EQUITY RESEARCH

Global Equity Weekly

March 20, 2003

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Companies mentioned and disclosures on p. 19

Global Equity Weekly

Global Equity Research

Global

Market Comment

Equity Strategy

Major equity, sector, and economics research published in the last week

20 March 2003

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Global Equity Research

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(see inside for analyst details)

Global Equity Sales

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UBSW Global Conference Diary

2003 Global Financial Services Conference

28-30 April 2003, The Pierre, New York City

This conference will provide institutional investors and industry leaders with an opportunity to discuss the key trends and issues impacting the financial services industry in the US and abroad.

The event will bring together representatives from financial institutions in domestic and international arenas. Three days of presentations and panels, featuring company chairmen and CEOs, will provide a vast forum to learn about the key developments shaping the future of financial services. Our preliminary schedule includes representatives from more than 90 banks, specialty finance companies, brokers, thrifts and insurance companies across the globe.

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Other conferences

European Utilities	London	1 April
Transport and Leisure Conference	Sydney	8-10 April
Global Financial Services Conference	New York	28-30 April
Australian Resources Conference	Sydney	7-8 May
Global Energy Conference	Phoenix	20-22 May

If you have any questions regarding UBS Warburg conferences, please feel free to contact Teresa Jandziol on +1-212-713 3262 or at: teresa.jandziol@ubsw.com

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Automatic Data Processing (ADP.N) — Neutral 1

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Report date: 14 March 2003
Price date: 19 March 2003

Outlook still grim – lowering estimates and price target

ADP has lowered FY03 guidance for sales, revenue and EPS. However, some of the downward earnings revision is due to planned increases in product and service investments, which we believe could have long-term benefits.

The current trading multiple for shares of ADP is near a 10-year low, reflecting macro softness in the employer services segment (60% of revenues) as well as deeper-rooted issues plaguing the brokerage division. In our opinion the valuation looks appealing at first glance, but we see no signs of near-term catalysts from the economy nor stabilisation in ADP's fundamentals to propel the stock higher.

We have lowered our FY03E revenue and EPS to US$7.0 billion and US$1.70 from US$7.1 billion and US$1.80, respectively. We have also lowered our FY04E revenue and EPS to US$7.4 billion and US$1.81 from US$7.6 billion and US$1.93, respectively, to reflect weaker sales growth in the employer services segment, another potential leg down in the Fed funds rate and an estimated US$15-20 million increase in pension expense. Our lower growth projections and lack of near-term catalysts for the stock have led us to lower our 12-month price target to US$31 from US$37 previously. Neutral 1 maintained.

Risks: Investing in shares of ADP involves general risks of technology stocks, as well risk of macroeconomic performance and impact on employment levels.

Price		US$30.34
Target		US$31 (+2.2%)
Market cap		US$18.3bn
Year end: Jun	**2003E**	**2004E**
PE	17.89	16.75
EPS adj	US$1.70	US$1.81
EV/EBITDA	9.84	9.18

Source: UBS Warburg estimates

Source: Datastream

Applied Materials (AMAT.O) — Buy 2 (under review)

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Report date: 18 March 2003
Price date: 19 March 2003

Rationalising its business to 'the next reality'

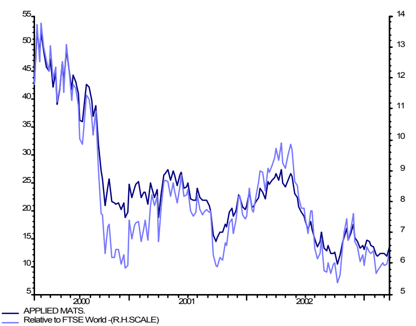
Applied Materials has announced a significant restructuring programme, including a 14% RIF. These actions are consistent with our expectation of an airpocket in SPE orders in the second quarter timeframe based on macroeconomic indicators. Moreover, we have been saying for some time now that we believe the SPE industry needs to rationalise in the face of secular slowing, and we expect to hear of further restructuring across the industry throughout first half 2003. While the targeted actions at Applied Materials would imply a reduction in the COGS and opex lines in our forecast model, we believe that some of these benefits could be offset by lower revenues than those modelled in our forecast. We are re-evaluating our forecast, but are not making any changes to our estimates, target price or Buy 2 rating.

Our 12-month price target of US$15 equates to 26x our CY04E EPS of US$0.47 plus net cash per share of US$2.65. This represents Applied Materials' historical average forward 12-month PE net of net cash since 1995 (excluding the bubble). Our target also equates to c3x book value per share. The stock has historically traded at an average of c5x its book value (excluding the bubble).

Risks to investment in the SPE sector include excess productive capacity and weak electronic end-market demand which may limit spending on capital equipment over the next several quarters. Sector shares are likely to exhibit high volatility in our view.

Price		US$13.54
Target		US$15 (UR) (+10.8%)
Market cap		US$22.1
Year end: Oct	**2003E**	**2004E**
PE	>100	31.30
EPS adj	US$0.08	US$0.43
EV/EBITDA	46.0	14.9

Source: UBS Warburg estimates



Source: Datastream

Baxter International (BAX.N) — Buy 2

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Report date: 14 March 2003
Price date: 19 March 2003

Price		US$21.00
Target		US$28 (+33.3%)
Market cap		US$12.5bn
Year end: Dec	**2003E**	**2004E**
PE	10.10	9.13
EPS growth	1.00%	10.6%
EV/EBITDA	6.91	6.36

Source: UBS Warburg estimates

Source: Datastream

What a difference a year makes – price target down 30%

Baxter management has cut 2003 guidance, citing continued weakness in its plasma products business and selected foreign exchange pressures on its dialysis business. Management widened its expected sales range for 2003 and lowered EPS guidance by 5% to US$2.10 to US$2.20.

Prospects for non-blood products operations remain unchanged to improved. Blood products (plasma and recombinant), the area of concern, account for 24% of sales but a somewhat larger percentage of earnings. The review of non-blood product areas was upbeat, but in our view current momentum will not offset weakness in the blood products sector near term.

We have reduced our 2003E EPS to US$2.08 from US$2.24. We have cut our 12-month price target to US$28 from US$40, a PE multiple of 13.5x our revised 2003E EPS, to reflect our lower earnings outlook. The shares trade at just over 10x our 2003E EPS, a 38% discount to the market, their cheapest level in years.

Risks include a deterioration in the plasma product market or pricing pressure in the recombinant Factor VIII market. A change in timing of ADVATE approval could adversely impact our earnings forecast. Other risks include litigation, product recall/failures, reimbursement changes, competitive product launches, supply/pricing dynamics in the Factor VIII market, and regulatory approvals.

