European Capital Partners

# Focus

## ECP European Value strategy: outlook & positioning

April 2017

## Market environment & outlook

***Political risk: a good example of not seeing the forest for the trees***

The persistent political tensions in Europe and the rise of populism have recently dominated investors' attention in the debate on the prospects of the European equities market. And yet the year 2016 has shown how difficult it is, notably for asset managers, to accurately predict not only the results of these political events but also their potential consequences on the financial markets.

In some ways, we could use an interesting analogy with the world of soccer and the role of the goalkeeper: at a penalty kick, the goalkeeper only has 2 (3) options: either to jump in one corner – left or right, or stay in the middle. Even for a professional goalkeeper, the training does not bring a lot of value add. Having studied hundreds of penalty kicks (which can be compared with the experience in portfolio management), will not give him any real edge when he faces a binary outcome. Psychology is important but is not very useful, especially when you are confronted to a professional who plays the poker face.

***"You are not winning a soccer tournament by specialising on penalty kicks"***

If we take this observation as a starting point, we must conclude that the in-depth analysis of such binary events in a highly complex political system presents a very marginal utility. The same goes for public opinion polls, which, as the concrete events of Brexit and US Presidential election have shown us, are not able to properly capture the populist sentiment. Thus, in the case of Brexit, these surveys gave investors a false sense of certainty.
In our view, it is therefore not relevant for portfolio managers to spend many hours analysing binary political events, at the risk of losing sight of the major trends actually in place in the markets and their portfolios.

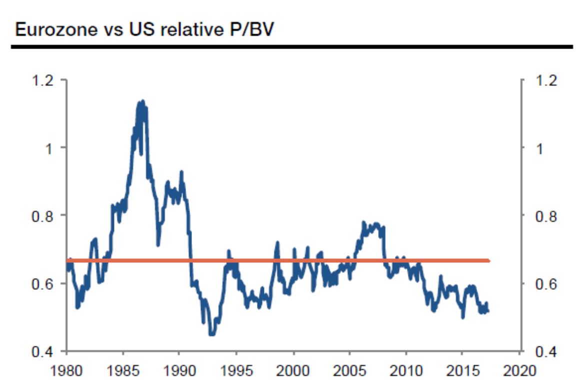
To continue our analogy with soccer, it does not make sense for a goalkeeper to only focus, during the whole match, on penalty kicks - risks that he cannot control - and at the same time underestimate bigger risks for which an adequate action on his side can make all the difference.

The European equities managers are currently confronted with this kind of situation. **Political tensions and fears of a rise in populism and its potential impact on the European Union are largely obscuring other factors that might significantly impact the medium- to long-term prospects of the European equities market**. **This widespread obsession of market participants with events that cannot be controlled, creates, in a way, opportunities for investors with a longer investment horizon**

***Fundamentally, European equities are a "must have"***

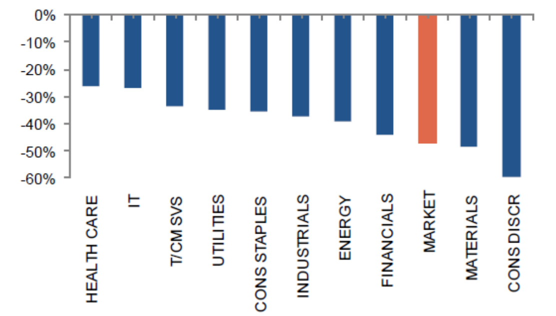
Given that it is not possible for us to influence the outcome of upcoming elections, it is therefore much more relevant to look beyond and understand current trends in the European equity markets. And we have to say that, in many ways, what we see is comforting our long-term positive stance.

First of all, valuations of the European equity market are still compelling both in absolute and relative terms. Over the past decade, the European Equity market has largely underperformed the US market leading European equities to a steep discount to their US counterparts: Eurozone equities are currently trading at an historical 50% discount in price-to-book value with all sectors derated while dividend yield of European companies is 50% higher.




Orange line: 10-year average. Source: Datastream, MSCI, SG Cross Asset Research/Equity Strategy

Eurozone vs US relative P/BV, by sector




Source: Datastream, MSCI, SG Cross Asset Research/Equity Strategy

Secondly, we are witnessing a gradual but clear improvement of the economic situation of Europe at various levels: growing growth, particularly in Germany and France, easing deflationary pressures, potential pick up of corporate earnings, higher business and consumer confidence and a still weak EUR.

GDP forecasts for global growth are in a 3 to 4% range over the next 3 years (IMF data) and we can expect that the European stock market will be the key beneficiary because: 1) Europe starts from lower valuation that the US market, 2) Europe still has a lot of excess capacity (low capacity utilisation and high unemployment rate) leaving a significant buffer to a healthy profit growth for European companies.

Hence, earnings growth in Europe has been virtually nil during the last decade. And the year 2016 has not been more favourable at this level. However, there are concrete signs pointing towards a change of paradigm in 2017 as over the first months of the year, earnings have been revised upwards for the whole market but also for every sector within it. There is every reason to believe that the growth of MSCI Europe in 2017 could reach 10%.
More importantly, the driving force of this upward trend is not only a return to normal in the face of an exaggerated scepticism of consensus but above all a renewed dynamism in the business of European companies.

