Baillie Gifford European Growth

BGEU offers investors an attractive option for European growth investing, combining listed and unlisted opportunities...

Update
19 January 2022

Summary

Baillie Gifford European Growth Trust (BGEU) aims to uncover the leading European growth companies, identifying companies with outstanding growth prospects in new technologies, new industries or in underappreciated sources of growth. The management team, Stephen Paice, Moritz Sitte and Chris Davies, believe the European stock market contains lots of stodgy, old-fashioned companies, but also lots of highly innovative and exciting businesses which are often overlooked by index-aware investors. They think that subtly and slowly the European market is changing as these companies grow and list, offering huge potential for investors who are exposed early on this journey.

Baillie Gifford were awarded the management contract in November 2019, yet they have a long track record of managing a similar strategy via the Baillie Gifford European Fund, which has generated an impressive five-year NAV total return of 97.5%, beating both its peers and benchmark. As we highlight in the **Performance section**, the open-ended strategy has generated these results with a higher five-year volatility than its peers, but this volatility is more than compensated for by its superior returns.

Stephen, Moritz and Chris look for companies with a highly asymmetric risk profile, and which they believe can at least double in value over the next five years. They highlight that much of their historical outperformance has been driven by a few outliers that have generated disproportionately large returns. Thus the team would rather avoid missing winners than holding losers. We cover the process in more detail in our **Portfolio section**.

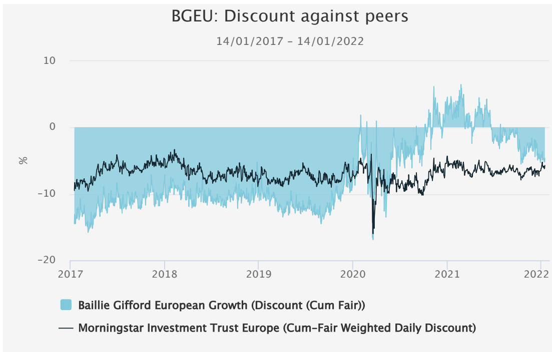
Since Baillie Gifford took over the trust there has been a substantial change to its **Dividend**. BGEU now pays a much lower dividend, reflecting a reduction in the underlying income that results from a greater focus on growth stocks. BGEU currently trades on a 4.6% **Discount**, amongst the narrowest in its peer group.

Analysts:

David Johnson

Key Information:

Price (p)	132
Discount (%)	-4.6
OCF (%)	0.65
Gearing (%)	9
Yield (%)	0.3
Ticker	BGEU
Market cap (£)	478,651,498



Kepler View

We think BGEU is a compelling option for long-term investors. The highly active approach taken by the Baillie Gifford team opens up the possibility of significant outperformance, and good stock-picking has almost doubled investors' money over the past five years. The closed-ended structure has the added benefit of allowing the managers to take significant exposure in the unlisted space, opening up the huge return potential in early-stage companies and providing a differentiator from the majority of the peer group. It is true though, that the approach has led to high volatility of returns and we think BGEU may be better suited to more aggressive or long-term investors who are able and willing to tolerate the higher risk.

Although BGEU's current discount is small, we think it could be an interesting entry point and we note that the trust traded on a premium earlier in 2021 when risk appetite in Europe was higher. Over the long run if the managers are correct about the return potential in their portfolio, then the discount is going to be immaterial to returns.

BULL
Open-ended equivalent has a long-term track record of outperformance
Manager's compensation package is designed to incentivise long-term value creation
High-conviction approach to European growth investing

BEAR
Gearing can enhance losses on the downside
Under Baillie Gifford, BGEU now has a lower dividend payout
Can underperform during a value rally

Portfolio

Baillie Gifford European Growth Trust (BGEU) aims to offer investors a portfolio of compelling European growth opportunities, with the sole objective of capital growth. BGEU is run by the three-strong team of Stephen Paice, Moritz Sitte and Chris Davies, all of whom have spent their investment careers with Baillie Gifford. Baillie Gifford took over the management of BGEU on 29 November 2019.

