FLASH

European small caps: After the rally, time to focus on the seeds of growth

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For professional investors only

Bill Barker, Head of Small Cap Equities, Pictet Asset Management

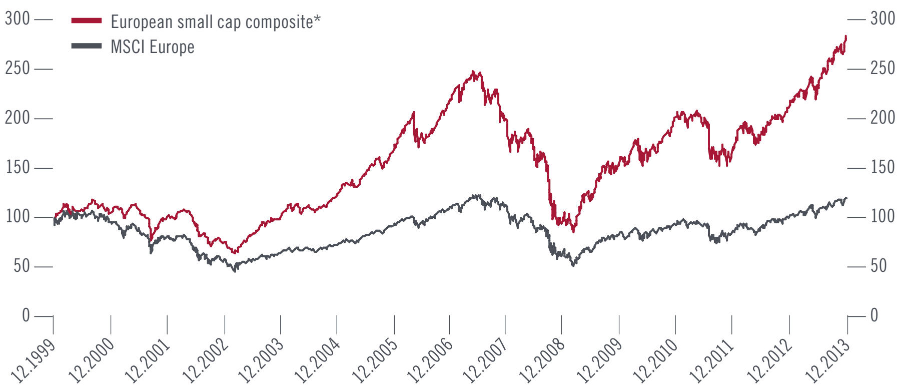
- European small caps are well placed to outperform larger peers.
- Earning upgrades, structural reform agenda and accelerating M&A provide positive backdrop.
- Exposure to growing emerging economies, a weaker euro are also a plus.

A promising asset class for canny investors. After seeing exceptional gains in the past five years, investors in European small caps should focus on carefully selecting stocks that will reap the rewards of structural reforms in the euro zone, a turnaround in the global M&A cycle and a recovery in emerging economies.

Small cap stocks at a global level have been at the forefront of an equity market rally which started in March 2009. The MSCI Europe Small Cap index has risen 138 per cent in the past five years,[1] including a strong 33 per cent advance in 2013. This compares with the wider MSCI Europe index, which has risen 73 per cent since 2009 and 20 per cent last year.

While investors worry the rally may lose momentum as prices creep higher, the investment case for small caps is still intact. It is worth noting that small caps reliably outperform in the long run: European small and mid-cap stock returns have beaten those from their large-cap counterparts in 11 out of the past 14 years.[2]

FIGURE 1 – PERFORMANCE OF EUROPEAN SMALL CAPS AND LARGE CAPS



*European small cap composite results from the linkage of HSBC Smaller European Companies (01/01/1999-01/01/2009) to MSCI Europe Small Cap Euro (01/01/2009-31/12/2013)

Source: Bloomberg, Pictet Asset Management, 31/12/1999-31/12/2013

The next impetus is likely to come from corporate earnings upgrades. Small-caps are expected to deliver earnings growth of 8.1 per cent this year, compared with just 4.7 per cent for large caps.[3]

We think a strong push for structural reform in some parts of Europe would help regenerate economic growth in the region. This would benefit small-cap stocks as they have typically higher exposure to sectors such as industrials, financials and consumer discretionary, which are sensitive to a turnaround in the economy.

But investors need to be more discerning, especially as the sector, with more than 2,700 stocks, is likely to see varying performance as economic fundamentals in Europe diverge.

[1] 01/01/2009-31/12/2013
[2] Bloomberg, Pictet Asset Management
[3] Market cap weighted, Bank of America Merrill Lynch, as of end-June 2014

Spain's "Fördern und Fordern"

In Europe, investors can exploit a growing divergence in economic performance as some of the region's smaller economies begin to find their footing. Spain, for example, is starting to enjoy the fruits from painful structural reforms implemented after the crisis. It has cut labour costs, become more competitive and reduced its trade deficits. Spain's economy grew 0.6 per cent in the second quarter, the fastest expansion since the final months of 2007. The Bank of Spain has upgraded its economic growth forecasts for both this year and next thanks to accelerating internal demand, in particular in business investment. Spain's unit labour costs have fallen 8 per cent in the past 5 years.[4]

From a certain perspective, we can draw a parallel between Spain today and Germany a decade ago. Having faced high unemployment rates for more than a decade, Chancellor Gerhard Schröder's government launched a comprehensive set of reforms in 2003. In order to improve the quality and quantity of labour, the government allowed small businesses to hire and fire more easily, reduced the amount and availability of unemployment assistance under the principle "Fördern und Fordern" (support and challenge) and cut income and corporate tax.

This enabled Germany to shake off its "Sick man of Europe" label, with its economy enjoying record employment today. Spain could follow a similar path – today's reforms should lead to tomorrow's growth, which would favour many small-cap companies. We think Spain's labour market reform will improve the country's competitiveness, which would benefit the small-cap sector, including industrial firms exporting overseas.

Italy, the euro zone's third largest economy, also stands to benefit if Prime Minister Matteo Renzi's reform programme on labour markets and public administration takes hold.

