Baillie Gifford™

European Fund: inflection points

June 2024

Investment manager Stephen Paice and investment specialist Tom Hodges explore the fund's recent strategic shifts and share insights on future investment opportunities in Europe.

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

Tom Hodges (TH): Good morning, everyone. Thanks to you all for joining this webinar on the European Fund. My name is Tom Hodges. I'm an investment specialist on the European Equities team here at Baillie Gifford.

Today, I am joined by Stephen Paice, who is the head of European Equities. And Stephen will be running through some slides today for about 15 to 20 minutes before we open up for some questions. In terms of questions, please just put them into the Q&A function, the chat function below.

The Q&A function, not the chat function. And we'll answer them at the end. And with that, I will hand over to you, Stephen.

Stephen Paice (SP): Okay, thank you, Tom. And a warm welcome to all those who have joined the webinar today. You'll be very pleased to know, hopefully, that the message today is much more upbeat and optimistic than it has been for some time.

As you'll be aware, we do have quite a distinct philosophy that for many years was very successful. And this is based on being long-term, managing a portfolio which looks very different to the index and being unashamedly focused on the most dynamic growth companies in Europe, owned and managed by people who we trust.

But from the end of 2021 to the end of 2023, however, we've experienced probably one of the worst drawdowns and periods of underperformance in setting up this vehicle in 1985 largely as a result of interest rate-sensitive valuation multiples collapsing. And it has not been an enjoyable experience for anyone but what I really want to get across today however is that the current environment for our style of investing has completely changed.

We still have exposure to structural growth across many themes, but we now also have cyclical tailwinds and inflection points, which are going to help drive value creation and a lot of valuation support as well. When you look at Europe as an asset class, it looks mispriced.

Calton Square, 1 Greenside Row, Edinburgh EH1 3AN
Telephone +44 (0)131 275 2000 / bailliegifford.com

105908 10048002
Copyright © Baillie Gifford & Co 2024.

It's trading at one of the largest discounts to the US that it has traded on for many years, if not decades. The European small and mid-cap area , something that we specialize in, looks even more mispriced.

And I think you have to go back to the late 1990s to see such a severe drawdown in small caps versus large caps. And I also think that when you look at the portfolio, relative to its fundamentals, like growth in sales and earnings and return on invested capital, and relative to the underlying index, the valuation looks extremely compelling.

Now, as ever, we want to remain objective, but there are lots of bargains out there and we are very happy with the way the portfolio is set up for the next five or 10 years. Now, when it comes to the kind of the environment in the market the best environment for stock picking is when your view differs greatly from what the market's is. And at the moment, I think there's still a lot of pessimism on inflation, problems with refinancing at higher rates. There's a lot of uncertainty when it comes to the outlook for the European economy. And obviously, we have unpredictable geopolitics and trade wars.

However, our view is that the end of cheap money and higher rates has actually caused a shakeout of weaker and irrational competition. And this has encouraged stronger companies to improve margins and exploit their strong balance sheets. Even despite that economic uncertainty, which is looking more and more like a soft landing, the biggest problem we've faced being long-duration growth investors was the interest rate cycle. But in Europe, we're now moving to a new phase. Rates are being cut or at the very least remaining stable in many countries. But we're also seeing a multitude of inflection points across lots of different industries pointing to the same thing. A normalisation of growth rates, a clear out of excess inventories and normal order patterns resuming and a general recovery in profitable growth.

Geopolitics, conflict, trade wars, these are going to be the biggest threat and continue to do so to our society and to our economies. But most of our companies are providing unique products and services and they have pricing power.

There are also new opportunities for companies that help solve some of the resulting problems from decoupling, energy crises and supply chain shocks. Companies like DSV, which is a freight forwarder and Autostore.

But on this slide here, I'll just give you some more company examples of how this is playing out. We are seeing companies become more disciplined. And I think for many of those dynamic growth companies, the strategy throughout COVID and up until the rate cycle changing, was to build as much scale as possible.

And arguably they overindulged, they'd spent too much money. So companies like Spotify, Adyen, even Tencent, which is held within Prosus, these companies were investing in the product, investing in their customers, and their margins suffered.

