GRANT'S
INTEREST RATE OBSERVER®
Vol. 30, No. 23c Two Wall Street, New York, New York 10005 • www.grantspub.com NOVEMBER 30, 2012

Above their weight

It isn't a stock market, but a market of stocks, as someone or another said. Some stocks are big, and they are in the S&P 500. Others are medium size, and they are in the S&P 400. Still others—the subject of this essay—are so tiny, so infinitely insignificant in the eyes of Wall Street that they are beyond the pale of any familiar index. Following is a survey of the stock market's bantamweight division. In preview, we're bullish on it.

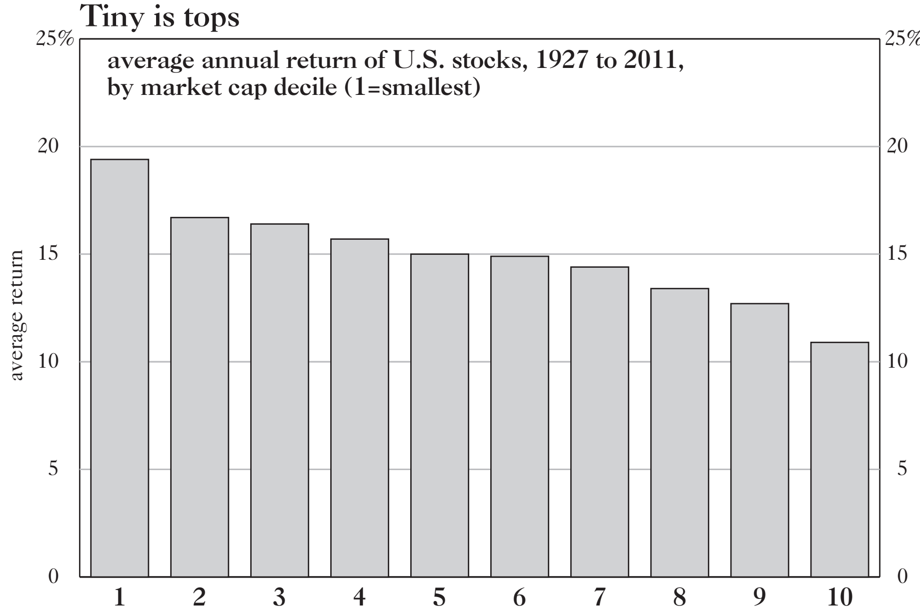
Research of Kenneth French and Eugene Fama into returns on American equities by market cap suggests that smaller is better than bigger (French and Fama are professors of finance, respectively, at the Tuck School of Business at Dartmouth College and the Booth School of Business at the University of Chicago). Between 1927 and 2011, the average annual return of the smallest market-cap decile totaled 19.4%, that of the top market-cap decile just 10.9%.

These are historical findings, of course. Though history is never bunk, the application of historical observations to investing is sometimes perilous. So we take the French and Fama observations not as writ but as an invitation to explore the field of equity-market opportunity in the waning weeks of 2012. Microsoft, MetLife and Apple—just for instance—are trading at most reasonable price-earnings ratios. Each is well financed and each comes under the intense gaze of the corporate-governance police. To pass them over in favor of a $130 million commercial real estate service company, a $16 million market-cap specialty chemical company, or a $16.5 million IT staffing business may not seem an obviously winning investment strategy.

Certainly, liquidity is not the outstanding feature of stocks of less than $500 million market cap. Let us say that you have painstakingly built a position in a certain microcap name. It trades 3,000 to 5,000 shares a day at a price of $10. But now you have changed your mind and want to sell. The ancient question—to whom?—presents itself. "The exit door is pretty wide," Brad Lawson, a Tacoma, Wash., microcap investor, dryly remarks to colleague David Peligal. "It's just at a price that is a heck of a lot lower than where you bought the stock."