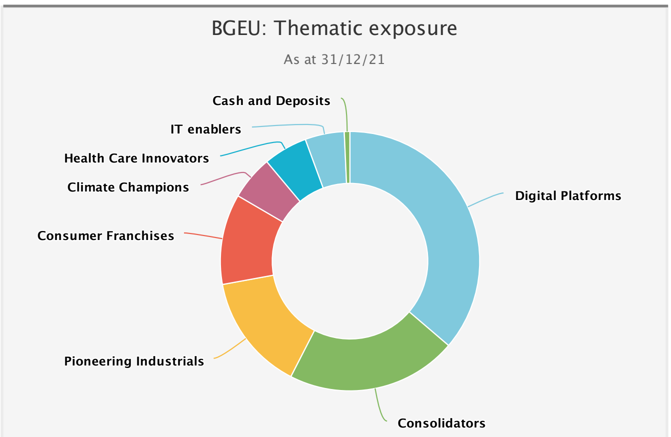
Under the stewardship of the new team BGEU now focusses on what the team believe are Europe's most attractive growth opportunities, targeting a return of at least 100% for each holding over a five-year period. The approach is entirely benchmark-unaware and highly active, from idea generation through to portfolio construction. The philosophy is that most of the stock market's returns over the long run come from a relatively small number of companies, and so the best results will come if an investor can identify these. While the team accept volatility and the possibility of loss in any one position, they believe this should be offset by the returns in their winners if they have picked them right.

The European markets are associated with many stodgy, large cap companies in traditional industries. In fact, during the aftermath of the 2007/2008 financial crisis many of these companies did very well as safe havens (with the exception of the banks). However, the Baillie Gifford team believe the best returns in future will come largely from newer companies which will grow into the giants of tomorrow, and they expect the index of twenty years' hence to look very different from today's.

BGEU's portfolio has a clear bias towards high-growth sectors and themes, particularly consumer discretionary, industrials and technology, however themes and sectors are merely an output of the team's process, as their bottom-up approach to stock selection pays no heed to them, or to country of listing. The largest thematic exposure, 'digital platforms', makes up c. 36% of the current portfolio. This theme includes companies like Prosus, the internet services conglomerate, and Delivery Hero, the food delivery company. It also includes the music streaming company Spotify, one of Baillie Gifford's highest-profile investments, with the company held in other Baillie Gifford strategies when it was still private, and continued to be held since its direct listing (BGEU has only held Spotify since Baillie Gifford assumed management of the trust). The team highlight the advantages that a founder-led company like Spotify has, as it ensures that it retains a long-term focus as well as ensuring its management remains ambitious.

The next largest theme is consolidators (21%). These are companies which are rolling up industries thanks to their superior operational abilities or efficiencies. A good example is IMCD. This top-ten holding operates as a specialty chemicals distributor, helping customers source important ingredients for a wide range of processes. This is a highly fragmented industry, giving IMCD the opportunity to acquire smaller peers and boost its growth. Companies under the industrial consolidator theme often operate in rather mundane sectors, which contributes to them being underappreciated. Examples include IT services and rubber compounds. Other themes include consumer franchises and tech enablers, with the rough breakdown of the current portfolio illustrated below.

Fig.1: Thematic Exposure



Source: Baillie Gifford

All are generally asset-light businesses whose value is in their intellectual property, software or human capital. The team's requirements for strong fundamentals, such as sustained earnings, as well as their bias towards capital-light business models, means their portfolio also demonstrates above-benchmark quality metrics. By focussing on disruptive, high-growth names, BGEU also shies away from many of the European 'old world' giants such as banks and energy companies, which dominate European bourses. This has led BGEU's portfolio to have an average market cap of roughly half that of its benchmark.

Price And Quality Metrics

		BAILLIE GIFFORD EUROPEAN GROWTH	FTSE WORLD EUROPE EX UK
Price	P/E Ratio	22.5	18.2
	P/B Ratio	5.8	2.2
Quality	ROA %	9.9	7.4
	ROE %	21.3	19.3
	Average market capitalisation (GBP mill)	20,976	40,281

Source: Morningstar, as at 31/10/2021

While technology and the internet are well represented in the portfolio, the team are open to ideas from anywhere and in any sector, as long as they meet their growth requirements. Recently the team purchased two of Europe's major low-cost airlines, Ryanair and Wizz Air. The team consider these to fit under the 'consolidator' theme, and that by surviving COVID-19 they are now in a stronger position than pre-pandemic because many of their rivals have been forced to close shop, allowing these two airlines to consolidate greater market share.

