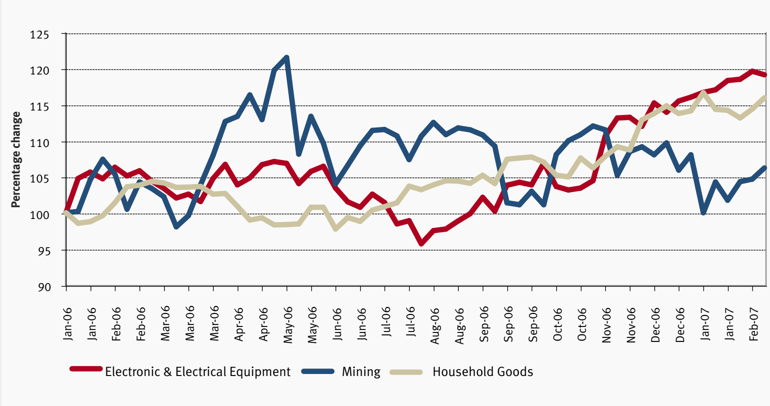
REAL ASSETS

A 'real' good time for the UK equity market

UK equities have been supported by merger and acquisition activity, which shows no sign of letting up. Bidders are encouraged by the attractive gap between the cost of borrowing and the earnings yield of the market, and there has been a noticeable increase in appetite for 'real' assets, writes Frances Hudson

Figure one: performance of listed sectors relative to UK equity market (indexed to 100 at 31.12.05)



Source: Bloomberg

The UK equity market has for some time been supported by a mix of favourable valuations, strong dividend growth and significant merger and acquisition activity (M&A), in both the large and mid-cap space, which shows little sign of abating. The attractive gap between the cost of borrowing and the earnings yield of the market is enticing private equity investors, who are driving much of the UK's current M&A boom. While it is becoming more of a challenge to identify value opportunities, particularly in the mid-cap stock universe after several years of superior performance, a carefully constructed pro-cyclical portfolio can continue to deliver.

An interesting facet of the recent spate of bid activity is the market's healthy appetite for real assets. Infrastructure companies such as utilities, ports, airports and road toll businesses have been the focus of much interest and there have been a number of these assets being privatised or sold off by their existing owners in order to capitalise on this demand.

AB Ports was bought by a consortium led by Goldman Sachs, while water companies Thames Water and Anglian Water (AWG) have also been swallowed up by private equity groups. While a significant number of deals within the retail sector have failed to complete, companies with hard asset backing have attracted a premium. For example, the prices paid for AWG and Viridian were higher than the consensus expected and suggest low risk, inflation-linked returns deserve a higher rating than the market currently perceives.

The utilities sector is one area that has been consolidating rapidly and, after recent deals on the continent, European companies are increasingly looking to the UK utilities sector, which is more open to takeover activity, as an attractive target. With high levels of liquidity in financial markets, there appears to be a large amount of cash looking for investment opportunities in a fairly small domestic sector.

POSITIVE SENTIMENTS

Gazprom, E.ON and Gaz de France have all shown interest in UK stocks and, given the ongoing negotiations between Spain's Iberdrola and ScottishPower, the utilities sector is shrinking by the day.

Shareholders of AWG, Viridian and ScottishPower have already benefited as have investors with extended exposure via International Power and Scottish & Southern, both of which have been buoyed by the positive sentiment surrounding the sector. The demand for real assets should continue to boost utilities and infrastructure companies.

In general, a bias to more economically sensitive sectors seems justified and there are a number of areas that warrant a more positive view than consensus, offering attractive investment opportunities.

The mining sector, particularly industrial metals, has enjoyed a strong run. Rising demand and higher prices, backed by global growth and the industrialisation of China, are the key drivers of the sector. However, the current valuation of mining companies prices in a significant fall in prices, over and above the removal of some of the speculative excesses. One of the key focus on change questions for investors is what is priced into the markets. The management teams of mining companies are upbeat about the outlook for demand and supply for industrial metals and our analysts cannot see any reason for a significant retrenchment in commodity metal prices to the extent that the market is discounting.

The main downside risks for the sector are a severe slowdown in the US or weaker Chinese growth prospects, neither of which is our central scenario. China remains a long-term growth story, to which mining is the most beneficially exposed sector. Iron ore, copper and platinum are particularly well supported by strong Chinese demand. Indeed, the longer-term growth dynamics of China, as well as other emerging markets, in terms of metal demand and lagging supply, appear to be undervalued by the market.

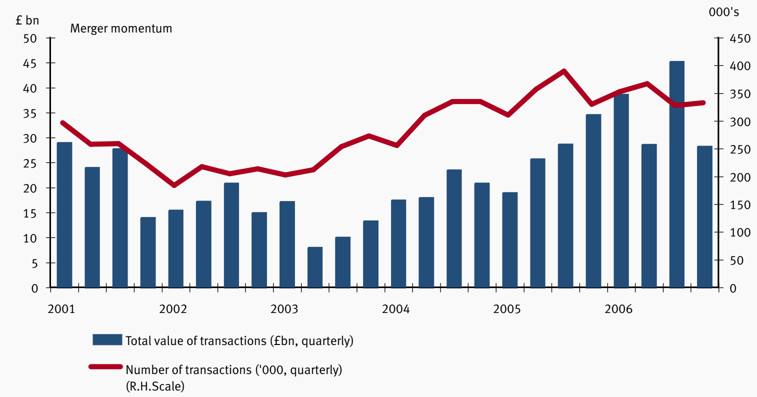
The distortions of hedge and commodity funds are a consideration when assessing the attractiveness of the mining sector. Increased speculative activity makes it difficult to judge to what extent metal prices have been inflated. As yet, however, there has been no drop-off in demand in response to price rises.

