Constructive Activist Investing in Europe:

Opportunities in Small Caps Could Be Most Attractive in 20 Years

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Petteri Soininen, Jimmy Tillotson
European Active Ownership Strategy

The European Active Ownership team believes the investment opportunity in European small caps is possibly the most attractive it has been for 20 years due to:

- Attractive absolute valuation levels
- Discounts vs. global and US indices
- Discounts to European large caps
- Historical precedents
- Record level private equity dry powder
- Reversal of flows

Executive Summary

In this paper, we draw asset allocators' attention to what we believe to be a rare opportunity to capitalise on an unusual set of circumstances leading to a material mis-valuation of European small caps.

Our intention is twofold: firstly, to attempt to explain why this opportunity exists; and secondly, to outline why we think the factors leading to this situation are likely to reverse and, hence, unlock potential opportunities for financial gains.

We believe the opportunity in European small caps could be the most attractive in 20 years, especially for a constructive activist investor, for several reasons:

1. European equities look attractively valued both in absolute terms and relative to their 20-year history; the UK market looks even cheaper;
2. European equities (STOXX 600) are trading at a forward P/E discount over two standard deviations below their long-term average vs. MSCI World, even when excluding the Magnificent 7[1];
3. Furthermore, European small caps are trading at a forward P/E discount two standard deviations below the long-term average vs. European large caps (not seen in 20 years);
4. The long-term positive "Small Cap effect", that European equities have historically witnessed, has seen a material reversal over the last two years, and we believe it will again turn positive as inflation abates and interest rates are cut;
5. In previous cycles, at similar valuation points, small caps have generated strong returns over the subsequent 12 and 24 months;
6. Record high private equity dry powder and attractive valuations provide further optionality for active owners to benefit from M&A; and
7. We see no structural reasons justifying the extreme discount of European small caps.

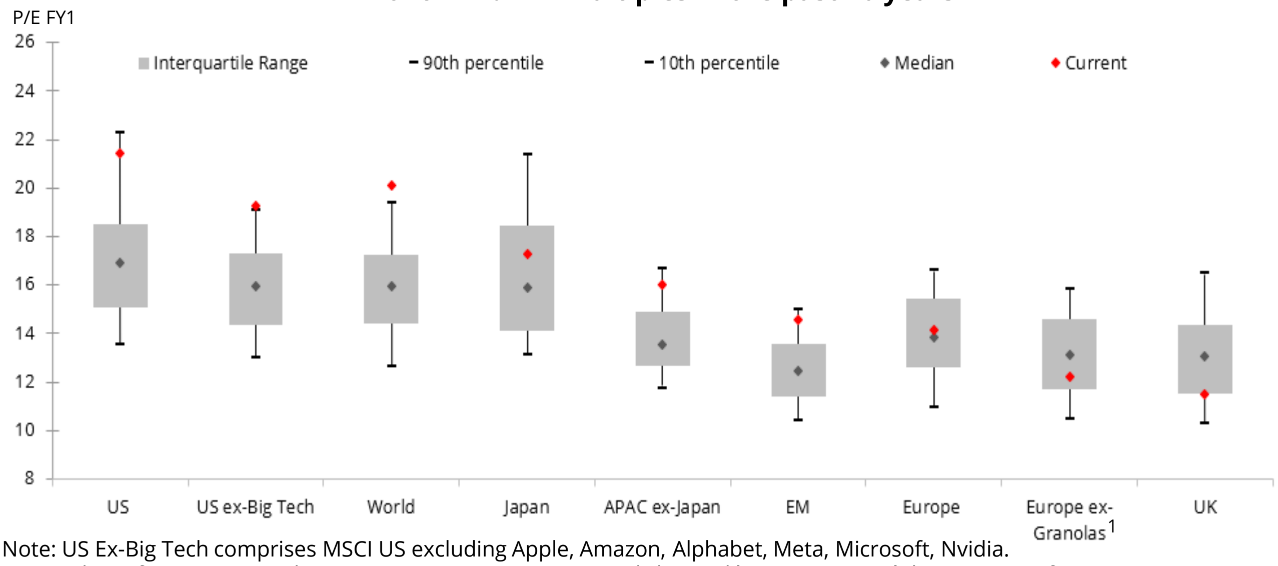
As constructive activist investors, we seek to create lasting shareholder value by making companies better. Not only do we believe European small caps offer a rare opportunity for financial gains, but with a portfolio typically comprising 15-20 high conviction positions, we can focus on what we see as the most attractive opportunities.

[1] Magnificent 7 refers to a group of US stocks comprising Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia and Tesla.

1. **European equities look attractively valued both in absolute terms and relative to their 20-year history. The UK market looks even cheaper.**

In contrast to US equities, absolute equity valuations in Europe do not look particularly elevated. The headline valuation is in line with the 20-year average and, when excluding Granolas[1], European equities are trading at a discount to that average. The UK looks even cheaper with valuation at the bottom quartile of the 20-year history.

