

Big returns come from small caps

John Collett asks the experts for their top investment tips among our smaller companies.

Taking the lead ... (from left) Sally Macdonald of Oroton; Chris Kelaheer of IOOF. Photos: John Reid, Louise Kennerley.

The accounts of our biggest listed companies are pored over endlessly by an army of analysts, which makes it unlikely that investors are going to come across hidden value among these giants.

Smaller medium-sized companies, on the other hand, are usually less visible so they provide potential to uncover hidden value and big capital gains. For investors who are patient and prepared to invest over the long term, smaller companies can add some zing to share portfolios.

Money asked leading small-cap fund managers and analysts for their tips from among those market minnows with well-established track records and a history of paying reliable dividends. Like any sharemarket investments, there are always risks. And smaller companies come with more risks than large companies. Their earnings tend to be the most responsive to economic conditions – both good and bad.

Shares should never be held in isolation but in a diversified portfolio. Many investors may find a better way to get exposure to smaller companies is to invest with a specialist smaller companies fund manager. Professional fund managers run portfolios holding dozens of smaller companies, providing small investors with instant diversification.

The stocks nominated by fund managers and analysts cover the spectrum of the Australian economy – retailers, financial services, technology – but there are no resources stocks. Smaller resources stocks may be terrific investments but are too speculative for novice investors.

TURNAROUND STORY

The managing director of Perennial Value Management, John Murray, nominates OrotonGroup, which designs and makes luxury handbags, leather goods and accessories. Murray is a fan of the managing director, Sally Macdonald, who since her appointment in 2006 has turned the struggling retailer around.

The company has expanded product lines and refocused on key brands including Polo Ralph Lauren and Oroton. Murray still has the Oroton briefcase he bought in 1991 and says the brand is “classic value fashion” – quality fashion that is not too expensive.

“We are believers in Oroton and growth will be driven by new stores and product lines like lingerie and menswear,” Murray says. Perennial first bought Oroton shares for \$3 each in 2007. The shares are now trading at about \$7. As a luxury fashion retailer, the company’s sales are vulnerable to downturns in the economy. A little over a year ago, towards the tail-end of the GFC, Oroton shares dipped to \$2.80 and in the year since, Oroton’s share price has increased 250 per cent.

Before it will invest, Perennial has to be convinced of the strength of a company’s balance sheet. And Oroton has good financial strength with low debt, Murray says. On a share price-to-earnings multiple of 11 times, Oroton shares are not cheap but they are still reasonable value, he says.

PIPING HOT

Reece Australia, a plumbing supplier, has many of the attributes the small companies fund manager and chief investment officer of Celeste Funds Management, Frank Villante, likes to see. House prices are rising and spending on renovation is healthy, which means Reece is “fantastically positioned” to take advantage of the trend.

Reece is a conservatively managed company, owned by the same family since the 1930s, and family interests own about 70 per cent of Reece shares. Australian corporate history is littered with examples of majority owners treating minority shareholders shabbily. However Villante says the Reece family has a long history of treating such investors well.

The company has a market capitalisation of about \$2.5 billion,

DRY



which puts it just inside top-100 companies. The company owns about \$250 million of land and buildings and Reece's management takes the view that property in the right areas can be an attractive long-term investment. Reece is No. 1 in terms of revenue, number of stores and on just about every measure Villante can find. Reece has no debt on its balance sheet; it is carrying about \$60 million in cash. Villante is expecting earnings to grow at more than 15 per cent a year between 2011 and 2014.

WEB WONDER

The co-founder of Smallco Investment Manager, Rob Hopkins, is excited about the prospects of the internet sector.

