Baillie Gifford™

European Equities
Q1 investment update

April 2024

Investment manager Christopher Howarth and investment specialist Thomas Hodges give an update on the Europe ex UK and Pan Europe strategies covering Q1 2024.

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Thomas Hodges (TH): Welcome to this quarterly update video covering the European equity strategies. My name is Tom Hodges. I'm an investment specialist on the European team, and I'm joined today by Christopher Howarth, who is an investment manager on the European team.

Now, Christopher, performance was fairly decent in the first quarter. It's much better if you go on a six-month horizon. But what we've really been seeing in the past quarter or so is that markets have started to recognise good operational performance from companies.

Christopher Howarth (CH): Yes. So now that the likelihood of a soft landing is starting to set in, it feels like there's an unwinding of pessimism underway in the markets. So while you do still see some extreme reactions around results, it's starting to feel as if we're seeing growth reappraised.

What was pleasing in the first quarter is that we've had a number of stocks that have done really well on good results.

Spotify, for example, has had some really impressive performance over the past six months to a year, really, but also over the past quarter. And it's a real testament to how the company has built something that customers really love. So we've now got 600 million monthly average users of Spotify, of which 230 million are premium subscribers, and we're starting to see some material progress to generating a decent operating profit as well. We believe that this is a leaner, better business than it has been in the past.

And then on Adyen as well, this is the payments company, we're starting to see growth accelerating there. And this is a company where up until recently the market was actually fearing that growth would decelerate. There was a fairly big sell-off about a quarter or two ago, which turned out to have been totally unfounded. So the competitors are starting to price more rationally, growth is accelerating and normal service has resumed. And then Lonza as well, this is a drug manufacturer, has seen some really strong performance this quarter.

And this is a company which has got secular and cyclical winds that are now starting to blow in the same direction.

TH: And cyclical and secular winds aligning, pointing in the same direction, that's something that we're talking a lot about around the desk, according to how it relates to the portfolio and also Europe in general.

And you mentioned Lonza there, Lonza as a biotech adjacent business has had a fairly tough 2023, but we're really starting to see demand begin to return.

CH: Yes, and you're starting to see the confidence in that demand come through with a recent purchase of a massive manufacturing facility from Genentech.

The issues which have been plaguing the drug manufacturers, whether that's inventory destocking or the drying up of the biotech funding environment, these are now more or less through. And that's good news for Lonza, it's good news for Sartorius Stedim and it's good news for Mettler-Toledo as well.

And so the long-term is also very attractive in these companies. So what we now have is a situation where we have a very long-term growth driver that's now combined finally with some cyclical upswings as well. So we're starting to see this in other parts of the portfolio as well.

And at a macro level, a lot of indicators are looking a lot healthier. Freight volumes have started to go up, which indicates a more confident consumer. And we're starting to see easier lending conditions. So for example, we've seen mortgage volumes in Germany start to tick up, which is very good news for Hypoport, one of our holdings, which is a mortgage origination platform.

So we think that 2024 could be meaningfully better for volume growth in many of the industrial companies that we own, like Kingspan in energy efficient insulation, and for the consumer-related businesses as well.

All of the businesses that we own have some kind of long-term growth driver behind them. And so the cycle moving in the same direction could be quite powerful for us.

TH: In terms of the detractors, there's two where the cycle really hasn't been in their favour, Soitec and HelloFresh.

CH: So Soitec is a semiconductor company. It manufactures the wafers that are used to make microchips. And the semiconductor industry has very strong multi-decade growth drivers behind it, like Moore's law, smartphones, and more recently, AI. But in the medium term, it also experiences a fairly regular cycle that's driven by chip makers' inventory levels.

Now after a difficult 2023, which had a semiconductor downturn that was exacerbated by destocking, we're now in the early stages of a cyclical upswing. And Soitec's valuation at this point still doesn't really look stretched.

And we think this is because the wafer cycle tends to lag other parts of the semiconductor cycle. So we believe that there's plenty of upside to come, both from a cyclical and from a structural perspective.

HelloFresh issued a profit warning, which highlighted declining consumer activity driven by its core meal kits business, something which isn't expected to turn around soon. This has been a poor investment.

We had thought that it had the potential to become an important part of many households' grocery needs as they expanded the menu and diets it catered for. But it has suffered a fairly deep Covid hangover, and the product clearly isn't as strong as we hoped that it would become. We've subsequently sold HelloFresh to fund other ideas.

