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January 2011 Markets & Stocks

Changing Gear

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7th January 2010

The market's strength has been fuelled largely by cheap money. And plenty of it! Reinforcing this rally has been China's stellar growth, holding the fort until signs emerge that the Fed's massive US stimulus is beginning to work. This seems to be happening now, and many forecasters are increasing their global growth expectations for 2011 and 2012.

Good news. But there is still plenty to worry investors. Sentiment is again at peak levels, downside protection as instanced by CBOE put to call ratios are at lows, and market volumes and the ratio of advancing to declining stocks are falling, all signs of a weakening rally. This may be a prelude to a short term correction. Could it presage worse? Fundamental grounds for concern longer term are regularly in the headlines: high commodity prices; developed economy government debt; Chinese overheating, to name three. Some analysts point to the yield curve, shown below for US government bonds. Their worry is that with global recovery picking up interest rates will increase, as reflected in rising long term government yields, thereby puncturing the cheap money rally. But the money flood may continue in response to high US unemployment, buoying markets, for some time.

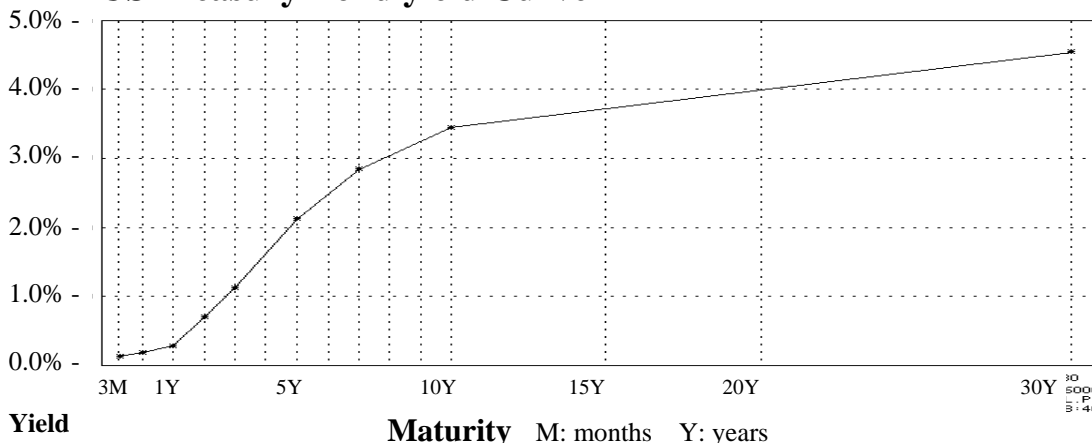
But this inflection zone has always been a necessary point in the recovery, and it is incomparably better to have arrived here than the alternative, though mismanagement of the transition by policymakers is still a very visible risk. The bear arguments rely on either technical analysis or global macro flaws. Neither are particularly reliable for timing market changes, and there are plenty of bullish technicians and economists.

We prefer to concentrate on the stocks we like, where we still believe there is good value on most non-doomsday scenarios. Volatility is part of the deal. In bonds, value is harder to find, but we have always preferred to stay at the shorter maturity end, despite the sacrifice in yield. Our central asset allocation for balanced accounts remains fairly neutral, 55% equities, 8% commodities, 37% bonds into 2011, probably changing bond weights shortly to take account of stimulus and recovery induced inflation. One thing we do know for sure is that nobody knows where the market will be at close of play today, let alone at the end of the year. Be wary of those who tell you different, rather than the market.

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**US Treasury Bond yield Curve**



Data sources:  
Bloomberg Longview,  
Elliottwave,  
TheDowtheory.com,  
Financial Times,  
07/01/11

# Cephalon (CEPH US) **BUY**

Buy Range \$60 - \$66 Down/UpSide Review \$57/\$84

Date: 09/12/2010

**Profile:**

- A 1987 biotech start up, Cephalon is now a leading global biopharma company with a diverse pipeline and \$2.19bn revenues. The portfolio includes treatments for central nervous system disorders, pain and cancer, with 8 proprietary US products and 100 products globally.
- 41% of Cephalon's revenues come from wakefulness pill Provigil, which goes generic in 2012. Cephalon are mitigating the threat with growth in existing lines plus a broad pipeline of drugs targeting pain, cancer, Lupus and bipolar disorder.
- On 8/12/10 Cephalon announced buying 19.99% of Australian adult stem cell business Mesoblast, paying \$220m for the stake, with a \$130m initial payment and up to \$1.7bn milestone payments.

