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European Crossroads

Equity Research

Taking the pulse of corporate Europe

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European CEOs see an urgent need to revive growth…

During the third quarter, we embarked on a tour of corporate Europe. We met with more than 30 European CEOs and discussed the opportunities and threats they see for their companies and the European economy. In this report, we distill the insights from those meetings to assess ways to break the cycle of stagnation that hangs over Europe.

…amid cyclical and structural challenges

European CEOs described a daunting array of challenges. Most immediately, the Euro area looks to be heading for another year of below-trend growth, with triple-dip recession risk looming. Longer term, the continent suffers structural weaknesses including ageing demographics, high relative energy costs, poor labour flexibility, low innovation, slow policy-making, and poor access to capital for SMEs. The confluence of globalisation and technological change is blurring the lines between geographies and industries.

A strong foundation on which to build …

Despite these challenges, Europe retains many advantages in the size and wealth of its markets, the quality of its products and institutions, and its heritage, culture and education systems. After six years of deleveraging and cutting costs, many listed European companies are in strong financial shape. The picture we took away was of Europe at a crossroads, with a choice between a path of eroding long-term competitiveness or one where it leverages its strengths to revive growth.

… but with a call for a coordinated response

The CEOs we met see the need for a coordinated response to reduce obstacles to operating and growing in Europe and competing globally from a European base. We assemble a collective 'op-ed' of their views and outline actions that may have the greatest positive impact, including speeding up and coordinating policy-making, improving labour market flexibility, creating a climate for innovation, increasing incentives for R&D, creating a balanced energy policy, and recasting declining industries. We conclude with an exploration of the major themes that ran through the course of our conversations to take the pulse of corporate Europe at a time of extraordinary challenged. See our accompanying piece *Investing at the Crossroads* for our investment recommendations in light of what we learned.

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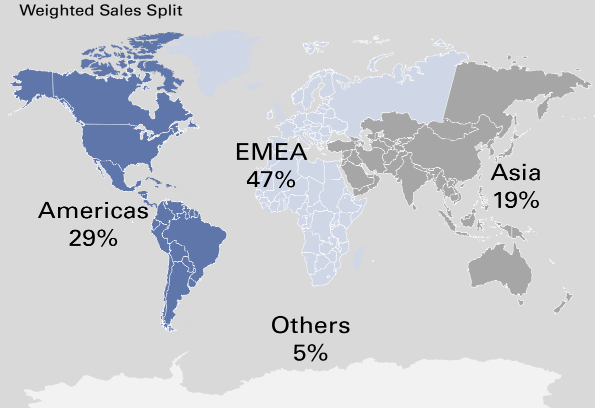
Introduction

This report shares some of the perspectives we gathered from meetings with European CEOs in 3Q2014. During these meetings, we discussed the major challenges these businesses face and the impediments the CEOs see to operating and growing in Europe, and to competing globally. Here, we present data and case studies relating to these issues. We also outline some ideas for their alleviation. In compiling this report, we have aimed to capture the sentiment conveyed in these meetings rather than to provide a full account of the complex political and economic issues facing Europe today. In doing so, we aim to provide a high-level snapshot of the current 'pulse' of the European corporate landscape. We hope this will be of interest to investors, policymakers and corporates themselves, when reflecting on the key issues of the day.

In compiling this report, we spoke to executives at the following companies and we thank them for their time and insights:

Company name	Sector	Market cap (mn)	Domicile	Company name	Sector	Market cap (mn)	Domicile
Adidas	Retail	€ 12,888	Germany	LEG	Real estate	€ 3,209	Germany
Aegon	Insurance	€ 11,854	Netherlands	LVMH	Retail	€ 67,328	France
Airbus	Aerospace & Defence	€ 38,757	France	Novo Nordisk	Pharma	€ 99,560	Denmark
Atlas Copco	Machinery	€ 27,787	Sweden	Petrofac	Oil Services	€ 4,859	United Kingdom
Bankia	Banks	€ 14,996	Spain	Randstad	Business Services	€ 6,348	Netherlands
Centrica	Utilities	€ 19,265	United Kingdom	Richemont	Retail	€ 38,623	Switzerland
Daimler	Autos	€ 65,245	Germany	Roche	Pharma	€ 203,095	Switzerland
Diageo	Consumer Products	€ 59,174	United Kingdom	SAP	Technology	€ 63,694	Germany
E.ON	Utilities	€ 26,083	Germany	Shanks	Utilities	€ 467	United Kingdom
EDPR	Utilities	€ 4,463	Spain	Solvay	Chemicals	€ 9,189	Belgium
ENI SpA	Oil	€ 57,407	Italy	Swiss Re	Insurance	€ 24,856	Switzerland
Eurazeo	Multi-Sector Holdings	€ 3,609	France	Veolia	Utilities	€ 6,980	France
GDF Suez	Utilities	€ 43,417	France	Vodafone	Telecoms	€ 75,366	United Kingdom
Gemalto	Technology	€ 5,269	Netherlands	Voestalpine	Steel	€ 5,528	Austria
Julius Baer	Banks	€ 7,993	Switzerland	WPP	Media	€ 20,265	United Kingdom
Kinnevik	Multi-Sector Holdings	€ 7,337	Sweden		**Total:**	**€ 1,034,909**	

Weighted Sales Split



Source: FactSet, company data, Goldman Sachs Global Investment Research.

As is clear from the chart above, many of the European companies we met with have diverse exposures outside the region. Indeed, it is worth noting that as of 2013, just under 50% of the sales of Stoxx 600 companies came from outside Europe, up from c.43% in 2005 (according to Bloomberg data). When discussing the European landscape, many CEOs we met were keen to point out that the profile of their business is not simply a reflection of the European macro picture.

Europe now: The view from European CEOs

During the third quarter, we embarked on a grand tour of corporate Europe. At that time, markets were exhibiting very low volatility across a range of asset classes, and for a third year, European corporates in aggregate were struggling to deliver meaningful earnings growth. The overwhelming consensus in the market was that, despite asset price recovery stimulated by ECB liquidity actions, Europe's prospects for growth and as an investment destination were poor.

The trip took the form of a series of interviews with a cross-section of leading CEOs encompassing the major European sectors and geographies, with a combined market cap of around €1 tn and a total workforce of almost two and a half million people. The purpose: to test this consensus, discuss why it had come about and brainstorm potential pathways to a brighter future. In short, over the past two months, we went in search of Europe and this report is the result of what we found.

Europe at a crossroads

It became immediately obvious from our initial conversations that European corporates feel the proliferation of challenges in their operating environment is as great as any period in modern memory. The twin juggernauts of globalisation and new technology have rolled over a landscape already laid bare by the aftermath of the global financial crisis and the Euro area sovereign crisis.

Europe has a bedrock of long-term embedded advantages that provide a stable base for attacking these new challenges. Near-term headwinds are considerable, however. European CEOs must contend with ageing demographics, high relative energy costs, poor labour flexibility, low innovation, high taxes, heavy public debt burdens, insufficient workforce skills, slow policy-making, inconsistent and outdated regulation, and poor access to capital for small and medium-sized businesses. As we write this report, the macro picture has darkened again and Europe now faces the spectre of a triple-dip recession.

The continued development of globalisation and the dizzying pace of technological change are also blurring the lines between geographies and industries. European CEOs must cope with low domestic growth, the repercussions of China's economic transformation, shifts in consumer habits in the digital age, and pressure from investors for short-term rewards at the expense of long-term investments, among a variety of other issues. The result has been a logical focus on cutting costs and husbanding resources since the global financial crisis. However, after six years, this strategy risks creating a negative loop in which a lack of growth leads to a lack of investment, which leads to a lack of innovation and job creation and in turn a lack of growth.

The CEOs we met see an urgent need for policymakers and businesses alike to act to break out of the stagnation trap. Based on our discussions, we provide a prioritised list of the primary obstacles the CEOs said are hampering their operations in Europe, preventing them from expanding in the region, and weakening their position against global competitors. We outline a series of policy steps, both large and small, that would reduce structural obstacles, including: speeding up and coordinating policy-making, improving labour market flexibility, reforming bankruptcy processes to reduce the risks from failure, increasing incentives for R&D, creating a more balanced energy policy, and recasting declining industries as innovation hubs for new technologies.

Some initiatives build on pockets of current progress, such as Spain's labour reforms and the move to a European banking union. Others seek to shift the debate from legacy sectors to modern jobs. We found CEOs were sceptical of the potential for radical positive change, but saw a need for constant small improvements. We draw on insights from the interviews and our previous research to offer self-help steps that companies can take to spur growth. **We came away from the meetings with a picture of Europe at a crossroads between a**

path of eroding long-term competitiveness, or one where the region leverages its strengths to adapt to the new rules and reality of the global economy.

Urgency and opportunity

Despite the challenging environment, the view we gathered is that Europe has many solid foundations on which to build. We were constantly reminded that Europe is the largest economic bloc on the planet, wealthy and mature as a market for goods and services. Indeed, when spending time in some of the great cities of the continent, it is difficult not to feel impressed at the scale of Europe's past achievements. The continent enjoys strong institutions, consistent rule of law, a broad and relatively deep education system, improving levels of health and increasing life expectancy. It has many qualities that are globally attractive, spanning culture, heritage, creativity, and an array of products and industries that are the envy of the world. **The balance sheet of Europe's potential is strong, but the P&L is cyclically and structurally challenged.**

With economic growth so low and with significant slack in the economy, the opportunity created by a small acceleration is high. Our research has shown the operating leverage of European companies makes them like 'coiled springs' that would see significant gains in profitability from even modest increases in demand. At the same time, the risk of allowing today's 'no growth' mindset to harden further is an urgent cause for concern. Discussion around the headwinds facing Europe dominated much of our interview time and we noted a particular sense of urgency over the impact of a further economic downturn, which we found surprising. Youth unemployment was consistently highlighted as the most pressing issue. Income inequality, the rise of less moderate political parties, nationalist/protectionist economic policy and fear of energy blackouts also littered our conversations with gloom.

Post-war Europe was galvanised by a determination not to allow differences to create dangerous division. Approaching the 70th anniversary of the end of World War II, there is genuine concern that the cracks now developing in the system will usher in a reversal of the progress that has been made in the pursuit of this cause. We recognise that GDP growth alone is not an all-encompassing indicator of the full experience for a population. But persistent low growth appears to be the genesis of many of the cracks that the European corporate sector is concerned are emerging in society today**.**

A final thought

Reflecting on our meetings, the abiding impression is a desire from the corporates to move on and return to a normal pattern of business development. Six years is a long time for internal focus, whether at the corporate or national level. The CEOs recognized that they have a role to play in resetting the direction for growth, and they want government to help create an environment for businesses to be competitive. We encountered an overarching frustration that the vision of an open European market that allows for the unencumbered flow of goods and services is failing, stymied by bureaucracy and the dominance of local interests. European CEOs argue the current path of patchy reform will be insufficient to drive a positive macro inflection across the continent. **After six years of the global financial crisis and its aftermath, Europe's business leaders are eager for a public-private collaboration to break the pattern of stagnation and set a course for long-term growth in a world of blurring lines.**

Opportunities, challenges, ideas

Our meetings allowed us to aggregate the common views of European CEOs about the obstacles to **operating** and **growing** a business in Europe and **competing** on the international stage from a European base. Although the CEOs we met represented different industries with different challenges, we found a number of areas of agreement. Below, we highlight the key impediments (and benefits) identified through our conversations. We also present some accumulated ideas for alleviating the challenges identified, first through the collective eyes of the CEOs and then from our own analysis.

Operating in Europe

The advantages of operating in Europe

It is often taken for granted, but relative to other regions of the world, Europe enjoys low corruption, strong governance, good universal health provision and high educational standards. In a global context, Europe enjoys a stable political environment and effective rule of law, and is home to well-functioning democracies.

Europe is also wealthy. The EU is the largest economy in the world and one of the richest, with a GDP per head of €25,000 for its 500 mn citizens. It is the world's biggest trading bloc and the largest trader of manufactured goods and services. The EU is the top trading partner for 80 countries (by comparison, the US is the top trading partner for just over 20 countries). It also ranks first in both inbound and outbound international investments. By operating in Europe, companies can benefit from the Schengen agreement for the free trade of goods and services, as well as movement of people.

Corporates operating in Europe are generally subject to tax rates that are below the OECD average. In the corporate sphere, financing conditions for large companies are also favourable.

The continent enjoys strong physical infrastructure and rapidly improving digital infrastructure. In a world increasingly centred on large international hub cities, Europe has the advantage of being home to a substantial number of these. The natural time zone advantage of being located between Asia and the US also confers a boost to our financial services and trading sectors.

Europe offers a rich, diverse environment with culture and history at its heart, rendering it an attractive place to live (and to attract talent to). With Europe home to 40 of the top 100 global universities, its corporates are able to harness some of the world's most talented people.

The key challenges/impediments associated with operating in Europe

In order of priority/frequency of discussion, we highlight the following:

Our contacts revealed significant frustration that Europe is not maximising its embedded advantages. This view comes into sharpest relief on the subject of the single market, with a prevailing sense that the ideal of pooling 500 mn customers is a dream rudely interrupted by uneven tax and regulatory environments, with national interests too often trumping EU harmonisation.

Companies operating across the continent feel they are not able to run a single set of European operations. The 'rules of the game' differ significantly across member states, with the effect that each entity must conform primarily to the labour laws, tax rates and licensing of the country in which it is located. Launching a product across Europe is effectively equivalent to launching a product across 28 different markets. Energy prices, mortgage rates, and the cost of mobile phone calls all vary widely between and sometimes within nations. This stifles the emergence of European champions, leaving sub-scale local players at the mercy of larger, more efficient global competitors.

The cost of operating in Europe is also high. Energy costs are a particular source of frustration and contribute to a high overall cost of living for workers in Europe and companies operating here. Housing costs – particularly in large cities – are high. In general, Europe is characterised by resource constraints, both in natural resources and space.

Europe is seen as inflexible. This is evident in the labour market, where high levels of unionisation and collective bargaining continue to apply (although, once again, this varies across member states). A degree of inflexibility is also apparent in the legislative framework of the continent. Many of the CEOs we met expressed a view that European policymakers responded too slowly to the financial crisis and that current consultation periods are too long, not only when it comes to legislative change but also on issues such as the approval of cross-border transactions.

There was also a clear view that the poor financing availability for smaller companies relative to their larger counterparts is an impediment to growth and a concern for companies of all sizes.

While the presence of world-class universities and business schools on the continent is certainly a boon for some employers, others flag the emergence of a broader 'skills mismatch'. In particular, this mismatch is manifested through a lack of skilled employees in the STEM subject areas (Science, Technology, Engineering and Maths).

Finally, one feature that many CEOs see as broadly unattractive about the continent is its attitude towards big business. There was a generally expressed belief that both policymakers and the press have a negatively biased view about the role of 'big business', which filters down into overall attitudes to entrepreneurship and risk-taking.

Resolving these impediments: Top 5 suggestions

If Europe is to attract more businesses and support those that it has, the CEOs argue that focusing investment stimulus, policy change and political rhetoric on getting the most out of the existing asset base is the logical starting point.

- **More integration***:* In broad terms, the CEOs want more intelligent integration across member states. European companies should be able to gain meaningful scale economies by operating across the continent. In practice, this means that (notwithstanding language barriers), there should be as much harmonisation on advertising standards, product standards and cross-border trade rules as possible.
- **Developing new skills in legacy sectors***:* To rectify the current 'skills deficit,' policymakers can establish incentives to increase STEM-based lifelong learning. Europe should take advantage of its world-class education system to attract top global candidates and make it easier for them to remain in Europe after their studies.
- **Financial markets and incentivising the optimal use of savings***:* Financial markets in Europe remain uneven. The creation of the banking union and single supervisory mechanism should create a broader, more liquid market and greater access to favourable financing rates.

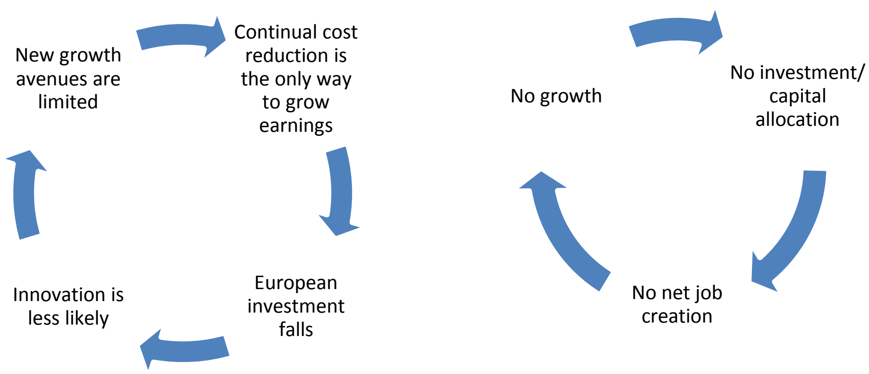
  To the extent that the companies we met expressed dissatisfaction with the uneven financing market, they see a need for better deployment of Europe's stock and flow of savings. This may include a review of the incentive structures that exist around encouraging investment in financial products and the regulated risk profile of existing funds. Investment capital should be allocated in a balanced and appropriate way that allows for the most effective return profile to coexist with risk controls to ensure the most productive long-term use of assets. The current situation is seen to overly favour downside-minimisation as the key objective.
- **Re-tilting the balance in the energy trilemma***:* High energy costs reflect resource scarcity and significant investments in renewables across the continent. In general, the

CEOs see the need for a more balanced approach to the 'trilemma' of balancing environment sustainability with energy affordability and the security of supply. In particular, this means reducing the dependency on a small number of power plants and fuel sources.

- **More constructive rhetoric***:* One of the common complaints among the companies we met was a sense that anti-business rhetoric prevails in the policy sphere and in the press. It was felt that policymakers need to embrace a collaborative discourse with business leaders.

Growing in Europe

Much has been written about the potential debt/deflation trap that faces Europe. Spending time closer to some of the continent's biggest firms revealed several other equally concerning negative loops. As 'no growth' has become an increasingly entrenched assumption in the corporate planning process, two new norms are evident in medium-term planning:



Over recent years, European companies have put in place a series of efficiency measures aimed at protecting FCF in the face of depressed demand. After six years of squeezing cost and efficiency improvements out of existing infrastructure, companies now risk cutting into muscle, rather than fat. Continued retrenchment risks impairing long-term productivity and competitiveness, particularly as other regions emerge from the financial crisis more quickly. Where European companies do seek to invest for growth, one commonly trodden path is to grow by expanding abroad. Here, we examine what the CEOs said would be needed to achieve growth within Europe itself.

The sources of growth in Europe

In the absence of a pronounced cyclical recovery in Europe, companies need to find other ways to grow. In this context, companies are looking to grow the top line through market share take, increasing pricing power, or simply by moving into faster-growing product areas (so-called 'pie shift'; see our GS SUSTAIN team's report Increasing the odds for monetizing growth: 18 companies growing through "pie shifts", November 5, 2014). Given relatively high cash balances and low leverage (versus history), there is scope for companies to grow inorganically. In doing so, if they can undertake either vertical or horizontal integration, then the prospects for pricing discipline and – ultimately – returns may also be positive.

Growth is likely to come from new places compared with the past and European companies may be able to make virtues of areas of weakness. Ageing, a growth headwind in some respects, is a potential opportunity in many areas, bringing an increase in demand for healthcare and asset management services. Finding ways to improve process efficiency or reduce the consumption of energy may also be areas where Europe can develop exportable expertise. Many of the challenges facing Europe today will be global challenges tomorrow and European expertise could be a highly exportable commodity in these areas.

As ageing populations need to save and invest more, and emerging market consumers become more affluent, a number of these areas have potential to become sources of secular growth for Europe.

The key challenges/impediments to growing in Europe:

In order of priority/frequency of discussion, we highlight the following challenges identified by the CEOs we met:

Central to the prevailing headwind is the demographic profile of much of Europe and the uneven approach to immigration adopted by different countries. Over elongated economic cycles, it is impossible to escape the correlation between economically active populations and GDP, which naturally confers a significant advantage to growing working-age populations around the world. Corporate strategies overall have adapted to this reality, resulting in capital allocation, capex and jobs being slowly diverted away from Europe, a situation exacerbated by the financial crisis.

The 'demand drain' created by a declining and ageing population is compounded by the relatively high welfare spend across the continent. The cost of these programmes is a major contributor to the high national debt levels and a drag on more flexible taxation policy in many instances. The welfare structures that developed post WWII, while supporting social cohesion, have become unsustainable as demographics have shifted.

Europe has also been caught on the wrong end of a radical shift in relative energy prices around the world. The current balance of sustainability, affordability, and security of supply is placing a significant burden on European consumers and industries and leaves the system vulnerable to external shocks.

The loudest lament we heard, however, was over the pace, complexity and dynamism of decision-making at the policy and regulatory level. Of all of these areas, the speed of decision-making was the primary concern. Relative to other regions around the world, this is seen as a major competitive disadvantage for Europe and one that needs to be addressed urgently.

The clock is ticking faster owing to the impact that technology is having on the globalisation of the corporate landscape. If more and more businesses can locate anywhere in the world, is a region that is perceived to be expensive, complicated, inflexible and less pro-business likely to be a first port of call?

Resolving these impediments: Top 5 suggestions

If European corporates are to find routes to growth, there are several necessary steps that need to be taken at the European level.

- **Speeding up policy-making***:* Paramount in the minds of many of the CEOs was the need to speed up the legislative and regulatory decision-making process to remove uncertainty and shift the agenda towards stimulating economic activity. A widely expressed view was that policymakers should consider introducing caps that shorten the consultation and implementation periods for new policy.
- **More forward-looking regulation***:* Regulatory infrastructure has a role in balancing multiple objectives, not just minimising downside risk. One practical example may be applied in the case of youth unemployment. There is a case to be made here for allowing employers increased flexibility in hiring and for reviewing employment practices for the long-term youth unemployed.
- **Increased openness and transparency***:* All manner of organisations are rethinking their structure to become simpler and more transparent to their employees and customers amid rapid changes in technology. This communication and openness may offer a template for policymakers and regulators. Where European leaders have openly acknowledged and discussed the obstacles facing their countries, they have improved

the resolve of the governments and the people to accept readjustment and change (Spain serves as a case in point here).

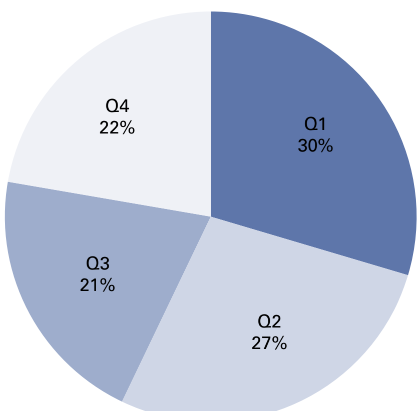
- **Maximising Europe's strengths**: The CEOs also stressed that playing to the region's strengths needs to be front and centre of the continent's growth strategies. On a simple level, there needs to be a much more high-profile push towards best-practice sharing across the member states. Developing forums for policymakers, regulators and business people seems like a clear way to take advantage of the architecture of the EU.
- **Changing attitudes:** A number of CEOs mentioned that after many years of sluggish growth and elevated unemployment in the continent, there is an acute need to excite and inspire people again, particularly young people who entered the working age group in recent years to find prospects looking bleak.

Competing globally from Europe

Having discussed the challenges of operating and growing within Europe itself, we now consider the relative position of European companies in a global context. We framed many of our conversations against our GS Competitive Positioning analysis, which evaluates the key metrics that determine how well companies are placed to navigate the major changes expected to affect their industries in the coming decade.

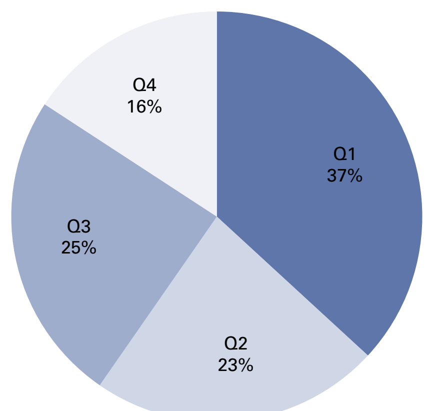
We highlight Europe's competitive advantages below:

Exhibit 1: 30% of European companies feature in the top quartile of their global industries, according to GS Competitive Positioning & Industry Positioning frameworks
Distribution of EU stocks across CP/IP quartiles



Source: Goldman Sachs Global Investment Research

Exhibit 2: Leadership is most pronounced in industrials, where 37% of European companies are in the top quartile of the global distribution
Distribution of EU industrial stocks across CP/IP quartiles



Source: Goldman Sachs Global Investment Research

Europe's strengths:

The ability of Europe's companies to compete purely on the basis of cost is generally limited, with the strongest global players focusing on areas where product differentiation, specialisation or branding can play a role in justifying higher prices. Whether in the premium autos segment, private banking, asset management, luxury goods or tourism, Europe has shown that it can occupy an important niche in the global market, taking advantage of its key strengths.

