

Private Wealth Management

Portfolio Strategy Review - September 2008

Investment Strategy | Australia

Key Points:

- September proved to be one of the most volatile months equity markets have experienced due to the increasing uncertainty around the state of the US financial system. Increasing concerns over China's economic growth and the resulting weakness in commodity prices only increased investors' risk aversion. The Australian equity market (**S&P/ASX200**) traded in a 520 point range before finishing the month at its lows, down 9.8%. The ASX200 returned -10.4% for the September quarter.
- Severe financial stress was evident across a broad range of measures as an unprecedented number of US financial institutions collapsed, were placed under administration by the Government or sold to peers. A US\$700bn "rescue package", proposed by the US Fed/Treasury failed to pass through Congress by month end resulting in further market declines. Restrictions on short selling of financial stocks, introduced across a range of global exchanges, also kept investors sidelined. The sudden announcement by ASIC that all short selling would be banned for 30 days in Australia, only added to the confusion.
- Despite the increasing concerns around the US financial markets, the domestic Banking sector finished September flat, suggesting current valuations reflected the poor outlook and the attempted remedial measures being undertaken offshore were signalling a base. The weakness in commodity prices also provided an incentive for investors to switch from resources into Financials. **Info Tech, Financials and Consumer Staple sectors outperformed** while the Materials, Utility and Energy sectors lagged. This sector performance was also consistent for the September qtr.
- As expected, the RBA cut rates by 25bp in early September. Domestic interest rate expectations then continued to move lower during the month reflecting the deteriorating outlook offshore, a weaker oil price and further RBA rhetoric highlighting the slowing domestic economic momentum. By month end the market was pricing a 50bp cut by the RBA in October and a further 25bp by December. The AUD suffered a major correction as domestic interest rate expectations reduced and the USD rallied; finishing the month at 80.5¢ (-5.3¢).
- The key issue for investors near term remains the trade-off between additional earnings risk from the slowing domestic economy, the weakness in commodity prices and the longer term implications from the financial meltdown offshore; versus increasingly attractive valuations for equities. While identifying market bottoms remains difficult we believe valuations are attractive and sentiment sufficiently negative to warrant an increasing allocation into domestic cyclicals, including financials. A subdued recovery or "double dip" slowdown remains a key risk. We continue to monitor opportunities in the Resources ahead of an expected improvement in news flow from China in 2009.

Goldman Sachs is currently acting as Financial Advisor to BHP Billiton and as such is an associate of BHP Billiton for the purpose of the Takeover Code.

Private Wealth Management Investment Strategy

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Performance Table –September 2008

	Accumulation Index Performance Since		
	31/08/2008	31/03/2008	30/09/2007
S&P/ASX 200	-9.8%	-12.0%	-26.8%
S&P/ASX 200 Industrials	-4.6%	-10.7%	-28.2%
S&P/ASX 200 Resources	-20.8%	-15.1%	-22.5%
S&P/ASX Small Ordinaries	-15.0%	-21.9%	-34.5%

	Relative Index Performance to S&P/ASX 200		
	1 Month	6 Months	12 Months
Consumer Discretionary	3.9%	-10.2%	-13.3%
Consumer Staples	6.6%	2.6%	15.2%
Energy	-2.9%	21.9%	32.0%
Financials	7.5%	2.8%	-6.2%
Healthcare/Biotech	3.9%	14.0%	24.6%
Industrials	1.2%	-3.9%	-7.9%
Information Technology	12.3%	16.5%	25.6%
Materials	-12.9%	-10.3%	-1.9%
REITS	4.0%	-4.5%	-13.7%
Telecommunication Services	5.2%	7.7%	24.4%
Utilities	-3.8%	-0.7%	-5.4%

