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Research and Insights

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The compelling opportunity in small companies

The gap between small and large-cap valuations is prompting a closer look at the value of small caps in a portfolio. Small-cap equities are a 'land of opportunity' for a risk-aware active investment strategy. Ausbil's Portfolio Managers, Arden Jennings and Andrew Peros, share Ausbil's unique approach to generating outperformance in these small but growing companies.

Arden Jennings CFA

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Key points

- Ausbil's approach leverages the existing long-term track record of the Ausbil Microcap Fund established in 2010 and Ausbil's 25+ years of experience.
- The Ausbil Australian SmallCap Fund adopts a high conviction, concentrated, actively managed small-cap strategy.
- At mid-2023, the market was offering a compelling opportunity for small-cap investors, with small caps trading at a 21% discount to large caps and a whole standard deviation from their long-term average.
- Differentiating factors include macroeconomic expertise, capability to invest in resources, ESG Integration, and a focus on liquid and profitable companies.
- We focus strongly on the sustainability of a company's business model and the appropriateness of its capital structure in our process.
- The Fund benefits from our coverage of both micro-cap and small-cap strategies.
- The application of macroeconomic analysis as a tool to guide and direct our research efforts, together with ESG integration in our investment decisions further reduces risk.

Q: What are the key attributes you look for in a small cap company?

We seek to invest in outstanding ASX listed businesses that are liquid and profitable whilst they are undiscovered, under-researched and under-owned. Identifying these companies early is key to capitalising on their growth prospects. The sustainability of the business model and the appropriateness of its capital structure are of particular importance to us. We focus on quality companies that have strong balance sheets, a high return on invested capital, affordable valuations, and with a board and management we can back. In addition to this approach, we incorporate ESG considerations into our investment decisions, helping to further reduce quantifiable and unquantifiable investment risks.

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Q: What differentiates the Ausbil SmallCap Fund?

We believe combining a macro understanding with our fundamental focus on return on invested capital, with the added risk mitigation that comes through the application of ESG in our process, differentiates our approach. Since the strategy's inception, our small-cap strategy has successfully applied macro guidance to setting portfolios that have been able to negotiate the recent rapid rise in inflation, the energy shock precipitated by Russia's invasion of Ukraine, and the rise in interest rates. This macro intelligence helped us shift our portfolio from growth towards value in order to negotiate this volatility, and then reduce our exposure to small resources companies with the slowing global economy.

Our small-cap investment process begins with intensive company meetings. These meetings also help us assess management and their strategic intention, as well as understand the key earnings drivers structure, strategy and potential growth. We lean on the sectoral expertise of Ausbil's Equity Research Team and the ESG Team whose analysts maintain sector coverage with in-depth proprietary company models that offer peer review over and above the top-down bottom-up assessment our team undertakes for each company. Our in-house natural resources expertise positions us to leverage major opportunities across this segment of market that other ex-100 strategies miss. We apply Ausbil's research team recommendations for the S&P/ASX 100-S&P/ASX 200 sector which are fully covered with active recommendations (representing approximately 75% of the Small Ords benchmark), and stock research and ideas from Ausbil's S&P/ASX ex-200 analysts.

All of this intelligence is filtered through our proprietary BOSS (Business Operations Sustainability Score) model, which augments the success we have achieved with the Ausbil Microcap Strategy. The BOSS model for the Australian SmallCap strategy incorporates analyst conviction scores across a range of fundamental analysis data points to provide an additional tool for idea generation and stock selection in a systematic way based ultimately on expected return on capital. To this, we add a strict liquidity focus that ensures we can enter, exit and position size our holdings to minimise market impact and further mitigate liquidity risk for unitholders.

Ausbil has active alpha generating strategies across the market-cap spectrum. This gives us early and intimate knowledge of companies as they graduate through the indexes with growth. Our ex-100 strategy benefits this way as the best companies that graduate from our MicroCap strategy are ready, in many cases, for a fully informed investment by our ex-100 strategy when they shift up indexes. Recent successes for Ausbil in this regard include Afterpay, IDP Education, Lynas Rare Earths and Allkem.

Q: Is ESG important to you?

