Exclusive Content from TheBull Premium.

THEBULL'S STOCK OF THE WEEK

Shareholders of McMillan Shakespeare continue to sing "Let the good times roll." MMS, Australia's biggest provider of salary packaging looks to build on its momentum as the best performing small cap of 2010. With shares currently trading at new 52-week highs of around $8.80, some brokers can see trading momentum push MMS towards the $10 level.

McMillan Shakespeare's primary businesses consist of salary packaging, novated leasing, operating leases, fleet management and workplace benefits. It serves state and federal government agencies, hospitals, charities, and private sector organisations. With 50 per cent of the salary packaging market, MMS is one of the dominant players in the outsourcing industry.

Equity research analyst Ian Munro of Lodge Partners Pty Ltd "is attracted to the firm's strong earnings momentum, and 50 per cent market share in the salary packaging space." His target price is $9.20. MMS earnings have increased 39% CAGR (compound annual growth rate) over the last 5 years.

Peter Russell of Intersuisse who has a buy recommendation on McMillan Shakespeare believes that the "five years of rapid earnings growth are set to continue, with well-priced diversification adding scale and cross-selling."

Michael Heffernan, senior client advisor and strategist at Austock recently commented MMS has a "reasonable dividend and attractive growth prospects. Its buoyant outlook statement was re-assuring, and the area it operates in is ripe for growth as the outsourcing trend continues."

Not everyone is thrilled with McMillan Shakespeare's current market valuation. Well-known Australian commentator, Roger Montgomery penned his concerns about MMS in his blog back in August. Being a value investor it is easy to see why he is less enthusiastic with MMS above $7.00, than $2.64, when he first wrote his opinion on McMillan Shakespeare. Montgomery was also unhappy with debt levels that MMS took on after its acquisition of Interleasing.

In McMillan Shakespeare's latest shareholder report, management anticipates that MMS will continue to grow at 3-8% pa depending on economic conditions and that they will benefit from improving employee participation rates with existing customers. MMS believes that it will create new business and have cross selling opportunities given its unique market offerings. Management pointed out eight new business contracts and 10 cross sell contracts that were achieved shortly after the acquisition of Interleasing in April 2010. High service levels and word of mouth promotion is also expected to continue to add to the growth story.

Having examined McMillan's financials it is easy to understand why many analysts are excited by the future prospects of MMS. With CAGR of 39%, normalised ROE of 42% and a P/E of 13.2x one can easily make an argument that MMS is not overvalued and has room to trade on the upside. Taking a look a chart of McMillan Shakespeare, one could surmise that Mr. Market currently believes that that MMS management will continue to keep the momentum ball rolling.

Montgomery does have a valid concern regarding the new debt levels that McMillan took on to fund its acquisition of Interleasing. Currently MMS does have more than adequate cash flow to service its gearing levels. An economic slowdown could impact its current cash flow, however.

As of Q4 2010, interest times cover ratio was 5.80. Management indicates that current debt levels are no concern.

The flip side of Montgomery's argument is if McMillan continues to perform well, then the company's bottom line will benefit substantially from its current capital structure. As we have all heard, leverage is double edge sword. Good and bad, hopefully MMS's shareholders won't fall on it.

In 2010, some of the regulatory uncertainty surrounding McMillan Shakespeare was cleared up with the release of the Henry Tax Review. No material changes were required in the business as a result of the review. Given the share price performance since the release of the report it is clear that the market does not think that the threat of new regulation is on the cards in the near future. MMS shares have rallied from $2.50 at the time of the release up to today's $8.80 high.

MMS's competitive advantage and unique market position is: they are the only integrated provider of salary packaging and "company car" solutions; acknowledged industry leading service levels, and the dominant player in Business Processing Outsourcing (BPO) given its scale.

Their proprietary, scalable salary packaging IT systems are difficult and costly to replicate. These advantages should continue to drive earnings momentum and share appreciation further into 2011.

The main risk to McMillan Shakespeare is an economic slowdown, where a sharp downturn in sales would be exacerbated by its large debt obligations. However, given management's impressive earnings track record during the worst global economic crisis in recent history, it's easy to understand why many analysts are optimistic on MMS.