PAN EUROPEAN EQUITIES

DOES A WEAK EURO MATTER?

FEBRUARY 2015 - BY THE EUROPEAN TEAM

First the facts

The Euro lost 20% of its value against the USD over the past 9 months and, over the course of 2014, decreased in value against all major Emerging Market currencies, except the beleaguered Russian Ruble. As a consequence, the MSCI Europe index shrunk 6.2% (total return) in USD, while the index was up 6.8% in Euros.

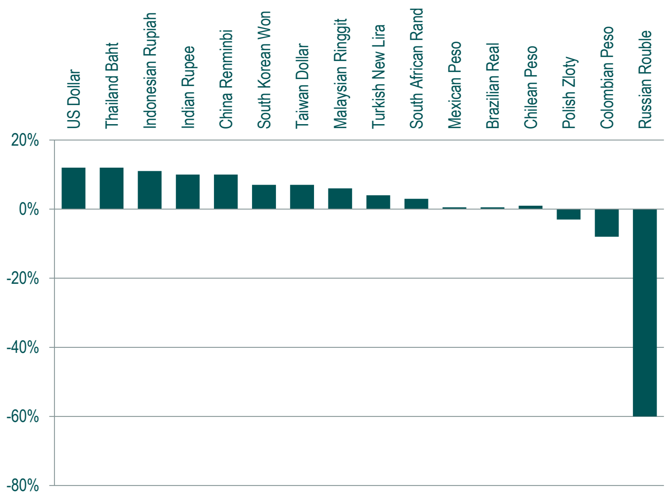

Figure 1: Euro against EM currencies and USD in 2014
Source: Factset

At Comgest we take great care to invest in quality growth stocks that remain relatively untouched by exogenous factors. In doing so, we focus on investment process and long-term performance and distance ourselves from things we can't control, including random events, short-term variations and the management of unpredictable currency fluctuations.

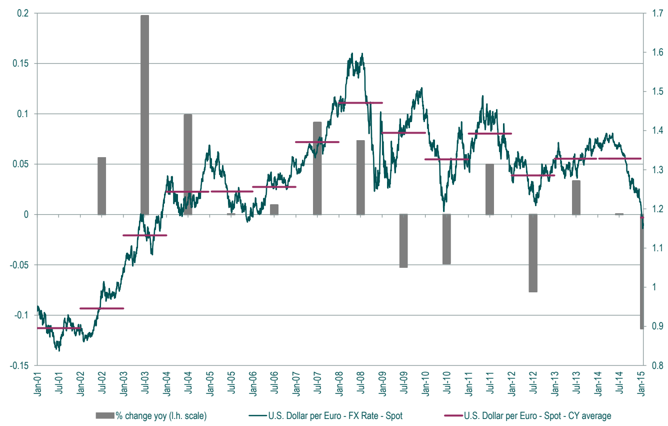

Figure 2: USD/€ exchange rate development
Source: Factset

How far can currency impact our portfolios?

Over the short term, the Euro moving 20% in relation to the USD is by no means unusual. Currency markets have always been volatile and we witnessed similar swings during the unravelling of the financial crisis in 2008, the Euro crisis in 2010 and the European recession in 2012. Over the past decade, however, recent weakness has driven the Euro's value relative to the USD to near historically low levels (see figure 2).

This scenario raises a question regarding the possible impact of a weaker Euro on the long-term competitiveness of our European portfolio companies. In very general terms, the question is whether capital returns and/or the growth of a company can substantially change due to currency fluctuations.

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While a persistent change of these parameters can affect a company's long-term cash generation, upon which its valuation is based, it is important, when examining this question, to distinguish between translation risk and transaction risk.

The overwhelming majority of Comgest's portfolio holdings are exposed only to translation risk, where sales and costs in each different currency are closely matched, and only a residual, i.e. profits, are impacted by the exchange rate. In the case of transaction risk, on the other hand, companies produce in one currency and sell in another, putting at risk not only their profitability but also their market competitiveness. Currency hedges used by companies can only delay, but not avert these types of impact.

Over the past 50 years, nations such as Germany, Japan and Switzerland have defended and in many instances extended their manufacturing leadership (for example in automobile and watch manufacturing) despite decade-long appreciations of their currencies. Over the same period, other nations (such as the UK, Italy and France) have witnessed a gradual erosion of their industrial base, despite depreciation of their former and present currencies. These facts indicate that currency appreciation, in isolation, is unlikely to undermine competitiveness.

Currency swings are, by their nature, typically linked to extraneous factors and are difficult to predict in an accurate and timely fashion. Comgest's 25-year track record in delivering double-digit EPS growth demonstrates that the quality growth stocks we select tend to have the capacity to offset the negative impact of such swings.

