

Welcome To The Two Speed Economy



Reporting Season Primer

An independent survey of current institutional investor sentiment
Summer 2010

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Foreword

In these uncertain times where investor support and liquidity are at a premium, the role of investor relations has never been more important. Radar Group's Research division is pleased to present our third semi-annual survey of institutional investor sentiment ahead of the December 2010 reporting season. Radar Research recently conducted in-depth interviews with 15 leading buy-side professionals.

Over the past few years, the Australian equities market has endured a period of extraordinary volatility. The All Ordinaries index peaked in November 2007 at 6854 pts. This was followed by a 54% fall to 3112 pts by March 2009, and then a subsequent rebound of 61% to 5002 pts as at April 15, 2010 as the Australian economy strengthened and there were indications of improvement in the US. European debt defaults, concerns over a possible tightening in China and the announcement of the proposed Resource Super Profits Tax saw the All Ords plunge by 15% to 4265 pts in May. In the six months to December 2010 we have seen steady growth, largely due to improving global confidence and commodity price appreciation.

This survey captures current investor sentiment and identifies and addresses the key issues which are impacting stock selection decisions.

A commonly held view of senior management teams of listed companies is that the information flow between themselves and the investment community is largely a one-sided affair. Our intention is that this report will help to fill this information vacuum, by sharing with you the concerns of investment professionals. We also offer ideas and strategies as to how companies can more effectively plan, target and execute their investor relations function.

All Ordinaries



source: IRESS

Introduction

Methodology

In essence, this report analyses and provides insights on how:

- Institutional investors perceive the Australian market and what factors will be influencing it.
- Are they bullish or bearish?
- Which sectors are the most attractive?

Interviews were conducted in December, 2010 so this research report provides an excellent insight into the perceptions of fund managers over the intervening six months since June 2010.

The survey questions and subsequent findings in this report are split into two sections.

In the first section, Radar asked respondents to identify the current issues and themes they are focusing on as part of their investment decision making process. Following from this, we asked respondents what additional information they would like companies to provide to gain a better understanding of how they are impacted by these issues.

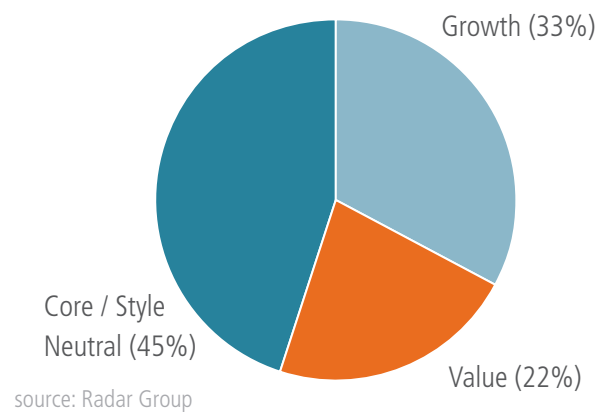
In the second section, we canvassed the views of respondents on the outlook for Australian equities over the next 6 months, both on a market and sector level, and their current portfolio weightings.

Survey Respondents

The fifteen respondents interviewed in this survey are institutional investors in the Australian equities market. Total Australian equities funds under management (FUM) of the interviewed institutions was \$87bn. Forty five percent of respondents are Core/Style Neutral, thirty three percent are Growth managers and the remainder were Value managers.

We intentionally chose respondents across a broad range of both investor size (in terms of FUM) and investment style. The smallest institution we surveyed managed less than \$500m, the largest, \$15bn.

Respondents Breakdown by Investment Style



Key Findings

Institutional investors believe Australian listed companies are generating strong cashflows and have robust balance sheets. However, they have concerns over the ability of industrial companies to generate revenue growth in the near term. **The mining boom and weak consumer confidence (resulting in subdued spending) combined to create a two speed economy.** There has also been an **escalation in corporate activity** which is expected to accelerate into 2011 as companies utilise their strong balance sheet positions and also take advantage of the robust AUD to pursue offshore acquisitions.

Consumer leverage is the key issue of concern for investors at present. While the impact of the stimulus package roll off has dissipated, continued interest rate increases and higher living costs generally are hitting household disposable income levels. Logically, this is also expected to have flow-on effects on consumer confidence.

Operating leverage is also seen as an important issue. Investors' views remain mixed over the economic outlook, and thus the earnings outlook, for cyclicals (given their high level of operating leverage). Some respondents are bullish on the macro economic outlook and are optimistic on top line growth prospects for Australian companies. Conversely, other investors expect only muted revenue growth for non-resources companies which are not enjoying the benefit of strong commodity price growth.

The strong AUD has created both winners and losers. While some sectors such as tourism are negatively impacted, most companies are expected to be able to manage their exposure relatively well.

Macro economic factors are front of mind with investors at present. Fund managers have mixed views on the outlook for global growth. The timing of the US economic recovery is still unknown. Many question China's ability to maintain the current growth rates going into 2011 under the looming spectre of inflation and likely Government intervention. Eurozone members, in particular the PIGS (Portugal, Iceland, Greece and Spain), continue to grapple with sovereign debt blowouts.

