In the meantime, FY11 consensus EPS is $2.35, representing a P/E of 13.8x or a 15% premium to the broad market multiple. As a result, LEI is trading at a 10% discount to the 5-year average of a 25% premium, and basically in line with the long term average of a 15% P/E premium. Consequently, I believe LEI is risk-adjusted for a write-down in the carrying value of the Al Habtoor operation, and the current CEO succession uncertainty. However, my belief is that management are being deliberately conservative, and based on the strong WIH pipeline, I expect 10% upgrades in consensus earnings over the next 12 months. Therefore, I believe the real FY 11 P/E is closer to 12.5x, which implies **a $38.00 target** based on a long term PE of 15x. As I have mentioned previously I urge investors to reject the current negativity and as the question "**what could go right**?" Under this scenario LEI could easily closer to $40.00.

LEI should be a core portfolio holding for anyone who believes in the "new world". Buy.

The table below shows the top traders in LEI shares in the last month. I find it very interesting that the top 4 buyers are also the top 4 sellers, with volumes almost identical. **This is telling me it would only take one solid institutional buy order to move this LEI market sharply**.


LEI AU A$ ↑ 32.19 -.23 T 32.18/32.19 498x1,239 EquityBAS

LEI AU Equity | 1) Actions | 2) Market View | 3) Intraday Graph | Broker Activity Summary

Range 08/03/10 - 09/03/10 Broker Name ☒ Show Charts View Buy/Sell

Filter All Trades Value Absolute

LEIGHTON HLDGS TotVol 22.664M TotVal 699.679M VWAP 30.8724 AUD

Buyers	Volume	VWAP	Value	Sellers	Volume	VWAP	Value
UBS Securities Austr	4.199M	30.8523	129.56MLN	UBS Securities Austr	3.914M	30.8752	120.83MLN
Deutsche Securities	2.944M	31.0673	91.47MLN	Deutsche Securities	2.909M	30.8200	89.64MLN
Citigroup Global Mar	1.972M	30.7407	60.63MLN	Citigroup Global Mar	1.979M	30.8228	61.01MLN
Macquarie Securities	1.691M	30.7996	52.08MLN	Macquarie Securities	1.938M	31.0598	60.21MLN
Morgan Stanley Austr	1.267M	30.7461	38.97MLN		1.324M	30.4512	40.31MLN
Goldman Sachs & Pa	1.167M	31.5841	36.85MLN	Commonwealth Secur	1.072M	31.0567	33.29MLN
Commonwealth Secur	1.093M	30.8084	33.66MLN	Goldman Sachs & Pa	1.007M	31.2331	31.45MLN
	957,962	30.4133	29.13MLN	Morgan Stanley Austr	987,883	30.9809	30.61MLN
Credit Suisse Equities	837,765	30.8795	25.87MLN	Susquehanna Pacific	940,421	31.0209	29.17MLN
Susquehanna Pacific	745,559	30.6614	22.86MLN	RBS Equities (Austral	852,883	30.4150	25.94MLN
ETRADE Australia	636,003	30.8848	19.64MLN	Credit Suisse Equities	786,950	30.7503	24.20MLN
RBS Equities (Austral	634,599	30.6519	19.45MLN	Merrill Lynch (Austra	560,969	31.5568	17.70MLN

Go Australia.

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