Source: IRESS, GSJBW Research estimates

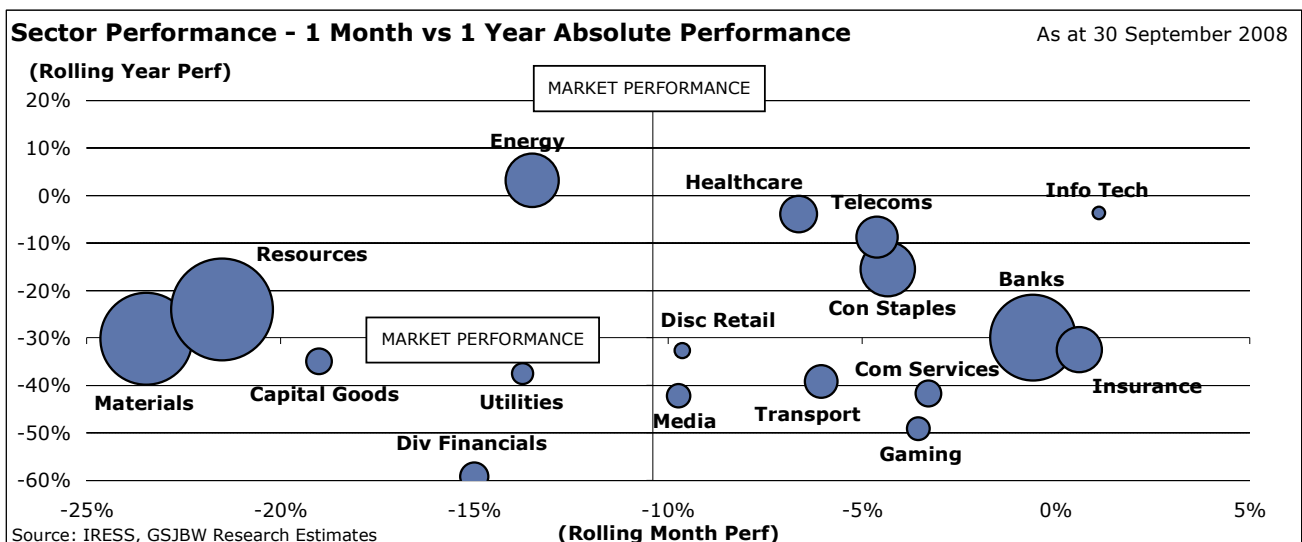
ASX 200 Leading Contributors in September 2008

Top & Bottom 10 Pts Contributors over September - ASX 200			
1. ANZ	20.9	BHP	-172.2
2. QBE	11.2	RIO	-60.0
3. LGL	4.4	WPL	-27.0
4. CBA	1.5	FMG	-19.4
5. MIG	1.3	WBC	-19.2
6. IAG	1.2	IPLDA	-17.6
7. COH	1.1	CSL	-11.0
8. ALL	1.0	SUN	-10.0
9. SGP	1.0	OST	-9.7
10. TCL	0.8	MQG	-9.5

The ASX 200 Index decreased by 535 pts in the month of September

Source: IRESS

Sector Performance for month end September 2008



REAL ESTATE INVESTMENT TRUSTS

The A-REIT 200 Index finished another volatile month, down 6.2% for September. Points of interest during September included:

- **Westfield Group (-3.7%)** - Confirmed it now had a 2.96% stake in Liberty International PLC that was acquired between June and July 08 for GBP91m (~A\$195m). This equates to a shareholding of 10.7m ordinary shares of 50 pence each.
- **Centro Properties Group (-49.7%)** - CNP's agreement to sell 29 of the 31 properties in the Centro America Fund (CAF), to a private real estate investment advisor fell through as renegotiated terms could not be agreed. The original contract price of US\$714m (CNP's share US\$333m) was a 10% discount to previous book value.

HEALTHCARE

For Healthcare, the month was dominated by the Medicare Levy Surcharge (MLS) threshold bill, which failed to pass the Senate despite a proposed compromise by the Government.

Ramsay Health Care (-5.4%) ended the month lower, while **Healthscope (+9.3%)** finished higher. The legislation has been re-introduced in the Lower House.

Sigma Pharmaceuticals (-5.8%) reported 1H09 NPAT of \$30.6m during the month, slightly below our expectations of \$32.1m. **CSL (-8.6%)** finished the month lower having begun shipment of its flu vaccine (Afluria) to the US for the 2008-09 flu season.

It was a quiet month for **ResMed (+0.2%)**, **Cochlear (+7.7%)** with still no update from COH regarding its BaHa warning letter. For **Ansell (+3.0%)**, latex prices remained stable during the month with spot prices at MYR606.5/kg.

INFORMATION TECHNOLOGY

Computershare (+4.0%) rose as the A\$/US\$ moved in its favour, though there are still some investor concerns about the implications of falling US interest rates. (Also, despite some big ticket M&A transactions in recent weeks, overall M&A volumes are still likely to be subdued for a while given bearish market conditions.)

INDUSTRIALS

Leighton (-19.3%) fell as the market moved lower, during the month LEI announced a number of contract wins.

United Group (-7.6%) declined despite its solid earnings outlook. We also saw some profit taking in **Transfield Services (-8.1%)** and **Downer EDI (-15.0%)** this month. TSE was also impacted by market concerns over a deteriorating US economic outlook.

WorleyParsons (-17.0%) largely traded in line with the oil price this month (lower). The global E&C sector came under pressure from a falling oil price in September, despite the outlook for hydrocarbon engineering demand remaining very robust.

Boart Longyear (-41.5%) came under pressure this month after the incoming CEO reduced his shareholding in the company by 50%. The stock was also impacted by the deterioration in sentiment for the global drillers following comments from one of BLY's key comparables, Major Drilling, which indicated that demand from junior explorers was slowing.

Nufarm's (-8.7%) share price fell following the release of its FY08 result, despite posting a strong set of numbers. **Incitec Pivot (-36.5%)** declined this month, caught up in the negative sentiment towards commodities. **Orica (-15.9%)** its share price appeared to track in line with that of commodity/resource based stocks.

