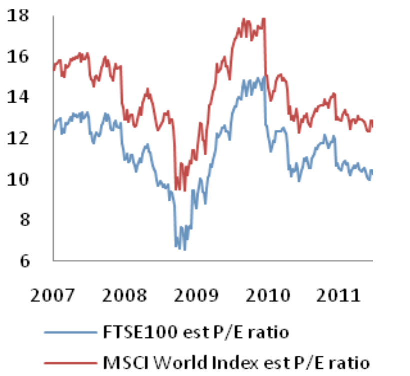
Tuesday, 17th January 2012

A dozen for twelve

FTSE-100

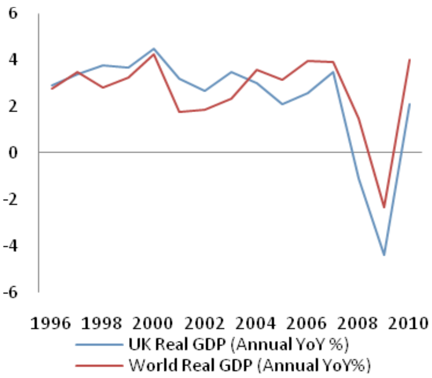
***Source**: Bloomberg*

Equity market valuation



*Source: **Bloomberg***

GDP growth



***Source**: Bloomberg*

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***Note:** All data is taken at close of business on Friday 13th January 2012*

Twelve stocks for the year 2012

- **Gloom abounds for 2012: according to many commentators, the Eurozone is about to implode under the weight of the sovereign debt crisis; Chinese growth is set to falter; the US needs more monetary stimulus; the UK is set on a course of fiscal austerity which may already have triggered recession.**

- **We beg to differ: a drop of almost 19% in the FTSE-100 from high to low last year (February to October) has already discounted to a large extent this year's recession. Equities anticipate global events typically by six months, and by June will be focusing on recovery in 2013. Superior returns are achieved by buying when all around is negative: canny investors are buying now.**

- One major turnaround factor, in our view, is the immense cash surplus of the global corporate sector (excluding financials). A McKinsey estimate recently put the cash surplus at around two trillion dollars. Although some of this will go into share buybacks, it will take only a modest recovery in business sentiment for a large proportion to be spent on new investment and on acquisitions.

- The problem, of course, is that sentiment will not recover as long as the eurozone crisis hangs over us. A lack of coherent economic leadership, a fragile banking system and diametrically opposed economic efficiencies in the constituent countries mean that the problem will still be around for all of the year ahead and into 2013 as well. We think that the solution lies in evolutionary steps towards fiscal union over a protracted period. Eventually markets will start to factor this in as a process rather than looking for a quick-fix solution.

- Our stock selection focuses on a range of criteria, including cash generation, inherent growth potential, and valuation. We have included some yield plays, and one of the gold majors as a hedge against setbacks to our central case. Finally, we include two small-caps with great potential.

A dozen stocks for 2012

Large- and mid-cap stocks	Ticker	Price (p)	P/E 2012 (e) (x)(	Yld 12(e) (%)	Mkt. Cap. (£m)
Arm Holdings	ARM	575	42.6	0.7	7,770
Barclays	BARC	201.2	6.3	3.8	24,545
BT(1)	BT/A	203.4	9.0	4.1	15,815
Centrica	CNA	283.0	10.3	5.8	14,640
Diageo(2)	DGE	1390	15.6	3.1	34,755
Petrofac	PFC	1554	13.2	2.7	5,375
Randgold Rsrcs	RRS	7115	15.6	0.7	6,494
Reed Elsevier	REL	522.0	11.1	4.2	6,320
Rolls Royce	RR/	762.5	14.1	2.5	14,238
Shire	SHP	2166	16.6	0.6	12,183
Small-cap stocks					
Kolar Gold	KGLD	14.1	-	-	13.9
Magnolia Petroleum	MAGP	0.91	-	-	5.1

Note: (1) Yr to March (2) Yr to June; all others based on fiscal year-end December
Source: Bloomberg consensus estimates

Outlook for 2012

The central risk: the euro

As summit meeting after dreary and ineffectual summit meeting on the debt crisis has shown, there is no single solution to Europe's debt crisis that can simultaneously meet economic needs and market expectations, while being palatable to voters and to political leaders who will need to seek re-election.

We think that there are four main elements that are required, namely:

- Credible fiscal rules for the future that will be binding on the 17 members of the eurozone, so that individual countries simply can't overspend and remain in the euro;

- Joint liability for euro-denominated sovereign debt – possibly with the ECB acting as guarantor for "Eurobonds". Understandably, this is anathema to the Germans;

- Commitment by the ECB to act as "lender of the last resort" to shore up liquidity and to nourish the waning appetite for sovereign debt – again fiercely resisted by the wealthiest eurozone economies;

- A proper structure of leadership for the eurozone akin to that which presides over the national central banks in the USA or other major western non-euro economies, vested with the authority to overrule individual political interests in all areas of monetary policy.

One should reflect, however, that the creation of the euro and monetary union started in 1969, with the recommendations of Luxembourg Prime Minister Pierre Werner, through the establishment of the EMS in 1979, to the reforms of Jacques Delors in the early 1990s, the Maastricht Treaty in 1992, and eventual adoption in 2002: 33 years from concept to implementation.

Fiscal union, with its much greater threat to national sovereignty, could be a good deal slower. So market hopes for either a quick-fix solution or as some commentators have called it, a "Lehman moment" (allowing one member state to become insolvent and exit the euro), as an instant panacaea for eurozone debt problems, are simply pie-in-the-sky.

We think that markets will eventually live with the notion of a long-term political process, and one which is likely to be interspersed with stress-tests during overall recessionary periods. The key point that aside from the austerity packages being implemented in Greece and Italy, much of the rest of the eurozone has a good chance of returning to growth – albeit at modest levels – in the second half of 2012. This alone will alleviate much of the stress and political angst being generated by the debt crisis, and might allow the Germans to give back a little more of the very considerable benefit they have extracted from the euro since its adoption.

The US economy in 2012

The most important point when considering the US economy is that deleveraging (reducing excess debt) has progressed further and faster over the last two years than it has done anywhere else in the developed world. The *Financial Times* noted recently that financial sector debt to GDP was back down to its 2001 level, while household debt to GDP was at its 2003 level. The critical housing market in the US is now very close to its bottom level in terms of both house prices and housing starts – quite a way ahead of where we feel the similar indicators would be in the UK cycle.

Economic data at the start of January has been encouraging too: Manufacturing numbers released at the start of the month showed the highest level for six months (measured by the ISM's headline index of manufacturing activity), with production, order books, and employment all suggesting a turning point in the economic cycle. US construction orders also exceeded expectations in the fourth quarter of 2011.

