

Introduction

Twenty for 2012: sustainable brands for the future

Sustainability in all its forms is a prerequisite for high performance. This is especially true as companies confront one of the toughest operating environments in recent memory. This chapter identifies companies which Morgan Stanley analysts believe to be the 20 highest-quality companies in their respective sectors – all of them powerful brands grounded in sustainability.

Under current market conditions, an increasing number of stocks appear to be dislocated from their fundamental valuations. Accordingly, we polled our analysts to identify the highest-quality companies in their sectors. Our driving principle in so doing was to create a list of 20 companies whose business models and market positions to which it would be beneficial to be exposed in 2012. We were trying to identify not the most oversold stocks, but the best franchises – and ultimately contenders for the strongest brands in these industry sectors in Europe.

The main criterion was sustainability – of competitive position, business model, pricing power, cost efficiency and growth. For each company, we have shown this through the evolution of return on equity (RoE). Although the quality of a business can be assessed by its return on capital, we are writing for equity investors and so we cannot ignore management's attitude towards capital structure.

We are not asserting that these stocks are all 'buys'; there was no prerequisite in our poll that they be rated overweight, nor any specific assumption about where we are in the economic cycle. Our analysts' strengths lie in understanding their industries and what will differentiate winners from losers as industry value chains evolve. It is these insights that we seek to exploit in this chapter.

Because this is an edited version of the original research paper, the profiles of all 20 companies are not included. Instead, this chapter presents the profiles of some of those companies that look likely to strengthen their brand quality during the testing times that lie ahead.

The 20 brands to watch are:

- Air Liquide;
- ArcelorMittal;
- British American Tobacco;
- BG Group;
- Carnival;
- Credit Suisse;
- ENRC;
- Iberdrola Renovables;
- Iliad;
- Inditex;
- JCDecaux;
- Michael Page;
- MTN;
- Nestlé;
- Partners Group;
- Rolls-Royce;
- SABMiller;
- SES;
- Standard Bank; and
- Veolia Environnement.

All these brands share the following characteristics:

- an average market cap of €20 billion (€15 billion excluding Nestlé);
- four-year sales growth of eight per cent and earnings per share growth of 14 per cent;
- margins rise by 208 basis points (bps) and RoE by 455bps;
- price/earnings ratio of 10.8, enterprise value/earnings before interest and taxes ratio of 9, free cash-flow yield of 14.8 per cent, and a dividend yield of 4.4 per cent; and
- debt/earnings before interest, taxes, depreciation and amortisation (EBITDA) of 1.6x, and interest cover 7.4, and a four-year net cash generation forecast at €35 billion, compared with 2008 enterprise value of €506 billion.

'20 for 2012' poll

Note: The 20 companies shown are selected from a total of 45 companies highlighted by our analysts from our European coverage universe
Source: Morgan Stanley Research

Financial metrics									
Financial metrics	Revenue CAGR, %	EPS CAGR, %	EBIT margin, %		ROE, %		Net debt/ EBITDA	Interest Cover	Cash gen % EV
			2009	2012	2009	2012			
Air Liquide	10	13	16	17	23	25	1.7	5.8	-4
ArcelorMittal	2	12	12	16	15	15	0.4	9.0	47
BG Group	3	2	47	45	30	18	NM	NM	12
British American Tobacco	3	10	36	40	33	34	1.5	9.7	3
Carnival Plc	8	9	17	17	10	11	2.2	4.6	-9
Credit Suisse Group	9	12	28	30	18	18	NA	NA	NA
Eurasian Natural Resources Corp.	8	8	52	51	36	24	NM	NM	56
Iberdrola Renovables	21	18	43	44	4	6	3.6	3.0	-64
Iliad	4	25	16	25	31	32	1.0	5.9	24
Inditex	13	12	16	16	31	29	NM	NM	10
JCDecaux	6	18	14	18	11	15	0.9	9.8	17
Michael Page	18	44	10	15	47	110	NM	64.5	-2
MTN Group	9	10	30	30	27	24	0.2	10.8	15
Nestlé	6	9	14	15	20	22	0.9	22.8	7
Partners Group	11	11	74	76	107	88	NA	NA	NA
Rolls-Royce	6	7	10	10	22	21	NM	43.5	9
SABMiller	6	11	21	23	12	14	1.9	4.8	4
SES	4	15	45	51	39	93	3.5	2.7	-8
Standard Bank	10	15	34	38	21	24	NA	NA	NA
Veolia Environnement	7	12	7	8	11	14	3.6	1.9	-5
Average/(Median)	8	14	27	29	27	32	1.6*	7.4*	7

