A CASE FOR SMALL & MICROCAP INVESTING

Avenel Financial Group was formed with one goal in mind:
To provide **access to information and opportunities** for quality investors, investment managers, and small companies.

One way we do this is by focusing on the Micro-Cap sector of the market in order to take advantage of inherent inefficiencies in valuation. We will provide informative material to our network in order to assist investors and management teams in their decision-making—and present them with opportunities outside of the traditional models available.

Micro-cap stocks maintain several advantages over other investment strategies.
Chief among this is the inherent advantages that exist within the relatively illiquid space of small and micro-cap stocks.
This creates several market inefficiencies which present valuation opportunities, which this paper will discuss in more detail.

Avenel Financial Group has also founded Co/Investor Club to help facilitate ideas and deal flow to its member base. Access to quality opportunities in the microcap space—whether in the form of public companies, private deals, or micro-cap investment managers—is often one of the more difficult hurdles for an investor to climb over when getting into the small and micro-cap space of the market. Our aim of Co/Investor Club is to serve as an initial filter and simplify the process for Club members in finding attractive opportunities and avenues for investing in small and micro-cap companies.

ADVANTAGES OF MICRO-CAPS

The Inefficiency of Illiquidity //

Institutional ownership of U.S. stocks has gone from less than 10% in the mid-1950s to almost 80% today. With institutional investors owning such a large portion of the stock market, these smaller companies usually get overlooked. The transaction risk for a large fund or institution to invest in small companies is far too high as they are unable to provide investors and institutions sufficient liquidity without effecting the price of a stock in a major way.

Another barrier for the entrance of large funds into the micro-cap market is the fact that not enough shares are available for them to acquire to have a meaningful impact on a large portfolio. In fact, many asset management firms prohibit investment in small and micro-cap stocks. This fact helps to create market inefficiencies in incorrectly valued companies as a large share of capital that could be invested in smaller, illiquid stocks refuse to even consider buying them. This characteristic is reflected in the subsequent performance of illiquid stocks, as can be seen in the chart below with annual return data covering the time period since 1971.

In summary, illiquid stocks are less likely to be owned by institutions or institutional products, and in turn it is more likely to be underpriced. So, the best returns over this period didn't just come from the smaller companies, but the smaller companies that were more illiquid—thus highlighting the importance of finding opportunities before they became widely known.

	Low Liquidity	Mid-Low Liquidity	Mid-High Liquidity	High Liquidity
Micro-Cap	16.03%	15.66%	9.65%	-0.29%
Small-Cap	15.68%	14.35%	12.20%	5.77%
Mid-Cap	14.19%	13.90%	12.67%	8.15%
Large-Cap	11.20%	12.05%	11.75%	8.89%

2017 Valuation Handbook: U.S. Guide to Cost of Capital

Higher Level of Insider Ownership //

Small and micro-cap companies generally have a higher level of insider ownership. This higher level of insider ownership better aligns management interests with shareholders and can be a driver of outperformance as management has increased incentives to efficiently manage and make more efficient capital allocation decisions for the company. The alignment of incentives between management and shareholders can create more opportunities to partner with effective management teams at an attractive price with equally attractive potential growth rates.

> ***Never, ever think about something else when you should be thinking about the power of incentives.***
> ***- Charlie Munger***

Less Analyst Coverage //

Less coverage from research analysts also makes the pricing of small companies more inefficient than the well-covered larger companies. The lack of awareness by institutions of small and micro-cap company's benefits the investor that understands the smaller-cap space. Analyst coverage is important because both investors and institutions tend to heavily utilize the research and they enable those investors to act on new information and invest in already covered companies. So, the fewer analysts that cover a certain area of the market, the greater the chance for that area to get overlooked and for inefficiencies in pricing to develop.

Information Asymmetry //

While it is easy to find information on large, widely-followed companies, this is not always the case for small companies. While the possible lack of information will turn a lot of people off, it can create massive opportunities for those willing to put in the effort to track down information and talk to management teams—which are usually more accessible among smaller companies. This general lack of information doesn't mean a lack of investment merit, and it can create large price-to-value discrepancies in the small and, especially, micro-cap space. At Avenel, we work to help investors track down information to take advantage of those discrepancies, and work to help companies whose stories deserve to be better-known find the right kind of investors in which to tell that story.

