TAYLOR COLLISON

Sharebrokers and Investment Advisers
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28 April 2010

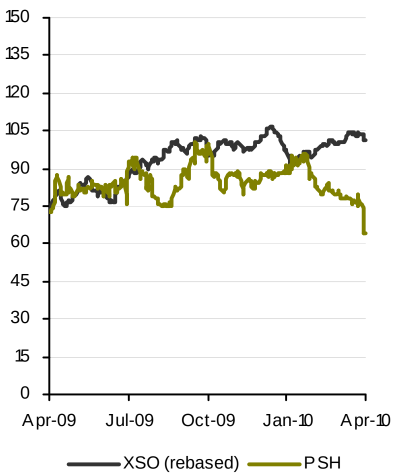
Penrice Soda

Marketperform

Price target
$0.62 (from $1.17)

Price
$0.64

Share Price History



Key Data

Market capitalisation
$58.5m

52-week range
$0.625 - $1.05

Fiscal year-end
30 June

Average monthly (12 mth) trades
4.9m

NTA per share
$0.80

Small Ordinaries weighting (%)
n/a

Analyst

James Lennon
02 9210 1338
jlennon@taylorcollison.com.au

Earning less from more

Having previously expected an imminent return to positive free cash flows following the recent completion of the Way Forward Plan, this has now been thwarted by the combined effects of increased production and de-stocking amongst key customers.

Key Forecasts - Excluding Unrealised Gains/Losses

Year Ending 30 June	2008A	2009A	2010F	2011F	2012F
Revenue (A$m)	135.4	162.3	162.5	168.5	173.9
EBITDA (A$m)	19.8	28.0	25.1	27.4	29.8
Net Profit (A$m)	6.6	9.1	5.1	8.7	10.9
EPS (cps)	14.6	18.2	6.8	9.5	11.9
Dividend (cps)	10.5	0.0	0.0	2.5	5.5
PER (x)	4.4	3.5	9.4	6.7	5.4
EV/EBITDA (x)	5.1	4.2	4.7	4.3	3.6
EPS Growth (%)	-1.8	24.1	-62.6	39.9	24.8
Dividend Yield (%)	16.4	0.0	0.0	3.9	8.6
ROE (%)	14.1	16.6	6.7	9.1	10.6

Profit downgrade on reduced soda ash demand

Penrice Soda has revised its market guidance for FY10, with management's expectations for underlying net profit having been reduced from $9.0m to between $5.0m and $6.0m. Furthermore, management expects FY10 free cash flow to be between negative $7.0m and negative $9.0m, which compares to previous expectations of a break-even position.

Key takeaways

Management has cited reduced demand and extended plant shutdowns amongst its major customers as key reasons for the flagged reduction in profitability in FY10. While providing a painful reminder of the risks of investing in companies with highly concentrated customer bases, in our view it also highlights Penrice Soda's potential vulnerability to import competition.

Material earnings downgrades

We have made significant downward revisions to our estimates following today's trading update. While our FY10 earnings changes are commensurate with management's revised guidance, our FY11 and FY12 forecasts have also been reduced. These revisions reflect our increased concerns regarding import parity pricing and emerging structural changes in the glass industry.

Downgrade to Marketperform

We have cut our rating to Marketperform and price target to $0.62ps following today's trading update. While lured by the current discount to NTA, recent capacity upgrades and potential for a significant improvement in cash flows, we are now of the view that Penrice Soda's earnings will remain suppressed until the US GDP run-rate or the AUD revert to their longer-term average.

The Power of Three

Event

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Earnings Revisions

We have made significant downward revisions to our estimates following today's trading update. While our FY10 earnings changes are commensurate with management's revised guidance, our FY11 and FY12 forecasts have also been reduced. These revisions reflect our increased concerns regarding import parity pricing and emerging structural changes in the glass industry.

