COMMENTARY

July 21, 2017

## Investing Environment

If we could use one word to describe the first half of 2017, it would be eventful. The S&P 500 has delivered its best first half since 2013. The energy sector, which was one of the best performing sectors at the start of the year, is back into bear market territory as oversupply concerns have emerged. Economic growth in the US has prompted the Federal Reserve to increase rates twice so far this year. However, there is still no clarity on the US President's corporate tax plans or the infrastructure bills.

Europe, on the other hand, has survived two elections and continues to post strong economic data points. The UK is working through the Brexit process, but there are still a lot of unanswered questions.

Emerging market economies seem to be stabilizing, and concerns that the Chinese economy will crash seem to have disappeared, or at least they are not in the news.

Given this backdrop, perhaps it is not surprising that risk assets have done well in the first half of 2017. The MSCI Emerging Markets Index is the best performing equity market year to date, and the technology sector is the best performing sector across all regions.

A lot of questions remain unanswered, and we cannot predict the market's reaction to unknown future global events. However, we remain optimistic about global small cap companies given their valuation and growth prospects.

## Back to global small cap

During the second quarter of 2017, 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 Index 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 8.4%. At the opposite end of the spectrum, energy was the worst performing sector, returning -16.7% for the quarter.

## Performance Highlights

As of June 30, our Global Small Cap Portfolio has outperformed the MSCI World Small Cap Index for the second quarter and year to date.

While stock picking has contributed positively to performance year to date, an allocation effect was also a contributor to our performance. As you know, most of our added value comes from stock selection; however, there can be periods when a modest relative country and/or sector bias could help or hurt us from an allocation effect point of view.

As bottom-up stock pickers, for us the highlight for the quarter was Autogrill (AGL IM). Autogrill is the world's largest food and beverage company serving travelers across the globe. Since it was spun off from World Duty Free in 2014, the new Autogrill has generated half of its revenue and two-thirds of its profit in the US. Fifty percent of its global revenue comes from airport locations and forty percent from motorway locations.

You may have driven the New York State Thruway to Albany or the Illinois Turnpike to Des Plaines, or perhaps instead you took a plane from LAX to go to Tampa. If you bought food or a beverage in any of these places you were a client of Autogrill, or to be more precise, of its US subsidiary, HMS Host.

Autogrill's market is large and growing and mainly captive due to the concession nature of the company's locations. Air traffic is growing faster than global GDP, and current economic growth and lower oil prices are leading to increased road traffic, creating a positive trend, especially in the US. The company's concessions last from five to fifty years, with the average duration exceeding seven years. Once the company wins a concession, it becomes the sole operator and makes all the food and beverage decisions for that location, including which brands will be available. Autogrill is the largest franchisee of Starbucks and Burger King, to name a few, and it also has its own brands. Each location enjoys monopolistic characteristics.

So what drove the stock up? Autogrill reported its first quarter numbers, which showed strong like-for-like growth of 4.8% that partially offset some contract exits. The company continues to benefit from a sustained growth in air traffic in North America and at its international locations. Margins also benefitted as the sales mix moved more towards high-margin segments.

Another top contributor for the quarter was Carl Zeiss Meditec, a German manufacturer of optical systems and industrial measurement and medical devices. The markets in which Carl Zeiss Meditec participates are growing at rates varying between 4% and 20% per year. The company is focusing on three trends that are affected by a rapidly aging population: loss of mobility, loss of vision and loss of cognitive abilities. One of the most frequently performed operations on human beings is cataract removal. Forty percent of the population will develop cataracts during their lifetime, and another 15% will have glaucoma or age-related macular degeneration.

So what drove the stock up? Carl Zeiss posted strong organic growth of 9% and impressive margin development in Q2. With the capital increase in March, the company has the potential to build on its growth momentum with future acquisitions.

