

# A cheap package



## Initiating coverage with a Buy recommendation

We are initiating coverage on Colorpak, a domestic folding carton producer, with a Buy recommendation and a price target of A\$0.75/share.

## A well run company in a competitive industry

The Australian carton board industry is both competitive and capital intensive. In the face of this difficult operating environment, Colorpak has successfully grown market share, margins and profits over a sustained period. This is a testament to management's strong operational and customer focus and the strategic direction they have taken the company.

## Solid growth outlook

A number of one-off costs should see a disappointing FY06 result, however we expect the company to return to earnings growth in FY07 and beyond, driven by underlying growth in key markets and continued market share gains. This is reflected in our double digit earnings growth forecasts for FY07E and FY08E.

## Cheap valuation

In our opinion, the most compelling aspect of the company is its cheap valuation. On our forecasts, the stock is trading on a FY07E P/E of 7.4x, a fully franked dividend yield of 5.9% and a free cash flow yield of 8.6%. We believe the longer the market continues to ignore the value in the stock, the more likely it is that Colorpak will become prey rather than predator in the ongoing consolidation of the Australian carton board market.

## Key risks

The increasing trend of multinational companies sourcing their pre-packaged manufactured products offshore is the key risk to our Buy recommendation. Other key risks include competition, product substitution, rising raw material costs, management departures and customer attrition.

## Estimates (Jun)

(A\$)	2004	2005A	2006E	2007E	2008E
Net Profit b/f Abnormals	NA	5.5	4.6	5.1	5.7
EPS	NA	0.069	0.058	0.064	0.071
EPS Change (YoY)	NA	NA	-16.9%	10.4%	11.1%
Dividend / Share	NA	0.025	0.028	0.028	0.030
Free Cash Flow / Share	NA	0.019	(0.110)	0.040	0.047

## Valuation (Jun)

	2004	2005A	2006E	2007E	2008E
P/E	NA	6.9x	8.3x	7.5x	6.8x
Dividend Yield	NA	5.2%	5.7%	5.7%	6.3%
EV / EBITDA*	NA	5.9x	7.0x	6.2x	5.8x
Free Cash Flow Yield*	NA	3.9%	-23.0%	8.4%	9.7%

\* For full definitions of *iQmethod*<sup>SM</sup> measures, see page 13.

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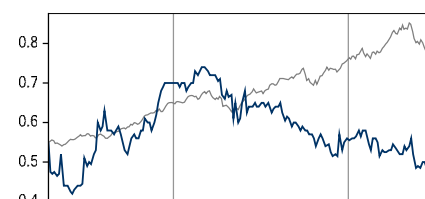
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## Stock Data

Price	A\$0.480
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\$0.690
Mrkt Val / Shares Out (mn)	US\$29 / 80.5
Average Daily Volume	41,878
ML Symbol / Exchange	XBVVF / ASX
Bloomberg / Reuters	CKL AU / CKL.AX
ROE (2006E)	10.2%
Net Dbt to Eqty (Jun-2005A)	64.5%
Est. 5-Yr EPS / DPS Growth	2.7% / 7.0%
Free Float	68.0%



- ColorPak Ltd - ALL ORDINARIES INDX

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Refer to important disclosures on page 14 to 15. Analyst Certification on page 13. Price Objective Basis/Risk on page 13.

05 July 2006

# iQprofile<sup>SM</sup> Colorpak Ltd.

## Key Income Statement Data (Jun)

(A\$ Millions)	2004	2005A	2006E	2007E	2008E
Sales	NA	59	69	73	78
Operating Expenses	NA	(47)	(58)	(60)	(64)
EBITDA	NA	11	11	12	13
Depreciation & Amortization	NA	(2)	(2)	(2)	(2)
EBIT	NA	10	9	10	11
Net Interest & Other income	NA	(2)	(2)	(3)	(3)
Associates	NA	NA	NA	NA	NA
Pretax Income	NA	8	7	7	8
Tax (expense) / Benefit	NA	(2)	(2)	(2)	(2)
Net Profit b/f Abnormals	NA	5	5	5	6
Non-Recurring Items	NA	0	0	0	0
Net Income (Reported)	NA	5	5	5	6
Avg F Diluted Shares Outstanding	NA	79	80	80	80

