Baillie Gifford European Growth

BGEU looks exceptionally cheap given the growth potential in the portfolio…

Update
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Overview

Baillie Gifford European Growth Trust (BGEU) owns a highly differentiated portfolio of high-growth companies based in Europe, managed by Stephen Paice and Chris Davies. The portfolio has almost no crossover with European indices and the typical European equity fund, Stephen and Chris purely looking for companies they have a high conviction can at least double in value over five years, and ideally for those that can be the biggest index weights in the future, rather than the present.

Growth equities have been under pressure this year, as rising interest rates and fears of a recession have led to high levels of risk aversion in markets. Stephen and Chris report that their portfolio has largely performed well operationally, with the long-term growth prospects unchanged or improved. Nevertheless, market sentiment means that valuations have fallen markedly (see **Portfolio**), arguably increasing the attractions for long-term investors. They have been adding to a number of stocks in their portfolio at lower valuations and have also picked up a handful of new companies where they believe there are exceptional growth prospects being discounted by consensus. Where there have been problems with portfolio companies, the managers are looking through what they see as temporary issues, focusing relentlessly on the long term.

While the growth bias is important, the trust also stands out for the highest allocation to mid-caps in the AIC Europe sector, and the 10.9% allocation to unlisted stocks. The trust has structural **Gearing** which contributes to volatility in the shares and amounts to c. 15% of NAV.

With its style out of favour, BGEU's shares have moved onto one of the widest discounts in the AIC Europe sector, and at the time of writing, this **Discount** is 14.1%.

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Analyst's View

The last two years have been disappointing for shareholders, but the question now for current or potential holders is what the future holds or what is priced in to the shares, both of BGEU and of the underlying holdings. The managers point to some stark statistics which highlight that the exceptional growth outlook for their companies is not reflected in their rating. Certainly it seems that all environmental factors have been working against the trust: high interest rates have led to investors favouring value stocks, risk aversion has led investors away from mid-caps and increasingly into cash, while the valuations of unlisted companies have been called into question in the absence of many deals. With BGEU's own shares treading on a wide discount versus history and versus peers, we think there is potential for strong performance once sentiment shifts, and the managers argue it is time to "lean into growth" rather than chase the defensive large caps that have performed better this year.

We acknowledge it may take time for sentiment to shift, and with a highly active portfolio like BGEU's, good results or operational developments for individual companies are likely to be as important to a re-rating. Promisingly, there are rumours that Northvolt, the portfolio's largest position and Europe's leading EV battery manufacturer, is seeking to IPO next year. This could not only see a valuation uplift in the portfolio if the pricing is good, but also dispel some of the negativity around private company valuations, which may be affecting BGEU's discount.

BULL
High-conviction approach brings outperformance potential
Managers' compensation package is designed to align long-term interests with shareholders
Wide discount could close over time

BEAR
Gearing can enhance losses on the downside
Active approach also increases chance of underperformance
Likely to continue to be volatile thanks to portfolio makeup and gearing

Portfolio

Baillie Gifford European Growth (BGEU) is managed with an unwavering focus on long-term growth by Stephen Paice and Chris Davies. Stephen and Chris focus on companies that are listed in Europe, but rather than start with a benchmark index and work outwards, they start with a blank sheet of paper and aim to find companies which can double in value (as a minimum) over five years, wherever they are. The portfolio has an exceptionally high active share of 91% versus the FTSE Europe ex UK Index, a commonly tracked measure of European markets and often used as a benchmark by the trust's peers.

Key contributors to this active share include the focus on mid-caps. BGEU has the highest allocation to mid-caps in the AIC Europe sector, according to Morningstar data. This reflects the managers' desire to uncover the growth companies of tomorrow rather than sit in the well-known market leaders in Europe. The managers argue that the index of twenty years hence will be radically different from today's and aim to invest in those companies which will sit at the top of the index then. Growth in earnings is expected to drive these companies, and the managers consider themselves growth investors. This means that they aim to find companies which can grow their earnings the most, and are willing to pay higher valuation multiples. For this style, the edge over the market comes when managers can find those companies where growth is likely to exceed already high expectations, in magnitude or longevity or in both. Stephen and Chris think they can find these companies in a variety of industries, from healthcare to hardware to the online economy and in the multiplicitous industrial sector.

