

Lazard Insights



Europe's Stock Markets: Challenging Misperceptions

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Summary

- For many investors, Europe's stock markets are associated with old-economy, low-growth sectors. But this fails to recognise how considerably the profile of the European market has changed in recent years.
- Europe has developed a greater emphasis on growth sectors with a global earnings dimension. This is driving increased financial productivity and a more resilient earnings profile.
- Yet the region's stock markets continue to remain modestly valued on an absolute basis and relative to other developed markets. At some point soon, we believe this anomalous situation will begin to unwind.

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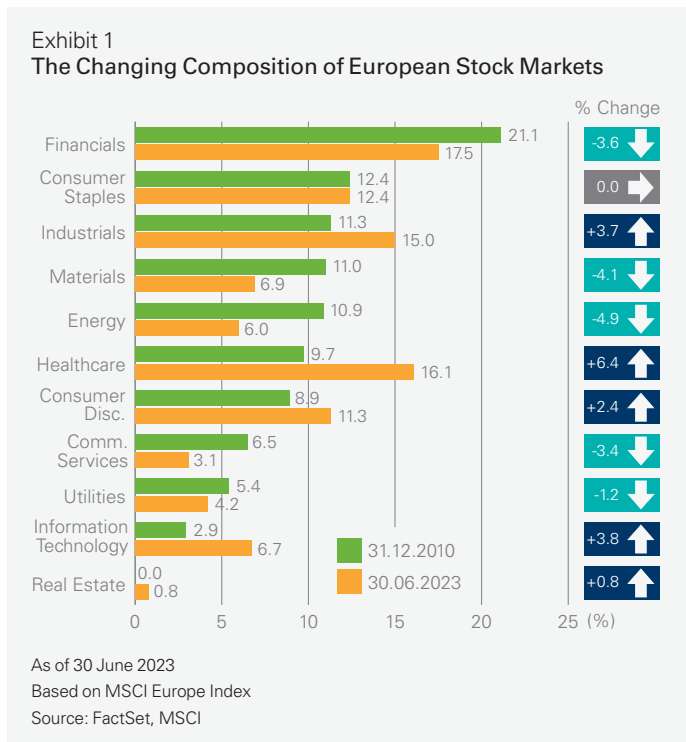
In the gap between widespread perception and reality can lie investment opportunity. We believe multiple misperceptions exist around the European stock market, the region's economies and its companies. Many of these misperceptions or stereotypes are often rooted in an outdated understanding of the European corporate and investment landscape. By hanging on to these outmoded perspectives, investors may be missing out on structural investment opportunities and exposure to Europe's world-class companies in long-term growth sectors. We set out to challenge these stereotypes below and encourage a more contemporary understanding of Europe's stock market scene.

For many investors, Europe drifted into the economic slow lane some years ago, languishing behind the dynamic economies of the US and Asia. Europe cannot lay claim to the numerous tech giants that bestride the US stock market, but that does not mean to say its stock markets still merit their reputation as a corporate retirement home for old-economy cyclical and value stocks.

Europe has become one of the most balanced markets in the world with global leadership in a range of growing and attractive sectors; it boasts greater sector diversification than rival major developed and emerging markets, which helps reduce risk; its companies are enjoying significantly improved financial productivity; and yet it continues to trade at a discount versus other markets, most notably against US stocks, and at historically low absolute levels.

Europe's Stock Markets: Turning to Growth

The profile of Europe's stock markets has changed significantly since the Global Financial Crisis (Exhibit 1).



Financials may still represent the largest sector within the European market, as represented by the MSCI Europe Index, but its dominance has been eroded. The cyclical energy and materials sectors have been in retreat, and the largely unexciting bond-like utilities sector has also contracted.

Meanwhile, the information technology sector has more than doubled in size. As well as high-profile growth successes, such as ASML, the Dutch-listed global number one supplier to the semiconductor manufacturing industry, the sector has also expanded through lesser-known corporate growth stories. These include companies such as Infineon, a semiconductor-maker heavily exposed to electric vehicle adoption, and Hexagon, a thriving geospatial measurement business.