		2010F			2011F			2012F	
Year Ending 30 June	**Old**	**New**	**Chg**	**Old**	**New**	**Chg**	**Old**	**New**	**Chg**
EBITDA (A$m)	31.0	25.1	-19.0%	33.4	27.4	-18.2%	34.9	29.8	-14.8%
NPAT (A$m)	9.9	5.1	-47.8%	13.6	8.7	-36.0%	15.2	10.9	-28.6%
EPS ¢	13.1	6.8	-47.8%	14.9	9.5	-36.0%	16.6	11.9	-28.6%
DPS ¢	3.0	0.0	-100.0%	6.5	2.5	-61.5%	7.5	5.5	-26.7%
Free cash flow (A$m)	3.3	-8.6	-362.1%	12.4	10.5	-15.8%	19.6	14.2	-27.5%

Key Points

Concentrated customer base. As per the company's trading update, management has attributed the bulk of the FY10 downgrade to reduced demand from the company's major soda ash customers – Owens-Illinois, CSR Viridian, and Amcor. While not disclosed, we estimate that these three customers ordinarily account for c75% of Penrice Soda's soda ash production.

Key drivers of reduced demand. While management has attributed the bulk of the reduction in soda ash demand to seasonal and cyclical factors, in our view there are also some indications of structural change within the industry. Management also noted reduced demand for sodium bicarbonate given the impact recent floods have had on demand for animal feed:

- **Seasonal**. While plant shutdowns are an ordinary course of business, it appears that Penrice Soda's key customers have been undertaking extended plant maintenance programmes given subdued levels of demand in their respective end-markets. According to management, these extended shutdowns were largely unannounced;
- **Cyclical**. Weak demand in end-markets such as housing construction and beverages has prompted local glass manufacturers to reduce production and inventories. And given recent pressure on the import parity price and Penrice Soda's c80% share of the domestic market, the company has been forced to sell product in export markets, and
- **Structural**. As per our October 2009 initiation of coverage note *Rising from the ashes*, there has been some technological innovation within the container glass industry that have led to a reduction in soda ash requirements. These include (i) increased use of glass cullets, and (ii) thinner glass bottles.

Cash flow impact greater than profit impact. According to management, free cash flow is expected to be c$8m lower than previous guidance. While noting that capex expectations for FY10 have not changed, the reduction in both sales and profitability has resulted in a substantial increase in inventory (c30% of surplus product) and debtors (payment timing).

Debt covenants not at risk. According to management, Penrice Soda is not at risk of breaching its debt covenants, despite the magnitude of today's downgrade. Based on previous conversations with management, Penrice Soda's debt covenants comprise leverage, debt serviceability, and net worth metrics. The facility is due to expire in March 2012.

Demand now recovering. According to management, de-stocking appears to have run its course, with demand "now stabilising and recovering". And given indications from Penrice Soda's key customers, management expect "soda ash sales volumes to firm and increase over the next 12 months."

Amcor adds a third production line. According to management, the recent commissioning of Amcor's third production line, which is ultimately expected to increase output by c50%, represents a significant positive for Penrice Soda given its recent contract renewal. Nevertheless, the timing of any uplift remains uncertain given teething issues and the prevalent use of cullets.

