# TR European Growth Trust

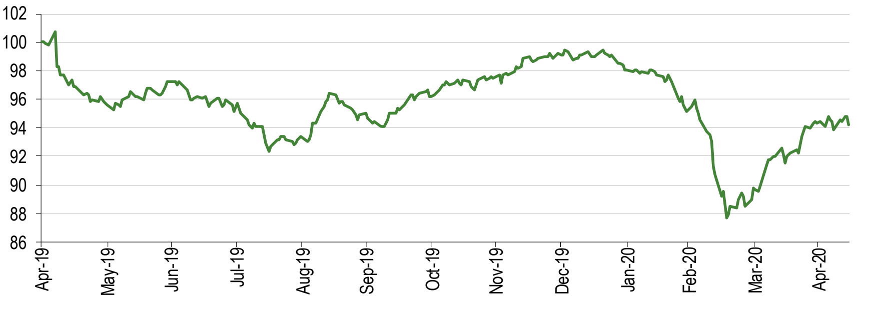
## Focusing on valuation and recovery potential

Investment trusts
European small-cap equities

**18 May 2020**

**TR European Growth Trust (TRG) suffered in the recent equity market sell-off for a number of reasons, including its relatively high level of gearing, procyclical bias and structural focus on the smaller end of the European small-cap market. However, by taking advantage of the chance to buy good companies at low valuations, and disposing of holdings whose balance sheets looked vulnerable, manager Ollie Beckett has so far outperformed the EMIX Smaller Europe ex-UK Index since the mid-March lows. The manager argues that while the COVID-19 pandemic may have wide-ranging effects, and an EU-wide approach to rebuilding economies is key to the union's long-term survival, there are many opportunities for small-cap investors to benefit from the recovery, whatever shape it takes.**

**Outperforming since March market lows (NAV TR relative to index)**




Source: Refinitiv, Edison Investment Research

## The market opportunity

Europe, like the rest of the world, has seen a sharp reversal in both the economic and stock market outlook as a result of the COVID-19 pandemic. Small-cap stocks have been hit harder, as investors seek safety and focus on liquidity. But many opportunities remain in this area, particularly among those companies whose strong balance sheets can better enable them to ride out the current volatility.

## Why consider investing in TR European Growth?

- Differentiated from peers through its focus on value, diversification and the smaller end of the small-cap market.
- Strong long-term performance versus EMIX Smaller Europe ex-UK Index.
- Maintaining some cyclical exposure should be beneficial in a recovery.
- Healthy revenue reserve (1.75x FY19 dividend) could allow TRG's board to maintain the trust's long record of year-on-year dividend growth.

## Discount wider than average; well-supported yield

At 15 May 2020, TRG's shares traded at a 14.9% discount to cum-income NAV. This is wider than both short- and longer-term averages (range of 9.6% to 13.6% over one, three, five and 10 years), suggesting scope for a re-rating, particularly if outperformance in recent weeks is maintained. Although focused on capital growth, TRG offers a 3.0% yield, and has a substantial revenue reserve to support future dividend payments.

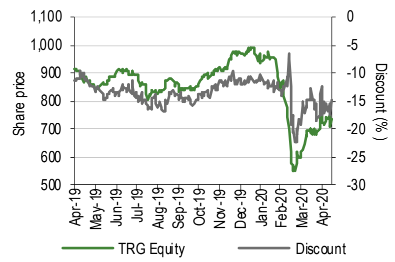
| | |
|---|---|
| **Price** | **733.0p** |
| **Market cap** | **£367.3m** |
| **AUM** | **£495.9m** |

| | |
|---|---|
| NAV* | 860.2p |
| Discount to NAV | 14.8% |
| NAV** | 860.9p |
| Discount to NAV | 14.9% |

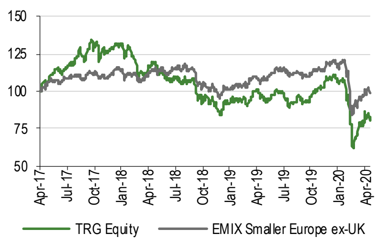
*Excluding income. **Including income. As at 14 May 2020.

| | |
|---|---|
| Yield | 3.0% |
| Ordinary shares in issue | 50.1m |
| Code | TRG |
| Primary exchange | LSE |
| AIC sector | European Smaller Companies |
| Benchmark | EMIX Smaller Europe ex-UK |

**Share price/discount performance**




**Three-year performance vs index**




| | | |
|---|---|---|
| 52-week high/low | 994.0p | 550.0p |
| NAV* high/low | 1,119.5p | 688.6p |

*Including income.

**Gearing**

| | |
|---|---|
| Gross* | 11.0% |
| Net* | 10.0% |

*As at 30 April 2020.

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***TR European Growth Trust is a research client of Edison Investment Research Limited***

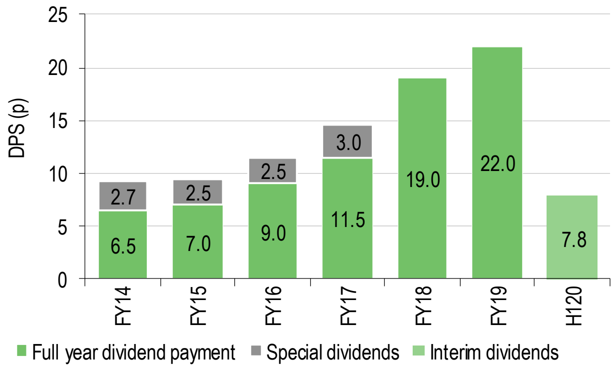
## Exhibit 1: Trust at a glance

| Investment objective and fund background | Recent developments |
|---|---|
| TR European Growth Trust seeks capital growth by investing in smaller and medium-sized companies that are quoted, listed or have operations in Europe (excluding the UK). | ■ 25 February 2020: Results for the half-year ended 31 December 2019. NAV TR +5.9% and share price TR +10.3% versus +4.0% for the EMIX Smaller Europe ex-UK Index. Interim dividend of 7.8p declared (H119: 7.5p).<br>■ 25 November 2019: All resolutions passed at AGM, including 98.6% of votes cast in favour of the continuation of the company. |

