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Decarbonisation, AI and onshoring: Global small-cap opportunities

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Research & Insights

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Global small caps in developed markets are offering compelling ways to benefit from the huge thematic changes in the world, including decarbonisation, artificial intelligence (AI) and onshoring. Simon Wood from Ausbil's Global Small Cap team talks us through an example of the companies he believes are showing earnings growth potential from some of the dominant themes expected to shape the world in the coming decades.

5-minute read

Key points

- The world is changing rapidly, with the shift to onshoring, the rapid rise of artificial intelligence, and decarbonisation. These changes are accelerated by ~US$2 trillion in US fiscal stimulus.
- This flood of money is an ideal funding and opportunity source for smaller, innovative and successful companies that may not yet be recognised for their full growth potential, and the future earnings streams they can generate from these seismic shifts in how the world works.
- Global small caps offer exposure to these themes often before the broader investment market has recognised their potential for growth.

Q: Can you describe some of the key investment themes you are seeing in your global small-cap universe?

SW: The rapid move toward onshoring, the expansion of artificial intelligence and data centre demand, and the fundamental shift toward decarbonisation are creating many opportunities for investors. These changes have only been accelerated by the deep fiscal stimulus programs implemented during and after the pandemic to support the economy.

The record global stimulus from governments (fiscal) and central banks (monetary) to help pull the world economy out of recession was so big, and so successful, that the world very quickly found itself rebounding with high economic growth and high inflation. This was much faster than most expected and what has led to the record rate rises we experienced across 2022 and into 2023. While the pandemic may have passed, there is still an overhang of major stimulus spending programs with a specific focus on building and extending America for the future, amounting to some US$2 trillion in future spending.

Some of the key fiscal spending platforms includes the following. The Infrastructure Investment and Jobs Act (2021) is providing US$1.2 trillion in stimulus, including US$550 billion of new federal investment in America's roads and bridges, water infrastructure, economic resilience, internet, and other initiatives. The Inflation Reduction Act (2022) has added US$500 billion in stimulus through spending and tax credits. The CHIPS and Science Act (2022) - CHIPS (Creating Helpful Incentives to Produce Semiconductors) - has added US$280 billion in funding for American semiconductor research, development, manufacturing and workforce development. According to Janet Yellen, Treasury Secretary, "these stimulus programs will lead to enormous investment across the country and are expected to create an enormous number of jobs."

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For investors, particularly in US equities, these stimulus programs are expected to contribute to and complement the already surging investment in onshoring and a renewal of US infrastructure; the rapid growth in artificial intelligence and associated data centre demand; and lastly, the boom in decarbonisation and net zero investment. This really is leading to a manufacturing renaissance in the United States.

