

# Research Bulletin

Australian Equities: Portfolio Strategy Review

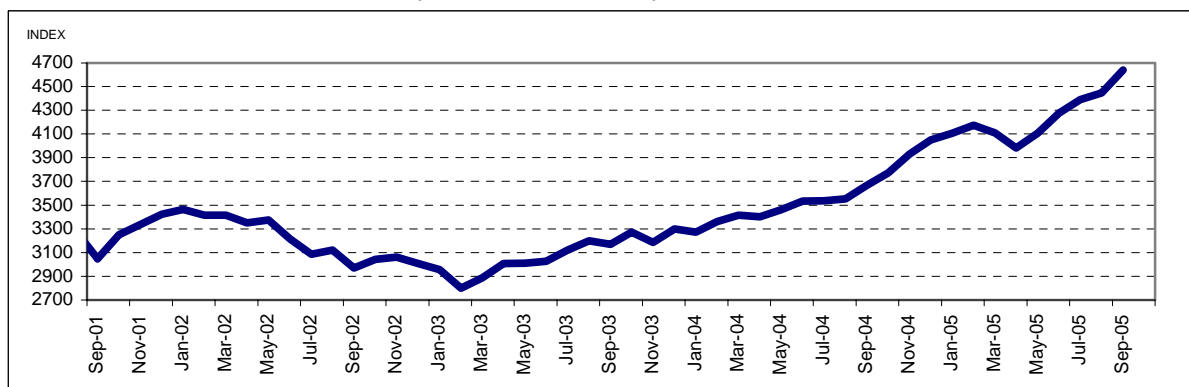
30 Sept 2005

- The Australian equity market has once again recorded a month of solid gains; with the benchmark **S&P/ASX200 rising 5.1% over September** and ending the month at new record highs. The absence of significant earnings downgrades during the August reporting season, continuing strength of commodity prices, combined with positive economic data, boosted the market's confidence.
- During September, the market's focus was on earnings leverage – **the Materials sector was the standout performer (+6.3%)**, mainly driven by resources (due to higher commodity price expectations) and building/construction companies (due to supportive infrastructure and housing data). The Healthcare and Energy sectors also outperformed the market whilst the Telecommunications, REITs and Information Technology sectors disappointed.
- On the economic front, Australia's Gross Domestic Product (GDP) increased by 1.3% during the second quarter of the year, which was well above consensus forecasts of +0.6%. Employment data was strong for the 12<sup>th</sup> consecutive month whilst the August housing credit data retreated marginally. The 10-year bond yield trended higher, finishing the month at 5.36% and the \$AU/\$US closed at 0.7624 cents.

Accumulation Index Performance			
	1 Month	6 Month	12 Month
S&P/ASX 200	5.1%	15.4%	32.1%
S&P/ASX 200 Industrials	3.7%	12.6%	26.7%
S&P/ASX 200 Resources	10.7%	28.0%	57.8%
S&P/ASX Small Ordinaries	4.2%	15.8%	30.0%
Relative Index Performance to S&P/ASX 200			
Consumer Discretionary	-3.7%	-11.9%	-21.9%
Consumer Staples	-2.2%	-6.5%	-6.8%
Energy	2.7%	22.0%	43.3%
Financials	-0.4%	0.4%	-1.4%
Health Care	0.9%	9.8%	11.3%
Industrials	-3.5%	-6.2%	-3.4%
Information Technology	-4.9%	-0.2%	8.2%
Materials	6.3%	10.0%	16.8%
REITs	-5.1%	-6.6%	-15.6%
Telecommunications	-12.8%	-28.8%	-34.9%
Utilities	0.6%	0.7%	0.6%

Source: GSJBW Research, IRESS

## Australian Equity Market Performance: S&P/ASX 200 Index (September 2001 – September 2005)



Source: IRESS

## Company Performance: Best and worst performing stocks

In September, the best and worst performing stocks (absolute share price returns) in the ASX 100 were as follows:

Best	% Change	Worst	% Change
Lihir Gold	44.4%	Telstra	-13.0%
Newcrest Mining	23.5%	Multiplex	-9.2%
Oxiana	20.7%	Coca-Cola Amatil	-8.5%
Macquarie Bank	19.4%	Cochlear	-6.6%
OneSteel	19.1%	Macquarie Communications Infrastructure	-5.7%
Caltex Australia	18.6%	Aristocrat Leisure	-5.4%
Rio Tinto	17.6%	Leighton Holdings	-4.3%
Zinifex	17.0%	Westfield	-3.6%
CSR	15.7%	PaperlinX	-2.8%
Rinker	15.4%	Telecom Corporation of New Zealand	-2.3%

Source: IRESS

## Significant Company/Economic News

### Lihir Gold (LHG)

Analyst: Ian Preston

- Investment View: Short Term Outperform; Long Term Buy
- Share Price as at 30/09/2005 \$1.92 Valuation: \$1.15

### Newcrest Mining (NCM)

- Investment View: Short Term Marketperform; Long Term Buy
- Share Price as at 30/09/2005 \$20.98 Valuation: \$9.33

Lihir Gold (+44%) and Newcrest Mining (+24%) traded to fresh record highs in September as the gold price hit an 18-year high of US\$479/oz. Much of the positive sentiment towards gold was driven by increased investor demand for a hedge against higher inflation concerns associated with high energy prices. Further, Goldfields Mineral Services noted a resurgence in physical gold demand at a time when global gold production is stagnant. However, the gold price retreated from its high, ending the month at US\$472/oz, on market expectations that US interest rates will continue to trend upwards, thus slowing the pace of inflation and boosting the value of the dollar.

### Macquarie Bank (MBL)

Analyst: James Freeman

- Investment View: Short Term Outperform; Long Term Buy
- Share Price as at 30/09/05: \$75.35 Valuation: \$62.60

Macquarie Bank reached all time highs in September, breaking through the \$75 barrier, as management stated it expects full year 2006 earnings will at least match the full year 2005 result, driven by solid fee income in buoyant equity markets, asset sales and specialist fund initiatives. Over the past year, the share price of Australia's largest investment bank has risen by 107%. It is now the 9<sup>th</sup> biggest company by market capitalisation in the S&P/ASX300.

### Telstra (TLS)

Analyst: Christian Guerra

- Investment View: Short Term Marketperform; Long Term Hold
- Share Price as at 30/09/05: \$4.07 Valuation: \$4.97

Telstra recently revised fiscal 2006 guidance, with management indicating that revenue slowdown, increased operating costs and an unsupportive regulatory environment would cause earnings to decline by 7-10% on the previous corresponding period. In a recent document released to the government, Telstra detailed the various well-known challenges it currently faces such as product migration, increasing capital expenditure requirements and declining free cash flows. The increasingly negative medium term outlook for Telstra, combined with the stock trading ex-dividend, saw the stock fall in 13% during the month. The CEO's strategic review is due to be released around mid-November.

