

TR European Growth Trust

Finding opportunities in European small-caps

TR European Growth Trust (TRG) lead manager Ollie Beckett says he and his team are still finding plenty of investment opportunities, in spite of the global bull market in equities arguably being closer to the end than the beginning. The managers focus on attractively valued smaller companies in continental Europe, where improving returns or management changes have not yet been appreciated by the wider market. After a stellar year of performance in FY17 (NAV and share price total returns of +54.0% and +75.5% respectively), recent returns have been more muted relative to the benchmark and peers, and the trust has moved from a slight premium to NAV to a discount, more in line with long-term averages. Beckett has recently taken profits in holdings where valuations looked stretched, and has increased TRG's gearing to take advantage of a dip in investor sentiment. The stock list is towards the longer end of the historical range.

12 months ending	Share price (%)	NAV (%)	EMIX Smaller Europe ex-UK (%)	FTSE World Eur ex-UK (%)	FTSE All-Share (%)
31/05/14	38.8	32.0	24.9	13.4	8.9
31/05/15	15.9	8.3	2.7	4.7	7.5
31/05/16	2.3	6.7	6.3	(3.7)	(6.3)
31/05/17	61.4	55.9	39.9	35.7	24.5
31/05/18	0.7	2.7	6.2	0.9	6.5

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

Investment strategy: Small-cap value and growth

TRG follows a bottom-up investment strategy, with the managers using a range of screens and valuation measures, and meeting hundreds of companies each year in their search for undervalued stocks with attractive growth or recovery characteristics. The trust holds a diversified portfolio of c 120-150 stocks from an investment universe of c 2,000 broadly sub-€4bn companies across continental Europe, and has a bias to the smaller end of the market, with 82% of holdings (including the effect of gearing) having a market cap below €2bn.

Market outlook: Growth at reasonable prices

In spite of a return to more normal levels of volatility after 2017's historic lows, many global stock markets continue to perform strongly following a sell-off in Q118. European small-caps have outperformed their larger brethren, but still offer higher forecast EPS growth at more favourable forward P/E valuations. While there are undoubtedly risks – from the threat of a global trade war to a potential collapse of Germany's ruling coalition – long-term investors may still be well rewarded by looking beyond the mainstream to find growing companies at reasonable prices.

Valuation: Return to more normal discount levels

At 29 June 2018, TRG's shares traded at an 8.9% discount to cum-income NAV. While this represents a substantial widening from a 10-year high premium of 3.2% seen in November 2017, and an average discount of 4.2% over the past 12 months, it is actually slightly narrower than average discounts over three, five and 10 years. TRG's shares currently yield 1.4% based on the FY17 dividend.

Investment trusts

2 July 2018

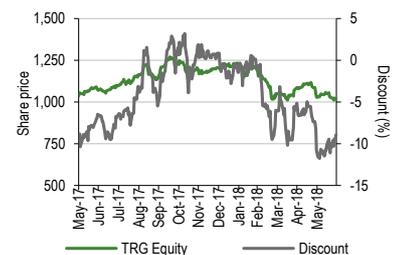
Price	1,020.0p
Market cap	£511.1m
AUM	£594.5m

NAV*	1,102.8p
Discount to NAV	7.5%
NAV**	1,119.8p
Discount to NAV	8.9%

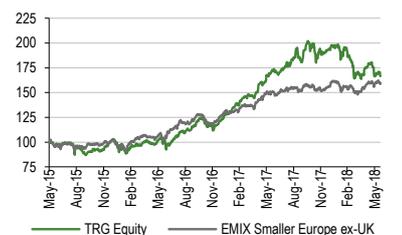
*Excluding income. **Including income. As at 29 June 2018.

Yield (incl. special dividend)	1.4%
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	1,270.0p	1,012.0p
NAV** high/low	1,247.0p	1,086.1p

**Including income.

Gearing

Gross*	10.0%
Net*	10.0%

*As at 31 May 2018.