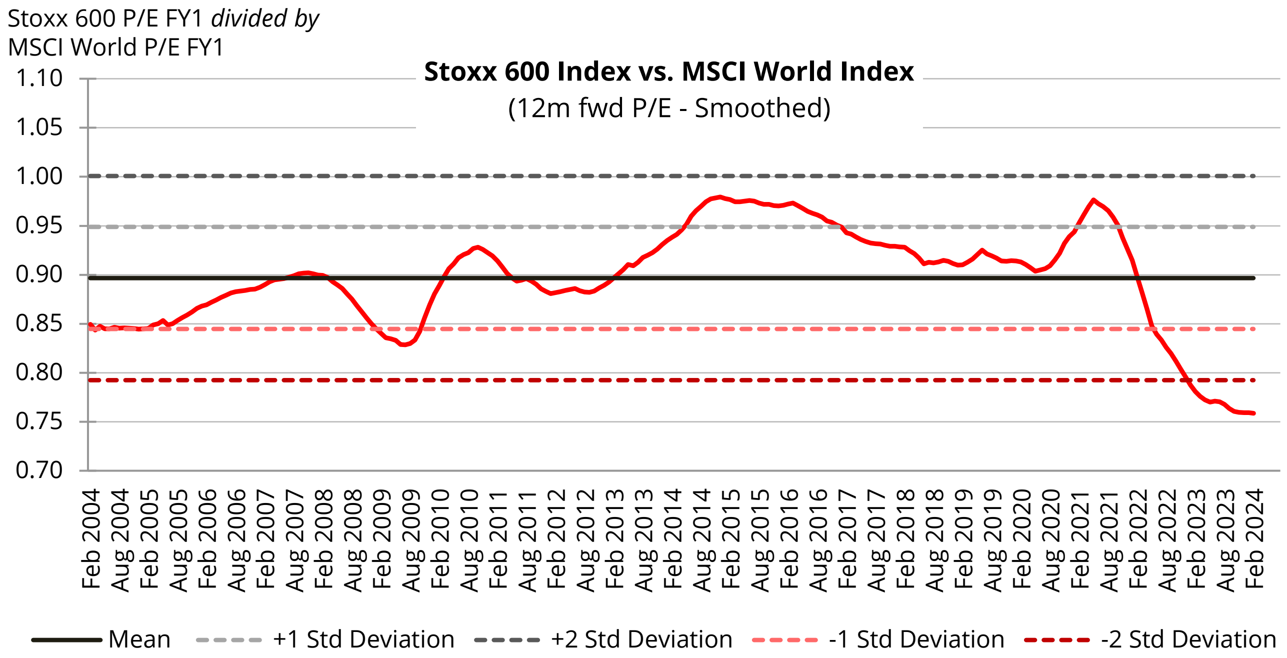
12-month fwd P/E multiples in the past 20 years



Note: US Ex-Big Tech comprises MSCI US excluding Apple, Amazon, Alphabet, Meta, Microsoft, Nvidia.
1 Granolas refers to GSK, Roche, ASML, AstraZeneca, Novo Nordisk, Nestlé, Novartis, L'Oréal, LVMH, Sanofi, SAP
Source: Bloomberg; FactSet; Redwheel analysis, 2 April 2024.
The information shown above is for illustrative purposes. Past performance is not a guide to the future.

2. **European equity valuations are now at extreme discounts vs. global and US indices.**

The chart below illustrates the valuation dislocation on a forward P/E basis, showing that the broader European index, Stoxx 600, is trading at a discount over two standard deviations below the long-term average vs. the MSCI World Index.



Source: Bloomberg; FactSet; Redwheel analysis, 2 April 2024.
Note: "Smoothed" - Analysis takes the rolling average 12-month forward P/E to smooth spikes in data.
The information shown above is for illustrative purpose. Past performance is not a guide to future results.

