THE INTELLIGENT investor SPECIAL REPORT

Small Companies Special Report

A LETTER FROM THE ANALYST

Dear Subscriber,

Welcome to *The Intelligent Investor*'s Small Companies Special Report. Before we begin, I have a confession to make. I'm very partial to investing in small companies, and have been ever since I began investing 14 years ago. Small companies, or 'second liners' as they are known, are often more dynamic and, if truth be told, much more exciting than their blue chip brethren.

But make sure it's the right kind of excitement. The 10–20% of your portfolio that you might decide to set aside for small companies shouldn't be treated as 'play money'. Instead, stick to the same conservative investing principles whether choosing small companies or large. In other words, look for a quality business with good management, some track record of profitability and, most importantly, an excellent price. The fact that a company is small doesn't mean you should relax your standards.

Instead, let your excitement come from buying underpriced, quality businesses that you hold for years. Indeed, some of the fun comes from identifying potential tenbaggers, such as **Harvey Norman**, **Flight Centre** or **Cochlear**. Rare quality these may be, but all were small companies once, and all had excellent business models when they floated a decade or more ago. Owning such great growth companies is very rewarding, in more ways than one. But small company investing is about more than quality growth stocks—you'll also find some fallen stars just ripe for a turnaround gracing the pages of *The Intelligent Investor*.

The purpose of this report is to recap on some of our best small company ideas and provide some new ones. Inside, you'll find summaries of **ARB Corporation**, **Infomedia**, **Volante Group, Croesus Mining** and **JB Hi-Fi**. We've also ferreted out a couple of new ideas—**GWA International** and **Wattyl**. While not strictly new—we covered both of them some years ago—we feel they now offer good value, although each is a very different company.

In *issue 175/May 05* we published the first of our popular 'radar screen' articles, which look at companies we're currently considering. We've since followed up these articles with half a dozen or so buy recommendations once we did more work. You'll find another radar screen inside, and we'll keep a close eye on the stocks in it for buying opportunities.

Finally, thanks to Gareth, Steve and Tim for their collaboration on this report. We hope you enjoy it.

Yours sincerely

James Greenhalgh

James Greenhalgh

ARB Corporation's American adventure

Who'd have thought kitting out four wheel drive vehicles with bull bars and other paraphernalia would be so profitable?

SNAPSHOT	
ARB CORPORATION (ARP)	**$2.83**
MARKET CAPITALISATION	$188m
HISTORICAL 12-MONTH PRICE RANGE	$2.66–$4.00
FUNDAMENTAL RISK	3 out of 5
SHARE PRICE RISK	3 out of 5
OUR VIEW	LONG TERM BUY

Four wheel drive accessories manufacturer ARB Corporation is the sort of stock you wish you bought ten years ago. Between 1996 and 2005, total sales grew at an average rate of 15% a year, while earnings before interest and tax grew at an even more impressive 23% a year. No wonder the stock has risen more than tenfold over the past decade.

But investing can't be done looking in the rear view mirror. While ARB's past performance offers a clue to its management quality and the above-average economics of its business, it doesn't guarantee impressive performance from here. High oil prices have put a dent in four wheel drive sales, and this has turned what has been a large tailwind into something of a headwind. Given the 20% fall in the stock price since we first recommended it in *issue 158/Aug 04 (LONG TERM BUY—$3.53)*, and a current PER of 15, plenty of investors think that ARB will struggle to produce above-average growth. While we don't expect a repeat of the incredible growth achieved over the past ten years, we think the company can continue to grow earnings at an impressive clip. And, come 2015, we expect people will still be wishing they bought this stock ten years ago.

First of all, the company is working hard on its sales network in Australia. As well as an impressive network of independent retailers stocking ARB products, there are seven company-operated stores and 15 ARB branded franchise stores. More stores will open soon.

The group also has significant untapped potential in the sports utility-mad American market, where it has operated profitably for years. The ARB Air Locker, an air-operated locking differential, is a particularly strong product there. Its reputation is such that many four wheel drive aficionados won't touch competing products.

We're a little more guarded about the opportunities the company is espousing in Thailand, the world's second-largest market for pick-up trucks. But, with a welder shortage at its Victorian manufacturing plant, the group will soon open a manufacturing plant in Thailand, where welders are plentiful, skilled and cheap. Addressing this skills shortage should help ARB improve profit margins. A falling steel price, which is smashing the likes of **BlueScope Steel**, will also help.

