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INVESTMENT PARTNERS

Brandes Investment Partners
Global Small-Mid Cap Equity Strategy Notes
Third Quarter 2024 (July 1 – September 30, 2024)

The Brandes Global Small-Mid Cap Equity Strategy rose 11.58% net of fees and 11.76% gross of fees, outperforming its benchmark, the MSCI ACWI SMID Cap Index, which increased 9.37%.

Annualized total return as of September 30, 2024	1-year	5-year	10-year
Brandes Global Small-Mid Cap Equity Composite (net)	35.41%	14.83%	8.81%
Brandes Global Small-Mid Cap Equity Composite (gross)	36.28%	15.60%	9.66%
MSCI ACWI SMID Cap Index	25.55%	9.19%	7.68%

Past performance is not a guarantee of future results. One cannot invest directly in an index. Returns include reinvestment of all dividends and are reduced by any applicable foreign withholding taxes, without provisions for income taxes, if any.

Positive Contributors
Notable contributors included holdings in industrials and health care.

Brazil-based regional jet manufacturer Embraer and U.K.-based aerospace and defense company Rolls-Royce reported improved earnings amid strong demand in their aerospace end-markets. Embraer also received a settlement from Boeing for the latter company's unsuccessful takeover bid, while its stock benefited from its recent inclusion in the MSCI Emerging Markets Index.

Within health care, leading contributors included Spain-based biotechnology firm Grifols and Netherlands-based Koninklijke Philips, as well as U.S. based Pediatrix Medical Group and Phibro Animal Health.

In July, Grifols confirmed that its founding family, which controls 30% of the company, is evaluating a potential joint takeover bid for the entire business with Brookfield, a multinational Canadian alternative investment fund. The structure and pricing of the takeover remain unclear, but the market reacted positively to their proposal.

Other solid performers included consumer staples companies Marks and Spencer (U.K.) and Calbee (Japan), as well as South Korea-based KT&G. Two U.K.-based companies, retailer Kingfisher and financial advisory St. James's Place, also aided returns.

Additionally, U.S. networking products company NETGEAR revised its guidance upward in September after a settlement agreement with TP-Link regarding pending patent infringement disputes. NETGEAR received a $135 million settlement and all pending litigation between the two parties will be dismissed or no longer pursued. NETGEAR also announced an earlier-than-anticipated 5G mobile hotspot launch.

Performance Detractors
While much of the Japanese market rebounded after its August decline—caused by the sudden volatility of the yen, Bank of Japan rate rises, and earnings concerns—our financials holdings did not follow suit. Hachijuni Bank and Shizuoka Financial Group declined.

Select U.S.-based investments also performed poorly. Notable detractors were in the consumer staples and energy sectors, specifically Innovex International and Edgewell Personal Care Co. A recent purchase, luxury goods company Burberry Group, also fell.

On a relative basis, our underweights in the utilities and real estate sectors, two of the strongest performers in the benchmark, weighed on returns.

Select Activity in the Quarter

The small-mid cap investment committee initiated a position in French retailing giant Carrefour.

Carrefour was founded more than 60 years ago and introduced the hypermarket format to Europe. Today, the company is one of the 10 largest retailers in the world, the second-largest grocer in France, and the largest grocer in Brazil. All told, 14,000-plus stores operate under the Carrefour banner, mostly in Europe and Latin America. These locations offer a mix of store format: grocery, hypermarket, convenience, and wholesale.

Carrefour has faced several challenges in recent years that have caused its market valuation to plummet to all-time lows. Economic growth in Carrefour's core markets has been anemic. During the past several years, Carrefour's top three geographic markets (France, Brazil, and Spain) have registered gross domestic product growth of less than two percent annually. This has led to weak consumer spending and increased competition among retailers. Outside of its core markets, Carrefour's once-successful expansion into Asia eroded into a loss-making business. Piling onto the company's woes was the French government's rejection of Canadian retailer Couche-Tard's $20 billion takeover bid in 2021—a valuation that was two times Carrefour's current market capitalization.

Against this backdrop, Carrefour has been slowly addressing each of the challenges it confronted. The company sold an 80% stake in its China business in 2019 and is divesting the remainder. In 2023, it finalized the sale of its Taiwan business, completing its exit from Asia.

To counter increasing competition, Carrefour has been changing the management structure of underperforming stores by converting more of them to franchise and lease-managed models. Doing so gives the independent operators more flexibility to reduce labor costs and improve productivity. The company is also six months into "investing in price," as it focuses on using the savings from recent restructuring and efficiency gains to improve pricing for consumers. It is early but there have been recent signs that being sharper on price is improving store traffic trends for Carrefour.

From a corporate governance perspective, Carrefour has implemented a more shareholder-friendly capital return policy, with increasing dividends and share buybacks—it is estimated the company will have a cash return yield (buybacks and dividends) of 13% this year. Unfortunately, because Carrefour is the leading retailer in France, it seems the government has veto power on any change-in-control involving foreign companies: this policy removes the option that it can be acquired for at least the foreseeable future.

While it is hard to get excited about a large retailer operating mostly in Europe's mature retail landscape (accounting for 75% of Carrefour's revenue), the company's depressed market valuation can translate even small operational gains into positive returns for investors.

