Contact Asset Management

INSIGHTS

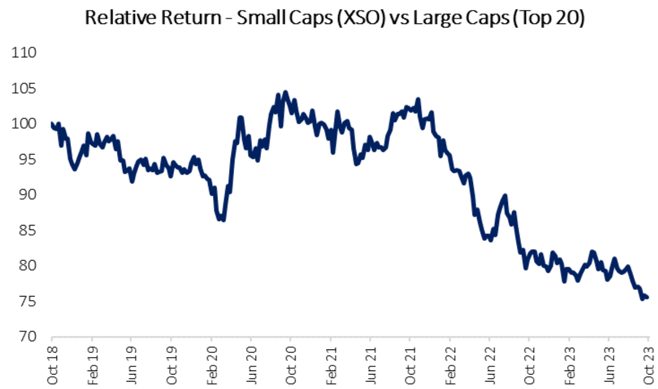
NOVEMBER 2023

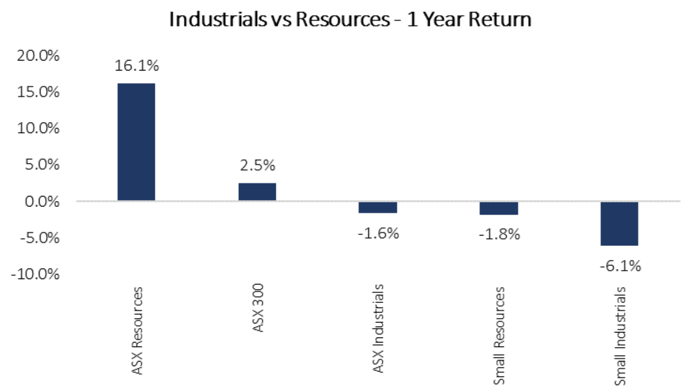
A Compelling Opportunity amongst Beaten Up Small Caps

Risk-off has dominated sentiment in recent months. Gyrations in global bond markets, combined with the escalation of tensions in the Middle East spooked investors. Many global markets are now in a "correction". Domestically, while Australian Equities markets have retreated from highs, there has been outsized declines in Small Caps relative to the broader market. We believe there are several excellent long-term buying opportunities. In this note, we discuss a stock that we consider mispriced, particularly given its Quality attributes.

Contrasting Performance between Large Caps and Small Caps

For the better part of two years, Australian Small Caps have delivered very underwhelming returns. Sentiment towards small caps has deteriorated to the extent that several interesting opportunities appear to be emerging. The following charts highlight the extent of the underperformance.





Source: Factset, Contact Asset Management

What we find interesting is that the Small Ordinaries index is trading at a discount to large caps despite offering superior growth outcomes. According to Macquarie Equities[1], Earnings per Share (EPS) for the ASX 300 is expected to decline by 5.4% in FY24 and then increase by 10.5% in FY25. Yet, EPS growth forecasts for Small Companies is expected to *increase* in both years (by double digit growth rates). We conclude that the risk-off mentality that is prevalent has created an outsized opportunity in many high-quality small caps.

To help illustrate our approach, we discuss a stock owned in the Contact Ex-50 Fund that we consider mispriced. We think it offers a great opportunity for long-term investors.

GQG Partners Limited (GQG)

GQG is a global investment manager. Since its establishment in 2016, GQG has grown rapidly to over US$100 billion funds under management (FUM). GQG has a primarily large-cap equities focus with products ranging across global, US, international and emerging markets. It has a global client base, comprised of institutional and sub-advisory funds (over 1,000) with additional exposure to wholesale and retail investor segments. GQG is led by co-founders Rajiv Jain and Tim Carver, who have built an enduring, highly client-aligned boutique asset manager.

[1] Macquarie Insights: "Australian Equity Strategy – October Equity Market Review" 1 November 2023

Why do we think GQG is mispriced by the market?

