RC GLOBAL
FUNDS MANAGEMENT

Our European Strategy and Our Overweight in the Continent

Roy Chen 31 December 2024

In this instalment of Insights, rather than adopting an industry and sector approach which we have done since we started our series of articles post the March 2020 Covid19 outbreak, in this article we are taking a regional approach. The way we invest is still driven by industry analysis combined with companies' fundamentals strengths irrespective of where they are based however, we note that there are always factors at play in each region/country.

In the last few years, we have seen the Covid-19 outbreak in 2020 and then the Ukraine conflict which erupted in 2022 plus a substantial slowdown in China which has resulted in Europe being hit hard and the region's equities underperforming, especially when compared to the US. Yet throughout this period we have maintained Europe as our No 1 or No 2 regional exposure. In this particle we put forward our argument for the overweight position in Europe.

First we look at the negatives

Recession risks and slower sales growth - Europe faces cyclical economic risks such as economic slowdowns and recessions which can negatively impact corporate earnings and stock prices. As the largest economy and previously its growth engine, Germany has lost access to cheap Russian gas which previously greatly benefited its manufacturing industry while facing slowdown in its largest export market-China. In general, Europe's overall growth rate tends to be slower than that of emerging markets, particularly in Asia and also the US these days.

Political Instability and Regional Conflicts: European countries, especially those in the EU, are often affected by political instability. The rise of populism, exit movements (for example Brexit), and political gridlock (like in France) can lead to market volatility and uncertainty. The ongoing Russia-Ukraine conflict can destabilize markets even further. Trade wars, sanctions, or regional military conflicts could have a significant impact on stock prices and investor sentiment.

Demographic Risks-from Aging Population to Labour market challenges – Many European countries face the challenge of an aging population, which results in a shrinking workforce and growing pension obligations. This can place a drag on economic growth and reduce corporate profitability in the long term. In that same vein, labour unions have become more active in certain countries, demanding higher wages due to the high cost of living. Strikes and social unrest can disrupt economic activities and affect businesses' ability to operate smoothly.

Climate Change and Environmental Regulations - Europe is at the forefront of addressing climate change, with stringent environmental regulations and goals for carbon neutrality.

Sector Concentration and Dependence on Key Sectors - European markets have a higher concentration in specific sectors, such as financials, energy, automotive, and luxury goods. If these sectors face difficulties, it could disproportionately affect the performance of European equities.

Technological Disruption and less opportunities in innovative IT segments - Europe's technology sector is not as dominant as in the US. This means European companies may face challenges in adapting to technological change, reducing their growth potential relative to firms in other global markets.

Other risks can include: Policy Changes and Regulations, Currency and Interest Rate Risk

The positives - arguments in favour of Europe

Diversification Across Developed Markets -Europe represents a large portion of the global equity market, and investing in European equities offers geographic diversification. By adding European stocks to a portfolio, investors reduce their exposure to specific risks tied to other regions, such as the U.S. or emerging markets. There is also Currency Diversification benefit. Although the Euro dominates, many European countries have distinct economic policies and currencies, which can add diversification against currency risk.

Valuation Appeal and Strong Dividend Yields. European equities have often been priced lower than U.S. stocks, making them attractive from a valuation perspective. Many European stocks trade at lower price-to-earnings (P/E) ratios, which can suggest that they are undervalued compared to their American counterparts. Investors seeking opportunities in undervalued stocks may find them more abundant in Europe, especially in sectors like financials, energy, and industrials, which have underperformed in recent years. Many European companies have a culture of paying consistent and relatively high dividends which is appealing for income-seeking investors.

Jefferies Global Research and Strategy, in recent note, suggested the gap between Europe and US has become too substantial to ignore. They present the case for EU equities is strengthened by several key factors.

- **Earnings-based valuations currently undemanding by historical standards**, while **book values remain well below pre-Global Financial Crisis peaks**.
- Region's record underperformance versus US in 2024 suggests potential for mean reversion, particularly as **European earnings show early signs of bottoming out**.
- They consider investment opportunities across **four main themes** worth highlighting**:**
    - **cyclical recovery**
    - **enhanced shareholder returns**
    - **structural change driven by technological advancement, and**
    - **commodity cycle exposure**.

The research mentioned companies such as **Air Liquide, SAP and Schneider Electric** which are seen to be well-positioned to benefit from these trends and are holdings in our portfolio, while the financial sector shows particular strength among cyclical stocks.

