

# Small cap prophets: A profit season guide

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**Summary:** Business conditions across the small caps sector have been tough for many, but not all. Some industries remain under intense pressure, yet there are reasons to be positive in others. Today we speak to five small caps experts to get their predictions ahead of the upcoming earnings reporting season, and they also give us their top stock picks.

**Key take-out:** The small caps experts predict that reported sales growth levels will be flat, or lower, in the next round of earnings results due the underlying weakness in economic conditions. Mining services companies will likely stand out, but for all the wrong reasons.

**Key beneficiaries:** General investors. **Category:** Shares.

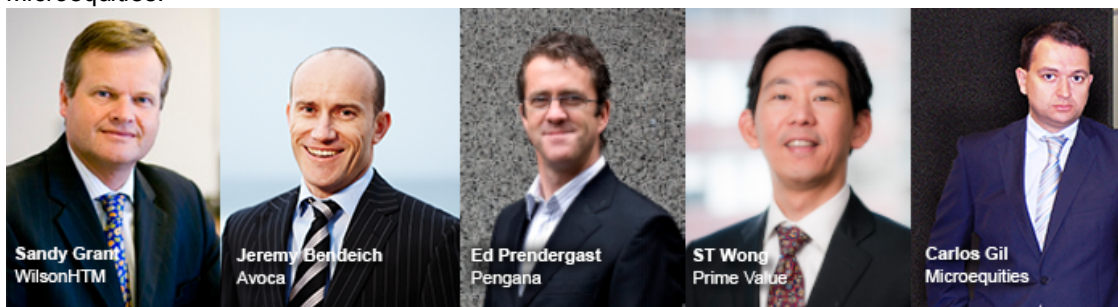
Tomorrow marks the official start of the full-year reporting season and there's a high wall of worry for small cap investors to scale given the unhealthy mix of economic and political uncertainties that lie on our immediate horizon.

What's worse is that views on this reporting season vary widely, with a number of experts warning that earnings are likely to miss their mark as companies struggle to hold their own against high costs, volatile commodity prices, big swings in the exchange rate and poor business and consumer confidence.

Feeling nervous yet? I won't blame you, as the uncertain outlook for the market is likely to persist for most of the first-half of the current financial year.

While it might not bring total comfort, I posed three key questions to a roundtable of leading small cap fund managers in the hope that it will help investors navigate what could turn out to be a treacherous reporting season.

The fund managers are Sandy Grant from WilsonHTM Priority Growth Fund, Jeremy Bendeich from Avoca Investment Management, Ed Prendergast from Pengana Capital, ST Wong from Prime Value Asset Management, and Carlos Gil from Microequities.



## Q1: What are you expecting in the August reporting season?

**Grant:** We expect a fairly subdued reporting season for small companies, but given the relatively high valuation multiples attached to many companies, there is scope for some share price declines despite many companies already giving earnings guidance.

In a similar manner to the share price performance of the past two years, the gap between the good companies with a clearly defined strategy that is being well executed and other companies that have no sustainable competitive advantage is likely to be vast.

Generally speaking, we continue to favour the industrial small companies relative to the small miners with little strategic or cost advantage.

**Bendeich:** We expect that earnings for cyclical companies will have deteriorated in the last quarter of FY13, as the economy

noticeably softened. Small cap stocks that are highly leveraged to this are discretionary retail, and industrial services. Given continuous disclosure requirements, the key risks will be around the FY14 outlook statements.

The RBA will cut interest rates and in 12 months the rate of decline in economic growth should bottom out and Australia will grow, albeit at a slower pace. As a result, we will be watching for quality names that get oversold this reporting season.

In aggregate, FY14 consensus earnings growth looks high given governments have to reduce spending and increase taxes, and consumers will not respond until employment stabilises.

**Prendergast:** Market forecasts for small caps are potentially too high in sectors such as retail and media where consumer and business confidence has not recovered, hence draining the rate of recovery already baked into forecasts.

Also, companies exposed to business spending are likely to provide poor outlook statements given anecdotal feedback regarding corporate spending.

**Wong:** The probability of disappointment should be reasonably low, on the back of investors selling down the obvious sectors and ongoing profit downgrade disclosures.

In addition, investor expectations should be somewhat more subdued as the macro backdrop has softened. There may still be room for disappointment from write-downs impacting, say in the junior miners segment.

In addition, the continuing downgrades amongst mining services companies could still throw up negative surprises.

