

PORTFOLIO

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Hidden jewels waiting to be uncovered

Some stocks that are still underappreciated by the market actually have plenty of upside, writes **Brendon Lau**.

An upbeat reporting season has reinforced the belief that earnings have troughed, sparking a 8 per cent rally in the small companies index since early February. It has also shed some light on where bargains might be lurking.

Such catches at the junior end of the market are becoming increasingly hard to find as our rigid continuous disclosure regime means that both good and bad news is quickly reflected in stock prices.

Despite this, there are a number of precious finds that are still underappreciated by the market. These gems have been easily overlooked under the deluge of companies that have published financial accounts in the past few weeks.

This week, experts nominate eight smaller companies that, they argue, are positioned to grow materially in the coming years.



Hastie Group

Shares in the building products and services firm Hastie Group have lagged the market since February, with a loss of 7 per cent while the S&P/ASX Small Ordinaries Index advanced 4 per cent. Sentiment towards the group had been dented when it posted a half-year result that was below market expectations with revenue of \$808.7 million and earnings before interest and tax of \$39.7 million. Consensus estimates were forecasting sales of \$870 million and earnings before interest and tax of \$44.4 million.

The head of small caps for Credit Suisse, Neil Watson, thinks investors are missing the point and that Hastie's interim results were solid considering the challenging operating environment. Further, the group generally held its margins over the same period last year.

"It's trading on 7.3 times consensus earnings for 2010-11 with

a reasonable balance sheet and a management view that 2010-11 will be a better year [than the current one] given a bottoming of their macro-environment and forward order book visibility into 2010-11," he says.

Credit Suisse believes signs of an expected recovery will be evident in the group's second-half result and that its solid operating cash flow, a better than expected dividend and expected contract wins over the next two financial years will spark a re-rating of the stock.

The broker is urging investors to buy the stock, as it sees more than 40 per cent upside in the share price, with a target of \$2.40 and estimated yield of more than 5 per cent.

Bull point: Brokers are expecting a strong rebound in earnings in the next financial year. Provides essential building services that should protect it from economic volatility.

These gems have been easily overlooked under the deluge of companies that have published financial accounts in the past few weeks.

Bear point: Overseas operations in the UK and Middle East are dragging on sentiment. Outlook for multi-storey developments globally is fragile. Investors may want to see more concrete proof of an earnings recovery before buying in.

STW Communications

This advertising and communications group is another stock underappreciated by the market, in Watson's opinion.

While STW Communications' revenue fell 9 per cent for the year ended December 2009 to \$275.9 million and its underlying net profit declined 15.4 per cent to \$33.1 million, Watson believes the stock is one of the best ways to gain exposure to the expected upturn in the advertising market as there are lower structural risks in the group than traditional media companies.

"The stock trades at an estimated

7.7 times price-earnings for 2010 compared to around 20 times for the domestic media sector, excluding News Corporation," he says.

Another positive from the group's result is the increase in its free cash flow of \$66.7 million, a sharp improvement to the \$19.4 million reported in the previous financial year, and its relatively steady earnings before interest, tax, depreciation and amortisation (EBITDA) margin of 27.5 per cent, which benefited from strong cost controls implemented early in the downturn.

So why is the stock lagging so far behind its sector peers?

"STW essentially operates as a holding company, thus the accounting is more complex than many peers and thus the market may apply some discount," argues Watson. "However, we argue this and any small company discount

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Small holdings a target when spring cleaning

Sally Patten

With the reporting season at an end and the global financial crisis fading into the background — at least as far as Australia is concerned — it is a perfect time for a little portfolio spring cleaning.

One target of any clean-up should be small holdings, which can emerge because the share price has collapsed, or through a takeover or demerger. Rather annoyingly, often investors never bought the shares in the first place.

Cast your mind back to the break-up of Alinta in 2007. Shareholders in the Perth-based utility ended up owning shares in Babcock & Brown Infrastructure, B&B Power and B&B Wind as they carved up the group between them.

