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Macro-Strategy Key Issue

UBS Evidence Lab: Is Eurozone investment gaining strength?

Equity Strategy

Europe including UK

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Eurozone investment appetite has picked up a bit, despite the UK's EU vote

Our new UBS Evidence Lab Survey shows that Eurozone investment continues to recover, with a bit more momentum than in early 2016. It is encouraging to see that the UK vote to leave the EU has not inflicted major damage on corporate investment plans, although the special UK section of our survey shows that Eurozone firms do not view the UK exit as a non-event. Spanish corporates continue to boast the strongest investment and hiring plans, followed by German firms, where the mood has improved. But confidence has cooled off in Italy and remains weak in France. Confidence in the Industrial sector, and particularly in Materials, has recovered a lot from very weak levels six and 12 months ago, thus narrowing the gap to Consumers. SMEs still face many headwinds, indicating that the recovery of this crucial sector will take more time.

UBS Evidence Lab survey: Credit recovery likely to proceed, albeit moderately

Eurozone investment remains heavily based on existing cash flow and retained earnings, but the outlook for bank credit seems to be improving. We expect the recovery in credit to continue, but at a moderate pace.

What does this mean for European equities?

Our survey suggests a modest pick-up in capex from c.30-year lows. But this depends on a pick-up in corporate profitability given the close linkages. China, EM and exports have all become bigger supports for capex in the last six months. This fits with our bottom-up data showing relative earnings upgrades for EM-exposed stocks in Europe for the first time in three years. Spain, Germany and the Consumer sector have the best pricing power and margin outlook; France the worst (and deteriorating) (Figure 2).

Sectors and stocks: Who are the likely beneficiaries?

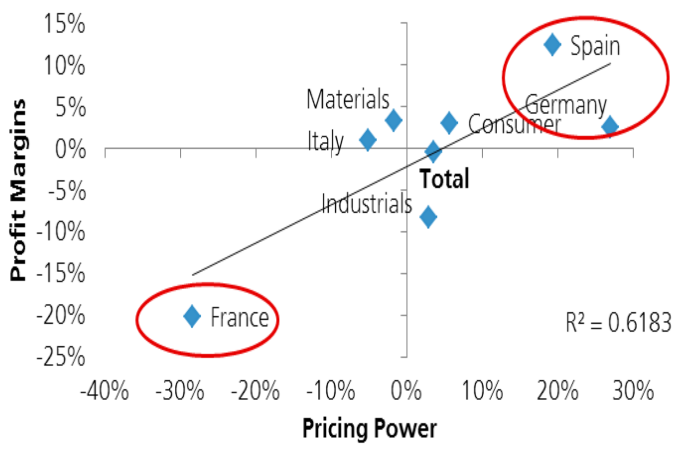
Shifts in technology are driving capex: it was cited as the most important factor in our survey. Sectors most correlated to a broader increase in capex and business investment are parts of Cap Goods, Autos and Financials. At a stock level, potential beneficiaries include: Valeo, Legrand and Hexagon (full list on p.5).

Figure 1: Net % of firms expecting to increase capex

	Germany	France	Spain	Italy	Total	Change vs Feb'16
Consumer	12%	6%	20%	5%	11%	-2%
Industrials	17%	7%	12%	5%	11%	13%
Materials	13%	-32%	20%	25%	9%	9%
Total	14%	-1%	18%	10%	11%	3%
Change vs Feb'16	8%	2%	7%	-5%	3%	

Source: UBS Evidence Lab

Figure 2: Pricing power/profit margin chg over next 12m*



Source: UBS Evidence Lab. *Net balance of responses.

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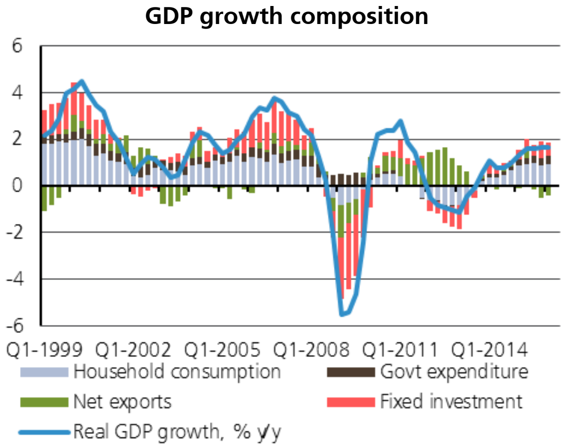
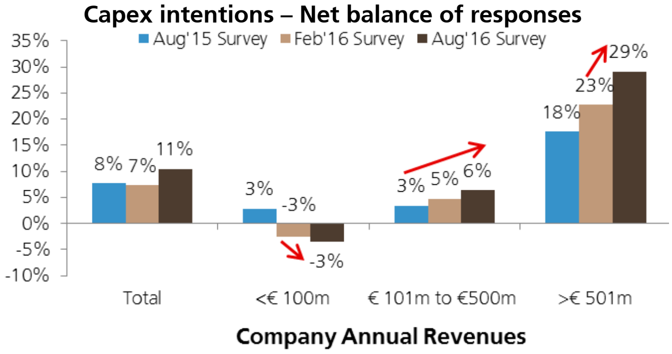
We would like to thank Tulika Poddar and Garima Jaiswal our research support service professionals for assisting in preparing this research report.

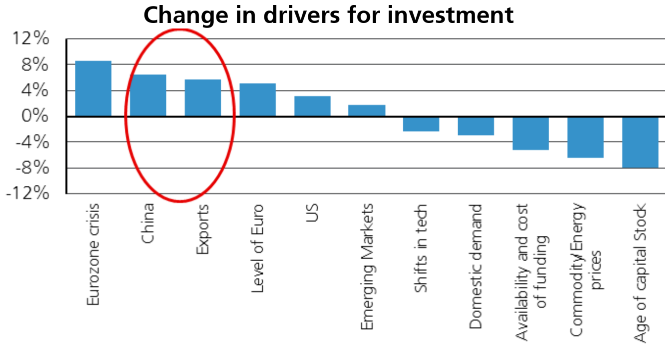
OUR THESIS IN PICTURES



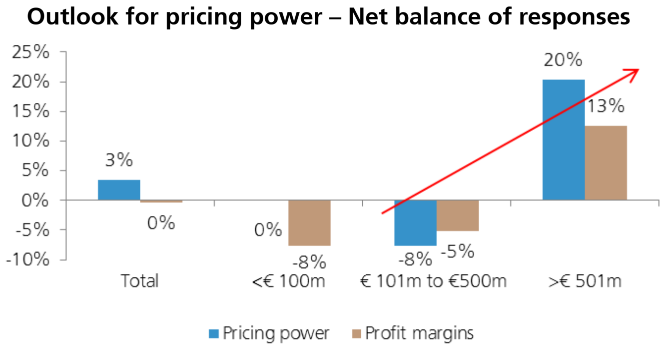
Fixed investment, a key driver of growth, has so far been lacking



Size matters…larger companies turn even more positive on investment as the outlook for SMEs remains weak



China, Exports and Emerging Markets have become a bigger support for investment since our last survey in February (see page 23)



The outlook for pricing power remains relatively weak in aggregate, but set to improve for larger companies (see page 35)

Sources for exhibits above: Company data, UBS Research, UBS Evidence Lab

Executive summary

Investment plans improving, despite UK vote to leave the EU: Our new UBS Evidence Lab Survey, conducted 5 July to 8 August, shows that Eurozone investment continues to recover, with a bit more momentum than in early 2016. It is encouraging to see that the UK vote to leave the EU has not inflicted major damage on corporate investment plans. Spanish corporates continue to boast the strongest investment and hiring plans, followed by German firms, where the mood has improved. But confidence has cooled off in Italy, and remains weak in France. Confidence in the Industrial sector, and particularly in Materials, has recovered a lot from very weak levels six and 12 months ago. SMEs still face many headwinds, indicating that the recovery of this crucial sector will take more time.

How would Eurozone firms respond to the UK vote to leave the EU? Some 36% of the Eurozone companies in our survey said they would reduce their overall investment spending either "somewhat" or "significantly" if it became clear that the UK will leave the EU. More than half of the companies would react within less than a year. 31% of Eurozone companies with UK operations anticipate adjusting their UK capacity strongly negatively as a result of the UK exit from the EU. Around 80% of the capacity relocation would move to the EU.

Recovery in credit likely to proceed, albeit moderately: Eurozone investment remains heavily based on existing cash flow and retained earnings, but the outlook for bank credit seems to be improving. We expect the recovery in credit to continue, but at a moderate pace.

What does this mean for European equities? Capex/sales is coming off a 30-year low in Europe, and there are tentative signs of life in the new survey data. For capex to rise sustainably, we need profit margins to recover from the current depressed levels. There are some signs of this occurring.

Pricing power and margins – who is best placed? The outlook for pricing power remains relatively weak in aggregate – just fractionally up on the last survey, with a net balance of 3% of the companies expecting stronger pricing power in the next 12 months. We combine this with the outlook for corporate profitability (which correlates closely), and conclude that **Germany**, **Spain** and **Consumer** stocks are best placed (but **Materials** are improving). **Bigger is best**: Since our last survey, the gap between the smallest and largest companies on investment intentions has widened significantly. Likewise, in terms of pricing power and profitability, larger companies are far better off.

What are the drivers and how are they changing? The biggest positive driver for investment is technological change. **What's changing?** China, exports and emerging markets have all become more supportive for investment by European companies since our last survey.

Sectors and stocks: Cap Goods, Banks and Autos have the highest correlations to investment (though it may be different for the Banks in this cycle). Some of the stocks exposed to a broader pick-up in capex include: Valeo, Legrand and Hexagon – full list on page 5.

Figure 3: Potential Beneficiaries from a broader pick up in capex and business investment

Name	Sector	Mkt Cap (EUR bn)	Price (p)	UBS rating	P/E 2016	DY 2016	P/E rel to sector (%) 2016	12m Rel Perf (%)
Continental	Automobiles & Components	38.3	191.3	Buy	12.1	2.3	146	4.4
Valeo	Automobiles & Components	11.0	46.2	Buy	13.5	2.5	162	31.7
Alfa Laval	Capital Goods	6.1	137.6	Buy	15.3	3.0	88	0.3
SKF	Capital Goods	6.9	144.3	Buy	12.2	3.9	70	-5.0
Legrand	Capital Goods	14.3	53.9	Buy	24.1	2.2	139	9.7
Siemens	Capital Goods	88.3	107.3	Buy	14.6	3.4	84	27.1
Zumtobel Group	Capital Goods	0.6	14.2	Buy	81.3	0.9	468	-44.2
Hexagon	Technology Hardware & Equipment	12.9	342.8	Buy	22.3	1.2	112	35.8
Wincor Nixdorf	Technology Hardware & Equipment	1.8	62.6	Buy	14.8	3.4	74	89.6
Atos	Software & Services	9.2	89.4	Buy	12.7	1.8	63	37.9
Capgemini	Software & Services	14.8	86.1	Buy	16.1	1.8	80	12.3
Indra	Software & Services	2.0	11.7	Buy	16.0	0.0	79	24.4
Ericsson	Technology Hardware & Equipment	21.9	62.7	Neutral	16.4	4.8	82	-19.7
Nokia	Technology Hardware & Equipment	28.1	5.0	Buy	28.0	3.2	140	-2.6
Iberdrola	Utilities	37.0	5.9	Neutral	14.5	4.9	98	2.0
EDP Renovaveis	Utilities	6.1	7.0	Buy	45.0	0.6	303	19.0
DONG Energy	Utilities	15.3	270.9	Buy	22.6	2.2	152	n/a

Source: Thomson Datastream, UBS European Equity Strategy

Is Eurozone capex finally recovering?

Context: investment is *the* swing factor in the business cycle

When will Eurozone corporates start to invest in earnest again, and how will this be funded? Gaining a clearer idea of corporate investment behaviour will be crucial not only for analysis of the Eurozone business cycle, but also the outlook for individual sectors and stocks.

When will corporates start to invest in earnest, and how will it be funded?

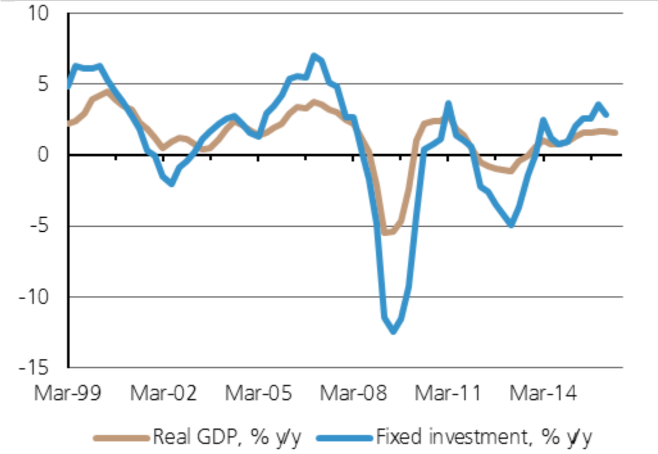
The Eurozone has made decent progress since the crisis, and has shown a decent degree of resilience in recent quarters despite disturbances from China/EM, the US, and the UK vote to leave the EU. Yet Europe's growth momentum is still not where it should be. In Q2 2016, real GDP was up by merely 1.6% y/y – not strong enough to achieve quick progress in bringing unemployment lower, accelerate deleveraging, or render the Eurozone immune to new external or internal risks.

Eurozone recovery continues, but at a moderate pace

The variable that represents the hesitant nature of the Eurozone recovery more than any other is fixed investment. Since bottoming out in 2013, investment activity has been relatively shallow by historical standards, and subject to repeated setbacks. The flip side of soft investment is credit growth, which remains modest, despite record-low interest rates.

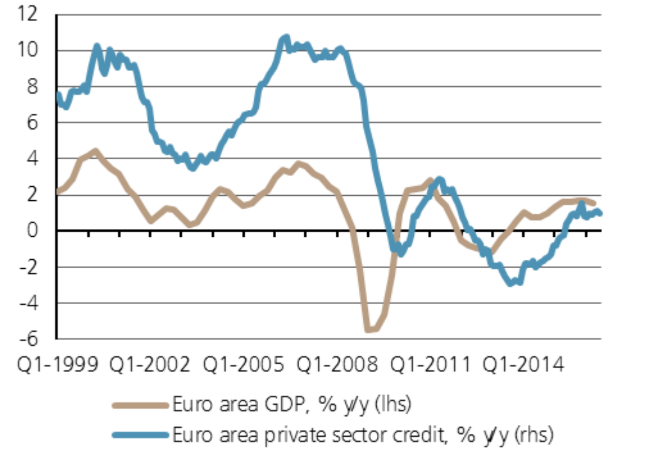
Subdued fixed investment is a key feature of the subdued economic recovery

Figure 4: Eurozone investment still subdued



Source: Haver, UBS

Figure 5: Slow recovery in credit growth



Source: Haver, UBS

Although fixed investment makes up only 18% of Eurozone GDP, it is traditionally the biggest swing factor in the business cycle (Figure 6, below). In other words, it is unlikely to be household consumption, government spending or net exports that will decide whether the Eurozone recovery reaches critical momentum, but fixed investment.

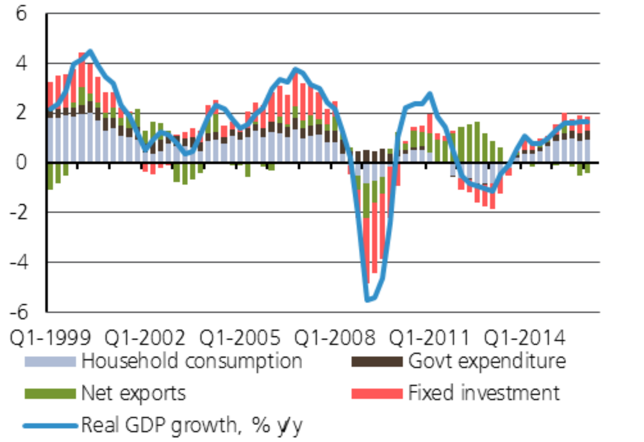
Fixed investment is the biggest swing factor in GDP growth across the business cycle

It is true that fixed investment has been a bit better in recent quarters: in Q4 2015 and Q1 2016, it was up by 3.6% y/y and 2.9% y/y respectively, a welcome change from the depressed levels of 2012-14 (Q2 data will be released on 6 September). But this pace is still subdued compared with pre-crisis standards. And given the latest shocks, above all the UK vote to leave the EU, we cannot be certain that the investment recovery will gain further momentum from here.

Investment has strengthened recently, but future momentum is uncertain, given new disturbances – above all the UK vote to leave the EU

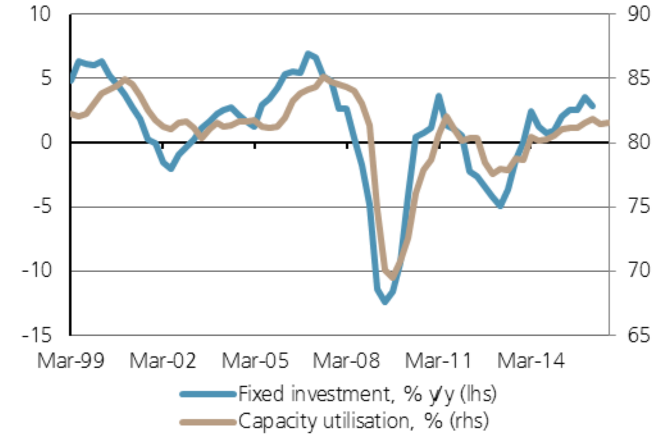
To gain an understanding of future investment dynamics, we think it is crucial to gain *primary* evidence, at the company level – which is what our UBS Evidence Lab survey is all about.

Figure 6: Contributions to Eurozone GDP growth (pp)



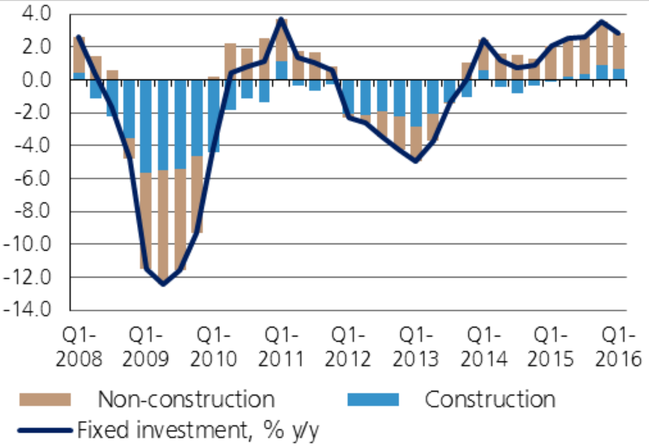
Source: Haver, UBS

Figure 7: Eurozone capacity utilisation and investment



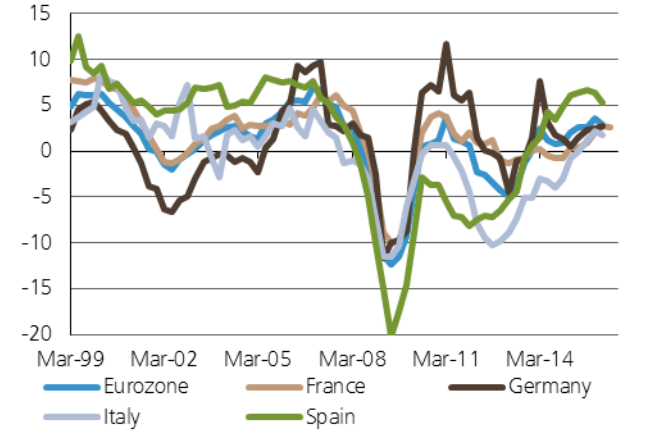
Source: Haver, UBS

Figure 8: Fixed investment growth (and contributions)



Source: Haver, UBS

Figure 9: Fixed investment growth, % y/y



Source: Haver, UBS

UBS Evidence Lab survey to analyse investment and funding

UBS Evidence Lab survey to shed light on Eurozone corporates' investment and funding plans

To get a clearer idea of the current and future investment behaviour and funding methods of Eurozone corporates across various countries, sectors and sizes, we conducted a UBS Evidence Lab survey. We interviewed:

1. 660 senior corporate decision-makers (mainly CEOs/CFOs);
2. representing companies in Germany (160), France (144), Italy (195), and Spain (161);
3. mainly from the Consumer, Industrials, and Materials sectors;
4. broken down by size: SME, bigger firms, and large companies.

We conducted this survey for the first time in July/August 2015, and for the second time in January/February 2016. Today's publication is the third survey, conducted between 5 July and 8 August.

Figure 10: Distribution of responses by country and sector

	Germany	France	Italy	Spain	Total
Consumer	24.1% (81)	20.8% (70)	28.3% (95)	26.8% (90)	50.9% (336)
Industrials	30.9% (64)	22.2% (46)	27.1% (56)	19.8% (41)	31.4% (207)
Materials	12.8% (15)	23.9% (28)	37.6% (44)	25.6% (30)	17.7% (117)
Total	24.2% (160)	21.8% (144)	29.5% (195)	24.4% (161)	100% (660)

Source: UBS Evidence Lab

Key implications: Macro

UBS Evidence Lab survey suggests an ongoing moderate recovery in investment

Our UBS Evidence Lab survey points to an **ongoing moderate recovery in Eurozone investment**: a net +11% of companies indicated that they plan to increase investment over the coming 12 months (33% planning to invest more, 23% less). This marks an improvement from our UBS Evidence Lab survey at the beginning of 2016, when the net balance was +7%. **This is an encouraging result**, particularly when considering that our latest UBS Evidence Lab Survey was conducted between 5 July and 8 August, and hence after the UK vote to leave the EU.

The initial reaction of Eurozone corporates to the UK vote to leave the EU was relatively measured…

After the UK vote, we cut our Eurozone GDP forecasts to 1.5% (from 1.6%) for this year and 1.3% (from 1.7%) for 2017. This move was particularly based on the assumption that Eurozone corporates would accelerate investment spending by much less than previously assumed (just 2.7% in 2016 and 1.8% in 2017). However, our UBS Evidence Lab Survey suggests that at least the initial reaction among Eurozone corporates to the UK vote has been relatively measured – as has also been reflected in other data, such as the Eurozone PMIs. This is encouraging.

