European Equity Strategy
How will European margins recover?

Equity Strategy

Europe including UK

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We expect earnings to surprise on the upside in 2016 driven in large by operating leverage and margin expansion. In this report we look at the key drivers of this margin pick-up and some of the key beneficiaries from it.

Driver 1 – labour costs at historical lows could boost margins

Labour cost inflation in Europe has been close to or at historical lows since 2014. This tends to impact margins with a lag of c. 1 year. Even if labour costs start to increase from here, given this lagged effect and the large gap between the movements in labour costs and margins we expect to see the benefits feeding through to corporates in 2016 (Figure 1). This could be especially beneficial for labour intensive sectors; these are largely cyclical sectors such as the Industrials, as well as retail sectors.

Driver 2 – the fiscal drag becomes a fiscal push in 2016

The government response to the crisis has much to do with the low margins seen in Europe today. As the second leg of the crisis hit in 2012 and private investment fell again, government policy was actually pro-cyclical and austerity pushed margins even lower. However, austerity is now fading and in 2016 the fiscal drag gives way to a fiscal push. This should contribute to a recovery in European profit margins.

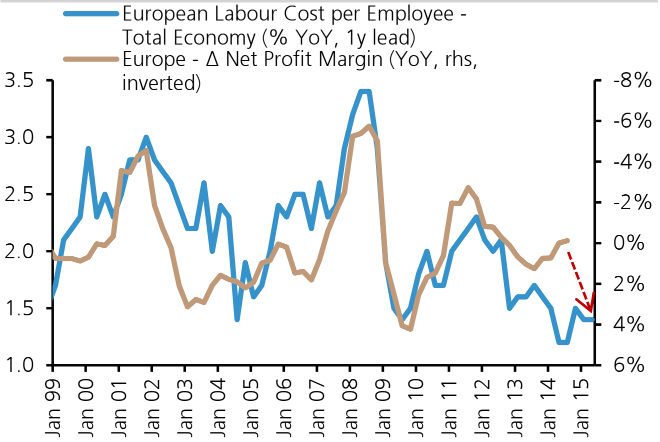
Driver 3 – low producer prices point to margin expansion

The current low inflation for producer prices is also a good lead indicator of margin expansion. While the hit to profits in commodity sectors happens very quickly, the benefits to other sectors tend to come with a lag (due to hedging, accounting timing, etc) and should be felt in 2016. Except for the bottom of the crisis in 2009, the current producer price inflation numbers in Europe are the lowest since the 90s.

On the sector level Construction, Autos, Transport could benefit

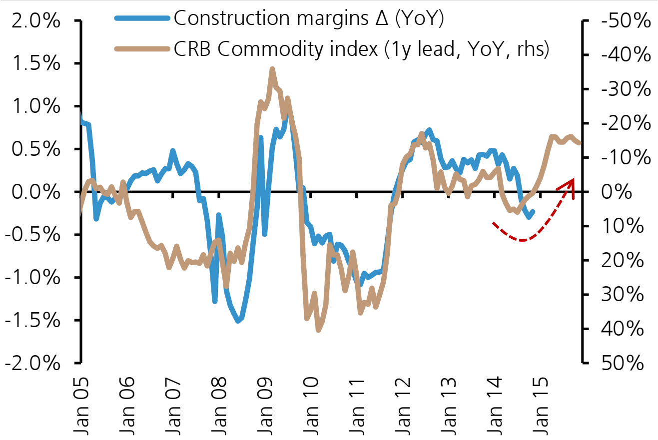
Autos and Construction stand out as key sectors with significant potential for a positive operating leverage surprise. In Construction we can see that current low commodity prices suggest a significant pick up in margins for the sector (Figure 2). We can see a similar relationship between oil prices and Autos and Transport margins. We also update our list domestic cyclical stocks with operating leverage potential (see page 8).

Figure 1: Labour cost inflation close to all-time lows should mean higher margins



Source: UBS European Equity Strategy, ECB, DataStream

Figure 2: Lower commodity prices tend to lead margin growth in Construction



Source: UBS European Equity Strategy, DataStream

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Macro drivers suggest margin expansion

In our outlook for 2016 we expect that earnings will surprise on the upside driven by operating leverage and a pick-up in margins (For more see: Outlook 2016: Operating Leverage - Set to Surprise, 05 Nov 2015). In this report we try to take a deeper dive into the drivers that we believe will be the catalysts for this movement as well as which sectors will benefit the most in this scenario. These drivers include low labour costs; low input costs as producer price inflation remains low; the end of the fiscal drag as austerity measures give way to government spending in Europe and more specifically on input costs, commodities and low oil prices, while detrimental to profitability in the Miners and Energy sectors, will benefit a number of industries such as transport and autos, in our view.

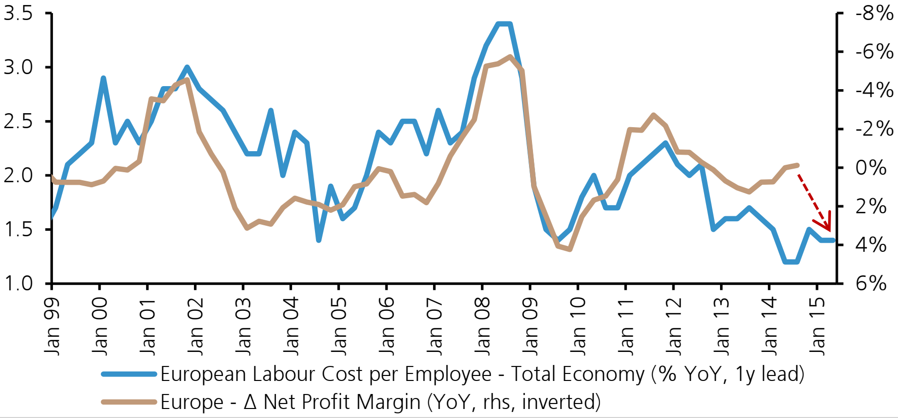
We expect operating leverage to kick in and margins to expand in 2016 – here we look at some of the drivers in more detail

Lower labour costs point to higher margins

Lower labour costs are a benefit to corporate margins, at least over the short term. Labour cost inflation in Europe has been close to historical lows since 2014, this tends to lead margins by approximately 1 year. We expect that in 2016 we will see the benefit of lower labour costs in Europe feeding through to corporate margins.

