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Defensive stocks for turbulent times

While there are no safe bets, some companies perform better than others, writes **Bina Brown**.

It has become increasingly obvious in recent weeks that there can be no guarantees even the most defensive stocks won't get knocked around in times of uncertainty. What has become apparent in the wake of some wild trading on the stockmarket, is that good businesses remain good businesses irrespective of what is going on around them and share prices should eventually reflect that.

Unfortunately, there is really no such thing as a "safe bet" when it comes to picking those companies that will withstand any further volatility, says senior investment analyst with Prime Value Asset Management, Fiona Clark.

One lesson from the global financial slump is that quality, well-run businesses with attractive earnings outlooks and strong balance sheets can still be sold heavily, some even more so than their less attractive peers, due to profit-taking and blanket selling, she says.

"The key difference, however, was that these high-quality companies bounced back much more quickly when conditions improved and outperformed over the whole cycle," says Clark.

Companies considered by several market analysts to be among the safer options include those that produce goods and services, which will continue to be in demand irrespective of the broader economic conditions, and ones well placed within their industry, have got good industry structure and quality management teams that are delivering in an uncertain and slowing economic environment.

Head of the Australian equities team at Fidelity, Paul Taylor, says markets remain nervous, sceptical, cautious and scared, and for very good reasons.

"We have a European sovereign debt crisis, a huge US debt issue, worrying US economic growth, slowing global growth and concerns that China may rein in growth too hard and go straight past the soft landing scenario and head direct to a hard landing.

"Further depressing the market is the thought that the sovereign debt issues in Europe and the US are likely to be with us for a prolonged period. Major readjustments like these take a long time to play out," Taylor says.

Notwithstanding the challenging economic outlook, there are still good investment opportunities in this lower growth world, he says.

"If you look at the whole market you see different pockets of growth and investment opportunities," Taylor says.

Much of his optimism comes from being in a vastly different environment to that of the original global financial crisis, which was all about debt on corporate balance sheets.

"Through the GFC, companies repaired their balance sheets and took their dividends back to much more sustainable levels. We're coming in to this slowdown in a much better position," Taylor says.

"Corporates are now in a much stronger position and have spent a lot of the time strengthening their balance sheets.

There are some companies which will always be able to steer the right course, no matter how choppy the waters. Photo: MICHELE MOSSOP

> **There are some ways we can reduce risk and provide some comfort during turbulent times.**
> Fiona Clark, Prime Value Asset Management

"Many Australian corporates have fantastic balance sheets. They raised the capital and they're still quite profitable. They're in really good shape."

Insofar as it is possible to have a safe bet at any time, analysts' picks for some of the more defensive companies include the following:

Campbell Brothers

A global laboratory and minerals testing business, Campbell Brothers provides exposure to the booming resources sector but with reduced exposure to commodity prices, says Fiona Clark.

"There are some ways we can reduce risk and provide some comfort during turbulent times. One of these is to invest in companies with indirect exposure to a particular risk factor.

"We quite like the resources sector and many of the larger resources companies," she says. "However, by investing in companies that service the resources sector, our exposure to commodity prices is reduced.

"Most large resource projects have long lead times so the earnings of the service companies, like Campbell Brothers, are much more stable."

Clark says the buoyant outlook for commodity prices should typically drive increased exploration for Campbell Brothers but management is aware of the cyclical risk of mineral dependency.

For this reason they are focused on continued diversification across sectors and geographies, especially environmental testing and industrial testing. They are also expanding their food-testing capabilities.

A client adviser and strategist with Austock Securities, Michael Heffernan, says Campbell Brothers' return on equity of about 16 per cent demonstrates the company's success in picking a string of acquisitions and investments that make money.

"The company has low debt and good profit growth and we expect it to just keep on keeping on," he says.

Coca-Cola Amatil

Coca-Cola Amatil's demonstrated

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High-quality defensive stocks

Safe

Selected defensive stocks and key metrics

Coca-Cola Amatil

Return on assets (%)	12.6	Div franking (%)	100
Return on equity (%)	36.3	P/E f'cast (x)	16.1
P/E (x)	16.9	EPS growth f'cast (%)	6.9
Dividend yield (%)	4.3	Div yield f'cast (%)	4.5

Campbell Brothers

Return on assets (%)	15.9	Div franking (%)	50
Return on equity (%)	22.5	P/E f'cast (x)	16.6
P/E (x)	22.6	EPS growth f'cast (%)	36.2
Dividend yield (%)	3.1	Div yield f'cast (%)	3.8

Domino's Pizza Enterprises

Return on assets (%)	18.5	Div franking (%)	100
Return on equity (%)	28.3	P/E f'cast (x)	18.1
P/E (x)	21.2	EPS growth f'cast (%)	16.8
Dividend yield (%)	3.4	Div yield f'cast (%)	4.0

Telstra Corp

Return on assets (%)	12.0	Div franking (%)	100
Return on equity (%)	37.1	P/E f'cast (x)	11.0
P/E (x)	12.0	EPS growth f'cast (%)	8.9
Dividend yield (%)	9.0	Div yield f'cast (%)	9.0

Woolworths

Return on assets (%)	16.4	Div franking (%)	100
Return on equity (%)	44.2	P/E f'cast (x)	15.3
P/E (x)	15.8	EPS growth f'cast (%)	7.6
Dividend yield (%)	4.4	Div yield f'cast (%)	4.6

1. Woolworths will announce their results on Thursday 2. Campbell Brothers has Mar-Sep reporting period SOURCE: BLOOMBERG

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ability to generate earnings growth in good and bad economic conditions, reflects the relatively inelastic demand for its products, says Benny Sada, a research analyst with *Australian Stock Report.*

For the past five years, the well-known brand has delivered consistent year-on-year earnings per share growth, and maintained a dividend payout ratio of more than 70 per cent.

