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Returns to illiquidity

In this Fed-centric world, people are spending less time reading corporate filings and more time parsing the deliberations of their monetary masters in Washington, D.C. So much the better for the inefficiency of markets, we say. Now unspooling is an exercise in security analysis.

We focus here, as we did in the issue of *Grant's* dated Nov. 30, on stocks so small as to be invisible to the naked institutional eye. To anticipate objections, we point out that most everyone has a P.A., or failing that, a stock-hobbyist brother-in-law, and besides, Apple Inc. started small, too.

One would suppose that even without the work of Roger G. Ibbotson et al., tiny stocks would deliver outsize returns. To own shares in a company valued at $152 million or less—the Ibbotson-defined demarcation point between small cap and micro, i.e., between the third and fourth quartiles in equity market capitalization—is really to own them. Selling is problematical, especially when everyone else is selling. Common sense would suggest that those who sacrifice the ability to turn on a dime should get something—an investment consolation prize—in return.

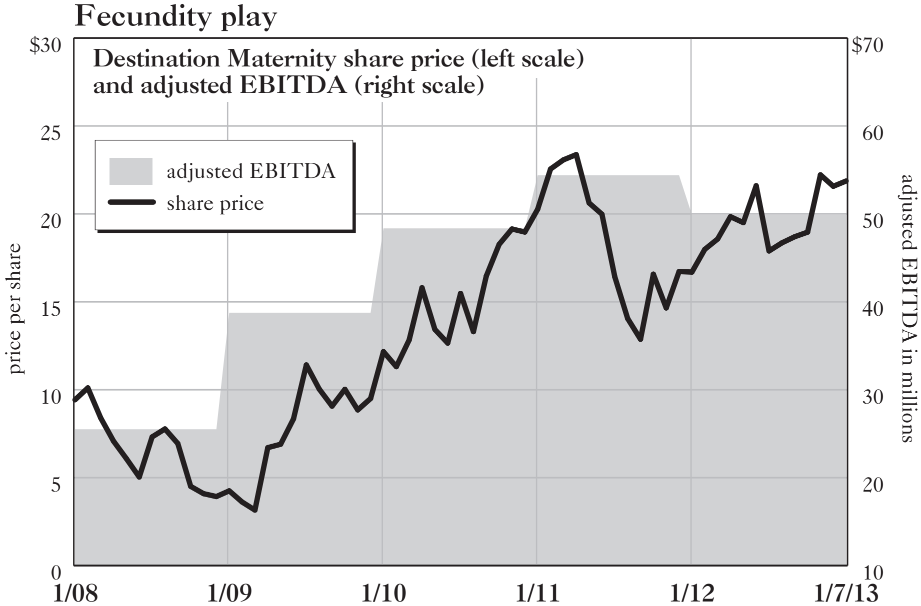
And this supposition the Ibbotson data, contained in a periodically updated study entitled "Liquidity as an Investment Style," tend to support. For example, between 1971 and 2010, "low-liquidity" micro caps produced an annual return of 17.9%, whereas low-liquidity large caps produced an annual return of 12.8%.

Past performance is beguiling, not predictive, of course, and especially so with shifting samples. In 1971, relates Daniel Kim, one of the Ibbotson authors, a micro-cap stock was defined as one with a market cap of less than $22.6 million; by 2010, the most recent selection year, the micro-cap, small-cap boundary had shifted to the aforementioned $152 million. In 1971, a "low liquidity" stock was one with an annual rate of turnover of 0.18 or less; in 2010, low liquidity meant an annual rate of turnover of 0.52 or less (in 1971, such a rate of turnover actually qualified as "high liquidity"). The stock market has gotten bigger and jumpier.

Anyway, the consolation prize seems to go begging. Data assembled by Mill Road Capital, Greenwich, Conn., suggest that businesses valued at $500 million or less constitute 80% of the population of American public companies but command just 3% of the composite public-market capitalization. To be sure, micro-cap companies come in many varieties. There are the profitable and well-financed and conscientiously governed ones—and the other kinds.

