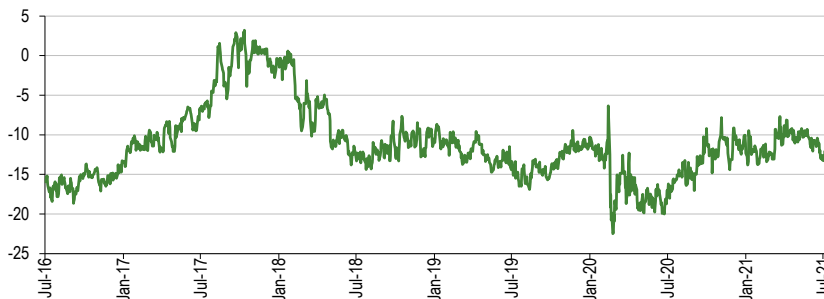


# TR European Growth Trust

Differentiated option at a significant discount

TR European Growth Trust (TRG) stands out among its more mid-cap focused peers for being a genuinely small-cap fund with a strong valuation awareness. This has served it well over the past year, and while it has yet to report its FY21 results, over the year to 30 June 2021 it posted share price and NAV total returns of 79.5% and 63.5% respectively, well ahead of comparator indices. The management team (lead manager Ollie Beckett, assisted by Rory Stokes and Julia Scheufler) caution that this was an exceptional year, but long-term annualised returns of c 15%+ underline the validity of TRG's approach even when its more value-orientated style has largely been out of favour. Despite the strong run of performance, TRG's shares trade at a double-digit discount to NAV, which has failed to close as it did in the previous period of exceptional performance from Q416 to Q417 (see chart), despite absolute NAV returns having been stronger.

## TRG's discount has persisted despite a stellar run of performance



Source: Refinitiv, Edison Investment Research. Discount/premium to cum-fair NAV.

## Why invest in European smaller companies now?

Europe is highly geared to the global economy, and companies based there tend to do better when the global economy is recovering or in growth mode. Although new COVID-19 variants may have pushed out the timelines for full economic reopening, the greater freedom afforded by the roll-out of the vaccination programme in the EU and elsewhere is underpinning business confidence. The region has a strong entrepreneurial culture with over 2,500 small-cap companies, many of which are better exposed to global growth trends than their larger counterparts.

## The analyst's view

TRG offers a differentiated approach to investing in European smaller companies, an area not well represented in the investment trust universe, with only four funds on offer despite a broad pool of companies (c 2,500) in which to fish. The managers seek growth but are valuation-aware, and their focus on cash-generative companies with strong market positions has provided decent returns for investors over many years. The long stock list helps mitigate the risk of smaller company investment, yet successful holdings can still have a meaningful impact on returns. While the outlook remains uncertain due to the pandemic, in our view the persistent double-digit discount to NAV seems unwarrantedly wide.

**NOT INTENDED FOR PERSONS IN THE EEA**

Investment trusts  
European smaller companies

11 August 2021

**Price** 1,435.0p  
**Market cap** £719.1m  
**AUM** £878.0m

NAV\* 1,671.6p  
Discount to NAV 14.2%

\*Including income. As at 10 August 2021.

Yield 1.6%  
Ordinary shares in issue 50.1m  
Code/ISIN TRG/GB0009066928  
Primary exchange LSE  
AIC sector European Smaller Companies  
52-week high/low 1,535.0p 944.0p  
NAV\* high/low 1,699.7p 1,069.3p

\*Including income

Gross gearing\* 10.0%  
Net gearing\* 10.0%

\*As at 31 July 2021

## Fund objective

TR European Growth Trust seeks capital growth by investing in smaller and medium-sized companies that are quoted, domiciled, listed or have operations in Europe (excluding the UK).

## Bull points

- Europe is geared to global economic growth and offers a high number of small- and mid-cap investment opportunities.
- TRG has a more overtly small-cap focus than its peers, allowing it to capture a broader range of opportunities.
- In previous periods of strong performance, shareholders were rewarded by appreciable narrowing in the discount to NAV.

## Bear points

- Further pandemic- or inflation-related setbacks could damage the global recovery.
- Smaller companies carry a higher risk of failure, although TRG mitigates this through holding a broadly diversified portfolio.
- So far, the discount has failed to narrow to the extent seen in 2017 (when the shares reached a premium), despite stronger absolute returns.