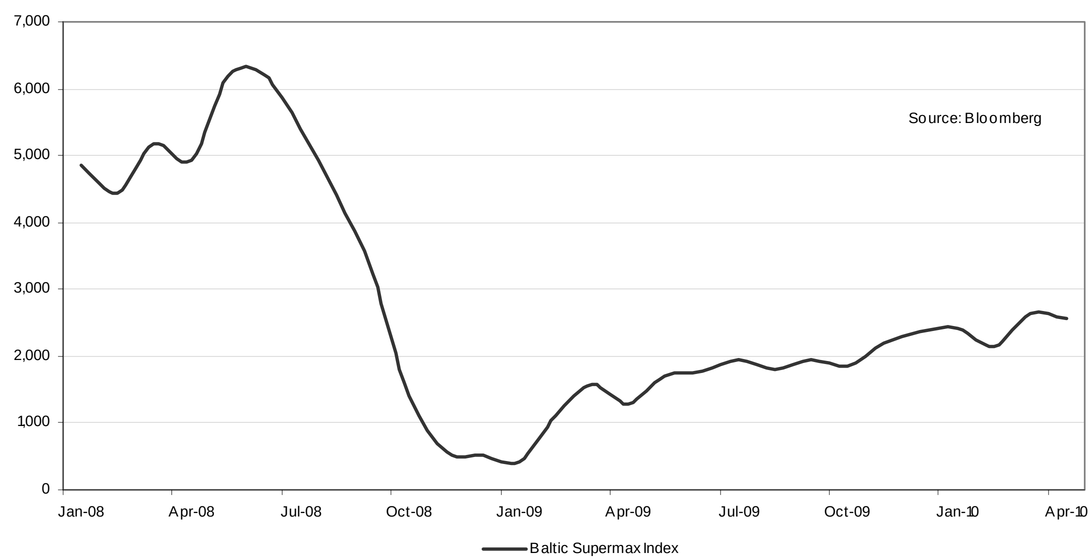
Product dumping remains contained. Management noted that there have been some isolated cases of product dumping of both soda ash and sodium bicarbonate in Australia. Nevertheless, given the strong Australian dollar and the fact that the global market remains long soda ash, management is actively pursuing a five-year extension to its current anti-dumping duty.

Key Takeaways

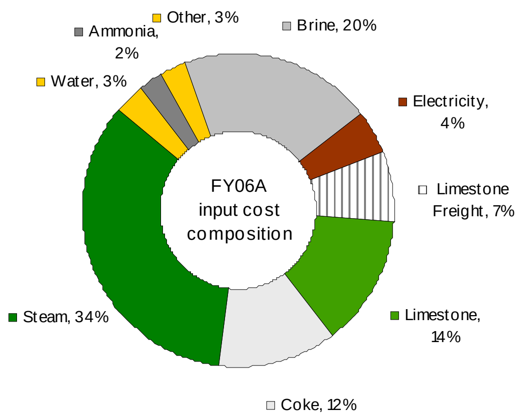
Internal systems. While we believed there was downside risk to our FY10 estimates given the strong Australian dollar and anecdotal evidence of increased competition in key offshore markets, we are surprised by the extent of the earnings downgrade. In our view, this raises question marks over the quality and/or adequacy of the company's internal systems.

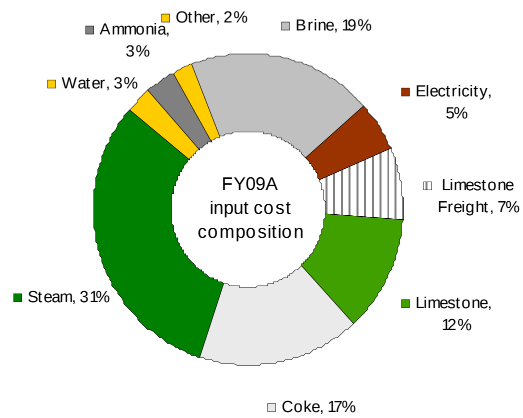
Supplier power. While a known risk, the simultaneous reduction in demand from Penrice Soda's three major customers does appear to be an extreme case of bad luck. While management are expecting an almost immediate recovery to 'normal' levels of demand, a more sinister view would be that Penrice Soda's customers are now importing a greater proportion of their requirements.

Import parity. Given the significant appreciation in the Australian dollar, reduced shipping rates, and general reduction in demand for soda ash globally, it follows that the import parity price is now likely to be significantly lower than it was 12-18 months ago. Notwithstanding logistical issues associated with importing Chinese soda ash, such competition remains a credible threat.