| Forthcoming | | Capital structure | | Fund details | |
|---|---|---|---|---|---|
| AGM | November 2020 | Ongoing charges | 0.72% | Group | Janus Henderson Investors |
| Annual results | October 2020 | Net gearing | 10.0% | Manager | Ollie Beckett and team |
| Year end | 30 June | Annual mgmt fee | Tiered (see page 10) | Address | 201 Bishopsgate, |
| Dividend paid | April, November | Performance fee | Yes (see page 10) | | London, EC2M 3 AE |
| Launch date | 1990 | Trust life | Indefinite, subject to vote | Phone | +44 (0) 20 7818 1818 |
| Continuation vote | Three-yearly, next 2022 | Loan facilities | £100m overdraft | Website | www.treuropeangrowth.com |

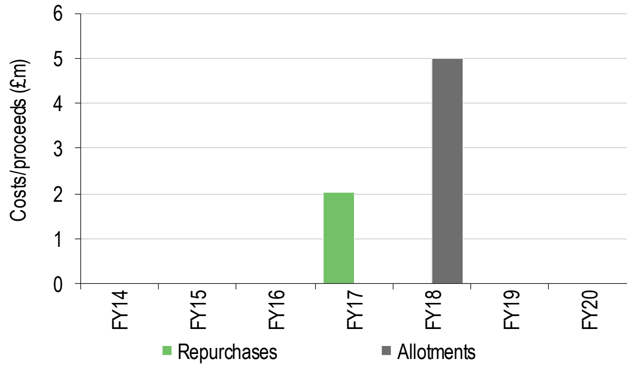
**Dividend policy and history (financial years)**

Since FY18, an interim and a final dividend have been paid in April and November. While the primary aim is to achieve capital growth, the board also hopes to maintain and grow the dividend.

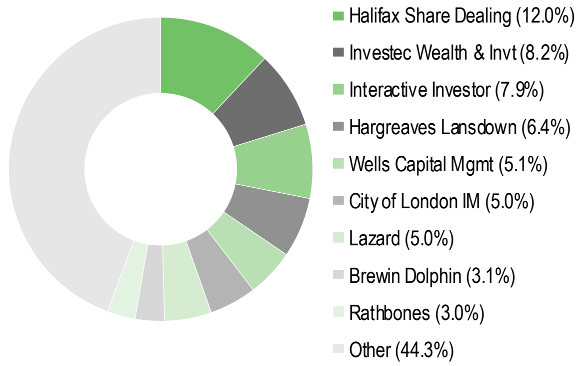



**Share buyback policy and history (financial years)**

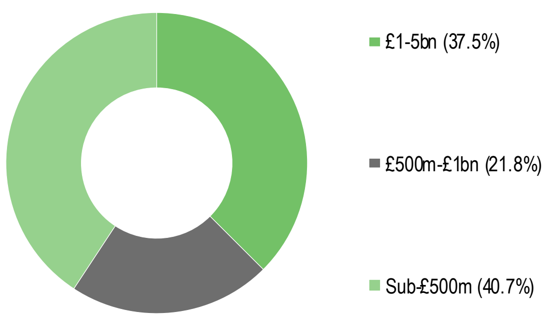
Renewed annually, TRG has the authority to buy back up to 14.99% of shares and allot up to 10% of shares to manage a discount or a premium. Buybacks are at the board's discretion following the removal of a hard 10% discount target in 2010.




**Shareholder base (as at 31 March 2020)**




**Portfolio exposure by market cap (as at 20 March 2020, adjusted for gearing)**




**Top 10 holdings (as at 31 March 2020)**

| Company | Country | Sector | Portfolio weight % | |
|---|---|---|---|---|
| | | | 31 March 2020 | 31 March 2019* |
| Van Lanschot Kempen | Netherlands | Banks | 2.2 | 2.3 |
| FinecoBank | Italy | Banks | 2.0 | N/A |
| DFDS | Denmark | Industrial transportation | 2.0 | 2.0 |
| Medios | Germany | Pharma & biotech | 2.0 | N/A |
| Nexans | France | Electronic & electrical equipment | 1.9 | 1.9 |
| Karnov Group | Sweden | Media | 1.8 | N/A |
| Banca Farmafactoring | Italy | Banks | 1.8 | 1.6 |
| SOITEC | France | Tech hardware & equipment | 1.7 | N/A |
| TKH Group | Netherlands | Electronic & electrical equipment | 1.6 | 2.0 |
| Gaztransport & Technigaz | France | Oil services & distribution | 1.6 | 2.0 |
| **Top 10 (% of portfolio)** | | | **18.6** | **17.5** |

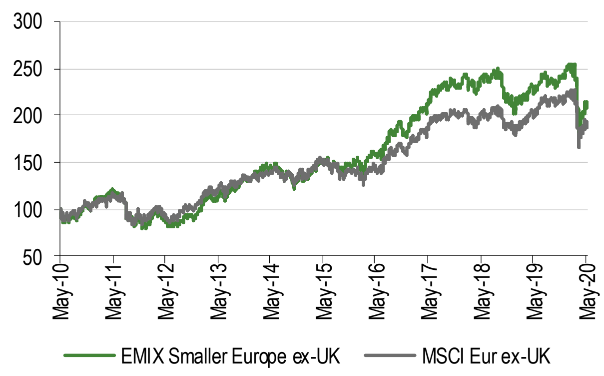
Source: TR European Growth Trust, Edison Investment Research, Bloomberg, Morningstar. Note: *N/A where not in end-March 2019 top 10.

