Baillie Gifford European Growth

2025 could be a year of recovery for BGEU...

Update
29 January 2025

Overview

Baillie Gifford European Growth (BGEU) owns a portfolio of companies that managers Stephen Paice and Chris Davies consider to be growth outliers in Europe. Stephen and Chris look for companies they think can at least double their money over five years and aim to outperform by taking a longer-term view than the market. The trust has cheap structural **Gearing** which contributes to the growth potential as well as the volatility in the shares and amounts to c. 14% of NAV.

BGEU's portfolio has a strong growth bias and a heavy tilt to the mid-caps. This, along with some stock-specific issues with private companies, has led to some disappointing **Performance** since 2022. However, the listed portfolio outperformed the FTSE Europe ex-UK Index over the latest financial year, which is one promising sign, buoyed by some strong performances from companies like Spotify. Stephen and Chris argue that growth is still being undervalued by the market, and they have made a number of new additions to the **Portfolio**. In their view, the secular growth drivers behind their portfolio are as strong as ever, and some cyclical headwinds are abating which is promising for 2025.

In response to the troubled performance, the board has decided to implement a tender offer for 100% of the shares if the trust doesn't outperform the index over the four years to 30/09/2028. At the time of writing, the shares trade on a 15% **Discount** to NAV, the widest in the peer group. The managers have retained their same core strategy, but have made some minor adjustments, determining they should be quicker to take some profits in their winners if they become expensive.

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Analyst's View

BGEU has a number of characteristics which should be attractive to a long-term investor. It has a portfolio full of companies with strong growth prospects, a bias to the mid-caps (which have outperformed over the long run) and structural gearing with exceptionally low rates. It also trades on a 15% discount at the time of writing, which, in our view, is verging on excessive for a listed equity portfolio. However, style and stock-picking just haven't worked in BGEU's favour for a number of years now.

The write-down of two unlisted investments in 2024 was the key factor behind the trust's underperformance over that year. Whist disappointing, we think that the effective reduction of the position in private companies reduces one of the sources of uncertainty around the portfolio and at 95% listed, it makes the proposition cleaner. In our view, the exceptionally wide discount is now much more attractive with this hard-to-value bucket much smaller. One way to think about this is to consider how difficult it would be to deliver 13 percentage points of alpha, which would have the same effect on performance as the discount moving from 16% to 5%.

The performance-conditional tender offer is welcome, in our view, although we would not expect it to have too much impact on the discount unless considerable underperformance was to build in the next year or two.

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 by Stephen Paice and Chris Davies who set out to identify the growth outliers in the European equity market. They look for companies that they think can deliver a return of at least 100% over five years, and ideally for those which they want to own for much longer than that. The strategy is built on the idea that most investors are relatively short-term in their perspective, and so by identifying companies that can deliver high growth many years into the future, BGEU can get an edge.

The approach has always been highly active, with Stephen and Chris paying little attention to the benchmark index. They are typically significantly overweight the mid-caps and have invested in private companies too, both of which are features that differentiate the trust from some other European growth strategies. **Performance** has been disappointing since 2022, with a number of factors working against the strategy. Stephen and Chris have made some tweaks to their approach in response. Notably, this means they have decided to be more conscious of high valuations in their holdings, and quicker to take some profits from winners. They have also decided to pay more attention to the index when sizing their positions, to make sure that when they have high conviction in a company, they are significantly overweight the index. Looking at their position sizes solely in absolute terms has led to some companies in which they have decided to take meaningful positions held at relatively modest weights versus the benchmark, the prime example being ASML. Increasing the active weights of high-conviction positions could increase how active the portfolio is, but bringing the same relative focus to underweights may have an offsetting effect.

These are relatively minor changes, though, and the core characteristics of the portfolio should remain the same. The table below illustrates the high sales and profit growth in the portfolio, both historically and what is forecast in the coming three years. Leverage is relatively low, whilst the expected return on invested capital is much higher than the index. The valuation is higher, as typically companies with such attractive growth characteristics should be expected to be more expensive. However, Stephen and Chris argue that the valuation premium they have to pay for these characteristics has fallen over recent years, meaning that their portfolio looks undervalued.

