Deutsche Bank
Markets Research

Europe
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Strategy

European Equity Strategy

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Strategy Update

High yield and telecom

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Last week we recommended we start thinking about developing value strategies with the preference for quality/growth looking increasingly extended. In order to understand what could trigger a rotation from growth into value we need to understand not only the drivers of financials, but also high dividend yield stocks.

On our work, what is critical in any dividend strategy is whether dividend estimates are rising or falling. High yielding stocks have been performing poorly because they have mostly seen cuts to their dividend forecasts.

A better performing style, which we outlined last year, has been to isolate companies where dividends looked too low and where there was scope for them to rise. During 2011 dividend payouts generally looked too low. Even stock screens focused on seemingly 'sustainable' dividend yields have struggled without the helping hand from dividend momentum.

Telecom is a great example of this. We have been underweight the sector (and still are) on the basis of the outlook for dividends and we have seen a substantial deterioration in the momentum in dividend estimates this year. But within the sector the few positive dividend revisions (Telenor and the UK segment) have outperformed the negative dividend revisions by 21% since the end of November.

Therefore a recovery in telecom will depend on how reassured we can become on their dividends. The telecom sector is burdened by a range of issues such as the quite onerous outlook for capex, regulatory and governmental interference and increasing competition in mobile. The cyclical nature of revenues is often overlooked and this is the key to dividends. If we can become more comfortable with revenues then we can become more comfortable with dividends and a mere absence of downgrades can trigger a recovery in the dividend revisions ratio from these very negative levels which should drive outperformance.

This is going to depend on the Euro area economy turning a corner, which by the way, should be the main driver of a broader rotation from growth into value. While we believe we still have some weak macro releases ahead of us, the ECB bank lending survey this week opened up the possibility of a recovery later in the year, and Italy could be one of the first off the blocks.

It still feels very early to make this call, but for those willing to adopt a more value bias and pre-empt this development then **Telecom Italia (Buy, Eur0.85)** might be sensible place to start.

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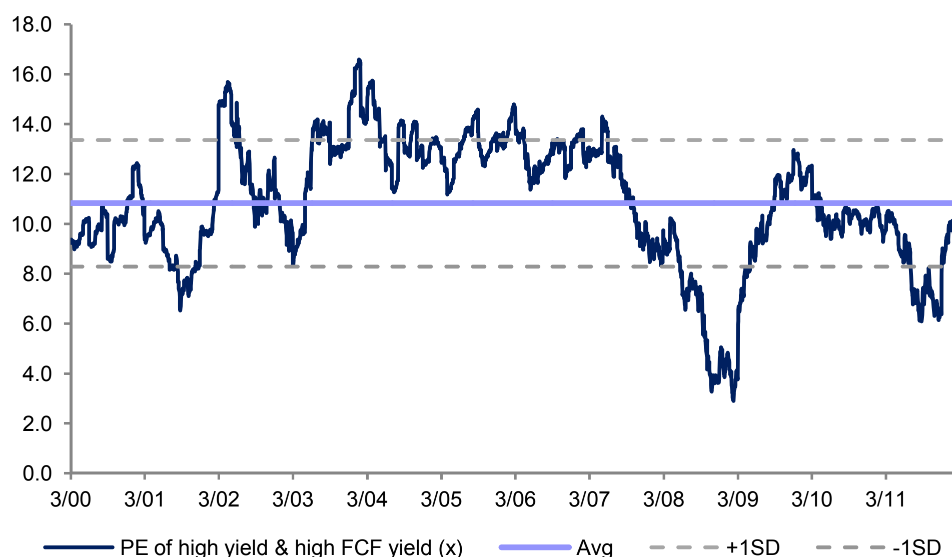
Turning high yield around

Last week we recommended we start thinking about developing value strategies with the preference for quality/growth looking increasingly extended. Despite the fall in volatility the cheaper end of the market has been left to rot while the safer styles of low volatility, and quality have continued to march on to PE relative highs. If we are going to be serious about this, we need to look again at companies with high dividend yields and ask what it would take to see a turnaround because it has been such a poor performing style.

Just as value has underperformed growth, the high dividend yield style has de-rated to the lower end of its historic range of 8.2x trailing versus a long run average of 10.8x. Alternatively, the PE relative of the style with the Stoxx 600 is 0.7x versus a long run average of 0.8x.

