

# Westpac Office Trust

## FY09 Result: A good yield generator

### Event

WOT reported a statutory FY09 NPAT loss of \$159.5M compared to a \$4.5M loss in FY08. The result was impacted by property devaluations of \$122.6M, and unrealised hedging losses of \$70.5M. NTA per unit fell from \$1.24 to \$0.86 (\$0.36 per IR). Portfolio income on a like for like basis grew by 3.4%, with the Trust distributing 6.65cps (or 3.4 cents per IR).

### Implications

The result was in line with management guidance and our expectations. An important development over the last month has been management's intention to seek investor approval to cease trading of IR units and commence trading of fully paid units on the ASX. The proposal to restructure has been assessed by the Independent Expert (IE) to be in the best interests of unitholders. Should the proposal be approved, this will allow the Trust to resume a disciplined growth strategy in a buyers market. However, the Trust's balance sheet has above-average leverage relative to that of its peers and may prove to be an achilles heel in the near term. Aegis estimates that over FY10 (including income growth), cap rates need to soften a further 100bps before lending covenants come under threat. More importantly, interest cover is 1.8x earnings compared to covenant of 1.5x, an adequate buffer considering the strength of tenant covenant. We attach a low probability for such an outcome. Finally, an FY10F implied distribution yield of 8.6% at current prices represents a solid yield in the context of current market conditions. Based on our DCF and NAV valuations, we value WOT at \$0.78 per fully paid unit (equivalent to \$0.28 per IR).

### Investment Opinion

The research on this company has been commissioned and as such Aegis has received a fee for its initiation and ongoing research coverage.

No part of either the fee received by Aegis or the compensation paid to its analysts involved in preparing this report was, is or will be directly or indirectly, related to the valuation, earnings forecast or views expressed in this report.

The DPS and DPS yield shown in 'Earnings summary' below reflects what investors receive under the instalment receipt structure. If the resolution to trade as fully paid units on the ASX is approved, DPS and DPS yield will be shown on a fully paid unit.

### Key Information

Share Price	\$0.29
Valuation	\$0.28

### Price Performance



### Market Statistics

Market Cap (M)	\$135
Shares (M)	482.2
% of All Ords	0.00
% of Sector	0.03
12 Month Range	\$0.22 - \$0.42
Company Risk	★ ★ ★ ☆ ☆
Share Price Risk	★ ★ ☆ ☆ ☆
Ethical rating	★ ★ ★ ★ ★

	Performance against indices (%)		
	3 Months	6 Months	12 Months
WOT	3.7	1.8	(29.1)
Sector	26.2	45.9	(5.4)
Market	17.9	36.4	(13.8)

### Key Assumptions

Beta:	1.2
Market risk premium (%):	6.0
Risk free rate (%):	6.3
WACC (%):	10.2
Forecast cashflow (years):	10
Residual value % of total valuation:	54.8
Nominal terminal growth rate (%):	3.0

### Earnings Summary

Yr to Jun	NPAT Rep \$M	NPAT <sup>1</sup> Adj \$M	EPS <sup>1</sup> c	EPS chg %	PER x	PER rel All Ords x	PER rel Sector x	DPS c	Yield %	Franking %	Deferred Tax %
2008A	(4.5)	31.9	6.6	28.1	4.4	0.3	0.2	4.0	13.8	0	100
2009A	(159.5)	33.7	7.0	5.5	4.1	0.2	0.3	3.4	11.7	0	100
2010F	33.8	33.8	7.0	0.2	4.1	0.3	0.3	3.4	11.7	0	100
2011F	34.1	34.1	7.1	1.0	4.1	0.3	0.4	3.4	11.7	0	100

<sup>1</sup> NPAT and EPS are adjusted by removing non-recurring items. All the above statistics are derived from normalised earnings.

