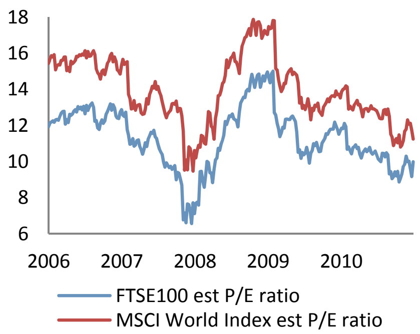
Monday, 5th December 2011

5 Quality Growth Stocks

FTSE-100

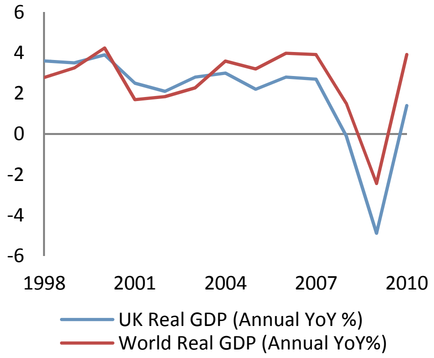
***Source**: Bloomberg*

Equity market valuation



***Source**: Bloomberg*

GDP growth



***Source**: Bloomberg*

Senior Analyst

Donald Linderyd

(t) +44 (0) 207 382 8421

(e) donald.linderyd@hbmarkets.com

***Note:** All data is taken during Monday 5th December 2011*

Structural growth at a premium

Buy low and sell high. How hard can it be? It should be even easier with so many stocks at low levels in the current market. The problem is that you risk buying into classic value traps; stocks that look "cheap" are usually cheap for a reason. Instead we believe it is currently more productive to look for growth companies. Public debt burdens force governments around the world to deleverage and reduce spending, which is negative for economic growth. With slow overall economic growth, companies that can still show growth in this environment are rare, and, as with most rare assets, valuations rise. In this report we search the FTSE 350 for growth companies that can withstand a tougher economic climate. We have found five stocks that we believe fit the description and provide good investment opportunities at this point.

The last few years of financial market turmoil and years if not decades of poor fiscal policies have left many governments heavily indebted. With highly leveraged public balance sheets governments are forced to deleverage to keep bond investors happy, interest rates at a reasonable level and budgets under control. We have witnessed throughout 2010 and 2011 how the market punishes countries with high debt levels. Greece, Portugal and Ireland have all been forced to seek help from fellow Euro-members and the IMF. The only long-term solution to avoid a similar situation in the UK, France, Italy, et al. is to deleverage.

Deleveraging usually means repaying debt, which puts further pressure on governments' budgets leaving them even less to spend on schools, hospitals and infrastructure. Government spending is an important driver of economic growth and as government spending declines the outlook for economic growth, especially in Europe, looks bleak for the near future. An imminent recession in the UK and the rest of Europe looks more likely every day.

In this economic environment, companies that can still deliver growth are scarce and scarcity often demands higher valuations. We saw this pattern during the 2008 downturn where a few sectors, such as luxury, agricultural and renewable energy, benefited from structural demand growth and outperformed the rest of the market, mostly driven by higher valuations and share prices to match.

We believe that the current market is similar in many respects and that in it will pay to invest in companies that can still show growth, preferably driven by structural changes in demand.

In order to limit our risks we search not only for future growth prospects, but also for companies that have a healthy growth track record. However, growth requires investments and investments need to be financed. With limited credit availability, we look for companies with healthy balance sheets and cash flow to be able to finance continued growth internally. To find the stocks that are driven by demand growth we should not only look at bottom line earnings growth, but also revenue growth which is equally important. Companies can grow earnings for a while by cutting costs, which could hurt future growth prospects. Companies that grow through organic sales demonstrate that there is a real demand for its products and services. This is the growth that we believe is scarce and warrants a premium valuation.

Our screen therefore looks for companies with decent historic and forecasted sales and revenue growth. Healthy cash flow growth and a strong balance sheet to support future investment is also important. Finally, we also prefer a growing dividend, to signal the management's confidence in the continuation of future growth. The companies fitting this description are likely be cash-rich and benefit from structural demand growth, driven by growing emerging markets wealth, changing digestive habits, an aging population and renewable energy.

