

European Equities Q3 investment update

October 2023

Investment manager Stephen Paice and investment specialist Thomas Hodges give an update on the Europe ex UK and Pan Europe strategies covering Q3 2023.

Your capital is at risk. Past performance is not a guide to future returns.

Thomas Hodges (TH): Welcome to this video. This is the quarterly update covering European Equities. My name is Tom Hodges. I'm an investment specialist on the European team, and today I'm joined by Stephen Paice, who is head of European Equities at Baillie Gifford.

In the European team at Baillie Gifford, what we're trying to do is create high conviction portfolios of some of Europe's great growth opportunities. What we're looking for is companies with large growth opportunities, the potential to expand their profit margins over time. We're also looking for strong and improving competitive advantages, and we want these businesses to be run by high-quality, exceptional people. And hopefully, or what our aim is to do by investing in these companies, is deliver exceptional returns to our clients over time.

So, Stephen, let's dive in. August was a bit of a torrid month for performance. And the big headline, of course, was the big sell off in Adyen. So let's kick off with your thoughts on broader performance before we move into Adyen more specifically.

Stephen Paice (SP): Sure. Well, August was a poor month, but I think we have to recognize that the performance over the last two years has been really disappointing. And we've been managing, as you know, European equities since 1985. We've experienced numerous drawdowns and rebounded from all of them. But I think this is probably one of the worst sets of conditions for our style of investing that we've ever had.

Now, the silver lining from that is that as long as we remain disciplined, the valuations across the board in the market and in our portfolio are now much cheaper, trading at much lower valuations, so we can take advantage of that.

Now, in the quarter we had some companies that were showing very good operational progress. We had meal kit provider HelloFresh, Kingspan, which is an Irish building materials company. These are

companies which are performing very well. Adevinta, which is an online classifieds business, is also being bid for. So we have some positive news still coming through.

But as you said, the main detractor was Adyen. But the reality is that over the last couple of months, certainly over the last year or so, performance is still very much driven by the narrative in the market, what central banks are doing, what expectations of interest rates are. And it has very little, at the moment, to do with fundamentals.

TH: In terms of Adyen, what are your thoughts on Adyen and what do you actually think that says about the overall market mood at the moment?

SP: Adyen is a Dutch payment processing business. It offers its merchants the software to authorize and accept payments from its customers, whether it's online or offline. It's a really high-quality business. It's very dynamic.

It has been growing kind of 30, 40 per cent in recent years. But the recent set of results flagged that they had lost a little bit of market share in the US. And this is, I think, more to do with some temporary phenomenon. We've spoken to some of their competitors like PayPal and Stripe, and at the moment we think that some of these problems which it has faced are going to be temporary.

They're not structural. Now, the Adyen share price sold off 50 per cent, roughly. Now, to me, that suggests that the market is putting far too much weight on one set of results and discounting the value of growth that Adyen has in the future, which is underpinned by a lot of investment in its products and a relatively low but increasing market share.

So, this is what I think's happening across the broader market. It is classic hyperbolic discounting. The market is paying up for near-term certainty and penalizing anything which is going wrong in the short term, and unfairly discounting any companies which may still be able to grow very profitably in the future.

TH: Yes, and I think that's a broader trend that we've seen across the board for the best part of two years now. And you can see it in the portfolio's valuation as well and how that's moved. But what are your thoughts on the overall portfolio positioning and valuation at the moment?

SP: I mean, as you said at the start, what we're trying to do here are find and invest in Europe's best growth companies. These are companies that are going to grow faster than the market, both in revenue and earnings and cash flow terms. These are companies that are managed by people that we trust and that have relatively low levels of debt.

Now, none of that has actually changed. What has happened, though, is that the valuation for these companies, and the portfolio in aggregate, is now much lower. And if you compare the multiples on these portfolios over the last two years, those multiples have fallen about 50 per cent.

The underlying market in Europe has maybe fallen closer to 20 per cent. But when you look at the growth rates, both in terms of sales and profits for these portfolios, we're capable of growing two or three times faster than the market. So, what we're offering now, and getting access to, is a lot more growth, but at [a] much lower and better price.

So, what we're trying to do now is take advantage of what we think is an inefficiency. We are leaning into those companies where we think the discount is most extreme and adding to some companies in the portfolio like Sartorius, which is a medtech company, Reply, CRISPR Therapeutics, Hypoport. We have a lot of companies which have been very weak, so we have a lot of opportunity to add, but at the same time we're trying to pick up some new names and add those to the portfolio as well.

TH: It's been quite an active third quarter for us, picking up new names. We've added three to the portfolios in the past few months. Maybe you could take us through the investment cases around LVMH, Moncler and EQT?