**Coca-Cola Amatil (CCL)**

**Analyst: Paul Ryan**

- **Investment View: Short Term Outperform; Long Term Buy**
- **Share Price as at 30/09/05: \$7.91      Valuation: \$9.00**

Coca-Cola Amatil reported a first half result in August that was largely in line with the market's (and our) expectations, alleviating fears of margin compression due to soft consumer markets and rising input prices, as slowing organic earnings momentum was offset by acquisition-led growth (SPC). However, the stock fell through September as the market re-based its earnings expectations for the fiscal 2005 result to be more in line with company guidance and with persisting negative economic data out of the company's offshore markets, Indonesia and South Korea.

**Woolworths (WOW)**

**Analyst: Phillip Kimber**

- **Investment View: Short Term Outperform; Long Term Buy**
- **Share Price as at 30/09/2005 \$16.63      Valuation: \$17.50**

**Metcash Trading (MTS)**

- **Investment View: Short Term Outperform; Long Term Buy**
- **Share Price as at 30/09/2005 \$4.20      Valuation: \$4.40**

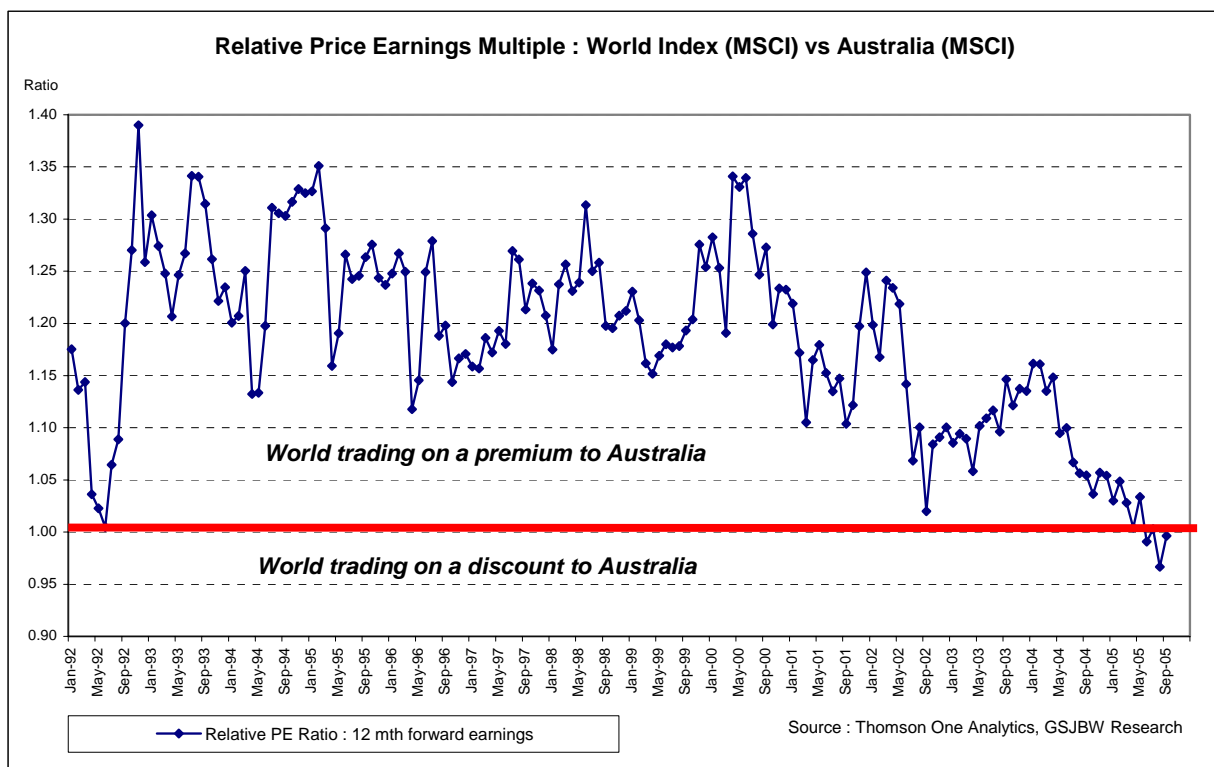
**Foodland Associated (FOA)**

- **Investment View: Short Term Marketperform; Long Term Hold**
- **Share Price as at 30/09/2005 \$27.30      Valuation: \$19.24**

Metcash had a solid end to the month as the Federal Court approved a date for the shareholders of Foodland Associated to vote on the two Schemes of Arrangement that will seek approval for the break-up of the Foodland group between Metcash and Woolworths. Meanwhile, Foodland's profit result was in line with market expectations, with no major deterioration in key markets in the face of a soft consumer spending environment.

**Relative Value: Australian Equity Market versus Global Equities (as at 30/09/2005)**

The Australian equity market continued to trade at a valuation premium to the global market in September.



