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MICROCAP INVESTOR

A GUIDE TO INVESTING IN UNDERFOLLOWED STOCKS

Investing where others can't or won't

CHAPTER 1

INTRODUCTION

Whenever you hear the media or investment industry talk about microcap companies, you mostly hear negative comments.

"They are risky."

"You shouldn't invest in penny stocks."

"They are volatile."

"They are fraud."

"They are unregulated."

"They are illiquid."

Consequently, the vast majority of investors do not get involved in stocks of microcap companies. They are scared because they have been trained by the environment to be scared. Most professional investors meaning money managers are not even allowed to touch them. They have certain restrictions as to the size of companies they can invest in.

Whenever I ask people why investing in microcap stocks is risky, I always get vague answers which tells me that they don't really know why they are risky, but they say it anyway because this is what they have been taught for years. You tell someone that they are smart, stupid, tall, or short over and over, and eventually they will believe you. Well, this is what the media and investment industry propagated over the years.

When starting a business, how do you define risk? In other words, what makes you scared? You worry about things like having enough customers, being able to satisfy them, providing good products or services, having enough money to cover the bills and not going under.

If you get these things right, everything else will take care of itself. Satisfied customers will generate revenues and they will keep coming back for more. Then, if you manage your expenses properly, the business will generate a profit which will make you and your partners happy.

However, if you are unable to satisfy enough customers to generate revenues to cover all of your expenses, then all kinds of problems will emerge. Employees will not get paid. Suppliers will stop delivering supplies due to unpaid bills. Your landlord will give you an eviction notice. The bank will call your loan. To keep the monster alive, you will have to keep draining your savings or asking your partners to put up more money. In this situation, no one is happy, fights break out, couples get divorced, and partners end up suing each other.

So isn't risk about business fundamentals? It is not according to Wall Street. Imagine a beautiful apartment complex. It has 300 apartments and is located in a college town. Because of its proximity (2 minutes away) to X University, all the units are almost always occupied. Also, the surrounding area is built out so no new apartment buildings can get built without demolishing other buildings. Consequently, the future competition is limited.

Because the average monthly rent for each apartment is $1,000, the entire complex generates more than $3 million in yearly revenues. After all the expenses, the net profit is approximately $1.5 million. Would you like to own a property/business like this? I would but according to the media and investment industry, this would be too risky because such a business is only worth $15 million making it a microcap. If the ownership was divided among 30 million shares, each share would be worth $0.50 making a penny stock.

I am sure you can see how ridiculous it would be to classify such a business risky, but this is exactly what they do with microcap companies. If a company has a small market capitalization and a low share price, it is automatically given a label - stay away, it is toxic.

What about a discussion about the company's products, revenues, growth, or profitability? It does not matter. If the company is small, it is toxic. End of discussion.

Because of this widespread view, the microcap space offers tremendous investment opportunities, not because the small companies are magical or have anything special, but because everybody else refuses to look at them. It is like going out to buy a house when all the prospective buyers are on strike.

CHAPTER 2

MICROCAPS ARE RISKY

Many public microcap companies are risky and there is no question about it. So the pundits have it partially right. However, the microcaps are not risky because they are small or because their stocks prices are in the pennies. They are risky because their businesses failed to operate profitably or because they are in the early stages of development (ex. new companies).

All companies, big and small, have something in common - when they were born, they were small. Amazon, Apple, Microsoft, Harley Davidson, and even Nike all started in a garage. They were tiny before they became big. In Wall Street terms, they were risky before they became investable. It took these companies years to establish their dominance, and eventually, they made their founders and early backers filthy rich.

When businesses are born, they start with an idea which can be something new, improved, or the same. To get them going, they needed capital. Some needed more capital while others needed less. Let's say you wanted to start a construction equipment rental company. You would need a lot of money to buy a pool of rentable equipment (lifts, electrical sew, rotary hammers, or drills). The likelihood of you having this much money is low so you need help.

If your business plan is decent and you have good sales skills, then you should be able to raise what you need from friends and family, angel investors, or venture capital firms. However, in return you have to give up some ownership interest. As a result, your investors would become your partners.

They are giving you the money because they want to see a return. Yes, some of them like you and support you no matter what, but they too want to see a return on their money. You can deliver that return by growing your business into a profitable enterprise that can later pay dividends, be sold to another company, or be taken public.

Most entrepreneurs dream of eventually being able to take their companies public because it is prestigious and they can get more money by selling to the public than to another company. Also, they can maintain a large ownership and keep running the company.

Many companies become public through a traditional IPO. They hire an investment bank that helps them through this process. First, the shares are sold in the primary market. This is where a privileged group of people (usually good clients of the investment bank) get to buy the shares of a hot IPO before the rest of us. Then, the shares are floated on the secondary market (ex. New York Stock Exchange or NASDAQ) where they may trade for years and even decades.

In the IPO process, the initial stock price is determined by the valuation which is calculated by the investment bank. This price is never below $1 per share because remember, according to the investment industry, anything below this level is a penny stock meaning that it is toxic, dangerous, and risky. NYSE and NASDAQ require a minimum initial stock price of $4 per share.

After the trading starts on the secondary market, the stock price fluctuates based on the supply and demand from market participants. Over long periods of time, the stock price should reflect the underlying business fundamentals.

Because the world of business is constantly changing, the companies have to keep working hard to stay profitable and growing. They have to keep coming up with ways to satisfy new and existing customers with new or improved products. If they don't, then the competition will take their market share.

Unfortunately, as the years pass, some companies fail to maintain the status quo. They lose their place in the marketplace and become less profitable and even unprofitable. As a result, investors abandon them by selling shares. With diminishing interest from new buyers, the stock price starts to fall causing the market capitalization to decrease.

If the stock price decreases far enough, the companies finds themselves in the penny stock and microcap territory. The prestigious exchanges do not want to have anything to do with these losers, so they delist them to lower and less reputable trading platforms (ex. venture exchanges).

In the U.S., the delisters can go from NYSE or NASDAQ to over-the-counter markets. In Canada, they go from Toronto Stock Exchange (TSX) to TSX Venture exchange. In UK, they transfer from London Stock Exchange (LSE) to AIM exchange.

Consequently, the venture exchanges (OTC is not technically an exchange) are filled with damaged companies which in many instances simply go there to die.

Wall Street conveniently points to this fact and says, "Microcap stocks are risky." I completely disagree. They should say, "Companies with damaged businesses are risky because they eventually die but in the process they go through a microcap size."

Here is what Wall Street conveniently forgets to point out. Venture exchanges also give businesses an alternative way of going public. Not everybody takes the traditional IPO route.

You see, to take the traditional route of IPO, your business needs to be a certain size and of profitability level. It needs to meet listing requirements of particular exchanges. If you have a business that does not generate any revenues yet, you cannot go through the traditional IPO process.

However, just because there are small revenues or no revenues at all does not mean that your company has no right of being public. Your financial backers might want their shares to be publicly traded from day one or they won't give you the money. There is nothing wrong with that. You provide liquidity to your partners' shares and focus on growing your business the same way you would if your company was still private.

With venture exchanges, you can do that because they have extremely low listing requirements. You have no revenue, no problem. Your are losing money, no problem. Virtually any company can become public.

From our point of view, this can be extremely scary. We have loser stocks getting delisted to venture exchanges because their businesses are flawed and now we have companies with no revenues that are also trading there. It looks like a junk yard.

Well, it is. Most of the companies in the micro space should be avoided. However, there are some companies that are fantastic. Yes, at some point, they had no revenues but now the situation might be completely different. The company might be growing revenues, generating cash flows, and even be paying dividends but very few investors are paying attention because it is trading on the same exchange as all the other junk companies.

For example, a couple of years ago, I invested in Unilens Vision, a specialty contact lenses maker. The company was growing revenues and paying dividends. The dividend yield was 5 percent before the stock price tripled. It was a perfectly fine company trading on OTC Markets and TSX Venture. I was able to buy shares unbelievably cheap because the company, due to its affiliation to microcap space, was labeled toxic where in reality it was everything but that.

What about companies that turn around? Is it possible that a Company XYZ delists from NASDAQ to OTC Markets, gets its act together, and relists on NASDAQ again? Absolutely, it is possible. It is all about business fundamentals. If the company develops a new product, makes a smart acquisition, divests a losing division, or cuts costs, it might turn its fortunes around. Businesses are not static. They develop, evolve, degrade, and improve. They are like living creatures.

To call microcap and penny stocks risky just because of their size and place of trading is ridiculous. However, because the majority of investment industry chooses to ignore this entire asset class, they ignore the bad with the good. You, on the other hand, can focus only on the good and make a lot of money in the process.

CHAPTER 3

WHERE THEY TRADE

In order to be a micro cap investor, you need to know various places where micro cap stocks trade. This is by no means a complete list, but these markets or exchanges are the most important ones especially for investors from the United States.

VENTURE MARKETS

Venture markets help small companies to get funded at the early stages. They are important to the health of the economies because small companies are responsible for most of the job creation. Canada is the home of TSX Venture exchange and London is the home of AIM Exchange. The United States does not have a venture exchange. Currently, over-the-counter markets serve the function of venture exchanges, but they are not exchanges.

