European Smaller Companies

ESCT shows how to perform well even when market sentiment is weak...

Update
27 September 2024

Overview

The European Smaller Companies Trust (ESCT) is managed as a diversified portfolio of European small- and mid-cap companies. The portfolio typically biases towards the smaller end of the market-cap spectrum compared to the benchmark index, which is where the team often find the most under-researched opportunities. The portfolio is broadly diversified across c. 130 positions. There is no specific investment style, with the managers using four broad categories, early-stage growth, quality growth, mature and turnaround, to describe the different businesses they invest in.

Lead manager Ollie Beckett, who has managed the trust since 2011 and been part of the team since 2005, has a strong track record against the benchmark and peer group since his appointment and over the short and medium term. Ollie and the team have believed for some time that European smaller companies are undervalued compared to history and to large-caps, as part of the market dislocation caused by higher inflation and interest rates. While they sensibly don't try to pin a time frame on a recovery, the performance of their companies and signs that the IPO market is restarting are positive signals that investor risk appetite may return.

The trust is geared c. 11% (see **Gearing section**), which supports the manager's generally positive view for the medium-term outlook for the portfolio. ESCT has a yield of 2.7% and has increased its dividend for several years, although as we discuss in the **Dividend section**, its primary goal is capital growth and underlying revenue can vary significantly.

The board has used buyback powers from late 2023 and through 2024, and ESCT has seen its **Discount** narrow slightly during 2024, and currently sits at c. 11%. The trust has a 'backstop' continuation vote in 2025 and every three years.

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Analyst's View

Ollie Beckett summarises the situation as, "Everything has moved to the right", which in the current febrile political environment in Europe, could be, and maybe is, an amusing pun, but he's simply referring to the x-axis of time, as the valuation gap between small- and large-cap equities in Europe , persists, and while some of the factors that might help close that gap, falling inflation and interest rates, are falling into place, investors still appear to be climbing the wall of worry, and holding off from chasing the valuation gap. This downbeat assessment modestly ignores that ESCT has not only outperformed its peer group and benchmark, but also the equivalent large-cap benchmark. We look at the numbers in the **Performance section**.

On the ground, the team see some signals that things are picking up. For example, they have bought into some IPOs recently, finding that the first IPOs after a long hiatus are both very high quality companies and priced for a successful IPO. They are also finding opportunities in the niches that smaller companies can occupy, for example automotive paint systems, that elude large-cap managers feeling miserable about the state of the European car industry. Or in other words, even when the macro doesn't look that enticing, there are still smaller companies that can make money.

The attractions of smaller companies have been a running theme for Kepler for a couple of years now. That might seem like a long time, but it's really the blink of an eye for a long-term investor and ESCT remains an excellent way to play this large but under-appreciated corner of the market.

BULL
Excellent long- and short-term track record
Strong diversification characteristics, even against other small-cap trusts
Large and liquid trust, but still on an attractive discount

BEAR
Although the progressive dividend gives a relatively attractive yield, revenues can and do fluctuate significantly
Investor sentiment to the asset class has stuck on 'negative' for some time
Gearing can amplify losses as well as gains

Portfolio

ESCT is a diverse portfolio of European smaller companies, with c. 130 holdings (at the time of writing) illustrating the team managing ESCT's preference for many smaller position sizes. ESCT's portfolio is, against the benchmark and European smaller companies funds on average, focussed more on the truly small-cap. So, while the benchmark index has c. 10–15% in companies below €500m market cap, ESCT tends to have 30-40%, albeit this may flex over time as the opportunity set evolves.

In keeping with this diversified approach, the team don't focus on a single style or set of criteria in building the ESCT portfolio, and instead will consider making investments across all stages of a company's life cycle, from early-stage growth, quality growth, mature and turnaround. In industry jargon we could say that they buy growth and value stocks, but the four categories are a good way to describe how they approach things. Investors can expect early-stage growth, which is inherently riskier but with greater potential upside, to be a relatively small proportion of the portfolio, although of course small high-growth companies can, if things go well, produce outsized returns for relatively small outlays of capital by the fund manager. At the time of writing, the portfolio has about 6% exposure to early-stage growth, 45% to quality growth, 33% to mature and 27% to turnarounds, which adds up to more than 100% due to the trust's gearing.