While the short-term translation impact of a currency move is comparatively easy to capture, this has little impact on our portfolio holdings. This is because the companies we invest in tend to be global market leaders with multi-national production and distribution networks. Translation risk therefore has a minimal effect on the ability of these companies to generate cash and, subsequently, little effect on their value.

Currency fluctuations tend to increase the volatility of reported sales and results. Given this fact, we find it extremely useful to analyse growth in a way that removes currency fluctuations as a factor, thereby giving us a clearer view as to actual performance. To assist this task, Comgest has developed a proprietary database to specifically track how European companies perform in terms of organic sales growth - defined as revenue growth excluding acquisitions, disposals and currency fluctuations. Organic sales growth is the most consistent contributor to P&L and ends up representing more than half of companies' EPS growth. Accordingly, when looking at the impact of currency fluctuations on reported sales, it is important to remember that organic sales growth is the most important driver of value for our quality growth companies.

Figure 3: Organic Sales Growth table
Source: Comgest company reports

How does the Euro's devaluation impact our European strategy?

As figure 4 indicates, most of our European strategy's top line exposure is shared equally between the Euro (35%) and the USD and emerging market currencies linked to the 'green back' (35%), with other currencies making up the remainder.

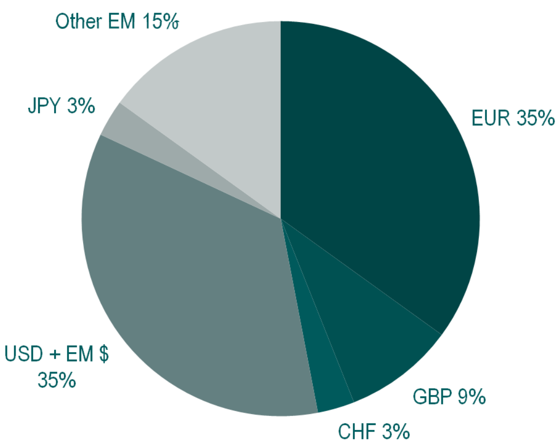

Figure 4: Top line FX exposure of the European strategy
Source: Comgest company reports

While there are some exceptions to the rule, most of the impact that currencies have on our portfolio companies is translational, not transactional. Provided the USD/Euro exchange rate does not move substantially from where it is today (USD/Euro rate of 1.13 as of January 23, 2015), currency in 2015 could substantially improve our portfolio's earnings growth - and that of the MSCI Europe benchmark index.

Assuming the exchange rate remains unchanged over the course of the year, the y-o-y depreciation of the Euro will reach more than 15% in 2015, a figure equivalent to three times the depreciation witnessed during the financial and Euro crises of 2008 and 2010 that, in those years, added approximately 2% to reported sales and EBIT growth for our European strategy.

As a ballpark figure - and taking into consideration the fact that our portfolio's stock composition is unlikely to change to any substantial degree in the next 12 months - one can therefore infer a significant and positive impact on reported earnings growth in 2015 purely on the basis of the recent currency moves. Such a forecast, however, is highly hypothetical. Would such an impact make any difference to our stock selection decisions? Given our long term perspective, the answer to this question is 'probably not'. Currency changes are often responses to chains of events with multiple correlated links. In relation to our European strategy, investors should also take the 20% appreciation of the Swiss Franc into consideration, as this might hurt the reported earnings growth of the Swiss companies that represent 14% of our large cap European position.

A closer look at the nature of the various business models we hold in the Comgest European portfolio examines currency exposures in more detail:

1. Comgest does not have many asset-intensive and export-oriented manufacturing businesses in its European portfolio. The companies likely to experience a currency mismatch on a transactional basis are Linde, Geberit, Zodiac, Essilor and MTU Aero. Of these companies, only Zodiac and MTU AERO have a significant transaction exposure. Both boast a strong Euro cost base combined with very high USD revenue exposure. MTU, for example, generates 80% of its revenues in USD, 75% naturally hedged by sourcing in USD. This means the company has a large USD net exposure that could be beneficial in the coming years.

2. A large portion of our European strategy is invested in service and retail businesses that naturally tend to generate costs close(r) to the consumer (i.e. Sodexo, Capita, Iliad, Intertek, Wirecard, Luxottica, Gemalto, H&M, Inditex). Hence there is little transaction exposure in these businesses. Here is an example that illustrates the scope of the currency translation impact: Sodexo lost 9% on its August 2014 FY EPS due to translation as it generates around 60% of its revenues outside Europe (and a similar % of costs). Translation impact could revert to positive in 2015 assuming current exchange rates don't move a lot. Luxottica is another example. The company generates 70% of its sales in North America and the Asia Pacific. In H1 2014 it reported sales growth of 0.5%, while sales growth was + 5.6% in constant currency terms.

