Europe Equity Market Outlook: Q2 2023

Investor confidence shaken, but opportunities remain.

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Market Overview

Investor Confidence Takes a Dent in March, but the Market Rolls On

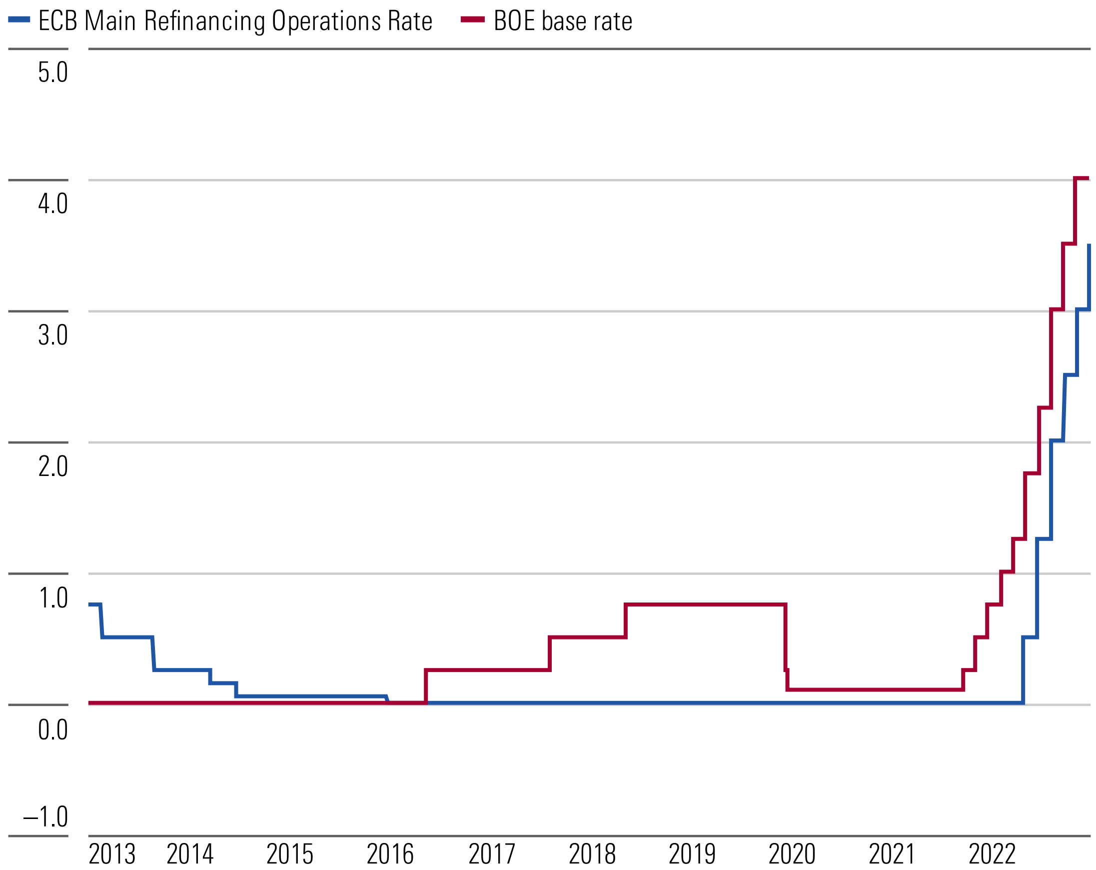
Central Banks Push On With Their Mission To Reduce Inflation

"Months of boredom punctuated by moments of terror" is an expression that was used during World War I, but is often applied to investing. This was certainly the case in March. The successive failures of several banks in the United States, and near failure of Credit Suisse in Europe, severely dented investor confidence in equity markets, and the banking sector in particular.

As interest rates continue to rise, pressure is mounting on businesses, with the banking sector at the coalface. However, central banks are caught between a rock and a hard place, with recent data in the United Kingdom showing inflation is on the rise again, forcing central banks to accept a certain level of collateral damage in the form of business failures, to achieve the goal of bringing inflation under control. This was demonstrated by the European Central Bank's 50-basis-point rise on March 16, bringing its base rate to 3,5%, a level not seen since before the global financial crisis.

We're at a strange point in the market cycle where conditions are far from perfect: persistent inflation, rising interest rates, and cash-strapped consumers all require investors to really look beyond the short term and have faith that the economy will be better in six to nine months' time. The problem with this situation is the confidence required to keep markets going is precarious, and incidents like those occurring in the banking sector in March are enough to tip the scales toward pessimism.

Interest Rates Grind Higher Despite Market Turbulence



Source: Eurostat. Data as of December 2022.

Europe Equity Valuations Pull Back Due To the Banking Crisis

Market Cap-Weighted Price/Fair Value Estimate for Morningstar Europe-Domiciled Coverage

Source: Morningstar. Data as of March 22, 2023.

European equity markets came close to being fairly valued during the quarter, but the recent Credit Suisse blow-up has brought them back to relatively attractive levels.

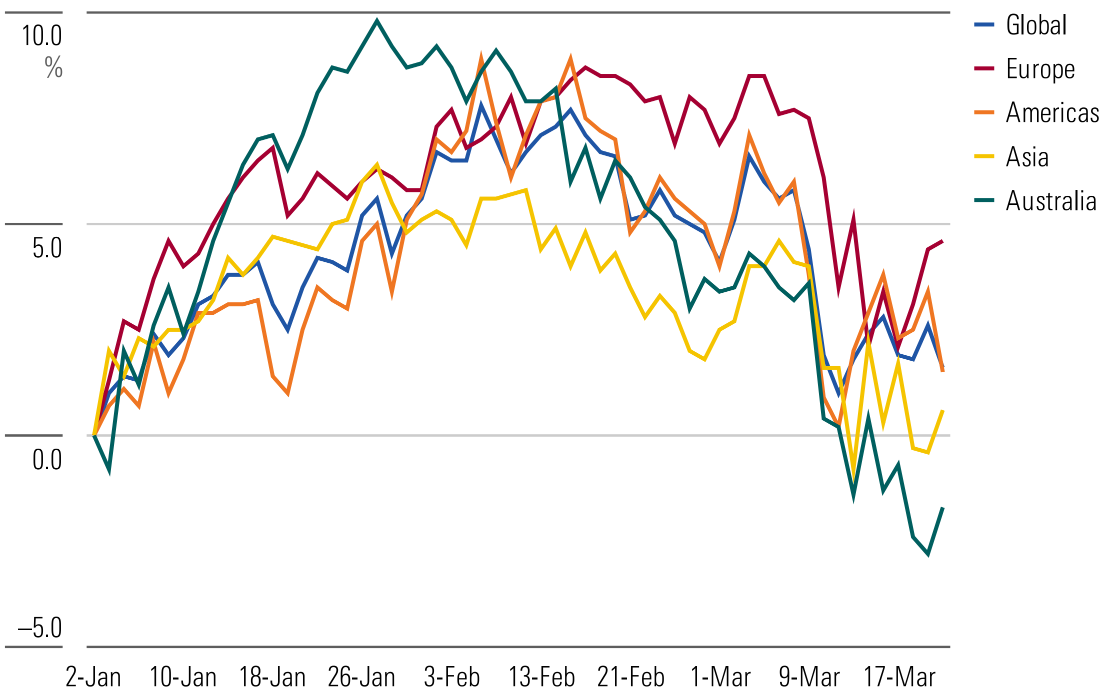
On a price/fair value estimate basis, the European market is trading at around a 5% discount to our intrinsic values. This is nowhere near the bargain territory it was trading at in late 2022, nonetheless it is a reasonably attractive proposition.

The market is clearly jittery after the events in the banking sector during March, which is being reflected in current market valuations. Risks remain, but with an improving corporate earnings picture, and barring a recession, this discount is likely to narrow as the year progresses.

Europe Outperforms in Q1, Bringing Valuations Higher Than North America

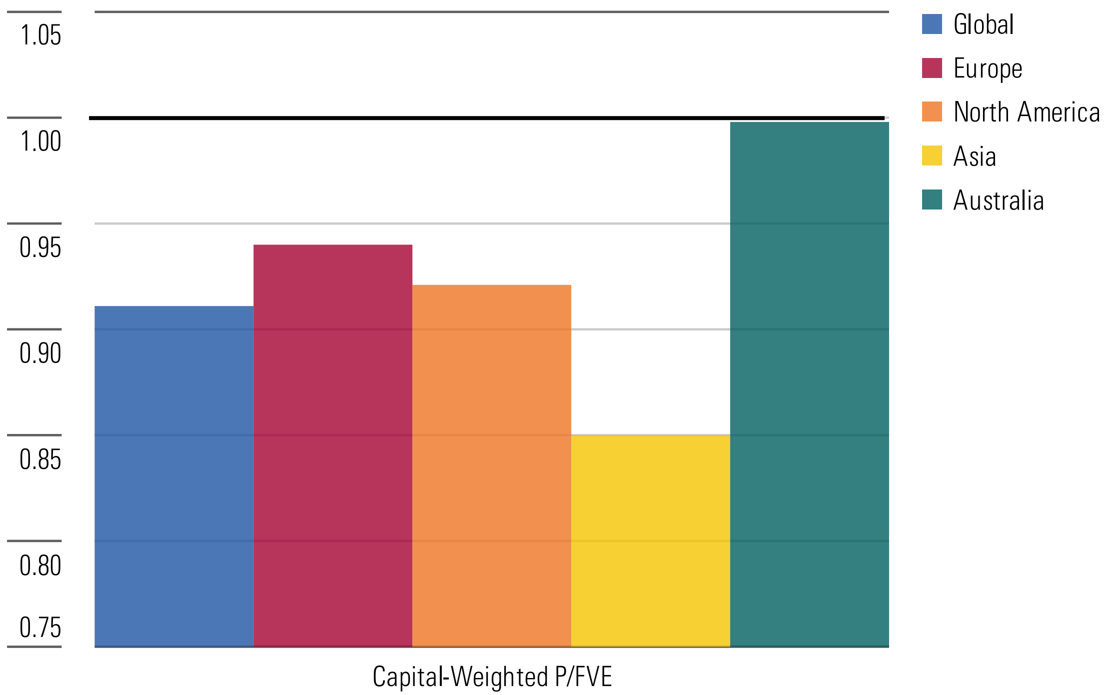
Europe's strong run, which began in the fourth quarter of last year, continued into 2023 before becoming slightly derailed due to the banking crisis. On a relative basis though, Europe outperformed the pack, rising close to 5% over the period. On a valuation basis, Europe now trades at a premium to North America, a situation we have not seen in several years, with the two regions trading above the global average.

Regional Price Movements Over the First Quarter



Source: Morningstar. Data as of March 22, 2023.

Capital-Weighted Price/Fair Value Estimate for the Regions



Source: Morningstar. Data as of March 23, 2023.

Value Coming Back Into Favour, Although Discounts Still Persist

While valuations of mid-large cap growth stocks remained broadly the same quarter over quarter, those of value stocks rose markedly, particularly in the large-cap segment, possibly as a result of investors increasing their cyclical exposure as inflation began to fall at the start of 2023. The flight to large-cap stocks seems to have come to an end in most areas, with small- and mid-cap stocks seeing their valuations rise materially during the quarter. The changes in Europe over the quarter contrast with those in the U.S., where valuations fell in some cases.

Investors in Europe Currently Favour Large-Cap Stocks, With Growth and Core More Highly Valued*

Europe Intrinsic Value-Weighted Price/Fair Value Estimate

Size	All	Style: Value	Core	Growth
All	0.91	0.83	0.88	1.03
Large	0.92	0.84	0.89	1.04
Mid	0.82	0.77	0.83	0.90
Small	0.76	0.68	0.85	0.82

US Intrinsic Value-Weighted Price/Fair Value Estimate

Size	All	Style: Value	Core	Growth
All	0.87	0.79	0.93	0.86
Large	0.88	0.82	0.95	0.86
Mid	0.84	0.75	0.88	0.89
Small	0.66	0.52	0.77	0.77

Overvalued
- ≥ 1.10
- 1.05 to 1.10

Fairly Valued
- 1.01 to 1.05
- 0.99 to 1.01
- 0.95 to 0.99

Undervalued
- 0.90 to 0.95
- ≤0.90

Source: Morningstar. Data as of March 22, 2023. * May not be fully representative of investment styles due to limited coverage in certain segments.

Sector Valuation Overview

Opportunities Remain Despite Rising Valuations

Banking Rout in March Pared Back Gains, but Q1 Was Still Positive

Despite the investor panic in March, European equity markets made decent progress in the first quarter, rising more than 5%, and bringing 12-month returns into positive territory, from the negative level last quarter.

Technology, industrials, and consumer cyclicals were some of the sectors to see large positive moves over the quarter, with each rising by double-digit percentages, but ultimately what we have seen is a levelling up, with 12-month returns for almost all sectors now broadly similar. The one exception to this is the energy sector, which is no longer experiencing the strong tailwinds of high energy prices, but is not collapsing either, falling less than 2% over the quarter, and still up almost 20% over the last 12 months.

The banking crisis in March has been a wake-up call for investors. Sector rotation will likely be prevalent over coming quarters as investors fully feel the impact of rising interest rates on different sectors of the economy and adjust their positioning accordingly.

Aggregated Stock Price Changes

Sector	TTM% Change	Trailing Quarter % Change
Aggregated European Market	1.0%	5.6%
Cyclical		
Basic Materials	(6.2%)	1.6%
Consumer Cyclical	3.2%	14.9%
Financial Services	5.3%	3.2%
Sensitive		
Communication Services	(0.4%)	10.7%
Energy	19.0%	(1.7%)
Industrials	3.4%	10.1%
Technology	(3.0%)	14.0%
Defensive		
Consumer Defensive	0.8%	4.5%
Healthcare	0.2%	0.1%
Utilities	(3.5%)	3.1%

Source: Morningstar. Data as of March 22, 2023.