Owning small parcels of shares can both add to administrative costs and hurt the performance of

the overall investment portfolio, warn the experts.

Investing is about conviction, says Evans & Partners head of wealth management Andrew Moir.

"If you have got lots of small parcels you don't have any conviction about making money," says Moir.

"You are effectively wasting money and you have always got to be vigilant about the return on your capital," he adds, noting that even if a stock in which an investor has a small shareholding doubles or triples, the overall impact on the portfolio will be negligible.

Furthermore, holding lots of small parcels translates into higher administration and accounting costs, although the extent is difficult to quantify.

"You have got to track more things," says Moir. "And your accountant won't be charging as



Andrew Moir says investing is about conviction.

Photo: JAMES DAVIES

much if you have more consolidated holdings."

Moir recommends investors sell shares where the holding represents below about 3 or 4 per cent of the entire share portfolio. The exception might be extremely high risk stocks

where the investor is taking a punt.

"If you have got 20 to 25 stocks, that is enough diversification," says Moir.

Morgan Stanley Smith Barney financial adviser Jeanette Brookes advises clients to sell companies

where they account for less than 5 per cent of a portfolio.

"Otherwise it is too many stocks. You need to consider if it is worth the time on paperwork," she says.

Brookes says that ideally investors should clear out their portfolios once a year, but argues that after a market crash is a particularly good time to embark on the exercise.

This is because some stocks that get hammered by the market during a crash may never recover. It can be much better psychologically to sell and start afresh.

The earnings season is another good catalyst to revisit portfolios.

As Moir argues: "You have got a clear view of what the results were and the outlook for companies."

Brookes says the extra cash could be used to top up existing holdings, particularly when companies launch special offers, or participate in capital raisings.

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From previous page is overdone." Credit Suisse has an outperform rating on the stock with a target price of \$1.18 a share and a forecast yield of about 5 per cent.

Bull points: Well positioned to benefit from upturn in advertising market. Has sizable market presence and is diversified across the communications industry.

Bear points: Particularly sensitive to a double dip in the economy. Complicated holding company status may not appeal to many investors.

Servcorp

Servcorp was punished by the market after it posted a 92 per cent plunge in half-year net profit to \$1.6 million on the back of a 29 per cent fall in revenue to \$84 million.

However, supporters argue that investors who are worried about its interim numbers are missing the point as the virtual and serviced office provider's earnings are expected to rebound strongly in 2010-11.

"Servcorp is investing heavily in expanding its network of serviced offices, in particular the new virtual office concept. The stock sold off on a misguided reading of the results — higher investment made the headline results appear worse," says Macquarie Funds Management portfolio manager Neil Carter.

"But, so far at least, everything is going to plan and management is accelerating its roll-out. There is risk in the expansion strategy, but with half the market cap in cash on the balance sheet we see the downside as limited.

"If you want leverage to recovery, this stock must be considered."

UBS is also bullish on Servcorp and is encouraging investors to buy the stock with a 12-month price target of \$5 a share.

Although Servcorp is trading on a price-to-earnings ratio of almost 30 times consensus earnings for 2009-10, UBS estimates this will fall to about 14 times and just 6 times over the following two years, as it reaps the benefit from its aggressive expansion strategy.

Bull Point: Strong earnings growth expected over the next few years. Very strongly leveraged to global economic recovery. Virtual office business growing robustly.

Bear Point: Shocking interim result hurting sentiment. High P/E for 2009-10 due to expected weak full-year result could keep investors at bay. All aggressive expansion strategies carry a fair amount of risk.

CSG

Another stock that appears to have been overlooked by the market is information technology and office supply and services firm CSG.

The company produced a highly credible first-half result by lifting sales 30 per cent to \$111.9 million and increasing net profit 11 per cent to \$12.3 million.

Macquarie believes the second half of the financial year will be even stronger due to the maiden contribution from the Konica Minolta Business Solutions acquisition, which is 15 per cent earnings per share accretive on a full-year basis.