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Exhibit 1: Trust at a glance

Investment objective and fund background

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

Recent developments

- 6 March 2018: Half-year report for the period ended 31 December 2017. NAV TR +5.5% and share price TR +14.1% compared with benchmark TR of +6.2%. Interim dividend of 5.0p per share declared.
- 27 November 2017: All resolutions passed at AGM.

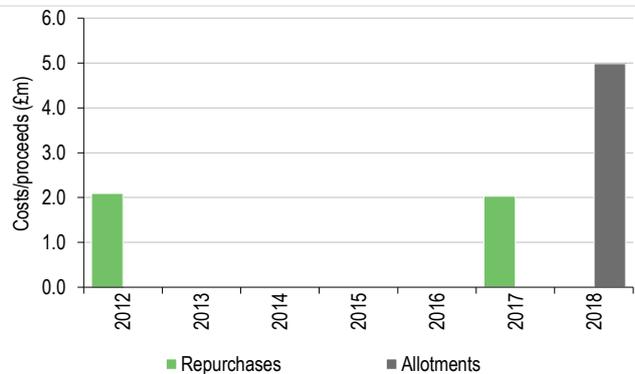
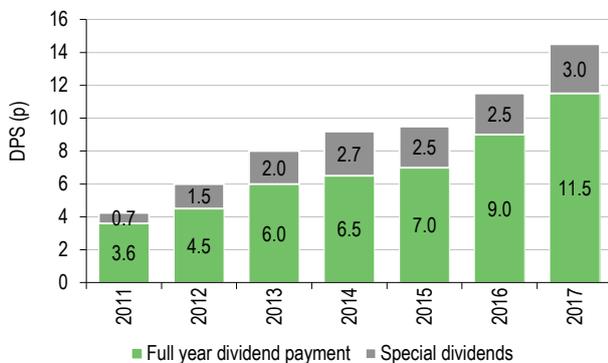
Forthcoming		Capital structure		Fund details	
AGM	November 2018	Ongoing charges	0.75% (30 June 2017)	Group	Janus Henderson Investors
Annual results	September 2018	Net gearing	10.0% (31 May 2018)	Manager	Ollie Beckett, Rory Stokes
Year end	30 June	Annual mgmt fee	0.60%	Address	201 Bishopsgate, London EC2M 3AE
Dividend paid	June, November	Performance fee	Yes (see page 7)	Phone	+44 (0) 20 7818 6825
Launch date	1990	Trust life	Indefinite	Website	www.treuropeanogrowth.com
Continuation vote	Three-yearly, next 2019	Loan facilities	£80m overdraft		

Dividend policy and history (financial years)

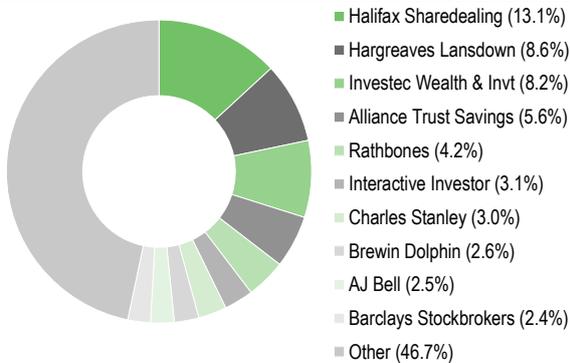
From FY18, an interim and a final dividend will be paid in June and November (previously a final dividend was paid in November). While the primary aim is to achieve capital growth, the board also hopes to maintain and grow the dividend. Special dividends have been paid in each of the last 10 financial years; however, the move to paying two dividends a year may mean this is less likely in future.