# Westpac Office Trust

Valuation: \$0.28

Company risk <sup>1</sup>: ★★☆☆☆

Share Price risk <sup>1</sup>: ★★☆☆☆

Ethical rating <sup>2</sup>: ★★★★★

Year end Jun. All figures in A\$M

<b>Profit &amp; loss summary</b>					<b>Ratio analysis</b>				
	2008A	2009A	2010F	2011F		2008A	2009A	2010F	2011F
<b>Operating revenue</b>	<b>86.9</b>	<b>97.9</b>	<b>98.5</b>	<b>100.9</b>	Revenue growth (%)	53.7	12.6	0.7	2.4
Invest & other income	4.3	(6.9)	(6.1)	(6.2)	EBITDA growth (%)	75.2	0.1	2.0	3.0
<b>EBITDA</b>	<b>80.9</b>	<b>81.0</b>	<b>82.6</b>	<b>85.1</b>	EPS growth (%)	28.1	5.5	0.2	1.0
Depreciation/Amort	0.0	0.0	0.0	0.0	EBITDA/Sales margin (%)	93.1	82.7	83.8	84.3
<b>EBIT</b>	<b>80.9</b>	<b>81.0</b>	<b>82.6</b>	<b>85.1</b>	EBIT/Sales margin (%)	93.1	82.7	83.8	84.3
Net Interest	(49.0)	(47.3)	(48.8)	(50.9)	Tax rate (%)	0.0	0.0	0.0	0.0
<b>Pre-tax profit</b>	<b>31.9</b>	<b>33.7</b>	<b>33.8</b>	<b>34.1</b>	Net debt/equity (%)	115.7	172.9	167.8	163.0
Tax expense	0.0	0.0	0.0	0.0	Net debt/net debt + equity (%)	53.6	63.4	62.7	62.0
Minorities/Assoc./Prefs	0.0	0.0	0.0	0.0	Net interest cover (x)	1.7	1.7	1.7	1.7
<b>NPAT</b>	<b>31.9</b>	<b>33.7</b>	<b>33.8</b>	<b>34.1</b>	Payout ratio (%)	109.4	95.1	94.9	94.0
Non recurring items	(36.4)	(193.2)	0.0	0.0	Capex to deprec'n (%)	0.0	0.0	0.0	0.0
<b>Reported profit</b>	<b>(4.5)</b>	<b>(159.5)</b>	<b>33.8</b>	<b>34.1</b>	NTA per share (\$)	1.26	0.86	0.89	0.93
NPAT add Goodwill & Pref	0.0	0.0	0.0	0.0	ROA (%)	5.9	6.4	6.8	7.0
<b>Adjusted profit</b>	<b>31.9</b>	<b>33.7</b>	<b>33.8</b>	<b>34.1</b>	ROE (%)	5.0	7.2	8.0	7.8
<b>Cashflow summary</b>					<b>Multiple analysis</b>				
<b>EBITDA</b>	<b>80.9</b>	<b>81.0</b>	<b>82.6</b>	<b>85.1</b>	Market cap (M)		135		
Working capital changes	(2.2)	0.8	0.0	(0.0)	Net debt (\$M)		715.3		
Interest and tax	(51.0)	(45.6)	(48.8)	(50.9)	Peripheral assets (\$M)		215.0		
Other operating items	(1.6)	(4.3)	0.0	0.0	<b>Enterprise value (\$M)</b>		<b>1,065.3</b>		
<b>Operating cashflow</b>	<b>26.1</b>	<b>31.9</b>	<b>33.8</b>	<b>34.1</b>	<b>EV/EBIT (x)</b>	<b>13.2</b>	<b>13.2</b>	<b>12.9</b>	<b>12.5</b>
Required capex	0.0	0.0	(10.0)	(10.0)	<b>EV/EBITDA (x)</b>	<b>13.2</b>	<b>13.2</b>	<b>12.9</b>	<b>12.5</b>
<b>Maintainable cashflow</b>	<b>26.1</b>	<b>31.9</b>	<b>23.8</b>	<b>24.1</b>	EV/EBITDA All Ind (x)	7.4	7.3	6.8	6.2
Dividends	(34.8)	(32.8)	(16.4)	(16.4)	EV/EBITDA rel All Ind (x)	1.8	1.8	1.9	2.0
Acq/Disp	(146.0)	(16.4)	0.0	0.0	<b>P/E (x)</b>	<b>4.4</b>	<b>4.1</b>	<b>4.1</b>	<b>4.1</b>
Other investing items	(22.5)	(0.2)	(15.6)	(15.6)	P/E rel All Ind (x)	0.3	0.2	0.3	0.3
<b>Free cashflow</b>	<b>(177.1)</b>	<b>(17.5)</b>	<b>(8.2)</b>	<b>(7.9)</b>	P/E rel All Ind ex banks (x)	0.3	0.3	0.3	0.3
Equity	1.4	0.0	0.0	0.0	P/E sector (x)	18.4	16.4	12.7	11.2
Debt inc/(red'n)	170.2	(0.5)	8.2	7.9	P/E rel sector (x)	0.2	0.3	0.3	0.4
<b>Balance sheet</b>					<b>Assumptions</b>				
	2008A	2009A	2010F	2011F		2008A	2009A	2010F	2011F
Cash & deposits	45.8	27.8	16.0	4.5	GDP growth (%)	3.58	0.50	0.00	1.40
Inventories	0.0	0.0	0.0	0.0	Interest Rates (%)	7.38	4.88	2.30	2.49
Trade debtors	3.5	0.5	0.5	0.5	Inflation (%)	3.40	3.65	2.50	2.50
Other curr assets	44.4	1.1	1.1	1.1					
<b>Total current assets</b>	<b>93.7</b>	<b>29.4</b>	<b>17.5</b>	<b>6.0</b>					
Prop., plant & equip.	0.0	0.0	0.0	0.0					
Non-curr intangibles	0.0	0.0	0.0	0.0					
Non-curr investments	1,260.6	1,172.4	1,182.4	1,192.4					
Other non-curr assets	20.4	0.0	15.6	31.2					
<b>Total assets</b>	<b>1,374.8</b>	<b>1,201.8</b>	<b>1,215.6</b>	<b>1,229.7</b>					
Trade creditors	15.4	13.3	13.3	13.3					
Curr borrowings	243.8	3.9	3.9	735.8					
Other curr liabilities	6.2	31.7	31.7	31.7					
<b>Total current liab.</b>	<b>265.4</b>	<b>48.9</b>	<b>48.9</b>	<b>780.9</b>					
Borrowings	503.3	739.2	735.6	0.0					
Other non-curr liabilities	0.0	0.0	0.0	0.0					
<b>Total liabilities</b>	<b>768.7</b>	<b>788.1</b>	<b>784.5</b>	<b>780.9</b>					
Minorities/Convertibles	0.0	0.0	0.0	0.0					
<b>Shareholders equity</b>	<b>606.1</b>	<b>413.7</b>	<b>431.1</b>	<b>448.8</b>					

