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FPM-Comment Reducing the Noise

Martin Wirth – 1/2024 dated January 22nd 2024

The principle "boom nourishes boom and vice versa" is too short-sighted. A differentiated view

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- Divided development on the stock markets
- Poor politics costs growth, impairs sentiment and thus determines returns on equity markets in the short term
- Valuation across the board has almost halved in the last ten years
- German investors are letting international investors get the better of them
- Valuations should result in very solid returns

On the face of it, 2023 recorded significant gains at index level. However, the overall picture does not adequately reflect the development. After a broad-based upswing in the first half of the year, price gains in the second half of the year were mainly concentrated on the very large stocks, while the broader market stagnated or even recorded significant price losses. This also applied to stocks that were by no means disappointing in terms of their performance, but where there were negative surprises, the price losses were sometimes drastic. This once again created new opportunities. Towards the end of the year, portfolio adjustments were made which, in our view, clearly overshot the mark. Overall, the indices of highly capitalized stocks recorded disproportionately high gains.

Divided development on the stock markets

What led to this split development and how should we deal with it?

First of all, the economy disappointed. This was particularly true of Germany. The recovery expected in the second half of the year failed to materialize. This had an impact on corporate earnings on the one hand, but to a much greater extent on sentiment towards German equities in general and small and medium-sized stocks in particular. And the problem has a name, even if political stock markets are supposed to have short legs: The German government, which is at least on a par with the governments of other European countries in this respect.

Bad politics costs growth...

It pursues its ideology-driven projects unclouded by professional competence, (unfortunately unintentionally) turns de-growth fantasies into reality and is surprised at the lack of support from voters and their migration to other parties.

The administration is flourishing, as is the bureaucracy, which is by no means the fault of the current government alone, and one of the few sectors in Germany that is constantly expanding its workforce is the state itself. Unfortunately, this is not happening in areas close to the people, but rather in the public administration departments. There, people are obviously thinking of ways to make life a little more complicated.

Shutting down the last nuclear power plants in the middle of the energy crisis was obviously not a masterstroke from an economic point of view either. Especially when you then complain about the patchy availability of French nuclear power plants. It is no wonder that various energy-intensive companies have moved to other locations and don't want to wait for a possible lower and, above all, secure energy supply at the end of the decade. And contrary to what the government is spreading: Prosperity is not primarily earned in healthcare services and through public administration, but in industry. And if this disappears, there will be less to distribute.

The measures to eliminate the housing shortage were also successful, at least for owners of run-down properties, who do not have to fear any new competition on the rental market for the time being: First of all, pretty much every measure that can deter potential investors is discussed and partially implemented, from rent controls, protection against termination of tenancy, tenant participation in the CO_2 levy, one set of regulations after another, garnished with rising interest rates, and then people wonder why new construction is collapsing. Since the state also wants to play landlord, it occasionally buys up a property that is then left to rot rather than being renovated due to a lack of money, as can be seen in Frankfurt.

The state always finds someone to blame for the weak development: Last year, the weak international economy, from which the export-heavy German economy suffered. For example, due to the weak growth in China, still only 5%. Oh well. And so, of course, the government continues to believe that the policy adopted is good, but suffers from poor communication. In other words: people are unfortunately a bit stupid, you have to explain it to them better, then they will finally understand the higher wisdom behind it.

All of this is quite entertaining if you are not affected yourself, but it also has an impact on the real economy. And is probably the main reason why Germany was at the bottom of the table in terms of growth last year. BUT: you can also see that a government policy, as long as it moves somewhere along normal, western and liberal lines, has a visible but limited impact on the economy. Assuming that the government's actions have cost a highly estimated 1% of national income, the damage amounts to €40 billion. That is a lot of money, but does not begin to justify the perception that the German economy is trapped in a deep and incurable crisis. A shrinkage of income, if you don't see growth as fundamentally undesirable, as some in the government do (even if you then formulate ever higher demands on the state and the general public yourself at the same time), is not nice. But not the end of the world: Germany generated a higher income in 2023 than in any year in history, with the exception of 2022.