Discounts To Fair Value Estimates Remain Across the Board

Share price gains over the first quarter drove valuations higher across some sectors; in particular, cyclically exposed sectors like consumer cyclical and industrials. Conversely, a sector such as healthcare saw its relative attractiveness increase over the period.

While the sands have shifted slightly, the message has not, every sector across our coverage trades at a level below our fair value estimate, an unusual, but welcome scenario. While sectors such as industrials are very close to their fair value estimates, others like consumer cyclicals and communications still offer material upside.

Despite the upheaval in the European banking sector in March, valuations here have not shifted significantly, with the financial services sector trading only slightly lower than in the first quarter of the year.

Morningstar European Coverage Average Price/Fair Value Estimate by Sector

Cyclical Sectors	Average Price/Fair Value	Sensitive Sectors	Average Price/Fair Value	Defensive Sectors	Average Price/Fair Value
Consumer Cyclical	0.78	Comm Svcs	0.83	Consumer Defensive	0.92
Financial Services	0.82	Energy	0.84	Healthcare	0.83
		Industrials	0.98	Utilities	0.92

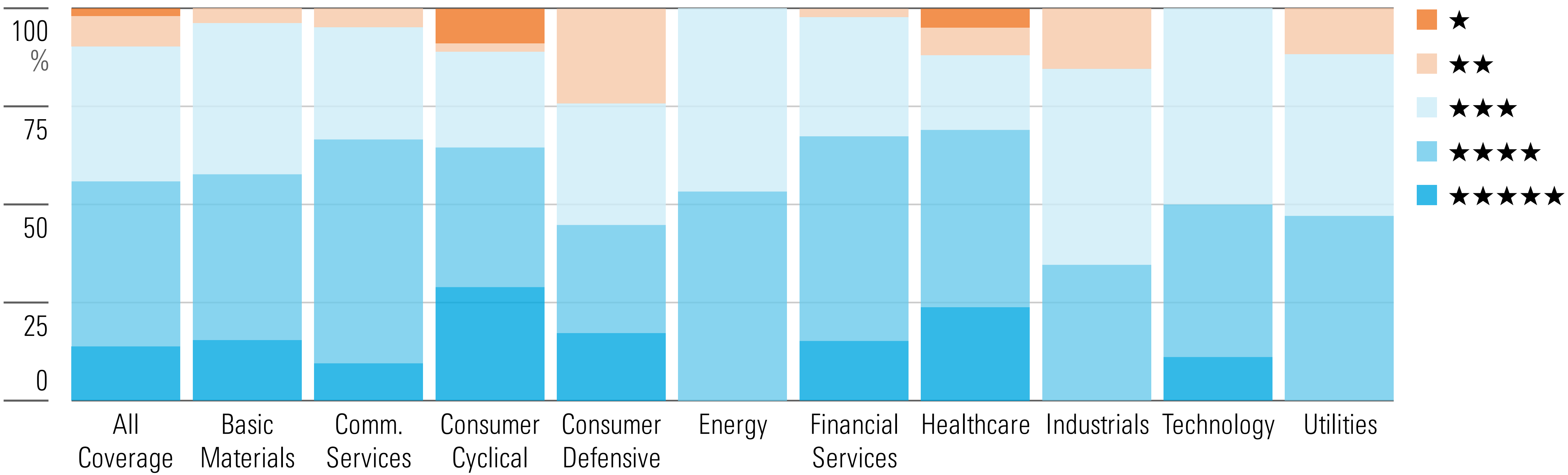
Source: Morningstar. Data as of March 22, 2023.

SECTOR VALUATION OVERVIEW

Four- and Five-Star Opportunities Abound

Despite rising share prices and sector valuations, opportunities remain abundant on the stock level. In all but two sectors, 5 stocks are present, and in the energy sector, which has seen massive rallies over the last 12 months, all the stocks we cover are fairly valued or better. In fact, across our entire coverage less than 10% of stocks are rated as overvalued.

Star Rating Distribution by Sector



Source: Morningstar. Data as of March 22, 2023.

Communication Services

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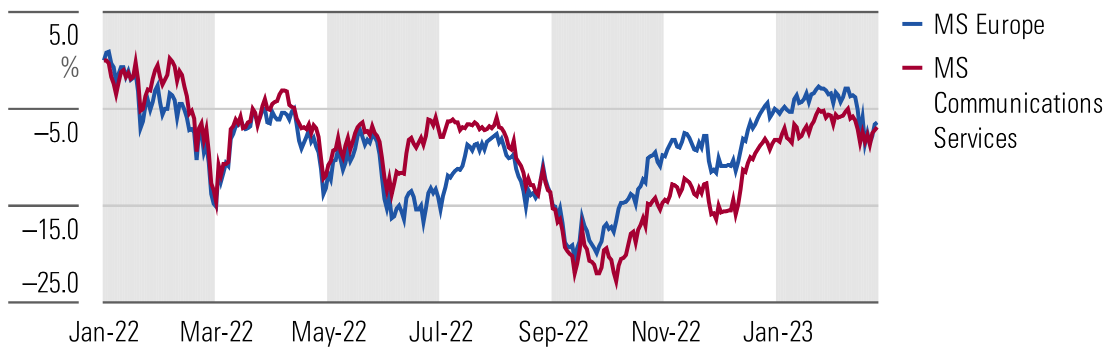
Underperformance Means More Opportunities in Communication, but We Prefer To Be Selective

The Morningstar European Communications Index has underperformed the Morningstar European Index in 2022. At the time of writing most stocks are in 4-star and 5-star territory, offering attractive upside relative to our fair value estimates. Although the European telecommunication sector is challenged as a whole, we believe the market has overpenalised some of these stocks, as we have not seen a significant deterioration of financial fundamentals among our coverage.

While some stocks have performed poorly year to date, other European telecommunication shares have shown resilience, showing flat or even positive shareholder returns year to date.

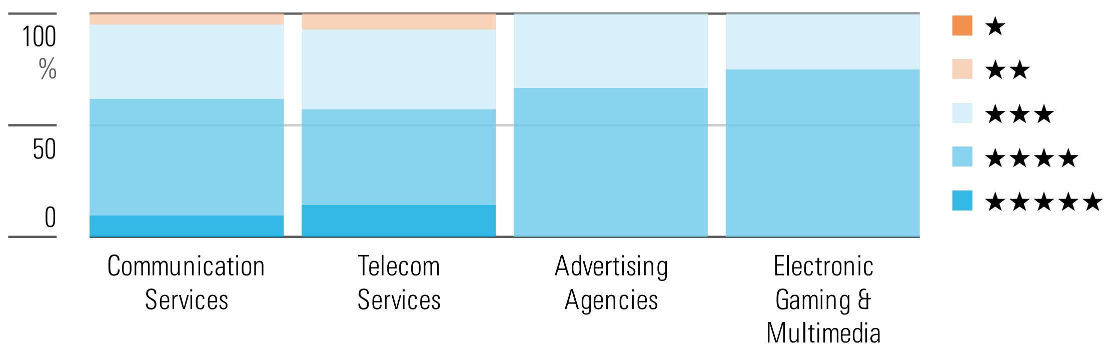
Conglomerates such as Vodafone, Telefonica, or Liberty Global have seen their share prices underperform leaner companies with exposure to healthier markets such as KPN, Swisscom, or Deutsche Telekom. We believe the latter have benefited from higher cash flow visibility, lower exposure to emerging markets, and better ability to pass price increases to customers. Although names like KPN and Deutsche Telekom offer less upside potential, they remain our preferred names given their better management and capital allocations, exposure to healthy markets, and cost controls. The European tower firms Cellnex and Inwit are also two of our top picks.

Communication Services vs. the Morningstar European Index



Source: Morningstar. Data as of March 22, 2023.

Communication Services Star Rating Distribution by Industry

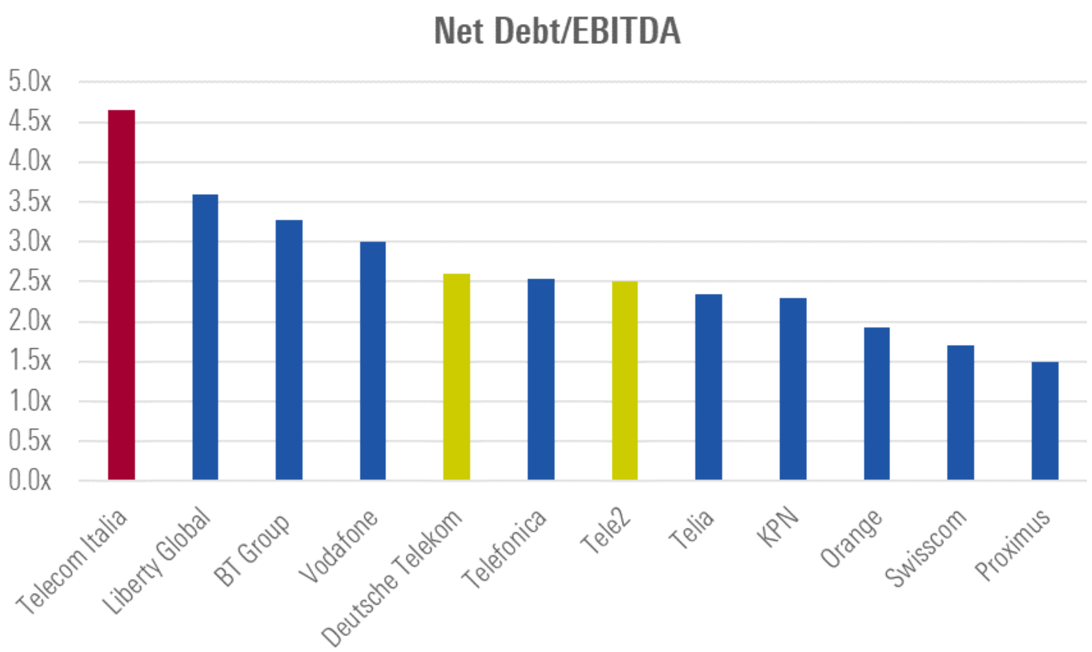


Source: Morningstar. Data as of March 22, 2023.

In a Period of Macroeconomic Uncertainty, Balance Sheets and Dividend Coverage Ratios Matter

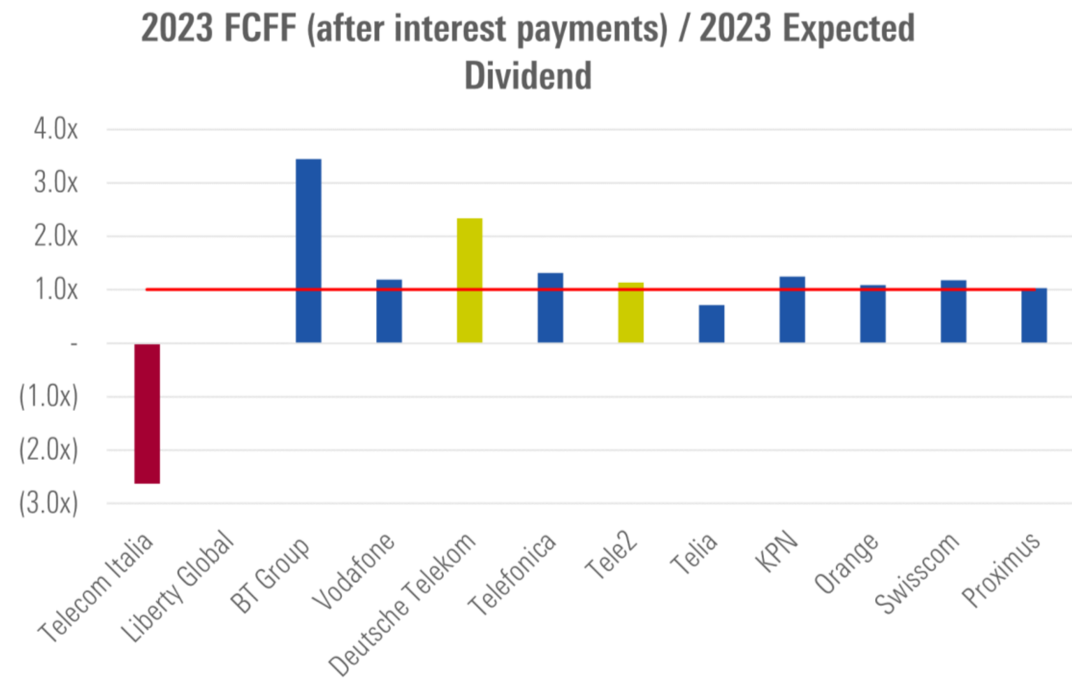
The U.S and European bank crisis in March 2023 has raised fears of potential bank runs and a recession. In a potential recession, we believe investors should prioritize telecommunication firms with healthier balance sheets, good capital allocation skills, and healthy dividend coverage ratios. We believe firms like Deutsche Telekom, KPN, Tele2 or Swisscom should perform better in a challenging macro environment. BT Group's management has also been good on capital allocation over the last few years, and shares remain undervalued.

Healthier Balance Sheets Offer Protection in an Uncertain Environment



Source: Company filings. Note: Last reported net debt/EBITDA ratio (excluding leases), except for Liberty, BT Group, Telia, and Swisscom (including leases).

Not All Dividends Are Covered by Free Cash Flow Generation



Source: Morningstar estimates. Note: Proximus ratio considers management's guidance of dividend being cut in half.

