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European Smaller Companies (ESCT)

Kepler GROWTH 2025

ESCT's portfolio is set to benefit from converging factors...

Update
28 May 2025

Overview

The European Smaller Companies Trust (ESCT) owns a diversified portfolio of European small- and mid-cap companies, with a bias to companies with a market cap of less than €1bn. The manager uses four broad categories; early-stage growth, quality growth, mature and turnaround, to describe the different types of companies invested in, and to inform risk controls, for example taking smaller positions in earlier-stage, more speculative companies than in mature businesses. This approach means that ESCT is not wed to a particular investment style such as growth or value, with the manager taking the view that in smaller companies returns can be generated in a variety of ways. While several themes, such as greater infrastructure and defence spending, may provide tailwinds to performance, ESCT's portfolio is equally able to generate returns from idiosyncratic stock opportunities not tied to a particular economic trend.

ESCT has a strong track record, outperforming its own benchmark and the equivalent large-cap index over the last five and ten years. Year to date, the trust has outperformed in a rising market, helped by its exposure to sectors such as defence, which has generated notably strong performance. ESCT primarily targets capital growth but has a yield of c. 2.4% and dividends have grown at c. 7% per annum over the last five years.

In May 2025 ESCT completed a tender offer for 42.5% of shares in issue and we discuss the background to this in the **Discount section**. This gave shareholders an exit opportunity at a small discount of 2% plus costs. Following the tender ESCT trades at a c. 8.6% discount.

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Analyst's View

This year's different fortunes for European and US equities are striking, with Europe up c. 8% at the time of writing compared to a decline of 11% for the S&P 500. In the **Portfolio section** we revisit European fund flows, which are a good proxy for investor sentiment. These show that investors have finally started to put money into Europe after a long period of indifference.

European smaller companies have kept up with the market, but as yet haven't seen the same shift to positive fund flows and as manager Ollie Beckett points out, small-caps remain on very attractive valuations. This has been the case for some time, but Ollie also believes that other factors are converging to create a positive outlook. ESCT's overweight position to Germany looked, until recently, unusual, but as the new government settles in, infrastructure and defence spending are both on the agenda. This coincides with German bond yields falling, as investors seek alternatives to US treasuries. ESCT is not a thematic fund but owns many companies that will benefit from these factors. Further, as we inch towards some form of peace settlement in Ukraine, there is the possibility of falling energy costs for European companies, which is particularly positive for energy intensive industrials in the small-cap universe, together with a potential boom for companies involved in post-war reconstruction.

It's normal for the first stages of a shift in investors' sentiment to a region to be focussed on the higher reaches of the index and Europe's recent resurgence is no different. ESCT's portfolio could be a significant beneficiary if that shift solidifies and investors begin the search for greater alpha.

BULL
Portfolio positioned to benefit from several positive trends
ESCT has outperformed both small- and large-caps over the long term
Investor sentiment to Europe has turned positive in 2025

BEAR
A recession in the US is likely to impact on all equity markets
Smaller companies can be more risky and volatile than large-caps
Investors may already be over-exuberant about defence spending

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Portfolio

The European Smaller Companies Trust (ESCT) owns a diversified portfolio of European small- and mid-cap companies, generally skewing towards smaller, under-researched companies. The portfolio is spread across c. 120 holdings with an average market cap of c. €1bn, rarely going above €3bn. This makes ESCT a true small-cap portfolio, with about half the portfolio in companies below €1bn market cap.

Manager Ollie Beckett and his team use four broad categories, early-stage growth, quality growth, mature and turnaround, to describe the different types of companies they invest in. These descriptions also help to steer portfolio risk controls, with smaller positions of less than 0.5% in earlier-stage companies that are more speculative than in mature businesses. This approach means that ESCT is not wed to a particular investment style such as growth or value, with the manager taking the view that in smaller companies returns can be generated in a variety of ways.