Elsewhere, the healthcare sector's index representation has grown by almost 50%. Once regarded as a defensive corner of the market, healthcare is now widely recognised for its long-term structural growth opportunities due to emerging technologies and a backdrop of an ageing global population.

Consumer discretionary, home to world-leading European luxury brand companies such as LVMH, now also constitutes a significantly larger proportion of the benchmark, as it has benefited from growing consumption from the rising middle-class populations in emerging economies. Indeed, European markets are the go-to destination globally for investors looking to play the consumer luxury theme.

The growth of healthcare, IT and consumer discretionary, and the decreasing relevance of financials, materials, energy and utilities point to a European market that has adopted a more growth-oriented bias.

Europe's Broader Sector Exposure

Sticking with a sector lens, the European market is better diversified than the US and Japanese market as well as broad emerging markets, all of which have more acute sector concentrations, most obviously the technology sector in the US (Exhibit 2).

Exhibit 2
Europe Offers Superior Sector Diversification

Sector	MSCI Europe (%)	MSCI USA (%)	MSCI Japan (%)	MSCI Emerging Markets (%)
Financials	17.5	12.3	11.9	21.8
Healthcare	16.1	13.0	8.8	3.8
Industrials	15.0	8.8	23.5	6.6
Consumer Staples	12.4	6.3	6.3	6.3
Consumer Discretionary	11.3	10.9	18.7	13.9
Information Technology	6.7	28.3	14.0	20.6
Materials	6.9	2.5	4.7	7.9
Energy	6.0	4.4	0.8	5.1
Utilities	4.2	2.3	1.1	2.5
Communication Services	3.1	8.8	7.2	9.7
Real Estate	0.8	2.5	3.0	1.8

As of 31 August 2023
Source: FactSet

Below the sector level, it is a similar story of change when we compare Europe's top 10 stocks post-GFC and today (Exhibit 3). Gone from the index's top table are old-economy names such as Vodafone, Rio Tinto and BP. In their place are Europe's growing global leaders, such as ASML, Novo Nordisk, a world leader in diabetes treatment, and the aforementioned LVMH. For exposure to luxury consumption, technology enabling faster and more powerful semiconductors, the chips that underpin the modern economy, or solutions to global health dilemmas, investors can turn to Europe.

Exhibit 3
Largest 10 Stocks in MSCI Europe Index by Market Capitalisation – 2010 vs. 2023

2010	(%)
Nestlé	2.89
HSBC	2.55
BP	1.94
Vodafone	1.94
Novartis	1.77
Royal Dutch Shell	1.68
TotalEnergies	1.60
Roche	1.47
Siemens Aktiengesellschaft	1.45
Rio Tinto	1.45
2023	(%)
Nestlé	3.29
Novo Nordisk	3.05
ASML	2.64
LVMH	2.33
AstraZeneca	2.08
Shell	2.08
Novartis	2.06
Roche	2.06
TotalEnergies	1.48
HSBC	1.47

As of 31 August 2023
Source: FactSet

We can also see Europe's forward-looking focus in its commitment to R&D investment, which is a hallmark of leading companies. Of the 20 largest European listed companies, 12 are currently

ranked in the top 50 companies for R&D investment globally. These include many corporate leaders within the secular growth industries of healthcare and information technology. R&D expenditure is often underestimated and can lead to unexpected market leadership in the future as well as encourage other companies in similar areas.

Green Europe

Of course, one of the biggest forward-looking opportunities is the climate challenge. As well as profiting from major domestic climate initiatives, such as NextGeneration EU (NGEU) and the Green Deal Industrial Plan, Europe's sustainability leaders stand to be major beneficiaries of the more significant and game-changing US Inflation Reduction Act. Europe leads the world in wind power generation, solar technology, developing environmental projects, automation, testing and electrification. The ESG credentials of its companies also place the region at an advantage, with many European firms having the strongest ESG ratings in global markets.¹

Europe's green leaders include companies such as ABB, a Swiss-based diversified capital goods business benefiting from structural growth trends in areas such as electric vehicles, factory automation and renewables. It has a leading market share in motion products and generators. For example, its electric powertrain components are used to repurpose heavy construction equipment from being diesel powered to electric powered. The company also has improving margins and a strategic M&A pipeline.

