Europe's SmallCaps: back in business

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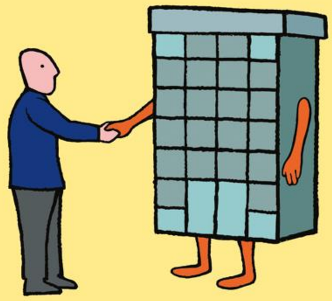


Executive Summary

European (ex-UK) SmallCaps are experiencing a marked recovery after four years of underperformance relative to LargeCaps. Having endured significant earnings contraction, capital outflows, and a prolonged valuation discount, they are once again attracting attention as both cyclical and structural tailwinds align:

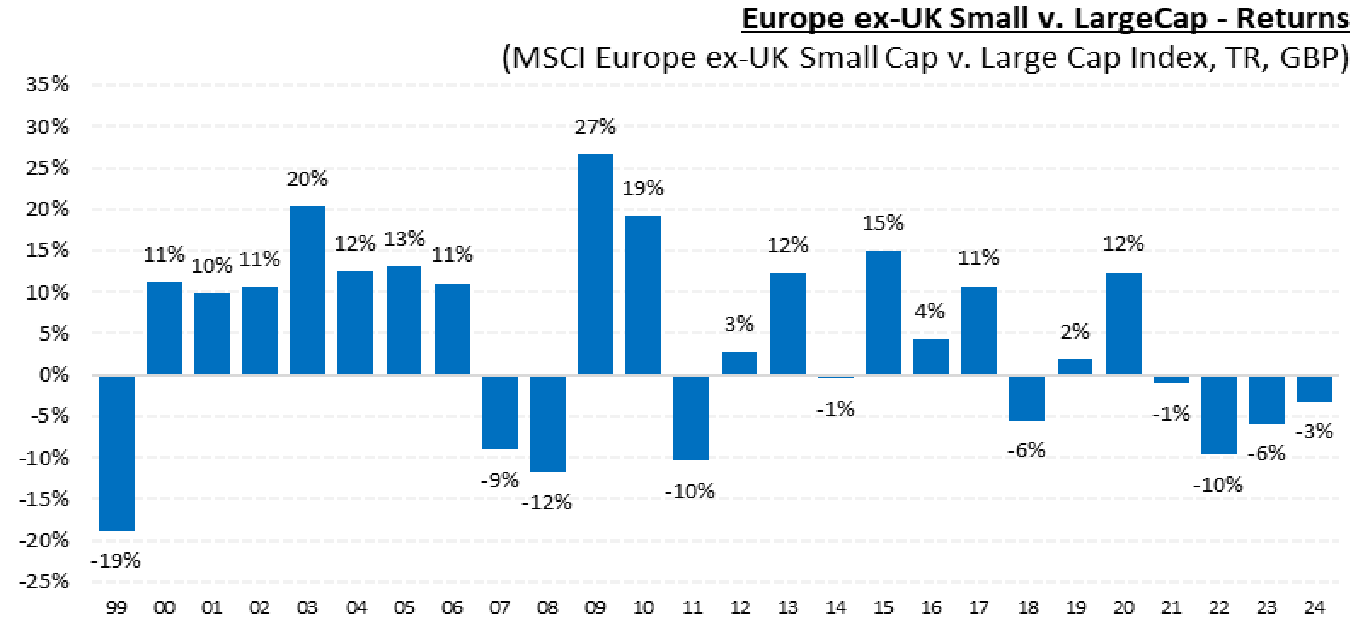
- Rebound from extreme undervaluation: By early 2025, SmallCaps traded at a record 13% P/E discount to LargeCaps, versus a long-term average premium of 16%, creating an attractive entry point.
- Supportive macro catalysts: Germany's €1 trillion fiscal package, aggressive ECB easing, and Europe's relative insulation from US tariff shocks have boosted sentiment and improved growth expectations.
- Early stages of a cyclical recovery: In past cycles (2003, 2009, 2012, 2020), SmallCap recoveries have typically been led by Value companies – the businesses most leveraged to improving economic momentum and falling borrowing costs. The resurgence that began in early 2025 shows the same pattern, suggesting that a new multi-year recovery in SmallCaps may already be taking shape.
- Earnings recovery potential: History shows that earnings tend to recover one to two years after valuation multiples expand, driving the next leg of performance. Consensus estimates for 2026 point to such a rebound, suggesting further gains for the asset class into next year and beyond.
- Capital flows stabilising: After years of heavy redemptions, outflows from SmallCap funds have slowed sharply in 2025, suggesting investor re-engagement may be underway.

If sustained, these trends could mark the beginning of a new cycle of outperformance for European SmallCaps, positioning them once again as a core allocation for equity investors.

1 – Setting the scene: years in the wilderness

After a strong rebound from the COVID-induced market bottom in March 2020 to mid-2021, European SmallCaps steadily lost momentum. They underperformed LargeCaps for an unprecedented four consecutive years - 2021 to 2024 (cf Figure 1) - marking their longest and most severe stretch of relative weakness in over 25 years.

Figure 1: Europe Small v. LargeCaps – Calendar Year Returns (Total Returns, GBP)