We have run this search on the FTSE 350 and it gave us 25 candidates to choose from. From here we have done further fundamental research to find the companies that we believe are the best to deliver sustainable growth over the next 12 to 18 months and therefore outperform peers and the market.

Quality growth

			Price Change, %		Valuation			Growth, %			
Company	**Rec.**	**Price**	**1 month**	**3 months**	**P/E (e)**	**Yield %**	**Price/ Book**	**EPS (e)**	**Sales (e)**	**Debt/ Equity %**	**Dividend Coverage**
ARM Holdings	Buy	591.0	-8.4	10.8	53.7	0.6	7.8	25.5	19.5	0.0	2.2
Burberry Group	Buy	1,286.0	-6.0	2.1	20.9	1.9	6.5	28.6	21.9	23.6	2.5
GKN	Buy	192.7	1.3	6.3	9.2	3.3	2.0	18.6	12.6	45.2	3.8
Shire Pharmaceuticals	Buy	2,108.0	5.0	10.2	19.1	0.5	6.2	23.4	23.1	45.2	8.0
Weir Group	Buy	2,054.0	6.4	16.2	15.9	1.6	3.9	33.4	33.7	39.9	3.5

Source: HB Markets, company data, Bloomberg

ARM Holdings

Buy (591p)

Target
685p

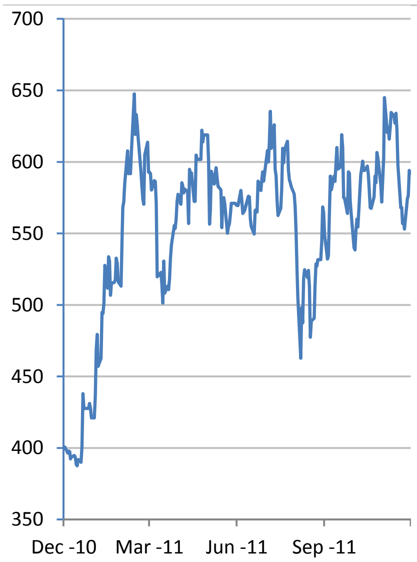
Market Cap
£7,986m

P/E est.
53.7x

Industry
Semiconductors

Ticker
ARM

Share price performance



Source: Bloomberg

Mobile data leader

ARM-based chips are used in around 10% of all mobile devices, including tablets and notebook computers, and the company expects this market share to rise to 15% by the end of 2011 and to 50% by 2015. ARM has good reason to feel optimistic.

Its core smartphone market keeps growing and its low powered chips are also being tested and used in tablets, PCs and even servers. Power consumption is at the very core and ARM's chips help extend battery life, reduce heat and reduce electricity bills.

Microsoft recently presented its next big operating system upgrade, Windows 8, running on a Samsung tablet powered by an ARM-based processor. The Windows platform, previously the playground for Intel and AMD, is another very large end market for ARM.

ARM also aims to break into the server market and especially with the cloud-based software providers such as Google, Facebook and Amazon. Again, ARM's low powered technology could provide significant costs savings. The focus on operating costs was evidenced by Facebook's recent announcement to build its new data centre in northern Sweden. The main reason – less cooling requirements in the relatively cool climate.

As ARM's business model is based around collecting royalty from licensing intellectual property to chip manufacturers, gross margins are very attractive. But more importantly, operating margins was a healthy 26% during 2010, up from mid-teens in the past years, and is expected to rise to above 30% in the next couple of years.

As solid structural demand drives the top line, the expected operating margin improvements multiplies into very healthy 23% earnings CAGR (compound annual growth rate) for the next two years. Trading on a high multiple it would not take a lot for the share price to tumble and the competition from Intel is fierce, but we believe ARM is on the path to become one of the really great technology companies.

