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Research Report: Market strategy

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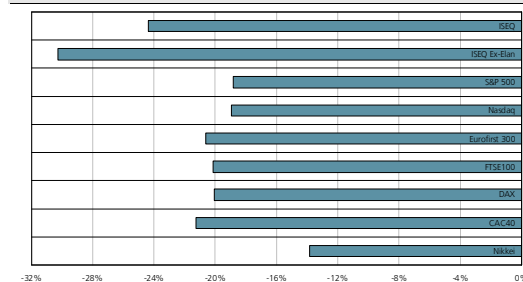
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International returns YTD (€)



Forecast revisions

	2008		2009	
	Prev	Rev	Prev	Rev
Dragon Oil	86.2	112.0	95.2	146.6
Greencore	28.4	24.4	31.1	28.5

Forthcoming results and events

	Prev. period EPS (c)	F'cast period EPS (c)
Monday June 30th		
IRE: National Income and expenditure (2007)		
IRE: Balance of International Payments (Q1)	-2495m	n/a
IRE: Credit aggregates (May)	n/a	n/a
Tuesday July 1st		
Boundary Capital - AGM - Maples and Calder, 75 St, Stephens Green, Dublin - 12.00		
IFG - AGM - Radisson SAS St. Helen's, Stillorgan Rd, Dublin 4 - 12.00		
Wednesday July 2nd		
CRH - trading statement (Conference call: dial +44 20 7162 0025 - 08.00)		
getmobile Europe - ex-dividend - final dividend rate - 10.0c		
IFG - ex-dividend - final dividend rate - 2.47c		
IRE: Exchequer returns (Jun)	n/a	n/a
Thursday July 3rd		
Donegal Creameries - AGM - Mount Errigal Hotel, Letterkenny, Co. Donegal - 11.30		
Friday July 4th		
IRE: Live register (Jun)	5.4%	n/a

Weekly Market Comment

SKG proves its leadership credentials; when will the rest of the industry ever learn?/Biotech may replace 'big pharma' as a defensive sector/Consumers reacting to food price inflation

SKG proves its leadership credentials; when will the rest of the industry ever learn?

- SKG's decision to take 80,000 tonnes of market-related downtime in the longer-term interests of stable containerboard pricing has not been followed by the other main players in the industry.
- SKG's share price has significantly underperformed its peers over the past year. While SKG now trades at a similar multiple to its peers, we believe that forecasts for the other players in the industry could prove too high and will have to fall. In this environment, SKG is likely to outperform.

Biotech may replace 'big pharma' as a defensive sector

- A look at the performances of the main US indices in recent quarters destroys the general view that 'big pharma' is defensive. US pharma is now in its sixth consecutive year of underperformance, the longest period seen over the past 30 years or more.
- So we have to look elsewhere for healthcare-related outperformance. Although it might be premature to call the biotech sector defensive as yet, it has proved to be a more resilient performer in recent times.

Consumers reacting to food price inflation

- Food price inflation is beginning to be reflected in changing consumer purchasing behaviour. It may be that such change and its effects, rather than raw material cost inflation and its potential recovery, will be the key considerations regarding food manufacturers' prospective performance.

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SKG proves its leadership credentials; when will the rest of the industry ever learn?

It became evident earlier this year that containerboard inventories were building in Europe. By end-April, the excess was estimated at about 150,000 tonnes (less than 1% of total annual production). The oversupply, however, was enough to reverse a 30-month period of containerboard price increases with testliner prices declining by approximately €30/tonne since April. The reason for the inventory build-up was primarily due to longer than usual Christmas and Easter holiday periods combined with a slight slowdown in the rate of box demand growth. With no new capacity coming on-stream until mid-2009, this should have been a relatively easy problem to solve – the main players would take some market-related downtime and prices would stabilise.

Smurfit Kappa Group (SKG) reacted as expected and announced that it was taking approximately 80,000 tonnes of market-related downtime (over 50% of the inventory build-up). Needless to say, there is a cost associated with this action which SKG was willing to pay in the longer-term interests of stable pricing.