Just to frame that point that ESCT invests in 'small' small-caps, the table below breaks down the portfolio market-cap distribution for the benchmark and the portfolio. This distribution has remained fairly constant over the last 12 months.

Market Cap Distribution

(%)	trust	benchmark
>£1bn	47.3%	71.3%
£500m to £1bn	29.6%	18.3%
Below £500m	34.0%	10.4%

Source: Janus Henderson, as at 30/06/2024. Note figures for ESCT are geared so add up to >100

While the fund management industry has in recent decades trended towards positioning 'focus' and 'conviction' as very strong adjectives to describe investment processes, and there are plenty of fund managers for whom this approach works, the **Performance** of ESCT illustrates that other approaches can work equally well or better, and clearly a 130-stock portfolio is less susceptible to big losses due to a single wrong decision, which many investors may very well find appealing in an asset class that can in some ways be riskier than large-caps.

Coming to some examples of Ollie and the team's recent activity, readers will probably have picked up a shift in fund managers' attitudes to the automotive industry, particularly in Europe, where technology-driven growth from EVs appears to have stalled, due to a combination of some strategic missteps and fierce competition from China. Ollie points to Dürr, an automotive paint equipment supplier, that is growing in spite of wider factors in the industry, because it offers a highly efficient, energy saving replacement for older technology that helps customers reduce costs. As a result, Dürr is seeing growing orders that defy the gloom surrounding the heavyweights in this sector. As well as being a good example of a smaller-growth company, this provides a nice example of diversification, given its positive progress in a larger industry that is under some pressure at the moment.

Another company the team has been drawn to for its growth potential is Envipco, which specialises in reverse vending, e.g. when a consumer returns an empty can for recycling and receives an incentive to do so. The team sees Envipco as the challenger to industry leader TOMRA, which, with revenues of c. 10× Envipco, illustrates the potential scale of the opportunity. Envipco is at the lower end of the market-cap spectrum at c. €300m. Clearly, this plays to a theme of sustainability, but does so in a very different way from the technology and infrastructure themes that dominate this area.

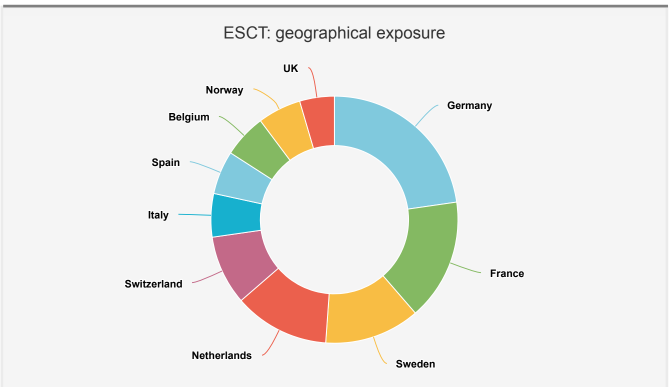
Ollie and the team have also taken up a small number of IPOs in the last year. Ollie believes the reason these IPOs were attractively priced is that private equity owners were keen to see the IPO market pick up again after a hiatus in 2022 and 2023. He also thinks it's quite probable that companies currently coming for IPO are likely some of the higher quality assets. IPOs have increased the trust's exposure to defence companies, including Renk, which makes gearboxes for military vehicles including the Leopard 2 main battle tank, as well as Exosens, which makes military night vision equipment. The team also bought French software company Planisware late in 2023. Renk and Planisware are both up c. 60% since IPO and Exosens is about level. Ollie's view is that as the recovery in the IPO market takes hold, the average quality of companies will probably slip, but at the moment there is a strong desire to reinvigorate IPOs and so it's worth paying attention to current proposals.

