# ASSESSING EUROPE, KNOCKING OPPORTUNITIES

**EDGE CAPITAL PARTNERS, LLC**

**Edge Capital Partners is an independent financial firm whose objective advice helps individuals and institutions realize their goals in the areas of investment management and corporate finance. The Edge Research Team's thoughtful and timely reports are based on extensive independent research and analysis of firms, financial developments, and macroeconomic trends.**

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## Executive Summary

Our firm has seen little reason for investing in Europe during the past three years, largely because we have been forecasting anemic economic growth in the region since the first quarter of 2008. Our analysis of the evidence has led to a simple thesis: broad exposure to Europe will be poorly rewarded on a risk-adjusted basis. We tested our thesis again in the last few weeks during meetings in Europe with a number of managers, most of whom are based in London, Zurich, and Geneva. These investors in equities, credit, and real assets have their fingers on the pulse of Europe which helps clarify our research on investment opportunities there. The information we have been gathering continues to confirm our larger thesis: Europe's structural challenges mean the region faces a prolonged period of poor economic growth. Despite the generally unfavorable outlook, we must be mindful that there are niche opportunities to generate attractive returns.

Our research suggests there may be an opportunity hiding in the equity markets: European based consumer-oriented companies with global brands like BMW, Louis Vuitton, and Nestle. We believe these firms may provide a significant opening for investors who are eager to bet on European equities. Although these companies face slow growth in their local economy, they may be attractive because of their outstanding prospects for increasing sales in the emerging markets. In particular, Asia's growing middle and upper classes offer these companies a significantly expanding market. We believe the emerging market consumer makes these global, consumer focused brands worth watching.

Another opportunity centers on senior bank loans held by the European banks. This strategy will require more patience given the substantial uncertainty about when the anticipated shakeout in the European banking sector will occur. We expect many banks in Europe to experience turmoil; the timing of the coming chaos will probably depend on factors beyond their control. While the timing is unknown, it is highly likely that any one of several possible events may trigger a stressed environment for European banks. That is why we are keeping an eye out for events that will force European banks to recapitalize. Those left with no other option may wind up selling loans from their balance sheet substantially below their current price at par.

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**Western Europe's Current Economic Challenges**

We believe Europe will be in a difficult economic environment for many years to come. GDP growth in Western Europe has been relatively slow since 2008, and we see no reason to expect a substantial improvement. Highlighted below are the real GDP growth rates in 2009 and 2010 for some of the largest economies in the developed and emerging markets.

Real GDP Growth Rates: Select Developed and Emerging Markets

| | 2009 | 2010 | 2011E | Cumulative |
|---|---|---|---|---|
| *Developed Markets* | | | | |
| United States | -2.4% | 2.9% | 2.5% | 2.9% |
| Canada | -2.6% | 2.9% | 2.9% | 3.1% |
| France | -2.2% | 1.5% | 2.1% | 1.4% |
| Germany | -5.0% | 3.5% | 3.2% | 1.5% |
| United Kingdom | -5.0% | 1.3% | 1.5% | -2.3% |
| *Emerging Markets* | | | | |
| Brazil | -0.2% | 7.5% | 4.1% | 11.7% |
| Russia | -7.9% | 4.0% | 4.8% | 0.4% |
| India | 6.8% | 9.1% | 8.2% | 26.1% |
| China | 8.7% | 10.3% | 9.6% | 31.4% |

Source: The Bloomberg and IMF

There are several reasons for Western Europe's anemic economic growth. These include unfavorable demographics, budgetary imbalances, rigid labor markets, costly regulations, high unemployment, and steep tax rates. Beyond these, other factors are also affecting Europe's economic growth in the near term. These include the role of the euro, the policies of the European Central Bank (ECB), and the structural challenges facing Europe's banking sector.

The single currency of the European Monetary Union (EMU), the euro, has and will continue to cause difficulties for member countries. Because of the single currency, individual economies in the EMU cannot respond to shocks to their economy by devaluing their currency. This matters because it removes an important tool for overleveraged nations like Greece that borrowed more than they can afford to repay.