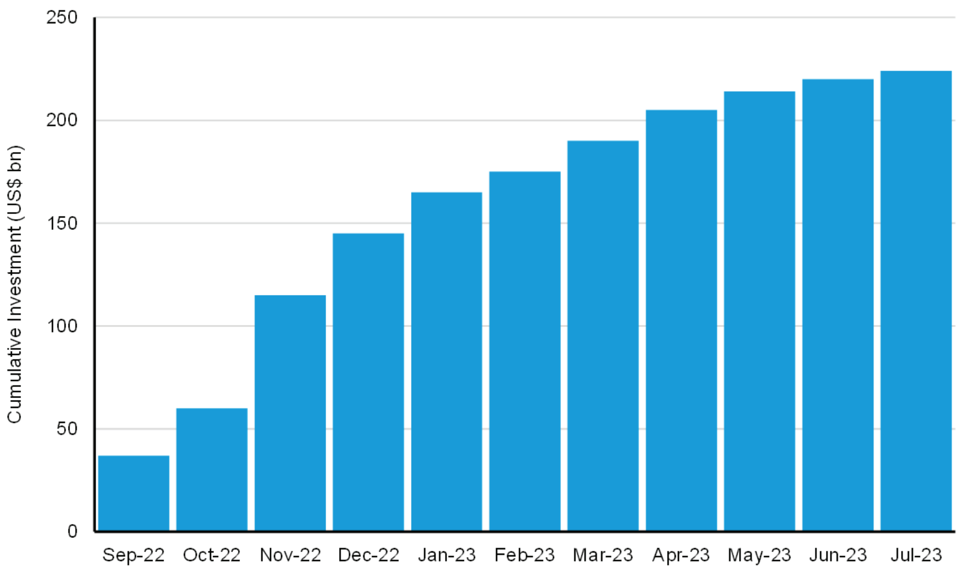
Reshoring or onshoring

Q: Can you explain the phenomenon of reshoring or onshoring as it is is sometimes called?

SW: To understand the shift to onshoring, you have to remember the confluence of issues that surfaced during the pandemic from 2020 through to 2022, and beyond, including geopolitics, national security concerns, energy security and global intellectual property (IP) rights. While the world was dealing with a global emergency through the biggest coordinated fiscal and monetary stimulus in history, a slow breakdown in US-China relations was occurring in parallel, some based on trade and security, and on differences in opinion between these nations on the origins of COVID-19, and some specifically on IP rights. Australia-China relations, and indeed those with US allies in general, had deteriorated. The political response to this was a policy of re-internalisation of manufacturing, or onshoring. The crisis in semiconductor supplies exacerbated the problems in the US, sharpening resolve amongst bureaucrats and politicians to move towards self-reliance on critical inputs. Moving beyond the pandemic with the invasion of the Ukraine by Russia, and the consequent energy crisis, the focus on onshoring broadened to include energy security.

As a result of the change in political sentiment, and now with focused stimulus and support programs in place like the Infrastructure Investment and Jobs Act (2021), Inflation Reduction Act (2022) and the CHIPS and Science Act (2022), investment in US manufacturing has accelerated, particularly in the clean technology and semiconductor space, as illustrated in Chart 1.

Chart 1: The boom in clean tech and semiconductor investment since the announced US stimulus in 2022 (IRA and CHIPS acts) – cumulative investment



Source: FT analysis of company and state press releases and data from fDi Markets, Rystad Energy, and Semiconductor Industry Association.

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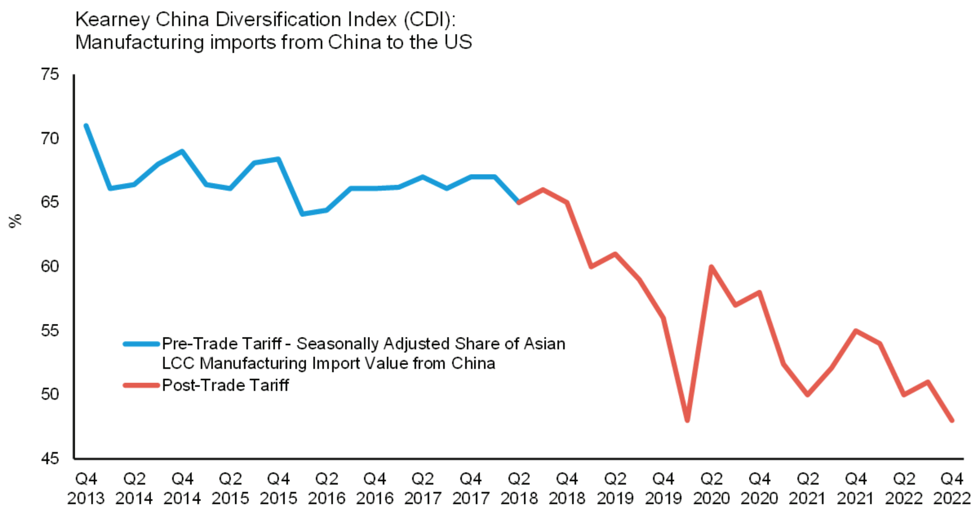
The reshoring phenomenon can be seen from another perspective, that showing China's share of manufacturing imports in the US, as outlined in Chart 2.

