PART I

Big Companies Start Small

CHAPTER 1

Microcap Stocks, the Neglected Asset Class

Considering the fact that almost 50% of the approximately 16,000 public companies (this number includes OTC market stocks) in the United States have market caps of under $500 million, the lack of research and media coverage on this sector is surprising.

U.S. Public Companies' Market Caps
- 7,360 under $500 million
- 6,622 under $250 million
- 5,713 under $100 million
- 5,053 under $50 million

—Thomson Reuters, September 7, 2014

The microcap sector is one of the least-understood asset classes on Wall Street. It is also the most neglected sector by the major financial media outlets. CNBC, Fox Business, and Bloomberg offer precious little content or commentary on microcap stocks. Fox Business's Charles Payne is the only mainstream Wall Street media pundit who has experience in the sector. Jim Cramer, on his show *Mad Money*, does occasionally comment on microcap companies (in fact, he has mentioned several RedChip client companies over the years), but he is largely focused on large and mid-caps. My show, *Small Stocks, Big Money*, is the only show approved by major networks (Fox Business, Bloomberg Europe, Bloomberg Asia) that focuses exclusively on microcap stocks, and at this point we still have to pay for our air time.

It is not often that we see the major business media outlets discussing, providing commentary, or interviewing the rainmakers in the U.S smaller-cap sector. Rarely do we see interviews with the CEOs of public companies with market caps under $250 million, though there are plenty of fast-growing, profitable companies from which to choose, some of which you will read about in this book.

> What the mainstream financial pundits forget is that big companies generally start small. In my debate with Herb Greenberg, Gary Kaminsky, and David Faber on CNBC in November 2011, related to reverse merger Chinese small-cap stocks, I tried to make the point that Blockbuster Video, Texas Instruments (NASDAQ: TXN), and even the New York Stock Exchange (NYSE: ICE), went public through the reverse merger process, an alternative to IPOs used by many small companies.

A *reverse merger* is an inexpensive way of going public that circumvents the IPO process and the associated costs. This alternative listing mechanism is used today by many start-ups and less developed companies.

Greenberg and others also betrayed their lack of knowledge of the microcap sector when they questioned whether institutions purchased small and microcap stocks covered by RedChip analysts when in fact hundreds of institutions meet with the CEOs of RedChip companies every year, many of whom build large positions in our stocks. Not only did they cut me off seven times in a 15-minute discussion, they implicitly disparaged the entire microcap asset class over and over again. Their show, called *The Strategy Session*, was later canceled.

Over the past 24 months, NASDAQ OMX Group and the NYSE: MKT has listed dozens of "small" companies that went public through the reverse merger process on the OTC markets, which is the home of thousands of smaller companies intent on listing on a major exchange. Another problem with the sector is that there are simply not enough independent analysts covering microcap stocks. There is a plethora of issuer-sponsored research, some of it quite good, but because it is paid for by the issuer, in some circles it is not given the respect that it deserves. The investment banks who focus on smaller-cap companies, with few exceptions, save their research for companies they back.

Considering the fact that almost 50% of the approximately 16,000 public companies (this number includes OTC market stocks) in the United States have market caps of under $500 million, the lack of research and media coverage on this sector is surprising. Michael Corbett, CEO of Perritt Capital Management, summed the issue up well when he explained that it is much easier for analysts and the pundits to talk about the big companies because there is so much history and information. Also, the white-shoe firms such as Goldman Sachs and JP Morgan learned a long time ago that because smaller stocks lack the liquidity of the larger names, it's harder to generate substantial fees trading these stocks. So it's best to stick with the big and midcaps where the fees are bigger and the information is better.

Sometimes big companies with long track records lose market cap due to a lack of execution, innovation, or poor financial management, and fall back into the microcap category. Superstar Phil Sassower invested in New Park Resources (NYSE: NR) in 1986 at 20 cents a share after it was delisted from the NYSE. He revitalized the company with new money and management, refocused the business, and made an enormous profit on his investment.

> You will hear over and over again in this book from the Superstars that management is the most important factor to consider when investing in small, lesser known companies. It does not follow logically that great technology or a great idea translates into a successful company.

