Janus Henderson
INVESTORS

The European Smaller Companies Trust PLC:

Finding tomorrow's winners

MAY 2022

ESCT
EUROPEAN SMALLER COMPANIES TRUST
EUROPE'S WINNERS OF TOMORROW AT THE RIGHT PRICE

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SUMMARY

Why invest in smaller companies?

- Capture the early high-growth stage to generate capital gains
- Risks are higher but these are often met with higher returns and can be mitigated

An imperfect market is good for investors

- Smaller companies are under-researched, so it is possible to find hidden gems
- With less readily available information, smaller companies are often mispriced, and this means opportunity for investors

How to invest in smaller companies

- Active management is well suited to smaller companies – the imperfect market provides the means to outperform
- Smaller company share prices diverge more – the dispersion of share price movements is more than 2x that of larger companies; this means higher risk but also offers potential for larger gains
- Diversification helps mitigate these higher risks

European smaller companies have returned

893%

to investors in the last 20 years, compared to 195% for the FTSE 100

Smaller companies deliver the goods

- European smaller companies have returned 893% to investors in the last 20 years, compared to 195% for the FTSE 100
- In volatile times, smaller company share prices tend to be disproportionately impacted – 2022 has so far proven a difficult market for this asset class
- It is important to look at the long-term picture, not focus on short-term fluctuations

Rapid profit growth explains high returns

- Between 2013 and the pre-pandemic peak, European smaller companies grew profits seven-fold, from £6.9bn to £46.6bn
- FTSE 100 and European large caps saw profits rise by two thirds over the same period
- Fewer than half of European smaller companies have yet reported 2021 results, but we expect total profits to have recovered almost to pre-pandemic levels
- Over the last three years, the median profit growth among European smaller companies is 14% per annum – five times and twice as fast as large European and UK companies respectively
- Before the conflict in Ukraine broke out, consensus expectations were for European smaller company profits to by 25.5%, almost double the pace of large caps. The outlook is less certain now, but this is true for companies of all sizes.

European smaller company median price/earnings ratio is

20.7x,

slightly higher than large caps, but for much more growth

Valuation – all that growth but almost no price premium

- European smaller company median price/earnings ratio is 20.7x, only slightly higher than large caps, but for much more growth
- The price/book ratio for smaller companies is cheaper than for large ones

Tapping into tomorrow's sectors

- Smaller companies have greater sector diversity than large ones and are more represented in high growth sectors
- The energy transition and technology are key themes
- Even in 'traditional' sectors, small companies are more likely to be disruptors

Small caps take you beyond the big economies

- Smaller company investment provides more potential for geographical diversification

Sources for data in the above summary are fully referenced in the respective sections of the following report

Viewpoint – Ollie Becket, portfolio manager, The European Smaller Companies Trust PLC

Smaller companies are very attractive for investors. They grow more quickly, they do not command premium prices, and they are under-researched, which means it is easier to find the hidden gems.

This provides significant scope for an actively managed investment trust like ours to outperform.

The European economy is often criticised for being sluggish and 'old world', but the universe of smaller companies proves that the region is producing dynamic and innovative businesses that can generate significant returns for investors. European small caps are especially diverse, with more than two thousand companies in a huge range of industries spread right across the continent. Many of them come out of family businesses whose managers are real experts in their field and they have been prudently managed with very little debt, helping keep the risks lower.

Having suffered in the pandemic, smaller-company profits bounced back dramatically in 2021. When the final tally of 2021 results is in, we expect them to have almost made up for the ground lost in 2020. For the year ahead, smaller companies in Europe will produce growth roughly twice as fast as their larger counterparts and are set to outperform growth rates among smallers in the UK and US too. The events unfolding in Ukraine will of course have knock-on effects on the economy in Europe and around the world. This means consensus expectations for short-term growth come with a health warning, and uncertainty means market conditions are unusually volatile. But the long-term picture is unclouded.

