Transcript

The Ideas Exchange

Episode 33: Small cap sector showing signs of recovery

November 2023

Rory Cunningham (00:01):
Welcome to The Ideas Exchange by ASX, connecting you with investment experts, market updates and Ideas. I'm Rory Cunningham, senior manager of investment products at ASX, and this is our regular podcast covering everything from investment trends through to different ways to invest using a variety of products.

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Rory Cunningham (00:46):
Welcome to the Ideas Exchange. I'm your host, Rory Cunningham from ASX. Our topic today is convergence. Over the past few years, there has been substantial divergence between large cap stocks and small cap stocks. And today's guest, Brittany Isakka from Superior Asset Management, believes the opportunity is set for there to be convergence between these two. Brittany, welcome to The Ideas Exchange. Before we get into it, Brittany, I might ask you just to explain to our audience who you are, what Superior does and also I'd be interested to know how you got into your current career.

Brittany Isakka (01:20):
Thanks Rory, and thanks for having me. So, at Superior, we are bottom up fundamental investment firm and we invest predominantly across small and micro cap companies, both in Australia and New Zealand. We also have a mid-cap product and a global small cap fund. So, our small cap fund has a listed investment, actually, on the ASX. Ticker is SEC, the Sphere Emerging Companies fund. And so my role in the team, I'm an analyst. So, an analyst role means you consist of a lot of reading. So, we read annual reports, we read half-yearly reports. Every day there's market announcements, company announcements. We also do a lot of

financial modelling. So, I know some of the competitors out there maybe don't do a lot of modelling, but for us as a team, we model every company we own. So, that includes looking at the balance sheet, looking at the profit and loss and looking at the cashflow statement in order to come up with a valuation for the company.

So, yeah, I started in the industry maybe five or six years ago, always was passionate about money, always passionate about, I guess, numbers so to speak. I did a degree in business and I was like where am I going to go to from here? And I was like, you know what, I'm not a creative, I'm not marketing. I really, really like numbers and I think finance is what I want to do. So, I started sort of on the asset management side and then made my way into equities and now we are looking at underlying businesses. Understanding what drives them is super exciting and small caps is a great place to be for that as well.

Rory Cunningham (02:41):
Yeah, definitely small caps is where there's a lot of excitement and action. So, let's start there. So, micro cap and small cap indices have underperformed over the last 12 months and three years relative to large cap Australian equities. And typically for our listeners we measure large cap Australian equities by their S&P ASX 200 index. So, Brittany, why is this the case? Why have small caps underperformed large caps?

Brittany Isakka (03:02):
Yeah, so you're exactly right. So, let's start at the beginning of 2022, because I think that's a period that's kind of when all things sort of heated up in markets. But since the beginning of 2022, we've seen small caps fall by about 19% and this compares to large caps which are actually up about 4% over that period. And this is just the end of last week. You look at micro caps, it's even worse. So, micro caps are down about 28% over the same period. So, it's quite a big divergence between large and small. The reason for this, and I think maybe some of your listeners out there have heard about this, but inflation, we are in a risk off environment and that's been the case over the last 18 months and it's been brought about by this rapid rise in inflation. The rapid rise in inflation has actually led central banks to raise rates in order to combat this.

So, in Australia April, 2022, interest rates are at 0.1%, so record lows. Today they're at 4.1%, and as we're recording this today, the RBA will make a decision about whether they raise rates again further. So, there's been a lot of sentiment and talk about these rising interest rates and that's sort of roughly the period that smalls have underperformed large. The reason for this is we, as some of your listeners might be aware though, these companies are smaller. Which means that they're typically less diversified businesses and they tend to be more volatile operationally than say your larger companies, the Woolworths of the

world, the commonwealth banks of the world. And then I think another point that maybe investors aren't aware of is the liquidity in the market. And this is really important for small caps. So, when there's a risk off environment, liquidity tends to dry up and this can create really big dispersions between sell-offs and prices from day to day. And so this part of the market we believe should be mean reverting, the liquidity should return once the macro improves and we think this will be supportive for small caps as well.

