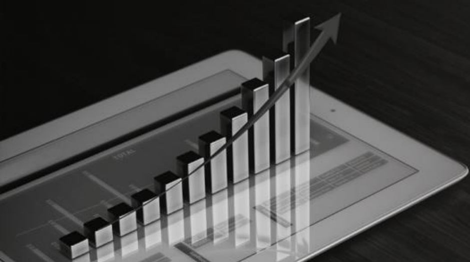

Valuation of our equity funds

Since the outbreak of the pandemic at the beginning of 2020, the valuation levels of stocks in Europe and the USA have experienced high fluctuations. A sharp drop after the start of the crisis was followed by a significant rise in valuations until autumn 2021. This was followed by a phase of rising interest rate and inflation expectations in 2022, which weighed particularly on higher-valued growth stocks. In this edition of our *Insights* series, we address the questions of what we look for when valuing companies, how the valuation levels of our funds and individual stocks have developed compared to history, and why we believe that it is not low P/E ratios but good quality and growth metrics that make a difference in the long term.

What do we look for in a company's valuation?

In all Berenberg equity funds, we focus on high quality companies with attractive long-term growth prospects. For us, deficits in a company's growth or competitive position cannot be compensated for by a lower valuation. We follow a conviction that Warren Buffet summed up many decades ago with the following quote:

"It's far better to buy a wonderful company at a fair price, than a fair company at a wonderful price."

This means that if the company can reliably generate significantly above-average earnings growth, an initially higher valuation level is put into perspective over time. Therefore, our focus is not on finding potential "bargains", but on companies with a good competitive position, strong management teams and solid balance sheets that benefit from structural drivers within their industry.

In essence, our investment philosophy is based on finding companies where the market underestimates the long-term nature of growth. In most cases, the analyst consensus shows a so-called "mean reversion", which means that long-term estimates move in the direction of the arithmetic mean. This can be observed for both good and bad companies. Essentially, the market overestimates the recovery potential of distressed companies, while underestimating the long-term growth potential of good quality companies. Identifying these market inefficiencies is the basis of our investment philosophy. Our focus is therefore not on estimates for the next 12 months. Instead, we focus on identifying quality companies whose long-term earnings potential is underappreciated by the market and not fully reflected in today's share price.

We include valuation ratios particularly at the end of our analysis process. Based on a detailed fundamental analysis, we make an estimate of the company's value creation power (i.e., the sum of earnings growth and distributions) for the coming years. We then put this in relation to the current valuation. In doing so, we are primarily guided by valuation ratios such as the price-earnings (P/E ratio) or the price-cash flow ratio. Furthermore, we compare the annualised returns with all other investment opportunities available to us on the market in order to obtain a final picture of the attractiveness of an investment. In addition to the expected level, the quality, visibility, and cyclicality of growth play a decisive role in order to meaningfully classify and compare valuation ratios.

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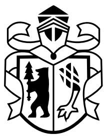
Within ***Insights*** *we aim to give you a better understanding of our investment philosophy and thinking.*



However, we deliberately do not use classic discounted cash flow approaches. Discounted cash flow models for growth companies are usually very sensitive to the assumptions made and often show a great dependence on individual main variables. We believe that our approach is overall more intuitive and useful for drawing conclusions without a set of implicit model assumptions. Moreover, if assumptions are stable, all valuation methods should produce the same result in the long run.

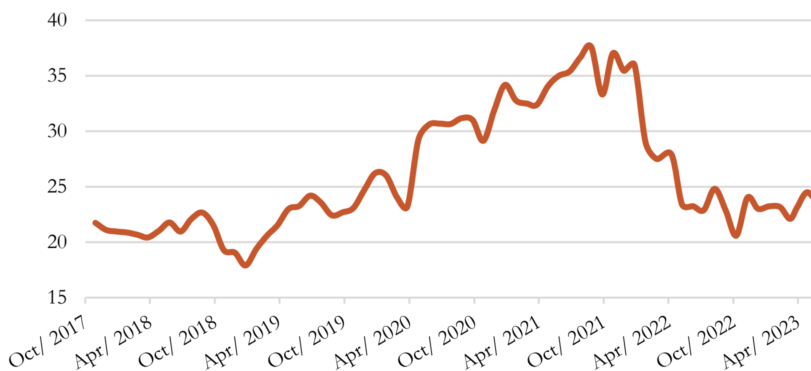
How does the valuation of our equity funds compare historically?