## Market outlook: Go placidly amid the noise and haste

After a seemingly endless global bull market in equities following the 2008/09 financial crisis, the party came to an abrupt halt in late February 2020 as the impact of the COVID-19 pandemic began to be felt widely outside China. As can be seen in Exhibit 2 (left-hand chart), the market sell-off in March wiped out almost four years of gains in European equities, both large and small. Although there has been something of a bounce over the past month-and-a-half (to mid-May), the impact of widespread lockdown measures on economic activity and company revenues and earnings remains hard to quantify, to say nothing of the human cost of the virus, with more than 300,000 deaths worldwide. Emergency stimulus measures by governments and central banks are of a magnitude never seen before, and could take generations to unwind. However, while the sell-off may seem indiscriminate, and with the caveat that valuation metrics like forward P/E ratios (Exhibit 2, RHS) may be of little use given the suspension of earnings estimates, opportunities may still exist to take advantage of any recovery in markets. In such a situation, a focus on lowly valued companies with strong balance sheets could quite literally pay dividends.

**Exhibit 2: Market performance and valuation**

**Performance vs index**




**Valuation metrics for Datastream Europe ex-UK index**

| | Last | High | Low | 10-year average | Last as % of average |
|---|---|---|---|---|---|
| P/E 12 months forward (x) | 14.9 | 15.5 | 7.3 | 12.2 | 122 |
| Price to book (x) | 1.4 | 1.8 | 1.1 | 1.5 | 95 |
| Dividend yield (%) | 3.1 | 4.5 | 2.7 | 3.2 | 97 |
| Return on equity (%) | 9.7 | 13.1 | 7.7 | 9.9 | 98 |

Source: Refinitiv, Edison Investment Research. Note: Valuation data as at 15 May 2020.

## Fund profile: Focus on true small-cap Europe

TR European Growth Fund (TRG) was launched in 1990 with the aim of investing for long-term capital growth in a diversified portfolio of smaller European (ex-UK) companies that its managers believe are good value. The investment team – lead manager (since 2011) Ollie Beckett of Janus Henderson Investors, assisted by Rory Stokes and Julia Scheufler – employs an unconstrained, bottom-up approach to portfolio construction. The fund is biased towards the smaller end of the small-cap universe, with c 63% of TRG's assets (at 20 March 2020) invested in companies with a market capitalisation below £1bn. Smaller companies may carry a higher risk of failure and can be illiquid, so TRG's managers prefer to mitigate stock-specific risk by holding a relatively long list of stocks (c 120–150). There is a maximum individual position size of 7%, although in practice few holdings exceed 2% of the total. The trust is permitted to hold unquoted investments (prior board approval is required), but currently has no such positions. TRG measures its performance against the EMIX Smaller Europe ex-UK Index (in sterling terms) and is a member of the Association of Investment Companies' European Smaller Companies sector.

Gearing is permitted up to 30% of net assets (with a normal working range of up to 15%) and is used flexibly in response to investment opportunities. The trust may also hold up to 20% in cash and/or fixed income. While TRG's main aim is to achieve capital growth, it also has a long record of year-on-year dividend growth and since FY18 has paid an interim as well as a final dividend to spread income more evenly through the year. The trust has a healthy revenue reserve, which should support its ability to continue to pay dividends even in the likely event of a fall in portfolio income as a result of the COVID-19 pandemic.

# The fund managers: Beckett, Stokes and Scheufler

## The manager's view: Positioned for recovery of whatever shape

Beckett says the fact that the impact of the COVID-19 pandemic has not been felt equally across the European Union arguably presents an existential crisis for the bloc, similar to the inequality of outcomes during the global financial crisis, as well as making a sustainable recovery in the region's stock markets less likely. 'If Northern Europe does not help Spain and Italy now, it will never be forgiven and the EU will probably collapse – because if it doesn't help when people are literally dying, when will it?', he asks. Conversely, if the EU does come together in terms of practical economic steps, the manager says it could be the start of 'something more interesting' in terms of closer integration – 'it is a pretty key moment politically for the EU', and fundamental to the attractiveness of Europe as a destination for investors. Towards the end of April, European leaders signed off on a €540bn stimulus package, but are yet to agree on a 'recovery fund', expected to be in excess of €1tn and targeted at the most affected industries and regions.

The manager points out that European small-cap performance is highly correlated to economic confidence, as measured by metrics such as purchasing manager indices (PMIs). 'When they are rising, small-cap and value stocks tend to outperform, but they have been going down since 2018,' he says. While the eurozone PMI number for April was 'hideous', at an all-time low of 13.5 on a composite basis for goods and services (where 50 is the divide between expansion and contraction), Beckett argues that it should pick up from there. 'The shape of the recovery is unlikely to be a straight line, but once we have formed a trough and can say it is getting better and not worse, you can be constructive on the outlook for smaller companies,' he says.

