INTERSUISSE INVESTMENT RESEARCH

Graincorp Limited | **GNC** | **11 February 2010**

Malt cuts risk, offers steady growth as attractive international agribusiness opportunity

Recommendation: Buy for long-term lower risk agribusiness prospects

Investment Rationale

GNC is a long-established grain storage business. Cash flows and dividends may be less volatile due to the major United Malt Holdings ("UMH") acquisition, mildly offset by more currency exposure and lower franking. The combined management is capable, having expanded and focused the businesses and lowered costs in lengthy restructuring. The acquisition history adds corporate appeal as investors warm to agribusiness prospects and sector consolidation. While GNC searches for a new CEO, it now has the challenge of proving it can deliver reliable dividends and growth despite Australia´s climatic challenges.

On 6 October 2009 GNC agreed to acquire UMH, the world's 4th largest commercial malt manufacturer. The $757m acquisition, from private equity group CHAMP, transforms GrainCorp into an international agribusiness, with malting operations across Australia, the US, Canada and the UK.

The deal was financed by a 9-for-10 rights issue at $5.65 and a placement at $6.35, raising $600m. This followed equity raisings of ~$200m earlier in 2009. GNC more than doubled both its issued capital and earnings base.

The key is the lowered risk. Agricultural and weather risk is much reduced, with malt producing 43% of combined GNC and UMH EBITDA in their respective first half 2009 earnings. Malt, processed from barley, is required to produce beer and whisky. UMH has successfully focused on building its malt quality and customer service to become a key supplier across growth market sectors.

Event

- We attended GNC's Investor Day in Geelong, arranged to put UMH key management, as well as GNC's, in front of institutions and analysts. We were not alone in finding encouragement in the expertise and strategy.
- In its traditional grain storage, handling and export business, GrainCorp is dominant in the east-coast bulk terminal and ship-loading capacity. Don Taylor, Chairman since 2005, has been a Director since 2003 when the Board set objectives of sustainable and rising returns to shareholders, to maximise its agri-food value chain and reduce volatility by diversifying. The grain production of the 1990's has not been seen since, while GNC has progressively pursued these strategies. UMH is a big leap forward.
- Post the 2009 capital issues, at 31 December 2009 debt is around $208m short-term (net of $75m cash) and $104m long-term, a very comfortable level giving potential for organic and acquisition growth on- and off-shore.

Impact

- A picture of the new, expanded, group is given on later pages. It is clear that while under CHAMP stewardship UMH was by no means starved of capital and, led by US-based Jim Anderson, still CEO of the renamed GrainCorp Malt, the US and Canadian businesses significantly focused on growth areas of brewing and distilling, cementing relations with key clients by quality and service. The same was done in the UK and Australia, where new plants being built will add to sales through 2010 and 2011.
- There is depth of management in both halves of the new GNC. The Board has a mix of grazier, accountant and corporate experience as has the Chairman and a new Director Don McGauchie, former Telstra chairman.

Recommendation

The past is little guide to the future, especially in this case. GNC holds its AGM in Sydney on 24 February: expect FY10 guidance. We see the UMH deal and GNC's new strengths as highly positive. These include sound financials, widely experienced and proven management, new plant expansions already funded, on target and with committed sales. Some synergies in market intelligence, up- and down-stream supply movements and global grain trading may lead to new organic and acquisition opportunities not possible before.

Overall, we see GNC as likely the most attractive agri-investment opportunity on ASX. Clients should Buy and build positions for quality sector exposure.

Snapshot

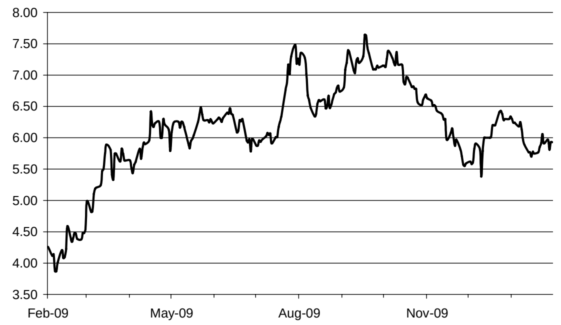
Last Price	$5.93
Market Cap.	$1,176 million
52 Week High	$8.85
52 Week Low	$3.86
Sector	Agricultural Products