Most institutional investors don't fish in the microcap pond, anyway. Tiny stocks make no measurable difference in the performance of large funds. Which brings us to one of the reasons the historic outperformance of bantamweight equities might persist: The sell side can't make ends meet conducting research into illiquid securities. Two cents a share is especially thin gruel when the number of shares in a given order totals, let us say, 5,000 instead of 500,000. The disappearance of small-stock-focused brokerage firms such as ThinkEquity LLC and Rodman & Renshaw is testament to the unrepaying economics of small-cap stock research. "So in most institutional investors' minds," says John Lewis, founding and managing partner of Osmium Partners LLC, a Greenbrae, Calif., hedge

Tiny is tops



source: Kenneth French Data Library

fund, "a market capitalization of less than $300 million is their equivalent of zero. This creates a large recurring market of structural pricing inefficiencies as low average daily trading volumes hurt the economics of Wall Street, which requires liquidity to compensate sell-side analysts for covering small companies."

It would be better for the microcap story line if that asset class had not suffered such grievous losses in 2008, Lewis points out—the Russell Microcap Index plunged by 40.7%, worse even than the 34.8% decline of the Russell 2000 Index and the 38.5% decline of the S&P 500 Index. On the heels of this debacle, by Lewis's estimate, two-thirds of microcap managers exited the field. One-third went out of business and another third took up the big (or, at least, bigger) stock business. It would be better, too, he notes, if retail investors had not fled the market in droves. According to EPFR Global, retail investors have yanked a net $15.8 billion from American small-cap equity funds in 2012 to date, 4.5% of the assets with which they started the year. On the bright side—certainly, for private equity buyers and strategic corporate acquirers—bargains are thick on the ground.

Consider, Lewis continues, the difference in valuations and change-of-control premiums paid in going-private transactions so far in 2012.

On the one hand, nonfinancial companies with market caps of less than $300 million were trading at average ratios of enterprise value to EBITDA of 6.5 times before they were plucked from the public market. To pluck them cost the acquirers an average change-of-control premium of 40%.

On the other hand, nonfinancial companies with market caps of more than $300 million that went private in 2012 were trading at average ratios of enterprise value to EBITDA of 9.6 times before they left the public-company fold. To buy them cost the acquirers an average change-of-control premium of 25%. "This showcases the double-barreled opportunity that exists in microcaps today," says Lewis. "We have been very bullish over the last several years given these dynamics."

Presentable microcap specimen No. 1 is a 30-year-old, $130 million market-cap provider of information and analytics on American commercial real estate. Reis Inc., quoted at 11.7 times estimated enterprise value to 2012 EBITDA, hardly looks cheap at a glance. However, CoStar Group, Reis's main competitor, commands a 31.6 times EBITDA multiple. Then, too, CoStar paid 25 times EBITDA to buy LoopNet, a Web site for commercial property listings; its pre-acquisition equity market cap was $860 million. John Carraux, senior research analyst and portfolio manager at Edina, Minn.-based Punch & Associates Investment Management, is an investor in Reis. At Peligal's request, he kindly agreed to talk his position.

Consider, said Carraux, that Reis's CEO, Lloyd Lynford, is the company's largest shareholder, with 11.7% of the outstanding 10.7 million shares. The balance sheet is debt-free and the business gushes free cash flow. "In 2011," Carraux continued, "over 75% of the company's $10.8 million in EBITDA converted into free cash flow. We would expect a similar conversion rate going forward. According to Bloomberg, the average Russell 2000 company converts less than one-third of its EBITDA into free cash flow. On a free-cash-flow basis, which we think is more relevant than EV/EBITDA anyway, the valuation is attractive at around 12 to 13 times."

