



21 March 2007

**Desane Group Holdings Limited (DGH)**

Buy

1H07 Result - Significant Upside Based on 25% Discount to Potential NTA

\$0.83

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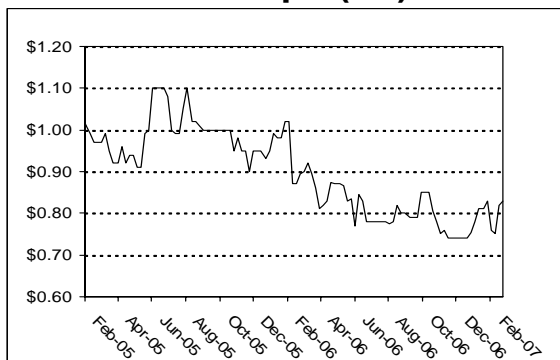
Market Capitalisation (\$m)	22.6
Share Price	\$0.83
52 week low	\$0.72
52 week high	\$0.92
Ave monthly vol (year rolling) (M)	0.187

**Key Financials**

	FY06 Actual	FY07 Est.	FY08 Est
Revenue (\$m)	4.5	3.3	3.0
EBIT (\$m)	3.0	2.5	2.3
NPAT Adj (\$m)	1.7	1.0	0.8
EPS Adj (c)	6.2	3.6	2.8
PE Ratio Adj*(x)	13.3	23.1	32.9
DPS (c)	2.5	2.5	2.5
Yield (%)	3.0%	3.0%	3.0%

**Net Asset Summary**

\$m	FY06 Actual	1H07 Actual	TC Indicative
Sirius Road	4.7	5.4	5.4
Orion Road	11.3	11.3	11.3
Lilyfield Road	11.2	11.2	11.2
Nicholas Street	7.0	7.0	7.0
Burns Bay Road	6.0	6.0	12.3
Other Assets	1.8	2.0	2.0
<b>Total Assets</b>	<b>42.0</b>	<b>42.9</b>	<b>49.2</b>
Interest Bearing Debt	16.2	17.0	17.0
Other Liabilities	2.3	1.9	1.9
<b>Total Liabilities</b>	<b>18.5</b>	<b>18.9</b>	<b>18.9</b>
<b>Net Assets</b>	<b>23.4</b>	<b>24.0</b>	<b>30.3</b>
<b>NTA per share (\$)</b>	<b>0.86</b>	<b>0.88</b>	<b>1.11</b>

**Share Price Graph (A\$)****Key Points From 1H07 Result**

Desane reported 1H07 NPAT of \$0.5 million, up 13.4% on pcp. The result included a \$0.65 million gain on revaluation of an investment property.

Rental income increased 34% on pcp to \$1.0 million, following a combination of higher occupancy rates and rental increases during the period.

The Company is currently trading at a 6% discount to its reported 1H07 NTA of 88 cents, and a 25% discount to what we believe is a conservative potential NTA of \$1.11.

**Our View**

- Property Portfolio Continues to Grow** - Desane currently owns five industrial properties in Sydney's inner suburbs, with 23,330m<sup>2</sup> in lettable area. Management have recently agreed to purchase a 2,000m<sup>2</sup> commercial property at Rozelle, with settlement due in October 2007. The property will be settled with vacant possession, allowing immediate refurbishment and upgrades. We understand management already have tenants in mind for this property, reducing the risk of vacancy post refurbishment.
- Significant Latent Asset Value in Balance Sheet** - Within the property portfolio, Desane has a 50% joint venture interest in a 12,000m<sup>2</sup> waterfront property located at Burns Bay Road, Lane Cove, in Sydney's Lower North Shore. The property and surrounding area is currently undergoing rezoning from *Industrial* to *Residential*. Subject to planning approval and market conditions, we believe a conservative development value for this property is \$30 million. This suggests there is potential for approximately a \$6.3 million increase (post tax) in the Group's net tangible worth.
- Risks Well Managed With Prudent Approach to Growth** - We believe key risks for Desane include exposure to movements in interest rates, property vacancy risks and the potential for delays with the rezoning of Burns Bay Road. The Company's prudent approach to property investment typically involves negotiating lease agreements on properties prior to settlement. As a result, the historical vacancy rate has been very low. The rezoning of Burns Bay Road is expected to be completed within 12 months, however these processes typically become quite protracted. We understand that all known stakeholders are supportive of this change, and as a result we believe the probability of the change going ahead is high. Accordingly, we conservatively expect realisation of this latent value to occur within the next 12 months to two years.
- Maintain Buy Recommendation based on discount to NTA** - Desane's property portfolio is underpinned by high quality tenants with medium to long term leases. The management team offer significant industry experience and the business model provides a combination of income from yielding properties and upside to NTA from realisation of underlying value in balance sheet assets. We maintain our Buy recommendation based on the Company's significant discount to our indicative NTA.