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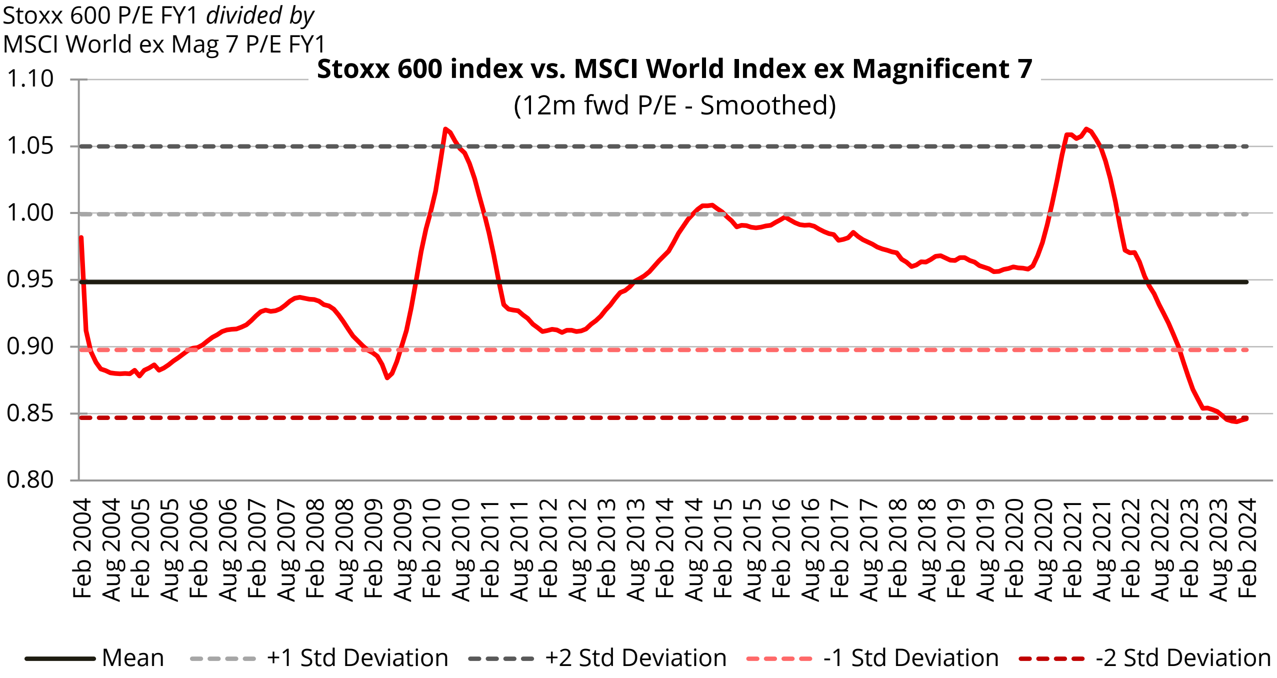
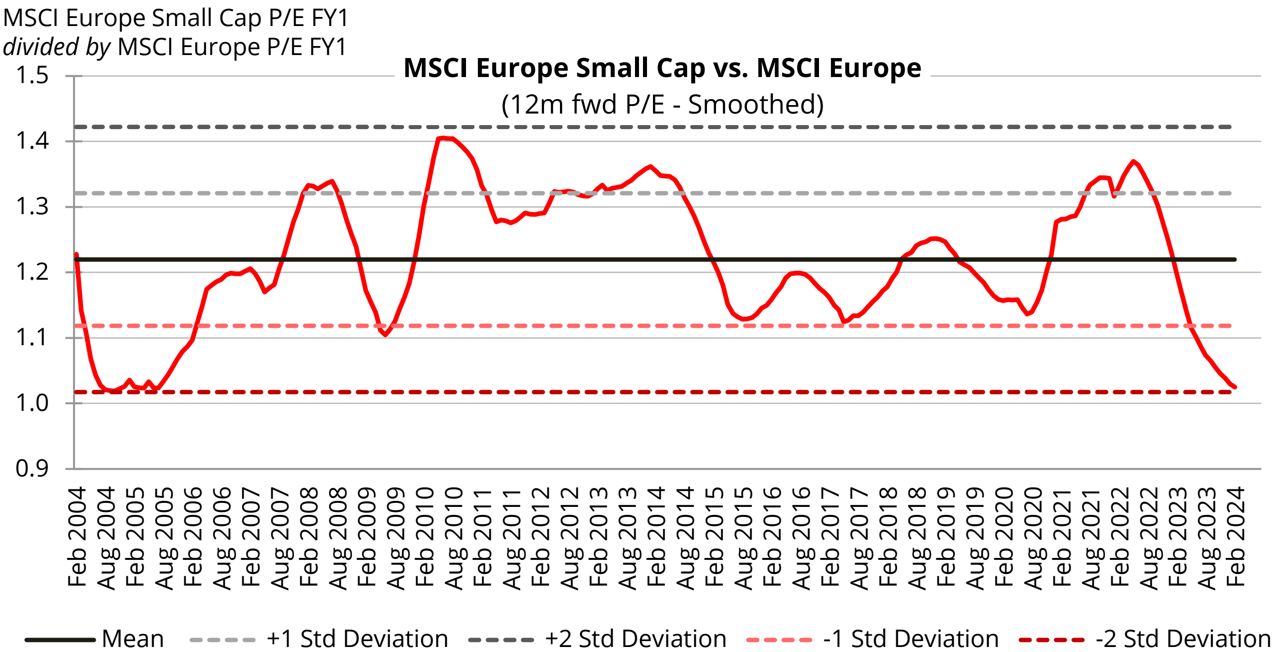
Even when we adjust the MSCI World Index for the impact of the US Magnificent 7 stocks, the Stoxx 600 index is still trading at a discount of two standard deviations below the long-term average, as shown in the chart below.



Source: Bloomberg; FactSet; Redwheel analysis, 2 April 2024.
The information shown above is for illustrative purposes. Past performance is not a guide to future results.

3. European small caps are now even cheaper than European large caps.

As depicted in the chart below, on a forward P/E basis, European small caps are trading at a discount two standard deviations below their long-term average against the broader European market, a level not seen for close to 20 years.



Source: Bloomberg; FactSet; Redwheel analysis, 2 April 2024.
The information shown above is for illustrative purposes. Past performance is not a guide to future results.

