

Reporting Season Snap Shot: Smalls Caps deliver some positive surprises

September 2011

In a month where volatility was the dominant theme across global and domestic equity and bond markets, overall results from the August 2011 reporting season were in line, or slightly better than, our expectations. However, few companies were brave enough to provide firm guidance for FY12 given the volatility in world markets and signs of weakness in parts of the Australian economy.

The trends emerging during reporting season included:

- **More positive surprises in small caps.** Despite the doom and gloom in the market, data from JPMorgan showed that there were more positive reactions to small cap results (27%) than large cap results (14%). For small caps, this was better than the previous reporting season and ahead of the number of negative surprises (13%).
- **Balance Sheets are stronger, capital coming back to shareholders.** A closer inspection of reported accounts provides investors with some comfort that debt levels have been reduced significantly. Average interest cover for the market on our forecasts is a healthy 21.7x – the average for stocks held in the Perennial Value Smaller Companies Trust (the Trust) is even healthier at 29.1x. As a result, several of the companies held in the Trust decided to increase returns to shareholders via:
 - Buybacks [Pacific Brands Limited (PBG), Coventry Group Limited (CYG) and iiNet (IIN)].
 - Growth in dividends [Mortgage Choice Limited (MOC), McPherson's Limited (MCP), Oakton Limited (OKN), Tox Free Solutions Limited (TOX), Breville Group Limited (BRG) and Prime Media Group Limited (PRT)].
 - Special dividends [NIB Holdings Limited (NHF) and Alesco Corporation Limited (ALS)].
- **M&A picks up, as corporates see value.** Despite the weak markets and investor caution, many corporates continue to see value with M&A activity picking up significantly during August. This was seen in the resources sector, with bids for Bow Energy and Minara Resources, as well as non-index stock WPG Resources (held in the Trust) - where One Steel is paying a significant premium for its iron ore assets. Outside of resources, there was an investor paying a large premium to acquire a strategic stake in Miclyn Express Offshore (held by the Trust and sold at a premium) and a bid from the Commonwealth Bank of Australia for Count Financial. Charter Hall also benefitted from a bid for its satellite, Charter Hall Office.
- **Two speed economy is real.** Several poor results from the retail and housing sectors were in contrast to a strong performance from resource companies and the mining services sector. The Trust has been favourably exposed to the mining services sector for some time and was encouraged by strong results and outlook statements from Tox Free Solutions, Industree, Ausdrill and Sedgman (all held in the Trust).

Guidance for FY12

While few firms were brave enough to provide firm guidance for FY12, companies in the mining services sector delivered buoyant results and generally gave a positive update on their forward order books.

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Our reporting season score card

During reporting season, the Team attended 128 ex-100 meetings.

- Good results are possible in tough sectors:** Detailed research and understanding of each company can sometimes identify good businesses which have been sold down on industry concerns but are able to outperform despite tough conditions. Fantastic Furniture (held in the Trust) is one such example. It delivered a 12% improvement in underlying profit, almost doubled its cashflow in a very poor retail environment and also disclosed positive sales growth in the start to the new financial year. Adelaide Brighton (held in the Trust) had been sold down by the market given its (relatively small) residential exposure. However, it surprised the market by reporting an interim result in line with early guidance and provided new guidance indicating a strong six months ahead. This reflected its large exposure to mining and infrastructure spending – something the market had overlooked.
- Valuations are compelling:** As the table below shows, the average valuation of the Trust is at a significant discount to the market - which in its own right is cheap by historical standards.

Prospective FY12	Price to Earnings (times)	Price to free cashflow (times)	Gross Yield (%)	Price to NTA (times)	Net Interest Cover (times)	3yr EPS growth (%p.a.)
Market Average (ASX 300)	10.3	9.8	6.9	1.8	21.7	9.4
Perennial Value Smaller Companies Trust	7.9	7.4	7.1	1.4	29.1	20.8
Premium/ (Discount) to Market	(23%)	(24%)	3%	(26%)	34%	120%*

Source: Perennial. As at 19 August 2011. The above figures are forecasts only.
* 4% premium vs Ex-100 market.

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*For Morningstar Award Disclaimer details please visit <http://www.perennial.net.au/content/documents/7326/1018142>.