In order to benefit fully from the upswing, the manager says that he is keeping some cyclicality in the portfolio, even though this was the main cause of TRG's underperformance in the February and March 2020 sell-off. 'In every other recovery period, TRG, small-cap and value stocks have done quite well, so we are quite well positioned for the recovery,' he argues, adding: 'I am not going to sell cyclical stocks, but I do want to ensure they have strong balance sheets.' With a larger number of family-owned companies with a focus on intergenerational stewardship, Beckett says European firms in general have stronger balance sheets than their US and UK counterparts. 'They are nowhere near as leveraged, and tend not to have done share buybacks funded by cheap debt post the global financial crisis,' he explains, adding that the team is only likely to get involved in more indebted companies at the point at which they seek to raise equity to repair their balance sheets. 'We have to decide who gains sustainably, who just bounces back with the economy, whenever that is (although it scarcely matters as long as their balance sheet is fine), and who loses,' he argues.

In the short term, Beckett says he still expects volatility, 'but we have to balance the portfolio and think about how we come out of this'. A stabilisation in markets since the worst of the sell-off in mid- to late March is enabling the team to explore or add to names further down the market cap spectrum, which have been disproportionately and indiscriminately hit. 'PVA TePla [which makes furnaces for use in high-end semiconductor manufacturing] has a solid order book, but it is a €200m market cap company and that's not what people want,' says Beckett. Other names in this camp include Arnoldo Mondadori Editore, an Italian book publisher and retailer with a market cap of c €330m. The stock was down more than 50% peak-to-trough, 'but book sales have held up well, so it doesn't make sense', the manager comments. 'It was on an 8x forward P/E at the end of March, and its numbers [due in mid-May for Q120] will probably be solid,' he adds. Although physical retail will undoubtedly be hit as a result of lockdown measures, Beckett explains that a large portion of Mondadori's revenues come from publishing, and says the c 5% yield 'is probably pretty safe'.

On the broader question of dividends, Beckett says that the dividend yield on the underlying TRG portfolio is likely to be significantly less in calendar 2020, as, for example, banks will be encouraged not to pay dividends, even where they are well capitalised and not lending to small businesses. However, the trust has strong reserves (see Dividend policy and history), and in any case is more focused on achieving capital growth. 'Many large-cap income funds are having to buy stocks like oil, tobacco and consumer staples – some of which are low to no growth, and some are in structural decline – and ending up with a portfolio that looks like 1990,' says the manager.

Looking ahead to the other side of the lockdown, Beckett expects to see structural changes in some areas of daily life, which will also have implications for investors. 'I think very few people will ever work in an office five days a week again,' he says. 'And while I think leisure travel will come back – because most people in Northern Europe will still want some sunshine, and people are increasingly living for experiences – I am less convinced about business travel. The virus has shown us that Zoom meetings work fine, so do I need to get on a plane and stay in a hotel? Probably not.'

## Asset allocation

### Investment process: Seeking mispriced securities

While TRG's overarching aim is to invest for capital growth in small- to mid-cap European companies, it seeks to do this by investing on a bottom-up basis in securities that the team believes to be mispriced relative to their long-term fundamentals. The trust's investment universe covers c 2,000 stocks across Europe with a market capitalisation below €4bn, from which Beckett, Stokes and Scheufler build a diversified portfolio of c 120–150 stocks. The managers use a range of quantitative screens to filter the opportunity set for attractive but undervalued companies. By undertaking hundreds of company meetings each year, they aim to assess the durability of business models, quality of management, drivers of growth and catalysts for revaluation. They also take account of in-house and external company research. For each potential investee company, the team builds financial models, using different valuation metrics to gain an understanding of the relationship between a firm's growth potential and its current valuation. The portfolio is built on a bottom-up basis, with no constraints on country or sector weighting, and position sizes are based on the managers' degree of conviction, although they rarely exceed c 2%, given the focus on diversification.

Beckett, Stokes and Scheufler view their investment universe in terms of a company lifecycle with four stages. The managers comment that the majority of investors tend to concentrate their efforts in the middle two segments, meaning they could be missing out on attractive opportunities.

- **Early cycle** – young companies with growing returns on capital, a clear strategy and operating leverage. The key valuation metric is enterprise value to sales (EV/sales). 'Internet of things' technology specialist S&T is a current portfolio example.
- **Quality growth** – companies with high returns on capital, growing revenues, sustainable margins and strong competitive positions. The team uses valuation metrics including P/E multiples, EV/EBIT (earnings before interest and tax) and EV to invested capital (EV/IC). An example is liquefied natural gas (LNG) storage and transport solutions provider GTT.
- **Mature** – cash-generative companies with steady returns on capital, whose shares are trading cheaply versus the value of their assets. Valuation metrics include EV/IC, EV/EBIT and free cash flow (FCF) yield. Ferry company DFDS (COVID-19 earnings impact notwithstanding) fits into this category.
- **Turnarounds** – companies that may have suffered declining growth or a specific setback, but where management cost-cutting or asset disposals may spark an improvement in margins.

Companies are valued on EV/IC, EV/EBIT and FCF yield. A focus on value growth, not volume growth, underlies French cable manufacturer Nexans' inclusion in this category.

**Exhibit 3: Portfolio characteristics**

| Metric | TRG | Index |
|---|---|---|
| Dividend yield forecast (%) | 4.4 | 4.2 |
| P/E forecast (x) | 9.8 | 11.0 |
| Return on equity (%) | 11.4 | 12.3 |
| Historic EPS growth (last three years) (%) | 14.4 | 10.5 |
| Forecast EPS growth (next 12 months) (%) | 18.8 | 13.1 |

Source: TR European Growth Trust, Edison Investment Research. Note: As at 20 March 2020.

As shown in Exhibit 3, TRG's holdings on average trade at lower forward P/E valuations than the benchmark average, with higher prospective dividend yields, and higher historical and projected earnings growth. Return on equity is typically also higher than the index average, but was lower at 20 March 2020. Beckett cautions that many of these metrics are currently 'fairly meaningless' given the likely impact of COVID-19 on company earnings and how that will feed through into dividends. Instead, he points to 'more interesting' metrics, such as net debt/EBITDA of 0.9x on the portfolio versus 2.4x for the index, interest cover at 13.5x compared with 10.9x, and net debt/equity at 69.7% versus 79.0% for the index.

