Morning Wrap

Today's Newsflow

Select headline to navigate to article

Eurocell A solid update with plenty more operational improvements to come

IRES REIT Opposition propose Rent Freeze Bill in Irish Parliament

Irish Banks Moodys lowers outlook on Irish Banks

easyJet Medium-term forecasts underestimating impact of new pricing algorithms

Irish Economic View CB analysis reiterates housing deficit

Equity Research 11 Dec 2019 08:18 GMT

Upcoming Events

Company Events

11-Dec	Quanex Building Products; FY19 Results
12-Dec	Lufthansa; November 2019 Traffic Stats

Economic Events

Ireland

United Kingdom

17-Dec	ILO Unemployment Rate Oct19
18-Dec	CPI Nov19
	PPI Nov19

United States

Europe

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Equity Research +353 1 6419221

Equity Sales +353 1 6670222

Bloomberg GDSE<GO>

Eurocell A solid update with plenty more operational improvements to come

Recommendation: Buy
Closing Price: £2.09

Robert Eason
+353-1-641 9271
robert.v.eason@goodbody.ie

Eurocell has issued a trading update for the 11mths to the end of November and we see no material changes to PBT forecasts (circa £23m), although there may be some mix effects. This reflects a stronger than expected outturn from Building Plastics, offset by a weaker than anticipated performance for Profiles.

Profiles has reported lfl sales growth of 5%, which follows 9% in H1 therefore implying circa 2% in H2 (versus Goodbody forecast of 5%). Management notes this reflects good contributions from both existing and new accounts. Building Products has had a particularly strong performance with lfl sales growth of 8%, implying 6% in H2 (versus Goodbody forecast of 1%) after 11% in H1. The strong H2 is reflective of better stock availability and a focus on improving operating standards. Group gross margins are expected to be ahead of last year as the business benefits from increased usage of recycled material and price increases.

Also evident in this morning's statement is the extent of self-help initiatives being worked on, aided by a new COO that started in August. These include: (i) Bedding down the significant increase in profiles capacity; (ii) Expansion of its recycling capability; and (iii) Options to expand warehousing capacity are under review.

Against what has been a challenging market backdrop (economic/political uncertainty coupled with adverse weather), we view today's update from Eurocell as strong and reflective of the progress management is making to drive performance. As a result, we believe a valuation of circa 10-11x PE for 2020 is undemanding.

Home…

IRES REIT Opposition propose Rent Freeze Bill in Irish Parliament

Recommendation: Hold
Closing Price: €1.82

Colm Lauder
+353-1-641 6042
colm.lauder@goodbody.ie

Sinn Fein put a Rent Freeze Bill before the Dáil (Irish Parliament's lower house) for a Second Stage hearing last night (known as the Fair Rent Bill) which would provide for a three-year rent freeze across the private residential rental sector (PRS). The bill was first introduced to the parliament on 5th December by Eoin O'Broin TD, Sinn Fein's housing spokesperson. Normally, legislation proposed by Sinn Fein would not make it past the first reading, however, Fianna Fail have suggested that they would back the bill which, combined with other opposition members, would ensure its passage to Committee Stage. The Bill also contains provisions on tax credits for new and existing tenants, equivalent to 8% of annual rental costs, which will run in parallel with the rent freeze. TDs (MPs) are expected to vote on the bill this Thursday to allow it advance to Committee Stage for further scrutiny.

The Bill further highlights the political pressure on Government in addressing the significant residential (mostly apartments) shortage. With a Minority Government in place, such moves reflect the political risk to the PRS sector given Government may support an amended version if it means it can continue to enjoy the support of the main opposition party, Fianna Fail. We note that the Minister for Housing considers the move to unilaterally freeze rents as unconstitutional, so such a Bill is unlikely to advance at Committee stage without major amendments. The introduction of the 4% cap on rental growth in rent pressure zones was not deemed unconstitutional when it was introduced in 2016.

The Bill comes as no surprise considering what has happened in a European context, with Berlin seeing similar attempts to introduce a rent freeze, with several other countries pushing for rent control. We have repeatedly stated that political risk is the key factor that will influence the attractiveness of this sector in the near term. At periods during the progression of the five-year rent freeze legislation in Berlin, listed landlords with exposures to the city saw the largest share price declines in a decade, with Deutsche Wohnen (Berlin's largest landlord) falling 14% in two days in June before ending the month down 24%, and Grand City Properties falling 6.3% initially before closing the month down 13%.