SP: Sure. I mean, over the long term, our turnover is still hopefully going to be between 10 and 20 per cent, so holding periods between five and ten years. But we've added a couple of luxury names to the portfolio. These will supplement some of the exposure we have to some of those other amazing luxury brands we have already. We have Cartier in the portfolio, we have Gucci, we have Ferrari as well.

But if there's something Europe does really well, it is luxury goods. So we've added LVMH. This is one of the biggest companies in Europe and certainly [one of] the biggest luxury goods companies in the world. But what we've come to realize is that, despite its size, LVMH as a business is actually becoming better and more powerful the bigger it gets. So I think that the long-term compounding which comes from sustainable profit growth in LVMH's case is definitely still being undervalued.

Moncler is a slightly younger and probably slightly more dynamic company. It's probably more well known for outerwear, puffer jackets, ski wear and knitwear. But through some very astute design merchandising under the control of its owner, effectively Remo Ruffini, who saved the business from bankruptcy, we think that the growth rates and again the profitable growth here is has been mispriced by the markets. So we're taking advantage of opportunities like this.

And then the final one, as you mentioned, was EQT. And this is one of the largest private equity companies in the world, but it's the only one with a kind of a Swedish culture. So there's very much a culture of building companies for the long term. It's not just about flipping them for a good price.

And EQT has one of the best reputations in the industry, and this will help it attract and fundraise. It has one of the best track records. So, if you look at the performance of its funds, [they are] top quartile pretty much in every area, and it's benefiting from structural growth. As we know, companies are staying private for longer, but also allocations are increasing towards private equity as well. And when we think about the valuation over the next five or ten years, we think there's a huge value which has been mispriced there.

So, these are the types of opportunities we're taking advantage of in the current markets.

TH: From one Swedish company to another - we did sell one holding we've held for a very long time, Nibe. It's been one of our best performers. That's not always the easiest experience, selling one of your best performers. So what are your thoughts on why we decided to exit Nibe?

SP: Well, it was probably actually quite easy to sell a big winner. But what we need to make sure that we're not doing is selling too early and missing out on years or decades of upside. But in Nibe's case, as you said, it's been a very good performer.

This is a Swedish heat pump manufacturer and it was benefiting from increasing penetration rates. Its products are being used to replace environmentally damaging oil and gas boilers, so very strong structural growth there, and certainly kind of a Covid boost from the energy crisis [when] the demand for heat pumps exploded. Which is good.

But what has happened is that the valuation multiple has rered significantly. And at the same time, this market demand has not gone unnoticed by other competitors, so there's lots more competition and a lot more capacity coming on, and it's probably not a capital cycle you want to invest in at this stage. So, we've taken the profits and we've reallocated them into companies that we think have a greater upside.

TH: And just finally, it's been a very tough period for us in performance. We're all very disappointed with [it]. Perhaps you could leave us with some thoughts on why you're optimistic about investing in Europe with our approach going forward.

SP: Sure. Well, the first thing to say is, the environment today is very different to what it was two years ago. Two years ago we had low but increasing interest rates. And in hindsight, a lot of hubris in the markets affecting valuations as well. Today, we have very high but potentially stable or even declining interest rates, and instead of hubris, we have a lot of fear and anxiety. And as a long-term stock pickers, this is normally quite a good environment.

Now having said that, we also believe that we have the right process. We're not going to change the philosophy. We're going to stay resolutely long-term bottom-up growth investors. But when we think about the operational progress in the portfolio, when we think about the exposure we have to the structural growth in the markets, and of course to the people and the managers and owners of those businesses that we're investing alongside, I think the future is definitely looking a lot more optimistic than it has been for some time.

TH: Well, thank you for that, Stephen, and thank you to everyone for tuning in.

European Equities (including Europe ex UK Equities and Pan European Equities strategies)

Annual past performance to 30 September each year (net%)

	2019	2020	2021	2022	2023
Europe ex UK Equities Composite	-5.4	52.6	24.5	-51.7	17.1
Pan European Equities Composite	-8.7	40.4	22.4	-51.6	18.1
MSCI Europe ex UK	0.9	5.1	27.1	-27.2	31.2
MSCI Europe	-0.1	-0.3	28.0	-24.3	29.7

Annualised returns to 30 September 2023 (net%)

	1 year	5 years	10 years
Europe ex UK Equities Composite	17.1	0.3	4.0
Pan European Equities Composite	18.1	-2.1	2.1
MSCI Europe ex UK*	31.2	5.2	5.1
MSCI Europe	29.7	4.6	4.4

* FTSE World Europe ex UK prior to 31/12/16

Source: Baillie Gifford & Co and underlying index provider. USD. Returns have been calculated by reducing the gross return by the highest annual management fee for the composite.

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