COMMENTARY

April 27, 2018

Investing Environment

Markets are normally quieter between earnings seasons, when stocks often trade sideways and the only catalysts are macro data points and stock-specific events. But this year investors have been on their toes after the back and forth on potential tariffs and trade discussions between the US and China.

With the US proposing tariffs on approximately US$50 billion of Chinese goods, it seems trade wars could be emerging as a new market theme. Not surprisingly, China responded with US$50 billion in tariffs—which prompted President Trump to instruct the US Trade Representative to "consider" tariffs on an additional US$100 billion worth of Chinese products. However, neither side has actually implemented these new tariffs, and officials from both countries claim there is room for negotiation.

If China decides to match the US dollar for dollar, it will have to target virtually all goods imported from the US. In 2017, the US exported US$155.2 billion to China versus China's US$433.1 billion of exports to the US.

Europe continues to experience healthy growth. The eurozone unemployment rate is at its lowest level since December, 2008. The UK reported a surplus, having generated enough taxes to fund all of its current spending. The last time we saw this kind of prosperity was back in 2002. If we turn our focus to Asia, we see that Japan has enjoyed eight consecutive quarters of GDP growth, and despite the US trade war headlines, China is experiencing undeniable strength in investments and private consumption.

Looking at investor sentiment, just a year and a half ago investors were concerned about deflation due to plummeting interest rates. With interest rates now rising, inflation has become the focal point.

While a lot of questions remain unanswered, we continue to feel optimistic about global small cap companies given their valuation and growth prospects.

Back to Global Small Cap

During the first quarter of 2018, the MSCI World Small Cap Index outperformed the MSCI World Large Cap Index. The MSCI Emerging Markets Index outperformed both the MSCI World Small Cap and the MSCI World Large Cap Index.

In the MSCI World Small Cap Index, health care was the strongest performing sector, delivering a positive return of 6.5%. At the opposite end of the spectrum, energy was the worst performing sector, returning -8.6% for the quarter.

Performance Highlights

For the first quarter, our Global Small Cap composite outperformed the MSCI World Small Cap Index.

One of the highlights for the quarter was *Horiba (6856 JP)*. Founded in 1945, Horiba is a Japanese manufacturer of measurement equipment, specializing in the analytics and measurement of small particles in the fields of environment, health, safety and energy.

Horiba is a niche market leader with a global vision, claiming dominant market share in multiple automobile and related markets, including automotive emission measurement systems and mass flow controllers. Horiba's strong brand reputation is underpinned by its pursuit of advanced technology and a track record of high performance standards.

Although headquartered in Japan, Horiba is a global company that generates two-thirds of all sales from international markets. Like many small cap companies, you may not be familiar with the Horiba name. However, if you remember the Volkswagen emissions scandal in 2015, it was Horiba's emission measurement system that helped discover the fraud. The company currently holds 80% of the global vehicle emission measurement market.

So what drove the stock up? Horiba's 2017 earnings exceeded analyst and investor forecasts. It also provided strong guidance for 2018 and increased its dividends.

As we look ahead, Horiba should continue to deliver strong top- and bottom-line growth due to an increase in demand for car emission measurement equipment and semiconductor-manufacturing equipment.

Another top contributor for the quarter was *Fuji Seal International (7864 JP)*. Fuji Seal is a producer of flexible packaging, primarily for food, beverages, home and personal care and pharmaceutical products. It is the leading player in the shrink sleeve label market in Japan, the US and Europe.

Besides its mainstay product (shrink sleeve labels), soft pouches have been a recent growth driver for the company, experiencing a double-digit growth rate. Another element that differentiates Fuji Seal is it offers a one-stop solution. The company produces multiple packaging products and matching machinery, which provides a better experience for clients.

So what drove the stock up? Fuji Seal's stock price declined after it missed analyst estimates due to temporary environmental factors such as typhoons in Japan and a hurricane and earthquake in

Mexico. However, investors realized these were one-time events, and with the company confirming its guidance, the stock rebounded strongly after the temporary drop in price.

One of our top detractors for the quarter was *Greencross (GXL AU)*. Founded in 1994, Greencross is the largest pet care specialist in Australia, providing both retail and veterinary services.

Greencross has 247 retail stores operating under the brand names Petbarn and City Farmers in Australia and Animates in New Zealand. The company also operates an online platform. In addition to its retail business, Greencross offers a wide range of pet services such as grooming, dog washing, obedience training and pet adoption.

