THE DRIVE YOU DEMAND

SWISS SMALL AND MID-CAP EQUITIES UPDATE

Diversified & High quality growth

For Qualified Investors in Switzerland or Professional Investors or Eligible Counterparties as defined by the relevant laws

Swiss & Global Equity | April 2019

UNION BANCAIRE PRIVÉE

Key points

- *All asset classes came under pressure in the second semester of 2018 due to mounting concerns over a marked global growth slowdown. Investors continue to face challenging and more volatile markets in 2019.*
- *The Swiss equity market delivered higher risk-adjusted returns relative to the MSCI AC World over the past 10 years. Swiss companies have continuously figured among the best value creators globally which is reflected in the market's attractive Cash Flow Return on Investment (CFROI) profile.*
- *As in the past couple of years, earnings growth is expected to be more dynamic in the small and mid-cap space in 2019. Contrary to the small and mid-cap segments of other countries which tend to be more domestically oriented, smaller companies in Switzerland are just as exposed to global end markets as their larger peers, and often command leading market positions in their respective industries.*
- *A bottom-up approach to stock selection should provide the appropriate vehicle for equity investors to navigate through complexity and low visibility while aiming to capture global growth opportunities.*

Zoom in on Brexit

- The BoE forecasts UK GDP growth to be at 1.6% in an orderly Brexit scenario, while a failure to strike a deal with the EU or an increase in uncertainty would depress growth to 1.2%. The UK PMI has recovered since the Brexit referendum in June 2016, however stalled recently in line with the global growth slowdown. GBP only depreciated by around 15% against the EUR and USD and most of the drop was recorded around the referendum date in June 2016.
- Switzerland and the UK have been in close collaboration to preserve their bilateral agreements in case of an orderly withdrawal through the "Mind the Gap" strategy, and in case of a disorderly withdrawal with an early application of new bilateral arrangements signed on free trade, migration agreements, transport and insurance agreements. While the two countries share strong political and social ties, Swiss small and mid-cap companies have less than 1% revenue exposure to the UK.

An active and differentiated investment approach to Swiss small- and mid-cap equities can create value in the current macro environment.

Focus on high quality and global growth in a volatile and desynchronised environment.

As the pace of growth in major regions like Europe and China is slowing down and others like the US and the UK are reverting to protectionism, global GDP growth for 2019 was revised down by the IMF from 3.7% to 3.5%. 2019 EPS growth expectations for the MSCI AC World stand at +6% currently but risks of further downgrades continue to loom. In this context, equity investors should focus on identifying companies exposed to structural global growth trends and/or quality companies that deliver resilient operational performances.

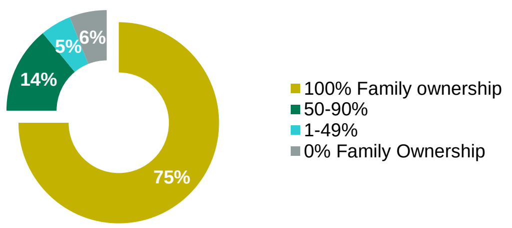
The weakness in Europe is marked by a manufacturing PMI dropping below the 50 landmark since February 2019. The weakest link is Germany which had its 2019 GDP growth outlook trimmed from 1.5% to 0.8% due to the auto sector difficulties amid new emission standards and tariff wars between Washington and Brussels. Chinese authorities seem to be carefully steering measures for a soft landing; Chinese names have been the best performing stocks in 2019 globally, with the IT sector up more than 25% year-to-date (end of February). The US and the UK revealed however unwavering challenges to globalisation and liberal integration.

Switzerland, a solid and high quality power

As many Swiss companies are leaders in niche industries and/or provide mission-critical products and technologies, they are probably more protected from tariff concerns as well as fears linked to Brexit and a global growth slowdown.