From an export perspective, it is also important to remember that product standards in Europe are high, standardised and generally well-policed, giving a de-facto safety and quality guarantee to consumers in foreign markets. Europe offers trusted brands with reputations built over many years. This trust is particularly important for winning longer-term contracts. Entering a 20-year infrastructure contract with a European company that has hundreds of years of tradition and is bound by the highest standards of corporate governance and disclosure may be seen by many buyers as a more attractive proposition than trusting a newer, even if more cost-effective, supplier.

Europe is also a pioneer in a lot of areas, often by necessity. Learning to live with limited resources, ageing populations and high population density, for example, means that Europe is spending more resources on renewable energy, drug development and elderly care, as well as waste management systems and other things that the rest of the world will ultimately need.

Importantly, European companies also have a significant 'installed base' to leverage. To the extent that European ships, planes, cranes, lift systems, and waste management systems, for example, are installed around the world, companies can continue to lead in the delivery of long-term service contracts.

Challenges/impediments facing European corporates on the global stage

In order of priority/frequency of discussion, we highlight the following:

In energy- and labour-intensive industries where competition is based on cost and price minimisation, Europe's companies often struggle to compete on the global stage. As discussed earlier, this has often necessitated a focus on more differentiated products.

Cost advantage can also be born out of scale advantage, particularly where there is a significant fixed cost component to overall costs. In this regard, European CEOs often feel that an inability to gain genuine scale economies across Europe impedes their ability to keep costs as low as players in China or the US can. The inability of a TV company in Europe to buy pan-European TV rights, for example, makes it difficult to compete with a global over-the-top streaming service that offers a single content package across the whole region.

Many companies in more mature regulated industries expressed a view that the regulatory landscape effectively stacks the odds in favour of 'disruptive' new business models. Incumbents in an industry may be held back from extending into new segments of the market, forcing them to cede future growth areas while defending their existing revenue lines. Examples are rife in the telecoms and utilities space. And as every start-up and private equity firm refines tactics for attacking legacy profit pools, they are able to concentrate their aim at the most attractive segments of an incumbent's business.

US technology companies were identified as a key competitive threat by three-quarters of the people we met, with the nature of that competition a particular point of concern. Traditional sector boundaries are being overwhelmed by the march of digitisation across the global economy. New industries face competition from US-based 'tech titans' that have large cash piles and investors and boards accustomed to them making forays into new areas, ranging from home automation and utility metering to communications and space travel. Whereas these companies are 'playing offense' in a bid for future growth, many European companies feel that they are forced into a defensive position, unable to make risky investments with distant payback periods given the short time horizon of the financial markets.

With a deeper and more liquid capital market and a broader culture of equity ownership, US-based companies are often seen as having an advantage when it comes to funding.

The rebalancing of the Chinese economy also poses a near-term risk to Europe's position in a global context. As the demand for capital equipment and basic resources subsides, many European companies find themselves with significant oversupply. With Europe's two major exporting sectors being machinery and chemicals, a shift away from infrastructure-driven growth and towards services and consumption-driven growth in China has severe near-term implications. As the Chinese economy rebalances and its businesses move 'up the value curve', they may also represent a new source of competition for Europe.

Resolving these impediments: Top 5 suggestions

Finding remedies to Europe's current problems requires a new toolkit. The explosion of data and the transparency that technology brings are taking costs, processes and jobs out of the system while creating a customer experience that is radically changing consumption patterns. The full force of globalisation is being felt across capital flows, talent flows and the relative cost of energy. The message from the beginning was clear: Europe must adapt to the rules and reality of the global economy and do it now.

- **Competition policy:** In the face of rapidly evolving business models, ever more globalisation and increased 'sector creep', corporates see a clear need for more holistic and flexible competition policy, acknowledging that old market definitions may no longer be fit for purpose.
- **Modern jobs:** Alongside this common desire for more modern regulation was a plea for one policy focus – 'modern jobs'. New incentive structures can encourage job creation in sectors that offer growth and have a place in the rapidly evolving global marketplace. Rather than supporting current jobs in sunset industries, European policymakers should place the emphasis on jobs that drive growth in the future. Supporting the creation of innovation hubs around Europe's declining industries should help the continent export the most value-added components of these industries. The European companies we met also expressed a desire for more incentives and collaboration around public/private R&D and innovation.
- **Promoting Europe:** The CEOs argue that those responsible for trade relations and delegations should recognise the shift of emerging markets up the value chain and reflect this in their trade delegations to emerging markets, showcasing Europe's attractiveness as a place to do business and with which to trade. It is also imperative for Europe to have a powerful online presence.
- **Increasing risk tolerance***:* European entrepreneurship will benefit from reforms that make it less risky to fail: for example, ongoing bankruptcy reforms that reduce the stigma attached to small business failure. There is also a clear need for entrepreneurs to be able to access investment capital.
- **Clarity and consistency:** There remains a lack of consistency across member states in energy policy and digital policy, to name just two areas. Increased clarity and consistency in cross-border regulatory frameworks will help industries operating in these fields to reap Europe-wide scale economies.

Self-help initiatives

The CEOs we met recognised that the solutions to Europe's problems don't all lie with the government. Our tour gave us a chance to compare their different strategies and to reflect on best practice when it comes to reviving growth and ensuring the region's competitiveness.

The response to the prevailing conditions over the past six years by European corporates has left many listed European names in a strong financial position. They have repaired balance sheets, reduced costs and tightened working capital.

This is the simplest response to economic or technological disruption. The harder road is to reinvest these savings in new avenues for growth and innovation and continue to drive businesses up the industry value curve. In the absence of a pronounced cyclical recovery in Europe, companies need to find other ways to grow. As new competition emerges at an ever faster rate, simply maximising margins and returning cash to shareholders will result in an older and (over time) less productive asset base, less and less able to compete with newer global rivals. Based on our meetings and our research, we see the following steps that companies can take themselves to lay a foundation for growth.

- Our research on competitive positioning has shown the rewards that can come from leveraging Europe's existing strengths, capitalising on its heritage of quality to develop and market brands of global appeal. Given Europe's disadvantages in areas such as energy and labour costs, European companies must focus on specialisation and the areas where they are able to differentiate themselves versus global peers.
- Europe has lower R&D spending than other OECD nations. It also has lower levels of innovation and fewer new patents. Companies may be well advised to commit to minimum R&D targets through the cycle.
- Companies also need to make it easier for workers to move between different roles within an organisation. In recognition of the demographic headwinds facing the continent, one option may be to take steps such as accepting people of all ages onto graduate schemes.
- To rectify the current 'skills deficit' that is reported by many employers, companies should expand their annual training and development programmes.
- All corporates should remain alive to the emergence of new sources of competition in their industries, facilitated by new technologies.
- Finally, companies should make the case to shareholders for projects that have longer-term breakeven points.

Breaking it down: A list of priorities

In summary, here is the prioritised list of recommendations for European policymakers that emerged from our meetings with European CEOs:

1. **Improve integration across the 'unified' market to allow companies to gain economies of scale**
    - Adopt a more holistic and flexible competition policy in the face of rapidly evolving business models, globalisation and increased 'sector creep.'
    - Increase consistency and clarity among member states in areas such as energy and digital policy. Introduce cross-border regulatory frameworks for industries operating in these fields to reap Europe-wide scale economies.
    - Increase best-practice sharing of individual business case studies, public-private collaborations and regional policy-making through a clearer forum for pooling ideas across member states.
    - Encourage putting the continent's significant and growing savings pool to the most productive uses within Europe by providing tax incentives or changes in capital requirements for investments.
    - Create greater connectivity between Europe's energy markets to reduce disparities in energy costs between regions.
2. **Speed up decision-making and create a climate for innovation**
    - Introduce caps on consultation and implementation periods for new policy.
    - Enact bankruptcy reforms to make it 'less costly to fail' and reduce the stigma attached to small business failure to increase the risk tolerance of Europe's entrepreneurs.
    - Increase public funding for R&D and collaborations between businesses, universities and governments.
    - Support long-term public infrastructure initiatives in areas such as energy, communications, transportation and logistics.
    - Reduce anti-big business rhetoric in the pursuit of short-term voter popularity.
3. **Address labour challenges, including skills mismatch, inflexible labour laws and lack of mobility**
    - Rather than supporting current jobs in sunset industries, place the emphasis on modern jobs. Support the creation of innovation hubs around Europe's declining industries to help the continent export the most value-added components of these industries.
    - Build on Spain's success in increasing labour market flexibility.
    - Reform immigration policies to improve labour mobility. There is no 'one size fits all' approach here as the issue of labour mobility manifests in different ways across the continent. The focus, however, must be on enabling the matching of skills and opportunities.
    - Provide carve-outs to inflexible labour laws, such as incentives for hiring from the large pool of unemployed youth.
    - Establish incentives to increase STEM-based lifelong learning (science, technology, engineering and maths).
    - Reach out to excite and inspire workers about Europe's potential, particularly young people who entered the workforce in recent years to find prospects looking bleak.

4. **Improve access to financing for small and mid-sized enterprises.**
   - Increase support for SME loan securitisation by reducing risk-weighting and capital charges for banks holding SME asset-backed securities.
   - Support peer-to-peer lending markets as a source of capital for small businesses.
5. **Better promote Europe on the global stage**
   - Leverage Europe's world-class education system to attract top global candidates to study in the region and make it easier for them to stay in Europe beyond their studies.
   - Ensure Europe captures the increase in tourist volumes from new markets by improving the ease of obtaining tourist visas in growth markets such as Asia and increasing the number of Mandarin-speaking tourist advisers in Europe.
   - Adapt trade delegations to the changing nature of emerging market economies, showcasing Europe's attractiveness as a place to do business and a trading partner as these economies move up the value chain.
   - Encourage exports of European expertise in the challenges of the future, such as caring for the ageing, energy efficiency, urban planning, renewable energy and waste treatment.

And a list of self-help initiatives for European corporates:

1. **Make the most of existing strengths**
   - Leverage Europe's heritage as a manufacturer of high-quality goods in developing brands with worldwide appeal.
   - Increase specialisation to reduce competition with lower-cost rivals in regions with labour and energy cost advantages.
   - Tap Europe's educational excellence by collaborating more with universities to enhance R&D efforts.
2. **Invest to keep up with global peers**
   - Europe is falling behind other economies in R&D spending and as a result has lower levels of innovation and fewer new patents. Companies may be well advised to commit to minimum R&D targets through the cycle.
   - To rectify the current 'skills deficit' that is reported by many employers, companies should expand their annual training and development programmes for workers.
3. **Future-proof processes and systems**
   - All corporates should remain alive to the emergence of new sources of competition in their industries, facilitated by new technologies.
   - Companies also need to make it easier for workers to move between different roles within an organisation. In recognition of the demographic headwinds facing the continent, they should also consider taking steps such as accepting people of all ages onto graduate schemes.
   - Companies should make the case to shareholders for projects that have longer-term breakeven points.

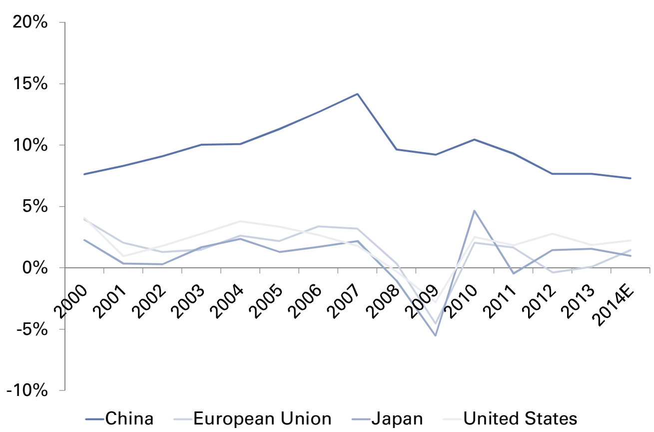
The following sections of this report attempt to give a flavour of the conversations we had. We have structured the sections along the lines of the interviews to give you a fly-on-the-wall view of our discussions. The list of topics and examples is not exhaustive, but it does reflect where we spent most time in our dialogues.

Europe today – current state of the union

In 3Q2014, six years on from the collapse of Lehman Brothers and five years since Spain lost its triple-A sovereign debt rating, Europe's economy remained blighted by below-trend growth prospects and the spectre of deflation. Despite this, equities were five years into a strong recovery (SXXP + c.95% from 2009 trough). In the first half of 2014, primary market activity was also resurgent, with corporates and private equity sponsors taking advantage of buoyant equity valuations. As of summer 2014, volatility across a broad range of asset classes was also at depressed levels as the pre-crisis 'Great Moderation' reasserted itself.

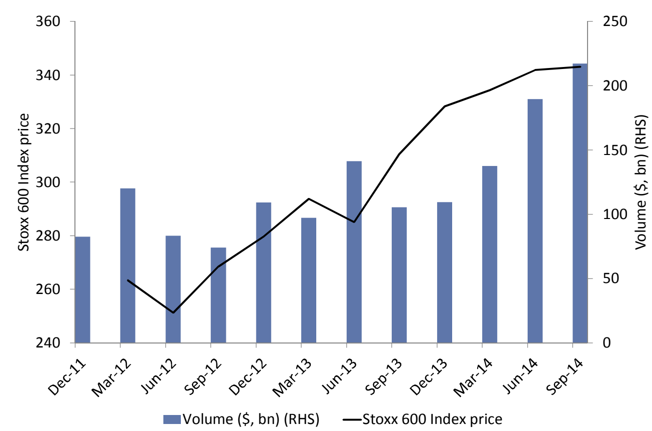
As 3Q drew to a close, cracks started to appear. As we publish this, both survey indicators and hard data across the Euro area continue to surprise to the downside. Indeed, Goldman Sachs' own RETINA tracker suggests -0.15% growth in the Euro area in the third quarter. Europe's position at an economic crossroads is becoming increasingly clear. For more information on the macro and market backdrop, see *GOAL: Adventures in Wonderland* (October 21, 2014).

Exhibit 3: GDP: Europe continues to languish
GDP growth over time (%)



Source: World Bank, Goldman Sachs Global Investment Research

Exhibit 4: Resurgent equity valuations in first three quarters of 2014 led to increases in primary activity
SXXP vs. M&A volumes

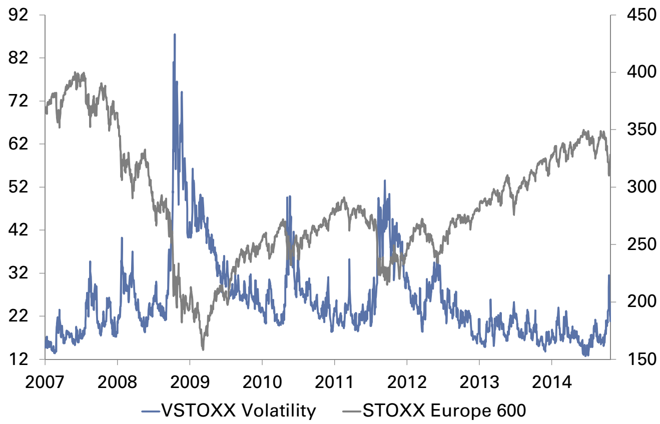


Source: Bloomberg

At this point, many are also left wondering if, in tackling its economic challenges, Europe has missed an opportunity to address the bigger structural headwinds that it faces. A lack of ICT graduates, cumbersome labour market regulations, demographic shifts, the brain drain, high energy costs, and fragmented markets for products and services were all concerns that were frequently raised. None of these challenges is new. What is new, however, is that the economic foundation on which Europe has to build its solutions is now much weaker than in the pre-crisis period.

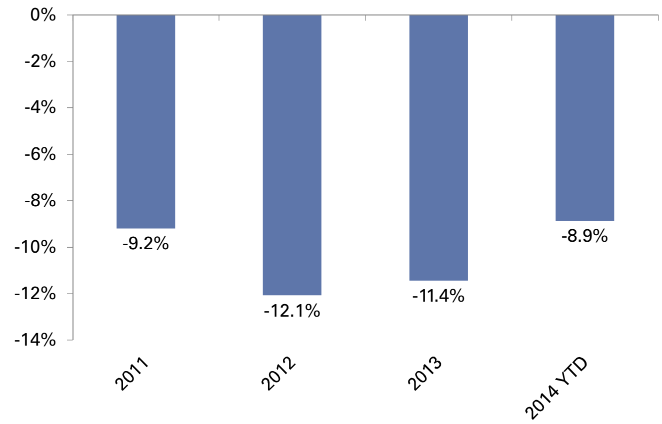
Among the CEOs we met, there was a general view that from here, the risks are asymmetric. If Europe falls into another recession, the consequences could be severe. While Europe's strong foundations have enabled it to weather two crises, there is a very real fear that these foundations could be severely damaged by a third.

Exhibit 5: Volatility was depressed and markets robust until the recent spike
European market volatility: VSTOXX Index



Source: Bloomberg

Exhibit 6: Over the past four years, earnings expectations have been revised down consistently in Europe
Stoxx 600 EPS revision – start of the year vs. end of the year (I/B/E/S estimates)



Source: Bloomberg

In this chapter:

We take a look at the current landscape in which European corporates do business and discuss some of the most prominent long-term features of that landscape, as identified by the companies we met.

One inescapable theme that was raised in many and varied guises was ***people***, both in their role as consumers and as employees, with **demographics** highlighted as a key theme in this area. The so-called '**skills mismatch'** was also addressed as an area of some concern, A related issue that infiltrated our conversations was **immigration and labour mobility**.

We also touch on the overall European policy environment and the extent to which the executives feel this influences the general **ease of doing business** on the continent. While many companies expressed an appreciation of the positive steps European policymakers have taken in tackling the crisis, there was a general sense of frustration about the pace of policy implementation at the European level.

The high (and disparate) **cost of gas and electricity** for industrial use across the continent was a source of increasing discontent, exacerbated by the shale revolution, which adds a further tailwind to US competitors.

Finally, at the end of this chapter, we turn to **financing and the flow of capital in Europe.** At one end of the spectrum, the corporates we met with expressed concern over the sustainability of very low credit costs in Europe. At the other end, there was unease that credit availability remains difficult in the SME segment.

Europe's people: Where 50 is the new 40

It is no secret that Europeans are having fewer children and living longer. The resultant demographic headwind is keenly felt by CEOs across the continent as they try to work out what their future customers and workforce will look like. With fewer people of working age, and older households potentially spending less, there is a direct challenge for growth. That said, if Europe can research and invest in 'solving' the ageing dilemma, from a policy and corporate planning perspective, it may well represent an opportunity for global leadership.

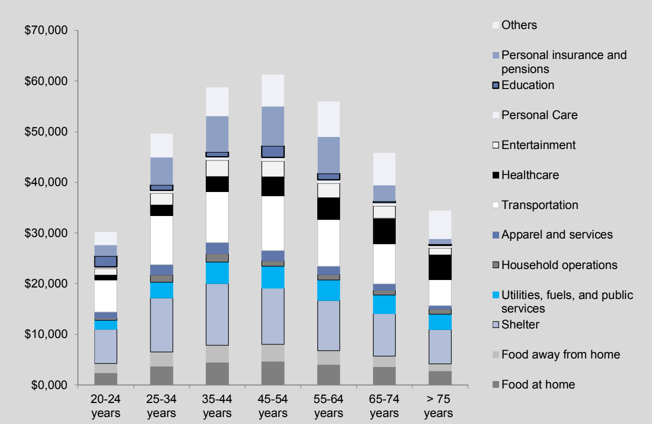
In 1900, the worldwide average life expectancy at birth was around 30 years of age. Today, according to UN figures, it is over 70 (79 across the OECD). This ageing population presents challenges for economic growth. There are now 600 million people on the planet aged over 65 (8% of the world; by 2035 it will be 13%) and half of the people that have ever lived to be over 65 are believed to be alive today. By 2050, those aged over 65 will outnumber children under five. Economies capable of growing their productive working population should grow faster, all else being equal. Although clearly there are complex relationships at play, and other factors of production (land, capital and enterprise) undoubtedly played a role, it is worth noting that between the 1970s and today, North America has outgrown Europe, when we consider its population has grown by c.50%, while Europe's has grown <20%.

Ageing is an even more pronounced phenomenon in Europe than it is across the world as a whole. The continent's working-age population has already peaked. Across the EU-28 in 2010, there were 310 mn people aged 20-64; in 50 years' time, there are expected to be 252 mn (UN Population Division). Correspondingly, the old-age dependency ratio is rising: from 26% in 2010 across the EU-27 (i.e. around four people of working age for every person over 65), it is expected by Eurostat to double by 2015. The worldwide dependency ratio was 16% in 2010 and it is expected to reach Europe's current ratio now by 2035. Most regions are ageing, with two broad exceptions – Africa and Latin America.

The implications of this demographic change are profound and numerous. The financial crisis has meant that Europe has – in some respects – had to accelerate its response to ageing. Many people are now working longer than they expected or planned as a result of changes in healthcare and pension provision, as well as the raising of retirement ages. This may be necessary to meet the long-term challenge, but raising the retirement age can be unpopular in the near term and has political consequences. It will also need to be combined with an increase in adult learning and retraining in order to develop a relevant skill set for this cohort; see next section, *A mismatch of skills and jobs*, for more.

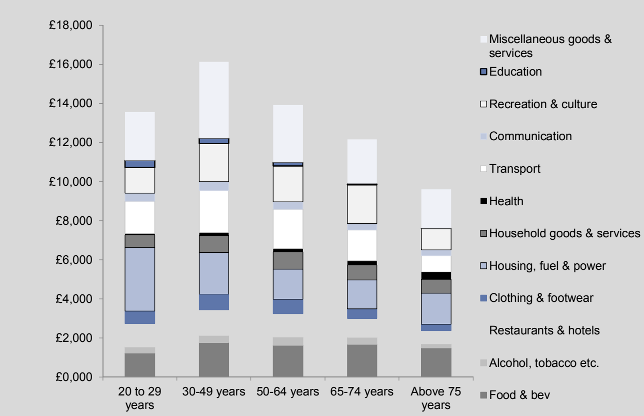
Consumption patterns are also an area of focus. Importantly – as shown below – historically, older households have spent less. In mix, studies show that spending on many common consumer items like clothes, cars, computers, travel and furniture all fall dramatically with age, while healthcare and prescription drug spend inevitably rises.

Exhibit 7: Spending falls…
US household expenditure by age of head of household, 2012-13



Source: BLS

Exhibit 8: …and the mix changes
UK household expenditure by age of head of household, 2012-13



Source: ONS

With appropriate education and skills-based training, and ongoing improvements in healthcare, there is every chance that the older cohorts in the future will spend more than current comparable groups. European corporates need to accommodate the tastes and preferences of these older groups in both their innovation and marketing spend.

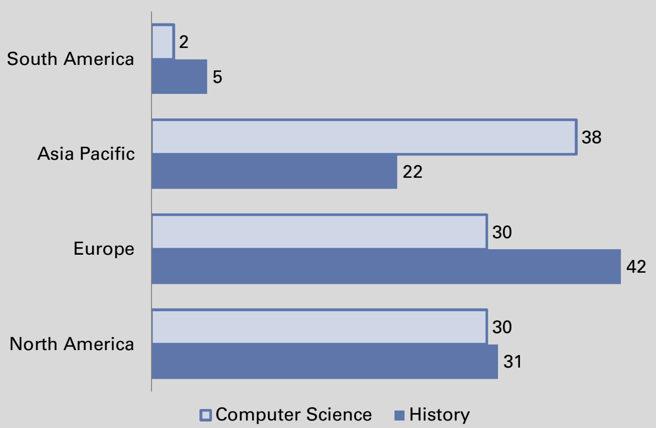
A mismatch of skills and jobs

A common theme across our conclusions is that Europe should focus on maximising the strengths it already has. However, the CEOs we spoke with were clear that the exception to this rule is in technology – here, no-one can afford to fall behind. So while education is, broadly speaking, a key strength for the continent, the lack of STEM skills is becoming a pressing problem. The employment profile is changing, and it seems clear that there is an important role for governments, corporates and universities to drive the agenda towards retraining and 'skills matching' in the region, as well as being able to bring in the right skills from elsewhere.

In July 2014, a CBI survey found that a quarter of UK employers that need technicians qualified in science, technology, engineering or maths (STEM) are experiencing difficulty recruiting. A third anticipated problems in the next three years. This reported 'skills gap' is broadly acknowledged as a Europe-wide issue: Eurofound's 2013 European Company Survey found that despite the slack in the labour market, 40% of EU companies have difficulties finding workers with the right set of skills, and here again, the problem is particularly acute when it comes to STEM subjects.

Exhibit 9: Are our universities sufficiently strong in computing?

