Investors' Chronicle | Alpha

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Alpha shares analysis

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Understanding momentum

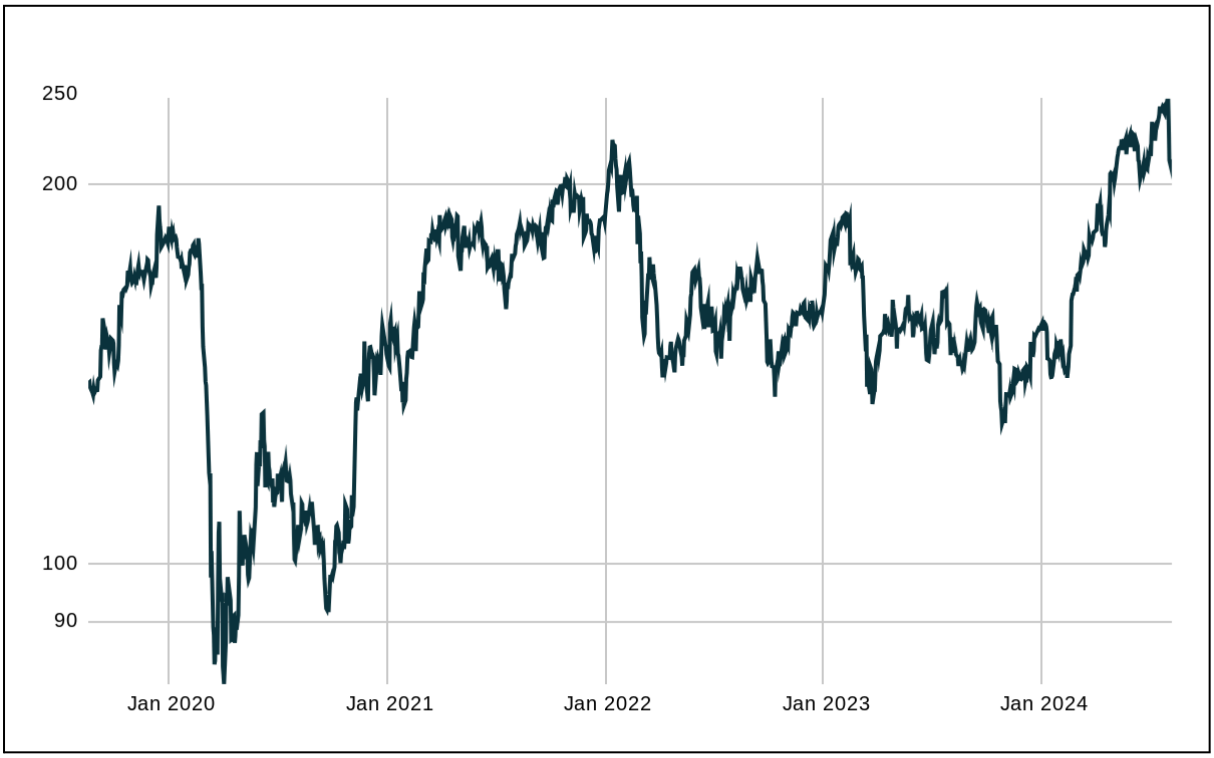
Our two stocks this week have each shown strong share price momentum, one up and the other down. Momentum-only investing can lead to missing vital signs and it is always important to understand fully what is driving a stock in either direction. This week we would still look to buy the stock that has been rising (for highly technical reasons) and would remain wary of the other despite a 40 per cent fall in the share price.

- **Barclays (BARC)** – banks are tricky investments. Use the wrong valuation measure (ie, PE ratios) and they can become a value trap as they will always look cheap. Return on tangible equity (RoTE) is what really matters. Rising market interest rates are pushing up the RoTE of all banks, thus the strong sector performances of late. Barclays does, however, have in the eyes of many investors a poisoned well at its core – global investment banking. The largest division and highly volatile, this arm of the group can (and often does) overshadow performance in other banking operations. If that is palatable, this stock looks cheap on an RoTE basis. If management's target of a 12 per cent RoTE is deliverable, then the gap between the book value (360p) and the share price (213p) can close and investors could easily see total returns of over 20 per cent through to the end of 2026. Risky but well worth a look.

- **Diageo (DGE)** – this global, premium drinks brand has de-rated sharply since the beginning of 2022, with the shares down by around 40 per cent. Is this major slide overdone leaving a solid buying opportunity, or is the lowered rating fully justified? After 10 years of running with a clutch of solid tailwinds Diageo has only managed to grow revenues by an average 2.5 per cent. In its late 2023 profit warning the new management team lowered medium growth targets to 5-7 per cent, but without the tailwinds and against the historic delivery record even this might be too bullish. If the shares were to fall another 10-15 per cent, they are probably worth a look, but for now there may be better opportunities elsewhere.

