

Headlines

Vodafone Q3 IMS (yesterday) undramatic, Accumulate maintained.

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Vodafone

Share Price: 177p
Market cap: £91.9bn
Current P/E: 11.0x
Current Yield 4.8%
(VOD.L)

| | 3 Mths to 31 Dec 10 | 3 Mths to 31 Dec 09 | Change |
|------------------|------------------------|------------------------|--------|
| Service Revenues | £10,960m | £10,734m | +2.1% |
| Net debt | £30.3bn | £30.5bn | |

Revenues were generally in line with expectations, possibly marginally ahead, and the marginal improvement in FY outlook was little surprise. The news on southern Europe was not particularly encouraging, but was balanced by good performance elsewhere. The note that subscriber acquisition costs (SAC's) on Verizon Wireless's launch of the iPhone would, of course, have a short term impact on Q4 results may have been marginally negative. However, the mood music on VW was very positive. So our recommendation remains unchanged.

Results

Europe. Service revenues grew by 0.2% organically YoY (-3.5% reported) to **£7,657m**, following a 0.1% gain in Q2. Turkey, which is now growing fast (+31.7%) since being turned round, is now included in Europe, and without this, growth would have been -0.9%. Management does not see "Old Europe" achieving positive growth in Q4, but the trends continue to improve. Specifically, northern Europe (incl. Germany, UK, Netherlands) showed positive growth, with the UK +7.0% after years of underperformance, driven by higher penetration of smartphones and bundles. Southern Europe (incl. Italy, Spain, Greece, Romania) continued to be challenged, mainly for macroeconomic reasons, with Spain down by 7.4% against -7.9% in Q2. In Spain, lower prices have not generated any elasticity, and Vodafone believes that all it can do is to continue cutting costs – it expects little change in Q4. Greece was flat QoQ at -20%. In Europe as a whole, falling Mobile Termination Rates continue to hit revenues, to the extent of 2.1 ppts in Q3 (1.8 ppts in Q2), and management is able to point to 4 quarters of positive and increasing revenue growth before MTR's.

Africa, Middle East & Asia Pacific service revenues grew by 9.3% organically (+18.1% reported) to **£3,210m**. Within this, India grew by 16.7% organically and now has 124m customers (+8.7m in the quarter). The commercial launch of 3G is planned for Q4, and Vodafone believe that it should add strongly to its brand. Vodacom and Other AMAP grew by 5.6% and 6.5% respectively.

Non-controlled interests. Management commented only on **Verizon Wireless**, whose results have already been reported as part of the Verizon results. Service revenues grew by 7.0%, driven by 1.0m net customer additions (total 94.1m) and smartphone-driven data revenue growth. VW will be launching the iPhone on 10 February (previously AT&T had a monopoly), and everyone expects this to be very positive as VW's superior network provides usage attractions. However, a higher than expected take-up will lead to correspondingly higher SAC's (ie subsidies on buying the handset with a contract), although this will lead to higher profits in the longer term. Management commented that it is "very happy with the strategic and commercial dialogue", consistent with much more positive tones coming from Verizon recently, and it is hard not to interpret this as being positive for the prospect of decent and reliable dividends from 2012 onwards.

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FY Outlook. This was unchanged (EBITDA margin decline to be substantially less than last year's -2.3 ppts, free cash flow to be greater than last year's £6.5bn, capex to be

flat before FX and operating profit to be £11.8 - £12.2bn). The guidance for operating profit had been raised (at the lower end) earlier this year, and Vodafone now expects the outturn to be at the top of that range. However this is before SAC's on the iPhone launch. If there were to be an absolute spike in iPhone take-up before 31 March, operating profit would be around the lower end of the range, but still inside it. As of 2 February, £1.5bn of the £2.8bn committed share buyback had been completed.

