Thursday, 22nd March 2012

US Consumer Exposure

UK stocks for US consumer recovery

European consumers are battling with unemployment and austerity-focused governments. In China, consumers seem to have lost a bit of their enthusiasm and recent trade data indicates that exports are slowing. However, on the other side of the Atlantic, corporate results have shown positive signs for a while and lately US macro indicators have supported a relatively optimistic view of the US economy and the US consumer. The US stock market has started to price in a recovery. And whilst US stocks are far from expensive we believe we can find better value in UK stocks with US consumer exposure than from domestically focused US companies. In this report we present our macro case for US consumer exposure and screen the FTSE 350 for quality stocks to capitalise on the US consumer recovery.

After five years of negative news, the US housing market it is now showing signs of stabilising, which is essential for US economic growth. House prices are still declining but the pace has slowed considerably, especially compared to the peak of the crisis in 2008/9. With stabilising prices, the number of homes sold has risen.

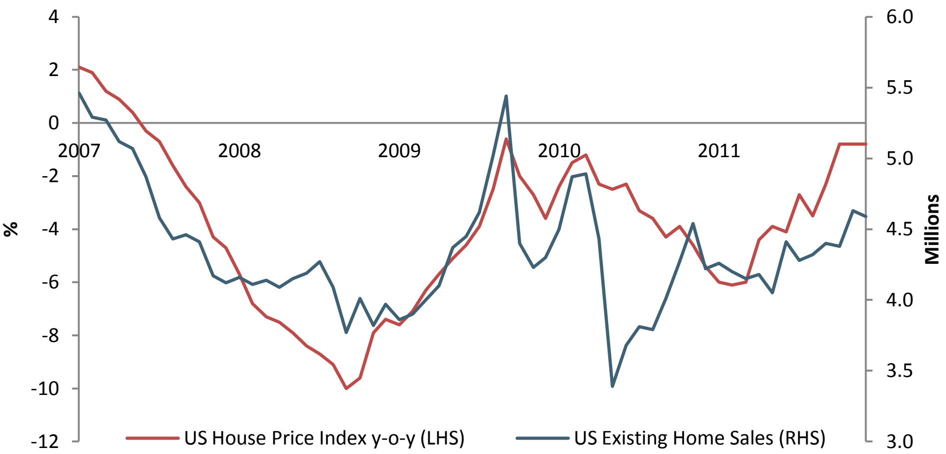
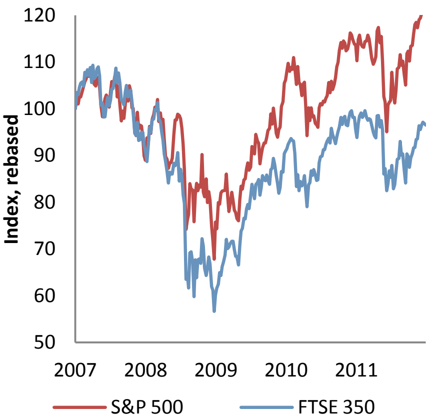


Chart 1: US house prices & existing home sales. Source: Bloomberg

A more stable housing market, albeit not a buoyant one, helps to remove some uncertainty for US households. In conjunction with a recovering employment market, US households should feel a bit more optimistic and secure about their future. The abating Euro-zone crisis should also be positive to US consumer sentiment. The US stock market has picked up on this development and started to re-rate US stocks relative UK stocks during the autumn, a re-rating which accelerated after New Year. The US equity valuation premium to UK stocks, measured by forward P/E, is now at its highest post crisis level.

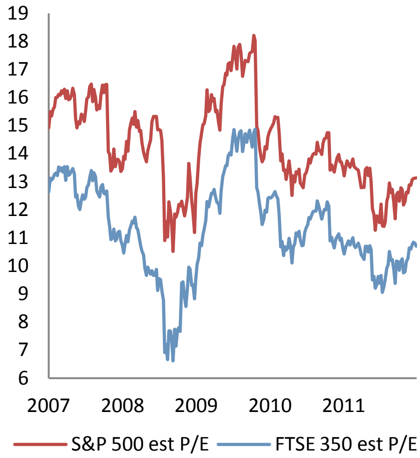
A higher stock market usually feeds back into more optimistic US consumers through the wealth effect, as retail investors feel better off with higher portfolio valuations. With the S&P 500 just ten percent off its all-time-high from 2007, more optimistic consumers feed into higher retail sales, driving corporate profits higher, which justifies still higher share prices and portfolio valuations.