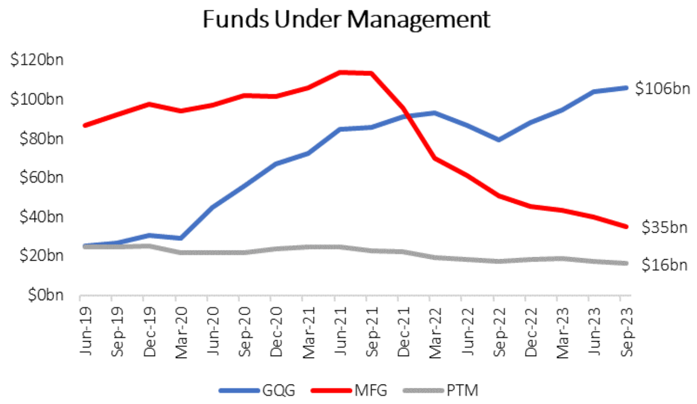
We struggle to reconcile why GQG is valued at similar multiples to other ASX listed Fund Managers despite far superior growth prospects. In a peer group that consists of Magellan Financial Group (MFG), Platinum Asset Management (PTM) and Perpetual Limited (PPT), GQG is the *cheapest*(!) based on forecast Price/Earnings Multiples. We consider GQG to be better placed than peers given high alignment, strong performance and a very competitive fee structure. It also has a large global distribution opportunity.

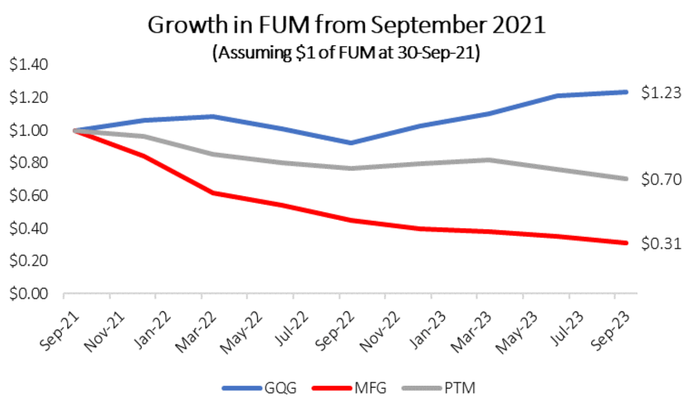
The growth in FUM has been very different for GQG versus its Global Fund Manager peers

The following charts highlight the change in FUM for the listed global fund managers on the ASX. Growing FUM is a critical success factor for asset management businesses and scale plays a significant role in profitability. Asset management is a business with high fixed costs, such as research, compliance, and technology infrastructure. As FUM grows, these costs can be spread across a larger base, driving economies of scale.

Over the last four years, GQG has grown from US$25 billion to over US$100 billion in assets under management. This is a vastly different outcome to peers and comes amid an additional headwind whereby more assets are flowing to passive rather than active management strategies.

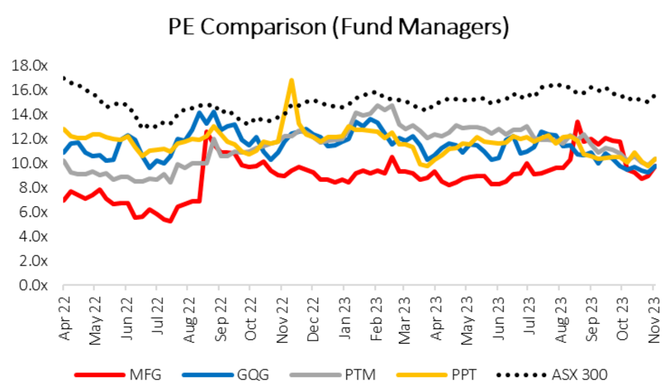
The chart below (on the left) illustrates the change in FUM for the ASX listed companies. We have not included PPT in this chart given the distorting impact of the Pendal acquisition. The chart on the right is possibly more illustrative of like-for-like performance. Since GQG was listed on the ASX in late 2021, the relative growth in FUM has been drastic. For comparative purposes, if we assume $1 of FUM in September 2021, GQG inflows have seen FUM increase by 23%. However, the $1 of FUM that MFG and PTM had just two years ago has declined to 31 cents and 70 cents respectively.