One would have thought that the other main players in the industry would have followed suit. However, this has not been the case. Both SCA and DS Smith have communicated to the market in the past few weeks, and neither has committed to taking any downtime. The simple reason for this is that containerboard producers are making a lot of money at the moment, and these players appear unwilling to sacrifice short-term profits for longer-term price stability. With new capacity scheduled to start coming on-stream in 12 months, it will become increasingly difficult to maintain pricing.

SKG and a number of smaller players have proved to be the real leaders in this industry, willing to do what is necessary to reduce cyclicity. For this, management should be given credit. SKG's earnings forecasts, however, have declined by more than those of its main peers, and its share price has significantly underperformed that of its peers over the past year. While SKG now trades at a similar multiple to its peers, we believe that forecasts for the other players in the industry could prove too high and will have to fall. In this environment, SKG is likely to outperform its peers. However, even if for nothing other than its leadership, we believe it should trade at a premium.

Biotech may replace 'big pharma' as a defensive sector

History may not be repeating itself. A look at the performances of the main US indices in recent quarters destroys the general view that 'big pharma' is defensive.

With the US market (S&P 500) down circa 18% from its high in October 2007 and beset by many issues, one may have expected traditional 'big pharma' to outperform. Not so – in fact, the S&P Pharma Index has fallen with the US market.

Looking further back, tracking some of the sector's biggest names (PFE, MRK, SGP, LLY, JNJ, WYE) against the market reveals that this maxim has been broken for a while. We are actually in the sixth consecutive year of underperformance, the longest period seen over the past 30 years or more (our data go back to 1973).

Relative outperformance was most marked in 1985-2003, shaped by the new product boom of the 1980s and 1990s. Since then, traditional 'big pharma' has grappled with lower R&D productivity, an increasingly cautious regulatory environment, questionable M&A and pricing pressures. The group's average P/E relative since 1973 has been 1.35x; this has dipped below 1x today.

So we have to look elsewhere for healthcare-related outperformance. On the products side, biotech has proved to be more resilient in recent times. The Nasdaq Biotech Index has outperformed by 9% since the US market's high of October 2007. As a sector that has only emerged in the last 30 years, and only for the last 10-15 years in public markets, many of the drivers are still company- and indeed product-specific. Although it might be premature to call it defensive as yet, it may be where the rhyme with history might ultimately lie.

Consumers reacting to food price inflation

What appears to be emerging from the results of food companies year-to-date is that branded food manufacturers are coping more easily with raw material price rises than are manufacturers of store brands.

This makes sense given that raw material costs in relation to either total costs or sales represent a lower share for branded manufacturers. The branded manufacturer has a broader range of cost variables to fine-tune in order to manage raw material price rises. This can be understood by repeating a joke about breakfast cereals – 4c of corn in a \$4 box of branded breakfast cereals. This may be an extreme instance, but it illustrates the point.

The different models also have another outcome: inflation in store brand prices will be higher for the same rise in food commodity input costs. This narrows the price difference between store and manufacturer brands, making the latter more competitive. For everyday items where there is heightened consumer sensitivity, it means that price increases (where accepted fully by retailers) for store brands are rising faster than for manufacturer brands.

These factors may account for the fact that, to date at least, major brand manufacturers are not reporting any significant volume loss to private label (General Mills and Mc Cormick noted this in the past week).

But brand manufacturers are sensitive to the impact that higher prices and the economic slowdown may have on volume sales and so are introducing branded value propositions within their range. Anecdotal evidence from the UK suggests that the trend towards premium priced

products within store brands may be decelerating, if not reversing, because consumers are switching to mid- to low-priced products.

Grocery retail (and food manufacturers serving this channel) is benefiting from a switch in spending from restaurants to at-home eating. But there is also some anecdotal evidence which suggests that meal solutions which can be assembled at home from basic ingredients are being substituted for retail equivalents.

Food price inflation is gradually beginning to be reflected in changing consumer purchasing behaviour. It may be that such change and its effects, rather than raw material cost inflation and its potential recovery, will be the key consideration regarding food manufacturers' prospective performance.

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