We are seeing a pivot away from growth at all costs to a better balance of growth and profitability. So these companies are becoming more disciplined. You can see companies like Spotify, which has gone from a breakeven 0 per cent operating margin. And in the next couple of years, we'll probably get to about a 10 margin. Spotify has risen in price four times since the bottom of the cycle. It's the same for Adyen, which had

Copyright © Baillie Gifford & Co 2024.

spent a lot of money hiring a lot of engineers and software engineers as well, where the margins had suffered but we're seeing these inflect as well. Adyen's margin last year was in the kind of mid to high 30s and in the next couple of years, we expect that to be above 50 per cent.

And it's the same for Prosus as well, where its underlying asset, Tencent, is able to grow top-line revenues of about 10 per cent. But because of the margins, because of this more disciplined approach to growth, profits are growing almost three or four times faster than revenue.

What we're also seeing is lower competitive intensity across multiple industries. Just to give a couple of examples, Ryanair continues to take market share. Even if there were any planes to buy, no one can afford to buy them. And this is making life pretty easy for Ryanair at the moment. It's able to grow, but also to push up prices.

We've got companies like Allegro, which is like a Polish Amazon, a very dominant platform in Poland. They face some potential competition from new Chinese entrants like Shopee and Temu, but we've not seen anything come of this. They've actually retrenched from that market. So more generally, companies are being more rational when it comes to picking fights, which is good.

And then when it comes to deal flow, I would say about 40 per cent of the portfolio would be invested in what we would describe as serial acquirers. So we've got companies like Topicus, which is a vertical market software business, which consolidates that very fragmented market. We've also got investments in companies like Beijer Ref, which is a distributor of HVAC and refrigeration equipment.

IMCD, which is a specialty chemicals distributor. All of these companies have very strong balance sheets. And in this environment, they're able to deploy incremental capital in buying up cheaper and distressed assets.

Then, as I said, in terms of inflection points. Now, I think this is probably one of the more important points in the near term. If it was just one or two inflection points that we'd seen within our companies and speaking to them, I don't think it would add up to very much, but we have seen so many inflection points. I think it's adding up to something quite profound.

So on the healthcare side, to give some examples, post Covid, we had a number of companies that were struggling to clear out the excess inventories that were built up during those supply shocks. Companies like Sartorius Stedim, which provides bioprocessing equipment to the biologics markets. Also Lonza and Gemmab, anything to do with biotech basically. But you can see in the chart on the far left here, the painful period, which is when Sartorius Stedim's book-to-bill number, the ratio of orders to sales, declined quite quickly but at the start of last year we saw this inflect and we're now starting to get into a more normal period for those companies which is very helpful.

In the middle chart um we've got companies exposed to real estate mortgage volumes. So we picked up a new holding in a company called Hypoport, which is effectively a software platform for mortgage originations in Germany. And we had bought this after this very severe downturn in the mortgage market in Germany.

Calton Square, 1 Greenside Row, Edinburgh EH1 3AN
Telephone +44 (0)131 275 2000 / bailliegifford.com
Copyright © Baillie Gifford & Co 2024.

So as you can see, the trend had been very positive, slowly rising upwards. See the trend had been very positive, slowly rising upwards and then the German mortgage market has gone through the worst downturn on record, which is the point that we got involved with Hypoport. And as of last year, we've seen the mortgage volumes starting to inflect and pick up. So lots of inflection points in real estate, construction markets for someone like Kingspan.

Then when it comes to corporate activity, we are looking at IPO markets and M&A. And M&A tends to lag equity valuations by about 12 months. And this is important for holdings like Kinnevik, EQT and VNV. These are holding companies or listed private equity firms that invest in private markets. So the health of the IPO market is beneficial for their business models. And you can see in the chart in the far right here, how few transactions we have had over the last year or two.

But even if you look at the number of announced or completed transactions, the number is still very low. But if you look at the number of announced transactions that are yet to be completed, this is a much higher number.

So with a lag, we expect that activity to pick up very quickly. So all of these things put together, as I said, is adding up to something quite profound.