…but Eurozone corporates do not view the UK exit as a non-event: investment and hiring plans would likely be scaled back; some capacity would likely be pulled out of the UK, mainly into EU countries

However, our survey suggests that **Eurozone companies do not regard the UK's exit from the EU as a non-event**. Although 52% of the companies in our survey said that they did not anticipate any changes to their investment plans if it became clear that the UK would leave the EU, 27% said that they would reduce their investment spending "somewhat" and another 9% said they would envisage "significant" reductions. A similar picture evolved with regard to potential changes to corporate employment plans. Changes to corporate investment plans would come relatively quickly: more than half of companies indicated that they would react within less than a year. Among those Eurozone firms in our survey that have operations in the UK (484), 31% anticipate adjusting their UK capacity strongly negatively as a result of the UK exit from the EU. And more than 80% of that relocated capacity would go to the EU. Sure, the UK exit from the EU is bad news for the EU itself, but some aspects – such as the likely relocation of investment from the UK to the EU – would deliver a benefit.

Investment plans and employment plans are positively correlated across countries, sectors and firm sizes – suggesting that capital and labour are not substitutive, but complementary. In other words, where investment plans are positive, employment plans tend to be positive, too.

Big country-specific differences

As before, our UBS Evidence Lab survey has produced noteworthy differences at the country level.

Spain still strong; Italy moderating; Germany improving; France weak

Our survey results remain encouraging for **Spain**, supporting the view that the momentum of the Spanish recovery should remain decent. We forecast 2.8% GDP growth for this year and 1.9% for 2017 – which marks a deceleration, but nevertheless a growth rate well in excess of Spain's potential output growth rate of 1.3% p.a. The net balance of Spanish companies planning to invest more (rather than less) over the coming 12 months is firmly positive, at 18%, up from 11% in January 2016. Corporate employment plans in Spain remain fairly encouraging, too, with a net 52% of companies reporting that they want to create more jobs, up from 31% in January 2016. This gives us greater confidence that Spanish unemployment – still at a rather high 19.9% in June – will continue to fall over the coming quarters, with positive implications for economic activity.

Growth momentum in Spain still appears to be strong

Compared with six and 12 months ago, our UBS Evidence Lab Survey results for **Germany** have shown further improvement. The net number of corporates planning to invest more rose to 14% from 6%, while the net number of those planning to hire again rose to 17% from 14%. This is an encouraging sign. After all, the ongoing global uncertainties and concerns related to the UK vote to leave the EU could have knocked sentiment in the highly export-dependent German corporate sector a lot more. Also, German corporates enjoy good pricing power and (moderately) improving profit margins. We expect German GDP growth of 1.4% in 2016 and 1.1% in 2017.

Attitude towards investment and hiring has further improved among German corporates

Corporate responses from **Italy** have clearly cooled. The UBS Evidence Lab survey suggests that corporate investment plans have moderated to a net balance of +10% from +14% six months ago and +17% a year ago. Meanwhile, the net balance of corporates that want to create more employment has narrowed further, to +2% from +4% in early 2016 and +25% a year ago. We see these developments as related to the challenges in the Italian banking sector. We forecast just 0.9% GDP growth for both this year and 2017. The outlook for pricing power over the next 12 months is negative.

Investment and employment prospects among Italian corporates have weakened

The UBS Evidence Lab Survey results for **France** remain subdued. Although not quite as negative as six months ago, corporates continue to signal a negative attitude towards investment. The picture on employment has improved, however, with a net positive balance of 10% of French corporates signalling that they anticipate increasing staff levels over the coming 12 months, up from -2% at the beginning of 2016. The pricing power of French corporates is weak and profit margins are under pressure: both are the weakest of the four countries. We forecast 1.4% GDP growth for both this year and 2017.

Investment appetite remains weak in France, but attitude towards hiring has improved

Credit recovery to remain moderate

Similar to the results we obtained in August 2015 and January 2016, the latest UBS Evidence Lab survey suggests that the credit recovery is likely to remain subdued. Asked about their expected funding structure over the coming 12 months, Eurozone corporates indicated that existing cash buffers and retained earnings would play the dominant role, at 40%, compared with bank credit at 28%.

Survey results suggest that the *relative* importance of credit in overall investment funding will not pick up quickly

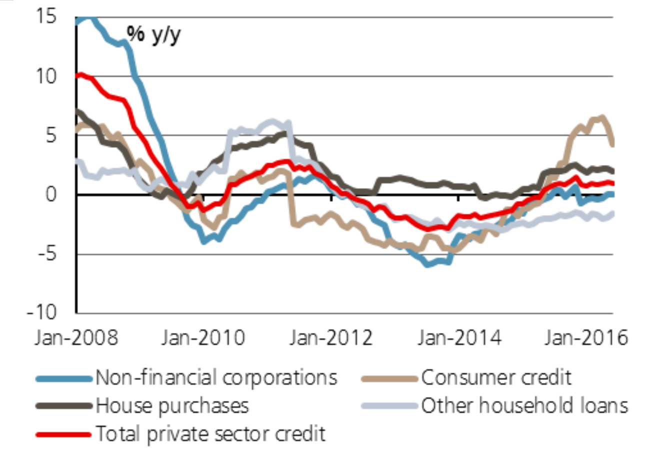
But these results need to be put into perspective. Firstly, while it is true that corporate credit has not yet reached significantly positive growth rates, the situation is a lot better than in 2013/2014, when the stock of credit contracted substantially. Also, consumer credit and mortgages are developing better than corporate credit, which also explains why overall private-sector credit growth is

positive. Second, despite some headwinds, supply and demand conditions for credit are improving, as has consistently been shown by the ECB's Bank Lending Surveys over the past two years. Admittedly, though, these improvements are coming from a relatively low base. Thirdly, even if the biggest share of corporate investment was to be funded by retained earnings for the time being – with bank credit playing a more minor role – there should still be plenty of room for credit to grow in *absolute* terms if investment continues to recover.

All in all, we come to the same conclusion that we drew after our previous surveys: that the recovery in credit is likely to continue, but at a gradual pace.

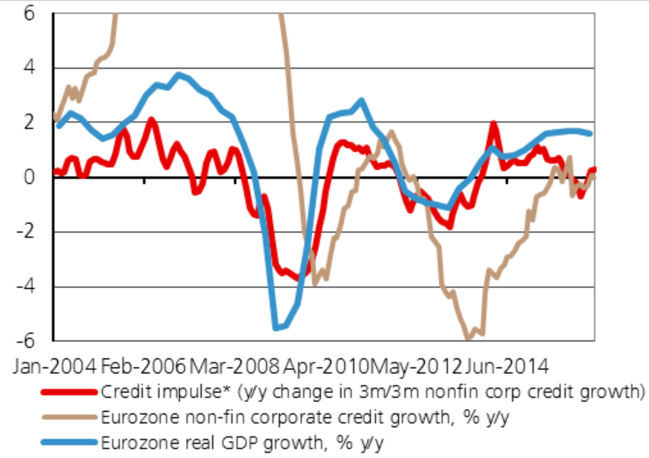
Credit to continue to recover, but probably not very aggressively

Figure 11: Eurozone private sector credit growth, % y/y



Source: Haver, UBS

Figure 12: Credit impulse* and GDP growth



Source: Haver, UBS. *Credit impulse: y/y change in q/q credit stock growth, where credit stock measures total outstanding nonfinancial corporations credit.

SMEs remain under pressure

A recurring theme of this series of UBS Evidence Lab surveys has been that responses from the SME sector remain subdued, and more cautious than those from large companies. Appetite to invest and hire is again softer among SMEs than at larger firms. Pricing power and profit margins are weaker. SMEs have enjoyed less substantial improvements to funding than have larger companies. Also, SMEs tend to be less interest rate sensitive, which suggests that the ECB's efforts to drive down interest rates has affected SMEs less positively than larger companies. This is a sobering conclusion, given that SMEs play such an important role in the European economy – contributing almost two-thirds to employment and almost 60% to value added.

The recovery of the SME sector continues to lag that of larger companies

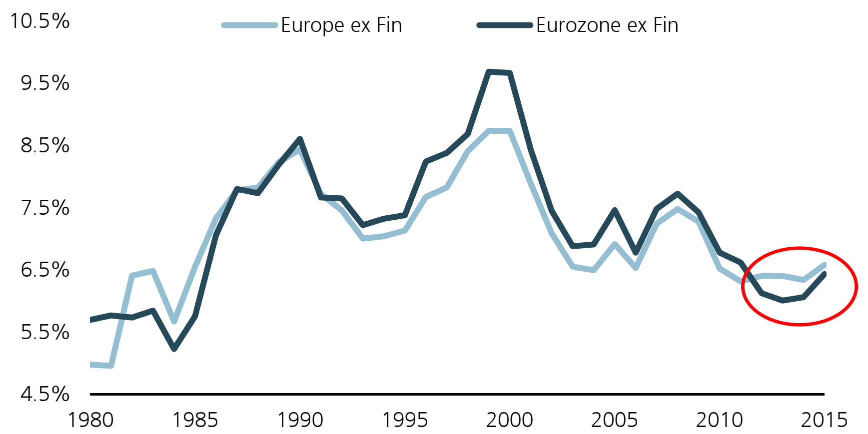
Key implications: European Equities

Investment intentions pick up modestly – but still subdued

Corporate investment intentions pick up modestly: On our comparable sample of 660 companies a net +11% expect to increase capex over the next 12 months – this is slightly up from the net +7% in our February 2016 survey. This fits with continued stabilisation in the Eurozone macro backdrop and the historic World scope data which shows capex/sales in the Eurozone bottoming out from c.30-year lows. But there is a big split at a country and sector level: Spain and Germany with the highest intentions, France the lowest. The 3 super-sectors (Consumers, Industrials, Materials) are now all evenly balanced – but this masks a sharp move up for Industrials and Materials. Indeed, over the last year the net balance of Materials companies intending to increase investment has risen from -24% to +9%.

As Capex/sales for the Eurozone picks up from c.30-year lows

Figure 13: Eurozone Capex/Sales: Just picking up from a c.30-year low…



Source: Thomson Datastream, Worldscope

Outlook for Profits and Pricing Power: best in Germany, Spain and for Consumers….

…but pricing power outlook is improving in Materials (-17% to -2%)

What is the outlook for Profits and Pricing Power? At an aggregate level, there is little expectation of improving pricing – a net 3% expected pricing power over the next 12 months (slightly up on February). But there was a big spread, with German companies expecting the best pricing (net +27%, up sharply from +12% in February) and **France** the worst (net -28%). Pricing power outlook has also improved in **Materials:** from -17% last time to -2% now.

We combine this with the outlook for corporate profitability (which correlates closely), and conclude that **Germany**, **Spain** and **Consumer** stocks are best placed.

Importantly, much of our survey refers to non-listed companies – the larger companies that were more likely to be listed had significantly stronger pricing power and margin outlook.

Technology is the biggest driver of capex spend

Technology driving capex: "Shifts in technology" was the biggest positive driver in our survey, with a net 54% of companies claiming it was a positive factor for capex. **Autos** capex is set to increase from €32bn in 2015 to €35bn in 2016 and much of it should be driven by the technological trends in the industry, such as autonomous driving and digitization. We believe that companies such as **Valeo** are likely beneficiaries. Within **General Retail**, John Lewis has commented that IT

spend has risen tenfold in the last 10 years. Even in **Utilities** there is a push to new technology such as renewables businesses with those more exposed likely winners.

Size matters: the gap gets even bigger. Throughout the survey SMEs fare worse than their larger peers in pricing power, profitability and capex intentions. Since our last survey, the gap between the smallest and largest companies on investment intentions has widened significantly: large companies have become even more constructive (+23% to +29%) and small firms remain stuck in negative territory. Indeed, since our first survey last August the gap in percentage points between the two has more than doubled from 15 to 32 percentage points.

The gap between the SMEs and the larger companies' investment intentions has doubled over the last year

Whilst this clearly has implications for the broader macro backdrop, the direct impact on the European market is likely to be muted. The SMEs in our sample have annual turnover of below €100m compared to an average of €2.2bn for the bottom decile of the Stoxx 600 index. So the vast majority of these SMEs are very likely to be unlisted. Indeed the large companies appear to be turning, but it has not yet filtered through to the small ones.

Listed companies are doing much better than non-listed

China, EM and Exports – starting to improve: The big change since our last survey has been that China, Exports and Emerging Markets more become a more supportive driver for European companies' capex. It is worth bearing in mind that our last survey was in February around the market low when China hard-lading fears were at a peak. Since then, EM currencies have risen and EM PMIs stabilised. This backs up our bottom-up data on earnings momentum which shows that European companies with high EM exposure are finally seeing more upgrades than the wider market.

China, EM and Exports are becoming more supportive for capex

Sectors and Stocks

If we were to see a pick-up in European capex, which sectors would likely benefit? Cap Goods, Banks and Autos are all positively correlated to a pick-up in the capex cycle. Banks tend to perform well as the credit cycle and investment cycle usually tend to be joined, although that could be different this time as we see the relatively large "self-funding" by companies in our survey data. We recently downgraded the Cap Goods sector from Overweight to Neutral – but this was in part driven by relative performance at an 8 year high and the dividend yield relative at a 5 year low. (*For more details please see*: Sector Score-Card: Repositioning post-referendum 11 July 2016). Nonetheless, there are stocks within the sector which could still be key beneficiaries and our analysts see as attractive, such **Legrand** and **Hexagon**. Elsewhere in Auto parts, **Valeo** is likely to be a beneficiary alongside **Atos, Capgemini** and **Indra** in Software and Services. Please see the full table in Figure 3.

We see some specific stocks that are likely to benefit from a pick-up in capex and investment…

…such as Valeo, Legrand and Hexagon

What are the catalysts to look out for? For a stronger support to capex we would look for a turn in European corporate profitability – given the close link between corporate profit margins and investment. We would also need to see continued improvement in the macro backdrop and economic lead indicators and increased capacity utilisation. Maybe the most important catalyst would be if companies' share prices started to react positively to capex announcements and investors rewarded companies for making increased investment plans.

How have capex plans changed since early 2016?

Are Eurozone corporates planning to expand investment?

The first questions in the UBS Evidence Lab survey aim to assess how the corporate investment climate is evolving. We asked the 660 companies whether they planned to increase, or decrease, their capex over the next 12 months. The exact question allowed for degrees of increase ("somewhat greater" and "significantly greater") and decrease – see Figure 14.

Net balance of companies planning to increase capex has risen to 11% from 7% in early 2016

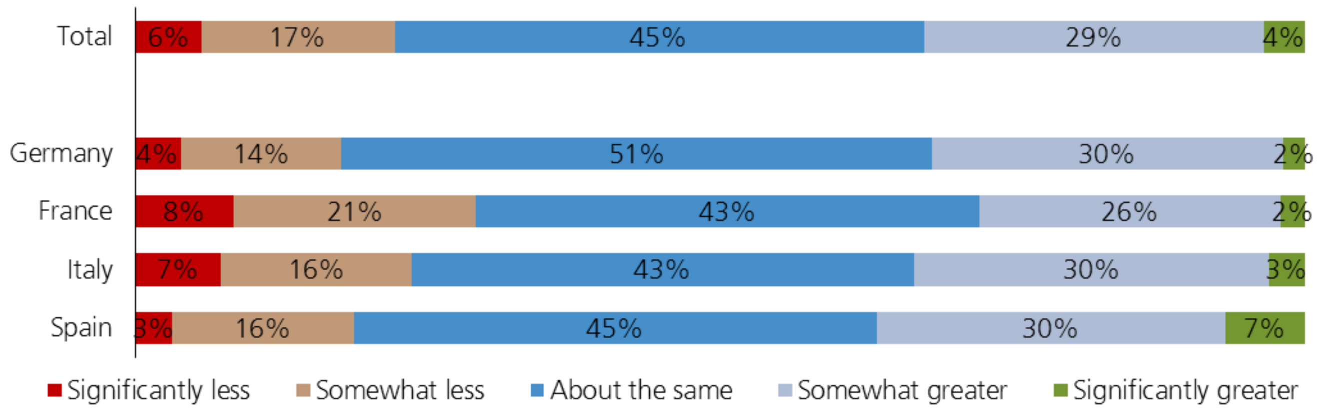
At a headline level, 33% of the corporates responded that they are planning to increase investment, compared with 22% that are planning reductions. This implies a net positive balance of 11%, which constitutes an improvement from 7% in our survey from early 2016 (Figure 17).

Country trends

Investment appetite strong in Spain; solid in Germany; moderating in Italy; weak in France

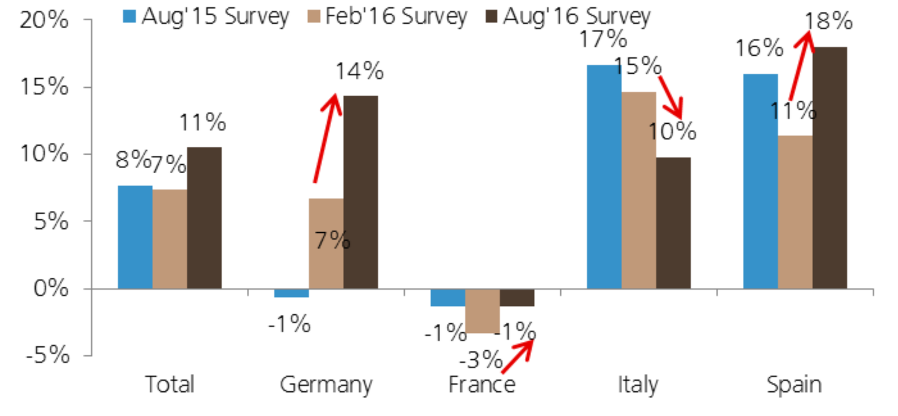
As in our previous survey, the aggregate net balance masks interesting country- and sector-specific details. The attitude to investment remains firmly positive in **Spain**, with a rather strong net positive balance of 18% (37% vs. 19%), an improvement from 11% in our survey from early 2016. **Germany** has also seen an improvement to +14% from +7% six months ago. In contrast, a moderation is visible in **Italy**, where the net balance has cooled off from +15% in early 2016 to +10% in August. We think this development might also be related to the problems in the Italian banking sector. Investment appetite remains weak in **France**, where more companies plan to reduce investment than plan to invest more, at a net balance of -1%. It is of little comfort that this figure is not quite as bad as the -3% balance that emerged from our survey in January (Figure 17).

Figure 14: COUNTRIES: Total expected investments in coming 12 months compared to past 12 months



Source: UBS Evidence Lab

Figure 15: COUNTRIES: Change in net percentage of firms planning to increase capex in next 12 months



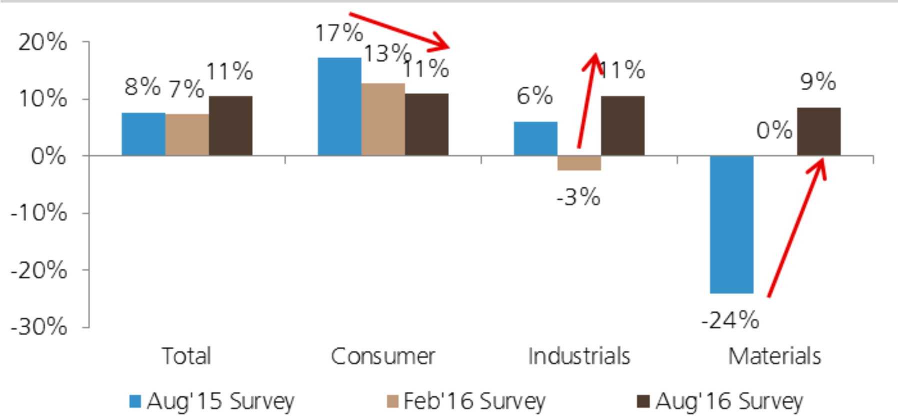
Source: UBS Evidence Lab

Sector trends

Compared with the surveys we conducted six and 12 months ago, sector-specific differences have largely disappeared, with net positive balances in a fairly tight range of 9-11%. Investment appetite in the materials sector – which was depressed a year ago and weak six months ago – has recovered strongly towards a net balance of +9%. Net investment appetite in the Industrial sector, which was still negative six months ago, has also improved a lot (+11%), and has even moved level with the Consumer sector (+11%), which led the race by a significant margin in our past surveys. The recovery of investment appetite in Materials and Industrials is an encouraging sign, indicating that corporates' concerns over depressed commodity prices and business cycle risks from China are receding (Figure 16).

Big recovery in investment appetite in industrials and materials; consumers moderating

Figure 16: SECTORS: Change in net percentage of firms planning to increase capex in next 12 months



Source: UBS Evidence Lab

Our Heatmap in Figure 17 shows key results for countries and sectors since February 2016.

Figure 17: Net percentage of firms expecting to increase capex over next 12 months

	Germany	France	Spain	Italy	Total	Change vs Feb'16
Consumer	12%	6%	20%	5%	11%	-2%
Industrials	17%	7%	12%	5%	11%	13%
Materials	13%	-32%	20%	25%	9%	9%
Total	14%	-1%	18%	10%	11%	3%
Change vs Feb'16	8%	2%	7%	-5%	3%	

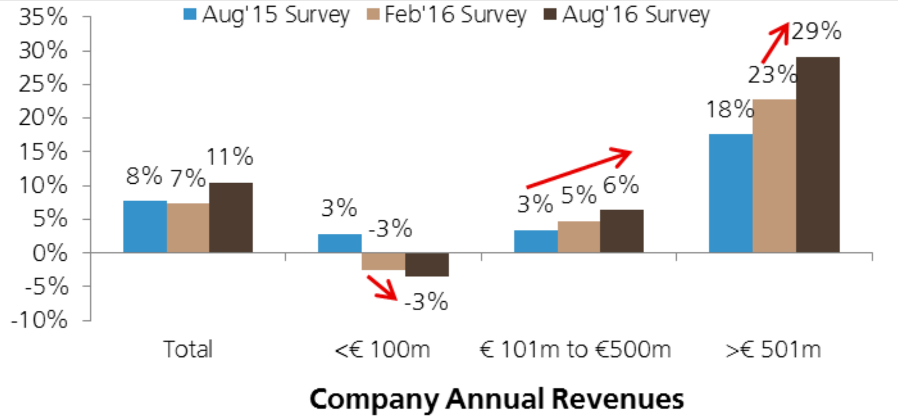
Source: UBS Evidence Lab

Results according to company size

Investment appetite among SMEs still weak; gap between small and large firms is getting wider

Our previous surveys showed that investment appetite in the SME sector remained subdued compared with larger firms. Has this changed? Unfortunately not. Among SMEs, the number of firms planning to reduce investment continues to outweigh the number planning to increase investment; the net balance of -3% is largely unchanged from early 2016. In contrast, investment appetite has slightly strengthened at larger corporates (from +5% to +6%) and has strengthened further among very large companies (from +23% to +29%). The gap between the smallest and largest companies thus continues to widen (Figure 18).

