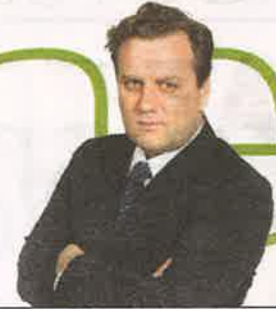
Smart Money



Joye: **Christopher Joye** Beware returns of a volatile manager **Page 29**

For contrarian investors with stock-picking skills, there's tasty potential in small-cap companies.

SMALL FRY SHOULD STAY ON THE MENU

Illustration Sam Bennett

Brendon Lau

This is a challenging time to be a small-cap investor, with the index lagging that of large caps by nearly the biggest margin since the depths of the global financial crisis in March 2009.

More alarming, there aren't any obvious catalysts on the horizon that could spark a turnaround in performance. The S&P/ASX Small Ordinaries Index has fallen nearly 2 per cent since the start of the year, compared with an 8 per cent gain by the benchmark index for the top 100 stocks.

While small caps are not thriving across the board, there are good reasons why investors shouldn't write off the sector. Average total returns this calendar year among the 10 best small-cap stocks are much higher than for the top 10 large caps. And analysts point to small caps as having the potential to outstrip the biggest 100 companies on the market in growth next year.

Picking the winners will be a challenge, however, and chief investment officer at Equity Trustees Shaun Manuell believes bigger companies will deliver better returns on a risk-adjusted basis.

"We think there's an opportunity for global cyclicals to make up some of the underperformance they had over the past 12 months," he says, "and that obviously leads you towards the large-cap miners.

"The large-cap stocks have a diversified revenue and client base. They are by nature safer and have bigger balance sheets."

For these reasons, his fund is currently weighted towards the S&P/ASX 100.

There are other reasons why small caps could keep underperforming, says Prime Value Asset Management portfolio manager S. T. Wong.

"The domestic economy seems to be softening," he says. "As a generalisation, small caps tend to reflect the domestic economy more. Also, when you look at the [small-cap] index, resources comprise a large proportion.

"Small miners are among the most challenging stocks on the market. They tend to be high-risk propositions even at the best of times, but are even riskier in this climate as commodity prices typically don't need to fall very far before their projects become uneconomic."

There is little doubt that passive investors looking to buy a basket of stocks would do well to stay away from the junior end of the market for now. But those willing to put in the extra work necessary to pick winners cannot afford not to look at the small-caps sector.

The difference in performance generated by small stocks and their bigger rivals says it all. The average total return delivered by the 10 best stocks in the Small Ordinaries Index since the start of this calendar year is about 170 per cent, while that of the 10 best on the S&P/ASX 100 Index is only about 50 per cent.

Portfolio manager for Pengana Emerging Companies Fund Steve Black says quality research goes a long way in the small-cap sector.

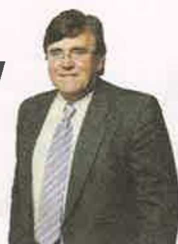
"Many of the near 1000 stocks we look at don't attract much stockbroker coverage," he says. "Accordingly, there's a far greater chance for these stocks to be

Continued next page

INSIDE YOUR LIFTOUT

Editor: Debra Cleveland
dcleveland@afr.com.au

Expert view
Super death benefit carries a tax risk
30



First class
In search of a real touch of glass
40

Bassanese
Market stalls as earnings wither
40

Keep small fry on the menu

From previous page

mispriced. Small caps is also where you find the future leaders."

Stocks such as CSL, Computershare, Cochlear and Sonic Healthcare are all good examples of large popular stocks that began as market tiddlers more than a decade ago. "These companies have been at least 20 baggers [stocks that have gone up by 20-fold in value] over the past 15 years," Black says.

"It's near impossible for large caps to enjoy share price appreciation of this magnitude."

Small caps are also hard to beat for earnings growth, given they are coming off a much lower base.

When resource explorers are excluded (due to their erratic growth profile), small companies are tipped to post average earnings before interest, tax, depreciation and amortisation (EBITDA) growth of just over 20 per cent for 2012-13 – twice that of the biggest 100 companies on the market.

The earnings growth potential for large caps will be considerably weaker over the next several years compared with the past decade or two, Evans & Partners chief investment officer Mike Hawkins predicts.

"If you go through the list [of large-cap stocks], particularly the top 20 stocks, they're very deficient on earnings [growth]," he says.

"And investing in equities is all about investing in companies that are growing."

On that note, here are 10 small-cap stocks investors should watch.

Prime Value's S. T. Wong: Ardent Leisure Group is one of his top picks. Photo Mal Fairclough

Key picks

10 stocks with the most potential

Name	Estimated EBITDA* growth FY13 (%)	Estimated FY13 P/E (x)	Estimated dividend yield FY12 (%)	Net debt to equity (%)	Total YTD return (%)
Breville	11.52	13.29	4.64	-26.50	128.90
M2 Telecommunications	107.51	9.97	5.66	66.39	46.86
Ardent Leisure	24.30	10.21	8.60	44.70	45.98
Fantastic Holdings	19.84	11.13	4.85	3.69	45.80
Technology One	11.72	14.89	4.71	-52.28	41.96
IMF Australia	n/a	8.86	8.78	-24.60	31.10
Beach Energy	19.21	12.52	1.46	-16.45	20.11
Miclyn Express Offshore	16.93	8.05	2.91	51.30	16.28
Royal Wolf Holdings	22.69	11.35	3.96	68.48	16.25
Acrux	176.79	11.72	1.96	-56.53	2.17

* Earnings before interest, taxes, depreciation, and amortisation

SOURCE: BLOOMBERG

Royal Wolf Holdings

The company, which converts shipping containers into storage, transportation and accommodation units for businesses in Australia and New Zealand, has been operating under the radar of most investors since it listed last May.

