

# The Leading Edge

In this edition of The Leading Edge we consider the outlook for equity markets in light of the divergent trends we are seeing between western and emerging economies.





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Australian Leaders Fund Limited (ALF) is a listed investment company focusing on the largest 200 listed Australian companies. ALF has a long standing agreement with Watermark Funds Management Pty Ltd as the external manager of the investment portfolio (formerly Braitling Investments Pty Ltd).

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The home exchange is Sydney.  
ASX code: ALF Ordinary shares  
ALFO Options

In this edition of *The Leading Edge* we consider the outlook for equity markets in light of the divergent trends we are seeing between western and emerging economies.

While overall global growth has been quite robust, strength in China and other developing countries has masked weaker activity elsewhere. We have held the view for some time that share markets would struggle to escape the poor fundamentals in the US and Europe impeding overall returns.

As economic news in the US and Europe has not been as dire as many feared and with China engineering a modest slowdown, markets have staged a strong recovery since September. The rally has been further fuelled by the prospect of additional monetary stimulus via asset repurchases from central banks in the US, United Kingdom and Japan.

While we retain a cautious view of equity markets given the soft economic outlook in the developed world, we have been overly cautious in our cash weighting and security selection which has held back performance in the short term.

### A two speed global economy:

We have clearly moved into a different economic environment. One of two speed economies, not just on a global scale but domestically in Australia as well. Economists are forecasting continuing strong growth in key emerging economies of between 5-10%, in sharp contrast to ongoing weakness in advanced economies that are crawling forward at just 2%-3%. This level of growth in the west is insufficient to create jobs, so unemployment levels are set to stay stubbornly high for some time undermining overall confidence.

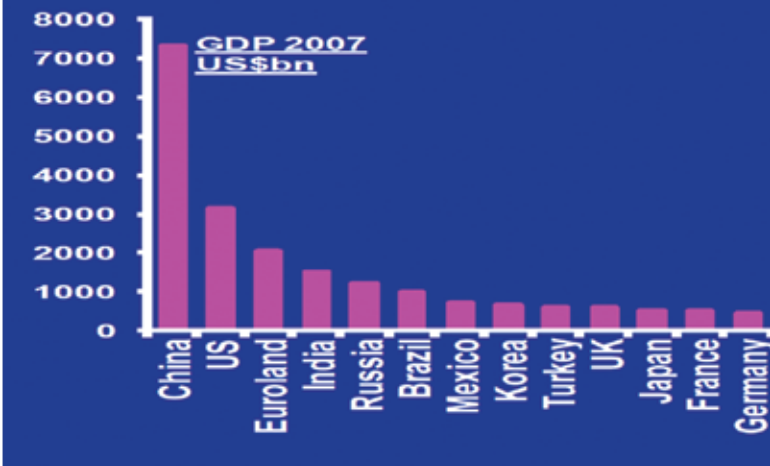
While at an aggregate level global growth will be healthy, western countries will not be participating. When we consider the outlook for the corporate sector, profit growth will be subdued, limiting overall equity returns.

The prospects for Australia are far brighter given demand from Asian trading partners and investment in the mining sector. Australian equity markets however are likely to follow trends offshore and thus any outperformance of Australian shares may be limited.

To fully appreciate the scale of change we are witnessing in economic leadership, one should consider the contribution to global growth coming from emerging Asia in the next 10 years (Fig 1). No European country even features in the top 10, and China is expected to contribute more than the US and Europe combined. This is a complete reversal from the past 10 years when the US and Europe accounted for the lion's share of global growth.

CONTRIBUTION TO GLOBAL GDP (\$USD)  
FROM 2010-2019

FIG 01



## GS Research

Behind these aggregate numbers an important shift in composition is also taking place, with domestic consumption in China and India overtaking fixed asset investment as the key driver of growth. Private consumption growth in these emerging economies will be more important going forward than private sector demand in the west.

In October the Chinese Communist Party released a preview of its 12th Five Year Plan, with the central theme being a “rebalancing of demand, with emphasis on stimulating consumption relative to export and investment”.

This outlook may well change if advanced countries miraculously resurrect their faltering economies. Economists fear we may enter a liquidity trap, similar to the Japanese experience in the 1990’s where low growth and deflationary trends become the order of the day. Evidence of this can be seen in the banking sector where balance sheets are shrinking in spite of highly accommodative financial conditions.

The legacy of the “Great Recession” in the US is an unprecedented burden of debt on both the private and public sectors (Fig 2); unemployment at 10%; and a housing sector stuck in a quagmire, with 6 million loans in various stages of foreclosure. Any recovery in the US will falter until we see a sustained improvement in employment, indebtedness and housing.

US DEBT TO GDP, BY SECTOR

FIG 02



On a positive note, activity in key cyclical parts of the economy; housing, construction, automotive and business equipment are at such depressed levels, demand is unlikely to fall further. So while we would not expect the US to slip back into recession, growth will be muted for some time to come.

Equity markets are putting enormous faith in the Federal Reserve's latest efforts to stimulate growth with the central bank expanding its balance sheet by printing new currency and buying longer dated securities to lower the cost of borrowing. We are in a perverse situation where the US Treasury is issuing bonds to finance a sizable fiscal deficit while the central bank is buying bonds back to stimulate private sector borrowing.

If the US is in some kind of liquidity trap as some noted economists would suggest, quantitative easing will have a modest impact on growth at best. Analysts have equated a \$1 trillion asset purchase program to a 25 basis point reduction in cash rates - hardly a game changing event.

We only have to observe the impact of further quantitative easing on financial markets to appreciate the ongoing role US financial conditions will play in international capital markets. The transmission of financial conditions in the US to international markets will be more important in this new global environment than underlying trends in the US economy.

In Australia we are also returning to a two speed economy, with a resumption of strong growth in the mining states contrasting with weakness elsewhere. This will manifest in a dichotomy across sectors and industries as well. While business investment is recovering, growth in household spending is likely to be restrained by tightening monetary policy.

The Reserve Bank action in raising rates further in response to "the large expansionary shock from the terms of trade" (November policy statement), is a clear sign of the strength the central bank sees emerging.

In spite of this favourable outlook, growth in private sector demand has not recovered as quickly as one might expect. In Fig 3 we can see that both consumption and business investment are weak notwithstanding strong confidence levels and elevated investment intentions.

PRIVATE FINAL DEMAND

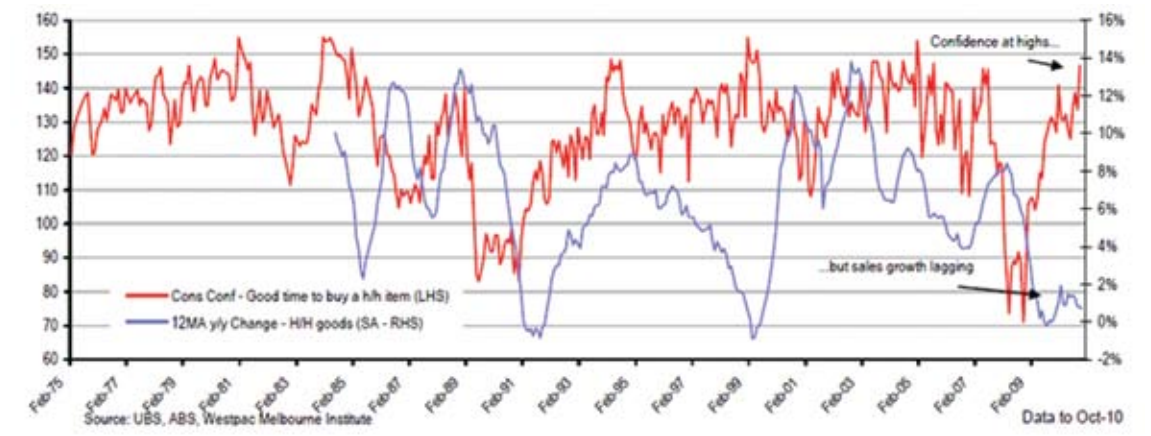
FIG 03



Households continue to act cautiously, even though consumer confidence has returned to peak levels (Fig 4). A surge in business investment expected to follow elevated investment intentions is yet to materialise (Fig 5). This set up looks encouraging, if we can just sustain a period without further financial shocks, the economy should strengthen further moving into 2011.