## Australian Equities: Key Issues for Portfolio Strategy

- The outlook for global markets into early 2006 is still relatively bright. Fears of imminent economic weakness continue to be dispelled by a reality of solid economic growth – more-so in Asia and the US – and strong corporate performance. After easing over the past year, global economic momentum looks set to accelerate into 2006. While this environment will ensure that the uptrend in global interest rates continues, we still believe that it will be mid-2006 before rising rates pose a material threat to corporate performance. As has been the case over the past two years, the rising oil price will continue, from time to time, to unsettle markets and economies. At levels in excess of US\$60 per barrel, the risk of a material drag on consumer spending is obviously increasing. If this risk was to materialize more forcibly over coming months, we believe it would be accompanied by lower long term interest rates and, ultimately, weaker demand for oil/refined products. We therefore suspect that any oil-related correction in global markets would be relatively short-lived.
- The US Federal Reserve will ultimately determine the duration of the current global business cycle. Goldman Sachs Research believes that the Federal Funds rate will continue to rise into 2006, peaking around the 5.00% level (currently 3.75%). To date, the Fed's ability to contain rising inflation risks (and an increasingly speculative US property market) has been curtailed by the resilience of long term bond prices. The Fed will become a far more potent risk for global markets if its "measured" increases in short term rates are ever accompanied by higher long term rates. In our view, the risk is mounting that long term rates move up over the next 6 months (oil price permitting).
- The domestic economy struggled in FY05. Discretionary consumer spending has been soft since late last year, residential construction activity has stagnated and the business sector (less-so service industries) is confronting higher cost pressures and sluggish sales. While this slowdown is not a surprise – given the boom conditions of 2002/04 – it remains an open question as to whether it will develop into a genuine cyclical downturn (i.e. rising unemployment) that persists well into 2006 or, with the help of a still supportive policy stance, prove to be short-lived. We believe that the risks are tilted in favour of the latter scenario. If so, it will imply that little has been gained in terms of resolving the structural imbalances/inflationary risks that now overhang the economy. Thus, interest rate pressures would in all likelihood quickly reemerge. GSJBW Research recently upgraded its outlook for the Australian economy. After growth of 2.3% in FY05, we expect production (GDP) to expand by 3.4% in FY06 and 3.4% in FY07.
- The policy stance in Australia remains on the generous side of neutral. Interest rates are relatively low, the terms of trade are at a 50 year high, government policy is expansionary and asset prices are healthy. While the Reserve Bank (RBA) has recently expressed contentment with the prevailing trends in domestic spending, inflation, house prices and consumer borrowing, we are not convinced that this will continue into 2006. Accordingly, we still expect that interest rates will move higher over the next year (5.50% currently), although much will depend on whether household spending rebounds through 2H05.
- Recent strength – off an increasingly narrow base in terms of stock performance - has pushed the ASX300 back into fully valued territory. At a sector level, all the major Australian sectors are trading at a significant valuation premium to global peers. On the basis of the prevailing outlook for profits, interest rates and liquidity, however, we continue to believe that the risk of a prolonged correction at this point is low. Material price weakness requires material profit disappointment and while FY06 and FY07 earnings estimates have been tempered post the recent reporting season, we still believe that the risks of major market-wide downgrades remains relatively contained – particularly while the RBA sticks to its more cautious approach. From a medium term perspective, however, it is important to keep in mind just how good the past three years have been. On the basis of GSJBW Research estimates, earnings-per-share growth for the ASX300 has expanded by 55% between FY03 and FY05 – a huge step-up in profitability. While the future is always clouded, we can confidently state that this sort of profit growth will unlikely be replicated from FY06 to FY08.
- We continue to recommend an equity portfolio based around a core holding of large-cap defensive stocks. Given full valuations, however, buying opportunities in this area are limited. In our view, **Origin Energy, Macquarie Communications Group, Metcash, Woolworths, Coca Cola Amatil** and **Promina** represent the best relative value. After a period of underperformance, the major banks were back in favour in September and should continue to perform well into their upcoming profit results. **Commonwealth Bank** and **St. George** are two stocks we prefer in the sector at the moment. For investors who are looking for a global growth/cyclical bias, the stocks we favor at current prices are **News Corporation, Inc., Aristocrat Leisure** and **AXA Asia Pacific**. We continue to believe the medium term outlook for the resources sector is favourable. Investors with a small exposure to the sector should therefore view any periods of share price weakness as an opportunity to add to positions in **BHP Billiton** and **Rio Tinto**. Recent weakness in global steel prices, along with our expectation of a step-down in the copper price over the next six months, may well prove triggers for such periods of share price weakness.

### GSJBW Market Forecasts:

As at 30/09/2005	Price Earnings Ratio (PER)			Earnings Per Share Growth (%)			Dividend Yield (%)		
	FY05	FY06E	FY07E	FY05	FY06E	FY07E	FY05	FY06E	FY07E
S&P/ASX 300	16.2x	14.5x	14.1x	28.5	12.0	2.9	3.8	4.1	4.3
S&P/ASX 300 Industrials	16.7x	15.4x	14.3x	12.2	8.5	8.1	4.5	4.8	5.0
S&P/ASX 300 Resources	15.2x	12.7x	13.7x	79.7	19.2	-7.1	2.0	2.4	2.6

Source: GSJBW Research estimates

## Portfolio Management: Buy Ideas

### Coca-Cola Amatil (CCL)

Analyst: Paul Ryan

- Investment View: Short Term Outperform; Long Term Buy
- Share Price as at 30/09/05: \$7.91 Valuation: \$9.00

Year End June	2006 Estimate	2007 Estimate	2008 Estimate
Net Profit (\$m)	\$370.0m	\$419.0m	\$458.4m
EPS Growth (%)	13.1%	12.8%	9.0%
PER (x)	16.0x	14.2x	13.1x
Yield (%)	4.7%	5.4%	6.0%

Source: GSJBW Research estimates

Coca-Cola Amatil share price has retreated as currency (Rupiah), consumer confidence (South Korea, Indonesia) and higher input prices have prompted the market to reconsider the risks to consensus 2H05 profit growth expectations, which were well above company guidance.

We believe that the stock is now being priced more in line with company guidance and while we see limited downside risk, the company's annual investor conference in mid-October is likely to be the key driver of sentiment. At the investor conference we expect the company will update the market on 3Q05 trading, strategies to maintain earnings momentum in its core Australian and New Zealand businesses and progress at the recently acquired SPC Ardmona business. However, we do not expect the company will materially alter its existing FY05 guidance ahead of the key November-December trading period.

Short term share price performance will continue to be driven by sentiment as FY05 earnings are leveraged to the November-December trading environment (weather, competitor pricing activity), whilst FY06 outlook is impacted by the input cost inflation (aluminium, sugar and plastic). Hence, while we would not chase the stock aggressively before the conference, positive earnings revisions, relatively low integration risk for SPC and forecast average earnings per share growth of 13% per annum over the next three years underpin our long term positive view on the stock.

### Metcash (MTS)

Analyst: Phillip Kimber

- Investment View: Short Term Outperform; Long Term Buy
- Stock Price as at 30/09/05: \$4.20 Valuation: \$4.40

Year End June	2006 Estimate	2007 Estimate	2008 Estimate
Net Profit (\$m)	\$135.1m	\$173.3m	\$191.8m
EPS Growth (%)	18.5%	16.0%	10.6%
PER (x)	17.7x	15.3x	13.8x
Yield (%)	3.0%	3.7%	4.4%

Source: GSJBW Research estimates

Following the recent release of Foodland Associated's scheme documentation, the visibility on the transaction structure has increased significantly. We now believe the risks of Metcash not acquiring the specified assets of Foodland have diminished and, hence, have incorporated a successful Foodland acquisition into our Metcash forecasts. This has resulted in a 24% increase to our earnings per share estimates in the 1<sup>st</sup> full year post the acquisition (i.e. FY07). In the medium term, Metcash's earnings growth profile is very attractive – on our estimates, 11% in FY08 and 13% in FY09.

Our positive investment case on Metcash is further enhanced by its defensive earnings characteristics (i.e. 100% of earnings are derived from groceries) and robust cash flow generation. From a valuation perspective, incorporating the acquired Foodland assets into our forecasts has seen our DCF valuation rise 33% to \$4.40 per share – consistent with our earnings uplift following a successful acquisition. Assuming Metcash delivers on our forecasts, we anticipate it will trade broadly in line with the All Industrials market (ex financials, News Corporation, Inc. and Telstra), which is currently trading on 16x FY07 forecast earnings (versus Metcash on 15.3x).

