

October 25, 2013

**Dear clients and colleagues,**

### **UK economy**

As was reflected in the latest Q3 numbers, UK recovery is on track in almost all segments of the economy. The service sector and construction orders are picking up nicely while retail sales achieved their fourth best quarter of the past 10 years. Thanks to a limited supply of properties and a relatively easy access to cheap credit, UK real estate activity is also very strong.

While we agree that UK is better positioned than most neighboring countries, we remain somewhat concerned in certain areas.

Recent growth has been concentrated in household expenditure rather than in investment. Investment intentions remain modest and UK productivity is still anemic. In the past 5 years, UK productivity has showed no gain.

Household real purchasing power remains weak. Personal borrowing is trending up while real wages are going down. Over the past year, the price of a house in London rose by £40,000 whereas the average annual wage before tax was £35,000. With house prices hitting record highs, London is becoming more unaffordable.

### **UK companies**

UK small companies continue to deliver robust stock performance year to date with a return of 37%. Forward earnings estimates are trending up which bodes well for stock rerating. UK and European exposed stocks are performing well compared to those that rely more on emerging markets. In fact, we have noticed more downgrades on stocks with stronger emerging market exposure.

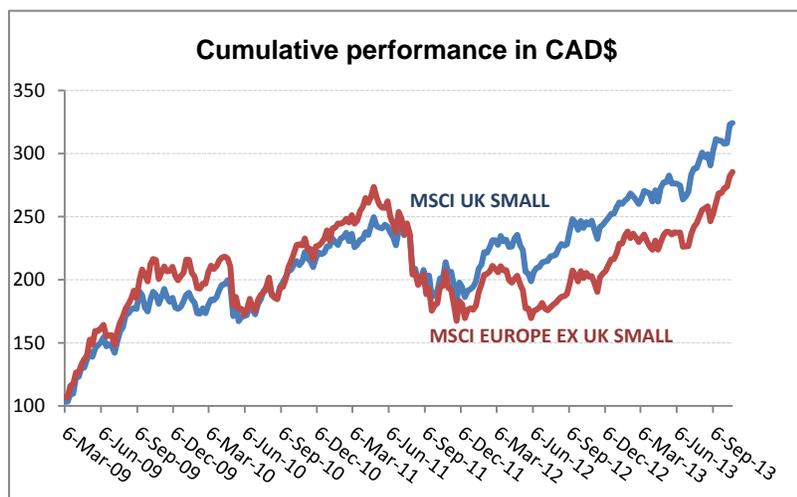
On the operational side, we noticed that several companies are still pursuing divestment of non-core assets. Companies continue to adjust to structural changes in their markets. In this context of weak revenues growth, capex programs have stabilized or even slowed. Companies are focusing on free cash flow generation and are increasingly vigilant on where they allocate their capital.

This report is provided solely for informational purposes and nothing in this document constitutes an offer or a solicitation of an offer to purchase any security. This report has no regard to the specific investment objectives, financial situation or particular needs of any specific recipient and does not constitute a representation that any investment strategy is suitable or appropriate to a recipient's individual circumstances. Global Alpha Capital Management Ltd. (Global Alpha) in no case directly or implicitly guarantees the future value of securities mentioned in this document. The opinions expressed herein are based on Global Alpha's analysis as at the date of this report, and any opinions, projections or estimates may be changed without notice. Global Alpha, its affiliates, directors, officers and employees may buy, sell or hold a position in securities of a company(ies) mentioned herein. The particulars contained herein were obtained from sources, which Global believes to be reliable but Global Alpha makes no representation or warranty as to the completeness or accuracy of the information contained herein and accepts no responsibility or liability for loss or damage arising from the receipt or use of this document or its contents.

Performance figures are stated in Canadian dollars and are net of trading costs and gross of operating expenses and management fees. Further information about the Global Small Cap Composite is available by contacting the firm. Global Alpha Capital Management Ltd. (Global Alpha) claims compliance with the Global Investment Performance Standards (GIPS<sup>®</sup>) and has prepared and presented this report in compliance with the GIPS. Global Alpha has not been independently verified.

Markets are increasing the pressure on management teams to redeploy their cash by increasing the dividend payout or by announcing share buybacks. We see little signs that would suggest a strong pick-up in M&A activities in the very short term. With high valuation multiples and fiscal issues to cope with, we understand why management teams are hesitant to announce major M&A deals.

At this point we are neutral on UK small caps. As Eurozone economy improves, we believe that European small companies could close the performance gap with their UK peers. As we can see below, that could potentially represent an appreciation of 15%.



Source: MSCI, GACM

### The Global Alpha Team

This report is provided solely for informational purposes and nothing in this document constitutes an offer or a solicitation of an offer to purchase any security. This report has no regard to the specific investment objectives, financial situation or particular needs of any specific recipient and does not constitute a representation that any investment strategy is suitable or appropriate to a recipient's individual circumstances. Global Alpha Capital Management Ltd. (Global Alpha) in no case directly or implicitly guarantees the future value of securities mentioned in this document. The opinions expressed herein are based on Global Alpha's analysis as at the date of this report, and any opinions, projections or estimates may be changed without notice. Global Alpha, its affiliates, directors, officers and employees may buy, sell or hold a position in securities of a company(ies) mentioned herein. The particulars contained herein were obtained from sources, which Global believes to be reliable but Global Alpha makes no representation or warranty as to the completeness or accuracy of the information contained herein and accepts no responsibility or liability for loss or damage arising from the receipt or use of this document or its contents.

Performance figures are stated in Canadian dollars and are net of trading costs and gross of operating expenses and management fees. Further information about the Global Small Cap Composite is available by contacting the firm. Global Alpha Capital Management Ltd. (Global Alpha) claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS. Global Alpha has not been independently verified.