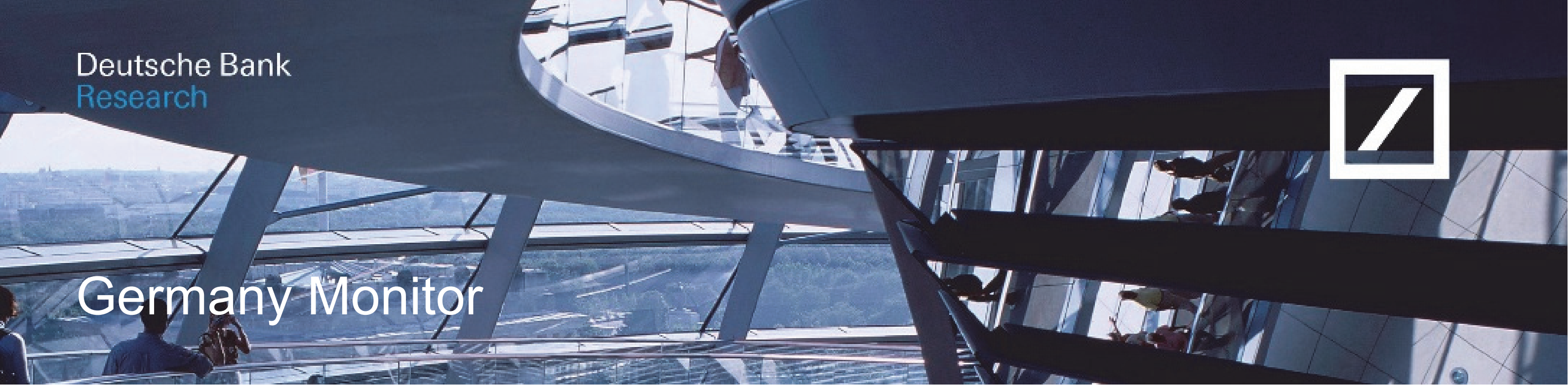


# Dax reform

## Reasonable, but won’t cure German stock market’s illness

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Germany’s main stock market index, Dax, is undergoing its biggest rule makeover so far. The number of constituents will rise from 30 to 40, trading volume will be dropped as a selection criterion and new members must have been profitable for two years before first-time admission. Governance standards are also tightened.

While the index will become more diversified and slightly “younger” as a result, the enlargement will not reduce the massive overweight of the manufacturing sector. The new profitability requirement creates a questionable bias against young and rising start-ups.

Furthermore, index rules cannot solve the fundamental problems hindering a stronger stock market (culture) in Germany – only policymakers can and should. Germany’s share in global market cap is only about half of its weight in the global economy. The most valuable company in the world is worth more than the entire future Dax 40 combined.

On Tuesday of last week, Deutsche Börse announced the biggest revamp to date regarding the rules for Germany's main stock market index, the Dax. This has followed heavy criticism from two directions. First, the collapse of Wirecard, one of the biggest fraud cases in German corporate history. Wirecard even remained a Dax constituent for two more months after its official filing for bankruptcy, as rules at that time did not allow for its immediate eviction. Wirecard had also postponed publication of its 2019 annual results several times, and as of June 2020, it still had not been able to get them certified by its auditor. Second, the standing of the Dax has long been called into question due to the index's resemblance to the old Deutschland AG (corporate Germany) of previous decades, with an outsized share of manufacturing firms, as well as other industries undergoing deep structural change and possibly even being in structural decline (such as autos, chemicals, banks, and utilities). By contrast, the Dax mostly lacks younger members from the tech and secular growth services industries, as critics have pointed out. Indeed, only three out of the 30 current constituents were founded during the last 50 years, and two of them entered the Dax during just the last few months. The majority are more than 100 years old. This is all the more staggering given that globally, eight out of the nine currently most valuable companies are less than 50 years old. The top six US companies are all less than 50 years old.

The announced changes primarily focus on:

i. Increasing the number of companies in the index from 30 to 40 (and correspondingly reducing the second-tier MDax from 60 to 50).

ii. Replacing the second selection criterion (share turnover volume) via a turnover threshold.

iii. A new financial requirement – Before first-time admission, firms must have been profitable on an operating (i.e. EBITDA[1]) level for two consecutive years. However, this is not applicable to existing index members (which could otherwise be easily demoted, even under exceptional circumstances, such as the current pandemic – which would be hard to justify and would create significant volatility).

iv. New governance requirements – Firms must have an audit committee on the supervisory board, and they must publish certified annual financial reports and quarterly statements within a certain time frame.