**Gil:** The recent share price rises in many small cap companies needs to be validated by a rise in earnings, otherwise this could plausibly lead to downward pressure on market prices.

I think industrial businesses not exposed directly or indirectly to resources are also going to have a challenge to deliver strong growth. However, one of the benefits of some selected small companies is they do have the ability to grow irrespective of the prevailing macroeconomic environment.

## **Q2: What are some of the key things you will be watching out for in the results?**

**Grant:** We are forecasting modest sales growth figures for the last half across most companies given an uncertain political environment and low consumer confidence restricting sales growth. Clearly mining companies, especially the mining service companies, are likely to report sustainably lower revenues for the last six months of the year.

One of the more interesting features of this reporting season will be the attitude of auditors and company directors to asset values. Following the decline in returns from many businesses there will potentially be pressure on some companies to make adjustments to some of the carrying values of some of the assets on their balance sheets. Although these balance sheet adjustments are non-cash items, there will nonetheless be pressure on some of these companies to potentially raise equity to repair their financial position.

**Bendeich:** Revenue growth will be hard to come by given weak economic conditions. Margins will likely come under pressure in this environment, especially for importers who have had a free kick from a high Australian dollar.

The mining services sector will continue to experience increased margin compression as excess demand flips into excess supply. This will impact revenue growth and margins. In addition, working capital requirements will increase as customers demand better terms.

**Prendergast:** Mining services is likely to be the source of further disappointment. Notwithstanding the slew of downgrades over the past six to nine months, we still expect further downward adjustment to expectations based on lower revenues and tighter margins.

As witnessed by the sharp correction in Ausenco's price following its downgrade this week, the market is clearly still adjusting to the worsening environment. Hence arguing that it is already "in the price" is bold.

**Wong:** I have segmented my analysis to two key segments – stocks that have outperformed year-to-date, asking the question of whether they will continue to do well; and the underperformers – is there value to be found?

Best performers year-to-date include three key sectors: consumer discretionary (including online companies), diversified financial services and junior telco companies. I will be focussing on the companies' ability to sustain and improve profitability through demand growth and their ability to price against the backdrop of slower economic growth, the employment picture deteriorating

and interest rates cuts that have yet to bite in a meaningful way.

On the downside, the worst performers year-to-date squarely include junior mining companies and mining services companies. Mining services clearly continues to be under pressure, and therefore I am looking for managements' responses to managing the difficult outlook and the state of cash flows and balance sheets.

**Gil:** In each company we observe a softer set of KPIs (key performance indicators) for management. Generally, earnings quality is always important, so we'll be keeping a close eye on metrics like operational margins including gross and EBITDA (earnings before interest, tax, depreciation and amortisation) margins.

### Q3: Which small cap stock(s) do you think will surprise on the upside or downside?

**Grant:** Companies with strong structural growth stories and competitive advantages are likely to post strong revenue gains. Included in this group would be Titan Energy Services (TTN), Silver Chef (SIV), Slater and Gordon (SGH), Drillsearch Energy (DLS) and NEXTDC (NXT).

### Fund Managers' Picks

Stocks that may surprise on upside	FM*	Est FY14 P/E (x)	Total 1-yr rtn (%)	Market Cap (\$m)	Industry
Titan Energy Services	SG	5.45	364.03	92.57	Oil & Gas Drilling
Silver Chef	SG/JB	15.73	144.97	229.81	Trading Companies & Distribution
BT Investment Management	SW	15.12	120.60	1,017.85	Asset Management & Custody
Henderson Group	SW	12.22	103.51	3,096.87	Asset Management & Custody
M2 Telecommunications Group	EP	13.92	97.40	1,083.07	Integrated Telecommunication Services
Slater & Gordon	SG	11.83	69.27	629.61	Specialised Consumer Services
Amcom Telecommunications	EP	18.07	60.78	446.32	Alternative Carriers
Austbrokers Holdings	JB	17.64	57.27	630.92	Insurance Brokers
NEXTDC	SG	n.a	33.00	471.49	Alternative Carriers
Vocus Communications		14.24	23.13	168.88	Alternative Carriers
Drillsearch Energy	SG	7.04	8.53	520.79	Oil & Gas Exploration & Production
Stocks that may surprise on downside	FM*	Est FY14 P/E (x)	Total 1-yr rtn (%)	Market Cap (\$m)	Industry
Specialty Fashion Group	CG	9.68	91.31	173.01	Apparel Retail
Pacific Brands	SW	10.03	64.20	732.61	Distributors
Gazal Corp	CG	n.a	52.77	147.77	Apparel, Accessories & Luxury
Domino's Pizza Enterprises	JB	22.41	31.84	795.98	Restaurants
OrotonGroup	SW	16.27	0.86	299.25	Apparel Retail
SAI Global	JB	15.00	-10.59	794.92	Research and Consulting Services
Noni B	CG	n.a	-11.37	19.90	Apparel Retail
APN News & Media	SW	4.10	-43.77	189.86	Publishing

