

Wallara

Asset Management Pty Ltd

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- Manages **Australian shares** for MLC, since 2004.
- Manages \$1.8 billion, across the company, as at 30 June 2011.
- Origins dating back to 1995.
- Based in Melbourne, Australia.
- Entirely owned by investment team.

Wallara is an Aboriginal word meaning “clear headed” and reflects the firms disciplined and distinctive approach to investing.

Why has MLC chosen Wallara?

MLC use Wallara because they have a clearly articulated philosophical belief that is based on shareholder value analysis. The experienced investment team combine to create an intellectual resource committed to investing in a fashion complementary to MLC’s strategy. Wallara manage a high conviction, large-cap, growth oriented portfolio of 25-30 companies with a low level of turnover.



Peter Wetherall
Managing Director

Philosophy on investing

Wallara is a bottom-up, active manager of Australian equities. Through their application of shareholder value analysis techniques they aim to identify stocks expected to deliver above average growth in shareholder value that they can purchase at a reasonable price.

They believe that superior returns are achieved by investing in companies with a strong financial position, an ability to reinvest capital at rates above the cost of that capital and past records of achievement. These preferences result in a portfolio with growth characteristics. Wallara is not a trading oriented investor and portfolios have only moderate turnover.

Investment process

Wallara’s stock research is aimed at attaining insight into the factors that drive shareholder value creation. This requires analysis of both qualitative and quantitative considerations. Qualitative analysis involves understanding the key drivers of a company’s financial performance; the quality of management; the outlook and structure of the industry it operates in; asset quality; the sustainability of any competitive advantage it might have; and, the presence of expansion opportunities via the investment of capital in new assets that will deliver returns above the cost of capital.

The quantitative analysis Wallara conducts involves the collection and analysis of at least eight years of historical company financial data to understand the historical performance of the company and the key financial performance drivers. Wallara then prepares two years of projected income, balance sheet and funds flow statements using in-house developed forecasting spreadsheets. The objective of this detailed analysis is to gain a deeper understanding of a company’s activities and to isolate key areas for discussions with company management. It also ensures they have internally consistent financial statements,

which is important given their focus on returns as the principal measure of financial performance.

Having created the required forecast financial statements, Wallara then imports the financial data into an internally developed based shareholder value analysis model. This software is used to calculate the cashflow return on investment (CFROI), cost of capital and DCF-based valuation of each company in their universe (around 120 of the largest listed companies by market capitalisation). The shareholder value analysis approach is quite sophisticated and explicitly takes into account the returns a company is generating, its sustainable or natural level of growth, its sustainable competitive advantage, its financial structure, the age of its depreciating assets and its size. Cash measures, not accounting based measures, and adjustments, are used to remove the impact of distortions such as off balance sheet financing, the impact of inflation, the life of depreciating assets, the effect of non-cash gains or charges and so on. One of the main advantages of the CFROI measure is that it levels the performance measurement playing field and allows meaningful assessment of performance over time and across different industries.

Once this research is completed, stocks in their research database are ranked according to a range of criteria and those considered for inclusion rank strongly against four key purchase criteria. These are:

- Qualitative assessment of outlook for shareholder value creation (i.e. management's track record of wealth creation future strategy). Wallara favour companies with a consistent record of valuation creation.
- Trend in Cashflow Return on Investment (CFROI). Wallara favour a rising trend.
- Trend in Consensus Earnings Revisions. Wallara favour a stable or rising trend in consensus forecasts.
- Price relative to Valuation. While Wallara favour companies that are cheaply priced, the stronger the potential for value creation the less discount to valuation they need.

Accordingly, stocks favoured by Wallara for their potential to generate very good investment returns are those which have:

- strong signals of future value creation indicated by a rising trend in CFROI;
- rising consensus earnings revisions;
- abundant opportunities for investing capital in projects that will deliver returns above the cost of capital; and,
- skilled management able to take advantage of these opportunities.

The portfolio is concentrated to ensure only the best ideas are put to work, but without losing the risk reduction benefits of portfolio diversification. The number of holdings is between 25 and 30 and guidelines are applied to control risk by limiting the maximum and minimum exposure of the portfolio to individual stocks and selected sectors.

Investment people

Wallara was founded in 1995 by Peter Wetherall, and consists of the following investment professionals.

Staff	Position	Qualifications	Started with Wallara	Industry Experience
Peter Wetherall	Managing Director	B.Eng. (Mining) Hons B.A. (Phil, Politics & Economics)	1995	30
Greg Marks	Senior Investment Manager	B.Bus Studies (Accounting) M.Ap.Fin	2000	16
Mike Macrow	Senior Investment Manager	B.Eco (Hon) MBA	2011	16
Ivan Reyneke	Senior Investment Manager	MBA B.Sc (Statistics & Actuarial Science) Chartered Financial Analyst	2004	15
Steven Lambeth	Senior Investment Manager	B.Com (Finance) Hons Chartered Financial Analyst	2004	11
Hongdi Liu	Equity Research Database Manager	B.Sc (Comp. & Maths) B. Computer Eng. Level 3 CFA candidate	2007	3

Stock Story – QR National

Large IPOs always create interest and this was certainly the case when the Queensland government offered its QR National (QRN) rail freight business to the market in November 2010. Opinion on the investment merit of QRN was sharply divided at the time of the float, but since then the shareprice rise has vindicated those, like Wallara, which subscribed for shares.

Wallara is always on the lookout for companies that have superior shareholder value creation potential. Companies create value in two ways: by increasing the return they generate from their existing assets or by investing capital in new assets that generate a return above the cost of that capital. What excites us about QRN is the company is able to create shareholder value in both of these ways.

At present QRN is blessed with a very high quality asset base, but its operating efficiency is well below par. This largely reflects restrictions on management while under government ownership. As a private enterprise, management decisions will be driven solely by commercial objectives and the company has tremendous opportunities to increase the utilisation of its train fleet and to lower costs through reduced manning and better procurement practices. The company announced a voluntary redundancy program in February 2011 which was offered to 3,500 of its 9,400 employees. There is also significant upside from restructuring contracts with its coal mining customers which provide higher revenues in exchange for greater flexibility in the availability of haulage capacity.

A sense of the potential improvement in returns is provided by its main competitor, Pacific National (PN). PN was also a government-owned entity which was sold to private sector interests in 2002. At that time its return on assets was 9%, but through cost reduction and capital efficiency initiatives this has now risen to 15%.

Given the quality of Australia's coal resources and our proximity to the strongly growing markets of Asia, strong growth in coal production is expected. The Australian Bureau of Agricultural and Resource Economics (ABARE) has forecast a 7.3% compound annual growth rate in thermal coal production over the five years to 2015, and 4.1% for metallurgical coal. This will underpin strong organic growth opportunities for QRN.

In terms of valuing QRN we believe it is important to understand that the company has two quite distinct businesses: the above rail haulage business which is a normal commercial activity, and the below rail track business which is a regulated asset. We value the track network at 1.1 times its regulated asset base (RAB) or \$5.3 billion, which is very close to the price offered to the Queensland government by a consortium of mining companies prior to the IPO. Using normal industry multiples on the other business profits give a combined valuation of \$2.75 per share based on the prospectus forecasts. However, these forecasts are likely to prove too low because they do not include any of the cost cutting or efficiency measures we have discussed. We see the potential for much higher valuations going forward so long as management is able to take advantage of the multiple opportunities to improve the operating performance of the business.

This stock may no longer be included in Wallara's portfolio as their view may have changed since this document was prepared.

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