Small-cap stocks set to thrive

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The latest earnings season confirmed our belief that the broad-based sell-off in small-cap consumer and retail stocks was overdone. High quality retailers proved that they were in a strong position to weather the economic uncertainty and that the short-term dislocation between the share price and the intrinsic value of many of these companies was a buying opportunity.

Our investment process is to buy undervalued growth companies with catalysts that we believe will re-rate the share price. In May, we undertook a rigorous analysis of small-cap retail valuations and broker expectations over the next two years, particularly comparing expectations for FY2025 to actual results in FY2019 on a per store basis.

What we found was a compelling investment case for a number of companies, exemplified by Harvey Norman (ASX: HVN). Consensus earnings forecasts for the company for 2025 were lower than the actual earnings reported four years ago, despite the current trading environment being stronger than in 2019. This suggested to us that the market has already baked in a worst case scenario for the stock, which we believed to be unwarranted.

We first bought shares in Harvey Norman in June at approximately $3.30 per share, a price that implied a lower than book value on the retailer's vast property portfolio. We have only seen this happen on two occasions in the past 15 years. This meant we were essentially buying the operating business for free.

Pleasingly, the catalyst played out when Harvey Norman reported better than expected results, which prompted analysts to upgrade earnings forecasts by up to 15 percent. Looking forward, we believe the stock is worth above $5.50 per share.

Retail resilience

Harvey Norman is one of many examples we saw during the earnings season of better than expected results from high quality small-cap retailers whose share prices have been sold off heavily. Many companies are exhibiting healthy balance sheets, holding very clean inventory and have begun to optimise their cost base in preparation for the uncertain macro environment.

While there will be some cyclical economic pressures over the next six to 12 months, we believe a number of companies are well positioned to gain market share. These include The Reject Shop (ASX: TRS) and Premier Investments (ASX: PMV), which both reported results approximately 10 percent above expectations and have catalysts that are likely to re-rate the companies' share prices over the next 12 months.

Premier Investments, which is run by the founder and chairman Solomon Lew, holds over $1 billion in cash and liquid equity investments in fellow retailers Breville (ASX: BRG) and Myer (ASX: MYR). The company announced a formal review to assess its corporate, operating and capital structure in order to unlock shareholder value.

The resilience of consumer spending for small-cap retailers also extended to the outperformance of companies exposed to the housing sector. Over the last six to nine months, we have been progressively increasing our exposure to the housing sector, taking a view that investors were too pessimistic about the impacts of high interest rates, high inflation and the difficult economic environment on some of the listed companies. Two of our high conviction stock picks in this sector include Maas Group (ASX: MGH) and Nick Scali (ASX: NCK), where both delivered strong results, confirming our investment thesis.

The artificial intelligence (AI) bandwagon

We are taking a positive view to AI exposed companies given our observations that there is real evidence that AI initiatives are driving efficiency gains in different industries. The positive narratives coming out of the world's leading technology companies suggest that investment into this space should continue over the next few years, and we want to be positioned accordingly.

A company we remain bullish on is data centre operator NextDC (ASX: NXT), which we began buying in February at approximately $10 per share. After speaking to many industry experts, the catalyst we identified was that large global technology companies are increasingly looking to put servers into partner data centres to complement their own data centres. This played out over the last seven months with NextDC winning two significant contracts. We believe this trend will continue with more AI related contracts to come over the next few years.

Another stock we own is connectivity services provider Megaport (ASX: MP1), a business that effectively enables data connection between companies and data centres. We began purchasing the shares in April at approximately $5 per share. This was on the back of a change in management with the Chairman and founder Bevan Slattery stepping back into the business. Bevan introduced financial discipline via right sizing the cost base as well as bringing on board the new CEO Michael Reid, a seasoned technology executive with an impeccable track record. With a revitalised management team, we believe Megaport is well positioned to take advantage of the demand for their services over the next few years.

We see a lot of value in small cap companies and are well positioned to take advantage of undervalued growth companies where we can identify a catalyst. We believe the headwinds faced by small-cap companies over the last few years can turn into tailwinds in the year ahead.