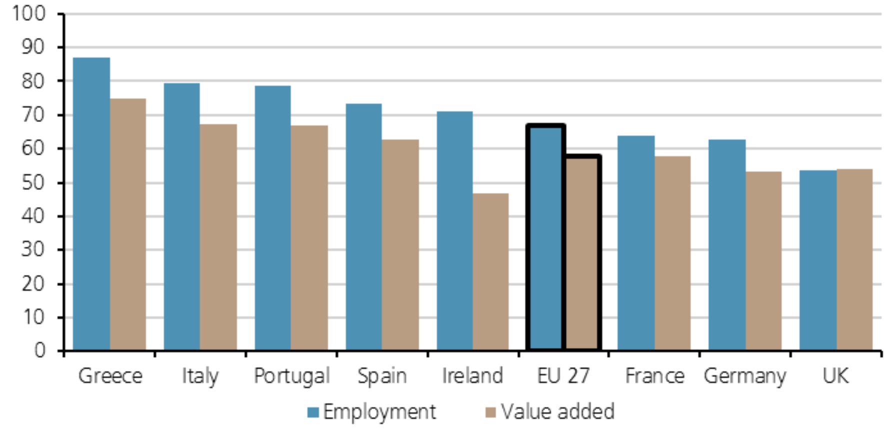
Figure 18: Net percentage of companies planning to increase capex – the gap between small and large companies continues to widen



Source: UBS Evidence Lab

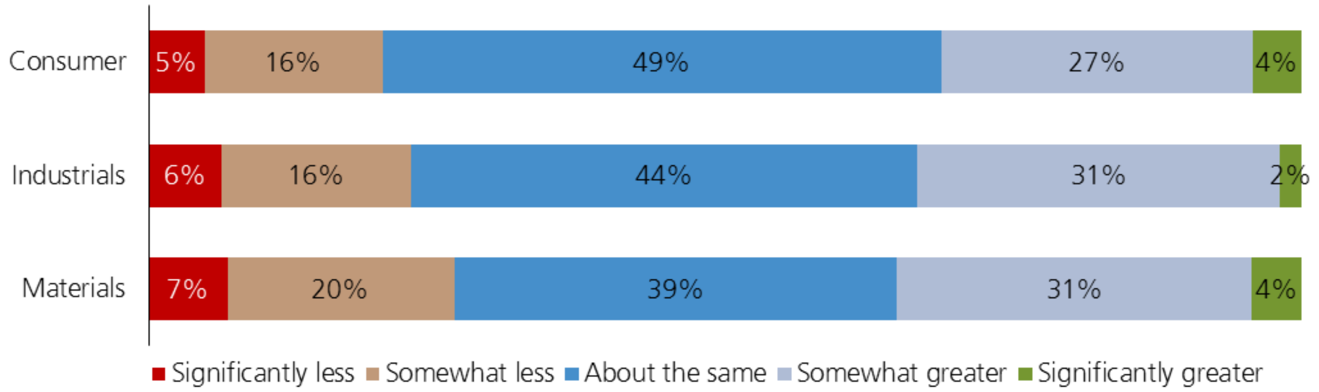
Considering the crucial role that SMEs play in the Eurozone economy (they essentially account for 60% of Eurozone GDP and 66% of employment, Figure 19), this trend is disappointing. The *direct* impact on the stock market, however, should be limited, given that companies below €100m of revenue are almost all unlisted.

Figure 19: SMEs' share in the economy, 2014



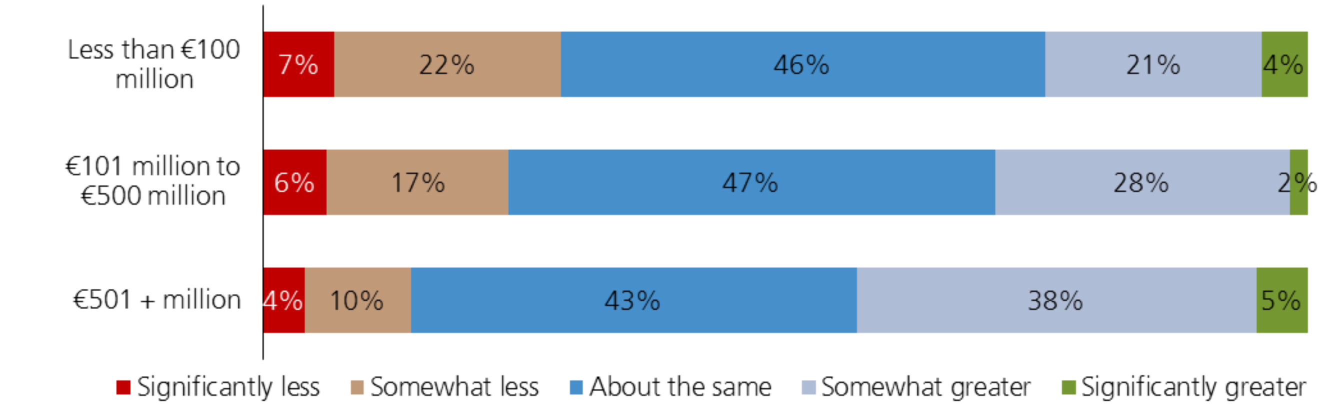
Source: http://ec.europa.eu/growth/smes/business-friendly-environment/performance-review/index_en.htm#sba-fact-sheets, European Commission, UBS. The European Commissions' definition of SMEs (≤ €50mn turnover) is somewhat more restrictive than our own (narrower than our own) which is ≤€100mn.

Figure 20: SECTORS: Total expected investments in coming 12 months compared to past 12 months



Source: UBS Evidence Lab

Figure 21: SIZE: Total expected investments in coming 12 months compared to past 12 months



Source: UBS Evidence Lab

How will Eurozone companies respond to the UK vote to leave the EU?

Our latest survey was conducted between 5 July and 8 August, which gave us an opportunity to ask companies to share their early assessment of how they might react to an exit of the UK from the EU.

How will the UK vote affect Eurozone firms' investment plans?

In the first question, we asked: "If it becomes clear that the UK will leave the EU, how will this affect your company's total intended investment plans?"

At the aggregate level, 52% of the companies responded that they expected no change. However, 27% anticipated reducing their investment plans "somewhat" and 9% "significantly". The reaction of German companies seems more sanguine than that of French, Italian and Spanish companies, with 64% of the former expecting no change in investment plans (Figure 22).

27% of companies say they would reduce investment plans "somewhat" and 9% "significantly" if it became clear UK would leave EU

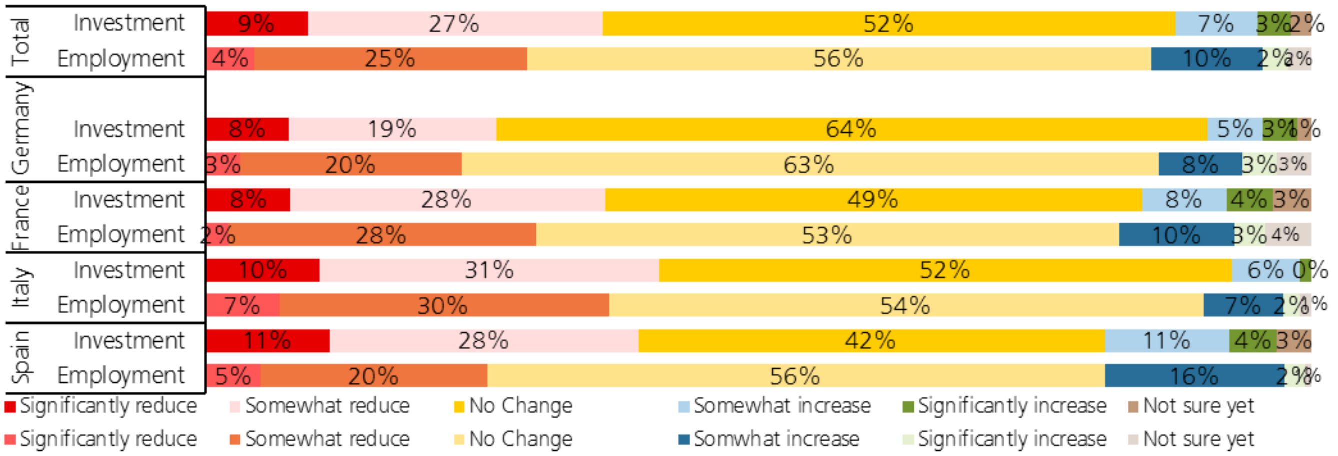
On a sector basis, companies in the Materials sector seem likely to respond more than firms in the Consumer and Industrial spaces: an aggregate of 46% of materials companies expect to reduce investment "somewhat" or "significantly" – more than industrials (27%) and consumers (32%) (Figure 23 next page).

How about employment plans?

Firms' intentions to change their employment plans as a result of a UK exit closely mirror their investment plans. At the aggregate level, 56% of the companies expect no change. However, 25% anticipate reducing employment plans "somewhat" and 4% "significantly". Once again, the reaction of German companies seems more sanguine than that of French, Italian and Spanish companies, with 63% of German firms expecting no change in employment plans. In terms of company size, very large companies anticipate adjusting their staffing levels by more than do companies in the two smaller categories. Little difference emerges at the sectoral level.

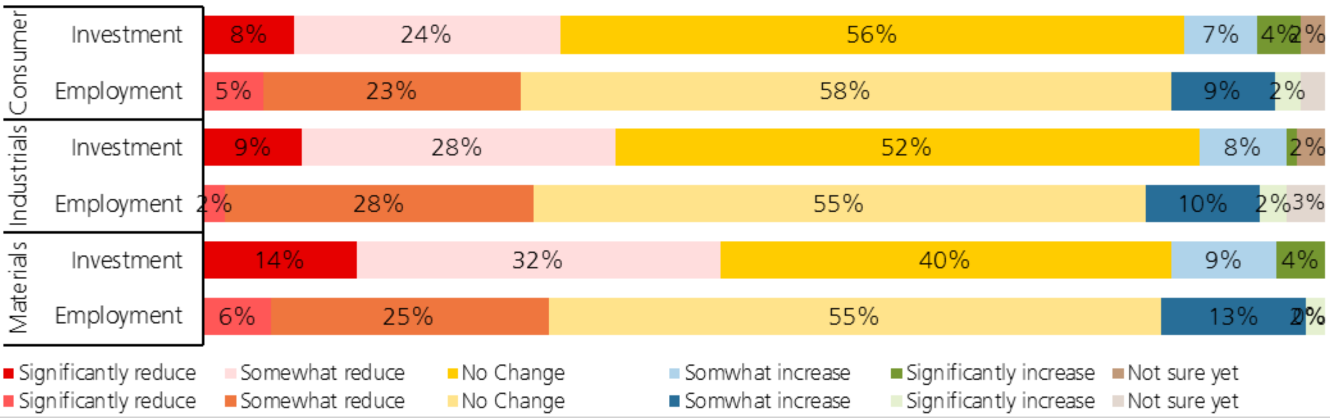
29% of companies expect to reduce employment if it became clear that the UK will leave the UK

Figure 22: COUNTRIES: How will companies adjust investment and employment as a result of a UK exit from the EU



Source: UBS Evidence Lab

Figure 23: SECTORS: How will companies adjust investment and employment as a result of a UK exit from the EU



Source: UBS Evidence Lab

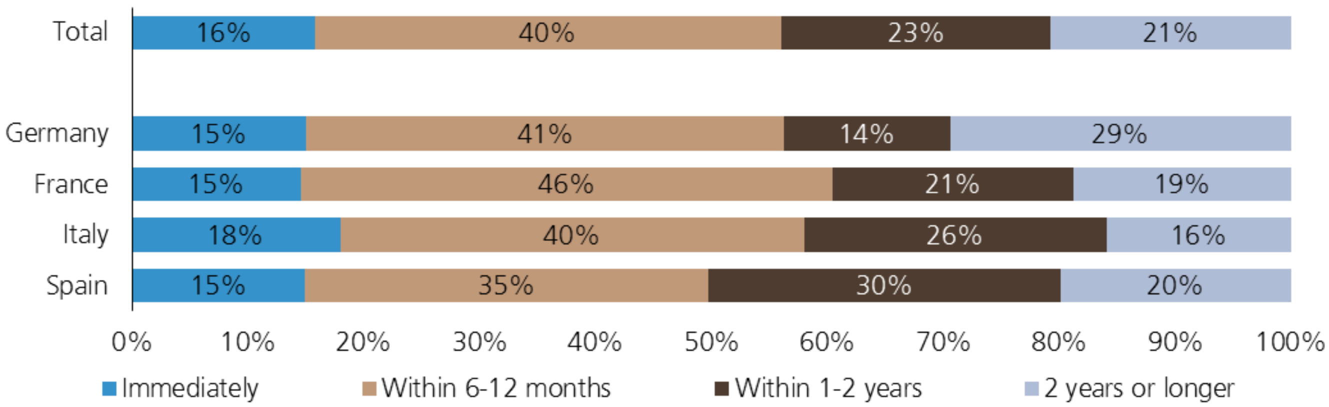
How quickly will companies change their investment plans?

Many companies – around 40% in aggregate – reported that they expect to amend their investment plans within 6-12 months if it becomes clear that the UK will leave the EU. Around 16% said they would even respond immediately. Hence around 56% of Eurozone firms in our survey anticipate responding quite quickly to the UK referendum vote to leave the EU.

More than half of companies would adjust their investment plans within a year

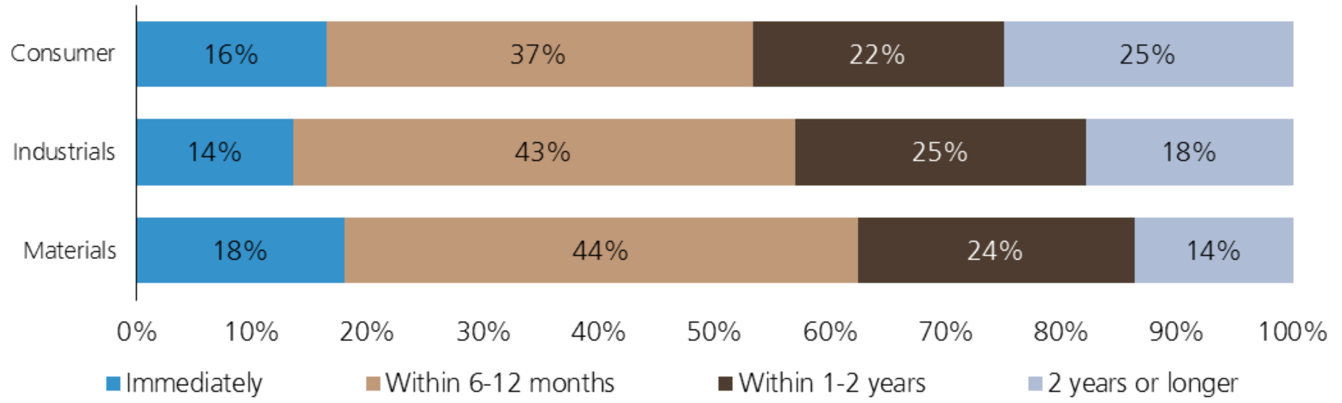
Spanish companies seem to be reacting a bit more slowly than their German, French and Italian peers. From a sectoral point of view, Materials companies anticipate a faster reaction than do Industrials or Consumer companies. And SMEs seem to be reacting more slowly than larger companies – understandable given their typically lower export orientation (Figure 24 - Figure 26).

Figure 24: COUNTRIES: How quickly will companies change their investment plans as a result of a UK exit from the EU?



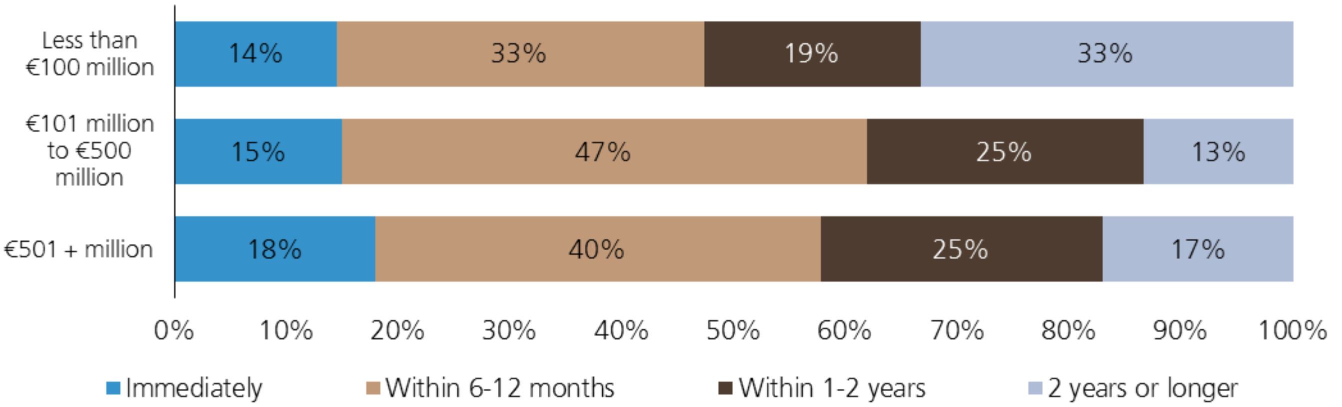
Source: UBS Evidence Lab

Figure 25: SECTORS: How quickly will companies change their investment plans as a result of a UK exit from the EU?



Source: UBS Evidence Lab

Figure 26: FIRM SIZE: How quickly will companies change their investment plans as a result of a UK exit from the EU?



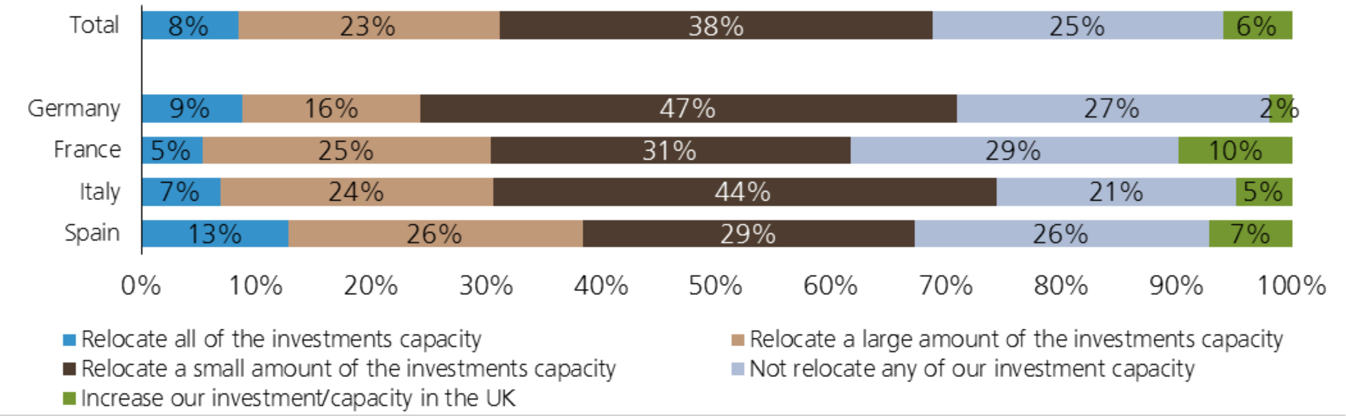
Source: UBS Evidence Lab

How much capacity will Eurozone firms more away from the UK?

Among the 660 companies in our survey, only 73% (or 484) have operations in the UK. Of these, 8% said that they would relocate all of their capacity away from the UK in the event of a UK exit from the EU. 23% responded that they would remove "a large amount". Hence an aggregate 31% of the Eurozone firms represented in our survey anticipate adjusting their UK capacity strongly negatively as a result of a UK exit. At a country level, the anticipated negative reaction of German companies seems relatively measured, while the reaction of Spanish corporates seems relatively strong. Some 27% of the companies we surveyed do not have operations in the UK.

31% of Eurozone companies would reduce their UK capacity strongly

Figure 27: How much capacity are Eurozone companies likely to pull from the UK as a result of the UK exit?



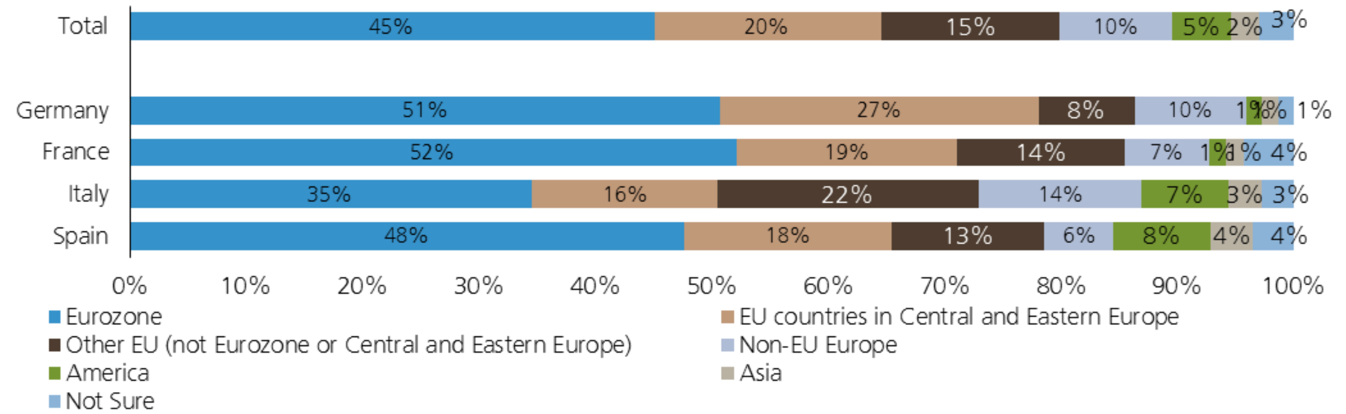
Source: UBS Evidence Lab

To <u>where</u> would firms move their investment/capacity from the UK?

Some 45% of the companies in our survey said that, should they pull investment and capacity out of the UK, then this would go to the Eurozone; another 20% referred to EU countries in Central and Eastern Europe (CEE), 15% to other EU countries (not Eurozone or CEE). Less than 20% would go elsewhere (Non-EU Europe, Americas, Asia) (Figure 28).

Around 80% of capacity relocation from the UK would go to the EU

Figure 28: To where would Eurozone companies shift the capacity that has been in the UK so far?