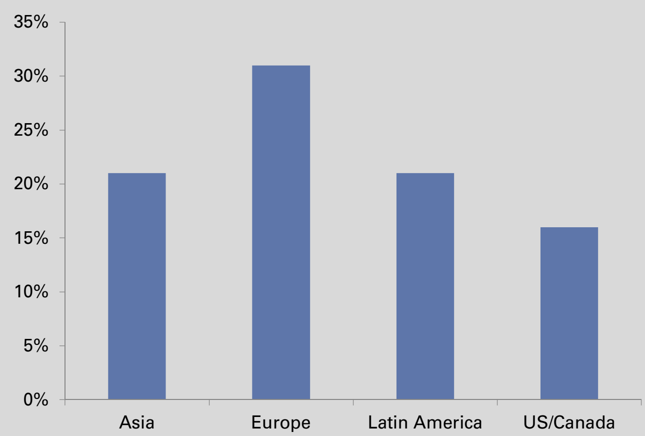
Number of top 100 universities in each region by subject, 2014



Source: Quacquarelli Systems (QS).

Exhibit 10: Levels of under-qualification most pronounced in Europe

Individuals whose skills and employment are mismatched (their qualification is at least a step below what is required by their job, using a 5-point ISCED scale), 2011



Source: European Commission.

The increasing 'skills gap' is a top priority for the EU. In its 2020 Strategy, the EC highlights the insufficient use of information/communications technologies as one of the key reasons for Europe's productivity gap relative to its main competitors. The accelerated displacement of many workers from declining sectors has underlined the importance of this challenge. Without the skills required to move into expanding sectors, these people remain unemployed. By 2015, there will be a shortage of ICT practitioners estimated at 384,000 to 700,000 jobs, jeopardising the sector itself but also ICT dissemination across all sectors of the economy, according to the European Commission. The mismatch between skills and available jobs also creates regional inequality: skills shortages and bottlenecks in high-growth areas contrast with areas of persistent high unemployment, without the two seeming to be able to combine successfully.

The development of technology renders jobs obsolete; it has done so for thousands of years. Retraining workers in sectors where employment is currently being replaced by automation helps to redress the balance of the situation. However, it is not enough to be reactive: in order to get ahead, Europe must look to the future and the next wave of technological employment displacement. What is new to this age-old problem is that the tasks in which machines can replace a human workforce are no longer just mechanical and physical, but intellectual too. The advance of computers, electronic communication and computerised big data threatens the large population of clerks, administrators, receptionists and secretaries. Barriers to computerisation include the need for creative intelligence (e.g. originality, knowledge of fine art) and social intelligence (e.g. perceptiveness, persuasion). Europe already has a strong legacy in education in the arts, but with Asian countries in particular improving their educational systems at a rapid rate, if this continent rests on its current system it will fall behind.

Immigration – a circuit-breaker for demographic headwinds?

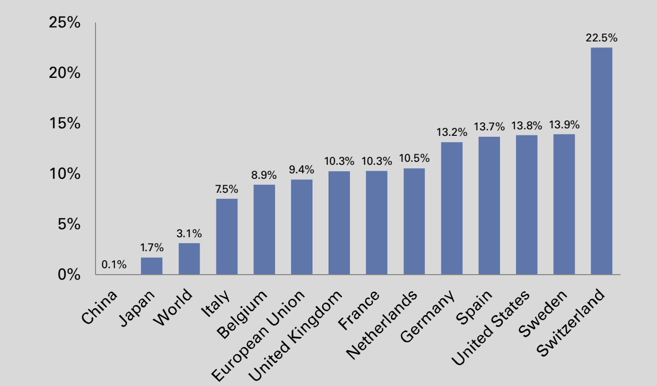
The two problems identified – demographics and skills mismatching – result in a struggle to staff businesses operating in Europe with the right skill level at the right cost, relative to other regions. Identifying and retaining talent throughout all layers of an organisation can absorb a substantial portion of management time. Being able to select the 'right' people from across the globe must be facilitated, but the rise of more far-right political voices in Europe raises the concern that the tide may turn away from increased labour market flexibility and mobility.

Having more economically productive people can only be a good thing for a region's growth. There are clear merits in attracting the right types of immigration, both into your country and into your region. Indeed, Europe's history has been shaped by migration for centuries and so-called 'replacement migration' is seen as one of the potential solutions to the demographic headwinds that Europe now faces. The recent backlash towards immigration policy in Europe has been well documented and can best be illustrated by the increased popularity of political parties supporting a tougher stance on immigration, most notably in the UK, France, the Netherlands, Switzerland and Austria. In February in Switzerland, a measure to reduce immigration quotas was imposed despite threats of penalties from the EU. In France in March, the anti-EU National Front party gained control of three times the number of municipalities as it had done in the 1990s. In the UK, there was the threat of legal action from the EC earlier in the year when attempts were made to limit welfare benefits to immigrants and in Germany, Angela Merkel has suggested that there will be attempts made to reduce the 'benefit tourism' the government believes has been seen in some cities where it is perceived that unemployed eastern Europeans have moved in to take advantage of schools, healthcare and the broader social benefits on offer.

Our recent meetings suggest that the business community is concerned that there are still labour shortages in many sectors and that without increased immigration among groups with the right skills, training and education, it will be difficult for Europe to stay competitive, especially in export-led countries like Germany. Indeed, many of the sectors in which Europe may hope to develop a competitive advantage are those in which we lack the necessary skills base. It is clear that attracting the right types of labour (workers with skills in which Europe suffers a deficit) requires the appropriate types of policy to support hiring and encourage mobility both to and within Europe.

Exhibit 11: Overall, the EU lags the US in terms of migrant populations…

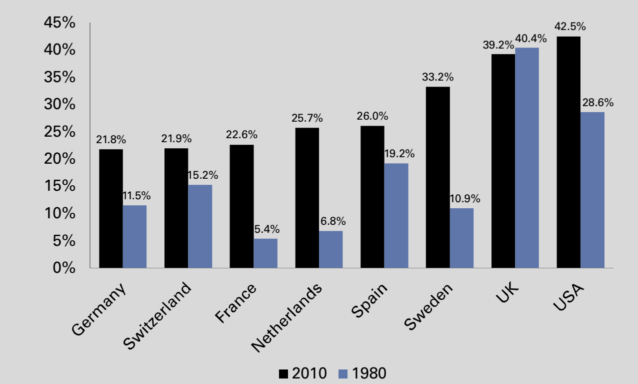
Migrant stock as a % of overall population, 2010



Source: World Development Indicators

Exhibit 12: …particularly when it comes to highly educated migrants

Highly educated migrants as a % of overall migrant stock



Source: World Development Indicators

Immigration can be a huge positive for growth and competitiveness. The UK's Centre for Entrepreneurs recently published a report highlighting that in the important SME segment (responsible for 60% of private sector employment in the UK overall), immigrants are responsible for 14% of all newly created jobs. If appropriate immigration policies are coupled with flexible and open labour markets, even when downturns hit and jobs are reduced, the results can be positive. Ireland offers a case in point. Having opened up its labour market in 2004 when eight countries joined the EU, by 2008, 15% of the Irish population was foreign-born and contributed to the economy's significant demand boost in the boom years. When the downturn hit, the outflow of migrants back to their home countries to the tune of 20,000 reduced the unemployment rate by 1 percentage point.

Ease of Doing Business – a pleasure doing business with you

In a broad sense, the managers we met expressed a view that simply doing business in Europe is much more difficult than in other places. The US and Asia were frequently cited as being more business-friendly. Survey data appears to bear this out. It also – importantly – highlights the wide differences that exist within Europe. For European companies to gain a pan-continental scale advantage, the gaps between member states and also between regions within those states clearly need to be closed.

As of June 2013, the World Bank's 'Ease of Doing Business' index saw the Euro area fare relatively poorly, although in broader Europe, Denmark, Norway and the UK all ranked in the top 10 countries in the world. The World Bank index ranks countries across ten topics: starting a business, dealing with construction permits, getting electricity, registering property, getting credit, protecting investors, paying taxes, trading across borders, enforcing contracts and resolving insolvency. Some of Europe's major economies score poorly in key areas. Germany for example, came 21st overall, including ranking 111th on the ease of starting a business and 81st in terms of registering property. France ranks 38th and Italy 65th. While no survey can be exhaustive, in general, a high ranking means that the government has created a regulatory environment conducive to operating a business. The wide variability of overall ranks across Europe suggests that the idea of a single market for business and entrepreneurs is still a long way from being a reality. While it takes over a month to start a business in Poland, it takes less than five days in Belgium. It can take nearly two years to get a construction permit in Cyprus, compared with 66 days in Finland. To import products into Slovenia requires eight different pieces of documentation versus two in France; the discrepancies are numerous and wide-ranging.

Exhibit 13: The Euro area scores relatively poorly on 'Ease of Doing Business' metrics. Germany – for example – features in 21st position overall, and 111th on opening a business

OECD high-income countries' comparative ranking on the World Bank Ease of Doing Business index, June 2013

Economy	Ease of Doing Business Rank	Starting a Business	Dealing with Construction Permits	Getting Electricity	Registering Property	Getting Credit	Protecting Investors	Paying Taxes	Trading Across Borders	Enforcing Contracts	Resolving Insolvency
Singapore	1	3	3	6	28	3	2	5	1	12	4
Hong Kong SAR, China	2	5	1	5	89	3	3	4	2	9	19
New Zealand	3	1	12	45	2	3	1	23	21	18	12
United States	4	20	34	13	25	3	6	64	22	11	17
Denmark	5	40	8	18	7	28	34	12	8	32	10
Malaysia	6	16	43	21	35	1	4	36	5	30	42
Korea, Rep.	7	34	18	2	75	13	52	25	3	2	15
Georgia	8	8	2	54	1	3	16	29	43	33	88
Norway	9	53	28	17	10	73	22	17	26	4	2
United Kingdom	10	28	27	74	68	1	10	14	16	56	7
Australia	11	4	10	34	40	3	68	44	46	14	18
Finland	12	55	36	22	26	42	68	21	9	8	3
Iceland	13	52	41	1	12	42	52	37	50	3	11
Sweden	14	61	24	9	38	42	34	41	6	25	20
Ireland	15	12	115	100	57	13	6	6	20	62	8
Taiwan, China	16	17	7	7	31	73	34	58	18	84	16
Lithuania	17	11	39	75	6	28	68	56	15	17	44
Thailand	18	91	14	12	29	73	12	70	24	22	58
Canada	19	2	116	145	55	28	4	8	45	58	9
Mauritius	20	19	123	48	65	42	12	13	12	54	61
Germany	21	111	12	3	81	28	98	89	14	5	13
Estonia	22	61	38	56	15	42	68	32	7	26	66
United Arab Emirates	23	37	5	4	4	86	98	1	4	100	101
Latvia	24	57	79	83	33	3	68	49	17	21	43
Macedonia, FYR	25	7	63	76	84	3	16	26	89	95	52

Source: World Bank.

Decision-making in Europe

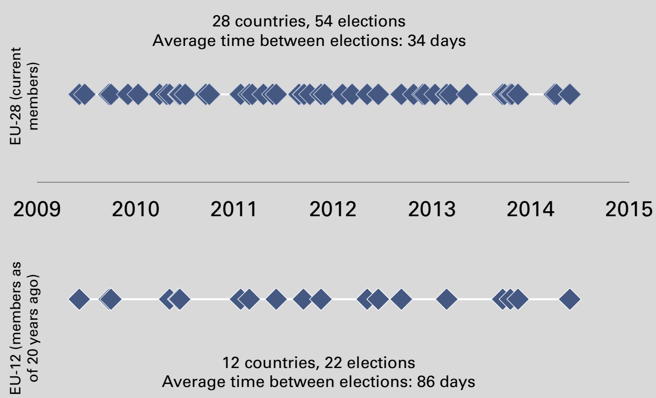
Across our discussions, we encountered a general frustration about the inefficiency and slowness of European decision-making and the legislative process. There is a sense that the European Union is too bureaucratic and stifles pragmatism and nimbleness at the national level. While some of this may be the unavoidable consequence of operating in accountable democracies, it was felt that progress could be made in efficiency in this area without impacting on democratic legitimacy.

Many of the CEOs we spoke to considered Europe's political stability to be a key strength as an operating base: countries in the European Union are unlikely to be transformed overnight. However, many felt that this went in many cases too far, with European national and supra-national bodies taking too long to work. While it is obviously important to reflect and consult before taking decisions, the periods taken to do this seem to be too long and too often run over. Further, many executives felt that the potential positive power of a body such as the EU was limited by the degree of self-interest of the members, which failed to prioritise European long-term interests over national short-term interests sufficiently.

Beyond the effect of the general attitude, there seem to be a few administrative factors that may be exacerbating this problem. It is little wonder that decision-making at the European level is stymied when we consider the conflicting and overlapping electoral cycles of the member states. Individual nations clearly hold their own elections during the term of a European parliament: there is almost one national election a month. Given that national elections involve a heightened political atmosphere that elicits popular promises from politicians and also demands their attention, and the run-up period lasts perhaps six to nine months, as many as a third of the nations of the EU-28 are distracted by home elections at any one time. Further, as we explore in later section *The risk of getting it wrong*, parties projecting a Eurosceptic or even anti-European message are rapidly gaining in popularity, making pro-European actions during election periods potentially risky.

Exhibit 14: EU expansion over the past 20 years has led to near-constant national elections

EU national elections across the latest term of the EU Parliament

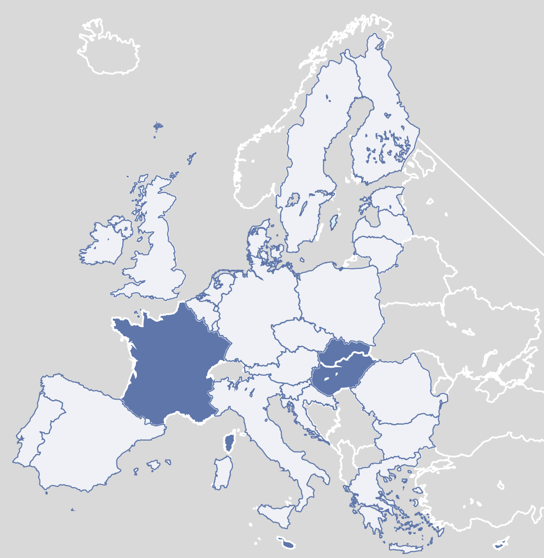


EU national elections (parliamentary or presidential only) across the term of the European Parliament elected 2009; EU-12 members vs. EU-28 members

Source: Compiled by Goldman Sachs Global Investment Research

Exhibit 15: The current political climate seems to favour coalitions, lessening the voting and legislative power of the government

Majority (dark blue) vs. coalition (light blue) governments across the EU



Source: Compiled by Goldman Sachs Global Investment Research

In addition, the sitting governments on the continent are overwhelmingly coalitions, as opposed to majorities. Again, this should ensure a broader degree of democratic representation, but also diminishes the power of governments to act quickly, instead requiring time and compromise (some of the executives we met feel this may be over-compromise) to achieve the support needed to pass any legislation.

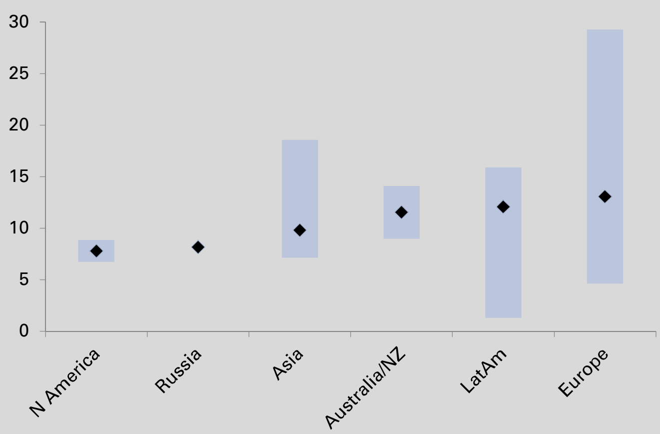
The high and diverse costs of energy in Europe

High energy costs in Europe have become the subject of much discussion in recent years. This was borne out by our meetings with CEOs. One implication of the US shale revolution is that energy-intensive industries (manufacturing, agriculture) in Europe have become less competitive relative to their US counterparts. The impact on corporate investment decisions is manifest. For energy-intensive production, locating in the US appears to make sense, just as locating in Asia often makes sense for labour-intensive activities.

European industrial electricity prices are clearly high in a global context. Our Utilities team highlights three key factors driving high European electricity prices:

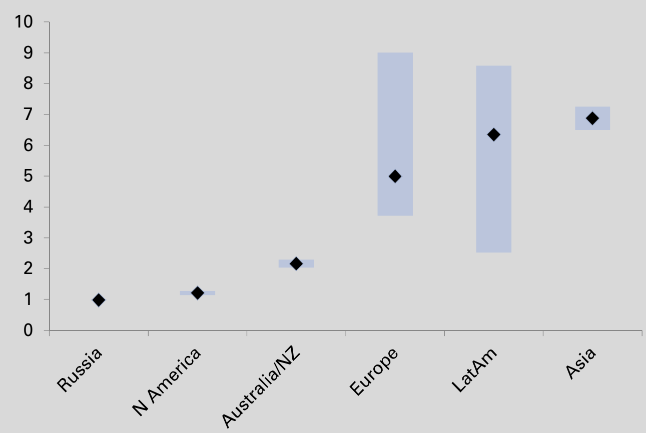
- **Renewable costs:** The size of the renewable base and the structure of the subsidies differ on a national basis across Europe. For example (according to the BDEW (Bundesverband der Energie und Wasserwirtschaft e.V.)), the annual cost to the public of renewable capacity in Germany reached c.€24 bn per annum in 2014 and this estimate is likely to rise over time, reflecting further growth of the renewables base and the associated required network investments. In Germany, renewable costs are recovered primarily by household tariffs and this often explains the large difference between household tariff levels and industrial prices. Renewable costs in Europe as a whole are also higher than in other regions. In effect, until storage solutions get better, during the transition to renewable energy sources, two generation systems need to be supported.
- **High gas prices:** European gas prices are well above the US level but below the level in Asia/Latam. As shown below, Europe's gas prices are a multiple of those in the US. Beyond industrial use, gas pricing is important as a price-setting fuel in the power markets in the UK, Belgium and Italy. Our Utilities team also expects gas to increasingly play a role in other parts of Northern Europe, such as Germany, Austria, Holland and France).
- **Price of carbon emissions:** European power markets reflect carbon costs as set by the European Emissions Trading System for carbon emissions. Although pricing for carbon is currently at much lower levels than historically (€6/t vs. up to €30/t in the past), it is still material for some power markets (for example, our Utilities analysts estimate it increases wholesale power prices in the Nordic markets by c.15%).

Exhibit 16: European corporates are subject to high and widely varying electricity prices…
Industrial electricity price (USc/kWh), box: min to max; star: median, 2012



Source: UK Department of Energy and Climate Change (DECC), IEA

Exhibit 17: … and gas prices
Industrial gas price (USc/kWh), box: min to max; star: median, 2012



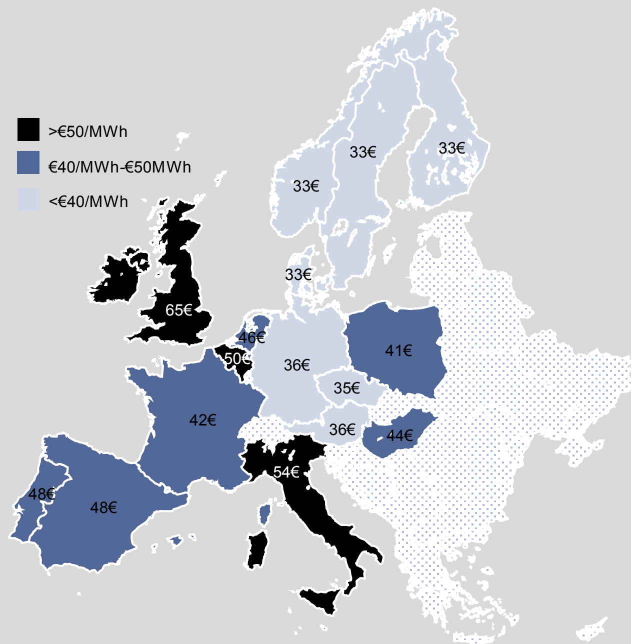
Source: UK Department of Energy and Climate Change (DECC), IEA

The problem of the high relative cost of energy in Europe is exacerbated by the shale revolution in the US. This is having real impacts on the investment decisions of European companies. This summer, for example, Voestalpine announced that it would build a plant in North America that would employ natural gas in the production of raw iron then to be used in the company's European blast furnaces. Meanwhile, BASF has said that it will build a new plant in Louisiana to take advantage of the lower energy costs and remain competitive. Harald Schwager, a member of the executive board at BASF, said: "We Europeans are currently paying up to 4-5x more for natural gas than the Americans.

Energy efficiency alone will not allow us to compensate for this. Of course, that means increased competition for all the European manufacturing sites" (quoted in The New York Times, December 2012).

Climate change policies, coupled with these high energy prices, have made energy efficiency improvements an area of increased focus in Europe. Evidence from the EC 2014 Competitiveness Report suggests that across the continent, improvements in industrial energy efficiency so far have been insufficient to offset increases in the cost of energy for industry. Indeed, the report finds that despite energy cost shares being relatively small compared with other cost components (at an aggregate level), their growth had a significant negative impact on export competitiveness. If energy efficiency can compensate for energy costs, in terms of international competitiveness, this is yet to materialise.

Exhibit 18: Wholesale power price differences within Europe are material (up to c.100% difference)
Power market prices across different regions in Europe in €/MWh, 2012



Source: Platts, Nasdaq.

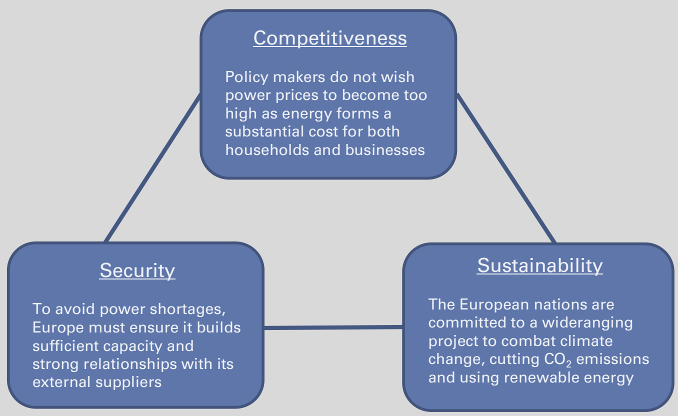
The Energy Trilemma

The impossible trade-off between three goals faced by the energy sector has kept corporates, governments, economists, engineers, NGOs and consumers in constant debate over the past few years in Europe as to how best to meet our energy needs now and in the future. The 'trilemma' in question is the balance between energy security, social impact (i.e. costs to consumers) and the environmental considerations of energy policy.

Over time, the emphasis in Europe has shifted: during the relatively prosperous years pre 2008, the emphasis was on environmental sustainability. As the crisis hit and companies and consumers were forced to turn their attention towards costs, affordability came to the fore. More recently, given geopolitical unrest in Russia and warnings from large utility companies about the reliability and availability of capacity, more weight has been given to security of supply, although some corporates felt this was not happening quickly enough.

When it comes to **de-carbonisation,** there is a clear push towards solar and wind sources to help cut carbon emissions and keep the spirit of the Kyoto Protocol alive (currently, 80% of Europe's energy comes from burning of fossil fuels). The scientific community believes reducing carbon dioxide emissions is an essential part of lessening the destructive impact of climate change and as a result the world's governments have hundreds of different policies in place to reduce carbon footprints. These directives are not cheap: China, the US and the EU together spend $140 bn a year subsidising renewable energy. One of the many challenges of a renewable energy policy is that legacy energy systems need to be run and maintained alongside renewable development until we find reliable storage and distribution solutions for the renewable capacity. Paying for two systems simultaneously is a cost that consumers, corporates and governments are not keen to bear.

Exhibit 19: Satisfying conflicting demands – energy policy must be all things to all people
The energy trilemma



Source: Goldman Sachs Global Investment Research

This leads us on neatly to **affordability** for end consumers (both individual and corporate), which has unsurprisingly taken on a new importance for governments looking to please the electorate post the financial crisis. Here, it is also worth noting the huge differences in prices – both retail and wholesale – that exist across Europe and the differences that exist even intra-country, in many cases as a result of the lack of connectivity of the European energy markets.

Finally, the increase in geopolitical risks in the past year has brought back to the fore the third element of the trilemma, **security of supply** (which is essentially the question of whether a country can be sure of having sufficient energy to run). Europe's major economies are highly dependent on energy imports.