Input prices. As per the charts below, (i) coke represents a substantial input cost for Penrice Soda, and (ii) according to the Sydney Morning Herald, coking coal prices are forecast to increase by c70% in the 12 months to April 2010. While noting that the majority of Penrice Soda's input costs are subject to long-term supply agreements, coke and ammonia are not.





Cautious recovery. While noting management's expectations for a reasonably swift recovery in demand and thus an improved performance in FY11, our earnings revision reflect a more cautious outlook for the Group. In essence, we believe today's earnings downgrade highlights the vast number of risks facing Penrice Soda and the overall lack of transparency within the industry.

Penrice Soda Holdings - Forecast Summary								
Sales Revenue		**2007A**	**2008A**	**2009A**	**2010F**	**2011F**	**2012F**	**2013F**
Chemicals	A$m	119.9	116.7	138.1	137.1	140.6	147.1	151.6
Minerals	A$m	14.4	18.3	24.1	25.4	28.0	26.9	27.1
Group	**A$m**	**134.2**	**135.1**	**162.3**	**162.4**	**168.5**	**173.9**	**178.7**
EBIT		**2007A**	**2008A**	**2009A**	**2010F**	**2011F**	**2012F**	**2013F**
Chemicals	A$m	8.7	7.8	10.0	6.9	7.2	9.1	10.0
Minerals	A$m	5.2	6.5	10.5	9.8	11.4	11.7	12.4
Group	**A$m**	**13.8**	**14.3**	**20.5**	**16.8**	**18.7**	**20.8**	**22.4**
EBIT Margin		**2007A**	**2008A**	**2009A**	**2010F**	**2011F**	**2012F**	**2013F**
Chemicals	%	7.2%	6.6%	7.2%	5.1%	5.1%	6.2%	6.6%
Minerals	%	36.0%	35.6%	43.6%	38.8%	40.9%	43.5%	45.8%
Group	%	**10.3%**	**10.6%**	**12.6%**	**10.3%**	**11.1%**	**12.0%**	**12.5%**
Earnings Growth		**2007A**	**2008A**	**2009A**	**2010F**	**2011F**	**2012F**	**2013F**
Sales	%	0.4%	0.6%	20.1%	0.1%	3.8%	3.2%	2.7%
EBIT	%	-5.2%	3.1%	43.7%	-18.3%	11.3%	11.6%	7.6%
Net Profit - Underlying	**%**	-25.7%	-1.6%	37.6%	-43.5%	69.1%	24.8%	15.8%
Per Share		**2007A**	**2008A**	**2009A**	**2010F**	**2011F**	**2012F**	**2013F**
Shares - Diluted Average	m	45.2	45.3	50.2	75.8	91.6	91.6	91.6
EPS - Diluted	cps	14.9	14.6	18.2	6.8	9.5	11.9	13.7
EPS Growth - Underlying	**%**	**-26.0%**	**-1.8%**	**24.1%**	**-62.6%**	**39.9%**	**24.8%**	**15.8%**
Debt		**2007A**	**2008A**	**2009A**	**2010F**	**2011F**	**2012F**	**2013F**
Net Debt - Closing	A$m	48.5	71.4	86.6	69.1	59.7	49.0	38.8
Interest Cover (EBIT)	x	3.2	2.4	2.4	2.0	2.7	3.4	4.2
Gearing (D/D&E)	%	**51.5%**	**59.7%**	**58.5%**	**42.7%**	**37.6%**	**31.8%**	**25.7%**
Dividends								
DPS	cps	10.0	10.5	0.0	0.0	2.5	5.5	6.0
Payout Ratio	%	66.9%	71.4%	0.0%	0.0%	26.3%	46.3%	43.6%
Dividend Yield	**%**	**15.6%**	**16.4%**	**0.0%**	**0.0%**	**3.9%**	**8.6%**	**9.4%**

Valuation. As per the table below, our risked valuation for Penrice Soda has fallen from $1.17ps to $0.62ps. This reflects (i) the significant reductions to our earnings forecasts, and (ii) the application of a 30% discount to the market multiple used in our EBIT valuation, which compares to 20% previously.