On the other hand, investors need to be aware of structural challenges in Norway and the Netherlands. Despite a strong depreciation of the Krone over the past year against major currencies, Norwegian exports have fallen in the past year. Private investment is quite subdued, while the housing market is slowing down. Dutch domestic demand remains fragile because rising unemployment and the falling level of income mean households are reluctant to spend.

M&A tailwind

Accelerating corporate M&A is a tailwind for small caps. So far this year, worldwide M&A volume is up 67 per cent to USD2.2 trillion, compared with the same period last year. In Europe, volume is up 91 per cent at USD607 billion[5], although it remains below the 2007 peak. We still see a great deal of upside: according to our calculations, global M&A volume only amounts to just around 1 per cent of total stock market capitalisation on a quarterly basis, compared with a peak which is normally at 2.5-3.5 per cent. So far, deals have been concentrated in large caps, but are likely to spread to mid- to small-caps as is typical at this point in the economic cycle. Between 1990 and 2014, 93 per cent of M&A activity in Europe involved companies with capitalisations of between USD250 million and 5 billion.[6]

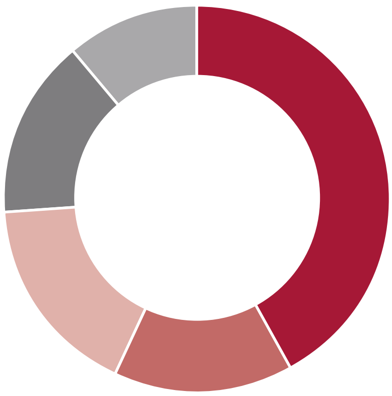
Moreover, large caps have become increasingly cash rich – to the extent that they can buy 70 per cent of the small-cap universe[7] – so they can carry out acquisitions without making a dent in their balance sheet. Expectations that interest rates in the euro zone will stay low for some time also encourage companies to finance their acquisitions cheaply in the debt markets.

[4] European Central Bank, as of Q1 2014
[5] Thomson Reuters, as of Aug 4, 2014
[6] UBS, as of June 2014
[7] JP Morgan

Emerging exposure

What is more, investors will benefit from small caps' exposure to emerging economies, especially by allocating to industrials and consumer discretionary stocks. In the small cap universe, we find a number of companies that are highly leveraged to economic momentum in emerging economies, which is starting to pick up again. To benefit from this trend, we added Finnish firm Valmet in April. Valmet, which develops technologies for pulp, paper and energy industries, generates more than 40 per cent of its revenues in emerging economies. It benefits from strong pricing power thanks to limited competition and a recovery in the developing world, the company's end market.

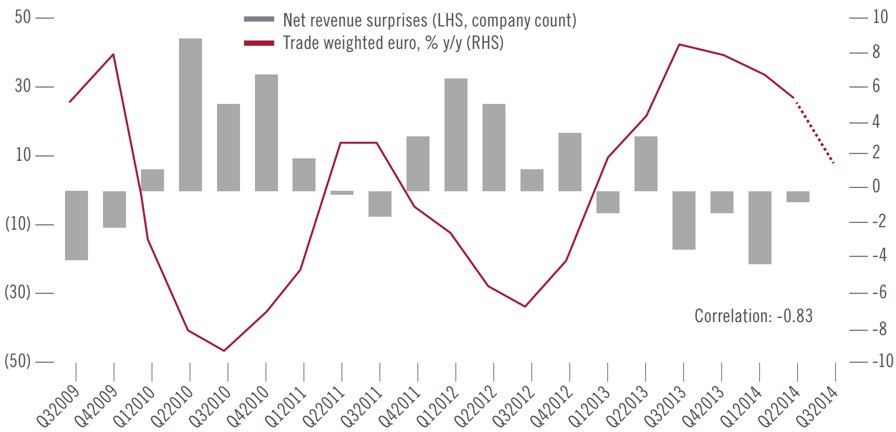
FIGURE 2 – VALMET REVENUES BY REGION, 2013



Source: Company data, Kepler Cheuvreux

A weaker euro is also positive for European small-cap exporters. The single currency has lost 1.3 per cent over the past year against major trading partners[8] as expectations grew that the European Central Bank would ease its monetary policy further. We find a strong link between the level of the euro and revenue surprises – as seen in Fig. 3, a weaker euro tends to lead to positive revenue surprises.

FIGURE 3 – REVENUE SURPRISES AND EURO



Source: Pictet Asset Management, UBS, Datastream

These positive factors should underpin prospects for the asset class, leaving it well placed to outperform larger peers even in this mature phase of the market cycle.

WHY PICTET ASSSET MANAGEMENT FOR EUROPEAN SMALL CAPS?

- **Research-intensive process:** Takes bottom-up earnings-driven approach under a proprietary analytical framework to identify the most attractive long-term investment opportunities with favourable valuation.
- **High conviction investments:** Typically holds 65-80 stocks; the average holding period for each investment is at least 12 months.
- **Experienced team:** The three-member investment team has an average of 17 years small cap investment experience.

[8] Bloomberg, 31/07/2013-31/07/2014)

Pictet Asset Management Limited
Moor House
120 London Wall
London EC2Y 5ET

www.pictetfunds.com
www.pictet.com