PUBLIC EQUITIES

# Uncovering Growth & Innovation in Germany's Hidden Champions

BARINGS INSIGHTS

Across the German equity market, small and medium-sized companies that are leaders in their fields, and have access to innovative technologies, look well-positioned for long-term growth.

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Investment Manager

Following a volatile and unpredictable 2020, German equities have been on a steady rise this year. Overall, the asset class remains supported by the recovery in both the German and global economies, which have been underpinned by the release of pent-up demand post-lockdown, robust public sector investments and a more optimistic export outlook. In fact, German manufacturing has significantly rebounded since the onset of the pandemic, with the Manufacturing Purchasing Managers Index remaining in expansionary territory since July 2020. At the same time, progress in vaccine deployment across Europe and the resultant reopening of economies have been supportive.

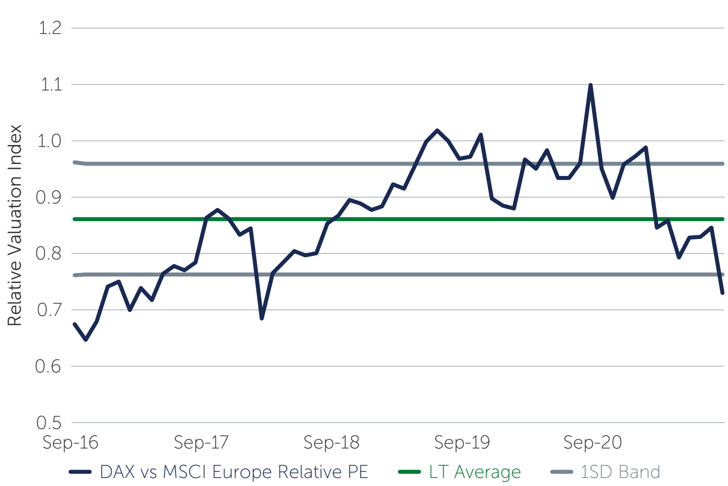
Despite this positive backdrop, there are a number of risks on the horizon. Inflationary pressures are increasing, driven by strong demand and global supply constraints—such as in the energy sector, where oil and gas prices have risen significantly. Markets are also contending with the prospect of monetary policy tightening, as a number of developed market central banks look to taper asset purchase programs and begin to think about raising interest rates in response to robust demand and inflationary pressures. There is also some uncertainty around a new government in Germany, following the General Election at the end of September. As a result, pockets of volatility are likely to impact markets in the near term.

However, we believe the German equity asset class remains supported and will continue to present long-term opportunities for investors. In particular, we see value in small and medium-sized companies with strong long-term growth potential and exposure to innovative technologies—which we believe are attractively valued in the current environment.

## Attractive Valuations & Robust Earnings

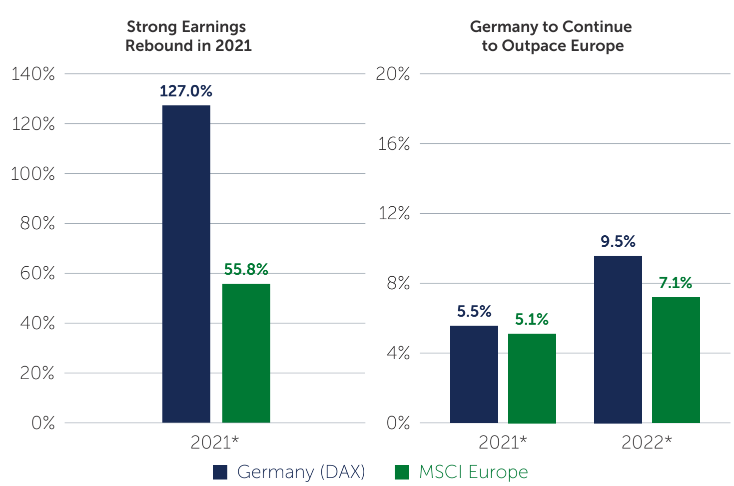
Since the second half of 2020, the relative valuation of German equities versus the broader European market has been on a downward trend. And earlier this year, the relative valuation fell below its long-term (5-year) average—suggesting that the asset class is undervalued by the market **(FIGURE 1)**. At the same time, German corporate earnings are expected to experience a strong rebound this year, from the pandemic-affected lows of 2020. In fact, over the next couple of years, German corporate earnings growth is forecast to continue to outpace Europe. As a result, we believe the German equities asset class looks attractive.

**FIGURE 1:** Attractive Relative Value for German Equities




SOURCES: Barings; Factset; MSCI. As of September 2021.
Relative PE: Index returns in based on DAX vs MSCI Europe.

**FIGURE 2:** Strong Earnings Growth Over the Medium Term




SOURCES: Barings; Factset; MSCI. As of September 2021.
*EPS Forecasts: Index forecasts based on the DAX index and MSCI Europe.

## Accessing Growth & Innovation

Looking across the German corporate market, there are a number of small and medium-sized companies (SMEs) that are leaders in their respective fields. There are over 2.5 million German SMEs, many of which are at the forefront of various innovative, high-technology industries such as medical and laser technology, software and machine manufacturing.[1] However, most of these companies remain in the form of "Familyunternehmen"—family businesses that are often less recognized by the wider market outside of their fields, and are therefore referred to as hidden champions.

