CONTINENTAL BLEND

THE CASE FOR EUROPEAN COMPANIES

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BAILLIE GIFFORD

RISK FACTORS

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CONTINENTAL BLEND

BY STEPHEN PAICE AND MORITZ SITTE

In December 2019, we became the portfolio managers of what was The European Investment Trust plc, following a decision by the board to appoint Baillie Gifford. In addition to renaming the trust as Baillie Gifford European Growth Trust plc, investors will notice a radical change in the portfolio, which has been reinvested in 40 or so companies which we believe are most likely to deliver outstanding growth over the next five to ten years. This reflects the board's decision to focus the emphasis of the trust on growth rather than value. Although the portfolio is similar to that of the Baillie Gifford European Fund, the trust will be able to invest in smaller cap and unlisted companies. This broadens our opportunity set in the listed sphere to around 1,150 companies.

INVESTING FOR GROWTH

In our view, the best way to create sustainable and growing returns for shareholders is by investing in growth-oriented businesses – innovative and adaptive companies, regardless of geographical location or sector. We look for individual companies, seeking out the ones that are run by exceptional people that we trust. Europe is home to many outstanding businesses: from 'hidden champions', industrial companies dominating attractive niches thanks to a dedication to product and service quality, to luxury brand businesses which benefit from heritage and provenance, to younger, disruptive, internet-enabled businesses.

Over the next two to three years, we also expect to have made investments in unlisted companies with valuations of at least €500 million, subject to shareholder approval. The portion of the trust's portfolio invested in these private companies is capped at 10%. This allows us to invest in Europe's most exciting growth companies, be they listed or not.

We think that unlisted companies are better held within the structure of an investment trust than a fund. Our shareholders can trade in the trust's shares at the market price whenever they wish, while the closed-end structure of an investment trust means that there is never any need for us to sell any of our holdings to fund redemptions. This means we can be patient long-term shareholders in private companies.

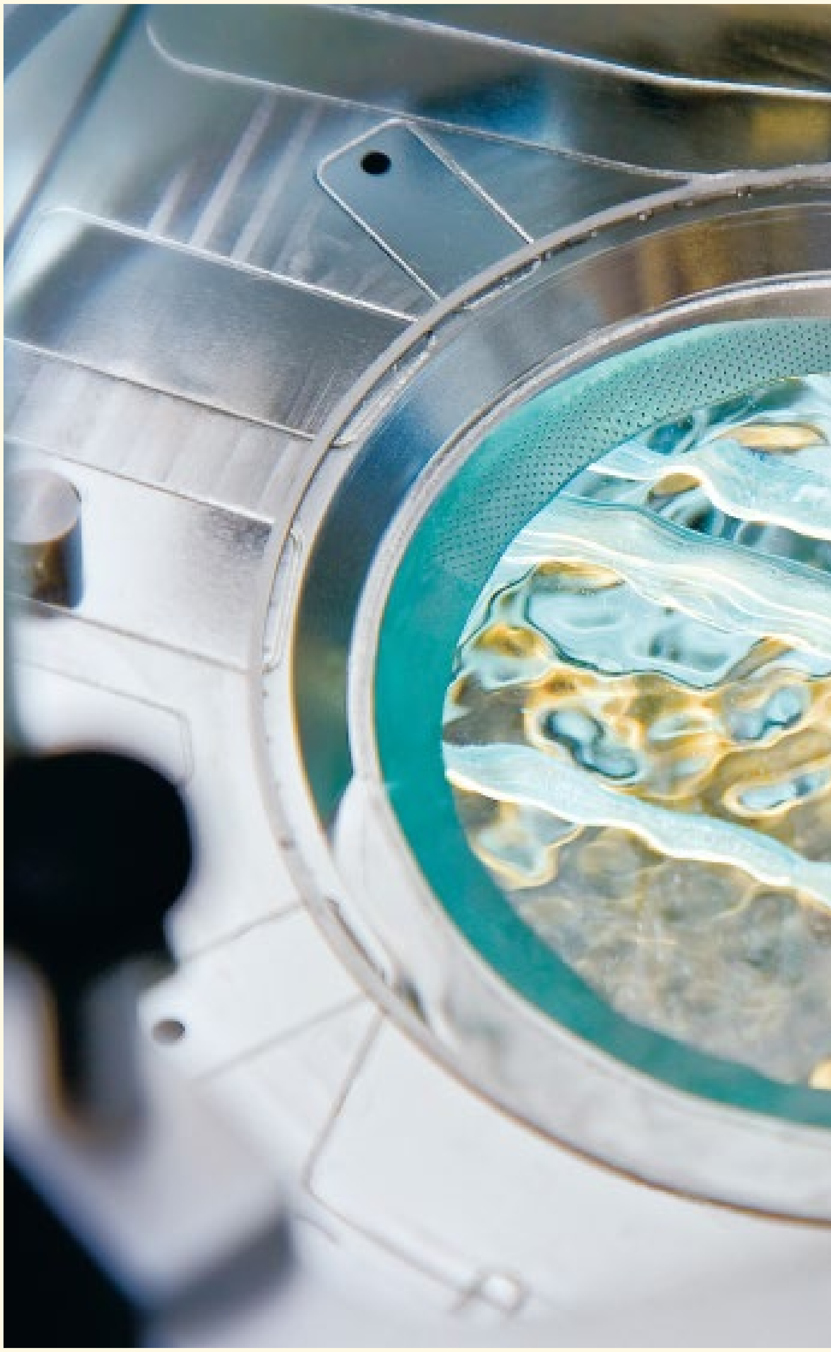
We are not looking to invest in embryonic businesses or ideas, but in established businesses choosing to remain private for longer. Businesses like these tend to be asset-light and do not require much capital, while owners often find it is easier to create long-term value without short-term shareholders. Baillie Gifford has been investing in unlisted companies since 2012.