Source: UBS Evidence Lab

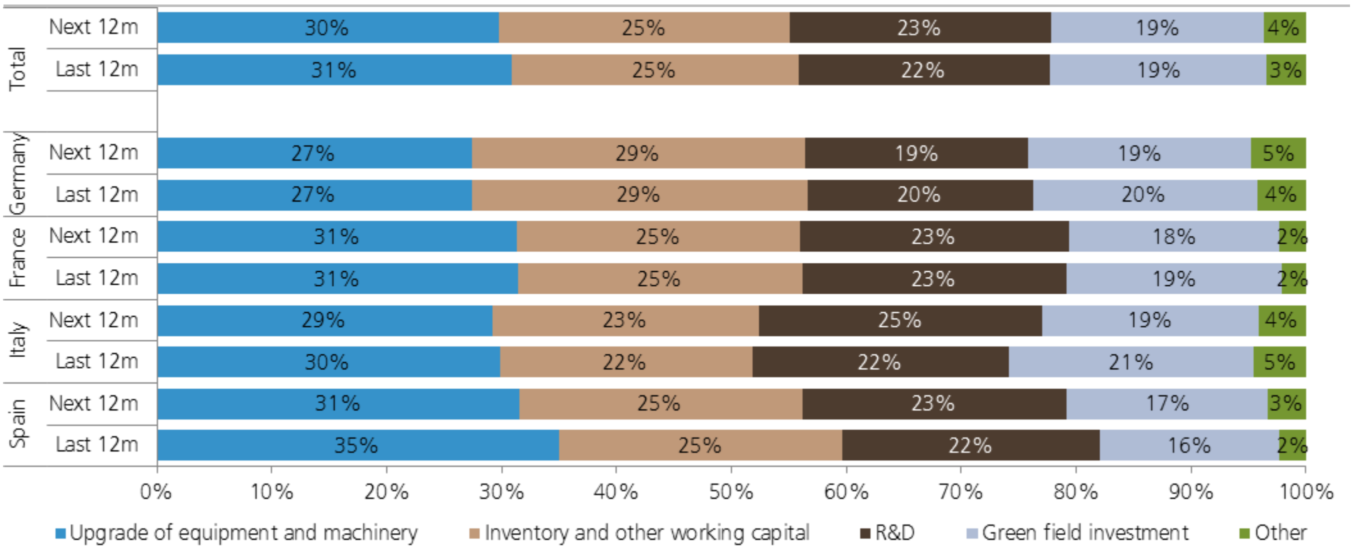
What are companies going to invest in?

Our UBS Evidence Lab survey also examines what *type* of investment is likely to be the focus for corporates. Looking back over the past 12 months, the majority of investment was oriented towards "upgrading equipment and machinery" and "inventory and working capital". Greenfield investment and R&D were much lower.

What *type* of investment are companies planning to make?

We asked the same question looking ahead to the next 12 months. There is little change to the outcome: maintenance-based investment continues to take priority over "new" investment in Greenfield and R&D.

Figure 29: COUNTRIES: What type of investment: past 12 months vs. coming 12 months

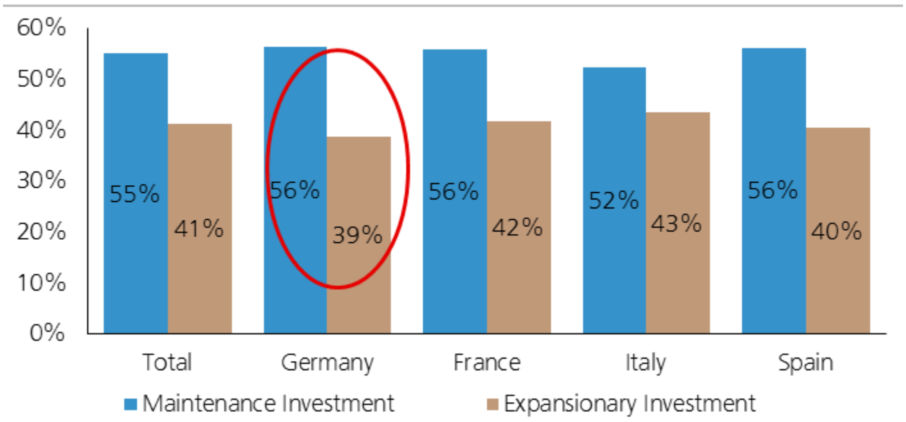


Source: UBS Evidence Lab

We can add together the responses for "upgrade equipment" and "inventory" and broadly bracket them as "maintenance" style capex. Likewise, "Greenfield investment" and "R&D" strike us as "expansionary" capex. Taking the two together provides some interesting results. At the country level Germany has the highest gap between maintenance investment and expansionary investment.

Germany: more focused on maintenance style investment

Figure 30: COUNTRIES: Expected split by type of future investment

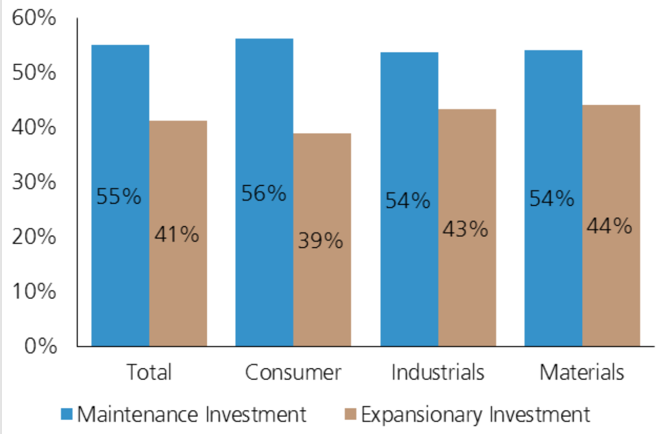


Source: UBS Evidence Lab

At the sector level, Consumers appear to be focussing more on maintenance-type investments. When we split the sample by company size there is clear ascending order: the larger the company the higher the share of Greenfield and R&D in planned investment.

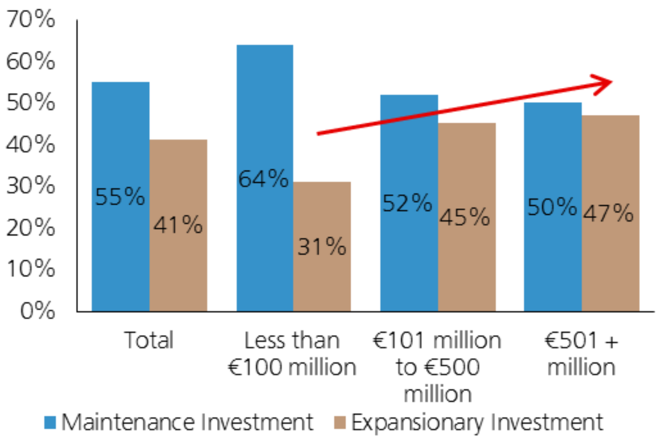
Consumers are more focussed on maintenance capex. Larger companies to do more Greenfield and R&D

Figure 31: SECTORS: Expected type of future Investment



Source: UBS Evidence Lab

Figure 32: FIRM SIZE: Types of future Investment



Source: UBS Evidence Lab

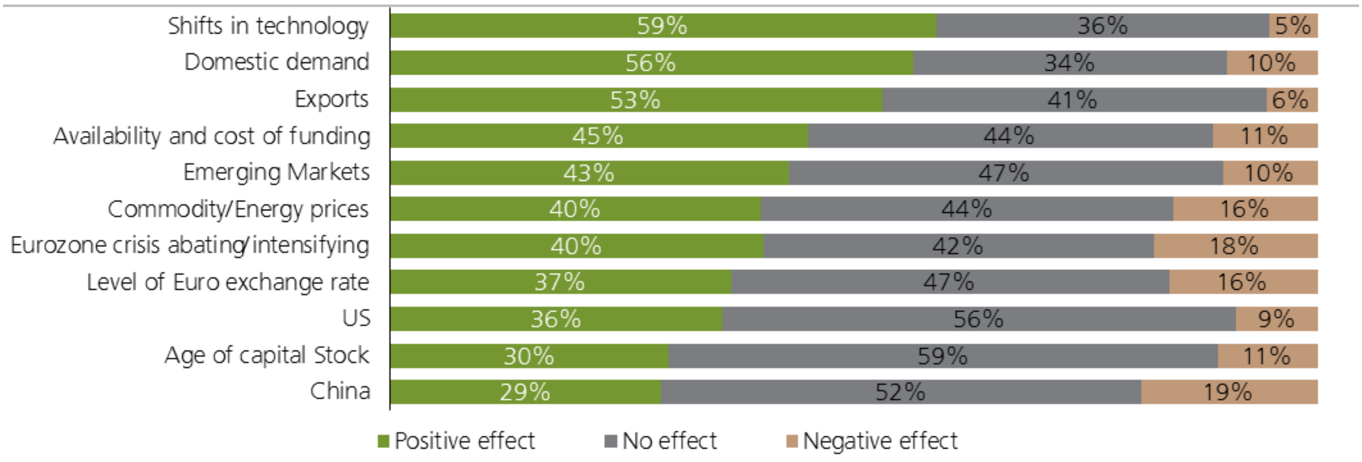
In our view, the preference for maintenance-style capex is a function of (a) the early stage of the (investment) recovery, where corporates act more cautiously, (b) the lingering doubts about the sustainability of the global recovery, and hence corporates' hesitancy to add substantial capacity, and (c) the lack of investment over the last couple of years, which increases the importance of maintenance capex to keep on operating with a more mature capital stock. Nevertheless, maintenance investment is still a contributor to the recovery.

What are the key factors driving capex decisions?

According to our UBS Evidence Lab survey results, the biggest positive factor driving capex is **shifts in technology**. This highlights the ongoing pressure companies face from disruptive technology and new entrants (such as e-commerce and end-customer disintermediation). It may also be a reflection of attempts to gain market share in a world where the total "pie" is only growing very slowly, if at all.

"Shifts in technology" is the biggest positive driver for capex…

Figure 33: Factors affecting companies' investment strategy



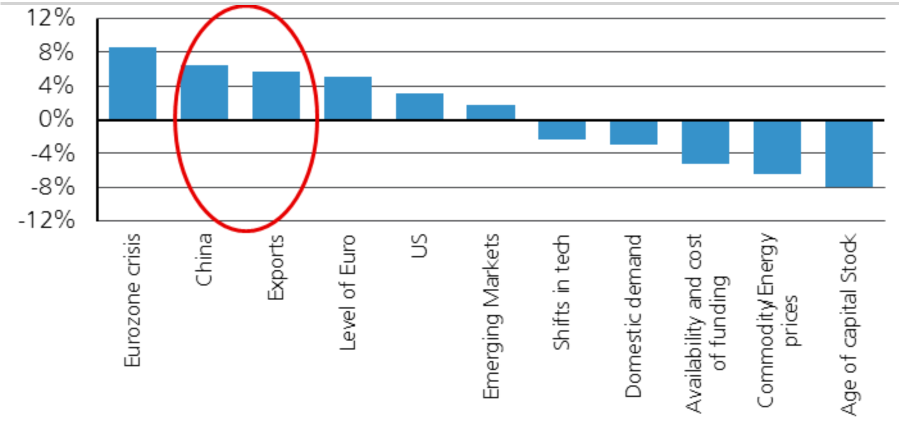
Source: UBS Evidence Lab

Changes since last report: What's going up and what's going down?

The big change since our last survey has been that the Eurozone crisis is seen as abating further – this went from a net small net positive of 14% in February to +23% now. Clearly the improvement post the Eurozone debt crisis is allowing companies to consider more investment. Additionally, the external backdrop is perceived to be improving with China, exports, US and Emerging markets all seen as more positive factors now than six months ago. Investors often question us about the potential headwind from the level of the Euro – but this seems a bigger net positive for corporates investment than six months ago. We would note that year to date the trade-weighted Euro is roughly flat year on year.

The age of capital stock is still a net positive driver but down to +19% from +27%. Availability and cost of funding also marginally deteriorated as a driver.

Figure 34: Change in net positive driver: February 2016 – August 2016 (ppt)



Source: UBS Evidence Lab

The exit from the Eurozone crisis is helping boost investment…

External factors such as China and exports are also improving drivers

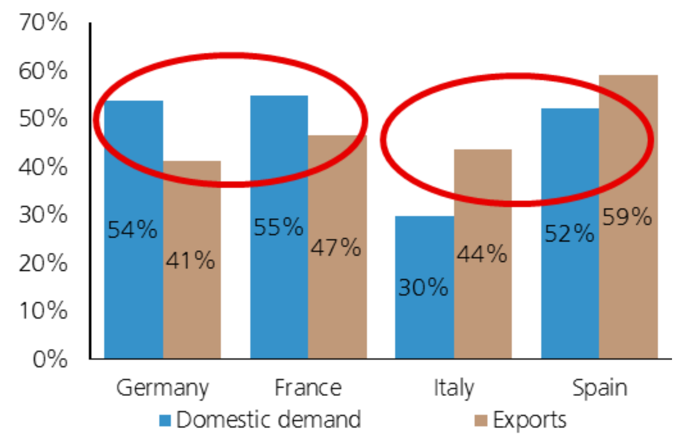
Countries: At the country level, domestic demand is the biggest driver for Germany and France. But for Italy and Spain it is exports. Domestic demand is noticeably the weakest in Italy and this has fallen since our last survey – from +39% to +30% (Figure 35).

German companies see domestic demand as a large positive factor…

…in Italy domestic demand is much weaker and falling sharply since our last survey: +39% to +30%

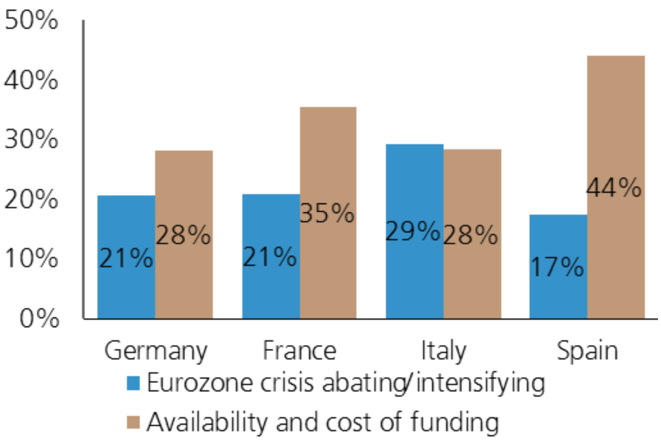
The abating Eurozone crisis is now seen as a positive factor for investment for all countries. But it has swung from a drag to a tailwind for France since our last survey: -14% to +21%. Likewise availability and cost of funding is also a support – particularly in Spain, but it has fallen in Italy and Germany.

Figure 35: COUNTRIES: Drivers for capex - domestic demand vs exports



Source: UBS Evidence Lab

Figure 36: COUNTRIES: Drivers for capex – Eurozone crisis and availability of funding



Source: UBS Evidence Lab

Investment funding: current structure and expected changes

In this section we look at how Eurozone corporates fund their investments and how the funding structure is likely to change going forward. Specifically, we also examine the role of bank credit in this context.

How do Eurozone corporates fund their investment?

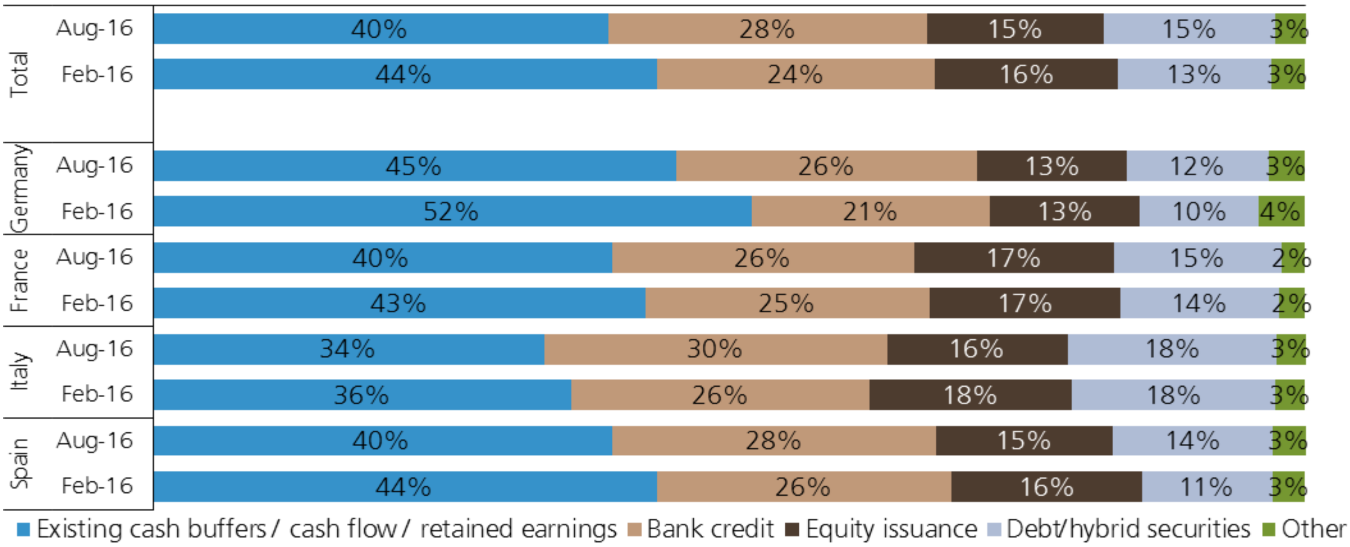
The results of our previous two surveys, six and 12 months ago, were somewhat sobering:

- Firms reported that **existing cash buffers and retained earnings** were the key source of investment funding, while **bank credit** was a distant second, followed by equity and debt issuance.
- Even more, firms indicated that they did *not* plan to use bank credit much more actively during the subsequent 12 months.

The picture hasn't changed much in our most recent survey. Retained earnings have remained the leading source of corporate investment funding over the last 12 months (38%), followed by bank credit (29%). For the coming 12 months, corporates expect the former source to go up to 40% and the latter to moderate to 28%. The survey results therefore do not suggest that corporates are likely to use bank credit much more aggressively over the coming quarters. However, looking at the details of the current and previous surveys, we note that the relative shares and dynamics of credit vis-à-vis existing cash flow / retained earnings are not quite as extreme as they were six and 12 months ago (Figure 37).

Existing cash buffers remain the dominant source of investment finance; bank credit less important – this trend is unlikely to change quickly

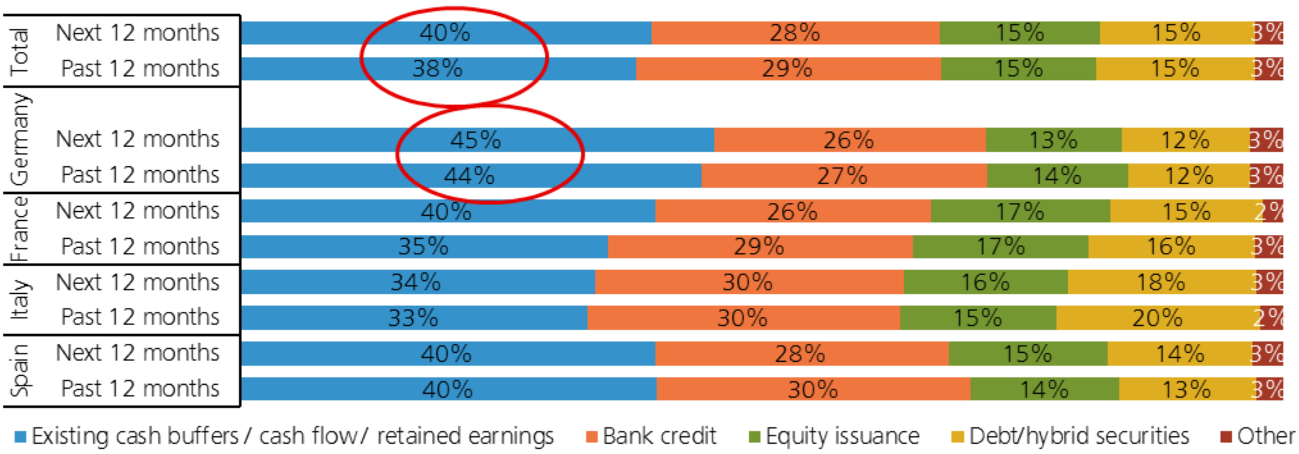
Figure 37:Funding of corporate investment over the next 12 months



Source: UBS Evidence Lab

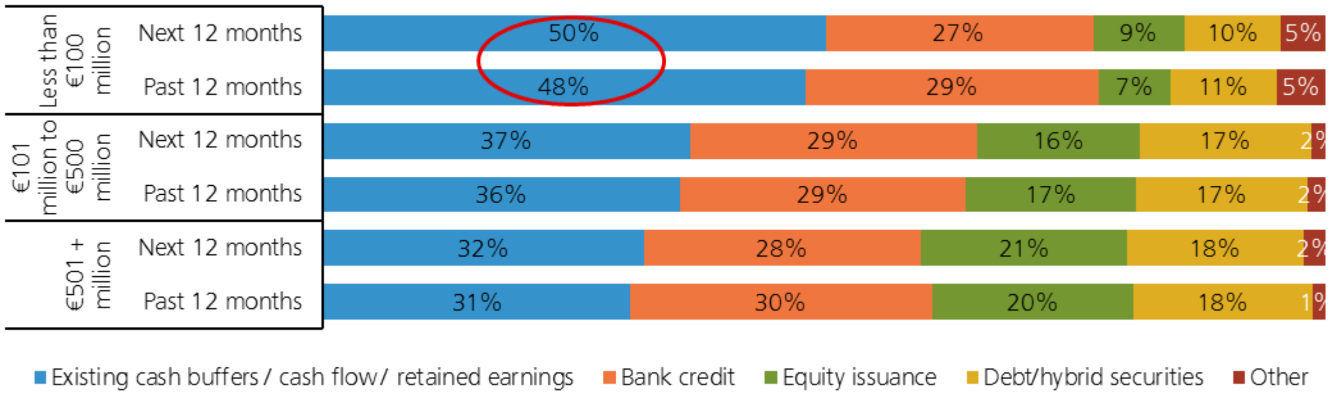
Reliance on cash buffers and retained earnings remains most pronounced in Germany (44-45%), and least pronounced in Italy (33-34%, Figure 38). As previous surveys have shown, companies' reliance on their own funds is also more pronounced in SMEs than in larger companies (Figure 39). On a sector basis, Consumer companies show the greatest reliance on cash buffers/retained earnings – well ahead particularly of Materials, which have a more balanced funding structure (Figure 40).

Figure 38: COUNTRIES: Corporate investment plans: past 12 months versus coming 12 months.