The ECB is playing a central role in arbitrating among the competing interests of the members of the EMU. From a monetary policy perspective, the ECB has its hands tied; it cannot afford a short-term, band-aid stimulus like the one Ben Bernanke and the Federal Reserve provided in the United States. In its effort to control inflation for a few nations (like Germany, which also happens to be the biggest economy in the European Union), the ECB has followed a tight monetary policy since 2010. This is in contrast to the Federal Reserve's loose policy designed to stimulate cheap lending and create high net interest margins for the banks.

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In addition, the ECB is Greece's biggest creditor. The ECB may not be able to afford to lend Greece more than the 90 billion euros it already has.

We expect structural challenges to European banks will hamper the region's growth over the near term. These issues in the banking sector are especially problematic because in Europe it is the banks that have lent corporations the money needed to capitalize their business (in the leveraged finance or bank loan market). European businesses are highly dependent on their banks for credit in part because the corporate bond market is not as developed in Europe as it is in the U.S.

The problem today is that the European banks, in general, are having difficulty underwriting new loans to companies in need of credit. Despite a dramatic reduction in leverage since 2007, Europe's systemically important banks are, on average, still nearly twice as levered as their competitors in the U.S. In addition to being too highly leveraged, the banks are preparing for Basel III, the new global regulatory standard for bank capital adequacy and liquidity that is scheduled for its first stage of implementation by January 1, 2013. The new rules will require banks to hold more capital and a higher quality of capital than under existing rules. Also, Systemic Important Financial Institutions (i.e., banks too big to fail) are subject to additional supervision and have to meet higher capital requirements of up to 2.5% of Tier 1 Capital by the end of this year. This implies a leverage ratio of nearly 14 times. As seen below, a number of large European banks, on average, have 22 times more assets than equity.

Select European Banks: Leverage Ratios

| | | Current Leverage Analysis | | 2007 Leverage Analysis | |
|---|---|---|---|---|---|
| | Country Headquarters | Assets/ Equity | Total Debt/ Tangible Book Value | Assets/ Equity | Total Debt/ Tangible Book Value |
| **European Bank Average** | | **22.04** | **12.35** | **28.81** | **19.61** |
| BNP Paribas | France | 23.33 | 21.38 | 28.53 | 32.11 |
| Societe Generale | France | 22.23 | 19.19 | 34.27 | 30.16 |
| Credit Agricole | France | 30.56 | 31.98 | 30.43 | 20.50 |
| Deutsche Bank | Germany | 37.82 | 8.74 | 52.52 | 13.55 |
| UniCredit | Italy | 13.73 | 8.34 | 16.37 | 11.83 |
| Banco Santander | Spain | 15.05 | 9.03 | 15.73 | 11.04 |
| BBVA | Spain | 14.75 | 5.09 | 17.96 | 12.20 |
| Credit Suisse | Switzerland | 22.86 | 15.13 | 22.74 | 18.00 |
| UBS | Switzerland | 25.40 | 9.57 | 51.91 | 40.17 |
| HSBC | UK | 15.85 | 2.52 | 17.39 | 4.70 |
| Barclays | UK | 23.93 | 11.59 | 37.79 | 26.57 |
| Royal Bank of Scotland | UK | 18.91 | 5.67 | 20.13 | 14.50 |
| **US Bank Average** | | **11.20** | **7.35** | **15.58** | **13.55** |
| Bank of America | | 9.92 | 6.46 | 11.69 | 12.6 |
| JP Morgan | | 12.02 | 6.69 | 12.68 | 7.45 |
| Goldman Sachs | | 11.65 | 8.91 | 22.37 | 20.59 |