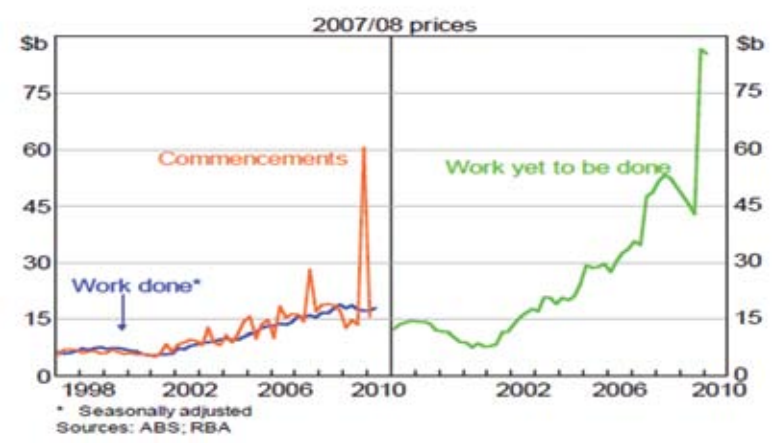
CONSUMER CONFIDENCE AND RETAIL SALES

FIG 04



PRIVATE NON-RESIDENTIAL CONSTRUCTION

FIG 05



We would expect to see a strong recovery in household spending as household income is rising with labour markets tightening considerably (Fig 6). Treasury forecasts have unemployment falling to 4.5% which is very low so early in the global recovery.

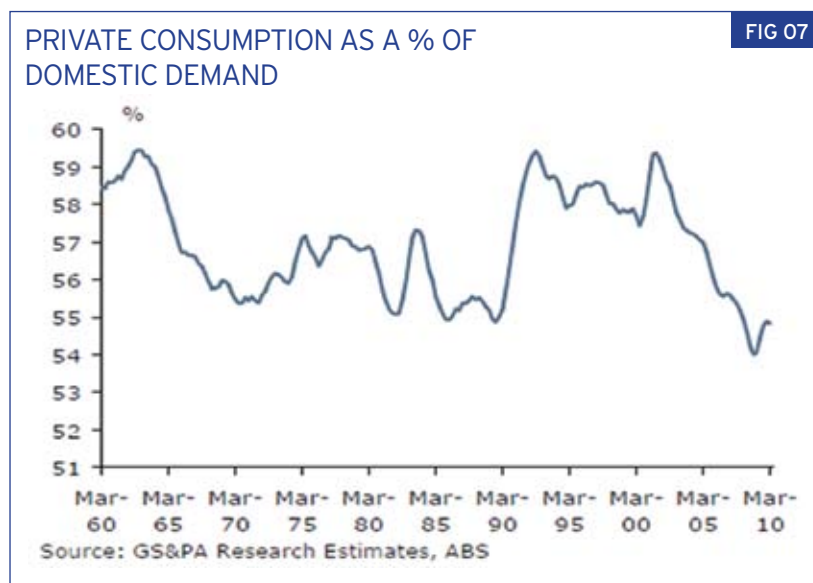
Minimum wage increases of 4.5% set by Fair Work Australia will quickly flow through to awards as remuneration “catches up” following years of wage restraint. With industrial action picking up in a number of sectors, there is an emerging risk of a sharp uplift in wages.

**STRONG GROWTH IN HOUSEHOLD INCOME.** FIG 06

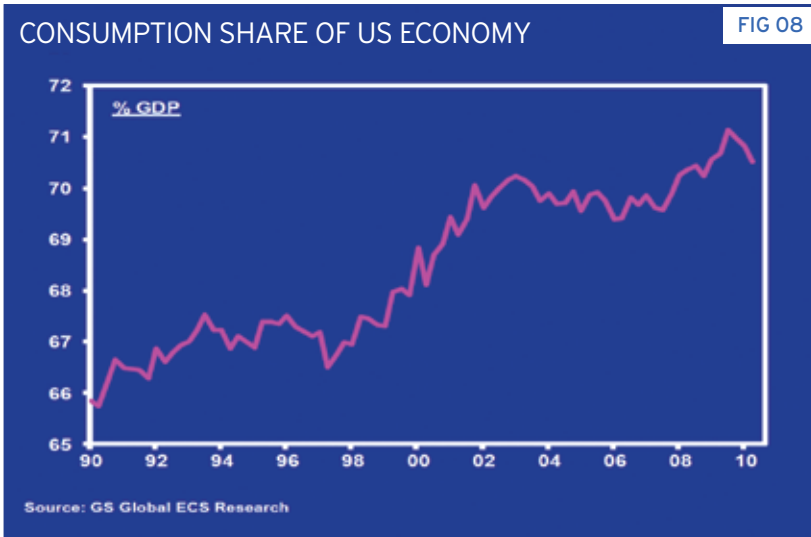
<b>Decomposition of compensation of employees</b>					
	2006	2007	2008	2009	2010 (f)
Number of Employees	3.1%	3.6%	2.9%	0.7%	2.3%
Compensation per hour	3.0%	2.9%	1.4%	2.1%	3.0%
Hours worked	2.1%	2.6%	3.2%	-0.8%	2.2%
<b>Compensation of Employees</b>	<b>8.2%</b>	<b>9.1%</b>	<b>7.5%</b>	<b>2.0%</b>	<b>7.5%</b>

Source: ABS, GS&PA Research estimates

It is a myth that Australian households spend beyond their means. The savings rate has risen to the highest level in 20 years as households have retired debt. Consumption as a share of the economy has fallen to the lowest level in 50 years (Fig 7). Given strong income and wealth trends noted above, we believe there is scope for household spending to stage a strong recovery even as monetary policy is tightened further.



Households in the US are in a very different predicament. Having spent the surplus capital from the housing bubble that eventually burst, consumption as a percentage of the economy (Fig 8) needs to shift back to sustainable levels. This will be a significant drag on growth.



Turning to the Australian corporate sector, we find businesses have also been cautious, reducing gearing and deferring investment decisions. Uncertainties around the new mining tax and the election have led to delays in a number of large projects. Encouragingly, we are now starting to see real progress on the backlog of projects. Our discussions with contractors, who have been frustrated by these delays, give us cause for hope that large orders are about to be awarded.

As we move into 2011 we would expect to see activity levels strengthen in the domestic economy. However as monetary policy continues to tighten, the recovery may be left wanting in some parts of the economy.

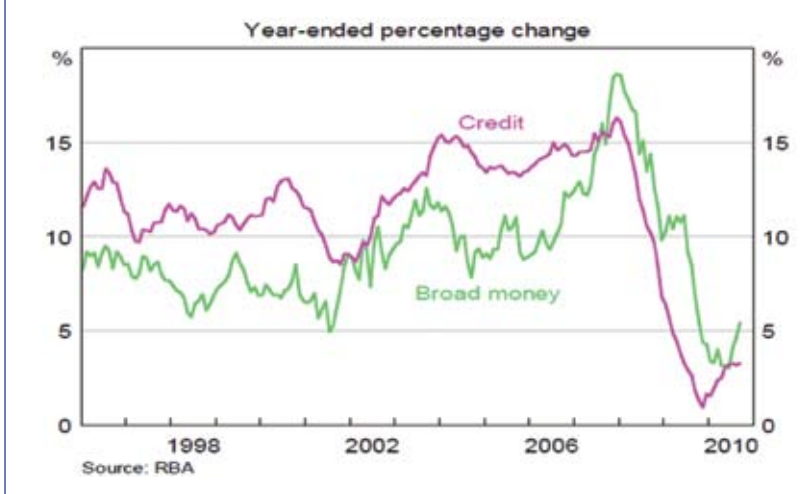
## The Australian Banking Sector

The major trading banks have released their annual results and many of the concerns highlighted in the May Quarterly Report are starting to play out. As loan losses have normalised, the banks have emerged from the GFC into a period of softer growth.

Demand for credit is surprisingly weak. Businesses have been retiring debt post the GFC and mortgage origination has been soft even as the housing market has strengthened. At the same time interest margins are under pressure as the banks struggle to pass on higher funding costs to customers.

