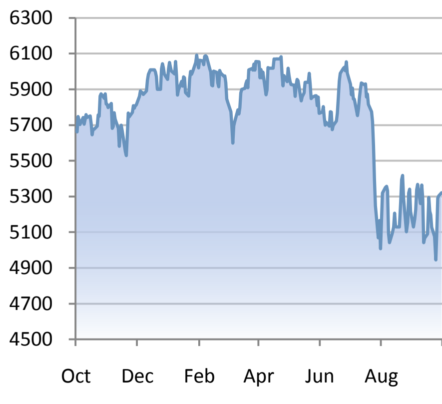
Tuesday, 11th October 2011

High-quality dividends

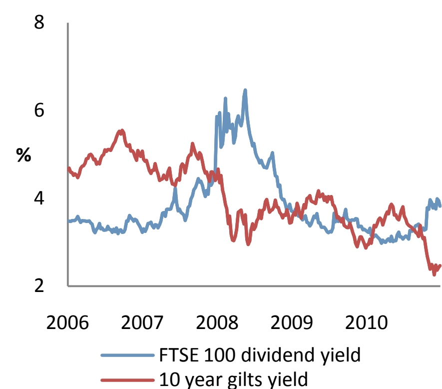
HB Markets

FTSE-100



Source: Bloomberg

Dividend & gilts yield



Source: Bloomberg

Senior Analyst

Donald Linderyd
(t) +44 (0) 207 382 8421
(e) donald.linderyd@hbmarkets.com

***Note:** All data as at the close of business on Monday 10th October 2011*

Safer stocks with good yields

In the light of the low-interest-rate environment and recent equity market volatility, how do you get a worthwhile return on your capital? One way is to look for high-quality stocks that deliver not only a potential for capital gain, but also a decent income. In this note, we identify stocks that can deliver this mix of income, relative safety and at the same time keep the door open for performance and capital gains. We have used a quantitative screening methodology to find high-dividend stocks of quality, and we recommend five companies in the FTSE 350 that fit the bill.

- *The return on cash in deposit accounts is typically around 3% at present. Bond yields are close to historic lows and some sovereign bonds have given rise to huge capital losses for the holders. For instance, top yielding bond funds offering average yield of 6.9% have suffered capital losses of 4.7% over the last year. By contrast, on average our five stocks provide a yield of 5.6% and have appreciated by 11.9% over the last year. In this note, we argue that shares with good dividend yields, where the underlying company has safety in its balance sheet and is generating cash to pay its shareholders, could provide an answer.*

- *Our search criteria are focused on a dividend yield of at least 5%, debt-to-assets of less than 50% and cash dividend cover of at least two.*

- *A search for high-yielding stocks in this market will throw up a number of companies for which the share price have fallen substantially and driven up the historic dividend as a percentage of the current share price. As we have seen recently, a high yield does not equal safety.*

- *Finding the gems amongst these companies takes a little more care. We have weeded out those that have high borrowings or which look like they may not be able to afford next year's dividend payment (limiting our choice to those which have the pay-out covered at least twice over from their expected cash flows).*

- *Our findings throw up five stocks in different sectors, taking in support services, construction, insurance, retailing and utilities. We recommend all five as portfolio holdings for today's troubled and volatile markets.*

Dividend stocks

			Price Change, %		Valuation			Growth, %			
Company	**Rec.**	**Price**	**1 week**	**1 month**	**P/E (e)**	**Yield %**	**Price/ Book**	**EPS (e)**	**Sales (e)**	**Debt/ Assets %**	**Dividend Coverage**
Interserve	**Buy**	312	2.2	-1.0	7.2	6.0	1.4	11.1	-2.6	12.3	2.2
Kier Group	**Buy**	1,344	6.8	18.5	9.3	5.0	3.3	14.0	1.7	2.6	2.6
Legal & General	**Buy**	105	10.1	11.8	7.8	5.4	1.0	-0.6	119.7	1.0	3.4
Marks & Spencer	**Buy**	330	3.8	5.0	9.7	5.3	1.8	4.0	3.6	34.4	2.3
Scottish & Southern Energy	**Buy**	1,349	2.8	5.8	11.6	5.9	2.7	7.7	22.7	26.0	2.1