The abiding problem is size in its many dimensions. Thus, a 10% position in a sweet, thriving, niche-y, undervalued, $250 million market-cap manufacturer would hardly add a whit to the performance of a $50 billion hedge fund. By the same token, it would scarcely be worth the bother to that $50 billion pool of capital to pursue legal remedies against the same seemingly sweet and thriving manufacturer if its management

Fecundity play



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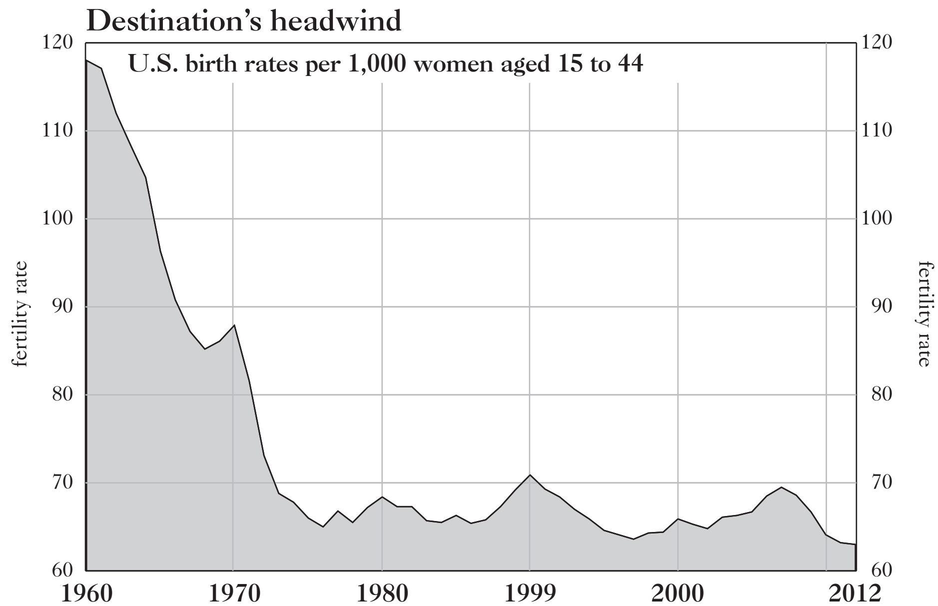


source: Centers for Disease Control and Prevention

turned out to be a pack of thieves.

Still, one wonders, if the value proposition is what Ibbotson says it is, or—technically—what it has been, why doesn't a class of micro-cap hedge funds emerge to seize it? Colleague David Peligal put the question to Mill Road's Thomas Lynch.

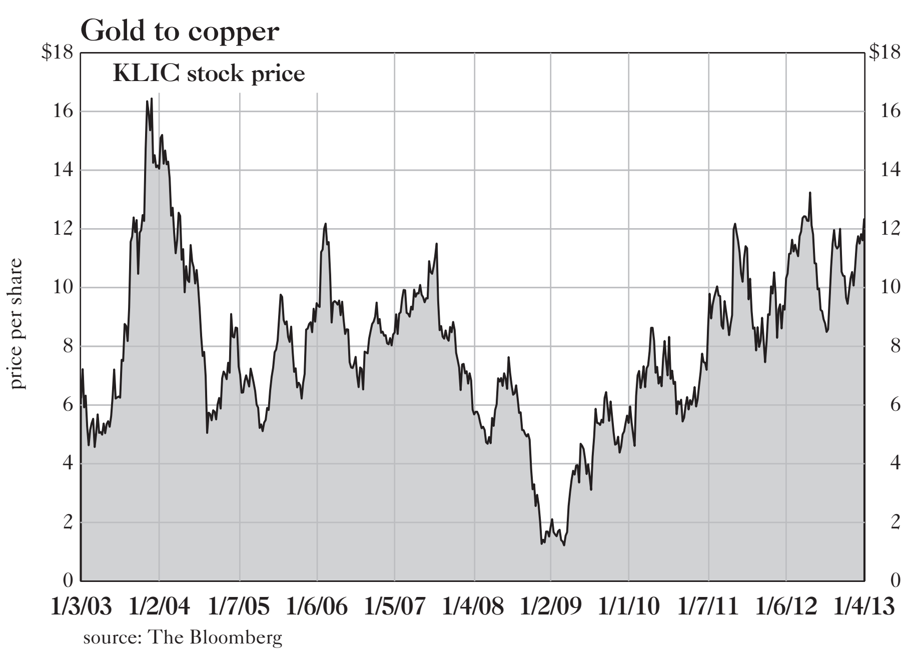
"I suspect one of the reasons is the Dodd-Frank legislation, which required all investment vehicles above a certain size [$150 million] to register," Lynch replied. "The funds that didn't meet that size threshold still felt great pressure to comply in order to raise capital from institutional investors. And there are fixed costs associated with registering.