**Risks and Key Issues:**

- The revenue decline facing Provigil is steep but seems already largely dealt with. Another 2010 acquisition, Mepha, replaces c. 50% of Provigil revenue with (albeit lower margin) generics, and existing products alone more than compensate for the sales lost, according to JP Morgan estimates.
- Cephalon is party to litigation, both ways, and recently paid \$375m in settlement of a False Claims claim and signed up to a 5 year 'Corporate Integrity Agreement'.

**Value:**

- Cautious growth estimates and excluding the impact of Mesoblast gives a value of \$77, but using consensus revenues gives us an \$84 target.
- Although the \$220m Mesoblast deal looks expensive (the target lost \$15m in y/e June 2010) the \$1.7bn milestone payments over ten years are conditional on delivery of targets and well covered by Cephalon cash flow, so should be accretive to valuation.

**Catalysts:**

- Provigil's 2012 end of patent fears and the Mesoblast deal have hit the price, we believe unduly.

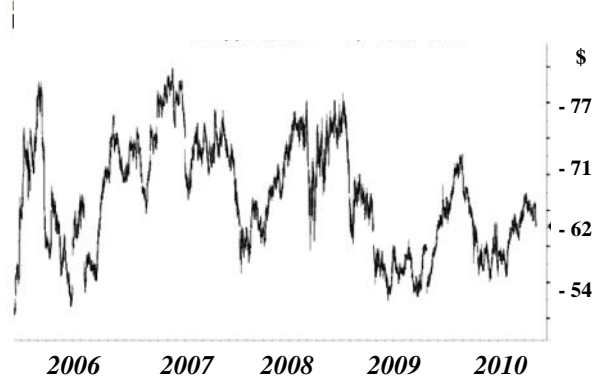
**BASIC STATISTICS**

<b>Share Price</b>	<b>\$ 63.2</b>
Market Cap	\$ 4.7bn
Enterprise Value	\$ 4.3bn
SEDOL	2185143
Gearing	0%
12 month High	\$ 72.9
12 month Low	\$ 55.0
Sector	Consumer, Non-cyclical
Next Results	11/02/2011
Consensus Rating	4.1 Buy
Website	www.cephalon.com

Year End	12 / 9 Act	12 / 10 Est	12 / 11 Est
<b>EV/Sales</b>	2.0 x	1.6 x	1.4 x
<b>EV/EBITDA</b>	5.6 x	4.3 x	4.5 x
<b>PER (GAAP)</b>	13.9 x	7.9 x	8.3 x
<b>Yield</b>	0.0%	0.0%	0.0%
<b>Dividend Cover</b>	n/a	n/a	n/a

**PRICE CHART**

Dec 05 to Dec 10



Prices can go down as well as up. Past performance is not a guide to the future.

Data sources: Cephalon, Bloomberg, Reuters,  
 Chart source: Bloomberg

# Smiths Group (SMIN LN) **BUY**

Buy range 1170p - 1300p, Down/Upside review point 1100p/1550p Date: 09/12/2010

SAMPLE

## Profile:

- When Smiths Industries sold Smiths Aerospace to GE in 2007 for £2,495m it became difficult to see the business as anything but a conglomerate. There is no connection between the five divisions: Smiths Detection (21% of 2009 sales): security devices, e.g. at airports; Medical Devices (31%): hardware, systems and consumables, 3/4 sales to hospitals; John Crane (28%): seals, 2/3 for the oil market, 1/3 industrial; Smiths Interconnect (12%): telecoms components and finally Flex-Tek (8%): tube and pipe.
- But they are all good businesses, with decent margins and returns (ROE from 13.3% at Detection to 22.2% at Crane) based on solid market positions, with growth prospects in expanding markets.

## Risks and Key Issues:

- Operating cash conversion has averaged 74% for the last four years, with e.g. operating margin 16.1% and cash margin on sales 14.8% in 2010, largely due to technology investment (in 2010 £93m was company funded, £13m customer funded).
- Can Smiths focus and build scale in its markets? Should it build by acquisition or realise value by break up?
- Detection is heavily regulation driven.
- Unfunded pension deficit is £386m, 35% of NAV, net gearing 76%.

