SHORT BRIEFINGS ON LONG TERM THINKING – EPISODE 7

FINDING EUROPE'S HIDDEN CHAMPIONS

MB – Malcolm Borthwick
SP – Stephen Paice

MB Hello, and welcome to *Short Briefings on Long Term Thinking*. Thanks for joining us. I'm Malcolm Borthwick, managing editor of Intellectual Capital at Baillie Gifford.

There are lots of reasons not to invest in Europe. Its economic growth is uninspiring and much of its stock index is made up of bureaucratic corporate dinosaurs. Also, Europe lacks the disruptive tech and social media companies found in the US and China, such as Apple, Facebook and Tencent.

So, what's the attraction? To find out, I'm joined in our Edinburgh studio by Stephen Paice, joint manager of the European Fund. But before we start the conversation, some important information. Please remember that, as with all investments, your capital is at risk and past performance is not a guide to future returns.

Stephen, why invest in Europe?

SP Well, firstly, thank you very much for that lovely positive introduction to Europe. Hopefully, we haven't scared everybody off. But I think it's a pertinent point that the sentiment just now in Europe is so negative. It's as negative as I've seen it for almost a decade.

I was at a conference, at the start there was an online poll, or an electronic poll, and the announcer, presenter, asked all the delegates in the audience which region would they most like to allocate more money to, or assets to, over the next six months? And when the poll results came in, Europe was at the very bottom. So, it had the least amount of people that were looking at that region to invest more of their capital. And I think that stems from a number of reasons.

We're just bombarded with negative headlines in the press; the FT, the newspapers, the general press and media. I think people are worried about GDP slowing, as I think the numbers are now showing. Obviously, the impact of Brexit; we have the Donald, Mr Trump, causing some issues with trade wars. For mainly those topdown macroeconomic and geopolitical reasons, a lot of investors are still sitting on the side-lines.

But if you're presenting it as a contrarian idea, as such, it is the reason why Europe presents such an opportunity. And when we look at Europe, we look at it in a very different way. We look at it from the bottom up, so we're identifying and focusing on the individual companies first, and we're not paying so much attention to the macroeconomics, which we know mostly doesn't really have that much to do with stock market returns.

MB And, as an investor, is it difficult to block out that noise, that negative sentiment?

SP It is. Perhaps one of the benefits of being based in Edinburgh is that we're not so much in that bubble that exists around London and some of the other financial centres around the world. It's part of our culture, it's part of the way Baillie Gifford operates. We have been bottom-up, long-term investors for over 100 years now, and it just comes through practice. We're now much better at avoiding and ignoring a lot of the noise. We rarely pick our phones up these days, and it's much more like a library, as you know, in the office.

And I think that comes through repetition. So, the more time we spend looking at individual companies, the more time we spend looking back through history, trying to identify what works and what doesn't, we kind of realise that the way to generate long-term sustainable returns is not to try and second guess the market or what's happening in the economy, or what the outcome of the next election is going to be. It is focusing on those big winners. It's focusing on those special companies, run by entrepreneurs, people that we trust, that have a greater than average chance of generating outstanding returns. And that's what you have to do to provide your clients with good value.

MB It's interesting, you talk about looking back through history, because you have done some research into what's made some of the most successful companies in Europe successful, haven't you?

SP Yes. Again, I think we now know that most of the returns in stock markets and portfolios are generated by a relatively small number of companies. So, what we wanted to do was focus on the European market and compare that to some of the other regions that create a lot more excitement and optimism, particularly in the US and China and so on.

So, what we did was, we looked at the European market over the last 30 years, and what we wanted to identify were all the companies within that period, within each discrete ten-year block, that appreciated more than ten times. And this is where the phrase tenbaggers comes from.

MB What does that mean, tenbaggers?

SP I think it actually originally came from baseball. So, a fourbagger was used to describe the home run. So, in effect, this would be two home runs and a double, it was described as. So, a tenbagger effectively means, in the stock market parlance, that a company's share price will appreciate more than tenfold. So, if you invest £100 over a ten-year period, if it was a tenbagger, you'd get £1,000. And that's what we want to identify.

These will be a relatively small subset of the European market, but when we looked at the number, for instance, of companies that appreciated more than tenfold, the probabilities of finding one of these tenbaggers in Europe is pretty much the same as it is in the other markets I mentioned, like the US and China.

So, this gives you some confidence. It gives us, certainly, some confidence that Europe still offers those long-term, bottom-up stock pickers a fabulous place to find and invest money. And one of the interesting points that came out of looking at these big winners in these different markets was that, while the probabilities were the same, the opportunity sets were different.

So, in Europe, for instance, we don't have a tech sector as developed and as big as the one that exists in the US, which is driving a lot of the stock performance there, with companies like Facebook, Amazon, Apple etc. In Europe, we've got a slightly different mix of companies, and what we found was that the types of businesses that do well, or have done well, in Europe are typically less glamorous; I think that's probably a good way to describe them. These will be your classic Mittelstand companies in Germany, but typically niche.

MB That's your small, medium-sized German businesses?

SP These are small, medium-sized niche B2B, or business-to-business, type companies, which will operate in fairly niche markets or industries. They could be chemical distributors, auto parts manufacturers, rubber compounders. There's lots and lots of these small, idiosyncratic companies that, importantly, tend to dominate markets. They will be extremely profitable. More often than not, they will have a founder, or at least a family, involved, so that gives them a different outlook. It allows them to invest with a much longer-term horizon.