Analyst: **Robin Hardy**

Barclays (BARC) - undervalued, but it's complex



Source: FactSet

Barclays is a combined consumer, business and investment banking group. It is a FTSE 100 constituent with a market capitalisation of around £30bn. Revenues, mostly net interest income, are around £25bn, and profit before tax (PBT) is around £7.5bn. Earnings per share (EPS) of around 35p pay a dividend of approximately 8.5p, and the group's total tangible assets (excluding acquired goodwill and brand values) is 360p, almost double the current share price.

Barclays has five core revenue streams:

UK consumer banking – everyday banking for small businesses, sole traders, personal customers, mortgages, and credit card payments via Barclaycard. This segment has a return on net tangible equity (RoTE) of around 20 per cent.

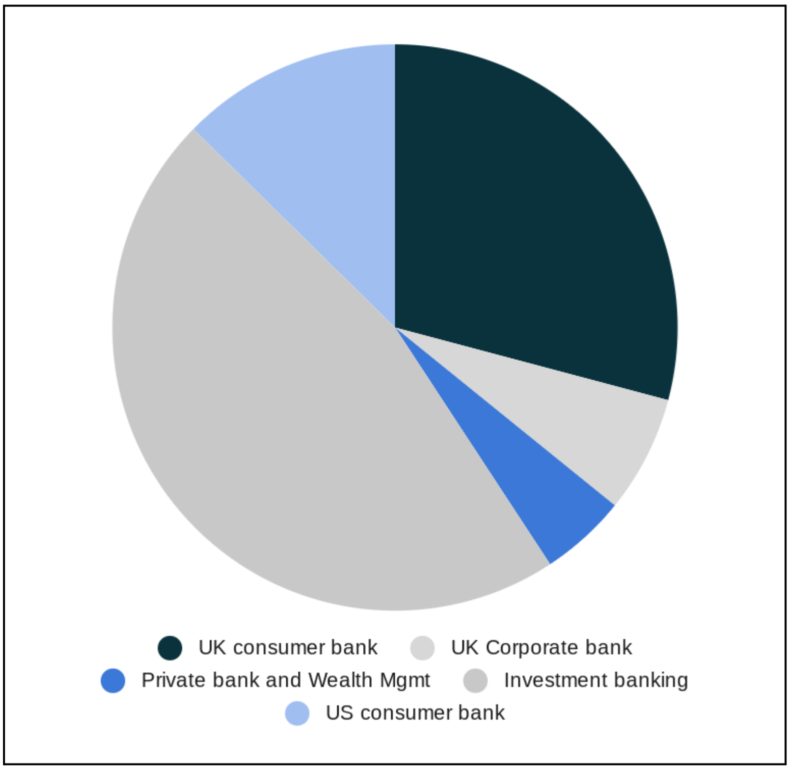
UK corporate banking – corporate lending and transaction banking for businesses with turnover greater than £6.5mn. This division has an RoTE of around 20 per cent.

Private bank and wealth management – personalised financial services and products for high-net-worth individuals (HNWIs), including loans, portfolio management, investing, tax services, insurance, and trust & estate planning. This segment has the highest stable RoTE at around 25 per cent.

Investment banking – the largest division, providing corporate advice, transactions, underwriting, broking (equities and fixed interest), and international/cross-border small company banking. This is the riskiest and most volatile segment of the group and typically makes an RoTE of no more than 10 per cent.

US consumer banking – a credit card issuer and online deposits and lending institution. Low costs and a wide net interest margin (NIM) but high impairments result in an RoTE below the group average.

Barclays revenue split - H1 FY2024



Source: Barclays

After two years of poor performance in 2022 and 2023, the shares have been strong year-to-date (YTD), rising by almost two-thirds to their recent high of just above 250p. This has led to a five-year total shareholder return (TSR) of approximately 70 per cent (90 per cent before the recent market fluctuations), with a two-year TSR of 38 per cent (recently 58 per cent). This return has been mostly from capital gains, with Barclays offering a dividend yield of around 3-4 per cent.

Analysis and conclusions

Banks are a perennial 'marmite' sector, and Barclays exemplifies this. As half of its revenue comes from a risky and volatile sector that negatively impacts the return on net equity (RoTE), it is easy to think that the tail is wagging the dog. However, Barclays has significantly outperformed the market in total shareholder return (TSR) over the past 2-2.5 years. Yet, as is always the case with banks, there is high cyclicality, and an inevitable and likely steep decline will occur later in the cycle. Banks are for trading, not buying and forgetting.

Rising net interest margin (NIM) despite likely fall in interest rates

All banks make more money when market rates rise, as their net interest margins (NIM) – the main element of traditional banking profits – grow. This happens because debt costs rise while savings rates typically lag. The past two years have seen a positive trend, although Barclays' NIM is harder to determine than that of its peers due to the scale of its investment banking arm. In 2023, the overall NIM rose from 2.86 per cent to 3.13 per cent, although it fell slightly in the last quarter. In the most recent quarter, it picked up again to 3.22 per cent, despite interest rates beginning to fall and is likely to fall further now that base and benchmark rates are decreasing.

