

# Post-COVID Small Cap Equity Sector Themes

What's Played Out and What's to Come



Technology



Real Estate



Consumer



Health Care

**T**here has scarcely been an era during which so much has changed so quickly in the markets and in people's lives. Yet we are likely still in the infancy of COVID-19's timeline, and even earlier in the scheme of the economic and lifestyle changes that will result. Much, of course depends on timing, but we know significant changes will come.

While our approach is driven by fundamental research and the evaluation of factors such as healthy balance sheets, high or improving Return on Invested Capital (ROIC), or fundamentally stable growth models, we are also continuing to monitor the impact of different sectors within the small cap space. Our investment professionals within our Small Cap Core, Small Cap Growth, and Fundamental International Small Cap strategies discuss how they see different sectors playing out and what they are tracking and expecting as the world settles into a new reality.



# Technology

Software should be one of the biggest winners from COVID-19. The increased proliferation of software as a service (SAAS) already had strong trends heading into the COVID-19 recession, such as digital transformation and the shift to cloud, and we believe these trends will only accelerate coming out of it. Over the last few years, companies have been removing legacy, on-premise (10 to 20-year-old) systems/hardware and migrating from manual processes (Microsoft Excel) to cloud-based architecture and applications. By doing this, operational flexibility and responsiveness increase, operating costs generally improve, and large upfront capital commitments are significantly reduced. We have been struck by the ease and pace of deployments of several cloud-based solutions. For example, Five9 (FIVN), a cloud contact center solution provider, has been able to deploy its solution in under 48 hours to facilitate 30,000 concurrent calls. It can also deploy its solution in the same amount of time for large workforces in a “work from anywhere” environment.

Further, ZScaler, a global cloud-based information security company, has been able to deploy its off-premise security solution for a customer with 50,000 employees enabling them all to work from home. These are just two examples among many, but the ability for cloud-based solutions to scale up to a significant number of deployments in such a short amount of time is both remarkable and very valuable and highlights the benefit of these types of solutions. We anticipate a greater need for these flexible solutions as the physical return of employees to work is likely to be prolonged and staggered. Much of the success of work from home has been enabled by cloud applications given the ease of deployment and ability to access applications from anywhere.

## — Small Cap Core perspective

The predicted revenue from SAAS in 2021 will be \$113.1 Billion.

—Gartner<sup>1</sup>

<sup>1</sup><https://www.bmc.com/blogs/saas-growth-trends/>

The cloud was built for this moment – with rapid deployment, scalability, and reliability as key drivers. The proof points in this area turned out to be as advertised. Over-the-top (OTT) media services such as Netflix or Amazon Prime, online video gaming, collaboration platforms like Slack or Microsoft Teams, online education platforms, mass notification capabilities, telehealth, virtual contact centers, and of course, videoconferencing providers like Zoom – all were put to the test and from our vantage point performed exceedingly well. While cloud-native applications have been rapidly gaining share, to us, this real-life experiment was a huge success for these technology enablers and will likely materially accelerate the trends we have seen over the last few years.

The future sounds relatively simple – all employees, suppliers, partners, and customers should be able to securely access whatever applications they are permitted at any moment from any location. The path, however, to achieving this is complicated and CEOs are asking themselves right now what they need to do to accomplish this goal. The urgency is real. As a result, we think this will result in important takeaways:

- Unleash a wave of technology spending that extends many years – potentially well above even recent heightened expectations.
- Accelerate the shift to public and private clouds.
- Result in manager focus on flexibility and ubiquity for all IT architecture decisions.
- Increase security spending for remote capabilities as a priority.

There will be many winners and losers as these trends evolve. Chip companies that enable rapid connectivity, enterprise and consumer applications built for the cloud, datacenters and cloud providers, and the service companies that help build and deploy these capabilities will all be massive winners, in our view.

## — Small Cap Growth perspective

It is a credit to our engineering culture that technological infrastructure has held up as well as it has. Tech has been resilient and software collaboration tools such as Zoom, Microsoft Teams, and Slack are clearly experiencing strong growth. Other beneficiaries include the aforementioned providers of cloud, remote access, and automation services — products that allow flexibility, scalability, and cost savings. New products will likely be created to address specific use cases that have been spotlighted in recent months. Products that require top-down sales processes, long implementation times, and weak remote access capabilities will struggle. We foresee an acceleration of certain trends that have already been taking place, although some gains will be temporary. Broadly speaking, the march of digitization will continue apace.

## — Fundamental International Small Cap perspective



## Real Estate

Commercial real estate could be at risk longer term. We think business leaders will be more willing to adopt work from home practices in a post COVID-19 world and as companies are operating successfully with a vast majority of its employees in a work-from-home setting. The feedback we've received is that working from home has exceeded expectations and companies will begin to allow more employees to do so going forward. The benefits of working from home will be less densely packed offices (lower disease transfer), less commercial real estate needed (lower expenses), and more flexibility for workers (more attractive employer). We think in the medium term residential real estate may benefit as citizens look to relocate out of large cities into smaller cities or more rural areas which could drive an improvement in homebuilding or remodeling. Further, we expect warmer weather locations to be the prime beneficiaries of this shift.

### — Small Cap Core perspective

An estimated 56% of the U.S. Workforce holds a job that is compatible (at least partially) with remote work.

