

EQUITY

Do Look Now: Finding Under-Appreciated Opportunities in UK Small Caps

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Given the large number of UK smaller companies (small caps), keeping on top of the potential opportunities has always been a challenge for investors. But as Richard Bullas explains, dwindling research coverage of the sector in recent years has made that challenge more intense while at the same time potentially offering greater scope for savvy investors to benefit. In this article, he reiterates the importance of taking a hands-on approach to small-cap investing.

We regard the UK small-cap market as one of the most sophisticated, diverse, and dynamic hunting grounds in the world.

With more than 1,250 stocks to choose from, the sheer scale of the United Kingdom's small-cap universe (as represented by the FTSE Small Cap and FTSE AIM indices) is one of the things that we think should make it attractive to investors.¹

There tends to be a greater weighting among smaller companies to newer-economy industries and sectors, and because these businesses are generally more dynamic and flexible than their larger peers, they can often grow a lot faster because they're coming from a lower base.

The wide investment universe should create the potential for valuation anomalies, allowing savvy investors to potentially take advantage of the market's inefficiency. As investors in this space, we try to seek out some of the under-recognised opportunities that we think are mispriced but offer superior upside potential.

The challenge for us as small-cap investors is identifying companies that appear undervalued; in other words, where we think the share price doesn't adequately reflect the quality of the company, profit profile and longer-term growth potential.

Less Third-Party Research

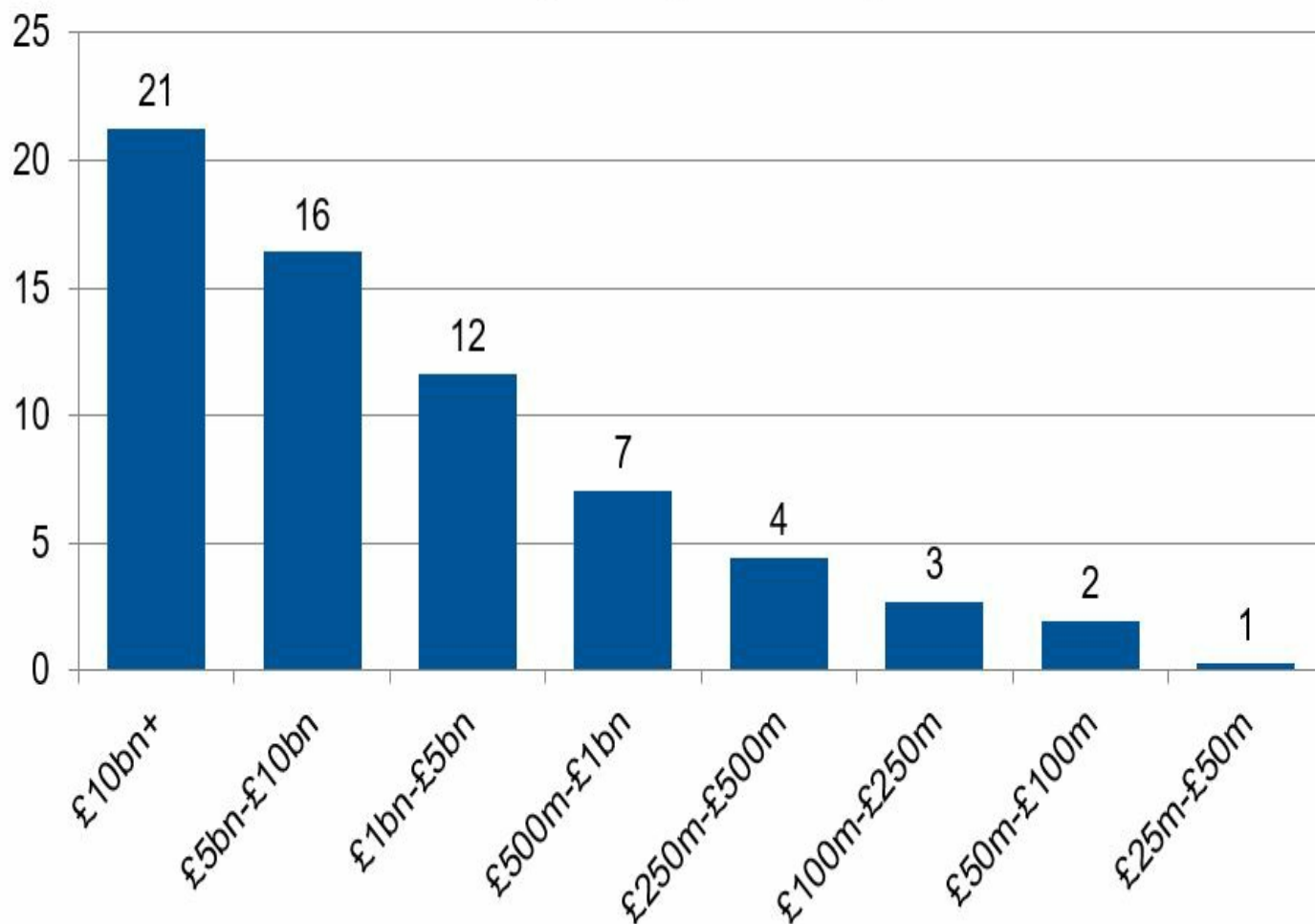
Traditionally, investors across all market-cap ranges have generally relied on external research—generally from investment banks or stockbrokers—to inform their decisions.