Other key issues which institutional investors are focusing on are: Earnings Quality and Cashflows alongside Interest Rate Exposure.

The investors surveyed remain bullish on the outlook for the Australian equity market over the coming six months. Two thirds of respondents expect the market to rise over the next six months, and just over half of respondents expect it to rise by up to 10%.

The sectors nominated as having the **best prospects were: Industrials and Consumer Discretionary (focusing on cyclical companies) and Resources.** The sectors nominated as having the weakest prospects were: Real Estate; Utilities and Telecommunications.

Interestingly, while fund managers highlight consumer leverage as their key area of concern, they nominated the Consumer Discretionary sector as holding good prospects for share price appreciation into 2011. Fund managers acknowledge near term earnings risk for companies in this sector but think they have been oversold by the market.

Current Issues and Trends

We started by asking what the key issues and trends institutional investors are focusing on. Companies are generating strong cashflows and have robust balance sheets. However, they are still finding it difficult to generate top line earnings growth. The two speed economy and an escalation in corporate activity provide the backdrop to the key issues outlined beneath.

In particular, corporate activity has driven up valuations in second tier miners and mining services companies. Portfolio managers (primarily growth managers) are finding this environment challenging as being on the wrong side impacts adversely on their performance.

Consumer Leverage is still top of mind for investors. Operating Leverage has resurfaced as a significant issue. The strength of the AUD is impacting many sectors. Macro economic concerns continue to drive investment decision making.

Key Issues			
Ranking	Summer 2010	Winter 2010	Summer 2009
1	Consumer Leverage	Consumer Leverage	Operating Leverage
2	Corporate Activity	Reg/Sovereign Risk	Currency Exposure
3	Operating Leverage	Macro Concerns	Earnings Guidance
4	Currency Exposure	Operating Leverage	Interest Rates
5	Macro Economic Concerns	Currency Exposure	Macro Economic Concerns
6	Earnings Quality	Earnings Quality	Consumer Leverage

1. Consumer Leverage

Consumer Leverage is the issue most frequently raised by investors during this survey.

The aggressive ratcheting up of interest rates by the RBA and the major banks, combined with the run off of the government's fiscal stimulus package, continues to dampen household disposable income levels. Many companies are currently feeling the impact of this in disappointing top line sales. Accordingly, the relative earnings sensitivity which a company has to disposable income levels is now a key area of focus for institutional investors. Investors are looking for companies which are not only reliant on the cycle to drive earnings but also have specific opportunities to see profits improve.

How to Address Consumer Leverage when Dealing with Investors

- Identify the share of total revenues and earnings that are derived from the consumer market.
- Communicate the company's view as to whether its customers perceive its product range to be more staple or discretionary in nature.
- Demonstrate any historical correlation between disposable income levels and revenues.

RBA Cash Rate



source: IRESS

Selected Investor Quotes

We are seeing inflation and deflation. While the volumes are there for consumer spending, prices are falling.

My biggest concern is top line sales.

Top line revenue growth, what is the economy doing? Everyone is focused on Christmas trading.

A lot of consumer discretionary names are under pressure as consumers aren't spending due to interest rate increases and low levels of confidence.

While forecasts for 2011 are reasonable, the market is too optimistic on 2012. Top line growth will be hard to get, consumers won't spend.

There is a lot of current debate on the impact of interest rates on the consumer related companies.

Interest rate increases have impacted on top line growth as consumers aren't spending. The question is how big is the impact? Year to date, volumes at Linfox have fallen 10%.

With the economy slowing in the middle of the year, we will be watching for the extent to which it will affect retail and consumer stocks.

Consumer confidence is shaky leading to a slowdown in retail spending.

The consumer is very volatile.

2. Corporate Activity

Low balance sheet gearing, a relatively benign domestic economy and attractive multiples are expected to drive corporate activity over the next six to twelve months. Another driver of corporate activity is the desire for companies to boost top line growth. This environment is discomfoting for growth managers as their bias is to the acquirer (who historically underperforms the market); the value manager will be more likely to hold the target.

How to Address Corporate Activity when Dealing with Investors

- Clearly articulate your capital management policy.
- Ensure the market is made aware of your policy on acquisitions. It must be strategically complementary and hit shareholder return hurdles.

Selected Investor Quotes

M&A will pick up as the sectors which can't get top line growth will buy it.

All the balance sheets are in order; we are worried about M&A activity. As a growth manager, you need to be on the right side.

The corporate sector is cashed up, which will lead to a pick-up in M&A activity, share buybacks and dividends.

Balance sheets are lowly geared at present, and there is increasing pressure for capital management initiatives which include buybacks and M&A activity.

Companies are taking advantage of low gearing to make strategically synergistic bolt-on acquisitions.

M&A will be important, it is moving into different sectors like Media and Diversified Financials.

Consolidation is likely at the smaller to mid cap end of the Resources sector.

We have only held the big Resources so we've been killed by the M&A activity in the smaller Resources.

