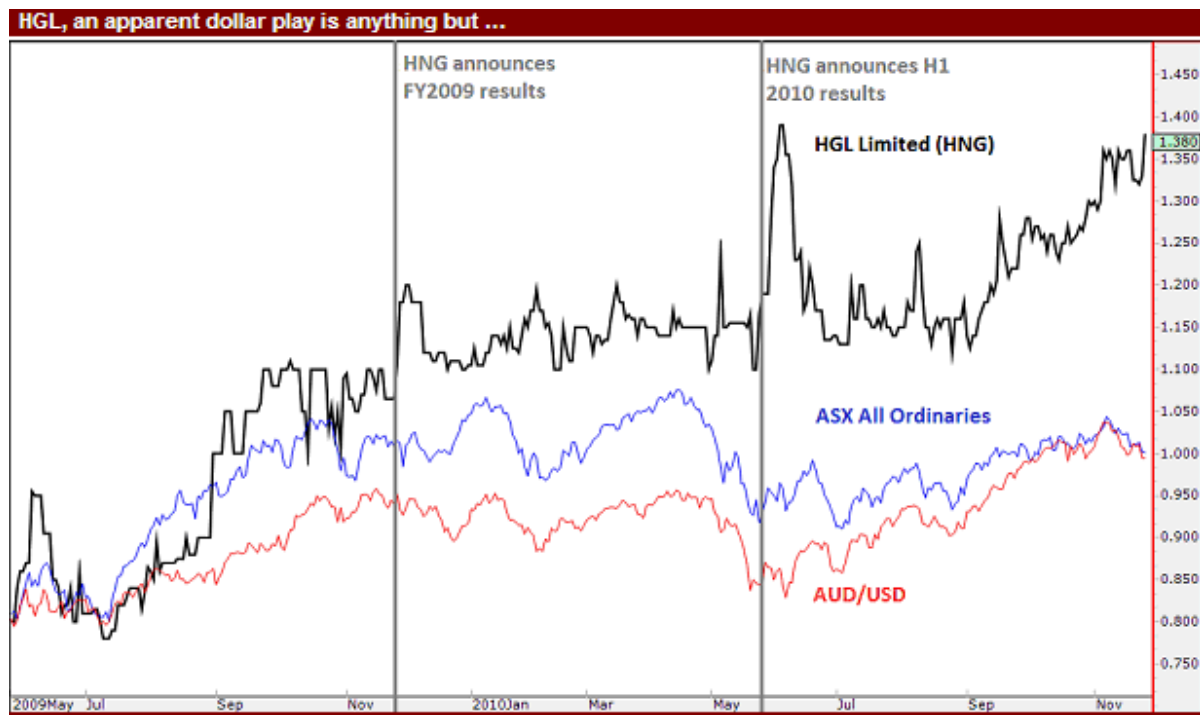


Under the Radar: HGL Limited

By Michael Feller
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PORTFOLIO POINT: HGL Limited (HNG), a company that invests in highly profitable importers, trades at a P/E as small as its market cap and is possibly one the market's best-kept secrets.

As the Australian dollar has surged against the greenback the past few months, importers have once again come into the spotlight with investors seeking a hedge to the deleterious effects a strong dollar can have on their portfolios. With this in mind we have uncovered HGL Limited (HNG), a little-known company that owns a range of importing businesses that service specialist niche markets. What we also uncovered, however, was that the strength of the dollar is of little concern to HGL, despite perceptions to the contrary, as illustrated in the company's share price performance.



Source: Lincoln Stock Doctor, November 25

New chief executive Michael Mahoney, speaking this week at HGL's excellent results announcement, said the currency's effect on gross margins has not been significant. So as for the idea that HGL is an Australian dollar play: "I'm pleased to say that's far from

the truth.”

HGL is currently in strong financial health and has been an emerging Stock Doctor star stock since its half-year results in May. HGL is a play on niche products with pricing power, products that will sell well and earn the vendor good, consistent products regardless of how the dollar is doing. And HGL’s products are certainly niche. Large-format printers are its biggest line, with annual sales in the year to September of \$60 million. Point-of-sale products, such as the hooks you see on shelves at Woolworths or the specials boards at Coles, are the next biggest segment, with annual sales of \$28 million, followed by home sewing and craft products at \$20 million. Architectural and high-end lighting equipment, eye testing instruments, exclusive beauty products, model cars and school hats make up the rest of HGL’s range.

