

Four best buys right now

REPORT PUBLISHED FEBRUARY 2011

Figuring out which of the 30 or so stocks on *The Intelligent Investor's* buy list you should add to your portfolio can be a daunting task. If you're grappling with that decision, this special report is for you.

The four stocks in this portfolio, **QBE Insurance**, **MAp Group**, **Metcash** and **AWE**, are not necessarily the most undervalued stocks on our buy list. Rather, they're a collection of good businesses that we think fit together nicely into a fledgling portfolio.

Blue chip industrial | Greg Hoffman

QBE: A classic Buy

A deceptively simple strategy has produced astonishing results. And now QBE is available at an attractive price.

In the insurance game, the policies you don't write are the ones that keep you profitable over the long term. And while no insurance company CEO wants their company to write unprofitable business, there are often incentives for individual employees to write business aggressively.

Try convincing an insurance company salesman to walk away from a contract for the sake of a 5% price reduction when their end-of-year bonus depends on how much premium they write. Yet, averaged over the whole organisation and several years, 5% of income is often the difference between profit and loss for an insurer.

HIH Insurance became Australia's largest ever corporate collapse when it was placed into liquidation in 2001, while in the US, America International Group (AIG) is on government-funded life support after posting the world's largest ever corporate loss, US\$100bn, in 2008. The message is clear; get underwriting wrong and the results can be devastating.

But get it right, as QBE has over the past few decades, and insurance can be a tremendously rewarding business. Investors who backed QBE over the past 20 years are currently nursing a capital gain of more than 10 times their original investment, plus an unbroken string of dividends to boot.

While we don't expect a repeat of this remarkable feat, the odds currently favour an attractive return. But before we turn to QBE's future, let's examine how it has achieved its remarkable past performance.

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KEY POINTS

QBE is one of Australia's highest quality blue chips

It faces clear short term challenges

The group's long term strategy remains sound and its growth opportunities clear

QBE INSURANCE | QBE

PRICE AT REVIEW	\$18.14
REVIEW DATE	28 Feb 2011
MARKET CAP.	\$19.1bn
12 MTH PRICE RANGE	\$16.09–\$22.63
FUNDAMENTAL RISK	2
SHARE PRICE RISK	3
OUR VIEW	BUY

“QBE has a clear culture of discipline, something that’s extremely valuable in the insurance business.”

CHART 1: QBE’S COMBINED OPERATING RATIO (%)

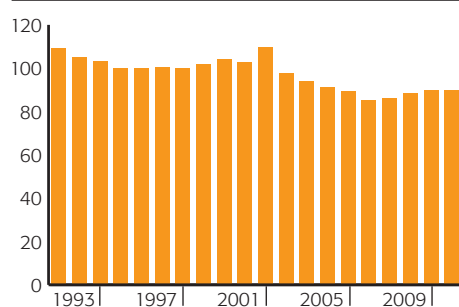


CHART 2: QBE 5-YEAR SHARE PRICE

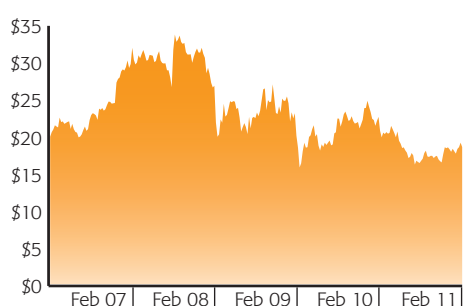


TABLE 1: QBE’S KEY STATISTICS

YEAR TO 31 DEC	2005	2006	2007	2008	2009	2010 (USD)
GROSS WRITTEN PREMIUM (\$M)	9,408	10,372	12,406	13,142	14,455	13,629
NET PROFIT AFTER TAX (\$M)	1,091	1,483	1,925	1,859	1,970	1,278
EARNINGS PER SHARE (C)	142.5	184.8	224.1	207.7	195.6	123.7
DIVIDENDS PER SHARE (C)	71.0	95.0	122.0	126.0	128.0	128.0 (AUD)
FRANKING	50%	60%	55%	20%	20%	12.4%
COMBINED OPERATING RATIO	89.1%	85.3%	85.9%	88.5%	89.6%	89.7%
RETURN ON AVG. SHAREHOLDERS’ FUNDS	23.9%	26.1%	26.1%	20.9%	18.4%	13.0%

In capable hands

QBE has a clear culture of discipline, something that’s extremely valuable in the insurance business. If a deal doesn’t make sense, or a market is overrun with competition, QBE will walk away. If that means losing market share, then so be it.

It’s taken decades but, with a stable management team and substantial inside ownership, QBE has convinced its staff that the long-term profitability of the business is far more important than any single year’s premium income.

