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# 16 Hot Small Cap Picks For 2011, and They're Not Resources

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With commodity prices now looking toppy, investors who enjoyed sizzling returns from small cap resource stocks last year - up 50 percent for the six months alone - might wish to consider rotating into small cap industrials in 2011. One noteworthy catalyst for a correction in resources is iron ore prices which are expected to drop sharply over the next five years from US$171/tonne to US$85/tonne due to oversupply.

Hard as it may be to swallow, The ASX Small Ordinaries Index – up 10.18 percent in 2010 - is expected to underperform the S&P/ASX 200, which finished the year 2.57 percent down.

The expectant fall in the ASX Small Ordinaries Index is being attributed to the deteriorating outlook for 'small resources' which now look over or fairly valued following their hard ran up on the China boom. Based on a forward price to earnings multiple (P/E) of 13, small caps now look expensive relative to their large cap counterparts.

With returns of up to 700 percent, the 10 best performers on the Small Ords in 2010 were all resources stocks (see below). However, they're eerily missing from brokers' picks for 2011. Based on their ability to deliver 'alpha' from strong market positions, and claw back market share on a more favourable cost base, it's the ASX Small Industrials Index that brokers expect to outperform both their resources counterparts and their larger peers this year.

Brokers urge investors to stay on top of the information flow emanating from these mostly 'off-radar' small caps, and to know when to either add to their positions or lock in gains over the next 18 months.

We asked three analysts to share their top picks.

### Ian Munro, Equity Research Analyst, Lodge Partners Pty Ltd

**1) McMillan Shakespeare (MMS):** The best performing small cap industrial of 2010, Munro is attracted to the firm's strong earnings momentum, and 50 percent market share in the salary packaging space. Currently trading at an 11 percent to his target price of $9.20.

**2) SMS Management and Technology (SMX):** Munro expects the IT services company to benefit from an uplift in project work in

2011 – buoyed by estimates that large Australian organisations will spend around $31 billion on IT/technology during FY 2010/11. Currently trading at around a 13 percent discount to Munro's 12 month target of $7.45, SMX increased its net profit after tax by 15 percent in 2010.

**3) M2 Telecommunications Group (MTU):** Included among myriad catalysts for this telco provider of retail fixed-line, mobile and data services in 2011 is ACCC's decision to reduce fixed line monthly rentals. Net profit is expected to jump from $16.2 million in 2010 to $22.9 million and $25.9 million in 2011 and 2012 respectively. The business model requires little capex plus few fixed assets, and owns valuable well recognised brands among its key target market of small and medium businesses. Munro expects it to be a net beneficiary of NBN.

**4) Select Harvests (SHV):** Responsible for 60 percent of Australia's almond orchards, Munro expects SHV to benefit from increasing the number of orchards under its management from 3600 acres to over 8,000 in coming years. He says it's well positioned to capture value from orchard development and management, primary and value-added processing, and sales/marketing within both domestic and export markets.

**5) Elders Ltd (ELD):** Australia's leading agribusiness is a higher-risk turnaround story based on its ability to revive the fortunes of its farm services division. Currently trading at $0.54, the company reported a net loss of $217.6 million for the year ended September 30.

**6) Miclyn Express Offshore (MIO):** Despite some short-term faltering earnings momentum, Munro says it's a good time to seek exposure to cyclicals like this with significant exposure to earnings in US$ and Euros within a declining A$ environment. The Singapore-based provider of service vessels to an expanding offshore oil and gas industry across South-East Asia, Australia and the Middle East is expected to deliver year-on-year EPS growth based on its vessel new-build program, current price $1.72.

**7) Mystate (MYS):** A possible merger with one or more credit unions – currently struggling to compete amid regulatory banking reforms - may act as the Tasmanian-based diversified financial group's catalyst for a foothold onto the Mainland market, current price $3.71.