So, there's a lot of these niche B2B industrial businesses, but there are also a lot of med-techs, business-to-business services and consumer discretionary. The other thing Europe has done very well over a very long period of time is produced some fantastic brands. So, this is the luxury brands like Gucci, which Kering now owns; it would be companies like Hermès, even Puma, Hugo Boss. Richemont, which owns Cartier, which is probably the best hard luxury brand in the world, I think.

So, these pockets of excellence still exist in Europe. I think that's what, again, should hopefully persuade investors that want to look at Europe that, while the opportunity set is different, we still have a great chance of making lots of money.

MB Give me an example of one of those idiosyncratic companies where there are barriers of entry.

SP One of our, in fact it's the largest holding we have, is a Dutch specialty chemicals distributor called IMCD. This is a company where the risk of technological obsolescence is pretty low. And it effectively acts as a consultant, so it's connecting chemicals suppliers to hundreds, if not thousands, of chemicals customers. And it's the middle man economic, so it's a network-type business; it outsources the distribution and the logistics and warehousing. So, it's actually fairly capital light.

But the attraction here is that it operates in a really unglamorous, unsexy industry. this is the one I visited in Rotterdam recently, and even though it operates in this fairly niche market, it's by far the largest. So, even though it's the largest, it only has perhaps 3 or 4 per cent of the global specialty chemicals distribution market, so there's a huge room and scope for it to continue growing. And it's also the natural acquirer and consolidator of that market.

So, the founder, who still runs the business today, he set it up 20 years ago, works out of this really small head office in Rotterdam. I think there's probably six or seven people there, it's pretty small. But they're nimble, they're quick. And as they operate in a family-founder-type business model, they attract other family-founder-type businesses who want to sell to them. So, their strategy is to buy up all these smaller distributors across the world and slot them into their network.

There's lots of these smaller businesses that, from the outside, don't look particularly attractive. But when you actually get into the types of things people look for, in terms of growth, competitive position and alignment, these are the businesses in Europe which stack up really well and these are the ones we're attracted to. It's not the large banks, it's not some of the larger energy companies. That's not our style of investing and that's not where we think we're able to add much value, or where any investors are likely to make outstanding returns.

MB You mentioned earlier founder-leaders. Europe has a very deep history of founder-leaders running its businesses, doesn't it?

SP Yes, and whether you're looking at Scandinavia or Europe in general, you tend to see a lot of very traditional companies that are now run by multigenerational families. Sweden is a classic example. We've got a number of families that effectively control holding companies, and those holding companies effectively control, or have a great influence on the boards of a lot of other companies that exist in those markets.

And by having that ownership and family oversight, you tend to see that these businesses are much more adaptable and are able to survive exogenous shocks, whether it's a recession or downturn. It's not just families, it [can] be a founder-type business as well. They're running their business, if it's a family, to pass on to the next generation in a better shape than they inherited it. And if it's a founder, it's your baby and you don't want anything to happen to it.

So, this is why they're probably less prone to take risks or undertake value-destructive acquisitions at the top of the market, where that might be the case in a bureaucratic company, where the chief exec is incentivised to grow as big as he can, a typical empire builder. So, I think when you look at alignment, Europe does punch above its weight in terms of the composition of the market being run by families or founders.

And I think that automatically, and, again, this is backed up with a lot of academic evidence, this type of ownership tips odds in your favour of outperforming. So, this is why we put a lot of focus on these types of ownership models. And I think in the fund, probably at the moment, by weight it's probably about 80 per cent of the investments that we've made will be in a company that is either run or owned and managed by a founder, or some type of meaningful inside owner.

MB And how do you deal with generational transfer? Because there is a drop off in the success of companies after, say, the second generation and then the third generation, isn't there?

SP Yes. I think it's called the 'stupid son syndrome' or even in some countries, it's 'clogs to clogs in three generations.' There is a risk that the company will be passed on. It's classic nepotism, where the founder will pass it on to his son or daughter and they may not be suitable for running a business. And that's something you need to watch for. A lot of the multigenerational families, however, that we've seen, will tend to take a backseat.

So, when the founder maybe retires or moves off the board, the family members then tend to go on to a supervisory board to protect the family interest, and they then bring in professionals to actually run the business. So, that's how to mitigate some of the problems with that. However, there are examples where the founder, who's been very successful in his or her own right, has then passed it on to the son who's gone on to be even more successful.

And I can think of examples at Kingspan, an Irish building construction materials company, which again, the son took over and helped internationalise that business and has taken it from strength to strength.

The underlying point is, you can't use any of these rules to guarantee success in anything. You have to look at each business on a case-by-case basis. You have to look at who's running it, whether they're suitable, whether incentives are aligned with what we like, and take it from there. But, certainly when we look at Europe, again, there are hundreds of these businesses which are run in a very entrepreneurial, long-term manner.

MB That's a good place to leave our podcast. Stephen, thanks very much for joining us.

SP It's been a pleasure. Thanks.

MB And you can find our podcast, *Short Briefings on Long Term Thinking* on Apple Podcasts, Spotify and on our website at bailliegifford.com/podcasts. We hope you enjoy it, and please spread the word.

And if you'd like to find out more about what we've discussed on this podcast, you can find Stephen's paper, *The Hunt for Europe's Tenbaggers*, in the Insights section of our website at bailliegifford.com.

And many thanks to Lord of the Isles for the music. Until next time.