Weekly Outlook

DOLMEN SECURITIES
member of the ERGO Group

6 June 2006

Brief Market View

The FTSE 100 index closed marginally lower last week, as shares were unable to make up lost ground in the wake of Tuesday's rout. Shares recovered from lows as a resurgence in M&A activity was underpinned by solid gains in utility and banking stocks. US stocks were lower in another week of volatile trading as gains towards the end of the week looked to have cancelled out heavy losses from Tuesday. But shares fell again on Friday in the wake of a weaker than expected jobs report. Stocks dropped on Tuesday after minutes from the last Federal Reserve meeting indicated that inflation pressures raised the chance of another interest rate hike in June. The Irish market outperformed its global peers last week to close by almost half a percent higher.

In a relatively quiet week for data, the outlook for monetary policy will remain the major focus.

On Monday evening Fed Chairman Ben Bernanke, was speaking at a bankers' conference in Washington and said that the U.S. Federal Reserve needs to be vigilant to make sure inflation stays under control even as the U.S. economy starts to shift to a slower pace of growth. "It is reasonably clear that the U.S. economy is entering a period of transition," Bernanke told the conference. "The anticipated moderation of economic growth seems now to be under way." While welcoming signs of cooler growth, the Fed chairman stressed concerns over core inflation, saying it had reached levels that "if sustained" would put it at or above the upper end of the range consistent with price stability. "These are unwelcome developments," Bernanke said of the quickening pace of non-food, non-energy inflation. "The (Fed's policy-setting) committee will be vigilant to ensure that the recent pattern of elevated monthly core inflation readings is not sustained," he said. Financial markets saw the comments as suggesting the Fed was likely to raise benchmark overnight interest rates for a 17th consecutive time at its upcoming meeting on June 28-29.

Then comes the main market event on Thursday with the ECB interest rate decision and subsequent press conference. While the strength of recent data has increased speculation of a possible 50bps hike, we believe a 25bp move is more likely. The latest bout of dollar weakness in wake of the much softer than expected non-farm payrolls in May, up only 75k versus consensus of 170k, supports the less aggressive move.

In the UK, the Bank of England announces its rate decision on Thursday (at noon UK time, 45 mins ahead of the ECB). Mixed data has left the market unanimous in its expectation of an unchanged at 4.50%. We expect such inertia to continue for the rest of this year.

While markets do present difficulties, they also provide opportunities to find lower entry levels into preferred sectors and stocks, but it also helps investors evaluate the make-up and risk profile of their current portfolio.

The stocks that will find most favour in the current period of market weakness are those with solid earnings with an attractive valuation and attractive yield. As a result we favour banking stocks (HBOS, Bank of Ireland), pharmaceuticals (GlaxoSmithKline, AstraZeneca), telecoms (BT and Vodafone), oil (BP, Sterling Energy) and insurance (Aviva, Legal and General). Also with the oil price weakening the stocks like Ryanair and British Airways, both of which are extremely profitable, should benefit.

In terms of corporate events to keep an eye on this week, Ryanair and Carphone Warehouse report FY results on Tuesday. Greencore reports interim results on Wednesday. On Thursday AstraZeneca will unveil its annual business review.

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Earnings Calendar

Date	Company	Event
6-Jun	Ryanair	FY
7-Jun	Greencore	H1

Upcoming events

12-Jun	Alliance & Leicester	Trading
13-Jun	RBS	Trading
19-Jun	Lloyds	Trading
21-Jun	HBOS	Trading