One of BGEU's most attractive features is its ability to invest in private companies, a common aspect of many of Baillie Gifford strategies and an example of the benefits of closed-ended structures. BGEU's private companies typically have a pre money valuation of €500m-plus. Currently 5% of BGEU's portfolio is split across three private companies: Northvolt, the electric vehicle battery manufacturer; FlixMobility, the transportation services company; and sennder, the digital freight-forwarder. BGEU's private holdings also differentiate it from the team's open-ended version of the strategy which does not hold unlisted investments. The board is seeking permission from shareholders to increase the limit private companies can make up on purchase from 10% to 20% of the portfolio. In keeping with the long-term approach, this is only at the time of investment though, and the managers will retain the flexibility to hold on to these companies as long as the growth prospects are attractive.

In order to identify stocks the team combine a wide variety of insights, be those academic, those of their own peers or those of Europe's most compelling entrepreneurs. However, sometimes this simply means gaining an understanding from competitors and suppliers of their investments. The team highlight that their investments in private companies offer them an edge in idea generation because small, more nimble companies can provide rare market insights that publicly traded companies cannot. The team have regular meetings to discuss stock ideas in which all members – 4 analysts and the PMs – are expected to contribute. There is then a period of reflection before the key decision-makers meet again to decide what to buy or sell (if anything). Rather than seeking to balance the portfolio by sector or theme, decisions reflect the level of conviction the managers have in each holding at that time. If one member has high conviction and the others are not as excited, it will still be included but at a lower weight. The team take collective responsibility for their picks though, rather than seeking to outdo one another or defend 'their' stocks.

The team look for sustainable returns potential and avoid 'speculative' growth stocks which may appear to have strong growth potential but are ultimately unproven in their ability to execute this. They also aim to ensure that management are aligned with the interests of the shareholders and wider society, an aspect we cover in more detail in our ESG section.

The team's assessment of a company's growth potential is designed to assess not only the likelihood of meeting this potential but also the potential return beyond this threshold, as well as discerning why the market hasn't identified the same opportunity which the team perceive. In our recent conversations with the team they highlighted the fact that the long-term returns of the open-ended equivalent of BGEU have been disproportionately driven by their return outliers, companies which have generated enormous returns over their holding period far above the returns of the market and BGEU's other holdings. The most extreme example of this is the team's holding of Atlas Copco, the Swedish industrial tools manufacturer, which has generated a c. 5,000% return over the last three decades.

Top Ten Holdings

HOLDING	WEIGHT (%)
IMCD	6.8
Adyen	4.3
Zalando	4.0
Prosus	4.0
NIBE	3.5
Avanza Bank	3.5
Atlas Copco	3.3
ASML	3.3
Ryanair	3.1
Northvolt	3.0
Total	**39.4**

Source: Baillie Gifford, as at 30/11/2021

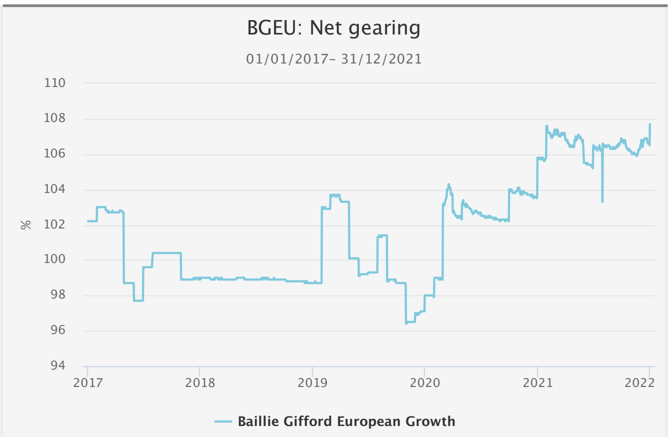
The team make it abundantly clear that the overarching element that unifies each aspect of their process is a desire to retain an optimistic view of their holdings. They believe that asking what can go right is far more important than asking what can go wrong, and they want to believe that potential winners will outweigh potential mistakes. In their minds missing winners – especially the return outliers – is far worse than owning losers.