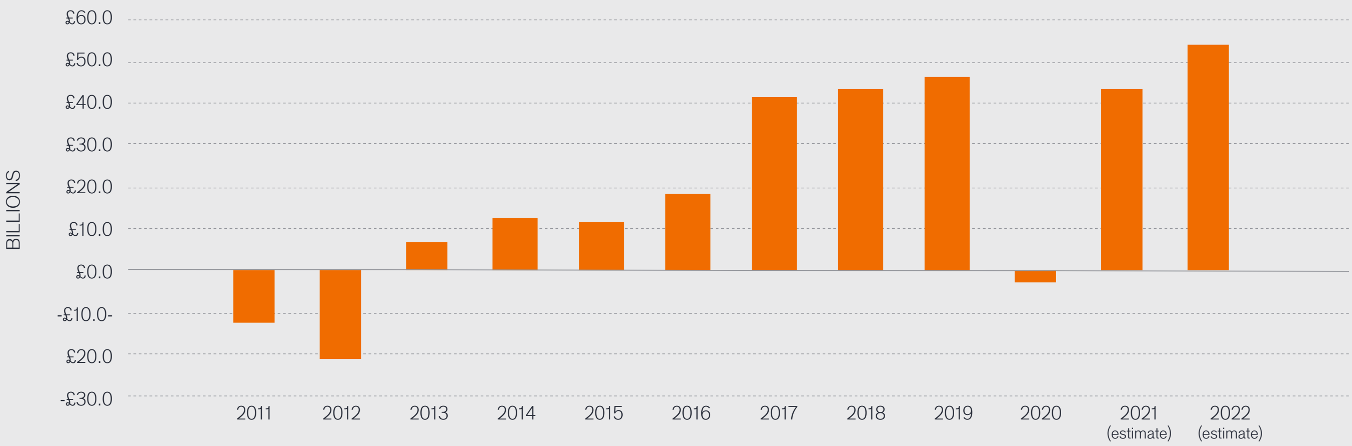
The future certainly does look exciting. The EU has announced a €807bn fund called NextGenerationEU, the largest stimulus package the EU has ever agreed. It is designed to boost the recovery from the pandemic, but more than half the cash is being devoted to modernisation plans focusing on research and innovation, the energy transition and wider measures to tackle climate change, digital transformation, healthcare and more. Smaller companies tend to be over-represented in all these areas.

The energy transition is going to be a big factor for some time to come, with a shift away from fossil fuels and the internal combustion engine. Significant capital expenditure and research and development are required and disruptive smaller companies are well placed to take advantage of this shift.

More broadly, smaller companies across Europe have strong environmental, social and governance characteristics (ESG). But interestingly they are often poor at presenting what they do in these areas because they are more focused on the operations of their business and have limited resources for PR and investor relations. This leaves our market laden with hidden ESG opportunities. In The European Smaller Companies Trust PLC we have considerable exposure to companies that can easily benefit from the premium attached to ESG companies once they improve the presentation of their activities. This will come in time.

Smaller companies are predisposed to grow more quickly and this high growth fosters strong investment returns. Yet valuations are inexpensive by comparison to slower-growing large companies. This is not to say that large cap companies should not form part of an investor's portfolio – far from it. Our contention is that smaller European must be part of the mix too – not overlooked. The asset class remains very attractive with the opportunity to uncover good investments in the years ahead.

EUROPEAN SMALLER COMPANIES – NET PROFIT



Source: Janus Henderson Investment Trusts analysis of company data compiled by Factset

Why invest in smaller companies?

Every company starts small. Today's global giants, whether they are big tech names like Facebook or multinational producers of the household goods we use every day like Unilever and Nestle, all began when an entrepreneur had an idea and made it happen. The big advantage of investing in a small company is to capture this growth potential early on. What's more, small companies offer better exposure to high growth niches like fintech, computer gaming, e-commerce and green energy, rather than the industries of yesterday.

The **rapid growth phase** offers the opportunity for significant capital gains because the market will pay a premium for a company that can show it is likely to be much bigger in future.

Early in a company's life cycle it needs capital to finance its expansion. It may be unprofitable in the early days, but if it is on a fast growth trajectory that shows profits are in view, the company's value can grow quickly – profits today are not even essential if profit potential is there. In time, it will begin to generate more cash than it needs to expand and will start to return this cash to shareholders, for example by way of a dividend. Eventually, when companies reach their mature phase, this cash generation can be very large indeed, though growth is now likely to be much slower.

From an investor's point of view, the rapid growth phase offers the opportunity for significant capital gains because the market will pay a premium for a company that can show it is likely to be much bigger in future. Moreover, smaller companies are more likely to be acquired by large, mature businesses with deep pockets that are looking for ways to revitalise their own growth potential. A takeover bid is often a very good way for an investor to realise profits both earlier than expected and at a premium.