Brambles (+2.3%) rose over the month. The company confirmed the first two months of trading of FY09 was in line with expectation. **Qantas (-7.4%)** continued to be the subject of negative media reports on its fleet safety while **Virgin Blue (-45.2%)** continued its share

price slide on the back of its weak FY08 result and cautious outlook comments. **Toll Holdings (-0.3%)** had a quiet month in terms of news flow, finishing the month flat.

Asciano (-35.5%) dropped sharply as the market again become concerned about stocks with high gearing levels and refinancing risk.

Macquarie Communications Group (-15.3%) announced the successful completion of the Partial Tender Offer for its Exchangeable Bonds at a ~10% discount. **Macquarie Airports (-15.6%)** reported slightly weaker than expected airport traffic during August, particularly domestic traffic at Sydney and at Copenhagen (which was negative). **Macquarie Infrastructure Group (+5.5%)** ended the month higher after the commencement of the buyback appeared to provide some support for the stock.

Australian Infrastructure Fund (-19.3%) was weaker as investors became increasingly wary of the slowdown in the domestic economy. **Transurban (+2.8%)** finished higher as investors sought exposure to stocks with defensive earnings and more conservative capital structures, whilst **ConnectEast (+5.8%)** ended September higher despite no further update on traffic.

MATERIALS - Underweight (Prefer Boral and OneSteel)

Building Materials

The US Government's bailout of mortgage providers Fannie Mae and Freddie Mac was positive for Building Material stocks. In its US Investor Update, **James Hardie (+6.4%) Boral's (-5.1%)** share price was partially supported by its on-market share buyback but has been weighed down by negative sentiment surrounding the US housing market. **Adelaide Brighton's (-12.9%)** share price hit new lows as the company announced that its FY08 NPAT was likely to be towards the lower end of guidance. **CSR's (-6.8%)** share price was impacted towards the end of the month by declining sugar prices.

Steel

Despite the relatively small amount of stock-specific news flow, ongoing weakness in global steel prices together with continued uncertainty surrounding the longevity of China's eminent slowdown underpinned a weaker domestic steel sector during September. **Bluescope (-17.8%)** declined. Given its exposure to Iron Ore, **OneSteel (-30.8%)** was the most impacted.

Diversified Resources

Both **BHP Billiton (-24.0%)** and **Rio Tinto (-33.1%)** underperformed the broader market in September. We can suggest numerous contributory factors, including softer commodity prices, and concerns that the worsening credit crunch can only negatively affect demand for raw materials. But we would suggest that the most potent factor has been the continuing deterioration in sentiment on China. The slowdown in China has undoubtedly been exacerbated by the shut-down of various industrial activities for the Olympics, but the conviction that the post-Olympic "bounce" will be somewhat anaemic appears to be growing. The fall in bulk freight rates, steel prices, spot market iron ore prices, and spot market thermal coal prices has only added to this concern.

Base Metals, Coal and Iron Ore

Carnage is really the only word to describe share price movements for the vast majority of pure-play resources stocks over the past month. **Pan Australian (-36.1%)** and **Aditya Birla (-29.1%)** were the main casualties, although **OZ Minerals (-8.3%)** held up relatively well during the month, albeit from an already depressed price level at the end of August. Among the coal names **Felix Resources (-15.8%)** was the best performer, while **Macarthur (-19.9%)** and **Centennial (-32.7%)** fell back sharply. Only three stocks in this sector posted price gains during September: **Iluka (+5.1%)** is relatively sheltered from the current volatility in exchange-traded commodities and **Portman Mining (+14.2%)** is under offer. But the sector's unlikely leading performer in September was **Minara Resources (+5.2%)** which rallied strongly on short covering, despite a 16% fall in the nickel price last month.

Precious Metals

Gold equities provided some of the very few bright spots among resources equities last month. **Lihir Gold (+17.2%)** was the best of the larger gold plays, while **Newcrest (+1.2%)** posted a much more modest gain. Among the small cap gold stocks **Bendigo Mining (+8.6%)** and **Avoca (+7.3%)** were marked higher, while **Kingsgate (-6.6%)** failed to capitalise on the firmer gold price.

TELECOMMUNICATION SERVICES - Overweight (Prefer Telstra)

Telstra's (-3.9%) declined sharply over the month. During the month, Telstra announced staff cuts as part of its transformation program. **SingTel (-6.3%)** finished the month lower as the market continued to be concerned about the valuation and earnings of its Associates.

UTILITIES - Overweight (Prefer Origin Energy)

Origin Energy (+0.6%) rose during September after selecting ConocoPhillips (COP) as its Coal Seam Gas (CSG) partner to develop a 4x3.5 mtpa LNG project. **AGL Energy (-10.8%)** finished the month lower on limited news flow. **APA Group (-16.2%)** and **SP AusNet (-9.6%)** ended the month lower on the back of broader market weakness. **Spark Infrastructure (-6.8%)** and **Envestra (-6.4%)** were also down, albeit volatile.