Share buyback policy and history (financial years)

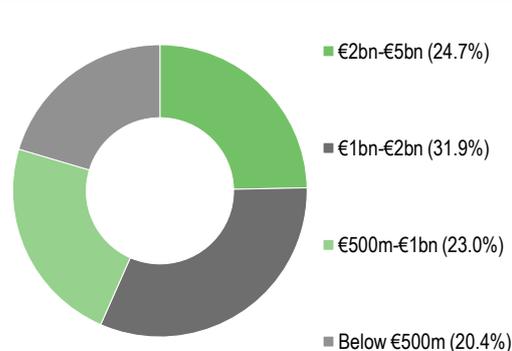
TRG has the authority, renewed annually, to buy back up to 14.99% of shares and allot up to 10% of shares to manage a discount or a premium. Buybacks are at the board's discretion following the removal in 2010 of an obligation to repurchase if the discount exceeded 10%.



Shareholder base (as at 18 May 2018)



Portfolio exposure by market cap (as at 2 July 2018, adjusted for gearing)



Top 10 holdings (as at 31 May 2018)

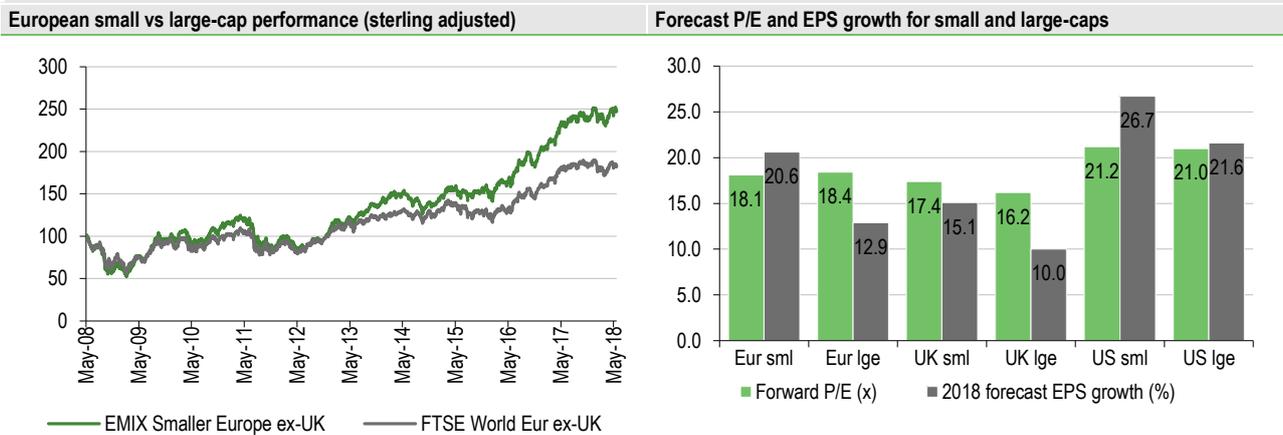
Company	Country	Sector	Portfolio weight %	
			31 May 2018	31 May 2017*
Van Lanschot Kempen	Netherlands	Banks	2.3	2.3
Brainlab**	Germany	Tech hardware & equipment	1.8	2.3
Fugro	Netherlands	Support services	1.4	N/A
Soitec	France	Technology	1.3	N/A
TKH Group	Netherlands	Electronic & electrical equipment	1.3	N/A
Dermapharm	Germany	Healthcare	1.3	N/A
Caverion	Finland	Building and industrial services	1.2	N/A
Lenzing	Austria	Chemicals	1.2	1.4
Gaztransport & Technigaz	France	Support services	1.2	N/A
Banca Farnafactoring	Italy	Banks	1.2	N/A
Top 10 (% of portfolio)			14.2	14.8

Source: TR European Growth Trust, Edison Investment Research, Bloomberg, Morningstar. Note: *N/A where not in end-May 2017 top 10. **Unlisted investment.

