Ditch FOMO and check out these 5 small caps

Charlie Aitken believes it’s time to be cautious on private tech valuations, unlisted tech/VC funds, and the WAAAX names in Australia. Charlie says they’re all priced with no margin of safety and could all be subject to de-rating on delivery of even the slightest disappointment. His advice in his article today is to lose any FOMO you may have and consider the real capital risk you’re taking in paying unprecedented valuations for broadly unprofitable stocks, at what is potentially the peak of the “valuation” cycle.

Sincerely,

Peter Switzer

Inside this Issue

02 It may be time to take some of the WAAAX off!
Time to WAAAX off!
by Charlie Aitken

05 Take a look at these 5 neglected small caps and mid caps!
AUB, DHG, SHJ, ALG & PGH
by Tony Featherstone

09 Buy, Hold, Sell – What the Brokers Say
10 downgrades, 4 upgrades
by Rudi Filapek-Vandyck

12 Questions of the Week
Will the ATO think my SMSF is diversified?
by Paul Rickard
It may be time to take some of the WAAAX off!
by Charlie Aitken

Sentiment and emotion play a huge role in the short-term pricing of equity markets. However, the way to compound returns in equities over the long run is to invest with a margin of safety, in companies that consistently grow their earnings and dividends.

As the British-born American investor, economist, and professor (widely known as the “father of value investing”), Benjamin Graham said, in the short run, the equity market is a voting machine but in the long run, it’s a weighing machine. That remains accurate today.

The hardest aspect of investing is remaining patient and unemotional. It’s hard to retain discipline when you see others making money in stocks you don’t own and sectors you don’t understand.

My advice is to resist “FOMO” i.e. the fear of missing out.

This is not the time in the equity market cycle or economic cycle to give into FOMO. I believe losing discipline now could lead to years of losses in the wrong investments.

While the biggest capital gains have been made in profitless new technology stocks, I believe the equity market is starting to behave more like a weighing machine i.e. NOT good for profitless, expensive, new technology stocks. Equity investors are more discerning and are simply not paying the lofty “valuations” that private investors were happy to subscribe in the private equity market.

We saw evidence of this when WeWork cancelled their IPO process this week. WeWork was “valued” at $47 billion after the last round of investment from Japan’s Softbank Vision Fund. The IPO process appeared unable to even get a valuation of half the previous round “valuation”. No wonder the vendors pulled it, particularly the highly geared Softbank Vision Fund, which needs high exit prices to justify their entire investment strategy. This is a reminder of the potential dangers of pre-IPO unlisted investments that mark their “performance” to “valuations” based off the last round of equity invested. Illiquidity works both ways and there are attributes of a Ponzi scheme about many of these unlisted investment funds. Just remember, lobster pots are very easy to get into but almost impossible to get out of…

The WeWork IPO cancellation shouldn’t have been a big surprise. The post IPO performance of UBER (UBER.US) and Lyft (LYFT.US) is evidence that the equity markets have become more discerning than the private markets in valuing still unprofitable technology stocks. The chart below confirms UBER is -30% since IPO and Lyft -42%.

This de-rating trend is spreading further to profitless food delivery stocks such as Grubhub (GRUB.US) which is down -61%, online real estate portal Zillow (Z.US) -53%, EV and battery manufacturer Tesla (TSLA) -25% and music streaming business Spotify (SPOT.US) -38% over the last 12 months, to name a few examples.

These may well prove to be good businesses, but they were clearly trading without a margin of safety.
Even after recent falls, it’s impossible to argue any offer clear “value” yet.

The US equity market appears to be pivoting away from unprofitable technology stocks towards highly profitable and cash generative established platform stocks, such as Microsoft (MSFT), Apple (APPL), Alphabet (GOOG) and Facebook (FB), to name a few. I think that’s sensible, as I see both valuation support and quarterly earnings growth confirmation pending (October) for those major US established tech names.

