Contactus@
ausbil.com.au

Ausbil Investment
Management Limited
ABN 26 076 316 473
AFSL 229722
Level 27
225 George Street
Sydney NSW 2000
GPO Box 2525
Sydney NSW 2001
Phone 61 2 9259 0200

The changing of the Guard: New opportunities in global small caps with rate stabilisation

Research & Insights

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2022 was a rough-and-tumble year for equities across the spectrum in the great monetary stabilisation. The rapid rise in interest rates to combat high and stubborn inflation saw a swing in the sectors offering the most compelling earnings outlooks in the marketplace. One of these is European Industrials. Ausbil's Global Small Caps team talks us through an example of the companies showing earnings growth potential in the current environment.

5-minute read

Key points

- Changing of the guard as niche industrials companies are expected to outperform the high-tech beneficiaries of the last decade's low inflation and low-rate environment.
- High quality industrial businesses are expected to perform well versus the wider market as interest rates and inflation remain higher and pose a headwind to expensive growth companies.
- Key themes of China reopening, decarbonisation and onshoring provide a strong demand environment for European and US industrials.
- The Ausbil Global SmallCap Fund (Fund) focuses on quality companies with unrecognised growth potential at attractive valuations.
- These companies, like Andritz in Europe, are expected to benefit from the key themes currently driving markets.

Tobias Bucks
Portfolio Manager -
Global Small Cap

Simon Wood
Portfolio Manager -
Global Small Cap

Joseph Kim
Equities Analyst -
Global Small Cap

Q: What are European Industrials and why are they looking interesting?

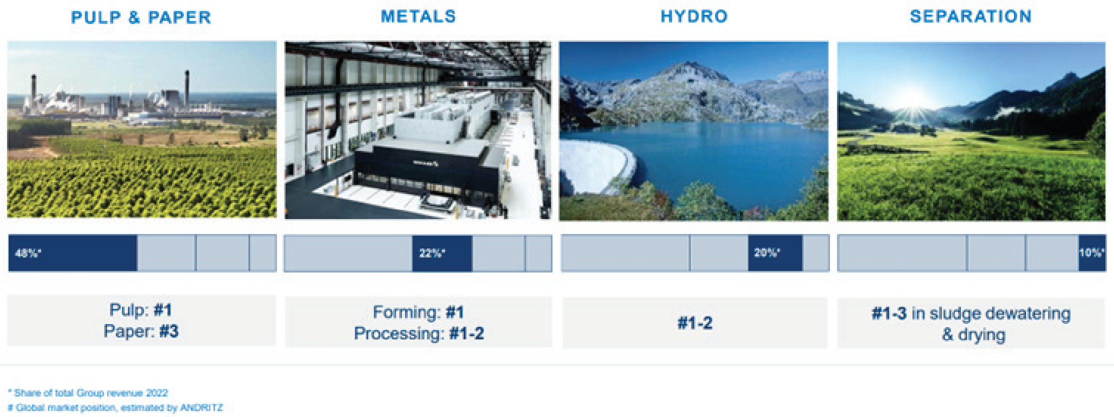
SW: The European Industrials market represent some of the highest quality industrial companies in the world, focused on a wide segment of the market including but not limited to industrial automation, electrical equipment, building products, airlines and logistics, and industrial machinery (including technologies required for decarbonisation and renewable energy).

Several characteristics currently make this market look very appealing. Firstly, the reopening of China after the strict COVID lockdowns and the recovery of emerging markets more generally are providing a strong demand backdrop. This can be seen in the strong recovery in Chinese economic data recently. Secondly, valuations look very attractive. Many European Industrials are trading on significant valuation discounts to the wider market and their overseas competitors in Asia and the US. Thirdly, the ongoing focus on decarbonisation and renewable energy from investors and governments creates further demand for key industrial products and services. Fourthly, and finally, many of the European Industrials have been improving their manufacturing efficiencies over many years.

Q: Can you give us an example of a company that captures this thematic?

SW: Andritz is a European engineering and technology company offering industrial machinery, equipment, and services for a wide variety of global industries. The company is headquartered in Graz, Austria and employs over twenty-nine thousand employees at nearly 300 sites globally. Andritz is a niche leader in hydroelectric turbines and systems, pulp and paper process equipment, metal working fabrication machines and biofuel processing plants, as illustrated in Figure 1.

Figure 1: Diversified across key decarbonisation, renewable energy and recycling markets



Source: Andritz reports.