We think strong American sales growth provides some evidence that ARB can continue to grow earnings despite running into a headwind. And if the oil price were to fall, it could provide a very nice boost, although it's not something we are counting on. ARB currently offers a reasonably attractive fully franked yield of 3.7% and, we believe, above average growth prospects without a matching price tag. **LONG TERM BUY.**

Disclosure: Interests associated with *The Intelligent Investor* own shares in ARB Corporation.

Will Volante emerge victorious?

Volante's business model is changing for the better. And we're quite happy to take advantage of the recent share price hiccup.

SNAPSHOT	
VOLANTE (VGL)	**$0.87**
MARKET CAPITALISATION	$112m
HISTORICAL 12-MONTH PRICE RANGE	$0.82–$1.70
FUNDAMENTAL RISK	3.5 out of 5
SHARE PRICE RISK	4 out of 5
OUR VIEW	LONG TERM BUY

When the headhunters approached Ian Penman, Volante's new managing director, to take the job in 2004, he was 'initially lukewarm'. The reason was simple—he believed the company to be a simple hardware middleman without much growth potential. Re-selling computer hardware is undoubtedly a cutthroat, seasonal, and cyclical business.

But in recent years, Volante's business has been changing. While it still generates most of its revenue from hardware sales, it now makes the majority of its profits from providing higher-margin information technology services such as security consulting and software development. It is this transformation that encouraged Penman to take the job.

The difference between the two divisions is obvious from their respective gross margins. Whereas the hardware sales margin is typically less than 10%, the gross margin on providing services to the same clients was 37% in 2005. But while the company's services business is growing strongly, the hardware sales business has been doing just the opposite in recent months.

Indeed, that's exactly why the share price has tanked. Hardware sales are likely to fall $24m below budget in the first half, which has to have an effect on the bottom line, notwithstanding $3.5m of cost reductions. In reality, occasional bad quarters and half-years are par for the course in this business. At the recent AGM, though, Penman confirmed that he expected full-year earnings before interest, tax, depreciation and amortisation (EBITDA) of about $30m.

What chairman Robin Crawford wouldn't confirm, though, was a continuation of the company's typically generous dividend. Volante paid out 8 cents a share, fully franked, in each of 2002 and 2003, and 8.5 cents in each of 2004 and 2005. But with paltry retained earnings, and some capital expenditure commitments this year, it's possible the dividend might be cut. Even if Volante reduced its dividend to 5 cents in 2006, that still represents a 5.7% yield at the current price—certainly nothing to sneeze at.

Volante is not without risk, of course. There has been a management shake-up at the company since Penman took control, and teething problems with the new sales system. Direct sales by hardware vendors are a competitive threat, as is the ongoing price deflation that bedevils the sector.

But we think the price forgives these sins. When you consider that IT services company Kaz, admittedly a slightly different business, was acquired by **Telstra** for 7.6 times EBITDA, Volante's multiple of 3.7 times looks cheap. Volante's forecast PER of about 11 is also very reasonable.

We've recommended Volante quite recently, initially in *issue 189/Nov 05 (LONG TERM BUY—$0.96)*. And, with each of Penman and Crawford buying shares at above the current level, we're confident enough to call the stock a LONG TERM BUY.

JB Hi-Fi packs 'em in

A retail slowdown is always a threat to retailers, but JB Hi-Fi's low-cost business model means it consistently sells more cheaply than the competition.

SNAPSHOT

JB HI-FI (JBH)	$3.83
MARKET CAPITALISATION	$394m
HISTORICAL 12-MONTH PRICE RANGE	$2.80–$4.35
FUNDAMENTAL RISK	4 out of 5
SHARE PRICE RISK	3.5 out of 5
OUR VIEW	LONG TERM BUY

JB Hi-Fi is a cut above your average retailer. The company has a significant share of a niche market, it's well-managed, and it has a proven track record—although its strong growth is a recent phenomenon. Its business is the discount retailing of mainly electrical goods such as televisions and stereos, as well as consumer products such as DVDs, CDs and computer games. While electrical goods retailing isn't anything new, JB Hi-Fi's business model is devastatingly simple.

Whenever we compare JB Hi-Fi's prices with other retailers, they are nearly always cheaper, which explains why the stores are regularly packed with shoppers. It makes profits at prices that other retailers can't because it has very low running costs. There's more on the company's low-cost business model in our initial review in *issue 176/May 05 (LONG TERM BUY—$3.43)*.