Equity market performance



***Source**: Bloomberg*

Equity market valuation



***Source**: Bloomberg*

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***Note:** All data as of close of business Wednesday 21st March 2012*

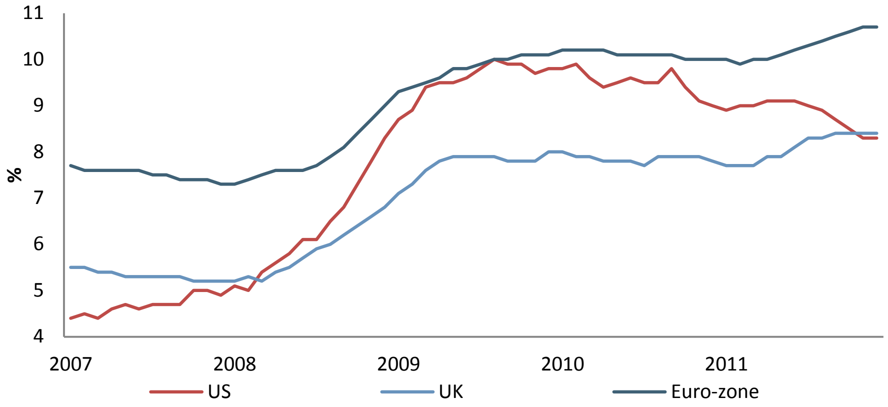


Chart 2: Unemployment rate. Source: Bloomberg

From the asset markets we have seen gold prices retreating and long bonds coming off their high, both signs that the market is reducing its risk aversion. The move in long US interest rates is particularly interesting.

Long interest rates have moved up in the US recently, despite the Fed's $400bn "operation twist" in which it buys long-term treasuries and sells short-term, to stimulate the economy through lower long-term rates. The strategy worked well during the autumn, resulting in record low ten-year interest rates below 2%. However, despite the fact that "operation twist" is still in place, long-term yields have risen sharply during March, reaching above 2.3%. We believe this development could indicate a number of things, such as increased economic optimism, higher inflation expectations and increased risk appetite, all factors that are normally good for stock market performance.

Chart 3: US long-term interest rate. Source: Bloomberg

A lower equity risk premium increases the present value of future cash flows, justifying higher equity valuations and supporting further multiple expansion, providing more support to consumer sentiment through the wealth effect.

As the US market has re-rated relative to the UK, the valuation gap has widened, making UK stocks relatively cheaper. However, in the UK, regional macro concerns still weigh on sentiment making regionally focused stocks less attractive. UK stocks with US exposure are a different story. We should therefore be able to find UK stocks with exposure to US consumers at relatively more attractive valuations.

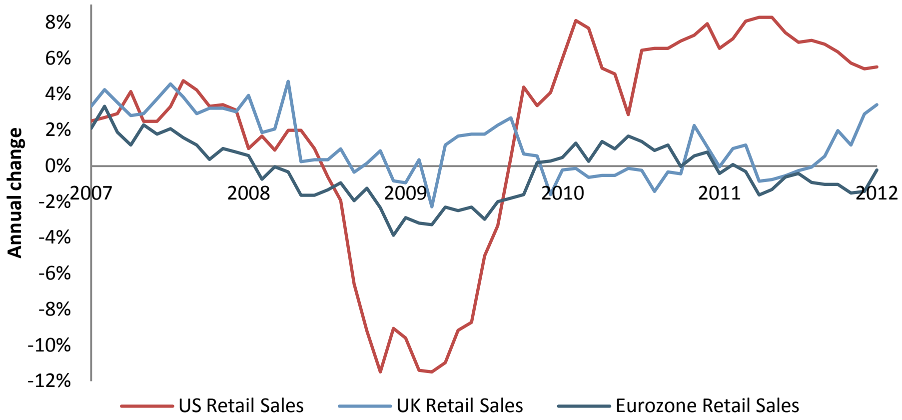


Chart 4: Retail sales. Source: Bloomberg, HB Markets

As an added bonus, the US$ has started to rebound and we could expect it to advance against Sterling, driven by the rising long end of the yield curve and reduced need for more quantitative easing, as the economy recovers. A stronger US$ should provide additional benefit to UK companies as the translation effect makes US revenue and earnings more valuable in Sterling terms, further underpinning the case for UK stocks with US consumer exposure.

