An enviable record

Roger Montgomery sees a tougher future for a great performer

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MCMILLAN SHAKESPEARE Group has had a charmed run in the media this year, with several fund managers extolling its virtues. Indeed The Montgomery [Private] Fund has profited handsomely from its holding. But after huge share price gains, is it time to take profits?

In an uncertain market, investors have clamoured for McMillan's "defensive growth" qualities. Recurring, reliable income from McMillan's salary packaging, car leasing and vehicle financing operations have helped it grow rapidly despite a slowing domestic economy.

The well-run company has an enviable long-term, consistent record and an A2 quality score – the second highest we can give an Australian listed company – and, if not for some debt, McMillan would be a candidate for our cherished A1 rating.

The company's return on equity (ROE) has averaged almost 40% over the past seven years and our forecasts suggest it should remain above 30% over the next three years. Remember, what you are looking for in your investments is big equity and big returns on equity. It really is that simple.

In addition to high rates of profitability, the net profit after tax itself has grown by 40%pa for seven years and earnings per share (EPS) from 16.7¢ in 2006 to 74.1¢ last year.

For those looking for income, dividends have grown from 9.5¢ to 47¢ over the same period. Had you owned $100,000 of shares in 2005, they would now be worth $773,750 and your income would have grown to just less than $30,000 on your initial $100,000 investment.

The risk, of course, is falling in love with a stock and disregarding its diminishing value. After soaring from $8.50 in January to $13, McMillan's valuation risks are rising. Skaffold suggests McMillan is no longer a bargain. Intrinsic value changes much more slowly than the manic-depressive changes of prices, but the value does indeed change and intrinsic value is expected to continue rising.

By 2014, intrinsic value should rise to around $12. As such, McMillan does not currently offer a sufficient margin of safety to buy today, but it is not so overvalued that it should be dropped from watch lists or dumped from portfolios. Indeed, McMillan has a history of overdelivering.

McMillan's debt of $101 million at June 30, 2012 and a 38% gearing ratio may concern some investors, but this mostly relates to car leasing services. And car leasing requires borrowing, albeit borrowing that is non-recourse and secured by the vehicles only.

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In any case, McMillan's interest cover is 9.5 times; it remains well within its banking covenants and had $54.4 million worth of cash in 2011-12. The balance sheet has plenty of firepower to fund more bolt-on acquisitions (and here's a piece of advice to management: the acquisitions must only be made at bargain prices).

More generally, McMillan also faces potential challenges from government job cuts and lower spending on outsourced services, aimed at reducing costs and shoring up shaky public sector budgets. McMillan has significant exposure to the health sector, and budget cuts in Queensland, in particular, could dampen its growth. Elsewhere, another threat is a change to the definition of charitable organisations and the federal government's push to reform the not-for-profit sector, because McMillan does considerable work in that sector.

Despite the general threats, McMillan expects continued growth in remuneration service operations thanks to contract wins. It was appointed the sole external provider of salary packaging and novated leasing services to the South Australian government for six years in April.

But the market has already priced in McMillan's potential growth and then some. Still, it would not take much of a fall in price for the gap between McMillan's market price and intrinsic value to narrow, meaning it deserves a prime spot on value investor watch lists, in anticipation of improving value.

Roger Montgomery is a portfolio manager at Montgomery Investment Management. For his book, Value.Able, see www.rogermontgomery.com.