A provision stipulating the short-term eviction of insolvent companies from the index already came into effect on short notice in August. The new changes will be implemented step by step between year-end 2020 and September 2021. Yet, will they solve the underlying issues, or could they potentially introduce new problems?

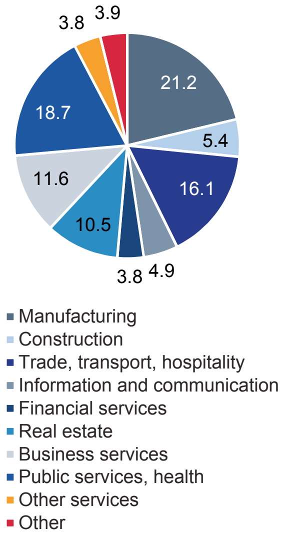
Regarding i), broadening the Dax is reasonable, in principle. Most other countries' main stock indices have more than 30 constituents – except for the oldest, the Dow Jones in the US. Yet, France (40), the UK (100), Italy (40), Spain (35), Canada (60), Australia (200) and Japan (225) all use more comprehensive benchmark indices. Even in the US, the S&P 500 is used as a reference as often as the Dow, despite the latter's strong 'sentimental bonus.' The larger base allows for greater diversification, reduces reliance on any single member (if applicable, the share of Dax heavyweights in the total index is capped at 10%), and it should bring the index more in line with the composition of the real economy. In that respect, the old Dax was far from being a representative sample, reflecting the German economy. Based on market cap figures as of 25 November, the manufacturing sector (services sector) accounts for 58% (less than 39%) of the Dax, even though it stands for only 21% (nearly 70%) of gross value added.[2]

Surprisingly, however, this biased picture would likely hardly change at all, assuming that the next ten most valuable and eligible companies could move up into the Dax by September 2021. In fact, the share of the manufacturing sector would even increase slightly, due to four new corporations in this bracket, and with a share of 20 out of 40 after the adjustment, the sector would maintain its dominant position in the Dax. At the same time, the share of services would stagnate, as new additions (two each) to business services and the trade, transport, and hospitality categories would barely compensate for the smaller weight of other services industries. Remarkably, financial services and real estate services would also see one more member each, but they would face declining and flat shares in total market cap, respectively.

[1] Earnings before interest, taxes, depreciation and amortisation.
[2] See also Schildbach, Jan (2017). German stock market rises to record highs: All is well – or is it? Germany Monitor. Deutsche Bank Research.