Sold through 12 separate subsidiaries, representing over 80 different international brands, these products may seem arcane but collectively they are worth \$170 million in sales, up from \$165 million the previous year. They are also products and brands that are profitable and important to the people that buy them. Through exclusivity agreements they are products where, for the most part, HGL is not competing to sell, and they are small enough in market size – on their own – to not attract new entrants. As an example, HGL’s Mountcastle subsidiary, which supplies school hats, holds 90% of Australia’s private school market. HGL’s SPOS point of sale business, meanwhile supplies both Woolworths and Coles.

To help retain the moat around these businesses, HGL further focuses on consistently high standards of quality and value-adding service to keep customers happy. At the other end of the supply chain, HGL’s subsidiary executives travel overseas regularly to build, maintain and expand relationships with suppliers. These executives also travel to keep in touch with international trends, Mahoney explains, which allows HGL to deliver products in Australia soon after they have been launched internationally.

As for the spread of brands, this also serves to mitigate risk should one line’s success fall below expectations, or there are supply chain issues. HGL also focuses on customers where the relationship is not one-sided. Although its cosmetics products are sold in large chains such as Myer, there is a focus on exclusive day spas and top-end hotels for distribution. And while SPOS sells to Coles and Woolworths, it is selling critical business products to these retailers, not shelf goods to the end consumer. With their own staff often operating from the customer’s premises, HGL has focused on offerings where it as a business is as important to the customer as the products themselves. There’s little in sales that’s more defensive than that.

Brands new and old



Source: Company website

But it's in the company's numbers that the story gets really interesting. On Wednesday's closing price of \$1.38, following the release of its financial year results, HGL has a market capitalisation of \$75.4 million, less than half of underlying revenues for the year. Based on underlying net profit after tax of \$6.8 million, not counting \$6.6 million in other income, including the sale of listed shares, the company reported core earnings per share of 13.3¢ and total EPS of 26.3¢. And when compared to Wednesday's \$1.38 close, that gives HGL a price/earnings (P/E) multiple of 10.38, or 5.25 if you count the other income. Either way though, those are tiny figures when you consider the defensiveness of HGL's business model and compare it to the industry group average P/E of 11.66 times.

Further, HGL has no debt and holds net cash of \$2 million. And while it is consistently scouring the market for further acquisition opportunities and new product lines, as at

September 30 it was not utilising its \$10 million bank facility. At the end of the financial year, statutory net tangible assets came in at \$57.242 million, being, in effect more than \$1 per share. Including the goodwill inherent in HGL's various subsidiaries – which are each focused on specialist markets with high barriers to entry – HGL has \$84.636 million in net assets, or total equity, which is well in excess of the company's share price. While it is difficult to value conglomerate-style businesses that operate across vastly different product lines, based on the company's book value, strong cash flows and high profit margins of 45% gross, it is not difficult to see that HGL is worth more than \$2 a share.

Following the release of its latest report, HGL declared a final fully franked dividend of 5¢ a share, bringing the total for the year to 11¢. With a stated policy of paying out 70–80% of underlying profits as dividends and with historical dividend yields well in excess of 5% per annum, HGL makes an excellent income stock. Based on current yields and a conservative estimate of 7% per annum growth from here on, HGL is arguably worth \$2.20 based on a stable growth dividend discount model that assumes a required return of 12%.

Overall, HGL is limited not by currency, not by market share and not by reputation, but by how it can find more people and more brands to bring within the tent. The company has undergone a great transformation into a niche importer in recent years, selling its funds management investments (it once owned large stakes in MMC Contrarian and Hunter Hall) and its share trading arm. This transformation follows previous reincarnations going back to 1898, when the company, then known as Hancock & Gore, first came into being as a Brisbane timber mill. HGL is much more than a currency play but is a well-run business with intriguing products and excellent results.



Michael Feller is an equities analyst at [Lincoln Indicators](#). Lincoln develops [Stock Doctor](#), Australia's premier fundamental analysis research service. The author or the Lincoln Australian Share Fund may have interests in any of the companies mentioned.