Communication Services | Top Picks

Name/Ticker		Rating	
Cellnex Telecom (CLNX)		★★★★★	Narrow-moat Cellnex owns and operates more than 100,000 wireless towers in Europe as a result of continued merger and acquisition activities since its IPO in 2015. Cellnex's business model is protected by long-term contracts, which provide high cash flow visibility, inflation protection, and growth optionality. Based on our unit economic calculations, we estimate Cellnex acquires towers at an internal rate of return in line with or slightly above its cost of capital, but we estimate returns will get closer to the 10% range as the acquired tower portfolios are made more efficient. Since late 2022, Cellnex's strategy has become more organic, with the aim of improving its tower portfolio and achieving a better credit rating. Our fair value estimate is EUR 52 per share.
Price	**Fair Value**	**Uncertainty**	
EUR 33.21	EUR 52.00	Medium	
Market Cap (B)	**Economic Moat**	**Capital Allocation**	
EUR 23.86	Narrow	Standard	

Name/Ticker		Rating	
Inwit (INW)		★★★★	Narrow-moat Inwit is the leading wireless tower operator in Italy, with Telecom Italia and Vodafone as its anchor tenant. Inwit has the highest tenancy ratio among European operators (close to 2.2 times) and leading EBITDAaL margins of more than 65%. We believe Inwit is a good company to navigate the current inflationary environment as its contracts are linked to the consumer price index with no cap and a 0% floor. In the next few years, we expect Inwit's EBITDAaL margins to expand above 70% due to new tenancy additions coupled with wireless towers' inherent operating leverage. We see Inwit as a good play for investors looking for lower uncertainty with growing dividends (Inwit's 2024 dividend will increase by 40%). Our fair value estimate is EUR 12.60.
Price	**Fair Value**	**Uncertainty**	
EUR 11.33	EUR 12.60	Low	
Market Cap (B)	**Economic Moat**	**Capital Allocation**	
EUR 10.91	Narrow	Standard	

Consumer Cyclical

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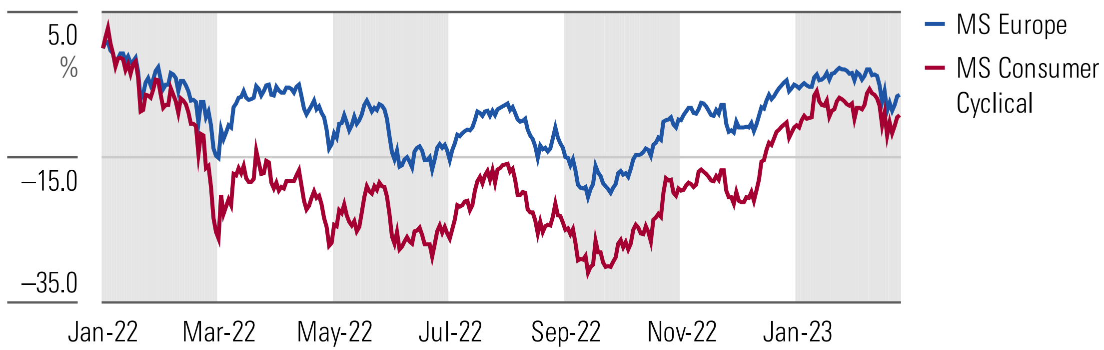
Luxury Segment Slightly Overvalued; Opportunities in Apparel and Food Delivery

While the Morningstar Europe Consumer Cyclicals Index significantly lagged the Morningstar Europe Index in 2022 as concerns about inflation, companies' ability to pass on price increases, and its dampening effect on consumer discretionary spending weighed on the sector; thus far in 2023, we are seeing a sharp recovery. Moderating inflation and the removal of COVID-19-related restrictions in China has helped boost consumer spending materially, leading to a more favourable outlook for consumer stocks.

The sector is largely attractively valued, with luxury goods now slightly overvalued, having previously traded well in excess of our fair value estimates, and apparel and internet retail companies' valuations currently looking alluring. Within the diverse internet retail segment of our coverage, we see pockets of opportunities in food delivery, while Zalando and Inditex look particularly attractive in the apparel retail segment.

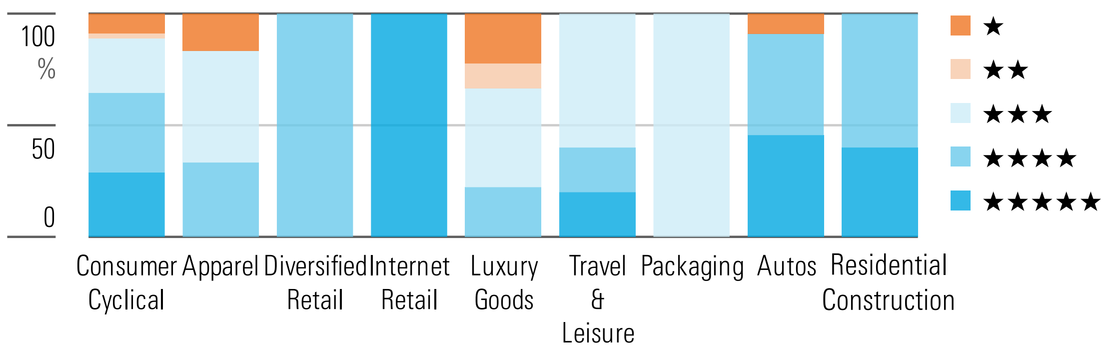
Food delivery stocks are long-duration assets, meaning that a combination of increasing interest rates, the anticipation of a tighter capital markets environment, and elevated inflationary pressures, have all weighed on stock performance lately. Despite an expected top-line growth slowdown as order growth decreases in the medium term, we remain constructive, but investors need to be selective. Strong balance sheets, a clear path to profitability, and resilient market positions are factors investors should prioritize. We see valuations as largely undemanding postcorrection, with Just Eat Takeaway our top pick in the segment.

Consumer Cyclical vs. the Morningstar European Index



Source: Morningstar. Data as of March 22, 2023.

Consumer Cyclical Star Rating Distribution by Industry



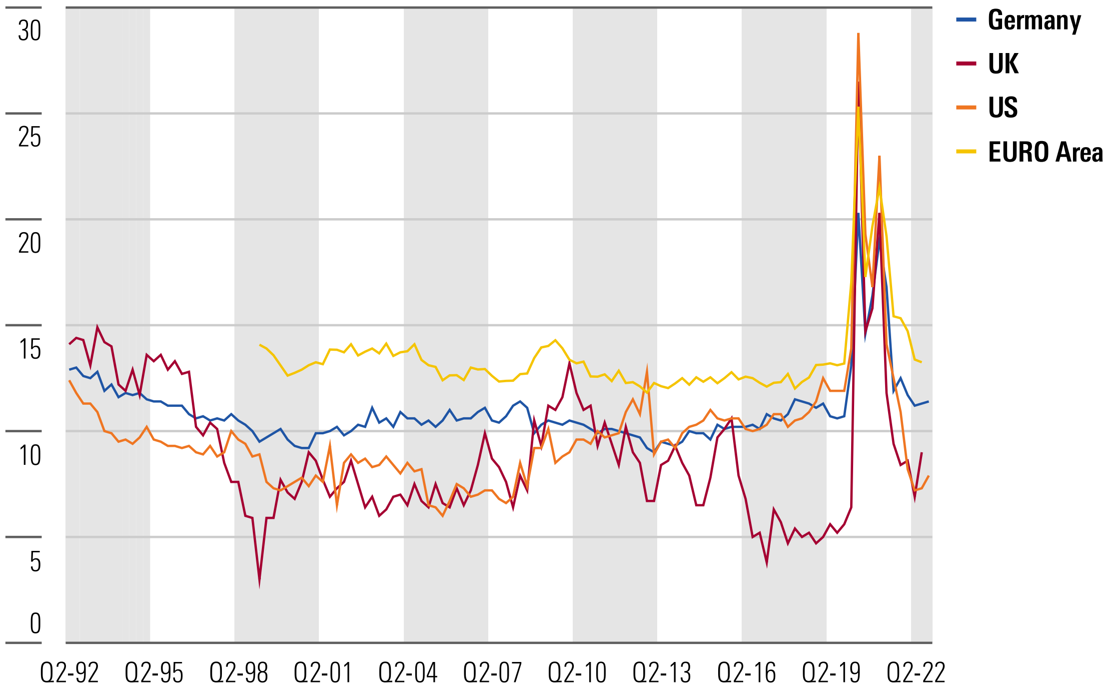
Source: Morningstar. Data as of March 22, 2023.

Consumer Habits Are Reverting To Prepandemic Norms

Google search trend data suggests interest in food delivery, though lower, remains elevated despite an eventual return to normalcy, a sign of persistent changes in consumer behaviour. However, we anticipate cohorts acquired during the pandemic will display weaker spending habits than historical generations and combined with a lack of strength in discretionary spending, will result in a noticeable slowdown of order growth in the medium term, reflected in our estimates being lower than companies' guidance.

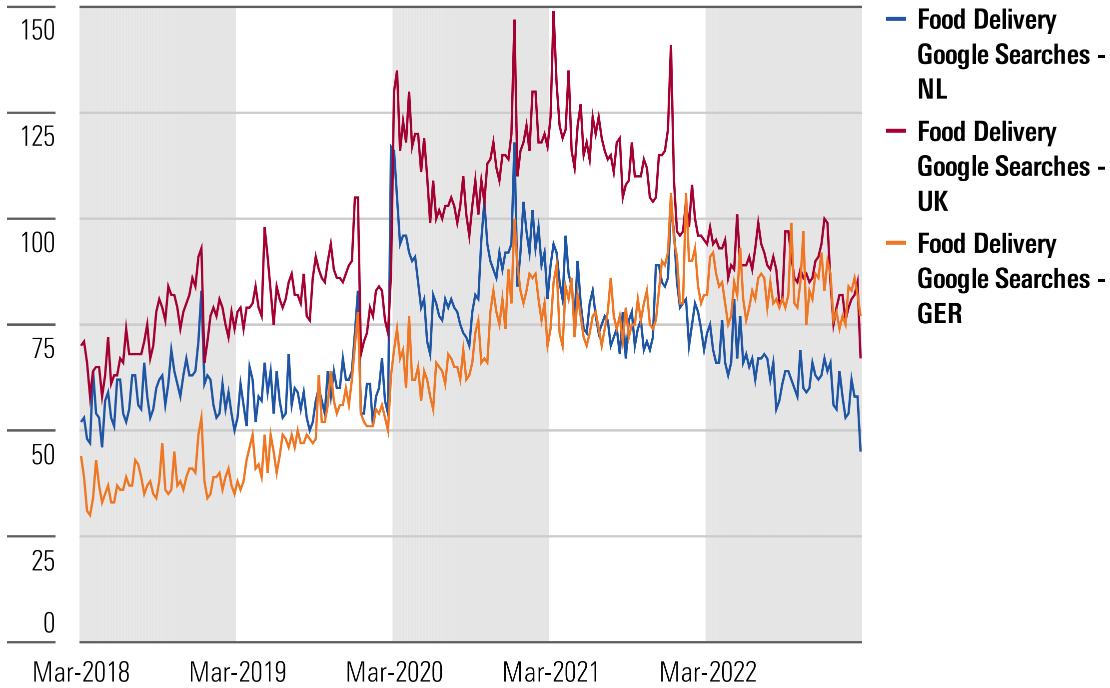
Personal Savings Rates at Prepandemic Levels

Downside risks for consumption of discretionary items amid inflationary pressures.



Source: FRED economic data. Data as of Dec. 15, 2022.

Though Gradually Normalizing, Interest in Food Delivery Remains Elevated



Source: Google Search Trends. Data as of March 12, 2023.

Consumer Cyclical | Top Picks

Name/Ticker		Rating	
Inditex (ITX)		★★★★	Narrow-moat Inditex is trading at a more than 10% discount to our fair value estimate in 4-star territory. Inditex benefits from an economic moat because of its intangible assets. The company's brand awareness helps it operate at a structurally lower cost than peers, bypassing 3%-9% of revenue in its marketing budget, and it has cost advantages from its scale and fast supply chain. With its low-single-digit penetration rate of global apparel sales, we believe Inditex is still well positioned to capture market share from weaker players, especially in times of economic difficulties. (We estimate around 60% of Western European apparel markets are still dominated by smaller, brick-and-mortar, and midprice players that could continue ceding share to Inditex). Further, Inditex was proactive and ahead of most peers in transitioning its business online, with its revenue from online and capital expenditure exceeding most European online pure-play firms. We expect cash flow and shareholder rewards to benefit from lower capital intensity as business shifts online (50% of business estimated by 2030).
Price: EUR 29.27	Fair Value: EUR 32.00	Uncertainty: Medium	
Market Cap (B): EUR 90.63	Economic Moat: Narrow	Capital Allocation: Exemplary	

Name/Ticker		Rating	
Just Eat Takeaway (TKWY)		★★★★★	Just East Takeaway is the best-positioned food delivery player. According to our estimates, in Germany alone, where the company is a dominant player (despite recent new entrants such as Uber Eats and Wolt), it is worth more than the current market cap, meaning investors get the rest of the business for free. The recent divestment of its iFood stake has removed refinancing concerns in the midterm while the Amazon/Grubhub partnership provides scope for profitable growth in the U.S. and a potential Amazon minority stake in future. Fresh 2023 guidance for adjusted EBITDA of EUR 225 million reflects the group's robust and profitable marketplace business, but the absence of top-line growth guidance creates uncertainty. The market appears sceptical about the sector's long-term growth potential, but Just Eat Takeaway's strong balance sheet and resilient marketplace business places the company in a strong position over the long term. From a valuation perspective, Just Eat Takeaway offers a rare investment opportunity in the food delivery segment.
Price: EUR 17.50	Fair Value: EUR 81.00	Uncertainty: Very High	
Market Cap (B): EUR 3.89	Economic Moat: Narrow	Capital Allocation: Exemplary	

Consumer Defensive

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Sector Provides a Safe Haven Amid Banking Turmoil and Inflationary Pressures

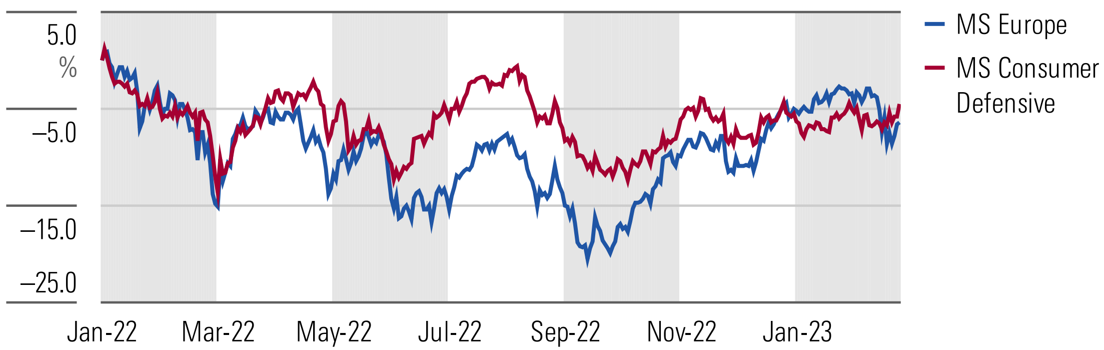
The Morningstar Consumer Defensive Index slightly outperformed in early 2023 as recent turmoil in the banking sector led to some risk-averse sector rotation. We think the consumer defensive sector will provide a relatively safe haven for investors, as it has done in previous recessions.

