New approach for the business location Germany

Germany is on the verge of recession

Dr. Michael Heise on Global Economics

July 2022

Germany is on the verge of recession. Consumers' purchasing power is suffering from the surge in inflation triggered by the rise in energy and food prices, which has now spread to many other groups of goods. As long as the Ukraine war and the sanctions against Russia continue, and unfortunately there is no end in sight, the energy markets will remain tense.

Germany particularly affected by energy price increases and supply problems

As an industry-intensive and open economy, Germany is even more affected than many other OECD countries by soaring energy and raw material costs and global supply bottlenecks. Following the mini-growth in the first quarter, gross domestic product is unlikely to increase much over the rest of the year, rising by an annual average of only around 1%, while in the EMU just under 2% seems realistic.

The massive rise in energy prices is impacting both companies and private households. At the consumer level, energy has become 35 - 40% more expensive in recent months than in the previous year, and further increases in gas and electricity bills are to be expected due to the delay in price adjustments in many contracts. As a cost factor in production, rising energy costs have also made many other goods significantly more expensive.

The development has social and political risks. If energy bills can no longer be paid or homes cannot be heated reasonably, politicians will come under considerable pressure. So far, the high energy prices as a result of the war in Ukraine and the sanctions against Russia have probably been accepted by many people, as the sanctions weaken the Russian economy in the long term and make it more difficult to finance the war. In fact, however, they have not produced a turnaround or a concession in Russian policy. Russia has benefited from huge price increases for energy resources and has arguably already posted record export revenues and foreign trade surpluses in the first half of the year.

At the same time, Germany's trade surplus has largely disappeared due to an import price increase of around 30% in the summer months. As Putin is using supply cuts for gas as a means of increasing pressure, reduced prices are not to be expected for the time being.

For German policymakers, this means that further relief programs will be introduced to cushion the impact on private households and the companies affected. As a result, the national debt will continue to rise, which will entail higher interest burdens for the state and make future generations pay the costs of the war.

Long-term risks for Germany as a business location

In addition to the economic effects, questions also arise regarding the longer-term business model of German companies. Energy prices are already extraordinarily high by international standards; in terms of electricity prices, Germany is at the top of the list of European countries for both industrial consumers and private households.

The refinancing of the EEG levy through tax revenue has brought about a one-time reduction in the price of electricity, but will not change the rising trend. And gas prices in Germany and other European countries are many times higher than in the US. There are therefore plenty of reasons for energy-intensive companies to reconsider Germany as a business location.

For many decades, Germany has been able to impress with other locational advantages, such as a first-class infrastructure, efficient administration, a technological edge and a very good education system. However, this image no longer corresponds to today's reality. The once highly praised infrastructure has lost some of its quality and can be described as dilapidated in many areas. The investment backlog in rail, roads, digitization and education is widely known, and it is not just for financial reasons.

Technological innovations are taking place in many cases in this country, but they are not being turned into large-scale economic successes. Qualified workers are in short supply. Germany is also not very attractive in view of its above-average tax and contribution burden in an EU or OECD comparison. Despite full employment, social security contributions have again reached 40 percent of employees' gross income. These burdens will continue to rise as the population declines and society ages. In this environment, it is not surprising that private investment in equipment in Germany has been declining significantly in relation to gross domestic product for years and that productivity progress leaves much to be desired.

The transformation needs a solid economic basis

The German economy is therefore by no means starting from pole position, but rather from one of the back places in the upcoming transformation of the economy into a green and digital future. To manage this transformation without major losses in prosperity, it is clear that far greater private investment in highly productive jobs and in efficient, climate-friendly technologies will be needed. Economic policy is responsible for ensuring that the framework conditions for such investment and innovation are right.

Additional investment by the state in physical infrastructure and in the education system are important steps, but they are more likely to be effective in the long term. To overcome the current stagnation and make rapid progress, it would be better to think of measures that help overcome the current supply-side problems. For example, the acute shortage of skilled workers could be alleviated by offering more flexible employment opportunities in terms of working hours or temporary work, and by making it easier to recruit foreign workers.

Short-time work regulations should also be phased out. Faster approval procedures and less bureaucracy could reduce obstacles to investment, as is being done with renewable energy projects. Tax relief is needed to compensate for purely inflation-related additional tax burdens on companies and private households. The "super depreciation" for climate and digitization projects, which has not yet been implemented, would also provide a clear investment incentive.

