

Colorpak Ltd (CKL.ASX)

INITIATING COVERAGE – Punching above its weight

 Wednesday 25 May 2005
 Containers & Packaging

Colorpak is a supplier of folding cartons and ancillary products to consumer brand companies. Specialising in the less economically sensitive healthcare sector, which accounts for 61% sales, the company is the fourth largest folding carton supplier in Australia with 9.4% market share.

Colorpak is extremely highly regarded in its industry and has comprehensively beaten its competitors in the annual BIS Shrapnel industry survey over the last four years. Although operating in a competitive and price sensitive industry, dominated by two significant rivals (Ampcor Cartons and Carter Holt Harvey), Colorpak has consistently taken market share, expanded margins, and enjoys impressive customer retention rates.

The company has been run by the Commins family since 1993 and has a history of augmenting organic growth with acquisitions. Over the last six years the company has acquired four competitors, which has not only boosted revenues (turnover CAGR 17%), but also supplemented its strategy of capturing additional elements of the supply chain.

The management are young, ambitious and experienced, and have an unequivocal belief that Colorpak can continue to take market share through operational efficiencies and by setting the benchmark for early adoption of technology.

Last year's acquisition of Wadepack by Carter Holt Harvey has created a significant opportunity due to the widely reported dissatisfaction of some customers. Colorpak believes that it will be a major beneficiary of this uncharacteristically high churn and has already announced a significant expansion of its Sydney and Melbourne operations to accommodate the work from newly acquired customers.

The shares are currently trading on a prospective P/E multiple of 8.8x and yield 4.1%. We are initiating coverage with a BUY rating and a price target of \$0.87.

Year to June (\$m)	2004a*	2005e	2006e	2007e	2008e
Revenue	49.1	58.0	66.5	73.6	78.8
% change	n/a	18.2%	14.6%	10.7%	7.0%
EBITDA	10.3	11.3	13.1	14.5	15.2
EBITDA margin	20.9%	19.4%	19.8%	19.6%	19.2%
NPAT (reported)	2.6	3.3	6.2	6.8	7.4
NPAT (normalised)	5.0	5.6	6.2	6.8	7.4
EPS(normalised) (cents)	6.4	7.0	7.6	8.5	9.1
% change	-	8.4%	9.9%	11.0%	7.7%
Dividend (cents)	-	2.5	2.9	3.2	3.5
PER (x)	9.3	8.8	8.0	7.2	6.7
EV/EBITDA (x)	7.5	6.7	6.1	5.4	4.9
Yield (%)	n/a	4.1%	4.8%	5.3%	5.7%

Numbers exclude abnormal items and goodwill, * pro-forma

Source: Company, Foster Stockbroking

Rating:	BUY
(previous):	n/a

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Share price:	\$0.61
Price target:	\$0.87
(previous price target)	n/a
NPV per share	\$0.87
Risk:	Med

Shares on issue (m):	80.5
Shares (diluted) (m):	80.5
Free float:	67%
Average daily volume:	120,298

Market cap (m):	\$49.1
Enterprise value (m):	\$76.6
Net Debt (m):	-\$27.5
Gearing (ND/ND+Equity):	40%
Shareholders equity (m):	\$41.9
Book value per share*:	\$0.42
* ex intangibles	

Forecast:	2005
Free cash flow (m):	\$4.41
Return on average equity:	14%
Net interest cover (x):	4.9

Forecast:	2006
Free cash flow (m):	-\$2.62
Return on average equity:	14%
Net interest cover (x):	5.2

Shareprice (cents):



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COMPANY DESCRIPTION

Colorpak is a supplier of folding cartons, blister cards, printed leaflets and display material to consumer brand companies. Specialising in short-run, high-quality solutions, the group has operations in Melbourne and Sydney and is the fourth largest folding carton supplier in Australia with 9.4% market share¹.

Figure 1: Packaging examples



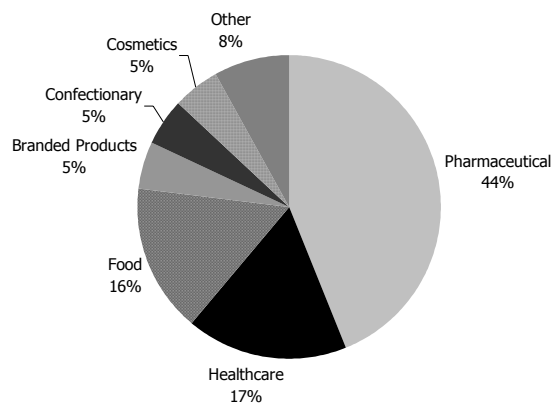
Source: *Company*

The group has a history of organic and acquisitive growth. Previously a family owned business (the Commins family retains a 33% stake) the company was floated on the ASX in April 2004 raising \$3m net. The rationale behind the listing was to provide access to capital, a currency for acquisitions and listed company discipline.

Colorpak has an assiduous culture and this is reflected in both industry surveys and high customer retention rates. Although a price-taker, Colorpak has been able to enjoy strong gross margins and expanding operating margins through its niche focus; the early adoption of technology; good working practises; and its strategy of bringing specialist value-add components of the supply chain in-house.

The group derives 61% of revenues from the pharmaceutical and healthcare industries, with the balance from food, cosmetics, confectionary, multi-media and wine. Colorpak services both national and international companies, including Cussons, L'Oreal, Sigma, Patties, AstraZeneca, CSL, Bayer, Nestle and Beringer Blass. A little over 40% of revenues are based on long-term contracts.

Figure 2: Colorpak revenues by industry (based on 2004)



Source: *Company*

¹ Based on 2005 revenues and BIS Shrapnel estimate of market size.

