HARGREAVEHALE

INVESTMENT BULLETIN

Lopsided

10th August 2010

About the Investment Bulletin:

- It is issued as a marketing communication.
- In its preparation, we are not obliged by FSA rules to comply with legal requirements designed to promote the independence of investment research; which include a prohibition on dealing ahead of the dissemination of investment research.
- It is not intended to address the circumstances of any particular individual or entity and it does not constitute a personal recommendation.
- The opinions and suppositions contained within the Investment Bulletin are those of the author and are held at the time of issue.
- All information contained in it is believed to be correct at the time of issue but cannot be guaranteed.
- Prices quoted in this newsletter are indicative market prices only. Prices are taken at the times stated.
- The main assumptions we have used are included in the text.
- The bulletin has not been disclosed to any of the companies referred to herein
- The bulletin will be issued on a monthly basis. However, we are not obliged to provide any updates on any of the investments previously recommended. Due to market conditions any opinions and recommendations included in this document may change without notice at any time after the document is issued.

Risk Warning - Please be aware that the capital value of, and the income derived, from any market investment can go down as well as up. Investors may not get back the original amount invested. Significant losses can be made even on 'low risk' investments. Past performance is not necessarily a guide to future performance. If you are not prepared to accept these risks to your capital please do not invest in the securities referred to herein.

Conflicting Interests - Conflicts of interest may affect the objectivity, independence and impartiality of this newsletter. Hargreave Hale Limited, its officers, employees, representatives, associates and directors may have already acted on the information contained in this newsletter and may have previously bought or sold, or may have a material shareholding or other interest in any of the mentioned investments. They may have provided significant advice or investment services in relation to these companies in the last 12 months.

Please read the important information at the back of this newsletter. More information is available on our website www.hargreave-hale.co.uk. Hard copies are available on request at any of our offices, for readers who do not have internet access.

Registered and settlement office: 9-11 Neptune Court, Hallam Way, Blackpool FY4 5LZ
Telephone: +44 (0) 1253 754700, www.hargreave-hale.co.uk
Member and SETS Participant of the London Stock Exchange, Member of the PLUS Market, Member of APCIMS
Authorised and Regulated by the Financial Services Authority, no 209741
Incorporated in England and Wales, Company Number 3146580. Telephone calls may be recorded.

Politicians continue to get steamed up about the banks, shouting at them to start lending to industry and smaller businesses, now their earnings and balance sheets are perceived to be on an improving trend. Question: Why are the banks not lending?

Everybody wants to be loved even bankers. Given the unusually generous margins achieved when banks actually decide to do what they are supposed to do which is lend, there has got to be some sensible explanation for why they are so reluctant to fulfil their destiny. Maybe it is just that corporates and individuals have decided to repair their own balance sheets by saving more and borrowing less.

The current state of bank balance sheets and heavy refinancing requirements going forward certainly suggests that shrinking loan books further is the sensible way for bank managements to proceed.

Since the onset of the credit crisis, the US Banks have written off about $500 billion and raised around $400 billion in new capital. In Europe something like Euros 530 billion has been written off and around the same amount raised.

In the case of Europe's banks is this enough or will there be more write offs to come?

Fortunately an expert answer is to hand in the form of recent stress tests on European banks carried out by the licensing authorities. The conclusion is that:" Going forward and under the most adversely stressed conditions", the maximum capital that the top 91 European banks would have to raise would be a mere Euros 3.5 billion.

This does stretch credulity. Talking to UK bankers involved at the coal face, it is clear that big dip, double dip or no dip there are real and continuing problems with the real value of existing loan books.