Assessment

As the company said, trends were unchanged from the previous quarter(s). Nothing was said about the sale of minority stakes in Polkomtel and, in particular, SFR in France, which it is thought could bring in €8bn or so (Reuters). However investors know that discussions are under way and that, in relation to SFR, both Vivendi and Vodafone wish to do a deal. The fact that neither is a forced buyer or seller should mean that agreement will be reached: if expectations were too far apart, we would assume that discussions would have terminated already. When a deal is announced, other things being equal we would still expect the news to be positive for the share price, particularly if some of the proceeds are allocated to a further buyback as well as paying down debt. One minority share that Vodafone has not been able to agree an acceptable exit price on is its Egyptian business. In the light of recent events we would not anticipate any movement on this in the short term.

There was also no comment on the various issues in India (put option on Vodafone Essar, CGT on the original purchase, backdated 2G licence charges). However, we believe that these should be resolved one way or another in the next 6 months or so, and this will remove uncertainty. The recent corruption scandal on licence awards may well lead in time to the market consolidation that Vodafone believe is inevitable, given that many smaller operators cannot continue to accumulate losses, and this should be positive for the company.

Finally, VW's performance was really spectacular in such a high margin market and, as noted above, Vodafone's comments were very positive. We have seen the prospect of dividends as providing an upside potential to a share price which is not overvalued on fundamentals, but it is likely that many analysts are now starting to build some assumptions on VW dividends into their models. We are unlikely to know until this autumn at least and more probably early 2012 what the level of dividend will be, nor what commitment may be made on future policy.

The appointment a few days ago of Gerard Kleisterlee, until then CEO of Philips, as chairman-designate, was uncontroversial in our view. While Vittorio Collau continues to run Vodafone well, there should be little to do. His emerging markets experience may assist in India, where developments are likely to continue to be choppy, and his assistance might be required with Verizon Wireless or possibly with SFR, if decisions become difficult and shareholders restive.

Valuation and recommendation

Consensus 2010/11 and 2011/12 estimates are for EPS of 16.32 and 16.6p, and DPS of 8.89p and 9.51p respectively, with DPS estimates in line with the company's forecast of at least 7.0% growth for three years. That puts the shares on a current P/E of 10.8 and yield of 5.0%. EV/EBITDA is 8.4. We continue to believe that the valuation is fair, with the increasingly likely prospect of significant dividends (and cash flow) from Verizon Wireless providing upside. **Accumulate maintained.**

Analyst: Tom Gidley-Kitchin

FTSE 350 Highest Forecast Yield with Cover > 2x

| Stock | Price | Yield | Cover | Stock | Price | Yield | Cover |
|---------------------------|-------|-------|-------|---------------------------|-------|-------|-------|
| 1. DRAX GROUP | 397p | 7.7% | 2.0x | 11. WH SMITH | 459p | 4.7% | 2.3x |
| 2. BEAZLEY | 117p | 6.2% | 2.7x | 12. BREWIN DOLPHIN | 160p | 4.6% | 2.1x |
| 3. BRIT INSURANCE HDG.N V | 1048p | 5.8% | 2.2x | 13. DEBENHAMS | 66p | 4.6% | 3.1x |
| 4. AVIVA | 443p | 5.8% | 2.2x | 14. MARKS & SPENCER GROUF | 358p | 4.5% | 2.0x |
| 5. BAE SYSTEMS | 330p | 5.2% | 2.5x | 15. MCBRIDE | 149p | 4.5% | 2.2x |
| 6. DAIRY CREST | 381p | 5.2% | 2.3x | 16. BROWN (N) GROUP | 282p | 4.4% | 2.2x |
| 7. LADBROKES | 135p | 5.1% | 2.1x | 17. WILLIAM HILL | 179p | 4.4% | 2.6x |
| 8. IMPERIAL TOBACCO GP. | 1908p | 5.0% | 2.0x | 18. HISCOX | 375p | 4.4% | 2.5x |
| 9. GREENE KING | 470p | 4.8% | 2.1x | 19. BRITVIC | 443p | 4.2% | 2.1x |
| 10. TUI TRAVEL | 243p | 4.8% | 2.0x | 20. ATKINS (WS) | 671p | 4.2% | 2.6x |