Originally from Victoria, the company has expanded quickly across Australia and it's now making a big push into Sydney. At 30 June 2005, the company had 48 stores, an increase of 16 on the previous year. And, this financial year, at least 16 new stores will be opened, the majority of them in Sydney. These store openings mean profit growth has been pretty impressive. In 2005, for example, the company reported a 50% increase in net profit to $20.7m.

Of course, the company has benefited from strong retail conditions. Until recently, consumer confidence and retail spending have been at record levels on the back of a strong economy and the 'wealth effect' from the property boom. But it's a vastly different story now. Higher interest rates, oil prices, overloaded credit cards and falling house prices have all taken their toll.

Slowing consumer spending will affect all retailers and JB Hi-Fi is no exception. Sales of its highest-margin products such as sound systems and plasma televisions will be affected if house prices keep falling. In such an environment, it's a relatively risky strategy to open stores aggressively. But JB Hi-Fi has gained market share from struggling competitors such as Megamart and **Strathfield** because of its low prices, and we can't see that changing soon.

So what about the stock price? Based on forecast earnings per share of 27 cents in 2006, the company is trading on a PER of 14. There are risks to investing in a fast-growing retailer at the moment, but we believe the potential upside makes it well worth it. LONG TERM BUY.

Disclosure: Interests associated with *The Intelligent Investor* own shares in JB Hi-Fi.

Croesus digs in

This miner has its share of problems, but we think there are many more ounces of gold to come from Norseman.

SNAPSHOT

CROESUS (CRS)	$0.325
MARKET CAPITALISATION	$107m
HISTORICAL 12-MONTH PRICE RANGE	$0.29–$0.64
FUNDAMENTAL RISK	4.5 out of 5
SHARE PRICE RISK	4.5 out of 5
OUR VIEW	SPECULATIVE BUY

The gold mining sector hasn't exactly been a glittering beacon of sharemarket value for quite a while. But while **Newcrest Mining**'s share price has been reaching for the stars, unjustifiably in our opinion, the share price of one of the smaller producers, Croesus Mining, has been distinctly earthbound. Indeed, we've had a Speculative Buy recommendation on the company since *issue 170/Mar 05 (SPECULATIVE BUY—$0.46)* and the share price is down 29% since then. We'll get to the reasons for that in a moment, but let's recap why we like this little miner.

Our interest has to do with the company's Norseman mining operations. If we had to summarise why we like those mines in three words, they would be 'excellent head grade', which refers to the high gold content of the ore mined. The company never has more than a couple of years

[CONTINUED ON PAGE 4]

Croesus digs in [CONTINUED FROM PAGE 3]

of gold reserves, though, because the ore bodies are 'fractured', meaning measurement isn't easy. But what we do know is that Norseman has produced 5.3 million ounces over the past 70 years, and we're prepared to bet the gold won't run out any time soon. Indeed, the company recently announced, for example, that it expects the Harlequin Lode to contain at least one million ounces of the shiny stuff.

That's the good news—and what we focus on when the short term looks a little ugly, as it does now. Poor gold production in the second half of 2005 and the related high cash costs, combined with some writedowns of legacy assets, pushed the company to a $17m loss last financial year, its first since 2001. Unfortunately the unpleasantness has continued this financial year, with Croesus's cash position deteriorating by $9m during the first quarter to $13m.

Management hasn't exactly been stable, either, with three managing directors in less than a year, although we weren't unhappy to see the back of the second one. But we definitely were sorry to see Ron Manners, the company's wise and humble chairman and founder, step down at the recent AGM in favour of a new chairman.

None of this is great news, but production problems are part and parcel of mining stock investment, and they help to explain the speculative nature of this recommendation. To shore up its cash position and focus on the more attractive Norseman operations, Croesus has recently sold its Davyhurst operations for $5m.

Our mild bullish stance on the long-term gold price, if we are allowed to admit to such macroeconomic leanings, tends to reinforce our case. Nevertheless, there is a risk that Croesus's operations don't turn around and that it's forced into a shotgun wedding, or worse. We don't expect that outcome, but it would be remiss of us not to mention it.

Whatever transpires, we're reassured by the quality of the Norseman operations themselves. That fact alone should help the company get through the temporary setback of producing 'just' 130,000-odd ounces this year. **SPECULATIVE BUY.**

Disclosure: Interests associated with *The Intelligent Investor* own shares in Croesus Mining.

