SECTOR SMALL CAPS

When patience pays off

The four stages of a start-up's life cycle provide rewarding possibilities

Investing in smaller companies is a well-trodden path to long-term wealth. Capturing growth as a company emerges from a start-up with an entrepreneurial approach to governance through to an established business with a board of experienced and independent directors can be richly rewarding.

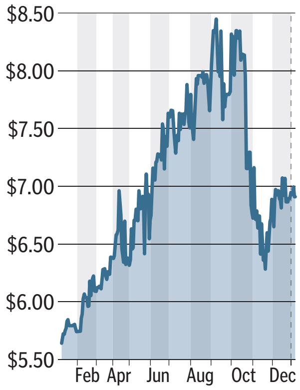
We believe there are four stages to a small company's life cycle. Beginning with the "early" stage, the product or service being offered is classed as disruptive and the governance entrepreneurial. Less than 1% of our portfolio is dedicated to these opportunities. Following the early stage is the "emerging" stage with the product or service being commercialised. We would invest between 1% and 3% of our small companies portfolio in these candidates.

As a company's product or service is proven we describe the business as "developed" and can invest between 2% and 5% of the portfolio. And once the proven product or service is sustainable, we describe the company as "core" and up to 7% can be invested. All the while the governance of the company is moving from entrepreneurial through to established, and not only do its earnings grow but the market's confidence in its prospects does as well.

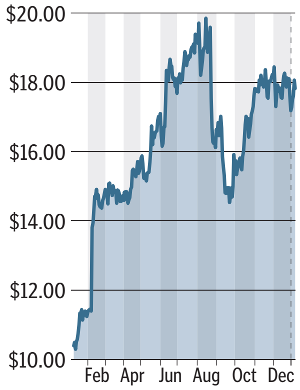
"Ten baggers" (shares that grow tenfold in a given time frame) are not uncommon and all that is required is patience, provided of course the right candidate has been selected. In this month's column, we examine three companies held in our small companies fund, acknowledging there is generally higher volatility among small companies and therefore an element of risk.

Roger Montgomery is the founder and CIO at the Montgomery Fund. For his book, Value.able, *see rogermontgomery.com.*

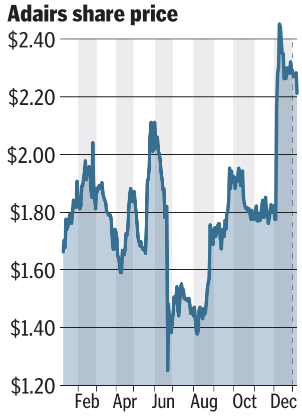
Contact Energy share price



IDP Education share price



Adairs share price



❶ Contact Energy

ASX code CEN
Price $6.98
52wk ▲ $8.45
52wk ▼ $5.59
Mkt cap $4.98bn
Dividend 35¢
Dividend yield 5%
PE ratio 15

BUY

Contact Energy is a New Zealand electricity generator and retailer. In NZ, electricity generation is largely renewable and the transport and manufacturing sectors are swapping carbon-intensive engines and boilers for electric, which provides a multi-year growth opportunity for Contact. An investor benefits from both yield and growth, harvesting stable cash flows with the addition of fully funded growth optionality that could double the dividend in a decade. The company carefully manages its investment, and with steady and predictable demand growth strong dividend payouts are expected.

❷ IDP Education

ASX code IEL
Price $18.38
52wk ▲ $19.84
52wk ▼ $9.88
Mkt cap $4.68bn
Dividend 19.5¢
Dividend yield 1.1%
PE ratio 70

BUY

IDP Education is a high-quality, capital-light business with strong returns, providing student placement and English language testing services. It is the leading placement agent for Australian universities with 25% market share, and, importantly, it is 49% owned by universities. IDP's defensive-style growth comes from rising Asian demand for international education and its expansion into the UK and Canada. We estimate intrinsic value at $25 a share, and possible catalysts for a share price re-rating include faster student volume growth and regional penetration.

❸ Adairs

ASX code ADH
Price $2.34
52wk ▲ $2.52
52wk ▼ $1.25
Mkt cap $394m
Dividend 14.5c
Dividend yield 6%
PE ratio 13

BUY

With a market cap approaching $400 million, Adairs generates annual sales of around $370 million (before the recent Mocka acquisition) from its 170 physical stores across Australia and New Zealand. Bed linen is the key driver of foot traffic. Growth has centred on new store roll-out, store upsizing, range expansion, online and loyalty. Adairs was trading at a cheap seven times forecast EBIT before buying Mocka, an online retailer, which has the potential to double over the next five years. The market values similar capital-light, highly scalable online businesses growing at 20% a year on around 15-20 times EBIT.

Prices as at close of ASX business, 10-January 2020.