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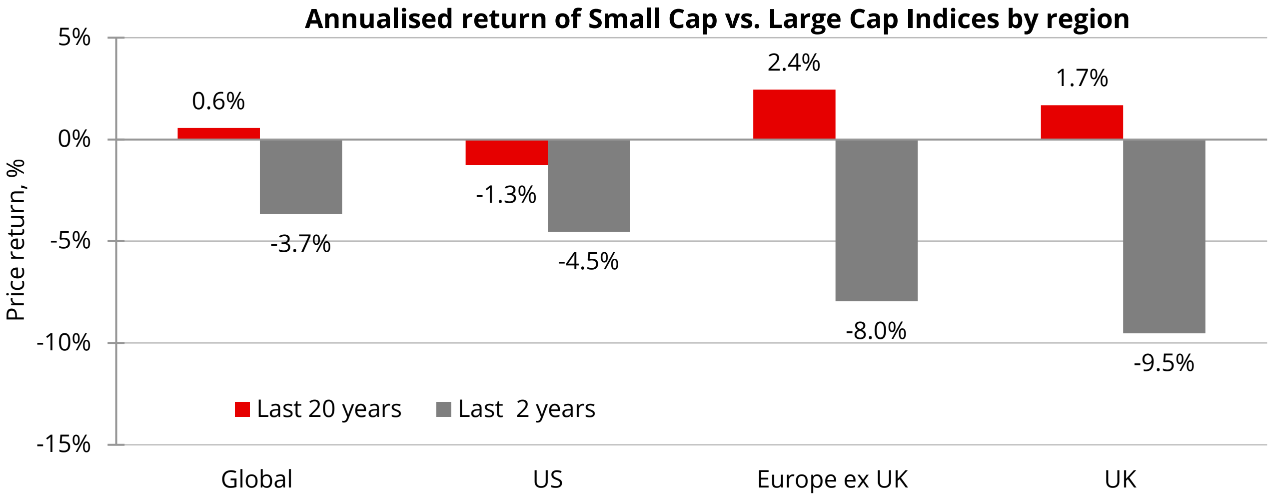
4. **The long-term positive "Small Cap Effect", that European equities have historically witnessed, has seen a material reversal over the last two years, and we believe it will again turn positive as inflation abates and interest rates are cut.**

As shown in the chart below, European (ex-UK) small caps have outperformed European (ex-UK) large caps by 2.4% per annum over the last 20 years but, in the last two years, small caps have underperformed large caps by 8.0% per annum.

In the UK, the reversal of the historically positive "Small Cap Effect" has been even more evident, with small caps underperforming large caps by 9.5% per annum over the last two years.



Source: Bloomberg; FactSet; Redwheel analysis, 2 April 2024.
Note: Data until the end of December 2023.
Past performance is not a guide to future results.

We believe that on average smaller firms can find more growth opportunities than larger companies. Furthermore, we see that in relative terms it is generally easier for companies to grow faster when they are smaller and at an earlier stage of development than when they have grown large and matured.

Smaller companies can find growth opportunities in niche markets and industries, which are too small or otherwise uninteresting for larger companies. Smaller companies can experience rapid growth rates as they capitalise on such opportunities and can scale their operations faster than larger companies. Notably, the one area where several (very) large companies have been growing very fast is the US technology sector, where companies such as the FAANGS (Meta (formerly Facebook), Apple, Amazon, Netflix, and Alphabet (formerly known as Google) and, more recently, the Magnificent 7 have shown strong growth.

Due to their size and potential for higher growth, small cap companies tend to be more sensitive than large cap companies to changes in macro-economic conditions, e.g., inflation and interest rates. Small cap companies are often perceived as more risky than large cap companies. For example, small cap companies may face challenges in accessing capital compared to large caps, especially when interest rates rise rapidly.

Due to their size, small cap companies may also find it more difficult to deal with rapid rise in inflation, as their ability to negotiate input prices and pass through price increases may be more limited than that of large cap companies with more pricing power. By the same token, small cap companies should see the benefits of lower inflation and interest rates faster than large cap companies.

Finally, European small caps have experienced an extended period of outflows as investors have generally shifted capital elsewhere (including private assets). This has led to lower and lower valuations, and it has dried up liquidity compounding the issue. This also works in reverse, and we would think that the attractive valuation levels of European small caps should start to attract investors' attention again, eventually leading to the flows reversing. This should be supportive for the re-emergence of the "Small Cap Effect".

5. **In previous cycles, at similar valuation points, small caps have generated strong returns over the subsequent 12- and 24-month periods.**

Historically, extreme valuation dislocations of European small caps have turned out to be very attractive buying opportunities. We have studied four points in the last 20 years when the small cap valuation deviation against large caps has pivoted (May 2004, March 2009, May 2015 and April 2020). As shown in the table below, small caps have generated strong absolute returns (apart from 2015) in the 12- and 24-month periods following these pivot points, and they have outperformed large caps by a significant margin in all periods.

Performance of MSCI Europe and MSCI Europe Small Cap 12m & 24m after peak deviation

Pivot Date	**01/05/2005**		**31/03/2009**		**31/05/2015**		**30/04/2020**	
Deviation vs Mean	-2.0		-1.2		-1.0		-1.0	
Performance post pivot	*12m*	*24m*	*12m*	*24m*	*12m*	*24m*	*12m*	*24m*
MSCI Europe	30.1%	48.4%	48.3%	54.8%	(13.9%)	(3.0%)	27.3%	32.4%
MSCI Europe - Small Cap	46.2%	87.3%	78.7%	116.9%	(1.9%)	12.0%	62.4%	34.5%
Small vs Large	**16.1%**	**38.9%**	**30.4%**	**62.1%**	**11.9%**	**15.0%**	**35.1%**	**2.1%**