The point I am getting to today is that there are a number of high growth, marginally profitable/unprofitable businesses listed on the ASX that have defied the broader de-rating of new technology stocks. Because genuine “growth” is hard to find in Australian equities, anything with growth gets priced very aggressively. That’s fun while it lasts but dangerous for those who are late to the party.

It takes very little for a stock that’s priced for beyond perfection to disappoint and de-rate aggressively. When you buy with zero margin of safety, this is effectively the risk you are taking. A classic recent Australian example is profitable, yet expensive, A2 Milk Co (A2M). In July, there was a competition between the broker analysts to see who could have the highest earnings estimates leading into the August result. My fund stuck to its process and sold out of A2M into this hype ahead of the result. We sold our final stake the day the A2M CEO was on the front cover of the *AFR*. What came next was a “not perfect” result, lowered margin guidance, and a -27% share price fall on the back of -12% EPS cuts by analysts. Yes, the stock fell double the EPS cuts, but that also occurs as P/E is simultaneously reduced to reflect increased uncertainty.

The A2M example should have been a clear warning shot for other highly-valued next generation, low/no profitability names. It doesn’t seem to have been and I think it is prudent to be cautious on WAAAX names in Australia. They are all priced with no margin of safety and could all be subject to de-rating on delivery of even the slightest disappointment. Quite frankly, when a group of stocks has an acronym, the vast bulk of money has probably already been made.

The market capitalization of the WAAAX names are somewhat astonishing: Wisetech (WTC $11.3 billion), Afterpay ($9 billion), Appen (APX $2.6 billion), Altium ($4.5 billion), and Xero (XRO $9.3 billion). Afterpay added $1 billion in market cap yesterday alone! The combined market capitalisation of the WAAAX names is a staggering $36.7 billion. The current combined EBITDA of the WAAAX names is $324 million, according to Bloomberg consensus. For $26 billion you can buy Fortescue (FMG) and $6 billion of EBITDA! OK, just making the point.

If the market turned from a “voting machine” to a “weighing machine”, there would be a clear problem, as profitability simply doesn’t support valuations. I again refer you to the recent US de-ratings example above.

In technology, it’s time to get out of “concepts” and into “cashflow” is my opinion. Do you really need to take the capital risk in highly valued “concepts” when Microsoft (MSFT) has $133 billion of cash and cash equivalents, $56 billion of annual EBITDA, has just raised its quarterly dividend by +11% and announced a $40 billion buyback? I don’t think so and I believe it is time to be cautious on private tech valuations, unlisted tech/VC funds, and the WAAAX names in Australia.

Peak cycle valuations have passed. Investors are becoming more discerning. The difference between public market and private market valuations is widening. It’s time for conservatism and a margin of safety in technology investments. That margin of safety can still be found, but it’s right up the quality and duration curve in established technology companies.

My advice is to lose any FOMO you may have and consider the real capital risk you’re taking in paying unprecedented valuations for broadly unprofitable stocks, at what is potentially the peak of the “valuation” cycle. It may be time to take some of the WAAAX off.

Past performance is not a guide to future performance, as we all know too well.

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needs of any particular individual. It does not constitute formal advice. Consider the appropriateness of the information in regard to your circumstances.
Take a look at these 5 neglected small caps and mid caps!

by Tony Featherstone

Value should be hard to find as the share market tests its record high. But there’s plenty of value for bargain hunters; the challenge is finding a re-rating catalyst for battered stocks.

Small- and mid-cap stocks are an example. For every soaring tech stock, many others are languishing on almost GFC-like valuation multiples. Small industrial stocks leveraged to Australia’s slowing economy have been forgotten in the momentum-investing craze.

The S&P/ASX Small Ordinaries Index, a barometer of stocks ranked 101 to 300 by market capitalisation, has a total return (including dividends) of 5.6% over one year. The S&P/ASX 100’s total return is almost 15%.

Over three years, the Small Ords has returned 9% annually versus 12.6% for the ASX 100, S&P Dow Jones Indices data shows. The underperformance of small-cap stocks versus their large-cap peers began in 2012 and the gap has barely closed.