Company description

ARM Holdings is the global leader in semiconductor intellectual property (IP). It designs and licenses IP for low-power processors and the ARM cores are the de-facto standard for embedded microcontrollers in mobile phones. 95% of all mobile phones sold today contain an ARM-based chip and the smarter the mobile is the more ARM chips it is likely to contain.
www.arm.com

Key financials

Year to December, £m	*2008*	*2009*	*2010*	*2011(e)*	*2012(e)*
Revenue	*298.9*	*305.0*	*406.6*	*474.8*	*537.4*
Gross profit	*266.1*	*279.6*	*380.5*	*n/a*	*n/a*
Operating profit (loss)	*63.0*	*38.2*	*105.7*	*178.4*	*222.1*
Net profit (loss)	*43.6*	*40.4*	*86.0*	*147.8*	*180.5*
EPS (p)	*3.4*	*3.1*	*6.4*	*11.0*	*13.2*
Net cash	*78.8*	*141.8*	*276.8*	*381.8*	*497.8*

Source: Company data, Bloomberg estimates

Burberry Group

Buy (1,286p)

Target
1,480p

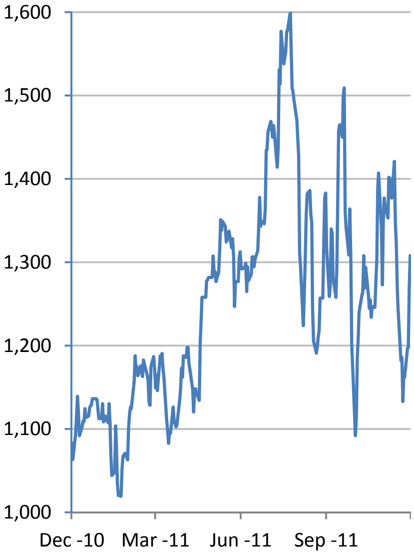
Market Cap
£5,640m

P/E est.
20.9x

Industry
Apparel, Accessories & Luxury

Ticker
BRBY

Share price performance



Source: Bloomberg

Structural emerging market wealth growth

When the rest of the world is slowing, governments are introducing new austerity measures on a weekly basis to keep bond markets happy, unemployment is rising and average disposable income is being eroded, the global luxury market is acting like it is immune. Swiss watch-makers are routinely publishing record sales figures and the last earnings season produced top-line growth of 24% y-o-y for the main European luxury players. Industry revenue is now 35% higher than before the financial crisis. This performance is clearly not a rebound but driven by structural growth.

As is the case in many areas of demand growth, emerging Asia accounts for 53% of the growth. However, the luxury story goes a bit deeper and the Americas produced a healthy 25% y-o-y organic top-line growth in Q3 and even crisis-struck Europe came in at +12% y-o-y. Much of the sales in luxury come from the tourism trade, so the sales in Europe and the Americas are naturally influenced by emerging markets tourism. However, the market segments the luxury companies are addressing are generally less sensitive to recessions, unemployment and austerity as the luxury players focus more on balance sheet wealth than customers with high income as the former group has proven to be more resilient. The strategy is clearly paying off, as we've seen strong growth in local customer demand in the US lately.

As one of the few beneficiaries of this structural growth in the UK market, in mid-November, Burberry reported a 26% increase in operating profit and 29% revenue growth for H1 2012. Burberry's focus on expanding its retail presence and digital marketing is likely to hold back operating margins in the short term, but it is already having a positive effect on the gross margins as they expanded 240bp (basis points) to 66.7% in the first half of the year. Operating margins in the retail/wholesale division increased 10bp.

At a 25% 2012 P/E premium to European peers, adjusted for Hermès' fantasy valuation, the stock may look expensive at first. However, the British luxury story is expected to grow even faster than peers by some margin, more than making up for the difference. As a rare play on emerging markets wealth creation and the resilience of western balance-sheet-rich we advise buying.

