



December 7, 2009

Research Report: Market strategy

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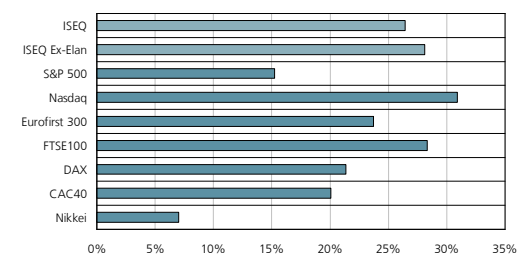
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Weekly Market Comment

International returns YTD (€)



Forecast revisions

	2009		2010	
	Prev	Rev	Prev	Rev
Abbey	38.2	40.5	65.0	65.0
HeidelbergCement	437.9	425.1	547.7	579.8
Irish Life & Permanent	19.3	-24.0	80.4	45.9

Forthcoming results and events

Monday December 7th

Origin Enterprises - AGM - The Westbury Hotel, Dublin 2 - 10.00

Vehicles licensed for the first time (Nov)

Wednesday December 9th

Irish Budget

Bellway - ex-dividend - final dividend rate 6.0p

Thursday December 10th

Consumer price index (Nov)

Industrial production (Oct)

Friday December 11th

Dragon Oil - Court Meeting and EGM - The Grosvenor House Hotel, 90 Park Lane, London W1K 7TN, United Kingdom - 10.00

Pivotal Budget may shape Irish economy for the medium term

- The December 9th Budget for 2010 provides an opportunity to put the Irish economy back on the path to recovery, but it must succeed on three fronts. First, it has to credibly reduce the structural deficit by €4bn. Second, the fiscal consolidation must take the right shape, avoiding tax increases and extra capital spending cuts (on top of those already planned). Third, it must reiterate the commitment to further fiscal consolidation in 2011-2013 and outline how this might be achieved.

Abbey Road

- It has been a rocky road for Abbey this year given the sharp downturn in the housing markets in Ireland and the UK. Although the headline numbers in its interim results are not pretty, they were actually better than our estimate. More than anything else, the results highlight how inexpensive the stock is.

Return to home meal preparation may not be as transient as most observe it to be

- The migration to the marketplace of goods and services which, under the previous century's breadwinner-housemaker model, were the output of domestic production and labour seemed to represent a logical progression in human development. However, there has always been an ebb and flow in human history between the industrious and breadwinner models. That one or the other may prevail is entirely contingent or circumstantial.

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Pivotal Budget may shape Irish economy for the medium term

Rossa White

The December 9th Budget for 2010 is a watershed. It is the chance to put the Irish economy back on the path to recovery, but it must succeed on three fronts. First, it has to credibly reduce the structural deficit by €4bn. Second, the fiscal consolidation must take the right shape, avoiding tax increases and extra capital spending cuts (on top of those already planned). Third, it must reiterate the commitment to further fiscal consolidation in 2011-2013 and outline how this might be achieved.

If the plan is credible and implemented without fudge, we see two potentially positive implications. It may set the economy up for an expansionary fiscal contraction: household confidence may improve, leading to a partial unwind of precautionary saving. In addition, Ireland may benefit on global government bond markets as investors demand a lower risk premium to buy our debt.

The timing of Budget 2010 could not be better, so the government has every incentive to hold its nerve. Prices are falling, making nominal cuts in wages or social welfare rates easier. The Consumer Price Index dropped 6.6% in the year to October. That includes mortgage repayments, where the trend will reverse in the next 24 months. Therefore, the HICP – comparable across the EU – is a better guide: this index shows that prices have declined almost 3%. Anyone who has remained in employment and suffered no wage cut is in the money; social welfare claimants of a year ago are 6% better off due to the unjustified increase in the rate in the October 2008 Budget.

Recent international circumstances have also fallen in the government's favour. The problems in Dubai and Greece have highlighted that smaller countries with banking and/or severe fiscal problems will be punished, particularly those that fail to deal with them adequately. Moreover, it is worth keeping in mind that the main driver behind the convergence of Irish spreads since March was the resurgence of global risk appetite. But there is no guarantee that financial markets will remain benign in 2010: the worst-case scenario is increased market volatility combined with an Irish Budget that fails to make the necessary deep adjustment.

Finally, to set the domestic context, the public seems largely in favour of taking the required dosage. The recent public service strike was half-hearted and that disparate sector is far from united. Moreover, non-state employees have offered little support.

Ireland's structural deficit is somewhere between 8-9% of GDP, based on our estimates. In other words, if the economy was operating at full capacity tomorrow, the country would still be left with a deficit of that magnitude (borne out of the failure to control current spending). That compares with a likely deficit of close to 12% of GDP this year. In the best case, we have to come up with savings of €13bn in the period to 2014 in order to clear that structural gap. With that in mind, the €4bn consolidation plan for 2010 (flagged in April 2009 and reiterated in the

pre-Budget outlook) must make permanent, irreversible, savings. There is no such thing as "bridging" measures for 2010: they have to hold in 2011, 2012 and indefinitely thereafter. Remember too that another €4bn in deficit reduction for 2011 has been promised to the European Commission.

The salient component of the structural deficit is our bloated public sector pay bill. It was financed by windfall property-related tax revenue that has evaporated. The economy is heading back to somewhere between the 2004 and 2005 size (in GNP cash terms) next year. Let's take 2005 as a favourable example. The public sector pay and pensions bill totalled €15.4bn that year. By 2009, it had reached €19.8bn, an increase of €4.4bn. About half of that jump resulted from inflating wages (and hence pension entitlements) and the rest of the bill from increasing the numbers employed.