Market outlook: Look beyond the obvious

The majority of developed global stock markets have bounced back strongly in Q218, in spite of a return to more normal levels of stock market volatility after the historic lows seen in 2017. After a slower recovery from the global financial crisis than seen in the US and UK, Europe's economies and markets are now on a growth path, with sterling returns of c 57% and 102% respectively from large- and small-cap indices over five years to end-May 2018 (Exhibit 2, left-hand chart). Forecast earnings growth for smaller European companies is better than for large-caps or UK companies (right-hand chart), and arguably only lags the US because of the one-off impact of tax cuts. However, the forward P/E valuation for European small-caps is lower than for US stocks or for European large-caps, suggesting higher return potential for investors in this area. The outlook is not without risk, given the threat of a global trade war and potential political instability at the heart of Europe, but patient investors may still be well rewarded by looking beyond Europe's household-name companies to find higher forecast growth at more favourable valuations.

Exhibit 2: Market performance and valuation



Source: Thomson Datastream, TR European Growth Trust, Edison Investment Research

Fund profile: Diversified European small-cap fund

TR European Growth Trust was launched in 1990 and has been managed since 1992 by Janus Henderson Investors and its predecessor companies. It invests in a diversified portfolio of smaller European (ex-UK) companies that the managers believe to be good value, with the aim of achieving long-term capital growth. The trust has been managed by Ollie Beckett since 2011, assisted since 2013 by Rory Stokes. Julia Scheufler recently joined the management team. While portfolio construction is bottom-up and unconstrained, TRG uses the EMIX (formerly Euromoney) Smaller Europe ex-UK index (in sterling terms) as a performance benchmark, and is a member of the Association of Investment Companies' European Smaller Companies sector.

The managers are biased to the smaller end of the investment universe, with c 80% of the portfolio in sub-€2bn stocks. Because smaller companies can be illiquid and may carry a higher risk of failure, TRG tends to hold a long list of c 120-150 stocks in order to mitigate stock-specific risk. No more than 7% of the portfolio may be in a single holding. Gearing is used flexibly in a normal working range of up to 15%, and up to 20% of the portfolio may be held in cash or fixed income. Unquoted investments may be held with prior board approval, but there is no current intention to hold any unlisted companies except for second-largest holding Brainlab. While capital growth is TRG's primary aim, it also has a 13-year record of year-on-year dividend growth, and has recently introduced an interim dividend payment to spread income more evenly through the year.

The fund managers: Ollie Beckett and Rory Stokes

The manager's view: Look for improving returns

Beckett comments that he and his team remain valuation-aware in a protracted bull market, where many investors seem happy to pay ever-higher valuations for stocks. "There is still value and growth out there – we are not negative – but some of our holdings were looking a bit stale, so we have moved on, sometimes reluctantly," he says. An example of a recent exit is eye surgery equipment specialist Carl Zeiss Meditec, bought at around €10 a decade ago, and sold in the mid-€50s on a P/E valuation of more than 30x. "We will continue to play the technological change theme, but we are not going to play themes or good companies at any price," Beckett adds. "We want to find undervalued companies where the perception is wrong."

Buying good companies that are out of favour is key to the TRG strategy's success, explains Beckett. While the portfolio's return on equity (ROE) is currently lower than that of the benchmark, the manager says the absolute level is less relevant; it is the rate of ROE growth that matters. "We are going off the beaten track to find companies where returns are improving," says Beckett, pointing out that TRG's exposure to the smaller end of the European small-cap market is higher than any of its peers'. While the managers have bought some companies at IPO recently, such as German medical firm Dermapharm, Beckett argues that IPO valuations are often inflated by brokers and, in aggregate, there are better-value opportunities in less well researched stocks that are already on the market.

Although valuations are higher in many cases than historically, the managers point out that earnings growth in Europe has improved dramatically, following a long period when economic recovery lagged the US and UK. However, in sentiment terms, investors are more nervous now than they were at the start of 2018, when market volatility was still at historic lows. "We have seen extremes of sentiment in quite a short period," says Beckett, adding that the "weirdly bearish" perspective of many investors is why TRG's level of gearing is higher now than at the beginning of the year. "We are probably in the fourth quarter of the bull market, but it could last another 18 months," he adds. "I can't promise the same kind of growth as the last few years, but I still think we can deliver healthy growth."