## Analysts

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## The fund manager: Ollie Beckett & team

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### The manager's view: Reasons to be both cheerful and fearful

Beckett says that with COVID-19 vaccination rates improving across Europe, continued economic growth and positive readings from sentiment surveys such as purchasing manager indices (PMIs), there are still many reasons to be positive on the outlook for European equities, although he does not expect to see a repeat of the strong gains of the past year to 15 months.

'As we begin to come out of the pandemic phase, we are optimistic on drivers such as pent-up consumer demand', the manager argues, pointing to demand for travel and leisure services as restrictions are lifted within the EU. He says TRG is overweight consumer discretionary stocks as a consequence. Meanwhile, an expected pick-up in capital expenditure following a period of corporate belt-tightening should be positive for industrial stocks (TRG's largest individual sector weighting), and fiscal stimulus programmes aimed at improving infrastructure will benefit companies that are exposed to areas such as construction materials, renewable energy and power grids.

Aside from the threat of new COVID-19 variants, the greatest imponderable currently is probably the re-emergence of inflationary pressure, with opinion split as to whether this is a structural issue or a transitory 'base effect' phenomenon. 'Within the portfolio we are not making a bet either for or against inflation', says Beckett. 'However, at an individual company level, it is key that firms have the pricing power to enable them to pass through any increases in input costs.' While the team is also keeping an eye on emerging signs of wage inflation – which could signal a more structural problem for employers – the manager says this currently seems more of an issue in the UK than on the continent. 'It is important to look at each company individually', he adds.

Underlining the team's cautious optimism on the outlook, TRG (which uses gearing in a normal range of 0–15%, although up to 30% is permitted) had net gearing of 10% at end-July 2021. 'We still expect the market to go up, but we are nervous that the market might have a wobble if inflation comes through more strongly', says Beckett. 'However, there is also a lot of good economic news. Ultimately, we will invest where we see value', he concludes.

## Asset allocation

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### Current portfolio positioning

With a very broad universe (c 2,500 companies) from which to select investments, TRG's manager prefers to hold a relatively long list of stocks (135 at 30 June 2021) in order to capture the available opportunities while mitigating the risks that may arise from holding small and micro-cap companies. As shown in Exhibit 1, as at 30 June 2021, the top 10 positions made up 17.0% of the total (a decrease in concentration from 19.7% a year earlier), meaning the average size of the remaining 125 holdings is c 0.7% of the total portfolio.

While all the current top 10 holdings were in the portfolio a year ago, only four of them were among the largest holdings at 30 June 2020. This arguably shows the performance potential of even a small holding in a high-growth, small-cap stock, with Westwing Group's share price rising by more than 350% in the second half of 2020 (TRG's H121).

**Exhibit 1: Top 10 holdings (as at 30 June 2021)**

Company	Country	Sector	Portfolio weight %	
			30 June 2021	30 June 2020
Van Lanschot Kempen	Netherlands	Banks	2.0	2.0
Recticel	Belgium	Rubber & plastic	1.9	1.2
TKH Group	Netherlands	Electronic & electrical equipment	1.8	2.4
DFDS	Denmark	Industrial transportation	1.8	2.3
eDreams Odigeo	Spain	Travel & leisure	1.6	1.0
Aareal Bank	Germany	Banks	1.6	1.5
Manz	Germany	Industrial engineering	1.6	0.6
BFF Bank	Italy	Banks	1.6	1.7
Westwing Group	Germany	General retailers	1.6	0.7
Kindred Group	Sweden	Retail providers	1.5	1.0
<b>Top 10 (% of holdings)</b>			<b>17.0</b>	<b>19.7</b>

Source: TR European Growth Trust, Edison Investment Research.

Geographical and sector allocations (Exhibits 2 and 3) are effectively an output of stock selection, although the sector allocation reflects the team's preference for attractively valued, cash-generative companies with good recovery or growth potential.