Figure 1: PE of European high yield



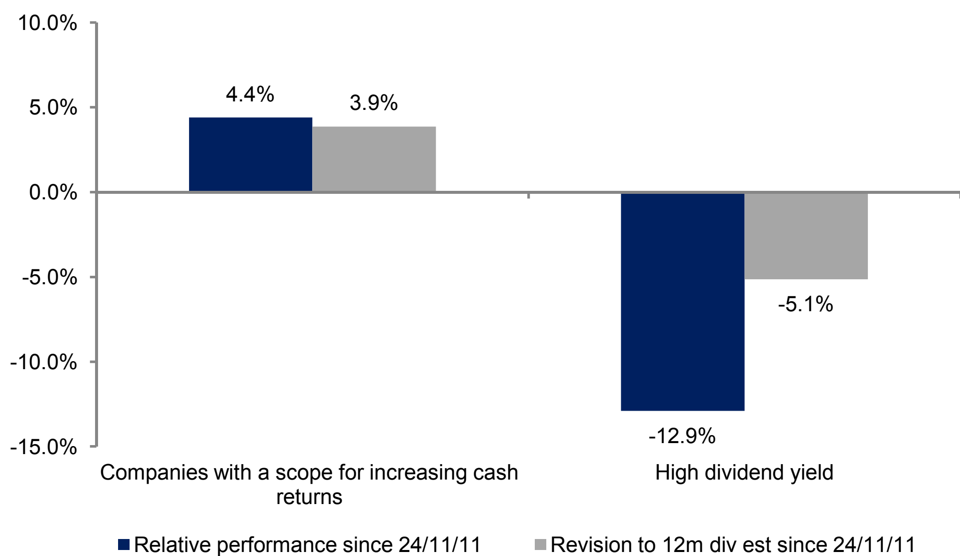
Source: Deutsche Bank Quantitative Research

The important thing to realize about how best to enact a dividend strategy is that it's the revision in dividend estimates that counts. Back in November our message was that it would be better to screen for where dividends could increase rather than high yield.

We recommended screening for companies with low dividend payouts, high free cash flow dividend cover and low debt *relative to their sector*, and to forget yield. Companies care about what their peers are paying out and this is why relative to sector was important. This approach also flowed from our desire to position ourselves for a rising payout with payout ratios looking too low overall – in March 2011 it was sitting at just 40%.

Since the end of November this screen has outperformed the market by 4.4% while high dividend yield has underperformed by 13% (Figure 2). This is because these companies have seen upgrades to their dividend estimates, while high yield has seen downgrades. The forward dividend estimates for high yield have fallen 5.1% since the end of November and the companies in our screen of low payouts have seen an average upgrade of 3.9% to their dividend estimates.

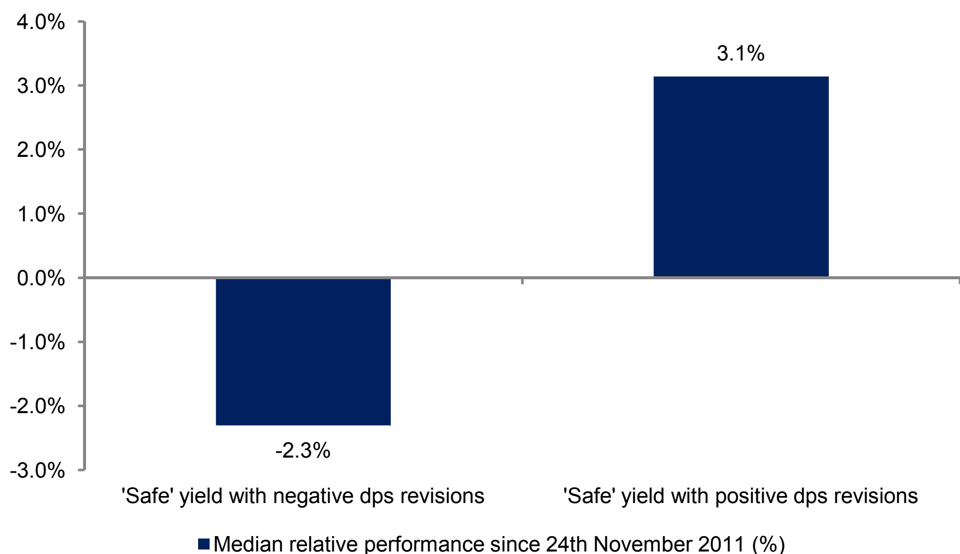
Figure 2: It's dividend revisions that matter