—Global Workplace Equality Analytics<sup>2</sup>



Construction has been one of the hardest hit industries so far. Home prices, while not nearly as reactive as the stock market, may move meaningfully lower in some markets. Many employers are in the process of considering permanent work-from-home arrangements, with major employers including Nationwide, Mondelez, and Barclays already announcing plans to shutter some offices due to their successful transitions to remote work. Among companies that fully retain their office space, it is nevertheless likely that a greater share of employees will have flexible work arrangements going forward. This could be a boon to shared working spaces, although reluctance to share common areas with strangers may materially hinder the format. Airbnb and other vacation rentals have suffered heavily and it is not clear

<sup>2</sup><https://globalworkplaceanalytics.com/telecommuting-statistics>

<sup>3</sup><https://www.forbes.com/sites/forbesinsights/2020/04/16/covid-impact-genz-versus-millennials/#1c8df8115b5d>

when, if ever, guests will reach their prior levels of comfort. Over-leveraged landlords and speculators are feeling the strain but we do not expect any major shock outside of certain localized pockets. A refrain that will be commonly heard over the coming months is that the desirability of urban living may be hampered by the threat of infectious disease. We take no view on this, but expect a pitched political battle between numerous real estate interests as well as players in the transit and automobile industries.

### — Fundamental International Small Cap perspective



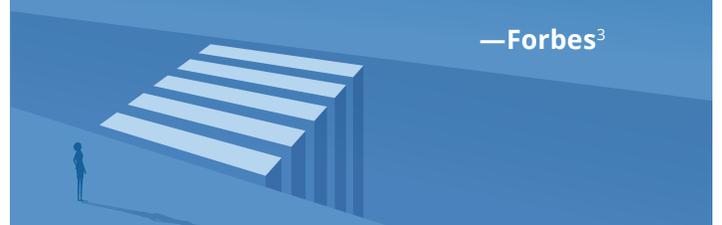
## Consumer

Experiences over things had been a huge trend, however, COVID-19 has upended that and it could persist in the short term until a vaccine is found. The travel and leisure industry has been hit particularly hard and we think a rebound will be gradual. Industries such as cruises, air travel, hotels, concerts and sports entertainment, restaurants, and mall-based retail will all be slow to recover. All of these activities require exposure to a large number of people in a small space and any activity that meets that description will not return to normal over the next 12 months. While some people are ready to get out and continue living as before, there will be a contingent of individuals that will show an unwillingness to re-engage in life as we knew it as they will not yet be ready to face a potential infection. We think the discretionary dollars spent on travel may not be fully spent elsewhere (on “things”), rather consumers will boost their savings rates, pay off debt, and try to improve their overall financial well-being. This will have profound implications for the economy at a higher level.

### — Small Cap Core perspective

57% of Millennials say they will change future social behaviors due to COVID-19.

—Forbes<sup>3</sup>



We expect the crisis will accelerate market share gains for e-commerce and delivery services. As many consumers are being forced out of their habitual purchasing decisions into products they have not tried before, it will be key to watch new habit formation. Some of these will stick, while some firms on the losing end will permanently lose customers. Fear of future pandemics may prompt consumers to stock up more on relevant products from cleaning materials to non-perishable foods. The experience of SARS in 2003 is instructive, with enduring increases in consumer demand for product categories like instant noodles and tissues well after the virus was declared contained. On the downside, much attention will focus on how cautious people will continue to be after the near term and how this will affect a range of industries from restaurants to entertainment to travel. All else equal, businesses that cater disproportionately to Millennials could face a greater downturn as the generation has now seen the second major economic crisis in its lifetime, with young people being the job market's biggest losers.

— **Fundamental International Small Cap perspective**



## Health Care

Our view is that society at large will be better prepared to handle pandemics in the future, including improved knowledge of precautionary measures and faster response times. Pharmaceutical and biotech companies may focus more on infectious diseases even after COVID-19 passes, and manufacturing capabilities for different types of vaccines and test kits will be bolstered. As medical products come more prominently under the purview of national security, a degree of deglobalization will likely occur, leading to reorganizations of supply chains and strategic redundancy. As with tech, there will be greater adoption of telehealth and remote services, as well as new products to fill gaps in existing capabilities. Employment in the health care sector is likely to increase, spurring on a secular trend.

— **Fundamental International Small Cap perspective**



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Beyond the impacts to human health and the needs being driven by COVID, there has been an impact on the pet health sector as adoptions have increased fairly significantly during the stay at home orders. We have even heard of several shelters that have no more animals left for the public to adopt across the U.S. We think that the increase in adoption of companion animals could accelerate the growth trends in veterinary space.

— **Small Cap Core perspective**

The Wisconsin Humane Society's web page for foster animals saw a 754% increase in page views in March<sup>4</sup>.



## Looking Forward

While the exact timing and people's comfort levels in reverting to previous consumption and lifestyle habits post-COVID remains an unknown, we believe small cap companies that exhibit healthy balance sheets or are at an inflection point in terms of their Return on Invested Capital (ROIC) are better positioned to thrive as we come out of the immediate effects of the pandemic. There is reason for optimism within the space: While during the last seven bear markets the smallest-cap decile lost money during the bear market's first six weeks, on average across all of those seven bear markets, the smallest-cap decile took the shortest time to overcome its bear-market losses.<sup>5</sup> Market stress will inevitably highlight winners and losers, and our expectation is that quality small caps will be on the forefront of the eventual recovery. In such environments, investors should be sure to evaluate their allocations to small cap strategies for historical downside protection during significant downturns.

**Please reach out to your SBH contact with any questions or visit [www.sbhic.com](http://www.sbhic.com) to learn more.**

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<sup>4</sup><https://www.jsonline.com/story/news/local/milwaukee/2020/05/20/pets-adoptions-leap-people-look-for-companionship-during-coronavirus/5188632002/>

<sup>5</sup><https://www.marketwatch.com/story/why-the-smallest-stocks-may-be-quickest-to-recover-from-the-coronavirus-crash-2020-04-03>