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What to Do if Your Small Cap Company's Stock is in a Funk

Capitalization strategy for a young or growing business is never easy. But to be a small, public company today is probably the worst of all possible worlds. Here's why.

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• *The cost of being a public company continues to rise.* With the passage of Sarbanes-Oxley, the cost of compliance and regulation has increased yet again. It's always been more expensive to be public. Today, it's almost outrageously more expensive. This has always been offset with greater liquidity, but read on to see what else has happened recently.

• *Fewer public companies than ever have analyst coverage today.* Between 2001 and 2003, the number of public companies covered by analysts dropped by 14 percent from 4,763 stocks to 4,103. Less coverage, less interest, fewer buyers. It's as simple as that. Fewer buyers mean more sellers, which means a lower stock price.

• *Raising new rounds of capital is harder if you're public than if you're private.* In theory, it seems that it would be easier to simply issue more public stock and attract more new investors. Plus you have the market price to set a value, rather than a negotiation with a private equity fund. In reality, public company investors are today nearly all "institutional" and their funds increasingly flow to the larger, less risky companies. By the same reasoning, today's bulge-bracket investment banks cannot make enough money doing offerings for a few million dollars versus hundreds of millions for major companies. Net result? Limited access to new capital for orphaned smaller companies.

Three-quarters of the companies who no longer have analyst coverage were "micro-caps." A micro-cap is a company with total market capitalization (number of shares times market price of stock) of less than $100 million.

The reasons for this decline in coverage are numerous. There continues to be consolidation in the financial services industry, leaving fewer firms and therefore fewer analysts in total. There have been severe layoffs and cutbacks since the market turned down in 2001, leaving fewer analysts working. Regulatory changes have resulted in changes to the compensation plans for analysts, making coverage less aggressive.

Lack of coverage results in greater volatility because there are fewer buyers to offset sellers. Lack of research coverage increases the likelihood of market mis-pricing by reducing the number of buyers and sellers. Lack of coverage reduces access to debt and equity markets, even for companies that are doing well.

So, what's a small, public company to do? Here are some options:

1. Go private.

With the private equity funds awash in cash, the timing is right for many companies that earlier elected to be public to now elect to be private.

This is easier to do than it might appear. If your small, public company truly has the track record and prospects to attract a private equity fund to do a buyout, offering a price that the public shareholders will accept may be easier than you think.

A typical premium to market price might be 20 percent, but many times a premium might not even be necessary if the stock is highly illiquid and the company's stock has been in the doldrums. But even a 20 percent premium may not be a bad deal for the new investor if the public stock price undervalues the company's true worth, especially with more capital to grow faster.

2. Do a PIPE.

A "PIPE" is a private investment in a public equity. Many follow-on investments in small, public companies actually come from negotiated transactions between the company and the private equity fund investor.

Typically, these are done at a discount to the current market price, often 10-20 percent. This discount incentivizes the fund to make the deal. The new stock is not offered to the general public but, if registered, the fund gains at least theoretical liquidity for their investment quickly, and this would not be the case at all in most private company investments they might otherwise undertake.

3. Work harder to publicize your company.

This may sound like a trivial, self-evident suggestion but what we're talking about is working really, really hard, spending lots of money, and becoming highly skilled in gaining attention in a very crowded marketplace.

Most small cap companies find that nearly all their resources and energy are devoted to being good at their core business, so there is usually little energy left with which to become a carnival barker. But that's exactly what a small cap company has to do to get attention and therefore buyers for its stock.

We're talking about stories in all kinds of media, CEO interviews on CNBC, investor presentations at conferences, and many more ideas that require planning, effort, money and time.

Given these options, it's not hard to see why many small cap CEO's ultimately conclude that going public was a big mistake and seek to reverse the whole process by retreating into the simpler world of having a private equity partner or partners. At least that's an option that many CEO's should look at more seriously.

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