Canaccord Genuity



Small Caps, Big Opportunities

/ Australian Equities

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Small caps have been hit from several directions, but some of the macro headwinds weighing on the sector may be on the brink of easing.

After materially underperforming the broader market this year, Australian small caps trade at a significant discount to their large cap peers. The ASX Small Ords now trades on 14.4x forward earnings, around 20% below both its 10-year average and the ASX 100's current multiple.

This discount looks particularly compelling given that small caps have historically traded at a premium to large caps and are expected to deliver stronger earnings growth over the medium term.

The valuation gap reflects real pressure on earnings and investor sentiment. Looking ahead, however, some of the key headwinds may be easing. If the RBA has in fact finished tightening rates, in line with our view, and geopolitical tensions subside, we see scope for risk appetite to improve which should be supportive of smalls. The recent flurry of M&A activity offers another potential catalyst, with takeover offers highlighting the gap between market prices and what buyers are prepared to pay.

This report explores the opportunity in small caps, highlights the importance of active stock selection and features selected small and mid cap 'Buy' ideas covered by the CG Research team.

Macro Headwinds Have Driven a De-rating in *ASX Small Caps*

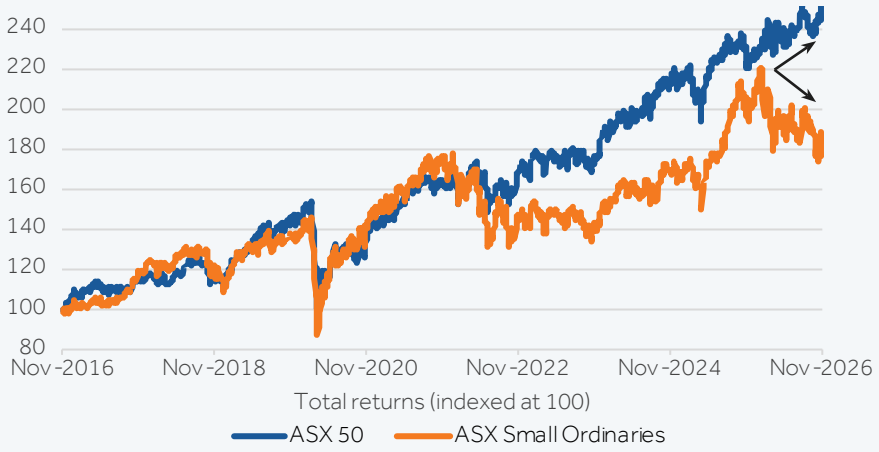
After materially underperforming the broader market this year to date, Australian small caps trade at a significant valuation discount to their large-cap peers. However, with interest rates (and bond yields), oil prices and inflation at or near cycle highs in our view, and the prospect of a US-Iran peace deal appearing increasingly tangible, the macro backdrop and investor appetite for ASX small caps could begin to improve over the next 12 months.

The current environment has been particularly challenging for small caps on several fronts.

Firstly, the ASX Small Ordinaries (Ords) Index is more weighted towards cyclical sectors and companies whose earnings are more domestically-focussed than large caps. This makes small caps, as a whole, more exposed to the soft domestic consumer and business environment.

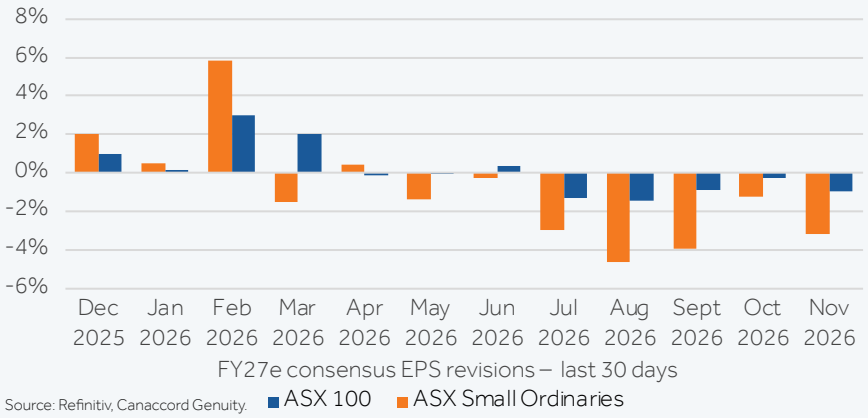
Secondly, small caps are more reliant on debt funding, particularly floating-rate debt, compared to large caps. Therefore, the RBA's five rate hikes this year have presented a material earnings headwind (via higher interest costs) for many small caps.

Figure 1: Small caps have underperformed large caps by ~20% this year



Source: Refinitiv, Canaccord Genuity.