Another very recent sign of life is some M&A activity in the portfolio, with Swedish retail finance business Resurs Holding, which was acquired at an almost 40% premium to its pre-announcement share price in June 2024. Clearly this is just one transaction, but a strong premium helps validate the team's view on valuations for small-caps.

The team has also recently made a rare foray into a UK stock, buying financial technology company IG Group, which they see as being in a turnaround situation where a new CEO has come in and the company is trading at a low valuation and is using some of its cash to buy shares back. The team have a very collegiate relationship with their UK equity counterparts, sharing the same office, so it's very straightforward to share information and insights on different companies.

Rounding things off, the charts below show how the portfolio breaks down in terms of geography and sector, although we note that ESCT is primarily about stock picking and there isn't a strong mindset around being over or underweight a particular country, beyond the fact that this is a European fund and will have a broad exposure to different countries. Ollie notes that the political events in France and Germany this year are unhelpful to investor sentiment, but perhaps more important are signs that factors that have held smaller companies back, such as corporate destocking, are easing, following a period after the supply chain shocks of the pandemic where companies ran stocks higher, eventually leading to softening order books for some smaller companies. With some easing of this, order books are looking more healthy. Clearly lower debt costs are also helpful. You can **read an article** we wrote earlier this year about how European fund managers tend on average to select for a faster growing set of European countries than the GDP index, and while we doubt this is a conscious decision, it just goes to show that looking at the macro for Europe as a whole doesn't always line up with how funds such as ESCT are positioned.

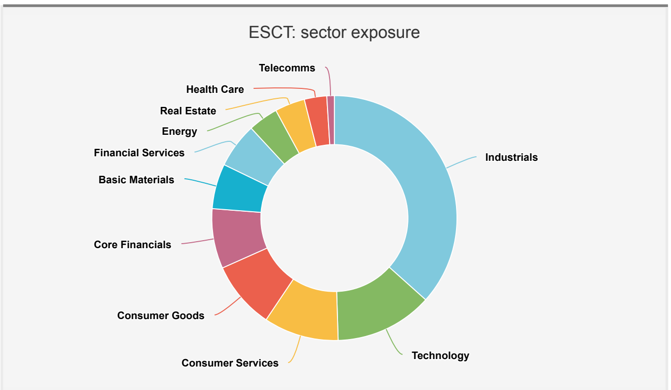
Fig.1: Geographical Exposure



Source: Janus Henderson, as at 31/07/2024

The next chart breaks down sector exposure, and it's no surprise, given the commentary above and the general shape of European equity markets, that industrials and technology are the dominant sectors, and as a wider point about diversification are, from a high-level perspective, one reason why investors overweight their home market of the UK might consider Europe as a source of diversification, as well as, of course, potentially attractive returns.

Fig.2: Sector Exposure



Source: Janus Henderson, as at 31/07/2024

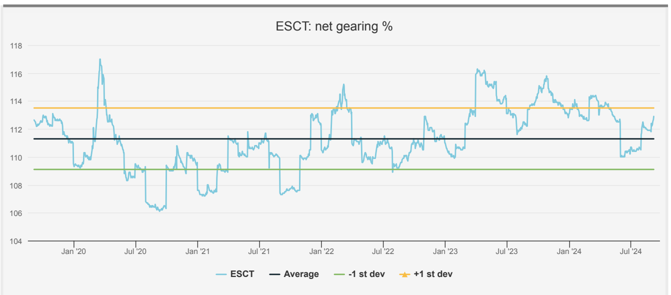
Overall, ESCT has a portfolio of smaller companies where returns may come from a variety of sources, from the big macro themes of the era, through to individual companies that have found or created their own niche or companies that are 'fixing' themselves through changes at a corporate level.

Gearing

ESCT is currently geared c. 11% and as the chart below shows, the level has been slightly above the long-term average through 2023 and 2024. Ollie doesn't try to time markets in the short term but does see the low valuation discount discussed in the **Portfolio section** as a reason to keep gearing in place.

The trust uses flexible borrowings rather than structural long-term debt, which gives Ollie greater scope to adjust as conditions change, reducing gearing in 2020 and 2021, for example. Formally the limit is no higher than 30% at time of investment, although for practical purposes the level over the last year or so is probably the upper limit of gearing in the foreseeable future.