Stocks may be sold when they reach the managers' assessment of fair value, if worsening fundamentals call the original investment thesis into question (such as companies with weaker balance sheets in the current crisis), or where the managers see better-value opportunities elsewhere. Portfolio turnover averages c 50% a year (slightly higher at 58.3% in FY19, falling back to an annualised 50.3% in H120), implying a holding period of around two years, although many companies are held for much longer than this.

## Current portfolio positioning

At 31 March 2020 there were 133 holdings in TRG's portfolio, compared with 139 a year earlier. The top 10 holdings made up 18.6% of the total, a slight increase in concentration compared with 17.5% at 31 March 2019. Beckett says that having a long stock list enables the team to look for stocks further down the market cap spectrum and get involved in earlier-stage companies, while still maintaining some liquidity.

**Exhibit 4: Portfolio geographic exposure (% unless stated)**

| | Portfolio end-March 2020 | Portfolio end-March 2019 | Change (pp) |
|---|---|---|---|
| Germany | 18.6 | 19.7 | (1.2) |
| France | 14.9 | 11.7 | 3.2 |
| Switzerland | 12.5 | 10.5 | 2.0 |
| Italy | 9.9 | 8.8 | 1.1 |
| Sweden | 8.3 | 8.6 | (0.3) |
| Netherlands | 8.2 | 9.8 | (1.6) |
| Finland | 5.3 | 7.2 | (1.9) |
| Belgium | 4.7 | 3.6 | 1.1 |
| Spain | 4.0 | N/S | N/A |
| Norway | 3.7 | 4.4 | (0.7) |
| Other | 10.0 | 15.7 | (5.7) |
| | **100.0** | **100.0** | |

Source: TR European Growth Trust, Edison Investment Research. Note: N/S = not separately stated; may be included in 'other'.

Country and sector exposures (Exhibit 4 and 5) are an output of stock selection, and there are no constraints on allocations versus the index. Over 12 months to 31 March 2020, there was relatively little change in the geographical breakdown of the portfolio; the only move of more than 2.0pp was a 3.2pp increase in the weighting to France. The largest fall in exposure was -1.9pp in Finland. There was a little more movement at the sector level, with the allocations to basic materials and industrial goods falling by 5.0pp and 3.2pp respectively, while technology rose by 3.5pp and consumer goods by 2.2pp.

**Exhibit 5: Portfolio sector exposure (% unless stated)**

| | Portfolio end-March 2020 | Portfolio end-March 2019 | Change (pp) |
|---|---|---|---|
| Industrial goods | 23.4 | 26.6 | (3.2) |
| Technology | 16.7 | 13.2 | 3.5 |
| Financials | 15.1 | 13.2 | 1.9 |
| Consumer goods | 14.3 | 12.1 | 2.2 |
| Business providers | 13.8 | 13.8 | 0.0 |
| Basic materials | 10.1 | 15.1 | (5.0) |
| Retail providers | 5.8 | 4.2 | 1.6 |
| Natural resources | 0.7 | 1.8 | (1.2) |
| | **100.0** | **100.0** | |

Source: TR European Growth Trust, Edison Investment Research

Portfolio activity has ticked up a little in response to the coronavirus pandemic. Beckett says he has sold anything with a weak balance sheet (he exited the majority of TRG's position in oil services company Fugro, which is 'quite leveraged', before the collapse in the oil price), as well as stocks where the response to the crisis alters the investment case, such as Air France KLM. The manager says he had bought the airline operator cheaply as a restructuring story. It was optimising its fleet, cutting costs, and making progress with pilots' unions in France, 'but clearly now it will end up more owned by the French and Dutch governments, so that went quite early'. Varta, which makes batteries for in-ear wireless headphones, was sold mainly on valuation grounds, but also because of analysts' unrealistic margin expectations in the face of emerging competition in China.

The team added three new names to TRG's portfolio during March 2020. Beckett says Dutch semiconductor equipment maker ASM International is a rare example of a growth company where valuations were reasonable. 'Semiconductor equipment is an industry that is structurally growing, but ASM's share price fell a long way in March to the point where the valuation was attractive,' he explains. 'If we see more situations like that, we will buy them.' ASM International's share price has risen by 66.9% since its low point on 18 March (as at 15 May).

The other two new holdings are well placed to benefit directly from efforts to combat the pandemic. Beckett says 40% of Swedish company Getinge's sales come from high-end oxygenation and ventilation machines, 'so it is seeing a massive increase in orders'. Because the machines are trickier for non-specialist healthcare professionals to use, the manager says there was initially some pushback on the share price. Since the low point on 13 March, Getinge's shares are up by 17.6%. Switzerland-listed Interroll makes conveyor belt warehousing technology, so should benefit positively from increased e-commerce and/or logistics automation. Its share price has risen by 45.3% from its 19 March low.

Beckett says 'defensive' companies on high P/E and price/book valuations have continued to perform well, so are unlikely to feature as purchases for TRG's portfolio in the near term.

The team has also topped up some existing holdings, such as Italian banks FinecoBank and Banca Farmafactoring; French silicon-on-insulator semiconductor wafer manufacturer Soitec; Daetwyler, a Swiss company that makes seals for the medical industry; and Finnish mining technology company Outotec. 'We think mining stocks will come out of the slump quite early,' says Beckett, pointing to the fact that China is already substantially back to work following the COVID-19 outbreak, 'so it makes sense to start nibbling at things like mining-exposed companies'.

