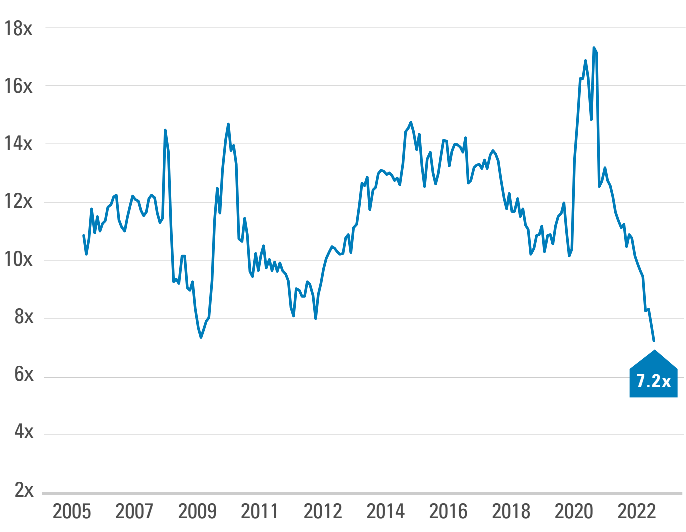
European equities are trading near a 20-year low, driven by macro and geopolitical concerns. We are finding significant opportunity in well positioned, financially sound businesses, that should have the wherewithal to navigate a possible recession.

The sharp year-to-date drawdown in global markets has created an opportunity that value investors patiently wait for: the chance to buy great businesses selling at prices well below their intrinsic values. While we see a broad array of opportunities across various geographies, Europe stands out as particularly attractive, trading at near 20-year lows.

A multitude of concerns ranging from high inflation, rising interest rates, and fears of a consequential recession have moved global stock markets into bear territory. Europe has been the hardest hit region, as it is highly exposed to soaring energy costs precipitated by Russia's invasion of Ukraine. While these concerns are valid, as disciplined value investors, we see the sell-off as an opportunity to find attractive investment opportunities in great companies that have been indiscriminately sold off along with the rest of the market. Generally, they are global businesses with strong balance sheets and franchises that should help them weather the storm and potentially emerge stronger from any potential downturn. Given this backdrop, it is not surprising that we have been adding to our European exposure across our portfolios, at the cheapest levels we have seen since the Global Financial Crisis
(Exhibit 1).

Exhibit 1: MSCI Europe Value Forward Price/Earnings Ratio



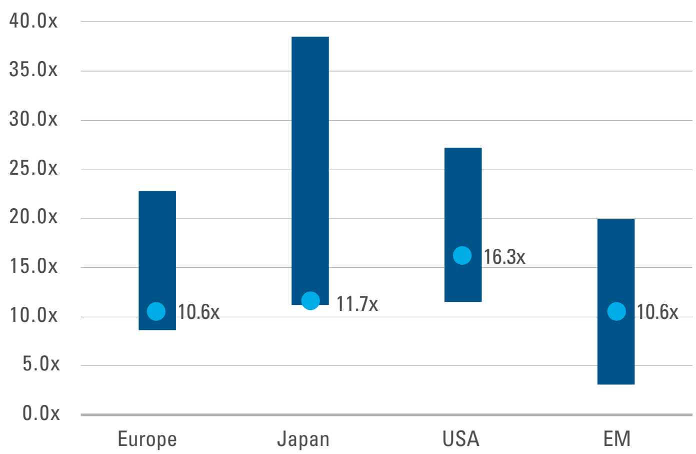
Source: Bloomberg, Pzena analysis
Monthly Bloomberg consensus FY1 (current fiscal year) P/E estimate data from April 30, 2005 – September 30, 2022.

EUROPE ALREADY DISCOUNTING A RECESSION

While Europe has led the sell-off in global equities, European corporate operating performance has held up with margins expanding by 45 basis points since the first quarter of this year[1]. Therefore, the sell-off has been almost entirely based on sentiment, as Europe's PE multiple has contracted by 33% since the start of the year[2], implying that a damaging recession is a foregone conclusion.