Major risks for Germany as a business location currently arise from the energy crisis. The German government is currently planning to end gas-fired power generation (13% of electricity production), shut down the remaining nuclear power plants (6%) and compensate for the shortfall by temporarily increasing electricity production through coal and by saving on electricity consumption.

This policy is based on the idea that Germany has a problem mainly with gas (and heat), but not with electricity. In a situation where there is an acute shortage of electricity in large parts of Europe, shutting down nuclear power plants and not commissioning those that still exist is hardly understandable. Renewable energies will hardly be able to compensate in the short term, and considerable logistical problems will have to be overcome with coal, which is not very environmentally friendly.

In the medium term, an enormous increase in electricity demand is to be expected if the advance of e-mobility and heat pumps is to succeed and if industry - also politically desired - becomes increasingly electrified. The general reference to renewables will be of little use if the missing distribution capacities and electricity storage facilities are not quickly built up.

If a short-sighted policy is pursued in these central energy policy issues, Germany will suffer considerable damage as a business location.

Conclusion

It is understandable that the Ukraine crisis has taken up all the government's attention in recent months. However, the economic impact of this crisis makes it increasingly urgent to improve Germany's location and competitive conditions again. Germany needs a strong economic base to manage the green and digital transformation in a socially just manner. A holistic approach to economic policy is needed in which unavoidable or politically desired additional burdens on companies, employees and the self-employed are offset or, even better, overcompensated for by effective relief elsewhere. Unfortunately, this view has been somewhat lost in recent years.

Disclaimer

LeanVal
RESEARCH

Notes on investment strategy - investment recommendation pursuant to Section 85 of the German Securities Trading Act (WpHG) in conjunction with the German Securities Trading Act (WpHG). VO (EU) No. 596/2014

General

The investment strategy and/or investment recommendations (hereinafter referred to as "analyses") are prepared by LeanVal Research GmbH for information purposes only.

Neither LeanVal Research GmbH nor its employees assume any liability for damages arising from the use of the analyses or their contents or in any other way in connection with them. The analyses do not constitute an offer or invitation to subscribe to or purchase any security, nor do they or the information contained therein form the basis for any contractual or other obligation of any kind. An investment decision should be made on the basis of a duly approved prospectus or information memorandum and in no case on the basis of the analyses. Investors should seek the advice of an investment adviser in making their investment decision. In this respect, the analyses cannot assume an advisory function. The opinions, estimates and forecasts contained in the analyses are solely those of the respective authors. They are date-related, not necessarily the opinion of LeanVal Re-search GmbH and may change at any time without prior notice.

The information and evaluations ("Information") reproduced here are primarily intended for clients of LeanVal Research GmbH in Germany. Should the original recipient forward the analysis, he/she is obliged to do so in compliance with existing regulations and laws and no obligation of LeanVal Research GmbH towards a third party arises from this. In particular, the information is not intended for clients or other persons domiciled or resident in the United Kingdom, the United States or Canada and may not be passed on to such persons or imported into or distributed in these countries. Distribution of the Analytics in other jurisdictions may be restricted by law and persons into whose possession the Analytics come should inform themselves about and comply with any restrictions. Any failure to comply with these restrictions may constitute a violation of applicable securities laws. Reprinting, redistribution, and publication of the analyses and their contents in whole or in part are permitted only with the prior written consent of LeanVal Research GmbH.

Information sources

All analyses are prepared on the basis of data from a data provider as well as from generally acces-sible sources ("information") that LeanVal Research GmbH considers to be reliable. However, Lean-Val Research GmbH has not verified the accuracy or completeness of the Information and assumes no liability for the accuracy or completeness of the Information. Possible incomplete or incorrect information does not justify any liability of LeanVal Research GmbH for damages of any kind, and LeanVal Research GmbH is not liable for indirect and/or direct damages and/or consequential damages. In particular, LeanVal Research GmbH assumes no liability for statements, plans or other details contained in these analyses with regard to the investigated companies. Although the anal-yses are compiled with all due care, errors or incompleteness cannot be excluded. LeanVal Research GmbH, its shareholders, corporate bodies and employees assume no liability for the accuracy or completeness of the statements, assessments, recommendations derived from the information contained in the analyses. Data source for all historical prices is Morningstar and LeanVal Research.

