Equity Market Review April 2023

A quantitative view on the valuation of the European stock market

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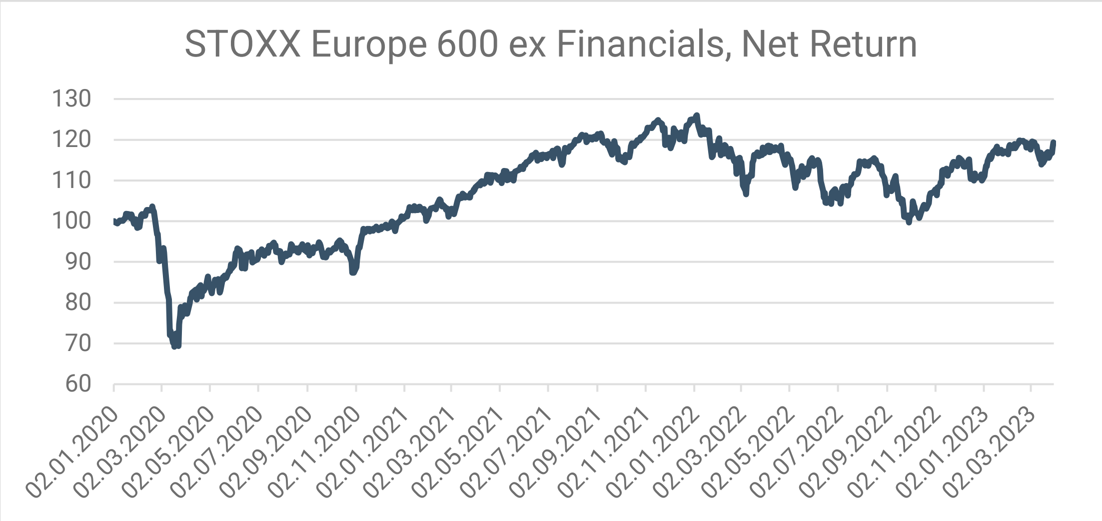
The earnings season for the fourth quarter 2022 has just ended. The results of the Stoxx Europe 600 ex-financials listed companies tended to be closer to the pre-pandemic numbers and therefore less volatile than last two years. However, companies were affected by inflation and rising interest rates. The European Central Bank increased interest rates on its main refinancing operations to 3.5% (FED funds rate: 4.75% - 5%), from 1.5% in our last publication. This was a rapid increase that pushed funding costs to their highest level since 2007 (before the subprime crisis).

News from the banking sector caused index volatility in March. On March 9th, the US bank Silicon Valley Bank was declared bankrupt, which was subsequently sold to First Citizens Bank. In the following ten days, the Swiss bank Credit Suisse came into focus, which finally concluded a merger agreement with UBS. Although concerns about the financial stability of the system have slowly eased, these events accelerated the outflow of bank deposits (given also more attractive money market funds) and made the European sector of small and medium-sized banks even more vulnerable. As a result, a more moderate central bank interest rate policy is assumed.

Considering the performance of the reference index, a return of 7.4% was achieved in the earnings season (January-March 2023). Fears of a severe recession tended to ease in the early part of the new year.

