EXPERT INSIGHT

Europe: a major investment opportunity in an economy confronted with deglobalisation

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EUROPE: A MAJOR INVESTMENT OPPORTUNITY IN AN ECONOMY CONFRONTED WITH DEGLOBALISATION

The rapid acceleration of globalisation following the collapse of the Soviet Union ensured the economic domination of the United States and the emergence of China as its potential successor as leader of the global economy. On the other hand, we had a Europe which was losing control faced with the globalisation of the 20th century and which must now face the challenges presented by the beginning of the 21st. Faced with these two heavyweights, Europe had to find a way to reinvent itself while juggling the two superpowers – one because it provided military protection and had imposed its currency on international trade, and the other because it was an indispensable trading partner at the other end of the same Eurasian landmass. Of the three major economic blocs, Europe is by far the most dependent on global trade. As a result, where American and Chinese businesses have been able to develop within a vast and homogeneous domestic market, European businesses have had to battle it out to grow outside their country of origin, or even outside the Union itself. This is likely one of the reasons why Europe does not have a major tech giant. Amazon, Google, Tencent and Alibaba have all had access to enormous domestic data markets, whereas Spanish or Belgian companies working in the same sector do not have access to German or Italian data. Linguistic, legislative and cultural differences have made it difficult for European business giants to blossom. In some sectors such as transport, European institutions have historically thought of the emergence of European business giants as a threat to competition. European companies have therefore moved towards exporting, without enjoying the benefits of a strong domestic base on a continental scale.

The absence of a budgetary union constituted another structural problem for Europe. The single European currency was launched as compensation for France's acceptance of the reunification of Germany in 1990; however, the Union has never succeeded in finding a budgetary counterpart for the monetary union. Germany, better disciplined than its partners, made the most of this situation by exporting industrial goods to the heart of the Eurozone. These were competitive once again thanks in part to the integration of the former GDR, and in part to the sacrifices made by German workers following the implementation of the Hartz reforms in 2005 and during the economic crisis in 2009. Here, Germany made the decision to maintain jobs while making concessions with regards to salaries in order to keep the unemployment rate low. The German economy was therefore able to benefit from the single market within the Eurozone, where the other economies were far less competitive.

However, although the risk of economic recession is now at its peak in Europe, and the war has broken out on the continent for the first time in decades[1], **the turning point we have reached in the globalisation process presents a unique investment opportunity on the continent. This claim may appear counterintuitive** in the sense that Europe has never looked so vulnerable, with its dependence on Russia for energy, the divisions created by Brexit, the importance of exports to its economy, pressure from the US to limit relations with China, and the continent's dependence on the dollar for its trade. **However, the accelerating deglobalisation could offer Europe a unique opportunity to turn these challenges into advantages and, as a result, to create tremendous potential value for investors compared to other geographical areas. Why?**

[1] With the exception of the Yugoslav wars at the beginning of the 1990s, Europe had not had an armed conflict since the end of the Second World War.

The return of European identity

Firstly, because **the Russian invasion of Ukraine has significantly strengthened European unity.** Nobody expected it, but in the first few hours of the conflict, not only did European leaders close ranks, but the population equally expressed a deep feeling of community and belonging. It is sufficient to note the backtracking by the nationalist parties on European questions, especially in countries which have just had elections, such as France, to see that Eurosceptic discourse does not get the same traction in 2022.

From a financial perspective, the union certainly is not united, however the foundations of a rapprochement are in place, notably thanks to the European Commission's debt issuance as part of the plan to revive the continent's economy following the COVID crisis. Meanwhile, for the first time in decades, Germany will probably have to accept a structural budgetary deficit, since its need to invest in defence and in transitioning to other energy sources is so crucial. The German economy imports energy from Russia and exports goods to China. This vulnerability will need to be addressed by large scale investment which, paradoxically, could bring Germany closer to its European partners in terms of using fiscal policy to build a strong industrial policy. During the COVID crisis in 2020, European governments made the decision to channel their reserves into the real economy to create recovery funds to restart the economy by leaving investment decisions up to asset managers within a set framework. These "public-private partnerships" have proven to be effective tools in capital allocation.