3. Operating Leverage

As the economic recovery ebbs and flows, the focus in the upcoming reporting season is on selecting those companies which will be able to achieve the greatest relative earnings uplift in the coming years. Operating leverage is a measure of how revenue growth translates into operating income or earnings before interest and tax (EBIT). They are looking for signs that growth is hitting the top line as operating profit growth over the last few years has been achieved largely through disciplined cost cutting. Investors are not only looking for companies which will benefit from an upturn in the domestic economy, but are also focusing on companies with exposure to high growth or recovering offshore markets.

How to Address Operating Leverage when Dealing with Investors

- Provide additional information regarding the cost base (Eg. a breakdown between fixed and variable costs).
- Provide a sensitivity estimate of the extent to which a % increase in sales translates into a % increase in EBIT.
- Highlight the historical correlation between the rate of economic growth and the rate of growth in revenues.
- Highlight the historical correlation between the rate of economic growth and the rate of growth in volumes and prices.

Selected Investor Quotes

We're focusing on operating leverage as it will be the most significant influence on the earnings of a whole host of companies.

Are we through the worst of the GFC? In Transfield Services' recent announcement, they told us it is still slow as the government is transitioning out of the stimulus spending, and the spending is drying up. I was sceptical about the Bilfinger Berger IPO, and it has been pulled. When are the corporates going to spend? Yes, the Resources and the Oil & Gas sectors are spending, not other sectors are. It's a two speed economy, with the West and Far North Queensland outstripping the rest of the country.

We aren't seeing any real recovery.

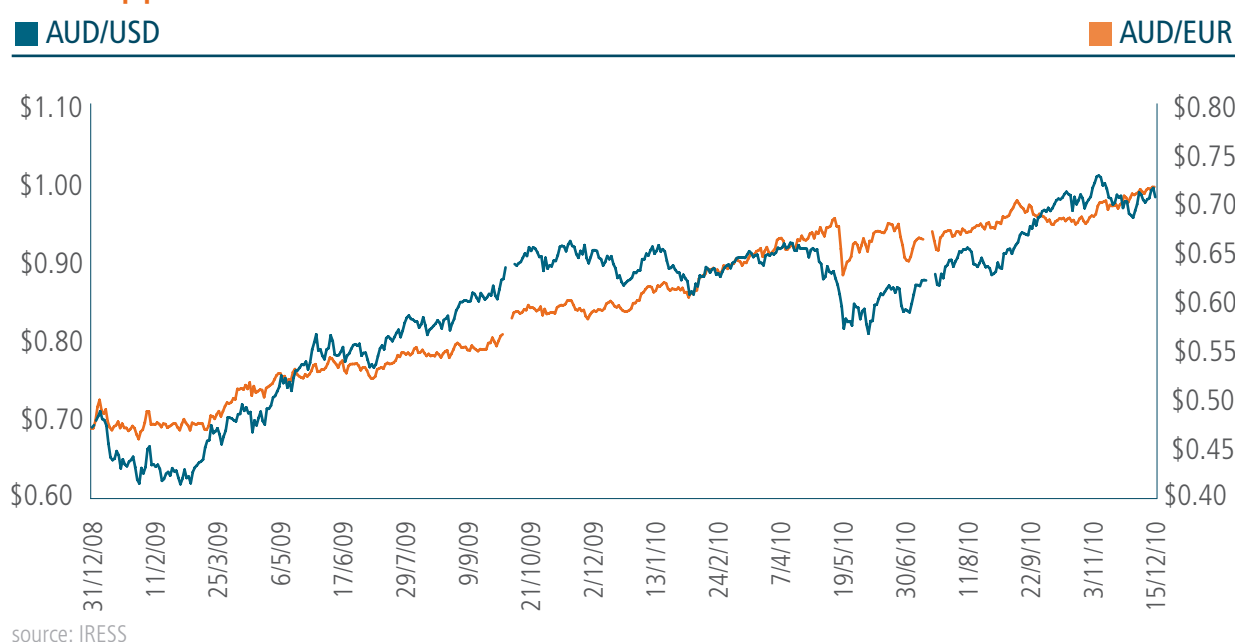
It's an iceberg economy; a lot of it is currently under water. There isn't much relief in the commercial activity. I think the interest rate shocks have abated.

4. Currency Exposure

Currency appreciation is again front of mind with investors. Severe global shocks are buffeting the USD and Euro. Conversely, strong commodity prices (generally quoted in USD) are driving the AUD. When we last did this survey in June 2010, many investors told us they were positioning their portfolios in anticipation of a US recovery which has not eventuated. By being on the wrong side of the currency, their positions have been negatively impacted.

While most companies can manage their currency exposure, the tourism sector is a loser as Australians are taking advantage of the strong AUD and travelling overseas. Conversely the dollar appreciation is a deterrent to inbound travellers. Exports are also under pressure as goods are now more expensive.

