

Characteristics of Micro Cap

This chapter will attempt to answer the following questions:

- What is a micro cap stock?
- Why do they exist?

THE NEBULOUS MICRO CAP (WHAT IS A MICRO CAP STOCK?)

Investors often refer to “the market” when speaking about stocks as a group. However, knowledgeable investors will agree that not all stocks are created equal. Different investors will often focus on more narrowly defined segments of the market. When looking at the composition of the market as a whole, these investors will normally classify stocks by certain characteristics. The two most fundamental characteristics of classification within the investment community are those of value and of growth stocks. Most investors are familiar with the concepts of growth and value investing, although agreeing on the definition of either is often a topic of debate among informed observers.

Taken further, the growth and value styles can be divided into

subgroups that categorize the investments by market capitalization. For example, there is large cap growth and mid cap value. These capitalization ranges are typically broken down into large cap, mid cap, and small cap when referring to the size of the underlying companies. These style and market cap definitions are the most basic categories of classification when referring to investment managers and the stocks they own. But when dividing the market of stocks by capitalization, a very large number of small public companies virtually disappear from the investor radar screen. These are a segment of companies often referred to as *micro caps*. It should be no surprise that, like the definitions of value and growth, the threshold sizes for large, mid, and small capitalization stocks are also subject to debate.

The market capitalization of a company is arrived at by multiplying the number of outstanding shares of common stock in that company by its current market price per share to arrive at the total value of all shares outstanding.

$$\text{Market capitalization} = (\text{shares outstanding} \\ \times \text{current market price per share})$$

To some degree, the demarcation of market capitalization is influenced by the many widely published market indexes such as the Standard & Poor's (S&P) 500 or the Dow Jones Industrial Average. The threshold sizes for market segmentation are often related in some ways to the relative market capitalization of the stocks contained within a popular market index.

For example, the S&P 500 Index is considered to be a large capitalization index. The smallest stock in the index has a market cap of \$414 million, with the largest having a market cap of \$286.6 billion. The 500 stocks that constitute the index have an average market capitalization of \$17.9 billion. The index has a median market cap of \$7.5 billion as of June 30, 2004. (June 30, 2004 is the date of all market capitalization data throughout this book unless otherwise noted.) These types of statistics will lead market participants to general ranges that define the boundaries of market capitalization segments. Currently, most market participants agree that large capitalization stocks are those that have a market capitalization of outstanding shares in excess of \$5.0 billion.

Another way to approach the issue of defining market capitalization boundaries is to study the market cap distribution of all public companies. Using a standard distribution of market capitalization values, the market cap of all public companies can be divided into groups based on the range of market capitalization in which they appear. The Center for Research in Securities Prices (CRSP) at the University of Chicago maintains an extensive database of stock prices often used for this type of market cap research. The CRSP produces a database of market performance indexes that are broken down by market value. The index that represents the smallest 20 percent of publicly traded common stocks is typically used as a proxy for the micro cap market. CRSP ranks the top 20 percent of the market in terms of capitalization as large cap, the next 30 percent of market capitalization following that as mid cap, the following 30 percent is a proxy for small cap, and as mentioned, the smallest 20 percent is considered micro cap. In addition, there have been those who segment the top 10 percent of companies by market cap and consider them to be mega cap companies. Conversely, the quantitative research group at Merrill Lynch, led by Richard Bernstein, has dubbed stocks with a market cap of less than \$100 million the “nano cap” sector.

The many academic studies of market cap segmentation coupled with the growth in the investment consulting profession have resulted in the definitions of capital markets becoming more structured. Institutional investors now segment the investment markets into narrow sectors ranging from nano caps through mega caps. This segmentation of the public investable market has given rise in part to the micro cap asset class.

