

Another poor result...time to deliver



Poor 1H FY07 result

Colorpak reported 1H FY07 NPAT of A\$2.3m, down 23% on the pcp, and a poor result given sales revenues were flat. Whilst the result was disappointing, we do not see structural issues in the business, rather the company has 'overstretched' in its ambitions to grow and has paid the consequences through some shorter term 'teething' problems. We're expecting improved results in the future driven by continued top-line growth and benefits flowing from the recent capex program.

Capex sown...now time to harvest

Packaging is a capital intensive business; however, the capital requirements tend to be 'lumpy'. Colorpak has just emerged from a period where it has outlaid a significant amount of capital in order to grow and with capex expected to be below depreciation for the next two years, we believe the company has built a solid platform to grow profits and generate robust free cash flow.

Earnings downgraded but stock remains cheap

Following the result, we have downgraded FY07 – FY09 earnings by 12%, 10% and 8% respectively. Despite this, the company remains attractively priced, trading on a FY07 P/E <10x and a FY08 P/E of <8x. In addition, the forecast free cash flow yield in FY08 & FY09 is >12% due to low capex requirements following the significant capital outlay over the past 2 years.

Buy recommendation maintained

Whilst the company has reported disappointing results over the past 18 months we remain comfortable with our Buy recommendation. We expect an improved operating performance in the future driven by a solid management team who are incentivised by a significant holding of equity in the company.

Estimates (Jun)

(A\$)	2005A	2006A	2007E	2008E	2009E
Net Profit b/f Abnormals	5.3	4.5	4.8	5.6	6.1
EPS	0.067	0.056	0.060	0.070	0.075
EPS Change (YoY)	NA	-17.1%	6.4%	17.2%	7.8%
Dividend / Share	0.025	0.028	0.028	0.030	0.033
Free Cash Flow / Share	0.019	(0.034)	(0.021)	0.069	0.070

Valuation (Jun)

	2005A	2006A	2007E	2008E	2009E
P/E	8.2x	9.8x	9.2x	7.9x	7.3x
Dividend Yield	4.5%	5.0%	5.0%	5.5%	5.9%
EV / EBITDA*	6.4x	7.1x	6.6x	5.8x	5.3x
Free Cash Flow Yield*	3.4%	-6.2%	-3.8%	12.5%	12.7%

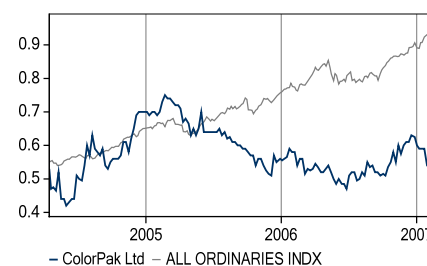
* For full definitions of *iQmethod*SM measures, see page 6.

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Stock Data

Price	A\$0.550
Price Objective	A\$0.750
Date Established	5-Jul-2006
Investment Opinion	C-1-7
Volatility Risk	HIGH
52-Week Range	A\$0.460-A\$0.640
Mrkt Val / Shares Out (mn)	US\$35 / 80.5
Average Daily Volume	114,666
ML Symbol / Exchange	XBVVF / ASX
Bloomberg / Reuters	CKL AU / CKL.AX
ROE (2007E)	9.7%
Net Dbt to Eqty (Jun-2006A)	66.9%
Est. 5-Yr EPS / DPS Growth	3.6% / 8.4%
Free Float	68.0%



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Refer to important disclosures on page 7 to 8. Analyst Certification on page 6. Price Objective Basis/Risk on page 6.

27 February 2007

iQprofileSM Colorpak Ltd.