Company description

Burberry is a global luxury goods manufacturer, wholesaler and retailer. It designs, sources and markets men's, women's and children's luxury clothing and accessories globally through a diversified global network of retail, wholesale, franchise and digital commerce channels. It also licenses third parties to manufacture and distribute Burberry branded products.
www.burberry.com

Key financials

Year to March, £m	*2009*	*2010*	*2011*	*2012(e)*	*2013(e)*
Revenue	*1,201.5*	*1,185.1*	*1,501.3*	*1,854.0*	*2,098.2*
Gross profit	*665.8*	*761.2*	*1,009.7*	*n/a*	*n/a*
Operating profit (loss)	*166.0*	*219.8*	*301.2*	*376.9*	*439.3*
Net profit (loss)	*(6.0)*	*81.4*	*208.4*	*273.1*	*319.0*
EPS (p)	*(1.4)*	*18.4*	*46.9*	*61.5*	*71.5*
Net cash	*7.6*	*262.0*	*297.9*	*319.2*	*435.2*

Source: Company data, Bloomberg estimates

GKN

Buy (192.7p)

Target
220p

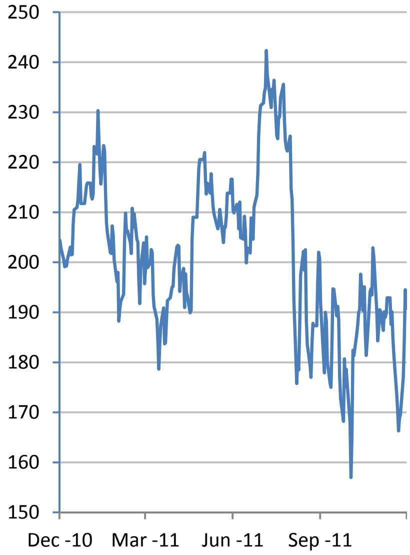
Market Cap
£2,993m

P/E est.
9.2x

Industry
Auto Parts & Equipment

Ticker
GKN

Share price performance



Source: Bloomberg

Quality pays

As a supplier to the automotive industry we would expect GKN's growth to be cyclical, but the aerospace division has acted as a diversifier. With cuts in defence spending expected to accelerate, a slowdown in the automotive sector could make earnings volatile going forward. However, as the military side of the aerospace business has slowed the civil market has recovered and with exposure to large platforms such as the Airbus A380 and Boeing 787, with strong and increasing demand from emerging markets and the middle east, aerospace could continue to provide a buffer with high visibility for GKN.

In addition, the automotive market has been surprisingly resilient throughout 2011, even though some European focused manufacturers were complaining about weakening demand in their last set of results, and we have seen reports of inventory adjustments. In a longer term perspective, affluent emerging markets consumers are yet again driving demand, especially in the premium segment, providing a structural growth element for GKN's business and the global auto market is set to continue its growth during 2012.

GKN's focus on quality engineering has allowed it to grow 200-300bp faster than the market and has resulted in a number of important programme wins over the last few years that have translated into improving market share.

Recent Q3 results were somewhat mixed with one-offs such as a £2-3m headwind from late Japanese recovery. Stripping these out, results were broadly in-line with expectations. Organic growth was particularly strong at +10% in the quarter with an order book pointing towards a similar performance in Q4.

Close to historic low valuations and on a significant discount to UK-listed industrials, GKN would not be a classified as a growth stock in its traditional sense. However, the company is expected to grow earnings by 19% CAGR over the next two years, which is considerably faster than its peers. If we add on a growth scarcity premium to the valuation, we see material upside to the current share price.

Company description

GKN is a global engineering group focusing on automotive, industrial services and aerospace. Operating in four divisions; automotive (43% of sales), powder metallurgy (13%), aerospace (29%) and land systems (15%), growth is driven by outsourcing, product substitution and market-share gains and outsourcing growth.
www.gkn.com

Key financials

Year to December, £m	*2008*	*2009*	*2010*	*2011(e)*	*2012(e)*
Revenue	*4,376.0*	*4,223.0*	*5,084.0*	*5,718.0*	*6,378.5*
Operating profit (loss)	*194.0*	*116.0*	*350.0*	*478.0*	*560.9*
Net profit (loss)	*-109.0*	*-36.0*	*305.0*	*310.6*	*378.2*
EPS (p)	*-11.7*	*-3.2*	*19.6*	*21.0*	*24.9*
Net debt	*651.0*	*320.0*	*155.0*	*97.7*	*106.2*