## Brief Company Description

*Desane's core business is commercial & industrial property management and property investment.*

Desane listed on the ASX in 1987 with a core business of commercial and industrial property investment and construction. Subsequent to listing, Desane underwent a change in strategic direction with current operations focussed on commercial and industrial property management and property investment. The Company's strategic focus is to acquire attractive commercial and industrial properties with strong tenant appeal in the \$5 million to \$15 million range, and subsequently generate a recurring revenue stream through management of the property portfolio.

Over the past two years the Company has consolidated its Sydney based property assets, involving the sale and refurbishment of various properties within the portfolio. As a result, Desane now owns more than \$40 million of Sydney based industrial property and other assets, whilst also managing \$13 million of third party owned commercial and industrial property.

*The Company has a conservative investment style which has delivered long term growth in NTA and a low historical vacancy rate.*

Management has stated its target to grow the Group's property portfolio to \$100 million in the medium term. The company has a relatively conservative investment style, which typically involves maintaining a low level of gearing and the negotiating of an extended settlement period on the purchase of new properties. This allows sufficient time to obtain any required planning approvals for refurbishments and building upgrades, as well as securing long term tenancy agreements before taking ownership. In addition, the majority of property acquisitions will occur following an existing tenant's request to move into a larger property, prompting management to source and acquire a suitable property. The extended lead times with property transactions have enabled Desane to maintain a very low level of vacancy rates, which we understand is currently sitting at approximately 5% of the Group's total lettable area.

## 1H07 Result and Property Update

*1H07 NPAT was \$0.5m, up 13.4% on pcp.*

Desane reported 1H07 NPAT of \$0.5 million, up 13.4% on pcp. The result included a \$0.65 million gain on revaluation of an investment property. Rental income increased 34% to \$1.0 million (compared with \$0.8 million in the pcp), following a combination of higher occupancy and rental increases during the period.

*The result included a \$0.65m gain on property revaluation.*

Operating expenses increased 62% on pcp to \$0.59 million, primarily due to the initial costs associated with leasing out new premises (eg marketing, commissions etc) during the period. With the majority of property now on medium to long term leases, we do not expect the same level of operating expenses in H2.

EBIT interest cover of 1.1 times was achieved during the period, compared with 1.5 times in the pcp. Whilst each individual property achieves a comfortable EBIT interest cover between 2.0 and 3.0 times on a stand alone basis, this ratio is significantly thinner when considering the overall Group and the impact of corporate overheads. Despite debt servicing capacity being demonstrated, this is at the lower end of our preferred comfort zone.

During the period, Desane increased its reported NTA by 4.8% to 88 cents per share, compared to 84 cents per share in the pcp. In maintaining previous practice, management did not declare an interim dividend. The Company's net debt to equity ratio remained relatively steady at 69.6% compared to 71.2% in the pcp.

*The company recently announced the purchase of a 2,000m<sup>2</sup> commercial property for \$3.8 million.*

Following management's strategy of growing the property portfolio to \$100 million, the Company recently announced the purchase of a new 2,000m<sup>2</sup> commercial property at Rozelle for \$3.8 million. Settlement for this acquisition is due to occur on 16 October 2007, at which point management will initiate upgrading and refurbishment works to the property. We understand funding will be provided through a combination of bank debt and proceeds from the sale of other properties. While management anticipate selling between one and three strata units (out of seven) at the Lidcombe property, should sale not be achieved in time, we understand the Company's bank is prepared to support full financing in the interim.

A summary of the property portfolio is as follows:

Property	Acquisition Cost (\$'000)	Construction Cost (\$'000)	Interest Capitalised (\$'000)	Other Capital Costs (\$'000)	Revaluation (\$'000)	Book Value 31/12/2006
Sirius Road, Lane Cove	2,900	672	0	185	1,575	5,331
Orion Road, Lane Cove	8,197	908	0	0	2,172	11,276
Lilyfield Road, Rozelle*	1,681	8,527	0	42	980	11,231
Nicholas Street, Lidcombe	3,050	3,356	177	420	0	7,003
Burns Bay Road, Lane Cove**	n/a	n/a	n/a	n/a	n/a	5,967
<b>Total</b>	<b>15,828</b>	<b>13,463</b>	<b>177</b>	<b>647</b>	<b>4,727</b>	<b>40,808</b>

\* Desane holds a 70% equity interest in the Rozelle property as represented by the book value above.