Figure 1: Performance of the Stoxx Europe 600 excluding financials indexed

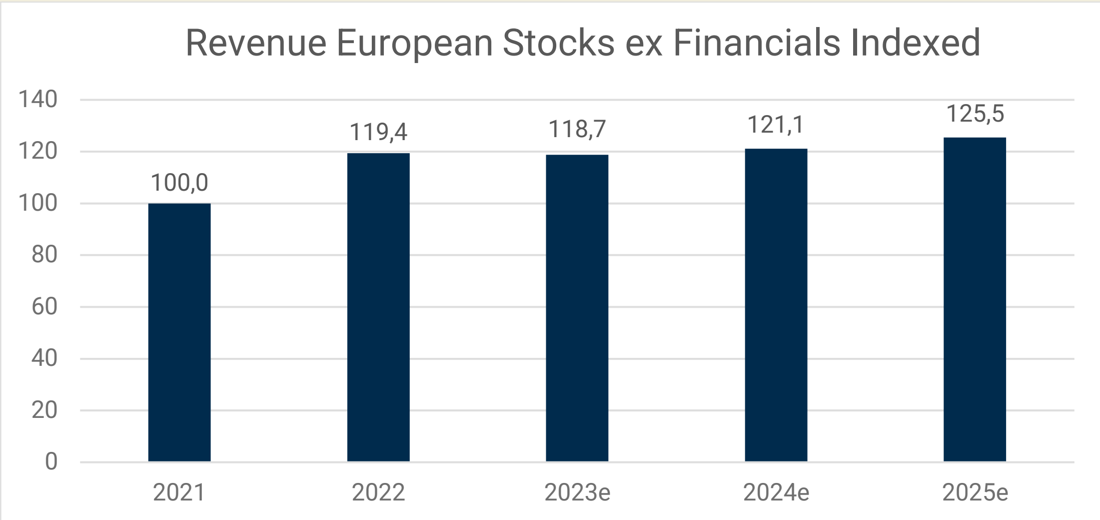


Source: Stoxx

Publication date: 06/April/2023 15:00

The revenues estimates (consensus) for the Stoxx Europe 600 ex-financials are almost unchanged for 2023 (-1%) and slightly positive for 2024 (2%) compared to our last analysis. The year 2021 serves as the base year (indexed data).

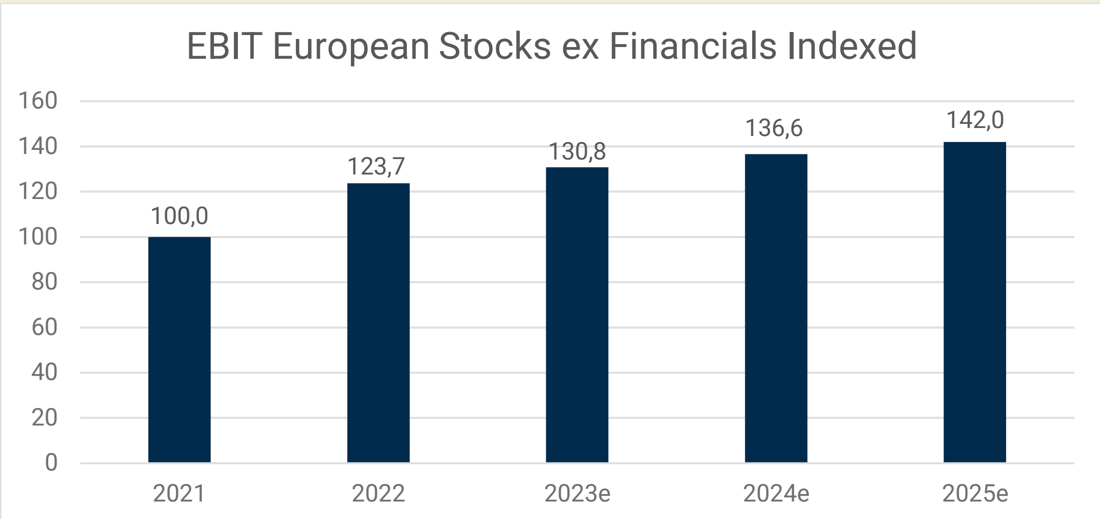
Figure 2: Development of revenues 2021 to 2025e indexed



Source: LeanVal Research, 2023 to 2025 are expected or preliminary values (e = expected).

The estimates for operating results (EBIT) are positive for both 2023 (+6%) and 2024 (+4%). There might be several reasons here. One argument is the absence of the banking sector in the data. Furthermore, it may be that the estimates have not yet been adjusted to the current economic scenario and future downgrades are therefore possible.

Figure 3: Development of operating profit 2021 to 2025e indexed



Source: LeanVal Research, 2023 to 2025 are expected or preliminary values (e = expected).

Compared to our previous analysis from 2022, some differences in multiples are evident. At the index level, Price to Book (PBV) ratio increased by 18% and Enterprise Value to Operating Income (EV/EBIT) by 9%. However, the free cash flow yield dropped by 19%. This indicates lower expected cash generation than the market value of the companies and therefore tends to lead to a lower credit rating.