Yes, Ausbil has integrated ESG across our investment strategies including in our ex-100 strategy. We believe the inclusion of ESG in the investment process, supported by well-founded ESG research and engagement, can improve our ability to identify mispriced stocks, better assess a company's earnings sustainability and, ultimately, lead to better-informed investment decisions. A focus on ESG issues has supported our engagement activity for positions in companies like Afterpay, Uniti Group and Johns Lyng Group.

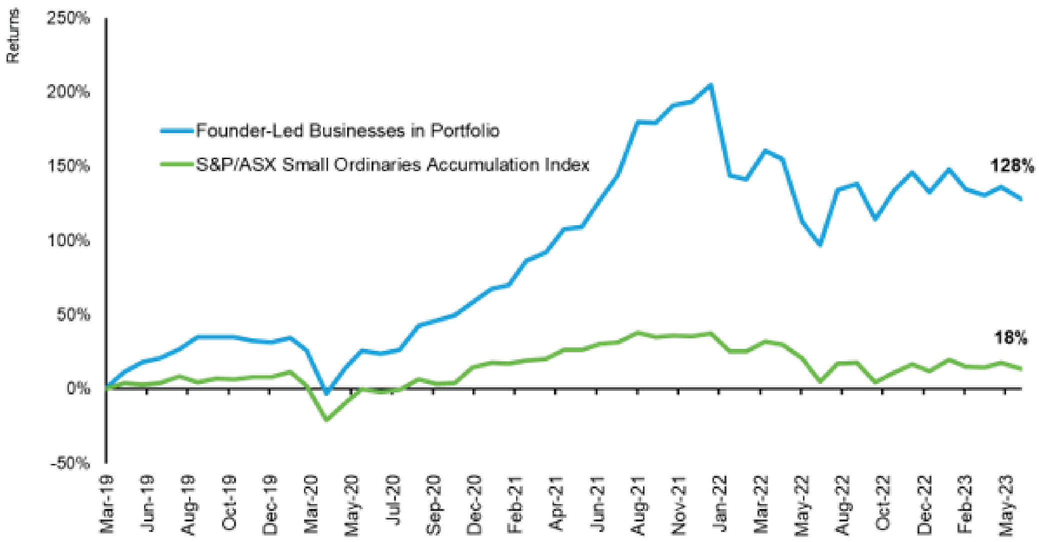
Q: How important is it to you that the companies you invest in are founder led?

In our experience, founder-led businesses generally outperform. When we look at the 15 founder-led businesses which we currently hold in our small-cap strategy over the last 4-years (capture pre and post COVID), as illustrated in Chart 1, these founder-led businesses have outperformed those whose leaders are not founders.

About Ausbil Investment Management

Ausbil is a leading Australian based investment manager. Established in April 1997, Ausbil's core business is the management of Australian and global equities for major superannuation funds, institutional investors, master trust and retail clients. Ausbil is owned by its employees and New York Life Investment Management a wholly- owned subsidiary of New York Life Insurance Company. As at 30 April 2023, Ausbil manage over $15.8 billion in funds under management.

Chart 1: Smaller companies have many more founder-led businesses



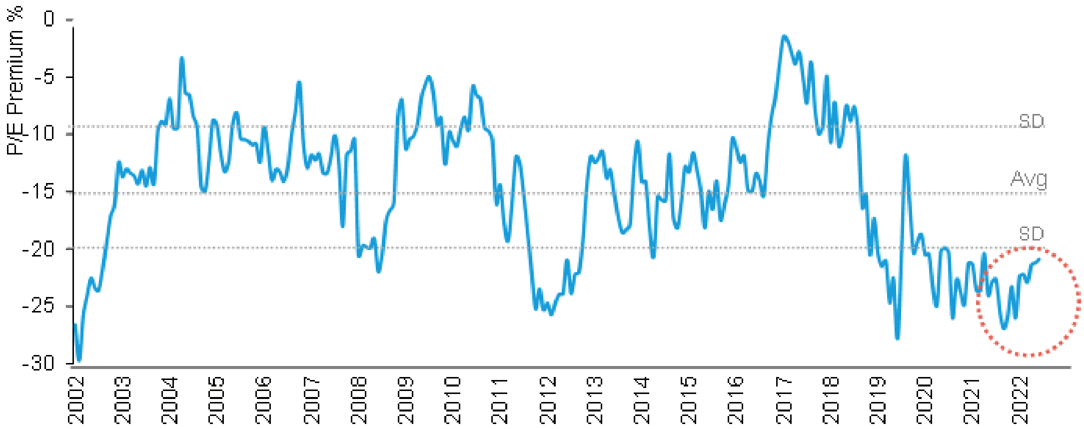
Source: Bloomberg. Total returns calculated from 31/03/2019 to 31/05/2023. Ausbil Founder Led Businesses index calculated as equally weighted average of portfolio holdings as at 31/05/2023.