Investment Fundamentals

Year-end September	FY08A	FY09A	FY10E	FY11E
NPAT, $m	-19.9	63.2	92.5	137.0
EPS, ¢	-26.8	73.5	47.5	69.1
EPS Growth, %			-35.4	45.5
PE Ratio, x	-	8.1	12.5	8.6
Dividend, ¢	0.0	7.27	22.0	31.0
Franking, %	-	100	70	70
Dividend Yield, %	-	1.2	3.7	5.2

Source: Intersuisse estimates

Price Chart



Business Description

Graincorp Limited (GNC) provides handling, storage, marketing, logistics & agronomic services to the Australian grain growing industry. Founded in 1916, it was privatised in 1992 & listed in 1998. Its Board has sought growth & diversification with acquisitions to counteract a slow decline in Australian grain output. The large crops of the 1980-90's now seem history & volatility has a large impact on profits despite GNC having the largest grain storage network on the east coast. GNC has over 250 country elevators, 20MT of storage capacity, from Qld To Vic, & operates seven bulk export terminals. Allied Mills is 60% owned in joint venture with Cargill, with flour mills nationwide. GNC is accredited for bulk wheat export. Its latest & largest move has been the acquisition of UMH. This gives vertical integration & global reach through the 4th largest maltster, one well placed to build on long-term contracts with major distilleries and brewers and a focus on growth areas such as micro-brewing. See the website www.graincorp.com.au

Analyst: Peter Russell

Graincorp Limited **GNC** **11 February 2010**

FY10 Earnings Guidance and progress of new malt houses at Arbroath, Scotland, and Pinkenba, Queensland

On 22 December 2009 GNC gave earnings guidance for FY10. This was reiterated on 21 January and again at the Investor Day, when it was noted that no financial surprises had emerged from either the storage and logistics or malt production units, and no unidentified capital needs had emerged from the latter.

Since the 30 September year-end, to 22 December 2009 country network receivals were 6.3 million tones (MT) and the outlook was for 7-8.5 MT. The **FY10 EBITDA outlook range is $180-210m**, including the equity accounted NPAT from GNC's 60% share of the Allied Mills joint venture with Cargill Australia. The outlook for **GrainCorp Malt's contribution to this EBITDA range is $100-120m**, for 10 ½ months of earnings from the effective acquisition date of 14th November 2009. To December, drought conditions in Queensland and NSW had reduced grain receivals, but conditions in Victoria were better than for the past three seasons, harvest meeting budget expectations.

On 22 December, the previous MD Mr Irwin, after a 3-week tour of GrainCorp Malt assets in the US and UK, "was impressed with GrainCorp Malt's focus on customer service. I was also impressed with the condition of the malting assets and the ability of the malt houses to produce malt with specific quality characteristics for individual customers. The assets are well maintained, and the future maintenance and capital expenditure requirements of the business unit are in line with our due diligence findings".

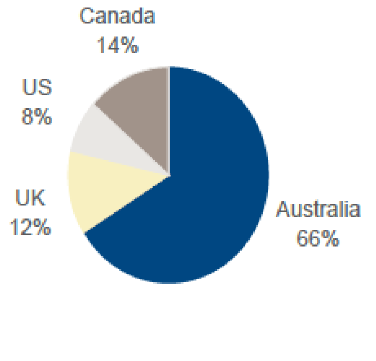
Mr Irwin also noted that, "Construction of the new **Arbroath** malt house is complete and has commenced producing its second batch of malt. The first batch produced was of very good quality". "The new malt house at **Pinkenba** is progressing well. Civil works are underway and the foundations for the steeps, germination vessels and the kilns are in place. The project is on budget and schedule". "There are several important markets we are unable to fully supply with our current capacity. The new capacity at Arbroath and Pinkenba will allow us to meet this demand". "Our assets will be running at around 95% capacity to meet our 14th November 2009 - 30th September 2010 projected malt sales volumes of between 920,000 to 950,000 T".

Further earnings guidance will be issued at the AGM on 24th February 2010.