Even if the German and European economies have become rather anemic over the years thanks to bureaucracy, constantly increasing taxes and levies and more and more regulations, a substantial amount of national income is still generated and distributed every year, and fortunately we can also participate in this distribution thanks to equity investments, among other things. Moreover, a further deterioration in government policy is not to be expected, as a lot has already been exhausted. And radicalization is also not to be feared, which is one of the advantages of the Chancellor. In this respect, the risk is very limited. If you want to assess the extent of the fall: at the beginning of 2022, mind you after the start of the Russian invasion of Ukraine, the German Council of Economic Experts was still expecting growth of 3.6% for 2023!!! The result, following a correct estimate for 2022, deviates from the estimate by a remarkable 4 percentage points.

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And this can be seen in the performance of the more economically sensitive sectors on the stock market since then. Which in turn means that the downward expectations are likely to be quite resilient. What is also ignored in the abbreviated view of "weak German economy = poor prospects for companies" is that listed companies are often globally positioned.

...and affects sentiment, which is the key component for equity market returns in the short term

However, the modest track record of both the German government and the European administration has come at a much higher price for investors in the short term than weak growth: as a result of the deterioration in sentiment, valuations for various market segments have shifted significantly downwards in recent years and in some cases are at all-time lows, which is all the more surprising given the continued availability of modest investment alternatives in the bond sector. This is in contrast to the general perception that equities are expensive. However, if Apple is worth more than the entire German equity market, which may well be the case and does not need to be discussed here, Apple's high valuation combined with its high index weighting does not necessarily mean that the entire US market, let alone the German equity market, is expensive.

A good part of this devaluation is therefore probably due to the perception of an extremely modest state of the German economy. Not only is this exaggerated, even though the sclerosis in Germany, as in Europe as a whole, has persisted for many years, it also primarily affects many companies that rely on the German market alone. Listed companies are generally international, often global, so the location of a company's headquarters does not have a decisive influence on its success. However, this is precisely what is implicitly assumed on the stock exchanges if you look at the valuation discrepancies between German and American companies with comparable products and business models and a similar regional positioning.

Valuation across the board has almost halved in the last 10 years

This was particularly reflected in the valuation of small and medium-sized companies. Due to the aforementioned general conditions, there has been extremely low investor interest over long periods of time and, at the same time, pressure to sell. These companies are also underrepresented in passive products, and as more and more capital is invested in passive products and flows out of active products, companies that are not in the top tier are also being sold, regardless of their actual value. At the same time, despite the recession in Germany, the companies' business was largely stable, in some cases sluggish, but also very good in others. In this respect, we see valuations that are often beyond good and evil and suggest a rather sad future. If you look at the share price performance alone, you don't immediately see that valuations have been falling for almost 10 years. This is due to the rising profits that most companies have achieved during this time. At the same time, the substance of the companies has regularly increased significantly since then due to the retained earnings. On today's basis, double-digit returns are theoretically almost the inevitable consequence in the future, given reasonably stable conditions. It should also be borne in mind that today's results are still being impacted by the lingering effects of the COVID pandemic and the turmoil caused by Russia's invasion of Ukraine, not to mention the soaring interest rates.

Valuation compression has various causes

What were the reasons why German (and other European) equities were neglected? We can only speculate.

Apart from the poor political performance in Europe, the easiest way to explain this of course would be to say that the bull market feeds the bull market and

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vice versa. Apple and the other American technology giants are worth more than the entire German stock market, so why bother going into detail. Irrespective of the valuation, admittedly, but this currently only plays a subordinate role in many investment strategies.

In addition, the global growth prospects have become rather weaker: Demographics, a more mature economy in China, more regulation, limitation due to the scarcities of natural resources, starting with the CO2 issue.

Excessive and sometimes senseless regulation is likely to play an important role

Then there is the excessive regulation: it also affects many investors in their own profession, especially in risk management, which often means that investments are assessed primarily in terms of their volatility and liquidity, but no longer on the basis of expected profitability, i.e. the valuation of an asset no longer plays the dominant role, if it plays a role at all. (See the willingness, not so long ago, to buy government bonds with a term of one hundred years and a yield of practically zero, mind you, under the watchful eye of the regulator). And with the neglect of valuation, the importance of the core parameters of an asset itself also dwindles, as this is all about assessing the prospects for success, quality and sustainability of a business model. Most companies were not founded with the main aim of generating low-volatility returns and enabling investors to join and leave the group of shareholders on a large scale at any time. We are right there with Milton Friedman: The business of business is doing business. And being profitable at the same time. However, the other parameters liquidity and low volatility are much better served by the bond market. This in turn explains why the change in preferences in this segment of the capital market has led to significant inflows and why there is generally not much activity in equities. And when there is, it is in the large stocks. The hunt for low-volatility investments in an uncertain and unstable world with company-like returns: This contrast offers arbitrage opportunities for specialists like Bernie Madoff.

