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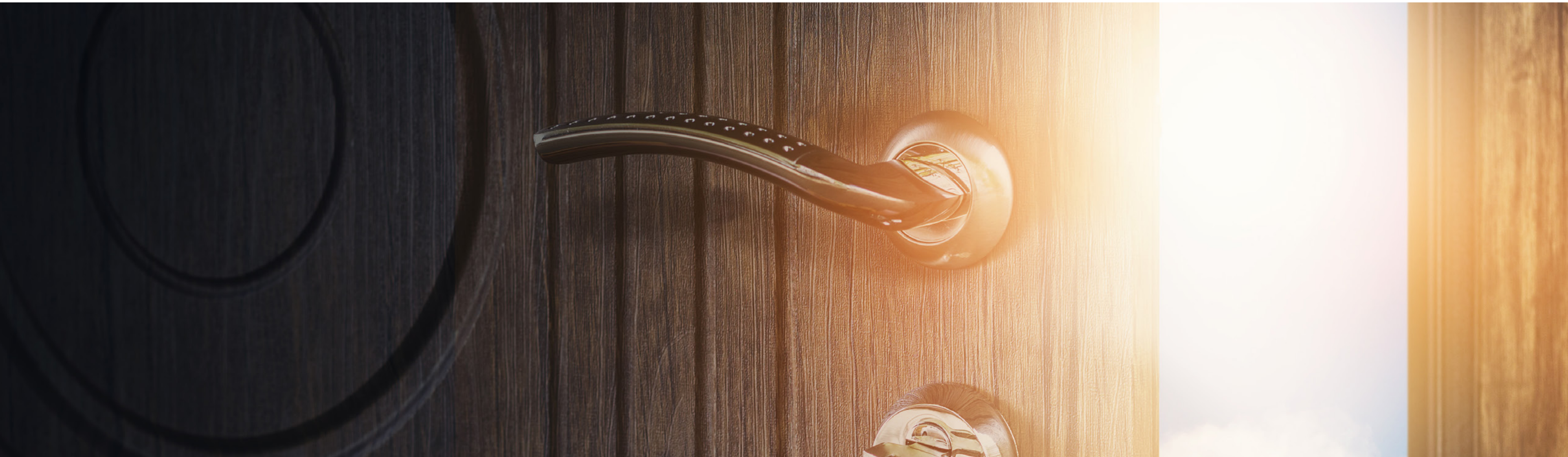

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# Unlocking Shareholder Value in Europe

While European equity markets outpaced much of the developed market competition in 2017, a bout of global volatility in the first half of 2018 dampened their momentum. We expect this sluggishness to be temporary, however. We believe valuations in the region remain attractive given Europe's broadening and accelerating economic recovery and the persistent corporate earnings growth that has accompanied it. Moreover, we see signs that European corporate management teams are beginning to embrace the shareholder-friendly behaviors that have long been commonplace in the U.S., potentially unleashing even greater economic and corporate growth on the Continent and ushering in an extended period of equity market outperformance relative to the U.S.

We believe we are in the early stages of a trend in which European corporate management teams increasingly take actions designed to unlock value on behalf of their investors, having seen evidence most notably in the following areas:

- **Shareholder Activism.** Local and international institutional investors are seeking opportunities to engage constructively with corporate management teams to improve governance and to build long-term shareholder value, a trend supported by encouraging shifts in regulatory policy.
- **Specialization.** A sharper focus on core operations has larger companies shedding ancillary businesses, often to the benefit of both the parent company and the newly independent spinoff, and unwinding cross-shareholdings.
- **Mergers and Acquisitions.** Strategic acquisitions—targeted purchases that complement or enhance existing lines of business—have become a priority, as companies seek to increase value rather than amass assets.

## Shareholder Activism: Agitating for Change

Activist investors typically encourage corporate management teams to take actions they believe will unlock shareholder value, ranging from improvements in operations and capital allocation to the replacement of board members/management and the sale of the company. While these engagements often take the form of private, ongoing dialogs designed to influence positive corporate behaviors, at other times they involve very public proxy battles or tender offers that play out in the headlines of the business press.

