For Microcaps…Its Rough Out There

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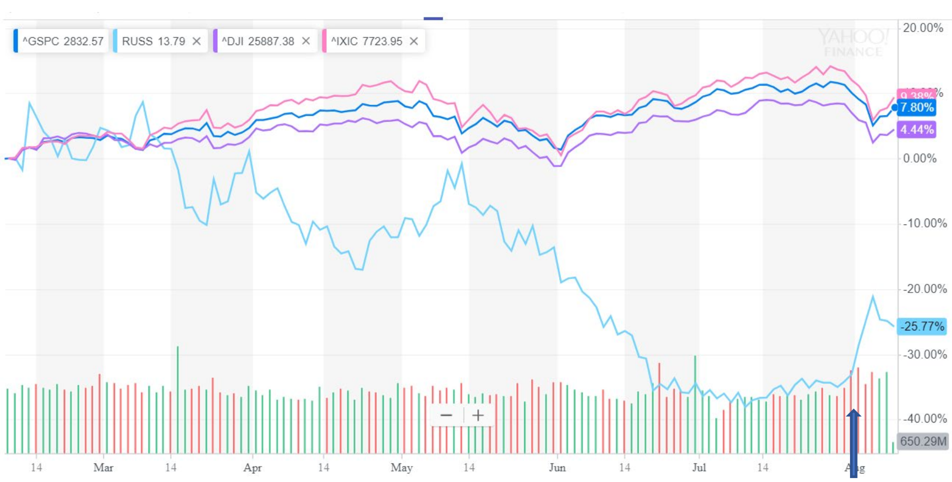
I have been providing independent microcap stock research under my own labels since 2002. Prior to that, I provided the same on the sell side for small regional broker dealers, and that included research as a part of those entities' corporate finance due diligence. I have been at this a while.

Over those periods that I was preparing research for "public consumption" I kept a track record of sorts comparing my research universe to that of the performances of three major U.S. equity indices; the Dow Jones Industrial Average, the NASDAQ and the S&P 500. Over much of that period, (and over reasonable periods of time) my research universes typically outperformed those indices, and often by meaningful margins. As a matter of full disclosure, there are a number of nuances that impact the relevance of those comparisons (transaction costs, spreads, liquidity etc.), so I fully submit, while the stock picks as whole have performed well, I am certainly no guru, and comparing the picks to those indices has some holes.

On the other hand, there have been a few times when the market value of my universe has taken it on the chin and traded to levels where it collectively *underperformed* the major averages. That has been the case over the past two months or so and while I just noted that those comparisons probably aren't all that relevant, to be honest, it drives me crazy when it happens, especially when it happens the way it has lately. For instance, during the financial crises, my universe imploded like most equity proxies/portfolios (although it still performed better than the indices) but that was expected given the general market malaise. Sometimes there is nowhere to hide, and no equity is safe. However, that is not the case today, at least not yet, and it certainly has not been the case over the past few months. Keep in mind, the past few trading sessions aside, the S&P set an all-time high *just two weeks ago.* In that environment, it's hard to argue that your picks are going down because they are following everything else to the bottom. Those instances generally find me asking, "why"? Before I get to that, the chart below from Yahoo/finance, illustrates the stark divergence of small stocks (represented here by the Russell 2000) versus their larger counterparts over the past 6 months:



On some levels, this chart makes me feel better, or at least maybe a little less worthless as a stock picker, since it does indicate that while portions of the U.S equity market (larger stocks) are trading to new heights, other parts (smaller stocks) are acting … like my research universe. Again, that scenario always finds me asking, "why"?

To edify, my pat answer to that question generally involves liquidity and that may explain some of the compression in small stocks coming into the new year. Recall, when we ended the year, we were anticipating Fed rate *hikes*, which translates to less liquidity, which is often an ominous sign for small stocks. That makes sense to me. To that point, the blue arrow on the chart above marks the point of the Fed's recent rate *cut.* Again, generally, small stocks do much better during periods of higher liquidity, which is true of most equities, but small stocks, especially microcaps are particularly sensitive to that variable. To that point, I generally tend to believe that microcaps do best when larger caps get pricey enough that investors start to "reach down" for cheaper stocks. (I think some would describe that as a "risk on" posture in the markets), but frankly, the chart above, albeit a reasonably short snapshot in time does not particularly support that notion since through the summer large caps were rising and small caps were falling…precipitously.

While liquidity, or at least its perception, has clearly been a driving factor, as much as I am always suspect of the term, the equity markets for some time now have in my view displayed an element of "this time it is different". Frankly, I am more willing to use that term these days. As I have referenced many times in this column over the past two years, given the **unprecedented** action of central banks around the world, this time clearly **is** different. I have also noted that I believe many of the largest capitalization companies in the U.S. today are markedly overvalued, but that is also in my view a function of central bank capitulation. In fairness many of those companies have used nearly free Fed money to execute massive buybacks that have among other things put a lot of bids underneath the shares of many of those issuers. (To that end, just this recently J.P. Morgan quant strategist Marko Kolanovic estimated that during the market pullback of recent days, stock buyback activity "likely tripled"). Its financial engineering at its best... or worst, depending on who you ask. If you doubt that notion, take a look at the growth of debt on the balance sheets of many of the largest public companies. As they say…follow the money. That is not a critique necessarily. In its simplest form, these companies have replaced equity with debt with near zero cost. Other than the fact that they are repurchasing shares at what I view as mind boggling valuations, you can't argue with companies taking advantage of free money.