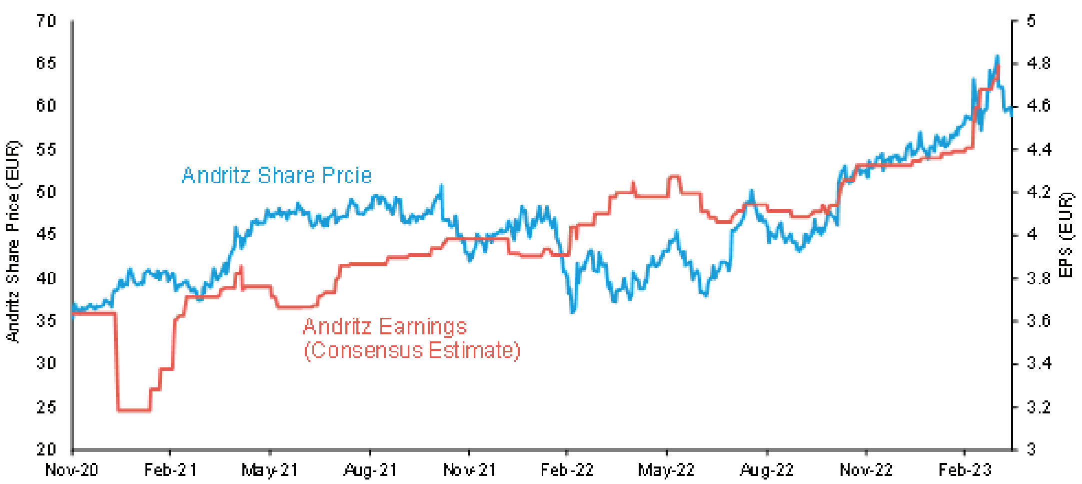
Q: Why do you like this company?

SW: Andritz is heavily exposed to some of the key themes that we believe are driving markets, including decarbonisation and renewable energy alongside the onshoring of manufacturing processes. Hydroelectric generation is currently the largest global source of renewable energy, with significant generation in the Emerging Markets specifically Brazil and China. Andritz is one of the global leaders in this field, providing large scale turn-key equipment, rehabilitation of existing power plants, and small and miniature hydropower modular components. This is an area that the US Energy Information Administration expects to grow rapidly in the coming years, which should benefit Andritz with their market leading position.

Andritz has many other segments that serve critical industries with strong growth prospects including pulp and paper, biomass power plants, metal working, mining and minerals, and recycling and waste management.

The company has an excellent management team with a focus on sustainable growth with strong ESG reporting. Overall, we expect Andritz to deliver unrecognised revenue and earnings growth in the coming years while maintaining a focus on sustainability, as illustrated in Chart 1. Andritz has an MSCI ESG Rating of AA as of 25 April 2023.

Chart 1: The value of Andritz tends to follow earnings growth



Source: Ausbil, Bloomberg.

Q: How does it fit into your strategy for finding unrecognised growth that the market is yet to rate?

SW: The Fund focuses on quality companies with unrecognised growth potential at attractive valuations. We believe Andritz is attractively valued, and the Fund expects that both revenues and margins will improve in the coming years. The demand backdrop from the industries that Andritz services is strong. Margins are expected to improve as industry barriers to entry are extremely high given Andritz's world class manufacturing and design facilities. These two elements are expected to lead to higher earnings growth than is currently forecast by the market. We expect the delivery of this higher earnings growth, and earnings surprise versus the market, to lead the share price higher. Of course, there are risks. China's GDP could slow (though this is not Ausbil's house view), input costs could run higher than expected with stubborn inflation, and there is always potential in companies for execution risk. However, on the balance of probability, the outlook is positive for Andritz.

Q: What kind of themes are you seeking to capture in your portfolio?

SW: We always seeks to hold companies on their own bottom-up fundamental drivers. The Fund is exposed to three key themes at present. Firstly, an improving demand backdrop as China reopens after its COVID lockdowns. We believe companies like Andritz will benefit from the re-emergence of China. Secondly, decarbonisation as the world transitions to more renewable energy. Thirdly, the Fund is exposed to the onshoring theme as several critical supply chains and associated componentry is brought back to the US from China. The Fund holds several semiconductor hardware companies that are expected to benefit from this theme.

Q: How do you apply ESG to your global small cap investing?

SW: Our approach to investing includes an assessment of ESG factors in our investment process and considers these factors in our investment decisions. We will not invest in companies that have known exposure to controversial activities.