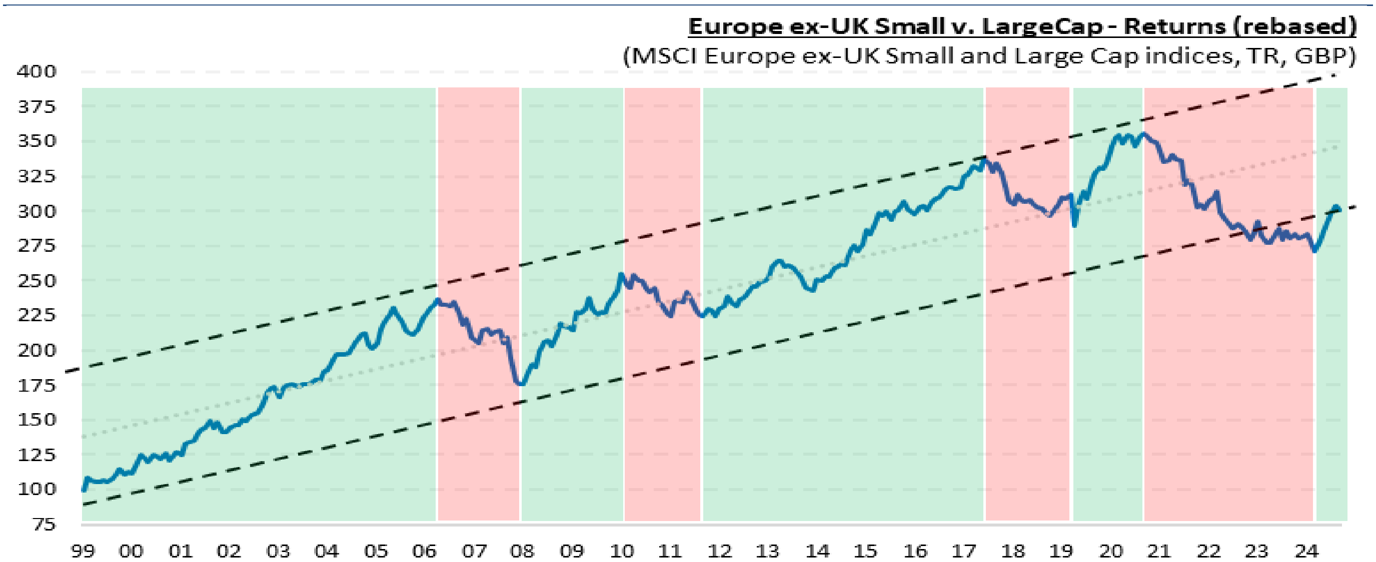


Source: Internal, MSCI, Factset.

Here is how the current period of underperformance compares to history (cf Figure 2):

- Mar 2007 to Dec 2008 (GFC) - 21 months; 22% underperformance;
- Dec 2010 to Aug 2012 (EMU Crisis) – 20 months; 11% underperformance;
- May 2018 to Mar 2020 (Economic slowdown) – 22 months; 13% underperformance;
- Aug 2021 to Jan 2025 (Ukraine, Inflation) - 41 months; 30% underperformance;

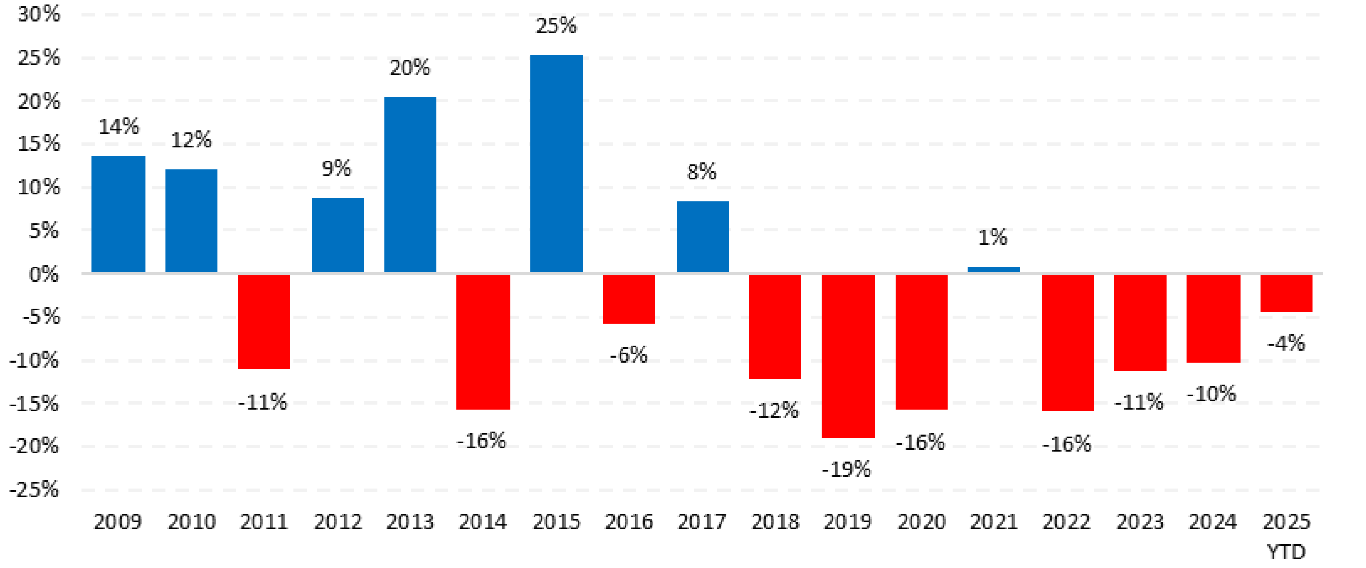
Figure 2: European SmallCaps – periods of Under (Red) and Outperformance (Green)



Source: MSCI, Factset.

During the past four years, UK-domiciled funds specialising in European SmallCaps suffered nearly £1 billion of net outflows, highlighting the decline in investor interest in the asset class.

Figure 3: Net flows in European SmallCap open-ended Funds, measured as % of AuM



Source: Internal, Investment Association.