## Notes To Accounts

The DPS and DPS yield shown in our Earnings summary on Page1 reflects what investors receive under the instalment receipt structure. If the resolution to trade as fully paid units on the ASX is approved, DPS and DPS yield will be shown on a fully paid unit.

**Notes:**1. The risk ratings are on a 12 month perspective, where five stars denotes low risk and one star denotes high risk. Company risk takes into account expected financial, strategic and execution risks associated with the company. Share price risk is a measure of the expected volatility of the price and other trading factors.

2. The Ethical rating rates a company on an ethical investment basis where five stars denote very good and one star a poor rating. The score is based on four key factors: areas of operating, environmental, corporate governance and social factors. For more information see [www.aegis.com.au](http://www.aegis.com.au).

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TABLE 2: RESULTS SUMMARY

		pcp	Aegis	Actual	Change	
		Jun-08	Jun-09	Jun-09	pcp	Aegis
<b>For the 12 months ended**:</b>						
Sales revenue	:\$M	86.9	94.3	97.9	+13%	+4%
EBITDA	:\$M	80.9	81.8	81.0	+0%	-1%
Depreciation & amort	:\$M	0.0	0.0	0.0		
EBIT	:\$M	80.9	81.8	81.0	+0%	-1%
Net Int Expense	:\$M	-49.0	-48.6	-47.3	-3%	-3%
Profit Before Tax	:\$M	31.9	33.2	33.7	+6%	+1%
Tax on Recurring	:\$M	0.0	0.0	0.0		
Profit After Tax	:\$M	31.9	33.2	33.7	+6%	+1%
Minorities/Associates	:\$M	0.0	0.0	0.0		
Preference Dividends	:\$M	0.0	0.0	0.0		
NPAT	:\$M	31.9	33.2	33.7	+6%	+1%
Non Recurring (net of Tax)	:\$M	-36.4	-21.1	-193.2	+431%	+816%
Reported Profit	:\$m	-4.5	12.1	-159.5	+3444%	-1417%
** All numbers are adj. for non-recurring items except Reported Profit						
<b>PER SHARE DATA</b>		<b>Jun-08</b>	<b>Jun-09</b>	<b>Jun-09</b>		
Average weighted Capital, fully diluted	:M	481	482	482	+0%	+0%
E.P.S. on Adj profit	:cents	6.6	6.9	7.0	+5%	+1%
D.P.S.	:cents	7.3	6.7	6.7	-8%	+0%
Franking	:%	0	0	0		
Payout Ratio		109%	97%	95%	-14%	-1%
<b>RATIOS</b>		<b>Jun-08</b>	<b>Jun-09</b>	<b>Jun-09</b>		
EBITDA Margin	:%	93.1	86.8	82.7	-10%	-4%
EBIT Margin	:%	93.1	86.8	82.7	-10%	-4%
Effective Tax rate	:%	0.0	0.0	0.0	+0%	+0%