Source: Company data, Bloomberg estimates

Shire Pharmaceuticals

Buy (2,108p)

Target
2,380p

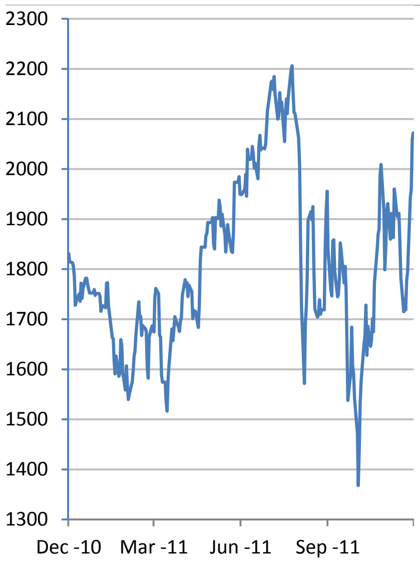
Market Cap
£11,857m

P/E est.
19.1x

Industry
Pharmaceuticals

Ticker
SHP

Share price performance



Source: Bloomberg

Strong product pipeline

The pharmaceuticals industry is a defensive sector with structural growth driven by themes like ageing populations and changing digestive habits in both mature and emerging markets. This puts industry revenues on a steady growth path. However, as large block-buster drugs come off patent, generic drug manufacturers start to produce cheaper alternatives, eroding margins. Large cap pharma are therefore forced to produce a constant pipeline of new drugs to defend revenues and earnings - something many of these companies have failed to do for years. As a result we have witnessed a general multiple compression in the industry, making a many large cap stocks look like value stocks.

In contrast to many peers, Shire Pharmaceuticals has managed to create a portfolio of products and a solid pipeline of new drugs, several of which could produce positive catalysts for the share in the next few quarters, as they get approval for new markets.

New drugs are forecasted to contribute to considerable sales growth over the next few years. The company reported strong Q3 results recently, reiterating its positive 2011 outlook, driven by better than expected Adderall XR and Dermagraft sales. The ADHD market grew 10% in Q3 and in the US; Vyvanse volume grew twice as fast.

Shire's success in ADHD treatments and its relatively recent entry into gastrointestinal indications (GI) has made Shire a prime takeover target. But its strong cash flow generation has strengthened its own firepower and enabled it to increasingly become an acquirer rather than the target, to support its organic growth.

The industry's structural growth and Shire's healthy product pipeline and considerably stronger than peers' sales and earnings growth underpins the valuation and warrants a significant valuation premium. And whilst cash strapped governments are trying to reduce healthcare spending, we believe Shire's growth prospects going forward will continue to warrant a scarcity premium, both in the industry and in the market.

Company description

Shire Pharmaceuticals is a specialty biopharmaceuticals company selling products in the areas of ADHD (attention deficit hyperactivity disorder), human genetics therapies and gastrointestinal diseases. The company's fastest growing products include Vyvanse (for ADHD treatement), Replagal (Fabry's disease) and Adderall XR (ADHD).
www.shire.com

Key financials

Year to December, £m	*2008*	*2009*	*2010*	*2011(e)*	*2012(e)*
Revenue	*3,022.2*	*3,007.7*	*3,456.3*	*4,232.1*	*4,767.4*
Gross profit (loss)	*2,614.2*	*2,619.7*	*2,992.9*	*n/a*	*n/a*
Operating profit (loss)	*664.7*	*626.1*	*819.9*	*1,241.8*	*1,461.8*
Net profit (loss)	*156.0*	*491.6*	*588.0*	*1,002.6*	*1,161.7*
EPS (p)	*28.6*	*89.7*	*105.3*	*172.7*	*198.4*
Net debt	*924.9*	*644.7*	*557.3*	*320.3*	*-392.4*

