False perspectives

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The dream of an industrial France having caught up with Germany's level of competitiveness resurfaces periodically. Indeed, the French industrial situation looks worrying from a macroeconomic point of view. Low labor cost competitiveness: France is uncompetitive in low value-added industries compared to emerging countries. Low apparent competitiveness of firms in high value-added industries. The share of manufacturing in the French GDP keeps decreasing inexorably. France is no longer one of the major industrial powers (see Table 1).

All this is true. However, this is a biased perspective, specific to export industries.

Are French corporations less competitive than their German counterparts on an international basis?

In fact, major leaders of the two countries are specialized in different types of industries, with fundamentally different cost structures, key success factors and modes of international development (cf. Table 2).

The majority of German leaders are in manufacturing with significant international scale effects, low transport barriers, large competitive and exporting production centers, strong barriers in terms of know-how and quality on an international basis: equipment goods, electromechanics...

This is even clearer when looking at the German Mittelstand. Its companies are world leaders in industrial niches with global market shares of 30-60%, based on the competitiveness of their plants, know-how and mainly German teams, exporting their products and know-how, and driven by the development of infrastructure and industrial equipment in emerging countries (Herrenknecht, Dürr…).

Major French leaders are more in industries with a long and differentiated value chain (industrial costs, plus marketing and branding costs, plus commercial cost toward diffuse consumers...) and/or more local scale-effect production processes, or requiring greater proximity and adaptation to final customers as well as local costs and teams: luxury goods, consumer products, IT services, catering...

The former are in *"export"* businesses. Competitiveness and international development translate into the exportation of goods from a few major production centers.

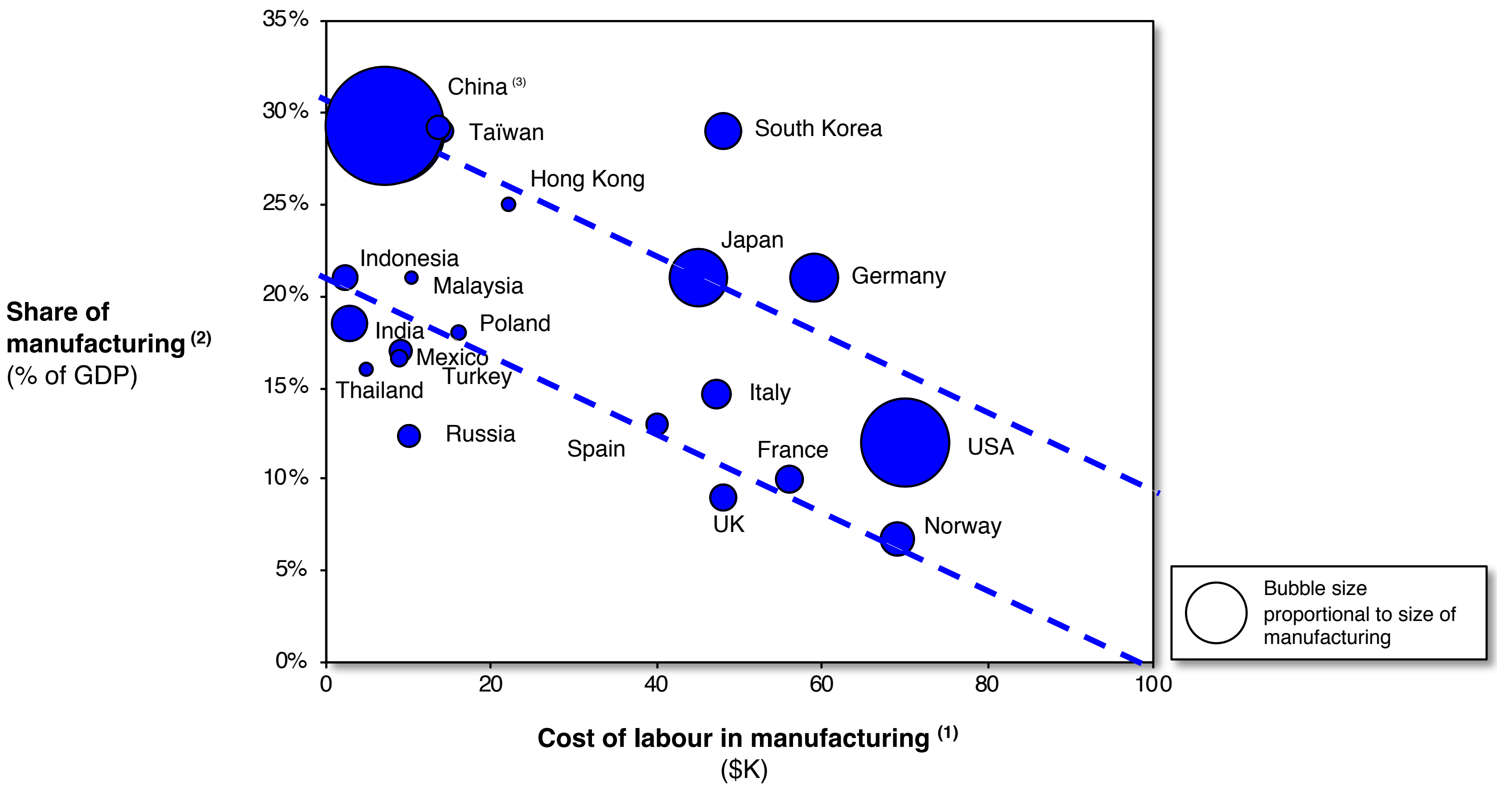
The latter are in *"projection"* businesses. Competitiveness and international development translate into the setting up of production centers and the development of marketing and sales teams in numerous markets close to consumers.