Room To Grow //

Warren Buffett has said of Berkshire Hathaway that its returns moving forward will not be as explosive as its returns historically since its massive size inhibits optimally efficient allocations of capital and in turn growth. Small and micro-cap companies don't have this encumbrance. This is catalyzed by the fact that small companies can be nimble and seize opportunities in market changes, product development and capital allocation where larger organizations are often impeded in their ability to react to market conditions quickly by internal bureaucracies and sheer size. This ability to rapidly pivot in strategy helps smaller companies to avoid overlooking important opportunities and weaknesses that may limit the growth or success of a larger business. It may also allow small companies with good balance sheets and astute management teams to allocate capital more effectively and urgently in volatile markets and recover more quickly than larger companies coming out of a crisis.

This allows the well managed small and micro-cap companies to experience higher year-over-year growth rates compared to the larger-cap companies. Large companies often run out of attractive places to reinvest their capital as they come to dominate market share in their respective industries, but small companies often have a much longer runway to reinvest profits and accelerate their growth. When this growth can be purchased at a value price, large returns are possible.

> ***I think you have to learn that there's a company behind every stock, and that there's only one real reason why stocks go up. Companies go from doing poorly to doing well or small companies grow to large companies.***
> ***- Peter Lynch***

More Likely To Be Acquired //

Another significant driver of outperformance is that merger and/or acquisition opportunities are far greater for smaller companies. There are both more suitors to acquire a small or micro-cap company, and more potential candidates for a small or micro-cap to acquire a company that could have a meaningful positive impact on its business and value. The simple fact that there are more small and micro-cap companies than large-cap companies and acquiring them takes less capital makes this benefit one that will always be present in the small and micro-cap space. This is especially true in the world of low interest rates that we find ourselves in today.

> ***Since 1993, more than half of all public M&A transactions involved micro-cap equities***
>
> ***- Furey Research Partners***

CONCLUSION

The small and micro-cap universe can be filled with great peril, as well as tremendous opportunity. Many of the world's best investors started by investing in small companies, and almost all of the world's great businesses started as small businesses. Investors want to find great companies early, and companies with the potential to become those great companies want to find investors that will support them along their journey in trying to achieve that potential. As Lawrence Cunningham writes about Warren Buffett and Berkshire Hathaway in his book "Quality Shareholders: How the Best Managers Attract and Keep Them":

> *"Buffett has tried to attract only what he calls 'high-quality' shareholders [QSs]. These are defined as shareholders who buy large stakes and hold for long periods. They see themselves as part owners of a business, understand their businesses, and focus on long-term results, not short-term market prices.... Buffett's success in attracting QSs has been an important reason for Berkshire's success. They gave him a long-term runway, helped promote a rational stock price, and deterred shareholder activists from seeking to break up the conglomerate as it grew galactically. Berkshire dramatizes the tremendous results that can accrue when QSs match up with outstanding managers.... To repeat a popular paraphrase of Buffett's 1979 letter to Berkshire shareholders, 'eventually, managers get the shareholders they deserve.'"*

At Avenel, we aim to ignite the win-win feedback loop between investors and companies for creating long-term value. We help small companies tell their stories and find quality investors to help them grow. And we spend time identifying and building relationships with some of the world's best micro-cap investors—and include their research alongside our own. Great investments can be difficult to find, but there are plenty of investors in the micro-cap space that have a track record of finding great companies early. The Avenel network provides them with a platform to tell both their stories and the stories of the companies in which they invest, all while providing value and investment opportunities for members of Co-Investor Club.

Whether you are someone that invests in small companies, or a small company needing to have your story told, reach out and let us know how we can help.

Phone: (704) 578-2238
Web: avenelfinancial.com
Email: info@avenelfinancial.com

Avenel brings experience and a unique blend of discovery, management, and execution to the financial well-being of clients in areas of IR Advisory & Business Development, Mergers & Acquisitions, Merchant Banking, and Philanthropy.