TABLE 2: QBE’S TEAM OF SHAREHOLDERS

EXECUTIVE	ROLE	YEARS AT QBE	NUMBER OF QBE ORD. SHARES*	CURRENT VALUE (\$M)
FRANK O’HALLORAN	Chief Executive Officer	34	1,343,769	24.4
NEIL DRABSCH	Chief Financial Officer	19	168,786	3.1
TERRY IBBOTSON	Global Head of Distribution	17	37,866	0.7
VINCE MCLENAHAN	CEO Australia & Asia Pacific	27	266,047	4.8
JOHN RUMPLER	CEO The Americas	13	78,190	1.4
STEVEN BURNS	CEO Europe	12	71,142	1.3
MICHAEL GOODWIN	CEO Asia Pacific	6	15,801	0.3

Source: 2009 annual report and ASX filings

Because of this, QBE continues to be one of the industry’s leading lights in its core business of insurance underwriting, besting even Warren Buffett’s legendary Berkshire Hathaway over the past few years.

For every dollar of premium QBE has received over the past five years, it’s paid out less than 90 cents in claims and expenses—and then it gets to invest those premiums and keep the returns it earns.

This underwriting discipline has seen QBE post an average return on equity of more than 18% for the past eight years. And if it can manage anything like 20% over the next five years (a difficult but not impossible task), then today’s buyer will do very well.

Go forth and multiply

QBE’s breathtaking growth over the long term has centred around a combination of organic (or ‘business as usual’) growth and an extensive list of acquisitions.

At an investor presentation last year, QBE’s respected chief executive officer Frank O’Halloran explained how, under certain conditions, acquisitions made more sense than organic growth: ‘When new business pricing is less than renewal pricing, I can absolutely assure you—and I’m happy to go through slide after slide—organic growth, when you’ve got new business pricing lower than renewal pricing, [that] is a recipe for absolute disaster.’

So, in the years when renewal pricing is greater than new policy pricing, O’Halloran goes shopping for existing insurance books which his expert underwriting team then improves. Individual policies or lines of business are combed through and the duds are either repriced or removed.

QBE has been successfully hoovering up smaller insurers since its 1959 acquisition of Equitable Probate and General Insurance Company, which would later put the ‘E’ in QBE. But with Australia accounting for just 2% of the world’s non-life insurance market, QBE recognised long ago that its future lay offshore.

Overseer

Pursued by most other companies, such a strategy would cause us some anxiety, but QBE has an impressive track record of making acquisitions work; O'Halloran and his team have successfully located and integrated more than 120 acquisitions over the past 25 years.

And it's not over yet. The company has a clear strategy involving further acquisitions, with billions of dollars worth of opportunities 'ex Australia' under consideration (Latin America is firmly on the agenda at the moment, for example).

But while QBE's international diversification has delivered long term gains, it's creating short term pain. And it's for this reason that the stock is currently trading at a knock-down price.

Facing challenges

QBE is currently suffering from the headwind created by the strong Aussie dollar. Most of its revenue is received in US dollars, euros or pounds, and it reports lower revenues and profits when the Aussie dollar rises against these currencies. This is why the group recently announced a switch to US dollar reporting.

Conditions are also quite competitive in many of the company's key markets at the moment. And the past few years have been particularly good ones for the group, making comparisons a little unflattering (like comparing the face one sees in the mirror with one's wedding photos).

Furthermore, investment returns are rather paltry at the moment as the majority of QBE's US\$23.6bn investment portfolio sits in short term deposits and floating rate notes predominantly in Europe and the US where interest rates are currently flat on the floor.

Long term view

Yet we view these as short term issues that are likely to reverse at some point. Indeed, when asked last year when current trends might change, O'Halloran's response was as clear as it was calm: 'It'll happen,' he answered reassuringly, 'but the key is to be patient and wait for it to happen.'

In the meantime, though, gloom surrounding the stock has pushed the dividend yield to 7.1%, mostly unfranked. And management has reiterated that QBE is on track to maintain this dividend level, barring any major change in the state of play. That means today's buyer doesn't need much in the way of capital gains to do nicely from here.

Yet we expect there to be healthy amounts over the years. We'll be surprised if QBE's share price doesn't begin with a 3 (or maybe even a 4 or 5) in a decade's time.

In the interim, the stock could remain out of favour for a while yet. For long-term investors, that presents an opportunity to build our positions and, potentially, reinvest dividends at attractive prices.

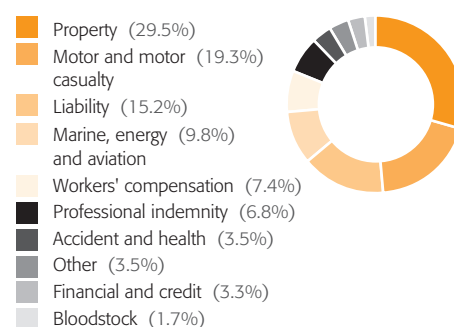
A high dividend yield, a track record of growth and first class management with a significant amount of its own wealth on the line renders QBE a classic buying opportunity for up to 7% of your portfolio. **BUY.**

Note: The model Growth and Income portfolios own QBE Insurance shares.

