MONTPENSIER FINANCE

EUROPEAN MID-CAPS RIDE THE WAVE OF ECONOMY RECOVERY

Strong performance and diversity makes Eurozone mid-caps an obvious choice.

Small and mid-cap companies based in the Eurozone have performed well over the last ten years. Based on 2019 estimates, earnings have grown by 250%, compared with 150% for their large cap peers.

The rebound in the Eurozone economy has helped. European economic momentum is better than in the US. European mid-caps are also more domestically focused than their large cap counterparts, so less likely to be hit by foreign exchange risk. The European small and mid-cap market is also extremely broad, allowing the active management Quadrator Fund team to add real value.

> ‘Volatility can be lower than for large caps’

‘There are around 2,500 stocks in the universe. The diversity allows us to access pure plays in specific areas, like robotics, that can be diluted by other less attractive divisions in larger corporations. A significant number of stocks have low or no coverage, which create market inefficiencies to exploit,’ says Olivier de Royère who co-manages the fund with Marion Casal.

Maintaining a close relationship with small and mid-cap senior management over long periods of time also helps de Royère and Casal build a strong picture of how each company is performing when analyst research is weak.

Larger stocks may be involved in key themes such as technology, they say, but the extent and impact of their involvement is often diluted because of the size of the company and its product range. The variety of small and mid-cap stocks also allows the two managers to pivot between growth and value as conditions dictate, sidestepping concerns about macroeconomic headwinds. And smaller stocks are not necessarily as volatile as people think, even in extreme bear markets like 2008.

‘Volatility can be an issue for a few months if too many non-dedicated investors want to exit. But on small market corrections, volatility can be lower than for large caps. The impact of economic or external events is often less extreme too,’ says de Royère.

To sort through the huge number of stocks on offer, the Montpensier Finance Quadrator team relies on a proprietary investment process to analyse the small and mid-cap market. The first two criteria are growth potential, based on EPS, EBITDA and revenue growth, and valuation compared to the market and historical valuations through the business cycle. The team also looks at visibility metrics, such as debt coverage, consensus dispersion and volatility. The final criterion is qualitative, based on each company’s business strategy. It also seeks out niche players and distinctive expertise that make a company stand out, or for specific cases of restructuring or M&A targets.

‘The Quadrator process is a strong combination of pure stock picking combined with quantitative methods. It helps us generate potential ideas and makes sure we do not miss major market movements,’ says de Royère.

Montpensier Finance managers also have an Environment Social and Governance overlay, using the MSCI Environmental Intangible Value Asset rankings. Red-flagged stocks involved in controversies such as bribery allegations or low-grade company are ignored. Where ESG data is incomplete, if mid-cap disclosures are weak for example, the two managers will make their own assessment.

The Quadrator team also deploys there proprietary

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in-house Montpensier Market Scan that looks at economic momentum by region and country, and monetary policy dynamics. Both help pick up signals of business and consumer confidence, market pricing, consensus and individual stock valuation changes.

‘We don’t have a pre-defined share of the fund allocated on the different criteria in our investment framework but they help us screening stocks when we want to have more growth or value holdings depending mostly on economic momentum,’ says de Royère.

> ‘The Montpensier Market Scan tool helps us to identify the timing for investing in value or growth stocks’

‘The Montpensier Market Scan tool helps us to identify the timing for investing in value or growth stocks or specific regions. The market valuation and earnings growth perspective also enables us to monitor more closely the market exposure of the portfolio,’ he adds.

At present, the Montpensier Market Scan shows that Eurozone small and mid-caps are performing well as the economy improves. Regional disparities are drying up, reducing any need to rely on country allocations. Across the Eurozone, earnings growth was 22% in 2017, with plenty of analyst upgrades and again above large cap trends.

With monetary policy likely to remain accommodative throughout 2018, analysts predict EPS levels could rise a further 10% this year. However, some valuations look expensive after a solid run.

‘Like all stock markets in general, we cannot say small and mid-caps are undervalued in terms of valuation multiples. But interest rates are low and economic momentum is very good,’ says Marion Casal.

The current risk premium on the sector is around 160 basis points higher than its average, making it an attractive proposition against other asset classes, most notably fixed income bonds.

Strong performance has led to changes in the Quadrator portfolio. The team recently sold its stakes in Lufthansa and biopharmaceutical firm Ipsen, both having reached their target prices with limited potential for further gains. Exposure to luxury boat maker Bénéteau and Carl Zeiss Meditec were reduced, again after a good run and a build up of short-term market optimism that may be excessive.

New holdings have filled the gap. Despite parts of the market looking expensive, Marion Casal says the sheer number and diversity of the mid-cap space means there are still plenty of opportunities. Amongst them is Koenig and Bauer, a professional printing firm that is bucking the sector’s structural decline with innovative technology allowing printing on new surfaces such as metal and glass. Piping and tubing manufacturer Vallourec was also added, following the recent rises in the oil price.

A recent rebrand at German telecom firm Tele Colombus should lift cash generation, prompting the Quadrator team to increase their stake. De Royere and Casal are still keen on animal health provider Virbac, despite recent internal problems and a now lapsed ban by the US Food and Drug Administration. Margins remain strong in the sector and revenues are growing as owners spend more on their pets.

Whilst regional outlook discrepancies are dissipating, the team retains its historical bias towards companies listed in France. The portfolio’s exposure to France is around 43%, an overweight when compared to the EuroStoxx Small benchmark.

‘Geographic exposure comes second to identifying good investment opportunities. Our ability to meet with company management on a regular basis is key in the smaller cap segment that is 15% of the portfolio,’ explains Casal.

The two managers see few investment opportunities in Spain, despite the country’s economic turnaround. There is more potential in Italy, even though the macro picture is weaker, particularly in favoured sectors such as industrials, healthcare, consumer and technology where niche market leaders abound.

> ‘Geographic exposure comes second to identifying good investment opportunities’

Marion Casal and Olivier de Royère caution small and mid-cap investors that volatility levels may rise this year and next. He says the market was almost too calm in 2017. The slow withdrawal of European Central Bank liquidity will affect all equity markets, they think, not just those further down the capitalisation scale. Well-run, pro-cyclical stocks should be able to ride out any storms.

‘As usual, it is important to be selective in the small and mid-cap space,’ says Casal.

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