German investors are letting international investors get the better of them

If you then consider how the stock market is viewed by the public in Germany, you can see another problem. The equity-based pension, which the current government had once planned to introduce, is being scrapped in view of the budget shortfalls, having previously been criticized as a form of gambling from many sides. The German Chancellor is proud of the fact that his savings are shrinking in real terms. The fact that the Quandt family collects dividends in the billions from their BMW shares every year is seen as a scandal and the like, instead of the critics coming up with the idea of buying a few BMW shares themselves and cashing in. In the USA, there have been 401 K plans for decades, which by and large correspond to stock pensions, as well as pension funds that are among the largest investors in the world. For firefighters and teachers, among others, while many teachers here would probably be horrified to become part of the gambling machine. As long as there is no family background, the majority of the largest German companies are owned by foreign investors, with ratios well above the 80% mark. You would have to imagine that in the USA.

Professional market participants are also shining in their attitude towards the companies they follow. While everything was painted in rosy colors at the time of the IPO, the outlook is suddenly rather gloomy after share price losses of 50-90%. The situation is split for established companies. There are companies that have benefited from the upheavals of recent years that are now suffering from the downside. The companies that have suffered, on the other hand, are benefiting from catch-up effects. Companies operating on the Internet were able to acquire new customers relatively easily, who can now spend their money

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differently again. Chemical and basic materials companies benefited from shortages and restricted supply chains and were therefore able to impose high prices, but today they are suffering from the loss of anticipated demand, higher interest rates and the reduction in inventories across the value chain. The same applies to DIY stores, for example, after "home improvement" was one of the activities that was not prohibited during the pandemic period. On the other hand, companies such as Lufthansa and TUI, as well as car manufacturers, are benefiting from the ongoing normalization, as pent-up demand has guaranteed good prices for more than a year. One could now assume that the current situation will settle down again. However, this is not the case: while it is assumed that the companies suffering from the normalization will hardly see any improvement, this is almost certainly the case for the current winners. There is no other explanation for the current valuations. In this respect, there is therefore no support from capital market participants.

Private equity funds conjure up volatility and therefore do not need liquidity

Private equity funds, on the other hand, are pure magic: here, the volatility of investments is conjured away by updating the purchase prices as long as the general conditions have not changed substantially. This means that there is no longer any need for liquidity, as there is no need to sell something that does not fluctuate in a panic. At the same time, nobody is interested in the fact that the risks are actually increasing significantly thanks to massive borrowing by the companies being "invested" in. And since at least reasonably successful companies have the ability to earn money over the years, the accumulated debt will regularly pay off. In this respect, these vehicles are also in a position to pay prices for companies that are well above the level that is usual on the stock market. And at the same time, nobody has to worry about the fees, which are significantly higher than what is usual for equity funds. In this respect, it is no wonder that this asset class has become increasingly popular in recent years, even if the rise in interest rates may have shaken up some funds.

As a result, the valuation differences between asset classes have grown massively in recent years. While it used to be common for equities to be valued at risk premiums of 3-4% over government bonds, this has long since ceased to be the case, apart from the heavyweights with a first-class business model. Today, these tend to be in the range of 7 to over 10%, without taking inflation protection into account in any way.

This leads to the remarkable discrepancies that can be observed everywhere. Just a few examples that are not necessarily represented in our funds, otherwise we could be accused of bias.

Substantial differences in the valuation of identical assets depending on ownership

And to all those who disagree with the current politics in Germany (according to surveys, two thirds of the population and perhaps some readers too): At the chemical company Lanxess, it is assumed that the joint venture founded in 2022 with a private equity company is actually bankrupt due to the usual level of debt there, that the catastrophic profitability of the chemicals business will not improve in the next few years thanks to record low capacity utilization and that a capital increase is therefore required that is higher than the current market value. It is questionable whether the private equity company has also written down the value of its stake in the joint venture to zero, as the market has done with Lanxess.