Finally, we would suggest two further wild cards. First, with US presidential elections this year, it is useful to note that in an election year, when typically a great deal is promised and spending is relaxed to boost jobs and growth, the US stock market usually goes up (eight out of ten times this has been the case in all election years since the 1920s). And secondly, do not overlook the possibility of a shock move by the Federal Reserve to boost growth for one last time. While the Fed disappointed markets in 2011, there is still a reasonable chance that it will announce a further round of quantitative easing (QE3) in H1 2012.

Overall, then, we expect the US markets to be supportive of equity markets in the UK over much of 2012.

China: a pull effect in 2012

Many commentators have cited the potential for a slow-down in growth in the Chinese economy as a drag on UK and European economies and their respective stock markets.

This is clearly another risk factor, but one which we also believe to be over-stated. It is true that growth in imports slowed to a 26-month low in the most recent figures, but still stood at + 11.8% y-o-y. We also note that for many key commodities, Chinese demand is still very strong. Copper imports stood at an all-time high of 500,000 tonnes (+50%), iron ore was 20% higher, and crude oil imports were also sharply higher. There is no slowdown in the rate of urbanisation in China, so we think that demand for materials for infrastructure and property development is likely to remain robust in 2012.

With inflation at a still modest 4% in China, we think that there is plenty of scope for economic policy to be fine-tuned to avert any significant slowdown in the rate of growth.

The UK

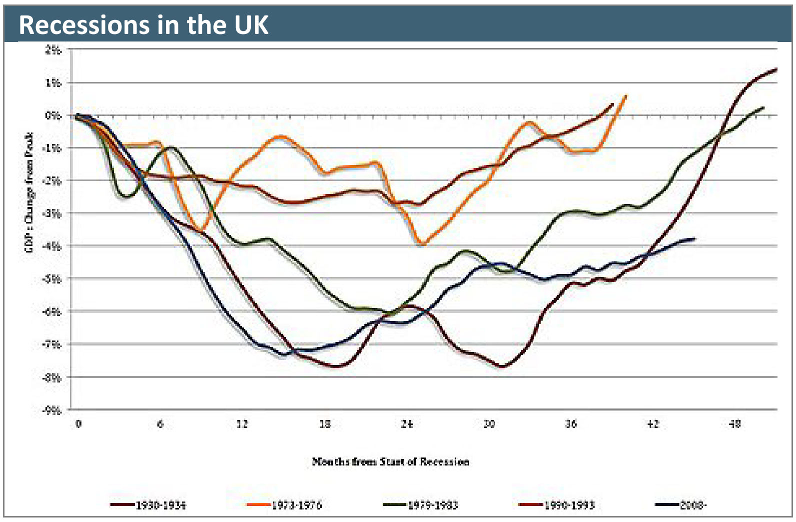
We enter 2012 quite possibly already in a recession, as markets await the next round of GDP data for Q1 to confirm the technical definition of two consecutive quarters of negative GDP progression.

Two of the leading experts have issued negative forecasts: in November, the National Institute of Economic & Social Research (NIESR) estimated a 70% risk of a double-dip recession, while the OECD has also predicted recession for the first-half of the year.

The central issue is that a return to recession greatly compounds the threat to recovery, which of course is already imperilled by the depth of the coalition's austerity measures, and particularly the tax rises and cuts to public sector spending. In addition, the overall objective of reducing the budget deficit is stymied as tax receipts fall further during a period of recession.

Technically (as measured by consecutive quarters of contraction on GDP or "negative growth") the UK's recession started in the spring of 2008 and ended in the summer of 2009. The British economy contracted by 7.1%. over the period. A further contraction in 2012 would thus create the phenomenon referred to by economists as a "double-dip."

The chart below (from NIESR) illustrates that the most recent recession is also the most long-lasting since economic record-keeping began, actually exceeding the time-span of the Great Depression of the 1930s.

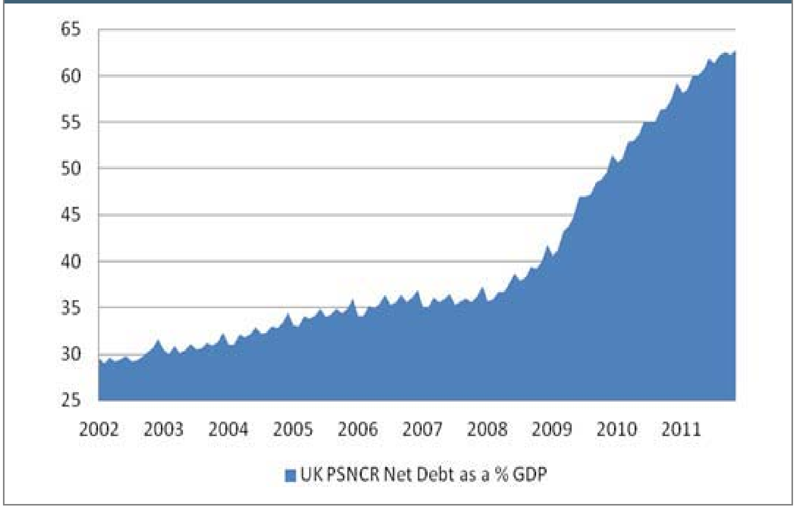


Source: NIESR

The great dilemma for the team advising Chancellor Osborne and the coalition government, is how far to tighten fiscal policy (raising taxes and cutting spending) in order to address the UK's debt burden, without strangling any recovery from the recession. The graph on the following page illustrates the extent of the debt problem, showing how the UK's net indebtedness has ballooned as a percentage of the overall economy.

The UK had one of the worst budget deficits in the EU in the last fiscal year, at more than 10% of GDP, ranking only slightly less extreme than Greece (10.5%), though the worst by far was Ireland (in excess of 30%).

UK net debt as % of GDP



Source:Bloomberg

The bright spots: We acknowledge that the British economic background doesn't look too conducive to a rally in equities. But it is important to understand that share prices will start to anticipate recovery as the year progresses, and that any positive news will encourage this sense of anticipation.

We believe that there are some bright spots beginning to emerge already, specifically:

- Output in the third quarter was a bit better than previously believed. Both business investment and construction output rose, rather than fell;
- Pockets of the economy are expanding: compare, for example the pre-Christmas statement of engineering firm Renishaw, which said that it expected to add 700 jobs in the UK over coming years;
- Despite the cut-backs in government spending, major projects such as the London to Birmingham high-speed rail link are being sanctioned;
- The 2012 Olympics will generate a significant influx of new business to the tourism, leisure and service sectors in the South East in the year ahead;
- Unemployment rises have been smaller than many economists expected.

Overall, then, we think that the mood in the UK stock market will be governed primarily by developments in the Eurozone, but if this does turn out to be a progressive solution negotiated in a tortuous political process – and not, as some fear, an untimely exit for Greece and any other of the high-deficit economies – then the stock market will look to the signs of recovery and will start to reflect the prospects for a stronger and healthier 2013.

The UK equity market is now trading on around 8.3x forward earnings, and there is absolutely no doubt that this is cheap by historical standards. At this rating it is likely the market may already be discounting further pressure on corporate earnings with any significant downside logically being linked to a further deterioration in European Government bond markets and hence the euro.

