CLIMBING THE SWISS FRANC MOUNTAIN

How Swiss companies manage to thrive despite the Swiss Franc appreciation

By David Simons

In our second SilverBullet issue, we focus on the impact of the Swiss Franc appreciation on the stock price performance of Swiss equities. Many people assume that a rising currency is bad for companies reliant on exports and thus negatively affects stock returns. As SilverCross has significant exposure to Swiss companies thanks to its investments in Belimo, Interroll and Panalpina, we wanted to test this assumption and see if this is actually true. Hint: it is not, so read on.

A Tsunami for Swiss Companies…

In September 2011 the Swiss Central bank put in place a ceiling of 1.20 for the Swiss Franc against the Euro. This was implemented in order to avoid the continued appreciation of the Franc, which would harm the competitive position of Swiss companies, or so the story goes. Investors however remained eager to buy Swiss Francs as a 'safe haven' in uncertain times. In order to sustain the 1.20 level, the Swiss Central bank had been buying massive amounts of Euro's and selling Swiss Francs. On the 15th January it surprised the market by abandoning its efforts to sustain the ceiling and the Franc dramatically appreciated against the Euro. Defending the Swiss franc from appreciating simply became too costly.

Companies including Swatch were talking about a tsunami for Swiss companies. Why? Because Swiss products overnight became much more expensive in other countries, making them less competitive. One solution would be for Swiss companies to lower their international selling prices to remain competitive against foreign competition, hurting profitability. At the same time, imports become much cheaper, leading to deflation. As deflation usually leads consumers to defer their spending, a severe recession in Switzerland sounds like the logical consequence.

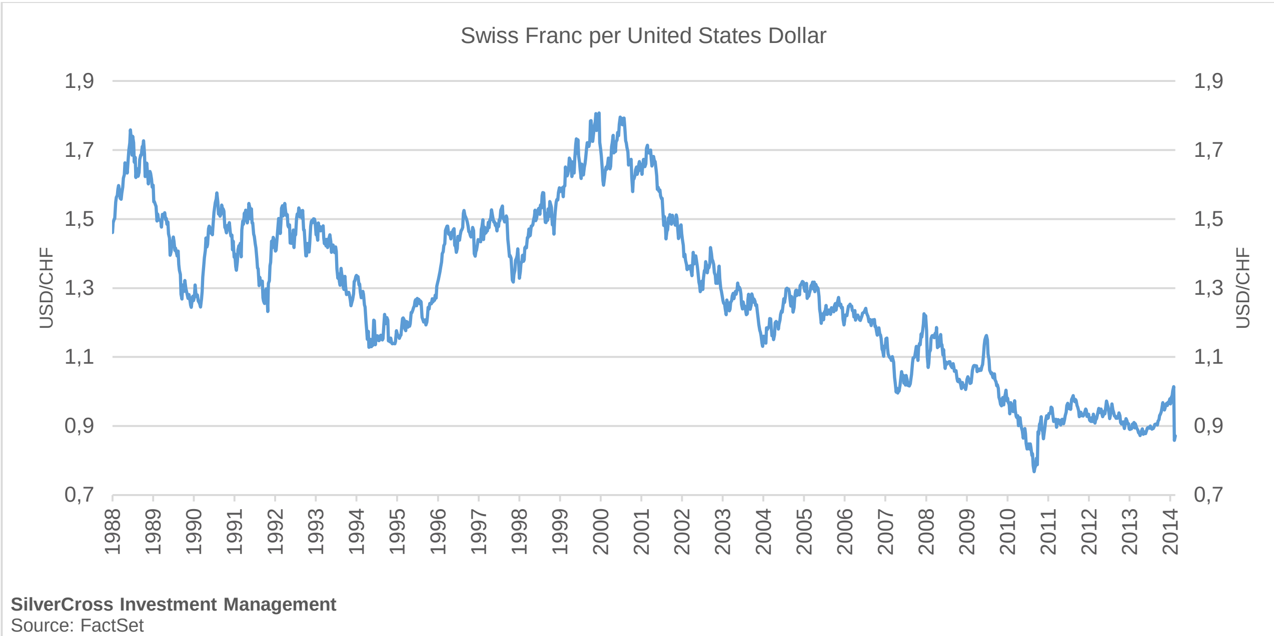
… A Disaster for Swiss Equities?

The scenario described above sounds like a disaster for Swiss equities. Indeed, Swiss equities declined by more than 15% in the immediate aftermath of the policy change while the Swiss Franc increased by 17%. So while Swiss investors suffered a large drop, foreign investors actually saw the value of their Swiss equity investments increase somewhat. But let's forget about the short-term volatility. As long-term investors we are interested in the longer term consequences. If currency appreciation is a bad thing for the competitiveness of companies, this should be visible in the stock price performance. So let's research.