Take the property loan books. Most of these books are being rolled over on what has become known as an "extend and pretend basis" meaning no third party RICS valuations. In the UK, commercial property has certainly been existing in something of a pretend market. Property held by banks has been withheld from the market because of fear that selling equals write downs equals impairments. It is certainly odd that the stress tests assumed such a small further financing need. If you look at just one bank in the UK, RBS, it has a portfolio of properties on its balance sheet with a value of £48 billion and they are currently said to be marketing £3 billion for sale. Now the property market is in a shaky position at present not helped by a statement by HM Government to the effect that it occupies around 70m sq ft of commercial space at present and could actually make do with around 45m sq ft of space. Retail rents remain under pressure and according to the Halifax, residential property prices are down by 16% from their August 2007 peak when the self certification mania was at its peak. So far this year they have fallen around 1.2%. It would be amazing in view of the state of the

market and the size of the portfolio, if property sales did not result in some big further writedowns.

At the same time, the banks have got to refinance themselves. The rating agency Fitch estimates that over the next two years something like £300 billion of debt instruments held by UK banks as a result of the Bank of England's special liquidity scheme and the Treasury's credit guarantee scheme is going to have to be refinanced. Here the banks are in competition with the Bank of England which is also in the refinancing market via gilt issuance as a result of the public sector borrowing requirement.

Lower bank impairment charges means less funding and less competition for Government gilt issuance. In the words of the late great President Nixon: "there will be no whitewash in the White House". But the reality seems to be that the formal definitions of categories of capital eligible as inclusion for tier one capital have been stretched to the limit.

This paves the way for the Japanese "walking dead" scenario, when banks are unable to increase their loan books because they have not raised sufficient new capital. They have not raised enough new capital as it suits the powers that be to be far too generous with stress tests. Not dealing with reality now via rights issues and placings could result in years of weak lending as the banks attempt to trade their way out of trouble.

As a result of all this, bank lending in Europe is now falling. In the US, bank lending is falling at a rate of 7%, unprecedented since the depression of the 1930's. In the UK, net bank lending is flat at best and although net figures are not provided by the major banks a minus figure seems likely. At the same time, saving rates are rising. In the US, after twenty years of decline, the annual savings rate is running at 6.9% of disposable income, well up from the savings rates at the beginning of the decade of less than 1%. Even the spendthrift consumer in the UK is saving at unprecedented rates .The CBI is forecasting an annualized savings rate of 9% in the UK by the end of this year.

Shrinking bank balance sheets and shrinking demand for loans are slightly unsettling for investors because they can signal the onset of deflation. At present, investors seem increasingly to be drawn to deflation rather than inflation hedges. Since May, retail US investors have taken around $40 billion out of US equity mutual funds and have been putting their cash into government and investment grade bonds, this despite the excellent corporate profits revealed in the last reporting season and the pitiful returns on Government bonds.

Certainly recent data in the US has at best been mixed and the focus now seems to be on the impact of the ending of the Government stimulus packages in the latter part of 2010. Increasingly the conversation turns towards the reintroduction of the quantitative easing programme and the possible impact on inflation going forward. The Fed is looking for an inflation rate of just under 1% by the fourth quarter of 2010 which is clearly supportive of recent retail investors decisions.

In the UK, there are more inflation hawks around partly as a result of errors in the Bank of England 's inflation forecasts last year. In May 2009, the Bank forecast an inflation level of 0.7% in the second quarter of 2010. The actual outcome was 3.4% because the downward pressure on prices as a result of the recession was insufficient to counter the inflationary impact of a weaker pound on retail prices of imported goods and services. Because of the proposed VAT hike at the end of the year the jury is out on the Bank of England's current assumptions about inflation reverting to a mean of 2%.

However, the combination of a recently stronger Sterling, the spare capacity in the economy, and the impact of rising unemployment on wage awards suggests that a subdued inflation rate going forward is the most likely scenario. Not good news for holders of inflation linked gilts and not good news for equities like property shares traditionally seen as hedges against inflation. A doubled monetary base as a result of quantitative easing, which normally would serve as an efficient transmission mechanism for the creation of inflation, has been negated by the fall in the velocity of money as a result of shrinking loan books and debt aversion by borrowers.

