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RESULTS AND EVENTS
MARKET COMMENT

Saudi Arabia may ignore OPEC decision to maintain production targets

Conall Mac Coille, Chief economist

Efforts by Saudi Arabia to raise OPEC’s production quotas were thwarted yesterday (June 8th) as a group of countries led by Iran (and including a representative of Muammar Gaddafi’s regime) blocked moves to raise output. Brent oil future prices for delivery in July rose to $118 per barrel following OPEC’s decision.

However, OPEC countries routinely cheat on their individual country quotas. Yesterday’s decision may therefore have little impact on actual crude oil production. The OPEC group is now split between Saudi Arabia, with spare capacity of close to 3.2m barrels per day (mbd), and the remaining 11 countries with only 1 mbd of spare capacity between them.

So there is little incentive for those countries with little spare capacity to vote for an increase in overall OPEC output. It is therefore likely that Saudi Arabia may unilaterally raise output to lower oil prices and sustain global oil demand. It has been reported that Saudi output rose by 200,000 barrels per day in May. So the oil market will be watching Saudi production closely in June.

In a quiet day for macroeconomic data, the market may focus on the UK trade data for April. UK GDP growth in Q1 was entirely driven by net trade with domestic demand remaining weak. However, the UK’s trade performance may in part have reflected a weather-related bounce following an exceptionally poor trade deficit of close to £6bn in December. If so, the strength of UK exports in Q1 may be temporary. Hence, net trade needs to provide the same strong positive contribution to GDP growth in Q2 to compensate for the weakness of domestic demand.

FINANCIALS

Bank of Ireland (BKIR ID)

Price: 14c Rating: Under Review Issued: 04/01/11

Adds more colour to capital plans

Emer Lang

On June 3rd, Bank of Ireland (BKIR) revealed that €700m junior and €1.9bn senior subordinated bondholders would be offered an equity alternative of 20c (versus 10c cash) and 40c (versus 20c cash) respectively for their debt, plus accrued interest (versus none). The announcement yesterday (June 8th) confirms that debt holders who opt for conversion to equity will get allotment instruments to convert to shares on August 12th at a price in a range of 11.3c to 11.76c. The instruments are on an-ex rights basis. Government burden-sharing policy dictates that bondholders are asked to amend bond terms to insert a call option to purchase outstanding securities following the liability management exercise (LME) at €0.01 per €1,000. On the basis of 100% equity take-up (see Scenario A on page 2 of our note), bondholders would receive 8.1bn of shares. The corresponding €2.3bn net capital boost would leave the subsequent rights issue at €1.77bn. The state will underwrite this at 10c per share.

The group stresses that margin recovery from current depressed levels is a key priority and is seeking to achieve a margin of over 200bps in 2014. Other key targets include a cost/income ratio below 50% and a normalised impairment charge of 55-65 bps, both in 2014. The CT1 ratio is expected to be in excess of the 10.5% required by the Central Bank and to achieve 15% in 2014 on a Basel 3 transitional basis.

Our existing estimates see the group TNAV at €7.6bn at the end of 2013. Key assumptions include impairment provisions of €6.7bn in 2011-2013 (BKIR estimates €6bn; Central Bank estimates €7.4bn) and a PLAR deleveraging cost of €1.5bn over the period. Depending on the take-up of the equity alternative, pro-forma shares in issue may be up to 31.1bn (shares under Scenario A plus current shares in issue).

For further detail, see our research note issued this morning.

Company summary and analysis

CONSTRUCTION AND BUILDING MATERIALS

Travis Perkins (TPK LN)

Price: 1040p Rating: Underperform Issued: 16/05/11 Previous: Neutral Issued: 23/02/11

Homebase like-for-like sales growth similar to Wickes and B&Q

Flor O’Donoghue

FACTS: Home Retail Group, parent of Homebase and Argos, has issued a trading update for its first quarter, which ran from February 27th to May 28th.

ANALYSIS: Homebase’s revenues for the period rose 1.6% on a like-for-like (lfl) basis but net closed space resulted in a 0.1% decline in reported revenues (to €458m). Gross margins fell 50 basis points due to adverse currency and shipping costs, as well as mix effects. According to Home Retail, the growth in lfl sales was due to a strong performance in seasonal categories such as garden furniture, plants and exterior decorating. Homebase’s lfl growth is consistent with that of Wickes (+1.9%) and B&Q (+1.5%). However, Argos continues to struggle and its lfl sales fell 9.6% in the quarter, reflecting a weak consumer electronics market.
DAVY VIEW: The lateness of Easter and the extra bank holiday helped the UK DIY sector this year, as is evident in what has been solid underlying top-line growth. However, market conditions remain difficult, and we believe further growth over the remainder of the year will prove a challenge, although the recent exit of Focus will help.

Company summary and analysis

BMF volumes remain poor
Flor O’Donoghue

FACTS: UK merchanting figures for April have been released by the Builders Merchants Federation (BMF).