Gearing

BGEU has net gearing of 7%, as of 30/11/2021. The team utilise gearing in a structural manner to buy attractive long-term investment opportunities which they would not otherwise be able to purchase. Gearing is implemented via two €30 million long-term debt facilities. The first has a maturity of 20 years from launch at a fixed rate of 1.57% and the other of 15 years at a fixed rate of 1.55%.

The Company also has an undrawn €30 million overdraft facility with The Northern Trust Company, which at present is capped at €15 million. As of 30 September 2021, BGEU's financial year end, the trust's maximum nominal gearing of €75m represents a potential gearing of 11.4% if fully drawn down.

Fig.2: Five-Year Gearing

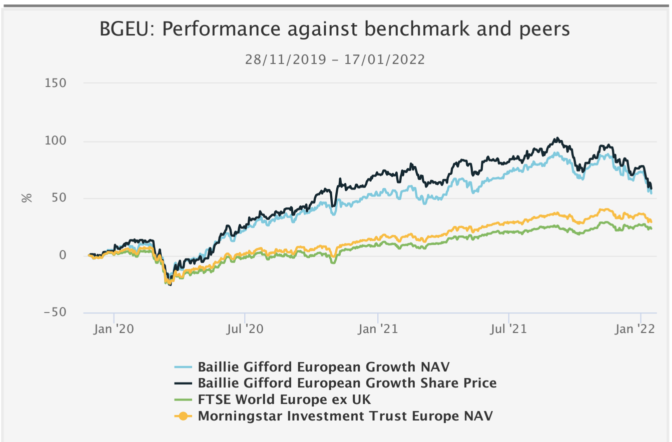


Source: Morningstar

Performance

Since Baillie Gifford took over as manager of BGEU on 29 November 2019, Stephen, Moritz and Chris have been able to generate an NAV total return of 54.0% and a share price return of 58.2%, far in excess of the returns of both the benchmark and sector. The benchmark FTSE Europe ex UK Index (in sterling terms) generated a total return of just 23.2% over this period, and the AIC Europe sector generated an average 29.0% NAV total return. Prior to November 2019 BGEU was managed by Edinburgh Partners, who followed a more value-biased approach to European equities. We note that the change in management came at an opportune time, as 2020 was one of the best years for BGEU's underlying strategy. Over 2020 alone BGEU generated an NAV return of 48.2%, far ahead of the 7.9% of its benchmark and the 12.8% NAV total return of its peer group. This enviable performance was in large part the result of the enormously strong tailwinds that growth investing saw in 2020. During the pandemic investors placed an increasing premium on companies which were still able to demonstrate strong growth potential despite the economic recession, with certain types of companies (such as the digital platforms and health innovators found within BGEU's portfolio) actually seeing their investment cases improve due to changing consumer patterns.

Fig.3: Performance Since Change Of Manager



Source: Morningstar

Past performance is not a reliable indicator of future results.

Over the past year the trust has generated an NAV total return of -0.3% (as of 14/01/2022), against the 11.9% return of its benchmark and the 10.9% NAV total return of its peers. Until September the trust benefitted from to the relative strength of European growth stocks, which posted some of the strongest earnings reports in recent history. This included major contributions from AddLife, the Swedish medtech company, which has a 0% weighting in the index, as well as investment company Kinnevik and speciality chemicals distributor IMCD, both of which are a mere 0.1% presence in the benchmark index. However, in the short period since the summer the trust has underperformed the index, in particular doing worse when the market has sold off.