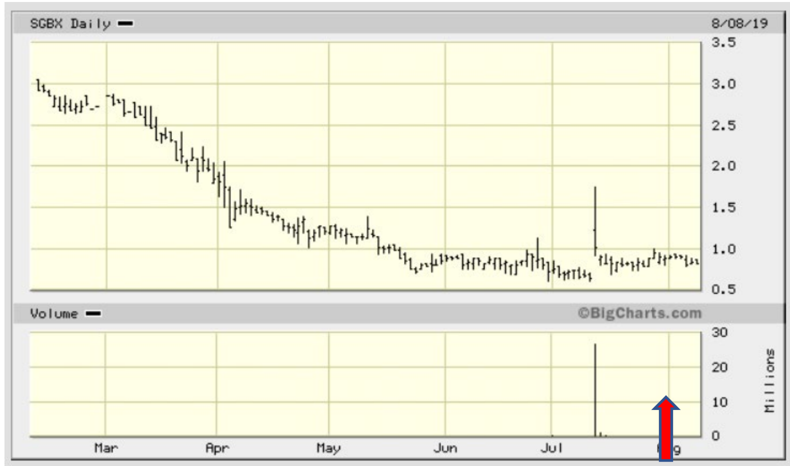
Moreover, there is apparently $14 trillion worth of sovereign debt around the globe that is currently trading at negative interest rates and there are some who believe that U.S debt is headed there too. I have to think that may have my past finance professors rolling over in their graves, especially when so many really smart people seem to think its tenable. Wrap your head around that for a moment… Here's a little math to illustrate the point. If you apply a -1% discount rate to a dollar 10 years from now, its worth $1.11 today. Put that into perspective, it's worth more today than a dollar in your hand.

Along those lines, here's another angle. According to www.gurufocus.com, Apple's debt per share in 2015 was $11.17, but in the current trailing 12 months it stands at $22.92. Keep in mind, their shares outstanding over the same period declined from 5.8 billion to 4.6 billion, a 20% decrease, which makes that statistic that much starker. As a side note, Apple's operating income in 2015 was $71.2 billion, while for the trailing 12 months it stands at $64.4 billion, however, the stock trades at a 17X multiple and a PEG ratio (Price to projected earnings growth) of 1.76. We used to think that a 17X multiple was for stocks growing earnings at 17% per year (I still do) and Peter Lynch suggested a PEG ratio of 1 was fair value. From that perspective Mr. Lynch might argue that Apple should be trading at closer to half of where it is today. Believe me, Apple is not even close to having the highest PEG ratio amongst some of today's most popular stocks. Coca Cola's (KO) PEG is 4.76, McDonald's (MCD) is 4.01 and Amazon's (AMZN) is 1.97. That list goes on.

On the other hand, from another perspective. What if Apple can replace its debt in the future at -1%? That would effectively turn the debt on their balance sheet into a profit center. Moreover, as long as one could reasonable expect to continue to make money into the future, even if its less money than the year before, the net present value of those cash flows is such that each dollar earned further out into the future is worth more than the previous dollar. If that is in fact the new world order, then I take back everything I just said about these stocks being overvalued. Its perplexing to me, but maybe everything I have ever learned about financial theory and valuation analysis is just plain wrong. Conversely, I am more inclined to think that this will not end well, and the greater number of people who ultimately believe this is all alright, the uglier that end will be. But that's just my view.

To circle back to the impact of all this on microcap shares; in spite of this presumably accommodative environment of low rates, I am not sure if I have ever seen small companies have a more difficult time finding capital in an environment where indices are trading near all-time highs. The fact that raising capital for microcap companies is rarely easy is not lost on me. I have suggested many times throughout my research that one of the bigger risks of buying (unprofitable) microcap stocks is that we know more dilution is coming, it's just a question of when and how much. The dilemma there is that if it takes too much and/or too long, the company can ultimately achieve what we always thought it could, but it can still end up a lousy investment because by the time it happens, the increase in market cap is over run up by the added shares. Unfortunately, the alternative (not being able to raise additional capital at all) is definitively worse. That is one of the reasons why microcap financing can sometimes be onerous (which in some cases is a polite way of saying usurious). Seeking capital when payroll is due and the bank account is empty is not a good place to negotiate from. Even issuers trying to be proactive (looking for capital 6 months before payroll is due and the bank account is empty) can't hide the inevitability of their capital constraints. It is an exhausting exercise with generally predictable outcomes. To illustrate my point, here are some recent charts from companies I either cover or at least follow in some capacity. The red arrows denote recent financings:

The chart above is **AzurRx BioPharma, Inc. (AZRX).** This has been one of my top coverage stocks for some time now. I have spent most of the time since initiation under water on the name. Further, I have increased the allocations of the stock as it has sold off, only to have it discount further. AZRX is as small BioPharma company working on a non-animal based alternative for the treatment of exocrine pancreatic insufficiency ("EPI") for cystic fibrosis and chronic pancreatitis patients. The company's therapy is yeast-based as opposed to the pig-based standard(s) of care, which currently represent an annual market in excess of $1 billion. They recently completed a successful phase II study for pancreatitis and are in the process of completing a second involving cystic fibrosis patients. Results to this point, including both safety and efficacy have been favorable. In short, the Company's results have performed to our expectations since the initiation, but the stock has not performed accordingly. Outside of its ongoing need for cash (not unlike nearly every small biopharma company on the planet), I have no good explanation for the stock's decline. They did announce an additional trial they are planning involving the use of their therapy in conjunction with current porcine based therapies, which I suppose some viewed as a hedge against lesser results from the CF trail. I on the other hand, interpreted it as a good strategic move because I believe initial commercialization alongside existing therapies would speed adoption. Obviously, some must disagree with that assessment. We expect results from the cystic fibrosis trial later this year. I continue to believe this could ultimately support double digit valuations.



The chart above is from recent coverage stock **SG Blocks, Inc. (SGBX).** Shortly after initiation, they announced that they were essentially shuttering their initial "flagship" project in Los Angeles, because the developers couldn't get it right. To be honest, I feel like they threw me under the bus. I don't expect management to share non-public information with me, but they could have done a better job of communicating timing. While a little jaded to the name, I continue to have an affinity for their product/process. We will see if they can pull it all together and put some wins on the board.

The chart above is from coverage stock **Summit Wireless Technologies, Inc. (WISA).** This is another name that has discounted markedly since the coverage initiation. I submit, like many microcaps working on emerging technologies, the valuation of WISA is an open book. I suppose one could argue that it is somewhere between $0 and $100 million depending on whether or not they gather adoption. The fact is, they *have been* gathering adoption and making additional progress towards that end since we initiated coverage. To translate, outside of having to raise more capital, I am remiss to figure out why the street appears to be so negative on the stock. Again, I recognize that there are some things that need to go right for them to be successful, and I am sure there are detractors in the audio space that see this as a non-starter, however, I would reiterate, *they have* gathered adoption from some big names in the space and I suspect they will gather more. They recently put out an announcement regarding what they see as their addressable market, which if it comes to fruition would support much higher prices for the stock. That said, we won't argue that they still have to actually "address" that market. Then again, if investors wait to buy the stock *after* they have already done that, I don't suspect they will be owning the stock close to $1.

OncoSec Medical Incorporated (ONCS) is not a coverage stock, although it has presented at a couple of our conferences, and I own the stock. They are working on a cancer therapy in conjunction with some other successful cancer treatments, most notably Keytruda. Like other biopharma's, this carries the risk that their therapy may not work. I think results to this point have been favorable, but that is apparently open to debate. However, they recently discussed an agreement with Emerge Health Pty *"to provide special early access to TAVO™ for advanced stage, melanoma patients. Emerge is the leading Australian company providing Special Access Scheme (SAS), full registration, and sales, marketing and distribution services of therapeutic products in Australia. Under this agreement, the SAS program effectively allows up to 1,000 Australian melanoma patients access to OncoSec's TAVO™ beginning as early as 4Q 2019, enabling access to TAVO™ at commercial reimbursement rates prior to formal approval by Australian regulatory authorities. In addition to accelerating our commercial plans, the agreement also provides clear recognition of our drug's therapeutic potential, as TAVO™ will be the only drug available under the SAS program for melanoma patients who have failed checkpoint therapy".* So then, **they could actually generate revenues in 2019,** which is good on the face, but may also help validate my notion that results have been favorable. Further, (and yes, I do recognize they are burning cash) the stock currently trades at about 90% of cash… perplexing.

H-Source Holdings Ltd. (HSCHF) is a recent coverage stock. With a market cap under $5 million, it's very small. They recently completed a $2 million raise (40% of the entire market cap) at a conversion price in excess of the prevailing market price. You don't see that every day. I think the stock has measurable opportunity, especially given the modest market cap. I included a 12 month chart as well just to illustrate how far it has come down. I think the selling is quite overdone, but I submit, that probably depends on their ability to execute with the new capital.

Circling back, what do each of these companies have in common? They are small unprofitable and/or pre-revenue stage companies in need of cash and that put(s) them in the unenviable position of being at the mercy of capital markets that are very adept at detecting blood in the water. The compression in these stocks going into financings is telling and, in my view, their pricing has more to with the critical nature of their capital needs than it does with the "fair" value of their enterprises. The discouraging part is that with interest rates where they are, supposedly to help foster growth, they don't seem to help the companies that really need it. In my view, that is discouraging and counterintuitive to growth. It makes one wonder, who is the Fed really trying to help, and who is rally driving the policy. I have to admit, it often looks like the tail is waggin' the dog, actually sometimes it looks more like the tail is waggin' the whole dog park.