OVER THE COUNTER MARKETS

In the United States, the most prestigious exchanges are New York Stock Exchange and NASDAQ. These exchanges want to upkeep their reputations and consequently, they only want to list companies that meet their strict listing requirements. The new companies cannot meet those requirements while the failed companies cannot sustain their listing requirements. They trade on over-the-counter markets which include OTC Markets and OTC Bulletin Board.

OTC Markets (otcmarkets.com) is owned and operated by OTC Markets Group which is a publicly traded company with a ticker symbol OTCM. OTC Markets is the more dominant trading platform to OTC Bulletin Board. There are approximately 10,000 public companies trading on OTC Markets.

OTC Markets date back to early 1900s which is when they were known as pink sheets. Similar to today, the securities that did not qualify to trade on an exchange, traded on over-the-counter markets between dealers without a centralized location.

The problem during those days was that the trading of these securities was extremely fragmented and inefficient. Market participants did not have access to pricing or volume information. They had no idea how much particular broker-dealers were willing to pay for securities and how much they were willing sell them for. In other words, the bid and ask information was not widely available.

When there is a problem, there is usually someone to capitalize on it. In 1913, Roger W. Babson and Arthur Elliot came together to form National Quotation Bureau which compiled bid and ask information from various broker-dealers and published it in a daily publication. The publication also included broker-dealers' phone numbers so that they could call one another to trade. National Quotation Bureau was a publishing company.

This publication was delivered to the stock brokerage houses each morning allowing them to make informed investment/trading decisions for themselves and on behalf of their clients. Because the bid and ask information was printed on pink colored paper, the publication became known as the pink sheets.

National Quotation Bureau operated in this manner for 86 years without much technological improvement. It kept delivering the pink colored publication until 1999. Even though Internet revolution was already underway, investors had to call a broker to get a quote. Because the company failed to improve and evolve, it lost a significant market share to NASDAQ and OTCBB (discussed shortly).

NASDAQ was formed in 1971 to do exactly what Pink Sheets was doing but electronically. When years later NASDAQ implemented trading capability, it stole the majority of trading volume for over-the-counter securities. In the late 1990s, some of that business came back because NASDAQ made a strategic decision to delist a lot of over-the-counter issuers. Today, NASDAQ is not involved in the over-the-counter securities because NASDAQ is considered an exchange since 2006.

Before 1990, the over-the-counter markets were a wild-west. There was rampant manipulation, fraud, and boiler-room selling tactics. Consequently, the Penny Stock Reform Act of 1990 was passed to bring reforms and provide transparency to over-the-counter securities.

This act mandated the Securities and Exchange Commission (SEC) to establish a system to provide quotation, pricing, and volume information for over-the-counter securities. To meet its mandate, the SEC formed Over-the-Counter Bulletin Board (OTCBB) to be run by FINRA. The broker-dealers would subscribe to the service to be able to enter their quotes and see other broker-dealers' quotes.

OTCBB became Pink Sheet's competitor. Within a short period of time, OTCBB stole market share from Pink Sheets by migrating more than 6,000 issuers to its platform. From the investors' point of view, the difference between the two was that OTCBB required its issuers to report current financial statements to the SEC while Pink Sheets did not have such requirements. As a result, OTCBB was considered safer for investing than Pink Sheets.

In 1997, a seed was planted that was going to change the fortunes of the two competitors. In that year, Cromwell Coulson and his backers acquired National Quotation Bureau (Pink Sheets). At that time, Pink Sheets was really struggling. It only had 1,300 issuers and its paper-based quotation platform was extremely outdated.

With all of these negatives, Coulson bought it because he saw the potential to turn it into something better. Since then, his firm developed technology to move the quotations online and developed a trading platform to allowed broker-dealers trade with each other rather than calling each other on the telephone. (OTCBB is quotation-only system). He also developed a tier-based listing system.

The problem that plagued Pink Sheets for decades was the quality of companies listed there and investors' inability to distinguish between the good and bad. Also, because there were no listing requirements, it attracted the worst players. The good companies did not have a way of differentiating themselves from all the junk. This is why he developed three-tiers classification system based on the issuers' quality and willingness to provide certain disclosures. He borrowed this idea from eBay where sellers are rated. The three tiers include OTCQX, OTCQB, and OTC Pink.

OTCQX is a premium tier designed for high quality companies that want to differentiate themselves. To qualify, the issuers have to meet high financial standards, show compliance with U.S. securities laws, be sponsored by an advisor, have a bid price of more than $1 per share, and be current in disclosures. In other words, the companies that qualify for OTCQX market place would also qualify for a listing on an exchange. However, they choose to stay because it is cheaper and less regulatory. There are many well-known International companies listed on OTCQX in addition to being listed on their local exchanges. They want access to investors from the United States without the high cost of compliance that traditional exchanges require.

OTCQB is the second-best tier. It can be viewed more of a venture market because it includes less established companies in the development stage which cannot meet the requirements of the higher-tier market classification. To qualify on OTCQB, companies do not have to meet any financial or qualitative benchmarks, but they need to be willing to report to SEC so that investors can easily access the information in order to analyze and study the issuers.

Finally, the third tier is OTC Pink which is for companies that provide too little or no information to investors. In other words, they do not have to do anything different than what they were doing before the three-tier classification system was introduced.

Obviously, this group includes some of the worst issuers who do not want to share information because they have something to hide. With that being said, this group also includes investable companies that either do not care about providing information or cannot afford it. Also, some of them simply did not get around to moving up in ranks.

In 2010, the company was renamed OTC Markets Group. Even though Coulson and his team were busy making changes to the formerly Pink Sheets company for more than a decade, it wasn't until 2010 that the competitive landscape between OTC Markets and OTCBB began to change. The issuers and broker-dealers started to notice that OTC Markets had developed a much better platform while OTCBB still had no electronic capability and relied on quotation system from the 1990.

The issuers and broker-dealers started leaving OTCBB in droves for the OTC Markets. Around that time, FINRA wanted to sell OTCBB but it was unsuccessful. Through improvement and skillful execution, OTC Markets officially defeated its competitor.

Today, OTC Markets is the dominant player in the over-the-market securities while OTCBB resembles more of a ghost town. In 2014, FINRA was looking to shut OTCBB down, but as of the writing of this book, the bulletin board is still in operation.

To buy shares on OTC Markets, you simply need a brokerage account. While most of the brokers allow you to trade there, some have restrictions and additional fees. So find one that does not discriminate against penny stocks. I find Interactive Brokers to be satisfactory to my needs.

TSX VENTURE EXCHANGE

TSX (Toronto Stock Exchange) Venture Exchange is located in Canada. It is owned and operated by TMX Group which also owns Toronto Stock Exchange. TSX Venture as the name implies is for junior companies while TSX is for senior companies which are more established. Similar to NASDAQ, the trading on TSX Venture is all electronic without a trading floor.

Even though the exchange has only been around since 1999 (previously Canadian Venture Exchange), it dates back to early 1900s. It is a combination of Vancouver, Alberta, and part of Montreal Stock Exchange.

Vancouver Stock Exchange was opened in 1907 mainly to provide start-up capital primarily for mining companies. Its focus differed from other exchanges such as Toronto Stock Exchange or New York Stock Exchange which catered to established businesses.

Because of its strict focus on junior mining companies, the exchange earned a bad reputation. The junior exploration business is extremely risky and attracts bad actors. Consequently, investors lost a lot of money. Some of the names that the exchange was called are the following:

"Scam Capital of the World"

"Canada's bad-boy exchange"

"Las Vegas North"

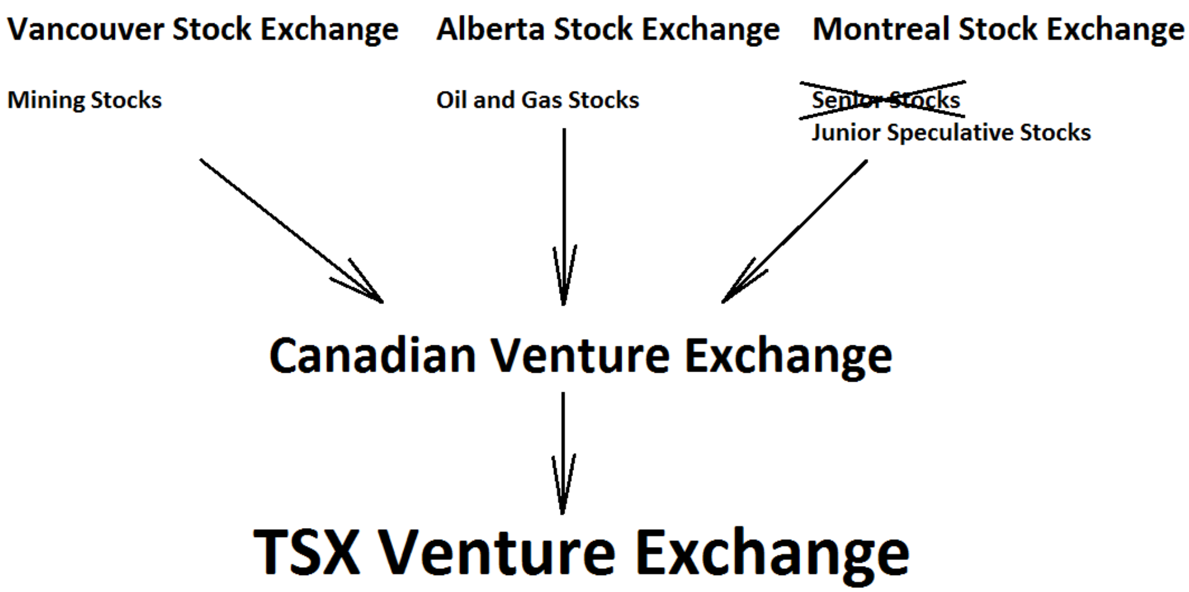
Vancouver Stock Exchange tried to diversify into other industries to improve its image, but it was unsuccessful in doing so. Once, it established itself as the place to raise seed capital for junior mining companies, this is what it stayed.