Source: Bloomberg; FactSet; Redwheel analysis, 2 April 2024.
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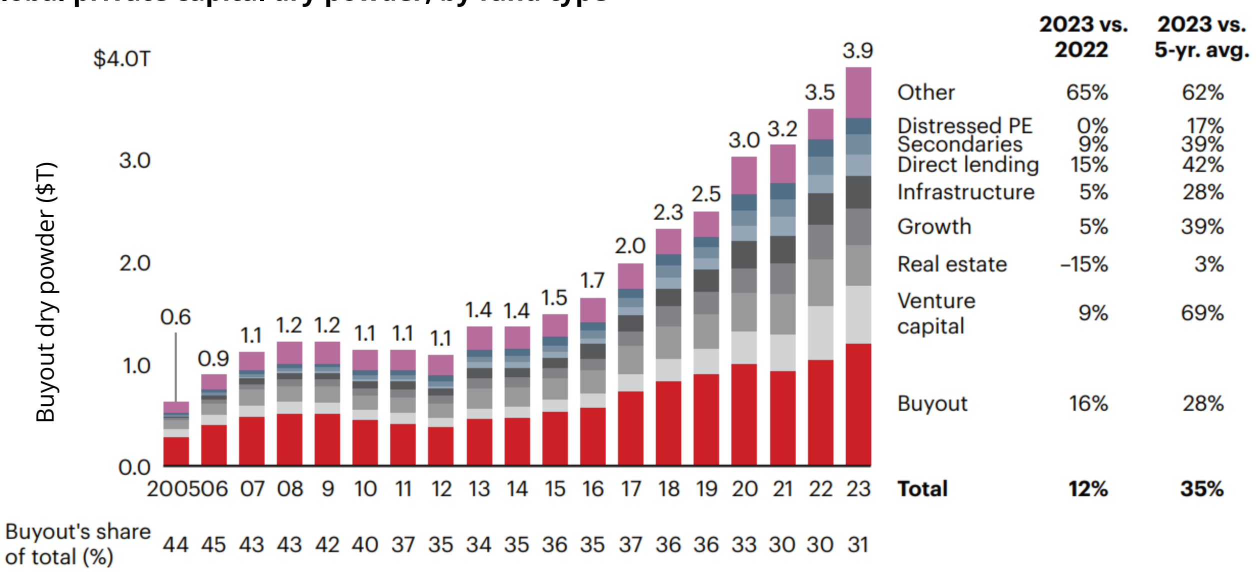
6. **Record high private equity dry powder and attractive valuations can provide further optionality for active owners to benefit from M&A.**

As shown in the chart below, private equity dry powder has rapidly increased in the last ten years and is today at a record high of $3.9T.

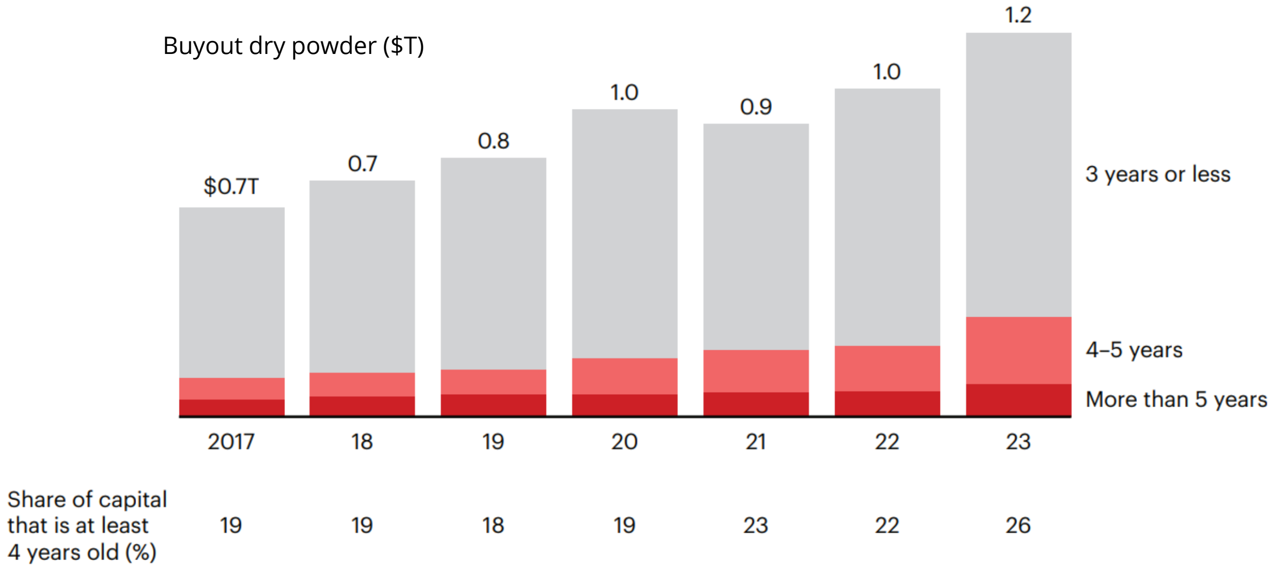
Global private capital dry powder, by fund type



Source: Global Private Equity Report 2024, Bain & Company, 11 March 2024.
Note: Buyout category includes buyout, balanced, co-investment, and co-investment multimanager funds; other category includes fund-of-funds, mezzanine, and hybrid; discrepancies in bar heights displaying the same value are due to rounding differences.
The information shown above is for illustrative purpose.

Buyouts, representing the largest portion of private equity dry powder, is also at a record high of $1.2T. Furthermore, as shown in the chart below, the global buyout dry powder is getting older increasing the pressure to put the capital to work.

