MICROCAPS SET TO MAKE A BIG RETURN

Despite the challenges faced by consumers, microcap companies that can thrive amid broader economic conditions offer exciting potential for outsized returns in the period ahead. By Joel Fleming, Microcaps Portfolio Manager

the 2024 outlook microcaps

M&A is starting to pick up and that's positive news for microcaps

2023 marks the second consecutive year of challenging index performance in the microcap space. On a two-year CAGR basis (to 31 October), the S&P/ASX Emerging Companies Index has returned -14.7% p.a., compared to +2.3% p.a. from the ASX 50.

With cheap money, illiquidity premia and strong momentum for conceptual businesses now distant memories, significant value is now emerging in the Microcap space. Many questions remain around inflation, interest rates, growth outlook and geopolitics. The primary concern revolves around their potential impact on underlying company earnings and the implications for the extensive investable universe that is Australian microcaps.

Money has flowed out of the sector due to significant global uncertainties, although we remain confident that it will return. Microcaps are inherently inefficient, and the current lack of interest in small and illiquid companies exacerbates this inefficiency.

We continue to concentrate on companies capturing market share and expanding into new markets. Beneath the surface, small and nimble companies continue to test new business models that aim to tap into emerging themes. We observe many companies progressing their business models and demonstrating tangible improvement in their economic fundamentals, often overlooked by the market. With M&A activity increasing, and our view that broader economic growth will be benign, the microcap space retains supportive of its potential for capital growth.

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The challenges that could derail growth

A key challenge into 2024 is the ability to grow in an environment where consumers remain under pressure and budgets are scrutinised more closely at both household and corporate levels. We continue to focus on companies that are gaining market share, expanding into new markets or are supported by long-term demand tailwinds. Businesses that can grow despite broader economic challenges are well-placed for success.

Our investable universe spans the entire economic landscape, providing early-stage access to emerging themes. Slower growth, rising costs and difficulties in sustaining price hikes will create a challenging backdrop for many parts of the market. However, small, fast-growing businesses with improving underlying fundamentals should be well-rewarded. The distinctions between thriving and struggling entities will become increasingly apparent.

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A second key challenge is around sentiment towards the perceived higher risk and lower liquidity aspects of the market. In the short to medium term, we anticipate increased M&A as a reminder of the strategic nature of some of these smaller businesses, providing ongoing opportunities for outperformance. A slower growth environment is likely to encourage larger businesses to seek ways to enhance their own growth profile, with M&A a key plank in this strategy. History has shown listed microcaps tend to be a fruitful hunting ground for this style of M&A.

We often observe significant value emerging at times when tangible business progress is overlooked due to size and liquidity concerns, and while M&A serves as a helpful reminder, closing the valuation gap will require improved sentiment to emerge in the sector. The underperformance has been significant. Many businesses have improved greatly over the last few years and the risk-reward equation continues to improve.

The sectors to watch

We continue to find attractive opportunities across the industrial, technology and resource sectors. Quality cyclicals appear overly discounted, with our view around the sustainability and growth of earnings at odds with current valuations.

Industrials: Our exposure to this sector includes engineering companies Lycopodium (LYL) and GR Engineering (GNG), who will be significant contributors to ongoing resource development and optimisation in Australia and internationally. Laserbond (LBL), specialising in surface engineering solutions, and XRF Scientific (XRF), a scientific equipment and solutions business, standout for their achievements in new product development, sustained demand and market share growth. Meanwhile, MaxiParts (MXI) is building scale in the commercial vehicle parts segment and Alliance Aviation (AQZ) continues to increase their fleet – and support major carriers domestically – while underpinning *Fly-in-Fly-out* services to the mining industry.

Technology: We believe mining software and consulting company, RPM Global (RUL) as being at an inflection point. The company has successfully transitioned from licence sales to a Software as a Service (SaaS) model, leveraging substantial product development to generate strong demand across various industries.

Similar to their more defensively positioned portfolio peers, we anticipate these companies growing their market share and improving underlying fundamentals.

Resources: While currently underweight resources, we anticipate base metals will be an interesting sector to watch in the coming months. We expect a potential rebound in commodity prices next year and are currently intensively researching assets and management teams poised to thrive in a more buoyant pricing environment, capturing strong available cashflows. Further consolidation across resources is anticipated due to underinvestment in exploration, a lack of exploration success, and the risk of stranded assets. This dynamic will increasingly focus the equation on M&A rather than building from the ground up.

How we are positioning the portfolio

We have always taken a long-term view when constructing our portfolios. Despite economic conditions cooling investor interest in the space, we remain confident our holdings are well-positioned to continue growing, capturing market share and evolving into increasingly vital and successful businesses in their respective markets. The portfolio is well-diversified by sector; end-market exposure; and stage in their life cycle. We believe that much of their potential is currently being overly discounted in the current market.

As examples of the diversity of our holdings, we would highlight companies such as pharmaceutical products business Botanix (BOT), where we await FDA approval, and our conviction in the sustained demand for IVF services at Monash IVF (MVF). Synertech's (SOP) Powerhouse solution is a leading, fully renewable microgrid system with a commercial order from Santos (STO) and significant market opportunity across the Energy and Resources sector. In the education technology space, after a period of significant investment, 3P Learning (3PL) is bringing to market its full suite of new and improved reading, writing and spelling products. We expect the significant investment made by these management teams will surprise to the upside in the coming years, forming the platform the foundation for strong growth and improved market positions.

Bigger picture themes continue to shape local and global economies, offering exciting opportunities for our portfolios. Populations are aging, the intergenerational wealth transfer has begun, the decarbonisation challenge remains, while cyber security, digitisation and the emergence of AI are all examples of significant market shifts that will create significant threats and opportunities for listed companies. Innovation and testing tend to start first in small and microcap companies, and we maintain the belief that the opportunity for long-term capital growth remains a significant attraction.

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Positive signs are emerging for microcaps