Equity Research; Brexit & Devaluation impact

COLLINS SARRI STATHAM INVESTMENTS

Research Report

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Analyst

Ravi Lockyer MSc Llb

Collins Sarri Statham Investments Ltd

"Brexit" & the Devaluation Impact

The FTSE 100 is a value weighted index – one whose performance is largely determined by just a handful of companies. "Brexit" reiterated this point. There are 162 "blue chip" companies (17.4% of main market UK listed companies) with a market capitalization exceeding £2bn (a rough threshold for FTSE 100 entry a decade ago). However the UK's top ten companies are a combined £797bn. As the table below shows, six of the ten report results and more importantly pay dividends in USD or Euros (making them more valuable in this environment).

Co	Market Capitalisation	Reporting Currency	Dividend Currency	Movement since June 23^{rd} (%)
RD Shell A+B	£171bn	USD	USD	+14.0
HSBC	£122.4bn	USD	USD	+35.0
BP	£91.7bn	USD	USD	+23.4
BAT	£89.3bn	STG	STG	+12.0
GSK	£82bn	STG	USD	+13.2
Astra Zeneca	£62bn	USD	USD	+21.4
Vodafone	£60bn	EUR	EUR	+2.4
Unilever	£45bn	EUR	STG	+7.2
Lloyds Banking	£37.5bn	STG	STG	-27.2
Rio Tinto	£35.9bn	USD	STG	+24.1

In April 2016 Vodafone's board decided to report and pay in Euros for Fy17. Vodafone has significant borrowings in USD and Euros despite no longer having much US exposure (it divested its major US asset; its 49% stake in Verizon Wireless in 2014). This probably explains its limited performance since June 23^{rd}.

Elsewhere share movements demonstrate the best performance has come from assets with the least UK exposure. The reverse holds as well, the worst performance (Lloyds) has come from the equities with the most UK exposure.

The decline in sterling to 31 year lows (Sterling dropped briefly to $1.02 in 1985) happened in two stages. Firstly in the early hours of June 24^{th} as the vote result became apparent (£/$1.34) then post the week of the Conservative party conference on the 7^{th} October and the "flash crash" that caused a drop in sterling during Asian trading to £/$1.14. This second decline was triggered by the PM's speech at the Tory party conference which suggested a "hard Brexit" that the UK would not bend on the issue of immigration, even if it meant losing access to the EU single market.

This is typical in a devaluation scenario. The first fall is in response to a shock event, the second in response to the aftermath and loss of confidence. The implications of "hard Brexit" i.e. withdrawal from the EU single market in return for immigration controls creates significant economic uncertainties specifically for UK GDP growth.

But the problem is the damage being done to the UK's image and perception abroad.

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Overseas investors typically view the UK through the prism of cosmopolitan London. But this is no longer represents the UK's real direction, and is at odds with a "Britain that works for everybody". Sterling has behaved like a third world currency. Investors have perceived the UK as becoming hostile to foreigners.

Pre vote Governor Mark Carney, governor of the Bank of England referred to the UK's reliance on funding its current account deficit on the "kindness of strangers". It is clear that post vote, overseas investors are voting with their feet. But despite the precipitous fall in sterling, the government has kept silent, which is tacit encouragement of the fall.

The PM believes the UK can hammer out new trade relationships on its own with non EU countries. Agreed deals can be legally signed *after* the UK leaves the EU. But what precisely will the UK export to the rest of the world? The UK is an import economy, reliant on financial services with limited manufacturing and industrial capabilities.

The UK requires access to the EU single market but if the last 40 years are representative, the UK will again try to "game" Europe ie extract the benefits whilst opting out of its rules, publicly denigrating the EU project, extracting rebates. It is unlikely the EU will permit the UK to replay this approach. There is widespread disillusion in the EU at the way the UK has behaved. The UK has set a very unwelcome precedent for the EU.

The UK approach assumes it is in a position to obtain EU member benefits from the new standpoint of being a non EU member. This laughable approach has some probability of failure. It will get nasty and take longer than two years to resolve. But until the relationship with the EU is clear, sterling is likely to be volatile. We see merit in sticking with companies with significant non UK businesses and overseas revenues.