Source: The Bloomberg

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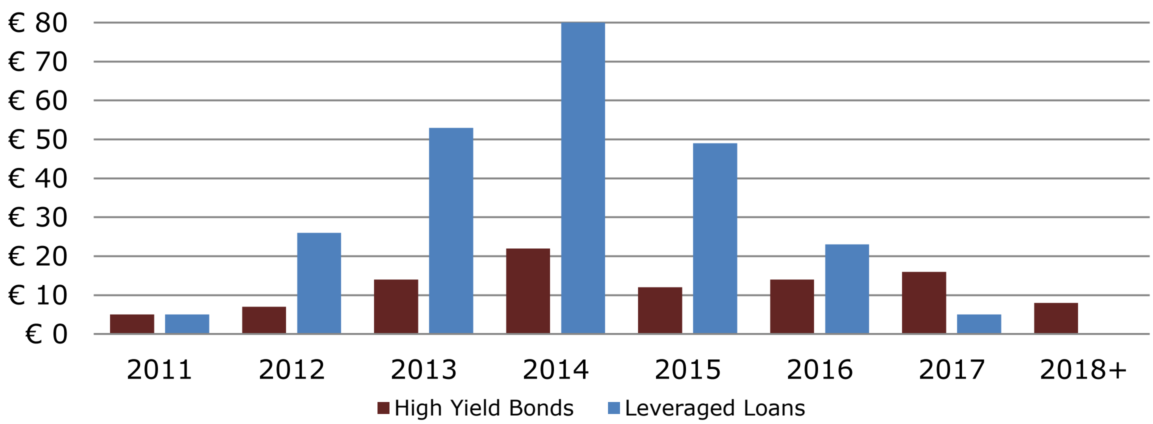
According to recent reports, Systemic Important Financial Institutions, such as HSBC, Deutsche Bank, Barclays, Royal Bank of Scotland, UBS, Credit Suisse, and Societe Generale, may encounter significant additional capital requirements. At a minimum, Basel III implementation creates headwinds on GDP growth. A recent OECD study suggests Basel III will lower global GDP growth from 5 to 15 basis points per annum. This is in part because, according to the OECD, Basel III will lead banks to increase their lending spread by about 15 basis points. GDP growth will suffer if borrowers face stiffer borrowing costs as a result of Basel III.

Given these additional capital requirements, many of the systemically important European banks cannot take on any more debt to underwrite new loans. As a result, European corporations are turning to Europe's high yield bond market for financing. Unfortunately, this costs corporations 500 basis points (5%) more than the loans banks issued as recently as 2008. Through May high yield European corporate bond issuance in 2011 has already exceeded the 49 billion euros issued in full year 2010 (source: Debtwire).

A Wall of Worry: European Loan Maturities




Source: JP Morgan

It is well known that most European banks are not marking to market the bank loans issued between 2006-2008. These loans are being held at par, a practice that may cause substantial difficulty with the looming wave of bank loans maturing between now and 2014. Our research suggests that companies who are currently paying LIBOR + 100 basis points for a bank loan issued three years ago are now paying LIBOR + 600 basis points in the corporate bond market. If the banks were to mark to market their loans in line with the bond markets, they would be forced into write-downs that would make it even tougher for them to meet the Basel III capital requirements. Apparently some European regulators are feeling forced into "extending and pretending" with the banks (in ways that parallel the ECB's dance with sovereign debt issues in countries like Greece).

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Another potential risk to the European banks is their dependence on money market funds for their dollar-funding needs. Our survey of the largest prime money market funds uncovers a surprisingly large exposure to European banks' short term debt. The nine largest prime money market funds average exposure to European paper is 52%. Fitch estimates that European banks, either through commercial paper or asset-backed commercial paper, account for $800 billion of prime money market funds. Any disruption in the European banking system may cause money market funds to hit the exit button, which would obviously create more funding stress for the European banks.

