

# Research Update



**Tolhurst Noall**  
Share Brokers & Financial Planners

## Colorpak Limited

*Packaging up the industry*

Code: CKL  
Price: \$0.67  
Analyst: Nick Maclean

02 December, 2004  
Sector: Containers & Packaging

**Recommendation: Hold**  
**Risk Rating: High**

### Key Points

- On Wednesday December 1, Colorpak announced plans to acquire Castle Graphics Pty Ltd for \$4m (5x EBITDA). The deal will be funded through the issue of 3.29m new shares at an issue price of \$0.61 and a \$2m cash payment (raised primarily through borrowings) payable to the owner of Castle Graphics, Garry Lingard. In addition, there are structured earn-outs with additional performance payments capped at a total purchase consideration of 5.5x EBITDA. These will be funded by further equity issues or cash.
- Castle Graphics is involved in the self-adhesive label and flexible packaging business. In FY 04 it earned \$0.8m EBITDA on revenues of \$6.5m, producing an EBITDA margin of 12.3%.
- Castle Graphics will initially be left to operate as a stand-alone business with CKL retaining key management executives. After approximately 18 months it will be integrated into CKL's new site which is being developed in Regents Park. As a result of this integration we have added \$0.5m in capex to our original \$4.5m Regent's Park capex forecast.
- The acquisition is an ideal fit with CKL's current operations particularly given it's focus on the pharmaceuticals/healthcare sector. While it brings new clients to CKL it also offers horizontal product expansion. This should help CKL grow its top line through both sales to new clients and increased sales to existing clients as a result of spreading its product offering.
- CKL has an excellent reputation within its industry and very strong long-term client relationships (35% of sales are generated from customers who have been with the company for more than five years). Furthermore, the company's top three clients who represent 30% of revenues have signed preferred supplier agreements. However, while this gives us confidence in CKL's ability to manage its financial structure, we would prefer to see it continue to pay down its debt and grow its interest cover.
- Excluding this acquisition, we believe CKL's current operations are tracking in line with our forecasts. In addition, we are excited by the potential ramifications for CKL from the recent proposed takeover of Wadepack by Carter Holt Harvey. Specifically we expect there to be some client fall out from this takeover, which could offer a feeding ground for CKL.
- As a result of the acquisition of Castle Graphics we have increased our valuation of CKL to **\$0.69** per share. Therefore, we continue our coverage with a **HOLD** recommendation.

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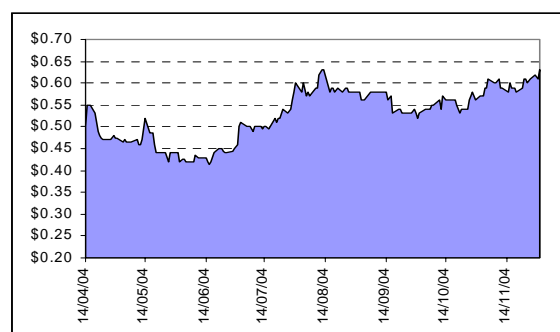
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### Undiluted Financials

	FY 04A	FY05E	FY 06E
Revenue (\$m)	49.6	56.0	65.3
EBITDA (\$m)	10.6	11.4	12.8
NPAT (\$m)	2.6	2.9	6.0
EPS (c)	6.40	6.72	7.4
P/E (x)	10.5	10.0	9.1
DPS (c)	0.0	2.5	3.5
Yield (%)	n.a	3.7	5.2
Franking (%)	100	100	100
Interest Cover	4.2	4.6	4.7

\* Note, NPAT is post-Goodwill Amortisation, EPS is pre-goodwill Amortisation, Interest cover assumes gross interest

### Share Price Graph






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## DETAILS

### *Industry Consolidation*

CKL's acquisition of Castle Graphics shortly after the recent announcement by Carter Holt Harvey to acquire Wadepack highlights our view that the Australian packaging market is consolidating. We believe CKL will continue to participate in the consolidation with this acquisition and the Wadepack acquisition making the company the third largest player in Australia – behind Amcor Cartons and Carter Holt Harvey.

