ENTRUST
PRIVATE WEALTH MANAGEMENT

GRAEME YUKICH
MANAGING DIRECTOR
(08) 9476 3950

BRAD GORDON
DIRECTOR
(08) 9476 3959

ANDREW FRY
DIRECTOR
(08) 9476 3960

MIKE PARKER
CHIEF OPERATING OFFICER
(08) 9476 3966

CHERYL BAKER-ARGYLE
GENERAL MANAGER
(08) 9476 3951

HELMUT ENGELHARD
HEAD OF RESEARCH & STRATEGY
(08) 9476 3978

ANDREW CHAPMAN
INVESTMENT ADVISER
(08) 9476 3961

JOEL RIDLEY
INVESTMENT ADVISER
(08) 9476 3963

BEN SNEDEKER
ASSOCIATE ADVISER
(08) 9476 3952

GAVIN HANNAGAN
ASSOCIATE ADVISER
(08) 9476 3956

ROWAN JONES
ASSOCIATE ADVISER
(08) 9476 3940

MARK ROBERTS
COMPLIANCE MANAGER
(08) 9476 3955

MARGOT BIGGS
ADMINISTRATION MANAGER
(08) 9476 3973

KYLIE LUND
CLIENT SERVICE ADMINISTRATOR
(08) 9476 3972

REBECCA KONNING
CLIENT SERVICE ADMINISTRATOR
(08) 9476 3962

AYM'E BATGER
CLIENT SERVICE ADMINISTRATOR
(08) 9476 3949

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Entrust Investment Views

The Proposed Resource Super Profits Tax: Implications for the Australian Economy and the Sharemarket

Key Points:

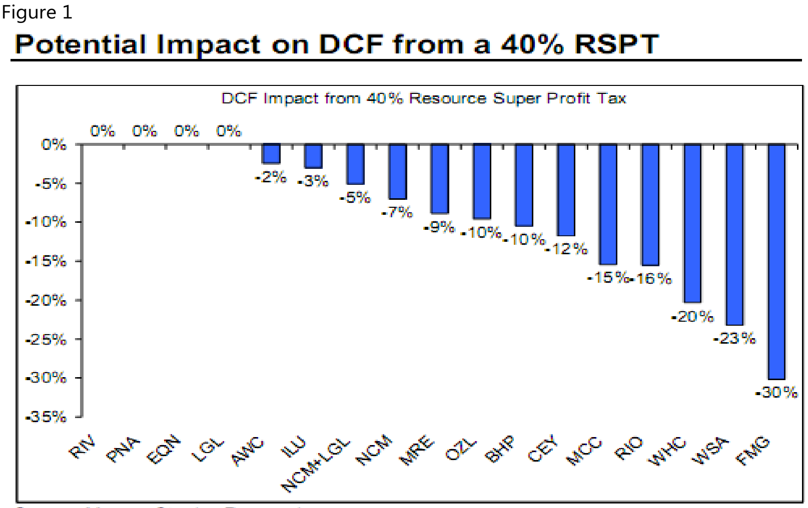
- Resource Super Profits Tax will raise additional revenue by lifting the share of resource taxes and royalties from 14% of pre-tax resource profits in FY2008/09 to a uniform 40%.
- Average valuation decline of ~15% for resource companies, but wide range (0%-30%).
- Short-term impact on Australian economy negative; longer-term impact uncertain.
- More underperformance from Resource stocks likely.

In response to the Henry Review of the Australian taxation system, the Federal Government has announced the introduction of a Resource Super Profits Tax (RSPT) from 1 July 2012 at a rate of 40% of assessable profits from all Australian resource projects, other than offshore petroleum projects. The RSPT is a profit-based tax designed to raise additional revenue from resource projects during periods of high commodity prices and will effectively replace existing volume or revenue-based state mining royalties. The proposal has been heavily criticised by the mining industry and rejected by the opposition Liberal Party.

Implications for Australian Resource Sector Valuations

Analysis by major broking houses suggests that the net present value (NPV) / discounted cash flow valuation (DCF) of major resource companies would decline by 10-20% under current commodity price forecasts, if the RSPT is applied in its proposed form (see e.g. Figure 1 below). The impact on reported net profits in the early years of the RSPT implementation is less uniform, because of the availability of accelerated depreciation for legacy book values and the refundability of state mining royalties. After the transition stage, EPS are likely to be 15-30% lower than under current tax arrangements. Significantly, resource companies will derive a smaller benefit from any commodity price spikes under an RSPT scenario.

Figure 1



Source: Morgan Stanley Research

The valuation of iron ore assets will decline the most under RSPT, reflecting both the low capital cost base of existing operations and the expected high profitability of the industry. Fortescue Metals will lose most value (-30%), but the NPV of Rio Tinto (-16%) and BHP (-10%) will also fall significantly. Export-oriented coal projects will be heavily impacted by the new tax (Whitehaven Coal -20% NPV; Macarthur Coal -15%) as will low-cost nickel producer Western Areas (NPV -23%). By contrast, there will be no impact on Australian-listed resource companies with overseas projects such as Riversdale, Panaust, Equinox and Lihir Gold.