The portfolio characteristics below help illustrate the point that ESCT doesn't conform to a specific value or growth strategy, although Ollie says that one of the goals is to find inflection points for a company's return on equity. The forward P/E ratios in the table are market expectations and the team's job is to identify where those expectations are too low. ESCT's track record, outlined in the **Performance section** suggests the team is good at getting this assessment right more often than not in a variety of market conditions.

Portfolio Characteristics

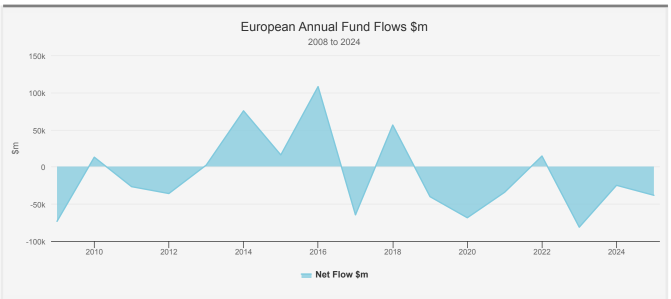
	THE EUROPEAN SMALLER COMPANIES TRUST	MSCI EUROPE EX UK SMALL CAP INDEX
Dividend yield forecast	3.30%	3.50%
P/E forecast	12.2x	12.7x
ROE	14.10%	12.70%
Historic EPS growth (3 years)	16.10%	11.80%
Forecast EPS growth (next 12 months)	23.40%	23.90%

Source: Janus Henderson as at 28/02/2025

So, while ESCT and its management team is fundamentally concerned with finding individual investment opportunities among the truly small and under-researched universe of European smaller companies, a few important themes are currently coinciding that, in our view, make this a good time to consider an investment. First, since 2022 smaller companies have traded at below average valuations, and as the table above shows, the index and the ESCT portfolio are well below the long-term average forward P/E of 14.7× for the smaller companies index. Recent M&A activity, including a bid for glassmaker Verallia, provides empirical evidence that valuations are considered cheap by private equity and trade buyers.

The next chart sets the scene for a long-term pattern of lacklustre investor sentiment towards European equities. This is the global total of flows in and out of European equity funds since 2008, showing that it has been almost a decade since investors bought more European equities than they sold.

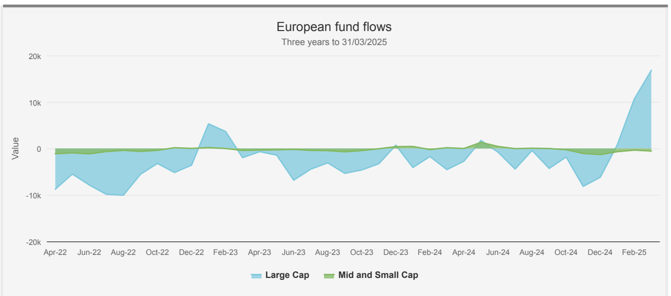
Fig.1: European Equity Fund Annual Flows



Source: Morningstar

The next chart focusses that down to the last three years, month by month up to the end of March 2025. Ollie notes that although there have been positive fund flows into European equities in 2025, suggesting an improvement in investor sentiment, this has not, yet, translated to smaller companies. The chart below confirms that, splitting out large- and small-cap equity funds, with large-cap the blue shaded area and small-cap the green area. This is not really a surprise, as one would expect that in the first wave of fund flows investors would be focussed on the index and large-caps. The opportunity for small-caps is when investors stick around for longer and start to seek the higher alpha that small-caps can provide.