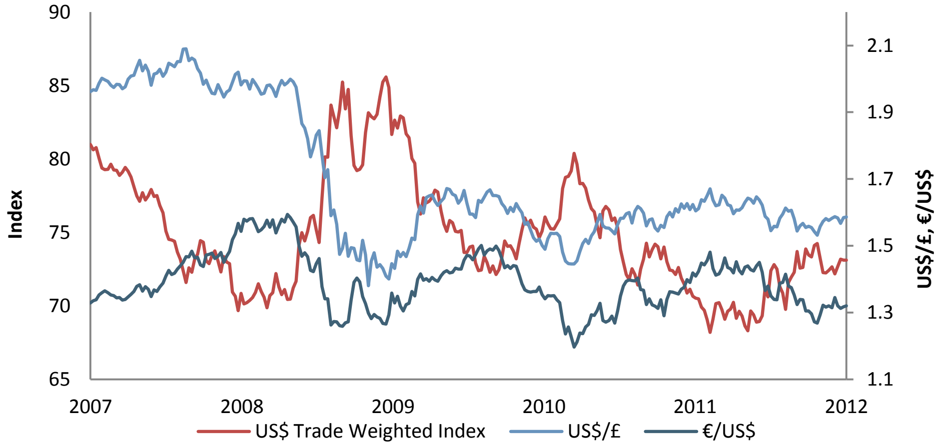


Chart 5: Foreign exchange rates. Source: Bloomberg

Risks

The US economic recovery is fragile and we are concerned about US government and consumer debt. And despite positive signs, the housing market is not yet out of the woods. Corrections in property markets and consumer debt are usually very drawn out affairs that take many years, or decades, to work out. We see no reason why this one should be any different. However, the recent return of high oil prices provides more immediate concerns, as an elevated oil price can act as a tax on consumers, reducing disposable income and immediately hurt retail sales.

However, it not the level but the rate of change that is the biggest threat. Sharp increases, like in 2008, often lead to demand destruction and directly impact the overall economy. Recently, we have witnessed oil prices rising close to 2008 highs, driven by geopolitical tension between the west and Iran. Thankfully, the slope has been much gentler than in 2008, allowing consumers time to adjust.

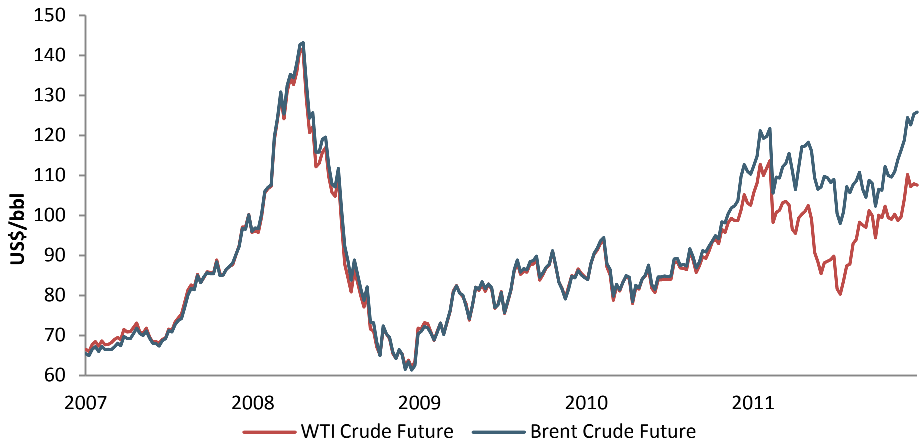


Chart 6: Oil prices. Source: Bloomberg

In addition, the UK and the US has agreed to release oil reserves to reduce pressure on prices from the supply side and to not risk a recession in a US election year. Also, Ali Naimi, the powerful oil minister of Saudi Arabia, said this week the country could boost supply by up to 25% to bring down "unjustified" high oil prices. Hopefully these steps will provide some relief and avoid a spike in global oil prices that could jeopardise a recovery in the US and elsewhere.

The selection

With our macro case as background, we have therefore screened the FTSE 350 for stocks with at least 20% of revenue directly or indirectly being related to US consumers. As we still believe the recovery is fragile we stick to our preference for quality stocks, a theme that has been performing well over the last six months. We have also favoured stocks with a clear competitive advantage, but we have paid less attention to structural and more to cyclical growth than previously, as we are looking for recovery at this stage of the cycle.

From an initial shortlist of 39 stocks we have highlighted four quality companies that we believe stand a good chance of capitalising on US consumers and where there still is significant upside yet to be priced in by the market.

