



Stocks

Bargain hunting – how to find top stocks that are going cheap

Mark Story - September 25, 2008

At face value the sharemarket's 32% drop since last November's highs means there should be spoils aplenty for those brave enough to start picking the sharemarket's low-hanging fruit. And given that current forecast earnings equate to an average P:E of 11X - well below an historical long-term average of 15X - bargain hunters should find it easier to sniff out value.

But with the entire S&P ASX/200 Index trading at an estimated 20% discount to fair valuation - a level unseen since 1984 - the market is clearly pricing in significant levels of earnings risk. And while the financial sector is trading at historically low P:Es, Goldman Sachs JB Were (GSJBW) analyst Chris Pidcock believes it carries the highest earnings uncertainty, especially given changes in credit growth and provision assumptions (as the turmoil in credit markets continues). Given this risk, Pidcock would like to see at least a 25-30% relative P:E discount before getting too excited about this sector.

Meantime, assuming investors take a two to three year outlook, Elio D'Amato CEO of share analytics firm, Lincoln Indicators says there's never been a better time to find good, under-valued stocks gratuitously over-sold during the investor flight to safe-havens. He says stocks bought on a P:E of 10X (that are fairly valued at 15X), should be primed for a re-rating when market sentiment recovers, without any additional reporting. But he says that's assuming these stocks have no skeletons on their balance sheet.

But while historically low P:Es reveal much about what's cheap, Matt Brooks equity strategist with ABN Amro Morgans says they must be assessed together with other key measures to gauge underlying risk, (especially while the tail of last year's credit crunch is still wagging). "Remember, the long-term value of any stock depend on the quality of its earnings," says Brooks. "And if a stock's growth rate exceeds its price to earnings (P:E) ratio, you should be getting a value-growth play." />

According to Brooks, what distinguishes stocks trading on similar P:Es is the stability of future underlying earnings. He says investors should selectively increase their exposure to bargains by focusing on businesses with strong franchises, and balance sheets, plus low debt-to equity-ratios. "Ideally, investors should be looking for stocks (especially industrials) carrying less than 30% debt-to-equity, plus a minimum interest cover of 3X earning before interest and tax (EBIT)," advises Brooks. "We also look for stocks carrying total debt at less than five times net operating cash flow."

As another measure of value, D'Amato recommends buying stocks where total short-term debt doesn't exceed 20% of cash-flow. And in order to replenish existing asset reserves, he also expects cash-flow to cover a minimum 5% of total assets. Given that it's a primary driver of share price appreciation, he says bargain hunters should also keep a close eye on earnings per share (EPS) growth projections.

While there's some residual earnings risk, GSJBW's bottom-up forecasts expect the ASX 300 Industrials to deliver +7% EPS growth in FY09, down from +12% at the beginning of 2008. And in the banking sector, where earnings uncertainty is most pronounced, GSJBW's bottom-up forecast for FY09 EPS growth is currently +7.6%.

But as long as investors are taking a longer-term view, Brooks says debt levels (assuming they're under 50%) can be less of an issue, especially for the utilities and listed property sectors, which he expects to out-perform during the new cycle of falling interest rates.

The market is typically prepared to pay a higher P:E for defensive stocks, like Woolworths or Telstra (with a P:E of 14X and 10% gross yield), due to the stability of earnings. However, that's not the case when it comes to cyclicals, and resource stocks like BHP and Oz Minerals serve as useful examples. Trading on P:Es of around 6X and 5X respectively, BHP and Oz Minerals have been discounted on the prevailing view that future earnings are under pressure now that the commodity boom is deemed to be over. Far from alone in rejecting the conclusion that commodities are at the top of their cycle, Brooks regards these stocks as attractive buying at current levels.

He also expects a counter-cyclical upside for Lend Lease from its involvement in the A\$5 billion Olympic Village development for London 2012. And while it goes against the 'top 200 theme', Brooks says waste management giant, Transpacific Industries has all the hallmarks of a strong valuation play with P:E (10X) half what it was during the peak of the cycle back in 2007. He expects earnings quality to offset the higher (than desirable) debt to equity. Boosted by the successful integration of acquisitions, Transpacific reported a 70% spike in annual profit and retained its guidance for double-digit growth.

Another stock with solid defensive earnings that D'Amato regards as extreme value (at around \$22/share) is QBE. Trading on a P:E of 13X, he expects Australia's biggest insurer to be in a good position to soak up market share following the (expectant) collapse of American insurance giant, AIG. Based on strong fundamentals he also likes the look of Incitec Pivot, Leighton Holdings, CSL, and Mount Gibson Iron Ltd which was recently caught up in the shorting frenzy. "Don't try and reinvent the wheel when it comes to bargain hunting," says D'Amato. "You're more likely to unearth true bargains within 'run-of-the-mill' industrials (or consumer staples) unfairly driven down by market sentiment."

Long-term buying opportunities (Source: Goldman Sachs JB Were)

Consumer stables	Telecos	Healthcare	Industrials	Resources	Domestic cyclicals
Woolworths Foster's Group Coca-Cola Amatil Ltd Wesfarmers	Telstra	Cochlear Ltd, Healthscope Ltd	Austar United Communications Brambles Ltd Toll Holdings Ltd News Corp	Bulks, copper, mining services & mining- service- related operations	Boral Ltd Onesteel Ltd