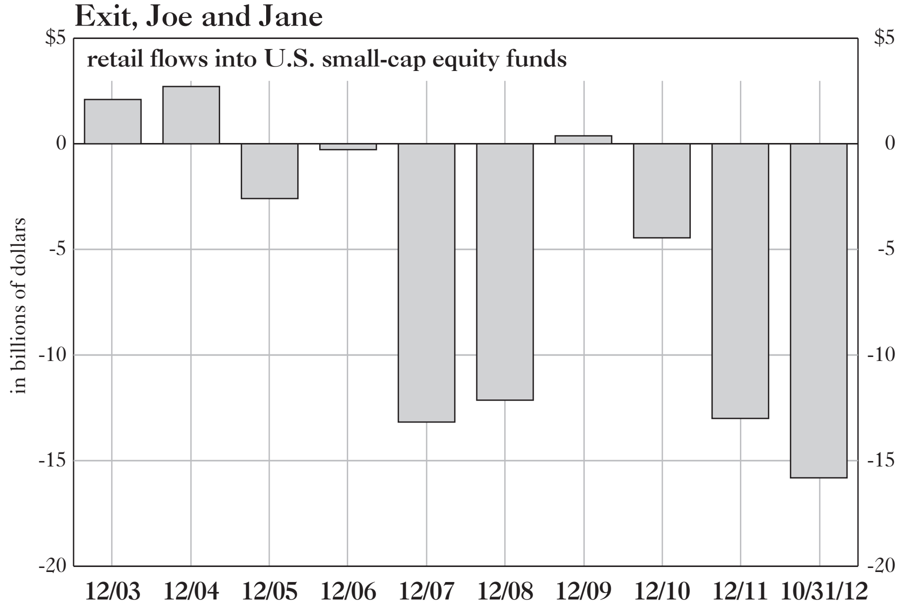
Reis operates on the subscription model, and what it offers was valuable enough over the past 12 months to induce 92% of its subscribers to renew (in the starving time of 2008-09, a mere 80% renewed, an 80% renewal rate being what most publishers can only dream of in the best of times). "You have incredibly loyal customers and a highly unique product that is not likely to be replicated by virtually anyone," says Carraux.

Presentable microcap specimen No. 2 is a tiny specialty chemical company with a newish product. Ocean Bio-Chem (OBCI on the Nasdaq) does $30 million-plus in revenues and earns on the order of $3 million. There are 8.3 million shares outstanding, of which the CEO, Peter Dornau, owns 55%. The company has a presentable balance sheet and a $16 million market cap. It is a story stock and here—courtesy of Harper Stephens, director of investment management at Thompson Davis Asset Management, Richmond, Va.—is the story:

"We've owned Ocean Bio-Chem for about a year and a half now and they continue to execute fundamentally," says Stephens. "They have a new product that is ramping and they just had an all-time record revenue quarter. In fact, over the past 12 quarters, it has broken revenue records nine times for that particular quarter of the year and just nobody cares—yet. The stock trades at around half the peer group's earnings multiple, 70% below the price-to-sales multiple, 80% below the price-to-cash flow multiple and around half the price-to-book multiple of its peer group."

Star Tron is Ocean Bio-Chem's prize elixir. It's an enzyme-based fuel additive that fights the corrosive effects of ethanol. Star Tron—Lowe's in Brooklyn sells an eight-ounce bottle for $6.97—gets mainly strong reviews on Amazon and on stripersonline.com, a fishing and

