Granolas: the European superstar stocks

As in the United States, European markets are dominated by a small group of large-cap companies. Overview.

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Two weeks ago, we explained in a FOCUS note ("The tip of the iceberg") the lack of depth in the US market. We highlighted the fact that the rise of the S&P 500 since the beginning of the year is only based on the performance of a few large technology companies.

Even if the effect is less marked, a similar phenomenon can be observed in European equities. Admittedly, the old continent does not (yet) have mega-cap companies worth more than a trillion dollars, as is currently the case in the United States with the GAFAs (Google, Apple, Microsoft Corp, Amazon, etc.). However, it is possible to isolate ten or so very large-cap stocks (over 200 billion euros) that are increasingly attracting the attention of foreign investors.

These ten stocks now account for almost one fifth of the market capitalization of the benchmark Stoxx 600 index. By 2020, investment bank Goldman Sachs had coined the acronym GRANOLAS for 11 pan-European stocks: GlaxoSmithKline, Roche Holding, ASML, Nestlé, Novartis, Novo Nordisk, L'Oréal, LVMH, AstraZeneca, SAP and Sanofi.

The great "Granolas" companies

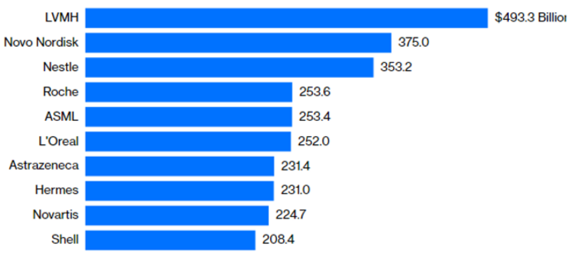
Three years later, the ranking of the largest capitalizations has changed somewhat. GlaxoSmithKline, Sanofi and SAP have dropped out of the Top 10, while Hermès and Shell have entered.

But the characteristics of these stocks remain the same: strong balance sheets, strong earnings growth that is not sensitive to the economic cycle and high dividend yields. Unlike the US, Europe is not dominated by technology. Instead, the luxury, healthcare and consumer sectors account for the lion's share of the Top 10.

For the first time in history, a European company has seen its market capitalization exceed 400 billion euros: LVMH Moet Hennessy Louis Vuitton SE, whose operating profit reached 21 billion euros in 2022. The other GRANOLAS are not so far behind: the Danish pharmaceutical company Novo Nordisk A/S has reached a capitalization close to 350 billion euros, while the Dutch semiconductor equipment company ASML NV is worth 230 billion euros. Ten European companies now have a market capitalization of more than $200 billion, crossing the threshold of "megacapitalization. Ten years ago, there were only three.

European Megacaps

10 European companies now have a market cap in excess of $200 Billion

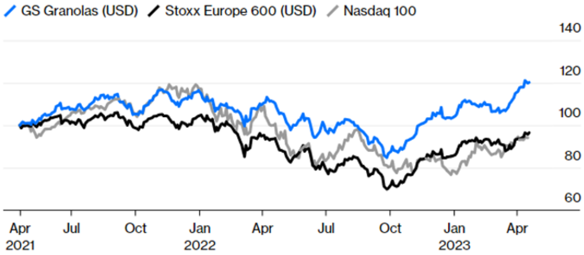


Sources: Bloomberg

These European "super-stocks" have contributed to the outperformance of the Stoxx 600 (vs. S&P 500 since the beginning of the year). Over the last 24 months, the GRANOLAS have clearly outperformed both the Stoxx 600 index and the Nasdaq 100.

Rise of the European Megacaps

Even in US dollar terms big European companies have been a good bet over the past two years



Source: Bloomberg
Note: April 2021 = 100 Goldman Sachs Granolas index comprises GSK, Roche, ASML, Nestle, Novartis, Novo Nordisk, L'Oreal, LVMH, AstraZeneca, SAP and Sanofi

As mentioned above, GRANOLAS have several common characteristics. First, strong sales growth, despite their large size. LVMH's first-quarter sales rose 17% year-over-year on the back of rebounding Chinese demand, while cosmetics maker L'Oréal SA reported a 13% increase in like-for-like sales in the first quarter. Norwegian pharmaceutical company Novo Nordisk predicted 2023 sales would rise about 27%, while ASML expects sales growth of more than 25% this year.

Most revenues are generated outside Europe, and many of these companies have dominant positions in "niches": Novo Nordisk controls nearly a third of the global diabetes treatment market by value, and its Wegovy is the first new obesity drug in years. ASML is the only company capable of producing the extreme ultraviolet lithography machines needed to write tiny features on chips.

A monopolistic or oligopolistic position and a demand that often exceeds supply allow GRANOLAS to pass on any cost increases to prices. This pricing power is particularly sought after by investors in the current context of inflationary pressure. The luxury and healthcare sectors are particularly well positioned to preserve their operating margins, which are very high (over 40% for Hermès and Novo Nordisk). These sectors are also relatively resilient during growth slowdowns and even economic recessions.

GRANOLAS also offer relatively attractive dividends, with an average dividend yield of around 3%. These dividends should continue to grow over time, due to strong earnings growth, a strong balance sheet and a payout ratio of about 50%.

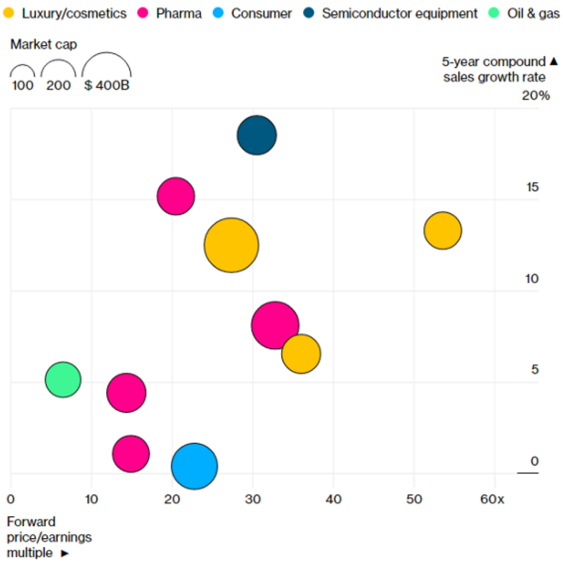
What are the downside risks?

The intrinsic qualities of GRANOLAS have not gone unnoticed by investors. Most of these stocks trade on relatively high price-earnings multiples. Hermes is trading at over 50 times estimated earnings, while Novo Nordisk's 33 times multiple represents more than double the average P/E for the pharmaceutical sector.

As the chart below shows, the 5-year sales growth justifies part of the valuation premium. But any sign of deterioration in their earnings power could cause these stocks to underperform. Another factor that could put downward pressure on valuation multiples is investor rotation toward more cyclical companies in the event of a strong recovery in global growth.

Growth For a Price

It's no surprise that Europe's fastest growing mega-caps are also the most richly valued on a price-earnings basis



Source: Bloomberg

Conclusion

Unlike the 2010s, Europe is no longer dominated by oil, banking and telecommunications companies. Today, a group of very large market capitalizations enjoys dominant positions in products whose demand is exploding internationally: luxury goods (LVMH, Hermès), consumer goods (L'Oréal, Nestlé), healthcare (Novartis, Roche, Novo Nordisk, AstraZeneca, Sanofi, etc.) or semiconductors (ASML). The current valuation premium seems particularly high on most of these stocks. But it is partly justified by superior earnings growth, a strong balance sheet and a sustainable competitive advantage.

NB : These are not investment recommendations

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