**Exhibit 2: Portfolio geographic exposure (% unless stated)**

	Portfolio end-June 2021	Portfolio end-June 2020	Change (pp)
Germany	25.7	22.4	3.3
Sweden	12.2	12.0	0.2
France	12.1	13.6	(1.5)
Italy	8.1	10.6	(2.5)
Netherlands	6.9	9.1	(2.2)
Switzerland	5.7	10.2	(4.5)
Belgium	5.0	4.3	0.7
Spain	4.2	2.6	1.6
Ireland	3.9	1.5	2.4
Norway	3.8	3.5	0.3
Other	12.5	10.2	2.3
	<b>100.0</b>	<b>100.0</b>	

Source: TR European Growth Trust, Edison Investment Research

**Exhibit 3: Portfolio sector exposure (% unless stated)**

	Portfolio end-June 2021	Portfolio end-June 2020	Change (pp)
Industrial goods	25.4	25.2	0.2
Business providers	17.8	7.4	10.4
Technology	14.1	17.2	(3.1)
Financials	13.1	15.1	(2.0)
Retail providers	9.9	5.1	4.8
Consumer goods	9.8	19.5	(9.7)
Basic materials	8.5	8.6	(0.1)
Natural resources	1.5	1.1	0.4
Telecommunications	0.0	0.8	(0.8)
	<b>100.0</b>	<b>100.0</b>	

Source: TR European Growth Trust, Edison Investment Research

Beckett says the level of corporate activity (for example takeovers and management buyouts) in the portfolio underlines the attractive valuations of many of TRG's holdings. Recent exits of this type include Finnish paper and fibre company Ahlstrom-Munksjö, Italian packaging firm IMA, French film and TV producer Mediawan, flooring manufacturer Tarkett (also French) and Norwegian bank Sbanken. 'There have been a number of private equity and management bids for companies whose value was not fully recognised by the market, and I would expect that to continue', the manager explains. At the other end of the valuation spectrum, the team has exited positions in highly valued companies such as French semiconductor wafer specialist SOITEC, Swedish messaging service Sinch and Swiss online pharmacy Zur Rose.

The IPO market has remained buoyant, with several flotations of quality companies whose plans to list had been set back by the pandemic. While Beckett describes the sheer amount of equity issuance as 'concerning', he says that away from the 'hot' areas where new issues might be of lower quality to capitalise on investor demand, the team has found some good names in which to

invest. These include Norwegian salmon delousing and aquaculture services business Frøy, German engineering firm Friedrich Vorwerk (which is exposed to the growth areas of electrification and energy transition) and Swiss aircraft components maker Montana Aerospace, which counts Airbus and Boeing among its customers. ‘We got Montana on a decent valuation because of the pandemic’s effect on civil aerospace’, says Beckett. Montana Aerospace is up 46.6% (at 10 August) on its May 2021 listing price of CHF25, although not all the IPOs have been an immediate success. ‘Some have worked straight away; others have shown a bit less growth or the story hasn’t yet performed’, the manager explains.

Away from the IPO market, the TRG team has also bought into some far more established businesses, including French retailer FNAC Darty (the product of a merger between bookshop chain FNAC and white goods specialist Kesa Electricals), telecom equipment specialist ADVA Optical, which is benefiting from the exclusion of Huawei from European 5G programmes, and AIB Group (Allied Irish Banks). While AIB might seem an unlikely inclusion in a small-cap fund, Beckett says that at the point of purchase, it had a market capitalisation of just €2bn. The share price more than trebled between late September 2020 and the end of May 2021, and while it has since fallen back somewhat, the bank’s market cap is now c €6bn. ‘Although we wouldn’t buy a company of that size, we also aren’t forced to sell, and it still looks pretty cheap’, says Beckett.

## Performance: Strong record of outperformance

**Exhibit 4: Five-year discrete performance data**

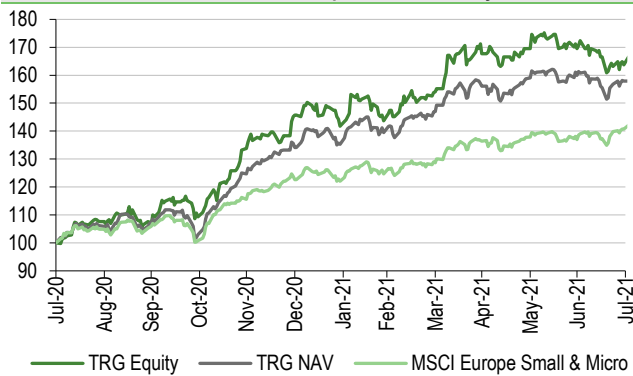
12 months ending	Share price (%)	NAV (%)	EMIX Smaller Europe ex-UK (%)	MSCI Europe Small & Micro (%)	MSCI Europe ex-UK (%)	CBOE UK All Companies (%)
31/07/17	65.4	48.2	30.0	27.0	24.2	15.0
31/07/18	(6.5)	0.4	7.3	9.8	6.1	9.1
31/07/19	(9.7)	(8.8)	(1.2)	(3.7)	5.0	1.1
31/07/20	3.4	5.7	(0.3)	(3.2)	(2.8)	(18.5)
31/07/21	63.7	57.9	38.9	40.7	26.4	26.4

