

European Equities Q4 investment update

January 2024

Investment manager Stephen Paice and investment specialist Thomas Hodges give an update on the Europe ex UK and Pan Europe strategies covering Q4 2023.

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

Thomas Hodges (TH): Welcome to this quarterly update video covering European Equities. My name is Tom Hodges. I'm an investment specialist on the European Equities Team and I'll be hosting this conversation with Stephen Paice, the head of the European Team. And in this conversation we will be covering performance, what we've been doing in the portfolios and why we're so optimistic for the future.

Stephen, let's dive in. As we start 2024, I think it makes sense to reflect over the past few years which have been volatile and ultimately disappointing from a performance perspective.

Stephen Paice (SP): Well, I think following quite a lengthy period of outperformance, we've been somewhat humbled by the markets over the last couple of years. But I think it's important to say that we haven't changed our investment philosophy.

We still invest in dynamic and innovative growth companies in Europe, managed by founders and families who have exceptional track records of capital allocation. And when we buy these companies, we tend to hold them for a very long period of time. And we think that every single one of the companies within the portfolio has a very good chance of at least doubling over the next five years.

In fact, with the valuation moves, the chances of that doubling are probably even higher now. But over the last couple of years, I would say that there have been two main headwinds to performance. The first obviously being the interest rate cycle. When interest rates have gone up, this has compressed the valuation multiples for the long duration and growth companies. And the second one has been a hangover from Covid.

And this has manifested itself in growth rates which have normalized and also excess inventories, which were built up during this kind of supply chain dislocation, being unwound. So, this has unhelpfully affected the performance of ecommerce companies, food delivery companies, health care companies like Sartorius Stedim. And it's definitely affected the longer-term numbers here. I would say, though, that I think we have turned a corner.

And when we start looking at the growth rates over the next 12 months, 24 months, we can see that the growth rates are starting to inflect. So, we've seen hopefully the bottoming of this cycle. Inventories have been unwound, so we're starting to see a more normalised period of ordering companies that have been focused perhaps a little bit too much on growth and now focusing more healthily on growth and profitability.

And when it comes to the macro side, real wages in Europe are growing. So this is helpful for demand. And clearly there are now signs that it's more likely that we're going to see interest rates being cut rather than being raised. And this is all going to be quite helpful for our style of investing

TH: And those expectations of rate cuts in the US led to a big rally in growth stocks in Europe, but also globally over the quarter. So, can you take us through any of the highlights that there were in the portfolios?

SP: Sure. Well, the Fed pivot towards the end of the year was definitely helpful to performance. So, we have kind of rebounded, but we still think there's a long way to go before we're back to where we would like to be.

The narrative around where interest rates are going to go when they're going to be cut is still the main determinant of prices at the moment. However, within the portfolio there were some positive signs from companies like Adyen, Schibsted and Adevinta, and CRISPR Therapeutics.

Now, Adyen was a company that in August actually fell about 40 per cent after a profit warning, which was driven by reported market share losses, which we think was driven itself by some irrational competition.

We thought that was a temporary problem and the more recent quarterly numbers have validated that thesis. So, we're starting to see kind of the rebound in the share price in Adyen and as a digital payment processor, we still think that the longer-term attractions whereby it can take market share from incumbent banks and help solve some incredibly complex payment problems for its customers is still undervalued and underappreciated by the market.

Schibsted and Adevinta, these are online classifieds businesses. So Schibsted is now selling – or looks to be selling – its main asset, which is Adevinta, which we also own. And it's selling that to a private equity company.

And while we would have perhaps hoped for a slightly higher price, it does give some indication that we're not the only ones to think that there are a lot of bargains out there in Europe for our kind of growth investing. Either way, it was a very nice boost to the share prices of both companies in the quarter.

And then finally, we had CRISPR Therapeutics. This is a very innovative biotech company where it has made somewhat of a breakthrough and has now had the world's first ever CRISPR gene editing therapy approved. And this is used for some blood disorders, and it's effectively a cure for sickle cell disease and some other things. And this is a massive breakthrough for biotechnology. This technology was actually only invented in 2012.

So it's actually remarkable what they've been able to achieve in the last 10 years or so, which led to one of the co-founders of the company being awarded Nobel Prize in 2020. So, I think this is just a good reminder that there's plenty of other things, plenty of innovation happening, that it's not all about central banks.

So I think there's a lot of good things happening in the portfolio.

TH: In terms of the lowlights, one of them, probably the headline one over the quarter was Prosus, which has exposure to Chinese gaming via its large stake in Tencent. There was the announcement of regulatory news in China which may ultimately curb spending on online games in China. So as its one of our biggest holdings and it's a company that we do get asked about quite regularly, perhaps you could remind us what the investment case is with Prosus?

SP: Prosus is a consumer internet holding company that listed in 2019. It's among the 30 largest companies in Europe, although it's not very well known. It has lots of investments as a holding company would, in areas like online classifieds, food delivery, edtech and payments.