Air Liquide

We believe Air Liquide is on the verge of a growth spurt, driven by increased average project size and lower capital intensity levels as a result of the current high energy price environment. During the 1990s the average project size was €15 million; according to Air Liquide, in 2007 the average size was closer to €40 million. With crude and natural gas prices rising, there is an upside to medium-term project sizes. We like Air Liquide's aggressive capital expenditure (capex) plans (€10 billion 2007-11e). In 2009 23 projects will start, with a significant percentage in China for various industrial applications. Air Liquide will also secure new sources of hydrogen and will expand its existing Gulf Coast hydrogen pipeline in 2009. For 2010 16 facilities are confirmed, with additional projects expected. At the end of 2009 and in early 2010 two large hydrogen facilities will begin operations for Neste Oil in Singapore and Rotterdam. Hydrogen for refiners should remain a significant growth engine for industrial gas companies over the medium term, contributing three to four per cent to top-line growth. We expect energy and emerging markets to add a further two to three per cent to Air Liquide's

current top-line growth of eight per cent. Over the past 30 years Air Liquide has demonstrated little correlation with gross domestic product fluctuations; its sales growth has been driven by capex. This is the result of its defensive business structure, based on take-or-pay contracts with raw material escalation clauses. We believe the market is failing to appreciate the group's global leadership position and superior growth prospects, underpinned by capex plans and investments in higher-return projects.

BG Group

BG offers upstream growth, leverage to tightening gas markets and substantial exposure to one of the industry's exploration hotspots through its position in Brazil. We believe the track record with the drillbit and the options for its liquefied natural gas (LNG) business provides a logic for sustained superior growth rates relative to the industry. The LNG business is growing rapidly: 2008 has been a step-change year, with profits more than doubling. LNG markets have tightened and, with demand expected to remain robust and further supply delays likely, we see the opportunities for BG expanding rather than

Valuation metrics							
Valuation metrics	P/E 2009	EV/EBIT 2009	FCF yld, % 2009	Div yld, % 2009	% 12-18 month upside/downside to		
					Base	Bull	Bear
Air Liquide	12.6	10.2	1.2	3.5	43	73	5
ArcelorMittal	3.5	3.2	20.8	6.6	224	408	-28
BG Group	8.7	4.8	5.1	1.6	120	178	18
British American Tobacco	12.1	9.4	7.8	5.4	28	40	-1
Carnival Plc	10.3	11.9	4.2	6.3	48	99	-23
Credit Suisse Group	7.4	NA	NA	2.7	28	71	-26
Eurasian Natural Resources Corp.	3.0	1.3	11.4	5.9	151	327	-50
Iberdrola Renovables	23.1	17.8	12.5	1.3	83	116	38
Iliad	16.9	11.5	5.5	1.3	81	111	24
Inditex	13.1	9.2	5.3	3.8	25	151	-25
JCDecaux	14.4	10.8	8.0	4.1	60	113	-8
Michael Page	8.7	5.8	14.7	4.5	-27	101	-63
MTN Group	9.6	5.8	5.5	5.2	35	64	-3
Nestle	12.5	11.7	7.1	3.3	29	43	-11
Partners Group	10.4	NA	NA	5.3	65	92	0
Rolls-Royce	7.3	4.9	6.7	6.0	72	94	3
SABMiller	11.2	11.7	6.9	4.2	5	86	-26
SES	10.5	11.6	4.4	5.5	84	140	0
Standard Bank	7.5	NA	NA	5.3	43	64	-2
Veolia Environnement	12.3	12.0	14.8	5.5	88	111	9
Average/(Median)	10.8	9.0	8.4	4.4	64	124	-8