Valuation Summary	FY11
Chemicals - Enterprise Value	
EBIT Multiple at 30% discount to Small Industrials	$57.7m
DCF based on 12.1% WACC and l-t growth rate of 1%	$77.3m
- DCF (explicit forecasts)	$51.2m
- DCF (terminal value)	$26.1m
Weighted Average (75% EBIT & 25% DCF)	$62.6m
Minerals - Enterprise Value	
- DCF based on 40-year mine life	$77.6m
Adjustments	
Franking Credits	$10.6m
Net debt	$69.1m
Equity Value	
- Including franking credits	$81.8m
- Excluding franking credits	$71.1m
Shares on issue	91.6m
Equity Value Per Share	
- Including franking credits	$0.89
- Excluding franking credits	$0.78
Risked Valuation	
Risk Buffer	70%
Price Target	$0.62

Investment View

We have cut our rating to Marketperform and price target to $0.62ps following today's trading update. While lured by the current discount to NTA, recent capacity upgrades and potential for a significant improvement in cash flows, we are now of the view that Penrice Soda's earnings will remain suppressed until the US GDP run-rate or the AUD revert to their longer-term average.

Penrice Soda Holdings

Year Ending 30 June	2008A	2009A	2010F	2011F	2012F
Profit & Loss (A$m)					
Revenue	135.4	162.3	162.5	168.5	173.9
EBITDA	19.8	28.0	25.1	27.4	29.8
Depreciation & Amortisation	5.5	7.5	8.4	8.7	9.0
EBIT	14.3	20.5	16.8	18.7	20.8
Net interest expense	5.9	8.5	8.2	6.9	6.1
Pre-tax profit	8.4	12.0	8.5	11.8	14.7
Tax expense	1.8	2.0	2.2	3.1	3.9
NPAT - Underlying	**6.6**	**9.1**	**5.1**	**8.7**	**10.9**
NRIs/Unrealised Gains (Losses)	0.6	-2.0	0.9	0.0	0.0
NPAT - Reported	**7.3**	**7.1**	**6.0**	**8.7**	**10.9**

Year Ending 30 June	2008A	2009A	2010F	2011F	2012F
Cash Flow (A$m)					
EBITDA	19.8	28.0	25.1	27.4	29.8
Change in working capital	-13.8	-15.2	-13.2	7.0	2.6
Other operating cash flows	-5.0	-12.7	-10.3	-9.2	-9.3
Operating cash flow	1.1	0.1	1.7	25.1	23.1
Capex	-20.8	-22.6	-10.3	-14.7	-8.9
Free cash flow	**-19.7**	**-22.5**	**-8.6**	**10.5**	**14.2**
Other investing cash flows	0.0	0.3	0.0	0.0	0.0
Dividends	-4.4	-1.7	0.0	-1.0	-3.5
Other financing cash flows	26.2	20.3	9.6	-5.0	-5.0
Change in cash	**2.1**	**-3.6**	**1.0**	**4.4**	**5.7**

Segmentals (A$m)					
Sales Revenue	**135.1**	**162.3**	**162.4**	**168.5**	**173.9**
Chemicals	116.7	138.1	137.1	140.6	147.1
Minerals	18.3	24.1	25.4	28.0	26.9
EBIT	**14.3**	**20.5**	**16.8**	**18.7**	**20.8**
Chemicals	7.8	10.0	6.9	7.2	9.1
Minerals	6.5	10.5	9.8	11.4	11.7