INVESTMENT CASE

Long-term outperformance in mature industries, particularly capital-intensive ones, can usually be attributed to management ability. With relatively little opportunity for pricing-power or precedent, it requires a fastidious management to deliver innovations and efficiency improvements in order to take market share and expand margins.

We believe that the management team at Colorpak has provided compelling evidence to support the argument that it is running the one of the most efficient folding-carton businesses in Australia. This subjective assertion is reflected in the more tangible evidence of a history of improving profitability (EBITA margins have expanded from 9.9% in 1998 to 16.5% in 2005e), organic market share gains (see page 7) and industry surveys.

As with all capital-intensive industries judging capital expenditure is key. The management must find the balance between maximising returns from aging equipment and maintaining efficiency leadership through productivity gains. This is a fine balance, with overemphasis on either potentially having a damaging impact on margins or cashflow.

Correspondingly however, if a company can successfully manage this dichotomy, it can enjoy a virtuous circle of expansion, which competitors find very hard to impede. We believe that building on the principals of Walter Commins, the Commins brothers Paul, Alex and Harry have achieved this self-sustaining cycle of growth. Consequently we expect Colorpak to continue to take market share through organic customer wins, augmenting this growth through strategic acquisitions.

Attractions

- **High quality investment** – It is not often we find such discipline, efficiency and good management practise in a 'small-cap' company.
- **Organic growth** – The company has been regularly taking market share and we believe that its size, reputation for consistency and competitive pricing should ensure this continues.
- **Positive short-term drivers** – The recent acquisition of Wadepack by Carter Holt Harvey has led to some customer churn, we expect Colorpak to be the beneficiary, allowing the group to achieve stronger than typical growth in 2006 and 2007, outstripping current expectations.
- **Increase in capacity** – Reflecting the management's confidence, Colorpak is currently undergoing a significant expansion in capacity adding about one third more floor space across Sydney and Melbourne.
- **Potential takeover target** – The folding carton industry has been consolidating for many years and although Colorpak is a predator we believe that equally the group would make an attractive target for either of the industry leaders Carter Holt Harvey and Amcor Cartons.

Recommendation

Our price target is based on our DCF valuation. At our target price the shares would be trading a PER multiple of 12.5x prospective earnings to June 2005 (falling to 11.4x in 2006). This is equivalent to a 19% discount to the average prospective multiple of 15.5x for the Industrial (ex-financials).

We recommended Colorpak to both value and GARP investors and are initiating coverage with a BUY and a price target of \$0.87, corresponding to a 43% upside.

INDUSTRY BACKGROUND

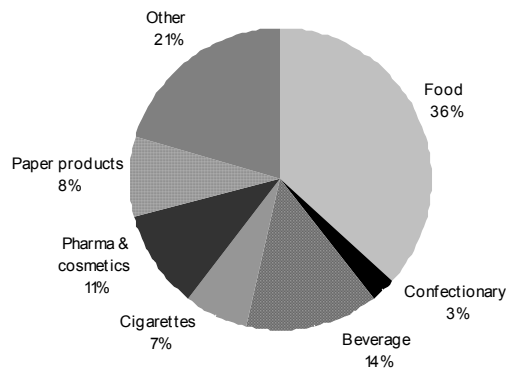
The Australian paper and board packaging market is estimated by BIS Shrapnel² to have been worth \$3.23bn in 2004. This can be divided into four segments: Corrugated containers (68% share); Folding cartons (19% share); Liquid packaging (8% share) and Paper bags & wrappings (5% share). As a whole the market has experienced compound annual growth of 4.1% over the last four years but historically has grown more or less in line with GDP.

Folding Cartons

The market for folding cartons can be broadly divided across two segments, which can be characterised as follows:

- High volume/low sophistication – mostly fast moving consumer goods ('FMCG') such as washing powders, cereals and tea bags.
- Short run/high quality - consumer branded products such as pharmaceuticals, cosmetics, wine and premium food items.

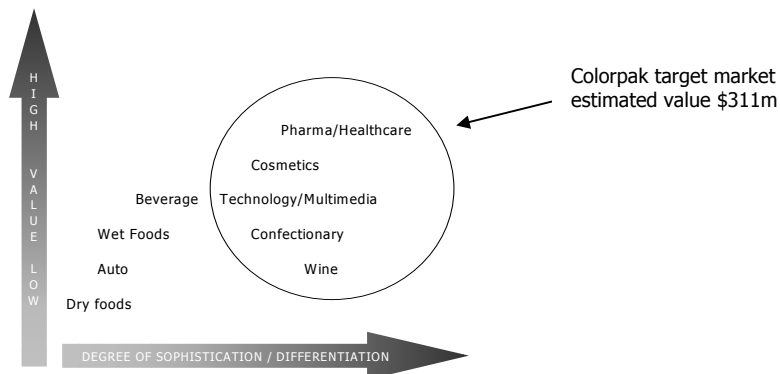
Figure 3: Folding Carton industry volumes by end use application (2004 estimate)



Source: *BIS Shrapnel*

Collectively BIS Shrapnel estimates that the paper & board packaging portion of the industry was valued at \$621m in 2004, having grown at a compound rate of 5.9% since 2000, but just 2.1% over the last year. Going forward growth is forecast to be in line with GDP². We estimate that the short-run sophisticated solutions targeted by Colorpak account for 30% of the carton board tonnage consumed and c.50% of the annual spend on carton products.

