

# Choose stocks with competitive advantage

## Small caps

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Value buys may always be in fashion, no matter which part of the economic cycle we are in, but growing confidence about global growth means investors could be rewarded for keeping an eye on small-cap market leaders trading at a premium to their larger rivals.

This is particularly so if the market corrects in the near term. While equities usually enjoy the so-called "Santa Claus rally" as we head towards the end of the year, investors shouldn't take this seasonal pattern for granted given how strongly stocks performed in September and October — a period that has traditionally been weak for sharemarkets.

But any dip will probably prove to be a blessing in disguise as it will give growth investors a chance to pick up quality emerging companies that are usually on higher than average price-earnings multiples.

This may run against investors' bargain hunting instincts, but the strategy makes sense for a number of reasons.

For one, these stocks normally cost more because the market has greater confidence in their earnings growth, and that should mean a less volatile ride for investors.

These stocks also usually have a growth profile that is superior to the competition, and that in turn implies they have a competitive edge that is difficult to beat. This could come in the form of a better product, a better service or a dominant market share.

Further, and perhaps most importantly, such companies offer "competitive leverage" as they refocus their attention on beating their rivals during an upswing in economic conditions — compared with focusing on survival during a downturn.

Emerging leaders start from a position of strength. Not only are they ahead of the competition, but they have a balance sheet advantage and are likely to have a bigger war chest to chase after opportunistic acquisitions.

One stock that fits into this category is M2 Telecommunications Group. The small to medium business telecommunications services reseller was trading at a discount to its peers on a P/E of about 5 times only 18 months ago, but the share price has since surged 400 per cent and is now on a

2010-11 estimated P/E of about 12 times, which is higher than Telstra on 10 times.

"If you look at our market cap, we would be eligible for the S&P/ASX 300 Index in the near term, and the index trades on a multiple of 13 or 14 times forward earnings," said M2's chief executive, Vaughan Bowen.

He believes M2's P/E should remain above Telstra's as M2 is better positioned than others in the sector that own network assets due to the impending implementation of the national broadband network.

However, M2's outperforming share price could put pressure on the board to make another meaningful acquisition.

Management is forecasting about a 7 per cent growth in organic sales for the current financial year to between \$425 million and \$445 million and a 40 per cent increase in net profit to between \$22 million and \$23.5 million.

The chief investment officer for Microequities, Carlos Gil, is a big supporter of the stock but

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acknowledges that M2 will not appeal to value investors.

"If you assume there will be no acquisitions, then it may be within 10¢ of fair value. But if they can close something of substantial scale within the next six months, then it will be a whole different ball game."

M2 has demonstrated a stellar track record in hunting out value-adding transactions and Mr Bowen indicated at the company's recent annual general meeting that his team is again on the prowl.

The company announced a small bolt-on acquisition yesterday morning. It is buying New Zealand-based telco Black and White Group.

The stock hit a record high of \$2.70 on Monday but has eased since. It closed 4¢ lower at \$2.63 on Wednesday.

Another high flyer is business software solutions developer TechnologyOne. The stock has rallied about 23 per cent since the start of the financial year and is close to last month's near three-year high of \$1.

This puts the stock on a current P/E of over 16 times, although this is expected to fall to under 14 times by the end of 2010-11.

"It isn't particularly cheap, but

again it's one with a wonderful track record of earnings per share [EPS] growth and consistent dividend," said Mr Gil. "They also don't have a recognised strong competitor here. If you are in the market for its products, you really don't have any real options."

This competitive advantage shows up in its results. TechnologyOne has lifted EPS by about 15 per cent on average over the past six years, although EPS slipped 9 per cent to 5.2¢ in the year ended September 30, 2009, due to the financial crisis.

TechnologyOne is scheduled to report 2009-10 results at the end of the month and consensus forecast is tipping a 15.4 per cent increase in EPS. Shares closed steady at 97.5¢.

Property information provider RP Data and serviced and virtual offices firm Servcorp also stand apart from the crowd.

The former's database is difficult to replicate and this gives RP Data a stranglehold on the market, according to Mr Gil.

While the stock is trading on a current P/E of over 20 times, its robust earnings growth profile means it is trading on a 12-month forward P/E of only 13.6 times.

However, investors might be better off buying the stock on dips. Mr Gil feels RP Data will look compelling only below 80¢. The stock hit a 2½-year high of \$1.25 during trade yesterday but had slipped 1¢ lower to \$1.22 by close.

On the other hand, some brokers are urging investors to act on Servcorp now. Select Equities believes the company is on the comeback after being squeezed by the global financial crisis.

Select also pointed out the robust operating leverage of Servcorp as management is focusing on rolling out virtual office packages under a new business model and aims to sell the same number of virtual packages per floor in a third of the space of the traditional floor.

"We believe that earnings are cyclically depressed and could grow significantly when global office markets recover, especially in light of the company's aggressive expansion plans," said Select analyst Danny Goldberg.

Select has a long-term "buy" recommendation on Servcorp, which is trading on a 2010-11 P/E of 30 times, and has a price target and forecast yield of \$3.35 and over 3 per cent.

The stock has been trading in a fairly tight band over the past several weeks, but finished 3¢ higher to \$3.05 yesterday.