Yield and cover based on consensus dividend and earnings estimate for first forecast year
Source: IBES/Thomson Datastream

FTSE 350 Lowest Forecast PE

| Stock | Price | PE | Stock | Price | PE |
|---------------------------|-------|------|---------------------|-------|------|
| 1. ENTERPRISE INNS | 104p | 4.2x | 11. AVIVA | 443p | 7.8x |
| 2. PREMIER FOODS | 22p | 4.7x | 12. BAE SYSTEMS | 330p | 7.8x |
| 3. PUNCH TAVERNS | 68p | 4.8x | 13. DAIRY CREST | 381p | 8.2x |
| 4. BEAZLEY | 117p | 5.9x | 14. OLD MUTUAL | 127p | 8.3x |
| 5. DRAX GROUP | 397p | 6.5x | 15. TULLETT PREBON | 398p | 8.7x |
| 6. ST.JAMES'S PLACE | 308p | 6.8x | 16. WILLIAM HILL | 179p | 8.8x |
| 7. DEBENHAMS | 66p | 7.2x | 17. PACE | 201p | 8.9x |
| 8. JD SPORTS FASHION | 863p | 7.6x | 18. LEGAL & GENERAL | 115p | 9.0x |
| 9. BRIT INSURANCE HDG.N V | 1048p | 7.7x | 19. FIRST GROUP | 377p | 9.1x |
| 10. SPORTINGBET | 51p | 7.7x | 20. HISCOX | 375p | 9.1x |

PE based on consensus earnings estimate for first forecast year
Source: IBES/Thomson Datastream

FTSE 350 Lowest Forecast Price to Book Value

| Stock | Price | Price to Book Value | Stock | Price | Price to Book Value |
|---------------------------|-------|---------------------|------------------------|-------|---------------------|
| 1. PUNCH TAVERNS | 68p | 0.3x | 11. UNITE GROUP | 200p | 0.7x |
| 2. BARRATT DEVELOPMENTS | 92p | 0.3x | 12. PERSIMMON | 399p | 0.7x |
| 3. ENTERPRISE INNS | 104p | 0.3x | 13. MARSTON'S | 103p | 0.7x |
| 4. PREMIER FOODS | 22p | 0.4x | 14. BIG YELLOW GROUP | 330p | 0.7x |
| 5. GRAINGER | 100p | 0.5x | 15. BARCLAYS | 301p | 0.7x |
| 6. HOME RETAIL GROUP | 217p | 0.6x | 16. PARAGON GP.OF COS. | 182p | 0.7x |
| 7. ROYAL BANK OF SCTL.GP. | 43p | 0.7x | 17. OLD MUTUAL | 127p | 0.8x |
| 8. BELLWAY | 602p | 0.7x | 18. ST MODWEN PROPS. | 166p | 0.8x |
| 9. RESOLUTION | 272p | 0.7x | 19. SVG CAPITAL | 233p | 0.8x |
| 10. TAYLOR WIMPEY | 35p | 0.7x | 20. DIXONS RETAIL | 21p | 0.8x |

Price to book value based on consensus book value estimate for first forecast year
Source: IBES/Thomson Datastream