## Key Cash Flow Statement Data

EBITDA	NA	11	11	12	13
Change in Working Capital	NA	0	(3)	(1)	(1)
Deferred Taxation Charge	NA	1	(1)	0	0
Other Adjustments, Net	NA	0	0	0	0
Cash Flow from Operations	NA	8	3	7	7
Capital Expenditure	NA	(6)	(12)	(3)	(3)
(Acquisition) / Disposal of Investments	NA	0	0	0	0
Other Cash Inflow / (Outflow)	NA	0	0	0	0
Cash Flow from Investing	NA	(6)	(12)	(3)	(3)
Shares Issue / (Repurchase)	NA	0	0	0	0
Cost of Dividends Paid	NA	(1)	(2)	(2)	(2)
Cash Flow from Financing	NA	(2)	10	(3)	(3)
Free Cash Flow	NA	2	(9)	3	4
Net Debt	NA	28	38	37	36
Change in Net Debt	NA	NA	NA	NA	NA

## Key Balance Sheet Data

Property, Plant & Equipment	NA	20	29	30	31
Other Non-Current Assets	NA	1	1	1	1
Trade Receivables	NA	11	14	15	16
Cash & Equivalents	NA	0	1	1	1
Other Current Assets	NA	1	1	1	1
Total Assets	NA	81	98	101	104
Long-Term Debt	NA	24	30	30	30
Other Non-Current Liabilities	NA	1	1	1	1
Short-Term Debt	NA	4	9	8	7
Other Current Liabilities	NA	4	3	3	3
Total Liabilities	NA	39	50	50	49
Total Equity	NA	43	48	51	54
Total Equity & Liabilities	NA	81	98	101	104

## iQmethod<sup>SM</sup> - Bus Performance\*

Return on Capital Employed	NA	NA	7.8%	7.8%	8.2%
Return on Equity	NA	NA	10.2%	10.4%	10.8%
Operating Margin	NA	16.5%	12.9%	13.7%	13.8%
EBITDA Margin	NA	19.2%	16.1%	17.0%	16.9%

## iQmethod<sup>SM</sup> - Quality of Earnings\*

Cash Realization Ratio	NA	1.4x	0.7x	1.3x	1.3x
Asset Replacement Ratio	NA	3.8x	5.4x	1.4x	1.4x
Tax Rate (Reported)	NA	29.2%	30.2%	30.0%	30.0%
Net Debt-to-Equity Ratio	NA	64.5%	79.9%	73.3%	65.7%
Interest Cover	NA	5.1x	3.9x	3.8x	4.2x

## Key Metrics

Franking	NA	100%	100%	100%	100%
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## Company Description

Colorpak is a major participant in the A\$600mn folding-carton segment of Australia's paper and board packaging industry. The company's products are heavily exposed to the higher margin pharmaceuticals and healthcare industries. The company is based in Melbourne, Australia.

## Stock Data

Price to Book Value 0.8x

\* For full definitions of iQmethod<sup>SM</sup> measures, see page 13.

## Investment thesis

Colorpak has an enviable history of profitable growth, increasing margins and returns, and solid cash flow generation.

The longer the market continues to ignore the longer term growth profile of the company, the more likely it is that Colorpak will become prey rather than predator in the continued consolidation of the Australian carton board market.

Carton board is a commodity product with strong price competition between suppliers. Furthermore, carton board manufacturers compete for market share through product innovation and quality improvements. This necessitates a large amount of capital be spent on manufacturing assets in order to keep pace with the latest design requirements and product standards. Despite these difficult industry dynamics, Colorpak has an enviable history of profitable growth, margin expansion and increasing returns. This is a testament to the management team who have a strong operational and customer focus, and have also shaped the strategic direction of the company.

The company has experienced a difficult operating environment in FY06 as a result of a number of one-off items – including the relocation of a factory and a difficult acquisition integration – however recent steps taken by the company to address these issues should see earnings return to an upward trajectory in FY07 and beyond. As evidenced by continued top line growth, the underlying business remains solid and capital expenditure committed in FY06 has set a sound platform to continue this top line growth into the future.

Despite the one-off nature of the issues the company faced in FY06, the market seems intent on capitalising this earnings base into perpetuity. We believe that the longer the market continues to ignore the longer term growth profile of the company, the more likely it is that Colorpak will become prey rather than predator in the ongoing consolidation of the Australian carton board market.

It is our positive longer term outlook and confidence that management will continue to grow the company profitably that underpin our Buy recommendation and price target of A\$0.75/share. In our opinion, the key attractions of the company include:

- 1. A solid growth outlook driven by underlying growth in key markets and continued market share gains. This is reflected in our double digit earnings growth forecasts for FY07E and FY08E.**
- 2. A focus on the faster growing, less volatile and higher margin segments of the market – pharmaceutical, healthcare and premium branded products.**
- 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 FY07E P/E of 7.4x, a fully franked dividend yield of 5.9% and a free cash flow yield of 8.6%.**
- 5. Takeover appeal. Recent M&A activity in the market includes Carter Holt Harvey's acquisition of Wadepack and Visy Industries' acquisition of P&I. We expect ongoing rationalisation of the Australian carton board market into the future.**

## Key Investment Considerations

### Industry structure

The A\$610m folding carton packaging industry is one segment of the broader A\$3.3bn paper and board packaging industry. Folding carton packaging is used to package various consumer products such as food, beverages, pharmaceuticals, cosmetics, confectionaries, personal care products, multimedia and technology.