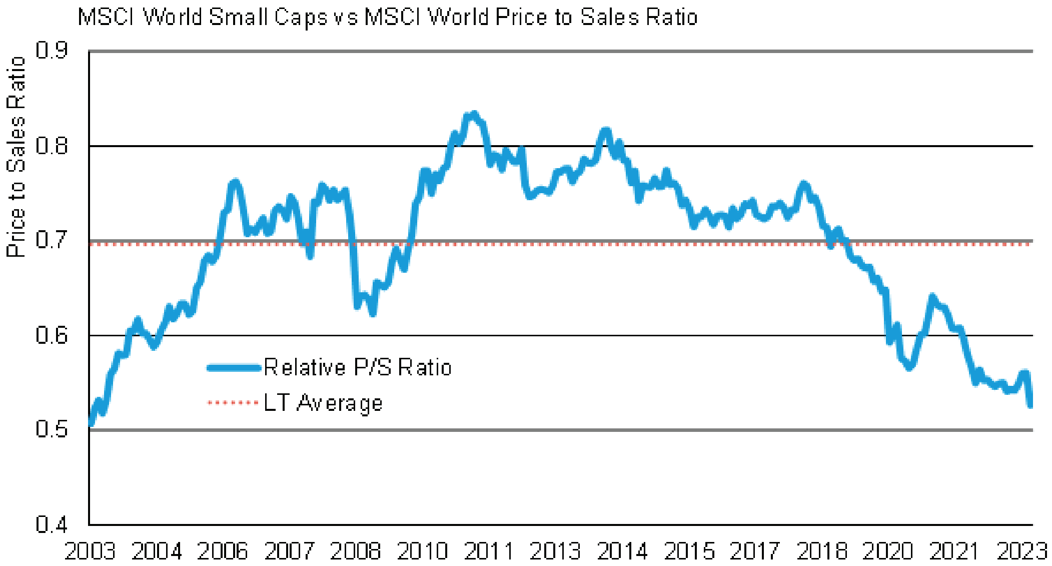
Q: What is the outlook for global small-cap companies?

SW: Global small-cap equities suffered across the board in 2022 largely as a function of the unprecedented monetary policy adjustment which occurred as interest rates were normalised from zero bounds reached in the COVID pandemic. With sustained high inflation, higher interest rates and a fall in growth, small companies were punished relative to larger companies because of the view that they had less pricing power to absorb the headwinds from adverse macro conditions.

We believe inflation is peaking and with recent lower reads, it is responding to the hawkish rate rise implemented by central banks globally in 2022. As a result, we expect interest rates to plateau into a holding pattern. While inflation is still stubborn, as it softens and central banks pause rate rises, this stabilisation is expected to see small companies rebound relative to larger caps as markets see a clearer way forward for earnings growth.

Global small caps are also significantly undervalued relative to global mid and large caps. Global small caps are trading on a significant price-to-sales discount which is comparable to back in 2003, before global small caps subsequently outperformed larger companies, as illustrated in Chart 2.

Chart 2: Relative value of small to large companies



Source: MSCI, FactSet

Given these observations, we expect that with the normalisation of rates, which have masked some of the underlying growth characteristics of global small caps, there will be significant re-rating of unrecognised growth opportunities.

Contact Us

Institutional

Mark Knight
Chief Executive Officer
Phone 0438 307 841
Email mark.knight@ausbil.com.au

Christine Leonard
Senior Manager, Institutional Business
Phone 0414 372 495
Email christine.leonard@ausbil.com.au

Wholesale

Hik Chadirchi
National Manager, Wholesale Clients
Phone 0424 160 728
Email hik.chadirchi@ausbil.com.au

Fawaz Rashid
Research Manager, State Distribution Manager NSW, Wholesale
Phone 0401 830 483
Email fawaz.rashid@ausbil.com.au

Rebecca Morgan
Key Account Manager, VIC & SA, Wholesale Clients
Phone 0407 917 661
Email rebecca.morgan@ausbil.com.au

Andrea McGarry
Business Development Manager, QLD & NT, Wholesale Clients
Phone 0411 465 426
Email andrea.mcgarry@ausbil.com.au

Dimitri Giannaras
Business Development Manager, NSW & ACT, Wholesale Clients
Phone 0431 576 815
Email dimitri.giannaras@ausbil.com.au

Marko Matosevic
Business Development Manager, VIC, TAS & WA, Wholesale Clients
Phone 0431 340 553
Email marko.matosevic@ausbil.com.au

William Orr
Business Development Manager NSW, Wholesale Clients
Phone 0402 620 188
Email william.orr@ausbil.com.au

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Ausbil Investment
Management Limited
Level 27
225 George Street
Sydney NSW 2000
Australia
Toll Free 1800 287 245

Contactus@
ausbil.com.au

ausbil