UK EQUITIES

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RETHINKING UK LARGE CAPS

ANALYST

Neil Shah
Chloe Wong
edisongroup.com
+44 (0) 20 3077 5700
finanicals@edisongroup.com

THEMES

As one of the largest issuer-sponsored research firms, we are known for our bottom-up work on individual stocks. However, our thinking does not stop at the company level. Through our regular dialogue with management teams and investors, we consider the broad themes related to the companies we follow. Edison themes aims to identify the big issues likely to shape company strategy and portfolios in the years ahead.

UK equities

Rethinking UK large caps

Edison themes

9 October 2025

In a year marked by tariffs and geopolitical uncertainty, returns of c 15% year-to-date are no mean feat. Both the UK100 and the Euro Stoxx 50 have posted (local currency) gains of 14.9%, outpacing the S&P 500 (14.2%). The US is being driven by one of the most compelling themes of our time: AI, with names such as Nvidia (+40% year-to-date) and Oracle (+72% year-to-date) examples of where investor interest remains. Elevated US valuations and continued concerns about the US growth outlook continue to result in diversification into the European and UK markets, where lower valuations and yield support offer a margin of safety.

The UK's unloved status may reverse post budget

The UK market offers opportunity. Bank of America's September 2025 poll showed UK equities as 'the most unloved assets right now', with a 20% net underweight position. This 18% swing from the August 2025 from 2% net underweight was the largest change since 2004 and is now more underweight than after the Brexit vote. Jitters ahead of Rachel Reeves' budget and a more stubborn inflation read in the UK have meant fund flows are going to Germany, Italy and Spain. We believe this is likely to reverse in the coming quarter for three reasons: (1) the German fiscal trade we saw in Q125 is in our view moving out of the honeymoon phase into reality and is yet to translate meaningfully into German corporate profits, making the UK relatively more attractive, (2) as with the last budget, we think the government has little leeway for anything drastic, providing scope for a relief rally (we have a webinar with Gervais Williams on 27 November to review the impact) and (3) the market expects the US dollar to weaken further, and this could refocus attention on domestic UK companies where profits are insulated from US dollar weakness; the UK250 has notably lagged the UK100 in the year to date.

Four themes we consider likely to attract new capital

The equities rally has been notable for the low volatility that has accompanied it, particularly given the backdrop of tariffs and geopolitical uncertainty. We consider the following themes likely to attract new capital, assuming volatility normalises:

- **Large-cap defensives:** flight to quality – consumer staples such as Imperial Brands, BAT and Diageo, utilities including National Grid and Centrica, healthcare names GSK and AstraZeneca and services like Compass Group offer 3–5% yields with defensive earnings and balance sheet strength.
- **Financials: yield curve plus capital returns** – banks including Barclays, HSBC, Lloyds and Standard Chartered benefit from steeper curves and are returning significant capital while trading at 6–9x forward P/E ratios and 40–50% below consensus target prices, despite operational improvements.
- **Early cyclicals: UK consumer recovery –** building materials (Forterra, Ibstock), home improvement retail (Wickes, DFS, Dunelm), electronics (Currys) and contractors (Galliford Try, Kier, Morgan Sindall) offer upside potential, as housing and consumer spending recover, with private equity's avoidance of turnarounds creating public market opportunities**.**
- **Defence: structural growth –** BAE Systems (£77.8bn backlog, up 25% over 12 months), Rolls-Royce and Melrose/GKN benefit from multi-year European rearmament programmes, providing government-backed revenue visibility with reduced cyclical risk.