As mentioned, there have been a large number of academic studies that explore the market cap segmentation of public companies. The outgrowth of one such study was the Russell 2000 Index, published by Frank Russell Company, of Tacoma, Washington. Each year, this company reshuffles the universe of U.S.-domiciled companies by total market value and selects the 3,000 largest U.S. domestic public companies. They then create the Russell 2000 from the bottom two-thirds of the 3,000 largest companies. The new universe contains stocks with share prices greater than \$1 that are publicly traded as of May 30 of each year.

In addition, Russell must receive documentation from each company that includes a company description and confirms the number of shares outstanding in order for the company to be eligible for inclusion. The Russell 2000 Index has become the most popular small cap benchmark against which the performance of small cap portfolio managers is measured.

With the introduction of the Frank Russell Company Russell 2000 Index, small cap stocks finally had an index of their own. The Russell 2000 was introduced in 1985, and by the early 1990s there was a proliferation of small cap mutual funds benchmarked against the index. The Russell 2000 is now the most widely quoted index of U.S. small cap stocks. Prior to the creation of the Russell 2000, micro caps were often grouped with small cap stocks. In addition, as mentioned earlier, the boundaries of where micro cap stocks ended and small cap stocks started were often debated within the financial community.

It was not until the early 1990s that micro cap stocks began to develop their own identity and their characteristics evolved sufficiently to separate them from the small cap segment. This was in part the result of the large and growing number of micro cap stocks in the public arena. It was also due in part to the continued refinement of market segmentation within the professional consulting and investment community.

Currently, the Russell 2000 has a range of market caps that has fallen for three years in a row, as of the most recent rebalancing on June 30, 2003. The largest stock in the index has a market cap of \$1.2 billion, whereas the smallest stock has a market cap of \$117 million. In comparison, the range in 2002 was \$1.31 billion down to \$131 million. The rebalancing pushes the weighted-average market cap down to about \$646.9 million versus \$696.6 million when the index was rebalanced in 2002. The average market cap for stocks in the newly rebalanced index is \$443 million, while the median capitalization is \$350 million. This index clearly reflects the definition of small cap within the investment community. Currently, most market participants agree that small capitalization stocks are considered those in the range of \$500 million to \$1.5 billion. Thus, if large cap is \$5.0 billion and up and small cap is \$500 million to \$1.5 billion, then by elimination mid cap stocks are those that fall in the \$1.5 billion to \$5.0 billion ranges. This still leaves the definition of micro cap as an unanswered question.

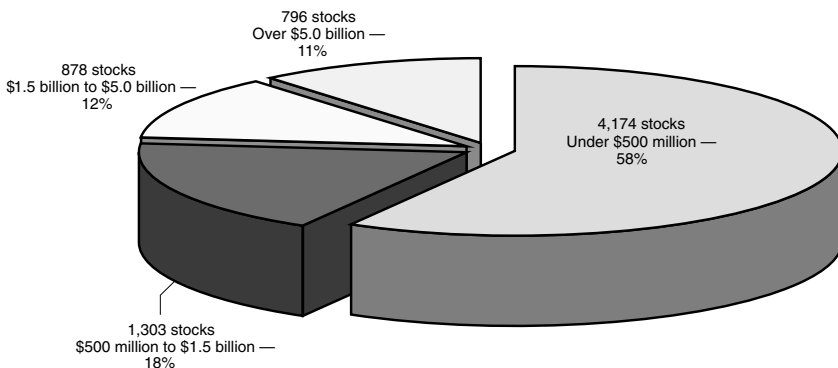


FIGURE 1.1 Distribution of reporting public companies by market capitalization, June 30, 2004.

These commonly accepted descriptions of market capitalization leave out one very large segment of the public markets. Currently there are more than 4,000 stocks listed on the New York and American stock exchanges, and the Nasdaq and over-the-counter (OTC) markets that have a market capitalization of less than \$500 million. Some observers might argue that micro caps begin at below \$400 million, or even below \$300 million, but in any case the absolute number of these micro cap companies is large. For purposes of this analysis, a market cap of below \$500 million will be considered a micro cap. Wherever the line is drawn, these small company stocks are generally known among professional investors as micro caps. In absolute number, the micro cap universe of 4,000 stocks has roughly twice the number of stocks than the universe of companies with market capitalization of over \$500 million! (See Figure 1.1.)