That’s unusual in a bull market. Typically, small caps outperform when risk appetite rises and funds flow to growth stocks. Not this time. Outside the star tech stocks and parts of the resource sector, there is waning interest in small caps.

Several factors explain this divergence. Record-low interest rates and the prospect of more cuts to come are pushing investors into large-cap stocks for franked yield. Income seekers gravitate to household-name dividend payers rather than small caps.

The boom in Exchange Traded Funds (ETFs) is another factor. Algorithmic trading strategies are thought to be pushing small- and mid-cap stocks with strong momentum higher and discarding the rest. ETF buying and selling is indiscriminate because it seeks to replicate an index.

The closure of several small-cap asset managers in the past few years and declining stockbroking coverage of small caps partly explains the performance divergence with large caps. Simply, fewer investors are analysing small caps, exacerbating pricing inefficiencies.

That’s good or bad depending on your perspective. I’m seeing more opportunities in neglected small-cap stocks than I have for years. It makes no sense that some are trading on valuation multiples that have not changed in a year, despite solid operating progress.

Private equity has spotted the opportunity. Witness the rising number of takeovers of small-cap minnows by local or international private-equity firms. GBST Holdings, Wellcom Group, Credible Labs, Chalmers and Navitas each had takeover bids this year.

This market is also sensing value in neglected small caps.

The Small Ords index slightly outperformed the ASX 100 in the past quarter. After years of underperformance, the Small Ords’ recent gains are significant and perhaps a sign that too many small caps have fallen too far.

However, caution is needed with talk of a small-cap recovery. Small-cap companies tend to be more leveraged to the Australian economy relative to their large peers that typically have a higher proportion of offshore exposure. The Australian economy is limping along, so there’s little joy for cyclical small-cap industrials that are heavily exposed to the domestic economy.
But every stock has its price. Valuation multiples for many small-cap industrials suggest the market is pricing in too much bad news. That's an opportunity for experienced investors who understand the benefits and risks of investing in small- and mid-cap stocks.

Here are 5 that offer value at current prices:

1. **AUB Group (AUB)**

   The insurance broker has had a disappointing 12 months with a total return of -13%. Over five years, the average annualised gain is 6.2%, Morningstar data shows. AUB, a former market darling, badly disappointed as the market lost confidence in its strategy and execution.

   AUB performed below expectation in FY19: adjusted net profit rose 4.1% to $46.4 million. Costs from fraud in the firm’s Canberra office and a challenging NSW Workers Compensation market dampened performance and offset solid gains in insurance and underwriting.

   At $11.02, AUB is on a forward Price Earnings (PE) multiple of about 19 times, consensus estimates show. Listed rival Steadfast Group is on a forward PE of 26. That's a large gap and a sign that better value might exist in AUB as its recovery plays out in the next few years.

2. **Domain Holdings Australia (DHG)**

   The online property advertising firm has given shareholders a wild ride since its 2017 Initial Public Offering (IPO). After trading above $3.50 after listing, Domain sunk to $2.07 in early 2019, after management changes and amid expectations of a property slowdown.

   Domain has recovered to $3.22, as the market looks to an improving property market, courtesy of falling interest rates. Rising auction clearance rates bode well for higher property turnover (off a 20-year housing turnover low) – and thus more advertising on Domain.

   My hesitation with Domain during the IPO was its growth prospects outside of Sydney and Melbourne. Domain benefited from exposure in its then parent company’s (Fairfax Media) *Sydney Morning Herald* and *The Age*. Unlike REA Group, which had national exposure through News Corp publications, Domain did not have as much cross-promotion in other states.

   Nine Entertainment Company’s takeover of Fairfax, which gave it majority ownership of Domain, gives the property portal serious national exposure via prime time TV. Witness the marketing synergies between Domain and Nine’s hit reality renovation show *The Block*.

   I expect at least two more interest-rate cuts in the next 12 months and an ongoing recovery in the property market, albeit less heated this time around. That’s good for Domain.