CONSUMER DISCRETIONARY

Media

News Corporation (-7.7%) finished the month down after Rupert Murdoch mentioned at the 17th Annual Communacopia that Australian newspapers had shown their first soft month in August; reflecting spreading global macro pressure already present in the US and UK.

After **Fairfax Media's (-6.4%)** share price range traded for most of September but finished the month lower. FJX announced that it was reviewing its strategic options with respect to the recently acquired Southern Star production business.

Consolidated Media Holdings' (-22.5%) shares fell as concerns emerged regarding the solvency of PBL Media (25% owned by CMH) given its high level of financial gearing and high degree of operational leverage to the recent weakness in ad markets.

Retail

Billabong (+9.2%) continued to rise on improved investor confidence in FY09 earnings and the ongoing depreciation of the A\$ against the US\$ (provides a translation benefit for BBG's US\$ earnings). There was no company specific news flow for BBG during September.

CONSUMER STAPLES

Wesfarmers (-7.5%) traded lower during September. WES announced the appointment of Mr Guy Russo as the Managing Director of Kmart. Mr Russo was formerly head of McDonalds' operations in China and Australia.

Foster's Group (+1.3%) finished the month up, appointing Mr Ian Johnston as CEO. Mr Johnston has been serving as acting CEO since July, having joined FGL as a non-executive director in September last year.

ENERGY

The oil price continued its sharp retreat from record highs of ~US\$145/bbl in August, reaching a low of ~US\$91/bbl mid September. The retreat in September was driven firstly by Hurricanes Gustav and Ike in the Gulf of Mexico; the impact of these hurricanes was a net negative for oil prices as they resulted in more shut-in refining capacity than oil production capacity. The retreat gained further momentum as concerns accelerated with regards to the state of global financial markets.

Woodside Petroleum (-17.8%) retreated from last months highs broadly in line with the oil price. **Santos (-5.0%)** announced it had purchased 100% of the Spar gas field from the

Gorgon joint venture for an undisclosed amount. The field is estimated to contain a gas resource of up to 600PJ with associated condensate of up to 8mmbbls.

Caltex's (+1.3%) share price ended the month higher despite the market turmoil, however crack spreads widened significantly during the month (from ~US\$4/bbl to a peak of ~US\$16/bbl) as Hurricane Ike took out a significant amount of refining capacity in the USA.

FINANCIALS ex PROPERTY TRUSTS

Banks

The Banks Sector finished the month flat (-0.6%), driven predominately by offshore news including the US government bailout of Fannie Mae, Freddie Mac and American Insurance Group, bankruptcy filings from Lehman Brothers and Washington Mutual, the Merger of Merrill Lynch with Bank of America, and the \$700bn Paulson bailout plan.

September saw **St George Bank (-5.9%) / Westpac (-8.8%)** released scheme document for the proposed merger. Whilst no new material details were provided, it's worth noting that SGB's board reiterated its support for the transaction.

NAB (-1.0%) and **ANZ (+12.9%)** both announced the issue to small Tier 1 hybrid issues. NAB issued \$600m Hybrid Tier 1 convertibles at a rate of 30 day bank bill rate + 200bp, as part of a private placement. This issue replaced a previous facility that has now been converted to ordinary NAB shares. ANZ also issued \$600m Tier 1 Hybrid Convertible noted at 30 day Bank bill rate + 200bp. ANZ indicated the shares are expected to convert on or post the 28 September 2009.

Macquarie Group (-16.0%) had a volatile month, its share price at one stage down to \$26.05 before recovering some of its losses. MQG had its credit rating affirmed by S&P however its outlook was downgraded to negative (from stable). MQG also announced it will look to sell its Investment Lending business in the near term. Whilst the company noted this sale is not material, we would expect near term benefits for MQG's surplus capital position of ~\$3.6bn (including CPS).

Insurance

Given the volatile state of markets, the insurers performed relatively well aside from **Suncorp (-18.6%)**, which was sold off due to concerns over its capital position and banking division.

Insurance Australia (+3.3%) and **QBE (+10.7%)** similarly announced that they should not be directly impacted by certain overseas collapses, with IAG confirming no material exposure to AIG, and QBE confirming that its investments had no direct exposure to Lehman Brothers, Merrill Lynch or AIG.

Diversified Financials

ASX (-14.7%) was sold down as investors worried about the impacts of the short selling ban on ASX's trading volumes (though, ironically, the ASX is currently gaining a small benefit via its derivatives business, especially options, since these products are still approved under the rules). **Challenger (-10.0%)** fell, but not to the same degree as some of its investment banking "peers" despite its removal from the S&P/ASX100.

