The Microcap Stigma

By: Dave Lavigne

As some of you may have figured out, I provide proprietary microcap research under my own label; Trickle Research. Stock Market Manager ("SMM"), which creates and distributes this newsletter, is the exclusive distributor of my research. I have been preparing microcap research to a variety of endpoints for a good portion of my professional career, which began in 1984. In that regard, I have become an advocate for the space and many of the companies that occupy it. My friend Carl Dilley, CEO of SMM, is also an advocate for the microcap space, which I think one can glean from his contributions to the Black Swan Connection.

Over the course of that "advocacy" I have often suggested that the "microcap" space is sometimes unfairly stereotyped or perhaps painted with a large undesirable brush. For most, even the financially educated, the term "microcap" conjures the seedy underbelly of the investment world, which is supported by Hollywood with titles like "The Wolf of Wallstreet" and "Boiler Room". By the way, regulators do their share to reinforce that stigma, and they, as Carl often points out, do so with considerable zeal. I think it is fair to say that the term "microcap" evokes far more negative reactions than positive. Again, as an advocate of the space, I think that is unfortunate.

Don't misunderstand, microcap stocks often do involve *some* common characteristics that investors need to be aware of. The typical mantra; "thinly traded", "illiquid", "undercapitalized", "early-stage", "not listed on a major exchange" and a host of others, are sometimes true…and sometimes they're not. Moreover, I will never dispute that the space has attracted its share, maybe even more than its share, of nefarious characters. I might even consider conceding that the *nature* of the microcap space (a discussion for another time) is on some levels conducive to some of the corruption the microcap space has seen. On the other hand, as Bernie Madoff has demonstrated, criminal activity in the financial industry is hardly concentrated in the small underfollowed sector of the equity markets. Fraudulent conduct in the financial markets is common, maybe even pervasive, and again, as my friend Mr. Dilley is quick to point out, sometimes the large offenses dwarf the impact of all the microcap offenses combined. That certainly is not to suggest that microcap crimes don't matter, I just think they get an inordinate amount of attention and ink vis-à-vis their larger counterparts, and I think that bias impacts the efficiency and by extension perhaps the potential value that small companies can provide as an asset class. We had an event in one of our coverage stocks a few weeks ago that remined me of the inefficiencies.

I launched the Trickle label at the end of 2016. The fist stock I placed under coverage was a Denver, Colorado based company called ID Watchdog. ID Watchdog is in the identity theft space and the time was posting results that I felt demonstrated a valuation catalyst. The stock was trading at around $.14 per share, and we initiated coverage in mid-October 2016 with a 12-24 month price target of $.42. We posted the ID Watchdog research on SMM.Global, sometime close to the end of 2016 if I recall correctly. Clearly, ID Watchdog, was one of those “thinly traded”, “illiquid”, “not listed on a national exchange” companies, in fact, it was/is listed on the Canadian Exchange and is incorporated in the Caiman Islands even though it is headquartered on Colorado. Those are some “red flag” microcap characteristics. However, ID Watchdog also possessed some characteristics that are not so “microcap-*ish*”. ID Watchdog has been operating in the personal identity theft space for over a decade, and its CEO Michael Greene is as capable a CEO as you will find at many much larger companies. Moreover, the company was/is profitable, and is growing at high (50%+) sequential YoY double digit growth rates. A few weeks ago, the Company announced it was being acquired by the credit reporting company Equifax, for $.40 per share cash, which, oddly enough, nearly hit our price target on the head. ID Watchdog IS a microcap stock. ID Watchdog IS NOT the “seedy underbelly of the investment world”. In fact, as I will argue, the microcap stereo type, probably cost long term, dedicated ID Watchdog shareholders money, and here is why.