Jim Collins's epic study of great companies in *Good to Great* teaches us that the first and most important thing a company must do to get better or to become great is to *get the right people on the bus* and *get the wrong people off the bus*. If this is true for big companies, then it is extraordinarily true for microcaps.

Collins's study looked at over 1,400 companies and found only 11 that made the transition from good to great, defined by outperforming the market by at least three times over a 15-year period. If less than 1% of those big companies made the transition from *good to great*, then one can imagine how few microcaps make the transition from *bad to better, okay to good,* or *good to great.*

Buying microcaps when they are least efficient, before the truth about the company is fully known by the Street, is how investors can maximize their returns. And this is what the Superstars have been able to do consistently. Inside this book you will find dozens of examples of how the Superstars invested in companies, many times when no one else would, because they had the acumen and the foresight to understand what others missed, a technology, product, or service that with the right capitalization, management, or marketing could become successful.

Barry Honig and Phil Frost invested in MusclePharm (OTCQB: MSLP), when it was a subpenny stock and hemorrhaging losses. They restructured the company, did a reverse split, and led a $10 million capital raise. What they saw was a company with industry-leading muscle-enhancing nutritional products and a very large market opportunity. Eighteen months after their investment, the stock traded at a $175 million market cap. The stock has

FIGURE 1.1 MusclePharm (OTCQB: MSLP)
Data Source: Thomson Reuters Corporation.

since fallen to a $64 million market cap. In 2014, the company generated $177 million in revenue, with a loss of $13 million. For the first six months of 2015, it reported revenue of $91 million and losses of $14.5 million (see Figure 1.1).

> Every stock has a life cycle. Every stock has its proverbial ups and downs. But the life cycles of microcap stocks are different, more erratic, and more volatile. They tend to move up faster but can also fall faster. Some trade in familiar patterns, up two to three points like clockwork only to fall back down two to three points the next day, week, or month. Indeed, the microcap world can be fast and furious. There are momentum plays every day of the trading year with daily and weekly price swings of 10% to 100%+.

The neglected asset class is full of opportunities for large gains, but is also fraught with risk. The chart of Galectin Therapeutics (NASDAQ: GALT) in Figure 1.2 tells a fascinating story. The stock closed at $8.08 December 31, 2013. Just 10 days later it closed at $15.10, an 87% gain in two weeks. It pulled back to $11.59 on January 24, 2014, then burst to $18.30 on February 27, 2014. Less than three months later it was back at $10.28 but then gained 42 percent over the next seven weeks.

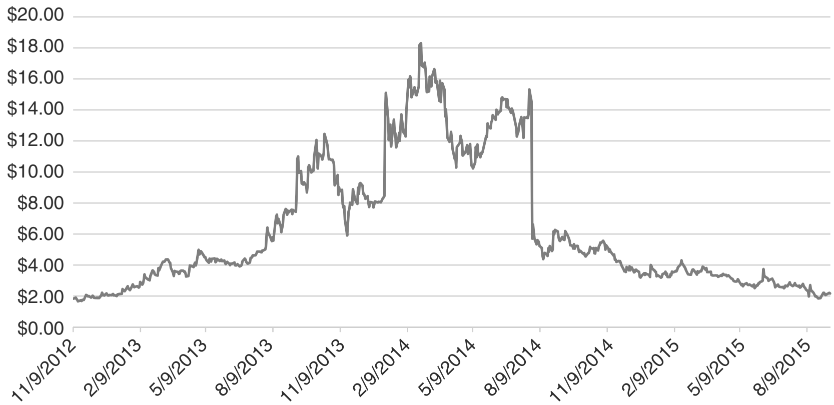

FIGURE 1.2 **Galectin Therapeutics (NASDAQ: GALT)**
Data Source: Thomson Reuters Corporation.