Figure 2: The tough macro backdrop has contributed to larger earnings downgrades among the Small Ords than the ASX 100



Source: Refinitiv, Canaccord Genuity.

Thirdly, smaller businesses can vary in their ability to absorb higher input costs. Those with less scale, profitability and pricing power may be more exposed to cost inflation, including the sharp rise in energy prices this year.

These earnings pressures are reflected in consensus EPS revisions, with Figure 2 illustrating that the ongoing market earnings downgrade cycle has been more severe for the Small Ords than the ASX 100.

Valuation pressure has been an additional headwind for small caps. Higher bond yields have put upward pressure on discount rates, disproportionately impacting small cap valuations, given the Small Ords' skew towards growth companies with longer-dated cash flows. At the same time, a deterioration in risk appetite has seemingly driven a rotation out of smalls. Together, these factors have contributed to the de-rating in small cap multiples relative to large caps, weighing on their performance this year to date.

However, looking forward, it appears we are nearing an inflection point where some of these macro and geopolitical headwinds should begin to ease. This could support a recovery in small caps, with both strong EPS growth and a re-rating in currently depressed valuation multiples contributing to potential upside from current levels (P = EPS × P/E).

Ultimately, if our base case views on RBA policy, the Middle East conflict and oil prices prove correct, the backdrop for small caps should become more supportive over the near to medium term.

Small caps offer attractive value in an otherwise expensive market

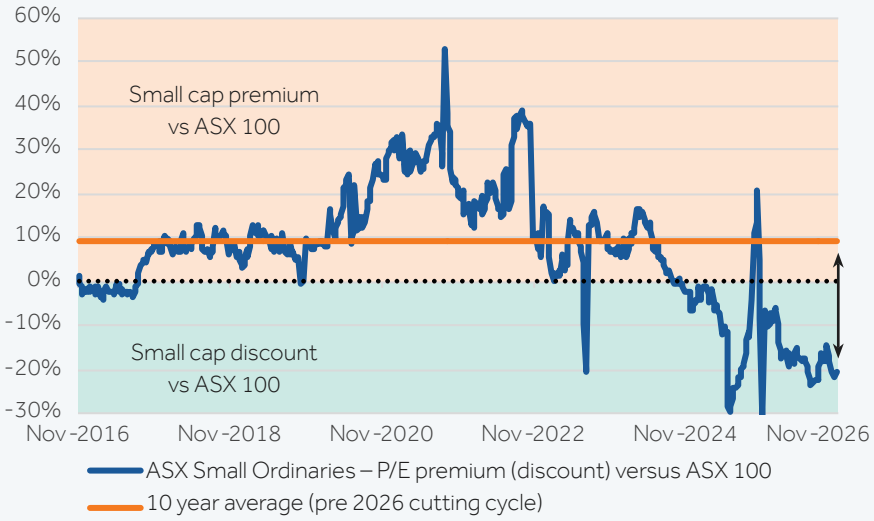
We view the Australian market as fully valued at the index level when assessed through the lens of the ASX 100 and 200, which are inherently skewed towards larger companies, including the Big Four banks, major supermarkets and Wesfarmers, each of which trades above its historical average valuation.

However, following significant underperformance, compelling value has emerged beneath the surface within the small cap market. The Small Ords Index trades on a forward P/E of 14.4x, around 20% below both its 10-year average and the ASX 100's current forward P/E of 18.1x. This P/E discount is relatively broad-based across GICS sectors.

As Figure 3 illustrates, small caps now trade at a 30% discount to their 10-year average relative valuation versus the ASX 100, having traded at a premium to large caps for most of the past decade.

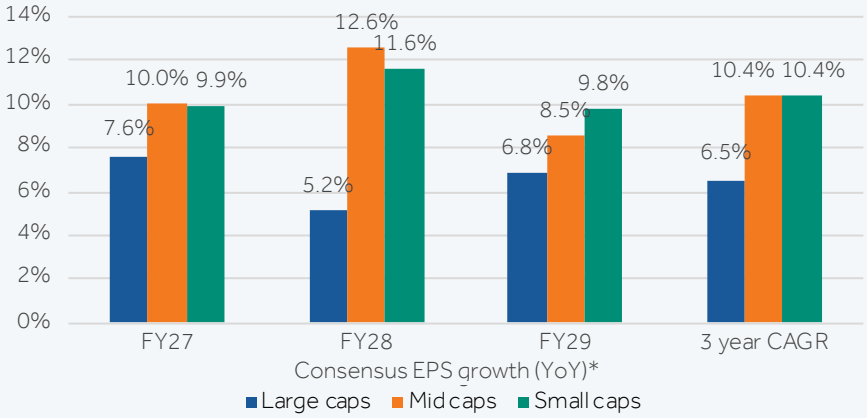
The valuation discount looks even more compelling on a growth-adjusted basis, with consensus pointing to a three-year EPS CAGR of 10.4% for both small and mid caps, comfortably ahead of large caps at 6.5%, as shown in Figure 4. This reflects the inherent skew of small and mid caps towards earlier-stage businesses with stronger growth profiles, which has historically justified their moderate P/E premium.