Asset allocation

Investment process: Seeking value in under-researched areas

Beckett, Stokes and Scheufler work together to build a diversified portfolio of small- and mid-cap European stocks from a universe of c 2,000 companies with a market capitalisation below c €4bn. The team first uses quantitative screens to help identify attractive businesses that are undervalued, and meets hundreds of companies each year in order to assess the quality of management, durability of the business model, drivers of growth and catalysts for revaluation. Potential investments are modelled using a range of valuation metrics to ensure the managers understand the relationship between a company's growth potential and its current valuation. Stock selection is mainly bottom-up, with no constraints on country or sector weightings, and positions are sized by conviction, although given the long stock list of c 120-150 companies, most are below 1% of the total.

Investments may be grouped into three broad headings. The majority are those that offer growth at a reasonable price, with structural growth drivers and high returns on capital. Turnaround situations, where factors such as a new management team have the potential to bring about operating improvements, are also favoured, with the balance of the portfolio in unloved, 'deep value' stocks that may be cyclically out of favour. Holdings may be sold when they reach the managers' assessment of fair value, if worsening fundamentals call the original investment thesis into question, or where there are better-value opportunities elsewhere. Portfolio turnover averages c 50% a year, implying a holding period of two years, although many stocks are held for much longer than this.

Current portfolio positioning

At 31 May 2018, there were 146 holdings in the TRG portfolio, up from 139 a year earlier. Beckett comments that although this is at the high end of the historical range of c 120-150, it is appropriate given the extended nature of the current bull market and TRG's focus on stocks at the smaller end of the market capitalisation scale. In line with the broad diversification of the portfolio, the top 10 holdings made up only 14.2% of the total at 31 May 2018, down a little from 14.8% a year earlier.

Exhibit 3: Geographic exposure vs EMIX Smaller Europe ex-UK index (% unless stated)						
	Portfolio end-May 2018	Portfolio end-May 2017	Change (pp)	Index weight	Active weight vs index (pp)	Trust weight/index weight (x)
Germany	17.4	19.8	(2.4)	15.2	2.2	1.1
Netherlands	12.0	9.3	2.7	6.0	6.0	2.0
Finland	11.3	5.3	6.0	4.7	6.6	2.4
France	11.2	13.0	(1.8)	11.2	(0.0)	1.0
Switzerland	9.8	7.7	2.1	10.6	(0.8)	0.9
Sweden	8.6	6.1	2.5	13.0	(4.4)	0.7
Italy	7.0	11.8	(4.8)	11.0	(4.0)	0.6
Norway	6.3	4.7	1.6	5.3	1.0	1.2
Belgium	4.6	3.8	0.8	N/S	N/A	N/A
Denmark	3.1	4.4	(1.3)	N/S	N/A	N/A
Other	8.7	14.1	(5.4)	23.0	(14.3)	0.4
	100.0	100.0		100.0		

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

Portfolio construction is bottom-up, with geographical and sector weightings (Exhibits 3 & 4) being principally an output of stock selection. Beckett comments that from a macroeconomic perspective he is probably more positive on Spain than Germany, yet he finds many attractive stocks in Germany and relatively few in Spain. The largest country weights relative to the EMIX Smaller Europe ex-UK index are the Netherlands and Finland; three of TRG's top five holdings are listed in the Netherlands, and the overweight to Finland is partly a result of having added exposure to the market early in its recovery, when there were "a lot of stocks we wanted to buy". The biggest underweights are in Italy, Sweden and Spain; Beckett comments that the reduction in Italy (the biggest 12-month fall in exposure) was less an attempt to mitigate political risk and more a result of profit-taking in holdings where valuations looked stretched, such as credit information service Cerved and electrical retailer Unieuro, as well as the "slightly disappointing" acquisition of fashion website Yoox Net-a-Porter by luxury goods group Richemont. Sweden is out of favour with many investors because of perceived overheating in the housing market; while he remains underweight, Beckett has bucked the trend by buying JM Group, the country's largest housebuilder, on a 7x P/E ratio and a 7% dividend yield.

