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EP 157 | Navigating Global Small Caps in an AI-Transformative World

[00:00] Andrew Johnson: Hi, everyone. In this episode, I sit down with Karan Phadke, Portfolio Manager on our Global Small Cap Strategy. We dive into several relevant topics, including his views on the global investment universe and how the portfolio is performing within it; the potential second-order impacts of the artificial intelligence (AI) revolution, exploring both the risks and opportunities that may arise; and finally, an inside look at the business models and management teams of two portfolio holdings: Cbiz and Convatec. Enjoy!

[00:00:31] Disclaimer: This podcast is for informational purposes only. Information relating to investment approaches or individual investments should not be construed as advice or endorsement. Any views expressed in this podcast are based upon the information available at the time and are subject to change.

[00:00:48] Andrew Johnson: Hey, Karan! Welcome back to the podcast.

[00:00:50] Karan Phadke: Hey, good to be here.

[00:00:51] Andrew Johnson: It's great to have you back. You and I obviously get to talk on a more frequent basis in our work here at Mawer and with our clients, but it's been a while since we've had you on to talk about the global small-cap portfolio and the broader investment universe that you're looking at.

There's been a lot happening around the globe. I thought we would start there. As I said, you oversee a broad geographical area of the market. What have you seen over the last six to 12 months when you're looking at companies and the portfolio across all these different markets?

[00:01:19] Karan Phadke: So in the global small-cap strategy, we have over 10,000 potential securities out in the investable universe, and we have investments that span many different geographies within that. One of the themes that’s not anything new for the listeners or for you is just the outperformance in the U.S. So the economy over there has been exceptionally strong. As a result, the currency has been also very strong and favorable. The U.S. has been an outperformer for some time now.

Other parts where we've been seeing some opportunity have been Brazil and parts of Latin America. More companies are coming up on the screens over there, and generally speaking, strong economies, good companies, well run. It's just a matter of finding the right valuation after adjusting for currency. In Europe, more generally, also nothing new. More sluggish on the fundamental side, with the industrial and markets not rebounding as strongly as the U.S. has been. Europe, just more generally, has slower growth across the board.

And then, finally, Japan seeing inflation. We've been observing this for just over two years now, but inflation was very difficult to come through initially. Both consumers’ and companies' mindsets around price increases have been changing. So after years of even deflation and just a complete cultural aversion to raising prices, we've started to see that in even the consumer-facing companies that we own over there. Time will tell if that's more of a structural change or just temporary, but that's been an interesting development, as well.

So that's sort of what we see at a broad level. But again, I think the important part to remember is that we invest in companies and not necessarily geographies. There are many instances of companies, for example, that may be in one geography but sell globally or to other markets. And really half of the job is making sure that we pick the

right CEOs and managers who will also find opportunities in the right asset classes and geographies around the world.

[00:03:20] Andrew Johnson: It may be just to that point, and more specifically to the current holdings in the portfolio, where are you seeing both strengths and weaknesses relative to the broader investment universe?

[00:03:30] Karan Phadke: On the strength side, we own a lot of U.S. companies that have been doing well. So we own, for example, PEOs, which essentially are outsourcing companies that help smaller businesses with staffing as well as payroll and health insurance. It's almost like an outsourced HR department. As you can imagine, they've been doing quite well on the back of strong employment and strong numbers in the U.S. So that would be an example that's done well.

And then on the European side, we tend to own more resilient, boring stocks. We own a couple of healthcare companies in both the UK as well as in Germany that sell generic pharmaceuticals, often over the counter and branded items. And those chug along regardless of the end market economy because people still need to take care of their health, and they provide affordable options for that.

So those would be some examples of growth companies that are doing really strong because they're buoyed by the economy, as well as companies that are just chugging along, regardless of what the economy does. Maybe not the fastest growers but also not hit on the negative side, even if macro is a bit weaker.

[00:04:36] Andrew Johnson: One inescapable theme right now is AI. Seemingly everything, everywhere, all at once. More specifically, we're talking about generative AI and all of the excitement around it. And I'm not discounting the potential that it may have in a more direct or acute way, but I'm more curious about the second-order impacts.

For example, there's talk about how the power supply might need upgrading to meet increased demands from data centers supporting those AI models. Another area I wanted to get your thoughts on was the replacement cycle of hardware and software for businesses around the world that will presumably need to be upgraded to integrate the widespread use of AI going forward.

In the global small-cap portfolio, some of our key long-term holdings fit into the category of either value-added resellers or IT solutions providers. These are a combination of distributors with this consultancy service that's layered on top of it for these businesses that are constantly trying to stay on top of their technology needs. How do you see the integration of AI in this sense and the potential impacts it may have on business models like those that I just mentioned?