DaimlerChrysler (DCXGn.F) — Reduce 1

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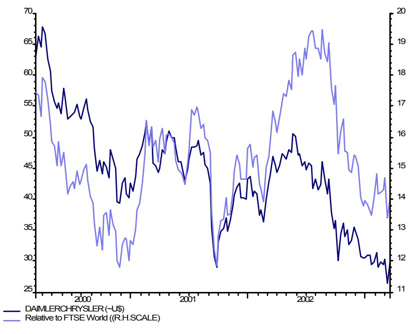
Report date: 18 March 2003
Price date: 19 March 2003

Price		€28.20
Target		€20 (-29%)
Market cap		US$30.8bn
Year end: Dec	**2003E**	**2004E**
PE	10.30	9.51
EPS adj	€2.73	€2.96
EV/EBITDA	3.76	3.93

Source: UBS Warburg estimates



Source: Datastream

The product is not enough – rating downgrade

We have downgraded our rating on DaimlerChrysler from Neutral 1 to Reduce 1. We have cut our price target from €31 to €20, based on a combination of sum-of-the-parts and implied-risk-based metrics, as well as conventional peer-group comparisons.

We expect auto demand to fall at least 5% in the US and Europe. We expect pricing and incentives to worsen. We see no macroeconomic support. We see a continued risk to earnings, both at Chrysler and at Mercedes Car Group (MCG).

Our EV analysis shows DaimlerChrysler trades at premium multiples to its peers on virtually all measures, despite lower productivity and returns. We calculate that DaimlerChrysler's implied WACC is c7%, in line with its historical average. We believe this is too low given an observed increase in equity market risk and increasing operational risk. Our sum-of-the-parts analysis supports this, yielding a fair value of €20.

Risks: Automotive demand and production schedules can change unexpectedly. In addition, pricing and costs can be affected by model changeovers, competitive, economic and political factors. Currency changes can also impact profit estimates. Financial service operations carry an extra dimension of risk.

FedEx (FDX.N) — Neutral 1

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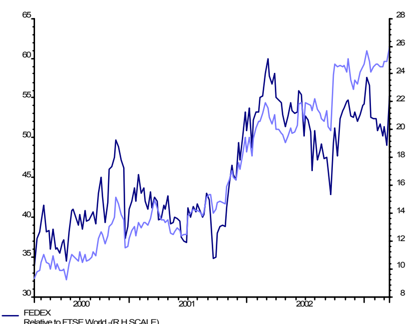
Price date: 19 March 2003

Price		US$55.18
Target		US$56 (+1.5%)
Market cap		US$16.5bn
Year end: May	**2003E**	**2004E**
PE	20.47	17.77
EPS growth	12.5%	15.2%
EV/EBITDA	6.44	5.95

Source: UBS Warburg estimates



Source: Datastream

Strong fiscal third quarter 2003 as competition heats up

FedEx reported fiscal third quarter 2003 EPS of US$0.49, versus our estimate of US$0.47 and consensus of US$0.50; and provided fiscal fourth quarter 2003 guidance of US$0.88-0.95.

FedEx posted another impressive gain in Ground, with volumes up 24% y/y. Competition has been heating up and it looks to us as if UPS is getting tired of losing share in its core ground business and is starting to push back. Asia continues to lead Express growth, up 18%, including a 35% jump in volumes out of China. Although negatively affected by winter weather, margins at Express continue to struggle and represent our only concern with FedEx. A more aggressive UPS in the Ground market also bodes ill for Express margins.

We have raised our fiscal fourth quarter 2003 estimates from US$0.86 to US$0.88, FY03E from US$2.65 to US$2.70, and FY04E from US$3.05 to US$3.10. Our US$56 price target remains unchanged and represents a 12-month forward PE of 18x and 8.9x lease-adjusted EV/EBITDA.

Risks: General risks to transportation stocks include economic (volumes), financial (debt) and event (potential M&A). There is also the risk of multiple compression as investors move away from the group at different stages of the business cycle.

Generali (GASI.MI) — Buy 2 (under review)

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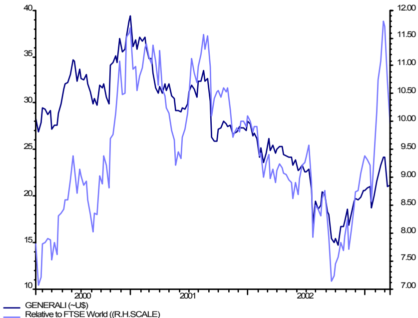
Price date: 19 March 2003

Price		€19.88
Target		€23 (UR) (+15.7%)
Market cap		US$26.7bn
Year end: Dec	**2003E**	**2004E**
PE	22.4	21.0
EPS stated	€0.89	€0.94
Net DPS	€0.30	€0.32

Source: UBS Warburg estimates



Source: Datastream

Mixed FY 2002 results

An FY02 net loss of €754 million was in line with our estimates. Writedowns were higher at €4 billion versus our €3 billion, but were offset by lower benefits to policyholders. The dividend was in line with expectations at €0.28/share. Italian new life business for January-February 2003 was up 16% y/y.

We estimate adj. NAV at c€16/share for 2002E (previous estimate €17/share) due to lower VOIF and higher goodwill (€2.6 billion versus our €2.1 billion). Generali trades on 1.2x P/adj. NAV 2003E, versus the sector on 1.1x. In a low-bond-yield environment we believe the company deserves a premium to the sector due to the presence of life growth and protected margins (Italian life). We maintain our adj. NAV 2003E at €17.3.

The results were in line from an earnings perspective but we believe that the adj. NAV will be somewhat disappointing (tba early April). Short term we see pressure but we confirm our long-term view that Generali will likely outperform the insurance sector due to its defensive nature.

Risks include: performance of assets invested in bond/equity markets; regulatory/tax changes; bond yield and/or investment return below expectations; policy guarantees; debt/default risk; exposure to large/catastrophic issues; credit rating downgrades; potential further reserves for annuitant mortality; and potential liability for mass premium reimbursement (Italy).

Harley-Davidson (HDI.N) — Buy 2

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Price date: 19 March 2003

Price target lowered on industry softness, upside bias not as visible

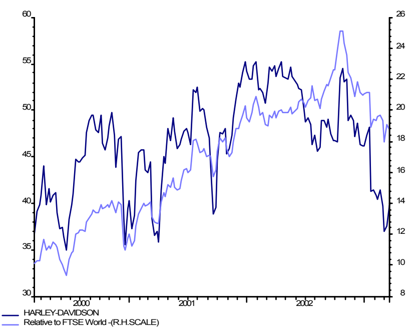
The Motorcycle Industry Council (MIC) released February sales data down 13.6% for on-highway motorcycle sales. While we continue to believe that demand for Harleys will be better than overall industry demand, the weaker industry data and the lack of upside bias in Harley's forward production guidance combines to reduce our target multiple.

We think that Harley may not have any catalysts in the very near term. The company is due to report first quarter results in mid-April and may not raise production guidance. Given that monthly MIC data has been weak, that may also provide a backdrop of concern about slowing demand for motorcycles. We have reduced our price target to US$46.50 from US$51.50 based on a lower target multiple for the motor company. While we had been using a multiple of 22x, we believe a multiple closer to 20x may be more appropriate. While the S&P500 multiple is currently trading about 17x forward EPS, we expect Harley's EPS to continue at a premium to S&P earnings growth and therefore believe that a slight premium to the S&P is warranted.

Risks for Harley include a change in demand in the motorcycle market in general and for Harley products specifically. Also, if the company were to miss earnings expectations, that would, in our view, jeopardise the PE multiple.