Low labour cost inflation tends to lead to margin expansion

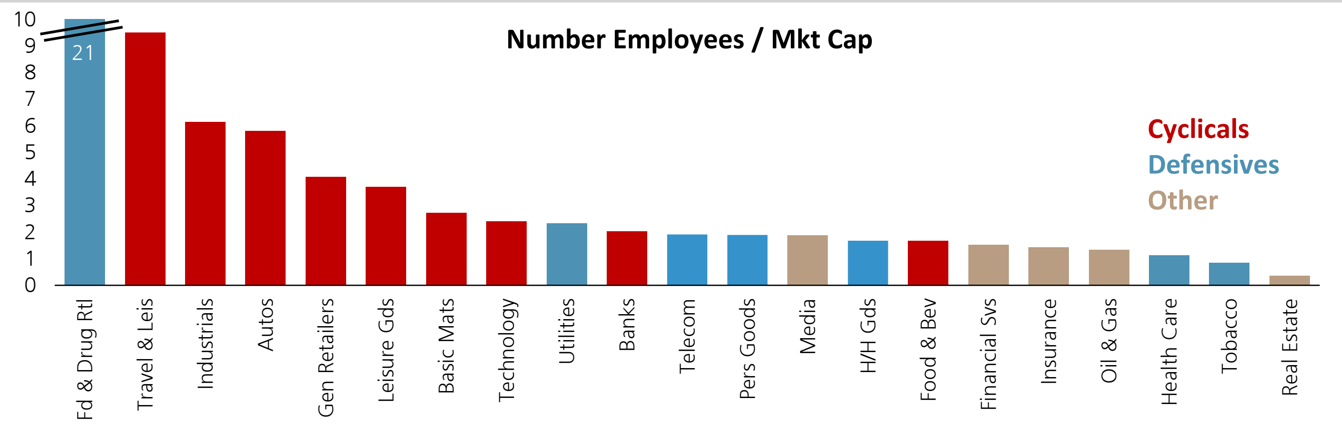
Figure 3: Labour cost inflation close to all-time lows should mean higher margins



Source: UBS European Equity Strategy, ECB, DataStream

Looking across sectors this should benefit especially cyclicals and the Food retail sector. Of the top 10 most labour intensive sectors, 8 are cyclicals.

Figure 4: Labour intensive sectors could benefit the most from lower labour costs



Source: UBS European Equity Strategy, DataStream

The end of austerity: a key potential driver of margin recovery

As we highlighted before, the gap between US and European profit margins remains close to all-time highs. (For more on this and other crisis gaps see: Buy crisis gaps at new high: Europe is cleansed, 10 Nov 2015 or Peak European profit gap to US: set to close, 20 April 2015).

The gap between European and US profit margins is close to all-time highs

The formation of this gap has much to do with the different government responses to the crisis on either side of the Atlantic. As the crisis started, US and European margins were at similar high levels and both fell together to similar low levels in 2009/2010. However, from that point on US margins recovered quickly and have sustained high margins since mid-2010 while Europe suffered a double-dip in margins and has seen low margins since 2012.

We believe austerity in Europe – which is about to end – coupled with government stimulus in the US – which is now fading – is one of the key drivers of this gap.

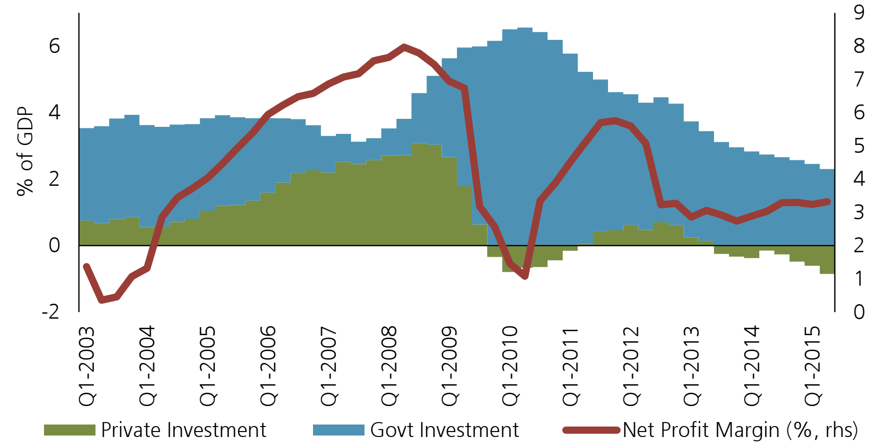
The government response to the crisis in Europe has much to do with its low profit margins

To illustrate the impact of the different government responses we use Kalecki's profit equation which derives corporate profits from: corporate investments, government investments, household savings, foreign savings (i.e. the current account balance), as well as dividends. As profits are more volatile than sales this gives us a good view of margins[1].

This analysis suggests that the key 'swing factors' for margins are private investment and government investment, which tends to be counter-cyclical. Hence, in Figure 5 we show a simplified version of the Kalecki profit framework focusing only on those two factors (more details and full framework in the appendix). We can see that as the crisis started and investment collapsed in 2009, European governments tried to counteract by introducing stimulus to reinvigorate the economy and corporate profits. This had an effect and margins recovered in 2010/11. However, we then had the second leg of the crisis and government policy was actually pro-cyclical rather than counter-cyclical with austerity measures being implemented and government investment reducing significantly at the same time as private investment was once again being cut. This pushed profitability lower again and contributed to the low margins we see in Europe today.