In fact, the managers report finding more and more potential investments with attractive growth characteristics but trading on low valuations. This has contributed to a relatively high turnover of 18% in the financial year ending September 2024, although we note that is still a relatively low number for an active fund and implies an average holding period of c. five years. New additions over the past financial year include Lonza, Genmab, and Camurus in the healthcare sector. The team have also bought Assa Abloy, Vitec, and Instalco. All these three are serial acquirers, businesses that are seeing attractive growth by consolidating their industries. Vitec operates in the business software space, competing with existing major holding Topicus.com. Assa Abloy and Instalco operate in the more physical industries of electronic lock systems and plumbing and scaffolding installation. They illustrate long-standing themes in the portfolio of the online economy and mid-cap industrial growth.

Portfolio Characteristics

	BGEU	FTSE EUROPE EX-UK INDEX
Sales 5Y Growth p.a.	10.7%	3.8%
Earnings 5Y Growth p.a.	17.8%	7.7%
Sales 3Y Forward Growth p.a.	7.8%	2.5%
Earnings 3Y Forward Growth p.a.	11.8%	5.9%
Return on Equity 1Y Forward	17.2%	14.9%
Return on Invested Capital	13.5%	7.7%
Net Debt to EBITDA	1.2x	1.7x
Price to Earnings 1Y Forward	21.6x	13.8x

Source: Baillie Gifford, as of 30/09/2024

The team have also taken a new position in a Polish supermarket chain, Dino Polska. Rather than acquiring competitors, the company is using its high free cash flow to rapidly expand its high-quality offering in underserved rural locations. The team describe it as one of the highest quality retailers they have ever seen, with a vertically integrated supply chain for the meat it sells that helps contribute to an exceptional ROIC, and they note it is compounding revenues at 20%. The team watched the company for some time before taking a position, waiting for a good entry valuation.

Another new purchase is the much better-known Novo Nordisk. The team think it is well-paced to build on its lead in the anti-obesity market, with IP built up over years of investigating diabetes and a strong manufacturing base. They think the company can grow its bottom line at 15% a year for at least the next three years, and the managers argue there are few companies that can deliver this, and certainly not with such high-quality metrics. Poor results from a trial of the new generation treatment CagriSema led to Novo's shares taking a hit pre-Christmas. The managers believe this to be an overreaction, given that the flexible trial design meant many patients did not reach the highest dose. Novo is a top-ten position in the portfolio, as the below table shows.

Top-Ten Holdings

HOLDING	% OF TOTAL ASSETS
DSV	6.1
Prosus	5.8
Topicus.com	5.2
Ryanair	4.9
Schibsted	4.3
Adyen	4.0
ASML	3.6
Novo Nordisk	3.5
Reply	3.5
Bending Spoons	2.9
Total	**43.8**

Source: Baillie Gifford, as of 31/12/2024

Some of the best returns over the past year have come from online businesses Spotify, Adyen, and Schibsted. Spotify needs no introduction, but Adyen is a payments provider competing with Stripe, whilst Schibsted is a Nordic online classifieds platform. The online economy continues to be an important theme in the portfolio: Prosus is a holding company with a large stake in Chinese e-commerce giant Tencent, whilst Topicus.com has already been discussed, and Reply is another digital business in the top ten. Stephen and Chris have, though, sold out of their food delivery holdings. In the case of Hello Fresh, they decided growth had decisively slowed whilst its plan to move into ready-to-eat food was unattractive. In the case of Delivery Hero, the team found it frustrating that the company didn't seem able to impose any pricing power with its leading position across multiple markets.