Does the peaking of rates mean pressure on the NIM and, in turn, the RoTE? No, because of the 'structural hedge'. This is a block of some £290bn of capital (present in all banks) used to buy forward a portfolio of bonds, 'interest rate swaps', and fixed interest rate products to smooth out and underpin the overall NIM. While current and forward interest rates may be dropping (though likely to remain 'higher for longer'), older assets held within the hedge are maturing. This means that very low rate products bought in the five years from 2016 to 2021 (UK benchmark yields and swap rates averaged around 1 per cent) are now being replaced at approximately 4 per cent. So, while the raw NIM (cost to borrower minus cost of funds) will drop, the hedge should be able to offset this, and the overall NIM is expected to rise through to at least 2026. This is a key element in management's guidance towards higher RoTE during that time frame.

Capital allocation and returns

While the market allows Barclays to trade well below book value, the bank has plenty of free cash flow to allocate, positioning it to make sizeable, accretive returns to shareholders. In the next three years, approximately £10bn will be paid out, primarily through share buy-backs (that's equivalent to nearly one-third of the issued equity). This should provide strong support for the share price and lays the ground for more rapid dividend growth beyond the current forecast horizon.

Increasing risk appetite

Barclays has already moved to increase its risk appetite by raising its risk-weighted assets (RWA) balance. In addition to purchasing close to £10bn of mortgages from Tesco and Kensington and striving to regain lost credit card market share, Barclays aims to add around £20bn more. This would bring the total RWA to about £130bn. Mortgages are currently profitable, with borrowing rates still high and high-street banks underpaying on many deposits, leading to a better net interest margin (NIM) than in recent years (from 2008 to 2021, mortgage NIM was often well below 100 basis points (bips) and could now be above 300 bips).

While mortgages are often classed as higher risk, the nature of housing generally means that even higher initial risks decrease significantly over time as property values rise and balances are paid down (although this occurs more slowly with today's longer-term 'marathon' mortgages). The overall loan-to-value ratio (LTV) across Barclays' mortgage book is just 53 per cent, indicating low risk, and the average new loan LTV is only 63 per cent, suggesting higher quality lending.

Having more RWAs means that more capital needs to be held, but it does not necessarily raise the weighted average cost of capital (WACC) given the actual risk profile. Taking on more risk should accelerate RoTE growth, making the 2026 target of 12 per cent seem more achievable to sceptics.

Part of this increased risk set-up relates to expanding the investment banking (IB) segment, with half of the planned future growth in group revenue coming from IB. Depending on your risk appetite, this is either fantastic or concerning, as it is likely to make profits and RoTE more volatile but with potentially higher returns.

Political climate change

A change of government should not significantly alter the trading environment for Barclays unless the plan to drive faster GDP growth succeeds, leading to an increase in new loans and a decrease in defaults – time will tell. However, a potential issue is the desire to penalise banks through banking levies.

The Labour government is unhappy with the gaps between loan and savings rates and views rising bank profits as excessive. A rising net interest margin (NIM) when market rates are falling will reinforce this notion, even though it is primarily due to timing differences favouring the structural hedge. The new government also opposes large buy-backs, preferring to see capital invested in the economy rather than returned to shareholders.

UK banks may face additional levies or surtaxes, which would not impact trading performance but would reduce free cash flow, diverting funds away from shareholder returns. This could hamper the share price (slowing net asset value (NAV) growth) and dividend growth rates (as more shares remain in issue).

Beating consensus for Q2 – or did they?

The recent Q2/H1 results from Barclays appeared to significantly exceed analysts' consensus, being about 20 per cent better than expected on most measures. Does this mean that Barclays is dramatically outperforming market expectations? Unfortunately, not. What occurred here was a clash between analysts' mistrust and management guidance. The board indicated a level of performance, analysts set their expectations considerably below that guidance, and the guidance proved accurate.

However, while this does not indicate a change in trading momentum, analysts having to align with the guidance and raise their forecasts is relevant to the valuation. Across the consensus, forecast RoTE are higher, and with no changes to capital requirements or the weighted average cost of capital (WACC), the low double-digit increases in forecasts should lead to higher target prices for the stock. Ten of 13 analysts who publish a target price have recently increased it, and the average target is 264p according to FactSet.

Striking a valuation

When evaluating UK banks, it is easy to fall into a value trap. On a price/earnings (PE) or other profitability basis, Barclays (and the entire sector) appears exceptionally cheap, with a projected PE ratio of less than four times by December 2026. This could be a warning sign because, at that stage, the PE is lower than the yield – a classic signal, especially in cyclical stocks, that profits and dividends are about to reduce sharply. However, the market does not use profitability or yield to assess value in this sector.