THE MICRO CAP DILEMMA (WHY DO THEY EXIST?)

In the world of professional investing, micro cap stocks are often overlooked simply because of their small size. To a large degree, this is the result of the growing size and scale of professional

investment management. For example, small cap investment managers who offer a good performance track record often find themselves with a billion dollars or more of investment capital to manage on behalf of their clients. A simple search of the Morningstar universe of small cap mutual funds yields over 1,450 small cap funds with an aggregate of over \$900 billion under management in these funds alone. It does not consider the separate private accounts of these institutional money managers. In addition, it does not consider the hundreds of private institutional money managers who don't manage a public mutual fund.

In the Plan Sponsor Network (PSN) database of money managers published by Thomson Financial, there are over 1,900 small cap managers listed with an estimated \$850 billion of small cap assets under management. This creates a situation where, for the purposes of liquidity and efficiency, professional investors must focus on small company opportunities that provide the scale and liquidity required to invest these larger pools of funds.

Professional investors also have limited resources available in terms of research capabilities to analyze and screen the thousands of smaller companies. In many instances, they rely on Wall Street research analysts to provide basic coverage of small company opportunities. However, Wall Street research is often hesitant to focus on small companies if those small companies don't appear to provide investment banking opportunities for the research firm or if the companies don't have sufficient market liquidity to allow for easy trading in the stock by larger institutions. This creates a situation where many small high-quality companies that are not seeking additional investment capital or have limited trading volume go largely uncovered by Wall Street firms and are largely unnoticed by small cap portfolio managers.

The world of small cap stocks is also where many research analysts begin their careers in the investment business. This is not to say that all analysts covering small cap stocks are new or inexperienced; however, a large number of analysts often begin their career paths in the small cap arena. This new analyst phenomenon often leads to research that is of lower quality than the research published by more seasoned analysts who are focused on the mid cap and large cap investment arena. From a business perspective, it makes sense that the resources of better, more experienced analysts are allocated to opportunities of the size

and scale that are more meaningful to large institutional investors. Large companies tend to be more complex, too. In addition, these larger companies often provide more active investment banking opportunities for the sell-side brokerage firm as well. So it's easy to see why many small and micro cap companies are either undercovered or not covered at all by Wall Street research firms.

In addition to these burdens, small and micro cap companies are often considered riskier by institutional investors. This notion of high risk may run contrary to the professional investors' fiduciary duty, which is often prescribed as limiting risk in the context of their portfolio management. So in the face of fiduciary responsibility, a typical professional investor would feel more comfortable owning Anheuser-Busch, with a market capitalization of \$42.6 billion, than Samuel Adams, the small microbrewery based in Boston, Massachusetts, with a market capitalization of \$217.0 million. Without regard to the idea that the smaller brewery is growing at a much faster rate (and makes better beer, in this writer's opinion) and also carries a generally lower valuation than Anheuser-Busch, professional investors, because of their fiduciary obligations and their perception of risk, would likely own Anheuser-Busch over Sam Adams.

When considering an investment, many institutional and professional investors equate a low share price with low quality or high risk. A share price of below \$5, or even below \$1, often brings to mind the notion of "penny stocks" with professional investors. Penny stocks are generally low-priced stocks normally trading below \$5 and often trading at below \$1 per share. They are speculative securities of very small companies. By definition, all penny stocks trade in the OTC Bulletin Board (OTCBB) or the pink sheets, but do not trade on national exchanges such as the New York Stock Exchange or the Nasdaq Stock Market.

