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Microcaps

Understand the risks and reap the rewards

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Whether you're an issuer or an investor, playing in the microcap arena can be riskier than with other forms of investment, at times significantly so. Many microcap stocks are traded over the counter, directly between brokers and dealers. As they are not often the focus of concentrated market interest, only a small number of shares are traded at any one time, and prices tend to be low because of the low demand. In addition, unlike microcap stocks that are not exchange-traded, they do not have to meet the strict listing standards designed to protect investors, and due to the relative anonymity of these stocks, investment researchers follow them less closely and file reports about them less frequently than their larger counterparts. The SEC has stepped in to address this, requiring microcap stocks with more than 500 investors or with $10 million or more in assets or that post their price quotes on the OTC Bulletin Board to file reports with the agency, detailing the stock's financial condition. But certain microcap stocks are considered risky investments for reasons apart from their place in the regulatory framework. Often, for new companies with no established history of success and with products or services that are in the infant stage, the likelihood of their success is difficult to gauge. In addition, the paucity of public information increases the risk of corporate fraud.

The tradeoff, of course, can be summed up in a Wall Street axiom: "The higher the risk, the greater the reward." With many microcap stock prices low and the companies small, tremendous room exists for growth and robust returns.

Understanding the Differences

It is important to understand what is meant by the terms *microcap*, *small-cap* and *penny stock*. The definitions of small-cap and microcap stocks are connected to the value of their market capitalization. Penny stocks, on the other hand, are defined by their per-share price.

- *Small-Cap Stocks*: The definition of a small-cap stock varies among the rating agencies and numerous brokerage houses. Generally, it relates to a company with a market capitalization of less than $1 billion. Historically, these companies have focused on the delivery of services and products to niche markets or emerging industries where substantial growth in demand is expected.
- *Microcap Stocks*: The SEC has indicated that the term *microcap stock* applies to those companies with low or "micro" capitalizations (i.e., meaning the total value of the company's stock). Depending on who you're talking to, there are many different market caps used to define what a microcap stock is. Generally speaking, companies with market capitalizations of less than $500 million are defined as microcap.
- *Penny Stocks*: The SEC has noted that the term *penny stock* generally refers to a security issued by a very small company that trades at less than $5 per share. Smaller start-up-type companies typically issue penny stocks – many of which may be thinly capitalized. These are often traded infrequently and, as a result, their true value may be unknown.

> ***Don't venture forth without a guide with no dogs in the fight.***

Challenges and Opportunities Presented by Microcap Stocks

(Note: As a public accounting firm, Marcum, its partners and employees are prohibited from opining on any particular security, strategy or investment product. The following comments are based on Marcum's experience as a service provider to microcap companies.) The general investment community came into 2015 really favoring small-cap stocks, predominately because of the stronger dollar putting pressure on large-cap multinational companies and the fact that small caps had under-

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performed for most of 2014. At least, that was the word on the street, and it seems to have been borne out by the Russell 2000, an index with a small-cap focus that, at press time, was outperforming the S&P by almost 3.5 percent year to date.

Microcap stocks provide smaller companies access to capital as well as the liquidity they wouldn't necessarily get from private investors. While microcap stock prices can be volatile – they are first to feel the effects of a down market and the last to recover – they also offer the potential for greater returns.

The Participants

Other than accounting and auditing firms that provide services to the space, the major market participants are typically investment banks (middle-market and boutique) and asset management firms, as well as the capital markets attorneys who work with them. Investor and public relations firms also play a significant role in the microcap space, as microcap companies generally lack the brand recognition of the Fortune 500; they need help getting the word out about who they are and the breadth of their services and other offerings.

Taking Marcum's role as an example, we are engaged directly by public company registrants, and we operate according to the Public Company Accounting Oversight Board's standards governing registered public accounting firms. We are engaged by a registrant's board and/or audit committee and typically work with the registrant's CFO and internal accounting staff. Our primary role is to audit the registrant's annual financial statements and review their quarterly results, which are included in the registrant's Forms 10-K and 10-Q, respectively. Additionally, we become involved in assisting the registrant in responding to SEC comment letters and Form 8-K disclosures (which the registrant uses to disclose material events and announcements).

Risk Reading

Whether an audit firm accepts the auditing assignment from a large-cap or a microcap company, the acceptance procedures are the same. In addition to a focus on the numbers, an auditor will be interested in the composition and responsibilities of the board of directors, including the percentage of independent directors, who's in charge of key committees, director time constraints and related party transactions. Additionally, the audit firm will want to have industry knowledge of the company's product or service to make sure, up front, that it has sufficient depth and experience to be able to properly service the registrant. Understanding an industry enables the professional skepticism that is essential when an auditor looks at a client's numbers, books and records.

Investors, on the other hand, are not just concerned with the integrity of those running the company, but also with their vision and ability to execute. Are the company's growth targets realistic and its milestones achievable? What is its strategy for creating awareness that will be critical to its success as a public company? Has the company been building a following that is necessary in order for its stock to be followed and ultimately traded?