As described above, earnings growth is the critical long-term value driver for us. In contrast, we consider changes in valuation levels to be a short-term factor that is difficult to control. Nevertheless, over the last three years, changes in valuation levels have been a dominant driver of the short-term performance of our equity funds. In this section, we will therefore take a closer look at the valuation of our portfolios, using the Berenberg European Focus Fund as an example.

From the end of 2019 to October 2021, a generally good environment for growth and quality stocks persisted. Reasons for this included accelerated structural trends, a flight to quality stocks in the environment of the COVID-19 crisis and hopes for permanently low interest rates. For the above-mentioned period, the European Focus Fund's valuation widened by more than 10 P/E points overall, from 26x to 37x – with portfolio holdings being almost unchanged.[1]

This was followed by a significant valuation correction last year. Starting from the valuation high in autumn 2021, the P/E ratio of our companies in the European Focus Fund has since fallen by around 40 percent (cf. Figure 1). The main driver for this was rising inflation and interest rate expectations, while the earnings development of our companies was little affected with a growth rate of 19 percent for the full year 2022.[2] The portfolio is currently trading at a median P/E of 23.5 for the next 12 months, which is below the long-term average of 26.0 since the fund's inception. Equity valuations have therefore normalised, and the valuation premium of the Corona years has been completely eroded.

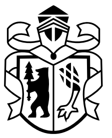
Figure 1: Median P/E ratio[1] of the European Focus Fund since inception



Source: Bloomberg, 02.10.2017 - 31.05.2023, 1: PE for the coming 12 months.

[1] We deliberately refer to the median P/E ratio of the portfolio in this section, as this most representatively measures the "mean valuation" without the distorting influence of outliers.

[2] We have ignored outliers due to base effects in this analysis. The actual profit growth including base effects was therefore even above 19 percent.



As Figure 2 shows, our portfolio companies also continue to offer significantly better growth qualities compared to the overall European market. According to analysts, the benchmark MSCI Europe is expected to show almost no earnings growth in the coming financial year. For the Berenberg European Focus Fund, in contrast, the analyst consensus expects an earnings growth of 16 percent despite the more challenging macroeconomic environment. For 2024, the picture is similar with 5 percent expected earnings growth for Europe and 17 percent for the European Focus Fund. We therefore consider the normalised valuation levels of our companies to be attractive against the backdrop of unchanged good growth and earnings prospects.

Figure 2: Estimated earnings per share growth comparison between the Berenberg European Focus Fund and the benchmark MSCI Europe.

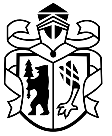
Growth earnings per share	2022		2023		2024	
	MSCI Europe	Portfolio	MSCI Europe	Portfolio	MSCI Europe	Portfolio
Weighted average	19%	19%	1%	16%	5%	17%

Source: Bloomberg, 16.06.2023

Why are some portfolio companies more expensive than they were historically?

As already mentioned, the valuation levels of our portfolio stocks have declined significantly over the last 15 months. Nevertheless, we hold shares in companies that are still trading substantially above their historical valuation. In the following, we will explain our motivation by means of individual examples and show why we consider a valuation premium to be justified for some stocks.

- **Example 1 - Lonza Group:** Lonza is one of the core positions in our European and global equity funds. The Swiss group manufactures drugs for clinical trials and commercial distribution on behalf of pharmaceutical and biotech companies. Over the next 12 months, the shares are valued at 32 times their expected annual earnings. The shares are thus trading 6 P/E points above their 10-year average of 26x annual earnings. However, we consider a comparison with Lonza's own valuation history to be misleading, as the Group's business has changed considerably over the period. Today, contract development and manufacturing of biologic medicines is the largest part of the business and the key growth driver. This business is growing at double-digit rates and generating high EBITDA margins. In the coming years, growth should accelerate further following strong investments in recent years. The less differentiated and lower-growth chemicals business, which was important for Lonza a few years ago, no longer plays an important role. The improved growth and quality profile of the company is therefore also reflected in the valuation of the share.
- **Example 2 - ASML Holding:** ASML is the world's leading supplier of (EUV) lithography machines used in the production of semiconductors. ASML is currently valued at 32 times annual earnings over the next 12 months. This is slightly above the 10-year average of 28x. However, ASML has transformed significantly over the last 10 years. This can be essentially described by the market maturity of EUV lithography. In 2010 and 2015, this critical technology for creating semiconductors hardly played a role, accounting for 0 percent and 2 percent of sales respectively. Accordingly, not only was the potential of ultra-high ultraviolet radiation unclear, but the