Major French leaders are no less competitive than German leaders. They simply have a different development model with less production staff in their home country. Not just to look for more competitive factor costs, but because the economic and commercial characteristics of the business in which they are present requires it.

- Table 1 -

Five countries (China, USA, Japan, Germany and South Korea) account for 55% of worldwide manufacturing [(1)] (2016)

- Share of manufacturing in GDP vs. labor cost



(1) Average labor cost on all manufacturing workforces including (a) direct compensation (wages and benefits including bonuses) and (b) payroll taxes and other labor taxes (pensions for pensions and disability, health insurance, sick leave, life-related insurance, work-related accidents, unemployment insurance, severance pay, other social insurance, taxes); (2) Food, beverages, textiles, chemicals, electronics... excluding mining production and utilities (electricity, gas, water...)
Sources OECD, Eurostat, Destatis, World Bank, The Conference Board, Estin&. Co analyses and estimates

Is there more value to one model than to the other?

As far as companies are concerned, no. Both are equally profitable; this profitability depends on their own competitiveness. Companies with a "projection" model may be more maneuverable and ultimately independent of the competitiveness and economic cycles of their home countries. In addition, it is difficult to defend a pure "export" model in the long term. In growing markets and to the extent that the optimal plant size grows slower than the global market, successful leaders move towards a "projection" model sooner or later.

On a short-term macroeconomic level, most certainly. Companies with an "export" model contribute to employment, tax revenues and the trade balance of their home countries. A larger proportion of the population is employed in Germany in intermediate value-added industrial jobs. But this model is threatened in the medium term by the rise of Chinese industries.

Companies with a "projection" model contribute a fewer of high-value-added jobs from top management, diverse experts, research and development centers. They should contribute to the balance of income and services in their home country through the management fees and dividends that derive from their activities and the value creation for their shareholders. However, the ownership of the main French groups is 45% of international. Those upstream payments do not flow with a sufficient level.

For main French leaders, everything is fine. They are in large numbers in businesses that, given the economic development cycles, are more ahead than those of the German industrial leaders.

However, for France, it is a double penalty: the insufficient base of competitive, value-added local jobs and the negative trade balance, coupled with the low upstream flow in income and a preference for high public spending, make the equation difficult in the short term.

Why this specialization?

Champions in each country developed in a different manner, conditioned in part by the characteristics of their national environment.

German groups benefited from regular trade-offs by local and central authorities over 40 years regarding social security, direct taxation, apprenticeship and the valuation of their currency (Deutsche Mark and Euro), all these elements having led to the development of an industrial base with high value added and competitiveness in terms of the reallocation of resources to resilient sectors and th retreat from non-competitive sectors.

French groups have developed internationally despite the trade-offs by local and central authorities (or because of them) regarding the cost of labor, the weight of public spending and social transfers, vocational training, support to distressed industries. They "looked elsewhere." With success. *Volens nolens*, those who succeeded have become very international, in structurally different industries than large German groups. Today, they are now much less dependent on their original basis.

What about the future? Should we develop an industrial model with high value added in France?

The French ambition to develop in industrial sectors of "excellence" with high value added (which are merely industries of the past) to catch up with the Germany of yesterday and today is akin to putting your troops on the wrong frontline. It is no longer low-skilled workers' jobs which are threatened in the long run by the Chinese wave, but the most advanced engineering, technology and research positions.

