



Outlook for the French and European equity markets in 2010

Three major themes should underpin French and European equity markets in 2010:

- A resumption in mergers and acquisitions;
- The pull of visible growth with numerous buying opportunities in discounted stocks;
- Defensive plays which boast an historically attractive yield/discount profile

RESUMPTION IN M&A

More than two years after the financial crisis erupted, European companies have started 2010 with **robust fundamentals** overall. Numerous economic stimulus packages and restructuring plans have enabled them to preserve margins and repair balance sheets. These include subsidised benefits for short time working, increases of capital and asset divestments facilitated by investors with abundant cash and a revival in the risk appetite. The normalisation phase would appear to be behind us and there is still much uncertainty on whether future growth will be self-sustaining and how crisis exit strategies might be introduced. The sheer size of government deficits and the rapid deterioration in public finances, particularly in Greece and Spain, could usher in austerity measures to reduce sovereign debt risk.

Companies should now profit from their good health and their capacity to generate cash flow to adopt more aggressive strategies as a way of maintaining their competitive edge and ensuring future growth. External growth is a credible alternative in an economic environment that should remain depressed in developed countries. And all the indicators today point to a recovery in M&A activity. Companies have significantly reduced financial leverage in 2009 by issuing new shares, **asset valuations are still cheap and credit conditions have improved considerably**. Lastly, heads of companies are now feeling more confident and are increasingly considering acquisitions in coming years.

- Kraft Foods' bid on the British company Cadbury, which is very active in India, is a perfect illustration of how determined companies are to reinforce their presence in emerging zones. And it is the same story with Vivendi's acquisition of GVT in Brazil or Heineken's purchase of Femsa in Mexico. European companies have traditionally had a high profile in emerging countries and some like Beiersdorf, Rémy Cointreau, and Intercontinental Hotels could be ideal targets.
- Within the universe of bid targets, geographical allocation plays an important role insofar as UK stocks are currently very attractive. The UK's regulatory and political environment is not a large barrier for a predator. UK stocks are also relatively vulnerable due to the 25% depreciation of sterling against the euro over the last three years. Lastly, most of them are not protected by a controlling shareholder. We have identified many potential targets on the UK market, notably Burberry, BG Group, International Power and Invensys.

THE PULL OF VISIBLE GROWTH

European markets have surged by almost 60% since March 9 2009, a rise that primarily boosted the most cyclical sectors and companies with the most degraded fundamentals. Ailing companies benefited from a spring back effect when credit spreads started to contract. Some valuations had effectively sunk to ridiculous levels. As a result, banking and mining stocks were the best performers last year. Car builders were also helped by car scrappage schemes and industrials in general benefited from expectations that companies would have to rebuild stocks.

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At the same time, many less cyclical sectors were left behind as investors focused on higher risk profiles.

As a result, there are now many investment opportunities among so called visible growth companies, i.e. those that can grow independently of economic cycles without seeing their earnings estimates revised down. We are currently looking at stocks that have lost their market premium and are trading at a discount to the market even when their fundamental qualities have not been called into doubt.

Persistent worries on economic growth and upcoming shifts in monetary policy will entail **renewed volatility** on equity markets. In the circumstances, **it makes sense to adopt an investment strategy focusing on visibility and discounted valuations.**

- ➔ With that in mind, the sectors that strike us as having the best potential are agribusiness, healthcare and software.
- ➔ When choosing stocks, our principal criteria are the capacity to preserve pricing; cost control and a robust balance sheet to facilitate acquisitions in the best conditions. For example, our main conviction buys in Europe are Nestlé, Heineken, Novartis and SAP.

DEFENSIVE PLAYS WITH AN HISTORICALLY ATTRACTIVE YIELD/DISCOUNT PROFILE

With markets expecting a substantial bounce in company earnings both this year (+30%) and next (+25%), defensive yield stocks have been upstaged in the earnings growth race. Telecoms, utilities, media and pharmaceuticals are expected to see earnings growth of only 2-7%. But two-thirds of headline earnings growth is expected to come from banks, insurance, metals and oil so it seems obvious that the modest earning outlook in defensive sectors is itself comforting in a macroeconomic environment that is difficult to predict. In other words, these sectors should turn out to be much less vulnerable if the cyclical recovery scenario behind the market bounce in March 2009 were to be called into question. Justified or not, the market will inevitably start to fret about the following points:

- will governments be able to pursue or even respect their commitment to stimulus programmes with the prospect of budgetary constraints looming?
- what exit strategy will central banks adopt as unorthodox monetary policy is wound down?
- what pattern will global growth take with households in Western countries paying down debt and credit becoming harder to obtain?

These stocks are less sensitive to the cycle and should become more attractive as markets turn away from recovery and become more concerned with visibility.

Three factors underpin the quality of their risk/return profile

- ➔ **Very predictable free cash flow generation**

Stocks concerned fall into two categories:

- **yield stocks** which derive cash flow from subscription revenue and long term contracts. These income streams are unlikely to be hit by twists and turns in the economy. The one risk to avoid here is a business model that is faced with structural decline. In telecoms, the market appears to have applied the dual punishment of both structural and economic risk. This looks excessive. France Télécom is trading on a PE of 9 for 2010 earnings and with a guaranteed EUR 7bn in free cash flow over the next 3 years. This means the 8.5% dividend yield is ensured at these levels.
- **restructuring plays** which have no other choice if they wish to survive than to restructure in depth. Cyclical risk only makes the restructuring more urgent. The strategy is well-known: the remedies boost visibility -the company is often reinforced by a new management team- without having to bet on the macroeconomic fundamentals turning out favourable. Shareholder constraints in these groups mean the financial priority is to generate high free cash flow to guarantee dividends and ensure key shareholders meet their IRR objectives.

