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Davy Research

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DAVY

Research Report: Market strategy

## New stock rating system

New rating system highlights likely outperformers; Davy conviction list comprises world-class companies and interesting opportunities

### New stock-rating system highlights likely outperformers

- We are introducing a new stock-rating system from today, July 1st, which we believe better reflects investors' increasing sectoral focus.
- These ratings aim to predict a stock's performance relative to the relevant E300 benchmark over the next 12 months.
- The new rating categories are: 'outperform' ( $\geq 10\%$  over the benchmark over the next 12 months); 'neutral' ( $\pm 10\%$  relative to the benchmark) and 'underperform' ( $\leq 10\%$  relative to the benchmark).
- Table 1 shows the ratings for each of the stocks we cover by sector.

### Davy conviction list — a mix of world-class companies and interesting opportunities

- Having assessed our top picks by sector (see Table 2), we have derived a conviction list of stocks which, we believe, will record a significant absolute and relative performance over the next 12 months.

#### Davy conviction list

CRH

Smurfit Kappa

Ryanair

EasyJet

Kerry

Glanbia

C&C

Irish Life & Permanent

DCC

Paddy Power

Source: Davy

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## New rating system highlights likely outperformers

We are today (July 1st) introducing a new stock-rating system which, we believe, better reflects investors' increasingly sectoral approach to the market. It also reflects our coverage of more international stocks across a range of sectors.

The key elements of the new system are:

- Each stock is rated 'outperform', 'neutral' or 'underperform' relative to the relevant E300 benchmark.
- Outperform: we expect the stock to outperform the relevant E300 sector by 10% or more over the next 12 months.
- Neutral: we expect the stock to perform in line with the relevant E300 sector (+/-10%) over the next 12 months.
- Underperform: we expect the stock to underperform the relevant E300 sector by 10% or more over the next 12 months.
- Under review: the rating is actively under review.
- Suspended: the rating is suspended until further notice.
- Restricted: the rating has been removed in accordance with Davy policy and/or applicable law and regulations where Davy is engaged in an investment banking transaction and in certain other circumstances.

Table 1 shows the ratings for each stock under coverage by sector. For a more detailed discussion of our views on stocks or our ratings, investors should contact the relevant analyst.

**Table 1: Davy stock ratings by sector**

<i>Sector/ Stock</i>	<i>Analyst(s)</i>	<i>Current rating</i>	<i>Benchmark</i>
<b>Construction/Paper</b>			
CRH	Barry Dixon	Outperform	E300 Construction & Materials
Abbey	Robert Gardiner	Outperform	E300 Construction & Materials
Barratt Developments	Robert Gardiner	Outperform	E300 Construction & Materials
Bellway	Robert Gardiner	Outperform	E300 Construction & Materials
Bovis Homes	Robert Gardiner	Outperform	E300 Construction & Materials
Persimmon	Robert Gardiner	Outperform	E300 Construction & Materials
Redrow	Robert Gardiner	Outperform	E300 Construction & Materials
Saint-Gobain	Tim Cahill	Outperform	E300 Construction & Materials
SIG	Tim Cahill	Outperform	E300 Construction & Materials
Taylor Wimpey	Robert Gardiner	Outperform	E300 Construction & Materials
Travis Perkins	Florence O'Donoghue	Outperform	E300 Construction & Materials
Smurfit Kappa Group	Barry Dixon	Outperform	E300 Forestry & Paper
<b>Construction &amp; Materials</b>			
Grafton Group	Florence O'Donoghue	Neutral	E300 Construction & Materials
Kingspan Group	Florence O'Donoghue	Neutral	E300 Construction & Materials
Berkeley	Robert Gardiner	Neutral	E300 Construction & Materials
McInerney Holdings	Robert Gardiner	Neutral	E300 Construction & Materials
Readymix	Robert Gardiner	Neutral	E300 Construction & Materials
<b>Construction &amp; Materials</b>			
Holcim	Tim Cahill	Underperform	E300 Construction & Materials
HeidelbergCement	Robert Gardiner	Underperform	E300 Construction & Materials
Lafarge	Tim Cahill	Underperform	E300 Construction & Materials
Wienerberger	Tim Cahill	Underperform	E300 Construction & Materials
Wolseley	Florence O'Donoghue	Underperform	E300 Construction & Materials
<b>Construction &amp; Materials</b>			
Qualceram Shires	Robert Gardiner	Suspended	E300 Construction & Materials
<b>Financials</b>			
Bank of Ireland	Emer Lang/Scott Rankin	Outperform	E300 Banks
Irish Life & Permanent	Emer Lang/Scott Rankin	Outperform	E300 Life Insurance
IFG Group	Emer Lang/Scott Rankin	Outperform	E300 General Financial
<b>Financials</b>			
Allied Irish Banks	Emer Lang/Scott Rankin	Neutral	E300 Banks
FBD Holdings	Emer Lang/Scott Rankin	Neutral	E300 Non-life Insurance
<b>Food &amp; Beverage</b>			
C&C	Barry Gallagher/Brian Fagan	Outperform	E300 Beverages
Carlsberg	Barry Gallagher/Brian Fagan	Outperform	E300 Beverages
Fyffes	John O'Reilly	Outperform	E300 Food Producers
Glanbia	John O'Reilly	Outperform	E300 Food Producers
Kerry Group	John O'Reilly	Outperform	E300 Food Producers
Origin Enterprises	John O'Reilly	Outperform	E300 Food Producers
<b>Food &amp; Beverage</b>			
ARYZTA	John O'Reilly	Neutral	E300 Food Producers
Total Produce	John O'Reilly	Neutral	E300 Food Producers
<b>Food &amp; Beverage</b>			
Donegal Creameries	John O'Reilly	Underperform	E300 Food Producers
Greencore Group	John O'Reilly	Underperform	E300 Food Producers
<b>Pharma &amp; Healthcare Services</b>			
Elan Corp	Jack Gorman	Outperform	E300 Pharma & biotech
United Drug	Jack Gorman	Outperform	E300 Health Care & Services
<b>Pharma &amp; Healthcare Services</b>			
ICON	Jack Gorman	Neutral	E300 Health Care & Services
Trinity Biotech	Jack Gorman	Neutral	E300 Pharma & biotech
<b>Pharma &amp; Healthcare Services</b>			
AGI Therapeutics	Jack Gorman	Under Review	E300 Pharma & biotech
Amarin	Jack Gorman	Under Review	E300 Pharma & biotech

