Fund managers hunt for value and quality

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Prime Value's Shih Wong sees opportunities in the general insurance sector and healthcare. **Photo: Mal Fairclough**

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It's still a difficult time for investors. The macroeconomic environment presents a bleak picture for company earnings. The United States economy is stuttering, China's slowdown is deeper and more protracted than previously thought and Europe's huge debt burden weighs on markets.

Against that backdrop, local fund managers are screening the market for value, hunting for bargain stocks oversold in the pessimism and sometimes finding attractive sector themes.

Fundamental stock-pickers Lazard Asset Management and Aberdeen Asset Management are focusing on individual stocks rather than trends or sectors, but both have a general tilt towards quality businesses with reliable earnings.

Aberdeen's Robert Penaloza wants earnings certainty and stability. **Photo: Jim Rice**

Lazard portfolio manager Rob Osborn likes companies that have strong cash flows, sound balance sheets and pay dividends. His two top picks are logistics services outfit Brambles and building materials company James Hardie.

"Brambles is a strong global franchise with good prospects for growth in emerging markets. The company has also maintained its market share and fended off some significant competitors," Osborn says. "In the US and Europe the business has shown it can perform relatively well in falling markets. It has a sound balance sheet with a strong management team."

Lazard holds Brambles across all of its Australian portfolios as well as the diversified income portfolio because of its dividend yield and cheap valuation.

Lazard's Rob Osborn: his two top picks are logistics services outfit Brambles and building materials company James

With regard to James Hardie, the improving US home building cycle underpins Lazard's expectations. "The company has a strong balance sheet which it can use to invest into new US capacity as the US cycle improves," Osborn says. "This means they are well positioned to capture significant market share from the traditional suppliers in the US. In Australia they should also see some improvements as the Australian housing market improves from the low point in the cycle. It has a strong management team globally."

Hardie. **Photo: Rob Homer**

Perennial Value Management's Grant Oshry says the energy sector is the lone standout among smaller companies. **Photo: Nic Walker**

Raven Capital's Simon Robinson sees a market mispricing opportunity in heavily sold drilling-services company. **Photo: Michele Mossop**

Aberdeen head of Australian equities Rob Penaloza says soft global economies may translate into flat revenue growth in the year ahead, and margins may be squeezed. It's all a matter of price, but Aberdeen wants earnings certainty and stability.

Wealth management household name AMP looks attractive as the company gains synergies from its AXA acquisition. Leverage to the wealth management industry and its annuity-style earnings are favourable in a difficult environment.

"They're doing some internal restructuring as well and there are some opportunities on the cost front. AMP's overseas alliances could help grow the top line," Penaloza says.

Beverage giant Coca-Cola Amatil is considered a good longer-term play, "particularly with the roll out in Indonesia which is under-penetrated." Penaloza adds: "Indonesia's a volume game that can move to price later, and they're starting at a very low cost base."

Diversified energy business SP AusNet "has been another nice holding", he says. "It's offering an attractive dividend yield at 8 per cent and it's one of the highest rated utilities."

Prime Value Management portfolio manager S. T. Wong finds opportunities in the general insurance sector and healthcare. "The trends emerging from IAG and Suncorp's general insurance businesses in the [2012] reporting season have been quite positive," Wong says. It's noteworthy that underlying general insurance margins are improving due to a better pricing environment for motor, home and commercial insurance.

"If these companies continue to build on operating efficiency improvements, there will be potential for better margins, particularly in their Australian general insurance businesses," Wong says.

Prime Value expects robust growth revenues and profits in healthcare over the next two years, boosted by demographic support from the ageing population's future demand on healthcare services.

"Companies within the sector are generally well managed, and have healthy balance sheets with good operating leverage," Wong says. "As a result, the opportunity to build scale will contribute to growth. Within the sector, companies such as [private hospital operator] Ramsay Health Care will benefit from the ageing population and potentially greater hospital occupancies."

Latex glove and condom manufacturer Ansell is well positioned for robust growth due to product innovation, exposure to emerging countries and potential acquisitions.

Perennial Value Management head of small caps Grant Oshry highlights the energy sector as the lone standout among smaller companies, particularly those that service the LNG sector or long-duration projects. These businesses have some earnings certainty since the projects will proceed even if the oil price declines.

"[Engineering and construction contractor] Clough has a strong balance sheet [net $146 million cash], a strong order book [$2.3 billion] which gives good earnings visibility for 2013 and the majority of 2014, and good momentum following an improvement in [second half] 2012 EBIT [earnings before interest and taxes] margins," Oshry says. "I'm encouraged by their new MD [Kevin Gallagher] who is very returns-focused."

Oshry highlights Clough's low trading price, below eight times forecast 2013 earnings. "With double-digit earnings per share growth and sustained margin improvement, it looks attractive."

Matrix Engineering is another energy pick. "It services deep offshore oil drilling and has high intellectual property around its product [marine riser buoyancy] and mostly supplies the export market," Oshry says.

"FY13 should see the benefits from a new production facility and much improved cash flow." Matrix's low valuation, double-digit earnings per share growth forecast and net cash balance sheet position are encouraging.

And for the contrarian investor, Raven Capital director Simon Robinson finds a market mispricing opportunity in heavily sold drilling services company Boart Longyear. Robinson thinks the market has overreacted to the company's guidance change, creating a significant price gap compared with the company's underlying valuation.

"Boart Longyear downgraded its forecast earnings for calendar year 2012 from $US460 million EBITDA [earnings before interest tax depreciation and amortisation] to a range of $US360-$US390 million EBITDA," Robinson says. "This downgrade resulted in the share price dropping from circa $2.40 to $1.40 in a matter of days, a 40 per cent fall compared with the EBITDA downgrade of 20 per cent."

Robinson says Boart is well capitalised with a strong balance sheet – with interest coverage at 16 times – and the company's first debt maturity is due in 2016.

"The stock looks cheap trading on a price to earnings ratio of five times Y12 and yielding 6 per cent."

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