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Global returns at a UK discount

UK companies source their earnings from around the world. Why are they valued at a discount?

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Since the Global Financial Crisis, zero interest rates and a flood of liquidity have helped to funnel investors into ultra-long-duration growth stocks. At its height, with some $25 trillion in central bank money swilling through the system, performance was concentrated in a handful of companies, the so-called ‘FANGs’, companies seen as global ‘platforms’, monopolies or near-monopolies providing services that had become infused into daily life. If money was free, long-term capital growth was the game to play.

The FANGs, of course, are US companies, and other markets fell from grace, the UK included. Not that the UK doesn’t have fantastic technology companies, but they lacked the scale, never mind the sheer ubiquity of the FANGs.

It was widely and rightly recognised that the UK was a highly globalised market. According to FTSE Russell, over 80% of FTSE 100 earnings are sourced outside the UK. Even in the FTSE 250, whose mid-sized companies are more oriented to the domestic market, overseas markets account for 57% of total revenues .

The issue with the UK is not its global reach but that the weight of the stock market is in consumer staples, financials, materials, industrials, sectors seen as mature, staid, analogue. Neither was it that UK companies were not leaders in their markets or that they didn’t generate good cashflows. It was just that in a world of cost-free capital, immediate cashflow was less valuable than long-term capital growth.

It hardly needs to be laboured that the time of free money has come to an end, at least for now. With inflation raging up into double digits, immediate cashflow starts to look very interesting. The question now is whether the UK is the place to capture those cashflows? Did it sell off due the unusual monetary environment, or because the UK is just not that interesting?

There are some important nuances here. One is that funds that have left the UK have not fanned out to markets worldwide. They have gone to the US, and largely, and not unreasonably, into outperforming technology.

The second is those overseas earnings. When you buy the UK equity market, you might be buying a market biased toward value rather than growth, but you are buying into the global economy. The question then is whether the UK, having been sold down for 15 years, has become undervalued, in particular relative to the US. And if it is undervalued, is there an opportunity to buy global earnings at a UK discount?

Let's look at some numbers.

The average PE for a company in the S&P 500 is 19.48x compared to 14.02x for the FTSE All Share and slightly less, 13.82x, for the FTSE 100. Of course, valuations on the S&P 500 are pushed up due to the presence of those expensive growth stocks. What does it look like at a sector level?
Looking at some of the sectors that dominate the UK equity market, we see the same pattern, though the margins are definitely narrower. The unweighted average PE for mining stocks in the S&P 500 is 14.96x, not a million miles from the 13.01x in the All Share, but the latter offers a yield of 5.93% against 2.56% in the S&P. Insurers offer a similar differential. Legal & General has a PE of 7.04x for a yield of 7.19%, while AIG has a PE of 17.66x for a yield of 2.1%.

Among banks, the differential is starker. The unweighted average PE for banks in the S&P 500 is 10.23x for a yield of 3.31%, compared to 6.87x for a yield of 4.45% in the All Share. Or again, among oil & gas stocks, the average PE in the S&P is 21.82x for a yield of 3.57% relative to a PE of 11.06x for a yield of 5.12% in the All Share.

There are differences of course between global integrated oil companies such as Shell and Chevron, with market caps of £166 billion and £356 billion respectively, and smaller, specialist companies, such as EQT or Tullow with market caps of £16 billion and £0.65 billion. But while Shell and Chevron are both undoubtedly 'majors', the former is on a PE of 4.91x for a yield of 3.64% compared to the latter's 10.02x for a yield of 3.08%. Chevron has outperformed Shell and BP by around 30% this year, despite that all three companies carry out very similar operations in much the same jurisdictions.

Similar examples from the banking sector might be Barclays and Wells Fargo, both institutions with international significance and well inside the 'too big to fail' category. Barclays is on a PE of 5.14x for a yield of 3.95% compared to Wells Fargo's PE of 12.69x for a yield of 2.54%.

Stock selection is all about understanding idiosyncrasy, about seeing the difference between one opportunity and another, while high-level data tends to be homogenising. But with that caveat in mind, it would certainly appear that the time might be ripe to reconsider the UK, that the UK equity market currently offers a discounted price on global earnings.

Note: All data is from Bloomberg unless otherwise stated

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