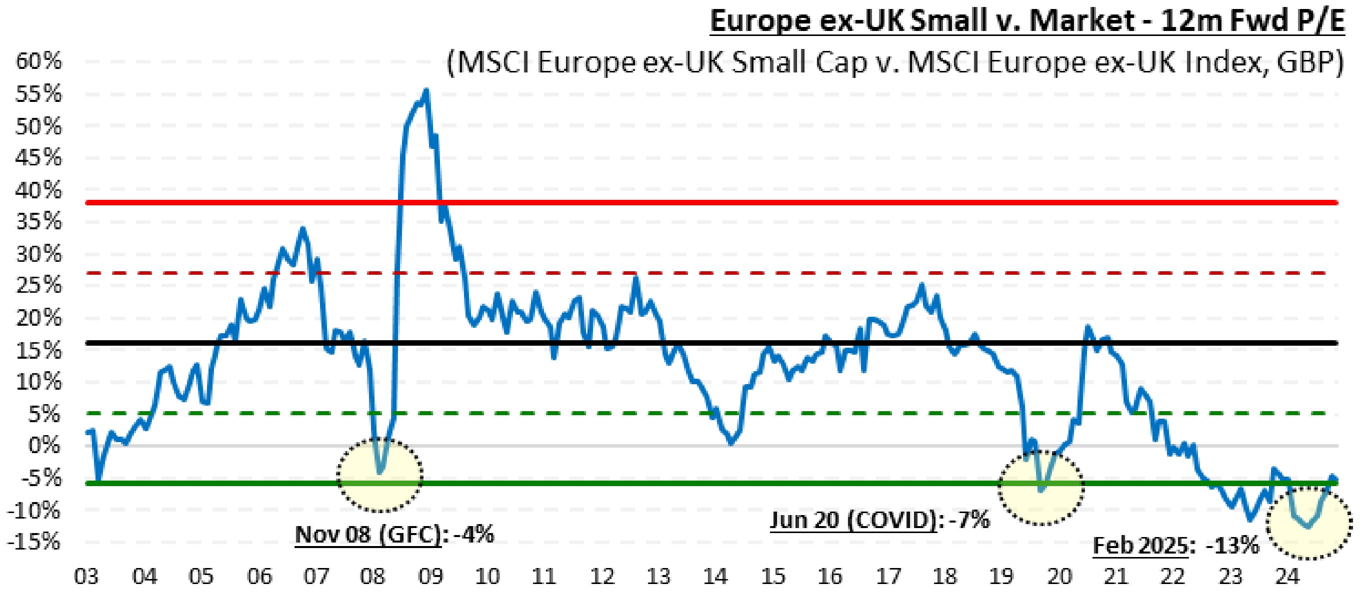
Several factors explain this extended underperformance:

1. The war in Ukraine, which drove political instability, higher energy prices, and supply chain disruptions.
2. The resurgence of global inflation, which disproportionately hurt longer-duration assets, and the aggressive monetary tightening by the ECB.
3. Sectoral effects: Banks, Pharmaceuticals, and Luxury Goods – all over-represented in LargeCap indices - outperformed.
4. The accelerating shift to passive vehicles, which disproportionately channeled flows into LargeCap benchmarks.

The first three factors led to a sharper earnings contraction in SmallCaps: a cumulative decline of 18% (GBP terms) in the three years to February 2025, compared with just 4% for LargeCaps.

The result was also a historic valuation gap. By February 2025, SmallCaps were trading at a 13% P/E discount to LargeCaps, far below the long-term average premium of 16%. **This was the deepest discount in over two decades, exceeding those seen during the Global Financial Crisis (2008) and COVID (2020).**

Figure 4: European Small v. LargeCaps – P/E differential (chart to 31 August 2025)



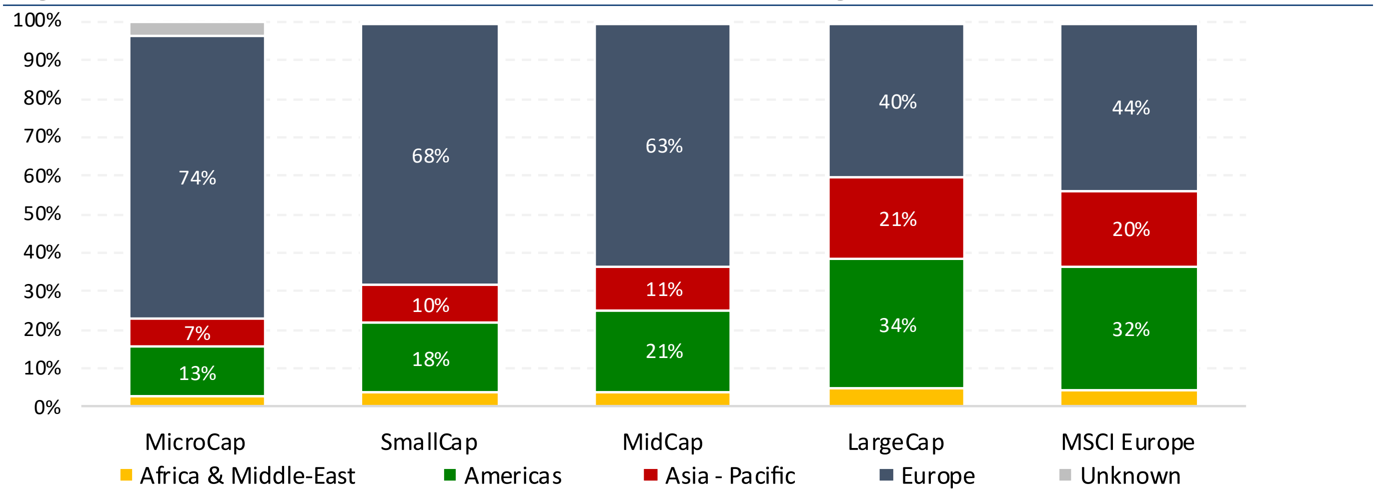
Source: MSCI, Factset.

2 – Is 2025 the turning point?

Sentiment shifted decisively at the start of 2025. Two factors played a pivotal role:

- Europe's fiscal stimulus: Germany announced a €1 trillion fiscal programme focused on defence and infrastructure investment. This bolstered European growth expectations and directly benefited domestically oriented Small Cap sectors.
- US policy shocks: Trade disruption risk rose sharply with President Trump's "Liberation Day" tariffs and growing uncertainty around US technology leadership following the release of China's DeepSeek in January 2025. European SmallCaps - deriving roughly two-thirds of their revenues from Europe versus c.40% for LargeCaps - were seen as relatively insulated from such volatility (cf Figure 5).