Global buyout dry powder, by years since capital raised



Source: Global Private Equity Report 2024, Bain & Company, 11 March 2024.
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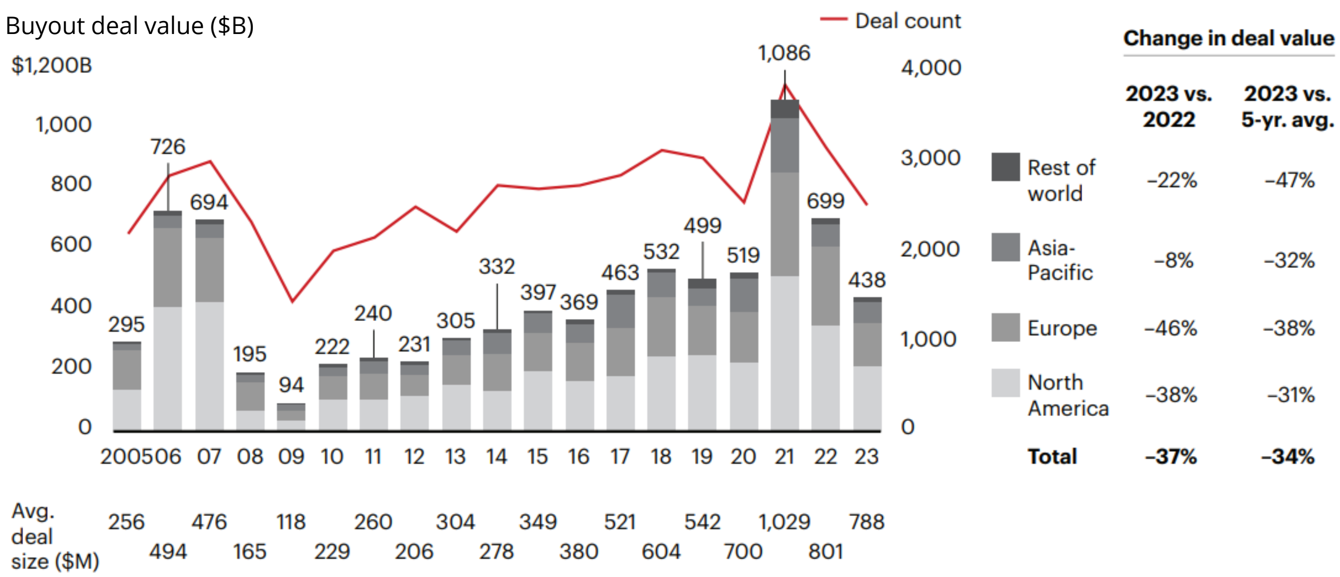
The historical buyout deal value by region, as depicted in the chart below, gives us a good indication of buyout capital targeting European opportunities. In the last years, Europe has represented roughly 1/3 of the global buyout activity by deal value, whilst the US share has been somewhat larger. Furthermore, both the deal value and number of deals had been trending upwards until last year.

Global buyout deal value, by region



Source: Global Private Equity Report 2024, Bain & Company, 11 March 2024.
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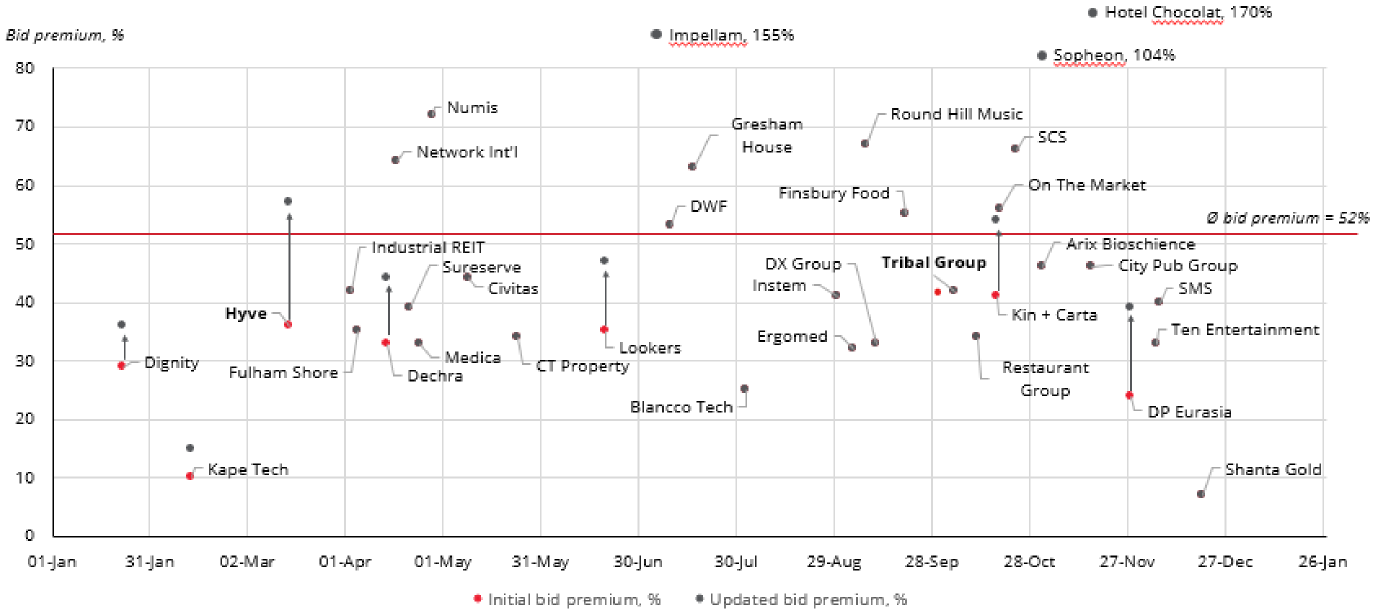
The low valuations of fundamentally attractive European companies have attracted steady interest from strategic and private equity buyers. This is illustrated in the chart below, which shows M&A in UK public companies in 2023. With private equity buyout dry powder at all time high levels and the capital getting older, we would expect that there is potentially more M&A to come across Europe, as well as in the UK.