Instead, it uses a simple form of economic value added (EVA), which compares the return on net tangible equity (RoTE) with the assessed weighted average cost of capital (WACC) to determine how the RoTE stands against the WACC. If RoTE is above WACC, the share price should be above the tangible net asset value (TNAV), and if not, then below it.

One issue with this approach is its subjectivity, as WACC calculations can vary depending on your view of both stock-specific risk and general equity risk relative to risk-free rates of return (RFR). Online searches for WACC computations for Barclays can yield results as low as 6 per cent. However, considering the RFR is 4 per cent, this estimate is too low; a more reasonable estimate is around 11-12 per cent.

Barclays is guiding to RoTE of 10 per cent for this year and potentially 12 per cent by 2026 as the net interest margin widens, economic growth picks up, loan loss rates fall, and the cost ratio continues to decrease (branch closures and AI help here, even if customer service suffers).

Not all observers are as optimistic as Barclays' board, but with RoTE already around 10 per cent in the Q2 results – and higher if adjusted for disposals of low RoTE businesses in Germany and Italy plus high-returning assets such as Kensington and Tesco mortgages – achieving a higher RoTE seems feasible. Adding 200 basis points to the RoTE over the next two years does not seem like a stretch, especially with the aim to grow risk-weighted assets.

Looking at the numbers today, even after the surge in the share price year-to-date (YTD) in 2024, there is still considerable value. The basic economic value added (EVA) calculation suggests a higher equity value than today's share price.

Implied equity fair value using EVA

	2024	**2026**
NAV	360p	475p
RoTE	10.0%	12.0%
WACC	11.5%	12.0%
EVA multiplier	0.87x	1.00x
Implied fair value	**313p**	**475p**

Source: Investors' Chronicle, Shore Capital (NAV forecast)

Another approach is to reverse engineer this process to determine the implied WACC from the NAV and the share price:

Reverse engineering the implied WACC

	2024
Share price	210p
NAV	360p
EVA divisor	1.71x
ROTE	10.00%
Implied WACC	17.14%

Source: Investors' Chronicle, Shore Capital (NAV forecast)

This implied or derived cost of capital is excessively high and again suggests undervalued equity.

Potential returns

Even after a strong share price performance year-to-date, there still appears to be considerable positive return potential for investors. Using the average analyst target price of 264p and assuming this is reached by the end of the forecast window (December 2026), this implies a 9 per cent annual capital return. Additionally, the yield, which is becoming cheaper to fund as large buy-backs occur, is expected to average 4.5 per cent per annum over this period. This suggests an annual TSR of 13.5 per cent over the next 2.5 years based on the average target price. If we consider more bullish target prices, such as Shore Capital's 310p or the 2024 valuation determined in the first table above, the TSR could exceed 20 per cent per annum.

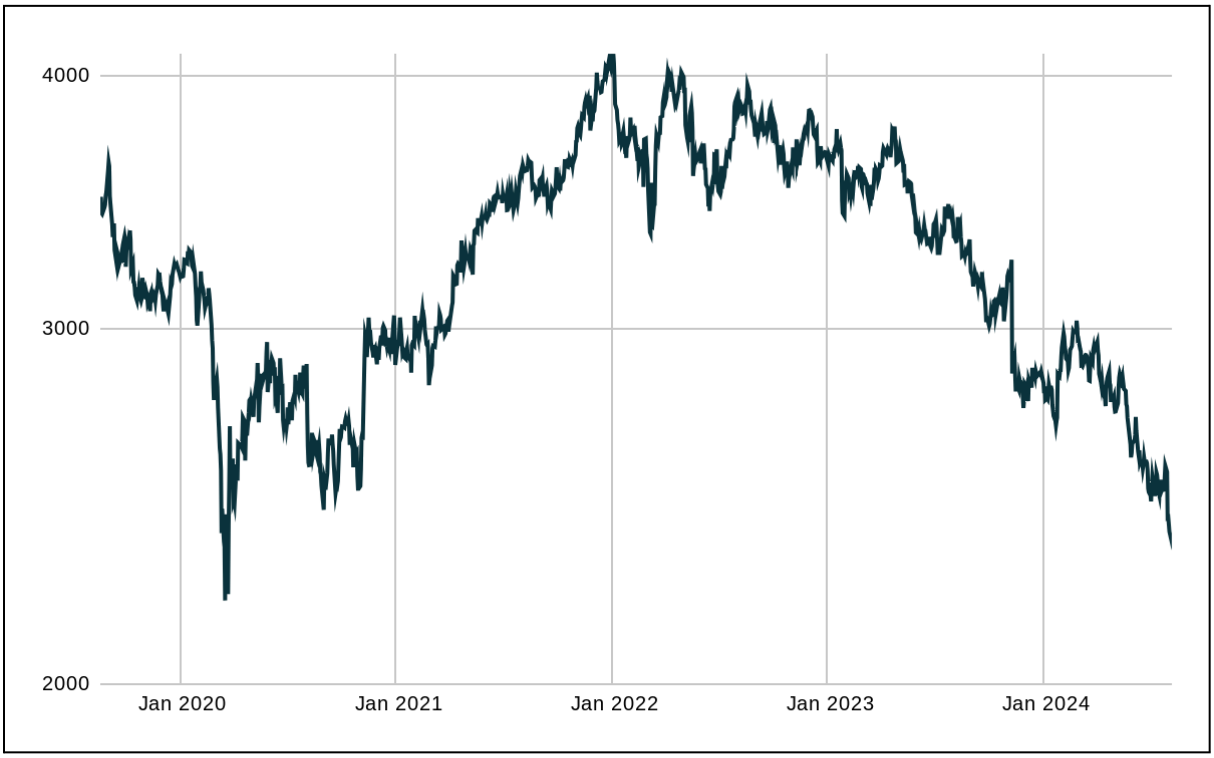
Banks are volatile and risky, and this valuation approach is complex and unusual, which may make some investors uncomfortable. However, this is the approach the market is likely to take. There are risks:

- Investment banking is seen as problematic by many investors, but these funds are not invested in Barclays, so they do not create an overhang of potential sellers.
- Surtaxes and tariffs may limit growth in free cash flow.
- Regulations may tighten further, requiring more capital to be held, thus reducing the funds available for generating returns. However, since the global financial crisis (GFC), UK banks have generally shown they are less risky than before 2007, making significant regulatory changes less likely.
- If interest rates fall more rapidly than expected, the ability to rebuild the structural hedge may impact the net interest margin (NIM). However, Barclays had anticipated five rate cuts through 2024 and now only sees one (which has already

occurred), making this scenario unlikely. Central bankers increasingly expect rates to remain 'higher for longer'.

There should still be good returns, but investors need to be aware of potential share price volatility and the ever-present risks. While banks are not for everyone, after several years of being out of favour, Barclays and much of the sector now merit fresh consideration.

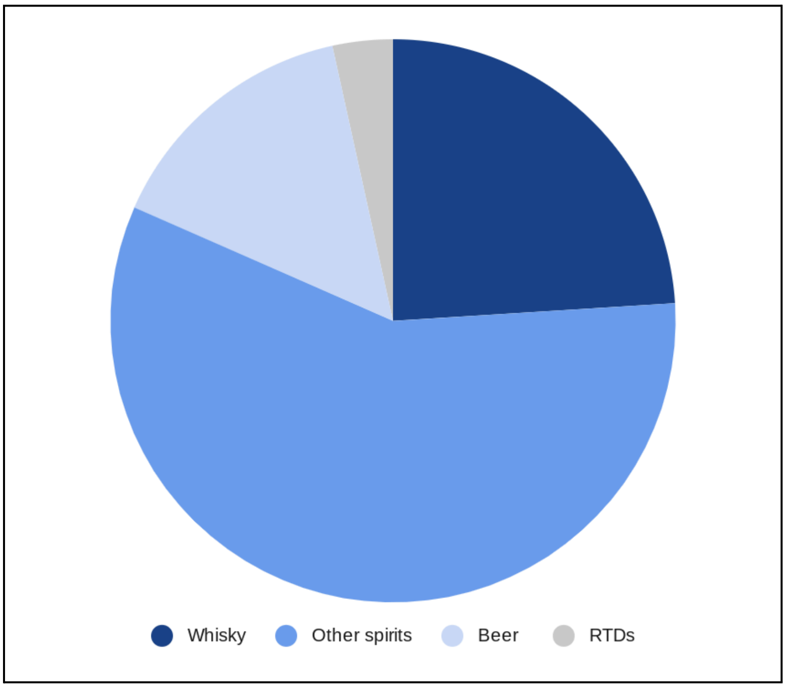
Diageo (DGE) - Tequila sunset



Source: FactSet

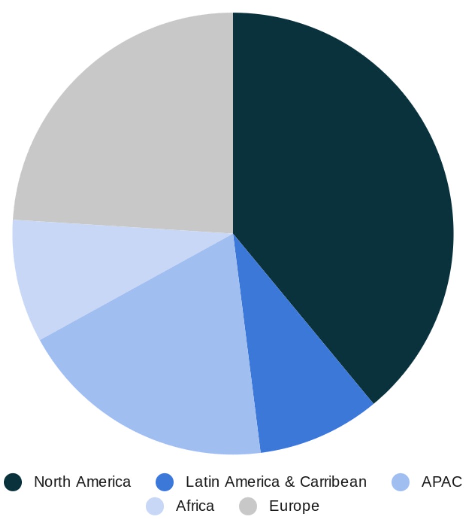
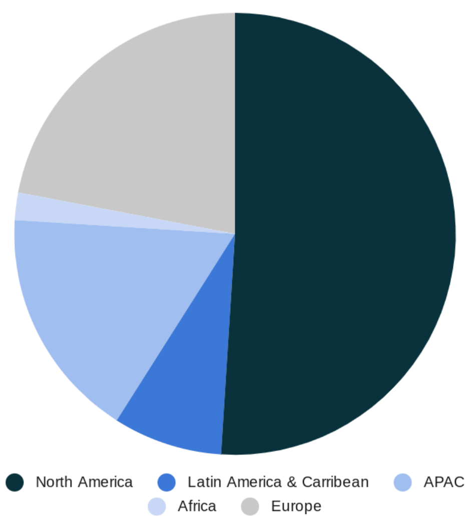
Diageo is a FTSE 100 international drinks company with a market capitalisation of over £50bn and revenues of approximately £16bn, distributed as detailed below. Earnings before interest, taxes, depreciation, and amortisation (Ebitda) are around £5.2bn, and earnings before interest and taxes (Ebit) are £4.75bn. The business focuses on the premium end of the spirits market, owning around 200 brands including Johnnie Walker, Buchanan's, Windsor, Bushmills (whiskies), Smirnoff, Ciroc, Ketel One (vodkas), Captain Morgan (rum), Baileys, Don Julio (tequila), Tanqueray (gin), and Guinness (beer). Diageo also holds a 34 per cent stake in Moët Hennessy, LVMH's wine and spirits business, which specialises in cognac and champagne.

Sales by broad product category



Source: Diageo | RTD = Ready to drink or pre-mixed

Operations by geography

Revenue	EBIT
	

Soure: RBC Capital Markets

Diageo's returns have a negative profile, with a five-year total shareholder return (TSR) of -23 per cent and a two-year TSR of -35 per cent. While in the long term, Diageo can appear to be a market stalwart, the reality is that the share price has recently surrendered most of the gains made over the previous decade. This raises the question: Is

Diageo a market stalwart that has been oversold, presenting a strong buying opportunity, or has the market correctly de-rated this stock?

Many investors view Diageo as a 'dividend hero' due to its strong history of progressive dividends dating back to before 2000. Since the millennium, the payout has increased more than threefold (from 33¢ to 103¢), with sterling dividend growth averaging approximately 7 per cent during this period. The key question is whether this growth will continue.