Fourth-quarter earnings reports were fairly strong, with many companies beating our estimates on revenue. Even though spot prices appear to have peaked, manufacturers are still pushing through unusually large levels of commodity cost inflation, and this is unlikely to ease until the second half of the year. In the fourth quarter, most manufacturers attempted to raise prices just enough to offset the spike in input costs, but converting that into earnings growth has depended on how successfully manufacturers controlled other operating expenses.

The consumer defensive sector often outperforms in market downturns, but those cycles have usually been accompanied by falling interest rates. This time, although low-income consumers may struggle, middle-income consumers have reverted to prepandemic savings levels and despite the broad-based inflationary pressure, so far seem willing to accept higher prices.

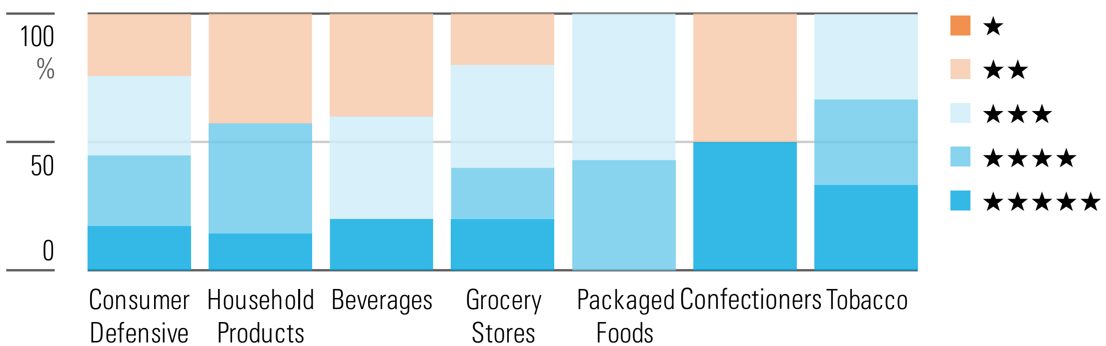
The sector now appears fairly valued at 0.92 price/fair value estimate although we see pockets of value among confectioners and beverage manufacturers. Despite a strong rally this year, some tobacco stocks remain undervalued.

Consumer Defensive vs. the Morningstar European Index



Source: Morningstar. Data as of March 22, 2023.

Consumer Defensive Star Rating Distribution by Industry



Source: Morningstar. Data as of March 22, 2023.

Inflation Pits Grocers Against Discounters, No Price War Expected Based on Market Trends

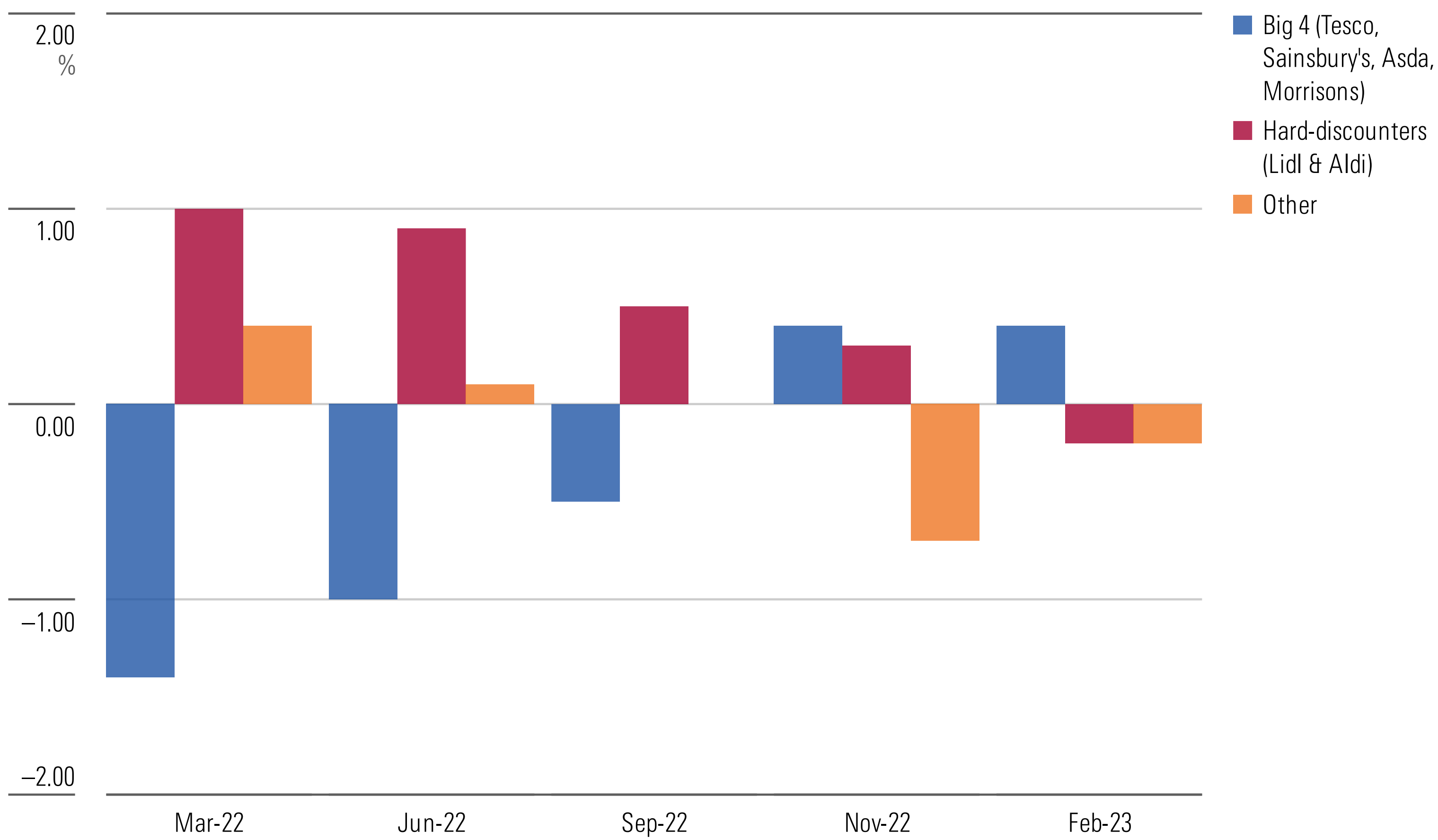
Higher inflation could spell trouble as consumers trade down, in which case traditional grocers without a strong market offering will find it difficult to compete with discounters. Recent share gains in the U.K. corroborate this. That said, a potential discounter-led price war would hit grocers in our list.

However, we don’t think this is likely as:

- at current price levels, discounters continue to gain market share;
- discounters’ profit margins are significantly lower than in the past; and
- grocers are much better positioned in the market-entry, value segment with significantly narrower price gaps versus discounters than in the past.

Market share development in 2023 so far reflects resilient big 4 performance and share gain peaking for hard-discounters while other smaller retailers/grocers continue to be market share donors.

U.K. Grocery Market Share Developments



Source: Kantar U.K. data as of March 22, 2023.

Consumer Defensive | Top Picks

Name/Ticker		Rating	
Anheuser-Busch InBev (ABI)		★★★★★	AB InBev is a high-quality business with monopolistic positions in several emerging markets in Latin America and Africa. While the company has lost share in developed markets, particularly to craft beer in the U.S., AB InBev should benefit from premiumisation into its global brands in other markets, making mix a strong growth driver. In our view, the stock is undervalued because of its high debt load. At the end of 2022, AB InBev reported net debt/EBITDA of 3.5 times, still much higher than the level of around 2.5 times that we think is maintainable in the long term. However, we expect leverage to fall to 2.3 times by the end of 2025. AB InBev reports in U.S. dollars, but generated less than one third of its EBIT in the U.S. in 2022. The strength of the U.S. dollar has weighed on earnings in the last few quarters, and reduced revenue by 3 percentage points in the first nine months of last year. Any reversal in the dollar's strength would boost earnings growth.
Price	Fair Value	Uncertainty	
EUR 57.59	EUR 80.00	Medium	
Market Cap (B)	Economic Moat	Capital Allocation	
EUR 111.90	Wide	Exemplary	

Name/Ticker		Rating	
Barry Callebaut (BARN)		★★★★★	Barry Callebaut is well positioned in an inflationary environment due to its cost-plus pricing model (contractually passing on input cost inflation to clients, including freight cost inflation due to container scarcity) and is currently trading in 5-star territory, presenting an attractive opportunity for long-term investors. Given the slow start to the year and a still uncertain macroeconomic environment, unchanged 2023 guidance on organic growth looks precarious and might create opportunities for long-term investors. That said, midterm guidance of 4%-6% volume growth and 8%-10% EBIT growth is best-in-class and given strong execution should be rewarded with an above-average valuation multiple.
Price	Fair Value	Uncertainty	
CHF 1,901.00	CHF 2,400.00	Low	
Market Cap (B)	Economic Moat	Capital Allocation	
CHF 10.32	Wide	Standard	

Consumer Defensive | Top Picks

Name/Ticker		Rating
Tesco (TSCO)		★★★★
Price	Fair Value	Uncertainty
GBX 259.00	GBX 298.00	Medium
Market Cap (B)	Economic Moat	Capital Allocation
GBP 18.27	None	Standard

Despite the negative macroeconomic environment and cost-of-living crisis in the U.K, we think the outlook for Tesco is not as bad as the share price suggests. As long as grocery players act rationally and don't undercut competition, we believe the macroeconomic backdrop is a net positive for Tesco due to its scale and dominant offline (27% market share), online (35% market share), and food-service (largest-player) position in the core U.K. market. A discounter-led price war is the bear case for the large UK supermarkets; however we don't believe this is likely because: 1) at current price levels, discounters continue to gain market share, 2) discounters profit margins are significantly lower than in the past, so less leeway to invest in lower prices, and 3) Tesco is much better positioned in the market-entry, value segment with significantly narrower price gaps versus discounters than in the past. Recent market share data suggests market share gains for discounters have peaked. Apart from an attractive dividend yield, Tesco shares are attractively priced, trading in 4-star territory.

Name/Ticker		Rating
Unilever (UNA)		★★★★
Price	Fair Value	Uncertainty
EUR 47.63	EUR 50.00	Low
Market Cap (B)	Economic Moat	Capital Allocation
EUR 117.83	Wide	Standard

Unilever has underperformed in recent years, having struggled to reignite organic growth. Trian Partners, led by CEO Nelson Peltz, has accumulated a 1.5% stake in Unilever and taken a seat on the board, in a move that we believe could finally be the catalyst to unlock value at the company. While the details are unknown how Trian intends to revitalise Unilever's flagging performance, this is undoubtedly an indication that significant change may be on the horizon. We think there are measures that Unilever could take to optimise the focus and speed of its investment strategies and innovation capabilities, including selling off some assets and shrinking in size. In time, we believe Unilever could grow earnings by at least midsingle digits on a maintainable basis.

Energy

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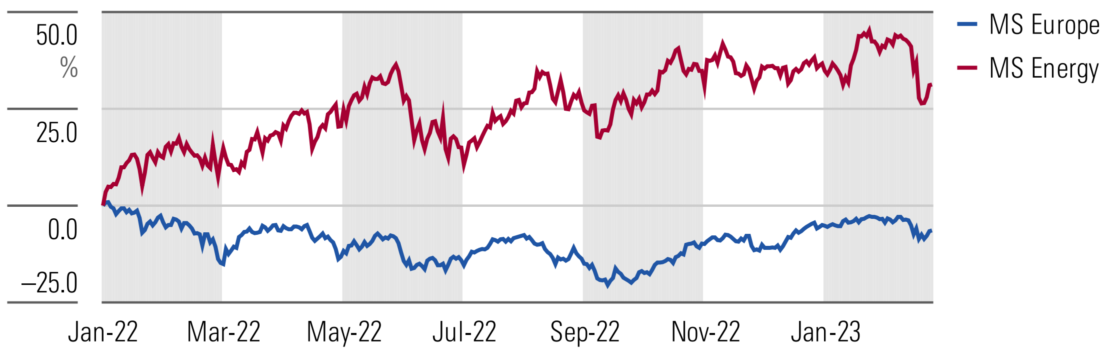
Integrated Oil Emissions Matter, Capital Allocation Matters More

Integrated oils made progress in 2022, albeit uneven, in further reducing emissions. That's good news as emissions are coming under increased scrutiny over time, and those able to operate with lower emissions will likely be at an advantage in the future. However, year-over-year changes are not necessarily going to influence any investment decisions or affect share prices. More importantly, it is the adoption, and ultimately the achievement, of long-term emission-reduction targets, which is influencing current capital-allocation decisions. These decisions in turn affect valuations and moats. European integrated oils' adoption of net-zero emissions 2050 targets, which includes scope 3 emissions, is in part resulting in more aggressive spending on low-carbon businesses, particularly renewable power generation. ExxonMobil and Chevron have also committed to net-zero emissions 2050, but only for operated asset emissions, meaning they are not investing to pivot from hydrocarbons, but are doing so to reduce emissions from hydrocarbon-producing assets or produce a low-carbon drop in fuels, not renewable power.

