The squeeze of Europe (2)

By

Jean Estin

Chairman & CEO Estin & Co

In a competitive environment, growing companies move down the experience curve by being faster than their stagnating competitors at cutting costs, improving quality… (assuming they have similar factor costs).

Despite rising wage costs, Chinese companies continue to improve their cost and quality competitiveness compared to their European counterparts, including Germany. Even with international expansion, European companies remain stuck in low growth.

Meanwhile, American companies benefit from a deep and expanding domestic market, with the corresponding benefits of economies of scale, cheap energy, and a strong innovation ecosystem.

Caught in between, Europe finds itself squeezed, like a marginal, low-growth competitor (see Table 1) (1).

The Squeeze

As a result, European companies face falling prices for global products (when calculated at constant functionalities) while their own costs improve only moderately. Their quality advantage is eroding due to the rapid rise of Chinese technology and expertise, while major breakthrough innovations and new industries primarily emerge in the United States.

This squeeze is amplified by two structural phenomena:

- Rising prices for fossil fuels and raw materials, driven by growth in the major Asian economies (2). Without massive development of nuclear power (3) or a resumption of supplies of cheap gas, Europe cannot remain competitive, having no adequate energy source on its soil or on its doorstep (*it produces just 7% of the world's energy*).
- Increasing energy costs, regulatory standards, replacement investments and transition costs (4) in Europe. These factors burden businesses in an aging, risk-averse, and slow-growing continent.

In any open economy, stagnating competitors suffer from rising energy and material costs driven by faster-growing rivals. They also face price pressures as competitors reduce their added costs. In the medium term, stagnation inevitably leads to shrinking profit margins.

Between North America, which continues its long-term growth trajectory (+ 4% per year[5]) with regular technological breakthroughs, and China, reasserting itself as a major economic power and

[1] Cf. also the premonitory June 2005 article "The Squeeze of Europe".

[2] Oil prices have risen by an average of 7% a year since 1970 in current dollars and 4% excluding inflation, with a high degree of cyclicality.

[3] Renewable energies cannot replace fossil fuels on a sufficient scale

[4] More ambitious and costly in relative terms than in North America or Asia

[5] + 4% per year in current dollars over 2008-2022E (IMF forecasts of October 2022 for 2022) and + 4% per year as well over 2010-2019 (excluding crises)

the world's leading industrial producer, Europe has lacked both growth and coherence for the past fifteen years. Key questions arise:

- How can Germany remain a leading industrial power without nuclear energy, no longer having access to competitive fossil fuels, in the face of a Chinese industry that is catching up technologically?
- How will France maintain the standard of living of its middle classes, when its major competitive leaders are developing jobs – including skilled jobs – essentially outside France, given their sectors (with a few exceptions)?
- Can the UK's gamble of freeing itself from continental Europe, which is not growing but accounts for 45% of its foreign trade, and banking on the USA and the fast-growing Commonwealth countries succeed? Will the revival of nuclear power, the international competitiveness of financial services – maintained even after Brexit – and the national steering of the British pound be enough?
- How can Italy recover given its shrinking workforce and high dependence on gas for energy? Can its northern network of specialized, export-oriented SMEs (vulnerable for the same reasons as the German Mittelstand) and a few world-class companies in niche sectors sustain growth?

The United States returned to growth after the 2008 financial crisis: continued growth of the working population; development of a new, abundant source of energy on American soil, shale gas and oil; massive development of the digital industries (from 5% to 10% of the US economy, boosting the economy between 2008 and 2022).

Conversely, Europe has stagnated: growth has stalled since 2008; investment in nuclear energy has been delayed, with a gap that will not be filled for another ten years (at best); no leadership positions in key technologies (e-commerce, search engines, cloud, etc.); average debt levels for European countries rising from 63% to 87% of GDP on average between 2008 and 2022, essentially to finance operating expenses and social transfers; and major German industrial groups beginning to relocate production outside of Europe.

A strategy of not growing in a growing world is not sustainable – it leads to decline.

For European companies, this gap between a stagnating Europe and a growing rest of the world is a major handicap. In a globalized economy, the cost of capital remains around 7%[6] — aligned with global growth plus dividends—while European firms operate in stagnant economies. As a result, their total shareholder returns (TSRs) struggle to exceed this threshold. Without *significant* changes in their businesses (geography mix, business mix, positioning in the value chain), valuations will inevitably decline.

[6] Cost of equity (K_e)

In Japan, an economy without growth since 1995, the average TSR of the Japanese stock market has been less than + 1% per annum from 1995 to 2021. Is this Europe's fate?

Escaping the Trap

Over the past decade, what strategies have allowed major European firms to escape this unfavorable environment (see Table 2)?

- International growth strategies in highly differentiated products benefiting from growth in Asia and the polarization of customers (luxury goods).
- Growth strategies in cutting-edge technologies driven by digital growth (semiconductors and their equipment, fintech, software) or in healthcare, in line with the ageing of the population.
- Growth strategies in international logistics and Oil & Gas driven by global growth and the ongoing globalization of trade.
- Investment strategies of large family holding companies and private equity firms in medium-sized companies operating in growing niches of all kinds in the European economy.