## Performance: Pro-cyclical bias affecting recent returns

**Exhibit 6: Five-year discrete performance data**

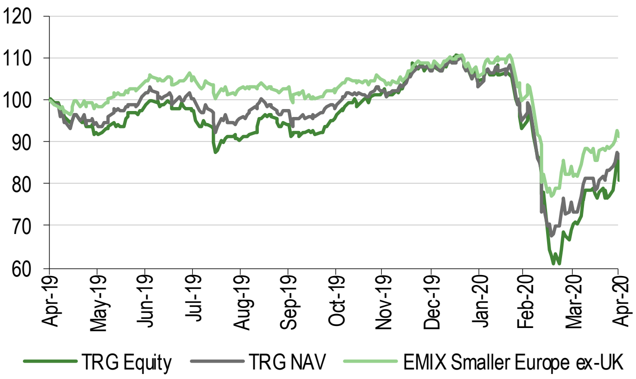
| 12 months ending | Share price (%) | NAV (%) | EMIX Smaller Europe ex-UK (%) | MSCI Europe ex-UK (%) | CBOE UK All Companies (%) |
|---|---|---|---|---|---|
| 30/04/16 | 3.7 | 5.4 | 5.8 | (4.1) | (5.6) |
| 30/04/17 | 50.7 | 48.1 | 32.6 | 28.9 | 20.3 |
| 30/04/18 | 16.9 | 8.7 | 11.5 | 7.2 | 8.1 |
| 30/04/19 | (13.6) | (7.8) | (1.9) | 3.2 | 2.5 |
| 30/04/20 | (14.4) | (13.9) | (8.7) | (7.2) | (17.2) |

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

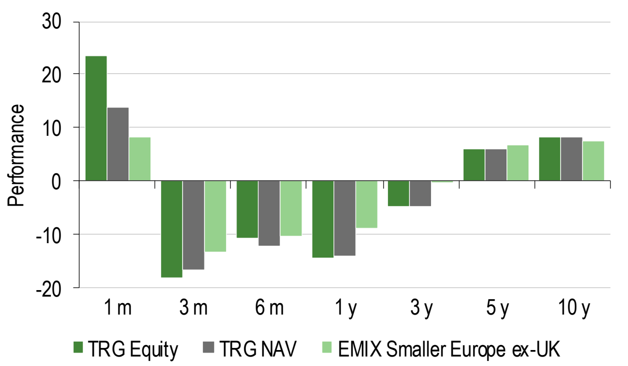
Beckett says that TRG's gearing, and its pro-cyclical positioning at the start of 2020 in the expectation of economic improvement, have hurt the trust's recent performance, given the impact of the COVID-19 pandemic on both the global economy and share prices. Over 12 months to 30 April, the NAV declined by 13.9% and the share price by 14.4% (having fallen sharply in March 2020 before recovering somewhat in April), compared with a fall of 8.7% in the EMIX Smaller Europe ex-UK Index (all in sterling on a total return basis). The magnitude of the March decline has had the effect of dampening longer-term performance numbers too, with TRG trailing the index over five years, and only marginally ahead in NAV terms over 10 years on an annualised basis (Exhibit 7, RHS), with a return of 8.4% pa compared with 7.7% for the benchmark. However, on a very short-term basis, TRG's NAV and share price total returns of 13.9% and 23.6% respectively in April were well ahead of the 8.4% gain in the index. Relative to other indices (Exhibit 8), TRG has comfortably outperformed the large-cap MSCI Europe ex-UK index over one month and three and five years, and has beaten the broad UK stock market in both share price and NAV terms over all periods shown except three years (all figures in sterling).

**Exhibit 7: Investment trust performance to 30 April 2020**

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

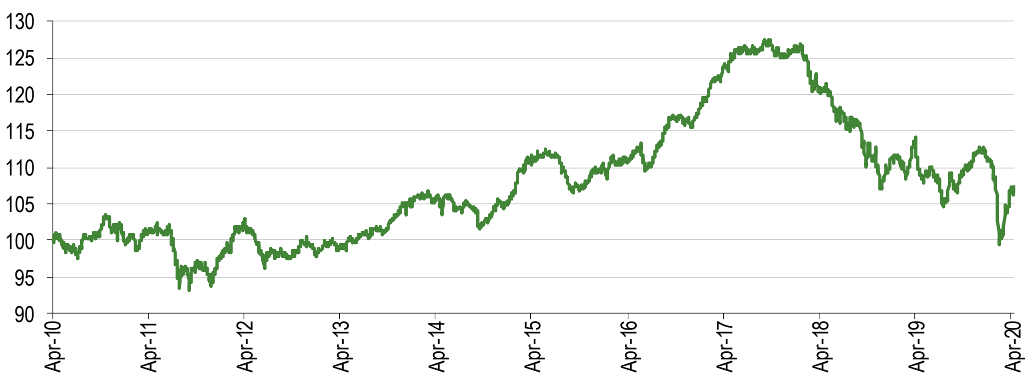
| | One month | Three months | Six months | One year | Three years | Five years | 10 years |
|---|---|---|---|---|---|---|---|
| Price relative to EMIX Smaller Europe ex-UK | 14.0 | (5.6) | (0.1) | (6.2) | (13.5) | (3.6) | 5.8 |
| NAV relative to EMIX Smaller Europe ex-UK | 5.1 | (3.7) | (1.9) | (5.7) | (13.6) | (4.0) | 6.8 |
| Price relative to MSCI Europe ex-UK | 18.2 | (6.7) | 1.0 | (7.8) | (15.8) | 6.5 | 17.2 |
| NAV relative to MSCI Europe ex-UK | 8.9 | (4.9) | (0.9) | (7.2) | (15.9) | 6.1 | 18.4 |
| Price relative to CBOE UK All Companies | 17.7 | 1.2 | 8.8 | 3.3 | (5.8) | 29.7 | 36.1 |
| NAV relative to CBOE UK All Companies | 8.5 | 3.2 | 6.8 | 3.9 | (6.0) | 29.3 | 37.4 |

Source: Refinitiv, Edison Investment Research. Note: Data to end-April 2020. Geometric calculation.