Across the European continent there are **437 companies** worth more than €5bn.

Smaller companies do come with higher risk, however. There are four facets. First, the company's product or service may not live up to expectations, perhaps because the market changes, new competition emerges or because the potential was overestimated. Secondly, a management team may simply make mistakes on the journey or miss opportunities. Thirdly, smaller companies are often less financially resilient – with more limited access to capital than large, cash-generative businesses, they may find themselves less able to withstand economic recessions or business interruption. And finally, the valuation of high-growth companies is very sensitive to changes in market interest rates, because these rates determine the value of future profits in today's prices by the process of so-called discounting. If the largest profits are more distant (the definition of a growth company) then a rise in market rates will push down the value of the company today.

Higher average returns over the long term are the compensation for this higher average risk.

An imperfect market

An imperfect market may sound like a bad thing, but in investment terms it offers real opportunities.

In a perfect market, there are so many buyers and sellers of shares, that assets are fairly priced based on all the information available at the time. The stock market for big companies is generally considered to be much closer to perfect than the one for smaller companies. Not only are there lots of investors trading all the time, but there are also lots of analysts closely watching the companies and forming opinions on their prospects. Across the European continent there are 437 companies worth more than €5bn.[1] Each of these has on average 19 analysts monitoring their every move and reporting to investors.[2] This adds up to a lot of scrutiny.

By contrast there are 2,145 smaller companies valued between €100m and €5bn[3], and each of these has just five analysts providing coverage on average. The number of interested investors is also smaller and the pool of liquidity shallower. With less analyst coverage, much more limited press interest, fewer investors, and a relatively small number of shares trading hands, it is much easier for companies to be mispriced – in other words, people are much more likely simply to miss what's great about an opportunity or fail to spot the implications of a vital change in circumstances.

1 Source: Factset
2 Source: Factset
3 Source: Factset

How to invest in smaller companies

Active fund management is particularly suited to smaller companies. Because the market is imperfect, it is easier to spot gems that others have overlooked, and to avoid companies that we judge to have poorer prospects. In the last ten years, the total return of the of The European Smaller Companies trust PLC has been 314%[4]. For comparison, our trust's benchmark has delivered a total return of 218%%[5]. The difference between these two figures reflects the value added by our active approach to managing a smaller companies investment trust. An index-tracking fund would therefore have delivered a much poorer return.

Active fund management is particularly suited to smaller companies. Because the market is imperfect, it is **easier to spot gems** that others have overlooked.

The potential for higher returns and the associated higher risk mean that diversification is key. By holding a broad spread of companies, the impact of one or two performing much worse than expected is typically offset by a few that significantly outperform expectations. A diversified portfolio captures the high growth characteristics of smaller companies and mitigates the risk. In The European Smaller Companies Trust PLC we have 130 holdings, providing a broad spread across different industries and geographies.

The wide divergence in performance among smaller company shares shows why diversification is necessary. Over the last five years, the dispersion of share price movements among European smaller companies is 2.3x greater than among large European companies and 3.0x greater than the UK FTSE 100[6]. This wide dispersion also plays to the strengths of an active fund manager as good companies with great prospects see their share prices move much further.

Smaller companies deliver the goods

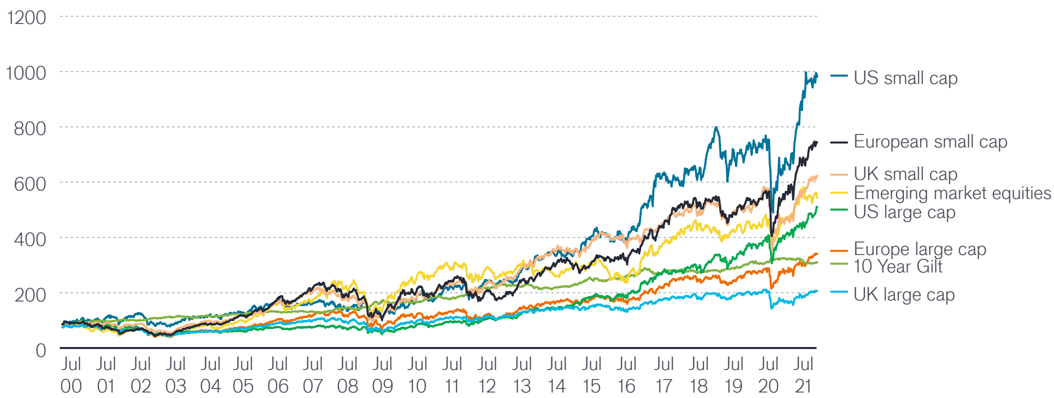
Not only do active fund managers have more scope to add value with smaller companies, but the asset class itself has proven to deliver higher returns than big companies too. Total returns include both share price growth and dividend income – this is the fairest way to compare different kinds of companies, especially because a large portion of returns from big, mature companies comes as an annual dividend. Even so, smaller companies deliver the goods. European smaller companies have performed especially well by comparison to their UK peers.