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Analysts

Neil Shah	+44 (020) 3077 5715
Chloe Wong	+44 (020) 3077 5700

financials@edisongroup.com

Companies mentioned in this report:

AstraZeneca
BAE Systems
British American Tobacco*
Barclays
Centrica
Compass Group
Concurrent Technologies
Currys
Diageo
Dowlais*
Dunelm
Forterra
Galliford Try
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The case for yield in uncertain times

The yield revolution: Why 5–6% matters now

The UK equity market is experiencing a quiet revolution in shareholder returns. The UK All Share currently yields 3.3% (according to LSEG data), with projected dividends of £83.9bn in 2025, representing 7% growth year-on-year. Quality dividend payers span the market: Imperial Brands delivered 50%+ total returns in 2024 while maintaining its substantial yield, while British American Tobacco (BAT) is up 30% year-to-date with a 6.27% dividend yield; consumer staples like Diageo, Unilever and Tesco offer reliable income streams; utilities including National Grid (benefiting from the £9bn Great Grid Upgrade), Centrica and Severn Trent provide regulated returns.

But the real breakthrough is the acceleration in share buyback programmes. UK companies announced £49.9bn in buyback programmes for 2024, with approximately 46 companies running active programmes. This adds roughly 2% to the dividend yield, bringing total cash distributions to the All-Share Index total returns of 5–6%, a highly competitive level in the current environment. Barclays exemplifies this trend, offering a 2.5% dividend yield plus buybacks for an 8% total shareholder yield.

Fund managers are delivering on these themes. Franklin Templeton's UK Equity Income fund yields 4.3% and recently upgraded its dividend growth guidance to 9–10% for 2025. JO Hambro Capital Management’s UK Equity Income fund yields 4.7% with a 21-year track record of approximately 9% compound annual dividend growth; its Q325 dividend was up 17% year-on-year.

With the Bank of England in a cutting cycle and bond yields compressed, equity income is becoming increasingly attractive relative to fixed income alternatives. This is particularly important now given recent Office for National Statistics (ONS) revisions that cast doubt on the supposed ‘massive wodge of cash’ consumers were thought to have accumulated during the pandemic. The ONS halved its estimate for the household savings ratio in late 2022, making one of its largest downgrades in three decades. After accounting for inflation, which peaked at 11.1% three years ago, households may not have the pent-up savings many economists assumed would fuel a consumer spending surge. In our view this makes the reliable income streams from UK equities more valuable, as they provide returns largely independent of uncertain consumer spending patterns.

The total return equation – combining yield with capital appreciation potential – looks compelling in an environment where consumer balance sheets may be less robust than previously thought.

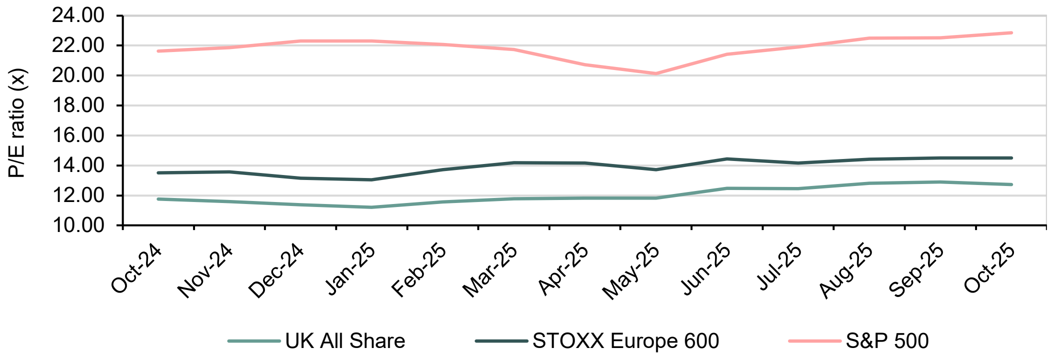
Valuation disconnect: 35% cheaper than global peers

The UK market trades at approximately 13 times earnings, close to its long-term average. Yet it sits at a 35% discount to the MSCI World index. This is particularly striking given that 80% of UK100 revenues come from overseas; these are global businesses trading at UK prices.