MONEY AND CREDIT

FIG 09



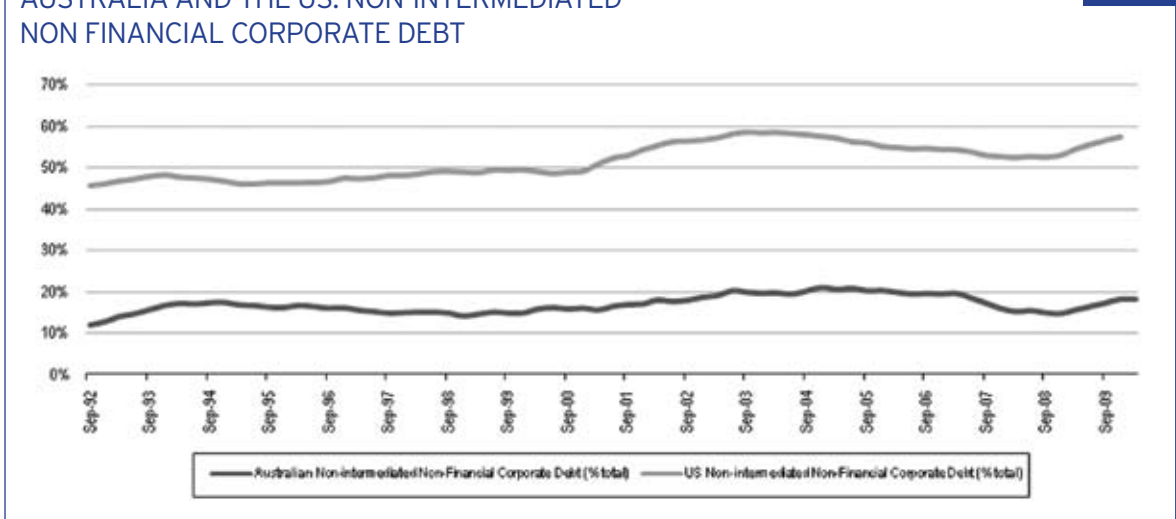
Subdued demand for credit post GFC

Business lending has been particularly weak as companies continue to act cautiously. While small businesses have continued to borrow, access to credit has been more challenging in the post GFC environment. Many of the larger companies on the other hand have reduced bank debt, either by raising equity or by taking advantage of lower rates offshore.

This disintermediation of traditional banking relationships will continue with larger companies electing to raise money directly in private placement and bond markets circumventing the local banks. In most western countries, large companies prefer to access capital markets directly. In Australia the banks armed with AA credit ratings have historically raised debt on behalf of corporate customers (Fig 10). This funding short-fall is at the heart of our current account deficit. As we don't have an established domestic bond market, Australian banks raise funds offshore and extend loans to the corporate sector.

AUSTRALIA AND THE US: NON-INTERMEDIATED NON FINANCIAL CORPORATE DEBT

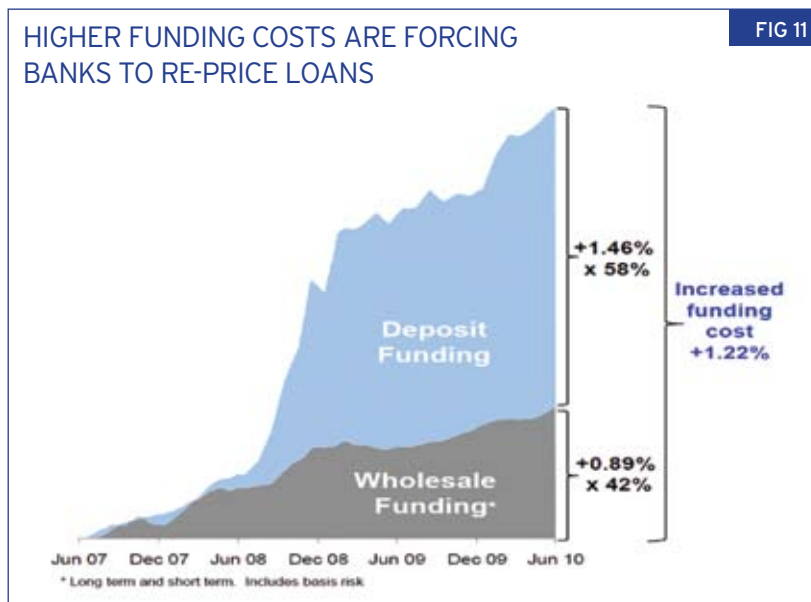
FIG 10



While mortgage lending has been stronger, it is well below pre-GFC levels. With housing affordability back at record lows and Australian property considered overvalued on most measures, mortgage growth is likely to be weaker in future.

### Interest margins under pressure

Funding costs have risen for two important reasons. Firstly, risk spreads in the post GFC world are much higher, so as banks refinance cheap pre-GFC debt, the average cost of funds increases. Secondly, in response to the crisis, banks have lengthened the term of their wholesale debt maturities and reduced their dependence on offshore funds by raising deposits. Longer term debt is more expensive and deposit margins have been bid up as banks compete aggressively for this prized source of funds (Fig 11).



### CBA Full Year Result

In response to claims in the media that banks are gouging mortgage lenders, you may be interested to discover that business customers are bearing most of the burden of higher funding costs. Mortgage margins are still very competitive.

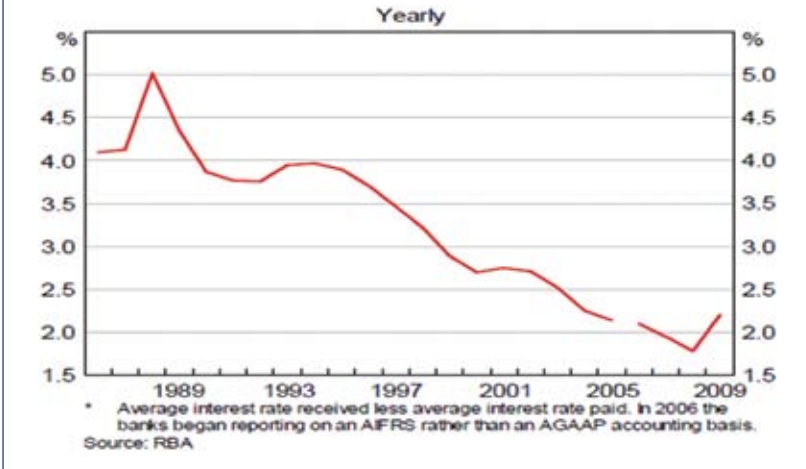
Banks profit from the margin they receive between their cost of raising funds and the rate charged on loans; The standard variable rate (SVR) for a home lender and a spread over the Bank Bill Swap Rate (BBSR) for business loans.

Margins have been contracting for 20 years following banking deregulation in the 1980's and the emergence of securitisation markets which allowed non-bank intermediaries and regional banks to compete with the majors (Fig 12).

With the collapse of securitisation markets and the withdrawal of offshore banks, margins have ticked up modestly. As funding costs have increased, banks have had to reprice their asset

AUSTRALIAN MAJOR BANKS' DOMESTIC INTEREST SPREAD

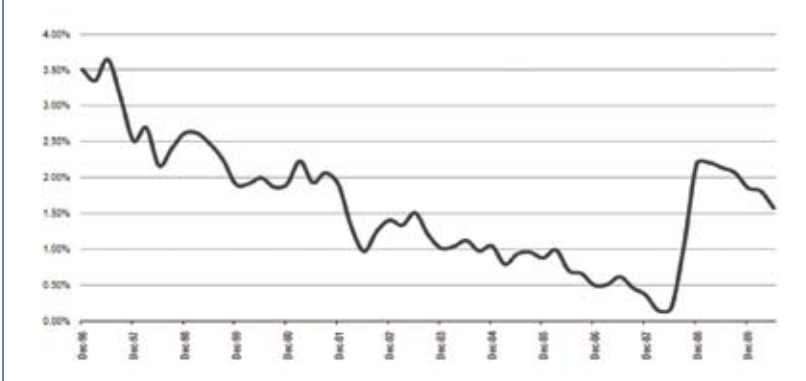
FIG 12



portfolios (loans). Looking at Fig 13 and 14 you can see that businesses having actually carried the brunt of additional funding costs and mortgagees have got off relatively lightly. This is what you would expect to see given losses incurred through the financial crisis were on business loans, mortgage portfolios performed very well and typically carry little risk of default.