Rory Cunningham (04:40):
Okay. Within side small caps, are there particular sectors or industries where you're seeing big divergence between say large listed peers and small emerging company peers?

Brittany Isakka (04:51):
Yeah, I think in the small cap space there has been a big dispersions in consumer discretionary and I think probably some of your other guests you've had on here have spoken about the space. Consumer discretionary stocks are exposed to the macro environment, so rising interest rates and higher inflation of that have impacted the consumer in that if you own a home, your interest costs have now gone up. And the cost of living pressures generally, I mean we can look at fuel prices, relatable for your listeners is like, for me, I go out and buy a coffee now it costs me five or six dollars and I remember a couple of years ago it would cost me $3. And I'm just like, man, how does a coffee cost that much money? And don't get me started on alternate milks, because that's whole other kettle of fish. So, because of this, investors, and we've heard this through general conversations, that they are steering clear of the sector. And for us we don't think excluding a sector makes sense. At the end of the day, we think everything has a price and a lot of these names, given some of the sell off in the names, they're trading it single digit, EV to EBIT multiples. So, cheap, we believe, for some of these names.

And when we do invest in the space, we'll look at the balance sheet and we prefer to own these retail names that have a cash balance sheet. Because it means when times get tough, they've got cash to support the trough in earnings. So, yeah, that's kind of what we're seeing at the moment in terms of sectors.

Rory Cunningham (06:05):
And that's, I suppose, an Australian market view. How does it compare to overseas markets?

Brittany Isakka (06:10):
Yeah, so globally there's a similar sort of trend in terms of large versus smalls, but maybe not as large. So, think small caps and we look at the MSCI world index versus large. So, small caps have underperformed by

about 9% since the beginning of 2022. So, definitely not as significant as Australia, but still there is an underperformance. However, maybe what some of your listeners might not be aware of is the global universe given it's global is significantly larger. So, if we look at small caps globally, they range from $500 million to $25 billion USD, so quite large. And the index consists of 12,000 stocks. In Australia domestically small caps are about 200 odd names, so vastly different. And so given the universe is larger, it means you actually can be a bit more particular about what you invest in because the benchmark of the MSCI World Index, the largest stock's actually only 0.2%.

So, if it doubles, it's not going to hurt you. Whereas domestically a stock doubles it's 5% of the index, it's really going to hurt you. So, that's one difference. And then also just the valuation dispersion. So, we've noticed in Australia there's quite a divergence between expensive companies and cheap companies, whereas globally we think the valuation, especially in the small cap, let's not talk about the mega caps of the world, they're different, again, but they trade on half the multiple almost of some of the same quality Australian businesses. And if I can use an example, so we own a company in our global fund called Zukin and it makes and designs software PCB, and it's a competitor for the likes of Altium in Australia. And so in Australia, Altium trades on about a 45 times PE one year forward, whereas Zukin trades on 25 times. So, you can see this equivalent business, same quality, but half the multiple.

And that's just given the size of the Australian market, there's less to buy and people are happy to buy and pay for quality companies. So, sorry, I said a lot there, but I think in summary, global smalls have underperformed similar to [inaudible 00:07:57], but in contrast, the opportunity set is larger and I think you pay less for the same quality business than you do domestically, but we think history is an example. The patent will reverse at some point. So, we think small caps do have to come back and so both globally and domestically there isn't great opportunity in smaller cap into the market.

Rory Cunningham (08:14):
Okay. So, let's talk about small caps coming back. What do you think are going to be the drivers for that convergence and are there already pockets of that that have occurred or are occurring right now?