Implications for the Australian Economy

The planned introduction of the RSPT has created additional layers of **uncertainty**, especially for major long-life projects. These include:

- the details and final shape of the government proposal (exposure draft legislation not due until mid-2011);
- the outcome of the upcoming Federal Election: if the Liberal-National Coalition wins, the RSPT will be abandoned; if the Coalition fails to win a majority, but can maintain its strong position in the Senate, the passage of any RSPT legislation will be highly doubtful.

The uncertainty is unlikely to be resolved before the Federal election and could linger on well into 2011. In response to this situation, major resource companies have already put new capital expenditure plans on hold pending a full review of the impact of the planned tax on their projects. Some exploration programs have been suspended (e.g. Xstrata). The details of RSPT implementation could be particularly important for the viability of Queensland's CSG-to-LNG projects. Multi-national resource companies may now accelerate the development of alternative projects overseas and slow down the progress of their Australian projects. Only those projects which remain highly attractive under worst-case assumptions are likely to proceed unchanged. As a result, we expect a **slowdown in buoyant mining investment** towards the end of 2010 and into 2011 with flow-on effects to the engineering & construction and resource services sectors.

The longer-term impact is harder to determine. While Australia will become one of the highest tax countries globally under an RSPT regime, other major mining countries (e.g. Chile, Peru, Brazil) have also recently increased resource tax and charges and others (e.g. South Africa) may well follow. Nevertheless, it is reasonable to expect lower resource investments in Australia under RSPT than under current taxation. However, there will be offsetting benefits in the non-resource sectors of the economy. Tourism and export-oriented or import-competing sectors of the economy will benefit from a lower exchange rate. The application of the extra tax revenue will also be important.

Implications For Australian Investors

- Most domestic and international institutional investors were overweight in Australian resource stocks based on the positive short and medium-term outlook for commodity prices given strong medium-term demand from China and India. While share price have fallen in response to the proposed RSPT introduction, we doubt that portfolio adjustments to a lower resource weighting have been completed. We expect more underperformance from the resource sector.
- The uncertainty over the final shape of the RSPT, or whether it will even be introduced at all, will limit any offsetting benefits for non-resource stocks.
- International investors have one more reason to take profits in a market that has strongly outperformed over the last year. These investors may not return until the RSPT issue is resolved one way or another. After an RSPT enactment, global investors may view Australian equities as less of a proxy for the global commodity cycle than before.
- At this stage, we believe that the negative impact of an RSPT has been largely priced into Resource share prices. The near-term direction of the Australian sharemarket is now more likely to be determined by developments overseas (China's tightening; implications of the Eurozone sovereign debt crisis for global economic growth; strength of the US recovery) and by any changes in the profit outlook for Australian companies.
- The Australian sharemarket is currently trading at the lower end of the recent 4,500 to 5,000 point trading range (ASX200 Index). While some further near-term weakness below the 4,500 level is possible, valuations are becoming increasingly attractive. The medium-term outlook for Australian equities remains positive based on attractive absolute and relative equity valuations and rising company earnings.

Appendix:
How the Resource Super Profits Tax Will Be Calculated

The RSPT Announcement Paper provides a table for the calculation of RSPT liabilities (Table 1 below) as well as a worked example. Major items in the calculation are:

Table 1: The Resource Super Profits Tax Calculation

Assessable revenue	
less deductible expenditure (including depreciation)	
less RSPT allowance	RSPT opening balance x RSPT rate
less any prior year project losses	
= RSPT project profit or loss	
+/- losses transferred	Project losses can be transferred
= RSPT net profit or loss	
RSPT liability = 40 per cent of RSPT net profit	If net loss, loss is carried forward
Closing RSPT capital account = undepreciated value of tangible capital, plus any unutilised losses	

Source: Australian Government, The Resource Super Profits Tax, Announcement Paper, Page 25

- **Assessable Revenue** – is the value of the mine/well production as close to the point of extraction as possible (i.e. before value-added processing).
- **Deductible Expenditure** – includes all costs incurred in producing a saleable product at the taxing point, e.g. a depreciation allowance for capital costs and mine operating costs.
- **RSPT Allowance** – is the allowable return on the RSPT capital account (defined as undepreciated capital costs plus any carry-forward RSPT tax losses proposed allowable return = Long-Term Government Bond Rate).
- **Prior Year Project Losses** – are carried forward until there are project profits to offset them or until they are transferred to other projects within the company.

The RSPT liability will be deductible against company tax, but will not generate franking credits. State mineral royalties and exploration expenditures will generate refundable tax credits which will be offset against RSPT liabilities.

Level 17, 140 St Georges Terrace, Perth WA 6000. ABN: 80 100 088 168 AFSL 222152