But the vast majority of its value derives from a stake in a very large Chinese company called Tencent. Now, Tencent has a social media platform called Weixin, or WeChat, which has over 1.3 billion users. So there is a huge opportunity here to develop its advertising spend on the back of that platform. In fact, I think about a third of all time in China spent on the internet is actually spent on one of Tencent's platforms.

It also has cloud software businesses, it has a payment business and it's one of the world's largest gaming companies. Now, there are sometimes noises made over proposed regulations which would be unhelpful for some of these businesses, but having looked at these, we don't think they're going to be material for the longer-term value creation of the business. And if anything, these proposed regulations are to try and foster a longer-term, healthier industry rather than anything else or to destroy profit pools.

So, we think that the growth rates and durability of the platform that Tencent has, has been mispriced. And if you think of investing through Prosus, you're actually getting all of these assets for a 35 per cent discount.

So while we're cognisant of the China risk, we think there's a sufficient margin of safety in this very low valuation to merit it being a relatively big position in the portfolio.

TH: And let's talk about portfolio activity now. There was only one stock added in the fourth quarter and that was the drug manufacturer, Lonza. So, take us through your thinking there.

SP: Well, I think Lonza is one of these very high-quality growth companies that has exposure to some very attractive secular growth but has faced some shorter-term temporary problems.

So I think we're being offered a bargain to invest at this point. So Lonza is a contract manufacturing and development organization or (CDMO) for short and effectively what it does is develops and manufactures drugs for large biotechs and pharma companies.

Increasingly those companies are outsourcing this manufacturing and development to companies like Lonza because it's a very capital-intensive business. And Lonza, with leading market shares, has the scale, has the reputation for quality and reliability to maintain or expand its market share in this industry.

So, the underlying dynamics are pretty strong, as are the fundamentals. Now, the temporary problems have come through some weaker R&D spend in certain regions and China in particular. There were some contracts that were canceled at the very last moment and we've had a recent dismissal of the CEO.

Now, we've looked into each and every one of these issues and we strongly believe, like it was with Prosus, that these issues are not going to materially affect the prospects for longer-term value creation. This is a company that could grow more than 10 per cent on its top line for a very long period of time, and this is being underpinned by the growth in the biologics market.

We have met and we know the chairman, who's now the interim CEO – he used to be the CEO of a company called Geberit, which was a very successful investment – and we believe that he knows what needs to be done to put the company back on track. So, we're being offered an attractive company, [with] high-quality growth, at discounted price.

TH: And so just finally, I know you're increasingly optimistic about the prospects for this portfolio. So, let's finish with hearing about why.

SP: Well, I'm naturally optimistic, but I do think for our style of investing, for growth investing, we are past the worst time.

We've gone through probably one of the worst periods of performance that we've ever faced. But when you kind of think about the valuations, I think that those valuations have fallen so much now relative to the index that our portfolios will probably be on a lower valuation multiple than the index within five years.

Now when you think of the quality within the portfolio that we have, the companies which are growing faster and will continue hopefully to grow faster than the index, that just seems like something's not quite right there. And again, it kind of gives me a bit more comfort that the style of growth that we have is being mispriced.

We also have exposure to some of the most attractive secular growth themes in the market. We've got semiconductor exposure through ASML and Soitec. We've got serial acquirers, that are able to consolidate very fragmented markets, like Topicus, IMCD, Atlas Copco.

We have got some of the best luxury brands in the world through Richemont, which owns Cartier. We own Ferrari through Exor and Gucci through Kering. We've got some of the best companies solving very complex logistics problems in the world, companies like DSV, and Autostore, and as we mentioned before with Lonza, we've got some of the most exciting healthcare and medtech names that we can invest in.

And these are all what we consider exceptional companies that have years, if not decades, of profitable growth ahead of them. So, while I don't have a crystal ball, when I look at the portfolio, I feel quite comfortable with the exposures that we have. But the thing which I think maybe gives me the most comfort is the alignment

that we have with the founders and the families and the management teams which are running these businesses.

We are investing alongside some of the best entrepreneurs and capital allocators in Europe, and these are the people that are going to create the value for our clients. So when you can pull these things together – lower valuations, [those] really high-quality growing companies in the portfolio – and think about some of those secular themes and growth trends that we are exposed to, there are plenty of signs to be a lot more confident and optimistic about the future.

TH: Stephen, thank you very much and thank you all for watching.

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

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

	2019	2020	2021	2022	2023
Europe ex UK Equities Composite	37.0	48.0	8.3	-42.9	14.1
Pan European Equities Composite	29.2	39.1	8.7	-43.6	13.5
MSCI Europe ex UK Index	25.9	11.6	16.5	-17.3	22.7
MSCI Europe Index	24.6	5.9	17.0	-14.5	20.7

Annualised returns to 31 December 2023 (net%)

	1 year	5 years	10 years
Europe ex UK Equities Composite	14.1	7.4	4.9
Pan European Equities Composite	13.5	4.6	2.8
MSCI Europe ex UK Index*	22.7	10.7	5.5
MSCI Europe Index	20.7	9.7	4.7

*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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