Babcock – FTSE 100 – BUY

Babcock is a diversified international defence contractor/ engineering support services business. It is split between i) Marine Technology (UK & Canadian submarine refits/ UK surface fleet refits, weapons handling & equipment support), ii) Defence & Security (training for British Army, RAF, RN), iii) Support Services (nuclear support, decommissioning, new building/ support at airports, rail & power facilities) and iv) International operations (air ambulance, firefighting, search & rescue / and power generation in Africa). Babcock is the UK's second largest Ministry of Defence supplier (around 7.7% of MoD procurement worth £1.5bn in 2016). However going forward MoD defence budgets are only expected to grow 0.5% above inflation. Babcock is targeting growth overseas.

Babcock has a strong track record of revenue & profit growth. It has a £20bn order book, (plus a £10.5bn pipeline), without sacrificing operating margins (c. 11%).

Consensus profit estimates; Babcock							
Year End	Revenue (£m)	Net Income (£m)	EPS (P)	DPS (P)	P/E (x)	Yield (%)	Share Price (p)
Mar-16	£4,150	£373.4	74.1	25.80	13.4	2.60	992.5
Mar-17	£5,187	£387.2	80.6	28.20	12.3	2.84	
Mar-18	£5,500	£431.1	87.5	30.65	11.3	3.09	

Source: Bloomberg

The consensus forecasts envisage revenue and profit growth ahead, yet the Brexit sell off has sharply cut Babcock's rating. The Babcock board has confirmed their guidance of revenue growth of 6.5%. This is a decent growth rate given the pressure on EU government defence budgets.

Company	BAB	**Key Catalysts**
Share Price	992p	Babcock's recent Investor Day (October 17th) focused on the DSG acquisition (which enhances Babcock's land/ army fleet management capabilities) and Babcock's impressive recent contract wins. (£80m missile tube deal with Gen Dynamics). Interim results due 22 November are expected to show revenue growth trends in line with expectations and international opportunities. SDSR 2015 (£9bn MoD efficiency drive to 2021) is a significant opportunity
Target Price	1150p	
52 Week Hi/Low	1105p/854p	
Shares O/S	505.6m	
Market Capitalisation	£5.02bn	
Avg. Daily Volume	1.72m	
Dividend Yield	2.59%	

Source: Fidessa

Key Risks to Price Target

i) Some risks to growth objectives as defence budgets contract in the UK/ EU/ North America and Middle East.
ii) Recent acquisition of Defence Support Group will take time to integrate
iii) UK Ministry of Defence budgets are expected to grow by inflation +0.5%

Mediclinic International – FTSE 100 – BUY

Mediclinic International is an international private hospital group, headquartered in London with operations in South Africa, Namibia, Switzerland and the UAE. The group has grown via acquisition, its major buyouts were Hirslanden (acquired in 2007 for CHF2.5bn) and Al Noor Hospitals (February 2016). Mediclinic has 73 hospitals with 10,200 beds, and 35 clinics.

For Fy16 Mediclinic revenues rose 7% to £2.1bn whilst underlying earnings rose 13% to £219m, helped by a strong performance at its Swiss operation (8% revenue growth to CHF1.65bn) and South Africa (9% revenue growth to (ZAR 13.45bn) and 15% revenue growth in the Emirates. There was a currency impact from the weak Rand in FY16. FY17 will be positive from a currency standpoint, due to Franc strength.

Mediclinic owns 29.9% of Spire Healthcare (LSE; SPI) a large UK healthcare business valued at £1.54bn. Mediclinic is rumoured to want Spire (source; Betaville 16 September 2016) for £1.8bn – a factor that has contributed to a 220p loss in the Mediclinic share price since late August when the Spire speculation emerged. The Mediclinic board has not commented on the Spire speculation which could double debt to over £3bn. Our view is investors have priced in a possible Spire acquisition.

Consensus profit estimates; Mediclinic International							
Year End	Revenue (£m)	PBT (£m)	EPS (p)	DPS (p)	P/E (x)	Yield (%)	Share Price (p)
Mar-16	2,100	245.0	36.7	5.24	24.5	0.58%	898.5
Mar-17	2,781	393.1	42.8	10.25			
Mar-18	3,029	457.7	50.2	12.65			

Source: Bloomberg

The consensus forecast for Mediclinic have incorporated the Al Noor acquisition and expected growth in demand in the Middle East, where there has been increased demand for private healthcare to treat lifestyle related ailments and due to ageing populations.

