Diploma Group Ltd
(DGX $0.33) Hold, Downgrade from Buy

EUROZ SECURITIES LIMITED
AUSTRALIAN RESEARCH

2 September 2010

- **6 month Price Target:** $0.35/sh
- **Reason For Update:** Full Year Result
- **What we know:**

DGX has posted full year NPAT for 2010 of $10m, up 400% on the previous year.

The increase in profitability is primarily driven by first significant contribution from DGX's property development business, which increased revenues from $9m in 2009 to $110m in 2010.

Operating cashflow generated was a healthy $66m, resulting in a significant reduction in project related debt, and net debt at year end was $24.6m at year end versus $102.4m at June 2009. This debt, being project backed, will fluctuate as projects are constructed and then sold.

The company raised $15m during the period, some of which was used to purchase future development properties.

A final dividend was declared of 1c, for a full year dividend during the year of 2c.

Operating conditions are challenging however and we are reducing our 2011 expectations from $12.2m to $8.1m, reflecting decreasing prices in higher end product (refer below), and a soft construction market. We would look to returning to a Buy with evidence the macro environment has improved.

- **What we think:**

Earnings

The 2010 reported numbers were solid, in trading conditions that proved challenging towards the later part of the year, as sentiment cooled in WA courtesy of the proposed mining tax and associated global economic uncertainty.

The deteriorating conditions have continued to have an impact over the last 6 months. While product in the price range of $400k to $600k continues to sell steadily, higher price product is proving harder to sell.

In particular, DGX has product at its Rise apartments available for sale which we had been forecasting to yield $20m, consistent with previous prices generated on the $50m of product already sold and settled (at an average price around $750k).

It is increasingly our view that this particular product will now need to be sold for a 20% to 25% discount, or approx $15m in order to clear the remaining apartments, which will decrease forecast 2011 EBIT by $5m.

We are therefore decreasing our 2011 NPAT forecasts from $12.2m to $8.1m reflecting the above.

On our revised forecasts, DGX is currently trading on a PE of 6.2x our 2011 earnings, hardly demanding. That said, the reduction in forecast earnings for 2011 is likely to weigh on the stock price until sentiment towards the sector changes or there is clear evidence the 2012 earnings we are forecasting are achievable. We are therefore reducing to a Hold recommendation pending 2012 earnings clarity.

Euroz Securities declares that it has acted as underwriter to and/or arranged an equity issue in and/or provided corporate advice to Diploma Group Ltd during the last year. Euroz Securities has received a fee for these services.

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We provide our analysis of performance by division (Euroz estimates) and new forecasts.

Revenue	1H 2010 Actual	2H 2010 Actual	2010 Actual	2011 Forecast	2012 Forecast
Construction (external only)	75.0	21.7	96.7	115.1	115.1
Property development	52.0	58.3	110.3	85.6	92.3
Other		1.8	1.8	1.6	1.7
Total Revenue	**127.0**	**81.8**	**208.8**	**202.4**	**209.1**
Cost of Sales	-114.5	-69.2	-183.7	-181.3	-183.5
Administration	-2.7	-3.3	-6.0	-5.1	-5.2
Marketing and advertising	-0.3	-0.5	-0.8	-1.0	-1.0
Occupancy	-0.4	-0.5	-0.9	-0.6	-0.6
Other	-1.1	-0.9	-2.0	-2.5	-2.6
Operating costs	**-119.0**	**-74.4**	**-193.4**	**-190.5**	**-192.9**
EBITDA	**8.0**	**7.4**	**15.4**	**11.8**	**16.2**
Depreciation & amortisation	-0.1	-0.1	-0.3	-0.3	-0.3
EBIT	**7.9**	**7.3**	**15.2**	**11.6**	**15.9**
Net borrowing costs	-0.2	-0.1	-0.3	-0.0	-0.0
Net profit before tax	**7.7**	**7.1**	**14.9**	**11.6**	**15.9**
Tax expense	-2.7	-2.1	-4.8	-3.5	-4.8
Net profit / (loss)	**5.0**	**5.0**	**10.0**	**8.1**	**11.1**
Margin	3.973%	6.089%	4.802%	4.003%	5.319%

Property Development

We note the following:

- Construction revenues slowed during the second half as work generally delayed.
- Property development continued steadily on presold product.
- The change in revenue mix resulted in increased margins in the second half, as property development contributed more of revenues.