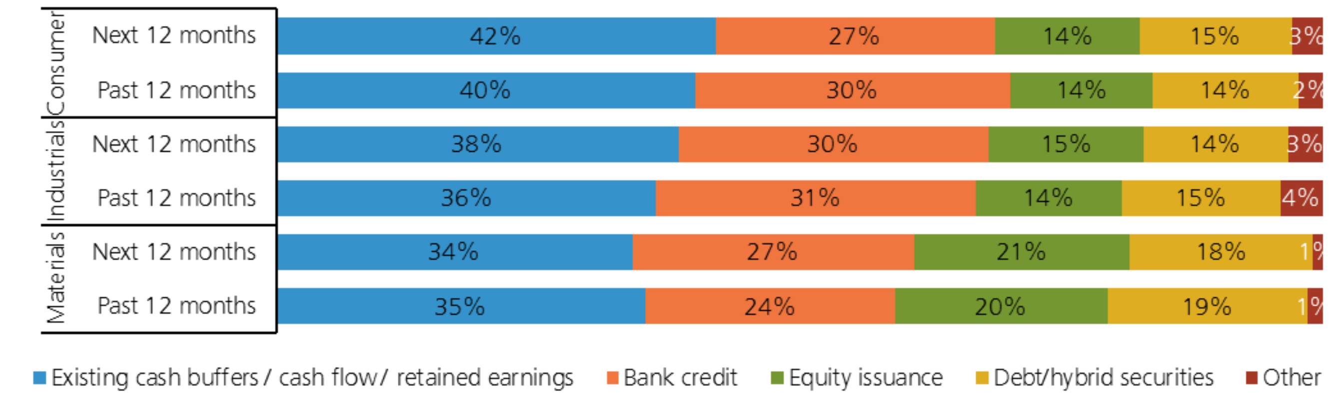
Source: UBS Evidence Lab

Figure 39: FIRM SIZE: Corporate investment plans: past 12 months versus coming 12 months



Source: UBS Evidence Lab

Figure 40: SECTORS: Corporate investment plans: past 12 months versus coming 12 months



Source: UBS Evidence Lab

Credit growth to pick up, but only gradually

When it comes to bank credit as a source of investment funding, how does our survey stack up against actual credit data and other credit surveys, such as the ECB's Bank Lending Survey? The sober picture that our three UBS Evidence Lab surveys over the past year have painted is vindicated by other data.

New survey backs conclusions of previous surveys: recovery in credit growth is likely to continue, but at a gradual pace

As Figure 41 shows, credit issued to non-financial corporations in the Eurozone (blue line) has hovered around zero for the last 12-18 months. While this might appear at first glance to contrast with the ECB's Bank Lending Survey, which has improved for more than two years now (Eurozone: Credit easing continued in Q2, 19 July 2016), the appearance is deceptive.

We do not see a contradiction between our UBS Evidence Lab Survey, the ECB's Bank Lending Survey, and the actual data

Firstly, while it is true that corporate credit growth is not yet significantly positive, the situation is a lot better than it was in 2013/2014, when the stock of credit contracted substantially.

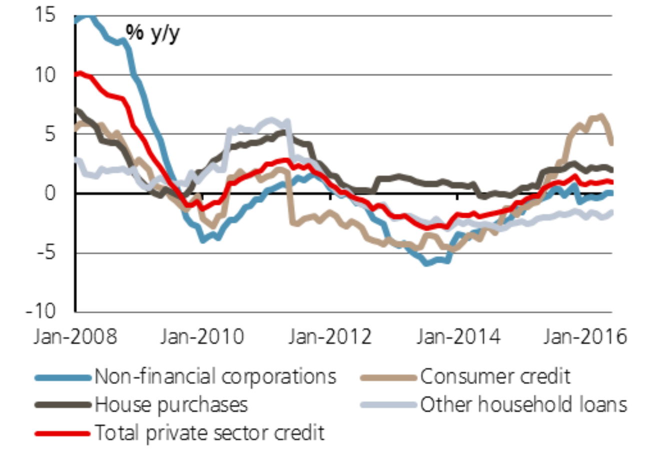
Secondly, *aggregate* credit growth is positive, thanks to consumer credit and mortgages, which are developing more positively than credit to corporates.

And thirdly, even if the largest proportion of corporate investment were for the time being to be funded by retained earnings, with bank credit only playing "second fiddle", there should still be plenty of room for credit to grow in *absolute* terms if investment continues to recover.

Yet, while we believe that both supply and demand conditions for credit are indeed improving (despite headwinds in some areas), we have to acknowledge that the recovery is coming off a low base. In other words, the conditions for credit growth are improving, but the road to full recovery remains long.

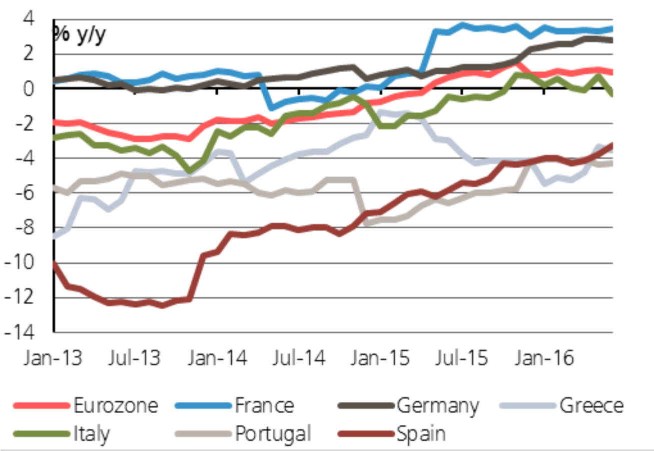
All things considered, then, our latest survey supports the conclusion we drew from our previous surveys, namely that the recovery in credit growth is likely to continue, but at a gradual pace.

Figure 41: Eurozone private sector credit growth, % y/y



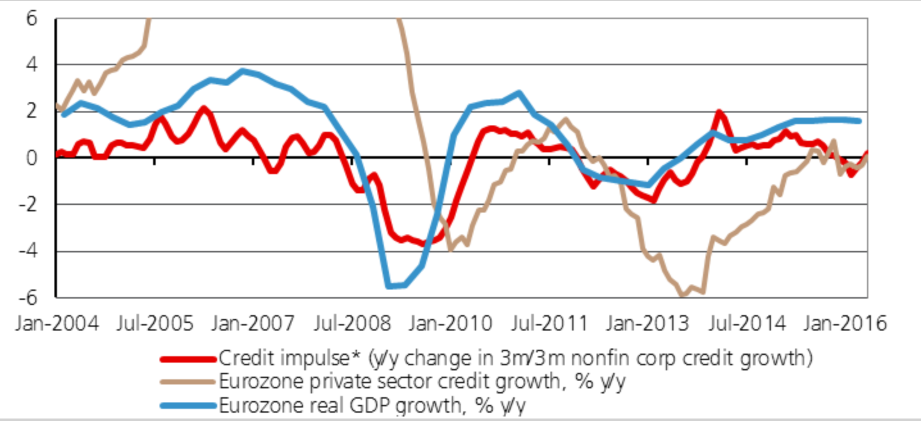
Source: Haver, Thomson Datastream

Figure 42: Private sector credit growth



Source: Thomson Datastream, UBS European Equity strategy

Figure 43: Corporate credit growth, Eurozone real GDP growth & credit impulse*



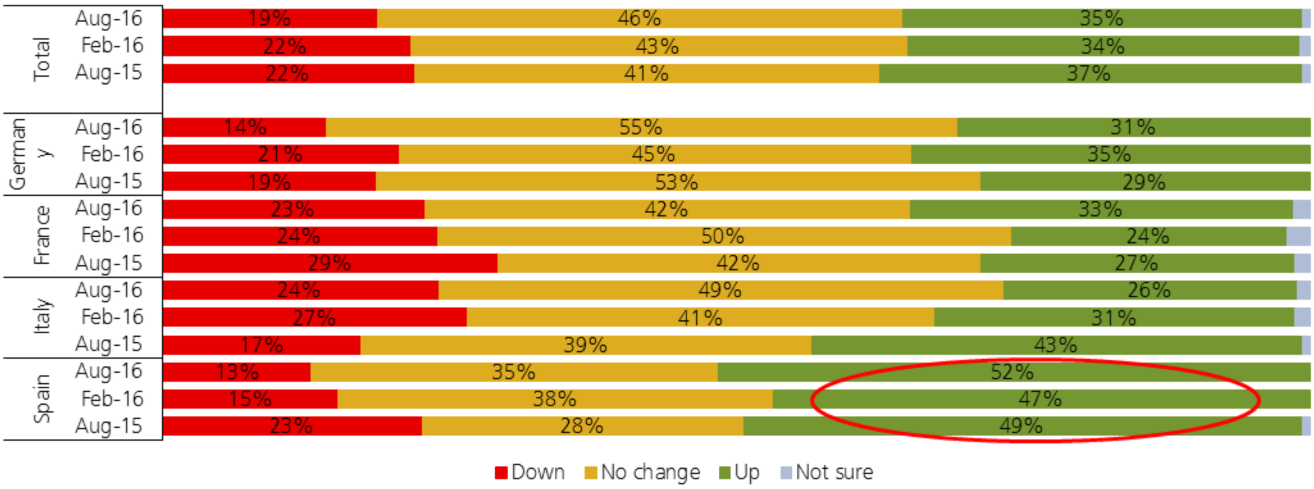
Source: Haver, UBS. *y/y change in 3m/3m credit stock growth, where credit stock measures total outstanding nonfinancial corporations credit.

Changes in employment plans

How will European corporates manage their staff levels over the coming 12 months? The results of our UBS Evidence Lab survey are reasonably encouraging, and have improved since the beginning of the year, with 35% of firms planning to increase staff levels (29% somewhat up; 6% strongly up), versus 19% planning staff reductions (15% somewhat down; 4% significantly down). This renders a net positive balance of 16%, up from 12% in our January survey.

Latest survey paints a reasonably encouraging picture on employment; outlook brightest in Spain

Figure 44: Corporates' employment plans over the coming year compared to previous survey results



Source: UBS Evidence Lab. Note: any deviations between the text and figure are due to rounding.

Employment plans remain strongest in **Spain**, where 52% of firms expect staff numbers to rise over the coming year, clearly outnumbering the 13% of companies that expect lower staff numbers – a net positive margin of 39%. This gives us confidence that the improvement in the Spanish labour market can continue, with positive implications for household incomes and confidence, and thus for consumption and GDP growth. This outcome is even more impressive than our survey in January, when Spain boasted a net positive number of 31%.

The employment situation is also solid in **Germany**, where 31% of companies plan to increase employment versus 14% that plan reductions, a net positive balance of 17%, up from 14% in early 2016.

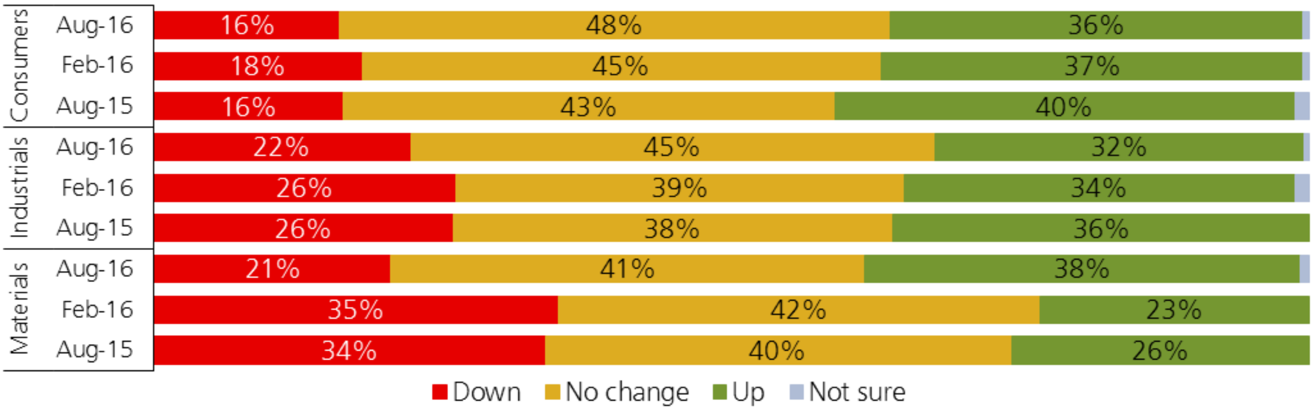
The employment picture has also brightened up substantially in **France**. In our January survey, the net balance of companies planning to increase vs. decrease employment was zero. In our latest survey, the net balance has improved to +10%.

However, in **Italy**, the situation has become less encouraging. Although the share of companies planning to cut staff fell from 27% to 24%, the proportion of those planning to grow employment fell by more, from 31% to 26%. As a result, the net positive balance has shrunk from 4% to 2%.

Substantial recovery in employment plans in the Materials sector

Across industries, companies in the Consumer sector continue to have the strongest employment plans, with 36% up and 16% down (net 20%). Staffing plans in the Industrial sector are also positive (net 10%, with 32% up, 22% down). In addition, the employment outlook in the Materials sector appears to have undergone a very substantial turnaround, with 38% of firms now planning to raise staff levels (up from 23%), while the share of companies expecting to cut employment declined from 35% to 21%. As a result, the net balance has more or less reversed from -12% to +17%.

Figure 45: SECTORS: Corporates' employment plans over the coming year compared to previous survey results

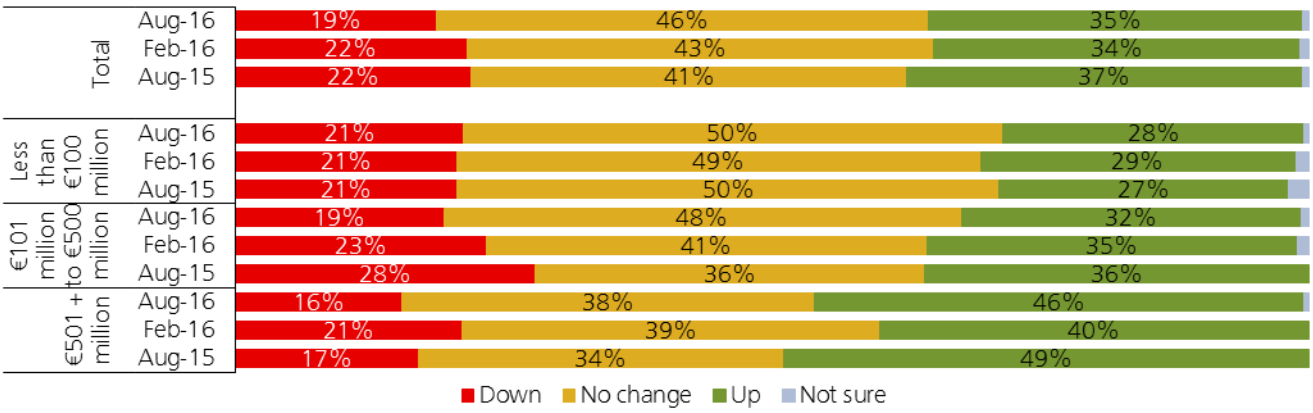


Source: UBS Evidence Lab

In line with our survey six months ago, **hiring plans seem to be positively correlated with company size**. While 28% of SMEs plan to increase staff levels, the respective share was 32% among mid-sized companies and 46% among the largest companies.

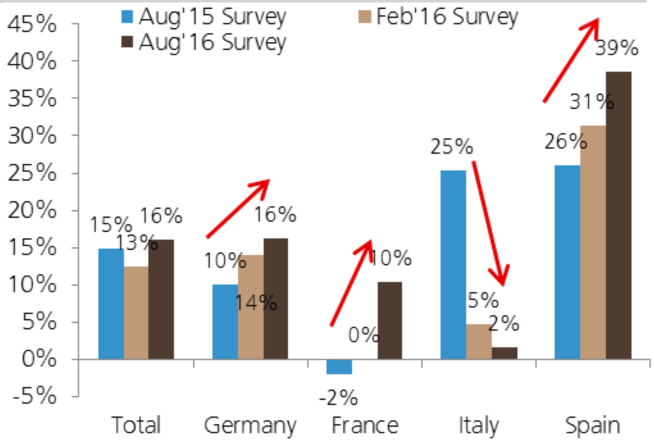
Strength of hiring plans is positively correlated with firm size

Figure 46: FIRM SIZE: Corporates' employment plans over the coming year compared to previous survey results



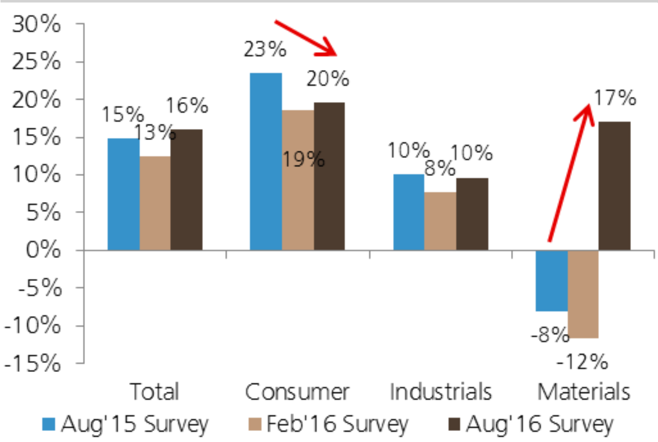
Source: UBS Evidence Lab

Figure 47: COUNTRIES: Net % of firms expecting to increase employment



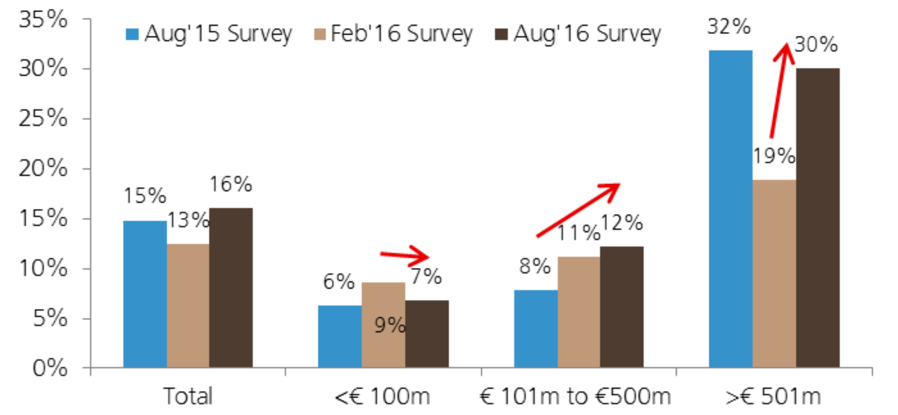
Source: UBS Evidence Lab

Figure 48: SECTORS: Net % of firms expecting to increase employment



Source: UBS Evidence Lab

Figure 49: SIZE: Net % of firms expecting to increase employment

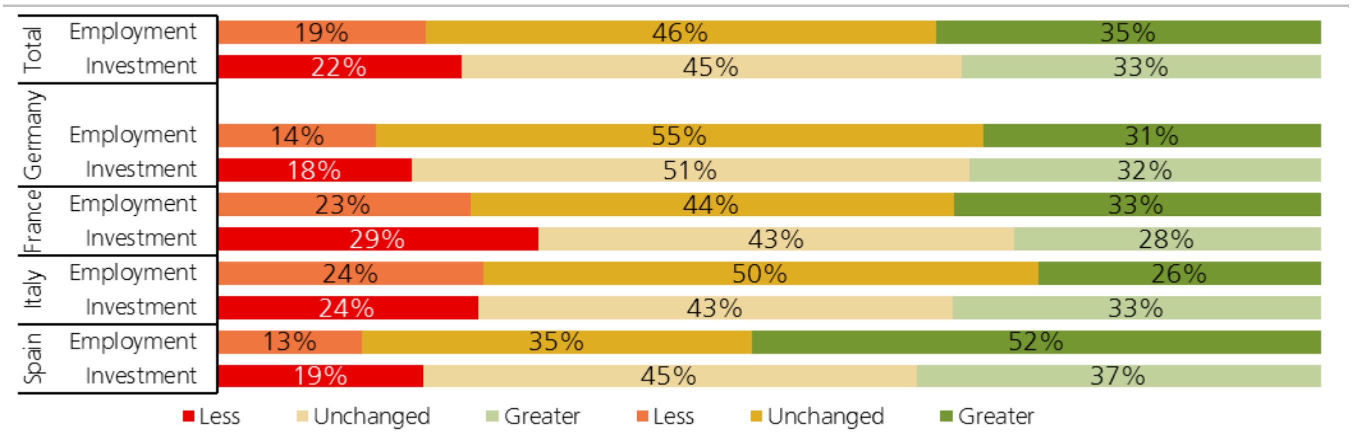


Source: UBS Evidence Lab

Overall, as we already observed in our previous surveys, **employment plans seem broadly positively correlated with investment plans** across countries, sectors and firm sizes (Figure 50). This supports the notion of a complementary, rather than substitutive, relationship between capital and labour.

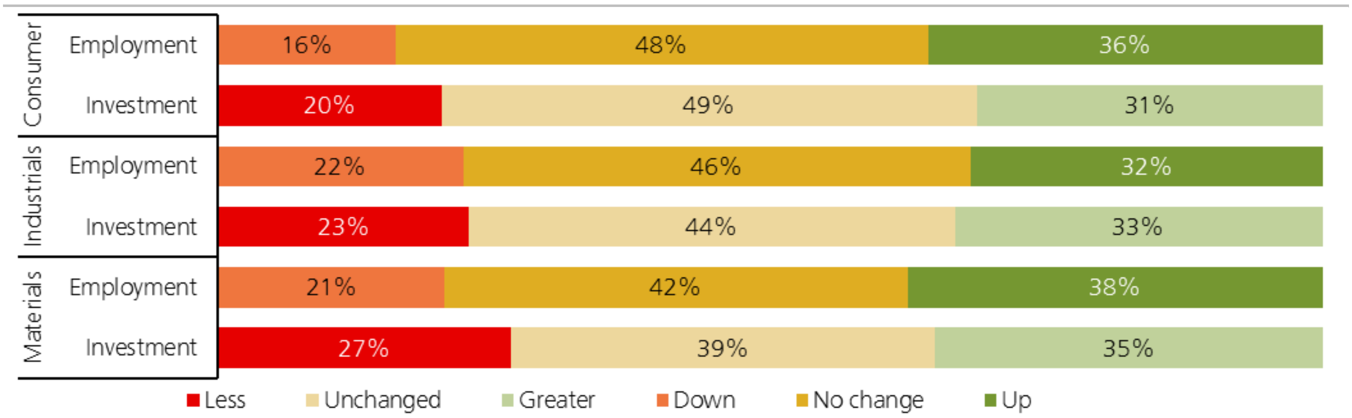
Investment plans and employment plans are positively linked

Figure 50: COUNTRIES: Firm's <u>investment</u> and <u>employment</u> plans are closely correlated



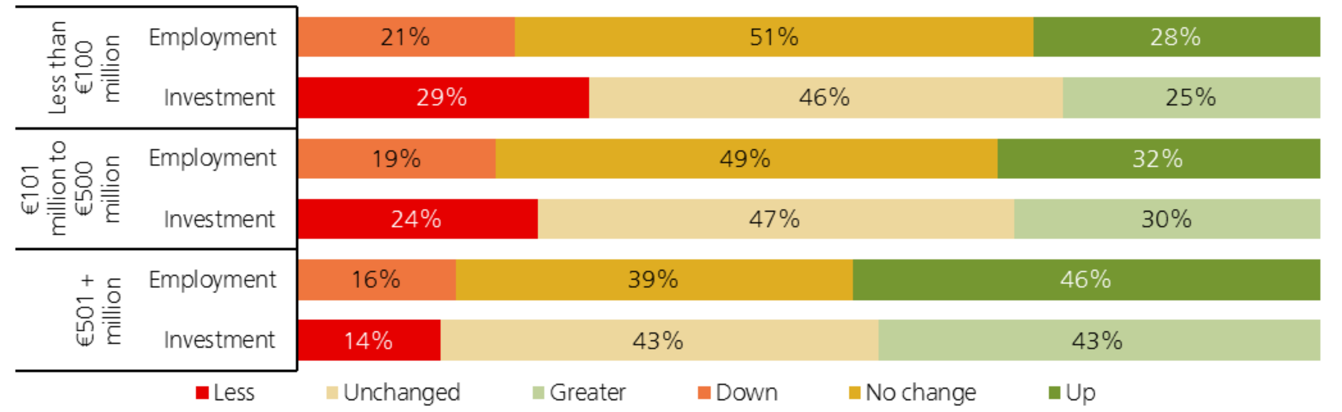
Source: UBS Evidence Lab. Note: any deviations between the text and figure are due to rounding.