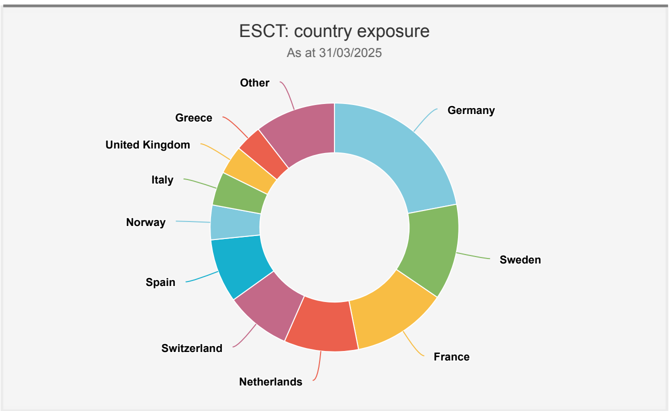
Fig.2: European Equity Fund Monthly Flows



Source: Morningstar

ESCT's country exposure is below, and this helps to highlight the overweight position in Germany, at almost twice the index. Ollie and the team have invested in a range of Mittelstand companies that could be the main beneficiaries of greater infrastructure and defence spending. This is the platform a new German government has been elected on and, helpfully, coincides with a move by investors away from 'safe haven' US treasuries into alternatives, including German bonds. This is helpful to Germany at a time when it seems highly likely it will borrow more money, as greater demand for its bonds should help limit its borrowing costs.

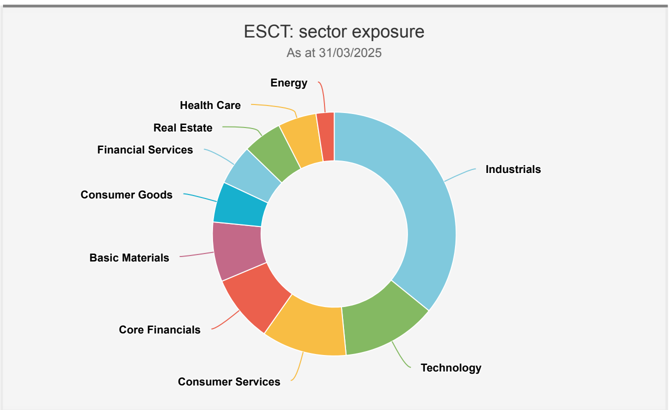
Fig.3: Country Exposure



Source: Janus Henderson

Ollie also notes that in Germany and elsewhere, consumers have yet to fully react to higher wages and lower mortgage and energy costs. The sector weights below show the expected large position in industrials. But it also shows that the portfolio has moved recently to be more overweight consumer-facing stocks. Ollie notes that this carries some risks, as the odds of a US recession have risen and this wouldn't be good for markets anywhere, but overall, he feels that valuations and wage growth justify the risk of taking a slightly more positive stance.

Fig.4: Sector Exposure



Source: Janus Henderson

Defence has been a theme in the portfolio for some time, with Ollie and the team even having participated in a handful of defence-oriented IPOs in the last year or two, during a period when IPOs more generally have been at a low ebb. Defence stocks have more recently come on to the radar of retail investors and the sector has seen some extraordinary price performances. Stocks such as Germany's Renk, which makes gearboxes for armoured vehicles, France's Exosens, which makes military night vision goggles and Spain's Indra Sistemas, which Ollie bought on the basis that the low valuation was compensation for relatively poor governance, are all well-known stocks that have performed strongly in the last year.

The team have identified other stocks such as Alzchem, known for production of propellants for airbags but where the same chemicals can be used for ammunition, and truck manufacturer Iveco, which is seeing growth in its military division. As a result of very strong price performance in some of these stocks, the team have been taking some profits, believing that while the theme of defence is likely to persist for some time, valuations still matter and it's important to maintain that discipline. Ollie notes that many institutional investors, such as German pension funds, have very low exposure to defence due to investment restrictions and so generally the stocks are under-owned by institutions and if this begins to change it could provide additional momentum.

The war in Ukraine has obviously loomed large in investors' thinking about Europe for several years. While a peace settlement seems, at the time of writing, just out of reach, the situation evolves daily and the equity market has already been anticipating how various companies might benefit, with those that can play a role in reconstruction front of mind. Ollie took a position in Austrian brick making company Wienerberger AG, which has seen a strong price performance year to date. It also seems likely that construction and engineering stocks already set to benefit from Germany's infrastructure programme, such as civil and industrial engineering company Bilfinger, could see a second benefit from peace in Ukraine. The trust's pro-consumer stance could also be assisted by further falls in energy prices resulting from a peace settlement.