It's important to note that despite the focus on growth – and the strong association of this style with Baillie Gifford as a manager – this isn't a factor fund. In fact, Morningstar holdings analysis suggests that the exposure to growth companies is not as high as a number of trusts in the sector. To some extent we think this reflects the sell-off seen over the past two years. Morningstar classifies companies based on various well-known valuation multiples, and we think the sharp decline seen in growth areas of the market in 2021 and 2022 has seen some companies BGEU holds reclassified as core rather than growth as their valuations have fallen. We can see the percentage of the portfolio classified as growth decline as a result, even though we know that turnover has been low and the managers' new ideas remain obvious "growth" companies. We think the key differentiating factor is really how active BGEU is – this is a high conviction portfolio of companies the managers believe will be long-term winners, and they are prepared to hold on to the companies they believe in through tough periods of performance.

The active nature is well illustrated by the top ten holdings shown below. Only one company in BGEU's top ten appears in the index' top ten: ASML. This is a world-leader in specialised components used in the most advanced semiconductors. The largest position is Northvolt, an unlisted and privately-owned company which by that definition does not appear in any indices or passive funds. Northvolt is Europe's leader in manufacturing batteries for electric vehicles. This means it has a critical role to play if we are to reach net zero as governments wish. Recently, the company revealed it had developed a new type of battery which did not rely on rare earth minerals. The potential for this technology is enormous, even if it

Peer Group Characteristics

	EQUITY STYLE VALUE %	EQUITY STYLE GROWTH %	EQUITY STYLE CORE %	LATEST % ASSET IN TOP 10 HOLDINGS	# OF HOLDINGS	MARKET CAP GIANT %	MARKET CAP LARGE %	MARKET CAP MID %	MARKET CAP SMALL %
Baillie Gifford European Growth	**8.3**	**54.3**	**23.8**	**35.6**	**57**	**11.7**	**28.1**	**41.3**	**4.7**
European Opportunities Trust	5.0	82.3	18.4	73.5	30	27.5	42.9	27.1	8.3
BlackRock Greater Europe	2.1	77.4	24.4	55.4	45	31.9	50.9	19.2	1.9
Henderson European Focus Trust	29.1	43.8	27.3	43.5	44	40.9	43.7	15.5	0.0
Henderson EuroTrust	12.6	53.4	37.1	43.5	48	46.7	40.6	15.1	0.0
Fidelity European Trust	15.2	48.2	27.6	40.0	103	45.0	35.5	11.8	0.0
JPMorgan European Growth & Income	29.2	33.4	37.5	27.0	274	57.2	32.4	9.8	0.8
Peer Group Median	12.6	53.4	27.3	43.5	48.0	40.9	40.6	15.5	0.8

Source:Morningstar

is too early to count on it. But this sort of dynamism is what Stephen and Chris prize. Northvolt is rumoured to be seeking to IPO next year, which could be a meaningful event for BGEU, both in terms of the potential impact on its NAV and as a validation of the unlisted portion of the portfolio. There has been scepticism in the market about the valuation of private companies as transactions have slowed, and a major IPO could, we think, give a boost to the whole sector. BGEU has five unlisted companies in all, which made up 10.9% of the portfolio at the end of September.

Top Ten Holdings

HOLDING	WEIGHT IN PORTFOLIO (%)
Northvolt*	5.3
Prosus	5.0
Topicus.com	4.4
Ryanair	4.2
Schibsted	3.6
ASML	3.5
Atlas Copco	3.5
Allegro.eu	3.3
EXOR	2.9
Kingspan Group	2.9
TOTAL	**38.8**

Source: Baillie Gifford, as at 31/10/2023, * = unlisted

Companies such as Prosus, which owns a significant stake in Tencent, and Allegro.eu, Poland's largest ecommerce player, bring exposure to the online economy and balance the exposure to hardware through Northvolt and ASML, one of the key global players in the semiconductor ecosystem. Meanwhile budget airline Ryanair sits alongside Kingspan Group, a supplier of insulation materials which is seeing strong growth in demand due to the importance of insulation to energy efficiency. The broad variety of companies in the top ten illustrates the go-anywhere approach of the managers: they are looking for companies they think can deliver at least 100% returns over five years, in whatever industry.

In 2023, there have been a number of new acquisitions. One is Hypoport, a German mortgage origination platform. Germans typically go to their high street bank for a mortgage and have not tended to shop around. Hypoport provides a platform where borrowers can seek out mortgages from multiple suppliers and find the best terms. Stephen and Chris think the German market is likely to shift in this direction over time, presenting a huge opportunity for Hypoport, and they bought in following a significant decline in the share price.

A very different set of new purchases has been the decision to buy into LVMH and Moncler. Previously the managers preferred Kering, but they have grown increasingly convinced of the ability of LVMH and Moncler to unlock increasing returns to scale through their ability to deliver increased sales even when increasing prices. The companies have high margins, and Stephen and Chris argue the brand power they have is very strong and hard to analyse with a balance sheet model.

