Little hope for a quick V-shaped recovery

Within the next five years, the vast majority of Europe’s largest companies may not be able to achieve results projected before the current crisis. Their implied equity risk premium has stabilised recently, however, it is still about 200 bps above the pre-crisis level.

Equity price have gone down sharply across all key markets in recent weeks, however, the story behind varies across individual industries. Using our proprietary model, which monitors expected future performance of large European companies and calculates implied equity risk premium for individual sectors, we observed a substantial shift in financial projections, shaken confidence of investors and changes in perceived risks across various industries.

The European stock market has recently recovered slightly but still (as of 15 April) 90% of companies from the STOXX Europe 600 index saw their stock analyst estimates downsized from the pre-crisis level, with transportation, leisure and automobiles among those being hit especially hard. Our model indicates that early hopes for a quick return to normal vanished as analyst expectations indicate negative effects on corporate profits also in the years to come.

Average change in Net Income estimates for all nonfinancial STOXX Europe 600 companies (19 February vs 15 April 2020)

Source: Institutional Brokers’ Estimate System (I/B/E/S), Deloitte analysis

The chart above demonstrates that within the next five years most European companies will not be able to achieve results projected before the current crisis.

Selected findings

• Transportation Infrastructure and Hotels, Restaurants & Leisure are expected to be severely affected. Their Net Income estimates for 2020 are on average more than 50% below the pre-crisis estimates (see the chart on the right)

• Net Income estimates of Automobile manufactures for 2020 declined by 29% on average. Forecasts for 2024 are down 7% compared to the pre-crisis level.

• For Media and Beverages, the current situation might mean bad times not only in upcoming months, but also in the long-term.
The crucial question is whether the recent significant drop in stock prices mirrors lower forecasts of future cash flows. It can be answered through the implied equity risk premium (ERP) which indicates an additional return for the investor. The first graph on the right shows changes of implied ERP compared to the beginning of the year. It has declined from the peak in mid March, but is still well above the pre-crisis level.

The implied ERP provides an interesting insight if broken down to individual sectors. Since we calculate betas for each company individually, the sector risk is already reflected in the model. Therefore, the implied ERP per industry can serve as an indicator of investor confidence. The higher the increase, the higher uncertainty and less visibility on the future development. However, an increase can also indicate an interesting investment opportunity provided the underlying expectations about future performance will materialise. The higher the change in the premium, the higher potential for extraordinary return for investors.

**Selected findings**

- Automobiles and Health Care Providers have undergone interesting development especially when viewed through changes in perceived risks that can be captured by implied equity risk premium.
- The premium for Automobiles increased by 250 bps compared to pre-crisis levels while the implied ERP for Health Care Providers is down 140 bps. Should the forecasts materialise, Automobiles would provide a considerably higher annual return than Health Care Providers.
- Implied equity risk premium of Europe’s largest companies has declined recently, however, it is still about 200 bps above the pre-crisis level.

**Takeaways for investors and appraisers**

- Look for unusually high or low ERP of an industry or company and try to figure out the reasoning behind it as it may signal an opportunity.
- Uncertainty, risk premia and investment opportunities vary significantly across industries.
- Seek up-to-date inputs such as betas or ERP.

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