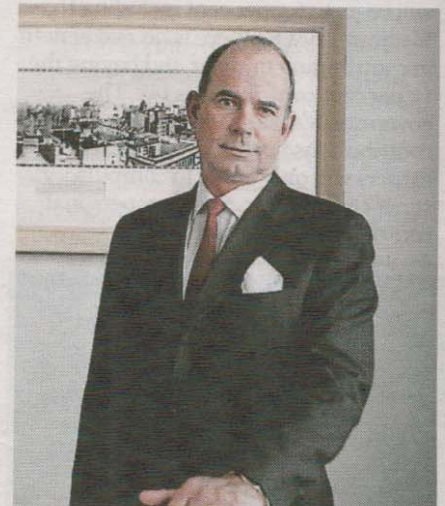
Hopkins particularly likes the well-established internet employment website, Seek, which he says has a "very impressive" management team led by the Bassat brothers who, together with Matthew Rockman, founded Seek in 1997. Rockman left the company in 2006.

Seek expanded into New Zealand and has investments in employment websites in China, Brazil and Malaysia. It owns more than 40 per cent in Zhaopin, one of China's three leading online employment sites.

Seek shares have had a big run. A



couple of years ago the stock was \$2; it is now \$8 and is on a price-to-earnings multiple of 23 times, which is expensive, Hopkins says. With a market capitalisation of \$2.8 billion, it is not a market minnow and is just inside the top-100 companies but still has plenty of growth potential. "We expect earnings-per-share growth of more than 40 per cent over the next year," Hopkins says. In internet commerce there is not much room for No. 2 and No. 3 players. "People looking for a job go to a site where they know all of the jobs are advertised,"

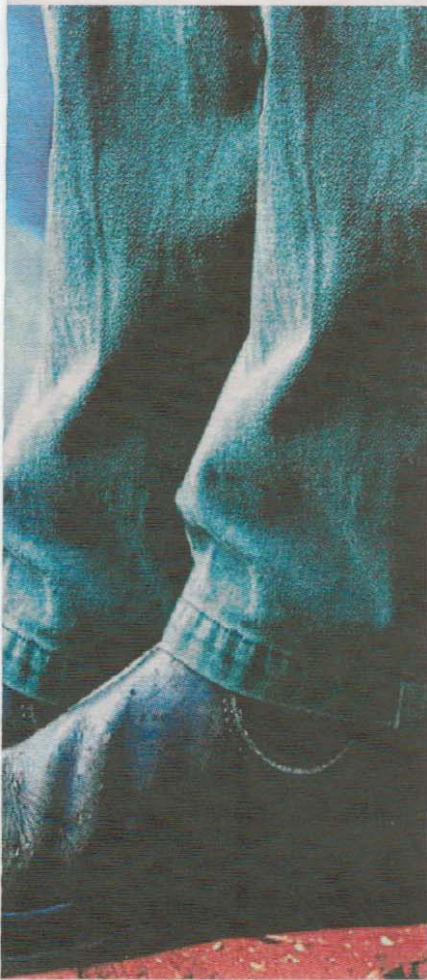


Hopkins says, adding that the internet sector has plenty of examples where the No. 1 player makes very good returns, while the No. 2 player is just profitable and the third-placed player loses money.

GRIM REAPER

Fortune favours the grave with InvoCare Limited, which provides funeral homes, burial services, cemeteries and crematoria around Australia and in Singapore. InvoCare operates two national brands, White Lady Funerals and Simplicity, and is the

COVER STORY



mid-range, which benefits the company as the mid-range is where most of the market is, Eley says.

TICKET CLIPPER

Funds management is a wonderful business because it is so scalable. Taking a percentage of funds under management – clipping the ticket, as it is known – has been the source of riches for banks and insurers.

IOOF, a funds management and investment platform administrator, is a very well-managed company, says Steve Black, a fund manager at Pengana Capital. It has a market capitalisation of about \$1.3 billion, which puts it at the larger end of the small-cap companies. It pays out about 80 per cent of its profits as dividends and is yielding about 5.5 per cent, fully franked. "It has done very well but we still see very strong upside in it," Black says. "It is a stock that has not been well understood by analysts, which is why it is starting to perform now as more analysts start to recognise that these guys are delivering really good results."

IOOF, led by managing director Chris Kelaher, is one of the big-five platform providers. These are the administration platforms used by financial planners, which provide their clients with consolidated reports on portfolio performances and taxes and enable easy switching between investments. The platform owner levies a fee that is a percentage based on the assets. IOOF has been acquiring platforms and has its own financial planning network. IOOF is considered a possible takeover target by one of the big banks or insurers.