Hardware is another key theme, with ASML and sister company ASM both held. ASML has a key technology used for the current generations of semiconductors, but the team think over time that ASM's technology will become more important. The team are particularly excited about Soitec, which manufactures substrates used to make semiconductors. The shares have been weak, and the team think it has been dealing with excess inventories at customers since the pandemic. With that set to clear, they have been adding to the position on weakness.

This position illustrates a number of the themes the managers are seeing. They note that some of their areas of interest have been going through downward swings of the cycle, such as semiconductors, medtech, and B2B businesses. Meanwhile, over 2024, market interest was relatively narrow-focussed on AI. The result is that as the cyclical headwinds shift to tailwinds, they think that valuations in companies with obvious secular growth drivers are attractive, and there is potential for 2025 to see this coming through. Entering the 2025 financial year, BGEU has a portfolio with a slightly reduced number of holdings, down to 54 holdings from 61 a year earlier, and more focussed on the higher-conviction positions exposed to these secular growth themes.

As of the end of September, 5.7% of the portfolio was invested in private companies. Two, McMakler and Northvolt, have been written down to zero for reasons discussed under **Performance**. The three others are Bending Spoons, an Italian acquirer of digital applications, Sennder, a road freight logistics company with a focus on digital in its systems, and Flix, an owner of bus operations like Flixbus and Greyhound. The team think the payoffs in these positions remain asymmetric, which justifies their investments despite the downside risks. They argue that an IPO from this portfolio might improve sentiment toward the holdings as a whole: high interest rates and economic uncertainty have contributed to muted realisations of private companies in recent years, and some scepticism about valuations. We note though, that these positions are much smaller as a proportion of the portfolio than they were a year earlier, meaning that returns are going to be much more dependent on the listed portfolio going forward.

Gearing

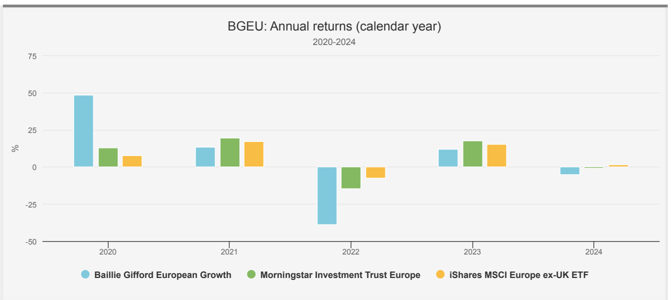
BGEU has secured long-term debt at highly attractive rates. The trust has a €30m unsecured loan note which matures in 2040 on which it pays just 1.57%. It also has a further €30m note which matures in 2036 on which it pays 1.55%. The managers have tended to run with low cash balances which means this debt is essentially all invested, and at the end of November, net gearing was 14%. The highly attractive rates on this debt mean the performance benefit of the gearing in a rising market should be particularly good. On the other hand, gearing does bring downside exposure too, and it has contributed to volatility in BGEU's NAV.

The board has restricted gearing to 20% of NAV, less the value of the unlisted equities. As of the end of September, unlisted equities made up 5.7% of the portfolio, so the maximum permitted gearing level was c. 18.8% of the whole portfolio. 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 of the end of December, net gearing was 14%.

Performance

BGEU's strategy delivered strong outperformance in a rising market in 2020 and early 2021, before a period of significant underperformance in a falling market in late 2021 and 2022. Since then, the trust has delivered positive returns but has not managed to keep up with the index's gains. The annual returns chart below shows the story clearly.

Fig.1: Returns



Source: Morningstar
Past performance is not a reliable indicator of future results.

We have discussed the reasons behind the underperformance in **previous notes**. Growth strategies fell out of favour in 2022, and the recovery in markets over 2023 and 2024 has been led by a narrow band of large-caps. BGEU's mid-cap tilt has therefore been unhelpful too.