M&A in the UK public equity markets in 2023



Source: Peel Hunt; Company announcements; Redwheel analysis, 2 April 2024.
The information shown above is for illustrative purposes.

7. After two years of outflows, European equites seem to be making a comeback.

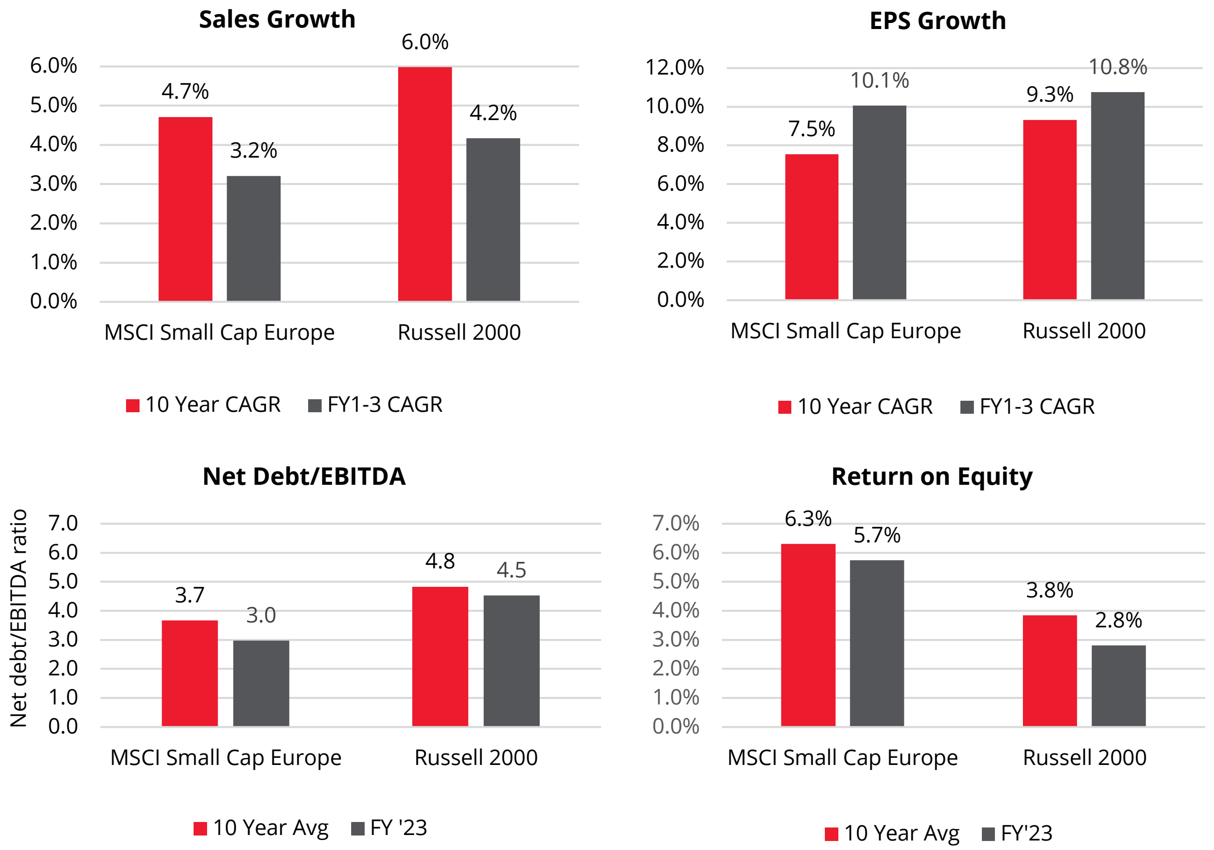
European equity flows have turned positive, with December 2023 and January 2024 seeing the second- and third-best monthly inflows on record according to the Calastone Fund Flow Index, with inflows of £476m and £471m, respectively. The record European equity inflow was £509m in December 2020.

Are there are any structural reasons justifying European small caps' extreme discount?

In our view, there are no structural reasons as to why European small caps should trade at the discount levels we are currently seeing. European small caps often have international/global revenue bases, attractive growth opportunities and solid balance sheets.

Using the MSCI Europe Small Cap Index and the Russell 2000 Index as proxies for European and US small caps, respectively, we make three observations:

1. The 10-year average Sales and EPS growth of European small caps is 4.7% and 7.5%, respectively, slightly below US small caps at 6% and 9.3%;
2. The FY1 leverage of European small caps at 3x Net Debt/EBITDA is well below the 4.5x level of US small caps (with similar difference over the last 10 years); and
3. The 10-year average ROE of European small caps of 6.3% is significantly above the 3.8% level of US small caps, in part due to the higher proportion of lossmaking companies in the Russell 2000.



