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Size is strength but there are exceptions

Small caps

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The notion that size is strength was well supported during the reporting period, with a greater number of small industrial companies missing earnings expectations compared with their larger rivals.

More than 70 per cent of juniors have handed in their results so far, with the profit season drawing to a close, and small industrials have reported about a 40 per cent jump in earnings per share over last year's corresponding period.

Yet Bloomberg data showed the ratio of negative earnings per share surprises in the S&P/ASX Small Cap Industrials Index have outpaced positive ones by two to one, while this ratio is nearly balanced for industrial companies in the S&P/ASX 200 Index.

High earnings expectations and their vulnerability to a smaller set of business drivers due to their lack of diversity are largely to blame for these emerging companies missing expectations, although there are a number of potential turnaround stories that are probably worth looking out for, given that experts are still upbeat about the outlook for small caps in general.

Air shuttle service Regional Express Holdings is one example. The airline posted an 8.3 per cent drop in net profit to $8.8 million for the half year to end December, but a 2.9 per cent rise in revenue to $121.2 million.

Analysts believe Regional Express will bounce back strongly in 2011-12. Photo: TANYA LAKE

Rising competition on its Adelaide to Port Lincoln route and the underperformance of its Pel-Air subsidiary were behind the result and it didn't help investor confidence that management declined to give a guidance for the full year due to volatile fuel prices and exchange rates, bad weather and the uncertain economic environment. But 2011-12 is tipped to be a big year for the airline as its Victorian air ambulance contract is tipped to kick in.

The Royal Bank of Scotland believes this will lead to a 54 per cent surge in earnings before interest and tax and an 11 per cent rise in revenue in the next financial year compared to 2010-11.

This puts the stock on an attractive normalised price-earnings multiple of under six times on RBS's estimates for 2011-12 and a yield of 6.7 per cent, although the broker has reiterated its "hold" recommendation on the stock as the airline has been a consistent performer through the downturn and the upside growth is not as high as others in this sector.

But investors with a longer-term outlook will find its solid track record and additional earnings growth from other government contract wins – such as the Northern Territory aero-medical service contract and a target system contract from the Department of Defence – attractive qualities.

The stock closed 4¢ lower yesterday to a six-month low of $1.06. RBS has a price target of $1.19 on the stock.

Resources and infrastructure engineering contractor VDM Group is another potential turnaround candidate. The stock slumped to a 19-month low yesterday as it shed 1¢ to 21¢, following its dismal interim profit result. The group turned in a net loss of $16.4 million compared with a $5.2 million net profit for the same period last year as revenue tumbled 19.3 per cent to $195.9 million. A write-down in goodwill of $21.2 million for its consulting division and project deferral in its civil construction business were largely to blame.

But conditions are likely to improve over the next six to 12 months as the company is sitting on an order book of $200 million, 60 per cent of which will fall in the second half of this financial year.

Management also said it had tendering opportunities in excess of $750 million and is looking to expand its resources service side of the business to capitalise on high commodity prices.

The stock is on a P/E of under seven times for 2010-11 and consensus forecast is predicting the multiple will drop to about three times next year. Further broker earnings downgrades can't be ruled out but if management can get a few runs on the board, the stock will probably get re-rated.