Stocks | 13.07.2009

## 15 small cap stocks poised for rebound

Many small-caps present rich-pickings for savvy investors.

While most of the 1550 small-caps with market caps under $250 million don't warrant analysis, the trouble is the few that do are all too often tarred with the same 'lost-boy' moniker. As a result, the fortunes of the good ones tend to be at the mercy of boutique brokers, and small-cap funds managers with a penchant for unearthing 'value-plays' they hope will be re-rated at some future date.

Despite being severely punished over the past 20 months, the tide for the small-cap sector seems to have turned since last March's bear-market rally. During fourth quarter and second half 2009, the Small Ordinaries Index has comprehensively outperformed its big cap counterpart with 22.7 percent, and 23.3 percent, compared to the S&P/ASX200, at 7.8 percent and 6.4 percent respectively. But in fairness these gains have been made off an incredibly low base, with many good small-caps now trading on PEs as low as 2X.

It's early days, but according to Daniel Rolley equity analyst with the Atom Small Cap Fund, the return of institutional and retail investors could see a small-cap resurgence. If the market continues trending sideways, Rolley expects to see a return to old-fashioned stock-picking based on fundamental analysis. And when this happens, Rolley says fund managers will need to move down the food-chain to find value.

Having been harshly over-sold since late 2007, he says investors are now able to buy small-caps trading well below their intrinsic value. But Rolley reminds investors that the gap between price and value sooner or later usually closes. "Due to their low PEs and unique business models (experiencing strong growth), many small and microcaps offer greater scope for outperformance than the ASX Top 100," says Rolley.

Based on their projected ability to return to their pre-March 2008 share price levels within 18 months, Rolley's favoured small-caps include Mirabela Nickel (MBN), which at $2.33 is currently trading 70 percent below its peak of about $8 in late 2007. This September, the "pure-play" nickel sulphide producer is expected to start commercial production at its world-class Brazilian-based Santa Rita mine, and based on net present value projections, Rolley says the stock is radically under-valued.

Surprisingly, regional airline Regional Express Holdings (REX) is also one of Rolley's favoured small-caps. Also trading 70 percent down on its former peak of around $2.75 in late 2007, Rolley is impressed by the airline's profitability, manageable debt, and lower operating and capital cost structure.

Rolley also likes electronics payments systems company, Customers Ltd (CUS) which received a significant revenue boost following greater transparency into direct (ATM) charging fees initiated by the RBA in March 2009.

Rolley also has his eye on a number of other small caps whose share prices have tumbled since late 2007 - and these include resources stocks: Nido Petroleum (NDO) 60c June 08 - currently 14.5c , Citadel Resources (CGG) around 40c mid 08 – currently 18.5c, and Linc Energy (LNC) mid 08 $5.40 currently $1.37; healthcare IT company, Isoft Group (ISF) late 07 over $1.40 – currently 63c; engineering solutions provider, Neptune Marine Services (NMS) late 07 over $1.10 – currently 52.5c; environmental engineering company, Cleanteq (CLQ) late 07 over 60c – currently 31c; and marketing services specialist, Photon Group (PGA) late 07 $6.50 – currently $1.90.

Given that stocks with market caps under $100 million (aka mirocaps) comprise an estimated 80 percent of the All Ordinaries, Lincoln Indicators' Elio D'Amato says investors both big and small ingore them at their peril. “The beauty of being a retail investor is setting aside an element of your portfolio to chasing the ‘sweet fish’ within the small-cap waters,” says D’Amato.

So which small caps does D’Amato like within the current market? Based on D’Amato’s research, 17 percent (264) of the 1550 companies (with markets caps below $250 million) have sufficiently strong cash flow, moderate gearing, tangible & scalable products, plus good client-bases - necessary to be regarded as ‘financially healthy’. He says it’s within this universe of stocks that investors are most likely to find the next Monadelphous (MND), an engineering group that saw its market cap soar from $87 million in 2003 to currently around $900 million.

Like Rolley, D’Amato fancies the fortunes of Perth-based, Neptune Marine Services which received share price kicker following its solid result in March. But due to strong cash levels, no gearing and a strong business model, his favourite small-cap is online travel agency, Webjet (WEB). Trading on a PE of 11.8X and paying a yield of 4.5 percent, Webjet managed to increase its interim earnings by 29 per cent (to $3.7 million) despite travel numbers tanking.

Trading on a low PE of 3.5X and a yield of 5 percent (fully franked), D’Amato also expects online lottery ticket company, Manaccom Corporation (MNL) (market cap $10 million) to continue out-performing after posting a 35 percent jump in profit to $1 million. “I like the way the defensive earnings from the lottery division diversifies cyclical exposure from its online marketing business," says D'Amato.

But its mining software company, QMASTOR (QML) with a market cap of $12 million that he regards as the ‘ultimate little microcap’. And while QMASTOR is exposed to the volatility of a mining downturn, it lists mining giants BHP, Rio Tinto, and Vale amongst its key clients.

Despite tighter operating conditions leading to the continued delay and cancellation of studies and projects, D’Amato also likes the look of project management consultancy Lycopodium (LYL) (PE 2X).

And given just how tough current operating conditions are, he’s particuarly impressed with Austin Engineering (ANG) for keeping its order book remarkably strong. Trading on a low PE, with modest gearing, Austin recently announced plans to further expand into South America through JV and acquisition.

For something completely different, D’Amato also likes global franchiser of retail and financial services stores, Cash Converters (CCV). Also trading on a low PE of 2X, with negligible borrowings, he sees the franchiser as a contemporary stock well positioned to capitalise on the prevailling economic climate.

The trick with small-caps, advises D’Amato is buy into them before a) institutional investors discover the story, b) the upside is factored into the price, and c) fund managers are mandated to buy it once market cap exceeds a certain size. “Given that there are 168 companies (over half with a dividend cover ratio of greater than one) with a market cap below $250 million (paying a dividend yield of 8 percent-plus), there’s no shortage of value to be found within small-caps.”