European Exposure: Largest Prime Money Market Funds

| Money Market Fund Ticker | Fund Assets | European Exposure |
|---|---|---|
| JINXX | $132,294,171,931 | 69.0% |
| FDRXX | $116,101,572,466 | 49.2% |
| VMMXX | $113,205,896,851 | 30.1% |
| TMPXX | $65,047,642,540 | 44.6% |
| POIXX | $50,236,137,004 | 52.3% |
| SHIXX | $49,670,878,669 | 55.6% |
| DADXX | $48,334,712,000 | 70.5% |
| SWSXX | $32,751,673,738 | 42.5% |
| LAPXX | $22,861,597,110 | 54.9% |
| | Avg. European Exposure: | 52.1% |

Source: Edge Capital Partners as of 5/31/11

In summary, Europe's financial system has an enormous debt burden which continues to restrain the region's growth. The long-term solution requires lower debt levels and higher economic growth. In order to get there, austerity measures are required which are unpopular and politically difficult. Meanwhile, structural challenges in the bank loan market are forcing corporations to borrow elsewhere at much higher interest rates. Unfortunately, it will take many years for Europe to sail around these sustainable headwinds.

**European Equities: Focus On Global Brands**

We have been right in our call to be underweight European equities. As of June 24, 2011, the SPDR STOXX Europe 50 ETF, which is dominated by companies located in the UK (36%), Switzerland (19%), Germany (16%) and France (12%), is down 25% since 2008. The SPDR EURO STOXX 50 ETF, which only includes continental Europe and is dominated by companies located in France (38%) and Germany (31%), is down 31% over the same period. Both of these European benchmarks have significantly underperformed the United States (SPY: -6.5%) and the Emerging Markets (GMM: 0.25%). Slower earnings growth and expectations for a weaker economy are the primary drivers of Europe's underperformance.

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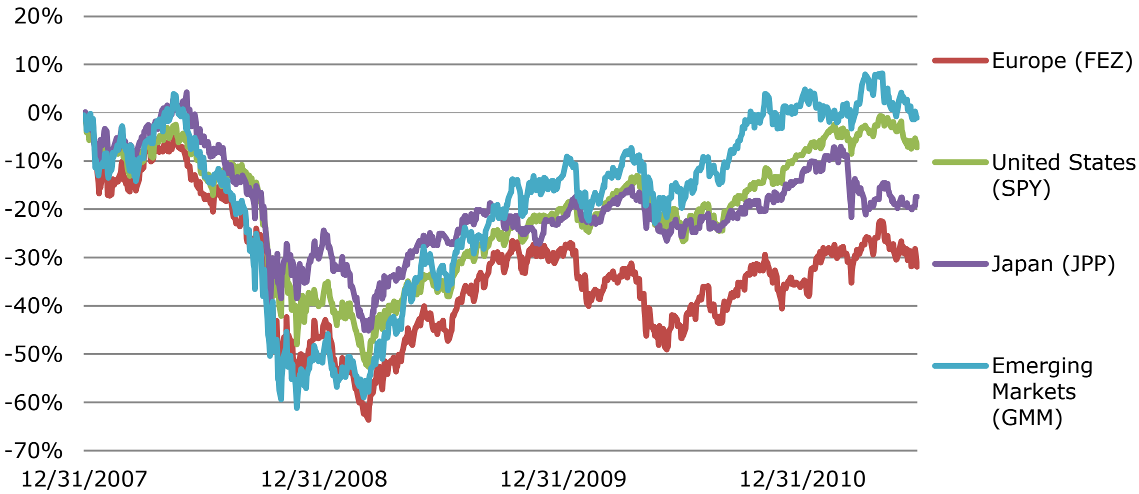
European Equities: Relative Performance Since 2008




Source: The Bloomberg

At first glance, valuation multiples in low growth regions like Europe and Japan look cheap relative to the U.S. and emerging markets. While this might lead some analysts to see European equities as being attractively valued, our research leads us to believe that valuation multiples in Europe will remain low for an extended period of time.