Source: Deutsche Bank

If you thought sustainable and safe high yield was the way to go, you would have struggled without a helping hand from dividend revisions. If in November you had run a screen of companies with a reasonably high yield, but not too high (greater than 3.5% and less than 7% because a very high yield can be self defeating and attract higher volatility), free cash-flow dividend cover of greater than 1.2x, and positive trailing and forecast dividend growth, then it has still been the change in dividend estimates that have driven performance within this style.

Figure 3: Relative performance of 'sustainable' yield driven only by div revisions

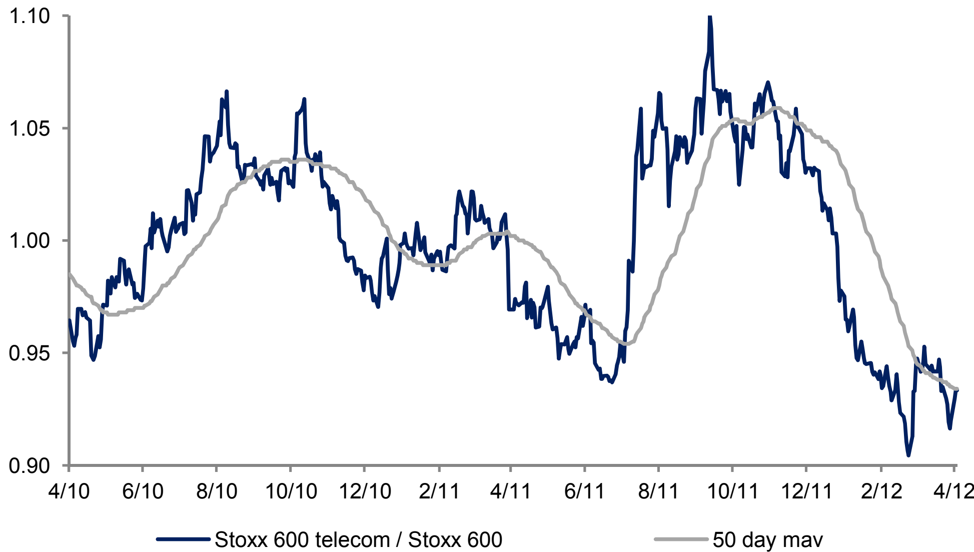


Source: Deutsche Bank

Figure 3 shows how 'sustainable yield' with downgrades to dividend estimates have not just failed to perform as well as sustainable yield with upgrades, but have underperformed the market by 2.3% since the end of November. Only those with sustainable yields and upgrades to those estimates have outperformed the market (+3.1% over the same period).

So however you slice it, dividend revisions are important for the performance of high yield. The telecom sector forms a major part of this style. It is the highest yielding sector in the market at 7% and the third largest sector in the value style at 11% of MSCI value. While we remain underweight, we find ourselves starting to re-test the arguments at these lower levels. The sector has underperformed the Stoxx 600 by 15% since October (Figure 4) and sits on a forward PE of 9.3x. What could turn it around?

