

OPPORTUNITIES ON THE ALT X

PICKING DEEP VALUE

IN SHARES THAT SURVIVED THE IMPLOSION

By Marc Hasenfuss

The increasingly audible murmur around the market these days – amid the backdrop of the “green shoots” scenario – is that the AltX, the JSE’s board for smaller companies, is likely to offer some enticing opportunities. A quick scan through the nearly 100 new listings of the past four years will show – almost without exception – that market value has taken a serious smack. The AltX is down around 70% and it’s not uncommon to find newer listings trading at less than half their respective values of 12 months ago.

Clearly, the fundamentals for newer listings are more heavily discounted – perhaps justifiably, considering those counters have less of a track record than public companies. For example, compare the share price movements of Abil and Blue Financial Services, Capitec Bank and African Dawn, Onelogix and Value Group or Aspen and Myriad.

While every listings boom is inevitably followed by an implosion in value, perhaps the fallout in sentiment for newer listings should

be different this time around. A repeat of the disastrous late Nineties scenario seems unlikely with – as JSE marketing and new business executive Noah Greenhill puts it – many newer listing displaying fundamentals that show incredible resilience to tougher economic conditions.

Other market commentators have argued it’s taken two to three years for the share prices of recently listed companies to fall to levels that represent more realistic value. Most counters have dropped below their initial IPO offers. Some newer listings have even seen their share prices falling to levels that would suggest the company is being priced for disaster after encountering operational hitches and making less-than-prudent acquisitions. The share prices of Dialogue, Afbrick, Brikor, Finbond, Vunani, Workforce, SA French and WG Wearne have all come back to earth with a bruising bump.

But many others haven’t really put a foot wrong performance wise...and yet they’ve been marked down in sympathy with the





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laggards. Greenhill said at a recent presentation to institutions in Cape Town that it was clear many AltX members remained positive about prospects and reassured their respective businesses were sound.

There's a gradually growing consensus that picking deep value among selective newer listings could garner returns that should exceed any tinkering around the more established listings. Indeed, history will show there are always a handful of companies that not only survive the inevitable implosion that follows a listing but also go on to great things.

Major companies such as Spur Corporation, Nu-World, Medi-Clinic, Investec, Grindrod, Italtile, Sasfin and Bowler Metcalf crawled out of the wreckage of the late Eighties' listings boom. The implosion after the late Nineties' listing boom saw a slew of small cap contenders go to ground, leaving enough smoking debris scattered about the JSE to keep retail investors away for several years.

But there were some notable small cap survivors from the late Nineties, such as Digicore, UCS, Brimstone, AdvTech, Peregrine, Adapt IT, AME, SecureData, Pinnacle Technology, Compu-Clearing, Datacentrix, Afgri and Adcorp – all of which were "priced to go" only five to six years ago.

In 2002 Brimstone – now trading at 545c on the JSE – was trading at between 28c and 58c/share, Pinnacle – now at 210c – traded between 2c to 8c/share in 2002. Digicore – now 380c – was trading between 5c and 20c/share as recently as 2005, while private education specialist AdvTech – now 420c – was trading as low as 28c/share in 2003.

However, it would be amiss for *Finweek* not to mention that over 2002/2003 most speculative attention was centred on the turnaround prospects for weird and wonderful pennystock listings, such as Whetstone, JEM Technology, Essential Beverages, Maxtec, Cycad, Central Information Holdings, O'Hagan's, Nimbus, MMW Tech, Afribrand, Sweets from Heaven and Nextvest. None of those amounted to much and thoroughly deserved pennystock status.

Still, with the benefit of hindsight it's easy to see strong long-term returns can be secured by carefully

seeking out better quality newer listings – especially those of the small cap variety. However, the reality for ordinary investors is that amid the prevailing market gloom and steady flow of negative trading updates it's difficult to invest with conviction in opportunities offered by bombed-out new listings.

Coronation Fund Managers small cap expert Alistair Lea says the JSE's mid-cap stocks – heavily weighted in retail shares – have lately enjoyed a remarkably strong run on the back of a stronger rand (and lower interest rate environment). That stronger performance has been replicated on a less impressive scale by the JSE's small caps. By

contrast, says Lea, the performance of AltX listings and fledgling stocks has been nothing short of abysmal. "My sense is that there isn't much opportunity left in the mid and small cap stocks. If there's opportunity it's in the JSE's fledgling companies and the AltX."

Lea says Coronation's smaller equity funds have been nibbling at AltX stocks. "At this point the risk: return profile is skewed in our favour. A 1% position in a portfolio could easily become a 4% position. If we lose some of the 1% position it's not the end of the world." Lea recommends investors do their homework (see accompanying 'What to look for' list) in establishing whether a company has sufficient strength in capital and management to stick around for the next two years.

To date the quality of newer listings on the JSE – the AltX, in particular – have, physically speaking, held up well and there have only been a couple of outright corporate disasters, in the form of Wellco (now revamped as Bio Science Brands) and Country Foods.

Still, the market's aware of some "stressed situations" where companies appear to be peering off a precipice. Those would include counters such as Kimberley Consolidated Mining (suspended for not issuing annual financial statements on time) and a number of companies (Imuniti, AH-Vest, Best Cut Holdings, IFCA Tech and Zaptronix) that seem to be genuinely battling to bring their business models closer to viability.

