RBS Morgans

7 November 2011

Produced by: RBS Morgans Limited

Collection House

Strong 1Q start

CLH's 1Q12 update provided evidence of continued earnings momentum, up 48% on pcp. On the back of a solid FY12 start and continued execution of the company's strategy, we upgrade to a Buy.

Change of recommendation

Buy (from Hold)

Important: The above recommendation has been made on a 12 month view and may not suit your investment needs or timeframe. The basis it is prepared on is summarised on the last page of this report. **PLEASE CONTACT YOUR ADVISER TO DISCUSS THIS GENERAL RECOMMENDATION BEFORE ACTING ON IT.**

Low-Mod Volatility

Target price
A$0.87

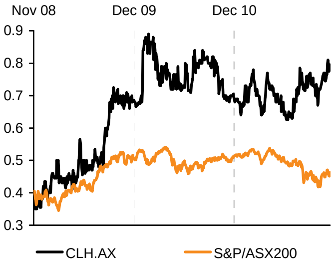
Price
A$0.790

Short term (0-60 days)
n/a

CLH111107

Price performance

	(1M)	(3M)	(12M)
Price (A$)	0.74	0.72	0.75
Absolute (%)	7.5	9.7	5.3
Rel market (%)	-2.8	9.6	16.8
Rel sector (%)	-2.3	19.6	19.7



Market capitalisation
A$77.67m (US$80.80m)

Average (12M) daily turnover
A$0.06m (US$0.06m)

Sector: BBG AP All Industrial
RIC: CLH.AX, CLH AU
Priced A$0.79 at close 7 Nov 2011.
Source: Bloomberg

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Key forecasts

	FY10A	FY11A	FY12F	FY13F	FY14F
EBITDA (A$m)	50.50	55.90	65.60	71.40	77.70
Reported net profit (A$m)	8.88	10.10	11.50	12.70	14.10
Normalised net profit (A$m)¹	8.88	10.10	11.50	12.70	14.10
Normalised EPS (c)¹	9.13	10.29	11.53	12.31	13.37 ▼
Normalised EPS growth (%)	11.80	12.80	12.10	6.71	8.63
Dividend per share (c)	5.80	6.20	6.70	7.00 ▼	7.40 ▼
Dividend yield (%)	7.34	7.85	8.48	8.86	9.37
Normalised PE (x)	8.66	7.68	6.85	6.42	5.91
EV/EBITDA (x)	2.87	2.75	2.52	2.43	2.30
Price/net oper. CF (x)	1.85	1.62	1.39	1.35	1.31 ▲
ROIC (%)	7.39	8.91	9.27	9.48	9.77

Use of ▲ ▼ indicates that the line item has changed by at least 5%.
1. Pre non-recurring items and post preference dividends
Accounting standard: IFRS
Source: Company data, RBS Morgans forecasts

year to Jun, fully diluted

Strong 1Q12 result – NPAT up 48% on pcp

CLH's 1Q12 update reported collections and commissions up 16% resulting from improved collection efficiency (a higher level of new PDL's flowing through); a 17% increase in Contingent Collections revenue (two new contracts won); and a strong increase in collections from the Arrangement Book. 1Q12 NPAT of A$3.5m was up 48% on pcp, with the EBIT margin up 500bp to 29%. CLH stated that past seasonal trends suggest the next six months won't deliver the same level of growth; however, management is confident of delivering solid EPS growth in FY12. For the first time, CLH provided earnings guidance comprising: 1H12 NPAT A$5.5m-$5.8m (A$5.1m in the pcp) and FY12 NPAT A$11m-A$11.5m (A$10.1m in the pcp). Given the strong 1Q12 start, we believe guidance looks relatively conservative (and assumes no growth over the remainder of FY12). In addition to earnings guidance, CLH has reaffirmed PDL acquisition guidance of A$60m-70m, with A$47m committed to-date.

Capital management initiatives a medium-term positive

CLH has confirmed several capital management initiatives to allow for continued PDL investment while reducing balance sheet leverage over the medium term. CLH has implemented a DRP, will undertake a small capital issue, and reduce the dividend payout ratio to 50-60% of EPS (from 60-65%). We view these initiatives as positive for the long-term growth and de-risking of the business. CLH will also continue to review the group's operating divisions to ensure all are generating acceptable ROC, with any non-core divestments (and subsequent reduction in gearing) a positive catalyst, in our view.