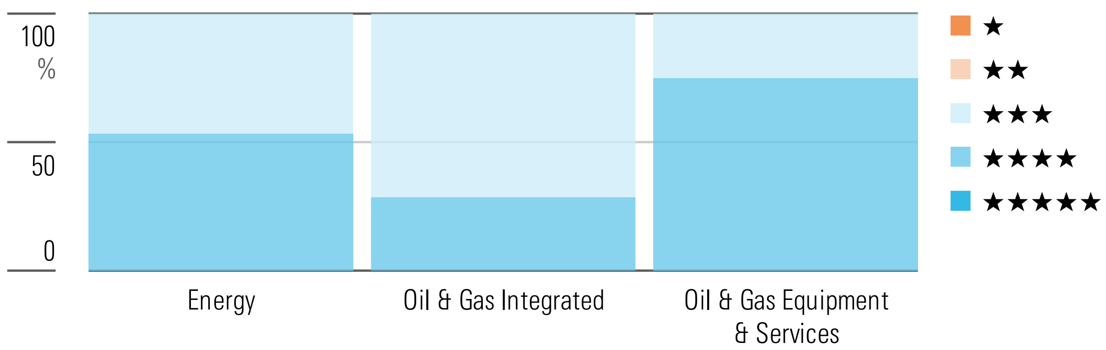
Reducing portfolio and operated asset emissions intensity has been marginal during the last two years, but companies have made demonstrable progress reducing flaring and methane emissions. European integrated oils are allocating over 20% of their capital budgets during the next five years to low-carbon businesses, not including retail marketing, compared with U.S. firms at 10%. More aggressive reduction targets and investment plans by European firms have not been rewarded by the market, evidenced by their underperformance and valuation discount to Exxon and Chevron, despite strong performance versus the broader market.

Energy vs. the Morningstar European Index



Source: Morningstar. Data as of March 22, 2023.

Energy Star Rating Distribution by Industry



Source: Morningstar. Data as of March 22, 2023.

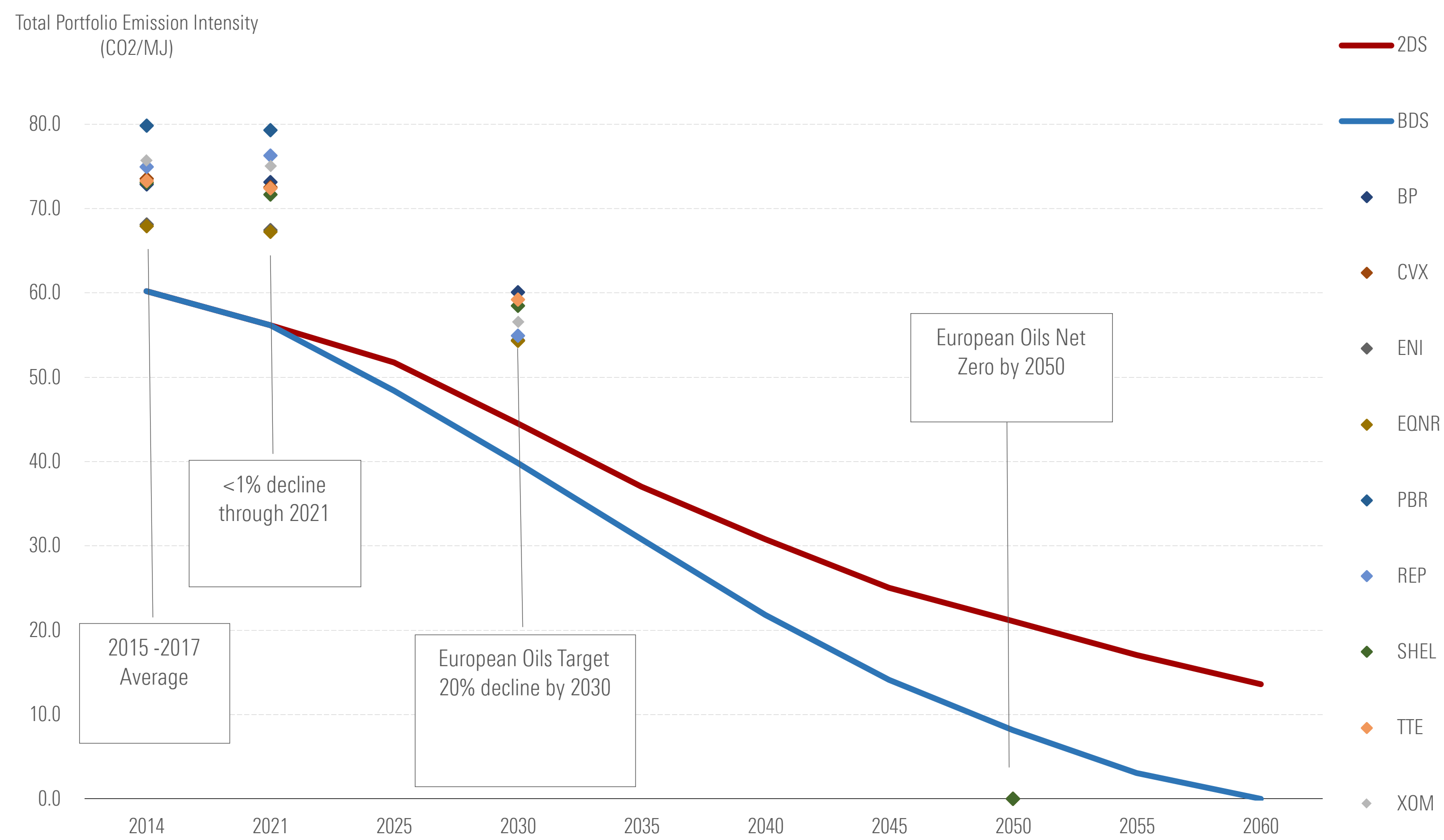
European Integrated Oil Emissions Targets Are More Ambitious Than U.S. Firms

All European integrated oils have signed up for net-zero emissions 2050 that includes all emissions, placing them on an even footing. This represents a major step as only Repsol had this target in January 2020.

This means European integrated oils are looking to exceed the necessary reductions in the International Energy Agency's 2 degree Celsius scenario, or 2DS, and Beyond 2 degree scenario, or B2DS1. While little progress has been made on total portfolio emissions intensity, declining a little less than 1% from average levels in 2015-17, this metric will be the most difficult to reduce as it incorporates emissions from products sold (scope 3). As such, meaningful progress will be measured over decades as the portfolio turns over, with firms targeting an average decline of 20% by 2030 and a measure of zero by 2050.

Achieving net-zero targets that include scope 3 emissions can only be achieved through a change in the type of energy supplied. While net zero can accommodate some hydrocarbon production as it allows for carbon offset, firms will also need to materially increase the amount of low- or no-carbon energy they produce.

Emissions Intensity Has Improved Little, but Is Set for Meaningful Declines To 2030 and Ultimately Zero in 2050



Source: Morningstar, European Commission, IEA forecast as of third-quarter 2022, IEA World Energy Outlook 2022. STEPS = stated policies scenario; APS = announced pledges scenario.

Energy | Top Picks

Name/Ticker		Rating	
Shell (SHEL)		★★★	Shell's strategy means it will retain exposure to oil and gas prices, while investing in the energy transition, allowing it to keep shareholder payouts strong. Shell's more moderate energy transition strategy will result in its oil volumes slowly declining as investments are increasingly allocated to liquid natural gas and renewables. The current strategy calls for a less capital-intensive model that leverages its own energy production and trading function along with sourced energy to serve customers' low-carbon energy needs, which it believes will be difficult to replicate and produce a competitive advantage. However, investors have not have entirely bought in, and with a new management team and more favourable commodity price outlook, it may look to keep oil volumes higher for longer. Such an announcement would likely boost shares as it did for peer BP.
Price	Fair Value	Uncertainty	
GBX 2317.50	GBX 2,600.00	High	
Market Cap (B)	Economic Moat	Capital Allocation	
GBP 153.86	None	Standard	

Name/Ticker		Rating	
TechnipFMC (FTI)		★★★★	TechnipFMC is the largest subsea service provider, and we foresee ample growth opportunities for the firm as investment in subsea engineering and construction strengthens over the next several years. The firm's share price has rallied in recent months, but we still see upside potential in future. TechnipFMC stands out as a leader for its efficiency-boosting products and services such as Subsea 2.0 and integrated projects, which will create more value for the company than the market seems to appreciate.
Price	Fair Value	Uncertainty	
USD 13.03	USD 18.00	Very High	
Market Cap (B)	Economic Moat	Capital Allocation	
USD 5.98	None	Standard	

Name/Ticker		Rating	
TotalEnergies (TTE)		★★★	TotalEnergies' latest strategic plan remains the same, aiming to achieve net-zero emissions by 2050 while delivering near-term financial performance. Its emissions-reduction goal is in line with many of its European peers, but in contrast to some, TotalEnergies does not plan a quick retreat from oil and gas. Instead, it plans to reduce emissions over time by expanding its ownership of renewable power assets. Its plan to return 35%-40% of cash flow to shareholders through the cycle rates as one of the highest payouts among peers.
Price	Fair Value	Uncertainty	
EUR 54.43	EUR 62.00	High	
Market Cap (B)	Economic Moat	Capital Allocation	
EUR 132.10	None	Standard	

Financial Services

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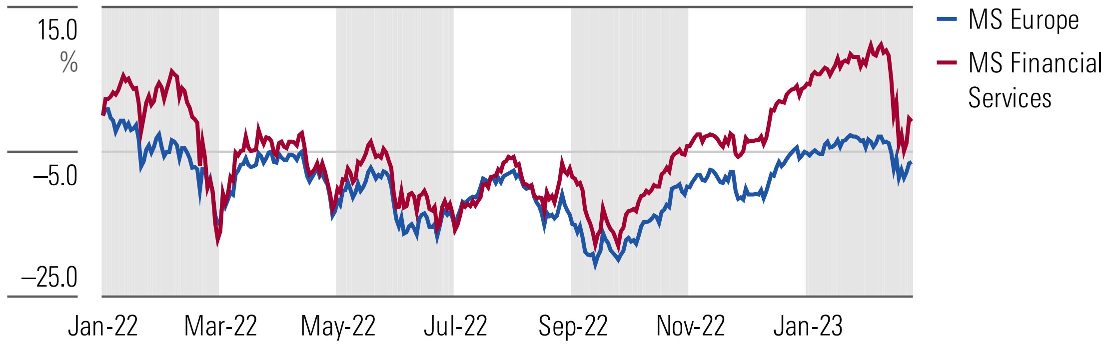
European Financial Services Remain a Good Hunting Ground

The Morningstar Financial Services Index has outpaced the Morningstar Europe Index since around September last year. Last quarter we attributed this to a rise in the prices of banking shares as the European Central Bank set out on a path of raising interest rates around that time last year. That has helped expand net interest margins. There seems to be increasing evidence now that the rise in interest rates will become more muted.

Pent-up consumer demand, soaring energy prices, and the Ukraine conflict led to unprecedented inflationary conditions. While everything is not yet well in the world, it looks better than it did. The failure of Silicon Valley Bank has led central banks to contemplate a second-order effect of their interest-rate hikes that possibly has longer consequences. As the world increasingly looks to technology to solve its problems and improve efficiency, higher interest rates are an inhibitor. A prolonged rise in interest rates would likely lead to more technology company failures because of lower supply, and the higher cost, of funding. Our expectation is that interest-rate rises will ease this year as inflation wanes and central banks turn their attention to underlying growth within their economies.

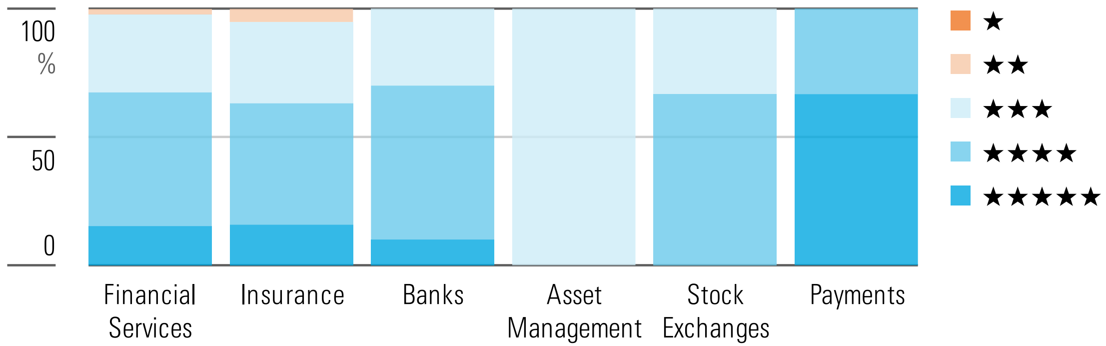
Our belief is that this year the outlook will continue to turn more favorable for banking stocks with traditional retail operations. As rates start to ease, technology will become more commercial again. We also like insurers that have had a hard time with inflationary pressure running through their claims as the uplift from price rises are yet to be seen.

Financial Services vs. the Morningstar European Index



Source: Morningstar. Data as of March 22, 2023.