Shaping Perceived Risk

If you're a microcap company, shaping investors' perceptions of your company relative to the risks associated with microcap stocks should be high on your to-do list. One way is to show that your company takes corporate governance matters seriously: often known as "tone at the top," it goes to the issue of management integrity. Companies would do well to trumpet the independence of their boards and the timely filing of their SEC reports, two areas where microcaps are generally perceived as falling short. You might make known that you've hired the right professionals and that you're working with top-tier legal and accounting firms. Microcaps shouldn't hide their internal talent under a bushel. Having a chief legal officer with sterling credentials can be comforting to investors.

In what appears to be a new trend, in the past year or so, we've also seen a lot of microcap companies trying, and in some cases succeeding, to uplist as a way of showing that they're growing and taking steps to reduce perceptions of undue risk. On the other hand, the risk factor, from an investor's perspective, is one of microcap stocks' big selling points; therefore, the strategy of marketing stock as a lower risk/lower reward opportunity could backfire with the high rollers. In fact, the past decade is replete with scrappy, innovative and, yes, high-risk companies that not only found their way into the public markets but became giants.

Liquidity and Valuation

Addressing any problems with corporate governance, internal controls and the existing internal and/or indirect capital structure are important to attracting investor interest, but getting listed on the NASDAQ, New York Stock Exchange or other notable international stock exchanges can be a major game changer for a microcap in terms of the marketability, liquidity and transferability of its securities. Liquidity-challenged nano-cap companies are particularly eager to move from the penny stock arena to the big boards. It's a sign of continued growth and success and a good way to attract investors. In fact, most institutional investors won't even look at a stock until it's listed on a major exchange.

But uplisting is neither automatic nor a foregone conclusion. It's a process, and one that can take six months or more *after* a company's financials are audited. To get listed on the NASDAQ, for example, a company has to have a minimum of 1.25 million publicly traded shares – with a regular bid price of $4 and at least three market makers of the stock – and it must meet various earnings and revenue requirements in addition to meeting stringent government standards. For the NYSE, companies must have at least 1.1 million shares issued to at least 400 hundred shareholders – with a market value of public shares no less than $40 million with a minimum share price of $4. As with a NASDAQ listing, various earnings and revenue requirements, in addition to stringent government standards, must be met.

While the range of valuations on a microcap stock can make it difficult to meet uplisting requirements, it also can make the stock attractive to OTC investors. Because such securities are thinly traded (i.e., one large trade can move the market price up or down tremendously), you can have a stock that's trading at 10 cents; then somebody sells 500,000 shares, and it's now trading at 4 cents, thereby affecting the valuation of the company by 60 percent in a matter of seconds. So microcaps are vulnerable to huge swings either way, and that's an inherent risk of the space (and a hindrance to institutional investors, which often need to move large blocks of shares).

The Next Facebook?

Among noninstitutional investors, however, microcaps have an appeal wholly apart from their low price and potential for rapid growth. Retail investors oftentimes "love the story." They think it might be the next Facebook or cancer-eliminating drug and want to get in on the ground floor. A lot of hedge funds follow these types of stocks because they can also take an activist role in them. (Editor's note: Activist strategies led gains in the hedge fund industry this past March.)

Like any sector, microcaps have their star performers. In the early years of the new millennium, dotcoms were hot. Today, biotechs and life sciences are on a tear. Tomorrow might see a resurgence of tech stocks. That's what's exciting about the space – the innovation and entrepreneurial initiatives. Microcaps that successfully up-list are not out of the woods. They've got to make sure that they stay listed, and they have to be more earnings conscious. They'll be followed by a wider audience – an audience with expectations of earnings, growth, new product development and distribution, etc. But that's one of the benefits of being visible on the larger exchanges and the excitement of being part of the microcap space. When a microcap delivers on this potential, investors get the pleasure of watching both the company and its valuations grow.

Acquiring a Microcap Company

A hot microcap company can also become an acquisition target. For a buyer, due diligence would start with looking at the business plan and the company's ability to execute it (the same factors that a company would emphasize in bringing an IPO to market). For an M&A deal, buyers will also want to perform an accretion/dilution analysis and take the pulse of existing investors to avoid a range of potentially hostile scenarios. Management qualifications come back into play, as does the quality of the target's financials and its financial and other professional advisors. Synergies and strategic fit (vertical and horizontal) might also be important areas of exploration. As is inherent in middle-market and large-cap transactions, the microcap target's ability to continue to deliver consistent earnings, dividends and growth, and product and brand recognition, do become factors requiring consideration.

About Marcum LLP

Marcum LLP is a registered Public Company Accounting Oversight Board (PCAOB) firm. Marcum's Assurance Division provides the most up-to-date service and guidance on SEC accounting and reporting issues. Services include Financial Statement Audits in accordance with PCAOB standards; Tax Compliance and Advisory Services; Due Diligence; Agreed-Upon Procedures and Other Attest Work; Internal Audit Services; Sarbanes-Oxley Section 404 Compliance Services and Software; Technical Accounting Assistance; and IPO Assistance. Marcum's SEC Practice led the audit industry in most net new public company clients in the fourth quarter of 2013.