We think it is right to expect volatility in the first half of the year, but we expect the benchmark FTSE-100 to end 14% higher by the end of 2012. We have suggested a target of 6,400 for 2012, with further progress to 7,100 in 2013.

Key indicators

UK economy	2010	2011*	2012(e)	2013(e)
GDP growth y-o-y (%)	2.1	0.9	0.8	2.0
Inflation (CPI, y-o-y %)	3.3	4.5	2.7	2.2
Base rate, year-end	0.5	0.5	0.5	1.0
Unemployment (%)	7.9	8.0	8.6	8.7
US$ to £1	1.56	1.55	1.56	1.60
£ to €1	0.86	0.83	0.85	0.85
Equity markets				
FTSE-100	5,900	5,572	6,400	7,100
AIM All-Share	934	693	780	860

Note: 2011 figures estimated for GDP and inflation
Sources: NIESR, Bloomberg, HB Markets estimates (targets for equity indices)

ARM Holdings

Buy (575p)

Target
685p

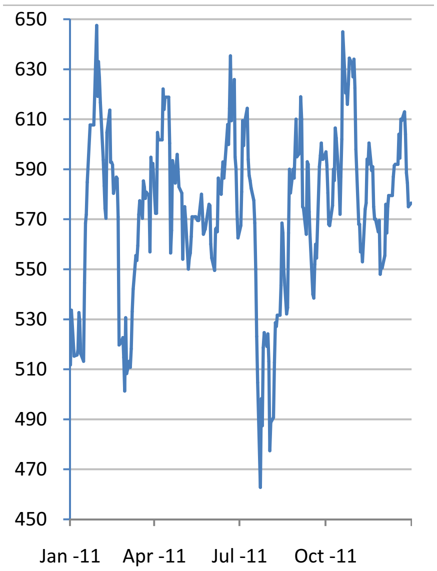
Market Cap
£7,878m

P/E est.
49.4x

Industry
Semiconductors

Ticker
ARM

Share price performance



Source: Bloomberg

Investment case:

- 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 the key, and ARM's chips help extend battery life, reduce heat and reduce electricity bills.

- Microsoft recently presented its next 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, offers immense potential 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.

- 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, the operating margin was a healthy 26% during 2010, up from the mid-teens in recent years, and is expected to rise to above 30% in the near future.

- 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. We believe ARM is on the path to become one of the really great technology companies.

- **Key risks:** cyclicality of the semiconductor industry; high valuation of the company leaves little room for any slowdown in growth or disappointments; income from royalties is growing more slowly than the booming licence sales.

The company:

- ARM has a dominant global position in the design of microchips using low power, for use in mobile devices. It is rapidly expanding into related markets, including microcontrollers, smartcards, PCs and servers.

- Headquartered in Cambridge, Arm was founded as recently as 1990. Since start-up, Arm has shipped over 15 billion microchips and sold over 700 processor licenses to more than 250 companies.. It earns royalty fees on every Arm-based chip sold, as well as generating revenue from its licences.

Key financials

Year to December, £m	*2008*	*2009*	*2010*	*2011(e)*	*2012(e)*
Revenue	*298.93*	*305.0*	*406.6*	*475.52*	*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*	*161.2*	*187.15*
EPS (p)	*3.4*	*3.1*	*6.4*	*11.8*	*13.5*
Net cash	*78.8*	*141.8*	*276.8*	*377.0*	*470.5*

Source: Company data, Bloomberg estimates

Barclays

Buy (201.2p)

Target
235p

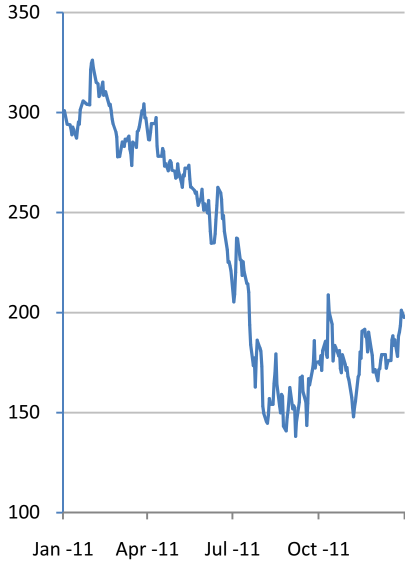
Market Cap
£24.3bn

P/E est.
7.5x

Industry
Banking

Ticker
BARC

Share price performance



Source: Bloomberg

Investment case

- On the back of the financial crisis of recent years, the sector is undergoing major structural changes that boil down to deleveraging and increased regulation, both having a negative impact on the sector's profitability and growth prospects. Nevertheless, we believe Barclays could be a beneficiary of the consequential consolidation and any positive signs from the European sovereign debt crisis.

- In investment banking, clients search for scale and strong balance sheets in order to reduce counterparty risks. Just last week, RBS closed its cash equities, corporate broking and M&A operations, leaving more business for competitors. Smaller rivals are also withdrawing from the scene in the face of tougher regulation. We believe Barclays, with a relatively strong balance sheet, economies of scale and available risk capital to be in a good position to take advantage of this consolidation, with the possibility of wider margins as competition decreases. This could be a major driver for a re-rating of Barclays going forward.

- BarCap, Barclays investment banking division, is particularly strong in FICC (fixed income, currency and commodities). However, the division's weak spot is equities. The US equities division is in reasonable shape following the purchase of Lehman Brother's US operations, but in Europe and Asia BarCap is in a weaker position. Barclays cost-income ratio is higher than its peers', partly driven by investment in the equities division. We believe Barclays has some flexibility here and earnings could therefore benefit from internal consolidation in the division.

- Equally important for Barclays' share price is the recovery potential. The stock is trading on a 22% 2013 P/E discount and this year's discount is even wider at 33%, pricing in too much sovereign debt risk, in our opinion. If there were positive signs of a reasonable solution to the Pan-European sovereign debt crisis, we believe this discount could be reduced substantially. In this scenario Barclays is our preferred play in the sector as it is in stronger shape than RBS and Lloyds and provides a bigger recovery potential compared to HSBC, Standard Chartered and insurers.

- **Key risks**: A deepening European sovereign debt crisis; weakening consumer credit quality; increased regulation.

The company

Barclays provides retail banking (14% of revenue), credit cards (12%), corporate (9%), investment banking (42%) and wealth management (5%) services in the UK (44%), US (19%) the rest of EU (15%), Africa (13%) and the rest of the world (9%).