Chart 2: China has a falling share of manufacturing imports into the US



Source: Kearney.

In 2013, China accounted for over 70% of manufactured import value to the US as illustrated by the Kearney China Diversification Index (CDI). By 2022, just over a decade later, this had sunk to around 47% of import value, a significant collapse in the share of imports. US policymakers are driving and funding the expansion of US manufacturing and this is creating myriad opportunities for investors.

Q: Can you describe some of the opportunities you are seeing with this onshoring?

SW: We believe we are seeing this impact across a number of key sectors, including information technology, hardware manufacture, construction, and in data centre development. An example is Sterling Infrastructure (NASDAQ: STRL). Sterling Infrastructure is a US construction company with a focus on both residential and non-residential construction. The company may benefit as fiscal spending is directed towards upgrading key US infrastructure like bridges, roads and airports, alongside huge capital expenditure in the construction and expansion of US data centres. Over the last two years, we believe Sterling Infrastructure has refocused its business operations on its more profitable segments, especially E-Infrastructure Solutions. This segment may deliver significantly higher margins for the group and may be a key driver of increased revenue and earnings. This segment specifically focuses on site development for e-commerce, data centre, distribution centres, warehousing and energy infrastructure, areas which may benefit from the recent US fiscal stimulus in infrastructure, jobs, inflation reduction and the onshoring of semiconductor manufacture.

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Decarbonisation

Q: Where are we on the journey towards decarbonisation?

SW: Climate risk is perhaps the peak issue of our era given the existential nature of the problem, and its potential to impact all of life. The key problem is the change in atmosphere, which due to the carbon being emitted, has lost much of its ability to shield the earth from the heat of the sun. The key solution to climate change is therefore decarbonisation, an attempt to reduce the earth's emissions of carbon that cannot be recycled by natural means, such that we reach a balance called net zero by policymakers.

The UN Climate Change Conference in 2021 (COP 26) saw 197 countries agreeing to what has been called the Glasgow Climate Pact, one which supports the goals of the Paris Agreement, but sees countries pull forward the starting line to next year from 2025 (as originally planned) in order to achieve their interim net-zero targets by 2030. COP 27 in November 2022 focused on the implementation and actions needed to meet the Paris Agreement. According to the UN Climate Change Executive Secretary, António Guterres, COP 27 was about implementation of the promises and agreements made at COP 26. It was also about looking at the 'global financial architecture' and how it can be leveraged to support climate risk mitigation, climate adaptation, and help thwart loss and damage. Of the almost 200 countries that had signed the Glasgow Climate Pact, only 24 had presented 'tightened national plans' since COP 26.

The UN is looking for faster implementation and more ambitious policy action and investment to help keep global warming to just 1.5 degrees by 2050. This target is becoming critical and COP27 was pitched as perhaps the last chance to pivot towards policy and action that could achieve this target. In 2023, the UN released a climate report noting that the pledges of 193 Parties under the Paris Agreement could put the world on track for around 2.5 degrees Celsius of warming by the end of the century. The UN is hoping that COP 28, in November and December of 2023, builds on the previous conferences in driving global transformation towards a low-emission and climate-resilient world, fosters ambitious climate action and facilitates implementation.

Structural growth trends like decarbonisation as the world seeks to achieve net zero climate targets by 2050, and the electrification-of-things to mobilise renewable energy and reduce carbon emissions, offers significant opportunity for investors. These fundamental thematic trends will require significant growth in the supply of future facing metals (copper, nickel, lithium, and others), renewable energy, energy storage, transportation that is not dependent on fossil fuels, and for manufacturing and building methods and materials that are sustainable and carbon free.

Q: How is decarbonisation making opportunities for global small caps?