The question of how we source and use our energy is a complex issue with many variables and a range of vested interests at play. Even those initiatives that seem broadly supported, such as electric cars, spark heated debate. It is difficult, if not impossible, to establish certain figures about total cost (including production of the car, of the energy, and of the systems needed to charge and fuel vehicles) and emissions (which must include those generated in the making of the cars themselves and the making of the electricity, the methods for which vary across geographies), let alone these figures by country.

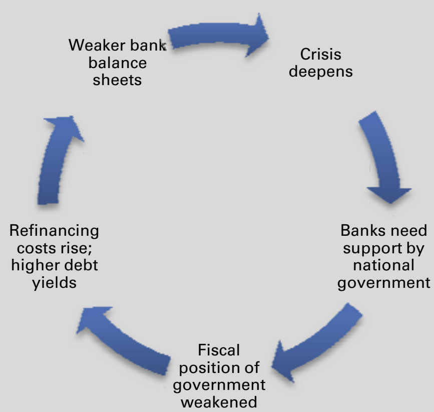
Sovereign debt and the banking union

Corporate experiences of the sovereign crisis varied widely and were largely conditioned by where companies are domiciled and listed. Rating agency rules relating to the link between corporate and sovereign ratings have meaningfully affected the corporate planning of a number of firms in recent years, with financing rates inextricably linked to the health of the national balance sheet. Putting institutions in place to avoid such a vicious circle of interdependence between corporates, banks and sovereigns in future is likely to be a crucial step in Europe's path to recovery.

The Euro area has been caught in a negative feedback loop between sovereign and bank balance sheets. Banking problems weaken sovereign balance sheets given the (often implicit) government guarantees provided to the financial sector, while banks typically hold a significant portfolio of domestic sovereign debt, such that a weakening of the sovereign balance sheet may raise concerns about the solvency of banks.

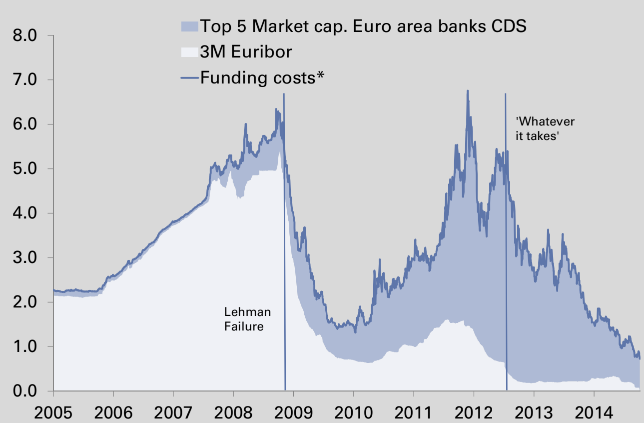
This negative feedback loop can have significant impacts on corporates. It affects listing destinations (consider Prada's decision to list in Hong Kong rather than in Italy) and can have significant impacts on strategic planning. Under the rules of most rating agency systems, corporates cannot have a credit rating more than two notches above that of the sovereign in which they are domiciled. This can have meaningful implications for the real economy. On July 6, 2012, our Telecoms team discussed the predicament with respect to Telefonica (a company which – at the time – derived <30% of EBITDA from Spain) in their note *Southern Europe: Adequate liquidity, inadequate growth*. TEF's subsequent sale of assets to shore up its balance sheet appears to have been a response to these concerns.

Exhibit 20: A vicious circle exists between sovereign and corporate balance sheets
The cycle of bank and sovereign dependency



Source: Goldman Sachs Global Investment Research.

Exhibit 21: Banks' funding costs have fallen significantly since the announcement of banking union
%pa, *Funding costs = Banks 5yr CDS + 3m Euribor



Source: Goldman Sachs Global Investment Research

As discussed by our Economists in Banking union at two: Cautious optimism and a cautionary tale (July 3, 2014), breaking this bi-directional link, and thereby establishing a 'level playing field' for Euro area banks independent of their domicile and associated links to specific sovereign credits, is seen as an essential support for financial stability, better integrated markets and effective monetary policy transmission. At the EU summit of June 28-29, 2012, recognising the "imperative to break the vicious circle between banks and sovereigns", the creation of a banking union was announced, among other measures. Three objectives were identified: (1) making the Euro area financial sector more stable and resilient; (2) overcoming cross-country segmentation in Euro markets; and (3) providing a framework for dealing with legacy problems so as to exit credibly from the financial crisis. The Banking Union came into effect on November 4, 2014, with the ECB becoming the lead supervisor for Eurozone banks under the Single Supervisory Mechanism (SSM).

The easing of this financing headwind in the past 18 months was cited as a particular positive during our meetings in peripheral Europe.

Financing corporate Europe – is capital getting to where it needs to be?

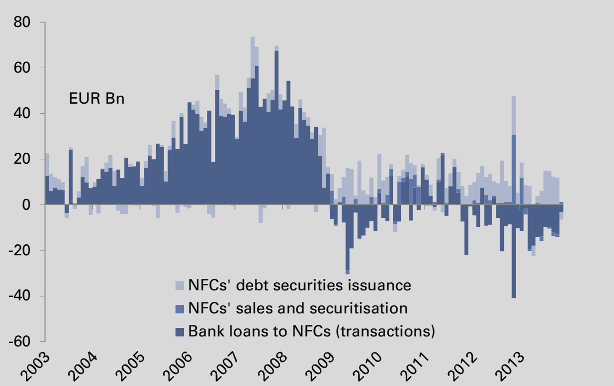
It is no surprise that the financing landscape was a topic of conversation in all the meetings we hosted. Over the course of the crisis, bank disintermediation led larger European corporates to access the listed debt market to an ever-greater extent. This dovetailed conveniently with investors' search for yield, which has resulted in falling financing costs for listed firms. Meanwhile, smaller companies in need of finance continue to struggle; too often their domicile rather than the soundness of their business determines whether they can access capital, and on what terms. The banking union, an increasing level of support for SME securitisation and more financial innovation (e.g. peer-to-peer lending) all offer green shoots. Even large corporates have a clear interest in these mechanisms working.

An inability to raise finance was seldom mentioned as a headwind for the corporates we met. Indeed, there were some expressions of concern about just how low the rates of financing have become across the listed credit market, even for businesses perceived to be of inferior quality. Several of the executives we met raised the issue of depressed risk pricing across the market and cited the unsustainability of current debt financing costs as a potential emerging risk. This fear of 'bubble-like' conditions emerging may well be one of the factors limiting the degree of investment being undertaken by European corporates.

While the large listed corporates that we met are not – in general – experiencing direct funding tensions themselves, the second-order effects of weaker credit availability for Europe's SMEs remain a concern. Given that in absolute number, more than 99% of the companies in Europe are SMEs and they generate around two-thirds of all jobs, it is essential that financing feeds through to these companies as well as the larger listed entities.

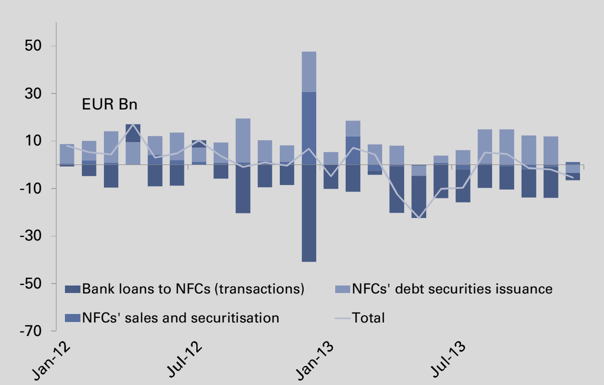
Lending and disintermediation: One logical outcome of reduced leverage in the banking sector has been the substitution of corporate financing into securities issuance ('disintermediation'). From its peak at the end of 2008, the stock of bank loans to NFCs has fallen by more than 10%, whereas the stock of outstanding debt securities issued by NFCs has risen by more than 50% over the same period (admittedly from a much lower base). Broadly speaking, across our coverage universe in Europe, around 50% of debt outstanding consists of listed debt (up from c.40% in 2007). According to February 2014 data from the ECB, the stock of outstanding debt securities issued by NFCs amounts to c.€1.1 tn, less than 20% of outstanding corporate external debt financing in the Euro area. This represents a much smaller share of overall corporate financing than in the US and demonstrates that the overall European corporate sector (and wider economy) is still highly dependent on the bank lending channel.

Exhibit 22: By all accounts, the credit market has done a good job of absorbing loan demand in Europe…
Proportion of debt by channel



Source: ECB, Goldman Sachs Global Investment Research

Exhibit 23: …although this hasn't helped SMEs to the same extent as larger corporates
Proportion of debt by channel



Source: ECB, Goldman Sachs Global Investment Research

European bank lending volumes fell significantly during the crisis. The most meaningful implications were for SMEs, which were often unable to access the listed debt markets. This clearly struck at the heart of the European economy, given that SMEs contribute more than half of the total value added in the non-financial business economy and have provided 80% of all new jobs in Europe over the past five years.

Capital and investment flows – a crisis of confidence

When speaking with corporates in Europe's periphery, it is clear that external capital flowing into the region can create (and is creating) a virtuous circle of increased confidence. There have certainly been signs of this in Spain. To a point, corporates draw confidence from the fact that investors are starting to return, and high-profile investment flows also help to build the all-important confidence of citizens and consumers. Mechanisms that increase the flow of capital to the most productive uses across the whole of Europe, regardless of national boundaries, must be encouraged.

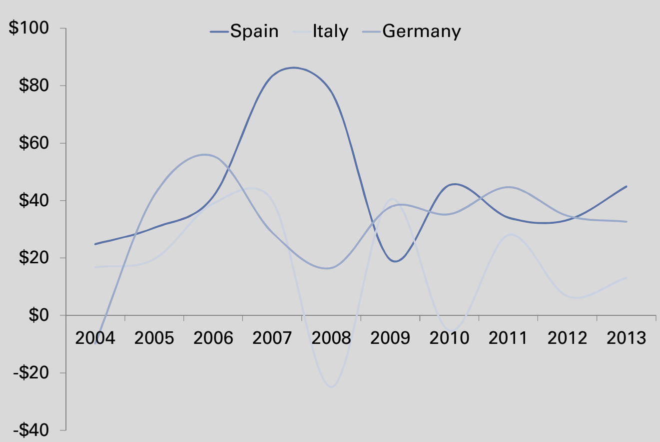
A number of the CEOs we met highlighted that attracting foreign capital and investment flows had catalysed a meaningful pick up in confidence in the region, particularly in the European periphery. The real question now is whether this capital is here to stay. One source of hope when it comes to ongoing capital support for the periphery is the creation of the European banking union, which our analysts expect will lead to a flow of deposit capital from the core to the European periphery. In the words of ECB president Mario Draghi: "With a European supervisor, borders will not matter. Issues such as … ring-fencing of liquidity will not be relevant." (February 12, 2014).

Crucially, corporates are looking to Spain as an investment destination. The autos sector offers a case in point. GM invested €165 mn in its Figueruelas plant in 2013 and plans to spend another €210 mn this year. Renault will create 250 jobs in its Valladolid factory in 2014 as it increases output. Overall, gross foreign direct investment (FDI) into Spain rose 8.8% in 2013 to €15.8 bn and the rise in net investment after deducting divestments was 36.3% higher, at €11.9 bn. In part, the return of investment reflects the reduction in wage costs. While wage growth across the OECD has been relatively flat in the past two years, Spain's salaries have continued to fall an average of 2% a year since the country's economic crisis began, according to the OECD's 'Employment Outlook 2014'.

See *Liquidity without borders: Eurozone's resolve for cross-border banking* (February 25, 2014) for a full discussion from our Banks team.

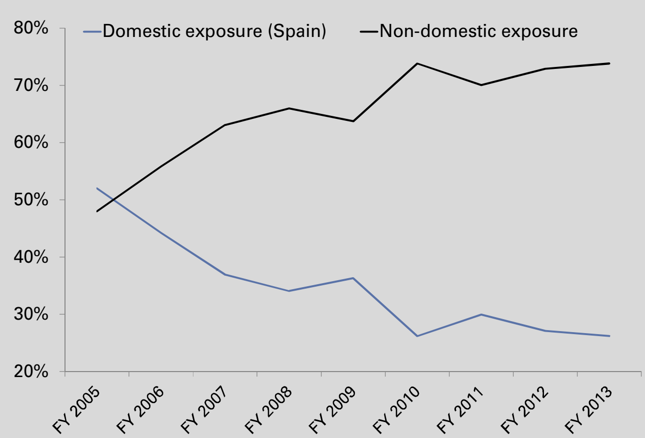
We would also highlight activity in Spanish financial markets, where the return of investor capital is not only evident in the performance of the equity market, but also in the actions of private equity firms. Earlier in 2014, Cinven agreed to buy the fibre telecom network of Spanish utility Gas Natural for $510 mn. High-profile investors like Bill Gates and George Soros, who have both invested in Spanish construction giant FCC over the past year, also improve broader perceptions of the health of the economy and corporate sector. A number of hedge funds were also among backers of the Spanish property investment trust Hispania Activos Inmobiliarios in February.

Exhibit 24: FDI flows into the periphery started to turn in 2013
FDI: New investment inflows less disinvestment, $ bn



Source: World Bank.

Exhibit 25: IBEX performance tends to track sovereign spreads and confidence in periphery growth, despite the high level of non-Spanish sales.
Domestic vs. international revenue exposure, IBEX 35



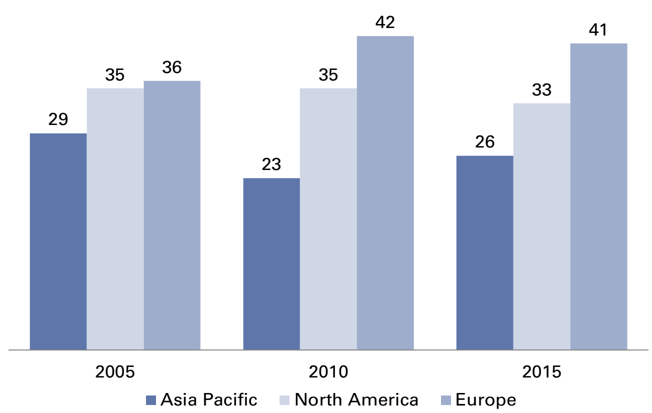
Source: Bloomberg.

Europe's strengths

Standing on the shoulders of giants: While the current macro picture might look disheartening, there remained a strong sense in our dialogues with executives that Europe's 'invested capital base' is still an area of profound and broad-based strength.

Europe ranks as the second-largest market in the global asset management industry. The continent also remains a clear leader in tertiary education and enjoys a stable political environment. In a world increasingly centred on large international hub cities, Europe has the advantage of being home to a substantial number of these.

Exhibit 26: Europe still holding its own in higher education
Number of universities in world top 100 by region



Source: Quacquarelli Systems (QS)

Exhibit 27: Free and fair (relatively!)
Ranking of 115 countries for democracy (politics, gender, economy, knowledge, health and environment)

	2010	2011	2012	2013
Sweden	2	2	2	2
Switzerland	4	4	4	4
Netherlands	7	7	6	6
Germany	9	9	8	7
Belgium	13	13	12	10
United Kingdom	10	10	13	14
United States	15	15	15	15
France	17	17	17	16
Spain	16	16	16	17
Japan	20	20	20	20
Italy	26	27	29	29
China	97	101	99	107

Source: Global Democracy Ranking

In common with the rest of the world, Europe was of course badly buffeted by the financial crisis. Subsequently, a powerful aftershock – in the form of the sovereign crisis – struck the very foundations of the European project, highlighting both a lack of convergence and a lack of integration between the member states. It threatened to up-end the vision of monetary union. But throughout this turbulence, several of Europe's industries continued to demonstrate global leadership. Europe's educational establishments continued to top global tables. Tourists from around the world continued to visit. Many of Europe's strengths have been built up over many decades, or indeed centuries. The weight of heritage that underpins much of its tourism, as well as its dominance in luxury goods, has – it seems – been largely unruffled by recent events.

And *within* Europe, positive steps continue to be taken in some key areas. Trade between member states continues to rise, with the harmonisation of product standards, for example, increasing the confidence that consumers across the union can have in buying from abroad and seeking the best deal.

In this chapter:
Europe clearly has many strengths. One conclusion from our meetings was that Europe needs to refocus on these areas of strength, and to capitalise on its advantanges. Rather than trying to be all things to all people, Europe needs to increase its degree of specialisation.

Here, we touch on these areas of strength. In particular, we highlight the attraction of **Europe as a destination for tourists and for students**. It is also clear that Europe is not just a destination for people, but also for wealth. A third of the world's AUM is run from Europe. The strength of governance and the low corruption levels in Europe support ongoing inflows, particularly in a world blighted by geopolitical unrest. We also leverage Goldman Sachs' Competitive Positioning frameworks to understand where European companies exhibit **global industry leadership**.

Europe as a destination

While Europe's heterogeneity often leads to frustration for corporates trying to launch new products, buy advertising space or meet varied consumer preferences, it is this very diversity across the continent (in culture, language and history) that makes it an attractive visitor destination in a global context. In trying to reduce barriers and increase integration between member states, it is important not to 'throw the baby out with the bathwater', steamrolling some of the very things that make each country unique and attractive.

Europe is home to some of the most beautiful cities in the world: Paris, Rome, London, Barcelona, Stockholm, Vienna and more have been famed for aesthetic beauty, culture, heritage and architecture for centuries. Unsurprisingly, tourist numbers are high. London tops the charts as the number one city in the world by both visitor numbers and spending, with an impressive 19 mn visitors expected this year, spending around $20 bn, according to Mastercard's Global Destination Cities Index – a meaningful boost to the economy. A Deloitte survey commissioned by Visit Britain suggested that tourism is the UK's fifth-largest industry, supporting 3 mn jobs and 200,000 small businesses. Tourism is clearly an important driver economically but also socially and culturally for Europe and is fast becoming an industry with a real competitive advantage for the continent, especially as tourists from the emerging middle class take to the air in their millions, most notably of course from China. According to Hotels.com's Chinese International Travel Monitor (CITM) report published in July, the average Chinese overseas traveller spends RMB6,707 ($1,086) per day while on vacation, excluding accommodation costs.

Exhibit 28: European destinations hold their own in global travel

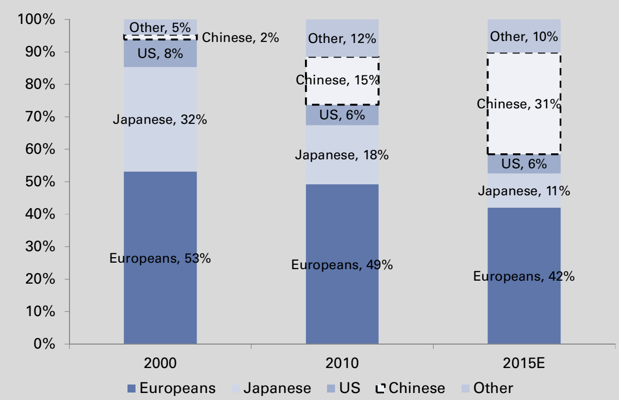
Most visited countries in the world by overnight visitors (mn); France figures from 2012

International Tourist Arrivals		
Rank	Country	2013 Visitors
1	France*	83.0
2	USA	69.8
3	Spain	60.7
4	China	55.7
5	Italy	47.7
6	Turkey	37.8
7	Germany	31.5
8	UK	31.2
9	Russia	28.4
10	Thailand	26.5

Source: UN World Tourism Organization © UNWTO, 9284403614

Exhibit 29: The Chinese customer is the biggest single spender in Europe, to be 31% of the European consumer base by 2015E from just 2% in 2000

Luxury goods consumer base in Europe in 2000, 2010 & 2015E



Source: Goldman Sachs Global Investment Research

Europe's popularity as a destination for the most populous country on the planet – China – will be fundamental for driving the tourism market on the continent, particularly as more and more young Chinese visitors come to Europe independently (rather than in pre-organised groups), stay longer and spend more money.

What does Europe need to do to attract (and prepare itself for) the potential influx of visitors? Schiphol airport offers a striking case study of a business that has geared itself up for a likely increase in Chinese visitors, with a free translation app for shops at the airport, handouts for Chinese new year in the arrivals hall, acceptance of Chinese currency and an impressive seven direct flights to Chinese cities operating daily. In Paris, stores like Printemps offer a dedicated entrance for Chinese groups. Harrods is also recruiting Mandarin-speaking staff.

When it comes to promoting tourism, possibly the most important thing Europe can get right at a continent-wide level is ease of access. The main obstacles in the existing system include long waiting times to get an appointment with consular offices, as well as for the visa to be issued, and the requirement to present a complex series of supporting documents. In a 2013 survey financed by the European Commission, approximately 30% of Chinese respondents perceived the supporting documents requirement to be highly problematic. A third of the Chinese travellers surveyed also feel that the time necessary to receive an EU visa is a problem to a high degree.

Educating the world

While acknowledging the skills mismatch in STEM that is currently top-of-mind for many companies in Europe – see earlier box *Europe: A mismatch of skills and jobs* – we also note that when it comes to tertiary education, many of Europe's institutions top global tables. The first- and second-order effects of increased foreign student numbers in Europe can be very positive. Increasing the 'stay rate' of the best foreign students should be a clear goal.

The number of higher education students worldwide is expected to quadruple from around 100 mn in 2000 to 400 mn in 2030, according to the European Commission. Europe currently attracts around 45% of all international students. Continuing to increase the absolute number coming to the continent should be a priority. Not surprisingly, most states have international student recruitment strategies in place. According to the EC's European Migration Network, several Member States (Finland, France, Ireland, Luxembourg, the Netherlands, Poland, Portugal and Spain) have already set targets relating to the number of international students. Poland aims to increase the share of international students from 1.4% in 2011 to 5% in 2020, Spain from 4.9% in 2012 to 10% in 2015, and Finland wants to increase the number of foreign degree students by approximately 77% to 20,000 in 2015. These targets are clearly also aimed at generating a positive impact on the states' economies given that typically, international students pay significantly higher fees than domestic students. Other countries have specific aims relating to the economic impact of international students (e.g. Ireland, which aims to raise the economic impact of international education to a total of €1.2 bn per year, an increase of €300 mn on current levels).

Exhibit 30: The preference of foreign students coming to the UK appears to be for strongly vocational education
Number of EU and non-EU students for courses in the UK, 2011-12

Subject Group	EU Students	Non-EU Students	Total
Business and administrative studies	15,185	42,220	57,405
Engineering & technology	6,795	19,490	26,285
Social studies	8,015	11,595	19,610
Creative arts and design	7,250	7,815	15,065
Law	3,735	8,440	12,175
Biological sciences	6,140	5,195	11,335
Subjects allied to medicine	4,870	6,185	11,055
Computer science	3,860	5,025	8,880
Languages	4,140	2,875	7,020
Architecture, building & planning	2,450	3,480	5,930
Physical sciences	2,605	3,065	5,675
Mathematical sciences	1,345	4,015	5,360

Source: UK Complete University Guide

Exhibit 31: The great majority of international students in the UK come from China and India
International UK students by country

Country of Origin	2010-11	2011-12
China	67,325	78,715
India	39,090	29,900
Nigeria	17,585	17,620
USA	15,555	16,335
Germany	16,265	15,985
Republic of Ireland	16,855	15,075
Malaysia	13,900	14,545
France	13,325	12,835

Source: UK Council for International Student Affairs

Based on the QS 2014/2015 ranking, four of the top ten global universities are in Europe (indeed, they are all in the UK). The other six are in the US. According to The Economist, a third of the top 100 schools for MBAs are also in Europe (2014).

A 2013 study by the European Migrant Network consulted 24 EU members to assess the economic impact of foreign students. Importantly, the 'stay rate' of foreign students has a big impact. In the Netherlands, tax revenue from foreign students is expected to reach €740 mn because of the 19% stay rate of international students. Fast-track student admissions systems are also quite common. So too are post-study work incentives, which channel foreign students into particular labour market gaps. Examples include establishing study programmes in necessary fields (such as nursing in Finland) and setting up mentoring programmes in the business sector.