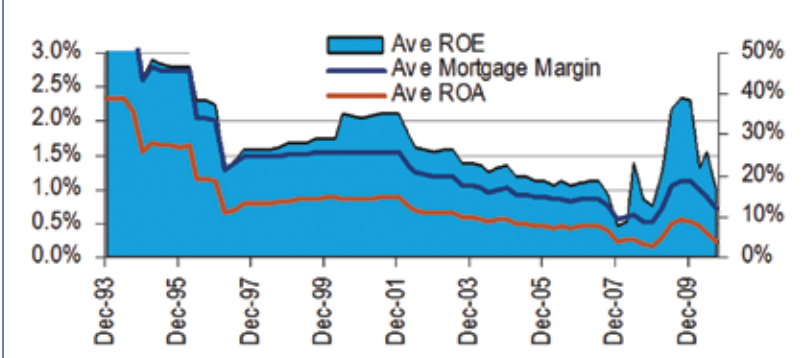
LARGE BUSINESS LOAN SPREAD TO THE 90 DAY BANK BILL RATE (1996- CURRENT)

FIG 13



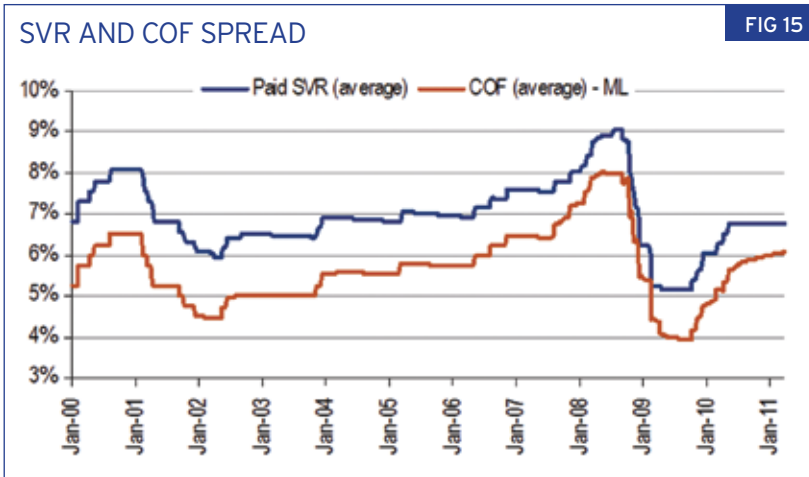
MARGINS AND RETURNS ON MORTGAGES

FIG 14



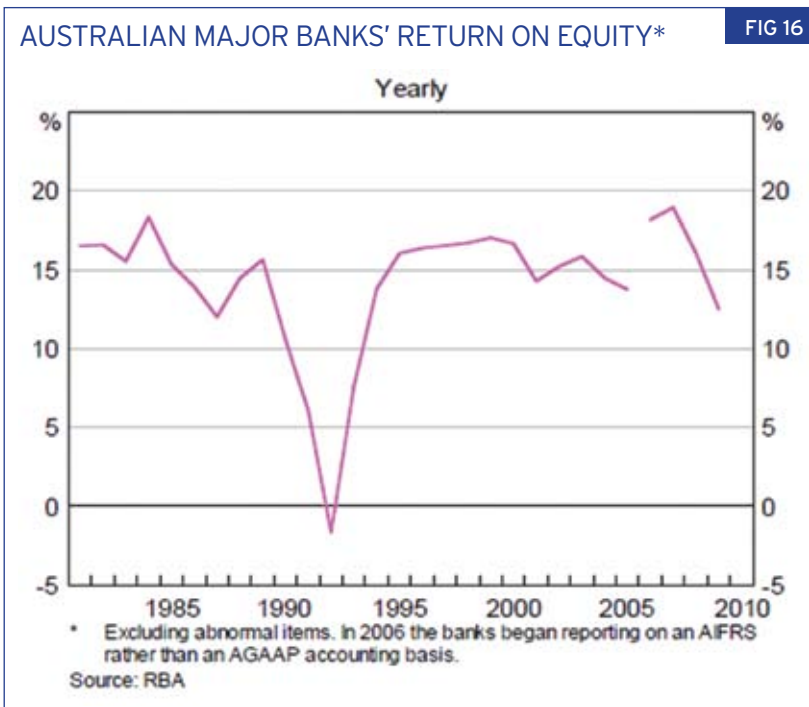
ML Research

Alternatively you can see from fig 15 the spread between the SVR and the average cost of funds (COF) has narrowed consistently over the last decade as mortgage lending has become more competitive.



### ML Research

The easiest way to evaluate the reasonableness of margins charged to lenders is to consider the returns banks generate over time. Fig 16 reveals that while banks have made attractive returns through the cycle, higher than other industrial sectors, returns are hardly exorbitant and in part reflect the higher risks in banking. Remember Westpac and ANZ barely avoided bankruptcy in the early 1990's.



## Capital requirements becoming clearer

The uncertainty that surrounded proposed Basel III capital requirements has been partially clarified following the release of the revised framework stipulating a minimum 7% Tier 1 capital ratio. The banks have plenty of time to move to the new settings given a proposed transition timetable from 2013 to 2019.

Prima facie, the major Australian banks emerge well placed under the draft Basel III standards, but it is likely that APRA will set a higher capital requirement for Australian banks than the minimum required under Basel III. This uncertainty will rule out potential capital management for some time until the regulatory regime has been clarified, although in the longer term some scope may still exist for capital management.

## Implications of a possible housing bubble for the banking sector

Some offshore investors are speculating on a housing bubble in Australia enveloping the banking system, an outcome not dissimilar to the events that lead to the GFC in the US housing market. Recent media reports in the Wall Street Journal and the Financial Times have also raised the spectre of a pending housing crisis. In light of this speculation, we consider the implications of a housing bust for the banking sector.

Mortgages account for roughly half of all bank loans outstanding. With such exposure comes an increased degree of risk, more so if residential property is overvalued. The performance of this key asset class is pivotal for the banks.

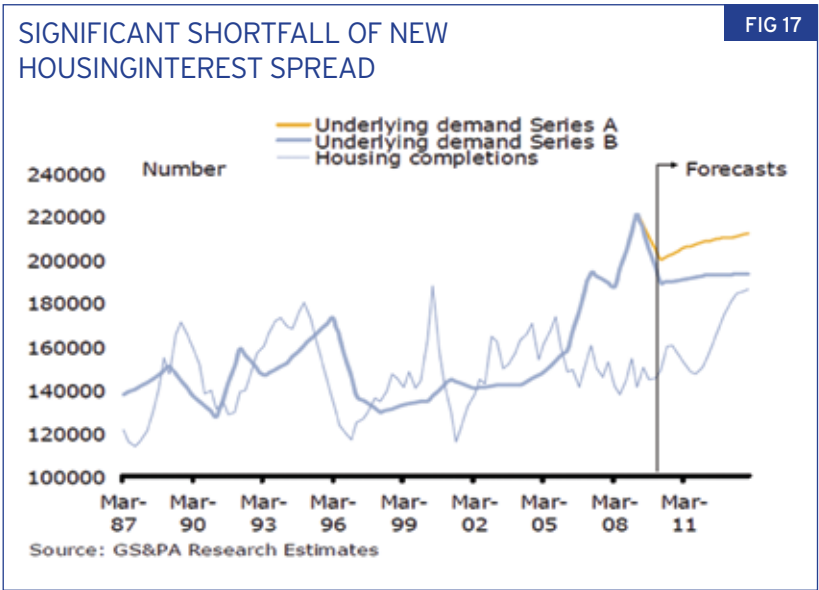
Property devaluation and deteriorating arrears may impact the bank's ability to access wholesale funds offshore, increasing the cost of servicing mortgages and therefore further exasperating loan delinquencies. This scenario highlights two key risks to the banking system: over priced assets (in this case real estate) and a dependence on offshore funding which may be withdrawn.

This is a highly stressed scenario and is fairly improbable in light of an improving economic outlook. While returns in housing are likely to be lower going forward, we don't foresee a collapse in real estate any time soon.

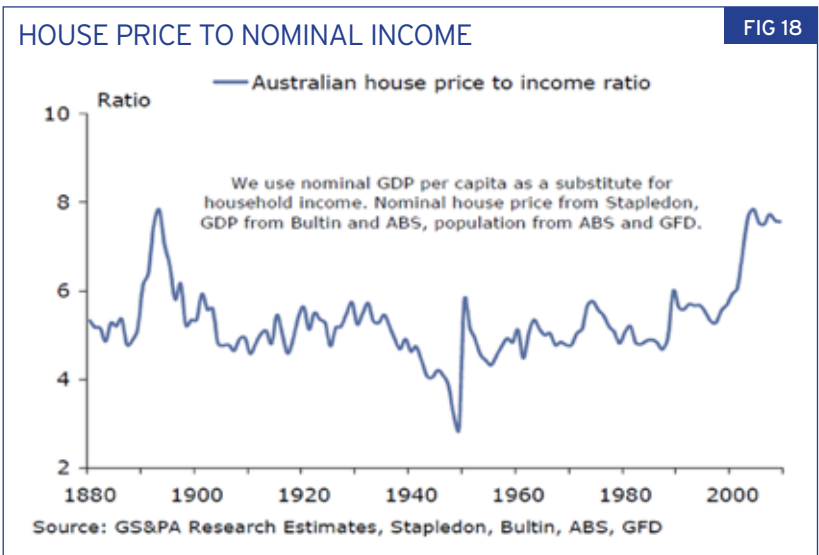
Property prices have been driven higher by a chronic shortage of housing, financial deregulation, and increased mortgage competition. Together these factors have seen mortgage lending grow at well over 10% pa for an extended period. The number of loans written has not actually increased meaningfully; asset inflation has been the key driver of credit growth in the sector.