Source: Aegis Equities

## Key Highlights

**Profit and Operating Earnings:** WOT reported an FY09 NPAT loss of \$159.5M, which included property fair-value writedowns of \$122.6M and an unrealised loss on hedging of \$70.5M. After stripping out fair-value movements and straight lining of rental income, adjusted NPAT was \$33.7M and in line with our forecast.

**Portfolio:** Rent reviews were conducted for over 192,180m<sup>2</sup> of tenanted space resulting in rental increases in the range of 2.75%-5.00%. Portfolio occupancy as at 30 June 2009 was 98.7% (including rental guarantee of Cannon hill). There are no major lease expiries in the portfolio unit mid 2011, at which time 5.7% leases will expire. The weighted average lease expiry for the Trust is 9.2 years, which for an office property portfolio, is an unrivalled lease profile for both listed and unlisted Funds.

**Revaluations:** On 17 July 2009, WOT announced it had independently revalued five properties (69% by value) and conducted director's valuations on the remaining three assets (31% by value). The portfolio carrying value decreased by 4.4% (\$54.2M) for the six months June 2009. Driving the valuation outcome was the cap rate expansion of 0.47% to 7.32% over the half year as cap rates continue to soften in light of prolonged credit market weakness. We note, the large fixed rent review component of the Trust has eased the extent of property devaluations experienced to date, protecting the full extent of property value weakness resulting from market rent declines.

**NTA:** As a result of softening property values and unrealised fair value adjustments to interest rate hedges, net assets have reduced by \$173M over the 12 month period to \$413.7M. Net assets per unit, or, NTA, has decreased from \$1.24 as at June 2008 to \$0.86 as at June 2009. The NTA per instalment receipt (net of IR debt obligations of \$0.50) is \$0.36.

**Proposal for Instalment Receipt Structure:** On 14 August 2009, WOT announced a meeting of investors to be held in September 2009. The purpose of the meeting is to seek approval for the cessation of trading IR units and commence trading of fully paid units. The Independent Expert report on the proposal deemed the restructure to be in the best interest of investors. For further details on the proposal, please see *Instalment Receipt Restructure Recap* on page 4.

**Outlook and Guidance:** As with a number of its peers, management has a policy of distributing cash profits after provisioning for operating capex. On this basis, management provided gross distribution guidance for FY10 to be 6.65cps or 3.4 cents per instalment receipt, which is the same amount paid over FY09. A successful capital restructure should attract a broader range of investors, which could potentially position the Trust to capitalise on accretive acquisition opportunities. In the interim, management intends to manage leverage of the portfolio through non-core asset sales.

## Instalment Receipt Restructure Recap

On 14 August 2009, WOT announced a meeting of investors to be held on September 2009, to seek approval for the cessation of trading IR units and commence trading of fully paid units. We recap the proposal below:

WOT management has put forward a proposal for investors to consider and vote on the following two resolutions:

1. Commence trading the ordinary units of the Trust on the ASX and cease trading the existing instalment receipts and
2. Approval for an extension of and amendments to the Business Development Agreement between the Trust and Westpac. The current agreement, which expires in July 2010, provides the Trust with support from Westpac in securing new properties.