Infomedia's repair strategy

Infomedia's market might be changing, but its years of experience count for something.

SNAPSHOT

INFOMEDIA (IFM)	$0.54
MARKET CAPITALISATION	$176m
HISTORICAL 12-MONTH PRICE RANGE	$0.45–$0.82
FUNDAMENTAL RISK	3 out of 5
SHARE PRICE RISK	3.5 out of 5
OUR VIEW	SPECULATIVE BUY

We first recommended this supplier of electronic parts catalogues in *issue 159/Sep 04 (BUY—$0.63)* and we've been positive ever since. Infomedia was, and still is, one of our strongest buy recommendations. We've included it here because it's a perfect example of the value you can find at the small end of the market. We recommend you review what we've written previously, particularly the articles in *issues 164/Nov 04 (BUY—$0.74)* and *174/Apr 05 (BUY—$0.52)* and the December 2004 special report titled *What would Phil Fisher maker of Infomedia?*

To understand this company, and what we believe to be its competitive advantage, it's best to try and understand the role that it is fulfilling. Car manufacturers such as General Motors, Ford and Toyota build cars. Hundreds of dealerships then sell the cars and, most importantly for Infomedia, repair and service them. When the dealership is repairing the cars, it needs a 'catalogue' to tell it which part is which and which ones to order. When the manufacturer builds the car it collects mountains of raw data on parts and this is where Infomedia comes in. Its role is to convert the manufacturer's raw data into a catalogue for the dealerships—one that is accurate and easy to use.

There is no doubt that Infomedia is very good at this business. The company has grown from $21m of sales in 2000 to $59m of sales in 2005. It now has more than 47,000 subscribers to its electronic catalogue, called Microcat, and it's highly profitable. But the share price has fallen 80% since its peak of $2.65 in November 2000. Presumably there is something going wrong?

Several manufacturers already produce their own electronic parts catalogues, such as Peugeot, for example. The risk, for Infomedia, is that more manufacturers head down this route. Ford Europe (which was once Infomedia's largest customer, providing 18,000 subscribers) and General Motors North America have both recently decided to have a go at it themselves. They think they can provide it cheaper and, given they own the data, they can do as they please.

But we think this risk is overblown and the shares look cheap. Our basic premise is that Infomedia is a specialist with many years of experience and, accordingly, it makes a better product. The manufacturers may be able to produce something cheaper, but this is such an integral part of a dealership's business that it doesn't really matter if the product costs $50 or $100 a month; it just wants the best product it can get. Although the next couple of years might be tough, this, combined with a couple of exciting new products, gives us confidence Infomedia's growth will resume.

The good news is that, at current prices, you don't even need much growth. The current share price provides a 6% fully franked dividend yield and an underlying PER of 10. Even so, we have confidence that better times are over the horizon and we reaffirm our **BUY** recommendation.

Disclosure: Interests associated with *The Intelligent Investor* own shares in Infomedia.

GWA keeps a lid on success

You may not know the company but you'll almost certainly know its brands. And its long-term record isn't bad either.

SNAPSHOT	
GWA INTERNATIONAL (GWT)	**$3.00**
MARKET CAPITALISATION	$835m
HISTORICAL 12-MONTH PRICE RANGE	$2.52–$3.50
FUNDAMENTAL RISK	2.5 out of 5
SHARE PRICE RISK	3 out of 5
OUR VIEW	LONG TERM BUY

In his book *One Up on Wall Street*, Peter Lynch lists thirteen characteristics of his perfect stock. One of them is 'It sounds dull', another is 'It does something disagreeable' and a third is 'It's a no-growth industry'. Well, GWA International which, despite its name only derives 15% of revenue from exports, scores a hat-trick. The company's name is as dull as they get; it makes toilets, of all things; and it happily acknowledges that growth won't be much higher than the economy in general.

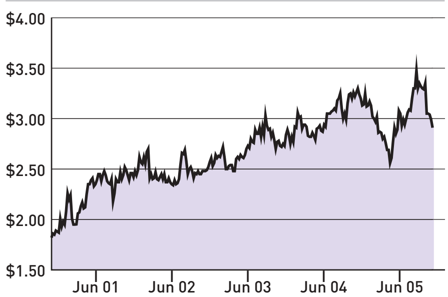
But GWA doesn't just make plain old toilets—it makes Caroma 'sanitaryware', as the company prefers to call it, Dorf tapware and Clark sinks. All brands are market leaders in their respective segments. GWA also produces Dux water heaters, Gainsborough door hardware, and Rover mowers. You may well have come into contact—quite literally—with one of the company's products today. Even if you've missed out on the pleasures of a Caroma toilet, you've probably sat in a Sebel seat, also made by GWA, at a stadium or concert hall at some point.