Commodities – Short Term and Long Term Price Drivers

At a time of unprecedented price volatility and growing uncertainty on market fundamentals, we provide a few simple notes on what we see as **short-term** and **longer-term** price drivers for commodities.

Longer term, we believe that the structural bull market endures, based on supply and demand fundamentals. The theme of industrialisation and urbanisation in emerging markets has not disappeared. Neither have the supply constraints for certain commodities been alleviated.

We believe the spot pricing of many commodities is currently being driven by forces other than fundamentals at this time.

Shorter term, speculative money is moving into and out of commodities according to sentiment rather than fundamentals, and following the ebb and flow of the US dollar. The USD has become the key short-term price driver, not just for gold, but for all exchange traded commodities. Short-term speculative money has moved neutral (oil) or net-short (base metals).

While acknowledging that transparency is very poor, we believe that commodity index funds (typically longer-term, long only investments) have not experienced large-scale redemptions, though some investors have sought to protect positions with put option strategies.

Short-term credit restrictions and elevated financing costs are restricting the activities of commodity traders in both physical and futures markets, with de-risking and counterparty switching common themes.

We believe that growth rates in China (GDP, Industrial Production, raw materials demand) have been slowing for some time, but that fears of a collapse in demand for raw materials post-Olympics are unfounded. We expect sentiment to improve as a cleaner read on the Chinese economy becomes available during 4Q08, and that the outcome in China will be considerably stronger than the market currently seems to believe.

What are the long-term drivers of commodities prices?

When we think about the future behaviour of commodity prices, we usually consider a number of price drivers. Under "normal" market conditions, a rough (descending) order of priority for these drivers is:

- 1) **Demand**, and the rate of demand growth.
- 2) **Supply**, and the ability of supply growth to match demand.
- 3) **Inventory levels**. Is the market comfortably supplied? Are stocks rising or falling?
- 4) **Production costs**
- 5) **Sentiment**, and the role of speculative investment flows.
- 6) **US dollar** strength or weakness.

In our opinion, the secular themes of the past five years are intact:

- The industrialisation/urbanisation process in key emerging markets (BRICs and "Next Eleven" countries) is far from complete and will continue.
- The vast population involved in these economies implies robust trend rates of global demand growth in the medium- and longer-term.
- For many key commodities - some more than others - a variety of constraints will cause supply to struggle to keep pace with demand.

The more constrained commodity markets will have a tendency to deficit, and will therefore be priced to achieve a market balance through encouraging new supply and/or destroying demand.

At some stage - it may be three months, six months, possibly more - we believe very strongly that these fundamentals will reassert themselves, with positive implications for commodities prices and resources sector earnings.

In today's market it is almost as if the above order of price drivers has been inverted, and in the short term, we believe that the strength of the US dollar and speculative/ investment fund flows have become the dominant price drivers.

The macro-economic outlook for the OECD countries has been deteriorating for at least the past 15 months, but China's dominance as the global engine of raw materials demand growth kept sentiment broadly positive until mid-2008. Sentiment on commodities has soured very significantly in the past two months because:

Slowing growth rates in China have been brought into much sharper focus by the Olympics-related slowdown. Softer steel prices, freight rates, falling spot market prices for iron ore, accumulations of iron ore stockpiles, the collapse in China's stock market, and the weakening outlook for China's real-estate sector have all been headline news.

HOW DO WE VALUE THE STOCKS LEVERAGED TO COMMODITY PRICES?

The below table illustrates where some of the covered base and precious metals stocks are trading compared to their long term GSJBW commodity forecast valuations and current spot market pricing valuation.

- The key difference in methodology behind these valuations is the commodity price factored into the discounted cash flow valuation.
- The GSJBW valuations in red incorporate commodity price assumptions as forecasted by the GSJBW commodity research analysts (see below) whereas current spot commodity prices are factored into perpetuity for the valuation in black.

On this basis value appears evident in **OZ Minerals, Equinox Minerals, Aditya Birla Minerals, Pan Australia Resources, Alumina Limited and Platinum Australia**. These companies all carry GSJBW 'Buy' recommendations.

	Closing ASX Price	Valuation	
		GSJBW	Spot
Base Metals			
OZL	\$1.60	2.49	2.22
EQN	\$3.57	4.27	4.89
KZL	\$2.86	2.91	2.14
ABY	\$1.21	3.28	3.11
PNA	\$0.59	1.07	1.29
AWC	\$3.67	7.04	7.06
MRE	\$1.30	3.40	1.91
WSA	\$8.45	6.59	4.35
IGO	\$2.72	4.91	4.71
ILU	\$5.00	3.65	4.19
Precious Metals			
NCM	\$25.50	17.16	23.04
LGL	\$2.65	2.00	2.32
SGX	\$4.70	2.75	3.12
KCN	\$5.71	6.19	6.58
SBM	\$0.33	0.46	0.48
AVO	\$2.07	1.20	1.13
BDG	\$0.16	0.56	0.56
AQP	\$8.50	9.36	8.84
PLA	\$1.72	2.13	1.86