Key Income Statement Data (Jun)	2005A	2006A	2007E	2008E	2009E
(A\$ Millions)					
Sales	59	71	72	78	82
Operating Expenses	(47)	(60)	(60)	(65)	(69)
EBITDA	11	11	12	13	14
Depreciation & Amortization	(2)	(2)	(3)	(3)	(3)
EBIT	10	9	9	11	11
Net Interest & Other income	(2)	(2)	(3)	(2)	(2)
Associates	NA	NA	NA	NA	NA
Pretax Income	8	6	7	8	9
Tax (expense) / Benefit	(2)	(2)	(2)	(2)	(3)
Net Profit b/f Abnormals	5	5	5	6	6
Non-Recurring Items	0	0	0	0	0
Net Income (Reported)	5	5	5	6	6
Avg F Diluted Shares Outstanding	79	80	80	80	80

Key Cash Flow Statement Data

EBITDA	11	11	12	13	14
Change in Working Capital	0	(2)	0	0	(1)
Deferred Taxation Charge	1	(1)	1	0	0
Other Adjustments, Net	0	0	0	0	0
Cash Flow from Operations	8	3	9	8	8
Capital Expenditure	(6)	(6)	(10)	(2)	(2)
(Acquisition) / Disposal of Investments	0	0	0	0	0
Other Cash Inflow / (Outflow)	0	0	0	0	0
Cash Flow from Investing	(6)	(6)	(8)	(2)	(2)
Shares Issue / (Repurchase)	0	0	0	0	0
Cost of Dividends Paid	(1)	(2)	(2)	(2)	(2)
Cash Flow from Financing	(2)	2	1	(2)	(2)
Free Cash Flow	2	(3)	(2)	6	6
Net Debt	28	32	34	31	28
Change in Net Debt	NA	NA	NA	NA	NA

Key Balance Sheet Data

Property, Plant & Equipment	20	25	29	29	28
Other Non-Current Assets	1	0	0	0	0
Trade Receivables	11	14	14	15	16
Cash & Equivalents	0	0	0	3	7
Other Current Assets	1	1	1	1	1
Total Assets	84	94	97	101	106
Long-Term Debt	24	29	33	33	33
Other Non-Current Liabilities	0	0	0	0	0
Short-Term Debt	4	3	1	1	1
Other Current Liabilities	4	2	2	2	2
Total Liabilities	38	46	46	47	48
Total Equity	45	48	51	54	58
Total Equity & Liabilities	84	93	97	101	106

iQmethodSM - Bus Performance*

Return on Capital Employed	NA	7.7%	8.0%	8.4%	8.6%
Return on Equity	NA	9.7%	9.7%	10.7%	10.8%
Operating Margin	16.4%	12.4%	13.1%	13.6%	13.4%
EBITDA Margin	19.2%	15.3%	16.7%	16.9%	16.6%

iQmethodSM - Quality of Earnings*

Cash Realization Ratio	1.5x	0.8x	1.8x	1.4x	1.3x
Asset Replacement Ratio	3.8x	2.7x	3.8x	0.9x	0.9x
Tax Rate (Reported)	29.9%	30.4%	29.8%	30.0%	30.0%
Net Debt-to-Equity Ratio	60.6%	66.9%	67.5%	57.1%	47.9%
Interest Cover	4.7x	4.1x	3.6x	4.1x	4.3x

Key Metrics

Franking	100%	100%	100%	100%	100%
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 * For full definitions of iQmethodSM measures, see page 6.

Company Description

Please see report published on 5 July 2006.

Stock Data

Price to Book Value 0.9x

1H FY07 result

Profit & Loss

Colorpak reported 1H FY07 NPAT of A\$2.3m, down 23% on the pcp, and a poor result given sales revenues were flat. The result was impacted by a number of issues including:

- A customer moving operations offshore in 2H FY06.
- A customer in the pcp being a 'one-off' promotional job.
- Expected volume increases from the capital re-equipment program have been slower than expected.
- Trading was slow in the 2Q as a result of customer de-stocking programs.
- Increased depreciation and interest from recent capital investments (A\$0.3m).
- Impairment loss as a result of machine failure (A\$0.1m).

Table 1: 1H FY07 result vs pcp

(A\$m)	1H FY06	1H FY07	Δ on pcp
Sales Revenue	35.1	34.9	-0.3%
EBITDA	6.5	5.9	-8.6%
D&A	-1.1	-1.3	18.6%
EBIT	5.4	4.6	-14.2%
Net Interest	-1.0	-1.3	27.0%
Profit Before Tax	4.3	3.3	-23.9%
Tax Expense	-1.3	-1.0	-25.9%
OEI	0.0	0.0	0.0%
NPAT	3.0	2.3	-23.0%
Normalised EPS	3.8	2.9	-23.0%
DPS	1.0	1.0	0.0%

Source: Colorpak, Merrill Lynch

Cash Flow

Despite a poor earnings performance, cash flow generation by the company was strong, improving markedly to A\$4m, well above the -A\$0.4m reported in the pcp.