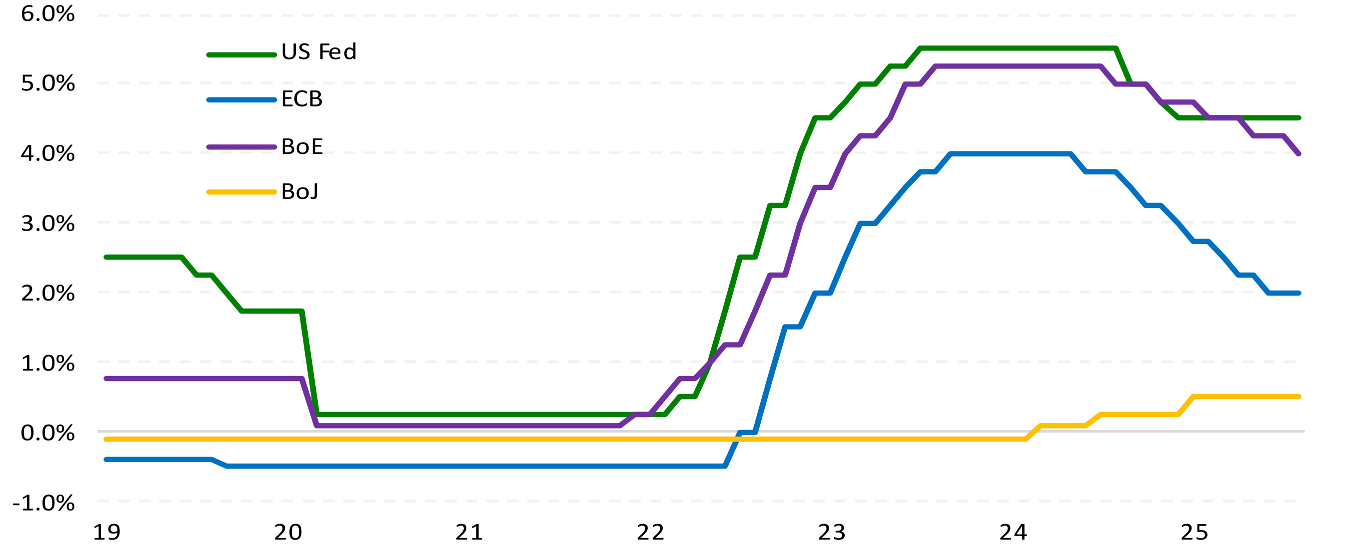
Figure 5: % Revenue Breakdown of Equity Indices by Region



Source: Internal, Factset. All based on MSCI Europe indices, as of October 2024.

Meanwhile, inflation continued to ease, giving the ECB scope to loosen policy (Figure 6). Since May 2024, the ECB has cut its deposit rate eight times by a cumulative 200bp - outpacing the Federal Reserve (three cuts, 100bp) and the Bank of England (five cuts, 125bp). This aggressive easing cycle has supported liquidity-sensitive SmallCaps.

Figure 6: The ECB has cut rates more aggressively than other major Central Banks

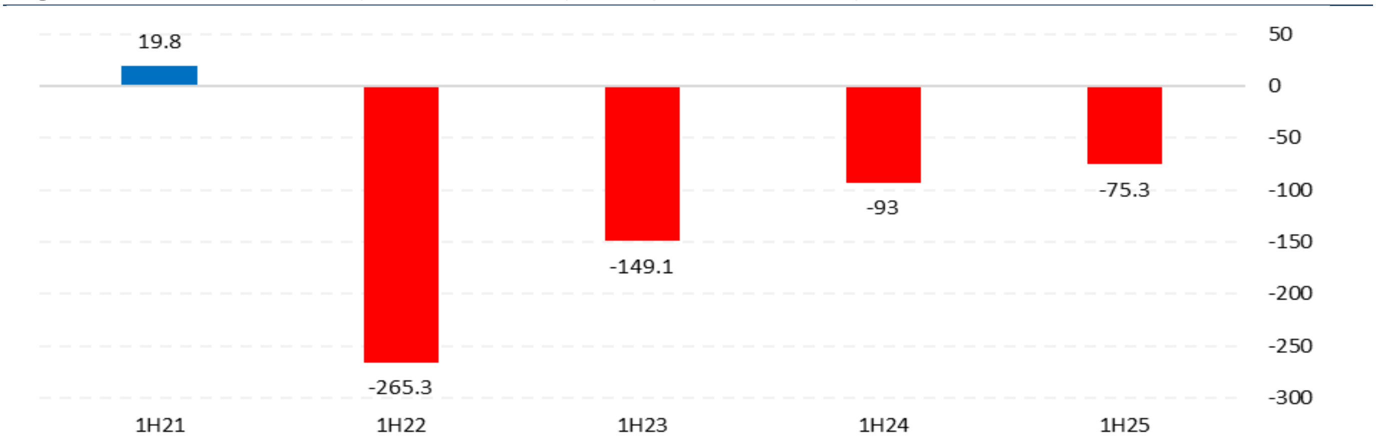


Source: Internal, Factset.

The market response has been significant:

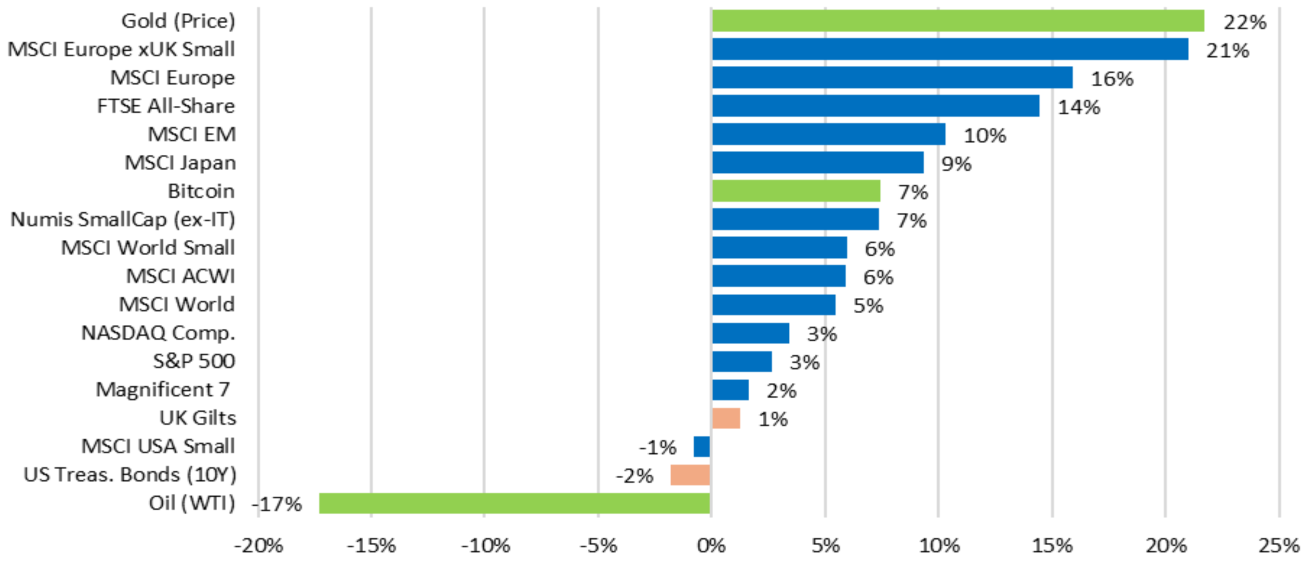
- **Outflows from SmallCap Funds have slowed sharply**, with just £75 million redeemed in H1 2025, less than in prior years (cf Figure 7).
- **Performance has been robust**: the MSCI Europe ex-UK Small Cap index is up 21% year-to-date (GBP), outperforming the S&P 500, the 'Magnificent 7,' and Bitcoin, while nearly matching Gold's returns (see Figure 8).
- **Gains have been broad-based geographically**, with nearly all European countries (bar Sweden) posting double-digit returns. Sector breadth has also been wide, with all but consumer staples and healthcare showing strong gains (cf Figure 9).

Figure 7: Net flows into (UK-domiciled) European SmallCap Funds (in GBP million)



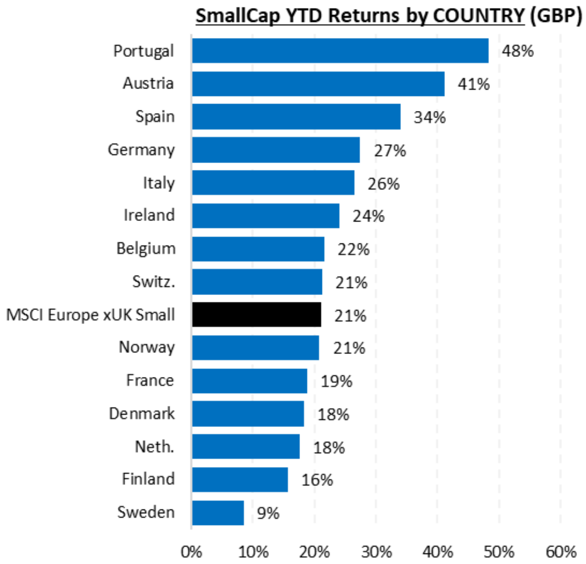
Source: Internal, Investment Association.

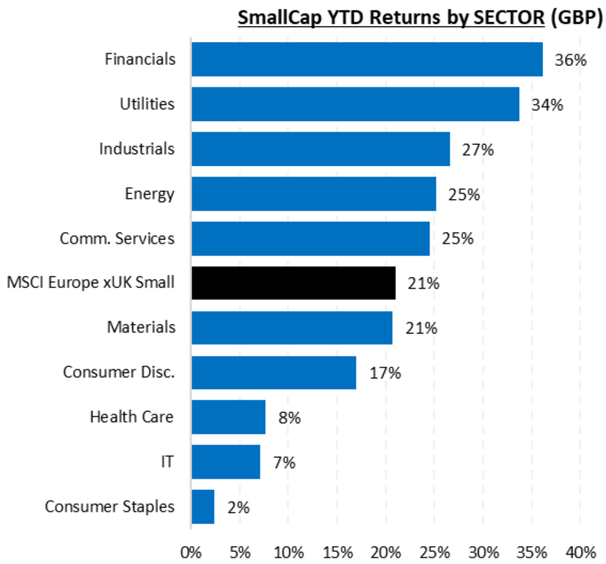
Figure 8: YTD Returns by Asset Class and Market (Total Returns to 31 August 2025, in GBP)



Source: Internal, Factset.

Figure 9: YTD Returns by Country and Sector (Total Returns to 31 August 2025, in GBP)





Source: Internal, Factset. Based on the MSCI Europe ex-UK Small Cap Index, by Country and GICS Level 1 Sector.