FTSE 350 Lowest Price to Cash Flow

| Stock | Price | Price to Cash Flow | Stock | Price | Price to Cash Flow |
|---------------------|-------|--------------------|----------------------------|-------|--------------------|
| 1. PUNCH TAVERNS | 68p | 2.7x | 11. CABLE & WIRELESS COMMS | 48p | 4.3x |
| 2. FIRST GROUP | 377p | 3.2x | 12. DRAX GROUP | 397p | 4.9x |
| 3. DIXONS RETAIL | 21p | 3.2x | 13. LADBROKES | 135p | 5.1x |
| 4. PREMIER FOODS | 22p | 3.3x | 14. CABLE & WIRELESS WWD. | 73p | 5.2x |
| 5. BOOKER GROUP | 56p | 3.4x | 15. GO-AHEAD GROUP | 1279p | 5.2x |
| 6. BT GROUP | 185p | 3.5x | 16. SHANKS GROUP | 117p | 5.3x |
| 7. DEBENHAMS | 66p | 3.8x | 17. EASYJET | 379p | 5.4x |
| 8. ASHTEAD GROUP | 185p | 4.0x | 18. NATIONAL GRID | 546p | 5.4x |
| 9. KESA ELECTRICALS | 130p | 4.0x | 19. LONDON & STAMFORD PR. | 127p | 5.6x |
| 10. ENTERPRISE INNS | 104p | 4.0x | 20. PERSIMMON | 399p | 5.6x |

Cash flow defined as net income plus depreciation, amortisation, provisions and net working capital
Price to cash flow based on consensus cash flow estimate for first forecast year
Source: IBES/Thomson Datastream

Prices are as at the close of play on 03 February 2011

FTSE 350 Lowest PEG Ratio

| Stock | Price | PE | PEG | Stock | Price | PE | PEG |
|---------------------------|-------|-------|------|--------------------------|-------|-------|------|
| 1. LLOYDS BANKING GROUP | 63p | 34.1x | 0.26 | 11. REGUS | 104p | 55.5x | 0.49 |
| 2. DIXONS RETAIL | 21p | 10.3x | 0.32 | 12. BELLWAY | 602p | 17.4x | 0.50 |
| 3. BARRATT DEVELOPMENTS | 92p | 43.0x | 0.34 | 13. DE LA RUE | 684p | 21.1x | 0.50 |
| 4. ROYAL BANK OF SCTL.GP. | 43p | 40.3x | 0.35 | 14. INVESTEC | 490p | 10.7x | 0.50 |
| 5. TAYLOR WIMPEY | 35p | 29.9x | 0.38 | 15. PERSIMMON | 399p | 17.4x | 0.51 |
| 6. BARCLAYS | 301p | 11.2x | 0.38 | 16. STHREE | 393p | 21.0x | 0.54 |
| 7. PREMIER FOODS | 22p | 4.7x | 0.43 | 17. KELLER | 625p | 14.6x | 0.56 |
| 8. REDROW | 117p | 27.7x | 0.44 | 18. KESA ELECTRICALS | 130p | 12.3x | 0.57 |
| 9. LAIRD | 170p | 14.2x | 0.45 | 19. F&C ASSET MANAGEMENT | 89p | 15.9x | 0.58 |
| 10. EASYJET | 379p | 10.1x | 0.46 | 20. DEBENHAMS | 66p | 7.2x | 0.60 |

PEG calculated by dividing PE ratio based on first forecast year earnings estimate by growth rate of earnings from between year 1 and year 3

All earnings taken after goodwill and exceptionals

Source: IBES/Thomson Datastream

FTSE 350 Best Stock Performance Over Last Month

| Stock | Price | 1m | 6m | 12m | Stock | Price | 1m | 6m | 12m |
|----------------------|-------|------|-------|-------|------------------------|-------|------|-------|------|
| 1. OCADO GROUP | 249p | +40% | +51% | +0% | 11. FILTRONA | 280p | +15% | +16% | +54% |
| 2. ARM HOLDINGS | 575p | +36% | +84% | +180% | 12. BARCLAYS | 301p | +15% | -12% | +2% |
| 3. RENISHAW | 1591p | +29% | +83% | +163% | 13. PREMIER FOODS | 22p | +15% | +23% | -35% |
| 4. REGUS | 104p | +20% | +39% | +15% | 14. HOME RETAIL GROUP | 217p | +15% | -11% | -19% |
| 5. EXILLON ENERGY | 393p | +20% | +130% | +109% | 15. HENDERSON GROUP | 155p | +14% | +16% | +29% |
| 6. LEGAL & GENERAL | 115p | +19% | +27% | +49% | 16. HOWDEN JOINERY GP. | 117p | +14% | +61% | +31% |
| 7. CHEMRING GROUP | 3451p | +19% | +18% | +6% | 17. KENMARE RES. (LON) | 37p | +14% | +182% | +73% |
| 8. SUPERGROUP | 1530p | +18% | +62% | +14% | 18. ITV | 79p | +13% | +54% | +41% |
| 9. RESOLUTION | 272p | +16% | +10% | -12% | 19. COMPUTACENTER | 439p | +13% | +56% | +42% |
| 10. ST.JAMES'S PLACE | 308p | +16% | +11% | -16% | 20. AVIVA | 443p | +13% | +18% | +11% |

