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Does crisis-hit Europe offer value?

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Joanna Faith finds out whether Europe's turmoil can be turned into opportunities for income investors.

Europe may not instinctively spring to mind as a top investment destination for income seekers. A torrent of negative indicators since late 2009 has left the region unloved and untouched by many investors.

Although the outlook at the start of this year seemed more optimistic, thanks mainly to the ECB's long-term refinancing operation (LTRO) essentially ending a run on European banks, investor appetite still appears weak. February alone saw £127m leave the Europe ex UK sector, marking the tenth consecutive month of outflows.

However, the battering the region has taken over the past three years has left a host of undervalued stocks, many of which have a strong history of paying dividends. Equity income investors, who are often punished for casting their nets too close to home, could now be penalised for ignoring the region.

European dividends

The conventional wisdom is that certain markets like the UK have the best dividend-paying cultures in the world, so there is little point looking further afield. According to Fidelity, however, this is no longer the case – 90% of high dividend-paying stocks come from outside the UK, with continental Europe proving a hefty contributor of high dividend stocks for a long time.

Market declines have made valuations in the region attractive and pushed dividend yields well above their 15-year averages and, as Fidelity suggests, this universe could very well expand as state-owned utilities are privatised.

Dividend yields in Europe are forecast to be 4.6% this year and are currently the highest in the world, above those available in the UK, US or Japan, where equity income has been an investment staple for decades.

Andreas Zoellinger, co-manager of the BlackRock European Equity Income fund, says European yields have become increasingly attractive, given that historically low interest rates mean high-quality government bonds are yielding very little, with German 10-year bonds offering 2%, UK 10-year gilts 2.4% and US 10-year treasuries 2.3%.

Resilient companies

Despite the dramatic pressure European companies are under thanks to the sovereign debt crisis, which reared its head again with a vengeance last month, the region hosts plenty of resilient businesses that generate most of their profits from overseas.

Lazard's Pat Ryan cites BMW as an example. The manager of the Global Equity Income fund, who has more than a quarter of his portfolio in European stocks, says the German auto giant is benefiting from a surge in demand from China.

The company is trading at less than 9x earnings for this year and paying a dividend of 3.5%. While this is "not awe-inspiring", Ryan believes there is potential upside from a special dividend as BMW is a liquid company.

"We think of it as a luxury goods company more than an auto company, yet it still trades at an auto company-type valuation," he says.

Insurance giant Munich Re is another example of an unloved stock that is a great source of value as well as an excellent dividend player. Yielding 5.6%, it has not cut its dividends since 1969.

Michael Clark, portfolio manager, pan-European equities at Fidelity, describes it as a global leader in reinsurance and the 'go to' company for complicated insurance agreements, like those needed for transport fleets and industrial units.

"It has been around for many decades and is firmly established with a proven business model. As a result, it has strong pricing power and is able to charge higher premiums," he says.

Financials in general are offering opportunities for income investors. Banks on the Continent are expected to yield 5.3% this year and non-life companies 6.5%.

However, it is not just the global players offering value. Ryan has identified selective opportunities among domestically-focused companies. One example is Atlantia, the Italian toll road company.

"Toll roads are a resilient business. Atlantia generated profit growth year-on-year for each of the past five years, even with the weakness we have seen in Italy, because it has very strong pricing power. It can raise tolls when it wants to offset a decline in traffic. It is a special situation," the manager says.

Areas of caution

While selective opportunities exist throughout the region, there are certain countries Ryan is avoiding altogether.

"The true peripherals like Greece and Portugal are relatively uninvestable at the moment because the economic situation is so weak even resilient businesses are under dramatic pressure," he says.

However, some companies get de-rated because they happen to be domiciled in a "scary" place but the business is actually globally diversified. These can be good opportunities, says Ryan. Luxury goods were strong performers for example.

With regards to whether dividend yields in Europe are sustainable, managers are sanguine. They accredit this to companies' high cash levels. With the exception of financials, globally dividends have recouped all the ground they lost though the cuts during the credit crunch, says Ryan.

"We are seeing growth again and, with cash on balance sheets, overall sustainability is attractive."

Top and bottom five performers (Source: Morningstar)

(IMA) Europe Excluding UK	27/04/2011 – 26/04/2012 % Chg
Threadneedle Eurp Sel Ret Net GBP	-3.28
Allianz RCM Continental European A	-3.80
Neptune European Income A Acc	-5.81
Williams de Broe European Inst R	-8.79
Henderson European Focus A Acc	-8.85
Cavendish European Ret Inc	-21.69
Santander MM European Equity A	-23.14
AXA Rosenberg European R	-23.59
HSBC European Growth Retail Inc	-23.63
HSBC GIF Euroland Equity A	-28.66
Mean/Count	-15.99

Adviser comment

Jonathan Davis, managing director, Jonathan Davis Wealth Management

The European Union (EU) is in the vice grip of politicians' and central bankers' cuts and, effectively, zero interest rates. Together, these are, economically, a killer to profit-seeking businesses. High dividend payers are unlikely to be able to retain such dividend levels.

On top of that, the euro is falling (due to ECB money printing) so import costs are rising, thus making businesses more expensive. Furthermore, the EU – unsurprisingly – is in recession. We actually believe it is in depression, due to the aforementioned inane policies. At this time, we are not investing a penny of client funds into EU equity funds, high income or not.