Given the strategic nature and earnings (and in turn, valuation) impact that a successful acquisition should have on Metcash, we believe the risk/return proposition is compelling at current levels and have recently upgraded our long term recommendation on MTS to Buy.

## Portfolio Management: Buy Ideas

**News Corporation, Inc (NWS)**

Analyst: David Roberts

- Investment View: Short Term Outperform; Long Term Buy  
 Share Price as at 30/09/05: \$21.59 Valuation: \$26.00

Year End December	2006 Estimate	2007 Estimate	2008 Estimate
Net Profit (\$m)	\$3,614.6m	\$4,061.6m	\$4,971.6m
EPS Growth (%)	28.3%	15.4%	21.8%
PER (x)	20.6x	17.9x	14.7x
Yield (%)	0.7%	0.6%	0.6%

Source: GSJBW Research estimates

The News Corp share price has certainly been a poor performer over the past two years. This has been a result of a general de-rating of all US media companies – EV/EBITDA multiples have contracted from the 14-16 range in 2002 to an 8-10 range in 2005. News Corp is currently trading on a 2006 EV/EBITDA multiple of 8.9x. The sector's de-rating generally reflects a concern that the value of traditional media assets will be compromised by the impact of new technology. The two other factors that have depressed the News Corp share price have been the rising Australian dollar and its removal from the ASX S&P 200 Index – a process which has taken 12 months and was completed in September.

The poor share price performance is ironic, as the performance of the company itself has basically never been better. Since 2002, profits, free cash flow generation and returns have all been increasing (in US\$ terms). We are projecting that these trends will continue into 2008 at which time the company will be virtually debt free. Balance sheet strength has enabled News Corp to recently introduce a share buyback program and lift its dividend. We believe the company will have scope to continue a capital management program over coming years.

We suspect that the drags on the News Corp share price are now beginning to abate and that the share price should begin to reflect the strong underlying performance of the company. We believe it is inappropriate to view News Corp as a "traditional media company". Over the coming years, we believe incremental profit growth will be driven by the satellite TV portfolio – BSkyB, DirecTV and Sky Italia.

**Alesco Corporation (ALS)**

Analyst: Nga Luu

- Investment View: Short Term Marketperform; Long Term Buy  
 Stock Price as at 30/09/05: \$7.98 Valuation: \$8.15

Year End December	2006 Estimate	2007 Estimate	2008 Estimate
Net Profit (\$m)	\$43.3m	\$48.2m	\$51.7m
EPS Growth (%)	14.5%	11.4%	7.4%
PER (x)	12.8x	11.5x	10.7x
Yield (%)	6.1%	6.6%	7.0%

Source: GSJBW Research estimates

The Alesco business model is similar to that of Wesfarmers. The company seeks to develop and maintain a portfolio of business's across a range of industries. The objective of this portfolio is to produce a return of funds employed (ROFE) of at least 20%. Alesco's portfolio covers four main industry groups – Construction & Mining, Building & Renovations, B&D Garage Doors and Scientific & Testing Equipment.

While part of the company's portfolio is exposed to the soft housing cycle, management has a strong track record of adding value via acquisitions. The B&D Garage Door business was acquired in 2004 and is currently in a restructuring phase that is expected to deliver a step-up in performance by FY08. More recently, Alesco acquired Concrete Technologies, a manufacturer/distributor of decorative concrete building products.

Following the Concrete Technologies acquisition and a good start to FY06 we recently upgraded our earnings estimates for Alesco. We believe the stock is attractively valued – a FY06 price/earnings multiple of 12.8x and a fully franked yield of 6.1%. The balance sheet also remains strong providing scope for further acquisitions or capital management.

**Portfolio Management: Switch Idea**

**Origin Energy (ORG)** **Analyst: Anthony Bishop**  
 **Investment View: Short Term Marketperform; Long Term Buy**  
 **Stock Price as at 30/09/05: \$7.31** **Valuation: \$7.72**  
**Australian Gas Light (AGL)**  
 **Investment View: Short Term Marketperform; Long Term Hold**  
 **Stock Price as at 30/09/05: \$14.82** **Valuation: \$12.73**

Year End June	2006 Estimate		2007 Estimate		2008 Estimate	
	ORG	AGL	ORG	AGL	ORG	AGL
Net Profit (\$m)	\$358.3m	\$427.5m	\$458.5m	\$428.0m	\$470.2m	\$425.1m
EPS Growth (%)	9.5%	1.5%	26.1%	2.1%	1.2%	-0.9%
PER (x)	16.3x	15.8x	12.9x	15.5x	12.8x	15.6x
Yield (%)	2.3%	4.8%	3.5%	4.9%	3.9%	4.9%

Source: GSJBW Research estimates

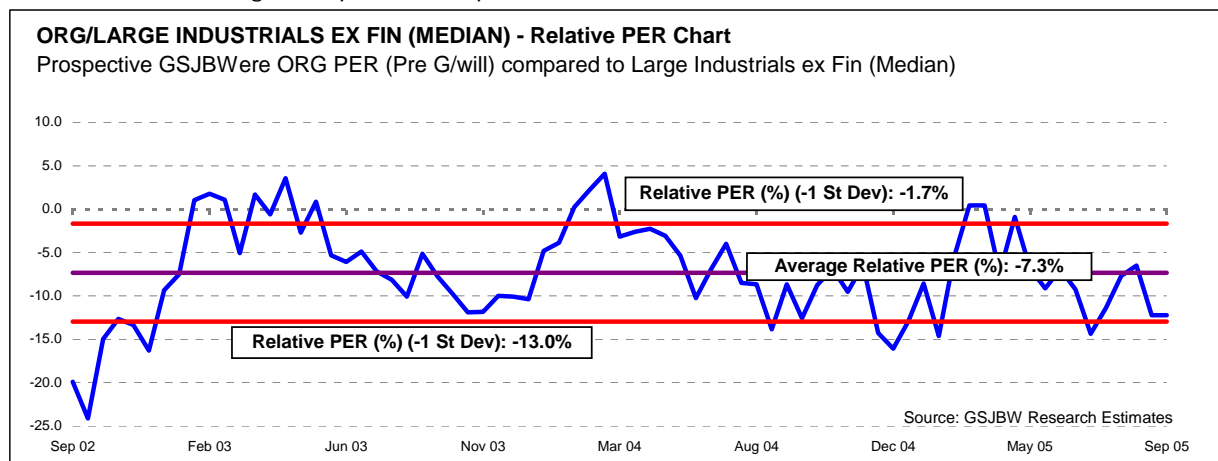
We remain attracted to the listed Australian utilities sector, with these companies continuing to provide investors with a strong defensive cash flow profile and long term growth opportunities. However, a core objective of equity portfolio construction is to maximise exposure to those companies expected to deliver superior profit/cash flow growth than the broader market, at the right price. To this end, we are comfortable for investors who may have large positions in the Australian Gas Light Company (AGL) to switch some of their exposure into Origin Energy (ORG) at current levels. We outline our investment case for each of these companies below.