So far, only around 10 per cent of the world's unicorns – private companies valued at over $1 billion – have come from Europe, so it still has some catching up to do. Yet when we speak to companies in Berlin and Stockholm, we can see that the mindset is changing.

THE TROUBLE WITH EUROPE

We can understand why investors are cautious about investing in Europe. Economic growth is uninspiring, its politicians even more so. Europe lacks a technology giant, such as Amazon or Google, and its lacklustre stock market is dominated by large, bureaucratic multinational companies in sectors such as financials, consumer staples and even healthcare. We don't mind, because we aren't buying those companies; we're investing in a small number of innovative, proactive companies that happen to be domiciled in Europe.

Looking at the market over the past 30 years, it is niche industrial businesses that have delivered the best returns. Companies such as ASML, whose lithography systems allow light to be projected through patterns to make blueprints for manufacturing semi-conductor chips, or Beijer Ref, whose environmentally-friendly fridges and freezers are playing a key role in reducing CO2 emissions in supermarkets and other commercial premises.

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SMALL CAN BE BEAUTIFUL

The internet has made it much easier for smaller companies. The old theory that economies of scale were the most important thing no longer holds. IMCD is a good example of a capital-light business, and has been run by the same chief executive officer and chief financial officer since it was set up in 1995. A Dutch company, it markets and distributes speciality chemicals, which are used in cosmetics, food, drink, cars, detergents, paints and medication. As more chemical companies are outsourcing distribution, it operates in a growing market.

However, to describe IMCD as an European business would be misleading. IMCD is very much a global business, which has made several acquisitions in the US, where it has full national coverage. We have noticed something similar when we compare Swedish engineering businesses, such as Atlas Copco or Alfa Laval, with their German or US equivalents. The Swedish businesses, with small domestic markets, had to leave their home markets in order to grow and develop international skills and a more adaptable culture. This now means they can say, ‘We’ve been in China for decades,’ an increasingly valuable advantage as markets in China, India and Latin America become more important.

ADAPTING TO CHANGE

We tend to like family-backed businesses, such as Atlas Copco, and NIBE, a leading manufacturer of heat pumps. NIBE has been run by the same owner for 30 years. These Swedish companies' business models depend on buying other family firms, and that depends on those owners being prepared to sell. Understandably, owners want to know that the businesses they have built up will be well looked after; family-run Swedish businesses with a long history of successful acquisitions tend to be more welcome purchasers.

Europe also has a rich provenance in leading brands such as Gucci, owned by Kering, and Cartier, owned by Richemont. A brand's reputation can take decades to establish, but it can be destroyed overnight. We have been impressed by the way in which Kering and Richemont have nurtured their brands, which we think comes back to their long-term vision. When watch sales fell quite dramatically a couple of years ago, Richemont, which owns watch brands such as Jaeger-LeCoultre and A. Lange & Söhne, took the decision to buy back inventory from distributors, jewellery shops and watch stores and to melt some of it down. It takes a lot of courage to do that and take a short-term hit to the margins, but the company was prepared to do it to safeguard the brand in future.

Adidas is a more mass-market brand, but has its own valuable heritage, dating back to 1953 when the founder, Adi Dassler designed the boots that helped the German team to beat Hungary in the following year's football World Cup. Adidas is doing well from the trend to wear sports or leisurewear all day. L'Oreal, another strong European cosmetics brand, has stayed ahead of the times, using digital sales and marketing effectively. We believe that the strongest European brands will have staying power, because they are owned by families who seek to pass on a healthier business to the next generation.

Europe has many of its own gems, brands with a heritage spanning decades, niche, almost hidden industrials, adaptive founder or family-run companies whose objective is not just to pass on the business but to hand it on to the next generation in better shape.

We do not invest by sector or country; we simply seek out the companies that we believe will deliver the best long-term returns for investors. Our focus is on the future, which is why it is important for us to be able to trust the people running the businesses we invest in, to understand the culture of the company and ensure that the right management is in place. Only then can we choose the companies that we feel will be winners.

A model walks the runway at the Gucci Cruise 2019 show at Alyscamps.
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