AUD Appreciation



How to Address Currency Exposure when Dealing with Investors

- Provide a sensitivity estimate of the extent to which a % increase/decrease in the AUD (relative to another currency) translates into a % increase/decrease in EBIT.
- Provide qualitative information regarding how currency fluctuations directly impact the cost base (Eg. which inputs are derived from where and in what currency) and what is the timing lag (if any).
- Provide detail regarding any hedging contracts.

Selected Investor Quotes

The AUD is a definite issue. There are a few beneficiaries, with opportunities for some. Companies with exposure to the weak numbers out of the US aren't doing so well.

We are closely watching for the effect of the exchange rate movements.

Tourism is suffering badly due to the high AUD.

5. Macro Economic Outlook

Macro economic factors continue to drive the Australian market. Fund managers have mixed views on the outlook for global growth. Conviction over the timing of the US economic recovery has muted. The impact of QE2 is viewed with caution. Many question China's ability to maintain the current growth rates going into 2011 under the looming spectre of inflation. Eurozone members, in particular the PIGS (Portugal, Iceland, Greece and Spain), continue to grapple with sovereign debt blowouts. Austerity measures introduced by the UK will serve to reduce demand for global commodities. Other countries are expected to follow suit.

Towards the end of our interviews in December, investors began to grasp the potential magnitude of adverse weather conditions on the earnings of companies. The ramifications of the current floods in both the eastern and western seaboard are yet to be quantified.

As discussed above in Currency Exposure, in June 2010 many investors were positioning their portfolios to capture the strengthening manufacturing sector and export recovery in the US. They have been hit with a double whammy of poor economic performance and the booming Australian dollar.

Institutional investors are focusing on the relative earnings exposure which companies have to the Chinese, US and European economies as part of their investment decision making process. For companies with these exposures, this should form a key part of a communication strategy with the market.

How to Address Macro Economic Concerns when Dealing with Investors

- Provide detail as to the geographical mix of export sales.
- Provide some colour as to the respective profitability of sales made to or within different offshore markets.
- Provide detail as to the contract terms regarding export sales. Eg. duration, pricing arrangements, take or pay?
- Provide detail as to any projects you may be involved with which are indirectly related to demand from offshore markets. Eg. mining contractors or construction of facilities which will aid exports to China.

Selected Investor Quotes

While the extreme weather may be a one-off, it is having a negative effect on the mining services, builders and construction companies.

Looking at the macro environment, we are coming into a mining capex boom, which is partially dampened by a reduction in the government stimulus spending.

My biggest concern is the US market. It is still under pressure. If it kicks ahead, we're good, but the biggest risk is if it stagnates.

The US economy is a big concern. We haven't seen the expected improvement as yet and the jobs market remains very weak. A jobless recovery is unsustainable.

6. Earnings Quality and Cash Flows

Earnings quality and cash flows are always important areas of focus for investors and this is once again reflected in our survey responses. Earnings quality is generally measured by satisfying three criteria: Are the company's earnings repeatable? Are they controllable? And finally, are the earnings bankable?

Earnings are typically considered high quality if they:

- are sustainable, rather than the results of one-offs
- reflect the performance of the business, rather than as a result of accounting practices (whether conventions such as accrual and historical cost accounting, or deliberate boosting of numbers)
- result in cash generation — i.e. cash conversion is high
- come from core businesses
- are low risk, stable and predictable, rather than "lumpy" with wide variations from year to year

There are often links between these factors, but not invariably. It is not, for example, unusual for a business to have cash generative earnings that are sustainable in the long term, but which may be subject to wide, unpredictable variations from year to year.

How to Address Earnings Quality when Dealing with Investors

- Clearly identify one-offs and provide reconciliations.
- Proactively address earnings quality, perhaps by referring to the cash conversion ratio for the period and providing commentary as to why it has changed from the prior period (timing differences) and/or why it differs from 100% (if the difference is material).
- Provide information regarding capital expenditure, such as: the level of maintenance capex, any delays in capex and the likely level of capex over the next couple of years (in absolute terms or as a percentage of sales or depreciation).
- Provide information regarding working capital, such as: the level of working capital to sales.

Selected Investor Quotes

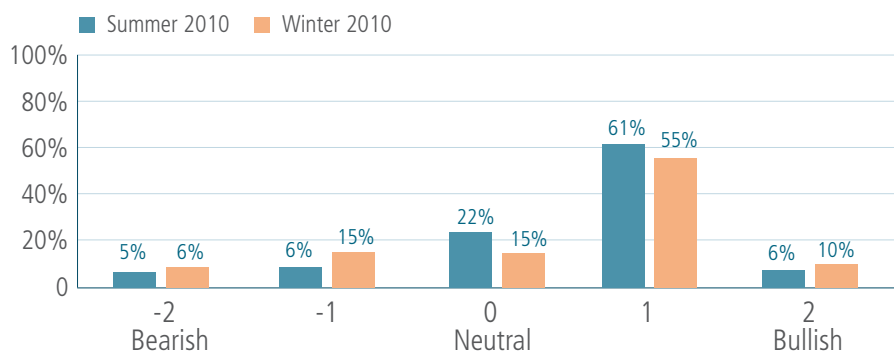
Given the current environment, cashflow generation and dividends are our key criteria. We are looking for companies with sustainable business models with the capability of delivering earnings and dividend growth.

