

## Talking Heads podcast with Damien Kohler

**Daniel Morris:** Hello, and welcome to the BNP Paribas Asset Management Talking Heads podcast. Every week, Talking Heads will bring you in-depth insights and analysis on the topics that really matter to investors. In this episode, we'll be discussing European small cap stocks. I'm Daniel Morris, Chief Market Strategist, and I'm joined today by Damien Kohler, Head of European Small Cap Equities.

Welcome, Damien. Thanks for joining me.

**Damien Kohler:** Good morning, Daniel. Thanks very much.

**DM:** Damien, it's been an exciting week, month, year! A lot of events [and] volatility, though we always say that in the volatility is the opportunity.

The more recent dynamics for equity markets have been twofold. Clearly, we're still assessing the implications of the conflict in the Middle East, trying to understand how high inflation is going to go and for how long. Perhaps we're starting to see a bigger impact of those concerns about inflation on bond yields, which – when they go up – tends to have a negative impact on equities.

But for a medium-term outlook, European economic data hasn't been so bad. In particular, I'd point to the manufacturing PMIs (purchasing managers' indices) across Europe, which perhaps surprisingly improved in April after the start of the war, when we might have anticipated a decline. If we look at retail sales across Europe, [they are] generally doing better [than] in March.

So, the macro picture is reasonably positive, certainly under the circumstances. If we then think about what's been happening in equity markets, particularly European small cap stocks, [the] good news is that European small caps have outperformed European large caps year to date. Can you explain why that's the case?

**DK:** Small caps have indeed outperformed the primary large cap indices this year, mainly in the Eurozone. The main driver was the type of companies in the small cap index versus large caps.

In large caps, you have luxury global consumer names such as LVMH, Hermes, where there's much more uncertainty in the Middle East, and you've got softer pricing power.

This has resulted in earnings expectations from sell-side analysts. And if you combine earnings downgrades and high valuation multiples, this was negative for the share price performance. So, this really weighed on the performance of large cap indices.

Second impact – we are less dependent on some crowded European champions. Last year was a year of defence companies. Defense companies performed significantly. But today you see that growth expectations are too high. Analysts have put too much high expectations on growth.

If you look at Rheinmetall, Airbus – all these companies you see some earnings downgrade. Valuation multiples are also quite high, so these stocks are underperforming. And this is the

second negative driver. What's positive on small caps, you are much more exposed to the local economy – to industrial reshoring, infrastructure spending, and, as you mentioned, manufacturing trends did improve in Q1 this year.

For instance, the steel sector is doing quite well in small caps because we benefit from protectionism set by the EU. Then in the energy sector, you have more exposure to offshore services, shipping, engineering or engineering infrastructure in the small cap index than in large caps.

And last but not least M&A (mergers & acquisitions) is still ongoing – depressed valuations in small caps continue to attract strategic buyers and private equity firms.

For instance, Beazley in the reinsurance sector in the UK was purchased by Zurich Insurance in Q1 '26. This reinforces the perception that parts of the European small cap universe remain undervalued.

**DM:** You've highlighted some of the key positive factors for small caps so far this year. That said, you've always got to be cognizant of the risks. What are the main concerns for European small caps these days?

**DK:** I don't have any specific concerns for small caps. The concerns I would have is a global concern for European equity markets, but also for global equity markets.

The key risk we are currently trying to assess [is] the following: inflation. Increasing inflation could impact the growth outlook of many companies in Europe and outside Europe. You see it already in the cost of goods in inflation, so you might have some margin pressure, but you don't see it yet on demand from consumers, or companies that are going to consider Capex due to the rising cost of funding. When you see 10, 20, 30-year government bond yields that are increasing significantly, this could have an impact on the valuation for growth companies trading at [a] high multiple.

This is a concern, so we need to be extremely cautious on the growth outlook. Then you've got the uncertainty in [the] Middle East – the impact it could have on the supply chain and so on. We have yet to see some disruption but we are already seeing some cost of transport going up, and so on.