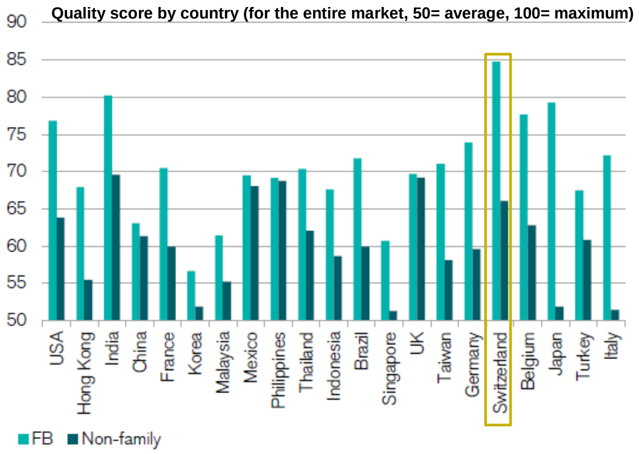
Switzerland continues to provide a stable and attractive environment for corporations. GDP growth for 2019 is forecast to remain around 1.5% with stable inflation below 1%, supporting steady private consumption growth of 1.6%. Furthermore, in line with the ECB, the SNB is not expected to raise rates in 2019 which should ease the upward pressure on the Swiss franc in the coming months. Despite the strong currency and historically low unemployment rates, Swiss companies have succeeded in bringing unit labour costs down over the last years. The country has one of the most dedicated and productive workforces; high salaries attract skilled labour and Swiss workers clocked in an average of 42.6 hours a week in 2018, the second highest level in Europe after Iceland with 42.9 hours. Family ownership is another pillar of the corporate sector, notably in the small- and mid-size segment. Three out of four Swiss small and medium sized enterprises are entirely owned by the founding family and family businesses in Switzerland employ close to 41% of the Swiss workforce.

Three out of four Swiss SMEs are entirely owned by the founding family



Source : Credit Suisse Succession Survey, 2016

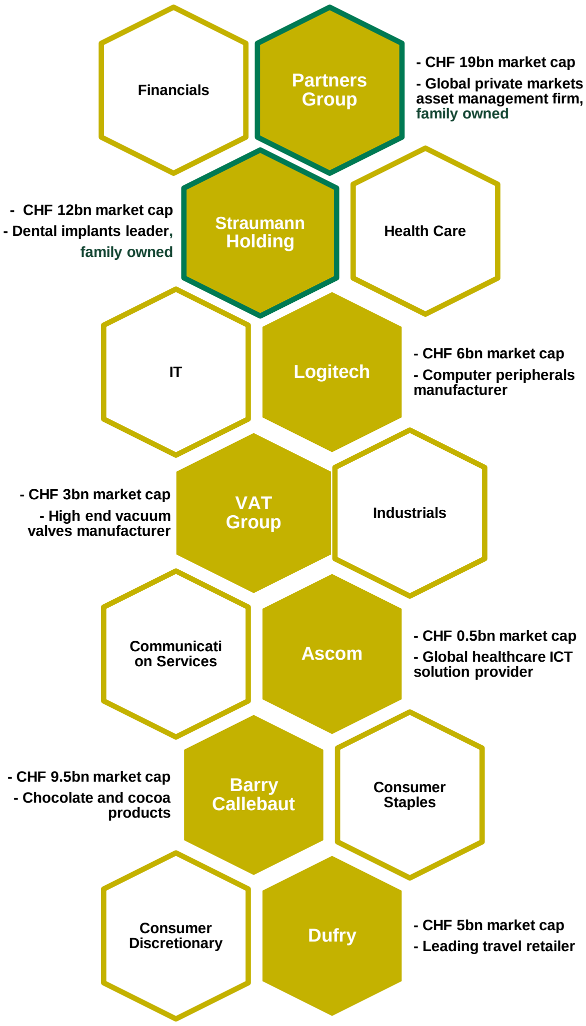
The Family factor adds to the quality score of companies



Source: Company data, Credit Suisse estimates

While Switzerland is renowned for its large global household names like Nestlé, Roche and Lafarge Holcim, the small and mid-cap space offers numerous global industry leaders as well.