Any more disasters or setbacks among new listings usually have an

FINWEEK'S DIRTY DOZEN

- 1 MYRIAD MEDICAL:** A good spread of products and should benefit from Government spending to upgrade public hospitals.
- 2 INSIMBI:** Cheap on an earnings basis, with compelling cash flows and dividend attractions.
- 3 O-LINE:** An understated contender that looks well managed and trades at a modest earnings multiple.
- 4 UNIVERSAL INDUSTRIES:** Defensive qualities in baking equipment supplies. And its management is confident enough to buy back the company's shares.
- 5 MAZOR:** Has rallied of late but still looks undervalued in relation to its long-term potential and opportunities for corporate action.
- 6 AFRIMAT:** No nonsense management has shown it's acutely aware of not only what the business is worth but also what other businesses are worth.
- 7 WESCOAL:** Arguably the most attractive coal play on the JSE. It's augmenting its merchant services with a well-timed entry into mining.
- 8 INTERWASTE:** Management strength apparent in its ability to overcome initial setbacks.
- 9 RACEC:** Strong rail and electrical niches that have recently attracted a strategic black empowerment investor.
- 10 MIX TELEMATICS:** Overlooked since its unbundling from Control Instruments. Strong across the income statement, balance sheet and cash flow statement.
- 11 CIC HOLDINGS:** Grossly undervalued brand distributor holding some lucrative contracts with blue chip clients.
- 12 PSV HOLDINGS:** A nicely diversified engineering business with strong order books and sizeable chunks of recurring business.

exaggerated effect on sentiment. It reinforces the nagging sense that newer listings are simply not able to deliver on the potential suggested in their prospectuses or pre-listing statements in the changed economic environment.

Most notable in the recent rallies on the JSE is that AltX-listed companies tended to lag the upward momentum and in some instances simply fail to catch the blasts of buoyant sentiment. Old market hands might argue it's those morbid moments that should be seized by investors.

Perhaps it's therefore significant that *Finweek* learnt last week that Shawn Stockigt – one of the more astute asset managers in the field of small caps – is planning to launch what we'd term a "distressed situation fund". Stockigt – a partner at Achelon Capital – will be teaming up with Trident Capital's Charles Petit in what will be called the Trident Special Opportunities Fund (TSOF).

The rather innocuous term "opportunities fund" may belie Stockigt and Petit's aggressive intentions with the fund. Stockigt says TSOF aims to take advantage of unique and high return investment opportunities not recognised or accessible to traditional investment funds. He says initially the fund will exploit the "current dislocation" in financial markets via investments in a pipeline of good quality assets held by unwilling investors or those under pressure.

Naturally, such a fund will carry a higher degree of risk than normal, which is probably why the minimum investment has been set at R500 000, with redemptions over three calendar months. But TSOF, which has set its total fund capacity at R500m, could well catch the last big waves of distressed investment dealings.

Obvious targets for TSOF would be unit trust companies where small cap portfolio managers are sometimes forced sellers of shares in a bid to meet fund redemptions. Many of those "forced" sales involve newer listed companies that are usually jettisoned before the more established holdings in larger counters.

WHAT TO LOOK FOR WHEN PERUSING BOMBED-OUT OPPORTUNITIES

- 1 Does the company have access to, or the capacity for, securing funding for at least the next two years?** (Things could conceivably get tougher in the months ahead, so it's important the company has an open line to credit.)
- 2 Check liquidity levels by measuring current assets to current liabilities.** (Quite an important measure in such desperate days, as it determines whether the company can handle its creditors should they come calling for settlement.)
- 3 Is there a reassuring cash flow?** (The closer net cash flows match operating profits, the better the quality of earnings.)
- 4 Does the company have a stable shareholder base?** (Look for meaningful shareholders, in the form of a family, institutions, management or strategic investor.)
- 5 Is the management team stable?** (A surprising number of new listings have seen changes at both the CE and financial director level – something that usually is interpreted ominously.)
- 6 Have there been any dramatic strategic shifts?** (A possible sign of desperation in a company is the tampering of operational tack.)
- 7 Is the tangible value of the company realistic?** (That's an important consideration, with some newer listings trading at discounts of between 50% and 60% to their last stated tangible NAV.)
- 8 Have gearing levels increased markedly over the past year?** (With squeezed economic conditions staunching cash flow it's important to determine whether a bigger debt load can still be comfortably serviced.)
- 9 Who are the company's main competitors?** (Returns might be difficult under the best circumstances if your company is making a cola, stitching shirts or brewing lager.)
- 10 Is the share liquid?** (It's comforting to know you can easily offload shares in a hurry if you need to...)

TSOF may even have an opportunity to cash in on the single stocks futures (SSFs) blowouts, perhaps cosyng up to financial institutions that now (perhaps reluctantly) hold sizeable stakes in an array of small cap counters. What may even transpire is that TSOF offers to swap its units in exchange for all or part of a portfolio of small cap investments a bank (such as Absa or RMB, for example) may have inherited from fizzled SSF deals.

One suspects TSOF could also feel its way around empowerment investment companies that may be feeling the strain from rising gearing levels and falling investment values.

Stockigt argues the current lack of liquidity in the small cap and mid-cap markets has resulted in limited exit opportunities for such sellers. "We've identified a pipeline of those investors and aim to acquire quality assets from them at additional discounts to current depressed market valuations."

In terms of relative value, Stockigt says the earnings multiples for small cap companies peaked at around 29 times in May 1998 and spiked to more than 20 times several times between late 2004 and late 2006. The current average earnings multiple for small caps is 7,5 times, which isn't far off the big "dips" in March 2002 (5,9 times) and December 1998 (5,9 times).

While valuations are fundamentally low, *Finweek* still believes there remains significant risk in selecting AltX or fledgling stocks. Things – especially in fledgling and small companies – can go wrong in a jiffy. Strategic errors sometimes set off a chain of unintended consequences, order books empty almost overnight as clients take strain and management teams squabble and take their eyes off the operational ball.

Consequently, it's probably best to accumulate a portfolio of shares rather than gunning for one or two winners. That way the odd 10-bagger or five-bagger will more than compensate for the risk of holding left-for-deads or blowouts. ■