Market Outlook

In this section we asked institutional investors about their view on the outlook for the Australian equities market over the next six months and which sectors they thought held the most and least investment appeal.

The clear takeout is that investors remain bullish over a six month view. 67% were bullish, 12% were bearish and the remaining 22% had a neutral view on the market. The market PE is trading at around 12 times which is attractive compared to the historic PE of around 15 times. Unemployment remains low which should support a rebound in consumer confidence. The key risks lie in China's ability to manage inflation without cramping growth, European authorities' ability to deal with the sovereign debt crisis as well the questionable strength of the US recovery.

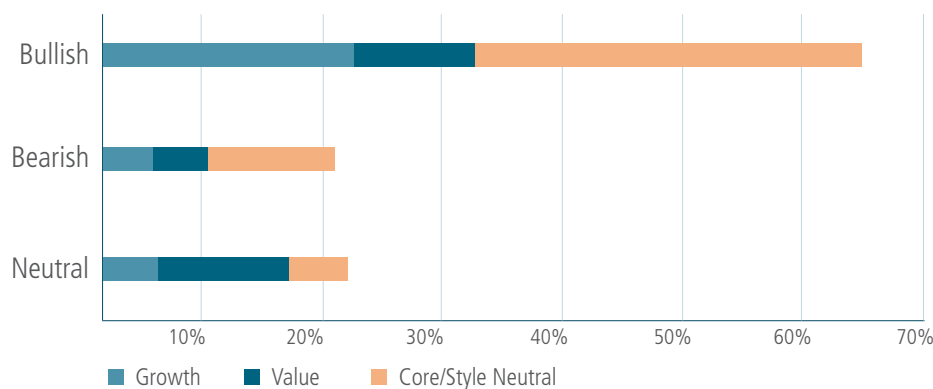
Respondents View on the Equities Market Outlook (6 month view)



source: Radar Group

As reflected in the chart which follows, there is no clear delineation of views by style.

Respondents View on the Equities Market Outlook (Style Breakdown)

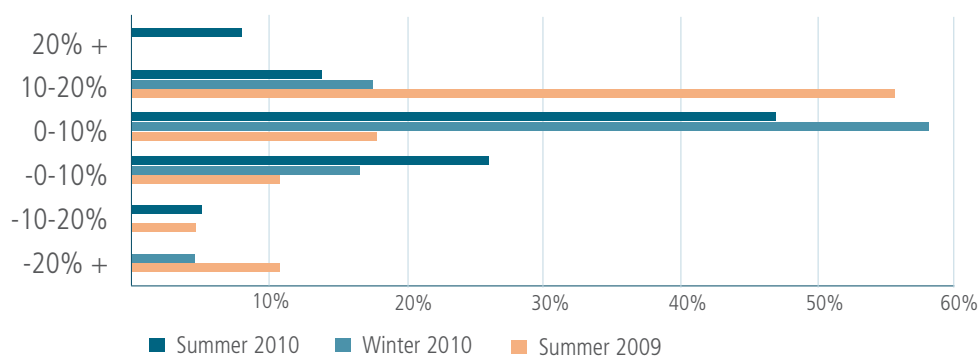


source: Radar Group

We then asked the respondents what their prediction was for the movement in the All Ordinaries index over the next 6 months. On the whole, they were a little more optimistic compared to previous periods. The most popular view is that the index will increase by 0-10%.

Institutional investors attributed this positive view to supportive valuations with the 1 year forward PE of just over 12 times residing well below the historical average. The outlook for the Australian economy is supportive. Despite concerns over consumer demand, unemployment is low, interest rates are not punitive, the political landscape has settled and there is still significant leverage to stronger commodity prices and Chinese industrialisation.

Respondents View for the Movement in the All Ordinaries Index (6 month view)



source: Radar Group

Movement of the All Ordinaries Index



source: IRESS

Selected Investor Quotes

The market will move sideways. There are a large number of moving parts. The offshore macro drivers are mixed. Onshore, income growth is strong, but balance sheets are being repaired. Offshore, we are seeing continued bailouts in Europe. We are hearing different stories about on whether the economy is overheated in China.

The market is looking good. China isn't imploding; government regulation is now settling down, labour unrest and unemployment are in good positions.

The market is incredibly cheap. I just don't know what the catalyst will be for a re-rating.

The market is OK, but needs a catalyst. The US will lead us this time. China will continue to grow at 8-10%.

Domestically, it's a two speed economy. The energy and resources sectors are strong, whereas property and retail is slow.