In founder-led business, there is a clear alignment of interest, or 'skin in the game', that is critical in that incentives tend to drive behaviours. Founders generally have significant shareholdings so they benefit along with other shareholders as the business succeeds for equity investors, not just management. Founders also tend to have a long-term mindset, even if this is at the expense of short-term profits, so long as they believe that these decisions will add positively to shareholder returns. Finally, culture matters to performance. Organisations that are founder-led typically have a stable, consistent yet evolving culture over the long term, and generally one that evolves for the better. You cannot necessarily put a dollar value on the benefit of culture, however a strong company ethos, or reason for being, can drive shareholder value through the value of many working on a common cause.

Q: There has been a large valuation gap between small caps and large caps over the last year. Why is this, and what does the opportunity look like?

The vagaries of 2022, and the impact of rapid rate rises was especially hard on small caps, punishing them harder than large caps for no apparent reason. The impact has been that at mid-2023, the small-cap industrials have been trading at a 21% discount to large cap industrials, well below their long-term average, as illustrated in Chart 2. In fact, small caps are trading a full standard deviation below their 20-year valuation average.

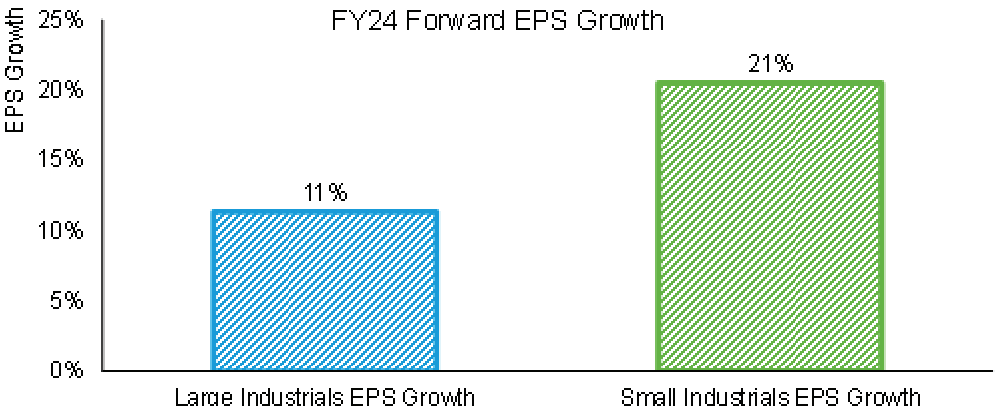
Chart 2: Small vs large industrials: a 21% discount, below long-term average



Source: Goldman Sachs data based on the S&P/ASX Small Ordinaries Index to April 2023, data is forward 12-month P/E.

As investors who focus on earnings and earnings growth as a strong indicator of a stock's worth, we think this discount to large-cap valuations is not sustainable when you compare consensus earnings growth expectations for FY24, as illustrated in Chart 3.

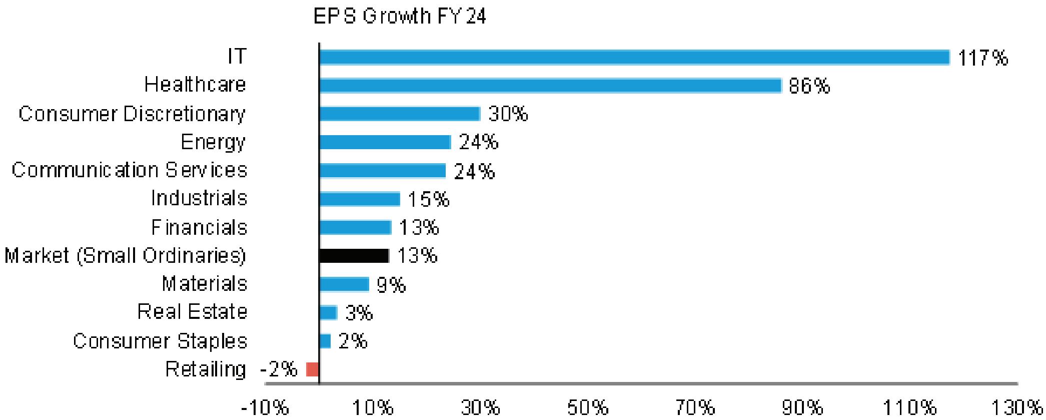
Chart 3: The disparity in EPS growth outlook for small companies compared to large



Source: CLSA calculated as an average of Bloomberg, IBES and FactSet estimates. Industrials exclude Financials, Property & Resources as at 31 May 2023.