The GrainCorp Malt businesses and their impact on the expanded GNC

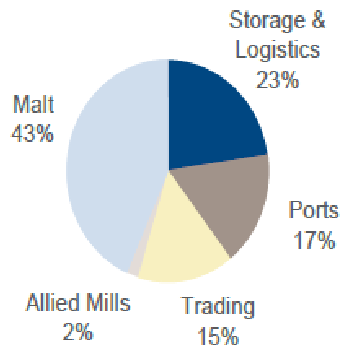
Processing barley and malt for beer and whisky in Canada, the USA, the UK and Australia (see p.4), UMH contracts with major brewers and distillers. With UMH, GrainCorp has substantially diversified and stabilised its earnings, very valuable in agribusiness, as follows:

Revenue by geography[1]



- GrainCorp Malt provides vertical and geographical diversification
- Majority of revenue continues to be generated in Australia

EBITDA by segment[2]



- GrainCorp Malt earnings are not significantly dependent on Australian weather conditions
- Increased exposure to downstream processing revenue provides earnings stability

Notes:

(1) Based on revenues for six months, for GNC ended 31 March 2009 and for UMH ended 30 June 2009.

(2) Based on EBITDA for 6 months, for GNC ended 31 March 2009 (excluding Merchandise and Corporate / Other) and for UMH ended 30 June 2009 (excluding unrealised mark to market derivatives adjustments).

The acquired businesses have substantial operations in Canada, the USA, United Kingdom, and Australia. Typically the maltsters have enjoyed very long relationships with customers who are the "who's who" of brewing and whisky-distilling:

- Baird's in Scotland has been supplying distillers for 100 years.
- Barrett Burston in Australia has been sole supplier of malt to Carlton & United Breweries (Foster's) for very many years.

These customers are very demanding in quality control and food safety standards, as poor product would make for costly damage to their brands. UMH has won business by focusing on the specific needs not only of a customer but of its particular breweries.

Two major expansion projects involving significant capital expenditure are under way:

- New capacity in FY10 at Arbroath in Scotland, that will enable Scottish distillers to source more local malt, and also enable exports to Europe and Japan.
- New facility in FY11 at Pinkenba (Brisbane region, Qld) that will enable export to San Miguel (based in the Phillipines) and Heineken's Asia Pacific operations.

<u>Combination of the businesses</u> allows a number of advantages – better global market intelligence and hence both better pricing and added in-house vertical integration; improved domestic and international trading abilities; complementary demand that potentially attracts grain into GNC's storage and logistics network. For instance, in Australia, Barrett Burston consumes up to 235,000 tonnes per annum ('tpa') of malt with at present only 20-30% coming through the GNC system. Allied Mills uses up to 800,000 tpa of wheat supplied by GNC although it has no physical assets in WA (an acquisition to come?). More grain can be pulled through the Canadian network. More volume raises market presence, grower connections and comparative advantage. There are significant opportunities for 'multi origin' export of wheat and barley, offering year round supply to export customers and increasing usage of plant infrastructure in Canada and Australia.

A joint team has been formed to oversee integration. The existing and long standing brand names will be retained. A senior GNC executive is moving to Vancouver as GrainCorp Malt CEO. The cultures are considered very similar and international risk and procurement strategies are being analysed. The task this year is to share best practices and build on complementary strategies.

The purchase terms for UMH acknowledged that malt earnings will ease through the cycle, but will be supported by growing long-term supply agreements with customers, new capacity coming on line and efficiency gains in integration of procurement and supply chains. The $757m acquisition price of UMH was attractive at 5.7x EBITDA and expected to be earnings accretive. It included all working capital ($167m) to operate the businesses, some $60m expenditure for Arbroath and Pinkenba, and a US$32.5m deal with Vancouver Port Authority for redevelopment of the malt house there. The success of UMH in building relationships with the faster growing sectors of the brewing and distillery markets is expected to continue, with the teams in place, strategies proven and opportunities identified.

<u>Comparative figures for GNC and UMH over recent years and periods, and derivation of forward estimates</u>

In FY09, GNC EBITDA trebled due to both higher volumes and lower costs. Ports were the highlight, their EBIT moving from $10m to $78m. Worst performer Merchandise lost $23m on it sub-scale and lower fertiliser and chemical prices. After a 3-month review, GNC decided in December to sell its merchandise service centres, and exit the merchandise sector by the end of FY10 at a likely net of tax cost of $3.5m. Net operating cash flow rose from minus $16m to $213m due to the higher EBITDA and lower inventories.