Fig.3: Net Gearing %

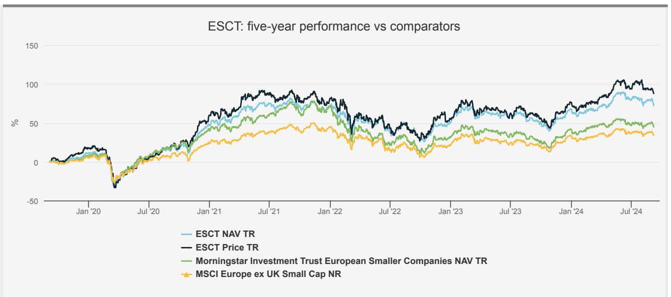


Source: Morningstar, as at 06/09/2024

Performance

Over the last five years ESCT's NAV and share price total returns are c. 75% and c. 90% respectively, with the Morningstar European Smaller Companies peer group producing an NAV total return of c. 45%, and the benchmark, the MSCI Europe ex UK Small Cap Index, a total return of c. 35%. The peer group figure is a weighted average and we note that ESCT is approximately one third of the overall peer group, meaning that mathematically it's increasingly difficult to outperform the peer group, which makes the outperformance even more impressive. Over one year ESCT has also outperformed, with the NAV and share price total returns of c. 13% and c. 17% both ahead of the peer group (c. 12%) and the benchmark (c. 10%). Although in the **Portfolio section** we note that European small-caps are at a discount to large-caps, partly as a result of their underperformance, ESCT has in fact also outperformed the equivalent large-cap benchmark over one and five years (c. 12% and c. 41%). It's certainly true that some active large-cap equity managers have produced even greater outperformance over five years, catching the tailwind of some of the largest stocks in Europe, but nevertheless it's impressive that ESCT has delivered performance in excess of large-caps during a period when this has been a major determinant of many other funds' performance, in Europe, the US and the UK.

Fig.4: Five-Year Performance



Source: Morningstar, as at 06/09/2024
Past performance is not a reliable indicator of future results.

Ollie has been involved in managing the trust since July 2011, and the chart and table below summarise how the trust has performed since then. While the outperformance is of course very impressive, this table also serves as a reminder that small-caps as an asset class have outperformed large-caps over longer periods of time.

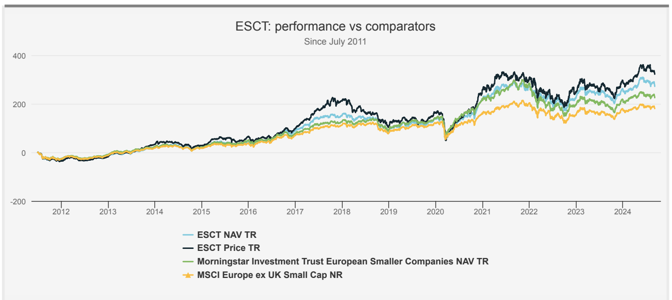
The chart below just puts those figures onto a timeline, which helps to show that the performance hasn't all come from a single period over Ollie's tenure, but through incremental gains during several phases of the market.

Performance Summary Since July 2011

	%
ESCT NAV TR	278
ESCT Price TR	326
Morningstar Investment Trust European Smaller Companies NAV TR	230
MSCI Europe ex UK Small Cap NR EUR	183
MSCI Europe Ex UK NR EUR	147

Source: Morningstar
Past performance is not a reliable indicator of future results.