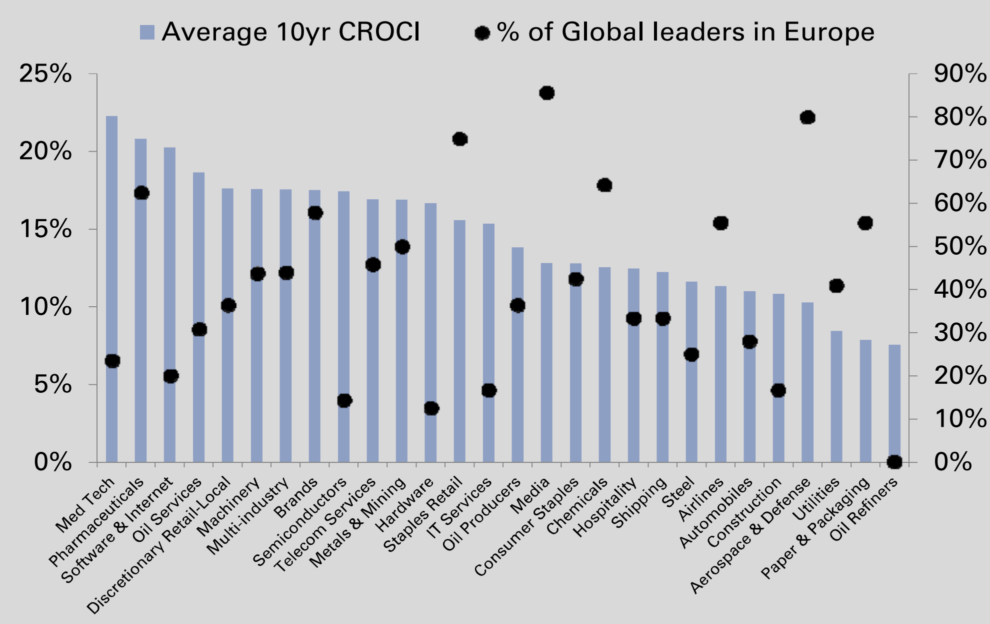
Where Europe leads the world

There are some areas in which Europe has maintained its competitive lead. A look through Europe's major exports alone tells a story, with the continent's well-established machinery and chemicals industries continuing to play a hugely important role. Goldman Sachs' proprietary frameworks for calibrating the quality of companies around the globe also paint a heartening picture, highlighting that many of the companies with the best opportunity set to compete in the global landscape are based in Europe.

Below, we show the percentage of companies in the top quartile of their industries' Competitive Positioning frameworks that are in Europe, along with the average ten-year CROCI of each industry (based on European data). Here, positioning is defined in sector-relative terms. While in telecoms, network quality may be a key determinant of a company's strength, in pharma, the exposure to patent expiry is included as a key measure. In each case, our analysts have established the vital ingredients for success and have ranked the companies in their global coverage accordingly.

As is clear, Europe contains a high number of global leaders across a variety of different industries, most notably aerospace & defence, media and staples retail. Chemicals, pharmaceuticals and paper & packaging also appear strong based on these global rankings. As is clearly illustrated, some of Europe's current strengths lie in low-returns areas. In other cases, areas where European companies currently lead are likely to be subject to rapidly evolving business models as a result of changing technology. Media and retail stand out in this regard. Based on our analysts' forecasts, both sectors are expected to see declines in CROCI over the next five years, whereas sectors like hardware and IT services (where Europe 'punches below its weight') are expected to generate increasing returns. The relative importance of these sectors clearly differs too. A strong position in pharma (an industry with 2014E aggregate EBIT of >€50 bn in Europe) is clearly worth more to the continent than a strong position in paper & packaging (2014E EBIT of <€5 bn).

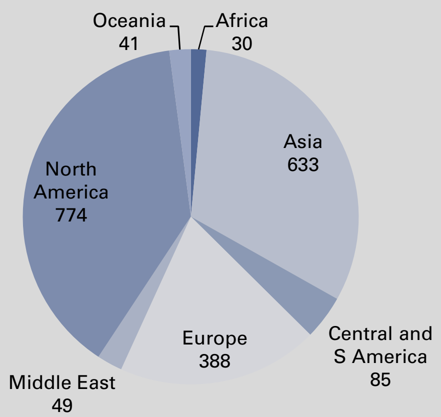
Exhibit 32: Europe suffers from having industry leadership in some low-returns industries
Percentage of top-quartile companies based in Europe; 10-year average European industry CROCI, 2014 (NB: Telecoms framework does not include the US)



Source: Goldman Sachs Global Investment Research

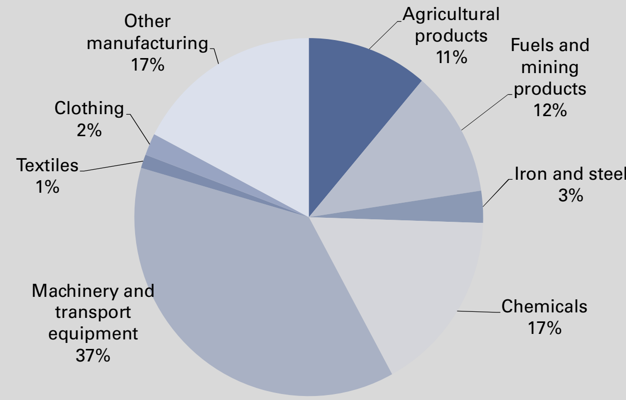
Many of Europe's most successful companies (often those topping the GS Competitive Positioning tables) are characterised by their ability to effectively redeploy capital into growing markets (from a geographic and product perspective) and to build moats or brands to protect their competitive advantage. Prudential is a great example of a business that has effectively recycled capital out of its European business and into Asia, as well as exporting its expertise and business model. In the case study that follows, we also look at the leadership Europe has in global consumer brands.

Exhibit 33: Europe contains fewer of the world's biggest listed businesses than Asia or North America
Proportion of 2,000 biggest listed businesses (by market cap) by region of domicile, 2014



Source: Bloomberg

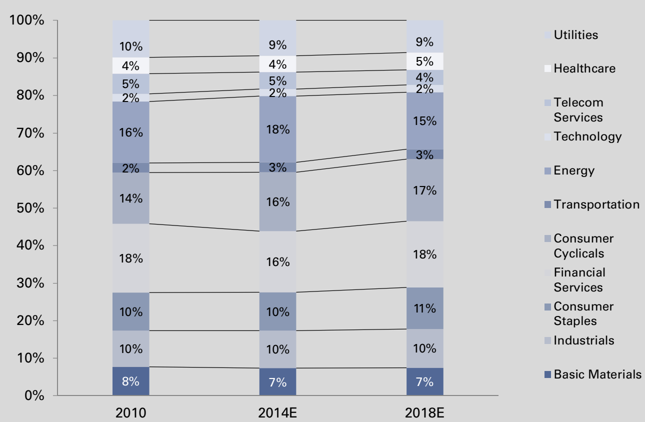
Exhibit 34: Europe's major exports – machinery and chemicals stand out
In USD at current prices, 2013



Source: WTO

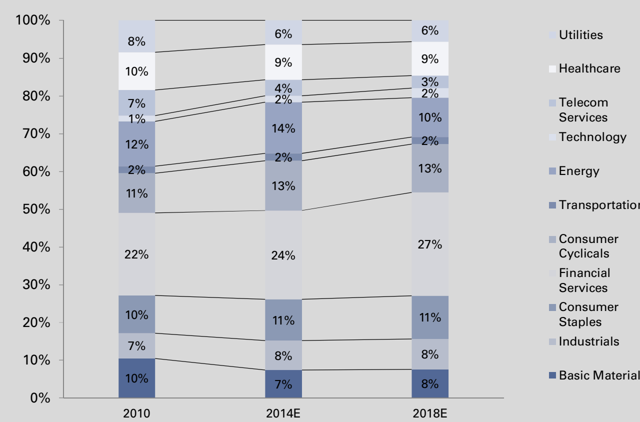
If growth in market cap is an indicator of market success, we note that in 2014, Europe is home to just 388 of the world's biggest 2,000 companies (by market cap). North America is home to 774 and Asia to 633. Over the past ten years, Asia has gained prominence at the expense of Europe: there were 581 and 455 companies respectively in each region out of the top 2,000 in 2004.

Exhibit 35: Healthcare and financial services set to gain share of total sales in the European index
Split of Stoxx 600 sales by sector, incl. GS forecasts



Source: Company data, Goldman Sachs Global Investment Research

Exhibit 36: The relative profit pool is set to shrink in the energy sector and grow in financial services
Split of Stoxx 600 pre-tax profit by sector, incl. GS forecasts



Source: Company data, Goldman Sachs Global Investment Research

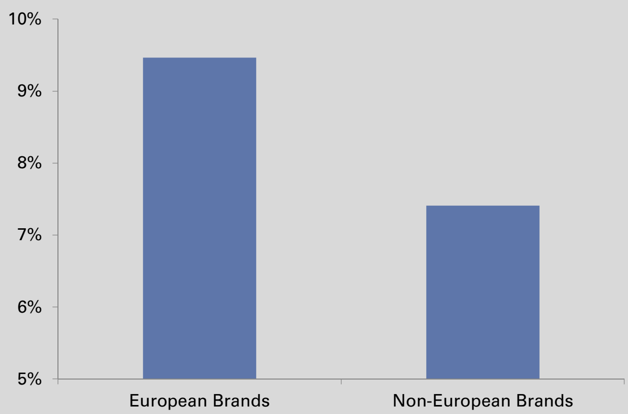
Europe: Playing to its strengths – case study

A key structural advantage of European consumer discretionary brands is their ownership and leadership of categories and products, supported by many years of specialisation. This provides a growth advantage and stronger pricing power relative to global counterparts.

Europe is the home to many global consumer brands, particularly in luxury: Europe has some of the strongest global brands across consumer discretionary categories including watches (Omega), jewellery (Cartier), apparel (Zara) and sporting goods (adidas). European brands make up 60% of top-quartile brands in our global Competitive Positioning framework. Our analysts believe this strength is largely due to the decades (and in some cases centuries) of knowledge built up, not only of artisanal craftsmanship, but also of target consumers, evidenced across the fashion houses of Italy, leather goods producers of France and watchmakers of Switzerland.

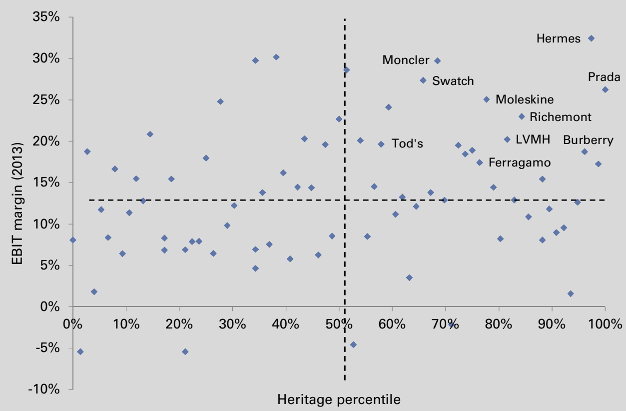
How does this affect the ability of brands to grow? The addressable market for consumer brands more broadly continues to grow and our analysts see diverging demand trends towards value-orientated product at one end of the market and branded product at the other. Industrialisation and globalisation have allowed greater automation of production and lower prices to satiate demand for value product; however, the relatively limited supply of brands and branded product more broadly provides an attractive supply/demand dynamic as the relative rarity of product entices demand from the expanding aspirational and wealthy consumer class.

Exhibit 37: We forecast European brands to grow revenue c.2 pp faster on average than their global counterparts
Revenue growth pa (2013-16E, %)



Source: Company data, Goldman Sachs Global Investment Research

Exhibit 38: European brands' heritage and credibility in their core product provide a competitive moat
Heritage score percentile vs. EBIT margin (%, 2013)



Source: Company data, Goldman Sachs Global Investment Research

Is there a risk that technology upsets Europe's position? The concept of technology disrupting consumer categories is not new (think consumer electronics and Apple, and apparel and food retail with e-commerce), but our analysts believe that technology, rather than being a disruptor between brands, is more likely a disruptive force between *brands and distributors* as it provides brands another avenue to disintermediate less profitable members of the value chain. Technology has undoubtedly lowered barriers to entry for new, niche brands to the market (Warby Parker in eyewear, Alex and Ani in jewellery), but the ability to command high price premiums without heritage or credibility is still limited. We note that Apple has recently hired Patrick Pruniaux, formerly Tag Heuer head of global sales, Paul Deneve, former YSL CEO, and Angela Ahrendts, ex Burberry CEO to help gain credibility in the watch market. Google has also entered a strategic partnership with Luxottica for Google Glass. We believe the concept of brand offers protection from disruption, providing a competitive moat and strong pricing power, through heritage, product credibility, and leadership in a category and/or product niche.

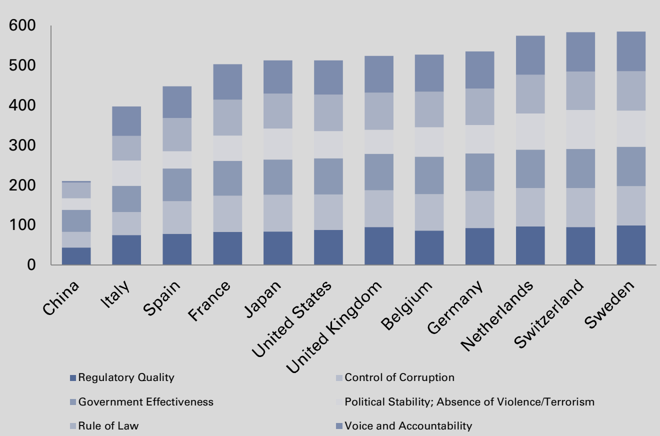
In Europe, this is highlighted by brands maintaining high gross profitability (average gross margin 60% versus non-European brands 45%). By identifying their unique strengths, a number of European companies have already been able to woo the US tech titans into partnerships or JVs. As mentioned above, in March 2014, Google announced that it was joining forces with Luxottica (maker of Ray-Ban, Oakley, Persol, and Oliver Peoples). Google hasn't merely been trying to build a new consumer product, it is aiming to start a revolution in how we interact with our devices and one another.

Strong and stable

Many of the CEOs we met mentioned Europe's stability as a base for operations. Democratically elected, accountable governments lay a solid foundation for businesses, which can expect reliability and predictability of law and regulation, along with freedom from corruption.

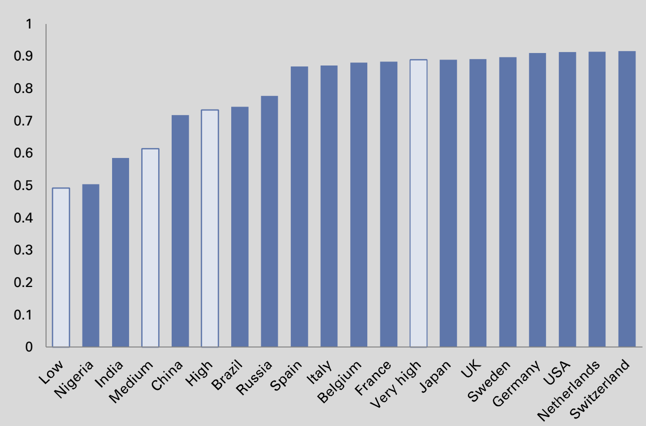
The manifest and long-established need for a democratic process in European countries may slow things down, but it also minimises the chances of sweeping transformative changes that come without warning. Businesses are aware that this is a risk of operating in emerging markets, particularly those that remain significantly underdeveloped, and where regulatory changes may meaningfully change the ability of foreign companies to operate in certain areas, or to repatriate cash. Governments in the EU almost always change through elections at times allocated in advance rather than abruptly or violently, and it is highly unlikely that international game-changers such as sanctions will be placed on the countries of the EU. It is not difficult for firms to persuade employees to move to and work in the European offices of international firms, unlike some EMs: some executives commented that it was difficult to station people in geographies that might be considered unsafe; where the education system might be considered below the standard they would wish for their children; or where social attitudes surrounding gender, race or sexuality affected the degree to which employees might feel comfortable.

Exhibit 39: European counties are well-governed…
Aggregated World Bank national governance indicators



Source: World Bank

Exhibit 40: …and highly developed
Human development index: by country and averages



Source: United Nations

The World Bank considers European countries to be the best governed in the world, based on the six metrics of Regulatory Quality, Government Effectiveness, Control of Corruption, Rule of Law, Political Stability, and Voice and Accountability. The executives we spoke to highlighted in particular rule of law and low levels of corruption as positive features, allowing them to carry out their business fairly and effectively, ensuring the safety of their operations and the protection of their physical and intellectual property. In the HDI – or Human Development Index, a composite metric designed to show achievement in basic development – western European countries all score near the top, clustering around the average for 'Very high' development. The combination of these factors means Europe offers a solid foundation upon which businesses can build.

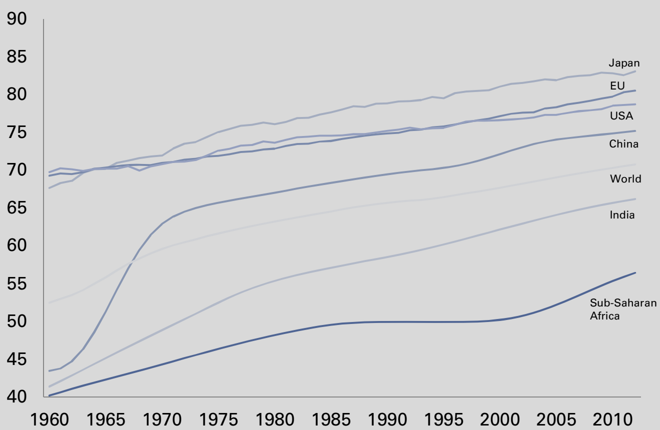
Healthy, wealthy and wise

There was a sense in our meetings that while there are undoubtedly opportunities for improvement across the continent, the positive aspects of Europe are seen as basic and fundamental, and so there is a tendency to overlook them or 'take them for granted'. However, some of these basic benefits – long life expectancy, access to education and universally available healthcare – are hugely beneficial and should not be forgotten.

Although the continent must remain sensitive to and disciplined about not resting on its laurels, the fundamentals for Europeans are very strong: the people of Europe can read and write, they live a long time, and they enjoy representative democracies, broadly peaceful interrelations and relatively high levels of wealth. As a result of high state spending, European citizens enjoy a broad range of high-quality state services. Private wealth is also high on the continent. A recent report by Julius Baer (reported by Reuters, October 1, 2014) suggested that private wealth levels in Europe reached an all-time high in 2014 and the bank forecasts a further 40% increase by 2019.

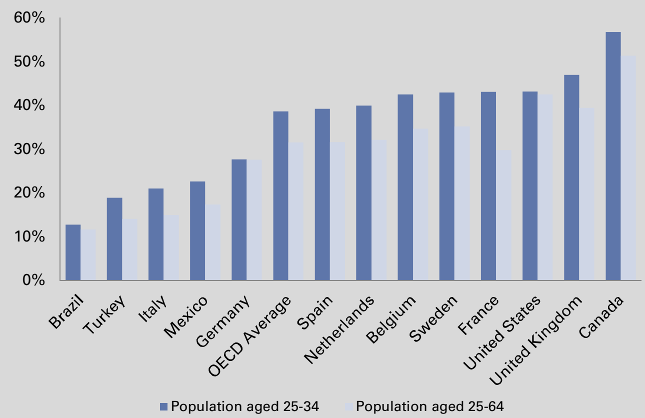
Europe is even advantaged linguistically. English, French and Spanish are widely spoken across the world, continuing to boost the relevance of their countries of origin.

Exhibit 41: Europe's people are long-lived…
Life expectancy over time



Source: World Bank

Exhibit 42: …and well-educated
% of population with a tertiary qualification, by age group



Source: OECD

Some of these head-starts can be fairly easily eroded, however. Those issues that can be addressed largely through financial commitment are most vulnerable to 'catch-up' from elsewhere. Already with primary and secondary school education, Chinese investments have seen Shanghai shoot to the top of the PISA table (a worldwide OECD study of the academic performance of 15-year-olds) for all three metrics of science, mathematics and reading. Other advantages are better protected: those that would involve widespread international change, like the use of European languages across the world, or those that will take time to filter through, such as the level of educational attainment of the whole population, should endure longer. However, none of these will last forever.

Europe's evolving challenges

Many of Europe's challenges aren't new. But with technology evolving and globalisation gaining pace, old headwinds are being exacerbated as new ones emerge. While some of these rising threats are uniquely European, many others are more universal in nature. In this section, we discuss the emerging threats that challenge the status quo of both policy planning and corporate strategy planning across the continent. A 'head in the sand' approach will not work at the company, country or continent level.

In this chapter:
One clear feature of the globalisation trend seen in the past decade has been the rising prominence and power of the BRICs nations, in particular China. Now that China is moving up the value chain, we discuss the extent to which a **rebalancing of the Chinese economy** may represent a new set of opportunities, or threats, for Europe.

As mentioned earlier, we also address the concept of **long-term capital** and the extent to which this offers a significant advantage to management teams as they form a strategic plan for the direction of their business.

Some of the most profound changes to global consumption patterns in recent years have been rooted in and facilitated by technology change. In the section titled '**The Changing Consumer; threat and opportunity',** we discuss the impact of these changes for Europe.

We also touch on the increasingly difficult job of regulatory bodies the world over, as globalisation makes **'Defining the denominator'** increasingly difficult for market share calculation purposes.

Regulators are also being challenged over lines between industries as well as geographical boundaries: in **'Technology transcends borders'**, we discuss the newly emerging challenges that companies like Google and Facebook bring to the fore.

Chinese rebalancing

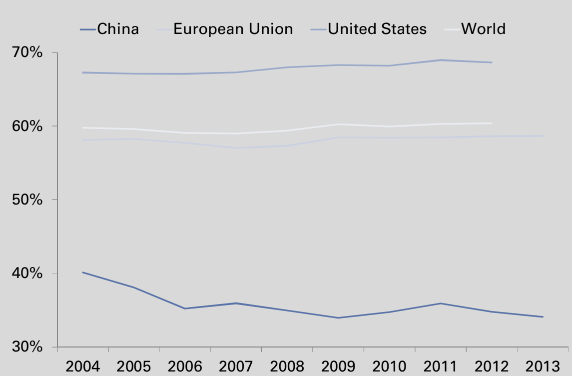
Since the 1970s, the increased integration of global supply chains and the rise in outsourcing have hugely increased the world's dependence on China as a manufacturing hub. In the process of this increased global specialisation, many blue-collar jobs have effectively been eliminated from the European economy. Now, as China moves up the value curve and starts to derive an increasing share of GDP from services, what does this mean for its relationship with Europe?

The EU is China's biggest export market (and China is the EU's second-biggest export market behind the US). The EU is also a sizeable and potentially attractive market for Chinese outward investment. What China does next is important for policymakers, corporates and investors in Europe.

Looking back, it is clear that globalisation and economic realignment allowed for a rapid 'catch-up' that delivered unprecedented levels of growth in the 2000s across a range of emerging markets, with many European corporates being key beneficiaries. Now, that tailwind has diminished, both for EMs generally and for China more specifically. For China to grow effectively from here it needs to continue to rebalance its economy away from heavy investment spending and towards consumption and foreign trade. Consumption has been slow to respond so far to policy changes designed to reduce savings, and private consumption remains stubbornly below 40% of GDP. Encouragingly though, in 2013, output from the services segment overtook that from the manufacturing sector (46% of GDP against 44% of GDP), representing a valuable first step for an economy looking to reposition itself away from making things for other people to selling products and services to its domestic population.

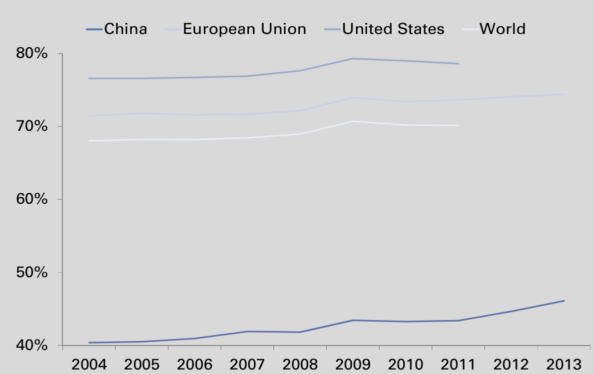
In terms of its relationship with Europe, it is clear that China is no longer simply going to supply cheap manufactured goods. Europe needs to understand what its competitive advantages are in the goods, services and products that China's c.1.4 bn consumers want to buy. As articulated in *Fortnightly Thoughts: The Consequences of China's price discovery* (June 13, 2013): "Apart from resources, China will also need a new set of solutions as its priorities change. With a rising impetus to reduce environmental costs, it seems likely that solutions in power and energy efficiency, especially if and when price signals for energy improve (fossil fuel subsidies amount to c.$20 per capita in China), will be needed. Education, testing and water are three other areas which should receive greater focus as consumer expectations for living standards rise. The need for more efficient allocation of capital even as the savings rate is expected to decline points to higher demand for financial services, insurance and asset management (mutual funds and equities account for less than 10% of Chinese household financial assets versus more than 20% for the US and the UK). Infrastructure solution providers in areas like logistics and communication should remain important as the penetration of online business models rises and economic activity moves further inland. We also believe that western technology and expertise in areas like shale extraction, automation and food production (like genetics, cold logistics, crop protection) will be needed more as China aims to resolve its energy, labour and food constraints."