In order to reinvent itself, Europe also had to rethink the way it perceives and rewards economic risk-takers. This was one of the major differences between Europe and the United States, where a successful entrepreneur does not just enjoy a more favourable fiscal and economic environment at every stage of development, but also a much more positive image. From this point of view, the development of "private equity" has helped to shape perceptions. Considerable momentum has been achieved by institutions such as the European Investment Fund, which has carried out remarkable work in coordinating capital allocation priorities at the Union level. **The COVID crisis in 2020, followed by the Ukraine crisis in 2022, have therefore led to a new European economic, political and cultural cohesion, which has established a genuine sense of belonging and laid the groundwork for a genuine industrial policy on a Union scale.**

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A more sustainable model for creating financial value

But the new competitive advantage for Europe does not stop there. **Europe has gained a headstart in two of the conditions necessary to generate financial performance during the last few decades:** on the one hand, it has recognised extra-financial criteria; and on the other, it has positioned itself around a number of structural growth "mega trends". We believe that these two factors will shape the generation of financial performance in the decades to come.

With regards to the importance of extra-financial factors, the necessity of a more sustainable growth model seems self-evident. The successive crises of COVID-19 and the Russian invasion of Ukraine show the extraordinary vulnerability of a growth model based around the optimisation of production costs, taxation, and the amounts of equity with which businesses can operate. Today, globalisation is synonymous with fragility. However, this is not necessarily a bad thing. The quest for infinite growth at any cost in order to justify the levels of debt and high valuations has a negative effect on the climate and on biodiversity (E), aggravates social inequality (S), and creates financial bubbles and poor allocation of capital (G). We all know that a more sustainable growth model which takes into account extra-financial criteria is the only viable option. Ignoring extra-financial factors would not only destroy financial value, but also generate considerable financial risks. Europe is leading the way in taking extra-financial criteria into account and enjoys a level of expertise that other regions are now looking to attain.

Additionally, our belief is that global growth is about to slow down and will be concentrated on a limited number of mega trends, most importantly among which will be the transition to alternative energy sources, a sector where European businesses are currently on top. In this new environment where over-optimisation leads to vulnerability, businesses all over the planet will be forced to invest heavily in order to become more resilient and at the same time remain competitive. A new cycle of capital expenditure is beginning after decades of underinvestment, accentuated by low interest rates, which encourage financial optimisation. In order to remain competitive in this environment, businesses will have to invest locally to build resilience. The transition to other energy sources should take up a significant chunk of these investments. The repatriation of the means of production should go hand-in-hand with improving the energy efficiency of the buildings, production tools, and transport links to worksites. By allowing costs to drop, so as to compensate the relocation costs, energy transition will become a competitive advantage for businesses around the world in every sector. Businesses which facilitate this transition will therefore enjoy strong upward global trends. Europe is the uncontested leader in this field, which means its economy benefits from a significant competitive advantage. In the same way, every business the world over will need to invest heavily in cybersecurity and in digitising its production processes and supply chains. 76% of medium-sized businesses in Europe consider digitalisation a priority[2]. By focussing on these mega trends, investors can foresee return expectations in line with those which the private equity industry has been known to generate in recent decades in an environment of falling interest rates and a strong appetite for risk. This will no longer be the case in every area. Locking onto these mega trends of growth will be essential and Europe is particularly well placed to do so.

> The third and no less essential element in Europe's favour is deglobalisation.