In the twenty years between December 2001 and 2021, European smaller companies have returned an astonishing 893%[7]. That means £100 invested turned into £993. This is more than twice the return provided by UK smaller companies, though these too have done well, with a total return of 396% (turning £100 into £496).

Large European companies have lagged well behind their smaller peers though the returns are by no means bad. Between 2001 and 2021 they returned 328%. That means £100 invested became £428.[8]. The FTSE 100 has performed significantly more poorly all these other groups, however. It has returned 195% in the last twenty years, meaning that £100 turned into £295[9]. Most of the return in the case of large UK shares has been by way of income.

If we look over the last ten years, European smaller companies have quadrupled an investor's money (+301%) beating UK smallers by one fifth (+258%) and big European companies by half (+194%). Once again the FTSE 100 was the laggard (+94%).[10]

SMALLER COMPANIES HAVE HISTORICALLY OUTPERFORMED



[3] Source: Factset
[4] Source: Janus Henderson Investment Trusts
[5] EMIX Smaller European Companies ex UK, 10 years to end February 2022
[6] Based on our analysis of the share price movements of over 3,250 companies across the UK and Europe
[7] EMIX Smaller European Companies Ex-UK
[8] FTSE World Europe ex UK Large Cap
[9] Source: Factset
[10] Source: Factset

Of course, it does matter when you start the clock. Year-to-date, share prices of smaller companies have proven especially vulnerable to rising inflation, rising market interest rates and the events in Ukraine. These short-term fluctuations are usually more extreme for smaller-company valuations. But investment decisions should always be taken with the long-term in mind, and on this basis the case for smaller companies is sound.

Rapid profit growth explains high returns

If we look at profit results for the last three years, smaller European companies have shown median, or typical, annual **growth rates of 14%**, five times and twice as fast as large European and UK companies respectively.

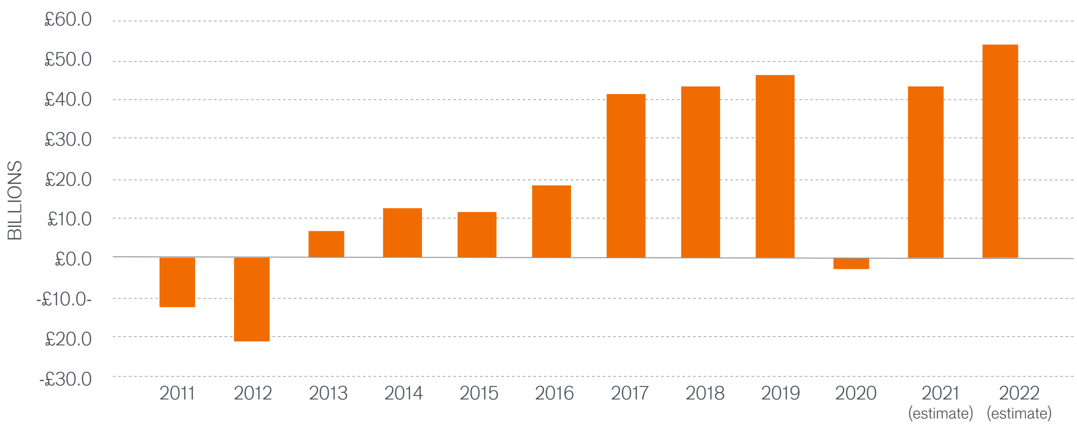
The returns from smaller companies are high because their profits grow so much faster than those of large companies. We have analysed the results of 3,256 companies of all sizes across Europe and the UK, of which two thirds are smaller European firms. Between 2013 and 2019 (respectively the first full year of recovery from losses made during the Eurozone crisis and the pre-pandemic peak), their collective profits grew almost seven-fold from £6.9bn to £46.6bn. Over the same period, large European companies saw their profits grow by two thirds from £145.2bn to £243.6bn. Profits from the UK FTSE 100 grew at the same pace as their large European peers, up from £48.6bn to £80.4bn.[11]