**Table 1: Davy stock ratings by sector (continued)**

Airlines & Other Transport			
Ryanair Holdings	Stephen Furlong	Outperform	E300 Travel & Leisure
easyjet	Stephen Furlong	Outperform	E300 Travel & Leisure
Irish Continental Group	Stephen Furlong	Outperform	E300 Travel & Leisure
Aer Lingus			
	Stephen Furlong	Neutral	E300 Travel & Leisure
Air France KLM			
	Stephen Furlong	Underperform	E300 Travel & Leisure
British Airways			
	Stephen Furlong	Underperform	E300 Travel & Leisure
Iberia			
	Stephen Furlong	Underperform	E300 Travel & Leisure
Lufthansa			
	Stephen Furlong	Underperform	E300 Travel & Leisure
Gaming			
Paddy Power	David Jennings	Outperform	E300 Travel & Leisure
William Hill	David Jennings	Neutral	E300 Travel & Leisure
Ladbrokes	David Jennings	Underperform	E300 Travel & Leisure
Resources			
Tullow Oil	Job Langbroek/Caren Crowley	Outperform	E300 Oil & Gas Producers
Glencar Mining	Job Langbroek/Caren Crowley	Outperform	E300 Mining
Petroceltic	Job Langbroek/Caren Crowley	Outperform	E300 Oil & Gas Producers
Aminex	Job Langbroek/Caren Crowley	Outperform	E300 Oil & Gas Producers
Kenmare	Job Langbroek/Caren Crowley	Outperform	E300 Mining
Ormonde			
	Job Langbroek/Caren Crowley	Neutral	E300 Mining
Petronet			
	Job Langbroek/Caren Crowley	Neutral	E300 Oil & Gas Producers
Dragon Oil			
	Job Langbroek/Caren Crowley	Restricted	E300 Oil & Gas Producers
Support Services			
DCC	David Jennings	Outperform	E300 Support Services
CPL Resources	Ivan Skelly	Outperform	E300 Support Services
Veris plc	Ivan Skelly	Outperform	E300 Support Services
Siteserv			
	Robert Gardiner	Neutral	E300 Support Services
Media & Technology			
TVC Holdings	Stephen Furlong/Ivan Skelly	Outperform	E300 Media & Entertainment
Independent News & Media			
	Stephen Furlong	Neutral	E300 Media & Entertainment
UTV Media			
	Stephen Furlong	Neutral	E300 Media & Entertainment
Datalex			
	Ivan Skelly	Neutral	E300 Technology
getmobile			
	Ivan Skelly	Neutral	E300 Technology
Trintech			
	Ivan Skelly	Neutral	E300 Technology
Property			
Blackrock Intl. Land	Stephen Lyons	Outperform	E300 Real Estate
China Real Estate Opportunities	Stephen Lyons	Neutral	E300 Real Estate

Source: Davy

## Davy conviction list

Having assessed each of the stocks in our universe, we have determined our top picks by sector.

