



SECTOR SMALL CAPS

Rewards come with risks

These companies can provide a portfolio with much-needed growth prospects

Continuing our theme from last month, examining some of the smallest Australian company opportunities, it is always first worth reiterating the risks.

There are massive rewards possible from investing in smaller companies, but a lack of liquidity means the race to the exit, if or when the need transpires, can be very tight indeed. The consequence of a narrow exit and illiquidity is that any losses could be magnified or any gains could be wiped out while you're trying to get out.

In calendar 2019, small capitalisation stocks such as EML Payments (ASX: EML) and Electro Optic Systems (EOS) rallied more than 200%. Avita Medical, which is owned by the Montgomery Fund, rallied 69%. Such returns are highly desirable, but as soon as the outlook deteriorates or a company doesn't grow quite at the rate expected, share prices can reverse with a determination that is rare among larger company shares.

Generally, however, despite their lack of size, access to capital markets, financial

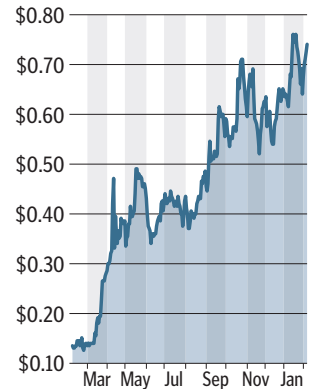
Electro Optic Systems



PointsBet Holdings



Avita Medical



resources, stability or competitive advantages, small companies provide at least some of the growth a portfolio needs to help investors maintain their purchasing power.

A number of research studies conducted over the past four decades, including those by Nobel laureates Eugene Fama and Kenneth French in 1992, demonstrate that small company indices have historically outperformed their large-cap counterparts on a

risk-adjusted basis. Add to that the fact that research reveals Australian small company fund managers tend to beat their small company index and investors have several very real reasons to consider investing in small companies or a small company fund.

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

1 Electro Optic Systems

EOS is the stuff of science fiction. It has three divisions: defence, space and communications. Defence has an order backlog of more than \$600 million and outstanding tenders of more than \$2 billion; in addition to tracking satellites, space is developing technology that can remotely move space debris; and communications is developing technology that provides bandwidth 20 times greater than that achievable using today's microwave technology. EOS is expected to earn more than \$200 million in revenue next year and EBIT of nearly \$40 million. It has no debt.

ASX code EOS

Price \$9.75
52wk ▲ \$10.80
52wk ▼ \$2.25
Mkt cap \$1.11bn
Dividend -
Dividend yield -
PE ratio 51

BUY
(HIGH-RISK)

2 PointsBet Holdings

PointsBet offers investors a ground floor (therefore higher-risk) entry into the commercialisation of legal online sports betting in the US. In the 19 months since the legislation banning online sports betting was repealed, 20 US states and Washington DC have passed legislation permitting some level of sports betting. Of those, we believe eight states will allow commercial online or mobile gaming at unrestricted locations. While PointsBet's share price has more than doubled in the past 12 months, the value of the opportunity to shareholders appears to far exceed the market value.

ASX code PBH

Price \$5.45
52wk ▲ \$6.65
52wk ▼ \$2.10
Mkt cap \$814m
Dividend -
Dividend yield -
PE ratio -

BUY
(HIGH-RISK)

3 Avita Medical

Avita produces a medical device called RECELL. Used to treat victims of the Bali bombings in 2002, RECELL produces a "suspension" of spray-on skin cells using a small sample of the patient's skin to help treat burns and defects. In the US, FDA approval for use of RECELL on patients over 18 paves the way to start commercial activities in the largest burns market. While it is in the early stages of its product rollout, the feedback from major burn centres in the US has been positive. But the trajectory of sales and profitability will depend on the speed of adoption and the effectiveness of Avita's sales team.

ASX code AVH

Price 73¢
52wk ▲ 78¢
52wk ▼ 13¢
Mkt cap \$1.57bn
Dividend -
Dividend yield -
PE ratio 45

BUY