Company	MDC
Share Price	898.5p
Target Price	1200p
52 Week Hi/Low	1191p/817p
Shares O/S	737.24m
Market Capitalisation	£6.62bn
Avg. Daily Volume	1.2m
Dividend Yield	0.83%

Key Catalysts

Spire is the major issue at the moment and our expectation is it will be resolved soon. An acquisition is not vital for profit growth and is a finely balanced decision given Mediclinic's net debt of £1.53bn (which would more than double if it borrowed to pay for Spire).

We like Mediclinic's exposure to growth businesses in private healthcare which should benefit from an ageing population and limited competition. Also positive is the international spread (c. 65% is the Swiss operation)

Source: Fidessa plc

Key Risks to Price Target

i) If Mediclinic buys Spire, it could be poorly received.

ii) A rise in sterling would impact EPS boost given revenues in Swiss Francs, UAE Dirhams and South African Rand.

iii) Medclinic has significant investment requirements to achieve growth objectives.

TUI AG – FTSE 100 – BUY

TUI AG was formed via the £5.6bn merger of Tui Travel with TUI AG in December 2014. Tui Travel was itself the product of a merger with First Choice Holidays in 2007 and Thomson Holidays (owned by TUI). The business reports and pays dividends in Euros hence weak sterling will impact revenues and profits. So far the TUI board have maintained the existing profit guidance of 10% annual growth in operating profit to 2018 reflecting higher passenger volumes.

This is despite a tough 2016 with heightened terrorist problems in France and Belgium, unrest in Turkey and North Africa. In addition "Brexit" i.e. weak sterling will cost TUI around €100m in lost profit. TUI has however hedged its US$ based petrol costs – 93% hedged in respect of winter 2016/2017.

The board reported they are discussing a merger between TuiFly and Eithad Airlines to create a new EU airline. This could mark a spin off opportunity for TUI AG and enable it to concentrate on TUI Cruises. TUI has been repositioning operations post the sale of its Hotelbeds Group for €1.2bn in April 2016. Hotelbeds was the world's largest bed bank offering 72k beds to travel agencies and airlines.

Consensus profit estimates; TUI AG							
Year End	Revenue (EUR bn)	PBT (EUR m)	EPS (EUR)	DPS (cts)	P/E (x)	Yield (%)	Share Price (p)
Sept-16	18.95	922	1.03	56	11.4	4.63%	1051
Sept-17	19.27	1020	1.13	61	10.5		
Sept-18	19.88	1077	1.23	63	9.6		

Source: Bloomberg

Consensus forecasts are taking TUI board's promises to heart. Partly this reflects TUI's increased commitment to shareholder returns (the Fy16 dividend was raised to 56 cents from 33 cents (FY15) / strengthening the balance sheet.

Company	TUI
Share Price	1051p
Target Price	1250p
52 Week Hi/Low	1269p/844p
Shares O/S	587m
Market Capitalisation	£6.15bn
Avg. Daily Volume	34m

Key Catalysts

TUI has been hurt from weak travel to North Africa/ Turkey due to heightened terrorist risk / €100m of adverse impact from FX movements and the Brussels airport attack in March 2016. An amelioration of these factors would improve trading performance.

The improving EU economy, particularly in Germany and the Nordic

Dividend Yield	4.63%	countries and ageing EU population is positive for TUI and specifically the TUI Cruises business.

Source: Fidessa plc

Key Risks to Price Target

i) A weak sterling and Brexit issues could hurt UK demand for EU holidays in 2017

ii) TUIfly/ Etihad merger could add value for TUI shareholders if an agreed transaction obtains regulatory and shareholder clearance.

iii) UK/ EU Holiday demand could weaken going into 2017

(NB. “PBT”- profit before tax, “EPS” earnings per share, “DPS” dividend per share, “P/E” price to earnings)

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Mediclinic Intl **Relevant disclosures: <NA>**

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