\*\* Desane holds a 50% interest in the Burns Bay Rd property. This investment is equity accounted for with current book value shown above.

## Significant Discount to NTA

*Desane is currently trading at a 25% discount to our indicative valuation of \$1.11.*

Desane is currently trading at \$0.83 compared with its reported 1H07 NTA of \$0.88, implying a discount of 5.7%. However, we believe the reported NTA is conservative, based on our assessment of the potential uplift in value of the Burns Bay Road property upon completion of rezoning. Based on our hypothetical valuation for this property of \$30 million, we believe Desane is trading at a 25.2% discount to our indicative NTA. The following table summarises our analysis of the Company's balance sheet, resulting in our valuation of \$1.11 per share.

(\$'m)	FY06 Actual	1H07 Actual	TC Indicative
Sirius Road, Lane Cove	4.7	5.4	5.4
Orion Road, Lane Cove	11.3	11.3	11.3
Lilyfield Road, Rozelle	11.2	11.2	11.2
Nicholas Street, Lidcombe	7.0	7.0	7.0
Burns Bay Rd, Lane Cove (J/V)	6.0	6.0	12.3
Other Tangible Assets	1.8	2.0	2.0
<b>Total Tangible Assets</b>	<b>42.0</b>	<b>42.9</b>	<b>49.2</b>
Interest Bearing Debt	16.2	17.0	17.0
Other Liabilities	2.3	1.9	1.9
<b>Total Liabilities</b>	<b>18.5</b>	<b>18.9</b>	<b>18.9</b>
<b>Net Tangible Assets</b>	<b>23.4</b>	<b>24.0</b>	<b>30.3</b>
<b>NTA per Share (actual \$)</b>	<b>0.86</b>	<b>0.88</b>	<b>1.11</b>

While we have only provided for a potential uplift in value for the Burns Bay Road property in the above table, we believe there is also potential for the group to realise increased value from the Lilyfield Road property. Our analysis of Desane's property valuations is based on various assumptions as described below.

### Burns Bay Road, Lane Cove

*Upon rezoning of the Burns Bay Road property we conservatively believe a market value of \$30 million is achievable.*

Following our site visit and discussions with management, we concur that this property would have market value of approximately \$30 million post rezoning, based on potential development value and subject to both planning approval and market conditions. An examination of available sales data in the area suggests this target value might even be conservative. We note that no independent valuation has been commissioned in determining this indicative valuation.

For the purpose of calculating our indicative NTA we have assumed a valuation of \$30 million. Given Desane's 50% equity interest is carried at a book value of \$6 million, this implies a potential uplift in the region of \$9 million (\$6.3 million post tax), upon sale of the asset or revaluation post rezoning. This translates to an increase in net tangible assets of approximately 23 cents per share after tax, which upon realisation represents a potential 43% appreciation in the share price.

*We expect the process of rezoning to 'residential' will be completed within 12 months.*

We believe the catalyst for realising this increase in value will occur post rezoning when the Company either offers the site for sale or commissions an independent valuation. As previously outlined, the rezoning process may take up to 12 months, suggesting sale and settlement of this property may not be finalised until FY09.

Alternatively, Desane's strategically located properties, in highly sought after locations could potentially attract the attention of other property investors / developers who recognise the latent value in Desane's balance sheet. As a result, there is potential for the crystallisation of this increased value to occur sooner than FY09.

## Lilyfield Road (Multimedia Centre), Rozelle

*Based on recent market transactions we believe valuation upside exists with the Lilyfield Rd Multimedia Centre.*

Desane's 70% ownership of this property is currently carried at a book value of \$11.23 million. Based on net rental income of approximately \$1.1 million per annum, combined with the close proximity to Sydney's CBD, we believe this property would currently attract a sale price in the region of \$13.5 to \$15.4 million. This indicative valuation assumes a cap rate of between 7.0% and 8.0%, which is considered relatively conservative, given our understanding that comparable industrial building transactions have occurred at yields of below 7%.

However, the likelihood of this property being sold in the medium term, and the group realising any additional value is relatively low. Therefore, in maintaining a conservative approach we have not included any provision for this potential upside when calculating our indicative NTA.