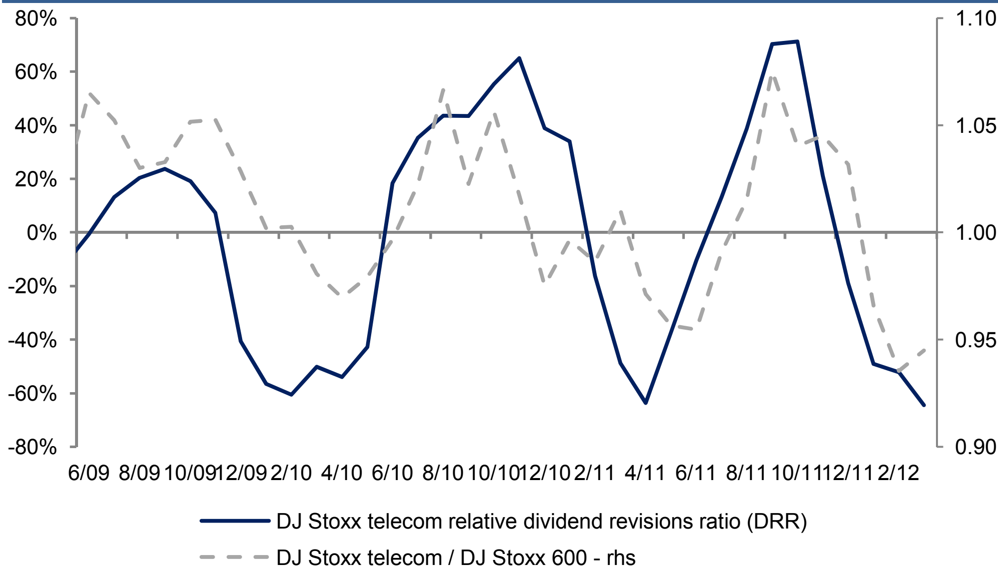
Figure 4: Telecom relative



Source: Datastream

Becoming more reassured about their dividends is going to be critical if we are going to see a recovery. Figure 5 shows the high correlation between the telecom sector's relative performance and the relative momentum in its dividend estimates.

Figure 5: Telecom dividend momentum and telecom relative performance

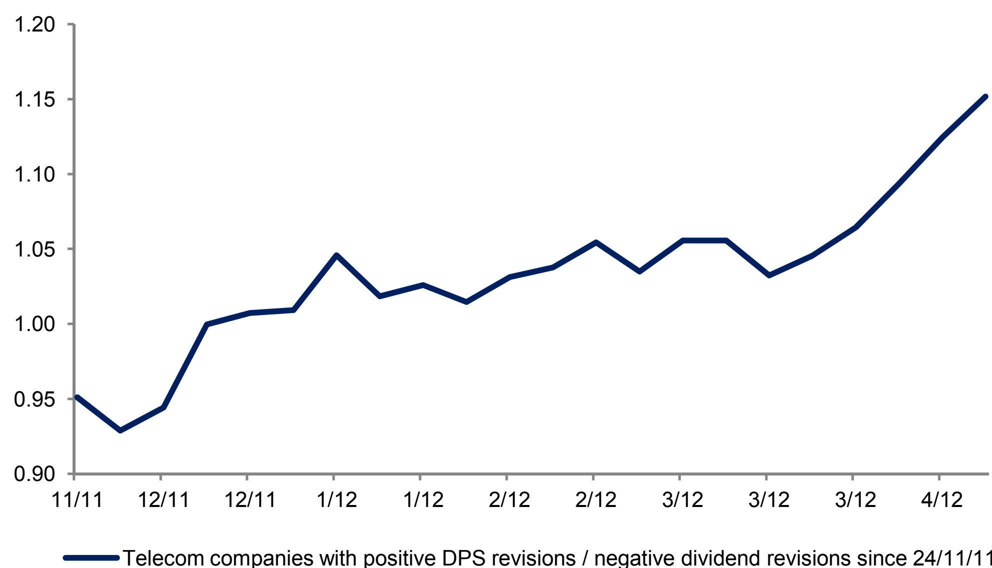


#upgrades to 12m forward DPS - #downgrades as a percentage of the total number of estimate changes. Source: IBES

This is a chart we normally produce when looking at earnings momentum but equally it can be done for dividends and it makes sense to us when looking at telecom. The sector's relative DRR (dividend revisions ratio) is already at the bottom of its range. A big adjustment has already taken place.

Dividends have been an important differentiator of performance within the telecom sector. The companies that have seen upgrades to dividend estimates, such as Telenor and the UK segment have outperformed the companies seeing downgrades by 21% since the end of November (Figure 6). Rob Grindle and our telecom team believe that there are still lingering risks around the dividends of KPN, Belgacom, Telefonica and France Telecom, but at some stage there might be scope for a broader turnaround or at least an absence of downgrades which one would need to look for first and would be enough to take the dividend revisions ratio back up to zero from -65% in Figure 5.