Fig.5: Performance Since July 2011

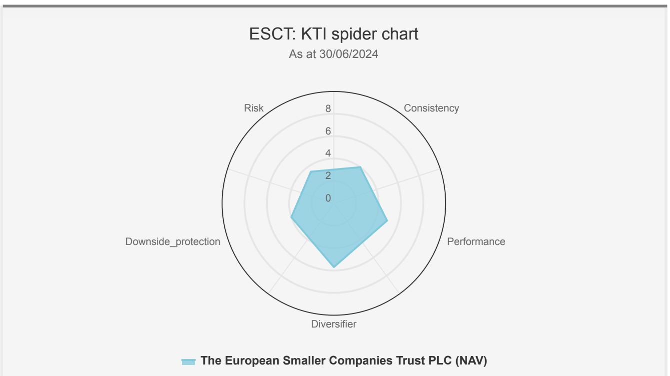


Source: Morningstar, as at 06/09/2024
Past performance is not a reliable indicator of future results.

In our proprietary KTI Spider Chart below, we show how ESCT has performed versus an expanded peer group of all European and European smaller companies trusts over the past five years in some key categories. Each category is scored out of ten based on rolling 12-month returns over the last five years, and scores are normalised to the peer group. As such this data reflects the performance characteristics investors would have experienced over the last five years.

Given the broad comparison group, ESCT's scores must be read in the context of the divergence between large- and small-cap, which is a structural factor beyond the control of the manager. In that context ESCT has a good score in performance, where it has outperformed the large-cap benchmark strongly over five years, even if some of the large-cap specialist trusts have outperformed even more, and also shows up well as a diversifier, which one might expect, given it's a small-cap specialist.

Fig.6: KTI Spider Chart



Source: Morningstar, KTI calculations

Past performance is not a reliable indicator of future results.

Dividend

ESCT currently yields c. 2.7%. At the time of writing the final dividend for the year ending 30/06/2024 is undeclared, but in the preceding ten years ESCT has had a progressive dividend. From time to time over that period the board has used revenue reserves to make up small shortfalls, and the trust has over a year's worth of dividend in revenue reserves. ESCT is, though, primarily seeking capital growth, and rises and falls in underlying dividend revenue are largely an outcome of, rather than an input to, the investment decision-making process. Thus in 2021 and 2022 the portfolio's more defensive stance coincided with companies that paid dividends. In our view, any investment trust that has put together a ten-year stretch of dividend growth is likely to take that into consideration when setting the dividend level, but perhaps the way to think about ESCT's progressive dividend is that it is done on a 'best endeavours' basis rather than as a core objective.

Management

Ollie Beckett is ESCT's lead fund manager. He joined Janus Henderson in 1998 and was appointed lead fund manager of ESCT in 2011. He also manages the Janus Henderson Horizon Pan European Smaller Companies Fund, the Janus Henderson Pan European Small and Mid-Cap Fund and the Janus Henderson European Smaller Companies Fund, managing £1.59bn, of which ESCT is £755.7m. Ollie first joined Henderson as an assistant portfolio manager for European equities in 1998 and was named fund manager in 1999. He moved to the Global Technology Team in 2000. He left Henderson in 2003 to pursue other interests, before returning to his current role with the firm in 2005.

On ESCT, he is supported by Rory Stokes and Julia Scheufler. Between the three, they don't divide the portfolio up by sectors, instead aiming to support and challenge each other in decision making. Ollie also notes that he places a lot of value in his informal network of other fund managers in the equities team, and he takes an active interest in what other teams in the UK and Europe are investing in, and as we note in the **Portfolio section**, the team recently bought a UK stock in collaboration with their UK equity colleagues.

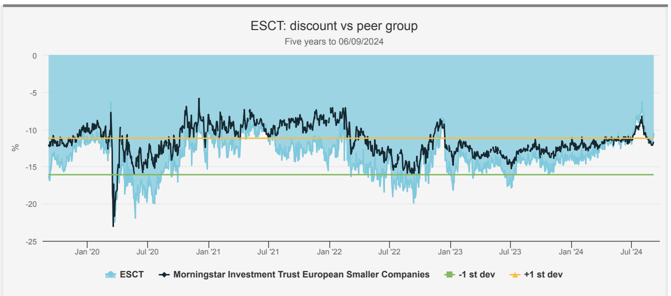
Rory joined Henderson in 2013 as a European equity analyst. Prior to that he worked on the sell-side in small- and mid-cap sales. He began his career at HOLT Value Associates in 2001 as a research analyst, and this is one of the screening tools that the team use as part of their initial process of identifying opportunities.