The folding carton segment can be divided into two parts:

- The short-run market that produces high quality packaging for consumer products such as pharmaceuticals, cosmetics, natural medicines, multimedia and technology, wine and premium food products.
- The high volume, lower sophistication segment that is mostly the fast moving consumer goods such as beer, cereal, packaged teas, washing powders and other food products.

The market is dominated by two producers, Amcor Cartons and Carter Holt Harvey (CHH), with a market share of ~30% each. These two companies focus mainly on the high volume, lower sophistication segment of the market, which provides both with better utilisation of their upstream paperboard manufacturing facilities. We estimate Colorpak is the fourth largest folding carton producer in Australia by sales revenue with a market share of ~9%.

The industry is relatively mature, characterised by:

- Mature production processes subject to technological enhancements that contribute to productivity and quality improvements.
- Buyers with sound product knowledge seeking higher service levels at lower cost.

Competition in the industry centres on price, print quality, design capabilities and the ability to meet customer service requirements promptly. Colorpak has consistently rated #1 in BIS Shrapnel's annual survey of carton board customers and so long as this customer focus remains at the forefront of the company's strategy, we believe continued market share gains will be made.

### Barriers to entry

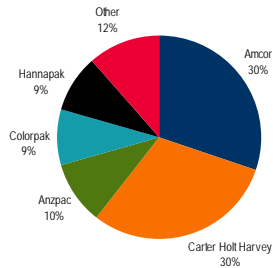
Cartonboard is a commodity product, however there are some features of the market that serve as barriers to new entrants. We believe these barriers are increasing as the market continues to consolidate. The main barriers to new entrants include:

- Customer relationships.
- Capital intensive asset base.
- Technically demanding design and production processes.

### Financial metrics

We have limited information on the financial performance of folding carton manufacturers, however we expect the shorter run, higher quality segment of the market would generate superior margins and returns to those operating in the

Chart 1: Australian folding carton market share



Source: Merrill Lynch estimates

Chart 2: Folding carton value matrix



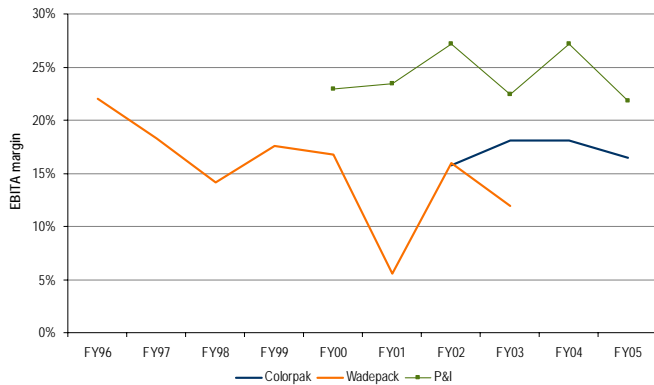
Source: Colorpak

higher volume, lower sophistication, commoditised segment of the industry. Three companies in the shorter run segment of the market for which we have financial information include Colorpak, Wadepack (prior to acquisition by CHH) and P&I (recently acquired by Visy Industries). Amcor and CHH predominantly operate in the commoditised segment of the market and do not detail the performance of their carton board operations.

Charts 3 & 4 below highlight the margins and returns generated by Colorpak, Wadepack and P&I. EBITA margins have remained relatively stable and are consistently >15%. We expect margins generated by Amcor and CHH who focus on the higher volume, lower sophistication segments of the market would be <10%.

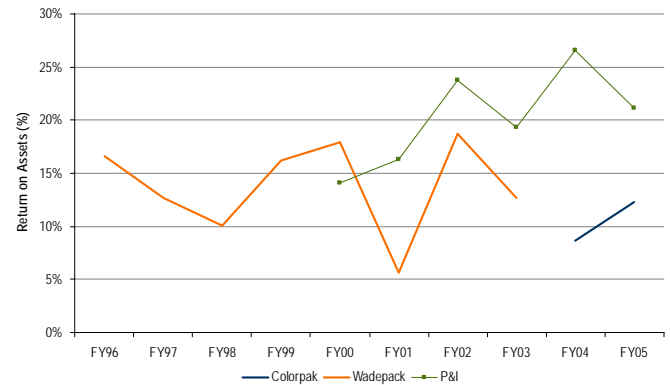
In addition, returns generated by the smaller players are respectable, with return on assets (ROA) consistently above 10%. Whilst we have limited historical information for Colorpak, their ROA is below that of both Wadepack and P&I due to previous acquisitions and the associated goodwill being carried on the balance sheet. We expect Colorpak's returns to increase through time as the full benefits are extracted from these acquisitions.