If Europe manages to avoid a long and severe economic downturn, value stocks appear generationally cheap, at their lowest level since the Global Financial Crisis (GFC). We find this rather remarkable considering the macroeconomic backdrop does not appear to be remotely as severe as the GFC and company balance sheets are in far better shape. While the EU may very well enter a recession (or already be in one), we believe much of the pain is likely priced in. Therefore, we believe this valuation reflects an overly pessimistic and fearful sentiment surrounding European stocks, creating the ideal environment to selectively buy shares of excellent companies trading at highly discounted valuations.

Exhibit 2 – Europe Approaching Historic Low Price/Earnings
Historical Forward P/E Ranges by Region



Source: Bloomberg, Pzena analysis
Chart based on MSCI Europe Index, MSCI Japan Index, MSCI USA Index, and MSCI EM Index. Monthly consensus FY1 (current fiscal year) P/E estimate data from June 30, 2005 – September 30, 2022.
Blue dots = FY1 P/E ratios as of September 30, 2022.

1. Bloomberg; Pzena analysis of MSCI Europe TTM op. margins
2. Bloomberg; MSCI Europe, forward price-to-earnings ratios normalized as of 12/31/2021 (Bloomberg Consensus P/E)

SELECTIVITY TO DEAL WITH MACROECONOMIC RISKS

Invariably, stock selection is crucial in the face of economic uncertainty. Investing in market leaders that have the capability and wherewithal to adjust their operations and pass through higher input costs is especially important in high inflation periods. Equally important is a balance sheet strong enough to withstand a potential downturn in the business.

In addition, many of the European companies we own in our portfolios are global businesses generating sales around the world, and their European domiciles are what is largely hurting their valuations. Their geographically diversified revenue streams leave them less exposed to Europe-specific headwinds (Exhibit 3). Additionally, with globally diverse sales they should see a benefit from a weak Euro relative to US competitors.

Exhibit 3: Percentage of Sales Generated Outside of Europe

Standard Chartered	93
Nokia	70
Shell	70
Michelin	62
HSBC Holdings	65
UBS Group	63
Rexel	44

Source: FactSet Revere (GeoRev). Data is as of December 2021

Below are some European-domiciled companies we own broadly in our European, International, and Global portfolios, which we believe fit these profiles.

COMPANY-SPECIFIC COMMENTS[3]

Michelin is a leading global manufacturer of tires for the premium car and off-highway segments. Michelin, similar to virtually all European manufacturers, has been incurring elevated raw materials and manufacturing/logistics costs in recent quarters; however, the company has been able to pass through price increases to mitigate the impact on the bottom line. In the first half of 2022, revenue grew 19% but volumes were down 2%, mostly driven by the company's ability to raise prices. Ultimately, we expect costs to normalize, while sales rebound with volumes, leading to positive operating leverage. In the longer term, Michelin is poised to benefit from the shift to electric vehicles, which require premium tires and advanced technical capabilities due to extra performance demands. We believe the stock is one of the portfolio's most attractive investments, trading at just 6.3x our normal earnings estimate. See our 1Q21 Highlighted Holding (https://www.pzena.com/wp-content/uploads/2022/10/PzenaNewsletter-Highlighted-Holding-1Q21.pdf) for a more detailed discussion.

Shell is an integrated energy giant with both upstream and downstream operations. After years of targeted investments, the company is a leading global player in the liquified natural gas (LNG) value chain. Given the prevailing environment, Shell and its peers have been generating record profits; however, its shares have been stuck in a range due to the same macro concerns impacting most companies with sizable European exposure. We believe the market underestimates Shell's ability to earn adequate returns through the impending energy transition. The company's multi-year investments in LNG, coupled with its longer-term ambition to be net-zero by 2050, map out a path for the transition that is reasonable and economically sound. Traditional hydrocarbon fuels are undoubtedly going to remain a vital energy source for years to come as the world ultimately transitions to greener fuels, and Shell's legacy upstream business has been generating record cash flow (forward FCF yield north of 20%[4]), which management has been using to reduce debt and buy back shares. At ~8x our normal earnings estimate and a forward price-to-earnings ratio under 4.5x — the lowest on record — Shell trades at a significant discount relative to US peers Exxon and Chevron, and we believe the company is well-positioned to capitalize on the clean energy revolution.

