

It could be a buying opportunity – for those brave enough

Smaller stocks may prove great bargains for investors

Nick Westra

Equity markets have collapsed and investors with both the means and the mentality to take on volatility have started to identify small- and mid-cap stocks as extraordinary bargains.

"[It's] a once in 10- or 20-year buying opportunity," said Himanshu Shah, president and chief investment officer at US-based Shah Capital Management. "And actually we have done nothing but buying in the last two months and loading up the wagon even more."

Smaller stocks have been pulverised for much of the year as investors ditched them for traditional safe-haven investments like blue chips, government bonds or even cash positions.

But the sell-off has been so extensive that many small- and mid-caps are now too cheap to ignore.

"From any matrix, whether you are looking at price to earnings, price to book, or price to cash flow, they are trading at historically low valuations," Mr Shah said.

And in many cases, they are down even as their fundamentals remain strong. Global Bio-chem Holdings, for example, increased its net profit in the first half of this year from the previous period by more than 160 per cent. Still, the producer of chemicals used in animal feed has fallen 65.68 per cent so far this year and trades close to just twice its earnings.

Shanghai Industrial Holdings recorded a 28.87 per cent profit increase in the first half, and even after announcing a key increase in dividend payments, the Shanghai-based conglomerate has still fallen 56.65 per cent so far this year.

And Sinofert Holdings, whose profit rose 135.90 per cent in the first half, has seen its shares plummet 51.92 per cent this year despite being well positioned to tap into robust mainland demand.

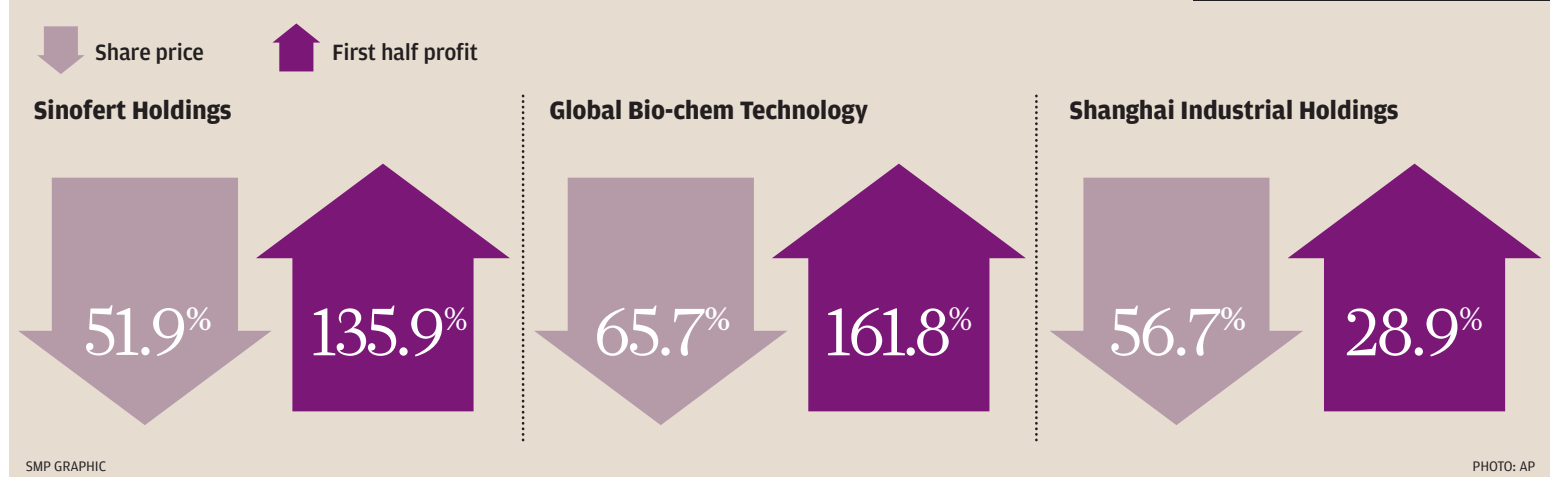
But while attractive valuations and strong earnings profiles may be enough to convince intrepid investors to re-enter the market, others may require more.

Many could be reluctant to take a chance on smaller stocks until the financial system has stabilised.

"You have to look at global macro-issues, especially the deleveraging and liquidity issues," said Frank Gong, chief China economist at JP Morgan. "And when you are facing a deleveraging issue and a liquidity issue, sometimes fundamentals don't matter."

Both large and small companies have been cut down this year because of cash flow problems stemming from a freeze in credit markets and a global economic slowdown.

And with equity markets spiraling



ling downwards as a result, investors seem less concerned with a company's growth potential than its ability to withstand collapse.

That puts smaller companies that usually run on tighter operating budgets at a substantial disadvantage.

"In the market there is a huge premium on liquidity," said Erwin Sanft, head of China and Hong Kong Equities research at BNP Paribas.

"And so even though these small caps may be good businesses, well managed, have a good niche, or are a leader in their segment, no one cares because they are small," he said.

But as many investors hunker down and wait for the storm to pass, others are taking stock of the potential bargains in the market and hoping a contrarian attitude will pay dividends soon.

"There are a lot of positives out here that people have not been looking at," Mr Shah said.

"A year ago it was greed that was driving investors, now it is sheer fear, and that creates good buying opportunities."

Other investors are also looking at potential opportunities in the small- and mid-cap arena but they are

approaching with some caution. "Business-wise these companies could be doing well," said Andy Mantel, managing director of Pacific Sun Investment Management.

"But we're not in a rush to load up on some new ideas even though prices are very low, because the overall financial crisis and its effect on these stocks could last a while."

Mr Mantel said that he was not trying to time the market because there were many hazards involved with picking small-cap winners in a bear market – chief among them being the lack of analyst research

reports written about the companies available to the public, or sell-side coverage.

Investors may also be waiting for the tide to turn in the Hang Seng Index since small- and mid-caps usually lag a large-cap rally.

But traditional market wisdom may be out of place in the current environment.

"This has been a very dysfunctional market worldwide and the carnage that has taken place in these names is mind-boggling," Mr Shah said. "So this is not a typical bull and bear market [situation]."