Idea Updates

"Long term investors (individuals who evaluate their portfolios infrequently) are willing to pay more for an identical risky asset than short term investors (frequent evaluation). Valuation depends on your time horizon."

"Most institutional investors have time horizons that are substantially shorter than what an investment strategy requires to pay off."

Michael Mauboussin. More Than You Know.

The bull market in UK equities hots up, with takeover speculation, both real and imagined, puffing up valuations. Here, as very long term investors – at least by most people's standards - we undertake an infrequent evaluation of our key sector assumptions and stock ideas – to ensure they still have the legs to make it to our time horizon.

1) Media

I had never heard of sector analyst Ken Doctor, or the institution he works for, Burlinghame – though I'm sure that the ignorance is mutual, but I admire his analysis of News International's recent activity. He was reported as saying – "Dow Jones isn't Google, but for Murdoch it offers a means to become #1 worldwide in business news and business news has become one of the most lucrative magnets for advertisers."

Most analysts we read have reacted to Murdoch's bid for Dow Jones – 65.0% above the price of the preceding day - with incredulity. Why would he buy a company that distributes news via the medium of dead trees? Doesn't he understand that newspapers are history?

What Ken Doctor and Rupert Murdoch understand, though, is that the appetite for trusted and accurate business and financial information is growing. And that that appetite cannot be sated by visiting Wikipedia or a blog on (News International's) MySpace.com – they are simply not authoritative. The territory staked out by the Wall Street Journal – its mindshare - is valuable and has high barriers around it. Murdoch and his successors can be sure this real estate will be visited by wealthy individuals and he won't care whether their point of access is by print or browser.

We watch Murdoch closely. Earlier this year he sold his stake in DTV, the US satellite broadcaster. This is how he explained the decision – "the appeal of triple play, which may become quadruple play (including mobile) is going to be very hard to compete with for DTV… we are reducing our satellite investment in what is certainly the most competitive of the three satellite markets in which we currently operate." So, Murdoch has sold a distribution asset – a satellite broadcaster, to fund the purchase of a platform-neutral content provider (Dow Jones). Should you follow Murdoch and sell your shares in Sky? All we know for sure is that its competition is going to get tougher, perhaps to the intensity of the US. Here is what Dan Marks, CEO of BT Vision – BT's "new kind of television service" – has to say. "We will have a very significant discount on what the customer would expect to pay for Sky Sports." Sky is a big boy and can probably look after itself, but marginal players will hurt – Virgin Media spent £25.0 million on advertising in Q1 2007, but still lost 47,000 subscribers.

Meanwhile, the real UK media bull market is in quoted owners of outstanding business information, particularly if it translates to the Web. Thomson's move on Reuters, at a 40.0% premium, absolutely underscores the value that UK investors have left on the table in these names. Assuming the deal is approved, there is still a straight 11.0% gain in Reuters stock through to completion, which with forecast dividends included, must amount to a 20.0% annualised return. It could be more, if Thomson's own shares advance later this year – which we expect, as investors digest the formidable nature of the emerging Thomson/ Reuters combine. Elsewhere, on only 16.0x next year's earnings Reed Elsevier is given away – an earnings yield of 6.25%, for its superlative positions in Legal and Scientific publishing and

perhaps the best collection of B2B and exhibition franchises under single ownership.

Perhaps the most obvious UK beneficiary of Murdoch's move on Dow Jones, though, is also the most wrongly priced. Pearson today trades at a lower price than it did the day before the bid for DJ. This is puzzling and presents an opportunity, in our view. The FT newspaper will generate revenues of c£260 million next year. It is, far more so than the Wall Street Journal, a global franchise, being the only newspaper on the planet with more readers outside its original home market than within. What is the world's most widely recognised business and financial newspaper worth? In the broker sum-of-the-parts we see, FT is valued at an average of £550 million, or little more than 2.0x revenues. Personally, I am disappointed that Pearson management has not been able to demonstrate more value for this franchise to the investment community at large. The worry is that private equity will strip this asset, which we think could sustain a value of well above £1.0 billion, or 4.0x sales. Further, what price Pearson's 50.0% stake in The Economist, in the light of Murdoch's move? Economist revenues grew 12.0% last year, to £248 million, driven in part by a 9.0% rise in circulation up to 1,200,000. That's 1,200,000 copies read by the smartest and richest people in the world (perhaps I should start reading it again myself) and it is why The Economist's print advertising grew 19.0% last year and electronic advertising up 39.0%. I guess The Economist could be worth up to 5.0x revenues, or £620 million to Pearson, or £0.77 per share. We think that at least £0.50 of this is not in the price today, but after May's events it should be.

2) Bank & Other Financials

We write this in the aftermath of HBOS' "accident" in the UK mortgage market. A miscalculation that probably has few implications for the long term value of this franchise. Nonetheless, investors lopped 5.0% from the market cap, just to be on the safe side. At HBOS' new price the shares trade at a P/E of 9.25x, with a historic dividend yield of over 4.0% net, higher than a gilt. Problem is, we completely understand investor disenchantment and concern with both HBOS and the sector. When interest rates are rising, banks get buffeted. And there is, at the back of everyone's minds, including our own, the whispering worry that this cycle-round, the banks may really have over-extended themselves in lending to the consumer. Bluntly, a property price collapse in the UK would spell bank dividend cuts. I admit we maintain an investment in Bradford & Bingley – a resonant brand, every penny of its lending secured against bricks and mortar (no other British bank can claim this), a very comfortably capitalised balance sheet – and a dividend yield high enough to set a junk bond investor rubbing his hands. More than any other holding, though, B&B keeps me awake at night – if the housing market goes wrong, it has nowhere to hide.