Key financials

Year to March, £m	*2009*	*2010*	*2011*	*2012(e)*	*2013(e)*
Net Interest Income	*12,149*	*11,974*	*n/a*	*n/a*	*n/a*
Gross profit	*n/a*	*n/a*	*n/a*	*n/a*	*n/a*
Operating profit (loss)	*2,383.00*	*4,370.00*	*6,040.00*	*9,996.57*	*9,914.14*
Net profit (loss)	*4,382.00*	*9,700.00*	*3,564.00*	*3,411.74*	*4,007.41*
EPS (p)	*57.5*	*81.6*	*28.5*	*26.4*	*31.8*
Net cash	*214,898.00*	*113,953.00*	*126,284.00*	*n/a*	*n/a*

Source: Company data, Bloomberg estimates

BT

Buy (203.4p)

Target
230p

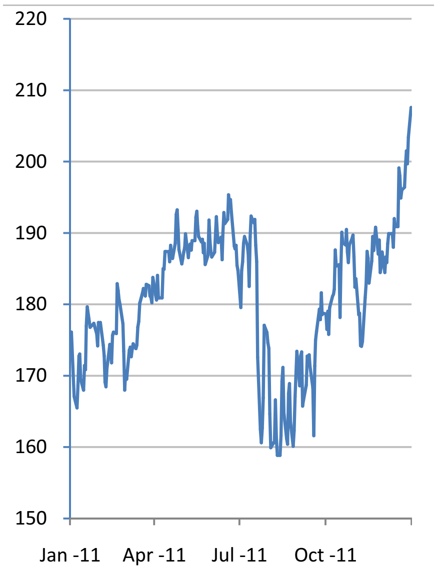
Market Cap
£16.14bn

P/E est.
9.2x

Industry
Telecoms

Ticker
BT/A

Share price performance



Source: Bloomberg

Investment case

- BT Group has invested considerable capital and years building its 21st-century fibre network, which is starting to pay dividends. Openreach, its wholesale division, now provides 80% of the capacity to the UK's retail broadband market.
- The fibre upgrade cycle improves network speeds and quality of service and puts fibre at a higher price point, compared to copper, with consequential margin improvements. Fibre revenue is almost double that of copper and will be a major driver of growth for BT. Despite this, consensus estimates are for flat sales, due in part to a conservative guidance from the management.
- BT's strong focus on cost control provides downside protection and with its pricing power we believe estimates look cautious and could very well be subject to upgrades. We have seen modest upgrades over the last few months. There should be more to come, providing catalysts for the share price. Once fibre investments start to reduce beyond 2014, we should also see cash generation to improve dramatically, giving further support to the shares.
- BT trades on a 25% 2012 P/E discount to the UK telecom sector. With one of the sector's highest operating margins (15%), a well covered (2.1x) dividend yield (4.7%) and the likely earnings uplift from fibre, we believe BT is undervalued. It currently represents our favourite stock in the telecom sector for 2012.
- **Key risks**: An increase of the rate of copper line loss due to increased mobile broadband or cable competition would be negative to BT's cash flow. LTE (4G) technology could have a negative pricing impact on BT's copper and fibre network. Sustained inflation would worsen the pension deficit and a negative pension review mid 2012 is likely to have a negative impact on earnings and the share price.

The company:

BT provides domestic and international telephone services, network solutions, web hosting and broadband access to retail, corporate, public sector clients around the UK (76% of revenue) and internationally (24%). Global services (44%) provides managed IT services for large corporate and public sector clients. Retail (36%) provides phone, broadband and TV services to businesses and residential customers. Wholesale (16%) runs BT's networks and sells network access, services and solutions to competing telecom operators. Openreach (7%) is responsible for the last mile and the company's fibre broadband network roll-out.

Key financials

Year to March, £m	*2009*	*2010*	*2011*	*2012(e)*	*2013(e)*
Revenue	*21,390.00*	*20,911.00*	*20,076.00*	*19,434.24*	*19,291.35*
Operating profit (loss)	*n/a*	*n/a*	*n/a*	*n/a*	*n/a*
Net profit (loss)	*739.00*	*2,555.00*	*2,907.00*	*3,015.09*	*3,154.46*
EPS (p)	*-193.00*	*1,028.00*	*1,502.00*	*1,753.17*	*1,865.18*
Net debt	*-0.0250*	*0.1290*	*0.1850*	*0.2250*	*0.2410*

Source: Company data, Bloomberg estimates

Centrica

Buy (283p)

Target
325p

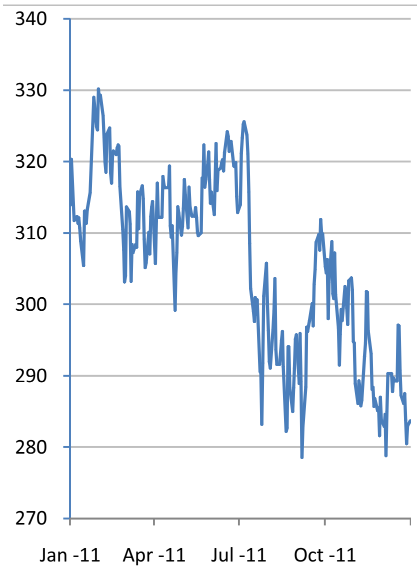
Market Cap
£14.6bn

P/E est.
11.0x

Industry
Utilities

Ticker
CNA

Share price performance



Source: Bloomberg

Investment case

- Centrica and SSE replied to EDF Energy's price reduction last week. Whilst the headline may be negative, it is an anticipated move and should ease the political pressure on energy providers in the UK to help lessen the burden for cash strapped UK consumers.
- The price reductions come after recent declines in UK gas and power prices which are positive for Centrica's downstream margins, offsetting the price cuts.
- In a difficult and capital intensive sector such as utilities that is faced by economic headwinds, investors should focus on strong balance sheets and improving operating performance. Centrica scores highly on these metrics, with net debt to EBITDA around 1x and peers just below 4x.
- This significantly reduces the financial risk in Centrica compared to peers and it provides flexibility to continue to invest in the business. The unique business of British Gas should therefore be able to capitalise on its strong position and take market share in this difficult environment.
- Despite a strong balance sheet providing flexibility, best in class return on assets (10%) and a comfortably covered (2.5x) high dividend yield (5.7%), Centrica currently trades on a 22% P/E discount (10.8x v 12.8x 2012 EPS) to peers. We believe this is unwarranted and argue there is scope for significant multiple expansion.
- **Key risks**: The price cuts started by EDF could develop into an unproductive price war in search for larger market share. In the longer term there is always a risk the UK regulators are not satisfied with the action taken by the industry and impose further price regulation. Falling energy prices is another risk to the Centrica share price.

The company:

Centrica is an integrated energy company sourcing, generating, processing, trading and storing energy. It operates four divisions: British Gas (downstream UK, 57% of revenue), Centrica Energy (upstream UK, 16%), Centrica Storage (UK, 1%) and Direct Energy (North America, 26%).