Dull but consistent

All in all, GWA is a very dull business, which is just how we like it. Apart from the odd cyclical hiccup, the company has produced a solid trend of rising profits and cash flows—year in, year out—since listing in 1993. And a glance at the five-year financial summary in the company's 2005 annual report shows some other impressive trends over the period. Return on equity, for example, rose to a record 15% in 2005, while employee numbers declined 13% over the five-year period, despite a 14% lift in sales.

But the past few years have been the best of times for building-related businesses. With the housing market now falling away, particularly in key markets such as New South Wales, GWA will experience one of its inevitable cyclical hiccups in 2006. In fact, the company has recently forecast that earnings will decline by up to 10% this year, and the stock has already fallen by a similar amount from recent highs. The more important question, though, is: could it get worse?

Dux of its class?



Financials

YEAR TO JUNE	2003A	2004A	2005A	2006E
NPAT ($m)	55.0	62.1	63.2	56.4
EPS	19.8	22.3	22.7	20.2
Chg (%)	+17.9	+12.6	+1.8	−11.0
PER (x)	15.2	13.5	13.2	14.9
DPS	18.0	20.5	22.5	20.5
Fkg (%)	100	100	100	100
Yield (%)	6.0	6.8	7.5	6.8

It's certainly possible, but on this point GWA's history is instructive. The last decline in earnings occurred in 2001 following the GST-inspired 'building bust'. Revenue fell 6% at the time, but earnings before interest and tax (EBIT) fell a relatively painless 8%. And an even more impressive result was reported in 2005—despite a 4% revenue decline, EBIT actually rose marginally.

Management's role here has been important. Highly respected ex-**Nylex** managing director Peter Crowley, who was appointed in 2003, was instrumental in keeping a tight lid on costs in 2005. Raw material expenses fell 8% while administration costs were reduced by 14%. While there's only so much that can be done—which explains why profits will fall in 2006—such cost control is admirable and it reassures us that GWA shouldn't usually get walloped when the cycle turns against it (unlike **Wattyl**, which you can read about on the next page).

Debt levels declining

Perhaps our main concern with GWA is the potential for acquisitions. Debt levels have been declining so that the net debt-to-equity ratio now stands at 38%, down from 62% five years ago. The company has stated in each of the past four annual reports that it is seeking acquisitions, although the last was the fairly small Stylus bathroom products business in 2001. While Crowley doesn't strike us as an empire builder, and directors control 18% of the company, there is the possibility of a 'big bang' acquisition outside its core businesses.

And nor is GWA a screaming bargain—although, with its excellent long-term record, it's never likely to be. While the stock is trading on a historical PER of 13, a 10% earnings decline this year implies a prospective PER of 15. And if the housing market does worsen significantly, which has to be considered a possibility, the share price will undoubtedly decline further.

Providing some support, though, might be GWA's traditionally high yield, currently around 6%, fully franked. Shareholders have also been rewarded with 14.5 cents of special dividends over the past five years, so it's certainly been a good yield stock. Still, we wouldn't rely on the special dividends to continue forever. GWA has been paying out its excess cash but, if a distressed business becomes available, it will probably divert that cash to an acquisition.

All up, GWA appeals to us as a high-quality, second-line stock suitable for most portfolios. We haven't reviewed the company since way back in *issue 91/Nov 01 (BETTER VALUE ELSEWHERE—$2.43)* and we think our former view was too harsh. It's dull, disagreeable and there's not much in the way of growth—we're re-commencing coverage with a LONG TERM BUY recommendation.

Waiting for Wattyl Day

Wattyl's business isn't an easy one. But there's value here if management can cut costs and revitalise its brands.

SNAPSHOT	
WATTYL (WYL)	**$2.50**
MARKET CAPITALISATION	$211m
HISTORICAL 12-MONTH PRICE RANGE	$1.85–$3.94
FUNDAMENTAL RISK	4 out of 5
SHARE PRICE RISK	4 out of 5
OUR VIEW	LONG TERM BUY

The Golden Wattle was officially declared the nation's floral emblem on 1 September, 1988. And Wattle Day, though a low-key celebration, still holds a special place in the hearts of many Australians, symbolising as it does the dawn of a new season, loyalty, hope, optimism and colour.

