



Ten Internet and IT Stocks To Watch

By Mark Story | 03.04.2011

It has been a long road since Y2K and the Dot Com boom and bust, but the IT and internet sector is starting to gain traction again with a number of companies reporting solid profits and dividends. Expecting to benefit from a notable uplift in information technology (IT) spending by state and federal governments, plus IT modernisation initiatives by the larger banks – with CBA alone committing over \$1 billion to core-banking upgrades - the outlook for listed IT services companies is better than it has been for many years. IT services may only account for less than 1 per cent of the market's total capitalisation, but some solid performing stocks are starting to put the sector back on the radar after many years in the doldrums. Based on projections by Paterson Securities, the IT services sector is expected to pay a very respectable average gross dividend yield of around 7 per cent in 2011. And with most stocks in the sector looking relatively cheap, investors could be rewarded for taking early positions with the hope of making gains over the long haul. Daniel Rolley Investment Analyst with Atom Funds Management says the bulk of the recovery may not hit until full year 2012 as IT spending lifts in the second half of 2011. He says timing an entry into the sector before the pending pipeline of growth is factored into prices could make for a prudent move.

Even though they've run hard over the last five years, the upside for Internet stocks is looking equally favourable. Having created near monopolies, Rob Hopkins managing director of Smallco Investment Manager says the best days for most Internet stocks are arguably ahead of them due to the systemic gravitation from print to online mediums. These stocks have successfully taken consumer eyeballs off newspapers, and Hopkins expects a quantum upside for the sector once advertisers follow in similar measure.

Once consumers' eyeballs are firmly committed to these channels as a preferred method of delivery, he says it becomes a very attractive proposition for advertisers. "Sticky revenue and a loyal client-base makes for 'virtuous circle' for the number one or number two players, making it harder for industry newcomers to successfully compete," says Hopkins. "These Internet companies also deliver high returns relative to the funds deployed."

Ben Kakoschke

Analyst

Paterson Securities

1) **SMS Management and Technology (SMX)**

Chart: Share price over the year to 01/04/2011 versus ASX200 (XJO)

Specialising in improving operational performance and IT delivery, SMX's expertise spans the financial services, ICT, government, defence, health, utilities, mining, gaming and infrastructure sectors – with the top 10 clients generating around 50 percent of revenue.

Kakoschke says SMX is well positioned to benefit from continuing strong demand from banks and resources, increasing federal government revenue, and any improvement in ICT demand. The company

reported a 14.7 percent increase in first half net profit, and declared a fully franked interim dividend of 13.5 cps - up 8 per cent on the previous period. Trading on a P/E of 12.9, Patersons is projecting EPS growth of 18.4 percent and dividend growth of 14.5 percent, gross dividend is 7.6 percent. 2) **UXC Ltd (UXC)**

Chart: Share price over the year to 01/04/2011 versus ASX200 (XJO)

The technology services group indicated that its new strategy is to retain the Business Solutions division and decouple it from the Field Services business. Kakoschke believes this change from the previous reviews wider range of possible outcomes (including divesting Business Solutions) demonstrates that UXC sees clear value in growing and turning around the Business Solutions division. Trades on a 16 percent discount to Kakoschke's 71c target, yield 6.4 percent.

3) **TZ Limited (TZL)**

Chart: Share price over the year to 01/04/2011 versus ASX200 (XJO)

Is a leader in the development of intelligent fastening and assembly enabling technology. Through its US operating subsidiary, TZL licenses its IP and offers application design and engineering services. It provides a full service capability in product development and engineering services through PDT Group. A speculative buy, trading at a 182 percent discount to Kakoschke's target price of 79c.

Rob Hopkins

Managing director

Smallco Investment Manager

1) **Oakton Ltd (OKN)**

Chart: Share price over the year to 01/04/2011 versus ASX200 (XJO)

Provides business-focused IT solutions, plus business consulting, financial management and assurance services to large Australian corporations. Much of the Hopkins favourable outlook is based on a turnaround within its troubled Victorian operation as the new state government resumes post-election spending. This is expected to boost utilisation rates above the current 73 percent level. Continued margin improvement is also expected from outsourcing up to 40 percent of its 'man hours' from India at a third to a fifth of the corresponding costs incurred locally. ROE 20.9 percent, Projected EPS growth 8.7 percent, dividend yield 5.7 percent.