Key financials

Year to December, £m	*2008*	*2009*	*2010*	*2011(e)*	*2012(e)*
Revenue	*20,872.00*	*21,963.00*	*22,423.00*	*21,664.11*	*23,192.11*
Gross profit (loss)	*4,208.00*	*4,300.00*	*4,828.00*	*n/a*	*n/a*
Operating profit (loss)	*1,983.00*	*1,804.00*	*2,187.00*	*2,397.55*	*2,715.46*
Net profit (loss)	*-137.00*	*844.00*	*1,935.00*	*1,316.56*	*1,400.77*
EPS (p)	*-3.3*	*16.4*	*37.3*	*25.7*	*27.6*
Net debt	*546.00*	*3,312.00*	*3,546.00*	*3,425.53*	*3,482.87*

Source: Company data, Bloomberg estimates

Diageo

Buy (1,390p)

Target
1,600p

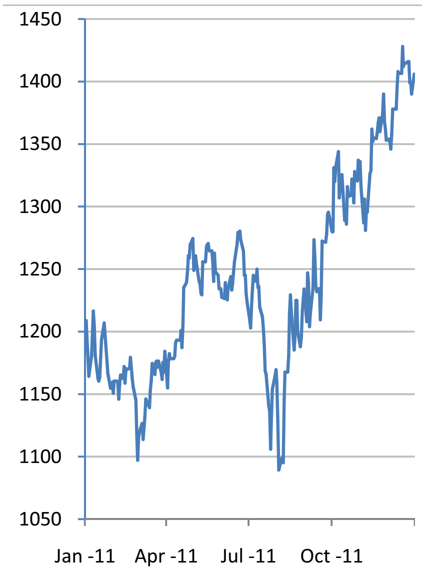
Market Cap
£35.2bn

P/E est
15.8x

Industry
Beverages

Ticker
DGE

Share price performance



Source: Bloomberg

Investment case

- Our recommendation on Diageo is based on three central factors: first, the relative stability of growth and earnings. At its last analysts' conference, Diageo committed to average organic top-line growth of 6% per annum, organic operating margin improvement, with the first 200 basis points to be achieved in the next three years, and double-digit EPS growth. While this appears ambitious, we believe that Diageo has the range of brands, global penetration and marketing prowess to achieve at least a significant proportion, if not all of this growth.

- Secondly, Diageo's organic sales growth has historically tracked very closely the rate of overall growth in the world economy. If we are correct in anticipating recovery in world economies from the second half of 2012 onwards, we believe that share price performance will reflect the growing feasibility of Diageo's stated growth targets.

- Thirdly, we admire the levels of exposure which Diageo offers to consumer trends in emerging markets. Africa (£1.0bn of sales in 2011), Latin America (£1.3bn) and Asia Pacific (1.4bn) in aggregate represent around 35% of Diageo's global sales.

- Given its brand quality, market leadership (globally ahead of other major beverage producers such as Pernod, LVMH and Remy Cointreau in spirits) and market penetration, we think the stock looks attractively prices at the current P/E and with a dividend yield in excess of 3%.

- **Key risks:** A return to recession in the USA; continuing economic turmoil in Europe; long-term unrest in Nigeria (for the Guinness brand).

The company:

- Diageo is a leading premium drinks business with an array of well-known beverage brands across spirits, beer and wine. These include Johnnie Walker, Crown Royal, J&B, and Bushmills whiskies, Smirnoff, and Ketel One vodkas, Baileys, Captain Morgan, Jose Cuervo, Tanqueray and Guinness.

- Diageo trades in 180 markets worldwide and employs a total headcount of 20,000 staff.

Key financials

Year to June, £m	*2009*	*2010*	2011	2012(e)	2013(e)
Revenue	*9,311.00*	*9,780.00*	*9,936.00*	*10,669.46*	*11,304.52*
Gross profit (loss)	*5,418.00*	*5,681.00*	*5,926.00*	*n/a*	*n/a*
Operating profit (loss)	*2,477.00*	*2,612.00*	*2,880.00*	*3,161.35*	*3,472.44*
Net profit (loss)	*1,605.00*	*1,629.00*	*1,900.00*	*2,209.70*	*2,460.42*
EPS (p)	*0.6440*	*0.6540*	*0.7600*	*0.8920*	*0.9890*
Net debt	*7,661.00*	*7,311.00*	*6,611.00*	*7,095.40*	*6,058.16*

Source: Company data, Bloomberg estimates

Petrofac

Buy (1,554p)

Target
1,800p

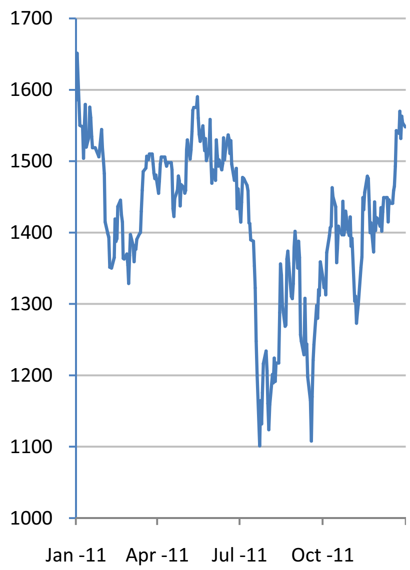
Market Cap
£5.4bn

P/E est.
13.2x

Industry
Oil services

Ticker
PFC

Share price performance



Source: Bloomberg

Investment case:

- Petrofac is a high-growth company within the oil services sector. In 2003 the group was achieving sales of US$711m, and by 2012 should be on course to achieve almost US$6.5bn – multiplying by around nine times in just a decade. Its stated growth target now is to double its earnings by 2015 relative to the US$558m made in the last reported financial year (December 2010), achieving double-digit growth each year to 2015.

- Petrofac's fastest-growing division is its Integrated Energy Services business, which includes production-sharing contracts and "production enhancement contracts". In these businesses it typically enjoys a share of the revenue as operator from the oil field. Important new contracts in this division are underway in Malaysia, Russia, Indonesia and Mexico.

- A collaboration agreement with Schlumberger – announced earlier this month holds out much promise. Schlumberger has particular expertise in sub-surface engineering, which complements well the acknowledged expertise of Petrofac in surface design and installation. It looks like a good marriage.

- At the interim 2011 stage, Petrofac had an order backlog of US$11.4bn, representing approximately 31 months of revenue at current rates. This gives a good deal of security to the revenue and earnings outlook for this company.

- **Key risks:** sensitivity of new orders to the oil price and to the viability of difficult and often inaccessible petroleum deposits for the major oil companies; operations often in hostile and dangerous geographical locations; dangers of oil spills with economic and environmental consequences; relatively high rating of stock (for the oil industry) leaves little room for any disappointments for shareholders.

The company:

- Petrofac designs and builds oil & gas facilities; its services include operating, maintaining and managing facilities and training personnel. It can also develop and co-invest in upstream and infrastructure projects, and is active in both offshore and onshore sectors.

- Founded in 1981 in Texas, USA, the company now has 27 offices worldwide and employs a total headcount of some 15,000 employees Petrofac's operational centre is in Aberdeen, with corporate HQ in London.