GNC figures

(A$ millions) *Y/E 30 September*	*2005*	*2006*	*2007*	*2008*	*2009*
Grain Receivals, million tonnes	**10.2**	**12.1**	**3**	**6.5**	**10.7**
Revenue	703	833	832	1534	**1730**
EBITDA	**92**	**121**	**32**	**51**	**165**
NPAT	14	32	-20	-20	63
EPS, ¢	14	78	-35	-11	34
EBITDA breakdown by Business Unit					
Storage & Logistics			**13**	**22**	**66**
Port Elevators			**6**	**10**	**78**
Trading / Marketing			24	28	40
Merchandise & Other			-1	4	-23
Allied Mills (equity accounted)			0	11	10
Corporate & Eliminations			-10	-24	-6
Total EBITDA			32	51	165

UMH figures

(A$ millions)	*CY2007*	*CY2008*	*12 mths to Jun-09*	*Interim CY2008*	*Interim CY2009*
Key business drivers					
Malt sales volumes (thousand MT)	1,032	1,061	1,046	539	524
Income statement (A$ millions) (1)					
Revenue	817	1,081	1,131	514	560
EBITDA excluding mark-to-market derivatives	64	108	133	52	77
EBITDA including mark-to-market derivatives	61	106	109	65	72
EBIT excluding mark-to-market derivatives	50	94	119	45	71
EBIT including mark-to-market derivatives	48	92	95	59	66
(1) FX rate used in translation, A$1.00 = US$	0.8387	0.8523	0.7472	0.9244	0.7125
Current FX rate A$1.00 = US$0.8664	0.8664	0.8664	0.8664	0.8664	0.8664
Income statement (A$ millions) (2)					
Revenue	791	1063	**975**	548	461
Adj EBITDA excluding mark-to-market derivatives	62	106	115	55	63
Adj EBITDA including mark-to-market derivative	**59**	**104**	**94**	69	59
Adj EBIT excluding mark-to-market derivatives	48	92	103	48	58
Adj EBIT including mark-to-market derivatives	46	91	82	63	54

The box shows the key group drivers –

- the Grain Receivals with EBITDA, NPAT and EPS and sector EBITDA of GNC and
- the Malt Sales with EBITDA and EBIT of UMH.

All figures are in A$, from GNC accounts and the Pathfinder Prospectus for funding the UMH deal. The A$ /US$ rates used for UMH are shown at (1).

In the last seven lines we have notionally converted the figures for UMH's EBITDA and EBIT at the recent exchange rate of US86.64¢ per A$.

This possibly gives a fairer picture to compare recent UMH EBITDA of around $105m and EBIT at around $92m, to compare with GNC's $51m for FY08 and $165m for FY09.

For GNC, $165m EBITDA was the highest over five years, but held back by $23m losses on merchandise, the sector now being closed. The $51m earned in FY08 was the second lowest over five years. Ex merchandise and with the reduced corporate costs now evident in FY09, we put the low year (FY08) EBITDA at $61m and the high one (FY09) at $184m.

This exercise, even if hypothetical, suggests the relatively steady base of GrainCorp Malt EBITA at some $105m and growing, and the weather-related volatility of the original GNC business at between $61m and $184m, a total between $166m and $289m annualised.

This compares with and endorses the guidance noted on page.2 for FY10 EBITDA of $180-210m with a Malt contribution of $100-120m for 10 ½ months.

Both consensus and our own estimates conform to this range and anticipate further growth in FY11 from the GrainCorp Malt business, including synergies and trading prospects and the impact of the added malt capacity already being built.

Beer and whisky consumption are growing in low single digits. However, beer consumption has grown much faster in Asia and developing areas. Whisky as an 'aspirational' drink is already growing very rapidly in these areas and this is set to increase. In North America, microbreweries are growing dynamically. Now ~35% of UMH sales are in these areas. UMH focuses on long-term contracts – 96% of FY10 production is sold, 66% of FY11 and 45% of FY12. It targets the top brands.

