

The Australian

Wealth

What's hot, what's OK and what's not in small-cap sectors

- by: Richard Hemmings
- From: The Australian
- September 28, 2011 12:00AM



Picture: Bloomberg *Source: Bloomberg*

IN small capitalisation stocks, the hottest area remains the mining services sector.

Mining Services

The companies servicing the mining sector can sometimes get too hot (such as Leighton Holdings and AJ Lucas) and are susceptible to cost blowouts. But on the whole, for small companies with order books running into the billions, life doesn't get much better.

These companies' prospects were underscored by the release of data from the Australian Bureau of Statistics in September that showed Australian mineral exploration expenditure for the 12 months to June this year rose to \$2.9 billion, compared with the \$2.5bn for the 12 months to June 2008, which was before the financial crisis.

The June quarter expenditure of \$907.4 million was up more than 42 per cent on the same period the previous year and 41 per cent up on the March quarter.

These figures directly affect providers of technology for analysing mineral samples such as Campbell Brothers and XRF Scientific, but they also underline just how profitable it is for all the other companies whose businesses service explorers, says Peter Mouatt, founder of Adam Smith Asset Management.

"It's good for all sorts of companies in the mining services sector: drillers, mining contract specialists, but it was also interesting that much of the growth occurred in coal exploration," he says.

Investors are particularly bullish about the companies that benefit from growth in coal and iron ore production, and to a lesser extent in oil and gas.

It is these commodities that are considered to have strong growth prospects because their demand comes from the growing Chinese and Indian economies.

Companies servicing this boom have been moving a lot of dirt around in places such as the Pilbara and the Bowen Basin in Queensland. These include really big companies such as Leighton Holdings, which purchased Henry Walker Eltin in late 2005.

Mostly though, it is the smaller operators that mid-cap miners are using to outsource operations. These include Mastermyne, MACA, WDS, Macmahon Holdings and NRW.

It also includes plant-hire groups such as Emeco and Seven Group Holdings, which has the franchise to sell Caterpillar equipment in Western Australia, NSW and the ACT.

Now, though, much of the excitement in the sector is in the providers of labour and infrastructure to enable companies to deliver on big contracts that become due in 2015. An example of this is Chevron's \$43bn Gorgon LNG plant located on Barrow Island off the coast of West Australia.

This month Skilled Group said it is launching a national construction labour business to tap into the boom for liquefied natural gas.

More broadly, labour hire specialists will benefit if they have workforces based in Queensland where the big coal-seam gas projects are set to kick off, as well as Western Australia.

Other beneficiaries include fellow labour hire specialist Programmed Maintenance Services, as well as Global Construction Services, which provides scaffolding, and Fleetwood and Decmil, which provide accommodation.

There are dangers of cost blowouts as experienced by Leighton Holdings, but with such a boom of activity, for these companies Australia is the lucky country.

Financial services

IN the wake of the GFC, small-cap financial stocks all seemed to be going up, grabbing market share off their (much) much bigger counterparts and enjoying the resurgence of the equities markets.

Companies such as finance providers ThinkSmart, Thorn Group and Cash Converters, as well as service providers to the wealth management sector, Bravura Solutions, Treasury Group, DKN Financial and Count Financial, could do no wrong.

But now, to varying degrees, they are almost all hurting.

The exception is Count Financial, which has received a takeover bid from the Commonwealth Bank). Even accounting services provider WHK is suffering: despite a recent bounce its share price is down more than 23 per cent from its 12-month high in February.

Of course, there are numerous factors but a crucial one is de-leveraging, a fancy way of saying that people are paying off debt. The savings rate for Australians is about 10.5 per cent of their income. Back in 2006 and 2007, before the financial crisis, it was negative.

For the wealth management sector, this is particularly damaging and some institutional investors question their business models.

"The trouble with those sort of companies is that all the money gets taken by the principals, the financial planners or fund managers. There doesn't ever seem to be much left for shareholders," says Rob Hopkins, a principal at Smallco Investment Manager.