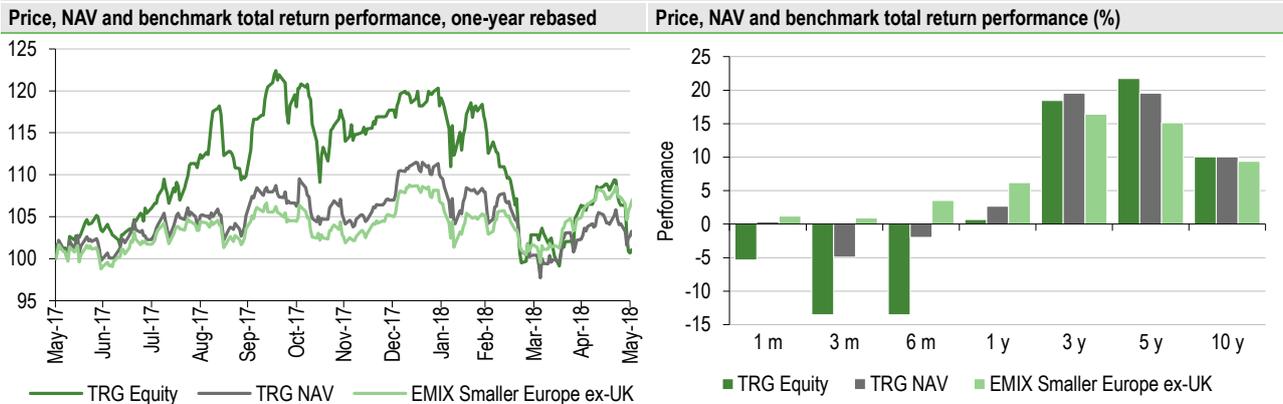
Exhibit 4: Portfolio sector exposure vs EMIX Smaller Europe ex-UK index (% unless stated)						
	Portfolio end-May 2018	Portfolio end-May 2017	Change (pp)	Index weight	Active weight vs index (pp)	Trust weight/index weight (x)
Industrial goods	21.9	23.0	(1.1)	15.2	6.7	1.4
Basic materials	16.3	12.9	3.5	10.6	5.8	1.5
Financials	14.7	13.6	1.1	22.4	(7.7)	0.7
Technology	13.5	14.9	(1.5)	9.2	4.3	1.5
Consumer goods	13.5	10.3	3.1	16.1	(2.6)	0.8
Business providers	12.5	16.4	(3.9)	18.2	(5.7)	0.7
Retail providers	6.7	8.0	(1.3)	6.5	0.2	1.0
Natural resources	1.0	0.8	0.2	1.9	(1.0)	0.5
	100.0	100.0		100.0		

Source: TR European Growth Trust, Edison Investment Research

The largest sector overweights are in industrial goods, basic materials and technology. However, Beckett has reduced TRG's technology weighting on concerns that investors are pushing many tech stocks to "spurious valuations" because of their association with hot themes such as electric vehicles and the Internet of Things. Beckett prefers hardware areas such as silicon carbide crystals (PVA TePla), which will help to facilitate the build-out of 5G networks, and silicon-on-insulator wafers (Soitec), which can handle the increased heat generated by higher processing power.