Housing affordability has reached historic lows, due in part to unremitting undersupply that stems from high population growth and poor planning by state and local councils. Given current population trends underlying demand for new housing is running at 190,000 while completions are falling well short at just 145,000 last year (Fig 17). By 2012 the national housing shortfall will have risen to a quarter of a million homes.

This shortfall and the availability of cheap credit have pushed prices higher over the last decade. According to the Australian Bureau of Statistics, Australian house prices have risen 11.5% over the past year, 50% over the past 5 years, and 165% over the past 10 years.

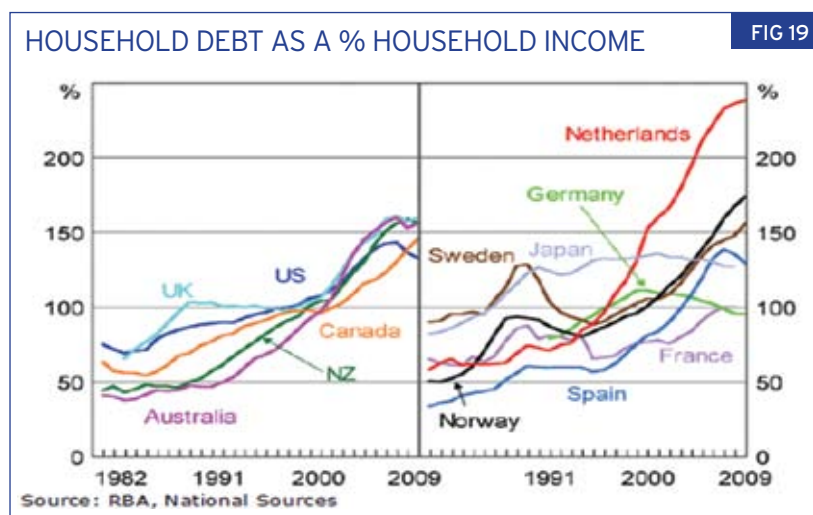


On most valuation measures Australian homes look expensive. Rental yields and income proxies (fig 18) indicate the housing stock is probably 30% overvalued. Given low affordability levels and constrained credit conditions, we would suggest there is limited upside potential for this asset class in the medium term. At the same time acute supply constraints will support prices at current inflated levels.



While prices have been moving higher for many years, there are few signs of speculative activity in housing. Investor demand peaked along with turnover back in 2003 and has returned to long term average levels.

Though gearing is somewhat elevated, household debt coverage is not dissimilar to other western countries (fig 19). While there will always be pockets of mortgage stress particularly in this era of two speed economies, given the overall strength of household income discussed earlier we would not expect to see a sharp deterioration in the performance of this key asset class for the banks.



## Seek (SEK)

Seek's share price has fallen recently following a disappointing update from its education business, highlighting increased investment at the expense of near term earnings. The announcement also confirmed the all important employment business is moving from strength to strength. We are confident unexpected costs in the education business are a short term setback providing us with an opportunity to buy an outstanding company at a good price.

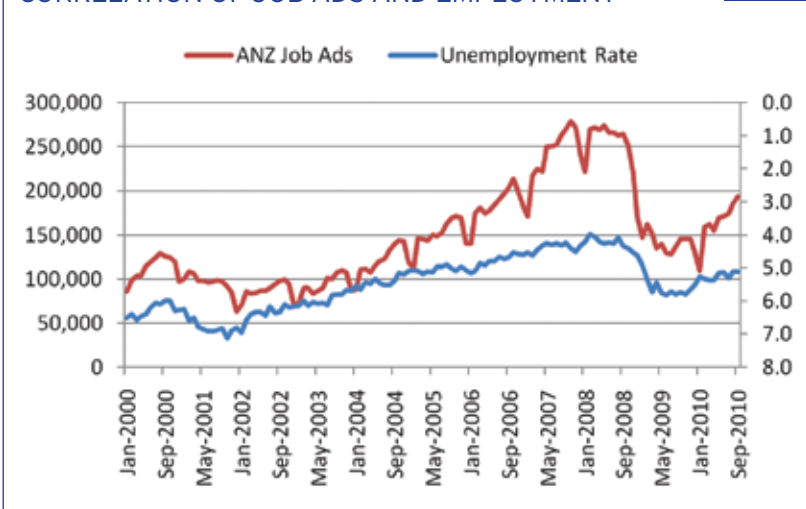
In 1997, Seek founded the now famous seek.com as an online portal for job seekers. Over the years, Seek has grown to be the dominant player in online job boards. Holding over 60% of all online listings, ahead of CareerOne (NewsCorp) and MyCareer (Fairfax), Seek's considerable pricing power is testament to the strength of this franchise. Seek's pricing is far cheaper than the print alternative, and a sharp discount to more advanced offshore markets. We believe that significant upside exists to current pricing enabling headroom for margins and profits.

The majority of Seek's revenue comes from large recruitment firms where the rate card depends upon the volume of ads placed on the site over the course of the year. In the 2nd half of 2009 job ads fell 40%, yet Seek's yield (price paid per ad) went up 20%. This structure helps protect earnings in a downturn. An opportunity exists for Seek to capture a greater proportion of the under-penetrated small to medium sized enterprises (SME) market, further boosting Seek's yields.

Fig 20 highlights the growth in job ads seen through the previous expansion. What is noticeable is the acceleration in job ads as the unemployment rate dropped below 5%. At this level, the labour market is very tight, and increased confidence creates a high level of churn. With unemployment approaching these levels, the outlook is very strong. We are buying a cyclical business as the cycle recovers.

CORRELATION OF JOB ADS AND EMPLOYMENT

FIG 20



Not content with the stellar growth of the online job board, the management team turned their attention to Education in 2004. Through a number of small acquisitions and organic growth this segment has grown markedly. The segment consists of Seek Learning, which uses the popularity of the job board to navigate job seekers to appropriate education courses, as well as Think, a domestic provider of applied education. The growth of both of these businesses is likely to stall this year as costs rise. Importantly, the investment will create a more robust business for the medium term. While it is disappointing that unexpected costs have arisen, we are confident that the investment will herald better results over the coming period.

Seek also hold 50% of IDP which offers placement services to international students wishing to study in Australia. While this business is clearly being impacted by regulatory changes and a rising Australian dollar, it represents only a small portion of the group. IDP is also initiating a push into the US market, which could provide significant opportunities for the business.

Finally, the team has made a number of investments in similar style online job boards in emerging markets. Seek holds interests in businesses in China, Mexico, Brazil and South East Asia. Leveraging off the skills achieved in Australia, these investments offer significant upside for Seek.

### Investment Case for Seek

Seek offers exposure to a strengthening domestic labour market. Seek is a clear market leader with significant pricing power. The company is investing in the education business for growth in the medium term. Share price weakness has created an opportunity to buy a high quality business at a good price.

## NEWS CORP (NWS)

While many still think of News Corp as a publishing and film business, the truth be known, the company's Cable division has grown quickly and now dominates the portfolio. The profile of this company has changed, News Corp has become a strong subscription business and should be re-rated accordingly. With concerns of a faltering US recovery the weak share price presents an attractive opportunity.

The Cable Networks division is benefiting from the considerable success of the Fox News Channel and FIC (Fox International Channels). Fox News has grown in popularity with ratings now in excess of its three competitors combined. The channel ranks in the Top 5 of all cable networks in prime time viewing. News Corp charges distributors a fee per subscriber for the channel, under a contract that typically lasts three years. In light of the huge growth in ratings this fee will continue to trend upwards. With a cost structure that is reasonably fixed, and contracts renewed periodically, the outlook for this business is strong.

Fox International comprises 28 brands and 200 channels on Pay TV platforms around the globe. Brands such as National Geographic and FOX are being embraced by developing nations. This natural market growth will drive channel launches into the future. This business should triple in size over the next five years.

The Fox Broadcast Network was hit hard by the GFC. As a single revenue stream business profits collapsed when advertising evaporated in 2008. The recent introduction of retransmission fees is transforming the economics of this business to a high quality subscription model. Essentially, distributors will pay Fox a fee per subscriber in the same way they would for a cable channel. Retransmission fees will take three years to roll through the entire distributor base, with a clear path of earnings growth now established.

News Corp has amassed a large amount of cash - some US\$7bn - and until June was under pressures to invest these funds. The proposal to acquire minorities in BSkyB makes a great deal of sense, given they already own 39% of the business. The deal fits well with News Corp's core strategy of Pay TV and subscription-based businesses and though a reasonable time remains before any deal is finalised, the potential transaction should alleviate investor concerns that the money may be spent on a more risky venture.

### **Investment Case for News Corp**

News Corp has repositioned itself and is now far less beholden to the ad cycle, with more revenues drawn from subscription businesses. A clear and predictable growth path has been established for the cable business. News Corp's valuation is undemanding, trading near the bottom of a range of media peers.