Exhibit 43: Chinese rebalancing towards the consumer seems to have been going backwards...
Household final consumption expenditure, % of GDP



Source: World Bank

Exhibit 44: ...but the services segment continues to grow (gradually) towards global averages
Services sector value added, % of GDP



Source: World Bank

The changing consumer: Threat and opportunity

The combination of economic pressure on consumers and the rapid development of online networks has led to a marked shift in how people want to consume goods and services, as well as what price points they are willing to accept. While all of the companies we met are acutely aware of the need to keep up with these new trends, there is also a reluctance to be an early/first mover in some of these areas, in part because the cannibalisation risk to existing products has not yet been fully established.

Many shifts have occurred in consumer behaviour post the financial crisis – some temporary, some more permanent. One such shift has been the hollowing out of the middle across a variety of "consumables"– in effect, we are seeing a barbell emerge, with both the high and low end gaining at the expense of the middle. This has been apparent in areas ranging from food and drink and clothing to asset management products – we have seen the rise of discount retail from the likes of Aldi and Lidl in the food space, while in the financial sector, there has been a huge increase in "value" tracker funds promising to imitate at a lower cost the most successful of the actively managed funds. In other words, simplicity, convenience and value are playing an increasingly prominent role in the consumer mindset.

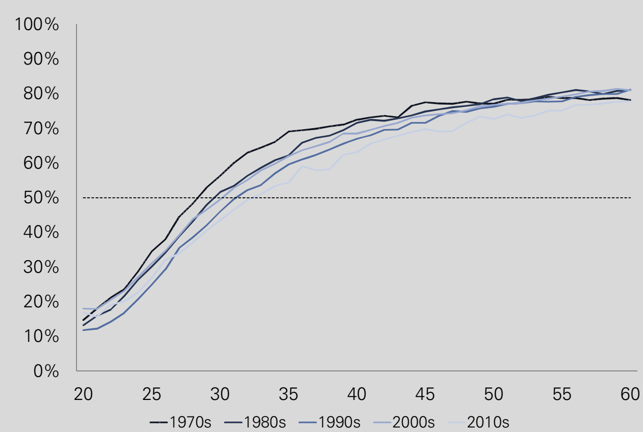
One other – somewhat related – trend is the rise of the so-called 'sharing economy', which appears to have been born out of a mix of necessity and convenience. It is thought that in the UK alone, the firms that will make up our sharing economy could generate revenues of £9 bn by 2025 (PWC). This includes a variety of end markets, from renting a room out in your house, renting out your car, and lending spare cash to a business start-up (peer-to-peer lending), to selling your free time to help others and borrowing a designer dress from a communal online wardrobe. Given that as many as one in seven people in the UK now work for themselves and 40% of new jobs are created by "self-employment", it is little wonder that huge potential is seen in this area, where people can monetise their everyday assets.

See *Fortnightly Thoughts: How the young are shaping future consumption* (October 23, 2014) for more discussion

Exhibit 45: Peer-to-peer reviews have gained currency in the sharing economy
Tripadvisor revenues, US$ mn

Source: Company data.

Exhibit 46: Some see the 'rental culture' as a key part of the drive towards collaborative consumption
Home ownership rate by age



Source: IPUMS-CPS and Goldman Sachs Global Investment Research

We have seen some backlash against what remains a largely unregulated industry (e.g. existing taxi populations in European cities versus Uber) and indeed many situations where rules and regulations were designed in a very different marketplace than the one that exists today. One might take Air BnB as an example – in London, UK, landlords need specific permission from councils to let rooms out for less than three months. From a policy-making perspective, it is not clear how these evolving (and in some cases genuinely disruptive) business models will be regulated. As things stand, rules set at a country level might simply not be fit for purpose as more and more emerging, network-based businesses appear to transcend global borders.

Technology transcends borders

Many of the CEOs we spoke to highlighted the titans of Silicon Valley as a major competitive threat. There is a general sense in Europe that the global scale and apparently unregulated nature of certain new (in some cases 'disruptive') business models creates a dangerous new source of competition. In some respects, Europe is at a crossroads on this issue. With increasing evidence of concern about data security and privacy, there may be a role for Europe in championing data protection and the rights of the consumer to decide how much of their information is used by big corporations.

As noted above, US tech companies represent a threat to many business models, even those outside the technology sector. It was clear from many of our conversations that European companies are thinking hard about new strategies to counteract this. The increasing ubiquity of Silicon Valley giants is not only challenging European companies to innovate around new ways of working, but is also raising interesting questions about existing regulatory frameworks and bringing issues like data privacy to the fore. As highlighted below, while there may be some evidence of Europe pushing back against the power of new technology-enabled business models and the use of big data, in reality these forces are likely to become an ever-more prominent feature of the corporate planning landscape.

Even as the adoption of new consumption patterns rises in Europe, the lobby against Silicon Valley is becoming more vocal. This has not been helped by high-profile cases of low tax receipts from companies like Apple and Amazon.

- In June this year, taxi drivers in London, Paris, Madrid, Barcelona, Berlin, Milan and Rome protested against the taxi-app Uber, which they argue is unregulated and threatens their livelihood.
- The launch of Netflix in France met with accusations of 'fiscal dumping' by the French film producers' association. It claims that Netflix is deliberately avoiding local taxes paid by national television channels and streaming services, which subsidise French films, by setting up its European headquarters in Amsterdam. That will also exempt it from a requirement that 40% of content on TV and radio must be of French origin.
- Meanwhile, European telecoms operators, which are currently regulated within national bounds, are also feeling increased pressure from new competitors. While over the past decade, politicians have put increasing pressure on the revenues available on roaming and call termination charges for the operators, large internet companies are able to act unfettered. Anyone can sign up to Skype or WhatsApp and speak to relatives in distant countries almost for free.

Even Europe's politicians have expressed some frustration. In May this year, Germany's economy minister called for a break-up of Google. "A breakup, of the kind that has been carried out for electricity and gas grids, must be seriously considered here," he wrote in an op-ed published by Frankfurter Allgemeine Zeitung. "But it can only be a last resort. That's why we are focusing on anti-trust style regulation of Internet platforms." In some respects, Europe is leading the world in taking back control from some of the US tech companies. The Right to be Forgotten Act, outlined below, is a case in point. Now, the US consumer watchdog is appealing to have a similar act passed there.

The Right to be Forgotten Act passed earlier this year represents one line in the sand for Europe

The test case privacy ruling by the European Union's court of justice against Google Spain was brought by a man who had failed to secure the deletion of an auction notice of his repossessed home dating from 1998 on the website of a mass circulation newspaper in Catalonia. Judges in the case found that the inclusion of links in the Google results was incompatible with the existing data protection law. They said the data that had to be erased could "appear to be inadequate, irrelevant or no longer relevant or excessive … in the light of the time that had elapsed". They added that even accurate data that had been lawfully published initially could "in the course of time become incompatible with the directive".

Is there a role for Europe in pioneering data protection, following on from this case? Just as individuals build up a credit score that is used by financial institutions to assess their creditworthiness, should there also be a digital footprint 'score', that individuals can access? Knowing what your online behaviour is telling advertisers, retailers and service providers seems natural in a world where 'freedom of information' currently doesn't extend to the individual whose online lifestyle is being tracked.

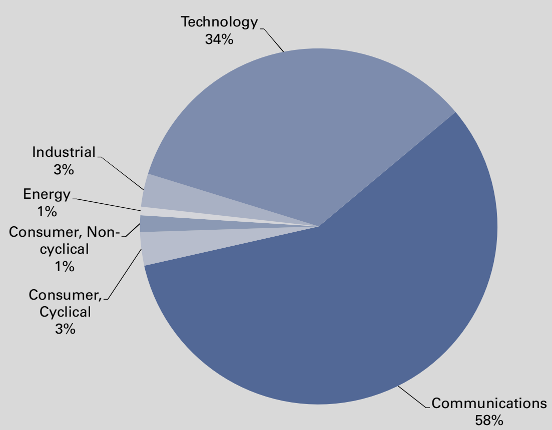
'Defining the denominator'

Many of the companies we met expressed a view that the lines between industries are blurring. With this, profit pools are becoming less clearly delineated. For regulators, this blurring of the boundaries (both between sectors and geographies) makes it all the more difficult to understand and define market structure and market dominance. Current competition policy needs to undergo a radical change to adapt to the global nature of certain new competitors and the new array of substitute products that are emerging.

As mentioned, one intriguing conclusion from our discussions was that businesses across all sectors see companies like Google, Apple, Amazon and Facebook as significant threats. This reflects a clear acknowledgement that the borders between industries are blurring. Even dominant players within their business areas see an existential threat from a rapid change in business model or an unforeseen substitute product emerging. In this context, traditional definitions of industries and sectors are being disrupted. So too is the definition of industry dominance, which is often very precisely defined by regulators (see the shipping example in Exhibit 48 below).

Exhibit 47: Industrial, energy and consumer companies had better watch out

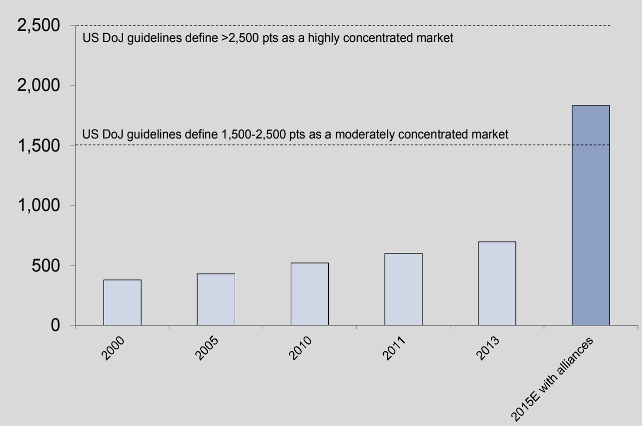
Google acquisitions 2003 to present by sector, number of deals



Source: Company data

Exhibit 48: Market definition is all-important when it comes to regulatory decisions

Herfindahl-Hirschman concentration ratio in global shipping, 2015E



Source: Company data, Goldman Sachs Global Investment Research

We have written extensively about market structure across sectors – why it matters, where it might change and the impact that change might have on growth and returns. Dominant players in consolidated, relatively unregulated markets often benefit from pricing and scale benefits that allow outsized growth and returns opportunities. But of course the very definition of dominance is subjective. Does Nike have a dominant share in 'branded trainers' or a very low market share across the broader 'apparel' category? In telecoms, is it appropriate to look at the blended level of dominance in a market across fixed and mobile or just in one silo? In beverages, do you look at ABI's share across the 'drinks' category or within 'beer' only?

Given this blurring of the boundaries between sectors, one of the key challenges for regulators at a national and European level is how to define relevant markets or categories. This debate must be settled before the discussion can even begin about what share levels might be permissible. And in an increasingly global market place, when one multinational takes over another, the anti-trust rules can be complex. It can even be unclear which competition bodies are in charge: when Telefonica bought E-Plus in 2013, there was a significant lack of clarity about whether European or German authorities would take precedence.

What is clear is that the rules in an ever globalising world are shaky and point to a required reform of competition polices not just at the national levels but potentially at a global level. Big data, along with its use and commercialisation, also presents a new challenge as an ever increasing set of firms look to exploit the informational advantages they have gleaned. Whether this is something national governments are comfortable with (especially when the corporation in question is domiciled outside their home market) remains to be seen.

Equity markets – changing the incentives of owners

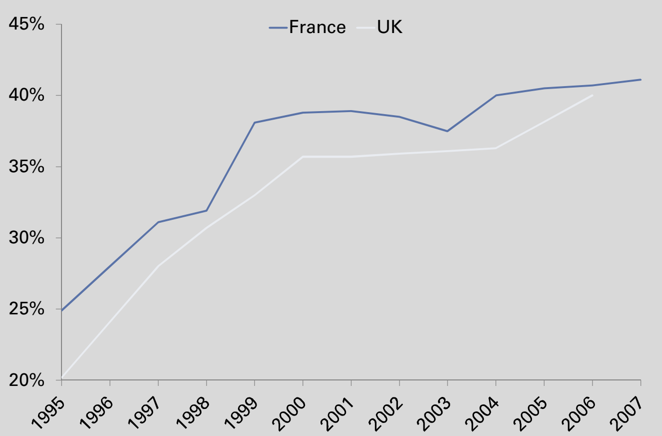
Just as politicians must satisfy the relatively short-term priorities of votes, CEOs also must also concern themselves with the apparently short-term desires of financial markets. The changing structure of equity ownership in Europe over recent decades has further compounded this. Incentivising stickier forms of investment capital should be a priority for Europe, enabling companies to focus on longer-term investment horizons.

The ownership of European equities has evolved meaningfully over the past 30 years. Long-term holders like pension funds have diminished in the overall shareholder base. As discussed in *Strategy Matters: Pension tension – lower bond yields increase solvency risk* (October 8, 2014), the direct equity investments of Euro area pension funds and insurance companies have fallen from >25% in 2000 to 12% in 2014. Across Europe, the structure of capital charges for insurance companies that are applied under risk capital models means that holding equities is effectively subject to more punitive treatment than holding fixed income instruments.

In the UK, there have been several changes which – over time – have specifically disincentivised pension saving. The annual tax incentivised contribution to pensions has fallen from c.£200,000 to c.£40,000 over the past five years. Meanwhile, the total lifetime allowance has fallen from c.£2 mn to c.£1.25 mn over the same period. UK pension funds also used to be able to claim tax relief on dividend income, an allowance that was withdrawn in the late 1990s.

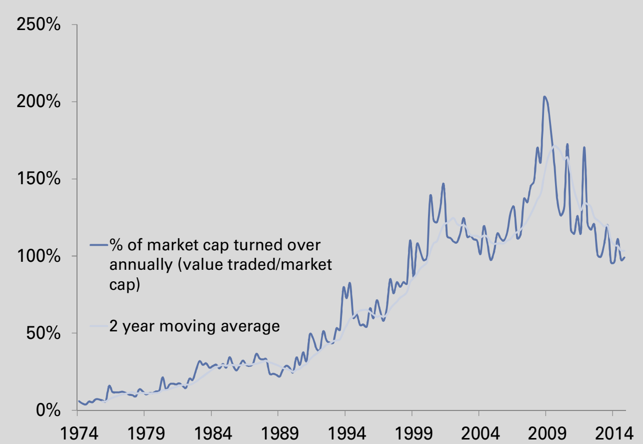
As shown below, the proportion of equities owned by foreign investors also continues to rise in Europe. In general, foreign funds tend to be more subject to capital flight in down markets.

Exhibit 49: Foreign share ownership has almost doubled over 20 years
Proportion of shares owned by foreign investors



Source: World Federation of Exchanges

Exhibit 50: Rising equity market turnover and declining holding indicative of shortening time horizons
Global equity market turnover, total value traded/total market capitalisation



Source: Datastream

Asset allocation has changed to the disadvantage of stocks for several reasons: a shortening in the duration of liabilities, accounting rules, the forthcoming Solvency II directive, and the perception by stakeholders that risks in financial markets have increased. **Even retail investors have been somewhat disincentivised from holding equities in some EU member states.** In 2012, for example, the French government introduced a 20 bp tax on financial transactions. While this tax is applied to most equity securities and to some derivative transactions, purchases or sales of fixed income securities do not fall within the scope of the tax. In 2013, the Italian government introduced similar rules that saw a levy of 10-20 bp on transactions in equities and some derivatives.

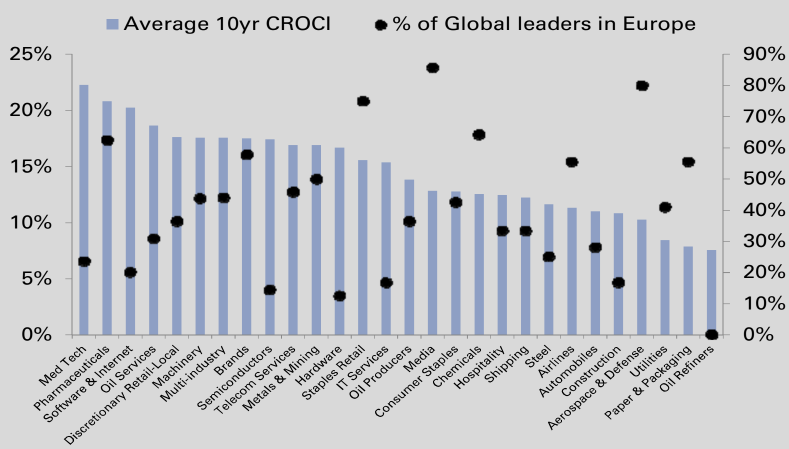
Never can say goodbye: Letting go of uncompetitive industries

One perception we encountered is that European policymakers are backward-looking, mistakenly protecting legacy industries in which Europe no longer has a competitive advantage. Given the speed with which the global economy is changing and oft-discussed topics like skills mismatches, this is perceived to be a significant misallocation of resources. While there are certain industries that may no longer logically have a home in Europe in general, it is possible that some elements (innovation, R&D) should remain. To the extent that Europe should maintain certain sunset industries, it must increase the degree of focus on high-value components.

When it comes to industries where Europe has a questionable competitive position, steel is a case in point. The world steel industry is generally characterised by low profitability and high volatility. Europe has little iron ore or coking coal. Energy and labour are expensive. In 2013, the EC put forward an action plan for a competitive and sustainable future for the European steel industry. Its plan "recognised the strategic importance of steel to the EU due to its close links with many downstream industrial sectors such as automotive, construction and electronics". Through a multi-point programme, the EU has increased support for the steel industry, rather than allowing it to decline. In other cases, it is national rather than Europe-level government that has intervened to support struggling industries. There are numerous high-profile examples across the autos industry, the steel industry and in the case of North Sea oil in which countries have tried to revive failing industry.

Of course in some cases, intervention is required to address market failures – for example, to ensure a level playing-field on the EU market and gain legitimate access to third-country markets for European steel producers by avoiding unwarranted trade restrictive measures abroad. But in other cases, intervention is much less clearly confined to offsetting market failures. For example, to protect heavy industry from rising power costs, certain governments have reduced the levies applied for industrial versus residential/consumer users.

Exhibit 51: Europe certainly has a good share of industry leaders – but are they in the right industries?
Cash returns and European global leadership across industries, 2014E)



Source: Company data, Goldman Sachs Global Investment Research.

High energy costs are eroding Europe's advantage in a number of areas. Even though EU firms generally perform well in terms of energy efficiency, this is not enough to fully offset the negative impact of energy price rises on industrial competitiveness. Several sectoral studies, focusing on energy-intensive industries (like steel, aluminium, ceramics and glass), show that their competitiveness may be particularly at risk because of high energy costs.

The need for Europe's member states to specialise in areas where they have a genuine competitive advantage may be 'easier said than done'. In particular, it may be difficult for governments to take a ruthless approach towards 'legacy' industries if it risks creating large unemployment. We therefore see a clear need for more 'innovation hubs' to be set up around sunset industries, enabling European companies to be at the forefront of industry change.

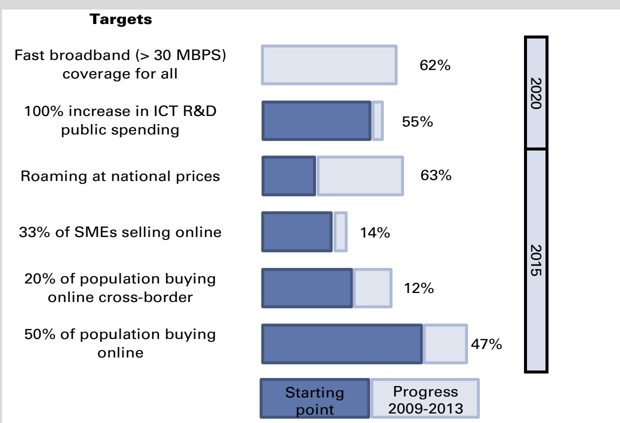
Coordinating Europe's efforts

The quality of Europe's infrastructure is a key issue for all businesses, whether big or small, located in Germany or the periphery. The continent's energy, communication and transport infrastructure all significantly affect Europe's ability to compete on the world stage. It is no surprise therefore that infrastructure investment and integration were discussed across many of our meetings. It seems clear that the EC has established a number of laudable programmes aimed at addressing these needs. However, their effectiveness and timeliness is the subject of some debate.

The quality of Europe's infrastructure will be vital for its long-run competitive position. For example, if European businesses are going to participate in the global rise of the sharing economy, and if the continent is to develop its own leaders in the sphere of 'collaborative consumption', it needs to ensure that broad-based digital foundations are put in place early. But these major, multi-year projects can often mean short-term costs need to be incurred to secure long-term gain. In these cases, the need for a long investment horizon can be somewhat at odds with a 4-5 year political cycle. As was clear in the 3G spectrum auction, a failure to look beyond the current costs and benefits can have significant negative longer-term consequences. This is where multi-year EU initiatives can play an important role in mandating actions that transcend the political cycles and incentives of individual member states.

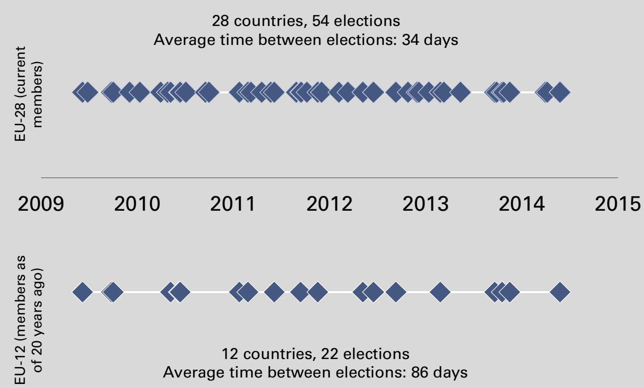
In theory, the institutions of the European Union are in a strong position to coordinate member states in finding solutions to the major headwinds the continent faces and which will – in many cases – require long-term planning. In practice, this is often an intensely complicated process, placed under strain by the fact that nations hold their own elections during the term of a European parliament; as mentioned earlier, there is almost one national election a month.

Exhibit 52: Some done, lots more to do
Selected digital agenda targets for Europe



Source: European Commission

Exhibit 53: EU expansion over the past 20 years has led to near constant elections
EU national elections across the term of the EU Parliament



EU national elections (parliamentary or presidential only) across the term of the European Parliament elected 2009; EU-12 members vs. EU-28 members

Source: Compiled by Goldman Sachs Global Investment Research

When it comes to rolling out high-speed fixed broadband in Europe, lessons have been learnt from earlier experiences. Some projects are too important and too long term in nature to be left entirely to national governments.

The EU is pioneering a number of initiatives in areas of collective importance, from inequality to energy. Within each initiative, both the EU and national authorities have to coordinate their efforts so they are mutually reinforcing. Most of these initiatives were presented by the Commission in 2010, with pan-European targets established for 2020. Many lie in regulated industries where the tools of intervention have already been established. Brussels is accountable on these topics and publishes frequent 'progress check' documents.

European responses

The financial crisis has elicited a logical response from corporates in the form of cost-cutting, capex reductions and tight cash management. Meanwhile, government responses among individual member states have been somewhat less uniform and have, to a large degree, depended on the level of distress in the country in question. The crisis has clearly also stimulated some Europe-wide policy responses like the recent monetary loosening that has led to a useful weakening of the euro.

With regard to the policy response to the crisis, the executives we met generally expressed frustration not with the intent or direction of policy, but with the speed at which it has been implemented in the Euro area. Many corporates look at the current growth trajectory in the UK and the US and ask whether the Euro area could also be achieving such a marked recovery if it had been able to act earlier on solving some of the emerging issues.

In turn, the corporate response to slow growth has been characterised by 'battoning down the hatches' through improving working capital management, cutting costs and limiting capex (effectively focusing on the denominator, as well as the numerator of ROCE). But while these actions may have served as a buffer against declines in free cash flow, they do little to remedy structural challenges. Indeed, in some respects, they are likely to promote a vicious circle of low employment, low investment and ultimately low macro growth.

Looking forward, we ask whether Europe's future strengths may be found in its current weaknesses. Densely populated cities, an ageing population and a lack of resources are all chalked up as headwinds for the continent. But ultimately, these challenges will – to varying degrees – affect large swathes of the world's population. To the extent that Europe can pioneer and manufacture solutions to these challenges (whether in waste management, town planning, renewable energy or healthcare), it has the scope to become an ever more indispensable partner for the rest of the world.

In this chapter:

There have already been some clear and positive pockets of reform in Europe, in many cases stimulated by the crisis (and in some cases mandated by the IMF in return for support). We discuss three of these areas in the sections ***labour market flexibility***, ***reducing the cost of failure*** and ***publicly funded R&D***. There have also been more centralised efforts, not least of which is the European Banking Union. In ***response time is key***, we compare the speed of Europe's policy responses with those of other affected regions. It is clear that in 2008, the institutions of Europe were not sufficiently developed to respond with a TARP-like solution to the banking crisis, but since then, the speed with which Europe has been able to introduce a centralised institutional framework has surprised many investors and commentators.

