THE FIVE WARNING FLAGS FOR INVESTORS IN SMALL-CAP STOCKS

By Marcus W. Robins

The five warning flags alert investors to potential problem areas in small-cap stocks. They also signal which stocks offer the best chance for smooth sailing.

As trading in equity markets moves faster and stocks get hotter, logical, cautious investors somehow undergo a complete transformation. Very smart, shrewd people turn into lascivious Pans cavorting at the financial bacchanal, leaving reason and responsibility at the door.

How many times must the same story play out before it becomes indelibly imprinted on our collective psyches? A company, or even a whole industry, takes off, its valuations and multiples soaring into the stratosphere. The party roars through the night, no one in sight to take the punch bowl away. And then just as suddenly the very smallest balance sheet ratio or footnote item rings a sour note, bringing all the festivities to a screeching halt.

Wouldn't it be nice if there were some warning flags that would allow the voice of reason to take over long enough for the fever to pass?

That is exactly the role the "Five Warning Flags" will play for investors in small-cap stocks.

Although no one is either smart enough or prescient enough to know exactly when to pull out before the bacchanal busts, we have assembled a five-flag system that, like semaphores signaling at sea, should alert investors to potential problem areas. The flags also signal which stocks offer the best chance of smooth sailing.

THE AUDIT FLAG

This flag is concerned with the auditors of the profiled company.

Big Five accounting firms are far from infallible, but their audits offer enough assurance to small-cap investors to merit an all-clear flag. Big Five coverage offers a certain comfort factor for investors. That does not mean that there aren't any small accounting firms with equal competence and expertise in certain specialized areas. But as a general rule, a Big Five firm offers investors greater assurance that all the bases have been covered, giving outsiders confidence that they can believe in the accuracy of the company's financials.

Where big firms shine is when the audit becomes a point of contention between the accounting firm and the client. Big firms are better able to withstand the loss of a client when pressure is applied to change an inconvenient opinion. Such pressures are a fact of life in the auditing business. This is where an accounting firm's size, stature, and knowledge represents the investor's best protection and first line of defense against the unscrupulous.

Sometimes, smaller accounting firms without broad industry experience simply aren't as well versed on public accounting practices, which can raise unwelcome questions about their clients.

However, the red flag really is raised when a company changes its auditors frequently.

A good example of this is Wiz Technologies, Inc. In the ultimate shell game, Wiz moved from auditor to auditor until it could influence the opinion and negotiate out of taking charges. First, Wiz fired its Big Five auditor and

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moved the account to a major regional firm. When the new firm refused to budge on a needed change in the accounting practices and required a charge-off, the firm switched again. But ultimately, the truth came out.

Our experience in evaluating the small-cap companies over the years has made it clear that the identity of the auditor is the best and simplest litmus test to the reliability of a company's financials.

THE AUDITOR'S OPINION FLAG

For me, the auditor's opinion represents a very simple litmus test as to whether the enterprise in question is worth following, let alone recommending. This warning flag signals small-cap investors to take note of anomalies, or at least find out what the auditors have discovered or believe is important to label an "exception."

The auditor's "unqualified" opinion consists of essentially three paragraphs. The first paragraph reports to the reader what process was taken to complete the audit. The second paragraph describes the procedures followed. The final paragraph is the conclusion, usually that everything seems okay. Of course, the auditors are not guaranteeing that.

Remember, the auditor's task is not to sanctify the potential of this company. Instead, it is an opinion on whether the audited company's books are correct according to GAAP (Generally Accepted Accounting Principles) standards, that the examination was essentially complete, and that nothing untoward was discovered in the process.

If there is a fourth paragraph in the opinion, this signals to readers the presence of an exception or that the auditors found a real problem and are offering a qualified opinion. This can occur for a number of reasons:

- *Going Concern*: The most notable of these exceptions is the "going concern" comment. This indicates that the company under scrutiny may not survive. The auditors may have found that emergency financing is needed, that a major contract has been lost, or other significant events have occurred or are imminent that threaten the very viability of the company.
- *Departing from GAAP*: If a company departs from GAAP in its performance reporting because management believes there is a more appropriate way to account for the company's activities, it can trigger a non-standard auditor's opinion. No matter how logical the process, if the approach doesn't adhere to the set standards that accountants generally follow, a "qualified" letter is issued.
- *Limited Scope*: A qualified auditor's opinion might be issued because of a limitation on the scope of the audit. That is, the auditors are forced to offer an opinion but have been unable to confirm the validity and quality of a major contract, or were unable to interview certain employees, probably officers, or failed to inspect certain inventory levels or off-site locations. As one would expect, this kind of limited investigation confounds the quality of the audit and, therefore, compromises the legitimacy of the opinion. This kind of letter or variance would also receive a red flag in our new warning system.