## JAMES HARDIE (JHX)

In the 1980's James Hardie pioneered an asbestos-free fibre cement technology. In the early 1990's, the company took this technology to the US. It quickly established support in hurricane and fire-prone areas due to the products durability, versatility and strength. Fibre cement managed to displace many other siding products and now James Hardie siding can be found in over 4 million US homes. One in every six new homes in America is built with James Hardie siding, a remarkable success story. With new housing in the US collapsing, we are buying a great business at the bottom of a deep cycle.

The chart below shows a 50-year history of US Housing Starts. We can see that the average over this period is 1.5m starts, and that the current level below 600k is unsustainable. The trajectory of the recovery will be crucial to the turn around.



Over the past 6 months concerns of a slower US recovery have emerged and this has greatly altered expectations. Forecasts of housing starts have been lowered as a recovery has been pushed further out. We believe this is an ideal time to buy James Hardie (and a US Housing exposure) as investors have given up on a recovery emerging.

There are a number of reasons why housing starts may surprise on the upside. Affordability has returned to levels where residents are incentivised to buy rather than rent. We just need to see stability return to the housing market for confidence to be restored.

There are a number of methodologies for looking at underlying housing demand; most point to a number in the order of 1.5m. This is simply based on population growth, the number of persons per household and a demolition rate of 300k homes per annum. While there has been a requisite increase in the number of persons per home, this underlying demand should see household formations return to historical levels.

In the depths of a deep housing recession, James Hardie was able to remain profitable. The company commands a 90% share of the fibre cement market, and has seen steady price increases throughout the downturn.

### Investment Case for James Hardie

James Hardie is a clear leader in all the markets in which it operates. The economic situation in the US is causing near-term headwinds. The housing market will inevitably recover, but the trajectory is unknown. Lowered expectations have created an attractive entry to buy a high quality business.

## Appendix: QR National

### QR National Privatisation

The fundamental case for investing in QR National (QRN) rests with the growth in steel and energy demand in Asia. Based on ABARE forecasts, Australia will export close to 300mtpa of coal this year, with shipments expected to grow by 30% or a further 100mtpa by 2015. QR Coal hauls two thirds of this load through its monopoly rail network in Central North Queensland.

Expansion plans in place by port authorities along the East Coast will deliver as much as 200mtpa of additional port capacity, suggesting growth could be as high as 10% pa over the next five years if planned mine development occurs. The rail sector will need to invest \$5 billion in additional network and rolling stock to match this. This is clearly a capital hungry growth business.

Rapidly expanding capital intensive businesses like QRN are only valuable in so far as they are profitable. They can destroy enormous amounts of wealth very quickly if poorly managed. Given the low returns achieved in the past, QRN in state hands has been run as an employment agency for Queensland rather than a profitable enterprise.

To profit from investing in QRN we need to be confident the company can significantly lift returns on the \$8.7 billion of capital employed in the business as well as the \$3.8 billion they are investing to grow. We can gain comfort from the experience of Pacific National (PN), QRN's major competitor where returns have doubled within 5 years of privatisation. QR Coal's operating margins at 24% are well below that of its rival at 32%.

In recent years the economics of the export coal sector have changed fundamentally. With coking coal prices above \$US200/tonne, mining coal has become an extremely profitable enterprise and miners are willing to pay away a greater margin to ensure reliable service and ongoing investment. In the past haulage contracts were awarded on a "lowest cost" basis reflecting tough conditions for coal producers and the poor returns in rail reflected this.

The opportunity with QRN is to participate in the growth of this industry on a more profitable basis as they reprice their back book of contracts on more favourable terms and improve overall productivity. QR Coal's legacy contracts are at sub-economic levels. Add to this the losses incurred in the freight business, and one can see why we are paying little goodwill for QRN with the shares trading in line with book value.

Ultimately the success of this investment will depend on the growth in demand for Australian coal and how much of this additional volume QRN captures whilst retaining its existing business in Queensland as contracts mature. PN, a subsidiary of Asciano, will also compete for this growth and try and capture QRN's Queensland volumes.

China as the world's largest steel producer is also the world's largest consumer of bulk commodities. However while China imports more than half of its iron ore needs, they are more or less self sufficient in coal given their substantial reserves in Shanxi, Shaanxi and Western Inner Mongolia.

Recently, China has started importing both thermal and coking coal to satisfy growth. While there is limited information available on domestic coal supply in China, a modest change in self sufficiency will have a significant impact on the seaborne market which is small at 1000 mtpa when compared with Chinese consumption of 3000 mtpa. Growth in power consumption in China alone will require an additional 200 million tonnes of coal each year; if this volume were to be imported demand for seaborne trade would rise by 20% each year.

While India is a net exporter of iron ore, they are a major importer of coal. The Indians will import 70 million tonnes this year with demand expected to grow at 10% p.a over the medium term. These two countries alone account for most of the growth in traded coal, and QR will try and service this growth via its rail infrastructure.

### **QRN comprises three operating divisions**

**Network** - The Central Queensland Coal Network (CQCN) of 2,300 km of narrow gauge track and a services business of 2,600 employees maintaining it.

**Coal** - The above rail haulage business transporting 200 mtpa of coal from mine to port with 83 complete train sets, representing 60% of industry shipments.

**Freight** - ARG Bulk- Rail hauler of non-coal bulk commodities in Western Australia and Queensland; Intermodal hauler of containerised general freight and a service provider to regional centres.

### **Network**

The 2,300km Central Queensland Coal Rail System is a regulated asset valued by the regulator at \$3.6 billion. The below rail network is a capital hungry business, with \$2 billion of capital expenditure sanctioned for major projects in the next two years.

The network is held under a 99 year lease from the Queensland Government providing access to QRN and third parties. As a natural monopoly tariffs charged to access seekers are heavily regulated under a Network Access Undertaking which is reviewed every three years by the Queensland Competition Authority (QCA), with the next reset at June 2013. Tariffs are calculated based on an approved return of 9.96% on the regulated asset base of \$3.6 billion, and are subject to a revenue cap so QRN bears limited volume risk.

The QCA uses a building block method to determine tariffs assuming an efficient operating and maintenance cost structure. On this basis revenues are largely set and QRN retains the benefit of any operating efficiencies. Recognising QRN's cost structure is uncompetitive when compared with international peers, this represents a significant opportunity. The Gooyella, Newlands and Blackwater systems together have contracted capacity of 225mtpa delivering coal from 37 mines to a handful of ports on the coast.

QRN is investing heavily in its network to match port expansion plans. The Goonyella and Abbot Point Expansion (GAPE) project is currently under construction at a cost of \$1.1 billion, and is due for completion in June 2012. This project will unlock 33mtpa of additional rail capacity matching the expansion of the Abbot Point Port. As a "Significant Infrastructure Investment" QRN is allowed to negotiate more favourable terms than under the regulatory access regime. Once the contracted load is fully utilised the GAPE project alone will increase the divisions profit by 50%.

There are several major projects being considered similar in size to GAPE, with the aim of matching network growth and port development. These projects will be underwritten by separately negotiated access undertakings, generating returns in line with GAPE creating significant value for QRN shareholders.

## QR Coal

The largest hauler of coal in Australia accounting for 60% of all coal movements via a relatively new fleet of 83 train sets (average age 9.2 years).

Coal haulage contracts are “take or pay” with an average contract term of approximately 8 years. The top five customers represent 70% of coal hauled with BHP Billiton Mitsubishi (BMA) the largest customer. QR Coal is progressively moving customers onto more attractive contracts with 18% of contracted volume shifted across to date. These new contracts are at much higher rates and are far more profitable.

Historically QRN has monopolised shipments in Queensland, and PN has held a similar position in NSW. Each player is now vying for business in the others home state as new contracted volumes are awarded for expansion projects and existing contracts are renegotiated on more favourable terms.

PN has been very successful to date in Queensland having secured contracts from Anglo, RIO, Macarthur and Xstrata for 45.5mtpa. QRN have retained on balance 60% of the contracts that have expired since PN entered the Queensland market. Their largest contract with BMA for 50mtpa comes up for renewal in 2016.

QRN has had its fair share of success in NSW as well, securing contracts for 20mtpa of coal. Recent wins with Felix and Peabody will take them up to 43mtpa over the next few years. QR is potentially more vulnerable in the far larger market of Queensland with disgruntled customers anxious to see improved levels of performance.

While the existing Queensland market is roughly twice the size of NSW, when we consider planned new mine development, the growth will be more evenly split between NSW and Queensland. So while QRN has a larger base potentially at risk they have a similar opportunity to capture growth projects in NSW as PN has in Queensland.