US Consumer Exposure

			Price Change, %		Valuation			Growth, %		
Company	Rec.	Price (p)	1 month	3 months	P/E (e)	Yield %	Price/ Book	EPS (e)	Sales (e)	Debt/ Equity %
Diageo	Buy	1,525.0	2.8	13.3	16.7	2.9	6.3	15.4	6.7	156.2
Intercontinental Hotels	Buy	1,436.0	0.9	31.7	17.5	2.5	11.7	9.5	4.7	126.3
Reckitt Benckiser	Buy	3,544.0	-1.0	13.1	14.5	3.7	4.1	0.1	2.2	43.9
WPP	Buy	854.5	6.9	31.5	11.5	3.2	1.5	13.1	5.6	73.0

Table 1: UK stocks with US consumer exposure. Source: Bloomberg, Bloomberg estimates

Diageo

Buy (1,525p)

Target
1,750p

Market Cap
£38,211m

P/E est.
16.7x

Industry
Beverages

Ticker
DGE.L

Share price performance

Source: Bloomberg

Focus on premium

The US market accounts for 40% of Diageo's EBIT (earnings before interest and tax). As young male unemployment in the US shows signs of declining and the overall economic picture becomes more favourable, Diageo's US sales should gain momentum.

Diageo has increased its advertising spend to grow its brands, which seems to pay off. It is now growing its value share, primarily through the premium segment, which should improve the mix and be positive for its margin development going forward.

In our 2012 outlook note 'A dozen for twelve' we highlighted Diageo's attractive exposure to emerging markets. Even though this is a well known story, we do not believe it is fully priced in, and recent investment on super and ultra premium brands have been rewarded with very strong organic growth, well above management's targets. We like the strategy as this segment should be more protected in a slowdown.

In Diageo's recent H1 results we saw emerging markets together with the recovery in North America, including the US, offsetting stagnation in Europe. Results were driven by price increases and a better sales mix, growing sales 7% from organic volume growth of 3%. The company reiterated its annual sales growth target of 6%.

Company description

Diageo is a leading premium drinks business with an array of well-known beverage brands across spirits, beer and wine, including Johnnie walker, Crown Royal, J&B, Smirnoff, Ketel One, Captain Morgan, and Guinness. Diageo's 20,000 staff operate in 180 markets worldwide with North America accounting for 34%, Europe 27%, Asia Pacific and Africa 14% each and Latin America 10% of sales. www.diageo.com

Key financials

Year to June, £m	*2009*	*2010*	*2011*	2012(e)	2013(e)
Revenue	*9,311.00*	*9,780.00*	*9,936.00*	*10,752.30*	*11,449.67*
Gross profit	*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*	*3,157.70*	*3,490.28*
Net profit (loss)	*1,605.00*	*1,629.00*	*1,900.00*	*2,303.38*	*2,571.13*
EPS (p)	*64.40*	*65.40*	*76.00*	*91.20*	*101.90*
Net debt	*7,661.00*	*7,311.00*	*6,611.00*	*7,265.57*	*6,232.65*

Source: Company data, Bloomberg estimates

Strengths

- Above industry organic growth target.
- Focus on the more resilient premium end of the market and increased advertising spend should drive value faster than the market.
- Strong balance sheet with net debt at 2x EBITDA gives the company scope for value enhancing acquisitions.

Weaknesses

- Having a tough time meeting strong competition in rum (Captain Morgan).
- Recent below industry volume trends in the value segment could spill over to the premium segments.
- The usually relatively recession resilient product line is not immune to an economic slowdown, as we witnessed in 2008-9.

InterContinental Hotels

Buy (1,436p)

Target

1,650p

Market Cap

£4,180m

P/E est.

17.5x

Industry

Hotels restaurants & leisure

Ticker

IHG.L

Share price performance

Source: Bloomberg

Re-launch

With muted new room supply in InterContinental's core US market it should drive daily rates higher, as the economy recovers. This should improve RevPAR (revenue per average room), a key industry metric. In fact, recent reports from InterContinental showed strong development in the crucial metric which grew 6% in January compared to just above 4.5% in Q4.

The company's re-launch of the Holiday Inn brand has been an important driver of RevPAR development recently. Further growth should come from its Crowne Plaza brand re-positioning and two new brand launches during 2012, one in the US and one in China.

InterContinental is less exposed to Europe, has a stronger balance sheet, higher margins and better return on capital than peers. We believe this warrants a valuation premium and not the 25% P/E discount it currently trades on.