Figure 51: SECTORS: Firm's <u>investment</u> and <u>employment</u> plans are closely correlated



Source: UBS Evidence Lab. Note: any deviations between the text and figure are due to rounding.

Figure 52: FIRM SIZE: Firm's investment and employment plans are closely correlated



Source: UBS Evidence Lab. Note: any deviations between the text and figure are due to rounding.

Capacity utilisation

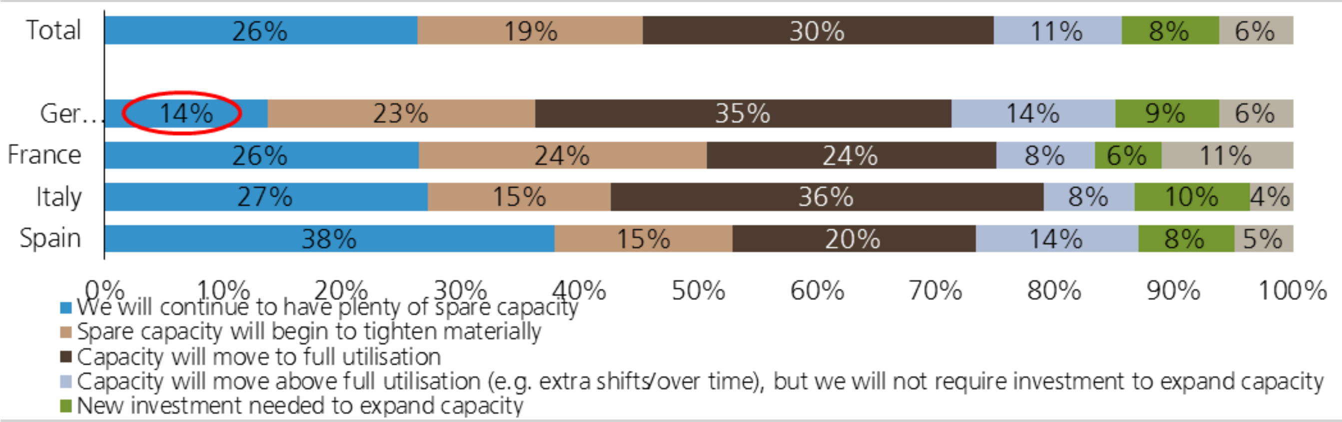
Capacity utilisation is higher in Germany than elsewhere

In line with the findings of our previous UBS Evidence Lab survey, capacity utilisation remains a lot higher in Germany than it is in France and Italy, and particularly Spain.

Only 14% of German companies reported that they still had plenty of spare capacity, compared with 26% in France, 27% in Italy and 38% in Spain. Conversely, 67% of German companies said that their spare capacity was either tightening materially, that they were moving to full capacity or that new investment was needed to expand capacity. The respective shares were 62% in Italy, 54% in France, and 43% in Spain.

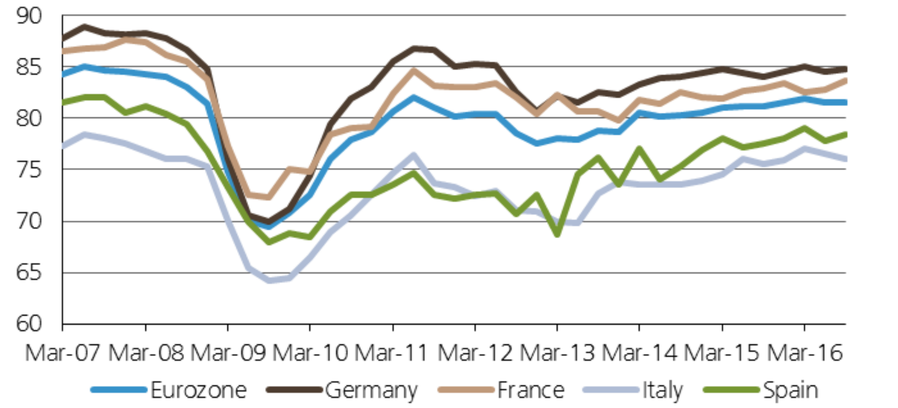
Overall, these findings support the view that the German economy is much nearer to closing the output gap than the other big economies in the Eurozone (see Felix Huefner: A German wage and inflation surprise? What if? 11 February 2016).

Figure 53: COUNTRIES: Expected changes over the coming 12 months in capacity utilisation



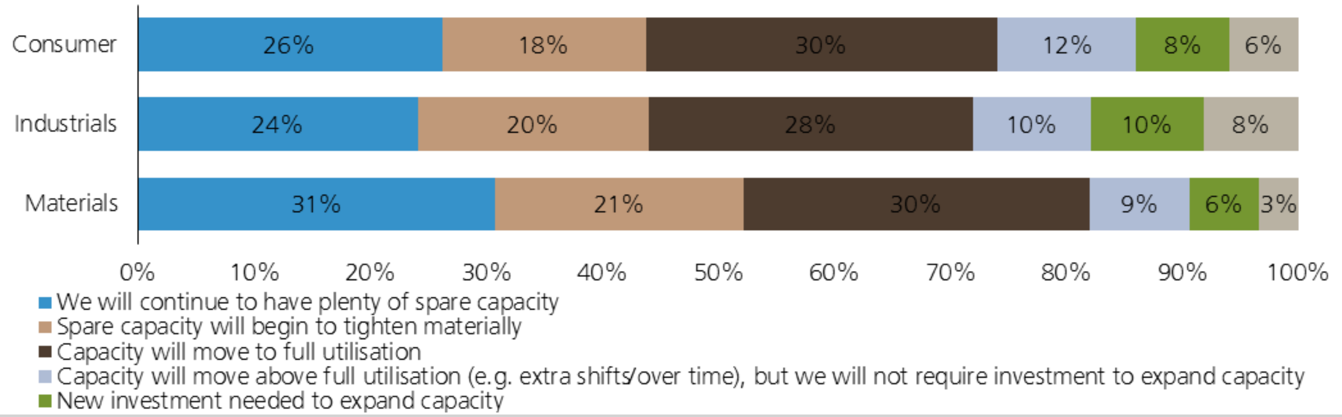
Source: UBS Evidence Lab

Figure 54: Capacity utilisation across the Eurozone, %



Source: European Commission, Haver, UBS

Figure 55: SECTORS: Expected changes over the coming 12 months in capacity utilisation



Source: UBS Evidence Lab

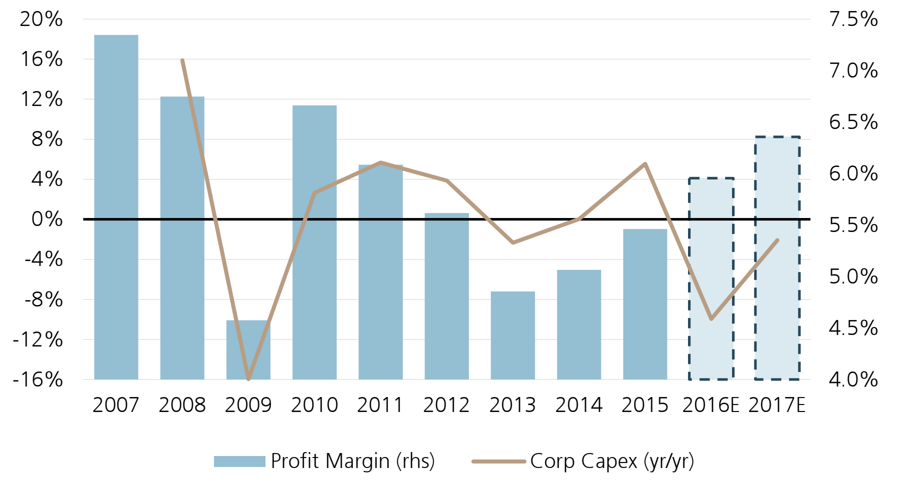
Pricing Power and Profit Margins

The willingness of companies to invest is clearly driven by the potential return on those investments, which in turn is connected to the current level of profitability. Higher profit margins should lead to higher capex. Given the depressed levels of margins we believe there is plenty of scope for recovery.

Profit margins are depressed – if they turn it should mean higher capex….

Given the linkages between margins and capex, we use our survey to ascertain the outlook for corporate profitability and pricing power.

Figure 56: Higher profit margins should lead to Capex



Source: UBS European Market Map

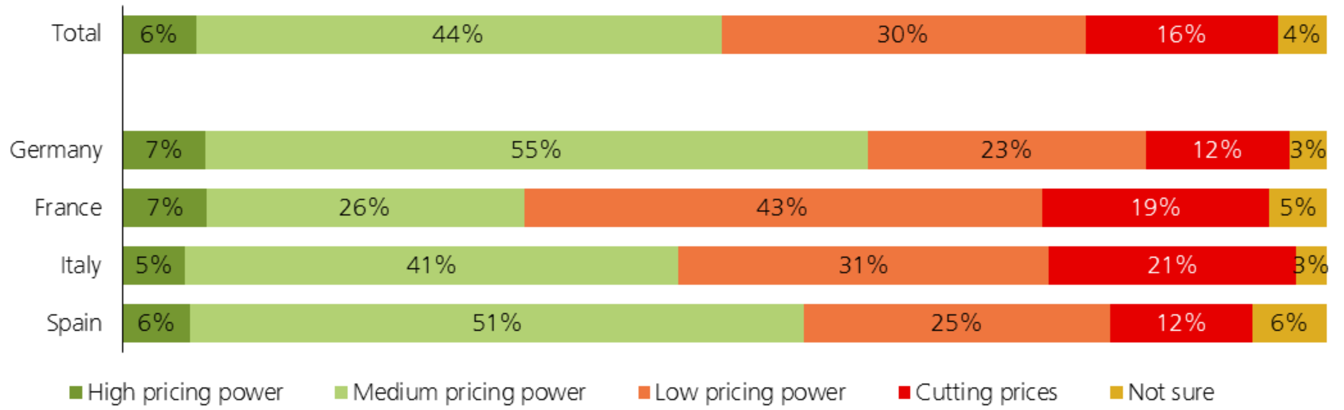
Pricing power expectations: still relatively subdued with a net balance of +3% seeing a rise in next 12 months…

Pricing power: In our survey the net balance of companies that expected to raise prices was just 3%. This is a very modest improvement from the previous net balance of -1%, but in reality still shows the extremely weak pricing environment European corporates are living through. In particular, just 6% saw "high pricing power" over the next 12 months and 16% expected to be under pressure to cut prices.

Germany and Spain have the best outlooks for pricing power, France the worst…

Looking into the detail, German companies had the best pricing power (net +27%) with French the worst (net -28%). Since our last report, German companies had a sharp improvement in pricing power expectations: from a net balance of +12% to +27%. But it deteriorated for France and Italy.

Figure 57: COUNTRIES: Expected changes in pricing power (ability to raise prices) over the coming 12 months



Source: UBS Evidence Lab. Note: any deviations between the text and figure are due to rounding.

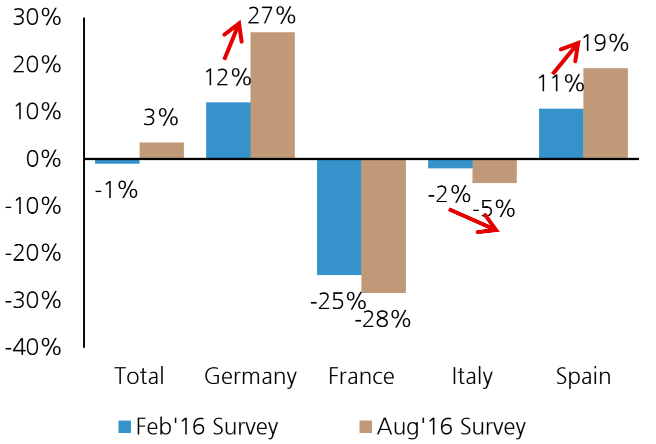
Big improvement in the outlook for Materials from last survey: net balance of -2% from -17%.

Maybe unsurprisingly the materials sector had the worst pricing power (net -2%) and the consumer-facing companies the best (net +6%). But the big change from last time was a sharp improvement in the outlook for pricing power in the Materials sector: from a net balance of -17% to -2%. We took the previous survey in February, close to when oil hit a low of c.$27/bbl.

Splitting the sample by size reinforced many of the findings elsewhere in the survey: things are a lot better for large companies than for SMEs. The largest

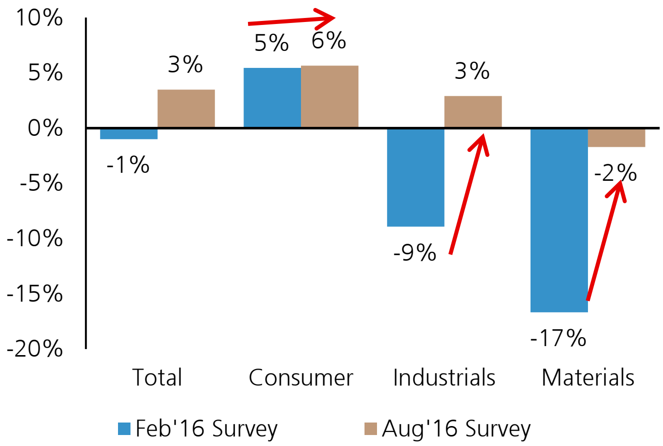
companies had a net balance of +20% with improving pricing power and the small companies a net balance of 0%.

Figure 58: COUNTRIES: Net % of firms expecting higher pricing power in next 12m



Source: UBS Evidence Lab

Figure 59: SECTORS: Net % of firms expecting higher pricing power in next 12m



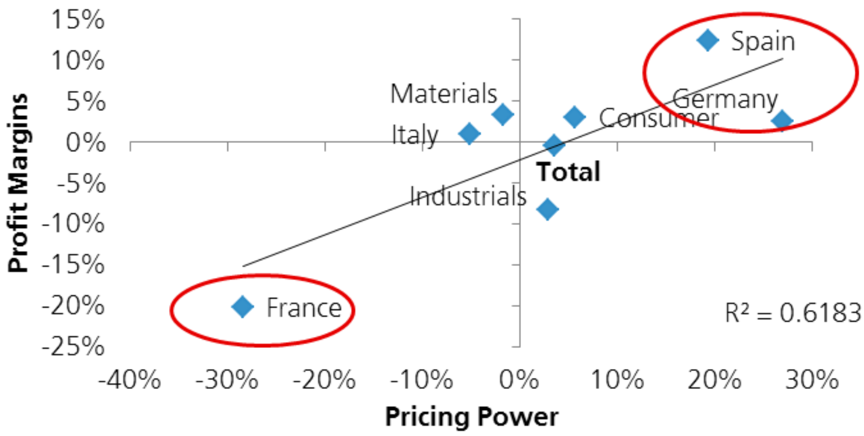
Source: UBS Evidence Lab

Profit margins: There were few expectations for profit margins to improve over the next 12 months (the net balance was 0%). This is down from the +6% net balance in February. We suspect that after 62 months of earnings downgrades in the last 68 months and with EBIT margins (ex-Financials) now almost back to 2008/09 lows, corporate confidence in forecasting recoveries may have waned.

Unsurprisingly, the profile of responses within the data fits very closely to the question around pricing power. Spain was the best placed country (+12%) and France the worst (-20%). The data in France was noticeably weaker than the last survey (-14%).

Consumers and Materials were the best placed sectors for expected profit margin expansion, but Industrials were negative (-8%). Looking at size, there was once again a big disconnect between the large companies (+13%) and the SMEs (-8%).

Figure 60: Net Balance of responses on Pricing Power and Profit Margin change over next 12m



Source: UBS Evidence Lab

Germany, Spain and Consumers have a positive outlook for pricing power and margins…

…France a negative one

Impact on Equities, Sectors and Stocks

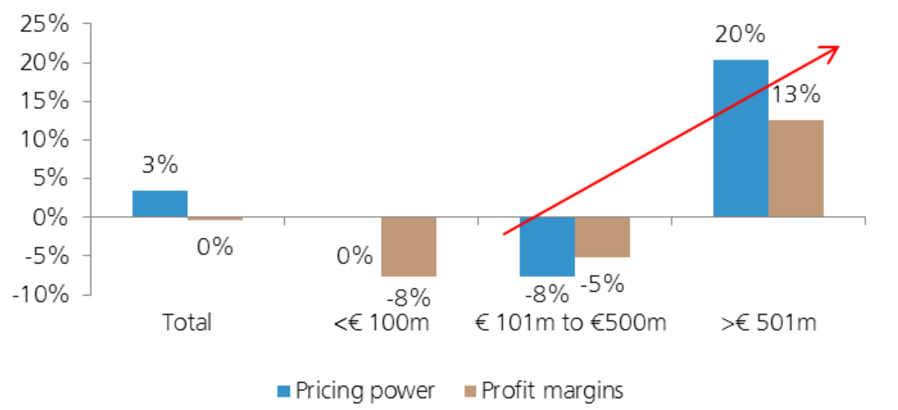
Capex-to-sales in the Eurozone is just coming off a c.30-year low. We would argue that to sustain the economic and profit recovery we need to see capex growth. After all, one company's capex is another company's top-line.

Profitability: As highlighted above, capex tends to rise as companies become more profitable. However, the relatively weak data on pricing power and margin outlook in our survey suggest that there are still headwinds facing the broader European corporate sector. But we would be cautious of fully extrapolating this to the stock market given the relatively small size of many of the companies in our survey.

Bigger is better: Indeed, for listed companies this may be less of a problem: there was a net balance of +13% of companies with annual revenues over €500m expecting profit margins to rise over the coming 12 months.

To give some context around the mapping of the UBS Evidence Lab survey sample to the European listed sector we looked at the average 2015 revenues of the smallest 60 companies (by market cap) in the Stoxx 600 index. This bottom decile had average annual revenue of €2.2bn. This compares to the "small" companies in our sample who have less than €100m annual revenues. So whilst the findings on the small unlisted sector may be concerning for economy wide growth, the much stronger showing in the large companies in the sample is what is directly relevant for the stock market.

Figure 61: Pricing Power and Margins: Net % of companies expecting improvements over next 12 months



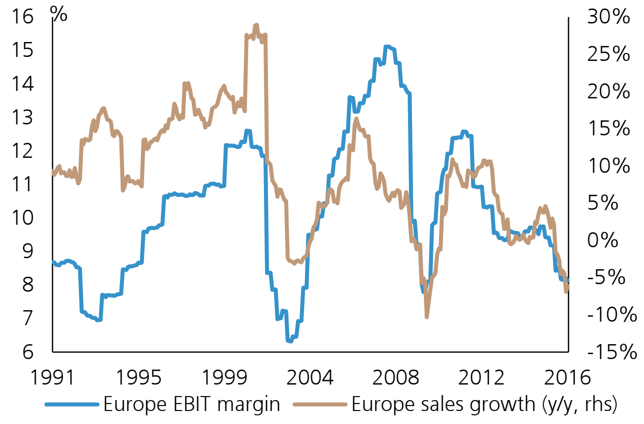
Source: UBS Evidence Lab

Profitability and pricing power looks weak for SMEs…

….but is far more positive for larger listed companies

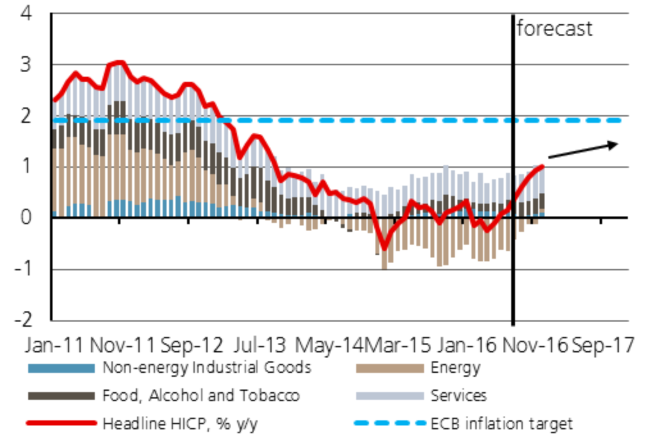
The connection between the low pricing power and profit margins is logical. We have been tracking the relationship between top line growth and profit margins post-crisis. EBIT margins for European corporates (ex-Financials) are almost back down to the lows of the financial crisis in 2008/09 (at 8.1% vs. the low of 7.8%). Why? Well, the top line growth for companies has collapsed – in part due to lower inflation and weak pricing power. Going forward these two factors should be less of a drag as inflation rises modestly and capacity utilisation gaps continue to close.