But it's one of Pengana's key picks for 2013, as it's a market leader in its field and has a solid management team.

"Over the past six years Royal Wolf Holdings has grown its portable storage fleet by around 15 to 20 per cent a year despite the soft economic conditions it's had to operate in," Black says. "We'd expect profits to continue to grow at around these levels, which places the company on a prospective price-earnings ratio of only 10."

Fantastic Holdings

While retail stocks are on the nose in this environment, the furniture chain is well placed to outperform next year, Black says.

Fantastic Holdings, which has 130 stores nationally, stands to be a prime beneficiary of any turnaround in the Australian residential market.

The retailer has also started to benefit from its business improvement program as it upgrades management and logistics systems.

"[While its] share price has recently begun to improve," Black says, "we still think the market is underestimating the operating leverage inherent in this improved business with the shares trading on a prospective P/E of 11."

Breville Group

While the stock has more than doubled since January, the small appliance maker is still good value given its robust gross margins of about 40 per cent, which is twice that of global peers, and its leverage to the rebounding United States economy.

The US market accounts for about 35 per cent of group sales, and Breville is expected to post its fourth straight year of earnings growth in 2012-13.

These factors, coupled with its superior return on equity and decent dividend yield of 5 per cent, more than justifies the stock's premium to the broader market.

Consensus estimates are forecasting an 11 per cent increase in sales to $461.6 million and a 13 per cent uplift in EBITDA to $81 million this financial year.

M2 Telecommunications Group

Those looking for yield and earnings growth cannot go past this fledging telecommunications group.

M2 has a stunning growth track record even through the global financial crisis, thanks in large part to a number of smart acquisitions in what can only be described as a highly competitive market offering few points of differentiation for smaller players.

> Small companies are tipped to post average EBITDA growth of just over 20 per cent for 2012-13 – twice that of the biggest 100 companies on the market.

Management is tipping another strong year with EBITDA growth of about 88 per cent and a 17 per cent increase in EBITDA margin to 17.9 per cent.

M2 is another small cap that deserves to be trading at a premium, but its stock is on a 2012-13 P/E of just a little over 10. Moreover, the stock has a grossed-up dividend yield of around 9 per cent.

Technology One

The enterprise software provider is a much-admired small-cap stock, particularly after its better than expected 16 per cent increase in full-year profit to $23.6 million, announced earlier this week.

Technology One also managed to expand its profit-before-tax margin by nearly 1 percentage point to 18 per cent, and management aims to increase this to 25 per cent over the next five years.

This means its bottom line is set to grow substantially ahead of revenue and the company is well placed to make a capital return, given it is hoarding $42 million in cash on its balance sheet.

While the stock is hovering around its record high of $1.41, almost all brokers have a "buy" recommendation on it.

Beach Energy

The Cooper Basin oil and gas company is one of Evans & Partners top mid-cap picks for the year ahead due to its leverage to the potential boom in shale gas.

Beach has recently started drilling for the unconventional gas and Hawkins believes the company will enjoy significant upgrades to its gas reserves over the next few years.

"This is on top of its conventional [oil and gas] business, which is doing quite nicely," he says. He values Beach at around $1.80 a share and that is just on its conventional energy assets. This means investors are getting the shale gas business essentially for free.

Acrux

The biotech has been a poor performer as investors fret about the slower than expected adoption rate of its testosterone treatment in the US and a fierce competitive response from market leader Abbott Laboratories.

These fears sent the stock crashing 40 per cent after it hit a record high of $4.76 in June this year, but the selling is overdone given the clear advantage of the Acrux treatment.

Management also went to great pains to point out that Cialis, an earlier treatment, needed five years to capture around a 50 per cent share of the erectile dysfunction market from Viagra.

Analysts have also forecast improved royalty payment streams with the sale of the treatment in other key markets such as Canada and Europe.

Just about all brokers are urging investors to buy the stock as its target price is nearly double where it is presently trading.

IMF (Australia)

The litigation funder is another misunderstood stock, says Prime's Wong.

Investors have trouble valuing IMF as it is difficult to predict its pipeline of future court cases.

For this reason, the stock always seems to trade at a relatively large discount to the market on a P/E basis.

"I really don't know what the ultimate pipeline [of cases] will be three years out, so I'd look at the liquidation value," Wong says.

If only current cases are considered, at a reasonable win-loss ratio, the base value of the stock should be around $1.20 a share on his estimates.

As it is now trading around $1.55, the downside risk is fairly limited, and investors are paying little for the future pipeline of cases.

Ardent Leisure Group

The leisure facilities operator is another of Wong's top picks.

Ardent's forecast dividend yield of around 9 per cent is a strong drawcard and the group has proven that its diversified business model can weather fluctuations in operating conditions. As an example, the extensive floods in Queensland last year didn't have a material impact on the group's earnings.

Consensus estimates forecast about a 15 per cent increase to sales and EBITDA for 2012-13.

Miclyn Express Offshore

While most contractors to the resources sector are under pressure due to falling capital spending, marine services company Miclyn Express appears well placed to post another year of record earnings.

Unlike many of its peers, Miclyn's annual general meeting held no nasty surprises. If anything, management said the strong fleet utilisation rates of 84 per cent in 2011-12 had carried through to the first quarter of the current financial year.

Citigroup singled out the stock as one of its key buys due to its strong cash conversion and balance sheet.

Experts also believe there is a good chance it will be sold into private hands by its largest shareholder, Champ Private Equity, which holds about a third of the company.