This legislation would go for further than European peers by introducing a nationwide freeze on rents for three years, which in the first instance will impact the NAV for the listed players through the yield impact, and naturally the evaporation of the approximately 4% forward rental growth assumption. The likely impact on residential investors' market sentiment is of course negative, reducing incentives to introduce much needed supply to the rental market and thus exacerbating the supply shortage. Following the vote on Thursday, the next stage of progression would be to Committee Stage, where the bill would be examined section by section, and amendments would be introduced.

Home…

Irish Banks Moodys lowers outlook on Irish Banks

Eamonn Hughes
+353-1-641 9442
eamonn.g.hughes@goodbody.ie

Barry Egan
+353-1-641 6059
barry.egan@goodbody.ie

Moodys has lowered its outlook on the Irish banks from Positive to Stable, citing the pressures from lower interest rates on future profitability. The agency indicates that this headwind is balanced by the ongoing de-risking of balance sheets as NPEs reduce, though they still remain sizeable. Moody's anticipate NPEs will continue to reduce and enhanced risk management and the macro-prudential mortgage rules will continue to hold back new problem loan formation. On Brexit, Moody's notes that it is creating economic uncertainty, but its impact on the banks should be modest given their capital levels and funding mix which is largely made up of deposits.

The reduction in the outlook is a little disappointing, but Moody's is obviously balancing the interest rate headwinds against the de-risking of balance sheets. The interest rate headwinds have been well flagged by the banks, most comprehensively at the H1 results with reduced NIM guidance across the sector. In our view this manifests into a flatter NII profile as the NIM pressures are offset by some loan book momentum. Elsewhere, our forecasts have ongoing NPE declines, with the c.5% figure for end FY19f likely to trend to c.3.5% by end FY20f. Our capital forecasts are relatively flat over the coming 2-3 years.

Home…

easyJet Medium-term forecasts underestimating impact of new pricing algorithms

Recommendation: Buy
Closing Price: £13.34

Mark Simpson
+353-1-641 0478
mark.a.simpson@goodbody.ie

The most relevant graph of the FY19 results presentation was on Page 27 and showed the yoy change on the late yield curve driven by the shift in easyJet's pricing model towards predictive demand. Theoretically, this raises the closing ticket price by up to 36% and the total revenue generation from a flight by 13.4%. This is the first clearly delineated example of the impact that big data can have on yield management, with its impact yet to be priced into easyJet's future valuation.

While the company does not expect to reap the full benefit of its new pricing model across all markets, it does believe that benefits will accrue each year over a medium-term horizon as it widens the application of its model and gathers the required data on new routes as they mature. As such, we have added 0.5% to our previous FY20F fares and 1% to our FY21 and FY22 forecasts, with this adding £26m to our FY20 pre-tax forecast and £85m and £150m (2yr & 3yr compounded impact) to our FY21 and FY22 forecasts respectively.

Our changes to our pre-tax forecasts puts us 5% above the market consensus for this year and 13% above for FY21. While year 3 forecasts are always subject to the volatility of the market, our FY22 forecast is now 25% ahead of consensus given the compounding impact of the changes to our fare assumptions. In terms of valuation, we see fair value on our FY20 forecast at £14.55 and at £17.82 on our FY21 numbers.

As such, we have moved our recommendation from Hold to Buy.

Home…

Irish Economic View CB analysis reiterates housing deficit

Dermot O'Leary
+353-1-641 9167
dermot.c.oleary@goodbody.ie

In a note published yesterday, the Central Bank of Ireland (CB) revisited the important issue of housing demand in Ireland. The analysis is not novel but reiterates the view that housing demand lies well above current supply levels.

Under its high migration scenario (30K per annum, which is below current levels), the CB is projecting household demand of 34K under unchanged assumptions for headship rates. The latter is an important assumption as Irish headship rates are high in an international context. Under a scenario that headship converges to UK levels, annual household demand rises to 47K per annum to 2030. If net migration falls to 10K per annum on average over the next decade, housing demand would still amount to 27K per annum. All scenarios lie above current levels of supply, with new housing completions set to come in at c.22K this year.

As we have noted before, estimating housing demand is a tricky exercise, especially in Ireland where migration flows are so volatile. A rarely discussed aspect of the debate is affordability. With lower prices and rents, headship rates may be lower in Ireland. Therefore, it is important to take account of both prices and volumes when assessing the level of new housing supply. As we have noted in our research this year, the price distribution of new homes does not match the income distribution of the population, leading to an increase in unsold stock and falling prices despite supply being below the CB's and our own estimates of housing demand.

Home…

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Goodbody, Ballsbridge Park, Ballsbridge, Dublin 4, Ireland
T (+353 1) 6670400 **W** www.goodbody.ie **E** research@goodbody.ie