

Small caps with takeover potential



The ongoing takeover saga surrounding Spotless (SPT) and private equity bids for PaperlinX (PPX) and Pacific Brands (PBG) highlight the potential for increased takeover activity in 2012.

Weak business conditions see material earnings downgrades across many non-resource sectors, and combined with poor investor sentiment, the share prices of many cyclical small-cap stocks slump. Many now trade on PEs well below 10 times forecast earnings.

While in many cases the low PEs reflect market concerns about further earnings downgrades, it is possible some companies could well be trading at, or close to, the bottom of potential earnings. The upcoming

reporting season and management outlook comments will be key to where many trade over the next six months.

Not only does private equity appear cashed up, but in general corporate Australia balance sheets are in good shape. The average net-debt-to-equity ratio of ASX-listed companies (excluding the banks and major miners) fell from around 50% in FY07 to 30% by FY10. The combination of strong balance sheets, slow organic growth prospects and cheap equity prices could prompt some domestic corporates to seek growth via acquisition. Large overseas companies could potentially see attractive opportunities to build or expand an Australian presence despite the

strong currency. It is also possible some companies could be taken private.

Second-guessing those companies that may be next is fraught with danger and, to an extent, speculative. We do not advocate building portfolios on the basis of takeover speculation, but suggest investors should continue to focus on stocks with sound fundamentals. Many of the stocks reviewed in this report have positive analyst recommendations, but in some cases business risk is also high.

The Pacific Equity Partners (PEP) bid for Spotless (SPT) is the second private equity attempt in less than a year. SPT has been a serial underperformer for many years and its share price languished before

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Stocks to watch

	ASX Code	Price \$	NPAT* \$m	EPS* cents	PER*	Yield* %	Franking* %	Sector	Rec
Atlas Iron	AGO	3.10	272	35.3	8.8	1.0	0	Materials	Buy
Telstra	TLS	3.31	3650	29.3	11.3	8.5	100	Telecommunications	Buy
Toll Holdings	TOL	5.00	311	43.6	11.5	5.2	100	Industrial	Buy

* Forecasts for FY2012

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the takeover interest. The situation has reached a stalemate, with a gap between SPT's expectation of \$2.80 per share and PEP's \$2.68 offer. Although the gap is seemingly small, it represents \$32m in cash, which would reduce the potential returns for PEP. It is unclear how this will play out, but if PEP walks away the SPT share price will continue to languish in the short to medium term well below the offer price.

Programmed Group (PRG) is similar to SPT in that it provides outsourced services, however it mainly focuses on maintenance and facilities management. PRG fought off a takeover from SPT in 2008 but has since fallen on tough times, with earnings and the share price declining. The tough economic environment sees clients reducing maintenance budgets, with pricing and margins under pressure. But the 1H12 result showed signs of improvement, with increased exposure to the resource and government sectors providing an offset to a fragile private sector. Net debt to equity has also been reduced to a manageable 30%. While conditions in the private sector remain subdued, we expect changes in business mix, tight cost controls and strong growth in offshore marine services to drive earnings growth in FY12 and FY13. Trading on an FY12 PE below nine times and with relatively low debt levels, PRG looks relatively cheap and could be a target for private equity.

Alesco Corporation (ALS) was once run with a private equity feel itself. Acquiring growth businesses with key positions in niche markets, improving productivity and selling underperforming businesses, it may now be in the crosshairs of private equity. ALS was caught in the latest housing and commercial construction decline, and after divesting the disastrous Water Products and Services business, is now focused on driving returns from three divisions: Functional and Decorative, Construction and Mining, and Garage Doors and Openers. The portfolio houses well-known names such as Lincoln Sentry and B&D Roller Doors. Trading on an FY12 PE of only 7.5x, ALS looks cheap enough to draw attention of private equity or even other building-related stocks like GWA Group (GWA), especially with the potential earnings upside if conditions improve.

Weak consumer spending has seen most retailers suffering, with earnings downgrades and significant share price falls. It is difficult to know how much of the weak retail environment is structural, with a shift to online shopping, and how much is due to an over-indebted consumer

building up their savings. The low share prices have prompted takeover speculation, but at this stage it is difficult to know to what extent takeovers will develop.