Current challenges and market dynamics

Diageo has a solid long-term story, but the sharp de-rating in the last two-and-a-half years (the share price is down over 40 per cent) has led some observers to believe the adjustment may not yet be sufficient.

The November profit warning

On 10 November, Diageo issued a three-part profit warning:

1. **US consumer demand**: Consumers in the US were drifting away from premium brands.
2. **Growth rate downgrade**: The company downgraded its guided medium-term growth rate.
3. **Latin American supply chain issues**: The largest issue was a sharp destocking in the Latin American supply chain, which accounts for only 11 per cent of revenues but saw a 15 per cent drop in wholesale demand and a projected 20 per cent drop in profits. This derailed growth at the group level.

Analysts initially viewed the Latin American issues as temporary, but recent results and management guidance indicate that 2023 revenues in this region may not recover until June 2027.

This profit warning also revealed that Diageo had engaged in 'selling in' more than 'selling out', meaning distributors were buying more than they were selling. This practice created a false impression of market demand. The revelation of this practice in Latin America raises concerns about whether it has occurred in other regions, suggesting potential future upsets.

Drinks market dynamics

The total beverage alcohol (TBA) market has been a steady performer, with per capita consumption rising from 5.6 litres in 1990 to approximately 7.2 litres today. Combined with the global population growth of 1.1 per cent, alcohol volumes have grown at around 1.6 per cent per annum. The value of alcohol has increased more significantly, with a shift from cheaper wine and beer to spirits, particularly premium brands. Long-term value growth has been closer to 3-4 per cent. Statista estimates the global alcohol market will reach $1.7tn in retail value by 2024, with around $1n from at-home consumption and $700bn from out-of-home consumption.

The outlook for the beverage alcohol market is less dynamic, with market estimates predicting that both volume and value will rise by only 1 per cent per annum through to 2030 as key trends driving growth have run out of steam.

Premiumisation and the consumer squeeze

The mantra of the branded or premium or 'reserve' segment of the spirits sector has been to 'drink less, drink better'. Before the consumer squeeze, this was a positive market development, with big name brands taking business away from cheaper local brands while spirits took market share from beer. According to ISWR, in 2021 (the last good year), total spirits volume grew by 3 per cent, but value increased by 15 per cent. Today, however, there is a growing trend of 'consumer downtrading', not just at Diageo but also at Pernod Ricard and LVMH, which have reported falling sales. The current trend seems to be to drink less and seek value, and even the long-term shift from beer to spirits appears to be slowing.