Chart 3: Australian folding carton market EBITA margins



Source: Colorpak, Wadepack, P&I, Merrill Lynch

Chart 4: Australian folding carton market return on assets



Source: Colorpak, Wadepack, P&I, Merrill Lynch

## Growth opportunities

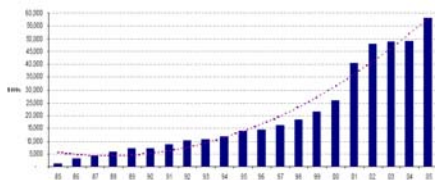
Colorpak has a solid track record of growth, achieved through a combination of organic growth and selected strategic acquisitions in core market segments. From 1985 to 2005 the company's sales revenue has grown at an impressive annual compound rate of 20%, significantly above the underlying industry growth rate of 2-4%.

### Organic growth

We believe organic growth in the future is likely to come from two main avenues:

- 1. Underlying Market growth.** The pharmaceutical, healthcare and premium product segments of the market comprise >60% of the company's revenues and comprise the faster growing and higher value segments of the domestic carton board market. Growth in the pharmaceutical and healthcare packaging market is primarily driven by new product launches and an ageing population. Further growth is being driven by legislation requiring more extensive product information for users.
- 2. Market share gains.** Following the consolidation at the top end of the

Chart 5: CKL sales revenue growth



Source: Colorpak

market, folding carton customers are looking to diversify their supply base to ensure they are not reliant on a single supplier. We understand Colorpak has had some recent contract wins as a result of this and we expect further market share gains from Colorpak in the future.

### Bolt-on acquisitions

Over the past seven years, Colorpak has acquired and integrated four complementary packaging businesses – Foilmasters, Hale Foldpack, Pemara Corporation's folding carton division and Castle Graphics. We expect further consolidation to occur in the folding carton packaging industry and believe Colorpak is a likely participant in this consolidation to augment future growth prospects.

We believe the likely opportunities for Colorpak are private companies at the smaller end of the market that have complementary operations, strong management and modern machinery. Depending on the size of the acquisition, Colorpak may look to raise equity to fund any acquisition. Alternatively, if Colorpak continues to trade at depressed levels it may become a target in the ongoing consolidation of the Australian folding carton market.

### Recent M&A transactions

The Australian folding carton market has undergone some degree of consolidation over the past five years, however we do expect further consolidation into the future. The most recent 'on-market' consolidation in the industry was the acquisition of Wadepack by Carter Holt Harvey (CHH). CHH launched a A\$2.60/share bid to acquire Wadepack in November 2004. The transaction multiples for this bid are detailed in table 1.

**Table 1: Wadepack acquisition multiples**

Multiple		FY03A
EV/EBITDA	x	8.0
EV/EBITA	x	10.4
P/E	x	12.3

Source: Wadepack, Merrill Lynch

Were we to apply these same acquisition multiples to Colorpak's FY05A, FY06E and FY07E financials we arrive at a 'takeover valuation' range for the stock of A\$0.67/share to A\$0.84/share.

**Table 2: CKL valuation using WDP takeover multiples**

CKL takeover range		FY05A	FY06E	FY07E
EV/EBITDA multiple	A\$/share	0.77	0.63	0.77
EV/EBITA multiple	A\$/share	0.90	0.68	0.82
P/E multiple	A\$/share	0.84	0.71	0.78
Average	A\$/share	0.84	0.67	0.79

Source: Colorpak, Merrill Lynch estimates

In our opinion, the longer the market continues to ignore the apparent value in Colorpak, the more likely it is that the company will become prey rather than predator in the consolidation of the Australian carton board market. We believe this is reinforced by Visy's recent entry into the market through the acquisition of P&I. Any acquirer will have to pay a price to satisfy the Commins family who own a 32% stake in the company, however we believe the family is not 'wedded' to the business and would be prepared to sell if the right price was offered.

## Valuation

### Discounted cash flow

Given the cyclical nature of Colorpak's earnings and the capital intensive nature of its assets our preferred valuation methodology for valuing the company is Discounted Cash Flow (DCF). Using a WACC of 10.2% and a terminal growth rate of 3%, we arrive at a DCF for the company of A\$0.78/share.