Nokia is the third largest global manufacturer of wireless telecom networking equipment. The company has been successfully executing on its turnaround strategy, closing the 5G competition gap, as it seeks to take market share from Huawei and Ericsson. Explicit bans or fears of using Chinese 5G equipment (Huawei and ZTE) have given Nokia an opportunity to catch up and should present it with some natural market share gains — particularly in Europe, where Nokia believes Huawei will shed its dominant market share. Nokia's balance sheet remains in excellent shape with a net cash position

3. All forward estimates from Bloomberg, FactSet, Pzena as of 9/30/2022
4. FactSet; FCF Yield – FY1

equal to ~15% of its market cap[5], and trades at 7.6x our normal earnings estimate.

Rexel is a France-based global distributor of electrical equipment and supplies to contractors, and a provider of services for automation and energy management. As a distributor, Rexel's cash flow profile is countercyclical, which benefited the company during the COVID-19-induced sales decline. The current inflationary environment has also been a net positive for Rexel, benefiting from the price increases that their suppliers have been instituting. The company recently posted record earnings, beating consensus estimates by 20% on the bottom line — a testament to its pricing power and strong competitive positioning. With Rexel's operations performing excellently, we believe investors are overly fixated on a particularly dire macro forecast instead of on the company's value-proposition, resulting in a valuation of just 6.2x our estimate of normal earnings, and a record low forward EV/EBITDA of 5.2x.

We find European banks particularly compelling, trading at just 6x forward earnings — the lowest level since the GFC and a 42% discount to the broad index[6]. This is despite lenders enjoying positive net interest income momentum on the back of ECB rate hikes. The material valuation discount stems from fears of a rise in defaults should Europe enter a severe recession. Our bank holdings are very well capitalized currently (average of 14.4% CET-1 ratios — well in excess of their regulatory minimums and managements' targets)[7], while credit has actually improved, as observed by a decline in non-performing loans since the start of the year[8]. These stocks are trading at roughly 85% of their tangible book values[9], reflecting the extreme macro pessimism.

One specific example is ING Groep, the diversified pan-European bank with leading franchises in Belgium and the Netherlands. Similar to peers, ING has been outperforming expectations on higher net interest income and lower credit costs—a function of rising interest rates and growth in performing loans. The stock, nonetheless, traded down due to its Russian business, European revenue concentration, as well as broader macro fears. We view ING's Russia-related exposure, which the Group reduced by nearly 35% to EUR 4.5bn (< 1% of the loan book) since the start of the war, as manageable and believe ING's large excess capital position (20–25% of market cap) should afford it the flexibility to navigate a European downturn and continue to return capital to shareholders.[10] Trading at just 5.2x our normal earnings estimate and ~66% of tangible book value, we believe a significant amount of pain is already priced in.

See our Highlighted Holding, Randstad as well.

CONCLUSION

Trading at near 20-year lows, Europe is one of the most attractively valued regions in our Global Universe. Like any cheap assets, European stocks do not lack for controversy. However, we believe the stocks are trading at valuations that more than discount the uncertain macroeconomic backdrop, and risk mitigation could come by way of careful stock selection.

5. Company filings
6. MSCI Europe Banks Index vs. MSCI Europe Index NTM P/E as of 9/30/2022
7. Bloomberg; Pzena analysis of CET1 ratios (Tier 1 common equity) as of 6/30/2022
8. Bloomberg; Pzena analysis of NPL ratios (Non-performing loans / total assets) between 6/30/2022 and 12/31/2021
9. FactSet, Pzena Analysis (simple averages)
10. Company filings

FURTHER INFORMATION

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