Short Term Fear versus Long Term Reality

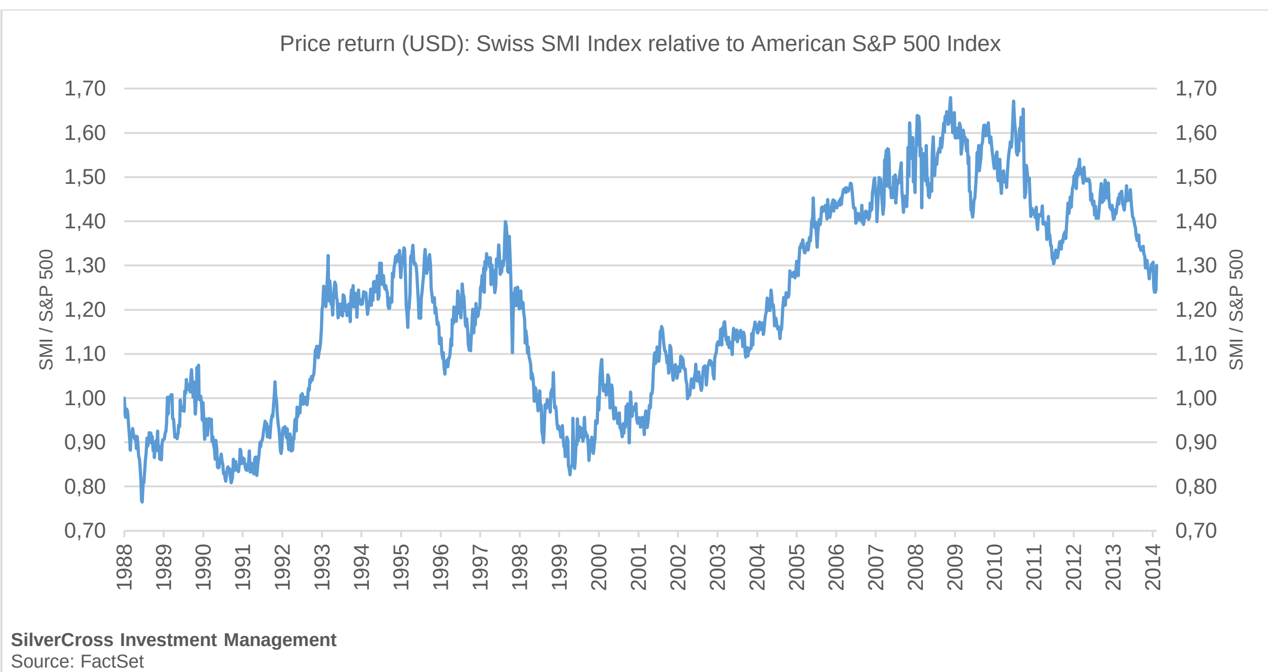
Common sense is that when countries debase or devalue their currency, it is good for companies and thus their stock prices should increase and vice versa. As a foreign investor however, the change in the value of the currency must be taken into account to calculate a total return.

We take a look at the long-term performance of Swiss equities versus both US and European equities. The graphs are revealing. First look at the graph below showing the USD / CHF exchange rate development.