"CSG is one of the larger IT stocks but it hasn't been well researched in the past, so the market has tended to overlook it," says Carter.

"The results were good and there is upside potential in both the IT services and photocopier businesses. At eight times P/E for 2010-11, we think this is very attractive," he adds.

The stock trades at a 21 per cent

Treasure trove

	P/E based on full-year earnings (x)	Estimated 12-month forward yield (%)	Estimated 12-month EPS growth 2009-2010 (% YoY)
Nick Scali	12.5	6.4	132.1
Codan	8.9	6.7	91.1
MyState	9.3	7.5	43.3
Webjet	17.3	4.5	37.4
CSG	11.7	2.9	12.7
STW Comms	8.2	4.8	-5.7
Hastie Group	7.9	6.3	-38.0
Servcorp	28.4	3.0	-95.0



Photo: PETER BRAIG
SOURCE: BLOOMBERG, BELL POTTER SECURITIES

discount to its peers on a P/E basis despite its strong growth profile over the next few years.

Macquarie is forecasting a 38.5 per cent and 25.8 per cent uplift in revenue for 2010 and 2011 respectively, with earnings per share expanding by well over 20 per cent annually over the same periods.

Macquarie has a 12-month price target of \$2.38. The stock trades on a forecast yield of about 3 per cent.

Bull Points: More good news to come as full-year result is second-half weighted. Room for profit upgrades as earnings come off cyclical lows.

Bear Points: Concentration of large important clients carries risks. Shortage of skilled workers could pressure margins through higher wages and slow organic growth.

Codan

It isn't only among the laggards that one can find undervalued stocks. Some such as Codan have rallied strongly in recent weeks but, say some people, remain at prices beneath their intrinsic value.

"It's a little business that is not particularly followed and it's done some very good strategic things in the last few years — like develop new products, taken a big part of their [manufacturing] off to Malaysia; they've made an acquisition for Minelab a couple of years ago that is performing fantastically," says Foresight Securities analyst Todd Guyot.

"You pull all those things together, the momentum is just very, very positive at the moment, and in my view that is going to continue for some time."

Codan, which makes metal detecting and niche communications equipment for the security and military markets, turned in a record first-half result last month, net profit more than doubling to \$13.6 million and sales jumping 25.7 per cent to \$89.4 million.

Guyot believes that Codan is in its

best shape ever and estimates the stock is trading on an undemanding P/E of about eight times 2010-11 earnings.

Foresight Securities has a buy recommendation on the stock but doesn't publish a price target.

Bull Points: Resilient to economic downturns. Growing focus on security bodes well for demand. High gold price driving sales of metal detectors from prospectors.

Bear Points: Sensitive to exchange-rate volatility as US and Europe make up large proportion of sales. Hitting capacity constraints as it is struggling to keep up with demand. Gearing is relatively high.

MyState

Shares in the Tasmanian-based diversified financial group may be hovering close to their record high since demutualising in September last year when it released a surprisingly strong half-year result two weeks ago, but Bell Potter Securities analyst Martin Pretty still rates it as one of his best-value buys.

MyState posted its maiden interim revenue of \$71.7 million and a net profit of \$8.2 million for the six months to December 2009, and said that it was on track to realise the forecast synergies arising from the merger of MyState Financial and Tasmanian Perpetual Trustees.

The result included six months of trading from MyState but the contribution from Tasmanian Perpetual Trustees was restricted to the period following the merger.

"[The figures] were well ahead of where I expected them to be, thanks to a strong uplift in its net interest margin. On a pro-forma basis, stripping out one-off expenses, underlying net profit was \$11.3 million," says Pretty.

"But MyState is also just getting under way on its cost-cutting program, having indicated it will cut costs by up to \$4.5 million in less than three years."

Although the stock has performed

relatively well recently, the share price is still lower than Tasmanian Perpetual Trustees' October 2008 level, where the volume weighted average share price was \$3.83, compared with MyState's current share price of \$3.41.

