BRIGHTER OUTLOOK FOR SMALL CAPS?

BY **KUEK SER KWANG ZHE**

The outlook for small-cap stocks is looking brighter this year as potential changes in global economic trends and market sentiment could see foreign funds flowing back into emerging markets, including Malaysia. This could push up the prices of small caps, say fund managers.

Choo Swee Kee, chief investment officer at TA Investment Management Bhd, says the FBM Small Cap Index fell more than 30% last year. It was a meaningful correction that presented several investment opportunities for investors with a higher risk appetite.

"Prices are much cheaper now and some stocks are trading at price-earnings ratios (PERs) of less than 12 times. This is despite the fact that the businesses of these companies are still growing at decent rates. Yes, it is a good time to bargain-hunt," says Choo.

The FBM Small Cap Index had rebounded 16.14% to 13,123.04 points year to date (as at Feb 21). However, it is still relatively low compared with its peak of 18,082.88 points in January last year.

The battering that the small-cap space received last year was due to retail investors exiting the market before and after the 14th general election. It was also because of significant earnings downgrades by analysts and research firms on small-cap companies, says Apex Investment Services Bhd CEO Clement Chew.

He adds that the average PER of the FBM Small Cap Index is now at a more reasonable level. "The FBM KLCI had fallen 3.6% from the start of last year to February this year. By comparison, the FBM Small Cap Index had fallen 23% over the same period. For investors with a bigger risk appetite, it is a good time to look at the small-cap space."

Global economic trends could benefit local small caps, according to Ang Hin Yik, investment services manager at Eastspring Investments Bhd. He says if the US Federal Reserve were to halt its balance sheet unwinding efforts and put an end to its interest rate hike cycle this year, the US dollar should stabilise or weaken. Coupled with a stable economic environment in the rest of the world, global fund flows that fled the emerging markets could return.

"Malaysia should be one of the beneficiaries if fund flows reverse and local small caps see a stronger rebound [than large caps] as investors' risk appetite improves," says Ang.

The unresolved trade war between the US and China has brought opportunities to some Malaysian companies in the technology sector, he adds. "Some companies are seeing higher loadings from [global] clients as Malaysia is seen as a preferred manufacturing destination. Some companies are grabbing this opportunity to expand their market share."

The ongoing trade war has ignited uncertainties in the tech sector and the raging war on 5G technology has slowed smartphone shipments considerably. Tech stock prices have retreated as a result.

"However, we view this as a golden opportunity to accumulate positions for the longer term as we believe the sector is still on a secular upward trend amid the introduction of new applications and gadgets such as cloud computing and medical devices," says Ang.

However, some fund managers caution about investing in the sector. Lim Tze Cheng, CEO of Inter-Pacific Asset Management Sdn Bhd (InterPac), says while the share prices of good small-cap companies are attractive, the domestic economy is slowing down. "This is partly due to the review of mega infrastructure projects by the government."

The payment of tax refunds (including the Goods and Services Tax and personal income tax) of up to RM37 billion will spur the economy, but its impact will only be felt by the end of this year or later, he adds.

A fund manager who declines to be named says political uncertainties could hamper the prices of small caps. "For instance, news reports say some members of the Pakatan Harapan coalition are plotting against Prime Minister Dr Mahathir Mohamad. What if such things really happened? It is hard to tell."

On the global front, Lim says there is a reasonably high chance that the US-China trade tensions may not be resolved this month. Eastspring's Ang says global economic growth may continue to slow down this year due to the lower growth rates in the world's major economies.

Apex's Chew says investors should take note of the liquidity issue in the small-cap space. "These stocks are generally illiquid, which make them risky and difficult to sell when market sentiment deteriorates. Also, since they have relatively lower institutional exposure, price volatility can be huge."

Investors should invest in good quality companies, says Ang. "To sum it up, we think there are pockets of outperformance in small-cap stocks after the drastic plunge in share prices last year. We expect good quality names to rebound as the selldown in 2018 was indiscriminate as investors' risk appetite had waned.

"The selling volume in the space has declined to indicate selling exhaustion. Insider buying of small-cap companies is also on the rise as their management teams are optimistic about their long-term potential. A lot of negativity has been priced in and valuations are now much cheaper."

The following are some small-cap companies that fund managers like.

SLP RESOURCES

SLP Resources Bhd manufactures plastic products and related goods. InterPac's Lim likes the company as it has enjoyed a high profit margin over the years. Its earnings could improve further due to its foray into the manufacturing of healthcare products and low raw material prices.

"The company enjoys a profit margin of about 11% to 12% over the year. This is an impressive number for a manufacturing company," says Lim.

"Manufacturers usually have single-digit profit margins of 5% to 6%. Even at 8%, they are considered pretty well run."

The main reason behind the double-digit profit margin is that the company produces various types of high-quality kitchen bags that cater for the Japanese market. These Mizukiri bags are suitable for the disposal of food items as they have tiny holes at the bottom for liquid to flow out, says Lim. "These are not the black rubbish bags that Malaysians typically use and I don't think it is sold locally."