Disclosure: Interests associated with the author, Greg Hoffman, and other staff members own shares in QBE Insurance.

CHART 3: QBE'S WORLDWIDE PORTFOLIO MIX

Gross earned premium for year ended 31/12/09



Source: QBE annual report 2009

“We'll be surprised if QBE's share price doesn't begin with a 3 (or maybe even a 4 or 5) in a decade's time.”

QBE RECOMMENDATION GUIDE

STRONG BUY	Below \$15
BUY	Up to \$19
LONG TERM BUY	Up to \$23
HOLD	Up to \$34
TAKE PART PROFITS	Above \$34

Blue chip industrial | Gareth Brown

MAp's jet-fuelled future

KEY POINTS

Leverage is the key to MAp's future

We're 90% confident of at least a good outcome for today's buyer

The stock is cheap

MAP GROUP | MAP

PRICE AT REVIEW \$3.05

REVIEW DATE 25 Feb 2011

MARKET CAP. \$5.7bn

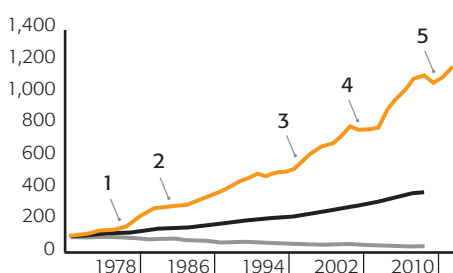
12 MTH PRICE RANGE \$2.55–\$3.38

FUNDAMENTAL RISK 3

SHARE PRICE RISK 3.5

OUR VIEW **LONG TERM BUY**

CHART 1: LONG TERM TRAFFIC GROWTH VS REAL GDP AND REAL AIR FARES



■ Traffic ■ GDP ■ Real airfares

Source: MAp 2009 Results 25 Feb 10

1. Oil shocks (1974–76)
2. Recession (1980–82)
3. Recession + Gulf War (1990–92)
4. S11, SARS + Iraq War (2001–03)
5. Forecast (2009–11)

Gareth Brown explains the multiple ways in which MAp Group benefits from the concept of 'leverage', making this stock an ideal Long Term Buy.

The key to MAp Group's past and future success can be put down to a single word. It's a rather ugly word, freighted with jargon, but it's accurate. That word is leverage, used not in the way of bankers and analysts, referring specifically to debt, but more broadly, akin to the story of Archimedes and his long pole [Hmm...Ed].

Understand an airport's leverage, of which MAp owns stakes in three—30.8% of Copenhagen Airport, 39.0% of Brussels Airport and the crown jewel, 74.0% of Sydney Airport—and the case for or against this stock is easily made. We believe that case is very much 'for'.

More money, more flights

An airport's leverage starts with passenger growth. As Chart 1 shows, over the past 40 years global air traffic has grown at more than 1.5 times the annual rate of real GDP growth (which, as you can see in the chart, compounds into a massive difference over 40 years, with air travel up more than 10 times versus real GDP up less than 4 times). The richer we become, the more we fly.

This leveraged correlation can't hold true forever or we'd all be spending everything on Jetstar (and still wouldn't get a free drink). Eventually, it will move closer to 1:1. But even in relatively rich countries like Australia and New Zealand, the correlation still holds.

And with much of the developing world just starting to fly, passenger growth over the long term is likely to outstrip real GDP growth for many years yet (see *MAp: The Risks* below). That means more and more passengers travelling through MAp's airports, spending more on duty free, takeaway food and parking. Especially parking.

Monopolistic leverage

The second form of leverage concerns an airport's monopolistic nature, especially in Australia where few alternatives to main city airports exist.

Whilst some of MAp's revenues are regulated, like landing charges, the really profitable stuff (parking fees, retail rents and other services) is not. To avoid these charges, passengers have to either drive or spend a day or more in a grubby train. It's the same with retailers. If they want to sell to the lucrative travel market, they have to pay the airport rents. There really is no alternative.

MAp knows this and charges accordingly. Table 1, which uses numbers from Sydney Airport but makes the general point, shows how since mid-2005 revenue per passenger has grown at 3.6% per year whilst the Australian consumer price index (CPI) has risen at 2.9% p.a.

This is despite the acute headwind of a rising Australian dollar, which has seen international passenger growth substantially lag domestic growth (the former generates higher revenue per passenger). Over the long term, revenue per passenger should beat the CPI by an even wider margin.

The combination of passenger numbers growing faster than GDP and revenue per passenger growing faster than inflation leads to rapidly growing revenue. Total revenue at each airport is likely to grow substantially faster than the home economy in which that airport is based. Table 1 shows how the revenue for Sydney Airport has risen almost 8% per year over the past 5^{1/2} years.

