Time for small cap investors to stop whinging

The 2024 year began the way 2023 ended. Globally, the MSCI World IMI Index (in AUD) rose 12.7% in the first quarter of the year while the ASX All Ordinaries Accumulation Index (including dividends) rose 5.5% over the same period. The composition of the rally changed meaningfully, though, with the Magnificent Seven becoming a magnificent five (**Apple** and **Tesla** both experienced share price declines over the quarter) and a significantly higher percentage of the market participating in the rally. More than half of the S&P 500 constituents traded at 52-week highs during the quarter.

Plenty of smaller companies have seen significant share price rises. There are reflections of the 2021 meme bubble in some Artificial Intelligence related stocks (I use the word “related” loosely). But, for the most part, I would argue there are often logical reasons for those that have risen to rise and those stocks that haven’t participated in the rally to be left behind. Companies that are delivering good results are seeing it reflected in share prices. Those that aren’t, aren’t.

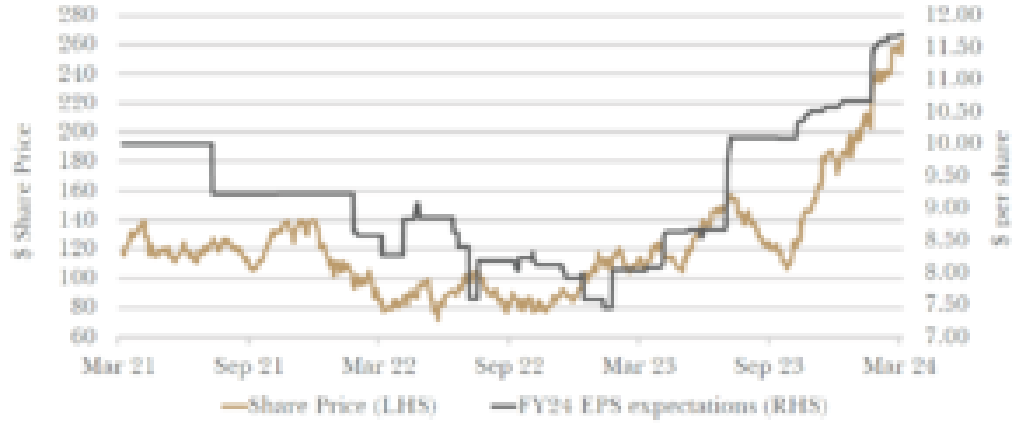
Take a couple of examples from our own portfolios.

Utilities software company **Gentrack** (listed on the ASX and NZX) has experienced a fivefold share-price increase in the past 18 months. Its market capitalisation — less than NZ$150 million not long ago — is approaching NZ$1 billion. That’s all thanks to a dramatic turnaround in profitability and growth prospects. Gentrack went from losing NZ$3 million before tax in 2022 to making NZ$15 million in 2023. We expect that to at least double again over the next three years.

Over in the US, insulation company **Installed Building Products** has seen its share price more than double since October 2023. Our original thesis was that, despite facing a difficult housing construction backdrop in the short-term, this company had great long-term prospects. The weak housing backdrop hasn’t proven an impediment at all. Rather than a 2024 year of no revenue growth, as implied in prior broker estimates, the company’s recent guidance suggests 8% growth in 2024.

They have historically given conservative guidance. In the chart below, you can see the impact that has had on expectations for 2024 profitability.

Installed Building Products Share Price vs Earnings Per Share Expectations



Source: Bloomberg

On the flip side, two years ago antipodean tourism operator **Experience Co** was expected (by the broker community) to make more than $0.02 in earnings per share this financial year. It will be lucky to break even. And US outdoor brand **Yeti** has seen expectations for its 2024 profits slashed by 40% and its share price hammered as a result.

Yeti Share Price vs Earnings Per Share Expectations

Source: Bloomberg

The message for investors and companies is clear. There are plenty of smaller companies trading at appropriate or even optimistic share prices. If your company isn't one of them, it's time to stop whinging about small cap malaise and start focusing on what the business needs to do to be recognised. Deliver profits, cashflow and growth, and there are plenty of investors who want to own your shares.

Deliver broken promises and your share price will remain in the dumps.

You can quibble about the magnitude in both directions. We sold a meaningful percentage of our investment in both IBP and Gentrack due to valuation. We think the long-term story for both Experience Co and Yeti is delayed rather than destroyed (the investment in the latter was made after most of the downgrades). And there are exceptions where good progress is not reflected in share prices.

But, overall, the market mood for small caps has changed from outright pessimism to selective optimism. The opportunity for share price appreciation is significant for those companies that can give investors a good reason to invest. It is up to us to find the right stocks and companies to deliver results.

This is an excerpt from the Forager Chief Investment Office Letter March Quarterly Report