Julia Scheufler is an Associate Portfolio Manager on the European Equities Team at Janus Henderson Investors, a position she has held since 2022. Prior to this, she was a research analyst with the team from 2018. She was previously a sell-side analyst and also worked in a multi-asset fund management team.

Discount

ESCT's current discount of c. 11% is narrower than the five-year average of c. 14% and, as the chart illustrates below, shows some inwards movement over 2024 as well. Further down we look at the buybacks ESCT has executed more recently alongside the narrowing discount. As the first chart below shows, ESCT's discount has tracked the peer-group average reasonably closely, with the current peer-group average also sitting at c. 11%. A further reference, the larger UK Smaller Companies peer group, has an average discount of c. 10%.

Fig.7: Five-Year Discount

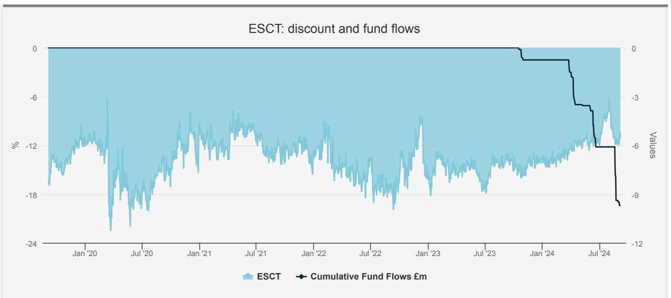


Source: Morningstar, as at 06/09/2024

The next chart shows ESCT's discount compared to cumulative flows in and out of the trust. The black line is ascending when the trust is issuing shares and descending when it is buying back. ESCT hasn't issued any shares during the last five years, and in late 2023 and through 2024 the board has used its buyback powers, and while we know that discounts and the impact that buybacks can have on them is a topic of debate, the chart does appear to show a correlation between the two.

ESCT has a continuation vote, held every three years, with the next vote scheduled for 2025. While the investment trust sector has seen a small number of continuation votes not passed in the last year or two, in general continuation votes remain a backstop, and one would normally expect a board to engage with shareholders well ahead of the vote in order to establish what, if any, changes shareholders would like to see.

Fig.8: Discount And Fund Flows



Source: Morningstar, as at 06/09/2024

Charges

ESCT's ongoing charges figure (OCF) is 0.65% (excluding its performance fee, see below) compared to an average of 0.90% for the AIC European Smaller Companies peer group. ESCT has a tiered management fee of 0.55% of net assets up to £800m and 0.45% thereafter. At the time of writing ESCT's net assets are c. £760m and therefore within the first tier.

ESCT also has a performance-related fee, which is detailed below. While the OCF for the financial year ending 30/06/2024 hasn't been published yet, ESCT performance in that period met the conditions for a performance fee. In the previous year, to 30/06/2023, the OCF including the performance fee was 1.67%.

The performance fee is 15% of the positive difference between the average annual NAV total return and the average annual total return of the benchmark, measured on a rolling three-year basis.

- Total fees in any year are capped at 2.0% of NAV;
- A performance hurdle over the benchmark of 1.0% must be reached before any performance fee can be earned and is excluded from the performance fee itself should one be payable;
- Performance is measured solely on the basis of NAV total return relative to the total return of the benchmark index;

No account is taken of whether the NAV grows or shrinks in absolute terms.

ESG

ESCT is assigned an overall average ESG score by Morningstar, which compares it to all similar funds, both investment trusts and open-ended funds. European equities as a group score better than average in a global context, so an average score within a peer group of European funds may still be slightly higher than the global average.

Ollie's view is, in summary, that he is broadly supportive of key ESG objectives, such as the energy transition, and views them as investment opportunities, as these are real-world trends and many European smaller companies are involved directly or indirectly in supply chains or in providing services to companies at the forefront of these trends. As we discuss in the **Portfolio section**, ESCT is exposed to a number of companies operating in different areas of sustainability, and this is likely to remain a key theme for the portfolio.

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