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Trading ideas for the week

Ryanair (€6.88) Strong results

- FY results : This morning, Ryanair announced results for the year ended 31/03/06. Net profit and eps of €302m and 39.3c respectively, were c.1% ahead of consensus forecasts of €299m and 38.9c, and were year on year increases of 12% and 11%. The earnings growth was driven by strong passenger and ancillary revenue growth more than offsetting higher fuel costs, as the airline's average fare continued to remain resilient.
- Hedging progress : Ryanair also announced that it has hedged 90% of its fuel needs from June to October at an average price of $70 a barrel, and that it hoped to hedge its winter fuel costs by the end of the summer. Summer bookings appear to be "moving along nicely", and it is now expecting a "5% to 10% increase" in current year net profit, if oil remains at $70.
- Online check-in : In addition to strong revenue growth, another offset against higher fuel costs is the recently launched online check-in service. Passengers are now able to check-in both themselves and their luggage online at ryanair.com, thereby by-passing time consuming airport queues. The resultant lower airport and handling costs are expected to generate annual cost savings of c.€30m.
- Oil headwind : Our current assumption is that Ryanair has to pay an average of $2.25 per gallon of jet kerosene over the 12 months ending 31/03/07, which is the kerosene price implied by NYMEX oil at $70 per barrel, and that these extra fuel costs are offset by a €1 increase in the average fare from €48.60 to €49.60. This would leave Ryanair's eps flat for the 12 months ending 31/03/07 at 40c.
- Earnings sensitivity : While a greater increase than this in the average fare creates the potential for some earnings growth, every c.6% increase in the oil price above $70 would fully offset every €1 increase in the average fare above €49.60.
- Attractive upside : However, Ryanair's continued expansion should ensure that passenger growth of at least 14% to 40m passengers is achieved during the 12 months to 31/03/07. Over the past 12 months, our continued BUY recommendation has been based on the view that given the secular growth prospects in Europe and the comparative multiples at which the US low cost airlines are rated, a multiple of 20x earnings is a fair rating for the shares. Therefore, our current 12 month price target of €8 (16% upside) is based on 20x forward eps of 40c : BUY.

Aviva (£7.35) Targeting strong international growth

- International targets : Aviva has announced some strong growth targets for its international business, under pressure to demonstrate its own growth potential, after its takeover bid for Prudential was rebuffed in March. The company has declared a stated objective of growing its existing international sales by at least 10% per annum over the next 5 years.
- Growth potential : The company also confirmed that growth in its international new business profit should at least match its sales growth. In 2005, 40% of group sales and 50% of group profit was generated outside of the UK. Aviva is targeting both its existing presence in developed markets such as France, the Netherlands, Italy, Ireland, Spain and Canada, for this sales growth, as well as building leadership positions in selected emerging markets, In Q1 2006, Aviva International grew its life and pension sales by 15% to £3.67 bn.
- Q1 sales : Aviva's overall group life and pension sales result for the 3 months ended 31/03/06 was £6.8 bn. This was 12% better than the consensus forecast of £6.08 bn, and was a year on year increase of 20%. The result was 9% better than even the top end of the forecast range of £6.24 bn.
- Bid target : Our current view is also that the end result of the recent £7.08 per share takeover offer for Prudential could be that Aviva itself ends up receiving a takeover approach. This is because the offer confirms Aviva's ambitions of building a global and US presence, and its European exposure may be of interest to AIG or AXA.
- Stand-alone value : However, even on a stand-alone basis, Aviva's share price would appear to have significant upside potential from current levels as a result of the continued buoyancy of the UK life sector. Given that Aviva's 2006 return on embedded value of 16.8% is 21% stronger than the UK sector average of 13.9%, our view is that its price to embedded value (EV) should trade at a similar premium to the UK sector.
- Attractive upside : Therefore, our current 12 month price target for Aviva of £8.50 (16% upside), is based on 1.6x 2006 EV per share of £5.30. The recent market sell-off has resulted in the UK life sector average falling by c.10% to a price / 2006 EV sector average multiple of 1.35x. Aviva shares will also pay investors a dividend yield of c.4% for waiting for this upside to be achieved : BUY.

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Trading ideas for the week (continued)