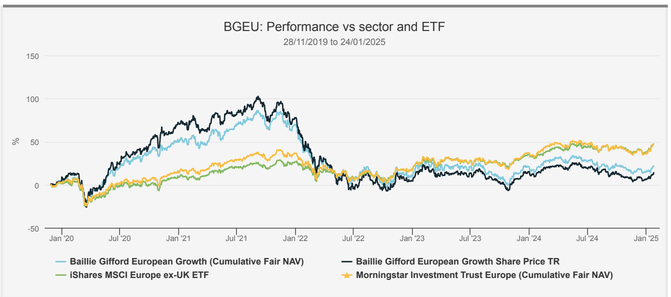
Over 2024, there was some encouraging performance from the listed portfolio, and indeed in the financial year to 30/09/2024, the public companies outperformed the benchmark. However, the unlisted holdings detracted from performance, with Northvolt and McMakler both being written down to zero.

Northvolt was hoped to be the European EV battery champion. It has had some operational challenges of its own, but the challenges in the automotive industry brought its troubles to a head. European EV manufacturers have faced competition from cheaper Chinese models, whilst sales of EVs have not been as high as hoped. Meanwhile, a tighter funding environment has meant that subsidies and financial support have not been forthcoming, and the company has filed for bankruptcy. McMakler is a German online property broker which has struggled amidst a property slump in its home country. There are clearly macro factors behind both business failures, with higher interest rates making funding harder to come by, and a weaker economy making customers less willing to spend. Both illustrate the risks of investing in relatively early-stage companies, which private investments often are.

There have been some strong success stories in the portfolio though, looking back over the past year. Spotify, for example, has benefitted from some cost-cutting and has shown it has been able to raise subscription prices without any issues. This is a testament to the strength of the ecosystem they have built. The team argue Spotify has shown it has real pricing power, and that the speed the company has managed to go from a 0% operating margin to 10% is exceptional. They have managed to grow subscribers by over 15% at the same time, whilst competitors like Amazon Music no longer seem realistic challengers. Adyen, a payments company the team have held for years, has also managed to grow clients and expand business with existing clients whilst improving margins. The team think its investment cycle was poorly timed from the market's perspective, but the volume and margin improvements coming through show the company's operating leverage. As a general point, they argue operating leverage is not yet really being rewarded by the market, and they think their portfolio will benefit when the market once again focusses on this. In fact, as discussed in **Portfolio**, the team are finding plenty of strong growth stories available on attractive valuations, which is promising looking forward.

Baillie Gifford took over the management contract in November 2019, and the returns since then have been disappointing. The NAV total return has been 21.7% compared to 47.2% for the index, whilst the weighted average return in the AIC Europe sector over the same period is also 47.2%. The board has responded by committing to a 100% tender offer should the NAV total return not outperform the index total return over the four years to 30/09/2028.

Fig.2: Performance Since Change Of Manager



Source: Morningstar
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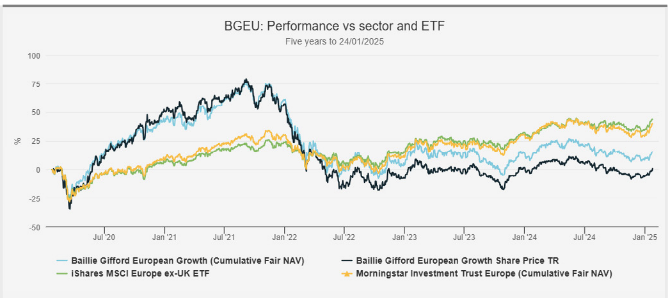
The managers have also done some self-reflection and have decided to be more conscious of valuations on their most successful positions. For example, they trimmed the position in Spotify a couple of times over 2024 as it more than doubled. They have also determined they should be more conscious of the benchmark when it comes to sizing positions. For example, the position in ASML is a high-conviction one, and it has long had a significant weight in the portfolio. But as it has grown to become a large position in the index, the team's conviction and successful stock pick have not fed through enough into alpha. The team have decided to back their conviction relative to the index more in future. These changes may reduce the exposure to the momentum factor in the portfolio.