company was also exposed to considerably more competition. By the end of 2022, the share of EUV is almost 50 percent and ASML, as a monopolist, is in a much better competitive position. This is also shown by the gross margin, which ASML has been able to expand by almost 10 percentage points over the last 10 years to almost 50 percent. Over the next few years, ASML should be able to grow earnings above 20 percent and be the only company to finance EUV's successor with High NA. Accordingly, we consider an increased valuation compared to ASML's past valuation to be justified due to the higher quality and better visibility of the business model.

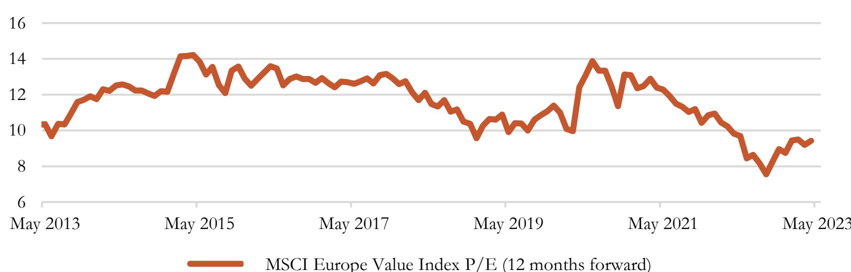
- **Example 3 - Kardex:** The Swiss company is the global market leader for automated storage solutions that are widely used in industry, logistics, healthcare and the public sector. The company is currently valued at an expected 12-month P/E of 25x above the 10-year average of around 20x. Over this period, however, the management team has made major changes which, in our opinion, justify the higher valuation compared to historical standards. For example, the quality of the balance sheet has improved significantly: Whereas in the early 2010s the company had to service net debt of almost 4x the EBITDA generated, the balance sheet now shows a substantial net cash position. The even more drastic change was the increased focus on the high-margin and more stable service segment. This segment has increased from a low single-digit percentage of sales to over 30% of sales. Due to the unabated high demand for automation solutions, we expect the company's turnover to continue to grow in the double-digit range in the medium term. The higher visibility and profitability due to more service revenues as well as the significantly improved financial position of the company justify the higher valuation in our opinion.

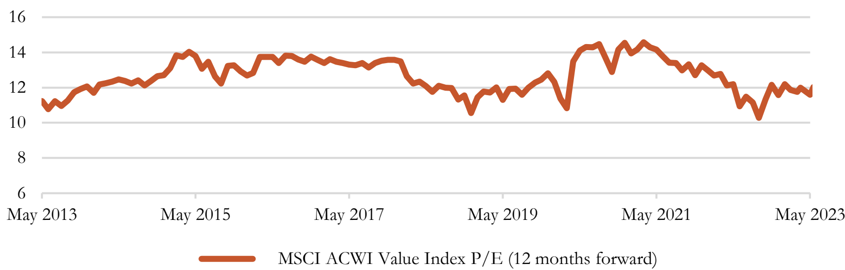
Overall, as the examples demonstrate, we believe that a valuation above the historical average does not need to be a warning signal per se. Instead, we believe that it always depends on the overall context whether a higher quality of earnings streams or accelerated growth prospects can justify a premium over one's history.

Why do we only hold a few value stocks?

At first glance, value stocks in Europe and the USA appear historically favourably valued. The European Value Index (MSCI Europe Value), for example, is currently trading at 9 times expected annual earnings and thus well below the 10-year average of 11.6x. A similar picture emerges for the global MSCI ACWI Value Index in Figure 3. Against this background, the valuation of our portfolios with a P/E ratio above 20 appears expensive at first glance. However, we are convinced that such a valuation comparison is actually meaningless.

Figure 3: Valuation levels of value stocks in Europe and the USA





Source: Bloomberg consensus data, 31.05.2013 – 31.05.2023

In Europe, the supposedly cheap "value stocks" are essentially made up of three sectors: financials, energy, and commodities, as well as various sub-categories from the industrial sector. In terms of the MSCI Europe Value Index, the three aforementioned sectors account for almost 60 percent of the index weighting.[3] Many companies from the above-mentioned sectors have shown little or no earnings growth in Europe over the last ten years, as their business models have been under structural pressure. For example, value companies from Europe were only able to increase their profits by an average of 1.2 percent per year in the years following the financial crisis from 2010 to 2019, which is a very sobering result considering the generally good economic development over this period.