In 2011, we are reducing earnings to reflect a price discount at the Rise apartments and softer construction market.

We provide below our indicative view of the make up of the development pipeline

	Remaining End value 2010 -2012	Interest	DGX share ($m)	Amount presold
Rise Apartments	20	80%	16	85%
Joondalup Gateway	18	100%	18	68%
Zenith Apartments	75	50%	37.5	85%
Eleven 78	80	50%	40	95%
Midland	18	100%	18	50%
Total			**129.5**	

	End value	Interest	DGX share ($m)	Status
Allure	45	100%	45	Zoned - premarketing shortly
Pier	65	50%	32.5	25% committed to by Government
Joondalup Cove	25	100%	25	next to currently selling Joondalup project
Joondalup Edge	10	100%	10	next to currently selling Joondalup project
176 Adelaide Terrace	55	100%	55	early days, but next to successful Rise and Sky
Other	33	100%	33	
			200.5	
Total			**330**	

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Overall we see a steady performance from this division for a number of years as the development pipeline is delivered, provided prices are maintained.

In 2011 however we see a short term reduction in earnings as higher priced product is discounted, and would look to return to a Buy recommendation with evidence the remaining stock can be delivered as forecast.

Construction

DGX state they have a construction pipeline of approx $320m to be delivered over a 3 year period.

This includes internal work and overall we believe the construction business has approx half of the external revenues we are looking for in 2011 locked away.

Notwithstanding the challenging market, we anticipate further newsflow on this front in the short to medium term. A significant return to construction would see us return to a Buy.

Macro Drivers

The long term macro driver for DGX is population growth and the WA economy generally.

WA has experienced significant population growth in recent times and we see this continuing on the back of a strong resources sector, which will also drive the economy.

Affordability is already a key concern and we can see this issue deteriorating further, particularly as interest rates rise. That said, DGX product is primarily priced in the range of $400k to $600k, still an affordable price point, and this is evidenced by DGX achieving 50% in apartment "pre sales" at its new Midland project recently (in its first week of marketing).

In the medium term, a combination of wary banks (and subsequent challenges for developers to access finance) has resulted, in our view, in an under supply of affordable residential apartment product to be delivered in 2012 to 2014. Notwithstanding some short term challenges and our consequent Hold recommendation, our long term view is positive.

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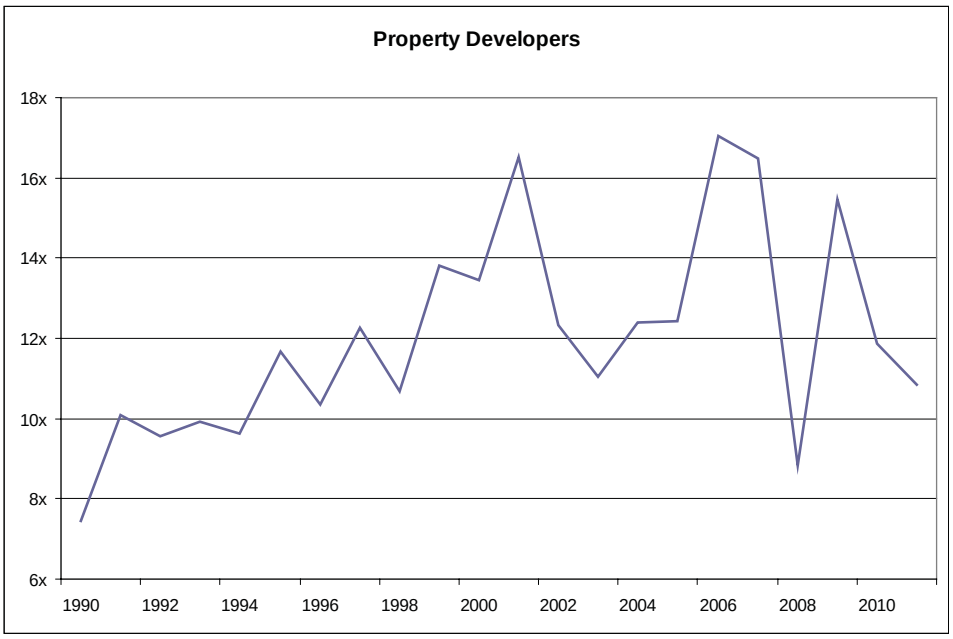
Investment Case:

DGX trades on a historical 2010 PE of 5.3x.

Peers would appear to trade on historical metrics in the range of 7x to 14x (11x median point) earnings, as indicated below:



Source: Euroz, reported data

The most obvious peer is fellow residential apartment property developer Finbar, currently trading at 7x its recent 2010 result.

It is unfortunate DGX, which does have a strong development pipeline, is likely to be impacted short term by price reductions on the higher priced Rise apartments. We are now forecasting 2011 EPS of 5.5c and on this basis DGX trades at 6.2x earnings.

While this is not demanding, a series of earnings downgrades since coverage commenced is likely to weigh on the share price and we reduce to a 6 month Hold, pending clarity on construction revenues and apartment prices. With a 12 month view, provided DGX can hit our forecasts, we see value at 8 x 2011 EPS of $0.44.

Catalysts

- Construction contract newsflow.

Risks

- Our earnings numbers are weighted towards the second half due to timing of settlements.
- Current price maintained.

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Diploma Group Ltd

EUROZ SECURITIES LIMITED

AUSTRALIAN EQUITIES RESEARCH

Sector: Property Developers
Recommendation: Hold

Price ($A): 0.33
Target Price ($A): 0.35

Market Cap ($A): 50.6m
Enterprise Value ($A): 75.4m

DIPLOMA GROUP LTD (DGX)				YEAR END 30 JUNE	
Income Statement	**09A**	**10A**	**11F**	**12F**	**13F**
Sales	143.5	207.0	200.7	207.4	242.5
Other	0.8	1.8	1.6	1.7	1.7
Revenue	**144.4**	**208.8**	**202.4**	**209.1**	**244.3**
Operating costs	-140.8	-193.4	-190.5	-192.9	-224.8
EBITDA	**3.6**	**15.4**	**11.8**	**16.2**	**19.5**
Depreciation	-0.3	-0.3	-0.3	-0.3	-0.3
Other non cash	0.0	0.0	0.0	0.0	0.0
EBIT	**3.3**	**15.2**	**11.6**	**15.9**	**19.2**
Net Interest income/(expense)	-0.1	-0.3	0.0	0.0	0.0
Associates	0.0	0.0	0.0	0.0	0.0
Other income/(expense)	0.0	0.0	0.0	0.0	0.0
Abnormal items (pretax)	0.0	0.0	0.0	0.0	0.0
EBT	**3.2**	**14.9**	**11.6**	**15.9**	**19.2**
Tax expense	-1.2	-4.8	-3.5	-4.8	-5.8
Discontinued operations	0.0	0.0	0.0	0.0	0.0
Minority interest	0.0	0.0	0.0	0.0	0.0
Reported Earnings	**2.0**	**10.0**	**8.1**	**11.1**	**13.5**
Dividends	-1.2	-2.4	-3.8	-3.8	-3.8
Adjustments (one off)	0.0	0.0	0.0	0.0	0.0
Retained earnings	0.8	7.6	4.3	7.3	9.6
Normalized Net Profit	**2.3**	**10.4**	**8.1**	**11.1**	**13.5**
Cash Flow (A$m)	**09A**	**10A**	**11F**	**12F**	**13F**
Pretax Profit	**3.2**	**14.9**	**11.6**	**15.9**	**19.2**