Our DCF derived valuation for Colorpak is A\$0.78. This underpins our price target for the stock of A\$0.75/share.

**Table 3: Colorpak PE valuation**

	FY06E	FY07E	FY08E
Through-the-cycle PER Multiple	11.0x	11.0x	11.0x
EPS Pre-Goodwill (diluted)	5.8	6.4	7.1
Value per ordinary share	\$0.63	\$0.70	\$0.78

Source: Merrill Lynch estimates

## Price-to-earnings ratio

Given the company's size as well as the cyclical and capital intensive industry it operates in, we believe an appropriate through-the-cycle multiple for the stock is 11x, a 30% discount to the market multiple of 15.5x. Applying this 11x multiple to our forecast FY07E eps of A\$0.064/share yields a valuation for the stock of A\$0.70/share.

Were the stock to reach our price target of A\$0.75 in 12 months time, it would be trading on a forward P/E multiple of 10.5x, which we do not view as unreasonable.

## Dividend yield

Based on a payout ratio of 40-45%, we forecast CKL currently trades on a fully franked FY07E yield of 5.9%.

## Free cash flow yield

Further supporting our Buy valuation and A\$0.75 price target is the company's attractive FY07E free cash flow yield of 8.6%. We do not expect significant investment in the business (potential acquisitions aside) in FY07 and FY08 due to the significant investment that has been undertaken over the course of the past two years.

## Key Risks

### Customer consolidation & rationalisation

The consolidation and rationalisation of the Australian supermarket sector has resulted in a negative impact on volumes in the carton board industry. Woolworths and Coles have spent a significant amount of time and capital rationalising their supply chains and reducing inventory levels which has translated to reduced demand for carton board products. In addition, the supermarkets are increasingly sourcing more generic brands from overseas, thereby reducing demand for domestic carton board packaging.

We believe this trend is more likely to impact the companies that have exposure to the high volume, low sophistication end of the market. Nevertheless, this phenomenon has the potential to impact Colorpak's customers and hence demand for the Colorpak's products.

### Competition

Carton board is a commodity product with strong price competition between suppliers. Furthermore, carton board manufacturers compete for market share through product innovation and quality improvements. This necessitates a significant amount of capital be spent on manufacturing assets in order to keep pace with the latest design requirements and product standards. Despite these difficult industry dynamics, Colorpak has an enviable history of profitable growth, margin expansion and increasing returns. We expect the company's focus on specific end use markets will provide some degree of insulation should a price war break out in the industry.

### Rising raw material costs

The folding carton industry is supplied with paperboard by local producers and imports through local paper merchants. Whilst supply shortages are uncommon, raw material prices are subject to fluctuations. Given the competitive nature of the industry and the associated difficulty in passing costs through to customers, any increase in raw material costs will have a negative impact on the company's

margins, earnings and cash flow.

### **Management changes**

Given the company's size, Colorpak is heavily reliant on a small number of key management staff. Loss of these personnel will have a material negative impact on the company, however we believe the risk of this is low given the Commins family involvement in the business and their retained 32% ownership stake.

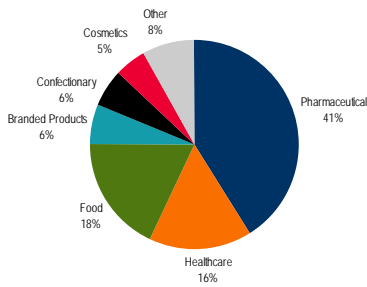
### **Customer attrition**

We estimate Colorpak's 3 largest customers account for ~35% of the company's sales revenues, hence the loss of a major customer would have a material earnings impact. This risk is partly mitigated by the longevity of Colorpak's relationships with its customers.

## Company Overview

Colorpak designs and produces folding cartons, printed leaflets, point-of-sale displays and other value-added paperboard packaging products. The company operates manufacturing facilities in Melbourne and Sydney.

Chart 6: CKL FY05 revenue by industry



Source: Colorpak

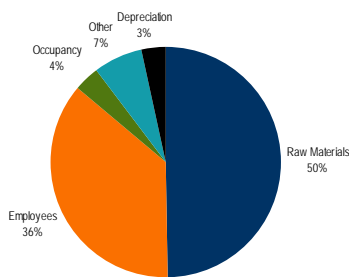
### Markets

The company focuses on providing packaging solutions to specific end-use markets. A major part of revenue is generated from the pharmaceutical and healthcare industry, with other markets including food, cosmetics, confectionary and branded products (refer chart 6). Colorpak services both national and international companies.