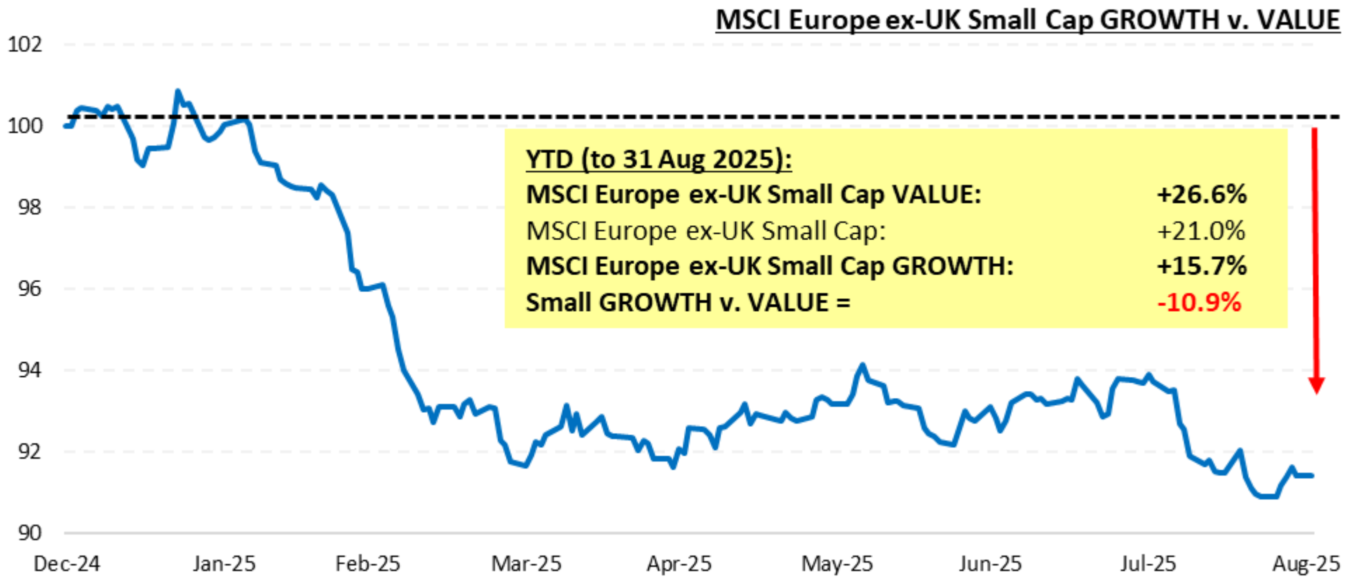
Drilling deeper, several cyclical sectors have been standout contributors (cf Figure 10). Aerospace & Defence (+114%), Airlines (+70%), Banks (+45%), Metals & Mining (+44%) and Insurance (+44%) have led the rally. By contrast, Professional Services, Life Sciences, House builders and Software remain laggards. Importantly, this rebound reflects a broader recovery in deeply depressed cyclical sectors, reinforcing the ongoing outperformance of Value versus Growth within SmallCaps (cf Figure 11).

Figure 10: YTD Returns by Sub-sector (Total Returns to 31 August 2025, in GBP)

TOP 10 Sectors	YTD Return	% Weight	BOTTOM 10 Sectors	YTD Return	% Weight
Aerospace & Defense	114%	0.6%	Distributors	-35%	0.1%
Passenger Airlines	70%	0.3%	Interactive Media & Services	-11%	0.9%
Electric Utilities	57%	0.1%	Personal Care Products	-11%	0.2%
Diversified Telecommunication Services	53%	0.9%	Trading Companies & Distributors	-11%	0.8%
Wireless Telecommunication Services	51%	0.9%	Technology Hardware, Storage & Peripherals	-8%	0.2%
Diversified Consumer Services	49%	0.1%	Professional Services	-7%	1.0%
Ind. & Renewable Electricity Producers	45%	0.5%	Life Sciences Tools & Services	-7%	1.9%
Banks	45%	5.3%	Household Durables	-5%	1.3%
Metals & Mining	44%	2.8%	Software	-4%	1.5%
Insurance	44%	2.5%	Health Care Equipment & Supplies	0%	2.3%

Source: Internal, Factset. Based on the MSCI Europe ex-UK Small Cap Index, GICS Level 3 Industries.

Figure 11: European SmallCap Growth v. Value (rebased at 100 on 31 Dec 2024 – data to 31 August 2025)



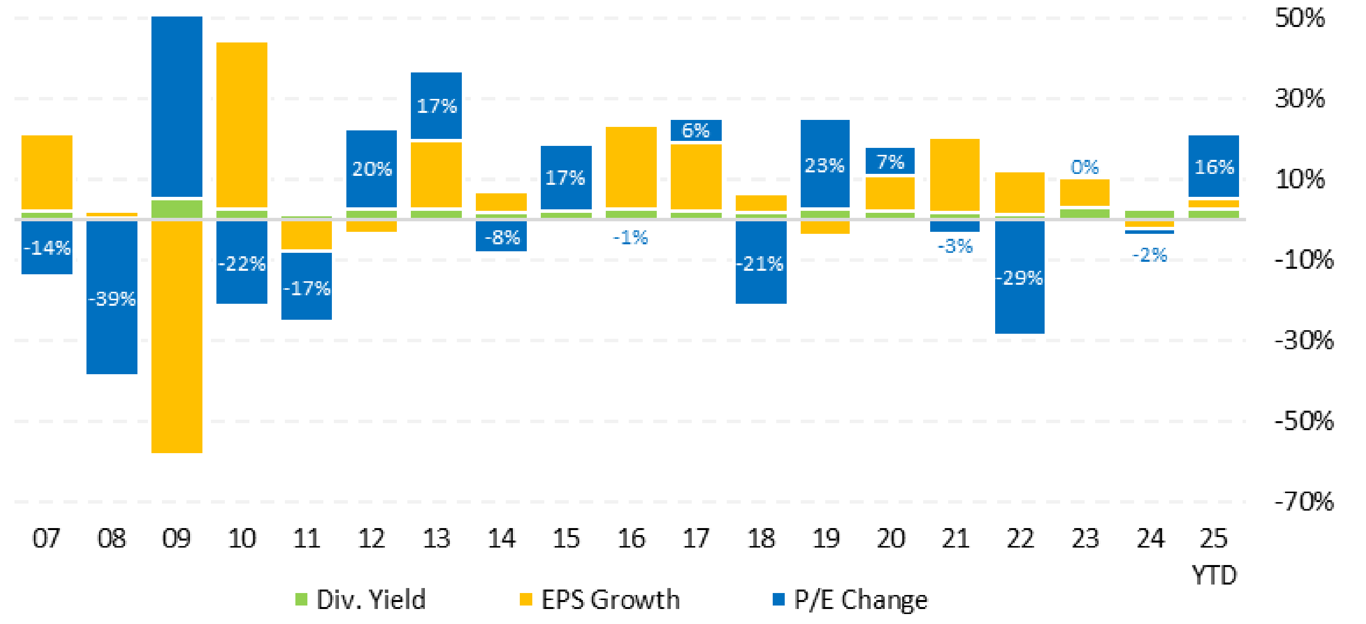
Source: Internal, Factset. Based on the MSCI Europe ex-UK Small Growth and Value indices (TR, in GBP)

3 – What next?