These qualities were in short supply at the recent annual meeting of paint and coatings manufacturer Wattyl, which owns brands such as i.d., Pascol, Solagard Estapol, and Killrust. There was, however, a fair bit of colour, as long-term shareholders vented their anger at the board. And it was clearly not the first time they had done so—Wattyl's recent history has not been a happy one.

In 2001, a cyclical downturn and underperforming international operations conspired with high debt levels to send Wattyl into a tailspin. Chief executive Ian Jackson was brought in to fix the problems and, over the past four years, he managed to sell the company's woeful US business, reduce the net debt-to-equity ratio from 57% to just 6% and pay out dividends totalling 78 cents. But, just as it seemed Wattyl might be ready to turn the corner in 2005, another triple whammy slammed profits—a poorly timed inventory rundown, a downturn in the Australian housing market, and soaring raw material costs courtesy of the oil price. The stock once again went into freefall, Jackson fell out with the board, leaving in May this year, and current chief executive Dr John Nolan took the reins.

Margin squeeze

As you might have gathered by now, manufacturing paint is no easy business. Normally we avoid highly competitive, capital intensive, cyclical businesses such as Wattyl, as we noted some years back in *issue 111/Sep 02 (STEER CLEAR—$3.15)*. But every stock has its price and Wattyl looks like it's made it there. It is priced at about seven times the average of the past four years' operating cash flow, a figure which includes the 'cash flow crunch' experienced in 2005. The reality is, though, that 2006 profits won't be much better than 2005. At the AGM, Nolan acknowledged that housing starts would fall 4% this financial year, while raw material costs would rise by another $7m. Wattyl's margins, then, are being squeezed. So where's the upside?

It's in cutting costs. For all of Jackson's successes, he didn't really succeed at reducing Wattyl's high fixed cost base. Nolan's record in that department, though, is rather better. He was managing director of building products groups Amatek Holdings and then Laminex, while they were under private equity ownership, increasing the value of both substantially before they were sold to **Fletcher Building**.

Since taking control of Wattyl in May, Nolan has begun implementing the rather unimaginatively named 'Project Focus'. So far he has cut costs by $7m annually, but more work needs to be done, including reducing the number of products and rebuilding relationships with key corporate customers such as Bunnings.

Industry laggard

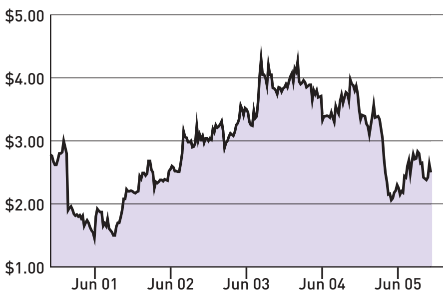
The upside, if he gets it right, is substantial. Wattyl's operating profit margins are currently an abysmal 4%. **Orica**'s Consumer Products division, where more than two-thirds of revenue comes from market-leading paint brand Dulux, boasts margins of about 12%. Historically, Wattyl's margins have exceeded 8%, so potential exists to return them to that level. Such a recovery suggests a net profit of $25m is possible, although that result depends upon a more favourable housing market.

Perhaps most interesting of all are the words uttered by Nolan when Laminex was sold to Fletcher Building three years ago: 'Our whole process is based around building the businesses and, when it's appropriate, exiting them'. While Wattyl's excellent brands have been tarnished by mismanagement, the company is the sort of branded, low growth, high cash flow business that tends to attract private equity funds. Its wide open share register, negligible debt and disgruntled shareholders make it a sitting duck for takeover.

Turnaround situations, though, are not low risk, especially when management owns as few shares as Wattyl's does. Cost cutting can backfire, while restructuring charges will probably mar the 2006 result once again. Moreover, there's no sign of the oil price easing, nor is the housing market recovering. Indeed, we wouldn't be surprised to see both worsen in the short term.

Wattyl, then, is not for conservative investors. But the company's strong brands produce excellent cash flow—a fact borne out by the high dividends paid out in recent years—and the cyclical downturn means it is once again somewhat underpriced. We are resuming coverage with a LONG TERM BUY.

Painting a picture?



