2001, and continue to enjoy a disproportionately large share of both income (58%) and wealth (68%). We should make clear that we have no normative view on whether plutonomies are good or bad. Our analysis is based on the facts, not what the society should look like.

This lies at the heart of our plutonomy thesis: that the rich are the dominant source of income, wealth and demand in plutonomy countries such as the UK, US, Canada and Australia, countries that have an economically liberal approach to wealth creation. We believe that the actions of the rich and the proportion of rich people in an economy helps explain many of the nasty conundrums and fears that have vexed our equity clients recently, such as global imbalances or why high oil prices haven't destroyed consumer demand. Plutonomy, we think explains these problems away, and tells us not to worry about them. If we shouldn't worry, the risk premia on equity markets may be too high.

Secondly, we believe that the rich are going to keep getting richer in coming years, as capitalists (the rich) get an even bigger share of GDP as a result, principally, of globalization. We expect the global pool of labor in developing economies to keep wage inflation in check, and profit margins rising – good for the wealth of capitalists, relatively bad for developed market unskilled/outsource-able labor. This bodes well for companies selling to or servicing the rich. We expect our Plutonomy basket of stocks – which has performed well relative to the S&P 500 index over the last 20 years – to continue performing well in future. From this basket, we would highlight in particular, at the moment, LVMH and Richemont.

Appendix 1. Background and Methodology of the U.S. Citigroup Smith Barney February 2006 Affluent Investor Poll

Greenwald & Associates and Synovate conducted the Citigroup Smith Barney Affluent Investor Poll, done in partnership with CNBC, between January 5 to January 20. Interviewing was conducted online with 561 investors who are members of the Synovate Consumer Opinion Panel. In order to qualify for participation, panel members had to have at least $100,000 in financial assets (excluding real estate and employer retirement plans), a definition that describes approximately one-quarter of all U.S. households. Survey results include 177 interviews with households that have $100,000 to $499,999 in savings and investments, 156 interviews with those in the $500,000 to $999,999 asset range, and 228 interviews with investors who have $1 million or more. Survey results have been weighted by age and asset level to reflect national population norms. The results of the Citigroup Smith Barney Investor Poll have a maximum margin of sampling error (at the 95% confidence level) of plus or minus four percentage points.

VALUATION AND RISKS

LVMH MOET HENNESSY LOUIS VUITTON (LVMH.PA, 1M, €80.60)

Valuation

Our target price is €87. We favor a Sum of the Parts approach to valuation. In Wine & Spirits, IFRS means the group has for the first time had to publish a plausible valuation for Moet Hennessy. This value arbitrates in any potential transaction between the two owners of the JV and hence looks highly robust. Variations in the value of the three smaller divisions (Watches & Jewellery, Perfume & Cosmetics, and Selective Retail) are not material in the total. Therefore the SOTP approach essentially boils down to the valuation of Fashion & Leather and hence Louis Vuitton.

Here we assume a 10% premium value for Louis Vuitton, compared to quoted luxury peers (Hermes, Bulgari and Richemont), reflecting the highest returns in the industry and scale dominance of the sector. High volume sales at high prices allow the brand to invest in brand communication and store environment in a way no competitor can match. This gives the brand a long-run growth dynamic while offering protection for the premium returns profile, justifying our premium valuation. Our target price is based on our SOTP of €87. Our €87 price equates to a 2006E group EV/EBIT multiple of 17.1x which represents an 8% premium to its European luxury peers and also seems appropriate given LVMH's superior returns.

Risks

We rate LVMH Medium Risk. The risk rating on the stock is derived after consideration of a number of factors.

These factors include an assessment of industry specific risks, financial risk and management risk. In addition, we consider historical share price volatility, based upon the input of the Citigroup quantitative research team, as a possible indicator of future stock-specific risk. With regard to LVMH, it is important to mention limitations in disclosure, however this has improved significantly in recent years. The following risks may impede the achievement of our target price:

- Changes in demand for luxury goods are correlated to the macroeconomic environment and the health of consumer spending patterns. Thus, any major change in the external political or economic scenario that may directly or indirectly affect consumer confidence is a risk to LVMH’s sales results.
- LVMH’s businesses are highly dependent on sales to tourists. This is vulnerable to geopolitical developments such as terrorism or a flu pandemic.
- The group is an exporter of products sourced in Europe and therefore can suffer adverse pressures from currency on both a translational and transactional basis. These impacts can be highly volatile and highly geared.
- The group uses hedging arrangements to protect the business from the worst effects of currency pressures. However hedging gains are a one-off source of profit that can fall away rapidly.
- The growth of luxury goods in emerging markets such as China, India and Russia is an important attraction for the shares. However these markets can be volatile and unpredictable.
- The key profit centre in the group is Louis Vuitton. Demand for the Louis Vuitton range has grown at very positive rates. However the product is overtly branded and the group would be vulnerable to changes in consumer taste in this area.
- Counterfeit goods remain a problem for Luxury Goods companies. Counterfeiting is particularly big in China and could dampen Louis Vuitton’s growth prospects within this critical marketplace.