Price		US$39.83
Target		US$46.50 (+16.7%)
Market cap		US$12.1bn
Year end: Dec	**2003E**	**2004E**
PE	17.29	14.77
EPS growth	21.2%	17.0%
EV/EBITDA	9.48	7.93

Source: UBS Warburg estimates



Source: Datastream

Kingfisher (KGF.L) — Buy 1

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Report date: 19 March 2003
Price date: 19 March 2003

Prelims and 2003-04E upgrade

Kingfisher's 2002-03 pre-exceptional PBT of £655 million (clean) was in line with forecasts, as were divisional profits. There was a good performance on cash, especially capex and stock. The Castorama integration is going well, and some markets will be exited. The dividend exceeded our forecast.

With strong momentum at B&Q and integration gains flowing as planned, we have upgraded our DIY division forecast by £10 million. We now assume 5% LFL at B&Q (was 4%), with an unchanged EBIT margin. With a slightly lower interest charge, the group 2003-04 forecast has risen by £15 million to £735 million.

Assuming 40p/share for KESA (9x PE post £500 million of debt), then the DIY division trades on 13x 2003-04E earnings, falling to 11.5x a year later. We set a target 2004-05E PE of 13.5x for the DIY division, a 35% premium to the UK non-food sector. There are few other comparables. We have raised our price target from 240p to 275p; we retain the Buy 1 rating. Although there could be volatility over the demerger period (still planned by the end of June), positive momentum continues in terms of forecasts and strategic change.

Risks: Sales of durables and home improvement items are dependent on consumer confidence and the state of the housing market, especially in the UK.

Price		237p
Target		275p (+16.0%)
Market cap		US$9.7bn
Year end: Jan	**2003E**	**2004E**
PE	14.46	12.55
EPS growth	4.48%	15.2%
EV/EBITDA	7.65	7.10

Source: UBS Warburg estimates

KINGFISHER (~US)
Relative to FTSE World ((R.H.SCALE)

Source: Datastream

Progressive Corp-Ohio (PGR.N) — Neutral 2

Another strong monthly result; stock appears fairly valued

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Price date: 19 March 2003

Price		US$58.91
Target		US$53 (-10%)
Market cap		US$11.8bn
Year end: Dec	**2003E**	**2004E**
PE	14.4	13.7
EPS growth	16.6%	5.19%
Net DPS	US$0.10	US$0.11

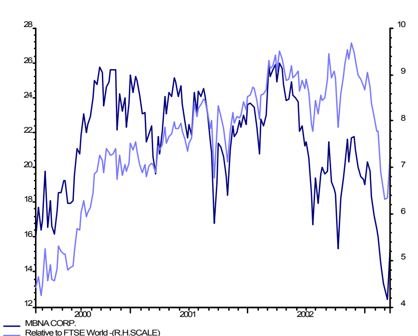
Source: UBS Warburg estimates

For the second month this quarter, Progressive produced better-than-expected underwriting results, as well as premium growth in line with expectations and a better-than-expected combined ratio of 89.8%. Having achieved rate adequacy and having strengthened its claims-handling infrastructure, we view the company is now more comfortable pushing for growth. Net written premiums rose 31% y/y, total personal policies-in-force were up 24% and commercial auto policies rose 35%.

We believe the improvement in underwriting fundamentals for the full year 2003 is more likely than not to decelerate from 2002's near optimal conditions. We expect pressure on net investment income as operating cash flows and maturing fixed-income securities are reinvested in the current low interest rate environment.

We have increased our 2003E operating EPS to US$3.75 from US$3.65. Our 2004 estimate is unchanged at US$3.95. We reiterate our Neutral 2 rating. Our 12-month price target of US$53 translates to 14x our 2003E EPS, a 27% premium to the P&C insurance group multiple of 11x. We believe this premium valuation level adequately accounts for Progressive's operating prospects.

Risks include: future adverse reserve development, further declines in interest rates reducing investment income growth, lower-than-expected growth or profitability, and the occurrence of weather-related or other catastrophic events.



Source: Datastream

Reckitt Benckiser (RB.L) — Buy 2

Price target increased to 1250p from 1100p

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Report date: 15 March 2003
Price date: 19 March 2003

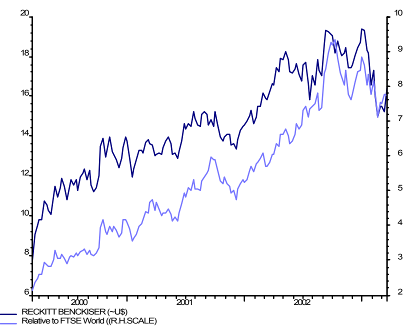
Price		1051p
Target		1250p (+18.9%)
Market cap		US$11.3bn
Year end: Dec	**2003E**	**2004E**
PE	16.41	15.22
EPS growth	10.8%	7.83%
EV/EBITDA	10.4	9.33

Source: UBS Warburg estimates

We have raised our share price target for Reckitt Benckiser to £12.50 from £11.00. Our new price target is based on fair value derived from a DCF valuation and peer group comparison, and lifts the 10% discount we had previously applied. We now feel more confident that post the failed placing of family stock in the market, the major shareholder, JAB, is now considering a more shareholder-friendly approach. Therefore, the impact of a technical overhang from a follow-up placing is likely to disappear in the next six months.

On 2003E EV/EBITDA the stock is trading on a 14% discount to the peer group and a 20% discount on PE, indicating an upside up to 1200p on peer group comparison and up to 1380p on DCF valuation. We set our 12-month price target at a weighted 1250p. We believe the current situation provides an attractive entry opportunity into a top-quality stock. Buy 2 maintained.

Risks: The household products sector is a competitive industry with a number of bigger, international companies competing for market share. Investment behind product innovation and marketing represents a substantial part of the costs, and can vary from quarter to quarter. The sector is also exposed to competition from private-label products manufacturers and industry consolidation of major clients. All these competitive threats can impact net revenue growth and profitability. FX changes can affect sales and profit growth momentum.



Source: Datastream

ScottishPower (SPW.L)

Buy 1 (under review)

Nothing to fear – price target down to 420p

In our view, ScottishPower is a low-risk, predominantly price-regulated business offering a good yield with material upside to fair value. We believe management will continue to downplay large-scale acquisitions, even after immediate performance targets are delivered. Despite its relatively good performance during the last year, ScottishPower still trades at a discount to our revised 420p price target. This is supported by our DCF analysis and by the stock's attractive multiples relative to its peers.

We expect management to be increasingly willing to discuss medium-term strategy over this year. Consequently, with acquisitions taking a low priority in favour of organic growth, we think the market is likely to become increasingly reassured. In our view, this should help close the gap towards our price target.

We have reduced our price target from 455p to 420p, reflecting our lower sum-of-the-parts valuation. The principal changes are: (1) the inclusion of energy contract liabilities in our valuation; and (2) a more conservative valuation of non-regulated businesses in the US.

Risks: Decisions by the state and national regulators in the US and UK can materially affect earnings and value. Despite operating a generally balanced position, ScottishPower may be exposed to changes in energy prices/demand. Earnings may be affected by fluctuations in the dollar-sterling exchange rate.