HelloFresh, a globally active internet-based food producer and retailer that has been extremely successful in recent years and operates with a sophisticated business model, is valued at 4.5 times last year's EBITDA, i.e. around €2 billion. Two years ago, the food delivery company Gorillas, known for its

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black-clad cyclists in some major German cities, was valued at a minimum of €3 billion in a private equity financing, without this business model being anything special. The company is now apparently bankrupt.

Software AG was taken over by an American financial investor last year. The offer was more than 50% higher than the previous share price. Six months later, the investor sells a division (you can calculate differently, but it is roughly estimated to be 50% of the group) and receives almost its entire purchase price back in return. Which, as I said, was 50% above the previous share price.

The free float of Telefonica Deutschland is being bought back by the Spanish parent company at 50% of the price of the IPO a good 10 years ago. Thanks to extensive dividends, which were more than covered by the free cash flow, the existing investor came out of the investment without a loss. Telefonica, on the other hand, can currently enjoy a free cash flow yield of 15 to 20%. The sellers can now invest their money in German government bonds at just under 2%, which is now considered attractive.

There are more examples, and probably even more a year from now.

What this will change is open, but ultimately irrelevant: Based on the valuation, there should be very solid returns

So far, so bad. The question remains as to why the situation should change now and what is needed to trigger a turnaround in investor interest. The only answer is that you usually only know afterwards. Valuation alone is not enough, but valuation is inevitably the decisive factor in the long term. With the appropriate horizon, i.e. more than two months, you can invest with a substantial margin of safety. And there are obviously already two groups of investors who are taking advantage of this opportunity. These are the companies themselves via their share buybacks, and financial investors.

After a long period of rejection of share buybacks in general, more and more companies are coming to the conclusion that their own shares are undervalued, right across the market. Most encouragingly, the reason for these buybacks is low valuation and not, as in the US, sufficient liquidity, regardless of valuation; or, worse still, pressure to compensate for dilution from share options issued, the value of which is regularly not taken into account when calculating earnings. An obstacle for smaller companies is often that not enough shares are traded on the stock exchange to implement the programs quickly. The situation is different for larger companies, where progress is also rapid. The total buyback volume is likely to be in the double-digit billion range. And every share bought back increases the stake held by the remaining shareholders, at a price that is currently quite favorable.

And the aforementioned financial investors. At the current level, we see these as more of a threat than an opportunity. Because unlike in the past, when they had to improve a lot operationally in order to achieve their target returns, today trivial financial engineering is sufficient to achieve substantial profits, see the example of Software AG. In this respect, there is a risk that equity investors will be ripped off, even with what at first glance appear to be attractive valuation premiums, if the majority of shareholders accept the investor's offer. Of course, it is still better than losing money, but after a long dry spell it is still not something you want, unlike an aggressive approach to share buybacks.

What is on offer in our funds and what can we expect here? What if everything were to return to more or less normal? Illustrated by some positions in the All Cap Fund:

A service provider that is the cost, quality and brand leader in its industry, with at least mid to high single-digit percentage growth and a P/E ratio of 10, with low required investments and a correspondingly high ability to pay dividends.

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A raw materials company whose new site is one of the cost leaders in the industry and whose investment costs today would be higher than the valuation of the entire group, with the new site accounting for only a quarter of output.

A defense contractor whose order backlog exceeds the current year's sales by a factor of 5 and is accompanied by rising margins and which is valued at a single-digit P/E ratio on the basis of incoming orders despite high visibility.

Two banks that will distribute approx. 30% of their market capitalization in the next 2-3 years, fortunately in large part in the form of share buybacks at (today's) half book value, which will automatically cause it to rise further and should strengthen the substance at the same time.

Industrial companies, 50% of whose profits come from recurring services and spare parts and which, with a solid balance sheet, are nevertheless only valued at a P/E ratio of 5-6.

We also see plenty of opportunities in other stocks in which we are not currently invested. This provides additional reassurance that these valuation levels are a broad-based phenomenon and hopefully we have not fallen into the individual traps that look cheap but have a substantial underlying problem. On this basis, we are very confident that the coming years should be more encouraging than the last. Valuations have downside limits, and if they are set by investors who then buy the entire company. And current earnings do not require any growth, not even nominal growth, to justify the share prices. And nominal growth is very likely from the perspective of higher inflation rates alone.

Sincerely yours,

M. Wirth

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