Key financials

Year to December, US$m	2008	2009	2010	2011(e)	2012(e)
Revenue	*3,329.54*	*3,655.43*	*4,354.22*	*5,736.44*	*6,469.13*
Gross profit	*552.88*	*617.18*	*759.08*	*n/a*	*n/a*
Operating profit (loss)	*357.57*	*432.42*	*541.79*	*654.50*	*778.83*
Net profit (loss)	*264.99*	*353.60*	*557.82*	*523.67*	*624.80*
EPS (p)	*77.11*	*103.19*	*162.46*	*151.90*	*181.00*
Net cash	*561.52*	*1,331.05*	*1,017.69*	*933.91*	*692.40*

Source: Company data, Bloomberg estimates

Randgold Resources

Buy (7,115p)

Target
8,200p

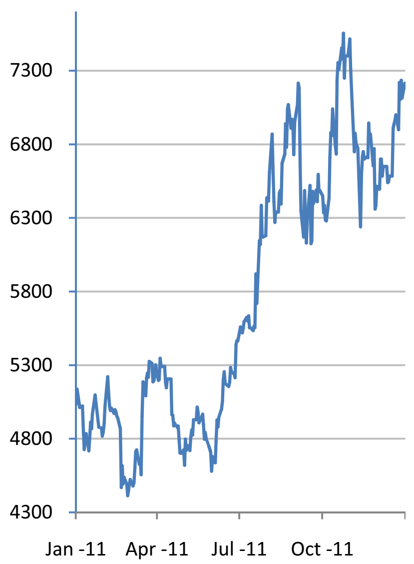
Market Cap
£6.6bn

P/E est.
15.6x

Industry
Gold mining

Ticker
RRS

Share price performance



Source: Bloomberg

Investment case

- The gold price performed stunningly for a large part of last year, rallying 45% between the end of January to a peak of US$1,900/oz. in early September, before falling back sharply again to close the year at US$1,600/oz. Gold remains the ultimate hedge, and the presence of Randgold in our preferred list reflects the risk of any worsening in the Eurozone credit situation or a major setback to the global economy from any other source.

- Randgold also had a stuttering start to the year 2011, with its share price trading in a range during the first six months as the mines suffered various operational problems related to the weather, then labour stoppages, and finally a major mechanical failure. However, it too managed a 46% rally between end-June and its peak in the fourth quarter.

- We take the view that if our relatively benign outlook for equities in 2012 is correct, then gold miners generally will not lead the market higher. Rather, it will be the cyclical industrials, banks and those which benefit most from a return of consumer confidence. But we would expect the first half of the year to be punctuated by significant volatility, and this may provide the impetus for the gold price to return to the US$1,800 – US$1,900 range. Thus we see Randgold primarily as a trading opportunity.

- **Key risks:** sensitivity of the gold price and inverse correlation to global macro-economic conditions; operational risks associated with the mining industry; geo-political risks of operating in Africa.

The company:

- Randgold Resources is an African-focused gold-mining and exploration company with listings on the London Stock Exchange and Nasdaq. Three of its major resource sites, totalling almost 20 million ounces, are in Mali, with a further 4 million ounces in the Côte d'Ivoire and 3 million ounces in eastern Senegal.

- Randgold also has an extensive portfolio of organic growth prospects, which is constantly replenished via exploration programmes in Burkina Faso, Côte d'Ivoire, DRC, Mali and Senegal.

Key financials

Year to December, US$m	*2008*	*2009*	*2010*	*2011(e)*	*2012(e)*
Revenue	*338.57*	*432.78*	*484.55*	*1,185.17*	*1,692.33*
Gross profit	*139.05*	*183.15*	*204.13*	*n/a*	*n/a*
Operating profit (loss)	*75.94*	*113.76*	*136.14*	*520.67*	*949.83*
Net profit (loss)	*41.57*	*69.40*	*103.50*	*397.78*	*661.56*
EPS (p)	*54.00*	*84.00*	*113.00*	*408.40*	*693.30*
Net cash	*251.84*	*603.26*	*379.33*	*542.80*	*949.60*

Source: Company data, Bloomberg estimates

Reed Elsevier

Investment case

Buy (522p)

Target
610p

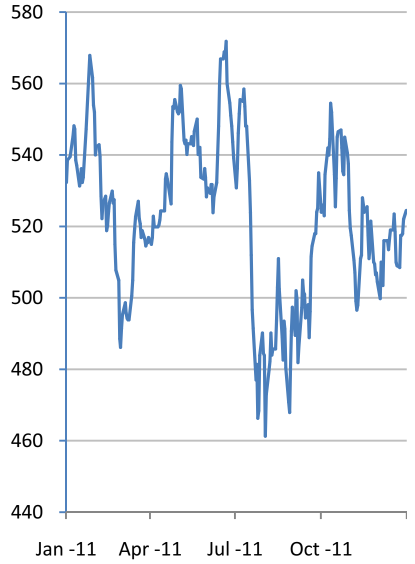
Market Cap
£6.3bn

P/E est.
11.1x

Industry
Publishing

Ticker
REL

Share price performance



Source: Bloomberg

- Reed Elsevier, and in particular its legal publishing business, LexisNexis, suffered in the aftermath of the financial crisis 2008 and investors quickly de-rated the stock from being a relatively safe publisher, with consumer-staples-like investment characteristics, to being much more cyclical. The downturn of 2008 and the following redundancies experienced in financial services and related industries, we argue, were exceptional and the de-rating was therefore much overdone.

- Reed has also had some trouble communicating with its investors over the last few years, which amongst other things led to the company's long-standing CFO Mark Armour announcing his retirement during the autumn 2011. With the last few investor events, market communication has improved, and we can now see evidence that the legal information business is solid. Also the view of Reed as a defensive publisher is slowly returning. This should imply multiple expansion of around 25% (Reed 10.4x v consumer staples 12.9x).

- Reed has a diversified high quality portfolio of assets, strategically moving away from print to digital media, that is steadily improving operating momentum. Business publishing and exhibitions have both shown improvements, being helped by a recovery in professional headcount. Longer term Reed is also well placed to capture emerging markets (currently around 10% of revenue) growth as professional services in these markets develops.

- We believe consensus growth expectations are too pessimistic, and combined with the possibility of multiple expansion, the stock has considerable relative upside potential.

- **Key risks**: The company has been acquisitive and despite a strong track record there is always a risk that Reed overpays for an entity. As around 30% of the business is cyclical a downturn will have a negative impact. The risk business is particularly vulnerable in a downturn as it is transaction related. The emerging open access publishing model is a long-term threat to its science publishing business.

The company:

Reed Elsevier is a publisher and information provider active in scientific, technical and medical publishing (Elsevier 34% of revenue), legal tax and risk information and analytics (LexisNexis: legal 27%, risk solutions 16%), exhibitions (11%), B2B publishing (12%). The company is dually listed in London and Amsterdam and derives 54% of revenue from the US, 30% from Europe and 16% from the rest of the world.