Source: GSJBW Research Estimates, IRESS. Prices as at COB 23/09/08

Commodity Spot Prices COB 23/9/08		
NY Gold	US\$/oz	895.30
NY Platinum	US\$/oz	1222.50
LME Copper	US cents/lb	317.15
LME Nickel	US cents/lb	771.20
LME Aluminium	US cents/lb	111.47
LME Zinc	US cents/lb	78.99
LME Lead	US cents/lb	90.13

Source :Bloomberg

		Summary of Key GSJBW Commodities Price Assumptions						Long Term	Long Term
		2007A	2008F	2009F	2010F	2011F	2012F	(2013 Nominal)	(2008 Money)
Aluminium	US\$/lb	120	127	133	135	136	145	127	110
Copper	US\$/lb	323	352	375	360	360	375	203	175
Nickel	US\$/lb	1689	1049	850	900	1000	1175	746	644
Zinc	US\$/lb	147	92	85	90	118	140	91	78
Oil	US\$/bbl	71.78	119.27	140.00	150.00	140.00	85.00	85.00	73.32
Uranium	US\$/lb U3O8	105.00	66.57	77.50	76.50	62.50	60.00	49.00	42.27
A\$ exchange rate	US\$/A\$	0.84	0.91	0.83	0.82	0.80	0.77	0.74	0.74
Gold	US\$/oz	697	873	876	912	949	987	669	577
Platinum	US\$/oz	1306	1764	1782	1855	1931	2009	1045	901
Palladium	US\$/oz	357	387	350	400	400	400	297	256
Rhodium	US\$/oz	5878	7636	7136	7463	7769	8087	4057	3500
		JFY 07-08A	JFY 08-09F	JFY 09-10F	JFY 10-11F	JFY 11-12F	JFY 11-12F	Long Term	Long Term
Thermal coal	US\$/t	55.65	125.00	150.00	140.00	140.00	100.00	(2013 Nominal)	(2008 Money)
% change (y/y)		6%	125%	20%	-7%	0%	-29%	70.00	60.38
Coking Coal (HCC)	US\$/t	98.00	300.00	330.00	290.00	250.00	200.00	108.00	93.16
% change (y/y)		-15%	206%	10%	-12%	-14%	-20%		
Iron ore (fines)*	US\$/dmu	80.42	144.66	170.70	145.09	130.58	117.53	78.00	67.28
% change (y/y)		9%	80%	18%	-15%	-10%	-10%		

Note: *includes an assumed freight premium for Australian producers from JFY'08-'09 onwards (not including our long term estimate).

Source: LME; Reuters; TEX Report; GSJBW Research estimates

Stock Update – Wesfarmers

Despite recent share price weakness, our retail team maintain a positive view on Wesfarmers (WES) and recommend investors consider the stock as part of a core long term portfolio. This positive view is predicated on:

The potential for significant earnings growth from a successful turnaround of the acquired Coles Group. Our retail team holds that the recent FY08 profit result demonstrated that WES have begun to stabilise the key Food and Liquor business. However we note that it is a 5 year turnaround and many challenges lie ahead.

Near term earnings growth from high coal prices. Although we note the presence of some downside risk to our current coal price forecasts for less premium grades of coal.

Value at current levels; the share price represents significant long term value, in particular we view the WESN price protected security as attractive to shareholders seeking share price protection in the event of underperformance in the stock.

Coles showing signs that it has begun to stabilise; albeit a long road ahead ...

At the recent Wesfarmer's profit result, there were signs of improvement in the key Coles Food & Liquor business with evidence of a stabilisation in Cole's earnings. Our retail team highlight this process is in its very early stages, faces many challenges and requires significant expenditure of capital. While more robust earnings judgements will be possible once a full twelve month period under Wesfarmers management is observed, a successful turnaround of the Coles business could significantly increase Coles group EBIT.

Export Coal Prices – metallurgical coal has been a strong contributor to the groups earnings, though we highlight some downside risk as supply constraints alleviate going forward...

Wesfarmer's currently has three coal businesses, which produce both metallurgical coal (used in steel production) and steaming/thermal coal (used in the generation of electricity). The breakdown in terms of amounts produced is presented below:

Curragh (6.9 million tonnes metallurgical and 2.4 million tonnes thermal)

Metallurgical Coal (Hard Coking Coal, Semi Hard Coking Coal, PCI) is the type used in steelmaking (see below chart). Thermal Coal – Only sold within the domestic market

Bengalla (40% WES, 5.6 million tonnes)

Thermal Coal for both domestic and export markets. WES is part of a joint venture.

Premier (2.9 million tonnes)

Thermal Coal – Only sold within the domestic market. Earnings were lower last year for Premier due to higher costs and plant outages at one of its major customers, a Western Australian power station.