Yet the risk of being underexposed to individual British banks is rising. There are three reasons for this. First, the history of the sector suggests that the business of British banking is a lot less risky than one's semi-permanent macro-economic paranoia makes it seem. By and large, banks earn attractive and stable returns to equity and, thereby, build durable business value. The FTSE Banks sector index stood at c1025 in 1987, 20 years later, the largest sector in the market, at 16.5%, it briefly exceeded 11,000, a more than 10-fold gain. Despite these obvious value-creating characteristics, new entrants have failed to break into the UK banking market, suggesting the barriers to entry remain formidable.

Here is the formula we were taught years ago to value banks. P/B = RoE-g/k-g. Or the "correct" P/B for any given bank is derived from calculating its sustainable Return on Equity, less its sustainable real growth rate (g), divided by its cost of capital (k) less the growth rate. We take a bank's cost of capital to be, as a rough but useful rule of thumb, its dividend yield plus the gross yield on a long dated gilt. Banks' real growth rate is probably somewhat in excess of that of the UK economy's own real growth rate, say 3.0%. Let's try it for HBOS. 20%-3%/(4.0% dividend yield+4.8% gilt yield)-3% = 17/5.8 = 2.9x. In other words, if HBOS can sustain a long run RoE of 20.0%, its warranted P/B is 2.9x. In fact, today it is 1.8x. 2.9 times HBOS' book per share of £5.45 makes £15.80. On this basis HBOS is 50.0% undervalued.

Next and of immediate interest, here are the comments of a former chairman of Barclays Bank, Matt Barrett, from a recent conference. "There will be consolidation in Europe. If not you'll have the barbarians at the gate. Europeans will get picked off by the surging behemoths from the US." Europe, he says, "is massively over banked and there are a lot of inefficiencies." "There's the potential for four or five major globally competitive banks to emerge from Europe."

Here is a justification for sitting on a portfolio of bank shares through a cyclical profit downturn – because the risk of getting caught short of a once-in-a-generation bank industry consolidation is so high. With interest rates rising, the "smart" stock market money is selling, but this is the time when ambitious bank boards really need to do deals, to deliver cost-saving driven profit growth through to the next credit upswing. The battle for ABN-AMRO demonstrates that Barrett is not talking baloney. The valuation of ABN-AMRO illustrates how much strategic value UK investors have left for the lucky holders of any British bank to receive a merger proposal. Even trading at a discount to the bids, ABN's P/B is 2.8x – getting on for double that of one of its suitors, RBS, at 1.5x. ABN's P/E of 18.0x compares, to Lloyds, say, of 11.0x. Lloyds has the largest collection of current accounts in the UK and the most bullish aspect of its recent generally optimistic trading statement was this observation – "we continue to increase our market share of new current account customers". It is the "stickiness" of current accounts that makes for the unexpected stability of bank returns.

Final reason to think about some banks and other financial service companies is the spectacular success of the Hargeaves Lansdown listing. This, by the way, is the first new entrant to the London exchange in years that Lindsell Train Limited will certainly invest in at some stage – it's a terrific franchise. Like us, though, many in the business of investment management must look on HL's current rating and despair. The market capitalisation to FUM relationship is over 10.0%. There's the scarcity value, of course, but even at the issue price this valuation is higher than that of any other conventional asset manager we know. The lesson, we submit, is that ownership of customers – client relationships – is much more valuable in our industry than (purported) investment expertise. We admire the asset gathering capacity of some of the UK banks. Arguably, HBOS' relationship with its customers is as deep and valuable as HL's. If Insight were valued like HL, it would account for more than a quarter of HBOS' capitalisation. This is worth thinking about, as would be the more than doubling of Rathbone and others' share prices, if their customer assets were valued similarly.

3) Cadbury

Last month Nestle bought Gerber (baby foods) in the US. Nestle paid 2.8x sales for the brands. Now in 2007, Cadbury will report £5.0 billion of global confectionary revenues and £3.0 billion beverages. All the press leaks suggest that private equity will pay £8.0 billion for those £3.0 billion of Schweppes sales, or 2.9x, begging the critical question. What is Cadbury's confectionary worth? Surely it's hard to believe that in a transaction those £5.0 billion could be valued at less than 3.0x sales? But that makes for a £23 billion EV. Strip out debt of £3.0 billion and the equity value could be as much as £20.0 billion. Cadbury shares outstanding amount to 2.1 billion, or over £9.50 per share of value, compared to the current £6.90. Look at the recent behaviour of the company – piece-meal acquisitions, aggressive cost-saving initiatives, even pleading guilty to the salmonella scandal – all actions of a company keen to deter bidders. The truth is Cadbury knows it is exceptionally vulnerable over the next few weeks/months to such a bid and if one comes there is tangible upside. We see Cadbury as a solid investment below £7.00 per share and an interesting speculation up to probably a pound above that.

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Lindsell Train Limited is authorised and regulated by the Financial Services Authority.

Issued by Lindsell Train Limited. LTL 000-051-6 20 June 2007