The impact of the pandemic in 2020 was severe, causing smaller company profits to tumble from a collective £46.6bn in 2019 into a loss of £2.3bn in 2020. Nevertheless, only just over one company in five booked a loss, but their losses were relatively large – the majority remained profitable. One in six large European companies also made a loss, a proportion not dissimilar to smaller firms.[12] Moreover, the rebound has been very strong indeed among European smaller companies. Fewer than half of them had reported 2021 financial results at the time of writing, but these booked £19.2bn in profits between them. By the time all the rest have published their figures, we estimate that 2021 profits will have reached between £42bn and £46bn, a whisker away from their pre-pandemic levels within a single year. Even if we look at median recovery rates, which remove the effect of very large changes at a few companies, we can see the typical smaller company grew its profits by almost a third (median: 29%) in 2021, compared to a one-fifth (median: 22%) recovery among large European companies.[13] The FTSE 100 have seen slightly faster growth in the last year, with median growth of 33% following very large falls in 2020.

If we look at profit results for the last three years, smaller European companies have shown median, or typical, annual growth rates of 14%, five times and twice as fast as large European and UK companies respectively.[14] They comfortably win the race over five and ten years too.

Before the conflict began in Ukraine, analysts expected European small caps to grow their earnings by 25.5%,[15] almost twice as fast as large companies in Europe and the UK. They also forecast European small-cap growth to exceed that of peers in the US and UK too (see table). This suggests total profits could top £54bn this year. Over this short-term horizon, much depends on how severe the economic impact of the conflict is on Europe and the wider world. It's reasonable to expect growth rates to be slower than the consensus suggested before the conflict began, but

EUROPEAN SMALLER COMPANIES – NET PROFIT



Source: Janus Henderson Investment Trusts analysis of company data compiled by Factset

11 Source: Janus Henderson Investment Trust analysis of company data compiled by Factset
12 Source: Janus Henderson Investment Trust analysis of company data compiled by Factset
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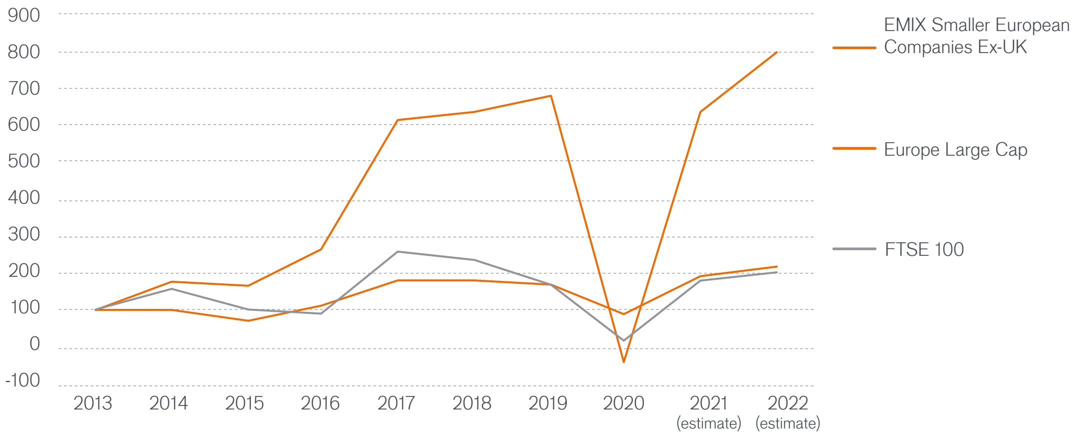
14 Source: Janus Henderson Investment Trust analysis of company data compiled by Factset
15 Source: JP Morgan

TOTAL NET PROFITS – GBP INDEXED



Source: Janus Henderson Investment Trusts analysis of company data compiled by Factset

Though smaller companies are valued at roughly the same level as larger companies, they have offered superior long-term returns.

equally, growth rates for companies of all kinds large and small will be affected. As always in times of uncertainty, focusing on the core investment case and the long-term prospects is crucial. Indeed, when profits grow rapidly and sustainably over time, they drive share prices higher. This explains why small companies have historically outperformed.