As the second leg of the crisis hit, policy response was actually pro-cyclical as austerity kicked in

Figure 5: Eurozone macro drivers of profits – austerity fading



Source: European Commission, Haver, UBS European Equity Strategy

Going forward fiscal policy moves from a headwind to a tailwind in 2016 – this should help boost profits

[1] For more details on Kalecki's profit equation and a comparison to the US see the appendix to this report.

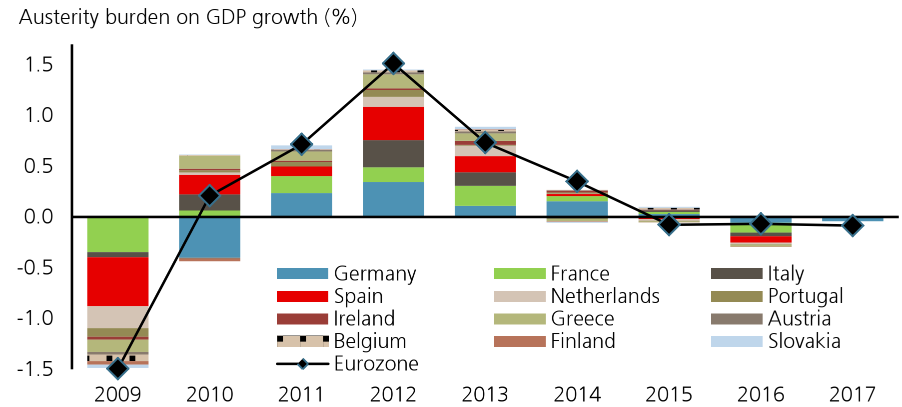
In 2011 margins showed signs of recovering as private investment became positive again but as we know this was short-lived. The trend in government investment however shows a gradual decrease in investment (we can see the blue area becoming thinner in the chart above).

Our economists can shed more light on this by looking at the impact of austerity on GDP. This differs from the government investment/savings (government revenues less expenditures) shown above as it looks at the change in the structural balance. The burden on GDP growth from austerity reached its peak in 2012, however it has slowly faded in recent years and in 2016 the fiscal drag finally gives way to a fiscal push. This should contribute to the gap between US and European margins narrowing.

Austerity was a heavy burden on European GDP – this is no longer the case going forward

For more see: European Economic Outlook 2016-17, 02 November 2015.

Figure 6: Austerity gives way to growth measures can help margins pick-up

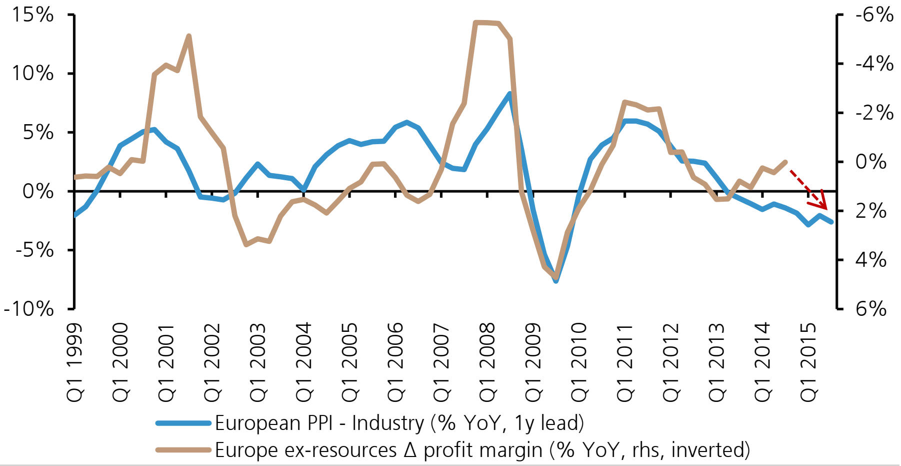


Source: Haver, UBS European Equity Strategy. NB - The austerity burden is measured as the change in the structural government balance. This assumes a fiscal multiplier of 1.

Producer price inflation staying low = margins higher

In addition to low labour costs, input costs are low and expected to stay low, providing further support for margin expansion.

Figure 7: Input prices point to higher margins in Europe



Source: UBS European Equity Strategy, European Commission, DataStream

The benefits of low producer price inflation affect margins with a lag – we could see a positive impact in 2016

The low PPIs tend to lead to significant margin expansion – with a lead time of approximately 1 year. While Energy and Metals & Mining sectors are hurt by the

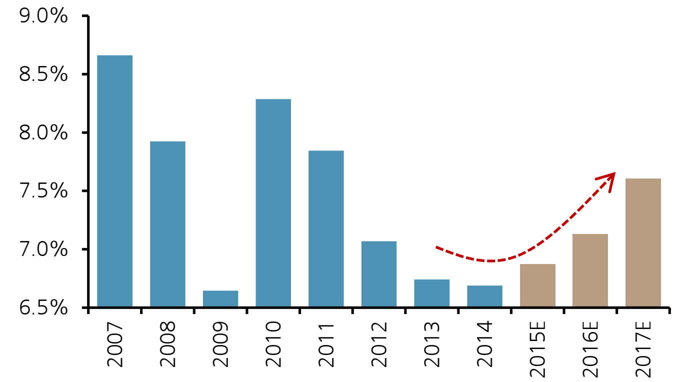
low commodity prices, other sectors tend to benefit from it with a lag given hedging, accounting timing, changes in consumer behaviour that can affect autos and transport for example. In Figure 7, we look at what this suggests for European margins. What it shows is that, except for the bottom of the crisis in 2009, the current producer price inflation numbers in Europe are the lowest since the 90s. This implies the potential for strong improvement in European margins in 2016.