Wesfarmers has benefited from higher coal prices off the back of growing demand for steel and energy, in particular from emerging economies. The table below shows the historical and estimated contribution to Earnings Before Interest and Tax (EBIT) from the Resources business:

Resources Division - Estimates								
(A\$m)	FY05	FY06	FY07	FY08	FY09e	FY10e	FY11e	FY12e
Sales	763.7	1,304	1,134	1,311	2,555	2,893	2,652	2,395
EBIT	251.2	577.8	338.0	423.0	1,461.9	1,566.6	1,257.9	999.3
EBIT Growth		130%	-41%	25%	246%	7%	-20%	-21%

Source: Company Data, GSJBW Research estimates

Contracted coal prices reached historical highs this year. Weighted average US\$ contracted Metallurgical coal prices for JPY 2008/09 are up ~230%. Our resources team believe metallurgical coal (providing most impact to WES earnings) will remain in tight supply though 2009 due to mining and infrastructure constraints, however we expect supply fundamentals for metallurgical coal to change in 2010 (see Table 1 and Chart 1 below), when investment in Australia's coal infrastructure leads to increased growth in exports and therefore downward pressure on prices.

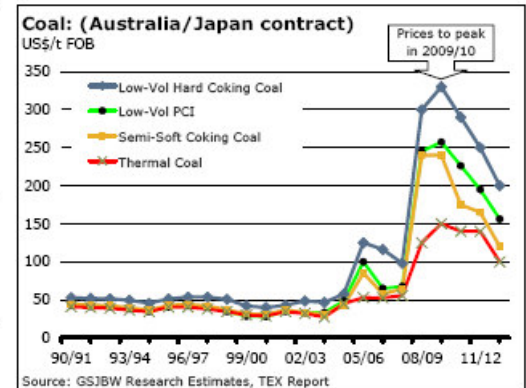
GSJBW Metallurgical Coal Price Forecast:

Table 1:

Metallurgical Coal Price: FOB Australia						
JFY	Hard Coking ⁽¹⁾		Semi-Soft ⁽²⁾		Low-Vol PCI ⁽³⁾	
	US\$/t	% Ch.	US\$/t	% Ch.	US\$/t	% Ch.
2003/04	47	-4%	31	-8%	33	1%
2004/05	58	24%	43	39%	48	46%
2005/06	125	117%	85	100%	100	107%
2006/07	116	-7%	58	-32%	65	-35%
2007/08	98	-16%	64	10%	68	4%
2008/09	300	206%	240	275%	245	263%
2009/10 (f)	330	10%	240	0%	257	5%
2010/11 (f)	290	-12%	175	-27%	226	-12%
2011/12 (f)	250	-14%	165	-6%	195	-14%
2012/13 (f)	200	-20%	120	-27%	156	-20%

⁽¹⁾ premium grade, low-vol brands, 70 CSR and above.
⁽²⁾ typical Hunter Valley brand. ⁽³⁾ Bowen Basin, VM<16%.
 Source: Company data, GSJBW Research estimates.

Chart 1:



Fiscal year 2010 coal price negotiations will provide greater certainty on how much of a contribution to earnings to expect from the resources division beyond 2009. A significant decline in coal prices would reduce group earnings and cash flows, likely resulting in an increase in debt levels to fund group operations/dividends.

Debt position is sustainable despite a somewhat complex structure.....

WES maintains a debt to equity ratio of 46.2%, a substantial reduction achieved following the \$2.5Bn rights issue in April this year. In relation to its debt obligations following the acquisition of the Coles business, WES will have \$1.3b of debt maturing in FY09, \$2.2b of debt maturing in FY10, \$5.1b of debt maturing in FY11 and \$1.1b of debt maturing in longer than 3 years. We are comfortable with the current structure of the company's debt and do not foresee any issues given it is staggered with a relatively long dated maturity profile. The overall cost of debt is approximately 8.5-9% for 2009 if we are to assume credit conditions remain as they are.

Biggest risk over the medium term is the consumer....

Our economics team expect consumer spending to continue to deteriorate throughout CY08. WES operates a number of businesses which will be impacted. However we have largely factored this into our estimates, reflected in our FY09 annualised EBIT growth forecasts of: Bunnings (0%), Target (-13%) and Kmart (-24%).

We also highlight that in light of near term weakness in the share price, and consensus earnings downgrades of circa 10% following the recent profit result, this is effectively priced in at current levels.

Despite risks, the stock is trading at a substantial discount, while WESN provides added price security

WES and WESN are trading at ~33.5% discount to our long term discounted cash flow (DCF) valuation of \$43.19. Despite overall negative sentiment in the market impacting many consumer related stocks, the current Wesfarmers share price presents an attractive opportunity to PWM investors who are willing to be patient.