**Australian Gas Light Company (AGL):** After a solid share price run over the last year, we believe that AGL is looking somewhat expensive at current levels, trading at a 16% premium to our DCF valuation. Although the stock is trading at a discount to the market on a price/earnings basis (FY06 forecasts), we expect that AGL will generate relatively flat average earnings growth of less than 1% per annum over the next two years.

Investors should note that our neutral recommendation on the stock reflects a number of positive factors we expect to support the share price, over and above its fully franked 4.8% dividend yield (FY06 estimates). These include a \$150m share buyback that has now commenced and will continue to the end of this calendar year, potential positive news flow as the PNG project progresses (e.g. customer signings, project sanction) and the possibility that the company could engage in an Alinta-style restructure of its regulated assets (i.e. spinning them out into a separate company and regearing them to provide high yield distributions and management fee income).

**Origin Energy (ORG):** Origin remains one of our preferred exposures to the utilities sector. While AGL arguably carries a more attractive dividend yield, we forecast that Origin will generate earnings growth of ~10% in fiscal 2006 and 26% in FY07. Further, the stock is currently trading at a discount to our valuation and at the lower end of its historical (3-year) price/earnings range relative to the market (refer chart), but with superior forecast profit growth.

The company's recent results for fiscal 2005 were largely in line with our expectations, with particular highlights being an unexpected rebound in retail margins and solid cash flow performance. However, continuing delays at BassGas, high levels of ongoing retail competition and the tremor caused by what we believe is conservative company guidance have resulted in subdued share price performance. Nonetheless, we continue to like Origin's vertically integrated business model, the company's strong defensive cash flow generation and material growth options in coming years and remain comfortable with the stock as a core long term portfolio exposure.



**Portfolio Management: Reduce Idea****Macquarie Infrastructure (MIG)****Analyst: Alison Booth**□ **Investment View: Short Term Marketperform; Long Term Hold**□ **Stock Price as at 30/09/05: \$4.01 Valuation: \$4.00**

<b>Year End June</b>	<b>2006 Estimate</b>	<b>2007 Estimate</b>	<b>2008 Estimate</b>
Net Profit (\$m)	\$112.6m	\$137.6m	\$254.7m
EPS Growth (%)	-89.2%	18.8%	79.0%
PER (x)	N/a	N/a	N/a
Yield (%)	5.2%	5.6%	6.0%

Source: GSJBW Research estimates

Whilst there is the potential for new yield-enhancing acquisition opportunities which could be viewed favourably by the market, we are becoming increasingly cautious on MIG given the risk of a prolonged weak operational performance by the M6 Toll road and the risk that future acquisitions will dilute the quality of the existing portfolio of assets. M6 Toll is MIG's largest asset by value (accounting for ~33% of our DCF valuation) and in our view, further disappointing traffic/revenue results over coming months will likely create a significant headwind to MIG's share price performance in the short term.

The current low bond rate environment is clearly supportive for the stock (and for the overall Infrastructure sector), given we use a risk-free rate of 6.5% in our DCF calculations. However, from a longer term perspective, our expectation of rising long bond rates remains a risk to performance. Given MIG's high debt levels, the sensitivity of our DCF valuation to small changes in operating assumptions is enhanced. In addition, only ~20-30% of our distribution forecasts for MIG are covered by underlying asset-generated cash flows, with the remainder covered by asset sale proceeds/refinancing proceeds. Given these factors and with the stock trading around our estimate of fair value (\$4.00), we believe it is timely for investors with overweight positions in MIG to reduce their exposure at current levels.

## Portfolio Management: Stocks Leveraged to Financial Markets

Stocks leveraged to the financial markets have continued to perform strongly in recent months, benefiting from the excess liquidity that is driving the overall market. In light of this, we believe it is appropriate to highlight some stocks within the diversified financials sector which we believe are fully valued. It is important to keep in mind that these stocks tend to outperform when the market is rising but underperform when it is retreating.

Table 1 highlights the solid performance of key stocks in this universe over the past five months, which on average have outperformed the broader market (S&P/ASX200) by ~17%.

Table 1

Stocks	Stock Code	Share price Performance (1 <sup>st</sup> May – 30 <sup>th</sup> September)
Australian Stock Exchange	ASX	36.1%
SFE Corporation	SFE	37.8%
Perpetual Trustees	PPT	31.6%
Computershare	CPU	30.1%
Macquarie Bank	MBL	64.7%
AMP Limited	AMP	17.4%
IOOF Holdings	IFL	18.2%
		<b>Average Performance = 33.7%</b>
S&P/ASX200	XJO	<b>16.5%</b>

Source: IRESS

It appears that the market is now willing to price some stocks for significant earnings upgrades on the basis that the equity market will continue its solid run into 2006 and 2007 – e.g. Australian Stock Exchange, Perpetual Trustees. In the case of Macquarie Bank, the market seems willing to pay up-front for the prospect that income from M&A deals will continue at their recent rapid rate and that specialist fund initiatives will be as successful as those that have been undertaken to date. Assessing the investment case in these companies therefore becomes a question of valuation (refer table 2).

Table 2

Company	PER		EPS Growth		DCF Valuation	Price
	FY06E	FY07E	FY06E	FY07E		
Australian Stock Exchange (ASX)	23.1x	21.1x	10.1%	9.9%	\$21.25	\$27.12
SFE Corporation (SFE)*	25.3x	23.0x	10.0%	10.4%	\$10.50	\$12.54
Perpetual Trustees (PPT)	21.3x	18.9x	7.8%	12.3%	\$60.90	\$67.75
Computershare (CPU)	20.5x	16.6x	28.8%	23.6%	\$6.25	\$6.60
Macquarie Bank (MBL)*	20.7x	19.7x	18.8%	5.2%	\$62.60	\$75.35
AMP Limited (AMP)*	18.3x	17.5x	-13.8%	4.3%	\$6.30	\$7.44
IOOF Holdings (IFL)	20.2x	16.8x	50.8%	20.1%	\$6.30	\$7.26

\* Forecasts are adjusted for June Year End

Source: GSJBW Research estimates

N.B. ASX, SFE and AMP are due for Sep 2005 mark-to-market of estimates. Market performance over the quarter has been above average for those stocks.