Gross value added in Germany by industry 1

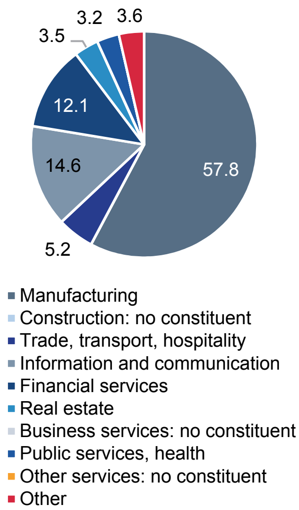
%, 2019




Sources: Federal Statistical Office, Deutsche Bank Research

Market capitalisation of current Dax 30 companies by industry 2

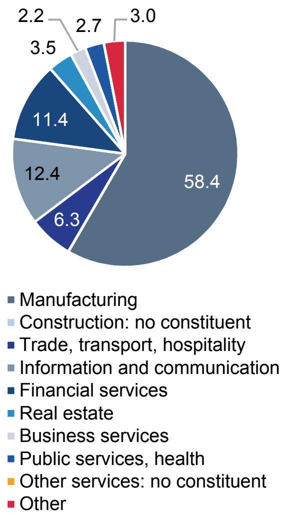
%, November 25, 2020




Sources: Bloomberg Finance LP, Deutsche Bank Research

Market capitalisation of potential Dax 40 companies by industry 3

%, November 25, 2020

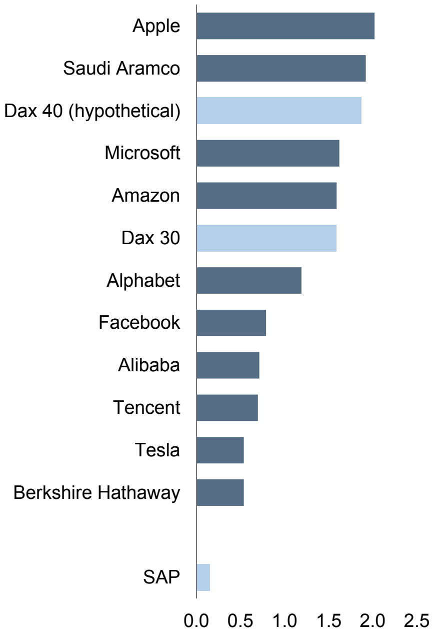



Sources: Bloomberg Finance LP, Deutsche Bank Research

One of the reasons for the overweight of manufacturing is that many of these industries are quite consolidated (due to age and economies of scale), and they are dominated by relatively few larger companies. In addition, the equity market reflects their global economic footprint (including sales and profits from onshore production abroad), in contrast to their share in German value added. Furthermore, only a small number of firms have opted for a listing on the German stock market at all (a mere 511 in total at the end of September, compared to 2,336 in the UK and Italy combined, or even 2,784 in Spain).[3] By contrast, many relatively large and successful Mittelstand companies are family owned, and thus operate mostly outside of any public scrutiny from investors, accounting firms, and financial supervisory authorities.

Top 10 companies by market cap globally & German Dax 4

USD tr; December 1, 2020




Sources: Bloomberg Finance LP, Deutsche Bank Research

As a consequence, Germany, the world's fourth-largest economy, accounts for 4.41% of global GDP, but only 2.26% of global stock market capitalisation, behind countries such as Canada, Hong Kong, India, or Saudi Arabia. The enlargement of the Dax is unlikely to solve the problem (judging by the price tag) of German companies being minnows by international comparison. The most valuable enterprise in the world, Apple, is worth more than the entire Dax 30 or hypothetical Dax 40 combined. The most valuable German company, SAP, is worth only 7% of Apple. German firms have fallen far behind and no index reform can change that.

The enlargement would meaningfully increase the total market cap of the Dax by 18% (from EUR 1.32 tr to EUR 1.56 tr). In addition, it would add three more companies to the index which are less than 50 years old – at least some improvement. Nevertheless, at just six out of 40, the share of these young firms would still remain fairly limited.

Points ii) and iv) may be reasonable adjustments that ensure higher corporate governance standards and that bring the index more in line with international peers.

With regard to performance metrics, not much would have changed if the new rules had already been in place during the last five years. According to an

3 1,466 firms are listed on Euronext, the joint stock exchange operator in France, the Netherlands, Belgium, Portugal, Norway, and Ireland.

analysis of Deutsche Börse, the average annual return of the larger Dax would have stayed flat at 6.1%, and volatility would have dipped slightly. Moreover, the elimination of the trading volume criterion would have resulted in a moderately lower return (down 0.4 pp to 5.7% p.a.) and a slight increase in volatility.

Regarding iii), however, the introduction of the profitability requirement seems doubtful, as it creates a substantial hurdle to clear (especially for young, rising firms, which still have to scale up their business models in order to recoup initial investments). Successful, listed start-ups (particularly from the tech sector) are relatively scarce in Germany. Yet, the case of the company replacing Wirecard in the Dax – indeed a rapidly growing (although still loss-making) tech enterprise – should not be used to construct a significant bias against unprofitable firms. Many of them will be young and relatively small. However, some of them may become the stars of the future, despite their youth and size. Otherwise, the Dax and its investors could risk (once again) missing out on possibly the strongest growth dynamic of these firms. Stock investors often assess future perspectives rather than past results, and much of the share price growth story might occur before a firm has achieved two full years with positive (and testified) EBITDA. The mid-cap index, MDax, already regularly outperforms the Dax.

Speaking of the MDax, it currently stands to lose almost half (47%) of its market cap (and therefore its prominence) as a result of the reform. Liquidity in the MDax leftovers may also be quite limited. Hence, it seems likely that its domestic and international standing will diminish considerably.

These drawbacks are likely inevitable, however, given that overall, the German stock market lacks sufficient depth and scope. Tackling one problem – the overly narrow benchmark index – automatically leads to a substantial weakening of the 'second string'. This can only change if political decision-makers finally acknowledge and address the fundamental problems that are hindering a stronger stock market (culture) in Germany.

Among these problems are:

— The preference for debt over equity in profit taxation.

— The predominant reliance on a pay-as-you-go public pension scheme (and the corresponding lack of a sizeable funded component).

— German households' risk-averse investment behaviour (which centres around bank deposits and insurance policies), modest financial literacy, and unease with the stock market (which for many – especially on the political left – still carries a negative reputation for speculation).

— The generous treatment of shares in family-owned companies in terms of inheritance taxation.

— One of the highest corporate tax rates by international comparison (which dampens firms' profitability, and thus, their attractiveness for investors), following tax reductions in the US, the UK, or France in recent years, for example, and no such tax reform in Germany for more than a decade.

While the stock index provider has now done its homework and taken measures to remedy shortcomings, political issues remain open and as pressing as ever, and can only be addressed by policymakers.

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