Elsewhere, France's Bureau Veritas is a testing, inspection and certification business with an estimated 65% of its revenues linked to sustainability. It is a global leader in marine certification (its highest margin division), where there are accelerating trends towards ships fuelled by liquefied natural gas (LNG). Bureau Veritas provides classifications to clients in areas such as structural integrity and cargo containment risks of LNG vessels. It also has expertise in design verification of wind and solar projects.

Another beneficiary of the net-zero transition is German semiconductor business Infineon Technologies. It is a leader in the production of chips used in electric vehicles (EVs). With EVs typically containing up to four times more semiconductor content than traditional internal combustion vehicles, the ongoing transition to electric vehicles is a significant driver of growth for the business.

Global Europe

Top-down perceptions of low-growth economies, ageing populations, volatile politics and high taxes have dissuaded investors from investing in European stocks in recent years. But buying European equities increasingly provides global economic exposure; it is less and less a bet solely on the prospects for the European economy. The region's companies now have far less exposure to purely domestic consumers and trends and represent much more of a play on the global forces driving economic growth.

We can observe this in the earnings profiles of the Continent's listed companies, which have become increasingly global over the past decade. European companies now derive over half of their revenues from outside the region, with emerging markets now accounting for one quarter of their top-line performance (Exhibit 4). Many European corporate household names look to non-European markets to generate the bulk of their revenue (Exhibit 5).

Exhibit 4
Revenue Source by Geography of European Listed Companies

Sector	December 2012 (%)	August 2023 (%)	Change (%)
Europe	61	42	-19
North America	16	26	+10
Asia Pacific	5	7	+2
Emerging Markets	18	25	+7

As of 15 August 2023
Based on the MSCI Europe Index
Source: FactSet, MSCI

Exhibit 5
Europe's Largest 10 Companies by Market Cap—Non-European Revenue as a Percentage of Total Revenue

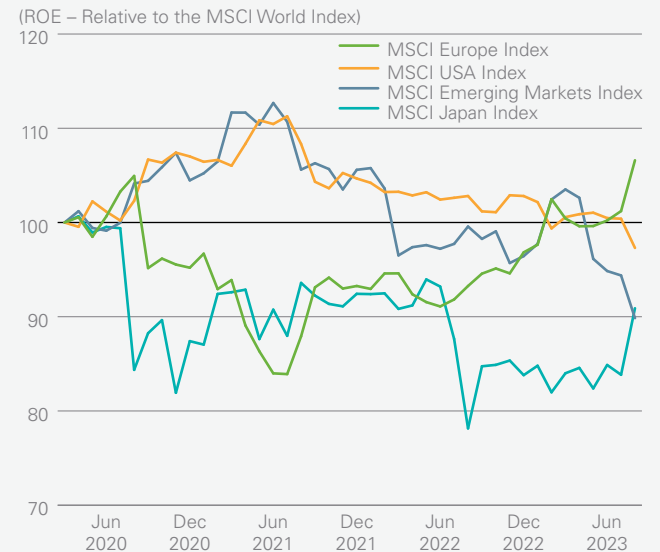
	Non-European Revenue Exposure (%)
Nestlé	c. 50
Novo Nordisk	c. 75
ASML	>95
LVMH	c. 65
AstraZeneca	>50
Novartis	c. 80
Roche	c. 80
Shell	>55
HSBC	>90
TotalEnergies	>30