Source: HB Markets, company data, Bloomberg

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Interserve

Buy (312p)

Target:
350p

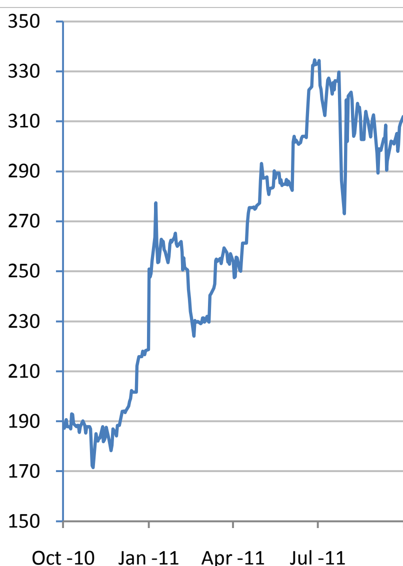
Market Cap:
£393m

Dividend yield:
6.0%

Sector:
Support services

Ticker:
IRV

Share price performance:



Source: Bloomberg

Investment case

- **UK support services-and-construction company Interserve has seen its share price decline by 11% over the three last months, at the same time as brokers have upgraded earnings forecast for the company by 5%.**
- **The stock is trading on a 30% discount to peer group on a price-to-earnings multiple, which we believe is unwarranted, given its recent set of results and prospective earnings growth.**
- **More importantly for dividend-hunters is the 6.0% yield, which seems secure at 2.2 times cover, adding to the 12% upside in our twelve-month 350p target.**
- **In the first half of this year, Interserve reported headline profit up 10.0% with free cash flow generation of £44.1m. It has announced over £1bn of contract wins so far in 2011, and says that its orders amount to £1.1bn of workload for 2012, within a substantial total future workload of £5.4bn. This is a growth stock as well as a high-yield opportunity.**
- **The company has issued guidance for the medium term which states that the company has the capability to double earnings per share over the next five years.**
- **Some of the risks to our buy case include the performance of the equipment services business. Being highly operationally leveraged, it could face margin pressure as demand weakens. In addition, demand from the austerity strapped UK public sector remains a concern and could trigger downgrades.**

Company description

Interserve is a services, maintenance and buildings group with its main operation in the public and private sectors in the UK, but also internationally. Offering advice, design, construction and maintenance services for buildings and infrastructure, it also runs operational systems and back-office services and provides specialist plant and equipment.
www.interserve.com

Key financials

Year to December, £m	*2008*	*2009*	*2011*	*2011(e)*	*2012(e)*
Revenue	*1,800.0*	*1,906.8*	*1,872.0*	*1,852.0*	*1,867.3*
Gross profit	*223.2*	*223.7*	*178.6*	*n/a*	*n/a*
Operating profit (loss)	*63.4*	*49.4*	*25.4*	*74.0*	*78.6*
Net profit (loss)	*54.4*	*68.7*	*49.7*	*53.1*	*54.1*
EPS (p)	*42.7*	*53.7*	*38.5*	*43.3*	*44.2*
Net debt	*107.9*	*37.3*	*53.8*	*61.3*	*66.3*

Source: Company data, Bloomberg estimates

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Kier Group

Buy (1,344p)

Target:
1,500p

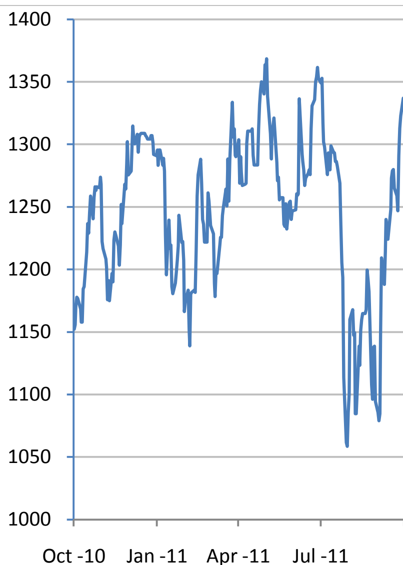
Market Cap:
£513m

Dividend yield:
5.0%

Sector:
Construction & materials

Ticker:
KIE

Share price performance:



Source: Bloomberg

Investment case

- **Kier Group has seen 9% upgrades to consensus earnings forecasts over the last month, driven by better than expected construction margins and greater than anticipated profits on asset disposals in its recent results.**
- **In the full-year results announced last month, the company showed a strong performance, with underlying pre-tax profits up 24% to £68.9m. Net cash was £165m after investment of approximately £50m during the year. Order books for construction and services increased to £4.3bn, underpinning the future outlook.**
- **The recent results are encouraging and provide evidence for Kier's revenue and margin resilience in difficult markets. In fact the recent upgrades to earnings could prove to be on the light side.**
- **The stock is trading on a justifiable 18% p/e premium to peers, given its strong cash generation and higher return on capital.**
- **At 2.6 times covered the 5% dividend yield is an attractive addition to the 12% upside to our twelve month target, for a stock with Kier's growth prospects.**
- **Some of the risks to our buy case include cut back in public expenditure, cancellation and/or renegotiation of existing contracts. A deteriation in the UK housing market would hurt land values and housebuilding operating margins.**

Company description

Kier Group is a UK construction company divided into three divisions: Construction, Facilities, Management and Homes & Property. Employing 11,000 people, the company has housebuilding operations in Central, Eastern and Southern England in addition to commercial property development operations.
www.kier.co.uk

Key financials

Year to June, £m	*2009*	*2010*	*2011*	*2012(e)*	*2013(e)*
Revenue	*2,111.9*	*2,056.0*	*2,123.0*	*2,172.4*	*2,240.0*
Gross profit	*186.8*	*209.0*	*245.0*	*n/a*	*n/a*
Operating profit (loss)	*53.9*	*57.8*	*59.7*	*61.7*	*65.4*
Net profit (loss)	*16.1*	*39.7*	*61.8*	*46.2*	*51.3*
EPS (p)	*44.0*	*107.3*	*163.9*	*143.8*	*153.2*
Net cash	*92.3*	*175.0*	*164.8*	*171.8*	*200.7*

Source: Company data, Bloomberg estimates

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Legal & General

Buy (105p)

Target:
120p

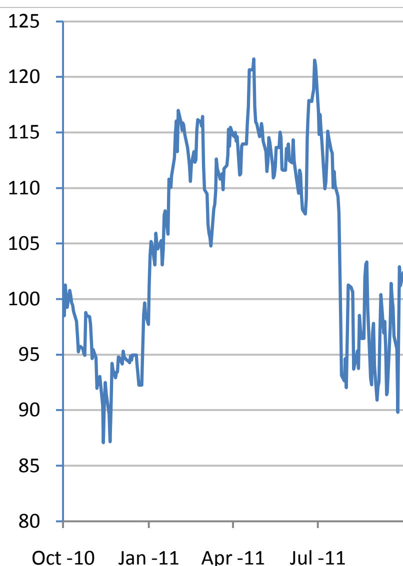
Market Cap:
£6,171m

Dividend yield:
5.4%

Sector:
Life insurance

Ticker:
LGEN

Share price performance:



Source: Bloomberg

Investment case

- **At 3.4 times covered, the 5.4% dividend yield from conservatively managed Legal & General should be one of the more secure in our screen, and provides an important addition to the 14% upside to our twelve-month price target.**

- **The shares have held up well in the current market, rising 3.2% in the last month. Legal and General is one of the few insurance stocks that shows a positive performance for the year to date, which is a testament to its safe-haven status.**

- **In the last interim report, the company confidently raised the dividend by 25%, after reporting that operational cash flow increased by 19%. The operating profit of £523m (3.5% down from last year) beat the £505m estimate.**

- **The stock is trading on a 4% P/E discount to peer group, which we believe is unwarranted, given its defensive characteristics, strong free cash flow, and over-capitalised balance sheet.**

- **Some of the risks to our buy case include the upcoming Solvency II regulation, which could be harder than anticipated. Prolonged low interest rates could make it increasingly difficult to meet consensus earnings estimates, although these are largely factored into brokers' estimates. Legal & General also holds a significant investment portfolio, including exposure to sovereign and bank debt, which could suffer from valuation downgrades. The company's exposure to Portugal, Italy, Ireland, Greece and Spain is estimated to £344m in a total sovereign debt portfolio of £5.3bn.**