Which sectors and stocks could benefit

Our bottom-up analysts forecast margin expansion in 2016

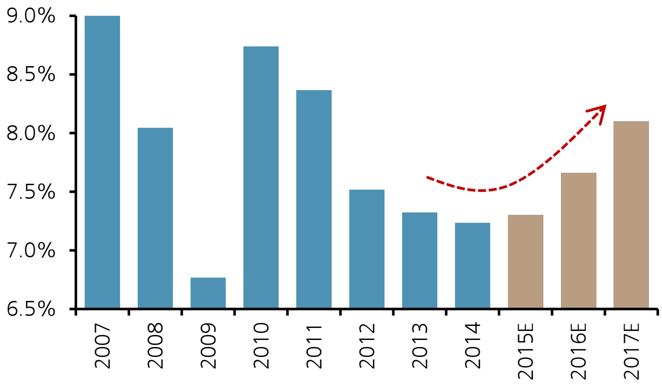
Looking at the micro data gives further granularity on where the margin expansion might come from and which sectors and stocks could benefit. If we aggregate our UBS analyst forecasts for European stocks we see a strong bounce back in margins expected over the next couple of years. And that is the case regardless of whether we include or exclude the Energy sector from the measure.

Figure 8: European net profit margin



Source: UBS European Equity Strategy

Figure 9: European net profit margin ex-Energy

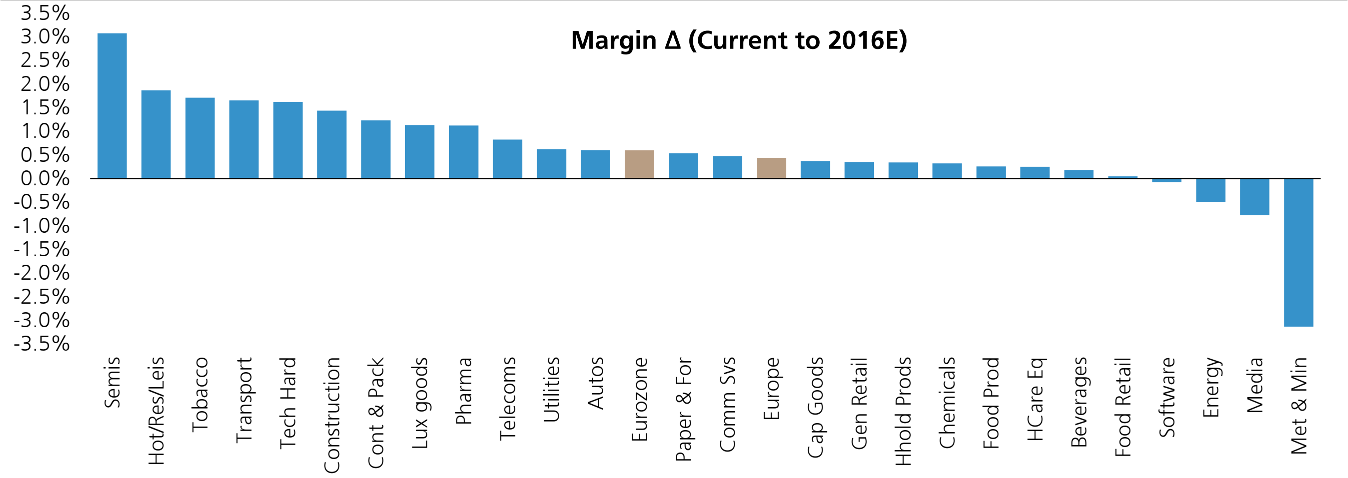


Source: UBS European Equity Strategy

Some sectors have greater potential for surprises

Our analyst forecasts for margin expansion across sector gives more details as well. Sectors such as Semis, Hotels, Tobacco, Transport, Technology and Construction show the strongest expected margin expansion.

Figure 10: Of the 14 sectors expected by our analysts to lead the margin expansion 10 are cyclicals

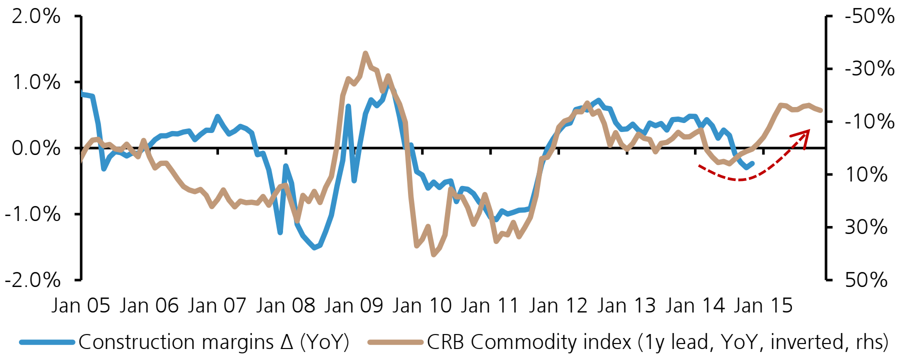


Source: UBS European Equity Strategy

Looking at some of these sectors in more detail; Construction is one of the key potential beneficiaries. We recently upgraded the sector in our outlook for 2016 based in large part on the potential for a pick-up in margins. If we look at the relationship between commodity prices and margins in Construction we can see

that current low commodity prices could lead to a significant pick up in margins for the sector.

Figure 11: Lower commodity prices tend to lead margin growth in Construction



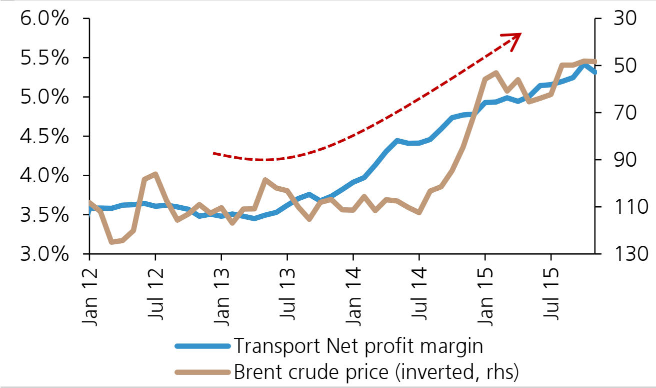
Source: UBS European Equity Strategy, DataStream

Low commodity prices could boost margins in Construction

Other sectors that could benefit are the Transport sector where low oil prices coupled with sustained demand tend to lead to higher margins (Figure 12). And the same is the case for the Autos sector where the lower oil prices point to strong margin expansion in the sector.