While many of the examples above are woven into various themes, ESCT is equally exposed to idiosyncratic investments that aren't tied to the fortunes of a particular European economy or macro trend. One example is Carl Zeiss Meditec, which provides equipment for corrective eye surgery. Among other things, this company is benefitting from the high prevalence of myopia in China, with for example China's People's Liberation Army giving treatment to c. 20% of recruits. Similarly, Ollie has taken a position in Elmos Semiconductor, which makes sensors for cars, on the basis that the automotive sector is deeply out of favour, European manufacturers have made various missteps in their transition to EVs, but all new cars, EVs or otherwise, have an increasing number of sensors and Elmos's valuation is not reflecting this.

Thus, while some themes, notably greater spending in Germany, and the widespread valuation discount of smaller companies, may prove important tailwinds, the overriding impression is that ESCT's portfolio also contains many idiosyncratic investments that are not especially tied to the

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success or failure of a single economy. ESCT's **Performance** record seems to confirm this, with outperformance in a variety of market conditions over a decade or more.

Gearing

ESCT is currently ungeared. As noted in the **Discount section**, in May 2025 the trust conducted a tender offer for 42.5% of the shares and ESCT repaid gearing ahead of this, which accounts for gearing falling to zero.

Leaving aside the reduction for corporate rather than investment reasons, the level has been slightly above the long-term average through 2023 and 2024 at around 15%, compared to the five-year average of c. 11%. Ollie and the team don't try to time markets in the short term but in general they take the view that it is appropriate to raise gearing when valuations are low. Following the tender, Ollie's preference is to increase gearing but he feels it is prudent to take this gradually as markets are often volatile in the summer months.

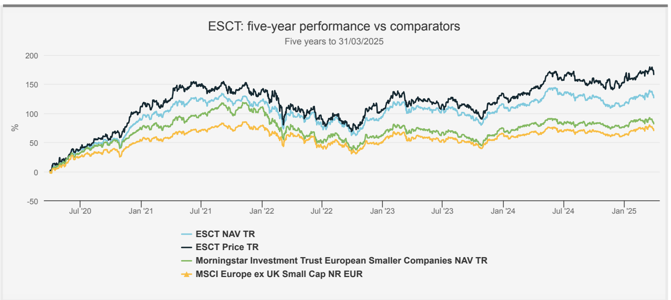
The trust uses flexible borrowings rather than structural long-term debt, which gives Ollie greater scope to adjust as conditions change, reducing gearing in 2020 and 2021, for example. Formally the limit is no higher than 30% at time of investment, although for practical purposes the level over the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

Performance

Over the past five years, ESCT's NAV and share price total returns of 132% and 174% exceed the benchmark's 73% and Morningstar European Smaller Companies peer group NAV total return of 85%. ESCT's discount has narrowed in conjunction with recent corporate activity discussed in the **Discount section** and this has played a role in the strong share price performance. ESCT's performance over the same period also exceeds the equivalent large-cap index, 80 %. Over ten years, ESCT's NAV TR of 182% is well ahead of the peer group's of 140%, and the small- and large-cap indices' of 125% and 109%, with ESCT's share price TR almost 200% over the same period.

Shorter term, over the past year, ESCT has lagged the benchmark and in essence this was caused by too much exposure to consumer discretionary and industrial companies. The team had taken a cautiously optimistic stance and note that this has 'moved to the right' as various factors have served to delay economic growth in Europe, not least politics in Germany and France. However, year-to-date ESCT has slightly outperformed the small-cap index, which itself has kept up with the large-cap index, both rising by c. 8%. We look at this in a little more detail in the **Portfolio section**.