3. For consumer product companies such as Heineken, Nestlé, Lindt or L'Oréal, the same holds true. Production usually takes place close to the consumer. Nestlé and Lindt, however, have significant overhead in Switzerland (5% and 12% of cost base respectively) with relatively small CHF revenues to compensate. The CHF appreciation and transaction risk will therefore impact these companies. For non-Swiss companies, however, translation could be a tailwind in 2015.

4. On the luxury goods side, the Richemont group might have a currency concern. Its manufacturing hub is in Switzerland (now hurt by the 20% CHF appreciation to the Euro and other currencies). Comgest estimates that around 25% of its cost base is denominated in CHF corresponding to a substantial transaction exposure. But isn't 'Made in Switzerland' part of the company's competitive advantage? Richemont has taken the decision to raise its prices by 5-7%, perhaps the only way to sail into this currency headwind. All Swiss luxury watch producers with pricing power in the upmarket and luxury watch markets are in the same boat in this regard. Most luxury brands boast positive price elasticity, so raising prices is not only feasible, but often has a positive impact on sales. In this regard, the French luxury company Hermes is the 'Rolls Royce' amongst its peer group and boasts a strong Euro production base. Its supply constraint business model secures a long waiting list for some products and its pricing power is very strong across all categories. Forex impact could be positive in 2015, both on a transaction and translation basis, with part of this effect being delayed until the following year due to hedging.

5. Research-intensive business models such as pharma and software constitute an important part of Comgest's European portfolio. The pharma companies Roche, Novo Nordisk, Bayer, Sanofi and our software holdings SAP, ARM, Amadeus IT and Dassault Systèmes tend to have a significant R&D footprint in their home countries thus creating a currency mismatch and subsequent transaction exposure. Roche is estimated to have 15% of its cost base, but only 1% of its global sales, in its home country Switzerland. Following the CHF appreciation, the negative impact on EPS in Roche's case has a real impact on cash flows. For SAP, Amadeus IT, DSTY, Novo, Bayer or Sanofi, however, the translation and transaction impacts could be positive due to a strong Euro cost base and high USD revenues.

The European portfolio reported EBIT growth of 5.2% in H1 2014, but EBIT growth at constant currencies stood at 10.5%, so approximately half of the growth was lost in currency translation. If we were to peg the EUR-USD exchange rate for the remainder of 2015 to today's rate (1.13 on January 23, 2015), the USD would - on average - appreciate 15% against the Euro in 2015. Given that EM currencies tend to be more linked to the USD than the Euro, this could create a positive translation impact not only on the 35% exposure to the USD (including USD pegged EM currencies), but potentially the 15% of exposure to non-pegged EM currencies. As a result of these factors, Euro weakness could become a significant tailwind for reported sales and earnings growth.

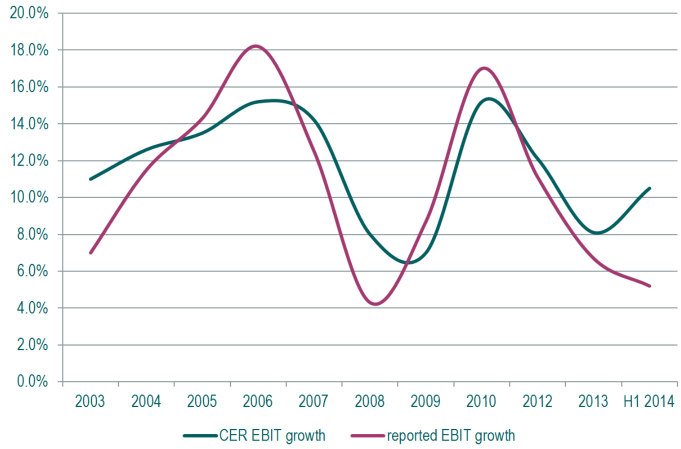

Figure 5: Comgest Growth Europe - organic vs reported EBIT growth
Source: Comgest company reports

Below are examples of the main holdings that suffered from forex exposure in 2014 in terms of sales and EPS. These figures demonstrate the potential impact currency swings may have on reported figures for 2015.

(%FX Impact on...)	Sales	EPS	Period under review
Inditex	-3	-10	9m-14 results to end October (estimated)
Bayer	-3	-7	FY14E guidance given on 30 October 2014
Sanofi	-4	-7	9m-14 results to end September
Sodexo	-5	-9	FY14E results to end August
Novo Nordisk	-4	-5	9m-14 results to end September
Roche	-6	-7	FY14E results to end June

Figure 6: Comgest Growth Europe holdings
Source: Comgest company reports

Conclusion

Recent forex movements add further volatility to the reported earnings, but looking ahead at 2015, they might support our Europe portfolio's reported earnings growth (and the MSCI Europe index) instead of depressing it, as was the case in H1 2014.

