Investment Dealers' Digest
IDD
Est. 1935
May 9, 2007/www.iddmagazine.com

Small, But Not Forgotten

As the stock market rallies, small-cap coverage enjoys a rebound

In the aftermath of the technology bubble, and on the heels of the SEC's research settlement several years back, microcap and nanocap stocks, already little followed, looked likely to slide further off the radar screens of research departments at big investment banks.

But a funny thing happened on the way to small-cap oblivion: Many of the little guys have caught the eyes of Wall Street research folks.

America's Growth Capital's Howe: 'The majority of microcap/nanocap public companies do have coverage, and in many cases, it's coverage from bulge-bracket firms.'

"Some companies are truly orphans and have no coverage, but the majority of microcap/nanocap public companies do have coverage, and in many cases, it's coverage from bulge-bracket firms," says **Ben Howe**, co-founder and CEO of **America's Growth Capital** (AGC). "Our team spends time every week digging through the hundreds of small-cap public companies, and we're stunned at how many of them have one or more research analysts. We're always looking for the hidden gem that we can write on."

Howe says the amount of small-cap coverage by investment banks and other institutions did indeed decrease at the beginning of the decade due to the tech bust. However, "post-bubble, the bulge-bracket banks, traditional boutiques and new research houses have all stepped in, and that research has picked up dramatically in the last few years," he says. AGC analysts cover 11 small-caps and one nanocap, **GlobalSCAPE**, a San Antonio-based file management software developer.

Howe says Boston-based AGC classifies firms with less than $1 billion and $50 million market caps as small-and nanocap, respectively. About 80% of small-caps are under $500 million and 50% are under $150 million, and many nanos operate in the technology and life science sectors, he adds.

At **Merriman Curhan Ford** (MCF), small-caps are defined as between $500 million and $1 billion, microcaps as $100 million to $500 million, and nanocaps as less than $100 million. San Francisco-based MCF's analysts cover about 200 smaller companies, of which 16% are nanocaps, 44% are microcaps, and about 15% are small-caps. The remaining 25% are mid-cap names, carrying market values of $1 billion to $10 billion.

"I tell our guys, 'We want to chart new territory and find [stocks] that institutions don't know about yet,'" says **Jonathan Merriman**, MCF chairman and CEO. MCF analysts are not usually interested in looking at companies with three or more analysts, he says

According to MCF data, approximately

3,000 US companies with market caps under $500 million have fewer than three sell-side equity analysts covering them.

In Merriman's opinion, coverage of smaller stocks has increased of late, but the number of players has not. "The economics of covering the stock on a research basis has declined dramatically, so the amount of volume that's traded through ECNs versus broker-dealers has expanded tremendously from 2002 to 2007," he says. "Covering small companies on the research side in order to generate commissions has gotten much more difficult, and that has kept a cap on the number of people who have aggressively come into the market."

Scott Van Winkle, a managing director of equity research at **Canaccord Adams**, notes that the brokerage industry underwent dramatic consolidation and contraction after the tech bubble burst. As a result, Wall Street had fewer boutique firms to cover smaller-cap stocks.

"Thus, the coverage of small caps declined," Van Winkle says. "More recently, a few firms have increased their emphasis on smaller-cap stocks, but I suspect there is less coverage today than in the late 1990s." One firm that went under earlier this decade was San Francisco-based Robertson Stephens, which was closed by its parent **FleetBoston Financial** in 2002.

"A lot of companies under $250 million and $500 million do not have research coverage, and I think the reason is that the vast majority of sell-side research is institutionally focused," says Van Winkle. "An institutional focus naturally gravitates toward more liquid issues, and liquidity is often tied to market capitalization. But I think that it varies depending on the industry segment." Boston-based Canaccord's analysts follow 275 North American firms with market caps of less than $2 billion.

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Van Winkle says Canaccord's sweet spot for research is a market cap below $2 billion.

"Our focus is to be a small-to-midcap research firm," he says, but the market caps can vary widely. Two companies he covers are **eDiets.com**, with a $90 million market cap, and **Whole Foods Market**, whose market cap is $6 billion.

Anand Aithal, managing partner of an investment research outsourcing firm, New York's **Amba Research USA**, has seen the demand for small-cap coverage grow. "I think sell-side departments [at banks] want to be as responsive as they can within a fixed budget," he says, discussing why more asset managers are asking Amba to assist with small-cap research. The demand is much greater today than three years ago, says Aithal, likely due to rising markets and a more robust economy.

Alas, one investment bank manager believes that trends in small-cap research are simply tied to deal flow. "When the prospects for banking include [more] IPOs and M&A, you'll see an increase in the research activities of the investment banks covering microcap companies," he says. "Having coverage in odd sectors will create credibility for participating in IPOs and M&A transactions, so when banking looks like it's getting hot, you get a rush to research coverage. Otherwise, these guys would just cover the large-cap companies, with their more significant trading commissions."

Merriman recalls that MCF's coverage of **Smith & Wesson Holding Corp.**, with a $545 million market cap, led to MCF co-managing the handgun manufacturer's sale of $80 million in convertible senior notes late last year.

"When we picked up the company, it was covered by zero analysts and its stock was around $2," he says, adding that the banking and research divisions at MCF, which was founded in 2002, have always been separate. "We were the first guys to pick up research coverage. We live to discover solid companies with great management teams and no coverage - the perfect situation."

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