diminishing. Furthermore, although BG eventually walked away from the Origin deal (for coal bed methane assets in Australia), we would argue that the interest and prices paid by competitors have again highlighted the entrepreneurial nature of BG's management team. It also confirmed the long-term supply constraints in the Pacific LNG market, a view long held by BG, and that replicating BG's integrated gas business is becoming increasingly difficult (and expensive). The upstream portfolio shows few signs of decline, the exploration track record is impressive and BG argues that the upside case from Brazil suggests it can grow somewhere between six and eight per cent a year to 2020, which is unique in big oil. With some of the most strategically valuable assets in the industry, increasing mergers and acquisitions should provide a floor for the shares, even in volatile markets. On the upside, we think it is one of the few companies in our coverage universe for which there are tangible catalysts for the share price to double.

Credit Suisse

Credit Suisse looks to be one of the longer-term winners of the structural crisis that has hit the global banking

system. The strong cash and capital generation of its asset and wealth management business – alongside its Swiss franchise – is the core attraction of Credit Suisse at a time when we think many banks will struggle to generate a lot of capital in a harsh downturn. We think this is around 80 per cent of its earnings power in the coming years. Moreover, it is benefiting from a 'flight to quality', with teams and clients coming its way. We also think it shares the attributes of our winners (which we call the new AA-ristocracy), which include a good capital base, strong deposit-driven funding, business diversity, avoidance of credit black spots and effective management. This is not to say that Credit Suisse does not have its own set of challenges: the stress in liquidity markets, disorderly unwind of leverage and the recession ahead have resulted in large writedowns, and we think more are likely ahead. However, a management team that has a reputation for cost cutting and turning Credit Suisse around once already should provide an edge over competitors. We think it could benefit from market share gains. We also see opportunities in potential consolidation, particularly in asset and wealth management, where many good assets could come up for sale as banks look to sell non-core

divisions. Its strong management team should be able to take advantage of this. Moreover, by recapitalising upfront, it may have the confidence to take advantage of these opportunities. The future will no doubt be challenging, but we think Credit Suisse looks reasonably well placed to be a longer-term winner.

Iberdrola Renovables

Iberdrola Renovables (IBR) is the world leader in renewables, with the largest wind power asset base and the largest project pipeline. It is also an early player in new clean power technologies, such as solar thermal and ocean power. Its main focus is to develop, build and operate wind farms, and it is not involved in the manufacture of wind turbines. Its asset base of seven gigawatts (GW) at the end of 2007 is mainly concentrated in Spain, the United States and the United Kingdom, while the project pipeline of 52GW spreads over 19 countries. Operating a wind farm typically provides stable cash flows from the sale of electricity at subsidised rates and is economically attractive, with asset returns of eight to 10 per cent over a 20-year asset life. We expect supportive regulation and increasing power prices to underpin revenues and returns in the long term. The economics of wind power are very close to being competitive at current commodity prices and we are bullish on the sector over the next five to 10 years. Renewables penetration remains very low in many countries and industry sources expect global installed capacity to more than double by 2012, with a compound annual growth rate of over 20 per cent. We believe owners' and developers' business models to be less cyclical than those of turbine manufacturers. IBR's main competitive advantages are its size and first mover advantage. Size and geographic reach diversify regulatory risk, improve negotiating power with turbine manufacturers and deliver economies of scale in operations and management. First-mover advantage and industry expertise are important to secure the best locations (those with the highest wind resources and highest returns). IBR's management has a very solid track record in bringing projects through its pipeline from the identification stage to completion. Iberdrola owns a 75 per cent stake and is committed to fund IBR's growth at least until 2012. Annual capacity additions of two gigawatts-plus should ensure that IBR remains the leader in wind, while its research and development efforts should secure leadership in other renewable technologies.