ANALYSIS: According to the BMF, UK merchanting volumes in April were down 4.9% on the same month last year. Taking the February to April quarter as a better gauge of underlying trends, volumes were 2.6% lower than the same three months in 2010. As we have noted before, this performance from the BMF members would suggest that the independents are losing market share to the publicly-quoted building distributors.

DAVY VIEW: Based on the trends in 2010 and the opening months of this year, the publicly-quoted builders merchants have come through the downturn in the UK better positioned than the independent sector. We expect the market leaders to continue to take market share in 2011, which will provide a helpful buffer against any slowdown in overall activity. An initial sense on how 2011 is progressing has already revealed that Grafton’s like-for-like sales (lfl) in the UK rose 5.8% in the first four months of the year; that Travis Perkins’s lfl merchanting sales increased 12.8% over the same period; while Wolseley’s lfl sales in the UK gained 1% in the quarter to end-April, partly reflecting a loss of a significant contract. Even allowing for factors such as price inflation, the difference between Grafton et al and the BMF is stark.

Sector valuations

PAPER AND PACKAGING

Smurfit Kappa Group (SKG ID)
Price: 834c  Rating: Outperform  Issued: 30/06/09

Outbreak of E Coli impacts corrugated volumes, 5% of SKG’s business
Barry Dixon

FACTS: According to an article in RISI, the outbreak of E Coli in Europe has led to a sharp reduction in corrugated box demand in Spain as well as in Northern Germany and the Netherlands.

ANALYSIS: In a presentation at its investor day, SKG indicated that approximately 5% of its corrugated volumes are used in “Agriculture, Forestry and fishing”. This includes fresh agricultural produce. While the E Coli outbreak will likely have some impact on SKG’s volumes, we believe that it will be short-lived. It has come at the end of the Spanish vegetable season and will hopefully have abated before the start of the fresh fruit season.

DAVY VIEW: While the impact of E Coli is an unwelcome development, we do not believe that it changes the underlying positive fundamentals of this industry in terms of recovering demand (circa 3% in 2011) and limited supply – no new capacity is expected until 2012 at the earliest, while inventory levels remain at historic lows. We reiterate our ‘outperform’ rating and 1200c price target.

Company summary and analysis

SUPPORT SERVICES

DCC (DCC ID)
Price: 2082c  Rating: Outperform  Issued: 30/06/09

Argos updates on trading
Caren Crowley

FACTS: Home Retail Group, owner of Argos, has published an IMS covering the 13 weeks from February 27th to May 28th 2011.

ANALYSIS: During the period covered, Argos experienced a like-for-like sales decline of 9.6%. The consumer electronics market declined significantly more than anticipated and has accounted for the majority of the reduction in Argos’ sales. Consumer electronics at Argos embraces everything from TVs to gaming systems to personal computing products. It is hard to know which of these products or systems are the worst performers, and this morning’s conference call with management may provide more granularity. However, Argos does report that ‘the continued growth in laptops’ helped the group hold its share of the consumer electronics market. This is a good performance when one considers the commoditisation of certain consumer electronic products (particularly TVs) and the renewed focus that grocers such as Sainsbury are placing on their offering in this space.

DAVY VIEW: Argos’s update is a dismal reading of the state of the UK consumer. It does have implications for DCC SerCom Retail, which distributes home entertainment products such as DVDs, CDs, and gaming systems and software, and DCC SerCom Reseller which markets laptop, PCS, netbooks, etc. However, at a recent Investor Day, DCC SerCom placed less...
emphasis on sales to high-street specialists such as Argos and stressed its sales to growing parts of the market such as grocers and internet-based retailers. In this regard, the latest readings from the BRC were encouraging. The BRC reported that non-store (internet, mail-order and phone) non-food sales growth in May grew by 10.4% despite tough comps (April 2011, which included Easter and a bank holiday, saw growth of 13.7% and May 2010 saw growth of over 20%). Smartphone technology is a big push for non-store, non-food sales. In its trading statement, Argos remarks that the number of downloads of its i-Phone app reached 1.7m.

Company summary and analysis

RESOURCES AND ENVIRONMENT

Providence Resources (PRP ID)
Price: 280c

Maximum exposure to Irish offshore
Job Langbroek

FACTS: Last week, the Irish Minister for Communications, Energy and Natural Resources announced that 15 separate applications had been lodged for acreage in the Atlantic margin licensing round. The closing date for applications was the end of May.

ANALYSIS: The Minister noted that this was the largest application ever for licensing offshore Ireland. It also included a number of companies not formerly involved in the Irish offshore. This is encouraging for the development of the Irish offshore and reflects well on current state policy of making licensing attractive and a tax scheme that rewards first movers for the risk incurred in frontier areas. The applications will now be processed over the coming months.