Premiumisation has been a strong driver for a decade, but even with that favourable trend, Diageo did not manage to reach the lower end of its target medium-term growth objectives of 6-9 per cent per annum in revenue. The US has been a major pressure point, but China is also becoming more of an issue. Overall population growth in China has reversed, and the number of 25 to 44-year-olds – a key driver of economic growth and alcohol consumption – is set to fall by 22 per cent by 2035. However, there is an argument that western and premium brands are still in a growth phase.

Another challenge comes from the growth of low/no alcohol drinks, which have been growing at over 40 per cent while overall market numbers have remained largely flat. Additionally, a growing number of Generation Z consumers do not drink alcohol at all.

View of management

Diageo has had a new management team for a little over a year following the tragic death of former CEO Ivan Menezes just a month before he was due to retire. Current CEO Debra Crew was already set to succeed him, but she is not universally liked and is sometimes blamed for the group's recent troubles. However, it is not entirely fair to place the blame on her, as the group was already facing significant challenges when she took over. Some critics accuse her of conducting a harmful 'kitchen sink job' with the November 2023 profit warning, but the 'sell in/sell out' issues were already present, premiumisation had peaked, and lowering the growth rate guidance was an honest and necessary step. The true test will be how she handles the reset or Plan-B and whether she can push up the longer-term rate of growth.

Tequila sunset?

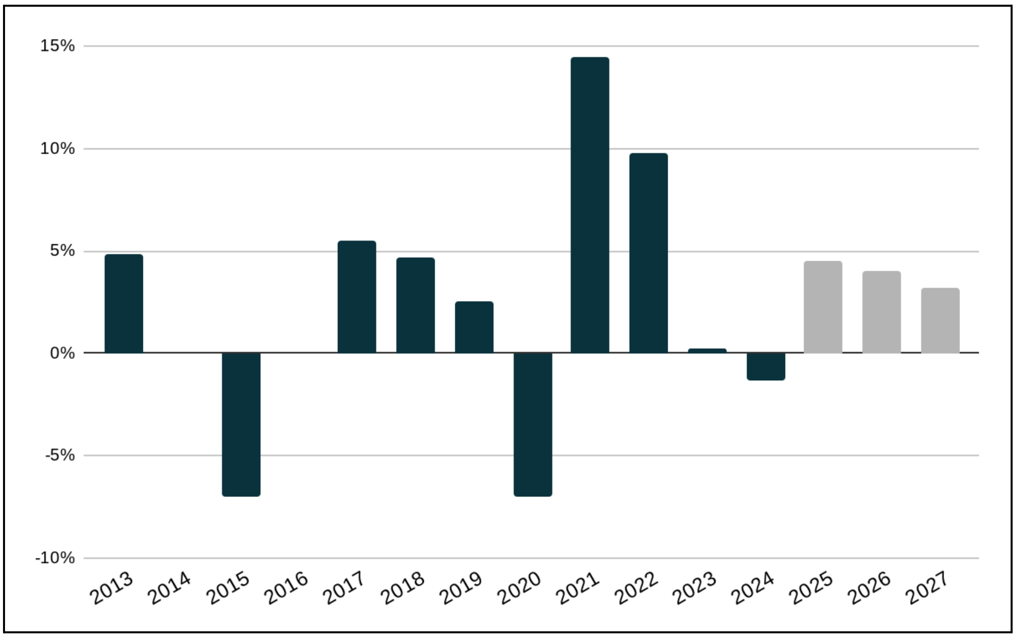
Diageo has greatly benefited from the global surge in demand and premiumisation of Mexico's native spirit, tequila. This category has been growing globally at several times the rate of growth for spirits more broadly and has increased from around 8-10 per cent of Diageo's premium portfolio sales to more than 40 per cent. However, while tequila has established itself, its best days may have passed, although growth continues. In 2023, sales of higher-priced brands (over $50) dropped slightly, while cheaper local brands (under $10) grew by 6 per cent. The slowing growth of this formerly powerhouse product is a major factor in group sales, excluding the recovery from the destocking in Latin America, which is forecast to barely move ahead in the next three years.

The question of growth

An overshadowed element in November's profit warning was the guidance downgrade. The forecast was lowered from a 6-9 per cent range to a 5-7 per cent bracket. This probably had limited impact on the share price because: 1) the old forecast was associated with the previous management, and 2) few believed it anyway.

What remains unclear is whether the market believes the new guidance. Over the past 10 years, excluding the Covid surge, Diageo has struggled to exceed a 5 per cent growth rate.

Diageo annual growth rates



Source: RBC Capital, Euromonitor

Since 2013, the group's growth rate has only averaged two-and-a-quarter per cent and that encompasses the spikes during Covid. It also covers the premiumisation of spirit sales, rapid growth in emerging markets and the tequila surge.

A safe dividend?

While earnings per share (EPS) are likely to decrease slightly, the consensus is that the dividend will continue to increase. Given that Diageo paid an increased dividend partly from reserves during Covid, this smaller earnings hiccup is unlikely to derail the dividend payment. However, growth is expected to slow, with dividend per share (DPS) growth forecasted to average only 2.5 per cent per annum from 2024 to 2027.