## Value:

- Smiths' cash flow yield is 6.3% after capex.
- Gearing levels combined with 12.9% ROCE gave 26.8% ROE in 2010, offering growth at an attractive price.
- Our DCF is 1550p based on steady state growth at c. 5.5% p.a. and ROS 21.2%.
- The current CEO halted a planned break up strategy with the crash. Could it be revived?

## Catalysts:

- Five businesses well placed for strong global GDP growth in a relatively resilient portfolio at an attractive value.

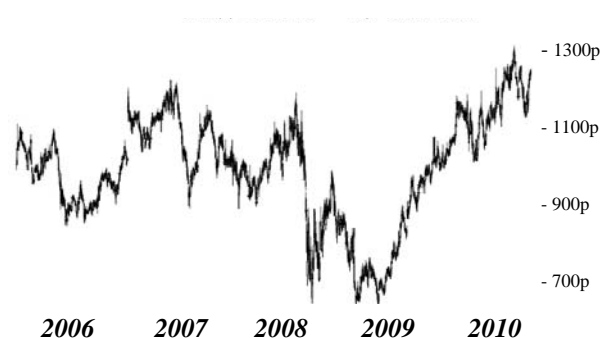
## BASIC STATISTICS

<b>Share Price</b>	<b>1230p</b>
Market Cap	£ 4,821m
Enterprise Value	£ 5,658m
SEDOL	B1WY233
Gearing	76.1%
12 month High	1297p
12 month Low	949p
Sector	Consumer, Non-cyclical
Next Results	23/03/2011
Consensus Rat-	4.1 Buy
Website	www.smiths-group.com

Year End	7 / 10 Act	7 / 11 Est	7 / 12 Est
<b>EV/Sales</b>	2.0 x	1.9 x	1.8 x
<b>EV/EBITDA</b>	9.7 x	9.1 x	8.4 x
<b>PER (GAAP)</b>	15.6 x	13.0 x	11.9 x
<b>Yield</b>	2.8%	2.9%	3.2%
<b>Dividend Cover</b>	2.3 x	2.6 x	2.6 x

## PRICE CHART

Dec 05 to Dec 10



Prices can go down as well as up. Past performance is not a guide to the future.

Data sources: Smiths Group, Bloomberg, Reuters,  
 Chart source: Bloomberg

**BP (BP/ LN) BUY**

Buy range 435p – 480p, Down/Upside review point 400p/615p

Date: 14/12/2010

**Profile:**

- BP's 3Q shows BP's balance sheet is in good shape with \$26.4bn net debt on \$89.5bn NAV, and even after the \$7.7bn Gulf of Mexico oil spill response cost PBT was \$1.6bn and operating cash flow -\$0.7bn. (3Q 2009: \$7.6bn and \$8.1bn respectively), demonstrating underlying profitability and cash flow were intact.
- The disposal programme is aiming to reduce debt to \$10bn to \$15bn by end 2011.
- Capex guidance is \$18bn in 2011, encouragingly expansive, but absence of Gulf revenue will weigh on 2011 revenues.
- BP now has an opportunity to restructure and pay a lower dividend in order to reinvest in new markets.

**Risks and Key Issues:**

- The US government is likely to pursue a claim against BP. The company has provided \$40.0bn against this and related expenses. But the full scale of a gross negligence claim is not yet known and ultimate costs may be higher.
- Though BP has said it will resume dividends, it has not said how much or what policy will apply. The consensus 2011 yield estimate is 5.1%.
- The new CEO has not really spelt out the strategy for restoring BP's fortunes, or even realising value. Given his predecessor's publicly abysmal performance, this board has a lot to prove.

**Value:**

- The 8.7x PER is at an 18% discount to Shell's 10.3x. Shell is a pretty comparable business.
- We have simply deducted \$40.0bn from BP's valuation and still see some 30% DCF based upside. We believe most of the risks are known, though the US government report is due to be released soon.

**Catalysts:**

- Reputational recovery and financial repair are under way, with the industry benefiting from rising energy prices. BP's basic cash flow generation power appears intact.

