

# Now's a good time to bullet-proof your smalls

Looking for value? Go for companies most likely to display resilience in a turbulent economy, writes **Gabriella Hold**.

One of the key issues for equity investors is how much the latest shake-out from the credit crunch will affect the real economy. And for those investors in small caps it's especially important, given junior names tend to be more leveraged to domestic economic conditions and are already suffering under the weight of higher input costs and margin pressures. But on the surface, the effects and implications for the smalls are exactly the same as for their larger cousins. Share prices across the board have tumbled and tighter conditions in credit markets mean a focus on companies with clean balance sheets is all the more important, whatever their size.

Souls Funds Management chief operating officer Frank Villante says recent events have highlighted that investors are less and less prepared to look through high gearing levels and complex structures.

"It's further articulation of the message of the last few months. Convoluted operating structures, poor profit and loss statements, lack of transparency in accounting, business models that don't hang together are problems," he says.

Opis Capital portfolio manager Robert Frost says with the tightness in credit markets, both big and small companies that require capital to grow their businesses are going to struggle.

"In terms of the smalls, it means that [companies] that are acquisition-driven, that are reliant on additional wholesale funding or anything involved in asset securitisation [is something] you are probably better off avoiding," Frost says.



Souls Funds Management's Frank Villante likes clear accounts.

Photo: ROB HOMER

Many fund managers are also more cautious on the earnings outlook given recent events. "The combination of weakness in parts of the domestic economy and a general lack of earnings guidance means there is a good chance that the high level of earnings downgrades we saw during the June half resumes again when annual general meeting season kicks off next month," Smalco senior fund manager Andrew Hokin says. "Sectors most at risk of downgrades include building materials, media and retailers. Recent weakness in commodity prices could also put at risk very strong earnings growth expectations across the small resources space in fiscal 2009."

For Eley Griffiths portfolio manager Brian Eley, a lot of companies deferring their outlooks to AGM season and the possibility of further downgrades means one of

his preconditions for a recovery in the smalls has not been met.

His preconditions for a general market – including small companies – rally are: interest rate cuts, a drop in the oil price, an end to earnings downgrades and stability in overseas markets.

While the first two are in place, there's only a "half tick" on the third, and he's "still not satisfied" on the fourth.

Amid these conditions most managers believe that finding a true safe haven is challenging.

Opis's Frost is focusing on companies that generate strong free cash flows, that are self-funding and have strong balance sheets. But even then, he points out, the slowing economy is still a threat. "There's not many places to hide and some of those self-funding models are still going to be under pressure due to the domestic environment."

His key picks include mining services group **Ausenco**, contract crushing group **Mineral Resources** and salary packaging and novated lease firm **McMillan Shakespeare**. Their strong balance sheets and cash flows should mean they fare better than most. He adds that investors can also tap into "old faithfuls" such as **InvoCare**.

The funeral services group is broadly seen as defensive as it is leveraged to the death rate.

"But... people go to find the safe havens when these things happen and they can be priced accordingly," Frost says. "Still, when people are looking for capital preservation it is still not a bad place to hide."

InvoCare is trading on a one-year forward price-earnings ratio of about 18 times and a two-year forward price-earnings ratio of 16 times. Some analysts are neutral given these relatively full valuation levels.

ABN Amro has a "hold" rating on InvoCare, noting slowing death rates in the near-term. But it continues to view the business favourably given recent and possible future acquisitions and the long-term death rate trending upwards.

Souls's Frank Villante suggests direct marketing group **Salmat** as another pick. He likes the company because it is a fairly robust, resilient business with a good balance sheet.

He says at the end of this year Salmat will have somewhere between \$180 and \$220 million in net interest bearing debt, but its earnings before interest and tax is more than \$100 million.

"So, in two years of cash-flow generation they would have no debt," he says. "The interest coverage is fine, the debt payback is fine and the quality of cash flow is very high." Salmat is predicting an earnings jump of at least 30 per cent this year due to solid growth in the catalogue and telemarketing sectors, and the benefits of the \$350 million takeover of business process outsourcing company HPAL. The group said it was comfortable with consensus forecasts of earnings of between \$75 million and \$80 million in 2008-09. Reported net profit for fiscal 2008 fell 71 per cent to \$12.8 million, in line with the company's downgraded July guidance, due to one-off losses and \$5.8 million in restructuring costs after the HPAL takeover.

Smalco's Andrew Hokin names online accommodation provider **Wotif.com** as a preferred pick. He says its dominant position in online accommodation bookings provides the company with strong medium-term growth as more consumers book holidays over the internet.

"We expect Wotif to defy a slowdown in consumer spending and deliver earnings per share growth of around 25 per cent in fiscal 2009," Hokin says.