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Auscap: mid-cap valuation gap hits 25-year high

A widening valuation gap between Australia's largest companies and the rest of the market is creating opportunities for active investors, with earnings growth disconnected from share prices, according to Auscap.

Co-founder and CIO, Tim Carleton, said the valuation dispersion between the ASX's largest companies and the SMID-cap segments has reached levels not seen in the last 25 years, creating what Auscap believes is a growing pool of opportunities outside the market's largest stocks. "The dispersion in multiples between the larger part of the market and the smaller and mid-cap part of the market is wider now than it was in the depths of the global financial crisis," Carleton said.

"Importantly, this dislocation hasn't been driven by earnings. Earnings expectations for the mid-cap segment have actually improved through 2026, while there have been relatively few revisions to earnings expectations for the ASX 20."

Carleton attributed the divergence to a combination of strong investor demand for large-cap stocks, the growth of passive investing and enthusiasm around major themes including artificial intelligence.

AI creates opportunities beyond the obvious beneficiaries

While he expects AI to be transformative, he cautioned that the companies attracting the most attention from investors will not necessarily be the biggest beneficiaries over the long term.

"I have no doubt that the AI developments are going to be transformative for mankind and there are going to be incredible leaps in the things that we can achieve," Carleton said.

"But that does not necessarily mean that there will be investment opportunities that will yield tremendous results for investors."

Instead, Carleton said some of the more interesting opportunities could lie with established businesses with strong competitive advantages that are using AI to strengthen their existing business.

CAR Group is one example, with the company using AI to improve everything from vehicle listings to the car-buying experience.

"CAR Group has more than 200 developers working in its Brazilian AI hub and technology is being used to automate vehicle listings, pricing and imagery."

"It demonstrates how established businesses can use AI to accelerate product development and improve margins without needing to be the companies building the underlying technology."

Consumer stocks face headwinds despite strong fundamentals

The same divide is evident among consumer discretionary companies, where weaker sentiment around household spending has weighed on valuations.

Auscap Deputy Portfolio Manager, Will Mumford, said concerns around inflation, interest rates, property prices and the cost of living had weighed on the share prices of businesses, despite their earnings remaining relatively stable.

“Investors worry about the impact on retail spending, and ultimately, they start paying less for the same dollar of earnings that these companies generate, which creates an opportunity.”

For example, Nick Scali, the furniture retailer, continues to expand its Australian operations while its UK business has moved from loss-making to break-even.

Mumford said the company’s UK expansion provided a significant longer-term growth opportunity, while its established Australian business continued to generate attractive returns.

“Even though the business has clearly been exposed to the economic ups and downs, over the long term, it’s had really strong compound earnings growth and attractive returns on capital,” he said.

Despite increased competition in Australia and relatively modest same-store sales growth, Lovisa is another consumer business Auscap sees as having significant growth potential, with Mumford highlighting the jewellery retailer’s strong returns on equity, continued store rollout and international expansion opportunity.

Passive investing is widening the gap

Carleton said the increasing flow of capital into passive investment strategies was another factor contributing to the divergence between share prices and fundamentals.

He pointed to significant trading volumes in companies including Sonic Healthcare and CAR Group around MSCI index rebalances, despite no corresponding fundamental news from the companies. For investors, he said the consequence was that share prices could move substantially away from underlying earnings, creating opportunities for those prepared to take a longer-term view.

“Share prices are moving in both directions, a long way away from their trend earnings, and that's creating opportunities for those that can see them and those that have the patience to have an appropriate time horizon.”

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