Investment view – upgrade to a Buy, A$0.87 price target

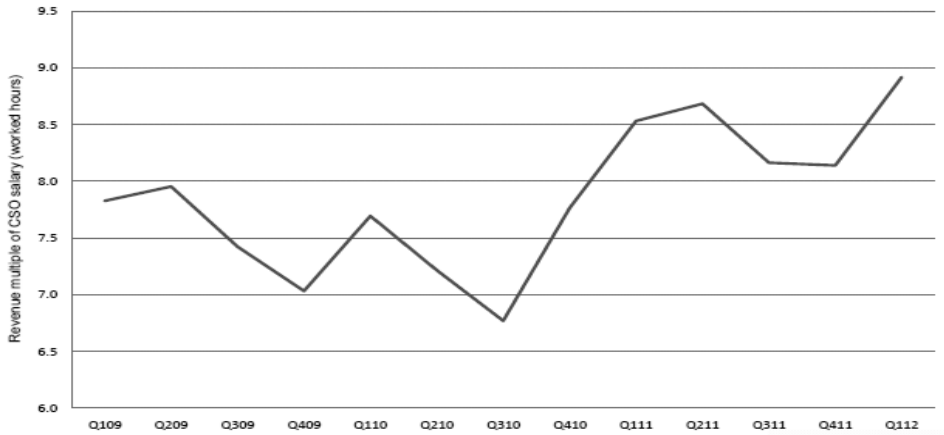
CLH has delivered consistent growth over the past three years, which we see continuing over the medium term given: increased PDL acquisition levels, new capital initiatives, improving results from Contingent Collections and an increased focus on ROC. With management continuing to deliver on CLH's stated strategy, we upgrade to a Buy. Our target price is set in line with our DCF valuation of A$0.87ps.

1Q12 update – strong start to the year

CLH recently announced a strong start to FY12 resulting from improved productivity and new Contingent Collections contracts.

- **1Q12 up 48%** - NPAT of A$3.5m vs A$2.3m in the pcp. PDL collections and commission (revenue) rose 16% to A$33.1m (from A$26.7m). EBIT margin expanded 500bp to 29%.
- **NPAT guidance** – 1H12 NPAT of A$5.5m–A$5.8m and FY12 NPAT A$11.0m–A$11.5m. We have upgraded our FY12 NPAT forecast to A$11.5m (from A$11.3m) noting we believe management has taken a conservative approach to issuing guidance.
- **PDL guidance** – CLH has reaffirmed FY12 PDL guidance of A$60-70m with A$47m of purchases committed to date. At 30 June, CLH had around A$25m of debt headroom to fund acquisitions (in addition to cA$55m in operating cash flow and capital initiatives mentioned).
- **Commission Collections** – two new contracts were secured in the quarter from major Australian Banks, contributing to a 17% increase in revenue on the pcp.
- **Productivity** – as seen in Figure 1, collection productivity was one of the drivers of the 1Q result (on the back of increased levels of new PDL's flowing through).

