Baillie Gifford™

European Equities
Q3 investment update

October 2024

Investment manager Christopher Howarth and investment specialist Thomas Hodges give an update on the Europe ex UK and Pan Europe strategies covering Q3 2024.

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Thomas Hodges (TH): Welcome to this quarterly update video covering the European equity strategy. My name's Tom Hodges. I'm an investment specialist on the strategy. And today, I'm joined by investment manager, Christopher Howarth. And in this video, we're going to be covering performance, and then moving on to some more interesting topics, such as serial acquirers and the semiconductor stocks within the portfolio, before finishing on Christopher's thoughts on the outlook for the years to come.

Starting with performance, the third quarter certainly wasn't without incident. We started off with a significant amount of volatility caused by the US jobs report, culminating in the worst few days we've seen in markets in recent memory, followed then by an ECB interest rate cut, the second rate cut of the year for the ECB. Then we had the Fed cutting for the first time this year. And then again, we had Chinese stimulus, moving the market fully from despair to optimism, perhaps highlighting the manic depressive nature of stock markets at times. This portfolio performed roughly in line with the benchmark over the quarter. And we had strong contributions from the likes of DSV, which announced that it would be acquiring DB Schenker, one of its peers, over the quarter. This is a large deal, which follows a long line of deals that DSV has done over many years, and we'll touch on serial acquirers in a second. We also had very good performance from the likes of Adyen, which we've mentioned in previous videos. We saw a re-acceleration of growth, while peers actually saw a deceleration of growth. Detractors from performance mainly came from the airlines. We saw the low-cost airlines Ryanair and Wizz suffer a weaker outlook for fares over the summer. And this seems to suggest that what we've seen from consumers post-COVID, a real COVID revenge spending spree, has started to end. But what we would say about both airlines is that they're the most cost-advantaged airlines in the European aviation industry. And actually, a weaker fare outlook probably puts them in a stronger position relative to their peers because they're able to reassert their dominance in the sense that they're able to underprice relative to their peers more profitably.

But anyway, turning to Christopher now, I mentioned DSV doing another acquisition. This is its first acquisition since 2019, but a really significant acquisition in DB Schenker, 14 billion euros. We tend to quite like companies which grow by acquisition.

Christopher Howarth (CH): Yes, and I think that sometimes surprises people because often when investors hear about M&A, they tend to think of past horror stories like the AOL failed merger attempt with Warner back in the thousands. But that really, in our view, obscures some of the success stories which are perhaps less well-known and often don't involve the same degree of inflated egos and overspending that you often find in this sector. I think some of this is encapsulated by the line in the TV show Succession where Logan Roy says, anyone can pay the biggest number. So, we think that the companies that do the best in M&A are often the ones which are very focused on the actual values that they're paying and they're very focused on returns metrics and they're not just thinking about trying to grow the business for its own sake. So, DSV is a really good example of a business that does this. It operates in a business where there are clear economies of scale, where owning a larger number of freight forwarders allows it to combine scale economies, and it's able to strip out costs by harmonising the IT systems across all of the companies that they own. So, we've owned DSV for a long time. It's grown to be now the largest freight forwarder in the world following its acquisition, and we expect further value creation to come.

Another great example of companies that grow by acquisition is Topicus. Topicus originally was the Dutch office of a more well-known company known as Constellation Software, which is famous for its long track record of successfully rolling up what are known as vertical market software. which are essentially businesses that operate in extremely specialized niches, which range from everything from Bulgarian pharmacies to South American window fitters. So it's very sort of specialized niches, often where there is near monopolistic characteristics. And Topicus has been able to deploy capital extremely efficiently by acquiring more of these businesses and continually redeploying cash flows at a very high rate of return. So, we're very optimistic about the ability of companies with this style of M&A to create significant amounts of value over time.

TH: Yeah, and Topicus is probably a good example of what we describe as a hidden champion within Europe, a company that does programmatic M&A. There's other companies that we have, such as Beijer Ref, for example, in HVAC distribution, Vitec, which is a similar business to Topicus in doing vertical market software serial acquisition. But maybe turning to something which is a bit more of an obvious champion within Europe, and ASML and semiconductors. Semiconductor stocks were quite newsworthy over the quarter because we did see a ratcheting up of rumours, certainly, around increasing restrictions with regard to the sale of equipment and also the servicing of that equipment to China. So I wonder if you've got any thoughts about that, but also semiconductors more broadly.