HEALTHY PERFORMER

Blackmores, the natural health remedies company, has very high returns on equity, which analysts say is a good thing because it shows a company is making good use of shareholder funds.

Whether it's arthritis, joint, bone and muscle pain or "brain health", Blackmores, which was started in 1938 by Maurice Blackmore, has a pill for everything.

Greg Canavan, a sharemarket analyst and editor of *Sound Money*. *Sound Investments*, a weekly report on the sharemarket, says Blackmores is a "nice little smaller cap" that is tapping into a growing market for natural remedies. It has a strong business in Australia and has established a presence in Thailand and Malaysia. The company distributes its products mainly through pharmacies and supermarkets.

Canavan says \$23 a share is a little expensive and would prefer to buy at \$20. "In 10 years' time, I think Blackmores will be a lot bigger company than it is now," he says.

only funeral services provider that has a national reach.

InvoCare listed in 2003, having been built up during the 1990s under the ownership of a US funeral services operator and private equity investors that have since sold their shares in the company.

"It's amazing, what we call the death-care industry," says Brian Eley, co-founder of Eley Griffiths Group.

"The number of deaths is rising as the population increases and ages. You have that demographic trend, which is positive for the stock."

InvoCare has been a very good performer, Eley says: The stock is not "super cheap" and it never will be because people know that it's such a good business. The fragmented nature of the market presents plenty of opportunities for the company to grow through acquisitions, he says.

As people become wealthier they tend to spend more on their relatives' funerals, Eley says, and a growing part of the business is pre-paid funerals. He also says the funeral care industry has a lot of pricing power, which means the industry can increase prices by a bit more than inflation with little resistance from customers.

InvoCare has prices that are in the

SIX OF THE BEST SMALLER COMPANIES WITH BIG FUTURES

OROTONGROUP (ORL)

Designer and maker of luxury handbags, leather goods and accessories.

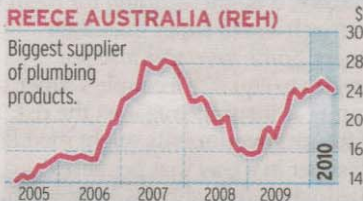


"Managing director, Sally Macdonald, has done a wonderful job turning around the business"

JOHN MURRAY, MANAGING DIRECTOR OF PERENNIAL VALUE MANAGEMENT.

REECE AUSTRALIA (REH)

Biggest supplier of plumbing products.



"Accounts are conservatively stated and management has a deep understanding of the sector"

FRANK VILLANTE, CHIEF INVESTMENT OFFICER, CELESTE FUNDS MANAGEMENT

SEEK LIMITED (SEK)

Biggest employment website



"The Bassat brothers (who run the company) are very impressive,"

ROB HOPKINS, CO-FOUNDER, SMALLCO INVESTMENT MANAGER.

INVOCARE LIMITED (IVC)

Biggest funeral director



"There are only two certainties in life - death and taxes. Investors cannot get exposure to taxes but they can get exposure to death,"

BRIAN ELEY, CO-FOUNDER, ELEY GRIFFITHS GROUP

IOOF HOLDINGS (IFL)

Investment platform and funds management business

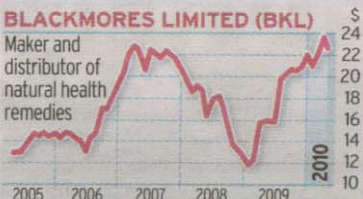


"It has proven management that is good at making acquisitions and cutting costs,"

STEVE BLACK, FUND MANAGER, PENGANA CAPITAL.

BLACKMORES LIMITED (BKL)

Maker and distributor of natural health remedies



"It is just one of those good little businesses that is in a growth market,"

GREG CANAVAN, ANALYST AND EDITOR OF SOUND MONEY - SOUND INVESTMENTS.

SOURCE: ASX