Sada says Coca-Cola's growing presence in Indonesia through a significant capital expenditure commitment over the next three years puts the company in a great position to leverage off the country's economic growth and gives it the added benefit of earnings diversification.

"Coca-Cola's dominant market share and strong branding power provides it with the flexibility to raise prices in response to rising input costs, and not suffer a massive drop-off in demand," he says. "Even in a scenario where consumer demand continues to remain stagnant, we feel the efficiency gains from Coca-Cola's project zero initiative will allow it to protect profit margins."

Project zero is Coca-Cola Amatil's major infrastructure and supply chain upgrade program.

Solid growth aspirations in terms of new products and an even greater foothold in non-alcoholic beverages globally should continue to see the company increase its already defensive earnings, says the chief executive of stock researcher Lincoln Indicators, Elio D'Amato.

The head of private wealth management at Wilson HTM, Andrew Coppin, expects there to be some benefits to Coca-Cola if SABMiller's hostile bid for Foster's goes ahead.

The disbanding of a number of joint-venture agreements with Foster's will give Coca-Cola freer rein where it has previously been controlled, allowing it to continue on its current expansion plans, Coppin says.

Domino's Pizza Enterprises

A low-cost dining option such as that offered by growing pizza chain Domino's Pizza Enterprises puts the company in the defensive and growth categories, says Lincoln's D'Amato.

"If the economy does start to slow we don't believe the underlying demand for pizza is going to change," he says.

"People will continue to consume what is essentially a low-cost dining option.

"The company also has strong expansion plans across the world, including Europe."

Austock's Heffernan says Domino's meets all the criteria for a good business, including low debt.

"It is a good cash-flow business that is being run properly," he says.

"While the anecdotal evidence seems to be that fast food is not shooting the lights out, there is no reason to believe Domino's won't continue to do well."

Deutsche Bank research analyst Raymond Gonzalez expects Australia and New Zealand to be the key driver of earnings growth in the medium term underpinned by more stores and more revenue per store driven by broader menus and online ordering.

Deutsche anticipates there will be 588 stores in Australia and New Zealand by 2013.

In contrast to most retail business models, Deutsche Bank views the internet as an opportunity for Domino's Pizza Enterprises to expand earnins through increased basket size, special offers and potentially lowering advertising costs.

The analysts say scale would also give the company an advantage over small independents through the ability to invest more in given online strategies. The outlook is for forward growth to reflect the past three years' 20 per cent compound annual growth rate.

Telstra

Telstra's dominant market share and confidence in its management to continue the positive momentum displayed in the recent half year puts it ahead of its rivals in the growing telco sector.

Sada says evidence that Telstra and Optus have been expanding their customer base and sales despite sagging consumer confidence is giving the telco industry favourable demand dynamics.

"This suggests consumers see mobile and broadband services and products as more of a necessity rather than a luxury," Sada says. "How many times have you heard someone say, I 'need' an iPhone."

He says the operational turnaround in Telstra was evidenced by the return to revenue growth in the second half, as well as the positive guidance for 2012.

"This, along with Telstra's strong free cash-flow generation, has boosted confidence in its ability to sustain a high-dividend yield – something we believe is yet to be fully priced into Telstra's share price," Sada says.

> **Consumers see mobile and broadband services and products as more of a necessity rather than a luxury.**
>
> Benny Sada, Australian Stock Report

"Telstra's rebounding second-half profit margin was delivered against rising mobile and broadband revenues, highlighting the success of its turnaround strategy. Telstra therefore has the firepower to continue its aggressive attempts to steal market share, thus forcing its competitors to respond at the likely cost of declining margins."

Prime Value Asset Management's Clark says Telstra is a good example of a company whose valuation has been negatively affected by external factors, which should not limit its future prospects.

Having traded under a cloud of regulatory and political uncertainty for quite some time, the announcement of the national broadband network deal has lifted some of this uncertainty, leaving management to focus on running the business.

"We do not expect exceptional earnings growth from Telstra but it provides defensive and stable earnings and a very attractive fully franked and sustainable yield," Clark says. "Most importantly, the valuation is not stretched, limiting the potential downside during a financial market storm."

Woolworths

If you take the view that regardless of what happens in the broader economy, we have to keep eating, then Woolworths is a pure play on consumer staples.

"You can't get more defensive than that," says Wilson HTM's Coppin.

Clark also likes Woolworths for its defensive nature.

"There is the classic defensive investment strategy based on which companies might do better when economic conditions are tough," she says. "For example, rather than the fancy restaurant, maybe we'll have 'restaurant night' at home; instead of expensive specialty store brands, maybe the supermarket brands will suffice."

Woolworths, with its history of providing strong returns on equity for shareholders and outperforming in difficult market conditions, is the best example in this category, says Clark.

She says it is hard to go past the quality management, which has delivered on its earnings promises, and has a simple and logical business model, a strong balance sheet and decent yield.

"Woolworths may not provide a 'wow' growth factor but should certainly help investors sleep more easily at night in turbulent times," says Clark.

Prescott Securities' Darren Wright says Woolworths' diversification into the sale of petrol and alcohol means it offers products that will always be in demand.

"Woolworths is a very efficiently run business with a less diversified portfolio and lower operating costs than its major competitors," he says.

Coppin says the biggest risk to the company is the expansion plan into the hardware market. The supermarket giant has teamed with Lowe's, a US leader in hardware retail, and is seeking to open 150 warehouse stores over five years, starting late next year.