Table 2 clearly shows that certain stocks are trading at a significant premium to valuation and on expensive forward multiples, resulting in less compelling risk/return trade-offs relative to their peers and to the market as a whole (which is trading on FY06 price/earnings ratio of 14.4x). Hence, we are comfortable for investors with overweight sector positions to take advantage of recent share price strengths to start moving towards more neutral positions.

We highlight that our preferred stock within the diversified financials sector remains Computershare. In a recent Research Bulletin (*"Earnings Leadership: Yesterday's Heroes and Tomorrow's Achievers"*, 21 September 2005), we highlighted that we expect Computershare will be a market leader in terms of earnings growth over the next three years, driven by organic/structural growth and recent acquisitions. Whilst the company is currently trading at a slight premium to our valuation, we remain comfortable to buy the stock into periods of market weakness as we believe it will be rewarded as the market gains confidence in management's ability to deliver on its targets. Our positive view on the stock is further strengthened by the: (1) supportive macro environment – short-term interest rates are rising in Computershare's key markets (US, UK, Canada) and the prospects for M&A activity in the US are continuing to improve; (2) potential upside risk to our synergy forecasts from the Equiserve acquisition; and (3) scope for acquisitions to also deliver revenue synergies (as previously demonstrated with the Georgeson acquisition).

## Stock Selection Using Quantitative Techniques

In previous editions of Australian Equities: Portfolio Strategy Review we have outlined the various inputs, results and methods of implementation for our main Quant stock selection model, highlighting that the rankings indicated this model are designed to be viewed on a twelve-month investment timeframe and that the results should be used as an adjunct to our fundamental bottom-up Research recommendations.

We have selected three stocks across a range of recommendations from the current top rankings in GSJBW's large industrial stock screening model (refer table below) to underscore the relationship between the quant inputs, model rankings and our current Research view:

- James Hardie Industries (Marketperform/Hold):** Scores well across every factor – strong profitability and growth therein (EVA™ spread and trend factors); has had and is predicted to generate positive earnings revisions; solid recent share price momentum (positive RSI factor) and appears reasonably valued (strong returns profile, trading at an undemanding 14.1x our fiscal 2006 earnings per share forecasts, with expected earnings growth of 44% in fiscal 2006 and 10% in fiscal 2007). Despite these fundamental positives, our neutral headline recommendation reflects the fact that the company has yet to achieve a resolution in relation to its asbestos liabilities and the significant uncertainty that this creates – in the face of a solid underlying business case.
- Rio Tinto (Outperform/Buy):** Rio scores well in terms of valuation (a strong returns profile based with solid cash flow generation) and predicted earnings revision (e.g. incorporating spot commodity prices into our forecasts would lift our full year 2006 earnings estimates by 31%), but profitability is close to average (EVA™ spread) and is not expected to significantly improve (low EVA™ trend – reflecting the margin impact of higher input costs). Our positive recommendation on the stock reflects our expectation for strong global commodity demand to persist in the longer term.
- Australian Stock Exchange (Underperform/Hold):** The company is strongly profitable (positive EVA™ spread) but this is not expected to significantly improve (ranks poorly on EVA™ trend). Although the stock is trading on a supportive near term valuation (strong ROFE/PEG factor), our more sanguine view on the stock reflects our belief that the market is currently factoring in long term equity trading volumes that are significantly above historical averages, a situation that we do not perceive as sustainable.

Stocks that we currently favour on both a fundamental and quantitative basis include: **Computershare, Rio Tinto, Sonic Healthcare, UNiTAB and Woolworths.**

### Updated table

Rank	Company	EVA Spread:		Earnings Revision:		Positive RSI	ROFE/PEG	TOTAL	Previous Rank (31-July-05)	Move in Rank
		Level	Trend	Actual 3 Month	Predicted					
		(out of 15)	(out of 15)	(out of 15)	(out of 15)	(out of 10)	(out of 30)	(out of 100)		
1	JHX	13	14	13	15	10	29	<b>94</b>	1	0
2	RIN	13	14	12	15	2	26	<b>82</b>	3	1
3	CPU	9	12	14	8	8	26	<b>78</b>	6	3
4	PPT	15	15	4	8	6	28	<b>76</b>	5	1
5	RIO	8	2	12	15	9	27	<b>73</b>	10	n/a
6	SHL	7	10	15	15	9	17	<b>73</b>	4	-2
7	UTB	14	15	4	8	8	23	<b>72</b>	9	2
8	COH	9	8	12	15	1	25	<b>71</b>	7	-1
9	ASX	15	0	11	8	5	30	<b>69</b>	24	15
10	TOL	12	13	3	8	6	27	<b>68</b>	18	8
11	WOW	13	2	5	15	4	28	<b>67</b>	12	1
12	CML	11	13	6	8	5	24	<b>66</b>	15	3

Source: GSJBW Quantitative Research

**GSJBW Model Portfolios**

**Income Portfolio**

Commonwealth Bank of Australia	Rio Tinto
Westpac Banking Corporation	West Australian Newspapers
Australian Gas Light	Rural Press
St George Bank	Alesco
Telstra	Foster's Group
Tabcorp	Hills Industries
Promina	Ten Network
Wesfarmers	Macquarie DDR Trust
Coca-Cola Amatil	Australand
Woolworths	Alinta
Macquarie Communications Infrastructure Group	

Source: GSJBW Research

**Our changes to the Income Portfolio during September 2005:**

Reduced: Alinta, Macquarie DDR Trust, West Australian Newspapers

Increased: Rio Tinto, Alesco

Added: Hills Industries

**Income Portfolio Summary: Fiscal 2006** (\*Please note, MCG and ALN excluded from the calculation of the EPS growth rate and PER)

Earnings per Share Growth	6.5%
Price to Earnings Ratio	14.4x
Average Yield	5.6%
Franking	84%

Source: GSJBW Research estimates

**Defensive Portfolio**

Commonwealth Bank of Australia	Telstra
BHP Billiton	Tabcorp
Woolworths	Foodland Associated
St George Bank	Australian Gas Light
Promina	Ramsay Healthcare
Westpac Banking Corporation	Macquarie DDR Trust
Origin Energy	Transurban
Coca-Cola Amatil	Mirrabooka
Macquarie Communications Infrastructure	Sonic Healthcare
Rio Tinto	Rinker
Australian Foundation Investment Company	Wesfarmers
Foster's	

Source: GSJBW Research

**Our changes to the Defensive Portfolio during September 2005:**

Reduced: Australian Gas Light Company

Increased: Woolworths, Australian Foundation Investment Co., Commonwealth Bank, Promina, Foster's Group

Removed: Macquarie Airports, CFS Gandel Retail

Added: Ramsay Healthcare

**Defensive Portfolio Summary: Fiscal 2006** (\*Please note, MCG and TCL excluded from the calculation of the EPS growth rate and PER)