Source: Refinitiv. Note: All % on a total return basis in pounds sterling.

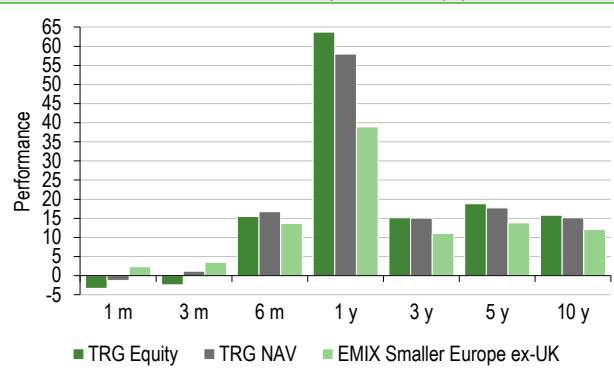
TRG has ridden the wave of the market rotation that began with positive news on COVID-19 vaccines in late 2020, outperforming both small-cap and broad European indices over the past 12 months to 31 July 2021 (Exhibit 4). Interestingly, after underperforming in the 12 months to 31 July 2019, the trust also beat the indices to post a positive share price and NAV total return in the 12 months to 31 July 2020, a period that was characterised by economic growth worries in the latter half of 2019, followed by the worst equity market sell-off in years as the pandemic took hold. As seen in Exhibit 5 (left-hand chart), from a low point at the end of October 2020, TRG opened up a clear gap versus the index, underlining the benefit of the manager’s valuation-aware approach at this market inflection point. Performance has tailed off a little in recent months as sentiment has swung between hopes of economic reopening and fears over the spread of the COVID-19 Delta variant, but over the longer term (Exhibit 5, right-hand chart) TRG has posted annualised NAV and share price total returns of 15% or more, which should remain achievable given the strong six- and 12-month returns. While behind the indices over one and three months (Exhibit 6), the trust has outperformed both the UK and European indices (all in sterling terms) over all other periods shown.

**Exhibit 5: Investment trust performance to 31 July 2021**

Price, NAV and benchmark total return performance, one-year rebased



Price, NAV and benchmark total return performance (%)



Source: Refinitiv, Edison Investment Research. Note: Three-, five- and 10-year performance figures annualised.

**Exhibit 6: Share price and NAV total return performance, relative to indices (%)**

	One month	Three months	Six months	One year	Three years	Five years	10 years
Price relative to EMIX Smaller Europe ex-UK	(5.6)	(5.7)	1.6	17.9	11.6	23.7	38.8
NAV relative to EMIX Smaller Europe ex-UK	(3.5)	(2.2)	2.7	13.7	11.2	18.5	31.2
Price relative to MSCI Europe Small & Micro	(5.9)	(5.4)	0.2	16.3	16.4	29.1	34.3
NAV relative to MSCI Europe Small & Micro	(3.9)	(1.9)	1.2	12.2	15.9	23.6	26.9
Price relative to MSCI Europe ex-UK	(4.8)	(7.1)	0.2	29.6	18.4	39.0	73.5
NAV relative to MSCI Europe ex-UK	(2.7)	(3.7)	1.3	25.0	17.9	33.1	64.0
Price relative to CBOE UK All Companies	(3.8)	(4.3)	2.1	29.6	46.6	80.6	128.4
NAV relative to CBOE UK All Companies	(1.8)	(0.7)	3.2	25.0	46.0	73.0	115.9

Source: Refinitiv, Edison Investment Research. Note: Data to end-July 2021. Geometric calculation.