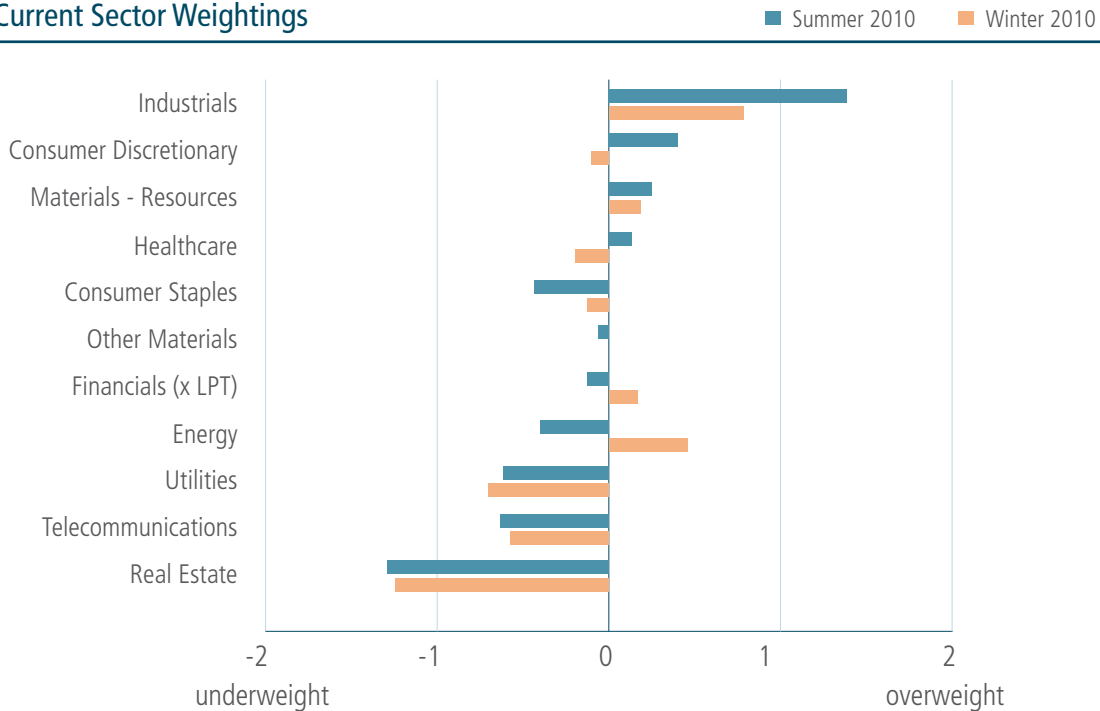
We are looking for an economic recovery. The landscape is generally benign, unemployment is low and interest rates aren't punitive.

Valuations, looking at long term trends, are cheap. Resources continue to power. However it is a two tier economy. Risks include a consumer slowdown, Aussie dollar and offshore sovereign issues.

Portfolio Weightings and Repositioning

Investors continue to rotate their portfolios into cyclicals. Portfolios are now overweight Industrials, Consumer Discretionary and large Resources. There has been a significant shift out of expensive Energy stocks, and minor shifts out of Financials.

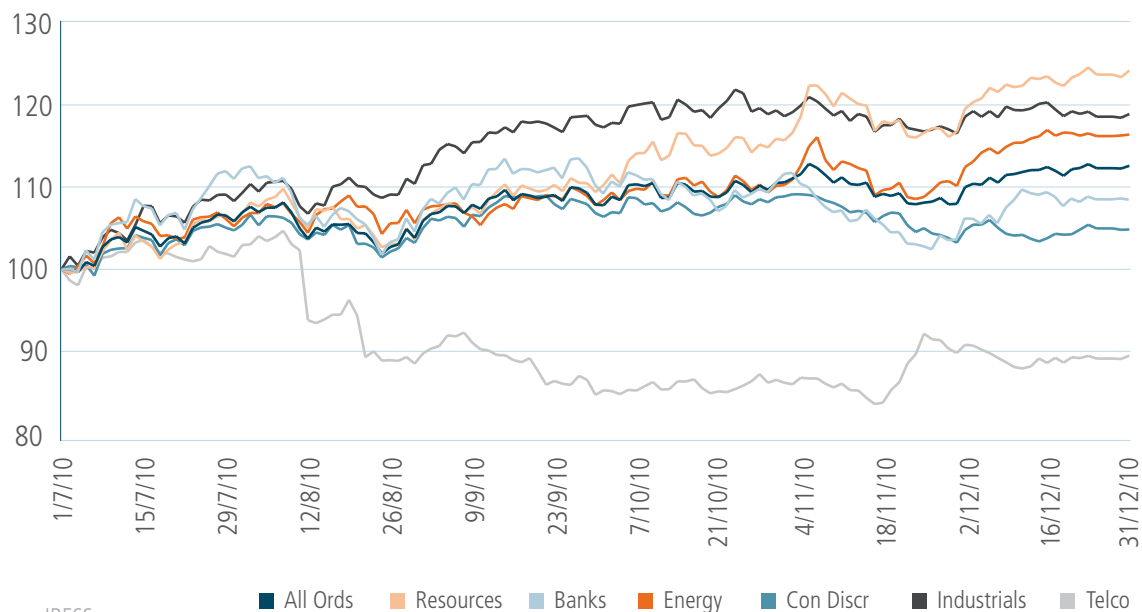
Current Sector Weightings



source: Radar Group

Winners and Losers

Movement of the All Ordinaries Index (Year To Date)