BGEU's strategy is not unique to the closed-ended space, as the team utilise the same approach in the open-ended equivalent of their strategy, which Stephen has been a named manager on for over a decade. It is important to highlight that the strategy has the typical risk/return

Five-Year Risk/Return Metrics

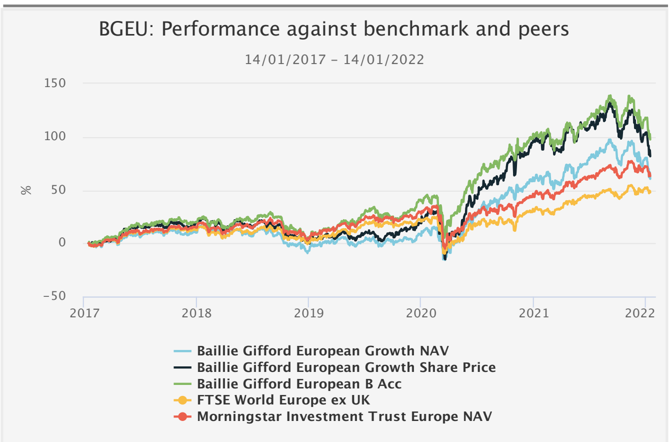
	STD DEV (ANNUALISED %)	SHARPE RATIO (ANNUALISED)	ALPHA (ANNUALISED %)	UPSIDE CAPTURE (%)	DOWNSIDE CAPTURE (%)
Baillie Gifford European B acc	15.6	1.0	8.7	129.0	88.0
Morningstar Investment Trust Europe	13.85	0.8	2.8	108.7	94.0
FTSE World Europe ex UK	13.6	0.6	N/A	N/A	N/A

Source: Morningstar, as of 31/10/2021

Past performance is not a reliable indicator of future results profile of a growth equity strategy, that being one which marries high returns with higher risk, meaning it may not be an ideal choice for a more cautious investor. Yet as can be seen in the below table, over the last five years the Baillie Gifford European Fund has demonstrated a superior risk/return profile to its peers and benchmark, indicating that the team have more than compensated their investors for the heightened risk. The fund's high Sharpe ratio of 1.0, an indicator of risk-adjusted returns, and Sortino ratio of 1.8, an indicator of returns adjusted for downside risk, perfectly exemplify this. The fund also brings with it stronger diversification than its peers, thanks to its asymmetric upside/downside capture. As is to be expected from the team given their historical performance, their fund has been able to generate a large amount of alpha over the last five years: 8.7% annualised, more than three times the 2.8% of the fund's peers.

Over the last five years BGEU has generated an NAV total return of 60.5% and a share price return of 81.7%, compared to its benchmark's return of 47.8% and its peer group's simple average NAV total return of 63.1% (as at 14/01/2021), although most of this reflects the performance of the previous manager.

Fig.4: Five-Year Performance



Source: Morningstar

Past performance is not a reliable indicator of future results.

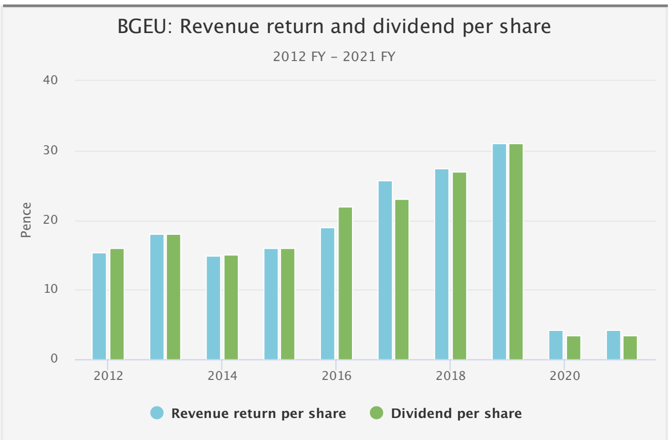
Dividend

BGEU follows the sole objective of capital growth, and as such the team do not make any accommodations within their investment process for the provision of income and BGEU's dividend is a mere by-product of the team's process and cannot be guaranteed to be maintained or grown. Any dividend paid is by way of a final dividend and the minimum required for the Company to maintain its investment trust status

We note that since Baillie Gifford took over management of BGEU in November 2019 there has been a clear shift in the trust's dividend profile. The board has dropped the payment of an interim dividend in favour of a single annual payment and has adjusted the allocation of costs to be 80% capital and 20% revenue (its prior allocation was two-thirds capital and one-third revenue). These changes reflect the changing return profile of BGEU, with the current team's growth-focussed approach more conducive to long-term capital growth than dividend provision when compared to the value-orientated approach of the previous manager.