"Now," Lynch continued, "it's difficult to be an effective micro-cap manager with over $100 million of assets. Typically, you're somewhere between $10 million and $50 million. Let's say you're a micro-cap hedge fund and you're managing $25 million. Let's say you're taking a *2%* management fee. You're making $500,000 a year for your whole firm. When you add all of the fixed costs of operating the firm, the person who is running it is probably not paying himself or herself anything.

"So you're getting by on whatever the carried interest is," Lynch went on. "If you add the upfront and annual costs of compliance and registration, you're probably adding $100,000 to $300,000 more per year, depending on how efficiently you do it. So there's been a great disincentive to do it. Because of the high fixed costs with operating a mutual fund, and because of style drift as capital inflows happen so readily, mutual funds are not really a player at all in micro caps. So there's no demand from mutual funds. Demand from hedge funds has diminished. Valuations have diminished. The earnings characteristics are still the same. Therefore, I think there is a strong argument that the history of outperformance of micro caps will continue in the future."

Asked to name a favorite ticker, Lynch mentioned Destination Maternity Corp. (DEST on the Nasdaq), a well-financed, shareholder-friendly and free-cash-flow-generating retailer with a market value of $291 million. Let the record show that Mill Road built a 9% position in Destination (and in the process doubled its money) in the four years beginning in 2007.

"Destination Maternity," Lynch led off, "is the dominant market-share leader in U.S. maternity apparel. Their market share is somewhere around 50%. They sell their products through their own retail stores, which are Destination Maternity, Motherhood Maternity and A Pea in the Pod. They also sell their products through major department stores—they are the exclusive provider of maternity apparel to Macy's, Sears, Kmart [and] Kohl's—so, huge market share. Also, high barriers to entry in the segment, because if you think of maternity apparel, you have to provide the customer every type of clothing for every type of occasion, and you have to do it in a very small amount of floor space because pregnant women are a small percentage of the shopper population. And so what that means is that these stores, or in the maternity section, you can't go three or four or five or six deep in any size, because you have such a wide variety of merchandise you have to supply in such a small amount of space, so it's very logistics intensive. You can only stock one of every size, and when that SKU is sold, you have to replenish it immediately. By being logistics intensive, that creates a very high barrier to entry. It is a very stable business model; if you look at maternity apparel, it is materially more stable than any women's apparel retailer, because the primary driver isn't fashion. . . , the primary driver is the birth rate."



source: The Bloomberg

Over the past six years, Destination has reduced its debt to $2 million from $118 million. It has cut inventory, lowered expenses and shrunk the number of brands it sells. The shares yield 3.24% and are quoted at 12.7 times the 2013 estimate. Management projects free cash flow of $20 million to $31 million in fiscal 2013 even in the face of a plunge in American fertility. In 2011, there were 63.2 births per thousand women of childrearing age, the lowest since 1920, when statistics began to be collected, and slightly more than half of the peak recorded in 1957. "[T]he economic downturn seems to play a pretty large role in the drop in the fertility rate," D'Vera Cohn, an author of a report by the Pew Research Center, observed to *The Washington Post*. If, as and when the natal winter ends, Destination and its shareholders will be grateful.