### *Expanding Horizontal Product Offering*

This acquisition is of strong strategic benefit to CKL. For instance, it will introduce new clients to the company of which 70% are in the healthcare/pharmaceutical sector - a key focus of CKL. We believe CKL will be able to retain at least the majority of these clients given its outstanding industry reputation and high client retention rate.

### *Product Expansion*

Furthermore, Castle Graphics offers earnings benefits through horizontally expanding CKL's product line which should enable it to further integrate itself into its clients operations. This is a very positive step as the more entrenched CKL becomes in its clients operations and processes, the more difficult it is for these clients to shift their business.

### *Funding*

CKL have elected to fund this acquisition through both taking on additional debt and issuing new equity. While CKL's debt to equity was high at FY 04 - further exacerbated by the company's negative Net Tangible Assets - we expect interest cover to increase to 4.6x in FY 05. This is a result of operating cash flows enabling the company to make ongoing principal repayments - an indication of the company's strong cash generating ability.

### *Interest Obligations*

However, we do note that while the company's long-term customer relationships provide a level of security, a downturn in business conditions or serious disruptions at the company's manufacturing plants could create problems for CKL. For example, it could cause a reduction in the company's interest cover.

### *Operational performance*

Nevertheless, we are confident that CKL's existing operations are tracking according to forecasts and are encouraged by its operating cash flows. In addition, current buoyant economic conditions and efficient management should support our margin assumptions.

### *Opportunities from Carter Holt Harvey's acquisition of Wadepack*

Furthermore, we view the proposed acquisition of Wadepack by Carter Holt Harvey as a huge opportunity for CKL, despite not including it in our earnings assumptions. We believe CKL could potentially benefit from any fall out from existing Wadepack customers that for whatever reason, do not wish to purchase their packaging requirements through Carter Holt Harvey. This leaves room for an increase to our estimates over the next few months.



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### **CONCLUSION**

We view this acquisition favorably. While we would like to see CKL continue to improve its debt profile we are confident that its operating cash flows will adequately cover its interest repayments while leaving room for a continued pay down of principal. With existing operations trading in line with our forecasts, strong economic conditions fuelling demand for its products and the potential to grow earnings from the Castle Graphics acquisition we have increased our valuation to **\$0.69 per share**. This would see the company trade on a FY 05 price/earnings multiple of 10x, fully franked dividend yield of 3.6% and Enterprise Value/EBITDA of 7x. We do not believe these ratios are demanding.

In light of our revised valuation and recent share price movements, we continue our coverage on CKL with a **Hold** Recommendation.



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### Explanation of Tolhurst Noall's Recommendation and Risk Rating system:

Recommendations are assessments of each Tolhurst Noall Analyst's view of potential total returns over a 1-year period relative to the performance of the All Ordinaries Accumulation Index.

Expected total Return is measured as (capital gain (or loss) + dividend)/purchase price

We have divided our recommendations into four main categories:

**Strong Buy:** Expected Total Return in excess of 25% over a 1 year period relative to All Ordinaries Accumulation Index

**Buy:** Expected Total Return between 15% and 25% over a 1 year period relative to All Ordinaries Accumulation Index

**Accumulate:** Expected Total Return between 5% - 15% over a 1-year period relative to All Ordinaries Accumulation Index

**Hold:** Expected Total Return between -5% and 5% over a 1 year period relative to All Ordinaries Accumulation Index

**Sell:** Expected Total Return less than -5% over a 1 year period relative to All Ordinaries Accumulation Index

### Risk Ratings:

Risk is a subjective assessment of overall risk within a company including price volatility and earnings variability, external liquidity, and size.

We divide our risk into three categories:

**High:** Company typically has high price volatility and earnings variability, low external liquidity and has a small market capitalisation.

**Medium:** Company typically has moderate price volatility and earnings variability, external liquidity and a medium size market capitalisation.

**Low:** Company typically has low price volatility and earnings variability, high external liquidity and is a large size market capitalisation.

I verify that I, **Nick Maclean**, have prepared this research report accurately and that any financial forecasts and recommendations that are expressed are solely my own personal opinions. In addition, I certify that no part of my compensation is or will be directly or indirectly tied to the specific recommendation or financial forecasts expressed in this report.