He expects the export of these kitchen bags to do well. In 2017, about one-third of the company's revenue of RM180 million was derived from its exports to Japan. In the first nine months of last year, about RM53 million of its RM140 million in revenue came from Japan.

Another growth driver going forward is the low raw material price of resin and the manufacturing of backsheet films for diapers, says Lim.

The raw material of plastic products is resin — a solid or highly viscous substance that reacts to certain conditions (such as heat) or other substances. There are various kinds of resin and the two most commonly used for industrial manufacturing of plastic products are low-density and high-density polyethylene.

The prices of these two resins have been trending down since last year due to an increase in supply. Lim says this is because resin capacity is building up in countries such as the US and India. Even in Malaysia, the Pengerang Integrated Petroleum Complex, scheduled for completion this year, will increase the output of petrochemical (the base material for resin) and could further in-

MOHD IZWAN MOHD NAZAM/THE EDGE

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HARIS HASSAN/THE EDGE

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PATRICK GOH/THE EDGE

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crease the global supply of resin.

The trend of low resin prices augurs well for companies such as SLP Resources as the raw material takes up about 70% to 80% of their production costs. "Even if resin prices do not drop further, it is good for the company," says Lim.

Another key driver for potentially better future earnings is the manufacturing of breathable backsheet films that help contain the liquid inside baby diapers. Lim says the company is strong in R&D and has come out with one of the world's thinnest backsheet for baby diapers. This product could boost the company's earnings in the future.

Lim says the company has a long history in the industry and a strong management team. "The company started as a business that traded in resin. Kelvin [Khaw], its group managing director, and the second generation of the Khaw family built up the manufacturing business. He is a technical person and has managed the company well. His background is a reason SLP Resources is strong in R&D."

P.I.E INDUSTRIAL

P.I.E Industrial Bhd started out as a manufacturer of wires and cables. In 1997, it expanded its capabilities to include mould and die fabrication, plastic injection moulding and printed circuit board assembly, among others.

Lim says the company tends to be overlooked by investors. Its quarterly numbers may not look particularly impressive while its accounts payable look huge in total. The company has a solid client base that includes multinational corporations but it is unable to publicise this fact due to the confidential nature of the contracts it has signed with clients.

However, if investors look carefully at the company's financials, it has good and stable earnings. It also enjoys a profit margin of 7% to 8% — a healthy rate in the manufacturing industry, says Lim.

He says the company's performance should be evaluated on an annual basis as it supplies products to industrial players. "They provide products to a niche segment of industrial clients. They are not in the cash business like Apple, which sells iPhones to the mass market.

"Industrial products include barcode readers, industrial equipment chargers and medical devices used by industry players. The volumes are several hundred thousand a year rather than millions.

"Its earnings also depend on product shipments and they only receive full payment after the products are delivered."

Lim says the company's accounts payable seem like a big number, but it is a manageable sum. The company had accounts payable of RM112 million in 2017, about 16% of its total revenue. "This rate is quite common among manufacturing companies that operate in the industrial segment," he adds.

The company had cash amounting to RM106 million and RM87 million in 2016 and 2017 respectively, without any debt, says Lim.

He says the company would attract more investor attention if its profit and revenue continue to grow. "I also like the fact that the company has been in the industry since the 1990s and has a strong management team."

KAREX

Karex Bhd, the world's largest condom manufacturer, is a home-grown company based in Klang, Selangor. It produces 15% of the global condom supply and supplies to well-known brands such as Durex.

However, local investors seem to have lost confidence in the company in recent years. This is reflected in its sliding share price. The stock had plunged 85% from its peak in January 2016 to 46 sen per share on Feb 20.

This is hardly surprising as the company's net profit has fallen drastically in the last few years. According to Bloomberg, Karex's net profit nosedived from RM66.7 million in 2016 to RM10.1 million in 2018 despite its revenue growing from RM343.6 million to RM408 million during the period.

TA's Choo, however, favours the stock and expects the company's earnings and profit margin to recover this year. He says the fall in net profit in the last three years was mainly due to higher administrative and marketing costs incurred to promote the company's own condom brand. The Karex condom, which has a higher profit margin than the company's non-branded products, has not been selling fast enough to cover the company's higher expenses.

"The company's management had to go through a learning curve in marketing and selling their own brand to consumers. Previously, they were only manufacturing products for other companies. But now, they are selling their own brand of condoms in the market," says Choo.

According to an analyst report by JP Morgan released in December last year, the percentage of the company's administrative and distribution costs as compared with its total revenue had increased by 15%, 20% and 22% in FY2016, FY2017 and FY2018 respectively. The report also pointed out that the Karex brand had a higher gross profit margin (of more than 50%) than its non-branded products supplied to other companies (28% to 30%). It was also higher than those sold to governments and non-governmental organisations via tender projects (12% to 15%).

Choo expects the company to turn around this year. He says sales of the Karex condom have improved in the last three years. The momentum could continue and contribute to the company's earnings.