Exit, Joe and Jane

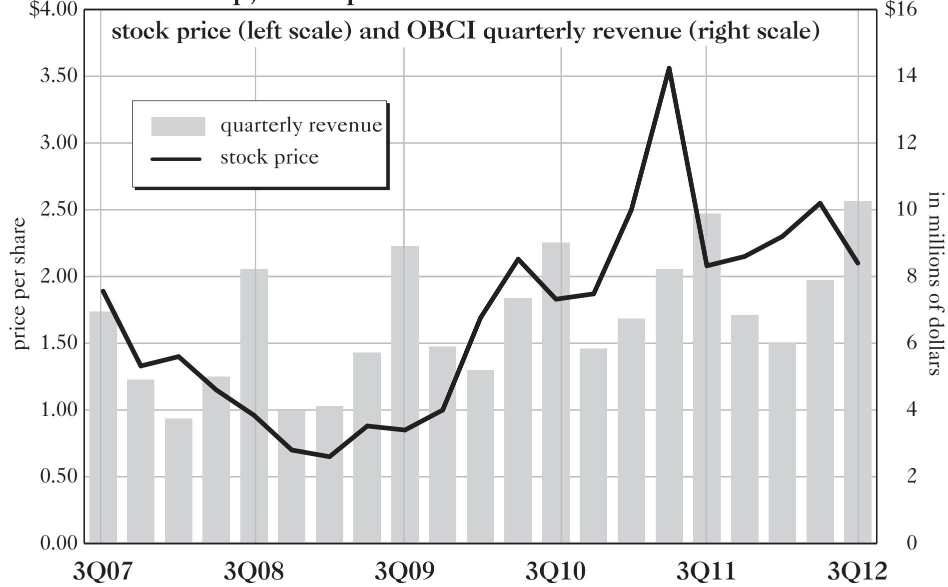


source: EPFR Global

boating enthusiasts' message board. Colleague Charley Grant, trawling around in the fuel-additives channel, spoke to an employee at Island Automotive in Marco Island, Fla. "[W]e've been selling it now for about three years, with no complaints about it," said our informant. "And I've had repeat customers for it. . . . [W]e basically recommend it for a lot of customers that leave for the summer, and leave their cars sitting. We tell them, 'disconnect the battery, fill the tank, put the stuff in and try to keep the water levels down,' because this ethanol is just killing fuel systems."

"They are doing about $9.5 million of Star Tron sales annually," says Stephens, "and if they can continue to grow and take share from the competition it *could* end up being a $50 million to $100 million per-year product [estimated size of the fuel treatment market is $1 billion]. Not will, but could. That would obviously be a game-changer for the company and it wouldn't surprise me (though it's not our thesis for why we own the stock) that a larger company would want to acquire OBCI." Even a potential transaction might provide liquidity to the CEO who owns more than half the stock, Peligal adds.

Revenue up, stock price not



sources: company reports, the Bloomberg

Mastech Holdings, a Pittsburgh-headquartered IT staffing business with a bargain-basement valuation and a $16.5 million market cap, is our presentable specimen No. 3. "Big companies such as IBM and Kaiser Permanente are always implementing various large-scale IT projects," Peligal advises. "Rather than hiring a full-time employee to fill a temporary billet, they turn to an IT recruiter. Mastech was founded in 1986 (today's public company was spun out of iGate in 2008). Its forte is importing skilled Indian tech workers to America under the HB-1 Visa program and programs like it. The company finances are strong, and the two co-founders, Ashok Trivedi and Sunil Wadhwani, own a combined 64% of the stock. Certainly, Mastech falls between Wall Street's ever widening cracks. At a ratio of enterprise value to EBITDA, its valuation—3.7 times—is less than half that of its admittedly larger competitors, Computer Task Group and CDI Corp.

"Mastech generated 42 cents of earnings per diluted share in the first nine months of 2012, compared to 23 cents of diluted earnings in the first nine months of 2011—not bad on a $5.15 share price," Peligal goes on. "From an operational level, the company is starting to see some payback from investments aimed at strengthening its recruitment capabilities. Remember, as Andrew Berger told me, 'The IT segment is basically the plumbing of the business economy. Nothing functions without it, whether you're involved in making, selling, distributing or advertising McNuggets, iPads, or Obamacare.'"

Berger is the chief investment officer at AB Value Partners, a 2011 start-up, and an enthusiastic Mastech investor. "Among the public companies in the IT staffing space," Berger tells Peligal, "in the last quarter it was the fastest growing. We've been on the conference calls, and we're the only ones to ask questions. We've been to the headquarters [and] we're the only ones to ever show up. It's just one of these small companies. . . , the public float on this thing is only $5 million. There's no debt. There's $3 million in cash. We're the largest outside shareholder. So there's just not a lot of liquidity. There's not a lot of interest in a stock like this, because only small firms like us can buy and follow the stock."

What do they say about good things?

•