[00:05:46] Karan Phadke: As you mentioned, Andrew, the two most obvious areas where AI is affecting the business models are hardware – things like NVIDIA graphics processing units, data center infrastructure, things of that nature – and then software, which is obviously OpenAI and ChatGPT would be the greatest example of software.

I think there's a third category where we tend to focus and that’s services. Services is basically companies that are helping their clients acquire and integrate the hardware and the software to be able to effectively use AI. So two business models that we own in the strategy would be value-added resellers and then IT consultants.

Value-added resellers are pretty straightforward. If you're a small business like Mawer, for example, and you want to upgrade either your hardware – so that could be laptops, servers, headsets, whatever it is – or you want to upgrade your software – Microsoft licenses, Salesforce licenses, things of that nature – you would go to a value-added reseller who functions as both a distributor of these products but also an advisor. They can bundle

together solutions for you and give you advice on what the right mix of these things is and, in some cases, also monitor your usage to make sure that you're being highly effective with what you spend.

So that's what a value-added reseller does. They, again, are acting as an IT provider that is giving customers solutions, and they're advising them. So over time, that business model has shifted from just providing hardware. It's no longer just, "Hey, here's a laptop, and we charge a markup on it." More and more it's, "Here's a solution. Here's the software, as well. We'll manage your licenses and make sure that you're using it effectively." It's becoming more like a consultant with an advisory component and that's allowing them to evolve as technology shifts and to continue providing value add to clients.

So I think that's on the value-added reseller side. And then on the IT consultant side, again, a big part of this is helping the clients along and helping them to actually integrate AI into their solutions. If you look back at the industry, 20 years ago, when Oracle and SAP first started releasing their software systems to companies, people thought, "Hey, software is going to take over all this work, and you won't need services anymore, and you won't need advisors."

But that wasn't the case because the consultants helped these companies integrate Oracle and SAP, and then they had a lot of add-on work beyond that too. In the more recent past, the cloud came out with Microsoft, Google, Amazon, and other cloud providers. Again, the concern was that once you shift to the cloud, well, then there's no more need for people. There's no more need for services because it's all done through software in the cloud. But this has not proved to be the case.

So the consultants and the resellers have helped their clients both move to the cloud and then also manage some of the workload that they're doing and continue evolving with the technology. Now we're seeing the same story with generative AI. Of course, it's still pretty early, so things can obviously change. But what we're seeing when we speak with customers as well as companies is that there's a very heavy lift involved initially to get the data cleaned and ready to use. A lot of help is needed, even on the models, if you want to create bespoke industry-specific solutions. We're not yet at the stage where a large organization, for example, can just type in their computer, "Build me a new client portal," and, *voila*, it's got all the bells and whistles that are industry-specific, that meet compliance needs, and that meet the company-specific needs.

You still need programmers in-house and IT consultants who have expertise, both in the industry and on the cutting edge of technology, to help them. One thing to keep in mind, though, is that, of course, culture is really important in these business models. We want to make sure that we have firms that are evolving, continuing to learn, hiring young people, and staying on the cutting edge because if you don't, then you will get left behind.

Some more of the body shop work where you're just doing really low-end work, often offshoring it, that stuff can get more easily disrupted by generative AI because it's just a lot more cost-effective to outsource it to software essentially. We don't want companies like that, and the ones that we own generally are pretty forward-thinking and have systems and incentives in place to make sure that they keep learning the newest technology and holding client hands to take them along the journey.

[00:10:00] Andrew Johnson: Yeah, it's always fascinating to me; those business models, on the surface, seem very transactional, whereas when you get to understand them a little bit better, they obviously have a high degree of recurring revenue because of the services that they're layering on top of all of the other distribution that they're doing.

[00:10:16] Karan Phadke: One of the things we have observed is that there are two things that always seem to go up, and that's taxes and IT costs. I think it would be hard to find many businesses these days where the cost

of IT is going down. You're right that it is transactional in terms of the actual goods and services that change hands, but it is very relationship-oriented in terms of the nature of the business over the long run. Customers keep coming back to trusted advisors and that's more of a relationship repeat sale, which is something that we like. There is still cyclicality in the IT industry, so that doesn't go away, but the long-term trends continue to be very positive.

[00:10:59] Andrew Johnson: All the more important to keep an eye on that culture of innovation and make sure that those companies and management teams have good alignments in terms of incentives to think long-term through those different cycles.