However, investor sentiment remains cautious. A recent BofA survey revealed that **while fund managers see upside potential in European cyclicals, they're maintaining a defensive positioning**, with utilities and healthcare among the most overweight sectors. This **disconnect between perceived opportunity and actual allocation** suggests significant **upside potential once sentiment shifts from "very bad" to even "a little less bad."**

Economic Recovery and Growth Opportunities - Europe's economic growth prospects, while slower than some emerging markets and the US, have improved since the pandemic, with recovery plans and infrastructure spending supporting growth. As mentioned in previously, this ranged from Post-COVID Recovery bolstering key sectors such as digital transformation, green energy and manufacturing to Infrastructure and Innovation**.** Significant investments are being made in upgrading Europe's infrastructure, digitalization, and technology sectors, creating opportunities for growth, particularly in areas like fintech and AI.

Exposure to Global Brands and Leaders - Europe is home to some of the world's most iconic companies, including global leaders in luxury goods (LVMH, Hermes), consumer goods (Unilever, Nestlé), automotive (Volkswagen, BMW), and industrials (Siemens, Airbus). Investing in European equities offers exposure to these renowned brands, which often have a strong presence in both developed and emerging markets. (NB we have some reservations here which are covered in the section "What we avoid" - eg autos, high-end consumer brands and miners

At RC Global, applying our industry analysis and fundamental research of companies within their respective industry, we have concentrated our investments in certain sectors. Currently, the portfolio has the following sector exposures:

- **Energy (10.58%)** – Mainly in large integrated oil and gas majors, followed by those in the Oil Services
- **Industrials (7.07%)** – mainly in the Equipment & Services (4.78%) as well as in Transport (2.3%)
- **Utilities (5.57%)–** we have a preference for large integrated utilities that are well diversified in various segments of the value chain.
- **Materials (3.84%) –** We prefer defensive and oligarchic industrial gases.
- **IT (1.21%)**
- **Telecoms (1.21%)**

Our European countries weightings

Germany	7.86%
France	6.28%
Norway	5.43%
UK	2.31%
Italy	2.28%
Portugal	1.75%
Spain	1.41%
Switzerland	1.23%
Netherlands	0.93%
Total	**29.5%**

Looking briefly at Germany, France and Norway our top 3 European markets

Germany

Despite the domestic German economy not in good shape and being an export-driven economy severely impacted by China's slowdown, we identified several German companies that are global leaders, competitive and resilient in their respective industry segment.

- **Linde** is the largest industrial gasses company globally -this is an industry in which we have a high conviction, it is highly concentrated in 3 companies and is most defensive within the more cyclical materials sector.
- **Siemens Energy** is a top 3 leader in the power equipment including gas turbine along with GE Vernova and Mitsubishi Heavy Industry of Japan.
- **SAP** is a leading IT software company globally along with Oracle and Salesforce in the US.

France

- **Schneider Elect** is one of the top leaders globally providing services and equipment to the datacentres and energy management.
- **Air Liquide -**top 2 globally along with Linde in industrial gases
- **TotalEnergies** is a top 5 integrated energy companies in the western world with particular strength in LNG and active in many high potential frontiers in Africa

Norway

- It may not have the largest corporations but it is the richest country blessed with its abundant oil and gas reserves. It is the only country in the continent to export natural gas to other countries now effectively cut off from Russian gas and having to increasingly rely on the import of LNG mainly from the US.
- It is also a maritime nation with many shipping companies listed on its exchange or in the US

Focus on Revenue by Geography for our Top 3 European countries

German Companies

On average, the six German companies in the portfolio generate less than 25% of their revenues from the domestic German economy, the highest being Fraport (58%) and E.ON (40%) and the lowest being Siemens Energy and Linde, both at just 9%. Four of the companies have US generating the largest share of revenue while the other two have Germany as the top market in revenue share. China also features highly with 3 of the companies having it in the top 3 countries in their revenue stream.

		Home Country	By Continent			
		Germany	Europe	America	Asia	Top Countries
Fraport	Industrials	58	75	25		Germany 58 Peru 18
E.ON	Utilities	40	95			Germany 40 UK 35
Siemens Energy	Industrials	9	40	30		US 20 Germany 9 China 4.5
Linde	Materials	9	24	49	24	US 32 Germany 9 China 8
SAP	IT	16	37	41	15	US 33 Germany 16 Japan 4
BASF	Materials	10	38	30	25	US 23 China 13 Germany 10

French Companies

On average, the five French companies selected in the portfolio generated less at 17% of their revenue from domestic France – highest being Engie (Utilities) and TotalEnergies to the lowest Technip Energies (oil services) with 0% where it counts Middle-East and Africa as top region. Once again, US revenues feature highly in 3 of the 5 companies and less for China.