Figure 4: Folding carton value matrix



Source: *Company*

² BIS Shrapnel: Paper and Board Packaging in Australia, 30th edition 2004-2005

Industry peers

Company	Market share	Description
Amcors Cartons	33.5%	A subsidiary of the global packaging giant Amcor Limited (AMC.ASX). Market Cap \$5.7bn. Last trading update: "Amcor Australasia experienced slowing growth, with volumes in many business segments lower than expectations." ³
Carter Holt Harvey Cartons/Wadepack	29.2%	A division of the vertically integrated wood, pulp and paper products company Carter Holt Harvey Limited (CHY.ASX). Market Cap \$2.2bn. Last trading update: "...lower volumes in the carton division.... Wadepack's earnings were in line with the valuation and integration of the Wadepack business is progressing well." ⁴
Anzpac	10.5%	ANZPAC is a subsidiary of British American Tobacco and specialises in cigarette boxes and FMCG. Customers include Imperial Tobacco, Mars and Coles. Outlook: "Fairly bullish over next 12-months due to capex expansion coming online. Industry growth more muted 1-2%. Some input costs rising due to higher oil price (freight and solvent based ink). Believe that there has been some customer dissatisfaction from the Wadepack acquisition"
Colorpak	9.4%	Last trading update: "With recent consolidation amongst competitors in the folding carton sector many opportunities for rapid growth have been presented to us." ⁵
Hannapak	8.5%	A private NSW company specialising in cartons for FMCG. Customers include: Unilever, Mead and Riverwood. Outlook: "Conditions in line with recent years in terms of both pricing and volume growth. Hoping for 10% growth in the year ahead through market share gains serviced by additional capacity. No atypical increase in input costs (wages & cartonboard). The Wadepack acquisition has created opportunities as some customers may prefer a less bureaucratic supplier than Carter Holt."
Others	9.9%	n/a

Globalisation

The global trend of centralising manufacturing to bases with lower labour costs may result in work increasingly being moved off shore. Although there is some evidence of this e.g. L'Oreal and Smith & Nephew moved to suppliers in Indonesia and Mexico respectively, there is not yet decisive evidence with Proctor & Gamble believed to be moving more work to Australia.

The area of the market most susceptible to off-shoring would appear to be the higher-volume, less value-add component. This area is characterised by longer, less time-sensitive print runs, less sophisticated products and less exacting standards. According to figures from *IBIS World*, imports currently only account for \$25.1m⁶ of domestic demand (exports total \$17.1m) and consequently at this stage overseas producers have yet to establish a meaningful foothold.

³ Nine-month trading update 27 April 2005. Update refers to Amcor Australasia which supplies a broad range of packaging items across the complete Amcor product line including: Corrugated boxes, cartons, cans, flexible packaging, PET products, bottles, paper, cartonboard and paper recycling. The last specific comment on the Carton division was in the interim report in February when the group said, "volumes were up slightly", with gains in Australia and New Zealand.

⁴ Nine-month trading update 20 April 2005. Carter Holt Harvey acquired Wadepack (previously the 4th largest folding carton manufacturer with 12% market shares) in February 2005.

⁵ ASX announced Trading Update - 1 March 2005.

⁶ *IBIS World*: Solid Paperboard Container Manufacturing in Australia 1 March 2005

COMPANY HISTORY

Colorpak can trace its heritage back to the 1920's, but the structure of the current organisation was established in 1993 when Walter Commins (ex MD and Chairman) bought out his partners and invited his sons - Alex (Managing Director), Paul (Executive Director) and Harry (National Production Manager) to join the company.

In 1995, Colorpak moved to a purpose-built (7,100sqm) facility in Braeside, Melbourne - with a further 10,000sqm of adjacent land available for future expansion. The company made the decision to focus on the pharmaceutical and healthcare industry which it believed offered more potential for growth, higher barriers to entry and better opportunities to add value and form stable, long-term relationships. The group is the largest supplier to this niche with a 45% market share.

The management also presciently observed that the consolidation of many of its customers (e.g Glaxo, Wellcome, SmithKline, Beecham, into GlaxoSmithKline) would require the fragmented packaging folding carton industry to undergo a corresponding consolidation, both to manage the concomitant increases in contract sizes, but also to drive efficiencies to offset the inevitable pricing pressure resulting from the award of larger contracts.

The company therefore embarked of a series of acquisitions (four to date), which began in 1998 with the acquisition of Foilmasters to the most recent Castle Graphics, in December last year. Acquisitions will remain a key part of the group's strategy and were part of the rationale behind the decision to list on the ASX.

In 1999 Walter Commins retired as MD and became non-executive Chairman of the company. His eldest son Paul assumed the role until December 2002 when the current incumbent, Alex Commins, succeeded him. In December 2004 Walter retired from the Board, to be replaced by Geoff Willis, who was a senior executive of Amcor from 1982 until 1998.

The company is currently building a 7,750sqm greenfield plant in Regent's Park to replace its 5,300sqm site in Erskineville. Originally it was planned that the facility would consolidate the Sydney operation with the recently acquired Castle Graphics. The company recently decided to retain the latter's premises however, as despite 46% increase in floor space, it believed that integrating the two sites would too quickly lead to capacity constraint. The site is expected to become operational early in 2006, a few months later than originally planned. The company is also planning to develop a 2,500sqm extension to its 7,100sqm Braeside facility, which it expects this to be operational by November 2005 (capex in 2006 is expected to be \$10m paid out of cashflow and a \$5.5m increase in debt.)

GLOBAL ALLIANCES

Colorpak has been proactive in participating in two global alliances: Global Packaging Alliance and Copapharm. The company believes that in view of the global perspective of many of its customers, the alliances give it an advantage over domestic rivals

The alliances provide Colorpak with opportunities to share global market intelligence and exchange technical and operational expertise. To date the partnerships have been instrumental in maintaining the Gillette account, but the group also believes they have assisted in its dealings with other global customers, such as Nestle. The burden on management time and company finances would appear to be minimal.