Corporates too have natually been forced to respond. There are some clear manifestations of this. **Cash holdings by corporates**, for example, have risen sharply, clearly a sensible insurance against a lack of macro visibility. We have also seen cost-cutting, capex reductions and a rise in defensive M&A (motivated primarily by the potential for cost synergies). We acknowledge that some of these things reflect secular trends – increased tech efficiency may, for example, simply reduce the level of capex required in certain industries.

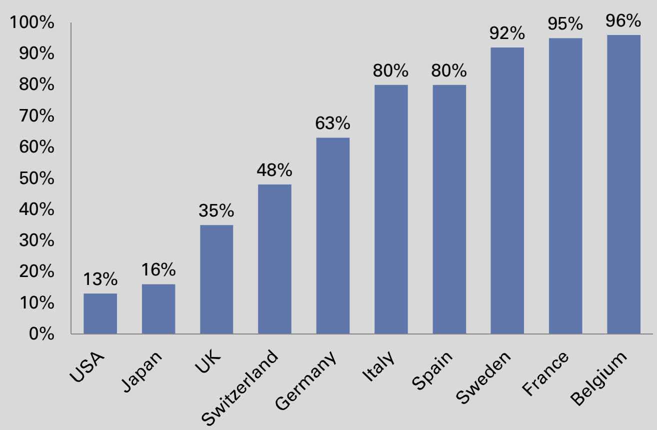
Labour market flexibility

As new technologies speed up the process of 'creative destruction' and shorten company life expectancies, the need for flexibility in the speed, scope and cost of restructuring is only likely to increase in importance. Although the crisis triggered pockets of reform across Europe, aimed at simplifying hiring and firing (in the main) and stimulating employment, the starting points and subsequent reforms have been far from uniform. Across our meetings, there was a broad sense that more action and more coordination are still required.

During our meetings, the changes made in Spain since the start of the crisis were regularly cited as being some of the most dramatic examples of policy reform. In many respects, the Spanish experience provides us with an excellent case study in what can be done despite starting from a rigid base. Outside Europe, the US is often discussed as the blueprint for others to aspire to and indeed, while Euro area unemployment remains stubbornly close to all-time highs, the US rate continues to fall. While the US does have a minimum wage, data from the OECD suggests that the necessary notice periods and costs to employers of dismissals are generally much lower in the US than other OECD countries.

Exhibit 54: Collective bargaining is still a potent force in Europe

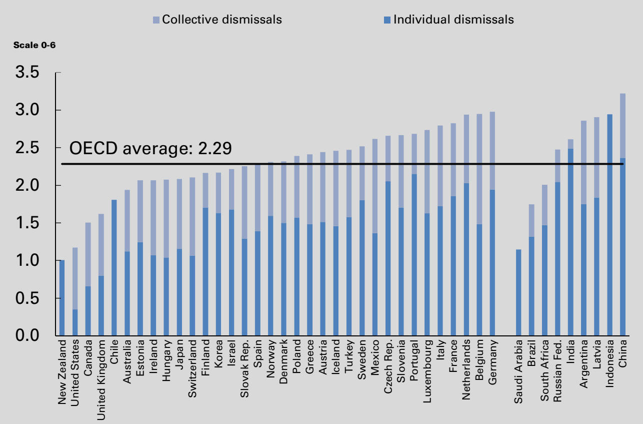
Collective bargaining coverage of total labour force, 2012



Source: OECD

Exhibit 55: Employee protection is higher in Europe than in the US...

Protection of employees against dismissal, 2013



Source: Laga International Dismissal Survey, 2012

Spain entered the crisis with one of the least flexible labour markets in the world as a result of its centralised wage bargaining and other protections that made it hard to dismiss employees or reduce wages. As a result of this set-up, in the boom years up to 2007, Spain hired hoards of temporary workers, which created a two-tier system of skilled permanent workers and unskilled temps. Spain had been slow to reform despite these issues and (as is often the case in Europe) the minority government struggled to win parliamentary votes on the issue. Indeed, on one occasion, tax hikes on high earners were announced and abandoned within just six hours.

In this context, and with unemployment >25%, the 2012 reforms came out of what can only be described as necessity. These reforms were aimed at reducing dismissal costs for permanent employees, reducing severance pay and achieving significant wage moderations through changes in the collective bargaining regulations. Specifically, the government approved a decree that lowers the cost of an unfair dismissal associated with an open-ended contract to 33 days per year worked from 45. Importantly, it has also made it less difficult for companies to justify a fair dismissal, with an associated cost of 20 days' wages. The net result in Spain has been increased hiring on permanent contracts and enhanced labour reallocation; OECD reports even suggest that the reforms have the potential to boost labour productivity too. During our discussions, France was frequently cited as a market in significant need of reform. The general consensus seemed to be that Spain had taken the important first steps along a difficult but necessary road, that Italy was behind but had at least elected a leader with a mandate for reform, and that it was only France that seemed unwilling to accept the reality of the 'new normal'.

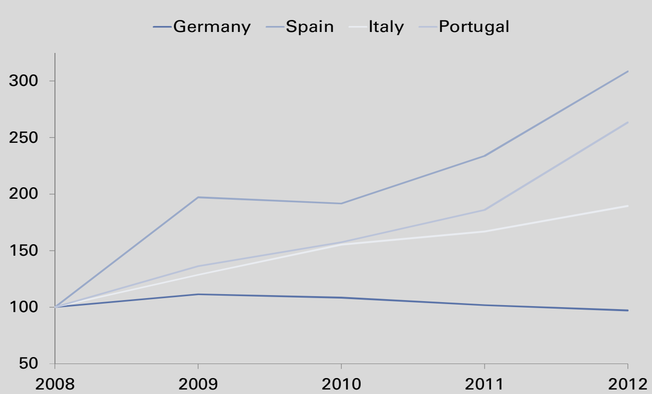
Reducing the cost of failure: Bankruptcy and restructuring

Across our meetings, there was a sense of frustration from executives who feel that Europe lacks the culture of entrepreneurship and risk tolerance that will be vital to bring the continent out of its current economic malaise. In this vein, we note that the 'fear of failure' is one of the key deterrents cited by young people in Europe when asked about the prospect of starting their own business. It is vital that the cost and social stigma associated with failure (in particular bankruptcy) is reduced.

In the US, Chapter 11 has been an important tool for companies in trouble. It offers a well-trodden path for businesses to free themselves of large legacy costs. General Motors offers a high-profile example of Chapter 11 in use – the company received $33 bn in debtor-in-possession financing to complete its asset sale and reorganisation. American Airlines is another high-profile example. In Europe, meanwhile, the situation has generally been rather different. In some cases, entrepreneurs who declared bankruptcy have been banned from starting a new business or even lost their right to vote in elections. Clearly, the stigma of bankruptcy heightens the 'fear of failure' among would-be small-business owners. It therefore seems like a positive that the crisis has prompted several European governments to introduce features already common in the US system: (1) promoting pre-insolvency alternatives, (2) facilitating cram-down mechanisms and debt-to-equity swaps and (3) mirroring aspects of US style debtor-in-possession (DIP) financing.

By July 2012, important reforms had already been implemented by some of the major European nations, including Germany, Spain and Italy.

Exhibit 56: Insolvencies have soared in the periphery
Corporate insolvencies in Western Europe indexed, 2008 = 100



Source: Creditreform Economic Research Unit

Exhibit 57: Lots done, but more to do to match global best practice
Impact of insolvency, 2013

	Time to resolve insolvency (years)	Cost (% of estate)	Recovery rate (cents on the dollar)
Japan	0.6	4	92.8
Germany	1.2	8	82.9
USA	1.5	7	81.5
High income	1.7	9	70.6

Source: World Bank

Spanish case study: Bankruptcy reform was one of many policy changes recommended by the International Monetary Fund when Spain sought European and international assistance amid the 2008 recession. The IMF drew attention to Spain's strict bankruptcy laws, highlighting that the Spanish insolvency process too often ended in costly liquidation rather than restructuring. Under the rules at the time, approximately 95% of companies that entered insolvency proceedings wound up in liquidation.

Since then, significant reforms have been introduced. While the major changes came in early 2012, even as recently as this year further improvements have been made. On March 7, 2014, for example, the Spanish government proposed yet more reforms aimed at providing stronger incentives for lenders to accept write-offs, maturity extensions, and debt forgiveness for struggling companies. The new rules also reduce the majority of creditors needed to vote for a restructuring. If creditors representing 60% of a company's debt agree, they can now force all creditors of a Spanish debtor to extend the maturity of their debt by five years or convert their debt into participatory loans, a hybrid of equity and debt. Judges have discretion to reduce the voting threshold to holders of 51% of a company's total debt. With approval of creditors representing 75% of total debt, companies can now force creditors to reduce outstanding principal, delay the repayment of loans by up to ten years, or swap debt for equity.

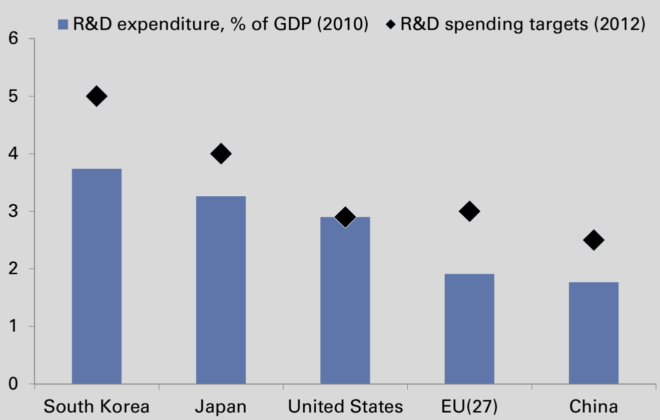
Publicly funded R&D

One widely held view among the CEOs we met was that Europe fails to support sufficient R&D or innovation spending. Certainly, the absolute level of R&D spend in Europe lags that of competing economies. This is taking its toll on the level of patent applications in Europe too. It seems clear that collaboration between governments, universities and corporates themselves will be vital in solving this issue and ensuring the incentives are in place to encourage innovation.

This point is not lost on European policymakers. One of the European Commission's key flagship programmes out to 2020 is the 'Innovation Union'. In its initial paper on this topic in 2010, the EC stated that, "perhaps the biggest challenge for the EU and its Member States is to adopt a much more strategic approach to innovation". The key target of the Innovation Union is for R&D spending to reach 3% of GDP by 2020. According to 2010 estimates, achieving this target could create 3.7 mn jobs and increase annual GDP by close to €800 bn by 2025. At its 2014 update on the progress of the Innovation Union, the EC identified Denmark, Finland, Germany and Sweden as 'innovation leaders'.

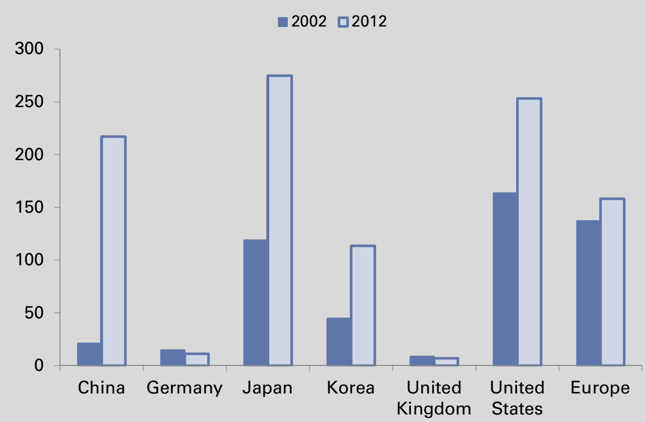
As shown below, even if it achieves the 3% target spend, the EU will be only on a par with the US's current spending level. It will still lag Japan and South Korea. The European Roundtable of Industrialists notes that the US is spending 20x more than the EU on procurement of R&D a year.

Exhibit 58: Even at its target R&D spend, Europe would only level-peg with the US
Gross domestic R&D expenditure as a % of GDP



Source: Europa

Exhibit 59: Europe's pace of innovation is improving in absolute terms, but still lags behind peers
Absolute number of patent filings, 2000 and 2012



Source: WIPO

Collaboration between universities and corporates is of course not a new concept and there are many grass-roots examples of this already in action. The University of Sheffield Advanced Manufacturing Research Centre (AMRC) in the UK is a prime example of how a coordinated innovation effort by Europe can pay off. Established as a £15 mn collaboration between the University of Sheffield and Boeing, with support from the European Regional Development Fund (ERDF) and the UK government, the AMRC has since gone on to establish a cluster of industry-focused manufacturing R&D centres and supporting facilities. These include Nuclear AMRC, focused on developing nuclear and other energy technologies, the AMRC Training Centre for advanced apprenticeship training and higher level skills for high-value manufacturing, and NAMTEC, which provides support to the UK manufacturing supply chain.

While there are some clear success stories of partnerships between public and private enterprises, certain corporates are relatively resistant to increased cooperation. When the government contributes expertise or financing, the fruit of the innovation is effectively a 'public good'. This can mean, or be thought to mean, that the ability of the private companies to monetise the innovation is therefore limited.

New models of collaboration and monetisation need to be found. Imperial Innovations offers an interesting example here – this is an AIM-listed company focused on "commercialising the best in UK academic research, drawn from academic centres within the 'golden triangle' formed by Cambridge, Oxford and London".

Speed of response is key

Among the companies we met, we often encountered a sense of frustration about the speed of decision-making and policy implementation across Europe. CEOs in the Euro area are now looking at the improving growth being posted in both the UK and the US, and contrasting it with the lacklustre growth within the currency union. The clear question is whether Europe could have acted sooner to stimulate the economy. In many cases, we encountered a perception that the institutions of Europe simply aren't nimble enough to take radical and timely action in the face of significant challenges.

One case in point is the action taken in the banks sector. In 2008, the US government launched the Troubled Asset Recovery Program (TARP), under which it bought illiquid mortgage-backed securities, equity and other assets from key institutions in an attempt to restore liquidity to the money markets. Putting TARP capital into the banks provided the necessary foundation for a transparent stress test to be undertaken. Effectively, by making the TARP available as a backstop, the Treasury avoided the risk that financial institutions would have their access to private capital cut off as a result of unfavourable stress-test results. As of the end of 2013, the TARP had more than recouped the initial investment by taxpayers and is deemed by most commentators as having been a success, at least in terms of mitigating downside scenarios.

Roll forward six years and only now, in 4Q2014, are the results of Europe's asset quality review (AQR) and stress test becoming clear. During the bumpy ride that Europe has taken over those intervening years, it is only when the continent has reached a relatively severe point that institutional reform has been passed. Peril – it seems – has helped to overcome some of the political resistance associated with creating a coordinated solution to crisis.

While the steps taken more recently towards institutional reform, through the creation of a common supervisory mechanism for the European banking sector, are a clear and positive mitigant of future banking crises, this case study highlights the fact that many of Europe's institutions have not yet developed sufficiently to respond rapidly to potential challenges.

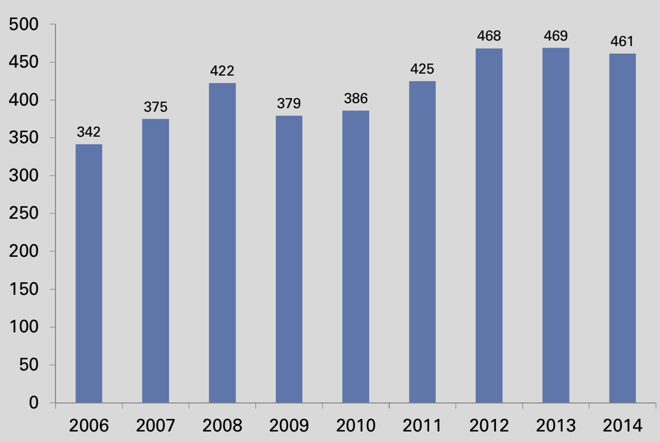
Capex cuts, FCF buffering

When faced with top-line pressure, the natural response is to reduce costs and protect profitability. Limiting the impact of this pressure on FCF also becomes a priority and discretionary or expansionary capex often also gets cut. But how much cutting is too much? There is clearly a risk that if you cut too deep, you can irreparably damage the fabric of a business.

In aggregate, European companies cut capex during the crisis both in absolute terms and relative to sales. In absolute terms, total capex across our European coverage fell from €422 bn in 2008 to €386 bn in 2010 and, on our analysts' estimates, has remained broadly flat in the past two years, from €468 bn in 2012 to €461 bn in 2014E. As discussed in *Fortnightly Thoughts: The capex conundrum* (September 11, 2014), this is driven by: (1) lower demand and confidence, (2) the impact of technology and (3) overcapacity. Between 2008 and 2010, capex/OCF fell from 69% to 55%, and between 2012 and 2014, our analysts' forecasts imply that capex/OCF will have fallen from 67% to 62% across our European coverage. This capex cut has helped companies to protect FCF and consequently in Europe, they now have an unprecedented amount of cash in hand and can well afford acquisitions. As discussed earlier, the low interest rate/cheap funding environment has enabled M&A as a further strategy to create scale and target costs at a time when capex has taken a back seat. According to Bloomberg data, M&A volumes in Europe have doubled in 3Q2014 compared with the same period last year (from $105 bn to $217 bn).

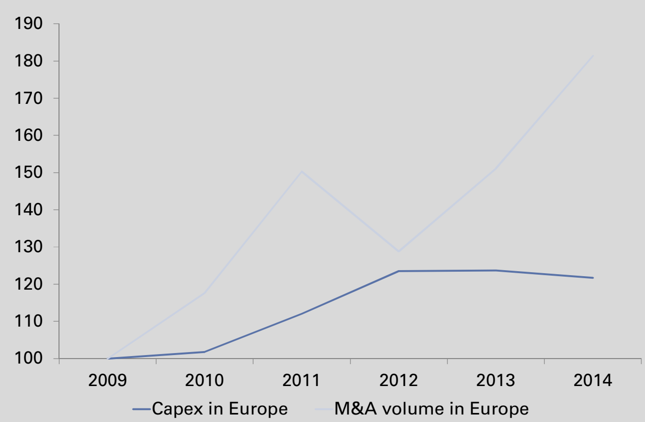
But as Europe continues to struggle to grow, most of these deals are aimed at providing cost synergies, making them very different from those in the 2007 cycle, when companies sought growth. In the absence of growth, companies squeeze costs to keep profit up. But in a lean period, even cost-cutting is very hard to achieve; therefore, cost synergy driven mergers become all the more important as this is the way to boost the bottom line. In times when overall demand growth is also stagnating, market share and pricing power become all the more important. As discussed in our report *The Structure for Change*, much deal activity in the year to date has also been concentrated on improving pricing discipline across industries.

Exhibit 60: Total capex across GS European coverage has remained broadly flat over the past three years
Absolute total capex, GS European stock coverage, € bn



Source: Company data, Goldman Sachs Global Investment Research

Exhibit 61: As corporate spend on capex has plateaued, M&A volumes have increased
Indexed, 2009 = 100



Source: Company data, Goldman Sachs Global Investment Research

Corporate cash holdings

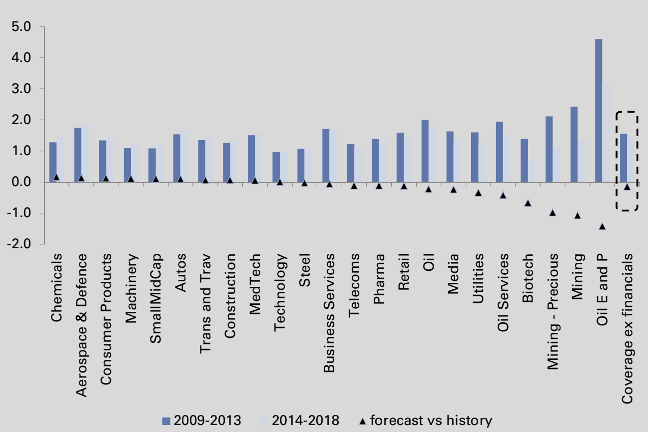
Despite the low cost of financing in the European debt markets, a large number of European corporates have very strong balance sheets relative to recent history (partly as a result of the FCF preservation measures discussed), with corporate cash holdings almost back to prior decade-highs in aggregate. In some cases, it is uncertainty that is preventing investment; in other cases, it is a lack of clear returns-accretive spending opportunities. Overall, there appears to be some circularity at work here, with weak growth prospects leading to limited corporate spend which – in turn – perpetuates a sluggish growth environment.

As already mentioned, a strategy of preserving cash and 'battening down the hatches' during the crisis certainly appears sensible at the level of individual companies. However, at a collective level this can lead to some unfortunate outcomes, as we will go on to discuss. Many of the executives we met believe that a key factor constraining growth is persistent high unemployment. For as long as employment levels remain depressed, there will clearly be constrained levels of real demand growth (as opposed to demand for certain assets that can be born out of quantitative easing and a search for yield). Labour market rigidity and high minimum wages were frequently cited as key constraints to improving employment levels. As already discussed, other factors contributing to stubbornly high levels of unemployment include skills mismatches, a 'hollowing out' of the labour market and poor credit availability for SMEs. It is clear that corporates themselves must also shoulder at least part of the responsibility for the still-high levels of unemployment across the region, as large corporates (those with turnover of >€50 mn) represent c.35% of total employment in Europe.

The International Labour Organisation's 2013 report 'The World of Work' argues that even though profitability is improving, firms are failing to translate profits into investment in advanced economies and that this is holding back the employment recovery: "Rather than putting these profits to work through productive investment in the real economy, increased revenues have more often been channeled towards higher cash holdings". There is a clear circularity here. A sluggish growth outlook for Europe drives firms to invest overseas or to simply transfer cash back to shareholders, exacerbating low growth and employment, as well as fuelling asset price bubbles in other areas of the market.

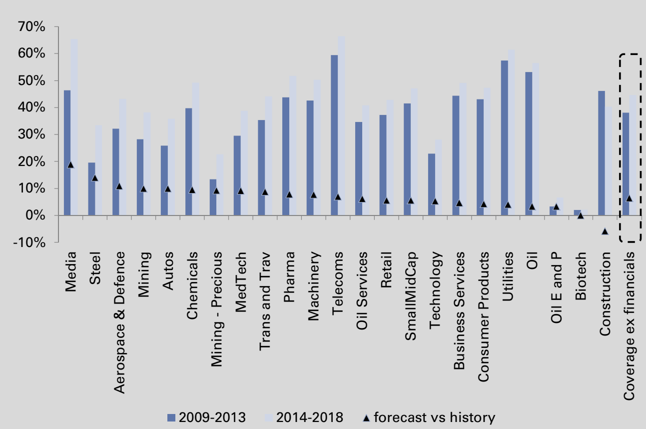
A 2013 survey of German corporates by the Wall Street Journal found that only 15% were planning to invest within Germany in the next year. When asked 'Which markets will be your main investment focus in the next year?', only 20% listed Germany or other Europe, with 11% identifying the US and 43% selecting EMs. It is tempting to argue that in order for domestic demand to be stimulated, European corporates should be encouraged to invest domestically. In reality of course, this may not be optimal for shareholders or for longer-term corporate health. In this Catch 22, the attractiveness of the investment landscape clearly needs to improve before the spend follows.

Exhibit 62: Investment levels are falling in almost all sectors (on GS estimates)...
Average capex/depreciation ratio



Source: Goldman Sachs Global Investment Research

Exhibit 63: ... while dividend payout ratios are set to rise
Average dividend payout ratio



Source: Goldman Sachs Global Investment Research

Necessity: The mother of invention

Many of the challenges that Europe faces, ranging from ageing to resource scarcity, are global in nature. Around the world, executives and policymakers are assessing the best way to harness big data and to ensure that capital is allocated efficiently. Can Europe act as an incubator for solutions to these challenges? Below, we consider the examples of energy & resources, and ageing & demographics – in all cases, Europe is something of a pioneer, developing solutions to the challenges posed by these trends.

Energy & Resources: Horizon 2020 is the biggest EU research programme to date, with some €79 bn of funding available for 2014-20. Energy research and innovation is one of the key priorities for the project, which has been conceived to support the transition to a reliable, sustainable and competitive energy system. There is also a separate but complementary programme for nuclear energy research activities adopted under the Euratom Treaty. In terms of budget, Horizon 2020 will dedicate €5,931 mn for non-nuclear energy research for 2014-20 and €1,603 mn for nuclear research for 2014-18.

To make the transition to a competitive energy system, there are a number of challenges to be overcome, such as increasingly scarce resources, growing energy needs and climate change. An obvious category of solutions, and one that features prominently across EU energy policy, is the development of renewable energy: this is more environmentally friendly, and produced 'in-house' and therefore secure (provided sufficient capacity can be built). The problems come with the third leg of the energy trilemma: renewable energy is more expensive. It does, however, create jobs and stimulate investment, and the EU believes that with enough research into and work on methodology and efficiency, the costs will become competitive.