One unlisted stock has been added over the period: Bending Spoons. This is an Italian software business which acquires struggling apps such as Evernote and manages them in a cheaper way, leveraging lower wage costs in Milan versus San Francisco and the scope to gain synergies by applying resources and solutions across different apps.

The managers have sold a small number of companies which they became convinced were likely to struggle in an environment of high funding costs. One was Aker Horizons, a renewables platform which the team thought would struggle in the current interest rate environment. The other was Embracer, a gaming company which has been on an acquisition spree. However, they have stuck with companies they think are long-term winners even if they are struggling to generate profits. For example, food delivery companies Hello Fresh and Delivery Hero remain in the fund. The managers argue that Hello Fresh is now in a strong position to reduce capex and lean into new business lines such as ready meal delivery, which offers a runway to eventual profitability. Delivery Hero is geographically diversified, with a strong presence in Korea, where inflation is lower and consumer spending under less pressure. The managers note its profitability is improving, even if revenue growth has slowed overall.

With the sell-off in growth stocks, the valuations on the portfolio now look much more attractive. The managers look at the PEG ratio, which is the P/E multiple divided by earnings growth and as such estimates how much value the market is placing on growth. They report the PEG ratio of their portfolio had fallen to c. 0.8 by the end of the financial year, ending in September, compared to a market level PEG ratio of 2.6. This is a pretty remarkable divergence, and if we do see the earnings growth the managers expect, then it implies either exceptional share price performance from the portfolio or remarkably low P/E valuations in future. They report the three-year consensus sales growth expectations of their portfolio is 5.8% per annum, and the equivalent figure for profits is 11.3%. This compares to 1.4% and 4.5% respectively, illustrating how market prices do not reflect consensus views on the exceptional growth in the portfolio, not just the managers'.

That said, there have been some issues with individual stocks in the portfolio which may have contributed to investor wariness about growth stocks and the wide discount on BGEU's shares. Most notably Adyen, a market leader in online payments, saw its share price halve in two days after weak results and fears of growing competition in the US marketplace hit the shares. While the managers acknowledge that US customers are often shifting to lower quality, cheaper competitors, they think Adyen remains a high quality operator and the share price decline is overdone. They point to the high revenue growth rates with a long runway ahead of it. They argue it has a great track record of providing complex solutions for the largest global players and it has historically been very profitable, currently guiding to a return to 50% EBITDA margin over the medium term. Needless to say, they have stuck with the position.

Another stock under pressure has been Sartorius Stedim Biotech. The company manufactures bioprocessing equipment for the biologics industry and reported a slowdown in demand and higher inventories following the slowing of a post-pandemic re-stocking boom. Stephen and Chris believe these are temporary issues and the long-term support for demand is very strong, and as a result they have added to the position on weakness. Nexans, the manufacturer of copper cables used in the offshore wind industry, is another position to have suffered. Again, Stephen and Chris believe the long-term thesis is sound, with the electrification of domestic and industrial power a secular trend.

Overall, the managers argue that the operational performance of the portfolio has been good over the past year, even if share price performance has been weak, and many companies are taking advantage of the environment to take market share. Stephen and Chris are also looking to take advantage by adding to their stocks on attractive valuations, with a problem for them being deciding which of the many opportunities to allocate capital to. They argue their portfolio has a strong growth outlook, a strong balance sheet and improving profitability, while valuations are now not reflecting any of that.

Gearing

BGEU utilises structural gearing. The trust has two long-term facilities which have locked in highly attractive rates. The trust pays just 1.57% on a 20-year €30m facility and 1.55% on a 15-year €30m facility. There is also an overdraft facility which facilitates short-term operations. This is worth €30m, although the board has agreed to cap its use at €15m for the time being. As at the end of September, this was all undrawn.

The board has restricted gearing to 20% of NAV, less the value of the unlisted equities. As at the end of September, unlisted equities made up 10.9% of the portfolio, so the maximum permitted gearing level was c. 17.8% of the whole portfolio. BGEU's net gearing stood at 15.6%, so reasonably close to the limit. Gearing has increased over the past couple of years as the portfolio has fallen in value. It rose from 4% at the end of the 2020 financial year and 7% at the end of 2021 to a level close to days last year. Rather than hold cash to offset this, the managers have maintained their conviction in their portfolio and stayed invested. Given the low rates locked in on the debt, this brings potential for strong returns when the portfolio performs well, although in the meantime it means the portfolio is exposed to any market declines. The gearing is a key reason why BGEU has been the most volatile trust in the peer group with the highest beta in recent years.