Structural forces explain some of the discount. UK pension funds have reduced equity allocations from over 50% in the 1990s to less than 5% today. Years of de-risking exercises, combined with Brexit and political uncertainty, have created persistent selling pressure that has depressed valuations beyond fundamental justification in our view.

However, the current environment is reshaping the opportunity in interesting ways. Higher funding costs have forced private equity to focus on high-quality, low-risk assets to protect returns on investment. This leaves turnaround situations and operationally complex stories to be sorted in the public markets; these are opportunities that private equity now largely avoids. For public market investors with patience to navigate regular reporting cycles and public scrutiny, these situations offer some of the best risk/reward opportunities available. We are picking up a definite leaning to profit improvement through self-help rather than reliance on demand growth in UK corporates.

Exhibit 1: The UK is attractively valued relative to European and US markets



Source: LSEG Data & Analytics

The market validation is clear: 41 takeover bids have been announced in the year to date, including for Dowlais, Alliance Pharma, Hargreaves Lansdowne, Assura and Wood Group. In 2024, 11% of the mid-cap index was taken over, the highest level since 2006. Private equity and corporate buyers are selectively acquiring quality assets while leaving value on the table in more complex situations.

Management teams are responding to this environment with increased urgency. Higher valuations elsewhere have created pressure to deliver numbers and demonstrate progress. This is driving increased corporate activity across buybacks, disposals and operational improvements, creating positive momentum in previously overlooked names.

The combination of record highs but relative underperformance in the mid cap segment versus US and European markets creates a contrarian setup. Bank of America's survey showing a 20% net underweight positioning and 'most unloved' status suggests maximum pessimism at potentially the wrong time.

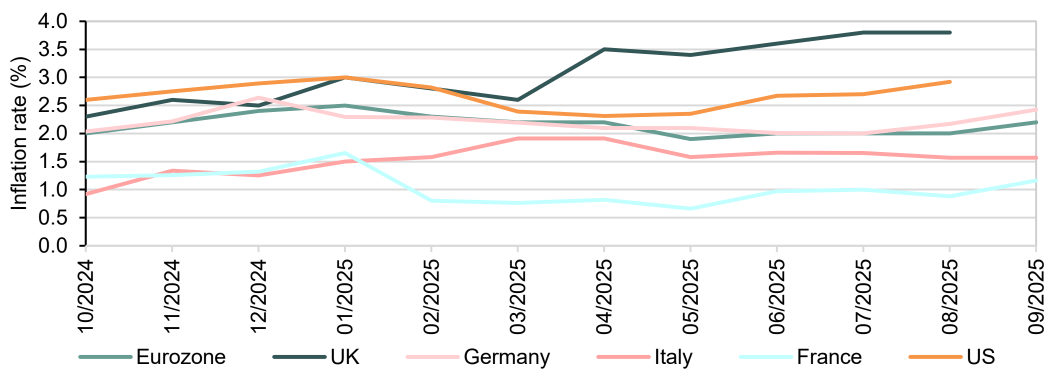
Rachel Reeves' budget: Clarifier not crisis

Near-term uncertainty around the 26 November budget has contributed to cautious positioning. Speculation about wealth taxes, property levies and potential banking or gambling taxes has weighed on sentiment, with LSEG reporting that UK investors now hold less domestic equity than at any point on record, while Calastone's latest fund flow data for August 2025 show £657m flowing out of UK equities; Calastone noted that the UK has been the least favoured equity sector in all but two of the last 51 months. However, the UK did buck the trend in August, with the outflows better than those seen for global equity funds, which saw £658m withdrawn.

The UK business environment faces legitimate headwinds. Electricity standing charges for businesses are set to almost double in April, rising by £3.7bn (94%), as small and medium-sized companies compensate for state-mandated discounts to energy-intensive manufacturers. This disproportionately affects hospitality, retail and small businesses, sectors that have reported 89,000 job losses in the past 12 months. Pub operator Wetherspoons noted its non-commodity electricity costs will rise £7m. UK businesses already face the highest electricity costs in Europe, and these increases will put pressure on margins across consumer-facing sectors.