The above extracted from the report “Full Year Results First Thoughts”, 2 March 2006, Analyst: Constanza Mardones

Compagnie Financiere Richemont AG (CFR.VX, 1M, SFr59.85)

Valuation

Our target price is SFr64. Richemont is defined as a luxury company and is benchmarked against a luxury peer group. However, its 18.3% share of BATs represents 36% of Richemont's enterprise value. To value Richemont we calculate a fair value for its luxury assets and rely on our BAT analyst, Adam Spielman, for the BAT target price. We acknowledge that Richemont has historically shown considerable innate volatility. A global business that reports in euros and has a Swiss franc quote, while holding a directly owned stake in another global business quoted in sterling, is to say the least unusual. There are unusually high levels of external, uncontrollable influences on the share price that are not linked to the usual luxury economics. Further, the public shares only have 50% of the voting rights, with the balance being held by companies ultimately held by the Rupert family. These issues raise legitimate concerns regarding the stock market rating. However, these issues are well known, fairly common in the luxury sector and issues of family ownership/visibility of earnings rarely become major stock market negatives in periods of P&L recovery. Despite a strong share price recovery, the Richemont luxury division still trades below sector valuation norms.

Relative valuation: We believe the last normalised (ie mid-cycle) growth and valuation cycle was 1996 to 1999. It follows that current forward luxury goods multiples should at least engage with the ratings experienced then. This is of course an imprecise exercise at the best of times, not least because accounting environments have changed, because the luxury sector in particular has/had poor earnings transparently and because the "back testing" of historical multiples references off actual profit outcomes, rather than expectations. The key influence when using such valuation frameworks has to be the confidence (or lack of) regarding current industry and sector forecast agendas. For the record, the average mid-cycle one-year forward multiple for the main luxury companies was around 23x P/E, while they are currently on a P/E multiple (on CY06 Citigroup and consensus earnings estimates) of 18.5x .

Mid-cycle (1996 to 1999) Dow Jones Euro Stoxx was trading on a TMT boom inflated year 1 P/E compared with 12.3x CY06 estimates now. The luxury goods sector traded at just over a 20% premium (23x compared with 19x) to the market in 1996 to 1999, while it is currently trading at around a 60% premium on CY05 estimates. At a sector level, one can make the case that we are yet to see "recovered peak" margins and further, that it has a unique opportunity to benefit from the current shift of the centre gravity of the global economy to Asia. Current sector earnings estimates continue to have upwards revisions whilst also offering premium earnings growth rates relative to the wider market.

Regarding Richemont, we believe the specifics of its leveraged P&L, and the probability of further upgrades make its (luxury only) P/E discount to the sector to March 2007E (10%) still look moderately conservative. The luxury only division is on 18.5x to March 2007E. We would argue that there are stronger drivers of relative earnings performance at Richemont than for the sector as a whole, not least because of the scale of the recovery seen now underway. Our target of CHF64 would see the shares on a luxury only P/E of 22.5x March 2007E, representing a 11% premium to sector averages (ex Richemont) to March 2007. This is based upon subtracting BAT's stake at our target. Equally this would put the luxury only EV to sales ratio on 3.3x, in line with sector averages. Though arguably ambitious, these multiples seem defensible on the basis that we expect further relative forecast upgrades from Richemont.

Risks

The Medium Risk rating on the stock is derived after consideration of a number of factors. These factors include an assessment of industry-specific risks, financial risk and management risk. In addition, we consider historical share price volatility, based upon the input of the Citigroup quantitative research team, as a possible indicator of future stock-specific risk. With regard to Richemont, we would highlight the following factors that could impede achievement of our target price:

Changes in luxury goods demand is correlated to the macroeconomic environment and the health of consumer spending patterns. Thus, any major change in the external political or economic scenario that may directly or indirectly affect consumer confidence is a risk to Richemont's sales results.

After several two years of steep price increases in the US we are concerned that any return to further US dollar weakness, which would necessitate further price increases, could impact demand. We are concerned that the price elasticity could have changed.

- Cartier has embarked on a strategy to increase its exposure to the entry-level luxury market. Up to a point this should be value enhancing, but Richemont needs to be watchful not to erode the brand value.
- Richemont's sales are also exposed to international travel patterns. The SARS virus took a toll on traveller numbers, but bird flu is now a risk, albeit one that is very hard to quantify. Terrorism attacks could severely impede travel and hence Richemont's growth.
- Company management is faced with the task of sustaining the more costconscious, business-case driven strategy, which will require different skills from the old "maison" driven strategy.
- Industry overcapacity and shorter development cycles could see a plethora of new launches from Richemont and its competitors that could push up costs.
- Though we believe Richemont still offers good prospects of upwards earnings revisions we wonder if the second half of this year will represent the tail end of the supernormal growth phase. Further, though it is impossible to quantify the odds, there is no denying that Richemont has shown above-average revenue vulnerability to events that have disrupted travel patterns. Avian flu could be highly disruptive of travel patterns.
- Exposure to the tobacco industry is a more company-specific risk. Richemont's investment in BAT gives it exposure to the tobacco industry, and the share price is thus susceptible to the litigation that goes with tobacco.

The above extracted from "Richemont: What a Wonderful World", 30 January, 2006, Analyst: Bruce Hubbard