Source: Bloomberg; Redwheel analysis, 2 April 2024.
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What about the risks?

While we are excited by the opportunity that the above dynamics represent, we should add for balance, that this is not without its risks. While inflation is coming down, it does remain elevated, resulting in elevated interest rates at both the short and long end of the curve with a risk of rates remaining "higher for longer"; the macroeconomic environment could further deteriorate with further knock-on effects to consumer and industrial demand; the political and geopolitical environment remains uncertain with significant conflicts in Ukraine and the Middle East as well as important elections being held over this year.

Furthermore, the world is undergoing significant technological transformation, with the rapid development of AI. The impact of this, positive and negative, on the broader corporate universe remains unclear. All these macro factors could continue to weigh on equity markets, including European small caps, for longer than expected. Finally, it is possible for cheap assets to remain cheap, with more protracted delay to any expected rerating, somewhat offset by the more attractive earnings yields on offer.

Acknowledging these risks, we remain excited by the investment opportunity that is represented by the dynamics explained in this paper.

About The Redwheel European Focus Strategy

The European Active Ownership team acts as a constructive public market activist investor seeking to create lasting shareholder value by making companies better.

The team manages the Redwheel European Focus Strategy which takes a high conviction, concentrated and long-term approach, with proactive ownership. The approach has been an alpha generator over 15 years. The Strategy has invested in over 50 European companies spanning large, mid, and small caps. We currently find the most attractive opportunities in small caps, which we believe haven't been this cheap for 20 years.

How the Redwheel European Focus Strategy is differentiated

Information advantage:	Through deep, private equity like research to identify high conviction opportunities;
Transformation arbitrage:	By finding company-specific value creation opportunities not priced in by the markets and actively working with companies to unlock them; and
Holding period arbitrage:	Given the Strategy can stay invested in and engage with companies over longer periods of time (typically 4-5 years).

Why invest in The Redwheel European Focus Strategy

- One of the longest standing constructive activist investment strategies in Europe tracing its roots to the Hermes Focus Funds launched in 1998[1].
- A concentrated, fundamental and bottom-up portfolio invested in European publicly listed companies that we believe have attractive core businesses and limited downside risk (margin of safety). The portfolio typically consists of 15-20 high-conviction and long-term (~4-5 years) positions.
- We seek to create lasting shareholder value by making companies better. The companies we invest in have significant opportunities to create additional value by improving a number of company-specific issues, and we can act as a catalyst for value to create change by constructively working together with our portfolio companies and other shareholders.
- Long track record: 15th anniversary in February 2024, involved in 50+ investments across various sectors in 14 European countries, bringing tangible change and improvements.
- Experienced Team: The Team has served on five Corporate Boards, including Chair in one, acted as a catalyst for Board renewal and CEO changes in 20+ cases, been involved in 30+ transactional transformations and M&A exits, and consulted many companies on strategic and operational transformation, capital allocation, capital structure, capital market relations and ESG.

Petteri Soininen

European Active Ownership Strategy since 2009

Previously, The Boston Consulting Group, Board member of AMG[2], 2015-2017 and EMGS[3], 2014-2023 (Chair Feb-Jun 2020)

Jimmy Tillotson

European Active Ownership Strategy since 2009

Previously, JM Finn & Co, Board member of Opus Group AB, 2018-2020

David Stewart

European Active Ownership Strategy since 2009

Previously, finance-related projects at Lloyds Bank, Barclays, Bank of New York

Antonio Salerno

European Active Ownership Strategy since 2009

Previously, Deminor (today ISS), Board member of Italmobiliare S.p.a., 2017-2021

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[1] Hermes Focus Funds was founded in 1998 focusing on the UK public equity market. The European Fund (ex-UK) was launched in 2002 following the same approach but focusing on continental European public equity markets.
[2] AMG Advanced Metallurgical Group N.V.
[3] EMGS Electromagnetic Geoservices ASA

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Key Information
No investment strategy or risk management technique can guarantee returns or eliminate risks in any market environment. Past performance is not a guide to future results. The prices of investments and income from them may fall as well as rise and an investor's investment is subject to potential loss, in whole or in part. Forecasts and estimates are based upon subjective assumptions about circumstances and events that may not yet have taken place and may never do so. The statements and opinions expressed in this article are those of the author as of the date of publication, and do not necessarily represent the view of Redwheel. This article does not constitute investment advice and the information shown is for illustrative purposes only. Whilst updated figures are not available for all sources, we have performed further analysis and believe that this data has not significantly changed and is reflective for 2024.

CONTACT US

Please contact us if you have any questions or would like to discuss any of our strategies.

invest@redwheel.com | www.redwheel.com

Redwheel London
Verde
10 Bressenden Place
London SW1E 5DH
+44 20 7227 6000

Redwheel Europe
Fondsmæglerselskab A/S,
Havnegade 39, 1058
København K, Denmark

Redwheel Miami
2640 South Bayshore Drive
Suite 201
Miami
Florida 33133
+1 305 6029501

Redwheel Singapore
80 Raffles Place
#22-23
UOB Plaza 2
Singapore 048624
+65 68129540