SW: There is a multitude of opportunities amongst global small caps from the shift to decarbonisation, but perhaps one of the most compelling is the shift to electric vehicles (EVs), energy storage, and charging infrastructure. According to the International Energy Agency (IEA), at the end of 2022, there were 2.7 million public charging points globally, of which over 900 000 (55%) were installed in 2022.

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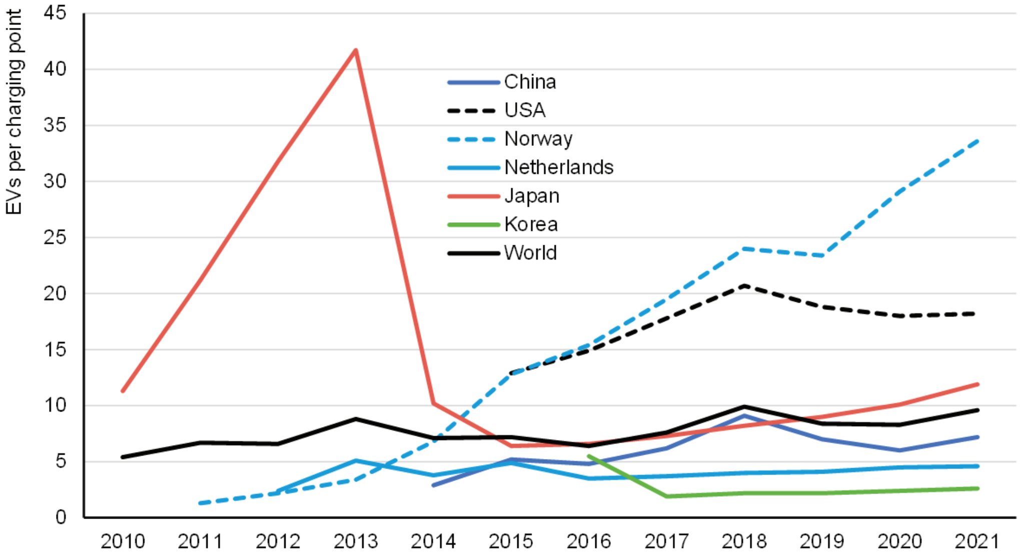
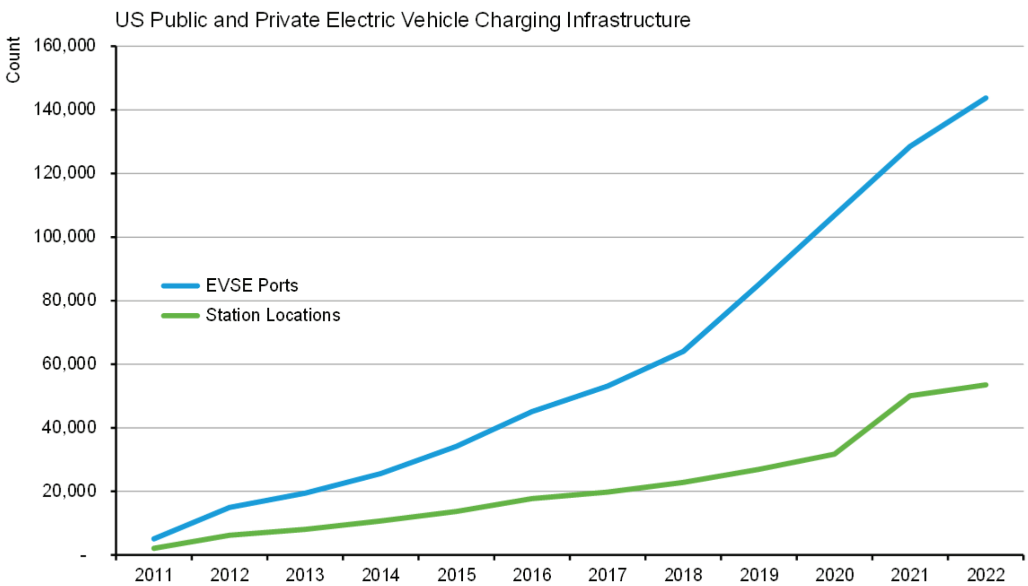
Chart 3: EV charging infrastructure



Source: International Energy Agency, 2021.