Fig.5: Five-Year Performance

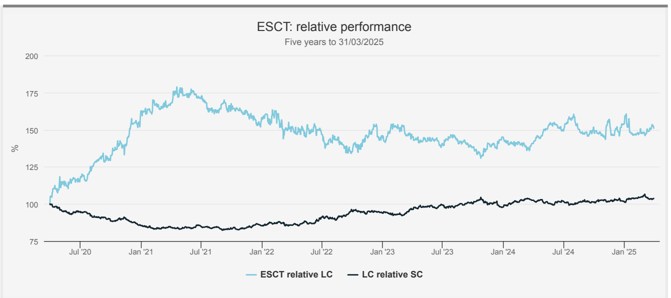


Source: Morningstar
Past performance is not a reliable indicator of future results.

The next chart shows ESCT's NAV total return relative to the large-cap index, and also large-caps relative to small-caps. This helps us to easily visualise when small- and large-caps are outperforming one another, and how ESCT fits into to that picture.

Over the whole five-year period, ESCT has outperformed both small- and large-caps in a period when, at an index level, large-caps have been outperforming. The beginning of the five-year period saw a marked outperformance by small-caps generally, and more so by ESCT, but since 2021 large-caps have outperformed small-caps, with the black line in the chart below sloping upwards. ESCT itself did see a period of underperformance against large-caps in 2021, but since then has been rebuilding its outperformance. We should reiterate that outperforming large-caps is not an objective of ESCT, but for an investor, the fact that it offers that potential even when small-caps as an asset class are out of favour is obviously very interesting.

Fig.6: Relative Performance

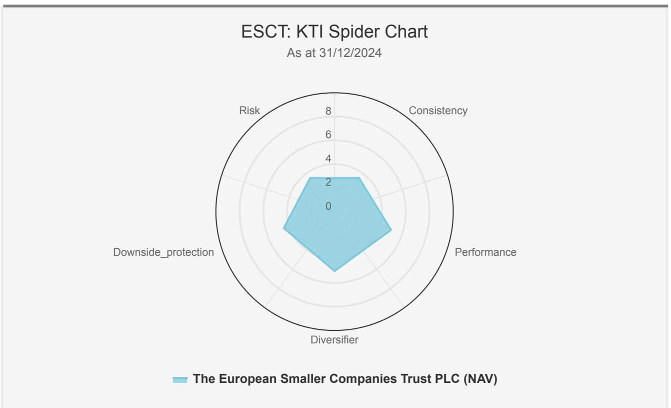


Source: Morningstar
Past performance is not a reliable indicator of future results.

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 past five years.

As we note above, ESCT's performance has exceeded the large cap index during a period where small caps have lagged. The expanded peer group used in this analysis is biased to larger cap trusts, which have also outperformed during this period, and this is essentially why ESCT performance score is average. As the relative chart above shows, ESCT's pattern of out- and under-performance has been variable over the past five years, which is why the objective quantitative analysis scores it below average for consistency. This may also be a characteristic of small-caps more generally. Nevertheless, one should read this chart in conjunction with the preceding charts, and overall we think an average set of scores in this wider context is highly creditable for a smaller companies specialist.

Fig.7: KTI Spider Chart



Source: Morningstar, Kepler

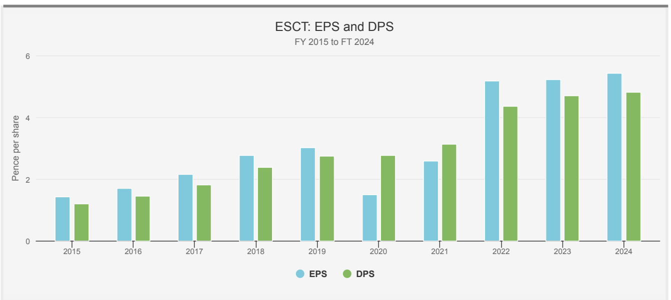
Past performance is not a reliable indicator of future results.