Select SPI Extra market leading companies

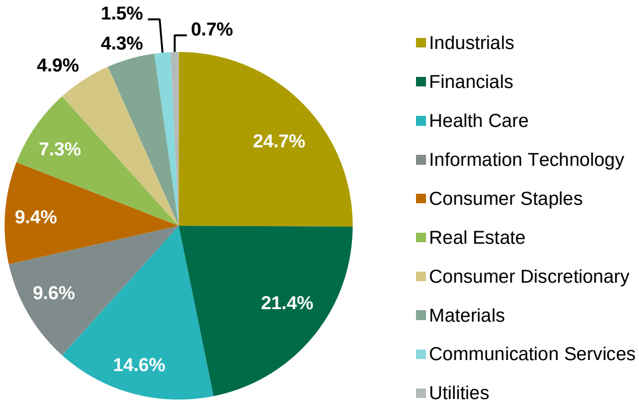


Source: UBP, Bloomberg Finance LP. February 2019

Swiss small and mid cap companies generate close to 45% of revenues in the US and emerging markets - which are expected to deliver higher GDP growth than other regions this year – around 30% in Europe ex-Switzerland and just under 25% domestically. Therefore, they offer attractive and well diversified regional end market exposure just like their larger Swiss peers.

The SPI Extra – the Swiss small and mid-cap benchmark – is also well diversified in terms of sectors, with especially the industrials and IT sectors having much more important weights than in the SPI. The industrial sector was the biggest contributor to Swiss GDP growth in 2010, 2011 and 2017 and has contributed positively in most other years since the global financial crisis. There is also less concentration risk in the SPI Extra as the top three single stock weights only account for 15% of the index whereas Nestlé, Novartis and Roche make up over 50% of the all-cap benchmark. Finally, the Swiss small and mid-caps have continuously improved value creation and now boast one of the highest aggregate CFROI-profiles globally.

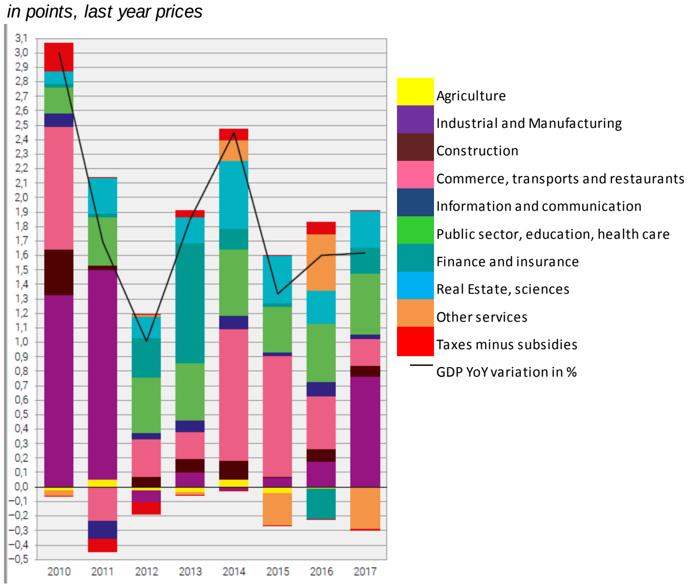
SPI Extra breakdown by sector



Source: UBP, Bloomberg Finance LP. February 2019

Contribution to Swiss GDP Growth

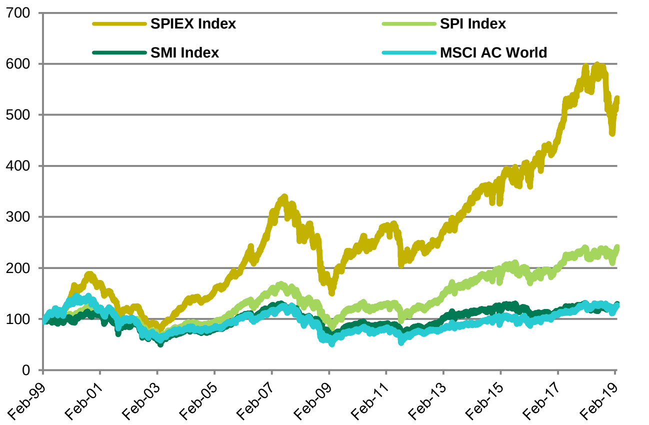
in points, last year prices



Source: bfs.admin, National Swiss Accounts -2010-2017-

Swiss small and mid-cap companies' balance sheets exhibit low leverage with 20% net debt to equity ratios compared to 72% for the average US company. All these factors have led to impressive outperformance of the SPI Extra versus the large caps and global equity markets over the longer term.

