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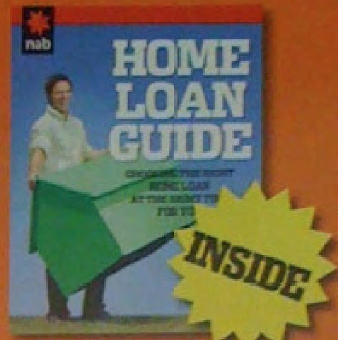

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It's quality that counts

Roger Montgomery has been 'long' in oil for a while

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TYPICALLY, AS MARKETS RISE, the frequency of opportunities to purchase businesses of extraordinary quality at throwaway prices declines. The value investor is forced to either search among progressively smaller companies or accept narrower margins of safety while not straying from the perceived safety of larger companies.

I don't like accepting smaller margins of safety and so, in the absence of fear of a market correction (currently the case), I will be happy to accept smaller companies. My view is that quality is not a function of size. Liquidity, on the other hand, is a concern (but not concerning): given two companies of equal quality and value, the one whose shares are more liquid is preferred.

I recently came across a small company whose market share is not at all small.

The company is Zicom (ZGL) and 40% of its operating earnings is generated by the manufacture and export of winches (up to 150-tonne capacity) and hydraulics mounted to offshore oil and gas service vessels. Its customers are ship builders and owners. Its only serious competitor is Rolls-Royce and little Zicom has meaningful market share. It is also one of the largest manufacturers and exporters of concrete mixers – another 40% of earnings – and a smaller precision engineering division the directors seem less interested in (despite 70% revenue growth in the recent half) given the potential of the winch business.

The order book of Zicom's winch division is up 30% on last year. First-half 2011 revenue grew to $S70.5 million (Singapore dollars) from $S47.5m in the previous corresponding half and profits rose almost 150%. With company statements in mind, if one annualises the first-half result, full-year profits of $S18m are possible and the total market capitalisation is just $A101m or 7.3 times (adjusted for currency).

You must know by now that I don't pay much (or any) attention to price-earnings ratios, preferring instead to focus on return on equity (ROE) and intrinsic value.

ROE could exceed 25% for this year and is expected to average 28% over the next three years. These are attractive rates of ROE that are unavailable in any bank account and that only a small percentage of Australian listed companies can sustain.

Buying a bank account that earns 25% with $10,000 in it, for $17,414, seems appealing to me, and with the marketing capitalisation of the company 1.74 times its equity, that's in effect what I see.

I have held the view for a long time now that the oil price must rise significantly. The International Energy Agency has suggested peak oil occurred in 2005-06. Supply from the five largest producers has been falling consistently. In October 2009, a report by the UK Energy Research Centre concluded that a peak in oil production before 2030 was likely. The UK Industry Taskforce on Peak Oil reported in 2008 that peak oil was likely to occur before 2013.

By 2030 China will import 79% of its oil and will be consuming 15 million barrels a day. Demand already exceeds supply although China is consuming less than 10m barrels a day. Higher oil prices will make deep sea oil exploration not only economically viable but necessary. The prospects, for a company profitably manufacturing large-scale marine winches, appear bright.

Many investors may baulk at the fact the company is Asia based, with Singaporean directors. If you were running a business however and exposure to growth in Asia appealed, wouldn't Singapore rather than Sydney be where you would locate?

Zicom is trading below 2011 intrinsic value and substantial rises in intrinsic value in the next two years are possible if profits can grow to circa $S22m by 2013.

When markets rise and your Value.able portfolio rises even more, it's difficult not to want to enjoy some fruits. But value investors must keep constant vigil and if it's high-quality smaller companies that suit, there are a few with exposure to oil and gas that your adviser should look at.

VALUE STOCK TO WATCH
Zicom (ZGL)

Roger Montgomery is a portfolio manager at Montgomery Investment Management. His book, Value.Able *is available at www.roger-montgomery.com.*