THE CAPITAL STRUCTURE FLAG

The balance sheet, dull though it may be, is the clearest window we have on a company's inner workings.

Because the potential perils this warns against are the most complex, I've turned it into two parts.

Amount of Debt

The first part concerns the financial structures of different companies, particularly their use of debt.

Businesses have assets and debt, similar to consumers who own homes and cars and yet take out loans to finance them. Most of the time, however, a business's lenders won't permit them to borrow as heavily as consumers are permitted to do. Unlike a home or a car, the assets a business employs are far more expensive to buy and not as easy to sell, so the fallback requirements—the level of equity versus debt—are much higher. In fact, when we step back from an individual piece of equipment to look at the whole financial structure of the concern, financial institutions want the equity portion of the balance sheet to significantly outweigh the debt.

Companies that build up a debt-to-total-market-capitalization (debt plus equity) ratio of greater than 0.4 should have a warning flag flown. This is a somewhat arbitrary figure. Many companies at that level of debt-to-total-capitalization have sufficient financial wherewithal to withstand almost any industrial, cyclical, or secular downturn; some companies are able to operate successfully without an iota of financial discomfort at far higher debt levels, while others prefer to steer clear of any long-term indebtedness.

In fact, there are industry groups where the line can rightfully be drawn at a different place. The airline industry, for example, has a deplorable record of bankruptcies, and long-term debt-to-cap ratios typically go through the roof. Only the highest-quality operations have ratios of less than 1 to 1.

However, the heavy-industry companies we cover all cluster around this 0.4 to 1 ratio of financial security. The best illustration, perhaps, of the rationale for this warning flag is the contrast between Schnitzer Steel Ind. (SCHN) and Recycling Industries, Inc. (RECY), which are both in the steel scrap recycling business. Schnitzer has much lower debt levels, strong cash flow, and a diversified operating mix. And it has grown over the long term without chasing after acquisi-

tions in an effort to consolidate the industry, except where it has made good strategic sense. Recycling Industries, on the other hand, entered the arena later, focused on buying smaller operations that could be folded into its home operations, and had an unfortunately weakened balance sheet when the scrap market withered in the wake of the Asian financial crisis. Schnitzer, too, is losing money, to be sure, but it has been using some of its ample reserves during the lull in scrap demand to upgrade its facilities and streamline its operations against the day when the market recovers. While Recycling Industries is in trouble, Schnitzer appears to be building a base for a much brighter future.

Non-Financial Issues

The second part of the flag looks at less understood aspects of the capital structure, particularly the equity account, which may actually hide things that could negatively affect shareholder returns.

While a quick check of a company's balance sheet may indicate that all is in order, there are some non-financial issues that could come back to haunt an investor and even derail the potential for gain.

• *Dilution of shareholder wealth*: The first warning signal of a management that does not adequately look out for its owners' best interests is the needless dilution of shareholder wealth. We follow a company whose management has begun to pursue interests, to our chagrin, that are not in line with the best interests of shareholders. Subsidiaries and ventures are added willy-nilly, it appears, in order to build bulk, but true earnings and a sustainable operating foundation seem fleeting despite protestations and corporate hype to the contrary.

• *Two equity classes*: The existence of two classes of stock—often Class A and Class B shares—is one tip-off that there is a possible bifurcation between shareholders' interests and management's interests. Each class of stock is supposedly equal in every way but one: One class has a substantially greater number of shareholder votes per share, thus giving the superior class a distinctive advantage in deciding monumental issues when they appear. Nike Inc. (NKE), for example, has Class A and Class B shares. Chairman Phil Knight and some of the other original founders possess the Class B stock, whose owners get to exercise 10 votes for each share owned. The obvious reason for the distinction is control, but on the whole, this arrangement so far seems not to have impaired the buildup of wealth for Class A shareholders. Indeed, they have pretty much enjoyed parallel appreciation in the shares along with Knight.

There have been cases, however, where the "controlling" management shareholders have not produced such stellar results for rank-and-file shareholders, and the super-voting power of the secondary class is used essentially as a club to ward off or defend the controlling parties' position. In general, companies with this kind of dual equity structure should be flagged and new investors should be aware of the potential conflict.

• *Convertibles*: I am a real fan of convertible preferred stock and debt. Unfortunately, convertible securities have been recently introduced into the annals of finance that have a tendency to return to the market and bite not only the issuing company and its management, but essentially destroy any shareholder value left in the marketplace. These disastrously contagious securities are what I have called "toxic convertibles" or "death-spiral convertibles." To understand what to watch for, you must understand why and where management employs these instruments.