Figure 5: Comparison of valuation multiples estimates for fiscal 03/2023 vs. 08/2022

Benchmark		Adj. P/B (T+1)	Adj. P/E (T+1)	FCF Yield (T+1)	EV/EBIT (T+1)	DVD Yield (T+1)
STOXX Europe 600 NR EUR	Mrz 23	4,7	18,8	5,6	14,3	3,5
	Aug 22	4,0	18,9	6,9	13,1	3,7

Source: LeanVal Research

The sectoral breakdown provides some interesting clues. The energy sector shows declining multiples (e.g. FCF yield 6.2x vs. 12.6x). This could be explained by the fall in some commodities' prices compared to the peak in 2022 (e.g. TTF gas) and thus the expectation of lower revenues. However, dividend expectations are improving. Except for FCF yield, the real estate sector shows higher multiples. As prices normalize, the extractive industry is reducing its estimates of shareholder compensation (FCF yield and DVD yield). Thanks to encouraging quarterly results, the communication services sector is developing positively (up P/E and EV/EBIT), while conversely the utilities sector is being revised downwards.

Figure 6: Valuation multiples of the sub-indices based on earnings expectations

Region		Adj. P/B (T+1)	Adj. P/E (T+1)	FCF Yield (T+1)	EV/EBIT (T+1)	DVD Yield (T+1)
Europa: DISC	Mrz 23	6,0	20,8	5,4	15,0	2,6
	Aug 22	4,9	21,3	6,5	16,7	3,1
Europa: ENER	Mrz 23	1,4	6,5	6,2	4,8	5,7
	Aug 22	1,5	10,3	12,6	6,8	4,3
Europa: FINL	Mrz 23	1,3	9,6	11,6	0,9	6,0
	Aug 22	1,1	10,8	10,7	1,3	5,4
Europa: HLTH	Mrz 23	7,5	21,0	5,2	17,5	2,9
	Aug 22	7,3	23,4	4,6	17,1	2,3
Europa: IMMO	Mrz 23	0,6	14,7	3,1	25,5	5,2
	Aug 22	0,7	12,7	4,4	20,7	4,6
Europa: INDU	Mrz 23	4,1	22,4	4,7	17,3	2,5
	Aug 22	3,6	19,6	7,3	14,8	3,4
Europa: INFT	Mrz 23	10,9	26,5	4,0	21,9	1,3
	Aug 22	8,4	29,6	4,5	21,0	1,4
Europa: MATR	Mrz 23	3,0	16,3	4,9	12,9	4,6
	Aug 22	2,6	14,7	10,0	11,1	6,8
Europa: STPL	Mrz 23	5,0	22,1	4,4	18,3	2,8
	Aug 22	4,4	22,1	4,6	19,0	2,7
Europa: TELS	Mrz 23	5,0	24,8	4,4	24,1	2,6
	Aug 22	3,1	19,8	5,9	1,6	3,2
Europa: UTIL	Mrz 23	2,1	14,5	2,2	8,5	4,8
	Aug 22	2,4	16,0	2,1	18,0	4,6

Source: LeanVal Research

The attention of stock markets in the coming months will probably remain on inflation rates and the monetary policy actions of central banks. For the short term, inflation is still expected to be structurally higher than the average for the past five years. The value of fixed assets will benefit from this development.

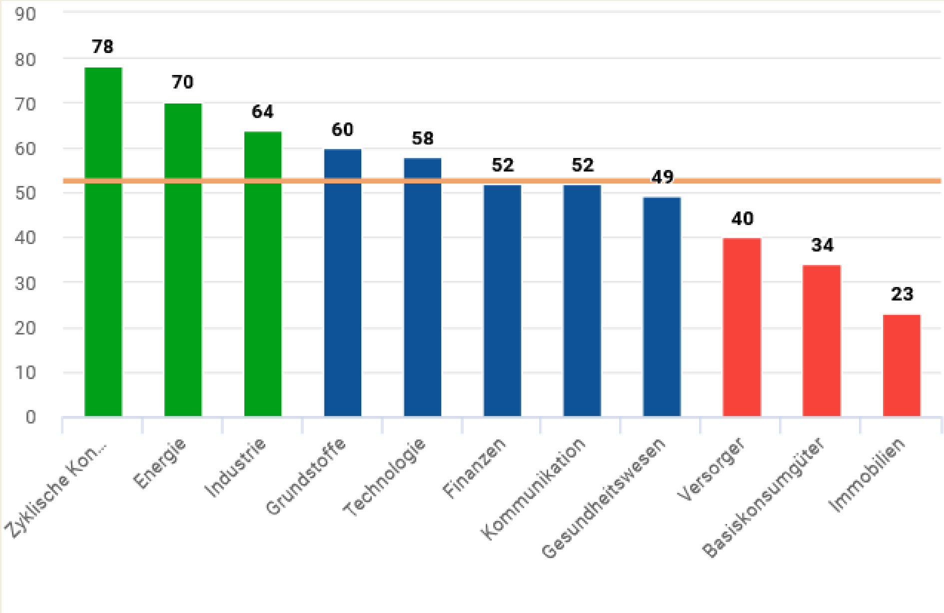
This will clearly have an in impact intrinsic business value in absolute valuation models. Dynamics of prices, volumes, operational costs and investments will take centre stage. It might be difficult for many companies to raise prices further without losing market share. Business models based on consumer credit could also run into difficulties. Further increases in operating costs could eat into profits and reduce margins. Therefore, restructuring plans as well as reductions in investments and shareholder returns (i.e. lower share buy-backs than in 2022) are to be expected.