Company description

Intercontinental Hotels operates a global hotels business comprising a range of franchised (37% of revenue), owned (35%) and managed (28%) hotels. The Americas is the most important region with 50% of revenue (64% of operating profit), followed by EMEA (Europe, Middle East & Africa) (24%) Asia Pacific (13%) and China (12%).
www.ichotelsgroup.com

Key financials

Year to December, £m	*2009*	*2010*	*2011*	*2012(e)*	*2013(e)*
Revenue	*1,538.00*	*1,628.00*	*1,768.00*	*1,831.59*	*1,925.05*
Gross profit	*769.00*	*875.00*	*997.00*	*n/a*	*n/a*
Operating profit (loss)	*363.00*	*444.00*	*559.00*	*587.20*	*635.08*
Net profit (loss)	*213.00*	*293.00*	*460.00*	*385.11*	*411.47*
EPS (p)	*72.20*	*99.00*	*155.40*	*130.20*	*138.80*
Net debt	*1,077.00*	*716.00*	*509.00*	*451.69*	*312.51*

Source: Company data, Bloomberg estimates

Strengths

- Re-positioning, re-branding and new brand launch efforts should provide faster than industry growth.
- Valuation discount despite a better performance on most metrics.
- Non-core disposals and industry consolidation should benefit the majors, such as InterContinental.

Weaknesses

- InterContinental operates in a very cyclical industry and an economic slowdown could hurt its highly operationally geared margins quickly.
- InterContinental runs the risk of overpaying for assets, as it takes part in the industry consolidation.
- Recent outperformance can limit the stocks near-term price appreciation.

Reckitt Benckiser

Buy (3,544p)

Target

4,000p

Market Cap

£25,898m

P/E est.

14.5x

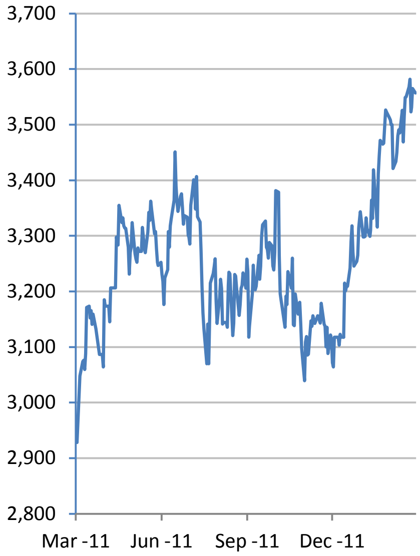
Industry

Household products

Ticker

RB.L

Share price performance



Source: Bloomberg

Best in class

With US consumer confidence returning we expect Reckitt Benckiser, with almost a quarter of its sales in the region, to benefit. Economic recovery usually means that households trade up from own labels and discount brands to first- and second-tier brands, something Reckitt Benckiser has in abundance. This should not only drive top-line but also allow margins to expand.

Rekesh Kapoor, Reckitt Benckiser's relatively new CEO, took over after long-time CEO Bart Becht in September last year and has still to convince investor that he is a worthy successor. Whilst there is no doubt Mr Becht was vital for the company's success, Mr Kapoor has been with the company since the 1980s and should be more than capable to continue to grow Reckitt's business, which provides multiple expansion capacity.

Comparing Reckitt's latest set of results should take the market a bit closer to embracing Rekesh Kapoor. Despite difficult commodity price inflation, the company was able to expand margins by 60 basis points, in contrast to main peers Unilever and Procter & Gamble where margins fell. Reckitt's 2012 guidance seems overly conservative, which provides scope for broker upgrades as the year progresses.

With best in class margins and return on capital, a healthy balance sheet and growth projections well above industry average, the stock should command a valuation premium instead of the +20% discount it currently trades on. Add on potential for positive earnings surprise and RB could provide substantial upside from here.

Company description

Reckitt Benckiser manufactures and distributes a wide range of household, health and personal care products, with brands such as Strepsils, Nurofen, Finish, Dettol, Vanish and Calgon. Europe is its most important market with 42% of sales, followed by North America, Australia & New Zealand (25%) and developing markets (24%), with the balance (8%) coming from its pharmaceuticals division RBP. www.rb.com

Key financials

Year to December, £m	*2009*	*2010*	*2011*	*2012(e)*	*2013(e)*
Revenue	*7,753.00*	*8,453.00*	*9,485.00*	*9,667.19*	*10,079.29*
Gross profit	*4,664.00*	*5,121.00*	*5,662.00*	*n/a*	*n/a*
Operating profit (loss)	*1,891.00*	*2,231.00*	*2,487.00*	*2,468.15*	*2,570.23*
Net profit (loss)	*1,418.00*	*1,568.00*	*1,745.00*	*1,802.53*	*1,893.68*
EPS (p)	*194.70*	*213.80*	*237.10*	*244.30*	*255.80*
Net debt	*-219.00*	*2,045.00*	*1,858.00*	*990.82*	*195.09*