A market of 450 million people

The third and no less essential element in Europe's favour is deglobalisation. Europe has lost its competitiveness during the era of accelerated globalisation. Its businesses have not enjoyed a strong enough domestic market to facilitate the emergence of international business giants in enough sectors. International trade in proportion to global GDP peaked in 2008. The deglobalisation trend is accelerating amid US-China tensions, the COVID crisis, and the Russian invasion of Ukraine. Against this backdrop, building resilience means strengthening ecosystems at the local level. This is where the size of the domestic market becomes particularly important. It is true that the United States and China represent two homogeneous domestic markets which allow businesses from these two countries to enjoy significant benefits; however, in the context of deglobalisation, American businesses will find it more difficult to access the Chinese market, and vice-versa. For its part, **the European Union is a market with almost 450 million people – one third more than the United States.** The lack of a homogeneous domestic market has reinforced the need for European businesses experiencing strong growth to fall back on growth capital. **Bringing in an equity partner capable of supporting a national business giant in its European development strategy is an alternative which hundreds of medium-sized businesses can get behind. If said partner contributed not only patient capital, but also a dense network of relationships in the target country, along with local operational expertise, Europe could see the generation of considerable economic value along the lines of what has already occurred in the United States. It also turns out that intermediate-sized businesses represent around a third of jobs in Europe and a third of GDP. The potential for value creation is therefore very significant.** Performing well in this field requires a deep understanding of national and even regional ecosystems, as well as a network that allows you to choose the right partners and the right interlocutors. "Good deals have no wheels" is our response here at Tikehau when we are asked why we have opened offices in eight European countries so far. And good deals are in no short supply on this continent, packed as it is with economic and entrepreneurial culture. In Europe, you need to be local – that is to say fully integrated in the national and regional ecosystems – and considered a local investor, which de facto places a firm barrier to entry and confers a competitive advantage on those who take this route. **It is worth the risk in the sense that this complexity partly explains Europe's inferior market multiples for companies, listed or otherwise, when compared with their American equivalents. We are certain that contributing to the success of European national champions represents for Tikehau and its partners a considerable reservoir of economic value** in this new global context. In a world where "local" is synonymous with resilience, and "global" tends to mean fragility, Europe has enormous potential for investers who want to contribute to the success of businesses in developing their activity thoughout the continent's domestic market as a whole. Deglobalisation makes the expanses of the European market an indispensable investment area.

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Interest rates set to remain moderate

Another potential competitive advantage offered by Europe lies in its new environment in terms of the expected trajectory of interest rates. What was initially perceived as a weakness in the lead-up to the crisis could now become an advantage. The European Central Bank's interest rates could be positive by the end of 2022; however, at the end of this upward cycle, their level should be well below the American figures (probably less than 1% in Europe against more than 3% in the US). This will not stop credit issues for the lowest-performing companies, nor will it prevent the emergence of special situations; however, the pressure on businesses and consumers with adjustable-rate mortgages should be less than across the Atlantic. This, coupled with valuation multiples which are lower than those recorded in the US make the Eurozone a particularly favorable area for investment, provided you can work out which businesses will benefit from this effect on a European scale.

[2] 2019 European SME survey

A stable ecosystem

Finally, Europe remains one of the most politically stable regions on the planet, which magnifies the success of European development in this regard. Its deep investment and entrepreneurial culture is maintained by its rich history and high-performing educational system. Young European graduates, who are often multilingual and highly trained, are a fantastic export. The legal systems which oversee economic fluxes are stable. Europe remains to this day one of the only alternatives for a global asset manager looking to invest significant capital and diversify their portfolio by moving outside the American continent. Deglobalisation, combined with the end of the long cycle of falling interest rates, has come hand-in-hand with an increase in the divergence of trajectories between different geographic regions, which has led to uncertainty. Europe's stability, despite potential economic growth that is lower than that of other regions, makes it an indispensable area for investment.

In conclusion, at a time when businesses are questioning their own reason for being, it could be an interesting exercise at the scale of the European Union. The US and China have placed their bets on technological, monetary and military domination to hold onto their positions at the head of the global economy. For Europe, attempting to compete in these areas would most likely end in failure. The region must find its own path, following the maxim "create, don't compete". Europe should develop its own model, inspired by both Atlanticist and Eurasian perspectives, and secure its own raison d'être, which lies in its uniqueness, its cultural wealth, and its excellence. The COVID crisis and the Russian invasion of Ukraine have accelerated this process. **Deglobalisation opens the way to an alternative path: the construction of a growth model that is sustainable and more local, and which allows its businesses to develop across the whole of the immense European market. As it confirms itself as a global leader in sustainable investment and energy transition, Europe will validate its own growth model and continue its integration.**

This is why, at the risk of going against the grain of current conventional wisdom, we affirm our belief that investing in Europe in the coming years represents a unique opportunity for value creation.