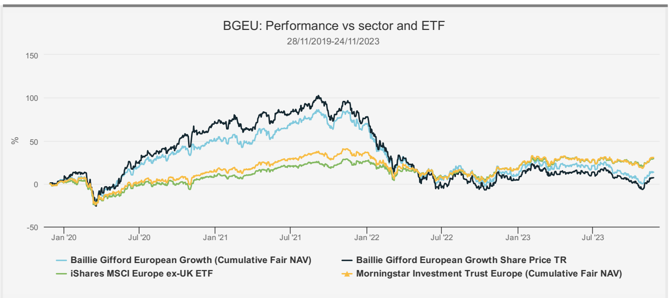
Performance

Stephen and Chris' strategy is to invest in companies they believe can deliver the highest earnings growth over the long term. This strategy has been under pressure since early 2021. Initially, the rapid rebound in economic activity following the emergence of vaccines led to a sharp rally in value over growth and investor preference for commodities, energy and low-duration assets. Over 2022, markets sold off sharply as investors began to price in higher interest rates; growth equities were worst hit. More recently, markets have generally favoured larger and less volatile companies as the economic outlook remains cloudy and uncertainty about inflation and interest rates lingers. This has worked against BGEU's punchier, more mid-cap focused portfolio. Style – i.e. value versus growth – has been a less important driver of returns over the past 12 months, but on a short -term basis continues to drive markets, with value or growth outperforming at times depending on changing expectations for interest rates.

Stephen and Chris argue that the superior earnings growth expected in their companies – based on analyst consensus, not just their own forecasts – is not being correctly priced by the markets. Whatever the importance of higher interest rates or recessionary pressures in the short term, over the long run they argue this growth should be rewarded by a significantly higher valuation, and this higher multiple applied to the higher expected earnings should deliver strong returns. It is clear to us that high interest rates are at least part of the story in keeping growth equities under pressure, given how markets react whenever data is released which suggests a peak in rates is near or has passed. On the other hand, it is worth considering that a lot of the performance potential in a highly active portfolio like BGEU is from individual stock picks, and operational developments at companies like privately-held battery manufacturer Northvolt, Prosus, with its exposure to Tencent and China, and the various food delivery companies in the portfolio will be important to returns, whatever the market preference for growth versus value. Additionally, the high weight to mid-caps is a key differentiator versus the peer group, and another factor that will be critical alongside the exposure to growth.

That said, in the last period in which growth was in favour, BGEU delivered exceptional returns. In fact, Baillie Gifford's first four years in charge of BGEU have been a volatile ride. The trust delivered exceptional outperformance in the first two years, as low interest rates and pandemic-related trends saw growth companies bid up, before giving it all back subsequently. At the time of writing, the NAV total return over the period has been 13.4% while the iShares MSCi Europe ETF is up 29.1% and the weighted average sector return is 30.5%. This exceptional performance in the first half of the period is likely a key reason Stephen and Chris are keen to lean into growth at this difficult time. With the growth in their market cheaply valued by the market, they argue we are at or near the maximum pain point for their style, which means potentially the moment of maximum opportunity.

Fig.1: Performance Since Change Of Manager



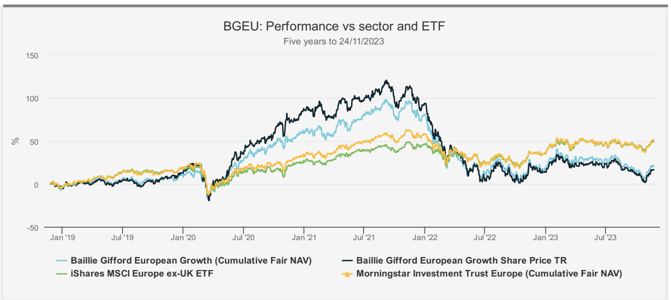
Source: Morningstar

Past performance is not a reliable indicator of future results.

Looking at a three-year period, BGEU has been the most volatile trust in the AIC Europe peer group, with the highest beta. The structural gearing has contributed to this, but we think the mid-cap exposure is important too. BGEU has also had the highest maximum drawdown in the peer group. These relationships hold over the past 12 months too, which means excluding the worst market sell-off, which occurred in early 2022. Given the style bias of the manager, exposure to mid-cap and gearing, we would expect volatility to continue to be a feature, but many factors have conspired to mean most of that volatility has been on the downside in the past couple of years, and we would expect that to change as or when markets rotate.

For the record, we show below BGEU's five-year returns. The trust has delivered a NAV total return of 20.7% compared to a total return of 49.1% for the iShares MSCI Europe ETF and a weighted average of 51.1% for the Morningstar Europe sector. However, we note that around a year of this was generated under a different manager with a very different strategy.