Source: Thomson Datastream

FTSE 350 Worst Stock Performance Over Last Month

| Stock | Price | 1m | 6m | 12m | Stock | Price | 1m | 6m | 12m |
|-----------------------------|-------|------|------|-------|-------------------------|-------|------|------|------|
| 1. HERITAGE OIL | 319p | -29% | -9% | -19% | 11. EASYJET | 379p | -14% | -5% | -7% |
| 2. MCBRIDE | 149p | -21% | +7% | -32% | 12. JPMORGAN INDIAN IT. | 417p | -14% | +5% | +14% |
| 3. CENTAMIN EGYPT NPV (LON) | 141p | -20% | -8% | +21% | 13. REDROW | 117p | -14% | +6% | -17% |
| 4. KESA ELECTRICALS | 130p | -18% | -3% | +1% | 14. CARPETRIGHT | 691p | -14% | -10% | -27% |
| 5. SPORTINGBET | 51p | -18% | -18% | -25% | 15. PARTYGAMING | 180p | -12% | -42% | -37% |
| 6. HOCHSCHILD MINING | 525p | -18% | +71% | +89% | 16. ENTERPRISE INNS | 104p | -12% | -0% | -16% |
| 7. DE LA RUE | 684p | -17% | -10% | -30% | 17. WEIR GROUP | 1565p | -12% | +28% | +96% |
| 8. FRESNILLO | 1414p | -15% | +32% | +100% | 18. GKN | 196p | -12% | +36% | +66% |
| 9. MOTHERCARE | 526p | -14% | +0% | -20% | 19. HALFORDS GROUP | 405p | -11% | -17% | +6% |
| 10. AFRICAN BARRICK GOLD | 525p | -14% | -3% | +0% | 20. ROTORK | 1636p | -11% | +8% | +29% |

Source: Thomson Datastream

Global Index Performance

| Index | Level | 1m | 6m | 12m | Index | Level | 1m | 6m | 12m |
|-----------------------|--------|-----|------|------|--------------------|-------|-----|------|------|
| FTSE 100 | 5983 | +1% | +11% | +14% | FRANCE CAC 40 | 4037 | +3% | +8% | +6% |
| FTSE 250 | 11576 | +0% | +14% | +23% | DAX 30 PERFORMANCE | 7194 | +3% | +14% | +27% |
| FTSE SMALL CAP | 3270 | +1% | +17% | +15% | TOPIX | 928 | +3% | +8% | +1% |
| FTSE ALL SHARE | 3101 | +1% | +11% | +15% | MSCI PACIFIC EX JP | 1279 | +1% | +8% | +9% |
| S&P 500 COMPOSITE | 1307 | +3% | +17% | +19% | MSCI EUROPE | 1207 | +2% | +8% | +10% |
| DOW JONES INDUSTRIALS | 12062 | +3% | +13% | +17% | MSCI WORLD | 929 | +3% | +13% | +14% |
| NASDAQ COMPOSITE | 2753.9 | +2% | +21% | +26% | | | | | |

Source: Thomson Datastream

Prices are as at the close of play on 03 February 2011

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