Of the 20 listed European groups that have created the most value over the last ten years, four are French, two are Italian or Franco-Italian, and two are German.

For Europe's largest firms, escaping the squeeze is still possible – if they actively pursue growth opportunities and develop competitive business models. It is a matter of strategic vision and execution.

Of the top 100 European market capitalizations, 32% have grown by more than 10% annually over the past decade: there is no such thing as fate.

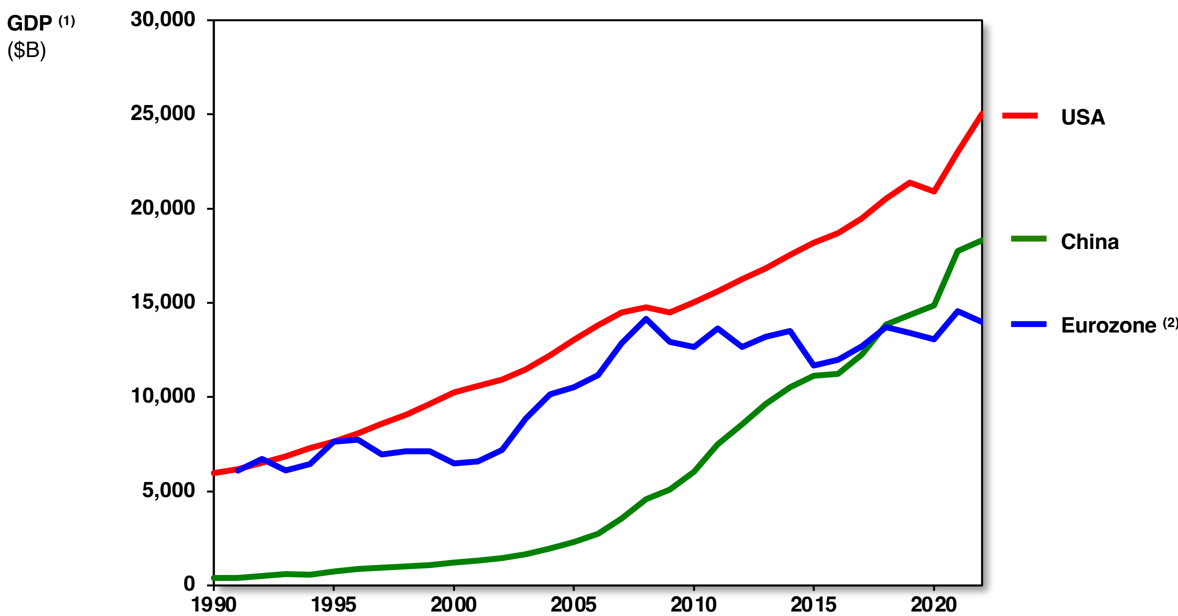
Jean Estin

December 2022

Estin & Co is an international strategy consulting firm based in Paris, London, Zurich, New York and Shanghai. The firm assists the general 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.

- Table 1 -

Growth in the United States, China and Europe



(1) Nominal GDP in current dollars; for 2022, IMF estimates of October; (2) Countries which are members of the euro zone in November 2022: Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Portugal, Slovakia, Slovenia, Spain

Sources: IMF, Estin & Co analysis and estimates

- Table 2 -

Top twenty European companies [1] with the strongest growth in market capitalization over 2012-2022

(among the top 100 companies terms of market capitalization)

	Market capitalization 2022 (€B)	Annual growth in market capitalization 2012-2022 (% p.a.)	
Hapag Lloyd (Germany)	34	46% [2]	*Maritime transport*
Adyen (Netherlands)	46	35% [3]	*Fintech*
Lonza Group (Switzerland)	38	33%	*Life sciences [4]*
Neste Oyj (Finland)	37	31%	*Oil and gas*
ASML (Netherlands)	233	28%	*Equipment for the semiconductor industry*
Sika (Switzerland)	38	26%	*Specialty chemistry*
DSV (Denmark)	35	25%	*Transportation and logistic*
Ferrari (Italy)	41	25% [5]	*Luxury cars*
STMicroelectronics (France/Italy)	34	21%	*Semiconductors*
Hermes (France)	156	21%	*Luxury goods*
Infineon Technologies (Germany)	41	20%	*Semiconductors*
LVMH (France)	353	17%	*Luxury goods*
Dassault Systemes (France)	48	17%	*Software B2B (3D simulation…)*
AstraZeneca (UK)	198	16%	*Pharmaceutical industry*
Orsted (Denmark)	36	15% [5]	*Energy*
Kering (France)	68	14%	*Luxury goods*
Investor AB (Sweden)	56	14%	*Investment holding*

32% of Europe's top 100 market capitalizations are growing at more than 10% a year

Note : market capitalizations as of 27 November 2022
(1) Western and Eastern Europe excluding Russia; (2) 2015-2022; (3) 2018-2022; (4) Pharmaceuticals, biotechnologies and nutrition; (5) 2016-2022
Sources : LSEG Workspace, Estin & Co analysis and estimates