TH: And HelloFresh wasn't the only holding that we sold over the quarter. We also sold Zalando and Auto1 for similar reasons. Zalando, which is an online fashion marketplace, experienced a major boom over the Covid period, but has faced a really deep transition after that.

And this hangover has revealed a lot of competition or rising competition, both from Google search, but also direct from brands themselves, and more recently, the rise of low-cost alternatives from Asia. We felt that the unit economics, what the lifetime value of a customer is, what the cost to acquire that customer is, it wasn't improving in a time that we felt was going to be reasonable. And so we subsequently sold. And we also sold Auto1. Auto1 is a used car marketplace, but with a bit of a twist. So it refurbishes the cars that it buys from sellers. And that's necessarily a more capital-intensive business. And it's struggling really to prioritize growth or profitability.

And a dialing up or down of one or the other really puts it in what we think would be a difficult position. And with us having so much competition for capital and portfolios, we decided to exit.

And those ideas that we've exited in favor of, that competition for capital, it really is quite attractive when you look at the two biotechs and the lock maker that we've just bought.

CH: Yes. So this is Camurus, Genmab, and Assa Abloy, three very different companies. Camurus is a rapidly growing Swedish biotech that's developed a way of turning medicines into long-acting injectable formats, which steadily release the drug over the space of up to about a month, which removes the need for daily dosing.

Now, this is particularly useful in situations where people would otherwise have to go to a clinic. So the first way that Camurus has had success with this technology has been in treating opioid dependents, so they can provide a medicine over the course of a month that only requires a single injection.

So it's always encouraging when you find companies like this, which are actually doing good in the world through their success.

Now, Camurus first came onto our radar during one of our quarterly idea-storming sessions. And there was enough enthusiasm on the team that we set up a meeting with management, and we also spoke to their main competitor as well. We thought that there was a major disconnect between the size of Camrys' growth opportunity and its relatively undemanding valuation. So we've bought it for clients this quarter.

Genmab is another name in the biotech industry. This one's been around for a little bit longer, and it manufactures antibodies to fight cancer. It's probably one of the best examples of European innovation in healthcare, and it's actually one of many fantastic ideas.

I was thinking of Novo Nordisk as well, but this is a company which we've had our eye on for some time, and we were very pleased to take position on share price weakness for clients this quarter.

So Assa Abloy, something completely different. This is a Swedish group of lock makers. It buys up lock makers around the world, reinvesting its cash flows into Bolton acquisitions, which in the past have included very well-known brands like Yale and Chubb Locks, and it uses these acquisitions to grow the business and add value to the business as a whole. This is a type of business model that we see a lot in the Nordics, the so-called consolidator or roll-up.

TH: Yeah, and I think those are fairly good examples of what we've been doing in the portfolio more broadly in the past six or so months, and that has really been adding a lot more to innovative healthcare companies, whether that's biotechs, whether that's the likes of a drug manufacturer like Lonza, which Christopher mentioned earlier, but also still sticking to our long-term preference for high-quality industrials with long growth runways.

And I think we've conveyed a message of optimism going through this update, but perhaps you could help us conclude with a fairly bullish message on why we're so optimistic right now.

CH: So, we think this is a really exciting time for European equities. We've got three important features that are combining to create something potentially powerful.

On the one hand, we've got the long-term secular tailwinds, which have always been there, whether it's semiconductor capex, the need to fight climate change or innovation in healthcare. And then you've also got the cyclical winds, which are starting to blow in the same direction.

And the third aspect is that valuations for growth companies are still pretty attractive right now. So, with all of that in mind, we think we're positioned very well.

TH: A potentially attractive cocktail. With that, thank you very much, Christopher, and thank you for joining.

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

Annual past performance to 31 March each year (net%)

	2020	2021	2022	2023	2024
Europe ex UK Equities Composite	0.8	80.1	-19.4	-11.6	7.2
Pan European Equities Composite	-10.6	79.0	-20.1	-12.6	5.9
MSCI Europe ex UK Index	-12.0	49.5	1.4	2.9	16.0
MSCI Europe Index	-14.9	45.7	4.1	2.0	14.8

Annualised returns to 31 March 2024 (net%)

	1 year	5 years	10 years
Europe ex UK Equities Composite	7.2	6.8	5.3
Pan European Equities Composite	5.9	3.4	2.9
MSCI Europe ex UK Index*	16.0	9.8	5.8
MSCI Europe Index	14.8	8.6	5.1

*FTSE World Europe ex UK prior to 31 December 2016.
Source: Baillie Gifford & Co and MSCI. USD. Returns have been calculated by reducing the gross return by the highest annual management fee for the composite.

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