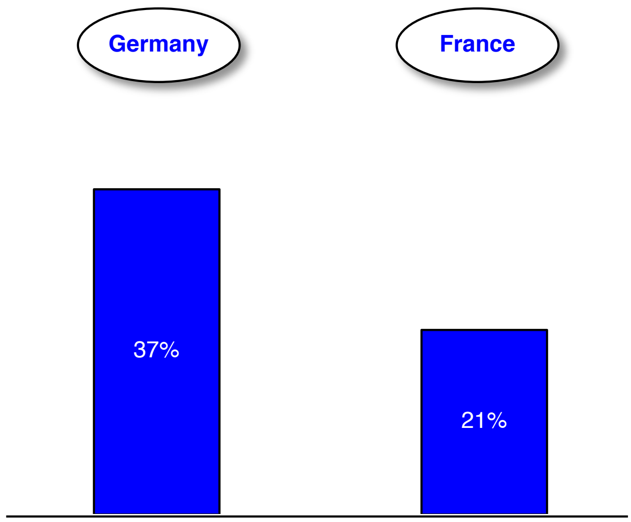
Chinese industries are growing in volume and quality. They represent potentially 15 to 20 times the size of European markets taken country by country, with the corresponding impacts on research and development investments and possible production scale effects. Technological gaps with their foreign counterparts are rapidly narrowing.

The German model is strongly threatened in the medium term by the rise of Chinese industries. It was 20 years ago that it should have been imitated.

- Table 2 -

Emblematic leaders in Germany and France have fundamentally different development models

- Share of the workforce employed in the company's home country - (Average 2017 - Non-exhaustive -)



	Germany		France		
Great iconic leaders	• Volkswagen • Daimler • Allianz • BMW • Bosch • BASF • Continental	• Fresenius • SAP • Henkel • Adidas • TUI • Linde	• AXA • LVMH • Saint Gobain • Vinci • L'Oréal • Veolia • Danone	• Schneider Electric • Michelin • Sodexo • Air Liquide • Lactalis	*Revenue > €15B*
Niche Leaders or smaller industries	• Heidelberg-Cement • Würth • Liebherr • Freudenberg	• Dürr • Mannesmann • Herrenknecht	• Technip • Pernod Ricard • Essilor • Plastic Omnium	• Groupe SEB • Legrand • Hermès • Vallourec	*Revenue ≤ €15B*

Note: companies with a worldwide leadership or co-leadership position
Sources: Bloomberg, annual Reports, analyst Presentations, Factsheets, Estin & Co analyses and estimates

With the time it takes to scale up in the French industry, a large number of companies would compete directly against Chinese leaders who have already surpassed them.

What is the real issue? For France, as for Germany, it is to develop great champions, with their ecosystems, in the major, defining industries *of the next 20 years*. These industries do not exist today, or only in an emerging form. It is difficult to predict what they will be. And the champions who will develop them will not be invented by the States.

A historic failure

The economic history of the last 20 years has been disastrous for European nations.

In the 1950s, 1960s and into the 1990s, European champions initiated the great waves of development of new industries or played a strong part in developing them against American or Japanese leaders: industrial goods and infrastructure in the 1950s and 1960s, consumer goods, household equipment and modern distribution in the 1960s and 1970s, services in the 1970s and 1980s, IT services, telecommunications, financial services, luxury in the 1980s and 1990s...

However, in the defining industries of the last 20 years (smart devices—computers and mobile phones—, software, search engines and social networks, e-commerce...), no European player has emerged with scale against U.S. and Chinese leaders.

The digital economy is growing at more than 10% a year and will account for about 10% of the global economy in five years. It becomes concentrated quickly and will be at 40% in the hands of 10 American and Chinese actors (see Table 3) [1].

The weak economic growth of Europe since the year 2000 compared to the one of the emerging countries, but also of North America, is actually explained in a simple way: *Europe has not invented any of the new major industries that have made the global growth over the past 20 years or simply participated significantly in these years.*

Why this break in a long and rather successful economic history until then? And how should the next 20 years be different?

What choices?

Macroeconomic choices in favor—or not—of growth (not just competitiveness) are always along two axes:

1. Interventionist economic and industrial policy vs. business-friendly environment policy (and entrepreneurs!);
2. Support to the industries and jobs of yesterday and today vs. policy favorable to "creative destruction" and the jobs of tomorrow.