Performance: Pause after stellar FY17

Exhibit 5: Investment trust performance to 31 May 2018



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

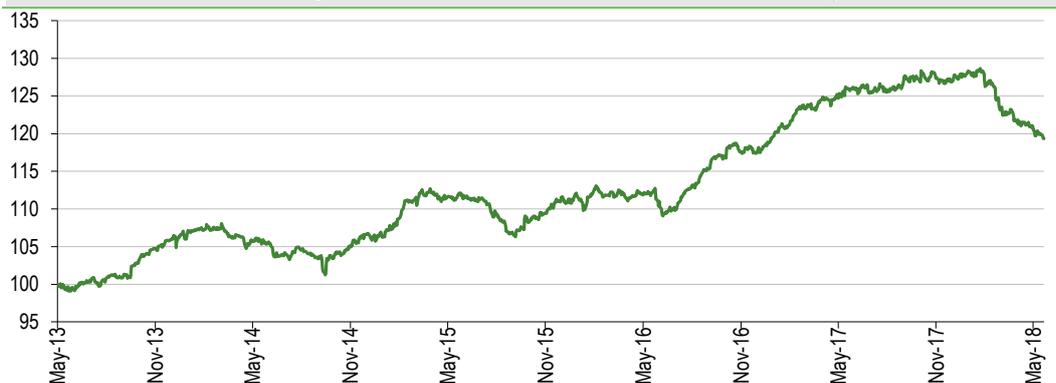
Having performed exceptionally well in FY17 (NAV total return +54.0% and share price total return +75.5% versus a benchmark return of +35.8%), TRG has seen a pause in performance recently, with flat to negative NAV total returns over one year and less, and a sharper decline in the share price as the shares reverted from an unusual premium to a discount (Exhibit 5). The longer-term record of outperforming the EMIX Smaller Europe ex-UK benchmark in both share price and NAV terms remains intact. As shown in Exhibit 6, TRG has also outperformed the broader European and UK indices by a significant degree over three years and longer, but generally underperformed over one year and less. Given the trust's diversified portfolio, the range of performance drivers is also broad. However, from 30 June 2017 to 28 February 2018, the top negative contributors (including online ad targeting firm Criteo, shopping website Showroomprivé and proton beam therapy stock Ion Beam Applications, together producing a negative return of 2.0pp) had a larger impact on performance than the top positive contributors (including the French Gaztransport & Technigaz, German tech stock S&T and Italian challenger bank Finacobank), which added 1.4pp.

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	(6.5)	(14.3)	(16.5)	(5.2)	5.3	32.0	6.3
NAV relative to EMIX Smaller Europe ex-UK	(0.9)	(5.8)	(5.3)	(3.3)	8.2	20.6	6.1
Price relative to FTSE World Eur ex-UK	(4.5)	(13.3)	(12.5)	(0.2)	25.9	70.6	44.5
NAV relative to FTSE World Eur ex-UK	1.3	(4.6)	(0.8)	1.8	29.4	55.8	44.2
Price relative to FTSE All-Share	(7.9)	(19.5)	(19.0)	(5.5)	33.7	83.9	32.8
NAV relative to FTSE All-Share	(2.4)	(11.5)	(8.2)	(3.6)	37.4	67.9	32.5

Source: Thomson Datastream, Edison Investment Research. Note: Data to end-May 2018. Geometric calculation.

Exhibit 7: NAV total return performance relative to benchmark over five years



Source: Thomson Datastream, Edison Investment Research

Discount: Wider but in line with long-term averages

Having narrowed steadily during a period of exceptionally strong NAV performance, TRG's discount has widened since the start of 2018, and stood at 8.9% (cum-income) at 29 June. While this is substantially wider than the one-year average of 4.2%, it is much more in line with the longer-term averages of 9.5%, 10.6% and 12.8% respectively over three, five and 10 years. The board last bought back shares in late 2016, when the discount to cum-income NAV exceeded 15%.

Exhibit 8: Share price premium/discount to NAV (including income) over three years (%)



Source: Thomson Datastream, Edison Investment Research

Capital structure and fees

Structured as a conventional investment trust, TRG has one class of share, with 50.1m ordinary shares in issue at 29 June 2018. The board may buy back or issue shares to manage a discount or a premium, although following the removal of a hard discount control mechanism (set at a discount of 10%) in 2010, there is no set level of discount or premium at which buybacks or issuance would occur. In the past 12 months, 395,000 shares have been issued (raising £5.0m), and no shares have been bought back. Gearing of up to 30% of net assets is permitted, with a working limit of 15% without board approval, via an £80m overdraft facility with HSBC Bank. If fully drawn, this would equate to 13.5% of net assets. Actual net gearing stood at 10% at 31 May 2018.