This means that equity investors have got to filter potential investment opportunities because they are less likely to be bailed out by the return of inflation. Cyclical plays and inflation hedges loaded with debt and with poor cash flows are probably best avoided even when on paper they might look very cheap. This is particularly the case with cyclical plays because the restocking following the savage panic destocking which took place post credit crunch in 2008 has resulted, when combined with cost cutting, in significant profit generation. But replacement demand is surely a different matter from aggregate demand going forward.

The alternative is to attempt to identify those companies which are beneficiaries of a secular increase in demand for their product, which hopefully might be generational. Such demand is ideally global so that there is some escape from low growth developed markets and some opportunity to participate in long term demand cycles where cyclical lows in GDP growth are actually equivalent to boom conditions in developed markets.

Such an economy is China, where analysts are now worrying that GDP growth will halve to 5% in the next eighteen months as the property bubble bursts in Shanghai and Beijing, and inflationary pressures accelerates the process of interest hikes. At the same time, China has to manage the transition from a low cost export orientated model to the growth of internal consumption, the first healthy sign being the increasingly vociferous demands from the workforce for better pay. This does not mean that the Chinese will abandon their export trade. On the contrary the ambition to export will get stronger.

In this context, it is curious that to date the Chinese have been relatively unsuccessful in developing their own global brands. China started out as a managed economy with the focus on managing shortages and the supply side. Industry was used to mass production which did not help product differentiation and a great deal of money was being made from OEM (original equipment

manufacturer) production, which was again not an incentive for brand creation. All that is changing but it will take time.

In the automotive industry for example China has recently taken over the US as the world's largest motor manufacturer. Last year there were approximately 87m motor cars produced in the world. But the Chinese local brands have yet to make it onto the world stage. Who has heard of Guanghou Auto, Chenzhou Jiao, Shannxi Auto, Shangdong Kaimma and Great Wall?

The fact is that the rising middle class in China as well as in India and Brazil for that matter are still obsessed with western global brands such as BMW and Mercedes and it is difficult to see this obsession disappearing fast.

And it is quite difficult for industry analysts in the developed economies to guess with any degree of accuracy the likely level of demand increase over coming years from these economies. After all, most such motor industry analysts have been dealing for years with an industry in decline, characterized by static demand, industry overcapacity and pricing pressures. By contrast, according to one of our fund managers who recently returned from India, the middle classes in Mumbai appear to be happy to pay a premium of up to 40% on list prices in order to get their hands on a bottom of the range BMW. The recently launched Porsche Cayenne Turbo sells at £169,000 in India and £85,000 in the UK.

The reason why forecasting demand for Western brand cars is such an interesting exercise is the fact that the number of cars produced by BMW and Daimler Benz is so small. Out of 87m cars produced last year, BMW produced just 1.2 m cars and Daimler produced 1.4m units. Volkswagen/Audi produced 6m units but even much more sizeable production is clearly just scratching the surface. Sales of VW cars in China rose by 46% in the first half of this year and VW is currently building two new factories to double its annual capacity there.

The fact is that private consumption spend in both China and India is rising sharply. In the last five years it has risen in India from an estimated 15,000 billion rupees to 33,000 billion rupees at present, and in China over the same period it has risen from an estimated 60 billion Yuan to 130 billion Yuan now.

Clearly we may be entering a period of recession in some of the BRIC economies and demand may well be slowing. But slowing demand for autos is likely to hit the lower priced mass market which is dominated by local Chinese manufacturers. The rich Chinese continue to get richer and the middle classes continue to burgeon. So there is a good long term case for investors to sit with well established niche global brands such as BMW because the secular growth in demand for such product should continually surprise on the upside.

The 2010 Brandx Top 100, a listing of the top one hundred most valuable brands in the world, saw China Mobile in 8th position, Bank of China at 24th and China Construction Bank at 27th position. The top car brand globally was BMW, coming in at 25th. Honda was in 46th position and Mercedes in 53rd position. Porsche was 65th. There were no Chinese, Indian or Brazilian cars in the top 100.