Valuation – all that growth but almost no price premium

Investors do not have to pay a significant premium for such dramatically faster profit growth, or for the superior long-term returns. The P/E ratio, which compares share prices to earnings (aka profits), is a simple way of looking at company valuations. The median or typical P/E ratio for European smaller companies[16] is 20.7x, only a tenth more than the 18.8x P/E for Europe's large companies and a fifth more than 17.3x for the FTSE 100.

The comparison is even more favourable if we look at the asset base of smaller companies – the so-called book value. The median P/BV (which compares the market value of the company to the book value of the assets) for European smaller companies is currently[17] 2.5x, a little way below the respective 2.6x and 2.7x for large European and UK companies.

If you look at the weighted average, which gives more prominence to larger companies in each index than the median figures, we can see the relationship is similar though the figures are higher. The P/BV ratio is 3.8x for European small caps v 4.2x for large caps. Across the Atlantic, US small caps are valued at 7.8x – more than twice as high as Europeans.[18]

In other words, though smaller companies are valued at roughly the same level as larger companies, they have offered superior long-term returns.

	2022 P/E – median
EMIX Smaller European Companies Ex-UK	20.7x
European Large Cap Ex-UK	18.8x
FTSE 100	17.3x

Source: Janus Henderson

16 3rd March 2022
17 3rd March 2022
18 Source: JP Morgan

	Price to book (X)	2022 forecast EPS Growth (%)
US Large	10.6	14.7
US Small	7.8	18.0
UK Large	4.2	13.5
Continental Europe Large	4.2	13.0
UK Small	3.9	19.8
Continental Europe Small	7.8	18.0

Source: JP Morgan

Tapping into tomorrow's sectors

EUROPEAN SMALLER COMPANIES – A BROAD MIX OF SECTORS

By market value

[19] Source: Janus Henderson Investment Trust analysis of company data compiled by Factset

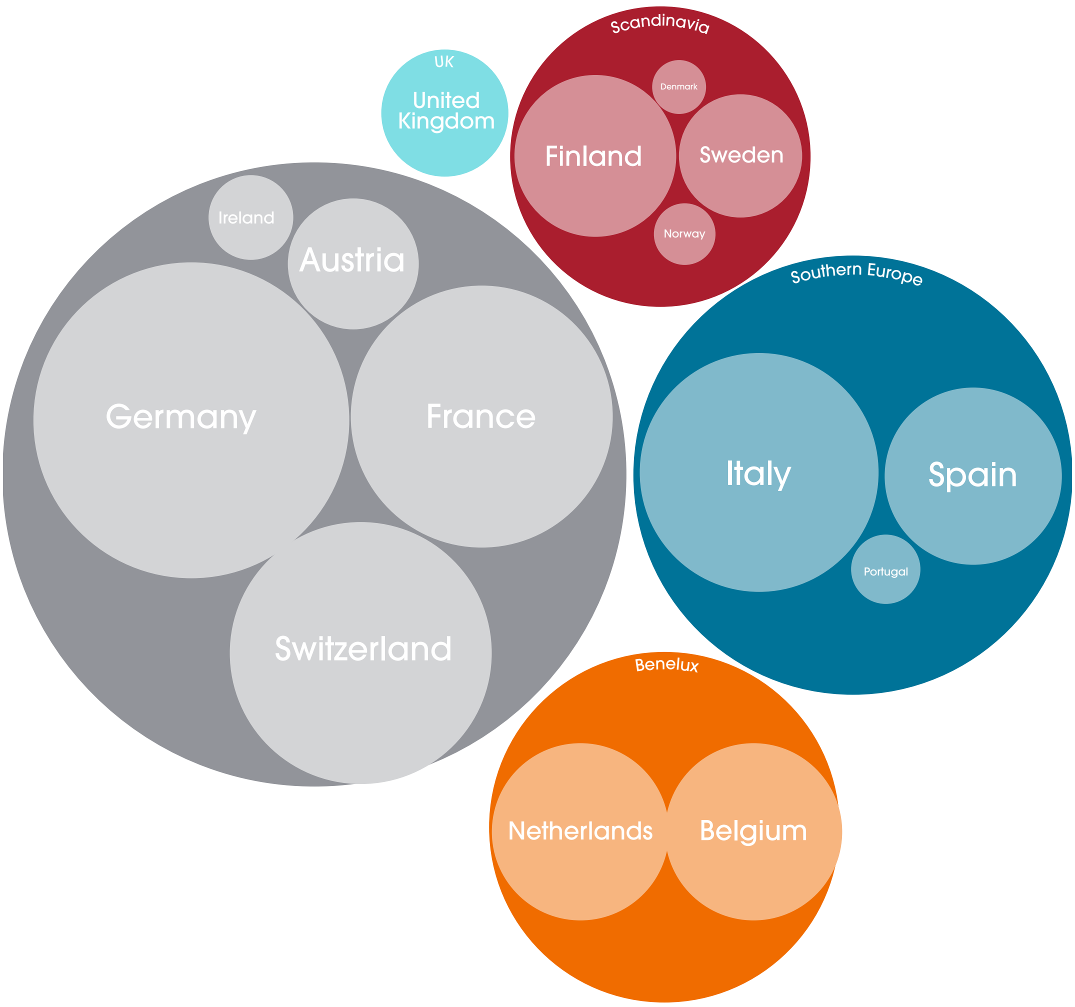
If we look at the mix of sectors by the market value of listed companies, we can see that slow-growth industries like food, drink and tobacco are scarce among European smaller companies. This sector accounts for just £1 in every £33, compared to £1 in £10 among big European companies and £1 in £7 in the UK FTSE 100. Equally, IT companies make up a six times larger share of the value of European smallers than they do in the UK FTSE 100. The UK stock market is especially skewed to oil and mining companies – equivalent to a third of its value between them – leaving returns for investors in large UK companies heavily dependent on volatile commodity prices. These two sectors are just £1 in every £22 among European smaller companies.[19]