GlobalPackaging Alliance: <http://www.global-packaging-alliance.com/>
 Copapharm Europe: <http://www.copapharm.com/>

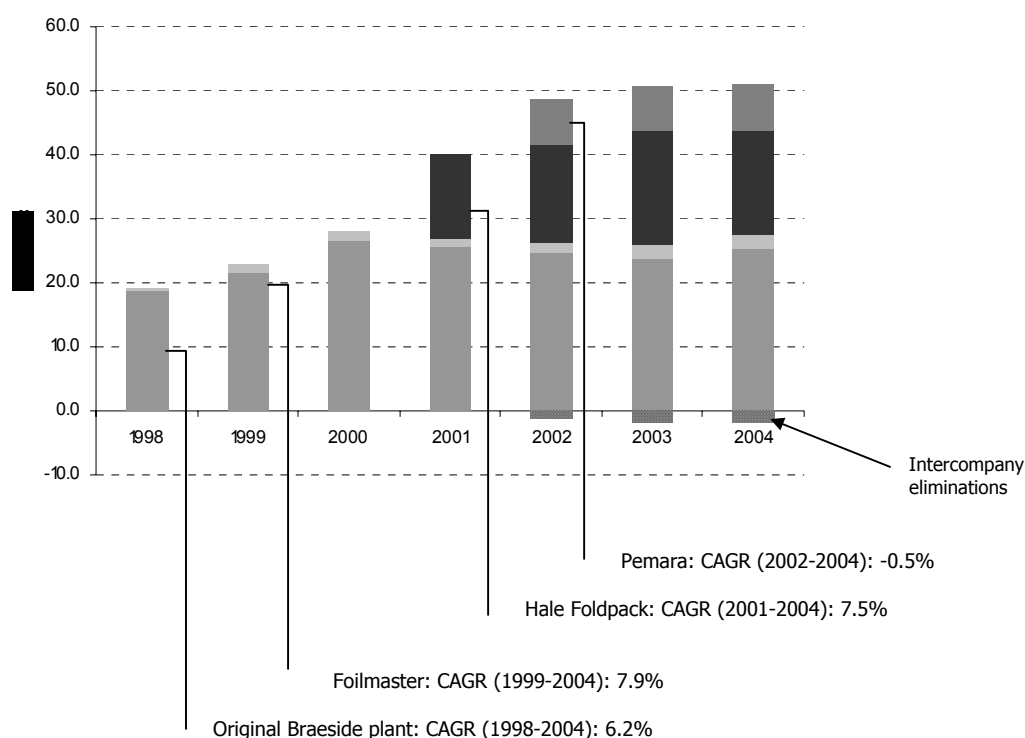
Despite 46% increase in floor space, Colorpak believes that integrating the two sites would too quickly lead to capacity constraint

ACQUISITIVE GROWTH

Colorpak's stated strategy is to augment organic growth with acquisitions. This strategy inherently carries more risk for equity holders (dilution, overpaying, unsuccessful integration), but nevertheless we believe the strategy is appropriate, as the benefits would appear to outweigh the risks.

Figure 5: Colorpak acquisition history

Date	Company	Cost	Revenue	Description
1998	Foilmasters	\$1.0m	\$1.5m	Foil stamping
2000	Hale Foldpack	\$9.0m	\$13.0m	Folded cartons
2001	Pemara Packaging	\$9.0m	\$9.0m	Folded cartons
2004	Castle Graphics	\$6.0m	\$6.5m	Blister packs & labels



Source: *Company*

- Colorpak remains comparatively small with 9.4% market share. Although a very efficient operator Colorpak would nevertheless benefit from additional scale in terms of purchasing power and fixed overheads (e.g. listing costs and head office).
- Most of the potential acquisition targets are unlisted and typically sell for lower multiples. We would therefore expect future acquisition to be EPS accretive, even before synergies. The recent acquisition of Castle Graphics was based on a multiple of 5x EBITDA, a 23% discount to Colorpak's multiple.
- Although Colorpak has enjoyed considerable success in winning customer from competitors, the due diligence requirement and risk of supply chain disruption, mean customer tend to be loyal. This tendency does not lend itself to rapid organic growth.

- Two of the group's acquisitions have added specialist skills (Foilmaster and Castle Graphics). We believe this vertical integration makes the Colorpak proposition more attractive by bringing more of the supply chain in-house and capturing incremental profitability. To date this has been focused on the pharmaceutical industry but future acquisitions may target other segments e.g. confectionary or beverages.
- The company has no physical presence in Queensland, where 18%⁷ of end users are based.
- With the exception of Pemara, which appears to have been both acrimonious and disappointing in terms of revenues, Colorpak appear to have enjoyed reasonable success in acquiring well and integrating acquisitions. The company has retained most of the senior management and staff of Foilmasters, Hale Foldpack and Castle Graphics.

The company concedes that Pemara was a difficult acquisition. After winning one of Pemara's largest customer Sigma, Colorpak went on to buy the business. Post acquisition Colorpak was forced to cancel a number uneconomic customer contracts and the group believes that it took 24-months to turn the business around during which time it lost or cancelled \$2.0m of turnover.

Castle Graphic acquisition

Castle Graphics ("Castle") was acquired on 1 December for \$4.0m (3.29m shares and \$2.0m cash) equivalent to a multiple of 0.6x sales and 5.0x EBITDA. The acquisition was in line with the group's strategy of reducing the number of suppliers in customers supply chain and expands its expertise to include blister packs, lid foils and self-adhesive labels.

The acquisition would appear to offer considerable cross-selling opportunities. Although Castle has a 70% customer overlap it will also introduce Colorpak to four new healthcare/pharma companies while Colorpak also has a number of customers that may be converted to Castle's offering.