As of 31 August 2023
Source: FactSet

European Financial Productivity on the Up

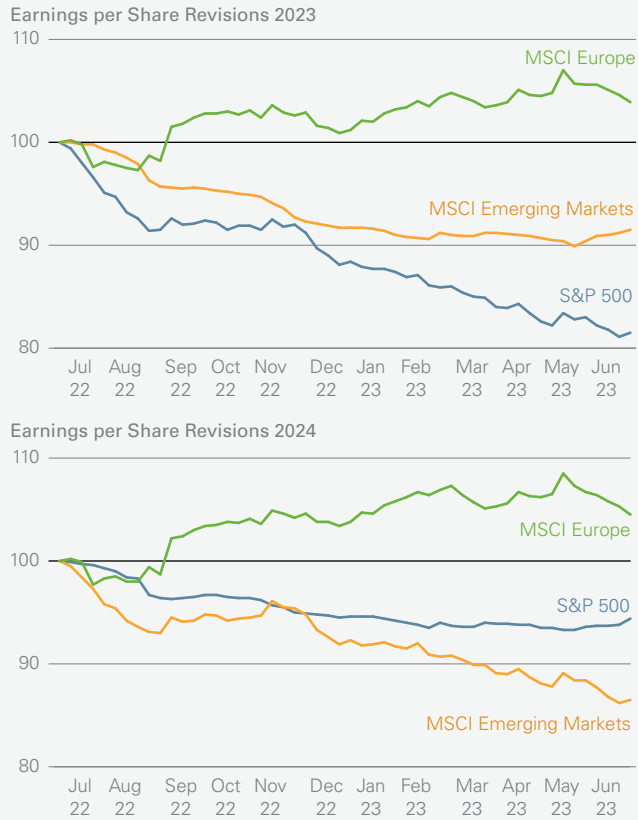
One of the arguably more overlooked post-pandemic corporate developments has been the strength of European earnings. Europe has enjoyed the largest improvement in returns on equity since the reopening of the global economy (Exhibit 6). According to a report by Goldman Sachs, European profits have grown by 51% since their pre-pandemic peak in 2019, outrunning US profits, which are up 35% over the same period.² This annual 15% growth rate makes it the fastest pace of any cycle since the 1980s. This partly reflects the sector composition of European markets, most notably the region's relatively high weightings in financials and commodities, but it also encompasses an across-the-board improvement in European corporate performance. European profit margins now stand at multi-year highs and are now nearly on par with global margins, having lagged for many years. Meanwhile, earnings revisions by European companies are eclipsing those reported by US and emerging markets' companies, a trend set to continue in 2024 (Exhibit 7).

Exhibit 6
Europe Has Enjoyed the Biggest Post-Pandemic Improvement in Returns on Equity



As of 31 August 2023
Source: FactSet, MSCI

**Exhibit 7
European Earnings Revisions Have Outpaced Global Markets**



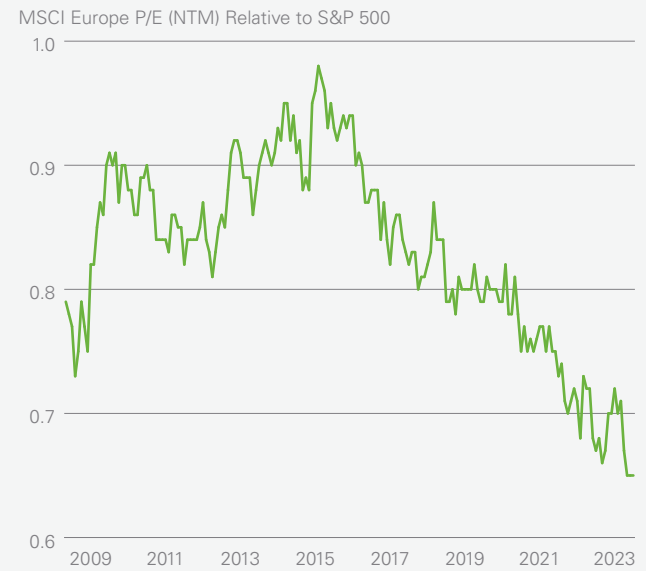
As of 31 August 2023
Source: FactSet, MSCI

One of the reasons for the uptick in European profitability has been its increased exposure to growth in different parts of the world. It also reflects the changed profile of the European market, as detailed above, with greater exposure to sectors associated with more robust earnings. In addition, some domestic sectors were heavily affected by the deflation of the last cycle and the negative interest rate cycle that ensued. With a normalisation of inflation and interest rates, European profits have not only rebounded but may also be more sustainable.

