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Liontrust SF European Growth Fund: Q3 2022 review

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The Fund returned -8.8% over the quarter, underperforming -2.0% from the MSCI Europe ex-UK Index and the -2.4% IA Europe ex-UK sector average (both of which are comparator benchmarks)*†.

After a strong rally in equity and bond markets in July, both sold off aggressively again in August and September.

The market's strong performance in July was aided by the anticipation of the Fed's rate rises peaking in 2023, raising hopes of a soft landing for the economy. However, in August, the Federal Reserve and other central banks repeated that their main concern remains the fight against inflation instead of supporting growth. This, along with hotter-than-expected US inflation reading in mid-September and subsequent 75 basis point interest rate hike by the Fed, were the key drivers of the sharp rise in bond yields and sell-off in stocks in the second half of the quarter.

We do not attempt to forecast or anticipate these moves in macroeconomics. Our focus is resolutely on our 20 sustainability themes that over the long-term should provide strong and stable growth, regardless of the business cycle, and on finding the rare companies that can harness this positive growth and can generate persistently high returns on capital.

Among the top performers over the quarter was Unilever following the announcement of robust interim results. Unilever has sought to become a leader in managing its many ESG impacts; it is not perfect, but has taken leadership positions in palm oil, plastics and emissions. Equally, Unilever has focused on its product portfolio by improving the nutritional profile of its portfolio, divesting some areas and improving others under the Sustainable Living strategy.

The company posted underlying sales growth of 8.1%, driven by strong pricing to mitigate input cost inflation. In addition, the company's guidance for underlying sales growth in 2022 was upgraded from to above its prior 4.5% - 6.5% range, driven by price with some further pressure on volume.

Sartorius Stedim, a leading German bioprocessing equipment and consumables manufacturer, posted a positive gain after reaffirming its guidance in Q2 results. Given the healthy underlying demand in its industry and good order situation, the company confirmed its full-year outlook as well as its ambitious investment program, despite higher inflation and lower Covid-related demand.

Software company Unifiedpost also produced a strong quarter, first jumping on the news that an existing shareholder, Alychlo, was increasing its stake in the company, and then performing strongly after a business update in August. In the update, the company announced that its customer base grew 15% year-on-year in the first half of 2022, to 910,845 customers. The company's consolidated business network expanded to over 1.75 million companies, representing an estimated share of 6% of SME businesses in Europe.

Exposed to our *Enhancing digital security* theme, Unifiedpost is focused on digitising SME documents and processes. The company's focus is on digital invoicing of accounts receivable and payable but it has also added a number of complementary services including identity management, digital payment facilitation and working capital analytical tools. The company has a positive environmental impact in driving digitisation of paper documentation, and societal benefits of reducing incidence of error and fraud, as well as helping to reduce the 'VAT-gap' tax evasion.

Among the weaker performers was GN Store Nord, a global leader in the hearing aid and unified communication markets (professional headset and connectivity), operating under the ReSound, Beltone and Jabra brands.

Shares in GN Store have underperformed over the year after a profit warning relating mainly to the professional headset part of the business. The company manufactures the majority of its products in China which have been unable to ship due to recent Covid-19 lockdowns. The company has stated that demand and the order backlog remains strong but unfortunately it has not been able to satisfy this with supply. The lack of profits has had a deleterious impact on leverage ratio but the company has recently restructured its balance sheet, raising over €500m, with debt and profitability normalising post the China lockdowns.

We recently spoke to the Head of Investor Relations who reiterated the improving supply chain situation and pointed to the previous resilience of the hearing aid market in an economic downturn. Despite the very poor performance, we continue to believe that this is a high-quality business in two attractive markets (high margins, high returns and reliable long-term growth) and is attractively valued for the longer-term prospects.

Netcompany posted a poor set of Q2 results, growing 7% organically despite the guidance of 13-18% for the full year. This poor performance was primarily due to illness amongst its Danish engineering team, cutting utilisation rates of its billable capacity dramatically. In addition, there were a few projects in the Norwegian and Belgian operations which did not go to plan, partly due to those contracts being signed in 2020 and the scope of the projects changing.

We spoke with the company recently on these issues and are satisfied that the illness issue is not systemic in nature, and that it is strengthening the audit process to ensure that project scope changes are accompanied with a revised costing to the client. Despite the poor performance in the first half, the company has retained its full year guidance based on a strong pipeline of projects and stronger than expected performance from the new Intrasoft acquisition. Overall, we retain confidence in our thesis and maintain the position.