Brittany Isakka (08:25):
Yeah, so I think we are starting to see some of those drivers occur now. We've touched on briefly inflation. So, early last year inflation was running rampant and it's actually fallen in the last 12 months. That's both domestically and global, and there's some commentary around Australia, the service inflation was a bit sticky last week, but generally it's fallen. And it's not back to central bank's target, but we think this is

a sign that things are easing. And given the inflation story, this is what's driving central bank's decisions around interest rates. So, I think once the market gets comfortable, the rates are close to peaking, I think we will see small caps will perform better. We like to say we're not macro experts, so we can't time when central banks will pause or whatnot, but our expectation is they're close to peaking, so maybe one or two more rate hikes to come, and then if this occurs we should start to see small caps perform well.

We're seeing this just in general, as you mentioned, mortgage rates are higher, [inaudible 00:09:19] spending has fallen, so all these kind of signal that the consumer is now feeling it and maybe the central bank doesn't have to raise so aggressively. So, if we look at past cycles, and you've had Covid, saw how rapidly small caps ran coming out of that. So, if we come out of this recession type environment, we think yeah, small caps will do well out of that.

Rory Cunningham (09:38):
Okay. And we've actually just recently gone through earning season. What did you see out of the reporting from small cap and micro cap companies that I suppose gets you excited or makes you perhaps a little bit nervous?

Brittany Isakka (09:50):
Yeah, so I think in Australia this reporting season, there was a super big divergence between those companies that were expensive or really well-loved, and those that were cheap. Or maybe short term, they're having a little bit of pressure. And so those expensive companies, they tended to get bought up on that earning certainty. People want earning certainty whereas the cheaper companies just continue to get sold off, and it's almost like investors are only looking at the six-month period. They're only looking at the short term, as opposed to considering the long-term outlook for these companies. So, we discussed consumer discretionaries, unloved media names which are tied to advertising and the macro are very unloved. So, there are pockets which are very expensive and then there's pockets which continue to remain loved because of the short-term environment.

Rory Cunningham (10:32):
Let's touch on tech companies for a moment. We've seen real divergence between profitable and unprofitable tech companies, I think in Australia but also globally. What's your outlook for the future of profitless tech companies?

Brittany Isakka (10:45):
Yeah, so that earning certainty piece that I touched on, that includes some of those profitable tech companies. So, some of them are trading on pretty significant multiples because of that earnings and that

certainty, whilst a lot of the unprofitable tech do remain unloved and they are not well owned. I think what we have noticed though over the last 12 months is that some of those tech businesses that were loss making are now refocusing on cashflow and earnings and trying to get to cashflow break even, because they realize the market's no longer paying them to grow at any cost. Debt costs money now with interest rates rising. So, there has been a shift in mentality and I think some of those companies have bounced off their lows last year. So, people are getting excited, they're going to start to earn money and maybe the tide is turning. We don't know generally what the market thinks. Obviously people still own them, but our view is that we don't like to invest in the unprofitable companies, be that tech or otherwise, because at the end of the day we've done back tests and studies on negative cashflow companies, and in the long run it matters and they do underperform. And at the end of the day if they don't start producing they'll go under. So, we avoid that space and yeah, that's why I stay away from them.

Rory Cunningham (11:49):
Now, it would also be remiss of us not to touch on mining and commodities given we're talking about small micro caps. So, it appears if, unless I'm incorrect, that [inaudible 00:11:59] doesn't own a lot, if any, mining exploration companies. Do you want to just talk through that and also your views on the mining sector generally?

Brittany Isakka (12:07):
Yeah. It's definitely one that's been sort of controversial. People love the space, particularly in micros and smalls. I guess for us, as you say, we don't invest in speculative mining companies and they do tend to comprise a lot of the smaller micro cap mining companies in Australia. A couple of reasons for that I guess is as you touched on, they're exploring. So, what that means is that they're going out to find a deposit of, say, copper or gold or lithium and they've found something but they're not sure yet. And that means they tend to burn revenue in cash. And then the companies that do make a profit and have moved from exploration to development, they tend to have shorter mine lives in the small cap end of the market, not always, but they do. And what this means is say they have a five year mine life or a 10-year mine life, which is short in mining terms, they'll go out and explore to try and find more minerals and mines to extend the longevity of the mine.