BGEU's most recent dividend was 0.35p per share for the 2021 financial year, and the same amount was paid in the 2020 financial year, the first under Baillie Gifford. This represents an 89% cut from the prior year's dividend of 3.1p per share (all figures restated in line with the 10 for 1 stock split implemented in January 2021). BGEU has a current share price yield of 0.3%, compared to the 1.3% simple average of its peers (as at 17/01/2021). We note that because of the change in BGEU's dividend profile it may no longer be suitable for income-focussed investors. Nonetheless, thanks to BGEU's reduction in dividend it does have a substantial revenue reserve coverage, which we estimate to be 4.1 times its most recent dividend.

Fig.5: Revenue Return And Dividend Per Share



Source: Baillie Gifford

Management

BGEU is co-managed by three investment managers: Stephen Paice, Moritz Sitte and Chris Davies, all of whom have spent their entire investment careers with Baillie Gifford. Of the three investment managers, Stephen has the most experience, having 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. Moritz has 11 years' experience, having joined Baillie Gifford in September 2010. He joined Stephen as co-manager on the open-ended fund in 2014, with Chris Davies joining Baillie Gifford in 2012 and the strategy in 2019. As we highlight in the **Portfolio section**, they follow a team approach where so long as one of the decision makers has sufficient conviction in a holding then it can be included in BGEU's portfolio.

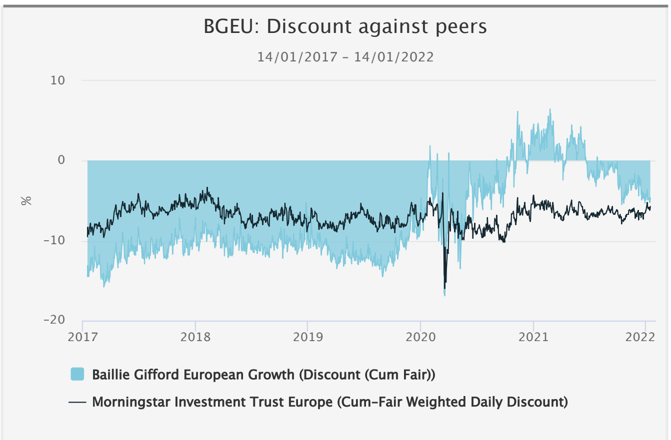
The trio therefore have extensive experience of working together on European equity strategies, in addition to the wider investment philosophy at Baillie Gifford. Furthermore, across the European equity team at Baillie Gifford there are an additional four equity analysts and one dedicated ESG analyst with whom the BGEU team work in order to generate further ideas and analysis on prospective holdings. We highlight that Baillie Gifford's partnership structure, coupled with the manager's compensation scheme (based on the rolling five-year outperformance of the benchmark), is suitable for a long-term approach to investing as it frees the investment managers from the pressures of short-term outperformance and allows them the time horizon needed to fully realise their investment hypotheses.

Discount

BGEU currently trades on a 4.6% discount, compared to a simple average of 6.9% for the sector (as at 14/01/2022). Since Baillie Gifford took over in November 2019 BGEU has traded at a much narrower discount than it did under its previous manager, trading at an average discount of 2.2% (compared to the 10.4% average discount at which it traded in the five prior years). BGEU's discount has widened in recent months, however, as can be seen in the below graph. We believe that this is the result of BGEU being caught up in investors' broader aversion to Europe, as over the last three months European equities have returned less than half the return of the wider global market. However, BGEU's discount has already begun to narrow from the 5% discount it traded on in early October. We note that BGEU currently trades on the narrowest discount amongst its peer group, with only one trust – BlackRock Greater Europe, another growth-focussed strategy – trading on a premium. In the periods when BGEU was trading on a premium over the past 12 months the board issued 2.4m shares (equal to 1% of the pre-issuance circulation), with the most recent issuance being made on 22 February when the trust traded on a 5% premium.

We believe BGEU's relatively narrow discount is the result of the strong performance track record that the Baillie Gifford strategy has demonstrated over the long term, suggested by the positive re-rating of the trust upon the announcement of Baillie Gifford receiving the mandate. We note that Baillie Gifford strategies have rarely traded at discounts wider than the peer group average in recent years, thanks to the strong following they command amongst both retail and professional investors due to strong long-term returns.