European Equities: Relative Valuations

| | ETF | Current P/E | P/B | 5YR Earnings Growth | Div Yield | PEG |
|---|---|---|---|---|---|---|
| Continental Europe | EURO STOXX 50 | 9.4 | 1.3 | 6.6% | 3.9% | 1.42 |
| Western Europe | STOXX Europe 50 | 9.3 | 1.6 | 6.7% | 4.6% | 1.39 |
| Japan | Russell/Nomura Japan | 13.3 | 1.0 | 36.2% | 2.5% | 0.37 |
| Emerging Markets | S&P Emerging Markets | 10.5 | 2.2 | 14.8% | 1.6% | 0.71 |
| United States | S&P 500 | 12.9 | 2.2 | 10.5% | 1.9% | 1.23 |

PEG Ratio = (Current P/E) / (Est 5YR Earnings Growth Rate)
The lower the PEG ratio, the more attractively valued

Source: The Bloomberg and State Street Global Advisors

It is important to note that the major European equity indices hold a significant concentration in financial services companies like banks and insurers. For example, financial services is the largest sector in the SPDR EURO STOXX 50 ETF (28%) and the SPDR STOXX Europe 50 ETF (25%). These financial companies are trading at relatively low valuations because of poor earnings outlooks. As a result, the European equity indices look extraordinarily cheap; however, low earnings growth

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forecasts, namely due to the significance of financial services companies in Europe's economy and equity market composites, means that the appearance is deceiving.

Despite this negative outlook, our research – as indicated above – reveals a few bright spots for select European equities. Chief among these are high quality, multi-national companies. Europe is home to some outstanding global companies that are industry leaders, carry valuable brand names, and offer attractive growth prospects. According to *Business Week*, 39 of the top 100 global brands are based in Europe.

30 Top Publicly Traded European Global Brands

| COMPANY NAME | DEBT TO ASSETS | DIV YIELD | 2012 P/E | P/B | EST LT GROWTH |
|---|---|---|---|---|---|
| PORSCHE AUTO | 38.5 | 0.9 | 5.6 | 0.7 | 37.0 |
| DAIMLER (OWNS MERCEDES BENZ) | 47.3 | 3.7 | 8.1 | 1.4 | 8.5 |
| BAYER MOTOREN WERKE (BMW) | 57.3 | 1.9 | 9.5 | 1.8 | 9.3 |
| AUDI | 2.7 | 0.4 | 9.5 | 2.2 | 9.0 |
| PPR (OWNS GUCCI) | 22.1 | 3.0 | 12.2 | 1.4 | 10.9 |
| PUMA | 1.8 | 0.9 | 12.5 | 2.3 | 19.2 |
| CHRISTIAN DIOR | 16.6 | 2.0 | 13.5 | 2.5 | 15.1 |
| ADIDAS | 16.3 | 1.5 | 14.2 | 2.5 | 14.9 |
| LVMH MOET HENNES | 14.2 | 1.7 | 17.4 | 3.4 | 12.1 |
| HENNES & MAURI | 0.0 | 4.4 | 18.4 | 10.5 | 4.7 |
| BURBERRY GROUP | 12.3 | 1.6 | 20.0 | 8.4 | 16.1 |
| BULGARI | 17.2 | 1.0 | 31.3 | 4.0 | 27.6 |
| HERMES INTL | 1.5 | 0.5 | 36.8 | 9.6 | 18.1 |
| HEINEKEN | 34.2 | 1.8 | 12.6 | 2.3 | 13.4 |
| ANHEUSER-BUSCH | 39.3 | 2.0 | 13.2 | 2.6 | 15.8 |
| DIAGEO (OWNS SMIRNOFF) | 45.0 | 3.4 | 14.5 | 6.4 | 11.1 |
| NESTLE SA-REG | 18.0 | 3.6 | 14.6 | 2.7 | 7.3 |
| DANONE | 33.7 | 2.5 | 15.7 | 2.7 | 10.0 |
| L'OREAL | 6.6 | 2.1 | 18.4 | 3.5 | 10.0 |
| ROYAL DUTCH SHELL | 13.7 | 4.7 | 7.2 | 1.3 | 3.7 |
| CREDIT SUISSE | 38.9 | 0.0 | 6.0 | 1.1 | 4.8 |
| BARCLAYS | 32.8 | 2.5 | 6.2 | 0.6 | 15.8 |
| BANCO SANTANDER | 34.8 | 7.7 | 6.5 | 0.9 | 14.4 |
| AXA | 2.4 | 4.6 | 6.9 | 0.7 | 32.3 |
| UBS | 26.9 | 0.0 | 6.9 | 1.2 | 8.3 |
| ZURICH FINANCIAL SERVICES | 4.1 | 0.0 | 7.9 | 1.2 | 9.1 |
| HSBC HOLDINGS | 11.8 | 4.1 | 8.9 | 1.2 | 22.4 |
| KONINKLIJKE PHILIPS | 14.4 | 4.5 | 10.4 | 1.1 | 9.3 |
| SIEMENS | 19.4 | 3.0 | 11.3 | 2.6 | 17.8 |
| SAP AG | 22.0 | 1.5 | 13.8 | 4.8 | 17.7 |
| **AVERAGE** | **21.5** | **2.4** | **13.0** | **2.9** | **14.2** |