DAVY VIEW: The Irish offshore looks to be subject to a new wave of interest on the back of a triumvirate of high oil prices, technology and a rewarding fiscal regime. Providence Resources provides the most comprehensive way to become involved in this sector through an Irish company. Moreover, the stock is currently priced to reflect not only the normal risking associated with oil and gas explorers but also an added Irish discount. This makes for very substantial value leverage in the event of success. This opportunity is discussed in detail in a research note to be issued later this morning.

Company summary and analysis

TRAVEL AND LEISURE

Air France KLM (AF FP)
Price: 1080c  Rating: Underperform  Issued: 13/01/11  Previous: Outperform  Issued: 18/01/10

May traffic statistics; cargo business weakens
Joshua Goldman

FACTS: Air France-KLM has released May traffic statistics.

ANALYSIS: Passenger traffic increased by 4.9% with capacity up by 5.9%, leading to a slight 0.7 point decline in load factor to 79.8%. The company noted that unit revenue per available seat kilometre (RASK) excluding currency was higher than in the previous year.

In the Americas network, traffic was very dynamic with demand increasing 7.8% for capacity up by 8.2%. The load factor remained at the high level of 86.1% (-0.3 points). Traffic in the Asia network rose by 2.7% for capacity up by 5.8%. The load factor fell by 2.4 points to 81.2%, with the situation in Japan continuing to weigh on operations in this region. The Africa and Middle East network remains affected by the geopolitical situation in the region. Thus, traffic declined by 5.3% for capacity down by 2.5%. As a result, the load factor lost 2.1 points to 71.4%. The Caribbean and Indian Ocean network was dynamic, with traffic up by 6.7% for a capacity increase of 6.9%. The load factor remained unchanged at 78.5% (-0.1 point). The European network was also dynamic with traffic increasing by 8.2% for capacity up by 7.6%. The load factor gained 0.4 points to 74.6%.

The cargo business was affected by the unrest in Africa and the Middle East as well as by overcapacity on departures from Asia. Against this backdrop, the group continued to control capacity closely, limiting growth to 2.7%. With traffic down 1.4%, the load factor was down 2.9 points to 67.8%. Unit revenue per available ton kilometre (RATK), excluding currency, posted a very slight decline.

DAVY VIEW: The cargo business appears to be weakening, as denoted by the 2.9 point decrease in cargo load factor and the slight decline in unit revenue per ATK. The passenger business is holding up reasonably well with unit revenue per ASK excluding currency increasing in May compared to the previous year and load factor only modestly declining.

Company summary and analysis
Deutsche Post DHL (DPW GY)
Price: 1252c  Rating: Outperform  Issued: 26/01/11

Wincanton releases preliminary results
Stephen Furlong

FACTS: Wincanton, a peer of DHL’s supply chain business, has reported in-line preliminary results.

ANALYSIS: In 2010/2011, group revenue remained constant at some £2.2bn while underlying operating profit reduced slightly from £54.6m to £53.0m. On outlook, the group commented that “while we face short term challenges in order to return the Group to profitable growth, we are optimistic of improving margins in the medium term through a combination of cost actions, efficiency improvements and, most importantly, making sure we create a product offering to support our customers in achieving their objectives. A strong focus on new business wins and on renewing key contracts has delivered an encouraging start to the new financial year and reinforces our position as a market leader. This positive momentum in the new business pipeline highlights increasing demand for agile, flexible supply chain solutions and demonstrates clear opportunities to leverage our scale, assets and infrastructure to deliver efficient, cost-competitive warehousing and transport services”.

DAVY VIEW: Wincanton issued broadly encouraging results, reporting a stable business in the UK and Germany. It is constrained by its balance sheet and has started to dispose of underperforming businesses – it announced the disposal of its German road business and its logistic operations in the Netherlands for an enterprise value of €46.5m. Wincanton is a peer of DHL’s supply chain business, which reported underlying EBIT of €274m or 12.5% of group underlying EBIT.

Company summary and analysis

EQUITY MARKETS

Global indices

FTSE European and UK indices scheduled review
Jim O’Neill

FACTS: FTSE announced after close last night (June 8th) the results of its scheduled Q2 UK and European indices reviews. Changes will be applied after close of business on June 17th and will be effective from the opening of markets on Monday, June 20th.

The reviews include the following:
• Kerry Group was added to the FTSEurofirst 300 index, arguably the primary European benchmark. The index sees six additions and deletions following the review.
• Tate & Lyle was added to the FTSE 100 index at the expense of TUI Travel – the sole change to the UK benchmark.
• Lafarge was deleted from the FTSE Eurotop 100 index where five additions/deletions were announced.
**THE DAY IN NUMBERS**

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Distribution of ratings/investment banking relationships

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This is a summary of Davy ratings for all companies under research coverage, including those companies under coverage to which Davy has provided material investment banking services in the previous 12 months. This summary is updated on a quarterly basis. The term ‘material investment banking services’ includes Davy acting as broker as well as the provision of corporate finance services, such as underwriting and managing or advising on a public offer.

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