

Small Caps

Beware: pleasant surprises ahead

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Investors have fairly low expectations for the February reporting season despite the market's recent bounce on the back of better than expected global economic data.

The S&P/ASX 200 Index has risen 4 per cent so far this year, with the United States showing more signs of growth, the Chinese economy holding up better than feared, and a growing appetite for riskier markets as a result of calm returning to the euro zone markets.

However, experts warn that more companies are at risk of issuing a negative earnings surprise than a positive one when the half-year reporting season begins next month – that is, assuming that these companies have not issued a profit downgrade before.

A number of companies from across a range of sectors have already adjusted market expectations downwards in recent times.

The notable ones include QBE Insurance Group, Platinum Asset Management, retailer Specialty Fashion Group and home builders Peet and Devine.

But a handful of companies could be well positioned to bring some cheer, particularly if their peers have issued an upbeat trading update that is driven by robust market conditions.

"I think where you will find the upside surprises will be in the companies associated with resource and resource development," Morningstar's head of equity research, Peter Warnes, said. He pointed out that mining and engineering services companies Ausdrill and Macmahon Holdings had issued strong profit growth guidance just before Christmas, the former tipping half-year net profit growth of 32 per cent to 37 per cent over the same period last year, while the latter upgraded its full-year profit forecast by about \$10 million to over \$55 million.

The fact that BHP Billiton and Rio Tinto alone have announced a project development pipeline of nearly \$US40 billion also bodes well for the sector, and Mr Warnes said he believed that earthmoving equipment company Emeco had the potential to beat market expectations.

The consensus estimate is that Emeco will report a 25 per cent increase in operating net profit to \$69.8 million for 2011-12 on a 10 per cent uplift in revenue to \$566.8 million. This seems a little light, given the guidance by some of its peers and the fact that Emeco is spending \$165 million on expanding its fleet, and that \$95 million of this fleet is now under contract.

Hope for the best

S&P/ASX 200 stocks with the highest interim EBITDA growth forecast

Security	Est EBITDA 1H12 (\$m)	Est 1H EBITDA growth (% pcp)	Est sales growth 1H2012 (%)	Total return 1-yr (%)
Transfield Services	107.0	248.06	-1.62	-31.7
Goodman Group	268.0	136.96	+1.24	5.6
NRW Holdings	89.8	102.22	+69.43	24.3
Leighton Holdings	901.0	80.31	+26.81	-26.4
Seven Group Holdings	156.5	79.84	+33.49	-15.5
Cabcharge Australia	47.8	75.78	+12.30	-20.4
QR National	496.0	67.62	+11.35	37.8
Brambles	799.5	47.08	+34.08	6.1
Wesfarmers	2,871.0	30.50	+9.64	-2.5
Investa Office Fund	86.2	29.43	-13.08	17.2
BWP Trust	44.1	23.43	n/a	5.9
Ausdrill	122.5	23.12	+31.30	8.5
Monadelphous Group	89.5	22.80	n/a	20.9
Downer EDI	259.5	22.35	+20.04	-19.5
Flight Centre	150.0	22.13	+5.78	-22.9

SOURCE: BLOOMBERG, FINANCIAL REVIEW

"Even QR National could surprise on the upside because you are comparing it with a shocking first half last

year when half its network was under water or washed away” Mr Warnes said.

He said telecommunication stocks could come in ahead of expectations as well, thanks to the explosive growth in the demand for mobile data. Operators such as iiNet and TPG Telcom are his key picks for the sector, although he also acknowledges that sector giant Telstra could also post earnings slightly ahead of the market’s expectations.

While investors shouldn’t expect much good news from consumer discretionary-related companies, Wilson Asset Management portfolio manager Chris Stott is telling investors not to underestimate four-wheel drive accessory supplier ARB Corporation.

The market is expecting inflation-like sales and profit growth in the six months to December, compared with the same time last year, after ARB’s management warned in November that the floods in Thailand were slowing the supply of utility vehicles that are made in that country. “People are expecting the impact from the floods to hit, but that is primarily a second-half story,” Mr Stott said. “So the first half should look pretty good.”

He also pointed out that ARB had a strong track record of over-delivering, and more interest rate cuts later this year could lift demand for its products.

On the flip side, he said the information technology sector was one that was most likely to spring a nasty surprise, as consensus estimates were for a fairly flat full-year earnings before interest, tax, depreciation and amortisation (EBITDA) of \$25.6 million for Oakton and an increase of close to 7 per cent in 2011-12 EBITDA for SMS Management & Technology.

“They have seen a softening in demand for their services, particularly in the past six months,” Mr Stott said.

“Market expectations are too high for their earnings growth this year—and even though their share prices have underperformed recently, you are likely to see further downside for some of those stocks.”

Another stock that some say could disappoint is accommodation booking site Wotif.com Holdings.

Morgan Stanley offered it as a tactical trading idea, as it said it believed the stock would underperform the market in the next 60 days as it has rallied ahead of its interim result.

However, the broker said there was limited room for the company to surprise on the upside because of a sluggish domestic leisure travel market and intensifying competition.

The Australian Financial Review

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