### Customers

Colorpak has long-established customer relationships with ~35% of the company's turnover accounted for by companies that have been customers for more than five years. Customer relationships include Cussons, L'Oreal, Sigma, Patties, AstraZeneca, CSL, Nestle, Huhtamaki and Beringer Blass. Colorpak's technical staff are often on the customer's site assisting them with their production line issues, ensuring that their carton processing lines are running at optimum efficiency.

Chart 7: CKL FY05 cost split



Source: Colorpak, Merrill Lynch

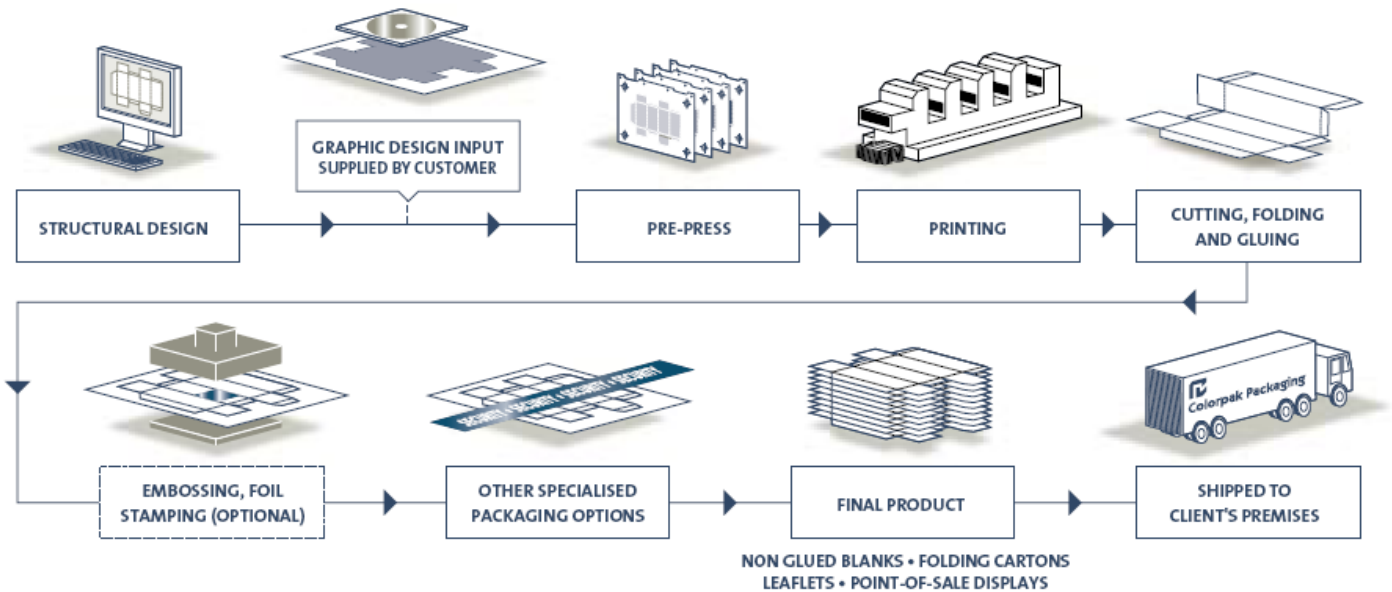
### Costs

Raw materials and staff comprise ~85% of Colorpak's cost base (refer chart 7). Raw materials predominantly comprise cartonboard sourced from local manufacturers and imported through local paper merchants. Total vertical integration is less common in the folding carton segment than in other paper-based packaging markets such as corrugated containers.

### Production process

The production process for Colorpak's products is relatively straightforward and typically follows a 7-stage process as outlined in the figure below.

Chart 8: Colorpak's production process



Source: Colorpak

## Forecasts

### Statement of Financial Performance

Following a promising first 12 months as a listed company, Colorpak's earnings performance in FY06 is expected to be disappointing, with the company recently announcing that it expects to report FY06 NPAT in the range A\$4.5m – A\$4.7m, a 15% decrease on the pcp. The key drivers of the poor result include:

1. Relocation of NSW business, with one-off relocation costs of A\$0.4m. Due to an unexpected delay in relocating the business, a large amount of work was temporarily transferred to Victoria, resulting in further one-off costs.
2. A poor integration of the Castle Graphics foil and self-adhesive label business acquired in December 2004, resulting in restructuring costs for FY06.
3. Additional depreciation costs as a result of the recent capital expenditure.
4. Increased interest costs as a result of higher debt levels.

We expect the first two factors to be specific to FY06 and hence should be non-recurring. This alone should add A\$0.5m to the bottom line in FY07E. In addition, the restructuring to be undertaken in the Castle Graphics business should have a positive impact on the cost base in FY07.