Source: The Bloomberg

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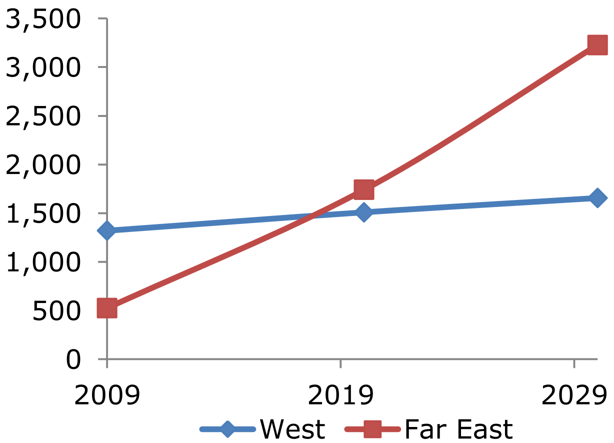
The attractive growth of these global companies is dependent on the emerging markets. Whether it is Adidas selling shoes in Brazil, Nestle selling chocolate in India, or BMW selling $100,000 cars in China, much of the near-term success of Europe's top global companies rests in the emerging markets.

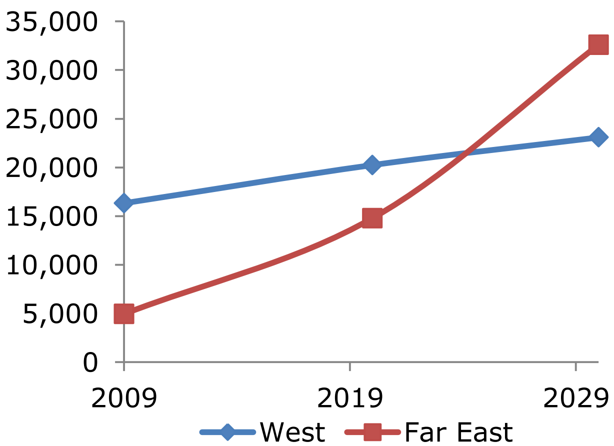
We remain bullish on the long-term prospects of the emerging market consumer. We expect the emerging markets will have their ebbs and flows, but the long-term growth trend for the middle and upper class is exceptional. Below we highlight the estimated growth in the world's middle class and its shift from the West to the Far East.

Numbers (millions) of the Global Middle Class




OECD estimates that Asia Pacific's middle class will more than double its population share of the global middle class population by 2030.