Now, cyclical rebounds are great, but they tend to be shorter or medium-term phenomena. Longer term, most of the value creation and the greater component value creation will come from exposure to longer-term secular growth trends. And this is something that we've consistently had within the portfolio. We have exposure to the best luxury goods companies, the best industrials in the world, companies that are benefiting from decarbonisation and the problems with the energy markets.

And we've been adding to three other thematics recently, one being healthcare. As I mentioned before, there have been a lot of short-term headwinds in terms of inventory corrections. But the underlying biologics markets and biologics would incorporate monoclonal antibodies, next-generation antibodies or cell and gene therapy. These areas are growing 10 per cent plus. And we expect those types of growth rates to support the value creation of companies like Sartorius, Lonza, which is an outsourcing CDMO business, and some of those other companies which have been affected by a reduction in R&D budgets.

But we have been able to pick up some of the most innovative healthcare names in the world that just also happen to be in Europe, companies like CRISPR Therapeutics which came up with the world's first ever gene-edited therapy to cure sickle cell disease and we also have taken a new position in Genmab which is one of the highest quality, most innovative drug discovery platforms in the world after it sold off as well. So we're taking advantage of these opportunities.

We have exposure to semiconductors and the capex required to build out the facilities and the products that society and the world is increasingly demanding. Now, of course, we don't have an NVIDIA. We don't have direct exposure to what's happening in the AI market where we're seeing an exponential growth in large language models and the requirements for data. But what we do have exposure to are the are the picks and shovels the companies that enable this progress that are less sexy, don't get into the headlines in the papers but they are equally as promising when it comes to companies like Soitec which is a French manufacturer of engineered substrates which go into mobile phones and other products like EVs we have obviously ASML,

Copyright © Baillie Gifford & Co 2024.

which is one of the most important semiconductor companies in the world, or even things like Atlas Copco, which is a Swedish engineering company but has a large component of its profits coming from vacuum pumps, which were acquired for clean rooms and manufacturing semis. So we've been adding to these areas.

And as I mentioned before, the outlook for serial acquirers, companies like Topicus, DSV, Beijer Ref, to consolidate these very fragmented markets in the current environment is extremely compelling. So again, we've been adding to some of these areas.

We can perhaps come back to the portfolio in the Q&A but as you can see here we have quite a diverse range of different growth within the portfolio we've got exposure to airlines through Ryanair, Topicus which is a relatively unknown vertical market software business, we've got companies like ASML. So what is consistent across all of these companies is that they fulfil the criteria that we're looking for in terms of being able to grow at much faster rates than the underlying market. These companies have very strong competitive positions and they are managed mostly by people who have skin in the game, people that we trust.

We can maybe touch upon some of the new additions that we've made and some of the sales in the Q&A as well. But as I said at the start, we're very happy with the outlook and the kind of the makeup of the portfolio as it is just now. I also mentioned the valuation support that we have which we haven't had for a number of years now.

So this slide here is quite a busy one, but the green line that you can see here is the forward price to earnings multiple of the fund. And the purple line is the forward earnings multiple or P/E forward multiple of the underlying index.

Now as you can see the premium of our fund to the index if you go back to 2020-2021 was very high and arguably with hindsight we were perhaps overpaying for growth at that point. However, what has happened now is, as you can see, the green line has fallen very sharply relative to the index.

So at the moment, the forward P/E of the fund is around 21x. The underlying index is about 14x, which is always going to be the case. Our companies are growing faster. They're higher quality. They generate higher returns. But the interesting thing here is that while our fund is derated by almost 50 per cent, we've not really seen much of a derating in the underlying index.

And at the same time, when you look at the blue bars, the light blue bars are the projected earnings growth for our fund over the next three years. And as you can see here, the projected earnings profile for the fund over the next three years is diverging from the underlying market.

So what we're getting here is more a bigger bang for your buck. So when we look at this, what we can think about is that the P/E of the fund would most likely, if the growth rates continue, be lower than that of the index within five years.

Now for the prospects that we have within the portfolio, that to us suggests that again, there is a valuation disconnect between the fundamentals of the portfolio and the price we're paying for it. So that's been a fairly concise kind of whirlwind tour of why we think we're rationally optimistic about the prospects of the future.