In addition, with the possible exception of copper, inventory levels remain low and the mining companies are valued at a material discount to the rest of the UK market despite having high free cashflow yields. Meanwhile, the sector is displaying good capital and supply-side discipline, with cashflows largely being employed for consolidation and share buybacks.

As well as positive sector fundamentals, there are also some supportive stock-specific drivers, which add to conviction on favoured mining holdings. Kazakhmys, for example, is the cheapest of the copper stocks and has a very low cost base.

It also benefits from its richness of resources and geographical proximity to China. As is the case with Anglo American, the potential for Kazakhmys to merge with one of its peers is underappreciated by the market, while the platinum metals group to which it is exposed is better supported by secular growth trends than other metals. Finally,

Figure two: announced UK merger and acquisition activity



Source: HSBC

Xstrata is favoured as it benefits from having one of the most driven and dynamic management teams in the mining sector. For the negatives to outweigh the positives on the mining sector, there would need to be a significant amount of disappointing economic data leading to a correction in metal prices.

ELECTRICAL SHINE

Meanwhile, opportunity is sparking in the electrical and engineering sectors, two areas in which there has been an encouraging pattern of growing top line profits and cost cutting. Recent trading statements from companies such as Morgan Crucible, Spectris and Invensys have been strong and their numbers reflect generally buoyant end markets, with the exception of those exposed to the US.

Many of the strongest performers have been those exposed to infrastructure investment and corporate capital spending. A number of these companies have also streamlined their portfolios. Cookson and Invensys, for example, have both benefited from disposals while the businesses they have been left with are generating much better returns.

The sector has also benefited from consolidation with mooted bids for Dominic Hunter, Enodis and Morgan Crucible's magnetics division, a trend that is set to continue as long as industrial corporate cashflow remains strong. Barring any major setback in the global economy, there is considerable scope for these companies to increase their margins.

Despite the frequent, so far misguided, predictions of an imminent collapse in UK house prices, the house building sector has shown commendable fortitude, bearing out the confidence of the management teams of such companies as Taylor Woodrow and Barratt Developments.

The UK housing market remains steady and has proved resilient to the latest increases in interest rates. The economic slowdown in the US also appears to have had a limited impact on those companies with operations there.

Although growth in the UK housing market has moderated somewhat, as reflected in lower mortgage approvals in December, house prices and mortgage applications still remain at respectable levels.

House prices rose 10 per cent per annum in January according to the Halifax Nationwide data, while the Land Registry reported an 8.5 per cent rise per annum in house prices in the fourth quarter of 2006. The attractiveness of residential property is also reflected in the buoyant buy-to-let market, which is becoming an increasing proportion of mortgage applications.

Constrained supply of housing and a growing population are creating a favourable environment for the housebuilders. UK demographics are changing and the rise in immigration into the UK, particularly from new EU member states, is creating additional demand for housing and services, which is unlikely to dwindle any time soon. This is exacerbating an existing structural undersupply of new houses, to which many observers believe tough planning restrictions in the UK have contributed.

These supply and demand dynamics bode well for the housebuilders and a positive view on the sector has been justified by recent M&A activity. UK housing giant Barratt Developments agreed to buy Wilson Bowden in a deal worth £2.2bn (€3.2bn), having beat off competition from rival Wimpey and a consortium led by HBOS. This is the biggest deal ever seen in the housebuilding sector and is likely to lead to further consolidation and ongoing bid speculation.

Those companies with strong land banks will likely find themselves targeted by private equity investors, given their appetite for companies with hard asset backing. Risks to the positive outlook for the housebuilders would be a change in consumer confidence or employment expectations, while a sharp deterioration in interest rate expectations would also be interpreted negatively.

Overall, the prospects for UK equities remain sound and there are opportunities to take advantage of positive business conditions around the world, retaining a bias towards stocks sensitive to economic growth as already discussed. In contrast, a more cautious stance on consumer stocks such as food, beverages, and tobacco is suggested. The operational gearing of these companies is low while valuations, inflated by M&A speculation, look unattractive relative to their growth rates.

Hudson: prospects for UK equities remain sound

Food and beverage companies have also faced rising costs as the prices of soft commodities, including foods, increased. Weather concerns, such as drought in the southern hemisphere and the return of the El Nino systems, threaten crop production in the US and elsewhere this year. These factors plus competition for some crops from biofuel production, suggest that prices are likely to remain high.

SHOPPING SHORTAGE

There is also a case for circumspection on general retail names, as the high street grows more competitive and household disposable incomes become more constrained. Travel companies are the exception, where difficult trading over the summer has prompted talk of consolidation within the sector on a pan-European basis. The announced merger between Thomas Cook and MyTravel is a timely example. Despite their sensitivity to the economy, airline stocks are showing improved profitability as a result of growing demand, rationalisation of their offers and cost cutting measures. Management statements from companies like easyJet and British Airways have been encouraging and the outlook for improving returns from here is good.

In summary, there continue to be attractive opportunities for a number of sectors in the UK. The macroeconomic environment is supportive as long as inflation is well contained and many of the risks are already priced in. The overall market continues to benefit from companies generating and dispensing cash, from M&A activity involving both large and mid-cap companies with a bias towards real assets and backed by significant private equity involvement.

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