Spending ($millions) by the Global Middle Class

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Far East = Asia Pacific
West = Americas, Europe, and Africa
Source: OECD, *The Emerging Middle Class in Developing Countries*

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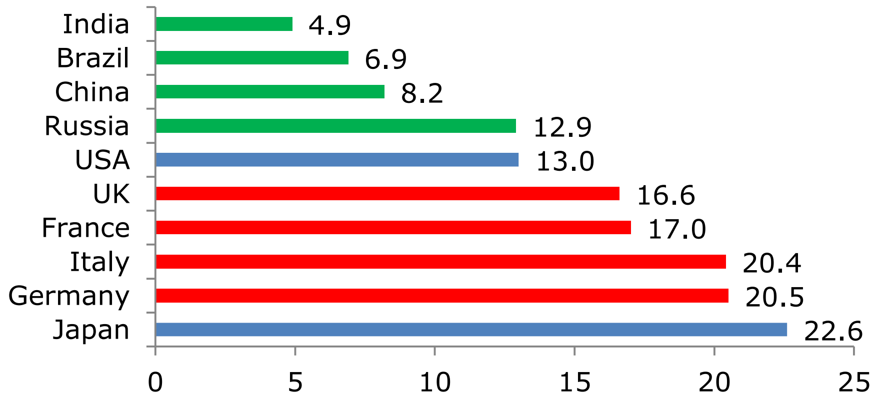
According to the annual *World Wealth Report*, the Asia-Pacific region is experiencing outstanding growth in personal wealth with 3.3 million high net worth individuals (HNWIs) as of 2010. This makes it home to the second largest population of HNWIs in the world, putting it behind North America and, for the first time, ahead of Europe. Importantly, with a young population, the demographics for the "BRIC" countries of the emerging markets are relatively favorable. The BRIC countries, on average, have 92% of their population younger than 65 years old – a sharp contrast to Europe's aging populace.

Elderly (65+) as a Percent of the Population (2010)




Source: Center for Strategic & International Studies

These global European brands carry risk. They are clearly dependent on the emerging markets for growth, particularly China. While Mercedes-Benz saw its worldwide sales grow 15% in 2010, its sales in China jumped 112%. This reflects the reality of an adage currently in vogue: "Made in Europe, Sold in China." Yet, this dependence carries risk: what if China falters? A growing number of analysts are becoming bearish on China because of their fiscal and monetary policies. The policies conducted by China will require change and therefore create uncertainty. Furthermore, valuations for these European global brands in the luxury goods industry reflect their growth opportunities and need to be purchased at the right price.

In summary, the broad European indices will likely underperform in the next 2-3 years relative to the global equity markets. Nevertheless, there are some bright opportunities with global consumer product companies based in Europe—assuming there is not a systemic breakdown among emerging markets consumers. Active management implementation is critical due to the construction of the European index ETFs and our anticipation of a shakeout between winners and losers.

**European Distressed Credit: A Potential Opportunity**

European distressed credit strategies have not lived up to expectations since the end of 2009 due to liquidity injections, lenient accounting rules, and "delay and pray" tactics. In short, the anticipated distress has yet to occur. Nevertheless, distressed credit investors may have their day again as they did in 2009.

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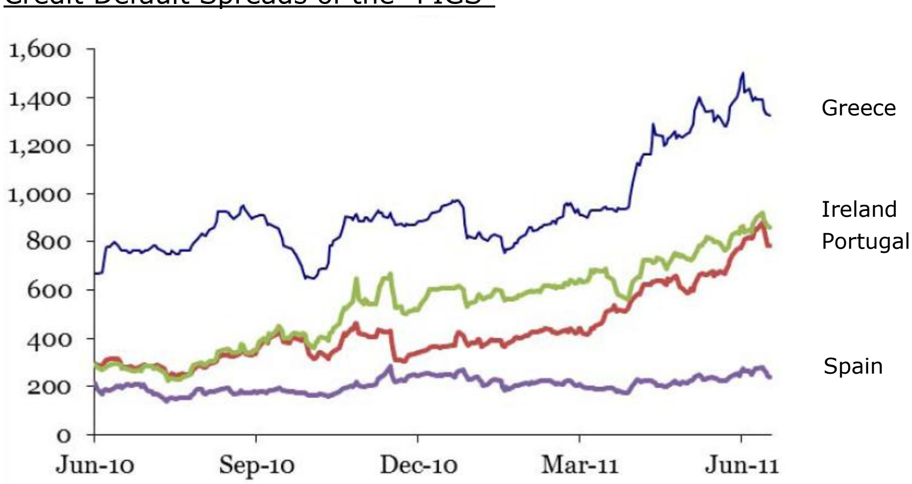
As discussed earlier, European bank balance sheets are highly leveraged and face major headwinds from multiple sources, including slow economic growth (market risk), upcoming capital requirements that may require restructuring (regulatory risk), government risk, and wholesale funding needs from money market funds globally (funding risk). Furthermore, reliable sources estimate that European financial institutions collectively have a portfolio of 1.3 trillion euros in non-core loans and 800 billion euros in non-performing loans. Balance sheet restructuring appears to be more "when" than "if" – leading us to view these loans as being for sale.