Source: Company data, Bloomberg estimates

Weir Group

Buy (2,054p)

Target
2,350p

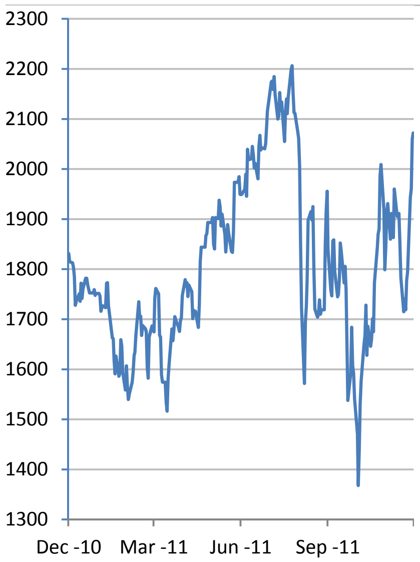
Market Cap
£4,341m

P/E est
15.9x

Industry
Industrial Machinery

Ticker
WEIR

Share price performance



Source: Bloomberg

Growing energy demand

The worst kept secret in the market is probably the never ending global demand for energy and the shortage thereof. In this environment a supplier to the sector such as Weir Group should have strong demand for its products and services. Indeed, recent years' results do not disappoint, with average revenue growth of 18% and operating earnings growing an impressive 40% on average over the last three financial years. Even during a generally very depressed 2009, Weir group reported 8% top-line and 9% operating income growth.

Recent comments from industry leader Halliburton expecting the pumping market to up capacity by 35% in 2012 bodes well for Weir Group's outlook, and indicates that the market keeps growing despite a weak global economic backdrop. And despite recent geopolitical tension in Iran we have not seen a sustained strong reaction in energy prices to a level where we start to witness demand destruction, which should be supportive for growth going forward.

Weir's recently announced US$675m acquisition of Seaboard Holdings drives Weir's upstream strategy in oil and gas forward and diversifies its position beyond pressure pumping, as Seaboard sells, rents and repairs surface wellhead equipment, primarily in the US market. The deal is expected to be completed during December 2011 and should be immediately earnings accretive. It should reduce Weir Groups earnings volatility, hence reduce its risk premium and justify multiple expansion.

For the next two years, Weir Group is expected to continue its strong growth by expanding earnings 25% CAGR, which is considerably more than what we can expect the overall market to report. It is also much stronger growth than what many other UK-listed industrial groups are likely to achieve. With this in mind and Weir's high margins and pricing power, the current premium valuation to peers is justified and could even be expanded, to reflect the rarity in Weir's growth and profitability profile in the UK market.

Company description

With a history dating back to 1871, Weir Group is an international engineering group focused on the manufacturing and services of pumps and valves. Weir Group operates in three segments: minerals, oil & gas and power & industrial. It employs 13,000 people in 70 countries around the globe.
www.weir.co.uk

Key financials

Year to December, £m	*2008*	*2009*	*2010*	2011(e)	2012(e)
Revenue	*1,353.6*	*1,390.2*	*1,635.0*	*2,145.4*	*2,497.6*
Gross profit (loss)	*423.5*	*455.2*	*617.3*	*n/a*	*n/a*
Operating profit (loss)	*166.5*	*185.3*	*286.4*	*391.5*	*461.4*
Net profit (loss)	*170.8*	*128.8*	*185.1*	*268.0*	*314.5*
EPS (p)	*80.9*	*60.8*	*86.9*	*129.2*	*152.6*
Net debt	*240.7*	*119.7*	*283.6*	*342.9*	*251.4*

Source: Company data, Bloomberg estimates

Recommendations

During the three months to 5th December 2011, the number of stocks on which HB Markets has published recommendations was 137, and the recommendations were as follows: Buy - 58; Speculative Buy - 11; Hold - 47; Sell - 21. Full definitions of the recommendations used by HB Markets in its publications and their respective meanings can be found on our website here.