Convertible securities are essentially financial instruments that can be transformed into another type of security or even debt after certain hurdles are cleared, or at the demand of management. Typically, the original securities are debt or preferred shares that transform into common equity. They are often used by management as a form of financing, particularly when other avenues are unavailable.

How does it work? Debt, or preferred shares, are offered at a lower-than-market yield, but with the provision that when the company's common stock reaches a higher price, typically 15% to 40% above the current market level, the debt converts at a higher predesignated price into common.

The story with toxic convertibles is that the convertible security is issued with a variable exchange rate, with the conversion price based on the lowest stock price up to the conversion date. The justification is protection against a price decline, but the scenario is that as the price declines, more and more shares can be converted, and the preferred shareholders receive an increasingly greater portion of the company.

The problem is that often the holders of the convertible, when they sense the company may take longer to bolster the share price, exacerbate the downward pressure on the common by shorting shares in the market. This places more and more pressure on the price of the stock and sends the shares in a downward spiral. Truly nefarious investors are attempting to drive the stock to zero and the company into bankruptcy because in this situation their short positions—which are really the "investment" of concern, not the convertible—do not need to be unwound and the gain is not taxable. [For more on this, see "Some Words of Caution for Investors in High-Tech Speculative Stocks" by James B. Cloonan in the July 1998 *AAII Journal*.]

For this reason, we would view as a flag any kind of convertible security that may be outstanding on a company's balance sheet to reflect not only the possible dilution that

might occur with even a straight convertible, but also to flag a situation where a possible toxic security may be involved.

• *Warrants and options*: Warrants and options are pseudo-securities that essentially place a call on a company's shares to be triggered at some future date by the appreciation of the stock in the market. Stock options, not the options that you see traded in The Wall Street Journal, are company pledges of stock to employees for performance. They typically have some sort of vesting schedule and are earned over time as part of the employees' compensation package. The problem is that they serve to produce some level of dilution for the outside shareholders, but overall, it is the kind of situation investors desire if it will help propel the overall business venture forward. I would not flag this situation.

Warrants are like options in that they are also activated by the outstanding shares in the marketplace hitting or passing through a certain price level. On the other hand, they typically exist as part of a reward due to a security transaction and were created as a form of incentive payment for the placing broker. Or, they can exist as a sweetener for the security placed and can lead to a hailstorm of dilutive situations for outside shareholders. Like convertibles, sometimes the security offered is not quite compelling enough to attract the market into completing the transaction. An additional incentive is needed to motivate buyers to help finance the company's growth. So, the investment banker believes that a warrant should be added to the security (it could be stock, debt, a convertible, anything) to sweeten the return and motivate buyers. The sad thing is that this form of financing has been abused and a tremendous number of warrants are outstanding for an array of reasons, thus limiting a good portion of the potential upside of the common shareholders' returns. We will flag these situations where outstanding warrants dilute the outstanding shareholder base by more than 5%.

THE OWNERSHIP PROFILE FLAG

Interpreting a small-cap company's ownership profile—the percentage of outstanding shares owned by insiders versus the percentage by institutions—is a little like reading an inkblot test. It can tell you a lot about management's mindset, and how the company is likely to behave.

• *Insider Ownership*: One of my bedrock assumptions when it comes to evaluating a small-cap company and its growth prospects is that the quality of management decisions—always a critical factor no matter what the size of the company—is even more important for small companies than big ones. Big companies usually have enough financial strength, product diversity, brand recognition, distribution channels, and management depth to insulate them from a few mistakes. Small companies are like foot soldiers walking through a minefield. One false step can blow the whole enterprise to smithereens. I want to know who the leader is, what his credentials are, and what his financial motivations are for keeping sharp.

Investors researching small-cap stocks should look for companies run by managers who themselves own enough shares in the company to motivate them not only to do a good job on day-to-day operations, but also to make sure that their operational success is fully recognized in the marketplace.

The rule of thumb we use is that small companies with the greatest potential of being managed to maximize the interests of all shareholders have insider ownership of more than 20% but less than 45%. Managers who spend nearly every waking moment doing everything in their power to benefit the company's shareholders is the ideal we're looking for. If the insider ownership profile is too low, say much below 10%, managers tend to be more like caretakers, willing to do a day's job for a day's pay, but lacking in the inspiration required to make a good product into a great one, perhaps. On the other hand, companies where insiders own over 50% are troublesome as well. Too often, this high concentration tends to encourage management to operate the company as a private fiefdom for the benefit primarily of insiders.