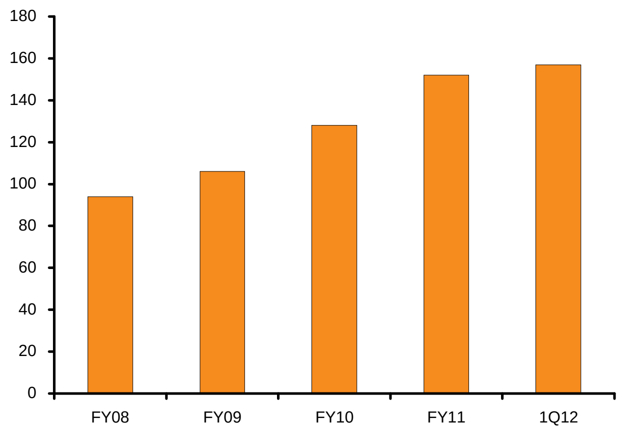
Figure 1 : Collections Productivity



Source: Company data

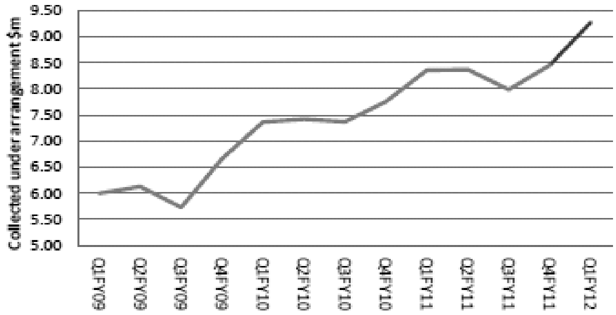
- **Arrangement book –** CLH's Repayment Arrangement book now stands at A$157m with over A$9m of collections from the book in 1Q12. The arrangement book continues to provide increased certainty over collections and cash flow for the business.

Chart 1 : Arrangement Book Face Value



Source: Company data

Chart 2 : Collections from Arrangement Book



Source: Company data

- **International expansion** – CLH has announced it will establish a Philippine-based call centre and subsidiary to be established in early CY12. The facility will commence with 50 staff with capacity to double. CLH has run an outsourced offshore collections model over the past 12-months to evaluate the opportunity and management has commented initial results are pleasing. We see the move to offshore (as implemented by other domestic collection agents) as a relatively low-risk (small initial capital outlay and leasing obligations) initiative which will provide CLH another lower-cost client solution.

Capital management initiatives a positive

As part of CLH's capital optimisation review, CLH will implement the below capital initiatives. We view these as a positive, providing the business with greater balance sheet flexibility to fund PDL acquisitions and reducing gearing over the medium term.

- Dividend reinvestment plan;
- Small capital issue in November;
- Reduced dividend payout ratio – 50-60% of EPS from 60-65%; and
- Ongoing review of operations – the board will continue to review the potential sale of any non-core asset that is not generating an acceptable return on capital.

Changes to forecasts

After making minor adjustments to our cost assumptions, incorporating increased shares on issue under the DRP and amending our dividend payout ratio (now 58% FY12, 57% FY13), we have made the following changes to forecasts:

Table 1 : Changes to forecasts

	FY12F		FY13F	
	Previous	Revised	Previous	Revised
Reported profit (A$m)	11.3	11.5	12.7	12.6
% change		1%		-1%
EPS (c)	11.6	11.5	12.9	12.3
% change		-1%		-5%
DPS (c)	6.9	6.7	7.7	7.0
% change		-3%		-9%

Source: RBS Morgans forecasts

Investment view – upgrade to a Buy, A$0.87 price target

CLH has delivered improved operational performance and consistent earnings growth over the past four years. We view the strong 1Q12 as positive, reflecting management's continued focus on improving productivity, strong PDL analytics and growth initiatives. We see solid medium-term growth continuing given: increased PDL acquisition levels, new capital initiatives, improving results from Contingent Collections and an increased focus on ROC. With management continuing to deliver on CLH's stated strategy, we upgrade to a Buy and set our price target at the DCF valuation of A$0.87ps (unchanged). At our target price, CLH would trade at an FY12F PE of 7.6x, broadly in line with its long-term average.

Key risks

Risks to CLH and our forecasts include: 1) increased competition for PDL acquisitions leading to CLH being unable to acquire enough volume to meet our forecasts; 2) lower-than-forecast returns on PDLs (and upside risk from greater-than-expected returns); 3) an unexpected write-down in a PDL investment, potentially leading to bank covenants being broken; 4) loss of a major client in the commission collections division (we note CLH has a longstanding agreement with St George Bank); and 5) a general downturn in economic conditions. We also note that there maybe a stock overhang from Trans Tasman Collections holding (10% of shares).