Operational leverage

There is little doubt that airports are wonderful assets but the power of airport leverage isn't explained by revenue alone. Operating leverage also plays a big part.

As utilisation of airport assets increases with passenger growth, variable costs tend to grow more slowly than revenue. That's been evident over the past 5^{1/2} years at Sydney Airport. The operating costs-to-revenue margin has fallen from 20.0% in 2005 to 17.7% in the year ended 31 December 2010. This flows through to earnings before interest, tax, depreciation and amortisation. EBITDA has grown at 8.5% per year since 2005, versus 7.9% growth in revenue.

TABLE 1: SYDNEY AIRPORT PASSENGER AND FINANCIAL PROFILE

YEAR TO	JUN 05	JUN 06	DEC 07	DEC 08	DEC 09	DEC 10	CAGR [^] (%)
REVENUE PER PASSENGER (\$)	21.89	22.65	23.86	24.72	25.86	26.52	3.6
CONSUMER PRICE INDEX	148.4	154.3	160.1	166.0	169.5	174.0	2.9
TOTAL PASSENGERS (M)	28.3	29.1	31.9	32.9	33.0	35.6	4.2
DOMESTIC (%)	66	66	67	68	68	68	4.8
INTERNATIONAL (%)	34	34	33	32	32	32	2.9
REVENUE (\$M)	619.2	659.3	760.5	812.7	853.2	943.0	7.9
EBITDA (\$M)	493.3	523.8	607.5	649.4	690.2	773.3	8.5
EBITDA MARGIN (%)	79.7	79.4	79.9	79.9	80.9	82.0	

* Note: Sydney Airport changed its balance date from 30 June to 31 December during this comparison period.

[^] Compound Annual Growth Rate

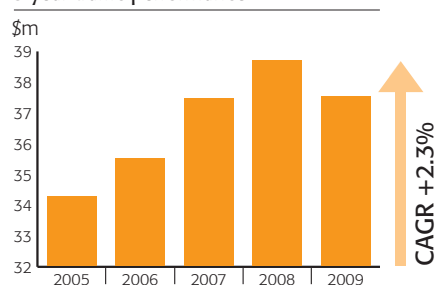
But it is fixed costs that provide the most operating leverage over the long run. Sydney Airport is able to easily fund maintenance capital expenditure. Unlike most businesses, the airport's maintenance capital expenditure tends to be lower than depreciation—an accounting charge on wear and tear on past capital expenditures like runways. In reality, such facilities require little ongoing maintenance spending.

Growth expenditure, on the other hand, does mount up. All those new passengers have to be accommodated somehow. Over the past few years for example, Sydney Airport has massively expanded car park facilities, revamped retail facilities at the international terminal and reinforced runways and gates to accommodate giant A380s.

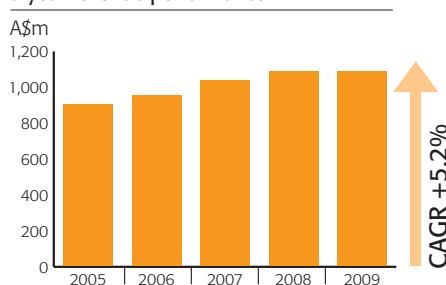
But there's leverage here, too. Investment in new infrastructure is lumpy in nature. But, as passenger use grows, say by 50% over a typical decade, the investment in new infrastructure grows by a lesser percentage because utilisation of existing assets also goes up.

CHART 2: 5 YEAR PERFORMANCE—MAP'S TRACK RECORD OF CONSISTENT DELIVERY

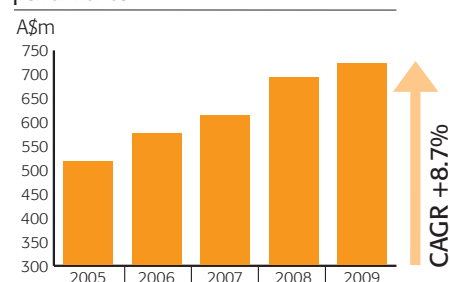
5 year traffic performance¹



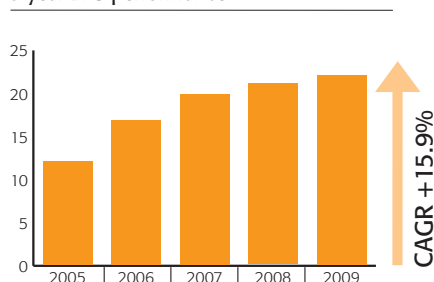
5 year revenue performance¹



5 year EBITDA (post corporate expenses) performance¹



5 year EPS performance



1. Proforma results are derived by restating prior period results with current period ownership interests and foreign exchange rates, and exclude ASUR.

Source: Reproduction of slide 34, MAP ASX release, May 2010

“It is fixed costs that provide the most operating leverage over the long run.”