And this means, again, cash is spent trying to explore, hoping to find something and it can impact value for shareholders. So, we see this misalignment between management, they're incentivized to say there's great prospects, there's lots of mine life here, give us cash, do a capital raise, give us more cash and we'll find something for you. This prolongs their employment and their earnings and their income. But there is definite risks and we've seen this number and number of times again

with small caps. So, if we do invest in the small cap micro or micro cap mining companies, we want ones that they do have a long mine life so that they don't have this risk. They've got good balance sheets, so they've got cash or very little debt. They've got a simple mine plan, so it's open pit, they're not deep underground where there can be a lot of issues operationally and from a cost perspective.

And they operate low on the cost curve, which essentially a cost curve means that they operate low on the cost curve such that if commodity prices fall they can still make a profit. I will mention one company that we do own to get exposure to the mining industry, and that's Deterra Royalties. The ticker is DRR. So, this business owns a 1.23% royalty for the iron ore production of mining area C, which is 65% owned by BHP. So, it's strong royalty income. It's 50 in mine life of a high quality asset, but you get leveraged the iron ore price. So, the benefit of this holding is given its royalty, they don't actually have any cap ex or op ex risk, unlike many miners. So, what that means is they earn really good margins, so 96% EBIT margin and they spit out most of their cash to shareholders. So, has a net cash balance sheet, which we also like. So, it kind of ticks all of our investing boxes, gives us mining exposure, but we don't have many of the risks that come with mining companies.

Rory Cunningham (14:27):
Okay, understood. Let's touch on your research process. Because you've mentioned it a couple of times, I'd be interested in diving a bit deeper and understanding how you go about choosing companies. Let's start with the fundamentals that you look for in a business.

Brittany Isakka (14:41):
So, exactly that. We are fundamental bottom up. So, we don't look at the macro per se. We're not trying to forecast interest rates or inflation. We get the company and look at their financials from a bottom up. So, our core philosophy is centered around three key metrics that we like to focus on and they are finding businesses with good, strong, free cash flow through the cycle. They've got lowly geared balance sheets with a preference for net cash, but they don't always, and that they're trading at a discount to what we think the valuation is through our financial modeling. So, those three metrics stay the same core to our philosophy. They don't change through the cycle. However, we do like to say that we keep an open mind. And what that means is the domestic market is smaller and there'll be changes with companies for a number of reasons.

So, there's inflection points and that might be an asset sale which delivers a balance sheet. It might mean a change in management and a management team we know and have followed in the past. It could be a capital raise again, which then frees up the issues on the balance sheet. So, there's a number of things that can happen quite quickly in

the small cap market, which means we're constantly turning over ideas, we're constantly reassessing stocks that maybe we looked at in the past, that something has changed. So, we like to keep an open mind.

Rory Cunningham (15:47):
Now there's a lot of companies in the small and micro cap space of ASX. Can you describe your overall investment process to find the companies that make it into your portfolio?

Brittany Isakka (15:57):
Yeah, so it's somewhat extensive I guess you'd say, but domestically we use a combination of both the team experience. So, the team collectively has decades of use experience. And we also use screening tools to filter the universe. So, what that means is we apply a screen to the universe on some of the metrics I highlighted. So, we look at return on investor capital, we look at the balance sheet, we look at the cash conversion, we put some of these metrics into Bloomberg or our filter screens, and this helps filter our universe to get the ideas that we think align to our process and our philosophy. And we do this similarly with global, given the size of the universe. And so once we find a new idea that we like, we will go and do the modeling as I mentioned. So, we look at the historic, we forecast out the future, what we think the future earnings will be.

We use a five-year DCF model to do that for all of our companies. We will also then meet with management. So, we have a call with management in the small and micro cap and it's usually easier to do that. They're not large caps, they're not just talking to the big companies with small caps, you get more exposure. So, we'll have a meeting with them, understand their growth prospects, what's their competitive advantage, how they're driving margins, some of these questions. And then we also look at the competitive landscape. We use Porter's five forces, which I'm not sure if your listeners aware, but it's things like threat of new entrants, some of the bargaining power of customers, the industry rivalry. So, we use that analysis to drive our valuation and then finally look at ESG. So, we don't exclude any companies, but we do look at the risks around ESG and factor that into our process. So, it is quite comprehensive.