3. **Shine Corporate (SHJ)**

   Listed law firms were all the rage a few years ago until Slater & Gordon’s near-death experience after its disastrous UK acquisition. Brisbane-based Shine Corporate was caught in the carnage, falling from $3.33 in mid-2015 to 77 cents.

   The market questioned the business model and
accounting practices of listed law firms, even though Shine avoided some of the mistakes made by larger rival Slater & Gordon.

Shine’s FY19 performance met market guidance: underlying earnings (EBITDAI) rose 1.6% to $38.3 million. The company expects earnings to rise 10% in FY20, suggesting a pick-up in growth.

Shine in June 2019 announced the settlement of a shareholder class action against it, related to alleged continuous disclosure breaches over its FY14 and FY15 results. Settlement of the $250 million class action, the terms of which were confidential, removes a headwind for Shine.

For all the short-term challenges, Shine has a good position in a long-term growth market and room to expand through acquisition of smaller firms. Gross operating cash flow continues to rise and Shine has implemented some good innovations in online claims for motor-vehicle injury and is expanding its family law practice.

At 77 cents, Shine is on a trailing PE of 9.7 times and yielding almost 5%. The national law firm could take time to recover but value is there for patient investors.

theme parks suffered, as concerns grew about the maintenance and safety of rides, and consumers chose other entertainment.

The market also worried that growth in Main Event, one of Ardent’s best-performing businesses, was slowing. Bad news seemingly appeared at every turn for Ardent.

Ardent streamlined its operations through divestment of the marinas and bowling businesses. Main Event is the key for Ardent, accounting for 85% of FY19 revenue.

The theme-park business is recovering but taking longer to resume growth than expected, thanks to Coronial Inquest hearings and delays in new attractions.

I’m not convinced the Gold Coast theme parks, particularly Dreamworld, will return to their former glory. The attractions look tired and competition from eco-tourism on the Gold Coast is growing. Kids these days seem to get more excitement via their iPad or smartphone than on another rollercoaster ride at a theme park for the tenth time.

Beneath the gloom, Ardent lifted revenue from continuing operations by 14.4% over the previous year. Morningstar values Ardent at $2 a share, double its current price. The research house concedes the pace of Ardent’s recovery is uncertain but argues that the assumptions in its forecasts are conservative compared to the company’s historic growth rates.

I suspect the market has given up on Ardent and is overlooking its stabilisation. The Main Event business should benefit from management rejuvenation, a lower Australian dollar relative to the Greenback and continued organic growth through new centre openings.
5. Pact Group Holdings (PGH)

The packaging group has had a terrible 12 months, falling from a 52-week high of $4.10 to $2.23. Over three years, the average annual return is -26%.

Like other packaging groups, Pact struggled with higher energy and raw-material costs that crimped profit margins and it lost market share in the key food, beverage and dairy segments. A stretched balance sheet that took Pact close to its debt covenants was another concern.

Pact said packaging pricing improved in the second half and resin costs fell, enabling it to recover some of the pricing lags from earlier periods.

Operationally, Pact looks to be stabilising but the valuation is not factoring in any turnaround. At $2.26, Pact is on a forward PE multiple of about 10 times, consensus forecasts show.

An average share-price target of $3.88, based on the consensus of six broking firms (too small a sample to rely on) suggests Pact is significantly undervalued.

I’m not as bullish but expect a recovery to unfold slowly in Pact, as its profitability improves and market concerns about its debt levels ease, as debt is refinanced or an asset sale creates balance-sheet breathing space.
In the good books

1. IOOF HOLDINGS (IFL) was upgraded to Outperform from Neutral by Macquarie

Following the Federal Court decision that IOOF directors and executives did not contravene the Act, Macquarie upgrades to Outperform from Neutral. Risks around completing the OnePath deal remain, although a material impediment has been removed. While there is still work to be done, Macquarie believes the steps taken by IOOF to regain the confidence of the market are encouraging. Target is raised to $7.00 from $5.80.