Financial Services Star Rating Distribution by Industry



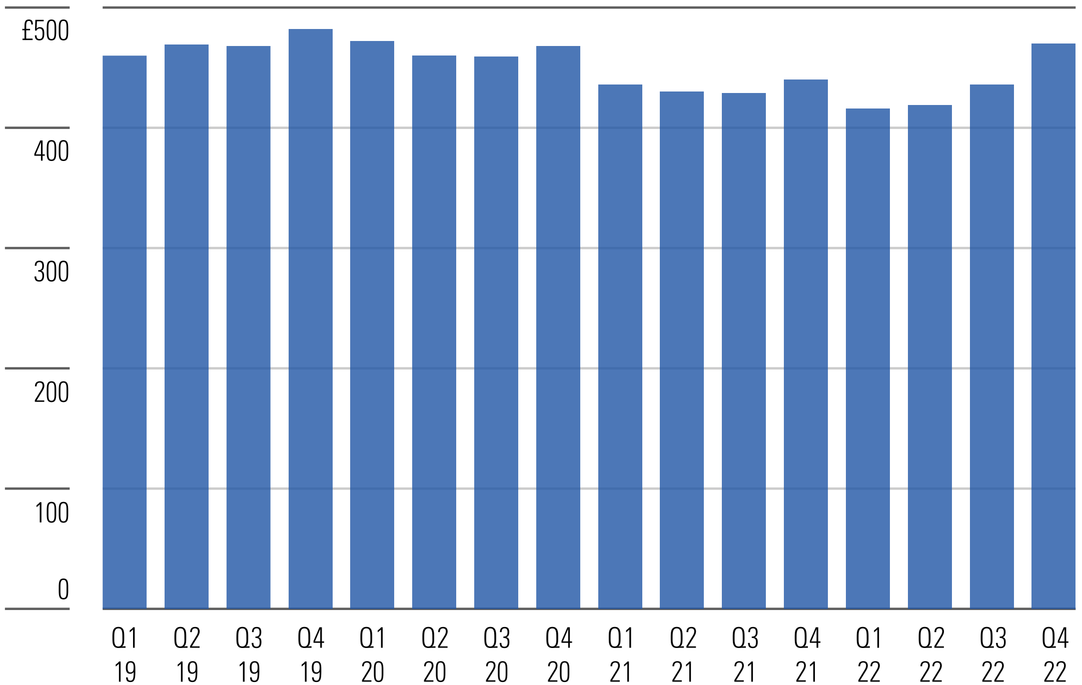
Source: Morningstar. Data as of March 22, 2023.

Motor Insurance Pricing Continues To Turn; Card Payments Continue To Rise

Motor insurance premiums within the United Kingdom rose sharply in the final quarter of last year, increasing by 8% in the quarter, and 13% over 2022. Some motor insurance have reported even sharper price rises than this.

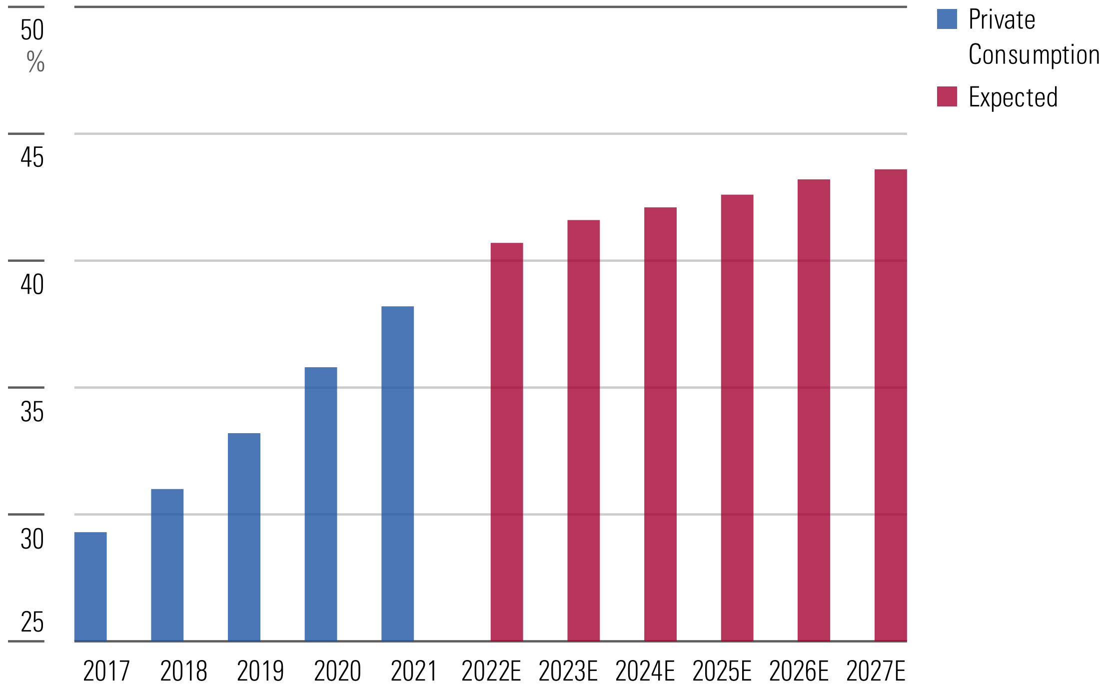
The shift from cash to cards is expected to continue in Europe, steadily growing the addressable market for in-store acquirers such as Worldline.

Comprehensive Motor Insurance Premium Tracker



Source: Association of British Insurers. Data as of March 22, 2023.

European Card Transaction Share



Source: Euromonitor. Data as of Dec.13, 2022.

Financial Services | Top Picks

Name/Ticker		Rating
Allianz (ALV)		★★★★
Price	Fair Value	Uncertainty
EUR 208.10	EUR 230.00	Medium
Market Cap (B)	Economic Moat	Capital Allocation
EUR 83.65	None	Exemplary

As our top pick Allianz might not sound like the most obvious choice. As the largest European insurer that we cover by market cap, one could have the impression that this is a business with a large and heavy fixed-cost base, but we don't believe this to be the case. Allianz has been on a strong simplicity and digitalization drive over the past half-decade, managing to extract a large amount out of its cost base. Last, while this is a company that is exposed to rising inflation via claims, we believe the business also shows some unique pricing power characteristics in trade and credit insurance. While the implosion of the Structures Alpha funds has not helped the brand, Pimco is Allianz's long-standing wholly owned third-party asset manager with one of the best industry reputations and brand names.

Name/Ticker		Rating
Admiral (ADM)		★★★★★
Price	Fair Value	Uncertainty
GBX 1,995.00	GBX 3,300.00	Medium
Market Cap (B)	Economic Moat	Capital Allocation
GBP 5.87	Narrow	Exemplary

Narrow-moat Admiral is probably one of the best inflation-protected insurance businesses within our European coverage. Its historical focus on more unique segments of the market has granted the company pricing power with its consumers that will prove important in coming quarters. The relationships that the company established early on have steadied the business and helped it remain nimble and adaptive. Its resultant lighter business model has meant more flexible capital-expenditure practices and Admiral is a well-capitalized insurer; against a backdrop of consolidation this will be increasingly important.

Name/Ticker		Rating
Worldline (WLN)		★★★★★
Price	Fair Value	Uncertainty
EUR 39.18	EUR 91.00	High
Market Cap (B)	Economic Moat	Capital Allocation
EUR 10.66	Narrow	Standard

High inflation and rising energy prices are squeezing households' purses across Europe. Travel activity has been improving based off the lows in 2020 and 2021, but in particular long-distance travel remains a drag on performance for European payment providers. Against this backdrop, more muted volume and revenue growth could be on the cards over the coming quarters. That said, we believe these factors are fully priced in already. Moreover, we don't expect a structural change to the long-term growth drivers of this industry—a shift from cash to cards. In our view, Worldline currently offers the greatest upside and we believe investors should capitalize on its current share price weakness to enjoy the strong long-term growth prospects of this narrow-moat business.

Healthcare

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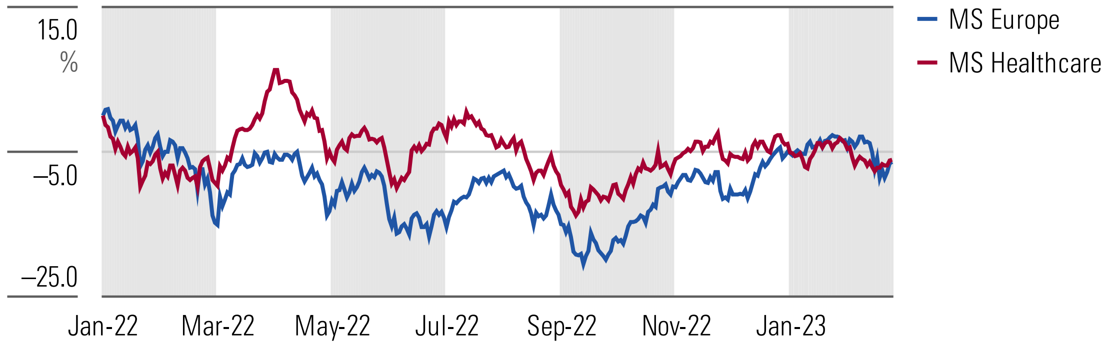
Healthcare's Defensive Attributes Should Hold Up Well During Potential Macroeconomic Headwinds

Healthcare Core Fundamentals Should Remain Solid if Economic Challenges Persist

Year-to-date broad European equity performance has largely been in line with the Morningstar European Healthcare Index. While the overall market is still working through many potential challenges, including a slowing economy, rising inflation, and rising interest rates along with banking system pressures, the healthcare sector has been fairly immune to these headwinds. The sector should hold up better than the overall market if these headwinds increase. The defensive nature of healthcare stocks should support stable demand through economic cycles. We expect our healthcare coverage (especially firms with moats) will be able to largely pass along inflation-related price increases owing to the strong pricing power enjoyed by the sector due to patents and high switching costs. While rising interest rates may hurt some smaller healthcare companies more reliant on external financing, most of our coverage in the mid- to large-cap segment generates robust cash flows and could actually benefit from rising interest rates by acquiring cash-strapped smaller firms at lower valuations.

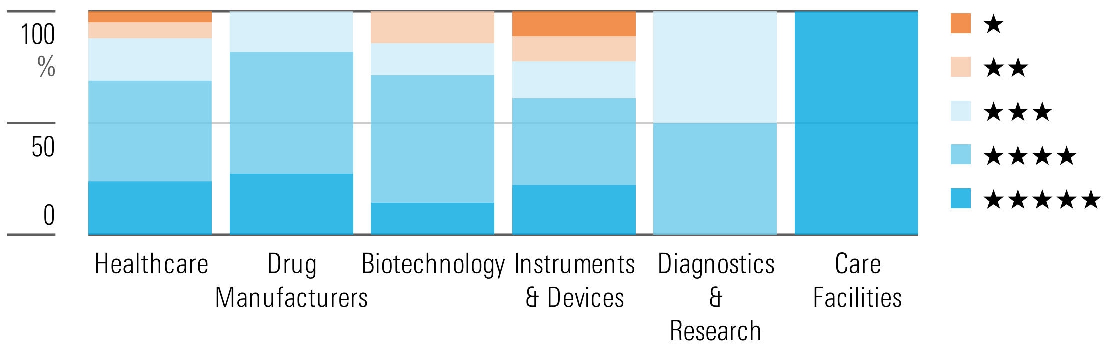
On valuation, we view the healthcare sector as undervalued. Our coverage trades below our overall estimate of intrinsic value. We see plenty of opportunities with over half of our European coverage rated 4- or 5-stars and relatively broad representation of undervalued stocks across the industries within healthcare.

Healthcare vs. the Morningstar European Index



Source: Morningstar. Data as of March 22, 2023.

Healthcare Star Rating Distribution by Industry



Source: Morningstar. Data as of March 22, 2023.

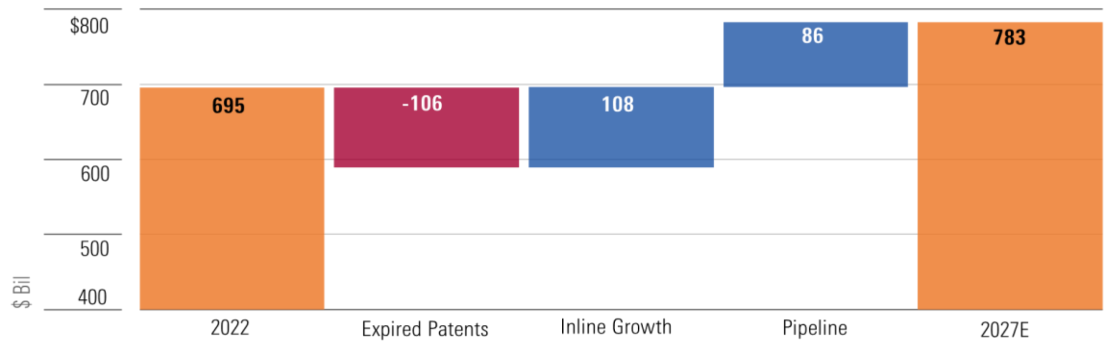
Healthcare Offers Several Industries With Attractive Valuations and Steady Fundamentals

We see attractive valuations within multiple healthcare industries, including the largest healthcare industry by market capitalization, the biopharma group. The drug group holds several undervalued companies and looks well positioned for long-term growth. As shown in the top right chart, we model 2.4% annual growth for the large-cap biopharma group over the next five years. This growth rate increases to 3.5%, excluding Pfizer's COVID-19 vaccine and treatment sales, since those sales are likely falling significantly as the pandemic recedes. While patent losses will slow industry growth, innovation is strong enough to more than offset generic competition. Further, with the group paying out close to 50% of earnings through dividends, we see strong yields and safe dividends, as the group rarely cuts dividends.

Beyond the biopharma group, we expect the other leading industries of devices, diagnostics, medical supplies, and services, to post steady long-term gains. Firms with high exposure to COVID-19 products like Pfizer, and some tool companies will, however, likely face slower growth, or even a decline in 2023 as sales of COVID-19-related products fall.

As interest rates increase, we could see a rise in acquisitions as cash-strapped smaller companies become more receptive to lower valuation offers. With the larger firms in the different healthcare industries typically generating significant excess cash, we could see an increase in the deployment of cash toward smaller and midsize targets. In the bottom right table, we highlight potential biopharma targets with likely rationales for the deals.