If you look at the growth of BMW in China, it has been exponential. In 1994, BMW sold just 480 cars. In 2009, the Group sold 90,000 cars and during the period has established a network of 150 dealerships which it plans to expand.
In the current year, it looks as though around 150,000 cars could be sold. China is BMW'S number one market for the 7 series sedan selling 17,000 last year and it is estimated that the average price premium for luxury models over European list prices is of the order of 30%, more if you want to avoid the average 3 month waiting list. The average age of a BMW buyer in China is 36, ten years younger than the average buyer in Germany and the US. China's growth is sending wealth and purchasing power downwards.

Penetration levels of only 3% to 4% for premium cars in China compares with 14% in the US and 20% in Europe. The real opportunity lies in the absolute level of sales. Last year only 400,000 premium cars were sold in China whilst 2.7m premium cars were sold in Europe and 1.1 million units were sold in the US. In China the three main players Audi (VW), BMW and Mercedes between them have an estimated 80% of the market. This is not likely to change and most wealthy Chinese seem reluctant to buy a premium car unless it is actually foreign.

Of course estimates vary of the numbers of new wealthy consumers entering the Chinese market each year. We know that existing car ownership is low, with 50 cars per 1000 inhabitants compared with 800 cars per 1000 inhabitants in the US. The number of potential premium buyers, defined as those with incomes in excess of $60,000 should grow from 30m today to more than 100m within 15 years, but such forecasts are useful really only to give an idea of the potential.

As it is, BMW's China business could contribute approximately 35% of Group EBITDA in 2010, with more next year particularly if austerity measures in Europe take their toll of the consumer, as seems likely. And of course there will be some benefit from the weakness of the Euro against the Yuan going forward although this will be limited by the foreign exchange hedging currently in place. Estimates suggest that each one per cent rise is worth £35m to profit.

Earnings are rising rapidly, with the estimated prospective PER for calendar 2010 of 11.8 falling to an estimated 8.8 in 2011 and 7.4 in 2012. Earnings look as though they could rise by no less than sixty per cent between now and 2012. This looks attractive for longer term European investors, particularly when dividend payments of 0.50 euros look possible this year with maybe room for a 60% increase in dividend payments next year, equivalent to a 2% yield. The world seems to be getting increasingly lopsided in terms of investment opportunities. Climbing aboard the investment vehicle called BMW which appears to offer long term secular growth opportunities for investors looks preferable to cyclical plays in Europe, where consumer demand is likely to be muted for some time to come.

George Finlay August 2010

HARGREAVEHALE

Office Network

Registered Office: 9-11 Neptune Court,
Hallam Way,
Blackpool FY4 5LZ
Tel: 01253 754700

London: Accurist House,
44 Baker Street,
London W1U 7AL
Tel: 020 7009 4900

Blackpool: 4 Neptune Court
Hallam Way,
Blackpool FY4 5LZ
Tel: 01253 621575

Lancaster: 25 Brock Street
Lancaster LA1 1UR
Tel: 01524 541560

Bangor: 2nd Floor,
30 Dean Street, Bangor
Gwynedd LL57 1UR
Tel: 01248 353242

Worcester: Virginia House,
The Butts,
Worcester,
Worcestershire, WR1 3PL
Tel: 01905 723551

Carlisle: 10b Clifford Court
Cooper Way
Parkhouse, Carlisle
Cumbria CA3 0JG
Tel: 01228 515224

Direct Deal: Virginia House,
The Butts,
Worcester, Worcestershire,
WR1 3PL
Tel: 08457 423325

Email: bulletin@hargreave-hale.co.uk

Important Information

Hargreave Hale Limited has approved this newsletter. Hargreave Hale Limited is authorised and regulated by the Financial Services Authority and is a Member and SETS participant of the London Stock Exchange, and a Member of PLUS Market and of APCIMS. The company is incorporated in England and Wales, Company Number 3146580. The registered office is: Marsden House, 4-10 Springfield Road, Blackpool FY1 1QW. Hargreave Hale Limited is an associate company of Investec Bank (UK) Limited, which is part of the Investec financial services group. Investec Bank (UK) Limited is also authorised and regulated in the UK by the Financial Services Authority.