At the start of 2015, in a period of scarce earnings growth in Europe, this currency momentum has been welcomed by the market. A word of caution: this likelihood should not be mistaken for something it is not – a boost to the long-term competitiveness of corporate Europe, something that the 8% jump of the MSCI Europe since the beginning of the year might imply (as of January 23, 2015).

While we are not looking to maximise short-term growth, the recent Euro slide might support short-term growth of reported earnings figures for our portfolio holdings. Comgest views this potential result to be neutral in terms of the longer-term competitiveness of our European portfolio, which is, of course, the outcome we are most focused on. In other words, recent currency fluctuations should not alter our clients' view of the firm's commitment to quality growth in European equities, a consistent and rigorous investment approach that has delivered double-digit organic earnings growth over the past decade irrespective of the volatility of currencies and economies. This is the benchmark for the future.

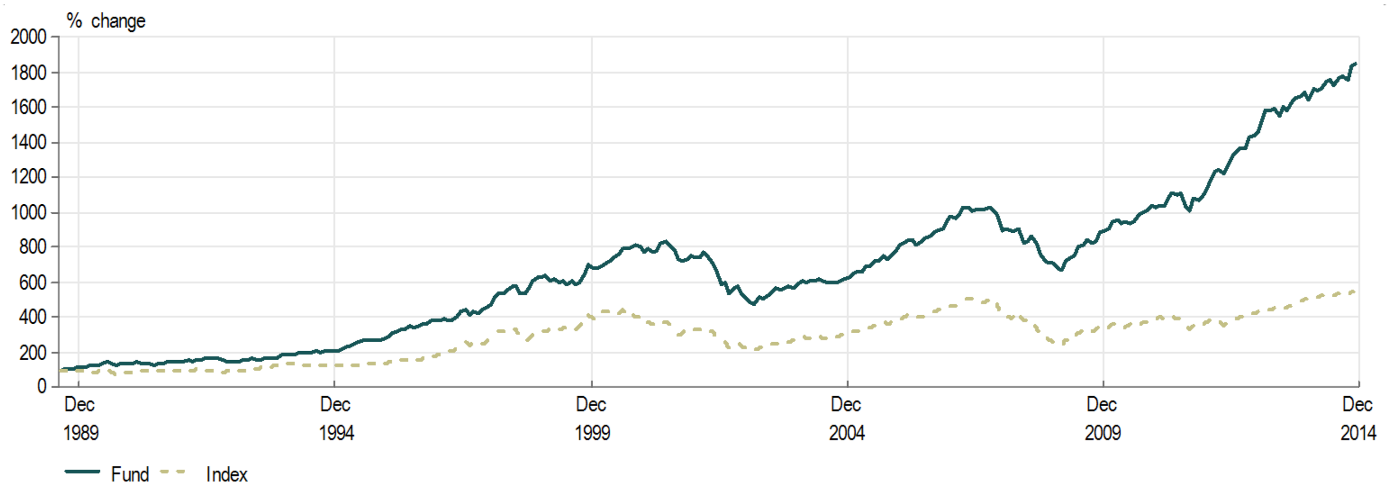

Figure 7*: Pan European Equity Strategy cumulative performance since inception (%)
Index of reference: MSCI Europe - NR.
Source: Factset/Comgest

	QTD	YTD	1 Year	3 years annualised	5 years annualised	10 years annualised	Since inception annualised
Strategy	4.22	10.14	10.14	19.43	15.96	11.52	11.52
Index	-0.15	6.84	6.84	14.51	8.92	5.82	6.87

Figure 8*: Pan European Equity Strategy rolling performance (%)
Source: Factset/Comgest

*Data represents gross-of-fees performance for all funds managed by Comgest in the relevant strategy. Performance is gross of management fees and performance fees (where applicable). The treatment of other fees may vary between collective investment schemes and discretionary accounts. The inclusion of management and other fees would have the effect of decreasing the performance results. Reference to the benchmark is for comparative purposes only and is not intended to indicate that the funds will contain the same investments as the benchmark. The volatility of the index may be materially different from that of the strategy. The index used for comparative purposes changed from MSCI Europe price to MSCI Europe dividends reinvested from 01/01/2001. If necessary, prior to 1999 figures are converted using the relevant FRF exchange rates. Investors have the opportunity for losses as well as profits. Past performance is no guarantee of future results.

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