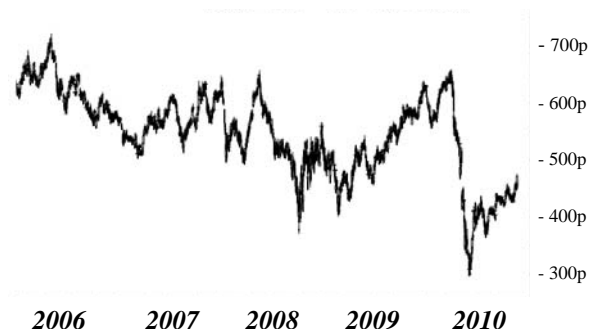
**BASIC STATISTICS**

<b>Share Price</b>	<b>460p</b>
Market Cap	£ 88,136m
Enterprise Value	£ 105,496m
SEDOL	0798059
Gearing	29.5%
12 month High	658.2p
12 month Low	296.0p
Sector	Energy
Next Results	01/02/2011
Consensus Rating	4.1 Buy
Website	www.bp.com

<b>Year End</b>	<b>12 / 9 Act</b>	<b>12 / 10 Est</b>	<b>12 / 11 Est</b>
<b>EV/Sales</b>	0.7 x	0.5 x	0.5 x
<b>EV/EBITDA</b>	4.7 x	4.2 x	3.6 x
<b>PER (GAAP)</b>	8.0 x	8.7 x	7.1 x
<b>Yield</b>	8.0%	1.4%	5.1%
<b>Dividend Cover</b>	1.6 x	8.1 x	2.7 x

**PRICE CHART**

Dec 05 to Dec 10



Prices can go down as well as up. Past performance is not a guide to the future.

Data sources: BP, Bloomberg, Reuters  
 Chart source: Bloomberg

**Siemens AG (SIE GY) BUY**

Buy range €88 - €97, Down/Upside review point €86/€110

Date: 15/12/2010

**Profile:**

- Industrial, energy and medical systems group Siemens says Q4 showed accelerated order intake (€23.5bn) mainly in Industry and Energy and record cash flow (€2.9bn), with profits consistently up across most divisions vs. a strong Q3. A €2.7 dividend beat expectations of around €2.1, up 69% compared to 2009. Siemens gave guidance of mild growth at 2x GDP.
- Sales growth has 'stabilised', and all sectors' operating margins are within targets, due to mix improvement, cost control and culling of reporting units.
- Restructuring nearly over, Siemens' mantra is now 'Capital Efficient Growth', targeting 15-20% ROCE. It is prioritising innovation driven and growth areas, highlighting environmental (renewables, energy) and emerging markets (36% of world GDP by 2015e, 30% of Siemens revenue in 2010).
- Q4 saw a -€0.4bn net loss (2009 -€1.3bn) due to a €1.2bn impairment at Diagnostics and €0.4bn SIS cost reductions. FY 2010 net profit was €4.1bn (2009 €2.5bn).

**Risks and Key Issues:**

- Cash flow will be reduced by capex to fund order intake, but working capital turn is now at a sustainable 8.9x.
- Siemens has today sold its restructured IT Solutions & Services (SIS) business to Atos for a headline €850m, retaining a 15% stake in the combined entity, which will dilute EPS in 2011.
- Pension deficit has deteriorated to €6.4bn.

**Value:**

- Operating cash conversion has been around or above 100% since 2002, and our DCF €110 does not seem demanding if global GDP picks up, as seems increasingly likely.

**Catalysts:**

- Siemens' reputation was hit by the 2007 'slush fund' scandal, and though restructuring one-offs continue, seems to be exiting a high risk phase.

**BASIC STATISTICS**

<b>Share Price</b>	€ 92.8
Market Cap	€ 84,820m
Enterprise Value	€ 90,160m
SEDOL	5727973
Gearing	18%
12 month High	€ 93.2
12 month Low	€ 60.8
Sector	Industrial
Next Results	25/01/2011
Consensus Rating	3.9 Buy
Website	www.siemens.com

Year End	9 / 10 Act	9 / 11 Est	9 / 12 Est
<b>EV/Sales</b>	1.2 x	1.1 x	1.1 x
<b>EV/EBITDA</b>	8.8 x	8.0 x	7.4 x
<b>PER (GAAP)</b>	21.8 x	16.5 x	14.6 x
<b>Yield</b>	1.7%	2.8%	3.1%
<b>Dividend Cover</b>	2.7 x	2.1 x	2.2 x

**PRICE CHART**

Dec 05 to Dec 10



Prices can go down as well as up. Past performance is not a guide to the future.