The OTCBB is an electronic quotation system that displays real-time quotes, last-sale prices, and volume information for many OTC securities that are not listed on the Nasdaq Stock Market or a national securities exchange. Brokerage firms subscribe to the system and can use the OTCBB to look up prices or enter quotes for OTC securities. Although the National Association of Securities Dealers (NASD) oversees the OTCBB, the OTCBB is not part of the Nasdaq Stock Market. Unscrupulous stockbrokers

will often claim that an OTCBB company is a Nasdaq company to mislead investors into thinking that a company is really bigger than it is.

The pink sheets are named for the color of paper on which these stock quotes are printed. They are listings of price quotes for companies that trade on the over-the-counter (OTC) market. OTC market makers are the brokers who commit to buying and selling the securities of OTC issuers. They use the pink sheets to publish bid and ask prices for companies of which they may want to buy and sell shares. A company named Pink Sheets LLC, formerly known as the National Quotation Bureau, publishes the pink sheets in both hard copy and electronic format. Pink Sheets LLC is not registered with the Securities and Exchange Commission as a stock exchange, nor does the SEC regulate its activities. The structure and use of penny stock issues is discussed in more detail in Chapter 12.

It is important to understand that the share price of a stock has no bearing on or relationship to market cap. A perfect example of this is Nortel Networks, with a share price of \$2.70 as of June 30, 2003. Nortel is not a micro cap stock or a penny stock. With 3.85 billion (yes, billion!) shares outstanding, Nortel sports a market cap of \$10.4 billion ($\$2.70 \text{ share price} \times 3.85 \text{ billion shares outstanding} = \$10.4 \text{ billion market cap}$). Nortel Networks is a large cap stock. (See Figure 1.2.) Conversely, Seaboard is an agribusiness company listed on the American Stock Exchange that currently trades at \$207 per share. With 1.255 million shares outstanding, the company has a market cap of \$260 million ($\$207 \text{ share price} \times 1.255 \text{ million shares} = \$260 \text{ million market cap}$). With a share price of \$207 per share, this is a micro cap stock. Thus, small companies can have big share prices and big companies can have small share prices. Share price in general is has no direct relation to the size of a company.

In fact, share price has no relationship to the size of a business. Consider the Internet boom for a moment. There were many multi-billion-dollar market cap companies that had no revenues, few employees, and limited tangible assets. In many ways, market cap reflects the consensus of investor opinion about the future prospects for a company.

The classic case study of this phenomenon is that of Amazon

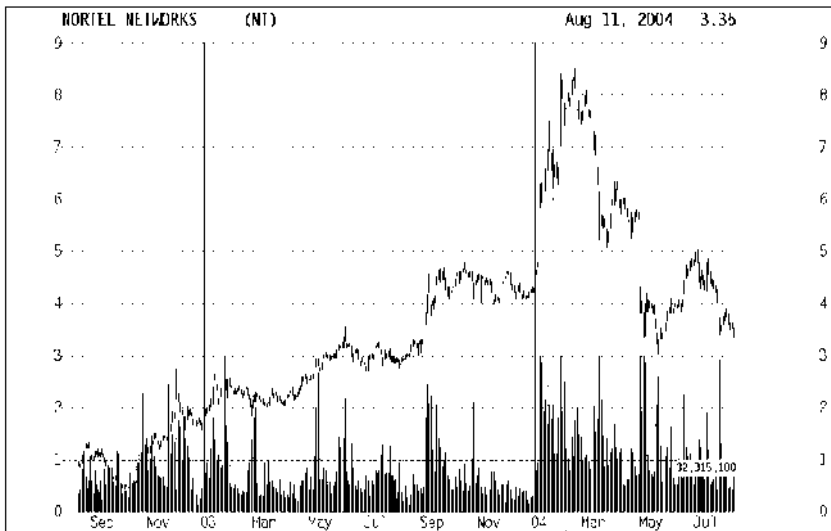


FIGURE 1.2 Nortel Networks price chart.