Jurisdiction - The information herein is intended for publication to UK residents who are clients of Hargreave Hale Limited and who have read our customer agreement. It is not intended to be published or made available to any person in the USA or any other jurisdiction that would result in contravention of any applicable laws or regulations. Therefore, if it is prohibited to make such information available to you, it is not directed at you and you should not review it. By reviewing the information contained in this newsletter, you confirm that you are satisfied that you are not in contravention of any laws and regulations and that your reading this newsletter is not prohibited.

Risk Warning - The investments or investment services referred to may not be suitable for all investors. Therefore, we recommend that you consult your independent financial adviser at Hargreave Hale Limited prior to taking any further action.

Taxation - Any reference to taxation may not be relevant to all readers as it depends on the individual circumstances of each individual and may be subject to change in the future. Please consult your tax adviser before investing in any product mentioned in this newsletter.

Information - The information contained in this newsletter has been obtained from reputable sources including trading statements, financial statements and other documents issued by companies, published broker research, trade and financial journals, government issued information, trade shows, analyst visits and presentations, other publicly available information. Every effort has been made to ensure it's accuracy, although Hargreave Hale has not independently verified all the information. The accuracy of the information, the reliability of its sources, nor it's completeness cannot be guaranteed, and neither Hargreave Hale Limited nor any if its directors, officers, representatives or employees accepts liability for any loss arising from the use hereof, no representation or warranty, either express or implied is made. Information, opinions and estimates contained in this newsletter reflect a judgement of individual stockbrokers acting for Hargreave Hale Limited at the original date of the opinion's publication by Hargreave Hale Limited and are subject to change, without notice. These opinions are not necessarily those of the company or other stockbrokers acting for the company, who are not obliged to follow recommendations included in this newsletter. We are not agreeing to, nor required to, update any commentary or data contained herein. Therefore, information may not reflect events occurring after the date of publication.

Risk Profiles - The profiles used to categorise investments contained herein are in accordance with Hargreave Hale Limited's customer agreement at the time the opinion is given, which may be subject to change without notice. Copies are available at any of our offices. Shares in the FTSE 100 index are considered lower risk than those in the FTSE 250 index, which in turn is considered lower risk than smaller companies.

Liability - We shall not be liable for any loss or damage arising out of the use of or reliance on the information provided including without limitation, any loss of profit or any other damage, direct or consequential. This does not however exclude or restrict any duty or liability to you that we have under the Act or under the regulatory system.

Distribution of information - The contents of this newsletter cannot be reproduced in whole or in part without consent from Hargreave Hale Limited. If permission is granted you must not distribute any information in this newsletter to any other person without attaching a copy of this 'Important Information' and obtaining the agreement of such other person to comply with the above terms.

Data Protection - We are a registered data user in accordance with the Data Protection Act, and we will treat data we have on you in accordance with that act. Telephone calls may be recorded.

External Interests – Hargreave Hale is an associate of the Investec group of companies, but for the purpose of research documents can be considered as independent from the group as the rest of the group have no influence on the timing or the content of such documents. The Investec group may have a relationship with any of the companies covered in our research which may lead to a conflict of interest. This may involve Investec acting as a market

maker or liquidity provider in the company's securities, being lead manager or co-lead manager in respect of a publicly disclosed offering of the company's securities within the last 12 months, providing investment banking services to the company, or being party to an agreement with the company to issue research recommendations. © Hargreave Hale Limited 2010