Alberta Stock Exchange was established six years after Vancouver Stock Exchange. It was incorporated in 1913 and started operations in 1913. While it also included junior mining stocks, Alberta Stock Exchange became known as the petroleum industry exchange. After a major oil field discovery in Alberta in late 1940s, the province became a major oil and gas producer and the Alberta Stock Exchange facilitated oil and gas companies in raising capital.

Montreal Stock Exchange was the oldest stock exchange in Canada. Its root trace back to 1832 when security trading took place at the Exchange Coffee House in Montreal. However, it wasn't until 1872 that Montreal Stock Exchange became an official exchange. This is around the time when Canada's industrial and financial development was happening so the exchange listed mainly bank, insurance, and railway stocks.

Unlike the other two exchanges, Montreal Stock Exchange was not about seed capital for mining or oil and gas companies. It was about catering to large and established names. However, in 1926, the "Montreal Curb Market" was started where people traded in speculative junior stocks. In 1953, the curb market became its own exchange, and in 1974, it merged with the Montreal Stock Exchange. As a result, Montreal Stock Exchange ended up with two types of companies trading on it: seniors and juniors.

In 1999, Vancouver Stock Exchange, Alberta Stock Exchange, and junior-part of Montreal Stock Exchange merged together to form Canadian Venture Exchange. Then, in 2001, TMX Group bought it and renamed it to TSX Venture Exchange.



So this is how TSX Venture Exchange became what it is today. Two-thirds of companies listed there are either mining or oil and gas stocks at the early stages of development. This means that many of them have no revenues, but expenses to advance their projects. The remaining portion includes all kinds of companies in different industries.

Because TSX Venture's main purpose is to fund early-stage mining and oil and gas project, it attracts investors who are speculative in nature. Consequently, regular companies with fantastic businesses are ignored because they are boring to speculators. This is an opportunity for you.

If you live in the U.S. you can either buy the shares from TSX Venture in two ways. You can buy them directly through a broker that support foreign trading. For example, Interactive Brokers allows you to buy shares directly from the TSX Venture exchange. Or you can buy them indirectly through OTC Markets (some US brokers do not allow this). Here is what I mean.

Oroco Resources Corporation is a Canadian exploration company listed on TSX Venture with a ticker symbol of OCO. If you have a broker that allows foreign trading, you can buy the shares in this company on TSX Venture using the OCO ticker symbol. However, this company is also listed on OTC Markets with a ticker symbol ORRCF. Consequently, if you cannot buy OCO shares directly, you can buy them indirectly through OTC Markets using ORRCF ticker symbol. However, these shares instead of being priced in Canadian dollars, they are priced in US dollars.

What is interesting about such dual listing between TSX Venture and OTC Markets is that the company might have nothing to do with it. The management of Oroco Resource did not do anything to lists its stock on OTC Markets. It was a US broker-dealer that did it. Remember, OTC Markets is not an exchange. It is simply a network of broker-dealers and they can sell whatever they want to each other.

Because Oroco Resource does not provide any information to US regulators, the stock is listed under OTC Pink tier classification. This can be misleading because you might assume that the company is unwilling to provide information but this is not the case. The company files all kinds of disclosures with the Canadian regulators which is where you can get all the information you need. So next time you see "OTC Pink" classification keep that in mind. Don't assume anything until you know the story.

AIM

TSX Venture is one of two true International junior markets. AIM is the second one. The surprising thing is that not many investors ever heard of it. AIM stands for Alternative Investment Market. It is a sub-market of London Stock Exchange and some consider it the most successful junior market in the world.

AIM was launched in June 1995 so in June 2015, it celebrated its 20th birthday. It started off with 10 companies, but by 2007, it was a home for 1,600 companies. During the 2008/2009, the exchange was hit pretty hard marking 2007 as a peak year. In 2013, it received a little bit of boost because the government allowed tax-free ISA (Individual Savings Account) accounts to invest in AIM stocks. Currently, the exchange lists about 800 companies.

It grew so successfully because it allowed young companies to become public with much lower regulatory hurdles and listing requirements. To attract small and emerging companies, AIM has a simplified regulatory environment. For example, while London Stock Exchange is regulated by the UK Listing Authority (UKLA), AIM is self-regulated. Actually, AIM is regulated by its parent company, London Stock Exchange which delegates the regulation onto Nominated Advisers (NOMADs) who are certified by the exchange.

The exchange does not have any minimum market cap requirements and the only requirement is that the issuer be "appropriate" for it. The appropriation decision is made by NOMADs who are hired and appointed by the companies themselves. With the help of NOMADs, the companies are taken public on AIM.

So the NOMADs are responsible for policing the companies that they take public. It is kind of like as if US investment banks regulating stock exchanges. Oh God help me.

Another reason why AIM became popular was because over the years it became more difficult for companies to list on US exchanges. The sizes of IPOs increased dramatically and regulatory burdens soared especially after Sarbanes-Oxley of 2002. Consequently, advisors started pitching AIM as an alternative route to go public.

AIM exchange attracts three types of companies:

- Early-stage
- Backed by venture capital
- Established

Early-stage companies find AIM attractive because of their ability to access UK's and global capital. This mostly includes companies with no revenues looking to commercialize a product or advance exploration projects. AIM is popular with gold, oil and gas exploration companies.

Companies that are backed by venture capital are also attracted to AIM. They tend to be high growing businesses funded by venture capital firms who are looking for an exit strategy. AIM allows them to exit earlier than they would with an IPO in the US.

Some established companies also choose AIM mainly because of low regulatory burdens. It is not unusual to see some delist from London Stock Exchange to trade on AIM. Also, companies with entrepreneurial management like fewer regulations on AIM.

While the AIM exchanges has been popular among issuers, it hasn't done that well for investors. In other words, as a whole it did not deliver any returns since inception in 1995. This is understandable because many young and early-stage companies go belly up. This is the fact of life.

With that being said, AIM is not a market for index investing. It is a place where individual stock-picking can pay off. The two most widely known success stories are Asos and Domino's Pizza Group. Asos is a British online fashion and beauty store that started on AIM in 2001 with a £12.3 million IPO, and today, the company is trading for the market cap of more than £6 billion. With this kind of valuation, the company could list anywhere in the world, but it chooses to stay listed on AIM. Domino's Pizza Group listed on AIM in 1999, but after successful run, it transferred its listing to London Stock Exchange in 2008. The stock was almost a 50-bagger since the company floated shares on AIM.

To buy shares on AIM exchange is not as easy as buying shares from TSX Venture exchange assuming you are an US investor. A lot of brokers are unfamiliar with AIM. So you need one that allows you to conduct international transactions. For example, Citi offers an international brokerage account that allows trading on AIM exchange. Another option is to open a UK brokerage account. However, this is problematic because many foreign financial firms do not accept US clients because of reporting requirements to the U.S. government.

NYSE AND NASDAQ

When it comes to microcap criticism, the majority of it is directed toward companies trading on OTC Markets, TSX Venture, and AIM. However, small companies also trade on New York Stock Exchange and Nasdaq.

NYSE MKT

New York Stock Exchange is the most prestigious stock exchange in the world. It also has the most stringent listing requirement which only the top quality companies can meet. However, New York Stock Exchange has a division that caters to small companies - NYSE MKT, LLC. This is the former American Stock Exchange (AMEX).

As mentioned before, NYSE was founded in 1792. For the first 40 years, most of the securities that traded there were federal, state, and municipal government bonds. In 1830s, the exchange became the home for railroad, mining, and insurance companies. However, because only the best companies were able to qualify for the listing on NYSE, there were other companies whose needs were not met.

To meet the unmet need of newer companies, non-exchange brokers got together and started trading unlisted stocks outside the NYSE trading floor literally on the curb. They became known as the curbstone brokers and their market place as New York Curb Market. In 1921, the curb market moved into a building, and in 1953, it became AMEX. At that point, there was no NASDAQ.

For many years, AMEX was considered a strong competitor to NYSE. However, NASDAQ which was founded in 1971 damaged AMEX and took a lot of its business. Many companies that were listed on AMEX switched to NASDAQ and new companies that could have qualified to list on AMEX went directly to NASDAQ.

In 1998, NASD, the operator of NASDAQ, acquired AMEX. Instead of integrating the two exchanges, they were operated as two separate exchanges under one ownership. In 2003, AMEX became independent again after it was back bought by its members.