Iliad

Iliad has established itself as one of the most innovative and successful European broadband operators,

pioneering triple-play for a fixed price of €30 a month while extracting record profitability from the business (38 per cent margins in 2008). With the French industry consolidating around three main players, some evidence of pricing power and no signs of a macro impact on consumer behaviour, we expect the broadband business to continue to deliver healthy margins and cash-flow generation. We see more than 80 per cent upside based on ongoing delivery in the core business. We view the move to fibre to the home as a key step to ensure a 'future-proof' business model, with a switch from a regulatory arbitrage to an infrastructure model. We expect this move to be fully financed by the broadband business and to enhance Iliad's average revenue per user growth potential. We also consider the mobile optionality to be worth pursuing. With entry in the much larger mobile market, this venture could double the value and size of the group over the long term without assuming more than 10 per cent long-term share. Despite an increased risk profile, we view the risk-reward profile as attractive and believe this venture provides an important strategic leg and growth driver to the story.

Nestlé

Nestlé is a market leader in an industry where scale and market leadership matter. The company has built leading positions in virtually all the categories in which it competes, either organically or through successfully executed acquisitions. This is important because market leadership typically allows a food producer to set the agenda in terms of innovation and to maximise pricing power versus food retail customers. Nestlé's global geographic presence enables the company to balance its growth profile between developed and developing markets without overly relying on one particular region. Nestlé has successfully improved both returns on sales (earnings before interest and tax margins) and returns on capital over the past few years, and we expect this to continue. The company has accomplished this through portfolio mix improvement (as a result of product innovation), cost containment and the elimination of surplus working capital, which has resulted in accelerated free cash-flow growth and improved return on invested capital. Nestlé's earnings growth has proved to be very stable and has consistently exceeded 10 per cent a year. The Nestlé earnings model is based on five to six per cent average sales growth, ongoing margin improvement and tight balance-sheet control. The company has strong risk management capabilities, which have allowed it to deliver record margin improvement in years of unprecedented commodity cost headwinds.

Rolls-Royce

Rolls-Royce is one of the three largest engine manufacturers in the world. It has a leading share in new wide-body programmes, such as the A380, B787 and the A350XWB (for which it is sole-source engine provider). In addition, it has a 32.5 per cent share in the V2500 engine (which powers the single-aisle A320 family). The company currently sells two-thirds of new engines with long-term maintenance contracts (called TotalCare contracts), whereby airlines pay per month for hours flown. Half of its total installed base is now covered by TotalCare contracts. This provides Rolls-Royce with a high-margin revenue stream for the next 10 to 15 years (given that engine manufacturers typically sell new engines at cost and earn 40 per cent gross margins on maintenance activities). In addition, TotalCare gives the company more visibility than many of its peers and provides protection against airline capacity cuts (given that the last aircraft airlines retire are those on long-term maintenance contracts for which they have been paying monthly). Rolls-Royce earns 40 per cent of its profits from non-commercial aerospace activities, led by its marine division. These parts of the business account for two-thirds of its profit growth over the next three years and give the company a much more defensive business mix than its peer group. This makes for a better risk-reward profile than those of its competitors, in our view.

Veolia Environnement

The world's largest operator in water and waste management, Veolia is well placed to benefit from three drivers for growth. Environmental standards are rising worldwide, leading service providers (typically local governments) to invest in infrastructure and improve operational sophistication. Capex requirements are therefore very high, creating growth opportunities for operators such as Veolia. This trend also incentivises municipalities and governments to outsource operations to the private sector. The operation of public services under long-term contracts is a structural opportunity for Veolia that is likely to be enhanced by budget constraints

in times of economic slowdown. Water and waste industries are very fragmented, but are consolidating. Large operators such as Veolia are well positioned to benefit from tuck-in acquisitions that strengthen their existing footprint. Barriers to entry are generally low for water and waste management activities, but are much higher for larger, more complex operations (water management for densely populated areas, drinking water production in polluted catchment areas, recycling and waste-to-energy solutions in waste management). The technological complexity of these solutions and Veolia's extensive experience of managing water and waste systems in large cities are a strong competitive advantage. Veolia's contracts are typically long term (12 years in water) and include some pass-through clauses on costs such as fuel and general inflation. So although fuel price increases depressed the EBITDA margin in 1H08, most of the earnings shortfall will be recouped at year end, when contracts rebase. Veolia's business model is one of growth through reinvestment. We estimate that half of budgeted development capex over the next two years is covered from internally generated cash flows.

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