MAP: THE RISKS

What might bring this analysis undone? This research is partly founded on the prosperous historical relationship between GDP growth and airport passenger growth. There may be a less than 10% chance of this relationship breaking down over the next decade but, due to MAP's inherent leverage—cherished in the good times—anything that damages revenue will lead to a more substantial fall in profits and distributions.

One of those risks is a terrorist attack, be it at one of MAP's airports or elsewhere. If the September 11 attacks are any guide, the impact is likely to be short-lived and growth would revert to trend. But the effects of such unknowns are impossible to anticipate, and a major disruption is conceivable.

Then there's the potential for currently unregulated charges like parking to be regulated. We've seen with the mineral resources rent tax the potential for governments to move against 'super profits', and reregulating or increasing tax on airports is a remote possibility.

Then there's the chance of a sustained global economic meltdown or a huge and continued increase in the price of oil, both of which could break the growth trend in passenger numbers.

These risks can be addressed in two ways. Firstly, we suggest you cap your portfolio exposure to 5%. Secondly, we recommend you diversify your portfolio appropriately. Cash, long-dated government bonds and sturdy utilities such as **Spark Infrastructure** should do comparatively well in any economic meltdown and oil stocks like **Santos** are likely to prosper from higher oil prices.

“It seems very likely that securityholders will earn total pre-tax returns of at least 10–12% per year over the next decade.”

MAP RECOMMENDATION GUIDE

BUY	Up to \$2.80
LONG TERM BUY	Up to \$3.50
HOLD	Up to \$4.80
SELL	Above \$4.80

Airports therefore should become less capital intensive as they grow, with a greater percentage of EBITDA arriving through securityholders' letterboxes as distributions. At Sydney Airport (and we're focusing on it because it represents two-thirds of MAP's asset value) total capital expenditure is actually expected to fall from \$1.3bn over the five years to 31 December 2009 to less than \$1bn over the five years to 2014; a time when EBITDA should rise substantially.

Finally, we come to financial leverage. Despite paying down debt significantly, and having a net cash position at the corporate level (equivalent to roughly 40 cents per security), MAP's underlying investments remain 'geared up'. Sydney Airport has almost \$5bn of net debt and, at current exchange rates, Copenhagen and Brussels have \$1.5bn and \$1.6bn respectively.

These debts mean that as EBITDA grows, cash flow available to pay distributions grows faster still, as the bottom of Chart 2 shows. These pro-forma numbers for MAP, not just Sydney Airport, show that for the four years to 31 December 2009, EBITDA grew 8.7% per year while earnings per security grew 15.9%—resulting from a combination of operating and financial leverage.

The case for MAP

Having explained why airports are such fantastic businesses, all we need to do now is make the case for MAP. That's quite straightforward.

There's a very high probability (greater than a 90% chance we'd suggest) that in a decade the global economy will be larger than it is today, passengers moving through MAP's three airports will grow at an even faster rate and revenue per passenger will, at the least, grow in line with inflation.

Now, recall the effects of operating and financial leverage on that growth. Remembering too that, with an internalised management structure, MAP no longer has to pay excessive fees to **Macquarie Group**. It's therefore highly likely that MAP's distributions will grow at a substantially faster rate than the overall economy.

Last year, ordinary distributions totalled 21 cents per unit, predominately taxable, delivering a pre-tax yield of 6.9%. MAP should be able to pay 23–24 cents in 2011—a prospective yield of 7.5–7.9%—fully backed by operating cash flow.

With further growth in distributions all but 'baked in', it seems very likely that securityholders will earn total pre-tax returns of at least 10–12% per year over the next decade, with a decent shot at 15%-plus total returns (see *Five stocks set to double*, 15 Oct 10).

MAP's security price has barely moved since 25 Aug 10 (*Long Term Buy*—\$2.96), despite having paid a 12.5-cent special distribution and 10-cent final distribution in the meantime. It currently presents an attractive opportunity suitable for almost any type of investor. MAP remains a **LONG TERM BUY** for up to 5% of an intelligently diversified portfolio but, before acting, please read *MAP: The Risks* first.

Note: Both the Income and Growth portfolios own shares in MAP Group.

Disclosure: The author, Gareth Brown, and other staff members own shares in MAP Group. Other staff members also own shares in Macquarie Group, Spark Infrastructure and Santos.

Blue chip industrial | Nathan Bell

Metcash: Top quality, budget price

Metcash is trading within spitting distance of its lowest ever price-to-earnings ratio; it's time to step up.

Dollar-conscious grocery shoppers load up their trolleys when items go on sale. It makes perfect sense; take advantage of low prices and cut your shopping bill.

Stocks are no different. When they're cheap that's the time to load up. And right now independent supermarket supplier Metcash is in the bargain bin.

Asked to name Australia's third largest grocery player, few consumers would answer 'Metcash'. So if you've never heard of this business, don't be surprised. The company commands a 19% share of our national grocery market, as you can see in Chart 1, but it doesn't own a single store. Instead, it licenses the IGA brand to private operators and typically supplies them with more than 60% of their stock, which includes the Black & Gold home brand range.