Margin/Ratio Analysis					
EBITDA margin	14.6%	17.3%	15.5%	16.2%	17.1%
EBIT margin	10.5%	12.6%	10.3%	11.1%	12.0%
Effective tax rate	21.2%	16.7%	25.8%	26.0%	26.3%
ROE (post-tax)	14.1%	16.6%	6.7%	9.1%	10.6%
RONA (post-tax)	7.6%	5.7%	4.1%	5.6%	7.1%
ROIC (post-tax)	8.7%	10.1%	7.2%	7.7%	8.8%

Balance Sheet (A$m)					
Cash	4.3	0.7	1.7	6.1	11.8
Receivables	19.1	24.7	27.6	25.3	26.1
Investments	0.0	0.0	0.0	0.0	0.0
Property, plant and equip	77.0	92.5	94.5	100.5	100.5
Goodwill	18.0	18.0	18.0	18.0	18.0
Other assets	47.1	62.2	73.0	69.5	67.1
Total Assets	**165.5**	**198.1**	**214.7**	**219.3**	**223.4**
Payables	24.9	33.0	32.5	33.7	34.8
Borrowings	75.7	87.3	70.8	65.8	60.8
Provisions	16.7	14.8	16.2	16.9	17.4
Other liabilities	0.0	1.9	2.4	3.8	5.5
Total Liabilities	**117.3**	**136.9**	**121.9**	**120.2**	**118.4**
Shareholders equity	**48.2**	**61.2**	**92.8**	**99.2**	**105.0**

Capital Position					
Closing Net Debt/(Cash)	71.4	86.6	69.1	59.7	49.0
Gearing (D/D&E)	60%	58%	43%	38%	32%
Net interest cover (EBIT)	2.4	2.4	2.0	2.7	3.4
Fundamentals					
Normalised EPS (cps)	14.6	18.2	6.8	9.5	11.9
EPS Growth (normalised cps)	-1.8	24.1	-62.6	39.9	24.8
PER (x)	**4.4**	**3.5**	**9.4**	**6.7**	**5.4**
Dividends (cps)	10.5	0.0	0.0	2.5	5.5
Dividend Yield (%)	**16.4**	**0.0**	**0.0**	**3.9**	**8.6**
NTA backing (cps)	64.0	81.0	81.0	88.1	94.5
EV/EBITDA (x)	**5.1**	**4.2**	**4.7**	**4.3**	**3.6**
Shares - Diluted Average (m)	45.3	50.2	75.8	91.6	91.6

DCF Summary	**A$m**	**Per Sh**
Explicit CF - Chemicals	51.2	$0.56
Explicit CF - Minerals	77.6	$0.85
Terminal CF - Chemicals	26.1	$0.29
EV - Group	**154.9**	**$1.69**
Nebt Debt/Dividends	-69.1	-$0.75
Net Imputation	10.6	$0.12
Equity Valuation	**96.4**	**$1.05**

Valuation Summary	**A$m**	**Per Sh**
EBIT - Chemicals (20% disc to XSI)	57.7	$0.63
DCF - Chemicals (WACC 12.1%)	77.3	$0.84
Blend - Chemicals (25% DCF)	62.6	$0.68
DCF - Minerals (WACC 12.1%)	77.6	$0.85
EV - Group	**140.2**	**$1.53**
Net Adjustments	-58.5	-$0.64
Equity Valuation	**81.8**	**$0.89**

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Analyst: James Lennon

Release Authorised by: Mark Pittman

Taylor Collison Limited
Sharebrokers and Investment Advisers
A.B.N. 53 008 172 450 AFSL No. 247083

Level 16, 211 Victoria Square
Adelaide, South Australia, 5000
G.P.O. Box 2046, Adelaide, South Australia, 5001
Telephone: 08 8217 3900 Facsimile: 08 8231 3506
Email: broker@taylorcollison.com.au

Level 10, 167 Macquarie Street
Sydney, New South Wales, 2000
G.P.O. Box 4261, Sydney, New South Wales, 2001
Telephone: 02 9377 1500 Facsimile: 02 9232 1677
Email: sydney1@taylorcollison.com.au

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