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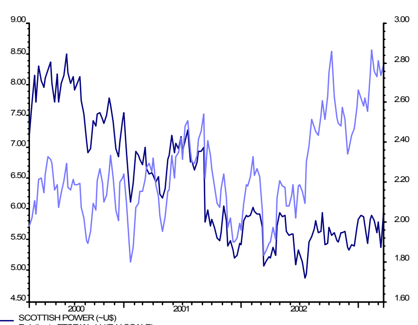
Report date: 14 March 2003
Price date: 19 March 2003

Price		380p
Target		420p (UR) (+10.5%)
Market cap		US$10.9bn
Year end: Mar	**2003E**	**2004E**
PE	11.45	10.86
EPS growth	25.1%	5.35%
EV/EBITDA	8.02	7.23

Source: UBS Warburg estimates



Source: Datastream

Telecom Italia (TIT.MI)

Neutral 2

Minorities foot the bill – downgrade to Neutral 2 from Buy 1

The announced merger with Olivetti has in our view compromised the investment case of Telecom Italia. The benefits derived from tax savings and leverage are unlikely to compensate for the merger ratio proposed. Also, it risks undermining the management goodwill gained in delivery of the industrial plan.

As we see it, a very defensive play would become the most leveraged European incumbent. Its equity would be much more exposed to changes in fundamentals and its valuation less predictable. TI's market cap/EV would fall from 60% to 30%, versus 36% and 40% for FT and DT respectively. Post the deal, the stock would trade a 7.4x 2004E EV/OpFCF (a 5% discount to its peers). This is not only due to high leverage, but also to the fact that Olimpia's weak balance sheet poses the risk of a similar deal in the future.

We have downgraded TI from Buy 1 to Neutral 2. Our new price target of €6.1 ex dividend (a 25% cut) comes from a SOTP after a 15% risk discount. At our new price target the stock would trade at s marginal discount to its peers (7.7x 2004E EV/OpFCF). The cut in price target factors in two effects from the merger: value dilution and increased risk.

Risks: TI is subject to competitive pressure and regulatory risk, as well as changes in macroeconomic conditions.

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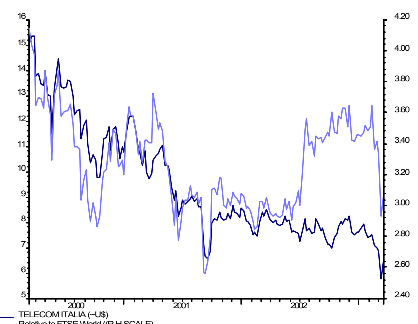
Report date: 14 March 2003
Price date: 19 March 2003

Price		€6.15
Target		€6.10 (-0.8%)
Market cap		US$42.5bn
Year end: Dec	**2002E**	**2003E**
PE	11.07	12.52
EPS adj	€0.56	€0.49
EV/EBITDA	7.09	5.32

Source: UBS Warburg estimates



Source: Datastream

Volkswagen (VOWG.F)

Reduce 1

Volume cut, US concerns, reduced price target

Management changes have focused on platform/module cost savings, new model launches, reduced capex and lower-cost labour contracts in Germany. However, we now have new concerns which has led us to cut expectations for all OEMs and to a major sector downgrade. New models should generate market share gains, in our view, but higher-than-expected US incentives, euro strength and our more negative market stance leave VW vulnerable at a time when good volumes are needed to generate new product returns.

We have reduced our EBIT for 2003E (-20% to €3.5 billion) and 2004E (-13% to €4.6 billion) and increased sector/stock risk analysis. We have cut our price target to €25.5 (was €48) and rating to Reduce 1 (Buy 2). Our new concerns and catalysts for share price weakness include possible US losses/break-even, timing of major US model replacements after 2004E, strong euro on China profits, reduced UBS Warburg market volumes and the possible impact of rating agency reviews on German pensions.

Risks: Profit, cash flow and price target are based on our long-term assumptions for underlying production, pricing and costs in the markets VW is exposed to worldwide. Automotive demand and production schedules can change unexpectedly. Pricing and costs can be affected by model changeovers, competitive, economic and political factors. Currency changes can also impact profit estimates. Financial service operations carry an extra dimension of risk.

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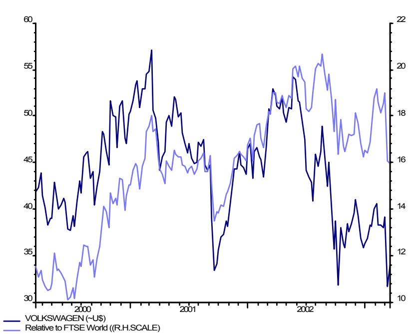
Report date: 18 March 2003
Price date: 19 March 2003

Price		€32.00
Target		€25.50 (-20.3%)
Market cap		US$13.3bn
Year end: Dec	**2003E**	**2004E**
PE	6.60	4.55
EPS adj	€4.82	€6.99
EV/EBITDA	1.59	1.33

Source: UBS Warburg estimates



Source: Datastream

Wella (WADG.F)

Buy 1 (under review)

Happy family

Procter & Gamble has confirmed its acquisition of 77.6% of Wella's voting shares from the family shareholders for €92.25/share. P&G also confirmed it will launch a tender offer for the non-voting shares at €61.5. In our view the substantial 50% discount between the voting and non-voting shares indicates P&G's focus on securing the sale of shares by the family, and thereby a stake in excess of 75% of the voting rights – an important benchmark.

The deal values Wella at €6.5 billion (including €1.1 billion debt) and translates into 1.9x 2002 sales (1.8x 2003E), 15.3x EBITDA (13.7x) and 22x EBIT (19x). P&G expects €300 million savings by year 3. We do not expect a counter bid as P&G has secured 77.6% in voting shares at an attractive price for the seller.

Risks: The acquisition is subject to regulatory and government approvals in various regions, including the EU and US. We think a major antitrust issue is unlikely as Wella's focus is on Europe while P&G has a stronghold in the US. P&G will have to continue the listing of the shares if shareholders of non-voting shares do not agree to the tender offer. While this will not prevent the deal, there will be costs involved us which could slightly impact the suggested synergy contributions. Wella's sales and earnings are also subject to currency fluctuations.

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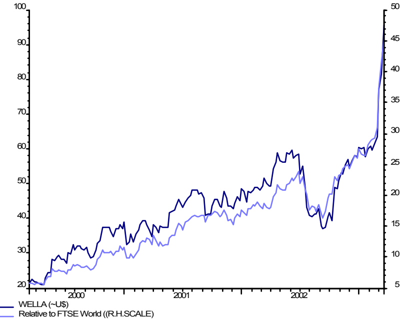
Report date: 15 March 2003
Price date: 19 March 2003

Price		€63.90
Target		€68 (UR) (+6.4%)
Market cap		US$5.8bn
Year end: Dec	**2003E**	**2004E**
PE	24.26	20.47
EPS growth	26.2%	18.5%
EV/EBITDA	13.9	12.5

Source: UBS Warburg estimates



Source: Datastream

Basic materials: Global

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Report date: 17 March 2003

Strategy update – Growth fears grow

Outlook for growth has taken a knock in the past month

The outlook for growth has taken a knock in the past month. The fall in the ISM to 50.5 suggests volatility and possible further falls below 50. The continuing fall in US 10-year Treasury yields reflects both a more conservative investment style as well as concern about growth, and it also pressures material prices. Unemployment in the US is rising again and non-financial debt is growing much faster than GDP at an annualised rate of 7.8% in fourth quarter 2002. These concerns are likely to keep basic materials equities volatile.