Over the past 24 months, however, many value stocks have benefited from rising commodity prices, an improved interest rate environment and good pricing power due to supply chain issues. Energy stocks, automotive stocks, and banks in particular saw significant margin increases. For example, the average EBIT margin of energy companies in Europe widened to 22 percent last year, while carmakers also posted record levels, averaging 11 percent. Both figures are more than double the average of the last 20 years.

However, in our view, the strong trends of the last few months cannot simply be extrapolated to the future for many value stocks. For example, the energy, materials, and industrial sectors are all expected to post negative earnings growth rates over the next 12 months. This is due in particular to a normalisation of margin levels from the current record levels. Earnings in the MSCI Europe Value Index, which disproportionately reflects the above-mentioned sectors, are therefore expected to remain virtually unchanged over the next three years, according to Bloomberg consensus data.

However, as figure 4 shows in a direct comparison of Europe and the USA, our portfolio has an expected earnings per share growth of 15.7 percent p.a. over the same period. In addition, the quality of our portfolio stocks is significantly higher, which becomes clear in the chart from higher margins and returns on equity as well as lower debt figures. Against this background, classic value indices only appear "cheap" at first glance. Currently, the return on capital of our companies in Europe and the USA is about twice as high as that of the value benchmark, which is why we believe that our companies can continue to grow profitably in the future and achieve an excess return compared to the overall market. A one-sided view of the historically low valuation levels of value stocks therefore falls short.

[3] Cf. MSCI factsheets May 2023

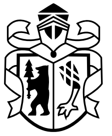


Figure 4: Comparison of valuation, growth, and financial ratios of our portfolios vs. MSCI value indices.

	PE blended 12m	Sales growth p.a. (2022-25E)	Earnings growth p.a. (2022-25E)	Valuation vs. earnings growth	Operating margin (last 12m)	Return on equity (last 12m)	Net debt/ EBITDA (last 12m)
European Focus Fund	**24.7x**	**11.7%**	**15.7%**	**1.6**	**21.1%**	**24.1%**	**0.7x**
MSCI Europe Index	**12.7x**	**1.9%**	**3.8%**	**3.3**	**13.7%**	**12.1%**	**2.3x**
MSCI Europe Value Index	**8.9x**	**1.2%**	**0.2%**	**36.9**	**13.7%**	**11.4%**	**2.3x**

	PE blended 12m	Sales growth p.a. (2022-25E)	Earnings growth p.a. (2022-25E)	Valuation vs. earnings growth	Operating margin (last 12m)	Return on equity (last 12m)	Net debt/ EBITDA (last 12m)
Global Focus Fund	**24.7x**	**11.7%**	**15.7%**	**1.6**	**21.1%**	**24.1%**	**0.7x**
MSCI ACWI	**12.7x**	**1.9%**	**3.8%**	**3.3**	**13.7%**	**12.1%**	**2.3x**
MSCI ACWI Value	**8.9x**	**1.2%**	**0.2%**	**36.9**	**13.7%**	**11.4%**	**2.3x**

Source: Berenberg, Bloomberg, 16.06.2023

Conclusion

In summary, the valuation of high-quality growth stocks has fallen back to historical average levels over the past few months. For companies that are still trading above their historical valuation levels, we see valid reasons to justify a valuation premium. Compared to the market as a whole and to value indices, our stocks are clearly ahead in terms of growth and quality indicators. The selection of high-quality business models with a stable earnings trend is becoming even more relevant against the backdrop of the clouded economic situation. We therefore continue to see many opportunities for our approach and believe that the normalised valuation levels, coupled with continued solid growth ratios, offer good entry opportunities over the coming months.

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PUBLISHER

Matthias Born | Head of Investments & CIO Equities at Berenberg Wealth & Asset Management

CO-AUTHOR

Matthias Born

Head of Investments & CIO Equities, Wealth & Asset Management

CO-AUTHOR

Tim Gottschalk

Portfolio Manager, Wealth & Asset Management

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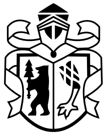

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Joh. Berenberg, Gossler & Co. KG
New Jungfernstieg 20
20354 Hamburg
Phone +49 40 350 60-0
Fax +49 40 350 60-900
www.berenberg.de/
funds@berenberg.com