Figure 6: Telecoms seeing upgrades to dividends / downgrades



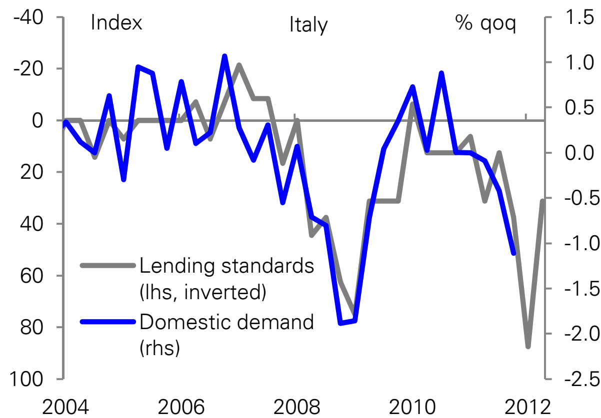
Source: Deutsche Bank, IBES

Pre-empting this requires us to take a view on revenues. This is partly about the continued growth in mobile data traffic through the increased use of smartphones, but it also comes back to the Euro area economy which we believe holds the key more broadly to the likelihood of a growth-to-value rotation.

We have been cautious of domestic demand in Europe because of a negative credit impulse. As a result we have been underweight companies with an exposure to domestic demand and these companies have de-rated accordingly (see our note '*A tinier ToT*', 23 March). This week we had the long awaited ECB bank lending survey and it was better than expected. Credit conditions of firms and households tightened by less in Q1 than in Q4.

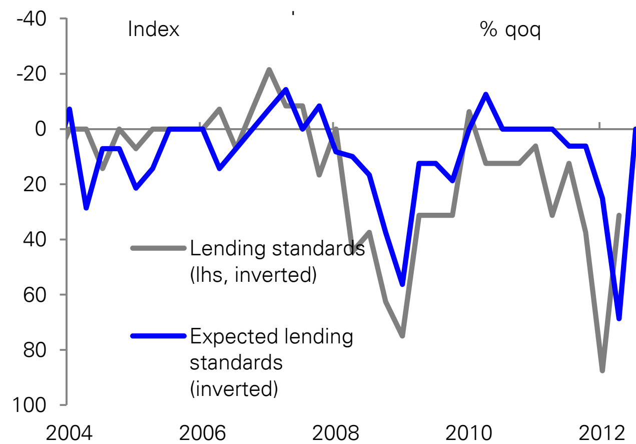
We still think we have a set of weak macro releases ahead of us but at some stage (and it could be sooner than we think) we may have to start to contemplate, and therefore price, a trough in the Euro area economy. And rather perversely it could form a reason for becoming more positive on telecom, a sector known more for its defensive attributes rather than cyclical. This would be barring regulatory/governmental interference and competitive pressures in mobile not increasing.

Figure 7: Domestic demand in Italy vs lending standards



Source: ECB

Figure 8: Prospects improve later in the year in Italy

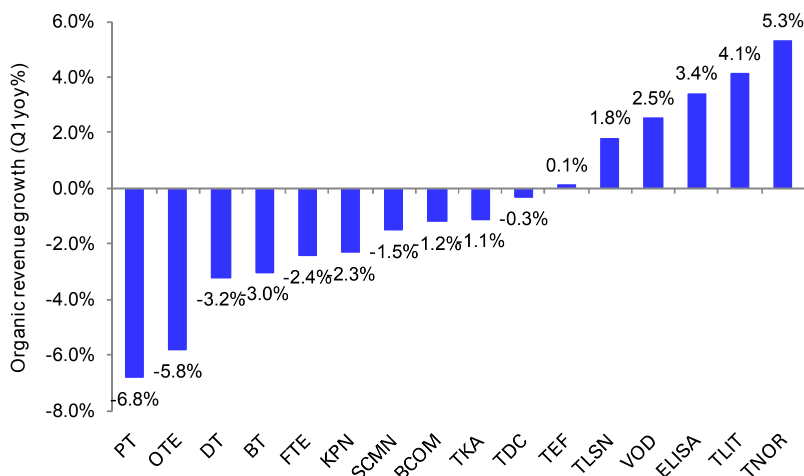


Source: ECB

One could envisage a situation where in Italy things start to improve ahead of the rest. We are still looking ahead to a fairly aggressive decline in domestic demand growth in Italy in Q2, but after that credit conditions could stabilize giving way to better than expected demand (Figure 7 and Figure 8). Dare we say it we could be close to the turning point on Italy.