This economic upturn is not only theoretical and is also perceptible in the results and comments published by the companies we are following and in which certain trends are evident: signs of improvement in the operating environment, sound balance sheets, more optimistic management outlook, surge of M&A activity (the Unilever and Aberdeen AM cases are good examples), etc.

### *Positive momentum is on the way…*

Even if our investment approach focuses on fundamentals and on a long-term perspective, we cannot ignore the potential impact of change of investors' behaviour on the financial markets.

European equities have been an unloved asset class for many months (even years) leading to a large underweight of European equities in the portfolios of most global investors. This underinvestment is mainly due to the uncertainties surrounding the European political environment.

We can expect a quick trend reversal after the French elections that should provide a huge upside potential for European equities. The earlier you come back to the European stock market, the higher should be your gains…if you have implemented a selective stock picking strategy!

### *What can make the difference…*

Let's come back to our soccer metaphor…while the vast majority of investor's are still trying to improve their penalty goalkeeping techniques and are staying away from the European stock markets blinded by short-term fears, we focus on improving the offensive qualities of our team and are building our portfolio for the future…We find the quality of the field is good and our competition is still distracted by all the political noise.

During these tough years for European equities, we have tirelessly applied our long-term investment strategy and focused on identifying quality companies which benefits from undervalued earnings power.
We always find many investment opportunities in a wide range of sectors, such as Industrials, cyclical and non-cyclical consumption, and pharmaceutical companies.
Once the other market participants finally realise the real potential of the European market, we will be ahead of the curve to take full advantage of this trend.

## Investment cases

**Leoni** is a German manufacturer of wires, optical fibres, cables and wiring systems; the company predominantly works with the automobile industry.

This is one of the investment case that is highly illustrative of our investment philosophy.
The position was initiated end October 2015 after the stock collapsed 40% in less than 6 months. At that time, the company was severely punished for having mismanaged internal planning and project execution while on the end market side, demand was uninterrupted.
Investors got scared away from a drop in earnings that was, from our long-term perspective, only temporary knowing that the issues faced by the company were self-created and that the solution was in their own hands.


The stock felt another 30% after the initial purchase; we kept our long-term view, revisited the case and, as there were credible signs that the management was addressing the internal problems in an entrepreneurial way, we decided to take benefit from this new share price drop to buy additional shares lowering our average purchase price.
However, investor sentiment did not really recover attracting also many short-sellers and the stock bottomed in July 2016 at approx. EUR 25.

Since then, the stock is up by around 85% making it entered in our top holdings and contributors.
This renewed interest from investors for Leoni finds its origin in a combination of fundamental improvement (better margins), improved management oversight (restructuring plan, reassuring management outlook) and change in investors' sentiment.

This shows how powerful a trend reversal can be when market sentiment suddenly shifts with short sellers burning their fingers and becoming forced buyers. It also shows the value of thinking long-term when investing into a company.

**Aberdeen Asset Management** is a global asset manager (Scottish domiciled) based in 26 countries. The company benefits from a strong franchise on Emerging Markets.

In early March, Standard Life (UK Life insurance and asset management company) and Aberdeen AM have announced merger plans to create the second largest asset management company in Europe with a combined market capitalisation of GBP 11bn.
Even if the merger is announced as a merger of equals, in reality, we see it as Standard Life taking over Aberdeen: Aberdeen's shareholders were not paid a takeover premium and we expect Aberdeen to take most of the hits when it will come to cutting costs and management layers over time. Both companies have their own challenges; Aberdeen's key challenge is the continuous outflow from higher margin strategies that led the stock price to fall far below our estimated intrinsic value on the back of investors fearing a dividend cut.

We are disappointed about the price Aberdeen is selling itself for, as we believe over time the value of Aberdeen would be much higher than the price they are willing to sell themselves for under current market conditions. As always, we have taken a long term approach when valuing Aberdeen Asset Management and we did not expect the company to sell themselves at a moment when active asset managers are feeling high pressure on both revenues and costs. We still believe in the brand value, the investment style and market position of Aberdeen Asset Management but acknowledge that at this point in time the value of the business may better unfold inside a larger group.

Despite our disappointment about the price paid by Standard Life, we absolutely agree that merging two active asset managers make sense; there is a lot of scope for expanding the business while reducing operating costs by removing several double functions (IT, HR, sales, legal & compliance ...). Based on comparable merger that took place since 2008, we expect the total cost savings to be around 25%-30% of Aberdeen's total costs.

It is important to note, that we do get paid in shares of Standard Life so we will participate in any future value creation. The merged company will have better means to battle the challenges across the entire industry. In short, we support the merger as we see it as being the quickest way to unlock value.

The merged company will execute its strategy from a sound basis: balance sheet is strong, revenue streams are better diversified and distribution of investment products have a true global scale. All items we deem to be of good value.

As investors in the merged company we can expect a high (minimum 5%) dividend yield that will increase over time. In addition, we expect the market over time to put a higher price on the merged company than they currently do. This should happen in sync with the merged company lowering its cost/income ratio. However, to fulfil that expectation the management first needs to prove that they can drive value from the merged company. We will monitor the entire process closely.

The deal is expected to close by Q3 2017 subject to shareholder and regulatory approval.


*Source: Bloomberg.*