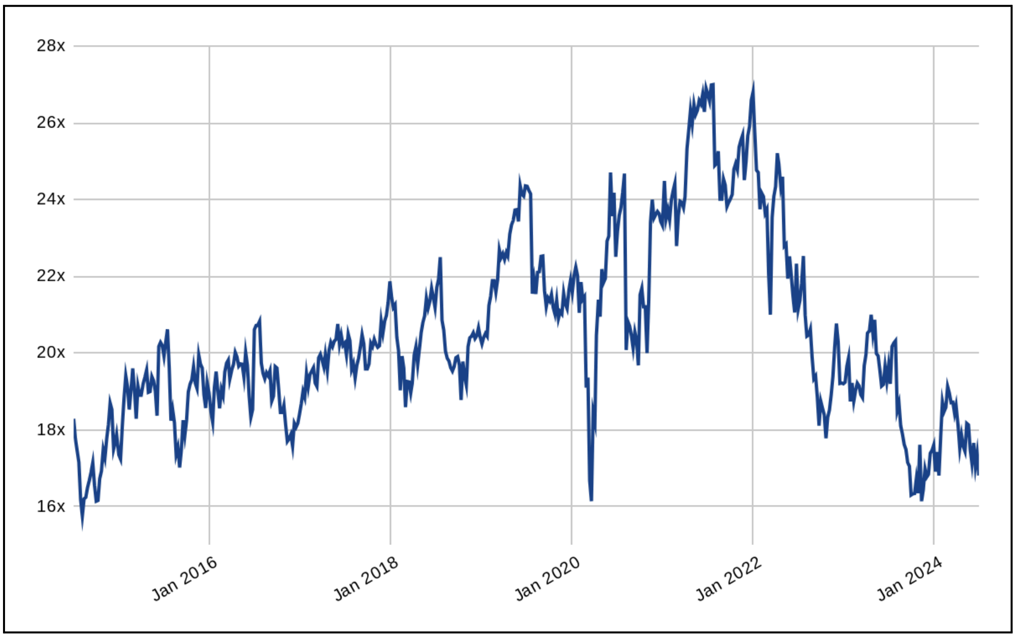
Diageo's own valuation history

When a stock experiences a steep de-rating, it is important not only to examine the specific drivers but also to consider its long-term valuation history. Is the de-rating a decline to historic lows or a reversion to the mean after a period of elevated valuation?

The chart below shows the Year 2 price/earnings (PE) ratio for Diageo over the last ten years. While the current rating is low, it is not significantly lower than the levels seen from 2013 to 2019. The recent peak from which the stock has fallen stands out as an overvaluation, so looking back at a share price above 4,000p reflects a substantially over-valued period. The Covid and post-Covid rebound were anomalies rather than a new norm, and like many stocks, the temporary surge was mistakenly perceived as a lasting change.

Currently, the shares are rated below their level of ten years ago. At that time, premiumisation was driving growth, consumers felt comfortable, emerging markets had a promising outlook, China was strong, the sell-in/sell-out issues were not seen as a major worry, total beverage alcohol (TBA) growth was above core GDP growth, and the beer/wine/spirits shift was a strong trend. Today, these factors are no longer present. Management has lowered long-term market growth expectations, and even these targets seem too high based on Diageo's past performance.

Diageo valuation over time



Source: FactSet

A cheap stock or not?

More likely not, but it also does not seem massively over-valued. The significant, two-year-long de-rating appears to have right-priced the shares, or at least brought them close to fair value. Growth is fairly anaemic at approximately 3 per cent in earnings per share (EPS), especially considering the expected rebound contribution from Latin America. To reach even the lower end of the 5-7 per cent growth objective, there would need to be a strong indication that a plan from the new management is taking effect. Even if this growth is achieved, it would mainly support the current valuation. Achieving the upper end of the growth objective could lead to a re-rating and stronger dividend per share (DPS) growth, but based on recent performance, this seems optimistic.

Analyst sentiment and alternative options

Analysts are not bullish on Diageo, with target prices lowering. Only 5 out of 16 analysts have a buy recommendation, while 4 have a sell recommendation—significant given that analysts rarely publish sell recommendations, indicating strong conviction in these negative calls. The best outlook seems to be that the share price stops falling, but with negative momentum, a fall to around 2,200p or possibly lower is quite possible. At that level, the PE ratio would be in the low teens, and the yield would be close to 5 per cent. A mean reversion on the PE ratio plus that yield could potentially offer double-digit total shareholder return, but "potentially" is the key word.

If you are looking for exposure in the drinks sector, Anheuser-Busch InBev might be a better option. It boasts near double-digit EPS growth, beer appears to be in a favourable position, and the company has a long and strong record of value-creating mergers and acquisitions (M&A). Almost all analysts recommend buying the stock, and the shares trade at a lower PE ratio.

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