GSK (1,480p) Positive Tykerb data

- ASCO conference: Over the week-end, GlaxoSmithKline revealed positive results from trials of its experimental breast cancer drug Tykerb at the American Society of Clinical Oncology (ASCO) in Atlanta. The data showed that Tykerb slowed aggressive, late-stage breast cancers that resumed growing despite standard treatment with the drug Herceptin. The results point towards potential future sales of over £1bn for the drug and have already prompted upgrades to forecasts.
- Q1 Results: In late April GlaxoSmithKline reported better than expected results for the three months ended March 31st 2006, driven by strong sales of its key drugs and vaccines. Turnover and EPS of £5,813m and 26.5p were year on year increases (on a constant exchange rate basis) of 10% and 17% respectively, and were ahead of consensus forecasts of £5,625m and 23p.
- Growth drivers: The key drivers of the results were strong performances of GSK's big name medicines. Sales of its Avandia/diabetes (+24% to £384m vs £320m exp.), Coreg/heart disease (+53% to £225m vs £170m exp.) and Vaccine (+44% to £366m vs £312m exp.) products beat expectations, while Advair/asthma (+12% to £816m vs £860m) was slightly behind.
- Pipeline progression: GSK also reported 'significant progress' in its near-term drug development pipeline, with its cervical cancer vaccine Cervarix filed with EU regulators and 13 other markets in March and strong Phase III data on Tykerb, a new oral medicine for breast cancer. This should support an earlier than expected filing with European and US regulators in the second half of this year.
- Product launches: GSK possesses one of the most exciting R&D outlooks in the sector. The next 12 months will see a host of key updates hitting the market, including 8 new products expected to enter Phase III development, 7 regulatory filings and 7 important product launches. These updates will keep sales forecasts ticking upwards over the course of 2006.
- Further upside: Given that the sector is currently trading at 19x 07 EPS we believe that no more than a 10% discount for GSK is appropriate to reflect its slightly slower than average earnings growth and therefore, our 12-month price target price of 1,650p is based on 17x 07 EPS of 97p. The strength of GSK's pipeline remains the key driver of our investment case, and we expect to receive further evidence of its positive impact on earnings over the coming months. **BUY**

RBS (£17.60) Upgrading from NEUTRAL to BUY

- Management meeting: Following our recent investor meeting with Group Finance Director, Guy Whitaker, we are this morning upgrading our RBS recommendation from NEUTRAL to BUY. Our new 12 month price target of £20.50 (14% upside), is based on 10x 2007 underlying eps of 205p. Our 2006 eps forecast remains 190p, representing 8% growth on the 2005 result of 175.9p.
- Savings growth: In line with recent results from the UK life assurers, it was confirmed that sales of savings and deposit products are very strong currently, resulting in the bank's liability growth exceeding its loan growth. When combined with a steepening US yield curve, this should ensure that there is no further significant erosion of the group's net interest margin in 2006. This was one of the main reasons why we had been recommending some profit-taking in recent months.
- Deal risk: It was also clearly stated that all of the group's growth targets could be achieved organically from its UK and Irish, US and Chinese operations and that the current share buyback programme would continue. If the upcoming IPO of the bank's Bank of China investment results in RBS diluting its shareholding below 5%, then this could provide further reassurance that the risk of a major RBS deal over the next 12 months is very low.
- Personal exposure: Despite recent press coverage of the Q1 rise in UK personal insolvencies, it was also confirmed that RBS has suffered no material deterioration in personal lending credit quality recently. Its lower than sector average exposure to unsecured personal lending of c.7% of global loan book provides some important protection from this risk.
- Recommendation upgrade: In addition to the upcoming Bank of China IPO, which recent press coverage has reported will show a trebling of the initial value of the RBS investment a year ago, another near term positive catalyst for the RBS share price could be the bank's H1 trading statement on 8th June. Therefore, ahead of the very often seasonally strong month of June for the RBS share price, we this are this morning once again upgrading our recommendation from NEUTRAL to BUY, with a new 12 month price target of £20.50 (16% upside), which is based on 10x 2007 eps of 205p : **BUY**.

Lloyds-TSB (502p) Attractive buying opportunity

- UK growth : Lloyds TSB announced profit before tax and eps of £3.47 bn and 44.6p respectively for the year ended 31/12/05. These results were ahead of consensus forecasts of £3.315 bn and 42p, and were year on year increases of 4% and 8%. The results showed modest retail banking growth and good cost control being less offset by higher bad debts than had been expected.
- SW recovery : The results also indicated that there has been no further deterioration in retail unsecured credit quality since the bank's trading statement in December, and that the outlook for Scottish Widows is continuing to improve. This business and Lloyds' Insurance and Investments division in general is benefiting from a strengthening UK life and pensions market, as well as increasing bancassurance volumes.
- Attractive yield : It is also worth noting that even though the 2005 bad debts charge as % of average loans was higher in retail banking, it was lower at the group's corporate lending operations as credit quality at the bank's Wholesale & International business remained strong. With an above average probability of a 2006 takeover approach, an attractive dividend yield of **6.8%**, and a stand-alone ex-dividend fair value per share of £5.70, based on 12x 2006 eps of 47.5p, our view is that the market sell-off of recent days has generated a very attractive buying opportunity in Lloyds TSB at current levels : **BUY**.

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