The other big reason is regulatory. Much has been made of the Future of Financial Advice regulation, which has the aim of ensuring that the consumers who pay for advice are receiving that advice and not being pushed into products that are aligned with a financial planner. For companies such as Count Financial, and to a lesser extent WHK, this produces extra administrative burden.

Similarly, the profits of companies such as Thorn Group and Cash Converters are vulnerable if the government cracks down on how much these companies can charge people for so-called "payday" loans.

Assistant Treasurer and Financial Services Minister Bill Shorten has introduced draft legislation that would cap interest rates and costs associated with loans of less than \$2000 to customers. Such loans would have a maximum upfront fee of 10 per cent and an interest rate of 2 per cent a month. If you borrowed \$100 under the proposed cap it would attract no more than \$12 in fees and charges, according to Shorten's model.

The "micro-finance" industry has reacted angrily to these proposed changes with claims they will lead to at least 2000 job losses.

However, amid the doom and gloom, institutions are still finding bright spots in which to invest. Hopkins says his fund is invested in portfolio services provider Iress Market Technology, which will benefit from the introduction of Chi-X in competition to the Australian Securities Exchange. His fund also has a stake in international funds management group Magellan Financial, which he says is growing funds under management very quickly.

Chris Garrard, an analyst at Cadence Capital, says his fund is heavily invested in FlexiGroup, which provides finance for electrical goods and IT products. He points to the strong cash position of the group and its consistent double digit net profit growth.

Which shows that even when a sector is down, there are opportunities for the canny investor.

Retail stocks

YOU don't have to be Einstein to know things are dire in retail land. The days of the summer sale are gone and it is a reality that sales are all year round. At the annual results presentation of Premier Investments, whose brands include Just Jeans, Jay Jays, Portmans and Peter Alexander, industry heavyweight and chief executive Mark McInnes said that retail was going through "structural change".

What he was saying was what every shopper knows: if you want to get good deals for clothes, DVDs, music, you name it, you go online.

His comments came as he unveiled his group's fall in net profit of 50 per cent for the year to July 30, part of which included the cost of the group's restructuring program. The conditions are tough across the sector, but it is the small retailer that is suffering the most. The difficult conditions have already claimed the likes of Colorado Group and bookstore chain Borders.

Small-cap specialist Issam Eid of Sigma Funds Management says for smaller retailers, one of their biggest costs is rent.

"Specialist retailers get the worst rental deals, so their cost base is higher and they find it harder to compete. Their rent usually runs at 17 per cent [of sales] while for a David Jones or Myer it runs at 7 to 10 per cent. Even for mid-caps like JB Hi-Fi, rents are lower."

Should investors throw up their hands at smaller retailers, then?

"If you deliver the right product for your customer at the right price, you will always do well," he says.

And speaking to small-cap fund managers about their favourite stocks in the sector, several names pop up, presumably because they deliver on Eid's dictum.

These names include outdoor clothing producer Kathmandu, fashion retailer Orotan, KFC franchisee Collins Foods and furniture manufacturer and importer Fantastic.

On September 21 Kathmandu reported that it had grown annual sales 24.5 per cent to \$NZ306m (\$245m) and increased net profit by 55 per cent to just more than \$NZ39m.

Ausbil Dexia's small-cap fund owns more than 5 per cent of the retailer. Its portfolio manager Chris Prunty says Kathmandu has two factors in its favour.

"They own their own brand so it's fully vertically integrated, meaning they own the brand as well as the store," he says.

"Plus, it's an immature rollout story, which means it can start 15 new stores a year for the foreseeable future."

Another company that is vertically integrated is Fantastic because it manufactures the furniture its stores sell.

Sigma's Eid says Fantastic is doing well because the company went back to providing customers with affordable product.

"Fantastic works because it operates at the lower end of the market, but a couple of years ago it went too far upmarket," Eid says. "Now it has cut prices and gone back to its core customer. It's paying off for them."

Copyright 2011 News Limited. All times AEST (GMT +10).