In its recent profit guidance for FY06, the company stated it expects FY07 NPAT to be in the range of A\$5.1m – A\$5.4m. Our own FY07E NPAT forecast of A\$5.1m is at the lower end of this range. In the shorter term, we are comfortable remaining conservative, however do recognise there is upside risk to our forecasts.

**Table 4: Statement of Financial Performance**

Year ending June (A\$m)	2005A	2006E	2007E	2008E
Trading revenue	58.3	69.0	72.4	77.2
- change	18.6%	18.4%	5.0%	6.6%
EBITDA	11.3	11.2	12.4	13.1
- change	6.6%	-0.8%	11.1%	5.8%
Depreciation	-1.7	-2.2	-2.5	-2.5
Amortisation	0.0	0.0	0.0	0.0
<b>EBIT</b>	<b>9.6</b>	<b>8.9</b>	<b>9.9</b>	<b>10.7</b>
- change	7.9%	-6.9%	11.4%	7.3%
Net interest	-1.9	-2.3	-2.6	-2.5
<b>Pre-tax profit</b>	<b>7.7</b>	<b>6.6</b>	<b>7.3</b>	<b>8.1</b>
Tax expense	-2.3	-2.0	-2.2	-2.4
Outside equity interests	0.0	0.0	0.0	0.0
<b>Net profit att. to s/hers</b>	<b>5.5</b>	<b>4.6</b>	<b>5.1</b>	<b>5.7</b>
- change		-15.2%	10.4%	11.1%
Net significant items	0.0	0.0	0.0	0.0
<b>Reported NPAT</b>	<b>5.5</b>	<b>4.6</b>	<b>5.1</b>	<b>5.7</b>
<b>EPS change pre goodwill</b>		<b>-15.2%</b>	<b>10.4%</b>	<b>11.1%</b>

Source: Colorpak, Merrill Lynch estimates

## Statement of Financial Position

We believe a company of Colorpak's size and concentrated earnings stream should be modestly geared to insulate against any unexpected events in the industry. As such we believe a maximum gearing range of 30%-35% is appropriate.

At end FY06E, we forecast Colorpak's gearing (debt / debt + equity) to rise to 45%, which is above the top end of our comfort range. Over the course of the next 12 months we would like to see the company use its forecast strong free cash flows to reduce debt and hence increase financial stability. Given the company has significantly invested in its assets over the course of the last two years and capital expenditure is expected to be significantly reduced in FY07, we believe debt reduction should be the priority with the proceeds from free cash flow.

**Table 5: Statement of Financial Position**

Year ending June (A\$m)	2005A	2006E	2007E	2008E
Cash	0.0	0.7	0.7	1.2
Receivables	10.8	13.9	14.8	15.8
Inventories	5.2	6.2	6.6	7.0
Other	1.1	1.3	1.3	1.3
<b>Current Assets</b>	<b>17.1</b>	<b>22.0</b>	<b>23.3</b>	<b>25.3</b>
Receivables	0.0	0.0	0.0	0.0
Inventories	0.0	0.0	0.0	0.0
Property, Plant & Equipment	19.6	29.0	29.9	30.9
Intangibles	43.8	46.1	46.1	46.1
Other	0.9	1.1	1.1	1.1
<b>Non-Current Assets</b>	<b>64.2</b>	<b>76.2</b>	<b>77.2</b>	<b>78.2</b>
<b>Total Assets</b>	<b>81.3</b>	<b>98.3</b>	<b>100.6</b>	<b>103.5</b>
Accounts Payable	5.9	6.5	6.9	7.3
Borrowings	3.9	8.8	7.8	6.8
Provisions	2.5	2.5	2.5	2.5
Other	1.3	0.5	0.5	0.5
<b>Current Liabilities</b>	<b>13.6</b>	<b>18.3</b>	<b>17.6</b>	<b>17.1</b>
Accounts Payable	0.0	0.0	0.0	0.0
Borrowings	23.6	30.1	30.1	30.1
Provisions	0.9	1.1	1.1	1.1
Other	0.6	0.8	0.8	0.8
<b>Non-Current Liabilities</b>	<b>25.1</b>	<b>32.1</b>	<b>32.1</b>	<b>32.1</b>
<b>Total Liabilities</b>	<b>38.7</b>	<b>50.3</b>	<b>49.7</b>	<b>49.2</b>
Net Assets	42.6	47.9	50.8	54.3
Share Capital	38.9	38.9	38.9	38.9
Reserves	0.0	-0.1	-0.1	-0.1
Retained Profits	3.8	9.1	12.0	15.5
<b>Shareholders' Equity</b>	<b>42.6</b>	<b>47.9</b>	<b>50.8</b>	<b>54.3</b>
Outside Equity Interests	0.0	0.0	0.0	0.0
<b>Total Shareholders' Equity</b>	<b>42.6</b>	<b>47.9</b>	<b>50.8</b>	<b>54.3</b>