\*Fund Manager - SG = Sandy Grant, JB = Jeremy Bendeich, EP = Ed Prendergast, SW = ST Wong, CG = Carlos Gil

Although there have been a number of the mining service companies have indicated that revenue growth has declined sharply in the second half, there may still be some disappointing revenue figures in this area of the market.

**Bendeich:** Two stocks that may positively surprise are Austbrokers Holdings (AUB) and Silver Chef (SIV). Austbrokers' recent acquisitions and premium rises may contribute more than expected to FY13/14 numbers.

Silver Chef's growing customer base, cafes and restaurants make it the fastest growing segment of retail, and their Go Getta product is gaining traction which could lead to another positive FY14 year.

On the other hand, Domino's Pizza Enterprises (DMP), trading on a high price-earnings (P/E) multiple, is vulnerable to further weakening in economic activity in both France and even in Australia – as McDonald's recent trading update suggested.

SAI Global (SAI) may experience continued organic revenue growth pressure, and with no recent acquisitions, FY14 growth of 10% in earnings before interest, tax, depreciation and amortisation (EBITDA) could be stretched.

**Prendergast:** My tips for positive surprises are M2 Telecommunications Group (MTU) and Amcom Telecommunications (AMM).

M2 is positioned to show solid earnings growth driven by the benefits of the Primus and Dodo acquisitions, plus a resumption of organic growth in its core SME operations. The defensive nature of its revenue streams insulates it somewhat from economic volatility.

Amcom is expected to continue its 20% earnings growth rate driven by further expansion in its fibre network in the Western Australia market. The move into cloud-based services provides a faster growing adjunct to its traditional offering.

**Wong:** In terms of small cap companies that could surprise, the diversified financials might be a possible area that could surprise positively. Companies such as BT Investment Management (BTT) and Henderson Group (HGG) could post better margins and increase dividend payouts.

Consumer discretionary companies that have been bid up on account of interest rates making an impact on consumer spending may warrant some caution. The top-line growth outlook may be anaemic, whilst margins could be weaker than expected. Examples include Orotongroup (ORL), APN News and Media (APN) and Pacific Brands (PBG).

**Gil:** We expect Vocus Communications (VOC) to deliver strong organic growth. If you look across the telco sector, including large companies like Telstra (TLS), M2 Telecommunications (MTU) and iiNet (IIN), the sector lacks true underlying organic growth and most of the growth from the larger players is acquisitive-based growth.

Vocus is an exception. We expect the business to continue to deliver fast organic growth, particularly in its fibre optic services business.

In terms of downside risks potential, we are not seeing any evidence of any marked improvement in Australian retailing conditions. So, for retailers, we would be wary of any short-term expectations to the contrary. Therefore, our expectations for companies like Noni B (NBL), Specialty Fashion Group (SFH) and Gazal Corporation (GZL) are tamed.

## Uncapped 100

### Small cap stocks covered by the Uncapped team

Code	Name	Rationale	Market cap (\$m)	Total return 1-year (%)	Sector (GICS)
MTU	M2 Telecommunications Group	Amazing growth story and well run company. High free float and strong insto support.	1,112	101.35	Financials
NHF	NIB Holdings /Australia	Only listed health insurer. Widely held. Good performer.	992	51.69	Information Technology
BRG	Breville Group	Well covered but good candidate for core holding due to good track record.	971	63.62	Industrials
ARP	ARB Corp	Well covered but good candidate for core holding due to quality management.	965	43.22	Industrials
MRM	Mermaid Marine Australia	Its strategically located facility on WA coast gives it a key advantage over competition in servicing Gorgon & Pluto projects.	900	54.41	Health Care
GEM	G8 Education	Only listed childcare operator. Acquisition strategy paying off with stock delivering solid gains.	731	193.81	Information Technology
AAD	Ardent Leisure Group	Widely held stock. Earnings more defensive than anticipated. Good yield. Potential core holding. A shining star in the biotech space and one of the	698	43.97	Telecommunication Services