Chart 3 compares EVs per charging station across a number of key countries. Of the countries shown, Norway and the US have the most EVs per charging station. Looked at another way, the rapid rise in EV penetration, in the US especially, is driving the growth of EV charging stations and ports, as illustrated in Chart 4. In the US, since 2011, charging infrastructure has risen with a compound average growth rate (CAGR) of 34% for charging stations and 36% for ports.

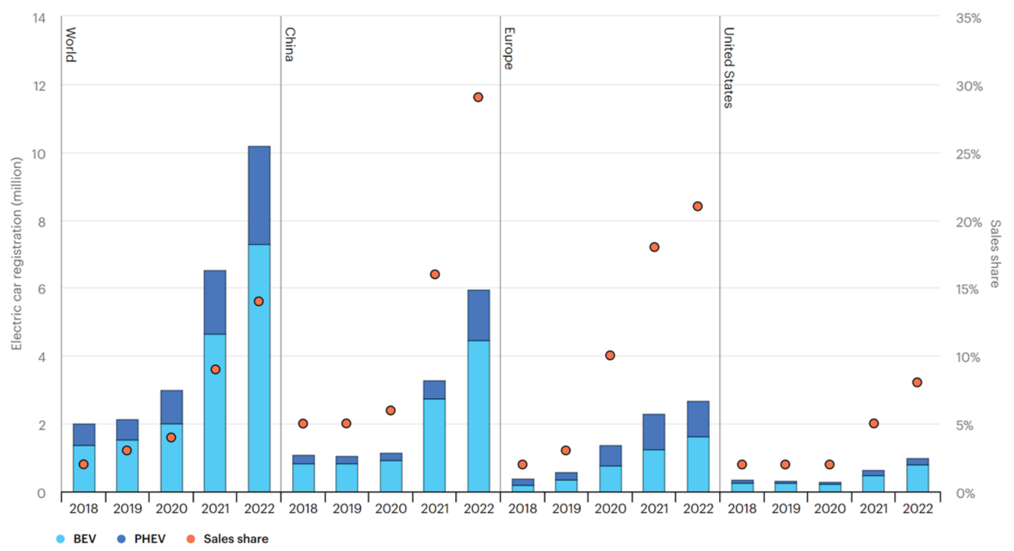
Chart 4: Growth in EV charging stations and ports across the US



Source: Alternative Fuels Data Center (afdc.energy.gov/stations/states), 2023.

The penetration of EVs in US car registrations is growing, but still significantly lags that of other major markets (Chart 5) as the US lags in the overall shift to renewables. The opportunity for investors in this data is the size of the US market, the impact of the inevitable shift to EVs, and the already fast-growing charging infrastructure in place. Geographically, in contrast to Australia with its vast and empty interior, the US is ideal for national EV charging infrastructure that links states to one another from east to west and north to south.

Chart 5: Electric car registrations and sales share, 2018-2022



Note: BEV (battery electric vehicles), PHEV (plug-in hybrid electric vehicles). Source: IEA analysis based on country submissions, ACEA, EAFO, EV Volumes and Marklines, 2023.

Q: Can you describe an example of a small cap that stands to benefit from this rapid growth in charging infrastructure?

SW: An example in our universe is Kempower (HEL: KEMPOWR), a Finnish developer and manufacturer of electric vehicle fast charging units. Kempower was originally founded by Kemppi Group; one of the global leaders in welding equipment. The US Infrastructure Act of 2021 directed US$7.5 billion in investment towards EV charging infrastructure, which may benefit Kempower's plans to accelerate expansion into the US market. Kempower's US manufacturing plant in North Carolina is now expected to be completed by the end of 2023. Kempower has seen rapid growth in its local region of Northern Europe and has expanded further across Europe and into the UK. The company has also won recent contracts in the US and Australia. Kempower are currently establishing a manufacturing base in North Carolina to cater for the strong expected demand in the US market. We believe Kempower's multiple product offering and flexible solutions can give it a strong competitive advantage against its European and US competitors, making it an ideal company to capture the rapid growth in charging infrastructure in the US, and globally.