Leading Biopharma Firms Poised To Grow at 2.4% CAGR Through 2027



Source: Morningstar. Includes branded drug sales at AbbVie, Amgen, AstraZeneca, Bayer, Biogen, BioMarin, Bristol, Gilead, GSK, J&J, Eli Lilly, Merck, Novartis, Novo Nordisk, Pfizer, Regeneron, Roche, Sanofi as of March 15, 2023.

Future Potential Biopharma Acquisition Targets

Acquisition Rationale	Future Targets
External pipeline gains	Incyte, BioMarin, Ionis, Moderna
Cost savings	Bristol-Myers, Midsize regional firms
Diversification/leveraging acquirer capabilites	Many smaller firms
Low valuation/ opportunistic	Bayer Pharma, GSK

Source: Morningstar.

Healthcare | Top Picks

Name/Ticker		Rating	
Elekta (EKTA B)		★★★★★	Buoyed by growing demand for radiotherapy, wide-moat Elekta should enjoy strong sales momentum for the next decade. The RT industry has consolidated substantially over the past decade, and the two main players are in a prime position to benefit from a market that we believe will grow in midsingle digits. Elekta has several things going for it in the near term, with the main catalyst being adoption of its magnetic resonance/radiation therapy Unity technology. The company has sunk immense amounts of capital and time into the platform and should now start seeing steady order upticks as clinical data highlighting its advantage starts trickling in. The company hasn't executed well historically, but with a strong product portfolio, it can finally make inroads into the lucrative North American market while continuing to see strong demand from emerging markets. Elekta trades at a material discount to its key rival as well as other medical technology firms.
Price	Fair Value	Uncertainty	
SEK 79.50	SEK 127.00	Medium	
Market Cap (B)	Economic Moat	Capital Allocation	
SEK 30.28	Wide	Standard	

Name/Ticker		Rating	
Fresenius (FRE)		★★★★★	Fresenius SE shares appear significantly undervalued because of the unprecedented challenges that the company's dialysis segment (Fresenius Medical Care) has been facing since 2021. Even with these concerns, we see a solid intermediate and long-term outlook for Fresenius SE, especially if the incoming management teams at Fresenius SE and Fresenius Medical Care can turn things around and if external factors such as labour pressures ease. The company's injectable therapies business (Kabi) is gearing up for potentially very large biosimilar launches in 2023 and beyond. The company's other segments appear solid. We think high-single-digit earnings growth compounded annually through 2026 remains possible at Fresenius SE. The shares appear to be discounting a much weaker scenario than that, and overall, we still view Fresenius SE shares as some of the cheapest in our healthcare coverage.
Price	Fair Value	Uncertainty	
EUR 24.34	EUR 52.00	High	
Market Cap (B)	Economic Moat	Capital Allocation	
EUR 13.73	Narrow	Standard	

Name/Ticker		Rating	
Roche (ROG)		★★★★★	We don’t think the market fully appreciates Roche's drug portfolio and industry-leading diagnostics, which combined create maintainable competitive advantages. As the market leader in biotech and diagnostics, this Swiss healthcare giant is in a unique position to guide global healthcare into a safer, more personalised, and more cost-effective endeavour. The collaboration between its diagnostics and drug development groups gives Roche a unique in-house angle on personalised medicine. While COVID-19 and biosimilar-related headwinds will likely drive Roche’s growth into negative territory in 2023, we believe the fundamentals are strong, and expect a recovery in 2024 as core blockbuster drugs continue to grow and pipeline drugs are launched.
Price	Fair Value	Uncertainty	
CHF 260.95	CHF 419.00	Low	
Market Cap (B)	Economic Moat	Capital Allocation	
CHF 212.07	Wide	Exemplary	

Industrials

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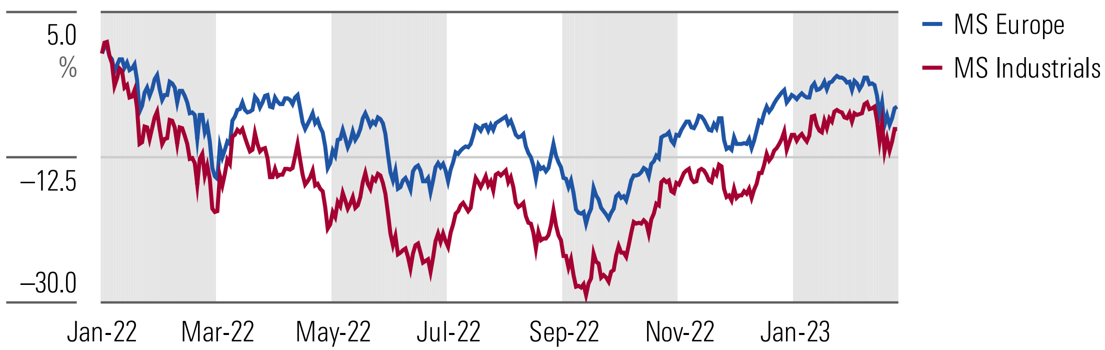
Strong Earnings Lower Recession Fears for the Time Being

The industrials sector lagged the wider Morningstar European Index during 2022 as concerns over an impeding recession and the energy-intensive nature of the sector worried investors. However, fourth-quarter earnings were impressive, which has led to the industrials sector closing ground year to date. Large price increases have managed to offset a decline in volumes and reduce the impact of cost inflation on the bottom line. Whereas lower energy costs are providing a conveniently timed tailwind to support profitability heading into 2023, further price increases will be tough to implement with clouds still looming on the macroeconomic horizon.

As investors have warmed to the construction sector, the sea of 4- and 5-star stocks have receded, with many previous bargains becoming fairly valued. The business services segment is one of the few areas left in which we see numerous opportunities. Here, the testing, inspection, and certification companies, are still highly attractive. Although a recession would prove damaging in the short term, these firms are famously nimble, with relatively flexible cost bases and exposure to structural growth trends such as the shift to carbon-neutrality.

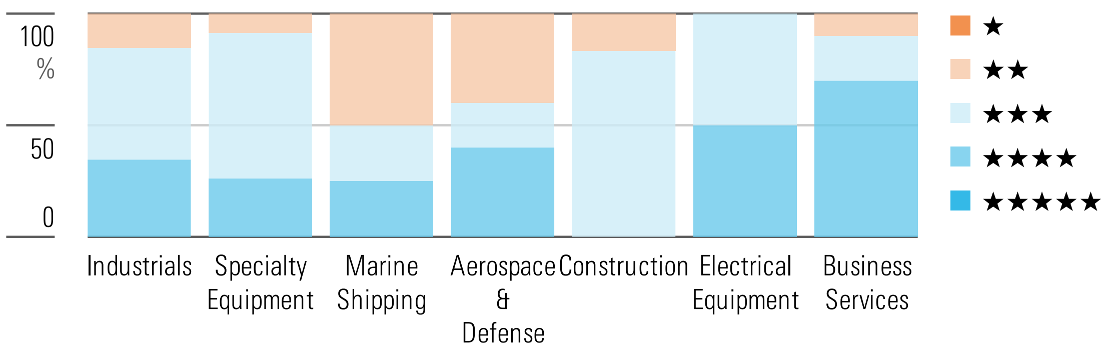
Another attractive area within the business services segment is in shipping and logistics. With shipping rates falling, as bottlenecks ease, the gravy train of easy money is coming to an end. But, for asset-light third-party logistics firms this isn't as devastating as many people think it is, with opportunities to profit as freight capacity shifts.

Industrials vs. the Morningstar European Index



Source: Morningstar. Data as of March 22, 2023.

Industrials Star Rating Distribution by Industry

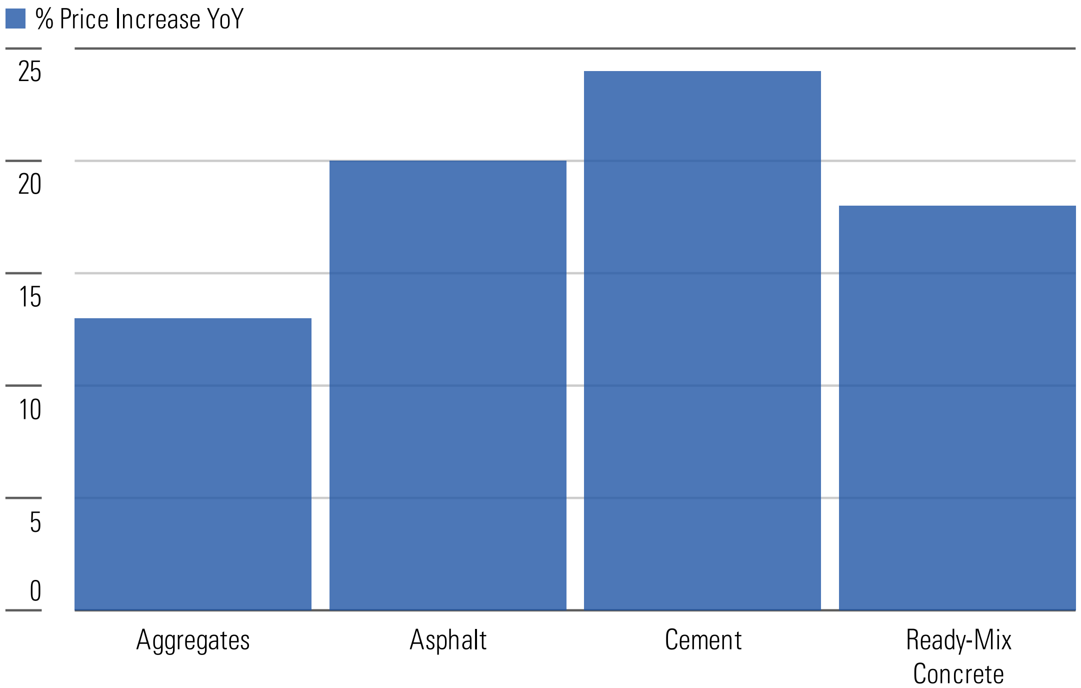


Source: Morningstar. Data as of March 22, 2023.

Impact of Price Increases Already Implemented and Low Energy Costs Will Protect Profitability

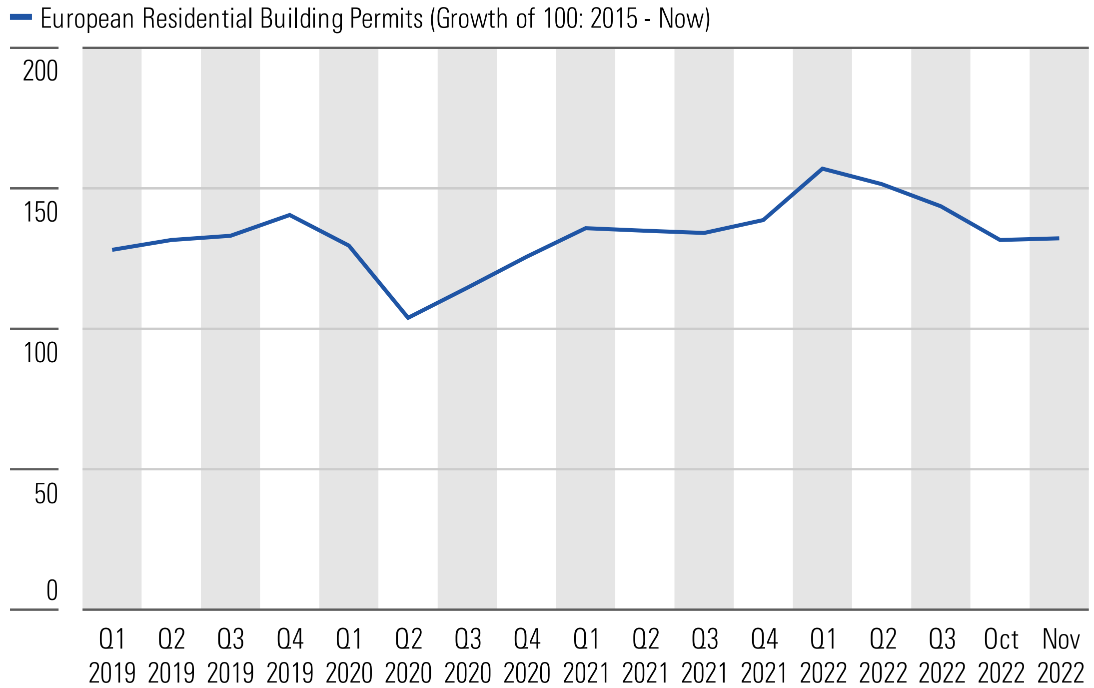
Price increases of up to 24% for building materials were recorded during 2022, helping to withstand significant energy inflation in Europe. Unsurprisingly, appetite for discretionary construction activity declined as the year progressed, most notably for residential construction, due to building material inflation and rising interest rates. However, prices are showing no signs of easing and guidance for sales growth has been consistent across the sector, reflecting confidence that higher prices will offset lower volumes.

Price Increases for Building Materials Helped Mitigate Cost Inflation in 2022



Source: CRH full-year 2022 earnings report.

We Expect Residential Construction To Remain Under Pressure



Source: Haver.