CH: So, semiconductors are a really fascinating area of the European market. ASML in particular, which we've owned for many years, is often described as one of the best businesses in the world. It's certainly one of the best businesses that few people have heard of. This is a business that holds an effective monopoly over the production of lithography scanners for very advanced logic chips in the semiconductor industry. But what's particularly exciting about semiconductors at the moment is that you have the confluence of both very long-term secular trends with a shorter-to-medium-term outlook, which is also very positive, as we've had a downturn in the semicycle over the past couple of years, and that is now showing very clear signs of inflecting. And on top of that, we've had a bit of a volatile period over the last quarter, as you mentioned, as news has at least sounded negative and has depressed some of the valuations in the sector. But we think that there is a clear disconnect between some of the headlines that you see about the US potentially banning exports to China versus the underlying very long-term picture of continual rising demand for semiconductors over the long term and the fantastic market positions of these companies. So we assume that over the longer term, China will become a smaller part of the overall demand for the equipment that ASML and other semi-cap companies are selling. But demand will continue to grow for this equipment. As we've seen in the US, it is very much in their interest to develop their own semiconductor manufacturing facilities, as we've seen with Intel, and that's going to be a very strong growth driver for companies like ASML in the future. And then also thinking longer term, one of the key trends over the past decade has been the ever-growing importance of lithography to the semiconductor manufacturing process. So this refers to the use of very high-powered lasers to etch a design onto a semiconductor chip. Now, that has been extremely supportive to companies like ASML, but over the past year or two, in our conversations with industry experts and with companies, and even with our conversations with ASML themselves, we've started to build up a bit of a picture that perhaps lithography is going to be less of a driver of change in the future, and that actually we might see the rise of other techniques like deposition and etch which are other stages in the manufacturing process, taking greater prominence. So, we're interested, therefore, in exploring some of the other opportunities that this might give rise to in the future, but we remain extremely positive on ASML as well. So, yeah, with the combination of all of these things, secular, cyclical and potential valuation effects recently, we remain extremely positive on this sector.

TH: And that's quite a good segue into sort of our final part on outlook, the secular and cyclical aligning. So perhaps you want to touch on that.

CH: So, we've seen over the past year or so, we've seen a period of prolonged weakness in demand across multiple sectors of the economy. And it is encouraging that this is now starting to show signs of ending. So, we're starting to see demand return after this period of weakness in sectors ranging from semis, as I've mentioned, through to healthcare as well. And then also with a potentially more accommodative financing environment, we may also start to see further M&A activity as well, which is good for our serial acquirers. But then looking longer term, of course, secular growth opportunities are extremely abundant. Decarbonisation and electrification, for example, is a very important trend. And that has been very supportive to a company like Nexans, for example, which makes deep sea cables for connecting offshore wind turbines to the shore. Of course, I've mentioned semiconductors, but a key theme there that I'm sure everyone has heard of is AI. AI is going to be ever more important to our lives, and that will be a very long-term growth driver for companies like ASML. And of course, there's also general demand for technology and industry, as reflected by the many very high-quality industrials in our universe. And of course, on top of all of this, valuations still remain very attractive at these levels, so that gives us lots of causes for optimism over the next few years.

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TH: Well, thanks very much for that, Christopher. Just to sum up before we go, performance was roughly flat versus the benchmark for the strategy over the period. We had strong contributions from serial acquirers like DSV. We also had some weaker performance from airlines, but also from semiconductor stocks, but we're feeling incredibly optimistic about cyclical growth beginning to come back through, as well as secular growth continuing, a real key component of our portfolios going forward, whilst valuations remain attractive. Thank you very much for joining us, and we hope to see you next time.

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

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

	2020	2021	2022	2023	2024
Europe ex UK Equities Composite	52.6	24.5	-51.7	17.0	30.1
MSCI Europe ex UK Index	5.1	27.0	-27.2	31.2	26.8
Pan European Equities Composite	40.4	22.4	-51.6	18.1	27.6
MSCI Europe Index	-0.3	28.0	-24.3	29.7	26.0

Annualised returns to 30 September 2024 (net%)

	1 year	5 years	10 years
Europe ex UK Equities Composite	30.1	6.9	6.8
MSCI Europe ex UK Index*	26.8	10.1	7.0
Pan European Equities Composite	27.6	4.6	4.5
MSCI Europe Index	26.0	9.6	6.2

*FTSE World Europe ex UK prior to 31 December 2016.
Source: Revolution, MSCI, FTSE. US dollars. Returns have been calculated by reducing the gross return by the highest annual management fee for the composite. 1 year figures are not annualised.

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