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In-depth analysis and insights to inform your decision-making.

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European Smaller Companies

EXPLOITING INNOVATION IN EUROPEAN SMALLER COMPANIES

KEY POINTS

- When it comes to small-company investing, insight into the innovative capabilities of companies is crucial. Innovation can be a key long-term driver of returns.
- Understanding the unique attributes of smaller companies is also essential to finding those with the potential and business acumen to make their ideas work commercially over the long term.
- We seek to uncover those companies that we believe can grow significantly in a durable fashion over the long term.
- However, smaller-company research demands an extra layer of insight and consideration.
- Investing in early-stage businesses also demands having a perspective that looks beyond the valuation data. True innovation has an investment horizon beyond just one year, or even three years; it's a long-term proposition.

When it comes to small-company investing, insight into the innovative capabilities of companies is crucial. Innovation can be a key long-term driver of returns. Understanding the unique attributes of smaller companies is essential to finding not only those with game-changing innovative ideas, but also those with the potential and business acumen to make their ideas work commercially over the long term.

We spend a great deal of time and resources looking for and researching companies we believe to be truly innovative—those that offer something unique within their field or industry and, as such, have the potential to gain an edge on the competition. Innovation comes in many guises, of course, but three broad classifications provide a basis for our research:

1. **New product innovation:** This is a very broad category, including new drugs, new software, or technology; it extends to new brands, new products, or formats, as well as new business models and services.
2. **Disruptive innovation:** Smaller companies set to successfully challenge incumbent businesses or the status quo.
3. **Sustaining innovation:** It is crucial that young companies keep reinventing themselves to keep ahead of the competition. The truly great returns come from businesses that can do that.

We seek to uncover those companies that we believe can grow significantly in a durable fashion, maintaining or improving their profitability and returns over the long term.

Developing and harnessing the innovation is just part of the journey. Creating a business that can exploit that innovation is also vital.

Earlier this year, we conducted our own study to identify how many smaller companies had demonstrated the super-compounding performance that we look for (defined as companies that have achieved a compound annual growth rate of at least 20% per annum over 10 years).[1] The result was illuminating. Only 1% of companies managed that feat over different periods. We found this to be an important insight, and it has subsequently helped underpin our investment process. Finding these durable compounders is critical—and that's always the challenge.

UNCOVERING INNOVATIVE POTENTIAL

Discovering smaller companies with significant potential derived from innovative ideas and products demands a nuanced approach. Simply screening for innovation is not an option. Instead, uncovering groundbreaking ideas with the potential to change the status quo and drive real growth demands a combination of curiosity, effort, determination, and judgment from a well-resourced research team. Company visits are essential.

Initial public offerings (IPOs) represent a rich source of new ideas—and an opportunity to capture the innovative ideas of smaller companies early on. Substantial rewards can come from identifying quality businesses—the leaders of tomorrow—early.

However, smaller-company research demands an extra layer of insight and consideration. The depth of fundamental research needed to make an assessment is the same as for other stocks, but the information available can often be patchy. Comparisons with similar public companies can provide a good baseline of information, particularly as a guide to valuation multiples being assigned to competitors.

An assessment of the company's plans and projections for future growth is also critical because an IPO valuation depends heavily on the company's future growth projections. We can also assess a "good seller effect"—typically when an IPO is offered by the company founders or if the purpose is to raise growth capital. We have found that certain private-equity firms are better than others. They have good and disclosed track records and are skilled investors. They can identify fundamentally attractive, long-term industries, and they put in place strong corporate governance and more professional systems and structures. Management pedigree is not always easy to gauge, and this is where conducting due diligence and learning about the company's leadership team is critical.

As for the current IPO market, we are probably approaching the end of the cycle. There have been a significant number of IPOs, but a narrower set of companies is coming to market now. They are also lower quality and generally have higher valuations. Even so, we are still very selective about the IPOs we choose to participate in.

MAKING THE TRANSITION TO SUSTAINABLE GROWTH

While finding innovative companies demands an added layer of research and insight, even more crucial is ascertaining which companies have the capacity to grasp the opportunity at hand and make it a long-term success. They may have great ideas, but often it takes longer to bring those ideas to market—to commercialize them—than originally planned. The hurdles to success are often high.

There are many reasons why such companies can struggle to make the transition: the "innovation" might not progress from idea to reality; the product can fail; new entrants might out-innovate; and incumbents may find ways to defend their businesses and profits.

Developing and harnessing the innovation is just part of the journey. Creating a business that can exploit that innovation is also vital. To capitalize on the growth potential, there must be investment in management, systems, and capacity far in advance of the target date for bringing a product to market. That demands capable and judicious management to help the company make the transition from a start-up to a small company that grows over time. Not surprisingly, many find this transition complex.