In addition to banks, European corporations also unquestioningly drank the debt Kool-Aid. Standard & Poor's forecasts Western Europe's default rate on speculative grade debt will rise from 3.8% at the end of 2010 to between 5.5% and 7.7% in 2011. Considering what looks to be a dramatic mismatch of supply and demand, distressed investors in Europe will be given a gift of attractive opportunities.

The big question is when European restructuring will peak. Several indicators suggest that 2012 may be the starting point and 2013 will be the zenith. For one, two-thirds of the outstanding bank loans mature between 2012 and 2014, which may prompt significant restructuring. Other potential catalysts for restructuring may begin having a major impact even sooner. The ECB is already tightening monetary policy (which negatively impacts the net interest margins of European banks and raises the cost of capital for corporations) and banks are beginning to prepare for the regulatory requirements of Basel III. A well-known catalyst is sovereign debt default. Because European banks have a large amount of sovereign debt on their balance sheets, a default may lead banks to sell distressed assets in a distressed environment. As measured by CDS (Credit Default Swaps), the market continues to pay substantially higher insurance premiums for sovereign default protection on the "PIGS" (Portugal, Ireland, Greece, and Spain) relative to Germany's 10 year bond.

Credit Default Spreads of the "PIGS"




Source: Strategas

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These potential catalysts for restructuring suggest another major issue facing European banks: structured credit. Structured credit vehicles like Collateralized Loan Obligations (CLO) own pools of senior bank loans that are securitized in the form of a debt security. When a CLO matures, the issuer has to sell the underlying bank loans of the structured debt security in order pay back principal. With most of the CLOs that were issued in 2006-2007 about to mature, and with many banks also holding CLOs on their balance sheets, we expect the unwinding of these structured credit vehicles could be chaotic. We suspect that there may be opportunity in this chaos.

It may be that bank loans along with non-core financial assets held by European banks offer the best opportunity on the long side. For example, if bank loans fall in price, banks may have to sell these or non-core financial assets to meet regulatory capital requirements. Private equity and distressed credit managers (who have the skill set and network to understand these complex loans and assets) are likely to pursue the most senior debt on the capital structure. Should it go into distress, the senior bank loan market may trade at 60-70 cents on the euro just as it did at the height of the financial crisis in 2008/2009. Overall, we anticipate that the first opportunity will be the banks selling good loans at distressed prices due to selling pressure. The second opportunity will be the banks selling impaired loans.

**Conclusion**

These potential shocks to the financial system will undoubtedly have a profound impact on all assets in Europe and are likely to reverberate across the world. But as our recent quarterly outlooks emphasize, the big “G” (for governments around the world) is the largest single factor affecting whether the global economic recovery continues or is impeded. In this case, we would not be surprised to see the big “G” support another bailout of the banks in order to prevent another financial crisis. If this is how they choose to act, the opportunity in European distressed credit will likely be negligible and European equities may move higher until the next bill comes due. While we will continue to stay on the sidelines for broad exposure in Europe, we will keep challenging our thesis and watching for new opportunities across the pond.