**Table 2: Davy top picks by sector**

<i>Construction/ Industrials</i>	<i>Financials</i>	<i>Food and Beverage</i>	<i>Pharma</i>	<i>Transport</i>	<i>Gaming</i>	<i>Resources</i>	<i>Support Services</i>	<i>Small-cap</i>
CRH	Irish Life & Permanent	Kerry	Élan	Ryanair	Paddy Power	Tullow	DCC	CPL
Travis Perkins	Bank of Ireland	Glanbia	United Drug	easyjet				TVC
SIG		C&C						
Bovis		Origin						
Barrett								

Smurfit Kappa

Source: Davy

After assessing this list and taking account of underlying risk profiles, we have derived our conviction list, which comprises our top-10 picks in our coverage universe over the next 12 months.

**Table 3: Davy conviction list**

CRH
Smurfit Kappa
Ryanair
EasyJet
Kerry
Glanbia
C&C
Irish Life & Permanent
DCC
Paddy Power

Source: Davy

## Our coverage universe has a number of world-class companies

Our conviction list focuses on what we believe are world-class companies — we think that investors will continue to focus on quality companies that compare well in a global context. We now cover a number of international stocks across a range of sectors (construction, airlines, gaming, and food and beverage) and we use four metrics to assess their quality in an international context:

- Leading market positions;
- Strong management as evidenced by consistent creation of economic value;
- Stable earnings; and
- Strong balance sheets.

From our universe of stocks, we have derived a conviction list which meets some or all of these criteria.

**Table 5: World-class companies on our conviction list — key metrics**

	<i>Industry leader</i>	<i>Strong management (5-yr ROIC-WACC %)</i>	<i>Stable earnings (5-yr CAGR EPS growth)</i>	<i>Strong balance sheet: (net debt/ EBITDA)</i>
CRH	Number 1 or 2 in most of its construction-related markets in Europe/ Americas	3.20%	-10%	1.9
Kerry	Leading player in the global food ingredients market	5.80%	5%	2.1
Glanbia	Leading player in the US dairy protein market	13.1%	9%	2.2
Ryanair	Largest low-cost airline in the world	6.10%	-3%	0.6
easyjet	A leading player in the European low-cost airline market	-0.3%	4.2%	0.3
DCC	Number 1 energy distribution company in Ireland/UK	8.8%	1%	0.4
Paddy Power	Leading player in the Irish bookmaking market with a growing presence in the UK	76.1%	31.5%	Cash positive

Source: Davy

A number of smaller-cap companies also have significant positions in interesting markets:

- C&C is one of the leading players in the cider market in Ireland and the UK. Recent analysis indicates that the new management team has been successful in rebuilding a number of key industry relationships in the UK while the roll-out of Magners Pear has also been encouraging.
- Smurfit Kappa Group is the leading supplier of corrugated boxes in the European market with over 25% market share. We believe that we are close to the bottom of the current (very deep) cycle and SKG is best placed to benefit from the upturn.

### **Outlook for financial sector: valuations attractive but risks remain**

Since the lows of early March, Bank of Ireland has increased 15-fold while Allied Irish Banks and Irish Life & Permanent have risen by almost a factor of seven. This performance was driven in part by the global rally in financial stocks but more specifically by the growing realisation that the Irish banks — apart from Anglo — are unlikely to be nationalised.

The issue now is where they go from here? Currently the two banks are trading on 0.85-1.0x times our 2010 tangible book value forecasts while Irish Life & Permanent is trading at 0.4x our 2010 embedded value, or 0.7x NAV if we back out insurance VIF and goodwill. This looks excellent value if our forecasts prove accurate and the stocks can return to double-digit ROEs. However, there are a number of key variables which will determine how this sub-normal multiple will evolve over time, i.e. whether share prices increase or book values decline:

- Timing and structure of NAMA;
- Once NAMA is enacted, the level of 'haircuts' applied to the assets transferred;
- The level of 'haircuts' will effectively determine the additional government capital required (if any) by the banks and thus any additional dilution;

- The ability of the banks to raise new equity — which could prevent further dilution by allowing them to buy back government prefs;
- The impairment losses on the remaining assets held on the banks balance sheets;
- The ability of the banks to restore profitability post-NAMA and the magnitude of those profits.

Applying sensitivity analysis to each of these factors gives a wide TNAV range for both Bank of Ireland and Allied Irish Banks.

Our preference amongst the big two is Bank of Ireland as we believe it does not need to raise capital to cover NAMA-related write-downs and — all going well — the stock has the capacity to rise significantly from here on a two-year view. However, the stock remains high-risk and given the strong run it has had, it is difficult to put Bank of Ireland on our conviction list ahead of Irish Life and Permanent at this point.

Irish Life & Permanent looks cheaper on a net asset value (embedded value) basis with no dilution or rights issue execution risk and looks the better bet from here.

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### Our ratings are based on the following parameters:

**Outperform:** Outperforms the relevant E300 sector by 10% or more over the next 12 months.

**Neutral:** Performs in-line with the relevant E300 sector (+/-10%) over the next 12 months.

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			Count	Percent
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Neutral	22	28	12	29
Underperform	12	15	1	2
Under Review	3	3	2	4
Suspended	1	1	1	2
Restricted	1	1	1	2

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