Despite M&As, small caps are the rising

Investors who focus on small companies ride a wave of new money, writes **Helena Keers**.

The number of Australian listed companies grew by 9 per cent last year to 1930, but many are now disappearing as a result of record merger and acquisition activity, and market experts recommend that investors focus on the emerging stars of the future.

Greg Cantor, chief executive of the $3 billion Catholic Superannuation & Retirement Fund, says smaller companies have attractive potential for growth. He has invested $90 million, or 3 per cent of his total fund, in Australian listed small caps, including Coates Hire.

"Small growth companies are an important part of our portfolio despite being more illiquid and volatile," he says.

This is because investors buying shares in smaller companies before they reach a certain size and make it onto the radar of predators and larger fund managers, can ride a wave of new

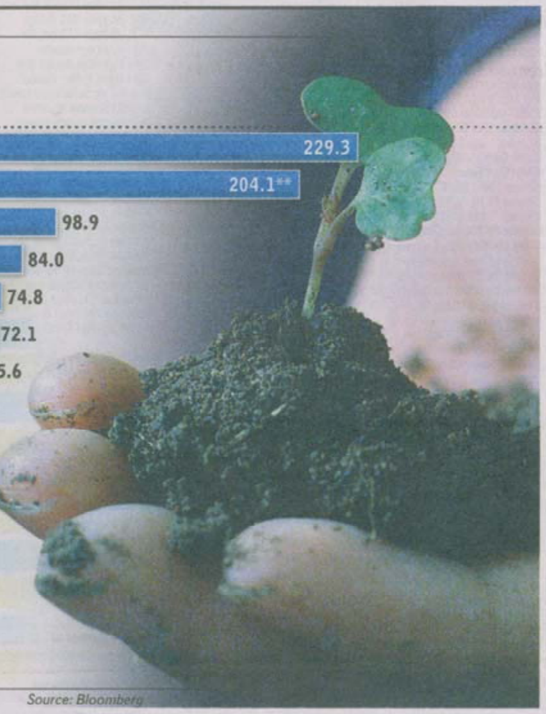
EMERGING STARS

Performance and valuations of smaller companies favoured by market professionals

Company	Market cap ($m)	P/E ratio (x)	Total return YTD (%)
Altium	72	51.3	229.3
Ausenco	250	22.9*	204.1**
SMS Management & Tech	263	21.8	98.9
Straits Resources	794	13.3	84.0
Oakton	332	22.4	74.8
Campbell Brothers	943	23.9	72.1
David Jones	1648	19.9	65.6
WorleyParsons	3712	26.6	48.7
ASG	99	18.3	28.7
Record Realty	204	2.8	22.1
Reece Australia	1686	19.5	18.5
Coates Hire	1519	14.3	18.4
Emeco	1225	15.4	1.58***
Redflex	226	49.5	-13.7
Repco	291	13.9	-34.2

* 2007 forward P/E ** Listed in June *** Listed in July

Source: Bloomberg



money to a tidy profit when M&A activity does chip in.

One option for investors is to climb on board newly floated companies. In the past two months 33 companies have listed on the stock exchange.

ASX spokesman Matthew Gibbs says there has been an increase in the number and type of listed managed investments (such as infrastructure trusts and exchange-traded funds) in the past few years.

Two recently floated companies that fund managers and analysts recommend buying include engineering company Ausenco and mining equipment company Emeco. BT Financial head of smaller companies Paul Hannan favours Ausenco.

"Ausenco has been re-rated as the next WorleyParsons after rising 205 per cent since its listing in June," he says.

The company is trading at 22.9 times 2007 earnings and closed up 5¢ on Friday to $3.06. Three months ago the stock was closer to $1.60.

Citigroup analysts prefer Emeco. The bank published a note on Wednesday with the title "What are you waiting for?" recommending investors buy shares in Emeco. Analyst Julian Mulcahy values the company at $2.32 a share and said in the note: "The rate of new investment is running well ahead of prospectus forecasts and acquisitions are likely."

He says Emeco has underperformed its peer group by 3 per cent in the past month but lack of news flow appears to be the only reason. The shares closed on Friday up 1¢ at $1.94.

Another larger mining services company that market commentators favour is WorleyParsons. Macquarie Bank small-cap portfolio manager Neil Carter says the company has been a massive success. "Even if commodity prices fall 20 to 30 per cent, resource projects will carry on and the demand for services of Worley and equipment of Emeco will continue to grow strongly," he says.

Shares in Worley fell more than 3 per cent last week to close at $18.22 on Friday.

Mining services companies tend to be more attractive to investors than resources stocks because they are less volatile. However, diversified mining stocks such as Straits Resources are also well liked.

BT Financial's Paul Hannan says: "Straits Resources has a range of products, including a salt operation, on the planning board and is a strong diversified stock."

The shares are trading at 13.3 times earnings which is a discount to the sector average and implies the shares are cheap at Friday's closing price of $4.20.

Other managers were not so keen on smaller resources stocks. Souls Fund Management's chief investment officer, Frank Villante, says: "There's a lot of conceptional and 'trust me' stocks. I find spurious resource stocks where operational cash flow is many years away. There's a fair bit of froth at the explorer end of the market."

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He prefers Reece Australia and Campbell Brothers, which have strong balance sheets. The plumbing business has no debt and owns most of its 280 stores.

"During tough times Reece has consistently increased revenue around 10 per cent and profit about 20 per cent. When the housing market starts to improve the leap in revenue and profit will be dramatic," Villante says.

Of Campbell Brothers he says: "The balance sheet has a lot of scope for further leverage to help with overseas acquisitions and it is feasible that Campbell will grow another 50 per cent in the next three years while continuing to pay steady dividends."

Reece and Campbell shares closed on Friday at $17.30 and $18.37 respectively.

Up and coming companies also include out-of-favour stocks. Analysts believe that car parts company Repco and traffic systems company Redflex have been oversold. Citigroup upgraded Repco a little over a week ago saying trading sales were improving.

The investment bank also

stars

upgraded Redflex recently to buy from sell and lifted the target price from $1.91 to $2.55 from $1.91. Mulcahy said in a recent research note: "Redflex is not a stock for the faint-hearted, and investors need to be prepared for the occasional hiccup in the US while the regulatory framework for speed cameras evolves. But with the company currently operating in only 16 states, and continuing to win the majority of new contract tenders, the long-term growth potential looks vast."

Other attractive sectors include retail, IT and property. Hannan says: "David Jones will be a clear recipient of money being invested back into retail. It's become an aspirational store."

Shares in David Jones have returned 65.6 per cent in the year to date and closed at $3.71 on Friday.

Hannan also says Metcash looks cheap.

Meanwhile, Carter rates small but growing IT stocks Oakton, SMS Management & Technology and ASG Group. He says a large Indian company called TGS is looking to make acquisitions in Australia, which could make them takeover targets. He prefers them irrespective of takeover talk.

"There is a global IT boom going on and very small local operations have been amalgamating," he says.

Record Realty and Altium are the top picks of Smallco Investment Managers' managing director Rob Hopkins. He says the property trust is misunderstood by the market because the values of its properties are geared up to 85 per cent.

"You need to be confident of a management team with that level of debt," he says.

Record trades on a yield of more than 10 per cent. Hopkins believes this yield will come down to 8 per cent as the share price rises to $1.50. It closed at 95¢ on Friday.

Of Altium, which has delivered a 229 per cent total return in the year to date, he says: "It has no debt and has always enjoyed positive cash flows." Shares hit $5 during the tech boom but fell below 20¢ in 2001. They closed at 82¢ on Friday.