Key financials

Year to December, £m	*2008*	*2009*	*2010*	*2011(e)*	*2012(e)*
Revenue	*5,359.88*	*6,060.47*	*6,055.00*	*6,022.29*	*6,260.48*
Gross profit	*3,434.76*	*3,811.85*	*3,846.00*	*n/a*	*n/a*
Operating profit (loss)	*886.80*	*770.04*	*1,068.00*	*1,587.08*	*1,676.58*
Net profit (loss)	*468.12*	*390.37*	*642.00*	*1,040.27*	*1,122.53*
EPS (p)	*n/a*	*n/a*	*n/a*	*45.90*	*49.10*
Net debt	*5,686.51*	*3,947.50*	*3,560.00*	*3,320.06*	*2,764.50*

Source: Company data, Bloomberg estimates

Rolls Royce

Buy (762.5)

Target

885p

Market Cap

£14.3bn

P/E est.

14.1x

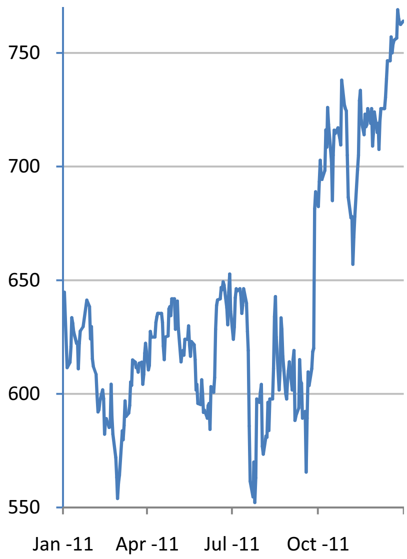
Industry

Engineering

Ticker

RR/

Share price performance



Source: Bloomberg

Investment case

- Rolls-Royce provides high quality aerospace exposure with solid market share growth, emerging markets exposure and a strong management that seems to be in tune with the markets.
- The Asian and middle east markets are growing in importance at RR and now accounts for nearly half of its £61bn order book. RR is well placed, compared to peers, to take advantage of the structural growth opportunities. In addition, the region also provides attractive diversification benefits as it is relatively less affected by global economics and European austerity programmes than RR's traditional home markets.
- The management's focus on improving execution and cutting costs to reduce earnings volatility has struck a chord with the market and the stock has enjoyed a string of positive earnings revisions. As the year progresses, we believe the benefits of this strategy along with further market share gains will continue to drive positive revisions.
- The $1.5bn disposal of its IAE stake in October was more welcomed news by the market as RR's exit from the difficult Airbus engines alliance with Pratt & Witney improved visibility.
- For 2012, new aircraft order flow, and especially for Boeing 787 and Airbus A380, is likely to propel RR to new highs. And with best in class return on assets (+10%), one of the industry's least leveraged balance sheets, RR provides relatively high quality growth opportunities that are likely to be greatly rewarded by the market on positive order news. In addition to the management's steps to de-risk the top-line, the well covered dividend yield of 2.6% provides another supportive feature for the share price.
- Key risks: Further cuts in defence spending as austerity stricken governments bow to market demands; worsening global economic climate; a weaker US$ is likely to hurt RR's margins. Any large contract loss would also be viewed negatively.

The company:

Rolls-Royce provides power systems and services for use on land, at sea and in the air through its four divisions: civil aerospace (45% of revenue), defence aerospace (20%), marine (24%) and energy (11%). The company designs, constructs and installs systems and equipment in the USA (28%), the UK (14%), the rest of Europe (22%), Middle East (14%), China (8%) and the rest of the world (14%).

Key financials

Year to December, £m	*2008*	*2009*	*2010*	*2011(e)*	*2012(e)*
Revenue	*9,082.00*	*10,414.00*	*11,085.00*	*11,414.64*	*12,800.27*
Gross profit	*1,804.00*	*2,111.00*	*2,200.00*	*n/a*	*n/a*
Operating profit (loss)	*781.00*	*1,081.00*	*1,037.00*	*1,173.87*	*1,423.80*
Net profit (loss)	*-1,340.00*	*2,221.00*	*539.00*	*828.33*	*1,018.19*
EPS (p)	*-73.63*	*119.09*	*28.82*	*45.20*	*53.80*
Net cash	*1,148.00*	*1,624.00*	*1,585.00*	*300.86*	*1,313.56*

Source: Company data, Bloomberg estimates

Shire

Buy (2,166p)

Target
2,500p

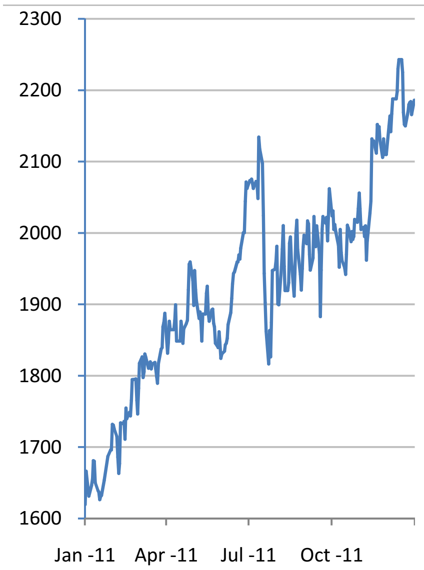
Market Cap
£12.3bn

P/E est.
16.8x

Industry
Pharmaceuticals

Ticker
SHP

Share price performance



Source: Bloomberg

Investment case

- As the pharmaceuticals industry struggles with generic competition when block-buster drugs come off patent, Shire has an enviably positioned product portfolio producing best in class top and bottom line growth rates. In addition, new drugs are forecasted to contribute to considerable sales growth over the next few years. When the company reported strong Q3 results recently, it reiterated its positive outlook going forward.

- In contrast to many peers, Shire Pharmaceuticals has managed to create 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.

- 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.

- Shire's healthy product portfolio provides considerably stronger than peers' sales (14.9% v 8.7%) and earnings (15.5% v 12.7%) growth, which underpins the valuation and warrants a significant premium (38% on next year's earnings). And whilst cash strapped governments are trying to reduce healthcare spending, we believe Shire's relatively sheltered growth prospects will continue to warrant a scarcity premium, both to the industry and to the market.

- **Key risks**: New drugs failing to get regulatory approval is a major risk to Shire's future cash flow and share price. Generic competition and governments' objective to reduce health care spending could put further pressure on the pharmaceuticals industry's and the company's margins. As Shire balance sheet grows stronger the company could be tempted into value destructive acquisitions.

The company:

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).