CLH – Financial Summary

Year to 30 Jun (A$m)	**AIFRS**	**AIFRS**	**AIFRS**	**AIFRS**	**AIFRS**
Income statement	**2010A**	**2011A**	**2012F**	**2013F**	**2014F**
Divisional sales	103.3	109.9	121.1	128.9	137.8
Total revenue	103.3	109.9	121.1	128.9	137.8
EBITDA	50.5	55.9	65.6	71.4	77.7
Associate income	0.0	0.0	0.0	0.0	0.0
Depreciation	-33.9	-35.7	-42.8	-45.9	-49.5
EBITA	16.6	20.2	22.8	25.5	28.2
Amortisation/impairment	0.0	0.0	0.0	0.0	0.0
EBIT	16.6	20.2	22.8	25.5	28.2
EBIT(incl associate profit)	16.6	20.2	22.8	25.5	28.2
Net interest expense	-4.8	-5.6	-6.4	-7.4	-8.0
Pre-tax profit	11.8	14.6	16.4	18.1	20.2
Income tax expense	-2.9	-4.5	-4.9	-5.4	-6.1
After-tax profit	8.9	10.1	11.5	12.7	14.1
Minority interests	0.0	0.0	0.0	0.0	0.0
NPAT	8.9	10.1	11.5	12.7	14.1
Significant items	0.0	0.0	0.0	0.0	0.0
NPAT post abnormals	8.9	10.1	11.5	12.7	14.1

Cash flow statement	**2010A**	**2011A**	**2012F**	**2013F**	**2014F**
EBITDA	50.5	55.9	65.6	71.4	77.7
Change in working capital	0.0	0.6	2.0	1.9	0.1
Net interest (pd)/rec	-4.8	-5.6	-6.4	-7.4	-8.0
Taxes paid	-4.2	-2.9	-4.9	-5.4	-6.1
Other oper cash items	0.0	0.0	0.0	0.0	0.0
Cash flow from ops (1)	41.6	47.9	56.3	60.5	63.7
Capex (2)	-2.8	-1.0	-1.0	-1.1	-1.1
Disposals/(acquisitions)	-0.2	-1.7	0.0	0.0	0.0
Other investing cash flow	-29.4	-48.6	-60.0	-60.0	-60.0
Cash flow from invest (3)	-32.4	-51.3	-61.0	-61.1	-61.1
Incr/(decr) in equity	0.0	0.0	0.0	0.0	0.0
Incr/(decr) in debt	-2.8	7.0	14.0	6.0	8.0
Ordinary dividend paid	-5.3	-5.9	-6.7	-7.2	-7.8
Preferred dividends (4)	0.0	0.0	0.0	0.0	0.0
Other financing cash flow	0.0	0.0	0.0	0.0	0.0
Cash flow from fin (5)	-8.1	1.1	7.3	-1.2	0.2
Forex and disc ops (6)	0.0	0.0	0.0	0.0	0.0
Inc/(decr) cash (1+3+5+6)	1.1	-2.3	2.6	-1.8	2.8
Equity FCF (1+2+4)	38.8	47.0	55.3	59.4	62.6

Balance sheet	**2010A**	**2011A**	**2012F**	**2013F**	**2014F**
Cash & deposits	0.5	0.3	2.9	1.0	3.8
Trade debtors	4.1	6.7	5.3	5.3	5.7
Inventory	146.5	162.0	182.0	199.0	212.5
Investments	0.0	0.0	0.0	0.0	0.0
Goodwill	0.0	0.0	0.0	0.0	0.0
Other intangible assets	21.8	22.8	22.8	22.8	22.8
Fixed assets	6.6	6.2	4.5	2.7	0.8
Other assets	1.5	0.4	0.4	0.4	0.4
Total assets	181.0	198.5	217.9	231.3	246.0
Short-term borrowings	0.6	2.7	9.1	9.7	10.5
Trade payables	4.1	6.9	7.6	9.5	9.9
Long-term borrowings	66.9	73.9	81.6	87.0	94.2
Provisions	14.2	10.8	10.8	10.8	10.8
Other liabilities	3.3	8.2	8.2	8.2	8.2
Total liabilities	89.1	102.6	117.3	125.1	133.5
Share capital	67.3	67.3	72.1	77.5	83.8
Other reserves	0.3	0.1	a	0.1	0.1
Retained earnings	24.3	28.5	28.5	28.5	28.5
Other equity	0.0	0.0	0.1	0.0	0.0
Total equity	91.9	95.9	100.7	106.1	112.5
Minority interest	0.0	0.0	0.0	0.0	0.0
Total shareholders' equity	91.9	95.9	100.7	106.1	112.5
Total liabilities & SE	181.0	198.5	217.9	231.3	246.0