On July 25, the stock closed at $15.32. Four days later the stock lost 66% of its value when healthcare analyst Adam Feuerstein published a scathing article on TheStreet.com about the company. The critique was prompted by a July 24 article published by a firm paid by Galectin to promote their stock. In the July 24 article, the paid promoter stated that Galectin was "nipping at Intercept's heels," with a Phase I drug that treats NASH, nonalcoholic steatohepatitis (a form of fatty liver disease). Comparing Galectin, which was still in a Phase I trial, with a $4.5 billion market cap company that had already completed a Phase II clinical trial for a similar drug with positive data, Feuerstein argued was misleading and unethical. Feuerstein also questioned the efficacy of the endpoints of Galectin's Phase I trial. Galectin promptly responded with a press release defending their development program for GR-MD-02 (their drug for the treatment of NASH), potentially allaying concerns about their technology. The bigger issue uncovered was that insiders had sold 700,000 shares of stock "in the last twelve months."[1]

The question begs itself: Was the stock trading efficiently between $12.00 and $15.00 with a market cap of $300–$350 million, or was it now fairly valued at a $100 million market cap trading at $5.00? Nothing had changed about the company or its technology from July 25 to July 29. But in one day it lost 66% of its market cap. What did change is information that was already public regarding the insider selling of 700,000 shares over the past 12 months was brought to the attention of investors who were unaware of this fact. The insider selling, combined with what appeared to be a company-sponsored promotional campaign of their stock by promoters who appeared to be making exaggerated claims about the prospects of their lead drug, resulted in a massive selloff.

The fact is the results of their Phase I trial and the technology behind it were well known on the Street. Institutions such as BlackRock, BNY Mellon Asset Management, and dozens of other sophisticated investment management firms were positioned in the stock and still are today. Institutional holdings after this "new" information came to light only dropped 2.7%, quarter-over-quarter. The selloff appeared to be mostly from retail investors, who either did not know or had not thought much about the insider selling.

> When a microcap stock has a small number of tradeable shares (float), the stock can make lightning-fast moves up or down. These stocks can make extraordinary runs in a matter of days, becoming tremendously overvalued, based on a well-placed blog, or positive industry article, or news of a big contract, only to come crashing down a few days or a few weeks later as more information about the company comes to market.

These erratic runs sometimes look like pump-and-dumps, but that does not mean the company is a fraud or misleading investors, though that is sometimes the case. It often means that someone or some group of investors hold cheap stock, often the previous owners of the shell company if it was a reverse merger. Drone Aviation (OTCQB: DRNE) is one such example. Figure 1.3 is disturbing. The stock ran from $0.65 to $1.17 in just a few weeks after they began airing commercial spots on DirectTV financial stations and other media outlets.

FIGURE 1.3 **Drone Aviation Holding Corp. (OTC: DRNE)**
Data Source: Thomson Reuters Corporation.

The 30-second TV commercial was factually accurate and was very effective in getting investors excited about the company. The stock went from trading 5,000 shares a day to trading hundreds of thousands of shares a day. But within four weeks after the run-up, it came crashing down to $0.30. The precipitous fall was due partly to a negative article written by a blogger who had little knowledge of the company or its technology, but who believed that with less than $5 million in sales, the stock did not deserve a $200 million market cap. Even though Dr. Phil Frost invested in the company, probably the savviest and by far the richest Microcap Superstar, this did not stop other bloggers from piling on with negative and for the most part factually incorrect blogs, which further helped drive the stock down. What was also true, however, is that there were a group of investors who held very cheap stock in Drone Aviation and many of them sold on the way up and on the way down. Hence, it looked like a proverbial pump-and-dump. Depending on where one bought and sold along the price continuum, and whether he was in for a short-term price swing or long-term gain, determines a lot about the state of mind of the investor after the stock lost 66% of its value. Those who did their homework realized that the precipitous price deterioration of Drone Aviation, like Galectin Therapeutics, created an excellent opportunity to accumulate.

Companies can be fundamentally sound and executing well, and still lose millions in market cap value for various reasons, including the filing of an S-1 or S-3 registration statement to prepare for a future capital raise. Investors fear dilution and exit, or short the stock, while potential new investors wait for the capital raise before positioning, and thus, the stock tumbles. Bill Hench of The Royce Funds says that he tries to buy stocks as cheaply as possible, but he does not try to time the market or his buys. The Royce Funds position for the long term and have billions under management. They can afford to wait two or three years for a stock to work out, but the individual investor often cannot. Thus, it is important to be prepared for the downside. The neglected asset class is also chock full of opportunities to lose. Lessons from the Superstars hopefully can help investors better understand and navigate the microcap landscape.

Note

1. Seeking Alpha, "Why This Penny Stock Dressed Up by Stock Promoters Is a Short," July 28, 2014.