Small-cap industrials still offer significant EPS growth of 21% based on consensus outlook, and superior to that being offered by large-cap industrials at 11%. This is offering compelling value to small-cap investors relative to large. The key questions is, where is this EPS growth expected to be in the marketplace? Chart 4 illustrates the consensus view as to where EPS growth is expected in FY24.

Chart 4: Where the market thinks EPS growth will come in FY24



Sources: Ausbil, Visible Alpha for S&P/ASX Small Ordinaries Index consensus as at end March 2023.

After a tough 2022, there is a wide divergence in growth expectations across sectors. This is an opportunity-rich environment for small-cap investors, with quality names in all these sectors, and significant opportunity as small companies begin to rerate on value compared to large caps.

Q: How were you able to successfully navigate a challenging 2022 in Small Caps?

2022 was another volatile year. In short, rising inflation following a reopening of economies post COVID was accelerated by Russia's invasion of Ukraine that triggered an energy shock still impacting markets into 2023. Record low interest rates also meant capital was invested in more speculative assets classes and sectors in a search for growth. With our disciplined approach to valuations, exposure to sectors such as information technology or high growth and interest rate sensitive sectors was minimal leading into 2022. Given that markets were pricing in a scenario of near zero interest rates for a significant period of time, this had unintended consequences on valuations and risk taking. With the rebound in rates and tighter monetary conditions, we have seen the tide go out on many speculative parts of the market and aggressive downward repricing for these assets. We believe this more speculative part of the market still has some volatility to play out. In ex-100 stocks, Ausbil was able to negotiate these challenges with our internal macro guidance towards stocks that benefit from inflation and rising rates, and in our resources and energy exposures given the sharp rise in energy prices and the growing demands for the commodities needed for decarbonisation. In the volatility, we were able to 'higher grade' the portfolio into more favoured positions for better prices, and we added stocks that were less cyclically dependent and possess an element of demand-inelastic pricing power such that they can grow earnings across the cycle. As illustrated in Table 1, the outperformance for the year has reflected this positive positioning and our process focus on quality, liquid and profitable companies.

Q: How has your Fund performed?

Based on the expression of our macro top-down view, combined with our bottom-up fundamental approach to investing in small caps, our returns can be viewed in Table 1.

Table 1: Fund performance (after fees)

Performance to 31 May 2023	Australian SmallCap Equity %	S&P/ASX Small Ords Accum %	Value Added %
1 month	-3.4	-3.3	-0.1
3 months	-2.9	-1.3	-1.6
6 months	-2.9	-2.5	-0.4
1 year	-1.9	-5.8	+3.9
2 years	4.2	-5.2	+9.3
3 years	19.6	4.5	+15.1
Since Inception 30 April 2020	**23.9**	**7.8**	**+16.1**

Performance to 30 April 2023	1 Month	3 Months	6 Months	1 Year	2 Years	3 years	Since Inception
Mercer Survey Rank	18/44	22/44	24/44	19/43	1/43	1/43	1/43

Source: Ausbil, net of fees as at 31 May 2023. Mercer Survey pre fees to 30 April 2023.

Q: What are your preferred stocks right now and why?

Two stocks have captured our interest lately, Imdex and Lifestyle Communities. While this is not financial advice, it helps illustrate the types of companies we think fit the characteristics of our investment approach.