Figure 62: European Sales Growth vs. EBIT margin (ex-Fins)



Source: UBS, Haver

Figure 63: Eurozone HICP Inflation



Source: UBS, Haver

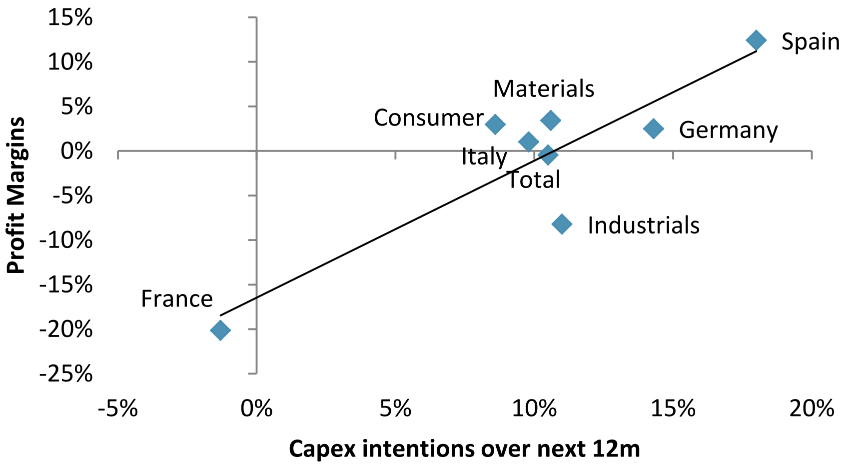
Who are the likely winners and losers?

Countries

The data from our UBS Evidence Lab survey suggests a stronger bounce back in investment in Spain and Germany with France still the weakest. But since our last survey back in February, investment intentions in Italy have weakened sharply. Profit margins and capex expectations move in a similar direction for the countries and sectors, as at a market level shown above.

UBS Evidence Lab survey points to a brighter outlook for profitability in Spain and Germany….but is less supportive of France

Figure 64: Capex Intentions and Margin Expectations move together



Source: UBS Evidence Lab

Beneficiaries of Technology-driven capex

"Shifts in technology" was the biggest positive driver in our survey, with a net 54% of companies claiming it was a positive factor for capex. Whilst the impact of technology varies from sector to sector, we can see specific industry examples of this.

For example, we believe Autos capex is set to increase from €32bn in 2015 to €35bn this year and that much of it will be driven by some of the technological trends in the industry, such as autonomous driving and digitization. We think companies such as Valeo are likely beneficiaries.

Please see comment below from our Autos analyst, Patrick Hummel:

"OEM capex should remain at elevated levels in the coming years: (1) we expect global auto production to grow further by 2.4% in 2017 and OEMs to remain overall optimistic on further volume growth (even though the growth momentum is likely to slow); (2) sector megatrends (CO2 reduction/electric powertrains, digitization, autonomous driving) should be a significant driver of investments. Overall, we expect European OEMs to invest €35bn in PP&E in 2017, flat over 2016 but above the €32bn spent in 2015. The VW crisis is likely to imply even higher sector-wide spending than previously anticipated on emissions reduction and electric cars. However, OEMs keep highlighting that a large proportion (>50%) of investment budgets are still flexible should demand slow unexpectedly."

Our Software & IT Services analyst, Michael Briest, highlights that the more local-bias to sales of the IT Services sector is likely to leave this group in a better position than the Software names to benefit from any improving capex picture in the Eurozone. "We believe **Indra's** high exposure to Spain (39% of sales) leaves it best-placed to benefit from the expected recovery there – although this is somewhat offset by a 27% exposure to LatAm. **Atos** and **Capgemini**, similarly generate 70% or more of their sales from Europe (c50% from the Eurozone), where capex trends seem more positive. For the software names, Asia is a more significant market (eg, Dassault 25%, SAP 15%). Europe still typically makes up 40-50% of sales in the sector, however."

External drivers becoming more supportive – EM, China and Exports…

Overseas exposure becoming a more positive driver: now exports are as supportive as domestic demand…

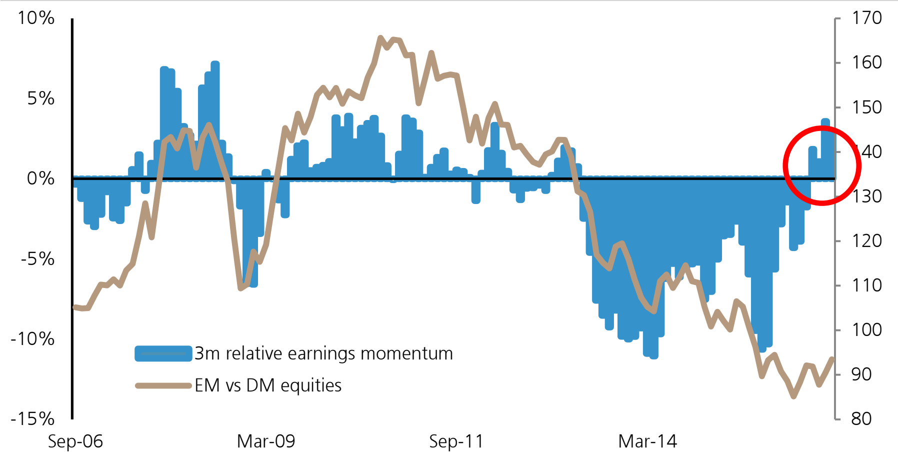
Another conclusion that comes from our UBS Evidence Lab survey is that the external backdrop is improving: exports are now seen as much as a positive driver for investment as domestic demand (in February there was an 8 percentage point gap).

In contrast to our survey in mid-Q1, there has clearly been an improvement in the external drivers for investment intentions. Some of the biggest improvements in the drivers for investment in the last 6 months have come from China, exports, the US and Emerging Markets. Domestic demand, whilst still supportive has come down a touch.

This ties in with our view that the external picture, particularly in Emerging Markets is at least stabilising if not improving. Corporate earnings back this up: companies with a high proportion of their revenues coming from the Emerging Markets are seeing more upgrades than those with high domestic exposure.

European companies with high EM exposure are now seeing improving earnings momentum

Figure 65: Earnings momentum – EM exposed European companies



Source: Datastream, UBS European Equity Strategy

Sectors & Stocks: The top-down view…

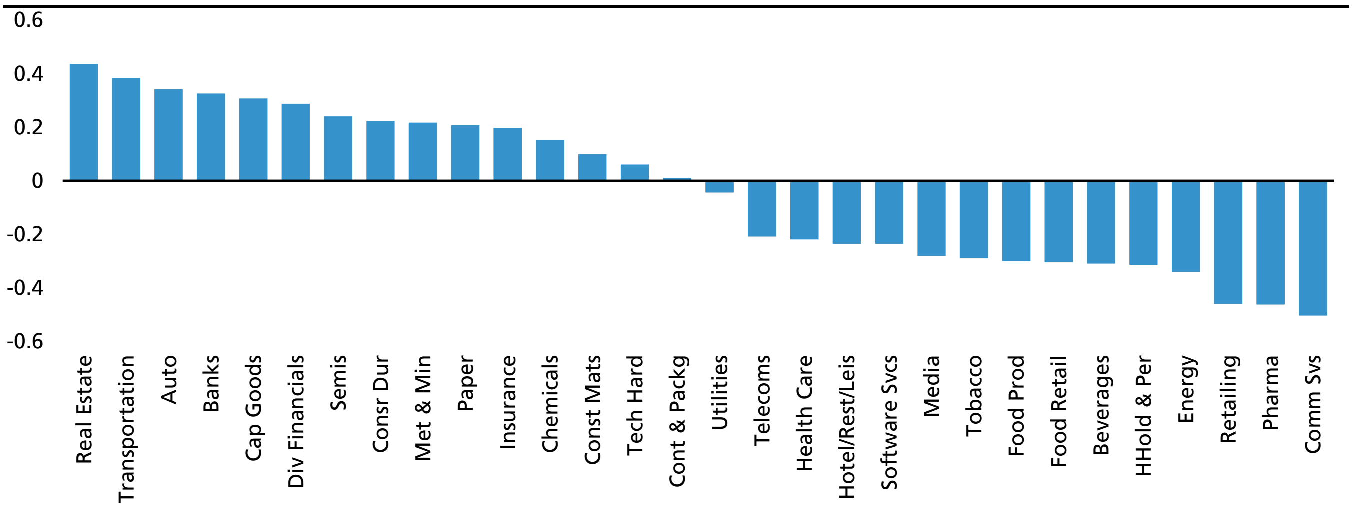
Cap Goods, Banks, and Autos tend to outperform when capex rises

If we were to see a pick-up in European capex, which sectors would likely benefit? We have run correlations for European sectors to a pick-up in German capital goods orders – a proxy for broader European investment.

Cap Goods, Banks and Autos are all positively correlated to a pick-up in the capex cycle. Banks tend to perform well as the credit cycle and investment cycle usually tend to be joined. There clearly are other issues facing the sector this time round though.

The problem with simply looking at correlation is the question of "cause and effect". The periods we have examined include the commodity super-cycle of 2003-2007 and the subsequent bust. From this perspective, the Metals & Mining sector is highly correlated to a pick-up in Cap Goods. But in this case it is most likely due to the coincidence that German cap goods orders were rising at the same time as Chinese demand for commodities was growing rapidly.

Figure 66: European Sectors correlation to German Cap Goods orders (2003-2016)



Source: Thomson Datastream, UBS European Equity Strategy

We recently downgraded the European Cap Goods sector from Overweight to Neutral. This was partly because of strong performance and less attractive valuations – the dividend yield relative to the market is at a 5 year low. The sector has the highest correlation to capex, but has outperformed year to date and the relative performance vs the broader market is close to a post-07 high. (*For more details please see*: Sector Score-Card: Repositioning post-referendum 11 July 2016).

Nonetheless, our analysts still see opportunities within the sector. *Please see comments below from our European Industrial Goods analyst, Guillermo Peigneux-Lojo:*

"We believe that the best way to play a broad capex / business investment recovery in Europe is through **Siemens, Legrand, Zumtobel, Wincor, Hexagon, Alfa Laval** and **SKF**.

In our view, the challenge for the sector is not so much the scope of the European recovery, but that it is China and, as an extension of China, emerging markets that drive demand and investments for the Industrials in Europe. It is therefore doubtful that the wider sector is a good way to play better European capex trends.

Germany, France and Italy are the biggest end markets for the sector in Europe, so the positive trends from Germany are encouraging. The slightly negative signals from France are obviously disappointing but hardly news."

Elsewhere our European Utilities team highlight some of the potential beneficiaries in their space:

"If we were to see a broader capex / business investment improvement in Europe, we believe that the impact in the utilities sector would be rather limited as capex needs in the region are relatively small. After the capex bubble in the sector seen through to 2012 – mostly in power generation assets and networks - we think that capex in the industry is set to remain now at lower levels and relative stable going forward.

There are however still some activities that could see some capex acceleration from an improved investment environment, such as renewables and smart networks, which are mostly driven by so-known decarbonisation megatrend. In such a scenario, we believe that the main beneficiaries would be stocks exposed to these activities such as **DONG** and **EDPR** – pure renewable players in Europe – and to a lesser extent **Iberdrola**. Companies with excessive exposure to power generation or with large nuclear decommissioning costs may not take part in such trend – at least at the same degree - due to the weakness in their balance sheets."

If we drill this down to a stock level, we can run a purely quantitative screen to look at the European companies that tend to perform well when capex is rising. Once again, some names are simply a result of "cause and effect" with some of the material stocks in the list. But cap goods stocks, tech hardware stocks and banks also appear.

Figure 67: Quantitative Screen: European stocks positively correlated to an improvement in Eurozone Manufacturing Orders

Name	Sector	Mkt Cap (EUR bn)	Price (p)	UBS rating	P/E 2016	DY 2016	P/E rel to sector (%) 2016E	12m Rel Perf (%)	Correlation to EZ Mfg New Orders
Raiffeisen Bank Intl	Banks	3.3	11.3	Neutral	5.9	3.4	62.7	-1.22	0.21
Kingspan	Capital Goods	4.4	24.8	Buy	17.6	1.4	111.2	21.6	0.20
Commerzbank	Banks	7.3	5.8	Neutral	10.1	1.7	107.5	-39.7	0.20
Henderson	Diversified Financials	3.2	243.9	Neutral	16.0	3.7	129.4	-16.10	0.19
Swedbank	Banks	22.0	188.7	Buy	11.1	6.8	118.2	5.5	0.16
Deutsche Post-DHL	Transportation	34.1	28.3	Neutral	13.2	3.4	94.9	21.37	0.16
Swiss Life	Insurance	7.1	241.4	Buy	8.4	4.4	88.2	10.2	0.15
SEB	Banks	18.3	78.1	Neutral	11.0	6.9	117.4	-15.9	0.15
Nokian	Automobiles & Components	4.5	33.2	Neutral	17.4	5.5	230.1	47.6	0.14
Rightmove	Software & Services	4.9	4248.0	Buy	32.1	1.2	174.3	5.17	0.14
Rio Tinto Plc	Materials	52.4	2440.0	Buy	19.0	3.4	n/a	-7.9	0.13
Intu Properties	Real Estate	4.9	315.7	Neutral	21.9	4.5	102.6	-15.8	0.13
ING	Banks	41.1	10.6	Buy	9.3	6.4	99.5	-15.0	0.13
Ashtead	Capital Goods	7.3	1239.0	Neutral	11.7	1.9	73.5	21.7	0.13
Deutsche Bank	Diversified Financials	16.7	12.1	Neutral	345.7	0.0	2792.5	-51.8	0.13
Renault	Automobiles & Components	19.8	72.7	Buy	6.0	4.2	79.5	6.4	0.12
Infineon	Semiconductors & Semiconductor Equipment	17.4	15.5	Neutral	20.5	1.7	100.8	81.57	0.12
Continental	Automobiles & Components	38.4	191.8	Buy	12.1	2.3	160.4	6.7	0.12
Hammerson	Real Estate	5.3	579.5	Buy	20.6	4.2	96.6	-20.2	0.12
Dixons Carphone	Retailing	5.1	378.8	Buy	15.3	2.1	84.4	-20.37	0.11
Lanxess AG	Materials	4.4	48.1	Buy	21.9	3.6	n/a	10.95	0.11
Volkswagen	Automobiles & Components	62.9	121.9	Buy	5.8	0.9	76.4	-23.38	0.11
FCA	Automobiles & Components	7.3	5.9	Neutral	4.7	0.0	62.2	-51.6	0.11
Anheuser-Busch InBev	Food, Beverage & Tobacco	182.1	112.6	Buy	31.0	3.3	n/a	22.54	0.11
St James's Place	Insurance	5.9	965.0	Neutral	28.8	3.4	302.4	-7.11	0.11
Freenet	Telecommunication Services	3.3	25.5	Neutral	12.8	6.5	78.3	2.65	0.11
KBC	Banks	21.3	50.9	Neutral	10.0	6.1	106.4	-5.2	0.10
easyJet	Transportation	5.1	1110.0	Neutral	10.1	5.0	72.7	-39.52	0.10
Helvetia	Insurance	4.5	491.0	Neutral	11.5	4.1	120.3	2.2	0.10
Porsche	Automobiles & Components	13.9	45.5	Buy	n/a	2.2	n/a	-23.74	0.10

Source: Thomson Datastream, UBS European Equity Strategy

Below we highlight the qualitative list of companies that our sector analysts see as potential beneficiaries from a broader pick-up in capex:

Figure 68: Potential Beneficiaries from a broader pick-up in capex and business investment

Name	Sector	Mkt Cap (EUR bn)	Price (p)	UBS rating	P/E 2016	DY 2016	P/E rel to sector (%) 2016	12m Rel Perf (%)
Continental	Automobiles & Components	38.3	191.3	Buy	12.1	2.3	146	4.4
Valeo	Automobiles & Components	11.0	46.2	Buy	13.5	2.5	162	31.7
Alfa Laval	Capital Goods	6.1	137.6	Buy	15.3	3.0	88	0.3
SKF	Capital Goods	6.9	144.3	Buy	12.2	3.9	70	-5.0
Legrand	Capital Goods	14.3	53.9	Buy	24.1	2.2	139	9.7
Siemens	Capital Goods	88.3	107.3	Buy	14.6	3.4	84	27.1
Zumtobel Group	Capital Goods	0.6	14.2	Buy	81.3	0.9	468	-44.2
Hexagon	Technology Hardware & Equipment	12.9	342.8	Buy	22.3	1.2	112	35.8
Wincor Nixdorf	Technology Hardware & Equipment	1.8	62.6	Buy	14.8	3.4	74	89.6
Atos	Software & Services	9.2	89.4	Buy	12.7	1.8	63	37.9
Capgemini	Software & Services	14.8	86.1	Buy	16.1	1.8	80	12.3
Indra	Software & Services	2.0	11.7	Buy	16.0	0.0	79	24.4
Ericsson	Technology Hardware & Equipment	21.9	62.7	Neutral	16.4	4.8	82	-19.7
Nokia	Technology Hardware & Equipment	28.1	5.0	Buy	28.0	3.2	140	-2.6
Iberdrola	Utilities	37.0	5.9	Neutral	14.5	4.9	98	2.0
EDP Renovaveis	Utilities	6.1	7.0	Buy	45.0	0.6	303	19.0
DONG Energy	Utilities	15.3	270.9	Buy	22.6	2.2	152	n/a

Source: Thomson Datastream , UBS European Equity Strategy

Appendix

1. How are funding costs evolving?

The funding costs of Eurozone corporates have improved over the past year, but what has been the most important driver? Our UBS Evidence Lab survey suggests that cheaper and easier access to **bank funding** has been the most important determinant of improved funding costs – acknowledged by 70% of the firms in our survey.

Cheaper and better access to bank funding remains a key driver of improved funding costs

In our most recent survey, the perceived improvement was particularly strong in France (76%), which is encouraging, and – as previously – Spain (74%).

Biggest improvements in France and Spain

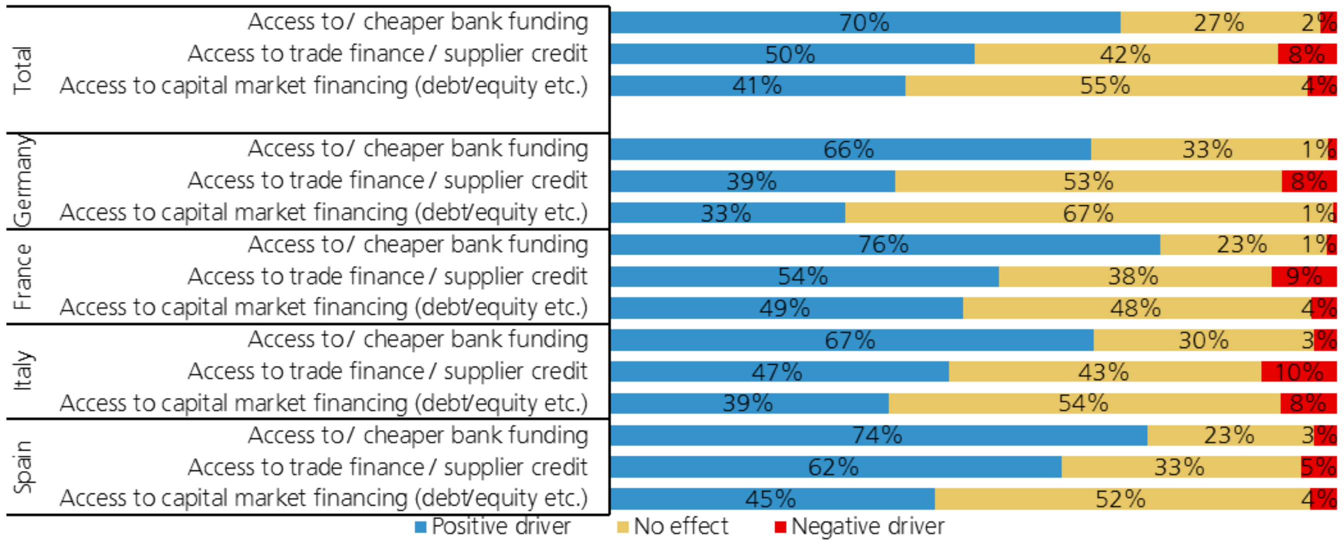
Improved access to trade finance and supplier credit was the second most important driver of easier funding, with improvements reported by 50% of respondents. In contrast, less than half of the companies (41%) mentioned improved access to capital markets as a source of better funding.

Access to capital markets funding has improved less

As in our previous UBS Evidence Lab Surveys, the perceived improvement in funding costs was positively correlated with company size, with large corporations reporting much bigger improvements than SMEs (Figure 71). This suggests to us that the ECB's efforts to ease financial conditions continue to filter through to SMEs more slowly than to larger corporates. However, in our August 2016 survey, 63% of SMEs reported that funding costs had improved, up from 55% in our January 2016 survey.

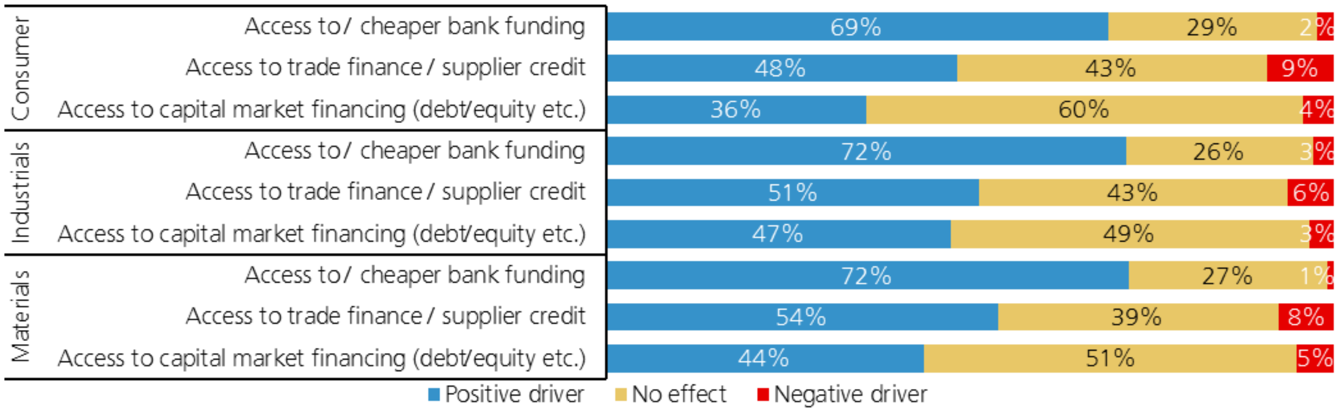
Improvements in funding conditions positively correlated with firm size: large companies benefited more than SMEs

Figure 69: COUNTRIES: Changes in funding conditions over the past 12 months



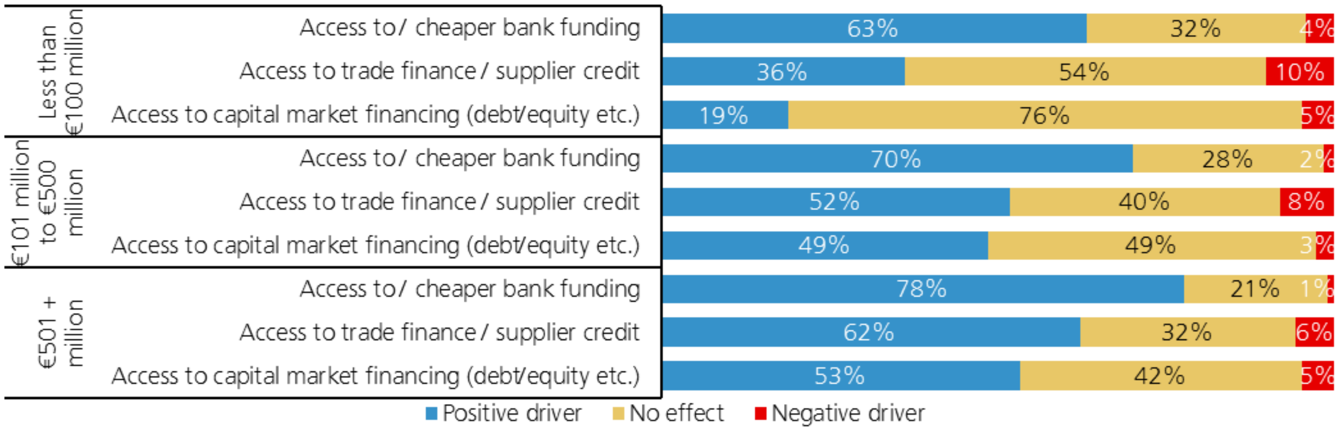
Source: UBS Evidence Lab

Figure 70: SECTORS: Changes in funding conditions over the past 12 months



Source: UBS Evidence Lab

Figure 71: FIRM SIZE: Changes in funding conditions over the past 12 months



Source: UBS Evidence Lab

2. How interest-rate-sensitive is corporate investment?

Most companies are "moderately sensitive" to interest rate changes

How sensitive are corporates to changes in funding costs? Our UBS Evidence Lab survey suggests that the majority of companies are "moderately sensitive" to interest rate changes (55%), followed by 27% that reported that they were "fairly" interest rate sensitive. The share of interest rate insensitive firms is 13%.