From the beginning of 2020 to the nadir of the stock market sell-off in March, the biggest detractors from TRG's performance included Denmark-headquartered ferry company DFDS Seaways, the Dutch bank Van Lanschot Kempen, and Madrid-listed online travel booker eDreams. As a long-term holding in the portfolio, DFDS – a major operator of ferries to and from the UK – had been hit by Brexit uncertainty. Now Beckett says, 'I think in the medium term it is massively undervalued and very interesting, but in the short term there are no passengers.' The share price has fallen by 47.4% in local currency terms year-to-date (to 15 May) but has outstripped the wider market bounce since its March low point with a gain of 27.9%. Van Lanschot Kempen has a small mortgage book that may be affected by customers struggling to pay, but Beckett notes that it is primarily a wealth manager, and as such 'the hit has already been taken' in the shape of falling assets under management. Its share price is down 37.7% year-to-date but it has rallied in the past month-and-a-half, up 32.1% from its March low. eDreams is the number one online travel agency in Europe, with brands including Opodo. While it has understandably been affected by the pandemic-induced restrictions on movement, the manager points out that as it is effectively a broker, a large proportion (c 80%) of its costs are variable, 'so it can go into lockdown and stop marketing, but it is in a strong position relative to others and will come out the other side. I am not going to sell it as the valuation is quite exciting,' he adds. While the share price is down 55.5% year-to-date, it is up 21.0% in local currency terms from the trough in March.

In terms of positive contributors to TRG's performance from 1 January to 24 March, the joint largest were Switzerland-listed online pharmacy Zur Rose (which also has a large presence in Germany), and German meal kit supplier HelloFresh, both of which are well positioned in a lockdown situation. While HelloFresh has seen 'phenomenal' sales, the manager says he expects some of the new customers to fall away again once grocery shopping normalises. However, he believes Zur Rose's new customers are likely to be 'stickier', given the COVID-19 pandemic is simply accelerating a trend that is already established. 'Why would you not want to get your prescriptions delivered when you need them?' he asks. 'It acts as one less thing to remember.' Another positive contributor was Swedish video game developer and publisher Embracer Group, which operates in a sector that has also benefited from people staying at home. All three of these stocks have continued to perform well. Year-to-date (to 15 May, in local currency terms), Zur Rose, HelloFresh and Embracer's share prices are up 55.7%, 114.0% and 56.1% respectively. Between 24 March and 15 May they saw respective share price rises of 20.7%, 52.4% and 30.0%.

**Exhibit 9: NAV total return performance relative to benchmark over 10 years**

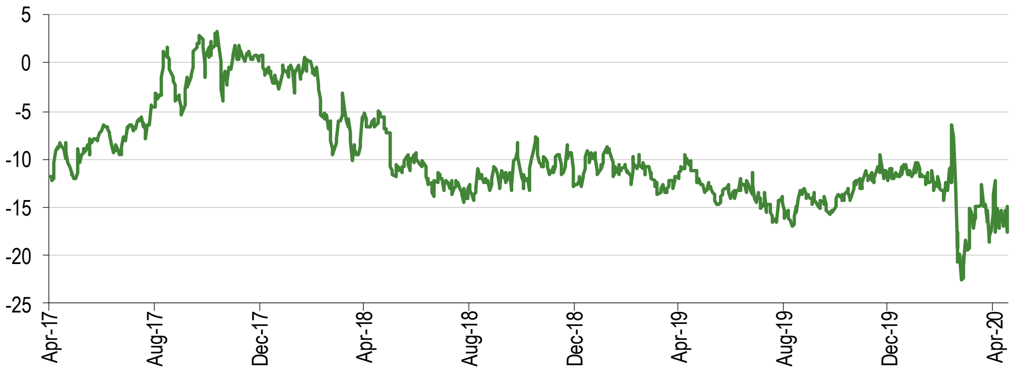



Source: Refinitiv, Edison Investment Research

## Discount: Volatile in the wake of COVID-19 sell-off

At 15 May 2020, TRG's shares traded at a 14.9% discount to cum-income NAV. While this was appreciably narrower than the five-year high of 22.5% seen on 23 March 2020, it remains wider than both short- and longer-term averages (respectively 13.6%, 9.6%, 10.7% and 13.2% over one, three, five and 10 years). Having traded at a premium to NAV as recently as early 2018, following a period of particularly strong investment performance, the shares traded broadly in a range of a 10% to a 15% discount from Q218 to Q419. However, the recent equity market sell-off has seen increased volatility in the discount, moving from a 12-month low of 6.4% to the abovementioned five-year high in the space of just 10 days. Given the severe impact of the COVID-19 pandemic on much of continental Europe, as well as a flight to safety by investors, causing them to shun small-cap and 'value' investments, it may take time for TRG's discount to settle back into a range, which could present buying opportunities for investors with a long-term view.