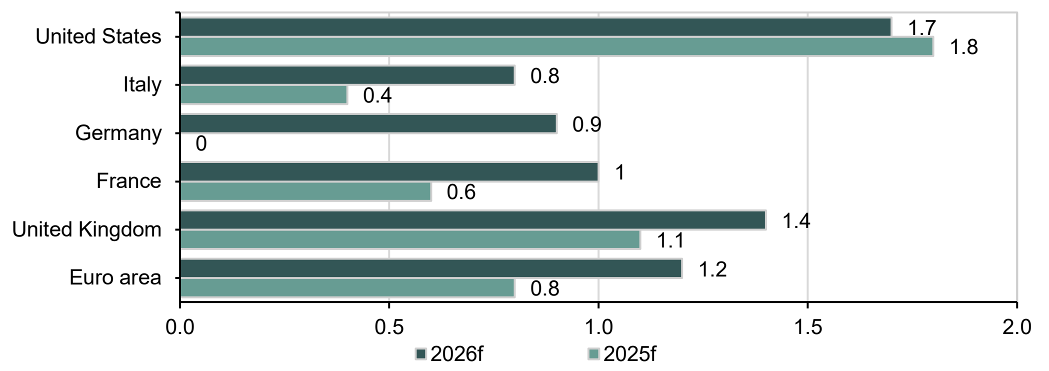
Yet the pessimism likely overshoots reality on the broader economic picture. The inflation trajectory is decisively positive, currently at approximately 4% but expected to fall toward 2% by end-2026 according to the Bank of England. A sharp 60 basis point drop is expected in April 2026, as energy base effects from this year's price-cap increase fall away. The IMF's 2026 GDP growth forecast of 1.4% year-on-year helps reduces the fiscal gap, and the UK is projected to grow faster than most of the euro area.

Exhibit 2: Inflation is a bigger issue in the UK, but is expected to fall



Source: LSEG Data & Analytics

Exhibit 3: UK GDP is expected to grow by 1.4% in 2026



Source: IMF

The post-budget outlook should improve regardless of specific measures. Worst-case scenarios appear largely priced in based on the 20% net underweight in the Bank of America survey, and historical patterns from Brexit uncertainty and the Truss crisis suggest UK markets rebound once clarity emerges. Whilst difficult to call the outcome, the extent of the tax rises and/or budget cuts are dependent on whether the Treasury see no upside to the productivity cuts the OBR has made in their forecasts. Changes in energy security, AI and demographics potentially offer some upside to the OBR forecasts. Delivery of the budget could remove the overhang and could open the door to a year-end rally.

Beyond immediate measures, opportunities exist for structural reform: removing the triple lock on pensions would have major fiscal impact; stamp duty reform could unlock housing transactions; and mandating UK equity allocations for pension funds could reverse decades of structural selling pressure.

Germany's catalyst: European fiscal revolution

Germany's decision to pursue rearmament and relax fiscal rules represents a once-in-a-generation policy shift. The programme, worth over €500bn, marks the third-largest economy's move from stagnation to growth mode. Yield curves are steepening globally in response, with significant implications for financial markets.

UK equities offer often-overlooked exposure to this European catalyst. Defence names are obvious beneficiaries: BAE Systems carries a record £77.8bn backlog and has seen its market cap reach £47bn, up 25% over 12 months. Rolls-Royce provides defence engine and nuclear exposure, while Melrose Industries' GKN Aerospace division manufactures fighter jet components using advanced additive manufacturing. Smaller-cap exposure includes Concurrent Technologies, where defence now accounts for 85–87% of revenue (up from 70% just a few years ago). The company recently secured a £4m deal with a UK defence prime contractor, and its products are well-suited to modernisation programmes replacing legacy systems with modular, open-standard solutions.