SRX	Sirtex Medical	best performing stocks in 2012. Great product (liver cancer treatment) and bright outlook.	694	96.94	Industrials
SGN	STW Communications Group	One of few companies able to benefit from online shift. Widely held and good insto support.	658	86.91	Materials
AUB	Austbrokers Holdings	The insurance broker is a strong performer. Widely held and well liked by small cap investors.	640	56.39	Consumer Discretionary
MMS	McMillan Shakespeare	One of the best performers since the GFC, but change to FBT rules is threatening growth.	612	-28.19	Consumer Discretionary
BDR	Beadell Resources	Will be a very big FY14 for miner as it has to prove it aims to produce 200,000 ounces of gold a year.	589	14.12	Materials
ACR	Acrux	One of the most successful Australian biotechs in recent history. Widely held by instos.	563	-8.81	Financials
RFG	Retail Food Group	Owns a number of well know franchise brands. Widely followed by instos.	543	69.68	Industrials
CCV	Cash Converters International	Strong performance is attracting investors. It's Australia's only listed pawn shop and pay day lender.	494	68.11	Industrials
SEA	Sundance Energy Australia	Analysts have a favorable take on the oil & gas explorer, but stock is still under radar of most. Sundance provides exposure to prospective Eagle Ford shale.	482	148.21	Health Care
NXT	NEXTDC	The cloud computing company is an IT sector darling. Fairly widely held and followed.	477	34.5	Industrials
BRU	Buru Energy	Substantial size but not often covered by press. Widely held with good insto support.	473	-49.41	Information Technology
AMM	Amcom Telecommunications	Well covered junior telco but good candidate for core holding.	456	64.3	Industrials
CCP	Credit Corp Group	Strong price run attracted good investor interest. Leveraged to any rise in loan defaults. Not well covered by press.	434	52.02	Financials
SLX	Silex Systems	Its uranium enrichment technology could become one of Australia's best innovations given its potential to change the nuclear power industry. Widely held stock in the waste solutions	431	-34.46	Consumer Staples
TOX	Tox Free Solutions	business. Its unique because it operates in a defensive-growth niche.	428	31.13	Industrials
BGA	Bega Cheese	Corporate interest in Australian food companies makes the cheese maker worth following.	421	89.74	Health Care
HZN	Horizon Oil	One of better regarded small energy stocks that doesn't receive much media attention.	420	34.55	Information Technology
CWP	Cedar Woods Properties	Property developer with good ROE and earnings growth track record.	415	61.99	Consumer Discretionary
MYS	MyState	Well regarded and could make good alternative to bank stocks. Has good yield and earnings growth over past few years.	397	47.78	Energy
FGE	Forge Group	One of the better performers in its industry. Good track record and potential core holding.	382	6.52	Consumer Discretionary
UXC	UXC	Company has turned corner and enjoyed re-rating. What's next?	348	84.32	Energy
RKN	Reckon	Fierce competition for cloud base accounting software puts it in firing line.	320	20.43	Telecommunication Services
MYX	Mayne Pharma Group	Sizeable generic drug maker with interesting board members.	318	101.79	Industrials
		One of few retail stocks that is performing well.			