Though activist investing is widespread in the U.S.—more than 400 companies on average have been publicly targeted with activist efforts each year since 2013, according to data provider Activist Insight—such engagement has been less prominent in other markets, including Europe, where activism has long been hamstrung by legal and cultural challenges. However, with stock valuations high and the low-hanging fruit seemingly picked over in the crowded U.S. market, many activist investors have turned their sights to the Continent, publicly targeting 135 European companies in 2017, an increase of 165% from 2014 (according to Activist Insight). This list includes Nestlé, which currently is engaged with activist hedge fund Third Point in one of the highest-profile activist campaigns ever waged in Europe. Though Nestlé is the largest consumer goods company in Europe and is widely respected as a top global operator in its industry, Third Point thinks the company can do more. Below we excerpt a letter to Nestlé's management team from Third Point in which the activist investor highlights the levers it believes Nestlé can pull to improve its operating performance:

> *"Third Point invested in Nestlé because we recognized a familiar set of conditions that make it ripe for improvement and change: a conglomerate with unrealized potential for margin improvement and innovation in its core businesses, an unoptimized balance sheet, a number of non-core assets, and a recent history of meaningful under-performance versus peers. It is rare to find a business of Nestlé's quality with so many avenues for improvement."*

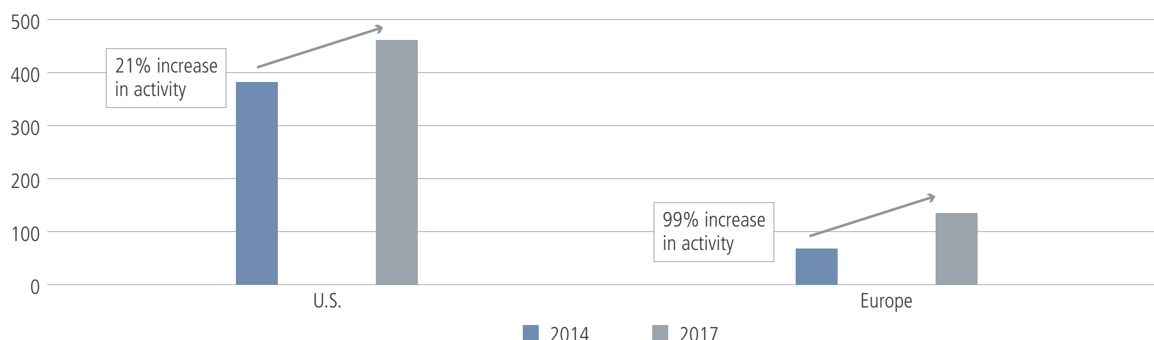
Nestlé is far from an isolated example. Unilever, number two to Nestlé in the consumer goods sector, has had the interest of activists ever since management rebuffed an acquisition attempt by Kraft Heinz in early 2017. Feeling the pressure to act, Unilever soon unveiled several measures intended to improve shareholder returns, including the sale of its low-margin margarine unit, a €5 billion share buyback program, and new and substantially higher profit-margin targets for its business. A number of other large, well-known European companies also are currently in the crosshairs of activist investors, including London-listed miner BHP Billiton, French aircraft engine maker Safran, German auto giant Volkswagen, and German steel and elevator manufacturer ThyssenKrupp.

Meanwhile, the legal impediments to shareholder activism in Europe have begun to ease. For example, in 2017 the European Union revised its Shareholder Rights Directive explicitly to encourage long-term engagement by shareholders and increased corporate transparency; EU member states have until mid-2019 to incorporate these new provisions into their domestic laws. We expect these and other new rules will further embolden investors to interact with their European holdings, potentially unleashing a new wave of shareholder-friendly actions by companies—either in reaction to or in anticipation of being targeted by activists.

The cultural mainstreaming of activist investing in the European mindset may take a bit longer, however. Even in the U.S., the activist investors that rose to prominence in the 1980s were derided as "corporate raiders," pirates in suspenders intent on pillaging helpless corporations for quick personal gain. Of course, the public image of shareholder activism has evolved in recent decades; while high-profile agitators in the '80s mold still exist, activism today is just as likely to be taking place behind the scenes, with traditional investment managers constructively engaging with their portfolio holdings in order to unlock long-term shareholder value.

**FIGURE 1. ACTIVISM IS TRENDING HIGHER, WITH EUROPE EXPERIENCING A SIGNIFICANT INCREASE**

Total Number of Companies Publicly Targeted by Activist Campaigns: 2014 vs. 2017




Source: Advisor Insight, Neuberger Berman. As of December 31, 2017.