One of our top detractors for the quarter was Greencross, based in Australia. It is Australia and New Zealand's largest pet-care company with a network of over 375 veterinary clinics and retail stores. Because of Amazon's plan to enter the Australian market in 2018, we saw the so-called "Amazon effect" on the entire retail industry in Australia, with all stocks being sold based on fear. Greencross was no exception. There is no doubt that Amazon will have an impact on some items Greencross offers, such as food and over-the-counter medication. However, the Greencross model of offering a full suite of services (veterinary, grooming, boarding, food, toys and accessories), similar to PetSmart, provides it with a solid "moat". We've spoken to management twice since May 2017, and we believe the Amazon fear is exaggerated. As the number one player in this niche market, and with a 7.5% market share, Greencross still has lots of room to grow.

**New Position**

Amid the market volatility, we have identified a number of new investment opportunities and added three new names to the portfolio, including Salini.

Italian-based Salini Impregilo is a global leader in heavy civil engineering construction and is active in more than 50 countries. The company constructs tunnels, dams, hydroelectric plants, roads and motorways, railways, airports, maritime projects, etc. Following its acquisition of Lane Industries in 2015, the company's exposure to the strong US construction market has increased considerably. The company is now well-balanced geographically with 25% of sales coming from the US, 25% from the Middle East, 23% from Europe and 27% from other markets. For its fiscal year 2016, Salini reported sales of €6.12B, new orders of €7.3B and an order backlog of €29.4B.

Salini replaced Astaldi, another Italian construction company, in our portfolios. The rationale for the switch was that Salini gives us exposure to the US infrastructure market at a large valuation discount when compared to its US peers. Having a global mandate gives us an advantage in exploring such mispricings. Salini was ranked number one by the *Engineering News-Record* in 2016 for US motorways. It is ranked number one in the water segment and number six in sewer/waste.

**Other New Buys and Sells**

We also initiated positions in SiteOne Landscape Supply and Titan Machinery. We recently profiled SiteOne Landscape in one of our weekly commentaries, and we will be profiling Titan Machinery in the near future.

Our preferred way to exit an investment is either via acquisition or when a holding's market cap reaches the upper limit of the index. These methods typically validate our investment thesis. In the second quarter, we exited Stillwater Mining as it was acquired. Another name we exited was Ubisoft Entertainment as its market cap approached the upper limit of the Index. We exited Astaldi for Salini, as we constantly seek to upgrade our portfolio with our best ideas.

**What else is new at Global Alpha**

The Global Alpha team was selected as an Emerging Manager of the Year in the international equity category by *Emerging Manager Monthly*. We are the first Canadian asset manager to have won the award. We thank our clients, colleagues, friends and families for their constant support. During the second quarter, Global Alpha crossed another important milestone as we now manage over $1 billion in assets for our clients.

The Global Alpha family is also growing. In June we welcomed Janine Tran Lam to the Global Alpha team. Janine will be responsible for the management of client relationships, operations and risk and compliance. She brings over 20 years of experience in the banking and financial industry to her role at Global Alpha. She is fluent in English, French and Vietnamese. We are excited to have her join our team. Welcome Janine!

**Outlook**

As always, the Global Alpha team was on the road in the second 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. Looking forward to the next few months, conference season is about to begin, and our team has their bags packed, ready to find new names and obtain updates on companies that are already on our radar.

Even when markets are strong, we continue to search for names that fit our investment criteria. The small cap universe still holds a large number of investment opportunities. Some companies, regions and industries have not participated very strongly in the recent rally and could provide interesting future investments.

Economic data and our "ears-to-the-ground" investment approach lead us to believe that fundamentals are improving in most regions of the world, which should support earnings growth in the near future. However, the market remains a pendulum, sensitive to global news releases. Overall, for the last few quarters, the market has been more optimistic than pessimistic in terms of world events.

The market remains liquidity-fueled, particularly in the US. Our ability to be highly selective and nimble in our portfolio holdings leaves us well-positioned to enter a period of great opportunity for fundamental stock pickers.

Within equity markets, we believe small cap names offer greater opportunities when compared to their large cap peers, given their attractive relative valuations, expectations for higher profit growth and the current M&A environment.

Our investments in high-quality companies with defensible business models and strong balance sheets have helped us outperform our small cap benchmark. 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.

We appreciate your continued confidence in us.

The Global Alpha Team