Our bottom-up philosophy is based on the trade-off between financial productivity and valuation—what should we expect and what should we pay? Focusing on high or rising financial productivity highlights companies with both significant levels of competitive advantage and pricing power. The earnings of these companies are more resilient in difficult times, providing downside protection. Sustainable financial productivity also works well in most rising markets.

High financial productivity, reflected in higher returns on capital employed, tends to come with better fundamentals and less risk. Europe is demonstrating greater financial productivity and improving fundamentals, yet this attractive combination continues to be largely ignored by investors, based upon current modest valuations, most notably relative to US stocks (Exhibit 8) and by historic absolute standards.

**Exhibit 8
The European Discount Versus US Stocks Continues to Grow Despite Europe's Improved Financial Productivity**

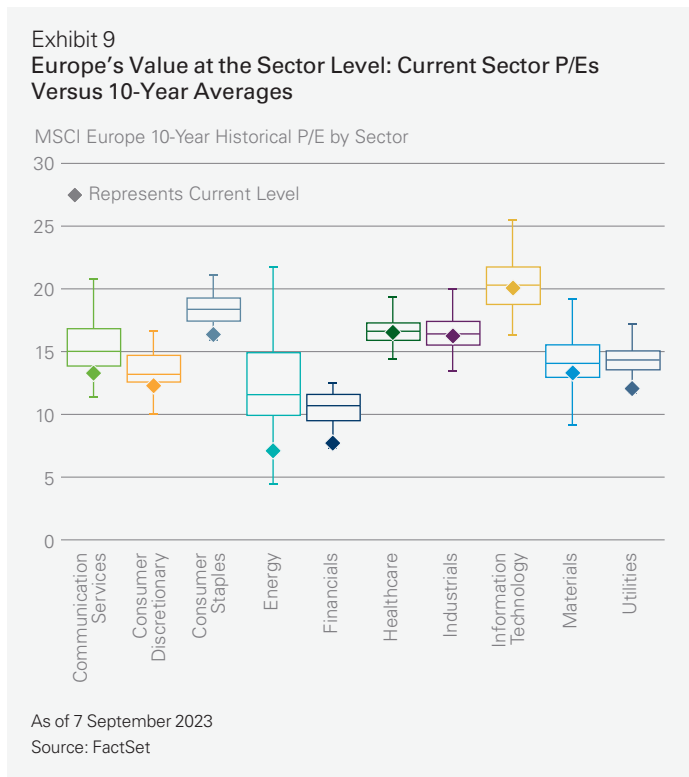


As of 7 September 2023
Source: FactSet

Drilling beneath the aggregate valuation for the European market, the compelling value currently offered by European stocks is evidenced in sector valuations. Every sector bar healthcare currently trades below its 10-year average (Exhibit 9).

Adding to this compelling picture is the improvement in European balance sheets, with clear evidence of reduced gearing since the pandemic (Exhibit 10). Lower borrowing is associated with a transfer of value to equity holders and lower risk. However, as evidenced by the current valuation discount, neither of these positive developments have been priced in.

With greater financial productivity, more resilient and diversified earnings, an improved growth profile, opportunities from the net-zero transition for Europe’s global sustainability leaders, and reduced leverage, we believe Europe’s valuation discount versus global markets, especially the US, should be narrowing, not widening. This paradox is unlikely to continue indefinitely. Equity markets often overshoot, and the momentum and direction of travel typically does not change easily. But this can create opportunity. We believe investors should cast aside previous assumptions about Europe and take a fresh look at the region.



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Notes

1. Source: [Morningstar Sustainalytics](#). Data as of 30 September 2023.
2. Source: Strategy Matters: European earnings success story—drivers and prospects—Goldman Sachs (24 May 2023)

Important Information

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