In 2008, NYSE acquired AMEX. The new owner rebranded and renamed it NYSE Amex Equities. In 2012, it rebranded it again as NYSE MKT, which is what it is today.

NYSE MKT is an exchange to support younger, high-growth companies in the small-cap space. In order to qualify for a listing, the companies have to meet one of four standards. One standard requires a certain pre-tax income while other standard requires a market capitalization of at least $50 million. Also, one standard requires a minimum stock price of $2 while others require $3. When listed companies fail to maintain their listing requirements, they get delisted to OTC Markets.

NASDAQ

Like NYSE, Nasdaq also has a division that caters to small-cap companies. Nasdaq has three different market tiers: Nasdaq Global Select (Large-caps), Nasdaq Global Market (Mid-caps), and Nasdaq Capital Market (Small-caps). Obviously, the listing requirements for the Nasdaq Capital Market are less stringent than those for Nasdaq Global Select and Nasdaq Global Market, but they are still much more stringent than those for OTC Markets and venture exchanges.

In order for small companies to be listed on Nasdaq Capital Market, they have to meet all of the criteria under at least one of the three standards: Equity Standard, Market Value of Listed Securities Standard, and Net Income Standard. The minimum stock price has to be $4 per share. Consequently, only the highest quality small capitalization companies are listed on Nasdaq. However, this does not mean that the most amount of money can be made in investing in them. Everything is relative to the underlying value or future value.

As mentioned several times, Nasdaq was founded in 1971. NASDAQ stands for National Association of Securities Dealers Automated Quotations. It was formed by the National Association of Securities Dealers (NASD) to trade unlisted stocks, mainly technology stocks. This is why Nasdaq is still associated with technology companies.

At the early days, Nasdaq was only a quotation system meaning that it did not offer any trading capabilities. Eventually, trading was added and Nasdaq assumed much of the over-the-counter trading. Until 1987, the trading took place over the telephone. The electronic trading was introduced as a response to the 1987 stock market crash when market makers did not answer the phone. To solve this issue, the Small Order Execution System (SOES) was launched to provide an electronic method for broker-dealers to enter their trades. This was an alternative trading system to the inefficient "specialist" system used by NYSE. To this day, Nasdaq has no trading floor and all the trading takes place electronically.

Nasdaq is owned by Nasdaq OMX Group which was formed in 2007, when Nasdaq and Scandinavian exchange group OMX merged. Nasdaq OMX Group is an independent company headquartered in New York. Its stock is trading on Nasdaq under ticker symbol NDAQ.

SUMMARY

It can most definitely be somewhat confusing where the micro cap or small cap companies trade. To give you a nice summary of what was discussed in this chapter, these companies can trade on the following markets or exchanges.

- Over-the-Counter Markets (OTC Markets or OTCBB)
- TSX Venture in Canada
- AIM in London
- NYSE MKT
- Nasdaq Capital Market

The goal of most small companies is to trade on NYSE MKT and Nasdaq Capital Market and beyond, but to get there they need to meet stricter listing requirements. Their business fundamentals should be strong enough to belong there.

The companies that want fewer regulatory hurdles like Sarbanes-Oxley might choose to list on AIM in London or TSX Venture in Canada. The obvious drawback of this choice is lack of access to US capital.

The companies that either fail to maintain their NYSE or Nasdaq listing requirement or look for alternative way to go public choose over-the-counter market like OTC Markets or OTCBB. There they don't have to disclose anything about themselves to the public, but as a result, they grouped with worst of the worst. Many investors will not even consider investing in companies trading on over-the-counter markets.

CHAPTER 4

FINDING MICROCAP INVESTING IDEAS

All the companies, irrespective of size, are different. They have different managements, products, services, and strategies. While they have unique ways of doing things, they are all trying to arrive at the same place which is to make their businesses successful.

We, as investors, are trying to buy into various businesses and benefit from their successes in the form of a higher stock price. The problem that we face is where to allocate our money for the best possible return. This is the focus of this chapter.

The only way that you truly learn about a company and its prospects is to study it. This is kind of similar to getting to know another person. You don't learn much about a person by looking at them. You have to shake their hand, converse with them, interact with them, or have a relationship with them. The same thing applies to companies.

In the ideal world, we would study all the microcap companies trading on the markets and exchanges and we would only invest in the ones that showed the best value and/or appreciation potential. This is not an impossible task. Between the exchanges mentioned you would have to study approximately 14,000 companies.

- OTC Markets 10,000
- TSX Venture 2,000
- AIM 800
- Nasdaq Capital Market 700
- NYSE MKT 400

While studying this many companies looks like an impossible task, you would not have to study them all because you would probably eliminate 10,000 of them for being non-inventable for lack of revenues or information. So in total, you would only need to study 4,000 of them. If you studied 10 companies per day, it would take you a little bit more than a year. Now, that’s manageable. After you did that, you would not have any problems finding investment candidates.

This is the kind of work that Warren Buffett did when he was younger. He read Moody’s manual page by page. He referred to it as turning over one rock after another to see if there is any value under each. This is the kind of work I did when I wrote *How to Profit from the Coronavirus Recession* book.

Another idea is that you can focus on only one exchange. Nasdaq Capital Market only has 700 companies. AIM only has 800 companies. It is absolutely doable to look through all the companies on a particular exchange, read the company’s annual reports, study their products, analyze their financials, and estimate current and future value. If you did that even with one exchange, you would find so many investment opportunities that you would not know what to do with them.

The problem, of course, is that our lives are hectic and busy. If you are an individual investor, you probably have a job or business that you need to run to generate money that you can later invest. If you are a professional money manager, then you have to spend a lot of time doing things that are unrelated to investing like marketing or talking with your clients. Either way, we have limited time for studying companies. Consequently, we might want to have ways of narrowing down the list of companies to study. As bad as it may sound, we look for shortcuts. We can accomplish this by going directly to the primary sources or relying on secondary sources. By primary sources, I mean companies themselves. This includes reading company's press releases, using various quantitative screens, performing keyword searches, or talking directly with the companies managements. By secondary sources, I mean copying other people who invest in the microcap space. This includes bloggers, hedge funds, newsletter writers, and investor relations firms.

STOCK SCREENING

There are many stock screeners available on the Internet. Some are free and some you have to pay for. They allow you to enter quantitative variables to generate a list of stocks. Many investors use Yahoo Stock Screener which works pretty well and it is free. You can use it to search for microcap stocks on OTC Markets, TSX Venture, Nasdaq, and NYSE MKT.

For AIM specific, London Stock Exchange has its own stock screen that allows you to search AIM stocks. It is also free.

Most investors do not have a problem with using the actual screens because most of them are self explanatory. If not, you can find various online tutorials on how to use them. The issue that investors have is choosing the search criteria.

No one can solve this problem for you. You need to know what you are looking for. There are endless numbers of variable combinations. However, the criteria that we can all agree on is the market capitalization of companies. Because we are dealing with microcap stocks, the maximum number should not exceed $100 or $250 million. Then, on the minimum size, you can go as low as you want.

The rest of the variables are up to you. Every investor that I talk to searches differently. Are you looking for high growth companies? If so, make sure one of your search criteria states that. Do you only want companies that are already profitable to reduce the risk? If so, check the search criteria that generate profitable companies. How cheap do you want them to be? You will have many criteria options to choose from such as price-to-earnings ratio, price-to-book ratio, price-to-sales ratio, or enterprise value-to-EBITDA ratio.

Some investors only want to invest in microcap companies that pay dividends because they believe that if a company is able to pay a dividend, then it has real customers and not playing any accounting games. If you feel dividends are important to you, then choose the proper search criteria. Just know that you will eliminate many good growth companies because many of such companies do not pay dividends but reinvest every penny back into the business.

The great thing about stock screens is that they are easy to use and quick to generate lists based on your criteria. The bad thing is that is that they are easy to use. If it is easy for you to use, it is easy for everybody to use which means that obvious mispricings are easy to spot. There are plenty of quantitative funds that automatically trade based on what the computers tell them to. As a human, it is hard to get an advantage over computers when it comes to crunching numbers. However, you can beat them when situations require thinking instead of just reading zeros and ones.

NEWS RELEASES

Scanning news releases can be a great way of finding investment opportunities. This is obviously more time consuming than running quantitative screens but it can yield better results because this method requires judgment.

In anything in life, people do not like to go backwards. In school, students progress from one grade to another. In sports, people want to progress too. At career, employees want to climb the corporate ladder and get promoted. In business, companies want to grow and acquire more customers. This is what we think we are supposed to do.

The reality is, especially in the world of business, that things do not always go up and up. Companies falter and fall from their grace. They lose clients, their products become obsolete, they lose to their competitors, and consequently, their stock price gets crushed. When that happens, they can no longer maintain their listing with NYSE, Nasdaq, TSX, or LSE. They get delisted to OTC Markets, TSX Venture, or AIM.

When that happens, many of the previous investors give up on them and new investors are not interested in them. Some of these companies will recover and some will die. You are interested in the ones that will recover because you can make a lot of money in them when that happens. Remember very few people are paying attention to them because they caused them a lot of pain and now they trade on “toxic” markets or exchanges.