Boom conditions continue in China, fuelling concerns of another bust

Growth fears appear to have extended to China, where ongoing boom conditions over the past two years are raising concerns of a subsequent bust. Investment growth experienced a sudden sharp slowdown in fourth quarter 2002 although it recovered in January. First quarter 2003 data could be crucial to judge whether the investment slowdown will be gentle or dramatic in 2003. While we acknowledge that China's current growth cycle is likely to peak in first quarter 2003, any ensuing slowdown should be gentle. Fears may nevertheless undermine some of the reality of China's underpinning of global basic materials prices. China's export and import growth were extremely strong in January 2003, matched by industrial production up 17% for the January-February period. Consumption is stabilising, with auto sales growth up significantly.

Geopolitical changes suggest global spending on security likely to increase

Geopolitical changes suggest that global spending on security will increase. The broadly defined military budget in the US could more than double from 3.5% of GDP to as much as 8-9% of GDP over the coming years. This would be supportive of basic materials demand. There are some fears for earnings growth from a bottom-up perspective and, certainly while oil and natural gas prices remain high, earnings and margins for chemicals and paper producers are likely to be squeezed. We expect to see further profit warnings and earnings adjustments. Despite this we remain optimistic for relative performance and we are overweight basic materials.

› **Chemicals:** Less positive with rising feedstock prices still hurting

› **Mining:** Neutral, exchange rates hurt outlook but prices continue to rise

› **Paper:** Positive, pulp turning, US demand stronger, concerns over energy costs

› **Steel:** Positive, US consolidation but increasing concern about stocks

› **Cement/Aggregates:** Neutral, demand concerns in state highway spend

Key changes to ratings

› Upgraded Inco and WMC Resources to Buy 2 from Neutral 2 on metals forecast upgrades

› Initiated coverage on Baoshan Iron & Steel with Neutral 2 rating

› Downgraded Stora Enso to Neutral 2 from Buy 2 on exchange rate concerns

Accounting: US

FASB takes step toward mandatory option expensing

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Report date: 14 March 2003

Move toward mandatory fair value employee stock option expensing

On 12 March, the FASB voted unanimously to start deliberating potential improvements to the existing rules on employee stock options. The board stated its intention of issuing an exposure draft later this year which could become effective in 2004. We view this as a clear indication of the board's resolve to move toward mandatory fair value employee stock option expensing.

While this news makes us more confident that options will be expensed, raising our estimate of the chance to 85%+ from 70%, we note that many technology companies continue to vigorously – some say ruthlessly – lobby against this initiative. The FASB disclosed that 88% of the comment letters it received from companies opposed option expensing, whereas 76% of the comment letters it received from investors and other users of financial statements favoured it.

Major accounting firms are also endorsing this effort

In addition to FASB's apparent commitment to expensing options, this time the major accounting firms are also endorsing this effort. In letters to the FASB, Ernst & Young, PricewaterhouseCoopers, Deloitte & Touche, KPMG and Grant Thorton all indicated favour for fair value expensing. Also, new SEC chairman Donaldson has formally expressed support for expensing options.

Based on the 2001 and 2002 disclosed fair value option expense reported to date by S&P500 companies (FAS 123), the fair value expensing of stock options could reduce S&P500 earnings by as much as 10% or US$5/share. Based on the same disclosures, the fair value expensing of stock options could reduce S&P500 technology sector earnings by as much as 20%. We believe that these earnings reduction estimates may somewhat overstate the actual adverse future impact to some companies' earnings, as many companies will probably award fewer options if forced to expense such compensation. In addition, we think many employees would be willing to accept less cash as adequate compensation versus the same value of stock options.

A company's eventually reported option expense may not represent the full and normal annual cost of the options for several years

Until a draft of the new rules is finalised, we remind investors of the difficulty of precisely quantifying the risk to individual company earnings. Companies volunteering to expense options this year have the opportunity to choose from three expense method alternatives – but all three are fair value approaches. One of these approaches, the prospective method, gradually ramps up the expense over several future years (based on option vesting period). It is unclear as to whether this method will be available beyond this voluntary transition period. Therefore, a company's eventually reported option expense may not represent the full and normal annual cost of the options for several years.

Option expensing is a certainty for the IASB

The FASB also decided to consider increasing disclosure requirements for pension plans. We think this, along with the addition of stock options to the agenda, signals the FASB's commitment to reducing differences between US and IASB standards. This may open the door to more substantial changes to US pension accounting in the future. The IASB will be re-evaluating much of its pension accounting rules as well. Option expensing is a certainty for the IASB.

Telecommunications: Asia

Is 3G a winner? Lessons from Korea and Japan

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Report date: 14 March 2003

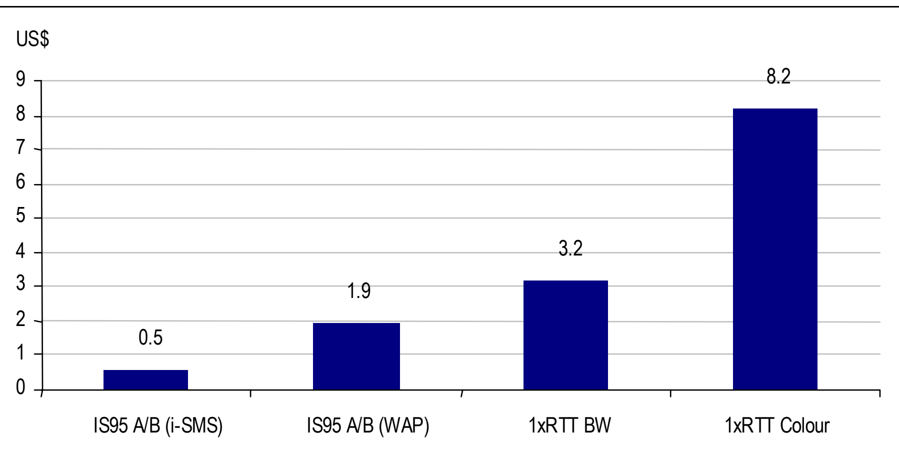
Is 3G necessary?

Is 3G necessary? In Korea and Japan, we think it is. Given the 2G capacity constraints at the leading operators, we believe 3G is necessary for voice even if it does not prove to be viable or successful for data. Without 3G, capex on 2G would arguably be much higher to sustain voice and basic data applications.

Will 3G be successful?

Will 3G be successful? We would argue it already is for the cdma 1x providers. Ultimately, we believe the success of 3G will be dictated by management's approach towards it. Finding the right balance between focusing on the existing business and 3G will be critical, in our view. We think the emerging data ARPU step-up effect and signs of robust data margins provide some hope.