Indices long term performances



Source: UBP, Bloomberg Finance LP, February 2019. Past Performance is not a guide for current or future results.

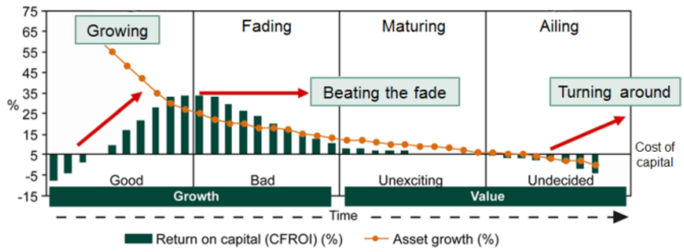
The SPI Extra P/E-ratio has de-rated by close to 25% over 2018, from 24.3x at the beginning of the year to 19.7x, trading below its historical average valuation multiple for the first time in three years. The small to large cap valuation premium moved from a peak of more than 50% mid-2018 to 36% by the end of the year as investors sought more defensive large cap names over the last quarter of 2018 amid increased volatility.

While the last quarter of 2018 was marked by negative earnings revisions for Switzerland, earnings momentum has reversed since the beginning of 2019 with the consumer services, healthcare and industrials sectors posting improved EPS trends for the SPI Extra. Mid-single digit EPS growth is still expected for the larger Swiss market with potentially higher EPS growth for the SPI Extra.

A differentiated and flexible approach to stock selection

The Swiss & Global Equity team has profound expertise and a long track record of investing in the Swiss small and mid-cap segment within its Swiss all-cap strategies which tend to have a higher allocation to the small and mid-cap segment than their benchmark, the SPI. The Swiss Small and Mid-Cap Equity strategy has been managed by the same team since launch in July 2015, applying the same proven investment process of all of the products managed by them. The team adopts a differentiated approach in assessing the economic returns of a company, using a cash flow based valuation framework, Cash Flow Returns on Investment (CFROI), instead of one based on corporate earnings. This holistic approach to gauge the company's value creation ability follows the life cycle of a company's profitability and allows the team to actively pursue growth opportunities and position portfolios according to their views on business and market conditions.

Three alpha opportunities along the CFROI life cycle



Companies which consistently generate value through high and stable CFROIs tend to perform better in relative terms than other more cyclical or restructuring-oriented companies in periods of market uncertainty.

Given the risk of earnings downgrades in 2019, those high quality companies where there is less risk of downward revisions due to the higher visibility they offer, make up the core of the Swiss small and mid-cap portfolios.

- The competitive advantages, leading market shares as well as global presence of many of the smaller industry leaders generally result in strong pricing power. Names like Straumann and Partners Group are two examples. Partners Group once again presented impressive AUM numbers with good FY2018 results confirming that investor concerns with regards to recent market volatility were probably overdone. Straumann suffered from a general rotation from growth into value names towards the end of last year but it seems that investors have since regained confidence in their resilient business model and the full-year results clearly confirmed that.
- With expectations of persistent market volatility, the team will continue to focus in the near term on such conviction names with resilient CFROI profiles and robust balance sheets. For the longer term, the team intends to take advantage of any market exaggeration related to companies with cyclical CFROI profiles but established business models.
- The team maintains a constructive view for the Swiss equity market in 2019 as it offers exposure to global growth opportunities. Positive mid-single digit EPS growth expectations plus a 3% dividend yield combined with a stable domestic environment continue to offer very attractive performance perspectives for investors globally.

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