Our telecom team's top pick is **Telecom Italia** (Buy, Eur0.85) because of the improvement in mobile operating trends in Italy which is already taking place despite the Italian economy. It is of course vulnerable to the ebb and flow of the sovereign crisis, but this might prove to the appropriate entry point for those keen to adopt a value tilt as we are. On DB estimates the company is on 6.6x 2012E and a dividend yield of 5.9%. Figure 9 shows the revenue growths across the sector in Q1. Note that we included Telenor (TNOR) in our strategy picks list for 2012 at the end of November (DB thematic basket **DBCGSP2P**).

Figure 9: Revenue growth in Q1 across telecom



Source: Company data, Deutsche Bank

Telecom Italia – valuation and risks

We value Telecom Italia using a sum-of-the-parts methodology. We employ a DCF valuation for domestic wire line and mobile: WACC is 8.55% and TGR is -0.25% for mobile and -1% for fixed, in line with European peers. For Brazilian mobile operations (TIM Participacoes), we use our Latin American analyst's target price. Other assets are minor positives: we subtract the capitalized holding company's costs and net debt to obtain equity value. We apply a 10% discount to savers, as the dividend yield differential should lead the discount to narrow further. T.I. trades at >20% discount to its European peers.Key downside risks: 1) outstanding cost cuts insufficient to offset prolonged revenue fall; 2) postponement in mobile service revenue turnaround.

Appendix 1

Important Disclosures

Additional information available upon request

Disclosure checklist			
Company	Ticker	Recent price*	Disclosure
Telecom Italia	TLITn.MI	0.71 (EUR) 27 Apr 12	1,6,14,17

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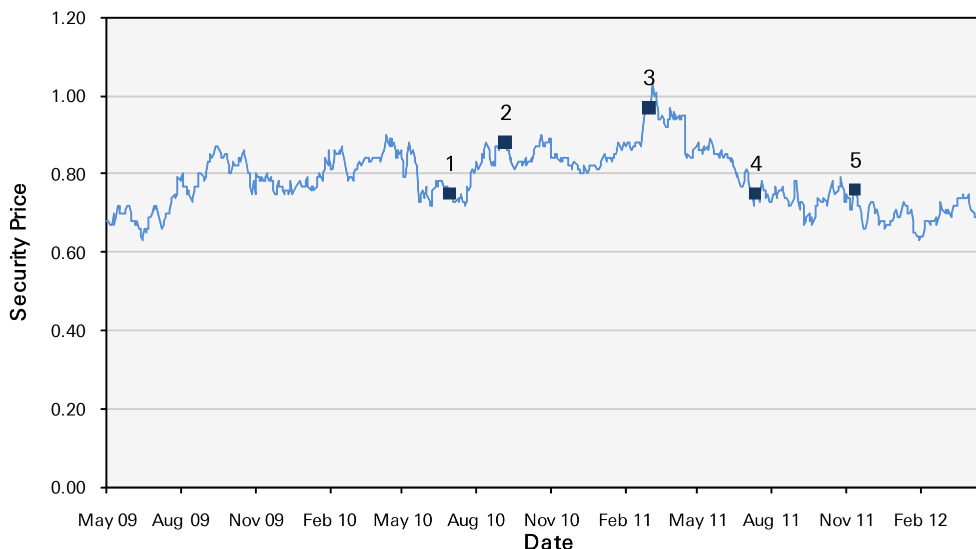
Historical recommendations and target price: Telecom Italia (TLITn.MI)

(as of 4/27/2012)



1.	01/07/2010:	Buy, Target Price Change EUR1.28	4.	14/07/2011:	Buy, Target Price Change EUR1.20
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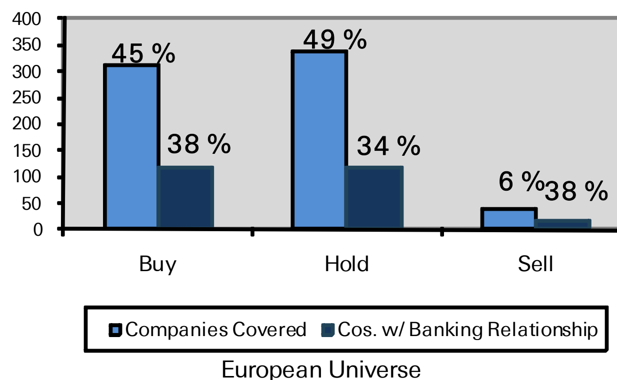

European Universe

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