As it is, the owners and the company appear to be living in harmony (though some of the biggest holders, including Renaissance Technologies, with a 6% position, are either in the quantitative investing or exchange-traded-fund management businesses; we would bet that their copies of Destination's annual reports mainly go unread). "We have continued to use our strong free cash flow to generate shareholder value," Ed Krell, the Destination CEO, wrote in the latest annual, "both through continued significant debt repayment and continuing to return funds to our stockholders via a meaningful regular quarterly cash dividend."

By no means does every member of the small- and micro-cap cohort sing from the same capitalist hymnal. One that has so far refrained is Kulicke and Soffa (KLIC on the Nasdaq), a $893 million-market-cap, Singapore-headquartered maker of semiconductor manufacturing equipment.

Either by the numbers or by the business narrative, K&S would seem to give a good account of itself. For starters, it's developed techniques to substitute copper for gold in making the leads that connect semiconductor circuits. It's a breakthrough that promises big benefits in operating margins and earnings. For another thing, the company is adapting its technology for alternative markets—bonding for light-emitting diodes, for example—and it has brought in a new CEO, Bruno Guilmart, former head of Lattice Semiconductor, to succeed a long-serving, underperforming son of one of the founders. As to the valuation, it is condemning as much as it is inviting.

"K&S trades at 5.6 times trailing earnings," colleague Evan Lorenz relates. "There's $5.86 per share in cash and not a dime of debt. Adjusting for excess cash, the stock trades at 2.8 times earnings. Given that the copper adoption cycle may last for three years, K&S may generate around $2 a share per year in net income. And if that comes to pass, the company may have around $12 a share in cash on its books at the end of fiscal 2016. Today, it's an $11.89 stock."

How might said cash be deployed? The insiders have done their best to make the company takeover-proof. The top brass tend to sell the stock they're awarded. No dividend is paid. No shares are repurchased. Might there not be a cash-absorbing acquisition or two in management's sights? An investor would hold his breath. Prospective, publicly traded targets are quoted not at K&S's rock-bottom multiple but—some of them—in excess of 20 times earnings.

"We don't have a buyback program in place," Joe Elgindy, the company's investor relations director, admits to Lorenz. "I would say there should be. You should do a buyback when you trade under your intrinsic value. We, unfortunately, don't. I think that would help in a lot of ways and give signaling as to how we view the industry. Not having one is detrimental to our valuation in a lot of ways." The bullish story on K&S is that management will throw the owners a bone: "They are getting so much pressure from investors," says Thomas Diffely, analyst at D.A. Davidson & Co., "even over the last six months, that I think they will end up doing something." From Diffely's lips—and Elgindy's, too—to the board of directors' ears.

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Kulicke & Soffa
(in $ millions, except per-share data)

	—fiscal years ended September—				
	2012	2011	2010	2009	2008
Revenue	$791.0	$830.4	$762.8	$225.2	$328.1
Cost of sales	423.6	442.5	427.1	136.4	194.3
Gross profit	367.4	387.9	335.7	88.8	133.8
Operating expenses	188.2	217.8	187.6	162.4	158.4
Operating income	179.2	170.1	148.0	(73.5)	(24.6)
Interest expense	5.0	7.6	7.9	7.1	3.9
Gain on extinguishment of debt	0.0	0.0	0.0	4.0	0.2
Profit before tax	174.3	162.4	140.1	(76.6)	(28.3)
Taxes	13.7	34.8	(2.0)	(13.0)	(3.6)
Net income from cont. ops.	160.6	127.6	142.1	(63.6)	(24.7)
Discontinued operations	0.0	0.0	0.0	22.0	23.4
Net income	160.6	127.6	142.1	(41.6)	(1.3)
Earnings per share	2.13	1.73	1.92	(0.67)	(0.02)
Free cash flow per share	2.33	2.63	1.08	(0.95)	0.38
Net debt (cash)	(440.2)	(279.3)	(82.6)	(3.4)	96.3

sources: company reports, the Bloomberg