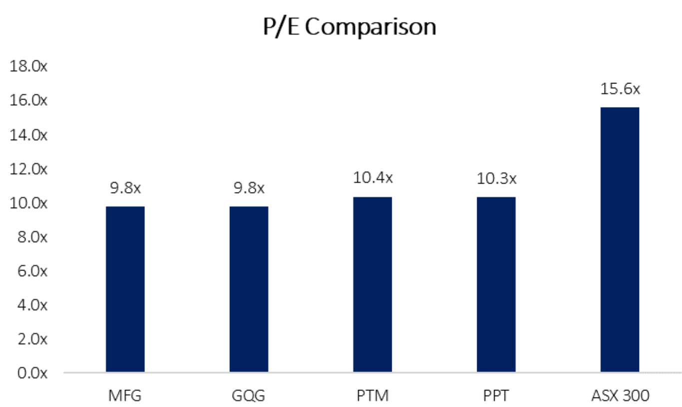




Source: Company ASX releases, Contact Asset Management. FUM is in local currency (i.e. GQG is US$)

Yet, GQG is being priced at a similar P/E multiple to a peer group that is experiencing declining earnings

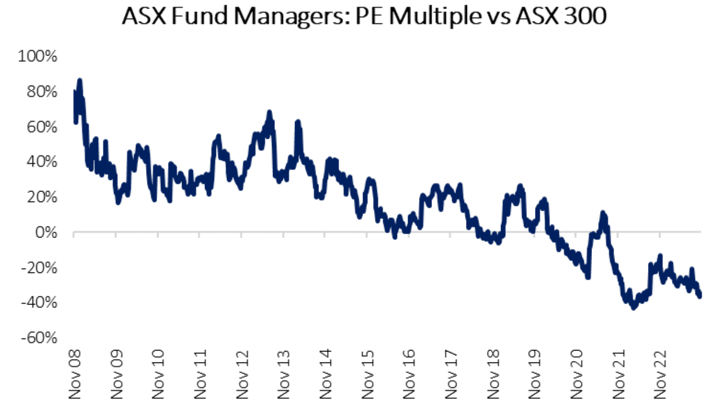




Source: Factset, Contact Asset Management.

The whole Fund Manager sector has de-rated

Given the company-specific challenges that have beset the sector, it is little surprise that the relative multiples have de-rated. However, the extent of the de-rating surprised us. Fifteen years ago, even amid the GFC, listed Fund Managers traded at a huge premium to the broader market. It was a time of solid flows and minimal fee pressure. As it stands, the sector is now trading at a 35% discount to the broader market.



Source: Factset, Contact Asset Management.

Conclusion

High-quality companies tend to outperform markets over the long term. At Contact, we look for the following attributes in our search for quality:

- Has an identifiable competitive advantage,
- Is profitable, has growing earnings and generates cash,
- Generates attractive returns on its invested capital,
- Has a strong Balance Sheet or, at least, is appropriately geared for its stage of growth,
- Is conscious of ESG and scores favourably with MSCI ESG Ratings, and
- Is run by capable, dedicated and trustworthy people. Ultimately, they are founders of the business or have significant "skin in the game".

We believe that GQG ticks a lot of boxes based on these criteria.

Often high-quality companies trade expensively, as investors crowd into these names. GQG is high quality, and we consider it cheap. Based on our analysis, at a share price of $1.30[2], we see significant upside in GQG and value the stock at over $2/share.

[2] As at 31 October 2023