Calton Square, 1 Greenside Row, Edinburgh EH1 3AN
Telephone +44 (0)131 275 2000 / bailliegifford.com
Copyright © Baillie Gifford & Co 2024.

The tide is turning, We have kind of turned that proverbial corner and we're now exposed to both cyclical and secular tailwinds. Valuations for European investing, for European growth investing and European small mid-cap investing are very, very attractive.

So I think today, this is the time we need to be bold and take advantage of the opportunities in front of us so I'll finish up there and I'll turn it back to Tom and hopefully we can answer some of your questions.

TH: Great well thank you very much Stephen. So in terms of some of the questions that we've been receiving, one has really stood out, particularly given our exposure to small and mid-cap. Do you think that the cycle is beginning to turn for those small and mid-cap ideas? Do you think that this is the time to be building that exposure relative to large cap where we've seen a lot more concentration in Europe? we've seen a lot more concentration in Europe.

SP: Yeah, so this dynamic has played out across multiple regions. It's not just in Europe. It's been probably even more pronounced in the US where we've had a much narrower leadership.

But I think one of the differences with Europe and the US is that when you look at the opportunities to invest in some of the larger companies in the US, you do get exposure to companies like Microsoft, Nvidia, Apple.

These are some of the best tech and growth companies in the world. So I can see some of the reasons for why that gap between large cap and small cap investing exists in the US. And Europe is very different. I think we've just seen a flight to safety during what has been quite a stressful period for investing.

We've seen kind of a lot of outflows across the region, certainly when it comes to European equities. And I think this is feeding into this valuation gap between small cap and large cap but we're not going out and saying okay we need to build up our exposure to small caps that that's not how we operate we are simply trying to find the best growth companies at the best price. And those happen to be in that sweet spot of between, let's say, 1 and 10 billion. So we have been deploying more capital into that area to take advantage of these faster growing, dynamic and entrepreneurial companies that are trading at record low valuations.

And one final point on this is that obviously the small-cap and mid-cap index is quite closely correlated with bond yields and we've seen this kind of drawdown as we've seen the rate environment change as well now that may or may not reverse i think it's probably more likely and to kind of follow that trend so it should be much more supportive for small caps.

But there have only been three drawdowns of this magnitude in small and mid-cap index since the late 1990s. We had one in the late 1990s. We had one in the GFC period, and we've had one now. And this one has been probably the most severe.

But after each of those drawdowns when the economy starts to turn around when risk kind of starts to come back to the market we've seen prolonged periods where small mid-cap starts outperforming so I'm not saying it definitely will happen but i think the probabilities are stacked towards that maybe being almost like the outcome but I think the probabilities are stacked towards that maybe being the most likely outcome.

Copyright © Baillie Gifford & Co 2024.

TH: And I think that leads us into another question which really largely relates to difficult performance over the past few years. Now with everything that we've been saying, we expect the environment to improve but you know do you think that our performance outlook looks strong for the next three to five years so we can close the gap on the index?

SP: I mean, I don't have a crystal ball. I can definitively say that, I mean, I can see one of the questions here. How long is it going to take to recover that underperformance? I don't know how long it's going to take. But what I feel very confident in is that that gap will close.

So if your starting point is at a relatively low level in terms of the price of the fund, then that catch-up period is actually going to be pretty value accretive for our shareholders, hopefully, and then those investors.

So as I said, all we can do is focus back on the process and the philosophy and the companies that we own in the portfolio. The biggest headwind to performance, which has caused this very disappointing period, has been the change in interest rates.

That has by far been the biggest contributor to underperformance. Now with that no longer being a headwind, if anything whether we see a normalization of rates in the kind of a range bound I don't know three to four percent or something that's absolutely fine.

What would be even better is if when we're moving into this phase where profits and earnings and free cash flow are going to drive value, we get at the same time a re-rating, but we're not banking on that. I feel pretty comfortable with the fact that the valuation and the value creation that we're going to have over the next three to five years is going to be driven by fundamentals, and that's the way it should be.

TH: Well thanks for that Stephen and with that I think we've come to the end of the questions so we'll end it here. Thanks everyone for joining and thank you for your support.