Data sources: Siemens, Bloomberg, Reuters,  
 Chart source: Bloomberg

# Tyson Foods (TSN US) **BUY**

Buy Range \$15.9 to \$17.6 Down/Upside Review \$14.6/\$32.0

Date: 02/12/2010

# SAMPLE

## Profile:

- Tyson Foods describes itself as the world's largest meat protein company, with four divisions: Chicken, Beef, Pork and Prepared Foods. Poultry production is vertically integrated, and Tyson is well positioned in regard to both suppliers and distributors in the other segments because of scale.
- 4Q exceeded expectations with good margins in all but food processing. Pork margins may be unsustainably high, and are vulnerable to increases in feed costs. However, this seems well discounted in the price, especially given Tyson's plans to offset grain costs via price mix and efficiency savings.
- Despite some necessarily unsavoury aspects of Tyson's operations (involving e.g. 46 million chickens a week) it is regulated by the FDA and claims to be in compliance with the rules.
- Arguably, a shift to fast food restaurants from home cooking is possible if food inflation picks up.

## Risks and Key Issues:

- Tyson is exposed to moves in underlying commodity prices.
- There has been and is litigation against Tyson on environmental and health grounds. There is a risk food manufacturers may be treated like tobacco companies, and this is not an ethical stock.
- There may be regulatory moves affecting volume food producers such as greenhouse gas emission controls, and disease outbreak is a risk.

## Value:

- Tyson appears deeply out of favour. This creates the value opportunity, with EV/EBITDA at 3.6x and a 6.0x current PER.
- Our DCF suggests a value substantially higher than our \$24 target, which is the high end of consensus.

## Catalysts:

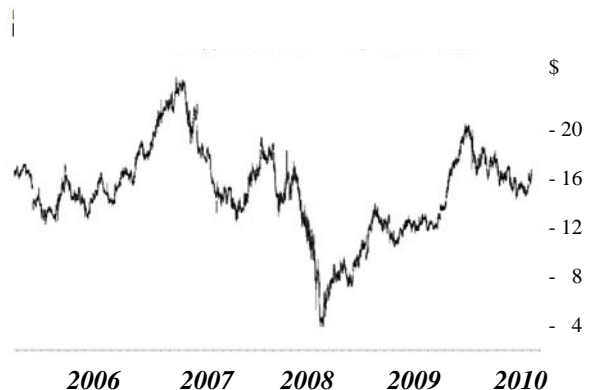
- Positive comments on Q1 in analysts' briefing.
- Low multiples reinforce low valuation argument for food giant with substantial scale driving costs down.

## BASIC STATISTICS

<b>Share Price</b>	<b>\$ 16.7</b>		
Market Cap	\$ 5,069m		
Enterprise Value	\$ 6,627m		
SEDOL	2909730		
Gearing	30%		
12 month High	\$ 20.6		
12 month Low	\$ 12.1		
Sector	Consumer, Non-cyclical		
Next Results	04/02/2011		
Consensus Rating	4.1 Buy		
Website	www.tyson.com		
<b>Year End</b>	<b>12 / 9 Act</b>	<b>12 / 10 Est</b>	<b>12 / 11 Est</b>
<b>EV/Sales</b>	0.2 x	0.2 x	0.2 x
<b>EV/EBITDA</b>	3.2 x	3.6 x	3.5 x
<b>PER (GAAP)</b>	6.5 x	6.0 x	5.9 x
<b>Yield</b>	1.0%	1.0%	1.0%
<b>Dividend Cover</b>	15.9 x	16.8 x	16.8 x

## PRICE CHART

Nov 05 to Nov 10



Prices can go down as well as up. Past performance is not a guide to the future.

Data sources: Tyson, Bloomberg, Reuters,  
Chart source: Bloomberg

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*It is not possible to list every possible risk, especially in brief notes like this. Indeed, it is often difficult to specify relevant risk factors, as the example of BP's Macondo well disaster illustrates. All the stocks in this note should be regarded as containing stock specific risks. This means they are likely to be inherently volatile, and on their own substantially more volatile than the market as a whole, or a diversified basket of stocks. They are recommendations for inclusion in Henderson Rowe clients' portfolios and may not be suitable for you. If in any doubt, please consult your Henderson Rowe adviser or manager.*

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