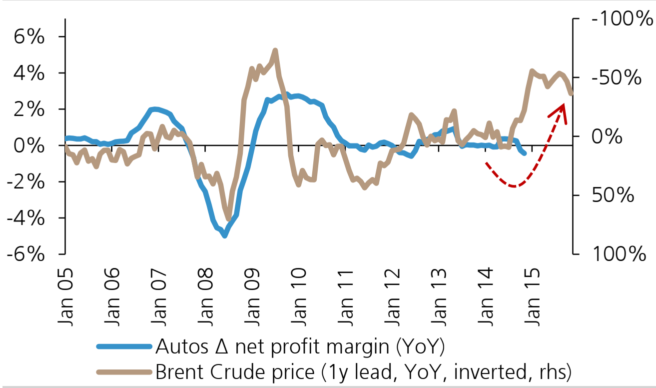
Autos and Transport margins could also benefit from low oil prices

Figure 12: Lower oil prices with sustained demand tend to lead to margin expansion in the Transport sector



Source: UBS European Equity Strategy, DataStream

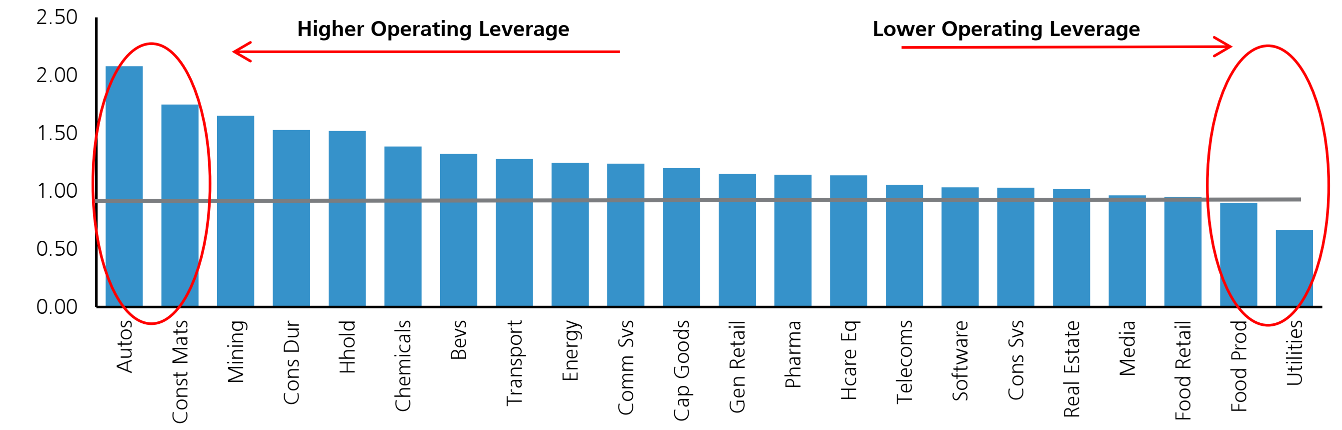
Figure 13: In the Autos sector too lower oil prices with sustained demand could help margins



Source: UBS European Equity Strategy, DataStream

We also try to gauge which sectors have the strongest operating leverage potential and could therefore surprise on margin expansion. To do that we look at the historical change in EBIT relative to change in revenues. Sectors such as Autos and Construction stand out as the key ones.

Figure 14: European Sectors Operational Leverage: % Change in EBIT / % Change in Revenues (10yr ave)



Source: UBS European Equity Strategy, DataStream

Putting together the expectations and the operating leverage data, we can check whether both sets of data are in sync which would give us more confidence in the case for margin expansion. In addition, we can see which sectors have the greatest potential to surprise if the operating leverage is high (low) and the expected margin expansion is low (high).

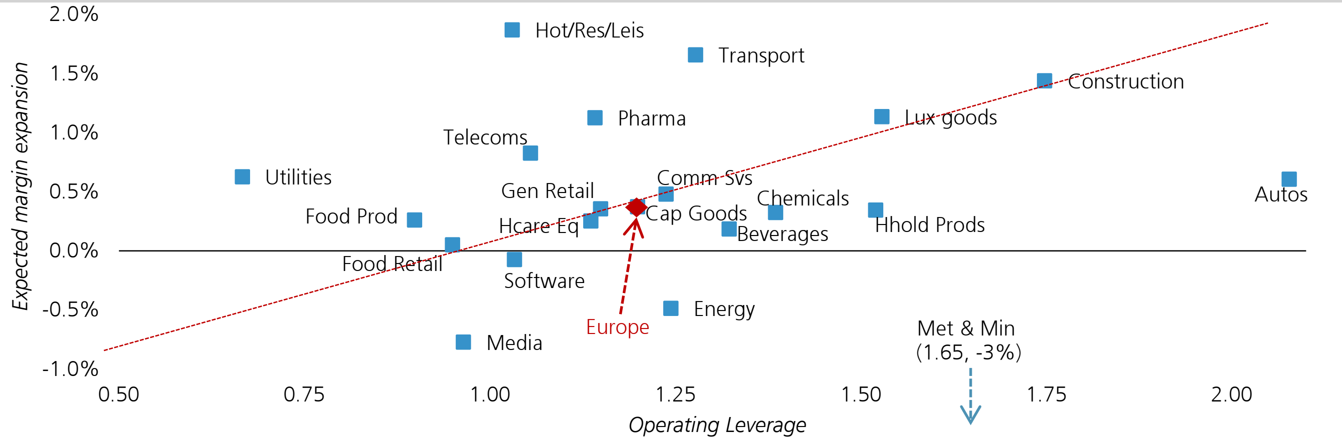
In the positive surprise camp, i.e. high operating leverage but more modest margin expectations we see Autos, Metals & Mining, Energy, Media and Household Products. It is worth highlighting that with commodity sectors it might be different given the past operating leverage during the super-cycle is not expected to repeat itself in the same way going forward.

