Remember, the camera never lies

Small caps

Gabriella Hold

A small cap-company focused on growth in the US market may seem an unlikely pick when it comes to choosing a defensive minnow stock. However, red light and speed camera group **Redflex Holdings** is one that ticks all the boxes when it comes to finding a resilient quality small-cap play for Wilson HTM institutional dealer Simon Robinson. He says it's one of the best stocks at the junior end of the market because of its competitive advantage, solid management, strong balance sheet and solid growth outlook.

Redflex, which is capitalised at $280.4 million, owns and operates the world's largest network of digital speed and red-light cameras and has a dominant share in the US.

Robinson says the growth opportunity in the US is huge. The market is still in an embryonic state and obstacles to camera installation are being unwound. Redflex estimates the total size of the US market is 65,000 cameras, with just 3000 current installations. It expects growth will average more than 25 per cent a year for the next five years.

Earlier this year, the group increased its revolving credit facility to $US65 million ($100 million) from $US50 million in order to facilitate this growth. It also signed two new photo enforcement contracts for cities in Ohio and Arizona.

"The competitive position of the company, coupled with the large market opportunity, strong margins and credible management all combine to make Redflex a very attractive business," Robinson says.

Yesterday, the group posted an 11 per cent fall in net profit to $4.2 million. The result was achieved on revenues of $57.6 million, which were helped by the fall in the Australian dollar.

Late last year, Redflex said a number of takeover bids valuing the company at more than $3.50 a share did not adequately reflect the underlying value of the business. Earlier this month, it reiterated this view but said it would continue discussions to see if a "substantially improved proposal" could be put to shareholders. Shares are trading at about $2.75.

For Opis Capital executive director Dean Fergie it's a totally different small cap that stands out as a key defensive pick. He names accounting software group **Reckon** as a "good solid business for these uncertain times".

"There are a lot more boxes ticked on this company than there are crossed, which is the exception rather than the rule at the moment," he says. "Everything is going in an upward direction, which is pretty rare because there are so many businesses where earnings are going backwards."

Fergie says Reckon's earnings are resilient as its accounting software packages are established, core products for many clients and are therefore less of a discretionary nature. Furthermore, Reckon has consistently grown earnings over a number of years.

Indeed, Reckon has been one of the bright spots so far this reporting season, pleasing investors with a solid result. It posted earnings before interest, tax, depreciation, and amortisation for fiscal 2008 of $19 million, an increase of 15 per cent over the previous corresponding period and in line with its guidance. Net profit increased by 14 per cent to $11.3 million. It also increased its final dividend to 3.5¢ a share, from 3¢ a share.

Reckon said it saw some short-term reduction in EBITDA margin percentages, but its recent purchase of the corporate services and bill-back division of Espreon was earnings per share accretive.

While it has not issued formal guidance, the group is tipping EBITDA of between $25 million and $26 million in 2009. Revenue growth in 2009 is expected to be 50 per cent greater than for 2008.

Macquarie Research says Reckon should be able to deliver revenue and earnings growth next year as it gets more customers and boosts its product offering. Reckon recently launched QBi Lite, a $29.95 entry-level package of its QuickBooks program, which is aimed at luring Microsoft Excel users to a more formal accounting package.

The counter-cyclical nature of life insurance means **Tower Australia** is a standout defensive play for Credit Suisse analyst Arjan van Veen.

The life insurance market has been growing at 12 per cent plus for the past two decades, he says, and growth should be much higher over the next year or so given people are more worried about their assets and tend to buy more insurance.

"The first thing that happens in these sort of downturns is that people focus more on protecting the assets they have," he says.

"Advisers also have more difficulty selling wealth management products, hence they tend to sell more life insurance products. And when you look at studies on what consumers stop spending on first in a downturn, insurance comes way down the list."

This was highlighted by the strength of the life insurance results in Commonwealth Bank of Australia's recent profit result. CBA said in-force premiums grew by 18 per cent to $1.054 billion to December 31, 2008.

Tower said at its annual general meeting this month independent analysis forecasts that Australia's life insurance market should triple by about 2020, with compound growth of nearly 13 per cent even during low-growth and recessionary periods.

Tower posted a 69 per cent rise in annual net profit to $68.7 million, while underlying profit, which strips out non-cash items and normalises investment income, rose 14 per cent to $67.9 million.

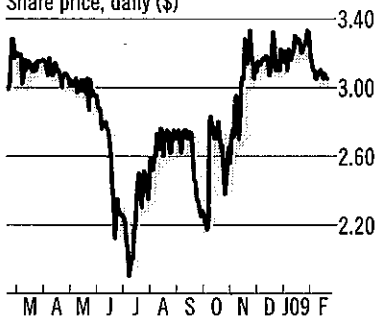
Growth was helped by life insurance earnings, which rose 35.2 per cent.

Van Veen notes that one risk for Tower is rising unemployment, which can lead to higher disability claims. Its disability business accounts for about 15 per cent of its book. But he adds that Tower is still a fundamental value story trading on a price-earnings ratio of around 11 times with 15 per cent plus earnings per share growth over the medium term.

Small but mighty

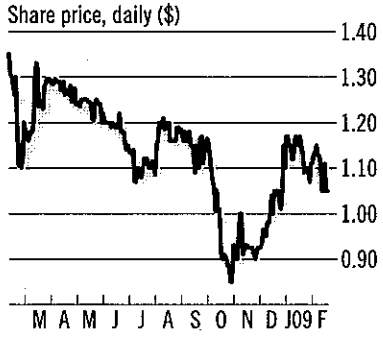
Fund managers' key defensive small cap picks

Redflex Holdings
Share price, daily ($)



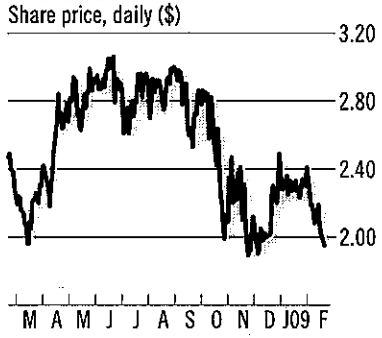
Market cap	$280.4m
Year-to-date change	-5.3%
12-month yield	2.1%
2009 adjusted earnings per share*	15.8¢
2009 dividend per share *	5.6¢
Price-to-book ratio	3.7x

Reckon
Share price, daily ($)



Market cap	$139.8m
Year-to-date change	0.0%
12-month yield	8.2%
2009 adjusted earnings per share*	10.4¢
2009 dividend per share *	6.9¢
Price-to-book ratio	3.4x

Tower Australia
Share price, daily ($)



Market cap	$693.5m
Year-to-date change	-21.7%
12-month yield	3.3%
2009 adjusted earnings per share*	20.0¢
2009 dividend per share *	5.5¢
Price-to-book ratio	1.0x

*Consensus estimates

SOURCE: BLOOMBERG