Looking forward, we think it is also important to note that the unlisted portfolio is down to c. 5.7% of the portfolio, so it will be less significant to returns. That said, there is still the potential for McMakler to be written back up, as the trust remains invested, whilst it has no further downside. The team argue the secular tailwinds behind their portfolio are still in play, and cyclical headwinds are abating if not turning. Meanwhile, the valuation premium demanded by the market for high-growth companies is still very low (see table in **Portfolio section**), which implies potential reversionary value.

For completeness' sake, we show below BGEU's five-year returns. The trust has delivered a NAV total return of 15.3% compared to a total return of 43.8% for the iShares MSCI Europe ETF and a weighted average of 40% for the Morningstar Europe sector.

Fig.3: Five-Year Performance



Source: Morningstar
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Dividend

BGEU doesn't have an income objective and the dividend policy is to pay the minimum dividend necessary to maintain investment trust status, i.e. 85% of net income. For the 2024 financial year, the board has recommended a dividend of 0.6p per share, up from 0.4p a year earlier. This equates to a yield of just 0.71%. Given the dividend policy, there is no commitment to maintain or increase the payout, and this plus the low yield means the trust is unlikely to appeal to income investors.

Management

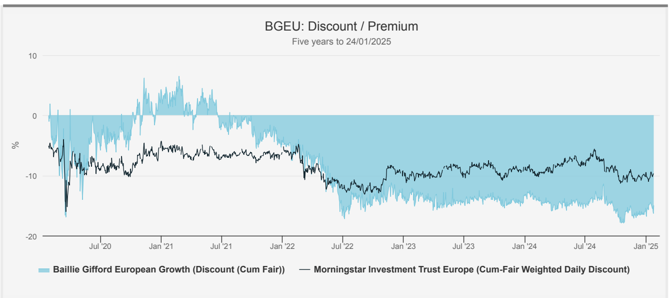
BGEU is co-managed by Stephen Paice and Chris Davies. Stephen and Chris have spent their entire investment careers with Baillie Gifford. Stephen joined Baillie Gifford in 2005. He has also co-managed the open-ended Baillie Gifford European Fund since 2011 and is head of the European equity team. Chris 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 fell onto a wide discount in 2022, as the chart below illustrates. Performance was particularly poor in late 2021/early 2022. We think the persistent discount is because it has not delivered outperformance since. Acknowledging the disappointing returns, the board has decided to introduce a 100% tender opportunity in 2028 if the trust does not outperform the FTSE European ex-UK benchmark in the four years to 30/09/2028. We think this is a bold decision which adds to the attractiveness of the shares on the current discount. First and foremost, shareholders would hope for performance to improve and returns to be delivered that way. However, the conditional tender offer opens up another route to value realisation if performance is behind the index.

Fig.4: Discount



Source: Morningstar
Past performance is not a reliable indicator of future results.

The board does not have a formal discount target but says it will buy back shares opportunistically and accretively. Over the 2024 financial year, it repurchased 1.8% of the shares in issue at the start of the year.

Charges

BGEU's latest ongoing charges figure (OCF), for the year ending September 2024, is 0.65% of NAV, which compares favourably to the average for the AIC Europe sector of 0.81%. This includes a management fee of 0.55% of the lower NAV and market capitalisation. On any net assets above £500m, the management fee would fall to 0.5% of the lower. With the shares trading on a discount of c. 15% at the time of writing, the implied management fee is c. 0.46%.

BGEU is currently reporting a KID RIY of 0%. However, we note the regulation around KID RIYs is changing, and a consensus on how they should be calculated has not yet been formed.

ESG

BGEU does not have a sustainable investment label under the FCA's regime. The managers do, though, consider sustainability when selecting investments, and examine a company's purpose, values, business model, culture, and operating practices and how they align with society's changing expectations. They then consider how this might impact returns and incorporate these considerations into their assessment of value. BGEU has received three 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, and it has also received a low carbon designation.

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