Also among the weaker performers in the quarter was Grifols, which is held under our *Providing affordable healthcare* theme. Grifols is a blood plasma manufacturer, and one of a handful of companies trusted to take donations from patients and convert it in a long and complex process into critical life-saving medicines. Given the size and complexity of this process, we see significant barriers to entry in providing such life-saving products to patients.

The first, and ultimately key driver of the company's poor performance, is the nature of the Covid-19 pandemic's impact on the blood plasma industry. The barrier around the long timelines required to collect, process and manufacture high quality healthcare products – from human donations – has become a near-term weakness in a world where everyone was forced to stay at home. This dynamic was further compounded when the incentive of paid blood donation was significantly weakened by US stimulus cheques paid to the broad population. The company has now moved through this dynamic, but the length of the manufacture process (again normally a strength) does mean it cannot achieve the full bounce back in revenues seen in almost any other more 'normal' company through this situation.

The second market worry is around debt. The organisation has taken an excellent (and unmissable) opportunity to acquire another business called Biotest. This makes rational business sense, but the timing of it – during a period of very low revenues / profits – has led to high leverage ratio. We believe this factor, in the context of rising interest rates, is another reason investors have been apprehensive. We have checked the covenants attached to the debt and do not believe there is a significant dilutive equity event coming, with leverage normalising in the next 12-24 months.

As a family run business, this organisation has significantly longer-term time horizons than most of the market. Its market communication is not the clearest but in our view it does make sensible long-term decisions – as evidenced by the strong long-term free-cash flow growth and total shareholder return generated prior to Covid. The combination of the points discussed above, however, provides the market with multiple reasons to be worried in the short term and no perceived reward in the shorter term either. However, we think the long-term upside for patients and shareholders is significant.

In terms of portfolio activity, we initiated a position in Scandinavian insurance company Tryg, which provides property & casualty (P&C), or non-life insurance to businesses and individuals. Held under our *Insuring a sustainable economy* theme, the vast majority of Tryg's insurance portfolios is providing accident cover. It also

has elements of health insurance within its portfolio in child and adult insurance, as well as workers' compensation products.

Vestas Wind Systems was another new addition over the quarter. This Danish firm, one of the three main players outside of China, is the quality leader in the supply of wind turbines globally, which are key to the transition away from Russian gas and fossil fuel dependency. Vestas' strategy to shift away from *just* turbine manufacturing towards turbine design, optimising connection to grid to yield highest cashflow and profitable service revenue look set to help it grow profitability for the next decade and beyond.

In terms of sells, we exited Zur Rose, the Swiss-listed online pharmacy which operates across Europe via its DocMorris brand, with the German market – valued at over €60 billion per annum – appearing to present a huge opportunity following a change in legislation which mandated the use of digital prescriptions. However, Zur Rose's share price has suffered in 2022 due to a delay to the rollout of the new digital system, as well as the general trend of technology-focused businesses suffering from higher discount rates amid the market rotation towards value stocks. The position was placed under review earlier this year as the regulatory backdrop shifted, before it was exited in Q3.

We also sold our long-term holding in Axa, the large European insurance company. Axa was one of the Fund's strongest performers in 2022 and a position which we had increased in 2020 due to attractive valuations. We sold the position to fund our new position in Nordic insurer Tryg which has a higher return on equity and a stronger growth rate.

Finally, we exited another long-term holding in Assa Abloy. This has been successful holding for us, with an excellent management team consolidating the lock and digital entrance market. However, we believe that the valuation does not reflect the reduced opportunity for market consolidation and potential for a slowdown in the residential construction market. We used the proceeds to fund our new position in Vestas.

Discrete years' performance*, to previous quarter-end:

Past performance does not predict future returns

	Sep-22	Sep-21	Sep-20	Sep-19	Sep-18
Liontrust Sustainable Future European Growth 2 Acc	-34.4%	24.1%	16.9%	6.0%	-2.7%
MSCI Europe ex UK	-12.8%	20.9%	-0.5%	5.8%	1.3%
IA Europe Excluding UK	-16.1%	22.4%	3.1%	2.2%	1.9%
Quartile	4	2	1	1	4

* Source: FE Analytics, as at 30.09.22, primary share class, total return, net of fees and income reinvested

For a comprehensive list of common financial words and terms, see our glossary at:

Key Risks and Disclaimer

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