FINANCIAL REVIEW smartinvestor

HD **Mighty mid caps**

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EQUITIES - MID CAPS

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Mid-cap contenders
Key financial data for companies considered under or overvalued.
* $A unless shown as euro or US dollar. ^As at April 1. Source:
ASX, Bloomberg

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TD

Finding a great start-up can be the proverbial needle in a haystack; better odds lie with a strong suit of stocks in the second tier of the ASX 200, writes Jeremy Chunn.

The sharemarket is a jungle – on fast forward. Extinction is a frequent occurrence and even apex predators can be carted out in sudden and bloody exits. In this dog-eat-dog environment, a little **company** with a good idea can put on muscle fast as investors seek a slice of the profits, pushing share prices higher and higher. Opportunities like that can deliver ripping returns to investors who get in early.

There are thousands of small companies though, so good luck finding the next one.

There are better odds backing companies which have proven themselves, where brains are balanced by brawn, where the outlook for growth is plausible and where volatility is less pronounced.

For many investors, mid-capitalisation companies just make more sense. Since the year 2000, the S&P/ASX MidCap 50 Index has roared ahead of Australia's largest 50 companies, the benchmark ASX 200 and the S&P Small Ordinaries Index. Goldman Sachs research shows the average annual return from mid-cap stocks over this period was 9.2 per cent per year.

The S&P/ASX MidCap 50 Index is made up of the 50 largest stocks after the top 50, but fund managers often choose from a bigger set. Andrew Waddington, Australian equities portfolio manager at BT Investment Management, defines the index as "50 small large caps and 50 large small caps". He says the key attraction of a **company** making its way higher in the ranks of market capitalisation is that cash-flow generation grows as capital expenditure intensity falls.

"The investment phase has been completed, the revenues get generated and the returns overall improve," Waddington says. As these escalating profits become distributable, they have a real impact on valuations, he adds. "It's the change in those return profiles which is important for the share price change."

How does 80 per cent share price growth for REA **Group** catch you, compared with less than 8 per cent for the index for the 12 months to March 26? BT also reckons mid-cap companies have a better chance of growing dividends, find it relatively easy to raise capital and are prime takeover targets.Pricing power

Everyone knows the Australian sharemarket is lopsided. Banks dominate the large end and resources stocks crowd out the long tail of small caps.

The spread of sectors in the middle is far more even and "a better reflection of the global economy", Waddington says.

PM Capital investment analyst Uday Cheruvu looks all around the world for mid caps, which he says can be worth up to $US10 billion ($10.8 billion), but Australian mid caps stand out because there's the chance to pick market leaders that have "pricing power" – the ability to control costs or pass them on to customers.

"That's more likely in the Australian mid-cap space than internationally," he says. "In Australia, even a top-two company in a particular sector can be a mid cap."

John Campbell's mandate, when selecting stocks for the Bennelong Avoca Emerging Leaders Fund, is to weigh anything outside the top 50. As a value investor, he reasons a company's shares are worth its total future payments to investors today. Some shares are cheap by his measure, but plenty are not.

"There are a lot of great companies in good industries that we like but then the second part of the equation is the valuations just don't stack up," he says.

James Hardie is a good company with good prospects, he says, but it's too expensive. "[With] this sharemarket we find ourselves in at the moment, there are plenty of quality companies that are priced at excessive valuations which precludes us from investing in them."

Sharemarket research tool Skaffold prices companies using past financial results and analysts' forecasts. Chief executive Chris Batchelor has found some mid caps for Smart Investor he reckons are worth further investigation. Batchelor's definition of a mid cap is a company worth between $2 billion and $10 billion, which includes about 80 on the Australian Securities Exchange.

Hyperion Asset Management's chief investment officer, Mark Arnold, says a company should be outside the top 100 to qualify as a mid cap, and he doesn't nominate a floor. "If something's really high quality, even if it's relatively small, we'd probably still consider it for inclusion in the [Australian Growth Companies] fund. If you can get a really high-quality business that's small compared to the potential … market, theoretically there's more upside," he says.

Fund managers don't rush in (and neither should you), and on average, he says, one name might be added to the fund a year. "We don't have a huge list of stocks we're ready to put into the fund," he says. "We're still very fussy."