But simply looking at the sector mix understates the advantages of smaller companies. For example, in the financial sector, there is a big difference between a legacy bank with a huge, expensive branch network and its complicated patchwork of IT systems stitched together from different eras compared with a fast-growing, nimble fintech that has reinvented some crucial financial infrastructure or found a new way to attract and interact with retail customers. Examples include Swedish digital platform for savings and investments, Nordnet (Sweden) and Italian online brokerage firm Fineco. Similarly, in the oil, gas and energy sector, a legacy oil company like Total is a world away from Friedrich Vorwerk, which is re-engineering energy grids and is in the vanguard of the energy transition. The same pattern is repeated across one industry after another, from telecoms and healthcare. The broad industrials group makes up the largest portion of The European Smaller Companies Trust PLC and it includes a range of high-growth engineering and business support companies like Montana Aerospace, which produces high-tech alloys for the aviation industry.

Small caps take you beyond the big economies

EUROPEAN SMALLER COMPANIES – A BROAD MIX OF SECTORS

By market value



[19] Source: Janus Henderson Investment Trust analysis of company data compiled by Factset

Finally, it's worth looking at the geographical distribution of small companies by value. The UK, French, German, Swiss and Dutch stock markets together account for almost nine tenths of the market value for large companies in Britain and Europe. This is not surprising given the size of their economies and their long histories. Among smaller companies these countries account for less than six tenths of the market value. In other words, a very large portion of smaller company value is to be found outside these big countries – for example, around a tenth is in Scandinavia where we have found some of the most exciting companies in the Trust. These include Norwegian construction software provider Smartcraft, Finnish educational technology specialist Sanoma and Karnov, a Swedish provider of tailored software to help those working in professional services.

The smaller company universe in continental Europe is also much deeper and broader than it is in the UK, providing a huge range of opportunities to add value through active fund management. For every £1 of larger company market value, smaller companies account for 20p, a ratio of 5:1. In the UK the ratio is 28:1.[20]

About The European Smaller Companies Trust PLC

The European Smaller Companies Trust PLC seeks capital growth by investing in smaller and medium sized companies which are quoted, domiciled, listed or have operations in Europe (excluding the UK). The Trust Invests mainly in Western Europe typically more than 120 companies with an average market cap of around £1bn and rarely above £3bn. The trust leverages Janus Henderson's European equity expertise to find quality growth companies.

Methodology

Janus Henderson analysed share prices, earnings data, company market capitalisations and valuation metrics for 3,256 large and small companies listed on European stock exchanges and the LSE. All data was converted to sterling using spot rates or period-average exchange rates as appropriate. Raw data was sourced from Factset.

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