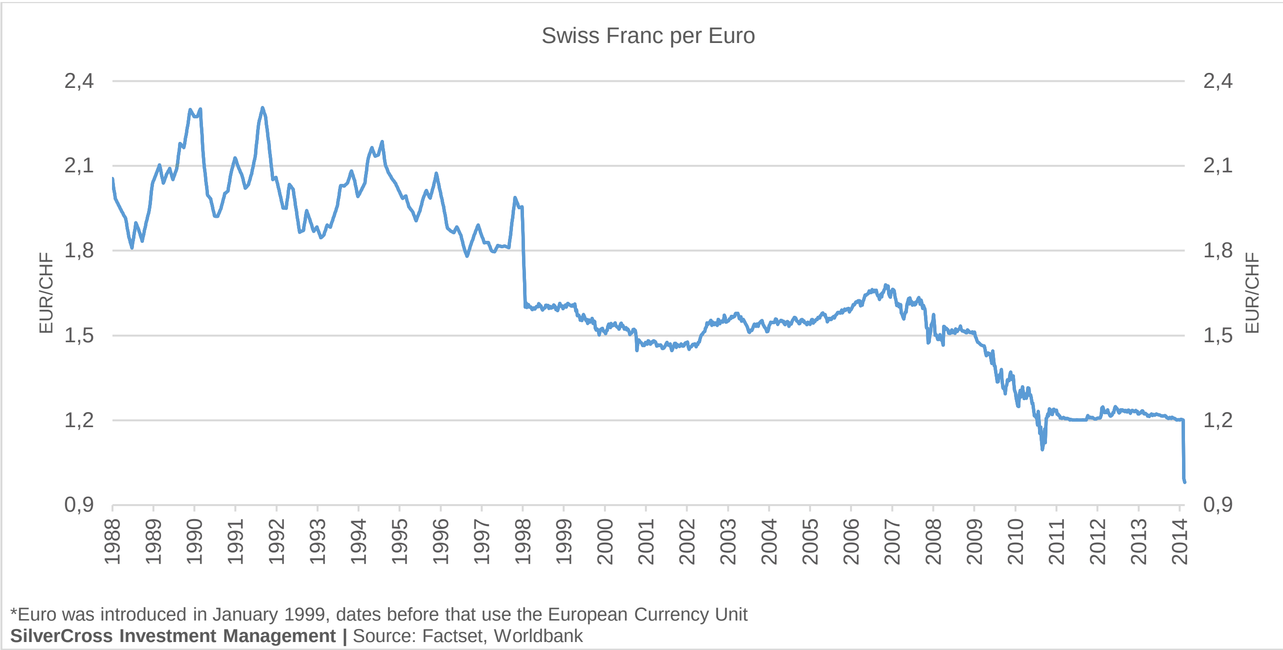
Graph 1: Swiss Franc against US Dollar

Graph 1 shows that the US Dollar has declined dramatically against the Swiss Franc since 1988. This should surely have negatively impacted the competitive position of Swiss companies, historically dependent on exports as its own economy is small, right? And as a consequence, Swiss equities must have underperformed US stocks? Wrong. Swiss stocks significantly outperformed US equities. Graph 2 shows Swiss stocks outperformed US stocks by 30%, both measured in US Dollar.



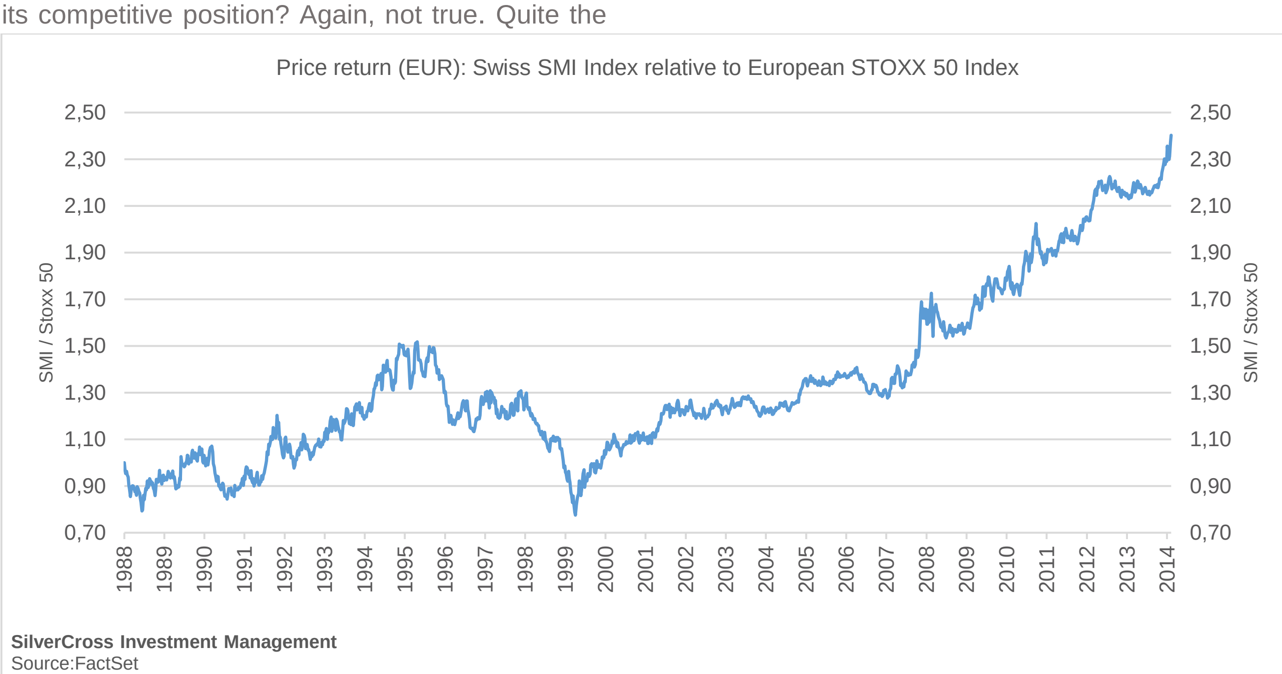
Graph 2: Swiss equities relative to US equities in USD

One can argue that the US economy only accounts for approximately 10% of Swiss exports, making it a meaningless comparison. So instead let's look at Swiss stocks versus European stocks. If you thought the Franc's appreciation against the US dollar was dramatic, then look at the appreciation against the Euro (see graph 3).