There are many ways, the fallen companies can turnaround. They can

- Develop a new product
- Finish developing a product
- Cut costs
- Sell unprofitable business divisions

- Refinance debt
- Replace management

To find companies that are undergoing such a big change is not as straightforward, which is good because it is hard for everybody. You literally have to look at one company at a time to see if any of these changes are taking place. Many times, the companies themselves are very quiet when the big changes are taking place.

One way to point you to companies undergoing a turnaround is to scan titles of press releases looking for signs of new product releases, business dispositions, or cost cutting initiatives. There are some investors that all they do is read news releases' headlines all days long to find investment opportunities.

Some markets or exchanges make it easy for you to access press releases of their listed companies.

OTC Markets allows you to view company press releases at

https://www.otcmarkets.com/market-activity/news

Nasdaq and NYSE are not that open about providing access to press releases to their listed companies for free. To get this data, you have to pay third-party information providers such as Bloomberg.

London Stock Exchange really excels at this though RNS (Regulatory News Services). RNS is a regulatory and financial communication channel for companies to communicate with the market.

RNS Search

http://www.londonstockexchange.com/exchange/news/market-news/market-news-home.html

What is fantastic about the search capability is that you can sort by news release categories. First, you choose an index FSTE AIM for AIM listed stocks, and then you choose the category such as acquisitions, change of name, directorate change, disposal, product launch, or transaction in own shares (buybacks).

So if you want to pull up AIM companies that just sold a business, you choose “disposal” news release category. If you want companies that just launched a new product, you choose “product launch” category.

INSIDER BUYS

We all know that companies’ insiders know their businesses better than anyone else. Consequently, when they buy stocks of their employers, we should pay attention because there could be a very good reason why they are buying.

In the United States, insiders have to disclose their buys and sells through Form 4 which they file with the SEC. To find companies with insider buys, visit SEC’s EDGAR and simply search for Form 4 filings. Also, there are plenty of websites such as insidercow.com that do the same job but quicker.

In Canada, insiders have to report their buys and sells to SEDI (sedi.ca). SEDI stands for System for Electronic Disclosure by Insiders. You can also use canadianinsider.com.

In the UK, you can access the insider data through RNS search that was previously described. This time you want to search news release category “Director/PDMR Shareholding.”

SPINOFFS COMPANIES

Many companies have various different businesses under their ownerships. The management would like the market to assign a full value to all of the businesses, but this is not always the case. Consequently, to create shareholder value, the management might decide to spinoff a business from its parent company in the form of an independent public company.

Usually new shares of the newly independent company are created and distributed to the shareholders of the parent company in the form of stock dividend. The new company is likely to be small and thus will trade on the market or exchanges with other microcap companies. Consequently, it is not uncommon for the shareholders to not want the shares. As a result, the stock price of the spinoff company might be under pressure in the short term until all the unwanted shares are liquidated. These unusually high levels of selling unrelated to the performance of the underlying business create opportunities for finding great investment opportunities.

It is easier to find spinoffs opportunities in the US because US companies are required to file Form 10-12B. To learn about spinoff opportunities, you can search for Form 10-12B on EDGAR or use websites dedicated to spinoff investing such as stockspinoffs.com.

Canadian or UK companies do not have to file any specific form when they spinoff a subsidiary. Consequently, it is much harder to find them. You literally have to read companies' news. Also, spinoffs are not that popular in Canada and UK.

INVESTMENT FUNDS

As you know there are thousands of investment funds that specialize in various strategies. Some of them focus on microcap stocks.

In the United States, you can track activities of investment funds by reading their 13-Fs, 13-Ds, and 13-Gs. Form 13-F is required to be filed with the SEC by institutional managers with $100 million in qualifying assets under management. Through this form, they show their portfolios of long positions. Schedules 13-D and 13-G must be filed with the SEC by a person or group that acquires more than 5 percent of any class of a company's shares.

In Canada, there is no 13-F equivalent. However, under the Canada's block shareholder reporting regime, a person of company that acquires more than 10 percent of a company's shares must report it on either Early Warning Report ("EWR") or Alternative Monthly Report ("AMR"). These two reports are the Canadian equivalents to Schedule 13-D and 13-G disclosure in the United States.

Consequently, when you know the name of the fund, you can view a list of the companies that the particular fund has more than 10 percent ownership in. To do that, perform the following steps:

1. Go to sedi.ca
2. Click "Access public filings"
3. Click "View insider information"
4. Under Option 3, type in the name of the fund

In the UK, there is also no form equivalent form the SEC's 13-F. However, there is something similar to 13-D/G. It is TR-1 Form. It is required to be filed with the Financial Services Authority (FSA) when a fund crosses above three percent ownership interest in a company. Because we are dealing with micro-cap stocks, the three percent mark is that not that difficult to achieve.

To find AIM companies that received large ownership notification through TR-1, go RNS search and search news releases using “Holding(s) in Company” category. This will generate a list of all the companies that received TR-1 communication within a particular time frame. However, if you want to search for TR-1s of a particular hedge fund, then you have to type in the name of the fund and select “free text search” in one of the filters.

The following is a list of investment funds that invest in microcap stocks. I am including it here so that you have a place to start, but you should build your own list. The way to do it is simply study lots of microcap companies and look up the funds that buy them. Then, research their investment strategies and if you like it, then add them to your funds-to-follow list.

The following is a list of funds in the United States that buy micro-cap and small-cap companies.

- 12 West Capital Management
- Blueprint Capital Management
- Coghill Capital Management
- Daruma Capital Management
- Lawndale Capital Management
- Lone Star Value Management
- Nantahala Capital Management
- Osmium Partners
- Perritt Capital Management

- Raging Capital Management
- Rutabaga Capital Management SAGARD CAPITAL
- Sagard Capital
- Schultze Asset Management

The following is a list of funds in Canada that buy microcap and smallcap companies.

- AlphaNorth Asset Management
- Boeckh Investments
- Corner Market Capital Corporation
- Pinetree Capital
- Stonehouse Capital
- The K2 Principal Fund LP

The following is a list of funds in United Kingdom that buy micro-cap and small-cap companies.

- Azini Capital
- CriSeren
- Helium Special Situations Fund
- J O Hambro
- Kabouter Management
- Oceanwood Capital Management
- Octopus Investments
- Oryx International Growth Fund
- Polygon
- Slater Investments
- Woodford Investment Management

WEBSITES

Because the investment industry is obsessed with large-cap investing, the majority of financial websites are dedicated to that kind of investing. This is where Wall Street makes most of its money in fees. People that are interested in micro-cap stocks are usually individual investors, or micro-cap specific funds. These are the kind of people that are likely to launch their own websites dedicated to micro-cap investing.

The following are websites focused on the US micro-cap stocks.

- Microcapexplosions.com
- Microcapclub.com
- Nonamestocks.com
- Otcadventures.com

The following are websites that focus on the Canadian micro-cap stocks.

- Cantechletter.com
- http://www.siliconinvestor.com/subject.aspx?subjectid=58047
- Pettycash.blog
- Smallcapdiscoveries.com

The following are websites focused on the UK micro-cap stocks.

- Aimprospector.co.uk
- Allenbycapital.com
- Finncap.com
- Investorschampion.com
- Johnsinvestmentchronicle.com
- Maynardpaton.com
- Sharepickers.com

TWITTER

Even though many people have Twitter accounts, it might not be obvious to them that Twitter can be a great place to find investment ideas especially in the micro-cap space. You already saw that many investing bloggers have Twitter accounts and you should definitely follow them there. However, there are many investors with Twitter accounts that have no websites and this is the only way to follow them. There are literally thousands of them and the key is to locate the ones share the same investing philosophy as you do. Once you locate a particular investor, look at his or her followers because they are likely to share the same investing philosophy. Then, follow the followers too.

The following is an example of investors that you should consider following on Twitter.

- MARIUSZ SKONIECZNY - twitter.com/ClassicValueInv
- IAN CASSEL - twitter.com/iancassel
- SEAN MARCONI - twitter.com/seanmarconi
- MIKE DD KING - twitter.com/MikeDDKing
- OTC BARGAINS - twitter.com/otcbargainsupp
- MR. CONTRARIAN - twitter.com/MrContrarian
- GLASSHALFULL - twitter.com/Glasshalfull1

INVESTMENT CONFERENCES

The issue that many small publicly traded companies have is lack of exposure to the investment community. One way to increase awareness of small companies is for their managers to present at various investment conferences that cater to micro-cap and small-cap investors and funds. Such conferences are organized by various entities such as investor relation firms, brokers, research companies, and even exchanges (ex. London Stock Exchange). By attending such conferences, you will be able to learn about many investment opportunities. Also, you will be able to meet the managers face-to-face.

The following is a list of some micro-cap and small-cap investment conferences in the United States.

ANNUAL ROTH CONFERENCE - Roth.com

Roth Capital Partners Conference is a very important conference for small-cap companies. The event is organized by ROTH, an investment banking firm dedicated to serving small-cap companies. It hosts close to 500 participating companies and over 3,000 attendees. This is a three and a half day event held in California.