Source: Colorpak, Merrill Lynch estimates

## Statement of Cash Flows

In line with disappointing FY06 earnings, operating cash flow is also expected to be poor. A number of issues have combined to negatively impact Colorpak's cash flow. These include:

1. Sales growth has translated to rising working capital requirements. Other distractions have recently occupied management's attention, however we expect working capital to be a key focus in FY07.
2. Relocation of the NSW business which has resulted in a shorter term increase in operating costs and increased working capital requirements.
3. A poor integration of the Castle Graphics business.
4. 'Catch-up' tax payments from FY05.
5. Additional interest charges as a result of higher debt.

Furthermore, free cash flow is expected to be weak in FY06 as a result of a significant amount of capital expenditure. We are forecasting capex of A\$12m spent on:

1. The new factory at Regents Park and commissioning of a second Roland 700 6-color printing press.
2. Finished goods warehouse in Melbourne.
3. A new foil press.
4. Ongoing maintenance capex.

With new premises and modern equipment now in place we expect capital expenditure in FY07E to be significantly reduced and return to levels more in line with depreciation.

**Table 6: Statement of Cash Flows**

Year ending June (A\$m)	2005A	2006E	2007E	2008E
EBITDA	11.3	11.2	12.4	13.1
Working capital	0.0	-3.0	-0.9	-1.0
Net interest paid	-1.9	-2.3	-2.6	-2.5
Tax paid	-1.5	-2.7	-2.2	-2.4
Other	0.0	0.0	0.0	0.0
<b>Operating cashflow</b>	<b>7.9</b>	<b>3.1</b>	<b>6.7</b>	<b>7.2</b>
Capex	-3.8	-12.0	-3.4	-3.4
Sale of Assets	0.0	0.1	0.0	0.0
Net investments	0.0	0.0	0.0	0.0
Acquisitions/Divestments	-2.6	0.0	0.0	0.0
<b>Investing cashflow</b>	<b>-6.3</b>	<b>-11.9</b>	<b>-3.4</b>	<b>-3.4</b>
<b>Free cashflow (OCF-Capex)</b>	<b>4.1</b>	<b>-8.9</b>	<b>3.2</b>	<b>3.8</b>
Equity raisings	0.0	0.0	0.0	0.0
Dividends paid	-0.8	-2.0	-2.2	-2.2
Net borrowings	-0.7	11.5	-1.0	-1.0
Other	0.0	0.0	0.0	0.0
<b>Financing cashflow</b>	<b>-1.5</b>	<b>9.5</b>	<b>-3.2</b>	<b>-3.2</b>
Effect of exchange rate	0.0	0.0	0.0	0.0
<b>Net change in cash</b>	<b>0.0</b>	<b>0.8</b>	<b>0.0</b>	<b>0.5</b>

Source: Colorpak, Merrill Lynch estimates

## Price Objective Basis & Risk

Our price objective for Colorpak of A\$0.75/share is underpinned by our DCF valuation of A\$0.78/share. Using a WACC of 10.2% and a terminal growth rate of 3%, we arrive at a DCF for the company of A\$0.78/share. Were the stock to reach our price target in 12 months time it would be trading on a forward P/E of 10.6x which we do not view as unreasonable.

Risks to our Buy recommendation and valuation are:

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

These risks are discussed in more detail earlier in this report.

## 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*<sup>SM</sup> Measures Definitions

Business Performance	Numerator	Denominator
Return On Capital Employed	NOPAT = (EBIT + Interest Income) * (1 - Tax Rate) + Goodwill	Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill
	Amortization	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
<b>Quality of Earnings</b>		
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
<b>Valuation Toolkit</b>		
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	Market Cap.
	Other LT Liabilities	
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

*iQmethod*<sup>SM</sup> is the set of Merrill Lynch standard measures that serve to maintain global consistency under three broad headings: Business Performance, Quality of Earnings, and valuations. The key features of *iQmethod* are: A consistently structured, detailed, and transparent methodology. Guidelines to maximize the effectiveness of the comparative valuation process, and to identify some common pitfalls.

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

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	0	0.00%	Buy	0	0.00%
Neutral	1	50.00%	Neutral	0	0.00%
Sell	1	50.00%	Sell	0	0.00%

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

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1145	40.29%	Buy	393	34.32%
Neutral	1474	51.86%	Neutral	430	29.17%
Sell	223	7.85%	Sell	44	19.73%

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