Figure 3: After de-rating materially, the Small Ords Index trades on a 20% discount to the ASX 100, well below its historical premium of 10%



Source: Refinitiv, Canaccord Genuity.

Figure 4: Despite their valuation discount, small caps (and mid caps) continue to offer stronger earnings growth prospects than large caps



*Based on the simple average of constituent EPS growth for each index, excluding statistical outliers and non-meaningful values. Figures are not weighted by constituent index weights. Large caps refers to the ASX 50; Mid caps refers to the ASX Mid Cap 50 (i.e. the ASX 100 ex 50); Small caps refers to the ASX Small Ordinaries (i.e. the ASX 300 ex 100). Source: Refinitiv, Canaccord Genuity.

Figure 5: Historically, rising short term rates have been a material headwind to small caps' relative returns versus the ASX 100

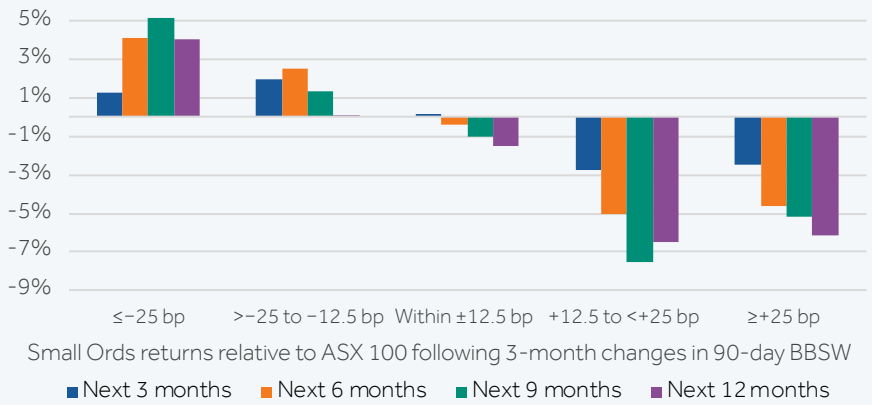


Figure 5 is an exploratory 10-year analysis; results are period- and specification-sensitive. Overlapping observations are not independent and some groups are small. Relative returns are cumulative percentage-point differences; historical association does not establish causation or predict future performance. Source: Refinitiv, Canaccord Genuity.

'Peak rates' could provide near-term relief for small caps

In recent weeks, in the lead up to, and following, the RBA's November rate hike, we have explored our preferred ways to position portfolios for peak rates, given our central view that the RBA's hiking cycle has finished – albeit with the caveat that rate cuts are still likely a late 2027 story.

We have already assessed which ASX 200 sectors are best placed to benefit from a less restrictive monetary policy backdrop, identifying Real Estate and Retail as the most interest-rate-sensitive opportunities (read here).

Small caps represent another attractive countercyclical opportunity ahead of a potential pivot in the RBA's policy stance in our view. To assess this, we analysed the relative performance of the Small Ords Index versus the ASX 100 following different three-month moves in 90-day Bank Bill Swap rates (BBSW), a proxy for near-term cash-rate expectations.

Figure 5 shows a consistent pattern: larger falls in BBSW have generally been followed by stronger Small Ords performance relative to the ASX 100, while rises have generally been followed by material underperformance. When short-term rate expectations have been broadly stable, the Small Ords has generally performed broadly in line with the ASX 100.

Therefore, history is consistent with our view that the RBA pivoting away from a hiking bias should represent the easing of a key headwind for small caps, even if the eventual tailwind of rate cuts is still likely ~12 months away. However, historical returns are not a reliable predictor of future returns, and cash rates are just one factor within a multivariate equation.

Active Stock Selection is Crucial When Investing in Small Caps

The index doesn't tell the full story when it comes to the opportunity within small caps.

While the Small Ords has underperformed the ASX 50 over the past decade, returning 6.3% p.a. versus 9.7% p.a., respectively, small caps offer particularly significant potential to generate excess returns above the index through active stock selection. As Figure 6 illustrates, the Small Ords exhibits much wider dispersion of returns, with a substantial gap between its strongest and weakest performers.

This reflects the breadth of the small cap market. The Small Ords includes high-quality businesses with strong competitive advantages and the potential to compound earnings significantly, grow into tomorrow's large caps, and deliver strong returns for investors. However, it also includes lower-quality companies with less established business models and a higher risk of failure.

