

Stocks

Our undervalued tech sector – cheap tech stocks with a future

Mark Story - July 31, 2008

Attempting to talk-up tech stocks within a falling sharemarket is a bit like trying to convert Mecca-bound pilgrims to Christianity during Ramadan. Like it or not, Australia's tech-stocks are priced as part of a global technology market, and the fortunes of the sector at-large depend somewhat on the sentiment dished out to the megastars.

Tech-stocks in the US have held up considerably better during the sub-prime melt-down than they did when 'irrational investor exuberance' of the late 1990s finally turned on the dot.com brigade. Sadly, the share price of companies with strong underlying fundamentals was mercilessly annihilated in the wake of negative sentiment dished out to the dot.goners.

Eight years on, tech-stocks in the US are holding their own, but the jury's now out on what impact the global economic slowdown will have on future tech-spend. While they rallied on the strength of Intel's robust sales forecasts mid July, tech-stocks lost ground two days later on revelations Microsoft and Google expect tougher times ahead.

And while Nikko Citi expects earnings growth within Japan's IT services companies to slow to 5.6% this year (from 9.9% in FY3/08) it says the stocks to watch for a likely revaluation include, Otsuka and Trend Micro.

Meantime, currently 10.7% and 13.9% off their respective (YTD) highs, Citi in the US has reiterated ON Semiconductor Corp (Nasdaq:ONNN) and Marvell Tech Group (Nasdaq:MRVL) as its top-picks in this sector. "While potentially temporal, the week's 12% oil price decline clearly helped tech stock performance," says analyst Craig Ellis.

Adding to the economic head-winds facing local tech-stocks, Australian investors continue to undervalue technologies they don't understand. Poor transparency aside, the 100-plus ASX listed tech-stocks represent little more than 2% of the total index. And with the market currently fixated on large-caps, too few broking firms have the resources to drill down below the ASX100, let alone into the market's bottom-feeders. Geoff Mullin chairman of Enterprise Pacific, expects (fledgling) tech-stocks to receive a better trading environment following the launch of the Asia Pacific Technology Exchange (APTE) early in 2009.

He expects APTE to accelerate the development of green technology companies, (especially those wired to the resources and transport industries) like Trackaxle Pty Ltd and Native Fire Ltd – two of first companies expected to list on the APTE. He also expects to see a counter-cyclical return to some tech-stocks, especially larger IT and some biotech stocks as parts of the resources sector come under pressure.

But according to Anthony Baring chief investment officer of JM Financial Group (which operates the Australian New Horizons Fund), the multiple erosion of small-caps means there are gems of opportunity within Australia's overlooked and undervalued technology sector.

As there are no emerging catalysts needed to re-stage a tech-sector comeback of Y2K or dot.com proportions, he says investors need to hand-pick selected tech-stocks displaying solid underlying fundamentals. These include good IP, highly capable management, a strong balance sheet, and exceptional revenue stream upside. Preferring to avoid 'one-product' companies, Baring is attracted to tech-stocks in the services and software space currently selling on a single P:E with little debt on the balance sheet, paying a decent (fully franked) dividend yield out of cash flow.

He says investors should also watch-out for management buying back their stock at historical lows. "Due to low liquidity, it doesn't take much to move these share prices forward," says Baring. "Management knows its business better than outsiders, and buying shares on relative valuations is often a good way of deploying their cash reserves."

Currently trading at historical lows of 53cps, Baring likes the look of specialist IT&T contracting and recruitment firm, Peoplebank Australia Ltd (PBA). Earlier this year Wilson HTM Investment Group placed a target price of \$1.65 (on PBA) pending its \$100 million acquisition of Australia's largest privately owned recruitment company, Ambit.

Also included among the Australian New Horizon Funds top holdings are: Silex Systems (SLX), a laser technology company that helps enrich uranium, Realestate.com (REA) - plus biotech firms Arana Therapeutics (AAH) and, Acrux Ltd (ACR). "Upside potential once revenue streams come on board can make biotech stocks look particularly interesting."

Due to current valuations, sustainable cash-flows and their underlying brand/franchise strength, Ray David analyst with UBS is especially attracted to accounting software provider MYOB (MYO) and Internet services firm, Melbourne IT (MLB). Currently trading on 11.1x (FY09E EPS), MLB is on track for 18% 1H08 EPS growth. And based on David's 12 month target price of \$3.80, the stock looks attractively priced at current levels (\$3.08).

Given the importance accounting software has within a business, David says MYO is defensively positioned to ride-out an economic downturn. With MYO's share price having declined 26% since the June 1H08 update, he says MYO looks attractively priced at 13.5x (adjusted FY08E EPS).

Last April, MYO returned \$80 million in capital to shareholders, or 20.8cps (2.8cps was fully franked). And based on target gearing levels of 1.75x debt (to adjusted EBIT), he estimates that MYO can pay up to another 21cps capital return in FY08 following the sale of the UK division.