Fig.2: Five-Year Performance



Source: Morningstar

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Dividend

Generating an income is not an objective of the board or manager. As the dividend policy is to pay the minimum dividend necessary to maintain investment trust status, i.e. 85% of net income, and as the portfolio is not managed to generate a rising income, BGEU's dividends should be expected to rise and fall over time. One dividend is paid each year, although in the 2023 financial year a special dividend of 2.2p was paid with the proceeds of a settlement with HMRC. For 2023, the board has declared a dividend of 0.4p per share compared to 0.7p for 2022. This amounts to a yield of c. 0.5%. Given the dividend policy and the fact the investment strategy is unlikely to lead to a high income on the portfolio, BGEU will not likely appeal to income-seeking investors.

Management

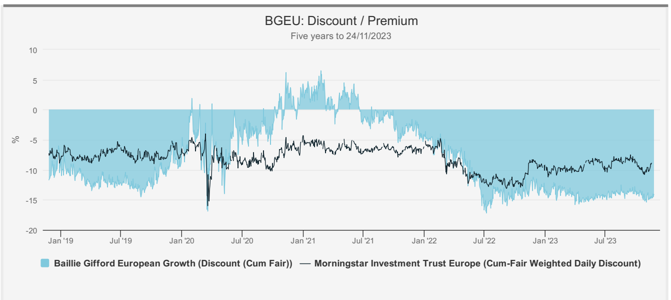
BGEU is co-managed by Stephen Paice and Chris Davies. Stephen and Chris have spent their entire investment careers with Baillie Gifford. Stephen joined Baillie Gifford in 2005. He has also co-managed the open-ended Baillie Gifford European Fund since 2011 and is head of the European equity team. Chris Davies joined Baillie Gifford in 2012 and the strategy in 2019.

Across the European equity team at Baillie Gifford, there are an additional five equity analysts and one dedicated ESG analyst with whom Stephen and Chris work in order to generate further ideas and analysis on prospective holdings. Baillie Gifford's partnership structure, coupled with the managers' compensation scheme, based on rolling five-year outperformance of the benchmark, is designed to encourage a long-term perspective on investments.

Discount

BGEU's shares have been trading on the widest discount in the AIC Europe sector in recent months, which at the time of writing stands at 14.1%. Obviously, this means that long-term shareholders have seen more downside to their investment in recent years for the discount to reach these levels. However, we think that looking forward, it also arguably increases the attractions of an investment given the potential for a narrowing discount to accompany a turnaround in performance. We think it is worth noting that the average discount for the sector is, according to Morningstar data, reasonably close to its five-year average, at 8.9% versus 8.1%. BGEU's discount, on the other hand, is significantly wider than its five-year average of 7.9%, underlying how out of favour BGEU is and how cheap the shares look.

Fig.3: Discount



Source: Morningstar

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The board has implemented buybacks while the shares have traded on a discount, but has not given an explicit policy on when they will be used, or a target discount limit. During the FY ending September 2022, buybacks were substantial, with c. 5.9m bought back – 1.6% of the starting number. However, during the 2023 financial year they have been used more sparingly. The total number was just c. 540,000, and buybacks have been very limited since May. The board has issued shares in recent years when the trust has traded on a premium, and retains permissions to buy back or issue new shares in future.

Charges

BGEU's latest ongoing charges figure (OCF), for the year ending September 2023, is 0.62% of NAV, which is lower than the AIC Europe sector's simple average of 0.83%. BGEU pays a management fee of 0.55% of the lower of NAV and market capitalisation. On any net assets above £500m, the management fee would fall to 0.5% of the lower. With a market cap of £308m and a NAV of £392m at the time of writing, we estimate the management fee to be c. 0.43% of NAV on an ongoing basis.

The latest KID RIY is 0.89%, which compares to an average of 1.23% for the Europe sector, according to JPM Cazenove. However, we caution that calculation methodologies may vary between trusts.

ESG

BGEU has received four out of five globes on Morningstar's sustainability rating when compared to its wider European equity peer group, which includes both open- and closed-ended funds. We note that, as a region, Europe ranks strongly from an ESG perspective, with strategies in the region often having individually strong ESG metrics when compared to other regions. We also note that BGEU has received Morningstar's "low carbon" designation, meaning it has very low exposure to carbon emissions, and indeed it has zero exposure to fossil fuel producers. In our view, BGEU is aligned with the aims and preferences of many ESG-conscious investors, even if it is not a sustainability strategy.

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