Note, though, that direct property-related receipts have declined €5bn since 2005. The public pay bill must be cut by a similar magnitude to help close the structural gap. Our public sector is not too out-of-whack in employment terms with the rest of Europe (albeit keeping in mind Ireland's low defence and age-related spending requirements); the problem is that we pay public servants over the odds. If we were to cut employment by the 17,000 that the Colm McCarthy-led spending group recommended, wages would have to fall about 10% in order to generate savings of €3bn from the public pay bill in total. It is best to frontload those cuts next week, so that public servants can plan with more certainty their new level of income.

It is vital not to lose sight of why this difficult fiscal consolidation plan is necessary. The overriding concern is to cement the financial viability of the Irish state: on that we have provided assurances to the European Commission. But the shape of the Budget matters hugely: Ireland must regain competitiveness for the medium term. Cutting the cost of government is not everything. The tax regime matters too. On this count, Ireland has lost its way in an international context.

Ireland's low tax regime has attracted significant foreign investment over the last decade (its stock of FDI to GNP is almost 90%, the third-highest ranking in the OECD). The new flow has increasingly shifted from manufacturing to internationally-traded services since 2000. But low corporation tax is not enough: Ireland used not to have excessively high tax on income too, helping to keep its large supply of graduates in the country as well as attracting highly-skilled labour from overseas. That model has changed dramatically over the last year as the marginal tax rate has jumped by four percentage points at a wage level of €5,000 below the average gross wage in the economy and by fully seven percentage points for a worker earning 25% more than the average. Only three euro area countries – Austria, Belgium and the Netherlands – will have higher marginal income tax rates than Ireland at the end of this year. Moreover, our key competitors in internationally-traded services – Luxembourg, the UK and Israel – all have significantly lower marginal income tax rates. Further income tax hikes (including social security) must be avoided next Wednesday if Ireland wants to avoid putting its export-orientated economic model in jeopardy.

Abbey Road

Robert Gardiner

It has been a rocky road for Abbey this year given the sharp downturn in the housing markets in Ireland and the UK. Falling volumes and house prices saw the group record a 60% decline in underlying operating profit in the six months ended October 2009. The housebuilding division saw profits fall 52%, while the UK plant hire business, M&J Engineers, lost €395,000 in the period. Although the headline numbers are not pretty, they were actually better than our interim estimate. We had taken a conservative view and expected H1 earnings per share of 9.5c; the group posted interim EPS of 11.5c.

More than anything else, the results highlight how inexpensive the stock is. At end-October, Abbey had a total of €92.9m in net cash – representing just over 377c per share. This equates to more than 85% of the current share price of 440c. The group generated just short of €20m in free cash flow in the six months, a performance which, if repeated in the second half, would bring cash balances to the current market price by end-April. That is unlikely to happen as the group replenishes its land-bank in the UK, but it highlights how successful the group has been in turning its work in progress into cash.

Despite the strength of the balance sheet, Abbey trades at a significant discount to its net asset value. At Thursday's closing price of 440c, the stock is trading over 40% below the value of its underlying assets. This clearly reflects the market's (valid) concerns about the carrying value of the group's land in Ireland. However, having significantly written-down the value of this land, it represents only a small part of Abbey's assets. In fact, putting a value of zero on the group's development land in Ireland reduces the NAV by just 41c to 583c. On this basis, we think the stock is exceptionally cheap and recommend that investors buy the shares. We currently have a target price of 583p per share, some 30% above current levels.

Return to home meal preparation may not be as transient as most observe it to be

John O'Reilly

A social phenomenon of the past half century of the industrious organisation of the family (i.e a family in which there is more than one significant contributor to household income) was the migration to the marketplace of goods and services which, under the previous century's breadwinner-housemaker model, were the output of domestic production and labour. In the industrious family era (broadly in train since the 1950s), laundry, infant and child care, meals and personal care (hair management) among other services (readers can add copiously to this list) were moved from home production to marketplace purchase. This became cultural (collective attitudes and behaviour that characterise the functioning of a group or organisation). It seemed to represent the natural order of things, a logical progression in human development. From an historical standpoint, there is nothing logical, natural or necessary to it. In human history there has been an ebb and flow between the industrious and breadwinner models. That one or the other may prevail is entirely contingent or circumstantial.

So, when you hear the following, think twice.

- Asda tells you its home hair care colourants are among the fastest-growing item in its stores.
- Technomic Research tells you that 40% of US consumers are likely to entertain at home next year.
- Cookery has moved from television spectacle to actual learning, and supposedly lost skills are rapidly re-appearing.

(You can think of your own examples.)

More than a reaction to income pressure may be taking place. Many of these behaviours may come to have a meaning or value which transcends their measurability in money. As Einstein observed, "not everything that can be counted counts, and not everything that counts can be counted". While falling income may have catalysed these changes, it is far from certain that rising incomes (though the duration of income pressure may be significant) will see their reversal.

Leszek Kolakowshi, the recently deceased Polish philosopher and historian of ideas, coined the expression "the laws of infinite cornucopia" to succinctly argue that an infinite number of explanations can be found for any given event.

No less than in the case of food, it should not be presumed that historic consumer behaviour or spending must necessarily return even if there is a return to household income growth.

A feature of the breadwinner/homemaker model was the predominant role of men as the sole or chief income earners. Looking at the latest UK employment data, which show a higher level of redundancies and male unemployment, the strange thought occurred: what are the chances of this type of family organisation recurring, with women as the predominant income earners?

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