The opportunity and risk therefore lie at the individual company level, rather than being distributed uniformly across the index, where weak performers can dilute the returns generated by stronger businesses and make passive exposure less compelling on a risk/reward basis. In other words, 'picking the winners' and 'avoiding the losers' is key.

Figure 6: The wide dispersion of small cap returns underscores the importance of active stock selection



Source: Refinitiv, Canaccord Genuity.

Taking these considerations into account, in our view investors are best placed to pursue the opportunity in small caps by picking stocks directly or investing through high-quality active fund managers, focusing on companies with attractive growth prospects and strong fundamentals while avoiding those at risk of permanent capital loss.

For those who prefer to invest directly, we have summarised some of the Canaccord Genuity Research team's key small and mid cap 'Buy' ideas across the industrials and resources sectors in Figure 7, with key thematics highlighted for selected companies. A broader list of ideas covered by the Research team is available in our most recent Invest Now publication.

Figure 7: Canaccord Genuity Research: key 'Buy' rated small and mid caps

Name	Ticker	Industry	Analyst commentary	
EQ Resources	EQR	Critical Minerals	**Thematic exposure: Defence and strategic minerals.** China controls 80% of global tungsten supply, with export restrictions by China and the US leading to extreme shortages of material outside China. This has resulted in genuine pricing bifurcation (APT prices currently ~US$2,500/mtu, ~3x China levels). EQ Resources is one of the very few listed tungsten producers globally, and CG Research forecasts a >170% increase in its tungsten production by 2028 to ~320,000mtu, alongside a similarly significant increase in earnings and cash flow.	**Latest research →**
Gentrack	GTK	Enterprise Software – SaaS	Gentrack is expected to report its FY26 result on 23 November 2026, with CG Research expecting it to be in line with guidance ($229m–$238m, EBITDA 13.5m–$20m). The stock has de-rated materially over the previous 18 months on the deferral of its Utilities pipeline; however, the pipeline has not dissipated, with 3-4x opportunities expected to be converted by March 2027, equating to >8m meter points. Any conversion of this pipeline should see investor sentiment improve and support a re-rating of the stock's multiple. CG Research's sum-of-the-parts analysis sees the Utilities division trading at 1.3x ARR, which is undemanding given historical growth (+22% 5yr ARR CAGR and trailing profitability).	**Latest research →**
Megaport	MP1	Software & Services	**Thematic exposure: AI Infrastructure.** Megaport's investment case is increasingly centred on its transformation into an AI infrastructure provider through Compute-as-a-Service, while retaining a valuable, high-margin networking platform. Recent strategic GPU contracts have materially increased ARR, earnings visibility and funding flexibility, supported by significant customer prepayments. Management expects annualised ARR to exceed A$1 billion once contracted capacity is fully deployed, while accelerating network growth provides an additional source of upside. CG Research views Megaport as one of the ASX's most leveraged exposures to AI infrastructure demand and digital connectivity.	**Latest research →**
Nick Scali	NCK	Consumer Discretionary	**Thematic exposure: Domestic consumer recovery.** Nick Scali is one of Australia's leading vertically integrated furniture retailers, operating the Nick Scali and Plush brands across ANZ and now expanding into the UK following its acquisition of Fabb Furniture. The investment case rests on a compelling store rollout runway, with management outlining a long-term target of 240–270 stores against a current network of 129, combined with strong financial metrics including a ~17% net margin and ~36% return on equity. The UK represents an additional earnings kicker as that business matures.	**Latest research →**
Ramelius Resources	RMS	Precious Metals – Producer	**Thematic exposure: Gold.** Ramelius Resources is guided to produce 205–225koz at AISCs of A$2,150–2,350/oz in FY27, positioning it among the lowest-cost gold producers on the ASX. The company is exceptionally well funded, with A$650m in cash and bullion, no debt, and total liquidity of A$1.15bn, including A$500m of undrawn facilities. Production is expected to grow from ~215kozpa today to more than 560kozpa by FY30. CG Research views RMS as one of the sector's highest-quality management teams, with a consistent track record of meeting and outperforming guidance.	**Latest research →**
Superloop	SLC	Telecommunications	Superloop is an enabler of internet and data centres, via its expansive fibre network that spans Australia and offshore destinations, serving business and wholesale customers. As wholesale and new developments become a bigger part of group earnings, CG Research expects margins to head higher, return metrics to improve, free cash flow generation to strengthen further, and growth to become more sustainable and recurring. CG Research estimates an FY25–FY29E EPS CAGR of >40% and highlights the 6.7x FY28 EV/EBITDA.	**Latest research →**

Companies are displayed in alphabetical order. Source: Refinitiv, Canaccord Genuity.

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