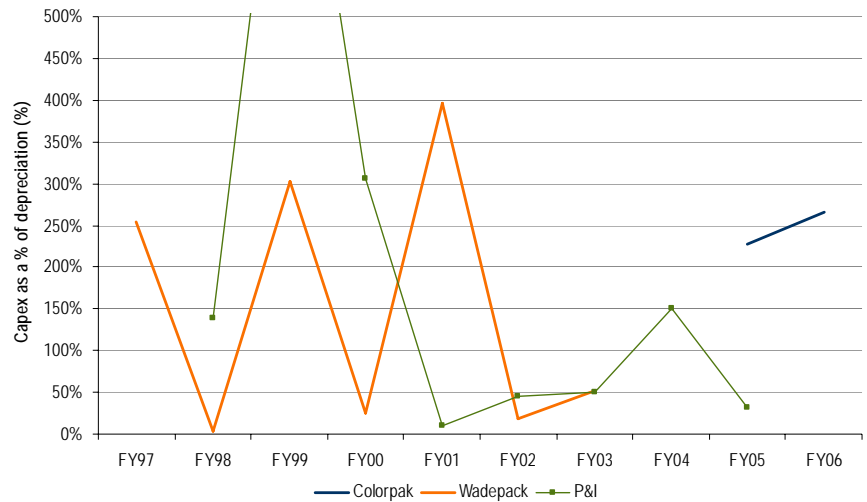
With the payment in early FY07 of the last of the major capital equipment items, capex for the next two years is expected to be below depreciation and we're expecting the company to generate strong free cash flows.

Balance Sheet

The company's balance sheet remains in reasonable shape with gearing (debt / debt + equity) at 43% at the end of the half and expected to fall to below 40% by the end of the year. Interest coverage ratios remain within our comfort range at ~4x. Given the (relatively) low capex burden expected for the next 2 years, we believe the main goal for the company should be to pay down debt.

Capex sown, now time to harvest

The packaging industry is capital intensive due to its fragmented nature and rapid advancements in technology. However the capex burden tends to be 'lumpy' with periods of high capex followed by periods of (relatively) low capex. This is demonstrated in chart 1 below for Colorpak and its major competitors. Typically, a company will grow to a point where it is running at full capacity and/or its machinery will be obsolete and a significant capital outlay is required for the company to move forward. The capital is spent, allowing another 2-3 years of (relatively) low capital growth before the process starts over. We believe Colorpak has just exited a capital intensive phase and is well positioned for a period of strong growth requiring minimal capital outlay.

Chart 1: Carton board industry capex as a % of depreciation


Source: Colorpak, CPI, P&I

Over the past two years the company has outlaid capital on:

1. The acquisition of Castle Graphics.
2. Construction of a finished goods warehouse in Braeside, Victoria.
3. Construction of a greenfields plant at Regents Park, NSW.
4. Commissioning of two Roland 700 six color twin coating machines.
5. Commissioning of two die cutters.

The last of this major capital spend was completed in early FY07, hence the company has established a sound base from which to generate profit growth and strong free cash flow into the medium term.

Earnings changes

Following the result, we have downgraded FY07 – FY09 earnings by 12%, 10% and 8% respectively. The net result of these changes is detailed in table 2 below.