Germany relative to France, Italy and Spain has a higher share of companies that are "fairly" or "very" interest rate sensitive

At the country level, interest rate sensitivity is very similar in France, Italy and Spain. The picture is different in Germany, which has a higher share of firms that are not sensitive to interest rates (24%, versus 8-10% in the other three countries). At the same time, however, Germany also has a higher share of companies that are "fairly" or "very" interest rate sensitive (36%, versus 26-34% in Spain, France, and Italy).

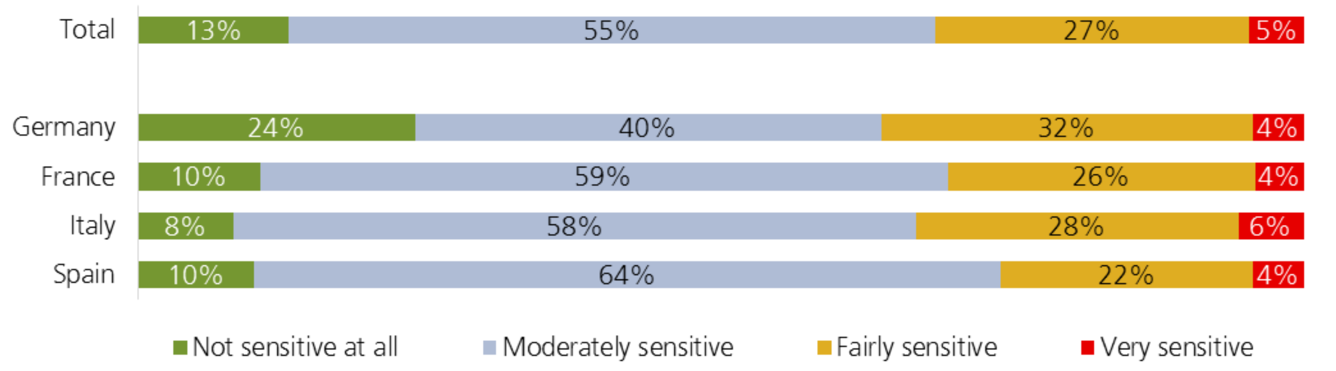
SMEs show lower sensitivity to funding costs than large firms

In terms of company size, SMEs report lower interest rate sensitivity than bigger and large companies, which seems to be a function of the strong reliance of SMEs on internal funds for investment purposes (Figure 73).

At a sector level, materials show somewhat higher interest rate sensitivity than industrials and consumer. This might be due to materials having a more balanced

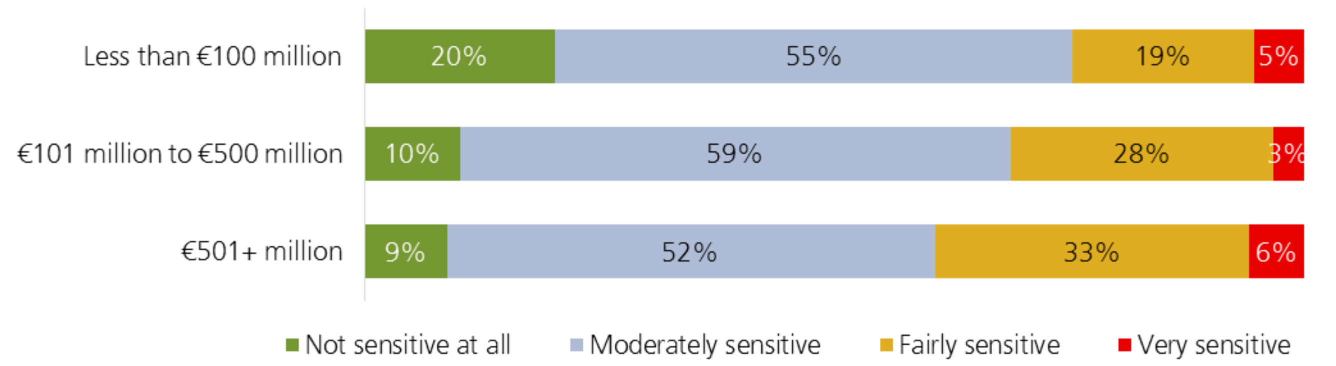
funding structure, with less reliance on own funds than consumer and industrials (Figure 74).

Figure 72: COUNTRIES: Sensitivity of investment plans to changes in financing costs



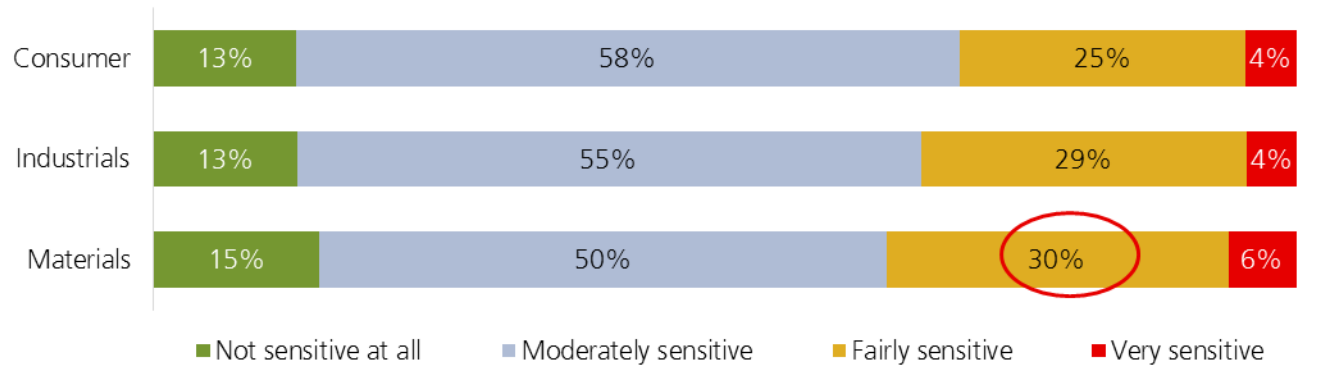
Source: UBS Evidence Lab

Figure 73: FIRM SIZE: Sensitivity of investment plans to changes in financing costs



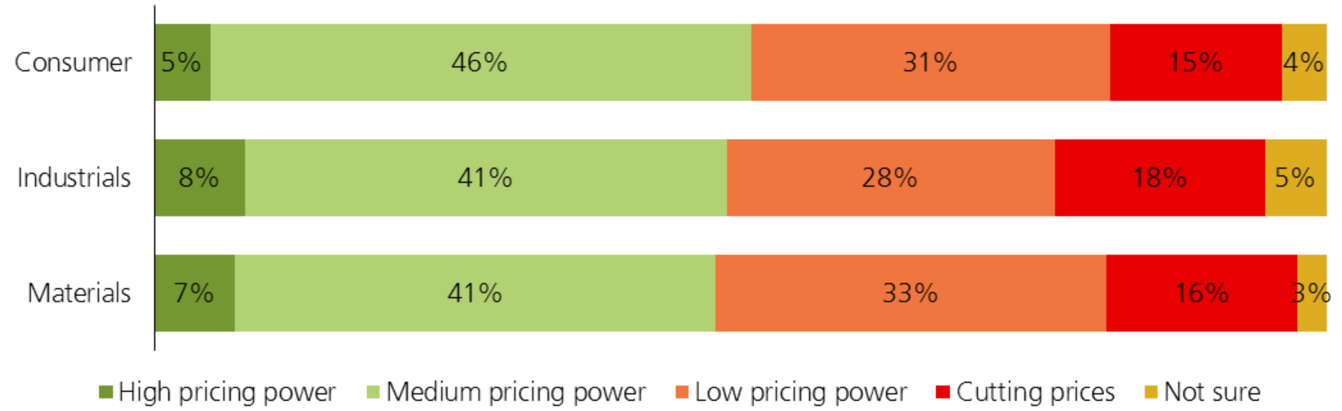
Source: UBS Evidence Lab

Figure 74: SECTORS: Sensitivity of investment plans to changes in financing costs



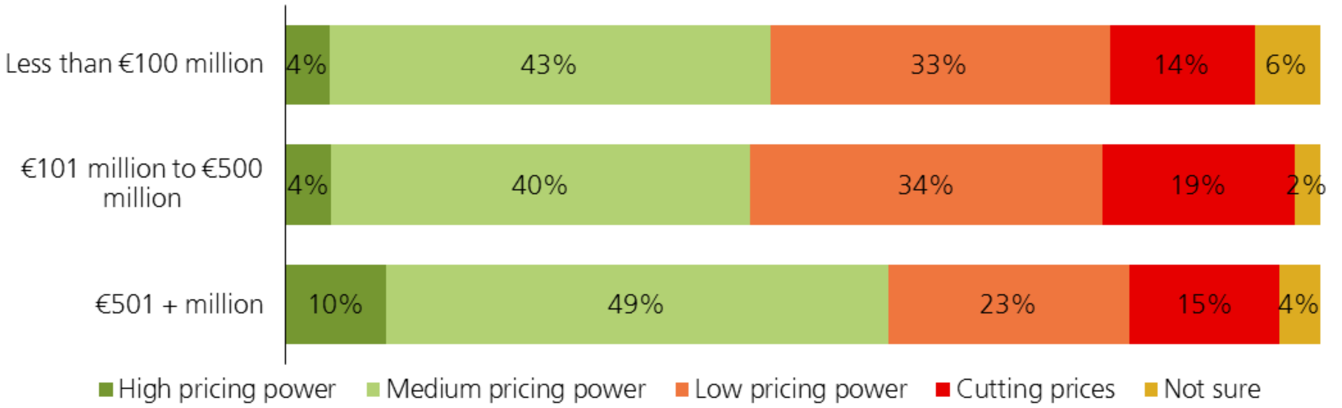
Source: UBS Evidence Lab

Figure 75: SECTORS: Expected pricing power (ability to raise prices) over the coming 12 months



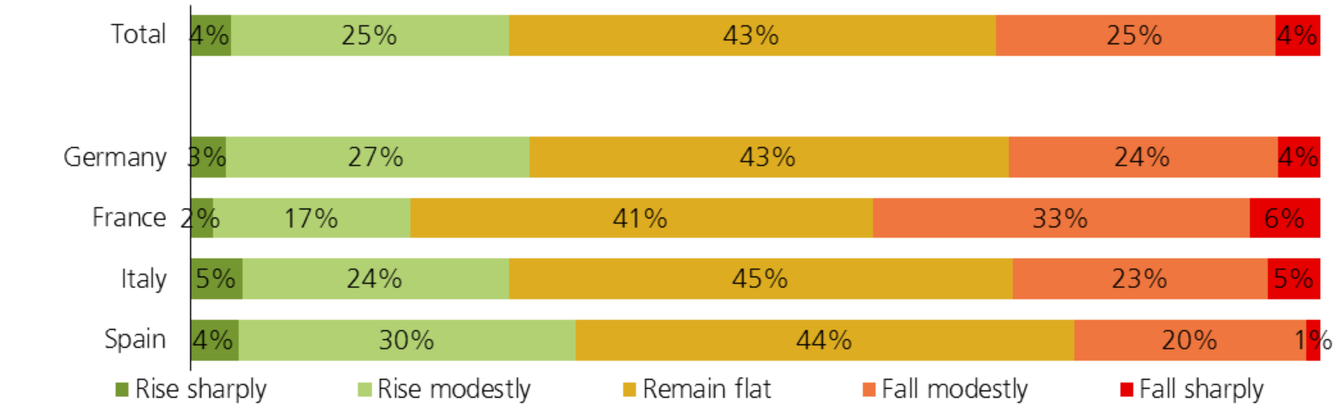
Source: UBS Evidence Lab

Figure 76: SIZE: Expected pricing power (ability to raise prices) over the coming 12 months



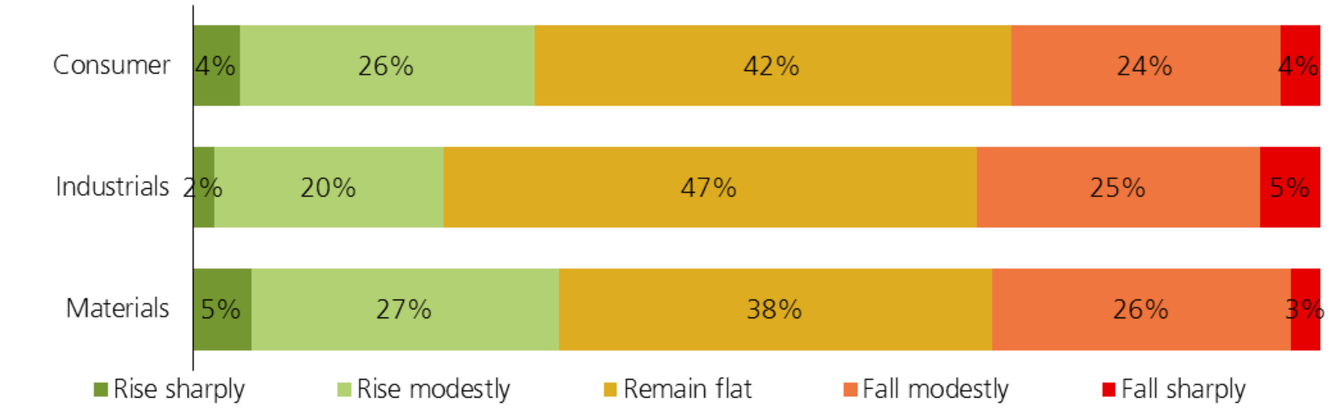
Source: UBS Evidence Lab

Figure 77: COUNTRIES: Expected changes to profit margins over the coming 12 months



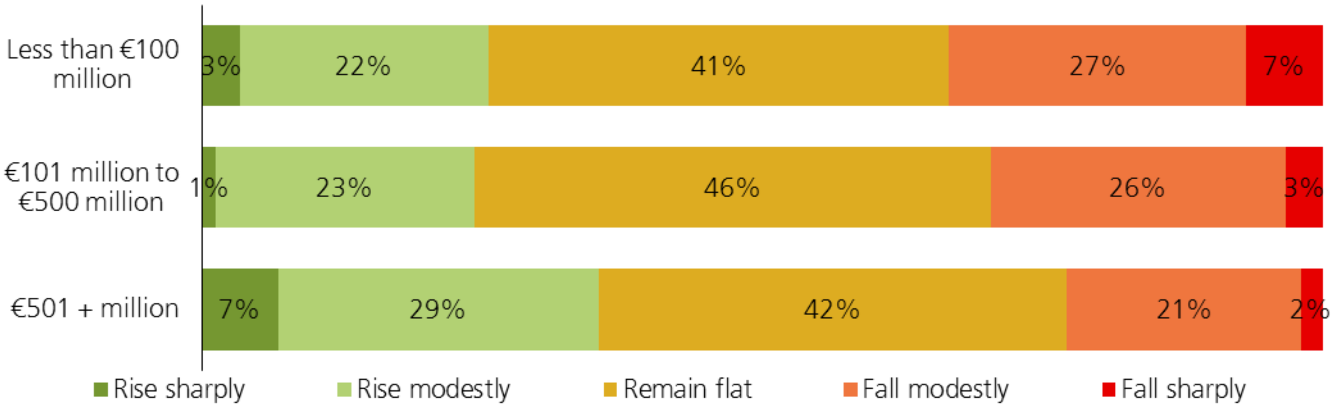
Source: UBS Evidence Lab

Figure 78: SECTORS: Expected changes to profit margins over the coming 12 months



Source: UBS Evidence Lab

Figure 79: SIZE: Expected changes to profit margins over the coming 12 months



Source: UBS Evidence Lab

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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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Alfa Laval	ALFA.ST	Buy	N/A	SKr137.40	23 Aug 2016
Anheuser-Busch InBev[3a, 3b, 16]	ABI.BR	Buy	N/A	€112.25	23 Aug 2016
Ashtead Group PLC	AHT.L	Neutral	N/A	1,243p	23 Aug 2016
Atos	ATOS.PA	Buy	N/A	€89.50	23 Aug 2016
Capgemini	CAPP.PA	Buy	N/A	€86.16	23 Aug 2016
Commerzbank[2, 4, 5, 7, 14]	CBKG.DE	Neutral	N/A	€5.90	23 Aug 2016
Continental	CONG.DE	Buy	N/A	€190.75	23 Aug 2016
Deutsche Bank[1, 2, 4, 5, 7, 16]	DBKGn.DE	Neutral	N/A	€12.40	23 Aug 2016
Deutsche Post-DHL[2, 4, 7]	DPWGn.DE	Neutral	N/A	€28.35	23 Aug 2016
Dixons Carphone PLC	DC.L	Buy	N/A	385p	23 Aug 2016
DONG Energy A/S[2, 4, 5]	DENERG.CO	Buy	N/A	DKr271.30	23 Aug 2016
easyJet[14]	EZJ.L	Neutral	N/A	1,107p	23 Aug 2016
EDP Renovaveis[5]	EDPR.LS	Buy	N/A	€6.95	23 Aug 2016
Ericsson[16]	ERICb.ST	Neutral	N/A	SKr62.85	23 Aug 2016
FCA[2, 4, 5, 7, 16]	FCHA.MI	Neutral	N/A	€6.03	23 Aug 2016
Freenet	FNTGn.DE	Neutral	N/A	€25.63	23 Aug 2016
Hammerson	HMSO.L	Buy	N/A	581p	23 Aug 2016
Helvetia Holding AG[2, 4, 5, 7, 59b]	HELN.S	Neutral	N/A	CHF495.25	23 Aug 2016
Henderson Group[7]	HGGH.L	Neutral	N/A	244p	23 Aug 2016
Hexagon AB	HEXAb.ST	Buy	N/A	SKr343.10	23 Aug 2016
Iberdrola[5, 7]	IBE.MC	Neutral	N/A	€5.91	23 Aug 2016
Indra	IDR.MC	Buy	N/A	€11.72	23 Aug 2016
Infineon Technologies AG[7]	IFXGn.DE	Neutral	N/A	€15.40	23 Aug 2016
ING[2, 4, 5, 6a, 7, 16]	INGA.AS	Buy	N/A	€10.77	23 Aug 2016
Intu Properties PLC[4, 5, 6a, 14]	INTUP.L	Neutral	N/A	317p	23 Aug 2016
KBC Groep NV[5, 7]	KBC.BR	Neutral	N/A	€51.62	23 Aug 2016
Kingspan[14]	KSP.I	Buy	N/A	€25.26	23 Aug 2016
Lanxess AG[13]	LXSG.DE	Buy	N/A	€48.36	23 Aug 2016
Legrand	LEGD.PA	Buy	N/A	€53.97	23 Aug 2016
Nokia[7, 16]	NOKIA.HE	Buy	N/A	€5.01	23 Aug 2016
Nokian	NRE1V.HE	Neutral	N/A	€32.99	23 Aug 2016
Porsche	PSHG_p.DE	Buy	N/A	€45.35	23 Aug 2016
Raiffeisen Bank Intl[5, 6b, 6c, 7]	RBIV.VI	Neutral	N/A	€11.64	23 Aug 2016
Renault[7]	RENA.PA	Buy	N/A	€73.00	23 Aug 2016
Rightmove[4, 7, 14]	RMV.L	Buy	N/A	4,237p	23 Aug 2016
Rio Tinto Plc[7, 16]	RIO.L	Buy	N/A	2,450p	23 Aug 2016
SEB Group[2, 4, 7]	SEBa.ST	Neutral	N/A	SKr78.80	23 Aug 2016
Siemens[4, 5, 7]	SIEGn.DE	Buy	N/A	€107.00	23 Aug 2016
SKF B	SKFb.ST	Buy	N/A	SKr144.10	23 Aug 2016
St James's Place PLC	SJP.L	Neutral	N/A	968p	23 Aug 2016
Swedbank[2, 4, 6a, 7]	SWEDa.ST	Buy	N/A	SKr189.10	23 Aug 2016

Company Name	Reuters	12-month rating	Short-term rating	Price	Price date
Swiss Life Holding AG[2, 4, 5, 7, 13, 59a]	SLHN.S	Buy	N/A	CHF243.60	23 Aug 2016
Valeo[5, 13]	VLOF.PA	Buy	N/A	€46.09	23 Aug 2016
Volkswagen[7, 22]	VOWG_p.DE	Buy	N/A	€122.95	23 Aug 2016
Wincor Nixdorf AG[13]	WING.DE	Buy	N/A	€62.52	23 Aug 2016
Zumtobel Group AG	ZUMV.VI	Buy	N/A	€14.14	23 Aug 2016

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