+ Depreciation	0.3	0.3	0.3	0.3	0.3
- Tax Paid	-4.0	-4.8	-3.5	-4.8	-5.8
+ inc (- dec) in provisions	0.4	0.3	0.1	0.0	0.0
- Profit/+ loss on disposal	0.0	0.0	0.0	0.0	0.0
+/- Other	-69.0	4.7	0.0	0.0	0.0
Gross Cashflow	**-69.1**	**15.3**	**8.5**	**11.4**	**13.7**
- Capital expenditure	-0.8	0.0	0.0	0.0	0.0
+/- Changes in working capital	-115.3	51.2	4.3	0.5	5.6
Operating Free Cashflow	**-185.2**	**66.6**	**12.8**	**11.9**	**19.3**
+/- Investments	**-0.3**	**0.0**	**0.0**	**0.0**	**0.0**
- Dividends	**-0.4**	**-2.4**	**-3.8**	**-3.8**	**-3.8**
+ Proceeds from equity raised	**0.0**	**14.2**	**0.0**	**0.0**	**0.0**
+ Acquisition	**-2.0**	**0.0**	**0.0**	**0.0**	**0.0**
+/- Minority interests	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
+/- Other	**65.0**	**0.0**	**0.0**	**0.0**	**0.0**
Net cashflow	**-122.8**	**78.4**	**9.0**	**8.0**	**15.5**
Cash at beginning of period	**20.1**	**-102.7**	**-24.3**	**-15.4**	**-7.4**
Net debt at end of period	**-102.7**	**-24.3**	**-15.4**	**-7.4**	**8.1**
Balance Sheet ($m)	**09A**	**10A**	**11F**	**12F**	**13F**
Cash	5.9	5.4	15.6	23.6	39.1
Receivables	45.4	31.4	31.8	31.8	32.4
Inventories	99.5	39.1	32.7	32.7	32.7
Other	0.2	0.0	0.0	0.0	0.0
Current Assets	**150.9**	**75.9**	**80.0**	**88.1**	**104.2**
Receivables	2.1	6.0	6.1	6.1	6.2
Inventories	19.8	23.0	21.8	21.8	21.8
Property/Plant/Equipment	1.9	1.7	1.4	1.2	0.9
Equity Accounted Investments	0.9	0.5	0.5	0.5	0.5
Intangibles	2.0	1.8	1.8	1.8	1.8
Deferred tax assets	0.0	0.0	0.0	0.0	0.0
Other	0.9	1.3	1.3	1.3	1.3
Non Current Assets	**27.5**	**34.3**	**32.9**	**32.6**	**32.5**
Total Assets	**178.4**	**110.2**	**112.9**	**120.7**	**136.7**
Payables	-56.1	-33.3	-30.9	-31.3	-36.5
Interest bearing liabilities	-108.3	-21.0	-21.0	-21.0	-21.0
Current tax payable	-1.1	-4.9	-4.9	-4.9	-4.9
Provisions	-2.5	-2.8	-2.9	-2.9	-2.9
Current Liabilities	-167.9	-62.0	-59.7	-60.1	-65.3
Payables	-1.0	-7.7	-7.2	-7.2	-8.4
Interest bearing liabilities	-0.3	-9.2	-10.0	-10.0	-10.0
Tax liabilties	0.0	0.0	0.0	0.0	0.0
Provisions	-0.1	-0.1	-0.1	-0.1	-0.1
Non Current Liabilities	**-1.4**	**-17.0**	**-17.3**	**-17.3**	**-18.5**
Total Liabilities	**-169.3**	**-79.0**	**-77.0**	**-77.5**	**-83.9**
Net Assets	**9.1**	**31.2**	**35.9**	**43.2**	**52.8**
Contributed equity	1.1	15.5	15.5	15.5	15.5
Reserves	0.8	0.8	1.2	1.2	1.2
Retained profits	7.2	14.8	19.1	26.4	36.0
Minority Interests	0.0	0.0	0.0	0.0	0.0
Total equity	**9.1**	**31.2**	**35.9**	**43.2**	**52.8**