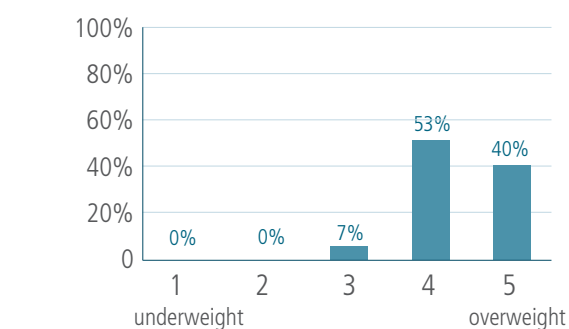


source: IRESS

Cycling into Industrials

Despite a very drawn out incubation period, institutions are still positioning their portfolios to benefit from an improvement in global growth, especially the recovery of the US economy. They see value in cyclical Industrials with both international and domestic exposure. Many cyclical companies are trading on reasonable multiples, and earnings are below long term levels. There is concern over the mining services companies as they have performed very strongly and are trading at very high multiples, but engineering and labour hire companies are poised to benefit from the capex cycle. Over 90% of respondents are overweight Industrials.

Industrials - Portfolio Weightings



source: Radar Group

Selected Investor Quotes

We are looking at a five year capex cycle, spending on resources projects and major infrastructure. The engineers, labour hire, mining services and transport companies will be beneficiaries, albeit at different point in the cycle.

Mining services companies have attractive multiples and good leverage to resources boom.

There have been a lot of delays in major projects. This plus labour shortages is impacting the mining services stocks. Look at the problems with Pluto.

It will be a mixed reporting season with downgrades in the cyclical industrials, especially retail and mining contractors.

The mining services and engineering firms will be the beneficiaries of the upcoming major resource and infrastructure projects. This demand will translate into more favourable contract arrangements including a move to a cost-plus basis and higher charge-out rates.

More cycling into Consumer Discretionary

The Consumer Discretionary sector has been a significant underperformer over the last six months. The sector is trading at a 20% discount to the market. Retail stocks are the choice companies while media stocks are facing structural challenges.

Selected Investor Quotes

Consumer Discretionary will come back in six months.

While consumer discretionary stocks like media are seeing revenue increases; they aren't banking the revenue as costs are up.

The consumer stocks are doing it tough, but it's almost all in the price.

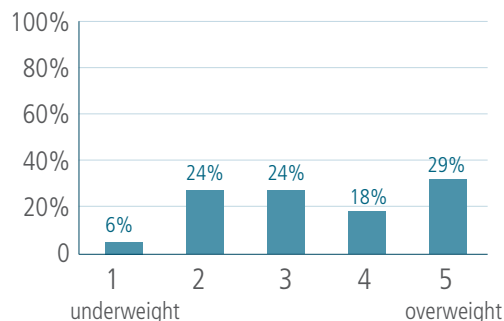
A pullback in discretionary spend is likely; and consumer de-leveraging continues

The retailers are undervalued.

We are expecting a rerating for the retailers' given their sales growth and earnings certainty. There is also earnings upside.

The retailers' margins should begin to reflect the benefit of the strong AUD.

Consumer Discretionary - Portfolio Weightings

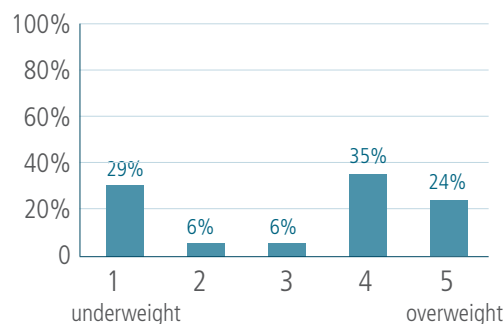


source: Radar Group

Resources still in Favour

While the Resources sector was the best performer over the last six months, PE multiples still remain reasonable (especially the larger stocks) as strong commodity prices boost earnings forecasts. Almost 60% of respondents are overweight the sector. They are cautious about the smaller Resources as they are trading at lofty multiples, often driven by M&A activity and speculation.

Resources - Portfolios Weightings



source: Radar Group

Selected Investor Quotes

I'm worried about small resources and mining services. It's just like the tech days.

The resource companies are experiencing cost overruns. Their problem is their ability to execute and deliver targets.

There are significant headwinds for the second tier resources, but currency benefits for the larger resource stocks.

Resources are on fire and will deliver for the next couple of years.

Mining is going gangbusters.

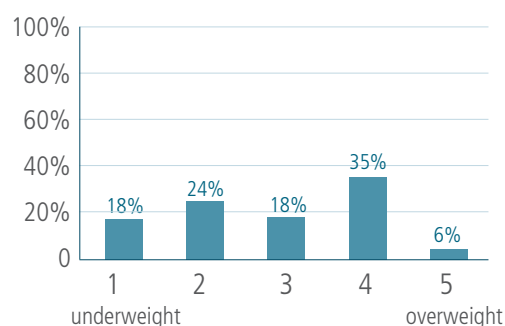
The resources are cum upgrades given the strong commodity prices.