2) **REA Group (REA)**

Chart: Share price over the year to 01/04/2011 versus ASX200 (XJO)

Encouraging within the online real estate advertising group's 35 percent EPS growth at half year were revelations that losses within its Italy-base operation had finally staunch. The company is actively seeking new acquisitions and has been eyeballing French real estate site SeLogger.com. ROE 37.6 percent and dividend yield 1.6 percent.

3) **Carsales.com Ltd (CRZ)**

Chart: Share price over the year to 01/04/2011 versus ASX200 (XJO)

A significant uplift in its display division shows that CRZ is having considerable success moving advertisers from newspapers to online. Trading at 21 percent discount to Hopkins 12 month target of \$6, CRZ posted an impressive first half result with EPS 46 percent above market expectations. ROE 48.6 percent, dividend yield 3.1 percent.

4) **Seek (SEK)**

Chart: Share price over the year to 01/04/2011 versus ASX200 (XJO)

Around 80 percent of job ad volume is now via the Internet and job seekers seem to prefer the on-line space. But with its share of spend still only around 50 percent, Hopkins says the opportunity for future upside is enormous. While international business accounts for only 15 percent of SEK's net profit, he says the longterm

opportunity for it to eclipse the size of its domestic market shouldn't be underestimated. As well as holding the number two job sites in China, SEK has the top two sites in both Brazil and Indonesia. Forecast earnings growth 27.6 percent, dividend yield 2.6 percent, and ROE 28.9 percent. **Nick Harris**

Senior Analyst
RBS Morgans Limited

1) ASG Group (ASZ)

Chart: Share price over the year to 01/04/2011 versus ASX200 (XJO)

Is a managed IT services provider focused primarily on providing managed services with contracts typically ranging from two to five years. State and federal government clients contribute over 60 percent of revenue and provide a high level of earnings stability. Improved working capital and a solid demand pipeline are expected to see the IT outsourcer deliver stronger cash flow numbers at full year 2011. While ASZ delivered a first half 2011 result in line with expectations, what did surprise was a higher than expected dividend. Given that abnormally high acquisition integration costs during the first half won't be repeated, Harris expects a strong second half performance. The stock is trading at a 29 percent discount to Harris's \$1.35 target price - which assumes ASZ will win a modest portion of its contract pipeline, and that growth in project work is accelerated following recent acquisitions. P/E 12.1, ROE 17.9 and dividend yield 5.9.

2) Macquarie Telecom (MAQ)

Chart: Share price over the year to 01/04/2011 versus ASX200 (XJO)

A full-service telco which provides 2,000-plus Australian 'businessonly' clients with all their telco needs, MAQ is repositioning its business to be 'hosting-focussed', and has added additional costs to the business - while re-allocating existing costs across business units. EBITDA during first half 2011 was up an impressive 48 percent year-on-year, while underlying net profit doubled from A\$4.8 million to A\$9.8 million and a 10c dividend was declared. The stock is trading at a 14 discount to Harris's \$13.23 target price - which is has been discounted 10 percent to reflect the lack of earnings transparency. He's forecasting full year 2011 (normalised) EPS growth of 66.90 percent, a dividend yield of 2.98 percent, and an ROIC of 124 percent. **3) NEXTDC (NXT)**

Chart: Share price over the year to 01/04/2011 versus ASX200 (XJO)

Is a start-up 'vendor neutral' data-centre (DC) which listed on the ASX late last year. Harris expects the recent hiring of sales resources across Brisbane, Sydney and Melbourne to lead to customer wins in the foreseeable future. He also expects recently hired experienced DC sales staff to be an important catalyst for the stock - leading to increased investor confidence and proof of market demand. The stock is trading on a 20 percent discount to Harris's \$1.94 target - which is based on the Brisbane facility being operational in June, followed by Melbourne in November, and then the Sydney facility becoming operational early in 2012.

END