Data ARPU (US$) step up effect with new technologies (US$)



Source: Company data — Note: Numbers as of December 2002

3G potential: five key criteria for success

We graded the operators based on five factors: technology issues and management execution; marketing services and applications; ARPU dynamics and mobile data economics; competitive environment; and regulatory considerations. SK Telecom ranked the highest and we upgraded our rating from Neutral 2 to Buy 2; NTT DoCoMo and LG Telecom were the lowest scorers.

Stock ratings and 3G weighted scores

	Stock rating	3G weighted score
SK Telecom	Buy 2*	3.6
KTF	Buy 1	3.4
KDDI	Reduce 2	3.3
Japan Telecom (J-Phone)	Buy 2	3.0
NTT DoCoMo	Buy 2*	2.9
LGT	Reduce 2	2.7

Source: UBS Warburg estimates

***SKT's rating upgraded from Neutral 2 to Buy 2 on 12 March; NTT DoCoMo upgraded from Neutral 2 to Buy 2 on 11 March**

Lessons to be learned

Market leaders in 2G may not necessarily have the best potential for 3G. While global market dynamics will differ in some respects, we believe 3G services will not be successful until network coverage, appealing handsets and compelling content are available.

Autos: Europe

Rising risks

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Report date: 18 March 2003

- **European volume forecasts cut to -5.5%.** We have cut our European car sales forecasts for 2003 and 2004. We now expect a fall in 2003 of 5.5% and a small rise of 1.8% in 2004E. This change is driven by: (1) weaker consumer confidence, (2) the volatile political climate relating to Iraq and (3) higher car ownership costs.

- **Earnings estimates cut by c10%.** We have cut our earnings for the sector by 11% and 9% for 2003E and 2004E. This is largely the result of our operational gearing analysis relating to our European volume downgrade and higher risks associated with the product launches in the current economic climate.

- **Increasing cash flow risks.** We see additional cash flow risks from the impact of FX and any rise in inventories relating to pressure on the supply chain in the event of war or terrorist activity. This cut to earnings, coupled with our reassessment of the risks for the sector, leads us to revise down many of our ratings and price targets, and reiterate our underweight stance on the sector.

- **Cut to ratings and price targets.** We have cut most of our ratings and price targets for the assemblers, as detailed in the table below. We do acknowledge that the near-term performance of the sector may more driven by political issue and sentiment. But we do not see any short-term rally justified in the medium term.

Changes to our ratings and price targets for the European OEMs

	Old		New			
	Rating	Target	Rating	Target	Price	Downside
DaimlerChrysler	Neutral 1	€31.0	Reduce 1	€20.0	€26.8	-25.4%
BMW	Buy 2	€42.0	Neutral 1	€25.0	€24.0	4.2%
Volkswagen	Buy 2	€48.0	Reduce 1	€25.5	€31.5	-19.0%
Porsche	Neutral 1	€400.0	Reduce 2	€220.0	€292.0	-24.7%
Renault	Buy 2	€52.0	Neutral 2	€31.0	€32.9	-5.8%
Peugeot	Neutral 1	€43.0	Neutral 1	€37.0	€37.3	-0.7%
Fiat	Reduce 2	€6.0	Reduce 2	€4.5	€6.0	-24.8%

Source: Reuters (prices as at close on 17 March 2003), UBS Warburg estimates

Statement of risk

Our profit, cash flow and price targets are ultimately based on our long-term assumptions regarding underlying sales, production, pricing and costs in these markets. Automotive demand and production schedules can change unexpectedly. In addition, pricing and costs can be affected by model changeovers, competitive, economic and political factors. Currency changes can also impact profit estimates. Financial services operations (customer credit advances, leased vehicles, dealer financing and car rental) carry an extra dimension of risk (loan/loss provision, residual values and fleet utilisation rates), and underlying vehicle demand and interest rates assumptions are used in formulating forecasts for this division. For these reasons our profit forecasts and consequently price targets may need to be reviewed.

Strategy: US

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Report date: 13 March 2003

Iraq invasion? Market, macro and sector implications

Although we are not able to truly quantify the equity sector implications of a possible US invasion of Iraq given all the unknowns (these include the magnitude and duration of an attack, the extent of, or lack of a global coalition, and the ramifications to the consumer and to the US and global economies), UBS Warburg analysts make an attempt at the discussion. The basic scenario we have laid out is as follows: The US, likely or not, makes a unilateral attack on Iraq, which is more protracted than the Gulf War, but nonetheless successful despite the lack of a global coalition. There is limited damage to the energy infrastructure, and the stock market (not being surprised by the action) has a relatively muted but negative response, while the impact on consumer spending and the economy is absorbed.

Executive summary

- **Edward Kerschner, Global Investment Strategy.** History tells us that markets' reactions to a worldwide crisis vary considerably. But the key factor in how stock markets react is the environment in which the event takes place. Confrontations, and even wars, in and of themselves, are rarely sufficient to disrupt markets over the long term.

- **Maury Harris, US Economic Strategy.** After a generally decent set of January Us economic data, the preliminary February statistics suggest that the uncertainty surrounding the evolving geopolitical crisis is increasingly delaying private sector spending. We adjusted satisfactorily to the post 9/11 environment (real GDP was 2.9% in 2002 on fourth quarter/fourth quarter basis) and as likely the most adaptable country on earth, we'll do so again.

- **Joseph Mezrich, US Quantitative Research.** Conventional wisdom is that decisive action on Iraq could precipitate a stock market rally. That would interrupt the continuing bear market, but not necessarily stop it. We find that a relief rally is priced in the market, but not to the full extent that could unfold. History suggests that conclusive action produces a fall in the risk premium that could boost stocks substantially. If one believes that this will be a protracted conflict, the risk premium would possibly expand.

Energy

- **Matthew Warburton, Integrated Oils.** Despite strong commodity prices, there has been limited enthusiasm for the US integrated oil sector during recent months, based on market expectations that oil prices will fall sharply after the resolution of the Iraqi crisis.

- **Ron Barone, Natural Gas & Electric Utilities.** If there is a war with Iraq, the impact on our stocks will be determined by the direction of oil prices. If oil prices go up, natural gas stocks would likely react favourably as several companies produce oil and gas. Also, it would diminish the possibility of fuel-switching to oil, from natural gas. If oil prices go down (as they did shortly after the last war with Iraq began), we believe the stocks may react

negatively as investors would perceive that lower oil prices would cause switching to oil by those industrial customers that have alternate fuel-burning capabilities.

- **Bill Featherston, Oil & Gas Exploration & Production.** With the seemingly imminent war at the forefront of investors' minds, and particularly energy investors, we thought we would provide several scenarios (including our view) outlining how oil prices, natural gas prices, and E&P stocks could fare. However, our views are colored by two beliefs: (1) the 1991 Iraq analogy is a misleading comparison; and (2) given fuel-switching, the price of natural gas is largely dependent on oil prices in the short term.