Greencross also owns and operates Australia's largest network of veterinary practices. Its more than 150 clinics include general practices, specialty and emergency centers, pathology labs and pet crematoria.

The Australia and New Zealand pet care industry has an addressable market of AU$9 billion and a compound annual growth rate of 4%. Greencross is the largest player in Australian market; twice the size of its closest competitor. One of the company's growth strategies is its co-location model, which situates retail stores in close proximity to veterinary clinics.

So what drove the stock down? The entire Australian retail industry is down thanks to the "Amazon effect". The online retailing giant plans to enter the Australian market this year.

Our perspective? Company fundamentals are still strong. In February Greencross reported 9% revenue growth, 4.5% like-for-like sales growth in mature stores and announced further new store openings.

One negative was the announcement of a change in CEO, which came as a surprise. The existing CEO will stay with the company for a transition period of five months. We will meet with the new management team when we attend the Macquarie Australia conference in Sydney next month. Given the company's current valuation and growth trajectory, we remain confident in our thesis, and continue to hold our position in Greencross.

New Position

Amid the recent market volatility we have identified a number of new investment opportunities and added two new names to the portfolio, including DMG MORI (6141 JP).

Founded in 1948, DMG MORI is the world's largest machine tool company. It produces machining centers, lathes, laser cutting tools and laser sintering 3D printers.

Our aging population, labour shortages and advancing technology are generating an increasing interest in factory automation. According to the Japan Machine Tool Builders' Association (JMTBA), in February 2018 total machine tool orders in Japan hit a second monthly record high of 155.2 billion yen—a 40% year-over-year rise on a global basis. In addition, as product complexity increases, so will demand for direct sales support.

What got us excited about DMG was their leadership in the industry. With 9% market share, it is almost double the size of its largest competitor. DMG has also integrated 3D sensing technology into its machine tools, which gives it an added advantage in attracting customers. With a direct sales force in the US and Europe, the company has the right strategy to gain market share. An experienced and stable management team, which owns approximately 8% of the company, further heightened our confidence in DMG MORI.

Other New Buys and Sells

We initiated a position in BofI Holding, and as usual, we will provide more details on the company in upcoming weekly commentaries.

In the first quarter we exited THK, which was replaced by DMG MORI, and Customers Bancorp was replaced by BofI Holding. We also exited Salini Impregilo and Cimpress.

What Else is New at Global Alpha?

The Global Alpha family is growing. In April we added Tracy Li and Anthony Sutton to the Global Alpha team.

Tracy is an analyst responsible for the Asia-Pacific region as well as coverage of the global Consumer Discretionary and Consumer Staples sectors. Tracy has worked in the banking sector in China. She is fluent in English, Chinese and Japanese.

Anthony is an analyst and trader responsible for covering Europe and the global Industrial and Materials sectors. He brings buy-side and sell-side equity research experience to Global Alpha as well as hands-on manufacturing experience in the UK. Anthony is fluent in English and French.

Welcome, Tracy and Anthony!

What is Our Ear-to-the-Ground Approach Telling Us?

The Global Alpha team was on three continents in the first quarter, doing on-the-ground research and attending conferences. We met with the management teams of existing holdings, their competitors and potential new investment candidates.

Various data points we have collected are pointing to improving global fundamentals. However, the risk of inflation is rising as input costs from labour to commodities are trending upward. Low interest rates have also led to an increase in debt levels. According to the IMF, global debt was at 225% of world GDP in 2016, which is higher than the previous peak reached in 2009. Our portfolio has a lower net debt level compared to its benchmark, the MSCI World Small Cap Index.

In order to improve domestic growth, governments have acted with fiscal stimulus and trade policy measures. Small cap companies are more nimble, with the ability quickly react to change, and they already have a higher fiscal burden (taxes) than their large cap counterparts, so these changes should be more of a benefit to small caps.

If we add in other outperformance catalysts, such as higher operating leverage and M&A, we believe that our portfolio of stocks—comprised of quality businesses with good long-term prospects and attractive valuation multiples—represents a good investment opportunity during the current market volatility.

We have identified companies with defensible business models and strong balance sheets which are trading at a large discount to their intrinsic value. As we reflect on the state of markets and the fundamentals of our target companies, we remain positive about the current environment and future growth opportunities.

Have a great weekend.

The Global Alpha Team