We like resources for the exposure to China.

Mixed Sentiment on Financials

While in aggregate, Financials portfolio weightings are slightly underweight, closer analysis reveals a wide range of positioning with 41% overweight, 18% market weight and 42% underweight. Investors are concerned about lack of credit growth and its impact on the banks, as well as potential regulatory pressure. None the less, the sector is trading at low multiples.

Financials - Portfolios Weightings



source: Radar Group

Selected Investor Quotes

The banks have come back, but I'm worried about the business cycle. The larger corporates are using the US private placement markets for funding, and the SME market is impacted by higher interest rates.

Financials are OK. The noise from the politicians provides a buying opportunity.

The banks are cheap at 9-10 times. It's hard to get strong economic growth and not have it translate into credit growth.

The market leverage for diversified financials is attractive; they are highly leveraged to the ongoing recovery.

We expect pressure will remain on the banks as politicians suggest different proposals to intensify competition. The re-appearance of Euro debt pressures has boosted funding costs, compressing margins.

The interest rate cycle is important for insurance companies.

Much of the negative news that plagued banks is fully priced into current share prices. It appears regulatory risks may be abating.

Business credit growth may be softer than expected so we are underweight banks.

The earnings of the banks are being impacted by slowing pre-provision profit growth, lower credit growth and increased regulatory pressure.

Polarised Energy

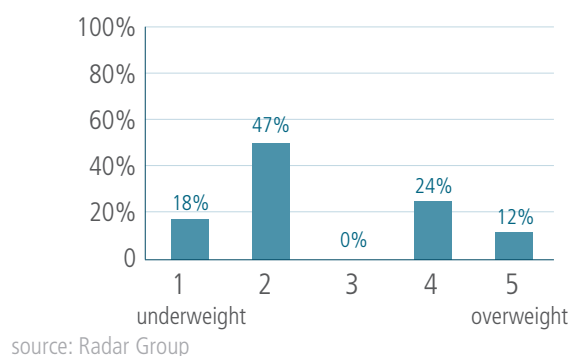
The view on Energy stocks is split. Two thirds of the surveyed institutions are underweight. The sector has enjoyed a very strong run, and multiples are high. There is concern over the valuations ascribed to the CSG and LNG projects.

Selected Investor Quotes

We are struggling for ideas in the energy sector, we are very underweight Coal

The valuations on the CSG and LNG projects are looking very expensive, so we are underweight energy.

Energy - Portfolios Weightings



Real Estate – Out of Favour

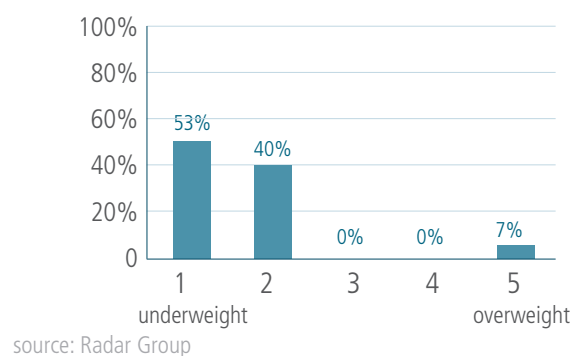
Real Estate and Utilities are erstwhile defensives that failed the stress test during the GFC. They didn't provide the protection investors expected during the last bear market and many were savaged as they were seen to be overgeared. They are still unloved. Listed Real Estate is trading above the general equity market multiple which is an historical anomaly. The sector is also suffering from dilutive capital raisings. This sector will always be adversely affected on a comparative basis as it is excluded by the mandates of many general equity funds.

Selected Investor Quotes

Our total return expectations for LPTs underperforms the market.

The PEs for the Real estate trusts are above the general market.

Real Estate - Portfolios Weightings



About Radar Group

Radar Research

Radar's research team draws on 45 years of experience in the financial sector delivering value to its clients through a unique combination of industry knowledge and experience, solutions-oriented advice, and a proven ability to deliver incisive and specialised research.

Radar Research provides unique insights into the opinions and behaviours of investors. Radar undertakes extensive research, qualitative and quantitative, to ascertain current institutional and retail sentiment and the factors influencing their investment decisions.

Services include:

- Institutional Perception Research
- Post Road Show or Meeting Feedback
- Retail Investor Surveys
- Post Result Snapshots
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- Investor Focus Groups

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Radar Group

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Radar provides expert advice and counsel to companies during corporate transactions that require direct engagement with, and support from, investors including mergers, acquisitions, proxy battles and capital raisings.

Through its research division, Radar provides unique insights into the opinions and behaviours of investors, and the factors that influence their investment decisions.

Radar's investor relations advisory business works with companies to increase their market value through targeted and analytical investor relations activities, and ensure they are maximising their relationships with current and prospective investors.

Radar has worked on some of the most significant corporate transactions in Australia over recent years and assisted a wide range of listed companies across all sectors and capitalisations.

For more information about Radar's services please visit www.radargroup.com.au or contact

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