While TRG's performance in calendar year 2020 was greatly assisted by holdings in 'stay at home' stocks such as internet pharmacy **Zur Rose**, meal kit supplier **HelloFresh** and online retailers **Westwing** (homewares) and **Boozt** (apparel), so far in 2021 some of the main contributors reflect greater optimism on post-lockdown economic reopening. These include banks such as **AIB Group** (share price +38.0% in local currency terms from 4 January to 10 August 2021) and **BFF Bank** (+55.9%), which tend to do better as economic growth raises interest rate expectations, and ferry operator **DFDS** (+34.9%), which has bounced back following a double whammy of COVID-19 and Brexit fears. However, given the ongoing battle between virus and vaccines, some stay-at-home winners such as Swedish online gambling operator **Kindred** (+69.7%), owner of the 32Red brand, have continued to do well also. Westwing had been among the top performers year to date, but a c 18% fall in its share price during July has seen gains for the year pared back to 17.7% (compared with 46.0% from 4 January to 31 May). Detractors included gaming IPO **Thunderful** (subsequently exited), online quizzes stock **Kahoot!**, which failed to live up to the team's growth expectations, and **Aker BioMarine**, which had a poor krill harvest but remains a favoured investment for the fund.

**Exhibit 7: NAV performance versus MSCI Europe Small & Micro over three years**


Source: Refinitiv, Edison Investment Research

## Peer group comparison

TRG is one of four constituents of the Association of Investment Companies' European Smaller Companies sector. While small in number, the funds adopt a range of approaches, with TRG being the most overtly small-cap and having the keenest focus on valuation. Montanaro European Smaller Companies (MTE) is much more orientated towards high-growth areas such as technology. Like MTE, the two remaining funds are arguably more mid-cap than small-cap, with the J.P. Morgan fund (JEDT) having recently changed its name from JPMorgan European Smaller Companies (JESC) to reflect this. JEDT and European Assets Trust (EAT) share a growth-biased (as opposed to value-biased) approach, although EAT also has a high distribution policy, paying out 6% of its NAV each year as a dividend to shareholders.

In performance terms, TRG's focus on valuation and recent tilt towards more cyclical areas have propelled it to the top of the peer group ranking over the past 12 months, although it also ranks a respectable second over three, five and 10 years, periods in which the growth style of MTE (which ranks first over these periods) has been more in favour. TRG has the lowest ongoing charges in the group, although it is the only fund that may levy a performance fee (capped at 2%). In spite of its good performance track record, the trust's discount remains the widest in the sector, while gearing is above average for the group. TRG's 1.6% dividend yield is the highest of the three funds that pay a 'natural' yield.

### Exhibit 8: Selected peer group as at 10 August 2021\*

% unless stated	Market cap £m	NAV TR 1 year	NAV TR 3 year	NAV TR 5 year	NAV TR 10 year	Ongoing charge	Perf. fee	Discount (cum-fair)	Net gearing	Dividend yield
<b>TR European Growth</b>	<b>719.1</b>	<b>52.6</b>	<b>53.2</b>	<b>121.5</b>	<b>393.7</b>	<b>0.7</b>	<b>Yes</b>	<b>(14.2)</b>	<b>110</b>	<b>1.6</b>
European Assets Trust	521.2	47.2	47.3	92.5	361.2	0.9	No	(4.6)	104	5.5
JPMorgan European Discovery	834.0	36.3	37.4	85.4	304.7	0.9	No	(13.8)	105	1.3
Montanaro European Smaller Cos	354.4	44.6	87.9	174.0	430.7	1.2	No	2.2	102	0.5
<b>Sector average (4 funds)</b>	<b>607.2</b>	<b>45.2</b>	<b>56.4</b>	<b>118.3</b>	<b>372.6</b>	<b>0.9</b>		<b>(7.6)</b>	<b>105</b>	<b>2.2</b>
<b>TRG rank in peer group</b>	<b>2</b>	<b>1</b>	<b>2</b>	<b>2</b>	<b>2</b>	<b>4</b>		<b>4</b>	<b>1</b>	<b>2</b>

Source: Morningstar, Edison Investment Research. Note: \*Performance as at 9 August 2021 based on ex-par NAV. TR = total return. Net gearing is total assets less cash and equivalents as a percentage of net assets (100=ungeared).

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