Before we wrap up, Karan, I always like to hear more about some of the individual stocks in the portfolio. There are a couple of good illustrations of our philosophy and our process. CBIZ, which is a professional services firm that we've held since 2019, and Convatec, a more recent holding. We've now been invested for a little over two years. Talk us through those two names and where they fit in the portfolio.

[00:11:33] Karan Phadke: Before we actually get into those two names, one piece I do want to touch on is the reason why they are a good fit or example of our philosophy. If you look just top down at the strategy, one of the things that we're really looking for is these resilient businesses; ones that do well through thick and thin. I touched a little bit on this when we spoke about the geographies, so that's one piece. Then the other piece is we want them to be well run with strong managers who are reinvesting capital intelligently. And then we want them trading at reasonable valuations.

On the bottom-up level, we take companies like CBIZ or Convatec and others, and we aggregate them. What we see at the portfolio level is actually that the strategy is pretty resilient relative to the average or the benchmark. It tends to have much more profitability or returns on equity using less debt. It also trades at a discount now relative to the benchmark from a multiple standpoint. So again, all of these things give us some comfort in the positioning of the portfolio. It's a function of picking individual companies and brick-by-brick building the portfolio. If, at the underlying level, we have solid characteristics that we're looking for, then we also double-check at the portfolio level that we're positioned well.

So that's just a quick piece on how we think about portfolio construction. If we go into these specific companies, as you alluded to, CBIZ is a long-time holding with a pretty straightforward business model. They're an accounting and financial services provider. They're more of a regional accounting firm that helps smaller to mid-sized clients rather than the big four, the KPMGs and Deloittes of the world. They're more of a regional accounting provider.

Despite this, as you can imagine, it is a very recurring business model. Corporates are very hesitant to switch their accountant. There's a lot of risk and work involved with switching your accountant. As a result, they benefit from strong customer relationships, repeat business, and the ability to pass through inflationary pressures. That's something that we've seen really strong over the past few years, the untapped pricing power that they had in the ability to pass through wage inflation because, again, some of these resources, like accountants and financial service advisors, are pretty scarce. So they've been able to pass that through quite nicely.

The industry itself continues to consolidate. As the demand for better technology and people goes up, it becomes more and more difficult for the very small accounting firms to stay afloat. CBIZ has been playing its part in this by growing both organically and then doing small tuck-in acquisitions of firms that fit well with the culture and can benefit from the scale that CBIZ provides to invest in the back office and in the talent. We've been holding this company since 2019. It's typical for us that when a thesis plays out, we continue to own it for pretty long, often five or 10 years, and the company still has a reasonable valuation and is managed by a long-time executive who's been there for several years and continues to just play the plan when it comes to the strategy.

The second holding, Convatec, is a more recent one that we purchased around two years ago. We found this thanks to a hint or tip from our colleagues in the Global Equity strategy, and we also leaned a lot on the work that our colleagues in the EAFE Large-Cap strategy had done. What they do is they're essentially a consumable medical device company; think about adhesives or plastics that often are attached or inserted into the body. It could be ostomy bags or bandages or wound care specialized for pretty severe wounds.

They usually operate in oligopolies. These are markets that are consolidated with only a handful of companies that can develop these sorts of products. They're often the number one to number three player in those markets. As you can imagine, patients are pretty loyal as are nurses who recommend the product. No one wants to risk using a different wound care device or ostomy bag and having leaks, for example. This is a very sticky recurring revenue business, and R&D is very important as well. Part of the story is that the CEO was brought in a few years ago specifically to improve their innovation engine: increase R&D and invest more in the business while, at the same time, taking out unnecessary back-office costs.

He's been successfully executing on this for the past several years and is trying to take the company from good to great. We like what we see in this business in terms of the resilience of the demand and also the upside potential if management is able to take the company to the next level. We think that on that basis, the valuation is reasonable given that we are seeing some evidence that the CEO is making good progress toward improving the company. So that would be Convatec, another one of our holdings that really illustrates the type of business management and valuation we look for.

[00:16:14] Andrew Johnson: Alright. Well, we've covered a lot, Karan. I think that's a great place to close things out. As always, great talking with you, and thanks for taking the time to jump on the podcast with me.

[00:16:23] Karan Phadke: Thank you.

[00:16:25] Andrew Johnson: Hey everyone, Andrew here again. To subscribe to the Art of Boring Podcast, go to mawer.com. That's M A W E R dot com forward slash podcast or wherever you download your podcasts. If you enjoyed this episode, leave a review on iTunes, which will help more people discover the “Be Boring, Make Money” philosophy. Thanks for listening.