Financials

YEAR TO JUNE	2003A	2004A	2005A	2006E
NPAT ($m)	–4.2	–28.3	10.0	11.0
EPS	–5.3	–34.7	11.9	13.0
Chg (%)	N/A	N/A	N/A	+9.2
PER (x)	N/A	N/A	21.0	19.2
DPS	18.0	30.0	22.0	12.0
Fkg (%)	100	100	100	100
Yield (%)	7.2	12.0	8.8	4.8

What's on our radar screen?

Here are nine more stocks that we're taking a look at. So far our radar screen articles have produced a handful of buy recommendations. Is the next one amongst these?

With more than 1,600 stocks on the Australian Stock Exchange, it can be difficult to know where to start. We're constantly searching for new buy ideas, so dozens of stocks drift across our 'radar screen' every week. Because we seek value, we're usually attracted to companies that have fallen sharply in price. But we're not completely averse to fast-growing businesses with hefty price tags—so long as we think the forecast growth will occur, of course.

While many stocks register a 'blip' when we pass our bargain detector over them, only a few go on to earn positive recommendations. Here is a selection of those companies where we're still digging. We'll keep an eye on each company but there's nothing stopping you from doing your own research. Let's get started in an unlikely place—technology stocks.

PowerTel pushes ahead

The funny thing about bubbles is that they're usually followed by an almighty wash-out. And that is exactly what's happened in the wake of the tech wreck five years ago. The weaker companies have by now failed, leaving behind those with real businesses and, in many cases, emerging cash flow.

Telecommunications company **PowerTel** was one of the many caught up in the technology bubble. It spent hundreds of millions of dollars building a fibre-optic telecommunications network connecting the major cities along Australia's east coast, only to suffer enormously because too much capacity ended up chasing too few customers. As the smaller players in the industry failed or were acquired, the larger ones such as PowerTel have finally achieved the scale they needed and are now cash flow positive.

While it's still a very capital intensive and competitive business, PowerTel is now a specialist provider of voice, data and internet services to businesses and wholesale customers. It expects to achieve revenue of almost $200m this year and earnings before interest, tax, depreciation and amortisation of more than $27m. A colleague of ours attended the November management briefing and suggested we 'look into it', and that's exactly what we're going to do.

Technology One for the road

Australia isn't known for prominent software businesses. If pushed, you might come up with accounting software provider **MYOB** as the country's best-known software brand, but there are a couple of quality stocks with low profiles. **Technology One** also develops accounting and management software, but mainly for medium-sized organisations, whereas MYOB's traditional strength was, until it acquired Solution 6, the smaller end of the market.

While Technology One was caught up in the tech wreck, its profitability suffered only slightly. And it seems to be well managed and shareholder-focused: rather than blowing its cash pile on acquisitions, the company managed to buy back 19.6m shares near the lowest price the stock ever traded in 2002. It also has several other positive traits—it expenses all research and development and pays an excellent fully franked dividend equating to a yield of 5.4%. And while profit growth will be anaemic in 2006, its forecast PER of 16 is hardly in nosebleed territory.

Melbourne IT: domains 'r' us

The third and final technology stock to register a 'blip' for us recently has been **Melbourne IT**. This domain name registrar was one of the more famous 'dot coms', soaring from $1.00 to more than $15.00 at the height of the tech bubble, on the back of actually selling '.com' and '.com.au' internet domain addresses to businesses and individuals. It's a competitive business, but somehow Melbourne IT has carved out a niche for itself in the domain name registration market. It's another cash-rich company, with $23m of cash on its balance sheet, a yield of approximately 5% and a price to operating cash flow multiple of about 10 times. But if technology stocks aren't your thing—and they are a bit riskier than some other sectors—what else is there?

Hunting for value at The Reject Shop

Retailing stocks can make you a motza, particularly if you buy them early in their life cycle (which is why we like **JB Hi-Fi**—see page 3). Belying the problems experienced by other companies in the discount variety sector, **The Reject Shop** has been very successful in this area, rolling out 11 stores in 2005 and managing to increase gross margin by 0.6% (which makes a big difference when margins are extremely low).

Unfortunately our unpleasant experience with **Miller's Retail**'s discount variety business last year means our view of The Reject Shop was probably coloured. At the time of its listing at $2.00 per share in June 2004, we ignored its single digit PER. That has cost us, with the stock now more than double that and trading on a prospective PER of 15. It's one we'll keep on the watch list, though, in case any hiccups provide us with a buying opportunity.