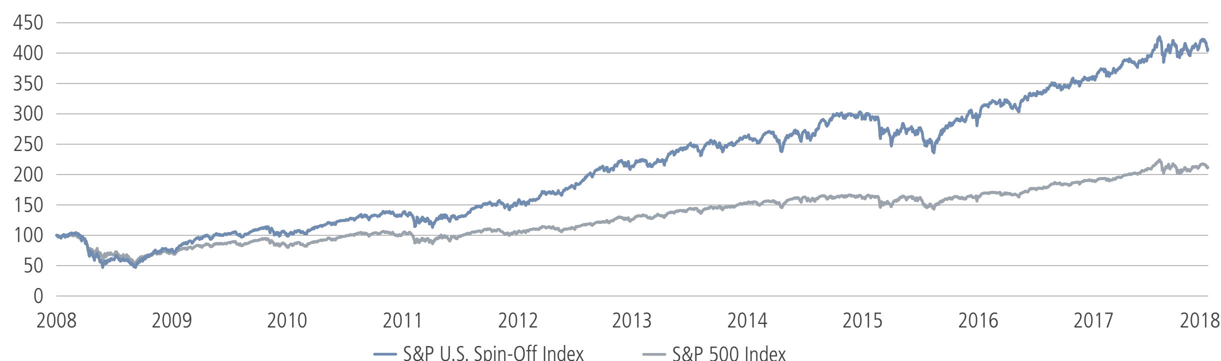
## Specialization: Greater Focus and Greater Value

Diversified companies typically receive a "conglomerate discount" in the financial markets, as they typically include both divisions that are of interest to investors alongside those that are less compelling. The argument for demerging—whereby a company splits into a series of smaller, more focused businesses—is based primarily on its potential to rid investors of this discount. We would also argue that the constituent parts of a demerged business are better able to grow, invest wisely and attract talent, ultimately resulting in divisions that in aggregate are of greater value when separated from the holding company.

Siemens is a high-profile example of a large European conglomerate that over the years has begun breaking itself apart into specialized divisions. The process started back in the early 2000s with the spinoff of its semiconductor business, Infineon Technologies, but has gathered pace in recent years. In 2013 Siemens listed its loss-making lighting division Osram Licht. In 2017 it merged its mobility and rail-traction devices business with that of French railway systems specialist Alstom to form a European rail firm with the scale to compete with increasingly ambitious Chinese competition. Most recently, Siemens sold its hearing aid business to private equity firm EQT and separately listed its medical technology solutions business Siemens Healthineers in a €30 billion IPO in March 2018.

Data from the U.S. show the value that can be generated for shareholders when companies refocus their strategy. The Bloomberg U.S. Spin-Off Index—which tracks the performance of companies that have been spun off from their parent with at least $1 billion in initial market capitalization for their first three years of independence—achieved an annual return of 17% for the 15 years ended December 31, 2017, compared to the 7.7% return of the S&P 500 Index. In 2017 alone there were 19 spinoffs worth about $76 billion in initial market value, driving a total return of 35% for the Spin-Off Index, compared to 21.8% for S&P 500.

**FIGURE 2. THE PERFORMANCE OF SPINOFFS HAS FAR OUTPACED THE BROADER EQUITY MARKET**
June 30, 2008 – June 30, 2018




Source: S&P Global. As of June 30, 2018.

The unwinding of cross-shareholdings—perhaps most familiar in Japan but still more prevalent in Europe than the U.S.—is another way companies can unlock value for shareholders. One current, high-profile example in Europe: Nestlé (Swiss, food and beverage) has a 23% ownership stake in L'Oréal (French, cosmetics), while L'Oréal itself owns almost 10% of Sanofi (French, pharmaceuticals). The cross-shareholding dates back several decades to a time when companies sought out peers to take large passive stakes in order to deter hostile takeover attempts. This structure can be a negative for shareholders in both the investing company and the investee; with less risk of being acquired, management of the investee can be less motivated to maximize value for current shareholders, while the investing company ties up capital in a passive investment unrelated to its core business.