The incumbent General Manager, Warren Smith, and other management personnel are being retained

Due to the highly competitive nature of the labelling market, Castle's EBITDA margins are only half those of Colorpak. However the acquisition would appear to be more about strategy and customer acquisition than synergistic margin expansion as earlier this month Colorpak launched "Pharmapak" a suite of packaging products aimed at the pharmaceutical industry.

The attraction of the solution is that it will allow companies to source a complete packaging kit of cartons, printed blister foils, self adhesive labels, flexible packaging and leaflets from one certified supplier. This is expected to reduce the number of vendors in customers' supply chains thereby reducing their audit work and inventory. We expect this to be well received both in terms of cross selling but also in winning work in the pharmaceutical sector.

⁷ BIS Shrapnel: Paper and Board Packaging in Australia, 30th edition 2004-2005

BUSINESS MODEL

Colorpak currently operates two brands (Colorpak and Foilmasters) from four sites - two in Sydney and two in Melbourne. Unlike its major competitors, Colorpak has neither the scale nor the inclination of replicating the strategy of being either a vertically integrated supplier (Carter Holt Harvey) or a packaging conglomerate (Ampcor).

Nevertheless, the company has followed a strategy of vertical integration by capturing value-add elements of the supply chain. These are brought in-house via the acquisition of suppliers (e.g. Foilmasters, Castle Graphics) or through staff training and the purchase of machinery (e.g. computer-to-plate equipment⁸, in-house laminating, on-site ink supply, coating and leaflet insertion).

Colorpak competes on the basis of higher value-add in terms of design, innovation, and quality of product, reliability and consistency. However, the group is also competitive on price. This is reflected in the BIS Shrapnel survey where Colorpak was rated most highly in a survey of 124 customers in 24 of the 27 most important factors graded by customers (it was the number one in the first nine most important factors).

Most orders are non-contractual spot work with just 42% of Colorpak's customers locked into contracts (industry average 30%). This lack of visibility is inherently unattractive, but is mitigated by the fact that customers are reticent to risk disruption to their supply chain and consequently there is a tendency to commit.

Colorpak enjoys long-term relationships with many customers with 35% of turnover derived from customers who have been with the company more than five years. Three of the group's ten largest customer have been with the company for more than fifteen years⁹.

Acquisitions:

Historically Colorpak has acquired four companies over the last six years, and although the company does not have a specific target, it would be fair to assume its intention is to look for one bolt-on acquisition every 18-months.

Capex:

Next year the group expects to invest heavily in expanding its facilities (c\$10m) but a longer term it expects to spend \$2.0 annually. We have assumed a 3% of sales annually in our long-term forecasts (\$2.3m rising to \$3.0m). Based on our assumption we expect the group to generate a FCF yield of 8% in 2007 rising to 11% by 2010.

Dividend:

The does not have a formal dividend policy but based on our estimates the payout ratio should be around 38% of normalised earnings. Based on our 2006 forecast for return on equity of 14% we estimate the group's sustainable growth rate is 9%.

Seasonality:

There would not appear to be any seasonality in revenues or profits. The plants are shut down for servicing for a week over Christmas

Related Party transactions:

The Commins Family Trust is the lessor to the Braeside and the new Sydney site. Colliers International has certified that these leases are at market rates. Shear Khan Pty Ltd, a company controlled by the Commins Family, will build the new Regents Park development - the tender will be assessed by the independent board directors to ensure the work is competitively priced.

⁸ Colorpak was the first company in Australia to invest in computer-to-plate equipment, which has reduced the company's time job time and reduced errors.

⁹ Colorpak listing prospectus.

Colorpak was rated number one in the first nine most important factors in the leading industry survey...the most important factor was price.

CARTER HOLT HARVEY ACQUISITION OF WADEPACK

In February this year Carter Holt Harvey ("CCH") completed the acquisition of Wadepack to augment its *downstream* operation. We believe the transaction has significance to Colorpak shareholders for three reasons:

- **It provides a benchmark valuation.** According to the bidder's statement CCH a paid 7.9x multiple to Dec'03 reported EBITDA (pre-significant items). However, assuming \$15.2m of net debt¹⁰ we calculate the multiple at 8.3x EV/EBITDA. This compares to prevailing valuation of Colorpak (using pro-forma numbers to Jun'04) of 7.5x. On a NPAT (pre-goodwill) multiple CCH paid 14.0x (to Dec'03) compared to Colorpak's multiple of 9.3x (pro-forma historic) and just 8.8x to June 2005.
- **Customer attrition opportunities.** Both Colorpak and another industry participants that we spoken to believe that some of Wadepack's customers are unhappy about the acquisition and are looking to move their accounts. With Wadepack enjoying turnover of \$80m this has presented Colorpak with a significant opportunity for customer acquisition, in what it typically a low churn industry. A recent announcement by Colorpak indicates that this process has already begun with the company committed to spending a further \$5.8m on capital equipment:

"With recent consolidation amongst competitors in the folding carton sector many opportunities for rapid growth have been presented to us. In order that we capitalise on these tranches of new business without compromising service to our existing client base, this equipment is essential simply to cater for our excess demand." – Alex Commins (CEO)¹¹

- **Colorpak is a takeover target.** We believe that the management team are committed to an independent future, and would appear to have an emotional attachment to the business due the family history. We nevertheless believe that the company is an attractive takeover target.

We believe that Colorpak is a better business than Wadepack and a takeover valuation would need to reflect this and capture the expected growth over the next two years. CCH or Amcor would be the most likely predators.