Billabong International's (BBG) has seen a sharp fall in its share price. The fall from a 25% increase of 1Q11 revenues released in October to a 23% decline in 1H11 operating profit announced in December reveals how sudden the retail fortunes of BBG changed. A strategy to acquire retail outlets to vertically integrate into the wholesale business was poorly timed. Short-term cashflow constraints hit interest coverage ratios and bring closer a

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breach of debt covenants. BBG retains a strong portfolio of market-leading lifestyle brands which trade buyers would be eager to acquire. The fall in market capitalisation could spark interest from an acquirer.

The media sector has also been under pressure, as weak consumer spending cut advertising expenditure. The share prices of most media stocks have fallen significantly. The sector is also undergoing structural change, with a continued shift from print to online. The federal government is also looking at the future of media regulation in its Convergence Review, with the potential for the abolition of the cross media ownership laws. The low prices and potential regulatory changes could see merger and acquisition activity in 2012.

In 2011, Southern Cross Media (SXL) acquired the Austereo radio network, diversifying its reach into metropolitan Australia and increasing exposure to a more resilient segment. But with a weak short-term outlook and significant shares issued to fund the Austereo acquisition, the share price languishes. The shares currently look good value on a PE of just over seven times and well below our valuation.

The SXL assets were previously the subject of merger interest when Macquarie Group (MQG) and Fairfax Media (FXJ) acquired and carved up Southern Cross Broadcasting in 2007. It is possible private equity could attempt a similar acquisition and "carve up". A strategic buyer with media interest could potentially emerge, although given the Austereo assets did not appear to attract much interest when they were bought by SXL, this is probably a long shot. Potential changes to media regulation could also see interest from larger media groups.

In 2011, rural and regional subscription television operator Austar (AUN) received a \$1.52 per share offer from the leading pay TV operator, FOXTEL. So far, the bid has received Foreign Investment Review Board approval and the deal is set to be voted on by shareholders at a scheme meeting on 15 February. However, Australian Competition and Consumer Commission (ACCC) approval remains the last hurdle. With AUN shares trading around \$1.20, well below the offer price, the market is pricing in a significant discount for ACCC risk. We believe the ACCC defeat in the Metcash (MTS) takeover lessens the risk, given similarities between the situations. While there is significant upside if the deal goes ahead, there is still a chance the ACCC could stop the deal. This would likely see the shares fall back closer to our \$0.98 valuation.

Consolidated Media (CMJ) also represents an investment in the subscription TV industry, with a 25% stake in FOXTEL and 50% in Premier Media Group, the producer of the Fox Sports channels. If the AUN/FOXTEL merger goes ahead, CMJ will benefit from ownership of the enlarged group plus cost savings to flow from the merger. Its holding in FOXTEL will be a great strategic media asset. The advent of digital TV and multi-channeling presents some risk, as does a slowdown in economic activity. CMJ's shares are tightly held, with interests associated with James Packer and Kerry Stokes owning 70%. There is some corporate appeal if these two media magnates attempt to resolve the ownership structure and take the company private.

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Australian banking sector



The share prices of Australian banks have been hurt by widespread perceptions that they face earnings pressure due to slower economic growth, reducing loan growth, higher funding costs, increasing bad debts, and softer consumer and business confidence eroding earnings power. While many northern hemisphere banks are still stressed, Australian banks remain robust and profitable.

Australian banks operate in an economy that is actually growing, they provide solid earnings growth potential, low fundamental investment risk and high fully franked dividends. Most importantly, none of the major Australian banks is going to default. They have no direct material exposures to PIIGS' (Portugal, Ireland, Italy, Greece and Spain) sovereign debt, but their share prices continue to suffer from "guilt by association."

Standard & Poor's (S&P) recently downgraded its long-term senior unsecured debt rating for each of the four majors from AA to AA-. Regional bank Suncorp's long-term credit rating was affirmed at A+. Bank of Queensland was downgraded from BBB+ to BBB and Bendigo & Adelaide Bank was upgraded from BBB+ to A-. The changes follow a review of S&P's global bank rating methodology.

CBA Group Treasurer Lyn Cobley said: "CBA remains one of very few banks globally in the AA category. Since the onset of the financial crisis in 2008, the Group has increased its capital base and improved its

funding and liquidity position by increasing customer deposits and long term wholesale debt and reducing our use of short term wholesale funding. At this point we do not expect this to have any material impact on our funding plans or expected pricing of our new issuance."