Fig.6: Five-Year Discount



Source: Morningstar

Charges

BGEU has a current OCF of 0.67%, which is lower than AIC Europe sector simple average of 0.86%. BGEU utilises a tiered management fee, with 0.55% charged on the lower of either the NAV or market capitalisation. Furthermore, for an NAV greater than £500m, the management fee is reduced to 0.5%. Based on BGEU's current NAV of £621m, we estimate its current management fee to be 0.54% of the lower of the market capitalisation.

The latest KID RIY is 0.74%, which compares to the AIC Europe sector simple average of 1.22%; however, we caution that calculation methodologies may vary between trusts.

ESG

While BGEU is not an 'ESG strategy', the team believe that their long-term approach to investing requires the full consideration of ESG risks. As we mention in the **Portfolio section**, ESG analysis is a key element of the team's process, with the alignment of interests between management and shareholders being seen as a key governance issue in the team's investment process. Alignment consists of two elements. On one hand, the team will assess the alignment of a company's management with their shareholders to ensure that the actions of the managers are conducive to generating long-term value for shareholders. On the other hand, the team believe that each company needs to earn the social prerogative to operate, which requires the companies to positively contribute to society. As a result, Baillie Gifford aims to use its influence as an owner to promote sustainable long-term practices, with a focus on general principles as opposed to set rules. We note that the team ensure that BGEU remains in compliance with the UN's

Global Compact principles, and they also operate a sector screen which excludes thermal coal, tobacco, tar sands and controversial weapons from the portfolio.

BGEU has been given a sustainability rating of 'average' by Morningstar when compared to its wider European equity peer group (which includes both open- and closed-ended funds). However, 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. This is the result of European policymakers and management teams having long been aware of the need to follow sustainable business practices, thus forerunning other regions in their adoption of ESG practices. We also highlight that BGEU has received Morningstar's 'low carbon' designation, meaning it has met the rating agency's requirements for a sufficiently minimised carbon risk, plus it also has a lower carbon risk than its benchmark.

Disclaimer

This report has been issued by Kepler Partners LLP. **The analyst who has prepared this report is aware that Kepler Partners LLP has a relationship with the company covered in this report and/or a conflict of interest which may impair the objectivity of the research.**

Past performance is not a reliable indicator of future results. The value of investments can fall as well as rise and you may get back less than you invested when you decide to sell your investments. It is strongly recommended that if you are a private investor independent financial advice should be taken before making any investment or financial decision.

Kepler Partners is not authorised to make recommendations to retail clients. This report has been issued by Kepler Partners LLP, is based on factual information only, is solely for information purposes only and any views contained in it must not be construed as investment or tax advice or a recommendation to buy, sell or take any action in relation to any investment.

The information provided on this website is not intended for distribution to, or use by, any person or entity in any jurisdiction or country where such distribution or use would be contrary to law or regulation or which would subject Kepler Partners LLP to any registration requirement within such jurisdiction or country. In particular, this website is exclusively for non-US Persons. Persons who access this information are required to inform themselves and to comply with any such restrictions.

The information contained in this website is not intended to constitute, and should not be construed as, investment advice. No representation or warranty, express or implied, is given by any person as to the accuracy or completeness of the information and no responsibility or liability is accepted for the accuracy or sufficiency of any of the information, for any errors, omissions or misstatements, negligent or otherwise. Any views and opinions, whilst given in good faith, are subject to change without notice.

This is not an official confirmation of terms and is not a recommendation, offer or solicitation to buy or sell or take any action in relation to any investment mentioned herein. Any prices or quotations contained herein are indicative only.

Kepler Partners LLP (including its partners, employees and representatives) or a connected person may have positions in or options on the securities detailed in this report, and may buy, sell or offer to purchase or sell such securities from time to time, but will at all times be subject to restrictions imposed by the firm's internal rules. A copy of the firm's Conflict of Interest policy is available on request.

PLEASE SEE ALSO OUR TERMS AND CONDITIONS

Kepler Partners LLP is authorised and regulated by the Financial Conduct Authority (FRN 480590), registered in England and Wales at 70 Conduit Street, London W1S 2GF with registered number OC334771.