Industrials | Top Picks

Name/Ticker		Rating	
CRH (CRH)		★★★	CRH remains our preferred pick in the European construction materials sector due to the significant contribution of revenue from U.S. infrastructure spending. As the largest roadbuilder in North America, CRH will benefit directly from the U.S Infrastructure Investment and Jobs Act, which is beginning to show in CRH's order book during 2023 and will help offset weakness in residential construction. The group is also benefiting from the onshoring of manufacturing operations back to the U.S. via recently signed legislation (CHIPS and Science Act and Inflation Reduction Act). In its latest earnings report, CRH announced a $3 billion share buyback, providing investors with an attractive 12% cash return yield (dividend plus buyback).
Price	**Fair Value**	**Uncertainty**	
GBX 4,129.00	GBX 3,950.00	Medium	
Market Cap (B)	**Economic Moat**	**Capital Allocation**	
GBP 29.88	Narrow	Exemplary	

Name/Ticker		Rating	
Intertek (ITRK)		★★★★	Currently, Intertek is the most attractive stock in the testing, inspection, and certification sector, and trading at a rare discount to our fair value estimate. Although the company is still recovering from the pandemic, and Chinese industrial disruptions, due to COVID-19 lockdowns in the first half of 2022, the company’s diverse exposure and flexible cost base should ensure that it will be well positioned coming out of the current crisis.
Price	**Fair Value**	**Uncertainty**	
GBX 4,039.00	GBX 4,900.00	Low	
Market Cap (B)	**Economic Moat**	**Capital Allocation**	
GBP 6.45	Narrow	Standard	

Industrials | Top Picks

Name/Ticker		Rating	
Maersk (MAERSK B)		★★★★	The gravy train of easy money is coming to an end as freight rates normalise and supply chain bottlenecks are finally unblocked. However, Maersk has made a small fortune over the last two years and has been wise in its capital deployment, paying down debt and expanding its logistics business. While revenue and profits must decline from here, we believe the market is being overly negative on the outlook for the business.
Price	**Fair Value**	**Uncertainty**	
DKK 16,390.00	DKK 20,000.00	High	
Market Cap (B)	**Economic Moat**	**Capital Allocation**	
DKK 281.74	None	Standard	

Name/Ticker		Rating	
Vinci (DG)		★★★	Narrow-moat Vinci is a 3-star stock offering investors defensive characteristics at a discount to our fair value estimate. Vinci's portfolio of long-dated concession assets such as toll roads and airports (70% of 2019 operating profit) is difficult to replicate and provides a stable source of income. The profitability of Vinci's portfolio of toll roads (more than half of group profit) is protected against inflation through contractual-linked tariffs based on inflation—and has been highly resilient to macroeconomic shocks. Despite greater cyclicality, Vinci's construction and energy business has a record order book of EUR 57.3 billion, which provides earnings visibility as the historically more resilient concessions business recovers from lower levels of airport traffic.
Price	**Fair Value**	**Uncertainty**	
EUR 106.72	EUR 116.00	Medium	
Market Cap (B)	**Economic Moat**	**Capital Allocation**	
EUR 58.96	Narrow	Standard	

Utilities

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European Utilities' Headwinds Look Excessively Priced in

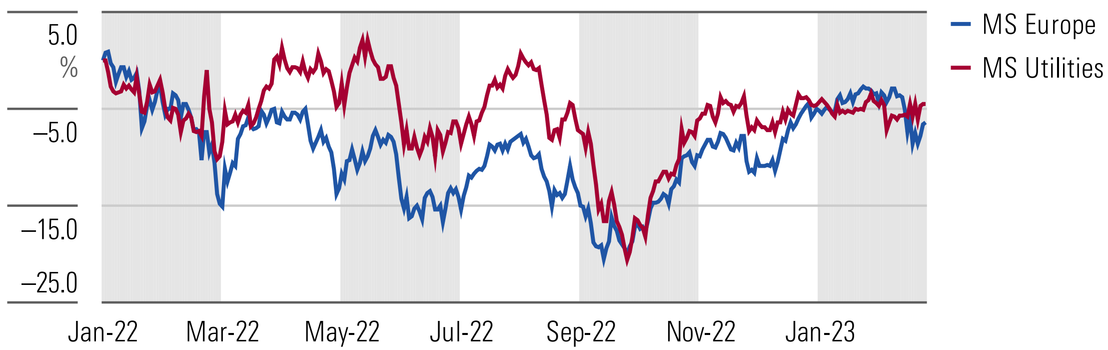
The Morningstar Developed Markets Europe Utilities Index decreased by 2% in 2022, slightly outperforming the broader index. This has flipped in 2023, with the sector up 2% year to date, underperforming the broader market. The latter was bolstered by cyclical sectors as fears of a severe recession in the eurozone abated.

Most integrated European utilities have reported record 2022 profits thanks to skyrocketing power prices in Europe due to the energy crisis. Networks have also performed well owing to the indexation of most of their revenue to inflation. This strong set of earnings reflects the favorable positioning of the sector against high inflation.

Utilities that posted the strongest results in 2022 are the most sensitive to power prices. Accordingly, their earnings will fall in 2023 on the implementation of various power price caps across Europe and the decline of power prices driven by the easing of the energy crisis. Integrated utilities with high international exposure and more limited sensitivity to European power prices should deliver earnings growth in 2023 and beyond thanks to high investments in networks and renewables. Likewise, purely renewable players should also deliver earnings growth in coming years thanks to capacity additions.

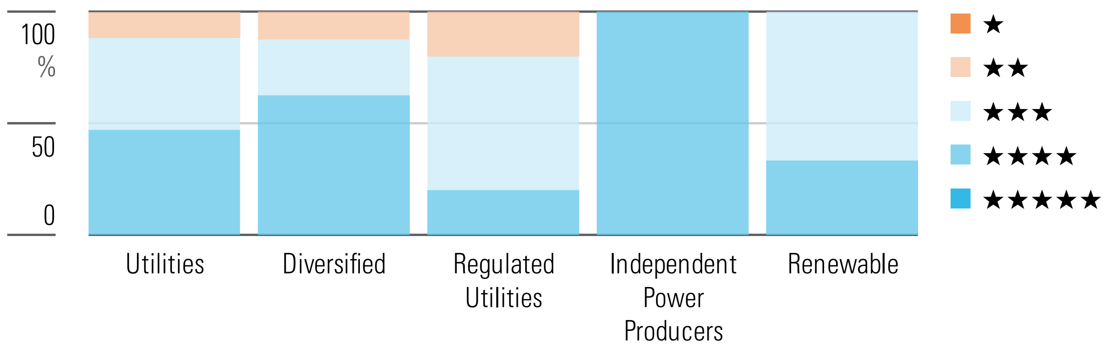
Overall, we view the sector as undervalued with a median price/fair value estimate ratio of 0.89. Investors are too focused on the sector’s headwinds, political risk, rising interest rates, and rising construction costs of renewable projects. We believe these headwinds are beginning to ease.

Utilities vs. the Morningstar European Index



Source: Morningstar. Data as of March 22, 2023.

Utilities Star Rating Distribution by Industry

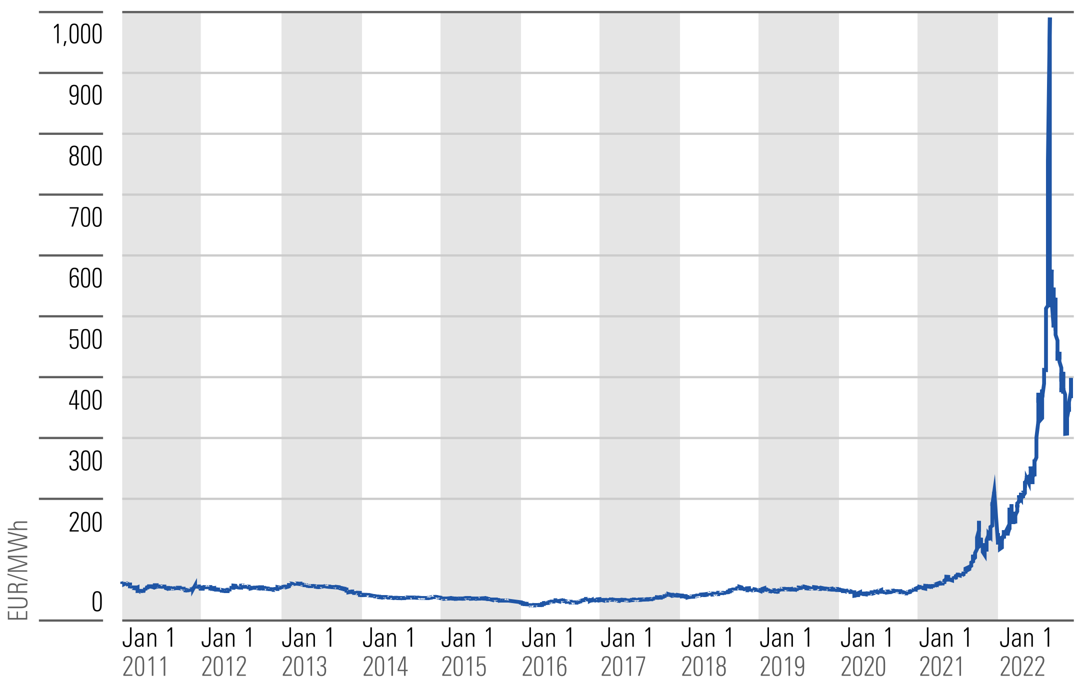


Source: Morningstar. Data as of March 22, 2023.

Sector's Relative Dividend Yield Is Falling, but Remains an Attractive Source of Income

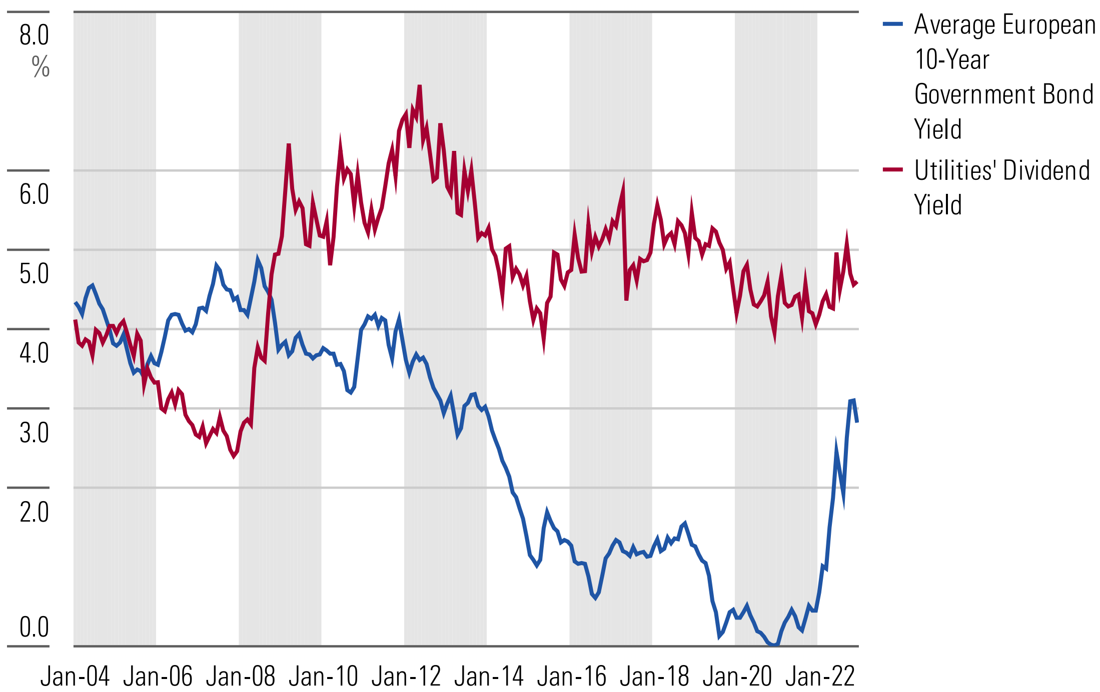
The sector's 4.3% median trailing dividend yield is below the 4.6% historical median. Likewise, the 130-basis-point premium to the average of the main European government bond yields is below the 270-basis-point historical median.

German Power Prices Have Receded From Their Extreme Levels



Source: Morningstar commodities. Data as of March 6, 2023.

European Utilities' Yield Premium To Government Bond Yields Has Diminished



Source: Morningstar. Data as of March 17, 2023.

Utilities | Top Picks

Name/Ticker		Rating	
Centrica (CNA)		★★★★	Centrica posted stellar 2022 profits thanks to soaring gas and power prices. Profits will decline in 2023 in the wake of the ebb of commodity prices. Still, we view the shares as materially undervalued with a cumulative free cash flow yield above 50% over the next five years. Moreover, capital allocation has improved considerably, evidenced by the ongoing GBP 550 million share buyback program and opportunistic reopening of the Rough gas storage asset for winter 2023. In the longer term, the latter could be converted to store hydrogen, which could be significantly value-accretive should the firm get a regulated remuneration scheme.
Price	Fair Value	Uncertainty	
GBX 103.20	GBX 140.00	Medium	
Market Cap (B)	Economic Moat	Capital Allocation	
GBP 5.68	None	Standard	

Name/Ticker		Rating	
ENGIE (ENGI)		★★★★	Engie's undervaluation reflects investors' distrust of the company, based on a bad capital-allocation track record. We think this scepticism is overdone as the company is delivering ahead of its targets with accelerated investments in renewables and disposals of noncore businesses at a high premium. After record 2022 profits, thanks to soaring power prices, earnings will decline in 2023. Further out, high renewable investments will support earnings and dividend growth. Last, Engie has limited sensitivity to rising interest rates thanks to a leverage well below peers. The outcome of negotiations with the Belgian government about nuclear provisions expected in the first half of 2023 will reduce uncertainties.
Price	Fair Value	Uncertainty	
EUR 13.88	EUR 18.00	Medium	
Market Cap (B)	Economic Moat	Capital Allocation	
EUR 32.84	None	Standard	

Name/Ticker		Rating	
RWE (RWE)		★★★★	RWE is the second-biggest offshore wind company behind Orsted. With the acquisition of ConEd's clean energy business, it became the fourth-largest renewable player in the U.S., a very favourable market for renewables since the adoption of the Inflation Reduction Act. The recent advance of the coal exit in Germany to 2030 could help reduce the discount of RWE's renewable operations versus peers. Last, RWE has one of the highest exposures to rising European power prices and clean spark spreads thanks to the high liberalised share of its renewable volumes and combined-cycle gas turbines.
Price	Fair Value	Uncertainty	
EUR 38.67	EUR 53.00	Medium	
Market Cap (B)	Economic Moat	Capital Allocation	
EUR 26.33	None	Exemplary	

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