TGA	Thorn Group	The Radio Rentals chain owner is also well supported by instos.	316	39.72	Financials
RCR	RCR Tomlinson	Good first half FY13 result and outlook, but will its fortunes change this year with the mining capex slowdown? The developer of one-use prefilled syringes is close to an inflection point as the market is expecting the company to announce a major contract with a pharmaceutical giant in the coming weeks.	314	47.21	Energy
UNS	Unilife Corp	Has a good track record and is leveraged to any housing recovery. The stock is also liquid with good insto support.	309	1.89	Health Care
MOC	Mortgage Choice	One of the better regarded mining & civil contractors with good track record in delivering on projects.	295	78.05	Consumer Discretionary
NWH	NRW Holdings	Noteworthy for its good pipeline of innovations. Well run, widely followed.	276	-62.67	Financials
SPL	Starpharma Holdings	High corporate interest in the sector and the shrinking pool of agri listed stocks make Ridley worth following.	271	-34.81	Financials
RIC	Ridley Corp	Well performing childcare centre property owner. Good yield story and outlook.	265	51.76	Health Care
AEU	Australian Education Trust	Largely forgotten by investors but could attract attention this year as it looks to gain US approval to use its intestinal shealth on diabetics.	259	-22.11	Consumer Discretionary
GID	GI Dynamics Inc	Transport equipment maker posted good interim result. Has appealing yield and growth.	258	105.82	Information Technology
MXI	MaxiTRANS Industries	Strong leverage to Japanese economy makes this an interesting stock to watch.	236	30.96	Telecommunication Services
AJA	Astro Japan Property Group	Strong jump in the share price of the equipment financing group has attracted a good following.	233	143.38	Consumer Staples
SIV	Silver Chef	Litigation funder is unique stock. Stock not liquid but its outlook appears promising given the number of potential class action lawsuits.	231	29.34	Consumer Discretionary
IMF	IMF Australia	In similar space as Credit Corp. Strong stock performance has attracted a following and the stock appears to be well placed to run further	227	144.36	Financials
CLH	Collection House	Acquisitive veterinary group. Good profit growth and share price performance, but gets little press.	219	143.52	Energy
GXL	Greencross	Noteworthy for turbulent past and exposure to soft commodity market.	212	192.16	Telecommunication Services
SHV	Select Harvests	One of the larger cancer treatment developers in this market.	210	101.18	Materials
BNO	Bionomics	Will be a big beneficiary if governments start spending on IT again.	206	6.69	Industrials
DWS	DWS	A successful medical tech story. Should be close to turning in maiden profit with its disinfection device.	203	47.06	Consumer Discretionary
NAN	Nanosonics	Potential large cap if it can launch its own satellite in 2015.	196	-28.71	Health Care
NWT	Newsat	Worth watching as it is trying to be the REA Group of Asia.	194	12.9	Health Care
IPP	iProperty Group	Illiquid stock but has suite of well recognised consumer brands. Defensive yield.	190	-11.45	Information Technology
PFL	Patties Foods		188		

WBB	Wide Bay Australia	The building society is trying to turn its fortunes around. Also worth watching for its exposure to Queensland housing market, particularly around major resource projects.	187	-20.43	Materials
DTL	Data#3	Well respected IT company that receives little press coverage.	185	7.62	Consumer Discretionary
GXY	Galaxy Resources	Good upside potential if it can get its problem-prone Jiangsu plant back on track. Won't be easy to right this ship.	177	n.a	Consumer Staples
SFH	Specialty Fashion Group	In early stages of turnaround. Can the women's apparel retailer sustain the momentum?	172	82.63	Industrials
VOC	Vocus Communications	Telecom stocks are in favour but Vocus is one of the least covered	171	25.21	Consumer Discretionary
IFM	Infomedia	Interesting tech play in the car parts market. Strong share price gain but gets little air play.	170	191.75	Industrials
IMD	Imdex	Drilling company is well supported by instos and should benefit from any rebound in exploration activity.	163	-48.72	Materials
CKF	Collins Foods	One of the few food franchise listed companies.	163	59.45	Information Technology
MLB	Melbourne IT	A perennial underperformer could be interesting turnaround story as management is in midst of restructuring the business.	156	28.96	Information Technology
HSN	Hansen Technologies	Operates in a high potential/growth industry but is not covered by press or brokers.	151	6.61	Materials
RCG	RCG Corp	The footwear retailer is one of the best performing consumer stocks as online competition is not a big threat. Company has a good yield as well.	145	67.74	Health Care
TFC	TFS Corp	The sandalwood products company offers exposure to both the agri and cosmetics industry. It will start commercial harvest this year.	134	14.29	Telecommunication Services
TGS	Tiger Resources	Future lies in its Kipoi copper mine expansion in the Congo but miner is fully funded with DRC govt holding 40% stake in tenement. Next 12mths will be interesting.	132	-32.76	Information Technology
UBI	Universal Biosensors Inc	Well regarded biotech and one of few that's successfully manufacturing in Australia. Struck deal with a few global medical companies.	131	25	Financials
MCP	McPherson's	The personal care and household products supplier had been relatively insulated from volatile discretionary spend and online threat, but its latest profit warning shows it's not immune.	131	-8.29	Materials
REX	Regional Express Holdings	Well run airline that is overshadowed by Virgin and Qantas.	128	6.28	Health Care
AZZ	Antares Energy	Liquid with good insto support. Already in production with exploration upside in Texas.	120	11.9	Health Care
ACL	Alchemia /Australia	One of the few biotechs with revenue stream. Good pipeline of oncology treatments.	117	-27.27	Information Technology
POH	Phosphagenics	Sizable biotech with a game changing FY14 year ahead. Good insto following but questions of poor audit and governance standard could dog company.	112	-21.43	Industrials
AMA	AMA Group	Good turnaround story but under the automotive services group is radar of most.	108	132.07	Materials
NEA	Nearmap	A stellar performer with an interesting business that offers high quality ariel maps to companies & government.	107	842.86	Health Care