Important Risk Warnings and Disclaimers

This report is published by HB Markets plc ("HBM"). HBM is Authorised and Regulated by the Financial Services Authority and is a Member of the London Stock Exchange.

This research is non-independent and is classified as a Marketing Communication under FSA rules. As such it has not been prepared in accordance with legal requirements designed to promote independence of investment research and it is not subject to the prohibition on dealing ahead of the dissemination of investment research in COBS 12.2.5. However HB Markets has adopted internal procedures which prohibit analysts from dealing ahead of non-independent research, except for legitimate market making and fulfilling clients' unsolicited orders.

RELIANCE ON THIS NOTE FOR THE PURPOSE OF ENGAGING IN ANY INVESTMENT ACTIVITY MAY EXPOSE AN INDIVIDUAL TO A SIGNIFICANT RISK OF LOSING ALL OF THE FUNDS, PROPERTY OR OTHER ASSETS INVESTED OR OF INCURRING ADDITIONAL LIABILITY.

By receiving this document, you will not be deemed a client or provided with the protections afforded to clients of HBM. When distributing this document, HBM is not acting for any recipient of this document and will not be responsible for providing advice to any recipient in relation to this document. Accordingly, HBM will not be responsible to any recipient for providing the protections afforded to its clients.

HBM may effect transactions in shares mentioned herein and may take proprietary trading positions in those shares, and may receive remuneration for the publication of its research and for other services. HBM may be a shareholder in any of the companies mentioned in this report. Accordingly, this document may not be considered as objective or impartial. Additionally, information may be available to HBM or the Group, which is not reflected in this material. The remuneration of the author of this report is not tied to the recommendations on any shares mentioned nor to the any transactions undertaken by HBM or any affiliate company. Further information on HBM's policy regarding potential conflicts of interest in the context of investment research and HBM's policy on disclosure and conflicts in general are available on request. Please refer to http://www.hbmarkets.com/important-info.

This document is not an offer to buy or sell any security or currency. This document does not provide individually tailored investment advice. It has been prepared without regard to the individual financial circumstances and objectives of persons who receive it. The appropriateness of a particular investment or currency will depend on an investor's individual circumstances and objectives. The investments and shares referred to in this document may not be suitable for all investors.

Past performance is not a guarantee of future performance. Investments may go down in value as well as up and you may not get back the full amount invested. The listing requirements for securities listed on AIM or PLUS markets are less demanding and trading in them may be less liquid than main markets.

This document is based on information HBM has received from publicly available reports and industry sources. HBM may not have verified all of this information with third parties. Neither HBM nor its advisors, directors or employees can guarantee the accuracy, reasonableness or completeness of the information received from any sources consulted for this publication, and neither HBM nor its advisors, directors or employees accepts any liability whatsoever (in negligence or otherwise) for any loss howsoever arising from any use of this document or its contents or otherwise arising in connection with this document (except in respect of wilful default and to the extent that any such liability cannot be excluded by the applicable law). This document is not to be relied upon and should not be used in substitution for the exercise of independent judgment.

This document includes certain statements, estimates, and projections with respect to the anticipated future performance of securities listed on stock exchanges and as to the market for these shares. Such statements, estimates, and projections are based on information that we consider reliable and may reflect various assumptions made concerning anticipated economic developments, which have not been independently verified and may or may not prove correct. No representation or warranty is made as to the accuracy of such statements, estimates, and projections or as to its fitness for the purpose intended and it should not be relied upon as such. Opinions expressed are our current opinions as of the date appearing on this material only and may change without notice. Other third parties may have issued other reports that are inconsistent with, and reach different conclusions from, the information presented in this report. Those reports reflect the different assumptions, views, and analytical methods of the analysts who prepared them. This report has not been disclosed to any of the companies mentioned herein prior to its publication.

The information contained in this document is confidential and is solely for use of those persons to whom it is addressed and may not be reproduced, further distributed to any other person or published, in whole or in part, for any purpose. Other persons who receive this document should not rely on it. HBM, its directors, officers and employees may have positions in the securities mentioned herein.

131 Finsbury Pavement,
London EC2A 1NT