¹⁰ Wadepack Appendix 4D – Half year results to 30 June

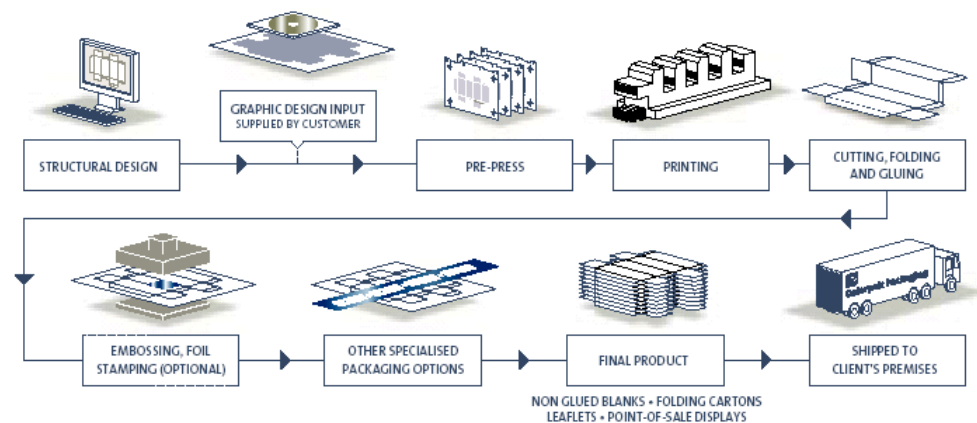
¹¹ Colorpak ASX announcement: 1 March 2004 "Growing demand accelerates requirement for new equipment"

FOLDING CARTONS AND THE PRODUCTION PROCESS

Packaging, although principally for protection, is also an important marketing tool. Manufacturers of branded products are willing to invest in the design, shape and format of their cartons, with a differentiated carton design becoming increasingly important in a crowded consumer market.

After the printing process the carton board is die-cut into its final shape, following which it is folded and glued. It then has any special enhancements added (e.g. varnishes, embossing, foiling or leaflet insertion) before being shipped to the customer flat packed.

Figure 6: Production process



Source: *Company prospectus*

SWOT ANALYSIS

Strengths

- Strong brand, highly regarded for quality and reliability
- Market leader in niche – pharmaceutical and healthcare
- Strong management team (young and experienced)
- Majority of end products are consumer non-discretionary and therefore less economically sensitive.
- Early adopter of technology with a modern and high-quality fixed asset fleet
- Most end products are consumer non-discretionary
- Loyal workforce (only one industrial dispute under the stewardship of the Commins family with average length of service 6.4 years)
- High barriers to entry due to technical expertise, capital intensity and reputation.
- High retention of customers
- Environmental attraction of cartonboard packaging which is increasingly recycled (or at least derived from *farmed* trees) and biodegradable¹²
- Relatively insulated from off-shoring due to focus on high quality, short-run work
- Broadening portfolio of ancillary products: blister packs, labelling, leaflet insertion
- Good corporate governance – three independent board member (including Chairman)¹³

Weakness

- Price-taker with only incremental product differentiation
- Lacking economies of scale verse two largest players (Carter Holt and Amcor)
- No presence outside NSW and Victoria
- High capex requirement (c30% of operating cashflow)
- Relatively small compared to customers
- Limited opportunity to aggressively take market share
- Balance sheet highly leveraged (gearing c40%)
- Lack of depth to product range with no alternatives to folding carton solutions (e.g. flexible or PET packaging)
- Diminishing market share opportunities in core niche (pharma) additional expansion is therefore likely to be derived from lower margin sales

Opportunities

- Short-term opportunity to take market share following the takeover of Wadepack
- Additional corporate activity either as a predator or as a takeover candidate
- Consumer awareness of the environmental damage caused by synthetic packaging
- High oil price will increase prices for cartonboard alternatives e.g. polystyrene & plastics
- Cross selling potential following acquisition of Castle Graphics
- Potential award of additional work following the merger of Proctor & Gamble with Gillette (both have brands which are Colorpak customers)

Threats

- Supply line improvements could lead to a reduction in inventories (it is estimated by BIS Shrapnel a 4% reduction in inventories could reduce demand by 1% in any one year)
- Potential requirement to re-tender for work following the merger of Proctor & Gamble with Gillette (both have brands which are Colorpak customers)
- Loss of work to cheaper overseas competitors
- Economic slowdown becoming recessionary could lead to fall in demand and margin pressure
- Customer loss due to poor execution of Castle Graphics integration
- Key man risk – the company would appear to be dependent on the continued commitment of Alex, Harry and Paul Commins

¹² Colorpak is a signatory to the National Covenant Action Plan, which aims to promote the adoption of environmentally aware business practises.

¹³ Colorpak has a Corporate Governance Code, which is founded on the best practise recommendations of the ASX Corporate Governance Council - March 2003. (<http://www.colorpak.com.au/corporate.aspx>)

INTERIM RESULTS & FULL YEAR EXPECTATIONS

Colorpak reported a very encouraging maiden set of interim results which put the group firmly on track to meet the guidance set out in the listing prospectus in March 2004.

Figure 7: First half results and Foster forecast verses prospectus guidance

Year to June (\$m)	1H2005a	2H2005*	FY 2005e*	2005e prospectus	Outperformance
Sales	27.89	30.16	58.04	52.70	10.1%
EBITDA	5.41	5.85	11.26	10.97	2.7%
margin	19.4%	19.4%	19.4%	20.8%	
PBT	2.57	2.64	5.21	5.05	3.1%
NPAT	1.41	1.85	3.26	2.91	11.9%
NPAT normalised	2.58	3.02	5.60	5.31	5.5%
EPS (cents)	2.06	2.30	4.28		
EPS normalised (cents)	3.32	3.75	6.96		

*Includes Castle contribution

Source: *Company; Foster Stockbroking Pty Ltd*

The company reported 14.5% sales growth on the 1H2004 which excluding a one-month contribution from the Castle Graphics acquisition (c\$0.5m revenue) equated to organic growth of 12.5%.