UndercoverWear flies under the radar

UndercoverWear is not strictly a retailer, but a direct selling company. Using the home party method that's popular overseas, the company's consultants sell lingerie and other clothing to female buyers (although the company's annual report was also popular with *The Intelligent Investor*'s male staff members). Like The Reject Shop, UndercoverWear is another recent float, although it has performed even more spectacularly, rising 232% from its 50 cent issue price.

The company certainly has the potential to grow strongly without the need for much capital investment—just the sort of business we love. In 2005, earnings per share before goodwill amortisation increased tenfold to 7.7 cents, and we suspect the company will exceed 10 cents fairly easily this year. Stock liquidity may be a sticking point, but it's one to keep an eye on.

What's on our radar screen? [CONTINUED FROM PAGE 7]

Noni B's A-grade performance

Returning to more traditional retailers, **Noni B**'s two main retail chains are its own brand, and Liz Jordan, both aimed at quality conscious women. Like The Reject Shop, the stock had a shaky start to listed life, remaining below the $1.00 issue price for most of its first few years. But since then the company's performance has been strong, and the stock now trades at more than three times that price.

We looked at the company briefly in our review of Souls Funds Management's portfolio in *issue 186/Oct 05*. Our conclusion then was that the prospective PER of 15 was probably a little high, but that we'd look for an entry point if a slowdown were to hit. Still, it's a quality small retailer that probably deserves a premium.

Now that we've had a look at some retailers, let's look at three companies that fit into the broad category of 'business services'.

HJ&B Group does the job

The recruitment sector consists of a significant number of small companies following a flood of listings over the past decade. But many of these stocks have performed poorly, including **Ross Human Directions** and **Hamilton James & Bruce Group**, which are respectively down 47% and 69% from their $1.00 issue prices. Make no mistake—this is a low margin and ultra-competitive sector, and profit warnings from both companies have been unpleasantly frequent. Indeed, they each served one up in November.

Over the past three years, though, HJ&B has been profitable and cash flow positive, so a recovery is likely at some stage. The company has also just paid a 2 cent special dividend. And, perhaps adding some takeover spice, **Chandler McLeod**, a competitor in the sector, has been creeping up the share register and now holds 15%. As Chandler is five times the size of HJ&B, and its stated aim is to participate in sector consolidation, it's quite possible that HJ&B won't be an independent company for long. Liquidity is once again an issue with this stock, but the company certainly doesn't look expensive.

Tribeca must try harder

After a disastrous incarnation as a provider of online education to high school students, **Tribeca** entered the financial services education market in 2000. It now provides financial services and financial planning training, professional development (including to *The Intelligent Investor*), and compliance training.

We haven't been overly happy with management's acquisitive tendencies: the recent purchases of accounting training and real estate training firms look to us to be outside the company's core business. While Tribeca has had a somewhat patchy record, based on the recent first-quarter profit before tax of $1.4m, the market capitalisation of $46m seems inexpensive for a company with an annuity-type revenue stream. We're watching Tribeca closely to establish whether the strong first-quarter result was more than a one-off.

Landmark White in the black

There will always be demand for property valuers, even if that demand varies with market cycles. **Landmark White** employs about 65 valuers, performing valuations for banks, institutional investors and property trusts. The company has several things going for it: it doesn't require much capital; existing shareholders retained almost 80% of the company when it floated in late 2003; and directors have been buying shares consistently over the past year.

But, as you might expect, the property market is making life difficult for the company. In 2005, earnings fell 27% to $1.4m—equivalent to 5.2 cents per share—and this year management expects to report a similar amount. With the shares well off their highs of about a $1.00 and not far from their 50 cent issue price, Landmark White doesn't look expensive on a prospective PER of 14. Of course, the property market might deteriorate further and, if that happens, Landmark White might become a very interesting counter-cyclical play.

We'll keep an eye on all of these stocks over the next few months. Most won't make the cut, but if you don't look, you won't find.

Disclosure: Interests associated with *The Intelligent Investor* own shares in Tribeca.

What's on our radar screen?

COMPANY	ASX CODE	SHARE PRICE	MARKET CAPITALISATION
PowerTel	PWT	$1.21	$168m
Technology One	TNE	$0.575	$172m
Melbourne IT	MLB	$1.325	$72m
The Reject Shop	TRS	$4.35	$110m
UndercoverWear	UCW	$1.66	$80m
Noni B	NBL	$3.55	$114m
HJ&B Group	HJB	$0.31	$19m
Tribeca	TBC	$0.335	$46m
Landmark White	LMW	$0.71	$19m