IDEAS INVESTOR CONFERENCES - Threepartadvisors.com

IDEAS Investor Conferences consists of three conferences: East Coast IDEAS (Boston), Midwest IDEAS (Chicago), and Southwest IDEAS (Dallas). The conferences are organized by Three Part Advisors, a capital markets advisory firm that provides investor relations, independent research and corporate development consulting services. The goal of the conference is to generate investment ideas for investors to outperform the markets.

LD MICRO INVITATIONAL CONFERENCES - Ldmicro.com

LD Micro Invitation Conference is an annual event organized by LD Micro, by-invitation only newsletter firm specializing in finding undervalued companies in the micro-cap space. The event takes place in Los Angeles, California. The companies that present have market caps between $5 and $500 million and approximately 75 percent of them are profitable and cash flow positive.

MARCUM MICROCAP CONFERENCE - Marcumllp.com

Marcum Microcap Conference is organized by Marcum Accountants and Advisors. The event is designed for companies with market caps of less than $500 million to make their presentations and network with the investment community. The conference takes place in New York City.

TAGLICH BROTHERS CONFERENCE - Taglichbrothers.com

Taglich Brothers Conference is organized by Taglich Brothers, a full service brokerage firm specializing in the micro-cap segment of the market for publicly traded companies. The company defines micro-cap market as companies with a market cap of less than $250 million. Taglich Brothers Conference is an annual event that takes place in New York City. Upon registration, you are able to view a lot of company's presentations online. The company also has many research reports available online for free.

SIDOTI EMERGING GROWTH CONFERENCE - sidoti.com

Sidoti Emerging Growth Conference is organized by Sidoti & Company, a research company focused on small capitalization companies. The conference brings approximately 100 presenting companies with market caps of less than $1 billion.

VIRTUAL INVESTOR CONFERENCES - Virtualinvestorconferences.com

The obvious problem with attending investor conferences is time constraint. Unless, you are a full-time investor or investment professional, you probably have some other type of job. Well, you can get access to virtual investor conferences where various public companies utilize to connect with the investment community.

The following is a list of some micro-cap and small-cap investment conferences in Canada.

BRISTOL SMART CONFERENCE - Bristolir.com

Bristol Smart Conference is organized by Bristol Investor Relations, one of Canada's investor relations firms. The conference features presentations from TSX and TSX Venture growth companies followed by Q&A sessions. The presenting companies represent various industries such as technology, consumer and retail, energy, services, and resources. Those who cannot attend can register for webinars.

CAMBRIDGE HOUSE INTERNATIONAL - Cambridgehouse.com

Cambridge House International is Canada's leading investment conference company. It puts out several events mostly resource based. However, it also has a technology conference with Cantech Letter called Cantech Investment Conference which is discusses in the next paragraph.

CANTECH INVESTMENT CONFERENCE - cantechletter.com

Cantech Investment Conference is a Canada's tech investment show. It is held in Toronto at the Metro Toronto Convention Centre. The conference is organized by Cantech Letter, an online magazine focusing on Canadian technology stocks.

OPPORTUNITY KNOCKS - howardgroupinc.com

Opportunity Knocks is an investor conference organized by The Howard Group, investor relations company specializing in micro and small-cap companies. The conference is a one-day event taking place in Montreal, Canada and it features several companies from the TSX and TSX Venture exchanges.

PDAC - Pdac.ca

Since Canada is the world's leader for the mining industry, this conference list would not be complete without mentioning PDAC. The Prospectors & Developers Association of Canada holds an annual convention in Toronto, Canada, for people, companies and organization connected with mineral exploration, development and mining. It hosts more than 1,000 companies and 20,000 attendees. It is the industry's most important convention in the world. The companies that attend the event range from the tinniest micro-cap explorers to large mining companies.

The following is a list of some micro-cap and small-cap investment conferences in the United Kingdom.

LONDON INVESTOR SHOW - Londoninvestorshow.co.uk

London Investor Show is a one-day event and exhibition geared towards providing education and information to traders and investors at all different levels. The event offers AIM Auditorium which includes a number of AIM CEOs to participate in face-to-face and scheduled presentation to investors. It is a great way to meet the heads of some AIM companies and learn the investment thesis straight from their mouths.

MASTER INVESTOR SHOW - Masterinvestor.co.uk

Master Investor Show is held annually in London. It features more than 100 exhibitor companies whose CEO and/or directors present to an audience of several thousand attendees.

ONE2ONE FORUMS - Proactiveinvestors.co.uk

One2One Forums is an investment conference run by Proactive Investors. The event takes place in London where hundreds of listed companies present to retail and sophisticated investors. Each company presents for 20 minutes and then there is a 10 minute Q&A session.

UK INVESTOR SHOW - Ukinvestorshow.com

UK Investor Show is an investment conference held annually in London. It features many different speakers. It also hosts CEO of many companies including the ones listed on AIM.

INVESTOR RELATIONS FIRMS

Presenting at investor conferences to a group of investors can most definitely increase awareness, but such awareness can be short lived, especially in a world that everybody has a five-second attention span. Consequently, small and micro-cap companies have to constantly communicate their message to the investment community through effective investor relations activities. Companies can do it in-house or outsource it. Frequently, they hire third-party investor relations firms to do it for them.

Following or putting yourself on the mailing list of some of the investor relations firms specializing in micro-cap companies can be a great way of learning about interesting investment opportunities. However, never forget one thing – investment relations firms represent the public companies, not you. So only allow them to bring you investment ideas, but you carefully chose the ones you want to buy based on your research.

The following is a list of some investor relations firms specializing in representing micro-cap companies in the United States.

- ACORN MANAGEMENT PARTNERS - acornmanagementpartners.com
- EVC GROUP - Evcgroup.com
- THE EQUITY GROUP - Theequitygroup.com

- HAYDEN INVESTOR RELATIONS - Haydenir.com
- JAFFONI & COLLINS - Jcir.com
- PORTER, LEVAY & ROSE - Plrinvest.com
- TORREY HILLS CAPITAL - Torreyhillscapital.com

The following is a list of some investor relations firms specializing in representing micro-cap companies in Canada.

- BRISTOL INSTITUTIONAL RELATIONS - Bristolir.com
- THE HOWARD GROUP - Howardgroupinc.com
- INVESTORFILE - Investorfile.com
- KIN COMMUNICATIONS - Kincommunications.com
- QIS CAPITAL - Smallcaps.ca
- SOPHIC CAPITAL - Sophiccapital.com
- VIRTUS ADVISORY GROUP - Virtusadvisory.com

The following is a list of some investor relations firms specializing in representing micro-cap companies in the United Kingdom.

- ALMA PR - Almapr.co.uk
- BLYTHEWEIGH - Blytheweigh.com
- FTI CONSULTING - Fticonsulting.com
- HUDSON SANDLER - Hudsonsandler.com
- KTZ COMMUNICATIONS - Ktz.co.uk
- WALBROOK PUBLIC RELATIONS - Walbrookpr.com

SUMMARY

As you can see, there are many different sources where you can obtain micro-cap investment ideas. There is no way you can follow them all. Once you have several ideas that look appealing to you, then it is time to conduct your own due diligence. It does not matter where you hear about a stock idea from you still need to study it yourself. This is the focus of the next chapter.

CHAPTER 5

DUE DILIGENCE

When it comes to investing in micro-cap stocks, due diligence is extremely important. With large companies, you can get away without doing much due diligence because large companies are being constantly talked about. They are under the microscope as hundreds of investors and analysts who pour over every little thing that is released to the market. With small companies, this is not the case. They may have no analysts covering them and very few investors are even aware that they exist. Consequently, the possibility of the management playing games and shenanigans is higher.

For example, I know this one company, which name I will not mention here, that the CEO is a total crook. He is being investigated for criminal acts and the investors in his company know nothing about it. He does not disclose anything in the filings. Because the stock is trading on OTC markets, the company literally releases whatever information it wants. A lot of it is pure fiction. When some investors contacted the SEC, they were told that SEC is not going to bother with such a small case. When it comes to micro-cap stocks, you are on your own. No one will protect you. You have to investigate and perform a serious due diligence to make sure that the company you are looking at is real and the managers are legitimate.

I tend to divide my due diligence into three parts: quick due diligence, medium due diligence, and full due diligence. As the name implies, quick due diligence is something quick designed to give you some basics facts about a company. It shouldn’t take more than 10 minutes. The idea is to eliminate the companies that you have no interest in pursuing.

The medium due diligence is a little deeper look at a company which should take about an hour. The idea of it is the same which is to eliminate unwanted companies because the last thing you want is to waste two days studying the company to find out that you are not interested because it has a lot of debt. If debt is the eliminating factor, it should have been spotted during the first 10 minutes of quick due diligence. Finally, full due diligence is where you spend three to seven days really studying the company. Because of such time commitment, you should only perform it on the companies that pass your quick and medium due diligence.

PLACES WHERE TO OBTAIN INFORMATION

The following is a list of where you can get information on companies.