**Exhibit 10: Share price premium/discount to NAV (including income) over three years (%)**




Source: Refinitiv, Edison Investment Research

## Capital structure and fees

Structured as a conventional investment trust, TRG had 50.1m ordinary shares in issue as at 15 May 2020, a level unchanged since November 2017. While the board retains the authority to repurchase up to 14.99% of shares or allot shares up to the equivalent of 5% of the share capital, in order to manage a discount or a premium, in practice these powers are used sparingly, and there have been no repurchases since the summer of 2016. Gearing is available via a £100m multicurrency overdraft facility with HSBC Bank, of which £52.0m was drawn at end-H120 (31 December 2019), representing gearing of 9.6% at that date. Net gearing stood at 10.0% at 30 April 2020.

TRG pays the fund manager, Janus Henderson Investors, an annual management fee of 0.6% of net assets up to £500m and 0.5% thereafter. The new tier was introduced from 1 October 2018. A performance fee (15% of excess performance, subject to a cap on total fees at 2.0% of net assets.) may also be paid if TRG's NAV total return outperforms the benchmark EMIX Smaller Europe ex-UK Index by more than 1.0% on a rolling three-year basis. No performance fee was paid in respect of FY19 (FY18: 0.20%), and ongoing charges were 0.72% (FY18: 0.71%, or 0.91% including performance fees).

## Dividend policy and record

TRG invests mainly for capital growth, but also has a long record of paying a steadily growing annual dividend. Having previously paid a final dividend, supplemented by a special dividend of varying size, each November, since FY18 it has paid an interim and a final dividend, in April and November. TRG's dividends have been fully covered by income (1.3x in FY19) for many years, although portfolio income is heavily weighted towards the second half of the financial year (H120 total income of £2.1m was 37% higher than £1.5m in H119, but compares with FY19 total income of £14.7m), meaning the interim payment is technically uncovered at the time of payment. This may be seen as pertinent given the widespread dividend cuts currently being experienced at the corporate level as a result of the COVID-19 pandemic. However, it is important to note the ability of investment trusts to keep revenue in reserve to smooth future dividend payments.

After accounting for both the FY19 final dividend and the H120 interim (paid after the period end), but excluding any dividend receipts in H220 to date, TRG has revenue reserves of 38.5p per share, sufficient to sustain annual dividends at the FY19 level for 21 months. This means that even in the event of a total collapse in portfolio income in the near term, TRG remains well placed to maintain and perhaps grow its FY20 dividend. The regular dividend (excluding specials) has grown at a compound annual rate of 27.6% over the five years to FY19. Based on the current share price and the last two dividends, TRG has a yield of 3.0%, which compares very favourably with the returns available on bonds and cash.

## Peer group comparison

There are four investment trusts in the Association of Investment Companies' European Smaller Companies sector, shown in Exhibit 11. The funds follow a range of investment approaches, with TRG generally having a lower average market capitalisation (given its small- to micro-cap focus versus the peers' small- to mid-cap bias) as well as a greater tilt towards value rather than growth.

With small-cap and value both having been broadly out of favour for some time, and suffering more in the recent equity market sell-off, TRG's NAV total return performance lags the sector average over one, three, five and 10 years, ranking fourth, fourth, third and fourth (albeit marginally) respectively. While recent declines have been exacerbated by TRG's pro-cyclical positioning going into the downturn, as well as by its above-average level of gearing, both these factors could work in the trust's favour if the market recovery since the March lows can be sustained.

TRG has the lowest ongoing charges in the group, although it is the only fund where a performance fee may be payable. It is currently trading at the widest discount to NAV (reflecting a lack of investor appetite for small-cap value) and has the highest level of gearing. The 3.1% dividend yield is a little below the mean, although it is worth pointing out that the average is skewed by European Assets Trust, which pays an annual distribution of 6% of NAV that may be funded out of capital, whereas TRG's dividends have historically been fully covered by income. Investors should note that in an environment of widespread dividend cuts at the corporate level, yield figures based on historical dividends (as these are) may not be a reliable guide to the future.

**Exhibit 11: AIC European Smaller Companies peer group as at 15 May 2020***

| % 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 |
|---|---|---|---|---|---|---|---|---|---|---|
| **TR European Growth Trust** | **355.8** | **(5.9)** | **(14.3)** | **38.3** | **136.9** | **0.7** | **Yes** | **(17.5)** | **110** | **3.1** |
| European Assets Trust | 310.3 | (2.9) | (2.9) | 25.8 | 197.1 | 1.1 | No | (10.8) | 100 | 7.6 |
| JPMorgan European Smaller Cos | 475.2 | (4.9) | (6.2) | 43.7 | 138.1 | 1.1 | No | (17.2) | 108 | 2.2 |
| Montanaro European Smaller Cos | 169.8 | 11.2 | 35.0 | 107.5 | 220.4 | 1.2 | No | (8.2) | 103 | 0.9 |
| **Sector average (4 funds)** | **327.8** | **(0.6)** | **2.9** | **53.8** | **173.1** | **1.0** | | **(13.4)** | **105** | **3.5** |
| **TRG rank in sector** | **2** | **4** | **4** | **3** | **4** | **4** | | **4** | **1** | **2** |

Source: Morningstar, Edison Investment Research. Note: *Performance to 14 May 2020 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).

## The board

TRG currently has six directors; all are non-executive and independent of the manager. Christopher Casey joined the board in 2010 and became chairman following the retirement of Audley Twiston-Davies at the 2019 AGM. Andrew Martin Smith was appointed in May 2008, Alexander Mettenheimer in 2011 and Simona Heidempergher in 2014. Two new directors joined the board during 2019: Ann Grevelius (in September) and Dan Burgess (in November). Burgess has succeeded Casey as chairman of the audit committee. Three of the directors hail from continental Europe, and the board members have diverse professional backgrounds, encompassing investment management, accountancy and banking.

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