Source: Company data, Bloomberg estimates

Strengths	*Weaknesses*
• Unjustified valuation discount, despite better performance metrics. • A conservative guidance should limit downside risk. • Considerable brand investment should ensure outperformance.	• Unproven CEO has still to win investors' respect. • Earnings revisions have been negative for the last couple of quarters. • Weakness in Europe could overshadow other regions.

WPP

Buy (854.5p)

Target
1,000p

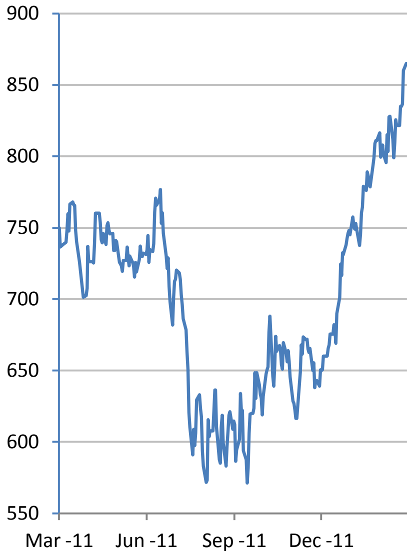
Market Cap
£10,754m

P/E est.
11.5x

Industry
Media

Ticker
WPP.L

Share price performance



Source: Bloomberg

A year full of major events

WPP's consumer exposure is indirect, but as a global advertising giant, WPP is well positioned to take advantage of a recovering US consumer, as companies battle to grab market share in the recovery. And with the US presidential election helping to drive business through 2012, we expect the relatively flat performance WPP reported from North America recently to recover.

With a number of global events during 2012, WPP's faster growing emerging markets are likely to be supplemented by growth from the London Olympics and the UEFA Football Championship. Together with a US consumer recovery we believe WPP has the scope to surprise on the upside.

Earlier in the month, WPP reported pre-tax profits topping £1bn for the full year, with like-for-like revenue growing 5% and operating margins reaching pre-crisis high of 14%.

With WPP's scale, earnings growth, strong cash generation and balance sheet we see little reason for its 13% P/E discount to peers. In fact, it's higher than peers' operational leverage should provide opportunity to grow margins further, as volumes increase. And as the cheapest stock in the sector it should be a good excuse for multiple expansion.

Company description

WPP is a global communications group, including advertising and media investment (41% of revenue), branding (25%), market research (25%) and PR (9%). With operations in 107 countries it employees 158,000 staff throughout North America (34% of revenue), Asia Pacific, Latin America & Africa (29%), Continental Europe (25%) and the UK (12%). www.wpp.com

Key financials

Year to December, £m	*2009*	*2010*	*2011*	*2012(e)*	*2013(e)*
Revenue	*9,660.30*	*9,357.00*	*10,021.80*	*10,517.75*	*10,973.11*
Gross profit	*8,956.70*	*8,586.50*	*9,238.50*	*n/a*	*n/a*
Operating profit (loss)	*737.40*	*977.60*	*1,257.00*	*1,428.57*	*1,520.62*
Net profit (loss)	*437.70*	*586.00*	*840.10*	*935.70*	*1,000.20*
EPS (p)	*35.30*	*45.90*	*64.50*	*74.30*	*81.50*
Net debt	*2,640.40*	*1,888.20*	*2,464.80*	*1,680.77*	*1,158.19*

Source: Company data, Bloomberg estimates

Strengths

- We expect strong earnings revisions to continue, driven by major global events throughout the year.
- WPP's founder and CEO Martin Sorrell is heading a well regarded and experienced management team.
- A strong balance sheet provides a strong position for opportunistic acquisitions.

Weaknesses

- WPP is highly acquisitive and it may struggle to integrate new businesses and/or overpay.
- Advertising is cyclical and signs of an economic slowdown could easily hurt earnings and investors sentiment.
- Recent share price outperformance may limit near-term upside.

Recommendations

During the three months to end-February 2012, the number of stocks on which HB Markets has published recommendations was 179, and the recommendations were as follows: Buy - 84; Speculative Buy - 4; Hold - 69; Sell - 22. 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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