If these problems can be solved, it is possible that the real money-spinner will be not just affordable energy, but the profit from selling the knowledge gained in the process. Chancellor Merkel has already shared her hope that these investments should more than pay off in the long term with the aim of energy technology becoming a key German export. According to the Renewable Energy Policy Network, China spent €56.3 bn on renewable energy investment in 2013; if those solutions are being produced in Europe, renewable technology has the potential to become a substantial revenue generator.

Resource constraints are not just a challenge to be addressed in the energy market. As a continent, Europe also faces a number of other physical constraints, not least space/land. Pioneering new housing models and closed-loop waste management systems, to name just two examples, may be other areas where Europe can lead the world.

Ageing & demographics: Given that Europe's demographic headwinds are by no means unique (just more immediate than those for others), there may be an opportunity for Europe to turn this into a source of competitive strength. Can Europe provide a blueprint for the rest of the world as it plans for the same issues of pension and healthcare reform? On the ground, there are examples of Europe already exporting some expertise in the area of ageing. For example, European firms, such as the German company Pro Seniore, already participate in building nursing homes in China.

Other interrelated topics are also vital for the demographic discussion. The impact of shifting demographics cannot be considered without also looking at migration policy (both within Europe and into Europe from the rest of world) and household formation trends. The ageing of the population also has implications for how we build houses, for the suite of asset management products that are developed, for the evolution of healthcare payment and delivery and for innumerable other areas of the economy.

Europe at a crossroads

In many respects, Europe finds itself at a crossroads. As articulated by our Portfolio Strategists in their report *Adventures in Wonderland* (October 21, 2014): "Markets and economies have recovered a great deal from the crisis that has overshadowed the market over the past half-decade, but it is far from clear what the route is from here." This uncertainty was also expressed by the corporates we met with when compiling this report. The optimal strategic path for these companies is highly dependent on the medium-term path that the global economy takes, whether one of normalisation, stagnation or moderation. Hopes of normalisation in turn depend on Europe's ability to embrace major structural reform.

Unfortunately, a sense that growth prospects are sluggish, that the workforce isn't skilled in the correct areas and that infrastructure development is lagging will become self-perpetuating in Europe if corporates choose to concentrate their growth and innovation spending abroad. This presents pressing challenges for policymakers. The easiest levers have now been pulled and there are difficult decisions ahead. Some potential solutions will inevitably involve near-term pain for longer-term gain. For policymakers, the risk of unpopular moves now seems all the more acute given the recent rise in the popularity of far-right parties across the continent.

What alternative scenario exists for Europe?

In this chapter, we touch on the upside and downside risks from here. If the current stagnation continues or – worse still – Europe enters a third recessionary period, this may have profound impacts on the strength of the continent's companies relative to global industry peers. While the full impact of prolonged economic weakness is hard to forecast, it may also raise the prospect of increased social unrest and political fragmentation. Although many of the parties that exploit economic weakness to gain support are anti-Europe, there is a clear case for 'more Europe' in solving some of the continent's ongoing challenges.

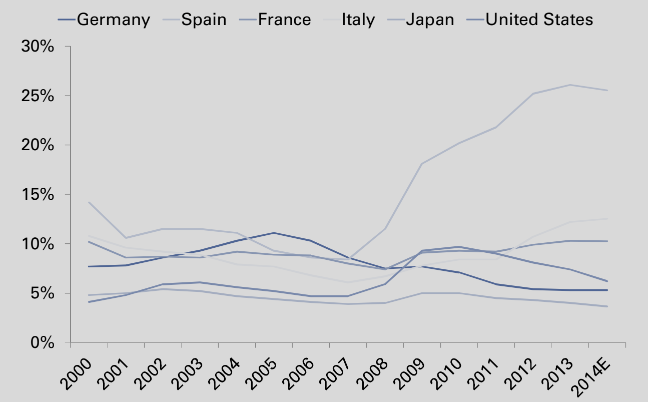
A more optimistic scenario also exists. As we have discussed in our report *Uses of Cash II* (April 29, 2014), having cut hard, many of Europe's corporates now look like 'coiled springs'. Even modest demand improvements and top-line growth have the potential to meaningfully propel profitability, on our analysts 'numbers.

Europe as a coiled spring

The pressures to which Europe is currently being subjected are widely acknowledged: the consensus outlook is for poor growth and a fairly bleak future. While this is clearly not good news for Europe, it does mean that the potential impact from a positive surprise could be substantial. This is compounded by the fact that corporates have dedicated years to becoming as efficient as possible, and to shoring up their balance sheets.

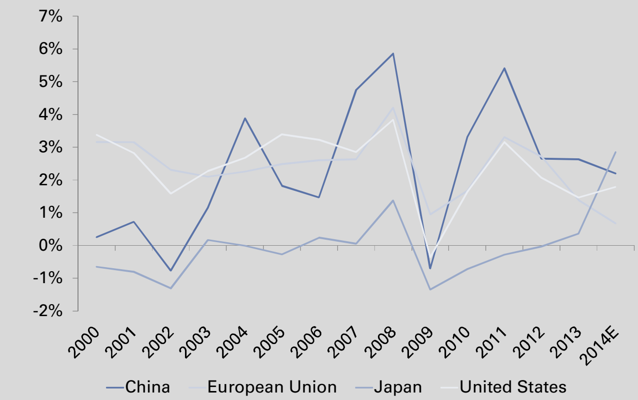
The prospects for European companies in the event of even a relatively modest ‘normalisation’ look bright. Our analysts’ forecasts suggest that European corporates have effectively ‘done enough’ on both costs and cash management during the recession for even a relatively modest top-line recovery (without a secular EM tailwind) to propel margins and FCF to new highs. In aggregate terms, our European coverage universe now resembles a ‘coiled spring’. To the extent that there is a ‘recovery phase’ (however muted), the corporates look well positioned to reap the rewards of pronounced operating leverage. While we acknowledge that margins are currently relatively high, we see limited risk of erosion given industrial overcapacity, high levels of slack in the labour market and falling commodities.

Exhibit 64: Unemployment is high – slack in labour market
Unemployment over time



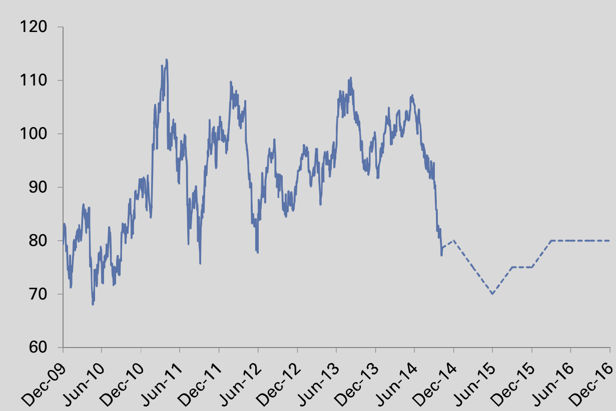
Source: National Labour Organisation, World Bank

Exhibit 65: Inflation is low – slack in the overall economy
Inflation over time



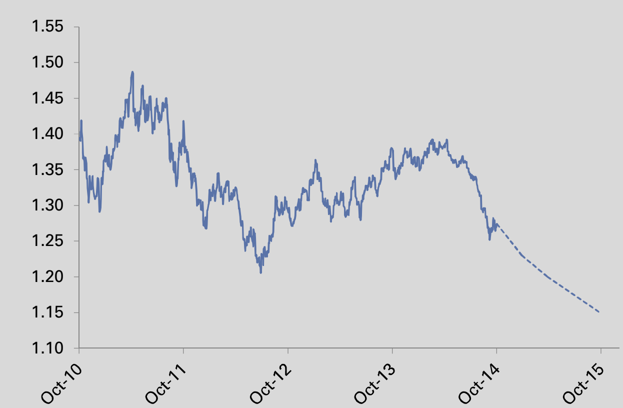
Source: World Bank

Exhibit 66: For many industries, the lower oil price is offering a tailwind on costs
Historical WTI price with GS forecasts included (US$/bl)



Source: Bloomberg, Goldman Sachs Global Investment Research

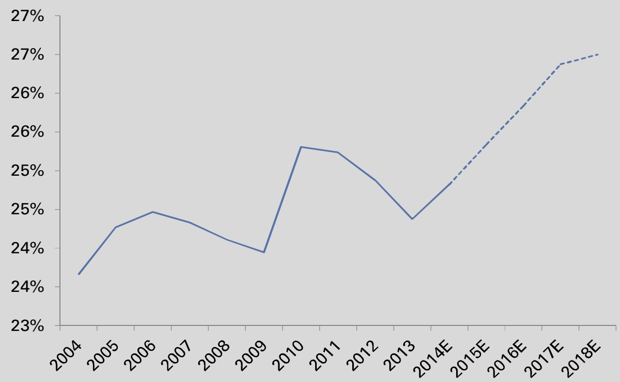
Exhibit 67: The weak euro is also a positive for European companies with meaningful exports
Euro/$



Source: Bloomberg, Goldman Sachs Global Investment Research

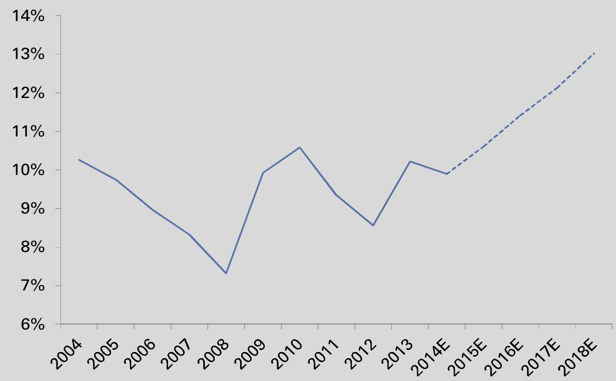
When we combine the remarkable expansion in forecast FCF generation with the balance sheet capacity we see across the market, it suggests a multi-trillion euro cash deployment opportunity. This cash will provide the fuel that corporates need to grow, both organically and inorganically. In our view, those that can do this successfully – by identifying accretive opportunities in their own or adjacent industries – will be the 'winners' over the medium to long term.

Exhibit 68: EBITDA margins expanding to new highs on our analysts' forecasts
EBITDA margins, market cap weighted



Source: Company data, Goldman Sachs Global Investment Research

Exhibit 69: FCF margins show 'coiled spring' profile too
FCF margins, market cap weighted



Source: Company data, Goldman Sachs Global Investment Research

The dangers of cutting too far

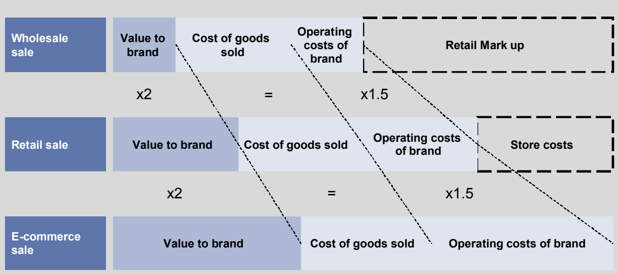
The financial crisis galvanised businesses into cutting costs and making themselves leaner and more efficient. This has been a productive process, as can be seen in the substantial margin expansion achieved across European stocks. However, if Europe does experience a period of prolonged stagnation, forcing companies to continue this process, there is a risk that they start ‘cutting into muscle’. Across all of our analysts’ work on competitive positioning, there is a clear motif throughout: the need for ongoing investment, whether in innovation or in the existing asset base. Companies must be careful not to choose a near-term margin boost over their long-term positioning.

In brands, failing to invest in technology will put companies permanently on the back foot: (1) e-commerce can expand the consumer and category reach of brands; (2) digital marketing helps brands build deeper immersive relationships with consumers; (3) big data can improve customer insights; (4) customisation may allow for faster supply chains and higher price premiums; and (5) differentiated brand extensions, even into the field of service provision, represent further growth opportunities.

In telecoms, network quality is crucial. Our analysts look at average wireline broadband speed vs. in-footprint rivals (with an upper cap of 100 Mbps for operators that have deployed FTTH or DOCSIS 3.0) and the share of overall market spectrum (MHz owned/total MHz available in the market) as indicators of competitive differentiation. The extent of fibre deployment, measured as the percentage of the wired network upgraded for high speeds multiplied by the average speed achieved, and the total quantity of wireless spectrum owned (in MHz), frame the long-term capex risk faced by the operator. In other words, by failing to invest today, companies in the space are simply deferring spend to tomorrow (and likely losing share in the meantime).

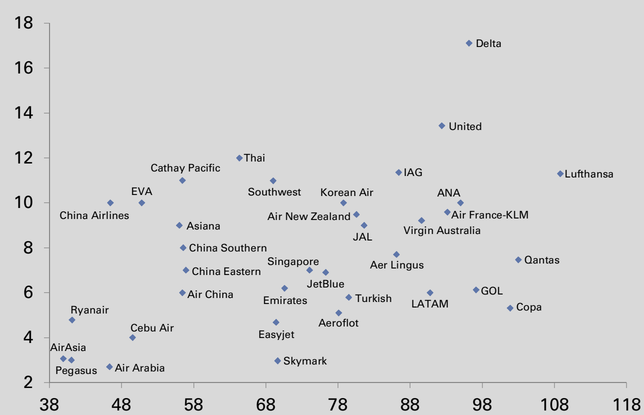
In autos, R&D spending as a percentage of sales is a key factor determining entry barriers. Increased innovation spend is also crucial to meet new regulatory emissions standards. **In shipping,** our analysts use average fleet age as a proxy for a dry bulk operator’s operational efficiency, as the ongoing technological advances in shipbuilding mean the key differentiation in operational efficiency has been on factors such as a vessel’s fuel consumption and hull design.

Exhibit 70: Failing to invest in e-commerce now has long-term consequences for profitability
Notional P&L of a retail, wholesale and e-commerce sale



Source: Goldman Sachs Global Investment Research

Exhibit 71: For airlines, superior unit costs and young fleets reinforce competitive advantage
Average fleet age vs. 2012-14E average unit cost (US$ cents per ATK)



Source: Goldman Sachs Global Investment Research

The risk of getting it wrong

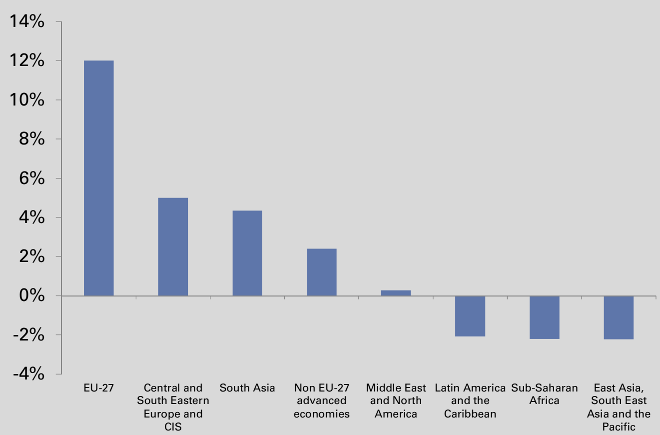
There is no doubt that the global financial crisis has taken its toll on the populace of European countries. The pain of multiple recessions, particularly that caused by high unemployment levels (especially among the young), has been felt across the continent. The people of Europe are becoming increasingly frustrated and are railing against their leadership, giving populist parties a chance to fire up support; if the economic situation worsens further, some fear the European Union may reach breaking point.

In October 2014, the IMF published a report saying the EU faces a 38% likelihood of falling back into recession soon. This is double the probability it forecast back in April. In addition, GS' own RETINA framework (which is used to track the evolution of real economic activity) suggests that Euro area 3Q GDP growth will fall into negative territory. And the current signs of a slowdown are not uniquely European. The GS advanced Global Lead Indicator for October suggests the October advanced reading places the global cycle deeper in the 'Slowdown' phase, with momentum declining.

The relatively unprecedented nature of a 'triple-dip' in recent history makes the precise implications hard to predict. As well as economic implications, there would likely be second-order effects across the social and political sphere. As shown below, Gallup's 'social unrest index' already shows a heightened risk of unrest in the continent. Recession, characterised by high unemployment and falling living standards, has also fed the growth of the far-right, anti-European, anti-immigrant vote. Across Europe, huge differences exist in unemployment benefits, giving rise to attention-grabbing 'benefit tourism' headlines, which can stir up anti-Europe rhetoric and add credence to some of the anti-immigration claims of certain right-wing parties. Gross replacement rates (expressed as the percentage of an average production worker's wage for a single-person family that would be replaced by the social security system if unemployed) vary greatly, from 80% in Luxembourg to 13% in the United Kingdom. Gross replacement rates are on average somewhat higher in Euro area countries, around 50%, compared with slightly below 40% outside the Eurozone.

Exhibit 72: The financial crisis had led to increased signs of (and potential for) social unrest

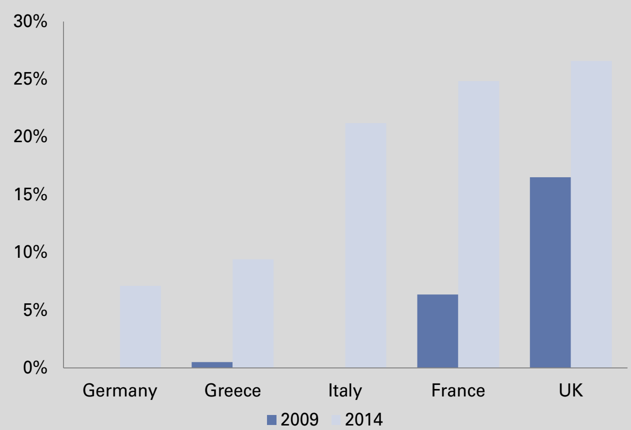
Change in the social unrest index, 2006-07 vs. 2011-12



Source: IILS, Gallup World Poll 2013

Exhibit 73: The rise of Euroscepticism

Percentage of the vote won by the largest Eurosceptic party, select European countries



N.B. party taken as largest party in 2014 and kept constant

Source: Compiled by Goldman Sachs Global Investment Research

There is no question that the popularity of Eurosceptic, often far-right, populist political parties has shot up in the past five years in Europe. There is no clearer manifestation of this than the last election for the European Parliament in May 2014. In the UK, the United Kingdom Independence Party became the first party other than the Conservatives or Labour to win a nationwide election for a hundred years, while in France, the election was won by Marine Le Pen's National Front, which quadrupled its vote share. Both parties wish their respective countries to leave the EU. Italian comedian Beppe Grillo's anti-establishment Eurosceptic party drew 21% of the vote despite being less than five years old, and in Greece, Golden Dawn increased its vote nearly twenty-fold from 0.5% to 9.4% in the 2014 EU parliament election. Even 7% of Germans voted for the newly created AfD (Alternative für Deutschland), which aims to abolish the euro.

A parting thought: Offence is the best form of defence

After a prolonged period spent defending existing profit and FCF pools, European companies now need to go on the offensive. The same might be said of European policymakers. Minimising the risk of a worst-case scenario has occupied the best part of seven years on the continent. Despite this, with economic data becoming weaker in the past three months, some are left wondering if Europe is on the edge of a third consecutive recession. Bolder measures are required on both sides to get Europe back onto a normalisation path.

Europe has many strengths and much potential, and while global economic realignment might mean the continent has to work harder than it is accustomed to doing in certain areas where its advantage is no longer assured, this should be seen as a reason to drive forward, not to give up. Substantial numbers wish to come to Europe because they believe it is an attractive place to live.

There are multiple channels through which increased confidence can manifest itself, but it is likely to be seen through an increased degree of specialisation, a clearer recognition of Europe as a brand and more emphasis on efficiency and innovation.

The continent needs to make an art of efficiency. Europe is a mature economy, facing many issues that the rest of the world will also have to come to terms with over the coming decades. Population density, demographic headwinds and expensive energy have forced Europe to innovate on efficiency. This drive for resource efficiency has, for example, clearly been exacerbated by the recent financial crisis. Can the continent now export this innovation?

There are a huge number of other areas where necessity has driven innovation in Europe, whether through enhancements to workplace productivity or the high levels of innovation in smart/connected living**. Europe's overall competitive advantage may simply lie in finding solutions to universal challenges.**

Above all, collectively, Europe must be bold, regain its lost confidence, keep the system simple and use all of its embedded advantages to do extraordinary things.

Appendix

Our research on other topics that are prominent in CEO thinking:

Home automation has existed as a concept since the idea of 'smart homes' in the 1960s, but only recently with the spread of internet-enabled objects has the house where the lights react to your presence and the fridge orders in food when you're running low looked like it might become a reality. The conversation has become more prominent since Google purchased Nest, a smart thermostat producer, in February, and Apple announced HomeKit, which will enable the control of various devices in the home through Apple's software. Our analysts have addressed this as part of the global series on the Internet of Things; find home automation in *Volume III: The next industrial revolution: Moving from B-R-I-C-K-S TO B-I-T-S.*

3D printing is growing rapidly: the market for 3D printers and services was worth $2.2 bn worldwide in 2012, up 29% from 2011. It offers significant raw material and assembly cost optimisation (less waste, fewer steps to produce complex structures), production closer to source and more customisation. Read about 3D printing in various contexts in Fortnightly Thoughts Issue 47: *Making things faster, stronger, leaner, better* and Fortnightly Thoughts Issue 77: *Let's talk* disruption, which includes an analysis of 3D printing in medicine. Medical use is already well established: 80% of hearing aids are 3D printed, and our analyst believes there is the potential to manufacture tailored devices, implants, and even organs. This is also covered in 'The 3D printing revolution in medical devices' in Fortnightly Thoughts Issue 70*: Healthcare innovation on the mend?*

New materials are coming to the fore that help to make products lighter, stronger and easier to use. As discussed earlier, with regards to energy, the planet's commodities are finite, and as many become more and more scarce, the search to replace them intensifies. Various carbon-based structures such as graphene and carbon fibre are being developed and exploited, but costs are still high; rare earths too, extensively used in manufacturing, are being investigated. In addition, unsurprisingly, there is a heavy emphasis and potential opportunity in using existing materials more efficiently. Fortnightly Thoughts Issue 72: *Material changes in the material world* and Fortnightly Thoughts Issue 47: *Making things faster, stronger, leaner, better* offer a more in-depth exploration.

Big data, as with many technological developments, some of which we discuss earlier, is increasingly seen as a fundamental tool that is imperative for companies to understand and exploit, rather than just something nice to have. Many of the pioneering tech companies, as we note, are currently coming from the US, and so it is unsurprising that the best exposition of big data comes from our Americas Technology team. See *Big Data: Storm clouds brewing* for an introduction to the phenomenon and our analysts' thoughts on the potential impact of the trend.

DNA sequencing technology has been talked about for years, but recent significant cost improvements may mean a revolution in diagnosis and treatment efficacy and efficiency is within reach. Genomics, the process of sequencing the human genome, is incredibly complex, but strides forward have been substantial: read the thoughts of Sir John Chisholm, Executive Chairman of Genomics England, along with other articles exploring the phenomenon, in Fortnightly Thoughts Issue 70*: Healthcare innovation on the mend?*

Driverless cars have come off the pages of science fiction and into real life: companies such as Google are already at testing stages. While universal adoption is still a way off, the implications for autos, tech and insurance companies, as well as governmental approaches to infrastructure, are huge. Our global insurance team describes their projected timeline, how the process might work and what the results might be, in *Volume IV: Smart technology and the future of insurance*, as part of the international Internet of Things series.

Nanotechnology – working with material at the atomic/molecular level – is becoming increasingly high profile as its usage spreads. More precise tools allow manufacturers to use different materials, or the same materials more effectively; as with new materials, this trend is born out of an acute awareness of the planet's finite resources, driving manufacturers to do more with less, and could bring substantial changes to manufacturing. We expand on nanotechnology in Fortnightly Thoughts Issue 47: *Making things faster, stronger, leaner, better* and it is one of our *Buzz! 22 things you need to know* in Fortnightly Thoughts Issue 75.

Details of related research:

Internet of Things Vol 3: The next industrial revolution: Moving from B-R-I-C-K-S TO B-I-T-S (July 16, 2014)

Fortnightly Thoughts: Let's talk disruption (July 16, 2014)

Fortnightly Thoughts: Healthcare innovation on the mend? (March 6, 2014)

Fortnightly Thoughts: Making things faster, stronger, leaner, better (January 17, 2013)

Fortnightly Thoughts: Material changes in the material world (April 14, 2014)

Americas: Technology: Infrastructure Software. Big Data: Strom clouds brewing (January 28, 2014)

The GS Big Data Bus Tour (April 14, 2014)

Internet of Things Vol 4: Smart technology and the future of insurance (September 24, 2014)

Fortnightly Thoughts: Buzz! 22 things you need to know (June 10, 2014)

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