Finding the upside potential in European equities

An improving economy and strengthening business sentiment in the eurozone are helping to shape better prospects for companies in the region with the cash and the right management to take things forward, believes William Hamlyn, Senior Investment Analyst, European & EAFE Equities at Manulife Asset Management.

With tentative signs of strengthening economic conditions across most of the eurozone and in an environment of very low interest rates, we believe there are a number of interesting investment opportunities within mid and large cap European equities often overlooked amid the noise created by the ongoing situation in Greece.

In our view, the news that the eurozone PMI[1] (Purchasing Managers' Index) is near a four-year high is revealing for one key reason: July's PMI was collected a week after the 5 July Greek referendum and began on the day that Greece and its creditors struck an agreement on a third bailout. While how the eurozone crisis evolves and resolves itself is important, it may be the case that, for now at least, the fortunes of the economy and overall sentiment will improve regardless of Greece's woes.

The current market environment does mean we are spending a great deal of time looking for high-quality companies that are capable of performing despite the economic circumstances. In this regard, we see upside potential in companies with steady cashflows, positive earnings and that are still trading at attractive levels with growth opportunities and strong corporate governance.

Healthcare

Across Europe, the healthcare sector features a number of positive traits which can lend themselves to attractive opportunities today. For example, we have seen more innovation and this has been aligned with greater levels of research and development productivity which has meant more new drugs coming to market recently. Many European healthcare companies are cash-generating and provide a good level of dividend yield for investors relative to the region's bond yields. Another contributing factor is that many healthcare companies have come through their "patent cliff" (when firms, particularly pharmaceuticals, can endure a sharp decline in revenues upon patent expiry of one or more leading products) unscathed.

Telecoms

Europe's telecoms have had a challenging few years largely because of a more stringent regulatory regime (cuts to roaming and termination rates and tight competition rules) coupled with an under-pressure business model based around legacy telephone networks. However the shift towards a digital market and a renewed focus on investment and consolidation by the European Commission (EC) could, we suggest, improve the business climate for many service providers.

Günther Oettinger, the EC chief responsible for initiating legislation on a digital single market in Europe, has also indicated his support for regulatory changes in favour of the industry, recognising that companies as well

[1] Markit Flash Eurozone PMI July 24 2015

as consumers should benefit from the liberalisation of telecoms markets[2]. Companies certainly have more pricing power than previously because of strong consumer demand for broadband services and various add-on products.

Telecoms companies are once again generating cash and returning to shareholders as their growing profitability comes on the back of increasing fees across a range of different products and services and we continue to see potential opportunities for a number of participants.

Financials

Our investment view is more nuanced when it comes to European financials. While we remain cautious on many peripheral European banks because of an uncertain Greece situation and underwhelming economic growth, there are some European banks about which we are more positive.

UK banks, for example, continue to report strong underlying profits on their core businesses and are also paying out dividends to investors at a greater rate than before the financial crisis. They generally have good levels of capital reserves and are also benefitting from a stronger economic story.

Turning to mainland Europe and perhaps not as compelling as the UK banking sector, we nevertheless believe Italian banks merit consideration as they continue to streamline their costs while looking to add new earning streams through offering asset management products such as mutual funds. They also tend to have superior capital bases compared to many other peripheral European names and this is against a backdrop of a steadily improving domestic economy (Italy's GDP is forecast to grow 0.7% in 2015 and 1.2% in 2016[3]).

Income from lending has stabilised and, though credit remains weak, the trend of Italian banks beginning to offer asset management services could generate growing fees, especially as more Italians are investing in mutual funds and other savings products. Northern Italy is more prosperous than many parts of non-peripheral Europe, while significant wealth pockets have clustered around cities like Milan, Turin and Parma, helping support demand for banking services. In light of this, we see attractive opportunities for banks to increase their already high dividend payments in the future.

Within financials, insurance is an industry where it pays to be very selective at a stock and country level. For example, we are mindful of potential headwinds for German life companies because of their exposure to prevailing low interest rates. Historically these companies have provided high guarantees to policyholders and though many are looking to counter losses by promoting new products with lower guarantees, the impact of new business could be slow to materialise. This may limit the ability of larger listed companies in this sector to return capital to shareholders over time.

By contrast, we see select opportunities in UK-based insurers that have plans to expand overseas. We like the emphasis of some underwriters, for example, on investing in those markets where the traditional insurer-broker models are beginning to fragment, such as France and Italy, and where direct distribution models and/or online comparison sites have yet to take hold. Having said that, barriers to entry into these markets remain relatively high so actively seeking out well-managed, well-resourced quality insurers which generate cash and pay out dividends has the potential to continue to deliver returns for equity investors.

Summary

Against a backdrop of an improving economy and with interest rates set to be low for a long time, we believe we will continue to see plenty of attractive investment ideas centred on well-run companies with strong balance sheets and decent valuations.

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[2] http://www.ft.com/intl/cms/s/0/12c80f3e-5939-11e4-9546-00144feab7de.html
[3] IMF World Economic Outlook July 2015