.com and Barnes & Noble. In May 1997, Amazon went public with a market cap of about \$400 million. By January 1999, the share price had reached about \$100 and the market cap was \$38 billion, as compared to Barnes & Noble, the nation's largest bookseller, with a market cap at the time of around \$2.6 billion. In 1998, Barnes & Noble had revenues of \$3 billion and earnings of \$1.29 per share, while Amazon had revenues of \$610 million and lost \$.42 per share. Yet with sales one-fourth those of Barnes & Noble, and considering that it was losing money versus turning a profit of \$1.29 per share, Amazon commanded a market value 14 times that of Barnes & Noble. And Amazon started out as a micro cap opportunity. (See Figure 1.3.)

Amazon is now widely held in institutional investment portfolios. At the time of its initial public offering (IPO), it is unlikely that many institutional investors owned the company. The belief was that individual investors were primarily willing to support early-stage industries such as computer companies and the Internet. This was the main driver behind micro cap stocks. However, few institutional investors would consider micro cap issues as viable investments because, in many instances, the business

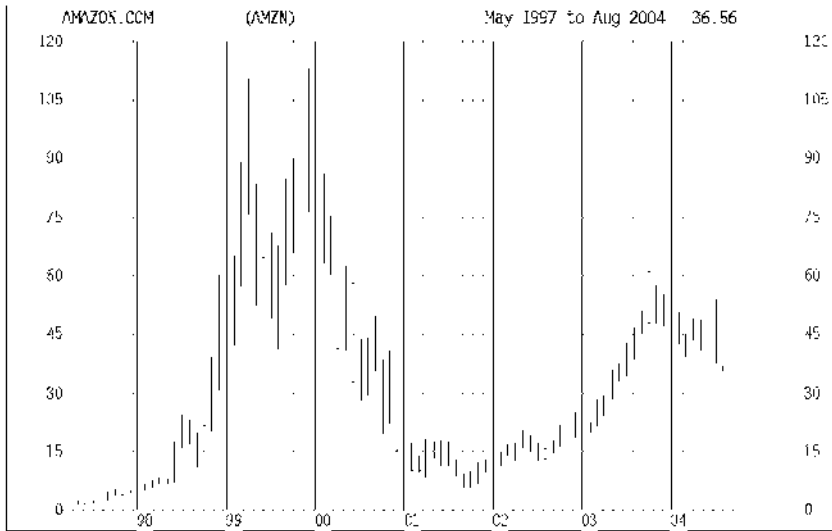


FIGURE 1.3 Amazon.com price chart.

models and technologies were largely unproven. It was only when the companies became large enough that institutional investors would consider the possibility of investing in them.

Each year hundreds of these small, undiscovered companies grow to become hot small cap opportunities as they emerge from the micro cap universe. When these small companies reach \$500 million to \$700 million dollars in market capitalization, they typically become the focus of small cap research analysts and small cap investment management companies that are actively seeking emerging opportunities from the micro cap segment. This leaves thousands of stocks to go virtually unnoticed by the professional investment community until they graduate into the ranks of the small cap and beyond.

In the year ended June 30, 2004, 554 companies graduated from the micro cap to the small cap arena simply due to price appreciation. In fact, the average 12-month return of the graduating class was 113 percent. During that same year, 651 companies descended from the ranks above micro cap into the micro cap arena when their market capitalization shrank to below \$500 million.

At the end of March 2003, American Airlines had a market capitalization of around \$300 million. As of June 30, 2004, the

stock closed at \$12. American Airlines existed as a micro cap because of a change in the dynamics of the airline industry as a result of the attack of September 11, 2001. Just as the consensus of investor opinion reflected a positive outlook for Amazon, a similar consensus of investor opinion had a very negative outlook for American Airlines. It is these very extremes in investor emotion that often create opportunity. And it is these extremes that are often reflected at some point within the micro cap segment. However, to better understand these extremes, an investor must understand the information advantage. Chapter 2 will examine the concept of the information advantage.