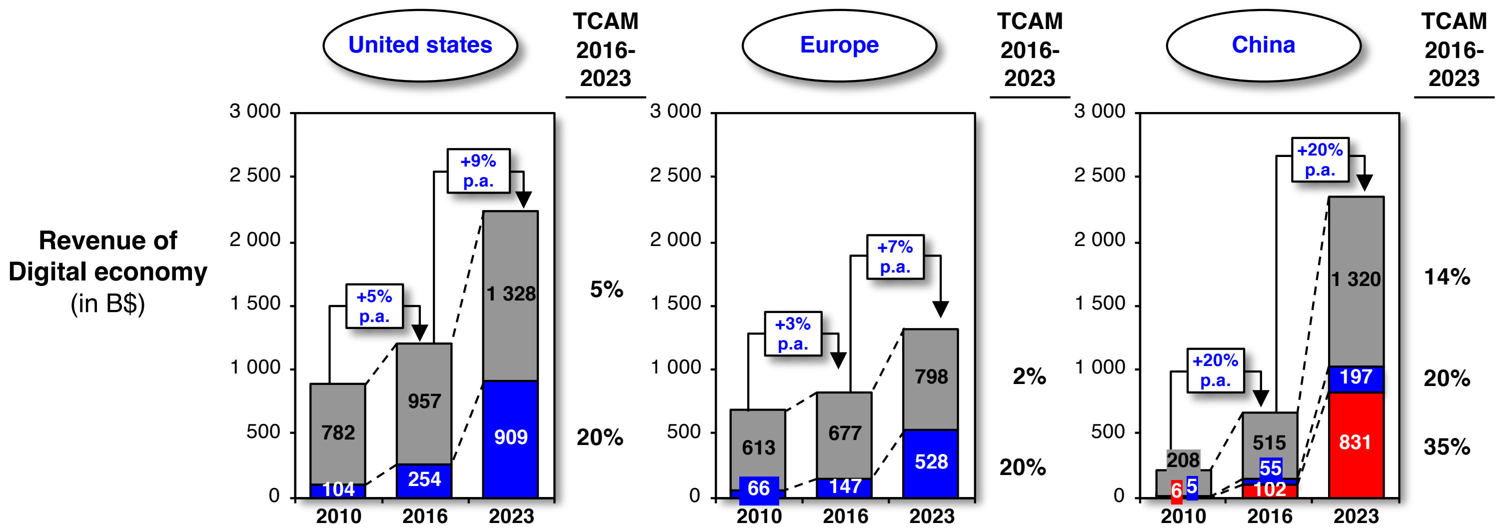
States can protect, administer and optimize the existing economy through various standards, regulations, processes and reallocation and transfer mechanisms. They cannot invent the economic contents of tomorrow. Five-year plans of the State have never replaced entrepreneurship.

In the absence of clear collective choices for the growth and fluidity of resources, we will succeed in developing the industries of yesterday

[1] The digital economy includes telecommunications operators (AT &T, Verizon, China Mobile, Deutsche Telekom, Vodafone, Orange...). If these actors were excluded, the share of the American and Chinese leaders would be more than 60%.

- Table 3 -

The digital economy is growing at 10% per year and will account for 10% of global GDP by 2023. It concentrates quickly in the hands of 10 U.S. and Chinese leaders



	United states 2010	2016	2023	TCAM 2016-2023	Europe 2010	2016	2023	TCAM 2016-2023	China 2010	2016	2023	TCAM 2016-2023
Share of leaders (en %)	11%	21%	41%		10%	18%	40%		5%	23%	44%	
Size of the digital economy (in B$)	928	1 211	2 237	9%	680	824	1 326	7%	220	672	2 348	20%
Share of the economy numerical GDP (In %)	6%	7%	9%		4%	5%	7%		4%	6%	12%	

U.S. Leaders (Google, Apple, Facebook, Amazon et Microsoft)
Chinese leaders (Alibaba, Baidu, Tencent, JD.com et Xiaomi)

Notes (1) GDP with inflation; (2) BEA and OECD definition of the digital economy: digital infrastructure (hardware, software, IoT...), e-commerce, digital media and social networks. The defined digital economy market includes telecommunications operators (in 2016, 34% of the market in the United States, 46% in Europe and 35% in China). If these players were excluded, the concentration of the market would be even stronger (more than 60% of the market held by the American and Chinese leaders in 2023).
Sources: Annual Reports, BEA (Bureau of Economic Analysis), BLS (Bureau of Labor Statistics), OECD, Bloomberg, IMF, Financial Analyst Estimates, Estin and Co Estimates

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Estin & Co is an international strategy consulting firm based in Paris, London, Zurich, New York and Shanghai. The firm assists the management of major European, North American and Asian groups in their growth strategies, as well as private equity funds in the analysis and valuation of their investments.