However, for a variety of regulatory and economic reasons, over the past five years there's been a noticeable drop in research coverage of small-cap stocks.

Small Caps Are Under Researched

Average Analyst Coverage

Average Analyst Coverage



Source: Bloomberg as at 28/02/19. Important data provider notices and terms available at www.franklintempletondatasources.com.

Over time, we've seen a reduction in research capacity in the stockbroking sector, and the introduction of the Markets in Financial Instruments Directive (MiFID II) last year accelerated the trend. MiFid II requires investment managers to unbundle research costs from trading fees and either pass on those costs to clients or absorb them themselves.

As a result of MiFid II, many investment managers have made substantial cuts to their research budgets. Investors are no longer willing to pay for simple company information that has already been reported and are instead demanding reports that are substantive and add value.

At the same time, stockbrokers—the traditional providers of investment research—have faced a challenging operating environment. In addition to the impact of MiFid II, falling commission fees and a lacklustre primary market (IPOs haven't been consistent) have been additional constraints.

It has been very tough for some of these businesses to adapt and to change. As a result, consolidation has occurred, and some have gone out of business.

All these factors are starting to have an effect on the small-cap market. Five years ago, an average of 11 analysts covered stocks in the £500 million to £1 billion market cap range. Today, that number is seven. Similarly, the average coverage of stocks in the £250 million to £500 million range has fallen from six to four, and in the £100 million to £250 million range from five to three.²

That is an average reduction of about 36% in terms of coverage.

So as capacity has been coming out of the stockbroking sector, it means potentially more inefficient pricing and opportunities for us to seek out undervalued stocks.

The market really is becoming more under-researched, and we believe that should present an advantage to investment managers like us willing to roll up their sleeves. We do the hard work researching companies to assess the fundamentals and seek out valuation opportunities.

Small-Cap Investing Is A Hands-On Job

To exploit market inefficiencies, small-cap investment managers really need to understand the companies and industries they are operating in. We think one of the big differences between some small-cap managers and their large-cap counterparts is this hands-on approach.

A lot of small-cap businesses are in niche industries. Investment managers interested in these opportunities can't just go online to find a research report from an investment bank or sell-side analyst. Of course, you can find a lot of other information through the Internet and research tools, but you have to be proactive and gather as much supplementary information as possible to be able to make an informed decision.

This means putting a lot of effort into sifting through what is a large universe of potential opportunities.

As a small-cap portfolio manager, I have a lot of interactions with chief executives and finance directors—the leaders of a business. So I can get the particulars from the source, including information about their markets, competitors and new products, as well as their opportunities and the threats to their business. Asking in-depth and probing questions helps me formulate an opinion on the outlook for the business and ultimately its potential value.

That's the part of the job that's most enjoyable to me—going out and meeting business owners and managers, whether through an on-site visit or in an office environment. I can better understand what they do, how they make their money and what their potential looks like over a three- and five-year period.

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[1.](#) The FTSE Small Cap Index is a small market capitalisation index consisting of the 351st and 619th largest listed companies of the London Stock Exchange. The FTSE AIM (Alternative Investment Market) All-Share Index is a capitalisation-weighted index of small and emerging companies traded on the London Stock Exchange. Indexes are unmanaged, and one cannot directly invest in them. They do not include any fees, expenses or sales charges. Past performance is not an indicator or a guarantee of future performance.

[2.](#) Source: Bloomberg, as at 28 February, 2019.