		France				
Engie	Utilities	44	82	12	4	France 44 Belgium 10
Total	Energy	24	65	12	12	France 24 US 8 Germany 8
Technip Energies	Energy		26	12	17	Middle East /Africa 45 US 6
Schneider Elect	Industrials	6	28	37	29	US 29 China 13 France 6
Air Liquide	Materials	12	38	38	20	US 32 France 12 Germany 6

Norwegian Companies

We have 2 oil and gas companies Equinor and VAR Energi where revenue is almost wholly from domestic Norway. We then have 2 shipping companies with nil revenue from Norway and count US as its largest revenue source.

		Norway				
Equinor	Energy	98				Norway 98
VAR Energi	Energy	100				Norway 100
Subsea 7	Energy	22	42	31	12	Norway22 Brazil 18 UK 17
Telenor	Telecom	31	72		21	Norway 32 Bangladesh 19 Sweden 17
Stolt-Nielsen	Industrials		21	38	29	US 30 China 8 Netherland 7
Avance Gas	Industrials		8	67	11	US 64 China 6 Saudi and Turkey both 3

<u>What has worked best for us?</u>

Of the holdings that we have held for over say 3 years, the following companies are the clear winners as at the end of Oct 2024

			<u>**Total Return**</u>
Linde	Germany	Materials-Ind Gases	212%
Enel	Italy	Utilities	87%
Schneider Elect	France	Industrials	85%
Iberdrola	Spain	Utilities	63%
Shell	UK	Energy	62%
TotalEnergies	France	Energy	61%
Air Liquide	France	Materials-Ind Gases	50%

Over the last several years we had realised good profits in:

- **Industrials -Transport-Shipping**
  Hapaq-Lloyd Germany (container shipping) +96%,
  Wallenius Wilhelmsen Norway (Car carriers)+67%
  D/S Norden Denmark (Products Tanker and Bulk Carrier) >+50%
- **Industrials -Equipment**
  ABB Switzerland *>+50%
  Siemens >+40%
- **Energy**
  BP* >+40%
- **Materials**
  OCI Netherland +67% (Materials-Fertiliser)

NB * denotes holdings we have bought back since taking profit

As for entries in 2024, it has been more challenging to find new big winners. The best are Siemens Energy (+51%), GALP *(+33% realised), BW LPG (+50% realised). Hence, we have been buying back previous winners – ABB, GALP and BP after reviews.

Which are the sectors and segments to avoid?

-Autos
-High-end Consumer Brands
-Metals & Miners

We had minor positions earlier in first two sectors but exited and realized profit in Mercedes Benz (+12%) and took a loss on PUIG Brand (-16%)

The key factor here is China. These businesses are highly dependent on both Chinese consumers and other industries from manufacturing to property, the latter area most deeply in trouble.

All 3 segments have performed poorly in 2024- which had impacted Germany (autos- Mercedes Benz, BMW and Volkswagen) and France (LVMH) in a big way

We do believe China will recover but the pace so far has disappointed investors who probably expectations may be too high. 2025 may see better entry points. Though we avoided Miners/Metals, we recently Germany biggest chemical manufacturer because its revenue is only 13% from China so will be hurt less while we wait for the recovery.

There are also areas which we had benefited greatly previously which are now facing significant headwinds prompting us to reduce (eg shipping) or even cut completely (eg fertiliser).

<u>Which are the European holdings we are most positive about now?</u>

- **AI theme we highlighted in our last article**

Industrials –	Schneider Electric, Siemens and ABB
Utilities –	Iberdrola, EDP, E.ON, Enel and Engie
Software –	SAP
Telecoms	Telenor

- **Recovery potential from better Chinese and world economy and aviation/travel**

Materials-	Chemical-BASF
Transport-	Airport -Fraport

- **Energy -Upside in new frontiers (eg Namibia, Guyana) and Offshore activities**

Integrated Energy-	GALP, Exxon-Mobil, TotalEnergies, Shell
Oil and Equipment Services-	SBM Offshore, Technip Energies, Subsea7

In conclusion we believe the companies we in Europe have solid financials and offer good potential to create shareholders value.

All material in this article is general information only and does not consider any individual's investment objectives.

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