Steeper yield curves benefit banks globally, supporting UK names including Barclays, HSBC, Lloyds and Standard Chartered. Metro Bank deserves mention here; while not yet a capital return story, that is likely to change next year if its net interest margin continues to expand in line with management expectations. Consensus earnings per share growth for FY26 versus FY25 exceeds 100%, which should drive the share price higher provided the company continues to deliver.

Industrial and construction companies with European revenue exposure, such as Morgan Sindall (a partner in National Grid's £9bn Great Grid Upgrade), stand to benefit from infrastructure spillover effects.

Four investment themes

Large-cap defensives: Flight to quality

Market volatility drives preference toward stable, liquid businesses offering yield plus reliability. Consumer staples including Imperial Brands (which delivered 50%+ gains in 2024), Diageo, Unilever and Tesco provide defensive earnings streams. Utilities such as National Grid, Centrica and Severn Trent offer regulated returns and essential service exposure. Healthcare names GSK (with its new CEO and 3.5–4.0% yield) and AstraZeneca round out the defensive options. Business services, like Compass Group with its global catering exposure, offer recession-resistant characteristics.

These businesses share common attributes: defensive earnings, 3–5% yields, balance sheet strength and global franchises that insulate them from UK-specific concerns.

Financials: Yield curve plus capital returns

Steeper yield curves benefit banks through expanding net interest income. UK banks are also delivering on operational improvements: loan growth is returning, cost control programmes are bearing fruit, credit quality remains excellent with low bad debt levels, and the regulatory tone has turned benign.

Capital return programmes are aggressive. Barclays offers an 8% total shareholder yield combining 2.5% dividends with buybacks. HSBC provides quality exposure and is approaching target prices. Lloyds offers pure UK retail banking exposure with a 3.0–3.5% yield plus buybacks. Standard Chartered provides an emerging markets focus with 50% estimated upside to consensus target prices.

Despite a two-year rally, valuations remain compelling: banks trade 40–50% below consensus target prices, at six to nine times forward price-to-earnings ratios and 0.6–0.8 times tangible book value per share.

Early cyclicals: UK consumer recovery

The setup for a UK consumer recovery faces headwinds from the ONS savings revisions and rising business energy costs, which will particularly affect hospitality and retail. However, interest rate cuts are underway, inflation is expected to fall sharply through 2026, and housing-linked sectors offer particularly compelling opportunities at current valuations.

Building materials companies Forterra and Ibstock could double based on our analysis on normalised housing volumes of 200,000 homes annually, well below the government's 1.5m total homes target. Home improvement retailers Wickes, DFS and Dunelm provide exposure to housing transactions. Topps Tiles merits mention here with its high operational gearing and improving momentum as the year has progressed. Currys in consumer electronics demonstrates the potential of improving performance and sentiment; its shares traded at 45–50p when Elliott's bid was rejected and now stand at 140p, with consensus targets above 200p. Construction contractors Galliford Try (recently promoted to the UK250), Kier and Morgan Sindall offer exposure to both housing and infrastructure.

These turnaround opportunities are particularly interesting in the current environment. Private equity's focus on quality due to higher funding costs leaves these operationally complex situations for public market investors. Management teams are driving activity to prove delivery in a higher-valuation environment, though energy cost pressures will test execution.

Current valuations of four to seven times earnings compare to normalised multiples of 10–12 times, implying two to four times upside potential from trough levels. The government's 'Get Britain building' agenda provides a catalyst, though the timeline may be extended given consumer balance sheet constraints and business cost pressures.

Defence: Structural growth

Multi-year European rearmament provides government-backed revenue visibility with reduced cyclical risk and no dependence on consumer spending patterns or energy cost fluctuations. BAE Systems exemplifies the opportunity: its £77.8bn backlog provides multi-year visibility, 75% of revenues derive from defence and key programmes, including AUKUS submarines, Tempest fighter jets and armoured vehicles, benefit from locked-in European budget increases.