Closing price (A$)	**0.79**	**Price target (A$)**	**0.87**
Valuation metrics			
Preferred methodology	DCF	Val'n (A$)	$ 0.87
DCF valuation inputs			
Rf	5.25%	10-year rate	5.25%
Rm-Rf	6.00%	Margin	2.0%
Beta	2.02	Kd	7.25%
CAPM (Rf+Beta(Rm-Rf))	17.4%	Ke	17.4%
E/EV*Ke+D/EV*Kd(1-t)		NPV cash flow (A$m)	174.4
Equity (E/EV)	60.0%	Minority interest (A$m)	0.0
Debt (D/EV)	40.0%	Net debt (A$m)	87.8
Interest rate	7.25%	Investments (A$m)	0.0
Tax rate (t)	30.0%	Equity market value (A$m)	86.7
WACC	12.5%	Diluted no. of shares (m)	99.3
		DCF valuation (A$)	**0.87**

Multiples	**2011A**	**2012F**	**2013F**	**2014F**
Enterprise value (A$m)	154.5	165.9	173.8	179.0
EV/Sales (x)	1.4	1.4	1.3	1.3
EV/EBITDA (x)	2.8	2.5	2.4	2.3
EV/EBIT (x)	7.6	7.3	6.8	6.4
PE (pre-goodwill) (x)	7.7	6.9	6.5	5.9

At target price	**2011A**	**2012F**	**2013F**	**2014F**
EV/EBITDA (x)	2.9	2.6	2.5	2.4
PE (pre-goodwill) (x)	8.5	7.5	7.1	6.5

Per share data	**2011A**	**2012F**	**2013F**	**2014F**
No. shares	97.3	99.3	103.1	105.8
EPS (cps)	10.3	11.5	12.3	13.4
EPS (normalised) (c)	10.3	11.5	12.3	13.4
Dividend per share (c)	6.2	6.7	7.0	7.4
Dividend payout ratio (%)	60.2	58.1	56.9	55.3
Dividend yield (%)	7.8	8.4	8.8	9.3
Franking	100.0	100.0	100.0	100.0

Growth ratios	**2011A**	**2012F**	**2013F**	**2014F**
Sales growth	6.3%	10.3%	6.4%	6.8%
Operating cost growth	2.1%	3.0%	3.5%	4.5%
EBITDA growth	10.7%	17.3%	8.9%	8.7%
EBITA growth	21.9%	12.7%	11.9%	10.4%
EBIT growth	21.9%	12.7%	11.9%	10.4%
NPAT growth	13.9%	13.2%	10.7%	11.5%
Pre-goodwill NPAT growth	13.9%	13.2%	10.7%	11.5%
Pre-goodwill EPS growth	12.8%	12.1%	6.7%	8.6%
Normalised EPS growth	12.8%	12.1%	6.7%	8.6%

Operating performance	**2011A**	**2012F**	**2013F**	**2014F**
Asset turnover (%)	14.5	14.5	14.4	14.4
EBITDA margin (%)	50.9	54.1	55.4	56.4
EBIT margin (%)	18.4	18.8	19.8	20.4
Net profit margin (%)	9.2	9.5	9.8	10.3
Return on net assets (%)	21.1	22.7	24.0	25.0
Net debt (A$m)	76.4	87.8	95.6	100.8
Net debt/equity (%)	79.7	87.2	90.1	89.7
Net interest/EBIT cover (x)	3.6	3.5	3.4	3.5
ROIC (%)	8.9	9.3	9.5	9.8

Internal liquidity	**2011A**	**2012F**	**2013F**	**2014F**
Current ratio (x)	9.6	7.8	7.6	7.9
Receivables turnover (x)	20.3	20.2	24.3	25.1
Payables turnover (x)	9.8	7.6	6.7	6.2

Source: Company data, RBS Morgans forecasts

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