## Earnings Outlook

*FY08 rental income is expected to increase to approximately \$3.0 million.*

With the majority of Desane's properties generating rental income we expect FY08 operating revenues to increase to approximately \$3.0 million. We have not made any allowance for the possibility of property sales in our forecasts, given the difficulty in predicting the timing and cash flow associated with these transactions. However, we understand management is currently looking to sell between one and three strata units at Lidcombe to supplement the proposed acquisition of the second property at Rozelle. Depending upon the outcome of any property sales, and the subsequent level of debt funding required to complete the Rozelle acquisition we anticipate the interest expense in FY08 is likely to be slightly above our current forecasts.

In addition, we have not factored any increases from property revaluations in our forecasts. However, following our previous discussion on the book values of the properties at Burns Bay Road and Lilyfield Road we believe there is also potential for property revaluation in the medium term.

The table below outlines our earnings forecasts to FY08, excluding any impact from the sale or revaluation of properties. Given profits from property sales and gains from revaluation form a core part of Desane's business, we expect the actual results to differ somewhat to our forecasts below.

*Upside to our forecasts is considered likely due to the potential impact from further revaluations and property transactions.*

PROFIT & LOSS SUMMARY (A\$m)				
Period	FY06A	1H07A	FY07E	FY08E
Operating Revenue	1.78	1.12	2.53	2.99
Gain on Property Sales	0.23	0.00	0.00	0.00
Gain on Revaluation	2.31	0.65	0.65	0.00
Other Revenue	0.14	0.07	0.15	0.04
<b>Total Revenue</b>	<b>4.47</b>	<b>1.84</b>	<b>3.33</b>	<b>3.03</b>
<i>Growth (pcp)</i>	28.6%	21.7%	-25.6%	-8.9%
Share of JV Profits	0.24	0.16	0.35	0.38
Operating Expenses	(1.23)	(0.59)	(1.01)	(1.05)
<b>EBITDA</b>	<b>3.34</b>	<b>1.35</b>	<b>2.53</b>	<b>2.33</b>
Dep'n/Other Amort'n	(0.02)	(0.01)	(0.02)	(0.08)
<b>EBITA</b>	<b>3.32</b>	<b>1.34</b>	<b>2.51</b>	<b>2.25</b>
Amort'n of Goodwill	0.00	0.00	0.00	0.00
<b>EBIT</b>	<b>3.32</b>	<b>1.34</b>	<b>2.51</b>	<b>2.25</b>
Net Interest	(1.07)	(0.56)	(1.11)	(1.27)
<b>Pre-Tax Profit</b>	<b>2.26</b>	<b>0.78</b>	<b>1.40</b>	<b>0.98</b>
Tax Expense	(0.57)	(0.25)	(0.42)	(0.29)
Minorities	0.00	0.00	0.00	0.00
<b>NPAT Adjusted</b>	<b>1.69</b>	<b>0.52</b>	<b>0.98</b>	<b>0.69</b>
<i>Growth (pcp)</i>	-6.7%	13.4%	-41.9%	-29.7%
Net Significant Items	0.00	0.00	0.00	0.00
<b>Reported Net Profit</b>	<b>1.69</b>	<b>0.52</b>	<b>0.98</b>	<b>0.69</b>
<b>EPS Reported (c)</b>	<b>6.2</b>	<b>1.9</b>	<b>3.6</b>	<b>2.5</b>
<i>Growth (pcp)</i>	-14.2%	12.4%	-42.5%	-29.7%
<b>EPS Adjusted (c)</b>	<b>6.2</b>	<b>1.9</b>	<b>3.6</b>	<b>2.5</b>
<i>Growth (pcp)</i>	-14.2%	12.4%	-42.5%	-29.7%

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## Investment Summary

*Limited downside to the share price based on the discount to our indicative potential NTA.*

While we believe the downside to Desane's share price is limited due to the Company's discount to our adjusted indicative NTA, we see cash flow management, interest rates and occupancy as the key operational risks in the business. At present, Desane's property portfolio is underpinned by high quality tenants with medium to long term leases, reducing occupancy risk. Desane's management team and board offer significant experience in commercial and industrial property management and property investment, albeit the Company remains dependent on a small number of key staff, increasing the risk profile.

Desane is a commercial and industrial property investment Company as opposed to a pure property developer. The Company generates recurring cash flows from existing properties which provide funding for the investment into new properties that have development potential. The Company has a track record of increasing its NTA, and at present is trading at a 25% discount to our indicative potential valuation.

*Maintain Buy recommendation.*

We believe the property at Burns Bay Road has an intrinsic value significantly higher than the current book value. Whilst it may take up to 12 months until the rezoning is completed, we believe the Company will endeavour to realise this latent asset value shortly thereafter. We maintain our Buy recommendation.

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