Broader exposure includes Rolls-Royce for defence engines and nuclear applications, Melrose/GKN for fighter jet components and additive manufacturing capabilities, and Concurrent Technologies at the smaller-cap end. Concurrent's 85–87% defence revenue exposure aligns it closely with structural growth in defence budgets, with its recent £4m UK defence contract indicating that higher spending this side of the Atlantic is becoming a tailwind. While the company's US exposure and strengthening position with US defence contractors represents the main growth driver, its products are well-suited to modernisation programmes replacing legacy systems.

Risks include potential budget cuts (though this is unlikely given geopolitical tensions), programme delays and valuations that appear fair rather than cheap for the larger names, though justified by visibility in our view.

Risk factors

UK-specific risks include a budget that is worse than expected continued political dysfunction, rising business energy costs particularly affecting consumer-facing sectors, sterling volatility hurting international earners, persistent fund outflows, housing recovery delays exacerbated by weaker consumer balance sheets than expected, and turnaround execution failures under public scrutiny.

The near-doubling of electricity standing charges for small and medium businesses from April represents a tangible headwind for hospitality, retail and consumer-facing sectors. The ONS savings revisions add to concerns about consumer spending growth. If households lack the expected pent-up savings, the recovery in consumer-facing sectors may take longer or prove more modest than hoped. This reinforces the importance of balancing cyclical exposure with defensive, income-generating holdings.

Global risks encompass US recession affecting UK companies' overseas earnings (80% of UK100 revenues), Trump's tariffs slowing global trade, geopolitical escalation and German fiscal stimulus underwhelming expectations.

Theme-specific risks include yield curve flattening for financials, recession driving bad debts, the housing market potential failure to recover for cyclicals with overly optimistic normalised earnings assumptions, budget cuts for defence despite the rhetoric and management failing to deliver on turnarounds under public market scrutiny.

Mitigants include M&A and buyback activity providing valuation support, valuation cushions, dividend yields offering a return floor and increasing management urgency to execute. The Shawbrook flotation and continued M&A activity suggest there is corporate confidence despite the headwinds.

Investment conclusion

UK large caps offer a rare combination: a 5–6% total shareholder yield, a 35% valuation discount to global equities, quality franchises and turnaround situations that private equity now avoids due to higher funding costs and execution risk.

The timing is compelling. Sentiment shows extreme pessimism; a contrarian signal. The budget may remove uncertainty. Macroeconomic conditions are improving, with inflation expected to fall toward 2% by end-2026. Management teams are driving increased activity in response to higher valuations elsewhere.

The October 2025 ONS revisions to household savings data add complexity but also reinforce the equity income case. If consumers have less saved than expected and face rising costs, they need income-generating assets more than ever. UK equities' 5–6% total shareholder yield becomes more attractive in this context.

Catalysts are building: the 26 November budget will provide clarity; Q4 inflation data should confirm the downward trajectory; the German fiscal stimulus benefits UK companies with European exposure; international fund flows show early signs of returning, as evidenced by the Shawbrook flotation; and corporate activity is accelerating through buybacks, M&A and operational improvements.

The investment strategy is straightforward: UK equities do not require exceptionalism, just a better narrative than currently priced. Dividend yields provide a return floor that matters more now that consumer spending may disappoint and business costs are rising. M&A activity validates valuations. Turnaround opportunities reward patient capital willing to navigate public market scrutiny while management teams drive execution.

We will be watching for budget specifics on taxation and spending, inflation data confirming the trajectory, the impact of rising electricity costs on business margins and consumer spending, housing transaction volumes, fund flow data for trend confirmation, corporate earnings delivery particularly in consumer-facing sectors, M&A continuation and management execution on operational improvements. The combination of ONS savings revisions and rising business energy costs has reset expectations for consumer-driven growth, but we believe this only strengthens the case for quality income-generating equities at current valuations.

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London | New York | Frankfurt
20 Red Lion Street
London, WC1R 4PS
United Kingdom