US Companies

- SEC Edgar
- Yahoo finance
- Morningstar.com
- Otcmarkets.com
- Insidercow.com
- InvestorsHub.com
- Public company's website

Canadian Companies

- Sedar
- Yahoo finance
- Morningstar.ca
- Sedi.ca
- Canadianinsider.com
- Stockhouse.com
- Public company's website

In UK or AIM Companies

- Public company's websites
- RNS London Stock Exchange
- Morningstar.co.uk
- advfn.com
- London South East (lse.co.uk)

QUICK DUE DILIGENCE

During the quick due diligence, you want to scan through some basics facts about the company to see if you are even remotely interested in pursuing it. Obviously, depending on the source of investment idea, you might already know some of these facts. For example, if you used a stock screener to search for profitable companies with no debt, then you know that you are dealing with a profitable company that is debt free. If you read about it on some blog, then you already know what type of business it is in.

Because there is no way that I can know your source, I still want to go over some of the basic things you should know about a company before proceeding any further.

COMPANY'S BUSINESS

To read about the company's business, type in the ticker symbol into Yahoo finance, Morningstar or just visit the company's website. For AIM companies, the best place for any financial information is the companies' websites. Unlike in the US and Canada, AIM companies are required to have all the financials published on their websites.

PROFITABILITY

When someone gives me a stock tip, the first question I ask is whether the company is profitable. This is not because I only want to invest in profitable companies but because this sets the stage property right from the get go.

To find out if the company is profitable, you can have a quick look at the income statement at Morningstar.com which works well for US, UK, and Canadian Stocks. Even though the dot com works well for all the stocks, Morningstar also has UK and Canadian version of its website. Morningstar.ca is for Canada and Morningstar.co.uk is for United Kingdom.

DEBT LEVEL

The other day, an investor was raving about how this particular company's market cap was so cheap in relation to the assets. I asked, "Does it have any debt?" The answer was, “Yes, the company has a lot of debt.” Well, this is a big deal. I hate debt. I lost a lot of money by not hating it early enough. When the company has a lot of debt, it can make you a lot of money but it can make you lose a lot of money. You better know right from the beginning what is the debt situation with your investment candidate. You can find it out the same way as you did with profitability.

CHART PATTERN

Picture can tell you a thousand words. When you look at a price chart, you get an idea of what investors went through over a period of time. If the stock price is down 90 percent, you know everybody is completely exhausted. If the stock is up 100 or 200 percent, then you know that investors are happy. I prefer buying from unhappy shareholders but this is not always the right thing. The stock might be up 100 percent and still have a lot more room to appreciate. This is especially true for micro-caps that have just been discovered by some institutions. While I don’t really do any technical analysis, I want to get an idea of the price patter over the last 5 or 10 years.

INSIDER BUYING

The ideal situation is when the company’s stock is cheap and the insiders are buying. During the quick due diligence, you want to find that out. In the US, you can quickly find that out by at insidercow.com or SEC’s EDGAR (look for Form 4). In Canada, use canadianinsider.com. In the UK, use RNS and search for “Director/PDMR Shareholding.”

FUND BUYING

When you are interested in a particular stock, it is useful to know if any investment funds are accumulating large stakes in the company. In the US, look at the company's SEC filings on EDGAR to see if any 13-D or 13-Gs have been filed. In Canada, go to sedi.ca under "view issuer information." When you type in the name of the company, you will be able to see if any early warning and alternative monthly reports have been filed by investment funds. In the UK, use RNS search and look for news releases categorized as "Holding(s) in Company." At this point, you don't really care who these funds are. You just want to know if someone else is buying.

NEWS RELEASES

I cannot tell you how many times, I spent hours learning about a company just to eliminate it after I read the most recent press releases. Save yourself some time and skim through them during the first 10 minutes. Is the company being investigated, sued, or delisted? Did it release a new product? These are the kind of things you will find out very quickly by doing this simple task. You can access the press releases on the companies' websites or through methods already discussed.

APPRECIATION POTENTIAL

Let's face it. We buy stocks because we want it to go up in price after we buy it. What's the point of buying it if it is overvalued? So find out if the stock appears to be cheap. What is the P/E ratio? How does the market cap compare to current net income and prior years' net income? Are the revenues growing? What is the dividend yield? How does the market cap compare to the book value? At this point, there is no way that you can value it properly, but you can get a sense of whether something is undervalued or overvalued.

MEDIUM DUE DILIGENCE

After the quick due diligence, you will know basic facts about a company and have an idea about whether you are interested. During the medium due diligence, you will undercover more facts about the company. It should take you a couple of hours to complete it. After that you will really know if I want to spend the next week or so really studying the company.

During the medium due diligence, read the annual report and proxy document, browse through the company's website, view the investor presentation, analyze insider buys, learn about the investment funds that are buying, and analyze the share count.

ANNUAL REPORT AND PROXY

Annual report and proxy document are the two most important filing that companies make to the public. Annual report describes the company's business, its products and services, competitiveness, financials, and risk factors. The proxy document describes who managers and directors are, how much money they make, what committees they serve on, and how much stock they own in the company. In other words, the annual report describes the business and the proxy document tells you who the business is run for – the managers or shareholders. If the managers get paid extraordinary amounts, then the business is run for the benefit of managers, not shareholders.

In the UK, the information from the proxy is included in the annual report so you only need to read one document, not two. You can always find the annual report on AIM listed companies because of AIM Rule 26 which requires AIM listed companies to have certain disclosures available on their websites. Such disclosures include description of the business, names and biographical details of directors, financial statements, and details of corporate governance.

For US and Canadian companies, both the annual report and proxy document can be available on the companies' websites under investor relations tabs, but not always. If these reports are not available you can obtain them form EDGAR in the US or SEDAR in Canada. In the US, the annual report is referred to as for 10-K and proxy as DEF 14A. In Canada, the 10-K equivalent is called Annual Information Form (AIF) and DEF 14A is called The Management Information Circular (MIC). To find Management Information Circular in SEDAR, you have to search for Proxy Circular.

Sometimes companies have annual reports and 10-Ks in the US and annual reports and AIFs in Canada. This is because 10-Ks and AIFs are required filings with the regulators while annual reports, which are pretty much the same thing but in a colorful format, are not regulatory requirements. However, some companies provide both. The AIF requirement in Canada is only for large companies. Small Canadian companies are not required to file it but many do.

When you read the annual report, try to understand as much as possible about the business. Depending on your familiarity of the industry, you might not understand everything. No one does. If the company is in a business that is new to you, don't worry. In the full due diligence, you will study the industry. For now, just grasp as much as you can. Read the risk factors because they might make you eliminate the company immediately. For example, I don't like when a company has a big customer concentration. Pay attention to whether the company is growing revenues and earnings.

When reading the proxy document, look at the management's compensation. How does it compare to the company's profits? Who does benefit from the profits more the shareholders who are the owners or the management? How much is the CEO making in relations to the other managers? Is the management compensation tied to the performance of the business?

Also, in the proxy document, look at how much of the business the management owns. If the insiders barely have any ownership interest (less than 10 percent) then this is a red flag. The ideal situation is when the insiders own a lot of shares because theirs and yours incentives are aligned.

COMPANY'S WEBSITE

When you are reading the annual report, it is usually useful to browse the company's website. The annual reports are wordy and it is nice to see the pictures or descriptions of products or services. Remember, the websites are intended for customers while the annual reports are for investors. If you were a customer, would you buy from this company? Is the website easy to understand and navigate?

INVESTOR PRESENTATION

Many companies will have investor presentations on their websites. This is the management's advertisement of why you should buy the stock. I like to look at investor presentations before and after reading the annual report. The first time you look at it, you don't really understand it that well but after you read the annual report, the content starts to make a lot more sense. Sometimes investor presentations are accompanied with audio or webcast.

ANALYZING INSIDER BUYS

During the quick due diligence, you learned whether the insiders were buying. Now it is time to analyze it. How significant are the buys in relations to their salaries and overall ownership? You will have to refer to the proxy document for salaries and ownership info.

LEARN ABOUT INVESTMENT FUNDS

Also, during the quick due diligence, you learned about whether some investment funds were accumulating shares. In the medium due diligence, research the particular funds. If they have a similar investment philosophy to you, then this is a good sign. Your company might quality for a full due diligence.

ANALYZE THE SHARE COUNT

When a company has a certain profitability level, it divides it over a total number of shares. This is how earnings per share are calculated. When companies issue new shares for whatever reasons, they dilute the ownership of existing shareholders. Consequently, one of the things that you should pay attention to is the total share count and how it changes from year to year. You can find that out from the footnotes for shares outstanding in the annual report. Make sure you look at a fully-diluted share count which includes outstanding shares plus options, warrants, and any convertible debt. Different investors have different opinions on how much is too much. Some want the share count to be below 20 million while others will tolerate anything below 75 million shares.

A stable share count can tell you a lot about the management and its attitude toward your ownership. If the management rarely issues new stock, then this is a good sign. They probably own a lot of the stock themselves and do not want to be diluted easily. However, if the management barely owns any stock and the share count keeps going up, then you know they do not respect their shareholders. You should stay away from companies like this.

FULL DUE DILIGENCE

Now you’ve completed quick and medium due diligence in a couple of hours, you should know if you want to spend the next week or so performing full due diligence. If you looked at ten companies, then maybe only one or two will make it to full due diligence because you only want to focus on the best investment opportunities. You only have so much money so why waste it on mediocre ideas.

In this step, you should learn about the company and its people in great detail.