Janus Henderson Investors is paid an annual management fee of 0.6% of net assets. A performance fee (amounting to 15% of outperformance) may be paid if TRG's NAV total return outperforms the total return of the benchmark EMIX Smaller Europe ex-UK index by more than 1.0% on a rolling three-year basis. Total fees are capped at 2.0% of net assets. Ongoing charges for FY17 were 0.75%, and a performance fee of 0.70% brought total fees to 1.45%.

Dividend policy and record

TRG invests for capital growth but has historically paid an annual dividend in November (made up of a final plus a special dividend), broadly commensurate with revenue returns. The final dividend has been fully covered by income in each of the last 10 financial years, and the total dividend has been covered in all but one of those years. The final dividend has grown at a compound annual rate of 7.5% over the past five financial years, while the total dividend has grown at a compound 9.1%.

With effect from FY18, TRG is moving towards paying an interim as well as a final dividend, to spread income returns more evenly across the year. So far an interim dividend of 5.0p per share has been paid in respect of H118. The revenue return per share in H118 was 0.69p, but historically income has been hugely weighted to the second half of the year (for example, H117 revenue return

per share was 1.00p versus FY17 revenue of 17.09p), so it is not possible at this stage to forecast the likely total dividend for the year. The move to paying an interim as well as a final dividend may make it less likely that TRG will pay special dividends in future. At end-H118 TRG had revenue reserves of 39.5p per share (34.5p after accounting for the interim payment), equivalent to nearly three times the total FY17 payout of 14.5p. Based on FY17 dividends, TRG currently yields 1.4%.

Peer group comparison

There are four funds in the AIC European Smaller Companies sector, with TRG being the second-largest in terms of market capitalisation. The recent underperformance has caused the trust to fall to fourth place in terms of NAV total returns over one year; returns over three and five years are above average (ranking first over five years), while 10-year NAV total returns are a little below average. Ongoing charges are the lowest in the group, although TRG is the only fund with a performance fee. The discount is currently the widest in the sector, and TRG also has the highest level of gearing. Excluding European Assets Trust (which has a high distribution policy set at 6% of NAV per year), TRG's dividend yield is broadly average.

Exhibit 9: European Smaller Companies peer group as at 15 June 2018*

% 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 (ex-par)	Net gearing	Dividend yield
TR European Growth	526.1	1.9	77.4	157.8	180.0	0.8	Yes	(9.2)	110	1.4
European Assets Trust	447.7	2.7	38.9	98.5	165.5	1.1	No	(1.2)	100	6.3
JPMorgan European Smaller Cos	681.5	14.8	81.0	150.9	215.2	1.0	No	(7.1)	100	1.6
Montanaro European Smaller	153.1	14.5	85.6	103.7	188.0	1.3	No	(8.9)	101	0.9
Average	452.1	8.4	70.7	127.7	187.2	1.0		(6.6)	103	2.5
TRG rank in peer group	2	4	3	1	3	4		4	1	3

Source: Morningstar, Edison Investment Research. Note: *Performance data to 14 June 2018. TR = total return. Net gearing is total assets less cash and equivalents as a percentage of net assets (100 = ungeared).

The board

TRG has five independent, non-executive directors. Audley Twiston-Davies joined the board in 2000 and has been chairman since 2002. Andrew Martin Smith was appointed in 2008, while Christopher Casey became a director in 2010 and is chairman of the audit committee. Alexander Mettenheimer and Simona Heidempergher were appointed in 2011 and 2014 respectively, and are both resident in continental Europe. The directors have professional backgrounds in investment management, accountancy and banking.

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