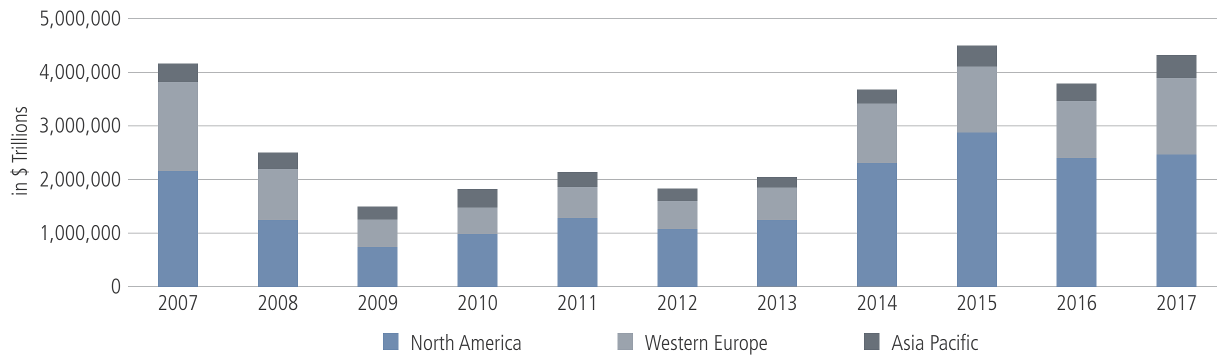
In this case, Nestlé's investment in L'Oréal dates back to 1974 and was bound by an agreement with L'Oréal's founding Bettencourt family. With this agreement having expired in 2017, investors are questioning why the investment still exists; L'Oréal has the balance sheet to repurchase Nestlé's stake—potentially selling its stake in Sanofi to raise some of the funds—while Nestlé could use the proceeds to boost returns via an acquisition or a share buyback. The resulting three companies could then be more focused and motivated to perform, and we believe would receive a higher market valuation as a result of shedding their cross-shareholdings. This sort of improvement can be carried out regardless of economic or business conditions and is a key reason underpinning our optimism on non-U.S. equities.

European companies to date have been much less aggressive than their U.S. counterparts in creating value for shareholders through specialization or simplification and, as with shareholder activism, we believe still have tremendous ground to make up. However, we think the recent increase in these activities is a strong signal for the future.

## Mergers and Acquisitions: Smarter Combinations

At the same time as companies are looking to divest assets or stakes that do not fit in their long-term strategy, many also are looking to add assets that do through mergers and acquisitions. As shown in Figure 3, global M&A volume fell off sharply in the aftermath of the financial crisis but has since rebounded, driven primarily by activity in the U.S. and Asia. But while M&A appears to have plateaued near 2007 levels in these two regions, activity in Europe remains well below its 2007 peak. Europe's share of global volume hit a six-year high in 2017, as its broadening economic recovery inspired a record year for European private equity fundraising and investments, while ongoing improvements in corporate balance sheets and continued low interest rates fostered an environment ripe for M&A deals.

**FIGURE 3. EUROPE'S SHARE OF M&A VOLUME IS AT A SIX-YEAR HIGH**



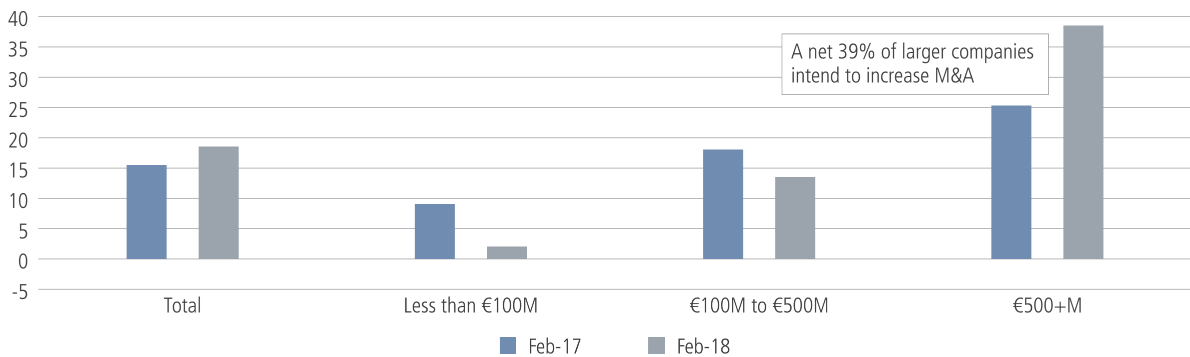

Source: Bloomberg. As of December 31, 2017.

After a record first quarter in which global deal value totaled $1.2 trillion, a 67% year-over-year increase, 2018 is shaping up to be another strong year for M&A. Notably, the data revealed that European M&A deal value doubled in the quarter,[1] outpacing the increase in other markets. This increase in European M&A is driven by several factors, including the opportunity to acquire underperforming targets and generate returns by extracting cost efficiencies, the desire of companies to build scale within their core competency, and the need to make large-scale investments in technology, which can be prohibitively expensive for smaller organizations. This environment may also mean that smaller, subscale companies are the most likely to be involved in M&A deals. Meanwhile, steadily rising interest rates in the U.S. suggest that higher rates in Europe may be inevitable, incenting management teams to consider acquisitions in the near term while low-cost financing is still available.