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These stocks are to be found in very different sectors (Carrefour, Thalès, and Sanofi-Aventis, etc) as each restructuring story is specific.

→ Protective valuations

As the cycle gets back to normal, the discount on defensive yield stocks compared to cyclicals, financials and the market itself, should gradually disappear. Without going so far as to expect these stocks to return to a market premium, valuations in line with the market average are perfectly feasible as has often occurred in the past in recovery periods. At the very least, it is very unlikely the discount on defensives will widen. This should mean an asymmetrical market performance with downside protection and participation in any market rises. This pattern allowed defensives to perform well in 2004 when the economy was emerging from the crisis.

→ Yield stocks have never been as attractive

The market's dividend yield (3.5% for 2009) is currently higher than the yield on credit markets. Following the contraction in credit spreads in 2009, the yield theme on equity markets has rarely been so attractive. Defensive yield stocks are even more attractive as the dividend yield premium on corporate bonds can be as much as 30-50%.

The fact that the underlying stocks are trading on such low multiples is a source of protection for yields. And with overcapacity rife, it is very unlikely that inflation will return and trigger competition for these high yields from other instruments.

About Edmond de Rothschild Asset Management

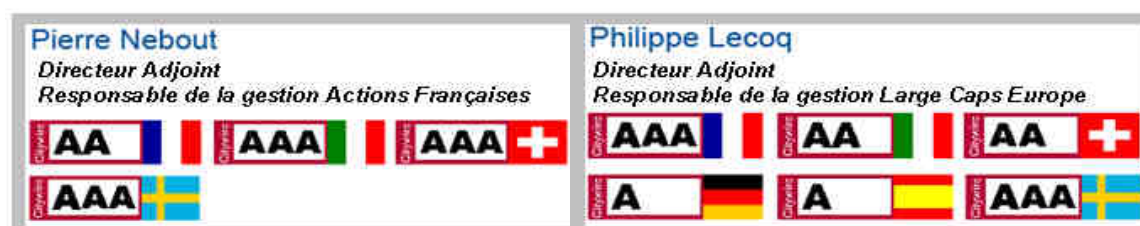
An affiliate of La Compagnie Financière Edmond de Rothschild, Edmond de Rothschild Asset Management specialises in equity, convertible bond and asset allocation for institutional clients, independent financial advisors, partners and private clients.

Focusing on stock analysis and selection and asset allocation, Edmond de Rothschild Asset Management relies on unique know how from more than thirty years experience. The results testify to the firm's impressive capacity to deliver sustainable performance. This historic success is also closely connected to a systematic focus on innovation, both in investment management techniques and in geographical approaches.

At December 31 2009, Edmond de Rothschild Asset Management had EUR 11.9bn under management of which close to 60% in Europe.

Tricolore Rendement, (EUR 3.12bn) run by Pierre Nebout ; Europe Rendement (EUR 908m) and Saint-Honoré Europe Synergie managed by Philippe Lecoq are the three largest France/Europe funds in terms of assets under management These three funds are rated ★★☆☆★ by Morningstar.

Pierre Nebout and Philippe Lecoq are both rated AAA by Citywire,



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Less than 10% of the 1,400 managers running funds marketed in France receive a rating between A and AAA. Only 1% are rated AAA.

Citywire ratings reward fund managers who have posted the best risk-adjusted personal performance over the last three years. The ratings take into account all funds managed by each fund manager. Ratings reflect how much added value a manager delivers. This is defined as how much outperformance against the manager's benchmark is delivered for each unit of risk assumed. Ratings are not based on any subjective assessments of a manager's ability but on mathematical performance records and amounts of risk taken.

About La Compagnie Financière Edmond de Rothschild

The Compagnie Financière Edmond de Rothschild Banque is the French branch of the Edmond de Rothschild Group. For several years now, its success has stemmed from its strategy of specialising in private banking and asset management. With close to EUR 34bn under management, La Compagnie Financière Edmond de Rothschild Banque is one of France's leading independent banks.

Its mutual asset management range has for several years been considerably enriched by a dynamic product innovation strategy. All asset classes are covered: equity, convertible and diversified funds, fixed interest and credit, structured management, direct alternative and quantitative management, multi management (alternative and traditional) as well as private equity funds (capital-development, biotechnologies, FCPI [French innovative funds], LBOs and funds of funds).

Potential investment risks

- ➔ *Asset prices can move on investor anticipations and entail a risk for share prices.*
- ➔ *The funds' performance will depend on the companies selected by the asset management company.*
- ➔ *As the funds do not have any guarantee or protection, the capital initially invested might not be restituted in full.*

The main risks for each fund mentioned in this document are described in more detail in the funds' full prospectus. These prospectuses are available on request from the head office of Edmond de Rothschild Asset Management or at www.edram.fr. Edmond de Rothschild Asset Management is listed in the French Commercial and Company Register under n° 332,652,536 R.C.S. Paris

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