Earnings per Share Growth	10.4%
Price to Earnings Ratio	14.8x
Average Yield	4.6%
Franking	81%

Source: GSJBW Research estimates

*All figures or amounts stated in the table above are an estimate only and provided by way of illustration. Actual figures or amounts may vary from those figures or amounts*

## **Balanced Portfolio**

BHP Billiton	News Corporation
Commonwealth Bank of Australia	Alesco
Woolworths	Sonic Healthcare
St George Bank	Computershare
Promina	Australian Gas Light
Westpac Banking Corporation	Foodland Associated
Origin Energy	Healthscope
Australian Foundation Investment Company	Brambles
Coca-Cola Amatil	Billabong International
Rio Tinto	Wesfarmers
Macquarie Communications Infrastructure	Rinker
Telstra	

Source: GSJBW Research

### **Our changes to the Balanced Portfolio during September 2005:**

Reduced: Billabong International, Sonic Healthcare

Increased: Woolworths, Promina, Alesco, Commonwealth Bank, Australian Foundation Investment Co., Macquarie Communications Infrastructure Group

Removed: Macquarie DDR Trust

### **Balanced Portfolio Summary: Fiscal 2006** (Please note, MCG excluded from the calculation of the EPS growth rate and PER)

Earnings per Share Growth	12.6%
Price to Earnings Ratio	14.7x
Average Yield	4.1%
Franking	90%

Source: GSJBW Research estimates

## **Growth Portfolio**

BHP Billiton	Computershare
Commonwealth Bank of Australia	Alinta
Woolworths	Salmat
St George Bank	Billabong International
Origin Energy	Sonic Healthcare
Promina	Rinker
Australian Foundation Investment Company	Macquarie Airports
Rio Tinto	Mayne Group
News Corporation	Brambles
Healthscope	Toll Holdings
Alesco	Cochlear
Aristocrat Leisure	

Source: GSJBW Research

### **Our changes to the Growth Portfolio during September 2005:**

Reduced: Billabong International, Sonic Healthcare

Increased: Alesco, Australian Foundation Investment Co., Commonwealth Bank, Woolworths, Salmat

Removed: Macquarie DDR Trust, Foodland Associated, Transurban Group

Added: Mayne Group, Aristocrat Leisure

### **Growth Portfolio Summary: Fiscal 2006** (\*Please note, ALN and TCL excluded from the calculation of the EPS growth rate and PER)

Earnings per Share Growth	15.1%
Price to Earnings Ratio	15.3x
Average Yield	3.4%
Franking	95%

Source: GSJBW Research estimates

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GSJBW Recommendation Changes in September

STOCK	ASX CODE	SHORT-TERM Recommendation		LONG-TERM Recommendation	
		NEW	OLD	NEW	OLD
Alesco Corporation	ALS	-	Marketperform	Buy	Hold
Babcock & Brown Infrastructure	BBI	Marketperform	Outperform	-	Hold
Foster's Group	FGL	-	Outperform	Buy	Hold
Just Group	JST	Outperform	Underperform		Hold
Lihir Gold	LHG	Outperform	Marketperform	-	Buy
Metcash	MTS	-	Outperform	Buy	Hold
Orica	ORI	-	Marketperform	Hold	Sell
Publishing & Broadcasting	PBL	Marketperform	Outperform	-	Buy
Select Harvests	SHV	Marketperform	Outperform	Hold	Buy
Tattersall's	TTS	Marketperform	Underperform	-	Hold

Source: GSJBW Research

Referred to in Document:

Company Name	Stock Code	Share Price (as at 30 September 2005)	Valuation	Short Term Recommendation	Long Term Recommendation
Australian Foundation Investment	AFI	\$4.10	\$4.25	N/a	Buy
Australian Gas Light	AGL	\$14.82	\$12.73	Marketperform	Hold
Aristocrat Leisure	ALL	\$11.85	\$13.10	Outperform	Buy
Alinta	ALN	\$11.85	\$10.90	Outperform	Buy
Alesco	ALS	\$7.98	\$8.15	Marketperform	Buy
Australand	ALZ	\$1.88	\$1.73	Marketperform	Buy
AMP	AMP	\$7.44	\$6.30	Marketperform	Hold
Australian Stock Exchange	ASX	\$27.12	\$21.10	Underperform	Hold
AXA Asia Pacific	AXA	\$4.86	\$4.70	Marketperform	Buy
Billabong International	BBG	\$13.05	\$13.15	Outperform	Buy
Babcock & Brown Infrastructure	BBI	\$1.81	\$1.58	Marketperform	Hold
BHP Billiton	BHP	\$22.25	\$11.83	Outperform	Buy
Brambles Industries	BIL	\$8.86	\$10.10	Outperform	Buy
Commonwealth Bank of Australia	CBA	\$38.41	\$38.50	Marketperform	Hold
Coca-Cola Amatil	CCL	\$7.91	\$9.00	Outperform	Buy
Cochlear	COH	\$39.21	\$41.80	Outperform	Buy
Computershare	CPU	\$6.60	\$6.25	Marketperform	Buy
Foster's Group	FGL	\$5.83	\$6.00	Outperform	Buy
Foodland Associated	FOA	\$27.30	\$19.24	Marketperform	Hold
CFS Gandel Retail Trust	GAN	\$1.81	\$1.66	Marketperform	Buy
Hills Industries	HIL	\$4.52	\$4.30	Outperform	Hold
Healthscope	HSP	\$6.30	\$5.25	Outperform	Buy
IOOF Holdings	IFL	\$7.26	\$6.30	Marketperform	Hold
James Hardie	JHX	\$8.95	\$8.86	Marketperform	Hold
Just Group	JST	\$2.53	\$2.85	Outperform	Hold
Lihir Gold	LHG	\$1.92	\$1.15	Outperform	Buy
Macquarie Airports	MAP	\$3.28	\$3.65	Outperform	Buy
Mayne Group	MAY	\$5.38	\$4.75	Marketperform	Hold
Macquarie Bank	MBL	\$75.35	\$62.60	Outperform	Buy
Macquarie Communications Infrastructure	MCG	\$5.93	\$6.32	Marketperform	Buy
Macquarie DDR Trust	MDT	\$1.15	\$1.18	Marketperform	Hold
Macquarie Infrastructure Group	MIG	\$4.01	\$4.00	Marketperform	Hold
Mirrabooka Investments	MIR	\$1.67	\$1.73	N/a	Buy
Metcash	MTS	\$4.20	\$4.40	Outperform	Buy
Newcrest Mining	NCM	\$20.98	\$9.33	Marketperform	Buy
News Corporation	NWS	\$21.59	\$26.00	Outperform	Buy
Origin Energy	ORG	\$7.31	\$7.72	Marketperform	Buy
Orica	ORI	\$21.00	\$15.57	Marketperform	Hold
Publishing & Broadcasting	PBL	\$16.48	\$15.45	Marketperform	Buy
Promina	PMN	\$5.00	\$5.25	Marketperform	Buy
Perpetual Trustees	PPT	\$67.75	\$60.90	Marketperform	Hold
Ramsay Healthcare	RHC	\$9.40	\$8.96	Marketperform	Hold
Rinker	RIN	\$16.58	\$13.07	Outperform	Buy
Rio Tinto	RIO	\$59.14	\$34.15	Outperform	Buy
Rural Press	RUP	\$11.80	\$9.00	Marketperform	Hold
SFE Corporation	SFE	\$12.54	\$10.50	Outperform	Hold
St George Bank	SGB	\$27.89	\$26.97	Outperform	Hold
Sonic Healthcare	SHL	\$15.50	\$13.60	Outperform	Buy
Select Harvests	SHV	\$12.50	\$12.40	Marketperform	Hold
Salmat	SLM	\$4.54	\$5.70	Marketperform	Buy
Tabcorp	TAH	\$17.25	\$17.85	Underperform	Hold
Transurban	TCL	\$7.20	\$5.65	Marketperform	Sell
Ten Network	TEN	\$3.64	\$3.50	Marketperform	Hold
Telstra	TLS	\$4.07	\$4.97	Marketperform	Hold
Toll Holdings	TOL	\$13.90	\$12.95	Marketperform	Hold
Tattersall's	TTS	\$3.26	\$2.70	Marketperform	Hold
UNITAB	UTB	\$13.10	\$12.90	Marketperform	Buy
West Australian Newspapers	WAN	\$8.30	\$7.45	Marketperform	Hold
Westpac	WBC	\$21.10	\$20.19	Marketperform	Hold
Wesfarmers	WES	\$40.15	\$35.91	Marketperform	Hold
Woolworths	WOW	\$16.63	\$17.50	Outperform	Buy