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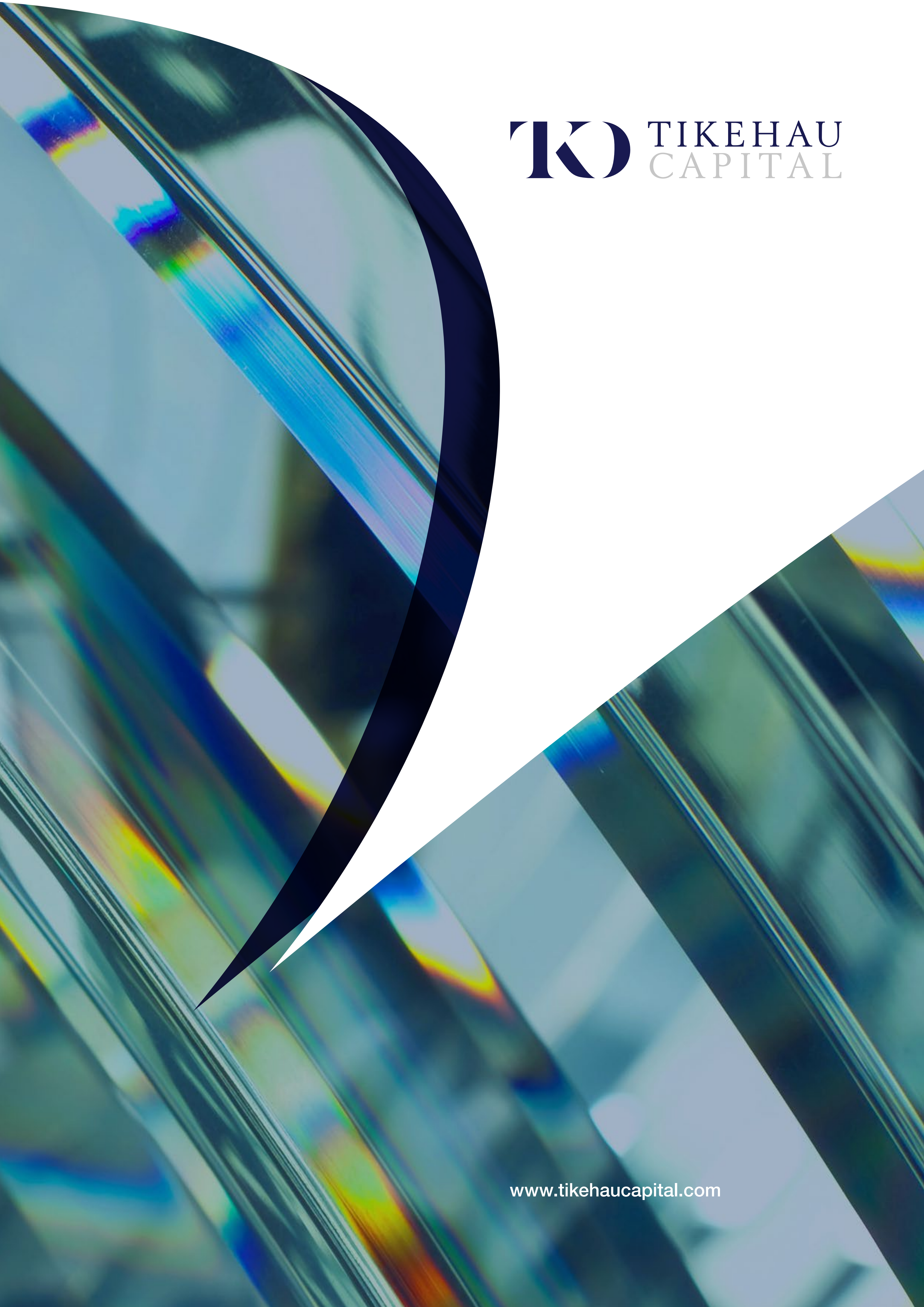

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