Company description

Legal & General provides savings, risk and investment management services such as annuities, long-term savings, life assurance and financial protection products, sold through bank, building societies, IFAs and directly to customers. With marginal exposure to the US, the Netherlands and France, the UK is its main market.
www.legalandgeneral.com

Key financials

Year to December, £m	*2008*	*2009*	*2010*	2011(e)	2012(e)
Revenue	*(31,644.0)*	*43,790.00*	*38,440.00*	*4,993.60*	*5,262.40*
Operating profit (loss)	*(1,112.0)*	*1,253.00*	*1,260.00*	*1,085.25*	*1,155.31*
Net profit (loss)	*(1,067.0)*	*863.00*	*820.00*	*795.67*	*828.08*
EPS (p)	*(17.9)*	*14.7*	*13.9*	*13.4*	*14.0*
Net cash	*6,897.00*	*7,373.00*	*9,704.00*	*512.00*	*523.00*

Source: Company data, Bloomberg estimates

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Marks & Spencer

Buy (330p)

Target:
380p

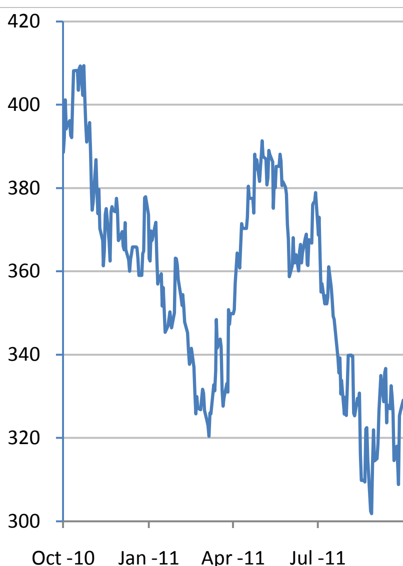
Market Cap:
£5,233m

Dividend yield:
5.3%

Sector:
General retailers

Ticker:
MKS

Share price performance:



Source: Bloomberg

Investment case

- **The shares in Marks & Spencer trade on an unjustified 5% P/E discount to peers, and have lagged the peer group's share price performance over the last month.**
- **With a 5.3% dividend yield, some 100bp above peers, and recent signs of market share gains, the shares are due a re-rating to turn the valuation discount into a premium.**
- **Tough UK retail conditions are driving more and more stores out of business. For every store that closes, a bit of market share becomes available for someone else to grab, and recent market share data suggest that M&S is gaining from this opportunity.**
- **Second-quarter sales missed brokers estimates, mainly due to slower-than-expected general-retail sales. However, the management has reiterated its full year guidance; giving us comfort that the healthy balance sheet and a 2.3 times cash dividend cover should be able to support the share price.**
- **The stock has also been subject to vague takeover speculation with Apax Partners, a private equity group, thought by some parties to be preparing a 450p bid.**
- **Some of the risks to our buy case include weakening consumer confidence, which would reduce footfall and trigger price wars, hurting both revenue and margins. Reports indicating loss of market share could undo some of the positive sentiment and lead to a disproportionate downgrade of the share.**

Company description

Marks & Spencer Group plc is a holding company providing retail of clothing, food and home products through its subsidiaries. Predominantly a UK operation, revenue is 53% derived from foods and the remainder from clothing and home products.
www.marksandspencer.com

Key financials

Year to March, £m	*2009*	*2010*	*2011*	2012(e)	2013(e)
Revenues	*9,062.1*	*9,536.6*	*9,740.3*	*10,152.0*	*10,671.4*
Gross profit	*3,371.9*	*3,618.5*	*3,724.7*	*n/a*	*n/a*
Operating profit (loss)	*772.5*	*841.0*	*821.9*	*837.3*	*913.0*
Net profit (loss)	*508.0*	*526.3*	*612.0*	*546.5*	*604.9*
EPS (p)	*0.323*	*0.332*	*0.384*	*0.341*	*0.376*
Net debt	*2,584.7*	*2,183.4*	*1,840.3*	*2,125.9*	*2,143.7*