Sales volumes, KT	*2005A*	*2009E*	*growth %*
NA regional/microbrewers	92.7	143.2	55%
UK distillers	64.1	109.5	71%
South America	79	129.2	64%

Barrett Burston Malting		**Canada Malting Company**		**Great Western Malting, US**		**Bairds Malt, UK**	
Capacity, '000 MT pa		Capacity, '000 MT pa		Capacity, '000 MT pa		Capacity, '000 MT pa	
Geelong	103	Calgary (west)	250	Vancouver, WA	117	Inverness, Scotland	45
Melbourne	23	Thunder Bay (mid)	120	Pocatello, mid-west	93	Arbroath, Scotland	to 83
Sydney	35	Montreal (east)	80	Montreal (east)	**210**	Pencaitland, Scotland	45
Toowoomba	25	50% of Canada's malt	**450**	Leading **US producer** in main		Grantham, England	31
Pinkenba, Q'ld	86	70% long-term contracts		barley region - north-west US.		Witham, England	53
20% of **Australia**'s	**Total**	60% sold to large NA brewers /		Over 800 customers - large to		Sales 90% UK. 40% to	**Total**
malt, 30% post	**186 to**	microbreweries. Also Asia,		microbrewers. Procures 40% in-		brewers, 66% to	**174 to**
Pinkenba	**272**	Safrica, SAmerica		house from 200 growers (aiming		distillers	**257**
46% exports to Japan, Korea,		Procure 80% of barley in-house		for 100%). To upgrade		90% of whisky is exports -	
Thailand, Vietnam		from >2,000 growers		Vancouver plant		Japan, Americas, SAfrica	
		Operates 9 grain elevators				Direct procurement, own seed	

Current capacity of 1,020,000 MT pa will rise by 86,000 when Pinkenba near Brisbane is open in January 2011, and a further 83, 000 on completion of the second stage of Arbroath, to a total of 1,189,000 MT. Currently malt sales are approximately 36% in US/Canada, 18% UK, 17% Asia, 15% Latin America, 9% Australia and 5% South Africa.

GNC also has a 60% interest in **Allied Mills**, a joint-venture with Cargill, the major international agribusiness group, with equal management rights. Acquired from Goodman Fielder in 2002, Allied Mills operates ten **flour mills** / mixing facilities across Australia, and supplies industrial bakeries, in-store bakeries and other food product companies. It services most blue chip food companies and many small customers through a national distribution network. It has ~50% market share of the human consumption market, with Weston Milling and Manisdra Group having a combined 90% of milling capacity. Prospects are from non 'white' flour and new products such as frozen dough, bakery, bead and cake mixes, batters, coatings, binders and specialty mixes. The organization has been changed to focus on this, while a new $97m mill at Picton, near Sydney, the first in NSW.for 50 years, will add to efficiencies and should generate $10m EBITDA improvement. A frozen dough plant was acquired in Yatala, Q'ld, for $9.5m in 2008 with a 10-year agreement with Donut King. Allied is the largest supplier to Goodman Fielder, with a contract to 2012. Additional plans for growth are under way. Like Malt, the focus is downstream, on efficiencies, quality and delivered cost reduction, winning/maintaining key customers and adding value down the chain.

Investment Summary

The fundamentals attract. We believe the GNC Board has a dividend policy of paying out 40-to-60% of net profit to shareholders.

GNC has a conservative balance sheet. We understand that trading, hedging and derivative positions are only taken to offset business trading risk. Its focus on effectively using its physical assets gives it more earnings stability and its cultural focus on quality service to key customers should continue to support earnings growth. Its geographically diverse operations offer a seasonal and weather hedge and enhance its market intelligence and trading reach. Earnings will be fuelled also by the current capacity expansions to supply known market needs. Possible synergies and organic and acquisition potential add further upside. Before the new group settles into its stride and becomes fully appreciated by the marketplace, the current price offers a long-term investment opportunity.

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Prepared by Peter Russell

INTERSUISSE LIMITED ABN 14 002 918 247, AFSL 246827		Market Participant of the ASX Group	
Melbourne Office:		Sydney Office:	
Level 37, 530 Collins Street,		Level 7, 5 Elizabeth Street,	
Melbourne, Vic, Australia 3000		Sydney, NSW, Australia 2000	
Telephone:	(+613) 9629 8288	Telephone:	(+612) 9233 2100
Facsimile:	(+613) 9629 8882	Facsimile:	(+612) 9233 2117
Email:	suisse@intersuisse.com.au	Email:	sydney@intersuisse.com.au

Internet: http://www.intersuisse.com.au