INDUSTRY

When I was new to investing, I literally had a hard time reading annual reports. This was because my circle of competence was very tiny. I had to learn the basics of the particular industries before I could comprehend the companies' annual reports.

To study a particular industry, search for relevant books, YouTube videos, Netfix documentaries, and Internet articles. You will be amazed at how much you will understand from the annual report when you do that.

HISTORY

I believe that companies' histories tell you a lot about why the business is run a certain way. For example, when you read a biography on Home Depot, you will understand why the company has certain margins today. With smaller companies, this is obviously harder but search the Internet. If you can find any interviews with the current or former CEO, you might get a little history lesson. Also, try fundinguniverse.com which has a database of companies' histories.

MESSAGE BOARDS

There are many message boards on the Internet where various investors chat about particular companies. Unfortunately, there are a lot of junk comments. Despite that you should read them because they will give you a sense of whether the stock is hated or not. I personally like to buy hated stocks. This is the contrarian in me. However, when you are dealing with small companies, you might find so little discussion that it will confirm that the stock is barely known. Also, some commenters are very knowledgeable. I connected with several of them after reading their insightful comments.

In the US, visit InvestorsHub.com. In Canada, use Stockhouse.com. In the UK, use London South East (lse.co.uk). Also, Twitter is fantastic. Search for $ABC (ticker symbol).

EMPLOYEES

If you had a friend working for a company you are researching, wouldn’t you ask him what it is like to work there? Of course you would. Well, then check out what employees are saying about their employer at glassdoor.com.

ANNUAL REPORT

You already read the annual report, but you probably only understood a portion of it depending on your experience. Now that you learned about the industry, reading it again will allow you to absorb more. This time, you want to answer the following questions.

- What products and services does the company provide and how they satisfy the clients?
- What countries does the company operate in?
- When was it founded?
- What kind of clients does the company have?
- How does the company make its products?

- Who are the customers?
- Does the company make its products or does it outsource the production?
- What is its business strategy?
- Does the company have any competitive advantage? If so, what is it?
- Does the company operate in a very competitive industry?
- Is the industry fragmented or does it have a few leaders?
- Where does the company get its raw materials for the production of its products?
- Does the company operate with one or more business segments?
- Is the product or service very important to its customers? Can they live without it?
- How many employees does the company have?
- Do any customers represent a significant portion of the company's revenues?
- Is the company involved in any lawsuits? If so, how much can it be liable for?
- How does the company grow?
- Which stock exchange is the company listed on?
- How does the company grow revenues?
- Are there any new products that will provide future growth?
- What is the runway for growth?
- If the company has debt, how significant is it? When it is coming due?

If you cannot answer these questions, then you don't understand the business well enough. Many times, you will have to use outside sources to get answers to these questions. For example, you might have to converse with the companies' management or clients to answer them. This is referred to as scuttlebutt research. I don't think I ever invested in a company without performing some level of scuttlebutt.

QUARTERLY REPORTS

Annual reports are great but if you are studying a company in September, they are a bit outdated. To fill in the gap, you need to read quarterly reports because lots of things can change within months. With AIM companies, they are only required to update investors on semi-annual basis.

In the US, the quarterly reports are called 10-Q which can be found on EDGAR. In Canada, companies file two separate reports: Financial Statements and Management’s Discussion & Analysis. Both can be found on SEDAR. In the UK, they are called half-yearly reports which can be found on the companies’ websites.

CONFERENCE CALLS

When reading quarterly reports, it is always useful to do that along with listening to the conference calls or reading the transcripts from the conference calls. I like to listen to several conference calls to see how the company progresses. Also, it gives me a sense of whether the management team is overly promotional. Unfortunately, companies remove old conference calls from their websites. So you might need to access the transcripts. I use SeekingAlpha.com for conference call transcripts for US and Canadian companies. For AIM companies, conference calls would be found on the companies' websites.

RESEARCH DIRECTORS

In the previous section, you already read the proxy documents which included bios of directors. During this step, research individual directors to find out their background, business experiences, successes and failures. Good quality directors have reputations to uphold so they are unlikely to be associated with fraudulent companies. Also, pay attention to directors' turnover by looking at several proxy documents and compare them to each other. If directors are quitting, find out why. Don't be afraid to call them.

INVESTIGATE MANAGEMENT

The proxy document contains well written bios that the individual members of the management team want the world to see. If you want to find out who they really are, you need to do some digging. Check out their LinkedIn and Facebook profiles. Google their names and see what comes up. You might get surprised how much you can learn.

INTERVIEW MANAGEMENT

If you are a serious micro-cap investor, I don't think you can get away without interviewing the management. In my opinion, this is an absolute must. Yes, I know that there are some investors out there specifically refuse to talk to the management because they do not want to be charmed by glamorous CEOs. Let me ask you this. All the other serious micro-cap investors talk to the management teams of micro-cap companies, do you want to be at a disadvantage?

Small companies struggle with coverage and visibility. More often than not, they will take your call even if you are a small shareholder. At the investor conferences, they will talk with you. If you have time, ask if you can visit the company. Take advantage of it because you will never have this chance with large companies. Can you imagine, the CEO of Coca-Cola taking the time and talking with you or inviting you to his office? Forget about it.

Now that you have done so much research about their companies, you will be able to have an intelligence conversation. When I talk with the CEOs, I usually like to start the conversation with something like:

- How did you get into this business?
- Was it is something that you always wanted to do or did you just happen to get into it by accident?
- How are you different from your competitors?
- Why do customers buy from you versus your competitors?
- Do you have any competitive advantages?
- What kind of challenges, if any, did you experience over the last five years?
- What kind of challenges, if any, is the company experiencing right now?
- Where do you see your company in five to ten years?
- What are your plans for growing the company?
- Are you looking at any acquisitions?
- When you make acquisitions, what do you look for in the target companies?
- What prices are you willing to pay for them?
- What is your philosophy on capital allocation?

These are some basic questions that you might ask but conversations never go according to plan. The best thing is to just let the conversation happen and slip your question into the conversation. You will already have the answers to many of these questions, but you want to hear it again from the CEO or CFO or whoever you are interviewing. You are checking for consistency in responses.

SCUTTLEBUTT

Because micro-cap companies have a greater chance of turning out to be frauds, I almost never invest in them unless I perform some level of scuttlebutt research.

Scuttlebutt means rumor or gossip. The meaning of the word originated from sailing. Water for daily consumption on a sailing ship was stored in a scuttled butt which served as a water cooler. A butt is a cask that was scuttled by creating a hole so that the water could be poured. Sailors would gather around the scuttled butt/water cooler to gossip about various different topics the same way people gather around water coolers at work.

The idea behind scuttlebutt is to get the people that know about the company to gossip to you so that you gain a better understanding of the underlying business and the people that are running it. The four main groups of people that you are trying to get feedback from are employees, customers, and suppliers.

I know this is a lot of work, but just do it. Talk to these people. With employees ask them about what it is like to work there. Ask them about the culture. With customers, ask them why they are buying from the subject company versus the competitors. Ask them why they are buying the product in the first place. With suppliers, ask them what it is like working with the subject company and whether there are any problems getting paid.

FINANCIAL ANALYSIS AND VALUATION

Now that you understand the company, you should be able to perform financial analysis, forecast future profits, and value the company. When performing financial analysis, I like to enter as much as 10 years of financial data into Excel. This includes the balances sheet, income statement, and cash flow statement. I look at the margins, growth patterns, expense levels, operating leverage, tax rate and much more. Then, I try to project future profitability based on the past and what I know about the business such as future products and growth prospects. Finally, I try to come up with a present and future valuation. If the stock price is trading for less than the valuation estimates, then I will buy the stock.

I am not going to discuss the financial analysis and valuation here because this is a vast topic. If you are reading this book, you probably already know how to read and analyze financial statements. How many people wake up one day and say, “I want to be a micro-cap investor even though I know nothing about investing”? Most of you already understand investing and are looking for ways to take that skill and apply it to micro-cap space which can yield you greater returns.

If you don't know, then you can read my two other books: *The Basics of Understanding Financial Statements* and *How to Value a Stock*.

SUMMARY

When it comes to micro-cap investing, due diligence is extremely important. In this chapter, I presented you with a method that I developed over the years to learn about the company but at the same time waste as little time as possible on unwanted investment opportunities. First, you perform quick and medium due diligence before you commits some serious times for full due diligence. I said that full due diligence should take you about one week. This is if you do it eight hours per day. Also, don't think that after one week you will know everything there is to know about a company. No, you will know enough to make a decision of whether you want to own it. Then, when you own it, you will continue learning. I would say, it takes months to get really comfortable with a company.

CHAPTER 6

CONCLUSION

Micro-cap investing is the most misunderstood asset class that there is. Wall Street hates it because it cannot make much money from fees. However, what is interesting is that the most sophisticated investors are attracted to it. You can have professional money managers who buy large-cap companies for their clients but buy micro-cap companies for themselves. Also, you have professional managers who quit managing money for others to invest their own money in the micro-cap space.

Micro-cap investing can be very profitable. However, in order to be successful, you need a way to get exposure to micro-cap investment ideas and know how to perform detailed due diligence on them. I hope that through this book, I helped you achieve that.

Happy Investing,

Mariusz Skonieczny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