Rory Cunningham (17:21):
There's a lot there.

Brittany Isakka (17:21):
Yeah. Yes. But I think it's important to do and it means we've got a really good idea about what the company does and what the future of the business looks like.

Rory Cunningham (17:27):
Okay. All right, well let's bring that to life with some case studies. So, can you share with us two stock stories from your portfolio and lay out your investment thesis for our listeners?

Brittany Isakka (17:37):
Awesome. I'd love to. So, I've got two names. One is Supply Network and the ticker is SNL. And it's maybe one that the listeners haven't heard of, but think of it as the [inaudible 00:17:47] for truck and bus parts. So, they supply independent mechanics with replacement bus and truck parts. They have grown their network organically, so they haven't acquired anything. They've expanded their sites over the last decade and they've strategically located them close to their customers. And what that means is they can service customers really quickly and get parts to them very quickly when they need it. And you can imagine trucks and buses are quite ongoing. They need things to be done quickly. There's kind of no pause in maintenance because they need to run all the time. They're on the road servicing consumers. So, what that means is given the quick service and turnaround, they've provided a really good customer experience and it's created really loyal customers.

And as a result, the business has actually compounded revenue at 14% per annum over the last 10 years. And they've actually grown earnings at 20%. So, they've grown earnings ahead of revenue over the last 10 years. And so given this and the network of effects of their branches and strategically locating their assets, they've also grown their rate of return to over 50% in 2023. So, it's been a really impressive story. We think it's quality business and actually despite its great performance, we don't actually think it's well known or well understood by the market. So, it's a business we really like and we've held for a number of years. Now the second one is probably a little bit more controversial, it's a consumer name and that's Harvey Norman. So, ticker is HVN. And unlike Supply Network, listeners probably know Harvey Norman. It's a large home and electronics retail in Australia.

They've got 197 franchise complexes in Australia. And then they also have over a hundred company operated stores globally. So, the share price sold off last year and even into this year given the weaker consumer backdrop. So, this gave us the opportunity to look at the name and funnily enough, it's also just recently entered the small cap index. That was also a great opportunity. What differs maybe from Harvey Norman versus maybe some other retailers is its property portfolio.

It actually has 4 billion worth of property on its balance sheet consisting mostly of its retail property assets. When we entered the name, the market was subscribing really little value to the retailer, maybe 50 to 60 cents per share, and the remainder is the property. So, given it's 4

billion, the market cap today I think is 4.8. So, a lot of value in their stock today is in the property. It's rebounded slightly from its lows, but we think investors are still really concerned about the macro and the short-term picture and housing. But we think looking at the longer term, if you take a longer term view, we're not dismissive of the short-term earnings pressure, but we think it's trading today on seven times next year's EV to EBIT. It's got really strong cash conversion and we think the property backing actually provides somewhat of a protection or a flaw to the share price. So, there are two names we like and own at the moment.

Rory Cunningham (20:21):
Great. Thank you for those examples, and hopefully useful for our listeners to hear about some of the research that goes into coming up with those investment ideas for your portfolio. So, Brittany, I suppose in closing, it sounds like as if there's a good opportunity on the horizon for small caps after a number of challenging years, particularly in light of higher interest rates. Any closing comments for our listeners today?

Brittany Isakka (20:44):
No, I think exactly that. I think there's an awesome opportunity now in smaller micro cap companies for those who do have a medium to longer term investment horizon. And as I mentioned, we have the SEC, which is listed on the ASX for those who are interested in small caps and want to go and have a look. So, yeah.

Rory Cunningham (20:58):
Great. No, thank you Brittany. Thank you for joining us today. And of course, thank you to all of our listeners. We look forward to seeing you next month on The Ideas Exchange.

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