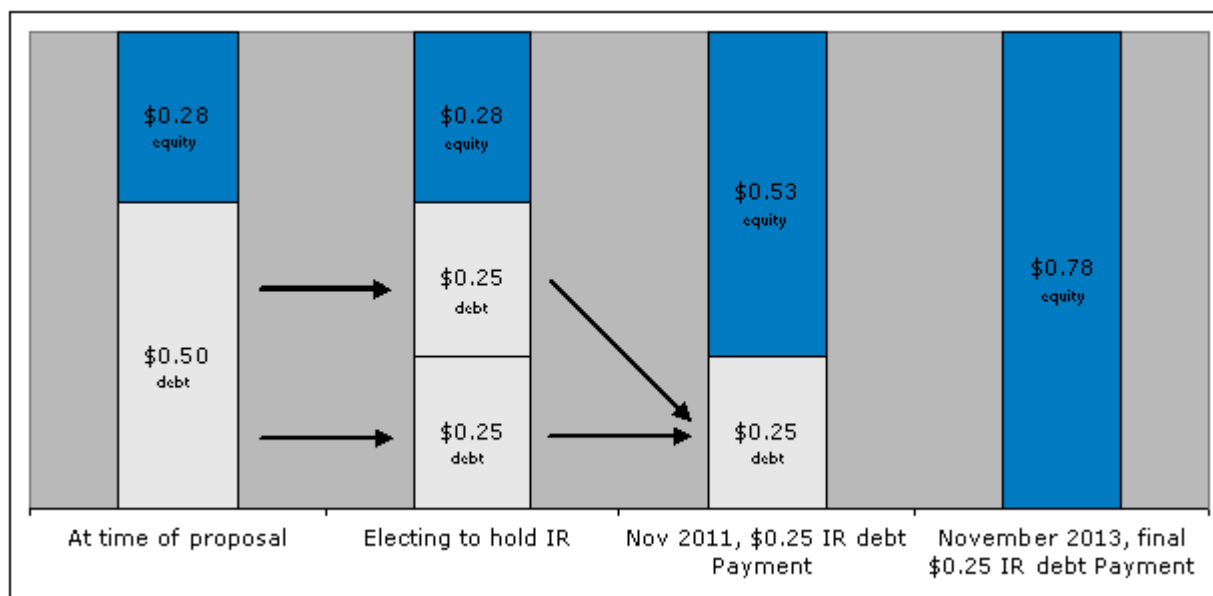
For more details on the proposal, please refer to the Explanatory Memorandum (EM) and the Independent Expert's report, which recommends investors vote in favour of the proposal and that it is in the best interests of unitholders. We, however, summarise the proposal briefly below.

Should the proposal be approved by a majority of investors (50% minimum), the Trust will trade on the ASX as fully paid units. Current holders of WOT instalment receipts (IRs) will have three options which are outlined below:

1. Continue to hold the IRs:  
Under the current IR structure, investors are required to pay the remaining debt amount of \$0.50 per unit in November 2011. However, the proposal requires unitholders to pay \$0.25 in November 2011 and defer the remaining \$0.25 payment until November 2013. We note the interest rate will remain fixed at 6.5% until November 2011 but will revert to the floating rate (plus a margin) for investors choosing to pay the remaining \$0.25 in November 2013. When unitholders make the final payment, the IR debt is retired and fully paid units are issued;
2. Sell your instalment receipts:  
Investors can sell some or all of their IRs. Investors are not required to repay the Instalment Debt to convert their Instalment Receipts to units prior to the trade. This will be achieved through a broker who will sell the whole underlying security and the settlement proceeds will retire all IR debt and remaining proceeds will be paid to the investor; and
3. Pay the instalment debt:  
Investors will have the flexibility to pay the IR debt anytime before November 2011, an option that is not available under the current structure. After payment of IR debt, the fully paid units will be traded on the ASX, with investors receiving the full distribution on units without the deduction of their instalment debt interest.

In Figure 2 below, we have illustrated the scenario of an existing investor electing to continue holding the IRs until November 2013.