However, expectations are quite different among sectors. Due to rising mortgage financing costs, the operating result of real estate companies should decline. The consumer discretionary and utilities industries may be affected by an economic slowdown. After a period of weakness, prices across energy and commodity sectors could rise again due to the European dynamic in supply and demand. However higher cost of capital could lead to lower new projects and investments in the mining sector. In the technology sector, topics related to artificial intelligence (ChatGPT) are likely to continue to be highlighted. Since the beginning of the year some tech giants have performed well (Microsoft YTD +17%, Alphabet YTD +15%). Stocks with high dividends and regular payments remain interesting. For example, RTL Group SA stock regularly pays a sizeable dividend with expectation for 2023 at around 8% (dividend yield). Worth to note that the small cap asset class may be more sensitive to potential credit risk and economic slowdown.

In this context, careful selection with a strategic perspective is required. For example, macroeconomic uncertainties (including the crisis in Ukraine) and increasing credit risks could lead to a rapid decline in the stock markets. To this end, hedging with derivative instruments could stabilize portfolio performance.

Based on LeanVal Research's multi-factor model, the consumer discretionary, energy and industrial sectors currently appear interesting. The real estate sector remains unattractive due to declining results.

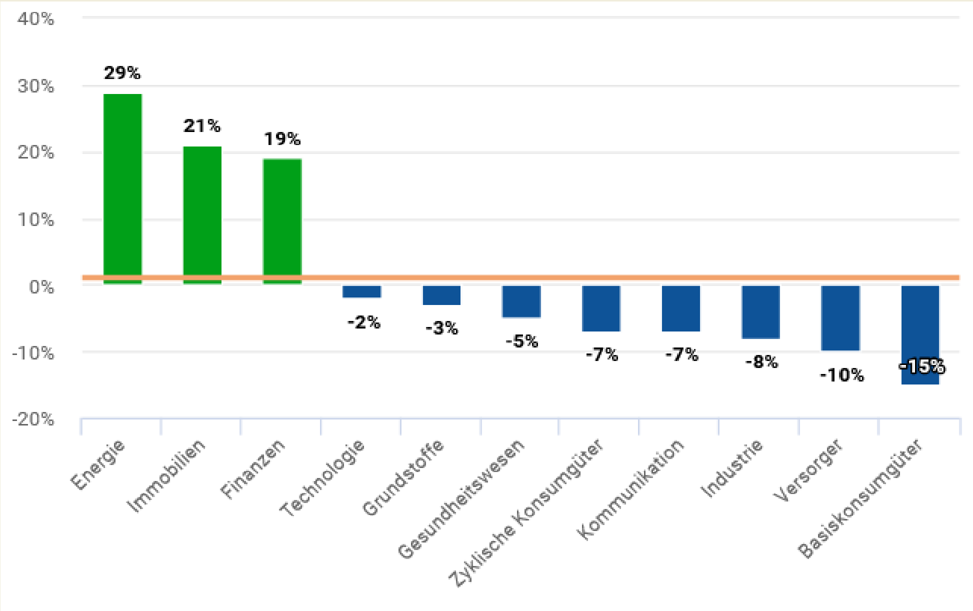
Figure 7: Relative attractiveness based on the multifactor approach (March 2023)



Source: LeanVal Research

The absolute rating highlights the energy and financial sectors. The real estate sector is at the top due to the fall in prices and the consequent impact on the implied valuation. On the other hand, the valuation in consumer staples is negative.