The IGA network boasts over 1,300 supermarkets, which arms Metcash with bulk buying power over suppliers. In turn, the savings allow operators to drop shelf prices and compete in the same ballpark as Coles and Woolworths—Metcash chief executive Andrew Reitzer has said that Metcash's bottom line would double if it competed on a level playing field with Coles and Woolies.

Size doesn't matter

Unlike its bigger rivals, which typically boast large stores, IGA stores come in a variety of shapes and sizes, including SUPA IGA and IGA X-press. This means they can squeeze into smaller, convenient locations where shoppers are prepared to concede higher prices to get in and out quickly (IGA's prices tend to fall when competing Woolworths and Coles supermarkets enter the neighbourhood). Though the average shopping list is also much shorter, this is Metcash's point of difference; competing head on with its larger rivals would be financial suicide.

Metcash adds value by acting as a central buying agent; armed with the collective buying power of thousands of independent grocers and liquor retailers, Metcash negotiates lower prices with suppliers than store owners could privately.

That Metcash is merely a supplier and doesn't own or lease any bricks and mortar is both a curse and a blessing. It means Metcash is less profitable than Woolworths, for example, as you can see in Chart 2 (over the page), as it splits the margin between the cost and shelf price with store owners (Woolworths and Coles keep every dollar); this allows operators to earn a healthy return and reinvest in their stores. But there's always a risk that renegade shopkeepers join an alternative buying group or bravely choose to go it alone.

On the flipside, however, Metcash has grown quickly because it hasn't had to develop its own store network, which takes time and large licks of capital; Metcash can add new stores at the cost of a phone call. That IGA carries a relatively narrow product range also means Metcash deals with fewer suppliers and products, which creates storage and distribution efficiencies.

Better still, management is shareholder friendly. Though Reitzer typically cashes in his company options, he runs Metcash like he owns every share. For example, practically all profits are distributed as fully franked dividends and, in a far-sighted move reminiscent of Woolworths, last February Reitzer served notice that he will retire in three years to ensure there's a smooth transition at the top (though we'd prefer it if he stayed).

KEY POINTS

Metcash hasn't offered such good value in years

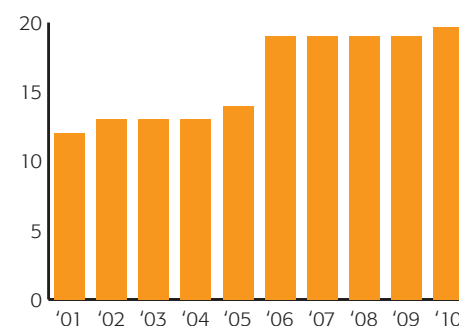
The company enjoys a profitable niche between its two larger rivals

A large fully franked dividend will make up much of the overall return

METCASH | MTS

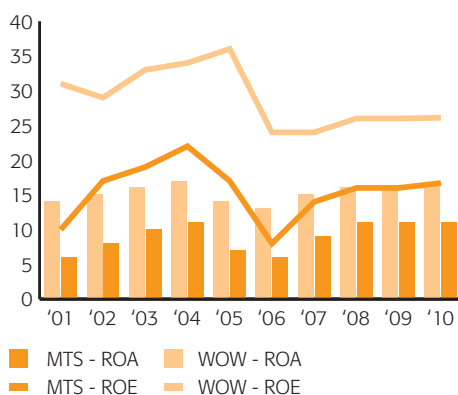
PRICE AT REVIEW	\$4.06
REVIEW DATE	25 Feb 2011
MARKET CAP.	3.1bn
12 MTH PRICE RANGE	\$3.84–\$4.57
FUNDAMENTAL RISK	2.5
SHARE PRICE RISK	3
OUR VIEW	LONG TERM BUY

CHART 1: METCASH GROCERY MARKET SHARE (%)

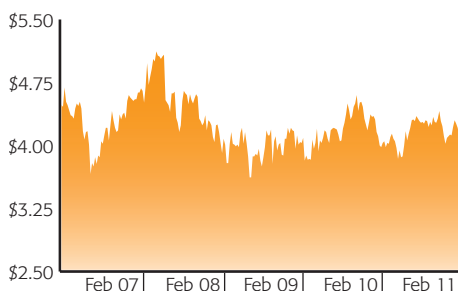


Source: Metcash annual presentations

“Metcash adds value by acting as a central buying agent; armed with the collective buying power of thousands of independent grocers and liquor retailers, Metcash negotiates lower prices with suppliers than storeowners could privately.”