We agree with this assessment. The downgrades do not significantly change the position of the major banks relative to other global banks relying on wholesale funding. The four majors are part of just a handful of AA-rated banks worldwide.

The four major banks source 20-25% of their funding from offshore wholesale debt markets. Due to the recent debt issues in Europe, wholesale funding for banks is becoming more expensive worldwide. Australian bank earnings could come under pressure from higher funding costs.

The Australian banks have strong funding positions, which have been underpinned by customer deposit growth exceeding loan growth. Strong customer deposit growth reduces the need for wholesale funding, with customer deposits now accounting for 55% of total funding compared to 50% pre-GFC. Offshore wholesale funding now represents 50-55% of total wholesale funding.

Despite price competition in home loans, banks have significant pricing power. Generally banks do not lose large market share when they re-price their loan books by passing on less than official interest rate reductions.

However, there is some tradeoff of net interest margins for customer satisfaction and market share.

In December 2011, ANZ hit the news after announcing it would review interest rates independently of official interest rate announcements. "By reviewing key variable lending rates each month we can more accurately reflect the sustained changes in funding costs we incur through the interest we pay to customers for their deposits and to investors in wholesale money markets," said ANZ chief executive Australia Philip Chronican.

Australian banks have strong balance sheets, with capital levels already exceeding the minimum requirements under Basel III. The International Monetary Fund (IMF) recently called on Australia's major banks to increase their levels of capital even further, warning the sector may not be able to withstand the dual shock of a residential property downturn and losses on corporate lending. Despite the warning, the IMF highlighted that the major Australian banks all have capital well in excess of the regulatory requirements with high quality holdings.

The current political and economic turmoil provides an attractive buying opportunity for investors prepared to look beyond the doom and gloom. Historically low valuation metrics and fully franked dividend yields of 7-8% make bank shares worth considering for diversified share portfolios. ●

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The wealth management industry is undergoing a shake-up, with regulatory changes in relation to superannuation and the provision of financial advice changing the operating landscape. Such industry changes often lead to consolidation and we have already seen the AMP (AMP) takeover of AXA Asia Pacific Holdings, Commonwealth Bank of Australia's (CBA) acquisition of Count and the move by IOOF (IFL) to acquire DKN Financial.

IFL is the product of a number of mergers in recent years, with the most significant acquisition the 2009 merger with Australian Wealth Management. IFL is now one of the main independent providers of a range of wealth management solutions in Australia. It is possible IFL could become a target for one of the larger players, such as ANZ Bank (ANZ), which has a relatively small exposure to wealth management. However, a complex holding structure for its Perennial funds management business could make a takeover difficult. Given the reputation of CEO Chris Kelaher, IFL is more likely to be an acquirer. The regulatory changes and acquisitive growth strategy make the stock one of the riskier wealth management plays.

Private equity has previously shown interest in Perpetual (PPT). With the recent share price correction and now \$800m market capitalisation, the company is again likely to be subject to takeover speculation. In 2010, US private equity major KKR offered \$38-40 per share in an indicative, incomplete, conditional and non-binding proposal, which PPT's board decided undervalued the company. Subsequent discussions did not produce an offer the board could put to shareholders. With the stock now below \$20, KKR will be relieved it didn't succeed and PPT shareholders will be disappointed at their board's poor judgment of value. Although



any bid now will be labeled "opportunistic," long-suffering shareholders might welcome an offer if the price were attractive enough.

With global food demand increasing rapidly, the 2010 acquisition of AWB by Canadian agribusiness, Agrium, highlights the strategic value of Australian agricultural assets to overseas buyers. Graincorp (GNC) initially attempted to merge with AWB, but was outbid by Agrium. With ownership of key east coast grain-handling infrastructure and significant market shares in storage, handling and port elevation services, GNC is one of the few remaining listed agricultural stocks of major strategic value. While the stock is currently rated as a Hold, an overseas company could well pay much

higher prices given the strategic significance.

As Australia's largest beef cattle producer, Australian Agricultural Company (AAC) owns a valuable land bank and a cattle herd of 600,000 head. It too could be of strategic interest to offshore buyers and already has a number of substantial shareholders, including IFFCO of the Middle East with a 20% stake.

However, there are some concerns reduced demand for live cattle from Indonesia could hurt earnings. Despite their strategic value, agricultural stocks remain exposed to cyclical weather patterns and are more suited to patient, higher-risk investors. ●



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