High operating leverage with modest margin forecasts could spell positive surprises…

…and vice-versa

In the negative surprise camp Hotels/Rest/Leis, Transport, Utilities, Telcos and Pharma have relatively low operating leverage but high expected margin expansion.

Figure 15: Operational leverage and margin expansion relationship – some sectors could bring surprises



Source: UBS European Equity Strategy, European Commission, DataStream

On the stock level we update our operating leverage screen looking for stocks with three characteristics: (1) exposure to the domestic European market, (2) cyclicality and, (3) operating leverage.

Below we screen for stocks with more than 50% of their revenues from Continental Europe, a beta over 1.2x (as a proxy for cyclicality) and operating leverage of over 1x. Unfortunately, we cannot screen on the same measure of operational leverage for the banks and hence leave those numbers as "n/a".

For more see: Outlook 2016: Operating Leverage - Set to Surprise, 05 Nov 2015

Figure 16: Domestic Cyclicals with Operational Leverage

Name	Sector	Mkt Cap (EUR bn)	Price (p)	Upside to PT	UBS rating	P/E 2015	P/E 2016	DY 2016	Beta	12m relative performance (%)	Contl Europe exposure (%)	Operating Leverage (EBIT over Rev growth '15 - '17)
Bankia	Banks	13.6	1.2	n/a	n/a	12.2	12.3	2.4	n/a	-11.2	100%	n/a
Banco Popular	Banks	7.1	3.3	n/a	n/a	21.1	12.5	1.8	n/a	-25.2	98%	n/a
Intesa Sanpaolo	Banks	50.3	3.2	n/a	n/a	15.5	13.4	4.1	n/a	25.7	94%	n/a
ING	Banks	46.6	12.2	33%	Buy	10.6	9.4	8.2	1.45	1.2	93%	n/a
Commerzbank	Banks	10.8	9.5	16%	Neutral	10.2	7.9	3.1	1.23	-23.8	91%	n/a
Nordea	Banks	40.3	91.8	5%	Neutral	10.8	10.4	7.2	1.15	-4.8	90%	n/a
SEB	Banks	21.2	88.0	5%	Neutral	11.6	10.8	5.4	1.26	-14.1	90%	n/a
Generali	Insurance	26.8	17.2	13%	Buy	9.7	9.3	4.6	1.20	-3.3	88%	n/a
Credit Agricole	Banks	28.9	11.0	n/a	n/a	8.9	8.0	5.0	n/a	-3.9	88%	n/a
Societe Generale	Banks	35.0	43.4	n/a	n/a	9.4	8.9	4.7	n/a	10.5	84%	n/a
Julius Baer Group	Diversified Financials	10.1	48.1	10%	Buy	15.3	14.2	2.4	1.25	15.3	83%	n/a
DnB ASA	Banks	18.8	110.1	14%	Buy	7.9	8.4	3.5	1.44	-13.7	80%	n/a
Swedbank	Banks	22.0	184.5	17%	Buy	12.2	10.4	7.0	1.32	-7.7	80%	n/a
Bnp Paribas	Banks	67.3	54.0	n/a	n/a	9.5	8.8	4.5	n/a	4.0	77%	n/a
Vinci	Capital Goods	33.3	59.9	12%	Buy	16.5	15.0	3.3	1.26	30.6	76%	10.7
Allianz	Insurance	74.5	163.7	11%	Buy	10.8	10.9	4.7	1.28	14.8	74%	n/a
Natixis	Banks	17.1	5.5	n/a	n/a	13.1	11.6	5.8	n/a	-6.2	72%	n/a
Accor	Consumer Services	9.0	40.1	37%	Buy	21.5	18.5	2.9	1.29	5.0	71%	2.6
Unicredit	Banks	32.1	5.4	n/a	n/a	14.3	10.7	2.3	n/a	-7.2	70%	n/a
Carrefour	Food Retail	20.1	27.3	17%	Buy	18.2	15.9	3.0	1.30	7.2	69%	12.8
AXA	Insurance	62.4	25.5	-4%	Neutral	10.8	10.6	4.5	1.36	26.6	69%	n/a
KBC	Banks	22.8	54.7	8%	Neutral	10.0	10.8	5.4	1.45	14.2	69%	n/a
Caixabank	Banks	20.8	3.6	n/a	n/a	16.4	12.1	4.1	n/a	-20.5	65%	n/a
Randstad	Commercial Services	10.4	57.4	1%	Neutral	17.8	15.0	3.2	1.27	38.2	64%	2.3
Deutsche Post-DHL	Transportation	30.6	25.3	3%	Neutral	15.2	13.9	3.9	1.22	-8.2	63%	3.1
Erste Bank	Banks	12.2	28.3	11%	Buy	12.8	11.6	2.8	1.34	26.3	60%	n/a
Hugo Boss	Consumer Durables	5.4	78.2	34%	Buy	15.6	14.6	5.0	1.05	-27.3	60%	1.1
BASF SE	Materials	65.1	70.9	9%	Neutral	13.0	13.6	4.1	1.27	-6.1	56%	n/a
Bank of Ireland	Banks	10.8	0.3	5%	Neutral	12.3	12.9	2.9	1.82	-7.8	55%	n/a
Renault	Autos & Components	25.0	91.7	20%	Buy	8.6	7.1	3.4	1.91	39.1	53%	4.1
Siemens	Capital Goods	75.1	91.2	21%	Buy	13.0	13.9	3.9	1.32	-5.8	53%	4.2
Adecco	Commercial Services	11.4	69.1	1%	Neutral	14.8	13.8	3.6	1.26	8.6	51%	0.9
Capgemini	Software & Services	14.9	86.4	3%	Neutral	19.8	16.7	2.0	1.25	38.2	51%	2.4
Valeo	Autos & Components	11.0	138.8	23%	Buy	17.1	13.1	2.5	1.49	33.2	50%	2.4

Source: Datastream, IBES, UBS European Equity Strategy, UBS European Equity Research

Appendix – Macro drivers of profit

We borrow from the Kalecki framework to analyse the relationship between macroeconomic drivers and corporate profits

To derive the key drivers of profit along the framework of the Kalecki profit equation we start by dividing the economy in 4 broad sectors: the private, household, government and foreign sectors. The last one simply accounts for transactions with any entities outside of the country.

