EUROPE EX-UK VALUE UPDATE

PZENA Investment Management

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Among global investors today, there is a growing sense of unease that markets are overvalued, with the MSCI All Country World Index trading at over 18x forward earnings (94th percentile)[1] while global bond yields have been marching higher. As such, the market's equity risk premium is once again disappearing before investors' eyes. The global market, however, has become heavily influenced by an ever-growing U.S. weighting, which itself is a function of a handful of massive—and expensive—U.S. tech companies. Europe, on the other hand, has become somewhat of an epicenter of investor pessimism, resulting in a large and diverse subset of fundamentally strong businesses trading at highly discounted valuations today.

The European Discount

Europe has been contending with a host of macroeconomic headwinds in recent months, none of which are without precedent and all of which have the potential to reverse, or at least improve, over time. These include

- a reduction in trade with China, which is in the midst of its own economic downturn. China is a vital market for European manufacturers; with Chinese consumers under pressure, imports from Europe have declined to €216bn from a high of €233bn in April 2023[2].
- the ongoing war in Ukraine, which is approaching its third year, and associated fears of another energy crisis.
- political turmoil in France and Germany, resulting in fiscal policy uncertainty.
- the threat of renewed U.S. import tariffs from the Trump Administration, which have the potential to further erode European exporters' revenue streams.
- anemic economic growth against a backdrop of lingering inflation and high fiscal deficits, particularly in France. Combined with a selloff in U.S. treasuries, which European sovereign debt tends to mirror, this has prompted a rise in long-term bond yields and raised borrowing costs for businesses and governments across the region.

Macro Fears Breed Opportunity in Specific Stock Selection

Each of the above-mentioned headwinds could have real financial implications for European-domiciled businesses if they persist or worsen. But given the MSCI Europe ex UK Index's 14.4x forward multiple[3], investors have already priced in much of the negativity.

More importantly, we stress that macroeconomic direction and corporate earnings—which stock prices track over time—are not inextricably linked (Exhibit 1). Individual businesses are exposed to a variety of factors outside of basic economic growth, and our investment process is designed to uncover companies that are temporarily under-earning for largely idiosyncratic reasons. Thus, we view individual stocks that have sold off because of country-specific macro fears as potentially exploitable value opportunities. A prime example of this is our collective French exposure, which consists of eight multinationals (Exhibit 2) that generate about 66% of their revenue, on average, outside of the EU. Despite doing much of their business outside France, their shares declined 8.6% on average from early June 2024 when France's political and fiscal woes made headlines following EU parliamentary elections[4], underperforming the broader MSCI Europe Index, which was up roughly one percent over the same period.

Exhibit 1
Correlation Between Year-Over-Year Nominal GDP Growth and Corporate EPS Growth[5]

Country	Correlation
France	2%
Switzerland	20%
Germany	13%
Netherlands	-13%
Sweden	37%

Source: FactSet, MSCI indices, (table includes five largest countries in MSCI Europe ex UK Index)

Exhibit 2
Pzena Europe ex-UK Portfolio's French Holdings

Company	Portfolio Weight[6]	P/2025E[7]	Non-EU Rev.	Perf. From 6/9/24[8]
Amundi SA	4.1%	9.4	41%	-0.9%
Sanofi	3.5%	12.0	82%	8.7%
Rexel SA	3.3%	10.2	56%	-5.3%
Michelin SA	3.1%	9.5	74%	-12.1%
SEB SA	2.9%	10.0	74%	-17.1%
Teleperformance SE	2.8%	5.2	85%	-16.4%
Arkema SA	2.3%	7.9	67%	-16.8%
TotalEnergies SE	1.3%	7.5	49%	-9.1%

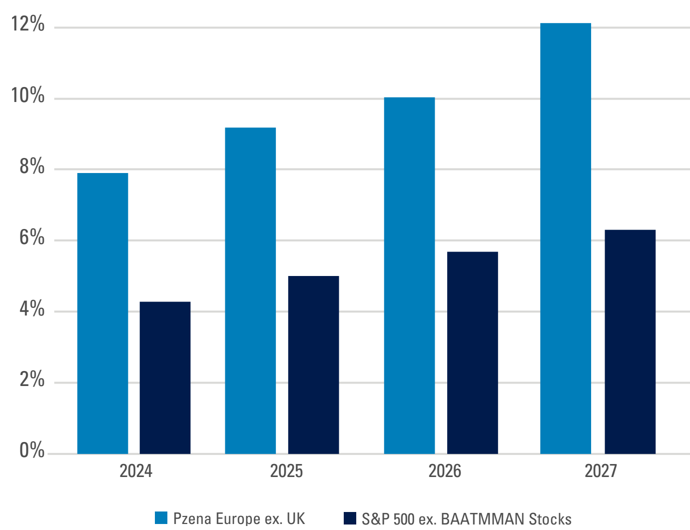
Source: Factset, Pzena analysis, defined as Country of Headquarters