Summary of the valuation fundamentals

The valuations underlying the investment recommendations for stocks analyzed by LeanVal Re-search GmbH are based on generally accepted and widely used methods of fundamental analysis, such as the DCF model, peer group comparisons, NAV valuations and - where possible - a sum-of-the-parts model. The calculated scores (Value, Quality, Stabilty, Growth) are the result of a proprietary model of LeanVal Research GmbH. They result from the comparison of fundamental key figures of the quantitatively analyzed company in relation to comparable companies within a sector (or region). Information on the general approach can be found at www.leanval.investments. The abso-lute target price and the associated absolute assessment (undervalued, neutrally overvalued) are determined using a forward-looking DCF or ROIC (return on invested capital) method. Estimates of future earnings serve as the basis for this. The earnings estimates are either based on a consensus or are made by LeanVal Research GmbH itself.

Updates

The recipients are not entitled to the publication of updated analyses. LeanVal Research GmbH reserves the right to update analyses without prior notice. A regular update of this document is not intended.

Compliance

LeanVal Research GmbH has taken internal organizational and regulatory precautions to avoid conflicts of interest in the preparation and dissemination of financial analyses. In particular, there are internal information barriers that prevent analysts from accessing insider information. Compliance is monitored by the Compliance Officer.

Explanation of the recommendation system

The relative assessment is based on the various scores of the individual companies in the areas of Value, Quality, Stability, Growth and Momentum which are compared with the average scores of the overall market and/or also with the respective sectors. The companies are ranked on a scale from 0 to 100. From this, the three ratings "unattractive" (0 to 30 on the scale), "neutral" (31 to 70 on the scale) and "attractive" (71 to 100 on the scale) are derived. The relative assessment can change at short notice due to the high complexity of the scores and the multiple interdependencies between the companies analyzed.

LeanVal Research GmbH's rating system for absolute valuation comprises the ratings "undervalued", "fairly valued" and "overvalued". The rating of a share is based on the expected return for the next six to twelve months. The expected return is composed of the prog-nostic change in the share price and the expected dividend yield. Changes in the discount factor or projected cash flows can lead to significant changes in the target price.

Rating system of the absolute valuation	
Buy	Potential > +15%
Hold	Low upside and downside potential
Sell	Potenzial < - 15%

Conflicts of interest

In the financial analyses, circumstances or relationships that could give rise to conflicts of interest because they could jeopardize the impartiality - of the employees of LeanVal Research GmbH who prepared the analysis, - of LeanVal Research GmbH as the company responsible for the preparation or of companies affiliated with it, or - of other persons or companies working for LeanVal Research GmbH and contributing to the preparation, must be disclosed. Information on interests or conflicts of interest that must be disclosed exists in particular if

1. significant shareholdings (= shareholding > 5 % of the share capital) exist between the above-mentioned persons or companies and the issuers who are themselves or whose financial instru-ments are the subject of the financial analysis,

2. the above-mentioned persons or companies manage financial instruments which themselves or their issuers are the subject of the financial analysis on a market by placing buy or sell orders (market mak-ing/designated sponsoring),

3. the above-mentioned persons or companies have been involved in the management of a consorti-um for an issue by way of a public offering of such financial instruments which are themselves or whose issuers are the subject of the financial analysis within the previous twelve months,

4. the above-mentioned persons or companies have been bound by an agreement on services in connection with investment banking transactions with issuers who are themselves or whose finan-cial instruments are the subject of the financial analysis within the previous twelve months or have received a service or a promise of service from such an agreement within this period, insofar as no confidential business information is affected by the disclosure of this information,

5. the above-mentioned persons or companies have entered into an agreement with issuers, who themselves or whose financial instruments are the subject of the financial analysis, for the prepara-tion of the financial analysis,

6. the above-mentioned persons hold management or supervisory board mandates with issuers whose financial instruments are the subject of the financial analysis, or

7. the above-mentioned persons or companies have any other significant financial interests in relation to the issuers whose financial instruments are the subject of the financial analysis.

LeanVal Research GmbH
Bleichstraße 52

60313 Frankfurt am Main
Telefon: +49 69 9494 88 050
E-Mail: research@leanval.investments