These are the kind of things that we have to manage, but this is nothing specific to small caps. These are global concerns that we need to deal with.

**DM:** If we balance that, Damien – on [the] one hand, still reasonably positive growth drivers for Europe, at the same time, some of the concerns you highlighted in terms of inflation bond yields. When you think about investing within small caps, how do you approach the market given all these uncertainties?

**DK:** First, [it's] very important to be selective in small caps – always remember the breadth of opportunities in small caps. It's always attractive because we have the flexibility to diversify the portfolio and allocate the capital to companies with the best balance between valuation, growth and earnings visibility.

In small caps in each country, we can have cyclical companies, companies with a much more resilient business model, or growth companies able to grow more than 10% per annum over [the] midterm in a consistent manner.

This kind of flexibility helps you to navigate. I use the term 'navigation' because in this kind of market trend, we need to be concerned about the growth outlook and valuation. There are two important topics that I would like to mention: Cash flow generation and shareholder returns through dividends and share buyback[s].

This is the most important one that I would like to flag on small caps. Forty percent of our portfolio is yielding more than six percent. This is something I've never seen over the last 20 years. Six percent is higher than many government bond yields in Europe and in the US, even after the rise seen recently following the conflict in Iran.

Let me explain why. The economic growth outlook in the world is limited. Small caps have strong balance sheet[s]. If economic growth is not exciting, then small caps are overcapitalized, so they just give the cash back to shareholders through share buybacks because valuations are quite cheap.

And this is another reason why you have more M&A on small caps. The valuations are quite cheap. You have share buybacks on an ongoing basis. So in our portfolio, this is part of an income strategy. Forty percent is yielding more than six percent.

The second strategy is to capture the growth when you think the earnings visibility is a bit higher than the average. The challenge we have in the market currently is that, as there's a lot of uncertainties on the growth outlook per region, we need to be extremely focused on growth and the change of growth expectations.

The second point that is quite interesting is that the AI (artificial intelligence) revolution is impacting already an increasing number of companies, not only in the semiconductor [sector]. On growth, these are the two drivers I'm looking at. We are looking at AI spending – what could be the impact on small cap companies – and we have more and more companies flagging the growth potential, either through cost savings or top line [improvement].

We have a lot of candidate companies that can benefit from a cyclical recovery. That's why I believe this market is positive for investors who can have a barbell strategy with a strong income-oriented strategy combined with a growth approach at reasonable prices.

I reiterate the fact that I've never seen an opportunity like this over the last 20 years. 40% of the portfolio is yielding more than 6% on dividend or share buybacks.

**DM:** If I could summarise some of the key points that you shared with us, Damien, when you explained why small caps have outperformed European large caps this year, you pointed to some differences in the construction of the indices – what sectors have higher weights in small cap than large – but also, small caps are more exposed to the onshoring trend than large caps. M&A activity has provided another tailwind. In terms of concerns, [you are] certainly worried about what's happening in the Middle East – [the] impact on growth and inflation. But on the positive side, you pointed to historically high dividend yields among some stocks in the index.

You mentioned the fact that 40% of the stocks were yielding more than 6%, and you saw a lot of attractive valuations among the stocks in the universe.

Damien, thank you very much for joining me.

**DK:** You are welcome, Daniel.

**DM:** That's it for this week's episode of Talking Heads. If you would like more information about our capabilities in European small cap stocks, please reach out to your asset management contact or check out Viewpoint, our website for investment insights, at [viewpoint.bnpparibas-am.com](http://viewpoint.bnpparibas-am.com). Viewpoint brings commentary and analysis in a variety of formats, from investment outlooks to asset allocation videos and podcasts to help investors make better-informed decisions.

You've been listening to the BNP Paribas Asset Management Talking Heads podcast with me, Daniel Morris, and Damien Kohler, Head of European Small Caps.

Please do join me next week. Until then, take care.