ODDO BHF

MARKET *view*

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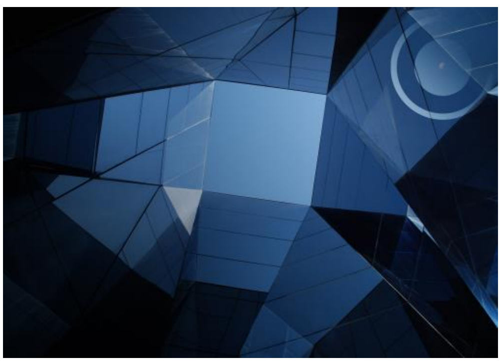
Small is beautiful



> *Our macro-economic scenario validates a very gradual repositioning towards European small caps*

Recent underperformance of European small caps

It is well established by financial theory (Fama & French) and empirical observations that, over a long period, European small caps have consistently outperformed large ones. However, over the past two years, we have seen a reversal of this trend: at the end of May 2023, the MSCI Europe Small Cap NR recorded a cumulative 2-year performance of -13%, compared with +12% for the MSCI Europe Large Cap NR. Moreover, small caps currently show a 33% discount to large caps. Let's try to understand the reasons behind this underperformance:

Firstly, it's important to believe in favourable growth prospects when investing in small caps. Indeed, the earnings of these companies are highly sensitive to economic activity, with an estimated multiple of 4 times nominal growth. **Secondly,** any tightening of monetary policies has a negative impact on the financing capacity of these companies, as the cost of capital for small caps is rising much faster than for large caps, reducing their relative earnings growth. **Finally,** the relative performance of small caps is also linked to liquidity. Central banks have switched from injecting money and expanding their balance sheets to drying up this liquidity. It's also important to note that small-cap equities amplify market movements, both downwards and upwards. For example, European small caps rebounded by around +90% one year after the decline triggered by the subprime crisis, and European micro-caps recorded a +115% jump just one year after the COVID-19 crisis. Our point is not to say that in absolute terms, small-cap equities will rebound massively, but rather to emphasize that, compared with large caps, we see an attractive entry point for a significant return to the mean.

Return to attractive valuation levels

Firstly, over the past 5 years, the P/E ratio of European small caps has dropped considerably (16.7 in 2018 vs. 13.2 today), while that of European large caps has remained relatively stable (13.7 in 2018 vs. 12.5 today). **Secondly**, the analyst consensus for small caps is +27% for 2023 and +16% for 2024, compared with 0% and +7% respectively for large caps. The question now is whether the consensus is too optimistic. Our historical analysis shows that expectations are often overly generous, but uniform across large caps and small caps, since both are equally revised by almost -5% each year. Our conviction to reposition ourselves in small caps therefore remains entirely valid, given that in the present case, we're looking at convergence towards large caps as much as absolute performance. **Thirdly,** small caps have fully integrated the rise in the cost of capital, with EV/EBITDA multiple (enterprise value divided by EBITDA) at 8x, i.e. levels seen in 2009.

Our macro-economic scenario validates a very gradual repositioning towards European small caps

Despite the high volatility, small caps represent an attractive opportunity today. As a reminder of our current positioning, we are slightly underweight equities due to the potential negative economic impact of tighter credit conditions. We recommend being highly selective when choosing equities to avoid excessive enthusiasm for certain parts of the market. We prefer stocks with reasonable valuation multiples, solid fundamentals and growth prospects above the market average.

This positioning reflects a particular market context, where the dichotomy between signals sent by companies (rather positive) and macro-economic signals (rather negative) could persist for a few months. Even if the current robustness of the labor market is contributing to business and consumer confidence, we believe this environment is likely to evolve less favorably in the next few months. However, in our macroeconomic scenario, it seems that the tightening of credit conditions in the eurozone has already been factored in, reducing the risk of negative surprises for investors in the event of a potential recession in the eurozone. Furthermore, we are approaching central bank terminal rates. Thus, a stabilization of financial conditions could boost the performance of small caps. What's more, we are currently seeing an improvement in market conditions for European small caps, with bank liquidity less tight in Europe than in the US. Finally, in a context where organic growth is becoming problematic, companies will seek growth through external operations. Recent deals such as Rovio, Dechra and Majorel are trading on average at a 30% to 50% premium to the closing price. Strategic players benefit from particularly attractive valuations and almost immediate accretive effect on their earnings. This is a strong incentive, despite the recent rise in borrowing costs. Marginal returns remain highly favourable to this type of merger.

To sum up, economic conditions could deteriorate over the next few months, which does not justify massive investment in small caps. However, the promise of a positive real return (net of inflation) is attractive, as are current valuation levels. This means that long-term investors can already consider realigning their positions, at the cost of high volatility and limited liquidity.

Past performance is not a reliable indication of future return and is not constant over time. These examples are not investment recommendations

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