CHART 2: METCASH VS WOOLWORTHS (%)


Source: Metcash and Woolworths annual reports

CHART 3: MTS 5-YEAR SHARE PRICE


MTS RECOMMENDATION GUIDE

BUY	Up to \$3.60
LONG TERM BUY	Up to \$4.50
HOLD	Up to \$6.00
TAKE PART PROFITS	Above \$6.00

PORTFOLIO POINT

Metcash is a high quality company but, as its Long Term Buy recommendation indicates, it's not a bargain. We recommend a weighting of no more than 5%, which allows room to buy more should its share price fall.

Price check

So why is Metcash trading at a knock down price? Firstly, analysts prefer growth stories, like Coles, as they're far easier to sell to brokerage clients.

Metcash has increased earnings per share (EPS) 25% annually since 2001, when it commandeered the sinking retail ship Davids and orchestrated a phenomenal turnaround. But it's now approaching middle age, as the supermarket industry is mature and suitable locations are diminishing.

Early on, Metcash's share of the grocery market increased in leaps and bounds, but it has meandered since carving up Foodland with Woolworths in 2005, as you can see in Chart 1 (on the previous page). From here, Metcash's growth will reflect how successful it is in achieving its aim of supplying 80% of its customers' stock, by expanding its IGA Select range and delivering more fresh produce and meat from its new distribution centres.

However, like rinsing grey hair with Restoria Express, Reitzer is aiming to stall the ageing process with acquisitions.

Shopping list

The recently attempted acquisition of the New South Wales Franklins grocery chain was an opportunity for Metcash to breathe new life into some underperforming supermarkets, in turn creating value for shareholders. Disappointingly, the deal was knocked back by the consumer watchdog, the ACCC. There's still a small glimmer of hope but, as the grocery market is mature, future opportunities for these types of deals will be rare.

Metcash is also sounding out opportunities in overseas markets. Though, having abandoned a joint venture in the Philippines in 2003, we'd prefer Metcash remained twice shy. We'd take stock and reassess if the company announced a material overseas acquisition.

We're also sceptical of the \$55m paid for a 50.1% stake in hardware co-operative Mitre 10 (Metcash also has an option to purchase the remaining 49.9% in 2012 or 2013).

Mitre 10 has buckled under the weight of Bunnings Warehouse's lowest price guarantee, and it might be squashed flat by Woolworths' joint venture with Lowe's. We're not overly concerned, though, as the investment is relatively minor and failure wouldn't likely have a lasting impact on Metcash's healthy balance sheet.

Quiet achiever

While limited growth options mean Metcash won't repeat the returns of the past decade, we're not prepared to write off a company that ranked among Australia's 10 best businesses just yet.

The grocery business is still minting cash and, while management have backed away from previous guidance of 6–8% EPS growth, it still trades on an attractive forecast PER of 12.4.

But today's investor doesn't need much growth to do well given the fat fully franked dividend yield of 6.3%. And, given these dividends will likely make up the bulk of our overall return, this stock will likely appeal to income investors.

Though we're comfortable with leisurely earnings growth, provided Metcash defends its competitive moat and the dividend cheques keep turning up, our greatest fear is that Reitzer—or his replacement—does something drastic and risky to stoke the growth fires, but we'll cross that bridge if and when we come to it.

If you're after a high quality business boasting a healthy yield, Metcash is a great stock to add to your shopping basket. **LONG TERM BUY.**

Note: The Income portfolio owns shares in Metcash and Woolworths.

Disclosure: Staff, including James Greenhalgh, own shares in Metcash.

Second line resource | Gaurav Sodhi

Back to ABC for AWE

With its last four wells ending in dry holes, Gaurav Sodhi explores what's next for this fallen star.

Producing oil has two opposing effects on the fortunes of an oil company; every barrel of production converts oil resources into hard cash, but it also bleeds the company of an asset. You can't have your cake and eat it too, as they say.

A key consideration for producers, therefore, is how to balance production and reserves. Falls in the share price of AWE suggest the company has this balance wrong.

We should not lightly dismiss the market's concerns. AWE's production profile is indeed in decline. But having grown from a \$20m minnow to a billion dollar producer in a little over a decade, AWE has established a track record that demands respect.

A key question remains to be answered; are recent falls in the share price a harbinger of things to come, or do they represent an opportunity?

A new hope

In 2005, AWE sanctioned the Tui project in the Taranaki Basin, offshore New Zealand. Just two years later, the project was producing oil at astonishing rates of 50,000 barrels of oil per day (bopd) (AWE's share is 42%) from a relatively small 25mmboe field.

Only 10 years ago offshore projects had payback periods of 10–15 years. The Tui project broke international records, taking just three months to pay back its initial investment—twice as fast as BHP Billiton's Shenzi field in the Gulf of Mexico, the next quickest. The project was upgraded last year and is now expected to produce about 50mmboe over its life—double initial estimates.

Naturally, Tui caused AWE's production profile to spike markedly. The production decline that so concerns the market is really just a return to normal levels after this sensational success. As Chart 1 shows, AWE will continue to produce steadily until at least 2020 with its current asset base, a situation that is far from crisis ridden.