**Chris Stott, Head of research, Wilson Asset Management (International) Pty Limited**

**1) Reckon (RKN):** Shares a duopoly (80-90 percent) within the SME financial software space with rival, MYOB. Stott expects the company to again participate in future price improvement initiated by MYOB later this year. The stock is currently trading on a 16 percent discount to Stott's target price of $2.75. He's expects calendar year EPS growth to be consistent with last year.

**2) Breville (BRG):** Underlying profit for the home appliances company rose 65 percent to $28.5 million in the year to June 30, 2010. And Stott says the company looks well positioned to outperform again this year due largely to an encouraging kicker from higher margin north American operation. Currently trading at around a 20 percent discount to Stott's $3.50 target.

**3) Skilled Group (SKE):** To Stott this is a turnaround story based on new management's ability revive the fortunes of a badly run business with strong upside from a recovering economy and buoyant labour market. Currently trading at around a 40 percent discount to Stott's $2.50 target.

**4) IPGA Ltd (IPP):** A microcap with a market cap of $73 million, IPP is an Asian-based company operating online property sites in Singapore, Malaysia, and Hong Kong. Expected to break even within the next 18 months, Stott is attracted to management's former involvement with larger counterpart realestate.com. Currently trading at around a 12 percent discount to Stott's $2.50 target.

**5) Resources Equipment (RQL):** Adding favourably to the company's already full order book is a longer-term demand from new clients and those already on its books to have their mines 'dewatered' following recent floods. Currently trading at around a 44 percent discount to Stott's $0.75 target.

**6) Corporate Travel Management (CTD):** Added momentum to its recent run-up since listing last December is expected to come from renewed business confidence and ongoing acquisitions. Market cap $117 million, currently trading at around a 20 percent discount to Stott's $2.00 target.

***Rob Hopkins, Managing director, Smallco Investment Manager***

**1) Macquarie Atlas Roads Group (MQA):** Formed a year ago out of the Macquarie Infrastructure Group, MQA operates two quality assets: APRR Europe's fourth largest motorway group and the Dulles Greenway in Washington DC. Since the split, MQA and its partner in APRR have bought out the toll operator's only minority, enabling it to realise tax losses - while significantly reducing refinancing risks. Hopkins values the APRR operation alone at $2.00, and post-refinancing within 12-18 months says the stock could trade up to $2.50, (currently $1.53), market cap $700 million. Further upside from a weakening A$ against the Euro.

**2) Ludowici Ltd (LDW):** This Brisbane-based mining services company represents a value-play that trades on a discount to peers on a P/E multiple of around 9 times. A provider of consumables and CAPEX equipment, Hopkins says LDW looks favourably wired to future volume increases. Capable management is focused on consolidating mining exposure, and recent acquisitions have positioned the company to capitalise on the robust demand cycle. Assuming the company can deliver 55 cps in 2010 and 70 cps the year after, Hopkins expects it to trade between $6 and $6.50 within 12 months. Current price $4.90, market cap $130 million.

**3) Magellan Financial Group (MFG):** An early-stage funds management business run by highly respected management, MFG has boosted its funds under management (FUM) by 60 percent to $2.17 billion in the last six months. Hopkins sees MFG as a three year play based on management's track-record to date. But if the fund growth continues at current levels, he says a 12 month target of $2.50 is achievable. Currently trading at $1.75, market cap $260 million.

**Best performing small caps of 2010**

| SECURITY | CODE | 31/12/10 | % GAIN |
|---|---|---|---|
| Aurora Oil & Gas | AUT | 224 | 730% |
| Intrepid Mines | IAU | 201 | 593% |
| Coalspur Mines Ltd | CPL | 195 | 491% |
| Ampella Mining | AMX | 333 | 455% |
| Gryphon Minerals Ltd | GRY | 180 | 300% |
| Sundance Resources | SDL | 57.5 | 271% |
| Regis Resources | RRL | 240 | 253% |
| Giralia Resources | GIR | 440 | 203% |
| Grange Resources | GRR | 75.5 | 180% |
| Integra Mining | IGR | 71.5 | 175% |



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