Given there are no large contract renewals in Queensland over the next few years, the competition will be for expansion projects, GAPE volumes and the BMA contract when it comes up in 2016.

PN is far more profitable than QRN, with operating costs 8% below those reported by QR Coal. A comparison with Class 1 rail companies in North America would suggest QR Coal operating costs are almost twice as high.

## QR National Freight

In 2010, QR Freight accounted for 40% of group revenues with a slightly smaller fleet than the Coal division, yet while QR Coal booked a \$383 million profit, the Freight division lost \$33million. Turning around the performance of this division is fundamental to the investment case for QRN.

The opportunities and risks of investing in a capital intensive growth business like QRN are clearly demonstrated here. The company will invest \$660 million in this loss making business in the next two years. While part of this investment is tied to new profitable contracts, if the business is still losing money in two years then this value has clearly been lost by QRN shareholders.

QRN Freight has three businesses. ARG Bulk, a hauler of mineral and agricultural commodities in WA and Queensland, acquired from Wesfarmers back in 2006; a subscale Intermodal business that is making small losses; and a regional freight business that is losing significant sums of money.

ARG transports 40 mtpa of bulk freight in WA and 20mtpa in Queensland. The main opportunity for growth identified by ARG is in the emerging Mid-West iron ore province in WA. While most of the anticipated growth in iron ore exports will come from the fully integrated Pilbara miners BHP, Rio and Fortescue, there are a number of large projects further south in the mid-west without rail infrastructure. ARG have moved quickly to tie up these emerging producers. They have contracts in place to double shipments from 10mtpa over the next two years and have struck heads of agreement with Gindalbie and Mineral Resources for additional tonnage if these projects are successful. All up QRN have identified 13 emerging producers with aggregate production of potentially 100 mtpa.

Regional Freight runs a number of unprofitable services transporting agricultural, general and containerised freight throughout regional Queensland. Considered a universal service obligation for sub-economic regions of Queensland, the division lost \$100 million in 2010. As part of the privatisation process the company has struck a 5 year Transport Services Contract (TSC) with the Queensland Government whereby the government will subsidise any losses in this division (PN are challenging the legality of this subsidy). As the payments from the Queensland Government are fixed and not tied to restructuring in this division, QRN will capture any margin improvement from reforms.

## **Corporate**

QRN is significantly overstaffed, both operationally and at corporate head office. The company has 5,050 employees working in internal divisions that are not directly associated with the core operations. Half of the workforce is not employed in the three operating companies, which suggests excessive overhead.

In addition to these internal divisions, the corporate centre incurs costs of \$245m, or 9% of external revenues. Asciano's corporate costs by comparison equates to 1% of revenues.

The government has extended Enterprise Bargain Agreements (EBAs) that prevent compulsory redundancies or forces relocations for 3 years until Dec 2013. While they cannot force redundancies, as a growing business QR can significantly lift productivity just through a hiring freeze. Furthermore, there is nothing stopping management from offering voluntary redundancies which should be well received given 35% of the workforce are over 50.

Across the three businesses we can clearly see the opportunity to improve performance and lift returns. In Coal, the focus is on back book repricing and growth; in the Networks division, extensions of the CQCN will proceed on more favourable access terms than those mandated by the regulator; whilst improvement in Freight is less certain, the TSC terms go a long way toward making this division profitable. Across the company there is scope to improve productivity and these benefits will flow through meaningfully once redundancy undertakings expire in 2013.

Whilst the prospectus provided information on employee productivity, the disclosure on asset utilisation was poor which is a concerning omission for a rolling stock business. For all we know, half the rolling stock could be held up in maintenance yards. For a capital intensive business you would think the company may provide some information on how the assets are performing.

At the heart of it, there is a significant opportunity to lift the performance of this business. The customers want it, the opportunity is there, it all comes down to the willingness of management to make the tough decisions and transform a highly unionised workforce.

### **Valuation**

This brings us to valuation. We are only paying book value for these securities. Most industrial company's trade at a premium to book value, a goodwill factor reflecting the superior returns a business achieves.

As QR National is currently not achieving its cost of capital and returns are inadequate, the securities attract no goodwill. When looking at QRN's businesses we should consider whether they should attract a premium.

In a growing coal market where producers are making a lot of money the coal supply chain is very valuable. With newly signed Coal contracts achieving returns in excess of 16% this business should be worth considerably more than the value of its rolling stock as existing contracts are repriced.

There are numerous listed regulated utilities that provide a guide to valuing the Networks division. These businesses all trade at a premium to their regulated asset values (RAV).

Furthermore, with QRN investing in projects such as GAPE where returns are above those set by the regulator, these assets should be worth more than other regulated utilities. The Queensland Coal Industry Rail Group of customers has already placed a significant premium on the value of the below rail assets, offering \$4.85 billion back in May 2010 (1.35 times RAV).

The value of the Freight division is less clear, though book value of the rolling stock which could be sold is a reasonable starting point.

Having considered the values ascribed to other International rail companies, Asciano and various regulated utilities we come up with a valuation range of \$2.50 and \$3.50 per share for QRN.

### **Investment Case for QR National**

QRN is a unique asset. The export coal chain in Australia will deliver attractive returns to all participants from miners through to infrastructure providers as growth in Asian demand continues. The economics of this business are underwritten in the medium term by long term take-or-pay haulage and access undertakings contracted with the mining companies. The opportunity to lift productivity and improve asset utilisation is significant, but may take longer than expected to emerge.