Imdex (IMD) is a leading global Mining-Tech company enabling contractors and resource companies to find and define ore bodies with precision and speed through a range of their products. These include drilling optimisation products, rock knowledge sensors and real time data and analytics. There has been a significant capex underinvestment by resources companies, as they focus on value not volume, therefore depleting their reserves and resources globally. We are attracted to the sustainability of the Imdex businesses model, with its rental/SaaS revenue, dominant market share in core orientation tooling, high return on invested capital and free cash flow generation. The recent acquisition of Devico is highly strategic given it is a leader in directional drilling and the #2 player in many sensor technologies behind Imdex as #1. Headquartered in Europe, the acquisition expands IMD's global footprint and further diversifies the business into higher-quality, and higher margin tools and technologies portfolio. The Fund recently participated in the capital raising to fund the acquisition, adding to our existing position having followed the company for over a decade.

Lifestyle Communities (LIC) is a founder-led organisation, providing affordable, resort style communities in Victoria via a land lease model selling homes at 70-80% of the median house price. LIC is supported by strong industry fundamentals with an ageing population. We liked the sustainability of the business model, supported by capital recycling of development sites, and the sustainable recurring income from rental revenue and DMF revenue. DMF revenue is becoming more predictable and significant as the business grows (and is higher margin). LIC has a strong pipeline of growth with 24 sites owned or currently under development, with sites growing by two per annum, with the ability to expand to three or four new sites per year as need. LIC was initially unearthed as a micro cap that has now graduated into the Ausbil Australian SmallCap Fund.

Q: What about the energy transition and decarbonisation?

Renewable energy and the key commodities that benefit from the electrification-of-things are looking towards years of demand that outstrips supply. Ausbil remains positive on the outlook in key metals given low levels of inventory, support from ongoing economic growth in China, and from the long structural themes of decarbonisation, renewable energy and energy security, and technology-driven changes in how we live, such as the electrification-of-things, and the shift to electric vehicles.

The ex-100 space is replete with small companies that are positioned to capture the drive to decarbonisation. With Ausbil's Global Resources Team, we benefit from specialised knowledge that many ex-100 strategies cannot access. This adds significant alpha potential to the strategy given the size of Australia's listed resources market. We do, however, note that with the rapid rise in rates we have been trimming some of the winners in many of these names and have exited Core Lithium (CXO) in recent months on valuation grounds. We had already exited Allkem and IGO due to their ascension into the ASX 100 (which is a good problem to have given that we had to sell as they became too large for our strategy).

Q: What is the outlook for small companies moving into FY24?

We believe calendar 2023 will be a tale of two halves. The first half, many Australian mortgage holders have faced significant increases in their mortgage repayments as fixed mortgages roll-off into higher cost variable rates. These are expected to place strain on household budgets and discretionary spend as the consumer repositions for these higher debt costs. This impact however may still take some time to flow through as excess savings are drawn down.

Risk remains high across a number of fronts, including monetary policy, economic slowdown, and a weakening consumer. Inflation remains elevated. In a tighter economic environment, the geopolitical risks are pronounced. Escalating tensions in the war between Ukraine and Russia, and Russia's growing distance from the rest of the world remains concerning.

Although the Australian economy is slowing on contractionary monetary policy, we believe Australia's resource economy is well-placed to outperform other developed markets with below-trend growth, but no recession.

While Ausbil's house view is that earnings growth will be hard to come by in FY24, key sectors and individual companies will still offer strong EPS growth opportunities well above consensus. With this in mind, we see ongoing support for earnings growth in quality industrials that exhibit defensive earnings that are less cyclical, and with some relative pricing power. Other sectors include Resources, and in Energy given the shock we have experienced from the invasion of Ukraine. In Resources, we have been invested extensively across the decarbonisation thematic, in copper, nickel, lithium and rare earths. We are avoiding sectors that are cyclical, over-exposed to slowing economic growth, and whose earnings are adversely impacted by inflationary pressures. This includes construction, retailing, some consumer discretionary and housing. We think inflation has peaked. As we see it slow, we will need to consider the post-inflation positioning for our portfolios. In the ex-100 space, there are many names that we expect will experience an element of re-rating in 2023 as rate rises end, and the market stabilises with falling inflation.

In terms of preparing our thinking, today is when we need to be considering what sectors will benefit as inflation falls back, when central banks have ceased raising rates, and looking for the seeds of the next expansion. The complex issue is, when does this occur? Regardless, while we believe earnings growth in 2023 will undershoot the last two years, there are companies with earnings upside that are yet to be appreciated by consensus. There are also quality leaders whose earnings are immune to the vagaries of the cycle. This is where we are seeing the potential for outperformance in FY23 and FY24.

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