- **James Stone, Oilfield Services & Equipment.** We believe oilfield service stocks will benefit from a quick resolution to the Iraqi situation even though there is a broad consensus that oil prices would decline after we attack Iraq. Our recent oil price forecast increase partially reflects the fact that the underlying supply/demand balance for oil has tightened in the last several months and therefore oil prices might not decline as steeply as previously expected.

Industrial & Transportation

- **David Strauss, Aerospace & Defense.** Valuations for the defence stocks today appear much more attractive than back in August. Today the stocks trade, on average, at a slight premium to the market on a forward basis and a slight discount on a trailing basis (reflects lower estimated 2003 GAAP EPS due to pension impact) versus significant premiums on both a forward and trailing basis back in August. We believe valuations are appropriate given where we are in the defense budget cycle.

- **Sam Buttrick, Airlines.** We expect full-year revenue for the industry to fall for a third straight year – about 4% – and are forecasting double-digit (or near) revenue declines over the next three months. As a result, while our March quarter estimates are generally consistent with the poor end of published forecasts, our June quarter estimates have dropped off the charts. As always, we call them estimates for a reason.

- **Rick Paterson, Transportation.** We do not view UPS or FedEx as being seriously at risk in the event of another Gulf War. We expect some minor service disruptions to operations in the region, and some relatively minor personnel and equipment issues if we move higher up the CRAF scale (unlikely, in our view). Both companies are well protected in terms of fuel exposure, and fuel presents a potential opportunity for investors as we believe both stocks may experience weakness in the event of a further oil spike, creating what we would consider attractive entry points. Our overall stance is neutral on these stocks. Our concerns are in the current pricing environment.

- **David Bleustein, Machinery & Multi-Industry.** 'How will the stocks under coverage respond to a war with Iraq?' Although no two scenarios are identical, we analysed the performance of the industrial stocks in and around

the dates of prior crises, including the Gulf War, the Cuban Missile Crisis, and the Vietnam War.

› **Richard Schneider, Paper & Forest Products.** It has already clearly had a weakening effect on demand as consumers and customers put off purchases. The US dollar has weakened further (which is somewhat of a positive for the group), probably partly because of the war concerns. Higher energy costs have put a squeeze on margins. Hopefully, there will be a positive resolution in a two- to three-month timeframe. This would begin to move pent-up demand into the market. We would expect volumes, which are missing from the industry, to bounce back. We think the situation could tighten up nicely. Plus, we believe we could have some lower input costs.

Consumer & Consumer Cyclicals

› **Robin Farley, Cruise Lines.** We believe the current environment is extremely challenging; however, we believe that whatever happens in Iraq in the next month will not be a long-term fundamental issue for the cruise sector. We believe that if and when resolution is perceived, recovery could reward investors that are able to hold the stocks past any potential disruption.

› **Caroline Levy, Beverages.** Using the Gulf War as a benchmark, we believe the following things could happen if the US invades Iraq: (1) general stock market weakness; (2) outperformance of non-cyclical stocks (beverages); (3) an increase in energy prices; and 4) a decrease in on-premise and travel-related consumption.

› **Saul Rubin, Automobiles.** The potential Iraqi campaign has asymmetric risks for the auto stocks. A successful campaign would probably not result in significantly better prices for auto stocks, while we believe an unsuccessful one could bring about a steep decline.

› **Linda Kristiansen, Broadline Retailers.** We believe department store stocks would, at best, experience a brief rally associated with an improved real income outlook as a result of lower energy prices. This compares with almost a three-year long period of outperformance that coincided with the outbreak of the Gulf War. There are several reasons we don't expect a repeat of this strong performance.

› **Brian Shipman, Media-Publishing.** We believe advertising in newspapers would probably dip initially on consumer spending fears by advertisers. To venture a guesstimate by how much, we'd put it in the 5-10% range. But we would also point out that this drop probably would not be as severe as for broadcast media given that broadcast has to run news 24/7 in a war scenario (at least initially), thus leaving no inventory to sell to advertisers.

› **Lee Westerfield, Media Broadcasting.** War in Iraq and the short-term impact on adspend: We calculate weekly 'lost advertising revenue' would be roughly US$100 million for broadcast networks, and in the vacuum of national marketing demand we believe it would put 1-2% pressure on radio pricing.

Strategy: Europe

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Report date: 19 March 2003

Tactical aggression, strategic defence

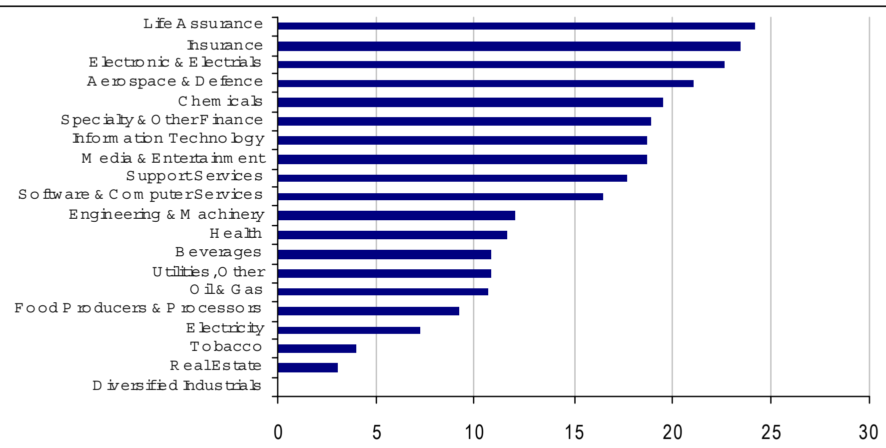
- **The 15% rally discounts success.** The rally in Europe has come earlier than in the 1991 Gulf War, suggesting investors are already discounting military success in a rapid war, with over 30% of Eurotop 300 stocks gaining more than 15%, albeit many from oversold positions.

- **The similarity in sector and stock moves to 1991 is striking.** Indeed, the sector behaviour is very similar to that seen after the allied attack began on January 17 1991. Insurance, tech and cyclical services led both the 1991 and the recent rally, while the oil sector was the clear loser.

- **Not only newsflow and momentum – valuation counted too.** Our 'valuation for sceptics' methodology shows that it was not just newsflow and momentum that drove sector returns in the 1991 war, but that valuation had a strong role as well. We therefore have tactical preference for insurance, aerospace, retailers and support services at the expense of oil stocks. Our tactical views will also be developed via the daily conference calls we are holding.

- **The strategic view retains a defensive bias.** Even the three months following the 1991 ceasefire saw a return to more defensive sectors, including pharma, food producers, tobacco and telcos. With worries that the US dollar will resume its downward slide coinciding with what we expect to be a disappointing first quarter earnings season, we want to remain defensive despite moving oils back to neutral.

Top 10 best- and worst-performing sectors since 12 March (%, abs)



Source: UBS Warburg/Datastream

UBS Warburg Forecasts	18-Mar-03	Mid 2003E	Dec 2003E
Eurotop 300	781	n/a	975
10 yr Bunds	4.16	4.00	4.20
ECB refinance rate	2.50	2.25	1.75
European EPS growth	n/a	n/a	20.3
European PE multiple	n/a	n/a	12.3

Strategy: Europe

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Report date: 18 March 2003

Germany at the crossroads

Given Germany's current options, we believe the German economy and financial markets are likely to remain unattractive for a number of years. As such, we expect the malaise to continue in both economic and financial market performances. Therefore, in our opinion, it is not too late to sell Germany.