**FIGURE 2: EXAMPLE OF INVESTOR HOLDING THE IR**



Source: Aegis Equities

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Aegis notes the approval of the proposal should achieve the following:

1. Enable management to appeal to a larger investor base and potentially attract institutional investors that have hitherto been deterred to invest in the Trust due to its structure;
2. The Trust's portfolio of prime quality assets fits well with the current theme of investors seeking greater exposure to Australian domiciled assets; and
3. Reduces investors concerns on the final \$0.50 call in November 2011 and provides a wide range of options for investors; and
4. There is the potential for the Trust to be included in the S&P/ASX 300 A-REIT index as liquidity improves which should have positive implications for the trading price.
5. We note that the market capitalisation of the Trust will dramatically increase from around \$135M to around \$375M based on current trading price. This could potentially result in WOT gaining increased status in the A-REIT sector.

## NAV Sensitivity

In addition to our primary DCF valuation method, we have undertaken a NAV sensitivity using property values as a variable.

- Based on a cap rate expansion of 25bps and 50bps, NAV valuation is in the range of \$0.34 to \$0.26 cents per instalment unit. We note that assumed costs of the transaction are as per the Independent Expert report and a base management fee multiple of 5x has been applied.

**TABLE 3: NET ASSET VALUE SENSITIVITY**

	NTA	NAV	
	FY09A	+25bps cap rate expansion	+50bps cap rate expansion
Westpac Place cap rate	6.88%	7.00%	7.68%
Other Assets WACR	8.10%	8.50%	9.30%
<b>Total market weighted average cap rate</b>	<b>7.32%</b>	<b>7.57%</b>	<b>7.82%</b>
Investment Property Value	1,172.4	1,167.7	1,130.4
Other Assets	29.4	29.4	29.4
<b>Total Assets</b>	<b>1,201.8</b>	<b>1,197.1</b>	<b>1,159.8</b>
Total Borrowings	743.1	743.1	743.1
Other Liabilities	45.1	45.1	45.1
<b>Total Liabilities</b>	<b>788.1</b>	<b>794.2</b>	<b>794.2</b>
<b>Equity</b>	<b>413.7</b>	<b>402.9</b>	<b>365.5</b>
Assumed cost of transaction	-	6.1	6.1
Management Fee Ongoing	-	11.5	11.5
<b>Net Equity</b>	<b>413.6</b>	<b>385.3</b>	<b>347.9</b>
<b>Value per whole unit</b>	<b>0.86</b>	<b>0.84</b>	<b>0.76</b>
<b>Value net of IR debt</b>	<b>0.36</b>	<b>0.34</b>	<b>0.26</b>
Change in % from June 2009	0.0%	-6.3%	-27.9%
LVR (debt/prop val)	63%	64%	66%

Source: Aegis Equities

## Investment Summary

- WOT owns and manages a high-quality commercial office portfolio of eight assets that generates a sustainable and predictable income stream. This in turn underpins our view of the Trust providing distributions with modest growth over the medium to long term.
- The portfolio metrics rate favourably against its peers.

## Investment Summary contd.

- The proposal to restructure has been assessed by the Independent Expert to be in the best interests of unitholders and that it improves flexibility. Should the proposal be approved, this will allow the Trust to resume a disciplined growth strategy in a buyers market.
- However, the Trust's balance sheet has an above-average leverage relative to that of its peers and may prove to be Achilles heel in the near term.
- The Trust has the option of selling smaller assets in the portfolio. Aegis estimates the sale of \$100M of assets could reduce gearing to below 60%. Nonetheless, this remains high and may require the Trust to raise new equity to fund acquisitions.
- Asset devaluation pressures continue to weigh on the sector, although there are signs emerging that the rate of decline has slowed. Aegis estimates that over FY10 (including income growth), cap rates need to soften a further 100bps before lending covenants come under threat.
- The more important covenant breach to consider is the interest cover covenant of 1.5x earnings. Aegis attaches a low probability for this breach to occur as it would require Westpac Bank, Woolworths or IBM to default on rent payments.
- Our valuation on WOT remains largely unchanged at \$0.28 per instalment receipt. This implies a fully paid unit price of \$0.78 implying an FY10 forecast distribution yield of yielding 8.5% on a fully paid unit basis.
- On an IR unit basis, our valuation of \$0.28 delivers IR holders an attractive 12.1% distribution yield. The difference in the IR yield and fully paid unit yield is due to the fixed interest component (being 6.5%) on the IR debt until November 2011.



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