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## Opportunity knocks

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Reading newspapers is like wading through a sea of gloom. Headlines warn of impending rate rises, falling property prices and shell-shocked consumers slashing spending. Business worry about the high dollar, wage pressures and weak demand. Commentators fret that the mining boom will hurt other industries.

Economic data warrants caution, not extreme pessimism. The global economy is recovering, albeit with bouts of volatility and patches of weakness and the local jobs market is strong.

Never underestimate the potential for countries to talk themselves into recession. I hear complaints about living costs and the big unknown is how falling capital city property prices will affect the consumer psyche – and banks' bad debts.

This is a dangerous time for share investors. A range-bound sharemarket could bounce between 4400 and 5000 points for another year.

What matters most for valuations is earnings expectations. Companies keep downgrading earnings guidance and analysts are reducing profit forecasts for industrial companies. It is hard to see a sustainable rally until this trend slows.

Still, there is opportunity. The accompanying table shows 39 stocks with a blended trailing and forecast price to earnings (P/E) multiple below 10 and a price to earnings growth (PEG) ratio below one, which in theory implies cheaper stocks.

Many deserve to trade on low valuation multiples because they are poor quality with awful prospects.

I run this database screen of the sharemarket during sell-offs as a starting point for analysis of higher-quality companies on good valuations. Three small caps caught my eye: Gerard Lighting Group, financial services company WHK Group and mining services group Ludowici.

Gerard, with more than 25 per cent of Australia's lighting products market, looks reasonable value. It was among the more prominent initial public offerings on listing in May 2010 after raising \$85 million. Its shares sank to 80¢ in December before rallying to their \$1 issue price.

They are now 92¢ and good judges, such as K2 Asset Management, have increased their holdings. Perennial Value Smaller Companies Trust holds Gerard shares, as do AMP and IOOF Holdings. Most important is the Gerard family's 52 per cent.

There was no obvious reason why Gerard shares sunk 20 per cent below their issue price within six months of listing other than broader market volatility, poor IPO sentiment and investors forgetting about small-cap companies that disappoint after listing. Gerard's operational performance warrants more attention, half-year revenue up 15.6 per cent to \$209 million and net profit up 69 per cent to \$9.6 million. It has good operating cash flow and debt is acceptable.

More acquisitions are likely and there is scope for stronger sales growth in energy-efficient lighting. In a shareholders note, Gerard said its three largest businesses (Pierlite, Sylvania and Crompton) released more than 200 new products that initially had higher profit margins than the group average and sales of intelligent lighting products have exceeded expectations.

Major risks are weaker building activity and the high dollar reducing export competitiveness. The upside is a strong balance sheet, positioning Gerard to grow through acquisitions, build market share and increase profit margins. The valuation is undemanding. Forecasts from Austock Securities, which underwrote the IPO, suggest a 2011-12 P/E of 8.4 and a 6.4 per cent fully franked yield.

I can't see Gerard, or many small industrials, taking off in these market conditions and will watch the effect of lower building activity on sales. Even so, the long term looks brighter than for many small-cap industrials – which I like when they have strong market share, a record of innovation, committed management and balance-sheet strength.



Bright side: Strong fundamentals will always reward patient investors.

The challenge is finding them at the right price when too much market noise makes investors deaf to screaming value.

Source: Morningstar \*The price-earnings (P/E) multiple blends the last actual earnings per share (EPS) figure and projected one-year EPS. \*\*PEG is the ratio of the stock's P/E to its prospective earnings-per-share growth rate (in this case, EPS is averaged over two forecast years). In theory, a PEG less than one shows cheaper stocks; a PEG above one shows dearer stocks. A PEG of one implies fair value.

	P/E ratio*	PEG ratio**
Sunland Group	9.8	0.21
The Rock Building Society	9.78	0.77
Gerard Lighting Group	9.74	0.23
Capitol Health	9.67	0.14
Cedar Woods Properties	9.61	0.28
Telecom Corporation of New Zealand	9.6	0.61
Rio Tinto	9.59	0.46
WHK Group	9.48	0.64
Ludowici	9.46	0.48
IMF (Australia)	9.27	0.16
Melbourne IT	8.97	0.77
Automotive Holdings Group	8.96	0.88
OM Holdings	8.91	0.14
Logicamms	8.88	0.51
Southern Cross Media Group	8.8	0.33
Service Stream	8.64	0.25
Watpac	8.62	0.65
CPT Global	8.26	0.05
OneSteel	8.14	0.17
Miclyn Express Offshore	7.88	0.22
Saracen Mineral Holdings	7.75	0.1
Aspen Group	7.66	0.54
MEO Australia	7.61	0.99
Zicom Group	7.3	0.15
Tower	7.1	0.33
Nuplex Industries	6.76	0.56
Mount Gibson Iron	6.63	0.08
Regional Express Holdings	6.53	0.84
CBD Energy	6.38	0.22
Pacific Brands	5.99	0.72
Structural Systems	5.64	0.05
Noni B	5.15	0.32
Australian Pharmaceutical Industries	4.8	0.19
Neptune Marine Services	4.64	0.01
Photon Group	4.48	0.08
Select Harvests	4.28	0.18
Perilya	3.99	0.33
Greencap	3.29	0.14
ING Real Estate Entertainment Fund	3.22	0.05
BRW		

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