Source: Company data, Bloomberg estimates

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Scottish & Southern Energy

Buy (1,301p)

Target:
1,500p

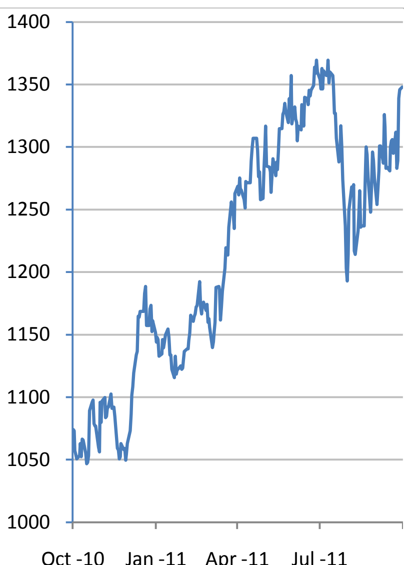
Market Cap:
£12,652m

Dividend yield:
5.9%

Sector:
Electricity

Ticker:
SSE

Share price performance:



Source: Bloomberg

Investment case

- **On a 13% discount to the P/E ratios of peers, SSE shares look too cheap. This is especially the case when taking into account the greater efficiency of its asset utilisation, with return on assets 240bp above peers and return on capital employed estimated at twice the average for the peer group.**

- **Despite being a strong performer in the European electricity space this year, we believe the stock is still worth buying, based on an attractive valuation and a handsome dividend yield.**

- **In our view, consensus earnings estimates may be on the low side and due for an upgrade, following recent strong retail pricing, with SEE raising gas and electricity prices in September by 11% and 14% respectively. This would make the stock even cheaper.**

- **With a diverse portfolio of power stations, including coal, gas, wind, and hydro, and one of the largest market shares of green power generation, SSE is better positioned than most to protect its earnings, regardless of any development in commodity prices.**

- **The management has a policy of increasing the dividend by two percentage points more than the retail inflation index for each of the next two years, and by at least the rate of RPI inflation thereafter. With the dividend covered 2.1 times by its cash flow, SSE with its 5.9% dividend yield should be an attractive investment for its defensive and income generating qualities in any portfolio.**

- **Some of the risks to our buy case are that expected earnings upgrades do not materialise, or that the market's perception of SSE's earnings power in the wholesale market has been overstated. The Competition Commission inquiry creates uncertainty around the retail-pricing environment going forward, and could be negative to sentiment, earnings, and the share price.**

Company description

SSE generates, transmits, distributes and supplies electricity to industrial, commercial and domestic customers in the UK and Ireland. The company also stores and distributes natural gas, and operates a telecommunications network that offers bandwidth and capacity to companies, the public sector, Internet service providers and others. Generation and supply of electricity account for 96% of revenue and 97% of revenue comes from the UK. www.sse.com

Key financials

Year to March, £m	*2009*	*2010*	*2011*	*2012(e)*	*2013(e)*
Revenues	*25,424.2*	*21,550.4*	*28,334.2*	*26,489.4*	*28,094.6*
Gross profit	*1,871.5*	*1,651.9*	*1,291.3*	*n/a*	*n/a*
Operating profit (loss)	*1,453.8*	*1,356.3*	*1,338.1*	*1,610.8*	*1,788.2*
Net profit (loss)	*112.3*	*1,235.3*	*1,504.5*	*1,059.7*	*1,178.6*
EPS (p)	*1.27*	*133.9*	*162.0*	*115.8*	*128.5*
Net debt	*5,100.3*	*5,756.6*	*5,100.9*	*6,643.7*	*7,204.8*

Source: Company data, Bloomberg estimates

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Speculative Buy	The stock or other security is of a speculative nature and may be issued by a smaller company. It may be illiquid, and the spreads between the bid and offer prices may be wider than those for a stock issued by a larger company. It is expected to outperform the benchmark stock market index of which it is a component by at least 12.5% over the twelve months following the date of the publication. The rationale for the recommendation may be linked to factors other than the usual determinants of share price performance, such as the possibility of development of new technology, a discovery of natural resources, or a take-over bid for the company.
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