We must emphasize that we are looking at an entire economy rather than single entities. So, one entity or sector's investment is another entity or sector's savings. For instance, investments by the government sector in infra-structure would go into a construction company and would therefore add to profits and, unless those are reinvested, savings for that company. If that company decides not to save those proceeds, it could use them to invest in a new factory in a different country; this would then become savings for the foreign sector. Given those 4 sectors encompass the entire economy the sum of investments in all four sectors must equal the sum of savings in all sectors:

Private Investments + Household Investments + Government Investments + Foreign Investments = Private Savings + Household Savings + Government Savings + Foreign Savings

Now looking at the corporate sector alone we have:

Private Savings = Private Profits – Distributions (i.e. Dividends)

Substituting we have:

Private Investments + Household Investments + Government Investments + Foreign Investments = Private Profits – Dividends + Household Savings + Government Savings + Foreign Savings

Moving our variable of interest (profits) to the left side we arrive at:

Private Profits = Private Investments + Household Investments – Household Savings + Government Investments – Government Savings + Foreign Investments – Foreign Savings + Dividends

Profits can be divided between the investments/savings in 4 macro-economic sectors: private, government, household and foreign

Or if we look at savings net of investments (or vice-versa) we can simplify the profit equation. We prefer to think of the private and government sectors as net investors and the remaining sectors as net savers but looking at it one way or another does not change the equation (only the signs need to be changed):

Profits = Private Invest + Gvt Invest – Hhold Savings – Foreign Savings + Dividends[2]

Where:

- *Private Invest* is investment by the private sector (Gross Fixed Investment + Inventory Investment – Capital Allowances);
- *Hhold Savings* are the net savings of the non-corporate sector;
- *Foreign Savings* equates to the current account balance (international receipts – international payments);

[2] For further analysis on Kalecki's equation see: Kalecki's Profit Equation after 80 years and Where Profits Come From

- *Gvt Investment* are investments by the government sector (government expenditures less revenues);

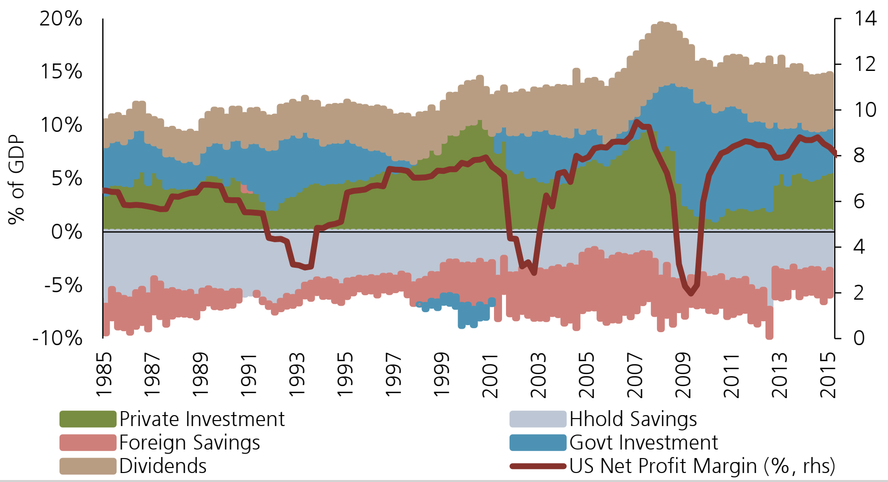
- *Dividends* are corporate distributions to households.

This of course is a model for profits rather than profit margins but it gives us a good indication of corporate profitability and margins given revenues are much more stable than profits. If we apply the model to the US, we can see that private and government investment appear to be the key factors that make profit margins move, while the remaining drivers are more constant.

We can also see that in 2009 as private investment collapsed, government investment quickly stepped in and contributed to a bounce back to strong margins in the US. In recent periods however, government investment is fading and private investment is coming back.

The key factors that appear to impact profit margins are private investment and government investment

Figure 17: US profit drivers – government replaced private investment

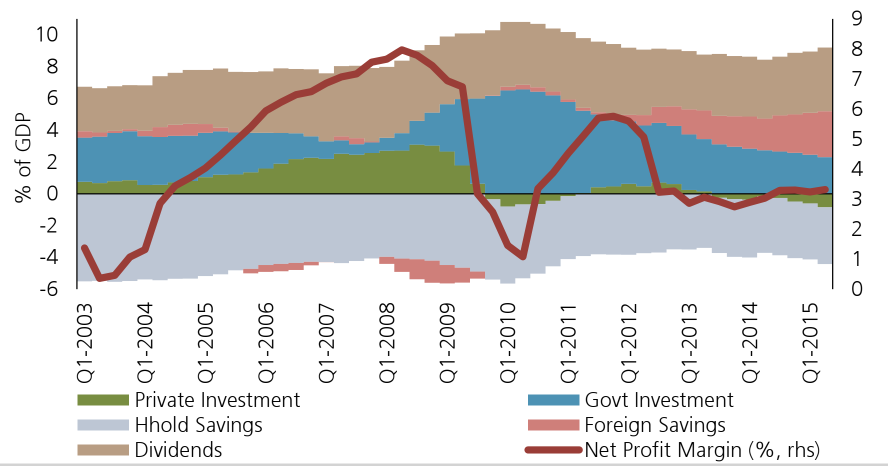


Source: US Flow of Funds, DataStream, UBS European Equity Strategy

Using the Kalecki framework to analyse the movements in European margins we can see how, initially, governments tried to "fill the gap" similar to in the US. However, as the second leg of the crisis hit in 2012 and private investment dried up once again, government investment was also cut as austerity was introduced.

