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Micro & Small-Cap Acquirers

Value Creation through Strategic Acquisitions

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Intro

When most investors hear the words **nano**, **micro**, or **small cap** (all referred to herein as micro-caps) and **acquisitions** in the same sentence, they tend to think of a small public company being acquired by a larger public or private company. While being acquired by a larger company is the goal of many small public growth companies' management teams and other shareholders, it is rather uncommon. In 2012, less than 3% of Russell Micro-Cap Index[i] companies were acquired[1]. As most management teams were struggling to grow their core business with the hope of being acquired, other management teams flipped the script and became acquirers. Examples of small public companies who grew through aggressive acquisition strategies include; SunOpta Inc (NASDAQ: STKL), Ideagen PLC (LON: IDEA), and Ensign Group Inc (NASDAQ: ENSG).

While there are a number of studies discussing the uncertain outcome of acquisitions, those studies primarily focus on the M&A activity of large and mid-cap public companies who acquire other public companies. There is limited research on M&A activity of smaller companies, but some studies suggest that the acquisition of small private companies have a much higher success rate. Hazelkorn, Zenner and Shivdasani (2004)[2] find that when the target is a publicly traded company, acquirers experienced negative short-term returns and an industry-adjusted negative return for the following two years. In contrast, transactions in which the target was a private company led to median short-term excess returns and median long-term excess returns. Two possible explanations were presented for this pattern. First, acquisitions of public firms are typically more complex and thus more prone to integration problems than the acquisitions of private companies. In the acquisition of private companies, acquirers are less likely to end up with the infrastructure and overheads of the target, facilitating post-acquisition integration. Second, acquisitions of public companies usually occur at a premium to an already-established share price (a share price which, in most cases, already includes a premium to a target's tangible value). Compared to public companies, private companies can sometimes be purchased without a considerable premium because no established public valuation benchmark is available.

Market Values

That second point is more relevant to micro-cap acquirers than it may appear at the surface. Public companies' value, or market capitalization, is a combination of tangible value and speculative value. Tangible value of a company can be determined through various financial metrics (book value, revenues, cash flows, etc.). Speculative value is the additional value, on top of a companies' tangible value, that the market has added based on investors expectations for future growth. There are numerous financial ratios that can be used to get a general sense of how market speculation affects a companies' market value. A very simple way to determine the market's expectations for a company's future is to compare book value and market value, also known as the price-to-book ratio (p/b ratio).

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[1] 'Opportunities for Alpha: Exploring Micro Cap Equity', RBC GAM-US Fundamental Series, RBC Global Asset Management, March 2013
[2] Hazelkorn, T, Zenner M & Shivdasani A 2004, 'Creating value with M&As', Journal of Applied Corporate Finance, vol. 16, no. 2-3, pp. 81-90, Blackwell Synergy

Most exciting high growth public companies have market values that are substantially greater than their tangible values. It is common in most acquisitions for acquirers to pay an acquisition premium, which is the difference between the estimated tangible value of a target and the actual price paid to obtain it. When acquiring a public company, acquirers usually need to pay a premium on top of an already inflated price in order to make a deal attractive to target shareholders. This results in acquirers overpaying for targets. While a target public company trading at a p/b ratio of 3:1 may only consider a purchase price valuing the company at over a 4:1 p/b to be an appealing offer, a similar private company may be ecstatic to have an acquirer value the company at a 3:1, 2:1 p/b or even less. To take this a step further, if a public company with a p/b ratio of 4:1 could acquire a similar business at a 2:1 p/b, the acquirers price should increase to maintain the pre-acquisition p/b ratio. In theory, the increase in tangible value with no change in speculative value should result in an increased market value for the company.

An Opportunity for Small/Micro-caps

While the above example is the common goal for companies trying to make accretive acquisitions, small public companies with exciting growth stories can have much more speculative value. It is not uncommon for companies who trade on the OTC Markets, NYSE Mkt, or NASDAQ to have 5:1, 10:1, 20:1, or, in some cases, much higher p/b ratios. If a company with a p/b ratio of 10:1 could acquire similar target companies valued at 2:1, while maintaining the same p/b ratio, the company could very quickly increase its market and tangible value.   While in theory, making acquisitions as a small public company makes a lot of sense, management teams of small public companies usually don't aggressively pursue acquisitions.

The reason why these companies don't aggressively pursue acquisitions usually comes down to a lack of capital. There are a variety of unique challenges for small public companies trying to raise growth capital and, in most cases, all of the capital earned and/or raised is being used to support core business growth, not to fund acquisitions. The strategy of using the majority of capital raised to fund core business growth is common among small public companies, but it may not be the most efficient way to grow. If a company could raise capital at its 10:1 p/b ratio valuation and purchase multiple similar private companies at a 2:1 p/b ratio they should be able to grow much faster than they would be able to if they tried to create the tangible value from scratch.

From the perspective of any long term shareholder of a small public company the question is simple: What is the fastest way to create substantial tangible shareholder value? Ultimately management needs to decide how they are going to grow their company. The management teams of SunOpta Inc (NASDAQ: STKL), Ideagen PLC (LON: IDEA), and Ensign Group Inc (NASDAQ: ENSG) saw growing through acquisitions as a huge opportunity and seized it. Other management teams take the road more commonly traveled and attempt to build core business value from the ground up. Unfortunately, in many cases the more common road for small public companies does not lead to long run success.

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[i] The Russell Micro-Cap Index is a capitalization weighted index of 2,000 small cap and micro-cap stocks that captures the smallest 1,000 companies in the Russell 2000, plus 1,000 smaller U.S.-based listed stocks. The broad index is designed to present an unbiased collection of the smallest tradable securities that still meet exchange listing requirements, so over-the-counter (OTC) stocks and pink sheet securities are excluded.

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