2. ILUKA RESOURCES (ILU) was upgraded to Outperform from Neutral by Macquarie

Macquarie upgrades to Outperform from Neutral, reflecting a view that the share price over-reacted to the downside risk in the zircon market. The broker calculates Iluka Resources is now trading on free cash flow yields of 13-15%. Target is raised to $8.70 from $8.50. The broker assesses material upside risk to forecasts running at a spot price scenario.

3. PREMIER INVESTMENTS (PMV) was upgraded to Outperform from Neutral by Macquarie

Macquarie found the FY19 results strong in the context of a challenging market. The company’s multi-channel strategy exceeded the broker’s expectations and earnings visibility has improved. Further clarity on the wholesale channel trajectory is likely to be a positive catalyst and wholesale remains the source of upside risk, in Macquarie’s view. Rating is upgraded to Outperform from Neutral and the target raised to $20.00 from $17.20.

See downgrade below.

4. REGIS RESOURCES (RRL) was upgraded to Equal-weight from Underweight by Morgan Stanley

Morgan Stanley introduces a new valuation system for its gold stocks under coverage to better capture value and more accurately represent the current value. The broker points out gold miners under coverage have continually found new resources and reserves and extended mine life, which is particularly pronounced for the mid-cap miners which operate assets with short lives. The broker raises estimates for FY20 by 8% for Regis Resources and upgrades to Equal-weight from Underweight. Target is raised to $5.20 from $4.65. Industry view is Attractive.

In the not-so-good books

1. A2 MILK (A2M) was downgraded to Sell from Neutral by Citi

Citi remains convinced margin pressure will make consensus forecasts look too optimistic and the analysts have now downgraded to Sell from Neutral. The target price declines to $12.20 from $15.15. Citi finds a2 Milk needs to increase investment in order to pursue growth in China and the US, and this translates into margin pressure. In addition, the analysts find the daigou channel is no longer reliable to drive growth and competition is increasing. Forecasts have been reduced following incorporation of lower margins. Target price decrease also includes a reduction in valuation premium.

2. CLOVER CORPORATION (CLV) was downgraded to Neutral from Buy by UBS

In FY19 growth occurred in all regions, and while cash flow was weak it improved in the second half. UBS continues to believe the outlook strongly favours
the company but, following the share price appreciation of 98% since February, most of the positive outlook appears factored in. Hence, the rating is downgraded to Neutral from Buy and the target raised to $2.75 from $2.15. The broker forecasts European revenues to increase out to FY21 as new regulations come into effect while any new competitor is at least 2-3 years away. There is also upside risk to forecasts should China mandate DHA increases.

3. FORTESCUE METALS GROUP (FMG) was downgraded to Underweight from Equal-weight by Morgan Stanley

Morgan Stanley acknowledges Fortescue Metals is a high-quality company but the stock is now 13% above the target. The broker expects the headline iron ore price and 58% price realisation will recede from current highs in the first half of 2020 as supply rises. Rating is downgraded to Underweight from Equal-weight. Target is raised to $7.85 from $7.65. Industry view is Attractive.

4. NEWCREST MINING (NCM) was downgraded to Underperform from Neutral by Macquarie

Following the recent rally in the share price Macquarie has downgraded to Underperform from Neutral. Target is $35.

5. NEW HOPE CORPORATION (NHC) was downgraded to Underperform from Neutral by Macquarie

Macquarie reduces thermal and coking coal price forecasts for 2019 and 2020, which weakens the outlook. Moreover, uncertainty surrounding the future of New Acland adds to the pressure on the stock. Rating is downgraded to Underperform from Neutral. Target is reduced to $2.10 from $2.20.

6. OROCOBRE (ORE) was downgraded to Underperform from Neutral by Macquarie

Macquarie downgrades to Underperform from Neutral. Target is $2.50.