In our initiating coverage of October 2016, we placed a 12-24 month price target on the stock. Over the next six months, ID Watchdog validated some of our assumptions and provided some new insights that brought us to point of thinking the value of the company was perhaps beyond our original targets. That is not uncommon in our research, especially since we use discounted cash flow analysis to derive our targets that include elevated discount rates to reflect execution risk. That is, once companies prove they can execute at levels commensurate with our model assumptions, our valuation targets increase by default because our discount rates are/were overstated. Succinctly, we think ID Watchdog’s buyout price should be higher than $.40, and we know several of their larger shareholders who agree with that. However, here’s the rub. Prior to the announcement, ID Watchdog was trading in or around $.23 or $.24, which means the acquisition premium was somewhere north of 70%. As I noted in our research update regarding the acquisition offer, it is difficult for a board of directors to turn down a 70% acquisition premium, even if they believe it is insufficient. The problem is, clearly, the stock should have never been (in an “efficient market” world) trading at $.24, where an insufficient offer might actually make sense on the face. In my view, THAT inefficient pricing is due in part to the negative baggage that ID Watchdog carries as a “microcap”. Put another way, I believe that in a more “efficient world”, where the trading valuation of ID Watchdog was not hampered by its microcap status, the shareholders of ID Watchdog would have been offered more money by the acquirer.

Recognize, inasmuch as I lament the microcap stigma, it is also the reason I have a job in the space. If microcaps all traded close to their “intrinsic value”, whatever that might be, I am not sure any of you would have much reason to read my drivel.

The above said, I think ID Watchdog provides both a cautionary tale (small companies being pushed into acquisitions below their true value) as well as a marked investment opportunity (ID Watchdog’s buyout occurred nearly 300% above our initiation roughly 6 months later). Of course, the latter of those requires investors to look beyond the ugly little labels and stereotypes.

As a microcap analyst, I write companies across a broad swatch of industries. I am, in industry parlance, a generalist (as opposed to an “industry” analyst). Th may be another way of saying I know a little about a lot of things but not a lot about anything. As a result, the common thread in the stocks I cover is not industry, but (my perceived) value, defined (by me) as companies that I think have a reasonable chance of performing much better over the next 12-24 months than the past 12-24 months, yet are valued at market prices that don’t reflect that expectation. While that is the general approach, the truth is, sometimes we find companies that have already performed to those expectations but the market STILL hasn't figured it out. I would put ID Watchdog in both categories above. In yet other instances, some of the companies we follow have some "value" characteristics that we think are either misunderstood or ignored by the market, for instance, we recently initiated coverage of a company called Social Reality, Inc. - dba SRAX, (Symbol: SRAX). While the company has a number of pieces to the business, we have suggested that one if its more promising is a product called SRAX MD. In short, we believe SRAX MD is likely by itself worth more than the market capitalization of the entire company… perhaps multiples of the current market cap. We also think it is likely they will attract suitors for the product or perhaps the whole company (if they haven't already) should the stock continue to lag and underperform. It is in our view a misunderstood and understated piece to the story that could create a profound valuation catalyst once someone figures it out. The danger is that if the stock continues to trade at depressed levels, a buyer could come along and strike a profoundly good deal relative to the currently depressed trading price. The SRAX research is available at www.SMM.Global, we would encourage you to give it a look.

As another example, one of our other coverage stocks is a small junior gold miner called "New Jersey Mining (symbol: NJMC). Without belaboring the history (this research is also available at www.SMM.Global) NJMC recently transitioned to production, which we expect to result in sequentially improving results going forward. The current market capitalization of NJMC reflects *a considerable discount to the cash that has been spent developing its assets* (largely by other operators). That is, if you started the entire business from scratch it would take considerably more than the current value of the company to get it to this point. In my view, THAT scenario reflects value on the face. Granted, they still need to execute on production and gold needs to hold up in this $1200 range, but if those play out as we anticipate, we think the value of the company could be multiples of today's current pricing.

To summarize, we understand some of the cloud around the "microcap" label. We have seen more than our share of the "pump-and-dump" schemes that have created the stigma and frankly, we loath them as much as anyone because they detract from the efforts of those trying to legitimize the space as a viable asset class. (It's difficult to compete against people who ***claim*** "300% monthly returns in microcap stock picks" when I am trying to provide microcap research that I hope can collectively outperform the S&P 500 by a few hundred basis points each year). For over 60 years (collectively) Carl and I have argued that the microcap space provides a host of positive economic catalysts like innovation and jobs, as well as sometimes extraordinary investment opportunities. The space includes many brilliant and innovative minds as well as hardworking entrepreneurs who drive employment growth and make the U.S. economy tick. Those people, and the companies they represent deserve better than Hollywood portrayals of thugs in suites and ties.