FEATURED ARTICLE

Identifying Promising Opportunities in MicroCap Investments

Investing in Microcap companies has many similarities to investing in larger companies – though certain unique risk factors more applicable to Microcaps require savvy investors to supplement their normal investment process.

■ BY SAM NAMIRI

Some of these considerations more applicable to smaller companies include the following:

- They are underfollowed and less regulated
- Tend to have weaker reporting systems and controls
- Have fewer resources in time and money than larger companies

At Ridgewood Investments, we have been investing in Microcap opportunities for many years and through our experience have come to develop our own five point investment process to help us focus on the most promising opportunities:

1. Focus on quality companies
2. Perform extensive due diligence
3. Pay the right price
4. Monitoring results
5. Implement A Sell Discipline *in advance*

Focusing on quality companies is an important initial step in MicroCap investing because in smaller and lower quality companies, the business model sometimes just doesn't work and a checklist helps you eliminate these investment traps *ab initio*. For example, customers may not want to buy the company's product or perhaps the product is one for which they can easily switch to a competitor or a new entrant into the market. Owning "quality" companies helps

lower these risks. At Ridgewood we use a checklist of over 20 items to help us measure if a potential microcap investment candidate passes this initial quality test. These checklist items range from financial ratios to qualitative aspects of the business such as barriers to entry and competitive analysis. (email us to get a copy of our checklist – note that the idea of having a checklist is inspired, in part, by Atul Gawande's book the Checklist Manifesto which we highly recommend)

Once a company passes the quality test, the next step is to perform intensive and thorough due diligence. We start off by comprehensively reading the company's SEC Filings (including footnotes!), conference calls and press releases. This is the time to be looking for buried red-flags and hidden pitfalls. For example, is the amount of options and/or warrants a company has issued reasonable and reflect positively on management's capital allocation abilities? We once identified a clean coal technology company that had a great product and seemed to have investment promise, but upon closer examination we noticed this company had a habit of regularly diluting the current shareholders by issuing an egregious amount of options and warrants. In this step we also scrutinize the totality of the company and management's history of past decisions and communications to see if they have a strong track record of capital allocation and strategic decisions or the opposite.

After the above initial stage of diligence, if the company still looks interesting, we start to have more extensive conversations with management, competitors, customers, suppliers and anyone else that can help verify and give more insight on the business and industry. We often travel to visit the company as well as attend trade shows and read industry publications if applicable. Not many microcap investors do this much due diligence on their investments, and even fewer sell-side analysts that cover smaller companies do so – partly because they don't typically have the budget to travel and invest in such deep diligence. As investors willing to go the extra mile, this step is one where we can develop "an edge" on the upside while also reducing the risk of investing in a poorly run or even fraudulent company on the downside. In the last three years, I've avoided two potential investments that ended up being frauds later – in both of these cases the companies refused my request to let me visit their operations.

Another key to reducing risk when investing in very small companies is maintaining valuation discipline. The cheaper that one can purchase a company's shares, compared to what its intrinsic value is, the less risk is being taken. In other words, purchasing a dollar for 50 cents is less risky than purchasing a dollar for 90 cents or even worse 150 cents. Rather than having a trader's mentality we focus on cultivating a business owner's mentality. Once we identify a good company that we want to own, even if we own some shares already, we get excited not dejected, if the price of a company's stock goes down and creates more compelling value for us to take advantage of.

Although it can be psychologically tough to buy more of a stock as it is dropping, by doing extensive primary research and developing strong conviction on the value of a company, it makes it easier to pull the trigger. Remember that there can be many reasons why someone wants, needs or is forced to sell a stock, however only one reason why someone would buy, which is that they think that it is worth more.

After buying, we continue to monitor and perform ongoing periodic due diligence updates on the business and the industry. This update process is continuous and lasts as long as the stock is in the portfolio. We continue to read all the news, press releases, SEC filings as well as have meetings with the companies, competitors, suppliers, customers and so forth.

Finally, always make sure to maintain and update price targets for each investment *upfront* (though targets can be updated in light of information). Once the company has hit its fair value, be happy selling the position. Also, if things change and the target price falls to where the prospective return is no longer attractive, look at selling the position as well. It's important to consistently revisit and re-check the original investment thesis to see if it still holds. This process has helped us reduce the risk of investing in microcaps. While no one can be right one hundred percent of the time (only liars), the hope is to have a good batting average for which one of the keys is to be selective based on a sound investment process and not swing at most pitches.

Sam Namiri is a Portfolio Manager and Analyst at Ridgewood Investments, where he concentrates on managing the Ridgewood Select Value Fund, our fund focused on investing in small and micro-cap companies. Ridgewood focuses on implementing intelligent value-oriented investing strategies (modeled after investors like Warren Buffett, Ben Graham, and Phil Fisher). Prior to Ridgewood, Mr. Namiri was an analyst at a small cap hedge fund and the founder of a jewelry television and manufacturing company. Mr. Namiri has a BS in Industrial Engineering and Operations Research from the University of California, Berkeley and an MBA from Columbia Business School. ■

www.ridgewoodinvestments.com