Not every company listed here is a hot tip. Some are included, even though they're expensive at current levels, because they are good companies. We've also included two offshore stocks for investors who have already thoroughly picked over local options and, of course, there are thousands of others just waiting to be discovered for those with appetites for the exotic.

ARB Corporation

Although the company has suffered as sales of four-wheel-drives have softened, Arnold at Hyperion says ARB Corporation's product range and the ability to expand its exports business and grow sales substantially over the longer term will see it pick up.

BlueScope Steel

Having endured a significant turnaround, BlueScope Steel is benefiting from stable international steel prices, which are increasing in Australian dollar terms, says Waddington at BT. A recovery in the residential building market and improvement in non-residential construction mean the company can sell more into the Australian market at higher margins, he says.

Boral

The company is in turnaround mode, according to Avoca's Campbell, who says current low earnings may pre-empt a significant cyclical rebound. The company is heavily exposed to Australian and US housing, both of which the fund manager says are synchronised in an up cycle. Opinions on Boral are divided, he says, as it has been a massive disappointment for the past five years or more.

Carsales.com

Carsales.com's share price has gained more than 20 per cent in the past year and earnings per share are forecast to remain strong, says Batchelor at Skaffold. In the past year the company has invested capital to grow, "which one would assume is gearing them up for the future, although it's decreased their cash flow," he notes.

CSR

There's a lot to like about the building products company – exposure to the building cycle, good management and strong market position – but Avoca's Campbell says CSR's weakness may be its aluminium business. "The economics of smelting aluminium in Australia with our very high cost of electricity are becoming very challenged," Campbell says, whereas the building products side of the business is very good.

DuluxGroup

Finally a way to make money from other people's home renovations, although you may have to wait a while. "[DuluxGroup] is not dirt cheap but it's a very high-quality company in our opinion," says Avoca's Campbell, who points out it's hard for international companies to compete in the Australian paint market as any imports would be 99 per cent water. "It's dominant in Australia and the cycle's moving in its favour." All the same, the company's price-earnings multiple is a little high, he says.

Flight Centre

The company has had consistently strong results for the past five years, says Skaffold's Batchelor, and is showing strong growth prospects from its global business. The travel franchise we all know from every shopping centre is only part of the deal, he says. "It has a lot of brands in other countries which are also doing very well, particularly in the corporate travel sector." Looking at the Australian market, an investor might conclude Flight Centre Travel Group is fully mature, but that would be ignoring its offshore potential. "The size of the pie is still very large compared with what they have taken hold of," says Batchelor.

Henderson Group

The investment company may have turned a corner in terms of retail inflows, says Arnold at Hyperion. "We think it's a good play on the eventual recovery in Europe," he says. "As the economy and markets start to improve, Henderson is well placed to take advantage of investors switching more money into equities."

iiNet

Having completed numerous acquisitions, iiNet is now anticipating organic growth while reducing costs. Revenues are expected to increase as new customers are signed up to national broadband network-type services and taking up bundled deals. Stable average pricing with lower investment intensity will lead to an improving return profile, says Waddington at BT.

IRESS

The financial services software company has deep penetration in Australia, but Hyperion says it is well positioned to grow in other markets, including Britain, Canada and Asia, where wealth management and financial markets are predicted to grow. "It's a high-return-on-capital business and we think it's got good pricing power and there are good economies of scale," Arnold says, adding IRESS may find it has competitive advantages relative to smaller rivals.

Maca

The mining services company has about four or five long-term clients and numerous three- to seven-year contracts, which forms a medium-term stable revenue base, BT's Waddington says. By being selective and maintaining strong relationships with its customers, Maca can manage operating costs well, which will lead it to generate above-industry margins. A number of customers are moving into new developments and will be partnered by Maca, which will bolster longevity of the revenue stream, he says.

Magellan Financial Group

This internationally focused value-based fund manager is a very well-run business which has performed exceptionally well for shareholders in the past two years, says Batchelor at Skaffold. "Magellan is hinged to equities markets but also to the skill of the managers," he says, which means if the managers still do a great job but the market flops there's no guarantee Magellan's share price won't do the same thing.