Not surprisingly, corporate sentiment reflects this enthusiasm, with a recent survey pointing to the sharp increase in European companies intending to acquire over the next 12 months.

**FIGURE 4. LARGER EUROPEAN COMPANIES POISED TO ACCELERATE M&A ACTIVITY**

Net % of Companies Intending to Increase M&A (by Size): Feb 2017 to Feb 2018




Source: UBS Evidence Lab. As of April 2018.

[1] Source: Bloomberg.

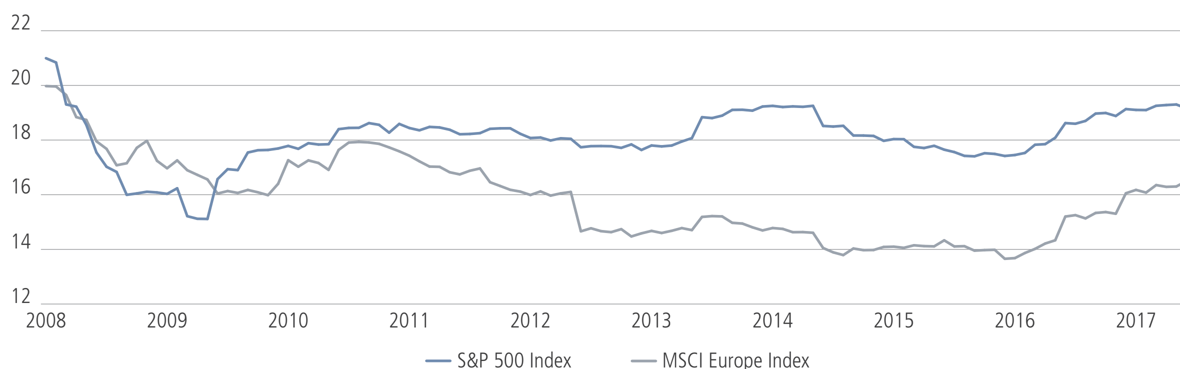
## A Cyclical Advantage for Europe

The U.S. recovered from the 2009 recession much more rapidly than Europe. As a result, the U.S. regained its pre-crisis level of economic activity in the third quarter of 2011, while Europe didn't eclipse its prior high for another four and a half years.[2] Unemployment, too, has been slower to rebound in Europe, standing at 8.5% in the latest reading compared to 3.9% for the U.S.

But the rates of economic growth are converging as the U.S. cycle matures and Europe's gains steam. The euro zone's 2.5% GDP growth in 2017 was its fastest rate in a decade, and outpaced the 2.3% improvement in the U.S. last year. Greater slack in Europe's labor market (limited demand to increase wages) and a stable euro (which is 5% above its level of a year ago) implies fewer inflation concerns and thus little pressure on the European Central Bank to raise interest rates. We are confident, therefore, that European businesses can keep both wage and finance costs under control, which means that corporate profits can compound faster than revenues. This could enable European companies to narrow the profitability gap with their U.S. peers. As shown in Figure 5, U.S. companies recovered their pre-crisis profit margins in 2011, while profitability of European companies continued to slide until 2016.

**FIGURE 5. GAP BETWEEN U.S. AND EUROPEAN PROFIT MARGINS HAS WIDENED POST-CRISIS**

Trailing 12-Month EBITDA Margin, July 2008 – December 2017




Source: Bloomberg. As of December 31, 2017.

As a result, U.S. corporate profits as a share of GDP stand at 9.5%, close to an all-time high and more than 40% higher than the long-term average. However, the combination of wage pressures, higher interest rates and an incrementally stronger dollar could push U.S. profit margins back toward the longer-term average. As a result, growth in U.S. corporate profits could lag that achieved by European businesses even if U.S. economic growth remains strong.

## Conclusion

While investor sentiment toward European equities of late has been buoyed by improving economic indicators and market fundamentals, an ongoing shift in the corporate mindset suggests an outlook that could be even more positive. We expect managements' sharpened focus on shareholder value and the transition toward more focused, resilient businesses may serve as a tailwind for valuations in European stocks, even as the economy recovers and corporate profits rebound. This environment should favor active, flexible investors in European equities able to take advantage of opportunities across the market-cap spectrum.

[2] Source: Bloomberg.

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