FPM-**Comment Reducing the Noise**

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Misallocation of capital: Where is the "really smart money"?

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- "Private equity" vs. "public equity"
- Irrational valuations
- Modern trends promote valuation discrepancies
- Good reasons for a reorientation towards small and medium-sized enterprises

„Private Equity“ vs. „Public Equity“

I recently read the headline in Citywire: "Family office study: Now is an interesting time to go into the offensive." On reading the article, however, I realized, contrary to my expectations, that an increase in the equity allocation is not being considered, but that the weighting of "alternatives" is to be increased at the expense of equities and cash. Why the allocation is to be shifted from public equity to private equity can probably also be seen as a cowardly act before the owner of the family office. Why discuss the fluctuations of the stock market when you can avoid this problem with private equity?

From an economic point of view, it is more than questionable to invest in private equity at present when large parts of the "public" equity market are trading at historically low valuations, whether based on price/earnings ratios (P/E) or enterprise value/EBIT, or in the case of growth stocks based on enterprise value/sales, after they have lost 80 to 90% in some cases.

There are a large number of companies that trade on price/earnings ratios of 5 to 8 or lower. Investing in low multiples on the stock market with manageable priced-in future expectations is likely to prove superior to private equity. Why? Private equity will not be able to acquire companies on a large scale at lower valuation multiples than are currently demanded on the stock market. Why would anyone sell a financially sound company to private equity for five to eight times annual earnings? Strategic buyers pay higher valuations, or the seller waits a little in case of doubt. As long as the exit multiples, i.e. the valuations that can be achieved on the stock market, do not increase, it is relatively difficult to sell private equity investments, apart of course in special situations. One example of this is the Douglas disaster after a holding period of several years.

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With financing costs now higher again and valuations on the stock market lower than in the past golden years, the model can no longer work as well as it used to.

This is a logical consequence of the low valuations for small and medium-sized companies and the slump in the prices of many growth stocks on the stock markets. Private equity investors therefore have no choice but to sell their holdings back and forth to each other in order to keep valuations high and avoid write-downs.

The prospect that the stock market is the better alternative for investing fresh money can also be seen from the fact that private equity is becoming increasingly active there. Examples on the German stock market include Software AG (where the entire purchase price was refinanced through the sale of a division to a strategic investor), as well as Aareal Bank, SUSE and Synlab. These companies had one thing in common: private equity investors were already involved and, due to the depressed share prices, they were able to top up at an attractive price despite a necessary premium on the current share prices, in some cases significantly below the IPO prices not so long ago. If desired, they can also seek a delisting - a bad habit that is spreading thanks to incompetent jurisdiction. It is only a matter of time before companies with a 100% free float are also targeted by corporate buyers.

Irrational valuations

A few examples illustrate just how irrational the valuations of many companies on the stock market are or were. In January, Deutz announced that it intended to sell a division that was no longer strategically necessary (electric motors for boats) to a strategic investor (Yamaha). Deutz received an estimated EUR 80 - 90 million as sales proceeds for 2% of Deutz Group turnover (approx. EUR 40 million), although this division made an EBIT loss of EUR 23 million (!). 15% of the market capitalisation achieved for 2% highly loss-making sales. Despite the jump in the share price following the announcement, Deutz's price/earnings ratio is still 7. Another example is Süss Microtec, which received EUR 75 million for a division that made a high single-digit million loss. Here too: For an estimated 10% or so of highly loss-making group sales, it received just under 25% of the stock market valuation. In both cases, the buyer would have been better off buying the entire company, taking the desired division and selling on the majority of the otherwise profitable company at a profit – the typical playground of private equity investors.

Modern trends are fuelling valuation discrepancies

What are the reasons for these valuation discrepancies? In addition to the growing preference of institutional investors for private equity investments, on the private investor side it is probably due to the trend towards ETFs that has been propagated for many years. No matter what you read, ETFs are recommended almost everywhere. Even if there are of course factor ETFs or ETFs on the MDAX or SDAX, the recommendations are predominantly ETFs on the MSCI World, S&P 500, Eurostoxx, DAX and other indices with highly capitalised shares. The money flows disproportionately into the large stocks, while small and medium-sized companies in particular lack investors. Add to the ETFs a few individual investments in well-known tech stocks and some gambling with Bitcoin & Co. and you have the "modern asset mix" and the explanation for the

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performance of the "Magnificent Seven". If you then realise that ETFs now have a market share of 60%, you get an idea of the meticulousness with which investments on the stock market are screened. But it gets worse: with newly allocated capital, the market shares are more likely to be 100% than 60%, and net probably even higher thanks to shifts from active to passive vehicles.