Germany's demographics suggest time is running out for finding a solution

German growth has underperformed for a decade or more. The structural reasons for this underperformance are well known and understood. With reform of the way EMU is run and supply-side reform in Germany, the prognosis may not be too bad. But there are new challenges facing Germany and it will have to run harder just to stand relatively still. The bald choice is to do nothing or reform, and if reform is chosen, to do it gradually or with a big bang. Doing nothing is a non-option, in our opinion. It implies an even weaker trend growth rate, higher unemployment and ever increasing government debt. This is simply not possible within the confines of the current EMU policy framework.

Big bang reform seems unlikely…

…this leaves Germany facing gradual reform

Big bang reform seems unlikely in this parliament given the political weakness of the current administration, the current parlous state of employment and finances, the entrenched interests of the unions and the electoral cycle itself. A grand coalition would not necessarily improve things. This leaves Germany facing gradual reform, which in turn implies a move away from tighter fiscal policy and agitation in concert with France for a more accommodative euro area policy structure. The result is that Germany is likely to repeat the lacklustre performance of the past decade but avoid collapse. In this sense it should remain very sensitive to the global business cycle, but will not be an engine of growth. The implications are bleak for the equity market – Germany is set to see poor returns with range-bound trading as it attempts to restructure in the coming years. We have long argued that the German market deserves a substantial discount to the rest of the European market.

Next five years likely to see further trend decline in importance of German market

The next five years are likely to see further trend decline in the importance of the German market in the European benchmark, but in a volatile manner. At a sector and stock level, the drivers of this decline are likely to be financials, with the more cyclical elements of the market in the more internationally exposed sectors providing much of the volatility. Sectoral investment within Germany is likely to be increasingly hard – trend weakness in financials and manufacturers could be accompanied by poor trends for high labour cost services as well.

Highly leveraged sectors will be at risk

If banks tighten lending conditions as a precaution against capital problems, we think highly leveraged sectors will be at risk, squeezed both by falling demand and rising financing costs. Sectors that produce mostly exported goods and services could also come under pressure as the process of reform and euro appreciation hinder German competitiveness. Large German stocks that screen as having high domestic business and high leverage, and are rated Neutral or Reduce, include **Deutsche Telekom**, **Continental** and **MAN**. In addition, financial stocks that our analysts rate Neutral and which have exposure to Germany's problems include **Deutsche Bank**, **Commerzbank** and **Munich Re**.

Global ratings: Definitions and allocations

UBS rating	Definition	UBS rating	Definition	Rating category[1]	Coverage[2]	IB services[3]
Buy 1	Excess return potential > 15%, smaller range around price target	**Buy 2**	Excess return potential > 15%, larger range around price target	**Buy**	45%	35%
Neutral 1	Excess return potential between -15% and 15%, smaller range around price target	**Neutral 2**	Excess return potential between -15% and 15%, larger range around price target	**Hold/Neutral**	47%	31%
Reduce 1	Excess return potential < -15%, smaller range around price target	**Reduce 2**	Excess return potential < -15%, larger range around price target	**Sell**	8%	25%

Excess return: Target price / current price - 1 + gross dividend yield - 12-month interest rate. The 12-month interest rate used is that of the company's country of incorporation, in the same currency as the predicted return.
1: UBS Buy 1/Buy 2 = Buy; UBS Neutral 1/Neutral 2 = Hold/Neutral; UBS Reduce 1/Reduce 2 = Sell.
2: Percentage of companies under coverage globally within this rating category.
3: Percentage of companies within this rating category for which investment banking (IB) services were provided within the past 12 months.
4: Closed-end funds ratings and definitions are: Buy: Higher stability of principal and higher stability of dividends; Neutral: Potential loss of principal, stability of dividend; Reduce: High potential for loss of principle and dividend risk.

Source: UBS AG, its subsidiaries and affiliates; as of 11 January 2003.

Companies mentioned

Company Name	Reuters	Rating	Price*
Applied Materials[1]	AMAT.O	Buy 2 (under review)	US$13.54
Automatic Data Proc.	ADP.N	Neutral 1	US$30.34
Baoshan Iron & Steel	600019.SS	Neutral 2	Rmb5.00
Baxter International[3a,7,10]	BAX.N	Buy 2	US$21.00
BMW[2,7]	BMWG.F	Neutral 1	€26.35
Commerzbank[8]	CBKG.F	Neutral 2 (under review)	€6.83
Continental[1]	CONG.F	Neutral 2	€14.05
DaimlerChrysler[3b,10,12]	DCXGN.F	Reduce 1	€28.20
Deutsche Bank[10,12]	DBKGN.DE	Neutral 2	€40.43
Deutsche Telekom[3b,3a,10,12]	DTEGN.F	Neutral 1	€10.75
FedEx Corp.	FDX.N	Neutral 1	US$55.18
FIAT[7,9b,10]	FIA.MI	Reduce 2	€6.19
France Telecom[3b,12,13]	FTE.PA	Reduce 2	€21.51
Generali[3c]	GASI.MI	Buy 2 (under review)	€19.88
Harley-Davidson Inc.	HDI.N	Buy 2	US$39.83
Japan Telecom[9a,10,12]	9434.T	Buy 2	¥323,000
KDDI Corp.	9433.T	Reduce 2	¥355,000
Kingfisher[3a,8,10,12]	KGF.L	Buy 1	237p
KTF	32390.KQ	Buy 1	Won23,150

Company Name	Reuters	Rating	Price*
LG Telecom	32640.KQ	Reduce 2	Won3,630
MAN	MANG.F	Neutral 2	€14.82
Munich Re[10,12]	MUVGN.DE	Suspended	€82.10
NTT DoCoMo[3a,8,10,12]	9437.T	Buy 2	¥220,000
Peugeot	PEUP.PA	Neutral 1	€38.53
Porsche AG	PSHG_P.F	Reduce 2	€300.00
Procter & Gamble Co.[3b]	PG.N	Buy 1	US$87.92
Progressive Corp.	PGR.N	Neutral 2	US$58.91
PT INCO Indonesia	INCO.JK	Buy 2	Rp6,200
Reckitt Benckiser	RB.L	Buy 2	1,051p
Renault	RENA.PA	Neutral 2	€34.44
ScottishPower[8,10]	SPW.L	Buy 1 (under review)	380p
SK Telecom	17670.KS	Buy 2	Won155,000
Stora Enso[10]	STERV.HE	Neutral 2	€9.78
Telecom Italia[7,10,11]	TIT.MI	Neutral 2	€6.15
United Parcel Srvc.[3b,10]	UPS.N	Neutral 1	US$58.63
Volkswagen[1,8,10]	VOWG.F	Reduce 1	€32.00
Wella[12]	WADG.F	Buy 1 (under review)	€63.90
WMC Resources Ltd[12]	WMR.AX	Buy 2	A$3.85

* As of 20 March 2003. Source: UBS AG, its subsidiaries and affiliates.

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