"Their own brand is more commonly seen on the shelf and has more exposure. This contributed about 4% to its total revenue in FY2014 and the number doubled in FY2016. It hit 15% in FY2018," says Choo.

The steady increase and higher sales of the Karex condom could see a recovery in the company's profit margin this year. "We are expecting it to climb about 10%," he says.

Choo says there have not been many changes to the company's core business. "It continues to supply condoms to the commercial and tender market. That is why its revenue has been steady. It is the profit margin that has been affected."

He says the management team has been looking for ways to improve the business such as being on the lookout for new factories and purchasing new machinery to improve efficiency.

BLOOMBERG

Year-to-date performance

COMPANY	SHARE PRICE (AS AT FEB 26)	CHANGE IN PRICE (YEAR-TO-DATE, %)	PE RATIO (AS AT FEB 26)	PB RATIO (AS AT FEB 26)
SLP Resources Bhd	1.27	9	15.95	2.22
P.I.E Industrial Bhd	1.59	7	13.39	1.51
Karex Bhd	0.395	−16	68.97	0.82
RGB International Bhd	0.235	24	9.99	1.5

RGB INTERNATIONAL

Apex's Chew is optimistic about the prospects of RGB International Bhd, a gaming products supplier that derives a large part of its revenue from Cambodia and the Philippines. It manufactures and distributes gaming products to overseas companies and provides gaming machine concession programmes to gaming operators.

Formerly known as Dreamgate Corp Bhd, the company's share price once hit a high of 49 sen per share in 2007 before crashing to 8 sen. Back then, the company was riding on Cambodia's growing gambling sector and even derived about half its revenue from the country at one point.

However, the Cambodian government sent out a directive in December 2008 and February 2009 prohibiting sports betting and electronic gaming machines in entertainment clubs. As a result, the company suffered huge losses and had to pull out from a joint-venture casino known as Chateau De Bavet.

"Since then, the company has revamped its business model and focuses on selling slot machines and providing concession programmes. Its concession business is doing well as it benefits from both sides of the equation. The company supplies the machines and takes 50% of the profit earned by the gaming operator while the operator does not need to bear any costs in acquiring the machines," says Chew.

The company has grown quite rapidly in recent years, he adds. "Its business model is pretty strong and earnings increased 19% and 22% in 2016 and 2017 respectively. This year, it should be about 16%.

"The company is trading at a price-earnings ratio of nine times, which is quite cheap. It has a strong balance sheet and is in a net cash position. It may gain more investor attention going forward." E

Asian small caps look attractive

Small-cap stocks in other parts of Asia are also starting to look attractive. Gary Lim, regional fund manager at Apex Investment Services Bhd, says small caps in the region have bottomed out. This is partly reflected in the MSCI Asia ex-Japan Small Cap Index, which had fallen 24.96% to 903.25 points last October but has been rising steadily since the start of the year.

The index has climbed 5.8% year to date (as at Feb 21) to 1,012.75 points. This compares with its previous peak of 1,214.17 points in February last year.

Lim's positive view on Asian small-cap stocks is based on two global events. The first is that the US Federal Reserve has indicated that it will end its balance sheet unwinding this year. It has also mentioned that a plan will be announced to "provide more certainty about the process for completing the normalisation of the Federal Reserve's balance sheet".

This could be positive for the stock market, says Lim. "To give you an idea, the Fed's balance sheet was about US$1 trillion before the 2008 global financial crisis and it went up to about US$4.5 trillion after the crisis. Many people expect it to fall to US$2 trillion or US$2.5 trillion. However, if the balance sheet run-off were to stop at the end of this year, the Fed balance sheet would shrink to about US$3.5 trillion — a higher level than what the market expects."

Lim says the possibility of the US-China trade war being resolved soon is another potential catalyst for the region's small caps. According to a CNBC news report, negotiators from both sides are drawing up six memoranda of understanding on structural issues such as forced technology transfer and cybertheft, intellectual property rights, services, currencies, agriculture and non-tariff barriers to trade.

Bloomberg has reported that the US recently sought a pledge to keep the Chinese renminbi stable. This is aimed at neutralising any efforts by Beijing to counter US tariffs.

"Over time, I think the US has realised that there is nothing much they can squeeze out of China [and it is time that the two parties strike a deal]," says Lim.

One way to invest in the regional small-cap space is through unit trust funds. According to the Lipper Fund Table, the Equity Asia Pacific Small & Mid Cap fund category generated an average return of -12.05% in the past 12 months (as at Feb 15). The returns were 25.38% and 16.13% in the past three and five years respectively.

The ringgit-hedged United Japan Discovery Fund, launched by UOA Asset Management Sdn Bhd, has been the top performer in the last three years, with a return of 66.55%. This is followed by Templeton Asian Smaller Companies MYR fund (33.75%) and PB Asia Emerging Growth fund (14.15%). Last year, five of the six funds in the category generated negative returns. E