LCM	LogiCamms	Strong price performance and reasonable valuation attracting interest.	105	48.47	Health Care
ESV	Eservglobal	Mobile money transfer company that has been gaining traction. Widely held by instos but low press coverage	103	118.42	Information Technology
BGL	BigAir Group	The wireless microcap has gained strong following over past year or two but is often overlooked by investors and the press.	96	55.36	Consumer Staples
SAR	Saracen Mineral Holdings	Emerging gold producer that is widely held by instos. Hitting milestones and looks cheap. Key asset is close to gold majors, which makes it a potential takeover target.	95	-66.67	Industrials
DRM	Doray Minerals	Widely held by instos. One of the more favored gold explorers by brokers.	91	-14.34	Consumer Discretionary
JIN	Jumbo Interactive	Innovative small cap facing off industry dominated by giants. Worth watching to see if it can carve out a profitable global business.	89	78.76	Consumer Staples
CLV	Clover Corp	One of the star performers in 2012. Operates in growing but relatively stable niche.	89	40.58	Health Care
PEN	Peninsula Energy	Widely held by instos and large free float. It's the only uranium miner on the list.	83	-6.67	Consumer Discretionary
AOH	Altona Mining	Noteworthy copper play with Xstrata pullout of Roseby project in Australia and the good ramp up of its Finnish project.	74	-48.15	Information Technology
CUV	Clinuvel Pharmaceuticals	Interesting skin disorder treatment developer that has done reasonably well over past year	73	14.46	Telecommunication Services
RUL	RungePincockMinarco	IT company to resource industry. Facing tough operating climate with new CEO trying to restructure and turnaround company.	72	48.41	Materials
WDS	WDS	Widely held with strong insto support. Engineering contractor diversified across mining, energy and infrastructure.	65	-0.95	Materials
TAN	Tandou	The only direct equity exposure to cotton prices. Also trades water rights and receives little press.	64	23.52	Health Care
CAA	Capral	An aluminium manufacturer that is actually holding up relatively well given that manufacturing is on the nose.	63	6.67	Industrials
CKL	Colorpak	The small cap packaging company has grown via acquisitions over past few years.	62	52.82	Financials
BOL	Boom Logistics	Crane hire group is riding out the downturn in construction. It's widely held by instos and is very liquid.	61	-48	Industrials
TSM	ThinkSmart	Potential turnaround story worth keeping eye on.	56	81.58	Information Technology
LGD	Legend Corp	Electronic parts supplier to utilities and other industries. Stable earnings with good yield. Often overlooked.	54	-18.25	Materials
KOV	Korvest	The construction products and services supplier has been hit by project delays and deferrals. But its relatively high yield could give it some support.	53	18.26	Information Technology
UML	Unity Mining	Growing Tassie gold producer with high free float. Valuation looks compelling too.	51	-30.48	Materials
YTC	YTC Resources	Next 12-mths will be eventful after YTC secured funding for its projects from Glencore.	47	-5.26	Consumer Discretionary
ISS	ISS Group	Good turnaround story from 2012 but the resource industry software developer under the radar of most. ISS has received a takeover offer	44	85.11	Consumer Discretionary



		after its inclusion in the Uncapped 100.			
		Alternative small cap to online property leader REA Group. It is trying to use more timely housing data as a competitive edge against REA.			
OTH	Onthehouse Holdings		41	14.64	Materials
		Under appreciated small IT hardware maker that is punching above its weight. Hardly covered by press.			
NTC	NetComm Wireless		33	121.74	Materials
		Potential alternative to star performer Ainsworth Tech. Has exclusive deal with US poker machine maker WMS.			
EBT	eBet		27	148.61	Health Care
		Unique product that could change global maritime safety practices with its man-overboard location beacon.			
MBO	Mobilarm		18	185.71	Consumer Discretionary
		Emerging hospital equipment supplier that has been ignored by market.			
PGC	Paragon Care		15	75	Information Technology

Source: Eureka Report, Bloomberg

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