It's taking a long time for the market to recognise the value of MyState and this may in part be due to the fact that there has been a regular drip of stock onto the market from MyState members, as each member received 387 shares under the demutualisation, notes Pretty.

Bell Potter has a buy recommendation on the stock with a price target of \$3.69 a share and an attractive forecast yield close to 13 per cent based on 2010-11 forecasts.

Bull Points: Merged business performing ahead of expectations. Stock is cheap compared with historical performance. Further synergies to be gained from merger.

Bear Points: Worries about access to capital for smaller financial institutions likely to keep such stocks out of favour. Strong price rally could encourage short-term profit taking from members of MyState pre-demutualisation.

Webjet

Webjet shares may have more than doubled over the past 12 months as the online flight booking site operator has managed to grow its business through the economic crisis, but Webjet is still a long way behind its peers.

Based on Bell Potter Research's estimates, the stock is trading at 14 times forecast earnings for 2009-10, against 28 times for rival Wotif.com, 29 times for Carsales.com, and even traditional bricks and mortar travel agent Flight Centre is trading on 16 times full-year earnings.

"If you adjust Webjet's market capitalisation to remove the \$32 million cash it had at last balance, which is around 17 per cent

of the current market cap, then it is clear that the market is not fully recognising its earnings and consistent growth," says Pretty, who holds the stock.

Webjet's lower valuation has sparked speculation it could end up being a takeover target as the deal could be strongly EPS accretive to a suitor on a higher multiple if it puts forward an all-scrip or part-scrip and part-cash offer.

Pretty thinks that obvious buyers may include international players like Expedia or Travelport/Orbitz.

Webjet delivered a strong first-half result that highlighted its operating leverage, with revenues up 32 per cent to \$18.4 million and net profit jumping 40.4 per cent to \$5.2 million.

Bell Potter has a buy on the stock with a 12-month price target of \$2.98 and a forecast grossed-up yield of around 8 per cent for 2010-11.

Bull Points: Cheap compared with other online businesses. Could be a takeover target. Strong branding and market position will make it hard to unseat.

Bear Points: Travel industry is susceptible to many variables — such as interest rates, currency movements and employment.

Nick Scali

The furniture retailer has rallied close to a two-year high after its half-year result rebounded strongly from the same time last year.

However, Wilson HTM Priority Growth Fund fund manager Sandy Grant believes there is more upside to the stock as it is trading at a significant P/E discount to the S&P/ASX Small Ordinaries Index and is yielding an attractive return on equity.

Nick Scali reported a 146 per cent surge in net profit to \$6.3 million for the six months to the end of December 2009 while sales grew at a robust 22 per cent to \$48.7 million.

While the earnings turnaround compares with a particularly poor comparative period, the underlying performance is strong, notes Grant.

"[Sales were] driven by same store sales growth of 14.4 per cent, plus additional contributions from one new store in the first half of 2009-10 and three new stores in 2008-09. Our forecasts assume three new stores during the current financial year and three new stores in 2010-11," he says.

"Balance sheet strength remains in place with first-half 2009-10 net cash of \$16.6 million, compared with \$11.5 million last year, and a zero debt position. Operating costs also remain well controlled."

Based on Wilson HTM's forecast, the stock is trading on an undemanding P/E of about 12 times for 2010-11 — a 25 per cent discount to the small-cap index. EPS is forecast to grow a further 7.8 per cent in the following year, which would lower its P/E to about 11.

The company says that the second half started well with strong comparable store sales growth in January, but warns that sales recovery is fragile with customers sensitive to rising interest rates and volatility in the economy.

Nonetheless, Wilson HTM believes the stock is a worthy buy and sees share price upside of between \$1.80 and \$2.00 a share with a fully franked forecast yield of around 6 per cent for 2010-11.

Bull Points: Strong results bolstering confidence in management. Leveraged to favourable outlook for residential housing market. Virtually debt free.

Bear Points: Customers sensitive to interest rate rises. Economic volatility likely to impact sales of large discretionary items.