Navitas

Strong performance over the past five years reflects strong earnings per share growth for Navitas. The forecast is its share price will pick up again from a two-year lull as overseas students are attracted by rising economies in emerging markets, such as China, south-east Asia and India, and a softening of the

Australian dollar. "When those nations are doing well, a lot of young people tend to want to come here and study," says Batchelor. "It's a global rollout story," says Arnold at Hyperion, adding a US start-up business should go strongly into profit over the next five years or so.

Perpetual

Share prices of asset managers are not as cheap as they were a year ago, but if investors have a view the Australian market is not going to correct downwards then earnings of companies in the sector should pick up on increased inflows. Stocks which maintain current P/E multiples will see an earnings uplift coming through, Cheruvu of PM Capital says. Perpetual stands out as it is much more aligned to that of the ASX, with the majority of earnings coming from its wholesale Australian shares fund.

Platinum Asset Management

Another internationally focused value manager, Platinum Asset Management has a strong outlook for growth, although Skaffold says it could be a little expensive at the moment. "Values are a bit higher than what we'd like to see," Batchelor says. "It would be nice to see a little bit of a correction to see prices come into line with values. But, of course, if you hold a stock you never want to see a correction, do you?"

REA **Group**

Skaffold has REA as an A1, it's top rating. Earnings per share growth, return on **equity** and forecasts are very strong, Batchelor says. "It generates a lot of cash … [but] while it has very strong prospects and has done very well over the last five years or so, a lot of the growth is now priced in to the share price." That makes REA look a bit risky right now. "[It's a] good business, [with] a lot to like about it – but price is the only issue." At Avoca, Campbell agrees REA is too expensive. "In terms of companies on stratospheric valuations, REA is probably the number one."

Reece Australia

The outlook for the plumbing and building supplies **firm** is strong, although Batchelor concedes just two analysts cover the stock (Skaffold relies on analysts for forward estimates used in its intrinsic valuation formula). "You always want to be a little bit cautious when a stock is not widely covered," he says. If both analysts are correct, Reece Australia is expecting strong earnings growth. "It is a little bit expensive," he says. "It's had a very strong run in the past 18 months or so." Exercise caution.

ResMed

"The stock's been going nowhere because there's been a change in reimbursement regulation in the US, which has caused some disruption in the distribution channel," says BT's Waddington. As that issue is resolved he expects growth over the next 12 months as the **company** brings on new products at improved margins. At Avoca, Campbell says ResMed is priced at a small discount to the industrial average, whereas over the past five years it was priced at a premium. "We think its growth prospects are pretty much as good as they've ever been," he says.

SEEK

SEEK has a good outlook and strong earnings growth (looking backwards and forwards), but the price is looking well above what Batchelor at Skaffold would consider fair value. "When a **company** is trading above its intrinsic value you do start to get nervous. You're then starting to bank on there being some really great growth, but it's got to come from somewhere." SEEK must do something exceptional to justify its high price, he says. On the valuations of the three internet companies (REA, Carsales.com and SEEK), he says: "I wouldn't be suggesting a **buy** at these levels but I might be suggesting a hold or perhaps taking partial profits."

Trade Me **Group**

Arnold at Hyperion says most New Zealanders have an account with Trade Me, which is like eBay, REA, Carsales and SEEK rolled into one. "It has a lot of eyeballs that go onto the **site** every day," he says. "It has a huge network effect going, with all of those features that attract buyers to the **site**."

Options offshore

Hugo Boss

The menswear brand, listed in Germany, is moving into **China** and the United States and switching from a wholesale model to a retail focus where higher margins await. "They have a laser-like focus on increasing shareholder returns because of a private **equity** owner on the shareholder register," says

Marcus Tuck, head of research at Insync Funds Management, whose Global Titans Fund includes companies capitalised between $US10 **billion** and $US2 **billion**. The fashion brand's return on **equity** has been close to 50 per cent, he says, and the fact they're shifting from wholesale to retail is good for extracting more margins over time.

Wyndham Worldwide

The US-listed **hotel** management **company** makes consistently strong returns on **equity** because of its low exposure to capital, says Tuck. **Hotel** owners who feel someone else could do a better job of managing can outsource to Wyndham, whose share price has gained 1700 per cent over five years. "It's a very asset-light business," he says. "As a result they have quite good return on **equity**, at about the 25 per cent level."

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