Another new addition is IPG Photonics (IPGP), the global market leader in fiber laser technology. IPGP is vertically integrated and sells some of the most advanced fiber laser systems worldwide. Its products are mostly used in industrial applications, and the company holds leading positions in lasers for welding, cutting, engraving, cleaning, and precision processing. Laser tools have been increasingly adopted across a variety of applications as the technology improves, costs fall and, in some cases, they deliver environmental benefits over alternatives.

Despite the favorable industry tailwinds and the company's leading market position, the industry has encountered challenges in recent years. The company's guidance for 2024 implies a revenue decline of more than 30% from its cyclical peak in 2021. Because IPGP is vertically integrated, the company has meaningful operating leverage. Since 2021, its gross margins have dropped to an estimated 37% from 48%. This translates into operating margins falling to less than 5% from 25%. This reduction in demand is primarily due to weakness in China's manufacturing sector, which once accounted for almost 40% of IPGP's revenue. Additionally, the company benefited from strong market share in laser welding and cutting applications used in electric vehicle (EV) manufacturing. IPGP has been stung by the recent lull in EV manufacturing capacity expansion. Beyond cyclical pressures, the company also faces the always-present threat of commoditization as a market matures and competitors enter offering lower pricing. IPGP has lost some market share in cutting lasers in China as domestic competition has heated up.

Despite the sharp retrenchment IPGP has experienced as a result of business and competitive threats, we remain optimistic about the company's long-term prospects. It is difficult to forecast the recovery of any particular use case, e.g., laser cutting and welding for EV manufacturing. However, we are confident that the increasing penetration of laser tools in manufacturing processes will remain a long-term trend. Outside of industrial uses, growing applications in the medical and micro-processing fields also exist. The near-term opportunity is from a rebound in industrial output, but the larger, long-term prospect is for continued expansion of the laser tool market.

Continued product commoditization and increasing competition is a reality for any industry as it matures. However, IPGP invests heavily in research and development (R&D) to continue offering products that compete on capability and low total cost of ownership—rather than on price. The company has invested 10% of revenue into R&D, which far surpasses its fiber laser peers. New products and applications account for an increasing share of IPGP's revenue, having increased to almost 50% today from about 20% previously, based on company disclosures. We believe the industry is still in the early stages of what could be a long and sustained positive adoption curve, which is partly possible due to product innovations from companies such as IPGP.

IPGP's share price is down more than 70% from its peak in 2021. During the past couple of years, the company has repurchased almost 20% of its outstanding shares. IPGP is still free-cash-flow (FCF) positive even with the sharp decline in its business. Excluding the cash flow benefit of share-based compensation and working capital releases, IPGP has an FCF yield on enterprise value of 5.5%, despite significantly depressed profitability. The company has more than $1 billion in cash and no debt, with a market capitalization of $3.2 billion. The timing and robustness of an end-market recovery is difficult to predict, but we don't believe the market value of the company requires a quick return to peak profits to be financially rewarding for the long-term investor.

Year-to-Date Briefing

The Brandes Global Small-Mid Cap Equity Strategy rose 20.74% net of fees and 21.32% gross of fees, outperforming its benchmark, the MSCI ACWI SMID Cap Index, which increased 12.47% in the nine months ended September 30, 2024.

Holdings in financials (e.g., Nova Ljubljanska Banka, Erste Group Bank, St. James's Place) and industrials (e.g., Embraer, Rolls-Royce) drove performance. Several communication services companies also delivered robust results, particularly Magyar Telekom and media firms ITV and Atresmedia.

Other notable performers included health care providers Phibro Animal Health, Koninklijke Philips, and United Therapeutics, as well as home retailer Kingfisher and clothing manufacturer Yue Yuen Industrial.

Major detractors included luxury goods companies Swatch and Burberry, as well as energy equipment company Innovex and Indonesian tobacco company PT Gudang Garam. Furthermore, investments in Mexico (Fibra Uno and Cemex) weighed on returns.

Current Positioning

The strategy continues to hold key overweight positions in consumer staples, health care, communication services, and financials, while maintaining underweights to utilities and real estate, as well as to typically cyclical sectors such as consumer discretionary and industrials.

Geographically, we continue to find value opportunities outside the United States, especially in the United Kingdom, Japan, and emerging markets. We remain materially underweight to the United States, with our allocation less than half the benchmark's 52% weighting.

Global small-mid cap equities continue to represent, in our opinion, fertile ground for fundamentally solid businesses trading at a discount to our estimates of their intrinsic values. Within the asset class, value stocks (MSCI ACWI SMID Cap Value) continue to trade in the highest decile of discount levels to the broader market (MSCI ACWI SMID Cap) on a variety of valuation metrics, including forward price/earnings, price/cash flows, and enterprise value/sales.

We believe that paying extremely close attention to valuations enables us to choose opportunities that others may miss. We are enthusiastic about the potentially undervalued companies we are finding and the diversification offered by the Brandes Global Small-Mid Cap Equity Strategy.

Term definitions: https://www.brandes.com/termdefinitions

The MSCI ACWI SMID Cap Index with net dividends captures mid and small cap representation across developed and emerging market countries.

The MSCI ACWI SMID Cap Value Index captures mid and small cap securities across developed and emerging markets countries exhibiting overall value style characteristics, defined using book value to price, 12-month forward earnings to price, and dividend yield.

The MSCI Emerging Markets Index captures large and mid cap representation of emerging market countries.

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