Dividend

ESCT currently yields c. 2.4%. As we have previously noted, ESCT's progressive dividend can be thought of as being on a 'best endeavours' basis, with the strategy primarily being aimed at generating capital growth. Nevertheless ESCT has over a decade of progressive dividends, with dividend growth over the past ten full financial years compounding at 15% per annum. This rate has slowed over the past five years to c. 7%, but nevertheless this is strong dividend growth that has exceeded inflation. In the current financial year, the interim dividend was maintained at 1.45p, with the interim dividend in the previous year around 30% of the total.

The chart below shows earnings and dividends over the past ten financial years. Generally, ESCT pays covered dividends but, as the chart shows, from time to time the board has used revenue reserves to pay part of the dividend, with 2020 and 2021 both requiring a top-up as the pandemic took its toll on underlying company dividends. Again, while ESCT is not an equity income trust, it could play a role in a long-term equity income portfolio which aims to balance current yield with dividend growth.

Fig.8: Earnings And Dividends Per Share



Source: Janus Henderson

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, pre-tender, c. £750m. 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.

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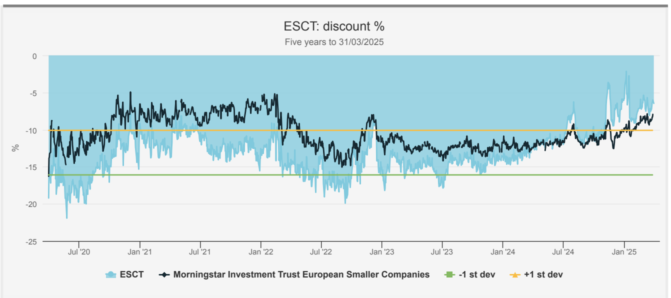
Discount

ESCT currently trades on a c. 8% discount compared to its five-year average of c. 13%. ESCT recently conducted a tender offer for up to 42.5% of its shares, at a 2% plus costs discount to NAV. The tender offer was the result of a negotiation between the ESCT board and largest shareholder Saba, an activist hedge fund. The tender offer included the relatively unusual option for professional investors to take their pro-rata share of the portfolio in stock rather than cash. This is referred to as an in specie transfer. While we can't know what Saba's position is, experience tells us that activist investors may 'short' stocks in an investment trust portfolio so that their only exposure is to the discount. An in specie transfer of stock in this scenario makes sense for both sides as it means the trust itself doesn't have to sell holdings in the market, potentially disrupting share prices, and the activist can more easily close its short positions without having to purchase shares in the market.

The tender was slightly undersubscribed, with 42.2% of shares tendered, of which about 70% took the in specie option. This suggests that exiting shareholders were predominantly professional investors, including Saba. The tender offer should, in our view, remove any reluctant shareholders and means that, if the positive investment case outlined in the **Portfolio section** comes to pass, the discount could narrow rapidly.

Fig.9: Five-Year Discount



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

Charges

ESCT's ongoing charges figure (OCF) is 0.67% (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. £763m and therefore within the first tier.

ESCT's KID shows a reduction in yield (RIY) figure of 0.0%. The current requirements for the KID RIY are under review by the FCA and in the interim various approaches, including putting a figure of 0.0% are being taken by different investment trusts.

ESCT also has a performance-related fee, which is detailed below. For the year ending 30/06/2024 the OCF including the performance fee was 0.75% (2023: 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.

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. ESCT is also assigned Morningstar's low carbon score.

The team take an integrated approach to ESG and believe that key ESG objectives, notably energy transition, are long-term investment opportunities, and ESCT is exposed to a number of companies operating in different areas of the energy transition. This helps to explain ESCT's low carbon rating, although the European smaller companies universe has a fairly low weight in carbon-intensive energy companies.

As discussed in the **Portfolio section** ESCT has taken an active approach to its exposure to defence stocks and this may not suit investors with specific ESG objectives.

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