We believe there are compelling opportunities in market-leading SMEs that are positioned to benefit from structural growth trends such as digitalization and the increased focus on sustainability. In particular, we see opportunities emerging across the health care, financials, technology and consumer sectors. For example, GFT, a market leader in innovative technology solutions for digital transformation in areas such as cloud computing, artificial intelligence and the internet of things, looks well-positioned for long-term growth, in our view. Software company PSI, which specializes in process control technology, helping their customers to utilize labor, energy and natural resources in an environmentally friendly way via business-critical software solutions, is another good example.

Outside of the technology sector, there are companies such as JOST Werke, a leading global supplier of safety-critical components for commercial vehicles, which looks well-positioned for growth via its dominant market position. And Einhell, a manufacturer of power tools and electrical garden equipment, has already been able to capture market share across Europe. We believe the company is set for further growth as people continue to spend more time at home.

Beyond market-leading SMEs, we see opportunities in larger-cap international companies. For example, pharmaceutical company Merck is leading the market in various areas such as autoimmune and inflammatory diseases as well as oncology and neuropathic diseases. As a result, we believe the company looks well-positioned to benefit from an increase in demand in the life science suppliers space, which is likely to drive growth over the medium term. Forklift trucks and logistics automation provider KION is another example of a global leader in its field, which has exposure to the economic cycle and strong rebound in construction activity that we are currently seeing across the German economy.

We also like companies with innovative business models. For instance, Hannover Re, one of the largest reinsurance companies in the world, has a nimble business model. It is able to quickly adapt to changes across the economic cycle—and as a result, it is more likely to benefit from a backdrop of rising reinsurance rates. At the same time, we believe many of these companies—be it the larger international players, or smaller SMEs—should be able to navigate the risks of production disruptions and rising costs due to supply chain disturbances, with many able to better reflect the increased cost burden in their product prices.

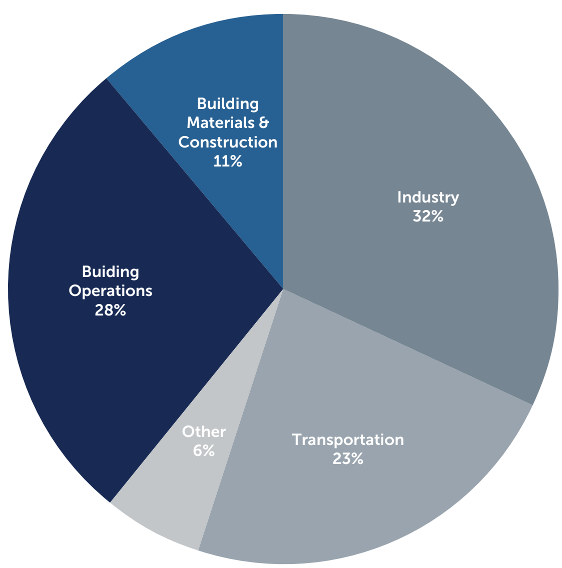
1. Source: Statista. As of December 31, 2018.

## Opportunities in Green Technology

Another area of growth where we see opportunities emerging is in Germany's eco-friendly technology companies. Following the European Union's agreement to reduce greenhouse gas emissions by 55% by 2030, energy efficiency in the building sector has become a key area of focus. In fact, CO2 generated in the building sector (including both building materials and construction and building operations) is around 39% of the total CO2 emissions in Europe **(FIGURE 3)**. Accordingly, the European Union has set a target to at least double the building renovation rate over the next ten years, in order to improve energy efficiency.

In this environment, the demand for eco-friendly building materials, solar energy, digital conversion-related security and automatic control systems is expected to increase going forward. Subsequently, companies with exposure to this theme—and which have access to unrivaled technologies in the field—are likely to benefit. One of these companies is Steico, a leading manufacturer of ecological construction products such as insulation materials that reduce CO2 emissions by conserving heating energy and load-bearing joists that are low weight and designed for maximum energy efficiency. In our view, the company has compelling growth prospects and a strong long-term demand outlook, as its products are likely to play a key role in helping customers meet carbon emissions reduction targets. Outside of the construction sector, there are other companies that we see as key beneficiaries of the transition to cleaner energy—from 7C Solarparken, which constructs and operates solar power plants, to biofuel manufacturer Verbio, to ABO Wind, a company that plans and builds wind farms.

**FIGURE 3:** CO2 Emissions by Sector




SOURCES: Global Alliance for Buildings & Construction; Architecture 2030. As of December 2017.

*“We believe there are compelling opportunities in market-leading SMEs that are positioned to benefit from structural growth trends such as digitalization and the increased focus on sustainability.”*

## Key Takeaway

While near-term risks are present for the German equity market—from ongoing concerns around COVID to inflation to monetary policy tightening—we believe the long-term growth opportunity in German equities remains quite compelling. We continue to see opportunities in companies that are exposed to structural growth trends across multiple sectors. Specifically, we like companies that are at the forefront of various innovative, high technology industries, as well as those with flexible business models and other competitive advantages, which we believe are undervalued by the broader market over the medium term.

As a fundamental, bottom-up manager, we take a Growth at a Reasonable Price (GARP) investment approach to identifying companies with strong long-term growth prospects. We see particular value in identifying companies with strong management, resilient balance sheets and positive environmental, social and governance (ESG) dynamics and policies. We also aim to capture macro risks through our cost of equity calculation, and we ensure that a company’s ESG score automatically impacts this cost of equity.

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