Table 2: Earnings changes

		FY07E	FY08E	FY09E
<u>Sales Revenue</u>				
Was	A\$m	73.4	79.0	83.8
Is	A\$m	71.9	77.3	82.0
Change	%	-2.1%	-2.1%	-2.1%
<u>EBITDA</u>				
Was	A\$m	12.9	13.9	14.4
Is	A\$m	12.1	13.2	13.6
Change	%	-6.4%	-5.6%	-5.2%
<u>EBIT</u>				
Was	A\$m	10.3	11.3	11.7
Is	A\$m	9.4	10.5	11.0
Change	%	-8.2%	-7.1%	-6.4%
<u>NPAT</u>				
Was	A\$m	5.5	6.2	6.6
Is	A\$m	4.8	5.6	6.1
Change	%	-12.5%	-10.0%	-8.3%
<u>Normalised EPS</u>				
Was	cps	6.8	7.7	8.2
Is	cps	6.0	7.0	7.5
Change	%	-12.5%	-10.0%	-8.3%

Source: Merrill Lynch estimates

Despite these downgrades, the company remains attractively priced, trading on a FY07 P/E <10x and a FY08 P/E of <8x. In addition, the forecast free cash flow yield in FY08 & FY09 is >12% due to low capex requirements following the significant capital outlay over the past 2 years.

Valuation

Our DCF for Colorpak is A\$0.76/share. This is based on a WACC of 10.5% and a terminal growth rate of 3%.

Recommendation

We remain comfortable with our Buy recommendation for Colorpak. Our positive recommendation is predicated on:

1. A solid growth outlook driven by underlying growth in key markets and continued market share gains.
2. A focus on the faster growing, less volatile and higher margin segments of the Australian carton board market.
3. A strong management team who own a significant proportion of stock and are intent on creating value for shareholders.
4. Cheap valuation. The stock trades on a forecast FY08E P/E of 8x and a fully franked dividend yield of 5.5%.
5. Takeover appeal. We expect ongoing rationalisation of the Australian carton board market into the future.

Price Objective Basis & Risk

Our price objective for Colorpak of A\$0.75/share is underpinned by our DCF valuation of A\$0.76/share. Were the stock to reach our price target in 12 months time, it would be trading on a forward P/E of ~10x, which we do not view as demanding.

The key risks to our Buy recommendation are:

- Product substitution.
- Competition.
- Rising raw material costs.
- Management instability.
- Customer attrition.

Analyst Certification

I, Campbell Morgan, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

*iQmethod*SM Measures Definitions

Business Performance	Numerator	Denominator
Return On Capital Employed	NOPAT = (EBIT + Interest Income) * (1 - Tax Rate) + Goodwill Amortization	Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill Amortization
Return On Equity	Net Income	Shareholders' Equity
Operating Margin	Operating Profit	Sales
Earnings Growth	Expected 5-Year CAGR From Latest Actual	N/A
Free Cash Flow	Cash Flow From Operations – Total Capex	N/A
Quality of Earnings		
Cash Realization Ratio	Cash Flow From Operations	Net Income
Asset Replacement Ratio	Capex	Depreciation
Tax Rate	Tax Charge	Pre-Tax Income
Net Debt-To-Equity Ratio	Net Debt = Total Debt, Less Cash & Equivalents	Total Equity
Interest Cover	EBIT	Interest Expense
Valuation Toolkit		
Price / Earnings Ratio	Current Share Price	Diluted Earnings Per Share (Basis As Specified)
Price / Book Value	Current Share Price	Shareholders' Equity / Current Basic Shares
Dividend Yield	Annualised Declared Cash Dividend	Current Share Price
Free Cash Flow Yield	Cash Flow From Operations – Total Capex	Market Cap. = Current Share Price * Current Basic Shares
Enterprise Value / Sales	EV = Current Share Price * Current Shares + Minority Equity + Net Debt + Sales Other LT Liabilities	
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

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XBVVF Price Chart



B : Buy, N : Neutral, S : Sell, PO : Price objective, NA : No longer valid

The Investment Opinion System is contained at the end of the report under the heading "Fundamental Equity Opinion Key". Dark Grey shading indicates the security is restricted with the opinion suspended. Light Grey shading indicates the security is under review with the opinion withdrawn. Chart current as of January 31, 2007 or such later date as indicated.

Investment Rating Distribution: Packaging Group (as of 31 Dec 2006)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1	33.33%	Buy	0	0.00%
Neutral	0	0.00%	Neutral	0	0.00%
Sell	2	66.67%	Sell	0	0.00%

Investment Rating Distribution: Global Group (as of 31 Dec 2006)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1306	42.74%	Buy	406	31.09%
Neutral	1509	49.38%	Neutral	446	29.56%
Sell	241	7.89%	Sell	53	21.99%

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