Ultimately these investors are gaining exposure to:
 The eventual turnaround of the Coles business, where it has already shown signs of stabilising
 Flow on effects to the overall business from leverage to 2009 metallurgical coal prices
 Compelling long term valuation metrics

Investors seeking added security effectively get a 'fee kick' from the WESN price protected shares

Finally, the WESN price protection security, currently trading in line with the underlying WES shares, represents compelling value to investors. There have been some changes to the price protected security since our last research note, namely to the cap and floor price following the entitlement offer in April:

If the two month VWAP for Wesfarmers Ordinary Shares is greater than \$35.14 but less than \$43.92 at the date of the Lapse Notice (approx 3 years away), holders of Wesfarmers PPS will receive a bonus issue of Wesfarmers Ordinary Shares (up to 0.25 Wesfarmers Ordinary Shares per Wesfarmers PPS) such that the total value of Wesfarmers Ordinary Shares received will be \$43.92 (this was previously \$45). If the two month VWAP for Wesfarmers Ordinary Shares is greater than \$43.92, holders of Wesfarmers PPS will not receive any bonus issue.

However, if the two month VWAP for Wesfarmers Ordinary Shares is below \$35.14 on the date of the Lapse Notice there is no additional price protection and Wesfarmers PPS Holders will receive the maximum bonus issue of 0.25 Wesfarmers Ordinary Shares per Wesfarmers PPS (source: company data).

In light of a volatile market, the WESN security provides the same benefits to investors as an ordinary WES share (such as dividends) with the added price protection feature. We would encourage investors to consider these securities given they essentially provide uncapped leverage on the upside (equivalent to the ordinary shares) with protection on the downside.

STOCK RECOMMENDATION SUMMARY			
		Price (\$A)	Recommendation
Code	Name	30-Sep-08	
ABY	Aditya Birla Minerals Limited	\$1.16	BUY
AMP	AMP Limited	\$6.98	HOLD
ANZ	Australia and New Zealand Banking Group Limited	\$18.75	HOLD
AQP	Aquarius Platinum Limited	\$5.87	HOLD
AUB	Austbrokers Holdings Limited	\$4.30	BUY
AUN	Austar United Communications Limited	\$1.13	BUY
AVO	Avoca Resources Limited	\$1.99	HOLD
AWC	Alumina Limited	\$3.07	BUY
AXA	AXA Asia Pacific Holdings Limited	\$5.03	HOLD
BBG	Billabong International Limited	\$13.70	HOLD
BDG	Bendigo Mining Limited	\$0.19	HOLD
BLD	Boral Limited	\$6.12	BUY
BXB	Brambles Limited	\$7.70	HOLD
CBA	Commonwealth Bank of Australia	\$42.62	SELL
COH	Cochlear Limited	\$59.30	HOLD
CPU	Computershare Limited	\$9.30	HOLD
CSL	CSL Limited	\$37.30	HOLD
EQN	Equinox Minerals Limited	\$3.10	BUY
HSP	Healthscope Limited	\$4.60	BUY
IGO	Independence Group NL	\$2.67	HOLD
ILU	Iluka Resources Limited	\$4.70	HOLD
KCN	Kingsgate Consolidated Limited	\$4.64	HOLD
KZL	Kagara Ltd	\$2.77	HOLD
LGL	Lihir Gold Limited	\$2.80	HOLD
MCG	Macquarie Communications Infrastructure Group	\$2.54	BUY
MCU	Mitchell Communication Group Limited	\$0.55	BUY
MQG	Macquarie Group Limited	\$37.00	HOLD
MRE	Minara Resources Limited	\$1.63	HOLD
MWS	Mds Financial Group Limited	\$0.03	HOLD
NAB	National Australia Bank Limited	\$24.26	BUY
NCM	Newcrest Mining Limited	\$27.63	HOLD
ORG	Origin Energy Limited	\$16.11	BUY
ORI	Orica Limited	\$20.95	BUY
OST	OneSteel Limited	\$4.60	BUY
OZL	OZ Minerals Limited	\$1.61	BUY
PLA	Platinum Australia Limited	\$1.60	BUY
PNA	PanAust Limited	\$0.56	BUY
QBE	QBE Insurance Group Limited	\$26.50	BUY
SBM	St Barbara Limited	\$0.29	HOLD
SDM	Sedgman Limited	\$2.15	BUY
SGB	St George Bank Limited	\$28.60	HOLD
SGX	Sino Gold Mining Limited	\$4.18	HOLD
TLS	Telstra Corporation Limited	\$4.18	BUY
TOL	Toll Holdings Limited	\$6.94	HOLD
UGL	United Group Limited	\$12.74	BUY
WBC	Westpac Banking Corporation	\$21.48	HOLD
WDC	Westfield Group	\$16.64	HOLD
WES	Wesfarmers Limited	\$28.48	BUY
WOW	Woolworths Limited	\$27.20	HOLD
WPL	Woodside Petroleum Limited	\$51.00	BUY
WSA	Western Areas NL	\$7.54	HOLD

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