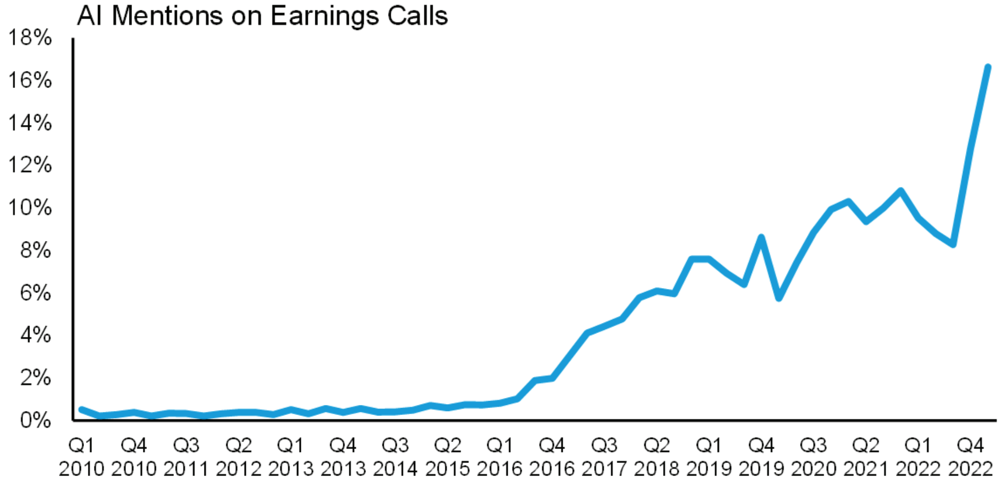
Artificial Intelligence

Q: In what way are you seeing the opportunity in artificial intelligence?

SW: Artificial intelligence (AI) has been around for decades, IBM's Deep Blue, the computer whose development began in 1985 at Carnegie Mellon University in the US, challenged the world chess champion, Gary Kasparov, to six games of chess in 1996, and subsequently lost four to two. Improvements made by IBM saw a 1997 rematch in which Deep Blue defeated Kasparov by winning two games and drawing three. It could be argued that Alan Turing, the English mathematician and polymath, set the ideas of AI into the minds of fellow scientists in his 1950 paper entitled, 'Computing Machinery and Intelligence'. Moore's law, the idea that computer memory and speed doubles each year was exceeded by the actual development of computing capacity, providing the essential capacity for AI to flourish. The path was set.

We have seen AI and its partner, 'big data', rapidly change the world in almost every part of our lives, banking, travel, entertainment, gaming and amusement, health care and many other technological applications that drive our daily communications and experiences. It could be argued that this explosion in consideration and application found its true inflection point in the thinking of the general populace with the November 2022 launch of OpenAI's Chat GPT (Chat Generative Pre-trained Transformer), a large language model-based chatbot. The explosion of broad-based interest in AI from this event is evident at the end of Chart 6, and a watershed in the potential for AI to change the world.