Calton Square, 1 Greenside Row, Edinburgh EH1 3AN
Telephone +44 (0)131 275 2000 / bailliegifford.com
Copyright © Baillie Gifford & Co 2024.

Baillie Gifford European Fund Annual Past Performance
To 31 March each year (net %)

	2020	2021	2022	2023	2024
Class B-Acc	7.7	59.9	-14.1	-8.1	6.3
Index*	-7.5	34.4	6.3	9.5	13.6
Target**	-6.1	36.4	7.9	11.2	15.3
Sector Average***	-9.4	39.6	4.2	6.5	12.3

Source: FE, Revolution, MSCI. Total return net of charges, in sterling.
Share class returns calculated using 10am prices, while the Index is calculated close-to-close.
*MSCI Europe ex UK Index.
**MSCI Europe ex UK Index (in sterling) plus at least 1.5% per annum over rolling five-year periods.
***IA Europe Excluding UK Sector.

Past performance is not a guide to future returns.

The manager believes the MSCI Europe ex UK Index +1.5% is an appropriate benchmark given the investment policy of the Fund and the approach taken by the manager when investing. There is no guarantee that this objective will be achieved over any time period and actual investment returns may differ from this objective, particularly over shorter time periods. In addition, the manager believes an appropriate performance comparison for this Fund is the Investment Association Europe Excluding UK TR Sector.

This communication was produced and approved in June 2024 and has not been updated subsequently. It represents views held at the time of writing and may not reflect current thinking.

This communication does not constitute, and is not subject to the protections afforded to, independent research. Baillie Gifford and its staff may have dealt in the investments concerned. The views expressed are not statements of fact and should not be considered as advice or a recommendation to buy, sell or hold a particular investment.

Baillie Gifford & Co and Baillie Gifford & Co Limited are authorised and regulated by the Financial Conduct Authority (FCA).

Baillie Gifford & Co Limited is authorised and regulated by the Financial Conduct Authority. Baillie Gifford & Co Limited is an Authorised Corporate Director of OEICs.

Baillie Gifford & Co and Baillie Gifford & Co Limited are authorised and regulated by the Financial Conduct Authority (FCA). Baillie Gifford & Co Limited is the OEICs' Authorised Corporate Director and is an authorised Alternative Investment Fund Manager and Company Secretary of investment trusts. The trusts managed by Baillie Gifford & Co Limited are listed on the London Stock Exchange and are not authorised or regulated by the FCA.

Investment markets can go down as well as up and market conditions can change rapidly. The value of an investment in the Fund, and any income from it, can fall as well as rise and investors may not get back the amount invested.

Calton Square, 1 Greenside Row, Edinburgh EH1 3AN
Telephone +44 (0)131 275 2000 / bailliegifford.com
Copyright © Baillie Gifford & Co 2024.

The specific risks associated with the Fund include:

- Custody of assets involves a risk of loss if a custodian becomes insolvent or breaches duties of care.
- The Fund's concentrated portfolio relative to similar funds may result in large movements in the share price in the short term.
- The Fund has exposure to foreign currencies and changes in the rates of exchange will cause the value of any investment, and income from it, to fall as well as rise and you may not get back the amount invested.
- The Fund's share price can be volatile due to movements in the prices of the underlying holdings and the basis on which the Fund is priced.
- A dilution adjustment may apply when you buy or sell shares in the Fund. This is applied to the share price and may reduce the return on your investment. Under certain market conditions it can be difficult to buy or sell securities and even small purchases or sales can cause their prices to move significantly. To manage the effects of this, we may apply an increased dilution adjustment. As a result investors may face increased dealing costs.
- Where possible, charges are taken from the Fund's revenue. Where there is insufficient revenue, the remainder will be taken from capital. This will reduce the capital value of your investment.
- Tax rates and the tax treatment of OEICs can change at any time.

Further details of the risks associated with investing in the Fund can be found in the Key Investor Information Document, copies of which are available at www.bailliegifford.com, or the Prospectus which is available by calling the ACD.

Calton Square, 1 Greenside Row, Edinburgh EH1 3AN
Telephone +44 (0)131 275 2000 / bailliegifford.com
Copyright © Baillie Gifford & Co 2024.