COMMENTARY

October 5, 2018

Dear clients and colleagues,

Last week, Global Alpha was once again on the road, this time in Germany. We were visiting the "Land of Poets and Thinkers" (and yes, Oktoberfest) to attend a conference in Munich for mainly German companies, with some Austrian- and Swiss-based companies also represented.

Politically, Germany has been in the spotlight as potentially being in the Trump administration's crosshairs for another trade war. The US and China are Germany's largest individual trading partners. Germany currently runs a 50 billion euro trade surplus against the US, up from 15 billion euros in 2009. This represents the fourth largest trade deficit for the US after China, Mexico and Japan. With the tit-for-tat tariffs with China well established and the United States-Mexico-Canada Agreement freshly negotiated, could Germany be Trump's next target?

So far, Germany has been only modestly affected by the tariffs imposed on European steel and aluminum exports, which account for approximately 7% of the trade surplus between Germany and the US. The largest part of the surplus is in automobiles and capital goods. Germany also argues that there are mitigating circumstances for the surplus that are largely out of its control, and this may explain why so far Trump has taken no action against the country. Some of the recent surplus is explained by the low euro and oil prices. Also, Germany's aging population affects consumption patterns and particularly imports.

On the political front, Bavaria has been in the news lately. The state will elect a new government in mid-October and the results may be an indication of what to expect in future state elections across the country. Bavaria's election has national implications as its Christian Social Union (CSU) party is represented in the national government and is one of Angela Merkel's allies. The latest polls suggest the CSU may lose its absolute majority due to the strengthening far-right Alternative for Germany (AfD) party.

However, the German economy continues to perform well and remains the driving force in the EU. August's record-low unemployment of 5.2% is stimulating wage growth (+3.2% year/year in Q2), and domestic demand is responding in kind. Worldwide Harmonized Light Vehicle Test Procedure (WLTP) certification issues are causing a slight drag on industrial production, but the German Central Bank expects "the pace of aggregate growth (is likely) to pick up again considerably" once the issue has been resolved. The Bundesbank forecasts 2.0% growth this year, slightly down from 2.2% in 2017. Germany posted a record tax surplus of 48 billion euros through the first half of 2018 and is the only European country to have posted a surplus every year since 2014. This year was a little exceptional as the delay in forming a federal government meant limited ability to sign off on investments.

So the reasons for investing in Germany remain unchanged. As Europe's largest economy, and the fourth largest in the world, it offers access to a large domestic market as well as the EU. Its location within Europe has made it a key trading hub, and it has the infrastructure to cope with this activity. With high worker education levels and productivity rates and a commitment to innovation (it is the leading R&D spender in Europe), Germany is one of the largest exporters of goods and services in the world.

At the conference, the atmosphere among companies was generally positive and most were optimistic about their business outlook and capability to negotiate any operational and/or macro concerns, such as a potential trade war with the US, Brexit and the dispute between the EU and Italy over the latter's proposed budget deficit. Their outlook on the long-term growth potential of emerging markets was also encouraging. Exposure to growing end markets, either geographically or by industry, is key to seizing additional growth opportunities over the medium term through internal investments or M&A. German real estate has some interesting fundamental drivers – higher rentals, vacancy reductions and limited building permits in some industries.

As well as attending the conference to generate new investment ideas, we took the opportunity to get an update from some of the current holdings in our portfolio.

Schoeller-Bleckmann is an equipment supplier to the oil and gas industry. It makes downhole tools and equipment for directional drilling and well-completion applications. The Company is the global leader in non-magnetic steel collars. Rig count trends in North America remain solid while the rest of the world is finally recovering. Exploration and production spending in North America grew by double digits and early shoots of recovery can be seen internationally.

Palfinger is a leading global hydraulic lifting, loading and handling system manufacturer. The Company enjoys diversified industry exposure to both cyclical and non-cyclical sectors which has enabled consistent growth at good margins. Palfinger aims to reduce leverage even further in 2019.

Cancom is an IT infrastructure and IT services provider. The company offers cloud solutions, which is a recurring revenue stream as opposed to IT solutions which provide one-off, project-based revenues. Cancom has done a good job in the past with business model transformations, but the current transformation towards a scalable cloud and software business is weighing on margins. Investment will continue in 2019, but Cancom also continues to take market share from small players in the industry, and its focus on services will result in a higher margin and low capex business.

Evotec is a drug discovery and development company that acts as a one-stop partner to pharmaceutical companies for external innovation. The Company has a clear growth plan and continues to benefit from the favorable trend of R&D outsourcing, which is driven by capital efficiency and elasticity. Evotec also has expertise in several diseases that are large potential markets.

We continue to be comfortable with our holdings in Germany and its surrounding regions, and believe there are further opportunities in the region that can add value for our clients.

Have a great weekend.

The Global Alpha team