Source: IRESS, GSJBW Research

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## Recommendation Definitions

### Short Term

Underperform (UP)	Stock is expected to underperform the S&P/ASX 200 on a 0-6 month timeframe
Marketperform (MP)	Stock is expected to perform in line with the S&P/ASX 200 on a 0-6 month timeframe
Outperform (OP)	Stock is expected to outperform the S&P/ASX 200 on a 0-6 month timeframe

### Long Term

Sell (S)	Stock is expected to underperform the S&P/ASX 200 for beyond 6 months
Hold (H)	Stock is expected to perform in line with the S&P/ASX 200 for beyond 6 months
Buy (B)	Stock is expected to outperform the S&P/ASX 200 for beyond 6 months

### Other Definitions

NR	Not rated. The investment rating has been suspended temporarily. Such suspension is in compliance with applicable regulations and/or Goldman Sachs JBWere policies in circumstances when Goldman Sachs JBWere is acting in an advisory capacity in a merger or strategic transaction involving the company and in certain other situations
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### Research Criteria Definitions

The above recommendations are primarily determined with reference to the recommendation criteria outlined below. Analysts can introduce other factors when determining their recommendation, with any material factors stated in the written research where appropriate. Each criterion is clearly defined for the research team to ensure consistent consideration of the relevant criteria in an appropriate manner.

#### SHORT TERM (0-6 MONTHS)

Relative Earnings Outlook:	Forward looking assessment of risk to consensus EPS estimates relative to estimated EPS risk across the market.
Earnings Revision:	The percentage change in the current consensus EPS estimate for the stock (year 1) over the consensus EPS estimate for the stock 3 months ago. Stocks are rated according to their relative rank, effectively making it a market relative measure.
News Flow:	The consideration of stock specific news flow, market and/or cyclical thematic and other issues such as index changes. Addresses two issues: (1) What is the potential news flow; and (2) What is the share price reflecting?
Relative Performance:	Historic rolling 3 month performance versus the broader market. Stocks are rated according to their relative ranking.
Valuation Support:	Considers a range of valuation methodologies, including discounted cash flow (DCF) valuation, PER, dividend yield and any other relevant measure.

#### LONG TERM (> 6 MONTHS)

Industry Structure:	Based on Goldman Sachs JBWere industry structure ranking. All industries relevant to the Australian equity market are ranked, based on a combination of Porter's Five Forces of industry structure as well as an industry's growth potential, relevant regulatory risk and probable technological risk. A company's specific ranking is based on the proportion of funds employed in particular industry segments, aggregated to determine an overall company rating, adjusted to reflect a view of the quality of a company's management team.
EVA™ Trend: <sup>1</sup>	EVA™ trend forecast for coming two years. Designed to reflect "turnaround stories" or to highlight companies Goldman Sachs JBWere analysts believe will allocate capital poorly in the estimated timeframe. (An ROE measure is used for insurance stocks in conjunction with an assessment of the strength of an insurer's balance sheet).
Growth Option:	A qualitative and quantitative assessment of a company's long term growth options that the analyst believes should be considered and possibly recognised by the market.
Price: Base Case DCF:	The premium or discount to base case DCF valuation at which the stock is trading relative to the average premium or discount across the market.

<sup>1</sup> EVA™ is a registered trademark of the U.S. consultancy firm Stern Stewart

#### For Insurers

Return On Equity:	Rating taking into account the expected level and trend of ROE over the next two to three years.
Balance Sheet:	Analyst's assessment of the quality and strength of the insurer's balance sheet, including conservatism of provisioning, sufficiency of capital, and quality of capital.

#### For REITs

EPU Growth:	Ranking of Earnings Per Unit growth relative to other listed Real Estate Investment Trusts. Used instead of EVA™ Trend.
Strategy:	Used instead of industry structure as many REIT investors are intra rather than inter sector focussed.
Yield:	Yield relative to the REIT sector average. Used instead of Valuation Support.

#### For NZ Companies

Relevant Index:	If a research report is published by the New Zealand affiliate of Goldman Sachs JBWere, the recommendation of a company or trust is based on their performance relative to the NZSX 40 Index (Gross) and not the S&P/ASX 200 index.
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#### Distribution of Recommendations - As at 30th June 2005

Short Term	Overall	Corporate relationship* in last 12 months	Long Term	Overall	Corporate relationship* in last 12 months
Underperform	19%	20%	Sell	9%	8%
Marketperform	55%	51%	Hold	58%	56%
Outperform	25%	30%	Buy	32%	36%

\* No direct linkage with overall distribution as the latter relates to the full GSJBW stock coverage (>200 companies). The above table combines the corporate relationships and recommendations of both Goldman Sachs JBWere Pty Ltd and its affiliate in New Zealand, Goldman Sachs JBWere (NZ) Limited.

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