Graph 3: Swiss Franc against Euro

Europe accounts for around 55% of Swiss exports, their largest trading partner being Germany. Surely the enormous rise in the Swiss franc must have hurt its competitive position? Again, not true. Quite the opposite. Swiss equities have massively outperformed European equities since 1988 (see graph 4).



Graph 4: Swiss equities against European equities in EUR

What Makes Swiss Equities Perform Better?

The reason for this counterintuitive outcome lies in the quality of many Swiss companies. Characteristics such as strong brands (think of Swatch); dominant positions in a niche thanks to superior quality based on years of innovation (think of Interroll); and stable management teams that manage their businesses for the long-term, are all key to the Swiss success story. It is also worth noting that Swiss companies are managed much more conservatively from a financial leverage perspective with the median Swiss small-cap company having a net cash position versus a Net Debt / EBITDA of 1.1x in the rest of Europe. Lower leverage has enabled Swiss companies to better navigate economic cycles versus their European counterparts. Who said lower risk goes hand in hand with lower returns?

Switzerland has a large industrial base that is often far removed from commodity-type products and services, giving Swiss companies the necessary pricing power to offset many years of currency appreciation.

These factors combined explain why Swiss companies continue to be remarkably successful on a global scale.

Another part of their success can be put down to the favourable business climate in Switzerland. Low taxes, political stability and a very open and international orientation are all contributing factors. At the same time, we see that much of Europe either implicitly or explicitly avoids reforms that can help reignite growth in Europe. Many Europeans don't want to give up the entitlements they have grown used to, while taxes seem to be going only one way (up) to finance unsustainable government spending habits.

Lessons Learned

1) Don't believe that the *'race to debase'* is about increasing the competitive position of an economy. It is done for the benefit of the governments, who aim to inflate their way out of their debt.

2) Look for companies with pricing power, dominance in a niche, innovative products and a strong and stable management team. These characteristics help companies overcome short-term setbacks caused by currency headwinds, creating superior long term shareholder value as a result. SilverCross is dedicated to finding small-cap companies meeting these criteria, using a disciplined approach. Many of these companies remain under the radar as they don't get attention from the media or big brokers, who primarily rely on corporate finance income from advising on M&A for companies. Smaller, conservatively-managed companies don't tend to carry out many acquisitions.

Why We Own Interroll

As an example of what our research unearths, we highlight Interroll, a Swiss company based in Sant' Antonio with a market cap of CHF 411m. It is a company we know well and have followed for years. Hardly anyone knows the company, yet its unit-load handling, internal logistics and automation systems are used by so many companies including large food producers (Procter & Gamble), airports, online retailers (Amazon.com), postal and pharmaceutical companies, that just about every person on this planet relies on its systems functioning properly. 16 million parcels roll over its systems every day.

The CEO has been in place since 1999. Under his watch the company's geographical footprint expanded to Asia and the USA, decreasing its dependence on the stagnant European market. Growth investments have pressured profitability in 2014 while the underlying business has continued to be healthy. Interroll has spent significantly on innovation over the years to make its products highly energy-efficient, ensuring the lowest total cost of ownership for its customers. For example, its "smart RollerDrive systems" prevent fragile objects from bumping into each other in logistics centres and help save up to 50% in energy consumption by stopping when there is nothing on them. Innovation has given Interroll significant pricing power. They have set up local production and service facilities across the world to enable them to meet customers' needs as quickly as possible and more importantly in this context, it ensures that currency movements only have a translational impact.

The founding family still owns 13% of the company, and another 13% is owned by an Italian family involved in heavy duty conveyors primarily for the mining industry. Family ownership helps the company remain focused on long-term success, even if this means sacrificing short term profitability. The company has no net debt on the balance sheet, ensuring it can survive the occasional downturn in this industry. This makes

Interroll an excellent example of the companies SilverCross invests in.

Want to know more about our investment process?

Visit www.silvercross-im.com

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About SilverBullet Insights: With this newsletter we aim to offer a mix of thought-provoking research and small-cap insight. A silver bullet refers to a straightforward solution perceived to have high effectiveness. This is what you'll find in our newsletters.

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