Key financials

Year to December, US$m	*2008*	*2009*	*2010*	2011(e)	2012(e)
Revenue	*3,022.20*	*3,007.70*	*3,456.30*	*4,233.81*	*4,775.14*
Gross profit (loss)	*2,614.20*	*2,619.70*	*2,992.90*	*n/a*	*n/a*
Operating profit (loss)	*664.70*	*626.10*	*819.90*	*1,256.00*	*1,472.88*
Net profit (loss)	*156.00*	*491.60*	*588.00*	*1,005.40*	*1,167.30*
EPS (p)	*28.60*	*89.70*	*105.30*	*173.20*	*199.30*
Net debt	*924.90*	*644.70*	*557.30*	*322.90*	*-375.95*

Source: Company data, Bloomberg estimates

Small-cap stocks

Kolar Gold

Buy (14.1p)

Target
20p

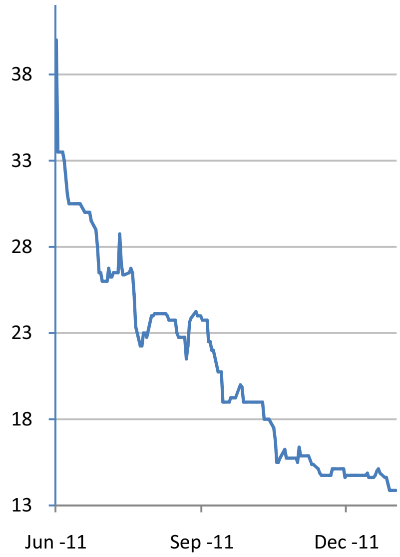
Market Cap
£13.9m

P/E est
n/a

Industry
Gold mining and exploration

Ticker
KGLD

Share price performance



Source: Bloomberg

Investment case

- Unusually among the junior miners, Kolar Gold targets a resource which is known to contain extensive resources and was successfully mined from the nineteenth century until 2001, (when gold averaged US$270/oz), at which point it was deemed uneconomic.
- The Kolar Gold Projects consist of a 100% economic interest in one granted Prospecting Licence (GP13) in South Kolar (in the southern Indian state of Karnataka), together with applications for six prospecting licences, four mining leases and three reconnaissance permits.
- The company expects to have a JORC-compliant resource statement demonstrating resources of one to two million ounces within the next two years. The resource has been described in the Competent Person's Report on Kolar as "one of the most prospective and yet undeveloped Greenstone Belts in the world".
- In our view, this is an early-stage mining company with a very high prospect of realising considerable scale and scope, and we would not argue with the company's broker, which has described the Kolar opportunity as like "walking into the Eastern gold fields of Western Australia in the 1970s, which led to the third and largest gold boom in Australia" (**source:** Ocean Equities May 2011);
- **Key risks:** political opposition, bureaucracy or other delays to the award of licences in India; risks of disruption to the joint venture with former employees of the discontinued mines; volatility of the gold price which could reduce the attractiveness of the prospects.

The company:

- Kolar Gold focuses on the Kolar Gold Field region to the east of Bangalore in India, once operated by Bharat Gold Mines Limited (BGML), in joint venture with the local workforce and community. In partnership with Geomysore Services India (GMSI) it is also developing the potential resources which surround and are adjacent to the Kolar Gold Fields.
- Kolar Gold Projects include options on 32 known mineralised projects including two historic mines and covering 297 sq km.

Key financials

Year to June, £m	**2011**	**2012(e)**
Operating profit	*-3.22*	*-1.20*
Net profit	*-3.26*	*n/a*
EPS	*-5.69*	*-1.20*
Net cash	*11.54*	*5.10*

Source: Company data, Bloomberg estimates

Magnolia Petroleum

Buy (0.91p)

Target
3.0p

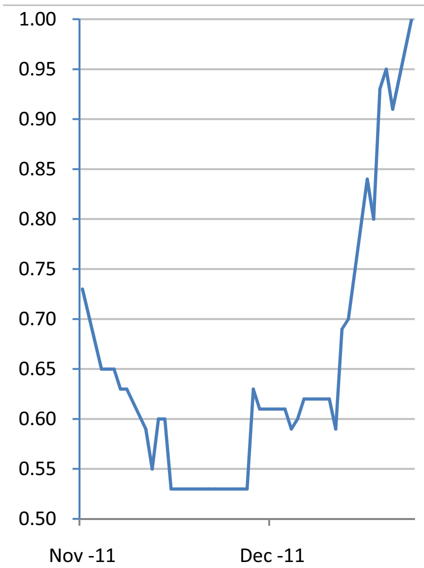
Market Cap
£5.1m

P/E est
n/a

Industry
Oil exploration and production

Ticker
MAGP

Share price performance



Source: Bloomberg

Investment case

- Magnolia has small working interests in 64 oil or gas producing properties, and in more than 90,000 acres under exploration. Significantly, it has exclusive rights to develop further prospects covering 21,000 acres in the Mississippi Formation in Oklahoma, where initial production on wells drilled in this area have reported up to 750 bbl per day.

- Magnolia was founded by a seasoned oil-industry team in July 2008, to take advantage of opportunities to drill wells in the Bakken shale formation in North Dakota. The company moved from PLUS Markets to AIM in November 2011.

- The independent "Competent Person's Report" on Magnolia's assets valued the producing assets at some US$1.5m. The non-producing interests covering Bakken, Woodford and Hunton were valued at US$16.5m. For its Mississippi prospects, the CPR estimates that after capital expenditure of US$2m (£1.25m), the project value net to Magnolia could be US$56m (£34.8m). The aggregate valuation, including the Mississippi prospects, could therefore be some US$74m (£46m).

- Shale oil and gas have increasingly become important constituents of the industry in the USA, with Total and Sinopec (China) both recently signing multi-billion deals in the sector. Shale oil has the potential to transform the mix of American petroleum supplies and to make it considerably less dependent on imports.

- **Key risks:** Early-stage company; not yet profitable; speculative and high-risk nature of exploration; volatility of oil price may undermine viability of some projects.

The company:

- Magnolia Petroleum is focused on the acquisition, exploitation and development of oil and gas properties primarily located onshore in the United States. Led by a highly skilled management team with over 100 years combined experience in the on shore oil and gas industry,

- Magnolia has a string of assets in well-defined oil-producing areas. It carries little exploration risk and has not focused its operations on greenfield sites.

- The Mississippi formation is a particularly attractive prospect for Magnolia, as its agreement will cover approximately 80 sq miles in a region where prior work has generated a payback within three months.

Key financials

Year to December, US$m	*2008*	*2009*	*2010*	*2011(e)*	*2012(e)*
Revenue	*0.00*	*0.16*	*0.24*	*0.30*	*0.80*
Gross profit (loss)	*0.00*	*0.11*	*0.15*	*n/a*	*n/a*
Operating profit (loss)	*-0.07*	*-0.06*	*-0.06*	*-0.25*	*-0.24*
Net profit (loss)	*-0.01*	*-0.08*	*-0.06*	*-0.25*	*-0.23*
EPS (p)	*n/a*	*n/a*	*n/a*	*0.00*	*0.10*
Net cash	*-0.96*	*-0.25*	*-0.10*	*-0.70*	*-0.30*

Source: Company data, Bloomberg estimates

Recommendations

During the three months to end-December 2011, the number of stocks on which HB Markets has published recommendations was 156, and the recommendations were as follows: Buy - 66; Speculative Buy - 12; Hold - 53; Sell - 25. Full definitions of the recommendations used by HB Markets in its publications and their respective meanings can be found on our website here.

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