## Sector Allocation (ASX) All positions as % of shareholder's funds

Company Name	Investment	%Long	%Short	Net Weight	ALL Ords Weight
<b>DEFENSIVES</b>	<b>9,287,707</b>	<b>25%</b>	<b>-15%</b>	<b>11%</b>	<b>19%</b>
Utilities	INFIGEN	345,000	1%	0%	0.1%
Utilities	ORIGIN ENERGY	2,200,800	3%	0%	1.1%
Utilities	SPARK INFRASTRUCTURE GROUP	2,460,964	3%	0%	0.1%
Utilities	APA GROUP	-1,651,317	0%	-2%	0.2%
Utilities	HASTINGS DIVERSIFIED UTILITIES	869,000	1%	0%	0.1%
Telecom	TELSTRA CORPORATION LTD	-1,967,000	0%	-2%	2.7%
Retailing Staples	WOOLWORTHS LIMITED	2,090,400	2%	0%	2.5%
Retailing Staples	METCASH LTD	-2,397,229	0%	-3%	0.2%
Healthcare	CSL LIMITED	2,773,146	3%	0%	1.5%
Healthcare	ANSELL LTD	-2,515,443	0%	-3%	0.1%
Healthcare	SIGMA PHARMACEUTICALS LTD	1,912,176	2%	0%	0.1%
Healthcare	RESMED INC	2,129,400	2%	0%	0.4%
Gaming	TABCORP HOLDINGS LTD	-1,928,218	0%	-2%	0.4%
Gaming	CROWN LTD	4,433,400	5%	0%	0.5%
Food Beverage	FOSTER'S GROUP LIMITED	2,514,250	3%	0%	0.8%
<b>FINANCIALS</b>	<b>21,252,229</b>	<b>36%</b>	<b>-11%</b>	<b>25%</b>	<b>33%</b>
Banks	COMMONWEALTH BANK OF AUSTRALIA	3,234,760	4%	0%	5.7%
Banks	NATIONAL AUSTRALIA BANK LTD	5,106,941	6%	0%	3.8%
Banks	WESTPAC BANKING CORP	6,943,968	8%	0%	4.9%
Banks	AUSTRALIA & NEW ZEALAND BANKING	2,266,000	3%	0%	4.4%
Banks	BENDIGO BANK LIMITED	-2,809,378	0%	-3%	0.3%
Diversified Financials	MACQUARIE GROUP LTD	2,481,500	3%	0%	0.9%
Diversified Financials	COMPUTERSHARE LIMITED	-2,783,340	0%	-3%	0.4%
Diversified Financials	IOOF	-2,076,478	0%	-2%	0.1%
Insurance	QBE INSURANCE GROUP LIMITED	3,606,669	4%	0%	1.3%
Insurance	SUNCORP-METWAY LTD	-2,122,050	0%	-2%	0.9%
Insurance	INSURANCE AUSTRALIA GROUP LTD	1,654,581	2%	0%	0.6%
Insurance	TOWER AUSTRALIA GROUP LTD	2,775,692	3%	0%	0.1%
Real Estate	GPT GROUP	672,568	1%	0%	0.4%
Real Estate	LEND LEASE CORP	2,300,795	3%	0%	0.3%
<b>INDUSTRIAL CYCLICALS</b>	<b>10,960,353</b>	<b>28%</b>	<b>15%</b>	<b>13%</b>	<b>12%</b>
Media	FAIRFAX MEDIA LTD	-685,000	0%	-1%	0.2%
Media	NEWS CORP INC	3,708,158	4%	0%	1.0%
Media	WEST AUSTRALIAN NEWSPAPERS HOLDI	-655,000	0%	-1%	0.1%
Media	SEEK LTD	3,177,626	4%	0%	0.2%
Media	TEN NETWORK	1,596,850	2%	0%	0.1%
Consumer Services	BRAMBLES LIMITED	1,425,142	2%	0%	0.8%
Consumer Services	NAVITAS LIMITED	-630,000	0%	-1%	0.1%
Consumer Services	PMP LTD	-485,140	0%	-1%	0.1%
Contractors	TRANSFIELD SERVICES LIMITED	2,494,000	3%	0%	0.1%
Contractors	MONADELPHOUS LIMITED	-1,169,000	0%	-1%	0.1%
Discretionary Retail	HARVEY NORMAN HOLDINGS LTD	1,556,343	2%	0%	0.2%
Discretionary Retail	BILLABONG INTERNATIONAL LTD	591,500	1%	0%	0.2%
Discretionary Retail	SPECIALITY FASHIO GROUP	-495,763	0%	-1%	0.1%
Discretionary Retail	DAVID JONES LTD	1,679,600	2%	0%	0.2%
Discretionary Retail	MYER	788,480	1%	0%	0.2%
Transport	QANTAS AIRWAYS LIMITED	1,315,000	2%	0%	0.5%
Transport	FLIGHT CENTRE LTD	-1,820,800	0%	-2%	0.5%
Transport	TOLL HOLDINGS LTD	1,878,600	2%	0%	0.3%
Steel	BRADKEN LTD	-2,476,197	0%	-3%	0.1%
Building Materials	BORAL LIMITED	1,492,200	2%	0%	0.2%
Building Materials	FLETCHER BUILDING	-164,804	0%	-1%	0.3%
Building Materials	JAMES HARDIE INDUSTRIES NV	2,314,306	3%	0%	0.2%
Paper/Chem/Agric	AMCOR LIMITED	-2,418,750	0%	-3%	0.6%
Paper/Chem/Agric	INCITEC PIVOT LTD	-2,057,000	0%	-2%	0.5%
<b>RESOURCES AND ENERGY</b>	<b>7,804,615</b>	<b>21%</b>	<b>-12%</b>	<b>9%</b>	<b>28%</b>
Diversified Miners	BHP BILLITON LIMITED	7,036,372	8%	0%	11.0%
Diversified Miners	RIO TINTO LIMITED	1,703,802	2%	0%	2.8%
Base Metals	ALUMINA LIMITED	-2,150,350	0%	-3%	0.4%
Base Metals	OZ Minerals	-841,500	0%	-1%	0.4%
Base Metals	PAN AUSTRALIAN RESOURCES LTD	779,579	1%	0%	0.2%
Base Metals	DISCOVERY METALS	991,915	1%	0%	0.1%
Base Metals	EQUINOX	-282,500	0%	-1%	0.3%
Base Metals	IVANHOE AUSTRALIA LIMITED	676,056	1%	0%	0.1%
Base Metals	INDEPENDENCE GROUP NL	-716,000	0%	-1%	0.1%
Bulk Commodities	GINDALBIE GOLD NL	955,800	1%	0%	0.1%
Bulk Commodities	MACARTHUR COAL LTD	836,500	1%	0%	0.3%
Bulk Commodities	FORTESCUE METALS GROUP LTD	-1,866,005	0%	-2%	1.5%
Other Resources	PALADIN ENERGY LTD	-1,399,350	0%	-2%	0.3%
Energy	WOODSIDE PETROLEUM LIMITED	2,240,088	3%	0%	2.5%
Energy	OIL SEARCH LTD	1,994,360	2%	0%	0.7%
Energy	CALTEX AUSTRALIA	-2,506,652	0%	-3%	0.3%
Energy	AUSTRALIAN WORLDWIDE EXPLORA	807,500	1%	0%	0.1%
Energy	NEXUS ENERGY LTD	-455,000	0%	-1%	0.1%
<b>SMALL CAPS</b>	<b>9,349,564</b>	<b>11%</b>	<b>0%</b>	<b>11%</b>	<b>10%</b>
<b>CASH</b>	<b>26,960,560</b>				
<b>NET SHAREHOLDERS FUNDS BEFORE PERIOD END ADJUSTMENTS</b>	<b>85,615,028.96</b>				
<b>All positions as % of Sharholders Funds</b>					

## Sector Exposure

Sector	Long	%	Short	%	Net	%	ALL Ord Weight
<b>DEFENSIVES</b>							<b>INDEX</b>
Infrastructure	-	0%	1,981,622	-2%	-1,981,622	-2%	2%
Utilities	5,875,764	7%	1,651,317	-2%	4,224,447	5%	2%
Telecom	-	0%	1,967,000	-2%	-1,967,000	-2%	3%
Retailing Staples	2,090,400	2%	2,397,229	-3%	-306,829	-1%	5%
Healthcare	6,814,722	8%	2,515,443	-3%	4,299,279	5%	3%
Gaming	4,433,400	5%	1,928,218	-2%	2,505,182	3%	2%
Food Beverage	2,514,250	3%	-	0%	2,514,250	3%	2%
	21,728,536	25%	12,440,829	-15%	9,287,707	11%	19%
<b>FINANCIALS</b>							
Banks	17,551,669	21%	2,809,378	-3%	14,742,291	17%	19%
Diversified Financials	2,481,500	3%	4,859,818	-6%	-2,378,318	-3%	3%
Insurance	8,036,943	9%	2,122,050	-2%	5,914,893	7%	5%
Real Estate	2,973,363	3%	-	0%	2,973,363	-3%	6%
	31,043,475	36%	9,791,246	-11%	21,252,229	25%	33%
<b>INDUSTRIAL CYCLICALS</b>							
Media	8,482,634	10%	1,340,000	-2%	7,142,634	8%	3%
Consumer Services	1,425,142	2%	1,115,140	-1%	310,002	1%	1%
Contractors	2,494,000	3%	1,169,000	-1%	1,325,000	2%	2%
Discretionary Retail	4,615,923	5%	495,763	0%	4,120,161	5%	1%
Transport	3,193,600	4%	1,820,800	-2%	1,372,800	2%	1%
Steel	-	0%	2,476,197	-3%	-2,476,197	-3%	1%
Building Materials	3,806,506	4%	164,804	0%	3,641,702	4%	1%
Paper/Chem/Agric	-	0%	4,475,750	-5%	-4,475,750	-5%	2%
	24,017,806	28%	13,057,453	-15%	10,960,353	13%	12%
<b>RESOURCES AND ENERGY</b>							
Diversified Miners	8,740,174	10%	-	0%	8,740,174	10%	14%
Precious Metals	-	0%	-	0%	-	0%	3%
Base Metals	2,447,551	3%	3,990,350	-5%	-1,542,799	-2%	2%
Bulk Commodities	1,792,300	2%	1,866,005	-2%	-73,705	0%	3%
Other Resources	-	0%	1,399,350	-2%	-1,399,350	-2%	1%
Energy	5,041,948	6%	2,961,652	-3%	2,080,296	3%	5%
	18,021,973	21%	10,217,358	-12%	7,804,615	9%	28%
<b>Small Caps</b>	9,349,564	11%	-	-	9,349,564	11%	10%
<b>Total</b>	<b>\$104,161,354</b>	<b>121%</b>	<b>\$45,506,885</b>	<b>-53%</b>	<b>\$58,654,469</b>	<b>69%</b>	<b>102%</b>
				<b>Cash</b>	<b>\$26,960,560</b>		
				<b>Total</b>	<b>\$85,615,028.92</b>		
All positions as % of Shareholder Funds							*There will be minor differences to NTA

## Attribution To November 2010\*

	1 MONTH			1 YEAR			3 YEARS		
	Fund	Index	Attribution	Fund	Index	Attribution	Fund	Index	Attribution
<b>Long</b>	2.7	-0.7	3.4	-3.2	3.2	-6.4	9.7	-6.9	16.6
<b>Short</b>	-0.6	-0.7	-0.0	8.3	3.2	-4.3	-5.7	-6.9	-1.9
<b>[Cash]</b>	0.1	-	0.1	13.5	-	-1.2	5.2	-	-3.2
	2.7	-0.7	3.4	-3.2	3.2	-6.4	9.7	-6.9	16.6

\* November results are preliminary and may differ slightly from NTA to be reported.





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