PERFORMANCE RATIOS	09A	10A	11F	12F	13F
Growth and Margins					
Revenue Growth	n/a	44%	-3%	3%	17%
EBITDA Growth	n/a	332%	-23%	36%	21%
EBIT Growth	n/a	357%	-23%	37%	21%
Normalized Net Profit Growth	n/a	358.5%	-22.1%	37.3%	21.0%
EBITDA margin	2.5%	7.4%	5.9%	7.7%	8.0%
EBIT margin	2.3%	7.3%	5.7%	7.6%	7.9%
Normalized net profit margin	1.6%	5.0%	4.0%	5.3%	5.5%
Effective tax rate	37%	33%	30%	30%	30%
Liquidity					
Capex/depreciation (x)	3.3	0.0	0.0	0.0	0.0
Current ratio (x)	0.9	1.2	1.3	1.5	1.6
Quick ratio (x)	0.9	1.1	1.5	1.8	2.0
Receivable days	18	22	17	18	21
Payable days	22	24	17	16	21
Risk Measures					
Dividend Cover (x)	n/a	n/a	n/a	n/a	n/a
Payout ratio (%)	59%	24%	47%	34%	28%
Net interest cover (x)	40.9	50.5	493.3	1181.0	na
Net debt/equity (%)	1126%	80%	43%	17%	net cash
Returns					
Return on avg capital employed (%)	35%	75%	35%	1204%	1795%
WACC (%)		10%			
Return on assets (%)	2%	11%	10%	14%	15%
Return on average equity (%)	22%	50%	24%	28%	28%
Company cost of equity (%)		14%			
SHARE DATA/VALUATION	**09A**	**10A**	**11F**	**12F**	**13F**
Share Data					
Issued shares (m)	120.0	153.3	153.3	153.3	153.3
Weighted ave shares (m)	120.0	131.1	153.3	153.3	153.3
Fully diluted shares (m)	120.0	131.1	153.3	153.3	153.3
Basic EPS (A$)	0.02	0.08	0.05	0.07	0.09
YoY change (%)	n/a	351%	-31%	37%	21%
Fully diluted EPS (A$)	0.019	0.079	0.053	0.073	0.088
YoY change (%)	n/a	320%	-33%	37%	21%
Fully diluted normalised EPS (A$)	0.02	0.079	0.053	0.073	0.088
YoY change (%)	n/a	320%	-33%	37%	21%
Dividend/share (A$)	0.01	0.02	0.025	0.025	0.025
Franking (%)	100%	100%	100%	100%	100%
Gross cashflow/share (A$)	-0.58	0.12	0.06	0.07	0.09
NBV/share (A$)	0.08	0.20	0.23	0.28	0.34
NTA/Share (A$)	0.06	0.19	0.22	0.27	0.33
Valuation					
PER (Basic) (x)	n/a	4.3	6.2	4.5	3.8
PER (Fully diluted) (x)	n/a	4.2	6.2	4.5	3.8
PER (Fully diluted, normalized) (x)	n/a	4.2	6.2	4.5	3.8
P/CFPS (x)	n/a	2.8	6.0	4.4	3.7
Price/NBV (x)	n/a	1.6	1.4	1.2	1.0
Price/NTA (x)	n/a	1.7	1.5	1.2	1.0
Dividend Yield (%)	3.0%	6.0%	7.6%	7.6%	7.6%
Fully dil. normalized 3 yr EPS Cagr (%)	n/a	n/a	n/a	n/a	n/a
PEG ratio (x)	n/a	n/a	n/a	n/a	n/a
EV	153.3	75.4	66.0	58.0	42.5
EV/EBITDA (x)	43.0	4.9	6.4	4.7	3.9
EV/EBIT (x)	46.2	5.0	6.5	4.7	3.9
EV/Revenue (x)	1.1	0.4	0.4	0.4	0.3

OTHER INFORMATION	
Estimated free float	35%
12-mth High/Low (A$/sh)	0.50 / 0.10
Average daily volume (A$m)	0.1
ASX Code	DGX
Next result	Feb 2011

COMPANY DESCRIPTION

Diploma Group Limited (DGX) is a commercial construction and property development business which offers a complete vertically integrated model by managing the entire design process of a project, from initial concept through to final delivery of the end product. The company has two divisions, Diploma Construction and Diploma Properties which are responsible for carrying out the business activities.

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