The continued recovery in European SmallCaps rests on five pillars:

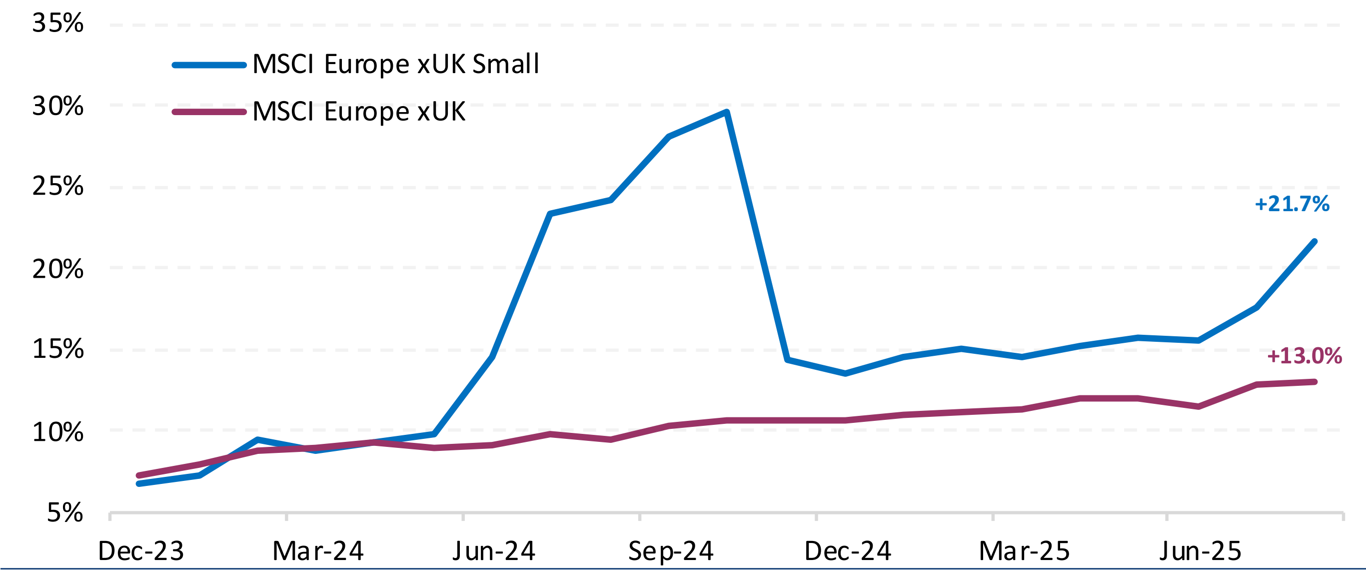
1. Earnings recovery: As Figure 12 shows, the asset class's 21% YTD return has been largely driven by a rerating rather than an earnings recovery. History suggests that earnings tend to recover a year or two *after* the rerating has occurred, driving the next leg of the performance cycle in SmallCaps. This was the case in 2010 (following the 2009 post-GFC rerating), in 2013 (after the 2012 post-EMU crisis rerating) and in 2021 (post-COVID). The evolution of the 2026 EPS consensus supports our expectation of an earnings recovery (cf Figure 13).

Figure 12: Drivers of European SmallCap Returns (Total Returns in GBP)



Source: Internal, Factset.

Figure 13: Evolution of Consensus for 2026 EPS

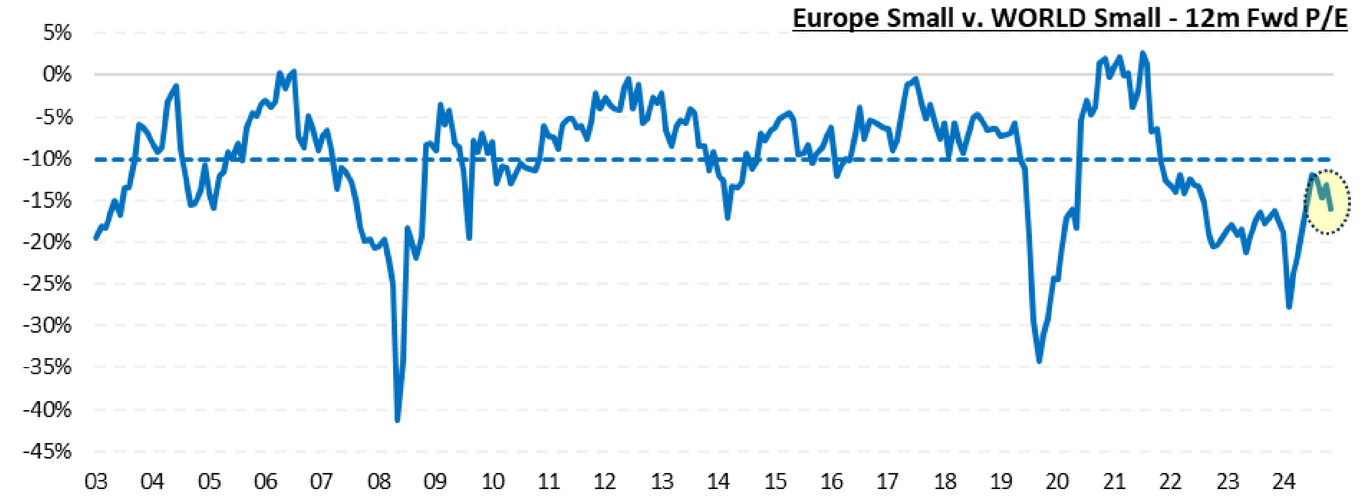


Source: Internal, Factset.

2. Valuation recovery: Despite the rerating of the past few months, European SmallCaps have plenty of scope to recover further:
    - In absolute terms – at the end of August 2025, the MSCI Europe ex-UK Small Cap Index was trading on 14.3x future earnings, well below the long-term average of 15.5x.
    - Relative to LargeCaps – as shown in Figure 4, the discount of Small to LargeCaps is currently at 5%, nearly two standard deviations below the long-term average *premium* of 16%. **In other words, the index is on the same relative P/E it was after Lehman Brothers' collapse in 2008.**

- Relative to the rest of the World - European SmallCaps are trading on a 16% discount to the MSCI World Small Cap Index, which compares to a long-term average discount of 10%.