7. PREMIER INVESTMENTS (PMV) was downgraded to Sell from Neutral by Citi

Citi analysts have downgraded Premier Investments to Sell from Neutral with a slightly higher price target of $16.80 (was $16.40). The analysts don’t see further re-rating happening because they don’t believe earnings upgrades will happen. With wholesale channels now the key earnings driver for Smiggle, and core retail sales slowing, Citi believes past the next six months, momentum is unlikely to stay strong. On Citi’s assessment, reported FY19 proved slightly ahead of market consensus. They also believe the share price is now trading at a premium to other discretionary retailers.

8. SOUTH32 (S32) was downgraded to Underperform from Neutral by Macquarie

Reductions to alumina and coking coal price forecasts have weakened the earnings outlook for South32 and Macquarie downgrades to Underperform from Neutral. The broker notes the company has started to materially underperform both BHP Group (BHP) and Rio Tinto (RIO). The absence of iron ore in the portfolio and the declining alumina and aluminium prices have combined to drive the underperformance, in Macquarie’s view. Target is reduced to $2.60 from $2.70.

9. SANDBFIRE RESOURCES (SFR) was downgraded to Neutral from Outperform by Macquarie

Following the recent rally in the share price, Macquarie downgrades to Neutral from Outperform. Target is steady at $6.80.

10. WHITEHAVEN COAL (WHC) was downgraded to Neutral from Outperform by Macquarie

Reductions to 2019 and 2020 coking coal estimates and 2019 reductions for thermal coal have weakened the outlook and Macquarie downgrades to Neutral from Outperform. Target is reduced to $3.40 from $4.00.

The above was compiled from reports on FN Arena. The FN Arena database tabulates the views of seven major Australian and international stock brokers: Citi, Credit Suisse, Macquarie, Morgan Stanley, Morgans, Ord Minnett and UBS. Important: This content has been prepared without taking account of the
objectives, financial situation or needs of any particular individual. It does not constitute formal advice. Consider the appropriateness of the information in regard to your circumstances.
Questions of the Week
by Paul Rickard

**Question 1:** What is the broker consensus target price?

**Answer:** Most of the major broking firms calculate a target price for the stocks they analyse. It is usually looking 12 months’ out. The consensus target price is the average of the broker targets.

**Question 2:** We were 95% equities and 5% cash in our SMSF just before retirement. However, just after my husband retired, we changed the mix of equities to include about 30% ETFs including SWTZ, MOAT, MFG and NDQ. We also chose higher dividend shares like bank shares and Rio, BHP but did keep some growth stocks. The ETFs are listed on the ASX but are they considered a different asset class (for ATO purposes) and will we satisfy the diversification rules?

**Answer:** You are certainly more diversified with the ETFs. The ATO uses pretty rudimentary classification schemes, based off the Annual Return Data that SMSFs submit. If you have classified MOAT and NDQ (which are listed on the ASX) as Australian equities, then their records will show that your exposure is 95% to Australian equities. But I think it is wrong to classify them as Australian equities – I would reclassify as international equities.

If you get queried by the ATO, it should be just a matter of confirming this with your auditor.

**Question 3:** I would be interested in hearing your view on the upcoming Centuria Metropolitan REIT (CMA) entitlement offer.

**Answer:** The institutional offer at $2.86 was very well supported and the stock is now trading around $3.06. The property acquisitions (on paper) strengthen the profile of CMA and the forecast distribution remains quite attractive. On this basis, I would be supportive of participating in the entitlement offer (obviously subject to cashflow and any exposure limits).

**Question 4:** I currently have shares in Thorn (TGA). They have had a rough run for about 18 months. They are offering a 24 cent share purchase for existing shareholders. What are your thoughts on the soundness of Thorn going forward?

**Answer:** Investors Mutual and Forager Funds have backed the institutional entitlement (a 1-for-1 entitlement at 24 cents a share) so I guess that is a positive. They are canny investors. But it has been a dog and Thorn Groups (TGA) underlying business (consumer finance) doesn’t do much for me so it is not a stock I have followed closely. None of the major brokers cover the stock. Morningstar says it is “undervalued” and has a target of 35 cents.

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