Although the market is worried about AWE's reserve position, we do not share those concerns. Having started the 2010 financial year with 68.9 million barrels of oil equivalent (mmboe), AWE ended it with 77.9 mmboe, and contingent resources (See Shoptalk) have grown to 57 mmboe, suggesting there is further growth to be pursued.

It's not the quantity but the quality of AWE's reserves that concern us. As the high margin Tui field declines, reserves are being replenished with lower value gas.

The BassGas project in the Bass Basin now houses the bulk of AWE's reserves (see Chart 2). Unfortunately for shareholders, east coast Australia is well supplied with gas and prices hover at a lowly \$4 a gigajoule (gj). BassGas is a large and stable cash generator, but it's more Ford than Ferrari; a way to get from A to B without excitement.

This is not to say that gas is not worth sniffing out; production from AWE's Perth Basin assets, for example, is persuasively profitable. The challenge AWE faces is to invest these strong and stable cashflows into the right new production ventures.

Shale putsch

In its onshore Perth Basin tenements, AWE may have found the perfect candidate.

Beneath the Perth Basin lie enormous swathes of porous shale-like rocks which, if saturated with gas, could be a major new asset for AWE. The acquisition of Adelphi was important not because of its size; AWE retains just 10% of Adelphi's major asset, the Sugarloaf shale gas field, but because it grants AWE access to vital shale production technologies which may help it realise greater riches in the Perth Basin.

We have been cautious about shale gas commercialisation on the east coast because of low gas prices. The Western Australian gas market, however, is an entirely different prospect.

The burgeoning LNG industry, with its attractive oil-linked prices, has sucked in huge

KEY POINTS:

AWE has had a disappointing year with the drill bit

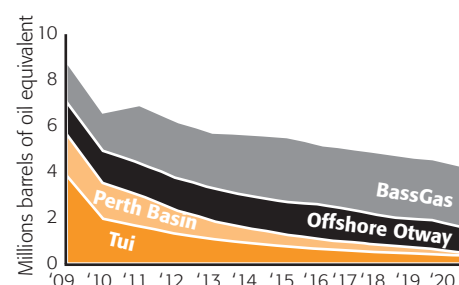
The market is concerned about a declining production profile

There is value and potential at current prices

AWE | AWE

PRICE AT REVIEW	\$1.63
REVIEW DATE	25 Feb 2011
MARKET CAP.	\$853m
12 MTH PRICE RANGE	\$1.47–\$2.89
FUNDAMENTAL RISK	4
SHARE PRICE RISK	4
OUR VIEW	SPECULATIVE BUY

CHART 1: AWE PRODUCTION PROFILE 2009–2020

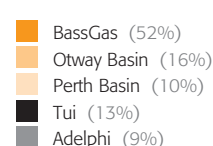


Source: AWE 2009 annual report

SHOPTALK

Contingent Resources: Contingent resources refer to the additional oil and gas estimated to be recoverable from known accumulations above and beyond established reserves. They are not currently considered commercially viable, often because of a lack of marketing, transport or other political or environmental obstacles.

CHART 2: AWE'S RESERVES BY FIELD



Source: Company accounts, 2010

TABLE 1: AWE'S TOTAL VALUE PER SHARE

LIQUIDS ASSETS	\$1.26
GAS ASSETS	\$0.78
CASH	\$0.12
CONTINGENT RESOURCES	\$0.22
CORPORATE COSTS	(\$0.19)
TOTAL	\$2.19

AWE RECOMMENDATION GUIDE

SPECULATIVE BUY	Up to \$2.00
HOLD	Up to \$3.00
SELL	Above \$3.00

volumes of gas, leaving the domestic market relatively neglected. WA thus has the highest gas prices in the country, hovering around \$8–9/gj and threatening to go higher.

AWE has already announced that it had found recoverable shale gas of about 4 trillion cubic feet (Tcf), or about the same volume as Woodside Petroleum’s renowned Pluto field. There is more testing to be done, but we believe the WA gas market provides a lucrative business for AWE.

For what it’s worth

Even with the succession of expensive dusters in the past year, we believe AWE is still worth in excess of \$2 per share (see Table 1). And that takes no account of exploration success in Yemen where the company may have unwittingly stumbled on an oil find (it was looking for gas). The huge shale gas potential could add \$1 to \$2 to the share price over time, although its development is no sure thing.

There is no doubt that AWE has disappointed this year. But the qualities that first attracted us to this fallen star still shine; high cash generation, stable production and an exploration hunger that has not yet been sated. Although investors will still require patience and a healthy acceptance of risk, AWE remains an attractive SPECULATIVE BUY.

Note: The model Growth portfolio owns shares in AWE

Disclosure: The author, Gaurav Sodhi, and other staff members own shares in AWE.

IMPORTANT INFORMATION

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