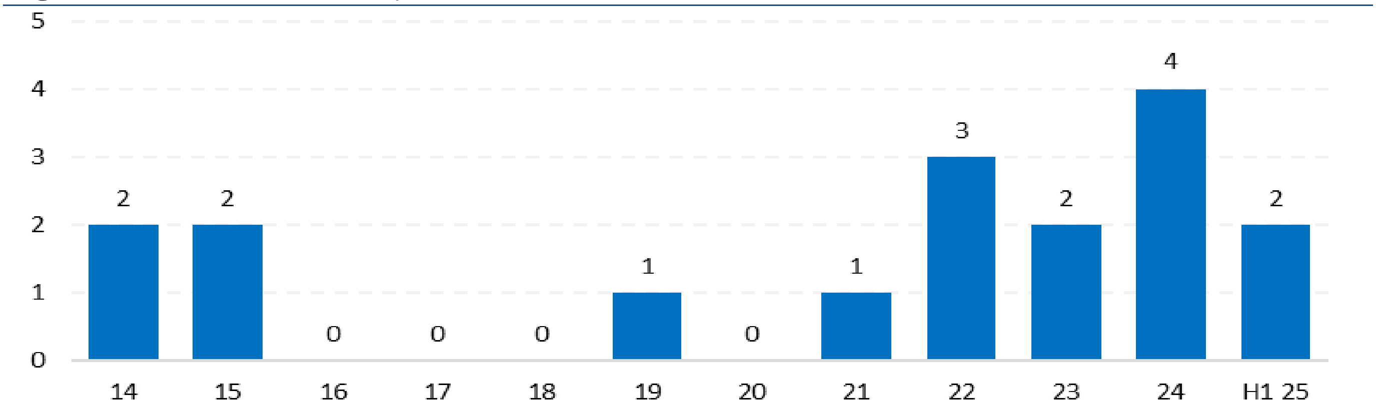
Figure 14: MSCI Europe ex-UK Small Cap Index v. MSCI World Small Index – Relative P/E



Source: Internal, Factset.

3. **Capital reallocation and improving liquidity**: Stabilisation of flows suggests that investors may begin to re-engage with the asset class. A recent report by Liquidnet ("European SmallCaps: A Potential Resurgence?", July 2025) showed that spreads on Smaller Companies have tightened by approximately 5%, while touch sizes - the volume available at the best bid and offer, a proxy for order book depth - have surged by c.25%, signaling renewed institutional interest. **Anecdotally, at Montanaro we have seen more RFPs and tenders for European SmallCaps from large European institutional investors this year than in the past five years combined.**
4. **M&A activity**: Attractive valuations, lower financing costs and a more stable economic environment are expected to sustain the recent resurgence in M&A activity. In October 2024, Bloomberg reported that transactions valued below $5 billion were rebounding sharply after three years of subdued dealmaking, with 240 deals recorded - the highest level since 2009. We have observed this trend within our own Funds as well – Figure 15 shows that we lost a record 4 European Smaller Companies to takeovers in 2024 (Epsilon Net, Terna Energy, Esker, Nexus) and a further 2 in H1 2025 (Fortnox, Biotage).

Figure 15: Number of European takeovers across Montanaro Funds



Source: Internal.

5. **Macro resilience**: Europe's relative insulation from US tariff shocks, combined with supportive domestic policy and monetary easing, positions SmallCaps to continue benefitting from both cyclical and structural tailwinds.

A Tangent: SmallCaps and the AI revolution

The initial wave of the AI boom largely rewarded the giants - Nvidia, Microsoft, and others crafting the infrastructure and models themselves. This has driven spectacular returns amongst the Magnificent 7 in recent years.

However, the next phase of AI's evolution is likely to expand far beyond, ushering in benefits across the 'real economy' as operational efficiencies, automation and AI-embedded products gain traction. A diverse array of nimble, smaller European companies are emerging as critical beneficiaries: chipmakers providing inference silicon; AI platform developers and consultants; sensor and automation companies enabling smart systems; as well as defence and space companies. These companies illustrate how the AI ecosystem is rippling outward - creating opportunity across industrials, infrastructure, cybersecurity, defence, and automation sectors.

The following examples (which we own at Montanaro) illustrate how diverse Small Cap companies are already positioned to capitalise on AI-driven opportunities:

1. **Belimo** (Switzerland) – Belimo is benefiting from the rapid expansion of data centres, a direct consequence of surging AI demand. Its energy-efficient HVAC and climate-control solutions are critical for cooling and managing the vast heat loads generated by AI infrastructure. This positions Belimo as an indirect but important beneficiary of the AI build-out across Europe, the US and beyond.
2. **Pfisterer** (Germany) - Pfisterer, a specialist in high-voltage transmission and distribution components, stands to benefit from AI-driven growth in electricity demand. The proliferation of data centres and AI computing clusters requires substantial grid reinforcement and more resilient connections. This creates a structural tailwind for Pfisterer's products as Europe upgrades its energy infrastructure to support the AI economy.
3. **Reply** (Italy) - Reply is well positioned to capture AI growth as enterprises seek partners to implement AI solutions across industries. Its expertise in systems integration and cloud-based architectures enables clients to embed AI into workflows, customer engagement, and analytics. Rising adoption of generative AI and automation provides Reply with expanding market opportunities and recurring project demand.

4 - Conclusion

European SmallCaps, long overlooked and under-owned, are now benefiting from a rare alignment of cyclical recovery, attractive valuations, and supportive macro policy. While risks remain - particularly geopolitical uncertainty and the durability of earnings growth - the stage appears set for a new cycle of SmallCap outperformance. For investors willing to broaden their focus beyond Europe's giants, SmallCaps once again represent a compelling opportunity.

Ultimately, European SmallCaps remain a stockpickers' market. The breadth and diversity of the universe (which includes more than 2,000 companies), combined with a structural lack of sell-side research, creates fertile ground for active managers who can identify those businesses with sustainable earnings power, competitive advantages and the ability to harness structural trends. However, you need a high level of in-house, buy-side resources to identify and invest in these "hidden gems".

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