PATIENCE, RATHER THAN VALUATION, IS KEY

Valuation discipline is of great importance when choosing the stocks to make up a portfolio. Yet investing in early-

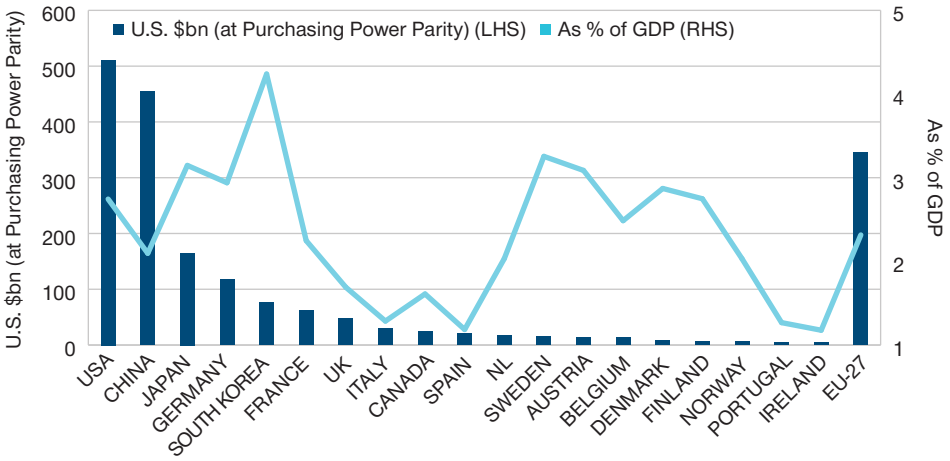
[1]The study analyzed the total shareholder returns of companies in the S&P Europe MidSmallCap Index over the decades ended 2007–2016. This universe typically contains 1,500–2,000 companies at each starting point. Sources: FactSet and T. Rowe Price.

PATIENT INVESTING—UK SEMICONDUCTOR COMPANY

The Wales-based company has a focus on compound semiconductors and makes the wafers used in the 3D-sensing camera in Apple's iPhone X. The compound semiconductor market has been an area of promise for a decade or more, but until now the products have been used only in niche applications. The company's visionary leader transformed the business by making acquisitions to build the right setup over that period. We identified several years ago what we believed was the significant growth potential for the field of compound semiconductors more generally, although the market has only recently started to recognize this as applications have begun to expand. We are confident that compound semiconductors are going to be a big driver of the semiconductor market, and we are starting to see that happening now.

FIGURE 1: **Europe Is Staying in the Innovation Game**

Gross Domestic Spend on Research and Development, as at December 31, 2016



Source: http://data.uis.unesco.org/, Science, Technology and Innovation, data for 2016.

stage businesses demands having a perspective that looks beyond the valuation data. Figures that suggest a company is delivering a 20x or 30x price-to-earnings multiple, for example, must be considered in the context of the longer time horizon needed for innovation to deliver growth and income. True innovation has an investment horizon beyond just one year, or even three years; it's a long-term proposition. For the patient investor with a fundamental belief in the management and the product, seemingly expensive stocks now can potentially yield appreciable gains over time as the benefits of their innovations are realized.

The process of adding innovation-led smaller companies to a portfolio also demands a more considered approach. In our view, this means starting with small positions and building a well-diversified portfolio over time. Ongoing meetings with the management and further research subsequently seek further evidence of the potential of the innovation or that management is demonstrating an ability to take the business to the next level. This provides the information to help determine when to adjust those positions over time.

CAPTURING THE INNOVATION EDGE IN EUROPE

So how does Europe fare in comparison with the rest of the world? We believe the European small-cap universe presents a huge opportunity for uncovering innovative companies. Figure 1 illustrates that Europe spends a significant amount on research and development both absolutely and as a percentage of gross domestic product.

Clearly, the U.S. has done very well in innovation—consider the rise of the FAANGs,[2] for example. China and Japan also have a great track record. While Europe may not yet have produced the types of start-up companies that have turned into an Amazon or a Microsoft, the Continent has a long and deep culture of fostering innovation.

Many academic institutions feature prominently, and the EU has a strong legal framework that protects innovation. Europe is also home to some of the most innovative industries on the planet—the automotive industry is a standout example, while genomics, particle physics, and renewable energy all have strong foundations.

Small, innovative companies can also be found in Europe in the health care, retailing, and industrials and business services sectors, not just technology. They are contributing to the process of disruption that is changing economic activity on many fronts—not only in Europe, but across the world

[2]Facebook, Amazon, Apple, Netflix, and Google (now listed under its parent firm, Alphabet).

BE SELECTIVE, AND LET THE WINNERS RUN

While Europe is rich in young, innovative companies that are capable of appreciable growth, history teaches us that relatively few of these types of entities can generate significant total shareholder returns over the longer term, so sound and deep research is necessary to identify them.

Our research shows that the market underestimates the scope for such enterprises to demonstrate durable and attractive rates of growth and grow much larger over the longer term. Discovering them at an early stage and holding them while they compound appreciably over the long term can offer opportunities to earn sizable returns.

Key Risks—The following risks are materially relevant to the strategy highlighted in this material: Transactions in securities of foreign currencies may be subject to fluctuations of exchange rates, which may affect the value of an investment. Investment in small companies involves greater risk than is customarily associated with larger companies, since small companies often have limited product lines, markets, or financial resources.

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