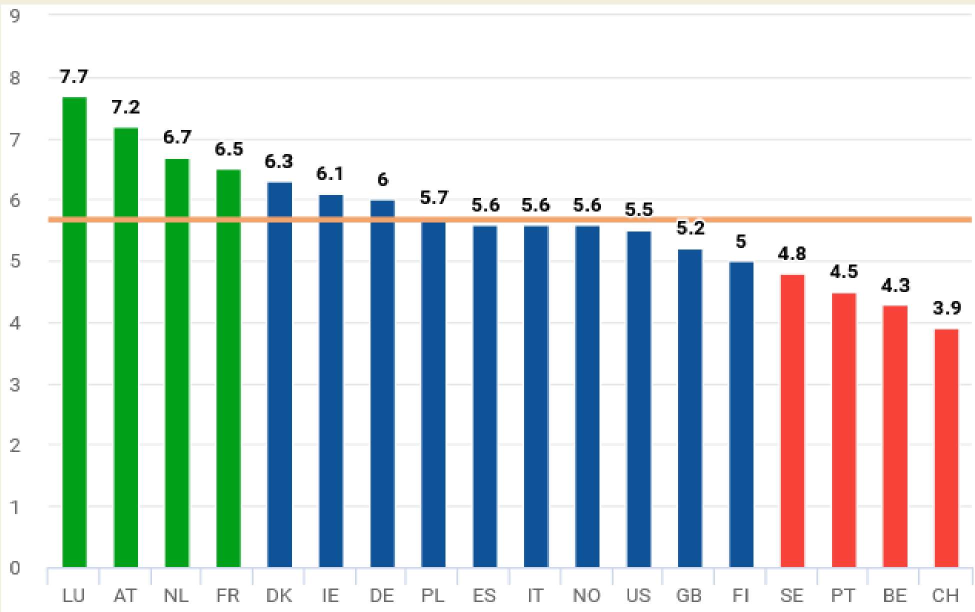
Figure 8: Absolute attractiveness based on the multifactor approach (October 2022)



Source: LeanVal Research

Geographically, some clues can be found among European countries. On a relative valuation, Luxembourg, Austria, Netherlands and France are the most attractive. Most countries are close to the average. At the bottom of the list are Switzerland and Belgium.

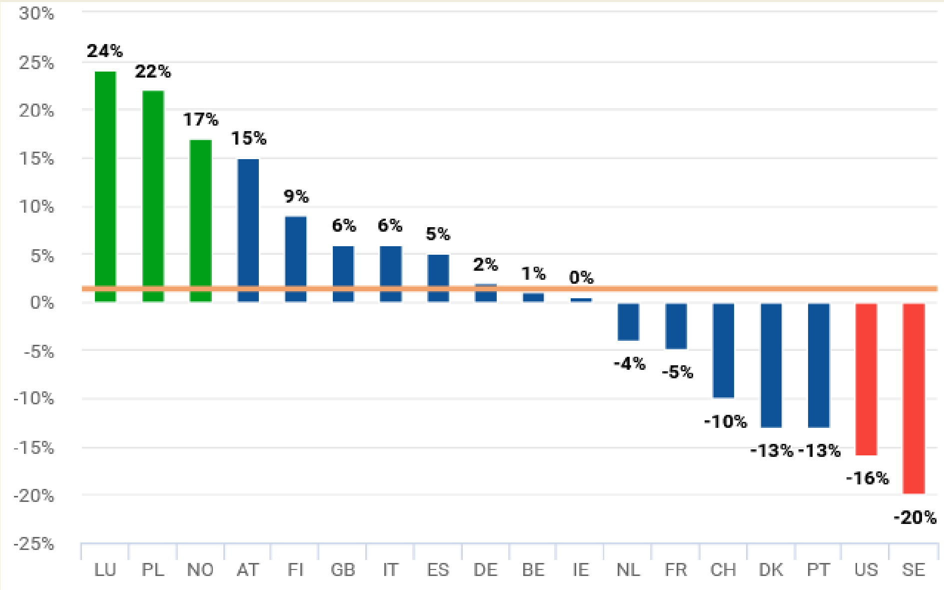
Figure 9: Relative attractiveness of countries (October 2022)



Source: LeanVal Research

In absolute terms, Luxembourg, Poland and Norway are among the most attractive countries. About eight countries have a below-average rating. Sweden and the United States of America appear less attractive.

Figure 10: Absolute attractiveness of countries (October 2022)



Source: LeanVal Research

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Rating system of the absolute valuation:	
Buy	Potential > +15%
Hold	Low upside and downside potential
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