The company experienced some EBITDA margin pressure in the first half (1H2004:20.7%) due to additional tooling expense, customer order mix (gross margins were 60.2% vs. 64.3%) and customer acquisition - new accounts tend to be lower margin.

Going forward we expect the gross margins to partially recover, but trend down over the long term due to expansion outside the healthcare industry. The costs of expanding Braeside operation and the some non-capitalised opening costs from the new Regents Park site in Sydney are likely to become apparent in the second half of this year and in 2006 while the acquired Castle business operates on an EBITDA margin of 10%.

Net profits after tax (pre-goodwill) rose 20.3% over the corresponding period last year (1H2004: \$2.3m). The result was boosted by a slightly lower D&A charge (\$1.9m vs \$2.0m) and a lower interest charge (\$0.95m vs \$1.1m) but the higher volumes were the main driver of the strong performance.

A fully franked maiden dividend of 1.0 cent per share was announced equivalent to a payout ratio of 30% of normalised earnings. We expect the second half payment to be 1.5 cents.

Outlook

At the interim results, released on 18 February, the company said of the second half:

"The outlook for the balance of the year is very positive and the company remains on track to at least achieve its prospectus forecast."

Harry Commins (National Production Manager) was quoted in an industry magazine in February 2005¹⁴ as saying:

"The company has experienced a large increase in work from the pharmaceuticals and cosmetics industries recently, creating the need for the company to expand its capacity."

¹⁴ Australian Printer" magazine Feb 2005: http://www.colorpak.com.au/about_news.aspx

FORECAST ASSUMPTIONS

Revenue:

- Long term GDP growth rate of 3.25% compared to 3.7% over the last six years¹⁵ and 3.6% between 1990-2000. GDP forecast for 2005 & 2006 are 2.5% and 3.1% respectively.
- Sydney: Forecast GDP +0.75%
- Castle: Forecast GDP +1.00%
- Foilmaster: Forecast GDP +1.00%
- Braeside: Forecast GDP +1.00%

Market share:

- We have assumed Colorpak's market share will rise from 8.0% to 9.4% this year due organic growth and the Castle acquisition. We then expect it to rise in subsequent years by between 0.1% and 0.5% annually.

Margins:

- Contracting gross margin (falling 5% over 10 years) due to expansion out of pharmaceutical industry
- EBITDA margins falling marginally with improvements in operating expenses and economies of scale offsetting lower margin work.

Acquisitions:

- None assumed

Share issuance:

- None assumed

¹⁵ OECD – Real GDP growth (http://www.oecd.org/country/0,3021,en_33873108_33873229_1_1_1_1_1.00.html)

Discount cashflow valuation

Our price target is derived from our DCF valuation. We have calculated the WACC based on:

- Beta: 1.12,
- Risk free rate: 5.4%,
- Equity premium: 6.0%
- Cost of debt: 7.5%
- Perpetuity growth rate: 2.5%.

Figure 8: DCF model

Year to 30 Jun (\$m)	2004a	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	TV
Turnover	49.1	58.0	66.5	73.6	78.8	83.1	86.6	90.3	94.1	98.1	102.3	
EBITDA	10.3	11.3	13.1	14.5	15.2	15.5	16.0	16.4	16.9	17.3	17.8	
LESS: tax on EBITA	(2.7)	(2.8)	(3.3)	(3.6)	(3.8)	(3.9)	(3.9)	(4.0)	(4.0)	(4.1)	(4.2)	
LESS: change in working cap.	(1.1)	(1.8)	(1.5)	(1.4)	(1.0)	(0.8)	(0.7)	(0.8)	(0.8)	(0.8)	(0.9)	
LESS: capex	(1.6)	(1.6)	(10.0)	(2.3)	(2.4)	(2.5)	(2.6)	(2.7)	(2.7)	(2.8)	(2.9)	
Free cash flow before financing		5.0	(1.6)	7.1	8.0	8.4	8.7	9.0	9.3	9.6	9.9	
NPV		4.6	(1.4)	5.4	5.5	5.3	5.0	4.7	4.5	4.2	3.9	56.7
WACC (%)	9.6%											
Perpetuity growth rate (%)	2.5%											
NPV of cashflows before debt (\$m)	98.6											
Less: Net Debt (\$m)	(28.2)											
NPV (\$m)	70.4											
Current Market Cap (\$m)	49.1											
Current Share Price (cents)	61											
NPV per share (cents)	87											
Upside from current	43%											
% of valuation derived from TV:	81%											

Source: Company, Foster Stockbroking Pty Ltd

Figure 9: Sensitivity analysis

Perpetuity growth rate	1.5%	2.0%	2.5%	3.0%	3.5%	4.0%
WACC						
7.1%	136	147	161	179	201	230
7.6%	120	130	141	154	171	192
8.1%	107	115	124	134	147	163
8.6%	96	102	110	118	128	141
9.1%	87	92	98	105	113	122
9.6%	78	82	87	93	100	108
10.1%	71	74	79	83	89	95
10.6%	64	67	71	75	79	85
11.1%	58	61	64	67	71	75
11.6%	53	55	58	61	64	68
12.1%	48	50	52	55	58	61