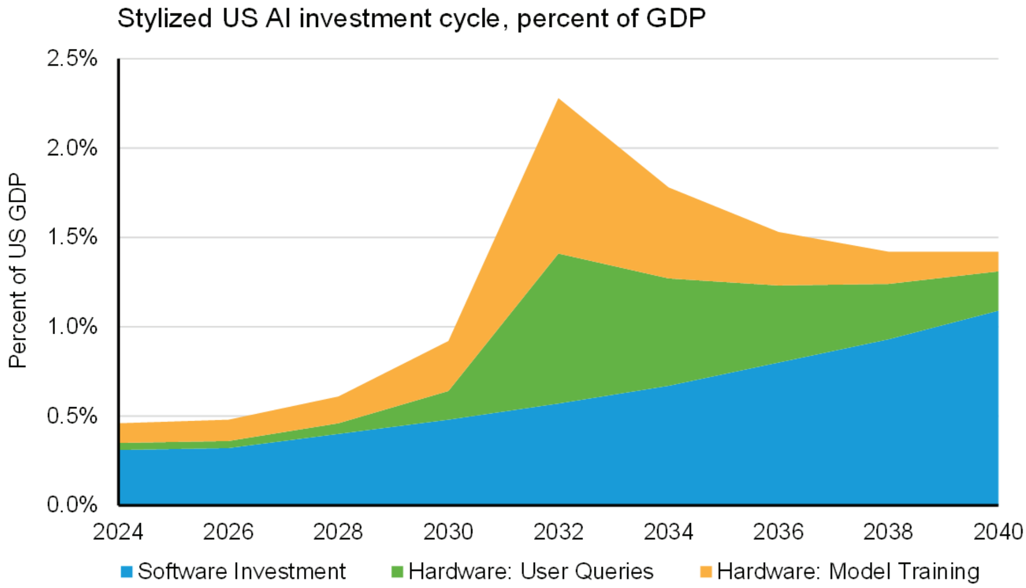
Chart 6: Mentions of AI in company earnings calls



Source: GS Data Works, FactSet, Goldman Sachs Research.

With ChatGPT heralding a new age across the globe, albeit one with its roots established deep in the last century, the potential for AI to be truly transformative has been demonstrated, as has the opportunity for investors. Capital is now truly AI ready, and investment is expected to accelerate rapidly in the coming decade, as Chart 7 shows. According to projections from Goldman Sachs, investment in AI will ramp up to a peak of around 2.25% of US GDP, before settling to a more long-run 1.5% of GDP annually. For some context, the US spent around 3.5% of GDP on military and defence in 2022.

Chart 7: AI investment is expected to accelerate rapidly before stabilising



Source: Goldman Sachs Research.

Q: What types of companies are set to benefit from this explosion in AI investing?

SW: AI is impacting every sector in the market because of its vast application potential, from streamlining manufacturing, to diagnostics, customer interface, decision support, complex sequencing capabilities, and predictive potential that can work in any industry, from mining to finance and entertainment. We are seeing many global small caps that are at the on-ramp and ready to join the AI super-highway. We believe one of these is Vertiv Holdings (NYSE: VRT).

Vertiv is a leading provider of critical digital infrastructure solutions with a strong focus on data centres, offering a comprehensive portfolio of products and services to ensure the availability and reliability of essential applications across a wide range of industries. The increase in capital spending focused on AI and data centre development, supported by the CHIPS Act, may provide continued demand for Vertiv's core range of products.

Vertiv's product portfolio encompasses a wide range of offerings, including precision cooling systems that regulate temperature and humidity, intelligent power distribution units for efficient power management, integrated racks and enclosures for equipment housing, and advanced monitoring and management software for optimising performance and ensuring uptime. They also provide services such as installation, maintenance, and remote monitoring to support the lifecycle of their products. Vertiv serves customers in more than 130 countries, offering tailored solutions and localised support through a network of service centres and partners worldwide. Given the strong demand for data centres and advanced computing, all driven by the AI explosion, we believe Vertiv is well positioned to benefit through earnings growth in the coming years that is likely to exceed consensus expectations.

Q: How would you sum-up the opportunity in global small caps from these three compelling thematics?

SW: Global small caps in developed markets are offering compelling ways to play these huge thematic changes in the world, specifically decarbonisation, AI and onshoring. The huge stimulus programs that have been launched in the US that will drive investment over the coming decade are an ideal funding and opportunity source for smaller, innovative and successful companies that may not yet be recognised for their full growth potential, and the future earnings streams they can generate from these seismic shifts in how the world works.

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