1. FactSet, P/E – NTM, monthly data 12/31/04 – 1/21/25
2. FactSet, China + Hong Kong, TTM as of October 2024
3. FactSet, P/E NTM as of 1/21/25
4. Simple average of total returns in EUR, 6/9/24 – 1/21/25
5. Quarterly data from Dec. 2004-Sept. 2024
6. As of Dec. 31st, 2024
7. FactSet, PE FY1 as of 1/21/25
8. Stock total returns in EUR, 6/9/24 – 1/21/25. For full portfolio performance please see our FactSheet: https://www.pzena.com/americas/institutional-investors/strategies/regional-equities/europe-ex-uk-focused-value/

European Value vs. American Exceptionalism

With the S&P 500 having outpaced Europe in nine of the past 12 years following the Eurozone debt crisis, the choice for asset allocators seems simple enough: keep doing what has been working. It is well known that eight mega-cap U.S. tech companies—and their superb earnings growth—have been largely responsible for the S&P's dominance in recent years; what is perhaps less understood is how the other 492 companies' financials compare to their global counterparts. Interestingly, given their exorbitant valuations and massive capex outlays, the BATMMAAN[9] cohort is only offering investors a 2.6% expected 2025 free cash flow yield today, well below the S&P 500 average[10]. Even if we exclude these eight juggernauts at the top of the S&P, our Europe ex-UK portfolio's average free cash flow yield is roughly double that of the U.S. index (Exhibit 3). A high starting free cash flow yield can provide investors with double-digit returns even assuming modest earnings growth.

Exhibit 3
Expected Free Cash Flow Yields



Source: FactSet, data as of 1/21/25 (only includes companies with estimates available, does not include financial companies)

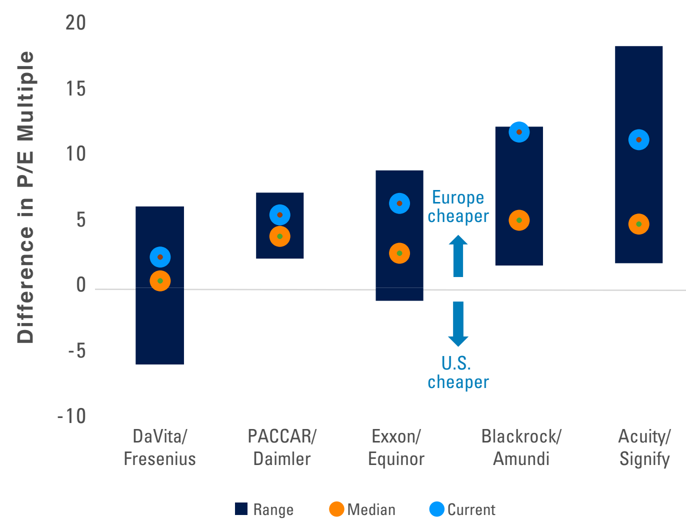
In continental Europe, depressed sentiment and low expectations have resulted in extremely undemanding valuations. Case in point, our Europe ex-UK portfolio is currently trading at a 9.9x forward earnings multiple[11] which, in our view, offers investors an asymmetrical performance outcome that is skewed to the upside.

An Inexpensive, Diverse Set of Businesses

Our Europe ex-UK portfolio is comprised of 34 distinct businesses, each with a European domicile; however, each company has diverse revenue streams and idiosyncratic risks that are not dependent on Europe-specific factors like GDP growth. These companies range from Italian utility Italgas, which is the largest gas distributor in its domestic market and generates all of its revenue within the EU, to French pharmaceutical giant Sanofi, which counts the U.S. as its single largest market. Overall, our portfolio's average non-EU sales exposure is 59%[12].

In our view, this offers investors somewhat of a geographic arbitrage opportunity; meaning, because of extremely depressed sentiment in Europe, we can own strong businesses with global revenue streams that are heavily discounted simply because of where they are headquartered. As illustrated in Exhibit 4, several of our portfolio companies with direct U.S. peers are trading at historically large discounts to those peers.

Exhibit 4
The U.S. Valuation Premium is Larger Than Usual



Source: FactSet, monthly NTM P/E data
**Exxon/Equinor data excludes CY20 due to XOM's large asset write-down that artificially depressed its EPS

Conclusion

Markets have applied an unusually large discount to European-domiciled companies, which we believe presents skewed performance outcomes—particularly for businesses that are not completely reliant on Europe for their long-term profitability. While the world is filled with uncertainty, it is precisely this lack of clarity and consensus that provides opportunities when reflected in valuations.

9. Broadcom, Amazon, Tesla, Microsoft, Meta, Apple, Alphabet, NVIDIA
10. FactSet, simple average of FCF yields as of 1/21/25
11. FactSet, weighted average of P/2025E as of 1/21/25
12. FactSet GeoRev estimates

FURTHER INFORMATION

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The MSCI Europe ex UK Index captures large and mid-cap representation across 14 Developed Markets (DM) countries in Europe. With 336 constituents, the index covers approximately 85% of the free float-adjusted market capitalization across European Developed Markets excluding the UK.

The MSCI Europe Index captures large and mid-cap representation across 15 Developed Markets (DM) countries in Europe*. With 414 constituents, the index covers approximately 85% of the free float-adjusted market capitalization across the European Developed Markets equity universe.

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