

INVESTMENT NOTE

24 JUNE 2015

HERMES: EUROPEAN CORPORATES FINALLY POISED FOR P&L RENAISSANCE

After all the geopolitical, systemic and macroeconomic events seen in Europe over the last five years, Tim Crockford, Co-Manager, Hermes Sourcecap Europe ex-UK & Martin Todd, Co-Manager, Hermes Sourcecap European Alpha, believe the profound changes undertaken at company level on the Continent have largely fallen under the radar. These changes have fundamentally improved the earnings outlook for the region.

Earnings disappointments

Between 2010 and 2014, European companies generally went through an earnings bear market. Every January, the year ahead was touted as the year European earnings would recover, but each year these expectations were gradually downgraded. This was largely due to the weakening European economic environment – which persisted due to high unemployment, excess capacity and deleveraging of balance sheets. Faced with revenue pressure on the top line of the profit and loss account, while rising input costs further depressed gross profits, companies had no choice but to attack the only area of the P&L directly under control – general expenses and overheads. Companies restructured cost bases over the course of this period, in particular in reducing fixed costs, allowing for lower breakeven levels and therefore a greater margin of safety through the downturn. For many companies, this was just a case of ‘running to stand still’. In the face of declining revenues, the more ambitious companies seized the opportunity to diversify sales into new regions and weeded-out less profitable or loss-making product lines. This allowed some companies to slow or even reverse sales declines and defend margins.

Super Mario

It was not until European Central Bank president Mario Draghi’s now infamous ‘whatever it takes’ speech in 2012 that bond markets started to anticipate some form of monetary easing from the ECB. This had the effect of compressing European yields, which eventually translated into lower financing costs for European corporates. Perhaps more surprising – given the questionable fiscal state of affairs of many European nations – governments have been more actively competing for new revenue streams by lowering corporate taxation, despite not affording individuals the same benefits, in order to spur investment in the region.

Profits renaissance

For the first time in five years, corporate Europe is now at a turning point and all four major lines in the collective P&L account look set for an upturn. Top-line growth, long absent in the Eurozone, is beginning to gather momentum – due to gradually rising employment, lower energy costs and improving consumer confidence. Gross margins have been boosted by lower input costs and efficiency gains have helped operating margins weather the storms rolling over the Eurozone since the onset of the global financial crisis. Higher demand should see operational gearing come to the fore, aided by the lubrication of QE and a competitive euro. Gradually easing fiscal conditions and low financing costs complete this picture. Europe should now finally be at the start of a positive trend for profit growth, with a strong likelihood of higher operating and net profit margins in this earnings cycle than what we have seen in previous upturns.

Supportive valuations

With earnings set to rebound, the market’s current P/E multiple of 15x 2016 earnings is attractive on both an absolute and relative basis. Expected earnings are still too low given the top line is now recovering, and we expect net income to surprise on the upside as European companies enjoy higher margins from the increased operational leverage created during the recent poor years. We therefore continue to remain positive on European equities, and recommend using any pullbacks in the market to increase exposure to those companies which have improved P&L accounts over the last five years.

European stocks might not be in the bargain basement any longer, as they were in September 2012, but with an earnings cycle just beginning, a CAPE multiple close to its long-term average, the support of QE and a healthy dose of scepticism on the region, European equities represent an attractive opportunity relative to the global universe.

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Notes to Editors:

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*Please note the total AuM figure includes £3.5bn of assets managed or under an advisory agreement by Hermes GPE LLP ("HGPE"), a joint venture between Hermes Fund Managers Limited ("HFM") and GPE Partner Limited. HGPE is an independent entity and not part of the Hermes group. £0.5bn of total group AuM figure represents HFM mandates under advice. Source: Hermes as at 31 March 2015.