Good reasons for a reorientation towards small and medium-sized companies

What could reverse this trend and shift the focus back to German small and mid caps?

1) Small and medium-sized companies are performing above average in the economic upturn. Based on the current situation (recession coming to an end, interest rate cut fantasies, low valuations), the opportunities are likely to significantly outweigh the risks from a historical perspective. Although the economic research institutes have revised their forecasts for 2024 back down to zero growth, the Ifo index has risen for the second time in a row and has now returned to the level of summer 2023. The chemical industry, an important sector, also appears to have found its bottom now that customers have finished destocking.

2) Although small and mid-cap stocks have historically traded mostly at a premium to large caps, this phenomenon has now changed. The absolute valuations of small and mid caps have halved from the valuation highs of the last 20 years and are now trading below the valuations of large caps.

3) Even if the capital markets are possibly too optimistic about the timing and extent of interest rate cuts, the so-called "Fed put" is once again a possible measure by the central banks. A year ago, when inflation rates were high, it would have been impossible for central banks to react to a slowdown in growth or a crisis by cutting interest rates, just as it was impossible when interest rates were zero. This is now different again and, apart from occasional, ever-possible corrections, equities therefore have additional support alongside the valuation and an improving economy. It is possible that investors are relying on this for many highly capitalised stocks with a demanding valuation. This would of course also apply to small and mid caps.

4) Even representatives of the left-of-centre party spectrum increasingly understand that the framework conditions for the German economy urgently need to be improved and are discussing tax cuts and a reduction in bureaucracy, among other things. Even if there is a long way to go, the chances of this happening have probably never been as good as they are today.

5) In view of the massive valuation discrepancies between public equity and private equity, it is only a matter of time before strategic private equity buyers become more active on the stock market.

6) Rich private individuals (in the billionaire category) will also exploit these discrepancies more and more. A good example is Klaus-Michael Kühne, who in addition to his stake in Hapag-Lloyd has now also acquired large blocks of shares in Lufthansa and Brenntag. What is the logical connection? Logistics, that is what he knows best! Daniel Kretinsky and his purchases of shares in listed German companies are another example. I can already hear the whining: the rich are getting richer.

7) When talking about the problems of Germany as a business location, one should always bear in

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mind that many German companies have a global presence and produce in numerous regions around the world. If you invest in German shares, it is a well-known fact that you do not regularly get companies that operate exclusively in Germany. What you do get, however, is German headquarters and the German legal system, which, despite all the complaints about the various difficulties, is still far above average. You don't have to take Russia or China as a yardstick here; you can also have some unpleasant experiences in the USA.

8) More and more companies are launching share buyback programs. When low valuations and high cash flows come together and these are then used aggressively for buybacks, sooner or later considerable added value is created for shareholders. The major German banks are currently good examples of this. Valued at half book value and four to five times annual net profit, large parts of the profit are used to buy back their own shares. This results in after-tax returns of more than 20%. German car manufacturers such as BMW and Mercedes also fall into this category, as do an increasing number of smaller companies. If valuations do not rise, at some point in the not-too-distant future you will become a proud owner of a company.

9) The concentration of an increasing amount of investor money in always the same stocks increases the risk for these stocks in a correction. What is no longer held (such as many small and mid caps) can no longer be sold by the masses during a correction. In fact, some shares in these segments are shorted by hedge funds and used as a source of financing for investments in the popular companies. Such shares could even benefit from a correction.

10) And last but not least: It remains to be hoped that the political framework conditions will improve to such an extent that the climate for entrepreneurial activity and for investors will brighten considerably after the next general election at the latest.

Since the shares of small and medium-sized companies have underperformed by 30 to 40% in the last three years, depending on the index (SDAX, MDAX), and are already lagging significantly behind again this year, there are at least good reasons to believe that, against the backdrop of a potentially improving economic situation, there may not be an immediate outperformance, but there is at least a more than realistic chance that the underperformance of recent years will come to an end. An investment in this market segment also provides better diversification and the potential to generate alpha through outperformance in the medium term. If the shares do not rise: Then the buybacks will show their effect.

Sincerely yours,

Raik Hoffmann

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