• *Institutional Ownership*: A high percentage of institutional ownership is another indication to us that the stock may not do well for outside investors. In fact, it can act to amplify the price volatility of a company's shares, particularly in broad market downdrafts as well as during rallies. Stocks with institutional ownership greater than 50% are very likely to experience the kind of turbulence that would upset most air passengers. In Focus Systems, Inc. (INFS) or even Electro Scientific Industries (ESIO) are good examples of stocks that have become mainstream market ideas and are much more easily jostled by the shortsightedness of institutional momentum players.

Low institutional ownership, on the other hand, may benefit individual shareholders since the "discovery" of the stock by the Street is an enormous push factor. As a company becomes better known, money managers begin to take positions. That has the effect of bidding the share price higher.

THE FLOAT & LIQUIDITY FLAG

If institutional investors can't trade a small company's stock without moving its price substantially, they will often shun it no matter how good it is.

Sometimes investors will discover a company with remarkably bright earnings prospects, a balance sheet strong enough to handle considerable growth, and a management team at the helm with the brains and the

moxie to make it all happen. The stock seems destined to get on an escalator for the moon. But, mystifyingly, nothing happens.

Institutional investors dominate the markets, and the availability of enough outstanding shares, or liquidity, of a given company's stock to permit them to make large-sized trades in and out of the market without significantly affecting the price is nearly as important as the company's fundamentals. Indeed, the runaway gains over the past couple of years in the major market indexes is a direct result of more funds flowing into managed funds and the managers seeking liquid, well-known names, where large positions can easily be amassed over a day or two of trading.

How can the lack of market liquidity arise with a public company and how is it manifested in the marketplace?

A perfect example of the dilemma the liquidity problem produces is a very interesting company, Hi-Shear Technologies (HSR). Its management had succeeded in pulling off a turnaround, sales of its best-known product, the "Jaws of Life," were proceeding apace, and its new line of explosive bolts was taking off. Management held about 80% of the company's outstanding shares, however, which meant there was really nothing left for the public to own. And since its market cap already was pretty low and the float was quite limited, it was obvious that institutions would probably not be attracted to the shares for a considerable time. It was an unfortunate waste of time—management knew they had increased the value of the company, but they were unwilling to loosen their grip on the stock enough to improve the float and therefore its liquidity. As impressed as we were with this company, its products, and its management, we decided not to waste investors' time outlining the virtues of a company whose stock no one could acquire.

Limited float has another deleterious impact on trading—the unusually wide spread between the bid and asked quotes for a given stock, often greater than an eighth to a quarter of a point. Some less active stocks with limited float may trade with a spread of as much as a point and a half to several points. Such spreads scare investors and traders away from a stock, and it is exactly the need for more interest and activity that will narrow the spreads.

What triggers the flag? If the available float of a company's shares is two million shares or less, and trading volume on the Nasdaq is less than 50,000 shares on average per day, the flag is triggered. At first blush, the hurdles may seem a little high. But if management were to own a quarter to a third of the float and a like position is held by institutions, we are still limiting the red flags to those operations with less than 3.5 million shares.

There are several steps that a company can take to improve the marketability of its stock. Among them are management liquidation of some of its founders' position for estate purposes or even selling option stock to finance additional purchases. This kind of activity happens every year, year in and year out.

A company can also take the initiative with soft and hard solutions. Assuming earnings are on an improving trajectory and the stock does have some investment value, management can do a lot of good by reaching out to investor groups and making its story better known.

Another solution is to increase the amount of shares available for trading. This can be accomplished through a series of stock dividends and splits. The perfect trading range for a young company to position its stock price is between $13 and $22 when the company's fortunes are expanding at a 25% or better annual clip, and between $17 and $29 when growth falls below that level.

That said, I should tell you that for those investors who really have patience—myself included—the market liquidity of a stock should not have much influence on the investment decisions if you are convinced that a given company offers a good opportunity for gain.

Why? Small-cap stocks have long shelf lives, and it doesn't make any sense, if you really want to reap the benefits from this particular asset class, to trade these equities in the same manner as you would the blue chips.

If you have patience (and patience is perhaps the one prerequisite for succeeding as a small-cap investor), the difference between the bid and ask prices of a stock should have little bearing on the stock's eventual appreciation. Moreover, the lack of liquidity that results from limited float tends to be alleviated over time since splits, stock dividends, insider sales, and secondary offerings all have a tendency to increase the number of shares outstanding and thus alleviate the liquidity problem.

In short, for true long-term investors, this last red flag is really just a signal that you may have to hold onto the stock for a long period of time. ✦