Source: Company, Foster Stockbroking Pty Ltd

FORECASTS

Profit & Loss

Year to 30 Jun	2004a	2005	2006	2007	2008
\$m	Pro-forma				
Revenues	49.1	58.0	66.5	73.6	78.8
% change	0.0%	18.2%	14.6%	10.7%	7.0%
Gross profit	30.2	34.9	39.6	43.3	45.7
% margin	61.4%	60.1%	59.5%	58.7%	58.0%
Staff	-12.7	-17.1	-18.3	-20.2	-27.6
Occupancy costs	-1.5	-1.8	-2.3	-2.5	-3.1
Other	-5.7	-5.0	-5.8	-6.2	-6.5
EBITDA	10.3	11.3	13.1	14.5	15.2
% margin	20.9%	19.4%	19.8%	19.6%	19.2%
Depreciation	-1.5	-1.8	-2.2	-2.4	-2.5
EBITA	9.1	9.5	10.9	12.1	12.6
Goodwill	-2.3	-2.3	-	-	-
EBIT	6.8	7.12	10.9	12.1	12.6
Net Interest	-2.1	-1.9	-2.1	-2.3	-2.1
Pretax profit	4.6	5.2	8.8	9.8	10.5
Tax	-2.0	-2.0	-2.7	-3.0	-3.2
Reported NPAT	2.6	3.3	6.2	6.8	7.4
NPAT (normalised)	5.0	5.6	6.2	6.8	7.4
Reported EPS (cents)	3.4	4.3	7.6	8.5	9.1
EPS (normalised) (cents)	6.4	7.0	7.6	8.5	9.1
% change	-	8.4%	9.9%	11.0%	7.7%
Dividend (cents)	-	2.5	2.9	3.2	3.5
EV/EBITDA	7.5	6.7	6.1	5.4	4.9
PER (normalised*) (x)	9.5	8.8	8.0	7.2	6.7
Yield	n/a	4.1%	4.8%	5.3%	5.7%

*before significant items and amortisation of goodwill

Source: Company, Foster Stockbroking Pty Ltd

Balance Sheet

Year to 30 Jun (\$m)	2004a	2005	2006	2007	2008
Current Assets					
Cash Assets	0.0	0.8	1.3	2.1	2.0
Receivables	9.5	11.0	12.3	13.6	14.5
Other	0.4	0.7	0.7	0.7	0.7
Total Current Assets	13.3	18.0	20.5	23.1	24.4
Non Current Assets					
PPE	15.2	18.0	25.2	24.6	24.1
Deferred tax	0.5	0.4	0.4	0.4	0.4
Intangibles	45.6	43.6	44.1	44.4	44.4
Other	0.0	0.0	0.2	0.5	1.0
Total Non Current Assets	61.4	62.0	70.0	70.0	70.0
TOTAL ASSETS	74.7	80.0	90.5	93.1	94.4
Current Liabilities					
Interest bearing liabilities	4.1	3.4	3.4	3.4	3.4
Payables	4.6	5.1	5.6	6.1	6.4
Other	0.0	0.0	0.0	0.0	0.0
Provisions (dividends and tax)	2.9	4.0	4.6	5.0	5.4
Total Current Liabilities	11.5	12.4	13.6	14.5	15.3
Non Current Liabilities					
Interest bearing liabilities	24.1	24.1	29.6	27.1	23.1
Provisions	0.7	0.9	0.9	0.9	0.9
Deferred revenue	0.0	0.0	0.0	0.0	0.0
Total Non Current Liabilities	24.8	25.0	30.5	28.0	24.0
TOTAL LIABILITIES	36.4	37.4	44.1	42.5	39.2
NET ASSETS	38.3	42.6	46.4	50.6	55.2
EQUITY					
Contributed equity	36.9	38.9	38.9	38.9	38.9
Accumulated profits (losses)	1.5	3.7	7.5	11.8	16.3
Total Equity	38.3	42.6	46.4	50.6	55.2
LEVERAGE					
Gearing (ND/ND+Equity)	42.4%	38.5%	40.6%	36.0%	30.8%
Interest Cover (EBITA/Net interest) (x)	4.3	4.9	5.2	5.3	6.1

Source: Company, Foster Stockbroking Pty Ltd

Cashflow

Year to 30 Jun \$m	2004a Pro-forma	2005	2006	2007	2008
Cashflow from Operations					
EBITDA		11.0	13.1	14.5	15.2
Net Interest		-2.1	-2.1	-2.3	-2.1
Tax Paid		-1.2	-2.1	-2.8	-3.1
Changes in working capital		-1.8	-1.5	-1.4	-1.0
Other		0.0	0.0	0.0	0.0
Net cash (used in) from operations		6.0	7.4	7.9	9.0
Cashflow from Investing					
Payment for PPE		-1.6	-10.0	-2.3	-2.4
Proceeds from sale of PPE		0.0	0.0	0.0	0.0
Purchase of a business (net of cash)		-2.3	0.0	0.0	0.0
Net cash from investing		-3.9	-10.0	-2.3	-2.4
Cashflow from Financing					
Repayment of borrowing		-1.9	0.0	-2.5	-4.0
Proceeds of borrowing		2.0	5.5	0.0	0.0
Equity issue		0.0	0.0	0.0	0.0
Dividends Paid		-0.8	-2.4	-2.5	-2.7
Other		0.0	0.0	0.0	0.0
Net cash (used in) from Financing		-0.7	3.1	-5.0	-6.7
Net change in cash held	-2.2	1.7	0.5	0.7	0.0
Cash at beginning of period	0.0	-0.8	0.8	1.3	2.1
Cash at end of period	-0.8	0.8	1.3	2.1	2.0

Source: Company, Foster Stockbroking Pty Ltd

Dupont analysis

Year to 30 Jun (\$m)	2004a	2005	2006	2007	2008
NPAT margin	10.2%	9.6%	9.3%	9.3%	9.3%
Asset utilisation	65.8%	72.6%	73.5%	79.1%	83.5%
Return on assets	6.7%	7.0%	6.8%	7.3%	7.8%
Financial leverage	194.9%	187.9%	195.1%	184.0%	171.1%
Return on equity	13.0%	13.2%	13.3%	13.5%	13.3%

Source: Company, Foster Stockbroking Pty Ltd

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