In Europe austerity reduced government investment in 2012 – a time when private investment was also falling

Figure 18: Eurozone macro drivers of profits – austerity fading



Source: European Commission, Haver, UBS European Equity Strategy

Statement of Risk

Risks include macroeconomic variables (such as GDP growth rates and inflation), economic slowdown, a weakening currency, global economic events, and government policy changes.

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12-Month Rating	Definition	Coverage[1]	IB Services[2]
Buy	FSR is > 6% above the MRA.	49%	33%
Neutral	FSR is between -6% and 6% of the MRA.	40%	26%
Sell	FSR is > 6% below the MRA.	12%	18%
Short-Term Rating	**Definition**	**Coverage[3]**	**IB Services[4]**
Buy	Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event.	less than 1%	less than 1%
Sell	Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event.	less than 1%	less than 1%

Source: UBS. Rating allocations are as of 30 September 2015.
1:Percentage of companies under coverage globally within the 12-month rating category. 2:Percentage of companies within the 12-month rating category for which investment banking (IB) services were provided within the past 12 months.
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UBS Limited: Joao Toniato; Nick Nelson; Karen Olney, CFA; Andras Nagy, CFA; Reinhard Cluse.

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Company Name	Reuters	12-month rating	Short-term rating	Price	Price date
Accor[4, 5, 7]	ACCP.PA	Buy	N/A	€40.79	07 Dec 2015
Adecco[2, 4, 5, 7]	ADEN.VX	Neutral	N/A	CHF69.70	07 Dec 2015
Allianz S.E[5, 7]	ALVG.DE	Buy	N/A	€165.05	07 Dec 2015
AXA[4, 5, 7]	AXAF.PA	Neutral	N/A	€25.81	07 Dec 2015
Banco Popular[2, 4, 5, 7]	POP.MC	Not Rated	N/A	€3.31	07 Dec 2015
Bank of Ireland[2, 4, 5, 7, 13, 14]	BKIR.I	Neutral	N/A	€0.34	07 Dec 2015
Bankia[7]	BKIA.MC	Not Rated	N/A	€1.18	07 Dec 2015
BASF SE[7, 14]	BASFn.F	Neutral	N/A	€72.64	07 Dec 2015
BNP Paribas[2, 4, 5, 6, 7, 22]	BNPP.PA	Not Rated	N/A	€54.02	07 Dec 2015
Caixa Bank[3a, 5, 7]	CABK.MC	Not Rated	N/A	€3.57	07 Dec 2015
Capgemini	CAPP.PA	Neutral	N/A	€87.37	07 Dec 2015
Carrefour SA[5]	CARR.PA	Buy	N/A	€27.85	07 Dec 2015
Commerzbank[2, 4, 5, 7, 14]	CBKG.DE	Neutral	N/A	€9.82	07 Dec 2015
Crédit Agricole SA[2, 4, 5, 7]	CAGR.PA	Not Rated	N/A	€10.97	07 Dec 2015
Deutsche Post-DHL[4, 5, 7]	DPWGn.DE	Neutral	N/A	€25.86	07 Dec 2015
DnB ASA[2, 4, 7, 22]	DNB.OL	Buy	N/A	NKr113.50	07 Dec 2015
Erste Group Bank AG[5, 7]	ERST.VI	Buy	N/A	€28.29	07 Dec 2015
Generali[2, 4, 5, 7]	GASI.MI	Buy	N/A	€17.50	07 Dec 2015
Hugo Boss[2, 4]	BOSSn.DE	Buy	N/A	€79.84	07 Dec 2015
ING[2, 4, 5, 6, 7, 16]	ING.AS	Buy	N/A	€12.62	07 Dec 2015
Intesa SanPaolo[2, 4, 5, 7, 13]	ISP.MI	Not Rated	N/A	€3.17	07 Dec 2015
Julius Baer Group[2, 4, 5, 7]	BAER.VX	Buy	N/A	CHF49.46	07 Dec 2015
KBC Groep NV[5, 7]	KBC.BR	Neutral	N/A	€56.58	07 Dec 2015
Natixis[7]	CNAT.PA	Not Rated	N/A	€5.45	07 Dec 2015
Nordea[2, 4, 5, 6, 7, 22]	NDA.ST	Neutral	N/A	SKr94.45	07 Dec 2015
Randstad	RAND.AS	Neutral	N/A	€58.24	07 Dec 2015
Renault SA[7]	RENA.PA	Buy	N/A	€94.35	07 Dec 2015
SEB Group[2, 4, 5, 7]	SEBa.ST	Neutral	N/A	SKr90.65	07 Dec 2015
Siemens[4, 7, 14]	SIEGn.DE	Buy	N/A	€92.98	07 Dec 2015
Société Générale[1, 2, 4, 5, 6, 7, 22]	SOGN.PA	Not Rated	N/A	€43.39	07 Dec 2015
Swedbank[2, 4, 5, 7]	SWEDa.ST	Buy	N/A	SKr189.90	07 Dec 2015
UniCredit[1, 2, 3b, 4, 5, 7]	CRDI.MI	Not Rated	N/A	€5.38	07 Dec 2015
Valeo	VLOF.PA	Buy	N/A	€141.50	07 Dec 2015
Vinci	SGEF.PA	Buy	N/A	€60.21	07 Dec 2015

Source: UBS. All prices as of local market close.
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